INVESTMENT INSIGHTS

Market Outlook

October 2022

The Perfect Storm?

Merriam Webster defines a perfect storm as: "A critical or disastrous situation created by a powerful concurrence of factors." This accurately describes the rough waters that investors have been navigating through in 2022. Inflationary pressures, rising interest rates, falling equity prices, and recessionary fears are the concurrence of factors.

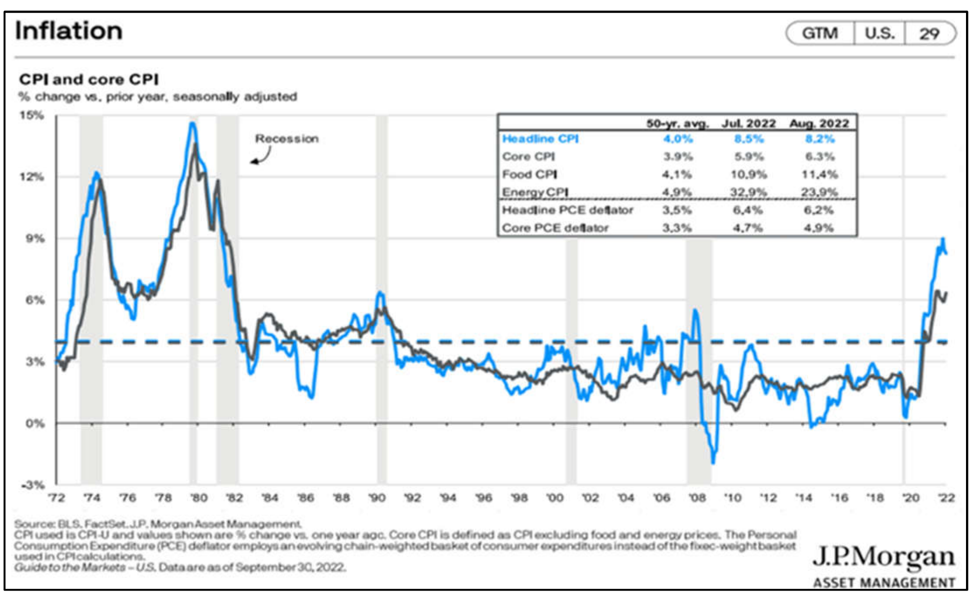
> Financial markets remain volatile while the Fed finishes their job battling inflation.

Financial markets will likely continue to be volatile until the Federal Reserve has accomplished its task of taming inflation. The Fed Funds Rate stands at 3.25% with the Fed raising rates 0.75% at each of their last three meetings. Market expectations are for two additional increases before year end, perhaps an increase of 0.50% instead of 0.75%, closing the year with the Fed Funds Rate near 4.25%.

In response to the Fed's tightening monetary policy, prices, as measured by CPI, have been steadily declining. CPI peaked at 9.1% in June on a year-over-year basis, a level not seen since 1981. July and August saw price increases of 8.5% and 8.3% respectively, and economists are expecting September to show 8.1%. While this is welcome news, the greater concern for current markets is that core inflation (excluding Food and Energy) has not yet peaked and price levels are still far above the Fed's preferred target of 2%. Inflation pressures are not just a U.S. issue. Global economies are battling rising levels of inflation, and their central banks are just now embarking on rate increases, which will determine the direction of international markets for the foreseeable future.

> Headline CPI has peaked, but Core CPI has not, and prices remain above the Fed's target .

> Global economies are also battling inflation, only they have just begun rate increase cycles.



	50-yr. avg.	Jul. 2022	Aug. 2022
Headline CPI	4.0%	8.5%	8.2%
Core CPI	3.9%	5.9%	6.3%
Food CPI	4.1%	10.9%	11.4%
Energy CPI	4.9%	32.9%	23.9%
Headline PCE deflator	3.5%	6.4%	6.2%
Core PCE deflator	3.3%	4.7%	4.9%

Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.
Guide to the Markets – U.S. Data are as of September 30, 2022.

J.P.Morgan ASSET MANAGEMENT

Bank of New Hampshire WEALTH MANAGEMENT

The Fed's determination to eradicate inflation will most likely result in a softening labor market and slowing economy. Because there is a lag between Fed rate policy changes and the economy's response, a more broad-based decline is still a likely scenario. As mentioned last quarter, many variables factor into the inflation equation making it difficult to predict the severity of a slowdown. We continue to maintain our neutral position towards equities, while favoring high quality, large capitalization companies over more speculative positions.

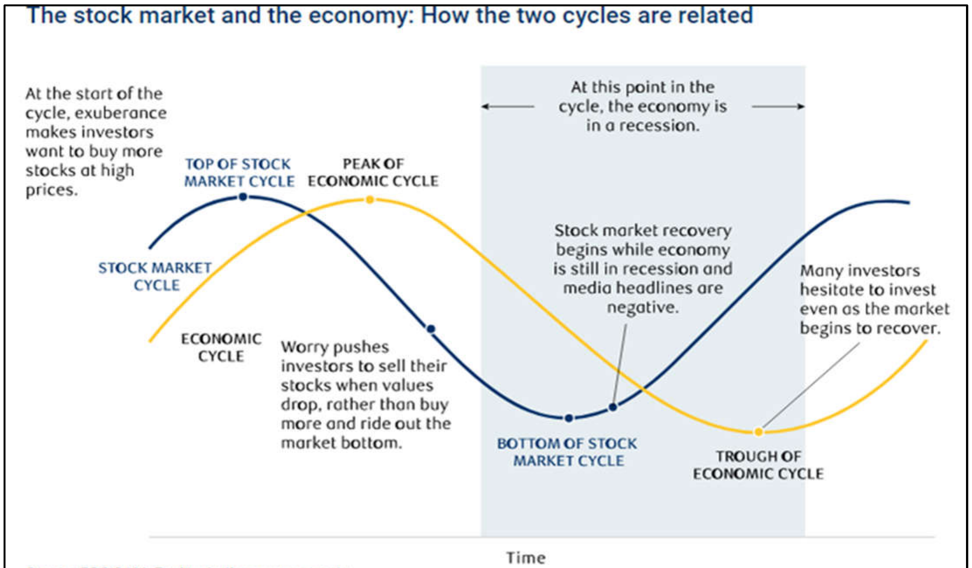
The fight against inflation will bring about a more broad-based economic decline.

Stocks, in anticipation of the Fed's response to rising prices, began correcting six months before CPI peaked. Year-to-date through September, the S&P 500 index is back in bear market territory after a failed rally in August. The index posted a decline of -24% while the tech heavy NASDAQ suffered a -32% decline over the same time period.

We expect continued volatility into next year as the market maneuvers through various headwinds caused by the midterm elections, inflation, rising interest rates, the strengthening dollar and the Russia/Ukraine war to name a few. We will be watching carefully for signs of a market recovery which, as shown below, usually happens before signs of an improving economy.

Mid-Term elections, inflation, rising rates, Ukraine war, all are headwinds the markets will need to maneuver.

The stock market and the economy: How the two cycles are related



Source: RBC GAM. For illustrative purposes only.

Fixed income normally serves as the ballast of the ship during tumultuous times. Equities and fixed income are normally negatively correlated, meaning that when stocks are down, bonds enjoy positive returns. As equity markets turn stormy, investors flow their money from the riskier asset, equity, into the relatively safer fixed income, causing bond prices to elevate.

Equities and Fixed income are normally negatively correlated, hence the perfect storm.

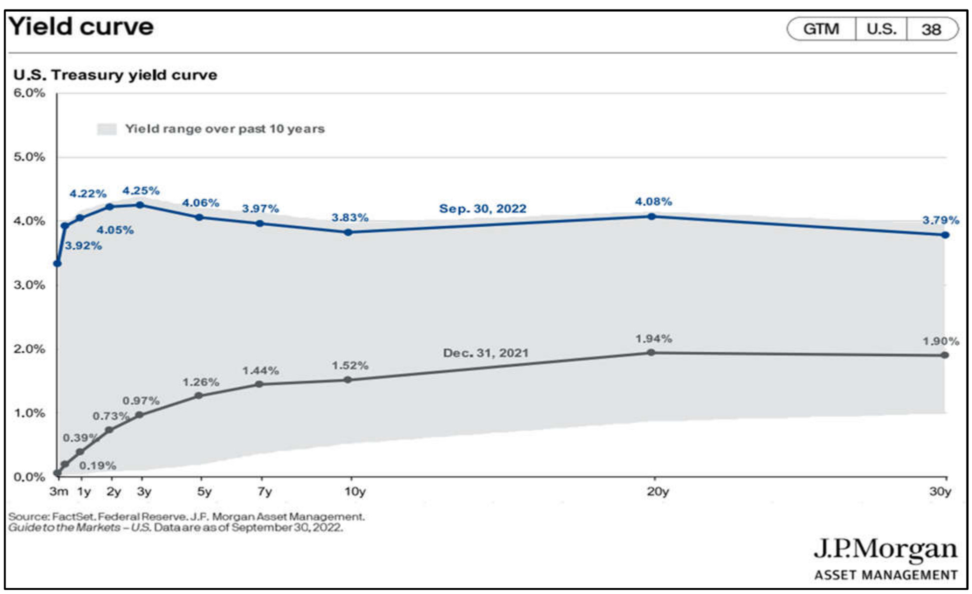
As long as a company's credit analytics are still sound and leverage is under control, their credit spread (the additional yield given for the additional risk taken to invest in an asset with more risk than US Treasury bonds) should remain stable.

Currently however, as the Fed has raised its interbank lending rate at such a fast pace, the price of existing bonds (which have borne very low yields for over a decade) has dropped dramatically. In addition, the balance sheet of certain creditors are not positioned as well as others to face the oncoming recession, and their credit spread has deteriorated, exacerbating the situation. The good news is that most creditors are well-positioned for this "rainy day" as they have just come out of 12 years of a bull market where they were able to stockpile cash.

> Creditor balance sheets are well positioned to withstand a recession and recover quickly.

The Fed's relentless attack on inflation has caused the entire US Treasury yield curve to rise significantly. Higher yields have led to higher lending rates. A year ago mortgage rates were about 3% but are now closing in on 7% which has caused the housing market to decline, and this has had a trickledown effect on sales of hard items such as washing machines as well as all of the services that support the housing and real estate industries. Additionally, the increase in US Treasury rates has not been consistent across the curve, with shorter-term rates now higher than longer term rates. Historically, every inverted curve has ended in a recession within the following 12-18 months. However, living through the perfect storm means that things that normally happen might not: expect the unexpected. We remain vigilant on tracking the course of the curve as it is still a good indicator of what the market is "thinking."

> Yield Curve is inverted with higher yields in the short term, this typically means recession in 12-18 months.

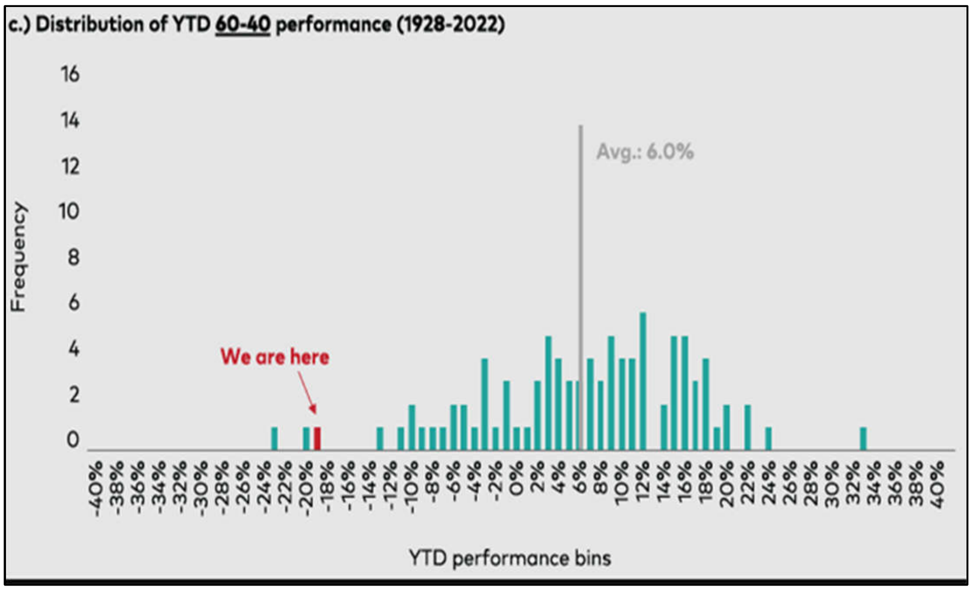


Looking forward, once inflation has subsided, it's possible that the Fed's actions will have caused enough economic damage that unemployment will rise. At that point, it's likely that the Fed will be forced to ease these pressures and start to lower rates. Although the current increase in rates has caused ancillary damage, it's nice to have fixed income actually creating some real income once again. Compared to inflation, it's still not a positive yield, but once inflation is tamed, we can continue to enjoy the higher rates that we're experiencing.

> The Fed's fight will cause unemployment to rise and the economic damage will need repair, bringing lower rates once again.

While the preceding paragraphs paint a somewhat dour picture, history offers up reasons to be optimistic towards the future. The decline in both equities and fixed income has some investors thinking that a diversified portfolio no longer offers protection against volatile swings in the market. A report from Vanguard notes that this has been one of the worst starts for the markets since 1928. The chart below shows the year-to-date performance through September for the last 94 years. It clearly shows how far outside the "normal" market returns this year really are.

Markets are off to their worst start Year to Date since 1928. This is outside the norm.



Keep in mind, the chart above shows returns from January – September since 1928. Since 1926, there have been 37 quarters where stocks and bonds both declined. That represents 10% of all quarters in that timeframe. And, "the frequency of down quarters for both stocks and bonds has been much lower since 1990 than in the first 60 years of the data set" (Kloepfer, 2022). This tells us that this storm, while worse than most, is not unusual. It also tells us that storms have been occurring with less frequency over time.

Storms are never easy to navigate, this one is worse than most, but also not unusual.

"Looking at annual returns, there have been only two calendar years when stocks and bonds were both down, 1931 and 1969, with a near-miss in 2018" (Kloepfer, 2022). We still have three months left in this calendar year. If both equities and fixed income end the year in negative territory it would be one we will remember.

So how does a Fed committed to fighting inflation and a double digit market decline in stocks bode for the future? History tells us that the long-term investor will be rewarded for staying disciplined. Since the 1960s, anytime the S&P 500 index posted a decline of more than 25%, the following 1, 3, 5 and 10 years periods were almost always positive. Ben Carlson put together the table on the top of the next page:

Long-term investors are rewarded for staying disciplined in their approach to investing.

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

The reward for patience is compelling, short-term risks for long term gains.

We cannot know for certain how deep a recession will be or when the economy will recover. We cannot know when the equity and fixed income markets will recover. We do know that the only way to achieve long-term gains like those shown above, is by accepting short-term risk. To do this, we must align our emotional time horizon with our investment time horizon, and remember that every perfect storm transitions back to calmer seas.

Our emotions can wreak havoc on our investment goals, this storm will also pass.

References:

Carlson, B. (2022, October 2). Getting long-term bullish. https://awealthofcommonsense.com/2022/10/getting-long-term-bullish/

Kloepfer, J. (2022, May 13). Stock and bond declines at same time in 2022: What it means. Callan. https://www.callan.com/blog-archive/stock-and-bond-declines/

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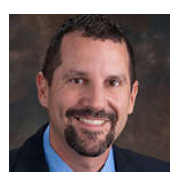

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