October 2022

INVESTMENT PERSPECTIVES

Staying Calm Amidst the Storm

The year 2022 has served as a glaring reminder that an investor's journey to their long-term destination is often anything but a straight line. The S&P 500 index and the and the 10-year US Treasury have both experienced sharp declines this year. It is an especially rare occurrence for these declines to occur in the same calendar year. It is easy (especially now) for macroeconomic and geopolitical concerns - inflation, market declines, rising interest rates, Russia-Ukraine war, looming recession- to cloud one's judgement. However, it is vitally important to not let market declines and gloomy economic outlooks set aside hard-earned wisdom and long-term thinking. While this is easier said than done, we recognize that it is challenging to find anything resembling "good news" in the present environment. In this *Investment Perspectives*, we will highlight several financial challenges we face and our roadmap for navigating the current environment.

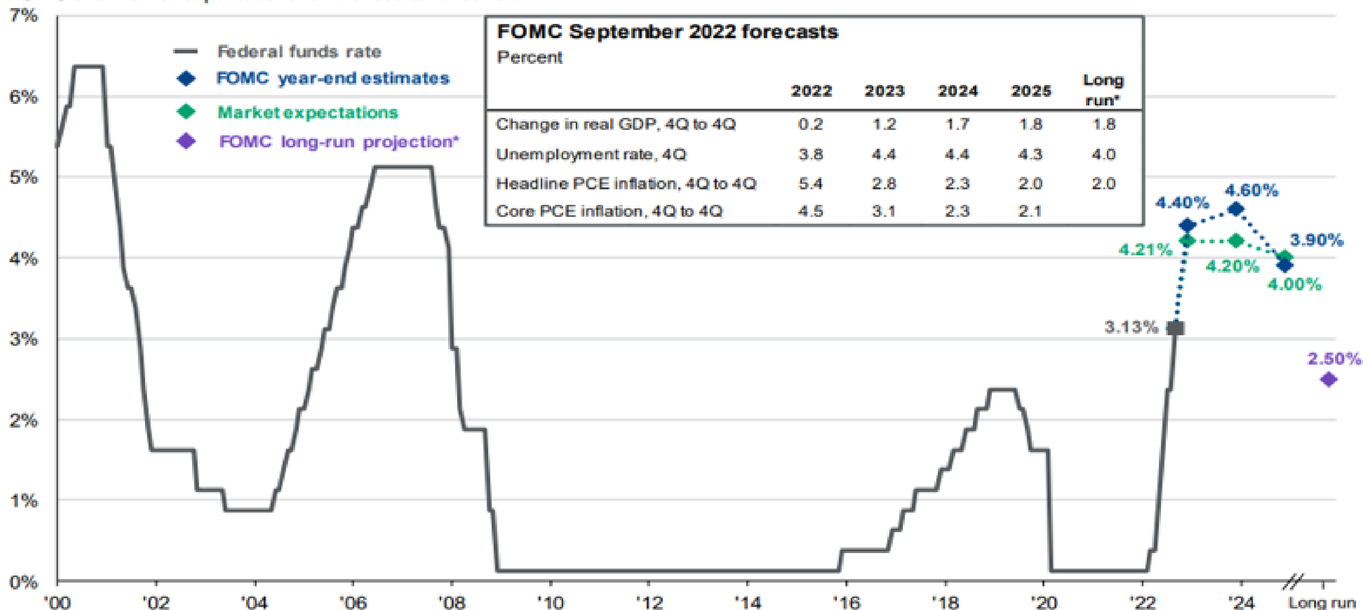
On that note, here is a quote from respected investor, Seth Klarman, to help put us in the proper frame of mind:

"While it is always tempting to try and time the market and wait for the bottom to be reached (as if it would be obvious when it arrived), such a strategy has proven over the years to be deeply flawed. Historically, little volume transacts at the bottom or on the way back up and competition from other buyers will be much greater when the markets settle down and the economy begins to recover. Moreover, the price recovery from a bottom can be very swift. Therefore, an investor should put money to work amidst the throes of a bear market, appreciating that things will likely get worse before they get better." – Seth Klarman, The Baupost Group

Inflation and the Fed

The consumer price index (CPI) resumed its upward trajectory, rising 0.1% in August. Over the past 12-months, CPI has increased 8.2%. Generally, inflation seemingly is becoming more broad-based and is remaining at stubbornly high levels. In their September meeting, the Fed raised the target for the fed funds rate by 75 basis points to a range of 3.0%-3.25% to help subdue inflation. Returning inflation to lower and more stable levels is clearly their primary objective. If they can achieve this, it has very positive implications for long-term economic growth. Below is a chart that shows where the Federal Open Market Committee (FOMC) estimates the fed funds rate to be at year-end vs. current market expectations. As illustrated in the chart, the market is expecting a slightly less aggressive path than FOMC estimates would indicate. Also, it should be noted that their long-run target sits at 2.50%, at a lower level than where we sit today.

History would suggest that this is going to be a 'tough needle to thread', highlighted by the FOMC September 2022 forecasts. Will reality take the path of what is presented in this chart? It is unknown. Regardless, it is instructive to understand where market expectations may diverge.

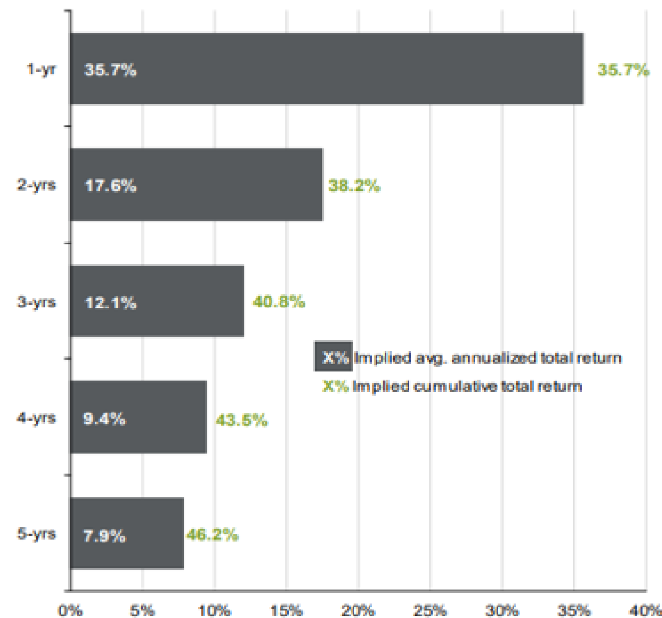


	2022	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	0.2	1.2	1.7	1.8	1.8
Unemployment rate, 4Q	3.8	4.4	4.4	4.3	4.0
Headline PCE inflation, 4Q to 4Q	5.4	2.8	2.3	2.0	2.0
Core PCE inflation, 4Q to 4Q	4.5	3.1	2.3	2.1	

Bear Market Territory

One question that has frequently emerged in our conversations with clients is the history of bear markets and the path to recovery. But what will that path look like? Below is a chart that shows the duration of bull and bear markets dating back to 1926. As you can see, they vary widely and were brought about by starkly different conditions, but the averages are an interesting data set. The bear markets average a 41% cumulative decline, with a much shorter 20-month duration than their bull market counterparts. We don't know how the current downturn will play out, but in the prior 13 declines, the market ended up higher roughly four years later.

Given where markets ended the 3rd quarter, it is interesting to look at the returns needed to recover the S&P 500 level seen in January 2022, over different timeframes. Hopefully, this provides some context to the shape of an eventual recovery.



Bull and bear markets

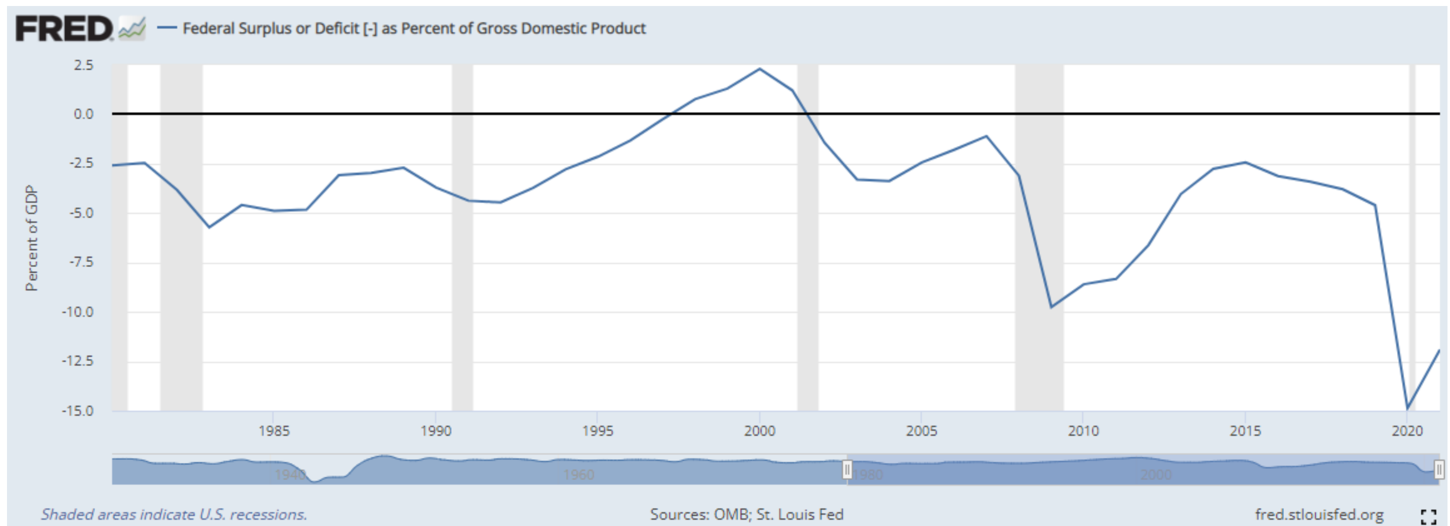
Bull markets			Bear markets		
Bull begin date	Bull return	Duration (months)	Market peak	Bear return*	Duration (months)*
Jul 1926	152%	37	Sep 1929	-86%	32
Mar 1935	129%	23	Mar 1937	-60%	61
Apr 1942	158%	49	May 1946	-30%	36
Jun 1949	267%	85	Aug 1956	-22%	14
Oct 1960	39%	13	Dec 1961	-28%	6
Oct 1962	76%	39	Feb 1966	-22%	7
Oct 1966	48%	25	Nov 1968	-36%	17
May 1970	74%	31	Jan 1973	-48%	20
Mar 1978	62%	32	Nov 1980	-27%	20
Aug 1982	229%	60	Aug 1987	-34%	3
Oct 1990	417%	113	Mar 2000	-49%	30
Oct 2002	101%	60	Oct 2007	-57%	17
Mar 2009	401%	131	Feb 2020	-34%	1
Mar 2020	114%	21	Jan. 2022**	-25%	8
Averages	**162%**	**51**	**-**	**-41%**	**20**

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. (Left) The current peak of 4797 was observed on January 3, 2022. (Right)*A bear market is defined as a 20% or more decline from the previous market high. The related market return is the peak to trough return over the cycle. Bear and bull returns are price returns. **The bear market beginning in January 2022 is currently ongoing. The "bear return" for this period is from the January 2022 market peak through the current trough. Averages for the bear market return and duration do not include figures from the current cycle.
Guide to the Markets – U.S. Data are as of September 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

Our Roadmap

The pain we are witnessing is primarily driven by the loose fiscal policies we have seen in recent years. We had a massive fiscal stimulus program that ran around 15% of GDP at the height of the pandemic in 2020. To put it in context, the deficit was nearly 10% of GDP the during 2008-2009 financial crisis.



The outcome of such easy fiscal policies is the persistent inflation we are living with today, which historically has not been good for investors. That is because it reduces purchasing power and corporate earnings. Thus, the Fed is resolute in bringing inflation down.

> *The FOMC is strongly resolved to bring inflation down to 2 percent, and we will keep at it until the job is done. So the way we're thinking about this is, the overarching focus of the Committee is*

getting inflation back down to 2 percent. To accomplish that, we think we'll need to do two things, in particular: to achieve a period of growth below trend; and also, some softening in labor market conditions to foster a better balance between demand and supply in the labor market.

- Federal Reserve Chair Powell

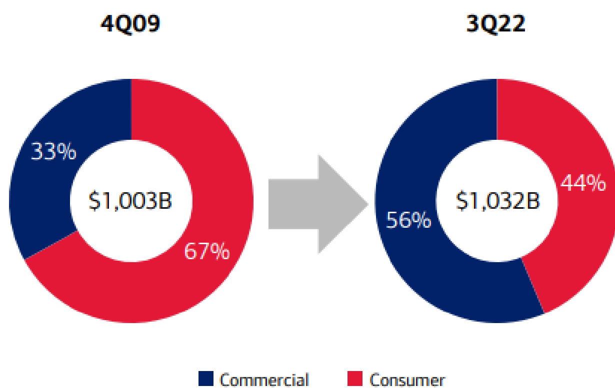
The above policy stance likely points towards a slowing economy driven by a worsening labor market and the resulting negative impacts to business earnings. While these assertions look fearful, such policies create market cycles that are anything but new -- as we saw in the historical data of bear and bull markets. The key thing to remember is that the American economy has always returned stronger because the power of our diverse economy and the ingenuity of our capitalistic system.

A case in point is our current banking system. The 2008 financial crisis led to financial reforms which not only reduced leverage in the American banking system but also changed the lending behavior of individual banks. We own Bank of America in your portfolio(s) and it presents an example of responsible growth across both their consumer and commercial loan portfolios. The bank reduced their auto and credit loan mix by 46% and 82%, respectively, since 2009. In their commercial book, the commercial real estate portfolio was kept flat, while other less risky loans grew. Since 2013, this has led Bank of America to pass the Federal Reserve's annual stress tests with flying colors when compared to their peer group. Moreover, the bank benefits from a low cost of doing business and their balance sheet remains overcapitalized. All of these positive developments happened because of the resolve of US businesses to become better, avoiding the mistakes of the past. Such behavior gives us confidence that we will emerge on the other side of the current downturn in an even stronger position.

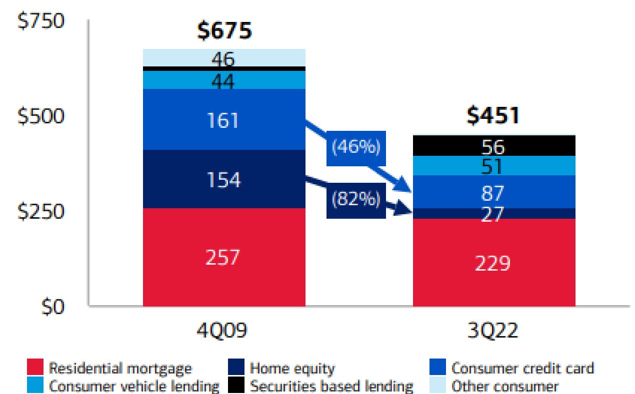
Credit Risk Transformation Reflects Responsible Growth

(EOP)

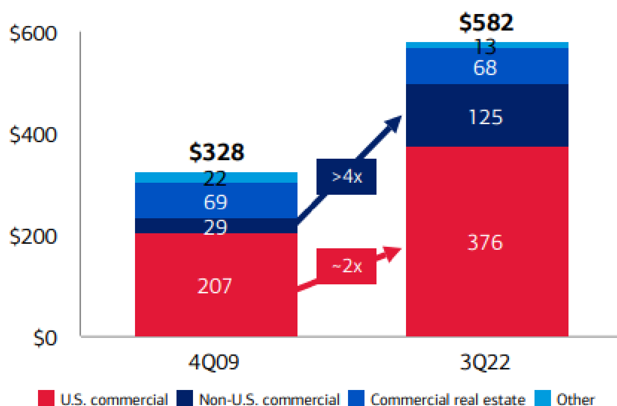
Loan Mix[1]



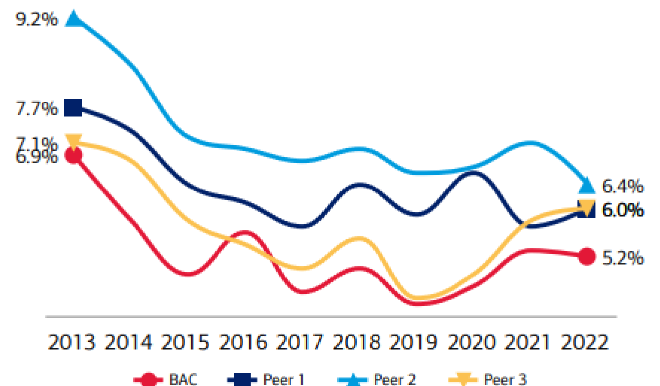
Consumer Loan Portfolio ($B)[1]



Commercial Loan Portfolio ($B)[1]



Federal Reserve Stress Test Loan Loss Rates (%)[2]



Note: Amounts may not total due to rounding.

[1] 4Q09 reflects December 31, 2009 information adjusted to include the January 1, 2010 adoption of FAS 166/167 as reported in our Securities and Exchange Commission (SEC) filings.

[2] Nine-quarter loss rate from Comprehensive Capital Analysis and Review (CCAR) severely adverse scenario.

source

Another quick example is CarMax, the largest used car retailer in the United States. Despite soft industry conditions, the company continues to take market share from its competitors. We are confident the benefits of their improved competitive position will be demonstrated when the industry conditions begin to recover.

Despite our long-term optimism, we know the local and national media will be the first to paint a gloomy picture of the economy. To that point, we also understand very few media outlets will ever spotlight the other side of the story i.e., how strong the economic growth is coming out of a recession. To reap those benefits, we continue to be patient and maintain our long-term focus. Patience allows us to stay invested and avoid the temptation to sell. This focus helps us to look beyond the short-term headlines and realize the benefits of being a long-term investor.

We have prepared ourselves for times like the present. Although never pleasant, we understand this is part of normal economic and market cycles. Our preparation involves maintaining a watchlist of potential investment opportunities, and thoroughly and continuously monitoring your existing portfolio positions. In addition, the cash in your portfolio(s) will enable us to make new investments as opportunities present themselves during market dislocations.

Admittedly, this year has been painful, as both stock and bond portfolio(s) have experienced declines. The silver lining is that we didn't have to sell assets at today's lower quoted prices. Rather, we have been opportunistic in adding to existing positions at these lower prices. This provides us with even better value, thus increasing the probability of higher returns in the future. As a reminder, we continue to invest in competitively advantaged businesses run by able management teams. They remain focused on continuing to grow future cash flows, even in the present economic environment. To that end, stock prices will invariably reflect the growth in earnings as business conditions improve.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of September 30, 2022, Hutchinson Capital Management (HCM) held:
146,683 shares of CarMax, Inc. (KMX)

As of September 30, 2022 (Prices in USD unless noted otherwise)
CarMax, Inc. (KMX) closed at $66.02

As of September 30, 2022, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	9/30/2022 Closing Price
Berkshire Hathaway Inc Class B	6.85%	$267.02
Progressive Corp	6.43%	$116.21
Apple Inc	6.12%	$138.20
Store Cap Corp Com	5.97%	$31.33
Bank of America Corp	5.84%	$30.20
Markel Corp	4.92%	$1,084.22
Microsoft Corp	4.51%	$232.90
Occidental Petroleum Corp	4.00%	$61.45
Jacobs Solutions Inc	3.97%	$108.49
Robert Half Intl	3.91%	$76.50

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html
HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.
Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.
Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.
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