

From: Aequitas Investment Advisors

Re: The Perfect Storm (This too Shall Pass)

Definition of a Perfect Storm: An unusual combination of events or things that produce an unusually bad or powerful result (Collins English Dictionary).

It certainly feels like we're in a perfect storm given the unusual events which have occurred over the past few years, including: the global pandemic, trillions of dollars of economic stimulus, the war in Ukraine, oil and gas shortages, high inflation, the Federal Reserve hiking interest rates, bond prices tumbling, a strong U.S. dollar, a bear market for stocks, political turmoil, and catastrophic weather events (unfortunately, we've probably missed a few). From an economic perspective, the storm probably began with the Coronavirus pandemic in early 2020 which has led to more than 6.5 million deaths globally (and counting), including more than 1 million deaths in the U.S. The good news is that with the help of vaccines and safety precautions, the end of the pandemic is in sight. The bad news is that the pandemic created a devastating ripple effect on the global economy which has been exacerbated by the war in Ukraine.

In the financial markets, the eye of the storm surrounds the Federal Reserve in its battle to combat inflation (other central banks around the globe are taking similar actions). With inflation running persistently high, the Fed has recently reaffirmed its intention to continue raising interest rates for the remainder of this year and into 2023. The goal of monetary tightening is to reduce inflationary pressures by dampening economic growth. Higher interest rates increase the cost of borrowing which negatively impacts corporate earnings growth and stock prices. Rising rates also put downward pressure on bond prices and home prices. Unfortunately, while the Fed's actions are necessary to combat inflation, the combination of lower prices for stocks, bonds and housing has created a great deal of anxiety and uneasiness for investors. This is probably what Fed Chair Jerome Powell meant when he stated late last month, "We have got to get inflation behind us. I wish there were a painless way to do that, but there isn't."

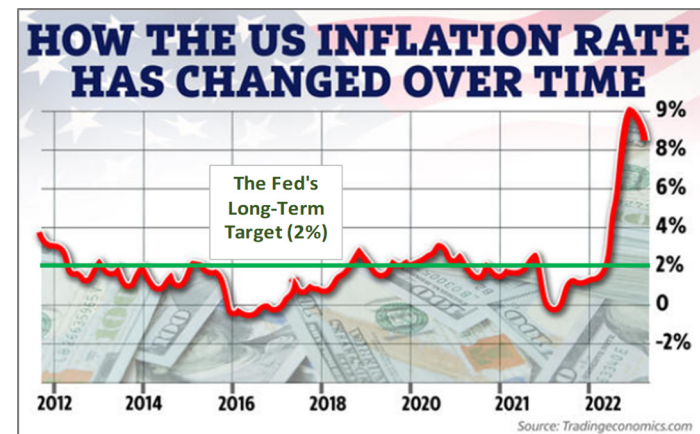
The Fed's Actions at the Beginning of the Pandemic

Last year, the Federal Reserve published a white paper entitled, *The COVID-19*

Crisis and the Federal Reserve's Policy Response, which provides important facts to consider as we review some of the causes of our current predicament (and remind ourselves just how bad things were in early 2020):

- Late December 2019 through March of 2020: Covid-19 began spreading around the globe causing the most severe economic downturn since the Great Depression. The U.S. GDP collapsed at an annual rate of over 30 percent during the second quarter of 2020. Unemployment rose from 3.5% prior to the downturn to about 15% in just two months. More than 22 million jobs were lost over a two-month period.
- The fiscal and monetary policies implemented between March of 2020 and March of 2021 in response to the pandemic were unprecedented in their "scale, scope and speed."
 - Legislation passed by Congress and signed by presidents Trump (2020) and Biden (2021) provided nearly \$5.8 trillion in fiscal support to the U.S. economy.
 - The Federal Reserve took extreme policy actions to maintain the functioning of the U.S. economy while at the same time reducing interest rates to near zero in order to stimulate growth.

All of the aforementioned stimulus and monetary support helped to create the fastest economic rebound in U.S. history. So successful were these policies that by the end of 2021 the unemployment rate had fallen back to under 4% and in 2021 the U.S. economy grew at its fastest pace in more than twenty years. Today, economic activity in the U.S. and most of the globe has largely recovered to pre-



pandemic levels. However, the increased consumer demand resulting from the stimulus and the gradual reopening of the economy, combined with global supply chain bottlenecks, a shortage of workers and the war in Ukraine, helped to create a surge in consumer price inflation to levels not seen in more than 40 years. Thus, the predicament we find ourselves in today.

The Fed's Reaction to Inflation (Policy Mistakes?)

For the twenty-year period ending in December of 2019 (pre-pandemic), the average annual inflation rate was a mere 2.1%. There were some years during that period when the Fed was more concerned about *deflation* rather than inflation. One of the ripple effects of the stimulus originating from the pandemic was a sharp acceleration in inflation. The Fed's first reaction was to label this spike as "transitory" given its belief that as supply chain issues eased and economic conditions normalized, consumer prices would eventually fall which seemed perfectly logical at the time. So far, however, all that's proven to be transitory is the Fed's messaging over the past eighteen months as it has abruptly shifted from low gear into high gear in its attempt to bring inflation under control. As a result, the Fed is subject to growing criticism that it made a series of policy mistakes in tackling inflation. Mohamed El-Erian, Allianz's chief economic advisor, recently commented on CBS's *Face the Nation* that the first mistake was in early 2021 when the Fed mischaracterized inflation as transitory. "By that, they meant it is temporary, it's reversible, don't worry about it." A second mistake was when the Fed recognized that inflation was persistent (mid to late 2021), but they didn't act in a meaningful way. He now sees there is risk the Fed will make a third mistake by reacting too strongly and tipping the economy into a recession. According to El-Erian, Fed Chair Jerome Powell has gone from, "looking for a soft landing to soft-ish landing to now talking about pain. And that is the problem. That is the cost of a Federal Reserve being late."

Presumably, had the Fed acted proactively, it might have implemented rate hikes sooner and more gradually which would have provided time for the financial markets to absorb the higher cost of borrowing. Perhaps inflation would have peaked sooner, and the stock market might not have reacted so negatively, and we would have experienced less pain. Of course, hindsight is 20/20 and it's easy to be critical of the Fed at this point in time. While we cannot change the past, we can evaluate reasonable economic assumptions looking forward and plan accordingly.

Are We in a Recession Now?

The best-case scenario would be an economic soft landing which would avoid a

recession, but that appears very unlikely at this point given the Fed's tardiness in monetary tightening. The next best-case scenario would be a mild recession, or perhaps a "rolling recession" which is the case being made by Dr. Ed Yardeni, president of Yardeni Research and an economist we've followed for more than thirty years. A rolling recession is one which affects only certain sectors of the economy at a time, rather than a broader recession impacting all sectors at once. Yardeni believes we have been in a rolling recession since the beginning of 2022 as evidenced by the first two quarters of mildly negative GDP growth (annual rates of -1.6% and -0.6% respectively). Traditionally, two consecutive quarters of negative GDP growth would meet the definition of a recession, but the National Bureau of Economic Research (NBER) has not declared a recession given that, among other factors, consumer spending remains strong, and unemployment remains historically low. These two factors would need to worsen materially for NBER to make the determination we are in a broad economic recession, so there is still hope we can avoid a more serious downturn, albeit dependent upon the Fed avoiding a third policy mistake.

Factors Suggesting a Brief and Shallow Recession

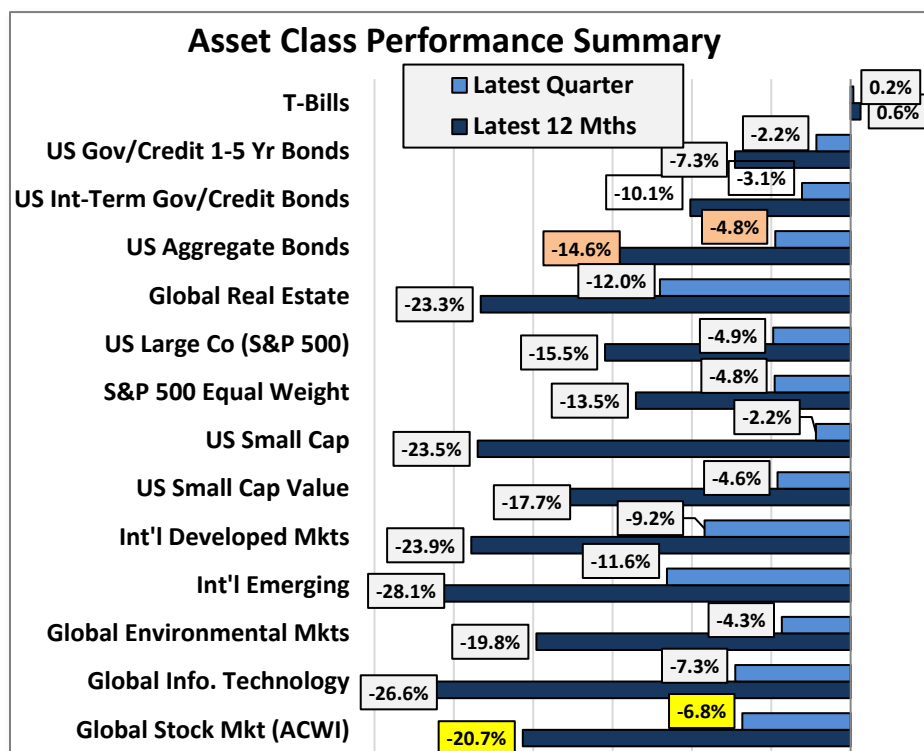
A recent article in New York Times, *Companies Hoarding Workers Could Be Good News for the Economy*, suggests that with the extreme shortage of workers in the U.S. (e.g., there are 1.7 job openings currently for every available unemployed worker), employers may be hesitant to lay off workers even when the economy cools. The authors suggest this may "...help prevent the kind of painful recession the Federal Reserve is hoping to avoid as it tries to combat persistent inflation." Supporting this view is the Fed's vice chair, Lael Brainard, who recently stated, "Businesses that experienced unprecedented challenges restoring or expanding their work forces following the pandemic may be more inclined to make greater efforts to retain their employees than they normally would when facing a slowdown in economic activity. This may mean that slowing aggregate demand will lead to a smaller increase in unemployment than we have seen in previous recessions."

The Conference Board (TCB), a global economic think tank and creator of the *Consumer Confidence Survey*, published its economic forecast for the U.S. economy which represents a reasonable assessment in our view. They project the U.S. economy will slip into recession in late 2022 or early 2023, but that the unemployment rate may only peak at 4.4 percent, which is quite low (and favorable) by historical standards. According to their forecast, "This expectation reflects severe labor shortages, especially in the in-person services sectors, that may continue despite the recession. We expect the coming recession to be relatively short and somewhat mild, and that the US economy will emerge from

the slowdown in 2023 still grappling with inflation well above the Fed's 2-percent target. This period will also exhibit stagflationary characteristics – though not as severe as those seen presently.” Their report projects core inflation to peak at around 5% by the end of this year and to recede to an annual rate of 2.8% by the end of 2023. (The Fed's long-term target is 2.0%.) Another TCB report published in early October, the *Measure of CEO Confidence* survey found the vast majority of corporate Chief Executive Officers are preparing their companies for a recession over the next 12-18 months, but 85% of those surveyed believe the recession will be “brief and shallow.”

Asset Class Performance Review

The tardiness of the Fed to deal with inflation coupled with its abrupt about face in monetary policy wreaked havoc on the investment markets. Over the past twelve months, in reaction to sharply rising interest rates, the U.S. Aggregate Bond Index plummeted by close to 15% (this index represents intermediate-term investment grade bonds). The shorter-term US Gov/Credit 1-5 Year Bond Index fared much better with a decline of 7.3% (the vast majority of our recommended bond funds are short-term). The only asset class or sector listed in the performance



summary below with a positive return was U.S. T-Bills which posted a modest gain of 0.60% (as of this writing, 3-Month Treasury Bills are paying about 3.5%). The Global Stock Market (MSCI ACWI) plummeted by close to 21% with returns of the other listed sub-asset classes and sectors in the performance summary ranging from a low of -28.1% (Emerging Markets) to -13.5% (S&P 500 Equal Weighted Index). *The latest trailing 12-month period is the first time in more than 90 years when both intermediate-term bonds and stocks have posted double digit declines!* Historically, bonds have typically performed favorably when stocks are down sharply, but not this time (consistent with this letter's theme of a perfect storm).

Returns on the international asset classes over the past year have not only been buffeted by a weakening economy and rising interest rates, but also negatively impacted by the strong U.S. dollar which has gained about 16% against a basket of foreign currencies over the past 12 months. While this magnifies the negative returns in the international asset classes in the short term, for U.S. investors this means we can buy shares of non-U.S. companies at a significant discount, much like it is now less expensive to travel abroad thanks to the strong U.S. dollar (a silver lining!).

The returns over the latest quarter were likewise dismal. The U.S. Aggregate Bond Index was down by 4.8% and the Global Stock Market was down by 6.8%. Shorter-term bonds performed more favorably (-2.2%). U.S. T-Bills posted the only positive return (+0.2%). Within equities, all of the sub-asset classes and selected sectors were down between 2.2% (U.S. Small Caps) and 12% (Global Real Estate).

The Bubble Appears to Have Deflated

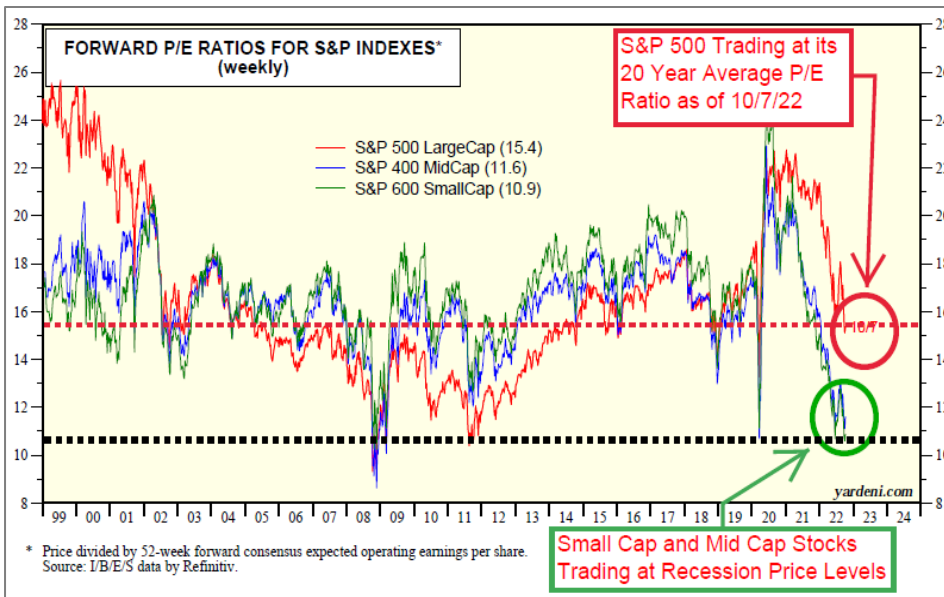
In the chart to the right, note the jagged path of the Global Stock Market (ACWI) for the past few years through 9/30/22 which includes the Covid-19 plunge in early 2020 (-34%), the stimulus-fueled surge (+236%), and the subsequent bear market (-26%). Also drawn on the chart is a dotted straight black line representing the



long-term growth trajectory of the ACWI. For the trailing 20 years ending 9/30/22, the ACWI generated an average annual return of close to 8% which we believe is also a reasonable future long-term rate of return assumption based upon current valuations. While the bear market of 2022 has been painful, we believe that stocks globally are now more attractively priced, and their future appreciation potential is more closely aligned with their long-term growth trajectory. Furthermore, certain asset classes are trading at significant discounts to their historic long-term valuation levels, especially Small and Mid-Cap U.S. stocks, and international stocks in general.

Current Stock Valuations

One of the more useful measures of forecasting future *long-term* stock market returns is the Price-to-Earnings Ratio (P/E Ratio) based upon one-year forward earnings estimates. Essentially, when stocks are “expensive”, their P/E Ratios are elevated and when stocks are “cheap”, the opposite is true. History has

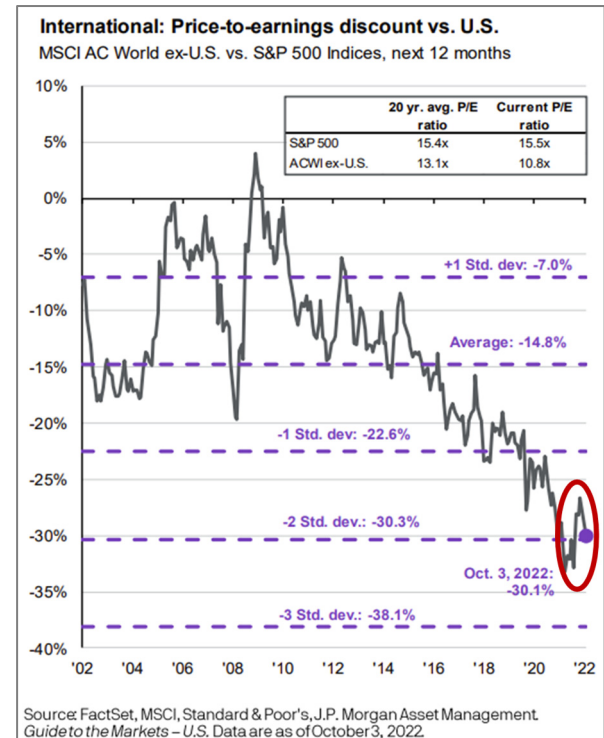


demonstrated that when valuation levels are high, such as they were to an extreme extent in 1999 an early 2000 (i.e., the Tech Bubble), future returns tend to be low. For example, in early 2000, the P/E Ratio of the S&P 500 peaked at a record-high of 26x earnings which implied a low future rate of return at that time. Indeed, the average annual return for the S&P 500 for the subsequent 5 years was -2.3%. In contrast, when the P/E Ratio was extremely low (under 10x) at the end of 2008 (i.e., the Great Recession), the subsequent average annual return of the S&P 500 over the subsequent 5 years was slightly more than 17%. Over the entire time

span indicated in the chart to the bottom left (close to 24 years), the average annual return for the S&P 500 has been 6.6%, but bear in mind that the chart begins near the height of the Tech Bubble. From the approximate point at which the S&P 500 returned to its long-term average P/E level at the end of 2002, the subsequent average annual return through 9/30/22 has been 9.5% which is close to its historic average return since 1926.

While the S&P 500 has “corrected” to a more reasonable valuation level during this bear market, the valuation levels of Small and Mid-Cap stocks are priced at extremely low valuation levels – even close to the extremely low levels of the Great Recession as indicated in the green circle and green text box on the graph to the left. For this reason, we have increased our model portfolio’s target weight to U.S. Small and Mid-Cap stocks.

Regarding investment opportunities elsewhere around the globe, we recommend maintaining our target weights to international stocks which also appear to be very attractively valued on a relative basis. In the chart below, the relative valuation level of international stocks (MSCI AC World ex-U.S. Index) is compared to the S&P 500 Index. U.S. stocks have historically commanded a “premium” over international stocks due to our country’s status as the premier capital market and safe haven. The average “discount” of international stocks over the past 20 years is close to 15%, but as of early October, the discount is about 30%, or twice the normal discount, i.e., the S&P 500 Index is currently trading at 15.4 times earnings while international stocks are trading at 10.8 times earnings. Of course, one of the reasons for the valuation discrepancy is that the S&P 500 has outperformed, especially since 2016. On the other hand, we don’t believe this discount will endure over the long-term which is why international stocks may provide more favorable returns looking forward.



Higher Returns Looking Forward Based Upon Historic Precedents

Beginning at its record high point on January 3rd of 2022, the S&P 500 fell into a bear market by mid-June and, as of this writing, reached a low point for the year on October 11th with a cumulative decline of 25% from its peak (a bear market is defined as a decline of 20% or more). While it is uncertain whether the stock market has reached a bottom in this bear market, the table below indicates subsequent returns for the S&P 500 following declines of 25%, or more. The average decline of the nine periods in the analysis has been 37.6% and the average *subsequent* appreciation has been 21.6% after 1 year, 36.9% after 3 years, 83.3% after 5 years and 213.7% after 10 years. In terms of compound average annual returns, these figures equate to 21.6%, 11.0%, 12.9% and 12.1% respectively. Such returns would go a long way toward restoring our portfolio values and getting the Global Stock Market back in alignment with its long-term growth trajectory as mentioned previously.

When the S&P 500 is Down 25% or Worse Since 1950						
Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		-37.6%	21.6%	36.9%	83.3%	213.7%

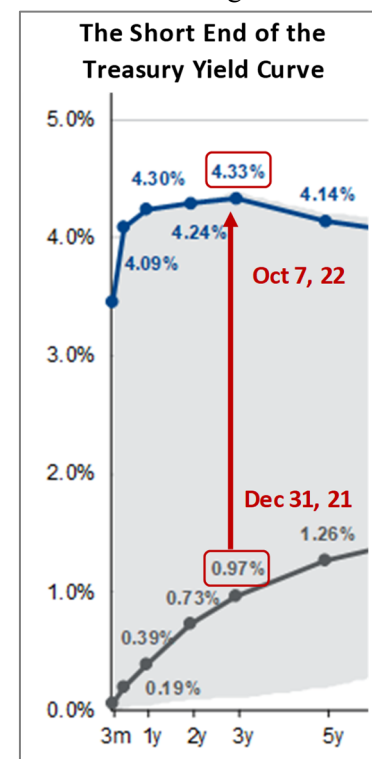
Data: YCharts

Silver Linings?

This year will likely be remembered as the year when one of our most important core principles appears to have let us down, i.e., maintaining a globally diversified and balanced portfolio to dampen portfolio volatility. With the Global Stock Market down more than 25% and the U.S. Aggregate Bond Index down over 15% this year, bonds have failed to significantly reduce downside risk and it may appear less attractive than normal to rebalance from bonds back into stocks.

Nonetheless, listed below are a few opportunities that have presented themselves this year, despite these disappointing “headline” results:

- **Portfolio Rebalancing Opportunities:** Rebalancing can improve client portfolio returns over the long term, whether rebalancing between stocks and bonds, or within the various asset classes. Differences in relative valuations are typically great opportunities to reduce exposure to more expensive asset classes and increase exposure to more favorably priced asset classes, even when all major asset classes appear to be down.
- **Higher Bond Yields:** While some of our clients who have already retired may wish to rebalance within equities rather than moving assets from fixed assets back into equities, yields have increased with rising rates, so the income component on our client’s bond portfolios has quadrupled since the end of last year based upon an average maturity of 3 years. Note in the graph to the right that the yield on a 3-year Treasury note began the year with a yield of 0.97% while today the yield is 4.3%. Even within IRA accounts, higher yielding treasury securities can be purchased to “lock in” current higher yields on future Required Minimum distributions (RMDs).
- **Increased Social Security Income:** One of the benefits of higher inflation is that the Cost-of-Living Adjustment (COLA) on Social Security payments will be adjusted upward again, this time by 8.7% next January for about 70 million Americans.
- **More Attractive Roth Conversion Opportunities:** With IRA account values down this year, a conversion from a traditional IRA to a Roth IRA might result in 20-25% less in taxes being paid with the added benefit that future appreciation would accrue on a tax-free basis. For example, if a portion of one’s IRA that was valued at \$100,000 at the beginning of the year is now converted at a lower value of \$75,000, then the tax on the conversion might be 25% less depending upon one’s tax bracket. Furthermore, this represents a particularly good opportunity for those who expect their marginal tax rate to increase in the future.



- **Tax Savings Opportunities:** As we have recommended and implemented successfully in past market downturns (2008 and 2020 notably), for taxable accounts there is a great opportunity to sell mutual funds and other securities that have a loss on paper and replace them with comparable alternative funds while realizing tax losses that can be used in the current taxable year or carried forward into future tax years.

We recognize that only a few of these opportunities may apply to each of our client's unique situations. We also recognize it may be difficult to celebrate these opportunities with our portfolios at such depressed levels. However, we are firm believers in focusing on those beneficial components of our process that we can control while maintaining our disciplined long-term perspective throughout these turbulent markets. Said another way, *when life gives you lemons, make lemonade!*

Closing Quotes and Thoughts

We customarily conclude our quarterly letters with the words of others who offer important perspectives. We begin with one of our favorites, Jeremy Siegel, professor of finance at the Wharton School and author of *Stocks for the Long Run*:

Despite all the ups and downs and crises, and bear markets that we've had over the last 30 years, the real return on stocks has been absolutely the same [i.e., an average of about 6% over inflation over the long term], which is really quite remarkable. And secondly, not only do stocks tend to overcome inflation in the long run, they completely overcome inflation. They have trouble when the Fed is tightening. We see that now.....When the Fed tightens and raises real interest rates all assets go down in price. Look at bonds, stocks, and [even] real estate [has] started to go down. There's no question about that. And in fact, many commodities [including gas prices] now are going down. But once that tightening is done, once normalization comes back, they [stocks] make up the lost ground and they get back to that long-term trend.

Next, comments from Bob Veres, financial planning columnist and commentator on the investment industry for more than 40 Years (was a classmate of Warner Henderson's at Union College):

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 scanning the headlines, don't bother; none of that is happening. Stock prices have never

been a precise indicator of what companies are worth. They are a very good indicator of what people are willing to pay 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 always, in the past, have surpassed) their original highs. What's happening right now is not unlike what happens when one of our 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 has to be cured if we are to experience a healthy economic life.

Finally, a major reason for our long-term optimism at Aequis rests on human ingenuity. In this vein, we will close with the words from another investment advisory firm, Cententus Wealth Advisors of Newtown Square, PA:

Our optimism is based on the instinctive impulse of all 7.5 billion humans on earth to become more: To be, to do, and to own. The spirit of capitalism combined with human ingenuity and technology are thriving all over the world. Despite government, politics, financial crises, armed conflict, natural disasters, religious strife, and terrorist atrocities. It's the combination of our human urge to become more, together with our natural ingenuity, which has driven the incredible explosion in quality of life in the last 10,000 years. We can be comfortable investing in a future shaped by human ingenuity, because it is a resource that can never run out, and we have not even scratched the surface of what it can accomplish.

We wish you and your loved ones well, and we look forward to our future meetings and communications (hopefully more of which will be in-person!).

