Fourth Quarter 2022 Review and 2023 Outlook

Investing can be humbling at times and 2022 provided a heaping helping of humble pie. To 2022 we say, "Goodbye and good riddance."

In this report, we will review what happened in 2022, how we are positioned for 2023 and what risk factors we're watching that will largely determine how the economy and markets evolve this year.

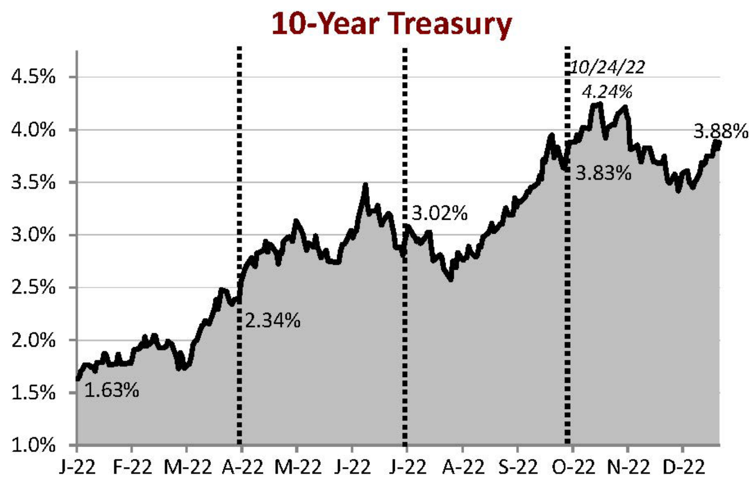
What Happened

The main driver of the poor results in most financial assets was the rapid change in Federal Reserve policy which drove up the federal funds rate by 4.25% during 2022. This pivot in Fed policy was in response to persistent inflation unleashed by too much stimulus to aid the economy during the pandemic and the Fed's mistake in maintaining their ultra-easy policy for too long. The rapid rise in the Fed's short-term rate drove longer-term rates higher. This prompted a re-rating of valuations across the market, but especially in the high expected growth stocks that had led since the financial crisis. The chart below illustrates the rapid and sharp fall in price-to-earnings (PE) ratios. We have more to say below about the fact that PEs remain above average even after last year's decline.

Source: Bloomberg and Monticello Associates; Data as of 12/31/2022

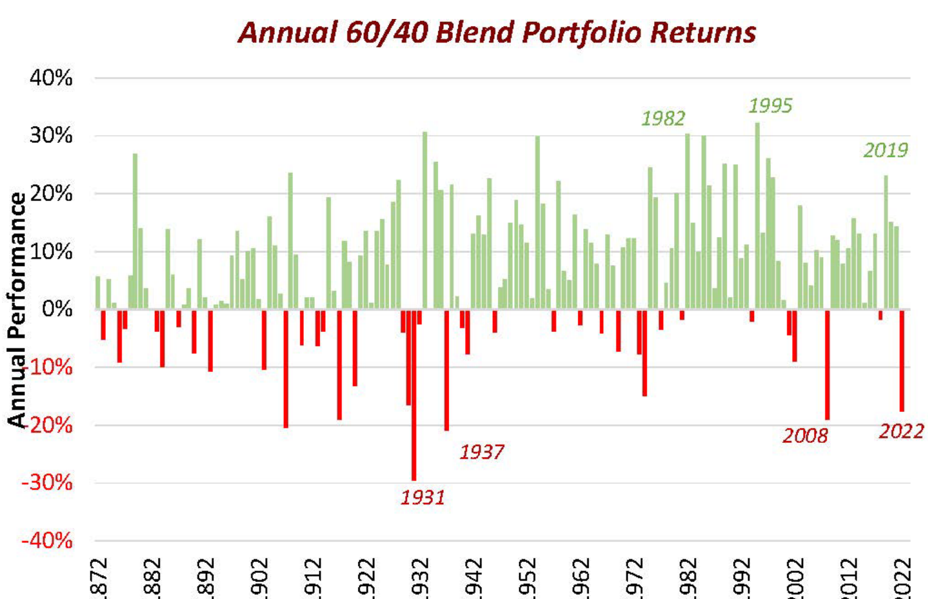
The damage sustained in both the stock and bond markets is evident in the first chart below. There's a lot of red. The second chart shows just how much the yield on the ten-year Treasury note rose. It was a rout for the history books.

Market Performance	Q1 22	Q2 22	Q3 22	Q4 22	Oct	Nov	Dec	2022	3 Yrs	5 Yrs	10 Yrs
S&P 500	-4.6%	-16.1%	-4.9%	7.6%	8.1%	5.6%	-5.8%	-18.1%	7.7%	9.4%	12.6%
Russell 2000	-7.5%	-17.2%	-2.2%	6.2%	11.0%	2.3%	-6.5%	-20.4%	3.1%	4.1%	9.0%
MSCI ACWI	-5.3%	-15.5%	-6.7%	9.9%	6.1%	7.8%	-3.9%	-18.0%	4.5%	5.8%	8.5%
MSCI EAFE	-5.8%	-14.3%	-9.3%	17.4%	5.4%	11.3%	0.1%	-14.0%	1.3%	2.0%	5.2%
MSCI EM	-6.9%	-11.3%	-11.4%	9.8%	-3.1%	14.8%	-1.4%	-19.7%	-2.3%	-1.0%	1.8%
CSFB High Yield	-4.2%	-9.7%	-0.4%	3.8%	2.8%	1.5%	-0.5%	-10.6%	-0.2%	2.1%	3.9%
Bloomberg U.S. Agg Bd	-5.9%	-4.7%	-4.8%	1.9%	-1.3%	3.7%	-0.5%	-13.0%	-2.7%	0.0%	1.1%
Bloomberg U.S. TIPS	-3.0%	-6.1%	-5.1%	2.0%	1.2%	1.8%	-1.0%	-11.8%	1.2%	2.1%	1.1%



Source: Bloomberg and Monticello Associates

Further illustrating the breadth and depth of the market rout last year, the chart below shows that last year's return for a typical portfolio, allocated 60% to stocks and 40% to bonds, was among the worst in history. And with bonds down -13%, it did so in a rather unique way relative to history. This is the first year both stocks and bonds finished the year down double digits.



Source: Bloomberg and Monticello Associates; Data as of 12/31/2022

How We're Positioned for 2023

We noted in last quarter's report that we are reducing our emerging markets allocation in favor of U.S. stocks. We also continue the process to exit select managers that did not live up to expectations in 2022. However, we are making a conscious decision to remain patient with most managers. Historically, patience with good managers has been rewarded and we believe our manager roster is populated with good managers. It would be easy to toss out a few after such a miserable 2022, but we have confidence that our managers are making the right moves for the future.

And our managers are making changes. For example, one mid-cap growth manager has turned over half of its portfolio to better position for going forward. Another large cap growth manager has eliminated all of the tech "platform" companies from their portfolio in favor of companies more likely to flourish in a higher interest rate, slower growth world. And many hedge funds repositioned their portfolios over the course of 2022, which resulted in better results in the second half of 2022. We believe managers are making changes that will be beneficial going forward.

The Outlook and A Visit with Monticello Associates Founder and CEO Grady Durham

For those familiar with Piedmont, you may recognize the name Monticello Associates, but for those that do not, a brief introduction is in order. Monticello Associates is an independent investment consulting firm that has assisted Piedmont for over a decade. Monticello has been assisting foundations, endowments and family offices since 1992 and has been a valuable partner for Piedmont over the years.

Grady Durham, the firm's Founder and CEO has been in the investment management consulting business for 41 years and we were pleased to have him join us to share his insights and perspectives on the current environment. He's been through several cycles and sees this one as normal: valuations reset, then earnings likely reset. Looking out over the next 3 – 5 years, Grady believes we will emerge from this bear market in a better place for investing. We have more normal interest rates, which should help separate the good companies from the bad. And, the number of stocks that do well should expand because those few tech-related stocks that led in 2020 and 2021 will not be the leaders in the next bull market. Indexing, which drove lots of dollars into those few tech stocks, is likely to fall out of favor and active management and focus on fundamentals should pay off.

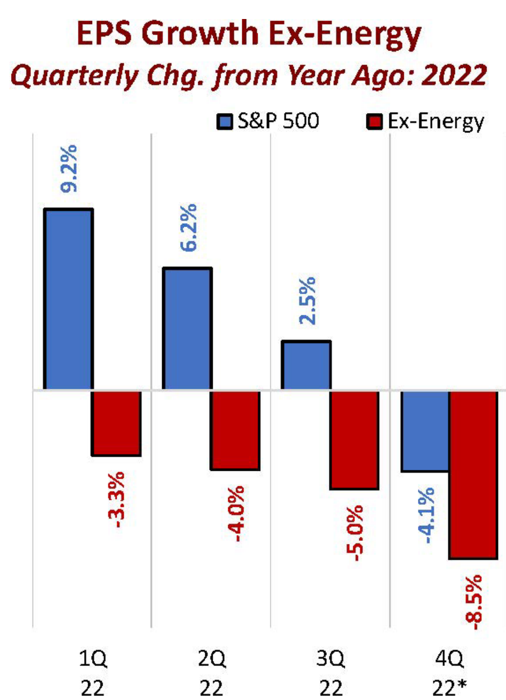
While optimistic about the next 3 – 5 years, Grady believes there's a good chance we're only about two-thirds of the way through this bear market. The reasons are highlighted in the following charts. First, you can see that compared to previous bear market bottoms, today's valuations are still elevated, and inflation is higher (this chart is updated from the one in last quarter's report). This could mean the Fed keeps pushing rates up to quell inflation and valuations continue to reset lower in response.

Market Bottom: Val. & Inflation

Bear Mkt Trough Date	S&P 500: P/E Ratio-TTM	10-Yr Trsy. Yield	CPI YoY Chg.
4/28/42	*7.2x*	*2.1%*	*12.6%*
6/13/49	5.7x	2.0%	-0.8%
10/22/57	12.2x	4.0%	2.9%
6/26/62	15.4x	3.9%	1.3%
10/7/66	12.9x	5.0%	3.8%
5/26/70	13.2x	8.2%	6.0%
10/3/74	*7.5x*	*8.0%*	*12.1%*
8/12/82	7.1x	13.6%	5.9%
12/4/87	14.7x	9.0%	4.4%
10/11/90	13.5x	8.9%	6.3%
10/9/02	*17.0x*	*3.6%*	*2.0%*
3/9/09	11.1x	2.9%	-0.4%
3/23/20	14.5x	0.8%	1.5%
Averages	**11.7x**	**5.5%**	**4.4%**
1/12/23	*18.8x*	*3.4%*	*6.5%*

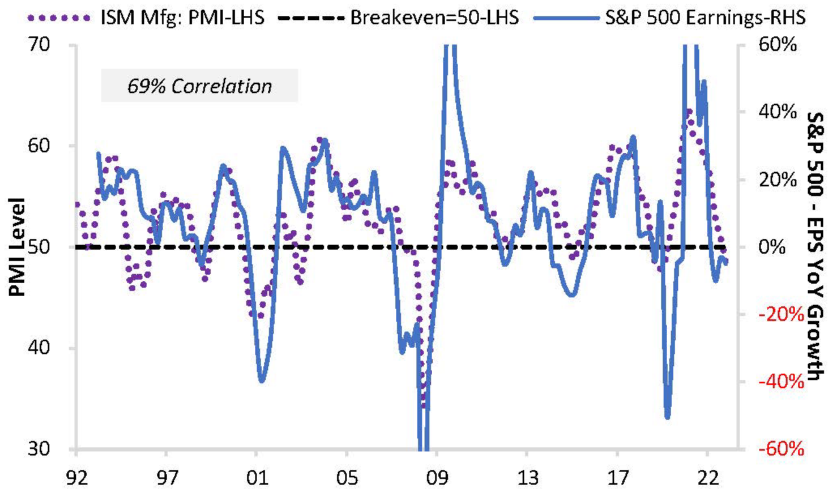
Source: Bloomberg, Strategas and Monticello Associates; Data as of 1/12/2023

Earnings represent another factor. If 2022 was all about a re-rating of valuations, 2023 will be about economic activity and earnings. The chart on the right shows the composition of earnings in 2022. Earnings in the energy sector offset outright earnings declines in the rest of the market. With oil and other energy prices lower today, energy sector earnings may decline while the rest of the sectors struggle in a slowing economy. In fact, Grady sees a good probability of recession this year. The level of earnings will tell the tale in 2023.



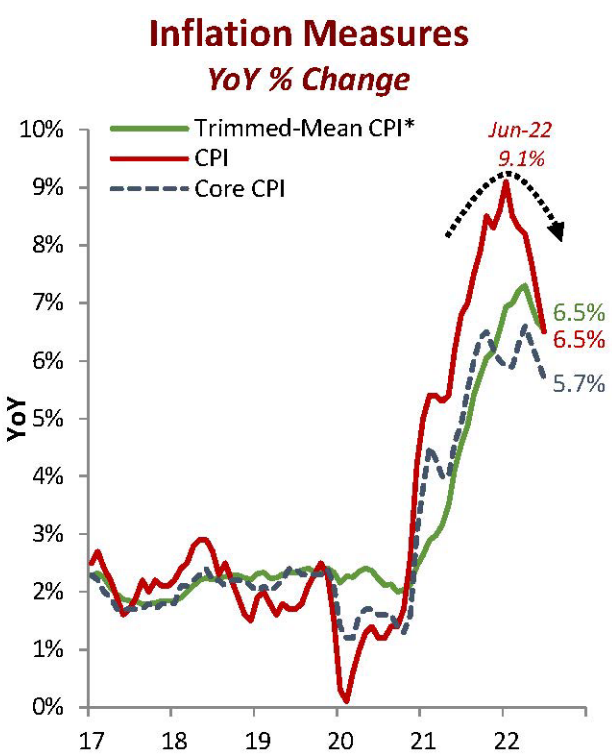
Source: Bloomberg, Factset, Strategas and Monticello Associates; Estimates as of 1/6/2023

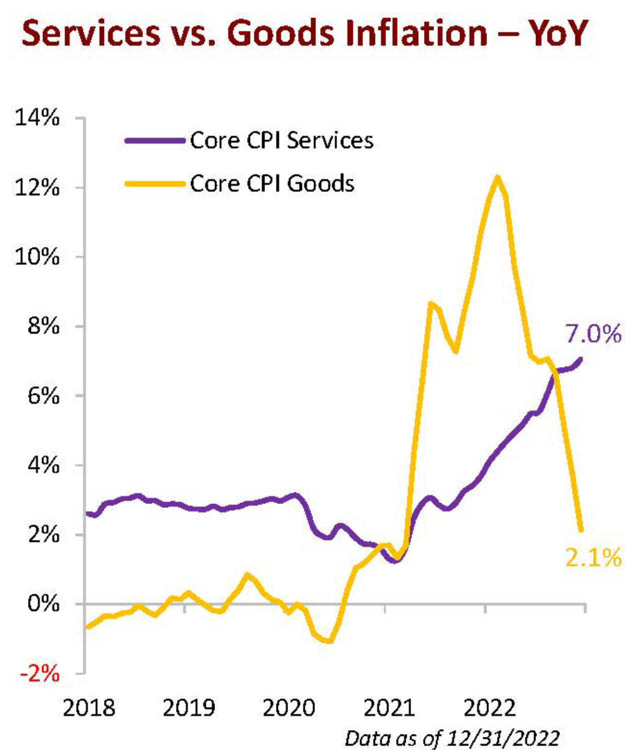
Informing this opinion, Grady pointed out that several indicators of future earnings point to lower earnings ahead. The chart below shows that activity in the manufacturing sector is highly correlated with earnings and that activity is falling.



Source: Bloomberg, Strategas and Monticello Associates; Data as of 12/31/2022

The wildcard remains inflation. Tell us what inflation will do going forward and we believe we could tell you what the Fed will do and how the market will perform. If inflation rapidly falls back toward the Fed's 2% target, markets, which are always forward looking, may look past challenging economic conditions with an eye towards recovery. If inflation proves quite sticky, the road ahead may be more perilous for the entirety of 2023. Unfortunately, both sides of this argument have data to support their opinions. The chart on the left below shows the source of many analysts' optimism about inflation. Indeed, consumer price inflation has rolled over and is moving lower. However, the chart on the right shows that prices in the services sector continue to rise strongly, indicating that the battle will be tough to win.





Source: Bloomberg and Monticello Associates

Ninety minutes with Grady is always fascinating and it was particularly good to speak with him at this juncture in the market and the economy. We share Grady's optimism that despite an environment that appears taxing in the near-term, it is also setting the stage for a rewarding three-to-five-year period. A more normal environment, where strong business fundamentals are rewarded and market leadership widens to include stocks other than a handful of companies, would be well received by our underlying managers and the market as a whole, in our opinion.

Conclusion

The market laid an egg in 2022. But we're going to use that egg to make a tasty omelet. Yes, that's corny, but it's a measure of our confidence in Piedmont's process and the current lineup of managers. We believe 2022 was an anomaly. We've never experienced a year where almost every sector, and just about every manager, performed poorly simultaneously. As we said last quarter, recent past performance is not indicative of future results. We are squarely focused on delivering the results you and we expect.

As always, please let us know if you have any questions or if you would like to discuss further Piedmont's investment strategy and positioning.

Michael K. Shields　　Daniel F. Smith　　John M. Simms, Jr.