OCTOBER 6, 2022 STATE OF THE ECONOMY CALL TRANSCRIPT

Michael Gibb: Good afternoon, everyone. Welcome to our October 2022 State of the Economy Call with Jean McGowan. My name is Michael Gibb, and I'm going to be administering the call today. I do have a few housekeeping items before we begin, but I'm going to be brief because we do have a lot to cover today. We've also received a good number of questions, and I'd like to give Jean time to answer those today. Due to the timing of the call, and complexity of what's going on in the market right now, this call is acting as a replacement for our September newsletter. We could not adequately cover every detail in a single page. We'll resume our normal newsletter cycle in October. Today's call is going to follow the same format as our previous call. Jean will give her prepared remarks and I will monitor for any questions that come through the chat. Following Jean's prepared remarks, if time, I will ask her the questions to allow everyone to hear her point of view. Lastly, before we begin, I want to express our support for our clients who were affected by Hurricane Ian. We have many clients who were affected and ask that you do not hesitate to reach out if we can do anything at all to help during this time. With that, I will stop talking and will turn it over to Jean.

Jean McGowan: Thank you, Michael. I'm really looking forward to this call. Michael laid down a challenge for me to get through the material in a timely manner to have time for questions. If for some reason I go long, I will certainly respond to any questions after the call.

Before I share the slides, I thought I'd make a few comments as there is a lot going on both in the economy and market. I thought I would highlight some of the key themes that we're going to dig into today before we get into the details. Firstly, we do not believe that we're currently in a recession. We have had two quarters of negative growth, but there are other factors going on in the economy that would call into question whether we're truly in a recession. Having said that, the Fed is very aggressive, inflation has been persistent, and we do see the risk of a recession as we go into 2023. We will certainly talk more about that later. Secondly, we are seeing some signs that inflation is peaking, but there are areas of inflation that are still a concern, stickier components, that we will discuss as we go through the slides. Thirdly, the Fed. The Fed was obviously late in the process of removing policy accommodation. This has caused them to have to move faster and is something we'll address along with our outlook for the Fed. The fourth main theme is one of economic and financial market uncertainty. It is important to remember that equity markets and the economy go through cycles over time, and that is what we are seeing now. Equity cycles tend to lead economic cycles. We are experiencing the negative part of the equity cycle right now. There's the potential that we'll see the negative part of the business cycle into next. Finally, the last key point that I hope you get out of today's call, is that while we are experiencing negative returns both in equity and bond markets, your portfolios are positioned in a defensive manner. Our strategy remains focused on high-quality and market-leading companies with the ability to work through difficult economic times to position themselves well for the future. While we may make some changes to your portfolio over the next quarter to take advantage of some market dislocations, we're not going to change our focus on the fundamentals. We want to make sure that we have companies that can meet our long-term growth criteria and do not want to feed into near-term uncertainty, or anxiety, in the market.

With that said, I'm going to share my screen and start talking about the slides and the economic data we are looking at. Moving to page 2. This is a quick view of where we are today and all of the different factors that are impacting economic uncertainty. I think there are some factors that we would view as leaning towards a recession and some that we would highlight as supporting moderate growth going forward.

Obviously, in the latter category, broad-based and persistent inflation is an issue. The aggressive monetary action by the Fed that (focused on reducing inflation), has the ability to slow the economy and lead us towards a recession. We're still dealing with supply chain disruptions that have been occurring since the beginning of the COVID pandemic, but they are getting better. We are also seeing labor shortages in some areas that are inflationary and potentially recessionary. Then, obviously, the one that we can't control - the war in Ukraine. This war has been disrupting global food and energy markets and causing global uncertainty. On the positive side, the labor market remains healthy. We're adding new jobs every month. There are still pockets of disruption in the labor market that are leading to higher inflation, but in general, we have a healthy labor market. The manufacturing sector, whether you talk about goods manufacturing or services, is still expanding. It may not be expanding as fast as it was a couple months ago, but we're still seeing that push from manufacturing that is supported by consumer demand.

We've talked in previous calls about the consumer shifting their buying preferences from goods to services. That relationship is starting to normalize, where we're seeing less spending on goods and more on services. This shift is not only supporting economic growth, but it's also helping to get the economy back into more balance in terms of supply and demand. Then, finally, excess savings. This is always a hard one to talk about, well both excess savings and disposable income. This is because they can be very different across the income spectrum. High inflation is causing pain for lower income individuals who don't have excess savings. We have to look at it from a broad top-down economic view though, and there is still plenty of disposable income to be spent in addition to excess savings throughout the economy. I think we may see a moderation in consumer spending, but there's no reason to think that we'll see a significant pullback in spending, at least over the next couple of quarters.

With that said, the next chart is a good one. It is a quick look at where we've been over the last several quarters and where we expect to go in terms of US GDP. The chart is showing the quarterly GDP growth on an annualized basis. We started at the fourth quarter of 2020 to pick up the time where the economy was reopening through where we are today. The green bars are actual GDP that has occurred, and the gray bars are estimates for the next several quarters. One key point to notice here, is that we've been through a period of reopening with excessive monetary stimulus and excessive fiscal stimulus that has driven above-trend growth. That dashed line is the long-term trend, which is right around 2%. We quickly came out of that, and we're now in a period that will last for some time of probably below trend growth. We did have two quarters of negative GDP growth - the first quarter and second quarter of this year. It does look like we have some positive momentum in the third quarter and will probably see positive GDP both in the third and fourth quarter of this year. It gets a little murkier as we get into next year due to the interest rate hikes. The estimates that we're using here show some moderate growth, actually no growth in the first quarter, very moderate growth in the 2nd, and potential for a little bit higher but moderate growth. I think those estimates could change as we go forward, and the risk of a recession next year is certainly on the rise.

Moving on to the next chart. I apologize for the fact that it there's a lot going on in this chart, but I think it is an important data series. This is the Chicago Federal Reserve National Activity Index. Basically, it is a series of 85 different economic indicators that they break out into four different market categories. You can see those in the key at the bottom. There are factors that describe production and income; personal consumption and housing; employment, unemployment and hours; and sales, orders, and inventories. So, it gives you a breakdown of the drivers of the overall economy.

There are two things in this chart that I'll focus on. Let's start with the green line on the chart. The green line is the overall index value, and you can see the last data point in August is 0. That is telling us that the economy, through August, was growing at trend. At trend means somewhere around 1 ½% to 2% - the long-term trend of economic growth. There are also gray dashed lines that you will notice on this chart. The bottom line at -0.7 indicates a recession and anything above the positive line at 0.7 suggests that the economy is growing so fast that there are concerns about inflationary pressures. We're right square in the middle of that. Anything from -0.7 to 0 means the economy is growing, just not at a typical or above-trend rate. Anything above 0 says the economy is growing above-trend. We are seeing that that number come down. It's bouncing around a little bit month-to-month, but this is telling us we're currently at moderate close-to-trend growth. We're not at a recessionary level.

The bars on this chart (which are the busy part of the chart), show the monthly contribution to the overall index from the different sectors that I just talked about (shown in the key). The reason I think this is interesting, is how much volatility there has been month-to-month in terms of what's contributing positively or negatively to growth. There is no clear trend across the economy of a sector that is doing well, and continues to do well, or a sector that is showing a decline, and continuing to decline. We're seeing variability within the areas of the market which makes it difficult to predict growth for the next quarter, whether it would be positive or negative on the margin. It is also hard to discern a trend when you have this much variability in these series.

Moving on to the next chart, I'm going to start digging into specific areas of the market. We will start with the labor market because that is something that I pointed out as a positive that is supporting the economy today. It is also a reason why we think that we're not currently in a recession. On the left-hand side of the page, you have the ratio of job openings to unemployed people. This comes from two different government data series, the first being the job openings and labor turnover reports, which is a great name. The acronym for that is JOLTs, which you may have heard of. Then the other piece of data comes from the Labor Department's monthly employment report. This chart shows the number of job openings in our economy related to the number of people that are unemployed. We did just get new data for this chart. What you have here is through last month, and it showed that for every unemployed person, there were currently about 2 job openings. That number has come down in the recent data that didn't make it into this graph. We're now at about 1.7 jobs per unemployed. That is because the number of job openings declined by about 1 million over the last month. We are seeing that number start to come down. The fact that there are more job openings then people is part of why we're seeing wage pressures. On the margin, a company needs to pay more to get a new employee to come work for them. The number we hope to see decline, and that the Fed certainly hopes we will see decline, is job openings to reduce labor pressure versus having a significant increase in unemployment.

The graph on the right-hand side of the page is primarily helpful for two reasons. One, to show how much the economy or the labor market has recovered since the pandemic and two, the areas of the market that are causing pressure on wages, particularly the service sector. The dark blue-green lines represent the change in the number of jobs from February of this year relative to February of 2020 (the last data point before the pandemic shutdowns). The gray bars represent August of this year versus that same point in February 2020. At the beginning of this year, we were still about 2 million jobs below pre-pandemic levels. We've since closed that gap significantly throughout the year as the labor market has expanded. We're now 270,000 jobs above where we were when the pandemic started. With this said, you can see as you look across the sectors – goods, transportation, financials, information, etc. – they've each seen significant job growth over this time period, while the service-oriented sectors are still below their pre-pandemic levels (particularly leisure and hospitality). Those are the areas, that as spending on services has started to increase and demand for services has increased, are still facing labor shortages. This has been part of the inflationary pressures we're seeing across the economy.

Moving on. We've talked about the supply chain quite a bit in the past. I was going to pull this slide out, but I think it's great to show how much improvement we've seen over the last 2 years. This is the New York Fed's global supply chain pressure index and as a reminder, a reading close to 0 means the supply chain is acting in a typical or more normalized fashion. And when you move above that, it is showing the number of standard deviations we are away from a normal functioning supply chain. You can see we peaked earlier this year at just over 4 standard deviations. That shows significant supply chain disruption, which we've all seen when we go to stores and see empty shelves or prices up on new and used cars due to lack of supply. As of last month, we're down to just about 1 1/2 standard deviations. That shows us that there is still some room for improvement in the supply chain, but we've also come a long way. As the supply chain normalizes and demand for goods decreases, it will significantly reduce some inflationary pressures in the market. We'll see this when we look at the next slide.

I thought it would be useful, rather than just talking about overall inflation numbers, to really dig into where we are seeing inflation and where we are seeing inflationary pressures ease. This table shows a point in time - looking at the August CPI data (The Consumer Price Index). The column that says August 2022 shows the year-over-year change for the overall CPI, which is 8.3%, and then breaks out some of the key components of the CPI data. The columns to the right of that show how today's numbers compare with the 6-month and 12-month average year-over-year change. This is helping us look at shorter- and longer-term trends in inflation. Is the trend in that particular data series towards less inflation or more inflation? It is very different as you look across some of these categories.

Food inflation is elevated and is still rising. I think anybody who has been in the grocery store will look at your cart and then look at the total on the register and not be surprised at all at the fact that food inflation is up almost 11 1/2%. Food away from home is also putting pressure on inflation, with some of this being due to rising costs for restaurants. Not only are restaurant product costs going up, but their labor costs are as well and are both being passed on to the consumer through higher prices.

Energy inflation has actually been helping reduce overall inflation over the last several months. Energy is always a volatile component in the inflation calculation. I don't know that we'll continue to see it go down as much as it has, but it will continue to be volatile. This is why we often don't look at energy when we're trying to look at trends in overall inflation, because energy is so volatile.

I think what's interesting in the middle of the page, is the core goods inflation. This is where our initial inflationary pressures were stemming from during the pandemic, because people were at home, buying houses, and doing renovations. The types of products they were buying included goods that were in short supply, putting pressure on prices. Due to this, we saw significant price pressures from this core goods area. As you can see, looking across categories like new vehicles, and particularly used vehicles, they are starting to dissipate. We would expect them to continue to dissipate for three reasons. One, we just talked about the supply chain improving. Two, people are shifting their spending patterns from buying goods to buying services. Lastly, three, as interest rates rise, they will further reduce demand. So, the area that was initially the push of inflation, is starting to ease.

The one that's a little more troubling, is the bottom sector where you have core services including shelter and rent. We're seeing significant inflationary pressures in rents and the cost of building homes, and that trend is still rising. It's .7% higher than the average for the last six months, and 1 ½% higher than the average over the last 12 months. So, the Fed is certainly paying very close attention to rents and wages because they tend to be stickier and represent longer-lasting moves in inflation. With this said, we are seeing some signs that these are leveling out. I don't have wages in the chart, but wage inflation while still high, has shown signs of leveling out over the last couple of months. We are very closely watching these “sticky” components and are seeing some signs that inflation - if not falling dramatically - has at least peaked. Then as fed rate hikes begin to hit the economy, we should see that come down even more.

Moving on. The other side of inflation that we always talk about is expectations. Expectations are important because they're much more highly correlated with individual spending activity and business activity. People make decisions based on what they think is going to happen to prices in the future, not necessarily what they are now. Here, we have two different looks at inflation expectations. The New York Fed does a monthly survey, and that gives us a look at 1-year inflation expectations and 3-year inflation expectations. Again, you can see short term, the 1-year inflation expectations peaked just under 7% and they're now down to 5.75%. Over a 3-year basis, the survey shows that after peaking just over 4%, people now expect inflation to be somewhere around 2.75% over the next 3 years.

The right-hand side of the page is the breakeven inflation rate embedded in the treasury inflation protected market or the TIPS market. I know we've used this chart before. It's a more market-based inflation expectation outlook, but it's showing the same things over different periods. Here we're showing the 2-year and the 10-year. Both are coming down significantly and getting closer to the Fed's 2% target.

Jumping to page 9, so we can talk about the Fed. On the left-hand side of the page is the Fed Funds rate. I started it after the end of the financial crisis, so the dark line is the actual Fed Funds rate, and the dashed line is the forecast. This particular forecast I'm using is the median expectation from the Fed. If I were to use a market-based forecast, it would be very similar in terms of pace of rate increase as well as peak terminal Fed Funds rate. I think we all know that the Fed was very slow to begin removing emergency accommodation, and that's forced them to have to act very quickly. We've gone from a basically zero Fed Funds rate at the beginning of the year to 3% to 3.5% now and likely 4.25% to 4.5% by the end of the year. It's likely that the range we arrive at by the end of the year will be the peak of the cycle, but I think what we will see is that the Fed is going to want to get to that terminal rate and then keep rates elevated for longer even if economic data is slowing. Even if they risk a recession, they know that in order to truly break inflation, they're going to need to leave those rates higher for longer. Chairman Powell has talked about not wanting to cause pain, but needing to cause pain in the economy. He's also talked about the lessons learned from the 1970s, when the central bank started to ease a little too soon (as economic data weakened), and it led to a second spike in inflation that required additional rate hikes. So, I think they're very mindful of history and will try to keep rates elevated for longer. You do see some forecast for modest rate cuts, but those aren't really until 2024.

On the right-hand side of the page is the Fed's balance sheet, which started to grow during the financial crisis and then grew even more significantly during the COVID pandemic. They have started to reduce the balance sheet, but it's a very slow process. Based on estimates and the pace that they're currently reducing the balance sheet at, it will be around $7.5 trillion by the end of 2023. This provides some help in fighting inflation, but from a historic perspective, we expect the Fed's balance sheet to remain elevated for quite a long time.

Fed policy obviously impacts interest rates across the curve, but their direct impact is on the front end of the curve. If you look at the chart on page 10, we've got the yield-to-maturity for the Fed Funds rate out to the 30-year Treasury. The green line at the bottom shows what yields looked like a year ago and the gray line at the top shows what yields looked like today. Well, today being last week. They're actually higher out the curve today than they were last week. The dark blue-green bars represent the change in yield over that one-year period. So, as you can see, we've had a significant increase in rates in the front end of the curve in particular. The 2-year Treasury is up, 380 basis points, although it's actually 15 basis points higher than that as of today. I think the other point that's important in this graph, is that the gray line shows that the yield curve is inverted between the 2-year Treasury and the 10-year Treasury, meaning that the yield on the 10-year Treasury is below that of the 2-year Treasury. That is not a typical curve shape we would expect to see. Generally, the further you move out in maturity, the more compensation investors require in terms of yield, in order to take more interest rate risk. But, when the Fed is raising rates aggressively and the market expects that the rate increases will not continue forever, you can get an inversion. Inversions are often from 2s to 10s and can be a signal of a recession. They don't have to be. We have had inversions that didn't lead to recessions, but every recession has been preceded by an inversion. The curve is very inverted today.

This leads us to the next page which talks a little bit about yield curve inversions, recessions, and the market. This is all based on historical data, so it does not mean it is going to happen the same way this time. I do think it's helpful to put in context. If you look at the five inversions in the top part of the table, on average, the economy goes into a recession 20 months following the inversion date. The shortest time period was 10 months in the 1980 and 1981 recession, and the longest was in 2001 where the curve inverted 34 months before. The number of months is probably not as important as understanding that the inversion does not mean an immediate recession. There is a time period between that inversion and a recession. I think the other thing, and again this is historical, is that from the time of the inversion to the start of the recession, the market can still do well. It is not the case, that because the yield curve inverts, we would expect the market to underperform or be negative going forward. In fact, in these time periods, the market was up almost 20% cumulatively.

I'm not going to go into detail about it, but I listed the inversion in 2019 separately because I didn't want to leave it out, but I think that the minor (short-lived) yield curve inversion in 2019 was not likely a signal of the recession that started in February 2020 as we shut down the economy. So, I left that one to the side. You might be asking today, where are we in this this timeline? The yield curve inverted 3 months ago on July 5th. This means we are 3 months into that time period. From July 5th through last night, the S&P is down 3.3%. Again, I would not put a lot of stock in expecting that we would get averages either in the number of months or the returns, but just to give you a historical perspective on yield curves and recessions.

I know I'm going way over my time. I have two more slides, but I thought before I go to those (because there are more equity market focused), I would just kind of give you a summary of what we've just talked about that is economic related. Despite the two quarters of negative GDP growth, we see momentum in the economy for the remainder of the year supported by the labor market, and by moderating, but still positive consumer spending. We do not think we are in a recession currently, but we do have concerns for next year. We expect that the Fed will continue to raise rates and reduce the balance sheet to stem inflation, even in the face of weaker data which obviously raises the recession risk. Even if we do see a recession next year, our belief (based on the fundamentals of our economy) is that the recession would likely be short and shallow. We do not see the same types of systemic risk in the economy that we saw in the financial crisis, so we don't see that type of systemic problem that exacerbates a recession and turns it into something that's deeper and more long lasting. I think my final point before we talk about the market a bit, is just to reiterate that recessions are part of the business cycle. They are painful for sure, but they also are a positive thing in removing excesses from the market and helping to reallocate capital to more productive and more efficient areas of the market. This helps set us up for a new market cycle.

Moving on to the next slide, and I'll cover this quickly. We've seen significant volatility in the equity market this year. The left-hand side of the page is the number of days that the market has traded intraday more than 2%. That number is 65, and that was before the last couple of days which would take us to probably 68 or so. On average the market has 33 days a year where we see that type of volatility. Not only are we seeing intraday volatility, but we're also seeing day-to-day volatility. For example, this week we had a strong Monday and Tuesday followed by weakness on Wednesday and again today. I think the hard part, is that the good days and bad days tend to come close together. This is why we say that timing the market is extremely difficult. When you shift to the graph, on the right-hand side of the page, this helps show that to be successful over the long term, it is about time in the market and not timing the market. So this data looks at the S&P 500 beginning in January of 1995 and goes through September of this year. If you were fully invested over that time period, you would have earned 7.8% annually. If you missed the best 5 days 10, 20 and on down, you can see that that return goes down pretty dramatically. If you couldn't predict those when the best 5 days were going to occur and tried to time the market, your return would decline significantly to the point that over a 27-year time period, if you missed the 50 best days in the market, you would have an annualized return of -1.7%.

Moving to the last chart, and I know we've used this chart before to look at drawdowns and market volatility in a different way. The bars represent the annual return of the S&P 500 and the diamonds represent the annual drawdown. From peak-to-trough within a year, what did the market do? You can see most years have some type of drawdown, with some being worse than others. This year the peak-to-trough is down about 23%, almost 24%. We are still obviously down for the year, but that number is a little different today versus when I put this graph together. The point of all this being that drawdowns are a normal part of the market, but negative returns are much rarer. They do occur, but generally not in consecutive years other than what we saw from 2000 to 2002. Generally, markets tend to recover. They move rapidly to price in changing expectations for changing market environments or economic environments, but they tend to recover before the economy recovers

What does all of this mean for your portfolio? Our growth and our income portfolios are defensively positioned. They're diversified not only across sectors of the market, but across names. The idea is that we focus on large, high-quality companies that are leaders in their market. The reason why a market-leading company is important, is when inflation is high, they have more pricing power and they are financially flexible (able to pull different levers, to deal with any near-term weakness without having to sacrifice investment in long term growth). Some of our companies may be more impacted by higher inflation than others and some of our companies are underperforming the market quite a bit, while others are outperforming the market quite a bit. This is where diversification matters. From a research perspective, what we continue to focus on is what the company is doing, how they are dealing with near term inflation (or whatever is slowing demand for their products, if that's the case), and how are they positioned for the future. Can they still invest for future growth? Once we get through a difficult economic period, are the growth drivers that we identified when we purchased the company still in place? As long as that is the case, that is what we're going to focus on. If we believe that a company cannot get through this period without significantly damaging its future prospects, then we would absolutely sell that company immediately. In times of trouble, we try to emphasize and remind you of those principles that we use in all market environments, but they're especially important.

We do these things all the time, but when volatility is high, we try to take profits on companies that are doing well even more readily to make sure that we're locking in those gains. In addition, we're spending some time now looking at opportunities in the market to potentially add some new names to the portfolio. There are certainly other good companies out there that meet the criteria that we've talked about, that have seen their stock prices decline far beyond what their fundamental outlook should be. We may make some changes to the portfolio this quarter to take advantage of those dislocations, particularly in our income portfolio, to potentially enhance the yield of that portfolio.

Finally, for those of you that have a fixed income allocation, you have probably noticed that we have been aggressively buying bonds in the fixed income ladder. We're focusing on short maturities and high-quality corporate bonds, but we are excited that for the first time in a while, we can provide some diversification from equity risk while providing incremental yield. This is with the understanding that it is very unusual this year that both bond and stock prices are down. We have mitigated some of this by the short duration of our corporate bond ladder. The other important point to remember, is that we hold those bonds to maturity. This means that these short-term price fluctuations will work themselves out, and when the bond matures, you will get your principal back and we will reinvest it in whatever area is most attractive.

To sum everything up, we are in volatile times, or difficult times. We certainly understand investor anxieties, and our focus remains on risk management and positioning the portfolios to minimize the downside risk. We are also making sure that we are staying invested to help you meet your long-term goals. With that said, and with just a few minutes left, I will turn it back to Michael for any questions.

Michael Gibb: All right. Thank you, Jean. Well, I want to be mindful of everybody's time and be respectful of everybody's time. So, I think we're going to go ahead and end on time, which is right now. Anyone who did submit a question either beforehand that Jean was not able to address during her presentation, or during the presentation, we will make sure that we reach out individually to get you the answers to those questions so that you're not left wondering. We will do this as soon as we possibly can. If any questions came up from anyone in attendance during the presentation that they didn't have a chance to ask, please go ahead and send those to your advisor or Jean, and we'll make sure we get those answered right away as well. With that said, we are going to go ahead and close the presentation. Thank you everybody for your time. Thank you for your continued support of our firm and thank you for continuing to allow us to serve you, serve your investment needs, and to take care of the finances of you and your family. We will see you all soon. Thank you.