THE PRIVATE CLIENT GROUP

BALANCING LIFE & WEALTH

ECONOMIC & MARKET INSIGHTS

Year-End 2022

EXECUTIVE SUMMARY

Heading into 2022, investors were optimistic. The economic recovery from the coronavirus pandemic had exceeded expectations and risk-assets had positive momentum after a year of robust gains. However, even the Federal Reserve did not foresee the sharp and sustained rise in inflation and the aggressive policy response that would trigger tighter financial conditions and result in a downturn in capital markets. Russia's invasion of Ukraine and China's harsh COVID lockdowns were two unforeseen events that caused a spike in commodity prices and turmoil in global supply chains that fueledinflation. Domestic forces were also factors, including the Fed's slow response to the inflation threat and the overhang from the high fiscal spending during the COVID crisis. The ongoing struggle to subdue inflation and the risk of new shocks to commodity prices from geopolitical or idiosyncratic events will continue to be a concern for investors in 2023.

The past year has once again shown that the investment markets can behave in unexpected ways. Investors were disappointed as the historic relationship between stocks and bonds, the typical mix in a diversified portfolio, fell apart. High quality bonds are typically a ballast during stock market downturns,helping to stabilize an investor's portfolio. This time spiking interest rates drove stocks and bonds downward in tandem. However, another investmenttenant, mean reversion, proved to be useful as sectors such as technology that soared during the COVID crisis plummeted and out of favor sectors such as energy and value stocks gained ground or at least declined less than other investments. Going forward, investors now face a new investment regime marked by higher interest rates, inflation and volatility than has been experienced in many years. It is imperative to think about portfolio positioning with a forward view and to not focus on past performance. Dispersion across asset classes, strategies and individual securities should be higher going forward, expanding diversification opportunities, and help to protect portfolios from elevated volatility. Higher volatility makes high quality assets more attractive versus assets that are highly leveraged with less reliable cash flows but also unleashes dislocations that can be exploited in less liquid markets.

This is an opportune time to revisit your investment portfolio to ensure it is in line with your financial goals and is effectively diversified across and within asset classes. Fixed income now offers attractive yields and if rates stabilize, extending duration could be a tailwind in 2023. For taxable investors,municipal bonds look appealing with higher tax-adjusted yields versus Treasuries and less volatility than other credit sectors. For those investors that do not need liquidity, private credit is exploiting the dislocation in public markets and offers a yield premium with less volatility than public credit. Real estate and infrastructure offer high income, inflation protection, and price stability relative to other risk asset classes. Real estate is benefiting from supply shortages in certain sectors and geographic regions while infrastructure is linked to the green energy transition and the fast-growing renewable energysector.

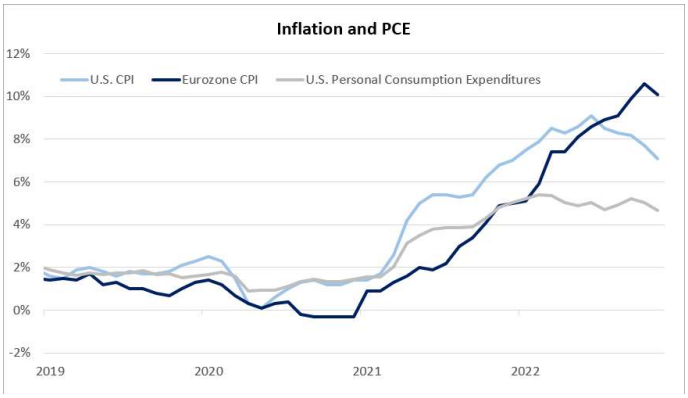
Finally, while equity valuations have reset, U.S. equities are not particularly cheap, and earnings estimates may prove to be too optimistic. U.S. investments have outperformed, but international equities offer attractive relative value and may reassert themselves. While Europe faces short-term headwinds, greater fiscal support, and more favorable financial conditions than in the U.S. could buoy this region. Asian markets are poised to benefit from the opening up of China and the expected upswing in growth after a lengthy period of COVID lockdowns. High interest rates may sustain the U.S. dollar a while longer, but the current overvaluation is not sustainable over the long-term and a weaker dollar will support non-U.S. assets, particularly emerging markets. A global equity portfolio with a material allocation to international stocks, including emerging markets and active strategies that can exploit valuation disparities,should be well positioned as the linkages between countries evolve and individual stock markets are shaped by local economic conditions and marketfactors.

Economic Insights

2022 will go down as a transitionary and challenging year for the global economy. A period that can be characterized by surging inflation, a subsequent hawkish response from global central banks, and the end to a decade-long period of abundantly easy financial conditions. The Fed Funds upper bound rate started the year at just 0.25% but ended 2022 at 4.50% following seven consecutive rate hikes ranging in magnitude between 0.25% and 0.75%.This reverberated throughout the economy and quickly pulled down asset prices and depressed activity in important economic sectors such ashousing.

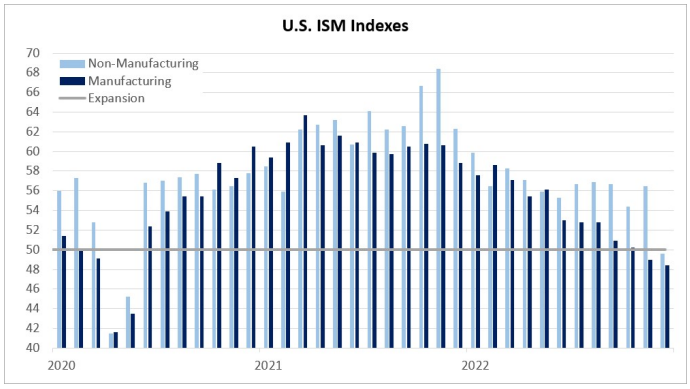
Predictions for some form of recession in 2023 are becoming more common as the economy faces a variety of challenges to growth going forward. On the surface, there appears to be limited areas of clear excess and overbuilding in the economy, hopefully paving the way for a milder recession were one to occur. The consumer has remained resilient given the backdrop, likely supported by a still strong labor market. While jobless claims and unemployment are trending higher, they remain historically low and there continues to be an undersupply of labor relative to the number of open positions. Wage growth has also stayed positive, although the unsustainable pace of increase has moderated greatly. The biggest uncertainty will likely remain the massive unwinding or moderation of modern monetary theory employed in many developed nations.

Changes globally in monetary policy also had important implications within currency markets. A flight to quality and higher relative, real interest rates contributed to extensive U.S. dollar (USD) strength over much of the year. Despite the USD giving back some gains more recently, the currency hit its highest level on a relative basis in about two decades over the course of the year. Dollar strength has left its mark on domestic growth, worsening the current account deficit, and limiting the competitiveness of U.S. manufacturing relative to overseas producers.



Bureau of Labor Statistics

Inflation surged to multi-decade highs over 2022. Luckily, it has shown signs of peaking and should continue to fall in the comingmonths. Going forward, the path of inflation might become more varied within different portions of the economy.

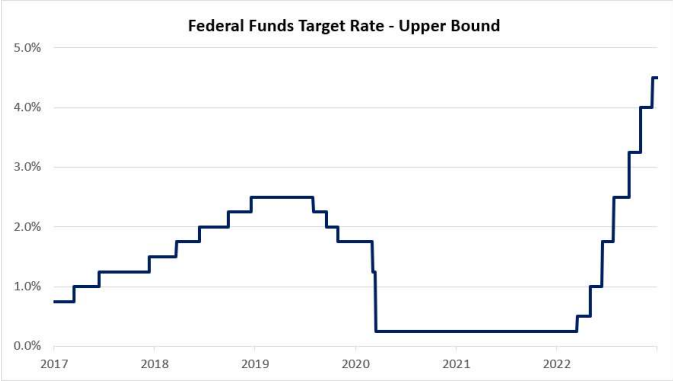


Institute for Supply Management

Both ISM indexes fell into recessionary territory (below 50) in late2022. This follows a historically strong economic period reflecting pent-up demand coming out of the pandemic. December was the first time the services index fell below 50 since the pandemic. Both metrics demonstrate that the economy is slowing and faces fresh headwinds in 2023.

Bloomberg

The USD reached new heights over the year. While it has since fallen, it remains at a historically elevated level relative to other major global currencies. The potential end or moderation of Fed tightening paired with hawkish actions from other global central banks could be a headwind to the currency in 2023.



Bloomberg

After policy rates went to 0 during the pandemic, 2022 saw a rapid rise in the Fed Funds rate. Over the course of the year, the Fed raised its policy rate seven times resulting in an ending level of 4.5%. There are expectations for additional hikes in early 2023,although futures markets are predicting that rates will be loweredby the end of the year.

Equity Markets

Volatility was elevated across equity markets in 2022 and many major indexes posted losses for the calendar year. This comes after the draining of excessive liquidity, lowered valuations, and overly zealous expectations for future corporate performance. While always painful to experience, lower starting valuations should contribute to more encouraging forward returns relative to the start of the year. Even with the recent performance, the S&P 500 Index has risen nearly 60% over the past 5 years through the end of 2022, translating to an annualized return of more than 9%. As always, it's important to take a longer-term view and acknowledge the compounding power of equity allocations within diversified portfolios.

2022 brought a swift change in market leadership. After nearly a decade of outperformance, growth shares vastly lagged value stocks due to fundamental factors, but more impact fully a re-rating of future (versus current) cash flows and profits. International equity markets outpaced U.S. counterparts in many cases in local terms. That said, the strength of the USD throughout much of the year diminished the magnitude of the relative outperformance. Within U.S. equities, more defensive portions of the market (such as utilities, staples, healthcare) were among the top relative performers, being close to flat. The energy sector was a standout, driven by a stark recovery in commodity prices and demand without an equivalent rise in supply.

S&P 500 earnings finished at a similar level to where they started. While revenues were higher, in part due to inflation, profits and margins came under pressure due to higher costs and a normalization of demand coming out of the pandemic. Current consensus analysts' expectations for double-digit earnings growth in 2023 might prove to be overly optimistic which could lead to continued volatility for equity markets. First-quarter results should offer additional visibility into the path of corporate profits for this year.

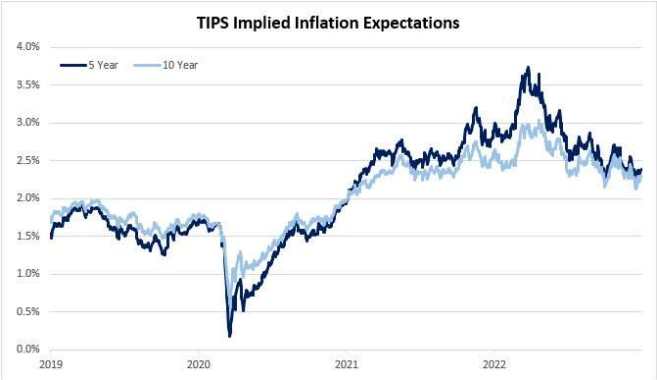
Bloomberg

Equity market valuations have fallen dramatically across the board,relative to the start of 2022. In many cases, markets are either near long-term average valuations (U.S.) or lower (developed, international, emerging markets). While it's impossible to predict short-term results, lower starting valuations have historically translated to enhanced medium-to-long-term returns.

Fixed Income and Alternatives

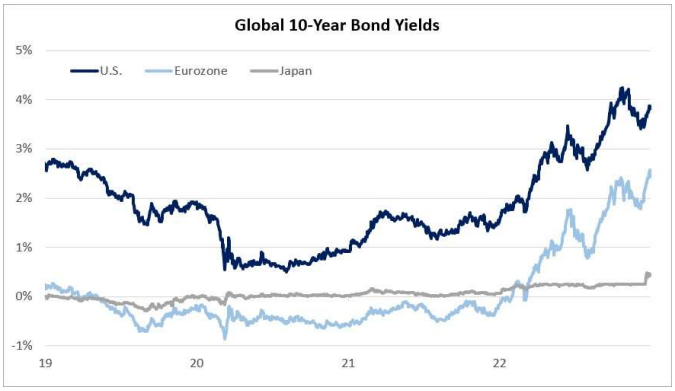
Fixed income experienced historic losses during the year as rampant inflation led the Federal Reserve to sharply hike policy rates while reducing its bond portfolio. The low level of starting yields did little to counteract bond price declines caused by the Fed's efforts to tighten monetary policy. Treasury prices saw the highest level of volatility since the Global Financial Crisis, negatively affecting liquidity and pushing up credit spreads. The result was double-digit losses across most major bond sectors. Non-U.S. bonds had a similar outcome and were further hampered by weakening currencies. The bond market appears to believe that the pain is almost over. The yield curve has been inverted with short-term rates higher than long-term rates, a recessionary signal suggesting that lower interest rates are expected in the future. By November, signs that inflation might be abating and signals from the Fed that the pace of rate hikes would slow created a positive backdrop. In the fourth quarter, bond yields declined, paring losses from earlier in the year. The yield on taxable U.S. investment grade bonds reached 5%, before modestly pulling back. Current yields are a good predictor of future returns and the reset in bond yields during 2022 provides investors with the highest level of income in years.

Municipal bonds, which tend to be a defensive sector, topped all other U.S. bond sectors for the year and in the fourth quarter. Fourth quarter relative returns were particularly strong due to favorable supply/demand trends with limited new supply and a downturn in outflows driven by tax loss harvesting activity. Municipal bonds overall are fundamentally healthy due to COVID stimulus and better than expected revenues. Defensive taxable bond sectors such as non-mortgage government agencies also outperformed. Treasuries and mortgage-backed securities were hampered by the pullback in demand from the Fed while a high level of sensitivity to interest rates hurt Treasury Inflation Protected bonds (TIPs). Two riskier sectors, high yield bonds and emerging market debt, saw the greatest widening in spreads. Default rates on corporate bonds have ticked up slightly but remain historically low and credit fundamentals are overall healthy, although lower quality segments such as sub-prime are showing signs of weakness.



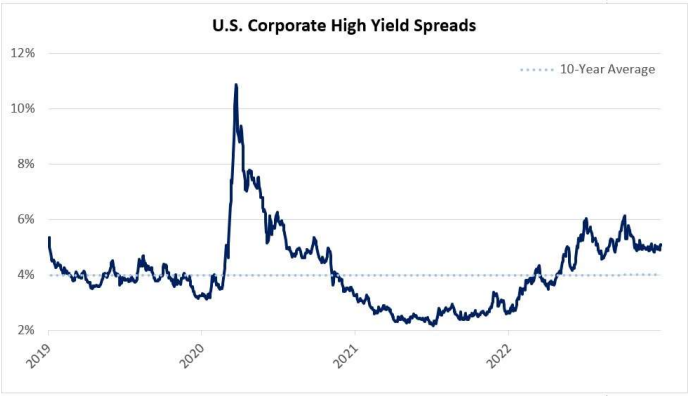
Bloomberg

TIPS breakeven, which indicate inflation expectations, are elevated above 2% but have moderated relative to earlier in theyear. Many inflation indicators are lagged to a degree and it'slikely that core inflation has peaked and will trend down over time.Inflation'sretreat would be further accelerated by a potentialrecession.



Bloomberg

Global yields across most developed nations marched substantially higher over the course of the year. Higher yields reflected a variety of hawkish actions by global central banks to fend off historically high inflation. The Bank of Japan has been an outlier but recently allowed its 10-year yield to move up slightly.



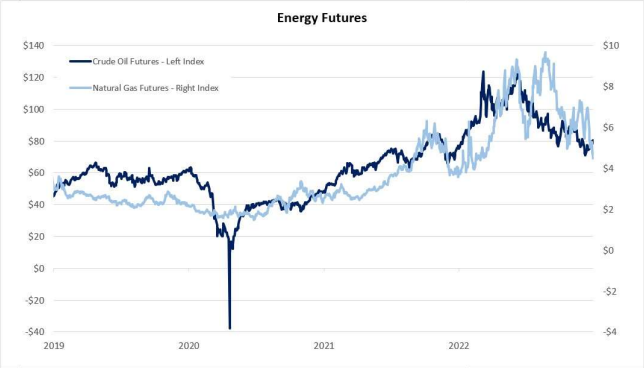
Bloomberg

Corporate high yield spreads were higher throughout the year but were below prior levels. Higher rates and spreads would greatly increase the borrowing rates for many corporations which could contribute to higher interest burdens for indebted companies going forward.

Most real assets performed well over 2022, acting as a natural hedge to historically high levels of inflation. While still enduring significant volatility, energy-focused commodities were among the top performers last year. A massive whiplash in supply and demand within and coming out of the pandemic fueled excessive volatility in the space. Over 2022, the military conflict in Ukraine paired with more normalized demand was met with more constrained supply. At its peak last year, oil (WTI) soared to over $120/barrel and natural gas prices in the U.S. reached their highest level since 2008.Both commodities have settled at lower prices, particularly natural gas which has been aided by a seasonably warm winter.

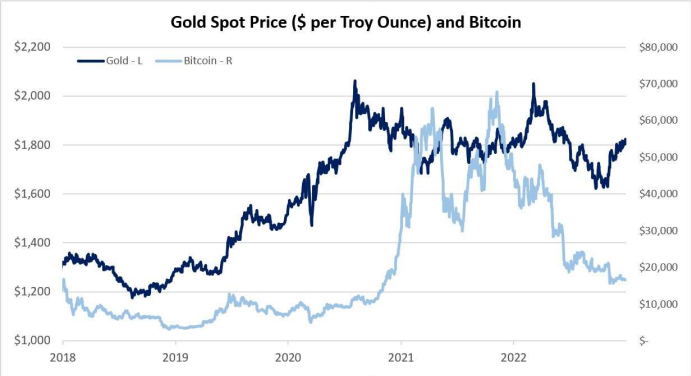
2022 was a sobering year for many crypto currency investors. Perceived as a digital store of value, Bitcoin fell more than 60% over the year. In addition to the implosions of several notable crypto exchanges and projects (Terra, Celsius, FTX, etc.), the value of many tokens appears to be more highly correlated to excess liquidity in the global monetary system than believed. Putting price action aside, the crypto currency industry offers an exciting promise of a new technology but still struggles to find pertinent use cases. Time will tell if the massive level of capital and talent that has flowed into the space will result in a productive innovation or will fall by the wayside. While gold handily outperformed nearly all cryptocurrencies, it failed to deliver on the inflation hedge many have employed it for in the past due to a strong-USD and higher yields elsewhere.

After a miraculous rise in 2021, public REITs came back to earth in 2022. The downward pressure of REIT returns came from a variety of factors including high starting valuations, higher borrowing costs (and subsequently cap rates), and recessionary fears. The sell-off has been broad-based, although office remains a negative outlier based on the greatest level of uncertainty of future demand. After a challenging year, many public REITs went from trading at premium valuations to discounts. Although the public REIT space is smaller and concentrated in different sectors relative to the private commercial real estate space, there could be pockets of opportunity going forward given the magnitude of dislocations.



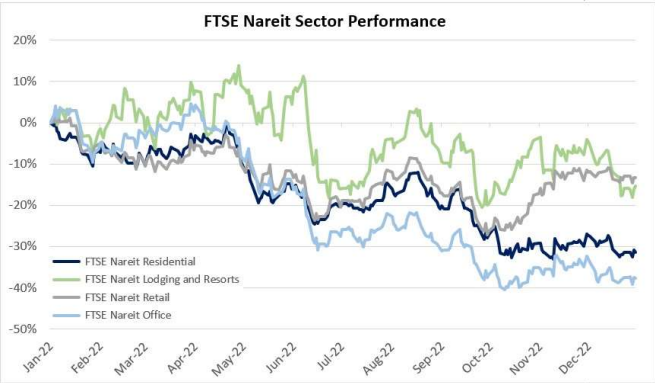
Bloomberg

Despite reaching multiyear highs throughout 2022, oil (WTI) and natural gas ended the year ahead but much closer to where they started. Pandemic-related supply and demand anomalies paired with the conflict in Ukraine have contributed to excessive volatility over the past several years in both commodities.



Bloomberg

Both considered a store of value by many, bitcoin and gold had very different outcomes last year. While many would have expected gold to have performed better in the current inflation regime, intended the year close to flat held back by higher rates and a strongUSD. Bitcoin declined precipitously, likely influenced by tightening liquidity conditions.



National Association of Real Estate Investment Trusts

Public REITs had a difficult year after an impressive 2021. While rents continue to increase in select areas like multi-family housing and industrial, the pace of increase has greatly leveled off.Office-oriented REITs have been notable laggards as the future of physical work continues to be redefined.

Steven W. Lieberman is the President and CEO of The Private Client Group Wealth Management, LLC. Investment advisory and financial planning services are offered through Summit Financial, LLC, an SEC Registered Investment Adviser (“Summit”), doing business as The Private Client Group (4 Campus Drive, Parsippany, NJ 07054. Tel. 973-285-3637).