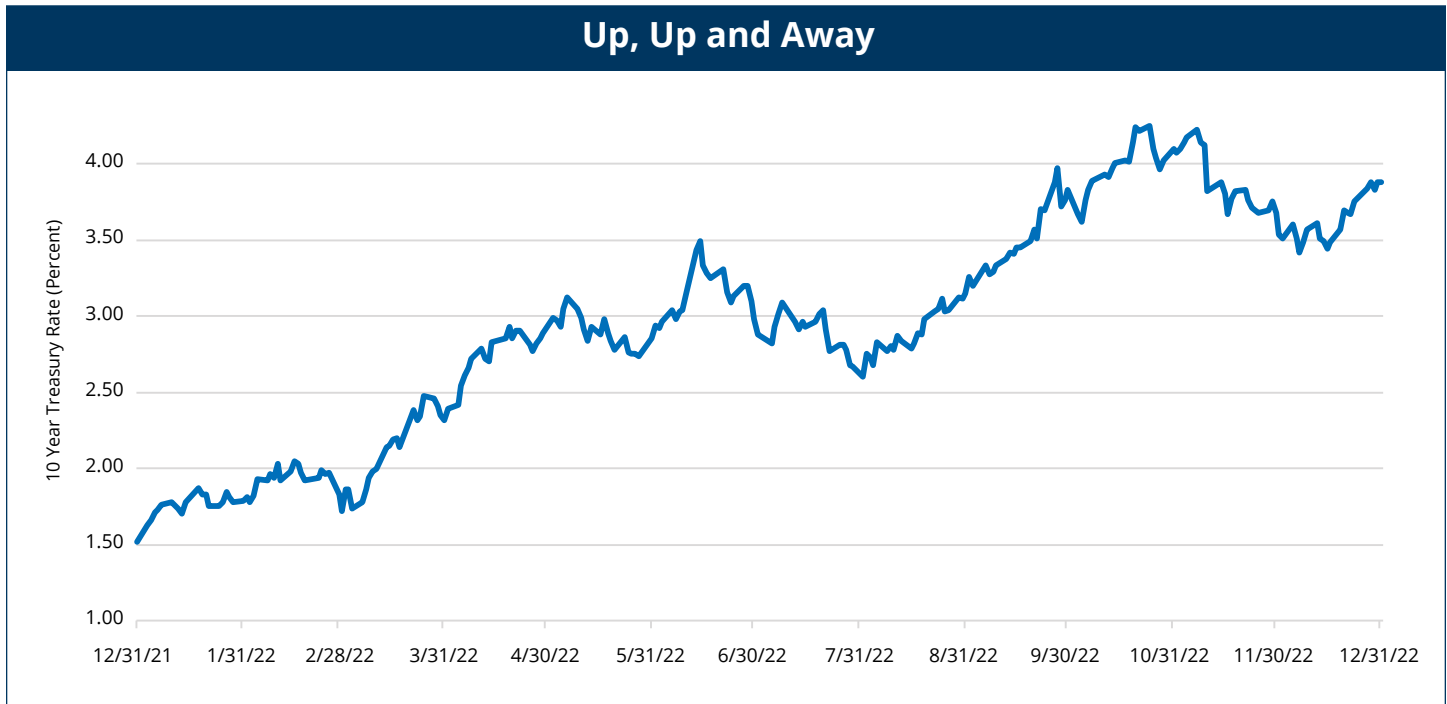


Breaking the Tape

Rallies in both the stock and bond markets during the fourth quarter of 2022 were a welcome means of closing out a year that offered little else for investors to celebrate. To be sure, 2022 was an unforgettable year in financial market history for all the wrong reasons. Most notably, the unprecedented rout in the bond market revealed the largely underappreciated risk for a supposedly “safe haven” asset class.

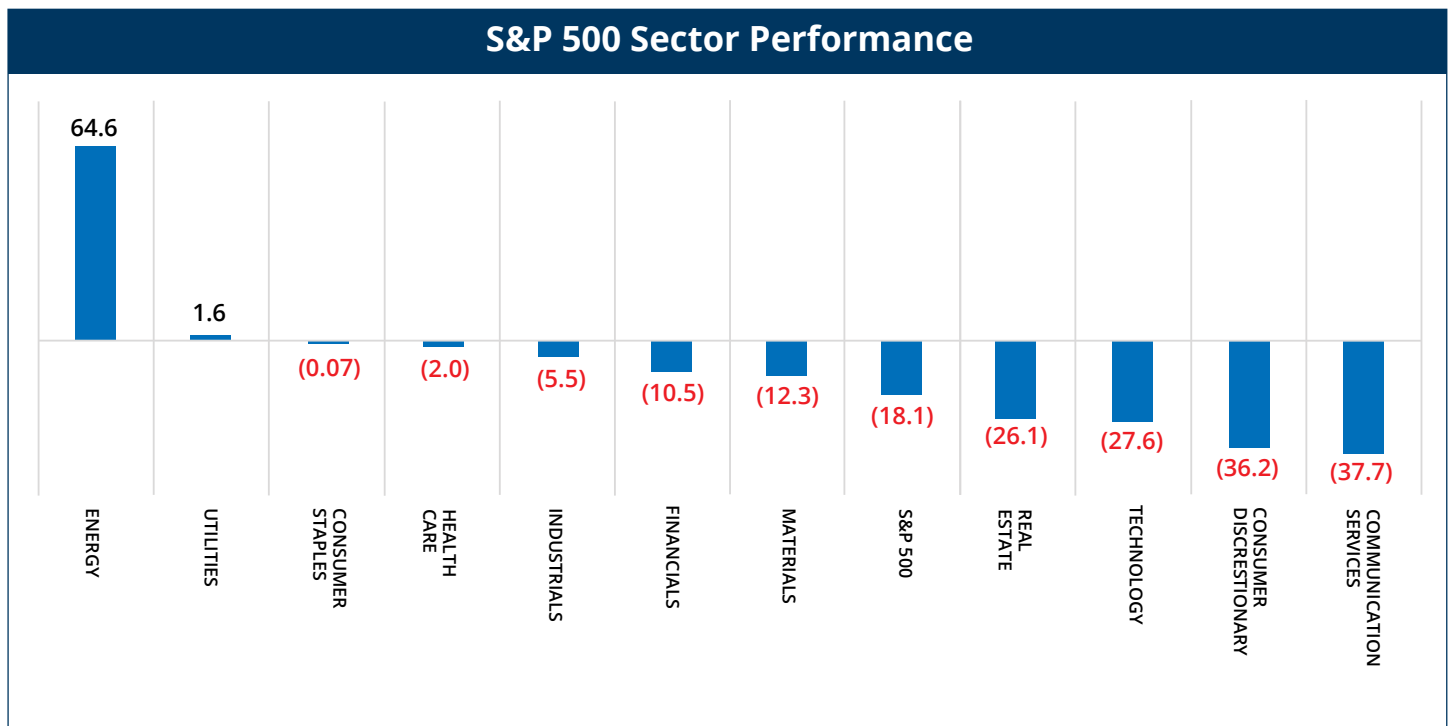
Bond yields surged on the heels of rising inflation pressure and the hawkish central bank policy aimed at bringing it back in check. The yield on the bellwether 10-year Treasury Note, which began the year at a meager 1.52%, rose to a peak of 4.24% in early October before settling down to 3.88% by the end of the year. The 2.36% increase from the end of 2021 was the largest positive change in the 10-year’s yield during a calendar year since 1962.



Source: YCharts, 1/6/2023

Rising interest rates put pressure on equity valuation multiples, which were trading at lofty levels at the beginning of last year. However, the pain in the equity market was not felt equally. High-growth sectors, like Communication Services, Technology and Consumer Discretionary, which had benefited most from ultra low-rate environments in 2020 and 2021, took the brunt of damage in 2022 – weighing heavily on return of the broad market averages.

Meanwhile, so-called “old economy” sectors, like Health Care, Consumer Staples and Utilities, proved far more resilient as investors sought a more defensive posture under threat of a potential recession. Benefiting from reopening demand and a geopolitical driven supply shock, energy stocks stood in a league of their own in 2022 gaining almost 65%.



Source: Morningstar Direct, 1/6/2023

For the full year, a combination of double-digit declines in both the S&P 500 Index and the Bloomberg Aggregate Bond Index led balanced portfolios to experience their worst calendar year loss since 2008.

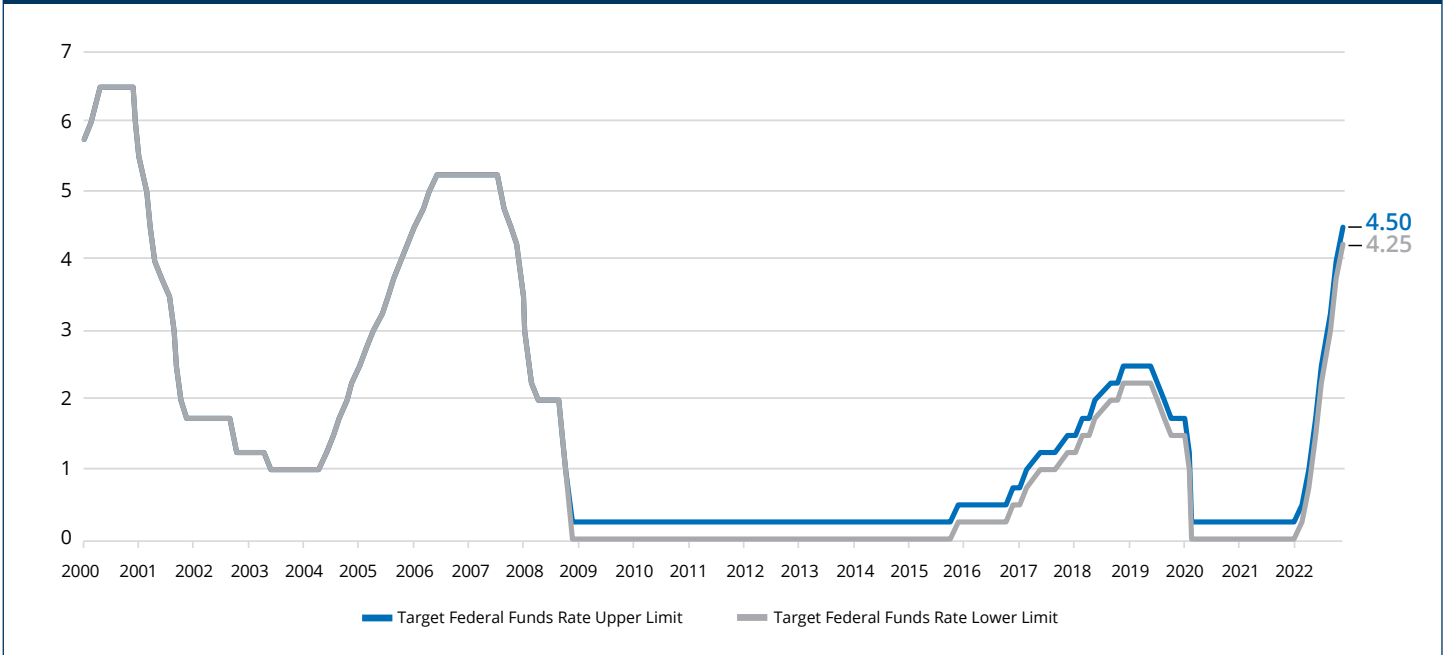
Too Much of a Good Thing

With inflation pressure accelerating at a rapid pace heading into 2022, central bankers began scrambling to reverse the flow of liquidity they had been pushing into the economy over the prior two years and reestablish their inflation fighting credibility. The drastic, yet necessary, monetary policy tools engaged in the early days of the pandemic, in conjunction with unprecedented fiscal stimulus, undoubtedly saved the global economy from a potential depression and stabilized financial markets. However, by the end of 2021, it was clear that such uber-accommodative policy had overstayed its welcome.

By keeping emergency monetary policy in place long after it was truly necessary, inflation surged to levels not seen in 40 years. As the Fed and other global central banks began to appreciate how far behind the curve they were, the policy impulse turned increasingly hawkish.

Over the course of the last seven consecutive Federal Open Market Committee (FOMC) meetings beginning in March, the Fed increased its Fed Funds Rate range from 0%-0.25% to 4.25%-4.50% – a level not seen since 2007. In concert with reducing its balance sheet or quantitative tightening, the Fed hopes to cool demand enough to bring inflation back down to its 2% target and keep it there.

Fed Funds Rate

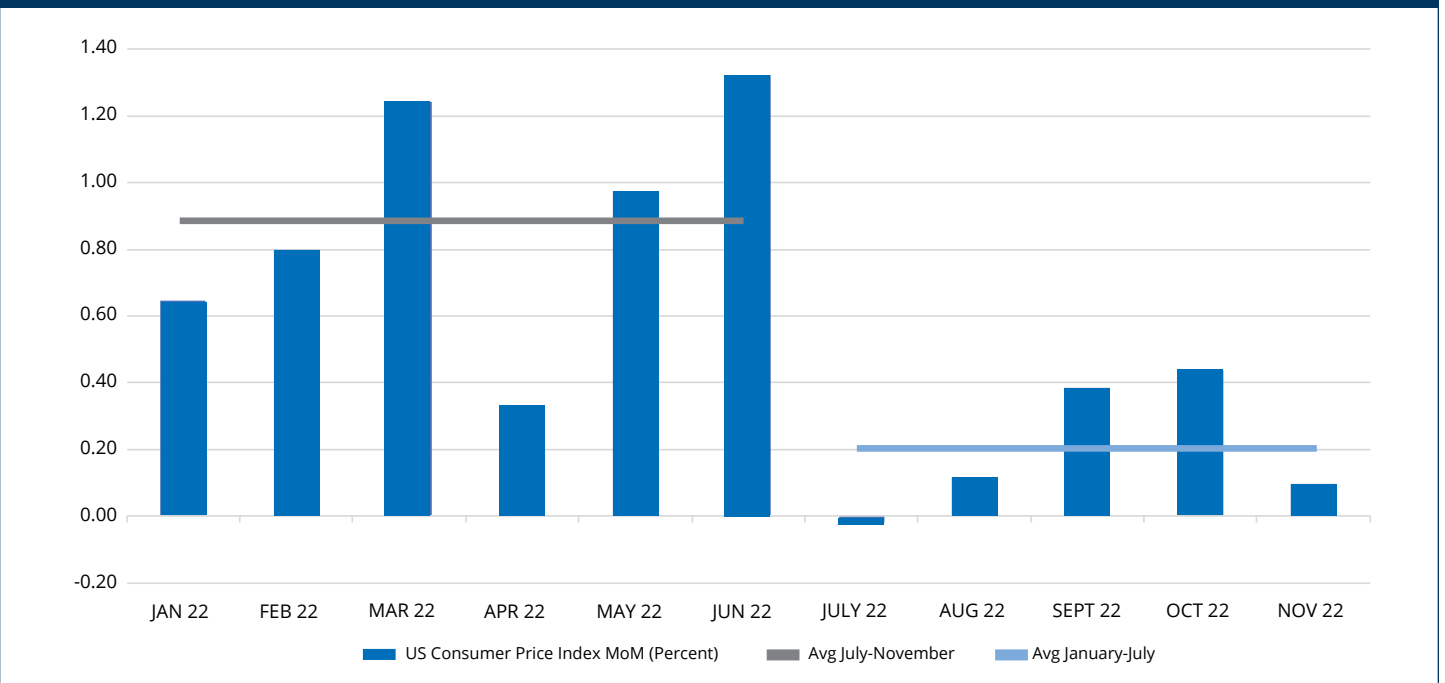


Data Source: YCharts, 1/6/2023

Cooling demand means slowing economic growth possibly to the point of causing a recession – a risk Fed Chair Jerome Powell seemed quite willing to take when he remarked that higher interest rates “will bring some pain to households and businesses” in his brief-but-direct August Jackson Hole speech. He would go on to add that “a failure to restore price stability would mean far greater pain.”

Recent inflation readings suggest progress is being made on this front. Headline CPI from July through November averaged a 2.4% annualized rate compared to 10.6% over the first six months of 2022.

Inflation Downshift



Data Source: YCharts, 1/6/2023

Despite Chair Powell's repeated statements reaffirming the Fed's commitment to continue down a hawkish path "until the job is done," investors have been skeptical of the central bank's resolve (or need for it) in the face of weakening economic data. Inverted yield curves and weakening company survey data have been flashing historically reliable warning signs that a recession is on the horizon.

Meanwhile, the Fed appears to be maintaining a perspective that a recession could be a necessary evil given the historically tight labor market. Getting inflation down to 2% is only half the job. Keeping it there will require wage pressure to dissipate by restoring balance to the supply-and-demand dynamic for labor.

So far, progress on this front has been modest with job openings continuing to far exceed the supply of unemployed workers. A glimmer of hope appeared in the December Non-Farm Payroll report, which showed average hourly earnings increased less than expected in addition to a downward revision to November's reading.

In a Goldilocks "soft landing" scenario, hawkish monetary policy will rebalance the labor market by simply destroying excess demand for workers without tipping scales in the other direction. The possibility of – and desire for – such an outcome has been suggested by Chair Powell, while acknowledging it may not be the most probable, given the imprecision of monetary policy's impact on the economy.

Investors have good reason to be skeptical. The Fed has clearly prioritized its price stability mandate over full employment by repeatedly communicating that the risk of doing too little to fight inflation is far greater than doing too much.

Outlook

Recent evidence that inflation pressure is subsiding in response to restrictive policy already in place sparked optimism that the Fed and other central banks can afford to be less hawkish, thereby decreasing the odds of a recession. At the moment, Fed Fund Futures market pricing suggests that the Fed is likely to pause rate hikes below 5% and begin easing later this year.

This outlook disagrees with the Fed's current view, which holds significant implications for both stock and bond performance in 2023. In other words, we expect the direction of financial markets to largely hinge on the whether or not the Fed's outlook converges to the market's, or the other way around. The equity market will be particularly vulnerable to further selling pressure if the Fed maintains its set course.

Our strategies benefitted from the flexibility to sell market risk and hold cash during episodes of extreme stress in 2022. Amid such a pivotal, yet unpredictable, standoff, we believe having the ability to be truly tactical will be a valuable feature again this year.

James St. Aubin

Chief Investment Officer

James St. Aubin, CFA®, CAIA®, is Chief Investment Officer for Sierra Mutual Funds and Ocean Park Asset Management. He has oversight as to all activities of the Investment Management department, in collaboration with Sierra co-founders David Wright and Kenneth Sleeper. An accomplished investment management executive, his career of more than 20 years includes leadership roles in asset allocation, manager research and portfolio construction. James earned a Bachelor of Science in Finance from DePaul University and is a CFA® and CAIA® Charterholder.

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