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Fourth Quarter 2022 Market Commentary

Inflation is the biggest problem facing the stock market today, and is primarily responsible for the fourth worst performing year in the stock market year to date in history (see chart below) as of September 29th. In this commentary, we will discuss why inflation, in particular the Federal Reserves' Bank (Fed) response of higher interest rates to fight inflation has caused so many problems. We will also review evidence that inflation may be peaking, the underlying strength of the economy, and how far market sell-offs typically decline and how long corrections usually last.

S&P 500: Worst Performance through 184 Trading Days (1928 - 2022)

Rank	Year	Price Return: First 184 Trading Days	Price Return: Day 185 to Year-End	Price Return: Full Year
1	1931	-29.6%	-24.8%	-47.1%
2	1974	-28.8%	-1.2%	-29.7%
3	2002	-28.6%	7.4%	-23.4%
4	2022	-23.3%	?	?
5	1937	-23.2%	-20.1%	-38.6%
6	2001	-21.2%	10.3%	-13.0%
7	1962	-19.4%	9.4%	-11.8%
8	2008	-19.1%	-25.0%	-39.3%
9	1966	-15.7%	3.1%	-13.1%
10	1946	-15.2%	3.9%	-11.9%
11	1981	-14.8%	5.8%	-9.9%
12	1953	-12.7%	6.9%	-6.6%
13	1940	-12.5%	-2.9%	-15.1%
14	1990	-11.9%	5.6%	-7.0%
15	1977	-11.6%	0.1%	-11.5%

Source: Standard and Poor's

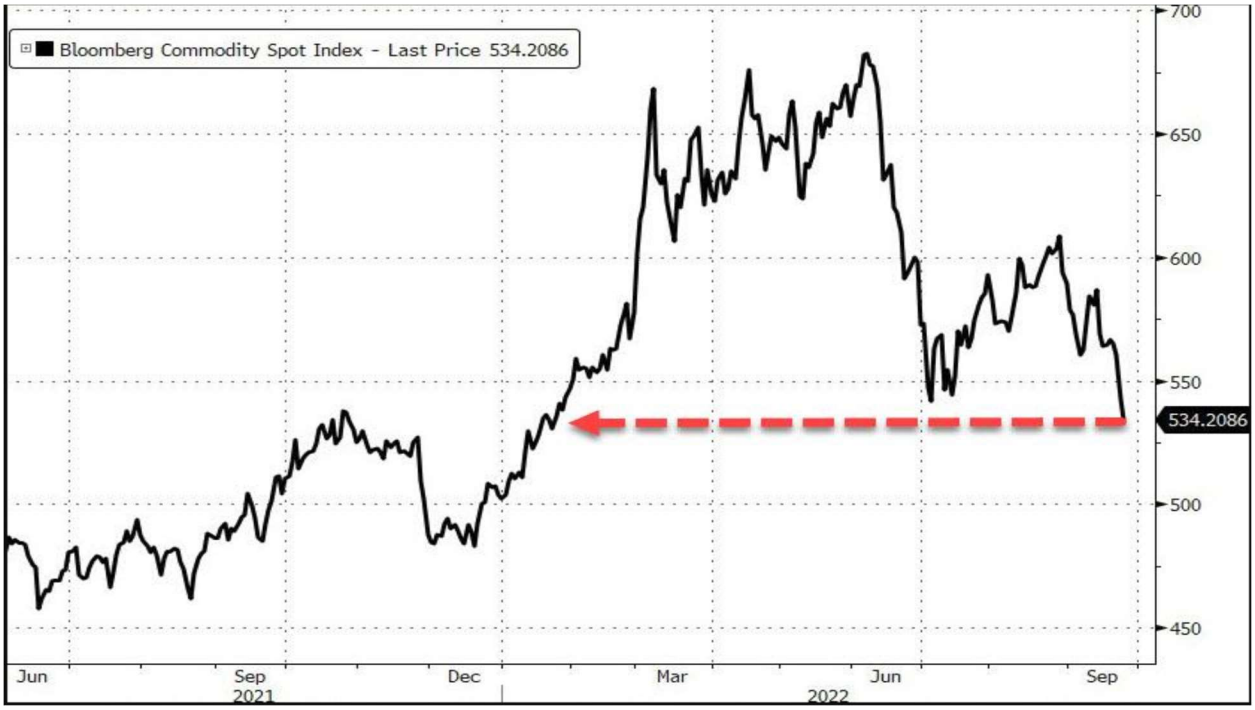
For the last 100 years the Federal Reserve has used higher interest rates to slow down high inflation. While higher interest rates will bring down inflation rates, they also tend to cause

recessions, reduce demand, lower home sales and values, and increase unemployment rates. Higher interest rates also affect stock market valuations, higher rates cause the value of the U.S. dollar to increase when compared to other currencies. For instance, if foreigners can buy a U.S. dollar that pays a 4% interest rate that is much better than a Japanese Yen that pays less than 1%, so the dollar rises in value versus its paper money peers. This is bad for American companies because it makes imports cheaper and exports more expensive; it also reduces the value of the overseas earnings that U.S. corporations earn because those overseas profits have to be repatriated at a reduced rate. Since the average company in the S&P 500 gets 50% of its earnings overseas, this reduces earnings growth. Since the beginning of the year the U.S. dollar is up 20% against a basket of international currencies- www.Marketwatchcom 9-22-22. Goldman Sachs estimates that earnings growth next year could be 10% less based solely on the move of the dollar (50% of earnings reduced by 20%-dollar increase). The reduced earnings lower stock valuations because the stock market is priced on a multiple of a companies' earnings, so if earnings decline, stocks typically fall in lockstep.

The other major reason why rising interest rates hurt stock market performance is because for the first time in 15 years, investors now have other options to invest their money outside of the U.S. stock market. The bond market is now yielding attractive rates and even short-term, one-year U.S. government guaranteed treasury bills now pay over 4%. For most of the past 15 years the S&P 500, the broad measure of the U.S. stock market, has yielded more income than a 10-year U.S. government bond. This low yield meant that almost every retiree over the last 15 years had to invest their savings into the stock market if they wanted to get any income for their retirement. The Wall Street Journal now reports that only 16% of the companies in the S&P 500 get more dividend income than even a two-year U.S. Government note (WSJ 9-20-22). This means investors can get more income at less risk by just buying a U.S.

government bond, which in turn is draining new money away from the stock market and worsening the current sell-off.

Some good news is that we are starting to see signs that higher interest rates are doing their job, and inflationary pressures are dissipating. For instance, the Bloomberg Commodity Price Index has given up much of its gains this year as the economic slowdown has reduced demand for commodities (see chart below). Some commodities like lumber are now back to their pre-pandemic levels (Wall Street Journal, September 28, 2022).



"The Bureau of Labor Statistics" August job report shows the work force is now back to pre-pandemic levels, which should help alleviate some of the supply chain issues. The backlog of a record 109 container ships that were stacked up outside the Los Angeles and Long Beach ports earlier this year has fallen by 80% (Port of Long Beach and LA). This easing of supply chains is also being confirmed by a drop of freight rates according to Freightos, a major freight forwarding company. Freightos reported transpacific ocean shipping rates have dropped 50% year over year as of September 9th as inflation has eroded buying power of

consumers, retailers pulled orders earlier in the year to avoid delays, and consumers switch to more services oriented spending as pandemic restrictions have eased up. Moreover, the ability of consumers to spend has also been eroded.

The personal savings rate of Americans spiked from 8.3% pre-pandemic in February 2020 to a record 33.8% during the COVID pandemic due to generous fiscal stimulus benefits from the CARES Act, and the American Rescue Plan (ARP) (Federal Reserve Bank). With all of the extra cash that consumers possessed, spending swelled and prices also accordingly took off. More recently, with the stimulus plans ending, the personal savings rate has slowed to a 13 year low of 5% in July of 2022, well below the 30-year average of 6.7%. With their dry powder waning, consumers may no longer be willing or able to afford the ever-rising prices of goods and services, resulting in a slowdown for both personal consumption expenditures. As spending slows, companies tend to cut prices, which will in turn, lower inflation and then allow interest rates to fall. A more balanced economic growth can then resume.

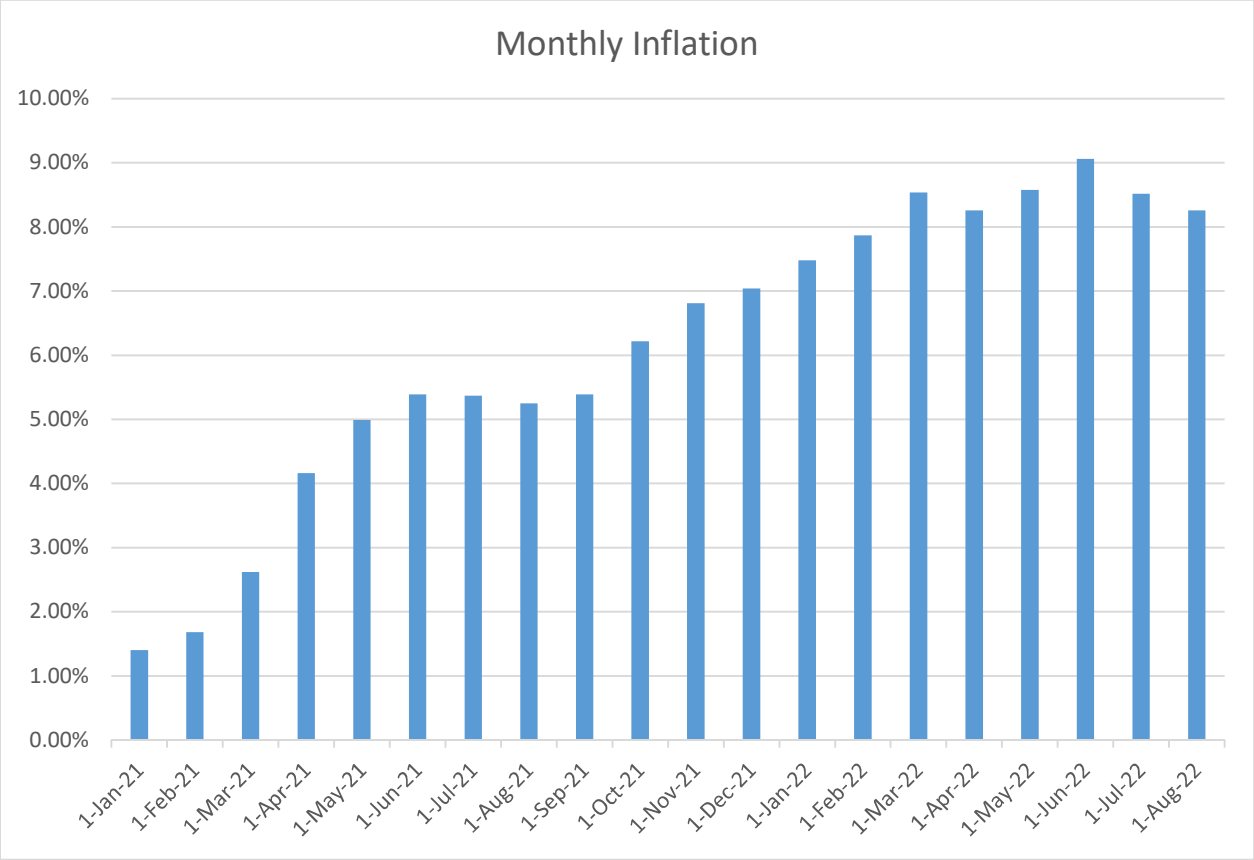
One hiccup here is that 17 states are now planning economic payouts to their citizens, including California which is offering over $1,000 to most residents to help offset the effects of inflation. While helping the poor is a good idea, giving money to people who have a job and don't need help could create another wave of inflation, so some of these programs may be hard to execute. The ancillary effects of this potentially increased inflation often tend to end up hurting the very people they are trying to help the most.

Higher interest rates have also decreased home sales, which have declined 19.9% since last September according to Zillow. In fact, sales in August of 2022 were at the weakest level since May of 2020, near the low of the pandemic, according to the National Association of Realtors. Since home sales are such a large percent of the economy, they have a large ripple effect on the economy. Slowing home sales will also slow inflation growth. As less people move, fewer homes are remodeled, and fewer realtors and movers get paid. New housing starts are also down 10.1% year over year as of September 2022, according to the U.S. Department of Housing and Urban Development. Likewise, we can assume a drop in the corresponding demand for lumber, windows, carpets, flooring and associated building materials is coming. This trend is likely to continue as the financing cost of a million-dollar home totaled roughly $30,000 a year ago with a 3% mortgage rate, and now the cost is over $70,000 for the same house with a 7+% mortgage rate today. This slowing in the housing market will reduce inflationary pressures.

Likewise, other items that are usually financed are experiencing similar fates. The U.S. Bureau of Economic Analysis reports that auto sales in the United States are expected to reach just 13.7 million units this year from an average 17.3 million units pre-pandemic. These weak sales have occurred even as inventories have risen from last year's semiconductor shortage of 20 days of auto inventory on hand to 33 days of auto inventory on hand as of September 30th (Bank

of America Securities). As sales continue to soften, auto makers will turn to discounts to move units and keep factories running, which will then lower inflationary pressures. Other indicators point to slowing inflation in the coming months as well.

Inflation is calculated by the Bureau of Labor Statistics on a year over year comparison. In January of 2021, the inflation rate was 1.4%, by January of 2022 it had increased to 7.48%, and it has peaked so far at 9.06% in June of 2022, with a slight downward leveling since then. However, once we get into January of 2023, the comparisons year over year will get a lot easier, if prices just maintain these current levels, the rate of growth will appear to decline on an annualized basis (See chart below).



Source: Bureau of Labor Statistics

The question that naturally arises is "How long will this sell-off last and how much will it go down?" The answer to this question is that the current market sell-off will end once inflation returns to the Federal Reserve target rate of 2%. After inflation gets hot, the Federal Reserve raises interest rates to slow growth or create recessions to bring inflation back down to their target rate. Since World War II, according to Deutsche Bank, the median decline in the S&P 500 during a recession is -24%. As of quarter end, the S&P 500 was already down over -25%, so based on historical averages we are near the averages in terms of percentage decline. Investment firm Guggenheim takes this research a little further and points out that in market pull backs greater than -20%, but less than -40% (current to our similar situation), which has happened eight times in the past since World War II, the average decline of the market was down -27%, and the average length of time until the bottom was reached was 11 months. This suggests that we are closer to a bottom than a top, and gives some indications of where the U.S. is in the cycle based on historical analysis. Furthermore, Guggenheim points out that once a bottom is reached, the average recovery time since World War II is 14 months. However, there is a wide disparity here, with the recovery in 2020 happening in under a year, and the recovery from the Great Financial Crisis taking almost five years.

In conclusion, rising inflation has wreaked havoc on financial markets worldwide this year. Nevertheless, there are signs that inflation is beginning to slow. In addition, the current bear market in financial markets has dropped to levels in both duration, and depth of the selloff that equity valuations are now back to historical fairly valued levels. Historically, the best returns have come after market pull backs when stocks come back to more attractively priced levels. Furthermore, yields in the bond market are the best they have been in over 15 years. Unfortunately, in the majority of bear markets, the financial markets only turned back up after the Fed pivoted in monetary policy. Currently, the Fed is still in tightening mode, with the

futures market putting an 85% chance of further interest rate hikes this year. The Fed has stated that they are focused on bringing wage pressures under control, meaning that they are aiming to bring the unemployment rate up (this would be a sign wage pressures are easing), not just commodity prices coming down. We believe the Fed will be successful in their goal, but probably not until well into 2023. This would also line up with easier year over year comparison on inflation. In the meantime, we continue to like companies who are returning cash back to investors, from both dividends and share buy-backs, and who provide goods and services which consumers need to use on a daily basis as the best way to ride out a turbulent market.

We thank you for your continued support.

Sincerely,

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