

Quarter-In-Review – Looking at the market and the macro backdrop in the third quarter, what jumps out to us is how little has changed from the first half of the year. We are talking about the same issues, worried about the same problems, anxious about the same unknowns. And the fact that so little has been resolved goes a long way towards explaining another down quarter for both stocks and bonds and the fact that no major asset class was immune from losses. On the equity side, every major sector closed in the red, but somewhat surprisingly, small-cap U.S. equities outperformed large-caps by a decent margin. Conversely, international equities struggled, and both developed and emerging equities lost double-digits over the three months.

For fixed income investors, the worst year in modern history continued to be difficult. The Fed raised rates twice during the quarter to bring the Funds Rate to between 3% and 3.25%, and long-term rates followed the Funds Rate higher. Intermediate-term Treasury bonds lost -5.7% during the quarter while short-term bonds dipped -1.6% and investment grade corporate bonds were hit with a -6.2% loss. As with stocks, there were few places to hide in the bond market. The one good thing you can say about rising rates, though, is that the yield on cash investments is now solidly in positive territory.

Changing Tides – What explains the broad-based losses across all asset classes this year? Why haven't there been places to hide other than cash? After all, gold and TIPS, two assets that are thought to do well during inflationary periods, are down -9.5% and -13.9% respectively this year. Is there some deep-seated reason, or are investor's simply acting as a herd?

To answer the question, it's first worth expanding the time frame somewhat. The chart below shows the performance of the S&P 500 from December 31, 2019 to the end of September this year. While the swoon during the COVID crisis in March of 2020 is indelibly ingrained within our memories, it is easier to forget the almost vertical recovery. It's not worth

Market Benchmarks			
Market Indices	3 rd Qtr	YTD	3-Yr An
S&P 500 Index	-4.9%	-24.0%	+8.0%
Russell 2000	-2.1%	-25.1%	+3.5%
Global Equities	-7.1%	-25.5%	+4.4%
Int'l Index (EAFE)	-10.4%	-27.2%	-1.0%
Emerging Mkts	-10.8%	-24.1%	-0.9%
Other Indicators	9/30/22	6/30/22	12/31/21
Fed Funds Rate	3.00%-3.25%	1.5%-1.75%	0%-0.25%
2-Year Treasury	4.25%	2.98%	0.73%
10-Year Treasury	3.80%	3.01%	1.51%
S&P 500 P/E Ratio*	15.2	15.9	21.2
Crude Oil	\$79.49	\$105.76	\$75.45
Core Inflation	4.9%	4.7%	4.7%
*Forward 12-month operating earnings per S&P			

rehashing the drivers of this, but basically it comes down to massive fiscal and monetary stimulus. Hundreds of billions of dollars (and yen, pounds, euros, etc.) were spent and printed to cushion consumers and businesses from a sudden economic stop. In retrospect, the policies worked. The global economy avoided a 1930s type hard landing, and unemployment levels didn't increase anywhere near as much as they could have. The markets responded accordingly.

But just as the tides both come in and go out, the post-COVID world was not sustainable. You give people money to spend, and they generally spend it. In a supply constrained world this leads to inflation. Then add in the dynamic of 0% interest rates (orange line in the chart below). If the cost of money is basically free, all sorts of assets get priced upwards off this artificial rate. And in many cases, these higher prices proved to be unsustainable given the fundamentals. Think of crypto currency prices in late 2021, meme stocks, or the short-lived SPAC mania. But artificially low interest rates impact every corner of the economy. Mortgage rates plummeted so buyers could pay 20% or 30% more for a house and still keep the same monthly payment. Bond prices shot higher due to falling rates. Investors were willing to pay much higher equity multiples in a world of zero (or negative) interest rates.



And behind the scenes, leverage was added to amplify returns.

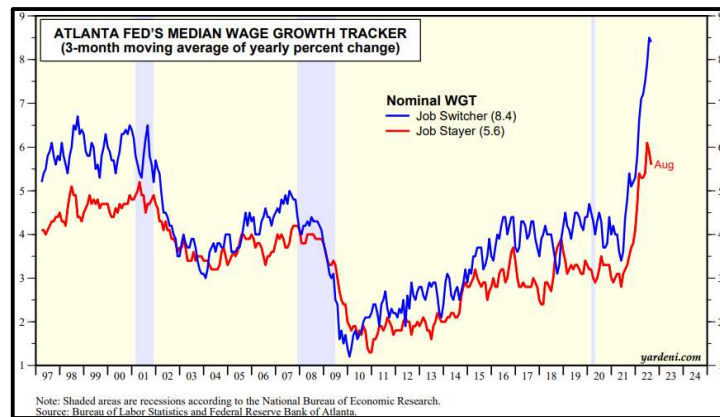
But all this changed in 2022 as rising inflation brought an end to ultra-low rates. Just as all assets repriced higher when rates went to zero, all assets have repriced lower as rates have normalized. Stocks, bonds, real estate, and leveraged strategies

predicated on cheap funding have all corrected lower. What's actually surprising if you look at the chart on page 1 isn't so much the correction in the S&P 500 as is the fact that it is still up over 21% from the pre-covid levels given the dramatic surge in interest rates. This is a testament to just how robust earnings growth has been the last two years.

This is all well and good I hear you say, but what does it mean for the future? Is this a one-time repricing that is nearing an end, or are we only part way through the process? Did the reaction to the COVID crisis unleash an inflation monster that cannot be slayed, or are central banks slowly getting their arms around the problem?

Two Possible Paths Forward – How inflation plays out over the coming months is the most important question in the markets today, but it is also the hardest question to answer. Economists seem little better than the ancient seers at the temple of Delphi in divining inflation's future (and many economists talk in the same riddles!!). And this gets to heart of why the markets seem to have been so volatile lately. Investors latch onto whatever the latest data point is and extrapolate it into the future. Then, when the next data point doesn't jive with the established narrative, you get a big swing in the other direction. But if you look through the day-to-day noise there are two pretty clear scenarios developing for the future of inflation, the economy, policy, and market direction. These two scenarios are certainly idealized versions of what will ultimately happen, but they might help us think through the path forward and how we should position ourselves.

Scenario 1 – Inflation Has Become Entrenched – This is definitely the scenario the market is worried about and the common refrain coming from clients. To think inflation is permanently entrenched in today's economy would require that something has fundamentally changed in the post-COVID world. Without question the stimulus thrown at the global economy in 2020 and 2021 was an order of magnitude larger than anything we'd ever seen outside of wartime, but both the fiscal spending binge and the accommodative monetary policy has come to an end. Why, then, should inflation continue at a rapid clip going



forward? In a word – wages. As you can see from the chart to the left, wage growth has soared over the last few months, and a tight labor market continues to put pressure on salaries. This has all the hallmarks of the traditional wage/price spiral of the 70's, just minus the labor unions and Nixon price controls.

The \$64 trillion question is whether wage growth slows as the economy slows. The Fed is hoping that tighter monetary policy feeds through into slower growth, which then leads to greater slack in the labor market and moderating wage growth. This is exactly what happened in both the 2001/2002 and 2008/2009 periods – slow growth and recession led to higher unemployment and slower wage growth. Is this time different? Can wages decouple from underlying growth and employment dynamics given the fact there are still so many unfilled jobs? This is the fear of those who think inflation is entrenched. At a minimum they think the Fed basically needs to engineer a relatively deep recession to break the wage/price spiral dynamic.

There is one other variable in this scenario – energy prices. Europe is currently experiencing an energy shock unlike anything we have seen before, and crude oil prices have rebounded in early October despite weakening demand. Constrained energy supplies are going to be a factor for many quarters to come, and elevated prices could feed through into higher inflation rates more than we've experienced over the last thirty years.

Scenario #2 – Inflation is Peaking – Whenever there's talk about the possibility of inflation trending lower people seem to have a visceral negative reaction. Have you seen gas prices? Do you know how much I paid for eggs yesterday? And they are right as there are few signs yet that the inflationary pressures of the last few months are anywhere near to slowing down. But let's lay out the more optimistic case, at least as it concerns inflation, as we head into 2023.

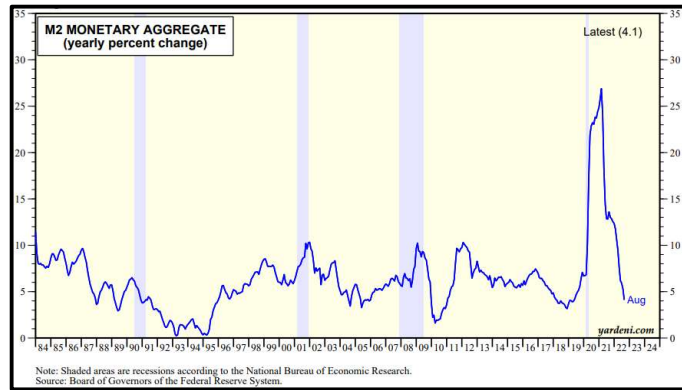
Economist Milton Friedman famously quipped that "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." This statement was made back in 1963, and ever since economists and pundits have debated the merits. Like skirt lengths, the monetarist school of thought goes in and out of fashion, but there is something to the idea that a massive expansion in the money supply drove inflation in the post-COVID world. The chart to

the right shows a measure of money supply, and you can clearly see the massive spike in 2020 and 2021. In retrospect, is it any surprise that close to +30% year-over-year money growth triggered inflation in a supply constrained world?

But that's in the past. Markets are trying to sniff out future trends, and at least by this measure, money supply growth has normalized. The chart goes back to 1984 and we are running at basically the long-run average based on the August data. Almost certainly the data for the final quarter of the year will approach zero.

Less theoretical and more real for us all is what is playing out in the housing market. At the beginning of the year the housing market was white hot – 30-year mortgage rates were under 3%, there was little inventory, bidding wars were commonplace, and prices were soaring. Today we see the exact opposite. Mortgage rates are approaching 7%, inventory levels are building, and price cuts are common. We all know that an increase in rates hammers affordability, but it's hard to appreciate just how much without an example (chart below). At the beginning of the year, a home buyer with a \$2500/month budget could afford a \$760K home assuming they put 20% down. Now they can only afford a \$475K home assuming the same budget, the same down payment, and using today's interest rates. The housing market has ground to a halt

Why does this matter? Housing's share of economic growth was 17.7% in the first quarter of 2021, a 14-year high. This captures everything from planning and land development, construction, the actual costs involved in real estate transactions, and the money people spend when they move into a new or existing home. And the 17.7% doesn't capture the knock-on effects. Some economists half-jokingly state that housing is the economic cycle. By this they mean the quarter-to-quarter swings in the housing market is really all that makes the difference between expansion and contraction. If this is true, economic growth, not only in the U.S. but around the world, is going to underwhelm over the next twelve months. Weak growth typically equates to slower inflation. The Fed knows this, and this is exactly what they are targeting.



One final argument in favor of the 'inflation is peaking' argument. Over the last nine months the decline in stock and bond prices has wiped out roughly \$36 trillion of wealth globally. I don't care who you are, this is a big number!! And you can't help but think this filters through into spending plans. That remodel can wait, I'll limp along with the old car

for a while longer, that anniversary trip to Europe is out. We are seeing the change in spending plans playing out in the data. Shipping costs from Asia have plummeted lately and there is no more talk about supply disruptions in many industries. There's actually talk about excess inventory problems. And used car prices are finally coming down, as you see from the chart at the bottom of the next page. You wouldn't think this category alone is a big deal, but used and new car prices make up close to 10% of the inflation index. When prices were up over +50% this boosted the inflation numbers noticeably. The good news is it won't repeat going forward.

How Does this Play Out? – We have to be honest with ourselves at this point - no one can be quite sure. The cycle of the last three years is unlike anything we've seen before. Massive COVID induced recession, enormous monetary and fiscal policy response, resulting supply and labor shortages, zero or negative interest rates that led to a repricing higher in all assets, and now a dramatic tightening in policy combined with a historic increase in interest rates.

Legendary investor Stanley Druckenmiller recently said something along the lines that he hates making predictions, but unfortunately, that is business he is in. Given this, we suspect this cycle is playing out in three acts.

The first act is basically complete – the main protagonists in this act were global central banks normalizing policy. The Fed, European Central Bank, and Bank of England all moving rates from 2020's emergency levels to something approaching neutral. Both short-term and long-term interest rates went up around the world, assets uniformly repriced lower, but economic growth proved to be surprisingly resilient.

We think we are now in the second act. How far do our



protagonists need to hammer rates higher before inflation cries uncle? This is where we think we have a few more months of the markets worrying that inflation is entrenched despite lower stock and bond prices and a clearly slowing global economy. This second act is going to be volatile with upswings based upon the idea that inflation is beat followed by downswings on any hint of robust employment or inflation news. During this period we also have the added dynamic of possible financial accidents. Just a few days ago the BoE was forced to bailout a number of U.K. pension plans that had made leveraged bets on lower bond yields. What other accidents are out there?

Ultimately, though, we think the protagonists win their battle and the third act is one of redemption (from an inflation fighting standpoint at least). Given all the current angst surrounding wage/price spirals and a repeat of the 70s, good news on the inflation front would be warmly received, even if it coincided with news of a recession in Europe, the U.K. (both of which are very likely), or the U.S. (less likely, but still possible). We wish we knew when the third and final act starts, but we'd only be guessing. All the ingredients are in place for a slowdown in inflation as we noted earlier, but whether it shows up in the October data or the data in the first quarter of 2023 is anyone's guess. But the one thing we are sure of is when investors sniff out the slowdown, we should quickly see the markets stabilize.

Strategy In Uncertain Times – What should investors do given the uncertain outlook over the next few months? There's no one size fits all answer to this question given that everyone's financial and emotional situation is different. But there are certain timeless recommendations that are worth reiterating:

- In our thirty years of business we've seen a number of bear markets. It's worth pointing out that the markets have always ultimately recovered.
- Your time horizon matters. It's easy to forget, but a long time horizon means you can

almost ignore the quarter-to quarter noise (this is hard to do, we know!!).

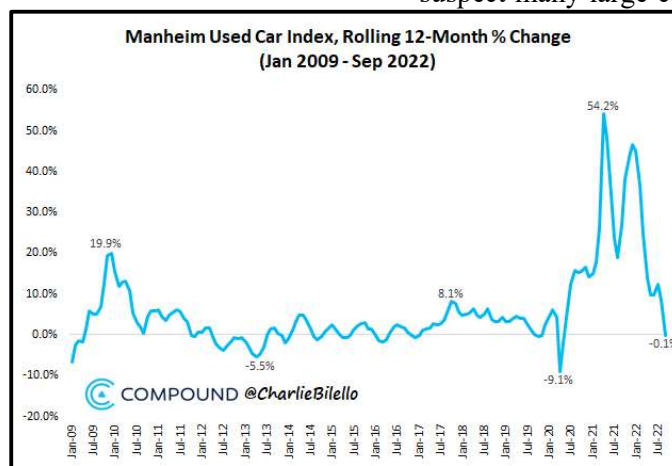
- Your spending rate also matters. If you are drawing down your portfolio by 2% or 3% a year you are going to be fine under almost any scenario. But if you are spending 7%, 8%, or more, there's a problem regardless of the market scenario.
- Do you have sufficient cash reserves? If you have six-to-twelve months of reserves on hand you have both a spending cushion and a psychological crutch. And you now have the added benefit of actually earning a return on cash.

What are we doing with our portfolio allocations? At the margins we are doing three things:

- 1) We remain more worried about Europe than any other region and are underweight European stocks.
- 2) Secondly, to hedge against the deeper recession scenario, we have cut our exposure to lower quality corporate bonds.
- 3) We have no direct Real Estate Investment Trust (REIT) exposure. This interest rate sensitive sector has struggled this year (-29.3%), and if rates continue higher, we are worried about further downside.
- 4) Finally, we think we are still in the early innings of the value stock resurgence. Value has outperformed growth this year (large-cap value is down -16.7% versus -30.5% for large-cap growth), and we think this trend can persist. The valuation discrepancy between the two remains historically wide, and we suspect many large-cap growth companies are much more at risk of earnings deterioration than your typical value stock.

And finally, these are trying times for all investors. We encourage you to reach out to your advisor to discuss your particular situation and how best to navigate the coming months.

Charles Blankley, CFA
Chief Investment Officer



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