WINTHROP WEALTH

AUGUST 2022 MARKET RECAP

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August was another difficult month for equities as the S&P 500 fell by-4.1%. The equity market has decreased in five of eight months in 2022 with the year-to-date decline at-16.2%. August was a tale of two halves as the S&P 500 rallied by +4.3% through the 16th, before declining by-8.1% to close the month. The S&P 500 is also still in the technical definition a bear market (a decline of-20% on a closing basis without a subsequent +20% increase) after the index fell by-23.0% from January 3rd through June 16th. Since the year-to-date bottom on June 16th, the market is higher by +8.2%.

- **Market Cap**: Small (-2.1%) outperformed Mid (-3.1%) and Large (-4.1%) Caps.
- **Style**: Value (Russell 1000 Value:-3.0%) exceeded Growth (Russell 1000 Growth:-4.6%).
- **Sector**: Only two of eleven sectors were positive in the month with Energy (+2.8%) and Utilities as the top performers and Health Care (-5.8%) and Technology (-6.1%) as the laggards.

The main cause of the market decline over the last two weeks in August was Fed Chair Jerome Powell's speech at the Jackson Hole Economic Symposium where he stated that interest rates will need to remain higher for longer than what the market expected. The most recent inflation data points have been encouraging. However, Powell believes that "a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down." While the stock market fell after Powell's latest tough talk, he has proven in the past that he is data dependent and will pivot accordingly. If inflation continues to moderate, Powell and the rest of the Fed can tone down their hawkish rhetoric. The situation is dynamic, but we will receive more clarity on where inflation, interest rates, and the economy are headed over the next several weeks as more data is available. Powell's latest pivot likely won't be his last pivot. Please see below for our latest thoughts on Monetary Policy and Inflation.

After the market posted strong returns in July, we stated that we expect more volatility rather than a quick ascent to new all-time highs. Our rationale was that the primary risks causing the market turmoil still remain, including, fears over the Fed tightening monetary policy, increased inflation expectations, the Russia/Ukrainian war, and covid induced shutdowns in China. As of now, not much has changed with any of these risks.

While the short-term environment is unsteady, we believe that for the market to reach a sustainable bottom, Fed tightening expectations need to soften, ideally through signs of disinflation. Over the long-term, we continue to suspect this difficult economic environment has created a strong buying opportunity for investors willing to live with some short-term discomfort. We believe those who were able to either stay invested, rebalance, or add to their existing holdings will eventually be rewarded.

We are sticking with our investment philosophy of maintaining a long-term viewpoint as the present environment is very volatile and fluid. Given all the uncertainty, we are maintaining a disciplined approach while continuing to look for opportunities to tax loss harvest, reposition and rebalance portfolios, and selectively put money to work for clients that have recently made contributions to their accounts. We did take the opportunity to reposition many portfolios by increasing the equity percentage when the S&P 500 fell close to bear market territory. This was not an attempt to call the bottom, but rather to take advantage of a significant decline by rebalancing for long-term investors. We expect to have more opportunities to rebalance over the next several months as our base case is that volatility will continue.

The markets have several major events over the next month, including, any update on the Russia/Ukrainian War and China lockdowns, the August Employment Report (9/2), Fed Chair Powell speaks at the Cato Institute (9/8), CPI Inflation (9/13), FOMC Meeting (9/21), and PCE Inflation (9/30).

At Winthrop Wealth, we follow a Total Net Worth Approach and we believe the right mindset paired with a comprehensive financial plan and a thorough investment process can provide confidence in working toward your long-term financial goals, especially during times of heightened market volatility. We help our clients navigate challenging markets by seeking to ensure their short-term cash flow needs are met while managing the rest of their investments in a globally diversified portfolio. By having two to three years of scheduled cash flows invested in ultra-short fixed income, we decrease the odds that we will need to sell out of risk assets after a market decline to fund distributions. Please see our recent Client Questions that can help put things into context:

- **Market Timing Does Not Work**
- **Cognitive Biases That Frequently Lead to Investment Mistakes**
- **Withdrawing Money**
- **Federal Debt**

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Fixed Income Market

An increase in interest rates also put downward pressure on the bond market throughout the month (bond prices move inversely to yields). The 10-Year Treasury increased from 2.65% to 3.19% in August, causing the Bloomberg Barclays US Aggregate Bond index (Agg) to decline by-2.8%. The Agg is now down by-10.8% year-to-date, which is the worst start to a calendar year since inception of the index in 1976. Prior to this year, the worst start to a calendar year for the Agg through August was-3.9% in 1981.

Our objective with fixed income is to provide ballast, stability, and income to portfolios. Bonds have not provided ballast for most of the year as interest rates have increased. The 10-Year Treasury yield started the year at 1.51% before increasing to its present level of 3.19%. Moving forward, we expect the negative correlation between stocks and bonds to return in the future once yields level out. The consensus estimates for the 10-Year Treasury yield are 3.1% and 3.0% in 2022 and 2023 respectively.

The increase in interest rates has also driven the yield to maturity of various bond indices to their highest levels in years. Yield to maturity is defined as the estimated rate of return an investor can expect on a bond if purchased today and held to maturity, assuming the issuer makes all of the interest and principal payments (no defaults). The yield to maturity on the US Aggregate Bond index increased to 4.0% at the end of the month.

Monetary Policy

Jerome Powell's eight-minute speech at the Jackson Hole Economic Symposium was the most important market event of the month as the Fed Chair made the case that interest rates will need to remain higher for longer to firmly bring down inflation. Powell's comments were meant to forcibly push back on the notion that the Fed would lower interest rates by the middle of next year. Furthermore, Powell stated that, "reducing inflation is likely to require a sustained period of below-trend growth. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses."

The Fed has now firmly admitted that inflation is a problem and that they will tighten monetary policy to attempt to bring it under control. The Fed's actions are designed to remove liquidity from the financial system to decrease overall demand for goods and services. A simple definition of inflation is, "too much money chasing too few goods." The Fed is about to shrink the amount of money available. The Fed will tighten monetary policy and overall financial conditions by raising interest rates and shrinking the size of their balance sheet.

Interest Rates: After raising interest rates by an uncommonly large 0.75% each at the June 15th and July 27th meetings, the top-end of the federal funds rate now stands at 2.50%. Thus far in 2022, the FOMC has raised interest rates by 2.25%. Fed Chair Powell recently stated, "our decision at the September meeting will depend on the totality of the incoming data and the evolving outlook. At some point, as the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases." The takeaway is that the CPI reading in mid-September will likely determine whether the FOMC raises rates by 0.50% or 0.75% at the 9/21 meeting.

Balance Sheet: The Fed is also beginning to reduce the size of their nearly $9 trillion balance sheet. The runoff plan started in June and will ramp up to monthly caps of about $60 billion for Treasuries and $35 billion for agency mortgage-backed securities. The monthly reduction of about $95 billion will be larger than the $50 billion per month pace that was used during the 2017-2019 runoff plan. At the current runoff rate, it will take over 4 years for the Fed's balance sheet to decrease to its pre-pandemic size.

A key question facing the markets and economy is: how high does the Fed need to raise interest rates before there are definite signs of disinflation? If inflation moderates quickly, the FOMC will not have to raise rates much further than current levels, and the greater the chance the economy can achieve the "soft-ish" landing (only a mild slowdown or recession) that the Fed is aiming for. If inflation remains persistent, the FOMC will be forced to raise rates much further than current levels, and the economy faces a higher risk of a "hard landing" (severe recession). The Fed's latest Summary of Economic Projections signal a peak federal funds rate of 3.8% by December 2023 (the Fed will publish a new set of projections at the 9/21 meeting).

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Inflation

The increase in inflation is driven primarily by supply chain bottlenecks, surging energy prices, strong consumer demand caused by a solid labor market, and massive amounts of stimulus. While inflation is still too high, several recent data points have decelerated from peak levels.

- The Bureau of Labor Statistics Consumer Price Index (CPI) increased by +8.5% Y/Y in July, down from a 40-year peak level of +9.1% in June. On a month-over-month basis, the CPI reading was flat.

- The Fed's preferred inflation measure (Core PCE inflation) increased by +4.6% Y/Y in July, well above the target of about 2%, but below the recent peak of +5.3% in February. On a month-over-month basis, Core PCE declined by-0.1%.

- The Bureau of Labor Statistics Average Hourly Earnings reading was +5.2% Y/Y in July, down from the recent peak of +5.6% in March.

While inflation is lower than peak levels, the key will be how long it takes for disinflation to set in and the growth rate to move back toward 2%. The Fed would very much appreciate a strong period of disinflation, allowing them to slow-down the pace of tightening. We will need to wait at least a few months for this evidence. The latest FOMC projections show inflation ending the year at +4.8% before falling to +2.6% in 2023 and +2.0% in 2024.

We are still trying to combat the current rise in inflation by holding little cash equivalents in portfolios, avoiding long-term bonds, and overweighting equities of companies that are able to grow their cash flows, earnings, and dividends.

Economic Data

Our view is that the that the economy is slowing from the post-pandemic boom due to fading stimulus, rising inflation, Fed tightening, and surging commodity prices. The current period is best characterized by high inflation and a lot of uncertainty caused by Fed tightening expectations, the Russia/Ukraine War, and China's covid lockdowns.

After increasing by +5.7% in 2021, Real GDP Growth is estimated at +1.7% in 2022 and +1.1% in 2023. Economic growth estimates have been decreasing over the past several weeks as economic indicators, consumer spending, and the housing market have all weakened while inflation has stayed elevated. The economy can probably best be described as firing on one cylinder, the labor market. While the labor market continues to show signs of strength, we do expect the unemployment rate to tick up over the next few months as several major firms have begun to announce hiring freezes or layoffs. The open question is whether the economy is headed for a slowdown/mild recession or a more severe contraction. Right now, we see a slowdown/mild recession as the most probable outcome.

Another open debate is whether the economy has already fallen into a recession. Real GDP increased by +6.9% in Q4 2021 before falling to-1.6% in Q1 2022 and-0.6% in Q2 2022. Many people define as a recession as two consecutive quarters of negative GDP. However, in the United States, the National Bureau of Economic Research (NBER) Business Cycle Dating Committee is charged with maintaining official records of expansions and recessions. The NBER defines a recession as a significant decline in economic activity, while an expansion is defined as a period where economic activity rises substantially. According to the NBER, since 1929 there have been 15 recessions in the US lasting an average of 13 months each.

In our opinion, the current environment likely achieves the NBER's definition of a recession, albeit a mild one for now. While the NBER does not view two consecutive negative quarters of GDP growth as a recession, the current period probably meets the test of a significant decline in economic activity. The NBER usually waits several months after the fact to announce the official start and end dates for recessions. Therefore, it is possible the United States is already in a recession that started in early 2022. Of course, not all recessions are created equal. The current period looks far better than past severe recessions like the Great Depression or Financial Crisis.

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Winthrop Wealth – Framework for Navigating Current Conditions

During periods of market volatility, we follow the same playbook and convey the same messages. At Winthrop Wealth, we follow a Total Net Worth Approach and we believe the right mindset paired with a comprehensive financial plan and a thorough investment process can provide confidence in working toward your long-term financial goals, especially during times of heightened market volatility.

The Right Mindset – Take a long-term viewpoint and avoid the impulse to market time

"Don't try to buy at the bottom and sell at the top. It can't be done- except by liars." -Bernard Baruch

Market volatility is stressful and controlling your emotions during these periods is critical. Market timing decisions are often emotional rather than rational and data based. We believe that making sudden large adjustments to portfolios is value destructive over time and a major reason for poor investor performance. Please see our Client Question titled Market Timing Does Not Work, where we discuss that: the stock market has historically increased over time despite frequent drawdowns, the average investor underperforms due to market timing mistakes, and the benefit of a diversified portfolio and a long time horizon.

Financial Plan

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and behavioral discipline that are likely to get you where you want to go." -Benjamin Graham

We believe that financial planning drives the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, seeks to optimize account structures, considers tax mitigation and estate planning strategies, and evaluates financial risks as circumstances and/or goals change.

We also stress test the financial plan for many different environments including extreme volatility and market declines. The financial plan does not assume perpetually strong markets and linear returns. Rather it assumes that your portfolio will go through periods of weakness throughout your investment time horizon. We often update financial plans during and after volatility to quantify the impact the market decline had on the probability that the client will reach their long-term goals and objectives.

Investment Process

"Good times teach only bad lessons: that investing is easy, that you know its secrets, and that you needn't worry about risk. The most valuable lessons are learned in tough times." -Howard Marks

Our investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. We help our clients navigate challenging markets by ensuring their short-term cash flow needs are met while managing the rest of their investments in a globally diversified portfolio.

Market volatility can be used to our advantage by tax-loss harvesting or reallocating to more attractive securities:

- Tax-loss Harvesting: Tax-loss harvesting is achieved by selling an investment with a loss and immediately purchasing a different security with similar (but not identical) exposure. The loss on the sold security can be used to offset taxable gains. Since we simultaneously sell a security to capture a loss and purchase a different holding with similar exposure, the client is never out of the market. We can capture losses during declines, and as the market recovers the new position also recovers PLUS the client has a tax-loss to offset future gains. Please see our **Client Question on Tax Loss Harvesting**.

- Repositioning Portfolios: Repositioning portfolios means that we can increase the overall equity allocation and/or reallocate among various asset classes. During a market selloff, portfolio equity allocations often fall below their target levels. For example, assume a portfolio is invested to its target allocation of 60% equities and then the stock market declines-10%. The new allocation would be about 54% or-6% below the target level. We can use the market decline as an opportunity to buy stocks at lower prices to bring the allocation back to the 60% target level. Furthermore, we can rotate to the equity asset classes that have become more attractive (for equities, we allocate across regions, countries, market caps, factors, styles, sectors, and industries). Keep in mind, some of the best buying opportunities have historically occurred during periods of market turmoil.

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Disclosures

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P Midcap 400 Stock Index is an unmanaged index generally representative of the market for the stocks of mid-sized US companies.
The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 index, which represents approxi¬mately 10% of the total market capitalization of the Russell 3000 Index.

The prices of small cap stocks and mid cap stocks are generally more volatile than large cap stocks.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia. The MSCI EM Index consists of the following emerging market country indices: Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa. Turkey, United Arab Emirates, China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.
The Barclays Capital US Corporate High Yield Bond index is an index representative of the universe of fixed-rate, non-investment grade debt.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays US Treasury Bills 1-3 Month Index is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months. The Index includes all publicly issued zero coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and at least 1 month, are rated investment grade, and have $300 million or more of outstanding face value.
Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Bloomberg Commodity Total Return index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13 week (3 Month) U.S. Treasury Bills.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.
All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.