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Third Quarter 2022 Commentary

Dear Clients,

Please find enclosed your September 30, 2022 Investment Reports.

A trying year for investors continued into the third quarter as the global capital markets wrestled with the challenges brought about by central banks fighting inflation. U.S. Large Cap Stocks fell 4.9% for the quarter, and their total return year to date is a sobering -24.9%. For the quarter, U.S. Mid Cap Stocks (-4.1%) and Small Cap Stocks (-2.6%) fared slightly better, but have also suffered the same order of magnitude declines as their Large Cap brethren year to date in 2022. Developed International Stocks (-9.5%) and Emerging Market Stocks (-10.1%) suffered even more for the quarter, buffeted by the dollar's continued strengthening (which thereby further reduces returns on international stock holdings for dollar-based investors).

Bonds fell slightly less than stocks for the quarter, but the buffer they often provide portfolios was largely absent as global interest rates continue to rise at a pace not seen since the early 1980s. For example, the rate on a typical 30-year mortgage rose over 1% during the quarter and has more than doubled over the course of the year, ending the quarter at roughly 6.7%. To put such a move in perspective, consider that if one were to hold housing prices and down payment amounts constant, the typical American would be facing 50% more in monthly payments to buy the same house in September 2022 that they could have purchased in December 2021. In such a dramatically rising interest rate environment, obviously something must give, and to date that "something" has largely been capital markets asset prices.

One of the central questions on the minds of U.S. market observers is when that "something" might become employment levels. The unemployment rate remains stubbornly low, matching the pre-covid low of 3.5%, a figure last seen in the late 1960s. There are a myriad of other economic variables one might consider in analyzing economic health, but it suffices to say that when data points are hitting highs or lows not seen in over 40 or 50 years, we are in an unusual economic environment.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	-4.9	-16.9	9.6
US Mid Cap Stocks	-4.1	-19.5	6.7
US Small Cap Stocks	-2.6	-20.8	5.4
Developed International Stocks	-9.5	-24.6	0.0
Emerging Market Stocks	-10.1	-24.2	-0.2
US Bonds	-4.8	-14.6	-0.3
Global Bonds	-8.8	-24.8	-4.0
US REITs	-10.3	-17.5	1.7

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
Developed International Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

On top of the unusual economic activity, we are also faced with political uncertainty, both domestically and internationally. As we have noted many times before in these write-ups: investors do not like uncertainty. There are no shortage of pundits predicting U.S. midterm elections, and while the betting markets suggest a split decision is most likely (i.e., the Democrats keep the Senate and the Republicans take the House), getting through the election cycle itself should likely result in a calming effect on the markets.

Internationally, there is no shortage of geo-political topics at hand, with the most concerning being the ongoing conflict in Ukraine. With no peace on the horizon, and the prospect of further destabilization, it is difficult to see

volatility coming to an end in the region. In China, where Covid headlines and lockdowns seem to be slowly receding from the news cycle, there is still the prospect of destabilization from any escalation with Taiwan. Additionally, the Chinese property market, by some estimates the largest single asset class in the world, has been (quietly) struggling (though the Chinese government is using its much heavier hand of direct intervention, which thus far has tamed any panic). The world beating Chinese growth for much of this century has moved rather quickly to the rearview mirror, with analysts now projecting 2022 Chinese GDP growth at a pedestrian 3 to 3.5% (and below Beijing's target of 5.5%). The Chinese leadership are well aware that China has reached the peak of its demographic growth curve, and a past demographic tailwind can no longer be counted on to aid their economic fortunes. Investors wonder whether domestic challenges will keep the Chinese focused on internal affairs, or whether such challenges will spur them to distraction elsewhere (in a manner analogous to Russia).

With plenty of uncertainty in our global economy and with central banks still fighting inflation, it is a tough season for investors. Indeed it has been a tough season for savers of any stripe. You may have heard it said that inflation is a tax; and it is in the sense that it transfers wealth from savers to borrowers. Who is one of the largest borrowers in the world? The United States government. As long as U.S. inflation runs above real output growth, the debt of the United States government shrinks in real terms. Your more expensive hamburger is (slowly) paying off the (real) federal debt (though figures quoting nominal debt will keep rising). We have often heard that "future generations will pay for our borrowing (i.e., extra consumption today)"; we are currently paying that bill through inflation.

In the midst of this turmoil, we do believe there are still some diamonds in the rough for long term investors. An obvious positive is that as interest rates have risen, so have the prospects for earning a return on your safer assets. For instance, one year U.S. Treasuries now yield over 4% for the first time since 2007, and 5 year real yields on U.S. inflation protected bonds are as high as they've been in almost 15 years. While the most commonly used U.S. Bond reference index has suffered its worst drawdown since inception (over 46 years ago), the portion of global negative yielding debt has dwindled to back to 2014 levels. Importantly, global bond investors can finally expect a positive return on their bonds to maturity.

The prospects of stocks are, as always, less certain than bonds in the short term. In fact, a short term investor is justified in his or her worry as to whether a few central bankers can masterfully engineer a soft landing for a complex economy, or whether an autocrat's quest for geo-political authority can be brought in line during the next quarter. However, we believe that over the long run, human ingenuity leads to economies that are capable of producing the same or better goods (and services) for less cost. Stock investors receive the benefit of this productivity increase in the form of dividends and share price appreciation. A stock is simply a claim on the future ingenuity of a business. Long term investors know that companies will keep coming up with new inventions and better ways to meet humanity's needs. The current value of the stock payoff stream will fluctuate over time, but in the long run, the payoff stream will compensate the investor for his or her optimism.

As always, we remain appreciative of your continued confidence and trust.

Leavell Investment Management, Inc.