Monthly Commentary

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Navigating

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GPS (Global Positioning Systems) offers us so much information about our surroundings and position in our world. On a recent vacation, we used the Navigate button in our Tesla to direct us efficiently to charging stations to help us reach our goal, home. The system calculated, like an aeronautical map used in aviation, our route with points of interest, neighborhoods, and terrain. It took a few moments as it planned our route to avoid heavy traffic, road construction, and other hazards attempting to ensure the car would have ample charge to reach the next point – charging stations and ultimately home. As we set off, the little red chevron that represented our car began following the planned route inching from right to left across our screen traveling west, north-west. The map was laid out in the standard position with North locked at the top. Our little chevron traversed across the fixed screen. I'm not fond of that traveling presentation. So, I pressed an icon on the top of the screen and suddenly our little chevron was fixed in the center pointing up (forward) as the map turned and moved under it! [Being simple minded, I prefer the chevron pointing the same direction as the car is traveling.] Which way was north, south, east west? Did I care? Cities, roads, and the world revolved around *me*! My real concern was that we were generally traveling west, north-west toward our goal, home.

How interesting to see two different perspectives of our lives and future. One that recognizes that we need to navigate through a world that exists outside ourselves and another that believes the world revolves around us and our needs. The second perspective seems to be that things happen to us and what comes at us is out of control. The first more global perspective says we can make choices based on what exists and, perhaps with a little guidance, navigate our future.

So too with investing and financial planning. The current backdrop seems out of control; swirling around in ways that can cause anyone to be dizzyingly confused about what direction they are actually headed. Yet, we must be reminded to keep on sticking to the game plan – continue to save; continue to invest (stay invested); continue to pursue our planning goals. That is being disciplined. We must continue to navigate within our world during confusing times. That's just part of life over the years.

Stock and bond market performance was BIG positive during July, the best month since 2020. The S&P500 gained +9.2% and the Bloomberg bond index advanced +2.4% (as bond market interest rates declined even as the Fed is continuing to raise short interest rates). July provided encouragement from a struggling first half of 2022. The advance reduced the YTD pullback to -12.6% after reaching bear territory with a -23% YTD loss on June 16. For those who closely monitor the market and in particular its different underlying components, the market presents a confusing story as it plays "tug of war" between old and new leaders. One day/week value-style beats growth; then it is growth beating value. It's large companies doing better than small; then it shifts around. This action occurs with foreign vs domestic, and in energy and commodities too. It's a dizzying "tug of war". In essence, the market is churning as big uncertainties remain. For July, portfolio returns were positive and encouraging; reducing the YTD pulldown.

Style	July	YTD
Small-Cap Stocks	+9.5%	-12.5%
S&P 500	*+9.2%*	*-12.6%*
Mid-Cap Stocks	+9.1%	-11.2%
Avg US Stock Fund	+9.0%	-12.7%
Large-Cap Stocks	+8.1%	-12.8%
Foreign Stocks	+4.5%	-15.7%
Bloomberg Bond Idx	+2.4%	-8.2%

Client Objectives (Stocks/Bonds)	July	YTD
20/80	+2.6%	-7.9%
35/65	+3.4%	-8.5%
50/50	+5.0%	-9.5%
65/35	+5.8%	-11.0%
80/20	+6.9%	-12.4%
95/5	+7.3%	-13.4%

There is a long route ahead to travel. When market damage occurs, repair work takes time. Recovery will likely not be quick like was the experience following the 1-month bear market that accompanied the early days of the Great Lockdown due to COVID. That's because it will take time to reverse the effects of massive fiscal and monetary stimulus that were instituted over the 20+ months from March 2020 thru '21. Recall, money supply (M2) grew in excess of +40% from all the government stimulus programs initiated during that time (huge, may be fastest rate in history); that growth of money supply was far more than needed to finance economic growth. [Money supply growth (velocity) influences the speed the economy grows.] Since the economy could not use all the money (M2), the excess M2 boosted financial assets with an exceptionally fast recovery of values. The ensuing powerful bull market (last) ran a short 22 months ("dying" on January 3, 2022 the last market closing high); on average they last 60 months). Recently M2 is growing at 2%. That's far slower than 2 years ago and not fast enough to finance economic growth at its historical 4% pace. The Fed is continuing

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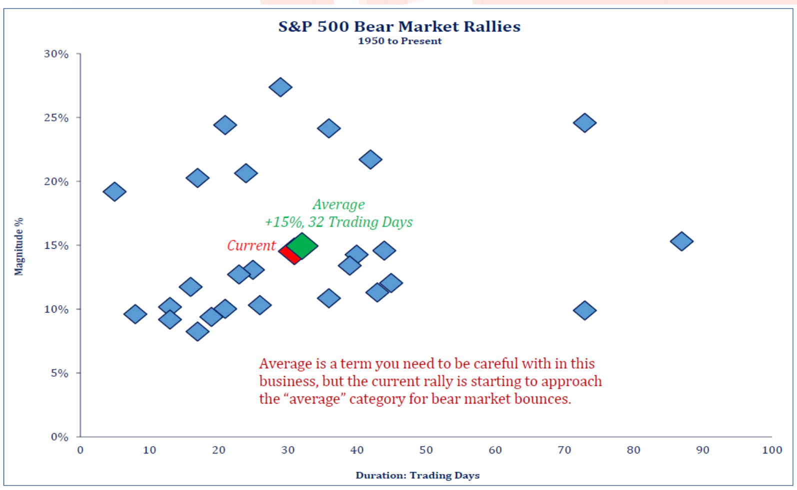
to raise interest rates to battle high inflation. They are acting quickly with aggressive rate increases to curb demand which still exceeds supply (broken supply chains are still recovering). When demand far exceeds supply, inflation results, and is a sign of policy mistakes. [The Fed can influence demand, but not act to change supply.] Raising rates change everything, but with a 6 month or so lag. Money policy is a slow government action where the effects are not known for a while. 2022 is proving to be the year of rates – inflation and interest rates.

Aggressive Fed policy tightening action will slow the economy. It will ultimately curb inflation – hopefully before it becomes too "sticky". Already the futures market suggests the 5-year inflation rate will return toward 3% (from 9%+ currently). The 5-year futures rate is a "prediction" five years away. Additionally, the Fed is yet to fully institute Quantitative Tightening (QT) which is the opposite of Quantitative Easing (QE, utilized for the past many years). During QE, the Fed was buying bonds from the public markets; meaning they were putting money (M2) into the system. QE and low or zero interest rates were "rocket fuel" for the financial markets. Now, QT will act in the opposite way, selling bonds and taking M2 from the system. Thus higher interest rates (making financing more expensive) + QT will continue to shrink the growth-rate of M2. Both will slow inflation, alter demand and slow economic growth; they also create a headwind for asset prices.

It is important to understand that peak inflation is a process; not a single point in time. Simply: peak inflation (the process) = "yes" it is occurring, but mission accomplished = "no" as many components of inflation remain elevated and sticky. Further tightening (raise rates and QT) is necessary. Tightening cycles typically end when Fed short rates are above CPI (inflation). Currently, interest rates remain below CPI. Another way to observe progress is monitoring (watching) the bond market yield curve. It predicts rates at future times, and can suggest clues about economic growth. [The yield curve plots interest rates of 1, 2, 3,...10, 20, and 30 year bonds; longer maturities typically provide higher yield than shorter maturities.] At present, the 2-year Treasury yields higher a interest rate than the 10-year Treasury by about 38 basis points (longer maturities normally provide higher rates than short). Thus, the curve looks inverted - yields are higher for the 2-year than 10-year. That's not normal and often signifies an economic pause (or recession) in the future. Fed action of raising rates is imperative to fight sticky inflation, but is also raising the risk of an economic recession. Because of inflation, the Fed is unlikely to be able to provide financial market support (be a backstop) should economic trouble arise while it is fighting inflation. Thus, the US and global economy is likely to experience a period of below-trend (slow) growth.



While July market performance was encouraging, we suspect it was most likely a "dead cat bounce." It was more likely a short counter-trend rally within the current bear market. History shows there can be many "dead cat bounces" during a bear market. The average of these advances is +15% over about 32 trading days. The recent July rally is approaching that average. Often, some counter-trend rallies will tempt investors to believe "travel is clear of near-term hazards." In the spring of 2001, during the early part of a 3-year bear market, a +22% rally occurred; it was tempting to believe that the "coast was clear." Not! More time remained before the bear market ended.

The market <u>bottoming process usually takes time</u> and more may be needed here. That's impossible to guess. As noted above, it's because M2 growth will be soft, and interest rates will remain high to curb inflation, could take a few years for inflation to return to historical 3% levels. Markets often find some recovery approaching mid-term elections. Investor sentiment may stay edgy from Russia/Ukraine, and China's rolling virus lockdowns hindering supply-chain recovery; and other geopolitical concerns; each seem at odds with normal economic growth prospects. Thus, the "all clear" signal does not appear yet. Not to be sounding "all" bear; know that the market never waits for the "all clear" to begin its recovery.

Whether action over recent weeks is the beginning of a durable recovery or just a "dead cat bounce," the chevron will keep traversing the financial landscape. Your financial path requires you to keep on keeping on. Keep doing what you were doing before the current "rainy" day. Know that sunshine will reappear. A key idea is that *no one knows how long any bear market will last; one of these powerful bounces will prove to be the start of the next bull market.* If you are not invested when that rally begins, you <u>will</u> miss the one that propels the market and your portfolio to new highs. That means, investing late will provide less than exciting returns and lower growth of portfolio values. It's like arriving to the party late – staying too long and arriving at the next party late; always missing out. The financial markets (stocks and bonds) lead the economy by 6 to 9 months. We continue to invest client portfolios for a slow growth economic environment resulting from higher interest rates. That advocates owning shorter duration assets – short maturity higher quality bonds + dividend paying stocks where valuations are better; "sprinkled" with energy and commodity exposure providing an inflationary hedge.

Thank you for asking Nvest Wealth Strategies to navigate your investment portfolios through the current up/down, gyrating financial market landscape; and for asking us to help you navigate your "financial peace of mind" with LIVING LIFE financial planning. Navigating through the changing world is critical to reaching your goals.

PS: It's fun to receive feedback from those reading these commentaries; that's encouraging. Fun too that some will share a story topic for an upcoming commentary (like surfing; or Dear future; I'm <u>(Ready)</u>?). Thanks for reading and sharing your thoughts!