KMR Financial Advisory, Inc.

Market Commentary

2nd Quarter 2022 Review & Outlook

2nd Quarter 2022 Market Review

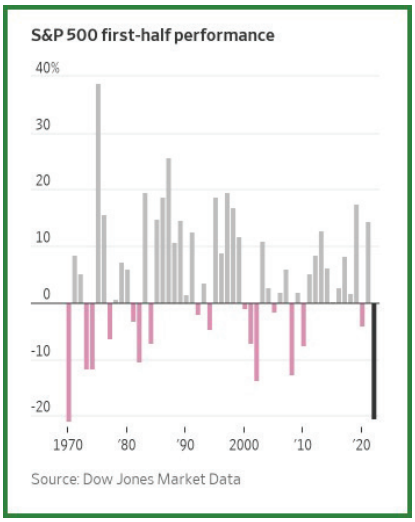
After a rocky 1st quarter of 2022, where we saw inflation take front-and-center in investors' minds (and the Fed's), plus the extraordinary events of a war in Ukraine with Russia and another COVID lock down in China, here came Q2 of 2022, and the bottom fell out of the both the stock and bond markets.

	BENCHMARK	Q2 2022	YTD
U.S. Large Cap Stocks	S&P 500® Index	-16.1%	-20.0%
U.S. Small Cap Stocks	Russell 2000® Index	-17.2%	-23.4%
International Developed Stocks	MSCI EAFE Index	-14.3%	-19.3%
Emerging Market Stocks	MSCI EM Index	-11.4%	-17.6%
U.S. Bonds	Bloomberg U.S. Aggregate Bond Index	-4.7%	-10.3%
Treasury Inflation Protected Securities	Bloomberg U.S. Treasury Inflation Notes Index	-6.1%	-8.9%
High-Yield Bonds	Bloomberg U.S. Corporate High Yield Total Return Index	-9.8%	-14.2%
International Developed Bonds	Bloomberg Global Treasury ex-U.S. Index	-11.5%	-17.6%
Commodities	S&P GSCI Total Return Index	2.0%	35.8%
REITS	Dow Jones U.S. Select REIT Index	-18.1%	-21.1%

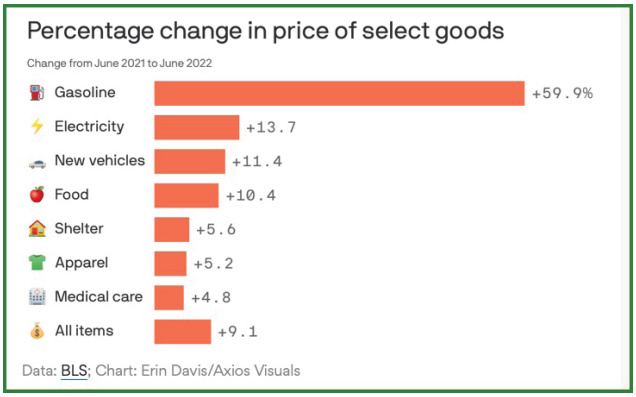
The result was that for only the 2nd time in more than 4 decades stocks and bonds both posted losses for 2 consecutive quarters. The last time investors saw back-to-back down quarters for stocks and bonds was in 2008 (remember the Great Recession?), and before that, 1981.

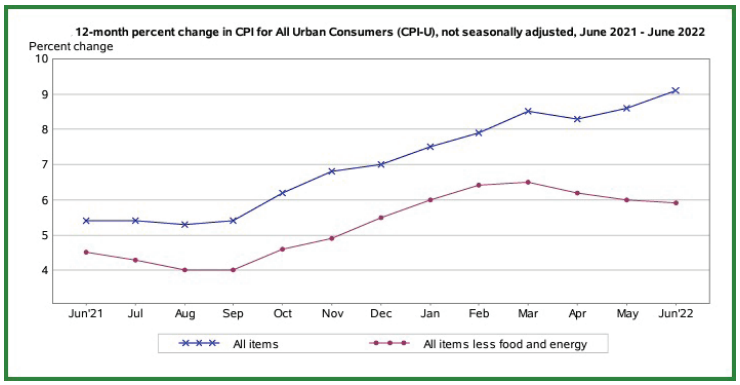
The S&P 500, the index of the largest stocks in the U.S., fell 20% for the 1st half, its worst first half performance since 1970. And the U.S. bond market, as represented by the Aggregate Bond index, had its worst 1st half of the year ***in history.***

The primary driver behind the performance was the unrelenting bad news coming out on inflation. As the quarter wore on, the monthly CPI numbers grew until by the June's number (announced in July) it was over 9%, something not seen since 1981. Gasoline was the overwhelming factor on these numbers (average gas prices breached $5/gallon for the 1st time in history), and electricity, cars and food showed big increases a well. This has caused the Federal Reserve, whose 2 mandates are stable prices (read: keep inflation down) and full employment, has finally woken up to the fact that inflation has become persistent and needs to be addressed immediately.

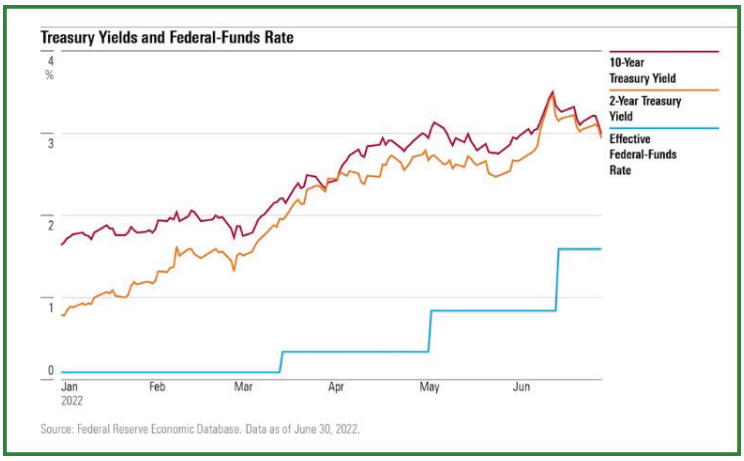


The primary tool the Fed has to control inflation is to raise interest rates. The Fed finally started raising rates in March, with 50 basis points, then another 50 basis points in May and the big whopper of 75 basis points in June. And along with this came the endless speculation on whether the Fed is doing enough or too much, the latter meaning in effect that it will force the economy into a recession. Raising borrowing costs is intended to slow the economy, and therefore will impact the higher growth companies the most, which has meant that technology companies and other high growth companies that have flourished during the pandemic have been hit hard. **Meta (Facebook)** dropped over 52% for the year, and **Netflix** is down over 70%.





And rising interest rates are detrimental to bonds, which prices go down as rates go up. The 10-year Treasury bond started the year at around 1.5% and ended the 2nd quarter at 3.2%. So, both stocks and bonds were getting hit by the double-whammy of high inflation and rising interest rates. There was truly nowhere to hide.



All 11 sectors in the S&P dropped during the past quarter, even the energy sector, which had a huge run-up in Q1 but with oil prices finally beginning to rollover and come down, the energy sector was down 5.3% for the quarter. Though this pales in comparison to technology and communications services down over 20%

U.S. equity sector returns

Data as of 6/30/2022

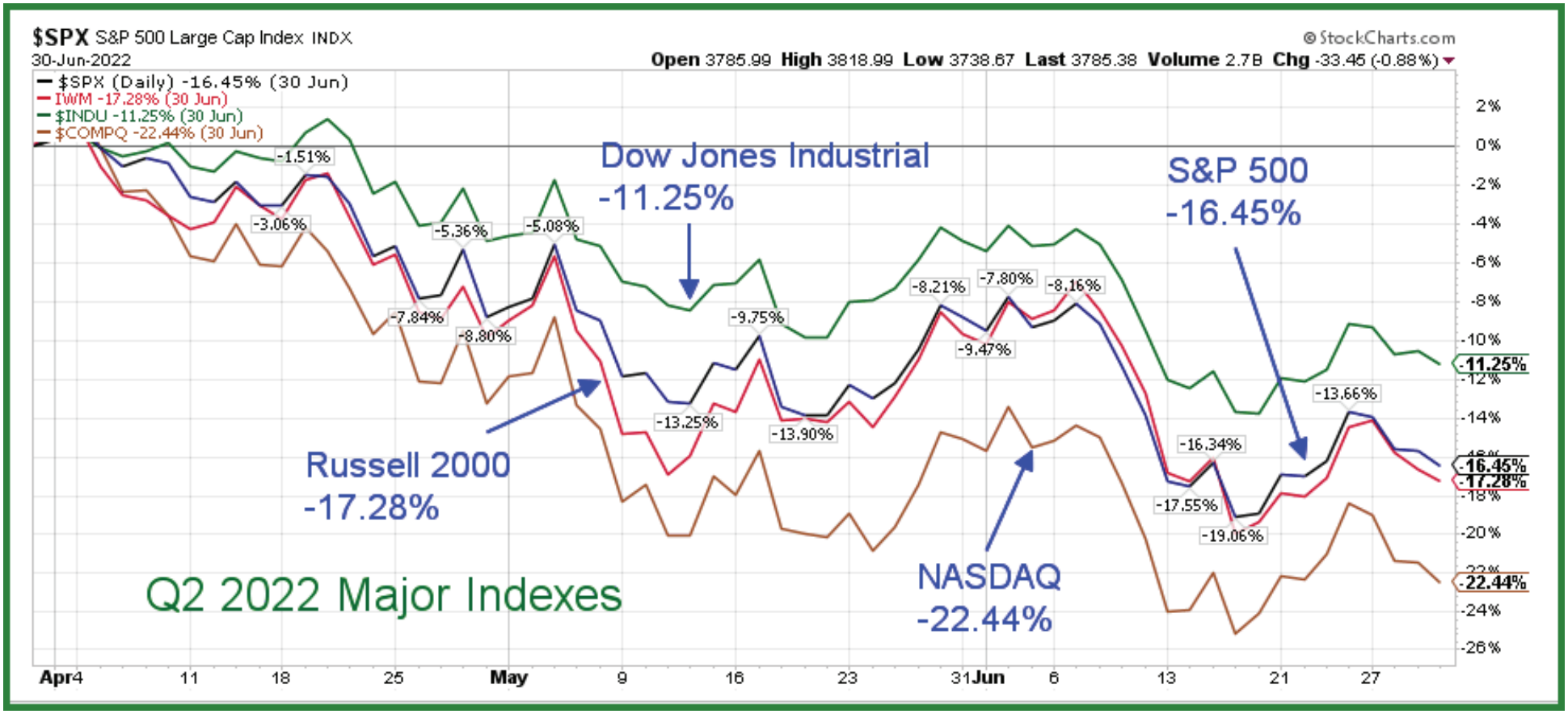
Index	S&P Weight	3-month Total Return	YTD Total Return
S&P 500 Index	100.0%	-16.1%	-20.0%
Information Technology	26.8%	-20.2%	-26.9%
Health Care	15.1%	-5.9%	-8.3%
Financials	10.8%	-17.5%	-18.7%
Consumer Discretionary	10.5%	-26.2%	-32.8%
Communication Services	8.9%	-20.7%	-30.2%
Industrials	7.8%	-14.8%	-16.8%
Consumer Staples	7.0%	-4.6%	-5.6%
Energy	4.4%	-5.3%	31.6%
Utilities	3.1%	-5.1%	-0.6%
Real Estate	2.9%	-14.7%	-20.1%
Materials	2.6%	-15.9%	-17.9%

Source: Bloomberg.

and consumer discretionary (Internet retail like **Amazon**, cars, household appliances and special items) down over 26% for the quarter.

And add to this dismal market performance, consumers are feeling gloomy. The Consumer Sentiment survey done every month by the University of Michigan, recorded in June ***its lowest value ever***, even beyond the depths of the early 1980's recession, which for those of us that remember it, was a tough one, with high inflation, high gas prices and a very high unemployment rate above 10%.

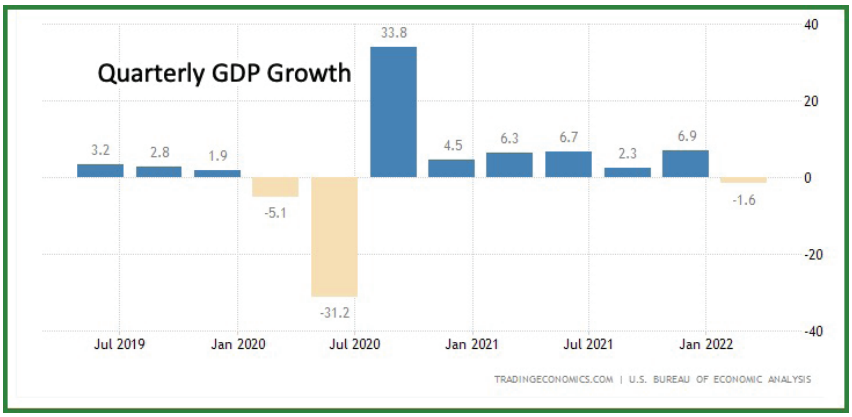
Index Changes over the 2nd Quarter 2022



Market Outlook

But the backdrop to all this horrible news and gloominess is:

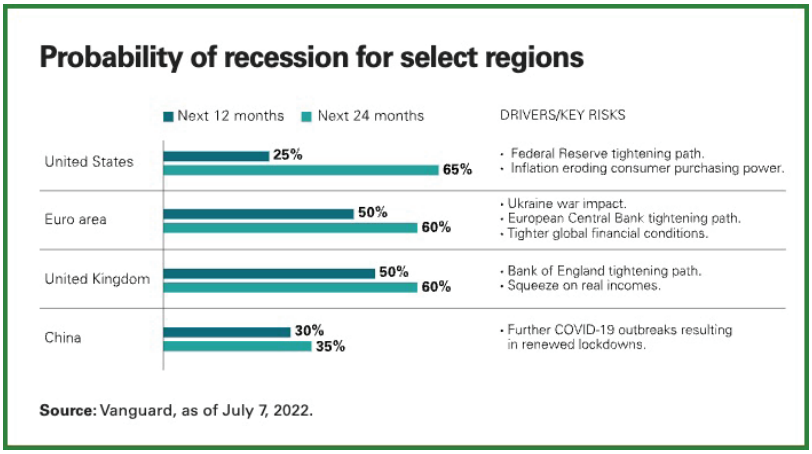
- We still have some of the lowest unemployment in history, with the June number at 3.6%, the 4th month in a row at that number, and
- The consumer still looks strong, with the latest earnings calls from CEO reporting strong sales. Plus, the retail sales number from June rose 1% from the previous month, and 7.7% from June 2021.



Will we have a recession? Technically (meaning 2 quarters of negative GDP growth), we may already be in one since Q1 was -1.6% and Q2 (announced on July 28th) may be down also. But these drops have some uniqueness to them, such as in Q1 imports surges as exports dropped-not long-term events.

Eventually we will have one: recessions are part of the natural economic cycles and serves an important purpose of wringing out unsustainable excesses in the economy and resets growth to a more sustainable level. The main question is how severe the pullback will be. A "soft landing" is the Fed's tightening goal, meaning a slowdown but not so much that it forces a recession. This might be too delicate of a balance to accomplish, but if the recession is not too slow and not too long, it could be a relatively benign event.

But beyond the technicalities, a sure-enough recession may not be right around our corner. Vanguard puts its probability of a recession within the next 12 months at 25% , and 65% at 24 months.

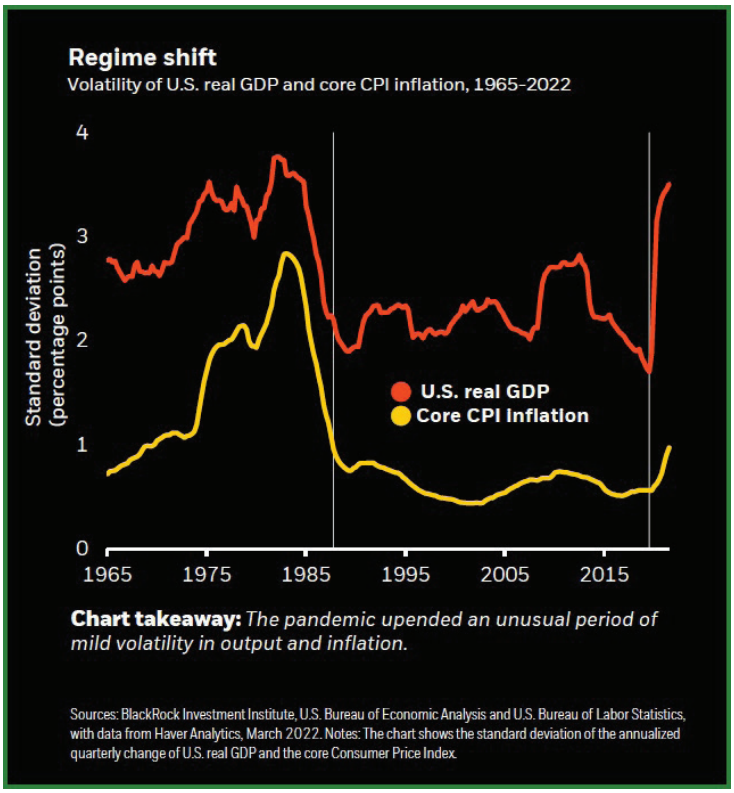


But for the stock market, it is earnings that matter, and we are in a hotly anticipated earnings season right now and we will soon see how the Q2 earnings turn out, which most believe will be below what the analysts have been predicting. But still if there are positive earnings and some growth, this may not be so bad for stock valuations.

And for the bond market, this very much depends on how the Federal Reserve and the other central banks around the world, react (the EU central bank raised rates yesterday for the 1st time in 11 years). Our Fed has said that they are committed to get inflation back down to the 2% level, like it was for years. But one of Blackrock's investment themes (Blackrock is the world's largest money manager and I use their models in designing portfolios) is that we will be living with inflation for some time. They say, "*for all the noise about*

containing inflation, we see policymakers ultimately living with some of it". They predict that the Fed will do one or maybe 2 more rate increases, then pause to see how the economy reacts, and realize that some higher levels of inflation may be tolerable, and the changes to make it lower may not be best for the long-term health of our economy. Their models remain overweight in equities and underweight in government bonds for long-term portfolios (these were published in May, which I have implemented. They just came out with new adjustments in mid-July).

From a strategic viewpoint, Blackrock has published an interesting narrative on what they expect to happen at the macro level. Their thesis is that "*the Great Moderation*", a period of steady growth and steady inflation, is over, and instead, we are braving a new world of heightened volatility and higher risk for both bonds and equities. They say:



"*The Great Moderation, from the mid-1980s until 2019 before the Covid-19 pandemic struck, was a remarkable period of stability of both growth and inflation. We were in a demand-driven economy with steadily growing supply. Borrowing binges drove overheating, while collapsing spending drove recessions. Central banks could mitigate both by either raising or cutting rates.*

That period has ended, in our view. First, production constraints –stemming from a massive shift in spending and labor shortages –are hampering the economy and driving inflation. Second, record debt levels mean small changes in interest rates have an outsized impact –on governments, households and companies. Third, we find the hyper-politicization of everything amplifies simplistic arguments, making for poorer policy solutions."

What this means for investing is that:

- There will be more volatility. Central banks will not be able to control inflation as well as they have in the past and will have to come to terms that to control inflation as they have in the past would crush economic growth, and therefore will have to learn to live with more inflation.
- The days of having a bull market in both stocks and bonds are over. Economic cycles will shorten, and equities or bonds will be doing well based on the Fed's response, but they probably will not be both outperforming at the same time.
- Living with higher inflation will cause bond holders to demand higher compensation (i.e., interest rates) to hold long-term bonds.
- The transition to net zero emissions (they see that being achieved in the latter part of the century) will continue to shape this new regime. But it will be a bumpy ride. They state that "*We believe investors can be bullish on both fossil fuels and sustainable assets, as we see a key role for commodities in the transition. Yet our work finds that changing societal preferences can give sustainable assets a return advantage.*"

Will this turn out to be correct? Who knows! But what I take from this is that investors need to be nimble and be selective, more than we have needed to be in the past. Market returns may be more volatile, but as always, the long term view is the most important view, and ultimately has the higher probability of success than trying to time the short term changes in the market. And the volatility that we have seen (and may continue to see) in both the stock and bond markets shows the value of having diversified, low cost portfolios comprised of index-based ETFs vs. the risk of holding individual stocks and bonds.

For now, our best course is to stay invested at our long-range targets (stocks vs. bonds), and see this period of gloom and doom thru to surely sunnier times ahead. Thanks for listening and please let me know when you have questions.

Frank Brannon, CFP®
July 20, 2022

Recommended Long-Range Asset Allocation Targets & Benchmark Returns

KMR uses established models designed and maintained by major money managers, i.e. Blackrock and Vanguard. After defining the clients risk tolerances and growth expectations and income needs, KMR assigns a investment model to the client that reflects a target asset allocation that is consistent with the risk and growth parameters. Below are the major asset classes allocation for each investment model that KMR utilizes as of **June 30, 2022,** and the benchmark return for that period for each (see below for benchmark explanation). Blackrock models were updated 5/18/22 and Vanguard models were updated 6/30/22.

Investment Model **	Large-Cap Equity	Mid-Cap Equity	Small-Cap Equity	International Equity	Fixed Income	Other	Cash	Total	YTD Benchmark Return*
Target Allocation 30/70	23.0 %	-	1.0 %	6.0 %	67.0 %	1.0 %	2.0 %	100%	(13.63)%
Target Allocation 40/60	31.0 %	-	2.5 %	7.5 %	56.0 %	1.0 %	2.0 %	100%	(14.63)%
Target Allocation 50/50	39.0 %	-	2.5 %	9.5 %	46.0 %	1.0 %	2.0 %	100%	(15.62)%
Target Allocation 60/40	47.0 %	-	3.0 %	11.0 %	36.0 %	1.0 %	2.0 %	100%	(16.61)%
Target Allocation 70/30	54.0 %	-	3.5 %	13.5 %	26.0 %	1.0 %	2.0 %	100%	(17.61)%
Target Allocation 90/10	65.5 %	-	5.0 %	20.5 %	6.0 %	1.0 %	2.0 %	100%	(19.59)%
Target Allocation Tax-Aware 70/30	58.0 %	-	2.5 %	21.5 %	16.0 %	-	2.0 %	100%	(18.18)%
CRSP Series 70/30	36.3 %	-	4.9 %	27.4 %	29.4 %	-	2.0 %	100%	(17.61)%

***KMR uses the BLACKROCK Benchmark for its investment models, which is explained as followed**: the equity portion of the benchmark is represented by 70% **MSCI ACW**I (All Country World Index) and 30% **MSCI USA** Index, while the fixed income portion is represented by a fixed 2% allocation to the ICE BofA ML US **T-Bill 0-3 Month** Index and the remaining allocation to the Bloomberg Barclays U.S. Universal Index (**AGG,** or **MUB f**or tax-aware models). These are popular market benchmarks tracked by ETFs and index funds. The ACWI is a global equity benchmark with approximately 50% allocated to U.S. equities. Thus, the 70/30 ACWI/USA equities benchmark is equivalent to 66% U.S. and 34% non-U.S. stocks, embedding a well-known home bias of +15%.

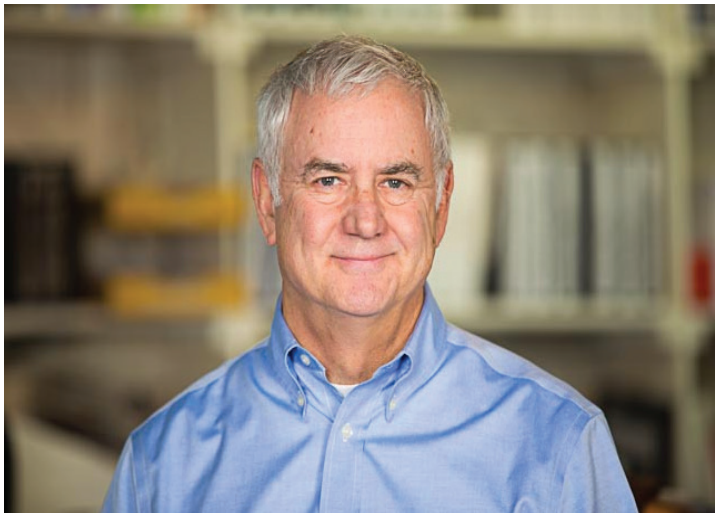
The Q2 2022 return for each index component is as follows:

iShares:MSCI USA EW	(21.07)%
iShares:MSCI ACWI	(20.69)%
iShares:Core US Agg Bd	(10.87)%
iShares:0-3 Month Trs Bd	0.09 %
iShares:Natl Muni Bond	(8.53)%

** Model names indicate the general asset allocation target but can be higher or lower than the name due to over- or under-weighting of asset classes. All models are developed by **Blackrock** except for the CRSP series, developed by **Vanguard**

About KMR Financial Advisory, Inc.

KMR Financial Advisory is an independent, fee-only registered investment advisor specializing in the development of comprehensive financial plans and developing & managing investment portfolios.



Frank R. Brannon, CFP ®, is the president of KMR Financial Advisory, Inc. Frank's educational background includes:

- **The Lovett School**
- **Tulane University,**
  BA, Economics
- **Georgia State University,**
  Master of Decision Sciences

Frank is a Certified Financial Planner™ professional and achieved his license in 1996. Frank has worked most of his career in corporate financial planning for a Fortune 200 company. He has lived his entire life in Atlanta.

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