Stapp Financial Investment Letter

Stapp Wealth Management, PLLC **Third Quarter 2022**

"For those properly prepared, the bear market is not only a calamity but an opportunity."
– Sir John Templeton

Market Recap

Among the many significant events that are driving financial markets this year, we believe the two biggest drivers of returns at this time are (1) the inflation we are all experiencing, and (2) the policy response to this inflation. The June inflation number came in at 9.1% - the highest inflation number we have seen in over 40 years. The numbers that came out in the July and August reports were lower, but they are still elevated above anything we have seen in the recent past. In response, the Federal Reserve has made it their top priority to bring inflation down. Since the Great Financial Crisis (GFC), the Federal Reserve has implemented monetary policy that is highly interventionist, disrupting the organic flow of markets. This means that anything they do has a larger impact on markets now than it did pre-GFC. Over the last decade, their policy has been extremely accommodative, which supported markets, but now they have reversed this stance, embarking on the fastest tightening cycle in history. This reversal in policy along with other factors, such as the geopolitical instability, has resulted in poor performance across investment markets this year.

Stock performance started the quarter off positive, but unfortunately reversed with most stock indexes finishing the quarter at new lows for the year, firmly in bear market territory. Bond performance has been the biggest surprise of the year. The most widely used index for bonds is the US aggregate bond index, or better known as the "the Agg." The Agg was originated in 1977, and prior to this year, the worst year it had seen was 1994, where it saw losses of 2.9%. The performance so far this year has far surpassed that, with losses of 14.6%. The founder of AQR Capital Management, Cliff Asness, has said in the past about managing risk – "One rule of thumb is double the worst that you have ever seen." Well, so far this year bonds have seen 5x the worst that has ever been seen. This performance threw every investor and risk manager off-sides, culminating in the largest wealth destruction in history. There have been few places to hide this year, but fortunately there are alternatives that have been able to post positive returns. Managed futures strategies have been far and away the best performers this year, returning just over 35%. This has provided a ballast to portfolios that utilize them.

Asset Class Performance

	3rd Quarter	Year-to-date
Investment Grade Bonds	-4.8%	-14.6%
Floating Rate Loans	+1.3%	-4.2%
High Yield Bonds	-0.7%	-14.7%
US Large Cap Stocks	-4.9%	-25.3%
US Small Cap Stocks	-3.8%	-24.5%
Developed International Stocks	-9.5%	-28.0%
Emerging Market Stocks	-11.6%	-27.2%
Gold	-8.0%	-7.4%
Managed Futures	+5.3%	+35.1%

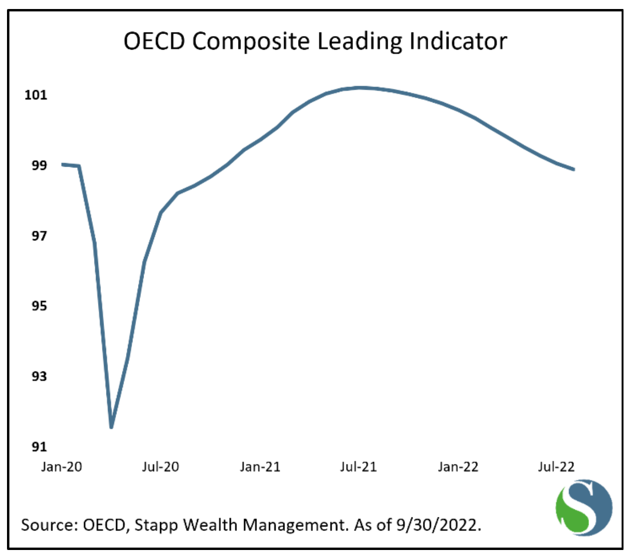
Data as of 9/30/2022. Source: Kwanti Analytics, S&P Global.[1]

[1]Indexes used: Barclays US Aggregate Bond Index, Morningstar LSTA US Leveraged Loan 100 Index, Barclays US Corp High Yield, Morningstar US Large Cap TR, Morningstar US Small Cap TR, Morningstar Developed Markets ex-US, MSCI Emerging Markets Index TR, Gold represented by the change in the gold spot price, Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.

Investment Outlook and Portfolio Positioning

Perhaps the largest driver of investment returns during a mid-long-term period is the economic and market regime that is occurring at the time. In the previous decade, we were in a regime of steady growth, low inflation, and accommodative monetary policy. What we are experiencing now is more consistent with lower growth, higher inflation, and more restrictive monetary policy – the reverse of the last decade. Examining inflation, it is likely that we will see inflationary pressures in the more discretionary style purchases abate as demand begins to decline, but the inflationary pressures in the staples we all need to function in our lives do not appear set to decline any time soon. This dynamic can be illustrated by recent commentary from corporate executives. Vicki Hollub, The CEO of Occidental Petroleum, warned, "The world risks living with oil shortages for a while...the lack of supply will continue to manifest itself as China starts to open up from Covid." Dirk Van De Put, the CEO of Mondelez International, one of the world's largest food producers, stated, "Our input costs for next year are going to be up as much as they are up this year so which means we need to keep on pricing...there will be more price increases coming in food in my opinion." On the discretionary side they aren't being as direct, but Nike's CFO stated, "Because we have a portion of that inventory being seasonally out of relevance, we've decided to take that inventory and more aggressively liquidate it." Significant inventory increases have occurred across many other discretionary sector businesses. So, food and energy costs are expected to keep heading higher, but on the bright side, we'll likely start seeing some nice sales on gym clothes and tennis shoes!

These dynamics are very suggestive of a staglationary regime. Staglation is an environment that consists of high inflation, high unemployment, and low growth. It is a unique regime because typically inflation is associated with high growth and low unemployment, like what we saw coming out of the pandemic, but when growth begins to decline and unemployment begins to rise while inflation is still elevated, we get the anomaly of stagflation. As shown in the chart on the right, we have seen global growth slowing as global leading economic indicators have been declining since the latter half of 2021, but unemployment is close to an all-time low, at least in the US. However, if the Federal Reserve achieves its goal, unemployment will start to move higher. It is hard to imagine how exactly that process will work its way through the system as many businesses still have "We're Hiring" signs posted on their windows, but it is likely that many white-collar, middle management style jobs and jobs in cyclical industries will be the ones most at risk.



Considering the investment implications, investors should have an allocation to assets that can perform in a stagflationary environment. Historically, stagflation has only occurred 18% of the time, so we do not have a ton of data to rely on, but looking at the chart on the next page, we can see that data we do have suggests stocks, bonds, and real estate can perform quite poorly, while commodities and other assets linked to inflation can perform fairly well.

Global Asset Performance by Environment

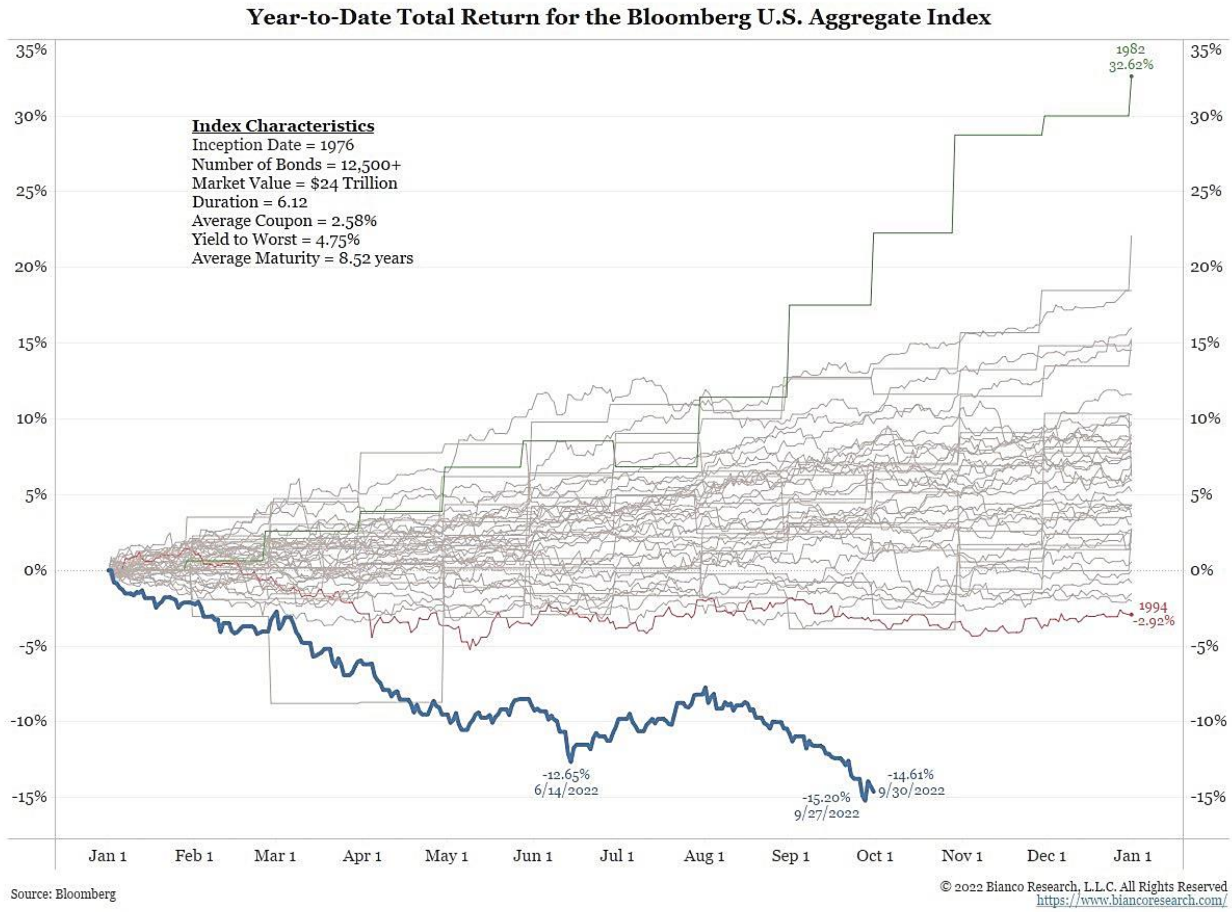
	Annualized Excess Returns*		
	Stagflation	**Other Periods**	**All Periods**
Frequency of Environment	18%	82%	100%
Assets			
Inflation-Linked Bonds	4.5%	2.2%	2.6%
Gold	17.6%	1.8%	4.5%
Broad Commodities	10.5%	2.4%	4.1%
Nominal Bonds	-1.2%	3.5%	2.5%
Corporate Spreads	-3.1%	1.8%	1.0%
Real Estate	-13.8%	11.8%	7.3%
Global 60/40 Portfolio	-6.6%	6.5%	4.1%
Equities	-10.2%	8.6%	5.1%

*Source: Bridgewater. *Excess returns are the returns above the cash interest rate.*

Putting this into context with what has already occurred this year, we have already seen large selloffs in stocks and bonds, so while what is suggested in the above chart doesn't make us optimistic, we are less pessimistic now than we were several months ago as we believe that much of the damage may have already been done.

As we look further out to 1-2 years from now, we believe there is a good possibility that there will be a shift from this inflationary/stagflationary environment to an environment of declining prices, otherwise known as deflation. This thinking stems from the delay that occurs between when tightening cycles begin and when the real economy feels the effects. When tightening cycles begin, the downstream effects are typically felt by the real economy roughly in the range of 1-2 years later. Should this outcome occur, it would likely continue to be a poor environment for stock investors, but a phenomenal environment for bond holders. As we have seen this year, bonds perform poorly in environments of rising inflation and inflation uncertainty, but they are traditionally one of the best performers in an environment of declining inflation or negative inflation. Of course, we will have to examine the developments that occur along the way, as different actions by the Federal Reserve or from actors on the fiscal side can easily alter any forecast.

Since this scenario is still a long ways away, a question to consider is – should investors continue to have large allocations to bonds in their portfolios? As mentioned previously, bonds have had their worst year in modern history by a magnitude of 5x, shown in the chart on the next page. This, of course, would make anyone weary to put money into bonds at this time. Our view is that bond fundamentals have changed enough from the beginning of the year to now to make them a much better place to hold your money. The first reason is that bond yields are now much higher, higher than they have been at any time in the last 10 years. The returns on bonds are closely correlated to their starting yields, so they now have the highest expected return they have had in a long time. The second reason ties into the possibility of deflation. If we do end up in a deflationary environment, bonds will likely become a major ballast for portfolios. This is what occurred in 1982, the year following the inflation spike that occurred at the tail end of the 1970s through 1981, when bonds rallied for a more than 32% return. There are still risks to bonds at this juncture, especially if inflation continues to accelerate higher, but we wouldn't advocate eliminating them from a portfolio based on their performance this year.



Given our outlook and the environment we find ourselves in, our portfolios are positioned defensively, structured with the following themes: (1) A large underweight to equities as we continue to view this environment as one of elevated risk with further downside risk to equities, (2) An emphasis on styles and sectors that typically perform well in stagflationary environments, (3) a small underweight to bonds, with exposure to bonds that are less interest rate sensitive than the aggregate bond index, and (4) a large overweight to alternatives that benefit from turbulence throughout global markets.

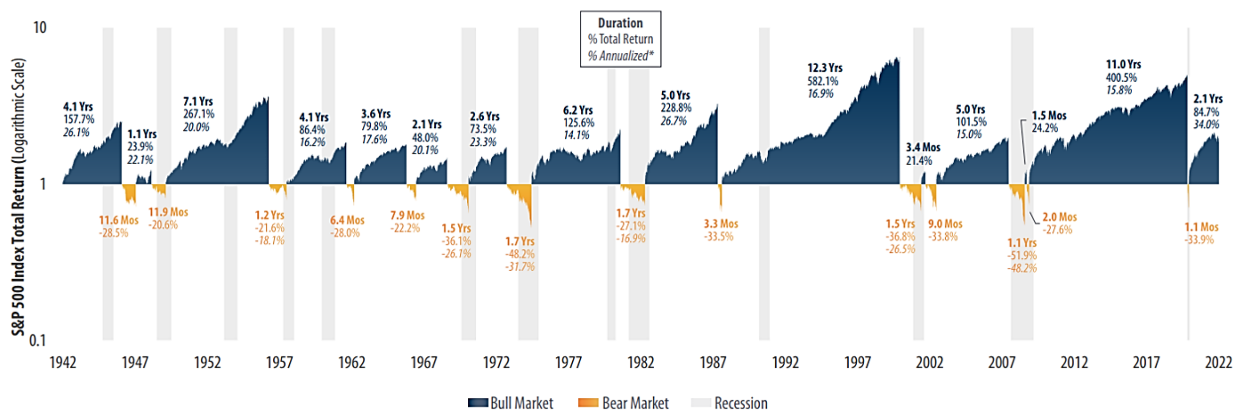
This is an environment that requires investors be nimble. Depending on the direction the economy and markets appear to be shifting, it is likely we will be making further portfolio adjustments as these shifts occur. We have several areas of the portfolios under examination already. We are reviewing reducing our exposure to Europe even further as the war has removed many advantages Europe had, we will be looking for an opportunity to add more exposure and more duration back to our bond allocation, and we are doing our due diligence on other alternative strategies that may add value to portfolios.

Closing Thoughts

They say happiness is the difference between expectations and reality. In an effort to promote the happiness of our clients, we want to give an idea of what we could expect in this bear market. If we were to look at averages, the average bear market lasts just over 11 months. Bear markets also have an average cumulative loss of 32.1%. This current bear market was considered to have started on June

13th when the S&P 500 fell 20% from its all-time high, and so far, the S&P 500 has experienced losses of 23.9%. If we were going by averages, then we could expect that we will continue to be in a bear market until June of next year and we could still see some further losses. This corroborates with other models we follow that suggest that we may begin to move into a more positive period in the economy by the second half of next year. Of course, anything can happen that could cause deeper losses for a longer period of time, or on the other side of the coin, lesser losses and a more rapid recovery. Since we can't know the future, we must account for both scenarios in our planning.

Fortunately, bull markets last much longer than bear markets. The last prolonged bear market last occurred in 2008, so it has been a long time since investors have experienced a real bear market. It is important to note that bear markets are a normal part of investing and on average we experience them about once every five years. Bear markets are often more memorable and are more testing times than bull markets, but if history is a guide, the last 100+ years of market history has been a better time for the optimists than for the pessimists.



Source: First Trust Advisors L.P., Bloomberg.

With this in consideration, what should investors be doing in times like these? Rather than telling you what we think, let's examine the actions of the world's most successful businessman and investor, Warren Buffett. Warren Buffett began his partnership in 1956, so he invested through the ups and downs of all kinds of market environments. From when he started his business to now, he has invested through 11 bear markets including the one we are in now. In bear markets almost every investor loses money. For the ones that don't lose money or even make money, they become famous and sometimes even movies get made about them. But, for the rest of the 99% that lose money in bear markets, and Warren Buffett is included in this crowd, it's natural to get an urge to panic and sell-out to save what you can, and some investors do that. Warren Buffett often lost money with everyone else during these times, but what set him apart is that he didn't succumb to his fear and sell-out. Instead, he viewed each bear market as an opportunity to buy attractively priced companies. This is in part how he was able to become so successful. He bought companies at bargain prices when no one else would. He realized early on that ultimately there are two possible outcomes in every bear market. Either markets recover eventually, or the world ends and the whole financial system collapses, and the problem with betting on the world ending is that if you bet on it ending and it does end, there won't be anyone to pay you your winnings. If we examine what Warren Buffett is doing now, we can see that he has not made any of his hallmark deals, but he has been making large purchases of shares of Occidental Petroleum. It would seem that Warren Buffett follows the stagflation outlook as well.

As mentioned previously, we have our portfolios positioned defensively, ready to take advantage of the opportunities that present themselves in these turbulent times. Depending on how this environment unfolds, we may have to exercise some patience, but we are ready to re-position the portfolios back to being more offensive when we get the opportunity. There are multiple catalysts that could signal this change in stance. A few possible catalysts that we would look for would be if the Federal Reserve pauses or pivots on their monetary tightening stance, if we get an upward inflection in the economic data, or if prices move lower to more attractive valuation levels. We aren't strictly committed to making a shift in the event that one of these scenarios occurs since there could be other developments working in the opposite direction, but any one of those scenarios occurring could be just enough to cause markets to reverse back into a bull market.

Until then, we must all exercise patience and keep ourselves focused on the longer-term outlook. If you have any questions, please do not hesitate to contact us. We appreciate the trust you place in us, and we are grateful for the opportunity to be the stewards of your capital.