Third Quarter 2022 — Economic and Capital Markets Commentary

The U.S. Consumer: Bearing The Weight

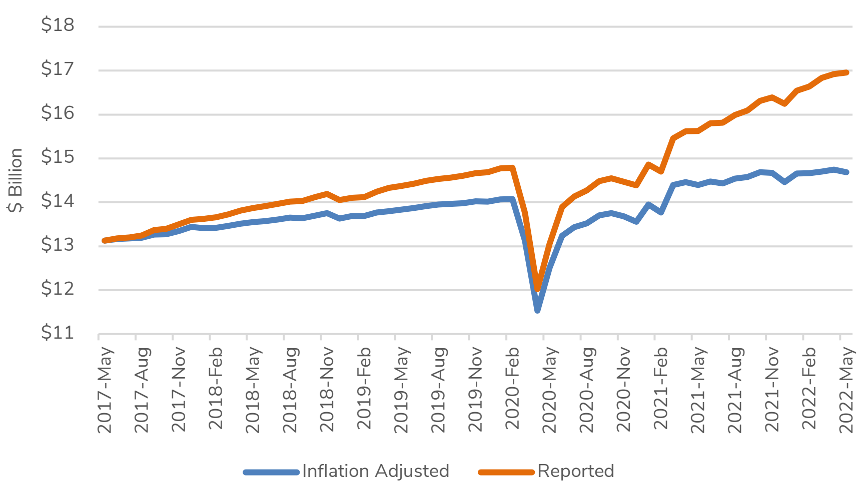
"We've grown dependent on American consumers as the world's spenders of last resort. They've kept Europe out of recession, allowed China to industrialize, and prevented global deflation."

– Evan Davis, British economist

The U.S. Consumer

"Never bet against the U.S. consumer" is a common expression on Wall Street, and despite the highest inflation in four decades, consumer spending in the U.S. continued its pre-COVID trajectory through the first half of 2022. This occurred as Europe seemed close to slipping into a recession due to the war in Ukraine, and the Chinese economy continued to sputter in the midst of unprecedented COVID lockdowns and ongoing real estate issues.

U.S. Consumer Personal Expenditures



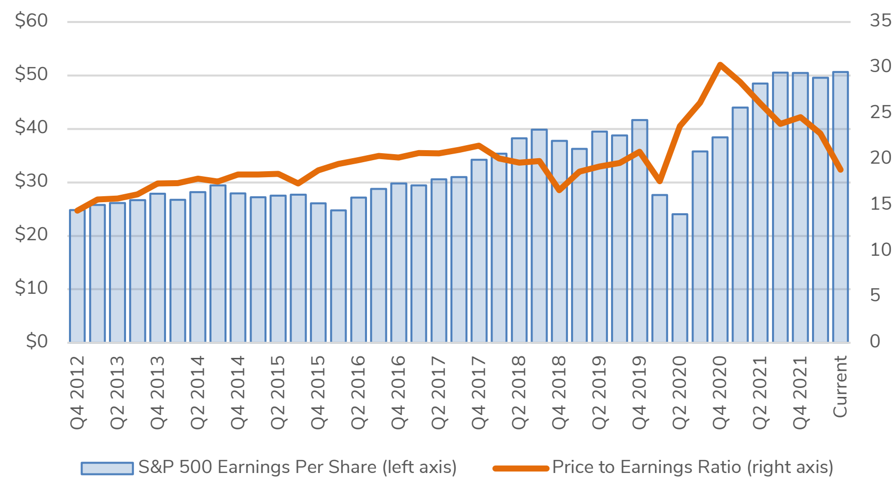
It is important to remember, however, that not all spending is created equal. Over the past year, increased spending in total dollars did not translate to significantly higher levels of spending growth from a "real," or inflation-adjusted standpoint. As shown in the graph to the left, inflation-adjusted spending (the blue line) has increased, but not nearly at the pace of reported spending (the orange line), as inflation has eroded consumers' purchasing power. The same goods and services simply cost more than they did a year ago.

We wrote at length last quarter about the global inflationary impact of rising energy prices, and this pressure only increased in the second quarter of 2022. Whether or not U.S. consumers can continue their spending pace and keep the U.S. and indeed the global economy afloat depends significantly on if, or when, inflation begins to curtail demand.

The U.S. Stock Market

Consumer spending, coupled with inflation, translated into continued revenue growth for most U.S. public companies during the first quarter of the year and is expected to continue as second quarter results roll in. However, the S&P 500 Index declined 20% over the past six months, as investors fretted about rising interest rates and inflation's impact on expected future sales and earnings. As a result, the price-to-earnings multiple of the broader stock market, one measure of how "expensive" stocks are at a point in time, reverted closer to its long-term average.

S&P 500 Index



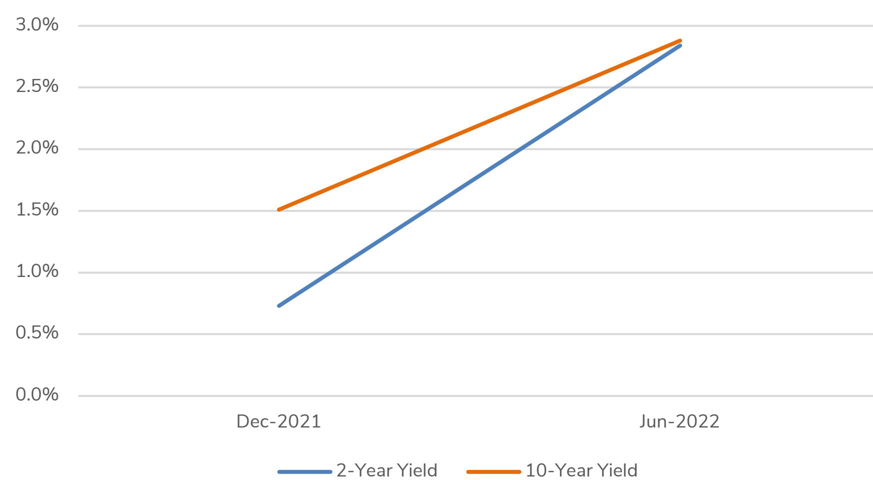
Corporate earnings grew as well, just not as much as revenues, as inflation finally caught up with the broader equity market. Companies across multiple industries reported significantly higher labor, raw material, and transportation costs due to a tight labor market and higher energy prices. Even the stock prices of companies in the consumer staples sector (necessities such as food and beverages, personal care products, and household essentials) declined, as their stocks were already relatively expensive when the year began. The ability to pass increasing costs on to the consumer without causing "demand destruction" is one issue many CEOs will continue to grapple with in the coming months.

The U.S. Bond Market

Bonds offered little protection for investors during the stock selloff in the first half of 2022, as bond prices declined as well.

In response to continued inflation, the Federal Reserve began reducing liquidity in the financial system through a process known as "Quantitative Tightening." In addition to refraining from reinvesting maturing bonds in the Fed's portfolio, the central bank increased the Fed Funds rate three times, raising the rate from near zero to 1.75%.

Yields on U.S. Treasury Bonds



In expectation of continued rate increases, bond yields increased with each new inflation report. This led to the worst six months in decades for bond investors, as bond yields and prices move inversely from one another; when yields rise, bond prices decline (a caveat being that most bond investors will still earn the yield-to-maturity they expected when they first purchased the bond, provided they hold to maturity).

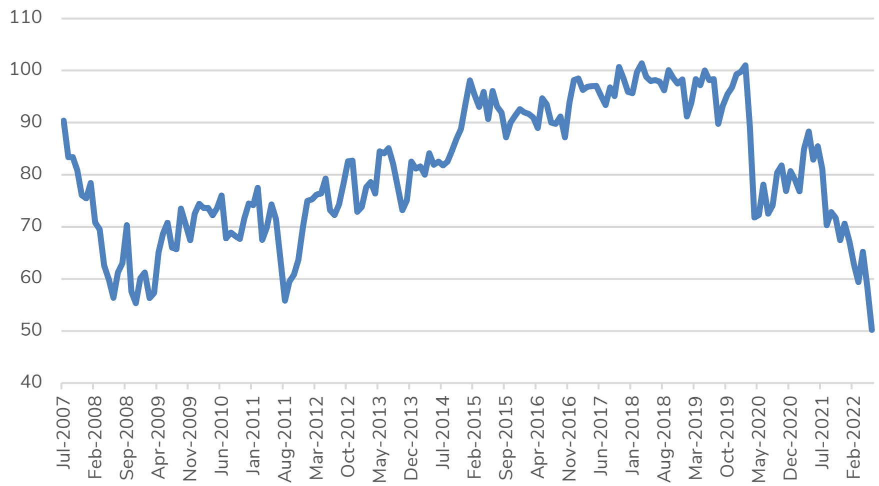
Said another way, to cope with higher inflation expectations over the coming months and years, bond investors demanded a higher return. It should be noted, however, that longer term yields did not reflect higher inflation expectations. At quarter-end, longer term Treasury bonds (20-30 years to maturity) offered investors little additional yield compared to five- or ten-year Treasury notes, indicating a reluctance on the part of investors to bet that 2022's high inflation would remain for decades to come.

Outlook: Keep the Long-Term in Mind

Stock and bond returns over the last six months reminded many investors that there is no "free lunch" in the financial markets. With higher returns comes higher risk, and the volatility experienced so far in 2022 seems to have more than made up for the lack of market volatility in the 18 months that followed the brief COVID-induced decline in the second quarter of 2020.

So where do we go from here? Heading into the second half of 2022, U.S. stocks are fairly valued in our opinion. Valuations are more reasonable than they have been since 2020, but that does not signal an "all clear." Valuations may be lower, but we anticipate continued stock and bond market volatility until inflation slows and investors have a clearer view of consumer spending.

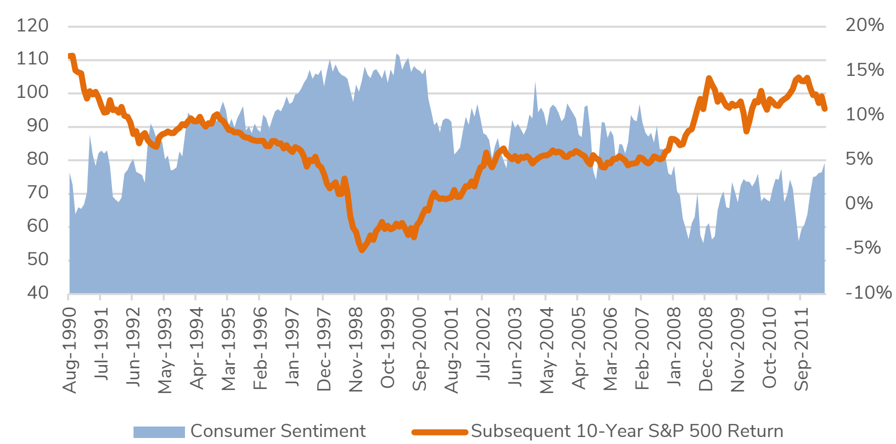
Consumer Sentiment



As an insight into that future spending, consumer sentiment turned sharply negative over the past six months, touching a low not seen even during the Great Recession. This should be expected as consumers' dollars suddenly did not go nearly as far as they had just a year ago.

That said, if history is any guide, this may actually be promising news for long-term focused investors. Historically, strong longer-term stock market returns often begin when sentiment is low, and the average consumer is concerned about their future prospects and those of the economy. As shown in the chart on the right, some of the strongest long-term returns during the last few decades came when consumer sentiment was near current low levels, such as after the Savings & Loan Crisis and following the Great Recession. The opposite held true during the euphoric sentiment of the late 90's tech bubble.

Consumer Sentiment vs. Subsequent 10-Year Return of the S&P 500 Index



At Mitchell Sinkler & Starr, we believe that one of our most important jobs is to continue to remind our clients to focus on their goals and to maintain a long-term outlook. Reacting to short-term market moves and trends can be detrimental to achieving one's goals, while remaining invested through periods of market stress may increase expected portfolio returns going forward.

We started this commentary with one Wall Street truism and are reminded of another: "Time in the market is more important than timing the market."

- Mitchell Sinkler & Starr's Portfolio Managers

Economic and Capital Markets Data

	June 30, 2022	December 31, 2021	June 30, 2021	June 30, 2017
S&P 500 Index	3825	4766	4298	2423
Price / Earnings Ratio	19.2	26.2	30.3	21.5
Dividend Yield	1.65%	1.38%	1.31%	1.97%
Federal Funds Rate	1.75%	0.25%	0.25%	1.25%
10-Year U.S. Treasury Yield	2.88%	1.51%	1.47%	2.31%
Gold	1808	1829	1770	1242
Oil (Brent)	110	75	73	48
Bitcoin	18,730	46,333	34,585	2,502
GDP* (Annualized)	-1.6%	6.9%	6.7%	2.3%
Unemployment	3.6%	3.9%	5.9%	4.4%
Inflation (Annualized)	9.1%	7.0%	5.4%	1.6%

Stock prices declined significantly in the first half of the year in preparation of disappointing guidance for the second half of 2022, as COVID stimulus effects completely wear off and inflation continues to pressure consumers. We expect, therefore, that forward guidance and not second quarter earnings will most likely be the data points that move markets in the third quarter.

* GDP Data as of 3/31/2022

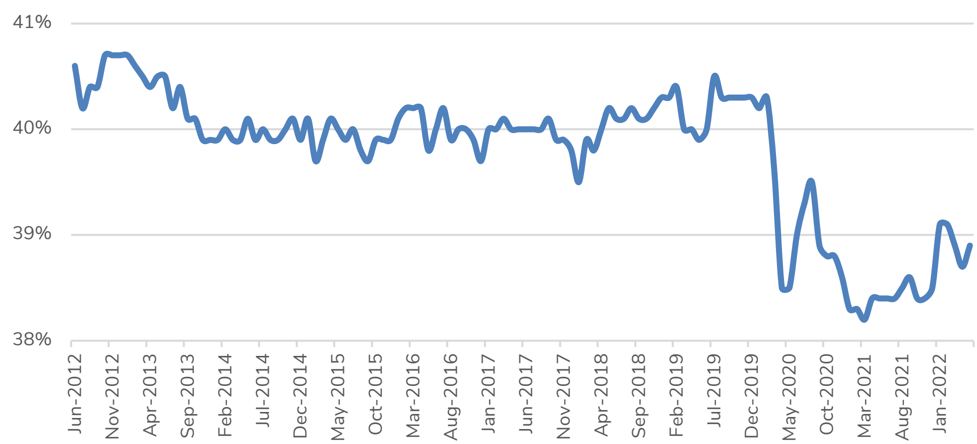
Quarterly Charts

A brief selection of quarterly charts offering insights relevant to the current period.

U.S. CPI Y/Y (U.S. Inflation Rate)

For some, current U.S. inflation has brought back memories of the 70's and early 80's, when high energy costs and a vicious wage/price spiral eroded consumer purchasing power for years.

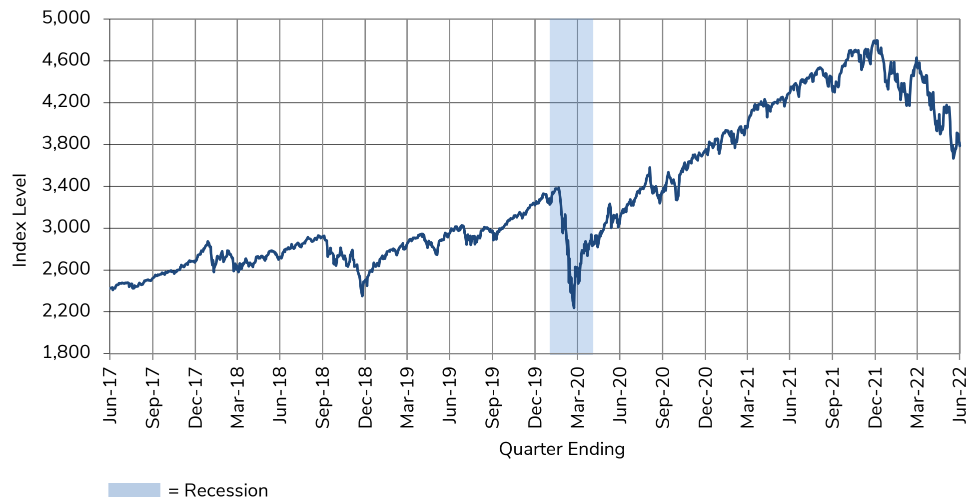
U.S. Labor Force Participation Rate, Ages 55+



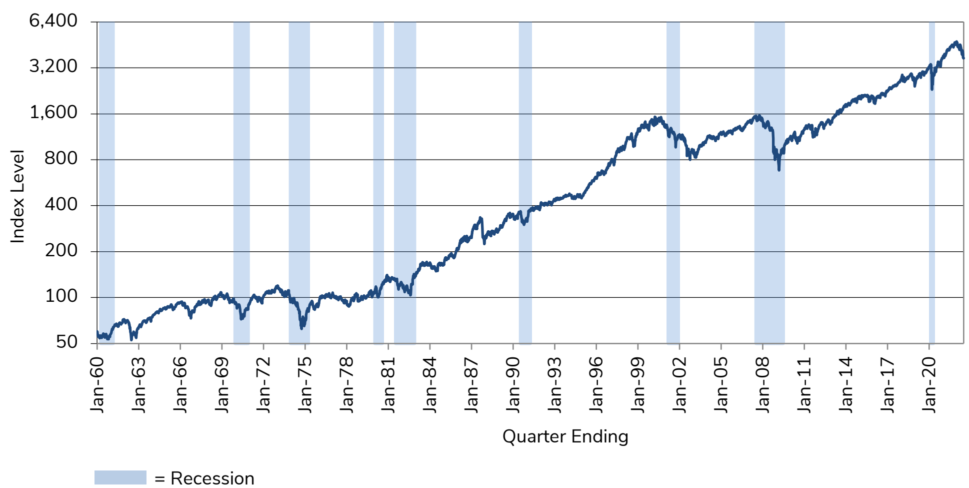
An acute labor shortage has exacerbated the current inflationary environment. When COVID struck, a significant number of the "baby boom" generation retired early and have since stayed retired.

As mentioned, volatility returned with a vengeance in the second quarter of 2022. The S&P 500 Index entered an official bear market (a decline of 20% from a high) in mid-June. Importantly, bear markets do not automatically imply recessions, although clearly pressure is building on the U.S. consumer.

S&P 500 Index - 5 Years



S&P 500 Index - Since 1960



Market declines experienced in 2022 thus far were not unusual or unique. While greater than the average decline for any given year, two of the past four years (2017, 2021) had been unusually calm, with dozens of new record highs, and selloffs barely registering 5% during those calendar years.

Fear The Bear?

The Beast Defined

Bear markets are commonly defined as any fall of at least 20% from an index's all-time high, with the duration and depth of the pullback measured peak to trough, starting from the previous high to the eventual bottom. The bear market in 2022 began on January 3 and as of this writing is still ongoing. Bear markets are distinct from "corrections," another commonly used benchmark indicating a decline of 10% from a prior high.

How Frequent and How Long?

Since the end of World War II, the S&P 500 Index has weathered 13 bear markets, one every six years on average. Market corrections, by contrast, have occurred much more frequently, about once every other year. The typical price decline in a bear market has been 33% and the duration of bear markets averages just over one year.

Of course, actual declines and durations vary widely. The steepest bear market in this period occurred in the wake of the Great Recession of 2007-09, when the S&P 500 dropped 57%, while the shallowest occurred from 1948 to 1949, with a decline of 21%. The shortest bear market on record coincided with the onset of the Covid-19 pandemic in March 2020 and lasted only 33 days. The longest followed the bursting of the dot-com bubble and lasted 929 days, from March 2000 to October 2002.

What it all Means for Investors

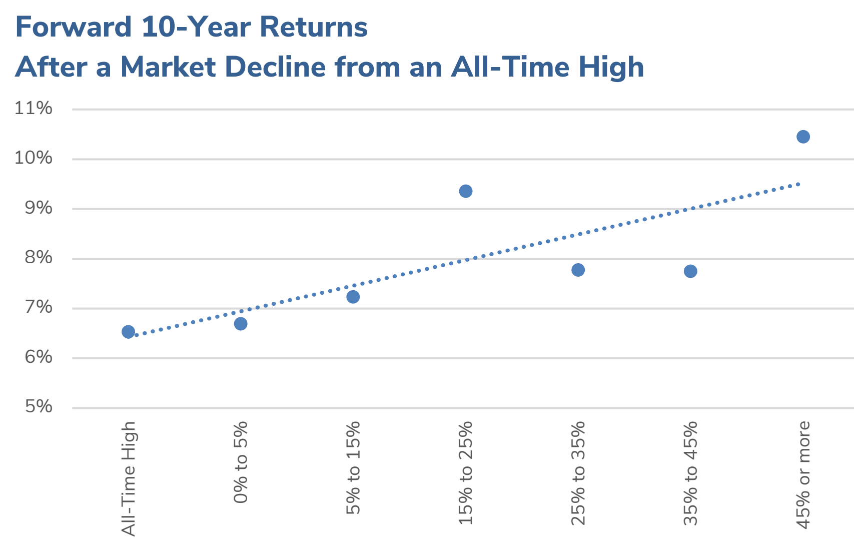
Clearly, in the short run, bear markets can cause investors financial pain as well as stress and anxiety, but they do not necessarily carry any greater significance. It is true that bear markets often coincide or even pre-date recessions – but not always. The bear market in 1987 did not presage a recession; nor did the two bear markets in the 1960s.

While it is natural to equate weakness in the stock market with weakness in the broader economy, the market is just one of many indications of the economy's overall health. Just as important are readings on employment, inflation, housing, credit, and consumption, to name a few. The market, like the economy, tends to move in cycles, and bear markets are simply a result of these ups and downs. The trend over the longer term, however, has always been to the upside, as gross domestic product (GDP) continues to rise over time. Any longer-term chart of the S&P 500 Index, such as that shown at the end of our Commentaries, confirms this trend.

In fact, for investors focusing on the longer term and with cash on hand, bear markets have been outstanding times to invest. Every bear market in the post-war era has been followed by a bull market lasting several times longer, with an average gain of 177%. Indeed, one of the worst mistakes an investor can make is selling at the bottom of a bear market and sitting on the sidelines as the market recovers.

As the chart to the right illustrates, future annual returns have typically been stronger following a market that is down significantly from its all-time high. This helps demonstrate some of the following traditional investment advice (within the context of an appropriate investment plan):

- Continuing to invest during a market downturn should typically aid in building long-term wealth.



- A market downturn may be a more favorable time to invest additional funds than when the market is hitting new highs.
- Selling during a bear market, especially for those with a long-term focus, can be detrimental to long-term portfolio growth.

To be sure, bear markets can be challenging episodes to endure, but as is often the case with investing, maintaining resolve and staying the course through tough times can be the best option for investors with a long-term focus.

Bear Markets

Peak Date	Trough Date	Decline (%)	Length (Days)	Preceeded Recession?
5/29/1946	10/9/1946	-27%	133	No
6/15/1948	6/13/1949	-21%	363	Yes
8/2/1956	10/22/1957	-21%	446	Yes
12/12/1961	6/26/1962	-28%	196	No
2/9/1966	10/7/1966	-22%	240	No
11/29/1968	5/26/1970	-36%	543	Yes
1/11/1973	10/3/1974	-48%	630	Yes
11/28/1980	8/12/1982	-27%	622	Yes
8/25/1987	12/4/1987	-34%	101	No
3/24/2000	10/9/2002	-49%	929	Yes
10/9/2007	3/9/2009	-57%	517	Yes
2/19/2020	3/23/2020	-34%	33	Yes

Bull Markets

Trough Date	Peak Date	Gain (%)	Length (Days)	Length of Preceeding Bear Market
10/9/1946	6/15/1948	21%	615	133
6/13/1949	8/2/1956	267%	2,607	363
10/22/1957	12/12/1961	86%	1,512	99
6/26/1962	2/9/1966	80%	1,324	196
10/7/1966	11/29/1968	48%	784	240
5/26/1970	1/11/1973	74%	961	543
10/3/1974	11/28/1980	126%	2,248	630
8/12/1982	8/25/1987	229%	1,839	622
12/4/1987	3/24/2000	582%	4,494	101
10/9/2002	10/9/2007	102%	1,826	929
3/9/2009	2/19/2020	401%	3,999	517
3/23/2020	1/3/2022	114%	651	33

Source: Bloomberg, data since 1945, price return only