MALVERN CAPITAL MANAGEMENT

4th Quarter Commentary and 2023 Market Outlook

January 2023

4th Quarter 2022 Review

Stocks staged a rally from mid-October through the end of November 2022. We are confident that the intra-day low on October 11th proves to be the bottom for the current "bear" market. Even though December was a down month for equities, the mid-quarter rally was strong enough to give us pretty decent gains for the quarter. In the 4th quarter, the Dow Jones Industrial Average advanced 16.01% while the S&P 500 Index jumped 7.56%. Large capitalization "value" stocks performed well with the Russell 1000 Value Index rising 12.42%. Growth stocks trailed significantly in the quarter with the Russell 1000 Growth Index moving up just 2.20% and the technology-heavy NASDAQ 100 Index falling fractionally. The big winner for the quarter was developed international stocks with the MSCI EAFE Index up 17.34%.

Bonds also gained as the Bloomberg Barclays U.S. Aggregate Bond Index rose 1.87% for the quarter. This Index contains high-quality bonds including U.S. Treasuries. Lower quality or "junk" bonds also faired well with the Bloomberg Barclays U.S. Corporate High Yield Bond Index advancing by 4.17%. High-yield bonds may become an interesting investment opportunity. The current default rate on high-yield bonds is just over 1% but the yield spread is over 500 basis points (the spread is defined as the bond's yield minus a correspondingly maturing Treasury bond's yield). Typically, the default rate is higher (over 6%) during slow growth or recessionary periods. The market is pricing in a high default rate yet it is not experiencing such defaults suggesting that the spreads could narrow over time resulting in higher junk bond prices. However, we will monitor what happens with the economy over the next few months before making a commitment toward investing in junk bonds.

Is the "bear" market over? Are we poised to see higher returns in 2023? As follows, we will examine factors influencing the markets and their returns and expound upon where we believe the financial markets are headed.

Indices Performance

Category	Representative Index	4th Qtr 2022	Full Year 2022	Six Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	16.01	-6.86	8.85	7.32	8.38	12.30
Broad US Large Companies	S&P 500 Index	7.56	-18.11	2.31	7.66	9.42	12.56
US Small Cap Companies	Russell 2000 Index	6.23	-20.44	3.91	3.10	4.13	9.01
US Mid Cap Companies	Russell Mid Cap Index	9.18	-17.32	5.43	5.88	7.10	10.96
Largest 100 NASDAQ Companies	NASDAQ 100 Index	-0.04	-32.38	-4.46	8.68	12.36	16.45
Large "Value" Stocks	Russell 1000 Value Index	12.42	-7.54	6.11	5.96	6.67	10.29
Large "Growth" Stocks	Russell 1000 Growth Index	2.20	-29.14	-1.48	7.79	10.96	14.10
Developed International	MSCI EAFE Index	17.34	-14.45	6.36	0.87	1.54	4.67
Emerging Markets	FTSE All Emerging Markets	8.50	-17.27	-2.65	-1.69	-0.22	1.97
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	1.87	-13.01	-2.97	-2.71	0.02	1.06
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	4.17	-11.19	3.50	0.05	2.31	4.03
Commodities	Bloomberg Commodity	2.22	16.09	-1.98	12.65	6.44	-1.28
Total US Market (all cap stocks)	Russell 3000 Index	7.18	-19.21	2.40	7.07	8.79	12.13
Real Estate Investment Trusts	Wilshire US REIT Index	4.05	-26.81	-6.60	-0.49	3.35	6.31
Cash	US T-Bill 90 Day	0.99	2.01	1.66	0.80	1.28	0.78

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2022.*
All returns include the reinvestment of dividends.

Federal Reserve and Interest Rates

The Federal Reserve has been quite active since March 2022 raising the Federal Funds rate seven times so far to the range of 4.25% to 4.50%. The Fed has been very clear that it wants the inflation rate to fall to its target rate of 2.0%. Its major policy prescriptions are raising the Fed Funds rate and implementing quantitative tightening (QT). QT is essentially the reversing of the bond purchases from its quantitative easing (QE) program started soon after the pandemic broke out in March 2020.

Since the Fed is very data-dependent, investors monitor every piece of data concerning rising or declining inflation. We can expect monetary policy to be very restrictive until we see a change in the outlook for inflation. Will the Fed pivot at some point in 2023? We believe that as the inflation rate does come down in the first half of 2023, the Fed will likely pause its tightening. We envision the Fed raising rates two more times in 2023 at a quarter point each time raising the Fed Funds rate to a range of 4.75% to 5.0%. We do not think the Fed will cut rates in 2023 even if we slip into a mild recession. The Fed does not necessarily have to continue raising rates until it achieves the target inflation rate. The Fed will stop when it thinks that enough tightening has occurred to allow for a lower inflation rate over time.

Causes of Inflation

As everyone knows, we have an inflation problem in this country. However, it is not just an American occurrence, it is global. But does global inflation have its roots in the United States?

Nobel Prize-winning economist, the late Milton Friedman once said, "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." Of course, the increase in the quantity of money comes from the government and government alone, in Friedman's assessment. This increase happens at a greater rate than the increase in output, thus, "too much money chasing too few goods."

Since the pandemic started back in March 2020, our government has been running the printing presses. Both the Federal Reserve and the U.S. Congress have been working overtime to create money. The Federal Reserve re-started QE whereby it would buy bonds and mortgage-backed securities with the intention of increasing the money supply and reducing longer-term interest rates. It also brought the Fed Funds rate to near zero percent. At the same time, the Trump administration flooded the economy with money through its various spending programs. The Biden administration has continued the spending spree with its own spending programs inundating the economy with more and more money. Inflation went from non-existent in the spring of 2020 to "red hot" by the middle of 2021.

The original QE program dates back to the financial crisis in 2008. At that time the Federal Reserve wanted to create inflation in an already slowing economy. It followed its original QE program with three additional programs to help ignite a very stagnate economy through the early to mid-2010s. It also implemented a near-zero interest rate policy as well. These programs did little toward creating any inflation in the economy and we suspect that the Fed did not think the post-pandemic liquidity would be inflationary either. But inflation did in fact follow and it appears that Friedman was proven right.

Going beyond the Friedman claim of inflation, we believe that any time we see a spike in oil prices it is followed by inflation. This was true in the mid-1970s and early 1980s. We define a spike in oil as a rapid increase in the price of oil over a very short period of time rather than a gradual increase in the price of oil over a prolonged period of time.

Friedman would most likely argue that higher oil prices are caused largely because there is too much money in the system and not because we don't drill enough or produce enough domestic oil. Oil prices also tend to move inversely to the dollar as oil is priced in U.S. Dollars. When the dollar declines, oil prices tend to rise and when the dollar rises, oil prices tend to fall. Going one step further however, Friedman would probably

say that the increased supply of money, triggered by the government, causes the dollar to fall, whereas a decrease in the supply of money causes the dollar to rise and puts pressure on the price of oil.

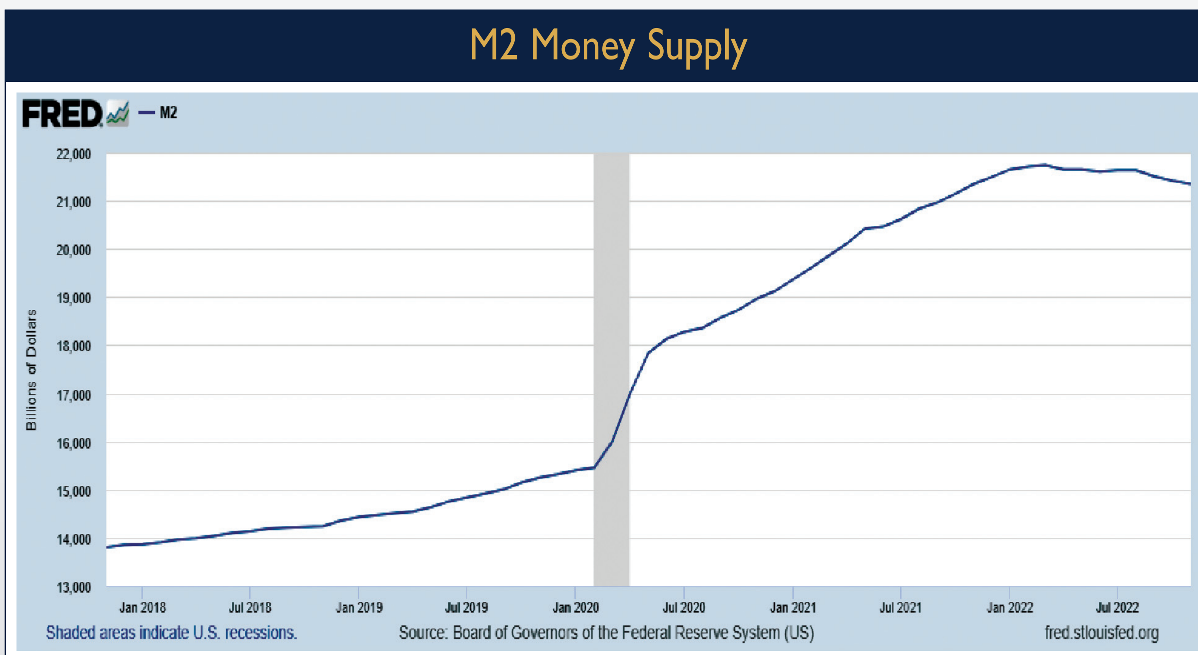
The question we raised earlier is: Is the U.S. responsible for global inflation? The answer is likely "no." Many countries around the globe also implemented their own versions of QE and government spending. In addition, there is a war in Ukraine which has contributed to global inflation. But the U.S. may be the primary culprit in that many commodities, in addition to oil, are priced in U.S. dollars so when the U.S. dollar falls commodity prices rise.

The M2 Money Supply is Falling, Is Relief in Sight?

What is M2? A simple definition would be that M2 is M1 plus time deposits (deposits less than $100,000) plus retail money market funds less IRAs and Keoghs. M1 includes demand deposits such as checking and savings accounts found at commercial banks and other liquid deposits plus currency existing outside the U.S. Treasury, Federal Reserve Banks, and depository institutions.

When the M2 money supply increases, we tend to see inflation increase. When the M2 money supply decreases, we generally see inflation decrease. Given the efforts thus far taking place by the Federal Reserve's raising of interest rates and QT, we have seen the M2 money supply begin to decrease.

The M2 increased dramatically following the government-induced liquidity during the pandemic in the spring of 2020 but has a way to go to fall to the levels last seen pre-pandemic. At least the progress made so far might give the Fed some cover so it may begin slowing its raising of interest rates.



Is the Economy Entering a Recession?

According to a Gallup poll conducted between November 9 and December 2, 2022, 45% of respondents rated the current economic conditions as "poor" while 40% rated them as "only fair." Only 15% rated it as either "good" or "excellent." In that same poll, 70% of respondents said that economic conditions were "getting worse" while 24% said they were "getting better." Americans who have been ravaged by inflation are

likely conflating their feelings about prices for goods and services with the economy and are ignoring the fact that the economy is growing, albeit slowly. But the perception of most Americans is that the economy is not doing too well right now.

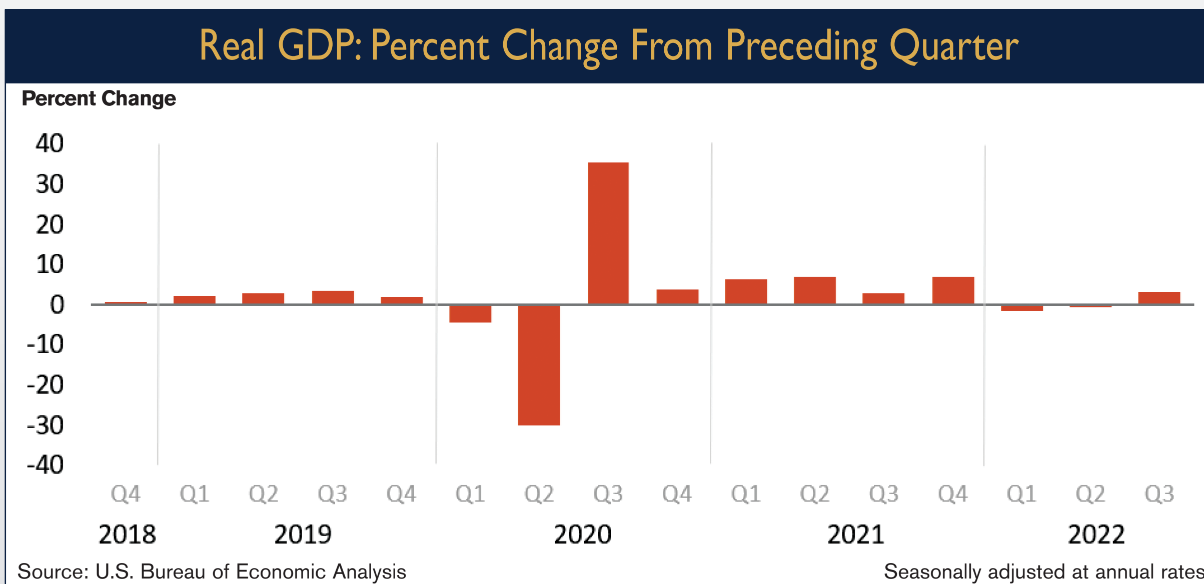
After two consecutive negative quarters of Gross Domestic Product (GDP) to start 2022, the economy rebounded and GDP showed an annual rate of growth of 3.2% in the 3rd quarter of 2022. In rating the economy, Americans don't seem to be putting a lot of weight on the strong jobs market. In December 2022, businesses created 223,000 jobs and wages grew by 0.3%. The unemployment rate currently stands at 3.5%.

Prognosticators, from Wall Street economists to news media figures, are declaring that we will enter a recession in 2023. They cite the inverted yield curve, high inflation, and a seemingly aggressive Fed that they believe will go too far as some of the reasons for our going into a recession.

We do not agree with these predictions. We believe that we will avoid a recession in 2023 and instead will experience slow economic growth. With such strong job creation, a low unemployment rate, current job openings at nearly 10.5 million jobs (November 2022), and nearly every industry facing job shortages, it is hard to predict a recession without some exogenous event occurring. In 2022, we saw the lowest number of corporate bankruptcies in a decade. Personal bankruptcies have also declined steadily every year since peaking in 2010.

Conversely, we cannot ignore the fact that the Conference Board's Leading Economic Index has been declining in recent months. The Index was down 1% in November, 0.9% in October, and 3.7% from May through November while it was only down 0.8% in the previous six months (November 2021 through April 2022). We believe the readings on this index are supporting a slowing economy rather than one slipping into recession.

Nonetheless, it appears that the stock market has already priced in a mild recession. If we do slip into a mild recession, there should not be too much of a long-term negative response by the markets.



Corporate Earnings

Earnings estimates for the S&P 500 Index have been gradually reduced all year. As of September 30, 2022, Standard & Poor's Corporation's analysts projected full-year 2022 earnings of $208.75 per share. As of December 31, 2022, those same analysts project full-year 2022 earnings of $200.12 per share, a decline of 4.1%. This drop does not represent a terrible downward adjustment for the quarter. However, it does

highlight a trend we have seen for most of last year concerning the full-year 2022 earnings. Likewise, the analysts at the Standard & Poor's Corporation now project full-year 2023 earnings of $226.49 per share, a downward adjustment from $238.54 as projected as of September 30, 2022.

These downward adjustments represent a slowing economy but certainly do not correspond to the magnitude of earnings declines we would expect to see if the economy were to slip into a recession. Analysts make their estimates based on looking at the financial statements but also base their estimates on what companies are saying in their conference calls when they release their earnings.

We believe that the modest decline in earnings estimates and the outlooks coming from companies are further evidence that the economy is simply slowing down and not entering a recession.

Market Valuation

At the end of last quarter, we showed a trailing Price-to-Earnings (P/E) ratio of 17.23 and we said that it represented a slightly under-valued Standard & Poor's 500 Index. We said it was slightly under-valued because it was below the 25-year average trailing P/E ratio at 19.99 (based on an average of the quarter-end P/E ratios for the past 25 years). We further confirmed the under-valuation by looking at the forward P/E ratio which was 15.35, lower than the 25-year average forward P/E ratio of 16.84 times.

With earnings estimates coming down do we still believe the market is under-valued? Based on a year-end closing price for the S&P 500 Index of 3839.50 and projected earnings per share of $200.12 for December 31, 2022, the trailing P/E ratio is 19.19 times. The 25-year average trailing P/E ratio is still calculated at 19.99 times. The Index continues to be below the average trailing P/E ratio. The forward P/E ratio is currently 16.95 times with the 25-year average P/E ratio now calculated at 16.82 times by JP Morgan Asset Management. We assess the current market to be "fairly" valued; not over-valued and not under-valued. If earnings estimates continue to fall, and prices rise or even stay where they are, we could start to see an over-valued market.

Where are the Markets Going in 2023?

It is very rare to have two back-to-back years of negative returns for the S&P 500 Index. Since 1980 we have only had back-to-back negative years in 2000 through 2002 when the Dot.com bubble burst and the United States suffered through the 9/11 attacks. The market entered the year 2000 at a quite lofty P/E ratio with the P/E on the S&P 500 Index at 28.43 times earnings (December 31, 1999). We entered 2022 with a P/E ratio of 22.89 times earnings (December 31, 2021). This is a vast difference in valuations.

The year 2023 is the third year of the presidential cycle. Since 1833, the third year of the presidential cycle is on average the best year of the four years within the cycle with an average total return on the S&P 500 Index of 11.90% and a cumulative total return of 559.35%. Year three is positive 74.47% of the time. History may not repeat itself but for some reason, there is a strong bias toward the third year. Perhaps it is because it is after the mid-term elections and there are no current political campaigns occurring.

As we discussed we don't believe the economy will slip into a recession this year and although the market has priced in a modest recession, the absence of a recession will be a catalyst to drive prices higher and support a higher P/E multiple on the market.

We expect that the Federal Reserve will pause its interest rate hikes this year. However, we do not expect it to reduce interest rates in 2023. As such the S&P 500 Index should be able to justify a multiple of over 20 times earnings. As discussed earlier, the full-year 2023 earnings estimate for the S&P 500 Index is currently projected to be $226.49 per share (estimates from Standard & Poor's Corporation analysts). Over the course of 2023, we believe that these estimates will come down by as much as 10% which would lower the estimate to $203.84 per share for the full year 2023. If we apply a 20 multiple to the $203.84 earnings

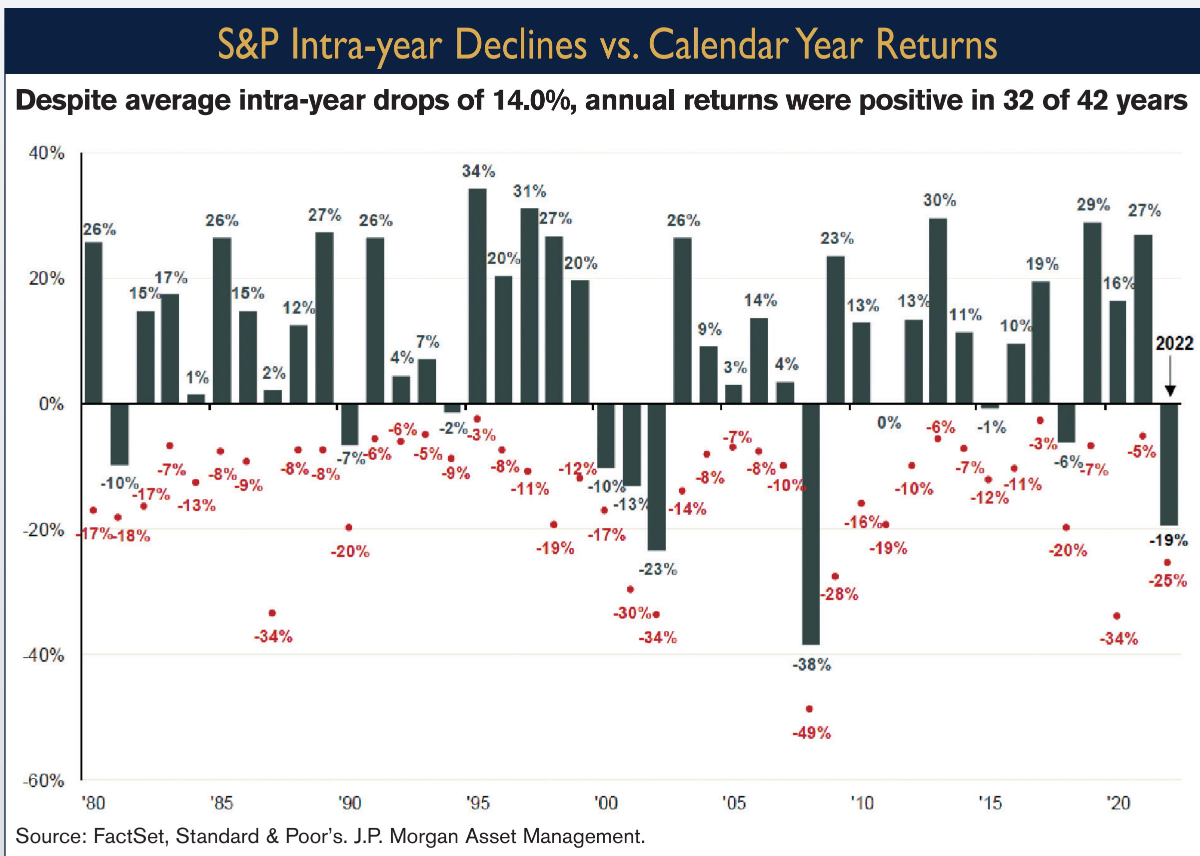
per share, we get a market price of 4076.80 for the S&P 500 Index, which is 6.1% higher than where it closed out in 2022. Adding about 2% for dividends to the price return, we can assume a total return for the S&P 500 Index of just over 8% in 2023. Again, we are assuming no mild or severe recession in 2023, rather we assume a modest economic slowdown.

As for the bond market, we project that we will see continued upward pressure on intermediate and long-term interest rates through mid-year with interest rates backing off in the 2nd half of the year. As such, we believe bond prices for intermediate and long-term bonds will fall in the 1st half of the year followed by a rise in prices in the 2nd half of the year. This suggests that we should keep our bond durations short initially before extending them in the 2nd half of the year.

Presidential Cycles & S&P 500 Total Returns

YEAR	AVERAGE	CUM.	UP YRS	DOWN YRS	WIN %
1	6.15%	295.22%	27	21	56.25%
2	6.94%	333.31%	30	18	62.50%
3	11.90%	559.35%	35	12	74.47%
4	10.03%	471.37%	36	11	76.60%

Presidential cycles from 1833 to 2022.
Source: Advisorperspectives.com



Source: FactSet, Standard & Poor's. J.P. Morgan Asset Management.

Conclusion

Both bonds and stocks had attractive returns in the 4th quarter of 2022. But is the bear market over? We believe it is over even if we're to see a mild recession. The Federal Reserve does not want to cause a recession through its monetary policy. It is a fine juggling act to raise interest rates just enough to slow the economy down to squelch inflation but not too much to cause a recession. This is an arduous task.

Inflation affects everyone but mostly affects those of lower income levels. It is a hidden tax on consumers. Essentially it is too much money chasing too few goods. Causes are multifaceted but are largely the result of too much government monetary and/or fiscal stimulus. M2's Money supply is shrinking and may be signaling an end to the high inflation rates we have been seeing. Largely due to inflation, the perception of most Americans is that the economy is not healthy right now. We do not see a recession occurring in 2023 even though the markets appear to have priced in a mild one.

Stocks are valued on earnings and earnings estimates have been declining over the past year. These adjustments to earnings are consistent with a slowing economy and we would expect them to fall much further if we had a recession on the horizon. At present, it appears that the S&P 500 is fairly valued for the current level of earnings. If earnings should rise, even with the downward adjustments in analysts' estimates, stock prices should rise accordingly. We expect to see a total return on the S&P 500 of 8% this year. We also expect bonds to do well in the 2nd half of this year.

As such, we are here to listen, counsel, and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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