Quarterly Review & Outlook

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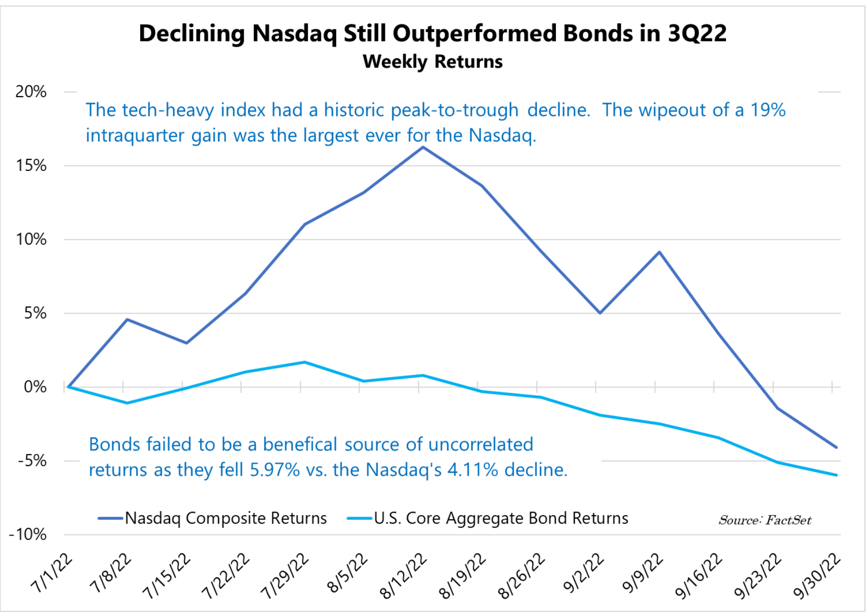
Ponte Vedra Beach, FL
904-648-2101

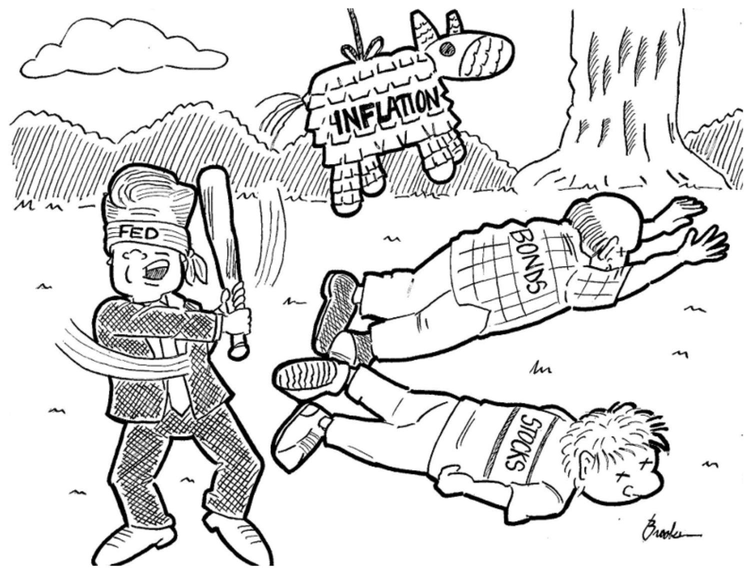
Anthony T. Brooks| *Portfolio Manager*
waycrosspartners.com

Louisville, KY
502-410-1900

Bears growled again after an early summer hibernation.

The law of gravity prevailed in the marketplace during Q3 as everything that went up during the first 6 weeks came crashing back down by the end of September. The persistence of inflation, the Fed's aggressive stance, and geopolitical tensions helped push the S&P 500 5% lower in Q3. Investors' summer started off hot with the market climbing 17% off its June lows through mid-August. A two-finger sternum poke from the Fed stressing their commitment to raise rates tipped the market into free fall for the next 7 weeks. There were few places to hide from the ensuing volatility. Bonds, the traditionally defensive asset class, performed worse than the tech-heavy NASDAQ composite falling nearly 6% (vs the NASDAQ's 4% decline). Small and Mid cap stocks held up better than large caps while growth-oriented stocks outperformed their value counterparts.





Feels like we're making some impact. Let's swing harder…

The Fed barks louder but inflation is still the bigger dog.

The peak inflation narrative that drove market optimism in early July began to wane after above-consensus Consumer Price Index and Personal Consumption Expenditure numbers were reported in July. These oft-cited measures of inflation bolstered the Fed's case that further rate hikes would be needed. While there is no surprise that rates would be marching higher to combat inflation, investors continue to be worried about the pace of planned hikes – and for good reason. The Fed has increased rates over 3% within a 5 month period; that's twice as fast as any other hiking cycle in the past 50 years (it took over 10 months in 1994 and 1999, the next two fastest cycles). Despite this ambitious tightening, inflation doesn't seem to be budging significantly. The hotter-than-expected August CPI print led the Fed to declare that market pain will be imminent in their quest to quell inflation.

Weak demand and strong dollar plague corporate outlooks.

If 2021 was the year of uncertainty in regards to corporate guidance, 2022 is shaping up to be the year of softness. Retail companies are still aggressively marking down inventory in anticipation of reduced demand. Homebuilders forecast housing slowdowns amid 6% mortgage rates. Media companies are seeing reduced digital advertising opportunities and tech executives highlighted how customers are shrinking IT spend in expectation of a recession. Larger multi-national companies are also having to deal with the strongest dollar level in 20 years. In an already faltering demand environment, the dollar is making US exports more expensive for foreigners and reducing absolute sales as overseas revenue is translated back into dollars. Rising rates and the specter of global recessions aren't helping to alleviate the dollar as a headwind to earnings growth.

Escalation of international policies escalated global concerns.

Much of the US dollar's strengthening could be attributed to its view as a safe-haven currency in a time of lingering international issues. The Ukraine-Russia war continued to drag on with Ukraine gathering momentum after launching a successful counter-offensive to reclaim territories. With winter approaching, Europeans dependent on Russia for natural gas began to worry that President Putin would cut off vital supply lines in retaliation for being ostracized. The UK dealt with a change of power in Buckingham Palace and more importantly on Downing Street as Liz Truss took over Prime Minister duties. With Truss came a controversial unfunded tax cut plan that sank the Sterling pound to its lowest level versus the dollar since 1985. The one international ray of optimism came from news of China lifting COVID restrictions, particularly off Chengdu, its fifth largest city. Still, the negative effect of regional lockdowns is expected to weigh on China's economic growth for the next few quarters.

Historical Returns following Rate Hike Cycles

First Hike	Last Hike	Total Increase	Length of hiking cycle (months)	12 Month Return after last hike
3/30/1983	8/9/1984	3.00%	16	18%
1/4/1987	2/24/1989	3.88%	26	19%
2/3/1994	2/1/1995	3.00%	12	36%
6/29/1999	5/16/2000	1.75%	11	-11%
6/29/2004	6/29/2006	4.25%	24	21%
12/15/2015	12/20/2018	2.25%	36	32%
3/16/2022	???	3.00%	6	???
Average*	--	**3.02%**	**21**	**19%**

**averages exclude current cycle* *Source: Federal Reserve of St. Louis, FactSet*

Outlook: Don't fight the Fed. Don't fear them either.

A successful investment strategy since 2009 has been to always bet with the Fed. Near zero rate policies made growth stocks a can't-miss opportunity for over a decade. With the Fed estimated to raise rates another 1.5% from current levels, one may assume the best course of action is to get defensive. However, the Fed was horribly wrong on forecasting inflation (the phrase 'transitory' didn't age well) and is likely wrong on forecasting the length of the current hiking cycle. The impetus for a bull market rally may not be a significant drop in inflation but rather just the point at which the Fed changes their mind. In the last 40 years, the S&P 500 has increased 19% on average in the 12 months following the end of a hiking cycle. Those odds may justify bargain hunting for quality companies in the midst of such market turmoil. For now though, resolution of the many issues spurring inflation is not likely to happen by year-end so markets are poised to remain volatile in Q4.

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