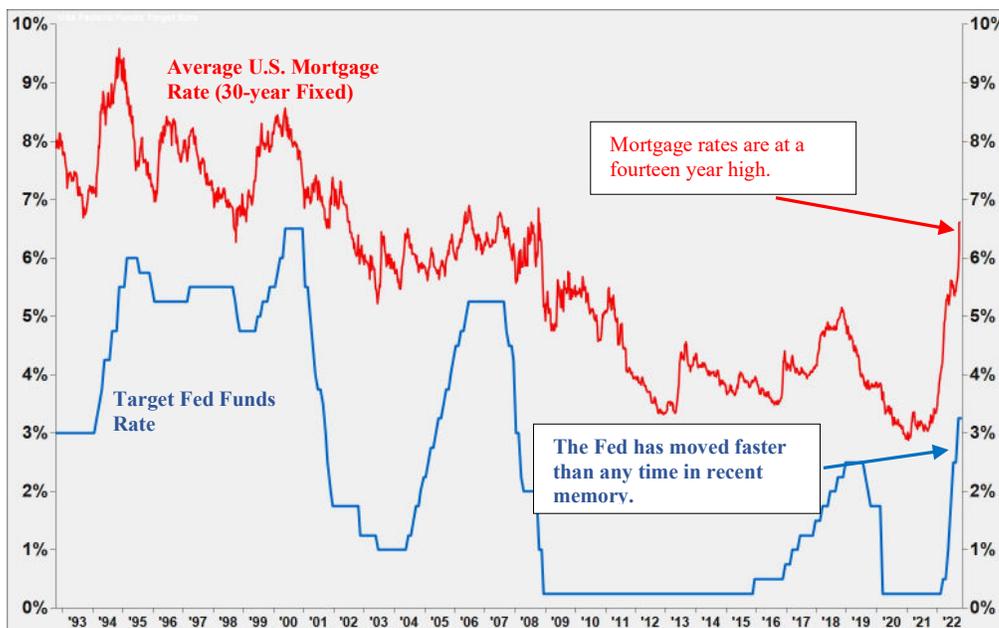




Fourth Quarter 2022 Outlook and Commentary

The U.S. Federal Reserve continued its aggressive interest rate hikes in the third quarter, and the consequences are reverberating across global capital markets. Seeking to stamp out inflation before it becomes deeply entrenched in the U.S. economy, the Fed has raised the so-called Fed Funds Rate by three percentage points in nine months, moving far faster than any time in recent memory. Mortgage rates, rates on business loans, and other key interest rates are also rising sharply, which is exactly what the Fed wants. Their objective is to dampen economic activity to the point that companies worry about demand for their products and hold prices in check.

The chart below illustrates the rapid increase in the Fed Funds Rate and its impact on mortgage rates. Home prices in many markets have already declined as potential buyers lose the ability to finance home

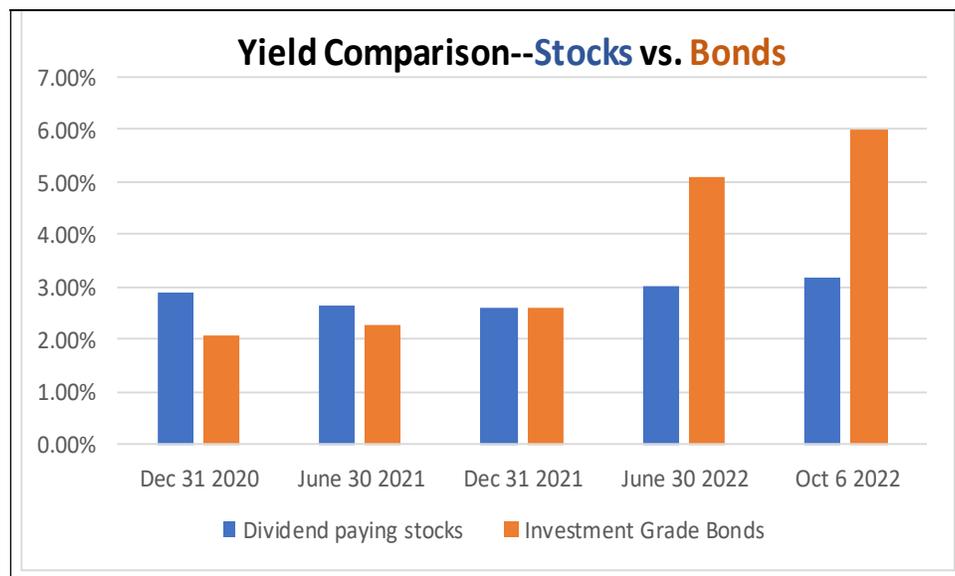


purchases. The Fed is committed to bringing inflation down and higher rates will eventually do the job. The question is how long it will take before the Fed deems inflation sufficiently under control to ease up on interest rate increases. Until that becomes a bit clearer, the impact of higher rates will continue to ripple across the global economy.

Ironically some of the biggest upheaval from rate hikes in the U.S. is taking place overseas. Before we get to that, let's start closer to home. While the Fed's monetary policy tools are powerful there is a significant lag--often estimated to be around nine months--before the effects of interest rate changes become apparent. The Fed's job is sometimes likened to driving with a gas pedal and brakes that operate on a thirty second delay. It's possible that the actions the Fed takes at its November and December meetings could have a bigger impact than anticipated and lead to a severe recession. That's not what

most economists expect, but the stock market doesn't like uncertainty and right now it's hard to know for sure what the economy will look like once the full effects of higher interest rates have taken hold.

Higher rates also chip away at the positive effects that low bond yields have had on stocks over the last ten years. During almost that entire time, large company dividend paying stocks yielded as much as or more than investment grade corporate bonds. With stocks offering significant long-term price appreciation on top of the dividend yield, they have been significantly more attractive than bonds. All of that changed dramatically over the last six months as illustrated below.



The proxy for dividend paying stocks is WisdomTree's flagship U.S. large company dividend paying stock fund (DLN). Investment grade bond yield is based on average effective yield for BBB bonds as reported by the St. Louis Federal Reserve.

Losing the tailwind of low bond yields has no doubt contributed to this year's stock market declines. Bond prices go down when bond yields go up, which is why the bond market is having its worst year ever. As of this writing the Bloomberg Aggregate Bond index is down an astonishing 14% on the year.

It's important to realize that although stock prices have declined significantly this year, the underlying value of U.S. publicly traded companies has not necessarily changed. Most of the largest components of the S&P 500--companies such as Apple, Microsoft, Amazon, United Health, Johnson & Johnson, and JP Morgan Chase--are very solid companies with strong balance sheets. If a recession comes later this year or next, their profits may temporarily decline, but they will recover quickly when economic growth picks up. When the technology stock bubble of the late 1990s burst, there were dozens of companies like Pets.com that had never figured out how to make money. Those companies didn't face a temporary rough patch; they disappeared entirely. When the housing bubble collapsed beginning in late 2007 large banks were decimated by huge loan losses. Companies serving the housing and mortgage markets had business lines that never fully recovered. There have been some recent excesses in financial markets, but relative to the technology stock and housing bubbles those excesses are very much on the fringes. Corporate balance sheets are in excellent shape, and, for better or for worse, companies have honed their ability to quickly react to declining business conditions through rapid workforce reductions.

The underlying strength of U.S. companies is the good news. The bad news is that it appears quite likely that a recession will begin within the next twelve months. One of the most important signals of an impending recession is an "inverted yield curve." Normally, an investor willing to tie up their money for a long time in a ten-year bond receives a higher interest rate than someone investing in a two-year bond.

That relationship gets reversed in a yield curve inversion. The yield curve has been steeply inverted for several months, sending a strong signal that a recession is likely to begin by the end of 2023. The biggest question is how deep the recession will be if and when it comes. There are reasons to think it will be relatively mild, like the recessions of the early 1990s and the early 2000s, but it's hard to be certain. Until the effects of higher interest rates come into sharper focus, the bear market may continue, with further declines possible.

The rapid interest rate increases in the U.S. are having dramatic ripple effects around the world as global investors are drawn to U.S. bonds by higher yields. That has triggered large flows from other currencies to the U.S. dollar, which is stronger relative to other currencies than any time in the last twenty years. Foreign stock investors have been hit hard with currency losses due to the stronger dollar. Currency losses have made a bad year for foreign stock investors even worse.



The strong dollar is particularly problematic for emerging market countries that have borrowed money in U.S. Dollars. With each dollar translating into, for example, more Indonesian Rupiahs, Indonesia's debt has grown. For a handful of countries that borrowed excessively, ballooning debt has put significantly more pressure on their currency, creating a vicious cycle.

As the bear market continues to grind on, it's important to keep several points in mind. First, recessions and bear markets are a normal part of investing. Over the last 100 years, there have been 22 bear markets, or one every four to five years. On average, bear markets last around nine months. It is notoriously hard to know when a bear market will end, but it usually comes at the point of maximum investor pessimism. Perhaps the most important thing to bear in mind is that **periods of below average returns in the stock market are typically followed by periods of above average returns**. Three months ago, we noted that five-year U.S. stock returns from the initial point of a twenty percent decline tend to be very attractive. From that initial twenty percent decline, S&P 500 annualized five-year returns have ranged from +1.6% per year to +26.0% per year and averaged +11.9% per year. From the bear market **bottom**, five-year returns have been even better, ranging from 6.5% per year to 31.8% per year and averaging 16.1% per year. You may want to highlight the previous sentence and refer to it from time to time in the coming weeks and months.

*Boston, MA
October 14, 2022*

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