Annual Investment Update

ECONOMIC REVIEW AND OUTLOOK

DECEMBER 31, 2022

After a decade of easy money and low inflation, 2022 marked the abrupt end of near-zero interest rates and a distinct shift in global monetary policy. As inflation climbed in the wake of the pandemic, central banks were slow to react to what they viewed as “transitory” inflation, or prices that would self-correct as economies normalized. Once the scope of the issue came into view, however, the Federal Reserve (Fed) moved swiftly to get ahead of inflation expectations before they became entrenched consumer psychology, which can be detrimental to the economy.

The price of this new policy stance should have been lower growth and, in any normal environment, higher unemployment. The past year, however, was far from a normal environment. Consumers were flush with stimulus cash, high savings rates from low pandemic spending, and plentiful jobs in a global labor shortage. These factors allowed growth to persist while supply chains recovered and job openings slowly filled, leading to an easing of inflationary pressures in the second half of the year without the recession that economists had predicted.

Significant challenges remain for 2023 as the fight against inflation is far from over. Prices are still rising faster than is ideal for a stable economy, and additional rate hikes may be necessary, even in the face of economic slowing or potential job losses. Sectors such as housing and autos that are sensitive to interest rates have already experienced a sharp decline in activity, manufacturing has begun contracting, and retail sales growth has slumped.

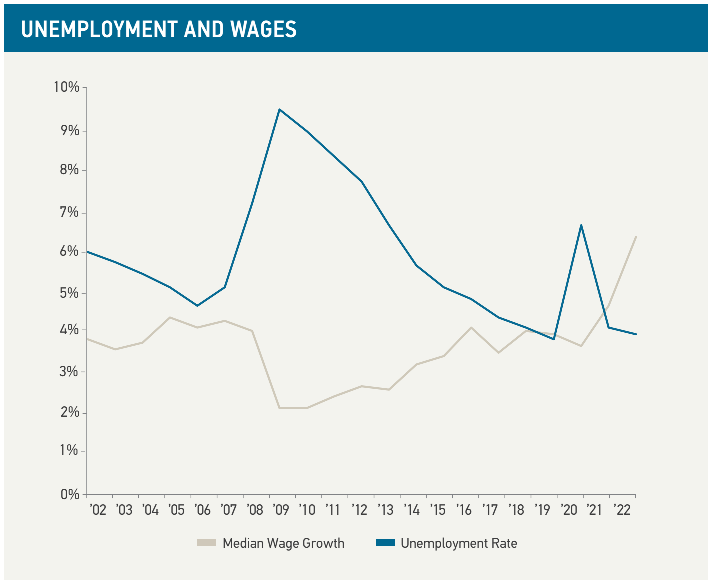
Despite all these challenges, there is reason for optimism. The Fed will likely pause its rate hikes in the new year to assess the efficacy of its new policies. Corporate profits are still growing at around 10% above 2021 figures, and unemployment is at an incredibly low 3.5%.

KEY ECONOMIC RELEASES

EMPLOYMENT	As of	Expected	Actual	Prior Period
Unit Labor Costs (3rd Quarter)	3Q	3.10%	2.40%	6.70%
Unemployment Rate	DEC	3.70%	3.50%	3.70%
Change in Non-Farm Payrolls	DEC	205K	223K	263K
INFLATION (Year Over Year)	**As of**	**Expected**	**Actual**	**Prior Period**
Consumer Price Index	NOV	7.30%	7.10%	7.70%
CPI Ex Food & Energy	DEC	6.10%	6.00%	6.30%
Producer Price Index	NOV	N/A	10.60%	11.20%
HOME PRICES (Year Over Year)	**As of**	**Expected**	**Actual**	**Prior Period**
S&P/Case Shiller Top 20 Mkts.	OCT	8.24%	8.64%	10.41%
MANUFACTURING ACTIVITY	**As of**	**Expected**	**Actual**	**Prior Period**
Capacity Utilization	NOV	79.80%	79.70%	79.90%
Leading Indicators	NOV	-0.50%	-1.00%	-0.90%
GDP Annualized (3rd Quarter)	3Q	2.90%	3.20%	2.90%

Source: Bloomberg

UNEMPLOYMENT AND WAGES



Source: Bloomberg

CONTACT US
TOLL-FREE **888.720.8382**
LOCAL **206.359.6462**
trust.perkinscoie.com

AT PERKINS COIE TRUST COMPANY, *we believe it is a priority to have a current financial plan, maintain a strategic asset allocation strategy and employ tax awareness in the investment process. We also believe that investors must focus on fundamentals and diversify their portfolios by asset class, style, size and geography to manage market risk. We invite you to contact us to learn how we can help you achieve your financial goals. For more information regarding our trust, investment and planning services, please contact us toll-free at 888.720.8382 or locally at 206.359.6462 or visit our website at trust.perkinscoie.com.*

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Perkins Coie Trust Company LLC is a Washington state-chartered trust company.

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ECONOMIC REVIEW AND OUTLOOK (CONTINUED)

Receding Inflation As the year 2022 began and global supply chains appeared to be returning to balance, inflation reaccelerated in February with Russia's invasion of Ukraine. This sent food and fuel prices soaring across the globe as access to supplies became uncertain and countries began stockpiling. What had been "COVID inflation" of prices for office furniture, computers, cars, and other discretionary items became "conflict inflation" affecting critical necessities with no substitutes.

Wages, in turn, also rose as employees demanded higher compensation to keep up with rising prices. U.S. wages rose 4.6% annualized in December, well above the pre-pandemic level of 2.9%. With job openings still at a remarkable 10.3 million and only 1.7 million people on unemployment, employees have significant power to demand higher wages. This gap, the difference between the number of people looking for jobs and the number of jobs available, is in the crosshairs of the Fed as it raises rates.

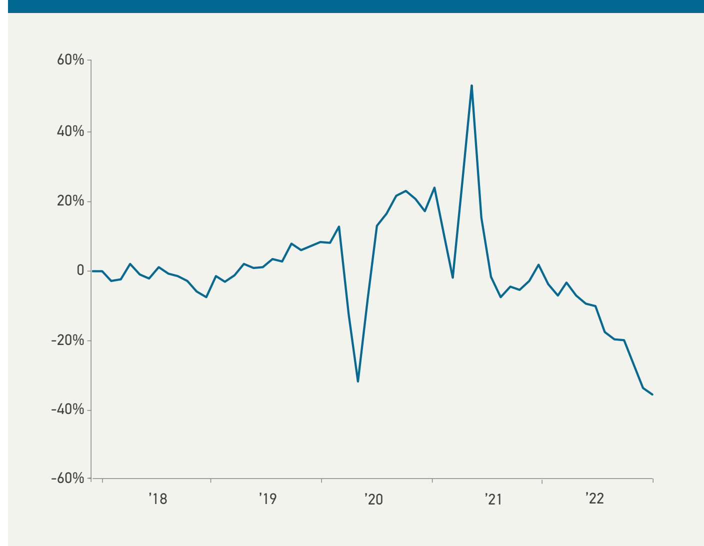
In the United States, inflation ended 2022 at roughly the same level it started, around 7%. This is far above the Fed's official target of 2%, but well below the peak of 9.1% reached in June. The Fed is attempting to engineer a "soft landing," whereby it reduces inflation without causing a recession. The large number of job openings gives the central bank some flexibility to be aggressive without destroying actual jobs, instead merely eliminating unfilled positions. Since the Fed cannot reduce food and fuel prices by planting soybeans and corn or pumping more oil, it is targeting inflation in the part of the economy where it can exercise tremendous control: the job market.

It's a Feature, Not a Bug The housing sector, by almost every measure, began to decline rapidly in 2022. U.S. pending home sales, a measure of signed real estate contracts for single-family homes, declined by 38.6% in November, the worst reading since the data series started in 2002. House prices, while still up 8.6% compared to 2021, were down every month since June. Companies have paused building new homes, and both housing starts and new building permits are down, at 0.5% and 11.2%, respectively. With 30-year mortgage rates sitting at 6.59%, there is a growing mismatch between potential sellers who are hesitant to give up their existing low-rate mortgages and potential buyers who are hesitant to take on significant monthly payments.

While the housing market may seem to be a victim of aggressive Fed policy, reducing excessive price appreciation—and thereby reducing the shelter-related component of inflation—is likely top of mind for the Fed.

We Are Not Alone Many international economies are also suffering from inflation and grappling with the need to tame it. The United Kingdom is likely in a recession already due to policy missteps. The European Union, facing war on its doorstep and dealing with the fallout from an uncertain energy market, looks poised to enter a down period through the winter. Both the Bank of England and the European Central Bank have been raising rates to combat inflation. Even Japan, which has battled disinflation since the 1990s, moved rates up in 2022. The only major economy not actively fighting inflation is China, which has been mired in its zero-COVID policy and a real estate crisis that has suppressed growth throughout the past year.

U.S. PENDING HOME SALES INDEX



Source: Bloomberg

BOND MARKET REVIEW AND OUTLOOK

DECEMBER 31, 2022

Inflation: The Enemy of Bonds Higher-than-expected inflation roiled the bond markets in 2022. Inflation has been referred to as the "enemy of bonds" as it erodes the value of a bond's interest payments as well as its principal. At the same time, rising interest rates drive down bond prices to align their yields with prevailing market rates. This perfect storm led the Bloomberg US Aggregate Bond Index, a benchmark that measures U.S. government and corporate bond performance, to return a negative 13% for 2022, one of the worst years for bonds on record.

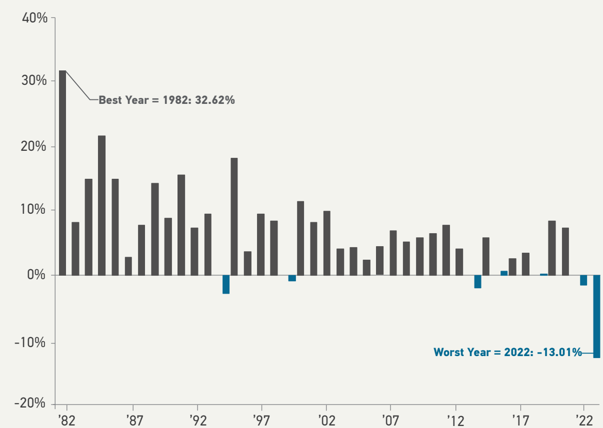
Following the extraordinary efforts to help combat the impacts of the COVID-19 pandemic, in late 2021 the Federal Reserve signaled a coming change in monetary policy. In order to satisfy the second part of its dual mandate—maximizing employment and keeping prices stable—it would begin raising the federal funds rate to curb increasing inflation.

In March 2022, the Fed raised its benchmark rate from 0.25% to 0.5%, and quickly followed that with six more hikes, including four consecutive jumbo hikes of 0.75% each. At the end of December, the Fed's key interest rate was 4.50%, its highest level in fifteen years. Fed Chair Jerome Powell reiterated throughout the year that fighting inflation was the central bank's number one concern and tightening would continue until inflation was closer to its 2% target.

The rapid increase in interest rates reverberated through the markets. Almost every part of the bond market, even those areas considered relatively safe, suffered significant losses. On average, U.S. Treasury bonds lost 12.5%, corporate bonds lost 15.8%, and municipal bonds lost 8.5%. Even Treasury Inflation-Protected Securities (TIPS), which offer a principal value indexed to inflation, could not handle the swift rise in interest rates. While TIPS can help protect against inflation over longer periods of time, price swings can more than offset the principal adjustment in the short term. TIPS were down 11.8% for the year.

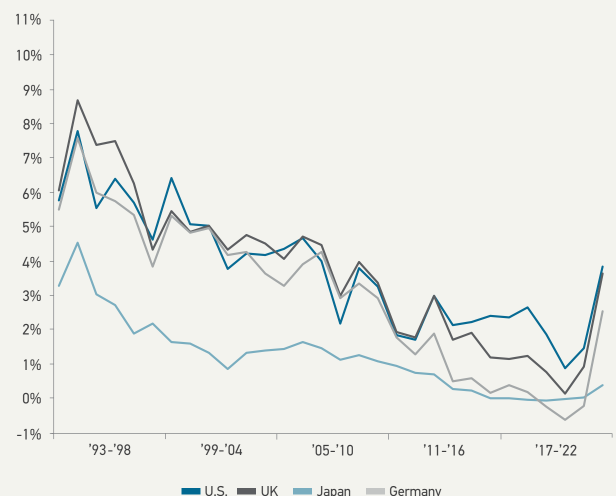
A similar story of elevated inflation and rising interest rates played out across most of the globe. Almost all central banks hiked rates, apart from the People's Bank of China, which marginally cut rates to offset slowing economic growth. Even the Bank of Japan unexpectedly lifted its 10-year government bond yield target from 0.25% to 0.50%, after decades spent fighting persistently low inflation.

BOND MARKET CALENDAR YEAR RETURNS 1982-2022



Source: Bloomberg

10-YEAR BOND YIELDS OF MAJOR DEVELOPED ECONOMIES



Source: Bloomberg

BOND MARKET REVIEW AND OUTLOOK (CONTINUED)

Inversion of the Yield Curve The rapid pace of hikes also caused an inversion of the U.S. Treasury yield curve in early July. An inversion occurs when short-term interest rates are higher than long-term rates. At the end of 2022, the spread between the 10-year and 2-year U.S. Treasury yields, an often-referenced measure, stood at 0.53%.

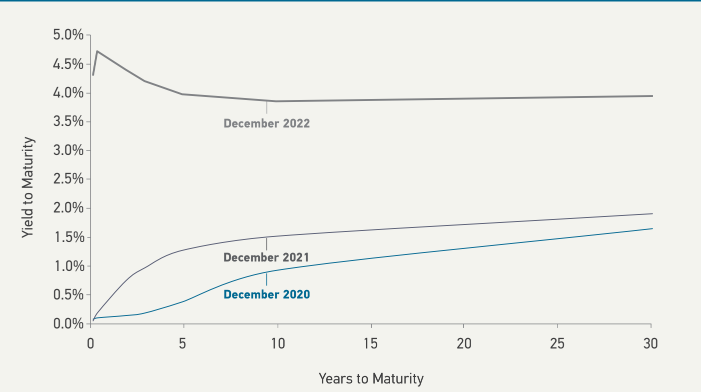
This is of concern because yield-curve inversions often precede recessions. When short-term rates exceed long-term rates, it makes more sense for banks and other financial institutions to make short-term investments rather than longer-term loans. This can reduce economic growth as projects that need capital go unfunded. Inversions have historically been considered a relatively reliable recession indicator, though there has been an average lag of 12 to 24 months before a recession occurs.

Silver Linings Heading into 2023, the Fed remains dedicated to bringing down inflation, and more rate hikes are expected. The most recent dot plot showed the Fed expecting its terminal rate to peak at 5.1%.

After the significant turmoil of the past year, however, the return profile for bonds is more attractive than it has been in years. The starting yield is a major determinant of a bond's total return and as of late 2022, short-term U.S. Treasury bonds, which are considered some of the safest fixed-income investments, were yielding north of 4%. Investment-grade corporate bonds were yielding above 5% and riskier high-yield bonds were close to 10%.

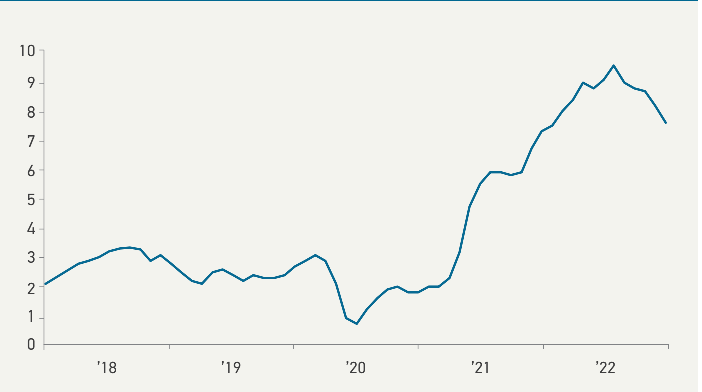
We are also starting to see signs of inflationary pressures easing, so it is likely that central banks can slow the pace and magnitude of rate hikes in 2023. At the end of the year, the 5-Year Breakeven Inflation Rate stood at around 2.3%, indicating that market participants also expect lower inflation over the next five years.

U.S. TREASURY YIELD CURVE



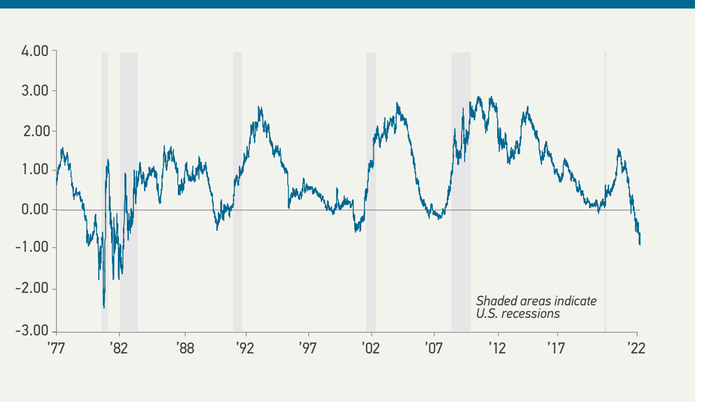
Source: Bloomberg

CONSUMER PRICE INDEX (CPI) YEAR OVER YEAR



Source: Bloomberg

10-YEAR TREASURY CONSTANT MATURITY MINUS 2-YEAR TREASURY CONSTANT MATURITY



Source: Bloomberg

STOCK MARKET REVIEW AND OUTLOOK

DECEMBER 31, 2022

Challenging Year for Stocks After three stellar years of double-digit returns, U.S. stocks had a tough 2022. Stocks rallied a few times throughout the year but ultimately ended in a bear market. The S&P 500, an index that measures the performance of the 500 largest U.S. companies, returned -18.1%, marking the benchmark's worst year since 2008.

As inflation persisted and the Fed became increasingly aggressive, investors fled from riskier parts of the stock market. Higher interest rates change the expected return for equities, and those whose value depends more on the promise of future profits are more negatively impacted as rates rise. That was certainly the case in 2022 with technology and other growth-oriented stocks suffering significantly more than their value-oriented counterparts, returning -29.1% and -7.6%, respectively.

Corporate earnings grew in 2022, but barely. S&P 500 earnings rose around 5% overall, but they declined when excluding the robust reports from companies in the energy sector. Higher costs associated with wages, supplies, and capital put pressure on margins. Nevertheless, the S&P 500's estimated net profit margin for the year remained remarkably high at 12%, down from a record of 13% in 2021.

Another Impressive Year for the Energy Sector For the second year in a row, energy stocks were the best-performing group. In late February, the Russian invasion of Ukraine sent oil prices soaring and worsened an already constricted energy market. The sector, which consists primarily of oil and natural gas companies, reported surging profits as energy prices remained elevated.

Even as oil prices fell from their highs, energy stocks held up due to their upbeat earnings expectations and relatively attractive valuations. Energy companies also aggressively boosted their dividends and bought back shares throughout the year, leading to two consecutive annual gains of over 50% for the sector.

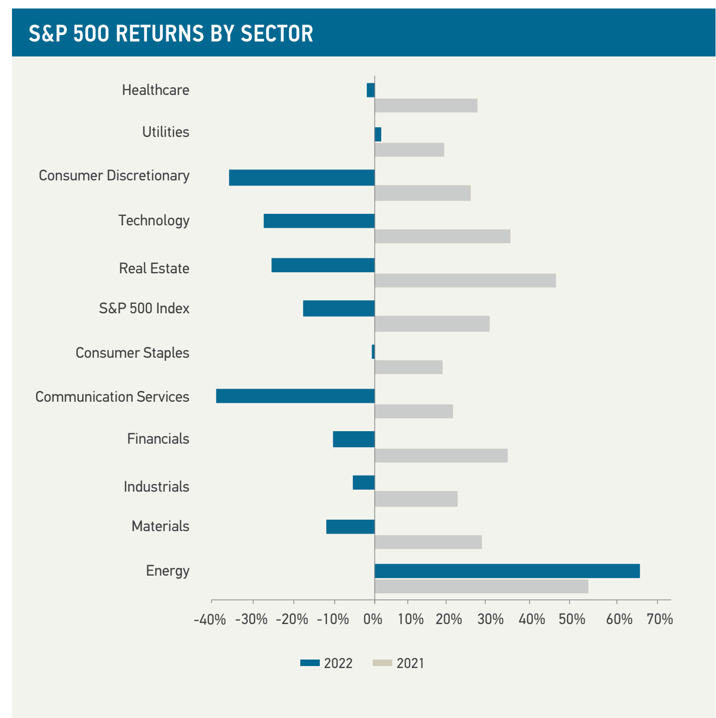
Outside of the energy sector, only utilities posted positive, though modest, returns. The utilities sector, along with consumer staples, is considered relatively defensive as people tend to continue buying food and paying their energy bills, even while their financial situation deteriorates and they cut other expenses.

Headwinds from Strong U.S. Dollar International and emerging stock markets were not spared from the volatility. As oil prices spiked, concerns about Europe's access to energy during the winter months took hold. In a region previously heavily reliant on Russian

STOCK MARKET RETURNS	Latest Quarter	12 Months	Last 3 Years
S&P 500	7.55%	-18.13%	7.64%
Russell 1000 Growth	2.19%	-29.14%	7.78%
Russell 1000 Value	12.40%	-7.56%	5.93%
S&P 400 MidCap	10.76%	-13.10%	7.20%
MSCI Developed (EAFE)	17.40%	-13.92%	1.44%
MSCI Emerging Markets	9.62%	-19.94%	-2.42%
Alternative Assets			
Bloomberg Commodity	1.18%	13.75%	11.72%
MSCI World Real Estate	5.86%	-24.49%	-2.16%
S&P Global Infrastructure Index	11.04%	-0.18%	1.67%

Source: Bloomberg

S&P 500 RETURNS BY SECTOR



Source: Bloomberg

STOCK MARKET REVIEW AND OUTLOOK (CONTINUED)

oil, the sanctions and resulting higher energy prices pushed euro-area inflation to nearly 11%, a record high and over five times the central bank's target. Higher costs caused an estimated 3%-4% reduction in European gross domestic product and squeezed households and corporations across the continent. However, the sectors that dominate the European stock market, such as financials and consumer staples, are more value-oriented, which helped buffer the market from some of the negative impacts of inflation and rising interest rates.

China, though in a different stage of its business cycle than most economies and with low inflation, had another tough year for stocks. Two key issues have dragged the country's economy and market lower over the past 18 months: a heavily indebted and unstable property market and its zero-COVID policy. While helpful in reducing the number of infections early in the pandemic, in 2022, the zero-COVID policy led to curbed consumer demand, high unemployment, weak business investment, and suppressed corporate profits.

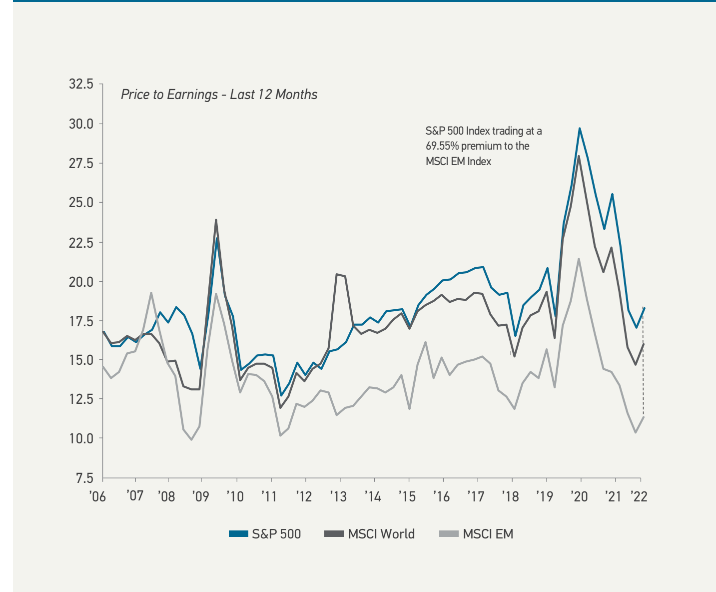
Another reason for the negative performance abroad was the strong U.S. dollar. The dollar rose sharply in 2022 as the U.S. economy, though not particularly robust, was in better shape than places such as Europe, Japan, and China. For U.S.-based investors, a strong dollar means that foreign revenues translate into fewer dollars when converted from their local currency. In the United States, the strong dollar also negatively affected the earnings of many large multinational corporations that make much of their revenue abroad.

Considerable Negativity Priced into Stocks The U.S. stock market has not had an "ordinary" year in a while. The last six years have included four years of above-average returns and two years of negative returns. Investors have endured two bear markets and a pandemic-induced global recession during that time. After a challenging 2022, there remains plenty to worry about—the economy, inflation, yield-curve inversions, interest rates, earnings, geopolitics, and the list goes on. However, it is important to remember that markets are forward-looking and tend to bottom before the economy does.

During the fourth quarter, stocks rallied when inflation for October and November, while still elevated, was below expectations and trending downward. As inflation continues to moderate, the Fed will likely slow or pause its rate hikes in 2023. Additionally, it may consider cuts should the unemployment rate rise meaningfully. Lower interest rates would benefit corporate profit margins and support higher stock valuations. A weakening U.S. dollar would also provide a tailwind for multinational corporate earnings and international stock returns.

While things can seem grim, time in the market, rather than timing the market, has worked in the favor of long-term investors and, historically, negative years for the S&P 500 have typically been followed by positive ones.

U.S. VS. INTERNATIONAL VS. EM VALUATIONS



Source: Bloomberg

U.S. DOLLAR INDEX (DXY)

Source: Bloomberg

INVESTMENT MANAGEMENT SERVICES

Perkins Coie Trust Company offers investment management services for trusts and estates, personal investment portfolios, individual retirement accounts, private foundations and endowments.

PATRICK A. CASEY is President and Chief Executive Officer of Perkins Coie Trust Company. He has over 30 years of experience in the financial services industry advising private clients in the areas of banking, trust and investment management, and wealth planning. He graduated from St. John's University with a Bachelor of Science in finance and received his MBA in management from Fairleigh Dickinson University.

ANDREW ELOFSON is the Chief Investment Officer at Perkins Coie Trust Company and is responsible for investment management, research, economics, and market outlooks. Andrew has over 23 years of financial services and investment experience across numerous asset classes, most recently managing taxable bond portfolios for high net worth clients. Preceding that, he managed over $4 billion in international equity mutual funds for large institutional clients.

SAMANTHA SUNDBERG, CFA, is a Senior Investment Officer of Perkins Coie Trust Company and is responsible for investment research, due diligence and management of investment portfolios for individuals, trusts and estates. Samantha has over 10 years of financial services industry experience, focusing on investment management and helping clients attain their financial goals. She graduated from the University of Michigan with a Bachelor of Arts in Economics.

MONICA GUPTA is an Investment Officer of Perkins Coie Trust Company and is responsible for investment research, due diligence and management of investment portfolios for individuals, trusts and estates. Monica has over 10 years of financial services industry experience focusing on client and investment management. Monica graduated from Pacific Lutheran University with a Master of Science in Finance.

GEORGE CHENG is the Investment Administrator at Perkins Coie Trust Company. He supports the investment team in all aspects of investment management including trade execution, investment research and analysis, performance measurement, investment compliance, and client reporting. George has over 12 years of investment management and project management experience across asset management, banking, and technology industries.

INVESTMENT PROCESS

1. **LEARN** CLIENT GOALS & NEEDS
2. **ESTABLISH** CLIENT INVESTMENT OBJECTIVE & STRATEGY
3. **DETERMINE** ASSET ALLOCATION STRATEGY
4. **CONSTRUCT & MONITOR** INVESTMENT PORTFOLIO
5. **REVIEW & REASSESS** CLIENT NEEDS

TRUST COMPANY SERVICE

The investment process at Perkins Coie Trust Company is always client-driven.

We meet routinely with clients to ensure that we incorporate changing life-cycle needs into our investment strategies.

WORTH KNOWING®

Annual Investment Update

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Trust & Estate Planning Practice Group

KEEP YOUR ESTATE PLAN CURRENT:
Changes in your own life can make a difference.

We want to be sure your estate is planned and updated so that your wishes are fulfilled. The laws governing estates and trusts are constantly changing, and nearly every year there are modifications at the state or federal level that can impact your planning. Changes in your own life can also make a difference.

We have put together a list of life events and other changes that may affect your estate planning. If any of these events or changes have occurred since you executed your estate planning documents, please contact our office so that together we can review your existing plan and advise you about any necessary or suggested updates.

SIGNIFICANT LIFE EVENTS

- Inheritance or gift received
- Health problems or serious illness
- Marriage of a family member
- Dissolution (divorce) or marital separation
- Birth or adoption
- Death or disability of a family member
- Real property purchase outside your state of residence

OTHER CHANGES

- Significant increase or decrease in estate values
- Income level or nature of income
- Asset ownership or business interests, including incorporation or partnership formation
- Employment status
- State residency
- Life insurance coverage or insurability
- Executor, trustee or guardian appointees

The preceding list is not intended to be comprehensive. Other events, including changes in the law, may occur that would necessitate a review of your estate plan.

THE FOLLOWING IS A BRIEF SUMMARY OF THE FEDERAL ESTATE AND GIFT TAX LAWS FOR 2023 FOR U.S. CITIZENS AND INDIVIDUALS DOMICILED IN THE UNITED STATES

FEDERAL ESTATE AND GIFT TAX EXEMPTION

Barring legislative action by Congress that reduces the exemption amount, in 2023, the federal estate and gift tax exemption is $12,920,000 per individual, which is an increase from the $12,060,000 exemption amount in 2022 (this increase is the result of a statutory inflation adjustment). The effective tax rate for transfers above this threshold remains at 40%. The surviving spouse may be able to use the deceased spouse's unused exclusion amount (the DSUE amount). In order for the surviving spouse to use the DSUE amount, the executor of the deceased spouse's estate makes a "portability election" on the deceased spouse's estate tax return.

ANNUAL EXCLUSION GIFTS

In 2023, each person (donor) has an annual exclusion from the application of the federal gift tax of $17,000 per recipient (donee) per calendar year, which is an increase from the $16,000 annual exclusion amount in 2022 (this increase is also the result of a statutory inflation adjustment). There is no limitation on the number of donees. Annual exclusion gifts are not included in the donor's federal estate and gift tax exclusion. Gifts must be completed by December 31 to qualify for the calendar year exclusion.

INCOME TAX BASIS OF TRANSFERRED ASSETS

Under the current law, a donee does not pay income tax for receiving property by gift or inheritance. However, a donor should be aware of the differences between the income tax basis treatment of assets that are given during life and the assets that are inherited at death. When assets are given, the donor's income tax basis in the given property is transferred to the donee. When assets are transferred at death, the income tax basis of inherited property is generally the fair market value at the time of the decedent's death. As a matter of overall strategy, donors commonly make lifetime gifts of cash or slightly appreciated property and retain highly appreciated assets until death or use such assets to make charitable gifts.

CURRENT ESTATE AND GIFT TAX LAWS SUBJECT TO CHANGE

The Tax Cuts and Jobs Act of 2017 (the Act) effectively doubled the federal estate and gift tax exemption (the exemption was increased from $5,490,000 in 2017 to $11,180,000 in 2018). In recent years, Congress has considered passing tax legislation that would reduce the exemption amount. However, even without new legislative changes to the current estate and gift tax law, the exemption is already set under current law to revert to the pre-Act level ($5,000,000, adjusted for inflation) after December 31, 2025. Therefore, taxpayers likely have a limited window to use the increased exemption amount.

STATE ESTATE AND INHERITANCE TAX

In addition to the federal estate tax, certain states impose a state estate or inheritance tax on residents as well as nonresidents who own property in the state. Either or both of these taxes are imposed by the state or by local jurisdictions in Connecticut, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington. Most states that impose an estate tax do not impose a gift tax, which can make lifetime gifting strategies even more advantageous.

WANT TO KNOW MORE?

If you have any questions about gifting strategies or other issues that may have an impact on your estate planning, please contact your attorney at Perkins Coie.

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