MARKET COMMENTARY

4TH QUARTER 2022

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In 2020 and 2021, we used superlatives such as "unprecedented," "record breaking," and "extraordinary" to describe the recently completed year for the markets. Though vastly different than the preceding two years, 2022 will keep this pattern intact. The broader markets endured their worst year since the financial crisis in 2008. The S&P 500® index declined nearly 20 percent. As challenging as it was for equities, the bond market suffered through its worst year in modern history. The Federal Reserve was forced to embark on an aggressive policy path that featured massive interest-rate hikes to combat severe inflation. This action not only suppressed prices that investors were willing to pay for financial assets, but also heightened the likelihood of an economic recession.

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Many of the factors that played a key role in 2022 are still in place as we head into 2023. Unlike 2022, this year starts off with stocks trading at much lower levels and presumably less risk. Market performance in 2023 will likely be dictated primarily by two elements: inflation and corporate earnings.

The Federal Reserve took center stage in 2022. At the beginning of the year, the Fed's lending rate stood at 0 – 0.25 percent. Following seven significant rate hikes, this rate currently stands at 4.25 – 4.5 percent. For perspective, most observers were expecting rates to increase in 2022 but remain below 1 percent.

The Fed's current priority is to tame inflation that threatened to reach 10 percent during the year. They are walking a fine line, attempting to raise rates high enough to subdue inflation without breaking the economy. Whether the Fed can orchestrate the elusive soft economic landing will go a long way toward shaping 2023.

Meanwhile, corporate earnings will be heavily scrutinized. For the most part, earnings were respectable in 2022. According to FactSet, the earnings for the S&P 500® are projected to grow 5.1 percent for the full year. These earnings gains were fueled by many companies passing through price increases that were greater than their input cost increases. This phenomenon is likely to change in 2023, as the lag in input costs catches up. Furthermore, many companies will have a difficult time raising prices against a backdrop of softening demand. The American consumer is showing signs of fraying; credit card balances jumped 15 percent in the last reported quarter, marking the largest spike ever. And while employment remains robust, we have recently witnessed an uptick in layoff announcements by corporate America.

As we look ahead at 2023, this year features something that the prior two years did not–low investor expectations. Most investors expect the Fed to remain resolute in their willingness to do whatever it takes to combat inflation which remains stubbornly high, even if it means inducing a recession. Corporate earnings are projected to be flat or even down for the year. Perhaps paradoxically, low expectations are generally positive for equity market returns. Should inflation moderate even slightly relative to expectations, it will likely catalyze the markets as investors gain optimism that the Fed will be able to likewise moderate their restrictive policy.

The Riverbridge portfolios are well positioned heading into 2023. As economic growth slows and input costs, including labor, increase, companies of all sizes will renew their focus on gaining efficiencies. Many of the Riverbridge portfolio companies across all market sectors are focused on enabling their customers to operate more efficiently. Rising borrowing costs will also impact those companies reliant upon debt to finance their operations. Riverbridge portfolio companies are internally financed, and rising borrowing costs will have a minimal impact on them. Overall, the fundamental vibrancy of our portfolio companies remains strong.