Hughes Investment Advisory Service LLC

October 1, 2022

Dear HIASLLC Clients,

Select Year-to-Date market index performances:

S&P 500	-25%
Nasdaq	-33%
Long Term Gov't Bonds	-31%
AGG Bond Index	-16%

I'd like to start out this Quarterly letter by expressing my concerns over the declines in our portfolios over the course of 2022 but especially in the last 3 months. Up until the middle of August our portfolios had been holding up quite well thanks to some timely defensive moves and good sector rotation within the equity markets. We've been holding more cash and short-term bonds. We were overweight in 4 of the best performing sectors of the market i.e.: Utilities, Healthcare, Consumer Staples, and Defense related companies. On the disappointing end were positions in gold, silver, mining companies, a commodity fund and large cap tech. These laggards traditionally would have done well during this inflationary period that we're in, but this time was different with every asset class dropping due to the strong dollar and extreme jump higher in interest rates. I never like to be in a position that requires excuses to my investors however this period since covid-19 arrived has truly upended most portfolios, including ours finally.

So where do we go from here and what do I see as a pathway through these difficult times? The answer I believe is to stick mostly with the long-held beliefs that I have formed over many decades of investing and are expressed below and in the summary at the end of this letter.

What changed? Covid-19 and the response from politicians and the Federal Reserve to covid created the conditions that we are experiencing today that are so difficult to navigate. What are these conditions? They are precisely what I have been writing and warning about for 2 years. Too much stimulus in the form of covid relief money from Washington and near zero interest rates for too long thanks to the Fed. We are now experiencing the results with 40-year high inflation and a stagnant economy, two conditions which are putting the Federal Reserve in a difficult position. In normal times, the Fed reduces interest rates when the economy slows but today with inflation at 40-year highs this is not an option until inflation comes down to an acceptable level which the Fed continues to say is 2%. The economy is kind of in this twilight zone, where if it's not in recession it is probably heading there soon. Depending on what you're looking at, the economy looks ok or looks in bad shape. It's one of the more uneven late cycle periods we have ever seen. We have a full-blown recession starting in the housing market. Corporate investment may be in recession. The consumer is hanging in along with the labor market.

Is there a light at the end of this inflation tunnel? Yes! The Fed has finally acted to curb inflation and they've acted swiftly, in fact they have been raising rates at the fastest pace on record. Now that the politicians in Washington have turned off the covid money spigot, and the Fed has acted on interest rates, inflation has likely peaked and should be coming down quickly in the months ahead. M2 money supply confirms this as well. Wall Street analysts and all business reporting is understandably focused on inflation and the Feds next moves. I believe that with the S&P 500 now in correction territory down -25% YTD and most other stock indexes lower than that, stocks are poised to rebound sharply once signs of an inflation peak appear.

Last Friday several Fed Governors started to float the idea of easing up on their projected interest rate hikes. Much rests on this question as the global economy is also on edge because of the Feds rapid interest rate hikes which effects the dollar's value relative to all other world currencies. The dollar is at multi-decade highs versus the Pound, Yen, Euro and Chinese Yuan. A strong dollar is good for the US, but a too strong dollar is potentially very bad for the current fragile world economic balance. We saw evidence of this last week in London with problems in their capital markets.

We currently have the greatest repricing in the history of fixed income in a short period of time. There are opportunities all over the place, and in the 4th quarter it's going to be a great time to be picking through those opportunities.

Is the economy now in recession? I believe it is or will be before year-end. Will the recession be mild with the desired soft-landing for the economy? That will depend upon how fast inflation comes down, the Fed's recognition of that and their response. Hopefully the Fed will tamp down their current path to hiking rates to give the economy a chance for a soft-landing otherwise a more severe recession is possible.

Well, enough of these geo-political macro-economic problems which while very pertinent to our investments are also, to a degree, external issues that perhaps we should ignore now that so many investments in the US are priced more attractively. Many of our favorite stocks are now inexpensive such as Amazon and Google for example. Bonds which I have mostly avoided for 5 years are now attractive with 10-year yields at 3.83% versus 1.48% one year ago.

Some important mid-year data points:

- Estimated 2022 Q3 GDP Growth +2.4% - Atlanta Fed Reserve GDP NOW
- Estimated 2022 Q3 CPI Inflation 8.3%
- 2022 S&P 500 Estimated Earnings of $215 – Yardeni Research
- 2023 S&P 500 Estimated Earnings of $235 – Yardeni Research

Now back to the question I posed earlier this year:

What is a "Soft Landing"? In Fed speak a "soft landing" in the business cycle is the process of an economy shifting from growth to slow-growth to potentially flat, as it approaches but avoids a recession. It is caused by Federal Reserve attempts to slow down inflation. Last quarter I said **My best guess and base case scenario of the Fed achieving a "soft landing" result is 33% at best and I will maintain that position.**

Is the damage done or is there another leg down ahead for stocks and bonds in the 4th quarter? My base case is that most of the damage is done. The Fed will raise rates again but not nearly as much as the consensus now fears. Inflation will remain a problem but has or will peak as supply constraints ease, the war in Ukraine hopefully subsides and the Fed rate hikes take hold. If the above case prevails, I believe that the 4th Quarter, will prove to be positive for stocks and bonds and we can see a snap back rally.

What about the upcoming elections? Polls are predicting a republican win in the House of Representatives and a 50/50 toss up in the Senate. A split government in Washington has always been more positive for the markets than when one party controls the executive and legislative branches. Historically the period after the mid-term elections for a first term president are one of the best performing in the following 6-12 months.

To be clear, the US and World economies are in a very difficult and challenging situation because of the Ukraine War, inflation, and rising interest rates. Given the uncertainty of what the inflation and earnings data will show in the coming weeks our best course remains a cautious investment approach that includes a diversified portfolio of high-quality equities, inflation hedges, cash and now some bond exposure. Primarily, if not solely, in US dollar-based assets. Why? The dollar is hitting all-time high levels against most major currencies and remains the world's premier currency. US companies are growing faster and have healthier more transparent balance sheets than foreign options and I believe that extreme risks are present with many investments outside the US.

Specifically, given the above concerns where do I find attractive investments and companies today? I'm focusing on equities with well-defined earnings prospects that can pass on higher input costs and prosper during periods of moderating economic growth and high inflation. Areas of focus include pharma, technology, defense, energy, infrastructure, and biotechnology. We are adding bond exposure for the first time in many years. Following the current worldwide economic disruption I fully expect that the US economy and US corporations will be in an even more dominant position relative to their competition. Will Apple, Eli Lilly, Google, Microsoft, Lockheed Martin, John Deere, Tesla etc. be more important to US and Worldwide growth or less? Will these companies be better positioned in their marketplaces? I can say decisively that the answer is yes!

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward now equally favors equities and fixed income equally. I believe that our portfolios are positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

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