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Investment Quarterly

Market Commentary

The French author and winner of the 1947 Nobel Prize in Literature, Andre Gide, once wrote: “One does not discover new lands without consenting to lose sight of the shore for a very long time.” Much the same could be said about investing. Volatility and uncertainty are a natural part of the investing process, and investors must agree to these risks if they hope to earn a return over time. Though markets tend to follow a course toward new highs over the long run, there will always be periods of turbulence that rock the boat and make investors uneasy along the way. Now is one of those uneasy times.

On the equity side of things, stock markets have been amazingly resilient.

After years of relatively smooth sailing during which portfolios benefitted meaningfully, we’ve begun to encounter some chop. A combination of inflation, higher interest rates, geopolitical instability, COVID overhang, and elevated valuations has led to a prolonged period of market malaise. Both stocks and bonds have declined year to date, with the S&P 500 Index down 19.96% through June 30th and the Bloomberg Barclays U.S. Aggregate Bond Index down 10.35%. Rarely does the bond market decline in such close correlation with the stock market. In more normal times, bonds will increase in value as stocks fall, helping to blunt any pain. Because this hasn’t happened, an otherwise modest bear market has felt much worse than that.

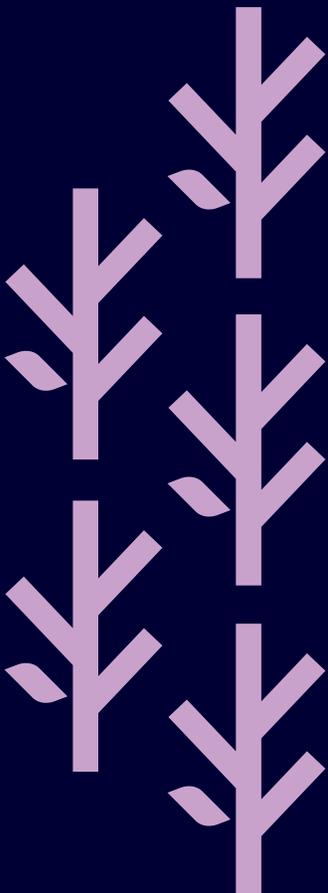
Fortunately, there is good news to be had. Bonds have started to act a bit

more bond-like in the past month, rallying off their lows as investors have sought safe havens. Going forward, absent any outsized changes in interest rate expectations, bonds should be more stable than they were in the first half of the year. For the first time in a long time, investors can earn a little bit of yield on their bond holdings, which increases their attractiveness and provides support for demand.

On the equity side of things, stock markets have been amazingly resilient. Despite an onslaught of disappointing news over the past few months, investors have refused to capitulate. Though stocks are down on the year, they remain higher than they were 18 months ago. Every time we see a period of meaningful declines, buyers step in to stem the tide and reverse markets upward. This is encouraging, and it calls into question whether we are truly in the midst of a bear market, and a mild one at that, or merely a severe correction.

If we are in a bear market, then it is reasonable to ask, how long and how bad can it get? Looking back throughout history, the average bear market has lasted about 12 months with a decline of roughly 35%. If past is prologue, then this would mean we’re about halfway through, with further declines to come. However, all is not lost. Dating back to 1957, there have been 12 bear markets. In 9 of those cases, returns were positive one year later, with the average return clocking in at 23.9%.

The news is even more optimistic for diversified investors. Looking at portfolios with a mixture of 60% stocks and 40% bonds, there have been 15 periods since 1945 where such portfolios declined by 10% or more, the



present situation notwithstanding. In all such cases, returns were positive over the ensuing 12 months, and the average return was 18.4%.

It is for these reasons that we always encourage clients to remain invested during periods of market volatility. One can never know exactly when a bear market will turn into a bull market, but missing that inflection point can seriously, and negatively, impact a person's long-term investment returns. For context, take a look at the below chart:



First, imagine that none of your money was invested. Then, imagine you decided to invest all of your money at point A (Black Monday), or point B (Dot-Com Bubble Peak), or point C (Housing Bubble Peak). Even if your timing had been horrible and you had invested at the peak of each prior cycle, and even in spite of 2022's market declines, you would have still made a handsome return through today simply by staying invested and trusting in the long-term behavior of markets.

Knowing this, and trusting in it, we have been cautiously opportunistic on behalf of clients. When appropriate, we have rebalanced to take advantage of lower prices. We have also made tactical adjustments to better position our equity and fixed income holdings in the face of heightened volatility and rising interest rates. Because the structural and geopolitical issues underpinning today's volatility are likely to continue into the second half of the year, we expect to continue with these types of adjustments in the months ahead.

Of course, we are always mindful of the impact of trading on client accounts. Be assured that, even though trading activity might be a little elevated this year by comparison with more sleepy periods, each trade we place is purposeful. As a result of our actions, we have been able to limit losses in fixed income portfolios and add value in areas like small cap and emerging market equities. On the whole, client accounts have held up better this year than a blended benchmark of bonds and global equities, and portfolios are positioned to benefit when sentiment turns around and markets advance in earnest.

To close, we cannot know the future with certainty. However, we can rely on history, past experience, inference, and probability to make reasonable guesses about what the future

might bring. In the very short term, markets are likely to be buffeted by the economy, inflation, the Federal Reserve, the war in Ukraine, and other top-of-mind issues. Looking further out, however, we expect markets to be just fine. Thus, we view any dips from here as further buying opportunities as the market makes its way toward new shores.

Until next time, may you have an enjoyable summer. ■

A Note From Lucie

We have been delighted to have many of you visit our new digs at 82 Columbia Street. We are settled in at this point and hope to see many more of you over the next few months. We will be hosting our annual Seasons of Maine art event on Thursday, September 29. Details and invitations will be in your hands soon.

Jen Eastman has assumed the role of Treasurer of the Board of the Bangor Symphony Orchestra. The BSO is one of our favorite organizations and we are thrilled to have Jen in that important board role.

Evangeline Eastman has joined the firm as our summer intern. Please be sure to read her intro in this newsletter. ■

Inflation: What Is It Good For?

Although the Fed initially assured us that rising inflation would be transitory and most of us took that to mean it would be a temporary bump in the road, here we are nearly a year later dealing with heightened inflation numbers, making that short-term outlook seem less likely.

What does inflation mean to you individually?

May's 40-year high Consumer Price Index ("CPI") of 8.6% doesn't necessarily translate into an 8.6% rise in every individual's spending. "Headline inflation," or the CPI, is calculated by the U.S. Bureau of Labor Statistics ("BLS"). This is the inflation rate of a basket of certain goods, the three largest of which are housing, transportation, and food/beverages.

What should you consider when looking at how that 8.6% inflation rate affects you individually?

While the CPI may be helpful in interpreting the average price increase for a specific basket of items, keep in mind that CPI is a nation-wide view and your personal inflation rate may look very different. Calculating your personal inflation rate will help you understand what, if any, adjustments you should make to your spending based on the inflation rate you are actually experiencing.

Let's break this down a bit. Unadjusted 12-month inflation as of May 2022 was 8.6% for all items. Over the last year, the items in the CPI basket that had the highest price increases were energy related, including fuel oil (106.7%), gasoline (48.7%), and utility (piped) gas services (30.2%). Health care services (4.0%) and housing costs (5.5%) were on the opposite end, having some of the lowest price increases over the last year.

What does this mean for you as an individual?

If you do not use fuel oil to heat your home but instead use natural gas, your personal inflation rate would not include the 106.7% increase in fuel oil pricing. If you use

electricity for heat, your personal inflation rate would be further reduced because prices for electricity have risen only 12.0% over the last twelve months (anecdotally, this may be higher in our area of Maine given recent rate increases). The bottom line of course is how much you are spending overall and how that relates to the success of your financial plan and goals. We would be happy to sit down with you to calculate your personal inflation rate if you would like.

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What are your next steps once you determine your personal inflation rate?

Once you've gotten a handle on your personal inflation situation, it is time to then "inflation-proof" any cash outside of your investment portfolio. You have entrusted us with your investment assets, but you may have cash or other assets outside your portfolio. Where should you put that cash now to meet your goals (perhaps a down payment on a house, or a vacation, or a new vehicle purchase)? Even with recent interest rate increases, inflation is currently higher than what can be earned in most savings or high yield checking accounts. Perhaps Series I savings bonds might make sense or a combination of savings bonds and laddered short-term CDs. Reviewing your short-term cash needs as well as your longer-term goals can help determine where to put your "cash on hand" so it does not lose its purchasing power.

Then there is the stock market, which year-to-date has been a bit dismal for returns. But, as mentioned in our market commentary, there are bright spots. Although the S&P 500 Index has returned a negative 19.96% (as of June 30, 2022), the healthcare sector has had a positive 4.8% overall return, with some individual stocks in that sector returning well over 20%. While a down market is generally when we discover what our

actual risk tolerance is, it is important to keep in mind that stocks are a very good long-term inflation hedge. Stocks are not usually top of mind as an inflation hedge, unlike other assets (TIPS, gold, etc.), because stocks don't always move in tandem with inflation year over year. While market returns are negative year-to-date, keep in mind that over longer periods, U.S. stocks have consistently performed above inflation.

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An additional item to consider is that many of us may not have thought of the need to review our real property replacement values to confirm that current homeowner's insurance is sufficient to meet the increased cost of replacing your home. If you are under-insured, it could translate into significant out-of-pocket costs were disaster to strike. In addition, you should review the fine print in your policy, as there is often a little thing

called "The 80% Rule." What is The 80% Rule? It is a stipulation that any damages to the property will be fully covered only if the property is insured up to a minimum of 80% of its current replacement value. Given the upward trend of real estate values over the past couple of years, it is likely we should all pull out our policies, double-check the insurance level, and see if The 80% Rule is included in the policy.

What is the most important thing to know?

Through it all, it is important to remember that inflation is not a U.S.-centric problem, and U.S. policy makers can only do so much to resolve the issue. The entire world is dealing with varying levels of inflation as a result of the Russian invasion of Ukraine, in addition to continued fallout from supply chain disruptions and other issues related to COVID-19. This means that inflation could be with us for a while.

As always, we would be happy to sit down with you to discuss these or other inflation-related conversations, or any other topics that are on your mind. ■

Welcome, Evangeline Eastman!

Evangeline Eastman has joined Birchbrook as our Summer Intern. Evangeline is a rising senior at Bangor High School, where she excels in the Humanities Academy, serves as President of the Key Club, and plays lacrosse, among other activities. When not working with Birchbrook, she volunteers at the Bangor Public Library, enjoys yoga, reading, bullet journaling, and spending quality time with her cats.

We asked her to tell us a little about herself:

What do you love about working at Birchbrook?

I love working at Birchbrook because I get to work with a bunch of super

nice people and learn skills and get experience that I think will help me in the future.

What is your favorite thing to do in Maine?

My perfect day in Maine would be driving down to Acadia National Park in the morning, hiking all afternoon, topped off with dinner and ice cream in Bar Harbor.

What is your favorite subject in school?

It would have to be a tie between math and history.

What flavor of ice cream are you?

I think Gifford's Pink Flamango, because the grapefruit and mango flavors are so bright and summery - also, flamingoes are my favorite animal! ■



We'd love to hear from you!

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