MARKET COMMENTARY

GOOD ADVICE

Investors have done well to heed Marty Zweig's advice, "Don't fight the Fed" since he published his 1970 book, *Winning on Wall Street*. This is what the headlines are telling us each week. So, against this muddled stream of seemingly conflicting and contradictory information, we look for signs regarding which way we are headed. Consider the following evidence for the "recession" case and the "boom" case.

In each case, efforts by the Fed to rein in inflation via tighter monetary policy proved effective in fighting inflation, but at the cost of a weakened economy. We could well be seeing the same process underway today.

Last week, Fed Chair Jerome Powell pressed his case for more interest rate hikes to calm inflation. The committee raised the policy rate 0.75% to 3.25%, and Powell affirmed his intention to "keep at it" until inflation is tamed. Markets expect another 0.75% increase at the November 2 meeting to 4%. If this plays out as expected, policy rates will have increased more over a 9-month period (3.75%) than at any time since 1980.

Starting this month, the pace of runoff from maturing bonds will double to $95 billion from $47.5 billion per month. Beyond this, the Federal Reserve intends to shrink its $8.8 trillion balance sheet. The process by which $4.5 trillion of assets were added to the Fed's balance sheet to add credit and bolster liquidity is set to reverse. The combination of higher rates and potentially less liquidity poses risks to markets and the economy.

The year-to-date 25% drop in long-term U.S. Treasury bond prices and 30% drop in the NASDAQ index are examples of how this process plays out. While painful, we note that resetting valuations is helpful when looking forward.

Even though valuations are better now, we should remain cautious because trends are poor. History also proves it can be painful to "fight the Fed."

VALUATIONS BETTER

As we discussed last December in a piece titled "Five Reasons for Caution," high valuations ranked at the top of our list of worries. However, those valuations are much better today, as the S&P 500 now trades at a more reasonable 16x earnings versus 22x at the end of last year.

Another metric to look at is the total value of U.S. stocks relative to the economy. On December 31, 2021, the aggregate value of U.S. stocks was $54 trillion versus a $22 trillion size of the economy (GDP). Thus, the ratio of stocks to GDP was 2.5 to 1. That ratio has fallen to 1.6 to 1 because stock values are now $42 trillion, and the economy is estimated to be $24.9 trillion.

As for bonds, U.S. Treasury prices are down as much as 30% for longer maturity issues. The jolt of higher rates through the spring and summer now means that investors can earn higher returns all along the curve. Consequently, the decline in bond prices means that forward-looking returns for bonds are far better today than last year.

DATA STILL WEAK

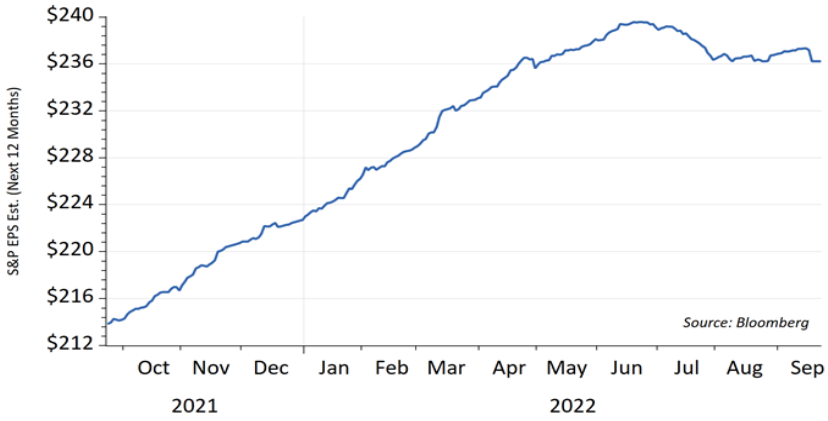
Even though starting valuations for both stocks and bonds are now better, we should still maintain a cautious and quality focus because data trends are poor.

Indicators flashing warning signs are illustrated on the next two pages.

Graph 1

S&P 500 EARNINGS FORECASTS FLATTEN OUT

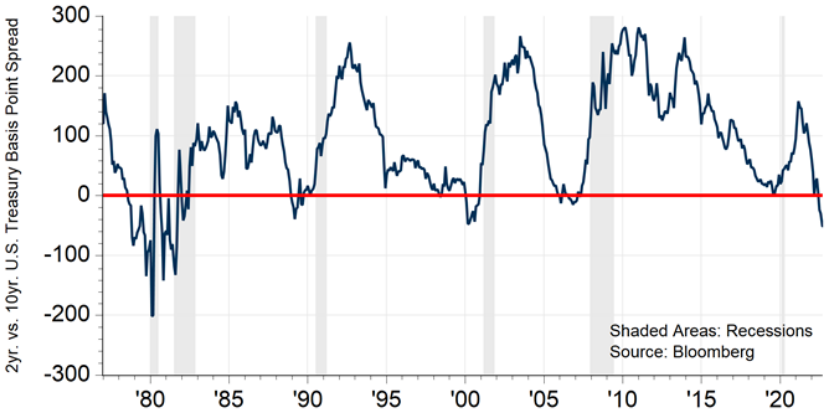
Market earnings forecasts are no longer growing. According to Bloomberg, 12-month forward expected S&P 500 earnings have been flat since summer's start. Previously, expectations had been on a steady rise.



Graph 2

YIELD CURVE RISES AND INVERTS

The yield curve, or difference between short and long-term Treasury bonds, is now inverted. The 10-year U.S. Treasury bond yield stands at 3.7%, while the 2-year U.S. Treasury note is 4.1%, making for a 0.5% inversion. Such inversions often precede recessions.



Graph 3

LEADING ECONOMIC INDICATORS FADE

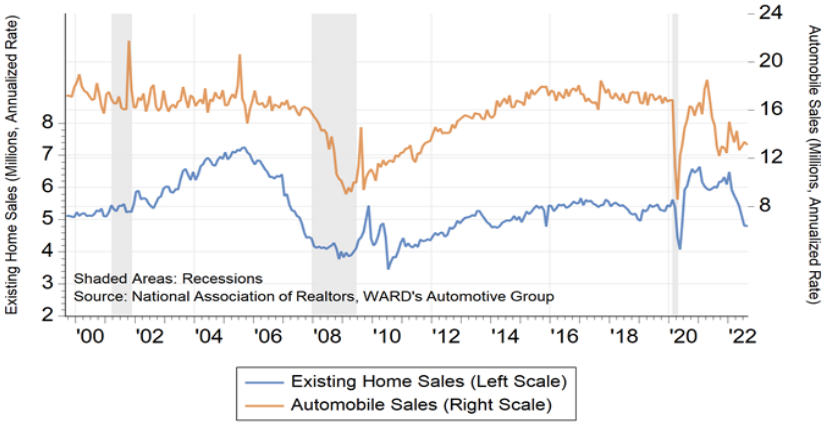
The Conference Board's Index of Leading Indicators has fallen every month since March. This index has also provided timely indications before past recessions.

Graph 4

BIG TICKET ITEMS (HOMES AND AUTOS)

Sales of big-ticket items like cars and homes are also down. According to the National Association of Realtors, existing home sales are off about 20% from a year ago. Meanwhile, automobile sales are stuck near 13 million annual units sold, well below the 17 million pace pre-pandemic.

Big Ticket Items (Homes and Autos)

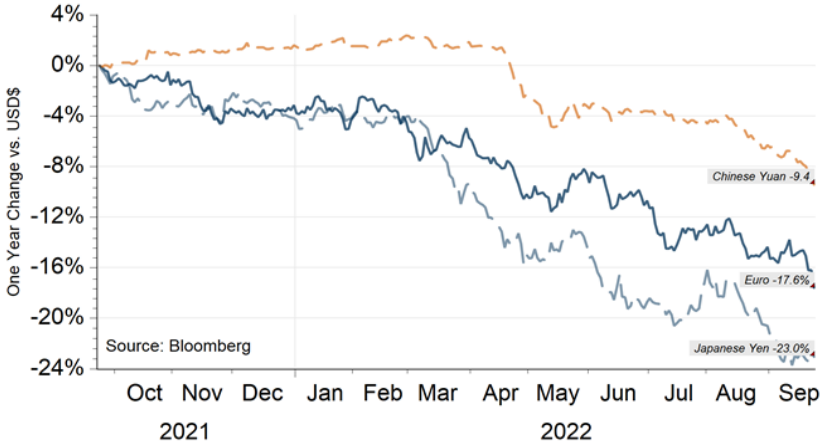


Graph 5

FOREIGN CURRENCIES DROP VS. DOLLAR

Outside the United States, a strong dollar is pressuring currencies, with major currencies down 10-20%. The strong dollar is helping to mask inflation pressures here (we estimate inflation would be up over 10% if the dollar was flat this year) but creates risk elsewhere. Currency volatility, elevated debt levels in emerging markets, and higher inflation are all troublesome to the global outlook.

Foreign Currencies Drop vs. Dollar

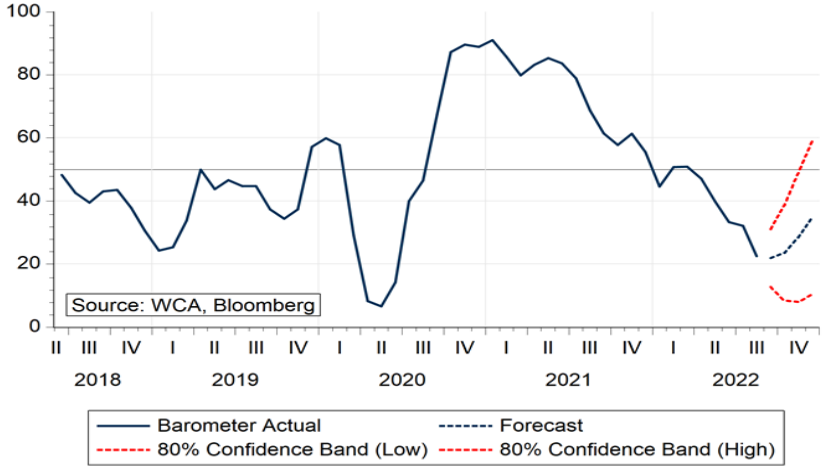


Graph 6

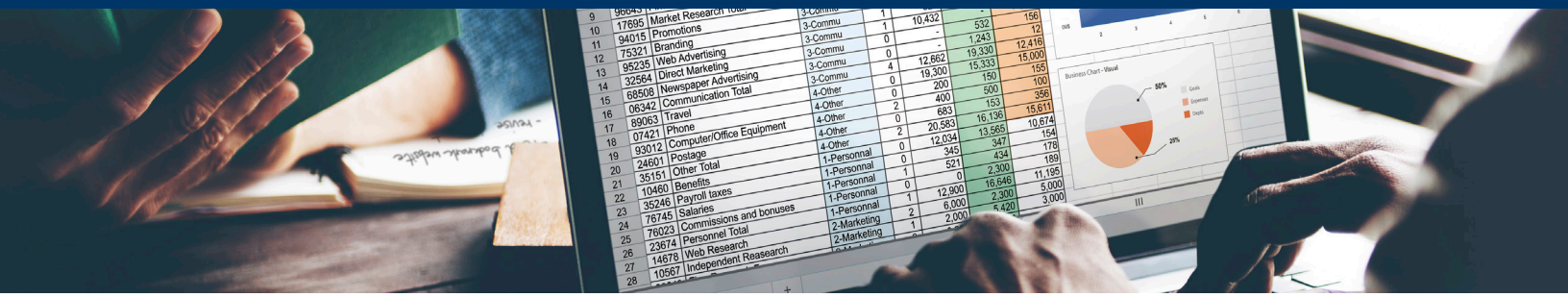
WCA FUNDAMENTAL CONDITIONS "BAROMETER"

Our WCA Barometer continues to exhibit weakness. The composite picture from this is that the near-term outlook shows weakening growth. While this may eventually lead to a reversal in Fed policy, it has not done so yet.

WCA Fundamental Conditions "Barometer"



CONCLUSION



While valuations for stocks and bonds are better now, we may not yet be out of the woods and should maintain a quality focus for two main reasons. First, data trends are still poor. But most importantly, history shows that it seldom pays to "Fight the Fed." So, as Chair Powell looks to take away the "punchbowl" to fight inflation, we should be patient and stick to our knitting.

And suppose the Fed should suddenly decide to do an about-face on tightening?

In that case, we see no reason why higher quality stocks would not also participate in a recovering environment. So why would we not seek out the most predictable, profitable, and resilient companies we can as we ride out the storm?

We intend to do just this as policymakers look to handle today's inflation problem.

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S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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