Q3
22

WEALTH MANAGEMENT QUARTERLY INVESTMENT LETTER

Peak Restrictive?

Quick Look

- Portfolios end the quarter in a protracted drawdown. As has been the case throughout 2022, portfolios are down regardless of risk appetite.
- The drawdown for 60/40, which began as soon as the calendar flipped to 2022, is now the 3rd worst drawdown over the last 50 years, being only eclipsed by the equity-driven losses of 1974 and 2008.
- The Fed has raised the Federal Funds rate by 3.0% since March, and has forecasted the need for another 1.5% in rate hikes by February 2023.
- Prior to this cycle, the Fed had not raised rates by 0.75% in a single meeting in more than 20 years, but the Fed has now raised rates by 0.75% in three consecutive meetings.
- Interest rates arguably drive changes in asset prices more than any other input, and it has been decades since rates have surged higher at this speed or magnitude.
- If 4.75% holds as the terminal rate, then the forward returns for bonds look as favorable as they have in years.
- A lot of bad news has been priced into the equity markets, and while the drawdown's floor is still not certain, equity markets often turn on a change in beliefs well before a change in fundamentals.

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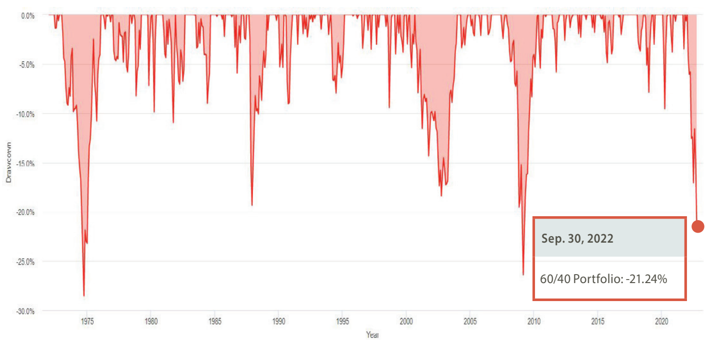
Quarterly Investment Letter, Q3 2022

For those, like Mr. Corleone, who insist on hearing bad news immediately, portfolios end the quarter in a protracted drawdown. As has been the case throughout 2022, portfolios are down regardless of risk appetite. Stock markets during the quarter saw a two-month rally wash away, retracing back into bear-market territory. Bonds, quite simply, are a near certainty to record their worst return year in history. With one quarter to go, balanced portfolios (i.e. 60% stocks, 40% bonds) are on track to post their worst calendar year return of the post-war era.

The drawdown for 60/40, which began as soon as the calendar flipped to 2022, is now the 3rd worst drawdown over the last 50 years, being only eclipsed by the equity-driven losses of 1974 and 2008. The drawdown chart below, aptly depicted in blood red, is as blunt a message as Tom Hagen himself could have delivered on the present situation.

60/40 Portfolio Drawdowns (Last 50 years)



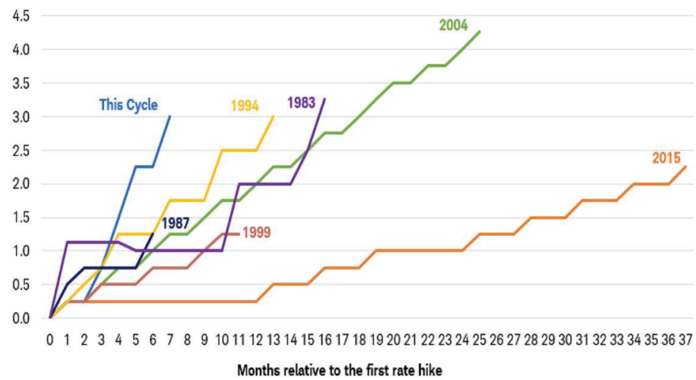
Source: Portfolio Visualizer

Just what, exactly, is the Fed doing?

There are a number of issues plaguing markets, but chief at hand is the persistence of inflation and the Federal Reserve's increasingly hawkish quest to dampen the flames. Our last five investment letters have centered around this core issue, but let's recount as the Fed's transformation during the past year has been remarkable. One year ago, the Fed was forecasting the need for one 0.25% rate hike by the end of 2022, with the poorly-aged assertion that they would not raise rates until they saw "actual inflation".

Fast forward to present, and the Fed has raised the Federal Funds rate by 3.0% since March, and has forecasted the need for another 1.5% in rate hikes by February 2023. Prior to this cycle, the Fed had not raised rates by 0.75% in a single meeting in more than 20 years, but the Fed has now raised rates by 0.75% in three consecutive meetings, with a fourth widely expected at their November meeting, inconveniently scheduled six days before midterm elections. Additionally, the Fed is no longer reinvesting its Treasury holdings in an attempt to reduce its balance sheet and shrink the U.S.'s monetary base.

Change in Fed Funds Rate During Restrictive Monetary Cycles



Source: Charles Schwab

The rapid evolution in market environment can best be visualized in the table on the following page, which shows the change in the Fed's 2022 forecast over the past 12 months. One year ago, the Fed's forecast for 2022 was for a year that produced above-trend economic growth, receding inflation pressures, and near rock-bottom rates, all of which would add up to a nearly ideal environment for risk assets. Instead, inflation estimates have more than doubled, and in response, the Fed Funds rate estimate has rocketed up 4%, while GDP growth estimates are in question of turning recessionary. The resilience of the labor market, which is the other half of the Fed's dual mandate, has given the Fed added clearance to squarely focus on their price stability mandate with aggressive rate hikes. The gradual worsening of these estimates are a 30,000 foot explanation for the current slump in risk assets.

U.S. EQUITY RETURNS (%)

As of 09/30/2022	Q3 2022	YTD 2022	3-Year	5-Year	10-Year
S&P 500	-4.9	-23.9	8.2	9.2	11.7
Russell 1000 (Large Cap) Growth	-3.6	-30.7	10.7	12.2	13.7
Russell 1000 (Large Cap) Value	-5.6	-17.8	4.4	5.3	9.2
Russell 2000	-2.2	-25.1	4.3	3.6	8.6
Russell 2000 (Small Cap) Growth	0.2	-29.3	2.9	3.6	8.8
Russell 2000 (Small Cap) Value	-4.6	-21.1	4.7	2.9	7.9

Source: Morningstar

Continued from page 2 . . .

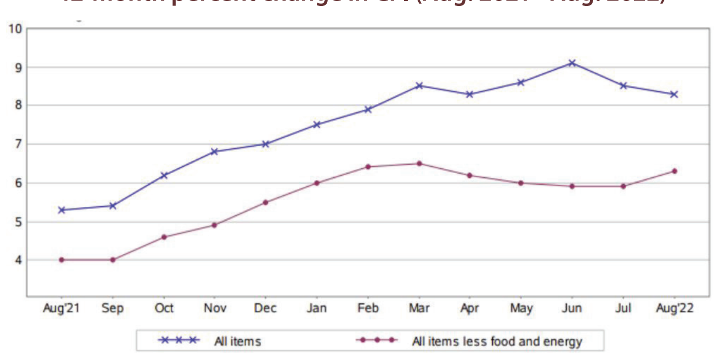
Change in FOMC Forecasts for Year-End 2022

	Sep. '21	Dec. '21	Mar. '22	Jun. '22	Sep. '22
Change in Real GDP Growth	3.8	4.0	2.8	1.7	0.2
Unemployment Rate	3.8	3.5	3.5	3.7	3.8
PCE Inflation	2.2	2.6	4.3	5.2	5.4
12/31/2022 Fed Funds Rate	0.3	0.9	1.9	3.4	4.4

Source: FederalReserve.gov

Interest rates arguably drive changes in asset prices more than any other input, and it has been 40 years since rates have surged higher at this speed or magnitude. For the past two decades, interest rates have moved more like a game of Chutes and Ladders; down the chute quickly in bad times, and then up slowly and gradually. This year, rates unexpectedly hit a ladder that has jumped them to near the top of the board, and assets have repriced accordingly. Understanding the slump in bond prices is straightforward; a bond yielding 1.5% at the beginning of the year is not as attractive as a new bond issue paying 3.75%, and therefore the 1.5% yielding bond will trade at a discount. The rise in interest rates affect stocks in a number of ways that are less straightforward, be it a higher discount rate adjustment on future cash flows, a reduction in business profits, reduced margin buying by investors, or the attractiveness of risk assets versus higher yields on safe assets. Finally, and particularly vexing for balanced portfolios, has been the relationship between the two asset classes, which are now at their highest correlation since the mid-1990s. In simple terms, stock and bond prices are moving directionally together, mitigating their diversification benefits.

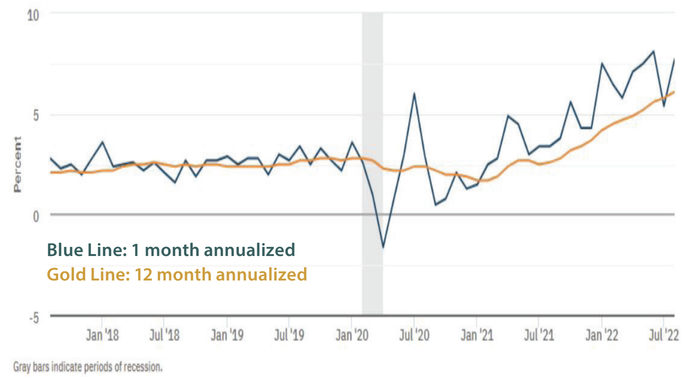
12-month percent change in CPI (Aug. 2021 - Aug. 2022)



Source: Bureau of Labor Statistics

The Fed's most recent shift into 5th gear of restrictive policy comes in response to the August inflation report. While headline inflation fell -0.2% Y/Y, continuing its descent from its June peak of 9.1% (good news), the core number reaccelerated to 6.3% year-over-year (bad news). Of note was the increase in what is known as sticky-price CPI, which is the basket of items that change price relatively slowly, increased 7.7% on an annualized basis in August, well above its 5.4% increase in July. On a year-over-year basis, sticky-price inflation is up 6.1%. Examples of sticky prices are rents, medical care services, or even haircuts or trash collection services. Shelter, which makes up 40% of core inflation, gained 0.7% last month, its highest month-over-month change in over 30 years. Shelter is now up 6.3% year-over-year and accelerating.

Sticky-Price CPI



Source: Federal Reserve Bank of Atlanta

Fed Chair Powell's recent comments have been noticeably candid as to not be misinterpreted. "There isn't a painless way to do it" he stated in talking about getting inflation back down to 2%. "We will keep at it until we are confident the job is done. Restoring price stability will likely require maintaining a restrictive policy stance for some time." The impact of rate hikes to alleviate sticky-price inflation will require some patience and do little to remedy supply side issues, but demand for flexible-price items, such as used cars, has cooled, and borrowing costs for other interest rate sensitive components of the economy, such as housing, have become materially more expensive. This all works to slow economic activity, which should slow hiring, which should slow wage growth, which should slow inflation.

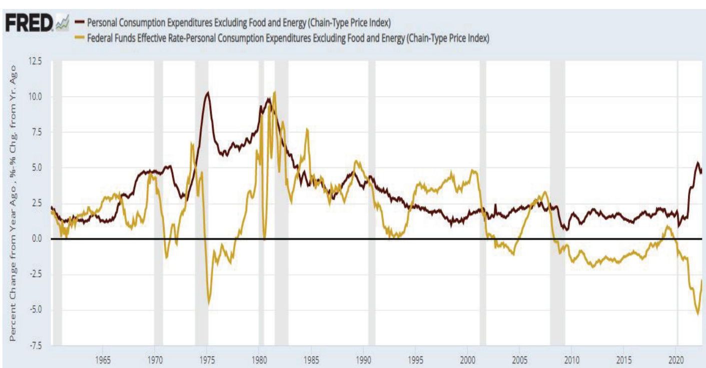
As for the growth outlook, Powell has stated that he expects a "very high likelihood of below trend growth", which is code that if a recession is required to bring down inflation, then so be it. As we stated in our last investment letter, a recession in the coming quarters is widely expected and it is almost certain there will be additional negative economic news in the coming months. This holds for the global economy as well, which is taking more of a direct hit from geopolitical events (Russian invasion, China's zero-COVID policy) and grappling with U.S. dollar strength, which has appreciated notably this year against Japanese yen, British pound and euro. Dollar strength exacerbates inflation globally, cutting back global demand as foreigners face higher prices in their currency. Inflation is presently higher globally than it is in the States.

When do things get better?

The third quarter was a mixed bag of news, but one positive was further evidence that inflation has probably peaked. Our best guess to the next piece of the puzzle is greater certainty in the terminal rate (the maximum fed fund rate in this cycle). Will a 4.75% Fed Funds rate be enough to tame inflation? That seems to be the million-dollar question right now.

The answer may lie in the chart below, the same data of which we showed last quarter but in a different format. The chart shows Core PCE Inflation on the maroon line and the Real Fed Funds rate on the gold line. Last quarter, these two lines were still gapping in opposite directions, as Fed rate hikes were not keeping up with the increase in core inflation. Over the past three months, progress has been made directionally for both lines. If the past two months of mild headline inflation continue into the coming months, the real Fed Funds rate (gold line) could turn positive by the first quarter of next year, potentially around the same time the Fed makes a final 0.25% hike in February. The crossing of the two lines would likely come by the middle of next year. The duration and certainty of both events will likely dictate market direction and provide the answer to the terminal rate.

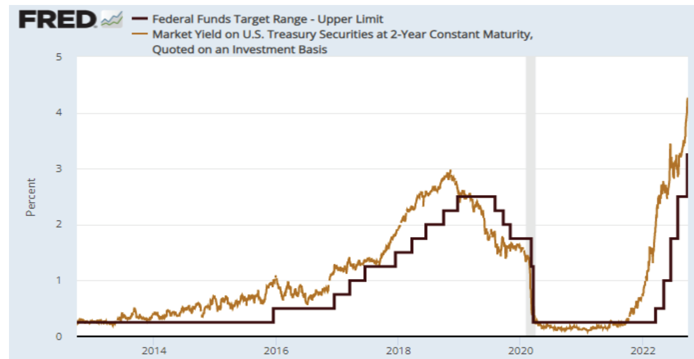
Real Fed Funds Rate vs. Core PCE Inflation



Source: Federal Reserve Bank of St. Louis

If 4.75% holds as the terminal rate, then the forward returns for bonds look as favorable as they have in years. As you can see in the chart in the following column, 2-year Treasury yields are now above 4%, having priced in further rate hikes. The ride up has been painful, but rates on the 2-year are now at a 15-year high after yielding just 0.20% one year ago. While short-term rates more closely follow the Fed Funds rate, investment-grade intermediate-term bonds should eventually be the benefactor of a recessionary environment with receding inflationary pressures. The Aggregate Bond Index now yields 4.75%. High-yield bonds are yielding 9%.

2-Year Treasury Yield vs. Fed Funds Rate



Source: Federal Reserve Bank of St. Louis

In order of priority, we would expect to see stabilization in the bond market prior to establishing a lasting stock market rally. On the plus side, valuations on stocks have declined meaningfully during the drawdown, as this year's multiple contraction of 25% has pushed the S&P 500 Index forward P/E below its 25-year average. International stocks are trading well below historical levels and are paying 3%+ dividend yields. Our portfolio tilts toward Value, Profitability, and Quality continue to help relative performance within our portfolios. A lot of bad news has been priced into the equity markets, and while the drawdown's floor is still not certain, equity markets often turn on a change in beliefs well before a change in fundamentals. The biggest headwind to stock markets may be fighting the Fed, so clarity in the terminal rate would be a boost to equities as well.

Wrapping up by circling back to the initial 60/40 drawdown chart, it is worth noting that both the drawdowns of 1974 and 2008 were followed up by consecutive calendar years of double-digit returns (1975-1976 and then 2009-2010). Small sample size perhaps, but history suggests better days are ahead for balanced portfolios.

INTERNATIONAL RETURNS (%)

As of 09/30/2022	Q3 2022	YTD 2022	3-Year	5-Year	10-Year
Int'l Developed ex US	-9.4	-27.1	-1.8	-0.8	3.7
Emerging Markets	-11.6	-27.2	-2.1	-1.8	1.1

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 09/30/2022	Q3 2022	YTD 2022	3-Year	5-Year	10-Year
Aggregate Bond	-4.8	-14.6	-3.3	-0.3	0.9
Muni	-3.0	-11.2	-1.8	0.4	1.3
Int'l Bonds	-6.0	-18.2	-5.4	-2.9	-1.4
High-Yield	-0.8	-13.5	-0.8	1.0	3.1
Short-Term	-1.6	-6.3	-0.6	0.7	0.9
90-Day T-Bill	0.7	1.1	0.6	1.2	0.7

Source: Morningstar

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