January 10, 2023

Dear clients and friends of Sapphire,

When I googled "Year in Search 2022," I expected the word *Inflation* to appear near the top of the list. Alas, *Inflation* did not even make the top ten. (*Wordle* was number one.) That said, inflation dominated the financial press and was certainly at the top of the list at the Fed, which targeted a federal funds rate in the range of 4.25% to 4.50% in mid-December in an effort to quell inflation.

The combination of high inflation and low civilian unemployment suggests that the Fed will continue to increase the federal funds rate during 2023. For context, the Fed's favorite measure of inflation was recently 5.5%, while its long run inflation target is 2%. Unemployment was recently 3.7%, while the 50-year average of civilian unemployment is 6%. Interest rate changes have a delayed reaction in the real economy. Only time will tell the degree to which recent Fed policy engenders price stability, full employment, economic expansion, or contraction in the form of a recession. An inverted yield curve occurs when short-term interest rates exceed long-term rates. The yield curve is currently inverted, which suggests that many fixed income investors anticipate a recession and lower interest rates in the future.

Rising interest rates contributed to a negative 13.0% year-to-date total return for the U.S. Aggregate bond index. Bond prices and prevailing interest rates have an inverse relationship. The S&P 500 index delivered a total return of negative 18.1% during 2022. International equities, as represented by the MSCI ACWI ex-US index, produced a negative 9.2% total return in local currency and a negative 15.6% total return from the perspective of domestic investors as the result of a strengthening US dollar last year. REITs (real estate investment trusts) as measured by the NAREIT equity REIT index were the worst performing assets and produced a negative 24.9% total return during 2022. It is worth noting that although we do not consider cryptocurrency to be an asset class, an asset, or even a currency, Bitcoin dropped nearly 65% during 2022 when quoted in US dollars.

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On a positive note, 6-month Treasury Bills yielded 4.76%, the investment grade corporate bond sector yielded 5.42%, and the valuation of "the market" as measured by the forward price-to-earnings ratio of the S&P 500 index was slightly below its twenty-five-year average of 16.8x at year-end 2022. In addition to relatively attractive current yields, we see compelling values among certain high-quality companies whose valuation multiples fell in response to rising interest rates.

It is essential to accept the fact that the future is, by definition, uncertain. As such, an appropriate strategic asset allocation is important to establish, document, maintain, and revisit regularly over time. We encourage our clients to help us maintain a shared understanding of their anticipated cash flows, tax considerations, long-term objectives, and willingness *and* ability to take risk. Within the parameters of each client's strategic asset allocation, we employ tactical asset allocation among sectors, strategies, and securities with the goal of managing risk and adding value for our clients. As an example, we shortened the average maturity of clients' fixed income allocations where appropriate to take advantage of comparatively attractive yields during the fourth quarter of 2022.

Please contact Sapphire at any time if you would like to discuss your portfolio or to learn more about how we can be of service to you.

Respectfully,

Paul Stropkay

Paul Stropkay, CFA

Sources

- J.P. Morgan Asset Management *Guide to the Markets®* U.S. 1Q 2023 as of December 31, 2022
- https://www.forbes.com/advisor/investing/cryptocurrency/crypto-market-outlook-forecast/

Disclosures

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