SPW Q4 2022 Manager's Note

We are thinking about .... Inflation and Interest Rates

Headline

Hints that peaking inflation and falling commodity prices might offer stock market support were short lived in Q3, as the hawkish Federal Reserve made clear its interest rate increases would continue. Many of the world's central banks are already tightening their monetary policy, making this a global interest rate increase. Geopolitical tension in Ukraine and Russia, and escalating US trade tensions with China show no signs of easing. Global uncertainty has further strengthened the U.S dollar, impacting US export competitiveness.

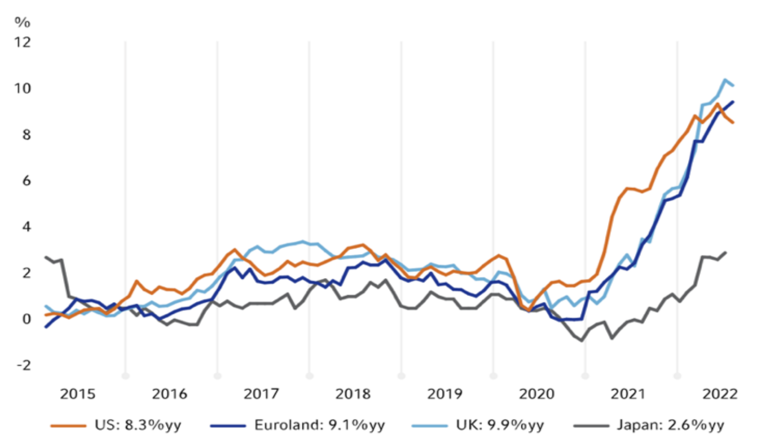
As we begin the Q3 earnings season, some parts of the economy have already contracted, but the strong US labor market continues to drive inflation expectations. We expect lower corporate earnings forecasts and a weaker 2023 first half outlook issued by many companies. Despite the already sharp Year to Date declines, significant risk in the equity markets remain as we start Q4.

Looking to Reduce Inflation: Balancing Supply and Demand

As noted above, the FED has pledged to fight inflation by increasing interest rates in an effort to better balance supply and demand. Rising interest rates affect stock prices for a variety of reasons, including:

- Investors switch to bonds, enticed by higher yields which may now be found.
- Owning stocks gives you a right to share in future company profits. But, if interest rates increase, the value of those future earnings is worth less. This is especially true of growth stocks where the company's profits are not paid out as dividends but reinvested.
- Company's cost to borrow increases, impacting its net revenues.
- Consumer spending may drop as consumers have less available capital due to increased debt costs and are at risk of losing their employment as companies cut overhead.
- Lower consumer spending, in turn, fuels a recession.

GLOBAL INFLATION RATES



In addition, when interest rates rise quickly, the impact can be destabilizing; corporate managers lose their ability to predict customer demand, cost of capital, and other key financial inputs; this can lead to defensive, reflexive, cost-cutting strategies which can ripple through the economy.

Graph Source: https://russellinvestments.com/us/global-market-outlook

Inflation and Interest Rates: No sign of Pause

Rising Rates: Bond Pricing as Interest Rates Start to Rise

Bonds traditionally offer the investor permanence and definition in the instruments' structure. That means you know how much regular coupon payment you should receive, and you know that when the bond matures you should get the full-face value of the bond, (assuming that it performs to the terms). As interest rates rise, the market value of the bond normally decreases. This unrealized "paper loss" is most relevant if the bond is sold before maturity. If the bond is held the full-face value of the bond should be recovered. This is an important point to be aware of when reviewing performance in any fixed income holding in your portfolio. We recommend investing in investment grade bonds and floating rate bonds, (that are structured to adjust periodically to the prevailing interest rate). An adviser cannot adequately advise a client without knowing the client's financial status. Though each investor's situation is unique, we often prefer investing in individual issues rather than a pooled fund of bonds, especially in a rising rate environment: this gives greater control and certitude as to the bond's cash flow. We have started to see some of the floating rate notes in clients' portfolios re-price closer to par value once the interest rate steps up.

Investing New Money

This comes down to risk tolerance. In some cases, clients see opportunity in this depressed market and are willing to look at cost averaging back into stocks, sectors or indexes that have seen deep declines. For such clients our general recommendation has been to remain cautious and look at averaging out over an extended time frame. For those with a more cautious approach we continue to allocate to short duration treasuries, non-exchange traded core Real Estate and to higher yield investment grade corporate bonds as interest rates have tracked upwards.

Rising Rates: Time to Review Cost of Funds

We have spoken with many clients about sales and purchase of real estate, home remodels, cars, or anything involving a loan. The sharp rise in rates has impacted buying power in many scenarios. If you have concerns about adjustable-rate financing or are looking to explore credit facilities, we can discuss strategies that could help.

End of Year Review

Tax planning is a focus for Q4. For those required to draw RMDs, we try to ensure distributions include balances across all retirement accounts. This year offers a unique opportunity to review unrealized capital gains and losses to permit meaningful portfolio restructuring with minimal tax consequences. The holiday season is also a time we see an uptick in money movements and wires which are always best to plan out ahead.

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