2022
REVIEW AND OUTLOOK

Q4

ADVISORS CAPITAL
MANAGEMENT

Q4

Year End Q & A

DR. ALAN GREENSPAN, SENIOR ECONOMIC ADVISOR

Alan Greenspan served five terms as chairman of the Board of Governors of the Federal Reserve System from August 11, 1987, when he was first appointed by President Ronald Reagan. His last term ended on January 31, 2006. He was appointed chairman by four different presidents.

Popular thought seems to be that a recession is required to bring down inflation. Do you think that is the likely outcome?

A recession does appear to be the most likely outcome at this time. While the last two monthly inflation reports did show a deceleration in the rate of price increases, it does not change the fact that prices are still increasing. Indeed, official inflation numbers could remain tame in the near term owing solely to the methodology by which they are measured, most notably housing costs. However, I don't think it will warrant a Fed reversal that is substantial enough to avoid at least a mild recession. Wage increases, and by extension employment, still need to soften further for a pullback in inflation to be anything more than transitory. So, we may have a brief period of calm on the inflation front but I think it will be too little too late.

As Chairman, did you fear recession as much as some do today? Or did you consider it a normal part of an economic cycle?

I don't know that "fear" would be the right word. Economist Paul Samuelson once quipped that the stock market had predicted nine out of the last five economic recessions. Unlike stock markets, it is not the job of the Federal Reserve to fearfully anticipate recessions. The Federal Reserve Act mandates that the Federal Reserve conduct monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." This requires that the Fed act as a moderating force upon animal spirits so that the economy neither overextends during bouts of euphoria nor descends into panic during times of stress. As an economy built on creative destruction, there will certainly be retrenchment from time to time.

The Twitterverse runs wild with theories that the Fed could "break something." What does that mean to you?

The "long and variable" lags with which the effects of monetary policy are transmitted could lead to any number of scenarios in which unforeseen consequences of monetary policy spiral out of control. Only three months ago, alarm bells were ringing that the U.S. dollar may be appreciating too quickly and could cause "something to break". This was caused, in part, by the divergence in monetary policies being conducted by the Federal Reserve versus the central banks of the other reserve currencies. That risk has receded, but it demonstrates how even sound domestic monetary policy can lead to global financial stress.

How long does it take for interest rate hikes to filter through the economy?

There are so many factors that determine the speed with which monetary policy effects are transmitted that it would be impossible to give a precise answer. It truly depends on the prevailing economic conditions at the time. For example, one positive surprise I have alluded to in a previous article is the resilience of the domestic consumer. I noted that the excess savings they were able to accumulate during the pandemic allowed them to continue spending even as interest rates were steadily increased. In short, if you have excess savings to spend down, and therefore do not need to borrow, then rising interest rates will have a much more muted effect on your purchase decisions initially and it will take longer for the effects of interest rate hikes to filter through to the economy. That is just one of a multitude of facets that affect policy lag.

What is the risk of lowering interest rates too quickly?

The most obvious would be that inflation could flare up again and we would be back at square one. Furthermore, this could potentially damage the Federal Reserve's credibility as a purveyor of stable prices, especially if the action were seen to be taken merely to protect the stock market rather than in response to truly unstable financial conditions. For that reason alone, I do not expect the Federal Reserve to loosen prematurely unless they deem it absolutely necessary, for example to prevent financial market malfunctioning.

This is the most volatile the market has been since 2008. Do you expect it to continue in 2023?

I do not expect 2023 to be as volatile. We went from a Federal Reserve that expected inflation to be transitory to one that deemed seven consecutive rate increases over ten months necessary to tamp down inflation. That is a total increase of 4.25 percentage points in the federal funds target rate, with more expected to come. Add in the massive amount of uncertainty generated by the war in Ukraine and I believe 2022 would be a tough year to top with respect to market volatility.

Do you have any thoughts on the collapse of FTX and the crypto market in general? Do you expect contagion?

I do not expect the fallout from FTX to spread beyond the cryptocurrency/NFT space. Based on the information that has come to light so far, the collapse of FTX was not a result of lax risk management, inadequate accounting procedures, or some feature inherent to crypto – it was purely fraud. With respect to the wider crypto universe – I view the asset class as too dependent on the "greater fool theory" to be a desirable investment. Fortunately, although FTX and firms like it have increased marketing of their products in recent years, the lack of any noticeable widespread market reaction to FTX suggests that they are still fairly concentrated in the hands of a relatively small subset of investors. Moreover, the differences we observed in the aftermaths of the popping of the tech bubble and the popping of the housing bubble showed clearly that credit-fueled asset bubbles create far more contagion when they ultimately deflate. There does not appear to be a significant amount of leverage dedicated to the cryptocurrency/NFT space at this time, so I do not expect contagion to spread very far beyond this particular asset class.

Covid-19 was unpredictable. Are there other black swan event you think about?

The black swan event I think markets, and really the world at large, ought to be most worried about is some kind of conflict erupting between China and Taiwan. I noted in a previous article that, owing to unfavorable demographic trends, China may have reached the height of its economic influence for some time. All the while, Xi Jinping has methodically consolidated power and made himself essentially president for life. He has been fairly candid in his intention to eventually bring Taiwan back into the fold, and he may begin to feel his window is closing. I venture he would view it as a blemish on his legacy were he to leave it undone. Taiwan has shown no willingness to acquiesce to Xi's plans and so the conditions for some type of conflict in the near future are there. The sheer amount of world trade that currently flows through that region, and the number of semiconductors fabricated by Taiwanese firms upon which the technologies we enjoy rely, make any conflict a potential nightmare scenario.

MACROECONOMIC
OVERVIEW

Next Steps: Dr. Charles Lieberman, Chief Investment Officer

Expectations for a mild recession are seemingly embedded most everywhere, even as the risks of a downturn have been pushed a bit further into the future. A few more Fed rates hikes are highly likely, but it is widely expected that the Fed will soon pause to see whether inflation will revert close to the 2% objective. Even that outcome is hotly debated. Inflation is moderating, but insufficiently to bring the Fed close to its goal. So, some additional rate hikes seem likely in the coming months. With so much disagreement, markets are likely to remain volatile, but valuations are already attractive, so the downside should be limited. Interest rates should rise a bit further, but the worst is behind us on this front as well.

The inverted yield curve is a clear indicator that investors believe a recession is coming soon, but most likely, only a modest downturn. Statements by senior Fed officials, including in the most recent FOMC minutes, were purposefully intended to push back against this scenario. The Fed has tried repeatedly to signal to investors that it intends to raise interest rates a bit further and to keep them at a higher level to squeeze inflation out of the system, with its forecasts revealing that this lengthy process is expected to continue into 2024. Moreover, Fed statements are also intended to convey that reducing inflation is by far the dominant objective of policy for the visible future, even if it results in a recession. The Fed has been exceptionally transparent.

Investors seem to be misinterpreting recent reports on inflation and job growth, including to the more moderate jobs report released in January. Investors desperately want to see evidence of "peak" inflation and somewhat weaker growth to build a case that a mild recession is nigh or already underway to justify forecasts of lower interest rates. We agree that inflation has peaked. But its composition suggests that inflation is far from vanquished. Goods inflation, which was highly susceptible to supply disruptions and the surge in demand due to the Covid lockdown, is declining quickly. In fact, many goods prices are now falling. But just as the surge wasn't sustainable, neither is the current decline. But as some goods prices go negative, they will push down inflation below its underlying trend. Moreover, service inflation is moderating rather little. And that shouldn't really be surprising since service inflation is dominated by the cost of labor and the U.S. labor market remains very tight. Until the labor market loosens, there is little reason to expect wage inflation to moderate much, if at all.

The pace of job growth is the other measure that is misunderstood. The slowdown in hiring is taken as part of the swing from extremely rapid growth in employment to outright job losses and a harbinger of more moderate wage inflation. Indeed, Friday's lower level of new hires was widely taken as an indication that the economy is downshifting to a noninflationary pace. This conclusion is premature. More likely, the slower pace of hiring reflects the low level of unemployed available to be hired. The unemployment rate is a mere 3.5% and only 5.7 million people are now unemployed. It becomes ever harder to hire as the number of unemployed declines. Because of the zero bound, we would have expected a slower pace of job growth even if the Fed hadn't raised interest rates at all. Very simply, we are running out of unemployed people to hire. As firms try to employ more workers, despite the shrunken pool of unemployed, they maintain upward pressure on wage rates. And firms are still trying to bring on more workers, as is clear from the number of job openings that still exceed 10 million. The Fed understands this and has stated that hiring must slow to a more sustainable pace, i.e., something less than the growth of the labor force. But the trend in U.S. labor force growth is as little as 50,000 per month and as much as 75,000, so well below the prevailing pace of actual job growth, which is still running above 200,000 monthly.

In our judgment, the risk of a near term recession is fading fast for many reasons. The housing market has been extremely weak, which isn't a surprise since it is the sector most responsive to changing interest rates. However, housing activity is likely to stabilize quite soon after declining so sharply in 2022. Another large decline in 2023 is unlikely, so housing will not provide much drag to the broader economy in

2023. Energy prices have already retreated recently, which is part of the outright decline in goods prices mentioned above. With inflation moderating, real household income is rebounding, which will translate into stronger consumer spending. Onshoring of manufacturing will promote more domestic investment, another tailwind to growth. Passage of the $1.7 trillion government budget will also add to demand. (Don't be surprised if some supplemental spending is approved to provide more defense equipment and munitions to Ukraine.) Two large, key economic sectors are reviving, autos and aircraft. As chip supplies improve, auto assemblies are picking up and so are Boeing aircraft deliveries. With the sudden end to China's Covid Zero policy, a reopening of China's economy should become visible over the course of the next several weeks. Putting all this together suggests that the near-term risk of a recession is fading.

A legitimate debate already exists over whether the Fed has already done enough to contain inflation. By itself, this may be sufficient to induce policymakers to soon stop raising rates to give some time for incoming data to settle the conflicting views. Those at the Fed who want to slow down rate hikes will use the recent jobs report to justify their view. But the unemployment rate hit a cycle low and job growth remains unsustainably rapid. So, there are likely only a few Fed officials who fall in that camp. Others at the Fed may be more disturbed by the sharp rally in stock and bond prices relaxing credit market conditions and worry that the market's reaction is premature and will counterproductively act to prevent the Fed from reaching its goal of inflation moderation.

So, it is our judgment that another 50 basis points remains more likely at the next meeting and possibly 25 at the following meeting before we expect the Fed to pause. Over time, the data will tell the Fed (and us) whether more rate hikes are needed. The Fed's actual policy behavior will reflect the performance of the economy regardless of its current expectations. The Fed's forecasts are just that, forecasts. The same idea applies to the markets, which must also forecast. Both will respond to incoming data. Given the underlying trends in the components of inflation and hiring trends, we think the Fed may return with some additional rate increases later in the year. That current, preliminary judgment will evolve along with incoming data.

The sizable decline in stock and bond prices in 2022 has established a lower, safer base for investment. If there is no recession in the near term, corporate profits may well surprise to the upside, at least for the first half of the year. But there are already so many stocks that trade at single digit price-to-earnings multiples that current valuations are already attractive. It is impossible to call the bottom of this stock slide, but valuations are so undemanding, we think investors should be putting money into equities. As investors, share purchases should work out well within a year or two. And as we have seen, any hint that we might be close to the end of the rate hike cycle is sufficient to send markets sharply higher.

Bonds are a little trickier, since we don't think rates have peaked, as yet. But the huge increase in interest rates seen in 2022 is highly unlikely to be repeated in 2023. Coupons are now considerably higher, too. And with the yield curve somewhat inverted, short maturities provide a nice safe haven even if the Fed has to tighten policy more later in 2023.

Geopolitical events could be wild cards this year, although they are an unknown risk every year, as Russia's invasion of Ukraine demonstrated early in 2022. Iran's nuclear ambitions are another wild card, as are the demonstrations within Iran that could yet topple that government. China could surprise everyone with some action against Taiwan, although we think this is fairly unlikely. Kim in North Korea is another wild card. And those are just some of the more obvious known unknowns. The list of potential surprises is truly almost endless. We will have plenty to monitor, as usual.

Geopolitics: A Look Around the World

UPDATE

David Ruff, CFA®, Portfolio Manager

Ending an extremely volatile year on a positive note, global equity markets rallied in the final quarter of 2022, recovering a significant portion of the steep bear-market drawdown. The MSCI ACWI Net Total Return Index, which captures the cap-weighted return of large and mid-cap stocks across 23 developed and 24 emerging markets, advanced 9.76% for the last three months. The advance was broad-based with seven of 11 sectors posting double-digit gains. Only the Consumer Discretionary sector failed to post a positive return for the December-ending quarter. This mainly reflects market sentiment migrating away from fear of inflation toward fear of recession in the US and Europe. By major region/country, Western Europe (+18.74%) ranked first, followed by Asia Pacific (+13.70%). The US (+7.04%) posted the lagging, but still positive return.

This final quarter trimmed the loss for 2022, but macro events including Russia's invasion of Ukraine engendering an energy crisis, and elevated inflation levels proved very damaging for global equities for the year, overall. Heightened inflationary concerns induced most central banks around the world to aggressively hike interest rates led by the US Federal Reserve's 400 basis point jump in the Fed Funds rate, an amount of increase not seen since 1980. The European Central Bank ("ECB") hiked its benchmark rate by 250 basis points in 2022. Additionally, ongoing Covid lockdowns in China, the world's manufacturing engine, resulting in supply chain disruptions hampering many company production operations. Finally, the ongoing battle between the US and China regarding advanced technology added to investor anxiety, making 2022 a very unique year for global equities. Despite global corporate earnings improving an average of over 14%, the above-mentioned index sank 18.36% in 2022 as earnings multiples came under severe pressure.

Western Europe's impressive final quarter 2022 equity return hinged largely on dissipating fears of the region facing full shutdowns of energy-intensive industries. As highlighted in the September quarterly commentary, investors expressed extreme anxiety about possible European energy supply chaos, failing to consider the impact from conservation, deferred closure of coal power plants, and accelerated LNG deliveries. These steps helped Europe prepare for the winter season. Germany, for instance, constructed a new Wilhelmshaven LNG floating terminal in record time and already received its first tanker ship delivery. This is an important step for Germany and the continent. Longer-term, renewed commitment to nuclear, new Northern Africa/Middle East gas pipelines, and accelerated alternative energy build should assure the continent achieves full independence from Russian gas. With the continent's inflation relating more to energy cost, the easing of crude oil and natural gas prices alleviated investor worries of falling corporate profits from input cost pressures. Natural gas prices ended 2022 at nearly 50% of summer levels and Brent crude fell 38% from the peak reached earlier in 2022. Accordingly, European equities snapped back from the excessive pessimism reflected in stock prices three months earlier. For sure, the continent's inflation readings are rolling over as Germany's year-over-year inflation dropped to 8.6% in December from November's 10.0% print. Still, inflation pressures remain elevated and the European Union's labor unemployment rate recently reached historic lows. Thus, like the US Federal Reserve needing to respond to labor market pressures, further ECB tightening seems likely. The resulting higher interest rates makes at least a mild recession inevitable for Europe. The degree and length of slowdown remain uncertain, but fortunately, European stock prices already fully discount this reality and valuation discounts to US equities remain extreme.

Asian stocks rallied strongly off depressed levels in the fourth quarter benefiting primarily from China's expected reopening. This boosted Chinese equities 13.46% and pushed many Asia Pacific equities to stronger gains including the Philippines (+20.66%) and Thailand (+16.73%). Even Japan, whose economy continues to struggle, registered a double-digit gain of 13.12%. To be sure, Japan will probably see decelerating exports to the Western economies in 2023, but the less aggressive Bank of Japan lowers the risk of monetary overtightening. Interestingly, despite softening economic performance in Japan, global desynchronization may be a key theme in 2023. While the US and Europe both face cooling economies from monetary tightening, China should generate an overdue post-Covid surge in economic activity as it reverses its zero-Covid policies and provides easier-to-access credit to boost its ailing property sector. These growth stimulative initiatives for China should significantly benefit the global economy and especially, the Asia Pacific region, through extensive, integrated trade links. As highlighted in our November 21st commentary *Our Thoughts on China*, the recent Party Congress detailed a shift in priority toward rekindling economic growth. We look for an improving Chinese economy to be supportive for many risk assets including commodity prices which should support natural resource-based economies like Australia and Brazil; non-dollar currencies, particularly many severely discounted emerging market currencies; and global equities generally with the post-Covid normalization of manufacturing production.

Of course, risks still remain in the 2023 outlook. The Ukrainian invasion certainly raised investor anxieties, and although geopolitical conflicts should not be underestimated, history shows business activity continues in periods of regional hostilities. Rather than trying to predict an uncertain future outcome, successful equity investors know diversification is key. Geographical diversification may be more important now as the world appears to be splintering into regional trade groups of the Americas, Asia, and Europe, but also time diversification, that is, staying invested in a variety of economic and market conditions. Thus, waiting for the war to end or interest rates to stop going up is a good strategy if you don't mind missing the first 50 percentage points of equity rally. Maybe an exaggeration, but investment timing is notorious for failing investors in the long term.

Equity bears also point to the higher interest rates retarding economic activity, possibly resulting in an economic and profit recession in the US and Europe. A slowdown should be expected but it would not surprise us to again see greater resiliency in these economies. As discussed earlier, employment remains robust in the US and Europe. Note, Europe's energy crisis has thus far proved not to be a crisis. Market multiples have adjusted to higher rates and we don't believe the unprecedented interest rate hikes in 2022 will repeat in 2023. Knowing that monetary policy works with a lag, the Federal Reserve and other central banks will at least slow, if not stop, their rate hikes to monitor the degree of economic deceleration and inflation abatement. Ergo, the ultimate end of the hiking cycle campaign should end sometime in 2023. Finally, while not all equities are undervalued, many have overly discounted their longer-term earnings power and offer a very attractive total return proposition at current price levels.

Is 60/40 Dead? The Benefits of a Balanced Strategy

UPDATE

Dr. JoAnne Feeney, Portfolio Manager

The 60-40 balanced approach to investing is most certainly not dead, as some have suggested. Even though bonds fell in price in 2022, they fell by much less than equities did, and that helped to reduce the decline in investor principle relative to all-equity portfolios. This year, yields on bonds and other fixed securities are starting out the year at high levels, so investors can now enjoy the higher income from those yields at a time when we expect only muted (and temporary) declines in bond prices.

ACM's Balanced strategies buffered clients from the worst of the equity (and fixed) market's decline last year when the S&P 500 dropped 19%, while the average corporate investment-grade bond fell nearly 16%. We were conservatively positioned in equities and provided dividend yields well above the S&P's, while ACM's fixed portfolio (the source of the fixed positions for T3 Balanced) fell just over 7% (gross of fees). Combining fixed asset exposure with equities helped cushion portfolios last year and put on full display the attractiveness of holding a balanced strategy.

Because equities are historically more volatile than fixed securities, investors will usually see less volatility in balanced strategies, but not always better total return than an all-equity strategy. Usually, equity markets rise, rather than fall, and so investors give up some total return in exchange for that lower volatility. Last year was an exception, though one that has happened several times in the last 40 years—investors in Balanced generally had better total return than investors in a similar all-equity strategy.

As the Fed moved to quell inflation, interest rates rose and fears of global recession rose with them. This pushed investors towards safer stocks, and that shift protected utilities, consumer staples, and health care stocks from the sort of declines felt by more growth-oriented sectors, including consumer discretionary, communications, and info tech. Those safer sectors fell by an average of 3%, while those growth sectors fell by an average of 36%. Correspondingly, value stocks fell a modest 7%, compared to the 30% drop in the S&P 500 Growth subcomponent.

ACM's Balanced strategies remain focused on quality companies that either have the potential to deliver multi-year growth across business cycles (and that we can buy at a reasonable price) or have defensive characteristics which would enable them to ride through business cycles with less disruptions. We also are selecting companies which bring the average dividend yield above that of the market (and targets vary by the specific version of Balanced), and allows investors to build a cushion into cash flows in the face of stock price gyrations. And, of course, fixed securities have historically delivered a buffer against equity market volatility, giving clients an opportunity to dampen principal fluctuations. Since the Fed has done most of its work through last year's increases in the Federal Funds rate, we can expect this year to see few rate hikes, and perhaps a decline in rates close to year-end. This points to less downward pressure on bond prices than we saw last year, making a Balanced strategy an even better insulator against equity volatility, and one where higher equity and fixed yields can help investors ride out stock-price fluctuations.

Fixed Income Recap and 2023 Outcomes Based on Fed Actions

UPDATE

Kevin Kelly, Portfolio Manager

2022 was an extremely challenging in year in fixed income across investment grade, high yield, and preferreds. 2022 was the perfect storm of rising interest rates, credit spreads widening, and geopolitical uncertainty given the invasion of Ukraine and increased tension between the U.S. and China. High inflation forced the Fed and many other central banks to begin aggressive tightening in order to preserve long-term economic stability. Monetary policy tightening led to heightened economic and recession fears that persist today.

ACM fixed income returns in 2022 benefitted from owning individual securities as these securities can be held to maturity. Many ETFs or mutual funds have specific criteria such as bonds with a specific maturity range, rating, or security type (bond or preferred). For example, if an ETF owned exclusively 1-10 year investment grade bonds, as time passed some of the shorter bonds with maturities less than one year got sold in 2022, which locked in principal/par losses. 2022 also highlighted the importance of security selection.

Many well selected securities drastically outperformed securities with a similar rating and maturity. For example, some preferreds with the same issuer outperformed others by more than 20% in 2022. Additionally, during times of distress, many bond funds and ETFs may be forced to sell at fire sale prices due to redemptions which then can negatively affect those who do not sell.

The 2023 outlook for fixed income is relatively positive for investment grade portfolios with a moderate duration (interest rate sensitivity). Yields on intermediate, investment grade corporate securities are at the highest level they've been at since 2009. The higher yields provide a large buffer to potential rate increases in order to still generate positive full year returns. If interest rates finish the year flat or down, then fixed income portfolio will perform well. While rates will remain volatile until the inflation outlook is clear, we remain confident that fixed income remains attractive.

Q & A with the Advisors Capital Investment Team

UPDATE

Question 1: Do You Expect a Fed Pivot?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth

No, I do not expect a Fed "pivot" in 2023. A pivot will come when the economy goes into recession, but that won't come in the first half of the year. It could come in the second half, if the Fed hikes rates more than they seem likely to do right now. I've pushed my expectation for a recession into 2024, so that's when I currently think the Fed could start to bring rates down. In the meantime, I expect a few more rate hikes to bring the funds rate to the 5% to 5.5% level before they pause.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced

Rate projections show that the market expects a Fed pivot in mid-2023, and we think that is too optimistic. The Fed is more likely to raise at the next two meetings and hold rates there for several months. There is a small chance that the Fed could cut rates close to year end if inflation slows materially. We expect the Fed to keep long-term inflation expectations anchored close to 2%, where they are now, so it must hold the Federal Funds Rate at high levels until the data show that inflationary pressures have eased.

David Ruff, CFA, Portfolio Manager – International ADR, Global Growth, Global Dividend

Knowing that monetary policy works with a lag, the Federal Reserve and other central banks will at least slow, if not stop, their rate hikes to monitor the degree of economic deceleration and inflation abatement. Ergo, the ultimate end of the hiking cycle campaign should end sometime in 2023.

Kevin Kelly, Portfolio Manager - Fixed Income

The Fed rate hikes in 2023 will be much slower (and lower in magnitude) than 2022. The Fed will likely pause in the first half of 2023 to observe the impact of the higher Fed Funds rate and state of the economy. Massive rate cuts are unlikely unless the economy severely weakens and inflation has significantly reduced.

Question 2: Will Value Continue to Outperform Growth?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth

I still prefer value over growth since I don't think we've seen the peak in rates and value stocks have declined enough to offer …. real value. I'm less confident that growth stocks offer value, as yet. Quite a few stocks now trade with single digit multiples and these are all value stocks, of course. Given the above, I think growth will struggle until 2024.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced

With more interest rate increases behind us than ahead, the valuation headwind that pulled down growth stocks in 2022 has abated considerably. This gives company fundamentals—namely, earnings—greater weight in driving stocks in 2023. Unfortunately, with economies around the world likely to slow further this year, growth, broadly, will struggle in the first half. But in the second half, investors will begin looking to potential earnings recovery in 2024. In addition, excess inventories will likely have cleared by mid-year, giving those companies a chance to turn sales declines into year-over-year sales growth. So we expect a difficult start to the year for growth stocks, followed by improvements through the summer, fall and winter.

Question 3: Will Inflation Drop to 5% or Lower?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth

Yes, I think it is likely that inflation will get to around 4%, or possibly even a bit lower in 2023. The devil's in the details, however. Goods inflation will certainly fall well below 4%, possibly even close to zero. In early 2022, goods prices surged to unsustainably high levels, dragging up inflation measures to unsustainably high levels. Now, goods prices are falling back, so they enter the price indices with deflationary numbers and push down the overall measures of inflation below underlying trends. In contrast, service inflation didn't surge like goods and they remain elevated. They will not retreat much until unemployment starts to increase, which hasn't even started yet. Because of goods, overall inflation will probably fall below 4%, but probably not below 3%.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced

Inflation has peaked and is moving lower and we expect that to continue through 2023 and to fall below 5% by the second half. Several factors take the pressure off inflation, even as two important factors will keep the pressure on. On the positive side, shortages and supply chain problems are continuing to resolve. We have seen reductions in food, energy, and many other commodity prices over the last six months and that is helping reduce broader inflation. On the negative front, wage growth remains elevated, even as the rate dropped a bit to 4.6% last month. And the imputed costs of housing have as yet to be fully reflected in the price indices and we expect several more months of positive contributions to inflation from that source. Eventually, though, falling rental rates and declines in house prices will pull inflation lower.

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