PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

Q3 2022

MARKET REVIEW

The Federal Reserve has a dual mandate: Stable prices and interest rates, along with maximum employment. The third quarter highlighted the part of that mandate the Fed is most focused on, and investors, discounting in a higher likelihood of an economic recession, reacted by further discounting risk assets. Indeed, a stoic Fed made clear that "a sustained period of below-trend growth" may be a necessary byproduct of the effort to bring down inflation. This risk-off sentiment sent stocks lower for the third straight quarter of 2022, while putting an exclamation point on the worst decline in the first nine months of a year in 20 years. By the end of the quarter, the Dow, the S&P 500, and the Nasdaq had entered bear market territory. All three benchmark indexes are down at least 21.0% on the year.

Will the Fed succeed in its mission to rein in inflation? Hopes for such an outcome were helped with crude oil prices declining sharply in the quarter for several reasons, including waning fuel demand, China's ongoing COVID lockdown policy, the unexpectedly benign impact of sanctions against Russian oil exports, rising inflation, and the strength of the U.S. dollar. The strength of the dollar often weighs on oil and other commodities that are priced in that currency, making them more expensive to purchasers using other currencies. Bond prices fell further, pushing the 10-year Treasury yield up more than 0.8% on the quarter. We started 2022 with a nearly 1.5% yield on the benchmark 10-year. As we finish the quarter with a yield of nearly 4%, some are wondering whether we've peaked on the interest rate front. Gold prices struggled to maintain any momentum, disappointing inflation-hedge-seekers by dropping more than 7.50% in the quarter.

The quarter started with a rebound in July as consumer discretionary shares helped drive the S&P 500 up over 9.0%, the best monthly gain since the end of 2021. The Nasdaq led the benchmark indexes listed here, climbing 12.4%, followed by the Russell 2000, which rose 10.4%. The Dow added 6.7%, while the Global Dow gained 3.8%. Long-term bond prices advanced, driving bond yields lower. The Federal Reserve still hiked interest rates 0.75%. August saw stock markets give back July gains, as investors grew increasingly worried that the economy was headed toward a recession. Crude oil and gas prices continued to fall. After adding over 500,000 new jobs in July, the labor sector continued to advance, albeit at a slower pace, with the addition of 315,000 new jobs. Fed Chair Jerome Powell's hawkish comments at the Jackson Hole gathering confirmed the Committee's stance that inflation had to be tamed, despite some economic hardship. Adding fuel to the fire, inflationary indicators in August showed prices reversed course from the month earlier. The Consumer Price Index rose 0.1%, while the personal consumption expenditures price index rose 0.3%. Inflation was certainly not falling as much as most had hoped.

Stocks soured further in September as investors worried about an impending economic recession, despite an uptick in consumer spending which accounts for nearly 70% of US economic activity. The Federal Reserve increased the target range for the federal funds rate 0.75%, while anticipating ongoing increases in the target range will be appropriate. Despite a surge in stock values early in the month, each of the benchmark indexes ended September in the red. Crude oil prices fell in September for the fourth consecutive month, and gains in treasury yields conflicted with reductions in fuel costs.

ECONOMIC REVIEW

The foregoing content reflects the opinions of Penobscot Financial Advisors and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions, or forecasts provided herein will prove to be correct.

Employment: Employment rose by 315,000 in August, better than expected but well below the revised July total of 526,000. Employment has risen by 5.8 million over the past 12 months, as the labor market continued to recover from the job losses of the pandemic-induced recession. This growth brings total employment 240,000 higher than its pre-pandemic level in February 2020. The unemployment rate edged up to 3.7% in August (3.5% in July), and the number of unemployed persons increased by 344,000 to 6.0 million, with both measures returning to their pre-pandemic levels. The labor force participation rate increased by 0.3 percentage point to 62.4% in August. The employment-population ratio in August, at 60.1%, little changed from the previous month. Both measures remain below their February 2020 values (63.4% and 61.2%, respectively), indicating that there may be structurally less of the population involved in the workforce

FOMC/interest rates: The Federal Open Market Committee increased the federal funds target rate range 75 basis points following its meeting in September. With the latest increase, the FOMC has increased interest rates by 300 basis points since January. In its statement following the September meeting, the Committee expects inflation will continue to run higher for the foreseeable future. The FOMC projects interest rates will increase another 125 basis points for the remainder of 2022.

GDP/budget: The economy has decelerated for two quarters in a row. Gross domestic product decreased 0.6% in the second quarter of 2022 after falling 1.6% in the first quarter. The decrease in GDP reflected downturns in private inventory investment, residential fixed investment, federal government spending, and state and local government spending that were partly offset by increases in exports and consumer spending. Imports, which are a subtraction in the calculation of GDP. increased. Consumer spending rose 2.0% in the second quarter after increasing 1.3% in the first quarter.

The Treasury budget deficit through August sits at $945.7 billion, $1,764.9 billion lower than the deficit over the same period in fiscal year 2021, as outlays dropped $942.9 billion while receipts increased $822.0 billion. So far in this fiscal year, individual income tax receipts have risen $574.8 million, and corporate income tax receipts have increased $33.8 million.

Inflation/consumer spending: While inflationary pressures appeared to wane in July, data for August revealed prices reversed course and moved upward. The personal consumption expenditures price index, a preferred inflation indicator of the Federal Reserve, advanced 0.3% in August after retreating 0.1% the previous month. For the year ended in August, prices have increased 6.2%. Prices less the volatile food and energy increased 0.6% in August and 4.9% since August 2021. In addition, personal income increased 0.3% in August, the same increase as in July. The Consumer Price Index, after only rising 0.1% in August, ended up rising 0.4% in September's release, an uptick that roiled both equity and fixed income markets and erased the gains made during the first part of the quarter. Despite these hot inflation numbers, consumer spending has remained robust, building on a 2% increase during the second quarter.

Housing: Sales of existing homes retreated for the eighth consecutive month in September, falling 1.5% from the August estimate. Year over year, existing home sales were 19.9% under the August 2021 total. According to the latest survey from the National Association of Realtors®, rising mortgage rates have impacted sales. A 30-year fixed rate mortgage started the year near 3%, and now the average has surpassed 7%. In addition, inventory remains tight as homeowners are reluctant to sell after locking in historically low mortgage rates in recent years. The median existing-home price was $384,800 in September, down from $399,200 in July but 8.3% higher than September 2021 ($355,100). The inventory of new single-family homes for sale in August represented a supply of 8.5 months at the current sales pace, down from July's 10.6-month supply.

Manufacturing: Industrial production increased 0.4 percent in September and 2.9 percent at an annual rate in the third quarter. In September, manufacturing output rose 0.4 percent after advancing a similar amount in the previous month. Industrial production slipped 0.2% in August after advancing 0.5% in July. The decrease in industrial production can be traced to a 2.3% drop in utilities output and a flat reading for mining. Transportation equipment drove the August decline, falling 1.1% after decreasing 0.7% in July.

Imports and exports: The price index for U.S. imports decreased 1.2 percent in September and 3.7 percent in the third quarter of 2022. The quarterly drop was the largest 3-month decline since the index fell 4.3 percent for the 3 months ended May 2020. Prices for U.S. imports rose 6.0 percent over the past year, the smallest 12-month advance since the index rose 3.0 percent for the year ended February 2021. In August, lower fuel and nonfuel prices contributed to the monthly decrease. Fuel import prices fell 6.8% in August following a 7.5% decrease the previous month. Despite the August decline, import fuel prices advanced 48.5% over the past year.

U.S. export prices declined 0.8 percent in September and 6.2 percent in the third quarter of 2022. The quarterly drop was the largest 3-month decrease since the index fell 7.3 percent from September to December 2008. Lower agricultural and nonagricultural prices each contributed to the September decline. Prices for U.S. exports rose 9.5 percent over the past year, the smallest 12-month advance since a 5.4-percent increase in February 2021.

The latest information on international trade in goods and services, released September 7, is for July and shows that the goods and services trade deficit narrowed by 12.6%, to $70.6 billion from the June deficit.

International markets: The global fight against rising inflation apparently has a long way to go, and economies are beginning to feel the impact. The Bank of England, undeterred by the prospects of an economic recession, tightened its monetary policy further in September, hiking the bank rate 50 basis points to 2.25%, equaling the August rate hike, which marked the first time in 27 years that the bank rate had been increased by more than 25 basis points. With these moves, the BOE has revised the near-term outlook for inflation from 13.3% in October to nearly 11.0%. In addition, the British government announced the

The foregoing content reflects the opinions of Penobscot Financial Advisors and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions, or forecasts provided herein will prove to be correct.

introduction of an energy-price guarantee that will cap household energy costs for the next two years. Nevertheless, the eurozone's annual rate of inflation hit 10.0% in September, the highest growth rate in prices since 1997. The war in Ukraine took another turn following Russian President Vladimir Putin's move to annex portions of eastern Ukraine, further adding to stock market concerns. In China, weakening manufacturing and a slowdown in the property sector prompted the People's Bank of China to relax its monetary policy in diverging from the policy tightening at other central banks. Overall for the markets in September, the STOXX Europe 600 Index slid 6.6%. The United Kingdom's FTSE fell roughly 5.1%. Japan's Nikkei 225 Index plunged 6.2%, while China's Shanghai Composite Index lost 5.1%.

Consumer confidence: The Conference Board Consumer Confidence Index® increased in September for the second consecutive month. The September index stands at 108.0, up from 103.6 in August. The Present Situation Index, based on consumers' assessment of current business and labor market conditions, improved to 149.6 in September, up from 145.3 in August. The Expectations Index, based on consumers' short-term outlook for income, business, and labor market conditions, rose to 80.3 in September (75.8 in August).

LOOKING FORWARD

The fourth quarter is expected to continue the trends from the previous three months. Inflationary pressures are likely to slow as the Federal Reserve continues its aggressive policies until inflation settles at the target 2.0% rate.

THE SHORT-TERM INFLATION OUTLOOK

Indeed, in the short-term, there are signs of progress in the area of inflation. Food commodity prices have backed off from their springtime peak. Crude oil and natural gas prices are well below their mid-summer peak, despite recent OPEC+ production cuts. Better automobile inventories are resulting in lower price pressure in the new and used vehicles space and airline fares have declined as well. If we assume that a September headline CPI monthly increase of 0.3% is repeated over the following three months, then year-over-year headline CPI inflation will be below 7.0% by December.

Core CPI inflation may fall more slowly, from 6.5% year-over-year in September to 5.4% year-over-year in December. Most of this is the result of shelter, which makes up over 40 percent of the CPI number. Housing prices, while stabilizing, tend to remain sticky and rents tend to lag the remainder of the market in declines. It's likely that the Fed will take this into account when targeting the end of their rate increase campaign.

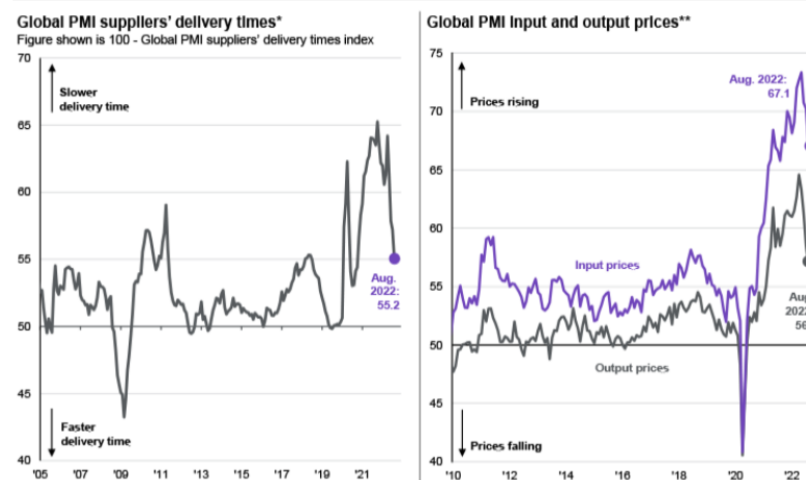
THE LONGER-TERM INFLATION OUTLOOK

While the Federal Reserve is waiting for more data showing actual declines in inflation, both leading indicators of inflation and macro-economic forces strongly point to lower inflation ahead.

The Fed currently forecasts the following inflation rates at year end:

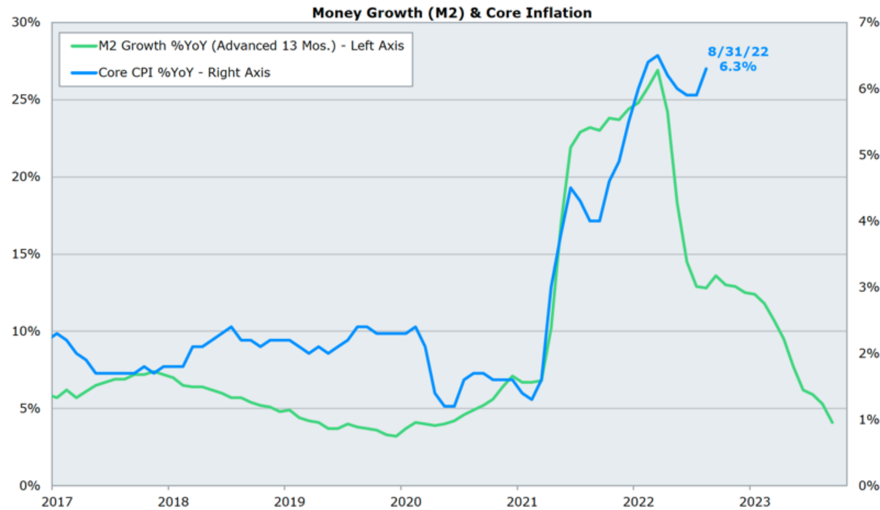
5.4% at the end of 2023
2.8% at the end of 2024
2.3% at the end of 2025

While these are subject to revision, what is notable is that market indicators and economists seem to largely agree with the Fed's projections, something that is certainly not always the case.

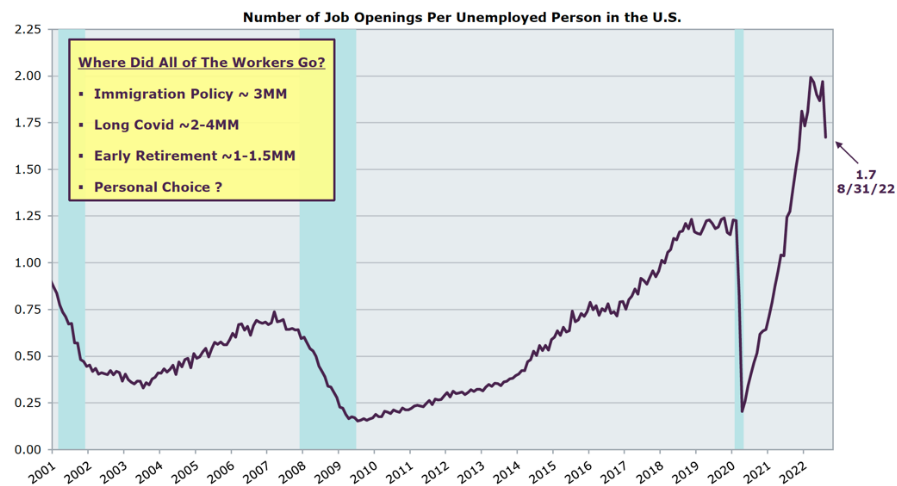


Supply chain issues are resolving, with delivery times returning to long-term norms and input and output prices showing marked declines.

The foregoing content reflects the opinions of Penobscot Financial Advisors and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions, or forecasts provided herein will prove to be correct.

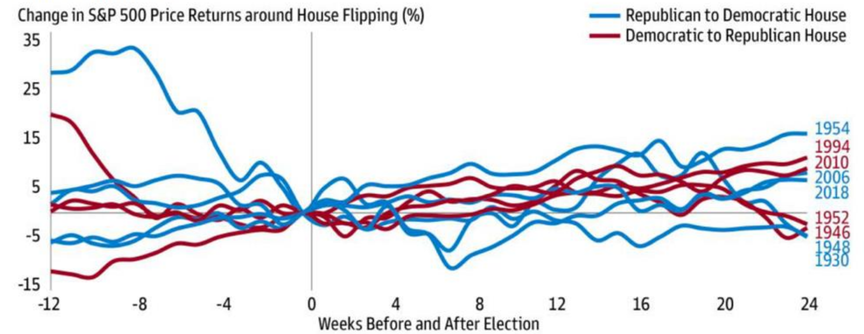


US Consumer spending is already declining in real-dollar terms, with nominal spending remaining flat in September. With a low likelihood of any stimulus programs being passed between now and the 2024 election, the consumer will likely continue to face challenges in keeping up with spending at prior levels as M2 Monetary Growth shrinks substantially (generally a leading indicator of inflation trends).



Substantial loosening in the labor market is removing some of the wage pressures, with the August Job Openings and Labor Turnover numbers (JOLTs) showing a removal of 1.1 million job openings.

WHAT ABOUT THE MID-TERMS?



Mid-term elections tend not to fall in the direction of the party occupying the White House and 2024 is not shaping up to be an obvious exception to this rule. The types of policies emerging from congress will likely be impacted should the Democratic majority in the House of Representatives flip to a Republican majority – but ultimately such shifts have not been good predictors of leading or subsequent market returns.

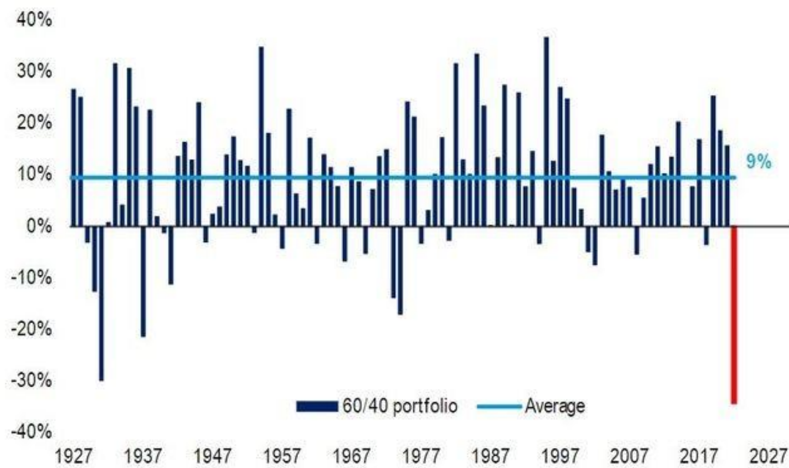
INVESTMENT IMPLICATIONS

The markets are likely to continue to churn for the foreseeable future. Much of the focus will continue to be on inflation and how quickly or slowly it abates. Many would argue that price pressures will be slowing with or without Fed rate involvement, so the issue of whether the current pace of tightening monetary policy will send the economy into a recession and, if so, whether the recession ends up being short or long, deep or shallow. Suffice it to say, the market has likely priced in some degree of uncertainty, with forward earnings currently priced meaningfully below longer-term averages. The trajectory of the Russo-Ukrainian war, a still-robust employment market, and oil and gasoline prices will doubtless feed into market gyrations for the foreseeable future.

The foregoing content reflects the opinions of Penobscot Financial Advisors and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions, or forecasts provided herein will prove to be correct.

Chart 3: "60/40" portfolio ann. worst YTD return in past 100 years

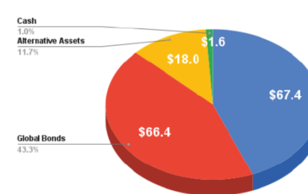
Annual 60/40 portfolio performance

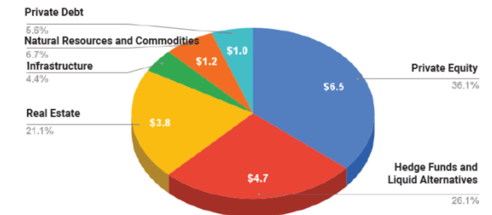


Source: BofA Global Investment Strategy, Global Financial Data, 2022 is YTD annualized

The existing pricing of uncertainty provides some attractive potential for risk assets, both equities (stocks) and fixed income (bonds). Whereas 2022 represented a period of high correlation (to the downside) between stocks and bonds (arguably the worst combined performance of a 60/40 portfolio in 100 years), 2023 could have potential to have that correlation continue – potentially to the upside. Declining rates, tightening credit spreads and a clearer picture of whether the Fed can manufacture a 'soft-ish landing' could accrue to the benefit of both stocks and bonds.

GLOBAL ASSETS	ALTERNATIVE ASSETS





TOTAL	$153.4	$18.0

Given the high level of correlation recently between the traditional stock and bond categories, many investors are taking more seriously the benefits of further diversifying beyond these two basic asset classes, into 'alternative' assets.

Alts have grown as a portion of global invested assets, currently comprising almost $18 Trillion dollars (around 12% the global investment landscape). Their ability to provide truly diversified returns are something we've been focused on and continue to find more opportunities to diversify client portfolios with.

The foregoing content reflects the opinions of Penobscot Financial Advisors and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions, or forecasts provided herein will prove to be correct.