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Economic Review

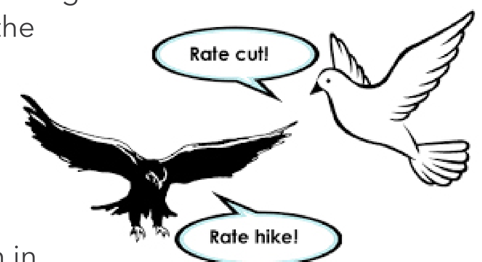
High inflation continues to make major headlines for the U.S. Economy, along with the Federal Reserve's actions to tame it. The September CPI report showed an increase of 0.4% month over month (m/m) and 8.2% compared to one year ago (y/y). The US Core CPI, which excludes the more volatile categories of food and energy has continued to rise, up 0.6% m/m and 6.6% y/y.

The Fed has clearly reversed their position on inflation, it is no longer "transitory". During the September meeting the Federal Reserve voted unanimously to raise the fed funds rate by 75 bps to 3.0%-3.25%, in line with expectations. The "dot plot" in the updated summary of projections shows voting members are inclined to raise rates at the two remaining meetings in 2022. This implies a 0.75% hike is likely in November and another 0.5% move in December. At the post meeting press conference, Fed Chairman Jerome Powell delivered a clear message that the Fed is ready to take rates into restrictive territory -- he said he wants to see real yields being positive across the entire curve -- and engineer a sustained period of below-trend growth. The most notable part of Powell's press conference was the opening line, when he said his message is the same as last month, and the Fed will "keep at it," -- meaning, the Fed will keep rates restrictive until there's compelling evidence inflation is firmly declining.

There were some bright spots during the quarter. Energy prices fell throughout the quarter, a drop of approximately 20% since June. This drop in costs has helped to boost consumer confidence, which typically happens when food and energy prices are falling relative to core goods. The U.S. consumer has also been buoyed by a strong labor market -- weekly jobless claims have remained at levels consistent with a healthy labor market, and average monthly job gains in excess of 400k per month. Those have combined with a low labor participation rate to keep the unemployment rate average 3.6% during the quarter.

Additional signs of recovery in supply chains can be seen in early stage input costs falling, initial stage material costs are negative y/y, helping to reduce the inflationary impact on production costs. Continued disinflation in the early phase should help to reduce the impact to the latter stages of production. Mid-stage input costs are still rising, but at a much slower rate. After peaking at 24% y/y, the rate has slowed to 9.6%, still too high for the Fed's comfort, but moving in the right direction. If the y/y rate for the early stage costs continue to stay low (or better yet negative), we may see finished goods prices ease. None of this guarantees the y/y CPI rate will fall, but it does indicate that there is some disinflation in the production process.

In summary, recessionary pressures are building. The economy is facing drags in several leading indicators including; depressed business confidence, slowing housing, rising rates and inflation. In addition, the continuing concerns about a slowdown are leading companies to guide analysts toward lower growth next year. While the likelihood of a recession rose during the quarter, our expectation is that any recession in late 2022 or 2023 will likely be mild.



Fixed Income Markets

The backup in yields presents opportunities in fixed income. Yields rose during the quarter, especially in the U.S. investment grade markets:

High inflation and the Fed's more hawkish stance have led to a sharp backup in bond yields so far this year, resulting in negative returns across fixed income markets. However, while the Fed appears likely to continue hiking rates through the end of the year, increased recession risks should limit further increases in long-term Treasury yields. Importantly, the sell-off in fixed income has also reduced valuations to much more attractive levels. With much higher yields, high-quality fixed income can now provide more of a buffer for portfolios in the case of a market correction or an economic downturn. With bond yields at multi-decade highs, we feel investors should look at short and intermediate bonds for income and diversification.

Maturity	Q2 Ending Yield	Q3 Ending Yield
Two Year Treasury	2.96%	4.28%
Five Year Treasury	3.04%	4.09%
Ten Year Treasury	3.02%	3.82%
Intermediate Gov/ Credit Index	3.48%	4.60%
US Corporate High Yield Index	8.89%	9.68%
Global Aggregate Index Yield	2.91%	3.70%

Equity Markets

Equity markets continued to be volatile this quarter. The S&P 500 was up 9.2% in July, down 4.1% in August and down 9.2% in September. For the quarter equity markets were down globally, with small cap stocks in the U.S. down 2.2% and Emerging markets down 11.5%.

Index	Q3 2022
S&P 500	-4.9%
Nasdaq 100	-4.4%
Russell 2000	-2.2%
MSCI EAFE	-9.3%
MSCI Emerging Markets	-11.5%

S&P 500 earnings continue to be challenged by slower growth.

Following a strong 2021, in which S&P 500 earnings per share (EPS) rose by 70%, profits are growing much more slowly in 2022. In the first half of the year, EPS fell by 3.2% year-over-year and analysts only expect a 1% gain for calendar year 2022.

U.S. equity valuations have fallen below their 25-year average.

U.S. equities slumped into a bear market in the first half of 2022, recovered much of their losses by mid-summer and slid again as investors worried about inflation, aggressive Fed tightening and the threat of recession. However, it is worth noting that the S&P 500 forward P/E ratio is now below its 25-year average of roughly 16.9x. This drawdown should set investors up for better returns in the long run, particularly if today's stressful climate is eventually replaced by one reminiscent of the last decade, an environment of slow growth, low inflation, low interest rates and high profitability.

International equities have come under pressure but long-term opportunities remain.

International equities have also had a rough year with market declines across developed countries and emerging markets. The local markets of Europe, Japan and EM outside of China have sold off less than in the United States, but the sharp spike in the dollar has amplified these losses for U.S. investors. However, it is worth noting that the dollar is now at a near 40-year high in real terms relative to trading partners and should eventually decline. In addition, equity valuations outside the United States remain far below their U.S. counterparts and their own long-term averages.

For long-term investors, international equities should provide solid returns from these starting valuations.

For many Americans, 2022 has been very disappointing with the Omicron variant prolonging the pandemic, sharply rising inflation and interest rates, falling stock prices and the shock of Russia's brutal invasion of Ukraine. When investors feel gloomy and worried about the outlook, their natural tendency is to sell risk assets in general and stocks in particular. However, history suggests that trying to time markets in this way is a mistake. Importantly, this is not to suggest that equity volatility in the year ahead will not remain elevated, as many other factors will determine that outcome. However, it does suggest that when planning for the rest of 2022 and beyond, investors should focus on fundamentals and valuations rather than how they feel about the world.

Meet Our New Director

Paul Fleming Vice President,
Trust Investment Director

Paul is located at our Carmel, Indiana office at 1216 West Carmel Drive.

He has over 30 years of experience in the investment industry. Paul previously held roles including Financial Advisor, Senior Trader, and Investment Executive early in his career. He later became a Director of Research and Investment Solutions, and most recently held the role of Vice President, Senior Portfolio Manager.

Paul graduated from Ohio State University with a Bachelor of Science in Financial Resource Management. In addition, he is a Certified Financial Planner, Chartered Financial Analyst, and Chartered Alternative Investment Analyst. In his new position, he will be responsible for developing and implementing appropriate investment programs for the investment of cash assets in discretionary agency accounts and fiduciary accounts. He is dedicated to delivering the highest level of service, and is looking forward to meeting clients in the near future.

Stock Market Down? It Could Be a Good Time for a Roth IRA Conversion.

Are you considering a Roth IRA conversion? If so, your timing can significantly reduce the tax bill. A conversion involves transferring funds from a retirement account such as Traditional IRA which is funded with pretax dollars, to a Roth IRA, which is funded with after-tax dollars. This means that you'll pay taxes on the amount that you convert, but qualified withdrawals during retirement will be tax-free. One way to lessen the tax burden is by making the switch when your IRA's value has dropped due to a market downturn.

The strategy makes sense if you think you'll be in a higher tax bracket during retirement—you'll save money by paying taxes now instead of later. Additionally, Roth IRAs carry no required minimum distributions (RMDs), so if you don't need the money it can grow tax-free for your heirs. This feature makes a Roth IRA an ideal wealth-transfer vehicle.

Another Roth IRA perk is that you can withdraw your contributions at any time, for any reason, with no tax or penalty. However, when it comes to Roth IRA conversions, you must wait 5 years (the 5-year rule) to withdraw converted funds to avoid a 10% penalty.

The best time to convert from a traditional to a Roth IRA is generally when the market is down and your traditional IRA has lost value, and/or your income is unusually low, and/or your itemized deductions for the year have increased.

Why Consider a Roth IRA Conversion?
There are several scenarios in which a Roth IRA conversion could be worth the effort—and the tax hit. These include if you:

- Expect to be in a higher tax bracket in retirement
- Want to leave a tax-free inheritance to your heirs
- Want better tax diversification
- Have income that is lower than usual this year
- Have more itemized deductions

It's important to note if you are required to take an RMD from your traditional IRA in the year you convert, you must do so before doing the conversion. An RMD cannot be included as part of the conversion.

Roth IRA Conversion Consequences
Of course, if you're considering a Roth IRA conversion, weigh the up-front taxes and the consequences of boosting your adjusted gross income (AGI) before making any decisions. Be sure you have the cash on hand to cover the tax bill—any IRA funds used to pay taxes will miss out on tax-free growth for retirement, undermining the very reason for doing the conversion.

Also, be aware that an increase in taxable income could bump you into a higher tax bracket. It could also lead to higher Medicare costs, higher Social Security taxes, and the loss of certain write-offs, such as the student loan interest deduction or the child tax credit. Crunch the numbers first to ensure that the potential consequences don't outweigh the benefits of the conversion.

How Much Can You Convert from a Traditional to a Roth IRA?
There is no limit on the amount you can convert from a tax-deferred account, such as a traditional IRA, into your Roth IRA in a single year. Of course, you will owe tax on the converted amount, so it's essential to weigh the pros and cons beforehand.

The Bottom Line
Whether the stock market is negative or your income is down this year, there could be a silver lining. And here's one more reason to consider a Roth IRA conversion: low tax rates and looming tax rate hikes. The current federal income tax rates, ranging from 10% to 37%, are set to expire at the end of 2025 if lawmakers don't extend them, which would reinstate the higher 2017 rates. This means a Roth IRA conversion could save you even more if you will be in a substantially higher income tax bracket during retirement.