Newsletter Update

June 2022

Flower City CAPITAL

Inside

Executive Summary

- Stock and bond markets are both down double digits to start the year - this is normal after three consecutive years of 20%+ returns
  - Markets are adjusting to the absence of pandemic-related stimulus as high inflation and policy normalization has led to rapidly rising interest rates
  - That doesn't mean stocks are cheap, instead they are more in line with historical valuations relative to fundamentals
  - To put things in perspective, US stocks are now near the price levels of last March

- Our outlook is biased to the downside, though we expect strong volatility in both directions
  - Rampant inflation is hurting consumers and requires higher interest rates to combat, which tightens financial conditions and leads to a slower economy
  - We are already seeing higher mortgage rates meaningfully impact the housing market

- Our clients' portfolios remain defensive
  - Since our last update we have been underweight stocks
  - Within bonds, a preference for short-term quality has also added value as rates have risen (prices fall when rates rise)
  - We are beginning to incrementally extend our fixed income interest rate exposure, and are cultivating a "shopping list" as both stock and bond prices become more and more attractive

Relevance to financial plans

All things equal, less expensive markets lead to higher long-term returns and stronger plans. Down markets provide the opportunity to tax loss harvest, streamline portfolios, and potentially upgrade risk positioning for those who have been waiting for a better entry point. We are doing all of these things and remain focused on the true measure of success - meeting your financial goals, not market returns.

Market Movements

Financial markets began the year at all-time highs alongside an extremely strong economy. Stocks were near record high valuations and bond yields were near record lows (yields fall when prices rise). Our January newsletter outlined the implication of lower expected returns from such a starting point.

This year represents the aftershock as investors adjust to the absence of massive pandemic-related government stimulus. Stocks have fallen as bond yields have risen with interest rates and inflation. This is because stocks are riskier investments and therefore require a higher return, which is only possible if prices start from a lower level. Year-to-date through June 10th, 2022 the S&P 500 is down about 18% while international stocks are down a bit less. The Bloomberg Barclays US Aggregated Bond Index is down about 11% over the same period while international bonds are down a bit more.

This selloff is unique in that there has been no place to hide. Stocks and bonds are both down at the same time whereas bonds can typically be counted on to offer some protection. This can largely be explained by the rapid normalization of interest rates (more on that later).

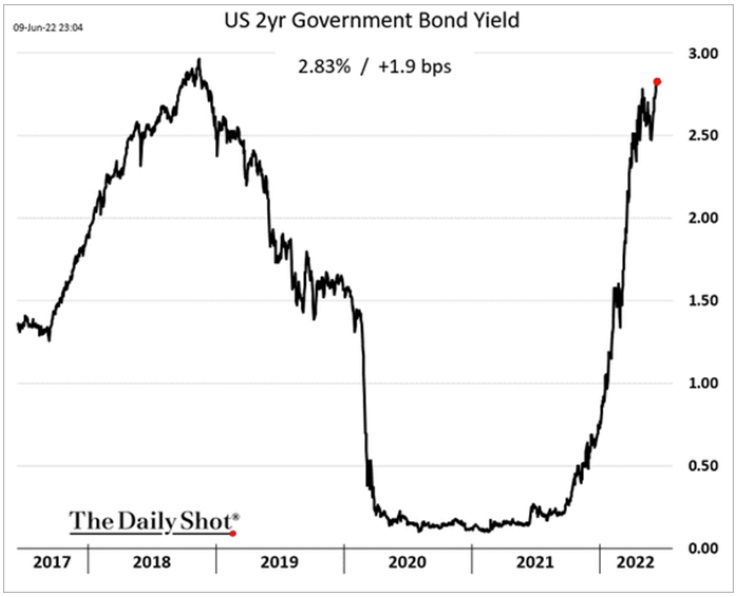
Chart 1

Bonds have offered little protection this year

S&P 500 Down Years (1976 - 2022)			
Year	S&P 500 Total Return (Stocks)	Bloomberg Barclays US Agg Index TR (Bonds)	60/40 Portfolio (S&P 500/Barclays Agg)
1977	-7.2%	3.0%	-3.1%
1981	-4.9%	6.2%	-0.5%
1990	-3.2%	9.0%	1.7%
2000	-9.1%	11.6%	-0.8%
2001	-11.9%	8.4%	-3.7%
2002	-22.1%	10.3%	-9.2%
2008	-37.0%	5.2%	-20.1%
2018	-4.4%	0.0%	-2.6%
2022 YTD	-17.6%	-10.7%	-14.8%
COMPOUND			@CharlieBilello

Chart 2

Interest rates and bond yields have risen rapidly



Stock valuations are in line with long-term averages and prices are back to early 2021 levels

An 18% negative return YTD for the S&P 500 sounds terrible, but it must be taken in context. We had three years in a row of 20%+ returns. As **Chart 3** shows we are essentially back to the levels of March 2021, still with significant gains over the past few years.

Does that mean stocks are cheap and we should be buying? It is true that valuations have fallen closer to their long-term averages (excluding Covid). Average does not mean cheap. Very rarely do markets correct to their averages, they are much more likely to overshoot.

Most of the carnage has occurred in the most speculative parts of the market. Cryptocurrencies, meme stocks, recent IPOs, and unprofitable tech companies have seen considerable price declines, many in the 70-90% range.

Chart 3 S&P 500 Price Level as of 6/10/2022

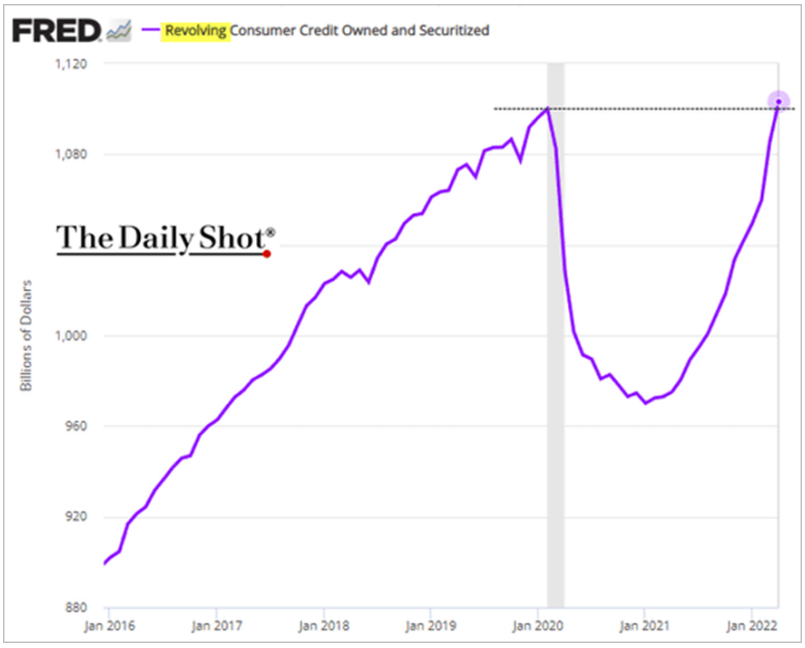
US Large Cap stocks are essentially back to the levels of March 2021

Outlook

No one can reliably predict the many market forces, government actions, and human emotions that commingle to move markets. An experienced portfolio manager we hold in great esteem recently confessed to not having a strong view on where things are headed, and he isn't alone. There are simply no historical precedents for starting at 8%+ inflation with interest rates at 3% with massive debts and aging demographics. It is in this spirit that we humbly submit our observations.

Chart 4

Consumers are saving less and borrowing more as inflation has outpaced wages



We do know inflation will be driving the boat. Consumers are purchasing less on a real basis as inflation outpaces wage growth. We can see this in a plummeting savings rate and rising credit card utilization. **Chart 4** shows revolving credit balances surpassing their pre-Covid highs as people borrow to maintain their spending on everything needed in daily life including housing, food, and healthcare.

Central banks are behind in raising rates to combat inflation. Why raise interest rates? Higher rates increase the cost to borrow money which translates to a reduction in demand. It is a blunt instrument to help slow the economy and typically takes several quarters to start to take effect.

We're already seeing the impact of rising interest rates in the housing market where 30-year mortgage rates are now over 5%. Purchase demand is falling and inventories are rising. This should help to cool the red-hot market where homes have been selling significantly over listing without inspections.

There is a strong correlation between financial conditions and the broader economy with a lag. Based on tighter financial conditions (higher rates, lower stock prices, and wider spreads for riskier borrowers) the economy is expected to slow considerably over the next year. Markets have already priced in this first phase of tightening suffering a significant pullback.

With inflation still strong, the Federal Reserve and other central banks will need to continue raising rates. Markets have not yet discounted this potential second phase characterized by softer growth and lower corporate earnings amidst commodity shocks and a weakening consumer base. We view it as very possible that a recession is coming in 2023.

A few notes on that. A recession is not the end of days, it's a slowdown in economic activity. It may actually be healthy in the long run (though admittedly unpleasant in the short-term) as the current environment is unsustainable. Second, the Covid recession was an extreme shutdown of the entire global economy and led to a massive contraction in GDP. Most recessions throughout history aren't nearly as disruptive.

Of course we all want to know the answer, but markets have a tendency of punishing those in a hurry and rewarding those with patience. We expect the current adjustment period to last another year or two.

Chart 5

Interest rate policy seems to be significantly lagging inflation

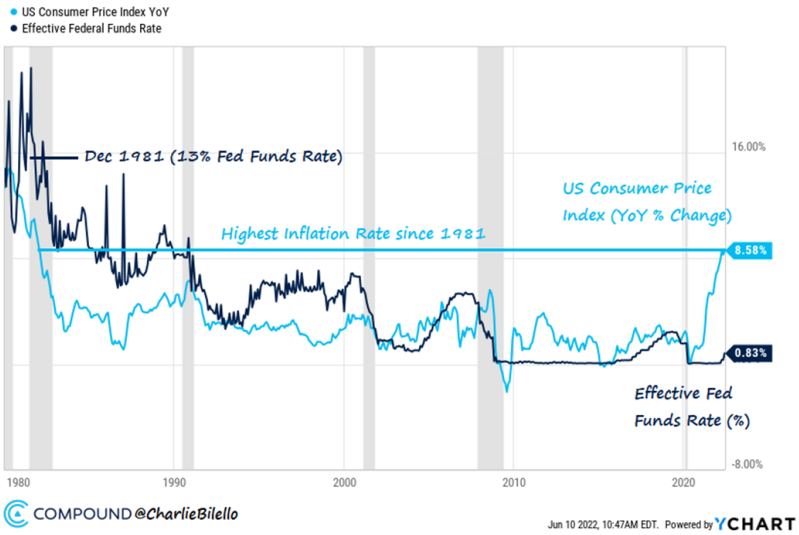
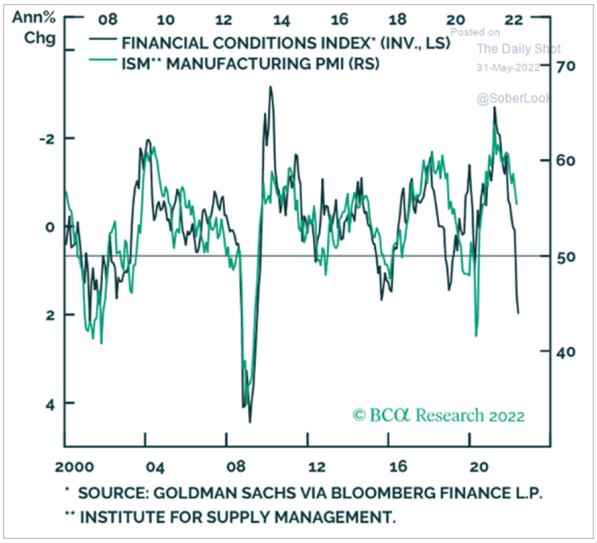


Chart 6

The economy (as measured by PMIs) is expected follow financial conditions lower



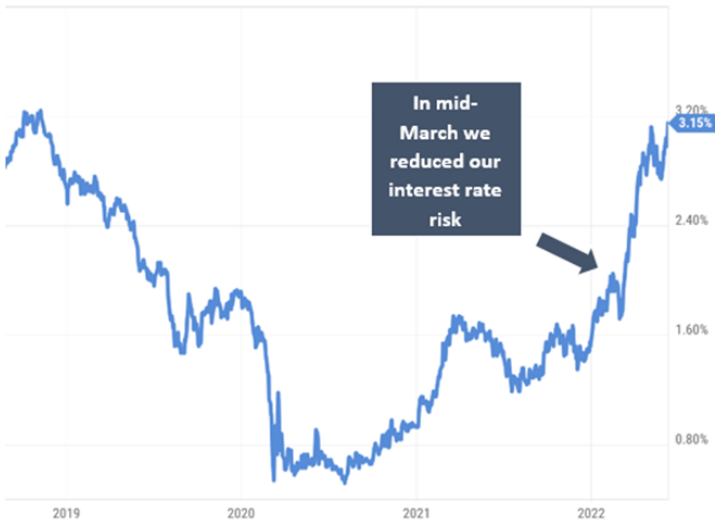
Portfolio Positioning

Since our last update in March, our portfolios have been modestly underweight their targeted equity allocations. We exited our real estate holdings following solid gains in 2021, and made a significant shift in our fixed income exposures toward shorter-term and higher quality government bonds.

These changes have added value to portfolios relative to our benchmarks, though this is a poor consolation when portfolios are down. Our private market investments for those who are eligible continue to perform in line with underwriting, further reducing exposure to market volatility.

Chart 7 US 10-YR Treasury as of 6/10/22

Short-term bonds have added value (less exposure to falling prices and rising rates)



Where do we go from here? We may further reduce risk by taking stocks even more underweight their target. We are also beginning to increase our exposure to more attractive longer-term bonds yields as they have already priced in much of the current tightening cycle. We expect to continue doing so as inflation data begins to roll over later this year.

We are also aggressively cultivating our shopping list of stocks and bonds that we would buy at the right price. Valuations across the board are becoming more compelling and we're seeing one of the best environments for new investments in years. Some of the bonds we've bought in the past are yielding high single digits. It might be possible to re-acquire them at low double-digit yields if the trend continues.

There are no guarantees of course. We expect strong volatility in both directions and will be patiently monitoring for any necessary changes.

Impact to Financial Plans

- We don't expect markets to go up in a straight line every year. In fact, for clients who have worked with us, you know we spend a considerable amount of time running downside scenarios because the true measure of success is meeting your financial goals, not market returns.

- Every challenge has its opportunities. We are using the down market to harvest tax losses from portfolios and have been able to efficiently exit many legacy positions. We even keep some clients on risk upgrade watch should markets correct enough that they feel confident in their plan to increase overall portfolio risk.

- Most importantly, lower starting values and higher interest rates suggest higher expected portfolio returns going forward over time. For those still accumulating, a down market is preferable to regularly add to savings. For our retired clients, we focus on getting the big picture right in terms of overall portfolio risk as well as ensuring sustainable spending levels. Either way, market cycles are unavoidable, and we remain steadfastly focused on your longer-term goals.

Important Disclosures