

Talbot Financial – Fourth Quarter 2022 Review

Please find attached your Talbot Financial fourth quarter 2022 portfolio review to supplement your monthly account statements available from Schwab. The report provides a performance summary of your investment portfolio compared to the S&P 500 Total Return Index (“Index”), Talbot Financial’s benchmark, and lists your investment portfolio holdings by industry sector.

2022 was a historically difficult year for the financial markets driven by higher inflation, rising interest rates and continued aggression by Russia in Ukraine. The stock market, as measured by the Index, declined 18.1% for the year, marking the worst one-year calendar return since 2008 and the fourth worst calendar year return since the Great Depression. Results were similar with both International and Emerging Market stocks. The bond market, which historically provides support during periods of equity volatility, did not fare much better than the equity markets. The Barclay’s U.S. Aggregate Bond Index, widely considered a proxy for the U.S. bond market, declined 13.1% for the year, its worst annual performance in its 50-year history.

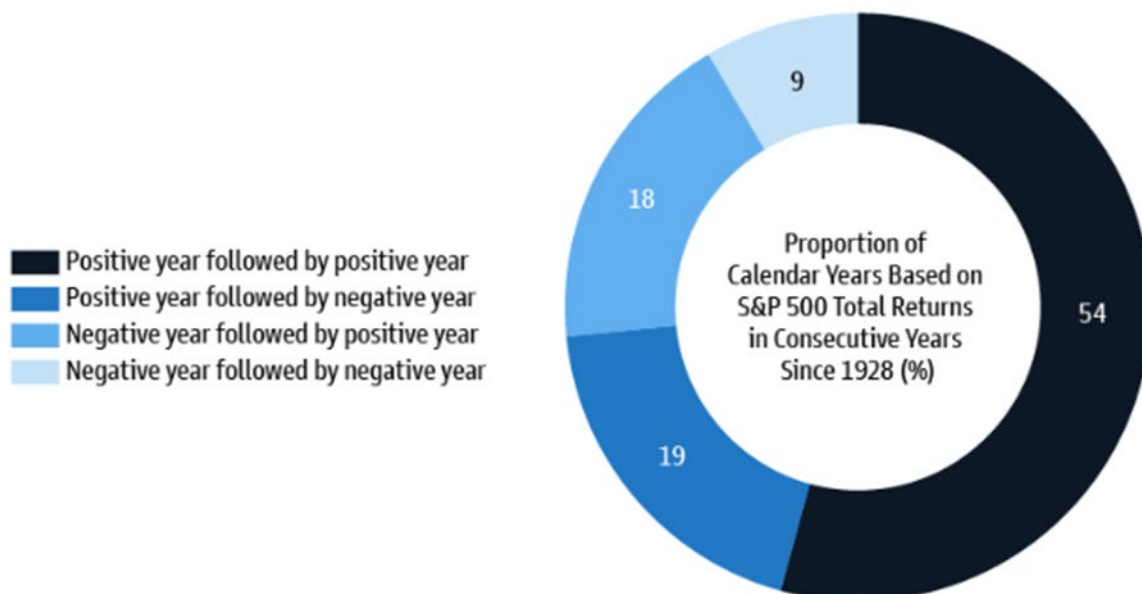
As we look forward to 2023 and beyond from an investment perspective, we have more reasons for optimism than pessimism. Including, mounting evidence that Federal Reserve rate increases are working to stem inflationary pressures, a stable U.S. economy, strong earnings, against a backdrop of a “reset” in market valuations for equities back to early 2021. Importantly, historical data indicates equity markets rarely decline for two consecutive years.

Since May of last year, the Federal Reserve increased short-term interest rates by 4.25%. As a result of higher rates, recent data shows commodity prices and many hard goods prices have peaked and are now trending down. Real estate values have contracted, consumer spending has slowed, and unemployment has ticked-up. All of this suggests the Federal Reserve’s goal of slowing inflation through higher short-term interest rates is working.

At the same time, the pace of growth of the U.S. economy is slowing. Fortunately, the economic growth is decelerating from a position of strength as our financial system is in far better shape than during any prior economic slowdown. The balance sheets of banks and other corporations are in strong condition. The consumers’ financial condition is also solid, with American homeowners holding the lowest amount of household debt relative to Gross Domestic Product (GDP) in over two decades. Personal savings remain above pre-pandemic levels and unemployment remains near historic lows.

Although corporate earnings for most large companies were favorable for 2022, negative equity returns were driven by a material contraction in price-to-earnings (PE) ratio valuations. Predicting a bottom in PE valuation is always a difficult exercise. However, valuations are far more compelling today than they were a year ago, as prices have fallen but earnings have remained solid.

Lastly, history teaches us the stock market rarely declines two years in a row. The chart below shows that since 1928, the Index declined two consecutive years only 9% of the time, or eight times in the last 94-years. Hence, history is on our side for a better year ahead in the financial markets.



Source: Bloomberg and Goldman Sachs Asset Management. As of December 31, 2022.

Predicting the short-term is difficult as it is often driven by investor sentiment. However, what is less difficult to predict are the actions of the companies in your investment portfolio. As long-term investors, we have identified top-tier companies benefitting from secular growth trends.

Our view is these growth trends will result in the companies in your investment portfolio remaining in superior financial shape over the long run, as compared to their competitors. First, the companies you own have relatively low debt and strong balance sheets. They do not have to refinance debt at higher interest rates. Second, they have strong and sustainable cash flows. They can fund their growth and pay shareholders back through dividends and share repurchases. Third, they spent decades building competitive advantages relative to their peers. These advantages tend to accelerate during slowing economic times, meaning these companies are positioned to grow their pace of market share gains in tough times.

In summary, we look forward to a productive year ahead as the economy and the companies you own put the shadow effect of the pandemic in the rear-view mirror. Further, the competitive advantages inherent to the companies you own not only remain in place but are getting stronger.

Our office in Bellevue is open and we would welcome the opportunity to review your portfolio in person, by phone or on a Zoom conference. Please feel free to contact us for a review, or to answer any questions you may have about your portfolio.

Sincerely,

Talbot Financial, LLC

www.talbotfinancial.com