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KEY POINTS

- Stocks and bonds worldwide posted negative returns in the third quarter, continuing their year-to-date decline. Looking ahead, we discuss why a stock market recovery could start soon and why bond markets are likely to stabilize.
- Global economic growth is slowing as central banks worldwide prioritize the fight against inflation and increasing interest rates at a pace not seen in decades. However, we highlight reasons why a potential recession would likely be mild and short-lived.
- It continues to be a challenging year for investors, even those with diversified portfolios. Amid difficult market conditions, we discuss two critical considerations for long-term investors.
- Investors need to be somewhat cautious in this environment. In our view, this means taking a defensive approach by being highly diversified and investing in high-quality assets. We discuss ways to do this and a common investment strategy to make market downturns work for you in the long run.

MARKET REVIEW

STOCKS RALLIED AT FIRST BUT THEN DECLINED IN THE THIRD QUARTER AMID PERSISTENTLY HIGH INFLATION

The stock market rally that started in mid-June continued until mid-August, with the global stock market up more than 13%.[2] Corporate earnings reports released throughout July and August showed many companies did better than expected in the second quarter despite rising inflation and supply-chain issues. Then in August, Federal Reserve Chairman Jerome Powell adopted a sterner tone in describing the central bank's determination to fight persistently high inflation. This more "hawkish" Fed stance and increased recession fears weighed on investors and started a stock sell-off that continued to the end of the quarter.

SIMILARLY, BONDS STARTED THE QUARTER UP BUT REVERSED COURSE AS THE OUTLOOK FOR INTEREST RATES SHIFTED HIGHER ONCE AGAIN

Bond prices broadly appreciated in July as concerns about future economic growth lowered longer-term bond yields. (Bond yields are inversely related to bond prices.) Slower growth concerns resulted in bond markets pricing in the possibility of the Fed *cutting* interest rates as soon as next year. However, midway through the quarter, amid a still strong economy and broadening inflation pressures, the Fed had to adjust its forward guidance to emphasize a "high-interest rates for longer" approach. The Fed also raised the ending target range for its policy rate to 4.25-to-4.5% by the end of the year, and 4.5-to-4.75% by early 2023. The surprise upward shift in interest rate expectations resulted in bond markets broadly finishing the quarter down.

STOCK & BOND MARKET RETURNS

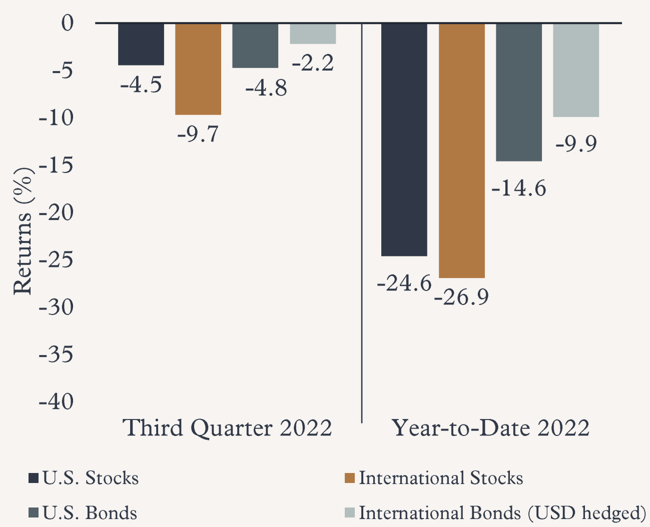

FIGURE 1. What at first looked like a turnaround quarter for the markets took a turn for the worse. Stocks and bonds worldwide finished with negative returns in the third quarter. Sentiment has soured because inflation has been much stickier than most had expected. Sustained inflation has forced global central bank plans to raise interest rates more (and quicker) than expected, which has caused all major asset classes to reprice downward this year.

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG. DATA AS OF 09/30/2022. SEE ENDNOTE 1 FOR ADDITIONAL DISCLOSURES.

MARKET OUTLOOK

STOCK MARKET VOLATILITY IS LIKELY TO REMAIN BUT A RECOVERY COULD START SOON

In the near-term, stock markets will likely remain volatile amid the current state of uncertainty. Volatility means there is potential for strong rallies and sharp declines, like in the third quarter. Worse-than-expected changes in central bank monetary policy and corporate earnings guidance will likely drive downside volatility. On the other hand, signs of progress in fighting inflation and indications of a milder-than-expected economic slowdown will likely cause market rallies, eventually resulting in a full-fledged bull market recovery.

Although no one can accurately predict or pinpoint a market bottom, considering how much stock markets have already declined amid extremely low investor sentiment, we think it's safe to say that we're close to one. Bear markets like the one we're currently in, caused by central banks raising interest rates to cool the economy and inflation, have historically averaged around 30% declines from peak to trough; the global stock market has already declined nearly 26% this year.[3] Moreover, given that interest rate expectations have risen materially, markets have already factored in an economic slowdown and ensuing earnings declines. As such, stocks will soon begin a new bull market recovery at first signs that central banks are slowing the economy enough to meaningfully ease inflation.

BOND MARKETS ARE LIKELY TO STABLIZE AND HIGHER YIELDS WILL BOOST FUTURE BOND RETURNS

Despite material declines and what seems like a situation that is far from over, bond market losses are not likely to continue. Because the bond market has already discounted the Fed's aggressive shift in interest rate policy, including multiple (more restrictive) changes to the policy, severe bond market volatility is likely to subside. Additionally, various inflation indicators and (more importantly) inflation *expectations* have been moderating since interest rates have (for several months now) already significantly increased. (See **Figure 2**.) As such, material interest rate (and inflation) surprises are likely behind us. The absence of these surprises will help stabilize bond markets.

Although bond prices are down materially so far this year, the result is that current bond yields are now significantly higher (the highest in over a decade), which will increase bond returns in the future. For example, the aggregate U.S. bond market is now yielding close to 5%, and the U.S. municipal bond market is now yielding close to 7% on a taxable-equivalent basis.[4] These higher yields will help recoup the temporary principal loss incurred by bonds amid the transition to higher rates. Higher yields will also ultimately shift bond returns materially higher than what they've been amid ultra-low interest rates over the past several years.

EXPECATIONS FOR INFLATION OVER THE NEXT 5 YEARS HAVE BEEN DECLINING

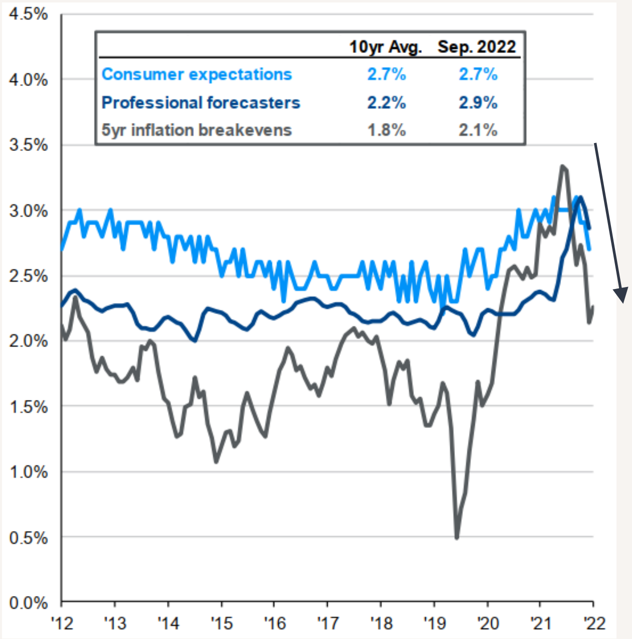

FIGURE 2. Declining inflation expectations means that the Fed may not need to surprise markets further. When inflation expectations rise, the Fed needs to surprise investors with more restrictive policy measures, which typically spurs market volatility. However, if inflation expectations decline (or remain contained), then the Fed can proceed with its plan of bringing down inflation gradually through a moderately restrictive policy.

SOURCES: FACTSET, FEDERAL RESERVE BANK OF PHILLADELPHIA, UNIVERSITY OF MICHIGAN, JPMORGAN. DATA AS OF 09/30/2022. SEE ENDNOTE 5 FOR ADDITIONAL DISCLOSURES.

ECONOMIC REVIEW

THE U.S. ECONOMY IS SLOWING BUT IS STILL RELATIVELY HEALTHY

The U.S. is weathering high inflation, slowing economic output, and the impact of the Ukraine war better than some other parts of the world. In the U.S., consumer spending and job growth remain relatively strong, which has allowed the Fed to raise interest rates more aggressively. However, the Fed's more aggressive rate hiking has started to impact business activity. For example, because mortgage rates have soared, the housing market —a substantial component of the U.S. economy and often a leading indicator of broader economic weakness— has softened materially. (See **Figure 3**.)

RISING MORTGAGE RATES HAVE LED TO DECLINING HOME SALES

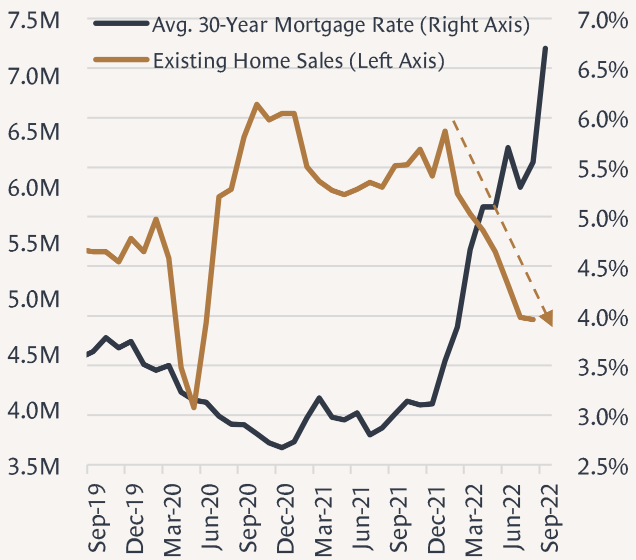

FIGURE 3. Mortgage rates are at their highest levels since 2006. Rising borrowing costs have weighed on demand for homes. As such, sales of existing homes have declined for six straight months amid lower homeownership affordability.

SOURCE: YCHARTS, FREDDIE MAC, NATIONAL ASSOCIATION OF REALTORS. EXISTING HOME SALES DATA ARE SEASONALLY ADJUSTED ANNUALIZED RATES AS OF 08/31/2022. MORTGAGE RATE DATA AS OF 09/30/2022.

INTERNATIONAL ECONOMIES BROADLY HAVE CONTINUED EXPERIENCING SLOWING GROWTH

Central banks around the globe are also prioritizing the fight against inflation, increasing interest rates at a pace not seen in decades. The result is a weakening in economic activity across many regions.

Amid surging prices, declining currencies, and disruptions from Russia's attack on Ukraine, Europe is facing (arguably) the biggest challenges at this time. As a result, consumer confidence in Europe remains depressed, and business activity has declined sharply. (See **Figure 4**.) The good news is that European governments have stepped in to help protect consumers and companies by subsidizing or capping the rising energy costs. Additionally, European countries are coordinating to find alternative gas sources to alleviate energy supply issues heading into the winter.

RECENT ECONOMIC DATA CONFIRMS THAT BUSINESS ACTIVITY IN EUROPE IS CONTRACTING

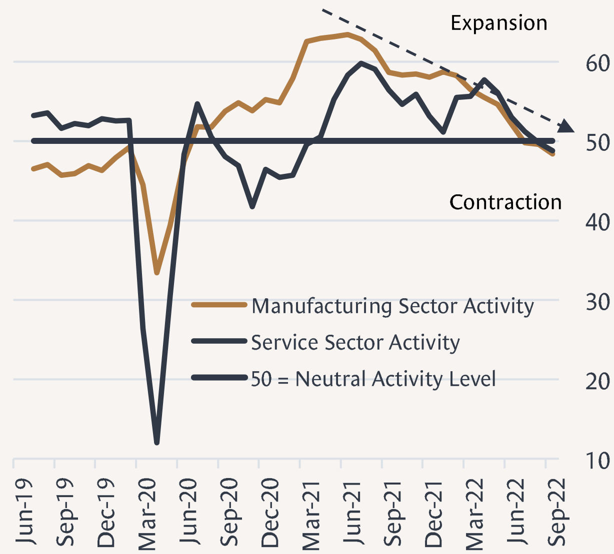

FIGURE 4. Manufacturing and service sector activity across the Eurozone is currently contracting, raising the risk of a recession there. Manufacturers were particularly hard hit by high energy costs after Russia's invasion of Ukraine materially sent up gas prices, while the services industry suffered as consumers have reined in spending amid high cost-of-living.

SOURCE: TRADING ECONOMICS, S&P GLOBAL ACTIVITY MEASURED BY PURCHASING MANAGERS INDEXES (PMI). DATA AS OF 09/30/2022.

Meanwhile, China's economic growth rate continued to be pulled down by its zero-COVID policy lockdowns and a slump in its real estate market. However, to shore up confidence and counter slowing economic growth, China announced major economic stimulus measures in the third quarter, focused mainly on infrastructure spending. Early indications are that these stimulus measures have helped moderate China's slowdown by offsetting weak consumer spending and declining home prices.

Emerging markets broadly (outside of China) continued to face headwinds from U.S. dollar strength, widespread central bank tightening, and the simultaneous slowing of growth in the United States, Europe, and China.

ECONOMIC OUTLOOK

THE U.S. ECONOMY WILL LIKELY CONTINUE MODERATING GRADUALLY

Business activity in the U.S. will likely continue slowing at a steady pace, consistent with Fed’s goal to help cool down broadening inflation pressures without creating a severe recession. Moreover, although the Fed has been aggressive with interest rate hikes this year, short-term borrowing costs are currently not at a restrictive enough level to outright stop (or postpone) most business and consumer purchases and investments. With that said, given the usual several-month lag, the braking impact of higher interest rates will likely continue spreading across more industries (outside of housing) and broadly lower labor demand, decelerate wage growth, and temper consumer spending.

LEADING ECONOMIES ABROAD WILL CONTINUE EXPERIENCING DECELERATING GROWTH

The environment in Europe is likely to remain challenging and volatile in the near term as higher energy prices impact the economy amid central bank actions to contain inflation. Europe is at a higher risk of heading into a recession sooner than the rest of the world, given the war's closer proximity and more direct impact. However, relatively low unemployment across Europe and government fiscal policies to counter the current geopolitical challenge should help moderate the recession's impact.

Although China set this year's economic growth target at about 5.5%, the lowest in three decades, a weak property sector, headwinds from local COVID-19 outbreaks, and declining export orders suggest growth will be lower, likely around 3%. China's current government leadership transition is set to be completed in March of next year. At that point, China should be in a better position regarding vaccination of the elderly and treatment stockpiles. However, delays in these efforts remain possible, which could prolong the commitment to zero-COVID policy and potentially delay an economic recovery

A RECESSION WOULD LIKELY BE MILD

Despite all the negative news and sentiment out there today, there are a few key reasons to be optimistic that a recession in the U.S. would not be a severe one.

Labor markets are healthy, given the current robust demand for labor. Moreover, should we enter a recession, companies may not be as willing to lay off as many workers this time around compared to past recessions.

Private sector (i.e., households) finances are pretty strong in most economies, particularly in the U.S. Household savings are still relatively high, and debt levels as a percentage of disposable income have remained relatively modest.

Banks have healthy balance sheets because of the regulation that followed the Global Financial Crisis. As a result, banks are not over-levered, carrying bad assets, or taking excessive risks.

Corporations broadly have healthy balance sheets. Corporations have strong interest coverage ratios (ability to pay their debts), ample cash, and still relatively high profit margins despite inflation cost increases.

For these reasons, a potential U.S. recession would likely be mild and short-lived.

ON THE MINDS OF INVESTORS

AMID DIFFICULT MARKET CONDITIONS – TWO CRITICAL CONSIDERATIONS FOR LONG-TERM INVESTORS

It's been a challenging year for investors, even those with diversified portfolios. Unlike most prior stock market selloffs, price markdowns have also affected lower-risk defensive asset classes like high-quality bonds. As disappointing and frustrating as it may be to see losses across an entire portfolio this year, investors need to keep a long-term perspective rather than make short-term investment decisions based on current market conditions.

HAVE A FINANCIAL PLAN TO GUIDE THE INVESTMENT PORTFOLIO

One of the fundamental investment principles of our investment approach is developing portfolio asset allocations informed by personalized financial planning. This means that one's strategic allocation to riskier growth assets (like stocks) and lower-risk defensive assets (like high-quality bonds) is determined based on a decades-long financial plan.

The financial plans we create for clients consider very conservative estimates of expected market returns, inflation, future income, expenses, and life expectancy. In addition, our financial plans incorporate Monte Carlo simulations that factor in various outcomes, including worst-case market scenarios. Taken together, we use these conservative estimates and Monte Carlo simulations to model relatively high success thresholds to ensure that one's financial plan will not be derailed by a broad-based, extended period of poor market performance.

AVOID LETTING EMOTIONS DRIVE SHORT-TERM INVESTMENT DECISIONS

Still, we recognize that amid market volatility like we've experienced this year, emotions can easily crowd out long-term thinking.

However, it's important for investors not to let emotional responses to portfolio volatility and drawdowns distract them from their long-term financial objectives. Examples of emotional responses would be to reduce or eliminate risk from one's portfolio by changing its strategic asset allocation or selling investments to cash. Although these actions may potentially avoid some near-term volatility, the reality is that they introduce a much greater and more permanent risk into the portfolio. It is the risk of falling short of one's long-term financial objectives because of missing part (or all) of a market recovery.

In difficult market environments, seeing portfolio performance can be stressful, but the trade-off to temporary emotional discomfort is the greater likelihood of meeting long-term return objectives.

Ultimately, most investor objectives require a portfolio that is reasonably expected to earn a positive return net of inflation. This return requirement, coupled with often decades-long time horizons, necessitates strategically investing one's portfolio in some combination of growth and defensive assets.

The good news is that historically, balanced portfolios have had a high probability of delivering positive returns net of inflation, particularly over long time periods. (See **Figure 5**.) However, investors must stay invested to realize those results, particularly amid difficult periods. Those investors with formalized financial plans (still on track for success) are best positioned to do so.

BALANCED PORTFOLIOS HAVE HISTORICALLY HAD A HIGH PROBABILITY OF DELIVERING POSITIVE RETURNS NET OF INFLATION, PARTICULARLY OVER LONGER PERIODS

Probability that a 60/40 Portfolio Has Had a Positive Real Return				
1-year	3-year	5-year	10-year	20-year
71%	80%	86%	90%	100%

FIGURE 5. Historically since 1928, a 60/40 (stock/bond) balanced portfolio has not experienced a 20-year period with negative real returns.

SOURCE: VANGUARD. DATA FROM JANUARY 1928 THROUGH AUGUST 2022. SEE ENDNOTE 6 FOR ADDITIONAL DISCLOSURES.

PORTFOLIO MANAGEMENT

REMAIN DIVERSFIED

Investors need to be somewhat cautious in this environment. In our view, this means taking a defensive approach by being highly diversified and investing in high-quality assets. In other words, avoid speculative areas of the market that tend to decline the most amid recessions.

Within both stocks and bonds, we recommend investing broadly across sectors to avoid being overly concentrated in areas particularly vulnerable to rising interest rates.

We also recommend tilting stock allocations toward more profitable and less expensive stocks, which should continue providing better relative performance as interest rates climb higher.

Lastly, we recommend keeping bond allocations invested in high-quality, intermediate-term bonds. These types of bonds now pay much higher yields and will resume providing portfolio protection, particularly if we enter a recession.

STAY INVESTED

Investors should stay disciplined amid market volatility. We highly recommend staying invested, given the potential for substantial (and fast) stock market rallies. Moreover, expectations of what the Fed will likely do with interest rate policy over the next couple of years are mostly priced into stock and bond markets, much more now.

While bear marks are undoubtedly painful, enduring them is critical for better long-term returns. In environments like this, it's essential for long-term investors to be diversified across high-quality assets and to stick to their strategic investment plan.

LEVERAGE THE POWER OF DOLLAR COST AVERAGING

For investors with excess cash (not needed for the foreseeable future), we recommend investing a pre-determined dollar amount on a regular basis to take advantage of currently discounted values for both stocks and bonds. By "dollar cost averaging", a common investment strategy, long-term investors can make market downturns work for them in the long run. We recommend continuing contributions when the market is down (both stock and bond markets) to purchase more shares and bond issues at a lower cost.

Capital markets are providing a great opportunity to buy high-quality companies and bonds at significant discounts – we recommend long-term investors take advantage of it while they can

KEEP PERSPECTIVE

We are going through a cyclical slowdown after years of positive economic growth, and above-trend growth more recently. For years prior to 2022, we've also experienced strong (above average) market returns.

The economy is slowing, but it will not crash. Inflation will remain elevated for some time, but it will come down. Rates have moved up dramatically (from zero) but are not likely to move much higher from here. Stock markets are volatile but currently present tremendous opportunities for long-term investors to get in at much better valuations.

News headlines and investor sentiment today is extremely negative and bearish. Stock and bond markets are in oversold conditions. For long-term investors, this presents an opportunity add to their portfolios despite it not feeling good now. Markets will recover and investment discipline will be rewarded.

REVISIT THE FINANCIAL PLAN

We continue actively analyzing client investment plans as part of our normal ongoing financial planning process. One of the main outcomes of this process is to determine whether one's portfolio asset allocation is still appropriate. Although it is rare that short-term market movements alone result in a needed strategic asset allocation change, there are occasions when aspects of one's financial objective and situation shifts. If you have recently had a material change to your financial objective or situation, please reach out to us.

SOURCES & ENDNOTES

[1] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Bloomberg Aggregate Bond Index. International bond returns are represented by the Bloomberg Global Aggregate Ex USA Hedged Index.

[2] Global stocks represented by the MSCI All-Country-World Investible Market Index NR USD, appreciated 13.34% from 06/17/2022 to 08/16/2022.

[3] Source: Goldman Sachs Asset Management. Global stocks represented by the MSCI All-Country-World Investible Market Index NR USD, declined 25.82% from 01/03/2022 to 09/30/2022.

[4] Source: Bloomberg, using yield-to-worst data as of 09/30/2022. The aggregate U.S. bond market is represented by the Bloomberg U.S. Aggregate Index and was yielding 4.75% as of 09/30/2022. The US. municipal bond market is represented by the Bloomberg Municipal Bond Index and was yielding 4.04% (6.82% tax-equivalent yield) as of 09/30/2022. The municipal tax-equivalent yield is calculated using a 40.8% tax bracket, which includes a 37.0% top federal marginal income tax rate and a 3.8% Net Investment Income Tax to fund Medicare.

[5] Professional forecasters reflects the latest quarterly Survey of Professional Forecasters on a 1-month lag. The Survey of Professional Forecasts is conducted by the Federal Reserve Bank of Philadelphia and reflects the median estimate by professional forecasters of average CPI inflation over the next 5 years.

[6] Periods analyzed are rolling monthly periods from January 1928 through August 2022. 60% stocks represented by the S&P 90 Index from 1928 through 1956; S&P 500 Index from 1957 through 1970; Wilshire 5000 from 1971 through April 22, 2005; MSCI US Broad Market Index through June 2, 2013; CRSP US Total Market Index thereafter. 40% bonds are represented by the IA SBBI U.S. Intermediate-Term Government Bond Index through 1972; Bloomberg U.S. Government/Credit Intermediate-Term Index from 1973 through 1975; Bloomberg U.S. Aggregate Bond Index thereafter.

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

IMPORTANT DISCLOSURE INFORMATION

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by Capstone Financial Advisors, Inc. ("Capstone") will be profitable. Definitions of any indices listed herein are available upon request. Please contact Capstone if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. This article is not a substitute for personalized advice from Capstone and nothing contained in this presentation is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Investment decisions should always be based on the investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. This article is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed by other businesses and activities of Capstone. Descriptions of Capstone's process and strategies are based on general practice, and we may make exceptions in specific cases. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request.

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