



# The ADVISOR

## Focus on Community Banking Issues

First Quarter 2023

### ECONOMIC ENVIRONMENT

#### A Year for the History Books

What a difference a year can make! Stubbornly high inflation, geopolitical turmoil, sharp central bank rate hikes, and the looming threat of a global recession defined 2022 as one of the most interesting years in recent memory from an economic standpoint. As we look to the year ahead, many of the key questions asked throughout 2022 remain in focus: When will the Federal Reserve conclude its tightening cycle? Will the effects of restrictive policy finally tame historic levels of inflation, and if so, will this come at the expense of the labor market? Will the United States fall into recession,

and would this lead the Fed to cut rates to reverse a potentially nosediving economy? In our view, it remains exceedingly difficult for the Federal Reserve to achieve a “soft landing” scenario, which would be characterized by year-over-year inflation approaching the 2% target without destroying consumer demand or eliminating millions of jobs. We find it more likely that the US economy, more specifically the labor market, will respond to the aggressive tightening cycle this year. This would foster a low-to-no growth environment as consumers and businesses rein in spending, eventually prompting a Fed pivot to lower rates late in the year.

Further complicating matters on a global scale is China’s move to relax its zero-Covid policies in

November and December, which initially was expected to revitalize goods imports and fuel demand for oil and other important commodities. However, a rapid spread in infections following the attempted relaxing of restrictions has led to a shortage of workers that threatens China’s export growth, a consideration that will weigh heavily on global economic activity. In December, Chinese exports fell at a 9.9% annualized rate, the steepest drop since the initial lockdowns in February 2020. American demand for made-in-China goods is expected to decline in tandem, a factor which when combined with a now-uncertain overseas labor supply, clouds expectations for global growth this year. In

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### EPG RATE FORECAST

January 2023

MARKET RATE	Actual (%) 12/31/2022	Projected (%) 12/31/2023	Yr1 Δ	Projected (%) 12/31/2024	Yr2 Δ
FedFunds	4.50	4.25	-0.25	3.25	-1.00
Prime	7.50	7.25	-0.25	6.25	-1.00
3mthTsy	4.34	4.05	-0.29	2.20	-1.85
6mthTsy	4.75	4.00	-0.75	2.25	-1.75
1yrTsy	4.68	3.95	-0.73	2.30	-1.65
2yrTsy	4.43	3.65	-0.78	2.35	-1.30
3yrTsy	4.22	3.60	-0.62	2.40	-1.20
5yrTsy	4.00	3.40	-0.60	2.45	-0.95
10yrTsy	3.88	3.25	-0.63	2.50	-0.75
30yrTsy	3.96	3.20	-0.76	2.55	-0.65

#### RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates. Depending on the actual timing of the ALM meeting, the forecast may be altered and/or updated. For the most accurate current rate forecast, please call EPG, Inc. at (781) 235-2666.

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# ECONOMIC ENVIRONMENT

response, the World Bank cut its 2023 global growth forecast to 1.7% from 3%, which would mark the third-weakest annual GDP growth in nearly three decades.

## *Inflation is Falling*

In our opinion, it is likely that headline inflation will continue to abate throughout the year as consumers pull back on discretionary spending and businesses cut costs. The CPI registered a 6.5% annualized rate in December, with gasoline, used cars, and airfares driving a -0.1% month-over-month decline. Supply chain bottlenecks have eased, and lingering effects from the energy supply shock have largely subsided. Additionally, rising shelter costs remain the largest contributor to inflation gains, a factor which we know lags housing market prices and is likely to drop in the coming months.

The wild card is whether excess savings built up by individuals during the pandemic can continue to drive spending, but recent trends suggest otherwise. The personal savings rate, defined by the Bureau of Economic Analysis as “the percentage of disposable income that people save,” fell to 2.4% in November after reaching 26.3% in March 2021. Putting this into context, the prior month’s 2.2% reading was the lowest since

July 2005. This startling trend suggests that historically high inflation has forced consumers to spend money that would have been saved in a normal environment. While it is apparent that year-over-year inflation is on a downward trajectory, it is now working from a higher base position, meaning that consumers are still paying much higher costs for essential goods and services than in years prior. This explains the continued increase in credit utilization and decrease in the personal savings rate in the face of cooling inflation.

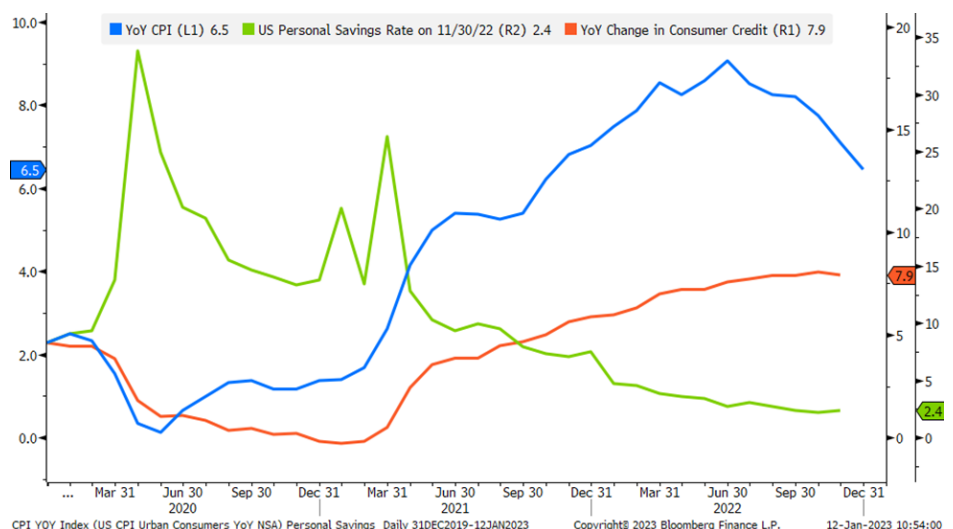
## *EPG Rate Forecast: To Cut or Not to Cut?*

Currently, a disconnect exists between market expectations for interest rate movement and the Federal Reserve’s own projections. After raising the policy rate by 50 basis points at the December FOMC meeting, the median estimate of Fed governors projects a 5.1% Fed funds rate at the end of

2023. Following the latest CPI release, the futures market is pricing in a terminal funds rate of 4.92% in June falling to 4.43% at year-end, implying about 50 basis points of rate cuts in the second half of the year. Fed officials have ceded that the magnitude of rate hikes is likely to slow, but have not provided any indication that cuts are on the horizon. Philadelphia Fed President Patrick Harker stated that “hikes of 25 basis points will be appropriate going forward,” but also implied that the central bank is likely to hold rates steady for some time. He echoed Fed Governor Michelle Bowman’s sentiment, who noted that the Fed lowered rates too quickly in the 1970s after initially hiking to combat inflation.

From our perspective, however, the effects of previous rate hikes are still being incorporated into the economy, which when fully realized, should push inflation

**Even Though YoY Inflation Has Cooled, Credit Utilization is Increasing, and Savings Rate is Falling**



Source: Bloomberg



lower as demand and employment falter. Again, we believe this lagging economic response raises the probability of the Fed overshooting the terminal rate necessary to bring inflation towards the Fed's target. Our updated view estimates a terminal Fed funds rate of 4.75% in the first quarter of this year, which indicates a 25 basis point rate hike in February followed by a likely pause, although there is potential upside to 5% with an additional 25 basis point hike at the March or May meeting. As the full impact of the existing hikes is reflected in demand and employment throughout the year, we then project the Fed to cut rates by a total of 50 basis points towards the end of 2023. This leads us to roughly a 4.25% Fed funds rates entering 2024. Even though Fed officials have refuted the notion of an impending pivot, we believe the trailing effect of last year's rapid tightening will push the US economy into a deeper recessionary environment sooner than the Fed anticipates, thus forcing the Fed's hand this fall. At the longer end of the yield curve, we expect the more market-driven 10-year Treasury to fall in response to slowing economic growth and activity. However, we believe the delay between slowing growth and anticipated rate cuts will allow the yield curve inversion to persist through the end of the year, before reverting towards a positive slope in 2024.

### *Are Cracks Forming in the Labor Market?*

Fed officials have repeatedly stated that a softening of labor conditions will be required to reduce inflation. Prior to December, this had not occurred; the 4.5 million jobs added in 2022 marked the second-best year for job creation since 1940 (2021 saw the highest growth with 6.7 million jobs added). While December's jobs report showed the unemployment rate fell to a record low of 3.5%, hiring and wage growth slowed. This was particularly interesting as one would expect slowing job creation to result in flat to higher unemployment, especially in the wake of accelerating layoff announcements within rate-sensitive industries. However, a deeper dive into the underlying data provides additional context. Over the past five months, job creation in temporary help services has dropped by 111,000, suggesting that employers may be avoiding temporary labor and reducing hours instead of laying off full time employees. Furthermore, the combination of deteriorating business sentiment and contractions in ISM services & manufacturing activity signals that companies are likely to reduce spending in the coming months, with hiring a primary area of risk.

Although small warning signals are certainly beginning to form,

the labor market does remain strong at the surface level. The Labor Department reported 10.458 million job openings as of the end of November, implying that there are 1.74 available jobs for each unemployed person. Additionally, the struggles to fill these openings may be disproportionately impacting small businesses. According to the NFIB Research Foundation, 55% of small business owners reported hiring or trying to hire in December, and 93% of those owners reported few or no qualified applicants for the positions they were trying to fill. When examining the labor market as a whole, there is still room for material weakening before swaying the Fed's policy stance. However, we do expect a gradual rise in the unemployment rate and continuing slowdown in hiring as businesses face shrinking demand. ♦





## FIXED INCOME STRATEGY

### *FIXED INCOME STRATEGY*

#### *We May Have Seen the Last of Aggressive Rate Hikes*

2022 observed extreme market volatility inspired by an aggressive Federal Reserve resulting in a significant increase to interest rates across the yield curve. As a result, causing equity and bond valuations to suffer as inflation was being addressed. The FOMC raised rates at seven meetings in 2022, from a range of 0-.25% to 4.25%-4.5% between March and December. During the fourth quarter volatility was subdued in comparison to the first three quarters of 2022, with longer term bond yields only moving a few basis points while short term yields continued to rise as the FOMC continued raising short term rates. The catalyst for the reduced interest rate volatility during the fourth quarter is a combination of better than expected economic data transpiring to what appears to be less aggressive rate increases going forward.

Although the FOMC is not at the end of its inflation campaign of raising interest rates as policy makers raised their terminal rate by 50 basis points to 5.1% during the December meeting. Jerome Powell commented in December

that they still have some work to do and their forecast for short term rates could be slightly higher, if the current rate increases are not enough to get inflation back to the target level of 2.0%. Powell also made it clear that the size of the rate increase at the February 1<sup>st</sup> meeting would continue to depend on incoming economic data, leaving the possibility for another 50 basis point increase or if economic conditions can validate a step down to a more traditional 25 basis point increase.

The FOMC stated that restoring price stability will likely require maintaining a restrictive policy stance for some time. That said, Powell did signal the plan to moderate rate increases going forward. This decision comes after the Fed was significantly behind the curve and had to raise rates at four consecutive meetings in 75 basis point increments between the June and November meetings, the fastest pace since the 1980s. With the possibility of a recession rising, the Fed may be getting close to the end of rate increases earlier in 2023 than previously projected.

Consumer price increases have moderated from the high of 9.1% in June and are projected to continue to decline in 2023. At this time, the rate hikes thus far have had minimal effect on increasing the unemployment rate and surprisingly the labor participation rate, in addition to the

surplus of workers available for every job opening. Many economists expect this to change in 2023 resulting in a slow down in growth, and the unemployment rate to rise as a result of the aggressive actions taken by the Fed in 2022 to contain inflation which could tip the US into a recession in 2023.

#### *Yield Curve Inversion Continues*

Treasury yields on the longer end of the yield curve have fallen further below yields on the shorter end. The relationship between the two and ten year Treasury yields began to invert early in the third quarter as recession fears had become a concern and longer term Treasuries were quick to react. With inflation still elevated, the Fed continued with aggressive rate increases at the September and November meetings. The relationship continued to invert and midway through the fourth quarter was nearly 80 basis points before ending the year inverted by 55 basis points. The scenario when short term yields exceed long term yields is often seen as an early sign of a recession on the horizon. Yields on Treasuries reflect investors' expectations on where short term interest rates are set by the Fed. Longer term yields are typically higher than short term yields because an investor would like to be rewarded for taking on additional risks such as elevated inflation.

## FIXED INCOME STRATEGY

The current yield curve entering 2023 suggests that investors believe that short term rates will be lower in the longer term than they will be in the near term. This implies that the Fed will need to cut borrowing costs to revive a slowing economy. The current yield curve is also implying that inflation will continue to come down as the unemployment rate should rise. However, investors will have to accept higher short term rates for the time being.

Fed officials still expect to raise the fed funds rate, but the recent better than expected economic data could allow them to be less aggressive at upcoming meetings. Treasury yields will continue to shape the economic outlook and play a key role in determining borrowing costs across the economy. We still believe the Fed will continue to be data dependent, and the yield curve continues to price into the market that the terminal funds rate may be short lived.

### *Fixed Income Investing*

2023 looks to be a challenging investment environment as funding costs are expected to continue to increase, coupled with a Treasury curve that is already inverted. Borrowing costs will likely be at or slightly above 5.0%, making it difficult for investors that are currently in a borrowing position to either fund loans or purchase assets. The interest rate volatility and the shape of the yield curve has created an opportunity in the

Callable Agency sector. Yields on 10 year and longer Callable Agencies are near 5.75% depending on call feature and term. This spread compared to 10 year Treasuries just above 3.50%, offers a significant yield pickup. In a typical environment this type of call feature would not be desirable. However, in the current state of liquidity in the banking community with the assumption that rates are projected to be lower in a year, loan demand should grow. While portfolio roll off will continue to be light as the majority of the mortgage market is over 100 basis points away from being refinanced into a lower rate. With the majority of other investment alternatives hovering around 5.0%, the additional yield from Callable Agencies is attractive to funding costs and could enhance liquidity in a year if it were to be called away.

As a compliment to the Callable sector, adding duration from Municipals or below market MBS would benefit in the scenario where interest rates continue to fall. Both Municipal and Agency MBS have similar yields near 5.0%. Although not as attractive from a yield perspective in comparison to where funding costs are, the longer duration of Municipals can offer price appreciation with their longer call features. Unfortunately with rates projected to be lower, longer dated call protection in the Municipal market comes at a premium in comparison to short dated call protection available in



the Agency sector. While discount priced Agency MBS (FNMA 4.0%) are over 100 basis points out of the money at current rate levels, they offer minimal prepayment risk and will also experience price appreciation into lower rates. For investors that want to minimize extension risk, the Hybrid ARM sector continues to offer value. Hybrid ARMs have underperformed fixed rate MBS and offer yields close to 5.0%. They also have an average life near 5 years which also favors them from a yield perspective in comparison to similar duration fixed rate 15 year MBS and Treasuries. ♦



## EQUITY STRATEGY

### EQUITY STRATEGY

#### *Equity Portfolio Management: 2023 Plan of Action*

With 2022 equity markets reflecting the uncertainty investors felt about the future, as the Fed raised rates and resulting economic damage was anticipated, 2023 is being positioned as a pivotal year for equity investing. 2023 may become the year of market recovery, representing growing optimism that rate hikes will only have “limited” negative impact on the economy and that consumer spending and money supply will continue to support growth in the economy and therefore in corporate earnings. Conversely, many compelling arguments look to 2023 as a year where growth and corporate earnings, both actual and forecast, will experience material damage from the increase in market interest rates that has and may continue to occur, as well as the resulting contraction in economic growth.

Thus, as clarity and visibility improve as to which path equity performance will take, a revisiting of the foundation of equity investment “best practices” components is of value as the year commences. Combined, we believe these components form a comprehensive

and useful approach to managing and understanding an institution’s equity portfolio.

#### *A 2023 Primer for Perspective on the Equity Markets:*

As more than one author has stated, “Does 2023 represent a move from rates to ratings?” This is a critical question that is at the forefront of equity market projections. As has been seen, equity investors over the last year have reacted with enthusiasm to any news or forecast which indicated the Fed would be less motivated to raise rates, and that in fact they would therefore pause any additional rate hikes. This seems counter-intuitive since underlying any shift in Fed inflation fighting focus would be a view that the economy has been damaged to the point of contraction, and that a recession would be highly likely. Thus, interest rate hikes could be paused, and the yield curve ultimately shift downward. Along with this, one would

assume earnings would suffer and therefore equity valuations.

A reason that may explain this phenomenon of negative economic outlook creating positive equity movement is the underlying assumption that a “soft landing” would be achieved. That is, the Fed was able to successfully guide a slowdown in economic activity so as to reduce inflation, but not to the degree that a deep “pain inflicting” recession would result.

Current volatility reflects the uncertainty of this outcome. To date, there has not been enough economic data yet to make a strong argument for or against a 2023 recession. While the S&P experienced a 19% decline in 2022, the activity underlying the index was a sideways trading pattern in the second half of the year.

As has been discussed extensively, investors are watching for any signs of earnings deterioration at

**S&P 500 Forward P/E Ratio vs 12 Month Forward Estimated EPS**



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Source: Bloomberg





# EQUITY STRATEGY

the beginning of 2023. Many are monitoring the underlying economic factors that may provide insight around this, which include:

- Consumer spending activity
- Inflation that is abating
- Retail sales shifts
- Wholesale inflation shifts
- Employment outlook

There are several additional dynamics which we believe must be incorporated into any economic forecast. These include the current state of liquidity in the financial system and the potential for an amplified economic contraction resulting from this lack of liquidity, as well as ongoing geopolitical uncertainty and government debt.

Earnings announcements over the coming weeks will provide some visibility into the likelihood of recession and a corresponding rate forecast.

## *Equity Portfolio Management: Process Matters*

With various stakeholders and decision makers typically involved in the development and management of an institution’s equity portfolio, having and consistently following a comprehensive process underlying equity portfolio management is critical. This helps ensure the best

possible balance between risk taken and return desired. The process begins with a shared and agreed upon philosophy that the institution follows and believes in for equity investing. What are some of the characteristics of a “strong” equity portfolio investment management philosophy?

### *The Equity Investment Portfolio Philosophy: It Sets the Stage*

First, the investment philosophy guides the decision-making process. It incorporates all the elements of portfolio management such as strategy parameters and guidelines, goal setting, risk tolerance, and time horizon for performance expectations. While all of these elements may not be explicitly identified in a philosophy statement, the philosophy reflects and guides these dynamics. It helps create goals that integrate the equity portfolio with the institution’s overall balance

sheet and helps all stakeholders understand the risk-return relationship embedded in the portfolio and related ongoing management of the portfolio.

With any investment philosophy statement, understanding the factors that contributed to its creation and periodically confirming these factors are still relevant, is useful. This avoids a philosophy that may slowly shift over time, or a portfolio that is no longer aligned with the investment philosophy of the institution.

### *The Equity Investment Portfolio Policy: Policy Guides Thinking*

While an investment philosophy frames broad perspectives and guiding principles associated with investing in equities, the institution’s investment policy “dives deeper” into

S&P 500 2022 Price Performance



Source: Bloomberg



## EQUITY STRATEGY

identifying and quantifying important parameters for investment. These include objectives, risk tolerance, constraints, management of the portfolio, and monitoring. It also reflects the role which the equity portfolio serves within the organization as to how it contributes and safeguards to ensure alignment with philosophy and risk tolerance. All of this is done through policy guiding strategy.

### *Equity Portfolio Investment Strategy: Guides Action*

Relevant and appropriate equity portfolio strategy must be actionable and reflect the investor's philosophy and risk-return profile. Strategy of "buy, sell, or hold" should always be consistent with, and compared to the institution's risk tolerance. Strategies need to create actions that when applied to the portfolio, help ensure that the portfolio is best positioned to achieve agreed upon performance goals. Finally, equity investment strategy must be framed, documented, and followed in such a way as to allow for monitoring and assessment of results on an ongoing basis.

The likelihood of continued equity market volatility reinforces the importance of understanding the degree of risk which is embedded in the equity portfolio and having the

ability to determine in a timely manner, when that risk "shifts."

Risk tolerance should reflect the corporate personality of the institution. Like an individual, the often-used phrase, "I want a portfolio that allows me to sleep at night," can also apply to the institution and its stakeholders. Resources to support management of the portfolio must be periodically reviewed and confirmed as appropriate as part of meeting and managing the risk-return objectives underlying the equity portfolio.

An institution's risk profile must anticipate more than just periods of stable and positive equity market performance, but also the inevitable volatile periods. With strategy, the ability to perform "backtesting," looking at history and how a strategy performed, can be a useful way to ensure that equity portfolio strategy construction properly reflects the philosophy of the institution and the policy which supports and reflects the investment philosophy. ♦





## ALM STRATEGY

### *ALM STRATEGY*

The beginning of this article may sound very similar to last quarter, in that many of the topics discussed three months ago still hold today. Funding costs continue to increase (but have shown some signs of stabilization), liquidity remains tight (although this seems to have improved for some) and concerns remain about the Fed and when they may pivot (but at least we are three months closer to the end of the tightening cycle!).

#### *Liquidity and Funding Costs*

About a year ago, when we were in a very different operating environment, cheap and plentiful liquidity seemed like it could last forever. How quickly things change! Municipal deposit costs rose first, as these are typically the most rate sensitive, followed by CDs. Early in the cycle, a 2% CD rate was sufficient to attract new money, and that lasted for a bit before moving to a 3% market rate. The new 3% level seemed to last a very short period before jumping to 4%, then to the mid 4's where we stand today. After CD rates moved, higher yield money market rates were next, with rates in the low 2's needed to attract money, before moving higher. It seemed that community based financial institutions would be able to hold the line on core savings and

checking accounts until the Fed eases, allowing them to maintain rates at ultra-low levels for the duration. However, pressure has been building recently on these vital sources of sticky, low cost funding, forcing institutions to nudge these rates higher. Rates have moved for more rate sensitive savings accounts (mainly the accounts that are managed to act more like Money Market accounts), but have yet to move significantly for many institutions. More could follow, though, especially if the Fed makes good on its plan to maintain rates at higher levels for longer. Combine the continued tight liquidity environment with a constant bombardment of higher rate offerings, from both traditional and on-line banks, as well as attractive shorter term Treasury yields, and we have the makings of a continued upward trend in core deposit rates.

#### *Should we stay the course with Wholesale Funding?*

The majority of our clients remain in a borrowing position, with most opting for overnight advances. With a cost roughly equivalent to Fed Funds, overnight advances are favorably priced compared with longer-term alternatives. If you believe that the Fed will stop soonlet's assume a terminal rate of 5.00%, followed by a plateau, then modestly paced cuts in late 2023-short term funding looks attractive compared with term. The current rate of 4.93% to lock in term funding for 12 months is in the ballpark

of what the average overnight borrowing rate will likely be over the next year. However, you would be locked in, and if the economy starts to show cracks and we enter a recession (even if only a mild one) in the summer, consumer spending may dry up. In that case, if liquidity improves you may want to pay off the advances, but could have a penalty, especially if rates have declined. Without the benefit of cost savings, maintaining flexibility could be more important. Once you move past a 12 month term, potential Fed easing makes overnight funding even more compelling.

The limited extension that exists is generally in the form of Broker CDs, mainly bullets, which offer attractive pricing compared with the FHLB, especially at the shorter end of the curve. A comparison of recent rates with similar terms:

- FHLB Bullet advance, 3 month term: 4.96%
- Broker CD, 3 month term (all-in cost): 4.45%

At the shorter end of the curve, the CD provides about 50 basis points of cost savings. In addition, it is categorized as a certificate, as opposed to a borrowing, and does not utilize precious borrowing capacity. The cost savings start to decline the further we extend out on the curve:

- FHLB Bullet Advance, 6 month term: 5.03%

## ALM STRATEGY



- Broker CD, 6 month term (all-in cost): 4.65%

At 12 months, the benefit declines to less than 20 basis points, in addition to the flexibility concerns discussed above.

### *Loan Growth in the Near / Medium Term*

When liquidity was plentiful and rates were near zero, holding excess Fed Funds was punitive to the bottom line, as cash was nearly a non-interest bearing asset. In that climate, even historically low yielding 30-year fixed mortgages under 3% looked attractive, and were accretive to earnings, boasting a spread of more than 250 basis points compared with Fed Funds. Institutions added longer term assets to their balance sheets at a very fast pace, and with low rates driving historically high prepayment speeds, there were more than enough mortgages to go around.

Today is a different story, however. Lending has slowed dramatically, liquidity has tightened considerably and funding is much more expensive. In addition, the growth that occurred over the last couple of years has pressured capital. The combination of these issues has forced financial institutions to be much more selective in what assets to add to the balance sheet. Funding a 5.50% loan with overnight borrowings at 4.50% is not nearly the easy decision of the past. However, even though that 100 basis point spread sounds skinny, it is accretive, and should remain accretive if the Fed stops at 5%. Then, once the Fed starts to cut and liquidity

improves, that loan will look much better, so although it appears not to be very attractive, it looks much more appealing when viewed over a 36 month window when funded with a blend of 12 months of higher cost advances followed by 24 months of cheaper deposits, potentially.

In addition, although many institutions added significant amounts of longer term assets over the last 2+ years, it remains a good time to add duration to the balance sheet. With the 10-year trading about 75 basis points below its recent high and the Fed near the finish line, it is likely that we have seen the high point in rates at the longer end of the curve in this cycle. With asset rates below recent high levels, but still well above a year ago, there could be a reasonable amount of refi risk in mortgage collateral. As a result, when adding duration to take advantage of current rates structure matters; for example, a 7% 30-year fixed rate mortgage sounds attractive, but how long could you reasonably expect that loan to remain on the balance sheet? If rates fall near the end of 2023, that could end up as a 12 month loan, and it is possible that a loan written 100 basis points below that could end up as a better long-term option, as the likely life would be longer. ♦



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