

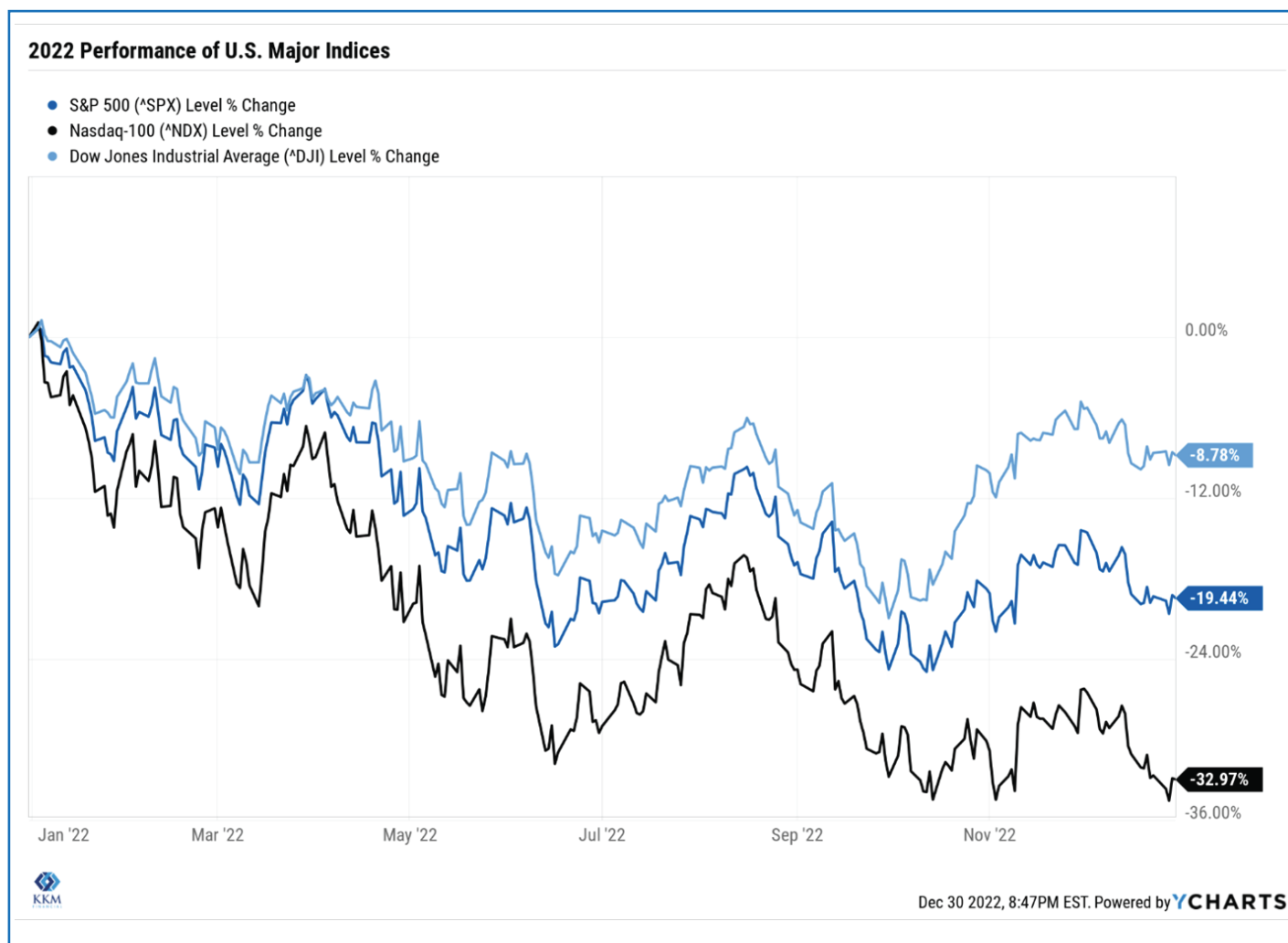
CIO CORNER



OUTLOOK 2023

**"An investment in knowledge pays the best interest."
-Benjamin Franklin**

Goodbye 2022 & Hello 2023 – U.S. stock investors could not be more eager to turn the page on 2022 as it was painful and challenging on a variety of fronts. It was the worst year for the stock market since 2008, with volatility to match: The S&P 500 saw 46 daily moves of 2% or more in either direction, the most since the 2008-09 financial crisis. All three of the major averages suffered their worst year since 2008 and snapped a three-year win streak. The Dow Jones fared the best of the indexes in 2022, down about 8.8%. The S&P 500 dropped 19.4%, and is more than 20% below its record high, while the tech-heavy Nasdaq tumbled 33.1%.



After years of zero interest rates that generously assisted financial asset prices, rates screamed higher in response to the aggressiveness of central bank policies implemented to combat the U.S. economy's soaring inflation. This sling shot up in rates left investors few places to hide.

These market-punishing Federal Reserve rate hikes which were designed to combat the steepest inflation in 40 years, will force this twelve-month snapshot to go down in the books as a year to forget. With historic velocity in the rate normalization process combined with wicked volatility injected into this year's acute equity market revaluation, investors may benefit in the New Year knowing that this brutal process (which took stocks and bonds down together) is largely in the rear-view mirror.

2023 OUTLOOK HIGHLIGHTS:

- Cautiously optimistic on U.S. equity markets recovering and not retesting 2022's October lows. 2023 S&P 500 target of 4600.
- Inflation should continue to ease in 2023, but recession risks grow as a concern.
- Encouraged that a full global economic reopening will finally come to fruition in 2023 post the Covid-19 pandemic, specifically in mainland China.
- The S&P 500 has historically outperformed the market in the 12-month period after a midterm election year, with an average return of 16.3%.
- As the Federal Reserve's aggressive tightening campaign nears an end, its enormous \$8.6 trillion balance sheet should serve as a significant shock absorber, allowing for a "soft-landing".
- Strengthen your core: remain focused on Essential names favoring blue-chip companies.
- U.S. equity returns will again be driven by earnings. Consider owning companies with pricing power, stable cash flows that trade at reasonable valuations.
- Trust the Bond Market as the Fed will most likely flinch and "pause" or "pivot" to avoid a recession.
- Sector themes will persist, selecting exposure will again be critical to take advantage of sector dispersion.
- Fixed Income opportunities in assets such as U.S. Treasuries and investment grade credit at the expense of senior loans and lower quality high yield. Selectively choosing higher quality corporate debt offers compelling yields. Municipal bonds also look particularly undervalued.

LOOKING BACK AT 2022

2022 was all about inflation. The global stock market experienced a massive pullback after forty-year high inflation invaded our economy which forced the "asleep at the wheel" Federal Reserve into taming inflation with a severely hawkish response. Thankfully, and finally, the October CPI print showed the first signs of inflation truly abating and markets rejoiced at the prospect of the Federal Reserve having the ability to stop aggressively hiking interest rates.

Whether the Fed pauses early this year or not, history suggests changes to monetary policy impact the economy with long and variable lags... so investors would be wise to remain wary in 2023.

The Fed's historically aggressive tightening cycle raised interest rates by a cumulative 4.25% this year, the most since 1980. Other central bankers around the world quickly followed lock-in-step.



As of December 30th, the S&P 500 was down almost 20% year-to-date (YTD). The U.S. stock market lost roughly \$12 trillion in market cap from its early January high. After three consecutive years of posting positive and impressive returns for investors, the benchmark U.S. stock market index recorded the worst annual performance since 2008. 2022 was a surprising and damaging year as both stocks and bonds were negative on the year.

Against the historic pandemic related volatility of 2020 and 2021, and after the Covid-19 global lockdowns (which saw the deepest global downturn on record, followed by the strongest rebound) 2022 growth outcomes were indeed far more stable. But this past year was remarkably turbulent, while the global economy was forced to contend with multiple headwinds.

Supply and demand issues again spilled into labor markets, additional global COVID-19 complications and a brazen as well as shocking Russian invasion of Ukraine were top of mind for investors globally.

While the 2022 selloff in the S&P 500 has been mostly driven by inflation and the Fed's assertive tightening, American households endured and revealed resiliency. Growth was dislocated and staggered primarily due to the meteoric rise in interest rates. The U.S. consumer stayed strong and corporate earnings found a way to persevere.

As the New Year is upon us, there are certainly risks on the horizon, including stubborn inflation, confusing labor shortages and the persistent and ever evolving global pandemic. Being optimistic while being realistic on the next economic cycle presents several challenging scenarios but, I do envision equity markets to move higher in 2023. Investors have focused on the reality of a potential recession and arguably the Fed desires some form of a recession to achieve their unrealistic and short-term target of 2% inflation.

As we head into 2023, I see a dynamic market cycle in motion, and it is critical to recall that market volatility can move markets erratically higher in a similar fashion that volatility typically moves markets spastically lower.

Fundamentally, I am optimistic as a solid foundation for a post mid-term election rally lay ahead. Valuations are not stretched (roughly 18x forward earnings) relative to history. When viewed through equity risk premiums and corporate earnings, growth should be above trend in 2023. Certainly, the interplay of inflation and central-bank intervention (or pausing) will ultimately shape the story of economic growth for 2023.

My 2023 Outlook theme reminds me of my college football days when Coach Lou Holtz taught us players the acronym "W.I.N." which stands for "What's Important Now". Continued consumer strength, earnings resiliency, and Fed Policy pivoting are three important inputs that will reveal "What's Important Now" in 2023.

2023 TOP 10 FOCUS LIST

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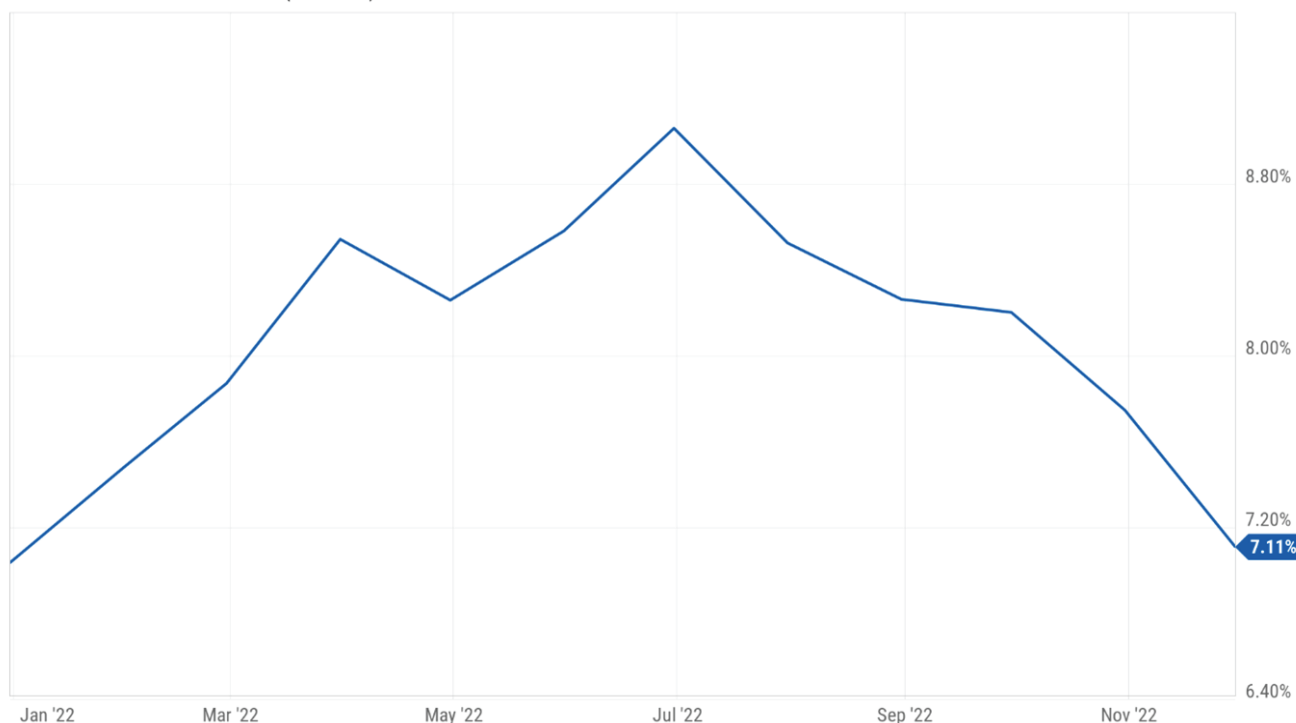
INFLATION:

Inflation and pressure from interest rate hikes are likely to ease in 2023, but ramifications have materialized as recession risks are growing. A mild recession in the U.S. is a possibility, but a worse and more challenging environment exists in Europe. End of year data was encouraging as prices rose less than expected in November, the latest sign that the runaway inflation that has been gripping the economy is beginning to loosen up.

The consumer price index, which measures a wide basket of goods and services, rose just 0.1% from the previous month, and increased 7.1% from a year ago. Economists surveyed by Dow Jones had been expecting a 0.3% monthly increase and a 7.3% 12-month rate.

Inflation in 2022 looks similar to the Grand Tetons in Jackson Hole, WY

● US Consumer Price Index YoY (I:USCPIYY)

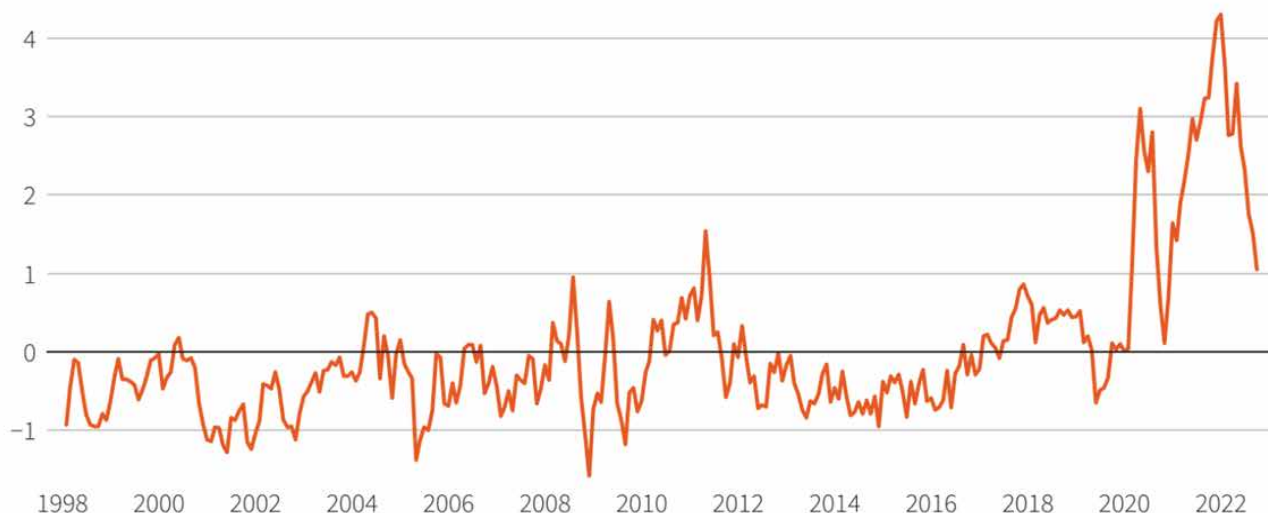


SUPPLY CHAINS:

Businesses globally have been forced to deal with a variety of headaches over the past two years associated with significant and on-going supply chain issues. Disruptions, delays, workarounds, and all-out stoppages (at ports) became common as COVID-19 brought the fragility of the world's supply chains out into full view. Consumers endured a chicken-and-egg scenario with inflation and supply chain disruption. Prices spiked because of supply chain disruption, helping to increase inflation, which in turn fed price hikes that then affected the supply chain. According to U.S. Bank, the cost of living in the United States, as measured by the Consumer Price Index (CPI), rose by more than 9% from June 2021 to June 2022. The massive 2022 rate hike campaign by the Fed was intended to stifle inflation in an effort to help solve the problem. Supply chain woes related to shortages and congestion at ports worldwide are expected to trickle into 2023 but, optimism in supply chain issues relieving is on the horizon.

Global supply chain strains have eased

But the improvement has been uneven across products, and some goods remain scarce.



Source: New York Fed Global Supply Chain Pressure Index

Reuters Graphics

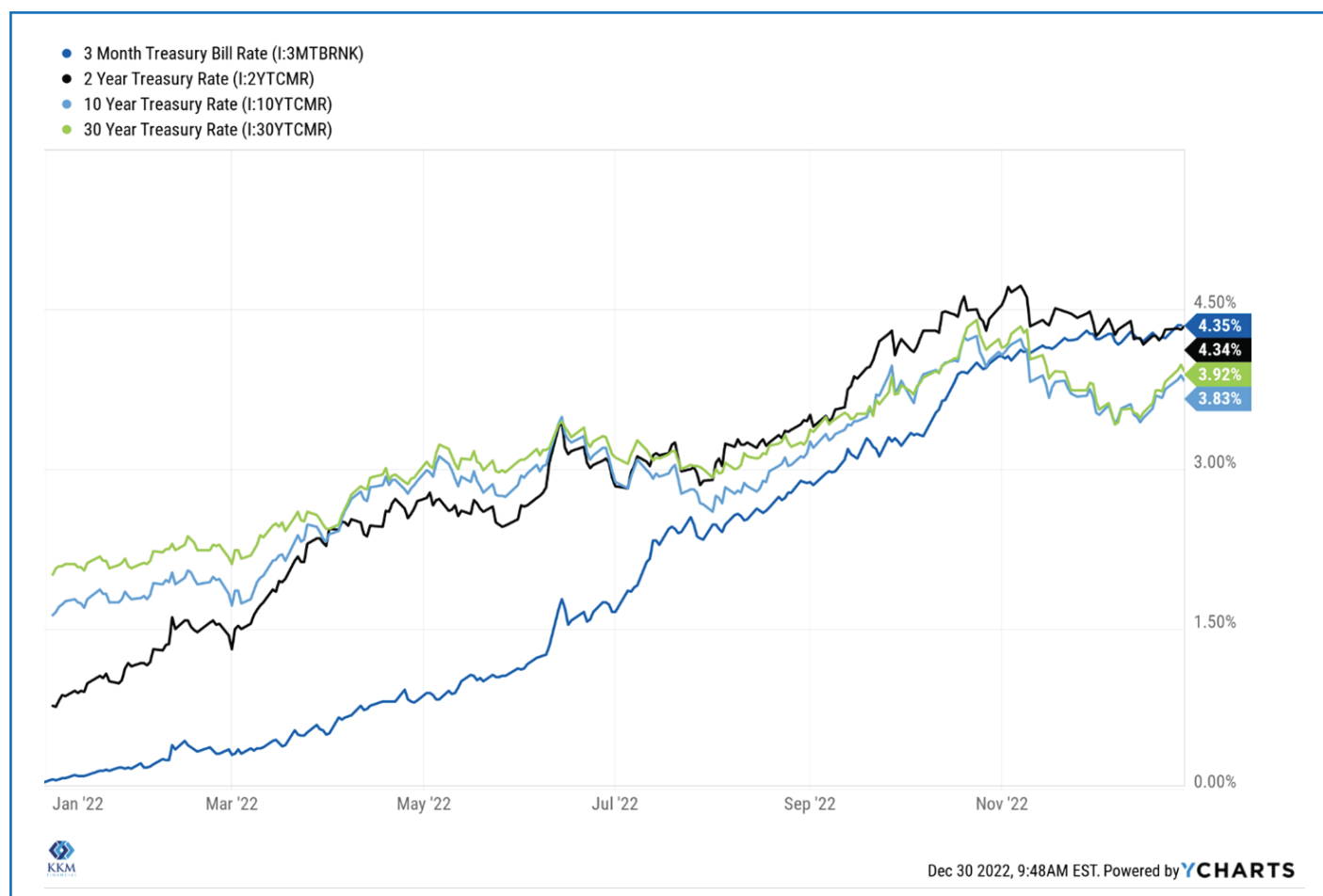
U.S. TREASURIES

As the Fed awoke from their slumber in late 2021 and realized that they can't manipulate the 10-year note to stay suppressed at 1.5% anymore, their ferocious rate rising campaign (kicked off in January 2022) pushed the 10-year yield to over 4.25% by October '22. I have never experienced such a one-way move in the Treasury complex in my entire trading career which started back in the U.S. Treasury Futures pits in Chicago dating back to the era when DVDs first went on sale (1997).

However, the Treasury markets are finally rewarding investors after this massive move higher in yields across the entire curve. Higher rates have created attractive and defensive yield opportunities on the short end of the curve, specifically Treasuries with less than one-year of maturity given the recent inversion of the 3-month and 10-year yield.

An aggressive Fed and the likelihood for more rate hikes to come mean yields on 3–12 month T-bills are now higher than those of all different tenors. And given the maturity band, the rate risk for this exposure is minimal, as shown in the following chart. It is hard to believe that 3-month bills are yielding more than 400 bps as we closed out the year, the same Treasury bill was yielding closer to 40 bps just one year ago.

With Fed Chairman Powell only unwinding the Fed's swollen balance sheet by \$95B per month, I believe they are intentional in having this \$8.6 trillion dollar shock absorber remain securely in place as Jerome attempts to toe-tap his way around a recession. I will again lean heavily upon U.S. Treasuries for overall market leadership in 2023 and also be mindful of the U.S. Dollar level. The Greenback's recent pullback should have a lagging and positive impact on equity markets moving forward. Any hint of dovishness from the Fed will push the U.S. Dollar lower too, aiding stocks.

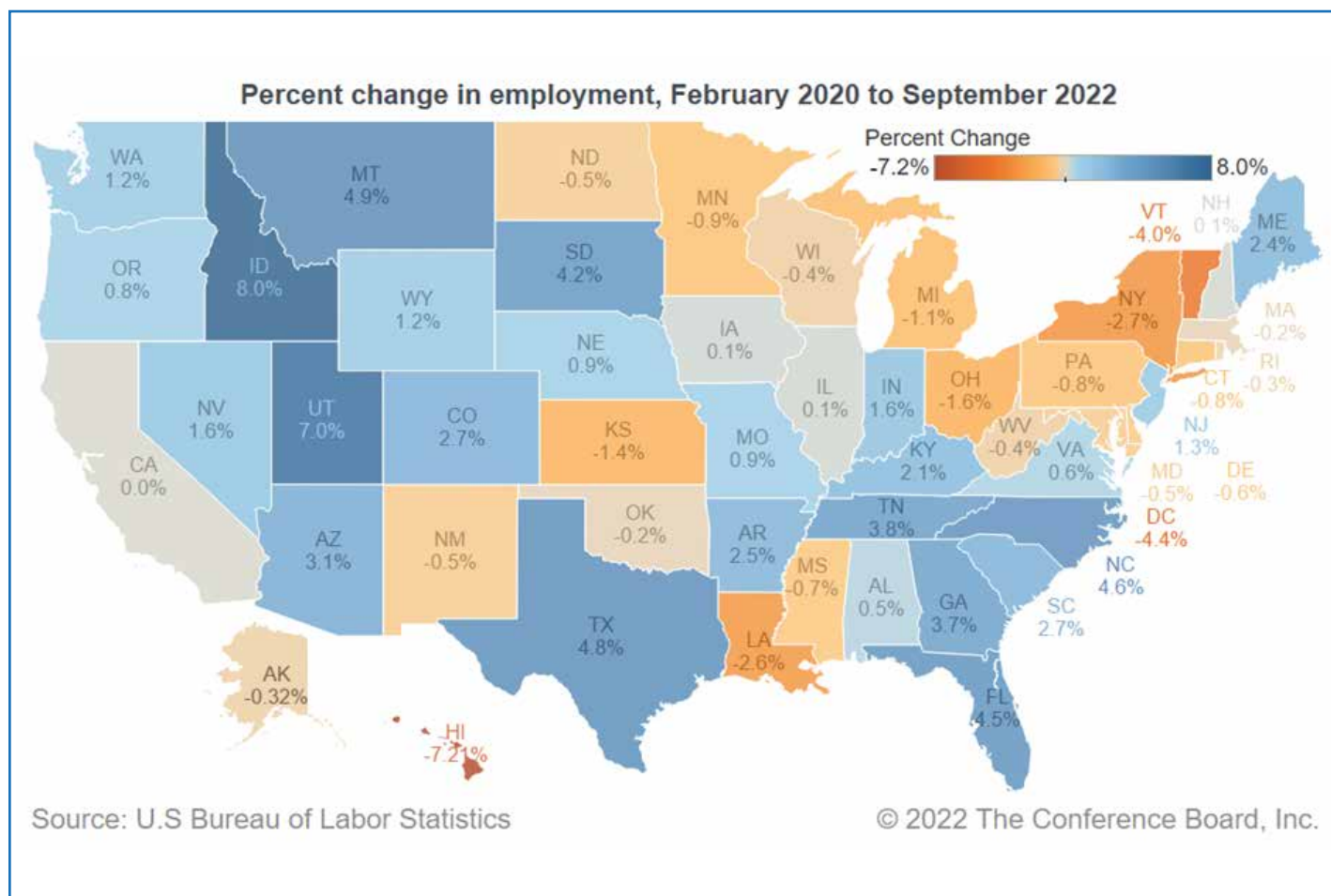


LABOR MARKET:

The labor market has remained quite strong even as fears of a recession mount, and Fed Chairman Powell has cited it as a key source of persistent inflation while the Fed continues to attempt to thwart. It is true that fewer workers are searching for jobs, and satisfaction among workers is up, but those are not the key takeaways from Q4 2022 New York Fed data on a labor market that continues to be too hot for the central bank's inflation-fighting comfort levels.

Workers are expecting and flat-out demanding more money than ever on the job. The lowest average wage Americans are willing to accept for a new job increased from \$72,873 in July to \$73,667 in November, the highest reading ever in the Federal Reserve Bank of New York's Center for Microeconomic SCE Labor Market Survey, released on Monday.

The level surpassed the \$73,283 record reached earlier this year in March, which it had more recently dipped below. The increase was most pronounced for respondents below age 45. Fed Chair Jerome Powell recently delivered, during his FOMC presser in December, that the labor market remains too hot and wage growth too high.

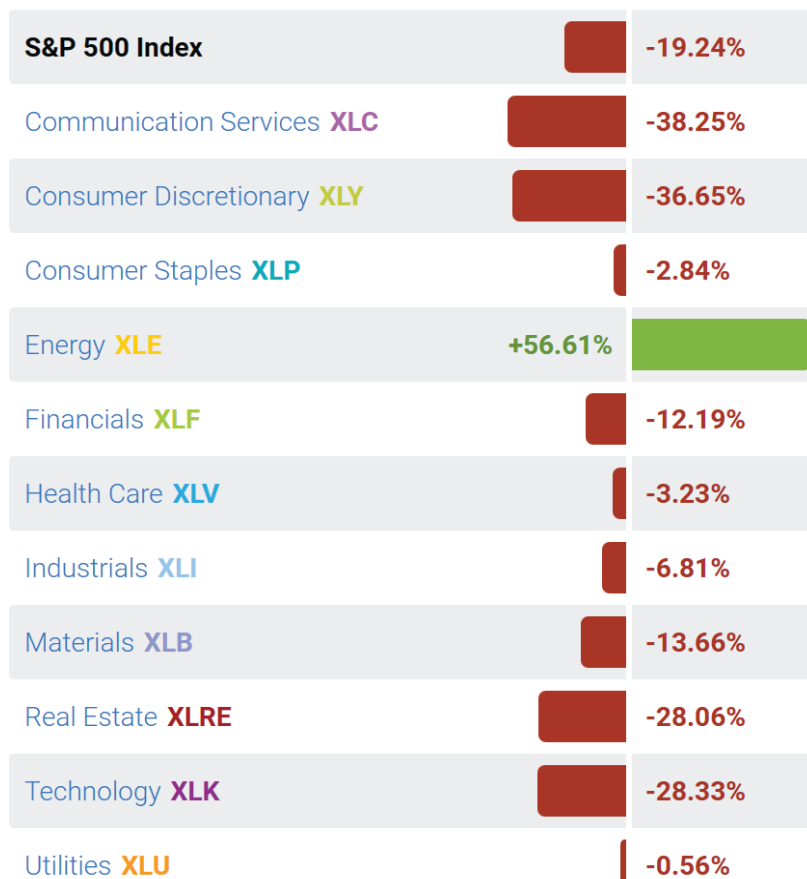


SECTOR SIGNIFICANCE:

Communication Services was the worst performing sector in the S&P 500 this year, falling more than 40%, followed by Consumer Discretionary. Energy was the only sector to rise into positive territory, climbing a remarkable 59%.

Repricing of valuations squarely hit Big Tech and Consumer-Discretionary stocks in the jaw while investors continue to tilt towards Healthcare, Consumer Staples, and Energy.

The KKM Sector Rotation model seeks to identify major themes in the market, have exposure to those sectors controlled by demand and eliminate exposure to those sectors controlled by supply. I believe having conviction on proper sector exposure and more importantly, tactically avoiding certain sectors that may lag will again be an important theme in 2023.



SECTOR TRENDS FOR 2022

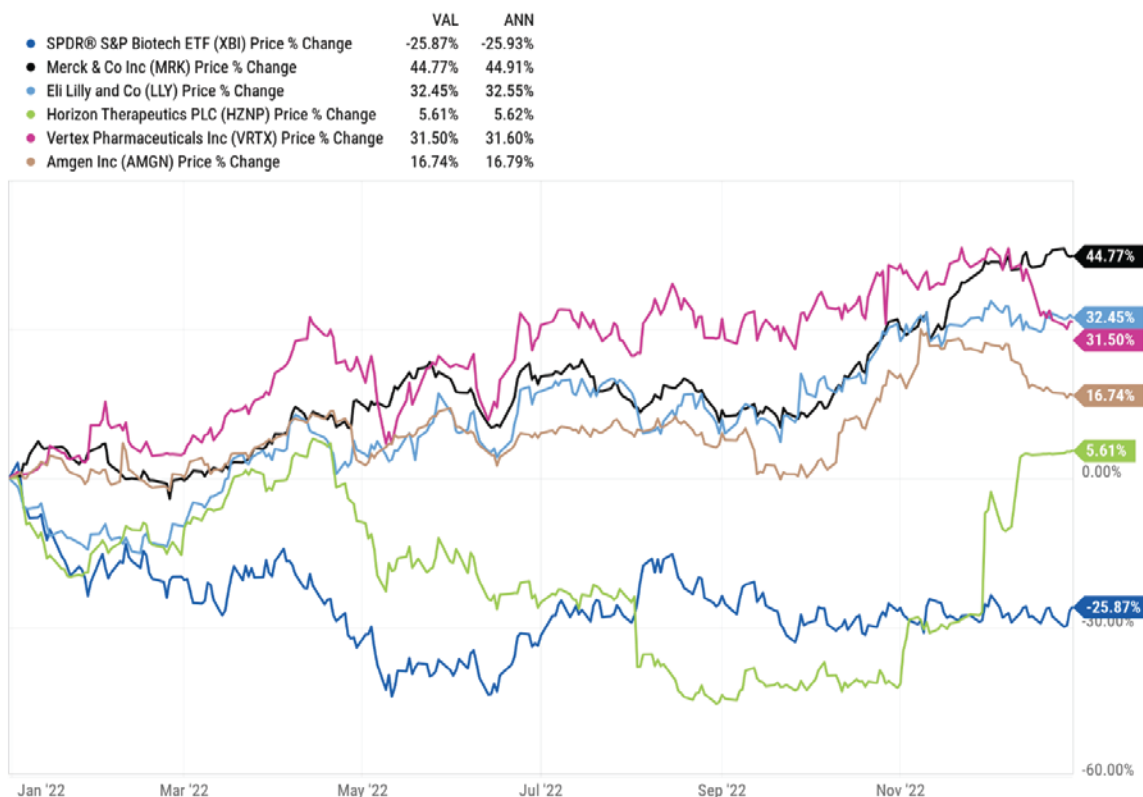
Energy

Crude oil peaked at \$127.98 a barrel in March as Russia's invasion of Ukraine sparked sanctions against Russian oil and natural gas and imperiled supply. The spike didn't last, however, as the U.S. and other countries sold oil from their strategic reserves, and China's rigid Covid rules caused demand to fall. By December, oil was back below \$80, but that didn't bother oil stocks. The energy sector has soared over 50% in 2022, thanks to a level of capital discipline that the industry has rarely shown.

Healthcare (Biotech too)

Consider the health care sector, which features innovative pharmaceutical companies that are well-capitalized and hold pricing power. Select drug makers can use near-term profitability to fund acquisitions and other growth strategies. That's especially important when rising rates may limit a company's ability to fuel their growth with debt. Investors looking to play defense this year ran to the notionally recession-proof, dividend-paying large-cap healthcare stocks. The Health Care Select Sector SPDR ETF (XLV) is flat on the year, which is a big win for 2022. Riskier healthcare stocks had a rougher ride, with the SPDR S&P Biotech ETF (XBI) falling more than 40% by mid-June. It has since rebounded but will finish the year down more than 20%. In biotech, it's the mature companies with plenty of cash (particularly those already generating revenue) that seem likely to retain investor confidence. While mergers and acquisitions heated up late in 2022 (Amgen acquiring Horizon Therapeutics), deal making still fell short of expectations, and Big Pharma has plenty of dry powder. Watch for more M&A next year. 2022 saw meaningful divergence across larger- and Smid-cap. Across Larger-Cap Biopharma, I anticipate improving growth helped by moderating FX headwinds, high-profile launches, and new products drivers from recent M&A. For Smid-cap Biotech, I see positive clinical data, lenient regulatory environment, new drugs with potential strong launches, and a more than likely uptick in M&A as fundamental drivers.

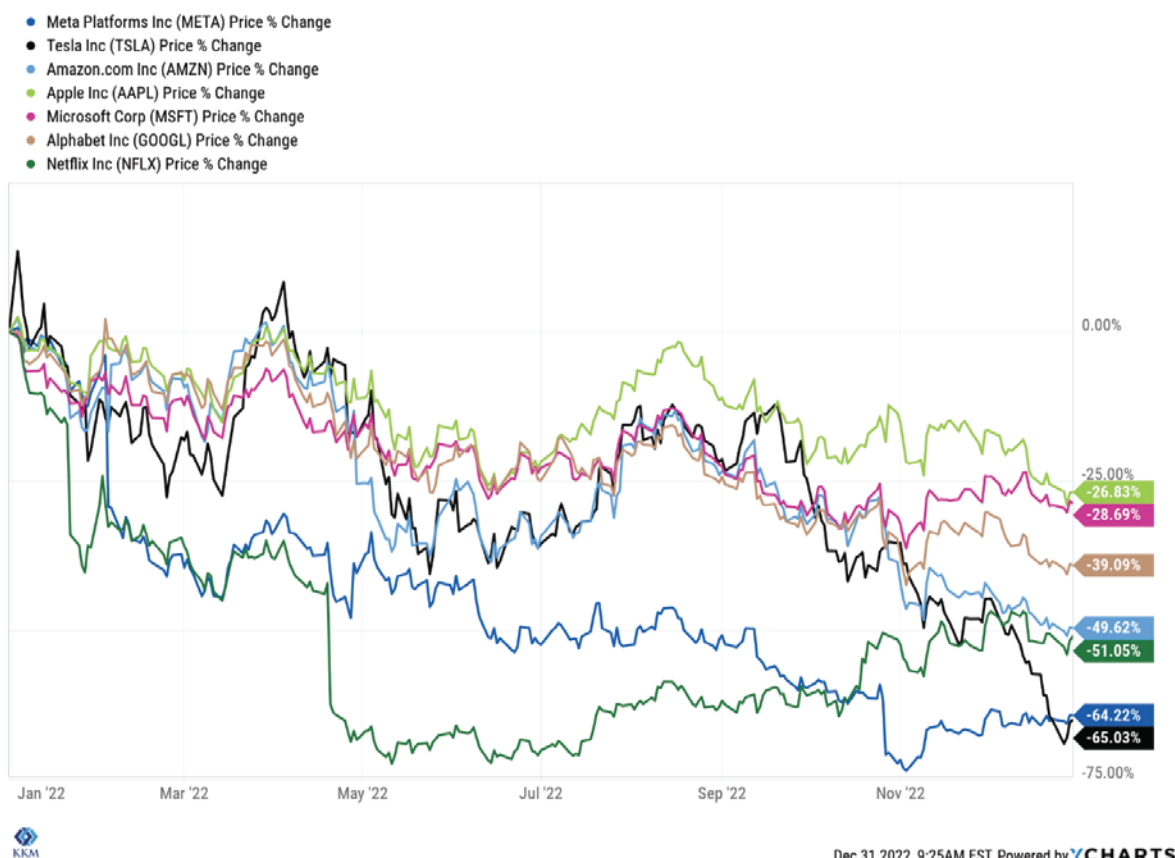
Dispersion in 2022 Biotech



TECHNOLOGY:

Technology stocks endured profound pain this past year, with many analysts likening the selloff to the bursting of the tech stock bubble more than 20 years ago. Surging interest rates and bond yields plagued tech sector investors and dampened sentiment for the space as tech became dramatically less alluring. A higher risk-free return also impacted valuations by reducing the present value of cash flows expected in the future by these high-growth companies. Arguably, some F.A.A.N.G. stocks are now ironically revealing value. Setting all politics to the side, Tesla stock price has revealed the most oversold conditions for a S&P 500 company via its RSI (Relative Strength Index) reading. Shares sank about 65% from the start of the year, amounting to a loss of more than \$700 billion in market value.

Tech Wreck 2022



ESSENTIAL STOCKS:

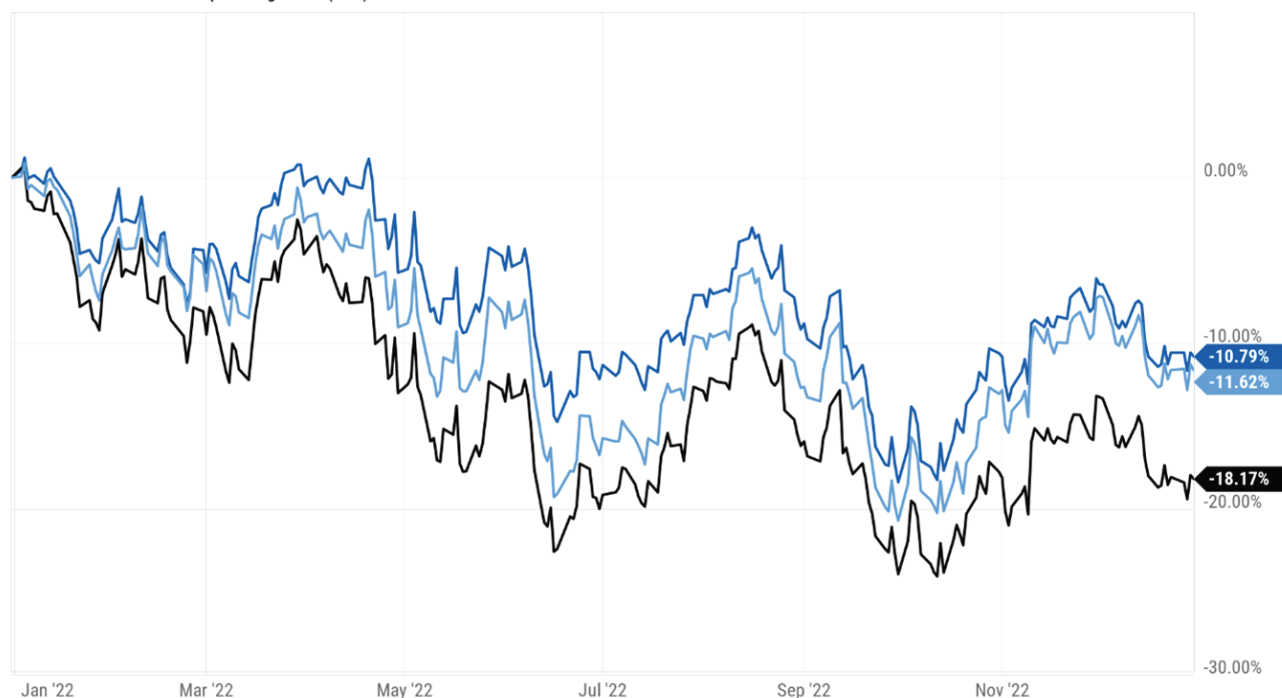
Higher inflation may remain into 2023, but it need not be a cause for grave concern. Investors can build a portfolio that acknowledges and mitigates inflation risks. Relying on equities relative to fixed income, and focusing on cyclical, industrial and real estate for sector exposure could prove to be effective approaches in the New Year. Equities tend to do well in inflationary environments because corporate earnings are also remaining strong. In addition, I believe equities of companies that are more directly tied to economic activity and interest rates will have the opportunity to outperform (again) this year.

Rely on large cap blended equities, especially cyclical ones, to drive capital appreciation again in 2023. Owning blue-chip names that I refer to as “essential” U.S. economy names in 2022 indeed created diversification and at the same time dampened volatility in the tumultuous markets last year. Invoke your inner Peter Lynch and think about names that you know and take it a step further focusing on names that you use in everyday life.

Owning a model portfolio in an equal weighted manner (like KKM's Essential 40) versus market cap weighted proved to be a proper strategy for 2022. For example, in 2022, Invesco S&P 500® Equal Weight ETF (RSP) was down 13.21% vs. SPDR® S&P 500 ETF (SPY) being down 19.48%. For a deeper drill down on the Essential 40 model portfolio which is equal-weighted, search ESS40TR.

Essential 40 (ESSIX) vs. S&P 500 (SPY) vs. Equal-Weighted S&P 500 (RSP) 2022

- Essential 40 Stock I (ESSIX) Total Return
- SPDR® S&P 500 ETF Trust (SPY) Total Return
- Invesco S&P 500® Equal Weight ETF (RSP) Total Return



Dec 31 2022, 10:26AM EST. Powered by **YCHARTS**

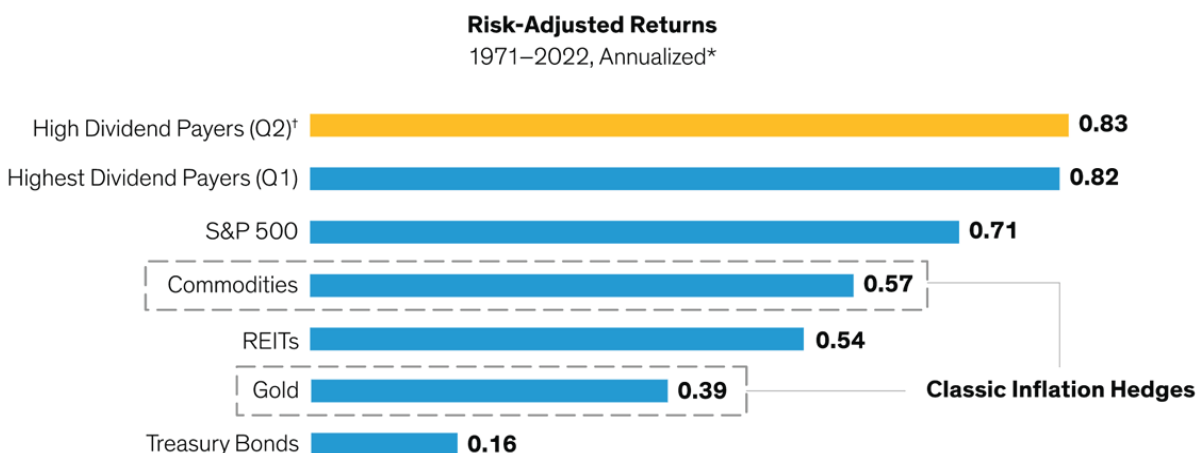
DIVIDEND FOCUS:

For the past decade investors had little reason to pay much attention to dividends. With U.S. tech darlings (F.A.A.N.G. stocks) generating double-digit returns and dominating total market returns, dividends appeared downright boring. Boring is now beautiful. And true to our KKM model portfolio's name of "Dividend Focus", I believe 2023 is a time to **focus** on certain dividend names. Defensively, dividend payers have a consistent track record of returning value to shareholders.

Typically, they also have a strong relationship to the value factor, a pro-cyclical exposure. As a result, dividend-focused strategies seek to position investors for a cyclical recovery, without needing to pinpoint the timing of the pivot. While inflation has declined from its June 2022 peak, it's still stubbornly elevated at a four-decade high. Consumer inflation expectations also remain near 40-year highs. While aggressive Fed policy has led to some improvement, defeating inflation will take some time as policy implementation has a lagging effect.

In the early 1980s when CPI was this elevated, it took nearly 15 months for inflation to work its way back below 3%. History shows, however, that dividend stocks thrive in prolonged inflation-driven markets. Since 1948 (including three periods of high inflation in the 1950s, 1970s, and 1980s) high-dividend stocks significantly outperformed their low-dividend peers and the broader market when 12-month average CPI inflation was in the top two quintiles (above 3.25%). Some investors rely on “classic” inflation hedges, such as commodities or real assets. History suggests that these assets tend to indeed perform well in inflationary eras. But if and when inflation retreats, those investors might be left in the cold. Assets held for inflation protection, such as commodity stocks or gold, are not reliable sources of long-term returns (per chart). On the other hand, high-dividend stocks have delivered stronger risk-adjusted returns over time.

Classic Inflation Hedges Have Lower Long-Term Return Potential



Past performance does not guarantee future results.

Commodities is a supersector based on Bernstein sector classifications for energy, industrial commodities and gold. REITs, or real estate investment trusts, are a GICS sector.

*Return/volatility

†Second-highest quintile of S&P 500. The third, fourth and fifth quintiles have lower risk-adjusted returns.

As of August 31, 2022

Source: FTSE Russell, S&P, MSCI and AllianceBernstein (AB)

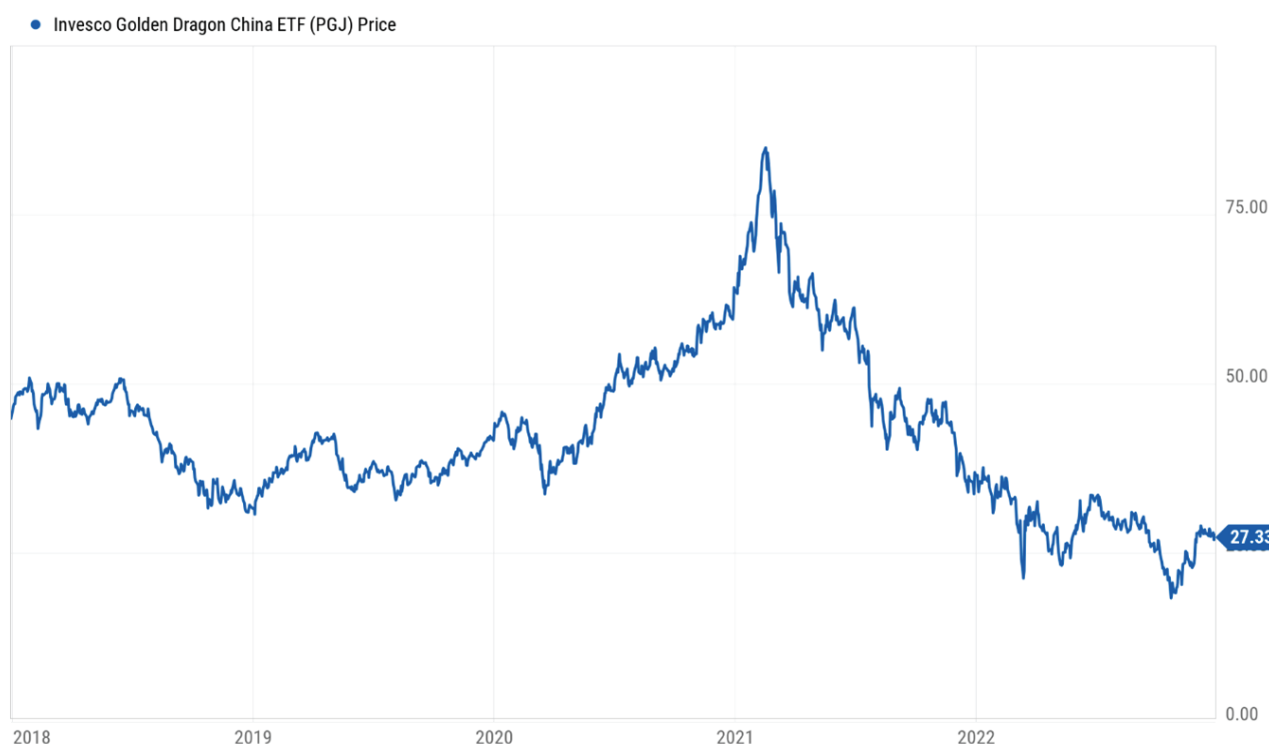
CHINA:

2022 was not a kind year for the broader emerging market complex, specifically for China's tech stocks. Emotions have been high as billions have been wiped off the value of the country's internet giants including Alibaba and Tencent. In addition, companies have posted their slowest growth rates on record. A consistent and persistent Covid resurgence in China, which the government countered with its strict “zero-Covid” policy of swift and harsh lockdowns in major cities, has hurt the world's second-largest economy.

2023 is the year of the Rabbit and cautious optimism is abundant. To close 2022, the Chinese government implemented sharp changes to its Covid policies, allowing domestic travel and quarantines at home in a move to keep businesses running. Among the changes, people will no longer need a negative Covid test to travel to a different part of the country. Local authorities have also removed many testing requirements. The changes from Beijing came just a few weeks after significant protests erupted across China over the country's strict Covid controls. Demonstrators severely clashed with authorities in several major cities, including Shanghai and Beijing.

Chinese internet firms have seen a slowdown as consumer spending was hit and advertising dollars were cut back. Investors are cautious but, slightly optimistic as signs that China's economic "reboot" has given investors hope of a turnaround. Broad swath potential exposure can be obtained through the Invesco Golden Dragon China ETF (PGJ).

Invesco Golden Dragon China ETF (PGJ) - 5 Year Chart



Dec 31 2022, 9:57AM EST. Powered by **YCHARTS**

VOLATILITY (VIX):

Equity investors faced wild market swings in 2022. The S&P 500 saw 46 daily moves of 2% or more in either direction, the most since the 2008-09 financial crisis. Next year is likely to be a strange mixture of known unknowns (Fed pause or pivot) and unknown unknowns (how they express themselves in the market and economy). All that means is that investors should expect an erratic, choppy market as rate hikes are digested and in turn affect the economy. Such conditions tend to favor options investors. It also places the VIX front and center. The CBOE Volatility Index, or the VIX, is the so-called "fear gauge" for Wall Street which is predicated on what traders are willing to pay for option premiums (puts and calls) traded on the S&P 500 seeking to determine what the next 30 days the S&P 500 will do, this is called implied volatility.

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POSITIONING TO 2023

Enthusiasm has been building over a potential slowdown in both the pace and magnitude of Fed rate hikes, the so-called Fed "pivot" or even "pause" you hear on CNBC often, has led to several brief but strong bear market rallies over the past six months. And several measures of inflationary data have begun to show signs of decelerating, fanning the Fed "pivot" flames. Despite the most aggressive Fed rate hikes in history, the economy, corporate profits, and labor markets aren't signaling a recession on the horizon just yet. All this has raised investors' hopes that the Fed will be able to engineer a soft landing in the first half of 2023. I am in the "soft landing" camp too.

Interest rates continue to rise as global central banks aggressively tighten to fight inflation, while still avoiding recession. With so much hinging on whether the Federal Reserve can engineer a soft landing, how should you position portfolios? As KKM partners with many top advisory teams and family offices across the country, please reach out to further discuss as each bespoke OCIO (Outsourced Chief Investment Officer) solution has important variables and inputs that we carefully measure.

Overall, I believe staying invested will be critical criterion in 2023, as there will be various spikes in volatility that may scare some investors to the exit doors. In the event cash might be raised during these potential volatile episodes, understand all of the tools in your toolbox which may help clients strategically gain appropriate exposure seeking to mitigate risk. In many ways, the COVID-19 crisis was more like a war or a natural disaster than an economic recession, and policymakers reacted with equal force. Globally, post-pandemic spending commitments totaled almost \$20 trillion, the highest levels of fiscal spending relative to GDP since World War II.

Household net worth remains near all-time highs, debt service payments are historically low and consumer sentiment has strengthened. Unpacking market issues will again be critical for investors in 2023. A unique confluence of events transpired in 2022. The continued economic reopening, Covid-19 variants and subsequent lockdowns, supply-driven inflation, and an ever-evolving framework from the Fed created confusion as there are no historical parallels or data points for reference. I favor an overweight on equities on a strategic horizon. Tactically, I believe an overweight to equities amid solid economic fundamentals expecting the stringent stance of the Fed to lessen. My view implies that I again prefer certain sectors and select equities with a blend of higher yielding yet quality fixed income this year. I envision a positive and moderate equity return for 2023, because of the Fed ending its historic rate hike cycle.

Thank you for your continued partnership and confidence in myself and KKM Financial, (KKM).

We are partners in your success. Have a healthy and happy 2023.