Dear Valued Client:

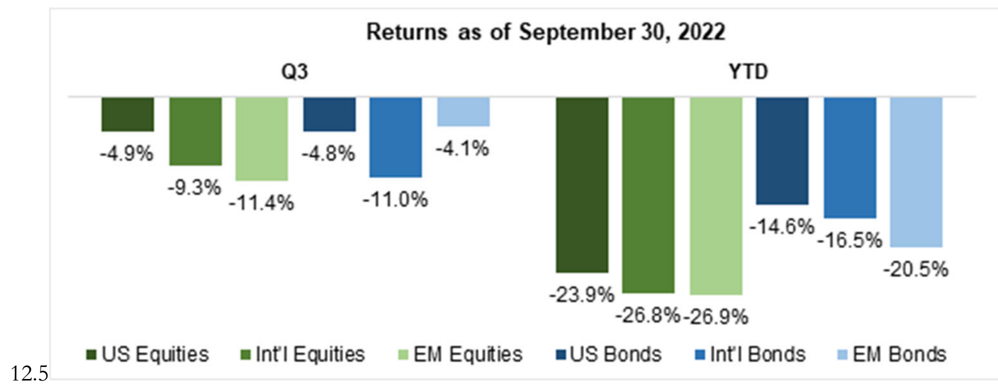
Last Spring, the hometown Boston Celtics were two games away from securing banner number 18 before falling to the Golden State Warriors in a terrific but heartbreaking (for Celtics fans) series finale. The Celtics' elusive search for another championship stands in contrast to the period in the 1960's when the Celtics dominated the league, winning championships every year but one in that decade (a total of 11 in 13 seasons). The team was led by its fearless captain and greatest winner in team sports history, Bill Russell, who left us this summer at the age of 88. Beyond basketball, Russell left his mark on the world in many ways including his indefatigable work fighting for civil rights and social justice- fights that continue in earnest today.

"Defensively, he was always there to help us" said one of his teammates. Russell had the athleticism and intelligence to force the opposition to do what he wanted them to do and the uncanny ability to "pivot" quickly to lend a helping hand to block or minimally alter a shot. It is said the defense wins championships and Russell's attention to defense certainly proved the point.

In today's market environment, defense is paramount as the risk on rally of mid-summer has yielded to a risk off environment. The market rally this summer was fueled by the narrative that inflation had peaked and that it was just a matter of time before the Fed would "pivot" and slow their rate hikes leading to a soft landing in the economy. Unfortunately, the strength of the labor market (which we wrote about in September) has seemed to deepen inflation fears. Last Friday, the Labor Department reported that the economy had added 263,000 jobs in September, while the unemployment rate had fallen back to multiyear lows of 3.5%. More concerning may have been a surprise drop in the participation rate, to 62.3%, indicating that competition for available workers would remain intense. Nevertheless, the increase in wages appeared to be slowing, with average hourly earnings continuing to decline on a year-over-year basis to 5%, compared with March's peak of 5.6%. Markets moved back into risk-off mode following a solid start to the quarter.

Below, we explore the conditions that are currently influencing the direction of markets and our thoughts on what could happen in the intermediate and long-term. Markets dislike uncertainty and the current environment has given us plenty to not like. The set up coming into the quarter is eerily similar to last quarter when markets went on a surprising run. Sentiment is in the dumps and earnings are expected to be poor. Is a contrarian move possible?

## Third Quarter Market Review

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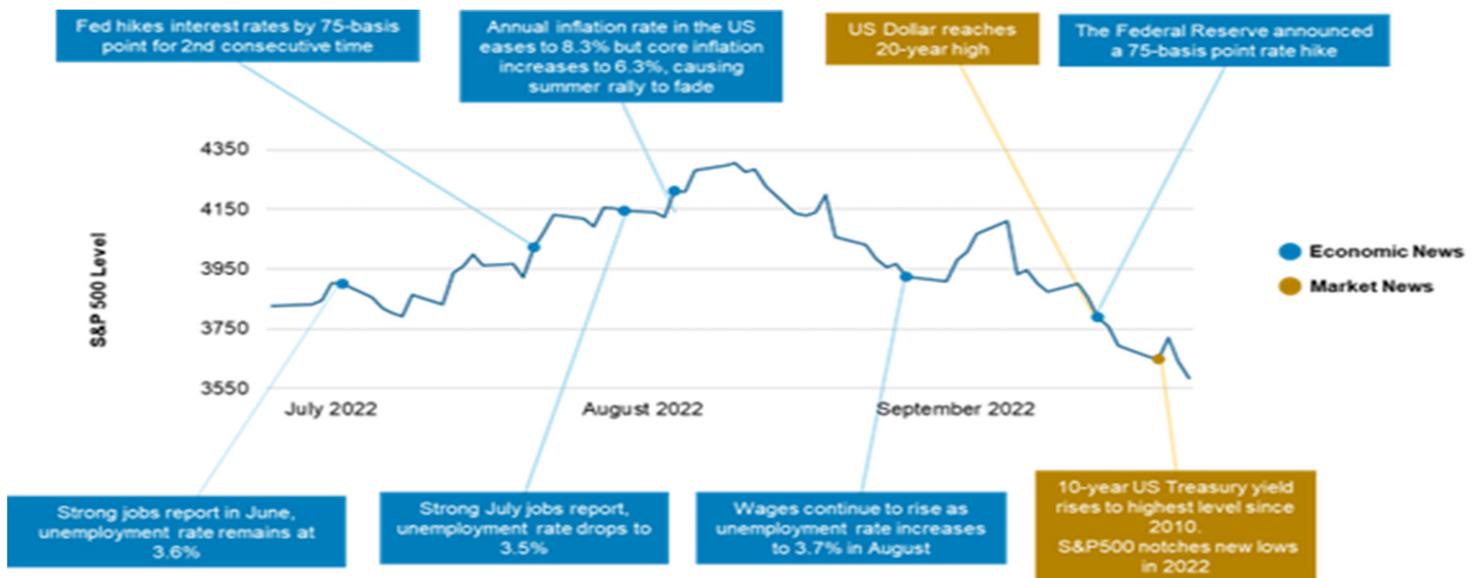
Source: Zephyr StyleADVISOR

- **The quarter began with a short-lived summer rally that fizzled only to set new lows.** Record high inflation, aggressive interest rate hikes from global central banks, and fear of recession left no place for investors to hide. For the third quarter, the diversified 60/40 portfolio invested 60% in global stocks, and 40% global bonds returned -6.8% and performed worse than one just invested in global stocks (-6.7%) as global bonds posted dismal returns (-6.9%). Within equities, US stocks sunk back in bear territory to end the quarter -4.9%. Similarly, US bond yields which move in the opposite direction of prices, rose to their highest levels in years as hopes for falling inflation were erased when core inflation rose in August despite falling gas prices.



- **Within US equities, 9 out of 11 sectors suffered losses in 2Q22.** Surprisingly, the consumer discretionary sector gained 4.4% for the quarter, helped by select stocks despite having a greater sensitivity to the overall business cycle. However, it remains the second worst performing sector at -29.9% for the year. Similarly, the energy sector gained 2.3% despite falling oil prices during the quarter and remains the only sector with positive returns of 34.9% for the year.

- **Value stocks reverse trends and underperform.** Growth stocks are often synonymous with the high-flying companies in the markets like technology, while value stocks are often considered undervalued, steady, and sometimes even boring. For the quarter, value stocks underperformed their growth counterparts, a reversal in trends from the prior quarter. Still, large-growth stocks are on pace to have their worst year since 2008.

- **International equities underperformed US equities in 3Q22.** Developed international, emerging markets ended 3Q22 at -9.3 % and -11.4%, respectively, as the energy crisis and recession fears continued to roil European economies while China continued to struggle under its zero COVID policy. A strong dollar also had a significant impact. Generally speaking, a stronger dollar translates to lower returns for international investments. This can be seen in its local currency returns, especially for developed international, which ended 3Q22 at -3.5%. In local currency, this would put it as one of the better performing developed market equity markets without the currency drag.

- **Bonds post steep losses in the third quarter.** US bonds fell 4.8% in the quarter as the Fed's aggressive efforts to tame inflation brought two more rate hikes of 0.75%, raising the effective federal-funds rate to 3.00%-3.25%, its highest level since 2008. Despite higher inflation, TIPS fell 5.1% due to rising rates despite inflation concerns. Longer-term Treasuries, which have the greatest sensitivity to interest-rate changes, were the hardest hit and fell by 9.6%. US high yield bonds were surprisingly among the best performing sector and only fell 0.6% despite ongoing recession fears. Lastly, a stronger dollar and inflation woes also led international bonds lower for the quarter.

- **Key commodities, including gold, oil, and copper, declined over concerns of weaker demand due to global economic slowdown.** Oil prices fell below $80/barrel to their lowest levels since Jan '22. Gold prices fell 7.9% for the quarter and have failed to meet expectations as an inflation hedge or a safe haven investment in 2022. Expectations for higher interest rates in the US led the dollar to rally 7.8% for the quarter and 17.6% for the year. One notable exception within commodities were grains, specifically wheat, with strong gains for the quarter as the conflict in Ukraine continues to impact the world supply. Finally, US REITs lost 10.8% for the quarter over concerns of rising costs due to higher interest rates.

## Outlook

The Federal Reserve has made it abundantly clear that they are willing to sacrifice the economy to recession to correct their policy mistakes and tame inflation. Inflation worries were exacerbated last week after the so-called OPEC+ group of oil exporters announced a 2 million-barrel per day cut in target production, pushing oil over the $90/barrel mark for the first time since late August. As noted above, financial markets overreacted last week to an insignificant dip in unemployment because the Fed overreacts to the data as well. Markets have been terrible at predicting the latest inflation and employment reports resulting in high volatility and moves to the downside. Hoping for better news has been disappointing to say the least, especially bad when you consider that we are in effect rooting for job losses! The Fed, and Chairman Powell specifically, have told investors that they want to see a material softening in the labor market, and an unemployment rate at 50-year lows does not fit the bill.

There are many reasons for the continued strength in the labor market. Employers are continuing to rehire both people who were let go during the pandemic and people who would have been hired if Covid had not happened. While this effect is fading—private payroll growth averaged 337K in the third quarter, compared to 527K in the first—it is still quite strong. Service sector jobs continue to be in demand, and we have yet to figure out the quagmire that is our immigration policy. For the Fed, the best possible labor market outcome next year is that wage growth slows without a big increase in unemployment, so a near-term sustained downshift in wage growth would allow officials to start talking about the end of the tightening. It is possible that some softening will show up early next year and that would be a welcome surprise.

Taking a step back, there are many culprits that have gotten us to this point. Bad monetary policy i.e., printing too much money has devalued the currency relative to the value of real goods and services, driving prices up. The pandemic sent shock waves across the world and disrupted our daily lives forever. Covid issues roiled supply chains and shipping, both of which, fortunately, are seeing some improvement. Some blame good old fashioned corporate greed whereby companies take the opportunity to drive up profits during a crisis. Demand has increased as consumers interact in a post-covid environment and spend the government largess they have been handed. The spending, moving from goods to services, has driven down the cushion that has so far buoyed the economy. Pantheon Macroeconomics reported that peak savings were at $2.1 trillion last August and about $630 billion of that has been spent. The aforementioned pressure on wages has also been a big contributor to inflation and that is one of the harder ones to contract. Throw in an unexpected war in Ukraine and it is not hard to see how we got here.

The Fed has begun to succeed in taming the housing market. Mortgage rates in the US have moved over 6.5%, well above levels at the beginning of the year. On October 3, 2022, Fortune magazine reported that "The U.S. housing market to see the second-biggest home price decline since the Great Depression". This headline, while attention grabbing, fails to account for the remarkable increases that took place over the past decade fueled by that same Fed. Housing still remains structurally undersupplied for the near-term and the pipeline for new home construction is dry. Rental markets are equally tight, with historically high occupancy levels. This dynamic does not bode well for the "shelter inflation" figure which makes up one-third of the overall Consumer Price Index (CPI) basket and more than 40% of core CPI. The US needs more housing, but this will not come quickly enough to meet demand. Recent data shows a drop in housing permits as homebuilders scale back. Hurricane Ian's effects on the price of materials on top of the billions of dollars in damage will be felt in the coming months as well. On a positive note, many homeowners took the opportunity to refinance into low fixed-rate mortgages helping to keep exiting home debt manageable.

The conundrum we face is not likely to reverse quickly as the impact of the Fed's hikes has yet to permeate the economy. The next 3-6 months should start to show a slowing in demand and a rise in unemployment. Volatility is likely to remain elevated as conditions push south. The impact of sticky inflation, elevated wage growth, and a higher cost of capital are placing downward pressure on earnings and profit margins. Some of the mark downs have been reflected in prices but P/E's still remain higher than they have been in prior periods of higher inflation. In addition, the US dollar remains stubbornly high, and this puts additional pressure on foreign companies and large multinationals (as well as many S&P 500 constituents with large overseas business). While analysts have brought down their estimates, we expect further downward revisions this quarter and next. More on that below.

There is no universal agreement on whether we are in recession now but next year seems like a good bet. First Trust CIO Brian Wesbury recently wrote "We are not "recession deniers," we just don't think one has started yet. The distortions of economic activity from lockdowns, massive deficit spending, and money printing are immense. It's hard to imagine the US can unwind these policies and not have a recession. Monetary policy, for example, is going to have to get tight and stay tight to bring down inflation and keep it there, so we don't get into a stop-and-go cycle of inflation problems like we did back in the 1970s and early 1980s. And a monetary policy that gets tight enough and stays tight enough for long enough to achieve that goal is very likely to cause a recession. We're just not there yet."

Markets have now retested and fallen below the lows earlier in the year. Sentiment according to the Bull/Bear is at –30.8%. The last time we saw this level was in early July when the reading hit –33%, just before earnings season and a (in hindsight) bear market rally. Since July, we have experienced a devastating hurricane, an averted but potentially upcoming rail strike, and an escalation in geopolitical tensions that shows little sign of abating. The wall of worry is high. So, what could go right?

Certainly, any signs of inflation slowing down would be most welcome. Earnings will be in focus this month and any surprises there could provide a boost. That said, Charles Schwab's Jeffrey Kleintop recently shared that there is a historically tight relationship between global manufacturing purchasing managers index (PMI) and earnings growth for global companies. He writes "the PMI tends to lead the trend in earnings growth by three months, with the dividing line at 50 between expansion and contraction in global manufacturing aligning with the analysts' consensus outlook for earnings growth and contraction in the coming year. The PMI turned negative in September as the quarter came to an end, likely pointing to flat earnings on a year-over-year basis for global companies as we look out to the fourth quarter." The survey did show a continued drop in the survey's measures of supply-chain tightness, which points to a steep slowing in margin inflation and in turn consumer inflation. Finally, we know that the cure for higher inflation is inflation itself. While sticky, we do expect inflation to come down next year, to what level is very unclear.

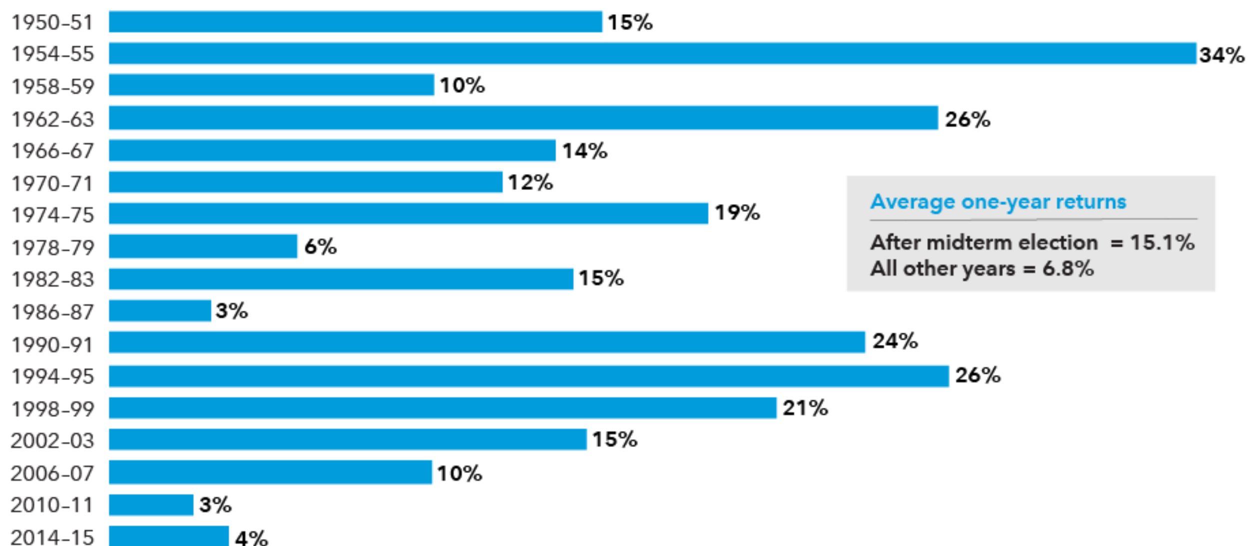
Minutes from the most recent Fed meeting showed that 'several participants indicated that, once the policy rate had reached a sufficiently restrictive level, it likely would be appropriate to maintain that level for some time until there was compelling evidence that inflation was on course to return to the 2% objective" - but a shift to smaller rate hike and then a pause may not too far off, if the inflation data behave. We have three CPI reports before the December Fed meeting which will impact the Fed direction. In the interim, we will see the mid-term elections play out where markets have historically done well post-election.

There are certainly no guarantees that this year will follow suit. However, investor pessimism, as seen in the Bull/Bear ratio and in the Put/Call ratio, could be signs that the markets are reaching an inflection point.

Markets can move higher during periods of tightening as witnessed with Fed tightening during the 2003-2007 bull market and again during the 2009-2020 bull market (St. Louis Fed). Certainly, the dynamics today are much different, and we are less sanguine about a quick return to a bull market as bear markets have normally lasted longer than average during recessions.

The silver lining for investors is that after these bouts of volatility, markets tend to rebound strongly in subsequent months. They have historically rallied shortly after midterm elections. History shows that this is not usually a short-term blip either, as above-average returns are typical for the full year following the election cycle. Since 1950, the average 1-year return following a midterm election is 15.1%, more than double that of all other years during a similar period.

S&P Index price return one year after a U.S. midterm election




Sources: Capital Group, RIMES, Standard & Poor's. Calculations use election day as the starting point in all U.S. election years, and November 5th as a proxy for the starting point in other years. Only midterm election years are shown in the chart. Results in USD.

We remain cautious and have been positioning portfolios accordingly. Specifically, we have raised cash during the quarter, reduced the duration and credit risk in our bond portfolio (replacing funds with credit and duration risk with ultra-short duration funds that are less sensitive to interest rate hikes yet yield north of 4%), and added more hedged ETFs to our portfolios that offer some downside protection through options and leave the door open to capitalize on a good portion of upside. We are very pleased with the performance of our long/short manager, the Invenomic Fund, currently one of the top hedge funds in the industry as ranked by Morningstar, Inc. The fund has provided terrific levels of protection and performance during the market downturn.

The bond market has experienced one of its worst years ever, creating a source of consternation for investors seeking safety. With rates up significantly from the beginning of the year, we are able to finally earn a modicum of return that has been elusive for many years. We still believe that bonds will struggle in the coming year as the Fed continues to tighten. As such, we will keep our interest rate sensitivity low and look for better re-entry

points next year. We will also look at other non-correlated assets to add to our portfolios in the coming year as appropriate.

In short, one might describe the outlook as "cloudy, with a chance of meatballs". The Fed is playing catch up and is very attuned to headlines that support their case for more tightening. For now, we will be watching those numbers with continued angst but maintaining our patience through this challenging time. In addition, we will continue our loss harvesting to help reduce current taxes and set up portfolios to offset future gains.

Our headwinds/tailwinds summary is below.

Headwinds

- Federal Reserve tightening aggressively
- Inflation (commodity prices) staying high in a decelerating economy
- Supply chain issues and declining labor participation hampering economic growth
- Equity and fixed income valuations remain high on an historical basis despite the recent pullback
- Elevated corporate and government debt levels now looking at higher interest costs.
- Geopolitical risks are escalated with the war in Ukraine showing no signs of abating and Chinese and North Korean saber rattling.
- Covid still impacting the world but to a lesser degree.

Tailwinds

- Strong labor market a double-edged sword
- Some signs of economic slowdown could start to show up in the numbers important to the Fed.
- Significant cash on the sidelines- hedge funds are holding a ton of cash and contrarian signals from sentiment readings are growing louder.
- Healthy consumer and corporate balance sheets and continued consumer spending although savings are diminishing.
- Earnings expectations are still positive in 2022

**PRW News**

PRW's Director of Advanced Planning Ted Dziuba was named Most Valuable Player of the Boston Metro Baseball League's 28+ division for the second year in a row. An avid baseball enthusiast and former minor leaguer in the NY Mets system, you can usually find Ted on a north shore ballfield throughout the spring and summer months playing for one of his 3 amateur baseball teams.

We will be launching our new website this quarter. Please look for an announcement soon.

Thank you for your trust and confidence. We look forward to connecting with you over the coming months.

William A. Payne     Richard A. Renwick     Elliot B. Herman

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Asset classes are represented by the following indexes:

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| **US Equities** | **S&P 500** – is an unmanaged index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the US economy (typically large cap companies) representing approximately 75% of the investable US equity market. |
| **International Equities** | **MSCI EAFE** – is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of countries considered to represent developed markets, excluding the U.S. and Canada. |
| **Emerging Markets Equities** | **MSCI Emerging Markets** – is a free float-adjusted, market capitalization index that is designed to measure the equity market performance of countries considered to represent emerging markets. |
| **Global Equity** | **MSCI ACWI -** measures large- and mid-cap equity performance of developed and emerging markets. Represents approximately 85% of the global equity investment universe. |
| **US Small Cap Growth** | **S&P 600 Growth -** measures the performance of the small cap growth segment of the US equity market. |
| **US Small Cap Value** | **S&P 600 Value -** measures the performance of the small cap value segment of the US equity market. |
| **US Mid Cap Value** | **S&P 400 Value** – measures the performance of the mid cap value segment of the US equity market. |
| **US Mid Cap Growth** | **S&P 400 Growth** – measures the performance of the mid cap growth segment of the US equity market |
| **US Large Cap Value** | **S&P 500 Value** – measures the performance of the large cap value segment of the US equity market |
| **US Large Cap Growth** | **S&P 500 Growth** – measures the performance of the large cap growth segment of the US equity market |
| **US Bonds** | **Bloomberg US Aggregate** — measures the market of USD-denominated, investment grade, fixed-rate taxable bond market of SEC-registered securities, including bonds from the Treasury, government-related, corporate, mortgage-backed securities (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS sectors. US Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to the US Aggregate Index on April 1, 2007. |
| **International Bonds** | **Bloomberg Global Aggregate ex USD** - is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classification. |
| **Emerging Markets Bonds** | **Bloomberg Emerging Markets USD Aggregate** - is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classification. |
| **Global Bonds** | **Barclays Global Aggregate -** measures the performance of global, investment-grade debt from 24 local currency markets. This benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. |
| **TIPS** | **Bloomberg US TIPS** - measures the performance of inflation-protected securities issued by the US Treasury. |
| **US Long Treasuries** | **Bloomberg Long Treasuries** - measures the performance of long-term US Treasury bonds, including all publicly issued securities that have a remaining maturity of ten or more years, are: non-convertible, denominated in US dollars, rated investment-grade, fixed-rate and have $250 or more of outstanding face value. |
| **High-Yield Bonds** | **Bloomberg US Corporate High Yield** - measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt. |
| **Consumer Discretionary** | **S&P 500 Consumer Discretionary Sector -** measures the performance of companies involved in industries such as: automobiles and components, consumer durables, apparel, hotels, restaurants, leisure, media and retailing. |
| **Real Estate** | **S&P 500 Sector Real Estate -** measures the performance of companies from the following industries: real estate management & development and REITS, excluding mortgage REITS. |
| **Energy** | **S&P 500 Sector Energy -** measures the performance of companies involved in the development and production of crude oil, natural gas and provide drilling and other energy-related services. |
| **US REITs** | **FTSE NAREIT All Equity REIT -** measures the price of physical commodities futures contracts traded on US exchanges, except aluminum, nickel and zinc, which trade on the London Metal Exchange. Weightings are determined by rules designed to insure diversified commodity exposure. |
| **Gold** | **Bloomberg Sub Gold** - measures the price of gold futures contracts, reflecting the return of underlying commodity futures price movements quoted in USD. |

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| **Commodities** | **Bloomberg Commodity** - dynamically rebalances exposure to maintain a 10% volatility target and represents portfolios consisting of the S&P 500 index and a cash component accruing interest. Uses S&P 500 methodology and overlays algorithms to control the index risk at specific volatility targets. |
| **US Dollar** | **US Dollar Index** - measures the value of the US dollar relative to the value of a 'basket' of currencies of the majority of the U.S.'s most significant trading partners. Factors the exchange rates of six major world currencies: euro, Japanese yen, Canadian dollar, British pound, Swedish krona and Swiss franc. |

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