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MARKET REVIEW

› 3rd QUARTER 2022

EXECUTIVE SUMMARY

- Equity and fixed income asset classes produced negative returns for the quarter.
- Annual inflation ending July 2022 was 8.5%, slightly down from 8.6% in June.
- Federal Reserve increased rates by 0.75% in June, and 0.75% in September – resulting in 3% in rate increases for the year.

Quarterly Market Review

3rd Quarter 2022

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"Human nature conditions us to do the wrong thing all the time"– Rob Arnott, CEO of Research Affiliates

Economic and market conditions were challenging for the third quarter of this year. Year-over-year inflation seems to have peaked in June, but the overall inflation outlook appears to be uncertain due to the tight US labor market, strict zero Covid policy in China, and the ongoing nature of the Russia – Ukraine war.

In response to this uncertainty and persistent inflation, the Federal Reserve continued their recent hawkish stance by reducing their balance sheet, increasing the federal funds rate by 3% this year, and warning of further tightening going forward.

Recession worries have increased due to a sharp increase in rates and the strength of the dollar versus overseas currency. Unsurprisingly, this has led to a decline in both the stock and bond markets with the 3rd quarter producing returns of -6.7% for stocks and -4.8% for bonds, which leaves investors with a more favorable market valuation level than at the beginning of 2022. For the year, tilting towards Value companies and holding shorter term fixed income assets helped moderate losses.

Sources: Capital Group, Bloomberg Index Services Ltd., Refinitiv Datastream, Standard & Poor's. As of September 23, 2022.

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QMR – Portfolio Update

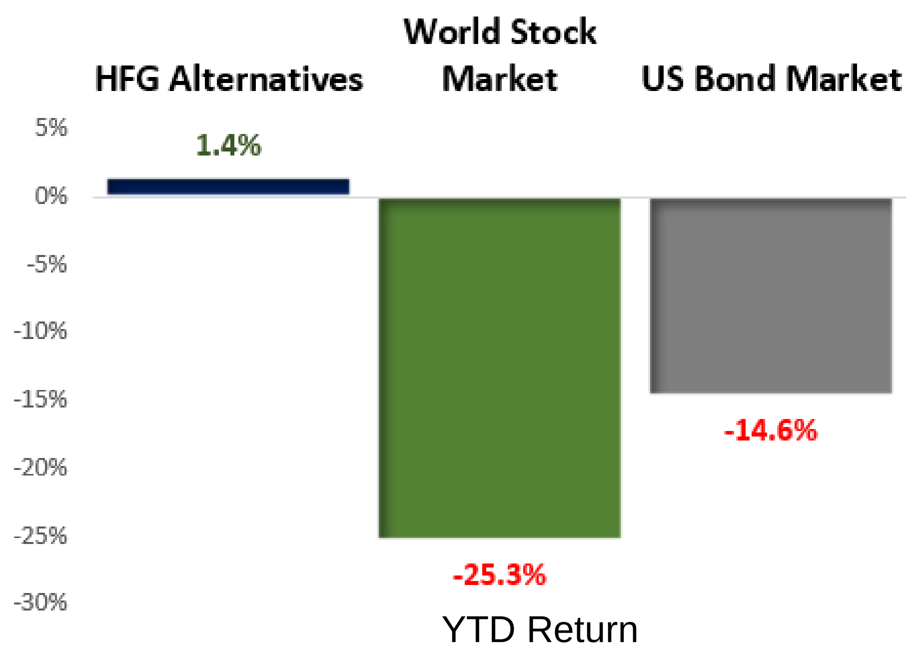
3rd Quarter 2022

<u>**Portfolio Update:**</u> At HFG we've continued to be diligent in rebalancing our clients' portfolios by systematically making sure the appropriate mix of stocks, bonds, and alternatives are kept on target for your specific risk level. At the investment committee level, we're currently reviewing the equity allocation between domestic and international stocks, while continuing to look for opportunities in the alternative investment space, such as private lending, farmland, and infrastructure investments.

<u>**Equities:**</u> The world stock market is down -25.3% for the year, and -6.7% in Q3 alone. There is a large disparity between "Value" and "Growth" companies, in which growth companies have taken the brunt of the decline for the year down -30.6% and -3.4% for the quarter. While still sliding, value companies are -18.0% for the year and -5.6% for the quarter. Compared to the average market portfolio, HFG clients' Price-to-Earnings is a reasonable 12.5x, compared to the S&P 500 at 19.6x. In other words, our clients are significantly tilted towards "Value".

<u>**Bonds:**</u> As rates have continued to increase this quarter, it has paid to be shorter term (as rates increase, the price of bonds decrease). The average maturity of a bond in the US is 9 years, which in turn has reduced in price by -14.6% for the year and -4.8% in Q3, compared to shorter term bonds declining -6% for the year and -2% for the quarter. We've continued to focus on allocating to shorter-term, high-quality bonds with the average yield generally around 4% as of this writing.

<u>**Alternatives**</u>: The overall alternative investment portfolio has provided positive returns for the year, in an otherwise gloomy return environment. Private Real Estate has returned +13%, and other private lending offerings have provided a stable return of 4% to 6% for the year so far. Hurricane Ian has negatively affected our reinsurance holdings that insures against natural disasters with a decline of roughly -10% for the year, as this was a 1-in-40-year hurricane event. The underlying reinsurers we're invested in have already started raising insurance premiums by 20-30%; which we anticipate will be beneficial for returns going forward.



QMR – Economic Update

3rd Quarter 2022

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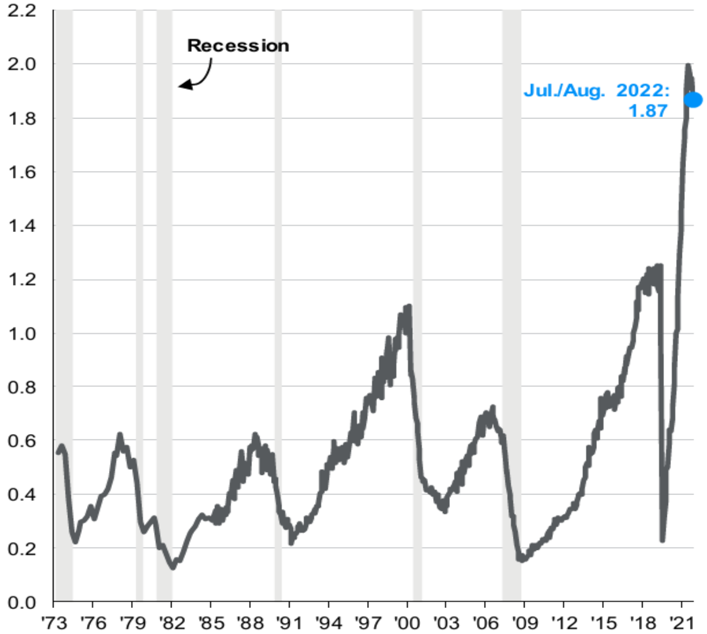
Economic – Going into the fourth quarter, there is increasing concern the US economy may slip into recession. The combined forces of fiscal stimulus and post-COVID reopening that powered strong returns in 2021 have now faded. The fiscal budget deficit in 2020 was $3.2 trillion, followed by a $2.8 trillion deficit in 2021. But the budget deficit now has fallen to under $1 trillion in 2022. This has reduced the flow of money, particularly to lower- and middle-income families and is contributing to slow growth in consumer spending. Furthermore, the doubling of mortgage rates since the beginning of the year has slowed home building and sales.

Labor Market – The labor market continues to be strong if you're looking for a job with 1.87 job openings for every unemployed person. This ratio is slightly down from a high of 2 earlier this year, but still at unprecedented levels. On the labor supply side, there were many early retirements and diminished legal immigration during COVID. The strong demand for labor could soften the blow of a recession for workers.

Ratio of job openings to job seekers

Job openings* lagged 1 month divided by unemployed persons, SA



The U.S. dollar

U.S. Dollar Index

Source: J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of September 30, 2022.

US Dollar – Going into 2022, the US dollar had 15 years of steady appreciation. However, despite this strength, the nominal trade-weighted dollar increased 19% in 2022 to a 20-year-high. Economic problems overseas, a hawkish Federal Reserve, and uncertainty for the Ukraine war have aided in the dollar's strength. A strong dollar should help control inflation but will most likely slow our exports market as it has become comparatively more expensive for foreigners to purchase our goods.

The strength of the US dollar has adversely affected the realized returns of overseas investments. For example, an investor not converting their portfolio to US Dollars would have returned -14.1% this year, while a US Dollar based investor would have returned -26.8% due to the appreciation of the US Dollar. These short-term extreme fluctuations can be painful, but over time they even out and provide an additional layer of diversification benefits to long-term focused investors.

Name	Q3	YTD
MSCI Developed International (Non-USD Based)	-3.5%	-14.1%
MSCI Developed International (USD Based)	-9.3%	-26.8%
United States Dollar Return Drag	**-5.8%**	**-12.7%**

Putting Market Declines in Perspective

3rd Quarter 2022

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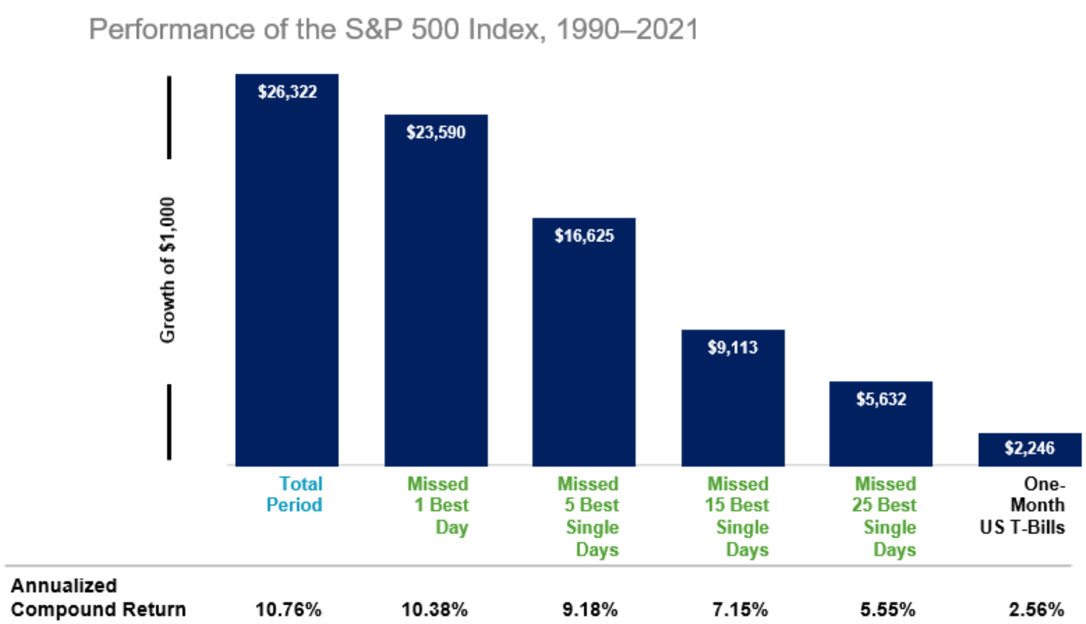
You wouldn't be human if you didn't fear loss. It is no secret that people feel the pain of losing money more than they enjoy the gains – especially if this person is retired and has stopped accumulating savings. The natural instinct is to flee when the market plummets – than the fear of missing out (FOMO) prompts people to jump back into the market when it is at all time highs. But smart investing can overcome the power of emotion by focusing on relevant research, solid data, and proven strategies. Here are seven principles that can help fight the urge to make emotional decisions in times of market turmoil.

Market Drawdowns are Par for the Course – If drawdowns or losses never occurred in the stock market, then investment in stocks wouldn't have any additional return over Government Bonds. Investors are compensated over the long term for this risk as stocks have tended to move steadily higher. The good news is these "corrections" (more than a 10% stock market decline) and bear markets (20% of more of a decline) don't last forever. On average, the S&P 500 has declined at least 10% about once a year, while a decline of 20% or more happens about every six years. While these declines are unpleasant, each downturn has been followed by a recovery, and new all-time highs.

Staying the course is easier said than done – especially in the midst of bear market and possible recession. You don't have to look too hard to find what seems like bad news: the Federal Reserve increasing rates, an energy shortage, and an uncertain outcome for the ware in Ukraine.

With all that's going on in the world, should I sell and sit on the sideline until the world issues are sorted out? In theory this sounds like the logical choice. However, in practice its exceptionally difficult to do. Not only do you need to sell at the correct time, but you also need to go back in at the correct time. On top of that, the stock market is a leading indicator so when we typically feel confident the economic headwinds are past us, the market is already up, and often significantly.

For example, the table to the right illustrates the affect of your total portfolio return if you missed 1 to 25 of the best return days in the market. During this time period if you had poor luck, and you missed being invested the five best days from 1990-2021, you would have a 1.58% lower annual return than if you were invested the entire time (10.76% vs 9.18%) – that's a 37% reduction in account value ($26,322 vs $16,625). To put this in perspective, there are 11,600 days in this time period, and you only missed 5 of them.



Putting Market Declines in Perspective

Continued...

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When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data: Ycharts

Source: awealthofcommonsense.com/2022/10/getting-long-term-bullish/

We're not predicting the market won't decline further, but based on history, this is a relatively common occurrence. For example, the S&P 500 has been down 25% or more nine times since 1950. The table to the left illustrates the forward one-, three-, five- and 10-year returns following a 25% or more decline on the S&P 500 over the last 72 years. History provides no guarantee of future returns, but there is a certain level of comfort in having seen this before and confidence that over the long term we should be bullish and hold course with our investments.

The Market Rewards Long Term Minded Investors - Is it reasonable to expect 30% returns every year? Of course not. And if stocks have moved lower in recent weeks, you shouldn't expect that to be the start of a long-term trend, either. Behavioral economics tells us recent events carry an outsized influence on our perceptions and decisions.

It's always important to maintain a long-term perspective, but especially when markets are declining. Although stocks rise and fall in the short term, they tend to reward investors over longer periods of time. Even including downturns, the S&P 500's average annual return over all 10-year periods from 1937 to 2021 was 10.57%.

World Stock Market Performance

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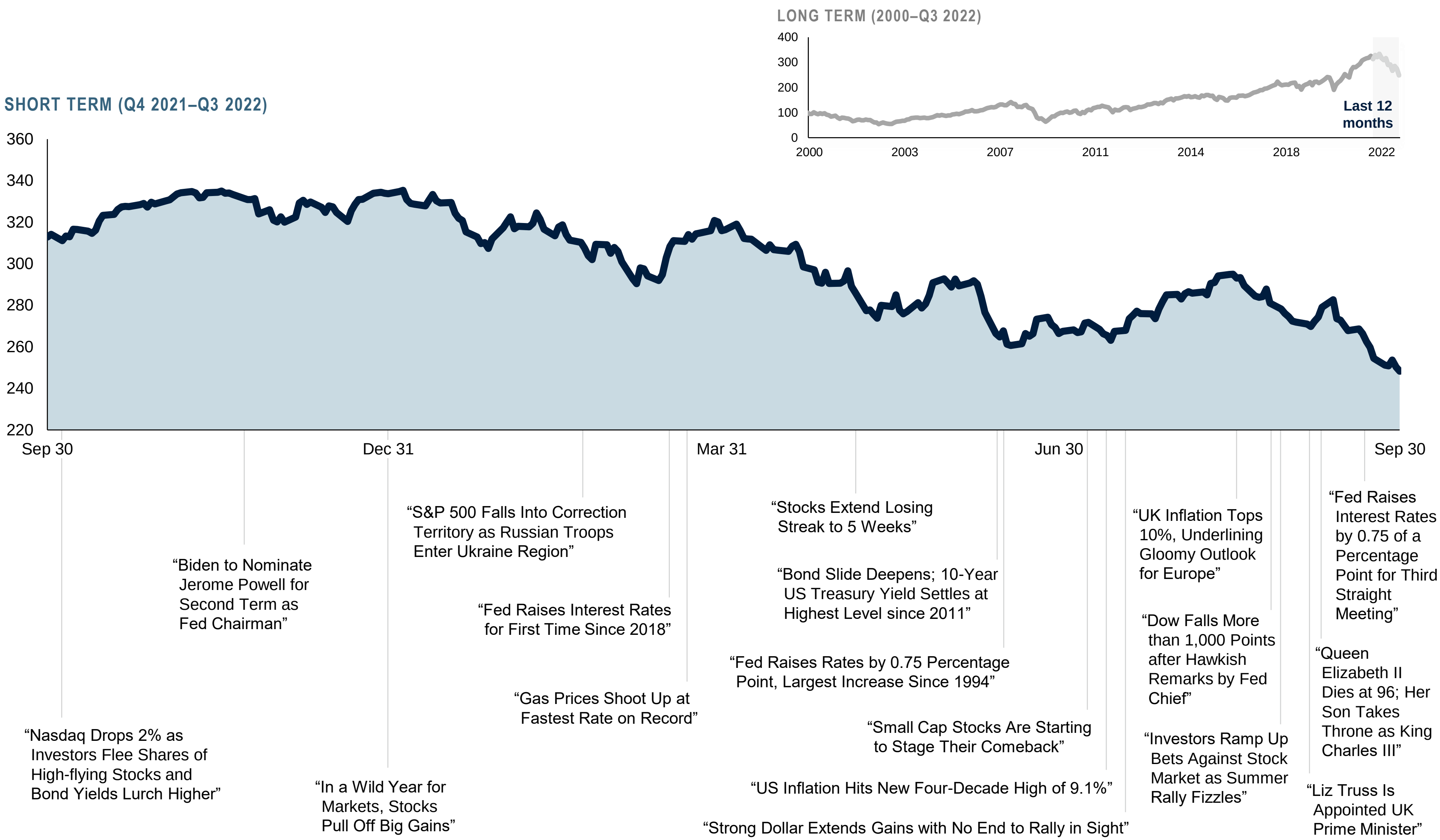
MSCI All Country World Index with selected headlines from past 12 months



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index (net dividends). MSCI data © MSCI 2022, all rights reserved.

It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

Global Valuations

What is the Investment Climate?

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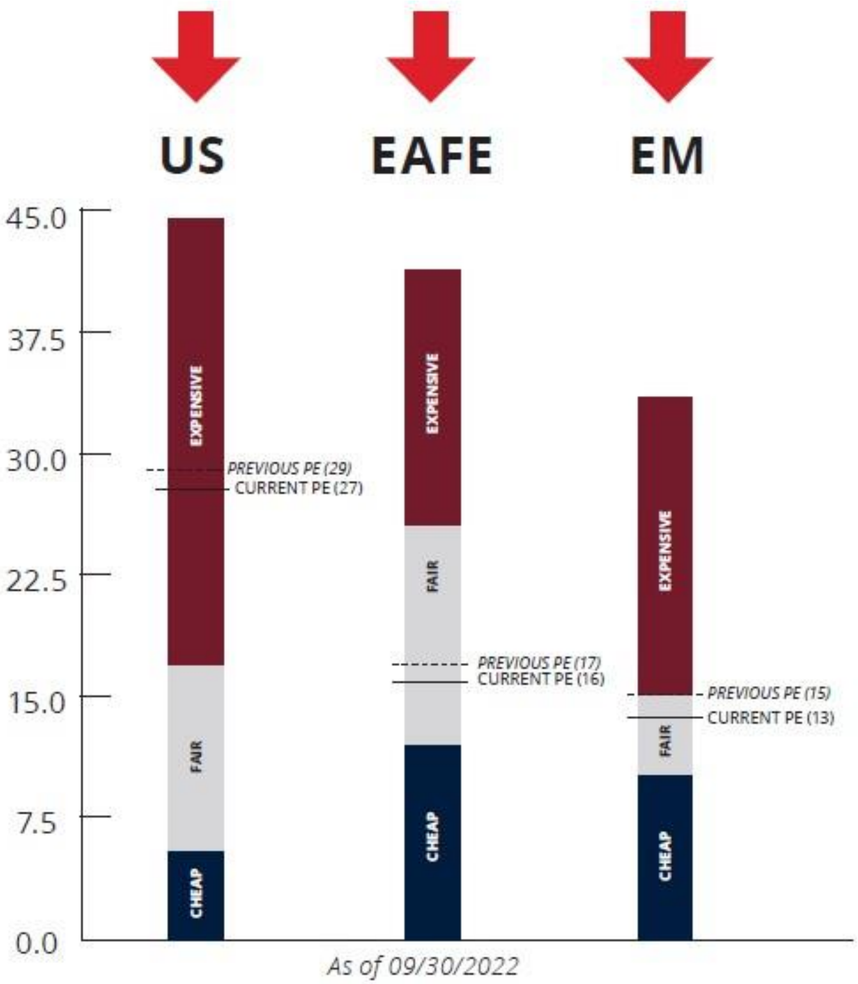
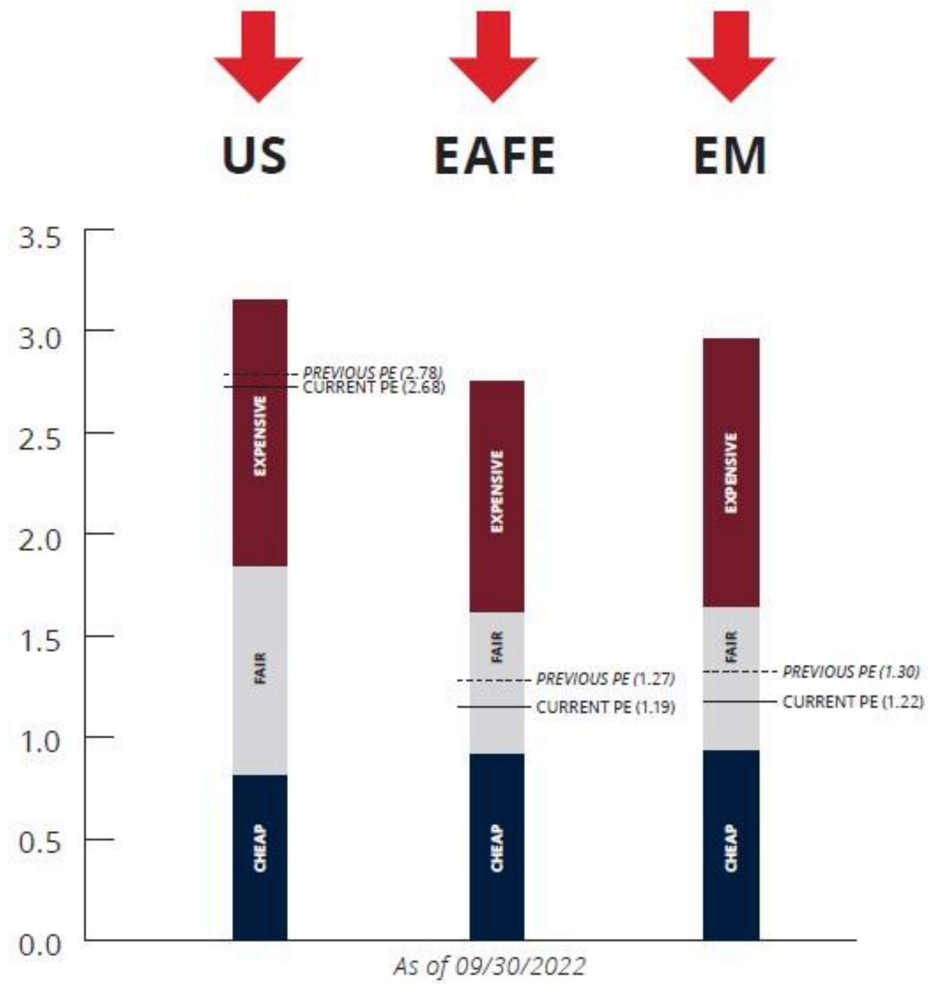
Price-to-Earnings (CAPE)



Price-to-Book Value



Cyclically Adjusted Price-to-Earnings or "CAPE" is a valuation metric, where the current market price is divided by the last ten years of average earnings (adjusted for inflation). The price you pay is what you get, and by utilizing average earnings over a longer period (10 years), we can put into perspective whether the current market price is trending toward expensive, undervalued, or fairly valued historically.

Quarterly Market Summary

Index returns

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	STOCKS				BONDS	
	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q3 2022	-4.46%	-9.20%	-11.57%	-11.12%	-4.75%	-2.21%
Since Jan. 2001						
Average Quarterly Return	2.1%	1.3%	2.4%	2.2%	0.9%	0.9%
Best Quarter	22.0%	25.9%	34.7%	32.3%	4.6%	4.6%
	2020 Q2	**2009 Q2**	**2009 Q2**	**2009 Q3**	**2001 Q3**	**2008 Q4**
Worst Quarter	-22.8%	-23.3%	-27.6%	-36.1%	-5.9%	-4.1%
	2008 Q4	**2020 Q1**	**2008 Q4**	**2008 Q4**	**2022 Q1**	**2022 Q1**

Long-Term Market Summary

Index returns as of September 30, 2022

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	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
1 Year	-17.63%	-23.91%	-28.11%	-20.49%	-14.60%	-9.86%
5 Years	8.62%	-0.39%	-1.81%	0.17%	-0.27%	0.71%
10 Years	11.39%	3.62%	1.05%	3.58%	0.89%	2.21%

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net dividends]), Emerging Markets (MSCI Emerging Markets Index [net dividends]), Global Real Estate (S&P Global REIT Index [net dividends]), US Bond Market (Bloomberg US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Global Aggregate ex-USD Bond Index [hedged to USD]).