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3RD QUARTER 2022

Market Commentary

There are two times in a man's life when he should not speculate: when he can't afford it, and when he can.–Mark Twain

The quarter began with an 11% gain for the S&P 500, but the rally quickly faded, leaving stock and bond markets to plumb new lows in September. While commodity prices declined this quarter, lagging effects in housing and other components of core CPI continued to advance. These persistent inflationary factors and expectations of further central bank tightening, along with accompanying fears of recession, drove the volatility this quarter. Inflationary pressures will abate over the next several quarters, but this process will take time and inflation is already provoking anxiety among American consumers who find it increasingly difficult to plan their budgets and future savings. Measures of the real US economy remain robust. Unemployment remains at lows not seen since the 1960s, and more workers participate in the labor force than before the pandemic. Corporate earnings will be impacted by economic weakness outside the US and the strength of the dollar. However, this weakness has largely been incorporated into current stock valuations, which now offer considerable upside should this current transition period end sooner than expected.

The United Nations Conference on Trade Development recently issued a report pleading with the Federal Reserve to ease its aggressive tightening policy, warning that further US interest rate hikes risk triggering a wave of financial crises across the developing world. Several countries already defaulted on their debt, including Lebanon and Sri Lanka. Argentina narrowly avoided default by accepting a deal with the IMF. While this period of commodity supply shocks, and tighter monetary policy poses severe risks to underdeveloped countries, nations with established public equity markets represent, for the most part, the most developed and least risky developing nations. Unlike emerging market debt investing, which encompasses the full breadth of the developing world, only a small group of relatively stable countries possess functioning stock markets. We tallied every country in which our four emerging market managers had, in aggregate, at least 1% exposure. The total came to twelve countries, only two of which – Brazil (7.2% of the total) and South Africa (2.3%) – had government debt rated below investment grade. Not surprisingly, Asia encompassed the vast majority of the allocation. Aside from Brazil and South Africa, the only other non-Asian countries on the list were Mexico and Poland.

A quarter century ago, developing Asian economies experienced a brutal financial crisis. The crisis began in Thailand and then spread across Southeast Asia, eventually encompassing China and Korea. Heavy borrowing in US dollars, combined with current account deficits, fixed exchange rates, and internal corruption put these countries in a vulnerable position. When global investors began to pull back from new investments, it spurred a banking and credit crisis. The humiliation felt across the region endures to this day and spurred policies to prevent a repeat of the late 1990s, including removing fixed dollar exchange rates and issuing government debt predominantly in local currencies. Importantly, when the UN report listed countries at risk due to inflation rates above 10% over the past year, no South or East Asian country made the list except for Thailand and Sri Lanka. The currencies of emerging market countries in which our managers invest held up better against the dollar than the euro, pound to yen. Asia contains the largest population of middle income consumers and houses leading manufacturing and technology companies.

The Tech Bubble of 2000-2002 and the 2008 Global Financial Crisis shaped our views of bear markets. In both periods, the S&P 500 fell by over 50%, and losses exceeded 80-90% for the sectors most directly impacted – technology in 2000-2002, and financials in 2008. However, by historical standards, these are outliers. The S&P

500 declined by more than 20% on twelve occasions between 1950 and the present, including the short-lived 30% drop in reaction to COVID-19 and the roughly 25% decline this year. Only the two bear markets during the first decade of this century saw declines greater than 40%. Of the remaining eight bear markets, only the 1973-74 bear market had a decline significantly greater than 30%. Peak losses from the other seven bear markets fell in the 20-30% range, equivalent to where we stand today. So, ignoring 2020 and 2022, out of the ten bear markets from 1950-2019, 70% had maximum declines in line with the S&P 500 in 2022.

The stratospheric valuation of technology stocks, combined with the bankruptcy of most of the telecom sector, drove the losses in 2000-2002. While this era perhaps offers the greatest similarities to the present, tech stocks traded at far higher valuations in the early 2000s. Microsoft, one of the few hot stocks from that period to remain a major a major component of the technology sector, traded at 62 times earnings in March 2000 compared to a peak P/E ratio of 38 last year. The triple-digit P/E ratios of other tech darlings such as Cisco Systems or Oracle Corporation dwarfed Microsoft's valuation during that period. The NASDAQ 100 Index, representing large US technology companies, traded at 175 times earnings at its peak in 2000 compared to a 38 P/E last year. It took over a decade for these stock prices to recover. Microsoft's stock price did not exceed its year 2000 peak until 2017. Cisco Systems' stock price still remains at about half its all-time high. Combined with the near-complete wipeout of unprofitable tech stocks (including an over 90% drop in Amazon.com's share price), investors suffered over an 80% decline in the tech-heavy NASDAQ for the index this year, which brought the NASDAQ 100 to a quite reasonable P/E ratio of around 23.

Bankruptcies surrounding telecom and corporate fraud scandals such as Enron, WorldCom and Tyco also roiled markets in the early 2000s. These incidents prompted reforms to corporate governance and gave lengthy prison terms to executives found guilty of fraud. This reduces the fraud risk for investors today. The explosion of internet traffic spurred massive, debt-financed investments in optical fiber to serve the explosion in traffic. The telecoms overbuilt and became unable to service this debt after demand waned and prices fell. Today, the debt levels of publicly traded companies remain well below the levels of the 1990s and 2000s.

Unlike the boom in tech-spending in the early 2000s, which was one-time hardware and software purchases, the pandemic-driven tech spending predominantly went to subscription-based software and cloud computing services, which represent a recurring, consistent source of revenue to the companies providing these services. This boom in pandemic- related tech spending is a primary reason why the high quality growth stocks that provided a cushion in past bear markets have borne the full brunt of this volatility. Software now comprises a large part of this universe and, fearful of slowing sales growth, the market drastically cut the valuations for the sector. These stocks possess stable recurring revenue, prudent levels of debt, and high returns on capital and should weather any difficult economic environment.

The 2008 Global Financial Crisis remains fresh in our memories. While most who watched the run up in housing prices and observed the ridiculous lack of underwriting on mortgages understood the unsustainability of the housing bubble, few saw the extent to which the banks exposed themselves to this risk, as most of it was hidden off balance sheet. The subsequent implosion of global financial markets threatened a catastrophic economic depression comparable to the 1930s. Fortunately, central bank intervention stabilized the financial system and allowed for a recovery that became the great bull market of the 2010s. As a result of the reforms initiated after 2008, the banking sector today owns higher quality assets and is far better capitalized.

With the less severe challenges facing the financial markets today than in either 2000 or 2008, what risks do remain? US Inflation averaged 1.7% annualized over the past decade. The pandemic-driven supply chain disruptions and commodity price shocks exacerbated by Russia's invasion of Ukraine created a 1970s-style inflationary supply shock that unsettled both the financial markets and real economy this year. While inflation will decline from the current 8-9% levels, persistently higher levels of 3-4% may be the new norm. Driven by poor financial performance and climate concerns, investments in new oil and gas production dwindled over the past several years. A similar situation occurred with minerals. A boom driven by Chinese demand in the 2000s turned to bust around a decade ago, driving major mining companies nearly to bankruptcy. The large mining companies today, similar to the emerging new paradigm in the oil and gas industry, emphasize capital discipline and cash flow over expanding production at any cost. The move to renewable energy trades a long term ...

dependence on fossil fuels for an immediate demand for an immediate demand for the minerals required for batteries, solar panels and wind farms. The media coined the term 'greenflation' to describe the impact of these policies for businesses and consumers around the world.

The cheap offshore manufacturing and shipping that led to declines in the prices of goods over the past 20-30 years also face challenges. Reliance on just-in-time inventories and outsourcing will decline. The pandemic made businesses realize the need for more robust supply chains. Geopolitical challenges and increasing costs will also lend support to higher inflation levels.

These factors will end the era of cheap energy and cheap capital that led to significant malinvestment over the past cycle. The beneficiaries of easy money over the past decade, namely speculative tech stocks, meme stocks and cryptocurrencies, continue to inflict the largest (and likely permanent) destruction of value. A higher cost of capital benefits suppliers of capital - including your portfolio. Bond portfolios will adjust to the increased rates and begin to deliver higher rates of return. These higher yields will better support distributions. Similarly, more expensive capital will impose discipline on the equity markets, favoring companies that can earn high rates of return and punishing those dependent upon cheap money and fanciful narratives. In the short run, this volatility may persist and even get worse, but it remains important to focus on long-term outcomes.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer

Smart Investing Webinar

Tuesday, October 11, 2022 at 11:30 Central on Zoom

We invite you to join Steve Browne, CFA, CIO and Alison Moss, CEO, for a discussion on the current market and economic conditions.

Link to join the webinar
https://us02web.zoom.us/j/82618953825?pwd=Skc2V0x4WUV6MFd1OURacE1DaTVRZz09

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Mark your calendar

November 23, 2022, Office Closed at 1:00 p.m.
In Observance of Thanksgiving

November 24-25, 2022, Office Closed
In Observance of Thanksgiving

December 23, 2022, Office Closed at 1:00 p.m.
In Observance of Christmas

December 26, 2022, Office Closed
In Observance of Christmas

2023 Smart Investing Webinars

January 17th at 11:30 AM Central
Smart Investing Webinar– Fourth Quarter Market Review

April 11th at 11:30 AM Central
Smart Investing Webinar– First Quarter Market Review

July 18th at 11:30 AM Central
Smart Investing Webinar– Second Quarter Market Review

October 11th at 11:30 AM Central
Smart Investing Webinar– Third Quarter Market Review