JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

2022
THIRD
QUARTER

INFLATION, FED SEND MARKETS LOWER

Market conditions deteriorated in the third quarter as inflation remained stubbornly high and the Federal Reserve aggressively fought against it. After 1.50% of rate hikes in the first half of 2022, the Fed raised interest rates twice more in July and September, each time by 0.75%, jarring stocks and sending bond yields higher. These policy moves alone would have put a damper on markets, but the Fed's rhetoric and projections of future rate moves scared markets even more. The S&P 500 lost 4.9% in the quarter and is down 23.9% in 2022. Bond markets have suffered historic losses. The Barclays Aggregate Bond Index has lost 14.6% this year, it's worst performance ever at this point in the year.

With inflation high and not dropping, the Fed is making it clear that it is prepared to fight long and hard to get it under control. As signs of economic slowing appeared, the market waited and watched for any sign of a Fed "pivot" from hiking rates to cutting, but no such signal was provided. Instead, the Fed has continued to communicate plans to raise rates further and keep them higher for longer. Fed Chairman Jerome Powell doubled down on this strategy in his testimony and press conferences, stating that economic pain is all part of the process. Without going as far as predicting a recession, he indicated it's possible that this policy would lead to one and may even be necessary to tame higher inflation.

BEAR MARKET BOUNCE

Stocks are in a bear market, but as always investors can find reasons to be bullish. This was proven true again as the S&P 500 rallied about 17% from mid-June through mid-August, before turning lower again. The market fell more than 6.5% from the mid-August highs through the end of September, finishing lower each week except for one. These bear-market bounces are common and one of the key reasons it pays to stay invested for the long term. There is plenty of bad news, especially when it comes to inflation. But while growth is slowing, recession is not a foregone conclusion. Corporate earnings have slowed but remain in positive territory. The labor market has remained resilient, and other broad indicators like the ISM are holding up. It's possible that inflation has peaked, and global central banks could soften their stance as the economy slows. Whenever the news seems all negative, there are always reasons the market could defy the narrative and "climb the wall of worry."

INTERNATIONAL TROUBLES

While the U.S. economy has slowed, the global economy is struggling even more. Global economic growth went negative in the third quarter. China's growth has slowed as it deals with internal political turmoil, continued disruption from government lockdowns, and a deflating real estate bubble. The U.K. is undergoing significant political and budget transformation that has put pressure on its finances and the British pound. On the continent, Europe is sliding toward recession. The war in Ukraine has brought significant economic pain on top of the human casualties. This is most evident in energy prices throughout the continent, which stand many multiples of where they were before the invasion because of Russia's supply shutoffs.

FEATURING

TOTAL RETURNS

	3Q 2022	2022
S&P 500	-4.9%	-23.9%
Dow Jones Industrial Average	-6.2%	-19.7%
NASDAQ	-3.9%	-32.0%
Russell 2000	-2.2%	-25.1%
MSCI EAFE (International)	-9.3%	-26.7%
Bloomberg U.S. Aggregate Bond Index	-4.8%	-14.6%

Governments and central banks in Europe had been focusing on fighting inflation, raising rates much as the Fed has in the U.S. With the onset of the energy crisis, European policymakers are now under enormous pressure to step in to help struggling businesses and consumers. It remains to be seen if such assistance will be of any help. Regardless, the trajectory of growth going forward will likely be a function of whether global central banks continue their fight against inflation or abandon it.

RATES SURGING, DOLLAR RISING

The combination of central bank tightening, economic slowdown, and a strong dollar have caused short-term interest rates to rise faster than long-term rates. This flattening of the yield curve usually portends further weakness ahead for the economy, but the extent and duration is unclear. What is clear is the higher yield on bonds makes them more attractive. Bond investors will benefit over time as the prospects for total return are brighter when starting with a higher yield. On average bond prices hit a bottom (and yields peak) within six-months before or after the yield curve inverts, suggesting the worst could be behind us.

The strength of the U.S. dollar has also contributed to higher yields in the U.S. A strong U.S. dollar brings a mixed bag of results. It serves as a headwind to U.S. corporate earnings. It makes U.S. imports cheaper, tamping down inflation in the U.S. Conversely, it makes U.S. exports more expensive for foreign countries, putting upward pressure on inflation overseas. This is particularly painful for exporters like China and Germany. It is a major issue for smaller emerging market economies. Many have significant dollar-denominated debt, and their commodity-focused and export-dependent economies can be devastated by shifts in the currency markets.

STOCK VALUATIONS BECOMING MORE ATTRACTIVE

Stock valuations are a function of price and earnings projections. Prices have fallen significantly year-to-date. Earnings have also slowed but have been resilient despite the overall economic weakness. Third-quarter earnings per share projections started the quarter at +10% compared to a year ago and remain positive around +3%. Whether those projections are realistic is a point for debate given the overall economic uncertainty. They may need to fall further to fully reflect the global economic slowdown.

This year, the forward price-to-earnings ratio on the S&P 500 index has fallen from 21.3x to 15.2x. The long-term (10-year) average is 17.0x. Valuations are helpful in estimating long-term return potential, but they are not a good timing tool to predict near-term market moves. Corporate earnings in the coming quarters will be a crucial data point in determining the opportunity in stocks moving forward.

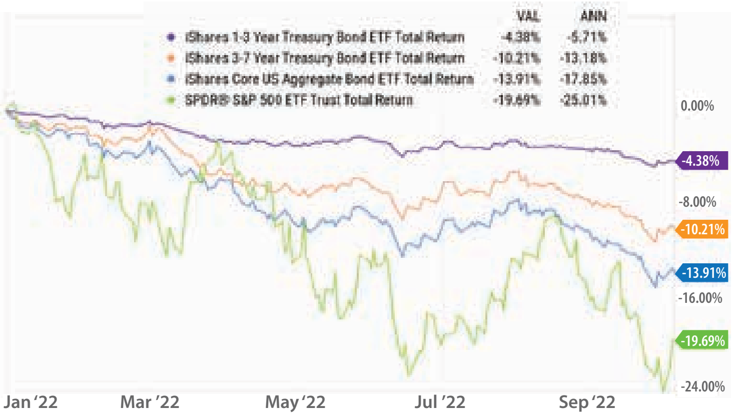
PIVOTAL MONTHS AHEAD

Investors have a lot to absorb in the months ahead. Central banks will remain in the spotlight, particularly the Fed. Markets are bracing for two more hikes before year-end, and the rhetoric in the press appearances will be heavily scrutinized for signs it will soften its stance. With most major economies at a tipping point, the economic data and corporate earnings releases and commentaries will also be key.

In tenuous economic times like these it's more important than ever to stay disciplined. Taking action based on short-term dynamics can derail a portfolio. As difficult as times like these can be, it pays to remember the cycle eventually turns in favor of the long-term investor, and the power of compounding resumes its upward force. The only thing every bear market has in common is they all end eventually.

A HISTORY LESSON ON ELECTIONS AND MARKETS

If there were any doubt about how government policy can influence returns in stocks, bonds and other assets, the last three years can serve as Exhibit A that policy can matter – a lot. From the government mandated Covid lockdowns in 2020 to the subsequent interest rate cuts to massive Covid relief government spending, we are now seeing the harsh whipsaw effects of swings in monetary and fiscal policy on our monthly investment statements. Hindsight is most certainly 20/20 as its clear the stimulative effects of the government response to the Covid pandemic (along with other factors) have resulted in an unwelcome hangover of pervasive inflation and stagnating economic growth. Unfortunately, the prescribed elixir for this malady is the blunt force tool of rapid and intense interest rate escalations employed by the Federal Reserve in the form of increasing the Fed Funds rate. This dynamic (along with many other global factors) has resulted in the double-whammy effect of declining stock prices along with higher bond yields (and therefore lower bond prices) as shown below. One could argue cash is a safe-haven, but even cash is robbed of purchasing power with elevated inflation.



A HISTORY LESSON ON ELECTIONS AND MARKETS

As macroeconomic and geopolitical events play out, political leaders are usually compelled to respond with policies to help soften the blow from exogenous events (pandemic, wars, etc.) or economic cross currents (inflation, slowing growth). These responses come in the form of new laws, policies and regulations factoring in all available information. These decisions are made by individuals, either elected or appointed as part of our democratic republic system of government. As such, we should be aware of the impact of who is in office making these decisions and of course, be vigilant and vote in these very important elections. And right on cue (as if we needed more news items in the cycle), the 2022 mid-term elections are upon us in yet another critically important juncture that could dictate how future policies are enacted.

While political opinions run a wide spectrum in our great country, it's helpful to be cognizant of two historical trends. The first is how congressional leadership has changed during prior mid-term election cycles and the second is what it has meant for market returns in the past. 2022 is a year unlike any other and there are many other factors in play. We are not predicting what is going to happen nor are we implying a forecast for future returns based on the outcome of this November's election.

WHAT THE NUMBERS SHOW

Broadly speaking, mid-term elections tend to favor the party opposing the sitting president. Typically, this is viewed as the electorate's implicit response to a president's aggressive policy implementation and a de facto "check" on the power of the Oval Office. According to Ned Davis Research, since 1902 the median number of House seats lost by a Republican president has been 27 while the median number of seats lost by Democratic presidents is 36. Today, the House of Representatives (435 total members) is comprised of 212 Republicans and 221 Democrats (and two vacancies). If history is any guide, even ½ of the historical median "flip" of 36 seats would place Republicans back in the majority in the House.

In the Senate, the historical median number of seats lost by a Democratic president is five while for a Republican president it's one. Currently there are 50 Republicans, 48 Democrats and 2 Independents (that almost exclusively vote Democrat) with the tie-breaker going to the Democratic Vice President. If the historical median applies to the Senate, Republicans could hold the majority here as well after election night 2022.

If that were to happen, what does it mean for markets? Is it a good thing or a bad thing and why?

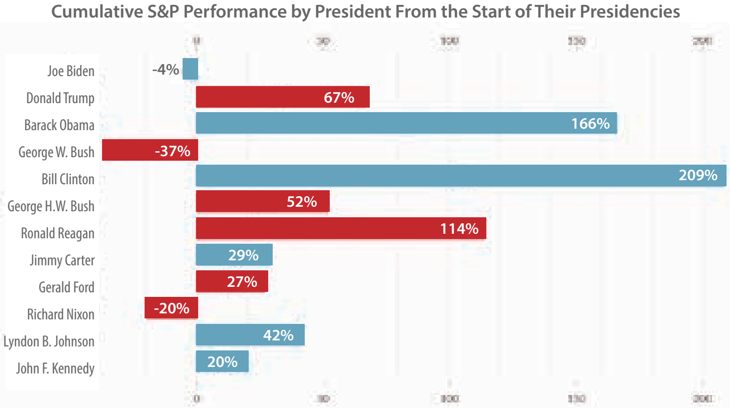
History teaches us that a healthy "mix" of opposing parties has yielded the best performance for the Dow Jones Industrial Average, also according to Ned Davis Research. A Democratic president with a Republican congress has occurred about 10% of all years with an average gain per year of 9.05%. This is second only to a Democratic President and a split congress (3.3% of the time), which has averaged a 10.4% gain per year. We must be careful attributing these returns the political environment alone, as there are many factors to consider. But there is certainly a historical precedent for strong markets with mixed government.

One possible explanation is that markets prefer the certainty that comes with a split government, gridlocked from being able to take political ambitions too far. Investors are likely more confident when the rules of the game are well known and unlikely to change on a policy whim or unchecked regulatory modifications.

BOTTOM LINE: INVESTING AND POLITICS DON'T MIX

Despite the historic trends for a split government, we caution our clients from extrapolating what they hear on the stump to their investment strategy. Too often, political opinion clouds investment acumen. There is no more clarifying example of this than the market returns during various presidential terms (shown below). Whatever one's political views, selling when your candidate loses and buying when your candidate wins has historically been detrimental to a long-term wealth plan. Markets have no allegiance to the Democrats nor the Republicans.

Cumulative S&P Performance by President From the Start of Their Presidencies



One person or one candidate certainly has influence on the investing environment, but policies and laws must be placed in the proper context with many other powerful factors including economic trends, geopolitical events, Fed policy, tax policy and valuations. We strongly encourage our clients to participate in the democratic process, know the issues and be active participants in choosing and supporting candidates. But we believe it's our duty to counsel our clients against allowing too much election-driven optimism or pessimism to detract from broader wealth planning and investment 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 material 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.

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:

- **Ryan Easter, PMP®**
  Chief Operating Officer
- **Katie Galbraith**
  Operations Manager

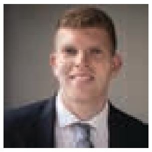

Easter


Galbraith

NEW DESIGNATIONS

Johnson is committed to continuing education to provide personal development for our employees and better service to our clients. Congratulations to Credit Analyst Emilia Connor-Brady, CFA, who has earned her Chartered Financial Analyst® designation, and Portfolio Manager Assistant Patrick Foy, CFP®, who has earned his Certified Financial Planner® designation.


Connor-Brady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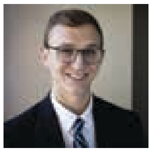
NEW ADDITIONS TO THE TEAM

- **Zack Berohn**
  Equity Research Associate
- **Sodora Ernst**
  Operations Associate
- **Holden Lipke**
  Operations Associate
- **Michael Riel**
  Trust Associate
- **Alex Wirt**
  Credit Analyst


Berohn


Ernst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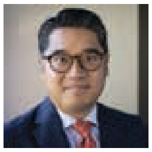
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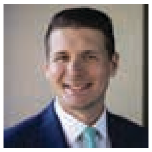
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WOMEN'S INITIATIVE POWERHOUSE EVENT

A powerhouse is a person or thing of great energy, strength, or power. Johnson Investment Counsel's Women's Initiative established our Powerhouse event as a way to showcase extraordinary female professionals in our region and provide an opportunity to gather, network, encourage, and share stories. This year's Powerhouse is Donna Salyers—entrepreneur, businesswoman, community advocate, and really great person. Join us and hear Donna's amazing story–one of grit and determination, business acumen, and boundless energy. We guarantee you will leave inspired!

Our Powerhouse event will be held Wednesday, November 16 from 4:30 to 7:30 pm at Hotel Covington. Scan the QR code to register by November 8th. Space is limited!

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ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $15 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.

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- ASSET MANAGEMENT

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