Market Health Report

3rd Quarter 2022

Market Recap

There is no sugar coating the situation, it has been a very hard year. After a very difficult first half of the year, equity markets rebounded in July and August when economic reports indicated a downturn in inflation from 9.3% to 8.6%. The Federal Reserve quickly threw cold water on any hopes that they would slow down the pace of interest rate increases however, which caused stocks to return to their yearly low. The Federal Reserve has repeatedly stated that they planned to stop inflation in its tracks no matter the economic consequences.

US Stocks (S&P 500) are down 24% for the year to date. Developed international markets (MSCI EAFE) are down 27% and Emerging international markets are down 27% (MSCI Emerging Markets Index).

Bonds typically increase in value when stocks decline, but not this time. Bonds as measured by Bloomberg U.S. Aggregate Bond Index fell an incredible 14.6% for the year to date. Though this index is typically considered a safe haven, <u>for the first time in 50 years bonds were unable to avoid the carnage.</u>

Unfortunately, the tools the Federal Reserve has at its disposal act like a sledgehammer rather than a scalpel. Additionally, they are looking at data that is several months in the past while the consequences of their actions cannot be known until several months in the future. There is great concern that the Federal Reserve may be too aggressive in using its limited tools and may cause too deep of a recession.

The Federal Reserve is between the proverbial “Rock and a Hard Place”. They can either keep up their aggressive strategy of raising rates until they see a substantial decline in inflation, or they can back down and risk inflation running wild like it did in the 1970’s.

<u>There are a couple of positive investment trends that have reduced the damage substantially for some of our clients.</u> Private Real Estate has been a strong standout with many funds returning more than ten percent. We also utilize (for aggressive clients) a Private Equity fund that has strong positive returns. Unfortunately, not every client qualifies for these two private investments. Using Private Investments removes the stock markets daily emotions (and thus volatility) from price performance. Pricing of these instruments are instead based on independent appraisals.

We have been conservative in our asset mix the past several years (anticipating a difficult future even if we did not know when) and have included anywhere from 20-40% of these private investments in our portfolios for those that qualify. If you want to understand how these investments can help you, give us a call. We certainly will be talking to all our clients more as we meet with you.

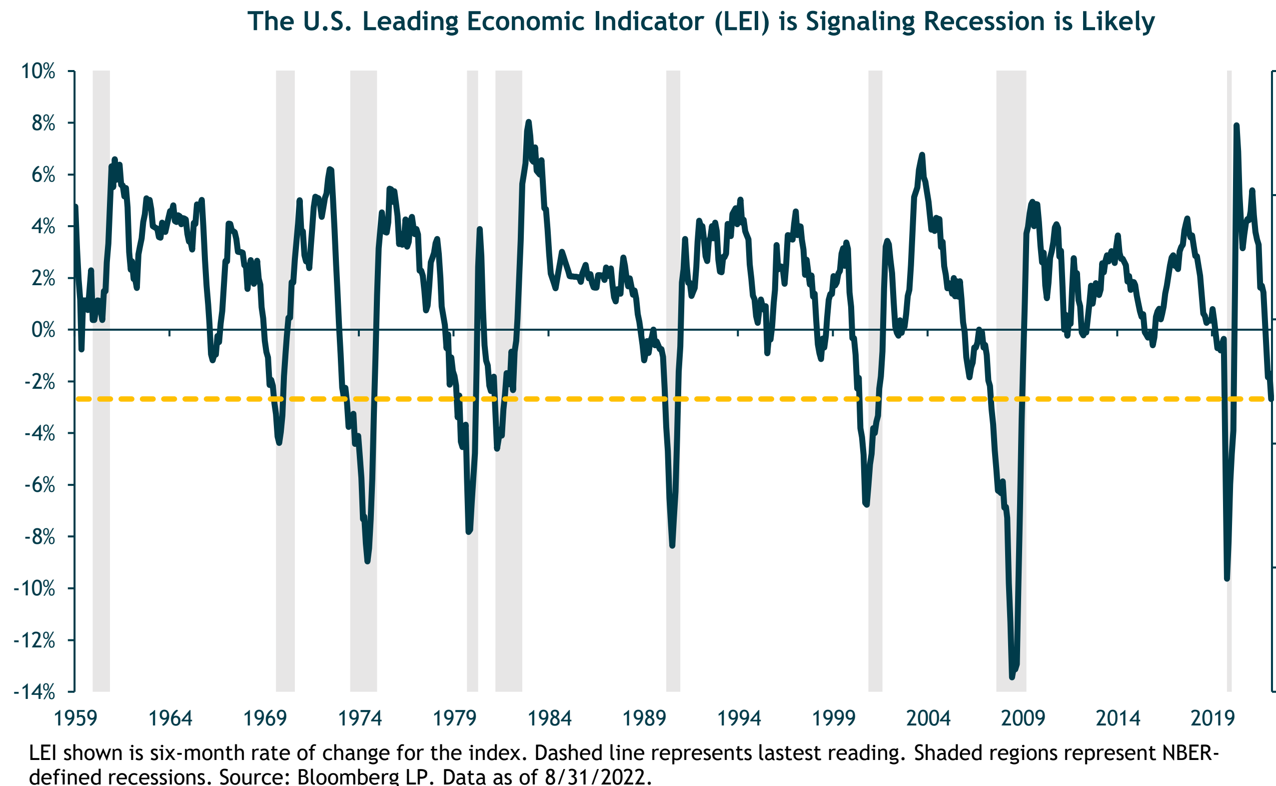
Investment Outlook and Portfolio Positioning

The economic backdrop for the U.S. and global economy deteriorated further in the third quarter. Stubbornly high inflation remains the key economic indicator. The Fed's response to the sharp spike in inflation has been to aggressively raise interest rates – their only means of bludgeoning economic activity to reduce aggregate demand and in turn bring inflation in line with their longer-term targets. This has been the catalyst for the steep declines in both stocks and bonds.

While headline CPI inflation (which includes food and energy) seems to have peaked, core inflation measures have continued to rise and are far above the Fed's 2% target. This indicates inflationary pressures have become more widespread throughout the economy, rather than driven by a few extreme outliers as in 2021.

Inflation is driven by events that central banks world-wide can't do anything about such as Covid-related supply chain disruptions, excessive government spending, and the war in Ukraine. Inflation is also driven by strong consumer demand and the central banks can use a sledgehammer approach of raising interest rates until consumers buckle in response. This will eventually bring inflation down, but it runs a high risk of causing a recession. Fed Chair Jerome Powell says the Fed is looking for "clear evidence" that inflation is headed to their 2% target. As such, and as expected, the Fed has continued its path of aggressive rate increases and has signaled there is more to come.

Leading Economic indicators have recently turned negative as evidenced in the following chart. Please keep in mind all cycles are precisely that- a cycle, ergo, it is a temporary situation.



LEI shown is six-month rate of change for the index. Dashed line represents lastest reading. Shaded regions represent NBER-defined recessions. Source: Bloomberg LP. Data as of 8/31/2022.

While we weigh the evidence as leaning strongly towards a U.S. recession, **there are still some positives supporting the economy and that may mitigate the *severity* of a recession** if/when it happens, including a strong labor market, rising wages, and a strong US consumer. Moreover, there don't appear to be any major, systemic economic/financial imbalances as were seen in 2007/2008. This last point is important to talk more about. The 2008 financial crisis can be likened to Covid. It was something new and not fully understood leading to rampant uncertainty. High inflation and recessions are not pleasant. The medicine is not enjoyable, but it is a cycle we have been through before and have gained a better understanding of; it's just a mater of time until the economy comes back into balance.

Our focus is on longer-term fundamentals and valuations, and we are not in the business of making shorter term bets on the markets. However, our analysis tells us that at current valuation levels, stocks may not be adequately discounting the potential for further earnings declines.

At the same time, the sharp increase in interest rates this year has driven bond yields up to more attractive levels – more attractive than they have been in about a decade. On a relative basis, core investment-grade bonds now look much better versus stocks than at the start of the year. Further, core bonds provide good downside protection, which would be especially helpful if conditions turn out to be worse than currently anticipated

Closing Thoughts

We plan to make some portfolio adjustments between now and year end. We plan to make the portfolios slightly more conservative and to focus on dividend-returning investments. We also plan to trigger tax losses where we can, to help when you file your tax return.

The Federal Reserve is under intense criticism for keeping interest rates too low for too long thus causing assets to increase too high in value. We all benefited from these price increases and now we are all paying the cost as prices return to more normal levels. As painful as this year has been, one positive outcome is that stock prices have been reduced to their historical averages. If earnings decline further in a recessionary environment, stocks can fall even more, but this is a temporary cycle as earnings generally rise over time.

It's been a tough year, with most investors (ourselves included) braced for more to come. But all bear markets come to an end, and it is worth remembering that the bottom is by definition "*the point at which things collectively feel worst*." Are we there yet? Probably not for a few months, but timing the markets is a fool's game. We think long-term and remain confident in our ability to deliver the long-term returns required to meet financial objectives while balancing risk.

As always, we thank you for your trust and welcome questions you may have.

Ron Dickinson, CPA, CFP®, MPA-Tax