



Economic Review & Outlook

FOURTH QUARTER | 2022

Sticking to the Treatment Plan

Last quarter, we talked about the U.S. Federal Reserve's (Fed's) shift toward rapidly raising interest rates as a ripping-off-the-Band-Aid® moment, and we expressed hope that the short-term sting would be better for investors and the economy over the long haul. Now, we're going to find out. "We believe a failure to restore price stability would mean far greater pain later on," Fed Chair Jerome Powell said in September as he announced a third consecutive rate hike—bringing this year's total increase to 300 basis points (3%). Inflation, more intense and less transitory than many once thought, is our most urgent condition, and the doctor's prescription—hawkish monetary policy and quantitative tightening—is very likely to slow the economy. "We have got to get inflation behind us," Powell said. "I wish there were a painless way to do that. There isn't."

The goal—some version of the "soft landing" we heard so much about in 2021—remains a possibility when we look at the signs so far: a potential peak in inflation, a strong job market, slow but steady wage growth, and largely resilient consumer

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spending. However, it's an elusive goal, tough to achieve and unlikely at this point. Powell himself admitted that a recession is a distinct possibility. The fact is, we may already be in a recession, and the Fed's plan is designed to chip away at the job market and consumer spending to keep inflation from spiraling out of control and causing long-term damage. In other words, there's most likely more pain to come. How much pain and for how long? Only time will tell.

What's needed, and what the Fed is trying to provide, is a treatment plan. One that can fix the underlying issues of the economy, allow for long-term healing, and prevent a relapse. It's a tall order. A good treatment plan requires hard work, discipline, and sacrifice—particularly when the patient starts to feel better. It requires time, and yes, some short-term discomfort. The doctor's ready, Powell indicated in September. Are we? Here, we'll share some thoughts on how we, as the patients, can prepare for treatment by revisiting our financial plans and building diversified portfolios that can address uncertainty and keep us healthy for the long term.

Economic Overview

INFLATION CONTINUES TO RUN HOT

The U.S. Consumer Price Index (CPI), which measures the change in price for a wide variety of goods and services and is used to measure inflation, accelerated to a 41-year-high of 9.1% in June before cooling a bit in July (8.5% annual rate) and August (8.3%). Month-over-month, the rate was 1.3% in June, an 18-year-high, before a flat figure in July and a 0.1% rise in August.

Although the August number wasn't devastating, it was higher than expected and showed food and healthcare costs climbing. Rising prices remained broad-based as core inflation, which removes volatile food and energy prices, rose by 0.6% over July figures, leaving an annual increase of 6.3% and holding at levels

not seen since the early 1980s. Some prices showed signs of easing, especially energy—gasoline was down 26% in August from its June peak—leading to speculation that inflation may have peaked in July. However, we will not know whether that's true for a while.

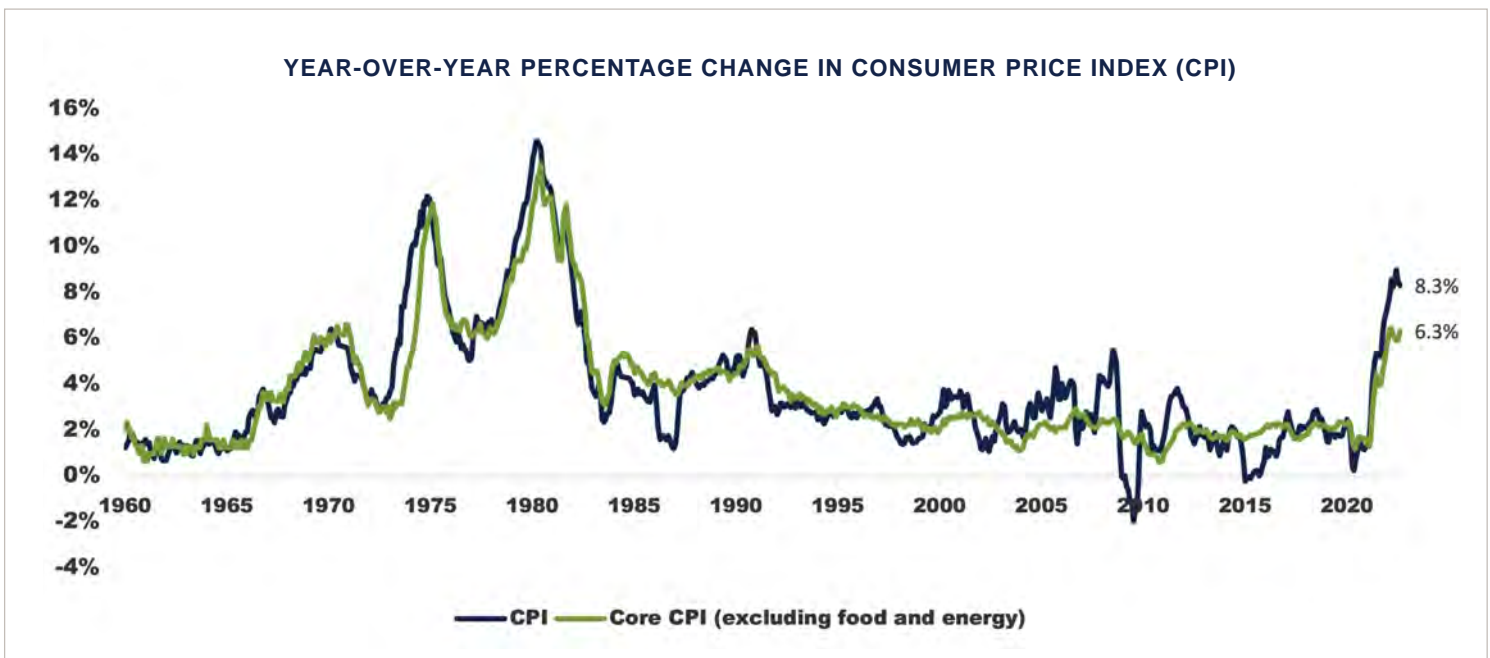
ARE WE IN A RECESSION? IT'S COMPLICATED

The U.S. economy met the technical definition of a recession—two consecutive quarters of negative Gross Domestic Product (GDP) growth—this summer when GDP fell 1.6% in the first quarter and 0.6% in the second. However, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), an independent nonprofit that determines recessions in the U.S., isn't yet on board. That's likely due to the continuing strength of the job market, industrial production, and corporate earnings. The NBER committee, created in 1978, typically announces a recession several months *after* the fact, as in 2020 when NBER said in June that a recession began in February and ended in April.

Regardless of how we label it, the fear of recession is very real. According to FactSet, the second quarter had the most S&P 500 Index companies mention recession in earnings calls since FactSet started tracking the data in 2010, breaking a record set in the early days of the pandemic. The closely watched yield curve between the 10-year and two-year U.S. Treasury notes remains inverted—which tends to predict a forthcoming recession—as the two-year yield surpassed 4% for the first time since the Great Recession in 2007, and the 10-year yield closed the month of September at 3.83%.

INTEREST RATES ON THE RISE

The Fed raised its key interest rate by 75 basis points (0.75%) in July and again in September. When this same increase occurred in June, it marked the biggest hike since 1994 and signaled five consecutive policy-meeting increases. The benchmark federal funds rate of



Source: Bureau of Labor Statistics

3.00-3.25% represented a 14-year high, dating back to the global financial crisis of 2008. The Fed indicated further big moves for this year and next, with policymakers predicting the rate to rise to between 4.0-4.5% by the end of 2022 and 4.5-4.75% during 2023. As recently as March, that projection was 1.9%.

Policymakers expect weaker economic growth than they had previously, with estimates of 1.2% GDP growth for 2023 and 1.7% in 2024. The Fed also forecasts that unemployment will rise over the next 12-18 months to the 4.4% range. Although the inflation forecast was revised higher, core inflation is projected at 4.5% by the end of 2022—more than a full point higher than the March 2022 estimate. Finally, the central bank continues the process of reducing its balance sheet, which had more than doubled to \$9 trillion during the pandemic and its aftermath. The Fed is allowing \$95 billion in bonds to mature each month without pumping the proceeds back into the debt market.

Asset Class Performance

Equities started off the quarter rallying in July and through the first half of August. However, concerns regarding inflation, Fed policy, and slowing economic growth led to significant declines for the remainder of August and September leaving the S&P 500 Index down -4.9% for Q3 and -23.9% year-to-date. After two straight quarters of contraction, the U.S. economy appeared to be growing slowly, with the Atlanta Fed's GDPNow model forecasting positive GDP growth for the third quarter. The CBOE Market Volatility Index (VIX), which ran hot earlier in the year, spent the third quarter in an elevated but not historically high range, especially given the equity market's decline. Consumer sentiment, measured by the University of Michigan U.S. Consumer Sentiment Index, remained well below 2021 levels but showed gradual improvement from June's record low. Consumer spending rose in August after declining in July, but most observers saw uncertainty in the data, especially given consumers' pessimism around long-term growth expectations. Amid ongoing interest rate hikes, the U.S. dollar continued to appreciate, with a nine-month, double-digit rise for the ICE U.S. Dollar Index, which measures the currency against a collection of large currencies.

The Bloomberg Aggregate Bond Index returned -4.75% in the third quarter, for a year-to-date decline of -14.6%, driven by the Fed's interest rate hikes and quantitative tightening, which raised concerns about liquidity as the central bank quickens its retreat. The market priced-in expected rate hikes through 2023, and while credit quality and spreads affect bond prices as well, so far, the drawdown is predominantly due to interest rate expectations. Oil prices declined during the quarter and ended far lower than historic highs in February and June but remained 5.7% higher than at the end of 2021. Broader commodities indexes followed a similar path in the quarter (-4.1%) but were significantly higher from a year-to-date perspective (13.6%). Gold prices declined during the quarter (-7.9%) and for the first nine months of 2022 finished well below March's post-pandemic highs.

Our Perspective

THE TREATMENT PLAN

It has been a tough year for the economy and investors. Supply chain issues, uncertainty surrounding the war in Ukraine, and the tight job market have all exacerbated inflation, setting up the need for a long-term treatment plan with heavy doses of interest hikes and quantitative tightening. Markets have moved ahead of the Fed, but the policymakers have done a good job of communicating their thoughts and following through on rate hikes. These events are important because untamed, excessive inflation can be very dangerous and much more painful than the Fed's course of therapy. Higher prices create a loss of purchasing power, which harms lower- and middle-class consumers the most, and makes it more costly to service debt (even for the wealthy) and drags on both equity and bond markets. Inflation leads to more inflation, too: When people and businesses expect prices to go up, they spend more, demand higher wages, and raise the price for the things they sell. We've seen it before, from 1965-1982, a period known to economists as the Great Inflation, marked by a peak that neared 15% annually in 1980. The current treatment plan is designed to avoid this scenario happening again.

WHERE DO WE GO FROM HERE?

There's no shortage of speculation about the future course of the economy and the markets, but the truth is, no one knows. We've seen stocks and bonds draw down, and we know that aggressive Fed tightening can cause a recession. Perhaps it already has. History provides an important example. In 1979, inflation stood at 10%, on

Q1	Q2	Q3	YTD
Commodities 25.6%	Diversified Bonds -4.7%	Commodities -4.1%	Commodities 13.6%
Gold 6.6%	Commodities -5.7%	Diversified Bonds -4.8%	Gold -9.3%
U.S. Stocks -4.6%	Gold -7.6%	U.S. Stocks -4.9%	Diversified Bonds -14.6%
Int'l Developed Stocks -5.8%	Emerging Market Stocks -11.3%	Gold -7.9%	U.S. Stocks -23.9%
Diversified Bonds -5.9%	Int'l Developed Stocks -14.3%	Int'l Developed Stocks -9.3%	Int'l Developed Stocks -26.8%
Emerging Market Stocks -6.9%	U.S. Stocks -16.1%	Emerging Markets Stocks -11.4%	Emerging Markets Stocks -26.9%

Indices used: Commodities—Bloomberg Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

a seemingly inexorable rise. The Fed raised interest rates dramatically to 20% in 1981 and steered through a difficult recession (1980-1982, as it turned out) with unemployment spiking over 10%. The Fed is in some ways trying to replicate that, though over a shorter time period and with less pain.

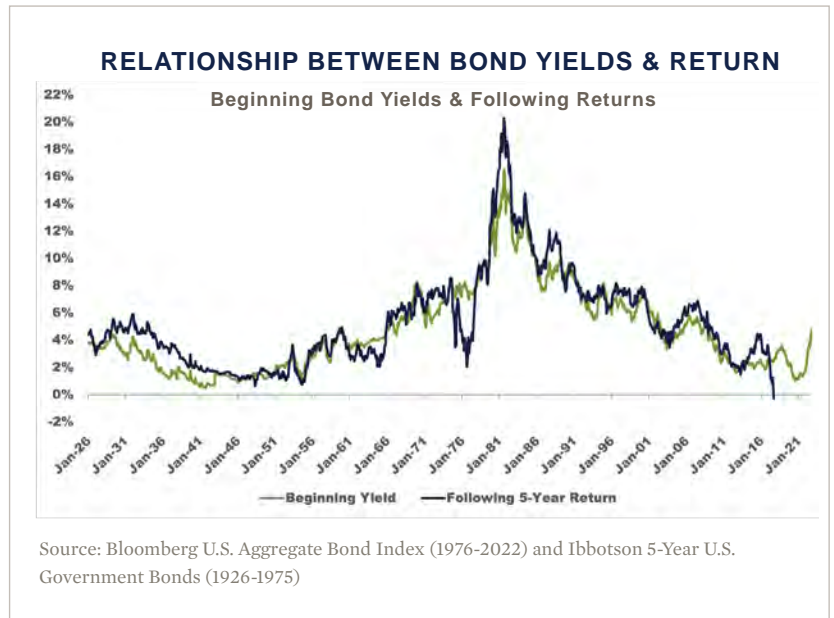
A soft landing, or at least “softish” landing is an even more optimistic scenario. The Fed has said they will remain very data dependent while trying to restrain inflation and keep unemployment from surging, to avoid a recession or at least a deep, long one. Stocks and bonds tumbled this year as the Fed raised interest rates, which has put pressure on the legislative and executive branches of our government to intervene. President Biden, who’s pledged to let the Fed do its work, touted the Inflation Reduction Act, a package of climate, health care, and tax programs signed into law in September, as a tool to reduce inflation. Although most economists think the legislation will have minimal impact on prices, at least in the short term.

While the goal of a quick recession or soft landing is not yet out of reach, it’s possible that a worst-case scenario could arise if the Fed abandons the plan—either because the pain becomes too much from a political standpoint, or cooling inflation makes it appear that we’ve achieved a full recovery too soon—leading to that long, deep recession it is hoping to avoid.

MARKET CHECKUP

One of the classic, foundational investment portfolios, the 60/40 mix of stocks and bonds, suffered through a difficult run during the first three quarters of 2022, falling approximately 20%.

Significant declines in both stocks and bonds in the same year is highly unusual. However, we expect to see more volatility in stock prices, noting that while valuations have come down significantly, they have not yet reached what we consider discount levels. The forward 12-month price-to-earnings ratio for the S&P 500 stood at 15.1 at the end of third quarter, down from 19.4 at the end of

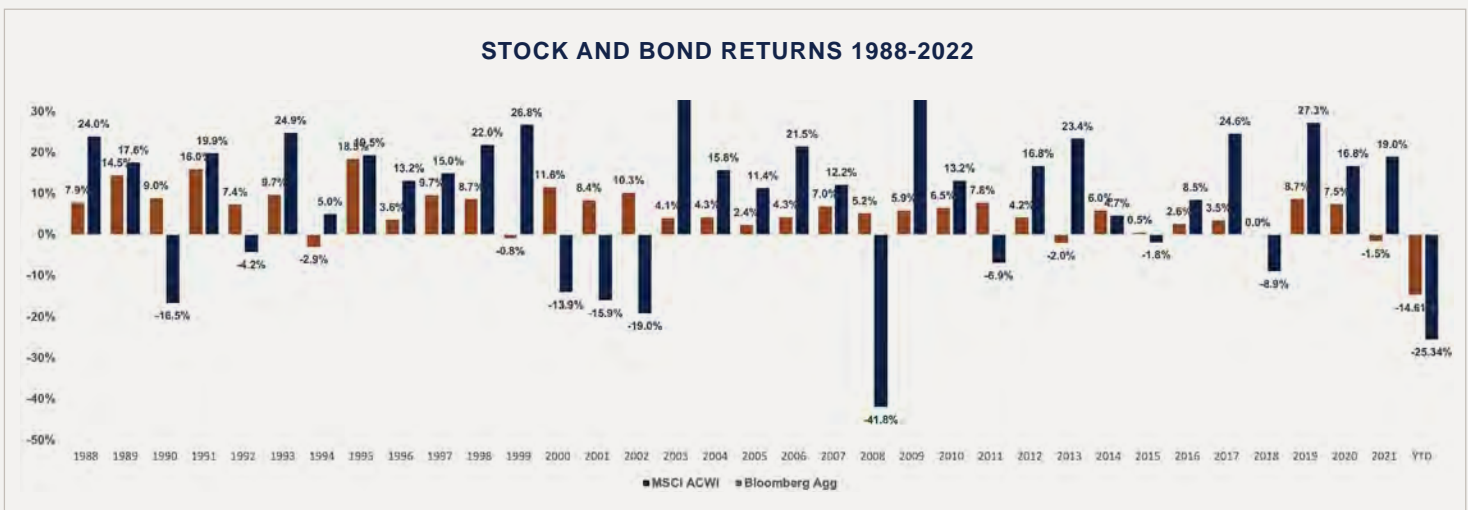


Source: Bloomberg U.S. Aggregate Bond Index (1976-2022) and Ibbotson 5-Year U.S. Government Bonds (1926-1975)

March, and well below its five- and 10-year averages. Historically, reasonable prices bode well for future returns, though valuations could normalize further. We currently have a positive view of long-term emerging market equities because the valuations are more attractive, but we believe they could still face some headwinds in the short term. Likewise, we expect to see further volatility in bonds, although the resetting of expectations in this higher-for-longer interest rate environment has us believing that forthcoming selloffs won’t be as dramatic as what we’ve seen in 2022. Higher yields traditionally result in higher returns in the future. As such, it is not time to panic. Bonds can reduce long-term portfolio volatility, providing income and returns to help investors through equity pullbacks.

Our Investment Strategy

It’s not easy to live through declining equity and bond markets, interest rate hikes, or recessionary fears. Seasoned investors realize



Source: FactSet

that markets will perform poorly at times, but it's still unsettling and stressful. Our principle of uncertainty means acknowledging that we don't know what's going to happen going forward, and that we need to plan, save, and invest for the future. Uncertainty is high right now, which only underscores the need to build—and stick to—a solid financial plan that aims to be resilient through the market's ups and downs. History tells us that it is wise to manage uncertainty through diversification across multiple asset classes that tend to react differently over market cycles. This strategy allows us to seek opportunities that can increase resiliency and also returns over time. We use a time-based approach to investing, which can help investors manage their emotions and avoid rash, short-term decisions in turbulent times. We believe it is wise to invest money needed in the short term conservatively, and then invest more aggressively with longer-term investments. Just as the Fed may face temptation to abandon the course and reduce our pain levels, you may feel tempted to change allocation levels or even pull out of the stock market completely. We believe neither is a good long-term approach. Instead, we recommend making sure that your short- and intermediate-term investing buckets are adequate—perhaps

adding to your reserves—and keeping your exposure to equities and higher-risk assets in your longer-term investments.

Conclusion

At Ronald Blue Trust, we look to biblical wisdom to inform our investment decisions. Ecclesiastes 11:2 says, “Divide your portion to seven, or even eight, for you do not know what misfortune may occur on the earth.” That message seems particularly relevant in times like these. No one knows how all of today's uncertainties will shake out, regarding recession, the future direction of the markets, or even the Fed's path forward. We do know that our central bankers are watching economic data carefully, and we'll continue to do the same. We'll look to adjust our portfolios to reflect the current and projected environment, which could mean investing in less risky debt, high-quality equities or possibly adding real assets such as gold, which can be favorable during recessions. In other words, we'll stick to our structured, carefully crafted treatment plan firm in the belief that it will help achieve your long-term investment goals outlined in your financial plan.

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