***FROM THE DESK OF BOB CENTRELLA, CFA*** ***October 11, 2022***

As I sit down to write this Outlook and review letter, I must admit I am struggling to find words to put down on paper that make sense out of what we've been through and where we are going. There is no question that this has been a confounding and challenging time for the markets (and us) and unfortunately, I think it will stay so in the near term. As you review your statements try to remember that we do have a long-term plan and yes this is a short-term hit to those plans, but we can get through this and back on track in time. I can rehash all the bad news we just endured, the past month especially, but it won't change a thing. So, for this letter I am going to give you some numbers to show how bad it's been and then spend a bit more time talking about where we might go from here. Overall going forward, we are in a wait and see mode as to where we go in the near-term and are very data dependent. The quarter just ended pretty much followed the pattern of volatility we've seen since September of last year when this all started. The bear is loose, and we can't keep him in the cage. Here are the monthly returns since last September for the S&P 500:

| | | | |
|---|---|---|---|
| Sept 21 | -4.65% | Apr 22 | -8.72% |
| Oct 21 | 7.01% | May 22 | 0.18% |
| Nov 21 | -0.69% | Jun 22 | -8.25% |
| Dec 21 | 4.48% | Jul 22 | 9.22% |
| Jan 22 | -5.17% | Aug 22 | -4.08% |
| Feb 22 | -2.99% | Sep 22 | -9.21% |
| Mar 22 | 3.71% | | |

A look at the monthly returns shows consistent selling with the occasional dead-cat bounce that only lasts a month then back to selling. Only 5 of the last 13 months are positive and other than the false July rally, the selling has intensified since April of this year. There has been a buyer's strike and the buy the dip mentality has been replaced with sell the rally. For the quarter the S&P 500 declined 4.93%, the Barclays Bond Aggregate which generally offers some protection, dropped 4.7% and the All-World Index (ex-US) swooned a whopping 11.1%. Year-to-date the S&P 500 has returned -24%, the Barclays Bond Index -14.4% and the World Index -26.8%.

A look at asset class returns for the quarter shows very few places to hide.

| ***Asset Class*** | ***% Rtn*** | ***Asset Class*** | ***% Rtn*** | ***Asset Class*** | ***% Rtn*** |
|---|---|---|---|---|---|
| Nymex Nat Gas | 24.7% | FTSE Italy | -3.0% | Comes Silver | -6.5% |
| Bovespa Brazil | 11.7% | IShares Muni | -3.6% | US 7-10 Yr bond | -6.2% |
| US Dollar | 6.7% | Vang Intl Bond | -3.7% | Japanese Yen | -6.2% |
| Orange Juice | 6.5% | FTSE 100 | -3.8% | Euro | -6.5% |
| Wheat | 6.0% | Nasdaq 100 | -4.6% | Dow Jones Ind Avg | -6.7% |
| Tel Aviv 35 | .46% | Euro Stoxx | -4.7% | Copper | -7.3% |
| Nikkei Japan | -1.7% | Coffee | -5.2% | Russian Ruble | -8.6% |
| US 1-3 Yr Treas | -1.9% | Vang Tot Bond | -5.2% | SP 500 Real Estate | -11.7% |
| Russell 2000 | -2.5% | German Dax | -5.2% | Hang Seng | -21.2% |
| CAC France 40 | -2.7% | S&P 500 | -5.3% | Nymex Crude | -24.8% |
| SP Midcap 400 | -2.9% | SP Sm Cap 600 | -5.6% | Nymex Gasoline | -32.3% |

On a sector basis for the quarter, Consumer Discretion was up 4.1% and Energy +1.2%. On the downside, Real Estate dropped -11.7%, Materials, -7.6%, Consumer staples -7.2%, Utilities -6.7%, Technology -6.4%, Health Care -5.6%, Industrials -5.1% and Financials -3.6%. Small Cap (-2.5%) and Mid Cap (-2.9%) outperformed Large Cap (-5.3%) while Growth outperformed Value across all cap sizes.

## KEY TAKEAWAYS LOOKING AHEAD

Last quarter I gave you my arrow map of what is going on in the market. It is still pretty much the same. ***High inflation is triggering → aggressive Federal Reserve rate increases and tightening monetary conditions, this will hopefully reduce inflation but also → slow economic growth, which will in turn → lead to a recession, which means → lower corporate profits and lower earnings for the stock market***. But now we also have a new twist where good news is bad news and bad good on the economic front. For instance, stocks shot ahead to start October rising 6% in 2 days only to come crashing back as stronger economic data (good news) was seen as bad because the Fed would have to stay aggressive in raising rates. Market participants are almost rooting for bad economic news so the end of fed tightening (good) will occur. Here are some key takeaways as we look ahead:

1. The Risks causing high market volatility are likely to persist, but our call for a milder recession still stands for now. When does the market fully factor in a recession view?
2. Inflation is the single biggest factor affecting the market and world economies as global central banks raise rates to fight it off.
3. Market valuation is getting more attractive as the S&P 500 now trades at 15.8x forward earnings, about equal to the 20-year average. However, the Earnings side of the PE (Price/Earnings) equation might need to come down further thereby making stocks more expensive than they seem.
4. Bond returns are not good either YTD but bond yields above 4% are now an attractive alternative sending our girlfriend TINA (There is No Alternative) on her way. We prefer laddering short-term bonds 1 to 1.5 years as the curve inverts after 5 years. FYI, inverted curve points to a recession and is 13 of 13 in predicting recessions.
5. We've had 4 bear market rallies in 2022 (Jan, March, May, July) with the last lasting almost 2 months (end of June to mid-August). October has been known to be the bear market killer month having ended 8 bear markets in the past. We seem to be due at least for another bear market rally. Will it come and will it last?
6. The US Economy is showing mixed signals but seems to be slowing. Unemployment just fell back to 3.5% the lowest since 1969. ISM services and manufacturing indexes are still in expansion territory but falling. Housing is showing definite signs of slowing due to high (7%) mortgage rates. Overall, the US GDP is tracking at around 3.0% growth in Q3.
7. The Fed has raised rates 300 basis points in the last 7 months (3x normal). It signaled that it will not slow down rate hikes very soon and there is a 95% expectation that they will raise rates another .75% in early November. The target Fed funds rate is currently 3.0-3.5% with a goal of 4.5% early 2023.
8. Mid-term elections in November could help rid the market of some uncertainty. Seasonally, markets tend to do better after the elections. I won't predict who will win R or D, but the pervasive view seems to be gains by the R's would be perceived positively by the market. Gains by the D's might not be perceived negatively so to speak, but the thought of more spending plans in the face of inflation could spook markets.
9. Corporate profit reports starting this week will begin to provide a better picture of how companies are dealing with inflation and the cooling economy.
10. Bearish sentiment is at its highest level since 2009 according to the AAII poll. Everywhere you look doomsday forecasts are abounding. On a contrarian note, this could at least set the markets up for a relief rally at some point at the hint of any positive news.

## SUMMARY

**Don't fight the Fed**. That continues to sum up what the markets are saying. As far as financial markets are concerned it is all about inflation, rate increases, and recession or not. In July when we saw a rally, the narrative was that the Fed was about to pivot and slow down rate increases thereby avoiding a recession. The "Pivot" hopes were dashed with the 8.3% CPI August inflation report and further jawboning by the Fed has produced a consensus that the Fed will continue to aggressively raise rates. Will they overshoot and cause a recession and if so, how severe?

What to do here? First, buying bonds yielding at or above 4% these past few months and going forward will at least protect principal while delivering a nice return (albeit below inflation). We prefer laddering maturities so you can take advantage of rising short-term rates. If yields approach 5%, then bonds get much more attractive. Second, we still prefer investing in the US as Europe and international economies have their own problems and are also battling the same demons as well as having an even greater energy crisis due to the ongoing war. Third, raising cash even in the face of a 20% down market is not likely to hurt until some more stability returns to markets. But investing for the long-term is still a great plan. We've been through bear markets before. They are painful, but eventually they end and historically have led to excellent investment opportunities. To show that there is some potential good news out there below I present this chart with some facts on bear markets.

## Recoveries have been strong

Five biggest market declines and subsequent five-year periods[1]

**1929–2019**

| Periods of decline | Decline[3] | S&P 500 12-month returns[2] (Positive periods (23); Negative periods (2)) 1st year after low | 2nd year | 3rd year | 4th year | 5th year | Average annual total return for the 5-year period | Value of a hypothetical $10,000 investment at the end of the 5-year period |
|---|---|---|---|---|---|---|---|---|
| 9/7/29–6/1/32 | -86.22% | 137.60% | 0.52% | 6.42% | 56.68% | 16.52% | 35.93% | $46,401 |
| 3/6/37–4/28/42 | -60.01 | 64.26 | 8.96 | 31.08 | 32.19 | -19.89 | 19.96 | 24,841 |
| 1/11/73–10/3/74 | -48.20 | 44.43 | 25.99 | -2.86 | 11.79 | 12.82 | 17.39 | 22,293 |
| 3/24/00–10/9/02 | -49.15 | 36.16 | 9.91 | 8.51 | 15.11 | 18.06 | 17.15 | 22,067 |
| 10/9/07–3/9/09 | -56.78 | 72.29 | 18.08 | 6.10 | 15.74 | 23.65 | 25.30 | 30,890 |
| Average | | 70.95 | 12.69 | 9.85 | 26.30 | 10.23 | 23.15 | 28,322 |

[1] Market downturns are based on the five largest declines in the S&P 500's value (excluding dividends and/or distributions) with 50% recovery after each decline.

[2] The return for each of the five years after a low is a 12-month return based on the date of the low. For example, the first year after the most recent decline displayed is the 12-month period from 3/9/09 to 3/9/10.

[3] The percentage decline is based on the index value of the unmanaged S&P 500, excluding dividends and/or distributions.

The average annual total returns and hypothetical investment results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or taxes. Investors cannot invest directly in an index. Past results are not predictive of results in future periods. The Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks.

Sources: Capital Group, Standard & Poor's.

The biggest issue is we don't know when the bear will end. Hopefully we don't get to the largest declines above as we would have a way to go. But the point is that patient investors have been rewarded after downturns. In fact, since the great depression in 1929, every decade has had a major decline in the S&P 500, and in every case the 5 years following have delivered on average, positive returns.

In sum, volatility is likely to continue and stock and sector selection for equities is of paramount importance. Dividend stocks, Health Care and somewhat more defensive companies are preferred but I still like the barbell approach of owning good growth companies on the other side for the long haul. I wouldn't commit new money to equities en masse but over the next few weeks during earnings season there might be some compelling opportunities due to over-reactions to weak earnings. In closing, my thesis of being cautious near-term but still optimistic long-term is intact.

***Have a great Fall and Winter and I'll be reaching out to see if you want to talk live.***

***Bob***