Market Commentary – Third Quarter 2022

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2021 was the worst year for the broad-based bond market since 1994. At that time, the Federal Reserve Chairman Greenspan hiked short-term rates by 300 basis points (one basis point is equal to 0.01%). This year, the Federal Reserve Open Market Committee (FOMC) has increased short-term rates by approximately 2.75% so far this calendar year, with an expectation that the Fed Funds rate will end the year north of 4%. This will make the current 12-month portion of the tightening cycle the fastest, highest series of hikes since the late 1980s. The good news, if you want to take it that way, is that even if interest rates rise another 1–1.5% on the short end of the yield curve, current bond coupons are high enough that bond investors should be able to earn positive returns—even if not very positive.

Sharply higher interest rates are also weighing heavily on the stock market as the market frets over when and if we will fall into a recession.

When coupled with revenue and/or earnings shortfalls caused by higher costs and continued supply chain disruptions, equity markets have had a very difficult time, falling into bear market territory for the fourth time this century.

The Full Volcker

Federal Reserve Chairman Jerome Powell has done a hard about-face over the last 12 months as he has gone from a distinctly dovish stance regarding inflation and interest rates to one that is being described as *the full Volcker*. (For those of you not old enough to remember, the late Paul Volcker was the chairman of the Federal Reserve credited with breaking the back of inflation in the 1980s.) Much like his 1980s predecessor, Chairman Powell now seems bent on resurrecting the focus on curtailing inflation even if it means pushing the economy into recession. Indeed, the beginning of the second paragraph of his remarks made at the annual Jackson Hole economics symposium stated as much. “The Federal Open Market Committee’s (FOMC) overarching focus right now is to bring inflation back down to our 2 percent goal.” Lest markets were unsure as to his intent, it was repeated in the body of the FOMC’s statement announcing an increase to its Fed Funds rate by 75 basis points to a range of 3–3.25%.

A couple of things may stand in the way of reducing inflation to its 2% target. First, as we have pointed out in previous commentary, the inflation of the 1970s and ‘80s was, in our mind, driven by demographic trends. In other words, the fact that the Baby Boom generation, at the time the largest in history by quite a large margin, was entering into the jobs market, forming households, having babies and demanding more *stuff*. You can’t have demographically driven demand coupled with relatively limited supplies of *stuff* without impacting pricing.

That’s Economics 101: If demand rises and supply remains constant, the price must rise to bring supply and demand into balance.

Yes, we understand that relatively unconstrained money supply growth was the culprit, but that money supply growth was driven by demand from the Baby Boomers.

Fast-forward to today. Money supply has, indeed, grown at unprecedented levels thanks in large part to government transfer payments intended to make up for lost income and revenues due to the COVID pandemic. A good chunk of those transfer payments went to the purchase of *stuff* as consumers hunkered down.

As factories closed worldwide and inventories were being sold to feed consumer demand, inventories were not being replenished and/or raw materials and parts were not being *produced or replaced. Boomers are no longer the largest demographic in the economy.*

That designation belongs to the Millennial generation. However, relative to the entirety of the labor force, Millennials do not represent as large a percentage of the labor force as the Baby Boom generation did at the same point in history (Boomers, as 16–34-year-olds, represented at their peak more than 50% of the labor force, whereas Millennials represented just about 40% of the labor force [see charts below]). The demographics just don't exert the same kind of demand pressures as they did in the 1970s and '80s. As a result, we don't believe that simply shutting down demand through higher rates will allow the Fed to get inflation back to a stable 2% level. Indeed, in his Jackson Hole comments, Chairman Powell stated that, ". . .in my view, that the current high inflation in the United States is the product of strong demand and constrained supply and that the Fed's tools work principally on aggregate demand." In other words, FOMC rate actions will have little impact on the supply side of the economy. In fact, in our view, higher rates make certain projects less attractive from a capital allocation standpoint and could actually reduce the investments necessary to bring supply back into balance by building more capacity.

Higher rates are already having a pretty significant impact on one area of the economy: housing. Last quarter we spoke about the problem of housing affordability and that rising rates were reducing affordability from both a purchase and rental perspective. With 30-year mortgage rates up more than 1.5% just since our last commentary, the payment on a 30-year mortgage for a median priced home ($428,000, as of our last commentary) has risen by more than 20% to $2240.41. (The example assumes a 20% down payment on the median priced $428,000 home, and a 30-year mortgage at median national rates of 5.1% and 6.82%, respectively.) This is having a noticeable effect on home sales, with month-over-month pending home sales down 2% in August and year-over-year pending home sales down more than 22%.

Events

Exogenous events are also having an impact on pricing and won't be impacted by rising interest rates. The war in Ukraine has certainly had an impact, particularly on energy prices. The reduction of Russian energy (oil and natural gas) has also impacted food production since natural gas is the primary raw material used in the production of anhydrous ammonia, which is used as a nitrogen fertilizer. As if Russian sanctions weren't enough, mysterious explosions on the Nord Stream Pipeline have further reduced the supply of natural gas to Europe, causing even higher natural gas prices and shutting down ammonia production plants, further reducing the available supply of nitrogen-based fertilizer and increasing prices.

Energy prices came down over the summer as demand for heating fuel lessened and the markets adjusted to more normal demand patterns outside of the Euro zone.

Indeed, declining energy prices have been a large contributor to the decline in inflation since June.

While consumers have certainly seen some respite from high gasoline prices as gasoline has fallen below $4 per gallon nationally, it remains well above the price from a year ago ($3.832 per gallon for the week of September 26, 2022 vs. $3.21 per gallon one year ago).

Some troubling news has come to the fore that we expect will cause prices to do an about-face. OPEC and Russia have recently announced that they have agreed to cut oil production by 2 million barrels per day to prop up oil prices.

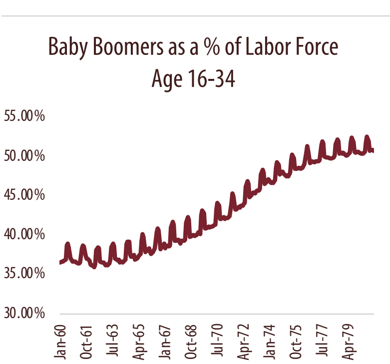
Though prices have dropped by 25% since June, the winter heating season would tend to push them higher.

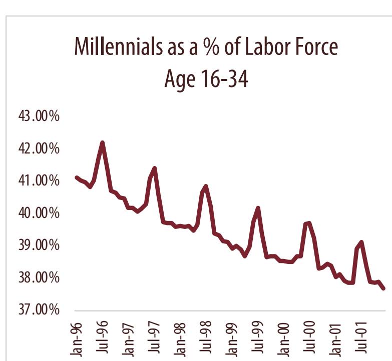
The announced production cut should accelerate that seasonal change. As we stated last quarter, higher energy prices act like a tax—particularly for the lower half of the income spectrum. This could well put a damper on consumer spending over the last third of the year and into 2023.

The Economy

The likelihood of recession is increasing. Indeed, based on what the media has used as a recession proxy (two successive quarters of negative GDP growth) we could be in a recession as second quarter GDP recorded a decline of 0.6%. This is on top of a 1.6% decline for Q1. Will we go farther from here? Possibly, though Q3 is still trending toward a positive print with the Atlanta Fed's GDPNow forecast pointing toward a reasonable 2-plus percent growth rate.

While the GDP Nowcast is often wide of the mark, what is interesting to note is that it is now significantly above the Blue-Chip





consensus estimates for Q3. (The Blue-Chip survey is a monthly economic survey put forth by Wolters Kluwer that polls America's top business economists about their forecasts of US economic growth, among other items.) We believe that Q3 will be positive, but not necessarily by much.

While it seems clear to us that we have thus far avoided a recession, our stance was bolstered by Federal Reserve Governor Christopher Weller at the 17th annual Vienna Macroeconomics Workshop on September 9. In his remarks, he stated, ". . . I think the argument that we entered a recession in the first half of the 2022 has pretty much ended—we didn't." Will we slip into recession during the back half of the year? Again, while the odds of a recession have certainly increased, we don't think it is likely to occur in the current calendar year. Let's look at the reasons why.

If we look at the spending components of GDP, we see that spending seems to be holding up and confidence seems to have bottomed. While it is possible to see both items turn down, and indeed we would not be surprised if that happens, it likely won't be enough to put a damper on the consumer portion of GDP. That said, sharply higher interest rates have pushed up mortgage rates to levels not seen this century, reducing housing affordability and (as stated earlier in this commentary) reducing new and existing home sales.

Business spending also seems to be holding up, with inventories continuing to build and capacity utilization as strong as it has been since 2018. Where we still see some issues, oddly enough, is in the continued strong labor market.

Businesses simply can't find enough people to fill open positions, and while the spread between job openings and unemployed people has narrowed from a peak of around two job openings for every unemployed person, it is still wide by historic standards (1.6 jobs for every unemployed person).

We strongly believe that we can't get a typical recession without significant deterioration in the employment situation. Bolstering that view, in our opinion, is that the quit rate continues to trend well above the 4 million number, with the most recent reading being 4.16 million. If quits continue to run strong, and as long as there remains a positive gap between the number of job openings (currently more than 10 million) and unemployed persons (currently just over 6 million), the economy should continue growing—even if it's not very fast.

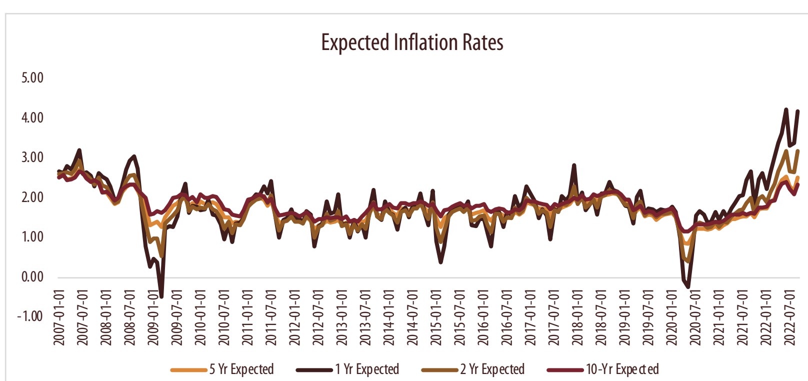
Interest Rates

The trend is still higher, at least on the short end of the yield curve. As indicated at the beginning of this commentary, Fed Funds now sits at a range of 3–3.25%. When does the FOMC stop the current hiking cycle? According to the dot-plot, it looks like the cycle will end sometime in 2023 at a terminal rate of 4.5–4.75%. Why so high and might things go higher? That really depends on several things, not the least of which is the expectations for future inflation. Indeed, Fed Chairman Powell indicated as much in his Jackson Hole speech. The public's expectation of future inflation was the second of three lessons that he stated were learned during the Great Inflation of the 1970s and 1980s. As you can see from the chart below (Source: Federal Reserve Bank of St Louis FRED Database), expected inflation rates out 1, 2, 5 and 10 years are well above the Fed's long-term target of 2%.

How high will the FOMC go? Well, that depends. While the dot-plot seems to indicate a range of 4.5–4.75%, the FOMC will keep tightening until the job is done—which could be higher or lower than the current dot-plot indicates. Indeed, Fed Chairman Powell said as much in his Jackson Hole remarks. He quoted former Fed Chairman Paul Volcker (which is why the markets think that Powell has gone "full Volcker") stating, "Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations." He followed that statement with the third lesson learned from the Great Inflation: "we must keep at it (raising rates) until the job is done."

Market Overview

It has been ugly this year. When the best non-cash asset class provided a -4.52% return, you know it's been bad. Even though equity securities have provided double-digit negative returns, fixed-income investors haven't fared much better. Every fixed-income asset class with a maturity beyond five years also saw double-digit losses. We fully expected negative returns from bonds for the current calendar year, simply because when starting at zero, there was virtually no interest rate scenario that would have



resulted in positive bond returns. However, no one could have foreseen the degree to which interest rates have risen and are expected to rise. We had thought it likely that rates would end the year north of 2.5%, and we were really thinking of a terminal rate for the calendar year of closer to where we are now. We, and everyone else for that matter, have been wrong. We now believe that Fed Funds will end the year between 4% and 4.25%, with the ultimate terminal rate dependent on expected inflation. While the dot-plot seems to indicate a range of 4.5–4.75%, if expected inflation won't move down, then it could well go higher.

Longer-term rates have been modestly inverted between 2- and 10-years, but have not yet broached a Fed Funds (90-day T-Bills) to 10-year inversion. We don't expect that to happen in the current calendar year. Assuming the FOMC does as expected and raises rates to around 4% by year-end, we could well be closer to a Fed Funds to 10-year inversion. At that point, the likelihood for a recession increases.

Equities have shown significant volatility so far this year. While equity returns have certainly been rough, the Chicago Board Options Exchange Volatility Index (VIX) has seen significant volatility, whipsawing between a range of 16.6 on the low side to north of 35 on the high side, with the general trend being higher. Indeed, the VIX has not sustained these levels since the period that encompassed the Great Recession and its fallout.

As interest rates have risen, equity markets have continued to slide over concerns that rates will go still higher, resulting in lower equity valuations due to higher discount rates. (In general, the higher the discount rate, all else equal, the lower the value of an asset.)

While all domestic equity indicis are down by double-digits through the end of the third quarter, value stocks have provided some relative protection from the storm.

Domestic Value indicis are down between 3% and 7% less than the broad market benchmarks (the S&P 600 SmallCap Index down 23.16%, S&P 400 MidCap Index down 21.52% and S&P 500 down 23.87%). With value providing better performance than the broad-based benchmarks, this infers that growth indicis are worse than the broad indicis by a similar amount.

What some pundits have termed the "Magnificent Eight" or "Mega Cap Eight" have been particularly hurt in the current selloff. Those stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA and Tesla), which represented approximately 27% of the S&P 500 by market cap as of late 2021, still represent more than 23% of the index—even though they have lost more than $3 trillion in market cap collectively, or more than 27%. Even more disturbing (in our mind) is that those eight stocks represent nearly 47% of the S&P 500 Growth Index as of 9/30 (Source: Yardeni.com, "Stock Market Briefing: The MegaCap-8," September 30, 2022).

Market Outlook

As we have been saying from the beginning of this commentary, the Fed Funds rate will continue to go higher. How much higher isn't as important as that we have already gone higher so far this year than we have left, in our view, to the top. Even if we get another two percentage points of rate hikes, which we also view as unlikely, we have been through the worst part of the interest rate storm.

We have shown the chart below before when we were concerned that there was very little likelihood for positive returns from any fixed-income asset class. As you can see from the current version of the chart, even if interest rates were to climb an additional 2%, shorter-term bonds as defined by Bloomberg Barclays benchmarks with three years or less maturity are able to generate positive returns. Even longer-term bonds, as defined by Bloomberg Barclays indicis with longer than three years to maturity, show only very modest declines if rates only rise by an additional percent. While returns certainly aren't exciting and don't beat cash, it is a dramatically better outlook than we have had for at least a year and a half.

For what it's worth, we are modifying our expectations for rates. Even though we had indicated the likelihood of rates going through our targets at points during the year, we believed that they would come back down to our modified targets. We no longer think that will be the case. At this point, we believe that Fed Funds will likely end the year at 4%, the 10-Year Treasury will end at 3.90% and the 30-year at 3.85%. Yes, we understand that this means a modestly inverted yield curve and, yes, we understand that a yield curve that has inverted from Fed Funds to the 10-year often indicates the likelihood of a recession. It just won't happen this year. . . in our opinion.

Barring any unforeseen dislocations, we don't see equity markets declining meaningfully from current levels.

With domestic equity markets down double-digits through the first nine months, we would expect continued volatility, but also believe that equity markets will likely end the year roughly where they are currently.

Of course, we do have midterm elections coming up and that could certainly change the calculus, but we don't really see any other major hurdles or potholes on the horizon.

Strategy Overview

We believe that downside risks relative to upside potential have moderated substantially and prudently increasing

Index/Security	YTW	Duration	Time to Maty	Rates 1% Up Return	Rates Flat Return	Rates 2% Up Return
Bloomberg Barclays US TR T-bills 1–3 Mo	3.28%	0.28	0.29	3.00%	3.28%	2.72%
Bloomberg Barclays 1–3 Yr US Gov't	4.20%	1.92	2.00	2.28%	4.20%	0.36%
Bloomberg Barclays 1–3 Yr US Gov't/Credit	4.42%	1.93	2.03	2.49%	4.42%	0.56%
Bloomberg Barclays US Corp 1–3 Yr	5.11%	1.95	2.10	3.16%	5.11%	1.21%
Bloomberg Barclays US Agg Intermediate	4.52%	4.60	5.58	-0.08%	4.52%	-4.68%
Bloomberg Barclays US MBS Index	4.63%	5.95	8.02	-1.32%	4.63%	-7.27%
Bloomberg Barclays US Agg	4.58%	6.28	8.59	-1.70%	4.58%	-7.98%
Bloomberg Barclays US Tsy	3.00%	6.43	7.86	-3.43%	3.00%	-9.86%
Bloomberg Barclays Global-Agg	3.99%	6.21	7.74	-2.22%	3.99%	-8.43%
Bloomberg Barclays US Agg Gov/Credit	4.55%	6.48	8.94	-1.93%	4.55%	-8.41%
Bloomberg Barclays Global Aggregate Corp	4.95%	6.22	8.90	-1.27%	4.95%	-7.49%
Bloomberg Barclays US Corp	5.48%	7.22	11.15	-1.74%	5.48%	-8.96%
Bloomberg Barclays US Agg Baa	5.80%	7.20	11.45	-1.40%	5.80%	-8.60%
Bloomberg Barclays US Treasury 20+ Year	3.88%	17.67	25.93	-13.79%	3.88%	-31.46%

exposure to risk assets makes sense. We still believe that short-duration assets will outperform long-duration assets, and don't foresee that dynamic changing any time soon. However, we really believe a quote from Nathan Rothschild a 19th-century British financier and member of the Rothschild banking family, when he said, "the best time to buy is when there's blood on the streets." Often, when markets go through extreme periods of duress, quality assets are frequently disposed of at prices that offer compelling opportunities. To put it another way, we should be greedy (buy) when others are fearful and fearful when others are greedy.

Risk is not a dirty word. It is something that should be observed and understood.

In that way, we may find opportunities that others overlook.

We believe that by taking a little extra time to fully understand what is happening in the economy and the market, we can help avoid bad surprises and identify situations where risks have either been overpriced or where the potential downside may be relatively limited.

Gauging appropriate valuation and purchase prices relative to risks taken has always been and will always be our primary focus.

Linking investment decisions to something tangible like the cash-generating capabilities of a business or investment, and assuming a minimum acceptable rate of return for each decision, should add value.

Elevated risks should translate into higher return requirements and lower valuations, all else equal.

Looking at investments, as would any rational person, helps us focus on the things that are the most important: return of and return on capital invested.

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