JAG CAPITAL MANAGEMENT LLC

Quarterly Comments

Opportunity Set is Growing Despite Fears

Bonds are Back!

As we highlighted last quarter, we believe the interest rate increases and inflation fears of 2022 have created an attractive opportunity for bond investors for 2023 and beyond. Indeed, being a prudent and diversified "lender" to the Federal Government, corporations, and municipalities now provides investors with the potential to earn mid-to-high single digit total returns, while moderating short-term portfolio volatility. This is a noticeable and welcome change from the fixed income investing landscape that has prevailed since 2007, and we believe many investors have forgotten the important role that bonds can play in long-term investment portfolios.

JAG has deep experience in managing bond portfolios. Our taxable fixed income strategies are well diversified, with short-to-intermediate term duration. We also offer clients the ability to customize their individual bond holdings in terms of credit rating, maturity/duration structure, and ESG/SRI restrictions. For taxable investors in higher tax brackets, we also offer customized municipal bond portfolio solutions that can be tailored to optimize tax-equivalent yields.

"You're unlikely to find anyplace on the market that is truly impregnable."

Source: Cartoonbank.com Tom Toro

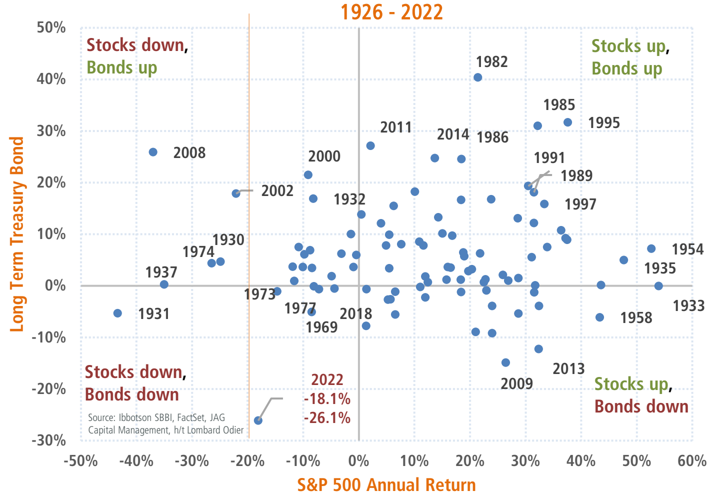
Market Overview

High inflation, a hot war in Europe, historically aggressive Fed rate hikes, and growing concerns about economic and earnings recessions conspired to make 2022 a dismal year for global investors. The S&P 500 posted its worst performance since 2008, and the broad bond indices delivered double-digit losses. In fact, the combined bear market in both stocks and bonds put 2022 in the running for the worst-ever calendar year for financial assets. The -26.1% drubbing of long-term Treasury bonds was — by far — the biggest such loss over the past century, and the traditional 60/40 portfolio mix of stocks and bonds sustained deep declines.

The fourth quarter delivered a respite of sorts from the bear market in stocks and bonds. After hitting a new low for the year on October 13th, stocks rallied through the end of November on better-than-feared corporate earnings results and a variety of data indicating that inflation had (finally) peaked. Hopes that cooling inflation would allow the Federal Reserve to slow the pace of rate increases were boosted after the Thanksgiving holiday, when Fed Chair Powell stated that interest rates would only need to rise "somewhat" higher than previous projections.

Investor optimism faded into year-end, as global central banks signaled that they were still committed to aggressively hiking rates, economic data showed clear signs of slowing growth, and several negative earnings announcements raised concerns of an earnings recession in 2023. At the December meeting, the Fed revealed

Annual Returns for S&P 500 (x) vs. Long Term Treasury Bonds (y)
1926 - 2022



that it expected rate hikes to take the Fed funds target rate above 5% (from the current 4.375%), which was higher than market expectations. Economic data released in mid-December, including regional manufacturing indices and the November retail sales report, showed a deceleration in the economy. Meanwhile, both the European Central Bank and the Bank of Japan surprised markets with hawkish policy decisions, providing yet another reminder that central bankers remain committed to rate increases despite the increasing risks of recession in 2023. As a result, a so-called "Santa Rally" failed to materialize, and stocks generated losses for the month of December.

For the full quarter, however, the S&P 500 rallied by 7.6% and the Bloomberg Aggregate Bond Index returned 1.9%. This was the only calendar quarter of positive returns for stocks and bonds in 2022. Financial markets are forward-looking mechanisms, and the unpleasant price action of the past year may have discounted a significant amount of bad economic and earnings data that could come in 2023. The fact that asset prices were able to stabilize last quarter despite so much negative news could be a sign that the end of the worst bear market since 2008 may be coming within sight.

"Markets reacted to the news by edging aside kind of awkwardly and then pretending to take a phone call."

Source: Cartoonbank.com Frank Cotham

Outlook

Last year's losses in stocks and bonds were driven by decades-high inflation, a historic Fed rate hike campaign, and global geopolitical unrest. But while those factors were clear negatives for asset prices in 2022, it is important to note that the market is potentially approaching a transition period that could see some of these strong headwinds abate in the months ahead. History teaches us that expecting market movements to move in concert with economic conditions is misguided.

Inflation has shown definitive signs of peaking and declining. The Consumer Price Index has fallen from a high of 9.1% in June to 7.1% in November, while other metrics of inflation have registered similar declines. To be clear, inflation remains much too high relative to the Fed's stated target of 2%. However, continued declines in year-over-year headline inflation data are highly likely, given the fact that we will soon be lapping the very high inflation prints that ensued after Russia's invasion of Ukraine last year. Although the resulting cascade of inflationary pressures from this war has not fully subsided, there has been improvement and some radical changes in European energy policy. The upshot is that the actions taken by EU policymakers in response to the Ukraine war have accelerated energy supply diversification by decades. We see some very interesting investment opportunities globally as a result of this.

Markets can thrive during various interest rate environments, but they tend to struggle when policymakers, rather than capital markets, dominate the path of rates. To paraphrase Jeffrey Gundlach from DoubleLine, our collective decades of experience teach us to listen more to what the capital markets say rather than what the Fed says. After a historically aggressive rate hiking campaign in 2022, we believe the Fed will soon pause. In December, the Federal Reserve signaled that it expected the peak interest rate to be just 75 basis points higher than the current rate. That level could easily be reached within the first few months of 2023, and the end of the Fed's hikes could remove a significant headwind from asset prices.

There is intense debate within economic circles about labor conditions. The headline unemployment rate and real wage growth numbers seem to be robust, a disclosed concern for the Fed. However, there is also the seeming disconnect between jobs created and workers. A significant percentage of new jobs created during the past year seem to be a result of individuals having multiple, part-time jobs. The calculation of these statistics present differing pictures about the health of the workforce. While larger companies seem to be right sizing their staffing through mass layoffs, mid-size and smaller companies are finding it easier to hire qualified workers.

As with so many aspects of the capital markets, challenging times often result in surprising outcomes. We adjust our expectations and actively manage investment portfolios with an eye towards the future reality. For example, starting during the pandemic, soaring transportation costs were an acute inflationary concern. Now, however, the shipping container industry is in the midst of an outright supply glut. Transport costs have come down significantly in recent months, which is easing cost pressures for many manufacturers and retailers. As another example, consider the calamitous outlook for energy prices that came in the wake of the Ukraine invasion. After reaching multi-year highs last spring, natural gas prices have declined precipitously over the past several months. There are dozens of other examples, but the common thread is that market cycles of fear and greed tend to overshoot in both directions. In hindsight, asset prices got ahead of themselves in 2020-2021. Similarly, the drubbing that both stocks and bonds took in 2022 could be sowing the seeds of better forward returns over the next several years.

Finally, while both economic growth and corporate earnings are expected to decline in 2023, we think those negative expectations have been at least partially priced into stocks and bonds at current levels. As such, if the economy or corporate America proves to be more resilient than forecasts, it could provide a positive spark for asset markets in early 2023.

As we start the new year, we should expect financial media commentary to be focused on the 2022 losses and current market risks, including earnings concerns and recession fears. To a certain extent, this is understandable. Large (greater than 10 percent) annual declines in stocks are relatively rare and always scary. 2022 was only the 12th "down a lot" year for the S&P 500 since 1926. Negative headlines tend to get much more attention and readership, no matter whether the topic is investing, geopolitics, or crime reports. While there are undoubtedly economic and corporate challenges ahead in 2023, some of those best-known risks are at least partially priced into markets already, and the truth is that there are positive catalysts becoming apparent as we start the new year.

More broadly, market history has been consistent: declines of the magnitude we saw in 2022 are usually followed by strong recoveries rather than further weakness. The S&P 500 hasn't registered two consecutive negative years since 2001-2002. Bonds, as represented by the Bloomberg US Aggregate Bond Index, have never experienced two consecutive years of negative total returns. And that reality underscores the point that bear markets like 2022 have ultimately yielded substantial long-term opportunities in both stocks and bonds.

The stagflation of the 1970s and sky-high interest rates of the early 1980s eventually gave way to the strong economic growth and market rally of the 1980s. The dot-com bubble burst of the early 2000s was followed by substantial market gains into the mid-2000s. The Great Financial Crisis of 2008-2009 remains the worst economic situation we have experienced in modern market history, and yet even that dark period was followed by strong rallies in the years that followed.

We are prepared for continued volatility and are focused on managing risks and preparing for future opportunities in stocks and bonds. We appreciate the patience of our clients during the past challenging year, and we are optimistic about the year ahead and the role of active management in this environment.

Warm Regards and Happy New Year,

Norm Conley
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Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/expertise without substantial reliance on non-Veteran-owned businesses.

About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm with offices in St. Louis and Chicago.

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