September Investment Outlook 2022

KLINGENSTEIN FIELDS
ADVISORS

Gregory W. Golinski, CFA
Director of Analytics
Partner

Current Market Conditions

Volatility returns in August

Volatility persisted throughout August as the Federal Reserve (Fed) reiterated that additional interest rate hikes would be needed to tame inflation. Nine of the eleven sectors in the S&P 500 produced negative returns for the month as investors continued to search for safe havens.

The U.S. yield curve flattened as the market priced in the possibility of an economic downturn and higher interest rates. Two-year Treasury yields have exceeded 10-year Treasury yields since the beginning of July.

Still, the financial markets rallied strongly from mid-June to mid-August. The S&P 500 appreciated over 17% on the hopes that the Federal Reserve Board would raise interest rates less aggressively than previously expected, increasing the possibility of the economy avoiding a recession. Since mid-August, however, the S&P 500 has declined by 8%, leaving averages down 16% for the year. U.S. small capitalization and international, as well as emerging market stocks also continue to perform poorly. The corresponding indexes are down year to date 17%, 19%, and 17%, respectively. One contributing catalyst for the recent selloff was commentary from Fed Chairman Jerome Powell at the annual Jackson Hole Economic Symposium, stating that controlling inflation is the Fed's top priority, and some pain will be required to achieve that objective. This commentary dampened the market's hopes for an easier pathway to lower inflation and a steadier economy.

At the beginning of August, expectations were that the Fed Funds Rate, which is the Fed's primary mechanism for influencing interest rates, would rise to 3.3% by this December. After the Fed's Jackson Hole commentary, that expectation rose to 3.7%. Other interest rates rose in tandem, with the yield on the ten-year U.S. Treasury Bond increasing

continued on page 2

from 2.6% to 3.2% by the end of August. The continued rise in interest rates has resulted in a broad measure of the bond market, down nearly 11% year to date.

Declining commodity prices have persisted, with oil below $90 per barrel after trading over $120 in mid-June, while industrial metal prices have broadly declined 17% year to date. Even once-hot areas like semiconductors have seen prices decline as supply and demand come more into balance.

Lastly, despite quieting down relative to earlier in the year, geopolitical risks remain elevated and could flare at any moment.

Economic uncertainties continue to confound the market

No two economic downturns or recessions are equivalent, and this year, the markets have focused on whether the economy may be on the verge of stabilizing or worsening. This uncertainty is driving stock market volatility, as shown in the chart below. In just the first nine months of the year, seven market changes have averaged 12%. That equates to a nearly 10% change every month (in absolute terms), or typically, the magnitude of expectation over the course of an entire year.

S & P 500 in 2022

Start	End	Percent Change
12/31/2021	3/14/2022	-12%
3/14/2022	3/29/2022	11%
3/29/2022	5/20/2022	-16%
5/20/2022	6/7/2022	7%
6/7/2022	6/17/2022	-12%
6/17/2022	8/16/2022	17%
8/16/2022	9/1/2022	-9%
Average Percentage Change		**12%**

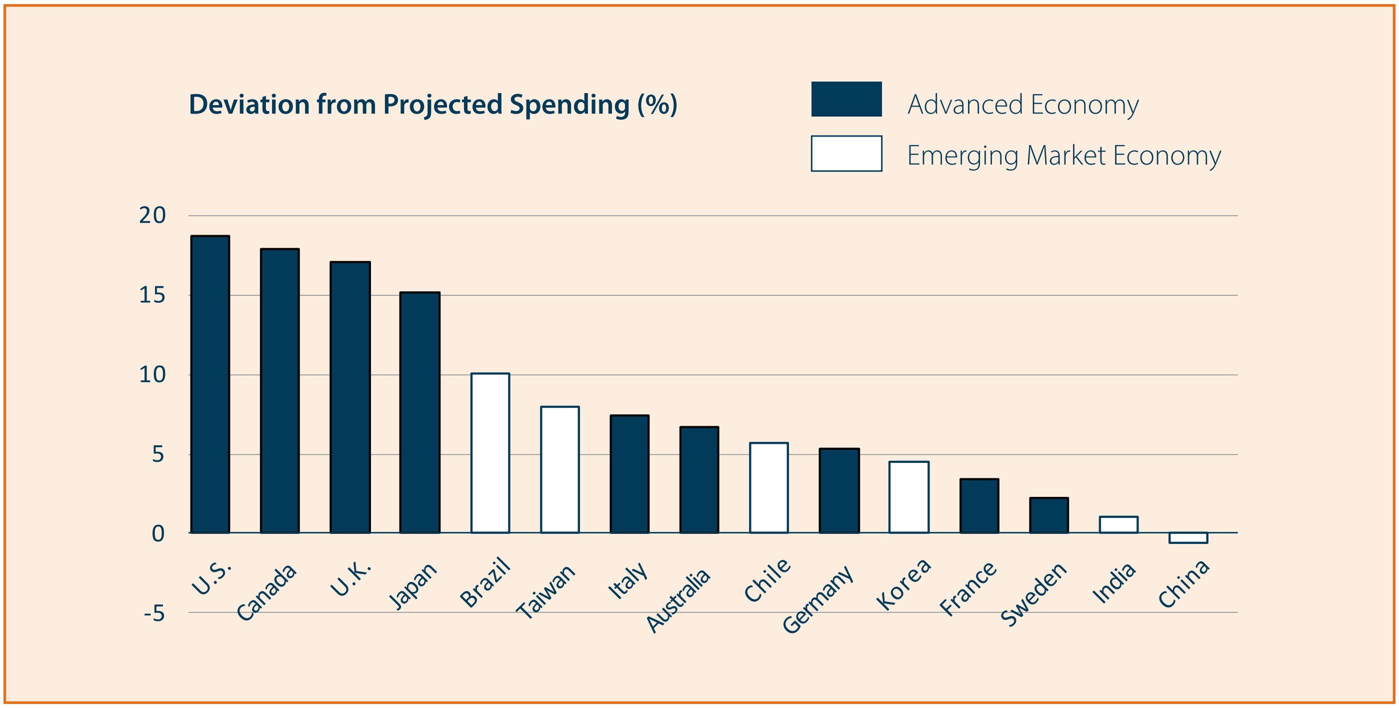
Source: Bloomberg, Klingenstein Fields Advisors

One of the factors that makes the current situation unique is the amount of liquidity injected into the system over the last two to three years. Liquidity has come from both fiscal spending (by the government) and monetary policies (by the Fed). This month, we take a closer look at the extent of these actions, and how the uncertainty around the unwinding of these policies is driving increased volatility in the markets.

continued on page 3

Fiscal stimulus is relatively easy to understand – it is simply increased spending by the government. As a response to COVID-19, fiscal stimulus was undertaken to help combat the unknown impacts of the pandemic on economic activity. Stimulus checks, payments to businesses, and loan forgiveness/forbearance, are among the many ways this fiscal stimulus flowed into the economy. The impact of COVID-19-related fiscal spending is significant, as can be seen in the chart below, and the Fed's "back of the envelope" estimate is that this fiscal stimulus is responsible for 2.5% of "excess" inflation.

In terms of monetary policy, there are two components to focus on: the Fed Funds Rate and the Fed's balance sheet. The Fed Funds Rate is the overnight rate the Fed charges banks to borrow money. This might seem somewhat esoteric, but it is a very powerful tool, as changes to this rate flow through a variety of other interest rates, from bonds prices to mortgage rates, and directly impact economic activity. The Fed's "balance sheet" refers to assets (primarily government bonds) that the Fed buys from market participants in a process known as "Quantitative Easing," or QE.



Note: Deviation from projected spending is constructed by calculating the percent change between each government's fiscal spending in 2020 against a 2020 projected value. The projected value is calculated by taking the average fiscal spending growth rate between 2015–2019 and forecasting out a year. Federal Reserve Board country classifications are used to group countries into Advanced Economy and Emerging Market Economy categories.

Source: IMF World Economic Outlook January 2022; staff calculations.

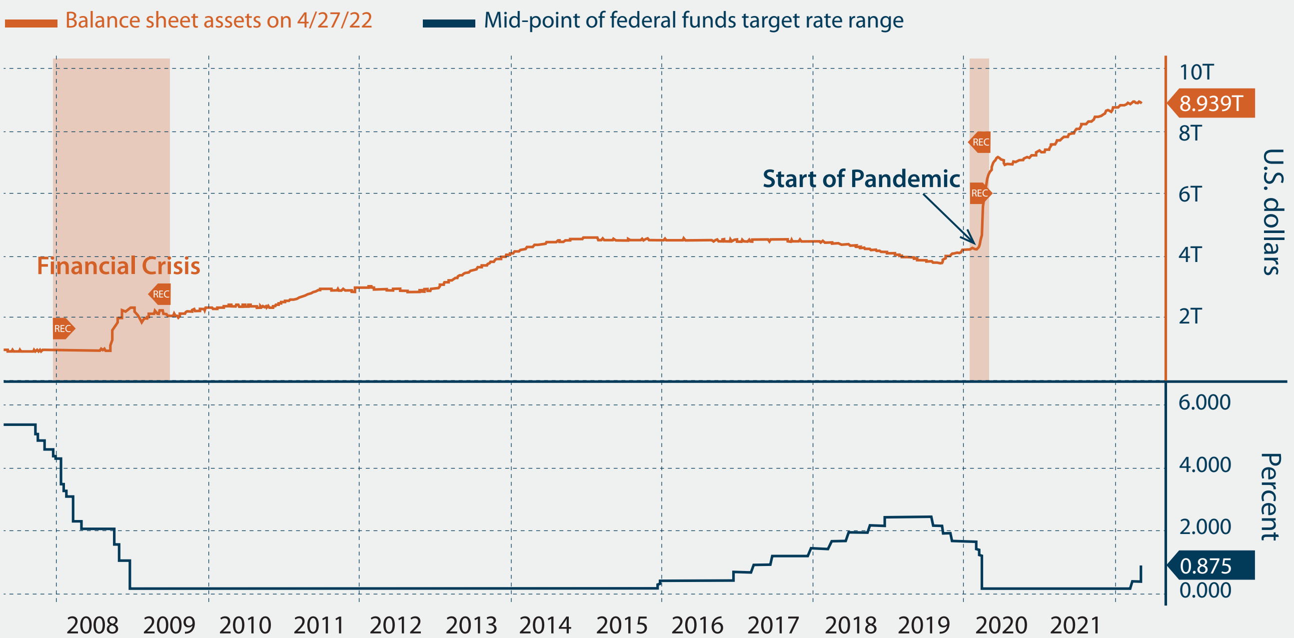
continued on page 4

The reverse of this process, which the Fed has recently embarked on, is naturally called "Quantitative Tightening". QE effectively reduces the bonds in circulation and injects liquidity into the market, driving down interest rates and greasing the economic skids.

In response to the pandemic, the Fed both reduced interest rates as well as engaged in sustained QE. The combined impact of this activity was rapid and significant, as is shown in the chart below.

Sizable Support

Fed's balance sheet is equivalent to a third of the size of U.S. GDP



Source: Federal Reserve, Bloomberg

Together fiscal and monetary stimulus provided a great deal of liquidity to the markets. The purpose of these combined policies was to avoid an economic catastrophe in 2020, but one outcome has been the high rates of inflation we see today. This creates a challenge for the Fed in determining how to lower inflation by reducing this liquidity through raising rates and quantitative tightening, without throwing the economy into a recession. Expectations on how successful the Fed will be in this endeavor have greatly contributed to volatility in the markets.

continued on page 5

Investment Approach and Strategy

Pulling the economic picture together

Fiscal and monetary policies play a very important role, but do not provide the entire picture when considering our current investment positioning. From an economic standpoint, we continue to see a confluence of factors, some positive and some negative. In both the U.S. and globally, we see positive economic growth rates for the next 2-3 years, though the growth has slowed. Corporate profits are showing a similar trajectory of positive but slowing growth. Inflation remains high, although recent moves in commodities could signal some inflation relief. Employment remains robust, which is important for the stability of the U.S. economy. Higher interest rates and the withdrawal of liquidity provides a headwind for the markets, but we believe this storm can be weathered if the underlying economy is sound.

One of the recent concerns is that, given the high rates of inflation, the Fed may need to harken back to the days of Paul Volker, who served as chairman of the Fed from 1979 until 1987, when the Fed Funds Rate reached nearly 20 percent, and the economy was crushed in the process of eliminating the runaway inflation of the 1980s. Another possible outlook is a "growth recession," where the economy grows at a much slower rate for an extended period. Given the significant uncertainties, and at times, conflicting data, forecasting the future in the short term remains challenging. We do expect increased volatility to continue, although we are not making any material adjustments to our investment policy at present, as we believe that, over the long-term, exposure to risk assets such as equities is crucial to the growth and preservation of wealth.

Things We are Watching

The Fed remains squarely front and center in terms of important factors to watch closely. We believe that the Fed has the ability to reduce liquidity and battle inflation without inducing an economic recession. While there is speculation that the Fed might take a slightly less aggressive interest rate approach to monetary policy, we think the recent commentary after the Jackson Hole symposium takes that off the table for the near term.