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Investment Management
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Dear Clients and Associates,

2020 and 2021 were confounding and surprising years for the investment markets. Despite a worldwide pandemic, a sharp temporary recession and market collapse, and worldwide geopolitical turmoil, the markets ended both years with incredibly strong returns. With that as a backdrop, 2022 was painful, but oddly predictable.

With the onslaught of the pandemic, governments responded by cutting interest rates to near zero and opened the floodgates of spending and stimulus. While seemingly necessary at the time to ensure the safety and livelihoods of millions, critics warned of the unwanted future effects of such actions. By the end of 2021, with an easy-money environment, coupled with optimism over a potential return to "normal", we saw a frothy environment in most asset classes – equities, housing, bonds, and cryptocurrency.

In 2022, the Federal Reserve began closing the money spigot. Interest rates rose dramatically, equity valuations and prices contracted, housing and mortgage markets cooled, and speculative assets like cryptocurrency and venture capital froze. With consumer spending and employment still hot, inflation was almost 8% in 2022. Americans were shocked by higher prices at the pump and the store, and the declining value of their 401k and their home. Markets fluctuated wildly. The total return for the S&P 500 in 2022 was -18%, the worst year since the great recession of 2008-2009.

As a group, the stocks in our portfolios outperformed broader market measures, which are dominated by large growth and technology stocks. While we do have exposure to technology with large, stable companies like Apple and Microsoft, our portfolios rely on healthy doses of stocks in areas like consumer staples and healthcare, which offer defensive protection in a down market. Hardest hit were high growth, low earning e-commerce and "Covid" stocks, which we largely avoid.

We continue to believe that a balanced portfolio (stocks and bonds) is a good strategy for this market and for the long term. In down equity markets, bonds usually provide a store of value and reliable income. In 2022, the historically quick rise in interest rates caused a decline in the value of bonds as well. However, in our individually managed portfolios where bonds are typically held to maturity, we are confident that the bonds will recover their value and provide a positive return. In addition, our bond holdings are generally short in maturity and of very high quality, making them less volatile than the broader bond market. The flip side of the higher rate environment is that attractive yields are once again available as we buy new bonds.

2023 holds much uncertainty. War continues to rage in Eastern Europe, affecting everything from food prices to supply chains to energy markets. Housing markets may have only seen the beginning of a decline. The Fed, to the criticism of some, continues its program to raise rates to throttle inflation. Whether they can ride the fine line between lowering inflation and forcing a painful recession – the vaunted "soft landing" – remains to be seen. Equity valuations have contracted, but it is unclear if slower economic activity and earnings have been fully factored into the equation. Covid, both here and abroad, continues to lurk menacingly in the background.

There are positive cross currents as well. Employment in most sectors remains strong. Many measures show inflation as high but abating in recent months. Earnings for large, strong companies like the ones we invest in may have moderated but remain healthy overall. Many stocks could be poised for recovery, whether it is in the short term or the long term. We continue to feel that a balanced, conservative portfolio is the prudent place to face the years ahead.

We wish you and your families health, happiness, and prosperity in 2023.

Stewart & Patten Co. LLC

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