Fox-Smith Wealth Management Quarterly Commentary

Third Quarter - 2022

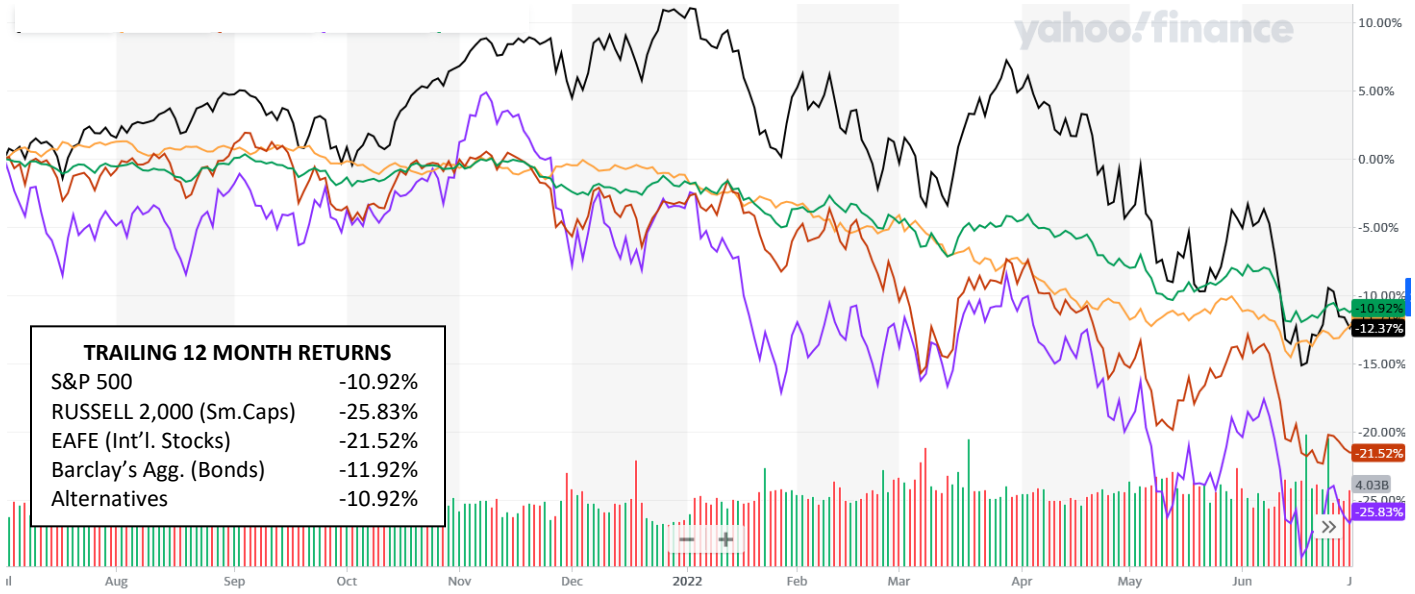
"The Laws of Physics Cannot be Broken, but They Can Often Bend"

Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

There are many universal laws of physics that cannot be broken. For example, you cannot travel faster than the speed of light. Molecules move faster as heat is added and slower as they cool. Without outside influence, everything in the universe tends to move toward entropy. There are countless more examples and, like it or not, we are all subject to these unbreakable laws.

Similarly, there are many commonly accepted "Truths" in finance which I have often referred to as the Laws of Economic Physics. It is always true that when the supply of an item exceeds demand for it, the result is a decreasing price. And when supply cannot meet demand, prices climb. Also, rising interest rates will always have a negative effect on the prices of previously issued bonds and falling rates will push bond prices higher. Economic laws like these are not debatable, but this is only true in a very limited number of cases.

Unlike natural physics, the vast majority of the laws of economic physics, while believed to be Truths, are not unbreakable. They are seen so often that they become accepted as laws when they really would be more accurately referred to as the *'Firm Suggestions of Economic Physics.'* The first half of 2022 has given us a stark reminder of this as we have watched one of those 'laws' being broken before our eyes.



TRAILING 12 MONTH RETURNS	
S&P 500	-10.92%
RUSSELL 2,000 (Sm.Caps)	-25.83%
EAFE (Int'l. Stocks)	-21.52%
Barclay's Agg. (Bonds)	-11.92%
Alternatives	-10.92%

Trailing 12- month Market Index Performance – Source: Yahoo Finance

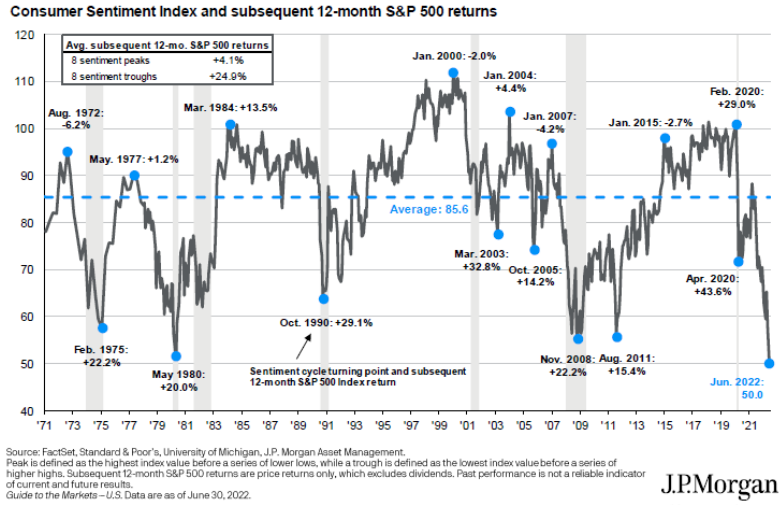
When analyzing the root causes of inflation, there are many different forces that can lay the foundation for it to flourish. It can be caused by a rapid global shift in demand for something or, by an unexpected disruption in the supply of something. It can also be caused by new innovations when demand is impossible to predict. There are scores of other causes of inflation, but these examples all prepare the ground for price inflation of specific items or services, not the broad economic inflation that we are currently experiencing.

In contrast, only a few things can result in broad inflation throughout the economy. The most common causes of systemic inflation are political instability, conflict (war), and mismanagement of the money supply, which is to blame for current inflation. When a country expands its money supply by 40% in 18 months, especially when that country primarily imports goods from other countries, you have a strong foundation for inflation. But this alone does not strike the match

that gets prices moving. If this is all that was required, we would have had high inflation in 2009-2010 since we printed a massive amount of currency in those years as well. This is where one of the *Firm Suggestions of Economic Physics* comes into play.

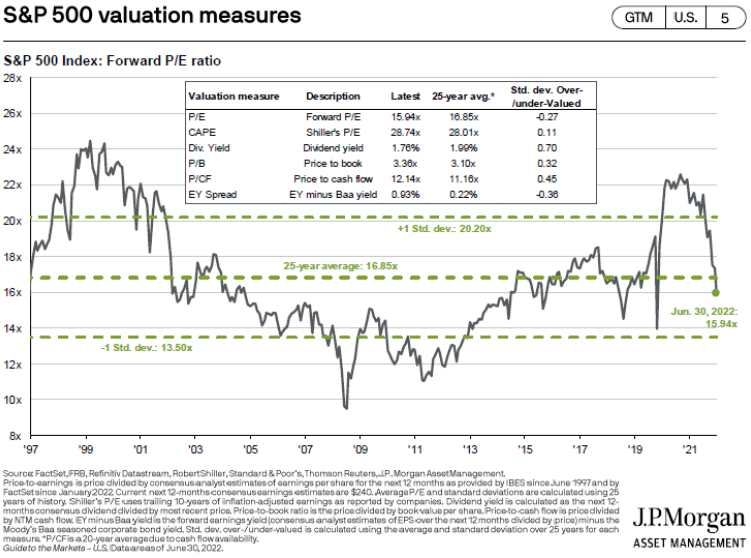
Once the foundation is laid, we have come to accept that it is a Law of Economics that inflation requires two things, rapidly growing economic activity (GDP) and consumer demand that is strong and growing. This feeds into a second accepted Truth in finance, that growing economic activity and consumer demand will increase corporate earnings and higher earnings always drive stock prices up. Therefore, it should be impossible to see the markets dropping and have declining GDP concurrent with high and rising inflation. Current conditions prove otherwise.

Since February, we have seen massive consumer demand and spending which has increased corporate earnings. Yet the market has been moving down for the last 5 ½ months. This is not supposed to be possible. To also have inflation at 40-year highs while the market pulls back is another supposed impossibility. So, even though this disproves several commonly accepted Truths, I will stop short of saying the Laws of Economic Physics have been broken. In my view, they are simply being bent and stretched. This is a very unique and contradictory climate which simply cannot continue indefinitely. You can only stretch a rubber band so far before it snaps back in reversion to the norm. But, in times like these, I always remind myself to be cautious because of the old saying "markets can stay irrational longer than you can remain solvent."



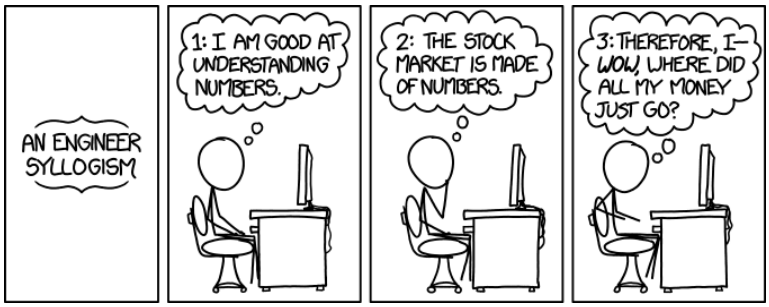
Source: JP Morgan Guide to the Markets

With all of this said, I have several projections for how I think things may play out for the rest of 2022: First, there are many questioning if we will see a recession this year. At this point, the majority of analysts and 'experts' have stated that they do not predict a recession mainly due to extremely low unemployment. I do not agree with this view. Not only do I predict a recession this year, I think we are already officially in recession as of the close of the second quarter. A recession by definition is two consecutive quarters of decreasing GDP. The first quarter of 2022 saw GDP decline -1.6% and I expect that when Q2 data is published, it too will show a decline in GDP. Yes, we have very high consumer spending, but there are some severe drags on economic activity that are like an anchor around the neck of GDP. Due to the labor shortage, businesses across the country have been unable to operate at full capacity. Many have limited hours or are remaining closed certain days each week, but even those operating their normal hours have been unable to serve as many customers as usual due to limited staff. Either way, there is a massive amount of economic activity that is not occurring because of the lack of labor to do the work. Additionally, supply chain problems continue to cause shortages of various products. It has been almost a year since I have seen a big box retail store or grocery store that doesn't have several empty shelves, evidencing items they just cannot keep in stock. If you are planning to buy something and the store does not have it, you don't spend the money. This is even more lost economic activity.



Source: JP Morgan Guide to the Markets

Early this year I predicted that these two factors might have as much as a 1.5% negative effect on GDP this year. This was confirmed by the FED in June when they stated that supply chain issues and the labor shortage had reduced GDP at an annualized rate of nearly 1.7% so far this year. It is pretty hard to avoid recession when so much economic activity is absent. On a positive note, consumer sentiment has reached a low which we have not seen since 1980. Historically, once we see sentiment this low it means the worst is already priced into the markets and things perform extremely well in the following year.



Second, without a major unexpected shock to the financial system, I think that we have seen the low point in the stock market or at least are very close to it. The current bi-polar economy should return to rationality very soon. Either the stock market will respond to the massive volume of consumer spending and begin climbing while inflation goes higher or, inflation will cool off and begin to decline and the recession will go on a little longer. Either of these outcomes will bring the markets back into congruence. I believe that the massive amount of cash in private hands will be a positive for the markets in the next few years which leads me to think that the most likely scenario is that the market will find its low point very soon and begin recovering. This means that inflation will likely remain stubbornly high, but at least our investments will begin keeping up with the cost of living again. Stocks have now declined to below historical average prices relative to earnings, so that adds to my optimism. I believe we will post a negative year in US stocks, but that the rest of 2022 will be much better as prices recover. However, to prepare for the possibility of a deeper recession, we have made moves in all of our portfolios to decrease risk and increase exposures to defensive holdings.

Third, my prediction for the second half is that we will begin to see improvements in the supply chain disruptions that are affecting the flow of goods around the world and within the U.S. I predict this will improve because it must improve. If we continue to see more and more empty shelves in stores, we run the risk of consumers beginning to operate from a mindset of scarcity. If that happens, things will get a lot worse since our behaviors change drastically in periods of scarcity. People will cease discretionary spending and will buy only necessities which will cause a very pronounced recession. Consumers will also cause a run on certain goods, many of which will be impossible to predict until they are gone. But a few items we can expect to run out will be soap and toilet paper, as seen in 2020.

Finally, while I do see the supply chain improving, I do not predict any relief in regards to the labor shortage. The shortage is primarily a demographic problem of having the largest group of people (Baby Boomers) now fully retired and becoming 100% consumers. This is met by a much smaller group of producers trying to serve their needs. The group that is currently in their most productive years, Generation X, was the first generation in American history to be smaller than their parents' generation. An extremely large population of consumers being served by a smaller group of producers is a problem that will not be solved until the Millennials begin reaching their peak productive years which will not happen until 2030 at the earliest.

In closing, I want to reiterate that there are a lot of very serious risks to the markets in the short term and that monetary policy has created even more risks. But, on balance, I have typically seen American consumers respond to risky economic times with fiscal responsibility and thrift. Those behaviors lead to long term growth and strength that, when added to trillions of uncommitted capital, should result in healthy growth for the next 5-10 years, so I remain (cautiously) bullish when looking forward.

Financial Trivia

Last quarter's trivia question was: "When adjusted for inflation, what was the highest grossing movie of all time? "

Answer: *Adjusted for inflation, the top five highest grossing movies of all time are Gone with the Wind ($1,606,254,800), Star Wars ($1,416,050,800), Sound of Music ($1,132,202,200), ET: Extra Terrestrial ($1,127,742,000), and The Ten Commandments ($1,041,450,000).*

The client who had the right answer and became the proud owner of a brand new, shiny Amazon gift card was Debbie B.

This quarter's question:

Who holds the world record for their picture appearing on the largest number of different currency notes?

E-mail your answers to Jen at jen@fswealth.biz and we will award a prize to the first correct answer *(Be honest, no "googling" it!)*

~ Disclosures and Definitions ~

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip stocks that trade on the New York Stock Exchange which are selected by editor of The Wall Street Journal.

The S&P 500 Index is a capitalization-weighted index made up of 5000 widely held large-cap U.S. stocks in the Industrials, Transportation, Utilities and Financial sectors.

The Russell 2000 index is an index measuring the performance of approximately 2,000 smallest-cap American companies

The EAFE Index is a stock index offered by MSCI that covers non-U.S. and Canadian equity markets. It serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australasia, and the Middle East.

Bloomberg U.S. Aggregate Bond – The Bloomberg US Agg Total Return Value Unhedged, also known as "Bloomberg U.S. Aggregate Bond Index" formerly known as the "Barclays Capital U.S. Aggregate Bond Index," and prior to that, "Lehman Aggregate 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 securities, MBS (agency fixed-rate pass throughs), ABS and CMBS (agency and non-agency).