OPPENHEIMER
INVESTMENT MANAGEMENT

2023 is all about Employment

Inflation concerns became so mainstream in 2022 that we encountered many pontificators at holiday parties this year. We heard multiple theories as to why inflation was so sticky and where it would go from here. We believe employment will likely dominate that chatter this year as the likelihood of a downturn appears to be growing. As a result, for our 2023 Economic Outlook we will dig a bit deeper on this topic and try to find some trends that might be early indicators of where things are headed.

Fixed Income Fourth Quarter Market Performance

The U.S. interest rate curve flattened during the quarter as yields on Treasuries 1-year and shorter rose substantially while yields on maturities from 2-years to 30-years were mixed. Most segments of the fixed income market generated positive returns during the quarter. Below are highlights on fixed income performance in the quarter.

- The 10-Year Treasury yield started the quarter at 3.83% and ended the quarter at 3.88%. Treasury prices fell as yields rose. The 2-year/10-year spread further inverted to finish the year at -0.53%.
- Investment grade and high yield credit experienced gains during the quarter. The Bloomberg Barclays U.S. Credit index returned 3.4% while the U.S. Corporate High Yield Credit index returned 4.2%. High yield was the best performing fixed income segments as spreads tightened 0.62% to 4.81% at the end of the quarter.
- The best performing segments of the fixed income markets were high yield corporate credit, municipals and leveraged loans.
- Leveraged loans appreciated due to credit spread tightening as the S&P/LSTA U.S. Leveraged Loan 100 index returned 3.8%.
- Municipal bonds, both investment grade and high yield, generated positive returns. The Bloomberg Barclays Municipal Bond index generated a 4.1% return while high yield municipal bonds appreciated by 3.5%.
- Non-U.S. local currency global bonds benefited from a declining U.S. Dollar and appreciated during the quarter. The majority of currencies appreciated relative to the U.S. Dollar.

The Relative Attractiveness of Fixed Income Persists

In our third quarter commentary, Senior Security Analyst Peter Vars, outlined a compelling argument for the attractiveness of fixed income as an asset class in the current economic environment with his contribution to our commentary entitled: ***The Case for Fixed Income Investment at this Time.***

Peter concluded:

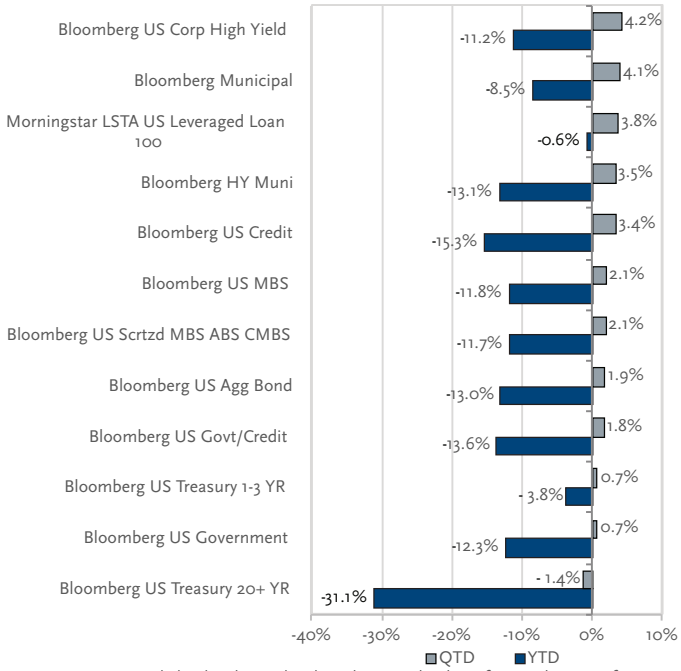
"We think the relative value between stocks and bonds currently favors bonds due to the relationship between the 10-year Treasury yield and the S&P 500 dividend yield. The 10-year Treasury now yields +1.96% more than the S&P 500 dividend yield, the biggest differential since +2.18% in April 2010 – when the 10-year Treasury was similarly trading near 4.00%. As evidenced by the data, peaks in this relationship are typically followed by outperformance in bonds vs. stocks."

While the yield gap between the 10-year Treasury and the S&P 500 dividend narrowed to 1.78%, there are still ample total return, income, and relative value opportunities being presented in the fixed income asset class. While the risks inherent in bonds remain, and there is no guarantee any investment strategy will succeed (please see the risks disclosures at the end of this presentation) we encourage you to review Peter's work and consider your long-term allocation to fixed income.

Our 2023 Economic and Fixed Income Outlook

Our disciplined investment process, now in its 24th year of successful execution, has proven to be dependable through economic cycles. We anticipate an economic downturn during 2023 as the Fed's interest rate increases begin to take hold. How deep or extended will it be? We attempt to explain below.

U.S. Fixed Income Performance Through 12/31/22



Investing in securities, including bonds, entails risks and may result in loss of principal. Past performance does not guarantee future results. Please see further disclosures at the end of this presentation.
Source: Morningstar Direct
Indices are provided for comparison only and are not available for direct investment.

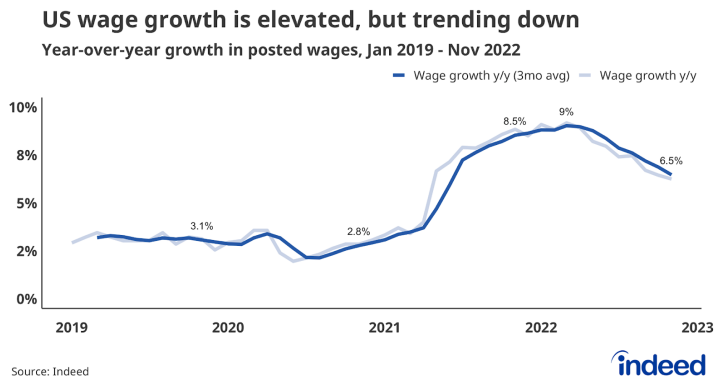
Corporate Earnings and Capital Expenditures: We are forecasting flat to moderately lower corporate profits in 2023. While corporate profit growth was a healthy +5.5% year-over-year in 3Q22, seasonally adjusted month over month growth rates have decelerated close to zero recently. A weakening growth outlook, higher interest rates, bloated inventories and stubbornly high wage growth are expected to result in slower sales growth and contracting margins. We expect more or less flat business investment during 2023. Weaker growth and profits and higher capital cost incentives will mostly be offset by increased efforts toward de-globalization/reshoring and investment in automation amid a historically tight labor market.

The ISM Manufacturing Index: After spending most of 2021 at a robust level in the high 50s to low 60s, the ISM Manufacturing Purchasing Manger's Index plummeted throughout 2022, crossing below 50 in November. Levels above 50 signal expansion while levels below 50 signal contraction. While manufacturing is a relatively small portion of the U.S. economy, economists view this index as a key leading indicator of economic strength. Consumers dramatically shifted their spending toward manufactured goods during the COVID lockdown era. In 2022, as the economy continued to reopen, consumers shifted away from goods back towards services. At the same time, corporate managers stocked up on inventory in anticipation of a strong economy in 2022 and ongoing supply chain challenges. Due to the demand shift and elevated inventories, it's not surprising to see production slowing. The ISM declined to a post-pandemic low of 48 in December. Meanwhile, PMI's in Europe and China also dropped into contractionary territory in 2Q22, although China should see recovery in 2023 after abandoning extreme COVID restrictions. The Markit US PMI Index, which includes more small manufacturers than the ISM Index, sank below 50 in October. Similarly, the ISM Services Index spent much of 2022 at very robust levels, reflecting the aforementioned post-pandemic consumer demand surge, but took a dramatic leg lower in December to 49. One data point is not a trend, but economists and investors will be watching this metric closely to see if the large services sector has sunk into contraction.

Gross Domestic Product: As the late German economist Rudi Dornbusch famously said, "No post-war expansion died of old age. They were all murdered by the Fed." The brief COVID downturn and asset bubble-based downturns of '01 and '08 notwithstanding, most post-war expansions have indeed been done in by Fed tightening, and the Fed is currently tightening as rapidly as ever. Thus, it makes sense why the street is forecasting the probability of a recession in the next 12 months at 65% as the cumulative impact of unprecedented rate hikes take effect. However, we believe the

Oppenheimer Investment Management LLC
Sales and Client Service

630 W. Carmel Drive, Suite 250
Carmel, IN 46032
CONTACT: Cyndi Collins, 317.843.3607



impacts lag a little more than expected and forecast 2023 real GDP growth in the range of 0.0-1.0% for the year. The Bloomberg consensus expectation is for 0.4% real GDP growth in 2023.

Unemployment: We forecast the unemployment rate to rise over the course of the year before ending in the 4.25%-4.50% range. As the title to this letter indicates, we expect employment to be the topic of discussion as we progress through 2023, and we believe a rise in unemployment is an inevitable, even necessary, result of recent Fed actions to reduce inflation. Labor demand is beginning to show signs of easing as the macro backdrop weakens and the war chests of pandemic PPP funds are depleted. JOLTS job openings are down ~12% from their peak in March and are on a clear downward trajectory. Meanwhile, labor supply remains well supported as wage growth is nominally strong (albeit slowing) and participation rates are high. Despite the characterization that labor participation is depressed in a post-COVID world, age-specific participation rates are up for every five-year bucket except for those over 70 relative to 2018 (a good year for the labor market).

Wages and inflation: Indeed.com is the most popular job listing website today. Indeed maintains an index of wage growth derived from the advertised wages from job listings on its site. You can see in the graph above titled "US Wage growth is elevated, but trending down" that the growth in advertised wages has trended lower for nine straight months. Though decelerating, wage growth still remains too high, at 6.3% year-over-year. We are seeing similar signals around wage growth deceleration from other metrics. The Bureau of Labor Statistics' Average Hourly Earnings (AHE) measure peaked in March 2022 at +5.6% and has since decelerated to +4.6%. The Employment Cost Index (ECI), the Fed's preferred measure of wage and benefit inflation, is reported less frequently, on a quarterly basis. The ECI peaked in 2Q22 at +5.1% and ticked down to +5.0% 3Q22. The 4Q22 number will be released on January 31st and we expect to see continued deceleration in line with the other metrics previously cited.

The Fed is intensely focused on wages now as they believe this is the primary remaining support for above target (+2.0%) inflation. Commodities and goods prices have declined recently. Shelter services are still adding to inflation, but we have good reason to believe shelter inflation will begin to wane in late 2023. Mark-to-market rents have turned negative in recent months, but there will be a significant lag before it shows up in the year-over-year number. That leaves core services ex-shelter which remains stubbornly high. The PCE core services ex-housing print for November was +4.32% and has remained above +4.0% on a year-over year basis since April 2021. We will need to see this number consistently headed toward the Fed's inflation target before we can be sure this rate hike cycle has peaked. The Fed believes that labor intensive services inflation is driven by wages.

Monetary Policy: The Fed is committed to finishing the job, even at the risk of a recession. The Fed's plan is to push the Fed Funds rate into restrictive territory and hold it there for as long as necessary. The difficulty is that parts of the economy are already weakening, and the rate hikes are beginning to be felt. We expect the Fed to slow the pace of hikes from 50bp in December to 25bp in February. We continue to expect the FOMC to set the peak rate for the cycle at 5.0-5.25%, after two additional 25bp hikes in March and May. These latter hikes remain dependent on economic developments such as employment data as previously discussed.

Interest Rates: The front end moved dramatically higher in 2022 as a result of 425 bps of Fed hikes during the last 9 months of the year, while the yield curve (as measured by the 2y10y spread) reached levels of inversion not seen since 1981 at -84 bps in December. In 2023, we expect intermediate rates to drift lower, with the 10 year likely ending the year between 3.25%-3.50%. Barring a dramatic change to the expected Fed policy path, we believe the 2y/10y relationship will remain inverted, but flatter, as expectations for a Fed pivot to easier monetary policy begin to be priced in.

Investment Grade Corporate Bond Outlook: The rate increases of 2022 presented investors with opportunities for increased income and yields in the future which helped corporate spreads remain fairly steady throughout the year. For 2023, we expect investment grade corporate spreads may widen modestly as the economy slows. However, while any forward-looking statements are subject to a variety of risks and uncertainties and actual events may differ materially, we believe credit fundamentals are generally strong enough to absorb some economic headwinds. Importantly, while economic and market conditions may change, we believe total return in fixed income should be positive amid higher yields and a potential rally in the second half of the year as the Fed pauses interest rate hikes. We believe credit selection will be paramount in this environment, as the focus will shift toward fundamentals and the ability of corporates to navigate this macro uncertainty. As always, we are positioning portfolios to be dependable components of an overall asset allocation. We remain focused on producing income, not over-reaching for yield, and taking advantage of opportunities presented by the market. There remain no positions in the portfolios with any credit concerns or sustainability concerns through the market cycle and capital preservation continues to be our foremost priority.

High Yield Bond Outlook: We anticipate a modest increase in high yield defaults during 2023. This increase will likely be the result of continued pressure on the retail sectors. Retail has experienced secular pressure of changing consumer preferences for online shopping, price transparency, supply chain challenges, and demand changes. The long-term average high yield bond default rate is now at 3.40%. We expect defaults to drift modestly higher than the long-term average in 2023. Much of this is already priced into the market. High yield spreads widened 160 basis points versus Treasuries in 2022. We believe spreads may have some room to tighten over the course of 2023 from the 2022 year end level of +481 (OAS). We are projecting a positive total return for the high-yield market based on coupon, modest spread tightening and a favorable movement in the 5-year Treasury rate.

Thank You

We want to thank you for your business and introductions to new clients during the past year. We look forward to serving you in 2023 and helping to successfully navigate the ever changing fixed income landscape. Please remember our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward tradeoffs in our portfolios. While market fluctuations can occur, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Leo J. Dierckman
(317) 843-3603
Leo.Dierckman@opco.com

Michael Richman, CFA
(317) 843-3602
Michael.Richman@opco.com

DISCLOSURE