Good afternoon,

The third quarter of 2022 ended much as every quarter has ended this year, which is down. In fact, this is the worst nine month start to the year since 2002. Here are the year-to-date returns of key market indices:

S&P500 (IVV)	-24.81%
Nasdaq (QQQ)	-32.82%
Int'l Developed Markets (EFA)	-28.81%
Emerging Markets (EEM)	-28.60%
US Bonds – Int-term (AGG)	-15.55%
US Bonds - Short-term (SHY)	-5.06%

Source: Charles Schwab

The returns of just about everything were negative. In fact, of the 112 asset classes represented by Morningstar, 104 have lost money so far in 2022. The last time the percentage was this high was 2008.

Of course, as it turns out, investing at the end of 2008 was not a bad idea. In 2009 only 2% of asset classes lost money, and in 2010 the figure was 0%. It's not a question of "if" the market recovers, but "when."

With this in mind, I'd like to discuss what we are doing in portfolios we manage today, as well as what we are watching going forward. Think of these as potential pivot points to lead us out of the current decline.

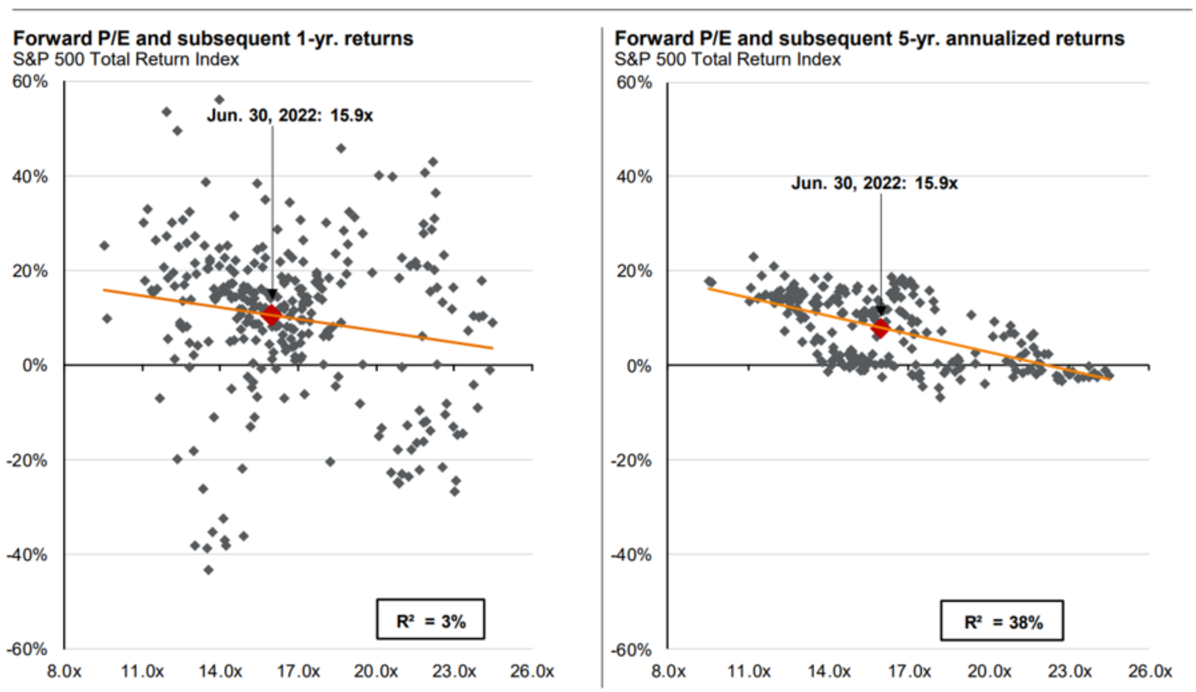
Pivot #1: Inflation This is the biggest item to watch by far, as it impacts just about everything. The Federal Reserve has stated that until it sees signs of a more sustained drop in inflation, it will keep raising interest rates. Current projections put the overnight rate at 4.5% in the 1st quarter of 2023, compared today's 3.25% rate.

The Consumer Price Index (CPI) came in at 8.3% for August. As long as the CPI remains above the Fed's target range of 2 -2.5%, they are likely to keep their aggressive rate-hike stance. This has many implications, as higher interest rates result in higher borrowing costs, slowing consumer demand, a drop in economic growth, pressure on corporate earnings; all of which can maintain a negative on stock prices.

One thing to keep in mind is that inflation is measured on a year-over-year basis. As we enter the 4th quarter of 2022, comparisons will be made to the end of last year, when prices were already rising. This, coupled with the effects of the rate-hikes, could result in a potentially dramatic decline in inflation.

Pivot #2: Earnings One of the things that has held up surprisingly well this year is earnings growth. The 2nd quarter saw earnings on the S&P 500 increasing at an 8.9% rate. The drop in stock prices, combined with the resilience in earnings has made stocks much more attractive on a valuation basis then they were at the start of the year. If 3rd quarter earnings reports this month show earnings are maintaining a positive trajectory, we might see stocks stage a meaningful recovery. The chart below outlines the current price/earnings (P/E) ratio and future expected returns and suggests we are in positive territory. There is little predictability on a 1-year basis, but when you broaden your perspective to 5 years, things become less chaotic.

P/E ratios and equity returns



Source: FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning 5/31/97. R^2 represents the percent of total variation in total returns that can be explained by forward price-to-earnings ratios. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since January 1997 and by FactSet since January 2022.
Guide to the Markets – U.S. Data are as of June 30, 2022.

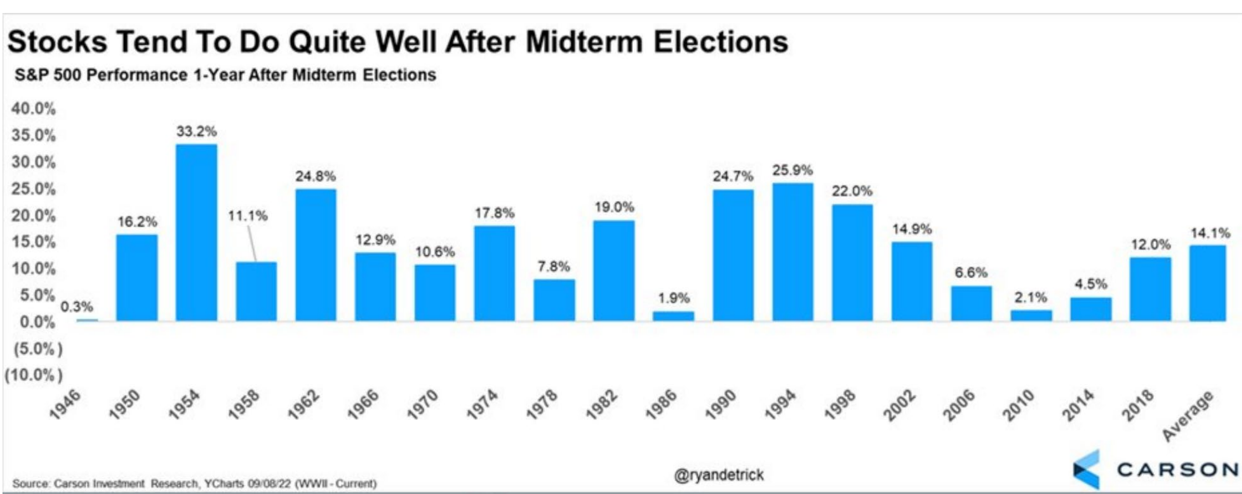
Pivot #3: The U.S. Dollar The dollar recently reached a multi-decade high against a basket of foreign currencies. This is great news if you are planning to travel to Europe, but not so great for investments in international equities. Simply put for every 1% rise in the dollar, foreign stocks will decline 1% for a U.S. investor. The primary reason for the dollar's dominance is both a stronger U.S. economy as compared to overseas as well as higher interest rates domestically.

However, as the chart below shows, when the dollar turns the other direction, it can turn quickly. This would lead to the potential for outperformance in international stocks. We saw this in 2017, which was marked by a period of international equity outperformance.

Source: Yahoo Finance

Pivot #4: Politics The mid-term elections are rapidly approaching. The current expectations are for the Republican party to take back the House. The Senate race is a bit more opaque. The current president's party typically loses seats in the House and Senate, so this is not entirely unexpected.

What I feel is important to bear in mind is that no matter which party controls Congress, stocks have historically done well 1 year after midterm elections, gaining 14.1% on average going all the way back to 1946.



While any of these pivots could lead to a turn in the market, it is important to bear in mind that they haven't yet occurred. Looking at declines during cyclical recessions historically shows that on average they last 16 months, and the current decline has lasted 9 months. Therefore, in terms of current investments, I am maintaining a defensive posture. This includes:

1. Investing in short-term bonds, rather than intermediate or long-term fixed income. In many cases, shorter-term yields are higher than the more interest rate sensitive intermediate term bonds.
2. Overweighting U.S equities versus International.
3. In the U.S stock portfolio, holding a higher allocation of value stocks vs. growth stocks. Investing in dividend growth as compared to just earnings growth as well.
4. Actively rebalancing portfolios when prices decline. Elevated volatility often leads to opportunity to buy future growth and lower prices. I am doing this synonymously with tax-loss harvesting in taxable accounts.

As always, please let me know if you have any questions or would like to discuss your investments specifically in greater detail. My direct contact information is below, and I welcome hearing from you.

Very truly yours,

James Herrell, CFA

James Herrell, CFA / Sr. Portfolio Manager
Generate Wealth LLC / generatewealthllc.com

jamesherrell@generatewealthllc.com
P:626-345-5830 / **M:** 805.451.5960
A: 155 N. Lake Avenue Suite 800 Pasadena, CA 91101