JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

2022
SECOND
QUARTER

STOCKS AND BONDS EXTEND DECLINES

A bruising start to 2022 picked up steam as losses worsened in the second quarter. The S&P 500 Index officially fell into bear market territory in June, and bonds suffered their worst selloff in the modern era. Stocks and bonds fell in tandem, an unusual occurrence that made the market volatility more unsettling. The S&P 500 Index had its worst first half since 1970. Mid cap, small cap, and international stocks also posted double-digit losses, falling roughly in line with U.S. large caps. Risky assets in general sold off in a flight to safety. The riskiest asset classes, such as cryptocurrencies, fell drastically amid the turmoil.

Interest rates rose sharply in anticipation of aggressive Fed tightening, which began in earnest with three hikes of its benchmark rate – 25 basis points (0.25%) in March, 50 basis points in May, and 75 basis points in June. Meanwhile, concerns about the state of the economy grew rapidly. The war in Ukraine kept the geopolitical risks elevated and continued to disrupt the energy supply chain. Inflation loomed large over it all. Commodity prices shot higher leading to sticker shock at the pump and the grocery store, which weighed heavily on consumer sentiment.

GROWTH STOCKS LAG

All sectors of the S&P 500 Index were negative for the first six months except for energy, which gained more than 31%. In general, defensive areas of the market like utilities, consumer staples, and health care stocks held up relatively well, finishing with single-digit percentage losses. But technology, communications services, and consumer discretionary stocks were punished. These three sectors are largely made up of growth stocks.

The losses in stocks were almost entirely attributable to a reduction in valuation multiples. Corporate earnings estimates have held up despite the economic clouds gathering. This drop in valuations brings the overall market more in line with long-term averages.

While earnings estimates have held up thus far, the risk of potential weakness going forward has been an overhang on the market. Rising input costs, lingering supply chain issues, and falling consumer optimism have led to concerns that companies will begin to see lower revenues and profit margins. Stocks did manage to stage a small rally in the latter half of June. Bullish investors cite peak inflation and peak Fed tightening as reasons the market could move higher.

Regardless, at times like these it can be helpful to look back at longer term returns. It has certainly been a painful 2022, and the losses this year have largely wiped out the gains of 2021. Still, the 3-year annualized return for the S&P 500 is 10.6%, the 5-year annualized return is 11.3%, and the 10-year annualized return is 12.9%.

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TOTAL RETURNS

	2Q 2022	2022
S&P 500	-16.1%	-20.0%
Dow Jones Industrial Average	-10.8%	-14.4%
NASDAQ	-22.3%	-29.2%
Russell 2000	-17.2%	-23.4%
MSCI EAFE (International)	-14.3%	-19.2%
Bloomberg U.S. Aggregate Bond Index	-4.7%	-10.3%

WEALTH MANAGEMENT
FAMILY OFFICE SERVICES
TRUST COMPANY
ASSET MANAGEMENT

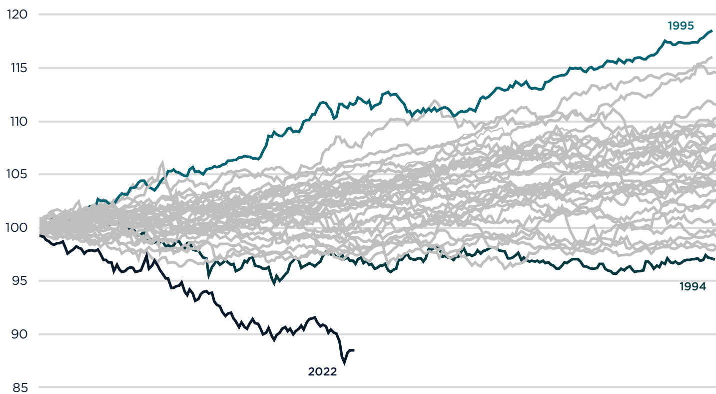
FED TIGHTENING GENERATES HISTORIC LOSSES IN BONDS

For the markets, the Fed's response to the spike in inflation far outweighed any other story, including the war in Ukraine. This is especially true of the bond market. With its power to adjust its benchmark interest rate, the Fed can alter the landscape across all interest-rate sensitive markets. The Fed dropped the Fed Funds rate to rock bottom in 2020 to support the economy through the pandemic. It characterized the inflation seen in 2020 and 2021 as "transitory," in part to justify keeping the Fed Funds rate at zero. When inflation numbers remained stubbornly high and moved even higher, it became clear the Fed was going to combat it aggressively.

Investors attempting to stay "ahead of the curve" pushed bond yields higher in anticipation of Fed tightening. This is why bonds experienced such significant losses in the first half. The Barclays Aggregate Bond Index fell 10.3%, which is by far the worst start for bonds to any year. With the Fed Funds rate at 1.75%, the Fed is arguably only half-way to the ultimate, or "terminal" rate, expected to be somewhere between 3.5% and 4.0%. But the bond market anticipates all of this, leading to interest rates in the marketplace well above where the Fed Funds rate currently stands.

WORST YEARS FOR BONDS IN HISTORY

BLOOMBERG US AGGREGATE INDEXED RETURNS EACH YEAR SINCE 1989



Source: Bloomberg, Johnson Asset Management, Data as of 6/30/2022

The severity of the move in interest rates sets up a brighter future for bond investors, as yields are now significantly higher. Current yields are closely correlated with the future return on bonds for the next five years. Higher yields also provide more cushion to offset price declines if rates move higher from here, which provides more return potential as rates fall.

The market is projecting that the Fed Funds rate will peak sometime in 2023 and the Fed will begin cutting rates at that time to provide support in the event of a weakening economy. It's important to note, again, here that predicting the path and rate of change in the interest rate market is very complex. The Fed will do its best to engineer what's known as a "soft landing" for the economy, but even Fed Chair Jerome Powell has acknowledged the extreme difficulty of doing so.

SLOWDOWN OR RECESSION?

As inflation and higher interest rates take their toll, the economy shows signs of slowing in 2022. The pandemic created one of the more unusual economic environments in the modern era. Massive stimulus amid global shutdowns created an environment where consumers had money to spend, but the supply chain and labor market were unable to keep up. Still, GDP growth was strong and consumers kept spending.

As we entered 2022, however, it became clear that inflation was going to drag down consumer sentiment and economic growth. As consumer spending slowed, inventories have begun to pile up at retailers, as noted recently by major stores like Target and Wal-Mart. Leading economic indicators remain generally positive but have slowed significantly since January. Manufacturing activity also remains in expansionary territory but has fallen as well. The labor market is strong for now, but jobless claims have been ticking up, and we may see a rise in the unemployment rate at some point.

A recent Fed study estimates that the supply chain issues account for 50% of inflation. China has continued to implement Covid lockdowns, leading to more supply chain disruption. Despite that, there is evidence that global supply chains are improving and overall demand is slowing. These changes could combine to bring down inflation and possibly drag the economy into recession. However, there are still few indications that recession is inevitable. Only time will tell.

DIVERSIFICATION AS CRITICAL AS EVER

Much is being made of the "death" of the balanced portfolio of stocks and bonds. It's possible (but not a given) that most of the pain in the bond market is behind us. Stocks are in a bear market, and no one knows, in the short term, where they will go from here. When both stocks and bonds have been under pressure, it can be tempting to question time-tested investment principles. However, in times of turmoil staying appropriately diversified and focusing on the long-term plan is more important than ever.

Understanding the dynamics of both stock and bond markets allows us to filter out the noise and negativity that inevitably comes with bad news. It also prevents rash decision-making that can permanently damage portfolios. We remain confident that building diversified portfolios tailored to the unique circumstances of each situation and focusing only on what we can control, we can help clients achieve their financial goals.

Disclaimer: Any expectations presented should not be taken as a guarantee or other assurance as to future results. Our opinions are a reflection of our best judgment at the time this presentation was created, and we disclaim any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise. The material contained herein is based upon proprietary information and is provided purely for reference and as such is confidential and intended solely for those to whom it was provided by Johnson Investment Counsel.

OUR APPROACH IN TIMES OF STRESS

WEATHERING THE STORM PART II: WHY OUR EQUITY INCOME APPROACH MATTERS

Almost every person with even passing knowledge of the market acknowledges its ups and downs can resemble a roller coaster over the years. But this notion is much easier said when markets are placid, market screens are green, and charts paint the affirming "up and to the right" trend. Conversely, we believe it's critical to acknowledge the very real psychological impact of enduring stormy markets when charts are "down and to the right" and implore all serious investors to remember the value of time in the market instead of trying to time the market.

Given the current challenging environment, we believe it helpful to dive into another critical aspect of our wealth management counsel: the thought process and methodology behind our long-held philosophy driving our Johnson Equity Income strategy. Equities are just one piece of the allocation strategy which includes a diverse portfolio of differing asset classes. Our Equity Income approach focuses on the large cap segment of the stock portfolio, which is complemented by exposure to small, medium-sized, and international companies.

JOHNSON EQUITY INCOME PHILOSOPHY

This strategy seeks to provide investors with an equity allocation that over time, seeks to outperform the broader S&P 500 index on a risk-adjusted basis, using a dynamically managed portfolio of high-quality US equities purchased at reasonable valuations. We accomplish this through our in-house fundamental research methodology which intends to yield a less volatile, more sustainable building block to our clients' investment strategies.

WHY QUALITY MATTERS

The term "quality" can mean many different things to many different people. We define it using some key empirical attributes reported by every publicly traded company. To start, we believe investing in quality companies provides much less risk of enduring a "disastrous loss", which is defined as a 70% decline in stock price from peak levels from which they never recovered. Since 1990, 31% (381) of the S&P 500 companies have endured this magnitude of loss and 315 of these companies were removed from the index. By owning "quality" companies we aim to avoid these types of catastrophes. In fact, since 2005, the S&P 500 had 207 of 856 companies (24%) experience this disastrous loss while our Johnson Equity portfolio had only 6 of 220 companies experience this type of loss. Clearly just avoiding the "potholes" can get a driver to their destination more effectively than reckless speeding.

So how do we evaluate "quality"? Essentially, we focus on three main attributes for our target companies: strong cash flow, a stable balance sheet, and an effective management team with a strong track record.

- **Cash Flow:** We've all heard "cash is king" in many circumstances and this is no different when evaluating companies' success in their competitive markets. Cash flow is critical for two primary reasons. First, cash flow isn't subject to the vagaries associated with nuanced accounting rules, which can be massaged to skew or obscure more telling financial results. Second, cash flow generation is a healthy read through to a company's competitive advantages in their respective market. Taking it a step further, cash flow trends identify if cash generation is improving or deteriorating over time as an indicator of future performance. In the most basic terms, we strongly believe if a company can achieve cash flow returns that exceed their cost of capital, with a stable and increasing trend in many economic environments, they have a clear competitive and defensible "moat" around their business.
- **Balance Sheet:** A strong and flexible balance sheet indicates a company's ability to fund their operations and pay their shareholders without having to access capital markets for additional cash (through equity or debt issuance). Companies with strong balance sheets tend to be conservative in taking on debt which allows operations and even dividend payments to confidently continue when the economic cycle inevitably turns. We typically employ this criterion to eliminate potential investments rather than a stock selection tool as we seek to avoid the potential boom-and-bust volatility common in companies with weak capital structures.
- **Management Team:** Another seemingly subjective criteria for our "quality" screen is an effective management team. Again, "effective" can mean many different things, but we believe astute financial analysis can provide insight into how well a management team is running the operation in addition to cash flow. In the end, management teams are

(article continued)

strategic allocators of the capital their investors have entrusted to them. Managers have a few main outlets to prudently invest capital and provide a return to shareholders who hold them accountable. Effective managers can balance the advantages and disadvantages of tools, such as dividend payments, mergers and acquisitions, share repurchases, debt reduction, and investments in new initiatives. Short-sighted management teams can certainly provide a high-dividend yield to their investors, but they may risk starving other parts of business through underinvestment or miss an opportunity to retire high-cost debt. Accordingly, evaluating and prioritizing a management team's long term track record can be a helpful indicator of future success.

VALUATION

Valuation can be defined as the price one is willing to pay for a future stream of earnings. The higher the price relative to a company's current (or future) earnings, the more optimistic the investor is that the company will deliver on its business plan to return cash to the shareholder. Despite all the historic advantages of identifying a quality company, a quality investment can only be executed if the price is attractive. That is why valuation serves as our effective "wrapper" around the quality attributes when deciding whether to include a company in our portfolio. We always view valuation through our quality lens as very often, a "cheap" (low valuation) company can be cheap for a reason, such as potentially a deteriorating market or business model. Accordingly, we tend to be more opportunistic in seeking out investment opportunities when the market may be broadly pessimistic (as indicated by price) than the true fundamentals of a quality company may indicate We believe using a seemingly attractive valuation as the sole driver in criteria for purchase, without the context of knowing the quality and fundamentals of a business, can be dangerous and result in a "disastrous loss" which is worth avoiding at all costs.

BOTTOM LINE

Constructing, guiding and maintaining families' wealth plans over many generations is the heart of what we do. The investment portfolio is critical to the success of these plans. We believe our Equity Income approach can be a core building block to this investment strategy. The first half of 2022 was an unfortunate reminder the "sunny days" of steady market returns will be interrupted by occasional storms. We hope this insight into our process will provide confidence and peace of mind when markets are turbulent.

Interested in more on this topic?

This article is excerpted from our July blog. To find the full article visit ***JOHNSONINV.COM/PERSPECTIVE.*** You will also find **"Weathering the Market Volatility Storm Part I"** as well as our full blog library.

PROMOTIONS

Our mission to deliver peace of mind through trusted counsel, exemplary service, and a genuine heart to serve, is made possible through the hard work and dedication of our employees. We are pleased to announce that these individuals have been promoted to new positions:

- **Joseph R. Abbot, CFA**
  Senior Research Analyst
- **Bryan J. Andress, CFA**
  Senior Research Analyst
- **Christopher H. Godby, CFA**
  Senior Research Analyst
- **William E. Jung, CFA**
  Senior Research Analyst

Abbot

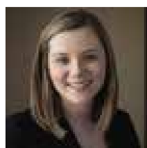
Andress

Godby

Jung

NEW DESIGNATIONS

Johnson is committed to continuing education to provide personal development for our employees and better service to our clients. Congratulations to Research Analyst, Kristen Curtiss, CFA, who has earned her Chartered Financial Analyst® designation. Portfolio Manager Assistant, Alex Wertz, CFP®, has earned his Certified Financial Planner® designation. Corporate Accountant, Jacqueline Wright, FPC, has earned her Fundamental Payroll Certification designation.

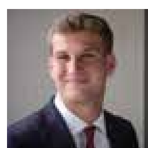

Curtiss

Wertz

Wright

NEW ADDITIONS TO THE TEAM

- **Drake A. Burris**
  Portfolio Manager Assistant
- **Cameron E. Byers**
  Digital Marketing Associate
- **Courtney E. Clouse, Esq., CTFA**
  Trust Officer
- **Dionne D. Deck**
  Client Support Assistant
- **Donald R. W. Ennis**
  Portfolio Manager Assistant
- **Melissa R. Evans**
  Client Support Assistant
- **Jacob M. Farwick**
  Portfolio Manager Assistant
- **Emma K. Kellerman**
  Portfolio Manager Assistant
- **Jack T. Lemmel**
  Portfolio Manager Assistant
- **Nathan D. Nichols**
  Portfolio Manager Assistant
- **Pamela A. Rogers**
  Receptionist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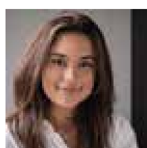
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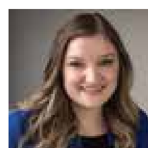
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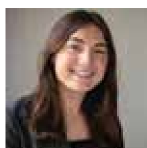
Deck

Ennis

Evans

Farwick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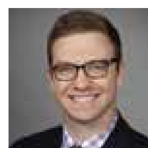
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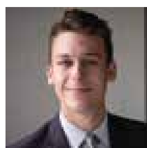
Nichols

Rogers

JOHNSON
INVESTMENT COUNSEL

ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $16 billion in assets for clients in 49 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-based, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

- WEALTH MANAGEMENT
- FAMILY OFFICE SERVICES
- TRUST COMPANY
- ASSET MANAGEMENT

LOCATIONS

CINCINNATI - KENWOOD
CINCINNATI - WEST
CLEVELAND - AKRON
COLUMBUS
DAYTON
METRO DETROIT

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

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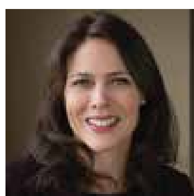
NEW SHAREHOLDERS

For more than 20 years, Johnson Investment Counsel has been 100% employee-owned. This independence allows our employees to focus on serving our clients without any pressure from external shareholders. We are pleased to announce and congratulate three new shareholders of the firm: Jamie Horn, Director of Marketing, Jon McEvoy, Senior Portfolio Manager, and Elizabeth Schaefer, Senior Portfolio Manager.

Jamie L. Horn
Johnson Investment Counsel
Director of Marketing,
Principal

Jonathan M. McEvoy, CFP®, AIF®
Johnson Investment Counsel
Senior Portfolio Manager,
Principal



Elizabeth R. Schaefer, CIMA®
Johnson Investment Counsel
Senior Portfolio Manager,
Principal

2022 TOP WORKPLACE

Johnson Investment Counsel has been selected as a Top Workplace by the Cincinnati Enquirer for the ninth year in a row. The award is based solely upon employee feedback and evaluates criteria such as opportunities for career development, workplace culture, compensation, and overall job satisfaction.

We are honored to receive this award and proud of our employees and their commitment to provide exemplary service to our clients.