



OUR VIEW



U.S. equities had the worst year since 2008, U.S. bonds the worst year since the 1970s.

Fourth Quarter Review

2022 was a year to forget for investors. U.S. equities had the worst year since 2008, U.S. bonds the worst year since the 1970s. Stocks and bonds both provided negative annual returns for the first time in decades, leading to the 3rd worst year of performance since 1950 for the “60/40” portfolio comprised of U.S. stocks and bonds. Despite a strong 4th quarter rally, global equities ended the year close to bear market territory.

Last year was a difficult transition from three consecutive years of double-digit returns for balanced portfolios of stocks and bonds. Russia’s invasion of Ukraine contributed to stubbornly high inflation, which added to the pressure on central banks to tighten monetary policy. China’s zero-Covid strategy and resultant growth slowdown also contributed to the disappointing year for investors.

Global equities, as represented by the MSCI All Country World Index, fell by approximately 18% for the year. The S&P 500 dropped 18.1%. U.S. small company stocks lost more than 20%, giving back much of the substantial gains of 2020 and 2021. Emerging markets stocks also lost more than 20%. The MSCI EAFE Index, which measures the performance of developed international markets in Europe, the U.K., and Asia, outperformed the U.S. with a late-year rally, falling by approximately 14%. The 4th quarter weakness in the U.S. Dollar helped boost the EAFE Index in dollar terms, but the dollar still gained ground relative to major currencies during the year.

Value led growth in 2022. The large company Russell 1000 Value Index outperformed its growth counterpart by more than 20%. The small company Russell 2000 Value Index outperformed the Russell 2000 Growth Index by more than 10%. In S&P 500 sector terms, energy stocks gained more than 65% for the year; the utilities sector was the only other sector with positive returns for the year. The communications services, consumer discretionary and technology sectors were the worst performers year-to-date, losing between 28% and 40% for the year. The “tech wreck” within the S&P 500 was fueled by rising interest rates and slowing post-pandemic growth rates; losses among smaller company growth stocks came amidst investor concern about rising rates as well as the path to positive cash flows and profitability.

The Fed’s move toward a more restrictive monetary policy caused major dislocation for bond markets worldwide. The Bloomberg U.S. Aggregate Bond Index lost 13%, the worst year in the history of the index. The shorter-duration Bloomberg 1-5 year Government/Credit Index fell 5.5%; the Bloomberg Municipal Index lost more than 8%.

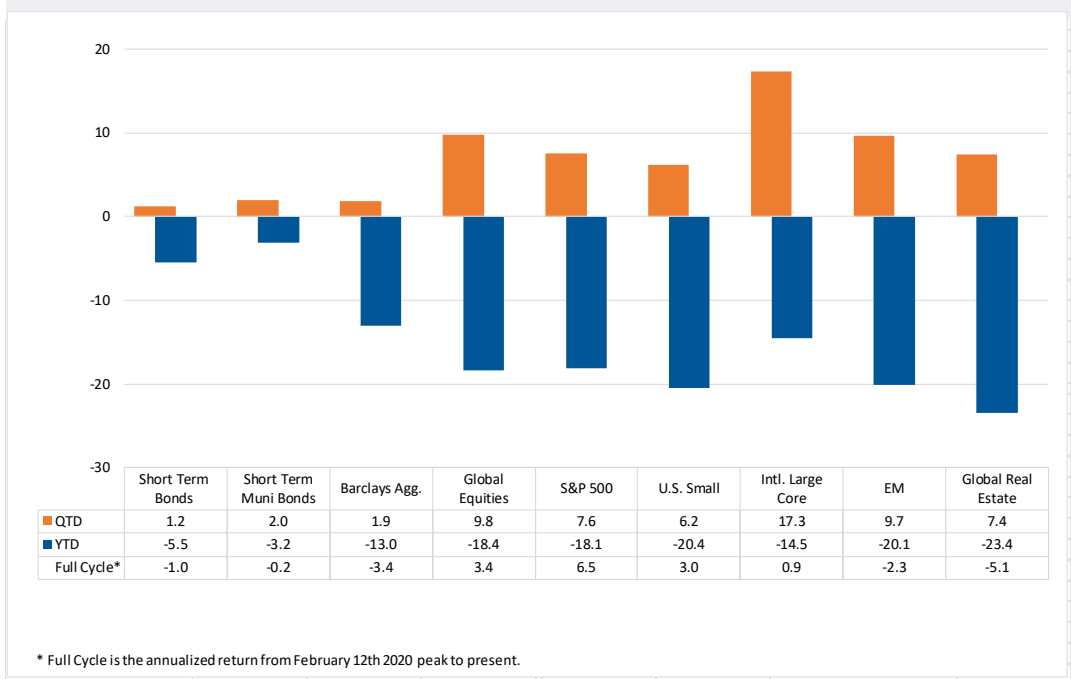


TFC's core positions in shorter-term, high quality fixed income holdings lost less ground than longer-term or more credit-sensitive holdings, but still finished the year sharply down.

TFC client portfolios fell in absolute terms along with market indexes and were slightly behind client benchmarks during the quarter. The only positive absolute returns for the year came from insurance-linked and private real estate holdings. TFC's core positions in shorter-term, high quality fixed income holdings lost less ground than longer-term or more credit-sensitive holdings, but still finished the year sharply down. TFC's value holdings helped relative performance, particularly in the U.S. TFC's growth holdings outside the U.S., which were big contributors in the 2020 rebound after the start of the pandemic, detracted from relative returns.

Quarter To Date Returns

12/31/2022



Although many investors think a global recession is inevitable in 2023, it is important to emphasize that in the history of U.S. recessions (other than the dotcom bust in 2001), equity markets bottomed well before the bottom in GDP, employment, and earnings.

Market Outlook

Pessimism is a logical emotion after last year's disappointing results and fears of recession to start this year. The challenges discussed at length last year, including inflation, Fed policy and geopolitics, remain in the headlines. Although many investors think a global recession is inevitable in 2023, it is important to emphasize that in the history of U.S. recessions (other than the dotcom bust in 2001), equity markets bottomed well before the bottom in GDP, employment, and earnings. "Less-bad" economic or policy news could be catalysts for a market rally, as could the avoidance of "worst-case" geopolitical scenarios.

Inflation and central bank policy remain at the top of most lists of investor concerns. We are cautiously optimistic about the trajectory of inflation, which is slowly declining from peak levels. Energy and other commodity prices have come down, which has helped reduce headline CPI. U.S. core CPI, which excludes energy and food prices, rose 6% in



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November, down from October’s 6.3% gain. Although the core measure is far from the Fed’s long-term target of 2%, there are encouraging signs of progress. Goods inflation has come down meaningfully from pandemic peaks, helped by the normalization of demand and easing of supply chain disruptions. We are also mindful of the pandemic-related distortions that are artificially boosting headline inflation statistics. For example, housing is the largest component of core inflation. Unfortunately, housing costs in the CPI data are lagged, with home price and rental increases of the last 18 to 24 months showing up now in the CPI data. The disconnect between housing-related costs reflected in CPI data and real-time measures is significant today. Real-time measures of housing-related costs and activity are slowing significantly, which should contribute to a meaningful slowdown in housing-related inflation later this year.

The tight labor market complicates the Fed’s rate-setting deliberations. Wage pressures are contributing to rising services inflation and to the concern that inflation expectations will become “un-anchored” from the Fed’s 2% target. The ratio of job openings to job seekers remains high, in part because labor participation has not recovered to its pre-Covid level. Departures from the workforce are particularly high among the 55+ population. The hopeful view is that if even a fraction of those people return—either because of boredom, falling asset values, or diminished Covid fears—then the labor force could expand enough to reduce wage pressures by closing the gap between job openings and job seekers. Increased immigration could also help. Our expectation is that the job market and economic momentum will slow enough to allow the Fed to pause their rate hike cycle in the first half of the year. In contrast to the pricing implied by the bond market, we think it more likely that the Fed will pause rather than reduce rates in 2023, unless the recession is more severe than we expect.

Recession fears are mounting, as economic and market indicators signal that a global recession is likely in 2023. We expect the U.S. economy to have a mild recession, given the strength of the consumer and relative health of the financial system in comparison with past economic cycles. Consumers have been willing to draw down the significant savings accumulated during the pandemic, while household debt and debt servicing ratios remain far below Global Financial Crisis heights. We are monitoring to see whether the willingness to spend continues if the labor market weakens materially. Some credit stress is emerging among the lowest income households, but so far that stress has remained contained. The housing market is slowing, but in contrast to 2008 lending standards are much stronger, housing inventories are much lower, and most U.S. mortgages are fixed rather than adjustable rate.

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Russia’s invasion of Ukraine was the amplifier that made everything worse in 2022. Despite the resilience of Ukraine’s military in response to Russia’s invasion, we are pessimistic about the prospects for a near-term resolution for the war. Successful Ukrainian counter-offensives in Kherson and Kharkiv represented small areas compared to all the contested territories. According to U.S. Joint Chiefs of Staff Mark Milley, “So, in terms of the probability of a Ukrainian military victory defined as kicking the Russians out of all of Ukraine to include what they define or what the claim is Crimea, the probability of this happening any time soon is not high militarily.”



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Chinese economic growth is likely to rebound in response to the end of the zero-Covid policy. China's GDP is far below its pre-Covid trend, reflecting significant loss of output caused by Covid controls. As restrictions are lifted, growth should bounce back. Chinese households have been in savings mode since the start of the pandemic, with family bank account balances up significantly from the beginning of 2020. Those funds should fuel a consumer rebound, and an eventual stock market rebound. In the near-term, however, there may be a disconnect between what Chinese households are allowed to do and what they are willing to do as Covid spreads through the population.

Tensions between the U.S. and China will be an ongoing source of geopolitical risk. Decoupling of China from the U.S. and other countries in select industries, particularly in semiconductor exports, is a source of conflict with global implications. China's reliance on Taiwan for 70% of its semiconductor supply is a factor that adds to the complexity of the U.S./China/Taiwan relationship. But China will remain far more integrated into the global economy than markets such as Russia, Iran and North Korea that became geopolitically isolated. China's 1.4 billion people account for a quarter of the global sales of clothes, nearly a third of jewelry and handbags, and nearly 40% of cars. China is the largest market for machine tools and chemicals, and its construction industry is a big buyer of building equipment. The 200 biggest multinationals in Europe, Japan and the U.S. earned \$700 billion in China last year. U.S. companies have made large investments in Chinese subsidiaries. As of 2020, the U.S. trade deficit with China disappeared once sales of in-country subsidiaries were included. Apple, BMW, Intel, Siemens, Tesla, and Walmart are among the companies that earn more than \$10 billion of revenue a year in China. For the U.S., fully decoupling from China would hurt corporate earnings and create major complications for the energy transition given the reliance on China throughout the supply chain for renewables.

Portfolio Positioning

Equity markets typically bottom while the economy is still getting worse, which we think is a hopeful reminder in thinking about the outlook for markets in 2023. The potential for a turbulent first half of the year is high, given the uncertainty about the path for inflation, Fed policy and reopening of the Chinese economy. Weather will be a significant near-term factor influencing the severity of recession in Europe, given the reliance on expensive energy imports because of the war in Ukraine. In this environment, we are investing new cash cautiously given the equally likely potential for positive or negative surprises.

TFC's longer-term view is positive. The end of extraordinarily "easy" monetary policy makes fixed income a more compelling investment option, particularly at the short end of the yield curve. The starting point for yields matters when thinking about bond market returns. With short-term bonds yielding more than 4% in comparison to last year's starting point of less than 1%, the bond market should provide an appealing combination of income and capital preservation if inflation returns to more manageable levels. Equity market valuations have corrected significantly, with valuation discounts relative to history notable among U.S. small company, European, and Chinese stocks. Equities are not a

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bargain, but it will not take much positive news to create a rally in some of the hardest hit segments of the market. Profitless innovation has repriced in a significant way, but we are still wary of some of the more speculative areas of the market, such as the large segment of young, unprofitable companies. However, there are opportunities among disrupters and innovators that have strong business models, paths to positive cash flow, and ability to self-finance in an environment in which capital markets have tightened considerably. Value stocks have been relative outperformers in a poor environment for growth stocks. Many value stocks will be tested by a potential recession and by disruption that continues to threaten legacy business models. We will be emphasizing higher quality value holdings that have the profitability and balance sheet quality necessary to withstand an economic downturn.

We remain aware of the potential long-term inflationary implications of the climate transition, re-shoring and “friend-shoring.” Steps to make supply chains more resilient, either by increasing inventories from just-in-time to just-in-case, and by diversifying suppliers are likely to be inflationary. Spending on defense, energy and food security may also contribute to long-term inflation pressures. TFC’s investments in real assets should provide some help in an environment in which inflation may be a more frequent risk than deflation.

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As always, we welcome your comments and questions.

Sincerely,

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