3rd Quarter 2022

STRAIGHT TALK

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2022
Market Returns

Domestic Large
S&P 500
-23.87%

Domestic Small
Russell 2000
-25.10%

Intl Developed
MSCI EAFE
-27.09%

Emerging Markets
MSCI EM
-27.16%

Fixed Income
Bloomberg US
Aggregate Bond
-14.61%

**Returns are from YCharts, with dividends reinvested, and are through 09/30/22*

We could write a dissertation on everything happening these days. (We have mostly resisted that urge but we have included more detail than normal on a second page!) There remains no shortage of risks and opportunities across markets, but as major indices have moved further into the red, the risks continue to outweigh any positives. Inflation and the Fed continue to move in the wrong direction for markets, and until that changes investors face a headwind from rising rates. For every risk or worry though, there is an opportunity, and we must not lose sight of those, even if it takes longer to realize the benefits they bring. Stocks will eventually bottom and move higher, and simple bond math dictates that better days are ahead.

This summer saw equity markets rally, eventually clawing back roughly half of the losses from the June lows. However, this gave way to poor September returns and new year-to-date lows across most markets. Meanwhile, fixed-income returns have continued to falter as the rapid increase in interest rates has caused dramatic repricing across markets. Volatility is likely to be an ongoing theme through the final quarter of the year, but at some point, the forward-looking nature of equity markets will see an end (or at least a pause) in Fed rate hikes, which should translate to better stock returns.

In bond markets, the rapid increase in yields has created short-term pain, but will add to long-term gains. Higher starting rates mean bonds have more of a cushion if rates do move higher and, if the Fed pauses or is forced to cut rates, then the possibility of capital appreciation will only add to returns. What happened in the 1994-1995 time period is an interesting case study for what we are experiencing today. Back in 1994, the Fed increased rates by 3%, the same as this year so far, the difference being that rates started at 3% and went up to 6%, this time we started at 0%. That difference played a part in the Bloomberg US Aggregate Bond Index only being down 2.92% that year, compared to a nearly 15% decline this year.

What happened in 1995 is equally interesting. After hitting peak rates early in 1995, the Fed held steady until the end of the year when two 0.25% rate cuts took place. The combined effect of higher starting rates and just 0.50% in rate cuts sent the index up 18.47% for the year. Now we do not know exactly when the Fed will stop raising rates, let alone when they might start cutting, but we do know that hikes of the same magnitude next year are highly unlikely. With another 1.25% increase (0.75% in Nov & 0.50% in Dec) baked into market expectations, it looks like we will be starting the new year with short-term rates above 4%. If the Fed pauses sometime in early 2023 we should see bond markets rebound, and if they are in a position to cut rates at all, the effect could help amplify returns to the upside.

There is no sugarcoating it, it has been a tough year for investing. We are facing the worst stock market returns since the Great Financial Crisis in 2008 and on a relative basis, the news has been even worse in bond markets, where we will likely see the worst calendar year returns ever. It has been a long grind lower across markets, but we continue to believe that we are closer to the end of it. Ultimately, being a successful long-term investor sometimes takes a strong stomach. Having the fortitude to stay invested when things look like they are falling apart is a major contributor to long-term success. There has been virtually nowhere to hide during this selloff and even the most well diversified portfolios have felt the pain. This will not be the case forever though, we have highlighted the improved outlook for bonds and eventually, stocks will benefit from lower prices and more attractive valuations. We understand how tough it can be to look at statements and continually see losses and we thank you for your trust and patience as we navigate this difficult environment. We are always here to help and happy to address any questions or concerns as they arise.

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Inflation & The Fed—We are used to things happening quickly in markets, whether the Covid crash and subsequent rebound or the rapid adjustment to Russia's attack on Ukraine. Where inflation is concerned, though, we may need to prepare ourselves for a more drawn-out move. We do believe that the data will trend lower, but how quickly we get anywhere near the Fed's 2% target remains to be seen. As we move into the new year, the inflation calculation comparisons will be higher and should result in lower year-over-year inflation figures. The Fed, for their part, remains firmly committed to bringing inflation down, and while they secretly might be content with inflation hovering around 3% rather than 2%, we remain a long way from that point. Market expectations are for more aggressive rate hikes into the end of the year and possibly smaller hikes in Q1 next year, at which point the Fed may decide to pause and see how things play out. Higher rates will be a drag on the economy and stock earnings, but much of the pain is likely already priced in. Among the key things for which we will be watching, is the point at which the Fed Funds rate meets or exceeds inflation figures. This will mark an important inflection point, and could signal that the battle is being won, and may even pave the way for rate cuts. However things end up happening, we expect that inflation will trend higher in the years ahead than it did in the 2008-2020 time period.

Geopolitics—These past few years have seen an increase in geopolitical conflict, as the world moves away from globalization and more towards nationalism. There have also been some eye-opening realizations as things have played out. We expect that Russia's war in Ukraine will be ongoing, with neither side in a position to end things decisively. What we have realized, though, is that any illusions about Putin's strategic mastery or the might of the Russian army have been shattered. Barring regime change, Russia is likely only going to get more and more isolated, in some ways that will make it more dangerous and in others, its fate as a failed state may well be sealed.

Elsewhere, China has just had its Party Congress. President Xi has gained an unprecedented third term (term limitations had to be amended to allow this) making him the longest-serving leader since Mao and further undoing any democratic reforms that were put in place in the time since Mao's death. Xi continues to purge the government of adversaries and while he has boosted the standing of the communist party, as he surrounds himself with yes men, he could be setting the stage for his and the party's undoing. Years of overbuilding and an overreliance on the real estate sector for growth have come into focus as the property market in China suffers. The Zero Covid policy has been a failure and whether Xi can admit defeat and move on after the elections remains to be seen. We are concerned that China will continue to move away from the democratic and capitalistic reforms that have allowed it to grow as it has over the last 40 years.

US Government & Elections—With everything else going on these days, the midterm elections have been an afterthought to most investors. The likely outcome of the elections has played a part in that. With expectations that Republicans will win the House and with the Senate a tossup, the most likely outcome points toward divided government. Markets generally like this outcome, as it limits the likelihood of any major policy changes. For all the bickering and finger-pointing we have seen over the years there is one important development that is worth discussing. We have a clear, bipartisan industrial policy that will boost US manufacturing and the security of our supply chains. The combined effects of Covid and distancing from Russia and China have western governments and companies looking to secure everything from energy to intellectual property. This shift will benefit US companies that boost capital spending and add to GDP growth over the long term.

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