MITCHELL SINKLER & STARR

Fourth Quarter 2022 — Economic and Capital Markets Commentary

Shifting of Energy

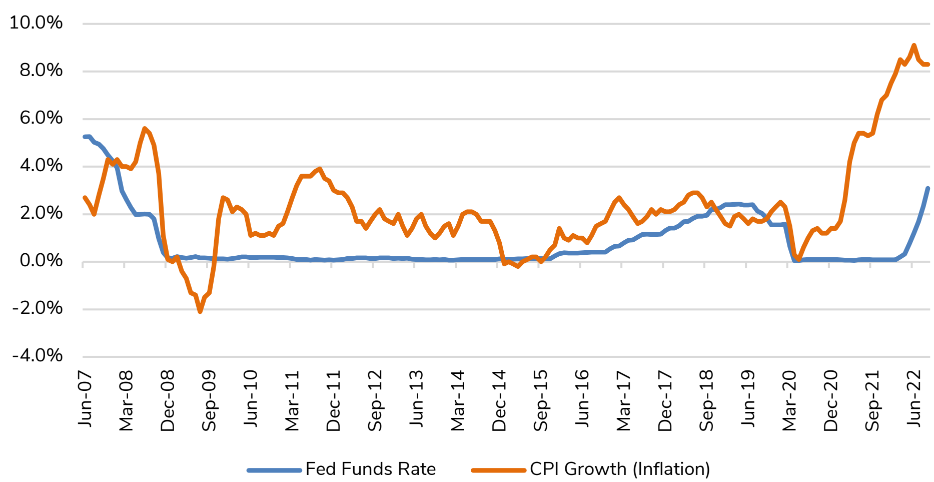
"Containment of inflation is fundamental to a restoration of sound economic growth."

– Treasury Secretary George William Miller, 1979

As the volatile markets of 2022 evolved, two primary issues drove both equity and fixed income returns: rampant energy price inflation and the Federal Reserve's response to it. The shift in Fed policy (raising interest rates and reducing financial liquidity via "quantitative tightening") was expected coming into 2022. However, the speed at which it occurred was extraordinary.

This pivot in the Fed's stance and the subsequent declines it led to in both the stock and bond markets reminded investors that the returns they enjoyed since the financial crisis in 2008-09 had been supported by a "dovish" monetary policy from the Fed. This policy quickly turned "hawkish" when real inflation, not seen since the early 1980s, returned with a vengeance over the past 12 months.

Federal Funds Effective Rate vs. CPI Growth (Inflation)



The Fed has stated its intention to focus solely on fighting inflation, and its rapid interest rates hikes are evidence of its serious intent.

Inflation readings at such elevated levels may not be easily subdued, however, and will likely need to wait until interest rates have dealt a significant blow to consumer spending (a.k.a. "demand destruction").

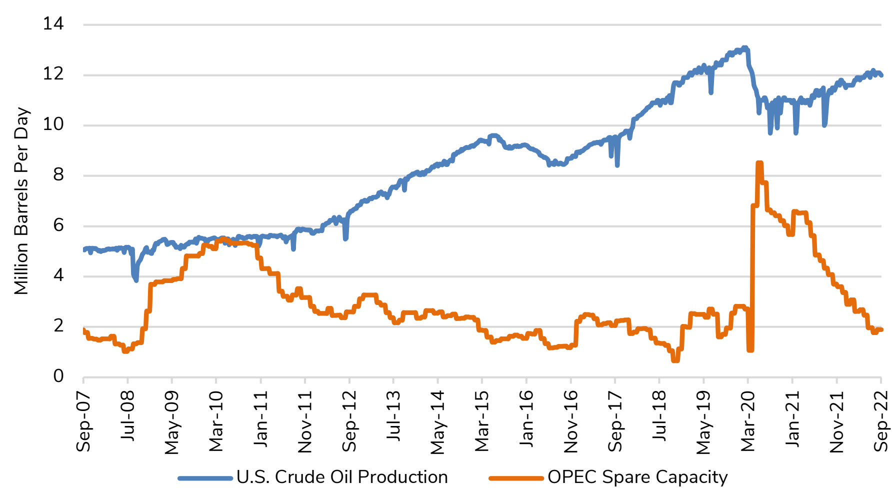
Energy—The Elephant in the Room

As the economy emerged from COVID, most inflation was largely attributed to supply chain issues. These issues continued to fix themselves in 2022 (in fits and starts). As evidence, consider the fact that prices for containers for transport across the Pacific sank over 65% from their extreme 2021 levels. That said, a more important driver of long-term inflation, energy prices, continued to evolve into a serious issue throughout the year.

Several factors are behind these higher prices:

- U.S. oil and gas production has been unable to surpass pre-pandemic levels or to match the torrid pace of growth experienced during the fracking boom of the 2010s. The majority of the highest quality oil fields appear to have now been used up. With higher labor and raw material costs and less profitable drilling areas, oil and gas producers have spent significantly more just to keep production from falling.
- OPEC production growth has also been limited, as there is less spare capacity available to increase production rapidly due to underinvestment over a number of years by OPEC members. The CEO of Aramco (Saudi Arabian Oil Co.) stated clearly earlier this year that it would take another five years to bring any significant production capacity online.

U.S. Crude Oil Production vs OPEC Spare Capacity



- In Europe, Russia's invasion of Ukraine clearly added fuel to the fire (pun intended). The lack of western buyers and access to western equipment caused a semi-permanent reduction in Russian oil output that we expect to stay in place for the foreseeable future. In addition, Russian disruptions to natural gas exports have crippled European energy consumers, both industrial and commercial.
    - Our opinion is that the European continent is already in or quickly heading into a recession caused by these energy-related issues. Manufacturing across various sectors (metals, chemicals, fertilizer, even toilet paper) has nearly ground to a halt in some countries due to energy costs.

Higher energy prices have reverberated across nearly every sector of the economy, driving other prices higher—from raw materials to transportation. U.S. companies have attempted to pass these additional costs on to consumers in the most efficient way—through higher prices—with mixed results. Currently, most consumers do not expect high inflation to last over the long term. But the fear of an entrenched inflationary wage/price spiral is one of the primary motives for the Fed's decisions to rapidly hike interest rates.

The Fed—A Seismic Shift

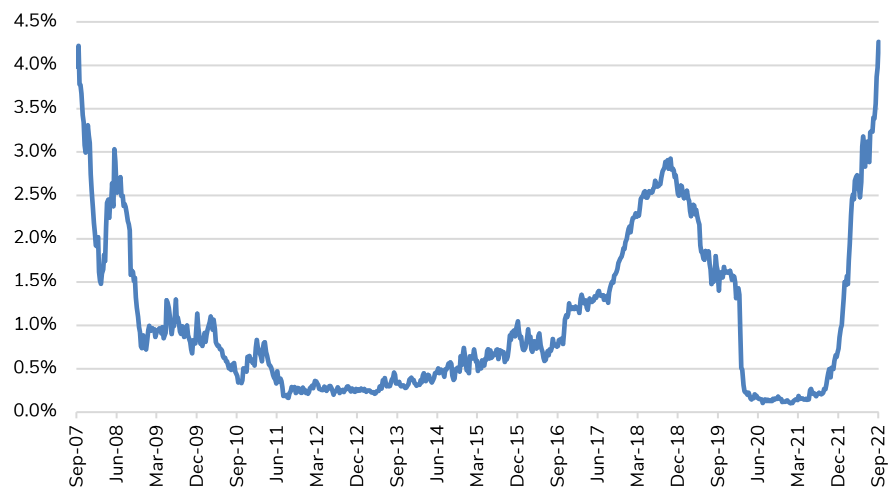
The Fed has two mandates from the U.S. Government: maximum employment and price stability. In recent decades, price stability was mostly the norm. This allowed the Fed to focus on its other mandate, pursuing maximum employment. The result was a central bank that became accommodative to markets and the economy, pushing interest rates down and more recently pumping trillions into the financial system when they sensed significant unemployment might loom on the horizon. This was known as the "Fed put"—the idea that the Fed would ride to the rescue of a battered economy and save markets from declining no matter what.

The shift in Fed policy from those "dovish" leanings took a sharp and aggressive turn in 2022. The higher rates the Fed imposed put indebted companies in a tough position as their funding costs increased. At the same time, unprofitable, aggressively growing companies relying on cheap debt and easy shareholder funding suddenly were subject to lower market valuations.

Outlook—The Volatility Will Continue Until Inflation Improves

Many U.S. companies have found it difficult to continue the rapid growth in revenues and margins they achieved in 2021. When this earnings expansion slowed, investors suddenly turned to other options, as portions of the bond market suddenly yielded far more than they had in over a decade.

2-Year U.S. Treasury Note Yield



The “Fed put” may be gone for the foreseeable future, creating an environment that markets have not experienced in a very long time. In this new paradigm, stocks with higher valuations, particularly in "growth" sectors that are more sensitive to interest rates, may be susceptible to declines in price if they fail to meet high expectations. Companies with tangible assets and consistent positive cash flows that are priced more reasonably may have a better chance to weather a less "dovish" environment. In addition, bond "ladders" made up of debt purchased from these sound companies should provide attractive income to investors going forward, including the ability to reinvest at higher rates in the short to medium term (if bond yields continue to increase).

At Mitchell Sinkler & Starr, we are cognizant of this shift to a potential new approach from the Fed and weigh its implications carefully when considering client asset allocation and security selection for the coming years.

- Mitchell Sinkler & Starr’s Portfolio Managers

Note: Our latest Investment Insights is included at the end of this report.

Data Sources: U.S. Federal Reserve, Bloomberg Finance L.P.

Economic and Capital Markets Data

	Sep 30, 2022	Dec 31, 2021	Sep 30, 2021	Sep 30, 2017
S&P 500 Index	3586	4766	4307	2423
Price / Earnings Ratio Dividend	17.6	26.2	25.7	21.5
Yield	1.75%	1.38%	1.32%	1.97%
Federal Funds Rate	3.25%	0.25%	0.25%	1.25%
10-Year U.S. Treasury Yield	3.83%	1.51%	1.49%	2.31%
Gold ($)	1662	1829	1886	1242
Oil (Brent, $)	88	78	75	57
Bitcoin ($)	19423	46333	34585	2502
GDP* (Annualized)	-0.6%	6.9%	2.3%	2.2%
Unemployment	3.5%	3.9%	3.9%	4.2%
Inflation (Annualized)	8.2%	7.0%	7.0%	2.2%

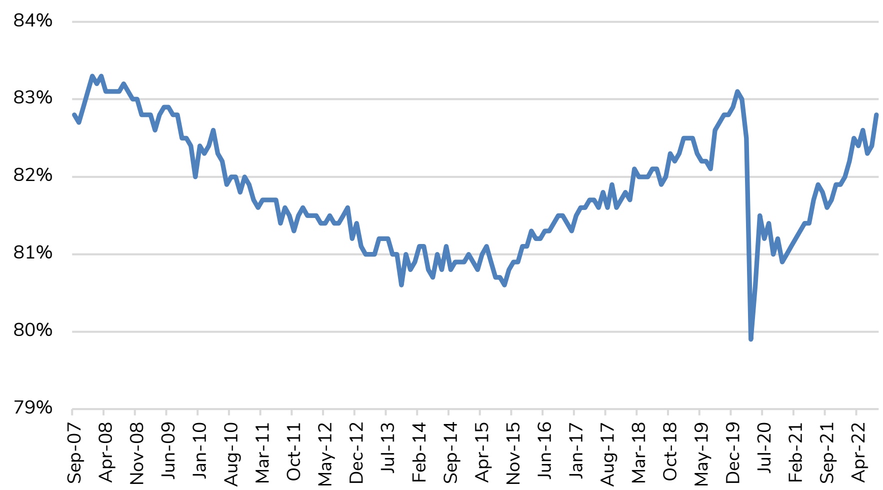
The Price-to-Earnings Ratio (a quick indicator on how cheap or expensive the stock market is) has declined significantly since the beginning of the year, as stock prices have dropped, while earnings have remained, for now, fairly strong.

* GDP Data as of June 30, 2022

Quarterly Charts

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

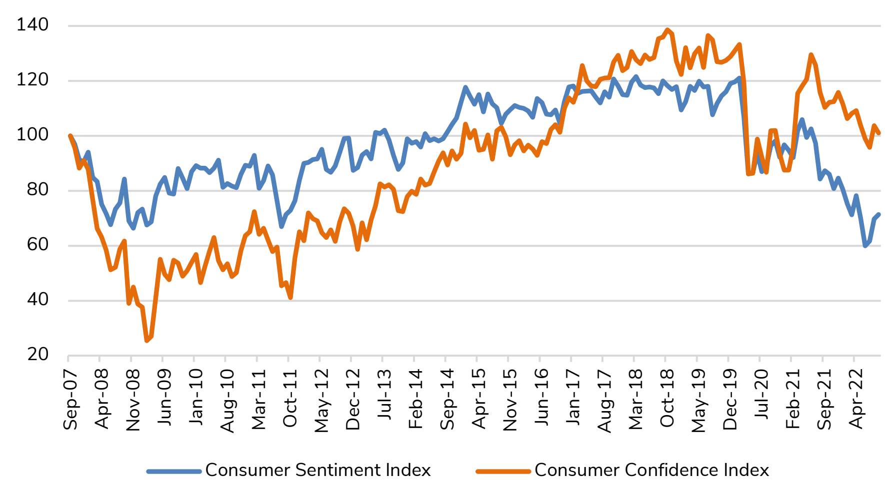
Labor Force Participation Rate (Ages 25-54)



In our prior commentary we mentioned the rapid retirement of older workers in the labor force caused by COVID. This has been mitigated in part by the strong labor participation rate of prime working age adults, which has nearly returned to pre-COVID levels.

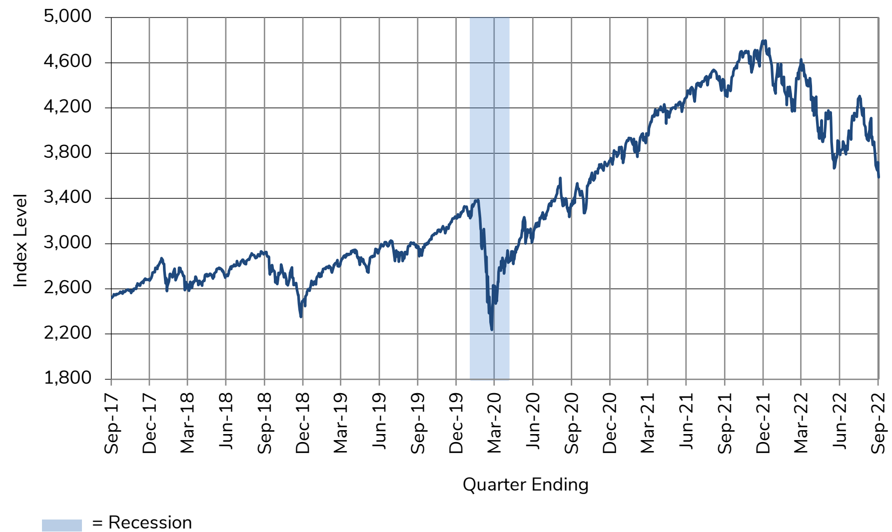
"Consumer Sentiment" data, based on a relatively small sample with a focus on perceptions of long-term consumer spending, has dropped to 2008-09 lows. In contrast, Consumer Confidence data, based on a larger survey and focused on perceptions of general economic conditions in the next six months, is relatively strong compared to 2008-09.

Consumer Confidence vs Consumer Sentiment

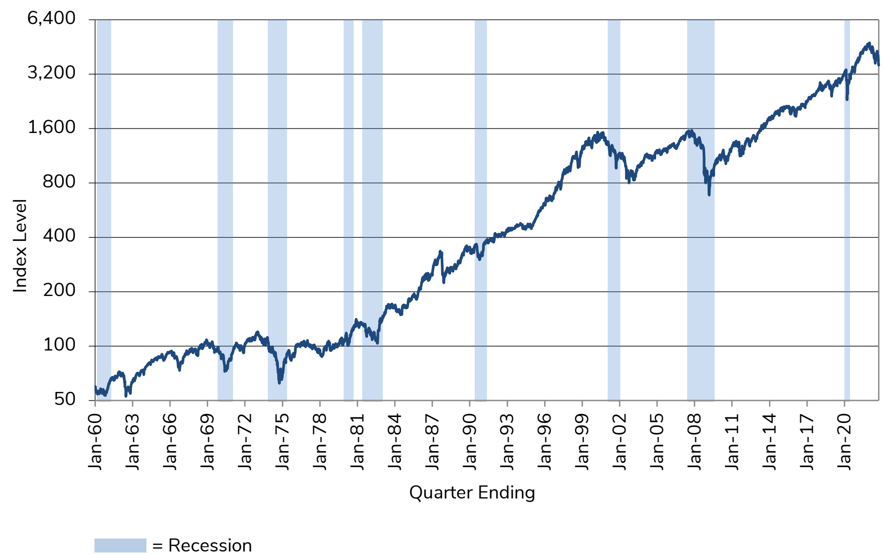


A "bear market rally" occurred in July and August, as lower gasoline prices and strong second quarter earnings provided hope for continued growth in consumer spending. This optimism ended when it was clear the Fed would not back down from its "hawkish" stance on interest rates.

S&P 500 Index — 5 Years



S&P 500 Index — Since 1960



Continued market volatility should be expected as long as inflation data remains elevated. Higher prices may cause the Fed to remain focused on tempering consumer demand, ideally without causing a recession and impacting employment too much.

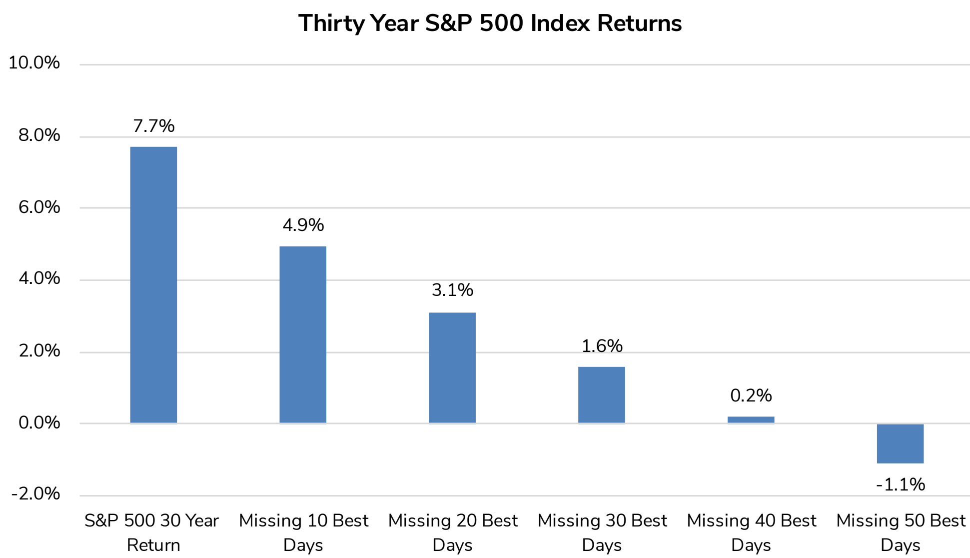
Investment Insights — The Mistake of Market Timing

October 2022

"Time in the market is more important than timing the market."

The bear market of 2022 has sent us all a stark reminder that stocks can be volatile. And after a decade of growth, many investors were unprepared for the declines. As a result, some may be tempted to "time the market" by selling now with the intention to buy later. However, there is no evidence this strategy works—and significant evidence that trying to time the market is detrimental to long-term returns.

As shown in the attached graph, missing out on only the ten best days over a 30-year period would have resulted in returns one-third lower than if the investor had stayed patient and stayed put. Missing more than those top ten days would result in even worse performance.



Performance is time-weighted, price-only return annualized for the 30-year period ending 6/30/22.
Sources: Bloomberg Finance L.P.

Compounded over 30 years, this kind of mistake would have a huge detrimental impact on the growth of one's portfolio. $10,000 compounded at 7.7% per year (the rate shown in our chart for the patient investor) grows to $92,828 over 30 years but only $42,485 when growth is reduced to 4.9% annually (the rate for the investor who misses the best 10 days).

Finally, perhaps counterintuitively, some of the best daily returns on Wall Street happen during bear markets, as stocks begin to stage a recovery on early expectations the economy may have hit bottom. Conversely, some of the worst days can occur during a bull market that is nearing its end, as sentiment turns negative. All of this means that timing the market correctly is extraordinarily hard.

The bottom line: funds that are appropriately invested for the long-term should stay in the market, despite the sometimes nerve-wracking volatility.

W. Gregory Richardson, CFA