July 13, 2022

Dear O'Brien Client,

Following a phenomenal three-year run through the end of 2021, the performance of global markets has frustrated investors here in 2022. Many of the dynamics that have unfolded – such as stocks (and even bonds) retrenching ahead of a sharp shift in Federal Reserve (Fed) policy towards tightening – are not unprecedented. The magnitude, speed, and simultaneity, of those retrenchments, however, are much rarer.

The table below illustrates the point. Every major asset class declined in 2Q. Most markets are down by double-digits for the year.

	2Q 2022	YTD 2022		2Q 2022	YTD 2022
Municipal Bonds	-2.9%	-9.0%	Emerging Market Stocks	-11.4%	-17.6%
Treasuries	-3.8%	-9.1%	Non-U.S. Stocks	-13.7%	-18.4%
Mortgage-Backed Bonds	-4.0%	-8.8%	Non-U.S. Developed Market	-14.5%	-19.6%
U.S. Aggregate Bond Index	-4.7%	-10.3%	Real Estate Stocks	-14.7%	-19.2%
Commodities	-5.7%	18.4%	**Global Stocks**	**-15.7%**	**-20.2%**
Investment Grade Bonds	-6.9%	-13.8%	U.S. Large Cap Stocks	-16.1%	-20.0%
Gold	-7.6%	-1.5%	U.S. Mid Cap Stocks	-16.8%	-21.6%
High Yield Bonds	-10.0%	-14.0%	U.S. Small Cap Stocks	-17.2%	-23.4%

Past performance is no guarantee of future returns. You cannot invest in an index.
Source: Morningstar Direct, O'Brien Wealth Partners, as of 6/30/22.

The economy has been equally frustrating. Second quarter gross domestic product (GDP) – released at the end of July – will likely show a second consecutive quarter of the economy contracting, meeting one rule of thumb for determining recessions. But context matters. The labor market added roughly 2.75 million jobs, industrial production rose roughly 3.5%, and corporate profits have continued to improve over that same time period.

Context also matters for the markets. For example, from 2019 through 2021 global stocks surged almost 75%. Even after incorporating 2022's selloff, global stocks are still up almost 40% since the start of 2019. And from the start of the bull market in March of 2009 through the end of last quarter global stocks rose 350%, or a solid 12% a year.

Looking toward the back half of the year, markets appear to be strongly doubting the economy is strong enough to withstand the ratcheting up of monetary tightening pressures by the Fed. The Fed, in turn, has made clear that they will tighten until inflation cools. Most recently, the Fed Chairman Powell stated at the end of June that it is "absolutely essential" to restore price stability, a recession is "certainly a possibility," and achieving a soft landing (slowing inflation without a recession) will be "very challenging."

The inflation outlook is likely therefore the fulcrum on which the economic and market outlook pivots from here.

This shift in rhetoric may be intentional. By talking tough, the Fed hopes markets will believe them to still be credible – which may allow them to ultimately have to do less tightening than they currently project. But it is also not hard to read between those lines and see what appears to be a warning that a recession may ultimately be necessary to tame inflation.

To that extent, headline inflation surged to an annual pace of 9.1% through June, the fastest pace in 40 years. Wages have accelerated in sympathy and are now well above a level consistent with the Fed's 2% average inflation mandate.

Pricing pressures are now also rising in markets where increases have tended to be stickier – such as shelter, recreation, education, and medical care. Clearly, the Fed has plenty of justification for continuing to raise interest rates at an accelerated pace.

The problem for the Fed though is that although financial markets have reacted swiftly to their tightening policy stance, it takes longer for tightening to impact the economy. Housing is one of the most sensitive economic sectors to Fed policy and is just starting to show signs of cooling. Labor markets, wages, and core inflation, by comparison, take upwards of two years to react to higher interest rates. This makes it hard to gauge in real time whether the tightening that has occurred is already sufficient to ultimately cool hiring, wage growth, and therefore demand to levels that would bring core inflation back in line with the Fed's mandate.

The result is that investors are in limbo heading into the second half of the year. Markets have already priced in elevated odds of a recession occurring relative to current economic fundamentals. On the positive side, this implies that if inflation does cool meaningfully in 2H the Fed can slow its pace of tightening and risk markets such as stocks are likely too cheap. On the negative side, if inflation does not cool, then the Fed will likely continue to rapidly raise rates and a recession (with layoffs) becomes much more likely over the next couple of years.

Given the recession concerns in the market today, it is worth exploring what the further downside to markets might look like. Since the 1830s, the U.S. has experienced roughly 30 bear markets. Broadly speaking, these fall into three different categories:

1) Structural: triggered by structural imbalances and financial bubbles (e.g. the Great Financial Crisis of 2008)
2) Cyclical: typically caused by an economy going into a recession
3) Event-Driven: triggered by one-off "shocks" that do not result in recession (e.g. oil price shocks)

Of these categories, a structural bear market that brings with it a 50% market decline (see chart below) appears to be the least-likely outcome today, as both consumer and business balance sheets are in much better shape than they were during 2008 (for example). A cyclical bear market is therefore the more probable downside scenario, where stocks tend to fall roughly 30% peak-to-trough over a two-year period, on average. At one point, markets were 23% off their peak this year, suggesting there could be some additional selling (but probably less than has already happened) in the event a recession occurs.

If a recession were to occur though, demand and therefore inflation are likely cooling rapidly, and the Fed would be shifting to rate cuts. These changes would remove the two biggest headwinds for bonds, which should allow those assets to rally and help mitigate the impact of further stock declines on diversified portfolios.

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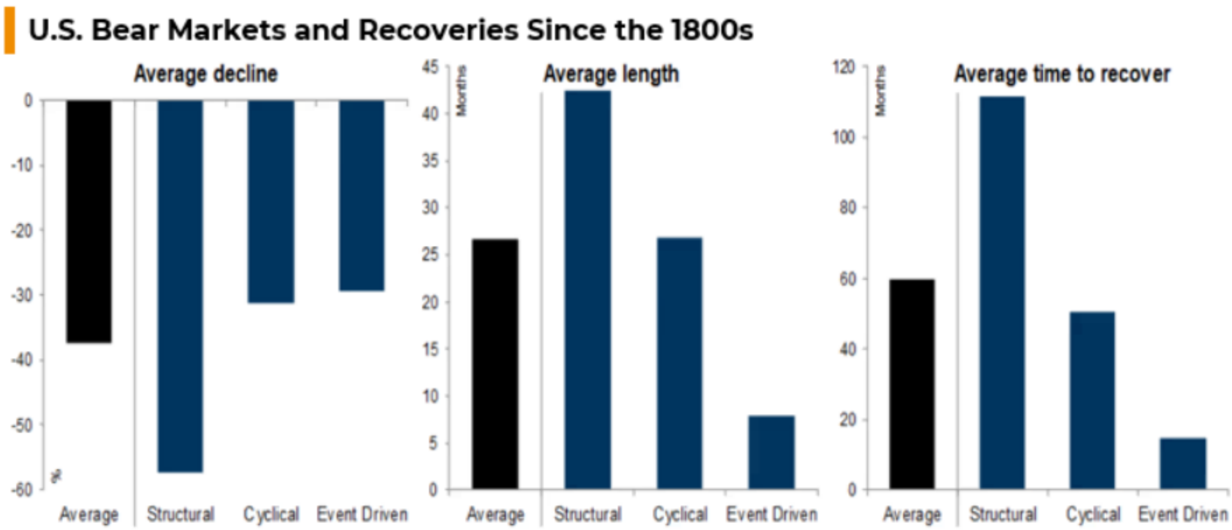

Past performance is no guarantee of future returns. You cannot invest in an index. Fed: Federal Reserve. Structural: Triggered by structural imbalances and financial bubbles. Cyclical: Typically, a function of rising interest rates, impending recessions, and falls in profits. Event Driven: Triggered by one-off shock that does not result in a recession. Source: Goldman Sachs, O'Brien Wealth Partners, as of 6/21/22.

Clearly, the near-term outlook is more uncertain than usual. But remember we are investing for the long-term, not trying to time near-term fluctuations. As shown below, since 1992 roughly 80% of the stock market's best days have occurred either during a bear market or in the first two months of a bull market. This dynamic makes market timing extremely challenging to accomplish, let alone repeat over time.

Past performance does not guarantee future returns.
You cannot invest in an index. Source: Ned Davis Research, Morningstar, Hartford Funds, O'Brien Wealth Partners, 2/28/22.

Long-term, the Fed probably remains credible, inflation therefore cools, stock returns improve, and bonds once again help diversify stock market risk. The current market pullback also has the potential of creating new long-term investment opportunities that were not there entering the year due to much higher valuations.

In the interim, we aim to stay disciplined by maintaining your target asset allocation. This will include staying invested in markets, rebalancing your portfolio if the deviations become too large, looking to de-risk portfolios within asset classes if

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economic conditions deteriorate, and adding opportunistic investments if the inflation backdrop improves. We will also continue to try to harvest capital losses where available that can be used to offset future capital gains.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

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