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2022 will forever be known in my mind as the year the Federal Reserve took on inflation. We started the year with a federal funds rate of less than 0.25% and ended the year at about 4.5%. While the Fed controls the overnight lending rate, the rest of the bond market took the cue and rates climbed across the entire bond spectrum. As we all know, when interest rates increase, bond prices decrease, and our intermediate bonds took it on the chin. Stocks were also hit as investors were concerned about a slowdown in home sales, the decrease in the overall demand for corporate goods and services and the rising costs of debt servicing along with the impact these costs will have on personal as well as corporate income.

Inflation impacts both the rich and the poor. It is a terrible cost that needs to be eliminated as soon as possible. Inflation is essentially too many dollars chasing too few goods. At the end of 2021 and the beginning of 2022, we had a perfect storm brewing. The dollars in circulation as measured by M2 money supply increased immensely due to increased government spending (some dollars were used to combat COVID) as well as historically low interest rates maintained by the Fed. At the same time, COVID created a mess when global manufacturing ground to a halt. You most likely know of someone who had to wait for several months for a dishwasher or an automobile. Then Putin's invasion of Ukraine increased oil prices which in turn impacts everything made with oil (e.g. gasoline and plastics) along with the shipping costs to ship items to market. With lots of dollars in circulation chasing fewer and fewer goods, you arrive at increased prices. What we have here is a perfect storm. The Fed addressed this storm by increasing interest rates from 0.25% to 4.50% - all in one year – and we are beginning to see the results. The year-over-year consumer price index (CPI) was 9.1% in July of 2022 and dropped to 6.5% by December of 2022.

With the federal funds rate increases as a backdrop, let's dig into last year's returns and how they were impacted. By the way, depending upon the size of your portfolio, the securities you hold may differ slightly from the securities mentioned below.

Fixed Income: Our fixed income securities had a difficult time in this rising rate environment. Typically, we turn to our fixed income securities to help us during uncertain economic headwinds. One of the reasons a 60% stock and 40% fixed income portfolio work so well over the long-term is due to the stability of the 40% in bonds. The bonds did not hold up as well last year. In 2022, we saw our short-term bonds (e.g., PIMCO Short-Term and Vanguard Short-Term Investment-Grade) go down between less than 1% to -6% while the intermediate bond funds (e.g., Metropolitan West Total Return, PIMCO Income, DoubleLine Total Return, Vanguard Core Bond) dropped anywhere from -8% to -15%. The good news is that the worst might be over. The bad news is that there could still be more Fed interest rate increases to go. Currently our model is approximately 40% short-term bonds and 60% intermediate bonds.

Large-Cap Domestic Equities: Our largest holding within our stocks or bonds is the Schwab Total Stock Market Index (SWTSX), which makes up close to 40% of our equity allocation. I like this holding because the low expense ratio (close to zero - 0.03%) and managers typically have a difficult time beating this benchmark index. Not in 2022. SWTSX was down 19.53% last year and ALL of our other managed, more value-oriented, securities beat it and beat it handily. For instance, Berkshire Hathaway was up 3.31% while Vanguard Dividend Growth was only down 4.88% and finished in the top 2% of the large-blend category at Morningstar. Our large-cap growth pick,

Primecap Odyssey Growth, also ranked in the top 2% according to Morningstar with a -14.35% return. For comparison's sake, Invesco QQQ (the NASDAQ 100) was down 32.58%. I was very pleased with the relative performance of these securities when compared to the total stock market. That said, a loss is a loss and we are always striving to make money – not lose less. However, it certainly helps to start 2023 on a slightly higher pedestal compared to the NASDAQ 100/FAANG names.

Mid and Small-Cap Equities: During the year we switched our mid-cap index fund from the Schwab US Mid-Cap ETF to the Vanguard S&P Mid-Cap 400 ETF. We are kind of splitting hairs with this move over the long-term, but in difficult markets, I believe, the S&P 400 index will hold up better. Our small-cap holding Vanguard Tax Managed Small Cap or for some - the Vanguard S&P Small-Cap 600 ETF - was down a little more than 16% in 2022. Not pretty, but it did what we wanted it to do – match small-cap stock returns.

Foreign Equities: The -7.04% return for Vanguard Global Wellington placed it in the top 16% within its category according to Morningstar. The -7.89% return for our First Eagle Overseas - a fund we have owned for a couple of decades - was enough to place it in the top 3% of the Foreign Large Blend category at Morningstar. Our relatively new addition, Dodge & Cox International, was only down 6.78% in 2022. Should the Fed continue to raise rates, I feel very good about these three foreign securities holding their own and, hopefully, finding some deeply valued companies that will earn us the big bucks when things turn around.

Outlook: If anyone tells you they know exactly which direction the market is going in 2023, they are lying to you. That said, let's look at some economic probabilities that Vanguard established. Vanguard's base case (along with one of my favorite analysts, Ed Yardeni) is a 60% probability of a mild recession which implies a federal funds rate at 5% (another 0.50% increase from 4.50%) and an economic soft landing. They also believe there is a 30-40% chance that bad inflation data will force the Fed to increase the federal funds rate to 6%. That extra 1% increase in the funds rate is NOT priced into the bond or stock markets. Thus, another 10-15% stock market decrease is still in the cards. Remember, Vanguard puts a 30% probability on that scenario. As the Fed awaits data pertaining to whether they have inflation in check or not, I continue to encourage those retirement savers who do not need their cash for three to five years to continue to dollar-cost average into this market. Should the Fed "pause" their interest rate increases, I believe you could see a rally in both bond and stock markets. This would mean that they would end their interest rate hikes and both stocks and bonds would welcome that news because it decreases uncertainty. As we all know, the markets dislike uncertainty. Some believe that the Fed could "pivot" and not only end the increases but start to decrease the federal funds rate! A Fed pivot could be extremely bullish for stocks and bonds depending upon the reason for the Fed pivot. I believe the odds of a Fed pivot are small.

Before I end this letter, I would like to discuss the silver lining to the interest rate increases we have experienced in 2022. The yield on Schwab's money market funds is higher now than it has been in years. The latest 7-day effective yield for the Schwab Value Advantage Money Fund – Investor Shares is 4.36%. If you have over $1 million in the money market, the yield bumps up to 4.52% for the Ultra Shares due to a lower expense ratio. These are money market funds that you purchase like a mutual fund with a one-day settlement. Moreover, there are no minimum dollar amounts and you can sell any dollar amount at any time without penalty. We are finding that banks and credit unions in the area are having a difficult time competing with this yield. For those of you who would like a little extra yield for your "safe" dollars, give us a call and we can set you up with a brokerage/taxable account if you don't already have one. Schwab also offers a CD marketplace that list hundreds of CDs from FDIC insured banks across the country. These rates are also competitive with the local credit unions and banks. Give us a call to find out more.

Enclosed you will find your Portfolio Holdings statement as of December 31, Performance Analysis and Position Performance summaries and a quarterly Account Management Fee Statement. Please contact us should you desire the most recent copy of our Form ADV Part 2A. In addition, please notify us should your investment objectives or personal financial situation change.

Thank you for being a loyal client and best wishes for a healthy, happy, and prosperous 2023!

- **You can expect to receive your 1099-Composite and Year-End Summary by mid-February from Schwab. Your 2022 realized gains and losses as well as the total amount of management fees paid will be included in this 1099. Please let us know if you would like us to forward the 1099-Composite and Year-End Summary to your accountant.**

- **With the new year upon us, this is an excellent time to review your IRA and retirement account beneficiaries to make sure they are up to date. Contact us if you would like us to send you the names Schwab Institutional has on file. Also, please consider contributing to your Roth IRA if you are able. You have until April 18th to contribute for tax year 2022.**

- **For those who can afford to maximize their 401(k) contributions in 2023, please note that the maximum you can contribute is now $22,500. For those over the age of 50, the catch-up contribution is $7,500. Thus, one could contribute $30,000 in 2023 if they are over 50 and have the means to do so.**