Q3 MARKET INSIGHTS

Fall 2022

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Markets began the 3rd quarter with a rally but disappointing inflation news sparked a sell-off that led to a 3rd straight quarter of losses for most asset classes. This year's one-sided market behavior and harsh correction is a result of the most aggressive tightening of monetary policy in decades. The Federal Reserve's (the "Fed") response to the early 2022 spike in inflation has been to aggressively raise interest rates, which continues to dictate the direction of markets, with any signs of additional tightening usually leading to sell-offs. As a result, the S&P 500® Index is down 23.9% for the year through September 30th (the index was down 4.9% for the third quarter). Interestingly, the percentage of S&P 500 individual stocks in a bear market (i.e. down more than 20% from their 52-week high) sits at 77% as of the end of the quarter, with the average stock down 32%. Further, almost half of the stocks that make up the Nasdaq Composite Index are down over 50% from their previous highs. There has been nowhere to hide as international equity markets performed even worse during the quarter with surging electricity prices in Europe and the U.K., interest rate hikes by the European Central Bank and Bank of England, and lasting geopolitical risks weighed heavily on foreign developed markets. For the quarter, foreign developed markets, represented by the MSCI EAFE Index fell 9.3% (-26.7% YTD). Emerging markets, meanwhile, underperformed both foreign developed markets and U.S. markets as a surging U.S. dollar offset hopes for a continued post-COVID reopening in China, with the MSCI Emerging Markets Index dropping 11.5% during the third quarter (-27.0% YTD). Fixed income markets have been equally affected by the Fed's actions as returns for the leading benchmark for bonds have been the worst on record. Year-to-date, the Bloomberg Barclays U.S. Aggregate Bond Index has declined 14.6% (and was down 4.8% for the quarter). Unfortunately, the data for that index only goes back to 1975. However, Vanguard, the mutual fund and ETF provider, furnishes bond returns that go all the way back to 1926. According to their data, the worst calendar year for bonds was 1969, with a negative return of 8.1%. If bond returns don't improve materially in the last quarter of the year, we may be looking at the worst annual return for bonds in almost a century.

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Naturally, one has to wonder if things can get much worse. The Fed has made it quite clear that they are laser focused on combating inflation. During the quarter, Fed Chairman Jerome Powell highlighted that the biggest risk facing the Fed is failing to restore price stability and that the Fed is strongly committed to using its tools to cool prices. As such, the Fed raised interest rates by 1.50% during the 3rd quarter in addition to maintaining its quantitative tightening program. We believe the Fed's focus on inflation is misguided, as they appear to be looking for clear and convincing evidence that inflation is declining before they stop raising rates. The problem is that established measures of inflation like the Consumer Price Index ("CPI") are a backward-looking indicator. By maintaining their current course of monetary tightening, the Fed risks pushing the U.S. economy into a recession or causing some sort of crisis. While the latest reading of the CPI showed that the prices of goods and services increased 8.3% year over year (still very high vs. its 20-year average of 2.4%), we see many indicators that suggest inflation may be subsiding. First, commodity prices such as oil, copper and lumber have already fallen 35%, 31%, and 71% from their respective peaks, while the average price of a gallon of gas has fallen for over 90 days- the longest streak since 2015. Second, elevated inventories have led to an above-average proportion of markdowns on goods like apparel, footwear and home furnishings (especially as retailers try to make room for holiday-oriented goods). Third, we believe food price increases are likely to fall during the fourth quarter as broader global food indices (like the United Nations Food Price Index) have declined for five consecutive months since record highs in March. This is supported by declines in the price of wheat, corn, and soybean oil which are down 28%,

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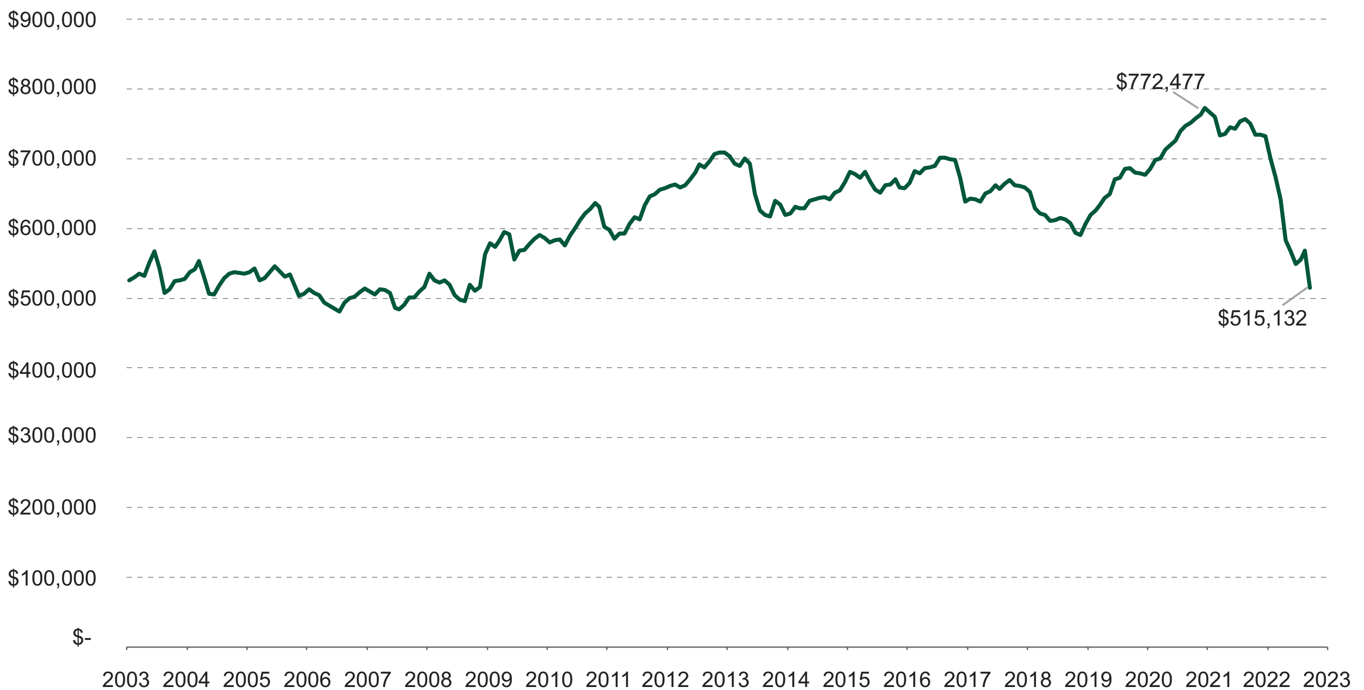
12%, and 22% from their respective peaks. Taken together, this should translate into grocery bills and restaurant costs easing in the first quarter and the early part of 2023. Finally, housing price increases have begun to plateau and should start to decline in 2023 as a result of rising mortgage rates. As a quick example, the chart below shows how much house an individual can afford to buy assuming a 20% down payment and a $2,500 monthly mortgage payment based on 30 year mortgage rates. As you can see, housing affordability has fallen significantly in the last several months (with affordability falling from $772,477 to $515,132 – a drop of 33%!), which should translate to lower prices in the future.

Inflation is going to have multiple pieces fall into place – declining commodity, food, retail goods, and housing prices – which should help inflationary pressures ease in the coming months. In addition to the fundamental components of inflation, the calendar effects will also help push inflation lower. As we transition into the fall, inflation indices will "roll off" two of the hotter monthly inflation datapoints reported in October and November of last year. How does this impact the year-over-year (YoY) pace? Current expectations for the month-over-month change in CPI for September (which will be reported in mid-October) is for an increase of 0.2%. The chart on the following page, courtesy of Bespoke Investment Group, shows the potential trajectories for the annual change in CPI based on various theoretical month-over-month changes in the CPI of 0.0% to 0.4%. Barring another big spike in costs, which would run counter to the facts laid out in the previous paragraph, we believe increases in the range of 0.0% to 0.04% are reasonable assumptions.

As you can see, if CPI were to remain unchanged and stay at 0.0% month-over-month, we would see CPI quickly fall to 3% by next March, and it would be 1.4% next May. If we saw a constant 0.1% move going forward, we'd see CPI down to 2.4% (the 20-year average) by next May. A 0.2% month-over-

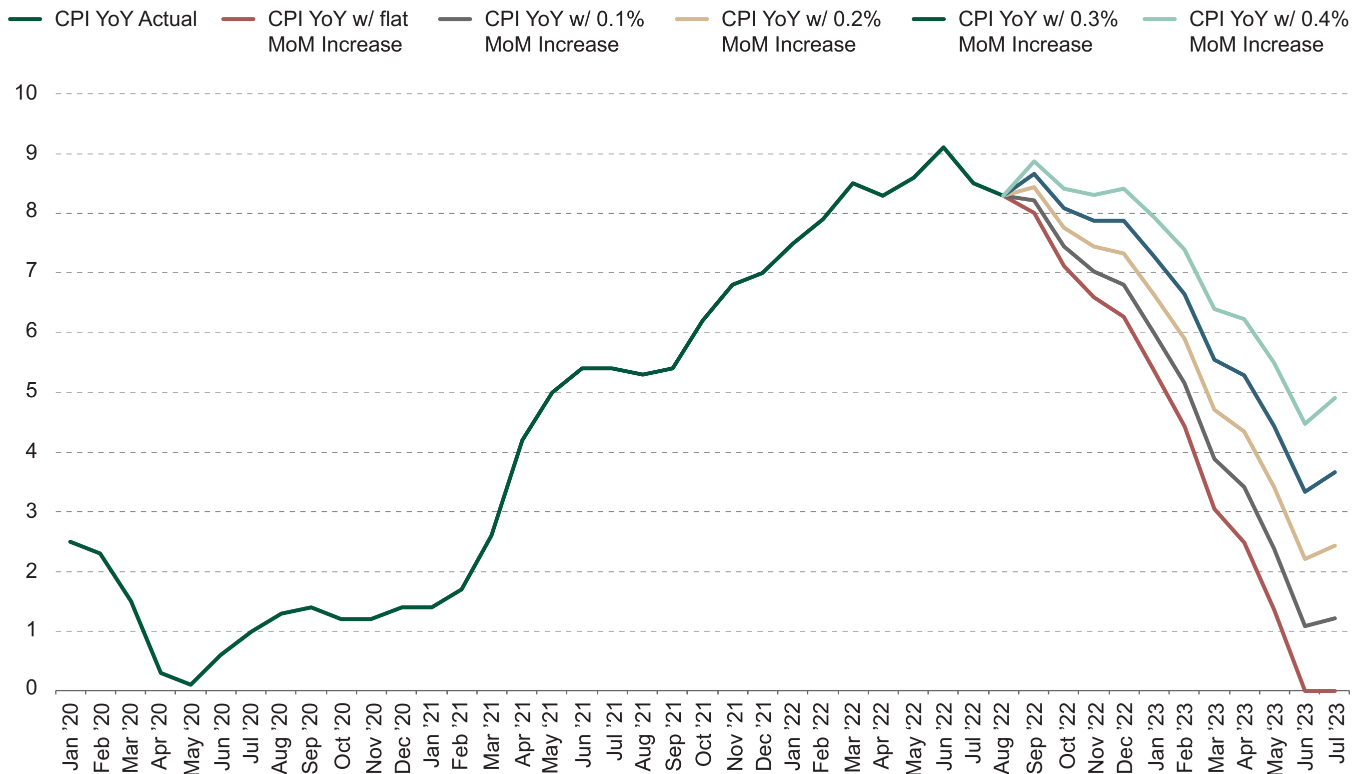
How Much Home Can You Buy with a $2,500 Monthly Mortgage Payment

(Assuming 20% Down Payment and Average 30-Yr Mortgage Rate)



Source: FreddieMac Primary Mortgage Market Survey

Potential Paths for Year-over-Year (YoY) Consumer Price Index (CPI) (%)



Source: U.S. Bureau of Labor Statistics, Bespoke Investment Group

month move would cause the CPI to fall to 2.2% by June, while a 0.3% month-over-month reading gets CPI down to 3.3% by June. Based on these different scenarios, we could see the CPI in the 2%–4% range by next spring or summer, which suggests that the Fed should stop raising rates soon as changes to monetary policy typically have a 6 to 12 month lag before impacting the economy. Again, the Fed is making policy decisions based on the current levels of inflation, which is a lagging indicator. This is akin to driving a car by looking in the rearview mirror – increasing the risk of a serious error. If the Fed continues to tighten after inflation pressures have eased, it could lead to a deep recession or other serious consequences.

As the central bank of the world's reserve currency, the Fed's actions are particularly important to the global economy. As the Fed raises rates, it puts pressure on other Central Banks to raise rates as well. This is because higher interest rates tend to attract foreign investment, increasing the demand for and the value of that country's currency. If the Central Banks of the world decide not to raise rates, they risk having their currency fall in value. A lower currency increases costs for imports and pushes inflation higher. The Bank of England ("BOE"), the central bank of the U.K., has also embarked on raising its interest rates in order to keep up with the Fed. However, higher rates combined with inflation caused by energy supply issues (due to the Russia/Ukraine conflict), have slowed economic growth. As a result, newly elected Prime Minister Liz Truss recently introduced a round of tax cuts in an effort to jumpstart Britain's sluggish economy. The proposed tax cuts did not have any form of spending offsets, and therefore raised concerns about the U.K. government's ability to pay off its debts. As such, the prices of U.K. Government bonds fell sharply on the news. Prices fell so severely that pension funds in the U.K. began to have liquidity problems due to the amount of leverage they employ. Backlash was so bad that the BOE had to announce that it was ready to buy an unlimited amount of U.K. government bonds to ensure that the market would function properly (basically re-starting quantitative easing to bailout the pension funds). This is a prime example of the unknown risks that are associated with raising interest rates in an overly indebted economy.

There is a long history of such accidents being accelerated or precipitated by Fed tightening policy. There was the Latin American debt crisis of the 1980s, the Asian crisis of 1997, and the Russian and Long-Term Capital Management hedge fund crises, both in 1998. In 2007, we had the U.S. housing crisis, which triggered the global financial crisis of 2008 and

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the euro debt crisis of 2011. If the Fed keeps unnecessarily raising rates, it could precipitate another crisis. We believe what happened in the U.K. is a warning sign of the severe impacts this tightening cycle can have on the global economy.

Will things get much worse? In our opinion future market returns are heavily dependent upon what the Fed will do. Again, changes to monetary policy typically have a 6 to 12 month lag before it affects the economy. With the Fed raising rates based on lagging economic data (like inflation), there is a risk that the Fed will be raising rates in an already weak economy (exacerbating problems). Ultimately, we believe the Fed has already gone too far in raising rates and will be forced to reverse course. This may include, ceasing the current rate hiking cycle, discontinuing quantitative tightening, cutting interest rates, or even restarting its quantitative easing program. The Fed likes to talk tough, but when push comes to shove and they are staring at a recession, they will likely ease. There is a 20-plus year history of this going back to the 1990's. Given the recent Fed actions and rhetoric, they have resisted the urge to change course on current policy stance; however, the tighter monetary conditions get, the greater the likelihood of a recession or some other crisis which will force them to pivot. This should be a materially positive catalyst for both stocks and bonds. The only challenge is that we do not know the timing as to when the Fed may adjust their plans. Also, the longer the Fed waits to ease, the more potential damage their tightening does to corporate earnings. As such, we expect the markets to remain volatile, until there is further clarity on future monetary policy.

WHAT HAS HAPPENED TO BOND PRICES?

Unlike the U.K., the Bank of Japan ("BOJ"), which is Japan's central bank, has decided to keep interest rates near zero to support its weak economy. This has led to extreme weakness in the value of the Yen, which has lost 25% of its value this year versus the US dollar. While inflation in Japan is low relative to that of the Western economies, the weaker currency is increasing the prices for fuel and raw material imports for which the Japanese economy is heavily dependent upon. These price increases are damaging an already weak economy. Therefore, in an effort to support the value of the Yen, the BOJ began to sell their holdings of U.S. Treasuries and use the proceeds to buy Yen. This action, along with the Fed's quantitative tightening program, which began in June, combined to drive U.S. Treasury and other bond prices lower during the quarter. This weakness, in our opinion, is creating an opportunity in short-term U.S. Treasuries. With yields near 4%, and inflation appearing poised to come down, investors have the chance to earn some positive inflation-adjusted income. Also, if the Fed does pivot, we would expect rates to fall (causing prices to rise), which could provide some capital appreciation for bonds as well.

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MARKETS MAY BE VOLATILE IN THE SHORT TERM, BUT PROBABILITIES FAVOR LONG TERM INVESTORS

The up and down movements of the stock market vary greatly on a day-to-day basis, and can give the impression that the probability of a positive or negative daily return is the same as flipping a coin. Similarly, the decline in bond prices in 2022 has left investors to wonder about the diversification benefits of the asset class. While near-term market movements are impossible to predict, history suggests that the longer an investor stays in the market, the higher the probability of a

positive return. The graph below details the probability of positive returns for both stocks and bonds assuming various holding periods.

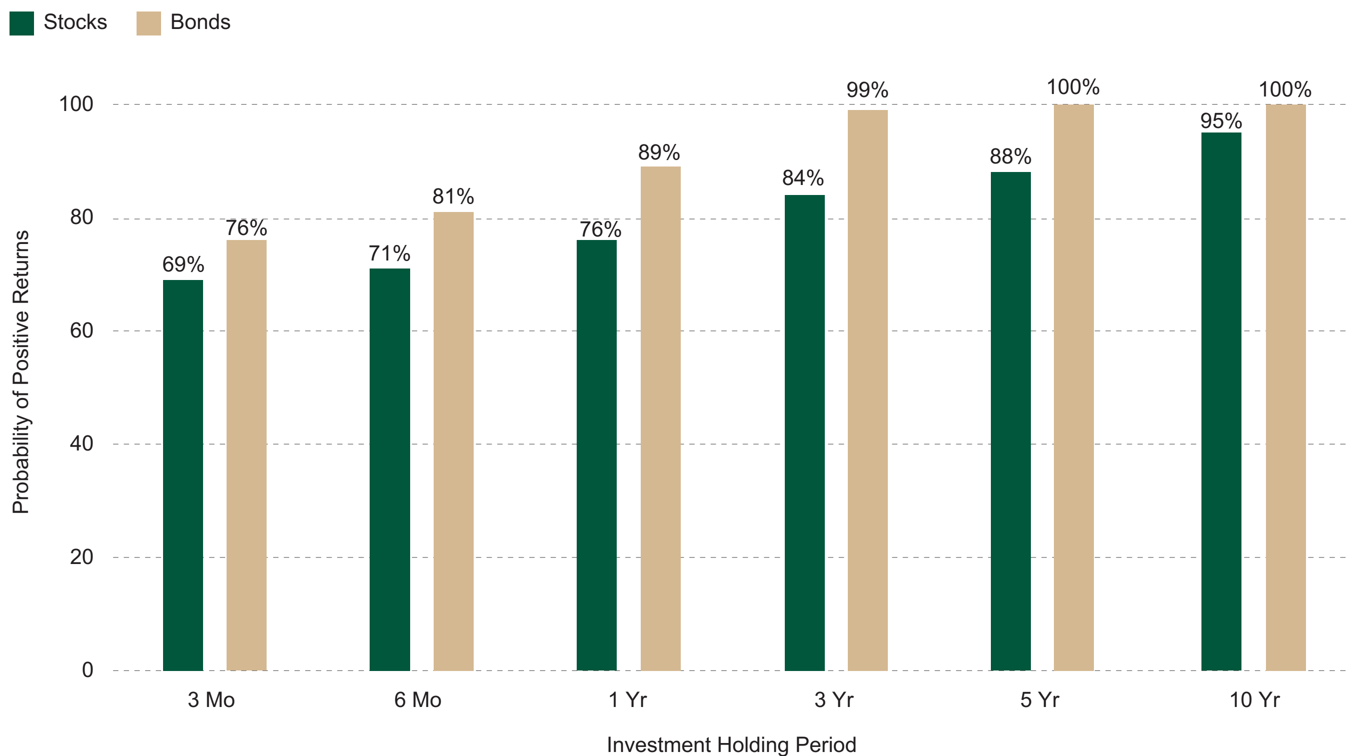
With data going back to 1925, we can see that over a relatively short three-month rolling period, the probability of a positive return for the stock market is almost 70%. The prospect for positive returns in equities continues to improve the longer the holding period. While the stock market is certainly better than a coin-flip over longer time periods, the bond market has the edge with more consistent and stable positive returns. Additionally, bonds have “almost” never had a negative three-year return, and over a 10-year period, the probability of positive returns for both stocks and bonds is close to 100%.

Over long periods of time, markets have tended to move steadily higher, but stock market declines are an inevitable part of investing. Emotional reactions to market corrections are perfectly normal. Daniel Kahneman, who won a Nobel Prize for his work in behavioral economics, demonstrated this with his loss aversion theory. This theory states that people feel the pain of losing money more than they enjoy the gains. It’s natural for investors to feel nervous when markets decline, but it’s the actions taken during such periods that can mean the difference between success and failure.

Oftentimes when investors frequently look at their accounts (e.g., on a daily basis), they have a worse investor experience from an emotional standpoint because their performance is perceived to be more volatile. This can often lead to losing focus of long-term goals and making poor investment decisions. The key to successful investing is creating and adhering to a thoughtfully constructed long-term investment plan based on your financial position, risk tolerance and investment timeline. Extended bouts of volatility like we have experienced over the past nine months should not alter an established, diversified approach designed to meet your long-term investment goals.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate these financial markets.

Probability of Positive Returns for Stocks & Bonds for Various Holding Periods



Source: Morningstar Direct utilizing IA SBBI US Large Stock TR USD Ext to represent Stocks and IA SBBI US IT Govt TR USD to represent Bonds between 12/31/1925 and 7/31/2022.

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All performance data is as of 09/30/2022 unless otherwise stated. Diversification does not ensure a profit or guarantee against loss. An investment cannot be made directly in an index. As with all investments, there are associated inherent risks, including loss of principal. Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments include risks such as exposure to interest rate fluctuation, credit changes and inflation. Positions held in cash are subject to inflation risk.

Past performance is no indication of future results.

Definitions:

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The Nasdaq Composite Index is a market capitalization-weighted index of more than 3,700 stocks listed on the Nasdaq Stock Exchange. The Nasdaq Composite Index uses a market capitalization weighting methodology. The index's value is calculated by summing the market capitalization of the index components based on the stocks' current price. This total is then adjusted a constant index divisor. The index was launched on Feb. 5, 1971 with an index value of 100.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

The Ibbotson Associates SBBI U.S. Large Stock Index is an unmanaged index representing the broad U.S. large cap stock market. The index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956. The Index returns do not reflect any fees or expenses.

The Ibbotson Associates SBBI U.S. Intermediate-Term Government Bond Index is an unmanaged index representing the U.S. intermediate-term government bond market. The index is constructed as a one bond portfolio consisting of the shortest-term non callable government bond with less than 5 years to maturity. The Index returns do not reflect any fees or expenses.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.

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