FORTHRIGHT PARTNERS, LLC

INVESTMENT LETTER, THIRD QUARTER 2022

EXECUTIVE SUMMARY

The Federal Reserve has slammed hard on the monetary brake.

Maintain a slight underweight in stocks due to geopolitical and policy uncertainties. However, we will purchase stocks opportunistically as their long-term risk/reward potential has actually improved.

Treasury Bills and short-term bonds offer attractive yields.

SLAMMING ON THE BRAKE

Imagine an 18-wheeler cruising at 60 miles an hour slamming on its brake to avoid an unexpected obstacle. The momentum is likely too strong for it to halt smoothly. The truck will probably still hit the obstacle, causing whiplash and potential collateral damage on the road.

Driver: the Federal Reserve
18-Wheeler: the US economy
Brake: rising interest rates
Obstacle: elevated inflation levels
Whiplash & Collateral Damage: slowing economy, volatility in all things financial (stocks, bonds, currencies, commodity prices)

INFLATION, THE OBSTACLE

The Federal Reserve is currently slamming hard on the monetary brake. In normal times, rising interest rates are very effective in squashing inflation by slowing economic growth. But these are NOT normal times. To paraphrase Jerome Powell, what if there is something structural and persistent? As we mentioned in the First Quarter Investment Letter, current geopolitical tension will likely lead to Regionalization of World Trade and Reshoring. This potential systemic change has significant inflationary implications. Perhaps more distressing is that interest rate levels have almost no impact on food prices and energy supply. But Russia does, and there is a lack of certainty to the future inflation path until the Russian/Ukraine conflict is resolved. Keep in mind that the Federal Reserve is fully committed to bringing inflation back to the stated 2% target. However, why is the 2% inflation rate so sacrosanct? For much of the past 50 years, inflation rates in the US have trended between 2-4%. It was not until after the financial crisis in 2008 (and subsequent weak economic growth) that inflation rates have been consistently at or below 2%. We do hope the Federal Reserve will “pivot” – not pivot to lowering interest rates in the near future, but pivot to be more flexible with its inflation target given current world affairs.

“The question really is, is this going to be a temporary thing that’s really related to the pandemic in some way, or is there actually something more structural and persistent happening? More frequent, larger, and more persistent supply shocks, for whatever reason, will have critical and difficult implications for the conduct of economic policy and monetary policy in particular.”

Federal Reserve Chairman, Jerome Powell’s remarks at Cato Institute’s Monetary Conference, 9/8/2022.

WHIPLASH AND POTENTIAL COLLATERAL DAMANGE

Our economy, the 18-wheeler truck, traverses on a global highway. Rapidly rising interest rates along with quantitative tightening have raised recessionary fears and caused stock and bond markets to swoon in the US. Higher interest rates have also attracted foreign deposits in search of better returns, pushing the US dollar to 40-year highs. A record high US Dollar is great for American tourists visiting abroad, but it makes American products more expensive (less competitive) and it is really bad for countries that have seen the value of their currencies decline. Commodities such as oil and grains are priced in US Dollar. As an example, the Euro has dropped 12% against the US Dollar this year, which means oil costs 12% more in Euro even if its US Dollar price remains unchanged. Consequently, other countries may be forced to raise interest rates aggressively in order to defend their currencies. A competitive round of global interest rate hikes to stabilize currencies is one of the last things we need.

SILVER LINING

After a decade of ultra-low interest rates, savers are finally being compensated. Higher borrowing costs also encourage financial discipline. While the Federal Reserve's hard braking has been painful, it is reining in inflation expectations and inflation has likely peaked already, though its downward path will probably be slow.

Stock prices and valuations have come down meaningfully (please see Third Quarter Market Highlights below for details). We are finding more attractively-priced stocks and are encouraged that most of the speculative excesses have been wrung out.

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."

Peter Lynch, manager of the Fidelity Magellan Fund from 1977 to 1990.

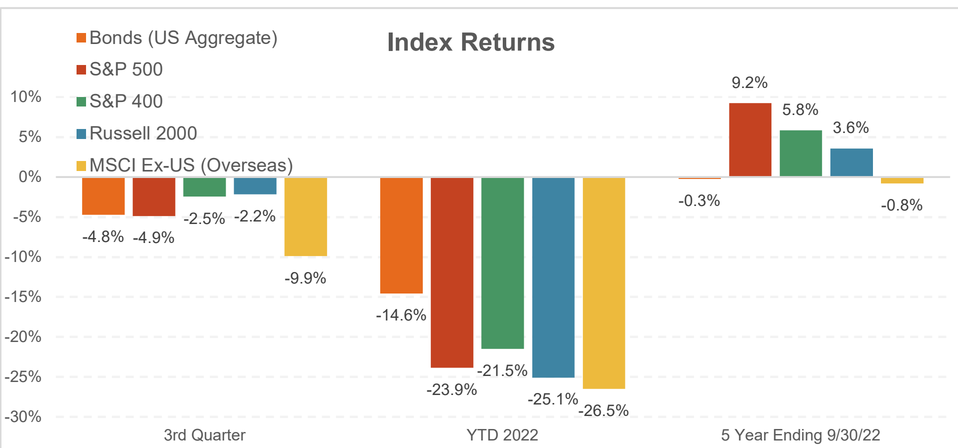
INVESTMENT STRATEGY

We would be more constructive on stocks if the geopolitical situation were more stable. From the bottoms-up company-by-company perspective, we find that most stocks are reasonably priced. This is not to say stocks cannot get cheaper in the near term, but their long-term risk/reward potential has actually improved this year. We continue to have a slight underweight in stocks because there are too many policy and geopolitical uncertainties at the present time.

On the fixed-income front, we have increasingly used Treasury Bills (1-12 month maturity) as bond surrogates in the past couple of months. However, at the time of writing, short-term bonds (2-3 years) are yielding over 4%, an attractive level not seen since 2007. We expect our bond positions to be primarily composed of Treasury Bills and short-term bonds for the foreseeable future.

THIRD QUARTER MARKET HIGHLIGHTS

September has historically been the weakest month in the stock market. This September is no different, with global stock markets losing 9-12% in one short month, erasing all the gains from July and August. Both bonds and stocks sold off violently as the Federal Reserve emphasized its commitment to squash inflation. 10-year Treasuries saw their yields rise from 3% at the end of June to 3.8% at the end of September while two-year bond yields jumped from 3% to 4.3%. Perhaps tellingly, both the Bloomberg Aggregate Bond Index and the S&P 500 Index lost about 4.9% in the third quarter.



Simply put, this year has been painful. All major equity indices are firmly in bear territory, posting 20%+ declines year-to-date. The most challenging aspect of this bear market is that bonds have not offered any safe haven. In the past, when stocks cratered, bonds usually rose in value because of the "flight to safety". This year, both stocks and bonds have moved in the same direction. Year-to-date the the Bloomberg US Aggreate Bond Index has declined over 14% and its 5-year annualized return has now turned negative.

It is difficult to focus on the long-term when the equity markets are seemingly in free fall. Pain avoidance is only human. However, the S&P 500 Index is 24% cheaper now than 9 months ago. When the things/stocks you like go "on sale", it is a good time to buy as long as you adhere to your "budget". The "budget", in this case, refers to your "risk budget" or target stock exposure. As mentioned, we have been underweighted in stocks and will maintain a slight underweight. However, we will not shy away from purchasing stocks opportunistically as long as we do not exceed your risk budget.

CONTACT INFORMATION

Baoky Vu, bnvu@forthrightinvestments.com

Beverly Kelly, bwkelly@forthrightinvestments.com

Hong-Tsun Simon, CFA, htsimon@forthrightinvestments.com