Hughes Investment Advisory Service LLC

January 1, 2023

Dear Clients and Investors,

Happy New Year! Both the stock and bond markets performed poorly in 2022. This is a rare occurrence, as equities and bonds usually have an inverse relationship. But with a hawkish Fed, both investment classes suffered notable losses in the same year for the first time since the late 1960's!

For Q4 the S&P 500 was up +7.1% and dropped -19.4% for the year.
The overall bond market was down -15% one of the worst years on record for bonds.

Key 2022 economic data points:

- Estimated final 2022 Real GDP growth 2.0%
- Estimated final 2022 Inflation +7.1%
- Estimated final 2022 S&P 500 Earnings $215

The above data is, after all, what matters most in calculating how the economy is doing which directly affects corporate earnings and the performance of investment classes across the board. Take out the 7.1% inflation rate and these numbers look very good, but guess what, we can't remove inflation from the numbers!

Looking back at last year's predictions: I was close on GDP Growth (+3%), Inflation (+6%), and S&P 500 Earnings ($225). I went against the consensus opinion of 2 rate hikes at the time and expected 5 Fed rate hikes totaling 1.5%, however the Fed raised rates 7 times totaling 4.25%! It was these larger and more numerous rate hikes that caused my S&P 500 +6% return figure to be too optimistic with the average dropping -19% for 2022.

For 2023 I'm forecasting:

- GDP growth of 1.2%
- PCE Inflation of 3.5%
- S&P 500 Earnings of $225 or +4%
- S&P 500 return of +14%
- A lower year-end Federal Funds rate of 3.5%

So where do we stand as we head into 2023? The interplay between Federal Reserve policy, inflation, economic growth, and earnings will drive the markets in 2023. The Federal Reserve continues to walk a tightrope in its battle to tame inflation. The Fed has been aggressive in raising the benchmark short-term interest rate to slow down demand for goods and services enough to lower overall inflation. Concurrently, the Fed is trying to guard against slowing the economy too hard and pushing it into recession.

Recent inflation data are mixed but showing clear signs of slowing. The Fed is hoping to slow the economy and inflation enough to get the inflation rate back to their desired 2% rate, however, the days of sub 2% CPI that we enjoyed from '08-'20 are likely gone, possibly for a long time. Inflation could fall far enough (3%-4%) for the Fed to essentially think it has accomplished its mission (although it won't say it directly as their target is still 2%) but for all intents and purposes, we could exit 2023 without an inflation problem.

Will the slowing economy result in a recession or a "soft landing"? The consensus on the Street going into 2023 is recession. The inverted yield curve strongly suggest recession. Current Atlanta Fed estimates for Q4 2022 shows positive GDP growth of +3.9%. That's not a recession! I don't know which it will be but in either case my core investment approach to 2023 will be similar. Owning a portfolio of high-quality companies that can outperform in a slowing or recessionary economy by growing earnings, increasing market share, and increasing dividends.

Touching on a theme that I wrote about one year ago, the worlds authoritarian leaders in Russia, China, North Korea, and Iran had a bad year. Russian aggression in Ukraine has not worked out for Putin. The other dictators know this. As a group their economies are reeling. Their international political isolation is growing as free market capitalism and freely elected societies show our socioeconomic strength. The West and our allies are strengthening our supply lines, re-shoring production, and slowly re-instating our energy independence from Russia. All positives for Western economies.

Specifically, given the above concerns where do I find attractive investments today? The 2022 generalized sell-off provides opportunities to buy attractive companies with strong individual stories that diverge from the gloomier top-down narrative. These opportunities could prove fleeting, so now is the time to take a hard look at equity portfolios with an eye to selectively upgrading holdings. The Cloud buildout continues, Digitization, Defense, Semiconductors and EV's, Space and Communications, Medical/Pharma/Biotechnology, Farming and Energy including clean energy such as Nuclear and Hydrogen. These are the growth areas where the US will play an important leading role in the years ahead.

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward now seems equal between equities and fixed income – the 60/40 portfolio is back! REIT's, MLP's and specialized bond/income funds look good as income producers. I believe that our portfolios are well positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

J. Britt Hughes
Investment Advisor Representative
Bay Colony Advisory Group, Inc.
britthughes@hiasllc.com
www.hiasllc.com

Investment advisory services offered by Bay Colony Advisors, a registered investment advisor, doing business as Hughes Investment Advisory Services LLC. No Advice may be rendered by Bay Colony Advisors d/b/a Hughes Investment Advisory Services LLC unless a client service agreement is in place. Bay Colony Advisors does not provide accounting, tax, or legal advice. No part of this newsletter should be considered investment advice. If your financial circumstances have changed, you should contact your investment advisor representative. Principal Office: 86 Baker Avenue Extension, Suite 310, Concord, MA 01742. Phone: 978-369-7200.