



WALKER, HIGGINS & ASSOCIATES
WEALTH MANAGEMENT, LLC

Quarterly Market Review and Outlook

2022 Q3 Market Re-Cap

The challenges of the first six months of 2022 did not subside during the 3rd quarter. Although, there was a brief respite during July, inflation data remained high and growing fears of a Federal Reserve induced recession caused markets to retest their 2022 lows. At this point, it seems that market participants are viewing almost all data through a negative lens.

Through the 3rd Quarter, U.S. stocks are down between 17%-33% depending upon the index.ⁱⁱⁱ Obviously, that is a sizable range, which will discuss in a bit. International stocks performance is mostly in line with U.S. stocks.ⁱⁱⁱ

As we have continuously said, a significant problem is the fixed income market. Typically, bonds are held in portfolios to offer stability during stock market volatility and provide an income stream. Unfortunately, bond performance in 2022 will likely end as the worst in over a half century.

For context, the worst calendar year return for the U.S. bond market over the last 50+ years is about -3%.^{iv} So far in 2022, the U.S. bond market has lost over 14%.^v Said another way, 2022 is shaping up to be the worst calendar year for bonds in over 50 years by 5x! International bonds have fared only slightly better.^{vi}

2022 Q4 Outlook & Beyond

Stock & Bond Market Situation

Unless someone has been living under a rock, everyone sees the pain that has hit financial markets. We want to be honest in our assessment of the situation, but hopefully provide a bit of encouragement.

First, we think that the prospects of avoiding a recession are slim over the next year or so. By the traditional definition (i.e., two consecutive quarters of negative GDP), we are already in recession. However, the Atlanta Fed projects 3rd Quarter GDP to be around 2%^{vii} and companies continue to look to hire. Our sense is that we are not in recession now.

Second, if the U.S. does go through an actual recession that includes higher unemployment, increased default rates, lower corporate earnings/profit, decreased home values, etc., then it would be reasonable to expect more stock market pain. From a historical perspective, an average Bear stock market decline (i.e., at least a 20% drop from a recent high) is around 41% and lasts 20 months.^{viii} This would suggest that if the current Bear market follows a similar path, then U.S. stocks could fall more. Obviously, we don't have a crystal ball, so this is just looking at possibilities through a historical lens.

Third, it is very common for people to assume that the current, or next, recession will be very similar to the previous recession. At this stage, we would suggest that the landscape is different than pre-2008. Lending practices have been much stricter over the last 10-15 years than pre-2008. Also, so many people refinanced in 2020 and 2021 that interest rates servicing mortgages should be very supportive.

Additionally, while the primary inflation problem is due to the abundance of liquidity within the financial system, people and businesses have cash. It is our hope that these excess cash reserves will serve as a bit of a safety net if the economy turns much more difficult. Currently, the M2 money supply (i.e., most of the liquidity in the financial system) is at, or near an all-time high.^{ix} Again, why we have an inflation problem.

Finally, other asset classes that have not been viable options in many years are starting to look attractive. For instance,

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CD rates have risen to rates not seen in years. No, CDs still are not going to keep up with inflation but earning an annualized rate of 2%-4% isn't horrible. We have begun to add CDs to accounts, where appropriate, and plan to continue.

Recession Investment Management Strategy

First, we want to absolutely adhere to the client's unique investment objectives, financial goals and timeframe. As we have said time-and-again, if you have a tolerance for investment risk and/or have a timeframe of greater than 10 years, taking drastic action may not be prudent. It is also important to be clear that when we say a timeframe of greater than 10 years, we do not necessarily mean you have 10 years until retirement, for instance. On the contrary, while it would seem obvious that someone in their mid-50s may only have roughly 10 years until retirement, we would suggest that their timeframe is hopefully longer. Current life expectancy in the U.S. is around 76 years old.^x Ideally, getting to retirement is not the finish line. Rather it is prudent to design an investment strategy that provides an opportunity of income and growth throughout retirement.

Second, this does not mean that we don't do anything. As we have stated, generally we are holding higher levels of money market in accounts than we typically would. Higher money market levels have served as a stabilizing force that we traditionally expect from bonds. Additionally, money markets serve to support those that take systematic distributions. Finally, higher money markets offer flexibility should stocks and/or bonds reach a point of value. It is possible that money market levels could be increased should that appear appropriate.

Third, as we mentioned above, we have added and look to continue to add CDs to accounts, where appropriate. We would caution against going too far out on the maturity scale in a search for a slightly higher yield. It seems to us that the current sweet spot is in the 3-6 month range. Per Pershing, LLC's Fixed Income Center, we can find CDs in the 3-6 month range that yield 2-4%. By keeping the maturity short, we have the flexibility to consider reinvesting upon maturity if interest rates continue to rise. We anticipate the Federal Reserve to continue to raise interest rates in the months ahead.

Finally, we would caution against a complete selling of all stocks. While it may seem wise to do so, it often ends up being riskier. Unless this cycle is different than the previous cycles, there will be a recovery. Since 1950, in the 2 years following a 20% or greater decline, the S&P 500 is positive 70% of time with an average gain of 26%. Over 3 years, the S&P 500 is positive 89% of the time with an average gain of 29%.^{xi} Rather, we would suggest that holding different types of stocks may be wise. We have added and will look to continue to add, where appropriate, dividend-paying companies that are generally used regardless of economics. These types of stocks typically offer a greater degree of stability, income via dividends and necessity due to their business model or product offerings.

Politics and Economic Policy

As the mid-term elections are less than a month away, many will be paying close attention to tight races in the House and Senate. Currently, the Democrats have an 8-seat advantage in the House of Representatives and the Senate is tied. Vice President Harris serves as the tiebreaker in split votes in the Senate.

We will only focus on the potential economic impacts of the election and leave the social impacts to another forum.

As we stated above, a significant reason for the high levels of inflation is due to record liquidity within the financial system. If you look at the M2 graph over the last 10 years, you will notice a huge spike during and after COVID.^{xii} This directly relates to governmental payments of all kinds during and following COVID. In short, the primary reason for the highest inflation in 40 years is due to government spending during and after COVID. The necessity of this spending can be debated, but its impact should not be up for debate.

The relevance as we see it, is that we would expect higher governmental spending should Democrats control Congress and the White House versus a split Congress. To be clear, Republicans haven't exactly been penny-pinchers recently. However, they also haven't proposed a \$10 trillion dollar spending bill.^{xiii} In our opinion, higher government spending will not reduce the M2 money supply, nor will higher spending reduce inflation. Instead, it will make a bad situation worse.

On the other hand, a split Congress or a Republican controlled Congress with a Democrat controlled White House should

result in little to no NEW spending. Obviously, this says nothing to reducing the \$2.7+ trillion annual deficit or almost \$31 trillion in federal debt.^{xiv} Baby steps.

Real Clear Politics latest projections show Republicans with 52 seats in the Senate. They project Republicans to win 218 seats in the House (218 seats are needed for a majority in the House), Democrats to win 184 seats and 33 races too close to call.^{xv} Should these projections come close to actuality, then there would be gridlock in Washington, D.C. Thus, we would expect little to no significant economic legislation to be passed over the next two years.

Summary

These are frustrating times. We are in the same boats with our clients and friends. The last two years has seen a lot of unprecedented upheaval, controversy, spending and emotion. Most of which is counterproductive. We continue to encourage our clients that while the storms of today may seem like they will never end or things have never been this bad, we should hold onto hope that bad times typically don't last forever.

Some of our most trusted economists feel that markets are beginning to reach levels of value not seen in several years.

Bob Brinker: "Combined with our estimated price/earnings ratio range of 18 to 20 times forward earnings, we expect the S&P 500 Index to challenge its record high by the second-half of 2023."^{xvi}

Kiplinger: "After a brutal first half of the year, bonds are starting to look a bit better..."^{xvii}

Brian Wesbury: "If you're a very long-term investor who doesn't want to time the market...just maintain your normal allocations to stocks and don't be shy about continuing to buy stocks at your normal intervals."^{xviii}

J.P. Morgan: "Forward P/E 25-year average = 16.84. Current forward P/E = 15.15. Shiller's P/E 25-year average = 27.97. Current Shiller P/E = 27.15."^{xix} ***Lower P/E ratios generally represent greater value***.

Finally, we are not managing accounts based upon gut instinct, hairs on the back of our neck or the latest news cycle. We try to our absolute best to maintain and develop plans for our clients based upon reason and logic. We are confident that overtime reason, logic and prudence will be a winning strategy.

We are looking to be cautious and prudent, but open to opportunities. We encourage you to adopt a similar mindset.

As always, should you have questions or need to update us on your situation, please do not hesitate to contact us.

Thank you for your continued trust and confidence. We hope that you and your family have a blessed Fall and Holiday season!

ⁱ <https://www.morningstar.com/etfs/xnas/qqqm/performance>

ⁱⁱ <https://www.morningstar.com/etfs/arcx/iyy/performance>

ⁱⁱⁱ <https://www.morningstar.com/etfs/xnas/acwx/performance>

^{iv} https://www.bogleheads.org/wiki/Bloomberg_Barclays_US_Aggregate_Bond_Index#cite_note-11

^v <https://www.morningstar.com/etfs/arcx/agg/performance>

^{vi} <https://www.morningstar.com/etfs/bats/iagg/performance>

^{vii} <https://www.atlantafed.org/cqer/research/gdpnow.aspx>

^{viii} "Market Insights: Guide to the Markets®". J.P. Morgan Asset Management. U.S. 4Q 2022. September 30, 2022. Page 16.

^{ix} <https://fred.stlouisfed.org/series/M2SL>

^x https://www.cdc.gov/nchs/pressroom/nchs_press_releases/2022/20220831.htm

^{xi} Sozzi, Brian. "Don't try to be a hero: The stock market will eventually roar back, history shows". Yahoo Finance. September 29, 2022.

<https://finance.yahoo.com/news/stock-market-eventually-roaring-back-history-shows-180334088.html>

^{xiii} <https://fred.stlouisfed.org/series/M2SL>

^{xiii} https://www.huffpost.com/entry/infrastructure-bill-biden-administration-progressive-democrats_n_605e518ec5b6531eed04e2a6

^{xiv} <https://datalab.usaspending.gov/americas-finance-guide/>

^{xv} <https://www.realclearpolitics.com/epolls/2022/house/elections-map.html>

^{xvi} Brinker, Bob. "Bob Brinker's Marketimer". October 2022. Volume 37. Number 10.

^{xvii} "The Kiplinger Letter: Forecasts for Executives and Investors". August 18, 2022. Volume 99, Number 33.

^{xviii} Wesbury, Brian S. & Stein, Robert. "Monday Morning Outlook: More Trouble Ahead". First Trust. September 26, 2022.

^{xix} "Market Insights: Guide to the Markets®". J.P. Morgan Asset Management. U.S. 4Q 2022. September 30, 2022. Page 5.