INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 3RD QUARTER 2022

The ACM Journal

A little help from our friends

Many of you know that our middle kiddo, Amer, was diagnosed with epilepsy a few years ago. He still lives a pretty normal life, but the combination of seizures and medication side effects have impacted him. His grades have slipped, his athletic performance isn't what it was a couple years ago, and he can't ride a bike or do any other activity where he could get hurt or harm others if he had a sudden seizure. He is also a 16-year-old, with no immediate prospect of being able to drive.

Despite the challenges, Amer has largely taken it all in stride. In fact, rather than dwelling on the limitations, he decided he would like to turn his experience into something positive this summer, with only a little prodding from his mom and me. That was the genesis of "Amer's Epilepsy Trail Run". He organized a 5k and 10k running race on the trails at Mendon Ponds Park. All the proceeds went to support EPI, Inc. which is the local epilepsy center. Amer recognized that while he has some limitations, there are many others in much worse situations than him, with uncontrolled seizures and severe restrictions on how they live.

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Portfolio Review

The stock market fell for a third consecutive quarter, adding to its losses for the year. After a slight rebound to start the quarter, gains reversed sharply in September as the S&P 500 fell by more than 9%, making it the worst month for the index since the Covid downturn of March 2020. International stocks fared worse than domestic stocks this quarter as the strengthening US Dollar continued to pressure returns. The rout in the bond market also extended into the third quarter, with the yield curve elevating to higher levels after two additional 75 basis point rate hikes by the Fed.

Persistent Inflation

Inflation was yet again a primary driver of weak performance in both stock and bond markets. The Fed remained aggressive in its fight to curb inflation with short-term interest rate hikes and a reduction in the size of its massive bond holdings, which also drains liquidity from the economy. Many countries are currently engaging in similar monetary policies, including the European Central Bank, which raised its rates above 0% for the first time since 2016. Despite efforts globally to reduce inflation, high readings persist. As energy prices eased in June, overall US inflation dropped from its recent high of 9.1%, but it remains at a historically elevated level. Core inflation, which excludes volatile food and energy prices, continued to rise throughout the quarter.

Interest rate hikes by global central banks are meant to deter consumer spending when the economy is overheating. While pent-up demand was the primary driver of inflation in the previous year, it appears to be less of an issue now as indicated by two consecutive quarters of negative real GDP growth. Now it seems supply disruptions are inflation's primary driver, so monetary policy tools may become less effective (see a further discussion in *The Bear Case*). In any event, actions by the Fed take some time before their intended effect on inflation is most impactful, so inflation could be around for a while even in the best-case scenario.

Earnings Forecast

Earnings growth for the S&P 500 has come down from its rapid rebound coming out of the pandemic. Inflation's impact on input costs is a primary reason. While earnings growth is still positive, analysts have been making downward revisions to their earnings estimates for the third quarter and into 2023. Recent movements in economic indicators such as the strengthening of the US Dollar and fall of the ISM Purchasing Managers' Index are historically correlated with weaker earnings growth. Not surprisingly, recessions often coincide with reduced corporate earnings.

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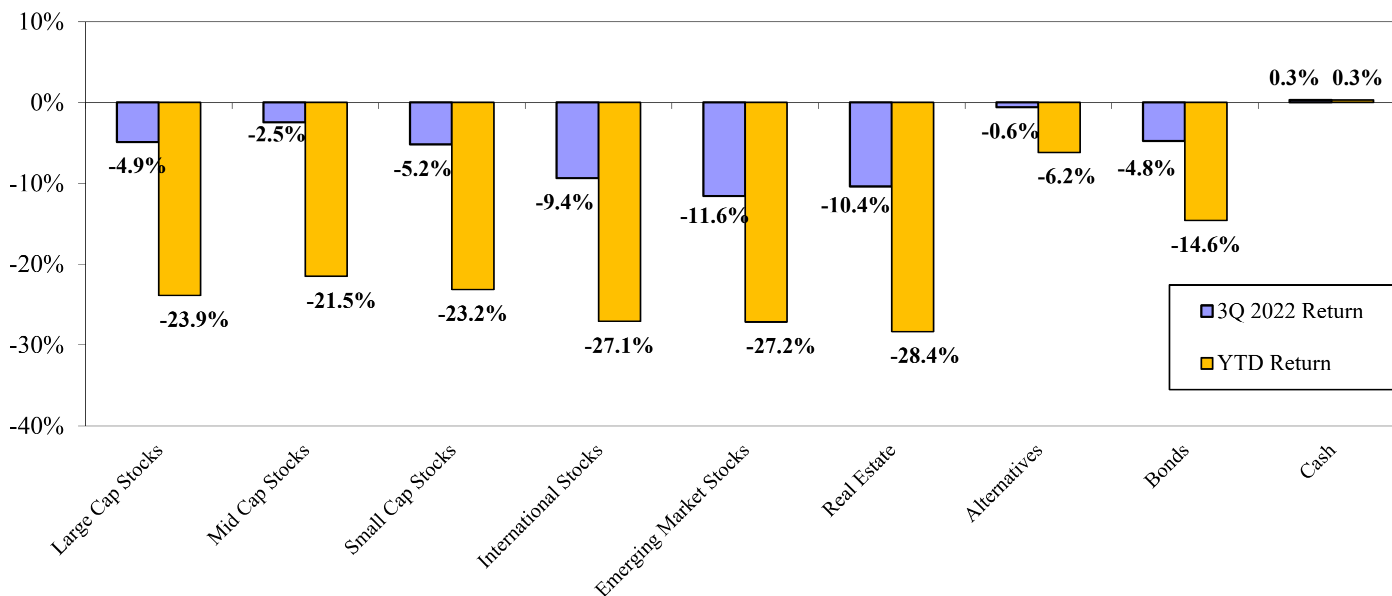
Third Quarter 2022 Asset Class Returns



Large cap, mid cap, and small cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones US Real Estate Index. Bonds are the Bloomberg U.S. Aggregate Bond Index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Cash is the yield on the 3-month T-Bill.

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Factor and Sector Performance

Stock market factors, including segments such as value, momentum, low volatility, and high-quality stocks, trailed overall stock market performance in the third quarter, but are still performing well for the year-to-date period. Large-cap value and low-volatility stocks are both outperforming the S&P 500 by roughly 10% so far this year. Strong performance for the value factor was driven by an overweight in energy stocks and underweight in technology stocks, which were the best and second worst performing sectors year-to-date. A similar dynamic was true for the low-volatility factor, which was overweight utilities and also underweight technology.

Valuations Looking More Attractive

The decline in stock prices has eased valuation ratios that were at historical highs. The CAPE ratio, a measure used to evaluate whether the market is undervalued or overvalued relative to long-term earnings, has fallen from 38 to 28 this year. The trailing twelve-month price/earnings ratio for the S&P 500 is down to around 18, while broad small-cap and international indices have price/earnings ratios in the 10-11 range, making them historically cheap. Lower starting valuation metrics bode well for higher forward-looking returns. But this is generally true over longer periods and does not mean that there is no more downside in the near-term. Additional downside is certainly plausible, especially considering the potential for a slowdown in corporate earnings.

Even if the market continues to slide, we'll focus on rebalancing and maintaining long-term diversification, and tax-loss harvesting. These are more powerful strategies than trying to move in and out of the market. For example, investing in the S&P 500 immediately before the Great Financial Crisis of 2007-2009 would have resulted in short-term losses of over 50%. Still, that same ill-timed investment grew at an annualized rate of more than 7% over the next ten years. We understand that market conditions for stocks and bonds this year have been painful but staying the course during turbulent times has proven beneficial in the long run.

The Bear Case

The field of economics is often referred to as the dismal science. Today's environment certainly helps us understand that moniker. Inflation is running amok, interest rates are moving aggressively higher, stock and bond markets are both down considerably, and we may already be in a recession. It is not hard to paint a picture of more downside ahead.

All eyes have been on the Fed lately to cure these problems, notably by curbing inflation so the economy can resume a more normal growth trajectory. To do so, the Fed has raised short-term interest rates from close to zero percent less than a year ago to over 3% today. The Fed adjusts interest rates largely in reaction to expected inflation; raising rates when inflation is hot and lowering rates when inflation cools. Many economists believe the Fed is behind the eight ball currently as inflation rages, and indeed some even blame the Fed for causing our current predicament.

The most basic definition of inflation is often summed up as too much money chasing too few goods. If you think this through, there are two ways inflation can spiral out of control: too much money in circulation causing excessive demand, or supply constraints weighing on the availability of goods. Today's inflation has both excessive liquidity and reduced supply. To confront excessive liquidity, the Fed can increase interest rates and engage in "open market operations" like quantitative tightening. Both of those are going on now, and the Fed has pledged to continue until inflation is under control.

The problem is that the Fed can't really do anything about supply constraints. In fact, it may make matters worse. By raising interest rates, the Fed will likely slow economic growth, perhaps even to the point of a nasty recession. If growth slows, corporate profits take a hit, unemployment rises, and there are fewer resources available to produce goods and provide services, further reducing supply. Reduced supply could result in even higher inflation.

The other problem is that the Fed is not the only actor in this drama. While monetary policy is important, fiscal policy also plays a big role. Unfortunately, while monetary policy is restrictive, fiscal policy is still very expansive. The CHIPS Act, passed last month, will result in $39 billion of new spending. The recently passed Inflation Reduction Act authorizes $391 billion in new spending, only somewhat offset by new revenue streams. And President Biden's executive action forgiving student loans could, by some measures, unleash an additional $400 billion or more into the economy. We offer no comment on the social merits of these initiatives but note that this increased liquidity will, at least to some degree, offset the Fed's efforts to curb inflation.

Federal, local, and international government policies are also weighing on supply. There have been few new permits for energy production this year, despite elevated oil and gas prices. This is an issue in the U.S., but even more acute in Europe where Russian energy has been cut off. Environmental restrictions make it hard to build new homes in many parts of the country, despite record-high home prices. And restrictions on farmers have led to unrest in Sri Lanka, the Netherlands, and Canada, and have also resulted in reduced food production, despite wheat trading near the highest levels in over 50 years. Some believe the solution to these issues is to transition away from fossil fuels, and that may solve some problems, but it could create others. For example, electricity is already in short supply in some markets, and it is unlikely there will be enough lithium and other materials if everyone starts driving electric cars, using electric lawnmowers, and moving aggressively away from petroleum-based products. It is also unlikely permits will be issued in much of the developed world to produce more of these minerals given the environmental impact of mining.

Unfortunately, that leaves us in a situation where inflation may persist despite the Fed's best efforts. Those efforts will almost certainly slow the economy, so a stagflationary situation reminiscent of the 1970s cannot be ruled out.

What does that mean for the capital markets? In a word: volatility. The stock market hates uncertainty, and there is plenty of that, both now and likely in the future. Stocks historically do ok during periods of high inflation as asset prices also rise. However, slow economic growth is not conducive to stock market gains. Bonds could also rally from here, despite the Fed raising short-term interest rates, particularly if it raises rates too far and the economy tips into recession. But those scenarios are far from certain.

It is possible that we're wrong in our assessment and the Fed will be able to engineer a soft landing. Still, the Pollyanna approach seems unlikely, so it is best to be prepared for a new era of increased ups and downs across all asset classes, and further declines in stocks.

The Bull Case

There's a lot of doom and gloom in the economic news lately, including in our newsletter articles. There is much to worry about, but that doesn't necessarily imply a disaster is coming. In fact, history is pretty clear that when all the "experts" are in agreement about a future event, the opposite transpires.

Today, market sentiment is about as bad as it gets. The black line in the chart below shows how individuals and institutional investors feel about the prospects for the stock market. It is almost as low as it was in 2008. That is not terribly surprising given how both stocks and bonds have performed so far this year. However, sentiment tends to be a contrary indicator. Usually when sentiment is at its worst, the market is making a bottom and it is about to rebound. Indeed, looking at the low point for sentiment in 2008 shows that it bottomed just about the time the stock market (the blue line on the graph) was also making a bottom. So, with everyone sure that the market is going to get worse, it could be time to start thinking about a rebound.

There are some other reasons to be optimistic, including valuation. The stock market is not particularly cheap right now, but it is well off its high of late last year when the Cyclically Adjusted Price/Earnings (CAPE) ratio was 38. It currently stands at 28 for the overall U.S. stock market, still well ahead of the longer-term average of 17. However, there are segments of the stock market, including value stocks, international stocks, and small-cap stocks that are far cheaper. It is certainly possible that investors start to take advantage of these lower valuations, driving stocks higher from here.

It is also possible that a "short squeeze" could move stocks higher in the near term. When sentiment is as dismal as it is today, generally some investors, particularly hedge funds, will take short positions on the stock market, hoping to profit from further price declines. However, if prices move higher, those funds often act to stop their losses by repurchasing the stocks they sold short. That additional buying pressure could result in a quick rebound higher for stock prices.

It could also be that stocks move higher from here because there aren't really any great alternatives for investors to park money. The bond market has not been the safe haven it has historically been during times of stock market duress, and investors are giving up on bonds

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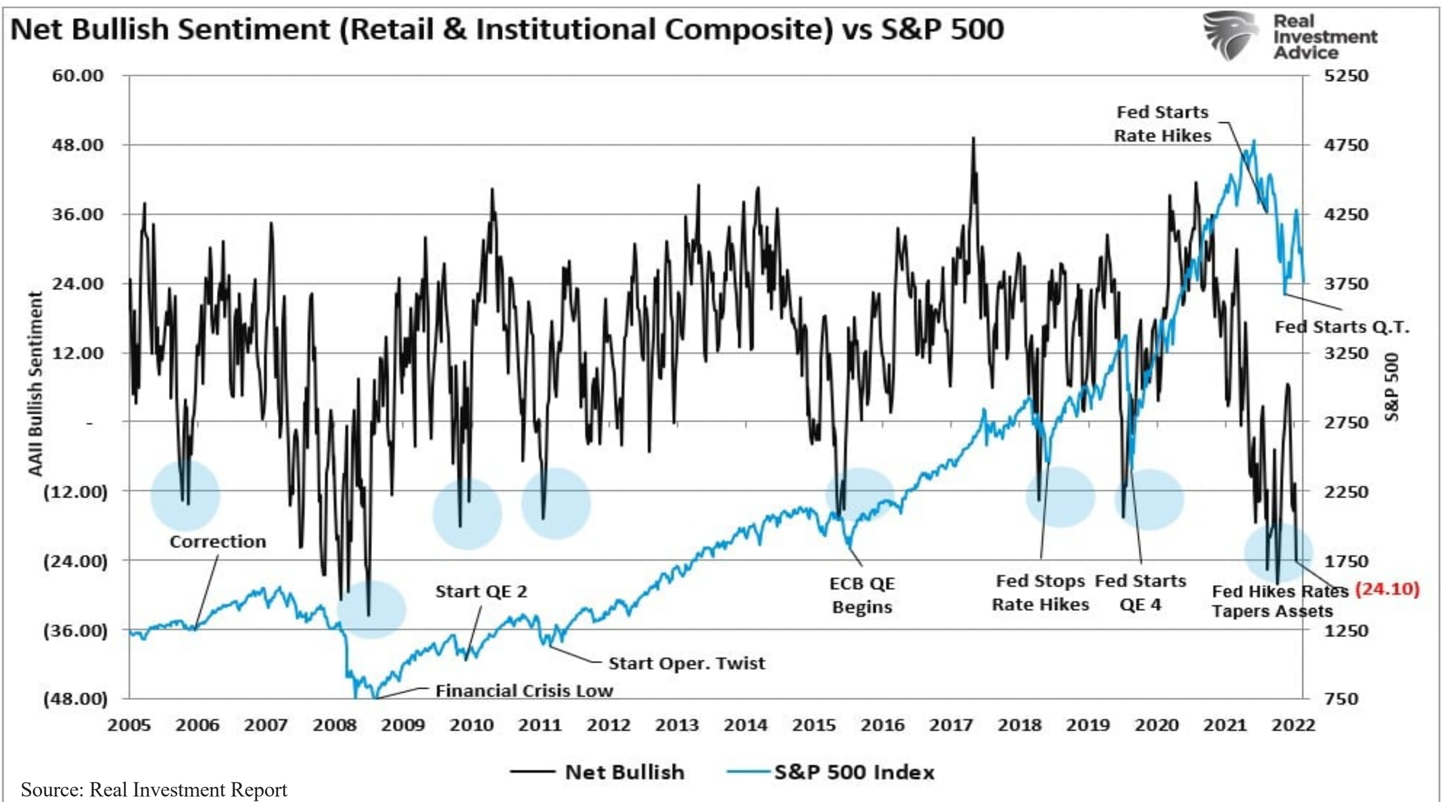

Source: Real Investment Report

Diversification Still Works

We have laid out both positive and negative cases for the capital markets in this newsletter. That certainly represents a lack of conviction about where the capital markets are heading. No one ever knows what the future holds in the investment world, but uncertainty seems extreme today. What's the best approach in such an environment?

In the investment markets, desperate times call not for desperate measures, but rather for shopworn advice that often seems hopelessly quaint. You guessed it: diversification.

Over the past almost 15 years, diversification was a fool's errand. Simply buying the largest, techiest, US-based stocks would have yielded the largest rewards. Why bother with small-cap stocks, international diversification, or Warren Buffett's precious value stocks (what does that old coot know anyway)? FAANG[1] stocks were all that were necessary to earn market-beating returns.

That has been true in other periods as well. The Dot Com Boom was a similar era of focus and concentration. Not putting all one's eggs in one basket risked missing out on technology's golden goose. Just as today, the phenomenon persisted long enough to make those of us building diversified portfolios look like Luddites.

Diversification also can look foolish during down markets. For example, when the Global Financial Crisis of 2008 hit, seemingly everything went down: stocks, commodities, junk bonds, international investments, etc. Diversification still seemed not to matter. After all, the only thing that goes up in a bear market is correlation.

However, many of the news stories in the wake of the last protracted downturn, and there were many, declaring the death of diversification missed one important point. Bonds went up 5.5% in 2008. That might not seem like much, but high-quality bonds were a welcome addition when stocks and other "risk on" assets were generally down 30% or more.

Today, after a long run of growth stock outperformance, we're seeing both stocks and bonds decline in tandem, again calling the value of diversification into question. This is unusual, as bonds typically save the day when stocks crater, as in 2008. However, there has been a place to hide this time, as many alternative assets have performed quite well. So-called managed futures funds, style premia funds, and even some private real estate funds have performed admirably so far this year.

These investments are off the beaten path for many investors, but they make the case that even in the worst of economic storms, there typically are some safe harbors.

It is also likely that small-cap, value, and international stocks will come to dominate returns in the coming decade, primarily because their valuations are so much lower than the tech stocks that have been overbought Wall Street darlings for far too long.

So, while it is trite, diversification is your best bet for an environment marked by the multiple cross currents of inflation, rising rates, recession, geopolitical events, and a heightened risk of a financial crisis. It will also result in stronger performance when investments ultimately recover.

[1]FAANG stands for Facebook, Apple, Amazon, Netflix, and Google. These were some of the best performers during the most recent bull market.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, NY, ACM is employee owned, independent, and minimizes conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

The Bull Case

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with the prospects of additional rises in interest rates (which drive down bond prices). T-bills yielding 3% to 4% are far more compelling than they have been the past few years, but still are not keeping up with inflation. So, a long-term allocation to stocks continues to make sense, and could put a floor under further stock market declines.

Finally, the much discussed "Fed pivot" could transpire. The Fed has been raising short-term interest rates to battle inflation. Rising rates drain liquidity from the economy and hurt the valuations of both stocks and bonds. However, there is a growing chorus of economists singing that the Fed has gone too far too fast and that it will have to reverse course as it tips the economy into recession or causes a financial crisis. The Fed is not giving any indication of that so far, but history does show the Fed cutting rates when economic pain sets in. A cut in interest rates would likely move stocks considerably higher in short order.

This is not to say that we're feeling terribly optimistic these days, but there is a case to be made that most of the damage in the stock market is past and there are some catalysts for a rebound from here. That is not our base case assumption, but this is the first time in a few months that we have been able to make even a modestly bullish case. That could mean we're getting closer to the bottom.

A little help from our friends

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I certainly helped with the project, as did the rest of our family, but Amer was right in there with the fund raising, asking for sponsorships, encouraging runners to sign up, as well as planning the route and other logistics. It turned out to be a huge endeavor that surpassed our expectations, thanks largely to the support we received from many different corners of our lives.

I thought we might be able to raise $30,000 if we were lucky. In the end we grossed over $70,000. We had hoped to get our friends and others in the local endurance sport community to join us, but we ultimately had 156 registered runners.

Beyond just the numbers, the event was truly touching. We had family, friends from many spheres of our lives, business connections, and classmates come out to run and volunteer. The architect from our home renovation five years ago heard about the run and came out. So did a guy who worked next door to our office for a few years. People seemed to come out of the woodwork, and the support was overwhelming.

It was also a great experience for Amer. He learned a lot of new skills and even had to be interviewed on TV a couple times. The videos are out there if you want to see him, and me, looking very uncomfortable in front of the camera. At the urging of a journalist friend, Amer wrote an essay about his experience with epilepsy for the Rochester Beacon, which also helped draw a lot of attention to his event.

In the end, it was a great and emotional day for us all. Our whole family ran the race. Amer won his age group for the 10k race. I jogged very slowly, exhausted from all the planning and perhaps a little worn out from having already run the 10k once that morning with my older son to set up flags to mark the course.

EPI was great to work with and they were thrilled with the success of the event. We were very happy to be able to support them but seeing Amer succeed and overcome his obstacles was certainly the best part for Nipa and me.

Armbruster Capital Management, Inc.

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