IRONWOOD
Investment Counsel, LLC

Ironwood Investment Counsel, LLC constructs and manages customized investment and wealth management programs designed to meet our clients' unique goals and objectives. Our distinctive process maximizes performance through return enhancement, risk reduction, tax efficiency, and cost containment.

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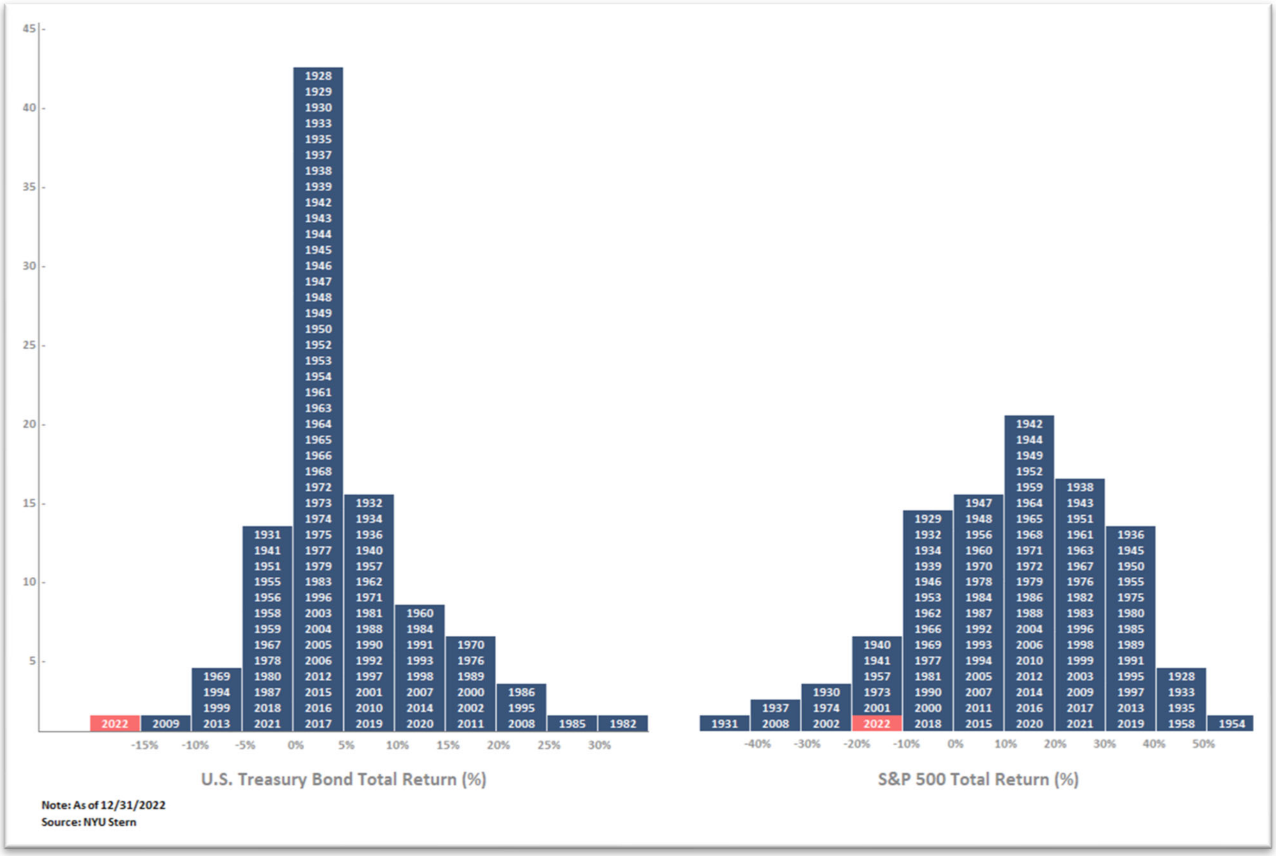
Fourth Quarter 2022 Market Commentary

Higher inflation and interest rates, monetary tightening and slowing growth weighed on markets for much for 2022 but the fourth quarter offered a reprieve from declining asset prices. The S&P 500 index, which tracks the largest 500 publicly traded companies in the United States by market capitalization, increased by 7.56% over the three-month period. Similarly, smaller publicly traded businesses appreciated over the quarter as the Russell 2500 index gained 7.43%. While the fourth quarter was meaningfully better than past quarters during the year, equity markets experienced negative returns for 2022. More specifically, the S&P 500 index declined by -18.11%, the Russell 2500 index fell by -18.37% and the technology-focused Nasdaq index lost -32.51% for the year.

International equities found their footing during the fourth quarter and returned 17.34% over the three-month period. In a rare reversal, the dollar declined relative to other foreign currencies, falling -7.67% for the quarter. This relationship propelled international markets ahead of domestic businesses in the short term. For the year, however, international stocks declined, posting a -13.92% return. A primary driver of these negative returns was dollar strength over much of 2022, amounting to 8.21% for the year.

Fixed income did not offer the historical correlative benefits it has during past periods of equity price declines. Typically, when equity markets are uncooperative, bonds increase in value while offering their contractually obligated coupon payment or stated interest payment. With interest rates on the rise for much of 2022, bond prices suffered. The Bloomberg Aggregate Bond index declined -13.04% for the year. This annual result was the worst outcome for the index since its inception. Even though the Aggregate and the Bloomberg Municipal 1-3Yr indices advanced 1.87% and 1.51%, respectively over the fourth quarter, the positive returns were not enough to offset declines for the year.

After three profitable years for the broad equity markets, 2022 was an outlier for many asset classes. It is extraordinarily rare for both stocks and bonds to decline in the same year. In fact, there are only five instances over the last century where both asset classes fell in the same calendar year. The following chart illustrates annual returns for stocks and bonds dating back to 1928, with 2022 represented in red.



Ironwood managed portfolios were not immune to the declines that characterized equity and fixed income markets in 2022. However, in years of heightened volatility, our focus on quality typically fares better relative to more speculative areas of the market. Further, we have found that as uncertainty increases, the importance of quality investing also increases. The result is often that, in periods of market duress, speculative areas of the market (which Ironwood does not invest) fall by a much greater magnitude relative to quality businesses. For instance, an index that tracks a basket of the largest "blank check companies" (aka SPACs: Special Purpose Acquisition Companies), raced ahead during the pandemic; but declined by over -73% during 2022. Additionally, the Goldman Sachs Non-Profitable Tech Index was down more than -62% last year.

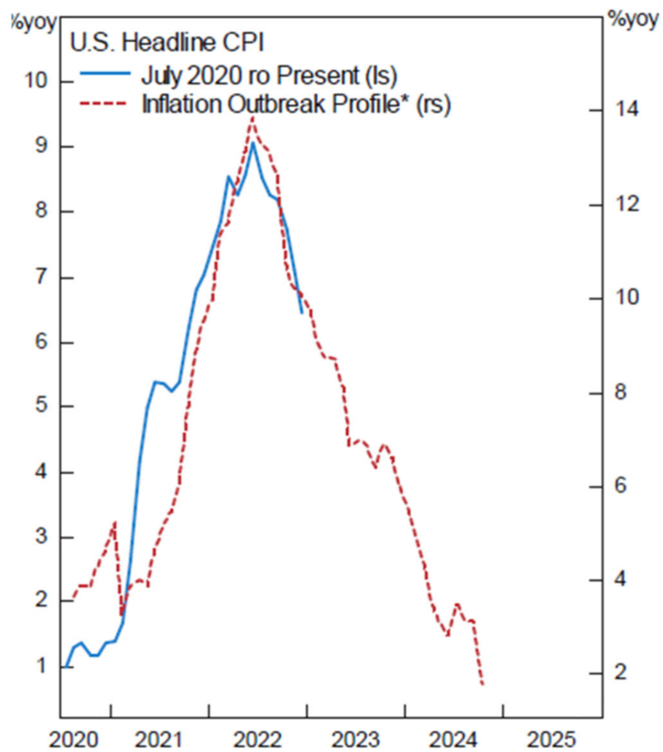
Inflation was the hot topic for global economies during 2022. Following strong economic growth on the back of Covid related fiscal and monetary stimulus, consumer and producer prices surged through the first half of 2022. To combat this ongoing risk, the Federal Reserve Open Market Committee (the "Fed") embarked on an aggressive path of interest rate increases not utilized at this magnitude in 40 years. Following an increase of 0.75% in November and another 0.50% increase in December, the current Fed Funds level sits at 4.375%. The Fed is expected to continue on this path with rates ultimately topping out at around 5% later this year.

Despite the Fed's insistence on more rate hikes, it is possible that the war against inflation has already been won. Consumer prices eased yet again in December marking the fifth straight month of decline. While still sitting at an uncomfortable 6.5% rate, this represents a nearly -30% decline in inflation since the June peak of 9.1%. Based on historical standards, inflation increases quickly and recedes nearly as swiftly after reaching its zenith. The chart below provides some validation for this relationship as it illustrates CPI over the last year and subsequent declines characterizing the last five inflationary cycles

The Fed was widely criticized for failing to recognize the persistence of inflation in 2021 and 2022. The risk in 2023, however, seems to be that the Fed will be overly restrictive and push the US economy into a recession. Should this event occur, it will be the most widely forecasted recession in history. Among 40 economists polled by Bloomberg at the end of 2022, only two expected a soft landing for the US economy over the next 24 months. Even the IMF now expects that one-third of developed economies will experience a recession this year. They do note, however, that the strong labor markets may help the US avoid this fate.

We do not ignore these types of macro-economic factors, but most of our time is spent on analyzing the things that impact holdings in a portfolio. One of our guiding firm principals is that we invest in the same manner and holdings as our clients. This principal is particularly important during challenging years such as 2022 so that when we rebalance and purchase additional equities and fixed income securities, our clients can take comfort that our firm's Partners and employees are doing the same.

U.S.: Current Inflation Versus Historical Profile



*Average of 5 major inflation outbreaks from the 1940s through the 1980s

As investors settle into 2023, we are encouraged by a number of opportunities. Within fixed income, after a rapid increase in interest rates last year, current yield levels are attractive for taxable and tax-exempt securities. More specifically, quality corporate bonds yield over 5% (A rated corporate credits), preferred securities offer approximately 7%, and tax-exempt bonds yield over 3% (this is a tax equivalent yield of over 5% at the highest marginal tax bracket). It is also worth noting that there has never been three consecutive negative years for quality bond indices.

While stocks recorded their worst annual decline since 2008, we see much to be hopeful for in select equities. Morningstar's Equity Research team believes that based on the 700 stocks they follow, the US equity market is undervalued by 16% relative to their fair value estimates. Further, they state that small-cap stocks are trading at an over 30% discount. Lastly, following China's abrupt ending of its three-year long zero Covid policy, we should expect an economic acceleration similar to what the U.S. experienced in 2021.

In summary, following poor years in the financial markets, there are typically opportunities abound where patient investors effectively turn “lemons into lemonade” through thoughtful allocations to quality securities that have the ability to earn returns over a series of years. When we look at the current landscape, we are encouraged by the higher yields offered in fixed income securities and the attractive prices of many of the businesses we invest in on behalf of our clients. We are not sure of the specifics that 2023 will provide, but we have great confidence that investments made or held today will offer meaningful returns over the coming years.

As always, please call or email our team with any questions related to your portfolio or any other matter. Additionally, we would welcome an opportunity to meet with you to review your portfolio and related wealth management items.

We wish you and your family a Happy New Year and hope that 2023 brings you peace, prosperity and happiness.

Ironwood Investment Counsel, LLC