Morris Capital Advisors, LLC

# Investment Commentary
# September 30, 2022

## The Good, the Bad, and the Ugly

The Good, The Bad, and The Ugly was the third of a series of movies dubbed “Spaghetti Westerns” starring Clint Eastwood. Created by an Italian producer and director, this final installment is credited with launching Eastwood’s career. The plot revolves around the search for confederate gold in the latter stages of the American Civil war as Eastwood (the Good) is confronted by two adversaries (the Bad and the Ugly). In the final sequence Eastwood faces a three-way duel. After a tense standoff, Eastwood prevails (of course), recovers the gold, and leaves the one surviving adversary to fend for himself.

I would not be surprised if our good investors feel as if they are also facing a three-way duel with bad central bank policy and ugly fiscal economic initiatives. The Fed badly misjudged inflationary pressures last year and moved aggressively this year to raise interest rates and drain liquidity. But as the quarter began, investors began to think that the Fed had moved too aggressively and would soon be forced to reverse its rate hike schedule. Talk of this Fed “pivot” pushed the market sharply higher in July through mid-August. The rebound faltered when the Fed reaffirmed its rate hike schedule after ugly inflation data, and then raised rates by 75 basis points at its meeting in September. As the Fed pushed short rates higher longer-term rates declined, leading to an inverted yield curve, a highly reliable recession indicator.

Many commentators believe that market risks are elevated today due to years of bad macroeconomic policy by the Fed. Since the days of Alan Greenspan, the Fed has become increasingly involved in managing market outcomes. The belief that the Fed would serve as a market backstop took hold during Greenspan’s tenure and was reinforced by Ben Bernanke who used the Fed balance sheet to create a wealth effect to support the markets and economy during the Great Financial Crisis. He greatly expanded the Fed balance sheet to inject liquidity into the markets, pushing interest rates to historically low levels. This policy, implemented around the world at Bernanke’s urging, popularized Modern Monetary Theory which held that massive debt and currency expansion could support the markets and economy with no adverse effects. It all seemed to work for a while as the markets rallied for almost ten years fueled by artificially low interest rates and successive rounds of qualitative easing. Very few stopped to think that artificially low interest rates were not effective policy prescription, but an indicator of structural flaws in the global economy.

Policy moves from Washington contributed to the ugliness. From the outset, this administration has pursued an energy policy that stifled domestic energy production, crushed exports, and raised gasoline prices at the pump. As demand grew, the administration was forced to beg OPEC for an increase in production, and make concessions to third-world dictators for additional supply. In a transparent effort to lower the price of gasoline, the administration initiated a substantial drawdown of our strategic petroleum reserve. The move did lower prices, and improved mid-term election prospects, but at a terrible weakening of our energy independence. Trillion dollar spending bills, including the inappropriately named Inflation Reduction Act that does nothing to reduce inflation, are now the norm. The debt-financed spending pushed federal debt to well over 100% of Gross Domestic Product (GDP). At these levels, a 1% increase in interest rates will add more than $250 billion to the federal deficit each year, and could trigger a “doom loop”, a vicious cycle where more borrowing to pay interest generates more interest and more borrowing.

It’s hard to feel good in the face of high inflation, rising interest rates, aggressive tightening by the Fed, and conflicting economic policy out of Washington; and it is not surprising that many people feel that our country is heading in the wrong direction. The standard of living for the average taxpayer declined as inflation eroded the purchasing power of their income. Even if the rate of inflation declines, prices will remain at a much higher level that just few years ago. But the markets always seem to do just the opposite when investors become too pessimistic, and in that spirit, let’s look at some positive factors. The job market is strong, with 3.5 million jobs created this year and unemployment at just 3.7%. By some estimates there are 11.2 million job openings verses 5.7 million unemployed. That is almost 2 openings for every job seeker, so there should not be a problem finding a job for those who want to work. Supply chain issues are dissipating as well, contributing to a rebound in the automobile market. Commodities prices are lower, with significant declines in lumber and copper, two important contributors to housing costs. Energy prices are also lower, but that may change when the drawdown of the strategic petroleum reserve is ended. While investor pessimism pushed the stock and bond markets lower, much of the bad news may already be priced in.

Despite this recent volatility, we are not in uncharted territory. Our financial markets have weathered adversity before, and the strength of our free-market economy is its ability to change and adapt. Our investment process is designed to build portfolios that can withstand these bouts of uncertainty, while remaining positioned to participate in the rebounds that inevitably occur. As in the past, we will continue to focus on strong, well-managed companies, trading at reasonable valuations that can adapt and change. That process has enabled us to build portfolios of good companies, while avoiding the bad and the ugly.

Sincerely,
Daniel A. Morris

*Market summaries on reverse page*

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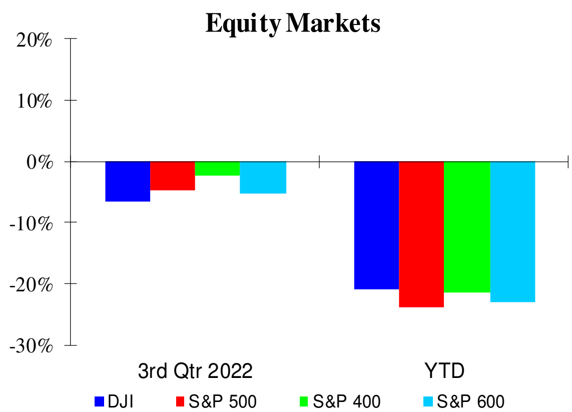
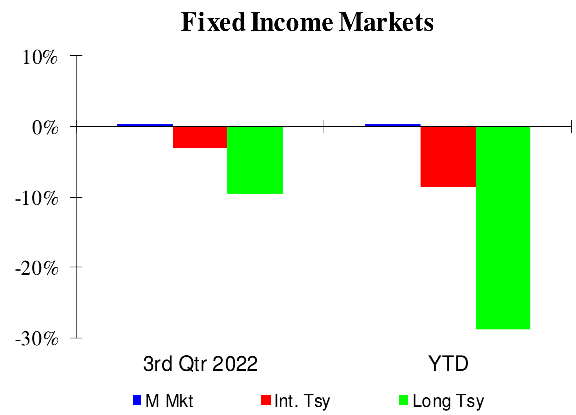
# Market Summary
# September 30, 2022




The stock market rebounded during the first half of the quarter, driven by resilient corporate earnings, signs of a possible peak in inflation, and a growing belief among investors that the Fed would "pivot" from its aggressive tightening cycle. The S&P 500 index rose 9.2% in July, its best monthly return since November 2020. The rally continued through mid-August until Fed Chairman Jerome Powell dashed investor hopes for a less-aggressive policy shift. The reversal gained momentum to the downside when Powell indicated that aggressive rate hikes through year-end would result in "economic pain". The selling continued as inflation pressures and a 0.75% rate hike reinforced investor fears. The major stock indices posted negative returns as both value and growth stocks declined. Only one of the 11 S&P 500 sectors registered a positive return. Defensive sectors outperformed on a relative basis as consumer discretionary and energy sectors fared better than technology and communications names.




The bond market declined during the 3rd Quarter of 2022, as rising interest rates across the yield curve pressured fixed income securities. The results were directly attributable to the continuation of the restrictive policies of the Fed and strong rhetoric regarding inflation by several Fed governors. The Fed raised the fed funds rate by 75 basis points in September, the third consecutive 75 basis point increase in this tightening cycle. Most bond indices posted solidly negative returns with short maturities outperformed longer-term bonds. Corporate bonds outperformed longer-duration government bonds on a relative basis, while higher yielding, lower quality corporate debt declined less than investment grade corporate bonds. Yields on short-term treasuries continued to move higher than longer-date m=treasuries, extending the steepening of the yield curve, signaling the potential of a recession. While central banks around the globe are raising rates, the aggressive moves by the Fed have contributed to a strengthening US dollar, contributing to a global economic slowdown.