ZWJ

INVESTMENT COUNSEL

As the third quarter was drawing to a close, the Federal Reserve signaled its determination to fight inflation with the traditional tools of raising interest rates and withdrawing liquidity from the financial markets. The market reacted as expected: interest rates broadly adjusted upward, and asset prices adjusted downward.

The equity markets had already experienced a significant downturn, but earnings expectations had not been significantly reduced. As we have noted in the past, the level of interest rates and inflation impacts equity valuations. Thanks to rising interest rates and rising consumer prices, equity valuations compressed through the summer. We enjoyed a brief market rally in July, but inflation remained high and interest rates continued to creep upward, so it could not last. The Federal Reserve Chairman, Jerome Powell, made it clear in a speech and followed through with interest rate increases that the central bank was determined to push inflation down.

Rising inflation expectations are rippling through Wall Street analysts' earnings forecasts. Naturally an optimistic group, they rarely cut earnings forecasts. In late September, they started reducing their market earnings estimates and bracing for recessionary earnings. Earnings on average over the past fourteen recessions have declined about 30%, but until late September the market earnings estimate had been cut about two percent. ZWJ incorporates multiple scenarios in our equity analysis and portfolio management, so we were more prepared for the change in direction than were passive investors. Indeed, we have found a few stocks that are already near the lows of recessionary scenarios. Most of the Wall Street analysts have yet to adjust their earnings estimates to reflect economic weakness, and the market will incorporate those changes with a focus on earnings. The story stocks have already taken a hit, but economic downturns wipe out stories as earnings take the prime position in equity analysis and valuation.

One factor that continues to show strength is the labor market. There are jobs for those that want one. A cost component for many companies is wage inflation, but this inflation is the one the Federal Reserve would most like to keep in check as it is the hardest to turn back. Yet there are already signs that the jobs picture may be changing, for a good number of companies have announced hiring freezes and even job cuts in an effort to protect their margins.

All of this is a good reminder of why we prefer active investment decisions over a passive index strategy. The market is not monolithic, and there are often opportunities for positive returns even in a difficult market. We do not believe that riding the index wave will be the most successful strategy in the coming decade.

We continue to think that high inflation environments would make defensive investments perform better. We want companies that offer more predictable revenues and offer to share cash flows with investors in the form of dividends. Having said that, we need to make sure our client portfolios also include opportunities for long-term growth even if they do not pay a dividend. The source of those revenues is another important consideration, for conditions in other parts of the world – especially Europe – are much worse than what we are seeing in the U.S. Some of our companies are being marked down for no other reason than their exposure to the European or Russian markets. If the Russia-Ukraine conflict reaches a conclusion, then these markets will re-open and the associated revenue streams should return.

As more market observers begin to admit recession is around the corner or already here, we turn our attention to what it might look like on the other side. The economy got overheated and is now cooling. That's basically what a recession is. It will heat up again. Due to the significant levels of debt issued by governments and corporations, as well as the rising level of consumer credit, we think the heating up process might be somewhat muted. We are not

Continued on Next Page ☞

expecting a V-shape recovery as we experienced in 2020, for at least some of that was spurred on by fiscal stimulus that contributed to the current high levels of debt. Demographic factors also warrant caution when setting future economic expectations. No developed countries are growing organically, so we cannot expect population growth to be a contributor to economic growth.

If growth will slow because of a recession and may not accelerate aggressively due to debt levels and population growth issues, then the recent increases in bond rates might be something to use to our clients' advantages. We have been keeping our average bond maturity quite short, since we expected rates to rise. At times we looked like Vladimir and Estragon waiting for Godot, but unlike Godot, those rising rates finally appeared. The rapid rise is almost shocking, especially in the shorter duration ranges. The 10-year Treasury was under 1.5% a year ago, and it is now over 3.5%. The rate has nearly tripled. The 2-year Treasury was 0.2% a year ago, and it is now 4.2%. An inverted yield curve – when the rate on the 2-year is greater than the rate on the 10-year – is almost always a sign of recession, so those short rates are likely to settle down. Locking in longer-term rates over 3.5% looks to us to be the right move, and we have been extending client portfolio maturities for that reason.

Our approach has done relatively well this year, as we stayed away from the story stocks, the meme stocks, and the momentum stocks. We kept our bond positions in high quality issuers. But returns have been absolutely negative. As one of our clients put it, "We are relatively pleased but absolutely dissatisfied." Losing less does not feel like winning, but we are winning. Decisions to hold back some cash for what we believed was an inevitable market correction have been proven correct. Amid the market turmoil, we might be adding new names or adding to existing names with that reserve cash. Being willing to stand steady while the market streams around you is the mark of a successful investor, and we are willing.

Bear markets are always trying times for investors and their fiduciaries. Bear markets always include sharp rallies and then reversals as investors try to guess when the bear market is done. After over five years of a market based on "set it and forget it," we are moving to a market based on volatility and uncertainty. This outlook may require different management strategies. We may be forced to trade in and out to maximize your investment returns, and we factor in the tax implications of every trade we make in client accounts. We will have investment positions that do not work out, but we will have more that do.

Meanwhile, our clients need to live their lives. Leave the worrying and timing to us; it's part of our service. Rest assured that our attention to preservation of wealth is always paramount in our minds. The assets you have entrusted to us are there for you or your beneficiaries to live on, and we manage them with that understanding.

Charles L. Abney III, CFA • Tres R. Carpenter, CFA, CFP® • Krista L. Cosgrove CFA
Stacey D. Ewing, CFA • Casey J. Flanagan, CFA • Emilie D. Hill, CFA • Clayton F. Jackson CFA • William B. Miller
Geoffrey Neville Jr., CFA • John B. Shepard, CFA • Kevin C. H. Yang, CFA • Bradford S. J. Young, CFA

ZWJ is an SEC registered investment advisor dedicated to serving the investment needs of individuals, families, foundations, and institutions. Every investment account is separately managed and individually tailored with stocks and bonds, in response to a client's unique financial objectives, income requirements, risk tolerance, and tax situation. Inquiries and referrals are always encouraged. This market outlook represents ZWJ opinions. This outlook is subject to change and neither constitutes a recommendation to purchase or sell any security nor engage in any particular investment strategy. The information contained herein has been obtained from sources believed to be reliable but cannot be guaranteed for accuracy.

75 14th Street NE, Suite 2900 | Atlanta, Georgia 30309 | Phone: 404.873.2211 | Fax: 404.873.6424 | zwjic.com