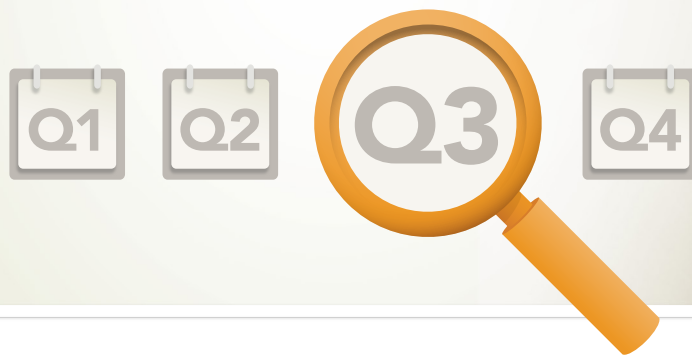


# Fall 2022 Market Review



Fall 2022

## Taking Our Medicine

*“Hey baby, there ain’t no easy way out  
Hey I will stand my ground  
And I won’t back down  
Well, I know what’s right”*

— *I Won’t Back Down by Tom Petty*

The third quarter began with a summer relief rally until Federal Reserve (“Fed”) Chairman Jerome Powell made it very clear to investors, “we’re not backing down”. Meaning that the Fed will battle inflation by aggressively raising interest rates even at the expense of economic growth. As investors finally got the message, the financial markets resumed their decline. By the end of the third quarter, U.S. stocks were trending towards their worst year since the 2008 financial crisis.

The Fed walks a tightrope. While it has to take steps to “cool down” the economy and bring inflation under control, it aims to do so without causing a severe recession. A strong economy generally leads to more jobs but quickly rising prices, while a sluggish economy can lead to fewer jobs but slower price increases. The Fed constantly is aiming to balance those two extremes with limited, but powerful tools.

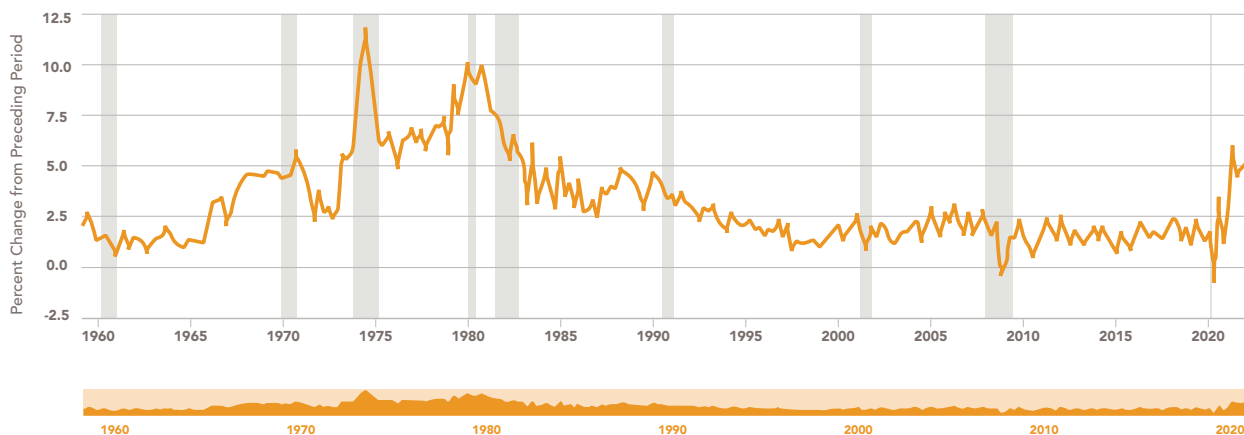
*Why does the Fed care about high inflation?* When businesses and consumers begin to expect high levels of inflation, when it becomes entrenched in everyone's considerations of the future, the world gets whacky. People stock up on products because "they can only" get more expensive later. Businesses start making pre-mature investment decisions. Workers, expecting their salaries to buy less each year, demand wage increases. Currencies deteriorate in value. Wealth, overall, erodes. High inflation is bad for business. Anyone who lived through the 1970's and early 1980's remembers just how bad it can be for the average consumer as well.

*How can the Fed affect inflation levels?* The answer is interest rates. Interest rates, the cost to borrow money, drives so much of the economy. Historically, low interest rates stimulate growth because houses, cars, equipment all cost less to finance. To stimulate, or reign in, the economy, the Fed sets an important short term interest rate. During the COVID pandemic, the Fed dropped interest rates to nearly 0% to stimulate borrowing, but many would argue it overshot it. That's when "bubble behavior" tends to start, such as investors gambling on cryptocurrencies and meme stocks. The euphoria and speculation seen in the financial markets last year were reminiscent of the tech bubble markets 20 years ago.

The Fed's current playbook largely is shaped by the lessons learned from the last time the Fed faced serious inflation in the late 1970s (Chart I). At the time, the Fed had lost its grip on price stability for nearly a decade and living with high inflation had become a way of life. President Jimmy Carter appointed Paul Volker to take dramatic action. The Fed's tough love ultimately pushed short term interest rates to 20% in 1981. Since then, inflation has been in check for nearly 40 years, coinciding with a long bull markets along the way for both stocks and bonds.

## Chart I: Inflation 1960-2022

**Personal Consumption Expenditures (PCE) Excluding Food and Energy**  
(Chain-type Price Index)



Shaded areas indicate U.S. recessions.

\*Source: The Federal Reserve Bank of St Louis and U.S. Bureau of Economic Analysis. The Federal Reserve's preferred inflation gauge and described by the U.S. Bureau of Economic Analysis (BEA) as "A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior."

Responding to surging prices by talking tough, increasing short-term interest rates, and a few other maneuvers, should eventually slow consumer demand and halt the surging inflation before it becomes entrenched in our economy.

## Until the Medicine Takes

The Fed's current decisive actions should ultimately lead back to a better environment for both businesses and markets. We applaud and are grateful for the Fed's moves. They are making tough and unpopular choices that are both bold and necessary.

The Fed will continue to pay attention to the impact of their actions on inflation and adjust accordingly. Once the medicine starts to work, the financial markets should begin to breathe a sigh of relief and today's uncertainty will begin to fade as it always does.

The medicine seems to be having an effect already. Companies' guidance and stock valuations are beginning to reflect the fundamental impact of higher interest rates. The housing market is finally showing signs of cooling down as mortgage interest rates have more than doubled this year. Economic forecasting organizations, such as the Conference Board, predict that the U.S. is on the precipice of a mild recession based on the influence of persistent inflation and Fed interest rate increases.

## Embracing Uncertainty

On one level, this year's market decline is not fully surprising. Historic market data shows yearly average market returns in the high single digits. Most Rebalance portfolios have been appreciating in the "teens" for the last three years. Something's had to give. But nevertheless, today's markets are stressful to be sure. Given the current uncertainty, it can be hard to feel like an optimist. But most of what happens in our lives is unpredictable. Despite what some "experts" might claim, it is not possible to forecast the future.

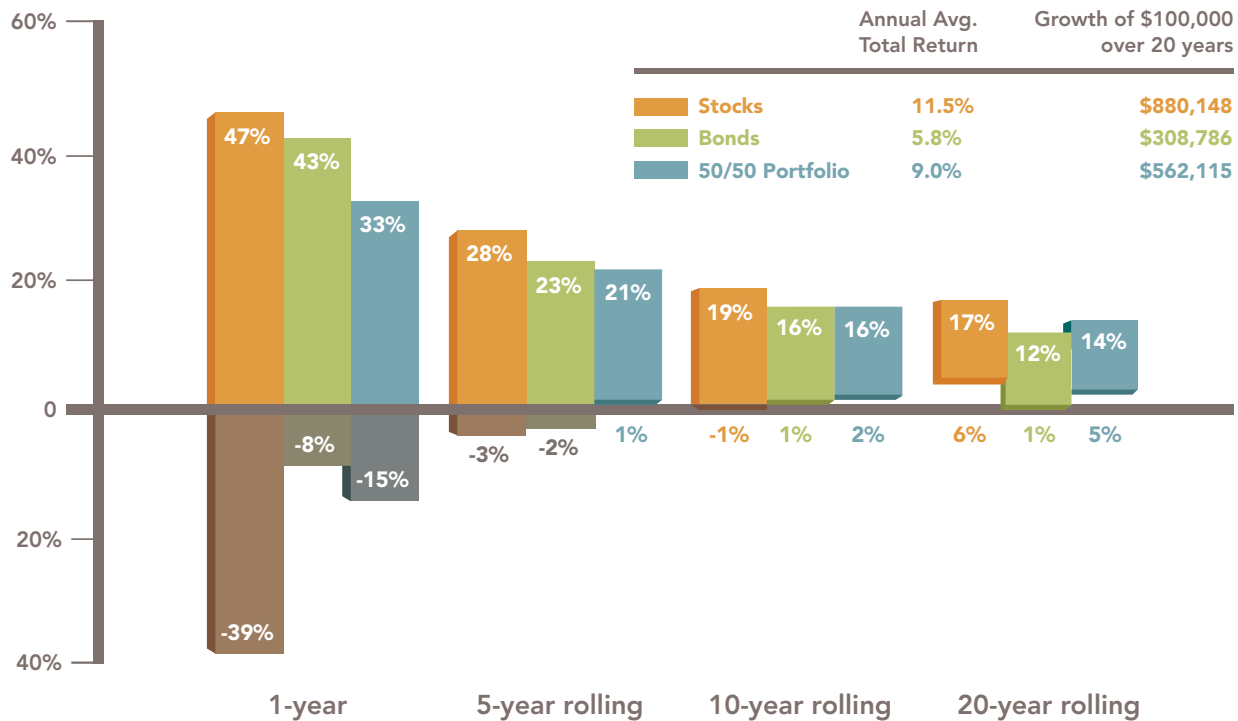
In spite of the ups and downs in the financial markets, most Rebalance clients find that they have a good investment experience without having to forecast what the market is going to do or trying to guess which companies will succeed and when. As strategic asset allocation investors, harnessing the power of index funds, Rebalance believes in capitalism and the ingenuity of people to solve problems and make their companies run better.

We empathize with those of you feeling anxiety during these times. Seeing your retirement portfolios go down in value can generate fear and bring out negative emotions. We are all human after all. But it is important to remind ourselves that these are the times when having a long-term financial plan, and sticking to it, pays off.

## Chart II

### Range of Stock, Bond, and Blended Total Returns

Annual total returns, 1950 - 2021



As Chart 2 shows above, staying invested and sticking to a plan has worked out well over the last 70 years, including navigating through wars, recessions, bear markets, bubbles and busts. A simple indexed stock and bond portfolio has averaged nearly 9% annualized return and over 5, 10 and 20 year rolling average periods always has had a positive return.







We continue to hear from our Rebalance clients that going through a thorough financial planning process has helped them live better during stressful economic times. While financial markets cannot be controlled, the risks you take investing can be managed. As the investment professional in your corner, Rebalance is here to help you make financial decisions you can live with.

In the absence of a crystal ball, rebalancing your portfolio allows us to manage risk and take advantage of price dislocations that present themselves during volatile markets. As always, we remain patient, diligent, and focused on the long-term. We always are available to talk through the current climate and help you put this challenging investment environment in perspective.

## World Markets Review

### Third Quarter 2022

The **Rebalance** Investment Committee works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the third quarter of 2022 these asset classes performed as follows:

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q3 2022	Stocks				Bonds	
	-4.46%	-9.20%	-11.57%	-11.12%	-4.75%	-2.21%
						
Since Jan 2001						
Avg. Quarterly Return	2.1%	1.3%	2.4%	2.2%	0.9%	0.9%
Best Quarter	22.0% Q2 2020	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	4.6% Q4 2008
Worst Quarter	-22.8% Q4 2008	-23.3% Q1 2020	-27.6% Q4 2008	-36.1% Q4 2008	-5.9% Q1 2022	-4.1% Q1 2022

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net dividends]), Emerging Markets (MSCI Emerging Markets Index [net dividends]), Global Real Estate (S&P Global REIT Index [net dividends]), US Bond Market (Bloomberg US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Global Aggregate ex-USD Bond Index [hedged to USD]). S&P data © 2022 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2022, all rights reserved. Bloomberg data provided by Bloomberg.

## Growth Asset Classes

**Large U.S. Stocks.** Large-cap U.S. stocks fell in Q3 2022 based on continued high inflation readings, tighter monetary policy, sharply higher interest rates and the increasing chance of recession in the U.S. All of these factors weigh on the valuation of equities. The Federal Reserve emphasized it was going to get tough and stay tough on inflation during multiple public presentations within the quarter.

**Small Cap Stocks.** Small company stocks fell during the third quarter based on the same forces pushing larger cap stocks lower and because they are less liquid and therefore more vulnerable to selling pressure.

**International Developed Stocks.** Foreign developed markets were particularly hard hit during the quarter. Foreign central banks that have been holding off raising interest rates are now being forced to do so to defend their currencies against a rapidly rising U.S. dollar. These interest rate increases may produce further slowing in the economies of developed markets outside the U.S. and pressuring stock prices.

**Emerging Market Stocks.** Emerging markets stocks fell sharply during the second quarter given the inflationary impact of weaker currencies on top of surging food and energy inflation.

**Real Estate.** U.S. real estate investment trusts (REITs) continued to be under pressure from sharply higher interest rates. This pressures REITs in two ways. Bonds become competitive to REITs for income-oriented investors and rising borrowing costs hurt real estate fundamentals.

## Income Asset Classes

**U.S. Government Bonds and TIPS.** Yields on the benchmark 10-year Treasury rose markedly during the quarter with the higher inflation readings, causing prices to fall sharply across all maturities including inflation protected bonds (TIPS). The U.S. consumer price index rose year over year by 8.3% in August, continuing a streak of surging inflation readings in 2022.

**U.S. Corporate Bonds.** U.S. investment-grade (higher-quality) corporate bonds prices fell in Q3 as interest rates rose, the economy weakened, and credit concerns negatively influenced spreads and pricing.

**High Yield Corporate Bonds.** More speculative high-yield corporate bonds fell slightly during the third quarter based on increased credit risk and rising interest rate spreads vs. their less risky investment grade counterparts.

**Emerging Market Bonds.** Emerging market bonds fell sharply during the quarter, as higher U.S. interest rates and a strengthening dollar increased credit concerns for sovereign issuers who face higher repayment burdens when their local currencies weaken vs. the dollar. The U.S. dollar index climbed 17% in the third quarter vs. a basket of global currencies.

**Preferred Stocks.** As a “hybrid” security that is part fixed income and part equity, preferred stocks are influenced by forces influencing both stock and bond markets. In Q3 2022, preferred stocks produced a slight negative return but outperformed broad bond benchmarks.

## The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.



The **Rebalance** Investment Committee members, April 2022. Left to right: Charles Ellis, Burton Malkiel, Jay Vivian, and Kristi Craig. **Rebalance** Managing Partners Mitch Tuchman and Scott Puritz are also members of the Committee but not pictured here.

**Rebalance** and its clients are fortunate to have such respected and savvy financial experts guiding key investment decisions.

**Professor Malkiel** is an emeritus Princeton University economics professor, a former longtime board member of The Vanguard Group, and a highly respected voice in the investment industry. Professor Malkiel has written hundreds of scholarly articles and opinions, notably the investment classic *A Random Walk Down Wall Street*, now in its 12th edition and mandatory reading in economics and finance courses in colleges around the world.

**Dr. Ellis** was Chairman of the Investment Committee of the famed Yale Endowment, working closely with investment legend David Swensen. He was co-founder and Managing Partner of Greenwich Associates, a consultant to institutional investors. In addition, Dr. Ellis served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.



Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over \$100 billion in IBM investment funds for more than 400,000 employees worldwide. Treasury & Risk named him among the “100 Most Influential People in Finance.” In 2010, Plan Sponsor gave him its Lifetime Achievement Award. He is on the Board of Directors and Investment Committee of ICMA-RC, which manages more than \$40 billion in public sector retirement assets.

Kristi Craig is the Chief Investment Officer at the National Geographic Society, overseeing a \$1.4 billion endowment. Previously, she was Director of Private Investments for the Georgetown University endowment, currently valued at \$2.6 billion. Ms. Craig also led business development for the Small Business Investor Alliance and served as a Senior Investment Officer for the U.S. Small Business Administration.

We thank them for their input and wisdom.

Very truly yours,

Your **Rebalance** Team