Quarterly Playbook

4th Quarter 2022

Current Financial Planning and Investment Themes

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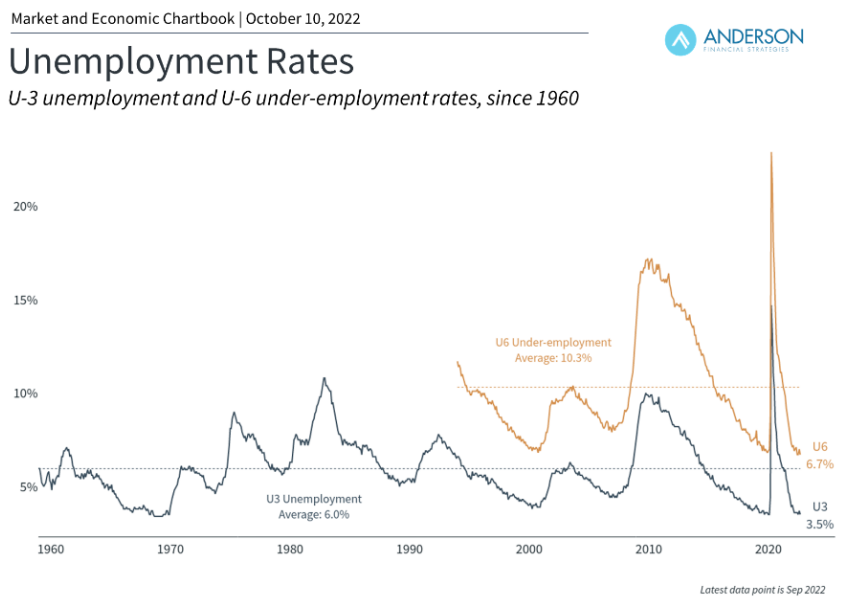
"Weathering the Storm"

We have been in the middle of an unavoidable squall, which keeps showing glimpses of calmer waters, but then pulls us back into the eye of the storm. However, it appears that the conditions may be starting to break and we just need to make our way through it. We will be looking for opportunities, but sometimes the best strategy is to wait for the storm to clear. We certainly don't want to drop anchor (go to cash and lock in current levels), but we also want to be patient before raising the sails (rebalance into more risk) …

US Economics



Unfortunately, so far this year, good news for the economy has been bad news for the markets. The economy is doing OK, and that's been the bad news. The Fed believes that the economy, specifically the jobs market, needs to weaken in order to reduce inflation. That really isn't happening. The September U-3 (official) unemployment rate improved to 3.5% from June's 3.6%, well below the long-term average of 6.0%. Additionally, the U-6 (broader definition including part-time) fell to 6.7% in September from the June rate of 6.9%, compared to the long-term average of 10.3%.

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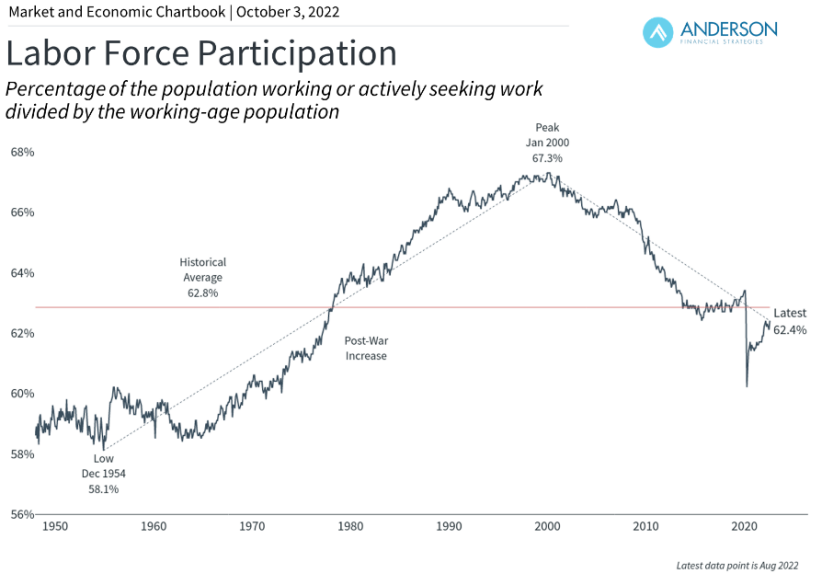
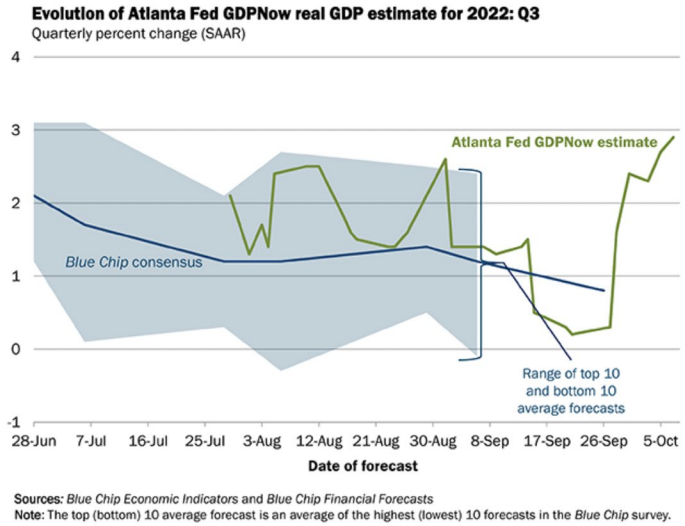
Additionally, the labor force participation rate strengthened up to 62.3% in September vs 62.2% in June. Improving labor force participation is a key ingredient in engineering the elusive "soft landing" in the economy because bringing more people into the labor market adds supply which lowers wage pressures – a major driver of inflation. Meanwhile, it appears the "short and shallow recession" may be over with the 3rd Quarter GDP estimate tracking at +2.9%, according to the latest GDPNow estimate. The Fed has been successful at slowing demand for a few major parts of the economy such as housing and autos. It has also been successful at crushing consumer confidence and household net worth. However, the household debt service ratio and consumer balance sheets still remain in good shape. Although, with the Federal Reserve spiking interest rates at a reckless pace, that may not last. For example, in less than a year, the rate on a 30-year mortgage went from 3.14% a year ago to 6.70% today. So the economy is in an "in-between" state, where activity and fundamentals have held up OK, but financial conditions have tightened significantly, just as the Fed intended. Our hope is that the Fed can find a way to become "rational" and not overtighten into a deeper recession.





On October 7, the GDPNow model estimate for real GDP growth in the third quarter of 2022 is 2.9 percent, up from 2.7 percent on October 5. View GDPNow for more details.

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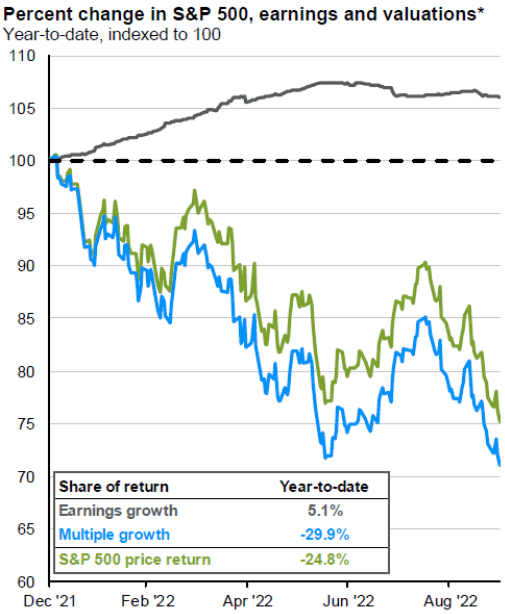
US Equity Markets

Year To Date Return

Size	Style: All	Value	Core	Growth
All	-23.7%	-12.2%	-22.4%	-36.2%
Large	-23.8%	-11.9%	-22.1%	-40.3%
Mid	-23.1%	-12.2%	-22.8%	-35.7%
Small	-24.7%	-15.2%	-23.2%	-35.3%

≥ 20% | -10% to 0%
10% to 20% | -10% to -20%
0% to 10% | ≤ -20%

To borrow a phrase from a friend, "sometimes you have to put up with the rain to see the rainbow". I think that is an excellent phrase to use with this stock market. We have certainly encountered "the rain" so far this year with steep stock market selloffs, especially in Growth and Small Caps. However, we are now into the 4th quarter and still have positive earnings growth and resilient earnings forecasts for the broad market indexes. So why such dismal performance? The answer is, we are still facing the same five factors that have caused investors to lose confidence and drive down the P/E multiple (the price paid for each dollar of earnings) by nearly -30% when looking at the S&P500. Those five factors are: 1. The Federal Reserve 2. Inflation 3. Recession 4. Supply Chain challenges 5. The ongoing war in Ukraine. These five factors haven't changed so far, but some are likely to in the near future. Let's talk about each of these factors. First off, the Federal Reserve is *talking* very recklessly, to the extent even the United Nations has called on the Fed to halt its interest rate increases. You are also starting to hear members of the Federal Reserve talk about "pausing" sometime later this year. That's all the stock market really needs! So far this year they have been driving the car at 100mph toward the cliff and saying "trust us, we will know when to brake". If the market hears "we've taken our foot off the accelerator," then that will be a big sign of relief. Our view is the market is pricing in a 3.5% Fed Funds Rate by year end, but the talk of 4.5% is a path over the cliff. Second, inflation has remained stubbornly high but is showing signs of moderating. While many are still adamant that inflation will be much lower in 2023. Third, the Recession fears have two dynamics: 1. The 3rd quarter is likely showing meaningful positive growth, ending the two prior consecutive quarters of negative growth. 2. There are fears that the Federal Reserve will go too far and cause a bigger recession in 2023, which is yet to be determined. Fourth, supply chain problems have been blamed for inflation and a hindrance to growing revenues, but recent data is showing signs of easing. According to the CME group, a few big indicators are that the Shanghai to LA shipping cost are near pre-pandemic levels and shipping costs for goods such as iron ore and coal have tumbled. Lastly, the ongoing War in Ukraine has no end in sight at this time, but there seems to be some signs of it being in a later stage. If there were somehow to be an armistice deal, markets would likely react very positively. So even though the five causes of the market's downturn have yet to change, it is likely some will, sooner than later….



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US Fixed Income

Market and Economic Chartbook | October 7, 2022

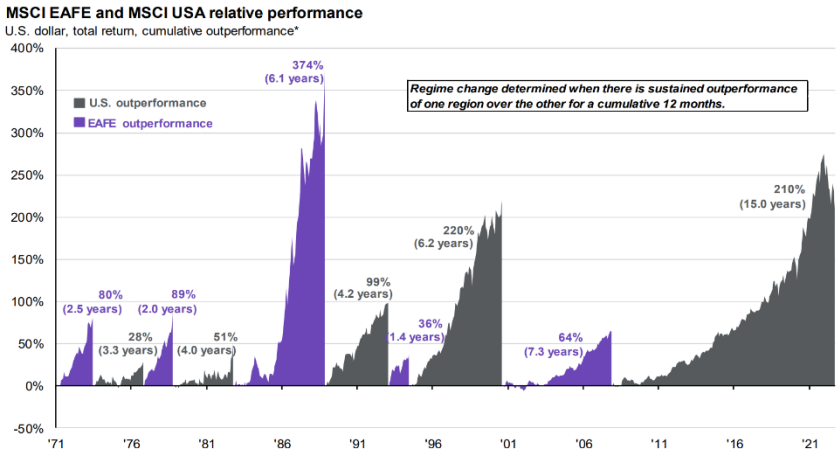
Fixed Income Performance

Annual bond sector total returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Treasuries 13.7%	High Yield 58.2%	EMD Local 15.4%	TIPS 13.6%	EMD Local 17.5%	High Yield 7.4%	Munis 9.1%	Munis 3.3%	High Yield 17.1%	EMD Local 14.7%	Munis 1.3%	EMD USD 15.0%	TIPS 11.0%	TIPS 6.0%	Munis -11.4%
MBS 8.3%	EMD USD 29.8%	High Yield 15.1%	Munis 10.7%	EMD USD 17.4%	MBS -1.4%	Corp 7.5%	MBS 1.5%	EMD USD 10.2%	EMD USD 10.3%	MBS 1.0%	Corp 14.5%	Corp 9.9%	High Yield 5.3%	High Yield -13.1%
Agg 5.2%	EMD Local 21.7%	EMD USD 12.2%	Treasuries 9.8%	High Yield 15.8%	Corp -1.5%	EMD USD 7.4%	EMD USD 1.2%	EMD Local 10.0%	High Yield 7.5%	Treasuries 0.9%	High Yield 14.3%	Treasuries 8.0%	Munis 1.5%	Treasuries -13.1%
TIPS -2.4%	Corp 18.7%	Corp 9.0%	Corp 8.1%	Corp 9.8%	Agg -2.0%	MBS 6.1%	Treasuries 0.8%	Corp 6.1%	Corp 6.4%	Agg 0.0%	EMD Local 10.1%	Agg 7.5%	Corp -1.0%	TIPS -13.2%
Munis -2.5%	Munis 12.9%	Agg 6.5%	Agg 7.8%	TIPS 7.0%	Munis -2.6%	Agg 6.0%	Agg 0.5%	TIPS 4.7%	Munis 5.4%	TIPS -1.3%	Agg 8.7%	High Yield 7.1%	MBS -1.0%	MBS -13.6%
Corp -4.9%	TIPS 11.4%	TIPS 6.3%	EMD USD 7.3%	Munis 6.8%	Treasuries -2.7%	Treasuries 5.1%	Corp -0.7%	Agg 2.6%	Agg 3.5%	High Yield -2.1%	TIPS 8.4%	EMD USD 5.3%	Agg -1.5%	Agg -14.4%
EMD Local -5.9%	Agg 5.9%	Treasuries 5.9%	MBS 6.2%	Agg 4.2%	EMD USD -5.3%	TIPS 3.6%	TIPS -1.4%	MBS 1.7%	TIPS 3.0%	Corp -2.5%	Munis 7.5%	Munis 5.2%	EMD USD -1.8%	EMD Local -16.0%
EMD USD -12.0%	MBS 5.9%	MBS 5.4%	High Yield 5.0%	MBS 2.6%	EMD Local -8.3%	High Yield 2.5%	High Yield -4.5%	Treasuries 1.0%	MBS 2.5%	EMD USD -4.3%	Treasuries 6.9%	MBS 3.9%	Treasuries -2.3%	Corp -18.1%
High Yield -26.2%	Treasuries -3.6%	Munis 2.4%	EMD Local -2.0%	Treasuries 2.0%	TIPS -8.6%	EMD Local -5.2%	EMD Local -14.3%	Munis 0.2%	Treasuries 2.3%	EMD Local -6.9%	MBS 6.4%	EMD Local 3.5%	EMD Local -9.2%	EMD USD -23.0%

Latest data point is Oct 6, 2022

The bond market has never in history experienced such miserable performance in such a short amount of time. Corporate Bonds are down 18.1%, and Treasuries are down 13.1% for the year. Again, this is all due to the Federal Reserve raising interest rates from nearly 0 to 3.25% since the beginning of the year. However, we are now seeing very attractive yields in fixed income which is something we haven't seen in more than a decade! So as painful as it was to get here, the forward looking return profiles for bonds are looking very favorable. Interestingly though, since the reason for the selloff was due to the precipitous rise in interest rates, the reverse can be possible if the Fed lowers interest rates next year as many are expecting.



International Markets

Earlier this year, we saw evidence of international markets being poised for outperformance in 2022. However the environment has changed dramatically with the rise in inflation and economic troubles, particularly in Europe. So, even with the valuation discounts provided by the market sell-off, it appears that the 15 year streak of US outperformance is set to continue for the time being. Relative valuations are still near a two standard deviation low when you look at the P/E ratio of the S&P500 vs the MSCI All-world ex-US index. We believe there is opportunity there once things change, but we don't see that happening anytime soon….

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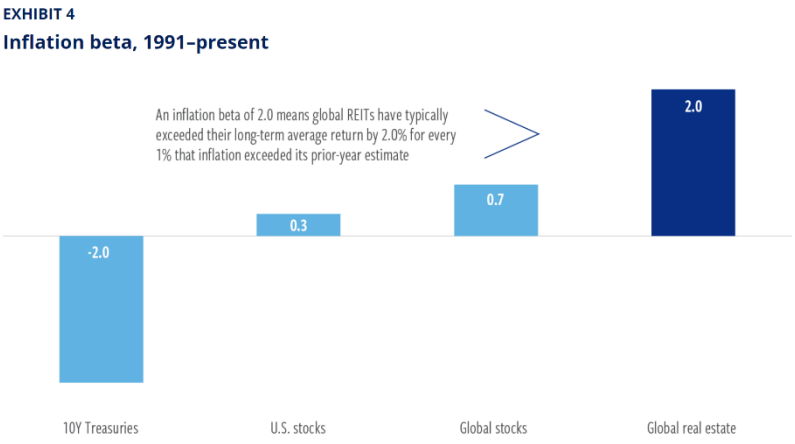
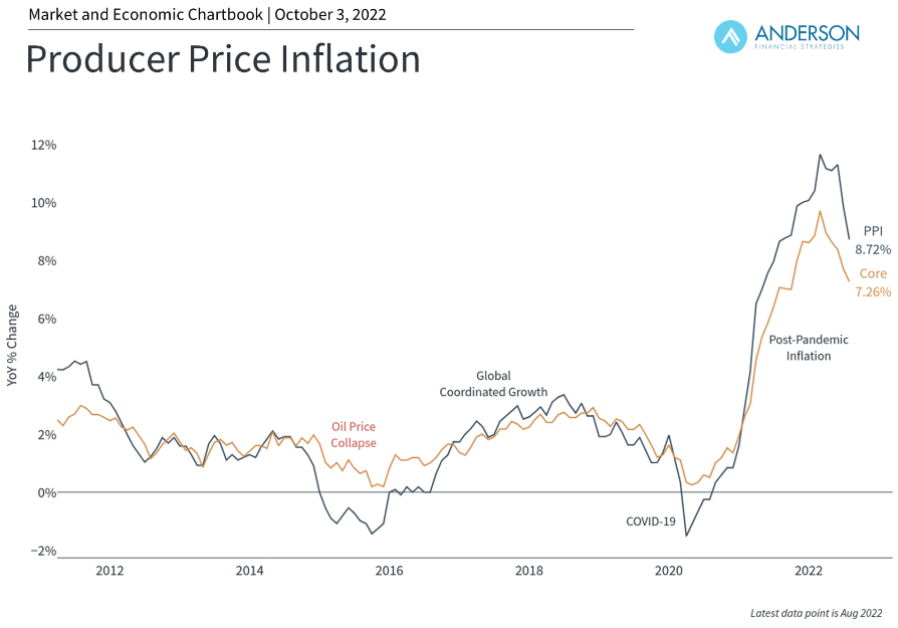
Real Estate

Rising interest rates have pummeled REIT pricing this year, especially in the most recent quarter. According to Morningstar, the Real Estate sector declined 9.5% just in the third quarter. Even though the current decline is primarily caused by interest rate increases, studies show that interest rates have little impact on longer term cash flows. Furthermore, as we have noted in the past, higher inflation provides a good opportunity for REITS to raise rents. When looking at longer term performance, global real estate has an inflation Beta factor of 2, meaning that for every 1% increase in inflation, REITS have outperformed by 2% according to Cohen & Steers research. So, while short term performance has suffered, REITS remain extremely attractive at this juncture.



Inflation, Interest Rates & the Fed



Inflation momentum has persisted much longer than nearly everyone has expected, including the Federal Reserve. It was approximately a year ago, the fourth quarter of 2021, that Jerome Powell ditched the word "transitory" when describing inflation. Even though we have seen some signs of the ingredients that add to the pace of inflation start to slow, reported inflation has only slightly come down. One leading indicator of inflation is the Producer Price Index that measures "the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services." Since this measurement is for the first transactions, it is considered a leading indicator.

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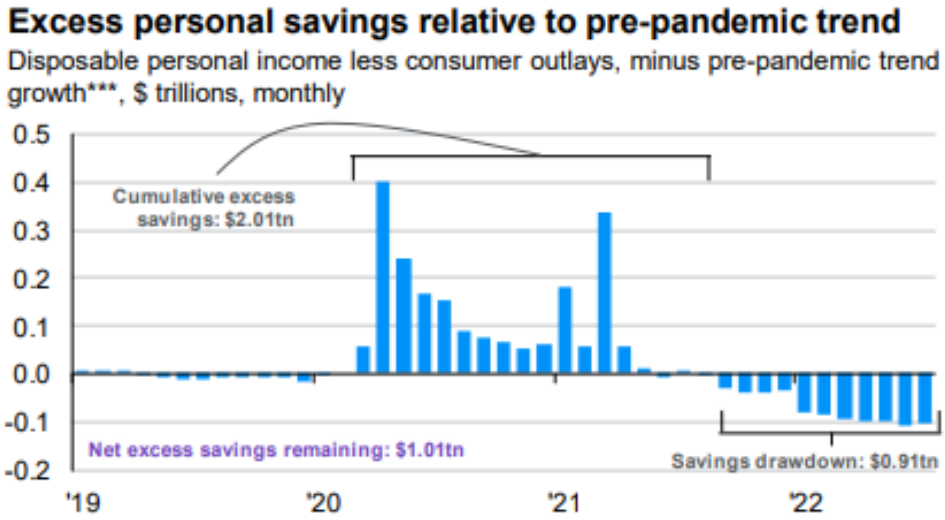
However, we have started following the Federal Reserve Bank of Cleveland's "Inflation Nowcasting" estimates which shows PCE remaining constant at 6.2% from August, Core PCE looks to be ticking back up slightly to 5.11% for the month of September from 4.9% in August. This is likely why the Fed provided yet another negative surprise to markets in September by raising the median projected Fed Funds rate by another 1% to 4.4% from 3.4% in June. In our view, 3.4% was reasonable and expected by markets, but 4.4% is much too far. We have very restrictive conditions in leveraged assets such as homes, autos, etc. The position that many, including the United Nations Conference on Trade and Development, is that the Fed and other Central Banks need to slow down and give the economy time to let the rapid pace of their interest rate hikes work their way through the system. In fact, the Fed has communicated their intentions to "front-load" rate increases early on, which many believe they have sufficiently done so. We believe there is a strong argument that financial conditions have tightened significantly, the Fed Funds rate is in restrictive territory, and at the very least future rate hikes (if any) should be more shallow than 75bps at a time. If the Fed just returned to 25bps hikes, the markets would soar! The problem is that the Fed is talking very recklessly and has eroded any trust and goodwill it may have had.

Percent

Variable	Median[1]				
	2022	2023	2024	2025	Longer run
Change in real GDP	0.2	1.2	1.7	1.8	1.8
June projection	1.7	1.7	1.9		1.8
Unemployment rate	3.8	4.4	4.4	4.3	4.0
June projection	3.7	3.9	4.1		4.0
PCE inflation	5.4	2.8	2.3	2.0	2.0
June projection	5.2	2.6	2.2		2.0
Core PCE inflation[4]	4.5	3.1	2.3	2.1	
June projection	4.3	2.7	2.3		
Memo: Projected appropriate policy path					
Federal funds rate	4.4	4.6	3.9	2.9	2.5
June projection	3.4	3.8	3.4		2.5



Meanwhile consumers have been hit with a double whammy as high inflation combined with high interest rates show sizable excess personal savings being drawn down by almost a trillion dollars, which also portends a decrease in inflation. This is further reasoning that the Fed needs to be careful not to cause excess savings to be completely exhausted.

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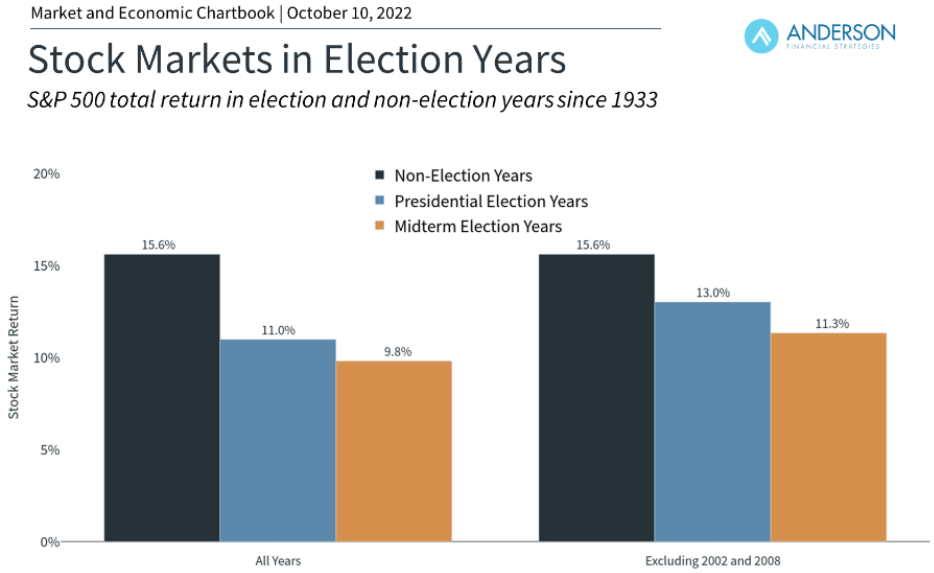
Legislative Affairs



At this point in the year, all eyes are on the upcoming mid-term election results. However, as we have pointed out in the past, just getting past the mid-term elections has major positive implications for the stock market. As you can see from the chart, non-election years are the best performing years by a large margin. Furthermore, it appears that there is likely to be some balance restored in Washington as the Republicans are very likely to take at least the House with only 218 seats needed and 220 seats solidly in their camp vs 180 for the Democrats (35 toss-ups) according to Real-Clear Politics. The Senate is more unclear as Republicans lead the Democrats by only 1 seat, 47-46 (7 toss-ups), again according to Real Clear Politics.

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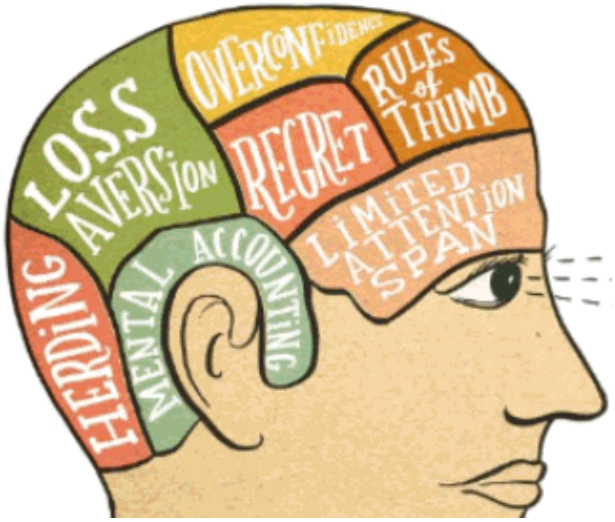
Financial Planning Corner

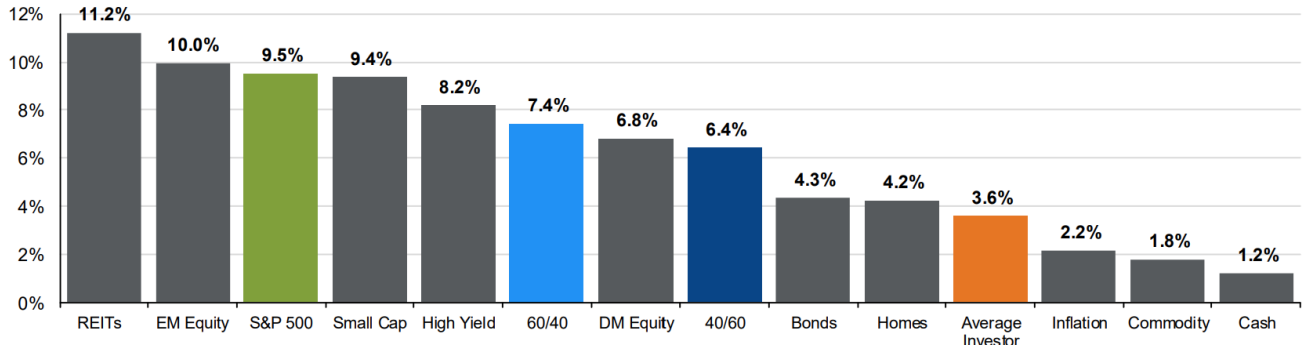


Examination of Your Financial Conscious

Various economic and investment environments, especially undesirable ones, can cause us to think differently when it comes to our finances. These varying thoughts are called "biases" and are a result of multiple influences in our lives. When it comes to investing there are several types of biases that can affect the way investors view their situation. We all have a lens that we view the world through and when it comes to finances, it is wise to be aware of common biases you may experience. These are not a fault of someone's character but rather a result of our human nature. Examining how these biases can affect your perspective can aid in understanding why you might feel less confident in your investing strategies from time to time.

Heuristics are mental shortcuts used to simplify and quickly reach a reasonable conclusion to complex issues. Gerd Gigerenzer and Wolfgang Gaismmaier, noted heuristic scholars, defined the word as "strategies that ignore part of the information with the goal of making decisions more quickly, frugally, and/or accurately than more complex methods". Our human nature is geared towards survival, so we all are predisposed towards making an immediate decision, which may not always be the right one. Below, we have highlighted some common investment biases due to our heuristic nature that we feel should be brought to investors' attention given the current market. As you can see in the chart by JP Morgan, over the last 20 years the average investor only earns a yearly return of 3.6% vs 7.4% for a basic 60/40 portfolio or 6.4% for a 40/60 portfolio. This can in large part be attributed to behavioral mistakes stemming from reacting to biases.

20-year annualized returns by asset class (2002 – 2021)



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- **Anchoring:** Tendency of investors to become attached to a value at a specific moment in time as the reference point. For example, you may judge an investment (or your account) based on a recent high or low point that you remember, rather than more standard benchmarks.

- **Inappropriate extrapolation:** Tendency to look at recent events (or market performance) and assume that those events or conditions will continue indefinitely. If an investor sees that one asset class is preforming better in poor market conditions, they may assume this will continue to do so and focus their investments in that market without substantial data to back up their assumptions. This bias is focused on a market level.

- **Loss of Aversion & Risk Taking:** While investors are risk averse when it comes to protecting gains (they do not want to give them up), they are risk seekers when it comes to losses (will take big risks to avoid realizing them). ***Many people feel it is more painful to lose 10% than pleasurable to gain 10%.***

- **Herd behavior:** Tendency for individuals to mimic the actions of a larger group. Sometimes also referred to as Fear of Missing Out (FOMO). This is commonly seen in those who invest large amounts of money into a trending industry, a singular stock, or even cash in uncertain times.

- **Attachment bias:** Holding onto an investment for emotional reasons rather than considering more practical applications. This is especially prevalent in inherited investment vehicles.

- **Endowment bias:** Feeling that because you own an asset, it is more valuable and special since it's yours. This is especially true, if you would not buy the asset if you did not already own it.

- **Confirmation bias:** Tendency to accept any information that confirms our preconceived position or opinion to disregard any information that does not support that preconceived notion. This is very similar to self-affirmation bias which is differentiated by the belief of the investor that when something goes right that it is of their own intelligence and when something does not work out, it is someone else's fault/bad luck.

- **Analysis Paralysis:** Describes an individual overanalyzing a situation and can cause a decision making to become "paralyzed" meaning that no solution or course of action is decided upon. A person may desire a perfect solution. An investor's outlook may be that investing is too complicated so more research must be done. The investor wants so much intel that they never make a decision.

- **Fear of Regret:** The tendency to take no action rather than risk making the wrong one. This would be someone holding onto a stock losing value out of fear of selling it and the stock rebounding.

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- **Over-Weighting the Recent Past:** Investors see the recent past trends and assume they represent a pattern that can become the basis for an investment decision. A fund that just had a great year or a stock that has had a great recent run, can influence investors to assume that recent past will repeat itself in the future, but they make this decision with a little real research. Some trends tend to persist, while others revert to the mean. Research must be conducted to gauge if it will hold true. This bias is geared towards a specific bond, mutual fund, stock ect.

- **Overreaction:** Investors emotionally react towards new market information. Good news raises a stock's price, but it causes a disproportional effect overpricing the stock. This sudden change erodes over time.

We are happy to talk to you about biases that you feel the most affected by! The best way to combat negative financial decisions due to biases is to recognize them and actively work to neutralize them.

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