Capital Markets Commentary and Quarterly Report: 4th Quarter 2022

Capital Markets Highlights

The U.S. stock market[1] rallied in the 4th quarter, but the gain of 7.55% was not nearly enough to offset losses in the first nine months of the year. For the full year, 2022, the market was down -18.13%, its worst result since 2008.

Fixed Income returns[2] were generally positive in the 4th quarter but were negative for the year. Short-term bonds performed better than intermediate- and long-term bonds but were also down for the year. The Bloomberg U.S. Aggregate bond index fell by more than -13%, its worst year on record going back to the 1970s[3].

For balanced portfolios, the year's losses for both stocks and bonds resulted in it being the second to worst year for a 60/40 equity/bond balanced portfolio since 1974[4].

In short, following three consecutive good years of stock market returns through 2021, in 2022, the combination of the Fed's seven increases in interest rates during the year from 0%-0.25% at the beginning to 4.25-4.50% at the end of the year, high inflation, and the war in Ukraine were overwhelming challenges for stock and bond markets that began the year at record highs.

In the 4th quarter, stock market investors were encouraged by better-than-expected earnings reports and more evidence that inflation has peaked. But after gains in October and November, the market fell -5.77% in December after Federal Reserve Chairman Jerome Powell said that the Fed anticipated that further ongoing interest rate increases will be appropriate to return inflation to 2% over time and raised the median projection for the Federal Funds level to 5.1% at the end of 2023 from 4.6% projected in September[5]. These were unexpectedly harsh comments for investors growing more optimistic following the best monthly inflation report in a year in early November and an even better report in December[6].

For the year, Value and Dividend strategies were down less than Growth. The best-performing market sector was Energy, up for two years now after being the worst-performing sector for a decade before 2021. Interestingly, the Energy sector's performance in the S&P 500 was up almost 10 times as much as the price of oil year over year, +65.7% versus +6.7%.

U.S. economic growth slowed in 2022 compared to 2021 but remained positive despite the fastest increase in interest rates since the 1980s. The latest revision of Q3 GDP was up 3.2%[7], and unemployment remains below 4%. The Conference Board's estimate for the full year 2022 U.S GDP growth[8] was +1.9% year-over-year, down

[1] All references to the stock market are the S&P 500 unless otherwise noted.
[2] This and subsequent references to the specific sector classifications and asset classes are based on their respective Sector SPDR ETFs
[3] WSJ, January 2, 2023, "For Battered Bonds, Threats of Further Losses Linger"
[4] J.P. Morgan Economic and Market Update as of December 31, 2022. Equity is represented by the S&P 500. Bond allocation is the Bloomberg U.S. Aggregate bond index.
[5] Transcript of Chair Powell's Press Conference, December 14, 2022.
[6] WSJ, January 2, 2023, "For Battered Bonds, Threats of Further Losses Linger"
[7] Bureau of Economic Analysis, December 22, 2022.
[8] The Conference Board Economic Forecast for the US Economy, December 14, 2022, Publication.

significantly from 2021's GDP growth of +5.6% but near the trendline pre-pandemic GDP growth rate of around 2% since 2000.

Looking ahead, we are optimistic about the outlook for the stock market in general and Matrix's portfolios in 2023.

The stock market's decline in 2022 brought equity valuations down to attractive levels, and our portfolios sell at a discount to the market. Throughout last year, we took advantage of market volatility to opportunistically scale out of positions into price strength and reinvest funds to improve the quality and upside of the portfolios. We begin the new year with portfolios well positioned for the environment we foresee in the new year, even if the economy enters a period of slower growth or recession.

We are more positive about stocks than bonds, but for the first time in years, have a favorable view of fixed income investments with shorter-term maturities, inside of 5 years.

Reviewing our Predictions for 2022

Looking back, the biggest misjudgment we made in last year's predictions was thinking that, despite the challenges the market faced after three years of positive returns and what was soon to be the inevitable end of the unprecedented zero interest rate environment, there were enough positives to allow the market to show a year of gains in line with historical averages of high single digits.

We were generally right directionally, and our cautions were warranted, but we did not envision that the overhangs would overwhelm the positives and lead to sharply lower stock and bond prices.

Going into the year we believed that the risks to the economy were more Covid outbreaks, higher inflation, and interest rates than expected, and geopolitical risks, particularly with China and Russia. A year ago, Russia was ominously massing troops on the Ukrainian border.

We had a high conviction level that the Fed would start raising interest rates from an artificially low level, and that would be a tough headwind for the market but thought the pace of increases would be far more measured than what actually transpired. In their year-end forecast for interest rates in December 2021, the Fed expected to raise interest rates by a total of 0.75% in 2022. We thought it likely would be more than that, as we felt inflation was an issue.

But we did not expect the Fed to raise them seven times last year by 4.25 percentage points, the largest and fastest pace of interest rate hikes since the 1980s, or to stay as hawkish as they did at the end of the year as evidence accumulated that their restrictive policies were working[9].

We started the year wary about many Growth stocks (but liked the ones we owned), thinking that too many were priced for perfection. We believed there would be a rotation from Growth stocks to Value and Dividend stocks, which proved out. We also thought that the economy would continue to grow, and, along with higher earnings and dividends and the rotation into Value and Dividend stocks, the market would show another year of gains. So, we were right in our areas of caution and which equity asset classes would lead or lag but were wrong about the overall direction for stocks, which turned out to be significantly lower.

[9] CNBC. December 15, 2022 "Fed raises interest rates half a point to highest level in 15 years"

We were correctly cautious about fixed income returns, believing that interest rates were inevitably headed higher. But we did not envision the Fed moving to its most hawkish policy in 50 years and the sharp declines in bonds that followed. We had also thought that short-term bonds would be more protective even in a normal, poor bond market.

Our 2023 Outlook

We begin the new year very optimistic about the stock market's prospects in 2023. Market valuations came down a lot last year, while earnings and dividends for many high-quality companies rose in 2022 and look solid for the new year. Our valuation work for both strategies show above-average appreciation potential. We anticipate good gains for the overall market and our strategies and believe that after a particularly bad 2022, stocks are poised to earn above average returns. The one caveat to this upbeat outlook is that we expect short-term market swings and volatility along the way.

We think that stocks will outperform bonds but believe that fixed income is more interesting today than it has been in years. High-quality short-term bonds (1-5 year maturities) offer a good income with minimal principal risk. We are less interested in longer-dated maturities where we believe there is interest rate risk from higher rates.

We look for a year of slower, but ultimately, modestly positive economic growth in 2023. We look for puts and takes in the economy along the way as it adjusts to higher interest rates. While it feels like a recession is a good possibility, it is not a sure thing. Unemployment is expected to rise as the economy slows but remain at a historically low level, with the last unemployment report of the year in December at 3.5%. Much depends on what the Fed does with interest rates this year.

We expect inflation numbers to continue trending down but worry that the Fed is hellbent on raising interest rates regardless of the data[10], anxious to reestablish credibility they lost by keeping rates too low for too long. If the economy goes into recession, it is important to remember that recessions are a normal part of the business cycle, usually short-lived and followed by long economic expansions and strong market recoveries. During the post-WW II period, a typical recession lasts about 6-12 months. Stocks generally sell off 3-9 months in advance and then start to rally during the recession[11].

We think the chances are good that the economic outlook may be much brighter six to nine months from now, and the stock market, as it has done historically, will likely rise well before the next economic expansion is evident. The timing of the next advance is unpredictable and being invested in the early stages of a market rally is key to good long-term investment results.

We continue to believe that Value and Dividend stocks are poised to show solid absolute performance and favorable relative performance vs. the overall market. But Growth stock valuations have come down significantly and are more attractive (looking like "values") to us now than they have been for several years.

The risks to the economy and stock market we see in 2023 are more unexpected Covid outbreaks and the disruptions they cause to economic activity (both at home and abroad), the Fed continuing to raise interest rates higher and for longer than necessary without regard to the evidence that they have already done more than enough

[10] WSJ, January 5, 2023. Alan Blinder. "What if Inflation Suddenly Dropped and No One Noticed"
[11] Mark Zandi, Chief Economist at Moody's Analytics, CNBC Interview, June 24, 2022.

to slow inflation, and the unpredictable but ever-present geopolitical risks, particularly with China and Russia's war with Ukraine.

Finally, as we have noted many times, there is always uncertainty about the future. We believe the formula for investment success is to look through near-term instability and stay focused on the long term. The best way to address that is to have an allocation to the stock market that is appropriate for the long-term, which includes both good and bad times.

Large Cap Value Strategy

In the 4th quarter of 2022, Matrix's Large Cap Value Portfolio (LCV) rebounded from the extremely difficult first 9 months of the year and performed in line with the S&P 500 but lagged the Russell 1000 Value® Index. For the year, the LCV portfolio modestly lagged the S&P 500 but had a more significant lag to the Russell 1000 Value®.

Our 2022 weakness was driven by a market that severely penalized the previous year's winners, of which we had many, and by the sharp pullback in Technology and Communications Services stocks.

In the 4th quarter, and throughout the year, we took advantage of stock market volatility to opportunistically scale out of positions into price strength and reinvest funds in new names or to fill out existing positions to improve the quality and upside of the portfolio.

In the 4th quarter, we started a new position in Amazon (AMZN) and trimmed the position in Schlumberger (SLB) on price strength.

Amazon is a leading mega-cap e-commerce and cloud computing company. Since starting in a small house in Seattle, WA, Amazon became one of the major tech disruptors of its generation with leading market shares in E-Commerce Retailing (40% market share) and Cloud Computing (33% market share). After hitting a record high of $188 in late 2021, Amazon's shares have fallen by more than 50% to a recent price below $90 per share. While not a traditional Value stock based on its current P/E, the company is now trading near the bottom of its historical valuation range on several other valuation metrics. We believe the worries about a slowdown in its business from the past few years of supercharged Covid economy growth provide an opportunity to buy a great company at a very attractive price.

The largest sector weightings in the Large-Cap Value portfolio as of December 31 were in Financials, Health Care, and Information Technology.

Financial stocks have sold off significantly, even though the current environment of rising interest rates, loan growth, and good credit quality should be very beneficial to their businesses. We believe their capital and credit metrics indicate more than enough strength to successfully navigate the current economic uncertainty. We look for significant multiple expansion in their P/E's coming out of a slowdown or mild recession and believe that Financials are one of the more attractive areas of the market.

Info Tech was one of the worst-performing market sectors in 2022, suffering as interest rates rose and business slowed. From current prices, we believe the names we own in this sector offer very strong appreciation potential, have very profitable businesses with solid growth potential and are valued at historically low levels.

Our Health Care investments are well diversified, should provide stable business performance, and exhibit good upside potential, while providing some defensiveness.

Looking ahead, in the aftermath of the LCV portfolio's 2022 decline, we are very optimistic about the portfolio's prospects in 2023. We believe it is very well-positioned to rebound in upcoming periods, as its companies have strong and growing franchises and are positioned to weather the uncertain business and financial environment. If we are right in our upbeat market outlook for the upcoming year, we expect LCV to fully participate in the market's advance.

At year-end, the LCV portfolio was trading at 14.1x 2023 estimated earnings, which is attractive on an absolute basis and at a solid discount to the S&P 500's 16.7x for the comparable period. The average of our estimated upside for stocks in the portfolio is nicely above our historic average and at a level that we believe suggests healthy upside potential for our LCV stocks and the portfolio overall.

Dividend Income Strategy

The Matrix Dividend Income (MDI) portfolio navigated the 2022 bear market extremely well and was down just modestly for the year, well ahead of the overall market (S&P 500®) and nicely outperforming the Russell 1000 Value® Index. For the 4th quarter, the portfolio had healthy gains, in line with the sharp move higher in the Russell 1000 Value index and well ahead of the S&P 500.

The Matrix Dividend Income strategy places paramount importance on a company's commitment to paying a dividend, and then sustaining and growing it over time. The stocks in the portfolio have strong financial positions, cash flows, and solid ongoing profitable franchises that should enable continuity and growth of their dividends even during recessions.

For the year, 23 of 27 holdings (over 85%) raised their dividends by an average of 6.7%. These increases were impressive in an environment where there are many questions about the strength and outlook of the general economy. At year-end, the portfolio had a 3.0% dividend yield, which compares favorably with the 1.76% yield on the S&P 500, the 2.32% yield on the Russell 1000 Value, and is still competitive to the 3.88% offered on the 10-year Treasury which was up sharply last year.

In the 4th quarter, we started a new position in Tyson Foods (TSN) and added to Morgan Stanley (MS).

Tyson Foods is one of the world's largest chicken, beef, pork, and prepared foods companies. Major customers include grocery chains, wholesale clubs, food distributors, fast-food franchises, and military commissaries. Walmart is its largest customer, accounting for more than 18% of fiscal 2021 sales. Tyson's share price topped out at over $100 in February of 2022. Since then, the shares dropped below $65 on falling earnings estimates for the upcoming year. Some of the reasons for the earnings are falling beef prices, rising commodity prices, foreign exchange, and higher investment spending. But the big picture is that the company has an outstanding long-term record of earnings and dividend growth, a strong balance sheet, and a valuation now at a multiyear low with a dividend yield of 3%. The company should benefit from the growing worldwide demand for protein. Exports generated just 10% of fiscal 2021 sales, providing a long runway for growth.

We trimmed our holding in Amgen (AMGN) on price strength, as the position had become oversized due to the stock's appreciation in 2022.

As of 12/31/22, the Dividend Income portfolio's largest sector concentrations were consistent with the previous quarter: Financials, Health Care, and Information Technology. We believe these exposures deliver an attractive mix of economic sensitivity, defensiveness, and growth potential.

We think Financials have become very inexpensive, as they have underperformed but have excellent prospects in the current environment of higher interest rates and good loan growth. To our mind, their credit quality and capital positions are strong, and we look for a significant multiple expansion in their P/E's coming out of a slowdown or mild recession, complementing their good and growing dividends.

Overall, Health Care has been a strong performer in a difficult market. We believe our stocks continue to have good upside potential stemming from visible, near-term value drivers and expect the laggards in the group to lead in the upcoming year.

We believe our Info Technology holdings are all very well-run companies with excellent outlooks for their long-term business performance and strong commitments to their dividends. The 2022 sell-off has positioned the group for a strong bounce-back in better times.

We are pleased that the MDI strategy is achieving its goal of being more protective than the market during a tumultuous 2022, while also generating a strong and growing income stream. It posted strong relative performance and preserved capital during 2022.

We have gradually been moving from a very defensive posture to a more offensive-oriented stance in our recent portfolio stock selections, with the goal to continue to defend well in a difficult market environment while preparing for better stock market returns in upcoming periods.

We believe the portfolio changes we have made during the year - selling winners, upgrading the quality of the holdings, and buying good dividend payers that sold off - position the portfolio to fully participate in the market's eventual recovery.

The MDI portfolio was attractively priced at 15.1x 2023 estimated earnings which is at a nice discount to the S&P 500's 16.7x. The median P/E of the portfolio was an even more compelling 13.4x 2023 earnings.

The Dividend Income portfolio continues to operate at a very high level and reported strong financial results in 2022 vs. expectations. Strong business performance with growing earnings, cash flows, and dividends, coupled with attractive valuations, should lead to solid stock gains in the upcoming year.

Our estimate of the average upside potential for the portfolio at year-end was well above its historical average, which generally has been bullish for the portfolio and the market in general.

Bonds

In the 4th quarter, the bond market showed a positive return, but it was one of the worst years in fixed-income performance in the last 50 years. Short-term bonds performed better than intermediate- and long-term bonds but were also down for the year. The Bloomberg U.S. Aggregate bond index fell by more than -13%. Municipal bonds suffered their worst losses since 1981[12].

Bonds usually provide a haven during periods of stock market decline but not in 2022 when the Fed and central banks around the world ended the long period of zero and negative interest rates and otherwise tightened monetary policy by reducing their bond holdings. The Fed raised interest rates seven times in 2022 by 4.25 percentage points and projects that they will continue raising rates in 2023, despite signs that inflation has peaked and is trending lower.

The 2-year Treasury yield ended 2022 at 4.43% vs. 0.73% at the end of 2021, the 5-year was 4.00% vs. 1.26%, the 10-year rate ended 2022 at 3.88% vs. 1.51%, and the 30-year was 3.96% vs. 1.90% over the same periods.

We think the Fed has done enough to slow the economy and bring inflation down, but they seem impatient that it is not happening more quickly. They know that monetary policy works with "long and variable lags", and we fear they are ignoring the better inflation data of the past five months with a goal to get the Fed funds rate to 5% or higher and restore some credibility they lost by waiting too long to begin raising interest rates when there were many signs that inflation was accelerating coming out of the pandemic.

Matrix's fixed income positioning has been very cautious in recent years, focusing on high-quality corporates, U.S. Treasuries, agencies, and municipals (where appropriate) with nearer-term maturities.

With our conservative shorter-term positioning, our taxable and municipal bond portfolio performance in 2022 was in-line to modestly better than their benchmarks and substantially more protective than the overall bond market.

Looking ahead, with high-quality shorter-term bonds now offering yields of around 4% or better, we are more interested in fixed income than we have been in years. However, we are still cautious about long-term bonds where we think there is more interest rate risk.

Balanced Accounts

Balanced accounts were up in the 4th quarter benefitting from the rally in stock prices and gains in the bond market and were further aided by our overweight to stocks.

With stocks and bonds both down for the year, balanced accounts did not get the typical benefit provided by diversifying among the two asset classes. Looking forward, we believe this is an outlier event and expect stocks and bonds to return to their long-term relationship, where stocks are the driver of long-term growth and bonds provide income and stability during difficult stock market environments.

With the sharp correction in stock prices, we believe that stocks are more attractive than bonds, but that high-quality short-term bonds now yielding more than 4% are also attractive investments and should provide stability, modest growth, and a healthy income stream for the portfolio in the upcoming year.

[12] WSJ, December 30, 2022, "After Muni-Bond 'Bloodbath,' Expectations for 2023 are Muted"

Tax Mitigation

As we discussed last quarter, we were very active in the last few months of the year in our tax mitigation activities with a goal of offsetting gains with losses when it made economic and investment sense. These actions allowed us to significantly reduce the ultimate capital gains realized in most portfolios. While we may not have been able to eliminate all your realized gains, our actions significantly lowered them while maintaining the integrity of the portfolio, allowing it to fully participate in a market rebound. We did not take every loss available when we judged the trade-off would be detrimental to future portfolio performance.

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We thank you for the trust you have placed in us and send our best wishes for a happy, healthy, peaceful, and prosperous 2023.

Disclosure:

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Definitions:

S&P500 ® Index *is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.*
Russell 1000® Value Index *measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values.*
Bloomberg US Aggregate Bond Index *is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market*
Price to Earnings Ratio *also called the P/E ratio, tells investors how much a company is worth. The P/E ratio simply the stock price divided by the company's earnings per share for a designated period like the past 12 months. The price/earnings ratio conveys how much investors will pay per share for $1 of earnings.*
Price to Book Ratio *also called the P/B ratio, compares a company's market value to its book value. The market value of a company is its share price multiplied by the number of outstanding shares. The book value is the net assets of a company.*
Earnings per Share (EPS) *is a company's net profit divided by the number of common shares it has outstanding. EPS indicates how much money a company makes for each share of its stock and is a widely used metric for estimating corporate value.*
Volatility *a statistical measure of the dispersion of returns for a given security or market index.*
Inflation *a sustained increase in the general level of prices for goods and services.*
Recession *a significant, widespread, and prolonged downturn in economic activity.*
Short Term Bonds *a bond that will pay back your principal, or mature, quickly, typically within four years.*
Intermediate Term Bonds *issued with maturity dates that are between two and 10 years.*
Long Term Bonds - *maturities of between 10 years and 30 years.*
Value Strategy *investment strategy that involves picking stocks that appear to be trading for less than their intrinsic or book value.*
Dividend Strategy *investment strategy of only buying stocks that issue dividends thus creating a reoccurring income stream.*
Growth Strategy *a collection of business initiatives that seek the maximization of a company's value within a period.*
Dividend Yield *a financial ratio that tells you the percentage of a company's share price that it pays out in dividends each year.*
P/E Multiples *the ratio for valuing a company that measures its current share price relative to its per-share earnings.*
Bear Market *is defined as sustained periods of downward trending stock prices, often triggered by a 20% decline from near-term highs.*
Discount *refers to a situation when a security is trading for lower than its fundamental or intrinsic value.*

Financials *a section of the economy made up of firms and institutions that provide financial services to commercial and retail customers.*
Health Care *all businesses involved in the provision and coordination of medical and related goods and services.*
Information Technology *businesses that sell goods and services in electronics, software, computers, artificial intelligence, and other industries related to information technology (IT).*
Fixed Income *types of investment security that pay investors fixed interest or dividend payments until their maturity date.*
Communication *includes companies that sell phone and internet services via traditional landline, broadband, or wireless. The communications sector also includes companies that create and produce of movies, television shows, and other content.*
Interest Rate *the amount a lender charges a borrower and is a percentage of the principal—the amount loaned.*
Loan Growth *the average of the increases in the Company's total loans less allowance for loan losses at the end of the four fiscal quarters of a Year as reported in the balance sheets included in the Company's quarterly and annual reports on forms 10-Q and 10-K.*
Credit Quality *a measurement of an individual's or company's creditworthiness, or the ability to repay its debt.*
Credit Metrics *directly reflect the book values of assets, liabilities, and shareholder equity*
Cash Flow *the net amount of cash and cash equivalents being transferred in and out of a company.*
Balanced Accounts *combines asset classes in a portfolio in an attempt to balance risk and return. Portfolios are divided between stocks and bonds, either equally or with a slight tilt, such as 60% in stocks and 40% in bonds. Balanced portfolios may also maintain a small cash or money market component for liquidity purposes.*