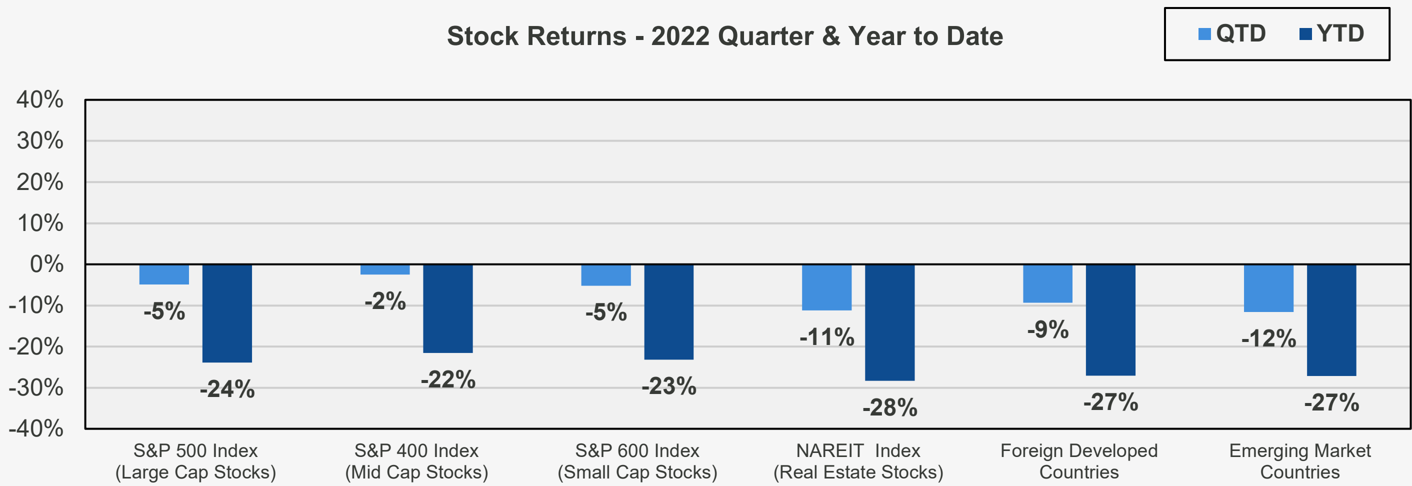
3RD QUARTER UPDATE

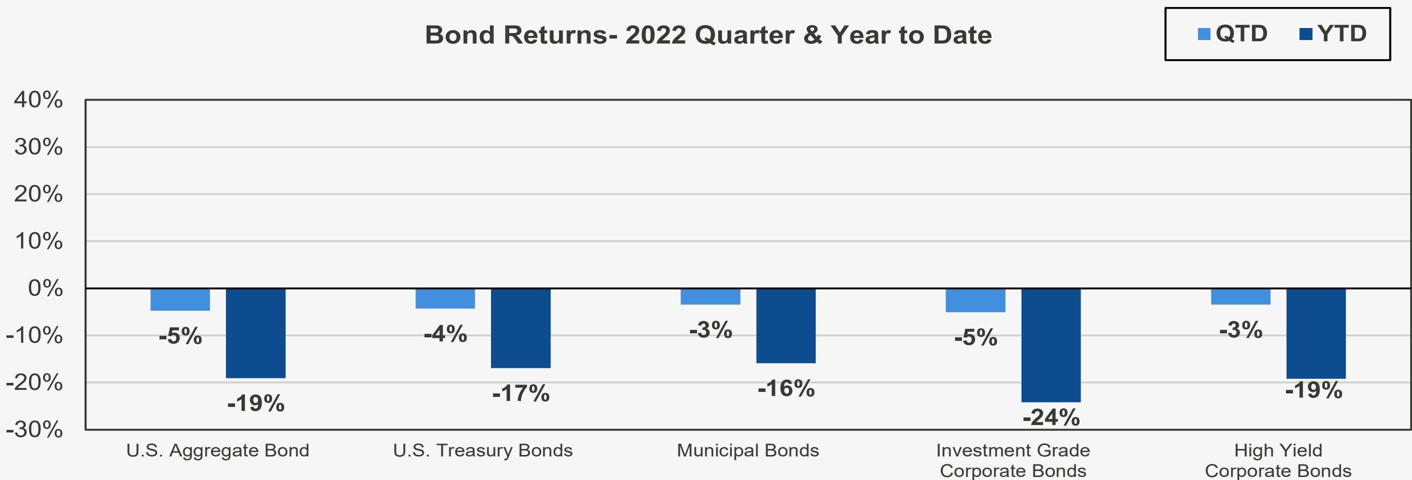
OCTOBER 2022

The third quarter continued the slide in the markets. U.S. stock markets were down another 4+% during the quarter bringing most U.S. stock indices down 20% - 25% for the year. International stocks fared similar. See chart below for quarterly and annual returns for various stock markets.



[1]

In historical periods of stock market drops, bonds have traditionally held up to balance out a portfolio's performance. However, this time the rise in U.S. interest rates has caused the bond market to drop as well.



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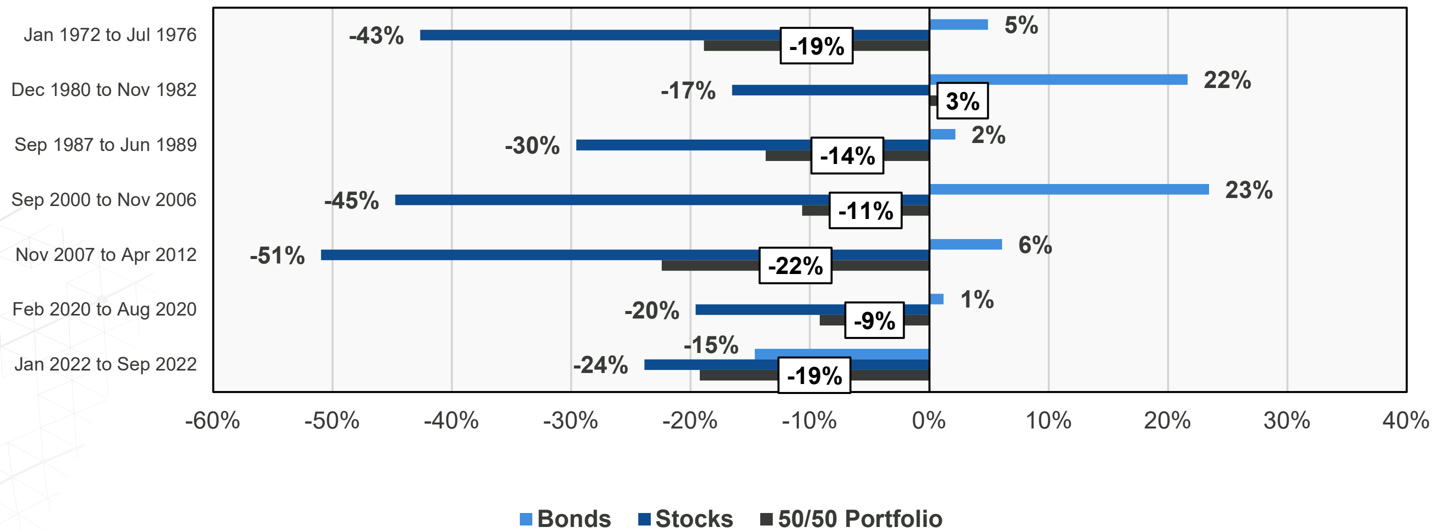
To help visualize how rare the performance of stocks and bonds has been this year, the chart below shows periods of stock market drawdowns with corresponding bond performance.



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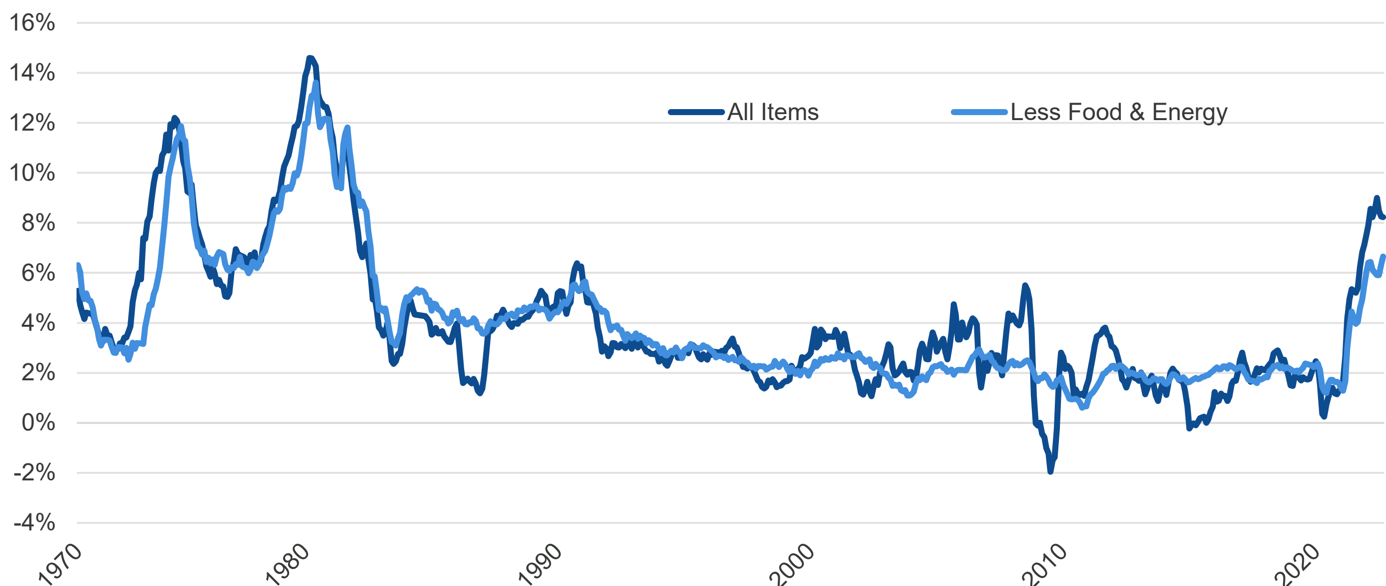
NOW LET'S BREAK DOWN THE THREE MAIN FACTORS AFFECTING THE MARKETS:

INFLATION:

First, we have rising inflation. The U.S. started 2021 with an inflation rate of 1.4%, entered 2022 at 7.5%, peaked at 9.0% and ended September 30, 2022 at 8.2%. We have just experienced the highest inflation rates in over 40 years. Inflation is not just a U.S. problem, as it has been rising throughout the world. Per the Organization for Economic Cooperation and Development, "the annual rate of inflation across the Group of 20 largest economies held at 9.2% from July to August." [4]



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FEDERAL RESERVE:

Secondly, in response to rising inflation the Federal Reserve has taken an aggressive response by raising short term interest rates throughout the year, and has publicly announced they will continue to raise rates until inflation begins to track back around 2% over the long run. The Federal Reserve press release, dated September 21, 2022, said, “The Committee is strongly committed to returning inflation to its 2 percent objective.” Since rising interest rates makes the cost of borrowing more expensive, the theory is that companies and individuals will borrow less, thereby purchase less and thus curb demand which should reduce overall price increases. The Fed Funds rate started at .25% in January, 2022 but has been increased on five occasions this year and stands at 3.25% at September 30, 2022. The Federal Reserve Board of Governors has signaled they intend to raise another 1.5% or more by the end of the year with the possibility of additional hikes in 2023. As the chart below indicates, rates are not “high” by long term historical measures, but short term rates are at their highest levels since early 2008. [6]

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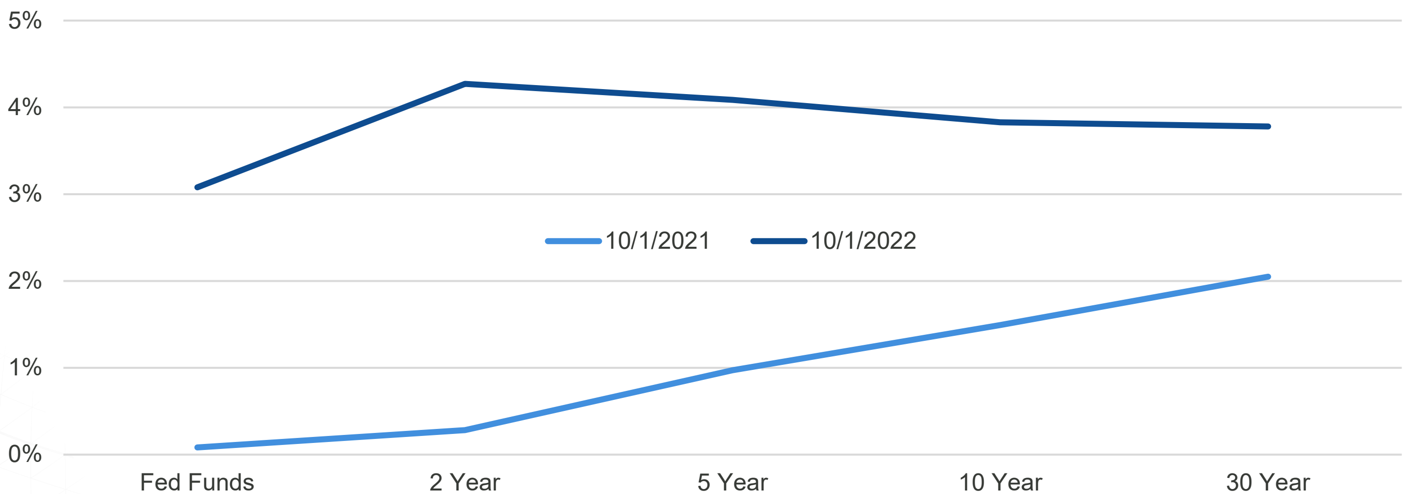
While short term rates are set by the Federal Reserve, longer-term rates are determined by the market. Looking at the various market rates we can see that the market believes inflation is a shorter-term item than a long-term problem.



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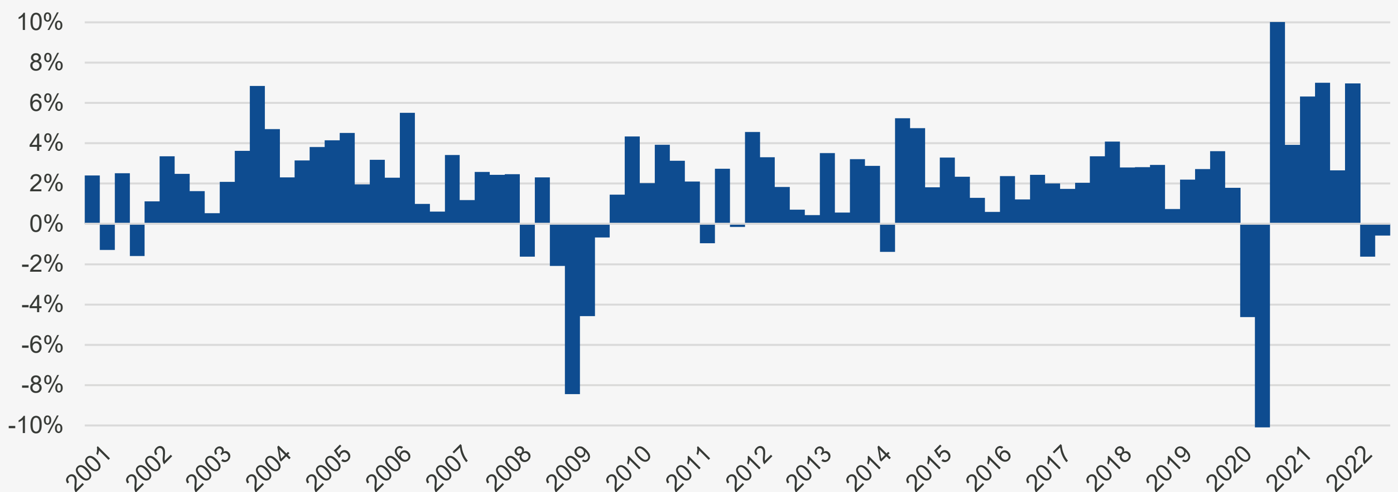
ECONOMIC GROWTH:

This brings us to the third factor, the byproduct of higher interest rates in an inflationary period is declining economic growth. The U.S. economy actually shrank during the 1st and 2nd quarters of the year. Historically, two consecutive quarters of negative GDP growth have signaled a recession. Since there are many other factors included in the actual determination of a recession, The National Bureau of Economic Research has not made the call that we are officially in a recession. Current expectations are for positive growth the remainder of 2022, but this remains to be seen. Projections for 2023 are for growth in the 1% - 2% range barring a recession. "The WTO (World Trade Association) recently lowered its forecast for global economic growth in 2023 to 2.3% from earlier expectations of 3.3%, and warned of even sharper slowdown should central banks raise interest rates too sharply in their efforts to tame high inflation." [9] Goldman Sachs recently published, "We see the risk that the economy enters a recession in the next year at 30% in the U.S., 40% in the Euro area, and 45% in the U.K." [10]



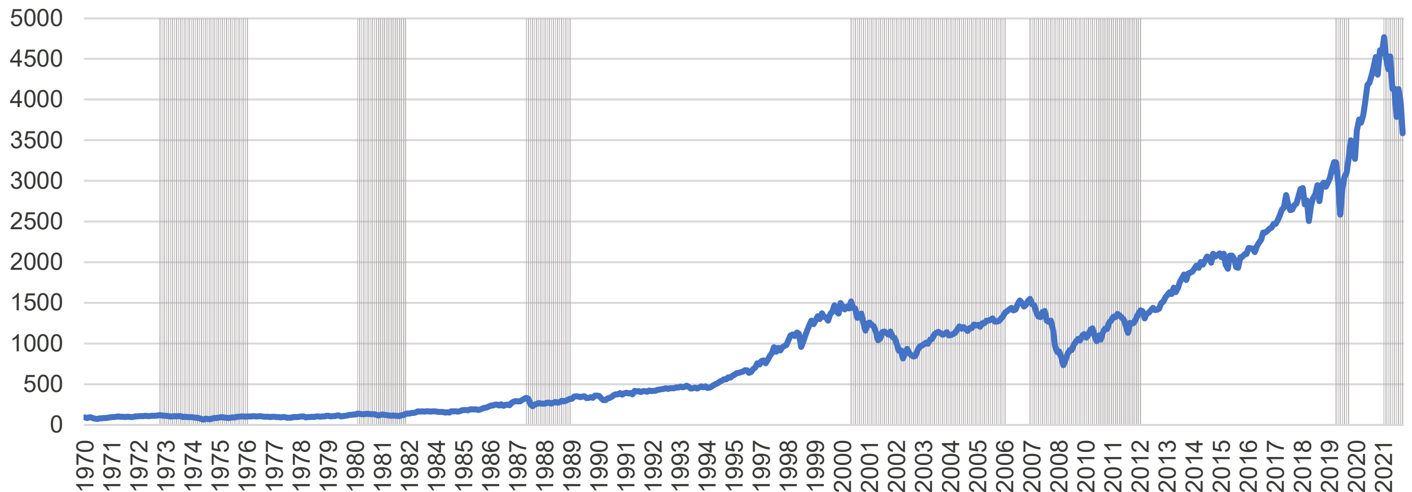
[11]

As part of our continuing analysis, we looked at U.S. stock market drawdowns since 1970. This is the seventh drawdown of 15% or more in the past 50 years. The chart below outlines dates, number of months from start to trough and months required to break even. Return numbers below are representative of subsequent returns from market bottoms.

Drawdown Period	Peak to Trough	# of Months to Trough	# of Months to Breakeven	Returns Following Market Trough 1 Year	3 Year	5 Year	10 Year
Jan 1972 to Jul 1976	-43%	21	21	38%	73%	118%	327%
Dec 1980 to Nov 1982	-17%	20	3	59%	105%	266%	477%
Sep 1987 to Jun 1989	-30%	3	18	23%	56%	122%	456%
Sep 2000 to Nov 2006	-45%	25	49	24%	59%	105%	116%
Nov 2007 to Apr 2012	-51%	16	37	54%	98%	182%	367%
Feb 2020 to Aug 2020	-20%	2	4	56%			
Average	**-34%**	**15**	**22**	**43%**	**78%**	**159%**	**349%**
Jan 2022 to Sep 2022	-24%	9	?	?	?	?	?

[12]

Each of the periods outlined has differing "reasons" for the stock market performance. In both the 1970's and early 1980's, high inflation was tamed with rising interest rates. Once the markets priced in moderating inflation the markets rebounded. The 1987 drawdown included "Black Monday", a day when the stock market crashed over 20% in a single day. Looking back, the market had run up too high, gaining nearly 40% in the first 8 months of the year. The early 2000's brought on the internet bubble which came on the heels of a very profitable period where the market had risen 250% in five years. The bubble burst over the next 30 months, making it the longest drawdown on record and the longest recovery since the great depression. 2008 was a result of the financial crises which was caused by excessive lending. Major financial companies and banks were wiped out and people lost their homes as the economy cratered after the splurge from too much easy money. COVID caused the 2020 drawdown and was the shortest drawdown and recovery period on record. While each of the drawdowns was painful, the long-term historical trend in the markets has been upward.



[13]

Another part of our analysis is to look at historical returns of a basic 60% equity - 40% bond portfolio using actual market performance of the key indices. Since actual portfolios are constructed to meet a client's specific goals, they consist of more than just stocks. Going back to 1928, in the past 93 calendar years there were 19 years where the return on a 60-40 portfolio was negative. Putting 2022 in perspective, the average annual return on that 60-40 portfolio is 9.1% compared to -20.1% for 2022 year to date.

Looking at 5 year rolling returns (1928-1932, 1929-1933, etc.) on that same 60-40 portfolio there were only four 5-year periods of negative returns and they were all in The Great Depression. The average annual return over each 5-year period was 8.6%. Using 2018 through 2022 year-to-date the rolling 5-year return is 6.1%.

If we move to a 10-year rolling return, there has never been a 10-year period of negative returns, including the period of the great depression. [14]

WHAT TO DO?:

So, that brings us to the important question – what to do? First, we continue to look for adjustments in our portfolios to meet changing times. These moves are intended to better position portfolios for where we see current opportunities and/or to minimize overall risk. While the sharp rise in interest rates has hurt the performance of current bond holdings, reinvested funds are now purchasing bonds yielding interest rates higher than we have seen in a long time. We look to reevaluate credit risk in our bonds, seeking to hedge against potential defaults should an economic slowdown come. We also look to reposition some equity exposure away from areas we believe will recover slower than others and take advantage of lower values in areas we believe could hold up better in a downturn and/or rebound faster in a recovery.

Morningstar, a leading stock research firm, computes the fair value of individual stocks and then builds up a model to indicate the fair value of the entire U.S. stock market. The fair value as of December 31, 2021 was 1.06, indicating the stock market was trading at a 6% premium to the fair value. It is not uncommon for stocks to trade above their fair value computation based on market sentiment and alternative investment opportunities. As of September 30, 2022 the U.S. market was trading at .79 of their computed fair value. That means a dollar in the U.S. stock market is 21% undervalued to Morningstar's computed fair value. [15]

WHAT TO DO?:

Further, our research looked at the potential cost of exiting the stock market during drawdowns in order to avoid the market altogether. We looked at the 20 best and the 20 worst performing days in the S&P 500 over the past 50 years. The data shows that all 20 of the best performing days in the last 50 years came during a market drawdown or very close after the trough in order to propel the rebound. Thus, unless you timed the reentry point exactly, you would miss out on a great deal of the recovery.

We have always maintained that a portfolio is a tool to an end. If you are in the saving / accumulating phase buying at today's prices is a 20% discount to buying at the beginning of the year. Keep saving, keep investing, and let the market recover.

But for many of you, the portfolio is a tool to fund your lifestyle. Withdrawing funds on a monthly basis reduces the assets in the portfolio at the same time the market is dropping in value. We understand that concern.

Our analysis shows that where we draw cash out of a portfolio has a huge impact on the overall portfolio's ability to meet future long term cash needs. Our research shows that if we actively determine where to fund withdrawals, we can significantly extend the life of a portfolio. Our overall strategy is to maintain enough cash and lower volatility bonds to fund cash withdrawals for a long enough period of time in order to let equities recover. This takes effort on our part and we are committed to making sure specific portfolio allocations allow for this. We actively manage where we source withdrawals so that we do not have to sell depressed securities in order to fund your lifestyle thereby giving the market time to recover.

We take a proactive approach to our research and analysis in order to ensure we are on top of the current market environment and for making the best possible decisions with the money entrusted to us. We are always available to discuss in more detail if desired. We are here to serve.

If you know of someone who could benefit from our services, please do not hesitate to contact us.

REFERENCES

[1] Information obtained from Morningstar Direct: Various Market Returns through September 30, 2022

[2] Information obtained from Morningstar Direct: Various Market Returns through September 30, 2022

[3] Information obtained from Morningstar Direct: Various Market Returns through September 30, 2022 & JVL Wealth Strategies internal computation.

[4] Dow Jones & Company. (2022, October 5). WTO sees sharp slowdown in global trade, pointing to possible recession. The Wall Street Journal.

[5] Information obtained from Morningstar Direct: "FRED, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy, Seasonally Adjusted , U.S. Bureau of Labor Statistics, Index 1982-1984=100" & "FRED, Consumer Price Index for All Urban Consumers: All Items, Seasonally Adjusted , U.S. Bureau of Labor Statistics, Index 1982-1984=100"

[6] Federal Reserve issues FOMC statement. (2022, September 21).

[7] Information obtained from Federal Reserve Bank of St. Louis: "Federal Funds Effective Rate, Percent, Monthly, Not Seasonally Adjusted"

[8] Information obtained from investing.com, accessed at https://www.investing.com/rates-bonds/world-government-bonds

[9] Dow Jones & Company. (2022, October 5). WTO sees sharp slowdown in global trade, pointing to possible recession. The Wall Street Journal.

[10] Struyven, D., and Milo, D. (2022, July 5). Revisiting recession facts. Goldman Sachs.

[11] Information obtained from Morningstar Direct: "FRED, Real Gross Domestic Product, Seasonally Adjusted Annual Rate , U.S. Bureau of Labor Statistics, Billions of Chained 2009 Dollars"

[12] Market monitor: October 7. Goldman Sachs: Asset Management. (2022, October 7).

[13] Information obtained from Morningstar Direct: S&P 500 Price through September 30, 2022 & JVL Wealth Strategies internal computation.

[14] Information obtained from Morningstar Direct: Various Market Returns through September 30, 2022 & JVL Wealth Strategies internal computation.

[15] Sekera, D., Caldwell, P., and Stafford, J. (2022, September 30). U.S. Stock Market Falls Back to Rare Undervalued Levels Following Recent Drop. Morningstar.