



Quarterly Update – September 30, 2022

September 30th marked the 3rd consecutive quarter for negative returns for both the stock and bond markets. Investors continue to digest the impact of historically high inflation, rising interest rates, and a slowing economy. While COVID is mostly in the rear-view mirror, the economy continues to grapple with labor issues and kinks in the supply chain. In addition, currency issues are bubbling up globally as the US dollar strengthens, geopolitical risks are rising, and energy supply disruptions continue as the Russia/Ukraine conflict drags on.

All the major asset classes we track are down for the year. The S&P500 is down approximately -24% while bonds (the Barclay’s Aggregate Bond Index) are down -14.6%. Growth and international stocks have fallen most this year as they lost -32% and -27% respectively. Dividend paying stocks represented by the Dow Jones Dividend Index was the best performing asset class, however they still posted a decline of -10% this year. It is not shown in the chart below, but energy and commodities are the only areas of the market to post gains in 2022.

Here are the returns of the major asset classes in 2022:

<u>Asset Class</u>	<u>Index</u>	<u>3rd Qtr</u>	<u>YTD</u>	<u>1yr</u>	<u>3yr*</u>	<u>5yr*</u>
US Large Cap Stocks	S&P500	-4.88%	-23.87%	-15.47%	8.15%	9.23%
US Mid Cap Stocks	Russell Midcap	-3.44%	-24.27%	-19.39%	5.18%	6.48%
US Small Cap Stocks	Russell 2000	-2.19%	-25.10%	-23.50%	4.28%	3.55%
Dow Jones Industrial Avg	DJIA	-6.17%	-19.72%	-13.40%	4.35%	7.42%
US Dividend Paying Stocks	DJ Select Dividend	-7.71%	-10.07%	-3.10%	5.88%	6.89%
NASDAQ	NASDAQ	-4.11%	-32.40%	-26.81%	9.74%	10.23%
Int'l Developed Mkt Stocks	MSCI EAFE	-9.36%	-27.09%	-25.13%	-1.83%	-0.84%
Int'l Emerging Mkt Stocks	MSCI EM	-11.57%	-27.16%	-28.11%	-2.06%	-1.81%
US Bonds	Bar Aggregate Bond	-4.75%	-14.61%	-14.60%	-3.25%	-0.27%

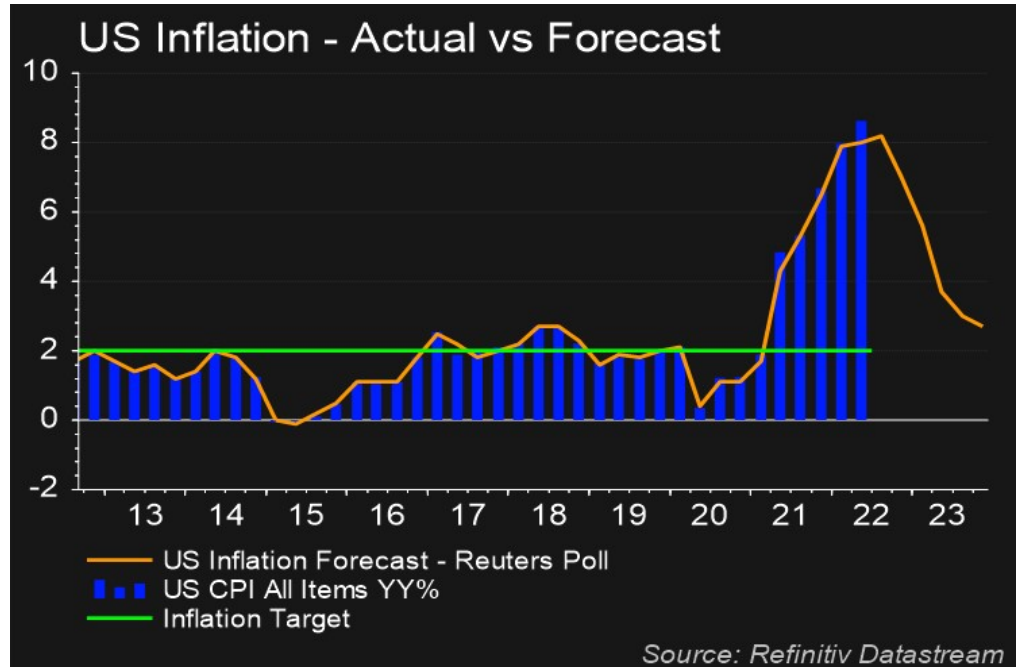
*return is annualized

The Federal Reserve increased the federal funds rate by 0.75% in July and September, bringing it to a range of 3% to 3.25%. This is the highest level for the federal funds rate since 2007. The FED is raising rates in an attempt to reduce demand and bring inflation under control. Ideally we would like to see gradual rate increases in rates that slow consumer demand over time. As consumer demand slows, inflation should start to subside as well. This is generally referred to as an “economic slowdown” which is absolutely healthy for the economy. The worry is that if the FED goes too far with the interest rate increases, the economy will slow down too much and US could fall into a severe economic recession.

¹ Source: Raymond James Client Center Reporting

The headline CPI, which is a common gauge of inflation, was reported at over 8% for August and September. These are the highest levels we have seen in over 40 years and have forced the FED to continue to raise rates. Even though the FED spent the entire year in 2021 predicting that inflation was going to be transitory, it has proved to be more sticky. Many FED watchers believe they were embarrassed by the mistake last year and don't want to make the same mistake again, even if they end up raising rates too far.

The blue lines in the graph to the right show the inflation readings since 2013. The orange line shows the forecast for inflation over the next year. According to this poll, many economists expect inflation to peak in the 4th quarter of 2022 and start heading lower in 2023. The good news is that if this poll is accurate, we could see the FED slow the pace of rate increases and we would expect to see the stock market react favorably.

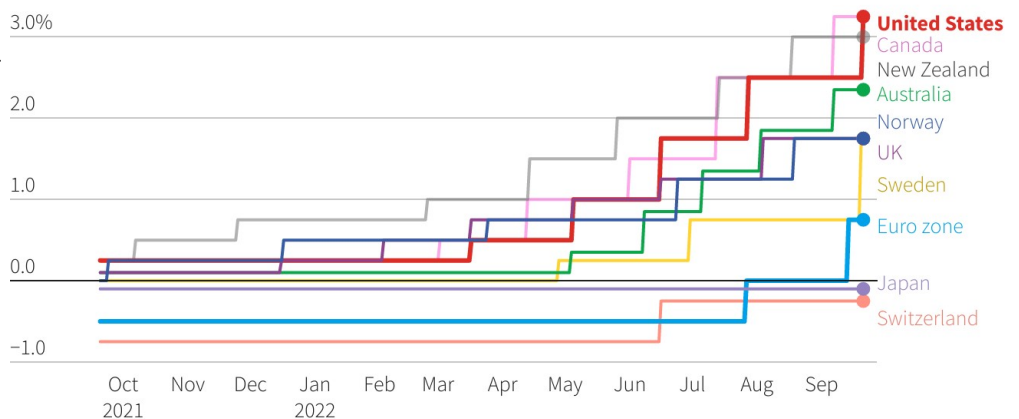


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The problem with aggressive rate hikes is that the economy reacts with a lag. It takes months for the rate hikes to work their way into the economy. The FED started raising rates in March of this year and they expect to raise rates another 1.25% before the end of 2022. In fact, most central banks around the world are trying to tackle the inflation problem by raising rates at the same time. If the FED raises rates too far too fast, it increases the probability of a “hard landing” or a severe recession.

Central banks ramp up fight against inflation

Policy rates of central banks overseeing the 10 most traded currencies, last 12 months



Source: Refinitiv Datastream | Reuters, Sept. 21, 2022 | By Vincent Flasseur

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² Source: Refinitiv Datastream, Global macro charts

³ Source: Refinitiv Datastream, Global macro charts & Associates, Inc. member New York Stock Exchange/SIPC
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We track a number of economic indicators and wanted to highlight one that has recently turned negative. The Conference Board LEI is an index that tracks 10 items that have proved to be economic indicators that lead as the economy grows or contracts. It follows information such as hours worked in manufacturing, new orders, building permits, etc. Historically when this index growth rate falls -5% over a 6 month period, it is a strong sign of economic recession. The chart below shows the index history going back to 2000. The red marks (recession signals) have been very accurate over the years.

Elevated recessions risks persist



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This LEI index does not predict length or severity of the recessions. Many times the stock market recovers well ahead of the economy, so it is not a very good “market timing” tool. But it does confirm many of our worries about the problems in the economy.

Looking at this LEI indicator combined with several others, we conclude there is a high probability the US will go into a recession in 2023. GDP has been negative for two quarters in a row and clearly the stock market is reacting to the slowdown by pulling back over -23% year to date. When we are in the midst of a drawdown, we always ask ourselves, “How far down can it go?” In order to get a rational estimate we have to look at two primary pieces of information, earnings and market multiple.

⁴Source: The Conference Board, “LEI Press Release | September ‘22” p. 2

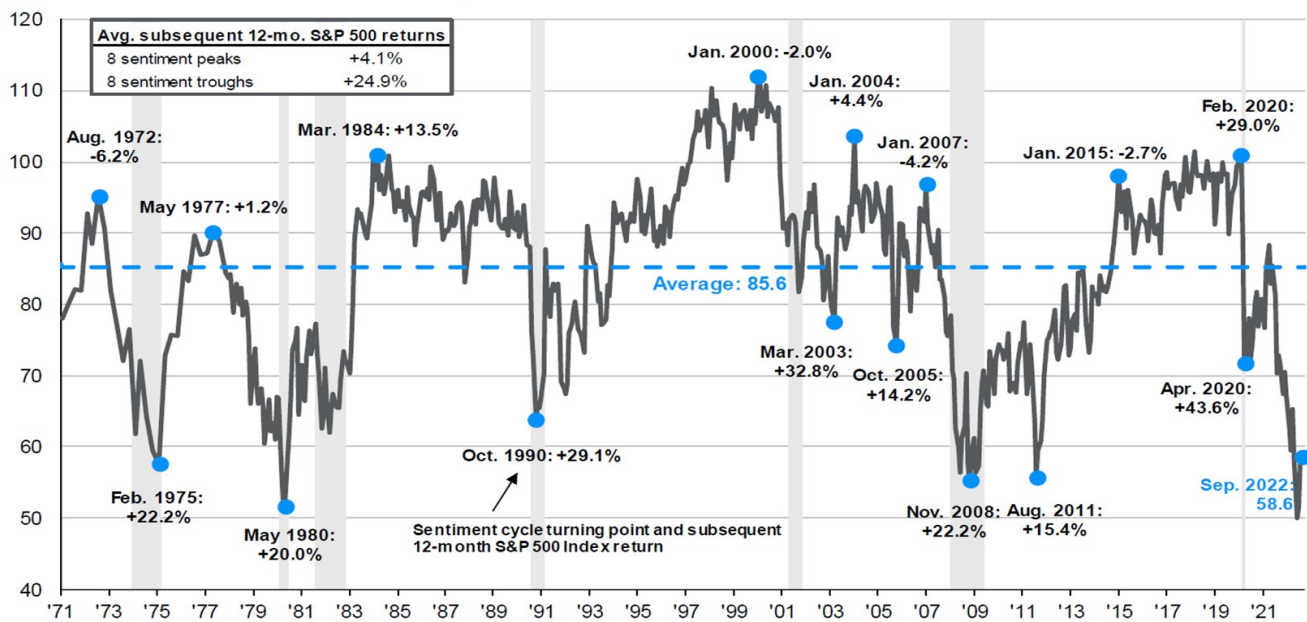
We get our earnings estimates from Strategas Investment research. They expect the S&P500 companies to earn about \$220 per share in 2022 and \$200 per share in 2023. They are currently slightly lower than consensus estimates, but regardless it is an earnings reduction of approximately 10% year over year. ⁵

In the current interest rate and inflation rate environment, many suggest an earnings multiple in the 15x to 18x range. With \$200 in earnings, that would equate to S&P500 fair value of about 3,000 to 3,600. At the end of September, the S&P500 traded at 3,585 so the fair value estimates are pointing lower for the market in general.

We are actually just starting to see EPS revisions and downgrades for US companies. For Q3 2022, 65 S&P 500 companies have issued negative EPS guidance. We expect these revisions to continue to move lower over the next few quarters, reflecting lower margins from higher costs, energy prices, supply chain issues, and labor issues.

In our opinion, there are two compelling reasons to stay optimistic about stocks through the end of the year...sentiment and the possibility of a FED pivot. Historically when investor sentiment gets very low it may be a contrarian buy signal. The chart below shows other points in history when sentiment was dramatically low. It is absolutely possible there may be more downside for stocks until they ultimately reach bottom, but the forward 1-year returns of these sentiment troughs are compelling. The election in November, inflations easing, and oil prices easing could all help investor sentiment before the end of 2022.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.

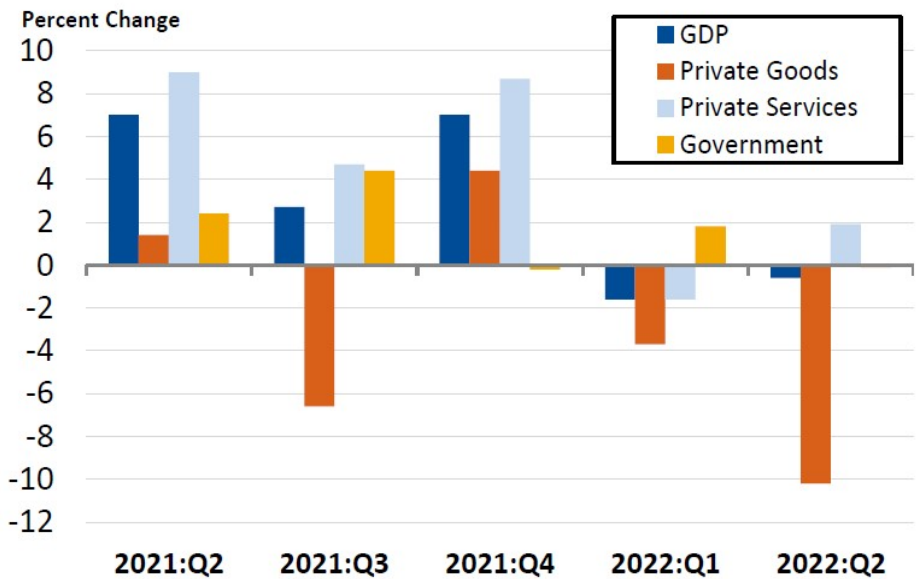
⁵ Source: Strategas, "Quarterly Review in Charts, 10/3/22" p. 25

⁶ Source: JP Morgan, "Guide to the Markets 3q 2022" p. 26

A FED pivot is another possible catalyst for the market. While it is unlikely they pivot from raising interest rates to reducing rates, it is possible for them to meaningfully slow the pace of rate hikes. This will give the economy time to absorb the rate changes already implemented and allow the FED to evaluate all areas of the market that are already showing signs of slowing. We believe the market will improve if the FED slows the rate increases by the end of the year.

We believe this FED action is possible because we already see reports of demand rolling over in used cars, new order backlogs, lumber prices, and some other commodities. According to the Bureau of Economic Analysis inside the US Department of Commerce, we have actually had a reduction in goods purchasing for three of the last four quarters (the orange bar in the chart to the right).

Real GDP by Industry



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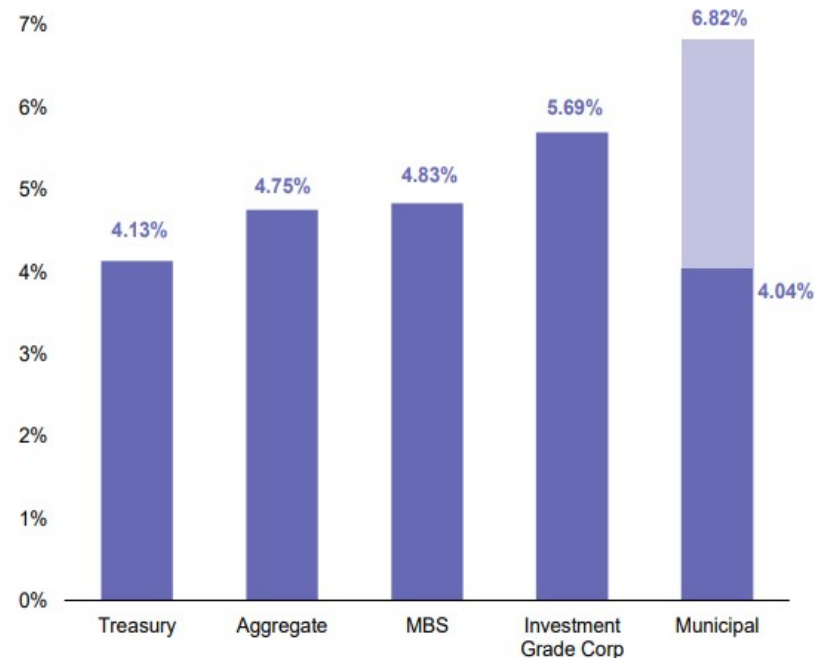
U.S. Bureau of Economic Analysis

Seasonally adjusted annual rates

Just like the commentary from last quarter, we would suggest carefully evaluating the stock exposure in portfolios. We think there may be a sentiment driven rally into the end of the year, but investors should remain flexible with their stock allocations since we are facing unusually high inflation and a possible recession in 2023.

When we consider best ways to position portfolios going forward, we can finally say that we are starting to like bonds again. The last 9 months have been rough for bond portfolios, but that pain has led to compelling rates on CDs, corporate bonds, and municipal bonds.

Tax-Equivalent Yield



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⁷ Source: BEA, "News Release | 9/29/22" p. 4

⁸ Source: Eaton Vance, "Monthly Market Monitor | October 2022" p. 36



We continue to like absolute return focused strategies, long-short funds, market neutral funds, and value-leaning dividend paying stocks. We think it makes sense to be more tactical with the stock allocation over the next year. We don't want to be significantly overweight stocks, but looking back over previous cycles we have to acknowledge that bear market rallies can be very strong.

Thank you for the trust you place in our team. Please reach out to us with any questions.

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