THE OPTIMIZED PORTFOLIO SYSTEM®

# 2nd Quarter 2022 Market Commentary

## *Markets Fall this Quarter, Amidst Economic Concerns*

As a cheerful reminder, the S&P 500 advanced 29% in 2021, leading us to start 2022 at all-time highs. However, as we headed into this year, markets could not fight off the continued economic headwinds any longer. After rallying in March to post 1st quarter results down only −4.6%, the S&P 500 fell another −16.1% in the 2nd quarter. With the index declining 20% in the first half of this year, 2022 will go on record as the worst first six months since 1970. Having achieved the 20% drop definition during the quarter, we can officially pronounce US stocks hit a bear market.

As you can imagine, the Portfolio Management Team has been very active this year monitoring, evaluating and opining on markets and the economy. Likewise, we have been using our tools, resources and experience to navigate markets with our best efforts. Overall, we are pleased to report the strategic allocations of TOPS have added marked value so far in 2022 versus the S&P 500 and US Aggregate Bond Index. TOPS investors have benefitted primarily through a high level of strategic diversification among stocks and tactics employed to reduce the impact of interest rate rises on bonds.

After discussing Q2 2022 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) How did we get here?
2) What should we do now?
3) What are we watching for?

*Year-To-Date Markets Review*

Equity indexes continued their negative returns into the second quarter. Value stocks (S&P 500 Value) far outperformed growth stocks (S&P 500 Growth), returning −11.3% and −20.8%, respectively. Large cap equities (S&P 500, −16.1%) underperformed both midcap (S&P 400, −15.4%) and small cap (S&P 600, −14.1%). Emerging markets (MSCI Emerging Markets) returned −11.4%, outpacing developed international (MSCI EAFE), which returned −14.5%. Real estate (MSCI World Real Estate) and natural resources (S&P GSSI Natural Resources) were both negative, down −14.7% and −10.4% respectively, in the second quarter.

With another rocky quarter, most equity indexes are showing double-digit negative returns year-to-date. A noted exception is natural resources. The S&P GSSI Natural Resources Index has returned

+15.9% so far this year. Value stocks (S&P 500 Value) returned −11.4% and are outperforming growth stocks (S&P 500 Growth), which have returned −27.6%. Small cap (S&P 600, −18.9%) is slightly outperforming midcap (S&P 400, −19.5%) and large cap (S&P 500, −20.0%). Emerging markets (MSCI Emerging Markets) returned −17.6 %, outpacing developed international (MSCI EAFE), which returned −19.6%. Real estate is also negative year-to-date, down −19.7%.

Much like the first quarter, rising rates led to broadly negative fixed income returns for the second quarter. The 10-year US Treasury yield increased from 2.32% to 2.98%, driving the Bloomberg US Aggregate Bond Index to a −4.7% return for the quarter. With the 10-year Treasury yield nearly doubling in the first six months, the performance result has been a double-digit loss of −10.3% for Bloomberg US Aggregate Bond Index to start the year.

The fixed income trends of the first quarter continued in second quarter (Q2) with credit (ICE BofA US Corporate Index, −6.7% Q2; −13.9% YTD) underperforming government (ICE BofA US Treasury Index, −3.8% Q2; −9.2% YTD), and shorter duration (lower interest rate risk) holdings outperforming longer duration (higher interest rate risk). This was seen in both credit markets, with the Bloomberg US Corporate 1-3 year (−1.0% Q2; −3.5% YTD), and government markets, Bloomberg US Treasury 1-3 Year (−0.5% Q2; −3.0% YTD), where the shorter duration indexes outperformed the previously mentioned full duration indexes. While returning −3.0%, TIPs (Bloomberg US TIPs) underperformed their nominal Treasury counterparts for the quarter but have slightly outperformed for the year, returning −8.9%. High yield (Solactive USD High Yield Corporates, −9.9% Q2; −13.8% YTD), international bond indexes (Bloomberg Global Aggregate ex-USD, −5.2% Q2; −10.0% YTD), and investment grade corporates (iBoxx USD Liquid Investment Grade Index, −8.6% Q2; −16.2% YTD) were also negative for the quarter, adding to the losses for the year.

*How did we get here?*

The economy and markets are in the midst of an important transition. Markets over the last ten years were largely driven by a solid underlying economy, with an unprecedented amount of monetary stimulus from the Fed. There was a combination of several types of stimuli provided, along with low interest rates, which helped stocks sell at multiples (valuations) above historical averages. When this happens, it means investors are willing to pay ahead (sometimes several years) for earnings. Specifically, many of the FAANG (Facebook, Apple, Amazon, Netflix & Google) stocks reached sky high valuations that were greater than 50 times earnings.

Some are now calling those valuations a “bubble,” and others are just waiting on a rebound to previously attained “bubble” prices. While it will take some time, history may prove we were in fact in a stock market bubble, especially in some of the tech and FAANG stocks. Although bubbles are nearly impossible to pronounce until after they pop, we have written consistently about these high valuations for the last several years.

Economics 101 textbooks would dictate pumping massive levels of stimulus into the system will create inflation. Inflation can be seen in many ways. Some would argue the “bubble” prices in tech stocks were a proliferation of inflation in equity prices. However, since it took a long time for inflation to register in traditional measures (such as CPI), some felt we were truly getting a free lunch. This was the basis of a relatively recent economic idea called Modern Monetary Theory (MMT). While there are nuances, MMT is based importantly on the idea the government should pump as much stimulus as possible until inflation comes. The ride up was fun, but we believe we are experiencing the raw reality of MMT and it is proving to be painful if they go too far. As an example, in hindsight, the 3rd congressional stimulus package may have been completely unnecessary and instead acted as fuel on the fire we now must put out.

The abnormal situation also created the “bad news is good news” environment discussed over the past few years. This may have contributed to the Federal Reserve’s hesitancy in acting to slow inflation this year. Even as abnormally high inflation began to materialize in reports, the Federal Reserve was slow to act.

The Fed is now admittedly behind the curve in cooling inflation, but it is not a simple error to correct. The Fed’s top tool for reigning in inflation is their ability to raise the Fed Funds Rate; however, rate rises take a while for the effects to kick in and have less impact on headline inflation (including food and energy). Further, since they have acted imperfectly so far, it increases the odds they are not able to navigate the rest of the task craft fully enough to avoid recession. Some even believe we are already in a recession, which will be labeled such in the future. If that is the case, it would be a unique recession, from a definition standpoint.

*What should we do now?*

According to the National Travel and Safety Board (NTSB), flying on private airplanes is much more dangerous than commercial aircraft. On large, commercial aircraft, fewer than 0.01 fatalities per 100,000 flying hours occur. On private aircraft, including recreational pilots, there are more than 2.3 fatalities per 100,000 hours flown. Therefore, it is at least 230 times safer to fly large commercial jets than private aircraft. By far, pilot error is the most cited reason for crashes in private travel.

We feel there can be some similarities between what we are able to provide as professional money managers and the overall benefits of professional air travel. While we could write an entire book about this idea, we can summarize some of the benefits we see down to experience, tools and process.

We are fortunate to have over 50 years in combined investment management experience on our current Portfolio Management Team, which does not account for the long list of additional experienced managers who have contributed to TOPS as former Team members or contributors.

When managing portfolios, we use a combination of professional tools and processes, which have been honed over the last two decades of serving our investors. While an amateur investor may make decisions in a silo (based on one idea or variable), or be significantly impacted by emotion, we typically approach decisions much differently. In addressing the question, "*What should we do now?",* we felt it would be helpful to look behind the curtain a bit and discuss some of our thoughts and the actions we are taking to best serve our investors.

First, we are able to reference sound economic and financial theories (and rules). The three of us on the Portfolio Management team have built this base of knowledge through our combined four financial degrees and four financial designations, along with ongoing daily reading and studying. As part of our investment process, we monitor thousands of variables across the economic and financial landscape as inputs into our decision-making activity. This knowledge base enables us to quickly digest financial information and ascertain the impact on our portfolios.

While sound theories always serve a purpose, in many ways, the last ten years in the market have been very abnormal through this traditional lens. The incredible impact of the Federal Reserve over the last decade distorted free financial markets and the way some economic and financial news impacted markets. Decades ago, finance textbooks did not talk about a Federal Reserve stimulus driven "bad news is good news" scenario. We had to use our base of knowledge to work through this unique environment. Going forward, as the Fed is pulling back their economic steroid drip, these rules and theories should be exhibited more clearly in market results. When managing portfolios, decisions become clearer when you are not continually dealing with Fed surprises like the consistent Fed put reality.

A second valuable tool is portfolio and economic modeling, including capital market assumptions and shock analysis. These tools are forward looking. With these tools, using sound economic & financial theories as a base, we can think through and develop different probable scenarios we see going forward. For example, in November 2021, we wrote an article for ETF.com where we highlighted the risks we saw in large cap growth stocks and longer-term bonds. Our modeling and shock analysis (running unfavorable scenarios for risk purposes) led us to believe there was above average risk in those asset classes. Therefore, coming into the bear market of 2022, we were fortunate to have an overweight to value stocks in our more conservative portfolios and a 50/50 allocation to growth/value in our more aggressive portfolios. These allocations have benefited our investors as the bubble in large growth stocks has popped (at least for now). Further, we recognized we were likely to enter a painful phase of rising interest rates. Therefore, we reduced our interest rate risk over the last few years. This decision has translated directly into our bond allocations outperforming the US Aggregate Bond Index so far this year. For example, the fixed income allocation in TOPS Balanced has outperformed the US Aggregate Bond index by nearly 4% (gross) year to date. Likewise, a recent review of a TOPS Balanced allocation over the last 15 years showed gross annualized outperformance of the TOPS fixed income allocation (6/20/2007 – 6/30/2022).

In our modeling, we track eight different valuation metrics monthly going back as far as 20 years and then rank them on a percentile basis. While valuations can be a poor indicator of short-term results, current valuations are one of the strongest indicators of future results over longer periods (10+ years). We feel this modeling bodes well for our TOPS allocations going forward. Large cap growth stocks are currently MORE expensive than they have been 71.4% of the time in the last 20 years. Though, many other asset classes TOPS holds are trading at much more attractive valuations. Small cap stocks, for example, are LESS expensive than they have been 99.6% of the time in the last 15-20 years.

A third tool we rely upon as part of our process is portfolio optimization. The acronym TOPS stands for The Optimized Portfolio System. Portfolio optimization strives to provide optimal levels of expected return for each unit of expected risk. In other words, when building our allocations, we strive to provide our investors with as much return as possible for the level of risk they are willing to accept. Portfolio optimization is long term and strategic in nature. Short-term (less than 12 months) returns do not typically affect optimization unless an asset class inherently changes. However, we are constantly thinking about how the inputs to our portfolio optimization process should be altered and how those changes impact investment decisions. We often say, “don’t mention return without mentioning risk in the same sentence.” As we manage through markets like 2022, we remain focused on how our decisions impact longer term portfolio optimization, not simply very short-term returns.

A fourth tool is historical reference and experience. In investing, “this time is different," often fails to be true. Therefore, while we feel it can be unwise to rely too much on historical references, they should absolutely be an input. For example, we looked back to World War II economics to learn more about inflation. According to Morgan Housel, author or "The Psychology of Money," 11% of the U.S. population, with an average age of 23, served in World War II. About half served overseas, with the majority returning home within 18 months after the end of the war. As the heroes returned home, the U.S. experienced a temporary period of double-digit inflation. Despite the Federal Reserve helping to keep the 2-year treasury below 2% for 10 years after the war ended, inflation was able to return to earth as supply caught up.

In that period, we had great demographics, rising wages, improvements in productivity and strong consumer spending. These attributes helped carry the economy into the early 70s. In 1973, it all changed, inflation spiked and didn't recede, remaining elevated for much of the next 10 years.

Eventually, famed Federal Reserve President Paul Volcker raised rates to fight runaway inflation, causing a recession. By 1984, Ronald Reagan was able to say, "This afternoon 6500 young men and women will be married, and with inflation at less than half of what it was just four years ago, they can look forward with confidence to the future."

Paul Volcker was able to break the back of inflation, but not without the pain of recession. Now, the Fed is trying to do something similar, but hoping not to create the recessionary pain. Sure, times are different now. The heroes returning from WWII didn't carry around pocket-sized supercomputers tied to powerful social media. Yet, inflation is still incredibly important, supply is currently an issue, and very few things crush confidence like uncontrolled inflation.

*What are we watching for?*

We believe we are in a scenario where it will take a while to get clear direction on inflation (maybe even another 18-24 months). In the meantime, it is possible stock valuations stay range bound. In other words, investors might avoid bidding up stock prices with so much uncertainty. Therefore, it seems within reason large cap stocks would continue to fluctuate near their current range of 14-18 times forward earnings. On the other hand, small, mid, international and EM are all trading at lower multiples, so we may see them bump up to historical averages with less clarity needed.

It is likely we are going to see bull and bear runs based off new information on inflation, Fed moves, earnings, commodity prices and supply chain. These are areas we are monitoring very closely and prioritizing in our modeling. As this commentary is being completed, we are getting some encouraging news regarding longer term inflation expectations, as 10-year breakeven inflation rates have receded from a mid-April high of 2.98% to close June 30th at 2.33%. This means investors feel we are not entering a new, longer-term inflationary reality, which for a short time looked to be a possibility. May's PCE reading, the Fed's preferred measure of inflation, moderated for the 3rd month in a row, settling at 4.7%. Further, we are seeing some softening in commodity prices and good news regarding supply chains. "June's surveys of five of the 12 district Federal Reserve Banks strongly suggest that supply-chain disruptions have eased significantly in recent months," according to Dr. Ed Yardeni. For those who follow our comments closely, you would know earnings will be a major focus as we start this new quarter as well.

A concern that mounted just as the quarter was ending is consumer sentiment levels. The most widely accepted Consumer Sentiment Index is provided by the University of Michigan. The index just registered a 50.0 in June, the lowest level on record (going back over 40 years). The index had been in the 90-100 range from 2014 to the beginning of the pandemic in 2020. While the pandemic brought lower readings of consumer confidence, recent drops to 58.4 in May and the previously noted 50.0 in June do give us some concern consumers may back off quickly.

Lastly, we are paying close attention to the fact the 2-year U.S. Treasury yield registered higher than the 10-year U.S. Treasury Yield in the first week of July. As we have discussed before, yield curve inversions do not guarantee a recession, but it has been a relatively accurate indicator historically. Further, the U.S. Dollar recently hit a 20-year high. For long-term investors in non-USD denominated assets (which would include some TOPS positions), this could provide an opportunity for outperformance in the future should the USD cycle weaker from these multi-decade highs.

*TOPS Portfolio Strategies*

One of the key tenets of our investment philosophy is for our investors to grow wealth. In the 20 years we have managed our portfolios, we have been successful in providing appropriate returns over time. There have been very few opportunities for growth in 2022. In this type of environment, we feel fortunate to be able to serve our investors so far this year in losing less than large cap U.S. stocks and the US Aggregate Bond Index respectively. We believe this cycle will pass, as many others have, yet no one knows exactly when that will happen. This is why we remain disciplined in our allocations. We are encouraged by the opportunities we see for long-term growth of our portfolios in the next growth cycle for stocks and yield opportunity for bonds.

*There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.*

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