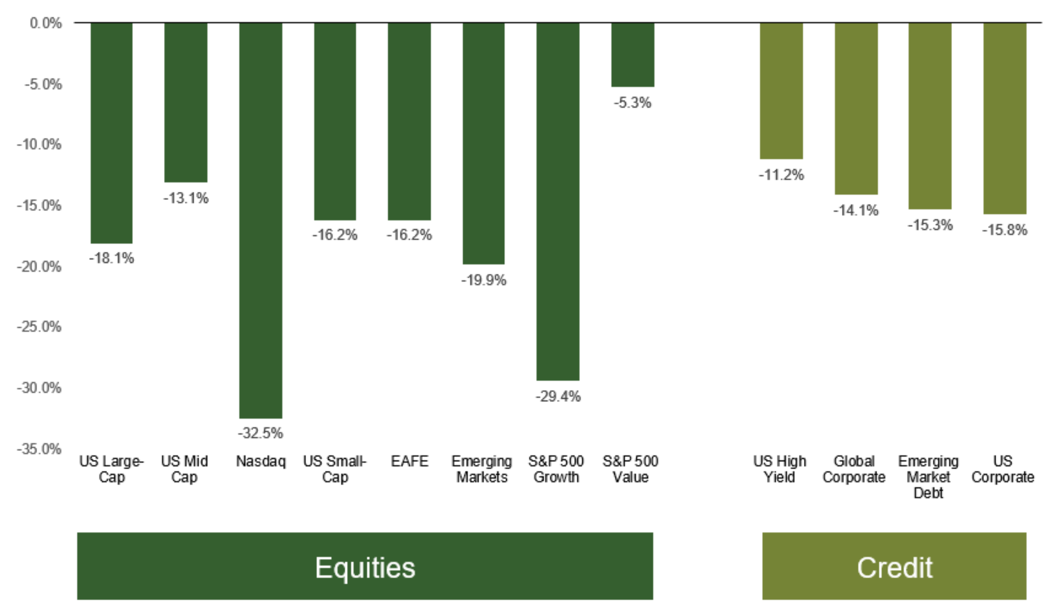
NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Finding Opportunities Amidst an Ever Changing Macro Backdrop

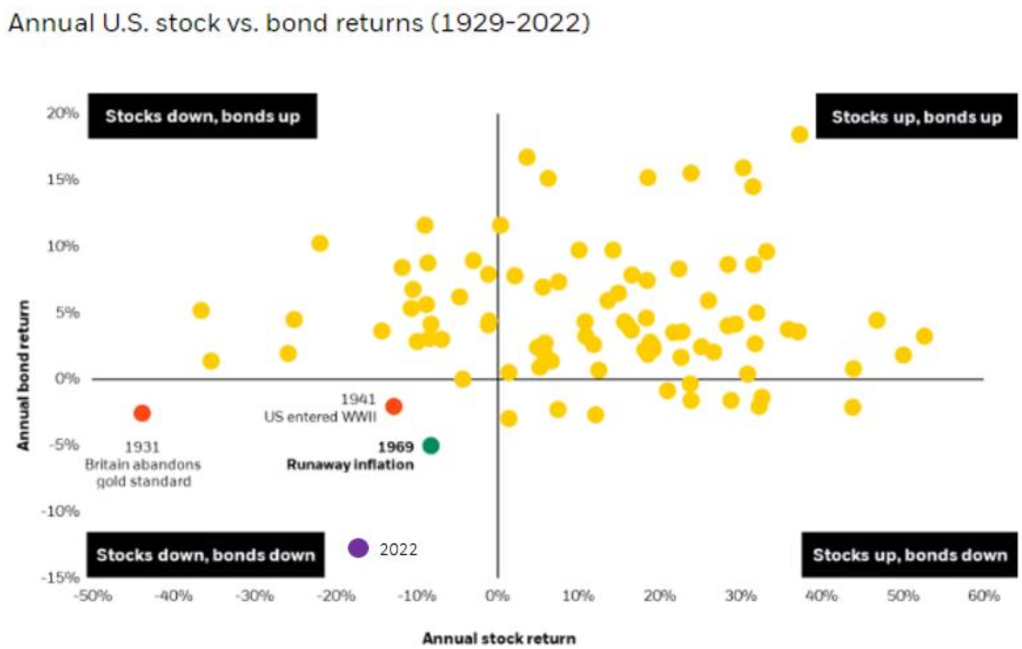
Worst year since 2008

2022 was a year in which valuations corrected, and in some corners of the market collapsed entirely. Performance of most all major asset classes was firmly in negative territory, with assets in the more growth oriented, speculative, or profitless camps hit the hardest. Volatility surged, with 122 trading days posting at least a 1% move in the S&P 500, the third most in the past 70 years (only 2002 and 2008 had more). The benchmark S&P 500 Index lost -18.1% on the year, the worst showing since 2008 on the continued anxiety surrounding interest rates, inflation, and the overall direction of the US economy. Mid- and Small-Caps outperformed their Large-Cap peers by a healthy margin. Mid-Caps returned -13.1%, outperforming by more than +500bps, while Small-Caps returned -16.2%, outperforming by just under +200bps. The outperformance of Mid- and Small-Caps had much to do with their overall sector composition skewing more towards Value than Growth, and having lower starting valuations compared to many Mega-Cap (Growth) stocks. As a whole, Value (-5.3%) handily outpaced Growth (-29.4%) on the year. 9 of 11 sectors posted negative returns on the year led by Growth oriented sectors such as Communication Services (-39.9%), Consumer Discretionary (-37.0%), and Technology (-28.2%). Individual Mega-Cap Growth stocks lost significant value, including Apple (-26.4%), Microsoft (-28.0%), Alphabet (-38.7%), Amazon (-49.6%), Meta (-64.2%), and Tesla (-65.0%). Notable positive performing sectors included Value driven Utilities, which gained +1.6%, and Energy, which rose a staggering +65.7% on the year.



Source: Nottingham Advisors & Bloomberg

Bonds fared equally as poorly, with the Bloomberg Aggregate Bond Index losing -13.0%, its worst showing on record. Treasuries, investment grade and high yield corporate bonds, and fixed income securities of nearly all types lost value. Bonds offered little hedge value against stocks as interest rates rose. Bonds and Stocks both zigged, while few asset classes (i.e. Gold) zagged. Stocks and Bonds both lost value for only the 4th time since 1929, as shown by the nearby chart from Blackrock. The bedrock 60/40 portfolio comprised of the S&P 500 and Bloomberg Aggregate had its worst showing in nearly 50 years.



The Fed

The Federal Reserve raised interest rates by +425bps in roughly nine months, the fastest pace of tightening on record. Hard to believe that just a year ago the benchmark Fed Funds rate was still zero percent. The Fed's urgency included "jumbo" rate hikes in 75bp increments multiple times as inflation was rising rapidly and showing no signs of stabilizing or slowing. Fast forward just a few months, and the Fed has already slowed their pace meaningfully, from 75bps in November, to 50bps in December, and an expected 25bps on February 1. The market is currently pricing in a nearly 100% certainty that the Fed will raise a symbolic 25bps and potentially pause. The Fed pause is widely anticipated, and reflective of slowing economic data, rapidly decelerating inflation, and the fact that monetary policy acts with a lag. The impact of all of the rate hikes of 2022 have likely yet to be felt, except perhaps in the housing sector, and will likely not be felt by the real economy until later on this year.

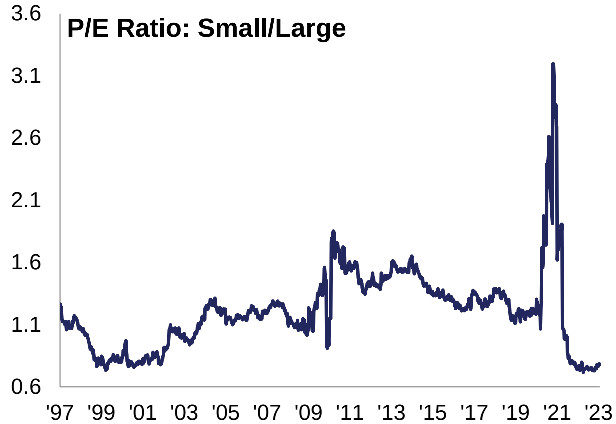
With that said, underlying economic data has remained remarkably resilient. Consumption has remained strong, although recently showed signs of slowing. With the consumer representing nearly 70% of the US economy, we would likely need to see a sharp drop off in spending before getting too worried that a recession is imminent. If a recession happens at all, it would likely be one of the most telegraphed and anticipated in recent memory. Nearly ⅔ of those polled by *The Wall Street Journal* back in October expected a recession in the next 12 months, while the most recent quarterly survey of professional forecasters polled by the Philadelphia Federal Reserve indicated 43.5% felt the same, the highest on record during the last 50 years. Taken together, market expectations of a recession appear to be consensus.

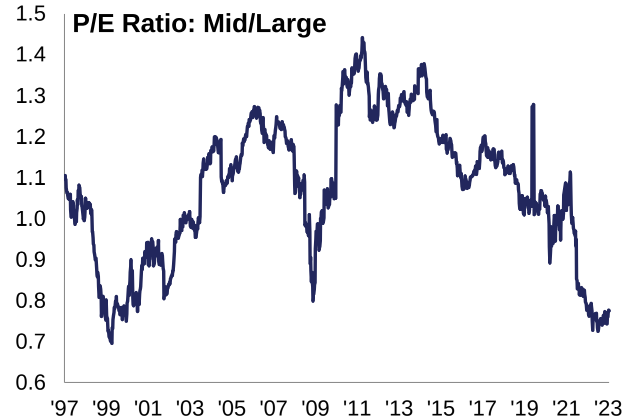
Interestingly, while recession fears appear to be the market's "base case" for 2023, it should be noted that the labor market remains incredibly strong under the surface. At present time, the unemployment rate stands at 3.5%, near record lows. There are more than 10 million job openings in the US, more than the total number of people looking for a job, Service sector employment is still below pre-pandemic levels. There has never been a recession post WWII with unemployment sub-4%. This gives us confidence that any economic slowdown, or even recession, could be buffered by the strong labor market, lessening any potential drop off in consumer spending. Even as news stories of headcount reduction and layoffs at the likes of Microsoft, Google, Facebook, etc. grab headlines, recent data from Zip Recruiter (the online job board) note that many of these workers are getting snapped up in a matter of a few weeks, underscoring the demand for workers, especially those highly skilled and tech oriented. Surely job gains are slowing, but the labor market remains in expansionary territory.

Valuations are cheap-"er" in many cases, and in others downright bargains

Valuations corrected meaningfully in 2022, with most of the froth coming out of even the most speculative corners of the market. From "FANG" to BTC (Bitcoin), SPACs to NFTs, IPOs, to anything left with an acronym, most were hit harder than the broad market. Nearly everything got walloped as investors took a ready-fire-aim approach to their investments. Shoot first, ask questions later. There were surely some babies thrown out with the bathwater last year, and there is value to be had in select parts of the market. While the S&P 500 trades roughly in-line with its historical 10- and 25-year average Price to Earnings (P/E) ratio of 16x, that represents a material correction in the context of history. With positive earnings growth and a slight dividend kicker, last year's return of -18.1% included more than -20% of multiple contraction. P/E corrections of 20% or more are rare, and historically have offered investors an attractive long-term entry point. So while the S&P 500 has definitely been cheaper in the past (i.e. 2008), they have rarely been cheap over the course of history.

Mid- and Small-Caps, on the other hand, look like downright bargains at current valuations. As we wrote about back in July (and subsequently purchased on multiple occasions), Small- and Mid-Caps are as cheap as we can remember when compared to Large-Cap stocks. Trading at 13x earnings, both represent meaningful discounts to history, and continue to trade at some of the lowest levels in more than 30 years. Cheaper than 2008 even. As the market's recovery broadens out, market advances are coming from a broader base. Market breadth is expanding, with the NYSE advance to decline ratio at the highest level since September, Nearly ⅔ of companies within S&P 500 are above their 200 day moving average, a measure of market trend. Long story short, equal weighting, focusing on Small- and Mid-Caps, or looking at the "average" stock in the market looks more attractive than those with the largest market capitalization or growth prospects.





Source: Bloomberg, Nottingham Advisors

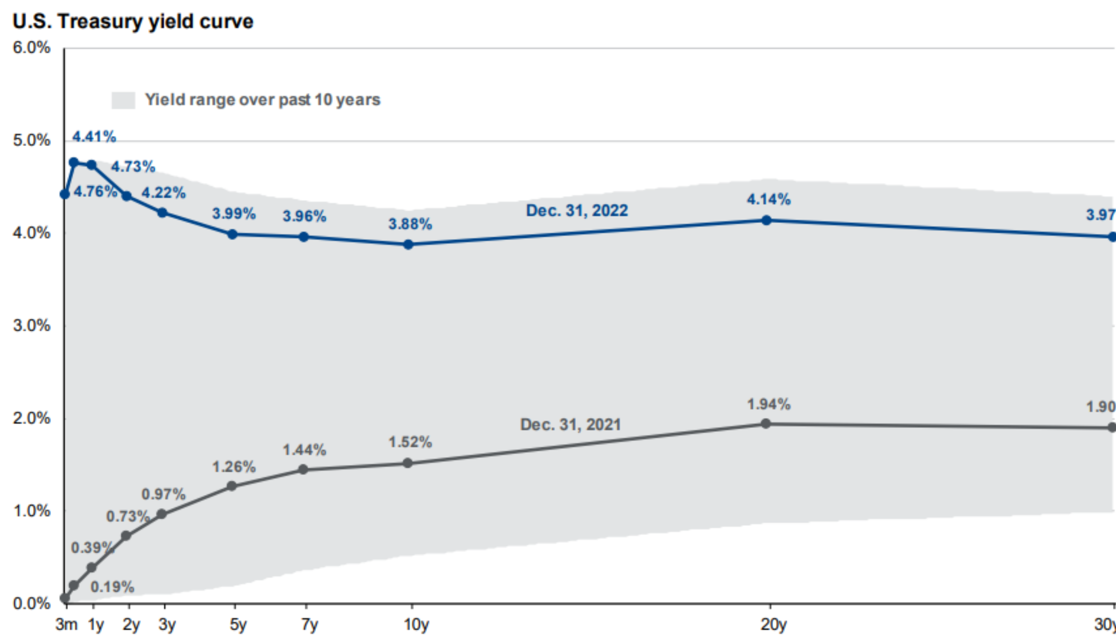
International equities appear cheap too, especially those in Europe and Emerging Markets. Trading at a significant discount to history and to US stocks, equity valuations reflect a lot of bad news. Russia's war in Ukraine and China's Zero Covid policy had investors running for the hills for most of 2022, but they're slowly returning as China re-opens (and officially ended the aforementioned policy in October) and the war enters year two without as severe an energy crisis or inflationary shock as once feared. The weather was warmer than expected and Germany looks to be breaking its dependency on Russian energy, building new liquefied natural gas (LNG) import terminals and diversifying its energy base. Oil prices are about where they were a year ago, before the invasion. China's reopening may help slow the export of inflation, help Europe skirt severe recession, buffer the global economy, and improve logistics and supply chains alike. All positive at the margin for the economic and inflationary outlook globally, but especially for Europe. A lot has changed in a short amount of time. Should the dollar continue its downward trajectory (it's at the lowest levels since June), international currencies will strengthen, and investors should most notably see a stronger Euro (more than 50% of the Dollar Index). This would be additive to total returns for dollar based investors investing internationally, previously a headwind for much of the past decade.

Bonds are also cheap, offering levels of yield we haven't seen in over a decade, and in some cases since before 2008. Short-term Treasuries yield nearly 4.75% risk free. In a world without any free lunches, this one is pretty close. Short- and intermediate-term corporate bonds readily yield 4-5%. High yield corporate bonds yield north of 8%. While yields have been higher in the past, today's starting point in yield is important. Cash is now a viable asset class and there is meaningful opportunity cost to let funds stand idle.

The shape of the yield curve is wonky. The 2-year Treasury is below Fed Funds, indicating the market expects rate cuts in 2023, with the inversion spanning the curve. The 10-year to 3-mo Treasury spread is the most inverted on record, portending recession. The measure's creator, Cam Harvey of Duke University, says this time may be different. With the curve nearly flat from 10's to

30's, the market is voting that long-term economic growth is going to be subpar at best (the old 2% GDP may be more like 1.5-1.75%) and inflation expectations are well anchored. If a low inflation, low growth future is in the cards, high quality bond duration looks like a viable hedge.

Furthermore, those who have historically looked for 5-7% annual portfolio returns can now come close to hitting those targets with bonds, or at least significantly less equity exposure than previously required. Asset allocations can be adjusted to de-risk portfolios and achieve more income and stability to help investors achieve their long term goals and objectives.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of December 31, 2022.

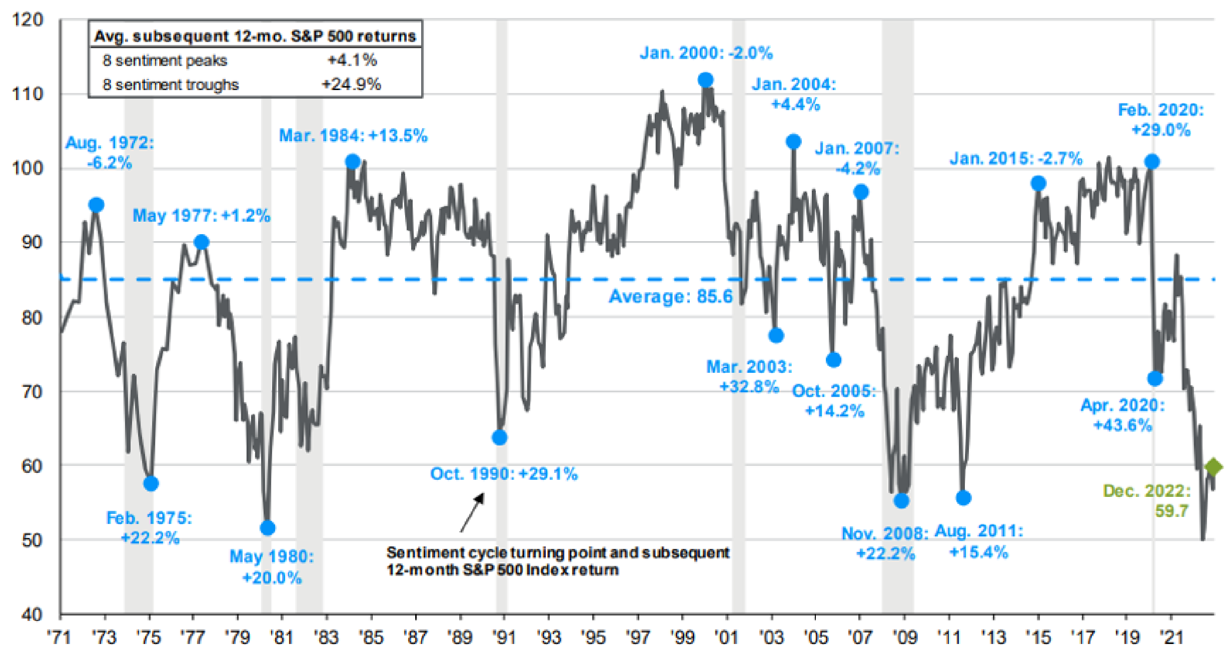
It's always darkest before the dawn

2022 saw stocks and bonds correct due to rising rates and rampant inflation. 2023 should be the year in which investors focus on corporate earnings as inflation comes back under control. With nearly 50% of the S&P 500 scheduled to have reported by this week's end, investors should have a real time bottoms-up view of the health of the consumer and near-term outlook for the economy. Earnings estimates have fallen coming into earnings season, but not off a cliff. The Dollar was a headwind in 2022, but could be a tailwind in 2023. Inflation coming down should help both consumers remain resilient, and companies maintain profit margins. Companies have raised prices and consumers largely haven't balked. In cases where consumers have balked to a degree, companies have raised prices greater than volumes have fallen. The previously mentioned layoffs and job cuts should help bolster earnings at the margin as companies' right size. Ultimately, if earnings come into focus and take center stage, the challenge will be determining what multiple to pay for those earnings in the future. Is it the 14x trough in 2008, the 16x long-term average, or a more recent 18x in a world where macro risks recede and markets can once again focus on company specific items?
Inflation by many measures is slowing meaningfully, and has been since June. Headline CPI has fallen for six straight months (from 9.1% Y/Y to 6.5% Y/Y), including -0.1% M/M in December, the

first month of decline since May 2020. Core CPI (ex food & energy) has fallen for three straight months (from 6.6% Y/Y to 5.7% Y/Y). Gas and other commodity prices are lower (although higher this month), manufacturing prices paid continue to fall as supply chains improve, while headline inflation has cooled. Rents are falling sharply in real time according to the likes of Redfin and Zillow, two online marketplaces. Strip out the stubborn and antiquated "owners' equivalent rent" from CPI, and CPI less shelter has collapsed. Last month alone, owners' equivalent rent added +0.8% to CPI when we can see in real time that rents were negative. This gives us confidence that the noisiness of shelter in CPI may abate, and inventors can focus on the critical drivers of inflation, or more importantly the fact that the Fed may just engineer a soft landing. The money supply is shrinking, with M2 contracting for the first time in history, reversing the pandemic acceleration from multiple avenues of stimulus which saw M2 explode more than 25%. Milton Friedman famously quipped that inflation is a monetary phenomenon, and with M2 contracting, inflation should continue to slow as fewer dollars chase goods and services. Time will tell, but the runway to a potential soft landing is lit.

Finally, the sum total of consumer anxiety can be seen in the University of Michigan Consumer Confidence Index. The latest reading of 59.7 from December is in the ballpark of trough readings from other major market turning points over the past 50 years. Consumer sentiment is bleak, highlighting the damage done in markets last year. A lot of bad news was priced into markets in 2022, and markets reflect that lack of optimism.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.
Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2022.

Portfolio positioning

In summary, there's ample opportunity for investors looking to play offense, defense, or a little bit of both. At Nottingham we're straddling the fence, finding opportunities to add to attractive long-term positions (i.e. Small- and Mid-Caps, International, Fixed Income), while also playing defense. While the runway to a soft-landing is lit, the runway could narrow or the lights dim at a moment's notice, finding ways to hedge portfolio risk is still critically important. We've recently added to positions in defensive sectors and income generating assets, while maintaining healthy exposure to cash/cash equivalent and precious metals to manage some of that risk.

After a strong start to the year for financial markets, Fed Chair Powell is set to take the mic Wednesday afternoon. With markets continuing to price in rate cuts and with economic conditions easing (i.e. higher asset prices), Powell could pull a Jackson Hole and give a hawkish speech to jawbone equity markets lower and bond yields higher. Inflation could remain stickier than anticipated, and of course the US (and the world) could fall into recession. While all of those scenarios have a non-zero probability, the bottom line is that our Team continues to find attractive investment opportunities despite this significant uncertainty. It's time to nibble, both strategically and tactically, while playing both offense and defense in today's market.

Thank you for the opportunity to be stewards of your capital and for your continued trust in our Team. To hear more about our outlook and how we're positioning portfolios for a range of outcomes, please give us a call. We'd love to hear from you.

Matthew J. Krajna, CFA
Co-Chief Investment Officer
January 2023

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