Mainsail Quarterly Market Commentary

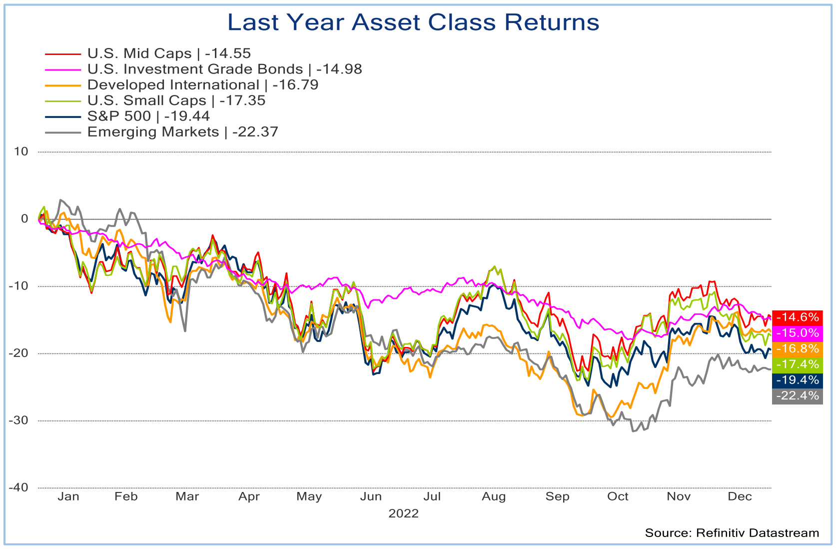
4TH QUARTER 2022 UPDATE & 2023 OUTLOOK

Best of Times, Worst of Times

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity." – Charles Dickens – A Tale of Two Cities

Dickens may have summed up 2022 better than anyone could have with his classic start to *A Tale of Two Cities*. Indeed 2022 was one for the record books, with many records set, both good and bad; it truly was a remarkable year.

- Bonds[i] had their worst year on record, declining a stunning 13.1% on the backs of rapidly rising bond yields. This decline capped off the worst 10 year stretch for bonds in history.[ii]
- Corporate Earnings reached record highs in 2022 but P/E valuations declined more than 30% as interest rates rose and investors fretted over fears of a slowing economy.
- The Federal Reserve raised rates by the most in any single calendar year ever.
- After spending much of the last decade in purgatory, the Energy Sector posted its best return since 2005, ending up an astonishing 60%.
- Money Market Funds and Short-Term Treasuries ended 2022 with yields in excess of 4%; levels not seen since the mid-2000s.
- The Crypto Currency market crashed in a remarkable reversal of fortunes, wiping out over 75% of the total market cap of all currencies.
- 94% of the 112 asset classes we track posted losses for the year[iii].
- Even the more conservative 60/40 portfolio[iv] took it on the chin with the benchmark posting one of the worst years in history, finishing down ~16%.



P: 804-693-5500 F: 804-693-2925 | 6641 Main Street, Gloucester, VA 23061 | 4510 Cox Rd. Suite 103 Glen Allen, VA 23060
www.mainsailwealthadvisors.com

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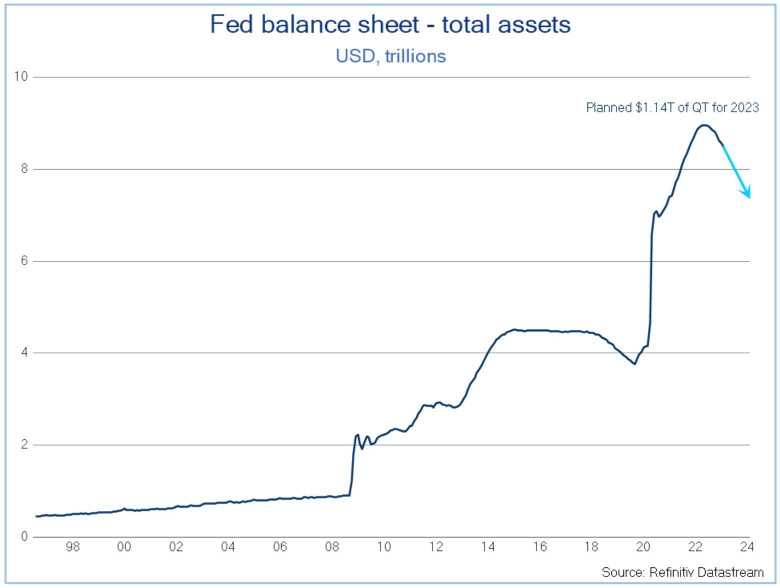
Expectations Heading into 2023



With inflation continuing to show signs of peaking, the Federal Reserve is expected to reach the end of its rate hiking campaign sometime in early 2023. While this should be welcomed by investors, there are headwinds for the market heading into 2023.

For one, the Fed plans an unprecedented reduction in its balance sheet, reducing its bond portfolio by $95B/month through the end of 2023. That amounts to a reduction of over $1T of market liquidity which will put some amount of downward pressure on both stocks and bonds.

Secondly, consensus estimates currently call for a decline in corporate earnings through the first two quarters of 2023. While markets tend to bottom before earnings do, we will keep a keen eye on the data for signs that the worst is truly behind us.

Lastly, the third major headwind we see is the competition for investors' capital. For the first time since before the financial crisis of 2008-2009, short-term interest rates have risen to a level which offers a compelling alternative to stocks. This will likely have an impact on investors' appetite for risk and could influence just how much upside stocks have for 2023 given all policy and economic unknowns.

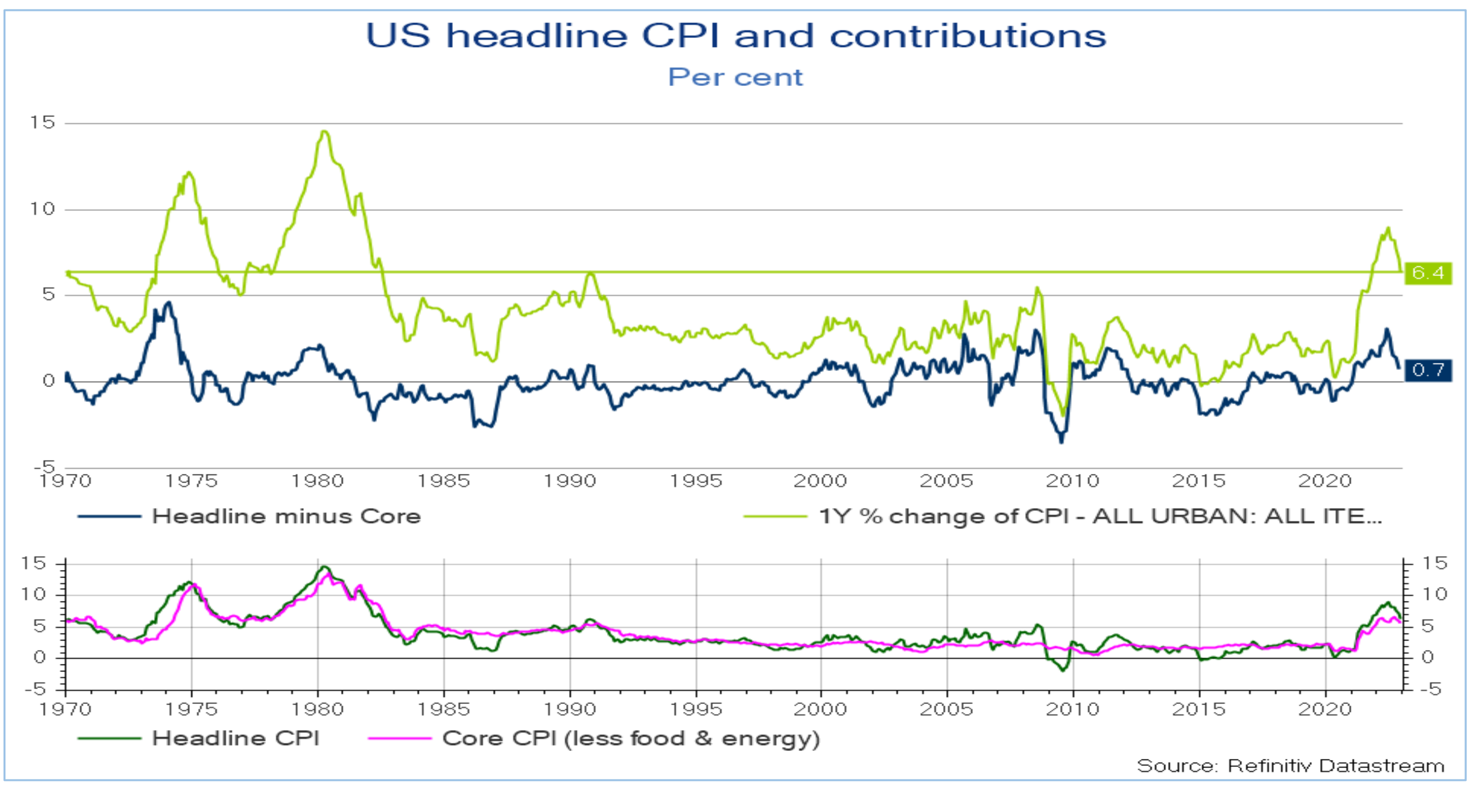
What does this all mean for markets?

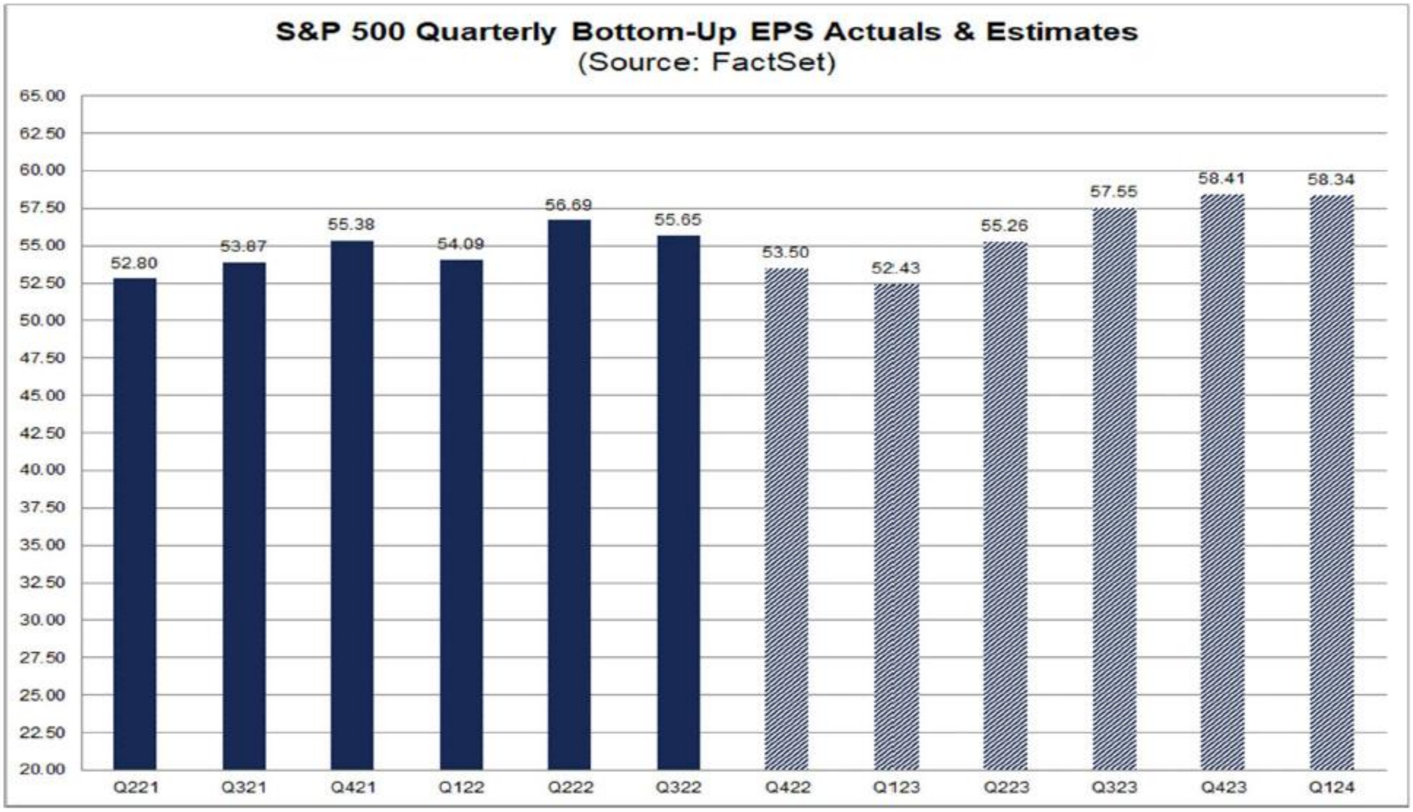
While the Mainsail Investment Committee (MIC) is cautious heading into 2023, our consensus view is the worst is likely behind us. Unlike the four most recent 20+% S&P declines, we think it will take some time for equity markets to recover to all-time highs. It is also our view that client portfolios with exposure to broad asset classes may finally benefit from the broadening out of investment returns away from the large cap, U.S. tech dominated returns of the last 10 years. This outlook gives us the latitude, and hopefully the time, to readjust our asset allocation strategies with the intent of providing better risk adjusted returns for our clients.

One theme the MIC thinks is likely to continue to play out in 2023 is a reversion to the mean in many asset classes which have been out of favor for the last decade - think bonds, international stocks, and large cap value stocks. Since the market bottom following the financial crisis in 2008-2009, investors have rewarded ambitious growth companies with outsized valuations, leaving value investors in the dust. As rates have risen throughout 2022, growth stocks have been under severe pressure with names such as DocuSign, Paypal, and Generac (to name just a few) all falling north of 75% from their peaks. While these companies may have long runways of growth potential, investors no longer see them as the only way to make money.

Another theme we think may play out in the next several years will be the participation in international stocks. While 2022 would have been the perfect year to see international stocks crater under the pressure of the China Zero COVID policy, the War in the Ukraine, or the incredibly strong dollar, international stocks actually outperformed the U.S.[v] In addition, after rising rapidly relative to other currencies earlier in the year, the U.S. Dollar peaked in Q3. As the dollar continues to weaken, we believe international stocks could give U.S. stocks a run for their money.

Finally, we believe inflation is likely to continue to moderate towards 3% by mid-year and if this can happen simultaneously with a continued strong labor market, an economic soft landing is possible and could be quite bullish for markets.





P: 804-693-5500 F: 804-693-2925 | 6641 Main Street, Gloucester, VA 23061 | 4510 Cox Rd. Suite 103 Glen Allen, VA 23060
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Based upon all of our analysis, the MIC heads into 2023 with a few goals in mind as it relates to managing our client's portfolios.

1. Given our view on the improved risk/reward profile for income producing assets, we favor increasing the weighting to bonds while pairing back any overweight tilts to growth stocks over value stocks.
2. For clients who are in the distribution phase, it may make sense to consider building up cash for needs that may exist in the next 1-2 years. It may also make sense to take advantage of the attractive rates on Money Market Funds and Treasury bonds for these safer buckets.
3. Over the last decade the MIC has tended to overweight stocks relative to bonds in many clients' portfolios given the low yield environment. Those who are near or entering retirement, or those with shorter term time frames, may now be better suited to move towards a more conservative portfolio and we are actively making recommendations to clients who fit that profile.

Positives

- Equity valuations are back to average levels[vi] and investor sentiment[vii] is extremely negative (typically a contrarian indicator).
- The Fed rate hike cycle is nearing its end[viii] - historically markets are higher 1 year after the cessation of a Fed rate hiking cycle.
- All the indicators are that inflation is coming down and we anticipate Core CPI to be under 3% Y/Y by mid-year.
- After years of Zero COVID, the Chinese economy is reopening which could provide a tailwind for global economic growth.
- The massive stockpile of cash in Money Markets gives investors dry powder to buy stocks.
- Employment remains stubbornly strong and wage gains are now outpacing inflation gains.

Negatives

- The double whammy of unprecedented supply chain disruptions coupled with massive government stimulus the world over has led to the most worrisome bout of inflation since the 1970's.
- In our view, bond yields are providing an attractive alternative for investors who have been forced to move out on the risk curve to generate returns over the last 10 years.
- Investor demographics continue to skew older and older which could dampen demand for stocks.
- Quantitative Tightening is likely to put pressure on both stock and bond prices throughout 2023.
- The War in Ukraine is a wildcard and could remain so for some time, clouding the economic outlook.
- While it is clear to us that the Fed intends to stop its rate hiking cycle sometime in the next few months, it is unclear what the path of rates will be for the remainder of the year.

Conclusion

In our view, while both stocks and bonds are certainly due for a bounce, the MIC believes that markets will remain range bound for much of the year absent some major positive change in our outlook. We do expect inflation to continue to decline and for investor sentiment to improve. As such, the MIC is not currently anticipating another large pullback given what we know right now. As always, we will continue to monitor changes in economic and market conditions and adjust our strategies to reflect our updated outlook. If you have any questions about your specific situation that you'd like to discuss ahead of your next meeting with your advisor, please don't hesitate to reach out.

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The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

INDEX DEFINITIONS

Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary. Past performance does not guarantee future results.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

The Barclays Capital US Aggregate Index is an unmanaged market value weighted performance benchmark for investment grade fixed rate debt issues, including government, corporate, asset backed, mortgage backed securities with a maturity of at least 1 year.

The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

The S&P MidCap 400® Index provides investors with a benchmark for mid-sized U.S. companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

Dow Jones U.S. Select Dividend Index represents the country's leading stocks by dividend yield and is made up of one hundred stocks which are selected to the index by dividend yield, subject to screens for dividend-per-share growth rate, dividend payout ratio and average daily dollar trading volume.

The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI}, which represents equity real estate investment trusts (REITs} and real estate operating companies (REOCs} traded in the U.S. The indices are designed to serve as proxies for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

MSCI Emerging Markets is designed to measure equity market performance in 25 emerging market indexes. The index's three largest industries are materials, energy, and banks.

NASDAQ Composite Index is an unmanaged index of securities traded on the NASDAQ system.

The Barclays US Corporate High Yield 2% Issuer Capped Bond Index is an issuer constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro rata basis.

MSCI World Ex-U.S. (Net Div) Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM} countries*-

-excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

ASSET CLASS DEFINITIONS

U.S. Large Cap Equity

Russell 1000 Index: Based on a combination of their market cap and current index membership, this index consists of approximately 1,000 of the largest securities from the Russell 3000. Representing approximately 92% of the Russell 3000, the index is created to provide a full and unbiased indicator of the large cap segment.

U.S. Mid Cap Equity

Russell Midcap Index: A subset of the Russell 1000 index, the Russell Midcap index measures the performance of the mid-cap segment of the U.S. equity universe. Based on a combination of their market cap and current index membership, includes approximately 800 of the smallest securities which represents approximately 27% of the total market capitalization of the Russell 1000 companies. The index is created to provide a full and unbiased indicator of the mid-cap segment.

U.S. Small Cap Equity

Russell 2000 Index: The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Index is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

[i] As measured by the Bloomberg Aggregate Bond Index
[ii] Bespoke Research
[iii] According to Blackrock
[iv] Benchmark 60% S&P 500 and 40% Bloomberg Aggregate Bond Index
[v] As measured by the S&P 500 and MSCI EAFE
[vi] Source: Raymond James Equity Portfolio & Technical Strategy
[vii] As measured by the AAII Sentiment Survey
[viii] Based upon the most recent dot plot from the U.S. Federal Reserve