MIDDLETON & COMPANY, INC.

Investment Update

October, 2022

2022 Third Quarter Update

Review: For the third quarter in a row, returns for most asset classes were negative. The resolve of the Federal Reserve to bring down inflation regardless of the potential costs, such as higher unemployment, has been stronger than many had predicted, putting continued pressure on returns. International equities were weaker than the S&P 500, partly due to the continued strengthening of the US Dollar. Fixed income markets delivered negative returns once again due to rising yields, with the Bloomberg US Aggregate Bond Index falling 4.8% in the quarter, only slightly better than the 4.9% drop in the S&P 500.

Period	3Q22	2Q22	1Q22	2021
S&P 500	-4.9%	-16.1%	-4.6%	28.7%
MSCI EAFE[1,2]	-9.3%	-14.3%	-5.8%	11.8%
MSCI Emerging Markets[2]	-11.4%	-11.3%	-6.9%	-2.2%
Bloomberg U.S. Aggregate Bond	-4.8%	-4.7%	-5.9%	-1.5%
Bloomberg Municipal Bond	-3.5%	-2.9%	-6.2%	1.5%

[1]Europe, Australasia, Far East

[2]MSCI returns are in U.S. Dollars

"Keep at it until the job is done"

Although they closed the quarter in negative territory, markets had been trending positively in the first half of the quarter. As of August 16, the S&P 500 was up nearly 18% from the prior trough reached on June 16. The catalyst for the selloff that followed was Fed Chair Jerome Powell's speech at Jackson Hole, Wyoming on August 26, which was more hawkish than the market had anticipated. He noted the lessons learned about inflation from the 1970s and early 1980s, which included the line shown here in the heading. This was most likely a reference to Paul Volcker (Fed Chair 1979-87), who aggressively raised rates to combat the inflation of the late 1970s/early 1980s and whose memoir was entitled *Keeping At It: The Quest for Sound Money and Good Government.*

Financial markets responded to the speech by pricing in additional rate hikes and a higher terminal (peak) rate, and the resulting selloff in equities and fixed income was exacerbated by a higher than expected August inflation (CPI) reading on September 13, which also drove higher rate expectations. The chart on the next page shows just how much expectations for future Fed Funds Rate have changed over the past year. This has been a key driver of the downturn and volatility we have seen in

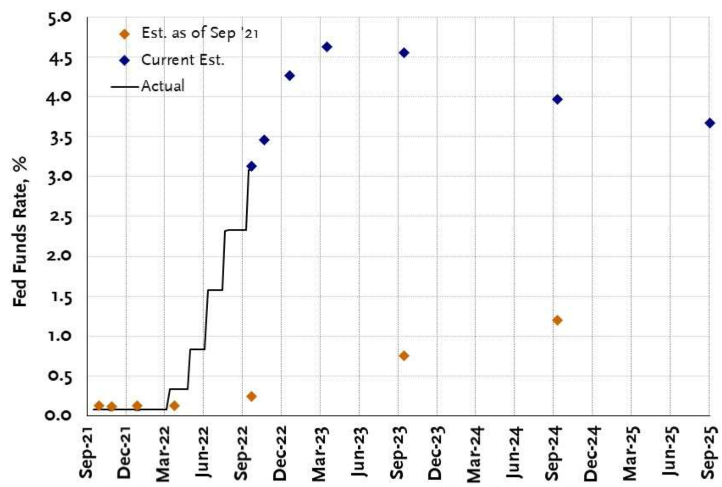
600 Atlantic Avenue
18th Floor
Boston, MA 02210-2211

Phone: 617-357-5101
Toll-free: 800-357-5101
Fax: 617-357-7199

info@middletonco.com
www.middletonco.com

financial markets over the same period. As shown by the orange dots, last year, the market anticipated just one 0.25% rate hike in 2022, ultimately reaching 1.0% in 2024. Instead, we have already had five hikes, likely seven by year end, with an expected peak rate of >4.5% by March 2023 (blue dots). The paths of inflation and rates will likely continue to be the primary drivers of financial markets for at least the next few quarters.

Actual and Market Estimated Fed Funds Rate, Current vs One Year Ago



Source: Bloomberg; actual data through 09/30/2022, and current estimates as of 09/30/2022

Outlook: The aggressive Fed posture, elevated inflation, and depressed consumer confidence has led to a decline in the 2022 estimate for US GDP growth, which now stands at 1.6%. It remains to be seen if the Fed can continue its aggressive rate hike path without triggering a recession. This has led to larger than expected market responses to single data points on inflation, jobs, and other economic metrics, as investors try to rapidly adjust their outlooks to be more positive or negative. However, many economic indicators that we track continue to be healthy, such as consumer spending and trucking volumes.

We continue to be cautious on international growth. The strength of the US Dollar is a significant headwind for many emerging economies, and developed international economic growth, particularly in Europe, appears to be more challenged than US growth due to the impact of inflation, central bank policies, and demographics. China's zero COVID policy also continues to be a global headwind, but there is some speculation that it may change following this month's National Congress, particularly after Xi Jinping was seen without a mask at recent events.

Strategy: We would characterize the first half of 2022 as a market concerned about valuations in the face of rapidly rising rates, but that appears to have shifted to a market now concerned about corporate earnings and economic growth. In such an environment, quality stocks at reasonable valuations should be better positioned, particularly those exposed to growth trends less dependent on the economic cycle. Higher bond yields also provide opportunities in fixed income that we have not seen in quite some time. Volatility will likely remain elevated due to continued uncertainty around inflation and rates, but as we noted last quarter, this should also provide opportunities to upgrade portfolios at the individual security level.