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Mid-Year 2022 Investment Letter by Erik Ridgley, CFA August 5, 2022

We wish all our clients and friends a safe and enjoyable summer. Below we provide a review of the markets in the first half of 2022, and our thoughts for the balance of the year. The big story of this year for markets has been the highest inflation rates since the 1970's, but the far bigger story is the human suffering and destruction from Russia's invasion of Ukraine. Markets spent the first two quarters of 2022 re-pricing to adjust for higher-than-expected inflation, which has impacted near-term returns for investors. We are now seeing "green shoots" of evidence that inflation is peaking in the U.S., but we expect that it will take a couple of years to get inflation down to the Fed's 2% target. In *real* GDP terms the economy contracted -1.6% and -0.9% in the first and second quarters, but in *nominal* GDP terms the economy grew +6.6% and +7.8% in the first and second quarters, respectively. Corporate earnings, which firms report in nominal terms, have held up well due to impressive pricing power. As always, we remain focused on generating superior long-term after-tax returns for each of our clients per their customized investment policy statements, and we are grateful for the trust and confidence our clients have placed in us.

Asset Class Benchmark Index Returns in 2022 - July; 2nd Quarter; 1st Quarter

July: +6.98%	2nd Q: -15.66%	1st Q: -5.36%	Global Equities: MSCI All Country World Index (ACWI)
July: +2.64%	2nd Q: -2.94%	1st Q: -6.23%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
July: +4.81%	2nd Q: -9.30%	1st Q: -5.80%	50/50 Allocation: 50% ACWI / 50% Muni Bond
July: +9.22%	2nd Q: -16.10%	1st Q: -4.60%	U.S. Large Cap Equities: S&P 500 Index
July: +10.44%	2nd Q: -17.20%	1st Q: -7.53%	U.S. Small Cap Equities: Russell 2000 Index
July: +4.98%	2nd Q: -14.51%	1st Q: -5.91%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
July: -0.25%	2nd Q: -11.45%	1st Q: -6.97%	Emerging Markets Equities: MSCI Emerging Markets Index
July: +8.97%	2nd Q: -16.88%	1st Q: -3.99%	Real Estate: S&P U.S. REIT Index
July: +5.90%	2nd Q: -9.83%	1st Q: -4.84%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
July: +2.44%	2nd Q: -4.69%	1st Q: -5.93%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

The Fed Must Bring Inflation Down to Its 2% Target

The Fed recognizes it is facing a historic inflation fight that it needs to win. Headline year-over-year consumer price inflation (CPI) reports of 7.5%, 7.9%, 8.5%, 8.3%, 8.6%, and 9.1% for the first six months of 2022 were quite humbling for the Fed. It has already conceded that it made a mistake in delaying the removal of overly accommodative monetary policy by at least six months. Most importantly, it has clearly stated that, regardless of various other exogenous inflationary forces over which the Fed has no control (e.g., excessive fiscal stimulus, energy crisis in Europe, Russia/Ukraine war, China covid lockdowns, snarled supply chains), it is the Fed's responsibility to bring inflation in the U.S. under control.

The Fed's stated goal is to achieve a reduction in the rate of increase of prices i.e., disinflation. The Fed is forecasting core personal consumption expenditures (PCE) inflation, its preferred measure of inflation, which excludes energy and food, to fall from 4.8% yr/yr in June 2022 to 4.3% yr/yr by December 2022 (with Fed Funds Rate of 3.4%), and to 2.7% yr/yr by December 2023 (with Fed Funds Rate of 3.8%), and then to 2.3% by December 2024 (with Fed Funds Rate of 3.4%).

How Does Raising Fed Funds Rates Reduce Inflation?

Raising Fed Funds Rates reduces inflation indirectly by reducing consumer demand, especially for products and services which are interest rate sensitive, such as houses and automobiles, or financed with credit card balances or home equity lines of credit (HELOC). Lower consumer demand (approx. 70% of the U.S. economy) will lead to lower corporate growth, lower employment, and lower commodity prices, which will reduce inflation, all else being equal. To summarize, reducing demand (including by enough to trigger a recession) with higher interest rates is the Fed's primary tool to fight inflation.

Why Does the Fed Focus on Inflation Expectations?

The threat of Fed induced recessions can influence inflation expectations. Too much demand or not enough supply (we currently have both) can each cause higher prices, however these conditions are typically self-correcting i.e., via negative feedback loops. In contrast, if wage-setters and price-setters expect high price increases will continue for long enough, then this inflationary mindset can become entrenched and self-reinforcing i.e., via positive feedback loops. A "wage-price spiral", which occurred in the 1970's, would be an example of this phenomenon, which the Fed very much wants to avoid. On the other hand, if wage-setters and price-setters are fearful of an imminent recession, then they will typically lay off workers or slash inventories, which then leads to lower wages or lower prices i.e., deflation. In effect, the Fed is using its hawkish rhetoric to play a game of chicken with wage-setters and price-setters.

Why is the Fed's Inflation Fighting Credibility Important?

By the time that Paul Volcker became Fed chairman in 1979, the central bank had dithered on inflation fighting for a decade, allowing expectations of high inflation to become entrenched. Consequently, people did not believe the Fed would do what it takes to defeat inflation, and this made Volcker's job much more difficult. He eventually convinced everyone that he was serious about defeating inflation, but not until after he shocked the world when he raised the Fed Funds Rate to 20% and caused two back-to-back recessions.

Now, after decades of low inflation earned by actions that enhanced its inflation fighting credibility, the Fed is hoping that its recent pledges to do whatever it takes to defeat this high inflation will convince wage-setters and price-setters that it will be successful. If so, then inflation will peak soon and steadily fall towards its 2% target over the next couple of years. If not, then this inflation fight will take longer and be more painful.

Will the Fed Keep Raising Rates Until Something Breaks?

The Fed's approach to tightening monetary policy has often been described as "keep raising rates until something breaks." The Fed has said it is willing to trigger a recession to defeat inflation, as it should be, but it will want to avoid a financial crisis that would deny access to debt markets for large corporations. Fortunately, U.S. banks are well capitalized and soundly managed, unlike in the lead-up to the 2008 Great Financial Crisis (GFC). However, if something breaks, the Fed might cut the Fed Funds Rate, and then also revert to extraordinary measures, such as quantitative easing (QE) and asset purchase programs (APP), as needed. This would be sub-optimal, of course, since many would argue that zero interest rates, QE, and APP are what caused this high inflation, although the previously cited exogenous inflationary forces have surely also contributed to higher inflation rates.

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Congress Re-Wrote the Rules for The Fed's Balance Sheet Expansions and Contractions in 2008

The Financial Services Regulatory Relief Act of 2006 authorized the Federal Reserve Banks to pay interest on reserves (IOR) held by or on behalf of depository institutions at Reserve Banks, which transformed the powers of the Fed when it became effective in the early days of the 2008 Great Financial Crisis (GFC), because it *enabled the Fed to expand or contract its balance sheet without directly causing the Fed Funds Rate to decline or increase*, respectively. The law, prior to Oct 1, 2008, effectively required the Fed's balance sheet to be quite small. This legislation re-wrote the rules for central banking in the United States, and it explains how the Fed can purchase and hold $8.1 trillion of assets on their balance sheet whether the Fed Funds Rate is zero or today's 2.50% (or any other level it chooses). This will be important to keep in mind as the Fed increases quantitative tightening (QT) later this year by not re-investing more of the proceeds from the maturing treasury bonds and mortgage-backed securities it purchased during the 2020 Pandemic Financial Crisis (PFC).

Review of 1st Half of 2022: 1st Qtr. Earnings +11.6% (act.) and 2nd Qtr. Earnings +6.3% (est.)

The S&P 500 index of stocks fell -19.96% in the first half of 2022, including dividends, from 4,766 to 3,785. 10-year Treasury yields rose from 1.51% to 3.01%, after peaking at 3.47% on June 14th. West Texas Intermediate (WTI) crude oil prices per barrel increased from $75 to $106, after peaking at $123 on June 8th. The US dollar currency index steadily strengthened from 95.67 to 104.68. U.S. unemployment rates improved from 4.3% to 3.6%. 5-yr breakeven inflation rates decreased from 2.87% to 2.58%, after peaking at 3.59% on March 25th.

U.S. economic activity declined in real terms in the 1st and 2nd quarters of 2022 after a strong 4th quarter of 2021, due to a winter surge in new daily Covid-19 infections from the Omicron variant, which also triggered draconian lockdowns in some of China's biggest cities. The U.S. economy *real* GDP (QoQ% SAAR) was -0.9% in 2Q22, -1.6% in 1Q22, +6.9% in 4Q21, and +2.3% in 3Q21. But earnings, revenues, and expenses are all reported in nominal terms, not real terms. The U.S. economy *nominal* GDP (QoQ% SAAR) was +7.8% in 2Q22, +6.6% in 1Q22, +14.5% in 4Q21, and +8.4% in 3Q21. (Note: the relevant formula is "Nominal GDP = Real GDP + Inflation Rate.")

U.S. headline inflation CPI (YoY%) was +8.7% in 2Q22, +8.0% in 1Q22, +6.7% in 4Q21, and +5.4% in 3Q21. The Fed's preferred measure of inflation, Core PCE (YoY%), was +4.8% in 2Q22, +5.2% in 1Q22, +4.6% in 4Q21, and +3.6% in 3Q21. The Fed's target rate of inflation is +2.0% for both measures.

Outlook for 2nd Half of 2022: On Watch for Soft Landing vs. Hard Landing as Inflation Declines

With the U.S. economy decelerating and inflation only just beginning to hopefully follow the Fed's forecasted glide path down to 2.3% by the end of 2024, many investors seem to have given up much hope that the Fed can successfully tamp down inflation without throwing the economy into a "hard landing" recession. This bearish view might turn out to be too pessimistic.

Consensus estimates for S&P 500 EPS growth are +7.7% in 2023 and +10.1% in 2022, after +50.5% in 2021 (up from +24.4% estimates for 2021 in Feb 2021, which explains last year's great returns), per I/B/E/S data by Refinitiv. Year-over-year quarterly EPS estimates are +11.6% in 1Q22 (actual), +6.3% in 2Q22, +8.0% in 3Q22, and +10.5% in 4Q22.

S&P 500 revenues per share are forecasted to grow +4.0% in 2023 and +11.9% in 2022, after +16.2% in 2021 (up from 8.7% in July), after falling -2.8% in 2020. Net profit margins are projected to expand to 13.3% in 2023 from 12.8% in 2022 and 13.1% in 2021, after declining to 10.2% in 2020 from 11.5% in 2019, per I/B/E/S data by Refinitiv.

The highly respected UCLA Anderson Economic Forecast predicted in June that U.S. real GDP will grow by +5.7% (actual) in 2021, and +2.8% in 2022 (down from +4.2% in December), and +2.0% in 2023 (down from 2.7%). Wall Street's full year consensus forecast for 2021 U.S. real GDP is +5.7% (actual) in 2021, +2.0% in 2022, and +1.3% in 2023, and the quarterly forecasts are -1.6% (down from +4.0% in January) in 1Q22, -0.9% (down from +3.6%) in 2Q22, +1.7% (down from +3.1%) in 3Q22, and +1.4% (down from +2.6%) in 4Q22, per Bloomberg <ECFC>. Europe's economy is forecasted to grow +5.1% (actual) in 2021, and +2.8% in 2022, and +2.1% in 2023 (per ECB), vs. its trend rate of +1% growth, and Japan's economy is forecasted to grow +2.7% (actual) in 2021, and +1.6% (down from +3.0% in January) in 2022, and +0.6% (down from +1.3%) in 2023 (per JCER), vs. its trend rate of +0.5% growth, after declining -5.6% in 2020.

Price/earnings (P/E) multiples are 17.7, 13.0, 12.0, and 11.1 for S&P 500 large cap, S&P 600 small cap, foreign developed, and emerging markets, respectively, where E is EPS on next four quarters (NFQ), per Bloomberg consensus. The long-term average for U.S. NFQ P/E multiples is 15 ½. Thus, U.S. large cap equity valuations are 14% above average, although most researchers would say that the lower interest rates we have today (and those forecasted for the future) should allow for higher P/E multiples, all else being equal. The counter argument to this would be that lower U.S. Treasury bond yields are signaling lower future GDP growth, which should dampen future EPS growth.

The yield curve is currently pricing in the Fed Funds Rate to rise to 3.25%-3.50% one year from now, and 10-year Treasury yields of 2.91% at year-end 2022, per Bloomberg <FWCM>. More importantly, the yield curve is priced for 10-year Treasury yields to remain below 3.25% for the next 5 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind, which it has been doing much more frequently this year.

The yield curve is inverted, with 10-year Treasury yields lower than 2-year Treasury yields by 40 basis points (bps). Yield curve inversion is a reliable leading indicator of a future economic downturn.

High yield bond spreads (over 10-year Treasuries) widened to 488 basis points (down from a peak of 604 bps on July 5th), indicating that credit markets have priced in an economic slowdown (but are not yet pricing in a recession).

Repeatable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g., >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because investors can use them to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with prudent trust & estate planning, via step up in cost basis when wealth transfers from one generation to the next.

Long-Term Investing

To paraphrase Warren Buffett, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, in order to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets.

As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized planning and disciplined implementation.

Risk Management

Asset allocations should be based on well-designed investment policy statements to enable investors to get through bear markets without selling equities, by using fixed income or cash to draw upon until stock markets have recovered, which is common sense short-term risk management. However, comprehensive risk management should also account for the long-term shortfall risk of not achieving long-term portfolio growth objectives due to sub-optimal asset allocations and portfolio construction. Along the way, contingency risks (i.e., low probability and high impact) need to be efficiently managed with various tools including adequate liquidity, appropriate insurance protection (note: we do not sell insurance), coordination with clients' trusts & estate attorneys, and proactive tax planning with clients and their CPAs.

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Conclusions

This year has seen the highest inflation rates since the 1970's, and markets spent the first two quarters of 2022 re-pricing to adjust for this higher-than-expected inflation. We believe that the Fed is now (belatedly) implementing a credible plan to bring inflation down onto a glide path towards its 2% target. There is already evidence of peaking prices for key input factors, such as commodities (including oil, copper, wheat, lumber) and freight shipping, although the Fed will want to sustain a tight monetary policy to keep inflation from flaring back up after it begins its descent.

With the U.S. economy decelerating and inflation only just beginning to peak, some investors and commentators seem to have given up much hope that the Fed can successfully tamp down inflation without throwing the economy into a "hard landing" recession. This bearish view might turn out to be too pessimistic. We observe that large cap U.S. equity P/E multiples are above average, but we also note that S&P 600 U.S. small cap, foreign developed and emerging markets P/E multiples look compellingly low. Fixed income yields have risen to attractive levels, although bond markets are still experiencing a volatile price discovery phase as investors await better clarity on the outcome of the Fed's inflation fighting campaign.

Please let us know if you have any questions, we are happy to discuss these topics in further detail. Thanks!

Best Regards, Erik

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