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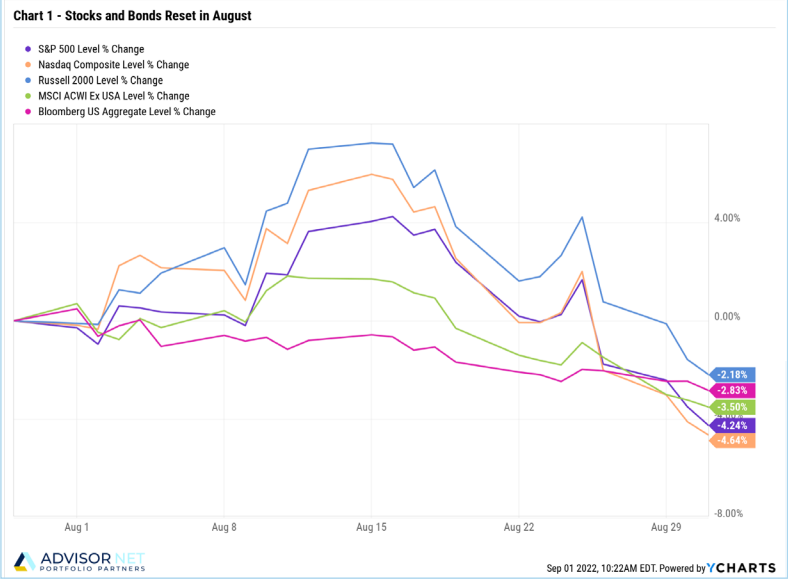
Newsletter

September 2022

Stocks Reset in August

After experiencing strong stock and bond returns during July and half of August, the month ended with losses across the broader markets. The hawkish tone of the Federal Reserve (the Fed) was likely the primary culprit to reversing the positive price action. The S&P 500 was lower by -4.24%, the NASDAQ Composite fell -4.64%, the Russell 2000 declined -2.18% and the MSCI ACWI ex-USA decreased -3.50% during August. The 10-year US Treasury rate increased from 2.67% last month to 3.15% at the end of August, which led to a -2.83% loss for the Bloomberg US Aggregate index. (CHART 1)

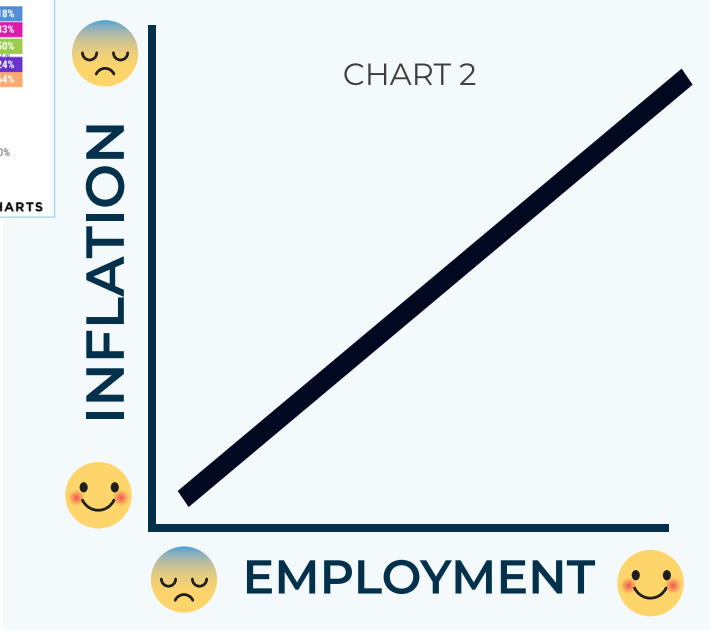


Fed Up with Inflation–A Tutorial on the Dual Mandate

Given the significant role the Federal Reserve has played in the capital markets since the Great Financial Crisis (GFC) in 2007/2008, we believe it is an appropriate time to review the basic objective of the agency and how it may impact consumers and investors. While it can seem complicated to outsiders, the Fed has a clearly stated and well-defined charter from Congress. The Fed was originally created by the Federal Reserve Act of 1913 primarily to serve as the lender of last resort. This changed with the Humphrey-Hawkins Act of 1978, which created the "dual mandate" to provide price stability and maximum sustainable employment.

The Fed updated its definition of the dual mandate in late 2020 to include: 1.) Target inflation rate of 2 percent as measured by the Price Index for Personal Consumption Expenditures (PCE) and 2.) Utilize a wide range of labor market indicators to estimate a longer-run normal rate of unemployment. According to the June 2022 Summary of Economic Projections, the longer run estimate is currently 4.0 percent.

The Fed's current mandate is to keep inflation around 2% and unemployment around 4%. The elegant simplicity of this dual mandate masks the complexity of the relationship between price stability and maximum employment, which are diametrically opposed. In other words, what is good for employment is bad for inflation and what is good for inflation is bad for employment. You see, what is good for the goose (grey duck for the MN crowd) is actually NOT good for the gander. (CHART 2)



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We think this paradox is largely responsible for the action of price returns in the US stock and bond markets since the GFC. The Fed has maintained a primarily dovish (accommodative) policy of low interest rates that has helped produce maximum sustainable employment. We believe this positive economic environment also helped to drive positive stock and bond returns from 2009 through 2021. In fact, the current US unemployment rate of 3.5% is much better than the targeted longer run objective of 4%. One may rationally conclude that the Fed has been successful in at least half its mandate of maximum sustainable employment during this period.

But what has been good for the goose has NOT been good for the gander. Predictably, this accommodative, low-rate policy stance has also translated into higher inflation. The US PCE (inflation) for July was 6.28%, which is much higher than the Fed's target of 2%. The Fed now appears to be "FED UP" with inflation and has flipped to a less accommodative (hawkish) policy stance in 2022. In other words, the Fed now must reverse course from stimulating the economy (maximize employment) to slowing the economy (reduce inflation). We believe this policy change has largely been responsible for the negative stock and bond returns experienced during 2022.

While it may feel like the Fed is attempting to lower employment and hurt the economy, we believe the Fed is pursuing its dual mandate in order to protect consumers from the loss of purchasing power. Consumers and investors have greatly benefited from an accommodative Fed for the last 12 years or so and, unfortunately, will now likely have a much less enjoyable experience as the Fed tightens policy in order to re-establish price stability (lower inflation).

What it Means to Investors

We believe the stock and bond markets are being strongly influenced by the market's expectations regarding Fed policy actions previously described. For example, the Fed raised rates on June 16th, but the yield on the 10-year US treasury bond started to fall on June 17th. We think the market was interpreting comments by Fed Chair Jerome Powell to imply a return to more accommodative policy sooner than expected. This decline in interest rates led to a strong rally in the stock market.

The stock market continued to rise into August on this hope for a less restrictive policy stance by the Fed. The bond market, however, started pricing in the prospect for higher rates and the yield on the 10-year US Treasury bond again began to rise in early August. This action culminated in a near-term price high and reversal on the S&P 500 on August 17 when the July Fed minutes were released and shot down hopes for a more accommodative stance.

We think the relationship between interest rates and stock prices will likely continue to drive the price action in the market for at least the remainder of 2022. ***If interest rates are going up, stock prices will likely go down; if interest rates are going down, stock prices will likely go up.*** While this may be an overly simplified explanation, the underlying fundamentals are complex and justified (as previously highlighted). We continue to position our client portfolios relatively defensive. While we remain open to the possibility of brighter days ahead, we will focus on protecting client capital until the risk/reward profile of the market is in our favor.

MARKET TRACKER – 8/31/2022

INDEX	3 mo	1 yr	3 yr	5 yr
S&P 500	-3.88%	-11.23%	12.39%	11.82%
MSCI EAFE	-9.24%	-19.37%	2.87%	2.12%
BAR AGG BOND	-2.01%	-11.52%	-2.00%	0.52%

(Source: yCharts)

S&P 500	3,955.00
DIJA	31,510.43
NASDAQ	11,816.20
OIL	$89.55 /BARREL
GOLD	$1,712.80 /OUNCE
10-YEAR TREASURY FIELD	3.15%
UNEMPLOYMENT	3.50%
GDP	-0.60%
PPI	9.76%
CPI	8.52%

(Source: yCharts and Dorsey Wright)

Thank you for your trust and support. Stay focused on your long-term objectives.

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The index, a member of the Dow Jones Total Stock Market Indices family, is designed to measure the performance of small-cap U.S. equity securities.

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Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, includ-ing Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The MSCI All-Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed country indexes include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United King-dom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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