Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

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Highlights:

- Regardless of asset type, 2022 was a rough year
- Market remains highly sensitive to Fed
- "Low unemployment recession" in our future?
- Medium-term prospects seem surprisingly bright

Introduction

"We were all going direct to Heaven, we were all going direct the other way."

Charles Dickens wrote *A Tale of Two Cities* in 1859. It told a story about a cast of characters in London and Paris seventy years prior. In the years since, his stirring words about 'the best of times and the worst of times' have resonated because each generation looks to its own time and wonders how it stacks up. It is easy to get hyperbole mixed up with history, of course, but for the economy in 2022, there really was, if not a tale of two cities, then a tale of two factors of production. Each "city," labor and capital, underwent something new and different.

For labor, there is more leverage than perhaps any time since the 1950s. Approximately 3.5 million workers have exited the job market during the post-Covid years, which has applied upward pressure to wages. The reduction in the workforce seems due to a combination of early retirements, Covid-related deaths, financial incentives to avoid work, a rise in drug addiction and other disabilities, and a tighter clamp on immigration. These variables have conspired to keep wage growth strong and employers reluctant to cut jobs.

But 2022 was indisputably bad for the other "city:" capital. The stock market had its worst year in more than a decade as the S&P 500 fell 18% for the year. And bonds did not fare any better, as the Bloomberg Aggregate Bond Index declined 13%, its worst performance since its inception in 1976.

The lead story for 2022 was inflation. There is no nice way to put it: the Federal Reserve was caught napping.

While the Fed began changing its guidance regarding inflation by November 2021, it clearly thought that rate tightening in 2022 would be a series of leisurely 25 basis point hikes. The December 2021 "Summary of Economic Projections" reflected a view that its target Federal Funds rate would be 1% in December 2022. The target rate is now 4.5%.

What changed? While inflation prints came higher than expected in the front half of the year, the Fed grew especially alarmed at reports that long-term inflation expectations were becoming unanchored. This occurred in May and June, spurring the Fed to hike at an aggressive clip of 75 basis points for four consecutive meetings.

Prior to those reports, Chair Jerome Powell argued that inflation should bend with a little pressure from higher rates, as inflation was basically the result of "transitory" factors such as temporarily impaired supply chains. After those reports, Chair Powell became the second coming of Paul Volcker, the inflation-fighting Czar of the 1980s.

While we are not great fans of these "Powell pirouettes," we understand that the Fed does not want to squander decades of anti-inflation vigilance. And as Powell has said repeatedly, the costs inflicted by nipping inflation in the bud are immeasurably cheaper than the costs inflicted by beating back inflation once the public is convinced that inflation is here to stay.

The Fed's speedy journey to restrictive rates created, for the capital markets, a difficult and challenging year. It may also create a recession. Time will be the judge of that because, while global reflation has created the "worst of times" for the financial markets, only the fullness of time will judge what global reflation has done to the real economy.

Domestic Economy Review and Outlook

This past year was bracketed by a weak, even recession-like, first half, followed by a decent rebound in the second. It resulted in GDP growth close to 1% for the entire year. While the final growth number may appear to reflect an economy still recovering from the pandemic, the underlying trends for economic growth seem weak as we enter 2023. The inflation surge strengthened the Fed's resolve to return to price stability,

which at this point can only be achieved by reducing demand.

The record rise in the Fed Funds rate, combined with the ongoing reduction in the Fed's bloated balance sheet, is exerting pressure on the most cyclical sectors of the economy: manufacturing and housing. Manufacturing, which admittedly accounts for only 11% of the economy, has fallen below 50 for the past two months, using the ISM (Institute for Supply Management) metric. This is consistent with the onset of a recession in the broader economy.

Additionally, the housing sector is reeling. Existing house sales fell 7% in November, the tenth consecutive month of decline. Pending home sales fell 4% in December and are down a whopping 38% year-over-year. Home prices, which surged over the past several years, are now declining month-to-month. While nationwide averages are still up year-over-year, the recent trends in this highly segmented market have been negative. Finally, housing affordability is becoming more challenging, as mortgage rates have virtually doubled over the past six months.

The tight labor market has helped the economy avoid tumbling into a serious downturn. With job creation at a solid pace, and wages and salaries rising, consumer spending remains robust. Consumption accounts for more than two-thirds of the economy and despite the Fed's rate hikes, job creation remains robust, with unemployment at 3.5%. We would expect unemployment levels to rise over the course of 2023.

The American consumer remains resilient. Though not on a spending spree, American families have been maintaining their lifestyle. But wages have not entirely kept up with inflation. Credit card balances are rising at a double-digit rate and savings are faltering to pre-pandemic levels. While the consumer is far from being strapped, thanks in part to the lingering effects of pandemic-era government largesse, spending will presumably be curtailed in a softening job market.

Recent inflation readings have been encouraging. It appears that headline CPI inflation peaked last June at 9.1% year-over-year and is now in the process of rolling over. Going forward, the largest component of the index, "renters equivalency," should fall as the housing market continues to weaken throughout the year. We also think the prices of commodities will continue to fall, as both U.S. and global demand weakens, although this tendency may be counteracted by the reopening of China. We could see the inflation rate being cut in half by year-end, although that would still be above the Fed's stated target. In the meantime, the financial markets remain volatile, shadowed by uncertainties regarding the prospect of a recession, its magnitude, and its impact upon the Fed's interest rate policy (ultimately, the cost of capital).

While we do not know if the Fed will be able to "engineer" a "soft landing, we do expect the economy to lose some momentum in 2023. The Fed still has some wood to chop if it wants to achieve price stability, and higher rates inevitably cut into the growth equation. At this point, we are looking for growth of less than 1% in 2023, with the distinct possibility of negative growth.

Looking forward, the stock market itself will most likely endure "whipsawing," as investors attempt to anticipate rate hikes and gauge their impact upon the economy. With the yield curve now inverted to a degree not seen since the early 1980s, further economic slowing seems likely as we move into the new year. It is quite possible that a new term will enter the American lexicon: "low unemployment recession."

Fixed Income Review

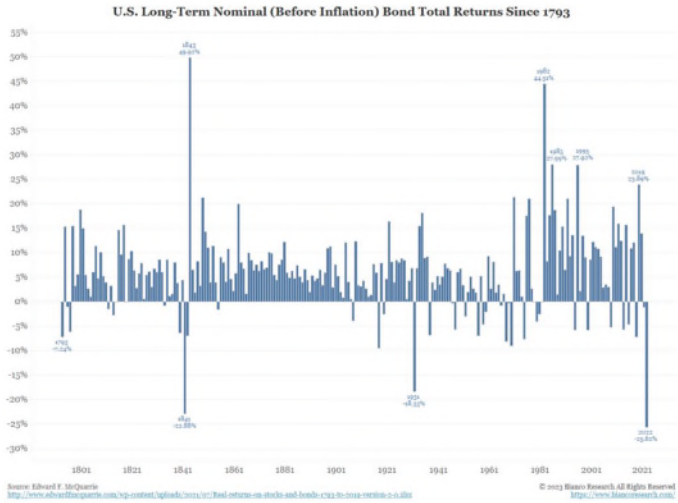
For a long time, the Fed's zero-bound rates and the quantitative easing led to inflated capital assets. Today, virtually all new data seems interpreted through the lenses of how it will affect Fed policy, which in turn affects the cost of capital and asset valuations. In a sense, the Fed was like a pusher, flooding the financial markets with cheap money, then leaving Jonesing users in its wake. One might say that the Fed giveth and the Fed taketh away, although there is nothing funny about collapsed asset values.

Inflation in the market for goods and services eventually arrived, of course, and with a vengeance. The ramping-up on the fiscal side, combined with impaired supply chains, led to too many dollars chasing too few products. But a key to understanding Fed policy is that it is focused on the real economy, not the financial markets. As a conceptual matter, and increasingly as a practical matter, the Federal Reserve only cares about the financial markets to the extent instability there can spillover *into* the real economy.

To be sure, since the Fed's tools are financial in scope, it transmits its policies to the real economy *through* the

financial markets. For instance, we do not doubt that the Fed placed a floor under the stock market for more than a decade, but the "Fed put" was designed to stabilize the economy in the teeth of market instability. When the risks to the real economy started spiraling in the other direction, to the "upside," the Fed abandoned, cruelly but inevitably, any market participants addicted to cheap money.

The addiction to cheap money was not limited to the stock market. The bond market also suffered as the "fix" was removed. Indeed, for long-term bonds, it was the worst year seen since the earliest days of the republic.



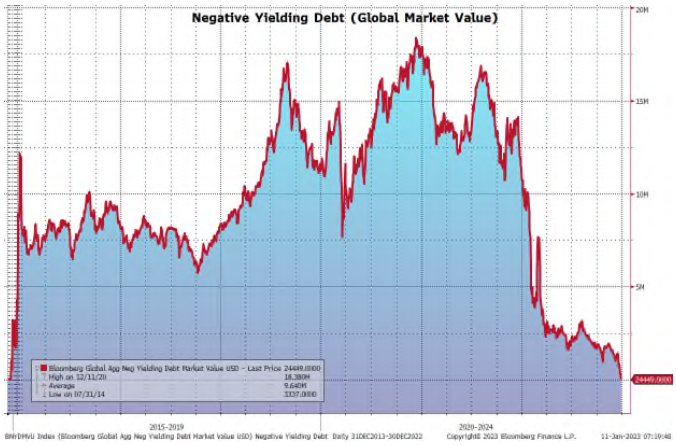
In an environment with the largest rate increases since the 1980s, last year's losses were higher than most investors have experienced. The higher rates had the knock-on effects of higher borrowing costs for governments, corporations, and the mortgage/housing market. While we began last year observing the increased risk that inflation would become embedded, few investors foresaw 'Headline CPI' peaking at 9.1%.

The Federal Reserve's inflation benchmark, 'PCE Core,' peaked at 5.4%. This is well higher than the Fed's 2% target. Naturally enough, the unexpectedly high levels of inflation were met with unexpectedly aggressive tightening from the Fed. Yet, despite the aggressive pace of tightening, overall financial conditions (as measured by the Bloomberg Financial Conditions index) were no tighter in December than they were in March. At this point, it does not look like financial market instabilities are spilling into the real economy.

Ultimately, with reference to interest rates and the real economy, the story of 2022 is global reflation. Rates skyrocketed under the pressure of inflation and newly vigilant central banks. For fixed income securities, it is a mixed picture, as what was lost on the valuation side is gained as income going forward.

One thing which is disagreeable to all creditors is inflation. Here too, though, it is entirely downside. Consider negative yields: it is counterintuitive that investors would *pay* for the privilege of lending, but that is precisely what happened in deflationary pockets of the global economy during the 2010s. While the topsy-turvy world of negative yields did not reach the United States to any significant degree, it was common enough in other parts of the world.

In any case, thanks to global reflation, negative rates have receded. The graph below shows the amount of outstanding debt priced below 0%. It is down to zero.



Source, Bloomberg

One gnawing concern is the newly divided government in Washington. We expect it will lead to budgetary brinksmanship, as we saw during the Obama years. While the brinksmanship comes from a good place—a desire to reduce deficits and ensure that government is living within its means—government spending can be an important delta for economic growth. Although fiscal support became overabundant during the pandemic, it is in the order of things for monetary authorities to reign-in profligate fiscal authorities.

2022 brought the restoration of that order. Life can become difficult when fiscal authorities constrain aggregate demand. When the economy faces downside risks, as it did in the 2010s, fiscal impasses force monetary authorities to "open the spigot" in a counteracting move. While we do not expect a return to

those days, we do think fiscal showdowns create uncertainties which impact both the real economy and the financial markets.

On the credit side, markets performed well in the fourth quarter, as OAS tightened from +146 to end the year at +121. Given the volatility in both the equity and treasury markets, investment grade spreads performed very well, both in the fourth quarter and for the year. But with the Fed determined to drive inflation down by reducing growth and demand, we see more downside risks for credit and remain cautious about investing in corporate bonds.

To date, the rapid rate hikes have not dented the low unemployment numbers. A low unemployment recession would be new territory, a flipside to the "jobless recovery" we saw in the early 2000s. One can easily imagine Chair Powell arguing, should a recession arrive, that although GDP has moved into negative territory, high employment levels, combined with the need to achieve *stable* long-term growth, make it necessary to maintain tight screws on inflation.

We think the market is overestimating the magnitude and speed with which the Fed reverses course. Our forecast for year-end 2023 puts the Fed Funds rate at 4.75-5.00%, higher than the level implied by the market (Fed Fund futures are currently at 4.45%), but lower than what is implied by the Fed's own "dot plots" (5.00-5.25%). We think this will cause the Treasury curve to flatten somewhat in 2023, while remaining inverted against recession risks.

While we think that inflation has peaked and will be more subdued this year, we do not think 2023 is the year to make interest rate bets. With the Federal Reserve and other major central banks reducing their balance sheet size, i.e., selling bonds, we expect interest rates to remain elevated. If the Fed's tightening causes the death of some zombie companies which relied upon zero interest rate policies for their survival, and if it speeds up the process of containing higher prices, then the path could be cleared for a healthier economy in 2024 and beyond. Of course, those are big "ifs".

We do know that the Fed does not want to repeat the same mistakes it made in the 1970s. In 1974, when a recession rolled around, the Fed eased despite continuing high inflation. Fed officials today believe that policy move contributed to the rampant inflation of the late 1970s and early 1980s. We expect that any Fed cuts this year would be a function, not of an earnings recession, nor even an actual recession, but inflation itself.

If inflation slides down to the 2% zone in a hurry, then all bets are off, as the risks facing the risk managers at the Fed would quickly shift from the upside to the downside. In our view, given policy lags, the Fed will probably pause as inflation moves towards 3%. But if inflation bends and does not break, then we expect the Fed to move into the "25 or nothing" phase of the tightening cycle. After all, the Fed can refrain from raising rates at any given meeting while asserting that the balance of risks remains to the upside.

As long as inflation stays elevated, we do not think the Fed will change its course. Quite the contrary, Fed officials seem to want to keep real rates positive for a while, both as a stabilizing discipline and to reinforce low inflation expectations. But Fed policy is a product of the evolving data, and if that data shifts the balance of risks to the downside, well, Chair Powell has a record of changing policy on a dime. For now, though, it appears the real economy, if not the financial market, is absorbing the rate hikes without too much of a problem.

Municipal Review

The municipal bond market was no exception to the carnage of 2022, suffering through one of its worst performances in decades. The negative performance for the year did not result from eroding credit quality. The key contributors were high inflation, the aggressive Fed policies in response to that inflation, and an exodus of tax-exempt investors. Fund flows were an important technical factor specific to tax exempt bonds. 2022 saw historic outflows, which helped fuel the negative performance.

On the bright side, municipal investors are now receiving substantially more tax-free income than at the start of last year. The "tale of the tape" tells the story:

AAA Municipal Bond interest rate scale (%)

	12/31/21	12/31/22
1yr	0.19%	2.82%
3yr	0.34%	2.58%
5yr	0.60%	2.56%
7yr	0.85%	2.56%
10yr	0.05%	2.64%
15yr	1.22%	3.16%
30yr	1.54%	3.63%

The higher yields reflect both the decline in valuations over the course of the year *and* the new income opportunities going forward. One year ago, equity markets seemed driven by TINA (There Is No Alternative). While 2022 was a hard road to travel, TINA is clearly not true today.

Credit quality for state and local governments held up well during the pandemic and improved during the reopening of the economy. The table below reflects the trends in 2022:

	Up-grade	Down-grade	Stable to Pos	Neg to Stable	Pos to Stable	Stable to Neg
Credits	171	59	100	133	10	37

Source, Fitch

Despite volatility and persistently high inflation, the credit picture was basically positive. However, as we enter a new year, with the probability of a recession increasing, surveillance of credit, both the current holdings and the relative value considerations for potential holdings, will become more important.

Looking forward to 2023, while we are constructive on the overall tax-exempt market, we do have some worries about the hospital and lifecare community sectors. Reduced federal support and labor shortages in these sectors comprise our largest concern. One trend which is not favorable to the industry is the increase of healthcare expenses as a percentage of GDP, which has risen in recent years and now tops 18%. We are also not very constructive about the higher education sector: we think that small colleges and universities which lack a focus or niche, or a large enough foundation, could be at risk.

Sector	Up grade	Down grade
Education & non-Profits	3	7
Energy & Industrials Infra	1	4
Hospitals	13	14
Life Plan Community	9	15

Source, Fitch

In terms of technical drivers, the table below reflects some of the flows. Investors pulled a record $148 billion out of tax-exempt mutual funds in 2022. ETFs, in contrast, experienced net inflows of $27 billion. Still, at the retail level, investors were leaving the space.

Municipal 2022	Fund Flows	Change In AUM
Mutual Funds	(148.3)	(228.8)
High Yield Mutual Funds	(21.2)	(40.0)
ETF	26.7	21.0
High Yield ETF	0.7	0.2

Source, Citicorp.

The exodus from municipal mutual funds, combined with higher rates and market instability, helped contribute to a reduction in new issuance. Where 2020 and 2021 offered nearly $500B in new supply, 2022 brought only $373B in new offerings. As a technical matter, the lack of new supply counteracted, to some degree, the sell-off. Due to the improved value proposition, we anticipate a reversal of fund outflows and increased interest in tax-exempt bonds among retail investors.

The glaring facts of the current rate environment for municipal bonds are inversion on the short end, extreme flatness in the belly, and steeper yields further out on the curve. Intermediate-style investors are not being compensated for buying intermediate length maturities. Our tactical positioning will favor overweight on the short end of the curve along with more weighting to the longer part of the curve. In other words, we expect to position portfolios into a more pronounced barbell. We think investors are being better compensated on the wings than being scrunched in the belly.

The credit overweight will continue to be in the A-rated sector along with bonds carrying AA bond insurance wraps. We see value in pre-paid gas bonds and bonds subject to the alternative minimum tax. We also seek to capitalize on inefficiencies in various bond structures, such as puttable and callable bonds.

Duration positioning will remain neutral to slightly-long our benchmark. This is based on our view that, with renewed investor appetite for our sector combined with low supply, technical factors will become more supportive. Still, despite the light issuance, the primary market continues to provide more value than the secondary, so we will continue to focus on spread tightening between the primary and secondary markets.

Until 2022, dating back to 1982, investing in municipal bonds, per the Bloomberg Municipal Bond Index, resulted in annual *tax-free* returns of 6.86%. On a tax-

equivalent basis, this is roughly comparable to the returns of the S&P 500 during that same period. It is slightly higher than returns to the Russell 2000 Index.

Some of those long-term returns are attributable to declining interest rates. While it is highly unlikely that we are on the front end of another forty-year secular bull in the bond market, it is worth noting that municipal bond yields are currently near their highest levels since 2009. This presents a lucrative opportunity for investors to lock in yield and potentially better returns over the next three to five years. In an environment where rates do not rise much, or actually decline, yield becomes the key factor in determining returns. And should rates continue on an upward path, where the secular bull in the bond market is replaced by the secular bear, the short / intermediate focus of our fixed income products shields clients from the damage inflicted upon investors with longer-dated maturities and longer-duration portfolios.

The rising rates in 2022 were painful, but it was useful pain, because on the other side of that pain was—and is—opportunity. The higher rates signal a new investment landscape, where capital has options and risk-takers are being compensated. Despite the erosion in portfolio value, this appears to us an ultimately more profitable outcome than scratching for basis points in a zero-bound rate environment.

Equity Review

While equities were mired in a bear market for much of 2022, the fourth quarter finished the year on a high note. The S&P 500 surged 7.1% to finish the year down 18.1%. As we had indicated at the end of 2021, the compounded returns over the prior five and ten years had been well above historic average, warranting a greater degree of caution regarding forward returns. After the decline in 2022, the trailing five- and ten-year returns for the S&P 500 are once again in line with the historic average.

The valuation disparity between Growth and Value, which exceeded even the Tech-Bubble of the late 1990's, has closed significantly. The Russell 1000 Value index declined 9.8% while growth benchmarks, such as Russell 1000 Growth index and the Nasdaq Composite, declined 30.5% and 33.6% respectively. As we start the new year, and despite the steep erosion in many of the growth names, we still see slightly more attractive valuations in the value segment of the market. The rise in interest rates alone over the past year accounted for the multiple compression experienced in the growth names which actually have earnings. But before calling "all clear," investors need to remain aware of just how extreme valuations had become at the peak.

The speculative corners of the market have seen even more severe drops than the 30%-plus index declines. Actual earnings for many of those firms have likely been pushed-out and some probably will not survive. More importantly, discount rates are unlikely to revisit the lows seen in the past several years, as monetary authorities are firmly on track to ensure that money once again has a cost. As such, business models which seemed reasonable when money was essentially free may not have seen the worst of it. As a point of reference, the Nasdaq Composite experienced three consecutive years of 20%-plus declines and bottomed out down 78.4% from the peak (3/10/2000-10/11/2012).

Our current thinking is that 2023 will be a soft year at best for GDP. Until inflation is genuinely brought under control, we would expect rates to grind higher, which increases the likelihood of a hard landing in 2023. We are now very focused on Chairman Powell's commentary regarding the potential structural shortage in Labor supply, a problem which cannot be quickly fixed. This leaves the Fed using the blunt instrument of higher rates to tamp down aggregate demand and bring it into tighter alignment with the *actual* Labor supply.

If we had to hone-in on only one factor at this juncture that concerns us the most, it would be wage inflation in the Services sector. The United States is a service economy, and it is in the Service sector where the labor shortage problem is most pronounced. We are encouraged that Goods inflation has finally rolled over and that housing inflation looks to be trending lower in 2023, but until the final leg of inflation (wage inflation in the services sector) is cut down, we do not see the Fed stopping, much less reducing, rates. That means we foresee a higher rate environment for the balance of 2023, which should continue to put downward pressure on multiples and favor the Value side of the market.

While consensus thinking at this juncture is that the economy will experience a short, shallow recession sometime this year, we think that the range of outcomes is quite wide and uncertain. If the economy experiences a harder-landing scenario, we could see S&P 500 EPS

down 20-30%. In our estimation, the declines to-date have only taken out the excess valuation of 2021, which was driven by the pandemic's ultra-low-rate environment. But the market has not yet discounted the growing probability that labor issues will prove more intransigent than expected, meaning a more prolonged and relatively severe recession.

Energy was the only sector to finish in the black for 2022. Supply remains constrained due to the war in Ukraine, but there are other factors as well. The newfound resolve from OPEC to manage its production levels, combined with national policy choices, both in the United States and abroad, regarding fossil fuels, have contributed to constrained supplies. Regardless of the potential slowdown or near-term recession outlook, we continue to believe that Energy once again has a strong secular story. And in a higher inflation world, commodities like Energy should continue to outperform.

Industrials were a strong leader at the end of the year on optimism for a short and shallow slowdown. While consumer spending may be slowing down, the need to retool and near shore supply chains is providing a solid tailwind for the sector. Additionally, if we continue to see structural labor shortages across the economy, factory automation efficiency will become an even bigger theme and tailwind for the group. Like Energy, we think Industrials are supported by secular tailwinds, despite any near-term recession concerns. Record backlogs at many industrials provide a good line of sight for solid demand through 2023 and beyond.

Even the slowdown in new home construction, which has been very sharp, will likely not persist as long as feared. We still have a structural shortage of housing in the U.S. As interest rates normalize, builders will be able to adjust pricing to the higher rates. We would also expect that the supply chain issues and labor shortages which plagued home construction in 2021 will also abate, enabling builders to generate reasonable rates of return even with lower average selling prices.

Financials also caught a bid at year-end as the market continues to look for signs that the Fed will slow interest rate increases. The most recent CPI report offered bulls hope that inflation is indeed receding at a faster-than-expected pace, which would allow the Fed to slow down the pace of increases. A slower pace of rate hikes leaves open the narrowing window for the soft-landing.

Healthcare and Consumer Staples continue to be relative outperformers in the quarter and year-to-date, which seems reasonable if we are headed for any kind of recession in the near term. Consumer Staples are not inexpensive, but Healthcare and Pharmaceutical stocks still represent some of the best value in the market today.

We are continuing to see consumer demand soften, but strong employment formation and still-plentiful availability of credit are providing support for aggregate personal consumption expenditures. Again, while spending on housing and consumer goods has meaningfully downshifted, we are not yet seeing the same on the services side of the economy.

Outside the United States, economic conditions remain even more challenging. At this point, lifting the zero-Covid policies has not allowed China's economy to return to its pre-Covid footing. It continues to be plagued with mounting infections, weak immunizations, and rolling shutdowns. As we move into deep winter, Europe is facing a possible steep fall-off if energy supplies are further restricted. Against this challenging global backdrop, at least in the near-term, it is hard to envision the American economy emerging unscathed.

If the economy is in fact shifting into a lower gear, we still think it is a bit too early to get more broadly constructive on the market. The 18% decline in the S&P 500 in 2022 has taken the excess valuation out of the market but has not, in our view, discounted any kind of normal recession yet.

Many investors still believe we are playing the game of "Fed saves the market." We think monetary policymakers are playing a new game, that, if anything, the Fed is looking to unwind the decade-plus of bailing out everyone. The open spigot has created significant distortions in normal functioning markets. But until this debate is settled, we would expect equity markets to remain more volatile than usual, even as everyone watches the same economic data.

We continue to be buyers of lower PE and higher free cash-flow names at this juncture. We are looking for opportunities to become more pro-cyclical, but we need to see stronger signals that the economic crosscurrents have achieved some equilibrium from which the market can take its next leg up.

Conclusion

Inflation is highly unsettling and creates a sense that things are spiraling out of control. In many cases, it means that things *are* spiraling out of control. To a central banker, though, inflation itself does not mean policy has failed. It was not long ago that Powell and other Fed officials were *promoting* inflation. Where inflation is concerned, policy has failed when the public begins suspecting that money today is worth more than money tomorrow and starts spending accordingly. *That* is the inflection point where inflationary fires become unleashed, and *that* is the moment the Fed wants to avoid.

But the reverse problem, achieving "escape velocity" from deflationary pressures, has been the problem preoccupying the Fed for more than a decade. Ultimately, the solution to that problem is inflation. The Covid-Era infusion of government spending, combined with the plentiful capital created by years of extreme monetary accommodation, has created, in our view, an opening of sorts. Two to three years ago, the Fed wanted inflation. Now they have it.

From a monetary perspective, providing the will is there, containing inflation is much more manageable than inducing inflation. This alone is reason to be optimistic about the economy's medium-term prospects: the Fed, at least, has a more straightforward task.

But in terms of the real economy, there are also reasons for optimism. We noted above that, as businesses and countries rethink their supply chains, extensive capital outlays are required. We also observed that the high cost of labor creates an incentive for businesses to invest in labor-saving equipment, machinery, and plants. And as the cost of climate change moves from economic abstraction to the accounting ledgers, it will require additional physical investments as well. All these investments spell jobs and growth.

On the demand side, more reinforcement is coming from federal expenditure on infrastructure. Presumably there will be additional stimulus from the generational transfer, as Boomers start dissaving, rather than saving, and the economy is revitalized by the post-Boomer generation. We saw something like this occur in the 1980s and 1990s, when Boomers were the ascendant generation. And underneath it all lurks the productivity gains promised by artificial intelligence, which will ultimately siphon jobs, but should also reconfigure the productive landscape to yield much more abundance. Way off in the distance, there is even the glittering prospect of fusion and clean energy.

In our view, it is not irrational to be bullish about the medium-term prospects of this economy. But it is, for now at least, 'A Tale of Two Cities," where the prospects for the real economy, and labor, do not necessarily translate as prospects for the financial markets, and capital. In an environment characterized by inflation and growth, rates drift higher, not lower, and we saw in 2022 what higher rates can do to asset valuations. This risk is only amplified by the Fed's clear desire—time will tell if they can pull it off—to put the economy under a positive real rate regime. Ultimately, such a regime would reward investors, but some pain must be endured to get there.

We think the Fed might pull it off, that the underlying growth fundamentals for this economy are relatively good and can absorb the higher rates. When the growth is there, then capital, smartly managed, can find ways to reward itself. We may not all be "going direct to Heaven," but there should be ample opportunities, in the months and years ahead, to avoid "going direct the other way."