BRIAN D. LOWDER, INC.

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FINANCIAL MARKET OVERVIEW

The three-year exceptional stock market returns (2019-2021) are now a distant memory. In six short months of 2022, the 80% three-year stock return on an all stock portfolio has been reduced by at least 20% through June 30, 2022. The overall stock market finished the second quarter down approximately 15%, but the mid-size and small company stock indexes and the technology stock index were down over 20%. Year-to-date, stocks are down between 15% (Dow Jones) and 30% (growth, technology and small-company stocks).

Large-company growth stocks and tech stocks had the worst performance in 2022 – down over 25% through June 2022. However, large-company value stocks (older and established companies) only declined by nearly 13% with most of that decline occurring in the second quarter. Small and mid-size growth stocks continued to get hammered during the second quarter – falling by 20% and down 30% year-to-date. Small and mid-size value stocks only lost about half as much as growth stocks during the second quarter.

Although the technology stock index was up over 30% during the 2021 calendar year, the same index was down 27% during the first six months of 2022. International stocks 13% during the second quarter and down 19% year-to-date compared to a 12% gain in 2021.

Emerging markets (smaller-country international stock indexes) were also down by over 10% during the 2nd quarter and down over 17% over the first six months of 2022. Emerging markets are down over 6 quarters in a row due to the poor performance of the Chinese stock market.

Even investment real estate prices continued to fall – down over 15% during the second quarter and down over 20% year-to-date thru June after posting a 40% return for the 2021 calendar year. Water utility stocks were also down over 20% during the first half of 2022.

After rising over 50% in 2021 and another 38% during the first quarter of 2022, Energy stocks continued to rise in 2022 until the month of June (down 23%). Year-to-date, energy stocks are up 29%. Other than energy stocks, the only other asset classes that posted a positive return during the first six months of 2022 were commodities (oil, wheat, soybeans, copper, livestock, gold, etc.) – up about 30% through June 30, 2022. However, the price of gold dropped over 6% during the second quarter and down approximately 1.5% year-to-date.

Fixed income or bond prices for short-term maturities were down slightly during 2022 through June – approximately 3%. Intermediate-term Treasuries posted a negative 10.55% return during the first half of 2022 and investment grade bonds were down 17% as interest rates continued to rise.

As interest rates rise, bond values fall. We are reminding conservative investors again: Interest rates will continue to rise as the pandemic recovery advances, supply chain problems persist and the inflation rate continues to rise. Expect negative returns for fixed income/bonds over the 2022 calendar year.

The following chart displays sample returns of various asset categories during the second quarter of 2020 and year-to-date:

Year-To-Date 2022	**2nd Qtr. 2022**	**Index Return *includes dividends reinvested*)**
- 15.31%	**- 11.25%**	**Dow Jones Industrial Average (^DJI)**
- 19.98%	**- 16.11%**	**Standard & Poor's 500 Index (^GSPC)**
- 21.32%	**- 16.82%**	**DJ U.S. Total Stock Market (VTI)**
- 28.21%	**- 21.10%**	**Large-Company Stocks-Growth (IWF)**
- 12.95%	**- 12.30%**	**Large-Company Stocks-Value (IWD)**
- 31.08%	**- 21.07%**	**Mid-Size Stocks – Growth (IWP)**
- 16.40%	**- 14.81%**	**Mid-Size Stocks – Value (IWS)**
- 29.47%	**- 19.26%**	**Small-Company Stocks- Growth (IWO)**
- 17.43%	**- 15.32%**	**Small-Company Stocks- Value (IWN)**
- 18.82%	**- 13.22%**	**International Stocks (EFA)**
- 17.22%	**- 10.43%**	**Emerging Markets Stocks (EEM)**
- 20.53%	**- 15.39%**	**Real Estate Investment Trusts (VNQ)**
Fixed Income (includes appreciation)		
- 2.99%	**- 0.49%**	**Short-term U.S. Treasury (SHY)**
- 10.55%	**- 4.46%**	**Intermediate U.S. Treasury (IEF)**
Alternative Investment Category		
- 1.46%	**- 6.75%**	**Gold (GLD)**

**All returns calculated using adjusted historical quotes from finance.yahoo.com*

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FINANCIAL MARKET OUTLOOK

The first half of 2022 ended with the worst 6-month performance over the past 50 years for both stocks and bonds. Investment grade bonds were down 17%, the broad U.S. stock market was down over 21%, technology stocks were down over 27% and crypto currencies down 60%. Everything was down except for commodities (i.e., wheat, soybeans, oil, copper, etc.) and personal residence values.

While we may be getting closer to the bottom of the stock market decline, unfortunately the overall economic conditions are more likely to worsen and/or *last longer* before they get better. We are still in the midst of a battle to reverse both **rising interest and inflation rates** simultaneously.

The problem is fairly straightforward: Raising or lowering either (inflation or interest) rate has the opposite effect on the other rate. <u>If the primary goal</u> is to **slow down and/or reverse the rate of *inflation***, one of the primary tools is to raise interest rates. Historically, when inflation is increasing at a 4% rate or higher, the Federal Reserve steps in and raises the *federal funds rate* – the rate banks charge each other for very short-term loans. Consequently, all other lenders (home loans, business loans, car loans, consumer loans and borrowing in general) begin raising their interest rates. Simply stated, rising interest rates increases the cost of debt (expenses) for businesses and consumers. Increasing costs/expenses translates into less purchases of cars, homes, and consumer spending etc. Slower or less consumer spending, combined with lower business activity and economic growth will eventually lead to reduced demand for goods and services. Eventually, inflation will trend lower.

<u>If the primary goal</u> is to **increase economic activity**, one of the primary tools is to lower interest rates. Lower interest expense to finance a home, car, education, credit cards, business loan etc. will increase economic activity and affordability. When inflation is rising faster than today's 7% annualized rate, we can't lower interest rates without the risk of throwing more fuel on the inflation fire ….. especially after the enormous deficit spending in 2020-2021 by the Federal Government trying to keep the economy afloat.

Under present conditions, overall consumption, personal spending and manufactured goods have been restricted and prices have increased dramatically. We have a supply chain problem – inability to find or receive delivery of the materials and inputs to manufacture products. With less product produced, consumers experience shortages on essential products in stores and online shopping.

The disruption was a direct result of shutting down the economy (restricting workplace interaction) to battle a novel disease – COVID. During the partially shutdown economy, manufacturing slowed, deliveries were reduced, less worker hours were required to maintain the lower output, and both the Federal and State governments increased their debt to fund cash payments to individuals and families to help them through the difficult times.

We had no experience or understanding about how to effectively battle this contagious disease while simultaneously trying to keep the economy (workplace) going. In less than a year later, deficit spending and economic disruption increased due to another unpredictable event - the conflict with Russia and Ukraine. Both of these events were not predictable and assigning "blame" simply lengthens the time to get through this mess.

Fast forward 2.5 years from when COVID first arrived and we still have supply chain shortages restricting our ability to produce and consume products. Both rising interest and inflation rates and the government has increased our country's debt along with the cost to consumers to service that debt. Restricting imports and the natural flow of economic commerce interrupts supply chains, causes continual price increases (inflation) and rising interest rates. On top of all of the problems above, now the financial markets are swooning downward and the number of tools available to fix these problems are few.

It's a matter of timing – how long will it take for a clear vision, actions and the necessary changes to be implemented? Simply stated, in order to resolve our economic problems and return to a "normal investment environment", we need to make changes. Presentation, appearance and talking about change is taking center stage rather than strategic vision and action. Talking, tweets, online postings, blaming politicians on either side, one-sided rants and published articles, videos, protests, controlled/fake interviews, and the like will only keep us on the current path toward hardship. If change does not occur very soon, *the road to the hardship finish line* is becoming closer.

Without change, the next financial chapter will likely be either **Recession** – a significant decline in economic activity or **Stagflation – lower or declining economic growth combined with inflation above a 5% annualized rate.** In the investment advisory field, we deal with **probabilities** when making decisions about the economy and the likely financial market reactions to economic and other data. **Possibilities** are irrelevant. The probability of a recession or stagflation is a near-certainty without change and leadership.

Real Estate Values. In a growing number of cities, personal residence values and buying activity have just started to decline. Expect this trend to continue. The primary reason for the 2-year abnormally high real estate appreciation rate during mid-2020 through mid-2022 was low mortgage interest rates – the lowest in over 50 years. Home mortgage

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rates dropped for 2 years and settled at below 3% by late 2021. Today, that same home mortgage rate 7 months later is a fraction below 6%. Looking forward, real estate buyers will need to be able to afford twice the monthly mortgage amount for the same mortgage loan balance compared to 7 months ago.

Not convinced that real estate prices will fall? Consider or explain this: all of the three largest homebuilder companies traded on the New York Stock exchange are down over 40% in 2022. The CEO of Lennar – the second largest homebuilder, explained that "so far in June, new orders, buyer traffic, sales incentives, and buyer cancellations have worsened in many of our markets due to the rapid spike in mortgage rates and from negative economic headlines".

Interest rates. As expected, the Federal Reserve Board raised interest rates again last month – this time by ¾%. Nearly everyone knew interest rates would rise – the only question now is how many additional interest rate increases are coming. If the fight to lower our inflation rate isn't showing any improvement, you can expect additional interest rate increases before year-end. How much higher will interest rates rise and over what time period can we expect the increases is unknown at this time.

During the 1st quarter of 2022, the performance of the (relatively safe) investment grade bond index fell 5.8% and by the end of the second quarter, the index lost another 11%. This stunning decline is a direct result of rising interest rates. Again, why did bonds post a negative 17% return over the first half of 2022? Because when interest rates rise, the *value* of bonds fall. Even after receiving and considering interest income, the loss in bond values greatly exceed the interest income.

The interest rate on a 2-year U.S Treasury Note has risen from ¾% at the end of 2021 to over 3% by the end of the second quarter 2022. The 10-year U.S. Treasury rate has increased from 1.5% at the end of 2021 to over 3% as well.

Confidence and a clear vision of progress are necessary to achieve economic improvement to avoid a recession or stagflation. The necessary transition to advance through our current conditions will take time and the likelihood of implementing new policy changes to work our way out of the current situation appears unlikely in the near term. We don't have a unified vision at this time, therefore do not expect conditions to change in the near-term. Be prepared for increased volatility for the remainder of this year.

Investment Outlook and Recommendations

Rising interest and inflation rates are clearly no longer speculation. This trend is in place and will not suddenly reverse. We desperately need to change course but the political environment is simply awful. The best analogy I can offer is the sports fan. The two major political parties are as adamant and unchanging as a die-hard sports fan. No matter how bad the win-loss record or how poorly managed your favorite sports team is, a die-hard fan will cheer and support the team no matter what.

Leadership is totally absent. Leaders of both political parties will not compromise even though history has recent examples of both parties doing just that. When Republicans had the White House, Democrat Tip O'Neil would not allow Ronald Reagan to implement his agenda without including some considerations and meeting him halfway on important agenda items. Bill Clinton also had to adjust course or "pivot" in second term when Republicans had a majority in both the Houses of Congress.

In summary, transitioning away from negative returns in the financial markets is not over and even though 1-day to 1-week rallies will occur along the way (similar to mid-March and the last week of June), the downward trend is still in place. There may be short-term financial market rallies along the way from brief encouraging news such as a) temporary monthly decline in interest or inflation rates or b) the upcoming results of the mid-term or fall elections, but the financial markets will not embark on a sustainable advance until the myriad of economic problems are confronted by the President and Congress.

Further, consumer sentiment (degree of optimism or pessimism) is extremely low – only 15% of consumers believe business conditions and their short-term financial prospects will improve.

In summary, one of two scenarios are most probable over the next 1-2 years: Economic growth is going to continue to decline and eventually pull inflation down with it (Recession) or economic growth will slowly decline, but inflation will remain elevated at 5%-8% annually (Stagflation). The long-shot scenario is weak economic growth continues and through the simple passage of time both the interest and inflation rates somehow subside without any material change in leadership or policy.

We have already made the following adjustments to managed accounts: 1) we eliminated clients' exposure to international and emerging stock markets as well as reducing exposure to U.S stocks in February and early March 2022. 2) The most recent and unexpected change was eliminating client holdings of Treasury Inflation Protected Securities (TIPS) that we purchased in ***mid-2021.*** Inflation was beginning to rise and the supply chain problems were likely to cause elevated inflation rates to continue. That scenario did in fact unfold and rising inflation rates did make TIPS a worthwhile investment holding.

What we did not expect was interest rates rising so quickly. Rapidly rising interest rates are actually a headwind or a negative attribute for holding TIPS. Why? Because rising

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interest rates pushed up the value of the U.S. Dollar. As the U.S. Dollar rises and the conflict in Ukraine continued, conservative U.S. and foreign investors plowed money into the safest and now higher paying U.S. Treasuries denominated in dollars. Therefore, we sold the TIPS and purchased 1-year U.S. Treasuries for the "safe" portion of client portfolios.

3) The same scenario (rising interest rates and value of the U.S. Dollar) and adverse consequences is underway regarding gold and gold mining stocks that we began purchasing in ***mid-2021***. You would think that rising inflation and global conflict/uncertainty together are a perfect environment for gold – and it was. But rapidly rising interest rates and U.S. Dollar make **guaranteed** U.S. Treasuries more attractive. We haven't sold meaningful portions of the gold positions in our client accounts, but the likelihood of removing these positions is growing.

Aside from the above changes, we are not making other significant changes to the investment holdings in our client accounts. We have already made meaningful changes throughout 2021 through mid-2022. It is more likely that we will implement any additional changes gradually if need be, assuming a significant sell-off does not occur. We will maintain our current asset allocation (proportional exposure to stocks, fixed income, etc.) for most client portfolios for now.

*Our primary focus is identifying what to purchase in the future. Change will come, the reversal of economic circumstances will arrive AND the financial markets are very anticipatory – usually the financial markets react approximately one year in advance. After muddling through the current economic circumstances AND considering that new elections are less than 2.5 years away, preparing for changes now is where our mindset is. Any change in leadership of both political parties will be a welcomed and anticipated outcome. It's simply a matter of time before investors' confidence is restored through progress and accomplishments. If progress is **not** restored, yes, the financial markets will continue to be subject to waves of selling.*

ANNOUNCEMENTS

Brian Lowder is a grandfather for the second time! Grace Violet Lowder was born on May 5th, 2022.

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