Third Quarter 2022

Market Recap, Near-term Outlook, and Performance Review

Market Recap

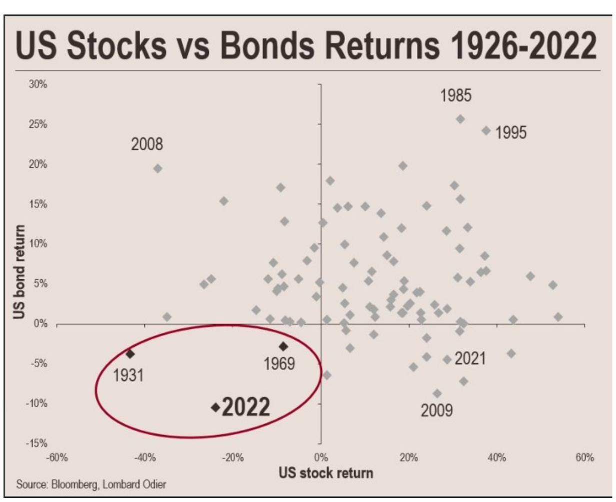
Q3 ended just as Q2 did, with overly negative investor sentiment and over-sold market conditions. As I speculated within last quarter's *Outlook*, a late-summer rally lifted stocks by about 15% from that Q2 morass. But the stock market would roll over yet again following Federal Reserve Chair Jerome Powell's hawkish inflation/interest rate policy commentary at the annual Jackson Hole Economic Symposium in late August. Unable to hold the prior 2022 lows struck in June, for the third consecutive quarter stocks ended Q3 sitting at new annual lows.

As measured by the Russell 3000 Index, a measure of 3,000 U.S. company stocks and a proxy for the *complete* U.S. stock universe, U.S. stocks finished Q3 with a loss of -4.46%, for a year-to-date loss of -24.62%. The tech-heavy growth component of the Russell 3000 Index finished Q3 with a loss of -3.37%, for a year-to-date loss of -30.57%. The cyclical-oriented value component finished Q3 -5.56% lower, for a year-to-date loss of -17.97%.

Late to recognize the extent of the inflation threat, Chair Powell expressed commitment to aggressive action to slow demand. Leaving investors with the understanding that the Fed is going to keep raising interest rates until achieving a "restrictive" level, and unlikely to pivot to easy-money policy again any time soon, Powell's comments reignited heavily negative investor sentiment.

The Fed Chair said the effort to reduce inflation will "bring…pain to households and businesses". It is necessarily a painful process. And exceedingly difficult to get right. Historically, the Fed has overtightened, leading to recession. Few are confident that the Fed can engineer a "soft landing" this time to avoid another policy-error induced recession. Uniquely challenging, economists and practitioners alike recognize that the methods of analysis and the prescriptive tools once useful for an industrial economy may be less effective in a modern service-oriented economy struggling with lingering pandemic-induced supply-side shocks.

While the decline in stock prices has been painful, bond performance is on track to be one of the worst years on record. Bond prices are inversely related to bond yields. The higher interest rates go to fight inflation, the lower bond prices go. As measured by the Bloomberg U.S. Aggregate Bond Index, U.S. bonds are down 14.6% this year. While a better showing than stocks, it is a statistical outlier for bond returns. The chart below shows that 2022 is one of only three years since the Great Depression with negative returns for both stocks and bonds. And absent a significant reversal before year-end, will go down as the worst year on record for U.S. bonds.



Traditionally owned for volatility reduction, bonds are supposed to be the anchor of a portfolio. It hasn't worked out that way this year. The once-trusty 60/40 portfolio, after expenses and management fees, finished Q3 with losses of -20% year-to-date. That loss ranks as the third worst year for nominal performance, behind two Depression-era downturns, 1931 and 1937, when 60/40 portfolio losses were -22% and -31% respectively. On an inflation-adjusted "real" basis, 2022 is already the worst year on record.

International investments have performed more poorly than their U.S. counterparts. And with U.S. inflation running in the high single digits, holding cash remains a losing strategy on a real return basis. There has been, simply put, nowhere to hide in 2022.

Near-term Outlook

Despite recession fears and market bears warning of a 20% corporate earnings recession, the current corporate earnings reporting cycle is proving to be reassuringly positive. Most reports thus far have surprised to the upside. While expectations had been reset significantly lower, reality has been better than feared. This glimmer of resilience has helped the stock market recover about 3% since the end of Q3, and we now sit a bit above the June lows.

Survey data reveals that, though stressed, both corporations and households are weathering the storm relatively well. Underlying hard data implies that both should continue to do so, in a static environment, for some time. But there are limits, time being one, to what remains tolerable for both. A corporate earnings recession would be the last shoe to drop, so to speak, ushering in another significant downside move in markets. In advance of that potentiality, however, our focus and potential portfolio action now pivots on one singular point — inflation.

- The rate of continued inflation determines the path and pace of the Federal Reserve's interest rate decisions. Market participants are looking ahead toward the November 1st/ 2nd meeting of the Fed's Open Market Committee, where the Fed is expected to hike interest rates by 0.75% for the fourth consecutive time — with an additional 0.75% increase also priced in for December's meeting. It is my belief that these next two moves are already priced into both stocks and bonds.
- The current level of interest rates does set the discount rate used in formulas to value stocks and bonds. The higher interest rates go, the lower the current value calculation of future earnings, therefore the lower that stock and bond prices will go. Any surprise moves by the Fed, higher or lower, in either the November or December meetings could have a material impact on stock and bond prices due to some basic algebra.
- Current interest rates help determine the "cost of capital". Cost of capital drives spending and/or investment by both individuals and corporations. The higher the cost of capital goes, the higher the probability for recession due to corporate and household belt-tightening. As the probability for recession rises, expectations for corporate earnings further decline. Again, any surprise moves by the Fed, higher or lower, could have a material impact on stock and bond prices.
- U.S. interest rates, relative to interest rates in other countries, drive the value of the U.S dollar. The higher the rate of inflation, the higher interest rates climb, causing the U.S. dollar to trade ever higher. A too-strong U.S. dollar is bad news for corporate earnings and therefore bad news for stock prices. As international earnings must be translated back into U.S. dollars for reporting of financial results, the more expensive the U.S. dollar the more of that income earned overseas takes a haircut when converted back to dollars. Any surprise move by the Fed…

While the rate of inflation is far more subdued that earlier during 2022, the pace continues to run higher than expected. September CPI increased 0.4% for the month, versus the 0.3% consensus estimate. On a 12-month basis, "headline" inflation was up 8.2%. Yes, off its 9% peak in June, but still hovering near the highest levels since the early 1980's. Another large jump in food prices boosted the headline number. The food index rose 0.8% for the month, the same as August, and was up 11.2% from a year ago. "Core" inflation – CPI excluding volatile food and energy prices and the Fed's preferred measure – accelerated 0.6% versus the 0.4% consensus estimate. Core inflation was up 6.6% from one year ago.

Should either the October CPI release (scheduled for November 10th) or the November CPI release (scheduled for December 10th) divulge similar numbers with no softening in the rate of change? Or worse yet, rising inflation? Then we must expect another turn lower in both the stock and the bond markets, as the Fed has made it very clear their commitment to achieving price stability as their top priority.

As always, I am available to discuss anything within this Outlook, or your own specific portfolio performance questions. And if there are any changes in your personal/financial situation that we have not already discussed, we need to schedule a more in-depth review. Until then, be well. And thank you for your continued trust and support.

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Performance Review

Lake Jericho managed and advised portfolios are typically invested in some variation of either one of two strategies - either (1) a concentrated individual stock strategy heavily biased towards U.S. large-company technology, health care, and consumer-focused stocks, or (2) a global-macro strategy broadly diversified by asset type, sector, and geography that is executed via exchange traded funds (ETF).

Within the individual stock strategy, macro factors can overwhelm individual stock selection and performance in the short run or for extended cycles. I regularly reinforce with clients that when growth-oriented strategies and/or market momentum stumble, Lake Jericho managed all-stock portfolios will experience those negative effects more deeply than typical U.S. equity indexes.

Within the global-macro strategy, I actively manage macro positioning, geographic diversification or concentration, asset types, sector allocations, and other performance factors. Additionally, these portfolios represent risk profiles that are not appropriately benchmarked against an all-equity index. Here too, these decisions all have meaningful impact upon returns and can cause our performance for any single quarter or for extended cycles to deviate from appropriate indexes. Performance must be measured versus similarly diversified benchmarks.

We provide the bulleted benchmark returns immediately below to demonstrate how each decision impacts returns. I then provide the iShares (by Blackrock) Core Allocation ETF Portfolio Series benchmarks within the tabled data at the end of this *Outlook*, for a proper, relative performance comparison against independent, objective, balanced, globally diversified strategies managed to standardized risk profiles.

- The Dow Jones Industrial Average finished Q3 with a loss of -6.17%, for a year-to-date loss of -19.72%, and a one-year loss of -13.40%. The DJIA is a price-weighted measure of the performance of 30 "blue-chip" U.S. companies.
- The S&P 500® Index, a broadly diversified, committee selected index of 500 large U.S. companies, finished Q3 with a loss of -4.88%, for a year-to-date loss of -23.87%, and a one-year loss of -15.47%.
- The technology and consumer-cyclical heavy Nasdaq Composite Index finished Q3 with a loss of -3.91%, for a year-to-date loss of -32.00%, and a one-year loss of -26.25%.
- Small- and mid-sized companies, as measured by the Russell 2500™ Index, finished Q3 with a loss of -2.82%, a year-to-date loss of -24.01%, and a one-year loss of -21.11%.
- International developed markets, as measured by the MSCI World (ex-USA) Investable Market Index, finished Q3 with a loss of -9.23%, for a year-to-date loss of -26.97%, and a one-year loss of -24.99%.
- International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, trailed their developed markets counterparts with a Q3 loss of -10.79%, for a year-to-date loss of -26.79, and a one-year loss of -27.51%.
- The Bloomberg Barclays U.S. Aggregate Bond Index, a measure of the performance of the U.S. investment grade bond market, finished Q3 with a loss of -4.75%, for a year-to-date loss of -14.61%, and a one-year loss of -14.60%.

The iShares Core Allocation ETF Portfolio Benchmark Series

Total Return Comparisons versus Comparable Risk and Allocation Profiles

All Periods Ending September 30, 2022

Core Allocation Portfolio (Ticker)	Q3 2022	Year-to-date	1 Year Total Return	3 Year Total Return	5 Year Total Return
Conservative (AOK)	--5.05%	-17.53%	-15.86%	-3.00%	6.50%
Moderate (AOM)	-5.35%	-18.62%	-16.40%	-0.87%	9.04%
Growth (AOR)	-5.95%	-20.79%	-17.54%	3.35%	14.01%
Aggressive (AOA)	-6.59%	-23.01%	-18.76%	7.28%	18.64%

The iShares Core Allocation ETF Portfolio series is designed to meet the needs of investors who would like to maintain fixed target levels of exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds, and other instruments. The Core Conservative Allocation Strategy seeks approximately 30% exposure to global equity markets. The Core Moderate Allocation Strategy seeks approximately 40% exposure to global equity markets. The Core Growth Allocation Strategy seeks approximately 60% exposure to global equity markets. The Core Aggressive Allocation Strategy seeks approximately 80% exposure to global equity markets. Presented here is the iShares Core Allocation ETF Portfolio Benchmark NAV total return performance as reported by iShares, constructed with no investment advisor fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

For any portfolio with an inception date within the current quarter, or within the current year-to-date, that observation period data will not be directly comparable to the iShares Portfolio Benchmark data above due to start-date differences. Nonetheless, your individual portfolio performance data is presented here for informational purposes. For direct comparison based upon exact portfolio inception dates, please access the custom reporting features within the Portfolio Analyst tool in the Client Portal.