TOWNELEY CAPITAL MANAGEMENT

Winter 2023

Economic and Market Review

2023 couldn't arrive quickly enough, as one of the worst years in U.S. stock and bond market history came to a close. 2022 will be remembered for the following events:

1. The first time in 100 years that the U.S. investment grade bond market suffered a double-digit decline.
2. The third time in 91 years that stocks and bonds both lost ground (1931 and 1969 being the others).
3. The S&P 500 Index's seventh worst year since 1926.

Despite the recent bounce back in bond and stock market indexes, we remain cautious. Weakening economic trends, inflationary pressures, geopolitical uncertainty and six consecutive quarters of profit margin declines for S&P 500 companies causes us to remain cautious heading into 2023. We favor US large cap value, international stocks and longer duration assets and will look to increase these weightings throughout the year.

TABLE 1

	Returns as of 12/31/22		Returns as of 1/27/23		
	3 Month	**12 Month**	**YTD**	**Since October 1**	**12 Months**
	10/01/22 12/31/22	01/01/22 12/31/22	01/01/23 01/27/23	10/01/22 01/27/23	01/28/22 01/27/23
FTSE Treasury Bill 3 Mon USD	0.87	1.50	0.32	1.20	1.82
Bloomberg US Govt/Credit Interm TR USD	1.54	-8.23	1.71	3.28	-5.17
Bloomberg US Agg Bond TR USD	1.87	-13.01	2.99	4.92	-8.40
Russell 3000 TR USD	7.18	-19.21	6.62	14.27	-4.22
Russell 1000 Value TR USD	12.42	-7.54	4.77	17.78	1.78
Russell 1000 Growth TR USD	2.20	-29.14	8.33	10.71	-10.46
MSCI ACWI Ex USA IMI NR USD	14.15	-16.58	8.75	24.14	-4.28
S&P GSCI Gold TR	9.45	-0.74	5.98	16.00	7.31

Inflation

Between January 1 and June 30, 2022, headline inflation rose by 5.4% to peak at 9.1%. During the year's second half, declining energy and goods prices helped lower inflation to just 0.9% over the six months. Should prices continue to fall, inflation could drop to 4% by May 2023.

The core inflation rate (which excludes food and energy) also declined, but at a slower pace. Core inflation peaked at 6.7% on September 30 and is currently at 5.7%. Shelter costs (33% of CPI) remain elevated, but recent rental surveys suggest those costs may decline over the next 6 to 12 months. Absent another economic or geopolitical shock, current data suggests inflation has peaked, as illustrated in Chart 1. Nevertheless, labor shortages and the Fed's massive balance sheet could keep inflation above the Fed's 2% target for years to come.

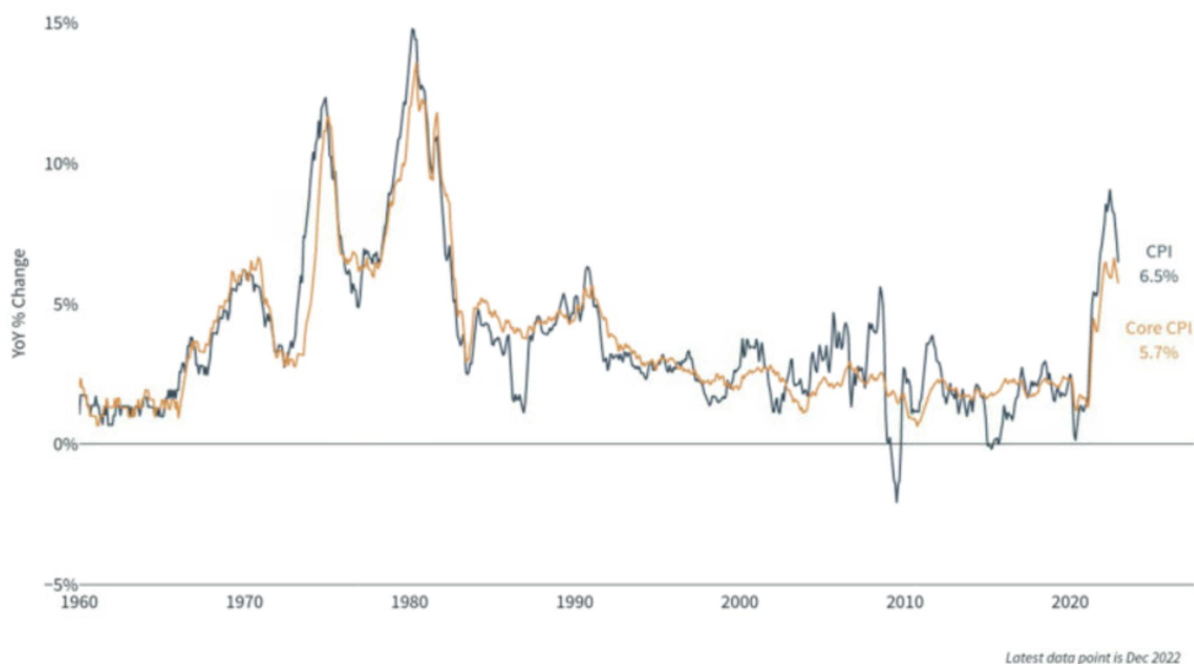
In This Issue:

Economic and Market Review

- Inflation
- Interest Rates and the Economy
- U.S. Bond Market
- U.S. Stock Market
- International Equity Markets
- Gold
- Portfolio Positioning

Secure 2.0 Brings Changes for Retirement Planning

CHART 1



- CPI is a commonly cited measure of inflation. It uses a basket of goods and services to track price changes for consumers.
- In order to measure the underlying trend in inflation, rather than temporary shocks to food and energy, economists often focus on Core CPI.
- Inflation remains at four-decade highs but price pressures are already cooling.

Sources: Clearnomics, Bureau of Labor Statistics

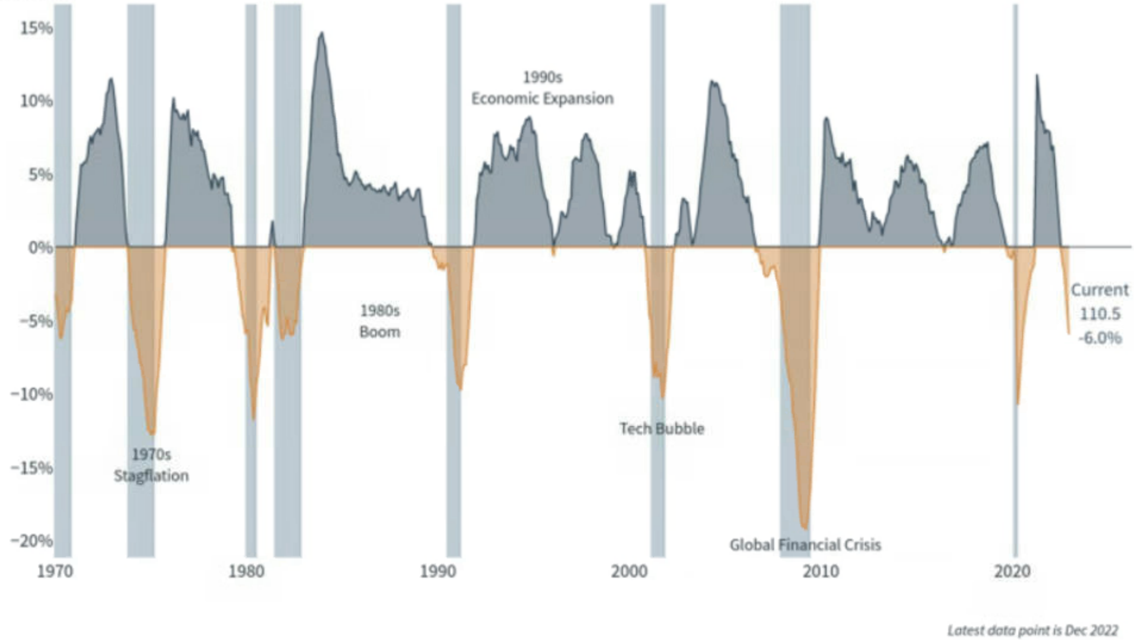
Interest Rates and the Economy

Having misjudged inflation as "transitory" in 2021, the Fed moved much more rapidly than expected last year, raising the Federal Funds Rate from 0.25% to 4.5% within nine months. These aggressive rate hikes, reminiscent of the Volker Fed's moves in 1980, pummeled stock and bond returns through most of 2022.

Higher borrowing costs and inflationary pressures have increased the likelihood of a recession. In addition, as more economic indicators flash red, the greater the consensus that a recession lies ahead. Chart 2 illustrates that before each recession since 1970, the Conference Board Leading Economic Indicator (LEI) turned negative. The LEI is currently down 6%, foreshadowing a recession.

Unlike prior recessions, however, this time the Fed will be challenged to keep policy the same, given inflationary headwinds and the already significant expansion of its balance sheet.

CHART 2



- This chart shows the year-over-year percent change in an index of leading economic indicators.
- This indicator usually turns negative several months before a recession as the economy decelerates.
- This patter is also evident over the prior seven recessions and is the result of the economic cycle.

Sources: Clearnomics, Conference Board, NBER, Refinitiv

U.S. Bond Market

Last year was an extremely challenging year for bonds. While interest rates rose during 2022, bond prices declined. As a result, the U.S. bond market (measured by the Bloomberg U.S. Aggregate index) had its worst year in its 46-year history, losing 13.0%. Before 2022, the worst U.S. bond market return over the last 46 years was only -2.9%, so 2022's showing was truly historic.

In addition, in the last 100 years, 2022 is the only year in which bonds recorded a double-digit negative return (as measured by the 10-year U.S. Government Bond Index). Bond returns will be negative if the interest on the bonds is not enough to compensate for the capital losses due to the declining bond prices. That was the case last year as yields started at extremely low levels and rose much faster than markets anticipated, causing negative returns.

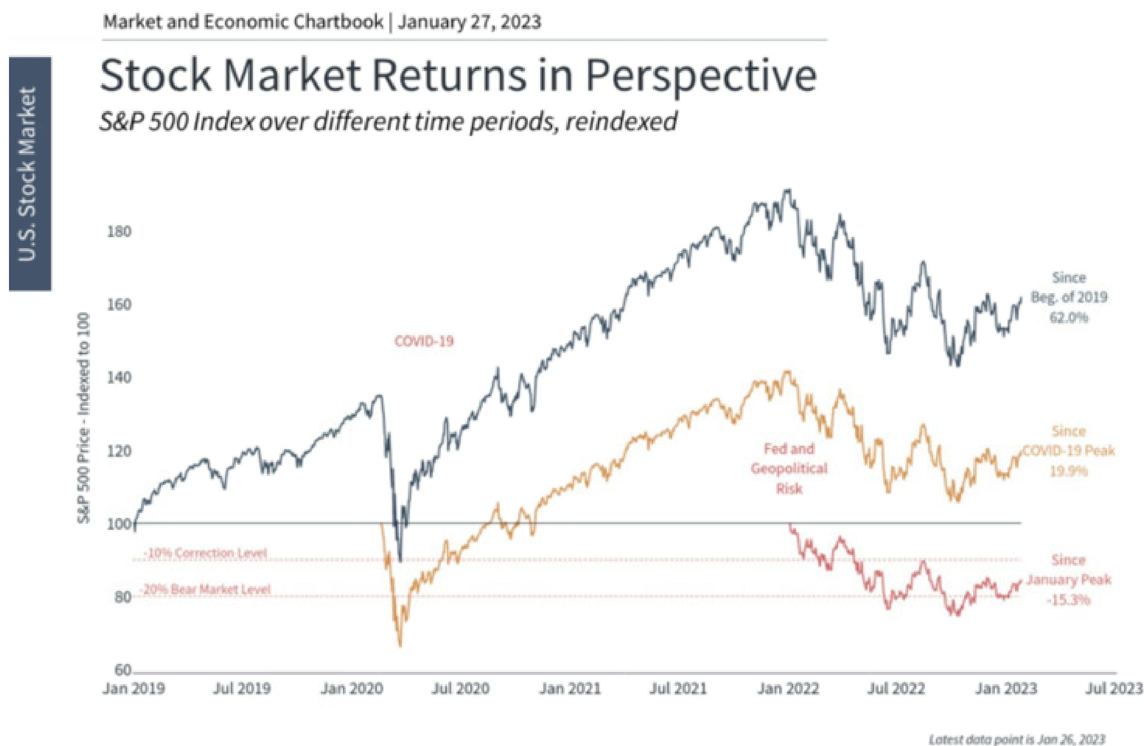
Bond yields have stabilized, and higher coupon rates should help bond returns over the next 12 months. Moreover, if the inflation rate continues to decline, the prospects for fixed income returns should be much brighter in 2023.

U.S. Stock Market

A flood of monetary and fiscal stimulus drove liquidity into risk assets, which caused virtually all asset classes to become overvalued and resulted in a broad market decline of 19.2%. Value stocks switched places with growth stocks, outperforming them -7.5% to -29.1%, respectively. 2022 was only the second year since the Great Recession that stocks finished a calendar year in the red. Since the market hit bottom in March 2009, stocks have gained a cumulative total of 646% and 62% since the beginning of 2019.

So far this year, stocks are up, possibly because investors expect the Fed to pause rate hikes. However, stock market valuation measures, such as the CAPE, PE, and Market/GDP ratios, remain elevated. At the same time, earnings estimates continue to be revised downward, suggesting more downside risk and volatility lie ahead.

CHART 3



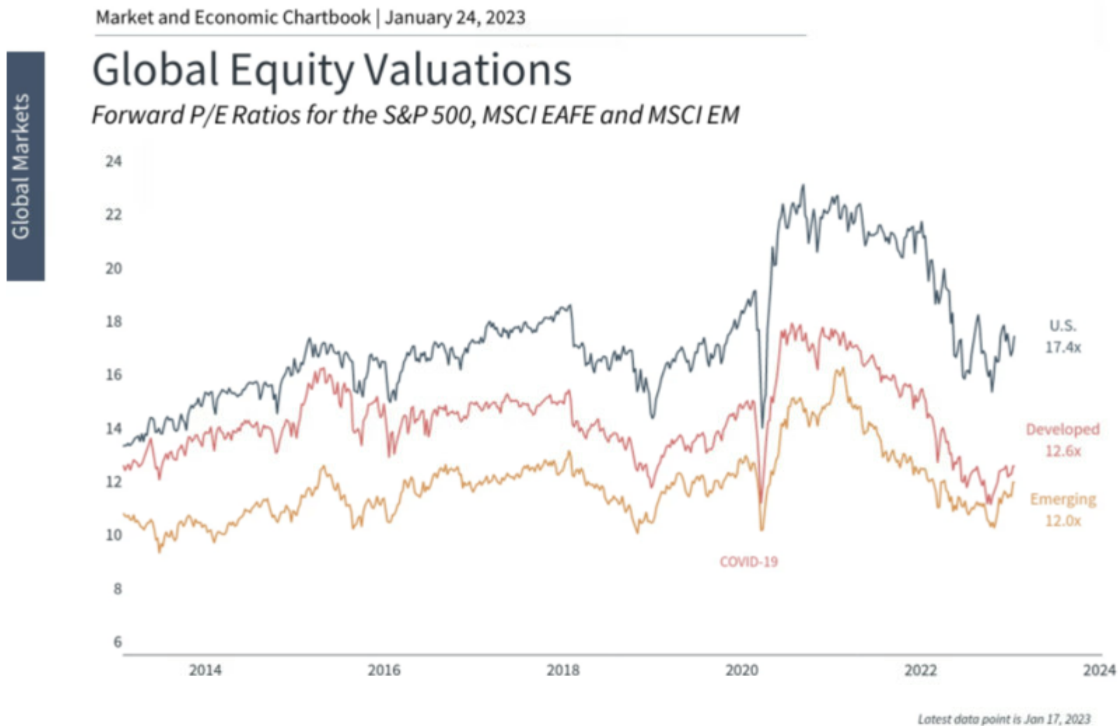
- A key principle of long-term investing is keeping market volatility in perspective.
- This means not just looking on recent performance, but on the broader context and different time frames.

Sources: Clearnomics, Standard & Poor's

International Stock Markets

For 10 of the last 13 years, domestic equities have outperformed international equities. Strong corporate earnings and a strengthening U.S. dollar boosted U.S. equity returns, while non-U.S. equities struggled to keep pace. By the end of 2022, the trend reversed, and non-U.S. equities began to gain ground. Non-U.S. developed market stocks gained 14.1% in the fourth quarter, edging out domestic equities, -16.6% to -19.2%, respectively, for the year. Moreover, international equity valuations are relatively more compelling than US equity valuations, suggesting the differential we've seen this past decade could narrow.

CHART 4



- Major stock market indices have taken very different trajectories over the past decade due to differences in growth.
- Despite the bear market, U.S. market valuations are elevated compared to other regions.
- International stocks, on the hand, are still cheaper in relative terms across both the developed and emerging world.

Sources: Clearnomics, Standard & Poor's, MSCI, Refinitiv

Gold

Historically, gold has reduced overall portfolio volatility, outperformed equities during market stress, and helped hedge against a declining U.S. dollar. While stocks sank in 2022, gold held its own, finishing the year relatively flat (-0.7%). Because gold is negatively correlated with the U.S. dollar, gold prices declined 9.3% during the first nine months of the year as the dollar surged. However, when the U.S. dollar reversed course in the fourth quarter, gold shot up 9.5% and was up 16% through January 27, 2023.

Portfolio Positioning

Last year, as inflation and interest rates rose, we rebalanced the fixed income segment of clients' portfolios to decrease risk. With interest rates stabilizing and the prospects for fixed income improving, we are considering raising the weighted average duration of the fixed income segment of client portfolios. Specifically, we see an opportunity in mortgage-backed securities (MBS) and may look to add to that exposure.

On the U.S. equity side, we increased exposure to actively managed funds as we see more opportunities for active managers to add value in this environment. For example, we added a new domestic large-cap value fund with a quality tilt to position the portfolio more defensively against recession.

In early 2022, we postponed increasing international equity exposure, given the conflict between Russia and Ukraine. As the U.S. dollar strengthened and international equities underperformed for most of the year, we have yet to increase exposure to that asset class. We continue to monitor valuations and the U.S. dollar's strength and anticipate the opportunity to add to the international equity segment is approaching.

Takeaways

Recessions are a normal part of the market cycle. Besides the brief dip from February 2020 to April 2020 (the beginning of the COVID-19 pandemic), the US hasn't seen a recession since The Great Recession of 2007-2009. Historically, recessions have happened every four years on average, so we are long overdue at this point. And because the stock market gained over 600% since the last recession ended, we also have more skin in the game today than we did 15 years ago. We're also 15 years closer to or further along in retirement.

History tells us that often, by the time the economy is officially in a recession, the stock market is already in recovery. When this occurs is, of course, impossible to predict accurately. That's why we design and manage client portfolios to provide global diversification through a balanced approach suited to each client's needs and risk tolerance regardless of market conditions. The financial markets will continue to rise and fall and rise again, and we are confident that this time will be no different. If you would like to review your asset allocation and risk tolerance and share any changes to your life or finances since we last met, please reach out to your Portfolio Manager to schedule a meeting.

Secure 2.0 Brings Changes for Retirement Planning

On December 29, 2022, President Biden signed into law the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act as part of a $1.7 trillion omnibus spending package. This new version of the SECURE Act contains more than 90 provisions with various effective dates – some are immediately effective, and others start later. Here are some of the highlights you will want to consider as you are thinking about your retirement plan:

Delayed Taxes and Lower Penalties

The previous version of SECURE (SECURE 1.0) raised the age at which you begin to take a Required Minimum Distribution (RMD) from your retirement accounts from 70½ to 72, starting in 2020. Now, SECURE 2.0 raises that age requirement again to 73, beginning in 2023, and to age 75, starting in 2033. The benefit of these changes is that retirement plan participants can defer paying income tax on their retirement account assets longer. SECURE 2.0 also reduces the penalty for a missed RMD from 50% to 25% of the RMD amount – and if the error is corrected quickly, that penalty is further reduced to only 10%.

More Opportunity to Catch up

For retirement plan participants over 50, catch-up contribution amounts have been increased to $3,500 for SIMPLE IRAs and $3,500 to $7,500 for other salary deferral plans. And beginning in 2024, participants with more than $145,000 in income from the previous year will be required to deposit their catch-up contributions in a Roth account. Additionally, those aged 60 to 63 will see an additional increase in catch-up contribution limits. For 401(k), 403(b), and governmental 457(b) plans, the maximum is $10,000, or 150% of the catch-up contribution amount in effect in 2024, whichever is greater. For SIMPLE IRAs and SIMPLE 401(k) plans, the max is $5,000, or 150% of the amount in effect for 2025, whichever is greater. However, remember that these provisions only take effect after December 31, 2024.

Use Excess College Savings to Fund Retirement

As of January 2022, 529 plans held more than $480 billion across approximately 15 million accounts. While 529 plans are specifically used to save for college, what happens when there is money left over? Beginning in 2024, SECURE 2.0 allows 529 owners to roll over the leftover funds to the 529 plan beneficiary's Roth IRA without losing the tax benefits on that saved money. There are, however, a few restrictions you should know about. First, there is a $35,000 lifetime cap on those rollover funds. The rollovers are also subject to annual Roth IRA contribution limits, and the 529 plan beneficiary must be eligible to make Roth IRA contributions in the first place; in other words, they have earned income. Additionally, the 529 plan account must have been open for a minimum of 15 years, and you will not be allowed to roll over 529 contributions or earnings made in the last five years.

As you can see, the new SECURE 2.0 Act brings a lot of changes to consider. As always, if you would like to discuss any of these changes or other actions you might take to ensure you are making the best decisions for retirement, please reach out to your Towneley team – we are here to help!

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