Capital Markets Commentary and Quarterly Report: 3rd Quarter 2022

Capital Markets Highlights

In Q3, 2022, the U.S. stock market[1] declined for the third consecutive quarter, falling by -4.88%. Year-to-date through September 30, the stock market was down -23.88%. There was considerable volatility during the quarter with the market rallying +17% between mid-June and mid-August, before selling off again after disappointing inflation data and concerns that the Federal Reserve's prescription to reduce inflation by raising interest rates and otherwise tightening monetary policy may cure the disease but put the economy in intensive care.

Most areas of the U.S. stock market were down in the quarter. The two sector exceptions were Energy and Consumer Discretionary. Growth modestly outperformed Value in the quarter but Value has been far more protective year-to-date through September 30.

It was also another tough quarter for fixed income investments with interest rates rising across the yield curve. The Federal Reserve raised interest rates by 1.50% in the third quarter, 0.75% in July and another 0.75% in September. After keeping rates near zero since March 2020, the Fed has raised interest rates five times this year, to the current range of 3.00-3.25%. At their meeting in September, they indicated that they may continue raising rates until they reach 4.60% in early 2023, before pausing[2]. It was a lot for the stock and bond markets to process.

The two-year Treasury yield ended the quarter at 4.28%, up from 2.96% on June 30. At the beginning of the year, its yield was 0.73%. The 10-year Treasury note yield was 3.83% on September 30, 3.02% on June 30, and 1.26% at the beginning of the year. The Bloomberg U.S. Aggregate Bond Index[3] was down -4.75% in the third quarter, bringing its loss to -14.61% year-to-date through September 30.

The price of oil declined in the quarter for the first time since 2020. After running up to over $120 a barrel in early June, it ended the quarter at $79.49, below the pre-invasion of Ukraine price of $91 and close to the price at the start of the year, $75.21.

[1] All references to the U.S. Stock Market are the S&P 500 unless otherwise noted.
[2] FOMC September 2022 forecasts
[3] The Bloomberg U.S. Aggregate Bond Index, or Agg, is a broad-based market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Our Thoughts Going into Q4

As the market sell-off accelerated in the September downdraft, we have become more optimistic about the prospects for stocks in the next 6 to 12 months. Stock and bond prices have come down a lot. The stock market valuation has dropped from 21 times earnings at the beginning of the year to 14.8 times estimated 2023 earnings, below its 25-year average[4]. Matrix's equity portfolios sell at discounts to the market and are at very attractive levels. Their embedded appreciation potential[5] on September 30 was well above its historic average. Outsized upside for our portfolios so far above the norm, about 2.7 standard deviations[6], are rare and have been relatively short lived in the past. Historically, these extremes in upside have generally been bullish for the market and our portfolios.

We think the Fed's actions to tighten monetary policy are having the desired effect of lowering inflation by bringing supply and demand into better balance. The economy is slowing, and prices are coming down. While this takes time to show up in the official inflation statistics, the real time data show price declines spreading throughout the economy. It became more obvious this summer with retail sales warnings and price cuts from Target and Walmart to clear excess inventory. A broad list of commodity prices has fallen. Gasoline prices are well off their peak as are used car prices, and now shelter prices (one of the largest components of the Consumer Price Index) are falling as home prices react to higher mortgage rates, which have doubled this year. Apartment rent prices are also flattening or dropping in many geographies.

Two other deflationary forces at work are the ending of Covid stimulus programs and the strength of the dollar, now at a 20-year high[7]. A stronger dollar lowers our import prices (the good side of dollar strength) but too much of a good thing can create a crisis for global economies (already suffering from the war between Russia and Ukraine) as the price of commodities (priced in dollars) and dollar denominated debt increases significantly.

In early October we saw further confirmation that the economy is slowing. U.S. manufacturing activity grew at its slowest pace in 2½ years in September and The Wall Street Journal reported that ocean carriers /are canceling sailings on the world's busiest routes in what is normally their peak season, with Trans-Pacific shipping rates down roughly 75% from year ago levels[8]. The Labor Department reported on October 4 that job openings dropped by 10% in August and layoffs rose. The Fed's policies to cool the economy and lower inflation take time but the numbers confirm that they are working.

The consensus view is that the Fed will follow through with its intent to increase rates by 0.75% in November, and then by another 0.50% in December, taking the Fed funds rate up to 4.25% by year-end,

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[4] Source: Bloomberg and JP Morgan Asset Management *Guide to the Markets*, September 30, 2022.

[5] A proprietary metric that Matrix uses to track the portfolio's appreciation potential.

[6] Standard Deviation is a measure of the amount of variability in a set of data. A normal distribution has a width of 1 standard deviation. A standard deviation above 2.5 has a less than 1% probability.

[7] Economic and Market Update, J.P. Morgan Asset Management, September 30, 2022

[8] WSJ October 2, 2022

near the terminal rate of 4.6% they have projected to reach in 2023 [9]. After that, we hope they will pause to evaluate the impact of what they have already done. Any signal from the Fed confirming that they are near the end of raising rates could ignite a powerful stock market rally.

Stock market bears argue that the Fed will keep raising rates, even as the economy slows, to cool the labor market and doing so will increase unemployment and push the economy into a deeper recession (a hard landing).

If we are not technically in a recession[10] now it feels like we may be on the precipice of one. But it is important to remember that recessions are a normal part of the business cycle, usually short-lived and followed by long economic expansions and strong market recoveries. Since 1921, the average economic expansion has lasted 47 months while the average recession has lasted 14 months. During the post-World War II period, a typical recession lasts about six to 12 months. Stocks generally sell off 3 to 9 months prior to recessions and start to rally during the recession in anticipation of the eventual recovery[11].

We think the chances are very good that the economic picture may look much sunnier six months from now and the stock market, as it has done historically, will likely rise well before it becomes obvious that inflation is coming down and the worst fears about the economy prove to be exaggerated. The timing of the next advance is unpredictable and being invested in the early stages of a market rally is key to good long-term investment results. Our advice is to stick with your investment plan and not overreact to current events or short-term market moves.

The primary risks we see to our optimistic outlook are: 1) that the war between Russia and Ukraine escalates and 2), the Fed keeps raising interest rates longer than necessary, in part, to push back against criticism that they waited too long to raise them. A convincing argument against doing more than necessary is the risk that higher rates may push the dollar ever higher and increase the likelihood of triggering a financial crisis outside of the U.S. that becomes a global contagion or push the U.S. economy into an unnecessarily deep downturn.

For the first time in years, we are more constructive about high quality short-term bonds. In this environment they offer a reasonable interest rate and have a key place in balanced accounts. We continue to be wary about longer-term bonds.

Below we provide a full discussion of the portfolios.

[9] FOMC forecast September 2022.

[10] Recessions as defined by the National Bureau of Economic Research.

[11] JP Morgan Asset Management Guide to the Market, September 30, 2022

Large Cap Value Portfolio (LCV)

In Q3, and for the year-to-date through September 30, 2022, the LCV portfolio trailed the performance of the S&P 500 and the Russell 1000 Value Index. Our 2022 year-to-date weakness has been driven by a market that has severely penalized last year's strong performers, of which we had many.

During the quarter, we started a new position in Air Products and Chemicals (APD) for accounts with cash to invest. Air Products & Chemicals is a leading global industrial gas company with very stable returns. The company provides industrial gas in bulk liquid and compressed gas forms as well as via on-site dedicated facilities. Because many of its contracts are long-term, the business is less cyclical than many industrial companies while benefiting during economic upswings. Air Products is a leader in hydrogen fueling systems and infrastructure, and the company sees great potential to extend its leadership in the years ahead. APD consistently returns capital to its shareholders through share repurchases and by steadily increasing its dividend. Its current annual dividend of $6.48 per share provides a 2.8% yield on September 30.

We also added to the position in Booking Holdings, a leading global online travel company.

On September 30, the largest sector weightings in the LCV portfolio were Information Technology, Financials, Communication Services, and Health Care. We think the first three sectors, which have lagged the market year-to-date, are positioned to lead the market and the portfolio higher in upcoming periods.

At the end of the third quarter, the average P/E multiple of the LCV portfolio was 13.6 times and 12.5 times estimated 2022 and 2023 earnings, a discount to the S&P 500's 16.0 times and 14.8 times estimated P/Es for the same time periods[12]. The average embedded appreciation potential for the portfolio was 70%, a level suggesting a very healthy upside potential for our LCV stocks.

We believe the Large Cap Value portfolio is well-positioned for upcoming periods, as the businesses are operating at a high level with strong earnings and cash flows, yet it sells at a very attractive valuation.

Matrix Dividend Income (MDI)

The Dividend Income portfolio trailed the overall market (S&P 500) and the Russell 1000 Value Index in the third quarter but has outperformed both benchmarks (net of fees), for the nine months that ended September 30.

During the quarter, we re-established a position in Home Depot (HD) sold earlier this year, after the shares declined sharply on big picture concerns about a softer housing market and lower consumer spending. We believe that HD is a very well-managed company, positioned to continue showing good profits even as the economy decelerates. The products it carries in inventory are in year-round demand from contractors and homeowners wanting to maintain and improve their homes. The company has

[12] Source: Bloomberg

historically been shareholder friendly, repurchasing shares and increasing the dividend, most recently by 15% earlier this year. On September 30, HD's current dividend yield was 2.8%.

We also added to positions in AbbVie, Air Products & Chemicals, Morgan Stanley, Paramount Global and Unilever.

We sold the entire position in Verizon, which was a disappointing investment, on concerns that the company is losing market share in a very competitive business and because we believed we had better use for the funds elsewhere.

In Q3, 2022, four portfolio holdings raised their dividends by an average of 7.5%. For the first nine months of 2022, 18 portfolio holdings have raised their dividends by an average of 8.1%. Looking forward, we expect further dividend increases in the portfolio in the fourth quarter, and by year-end expect the vast majority of our holdings to have increased their dividends for the year. These increases are all the more impressive in an environment where there are many questions about the strength and outlook for the economy.

On September 30, 2022, the portfolio had a 3.38% dividend yield, which compares very favorably with the 1.85% yield on the S&P 500, the 2.56% yield on the Russell 1000 Value, and the 3.83% yield on the 10-year Treasury[13].

At the end of Q3, 2022, the MDI portfolio's largest sector concentrations were in Financials, Health Care, and Technology. These large sector weightings provide a nice balance of economic sensitivity and stable earnings growth.

On September 30, the MDI portfolio's estimated P/E multiple was 14.3 times and 13.3 times estimated 2022 and 2023 earnings, a discount to the S&P 500's 16 times and 14.8 times estimated P/Es for the same time periods[14]. The average embedded appreciation potential for the portfolio was more than 50%, which is well above its historical average and an unusually large upside potential for our high-quality equity income MDI portfolio.

We believe the MDI strategy is ideal for conservative, income-oriented equity investors. The portfolio has provided more downside protection than the S&P 500 Index, defending well during periods of market turbulence, while still allowing for meaningful appreciation over time.[15] The highly diversified, all-weather MDI portfolio should be well-positioned to have good performance in the volatile market we anticipate during a period of slower growth and higher interest rates.

[13] Source: Bloomberg

[14] Source: Bloomberg

[15] Since the inception of the MDI Composite on January 1, 2022

Bonds

In Q3, 2022 central banks around the world continued to raise interest rates and tighten monetary policy to combat inflation. The Q3 losses added to a year of negative results for fixed income markets. On the shorter end of the yield curve, the two-year U.S. Treasury yield rose to 4.28% on September 30 versus 2.96% on June 30 and 0.73% on December 31, 2021. The 10-year yield was 3.83% on September 30, versus 3.02% on June 30 and 1.51% on December 31, 2021. The Bloomberg U.S. Aggregate bond index (U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities) was down -4.75% in the third quarter, bringing its loss to -14.61% year-to-date through September 30, the worst return in this fixed income benchmark's history going back to 1976[16].

Losses were greater for longer maturities. The 30-year Treasury is down more than 30% year-to date, through September 30.

While our bond portfolios were lower for the quarter, they benefitted relatively from their focus on high-quality corporates, U.S. Treasuries, agencies, and municipals (where appropriate) with nearer-term maturities.

With this conservative shorter-term positioning, our taxable bond and municipal portfolios performed in line with their benchmarks for bonds with similar duration, and our declines were much more modest than the overall bond market.

With yields having risen so quickly, and signs that the economy's growth rate is moderating, we believe that current short-term high-quality bond prices largely reflect the anticipated Fed increases for the balance of the year. For the first time in years, we think there are good opportunities in short-term bonds. We continue to be wary of intermediate and longer-term bonds. Investors are getting the same or less income that short-term bonds are paying while taking on significantly greater principal and interest rate risk. We have used the rise in rates to be more active in buying bonds with 6-month to 36-month maturities and selling some of the short-term ETFs that we were using as a short-term fixed income placeholder. For taxable accounts, these swaps have also created some realized taxable losses.

Balanced Accounts

This quarter and year-to-date have been highly unusual periods when both stocks and bonds declined. More typically, bonds provide a cushion during periods when the stock market declines. We expect the long-term balance and diversification benefits between the two asset classes to return in upcoming periods.

With our expectation that economic growth will resume when interest rates stabilize, we continue to believe that stocks are more attractive than bonds at current levels. Bonds play an important role in balanced accounts and as rates have moved higher, they now offer a reasonable income stream and should provide greater stability if stock volatility continues in upcoming periods. So, while our outlook

[16] Source: Bloomberg, FactSet, J.P. Morgan Asset Management.

for stocks is favorable, for the first time in some time we are upbeat in our return expectation for short term fixed income securities.

Realized Capital Gains Outlook and Tax Mitigation for Taxable Accounts

We were more active than usual earlier in the year, locking in profits on relative strength in some names to upgrade the quality and future upside potential of the portfolios. Those stocks were strong performers in a difficult market. They did their job and were at or are close to our fair value/targeted upside. In a better market, we think the new names we have been buying or the existing holdings we added to on price weakness have much more upside than the names we sold.

While gains this year have been higher than usual, we have been active in our tax mitigation trading to significantly reduce the gains and will continue to do so in Q4. In light of the most recent leg down, we expect to continue to make meaningful progress in lowering the realized capital gains in the 4th quarter.

Some of the trading we did was to take losses now or be set up to take losses later while keeping the integrity of the portfolio intact.

For example, we doubled up on many names that were trading below their cost and funded the purchases with sales of some that had modest losses or were in similar industries. We think these doubled-up names have great upside, but we wanted to be able to take the loss on higher-cost shares. So, if you see a lot of buying in a name and an outsized position in your portfolio, it is likely a tax double-up that we plan to bring back to normal size later.

The combination of higher than usual purchase and sales and tax mitigation trades has created more portfolio activity than usual this year. After we complete our 2022 tax mitigation trading, we expect our activity to return to more normal levels.

Beginning last quarter, we have included a preliminary year-to-date capital gains report as part of the quarterly report. The report provides an approximate look at the realize gains for the year-to-date through September 30. You should continue to **only** use your custodian/brokerage house 1099 form in doing your year-end taxes.

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Thank you for your continued confidence in the Matrix team.

After a difficult nine months of 2022, we are confident that the portfolios are well-positioned to fully participate in the better environment we expect over the next 6-12 months. If you have any questions about any parts of this commentary, our outlook, or your portfolio, please do not hesitate to call.

Stay well. Best regards,

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