the financial planner

GOLDMAN LANCASTER, INC.
REGISTERED INVESTMENT ADVISOR

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The Markets

As we look back on the second quarter of 2022, we are reminded of the old saw, perhaps bellowed by a 19th century naval captain, "the floggings will continue until morale improves!"

It was a shipwreck of a quarter for investors of all stripes, after all. Inflation continued its surge, hitting 8.9% year over year in May, and rising further to 9.1% year over year in June. In response, the Federal Reserve finally called "all hands on deck" with outsized interest rate hikes in May and June. The combination of high inflation and an aggressive Federal Reserve helped to push interest rates starkly higher. The yield on the 10-year U.S. Treasury hit a high of 3.48% on June 14th before retreating to 3.02% by month-end, still up from 2.32% at the end of May and 1.52% at the end of 2021. In a foreboding sign for home prices, rates on 30-year mortgages rose to their highest levels since January 2008, reaching 5.7% at the end of June, this up from 4.7% in March and 3.1% at the end of December, per YCharts. Against this backdrop, the Barclays U.S. Aggregate bond index fell by nearly 5% for the quarter and more than 10% through the first six months. This represents the worst January-through-June performance for the "Agg" since its inception in 1973.

Stock prices fell sharply in tandem. The S&P 500 index plummeted by more than 16% during the quarter, and not to be outdone, the S&P 500's 20.48% loss from January to June fits the accepted definition of a bear market and represents the worst start to a calendar year since 1962. The tech-heavy NASDAQ 100 did even worse, dropping by 22.3% in Q2 and around 30% year-to-date through June 30. This makes sense…"big tech" has been the biggest benefactor of low interest rates and easy money the last decade, and therefore possibly subject to the largest recalibration as

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What's New?

Next year could bring the biggest increase to Social Security benefits in four decades.

The inflation gauge used by the Social Security Administration (SSA) to set the annual COLA came in at 9.1 percent for July — the first of three months the agency uses to determine the final figure, slated to be announced in October.

We won't know the exact increase until then, but it is highly likely to be at least 8%, and probably closer to 9%. For retirees who rely substantially on this stipend, this is a silver lining to the clouds cast by the recent surge in prices.

Interest Rate Update

From Barron's 8/22/22	Now	1 Yr Ago
Prime Rate	5.50%	3.25%
3-Month T-Bill Rate	2.61%	0.07%
5 Year CD - National Avg.	0.69%	0.31%
Freddie Mac 30 Yr. Fixed Conventional Mortgage	5.03%	2.34%

Financial Markets Scoreboard

Index Returns (through 6/30/22)	Year-to-Date	Twelve Months
Dow Jones Industrials	-10.78%	-14.44%
Standard & Poors 500	-16.10%	-19.96%
M.S. EAFE (Developed Markets Foreign Stocks)	-14.29%	-19.25%
M.S. EM Free (Emerging Markets Stocks)	-11.34%	-17.47%
Barclay's Capital U.S. Aggregate Bond	-4.69%	-10.35%
Barclay's Capital US Corporate High Yield Bond	-9.83%	-14.19%

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THE PERSPECTIVE PAGE
INFLATION AND EQUITY VALUATIONS

As discussed in ***Markets***, inflation continued to surprise to the upside during the first half of 2022. In fact, the 9.1% CPI print in June marked the highest year-over-year increase in 40 years.

It is widely accepted that moderate inflation levels are needed to drive healthy economic growth. From 1992 to 2019, the annual inflation rate averaged about 2.25% and exceeded 5% only twice, a very favorable backdrop for stocks.

Investors should be cautious whenever inflation is negative or too high. The impact of high inflation on equity markets comes in two forms: corporate earnings and stock valuations.

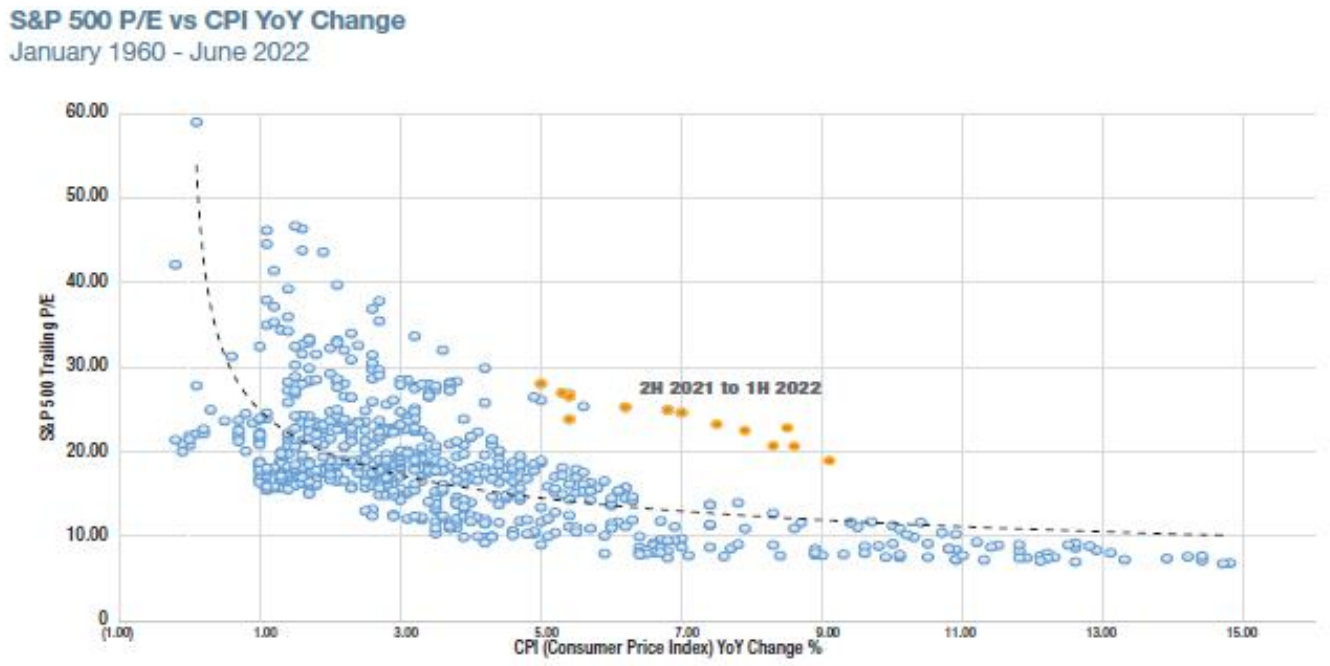
Without the backdrop of a recession and earnings dropping, corporate cash flows tend to keep pace with, or even outpace, inflation. That is particularly true when inflation increases, and companies pass on higher costs to customers.

An example is the "great inflation" period in the 1970s, when corporate net cash flow grew faster than inflation. Periods like this bolster the belief that for long-term investors, equities can serve as an effective store of value versus inflation.

Although corporate profits might not be hurt by inflation, equity valuation levels are the second aspect to watch in equity markets during high inflationary periods. This is because when inflation turns higher, stock P/E ratios tend to go lower. This is because rising inflation reduces the value today of earnings received tomorrow.

Going forward, the equity discount rate may increase due to Fed rate hikes, inflation, and increased interest rate volatility. The graph below shows the historical relationship between the level of inflation and the price -to-earnings ratio of the S&P 500 index. The yellow dots show most recent levels, and indicate the market is trading at a the top of the historical range price-wise.

Against this backdrop, we think "value" and dividend paying stocks should remain a focus within diversified portfolios.



Source: fred.stlouisfed.org

Markets *(Continued from page 1)*

the backdrop changes. What about outside the US? Things weren't much better. The most widely followed indices that broadly track foreign stock markets were also down double digits. In other words, there was virtually no place to hide.

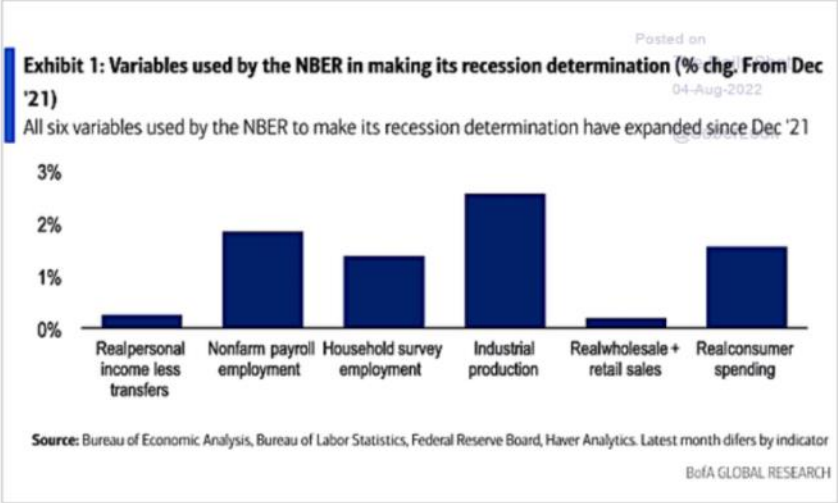
How does this happen? Start with a global economy already vulnerable to inflation due to excessive stimulus and loose monetary policy, suffering acute supply chain disruptions and tight labor markets, and add Russia's invasion of Ukraine. Then mix in tightening financial conditions resulting from central banks around the world raising interest rates in concert, plus the typical market challenges of a midterm election year coming in the third year of a bull market, and *voila!,* you have a perfect brew for such an episode.

These market moves seemed to reflect both an inflation scare and a growth scare. The effects of inflation are easy to characterize; higher inflation and higher interest rates reduce the value of dollars received in the future. This affects the calculus for both stocks and bond prices in a negative way. But if the economy remains strong even while prices are rising and business booms, rising corporate earnings can help buoy stock prices. Conversely, the effects of economic recession are easy to characterize as well, at least in theory; a slowing economy causes businesses to lay off workers and lower prices to reduce inventories, bringing down inflation and interest rates, hurting stocks and risky bonds and helping the value of the highest quality bonds. In the latest episode, we saw negative effects in both respects.

Now for the ironic part…as the calendar turned to July and August, morale did improve, despite the floggings! Telltale signs that the inflation surge may be beginning to lose a little steam emerged, while other signals suggested the economy's still-positive momentum may be waning. And stocks bounced. What first looked like a baby bear market rally extended through the middle of August, looking like at worst a full-grown bear market rally and at best a new bull market. Alas, only time will reveal its true nature. But we do know from history that the market is forward-looking and tends to lead the economy. Said differently, markets tend to bottom before the economy does. Consequently, attempting to time markets in anticipation of an economic recession - which is only identified in hindsight using data that is weeks or even months old - is generally not a winning investment strategy. We also know that despite 12 recessions and 12 bear markets since 1947, the S&P 500 Index has returned 12.57% annually across that timespan. Further, markets have historically posted exceptionally strong returns in the wake of bear markets. Since 1926, U.S. stocks returned an average of 22.2% in the first year following a 20% decline—and a cumulative return of 71.8% after five years.

The takeaway is that time is generally on the side of investors as long as they are positioned in a manner which is simpatico with their risk tolerance and both their short and long-term financial goals.

U.S. GDP came in negative in both the first and second quarters of 2022, causing some to conclude that the economy is already in recession. We don't think so. Support for our view is presented in the graphic to the right, which details the primary datapoints used by the National Bureau of Economic Analysis, the arbiter of start and end dates for recessions. Presently all six of their primary data points indicate economic expansion. But if inflation persists and the Fed keeps raising rates, it is likely just a matter of time before this expansion gives way to the next recession.



The Personals

The COVID pandemic made a meaningful impact on our lives, changing the day-to-day and dampening our desire and ability to travel From our perspective, it wasn't all bad. We put more energy into our home. We played more games, read more books and walked more.

For a brief time Mike, Carol and I were working from home 100% of the time. But after a month or so of that, I started venturing back to the office some days and by the middle of 2021 we were all back in the office at least half-time as a matter of company policy. In practice, working from home a couple days a week is quite nice.

Of course, enjoying being home so much revolves around more than just work life. Economy-wide disruptions have made eating out and travelling less enjoyable and more of a hassle. Gatherings with friends and relatives at home has often been a more enjoyable experience.

So it was wasn't much of an irony when we took a road trip last month up to Santa Ynez (dog in tow, of course) to spend a couple days with our friends Dean and Janet, and rather than spend our days together tooling around the area, wine tasting, shopping etc., we four decided we would rather hang out at their house to enjoy a summer day by their pool with snacks and wine and several games of Mexican Train. These days, even when we travel we stay home!

From there, we continued up the central coast and enjoyed several more days of rest and relaxation. Here's the view we enjoyed on a sunset walk along the bay at Shell Beach.

THANK YOU!

...to the following clients and colleagues for showing your confidence in us by referring your friends, family members, associates and clients during the last three months…

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