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Quarterly Market Insights

Interest Rate Worries and Economic Uncertainties Cloud the Outlook

The table of returns below reflects a continued drop in stocks and rise in bond yields during the third quarter. While there was a rally in stocks during the period, the stock market sold off in September and was ultimately down for the quarter.

Stock Indices	Q3 2022 Return %*	YTD Return %*
S&P 500 (large)	-4.88%	-23.87%
S&P 400 (midsize)	-2.46%	-21.52%
Russell 2000 (small)	-2.19%	-25.10%
MSCI EAFE (intl.)	-9.36%	-27.09%
Bond Yields	**Sept. 30, 2022 Yld. & Qtr. Change**	**Dec 31, 2021 Yield**
3-month T-bill	3.33% (+1.61%)	0.06%
2-year Treasury	4.22% (+1.30%)	0.73%
10-year Treasury	3.83% (+0.85%)	1.52%
30-year Treasury	3.79% (+0.65%)	1.90%
Commodities	**Sept. 30, 2022 Price & Qtr. Change**	**Dec. 31, 2022 Price**
Oil per barrel	$79.74 (-$26.02)	$75.21
Gold per ounce	$1,668.30 (-$139.00)	$1,828.60

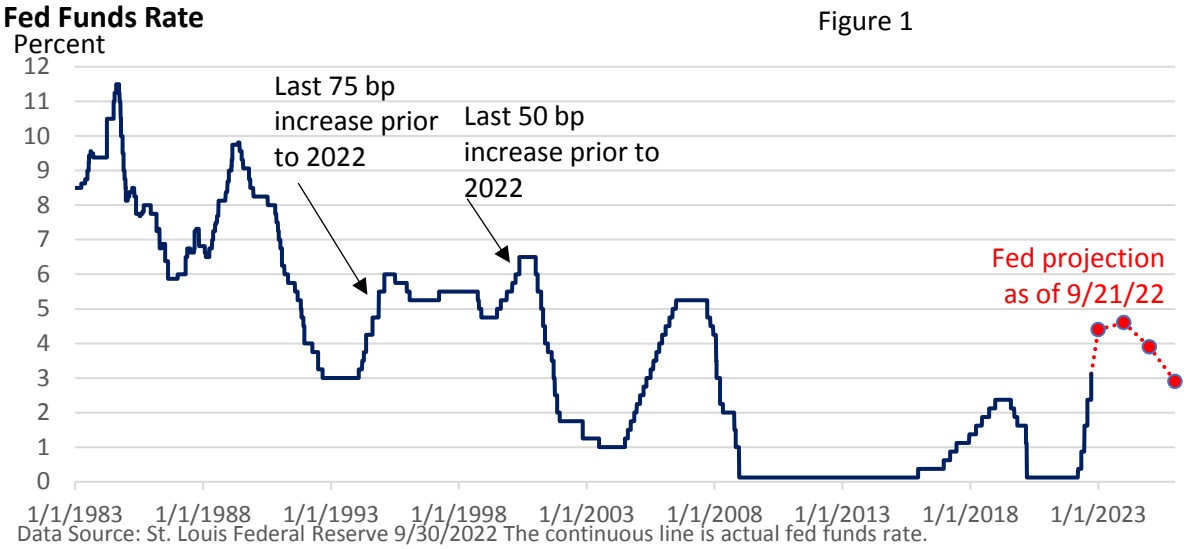
*Stock indices include reinvested dividends and are not annualized.

The Federal Reserve hiked its key rate, the fed funds rate, by another three-quarters of one percent in **July** to 2.25—2.50%. Some of Fed Chief Jay Powell's remarks seemed to suggest the Fed might soon slow its pace of rate increases. As expected, stocks gained ground. In fact, the S&P 500 Index retraced more than 50% of its prior peak-to-trough decline.

But Fed officials pushed back on the idea of a Fed pivot. At the end of **August**, Chairman Powell's short but direct nine-minute speech at a symposium in Jackson Hole, WY, stressed the Fed's resolve to bring inflation back down, and stocks gave up ground.

A disappointing September Consumer Price Index (which gauges the rate of inflation for consumers) and a very aggressive tone from the **September** 21st Fed meeting, including another three quarters of a

percentage point increase, signaled a steely resolve to squash inflation (primarily by raising interest rates), and market volatility stayed high into the end of the month.



Data Source: St. Louis Federal Reserve 9/30/2022 The continuous line is actual fed funds rate.
The dotted line represents Fed projection for year-end 2022, 2023, 2024, 2025.
Projections subject to change.

In figure 1 above are the actual fed fund rates going back to 1983 and up to the present (the continuous line). The figure also includes the Federal Reserve's current projections for interest rates going out to 2025 (the dotted lines). Thus, the Fed expects to continue to increase interest rates into 2023 until they peak (around 5%) and then begin to lower them after that.

Take the Fed's projections, however, with a couple of grains of salt.

A little over a year ago, the Fed failed to forecast the initial strength of the economic recovery and bet that last year's surge in inflation would be transitory. In fact, they expected rates to be around 1% today on the federal funds rate (it is currently in the 3% to 3.25% range and are expected to be in the 4.25% to 4.75% range before year end 2022).

While the stock market has had a very difficult year, what few people realize is that, from a performance standpoint, 2022 is shaping up to be the **worst bond market** going back 45 years as measured by a common bond index (the Bloomberg U.S. Aggregate Index). That is what happens when investors expect rates to stay lower for longer, find they are wrong, and then must re-adjust to aggressive increases in interest rates today and going forward.

This is why we have always emphasized **individual** bonds and a bond ladder whenever possible in the fixed income allocation for our clients. By properly selecting (and continually monitoring) individual

bonds, this strategy virtually assures return of principal (when held to maturity) and income, even in tumultuous times like we have now.

How This Has Affected the Markets

The speed and tenacity of the Fed's moves have jarred investors. Higher interest rates compete for investor dollars and slow economic growth.

The soaring dollar against major currencies, which has occurred amid heightened global uncertainty and higher rates in the U.S. (rising interest rates encourage foreign investors to seek higher returns in the U.S.), added to financial instability around the world.

Additionally, the Fed's campaign is raising fears that it could "break" something in financial markets, whether in the U.S. or abroad. As Warren Buffett is credited with saying, "you find out who is not wearing trunks when the tide goes out."

Furthermore, an economic downturn is a real possibility next year. In fact, there is a lively debate on whether the world will face a recession in the near future.

But bear markets end when negativity is high. No one rings a bell when the worst is over. During the recovery from the 2008-09 financial crisis and the pandemic-led bear market, sentiment remained decidedly negative as stocks rallied for much of this time.

Economic and market forecasting is a very inexact science. Simply put, there are too many unknown variables. But the table below offers a historical perspective.

Declines in the S&P 500 Index since the end of WWII

Decline %	Number of declines	**Avg decline %**	Avg length of decline (months)	Avg recovery time (months)
5-10	86	**-6.7**	1.0	1.5
10-20	28	**-14.0**	4.0	4.0
20-40	**9**	**-27.9**	**10.6**	**13.8**
40+	3	**-51.4**	22.8	58.0

Source: Guggenheim 5/16/2022 The S&P 500 Index is an unmanaged index of 500 larger companies which cannot be invested into directly. Past performance is no guarantee of future results.

To put this into context, focus on the 3rd column, **Average Decline %**. The peak-to-trough decline for the S&P 500 is **25.2%** through September 30 which is closer to some of the more extreme historical declines.

The Cure and the Way Forward

My goodness: stocks are taking a terrible beating these days. From the way the market is behaving, one might think that some of the world's largest and most profitable companies are suddenly becoming dramatically less valuable. Are they all laying off workers, slashing prices, closing factories, and declaring imminent bankruptcy?

If this is sending you to anxiously scan the headlines, don't bother; none of that is happening. Stock prices have never been a precise indicator of what companies are worth (at least over the short to intermediate term). They are a very good indicator of what people are willing to pay (at any given point in time) for their shares, and right now there seems to be more sellers than buyers.

Why? The reasons for bear markets are seldom rational—which, of course, is why bear markets end and stocks return to (and at least historically have always surpassed) their original highs. What is happening right now is not unlike what happens when one of your children is diagnosed with an illness, and the remedy is a daily dose of some awful-tasting medicine. The illness, in this case, is **inflation**, which absolutely must be cured if we are to experience a healthy economic life. Few things are worse than having the money you've saved deteriorate in value at double-digit rates, which is precisely what has been happening this year.

The cure, which any child will tell you is more unpleasant than the illness itself, is the U.S. Federal Reserve raising interest rates, which is its way of reducing the amount of cash sloshing around in the economy. Rising consumer prices, just like rising stock prices, come about when there are more buyers than sellers (or supply constraints). Reducing the available cash reduces the number of buyers in relation to sellers (ironically, both in the consumer marketplace and on Wall Street), and finally slows down the inflation rate to manageable levels.

We can already see how this works in the housing market where, just a few short months ago, multiple would-be buyers were bidding against each other to pay more than the asking prices. As mortgage rates have risen, the frenzy has completely dissipated. The process takes longer in the consumer marketplace at large, but you can bet it's working behind the scenes.

Doesn't less spending mean less economic activity? Doesn't that lead to a recession? The answers, of course, are yes and maybe. But at this point, a recession might not be all bad for the economy. Recessions act like a cleansing mechanism, exposing/eliminating waste and inefficiency, and ultimately creating a healthier economy when we come out on the other end.

So right now, we're taking our medicine and boy does it taste awful. We are also, collectively, suffering an economic illness. Anybody who has come down with a bug and taken medicine to cure it knows that the former unpleasantness doesn't last forever, and therefore neither does the latter.

Bottom Line

The bottom line is to stay the course of the plan that was constructed for you assuming it was well thought out and appropriate to your situation. Yes, this has been painful but fight the temptation to make dramatic changes unless your circumstances have changed. If it takes updating your plan, we would be glad to do that too.

Either way, please let us know if you have any questions or concerns. We are just a phone call or e-mail away. Things will eventually improve, and we want to help you in any way that we can.

Hopwood Financial Services, Inc.