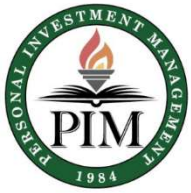


PERSONAL
INVESTMENT
MANAGEMENT, INC.

Summer Blues

Brian C. Fahey, CFA, M.ECON. & Christopher J. Reedy, MBA, CFP®, CIMA

In This Edition

We begin this edition of our quarterly News Release with a brief discussion on one important element of estate planning and conclude with a detailed market commentary.

Estate Planning

Christopher J. Reedy, MBA, CFP®, CIMA®

Estate planning is primarily about the effective transfer of assets to named beneficiaries via beneficiary designations on financial accounts and insurance policies, via the Will document and via trust planning. But there are three components of a comprehensive estate plan that may go into effect during your lifetime: 1) Living Will – the document which expresses your intentions regarding life support, 2) Health Care Power of Attorney – the document which assigns the rights and responsibilities associated with health care decisions to another person in the event of your incapacity, 3) Financial Power of Attorney – the document which assigns the rights and responsibilities associated with financial decisions to another person in the event of your incapacity. What follows is a brief discussion about this last document, the Financial Power of Attorney – specifically when to enact and how to enact this provision.

When to Enact

When to enact a Financial Power of Attorney, the specific timing, is an important consideration. Generally speaking, the transfer of financial authority to whoever you have designated to be your trusted agent takes place one of two ways: 1) you grant financial power of attorney while you have full command of your faculties, 2) financial power of attorney is imposed upon you when others deem you to be of diminished capacity. The challenge with choosing option 1 is that you may not feel the need to pass along financial responsibility to another. The challenge with option 2 is that having financial power of attorney enacted upon you is a more formal and possibly less collegial process.

If you have chosen a close family member and/or someone you trust implicitly, then you might consider granting financial power of attorney when you reach a point when keeping track of everything starts to become challenging. Challenges may be related to memory issues or issues staying organized, etc. Think of it as passing responsibility to your own, personal, chief financial officer. When viewed in this light, many of us might quite enjoy being rid of the tasks of paying bills, reviewing financial account statements, etc. at any point in life. Approaching it this way has many positive implications, most noteworthy for the sake of this discussion is that you are making an active decision while fully cognizant.

Option two is to maintain full financial responsibility until such time as others, your loved ones presumably, observe that you may no longer be capable of managing your financial life. There are two possible complications to this approach worth noting. First, you may not agree. If you don't agree, then things may become contentious. And if your loved ones are right and you are wrong, then financial things may get missed and create further complications. Second, the process of imposing a financial power of attorney most often requires signed statements from one or two physicians attesting to your diminished capacity. Your loved ones, therefore, are going to have to have you evaluated to obtain the required attestations. Now, this may all work out just fine. This approach is taken often enough. But it requires more work of everyone and has the possibility of creating relationship tension that all would rather avoid.

How to Enact

Schwab and TIAA each have their own power of attorney form or will accept a Power of Attorney document drafted by an attorney. The method that is most effective will depend upon your personal situation.

At PIM, we have years of experience with this administrative process and are at the ready to help when the time is right.

A final word. The topics we choose to cover in our written communications are often inspired by what we are experiencing regularly in our work with our valued clients. This specific topic has come up a few times recently. Therefore, if all of this is familiar to you because we just discussed it, then thank you for bringing this issue to our attention, for prompting us to cover it here for the possible benefit of many others.

Market & Economic Commentary

Brian C. Fahey, M. Econ, CFA & Christopher J. Reedy, MBA, CFP®, CIMA®

The S&P 500 was down 8.22% in June, a fitting end to the worst first half of a year since 1970. The aggregate bond market was down 4.6% in the second quarter of the year, approaching the worst annual performance (5.3%) since 1980. The catalyst for this challenging period in capital markets was aggressive Federal Reserve actions and a shift in policy focus on how best to fight inflation. The story has been painfully similar all year: inflation beats expectations, and the Fed responds by making financial conditions more challenging. Capital markets reacted accordingly. For the year, the S&P 500 is down 19.96%, US small cap stocks are down 23.47%, non-US large cap stocks are down 19.05%, emerging markets stocks are down 17.40%, non-US small cap stocks are down 24.30% and the US bond market is down 10.26%. There is nowhere to hide.

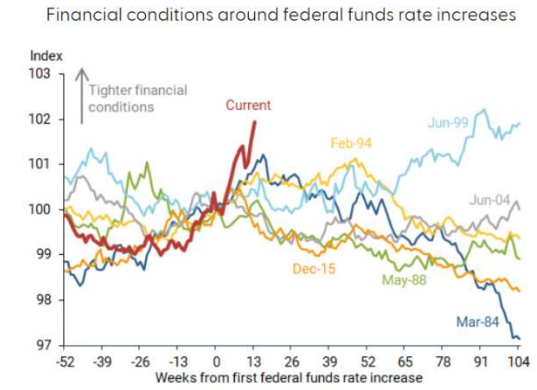
The Two Measures of Inflation

Inflation data for May showed us that inflation is both accelerating on a headline basis and decelerating on a core basis. Core inflation rates fell in May for the 3rd consecutive month and have declined by 0.5% since March as demand for goods cools and supply chains recover. The difference between the two measures is food and energy, which are included in headline and excluded in core inflation. Traditionally, the Fed worries about core inflation because they have little influence on the price of food and energy. The Fed is a powerful institution, but they cannot increase global energy production or change the weather to improve crop harvests. It therefore makes sense that the Fed focuses on what

they can influence, which is core inflation. With a string of positive data points, one might assume that the Fed was doing its job and concern about inflation would ease. The Fed instead shifted its focus to headline inflation. In the June press conference, Chairman Powell said the Fed is now worried about headline inflation because that's what everyone understands and what shapes expectations. Headline inflation remains elevated and is expected to increase in the coming months to 9.6%, according to market data. It is truly surprising that the Fed has chosen to set policy around a measure of inflation over which it has only partial influence.

Within Core Inflation: the "Price-Spiral Spillover"

Even though inflation, on a core basis, is declining, the median price of goods and services is still rising. Remember, core inflation measures the price change of a basket of goods and services. At any given point in time some of those items are increasing in price and some are declining in price by varying degrees. A steep fall in the price of a few items can mask an increase in the price of other items. That is what is occurring now and is a contributing factor to the Fed's aggressive posture. Essentially, prices of the average good/service are rising because the overall price level of the economy has increased. Said another way, some companies, that have not experienced increased production costs due to supply chain or other issues, have raised prices because other companies, offering completely unrelated goods and services and that have experienced increased production costs, raised theirs. Economists use the term "price-spiral spillover" to describe this phenomenon. This type of inflation is not the transitory pandemic supply shock, but a more systematic type of inflation based on relative prices within the economy. The Fed's aggressive policy stance is intended to put a stop to this. For the moment, the market seems to believe that the Fed is on the right course to bring inflation under control. This is largely because the Fed has tightened financial conditions at the fastest rate and by the largest amount of any period in forty years, as shown in the chart.



Source: Goldman Sachs US Financial Conditions Index and FRBSF staff calculations.

Looking Forward

2022 has proven to be exceptionally challenging. We're experiencing a global economic slowdown, a land war in Europe and a bear market in nearly every asset class. Uncertainty remains elevated. At this point we see three main ways the rest of the year may develop.

Soft landing (20% odds): While still possible, the elusive "soft landing" will require a fair bit of luck for the global economy. In this scenario headline inflation would need to show convincing weakness. Signs of this occurring would be found in falling commodity prices, ranging from industrial metals to energy, and including soft commodities such as grains. There are recent examples of this occurring. Falling commodity prices would then extend to falling prices of goods and services. The economy would need a goldilocks set of conditions to make this a reality; low enough demand from consumers to slow inflation, but easy enough financial conditions and just enough growth to avoid a recession.

In this scenario our portfolio strategy would be to increase long-term bond exposure and add exposure to the growth equities that have declined significantly this year.

Stagflation (10% odds): Of the possible outcomes, stagflation would be the most troubling. In this scenario we would experience a recession that does not bring inflation near to the Fed's target of 2%. This is most likely to occur if the Fed loses its nerve in the face of a recession and only does half the job of bringing inflation under control. This is exactly what the Fed did in the early 1970s. In that period the Fed raised interest rates enough to cause a mild recession, but a preference for labor market stability over inflation concerns caused the Fed to lower interest rates before inflation fell convincingly. Within a few years inflation was an even larger concern and forced the Fed to be extremely aggressive in the late 1970s and into the early 1980s, taking short-term interest rates to 15%. Signs of this scenario developing would be fairly evident, the Fed would signal "mission accomplished" while inflation remained ~5% and unemployment was near the same level.

Investment options during periods of stagflation are limited. We would move our bond portfolio to extremely short-term, high-quality bonds. Equity exposure would be concentrated around firms with pricing power and strong balance sheets, such as natural resource firms, healthcare, and consumer staples. Investment in countries without inflation, Japan for example, also tend to perform relatively well in stagflation periods. The odds of this outcome are low because stagflation is ultimately a policy choice, one that no central bank wants to make.

Recession (70% odds): It is possible that a recession has already begun. The US is likely to experience negative GDP growth for the second quarter, which after -1.5% in the first quarter would mark back-to-back contractions. Further evidence of a recession would come from weakness in the labor market, which is more of a trailing than leading indicator. Some of the more technical labor market indicators moved into the warning zone at the end of June. The upcoming earnings season will reveal the relative strength, or weakness, of corporate America.

The equity market has already priced in the idea that a recession is likely, with the consumer discretionary sector suggesting an 80% likelihood. However, a recession is not inevitable. The Fed has shown that they are willing to move quickly in response to incoming data. It's interesting to note that the market is pricing in high odds that the Fed will be cutting interest rates next year. The bond market has seen yields decline substantially since the Fed increased the short-term interest rate by 0.75% last month. The ten-year Treasury has fallen from 3.5% to 2.8% in three weeks. These are signs that the market believes inflation will dissipate and allow the Fed to ease financial conditions, possibly due to a recession.

Investment strategy for a recession is similar to a soft landing but with more patience. Portfolios need to be prepared for declining growth rates and declining inflation. The first asset that does well under those conditions are long-dated Treasuries. Equity exposure should remain reduced until valuations become compelling. There are a few limited examples of that occurring now in the technology sector. However, with overall analyst expectations of earnings growth still expected to be close to 9% and profit margins a record 13%, the market has yet to revise expectations to reflect this scenario. On average, earnings fall by 20% during a recession. Analysts are often slow to adjust to macro-economic conditions. Recall that earnings estimates dramatically under-shot actual earnings for several quarters in 2020 as the economy quickly recovered from the pandemic. When there is more visibility into earnings, it's

likely that technology, consumer discretionary, financials and communication services will all outperform.

Summary

The first half of 2022 has been extremely challenging. We did not expect a war in Europe, or for inflation to strengthen its grip on the economy. We were fortunate to have perceived fragility in the markets and to have reduced risk in client portfolios prior to the onset of negative economic and geopolitical events. Internally, we measure the relative performance of our investment models against a series of blended benchmark portfolios. While individual clients may experience different investment outcomes based upon risk profile and custodian(s), our models are performing well on a relative basis. The upside to the rapid repricing of risk in the markets is that we may be closer to the end of this challenging period than historical averages would suggest. If we do go into a recession, it's possible that the market recovers before the end of the year, even if the real economy does not until mid-2023. Financial markets, as leading indicators, tend to recover ahead of the underlying economy. Whatever the ultimate timing, we will stay patient, diligent, and disciplined.

Closing Comments

We are programmed to make progress. Whether in the early stages of our careers, highly experienced and comfortably positioned, or retired, we move through the world expecting to expand our social, intellectual, and financial horizons, each to varying degrees as suits our personalities and interests. We expect to do this incrementally. We understand that we will experience setbacks occasionally, and we take these in stride.

We understand that market economies are cyclical, always on the way to peak expansion, or heading away from it. We have all seen the clock illustration in which peak economic output occurs at 12:00 and the bottom of the cycle occurs at 6:00. And we know that the clock is always ticking.

We know these things. Which is why the current situation is so frustrating. It's frustrating because it feels like a waste of time. This is a period during which our financial status is contracting. This is a period during which it may be prudent to slow spending, to experience less, to live less enthusiastically. We know this is a temporary condition, but we don't know when it will end.

We understand all of this. So, allow us to offer a word of encouragement. Think back to what you remember the world to have been like pre-COVID, pre-Russia invasion, pre-bear market, pre-recession. And know this. We will be there again. And when we get there, maybe we will have a better appreciation for it. In the meantime, we'll all try our best for each other. We'll do our best for you, as is our professional responsibility, and you can do your best for those you might help through whatever challenges this period has brought to bear. Maybe this is a good time to embrace that we're all in this together.

From our families to yours, have a great summer!

PIM