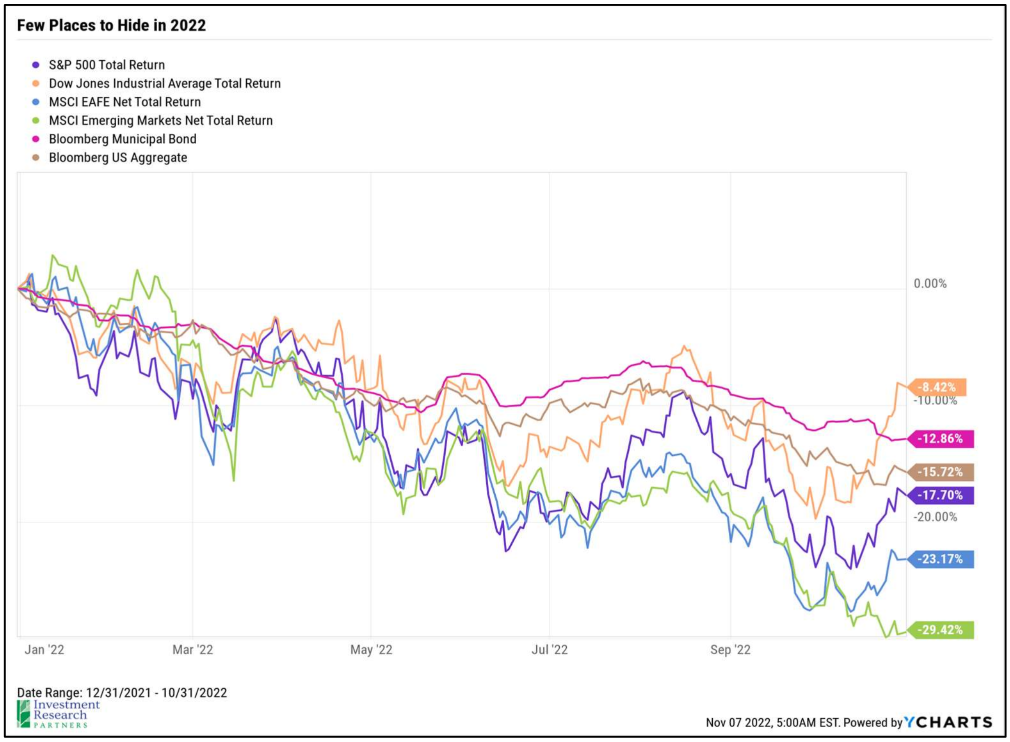
Monthly Investment Update

October 2022

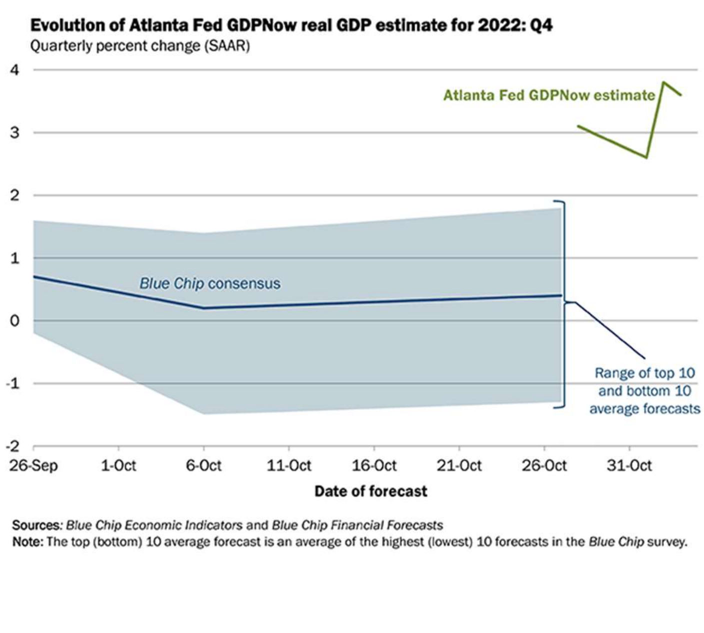
"The stock market has predicted nine of the past five recessions."



This famous quip comes from economist & Nobel Prize winner, Paul Samuelson. It is said to have been later completed by Wall Street Journal editor, Robert Bartley, who remarked,

"and, in the other four, Washington got the message and mended its ways in time."

And therein lies what has become a nearly singular focus for investors as the year has dragged on: "When will the Fed stop?!" In a year marked by the worst conflict in Europe since World War II and its ripple effects around the globe, investors have increasingly turned their collective attention to interpreting the words of the Federal Reserve's Open Market Committee (FOMC) and its current leader, Federal Reserve Chair, Jerome Powell.



Are we in a recession? It's truly difficult to determine until after we're in the thing, and we have collectively completed our postmortem, and some official-sounding organization like the National Bureau of Economic Research officially calls it. In fact, the NBER is the organization that most industry practitioners have standardized on for our official recession calls. But, even the opinions and estimates of top economists and government officials vary widely, just look at the Atlanta Fed's estimate versus their bogey of top economists. As Danish philosopher, Soren Kierkegaard, said,

"Life can only be understood backwards, but it must be lived forwards."

To determine if we are in a recession, you might simply look out your window, ask your friends, neighbors, are they spending more or less or the same this holiday season? Are they forgoing that vacation, that car, that house, that new family for fear of the future, a future economic downturn or loss of their job? We are a very large and very diverse country with lots of differing experiences, perspectives, and increasingly too many crosswinds to say there is truly an "average" American with an "average" experience. But, if we ask enough people in varying stages of life and geographies these questions, you'll get a pretty good sense of whether things are slowing or evening contracting.

Our activities collectively as individuals account for roughly two-thirds of US gross domestic product (with the balance mostly from business & government spending), so when enough of us get worried or fed-up (no pun intended) and collectively turn inward to preserve our standard of living for the future, a recession happens. Sometimes they are shallow, sometimes they are deep. The deep ones typically coincide with a wave of credit events and failures, but not always. The financial crisis of 2008-2009 stemmed from a wave of these things over several months. The pandemic actually saw relatively few defaults and failures, likely due to the unprecedented stimulus thrown at the economy at the time by the federal government and the US Federal Reserve (remember those stimulus checks and rescue loans?). For some, like those who refinanced an existing mortgage at a near-zero interest rate, that stimulus may have been like an elixir that improved financial health and future economic prosperity, but for others it may have just been enough to keep them on financial life support.

Peak Month	Trough Month	Expansion Duration (past trough to recent peak)	Contraction Duration (recent peak to recent trough)
September 1902	August 1904	21	23
May 1907	June 1908	33	13
January 1910	January 1912	19	24
January 1913	December 1914	12	23
August 1918	March 1919	44	7
January 1920	July 1921	10	18
May 1923	July 1924	22	14
October 1926	November 1927	27	13
August 1929	March 1933	21	43
May 1937	June 1938	50	13
February 1945	October 1945	80	8
November 1948	October 1949	37	11
July 1953	May 1954	45	10
August 1957	April 1958	39	8
April 1960	February 1961	24	10
December 1969	November 1970	106	11
November 1973	March 1975	36	16
January 1980	July 1980	58	6
July 1981	November 1982	12	16
July 1990	March 1991	92	8
March 2001	November 2001	120	8
December 2007	June 2009	73	18
February 2020	April 2020	128	2
1854-2020		41	17
1945-2020		64	10
1977-2020		81	10

Since World War II, there have been 12 recessions.[1] The average economic expansion, excluding the most recent following the COVID-19 induced recession, has lasted 64 months. In the 1970s and 80s, a handful of legislative initiatives sought to improve the Fed's performance and ability to manage boom and bust cycles:

The Federal Reserve Reform Act of 1977, which requires the Fed to direct its policies toward achieving maximum employment and price stability and report regularly to Congress.

The Community Reinvestment Act of 1977, which requires the Fed and other bank regulators to evaluate banks on their performance in meeting the credit needs of low- and moderate-income communities in the markets they serve.

The Full Employment and Balanced Growth Act of 1978, which amended the Employment Act of 1946 and makes more explicit the Fed's "dual mandate" to support maximum sustainable employment and price stability.[2]

Interestingly, since these pieces of legislation were enacted in the late 1970s, the average economic expansion has increased to 81 months. Contractions still last about 10 months in both cases, including the short two-month contraction witnessed during the pandemic. It's likely that these policies, coupled with the increase in data availability, have helped monetary policy makers to better navigate the economic cycle.

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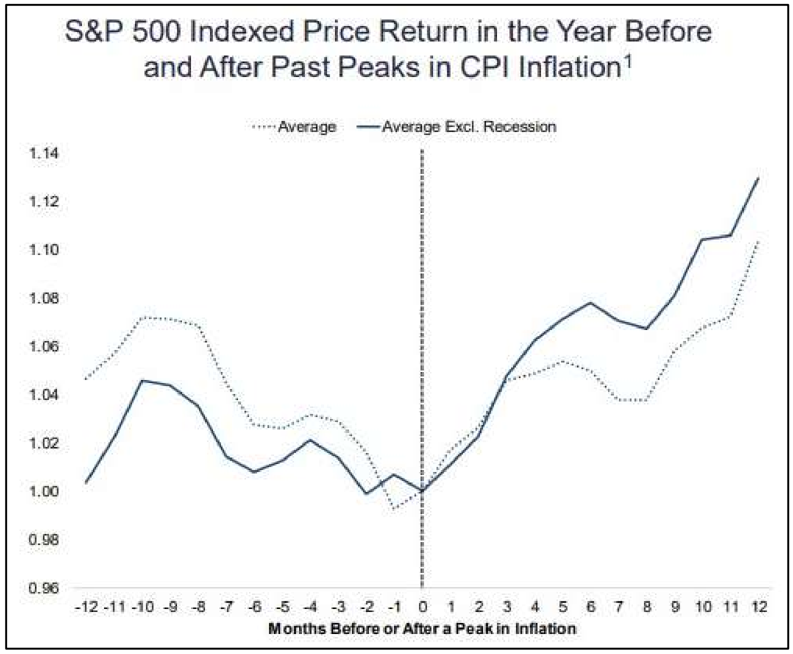
[1] https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions
[2] https://www.federalreservehistory.org/

Despite its seemingly improving ability to temper the economic cycle, the Fed can't escape the drastic impact it has on markets during times of stress. Last Wednesday, during the most recent FOMC statement release and press conference, the S&P 500 declined 3.5% from its intraday high at 2:35pm (five minutes after the press conference started) to the close. Put differently, the 500 largest companies in the US lost more than $1 trillion in value in less than two hours as one human being gave a press conference and answered questions from some of the nation's top financial reporters. And, this is just 500 stocks; these words and policies have similar implications for the pricing of all assets (trillions of dollars more). Imagine that pressure. Mr. Powell may be in the position of knowing that his policy tools are working, but he must carefully message the future intentions of his institution so as to not give false hope to market participants (higher stock prices and investor confidence are inflationary, so giving too much "good news" may actually be counter-productive for the Fed).

Is it even the right question to be asking if you're an investor, not an economist? Trying to predict the economic cycle is very important, but that's what all other investors are doing too with varying levels of information, emotional preparedness, and sophistication. Our base case from here does not include a steep recession or cascade of defaults, business failures, and hidden shocks, but this is based on data that we can observe today. On the following pages, we discuss our reasons for optimism from here.

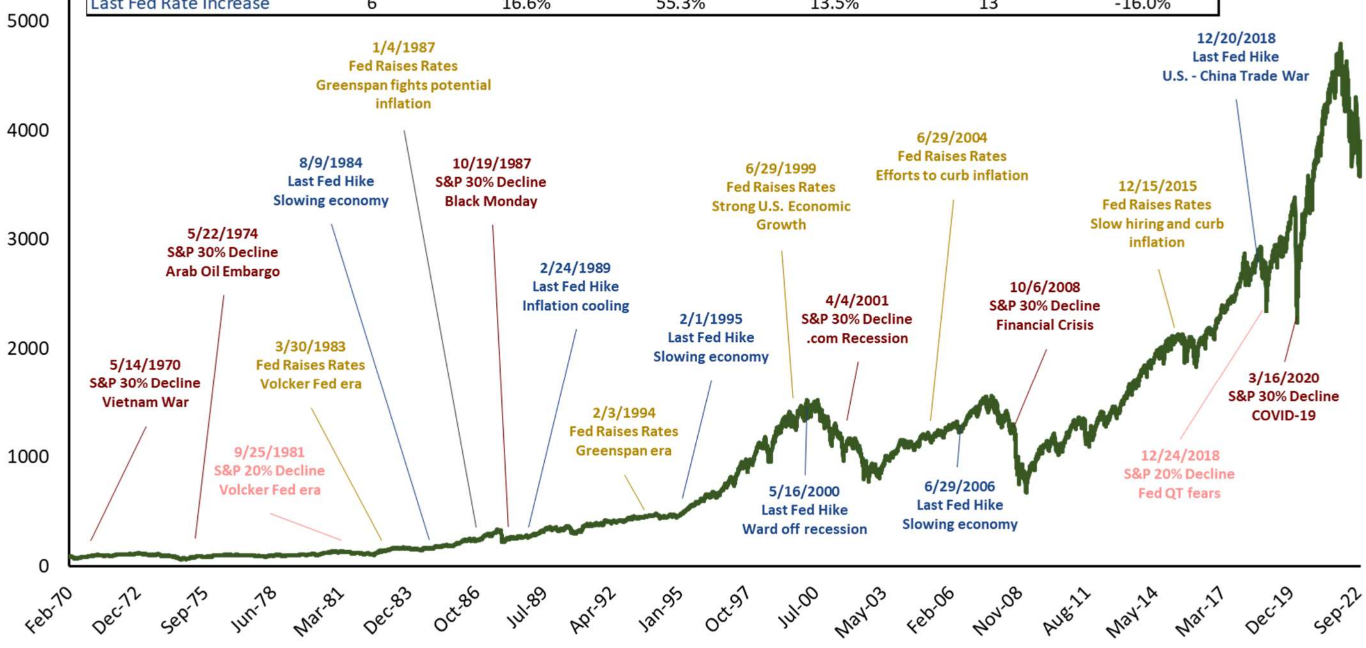
So, What Can We Expect From Here?

Anyone who claims the ability to predict the next move of Jerome Powell or Vladimir Putin is irrationally confident in their abilities (to put it nicely). What we can do is observe as many data points as they may be observing, and attempt to draw conclusions about how this data impacts their motivations and goals (And, surely Mr. Powell would loathe to be lumped into the same sentence as Mr. Putin…maybe Putin feels the same about Powell). Nevertheless, these two individuals have moved markets all year, plain and simple. Putin seems to be losing his war, Powell seems to be winning his. Home prices have begun to soften as has manufacturing activity and energy prices. And, interestingly, when inflation peaks, that tends to be a good time to invest in equities on average.[3]



Additionally, investing after market declines and when the Fed stops raising interest rates tends to also be very fruitful on average, though certainly not a precise timing tool.

Event	Number of Instances	Next 1 Year Return	Next 3 Year Return	Next 3 Year Return (annualized)	Months Until S&P 500 Bottom	Additional Decline to Bottom
20% S&P 500 Decline	8	10.5%	37.6%	10.8%	7	-19.9%
30% S&P 500 Decline	7	23.9%	43.1%	12.2%	4	-15.1%
First Fed Rate Increase	6	9.4%	43.9%	11.8%	21	-16.2%
Last Fed Rate Increase	6	16.6%	55.3%	13.5%	13	-16.0%



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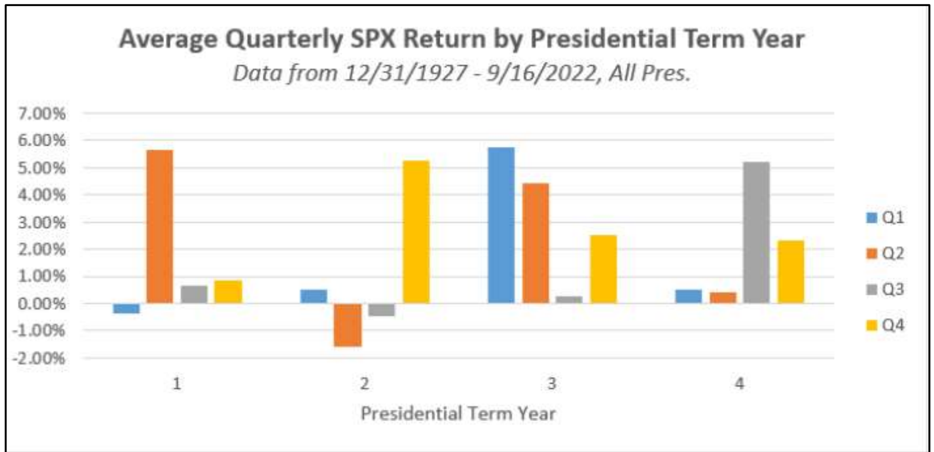
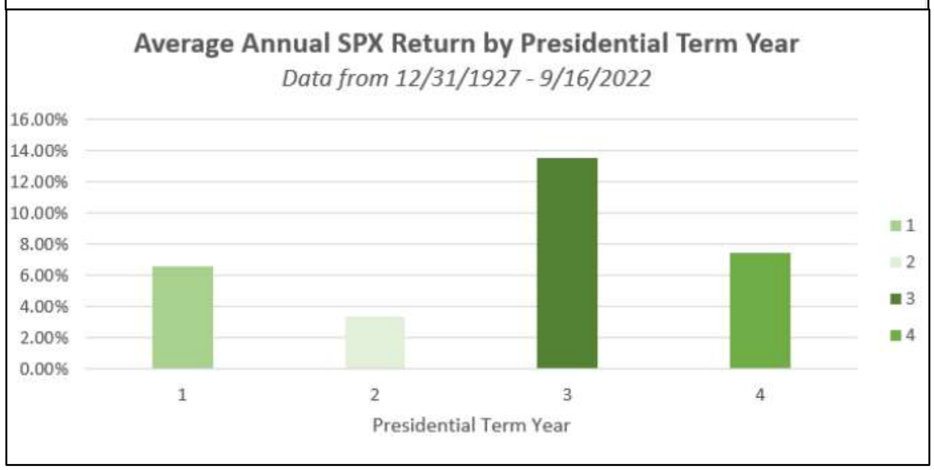
[3] Source: Investment Strategy Group, Bloomberg.

[4] Notes: Data uses S&P 500 price returns from 1970 to 1990, S&P 500 total returns thereafter. Returns calculated using monthly data. If an event occurred in the first half of the month, that month's performance was considered in the subsequent results. If an event occurred in the second half of the month, results were calculated using the subsequent month as the starting point.
October 19, 1987 ("Black Monday") triggered both a 20% S&P 500 decline event and a 30% S&P 500 event, and it is counted in both above.
Source: Bloomberg, YCharts as of September 30, 2022

We are on the eve of midterm elections as this piece is being written. It's difficult to say which party will gain power, but we can observe the historical relationship between election cycles and stock prices. **The two quarters leading up to a midterm election, which are living through now, tend to be the worst during the 16 quarters of a President's term, while the following three quarters tend to be some of the best**.[5] While these are just averages, and actual years could be significantly different, it stands to reason that the removal of one point of uncertainty calms investors. And, it's likely that markets benefit from initial pushes for legislation (often stimulative) from the new party in power.





Rarely in our investing careers have we witnessed assets be perfectly priced. Benjamin Graham's famous parable of "Mr. Market" perhaps described it best; an irrational and emotional business partner who offers to buy out your share each day at significantly different prices based on his wild swings from optimism to pessimism and back. 2022 will be marked as a year of extreme pessimism by "Mr. Market". This is not to say that his concerns are not valid and that there are real storm clouds on the horizon. Investors who pay attention typically identify most of the same risks, but it is their weighting of the importance of those risks toward the future profitability of the businesses they own that makes the market swing. Our base case is that "Mr. Market" may be overly focused on the risks of now and forgetting the potential benefits of the future. **Stocks are cheaper, bonds are cheaper, the economy is not collapsing, there will be an inevitable swing toward optimism again, and likely soon *"[the Fed] will get the message and mend its ways."***

Thank you for your trust and confidence as we steward your wealth. We are available to review your portfolio and goals at your convenience.

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[5] Dorsey, Wright & Associates, LLC

Outlook Summary

Economy

- ✓ **Labor**
- **Earnings**
- **Household Sentiment**
- **Inflation**
- **Financial Conditions**

Valuations

- **Equity**
- **Credit**

Technical

- **Trend**
- **Investor Sentiment**

Economy

- Economic growth has begun to soften as households and businesses are becoming more cautious with their borrowing and spending
- ✓ The labor market remains a key pillar of economic strength as the economy is near full employment and job openings are still well above long-term averages despite declining over the last few months (a potential early sign of inflation abating)
- Corporate earnings expectations have come down, but are still anticipated to rise in 2022 and 2023
- Household sentiment and inflation have been closely tied in 2022, and both appear to be slowly trending in the right direction over the last few months

Valuation

- Stocks indices are trading near or below long-term averages, and significant dispersion across companies and industries still exist (opportunity for active managers)
- Credit spreads a near long-term averages, but higher interest rates present concerns about potential defaults

Technical

- Stocks have attempted to re-enter a long-term uptrend multiple times in 2022, but none have been sustainable thus far
- Investor sentiment quickly recovered in October, which gives us caution that investors are still too optimistic about a potential “Fed pivot.”

Prices & Interest Rates

Representative Index	Oct. 2022	Year-End 2021
Crude Oil (US WTI)	3,872	$75.21
Gold	$1,634	$1,828
US Dollar	112.12	95.97
2 Year Treasury	4.51%	0.73%
10 Year Treasury	4.10%	1.52%
30 Year Treasury	4.22%	1.90%

Asset Class Returns

Category	Representative Index	Oct. 2022	YTD 2022	2021
US Large Cap Equity	S&P 500	8.1%	-17.7%	28.7%
US Large Cap Equity	Dow Jones Industrial Average	14.1%	-8.4%	21.0%
US All Cap Equity	Russell 3000 Growth	6.1%	-26.4%	25.9%
US All Cap Equity	Russell 3000 Value	10.4%	-9.5%	25.4%
US Small Cap Equity	Russell 2000	11.0%	-16.7%	14.8%
Global Equity	MSCI All-Country World	6.0%	-21.1%	18.5%
Global Equity	MSCI All-Country World ESG Leaders	5.4%	-23.5%	20.8%
Foreign Developed Equity	MSCI EAFE	5.4%	-23.2%	11.3%
Emerging Market Equity	MSCI Emerging Markets	-3.1%	-29.4%	-2.5%
US Fixed Income	Bloomberg Barclays Municipal Bond	-0.8%	-12.9%	1.5%
US Fixed Income	Bloomberg Barclays US Agg Bond	-1.3%	-15.7%	-1.5%
Global Fixed Income	Bloomberg Barclays Global Agg. Bond	-0.7%	-20.4%	-4.7%

Source: YCharts as of October 31, 2022

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