Talbot Financial – Second Quarter 2022 Review

Please find attached your Talbot Financial second quarter 2022 portfolio review to supplement your monthly account statements available from Schwab. The report provides a performance summary of your investment portfolio compared to the S&P 500 Total Return Index ("Index"), Talbot Financial's benchmark, and lists your investment portfolio holdings by industry sector.

Investment Review

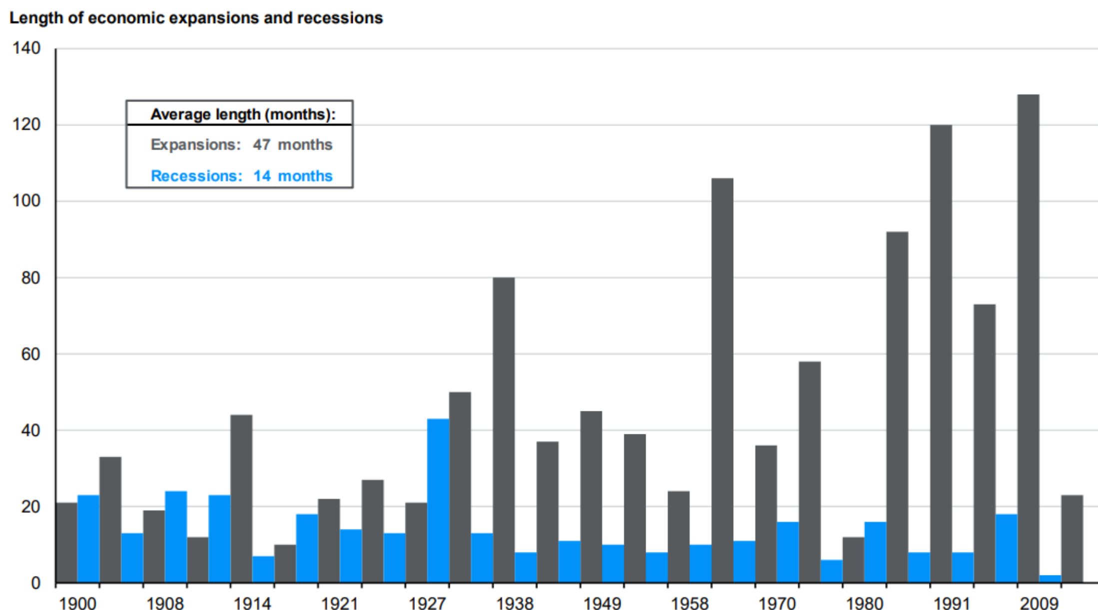
Higher inflation and the fear of a potential economic recession resulted in a broad sell-off across the financial markets during the first half of the year. The Index declined 16.1% during the second quarter and is down 20% through the first half of the year. Furthermore, the Bloomberg U.S. Aggregate Bond Index, a measure of the total bond market, fell 10.3% through the first half of the year. Therefore, the sell-off has adversely impacted both stocks and bonds.

The latest inflation figure, as measured by the Consumer Price Index (CPI), was 9.1%; a level not seen in 41-years. The U.S. Federal Reserve ("the Fed") attempts to manage inflation through changes to short-term interest rates. By raising interest rates, the Fed increases borrowing costs, thereby, reducing the level of investment and spending by businesses and consumers. The intended outcome is to slow the economy in order to subside inflation. Some leading indicators imply that moves by the Fed are working as inventories have increased at large retailers, suggesting a slowing in consumer spending, and most major commodity prices appeared to have peaked.

The primary risk associated with interest rate increases is the adjustments may push the economy into a recession. Our view is the current economic signals are mixed as to whether a recession is imminent. For example, favorable data points include earnings estimates for large "blue chip" companies have remained solid, and the labor market is strong.

Our perspective is the U.S. economy will likely experience a recession. However, we feel it will be a recession that is shorter in duration and less severe as compared to historical recessionary periods. The reasons for a forecast of a moderate recession are continued strong global demand by businesses and consumers of U.S. products and services, as well as the strength of the personal balance sheets of consumers.

In light of a potential recession, we have analyzed the historic correlation between economic downturns and equity market returns. In summary, periods of economic recessions have on average been much shorter in duration than periods of economic expansion. The following chart* depicts the length of recessions and expansions since the early 1900s. Over this time-period, the average length of a recession was 14-months, while the average length of an expansion was almost four-years.



Furthermore, since World War II the average duration of a recession has been just one-year and the average expansionary period has lasted five-years. Stated another way, over the years the U.S. economy has swiftly absorbed recessions, and then proceeded to grow again for an extended period.

Additionally, history has shown that financial markets are forward-looking in nature. Meaning, the stock market has typically bottomed out well before the economic data begins to improve. The current Bear Market (i.e., over 20% decline in the Index) and subsequent equity valuations suggest it is likely that a meaningful percentage of a recession has already been factored in by investors.

The relevant takeaway in reviewing the historical patterns of recessions and equity market returns is we see no reason to modify our investment strategy of owning a portfolio of industry leading companies with superior financial characteristics and sustainable competitive advantages. These financial characteristics include strong balance sheets and cash flows, expected high returns of capital to shareholders through dividends and share buybacks, and ever widening "moats" around their businesses to remain market leaders. These fundamental characteristics have historically provided opportunities for the strongest companies to gain market share during periods of economic downturns. We continuously monitor your investment portfolio on a company-by-company basis to assess if any of these characteristics have changed. In short, the financial characteristics of the companies in your investment portfolio remain intact.

In closing, we believe the odds of recession have increased recently. Importantly, in relative terms we think the recession is likely to be shorter in duration and less severe in nature. Furthermore, the companies in your investment portfolio are well positioned to both weather the storm and emerge even stronger on the other side once the economy enters its next phase of expansion.

Our office in Bellevue is open and we would welcome the opportunity to review your portfolio in person, by phone or on a Zoom conference. Please contact us for a review, or to answer any questions you may have about your portfolio.

Best wishes,

Talbot Financial, LLC

www.talbotfinancial.com

P.S. We encourage you to utilize several financial planning calculators available on www.talbotfinancial.com, including retirement savings, home budgeting and net worth calculators. The link to the calculators is: Talbot Financial | Calculators.

* Source: J.P. Morgan Asset Management Guide to the Markets