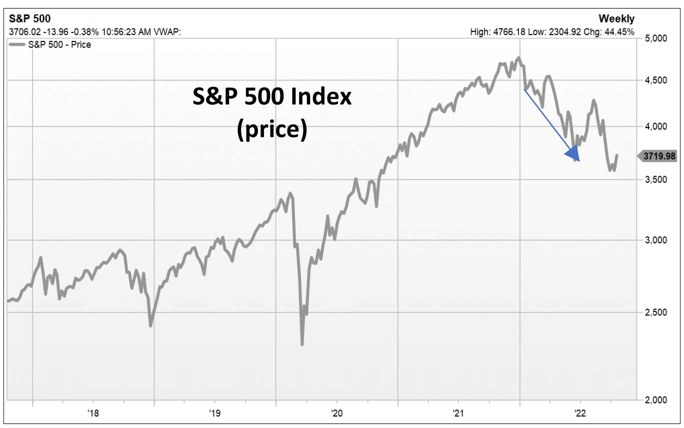
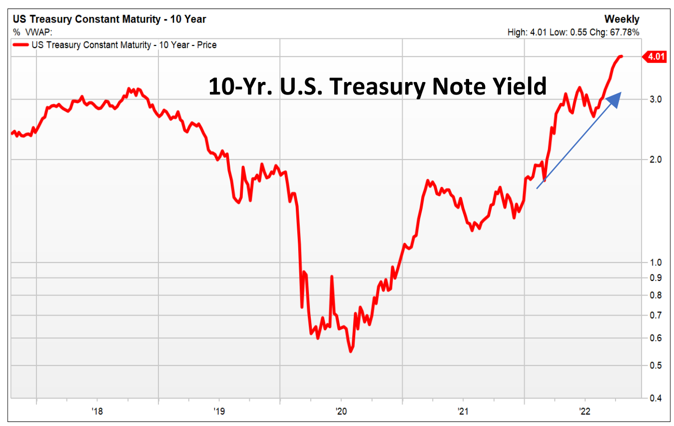
Economic and Financial Market Update – October 2022

Patience is a tall order, but a recipe for success!

Volatility in financial markets, like that investors have experienced during 2022, makes patience challenging. This year has certainly challenged patience as virtually all asset classes except cash and commodities have declined in value. However, as we have noted, and experienced previously, patience is the necessary ingredient for long-term investment success. The longer one's time horizon, the greater the likelihood of continued success.

From almost the first day of this year, investors have been subjected to a litany of less than favorable headlines that "moved the market." Russia invaded Ukraine; energy prices "exploded;" transitory inflation became "sticky;" the Federal Reserve turned "hawkish;" interest rates reached 40-year highs[i] and U.S., and global economies weakened. As a result of this uncertain environment, the S&P 500 has declined 21.3%[ii] year-to-date, and bonds have performed similarly. The Barclay's Aggregate Bond Index, a proxy for the bond market is off -16.6%[iii] while the 20-Year U.S. Treasury Bond Index is off -37.1%[iv]! Bonds which traditionally trade counter to stocks (stocks up, bonds down and vice versa) have traded in the same direction this year and thus have not provided support for most portfolios.





Source of both charts: FactSet Research Systems

The culprit? ***Inflation***. Multiple factors including significant government stimulus payments during and after the covid lockdowns, the "easy money" (stimulus) policy of the Federal Reserve, the disruption of the global supply chain, labor and energy shortages and pent-up demand for consumer goods created the ideal environment for rising inflation e.g., too many dollars "chasing" too few goods. As demand increased so did prices. In less than two years, the U.S. annual inflation rate increased from less than +1.50%[v] to the current annualized rate of +8.1%[vi].

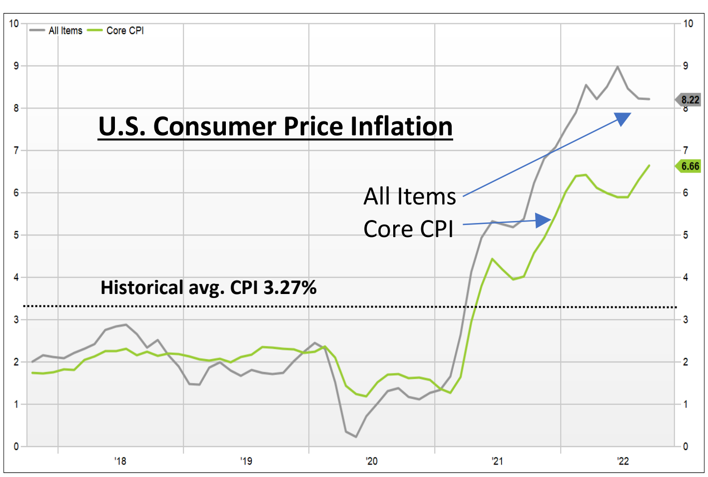


Chart Source: FactSet Research Systems

Defeating inflation and maintaining price stability is one of the Federal Reserve's mandates and achieved by slowing excess demand. After a slow start raising rates (March and May meetings), the Federal Reserve concluded that inflation was not transitory, and a more restrictive policy would be required. As a result, The Fed has increased rates by 2.75% since June bringing the Federal Funds rate to a range of 3.00%-3.25%. More hikes are likely. The current rate compares to a Fed Funds rate of 0.25% from March 2020 until March of this year. With rates that low it made sense to borrow to invest, spend or expand one's business. Demand, demand, demand.

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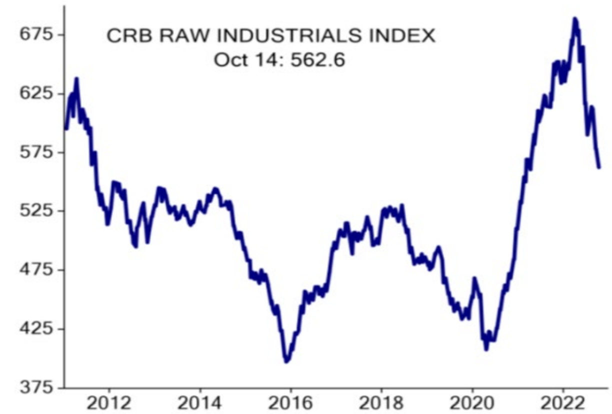
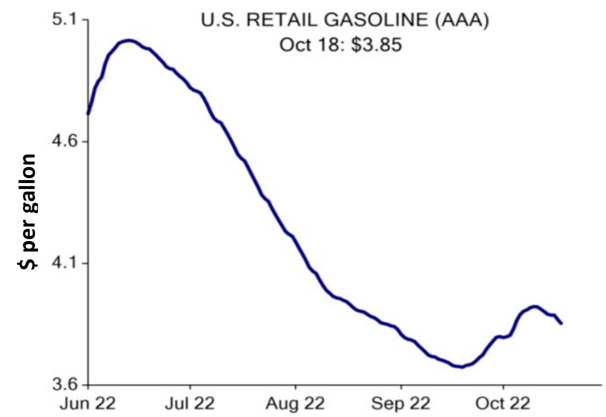
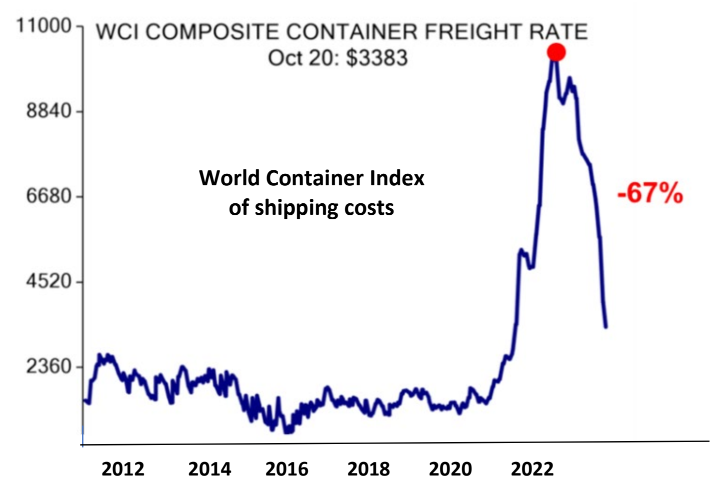
As rates have risen, the housing market has slowed, demand for cars has dwindled, consumer sentiment and net worth have declined, and consumers, whose spending accounts for 70%[vii]+ of U.S. GDP, have become more reserved. That slowing demand combined with an improving supply chain has begun to "take the heat" off prices and potentially reduce inflation. The charts below are factors we believe are/will contribute to lower inflation.



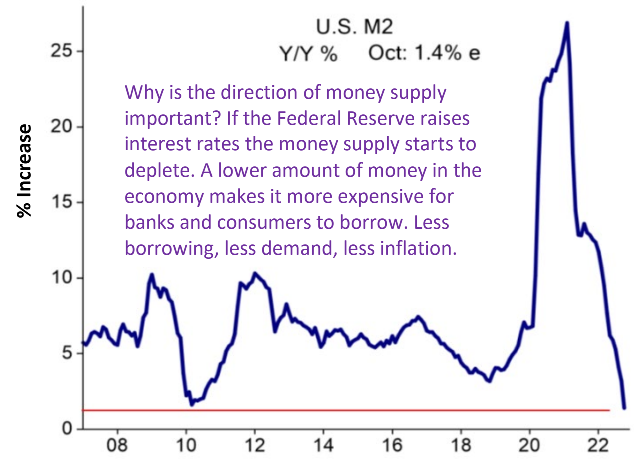


The positives resulting from higher interest rates and declining demand are that numerous basic prices are declining, others not increasing as rapidly, and the costs of transporting and warehousing are receding.

The adverse effect is that higher rates negatively impact the economy. Several Federal Reserve districts report weaker manufacturing, the strong U.S. dollar makes American goods less competitive overseas, corporate borrowing costs rise, and disposable income shrinks. The same scenario is playing out across the globe as other central banks deal with high rates of inflation in their countries.



Money Supply



Source for all charts on this page: Evercore ISI, Inc.

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A Fine Line.

The U.S. economy has experienced back-to-back quarters of declining GDP growth and thus is technically experiencing a recession[viii]. Despite those two negative GDP quarters, U.S. Industrial Production and Capital Spending data remain positive and, if one looks at the labor market (a good indicator of economic health), there is no indication of a current or significant recession. Initial Jobless claims have been surprisingly soft and the U.S. Unemployment Rate of 3.5%[ix] is at a 50-year low[x]. The demand for those willing to work will remain intense and wage increases will keep pressure on wage inflation.

The Federal Reserve has a challenging job. The success of achieving its mandate to maintain price stability, means fighting historically high inflation as aggressively as possible. At the same time, knowing that Inflation is central to the outlook for interest rates, The Fed needs to closely monitor the impact of its hawkish actions so that it does not make a policy mistake and raises rates too high, too quickly and cause a financial "crack" and a deeper than anticipated recession.

The U.S. economy is different today than it was in the nineteen seventies when the U.S. last experienced high inflation. Today the lower percentage of union workers with cost-of-living clauses in labor contracts and much more global competition should make inflation easier to "tame" as demand slows, and supply chain disruptions disappear. Also, as mentioned in a previous ***Market Update*** the U.S. economy is far less dependent on manufacturing that it once was and thus the time required to shut down, lay off, rehire, and then restart is minimal. Quick and decisive action by the Fed in analyzing economic data will be the key to achieving a "soft landing," maintaining an important level of employment, and not undermining corporate earnings growth. We monitor these factors intensively.

Our Thoughts and Actions

Market corrections are difficult to endure, but not unusual. Since 1980 there have been corrections of 10% or more during twenty-three (55%)[xi] of those forty-two full years and yet the compound annual rate of return of the S&P 500 (including dividends) was +12.16%[xii]. Looking at shorter periods beginning from 2000 and 2010 the annualized rates of return were +7.56% and +14.89%[xiii]. Those periods too included years that experienced declines of 10% or more during the year.

We believe that the key to investment success is staying disciplined and avoiding trading in and out of the market. We think that the current uncertainty provides opportunities, the challenging factors will be rectified, and those with patience and discipline rewarded. We do not believe a recession will be a significant one, that inflation will begin to slow more quickly and that stocks will rebound from current depressed levels as clarity on the low in economic activity and the level of terminal interest rates become clearer.

As we described in the last ***Market Update***, we reduced stock holdings on multiple occasions last year to keep portfolios within asset category guidelines and consistent with client objectives. During the past several months we have modestly added to existing stock holdings at what we believe are attractive values. During this period, we have continued to add to portfolio holdings of short-term floating rate bond investments to reduce volatility and benefit from rising interest rates. We will continue to be disciplined and take advantage of opportunities to further enhance the quality and capital appreciation of portfolios.

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As always, thank you for your confidence, particularly during this volatile period. Our focus is always on managing your assets with a longer-term perspective and discipline and to adhering to a philosophy that avoids reacting to extremes. Our goal is to achieve attractive *real* rates of return, over reasonable periods of time.

We highly value our relationship and friendship and look forward to any questions, comments, or critique. We also look forward to seeing you soon.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

Diversification and asset allocation do not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

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The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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[i] FactSet Research Systems, 10/23/2022
[ii] Barron's Magazine, 10/24/22 edition
[iii] Barron's Magazine, 10/24/2022 edition
[iv] Barron's Magazine, 10/24/2022 edition
[v] U.S .Bureau of Labor Statistics, 10/02/2022 data release
[vi]U.S. Bureau of Labor Statistics, 10/02/2022 data release

[vii] Federal Reserve of St. Louis, 10/23/2022
[viii] National Bureau of Economic Research, 8/15/2022
[ix] Bureau of Labor Statistics, 10/02/2022
[x] FactSet Research Systems, 10/23/2022
[xi] Bespoke Investment Group, 10/20/2022
[xii] Stern School of Management, New York University, 10/23/2022
[xiii] Stern School of Management, New York University, 10/23/2022