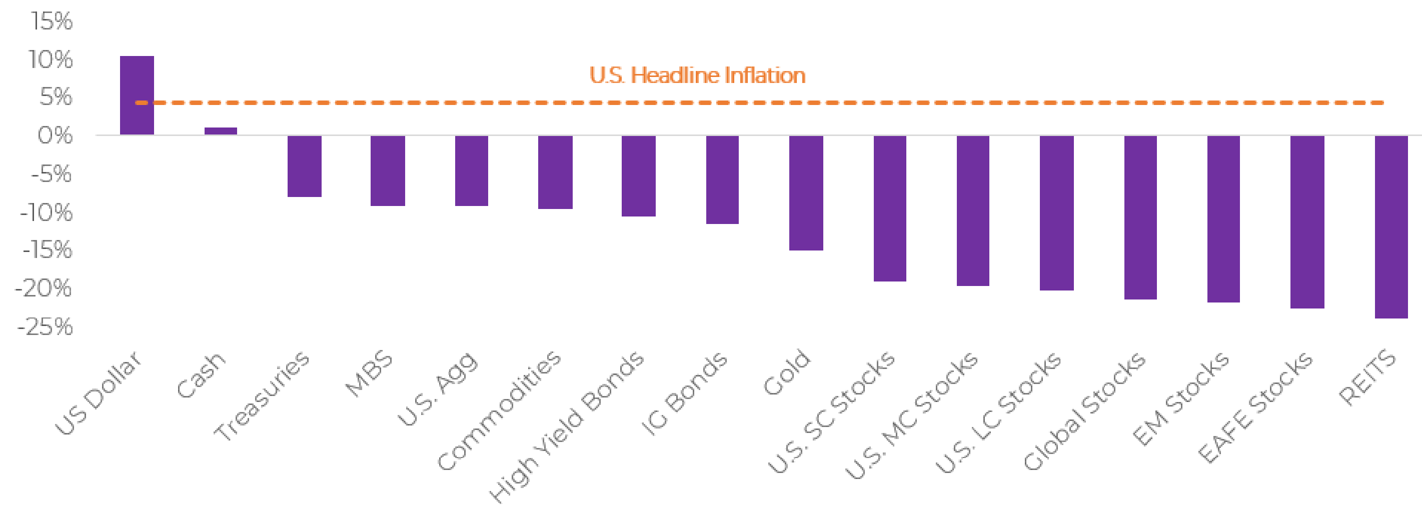
October 14, 2022

Dear O'Brien Client,

The third quarter of 2022 has passed and the frustration for investors has continued, with every major asset class declining again – and stocks and bonds down for a third consecutive quarter.

While there was a rally in markets during the first half of the quarter, tough talk from the Federal Reserve (Fed) on the need for an extended period of rate hikes more than snuffed it out by quarter-end. The graph below summarizes the result.

U.S. Inflation vs Asset Market Performance the Past Six Months



MBS: Mortgage-Backed Securities. Agg: Aggregate Bond Index. IG: Investment Grade. SC: Small Cap. MC: Mid Cap. LC: Large Cap. EM: Emerging Markets. EAFE: Non-U.S. Developed Markets. Source: Morningstar Direct, O'Brien Wealth Partners, as of 9/30/22.

The dollar and cash are the only major asset classes to experience positive returns over the past six months – and the dollar is the only one to outperform inflation. The fact that inflation-sensitive assets, such as commodities, are down even though inflation remains stubbornly high suggests the Fed's rapid tightening of interest rates is overwhelming all other market fundamentals.

Despite the continued market downturn, economic activity is re-accelerating in 3Q. The Atlanta Fed publishes a real-time estimate of economic growth, and they currently indicate 3Q real (inflation-adjusted) GDP growth to be almost 3% (versus an outright decline the first half of the year). The economy also added an additional 550,000 jobs in the first two months of the quarter – and roughly 3.25 million jobs year-to-date.

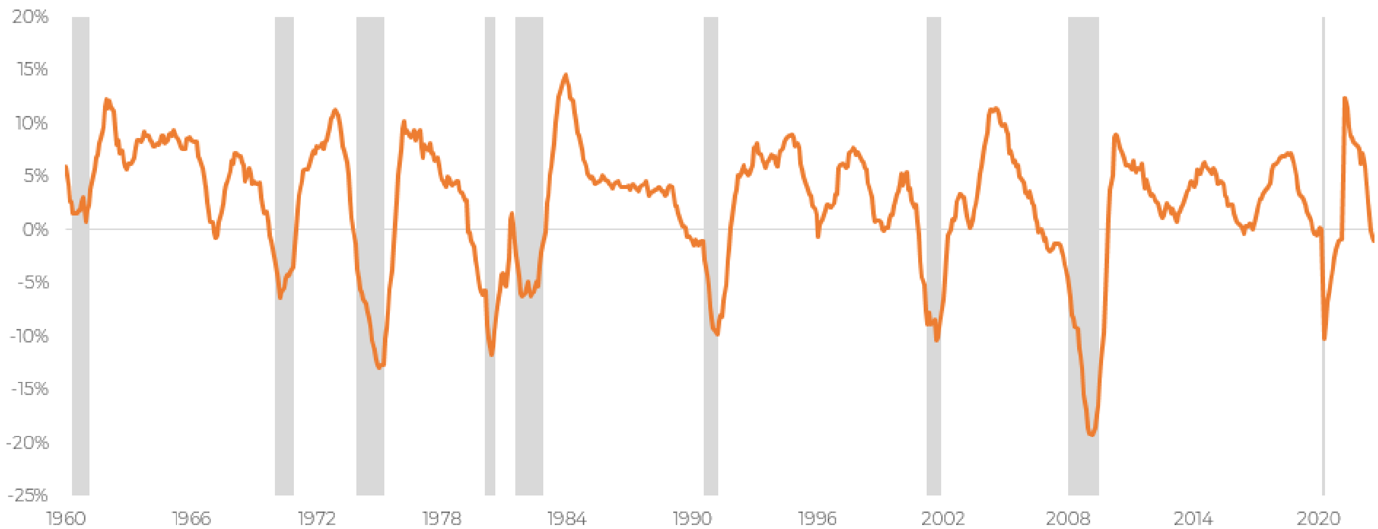
Perversely, that reacceleration in growth has probably created a greater problem for the Fed. Faster economic growth means demand for goods and services is accelerating – putting additional upward pressure on prices. Still solid job growth also indicates that labor markets and wage growth have not been impacted meaningfully by the tightening that has already occurred this year either. Much like the market rally earlier in the quarter, it appears that good economic news has become bad news for the Fed.

At their late September meeting, the Fed raised interest rates to a level that they consider outright restrictive for economic activity for the first time this tightening cycle. And they appear to have become even more entrenched in immediately increasing, and maintaining for longer, this stance. Specifically, Fed Chairman Powell noted in the aftermath of that meeting that "we are taking forceful and rapid steps to moderate demand" and that "restoring price stability will likely require maintaining a restrictive policy stance for some time."[1]

The problem with this stance is that Fed tightening impacts labor and wages with a lag of up to a year-and-a-half, so it is hard to know whether the tightening that has already occurred would be sufficient if given time to fully flow through the economy. The Fed's unwillingness to slow down (let alone stop) tightening despite this knowledge and their having raised rates to a level they now consider restrictive for growth likely makes the question when, rather than if, a recession will occur.

The leading economic indicator index, which monitors indicators such as initial unemployment claim filings, single-family building permits, and manufacturing new orders for consumer goods and materials, for the U.S. highlight this risk. As shown below, this index has stalled. While it has been at similar levels historically without a recession (gray bars) occurring, its performance this year suggests the odds of a recession occurring have risen materially.

U.S. Leading Economic Indicators (Year-Over-Year %)



Gray bars denote U.S. recession as identified by the National Bureau of Economic Research (NBER). Source: S&P Global, The Conference Board, NBER, O'Brien Wealth Partners, as of 8/31/22.

When discussing recessions there is a tendency to assume what happened in the most recent recessions is a reasonable base case for future recessions – a behavioral finance concept known as recency bias. Yet these recessions were unusually bleak, with widespread shutdowns occurring during the COVID recession, and the bursting of a housing bubble driving the Global Financial Crisis.

Today's economy is different, with important supports that make the magnitude of the economic decline the past two recessions less likely to re-occur. Household balance sheets are the healthiest they have been in decades. Consumers also still hold almost $1.5 trillion in excess savings from COVID stimulus checks that could be used to help mitigate inflation and/or income losses. Business balance sheets are also much healthier, with little publicly owned debt maturing through next year.

[1] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220921.pdf

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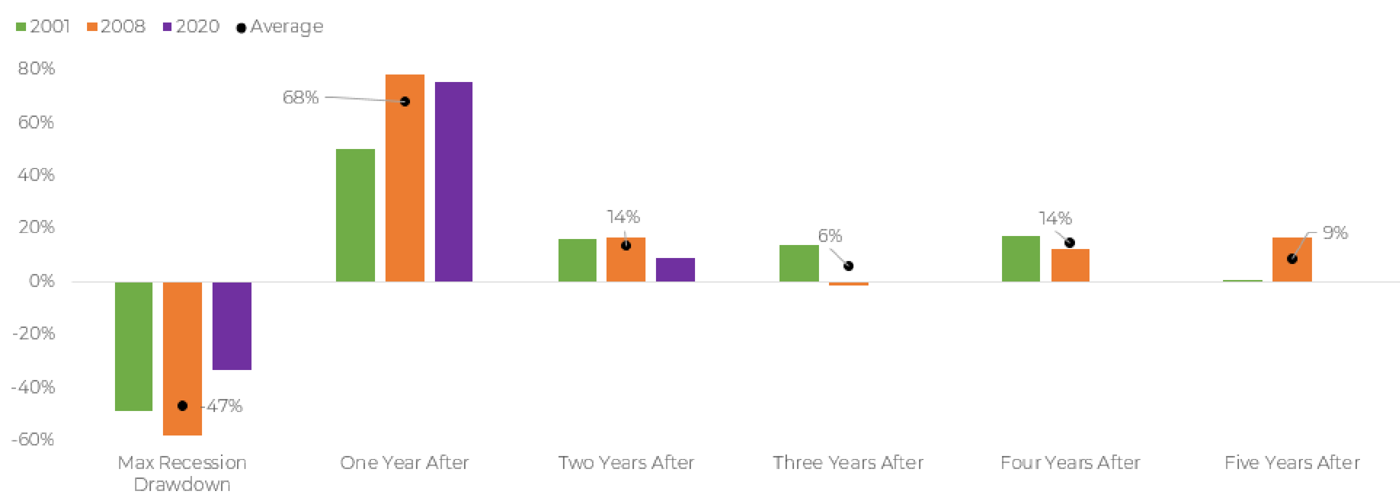
While the bulk of the economic downside is yet to come if a recession occurs, markets are forward-looking and have already started to price in this risk (global stocks are down -26%). During previous recessions since the early 1800s the stock market typically fell between -30% and -35%. So, it is possible to see some additional downside before we are on the other side. And to the extent the Fed continues to rapidly raise rates before a recession occurs, it is also possible that bonds continue to suffer as well.

So why stay invested?

First, we incorporate negative market scenarios such as the one we are currently experiencing when constructing and stress testing your financial plan and asset allocation targets. We do not just plan for rosy scenarios when trying to help you achieve your financial goals and we design portfolios to try to maximize your probability of success in both up and down markets.

Second, no one knows exactly when markets will bottom. But we do know that roughly 80% of the stock market's best days the past 30 years have occurred either during a bear market or in the first two months of a bull market.[2] We also know that while stocks tend to experience sharp selloffs during recessions (for example the last three recessions in the chart below), they also tend to bounce back meaningfully in the year following those declines. Even after the strong initial rebound, stocks tend to continue to experience positive returns on average, albeit at a more moderate pace as long as the economy continues to expand.

Global Stock Performance During and After the Last Three Recessions



Past performance is no guarantee of future returns. You cannot invest in an index. Global Stocks: MSCI All-Country World Index (ACWI). Source: Bloomberg Finance, LP, O'Brien Wealth Partners, as of 3/24/22.

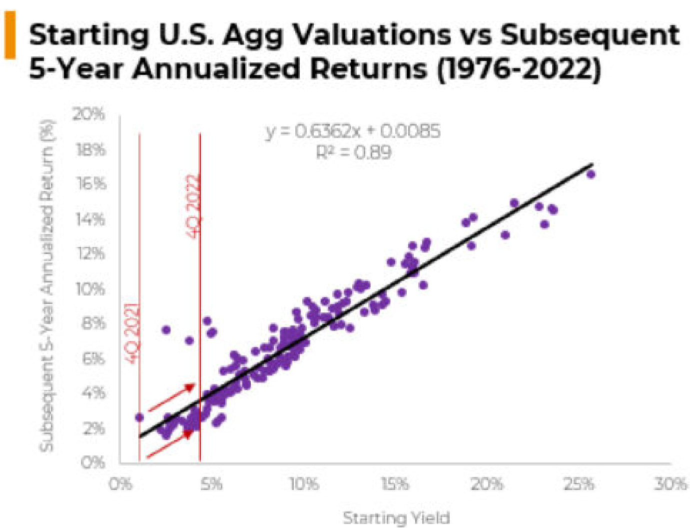
And while bonds may remain under pressure if the Fed continues to rapidly raise rates, once a recession occurs it means demand and therefore inflation are likely cooling, and the Fed is probably shifting to rate cuts. These changes would remove the two biggest headwinds for bonds and could allow bonds to not only start diversifying stocks again, but also to potentially experience strong returns of their own. For example, if 30-year treasury rates fell 1% from their current level, it would equate to a roughly 25% return for long-term treasury bonds.[3]

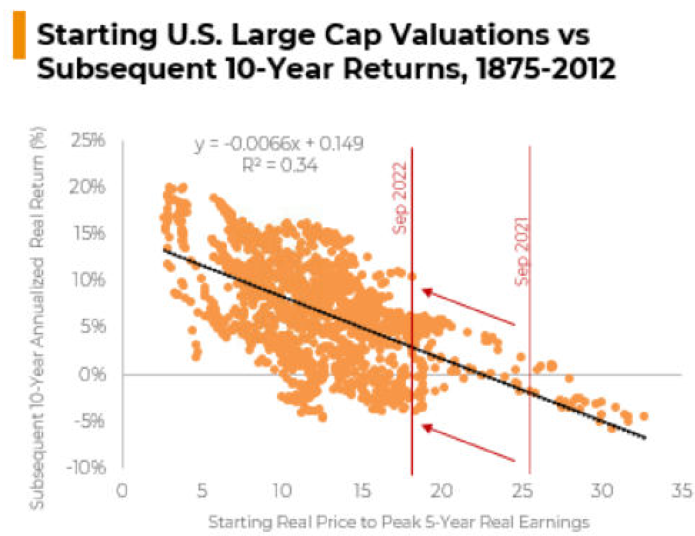
[2] Source: Ned Davis Research, Morningstar, Hartford Funds, O'Brien Wealth Partners, 2/28/22.
[3] Total return estimates, assuming a parallel shift in the yield curve. Source: JPMorgan Guide to the Markets, O'Brien Wealth Partners, as of 9/30/22.

There are a few silver linings from the continued market declines this year worth noting as well. One is that there is income in bonds again. Low interest rates in recent years have pushed investors far out the risk spectrum in search of income opportunities. But the sharp rise in rates this year means there are now reasonable alternatives for generating income. Investment grade corporate bonds, for example, now provide close to a 6% yield – almost double their typical yield of the past decade.

Another silver lining is that both bond and stock markets have become less expensive than they were entering the year. While valuations are not a significant driver of short-term market returns, they do correlate with longer-term returns. As shown in the graphs below, cheaper starting valuations have set both bonds and stocks up for better returns over the next decade than they had entering 2022.

For example, the U.S. Aggregate Bond Index (bottom left) was yielding 1.75% entering the year vs 4.75% entering 4Q. This higher starting yield implies a much improved expectation for returns over the next five years (as shown by the direction of the red arrows). And for stocks (bottom right), starting valuations have fallen from over 25 times earnings a year ago to a little over 18 times earnings entering 4Q. This lower starting valuation similarly correlates to a stronger average return for stocks (as shown by the direction of the red arrows again).





LEFT: Agg: Aggregate Bond Index. Source: KKR, O'Brien Wealth Partners, as of 9/30/22. RIGHT: Source: Yale University, Robert Shiller, O'Brien Wealth Partners, as of 9/30/22.

Between now and when we may be able to start to capitalize on those silver linings that are appearing, Fed actions and incremental labor market and price data will likely continue to dominate market fundamentals.

One area of the market we view as relatively attractive as this uncertainty persists is treasury bills. Following the latest Fed rate hike, one-year treasury bills are providing a return of roughly 4%. While that is not enough to match inflation, by buying and holding such instruments to maturity we can provide a measure of capital preservation and a source of positive returns that are currently lacking from other asset markets.

We aim to remain disciplined by staying invested in markets, rebalancing your portfolio if the deviations become too large, looking to de-risk portfolios within asset classes if economic conditions deteriorate, and adding opportunistic

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investments if the inflation backdrop improves. We will also continue to try to harvest capital losses where available that can be used to offset future capital gains in taxable accounts.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

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