FLIPPIN, BRUCE & PORTER

A BUSINESS OF CANTOR FITZGERALD INVESTMENT ADVISORS

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Most investors will welcome the New Year and say good riddance to 2022, hopeful for better returns this year. That would be a reasonable bet, as last year saw the worst stock market since 2008. It may be difficult to believe, but 2022 would have been even worse if not for a relatively strong rally for equities in the fourth quarter. The big story for the year was sharply higher interest rates which led to significant multiple compression for equities, particularly for the highest valuation segment of the market. Therefore, value and dividend stocks held up much better than growth stocks. Higher rates also led to very poor returns for fixed income assets, creating a rare situation where balanced portfolios didn't see diversification benefits from owning both stocks and bonds.

Higher interest rates came at the hands of the Federal Reserve's Open Market Committee which raised the fed funds rate seven times last year. The cumulative percentage point increases total 4.25 surpassing 1994s six hikes totaling 2.25. The FOMC really had no choice but to raise rates to curb soaring inflation, with the CPI topping 9% year over year this summer, a 40-year high. In addition to raising rates, the Fed also began to reduce its balance sheet by letting bonds mature that it had purchased over the last decade in its quantitative easing program. This "quantitative tightening" should continue in 2023, and further fed funds increases are also likely. But there are signs that inflation is cooling, which may result in the FOMC pausing its increases in the first or second quarter. Some Wall Street strategists, including JP Morgan's, are predicting the Fed will overtighten, forcing it to quickly pivot back to lowering rates in the back half of the year. We remain skeptical of that outlook for rates. We expect the FOMC will do just as it has forecasted, electing to maintain rates above 5% for some time in hopes that inflation fears will be fully extinguished.

Despite rising rates and the uncertain economic environment they create, fundamentals for corporations have proved resilient. Earnings for the S&P 500 for 2022 are still being tabulated but are forecasted to come in modestly higher than 2021, aided by large profit gains from the Energy sector. Analysts are currently projecting about a 4% increase in S&P earnings this year, to $230 per share. We believe this will prove too optimistic given the challenging economic backdrop expected. Consumer demand is likely to falter in 2023 with lingering effects from inflation, higher interest rates impacting housing affordability and dwindling excess savings post-Covid. We are already seeing corporations announce cost cutting measures, including layoffs, in an attempt to maintain margins and earnings. More cuts will undoubtedly follow, and unemployment is likely to move higher. Capital spending is also likely to fall. Given these pressures, it would not be surprising to see very slow growth in the US in 2023 and possibly even a mild recession. China's retreat from draconian Covid lockdown policies should provide some offset to slowing economic conditions here and around the world.

While we have painted a rather grim outlook for the economy, we believe much of that outlook is already discounted in current equity markets. Valuation of the US equity market at approximately 17 times earnings is reasonable given the inflation, interest rate and growth outlook. Value stocks are even more attractively valued, at around 14 times earnings. The pressure felt from the extreme rise in interest rates should not be repeated in 2023. As inflation continues to ebb, the FOMC will become less hawkish with rates, setting up a scenario where markets can look past any trough in economic activity and begin pricing in the imminent recovery. We saw this scenario play out most recently in 2020, when stocks began to anticipate an economic bounce well before the economy bottomed. If we are correct in our view, value/dividend stocks may continue to lead the market and outperform growth/momentum stocks.

While no manager likes to see negative returns for clients, our EDP equity returns held up better than most all other stock strategies last year. Longer-term total returns versus the Russell 1000 Value index also compare quite favorably. Furthermore, cash flow generation from both dividends and option premiums, a key objective of the strategy, met our target for the year. We established a new position in Advance Auto Parts during the quarter. With a 4% dividend yield, the shares will serve as an income-enhancing replacement for Genuine Parts, another automotive parts retailer in the portfolio. Genuine Parts weighting was reduced during the quarter, along with reductions in Exxon and Merck, primarily through call option exercises.

We encourage you to contact us with any questions you may have. For additional firm wide information please visit our website at www.fbpinc.com or call us at 1-800-851-3804. As always, we appreciate your continued interest in our firm.