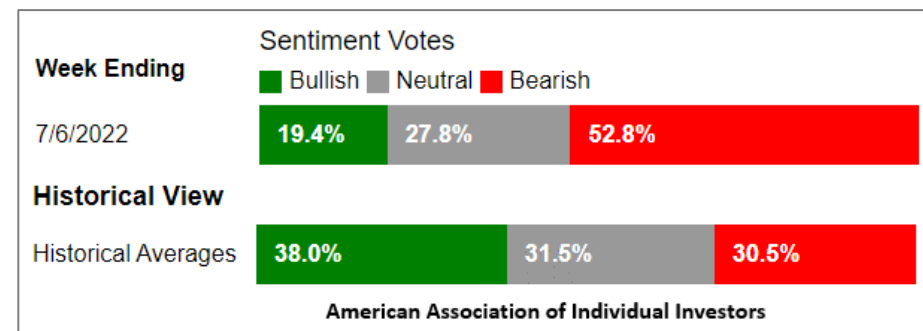


From: Aequitas Investment Advisors

Warner / Jim Spencer

Re: Weathering the Storm

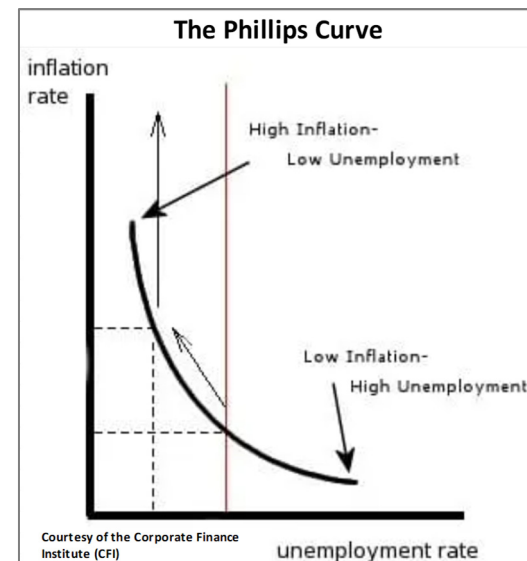
The first half of 2022 officially went down as the worst six-months for the U.S. stock market to begin a calendar year since 1962! The year began on an optimistic note given record-low unemployment, rising wages, and an economy that in 2021 had grown at the fastest clip in more than 35 years. Our optimism needed to be tempered, of course, by the fact that inflation was stubbornly high. Just last week, the Bureau of Labor Statistics reported that inflation surged by 9.1% year-over-year through June 30th which is the highest level since 1981 when Ronald Reagan occupied the Oval Office and Paul Volcker was at the helm of the Federal Reserve. While we were comforted late last year by Jerome Powell’s statement that inflation was “transitory”, the Fed abandoned this language in early 2022 (although some inflationary components are in fact transitory) and adopted a much more aggressive stance by announcing steep rate hikes and stating that the Fed will “do whatever it takes” to bring inflation back down to its target level of 2% by late 2023. With inflation running hot and hitting consumers’ budgets, led by gasoline and food prices, in just six months the mood of the country has gone from relative optimism to the highest level of pessimism in more than fifty years based upon the University of Michigan’s Consumer Sentiment Index. Voters are expressing their pessimism, too, as the latest Times/CBS Survey indicates that more than 75% of U.S. adults feel the country is heading in the wrong direction making this a truly bi-partisan issue! The last time voters expressed such pessimism was in 2008 during the Great Recession.



Investors are less optimistic, too, as the most recent survey by the American Association of Individual Investors (AAII) indicates. Just 19.4% of investors are bullish which is one of the lowest readings since March of 2009 (an interesting historical note is that on March 9, 2009, the stock market reached its low point during the Great Recession and from that date forward surged by more than 400% over the subsequent 10+ years; more on bull and bear markets further on in this report). Close to 53% of AAII members are bearish and expect stock prices to fall over the next six months. According to the survey, “Continued volatility in the major stock indexes along with inflation, [weakening] corporate earnings and increased chatter about the possibility of a recession are all likely weighing on individual investors’ short-term expectations for the stock market. Also influencing sentiment are monetary policy [i.e., the Fed], the coronavirus pandemic, politics, and the ongoing invasion of Ukraine by Russia.” These last two sentences pretty well summarize the mood of most investors today.

The Phillips Curve and the Fed’s Dilemma

The Phillips Curve is an economic theory developed in the 1950’s by the New Zealand economist A. W. Phillips which posited that inflation and unemployment are intrinsically linked and have an inverse relationship. Expressed in the chart to the right, the Phillips Curve theory argues that with strong economic growth comes higher employment and higher inflation. Conversely, with weaker growth comes higher unemployment and lower inflation. Economists since the 1950s have debated Phillips’ theory, but today many economists are dusting off the theory and applying it to explain the Federal Reserve’s current predicament. While we should be happy to see low unemployment, higher wages and strong consumer demand, those same factors are exacerbating our inflation problem. The antidote? At least one part of the solution is to raise short-term interest rates to



slow the economy enough to achieve what the Fed hopes will be a “soft landing.” However, the Fed faces a dilemma in that slowing the economy will necessarily lead to higher unemployment and possibly a recession. Yet, this may be necessary medicine if the Fed is intent on bringing inflation under control. Further on in this quarterly letter, we will look at the prospect of a recession and how the U.S. stock market has performed in past recessions and accompanying bear markets. First, we will review the most recent (dismal) performance of the major asset classes.

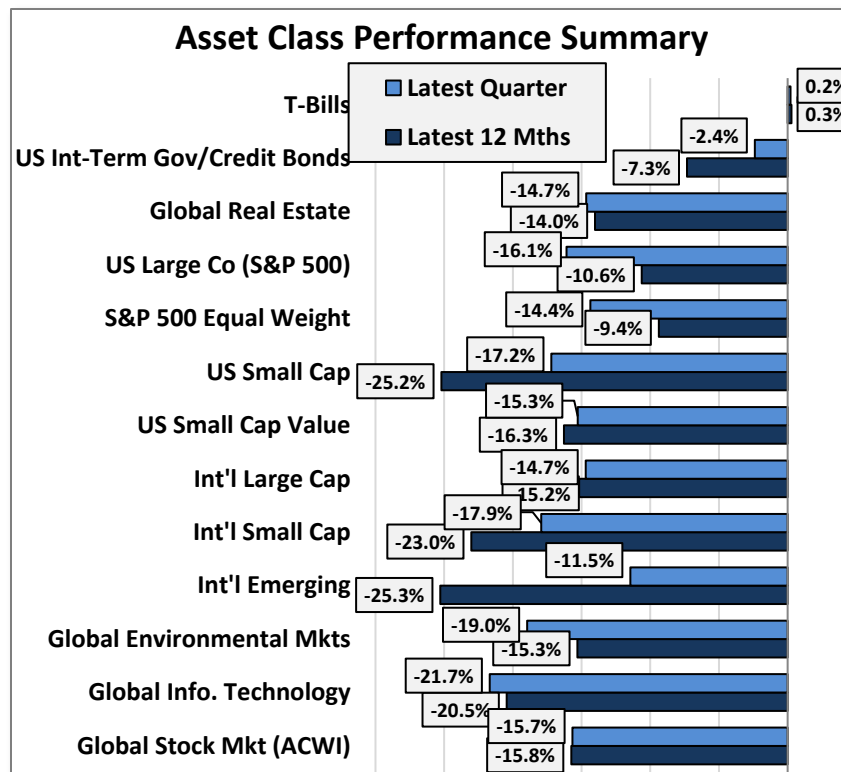
Asset Class Performance Review

The latest quarter was horrible for all of the asset classes with only U.S. Treasury Bills (i.e., a cash equivalent) in positive territory. Cash has been king so far in 2022. U.S. Intermediate-Term Gov/Credit Bonds, which are normally a relatively safe haven when stocks prices fall, were down by 2.4% for the quarter (there is some good news on bonds which we will report on later). The Global Stock Market was down by 15.7% for the quarter and the range of returns for the other asset classes and selected sectors within Equities was between -11.5% for Emerging Markets and -21.7% for Global Information Technology.

U.S. Stock Market Style Box Second Quarter 2022				
	Value	Blend	Growth	
	-8.2%	-15.6%	-29.8%	Large
	-12.7%	-15.4%	-21.3%	Mid
	-12.8%	-14.9%	-22.4%	Small

for Emerging Markets and -21.7% for Global Information Technology. Within the U.S. stock market, Growth Stocks continued to lead the way downward given their greater sensitivity to rising interest rates and their lofty valuations. Within the Morningstar U.S. Style Boxes (in the chart to the left), Growth Stocks were down between 21.3% and 29.8%; and Value Stocks were down between 8.2% and 12.8%. The S&P 500 was down by 16.1%. There was no place to hide during the latest quarter (and so far this year).

Returns over the trailing twelve months were similarly negative due largely to the sharp stock market selloff during the latest quarter. The only positive return came from U.S. T-Bills (+0.3%). U.S. Intermediate-Term Gov/Credit Bonds were down by 7.3% (longer-term bonds were down by close to 12%). Our recommended strategy has been to maintain a shorter duration in our clients’ bond funds allocation in anticipation of rising rates. This strategy has helped over the past 12 months as U.S. short-term bonds (not included in the table) were down between 3.2% and 5.9%. Within the stock asset classes and select sectors, the Global Stock Market was down by 15.8% for the year with the



others down between 14.0% (Global Real Estate) and 25.3% (Emerging Markets). U.S. Small Cap stocks were down by 25.2% for the trailing 12 months, but we see their current valuations as particularly attractive on a relative basis.

A Recession in the Future is Likely, but When and How Severe?

Based upon the opinions of several economists we follow, a few believe that the economy is already in a mild recession, while the majority believe that a recession might not begin until early 2023. Most believe the downturn will be moderate and significantly less severe than the Great Recession which was the worst recession since the Great Depression (if we can at least keep the word “Great” out of the next recession’s label, things might not be so bad). The reason economists are hesitant to call a recession at this point is that the labor market remains robust, wages are still growing, and consumers are still spending despite higher prices. On the other hand, many leading economic indicators are showing signs of weakening at a time when the Fed and other central banks around the globe are tightening monetary policies to fight inflation. Regardless of when a recession might begin, even a moderate recession would nonetheless be painful as millions of Americans would lose their jobs, consumers would cut

back on their spending and corporate earnings would suffer.

Of course, the likelihood of a recession is heightened if consumers and businesses are less confident about the future which they certainly are at the present time. Small businesses may be particularly vulnerable to the impact of a recession according to a recent poll by Kabbage, a small business lender owned by American Express. According to their survey, “More than four in five small business leaders say they worry that a recession will hit the economy soon and it will impact their businesses.” As interest rates climb, it will be more expensive for businesses to borrow which will increase their costs further. Kabbage found, however, “that small-business owners may be drawing lessons from the pandemic to help them prepare for a recession. Around 80% of respondents are confident about their businesses surviving a potential recession and said the top reason they feel that way is that the pandemic has helped them [develop] a greater sense of resilience and to prepare for any upcoming economic turbulence ahead.” According to Gina Taylor Cotter, executive VP of Kabbage’s Small Business Banking, “Small businesses are traditionally optimistic through difficult times because they’re comfortable making the necessary modifications to persevere.”

The Bulls and the Bears

For investors, a recession is typically preceded by a bear market which is defined as a drop in stock prices of at least 20% from the previous market high. Since 1960, we have had ten bear markets lasting an average of 14 months with an average drop in stock prices of 37% (excluding our current bear market). During that same 62 years, we have experienced nine recessions. The current bear market began in early January of 2022, when the MSCI All Country World Index (ACWI) reached its record high. Since the peak through July 11th, excluding dividends, the ACWI Index was down by close to 22%, the MSCI USA Equal Weighted Stock Index was also down by 22%, and the S&P 500 Index was down by 24%. The technology-heavy NASDAQ Index peaked on November 19, 2021 and was down by close to 30% through July 11th. Unfortunately, we may see further downside ahead based upon historic bear market averages, especially as the Fed ramps up its plan to fight inflation by raising interest rates. On the positive side, stock prices have now corrected to more sustainable levels and the potential gain for stocks once the bear market ends is quite



Bull and Bear Markets for the S&P 500 Index (Excluding Dividends)

Bull Market Began	Bull Market Return	Duration (Months)	Average Annual Gain	Market Peak	Bear Market Return	Bear Market Duration (Months)
Oct-60	39%	13	36%	Dec-61	-28%	6
Oct-62	76%	39	19%	Feb-66	-22%	7
Oct-66	18%	25	8%	Nov-68	-36%	12
May-70	74%	31	24%	Jan-73	-48%	20
Mar-78	62%	32	20%	Nov-80	-27%	20
Aug-82	229%	60	27%	Aug-87	-34%	3
Oct-90	417%	113	19%	Mar-00	-49%	30
Oct-02	101%	60	15%	Oct-07	-57%	17
Mar-09	401%	131	16%	Feb-20	-34%	1
Mar-20	114%	21	54%	Jan-22	-24% *	5
* through 7/11/22						
Averages excl COVID	157%	56	20%	Averages excl Current	-37%	14

substantial. Based upon historic data, the average bull market gain for stocks following bear markets is 157% over an average of 56 months, or 4.7 years. This equates to an average annualized rate of return of 20% during bull markets which is why we believe it is important to maintain a long-term view, especially during bear markets (note: the average returns in the table above exclude dividends which understates actual performance).

Some Silver Linings?

In a recent Bloomberg Opinion article published on July 5th, Mohamed A. El-Erian, economist and current chief economic advisor at Allianz and former CEO of Harvard Management Company, wrote a particularly insightful piece in which he stated that while the “pain may not be over for investors,” there are some silver linings as we look forward, including (the bold, italic emphasis is ours):

- ***First, genuine and more sustainable value is being restored after a period in which asset prices were lifted artificially and distorted by huge and predictable injections of liquidity by central banks.*** Already some prominent individual stocks are in oversold territory, having been technically contaminated by what has been a generalized selloff as liquidity has been receding. [Aequitas comment: we see attractive

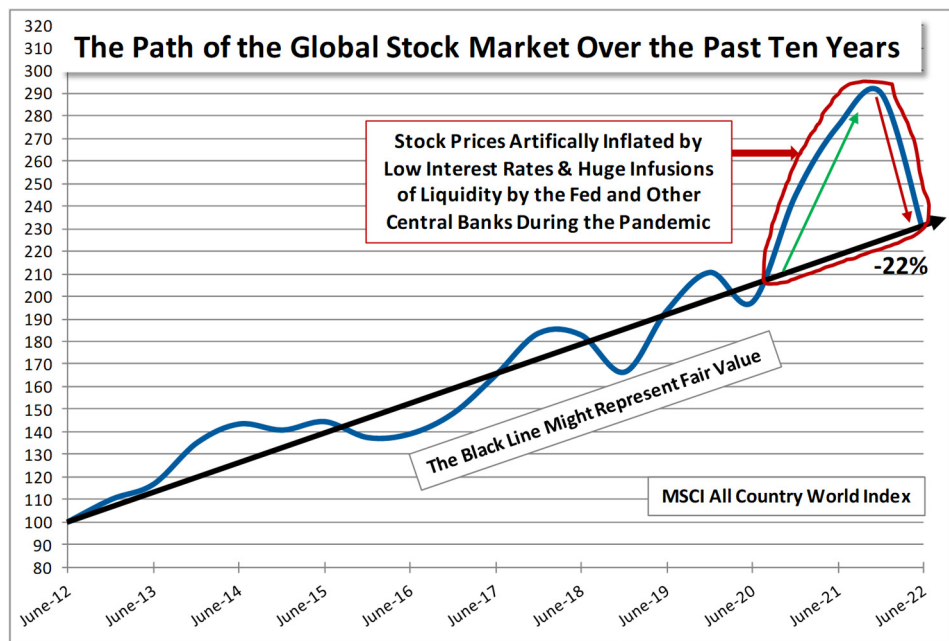
valuations in several areas of the stock market which should bode well for future returns over the long term.]

- **Second**, after tracking equities lower and, in the process, experiencing historic losses, **government bonds are resuming their role of risk mitigators in diversified investment portfolios. This is better news for investors who, for most of the first half of this year, felt that there was nowhere to hide.** [Aequitas comment: while high-quality bonds suffered during the first half of 2022, they still serve as a safe haven and should provide much better returns with higher yields going forward.]

El-Erian concludes:

For long-term investors, it will prove beneficial over time that markets are exiting an artificial regime that was maintained for far too long by the Fed and that resulted in frothy valuations, relative price distortions, resource misallocations and investors losing sight of corporate and sovereign fundamentals. **The promise now is one of a more sustainable destination. Unfortunately, it comes with an uncomfortably bumpy and unsettling journey.** [Aequitas comment: Amen]

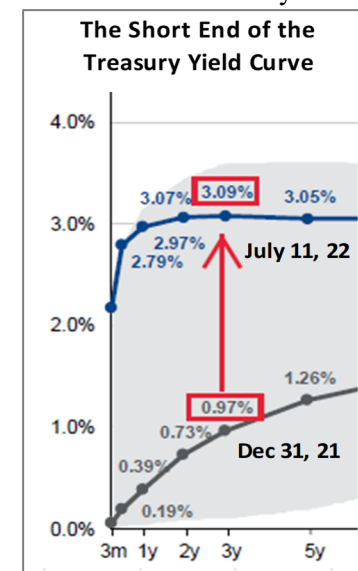
To expand upon El-Erian’s premise, we created the graph below to indicate how highly inflated stock prices were following the brief COVID bear market in



early 2020 through January of 2022 when the MSCI All Country World Index peaked. Most of the price distortion which El-Erian referred to has been erased following the 22% stock market correction over the past six months. While we might not have reached a bottom yet, El-Erian suggests that stock valuations are now priced at more sustainable levels which we agree with. This is good news for long-term investors looking forward, although the process of getting here has been painful.

Good News About Bonds!

Bond prices have taken a hit, as well, during the first half of the year, but the prospect for their future returns has improved considerably. In the chart to the right, note that the yield for a 3-Year Treasury Note at the end of last year was just 0.97%. On July 11th, the yield had risen to 3.09%. A 3-Month Treasury Bill (i.e., a cash equivalent) was yielding close to zero percent and now offers a yield of over 2% (good news for savers and money market funds). High-quality short-term corporate bonds offer yields of close to 4%. For taxable investors, municipal bonds offer taxable-equivalent yields of more than 6%, depending on one’s tax bracket (4.3% on a tax-free basis). These yields should improve overall future portfolio performance for our clients and will help offset some of the erosive effects of inflation (and will even be more beneficial once inflation subsides). Longer term, more favorable returns on bonds reinforces our view that a balanced portfolio structure consisting of high-quality bonds and globally diversified stocks will serve the best interests of our clients in achieving their lifetime financial goals.



Closing Remarks on Optimism

It is certainly an easier task writing our quarterly letters when the stock market is performing well, when there is less economic uncertainty, and when the world is in a better place. At times like these, when pessimism creeps in, we find it helpful to examine the lessons of history which inform us that there have always been bull and bear markets, but that over the long run, disciplined investors have earned favorable returns and achieved their financial goals by staying the course with their diversified portfolios, albeit with prudent adjustments along the way.

We also find it helpful to maintain an optimistic view about the future, especially during challenging times. A recent research study by the American Geriatrics Society found that those with the highest levels of optimism enjoyed a lifespan of between 11% and 15% longer than those who were less optimistic. In that spirit, we will close with a few quotes written about optimism which we hope some readers may find inspiring:

“Optimism is a huge asset,” Melinda Gates wrote in the 2017 Bill & Melinda Gates Foundation annual letter addressed to Berkshire Hathaway CEO Warren Buffett. “We see this in you, Warren. Your success didn't create your optimism,” she writes. “Your optimism led to your success.”

“A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.” Winston Churchill.

“My friends, love is better than anger. Hope is better than fear. Optimism is better than despair. So let us be loving, hopeful and optimistic. And we'll change the world.” Jack Layton, Canadian academic and politician.

“Human spirit is the ability to face the uncertainty of the future with curiosity and optimism. It is the belief that problems can be solved, differences resolved. It is a type of confidence. And it is fragile. It can be blackened by fear and superstition.” Bernard Beckett, New Zealand teacher and author.

“I am an optimist... I choose to be. There is a lot of darkness in our world, there is a lot of pain and you can choose to see that or you can choose to see the joy. If you try to respond positively to the world, you will spend your time better.” Tom Hiddleston, English actor.

We hope that you have an enjoyable summer, one full of joy *and optimism!*

