U.S. MARKET REPORT

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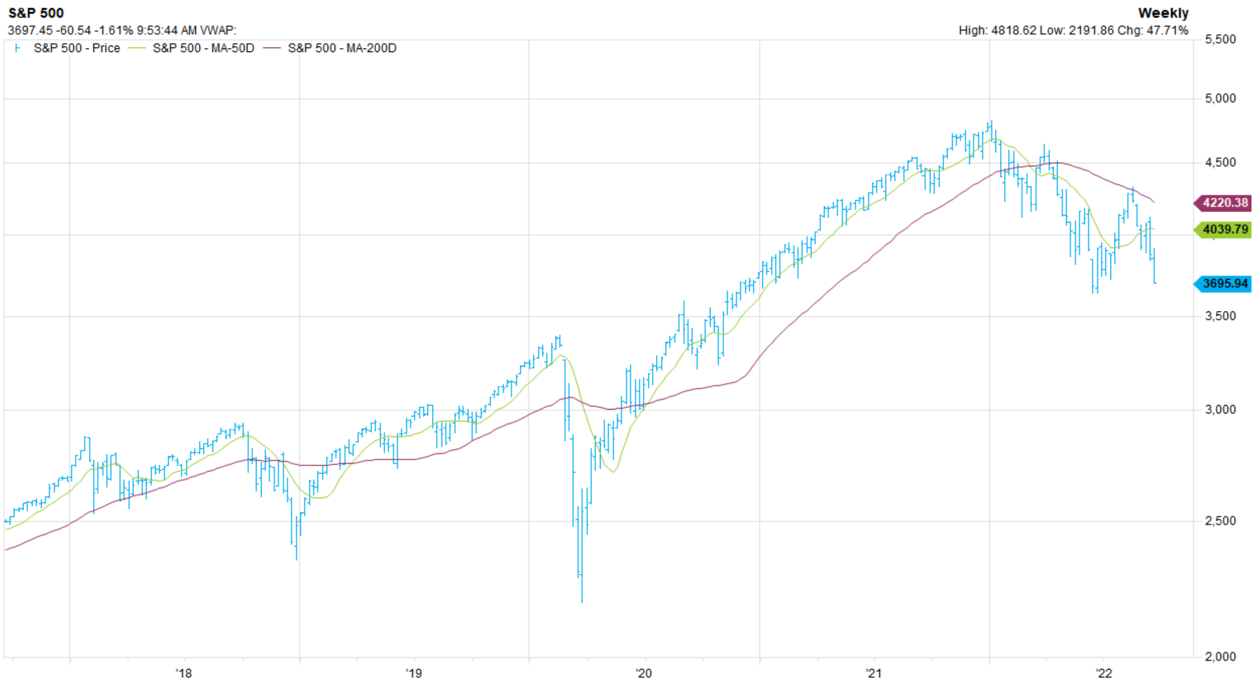
S&P 500



- Inflation is the key fundamental to stock performance, and the August report was a disappointment.

- The markets are now pricing more interest rate hikes, and that high rates will last longer than previously expected.

- The strong dollar will depress international corporate earnings, and higher rates are increasing recession fears.

- Investor sentiment has turned very negative in parallel with declining stock prices. This is a contrarian indicator and would suggest higher prices going forward.

- We remain bullish on energy stocks despite recent declines.

Consumer prices rose 0.1% in August despite a sharp drop in gasoline prices. Excluding food and energy, the CPI was up 0.6% for the month. Both measures were higher than expected, and the gains were caused largely by increases in food, housing, and medical care services. On a year-over-year basis, the CPI was up 8.2%, which is below the 8.5% gain the previous month but, as already mentioned, more than expected. The second level issue is that a high inflation report like this only increases expectations that the Federal Reserve will stay aggressive in monetary tightening.

This past Wednesday the Federal Reserve raised rates by an expected 75 basis points, taking the funds rate to 3.0-3.25%, and the messaging was tough. Expectations have risen, and rates are expected to increase another 125 basis points during the last two Fed meetings this year, which would take short rates to about 4.5%. And now additional rate hikes are expected in 2023 with the peak rate being somewhere upwards of 5%. Also, Fed Chair Powell's comments leaned hawkish. He stressed the important of price stability, emphasized the need to maintain a restrictive stance, pointed out there has only been modest evidence of the economy cooling off, and conceded that combating inflation is likely to require a sustained period of below-trend growth and some softening of labor market conditions. Powell also noted the historical record cautions strongly against prematurely loosening policy.

The U.S. dollar has been strengthening against all the major foreign currencies in a rally stronger than any seen in decades, and the rally is not over. The Fed's determination to bring inflation down through higher rates, along with weaker or no response from foreign central banks, suggests that the dollar will likely continue to rally. The BoE and the ECB have been tightening, but at a slower pace. The BoJ has amazingly stuck to its loose monetary policy of pegging 10-year bond yields, and the Chinese Yuan has weakened as that government fights an unprecedented economic slowdown. The strong USD will help the Fed in its fight against inflation, but it also will have a negative impact on corporate earnings since business conducted in Euros, etc., translate back into smaller USD amounts. On the whole, priority number one must be reducing inflation.

Individual investors have turned very bearish, which is a contrarian indicator suggesting that we may be nearing a market low. For the week that ended September 21, 2022, the survey by the American Association of Individual Investors (AAII) indicated that only 17.7% of those participating were bullish, while 60.9% were bearish. This 43.2 negative spread was worse than the lows seen during the dotcom bust in 2000 and the pandemic, and not far off the -51.4% trough during the Great Financial Crisis of 2008-9. According to AAII, the S&P 500 index has historically gone on to realize above-average and above-median returns during the six- and 12-month periods following unusually low readings for bullish sentiment and the bull-bear spread. It's also worth noting that September has historically been the worst month for stock prices, while the fourth quarter has been the best.

What could turn this bear market around? Some good inflation news. Bank deposits and other measures of the money supply are now in decline. Just as the poor August inflation report caused despair in investors and heightened concerns of rising rates, a good inflation report could cause excitement and a willingness to take on risk in the expectation that the end of this cycle is in sight. Today's economic conditions are unprecedented, and we remain cautious, but the negativity we now see does remind us of the sentiment during past bear markets. For sure, the Fed will crush the inflation. It's only a matter of time. Slowly adding to positions as prices decline typically works out well when later reviewed after a new market cycle commences.

Oil prices and energy stocks have been falling but we expect prices to rebound in the year ahead. Established in 1975, the U.S. Strategic Petroleum Reserve (SPR) is now at its lowest level since December 1984. Nearly 7 million barrels of oil were released in the week ended September 16th as part of an ongoing effort by the Biden administration to lower energy prices before the elections on November 1st. Oil inventories are still low, but they would be much lower, and prices would be higher if not for such oil releases. Also contributing to the recent weakness in oil prices is the economic slowdown in China as that country has had restrictions on movement and business because of their no Covid policies. Recession fears elsewhere have also come into play. Nonetheless, the election will be over, and the U.S. will start refilling the SPR in 2023 most likely. Furthermore, there are other supply issues still on the horizon because of the Russian-Ukraine war. China will also likely get its footing at some point. Energy stocks remain inexpensive and are generating lots of cash even at these lower prices. We remain positive and think they are a good contrarian investment.