CHOATE
INVESTMENT
ADVISORS

2022 Q2 REVIEW

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2022 Second Quarter Review

With rising inflation and slowing growth, the stock and bond markets continue to struggle in Q2 2022. In response to persistent inflation, the Federal Reserve and other central banks are further increasing interest rates. In April, the year-end forecast for the Fed funds rate, which affects many consumer interest rates, was 2.7%; today, the year-end forecast is 3.4%. Rising interest rates continue to put pressure on bond prices. The Bloomberg Aggregate bond index is now down -11.5% year to date vs. a decline of 5.9% at the end of the first quarter. If the year was to finish today, this would be the worst performance in the history of the index. The S&P 500 is down 19.3% year to date, and the MSCI All country world index is down 19.2%. This is the largest decline in the first half of the year since 1970.

For the second quarter, the S&P and MSCI ACWI are down 16.7% and 15.7% respectively. Investors are not only being buffeted by inflation and the jarring shift in central bank policy, but also war and other geopolitical concerns, the continued impact of the pandemic, particularly in China, and a highly charged political backdrop. It is no surprise that consumer sentiment and investor sentiment are very low.

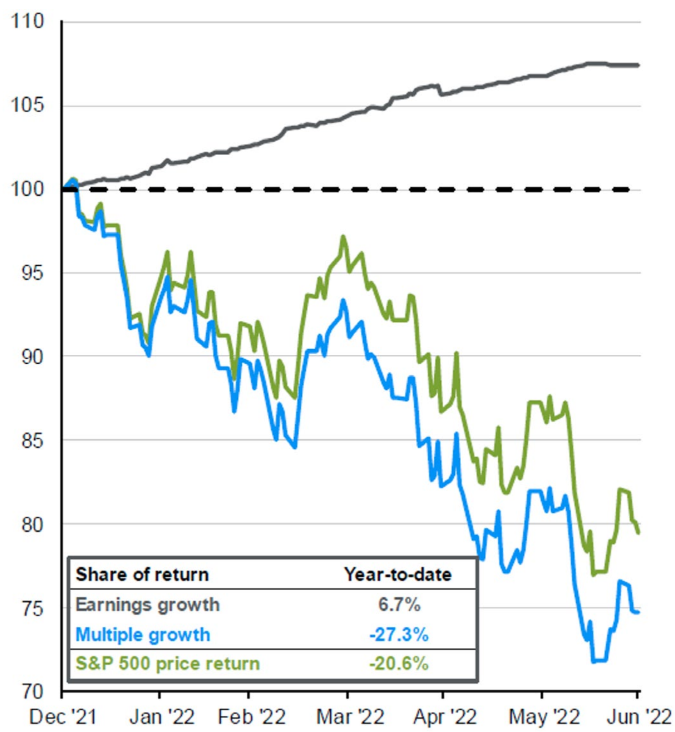
Year-to-date our equities underperformed the market.

Q1 performance was largely driven by multiple compression which disproportionally impacted faster growing companies. These companies have more of their value based on future earnings. When interest rates rise, investors discount that future growth because it is worth less in a higher rate environment.

As the chart from JP Morgan highlights, growth in earnings is still positive for the S&P 500, but multiples have been significantly compressed and stock prices have gone down.

Percent change in S&P 500, earnings and valuations*

Year-to-date, indexed to 100



Source: JP Morgan Guide to the Markets, 6/30/22

Source: Compustat, FactSheet, Standard & Poor's, J.P. Morgan Asset Management. Historical EPS levels are based on annual operating earnings per share. Earnings estimates are based on estimates from Standard & Poor's and FactSet Market Aggregates. *Earnings and multiple growth are both year-to-date percent changes of next tweleve-month estimates. Past perfromance is not indicative of future returns. *Guide to the Markets – U.S. Data are as of June 30, 2022.*

Forward price to earnings multiples (the price paid today for future earnings) for the S&P 500 are now below the long term average.

S&P 500 Price to Next Twelve Month Earnings Ratio

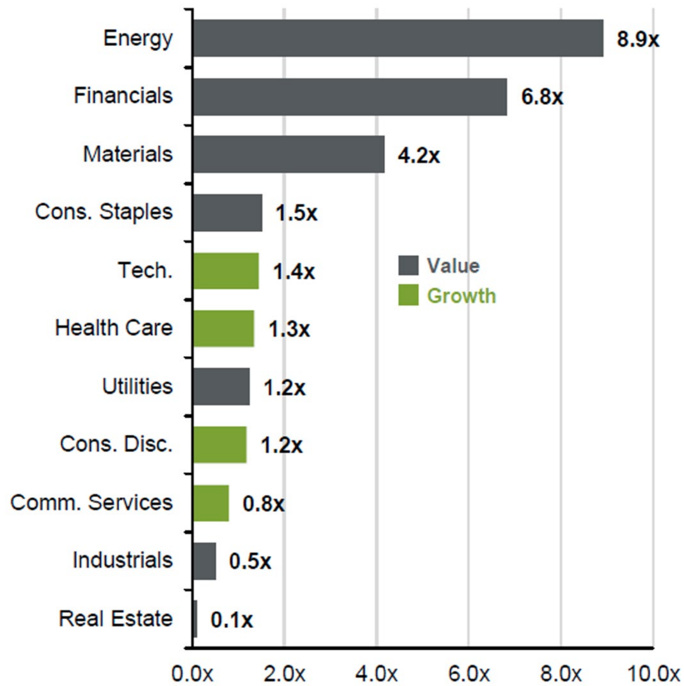
Source: Bloomberg. Data as of 6/30/2022.

During the second quarter, investor concern shifted to assessing the impact of higher interest rates on slowing the economy. This should lead to a renewed focus on company earnings and business resilience. As we explained in our Q1 update, we think the companies we recommend will produce sustainable earnings growth.

Our overweight to the healthcare, technology, and consumer discretionary sectors was a drag in the first quarter relative to the S&P 500, but these types of firms generally have less operating leverage than companies in sectors we do not own, which we think should contribute to their resilience in the face of a slowing economy. Again, a recent chart from JP Morgan illustrates this:

Percent change in S&P 500, earnings and valuations*

Year-to-date, indexed to 100



Source: JP Morgan Guide to the Markets. Operating leverage is a bottom-up calculation based on the 5-year compounded annual growth rate (CAGR) in EBIT divided by the 5-year CAGR in revenues. Each sector's operating leverage is weighted by market cap. Calculations use EBIT and revenue over the 5-year period between 2016 and 2021.

The higher the operating leverage, the greater the impact on earnings from a decline in revenue, which makes companies with operating leverage more cyclical and, we believe, vulnerable to economic downturns. Since the companies we recommend tend to have lower operating leverage, our recommended equities performed incrementally better than the market.

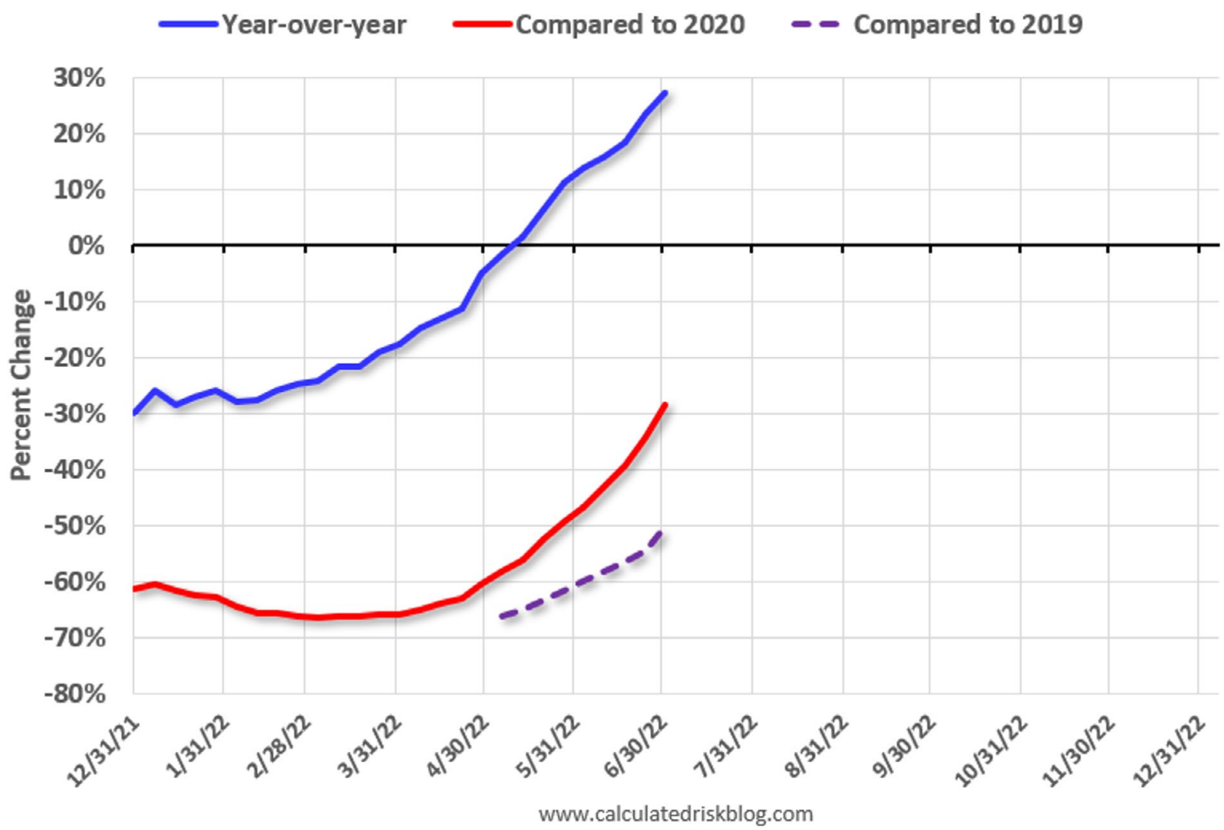
As rates increased, our recommendation to shorten duration within our recommended bond mix led to outperformance versus the Bloomberg aggregate benchmark index for the period, but given the 11.5% decline in the bond index, bonds in our portfolio still declined in price and did not provide the safety that investors have traditionally expected from bonds.

We were active this quarter and built on the portfolio changes from earlier in the year. We harvested losses where appropriate and worked hard to adapt client portfolios to meet current circumstances. We reduced our recommended equity allocations and are now underweight stocks versus our long term strategic targets. We continue to assess our mix of active managers and index funds. In Q2, we introduced a new large capitalization active manager, as well as a US small capitalization index fund. In our bond holdings, we continue to favor high quality and low duration bonds with an emphasis on price stability. One silver lining is that we anticipate portfolio income to rise with higher rates.

Going forward, we are keeping an eye on several factors as we look to the back half of the year and 2023:

1. Inflation: Inflation remains front and center in our analysis because the trajectory for inflation will determine what the Federal Reserve and other central banks decide on interest rates. Mortgage rates are higher, and we are finally seeing an increase in housing inventory. We believe this is a necessary first step for home price appreciation to abate.

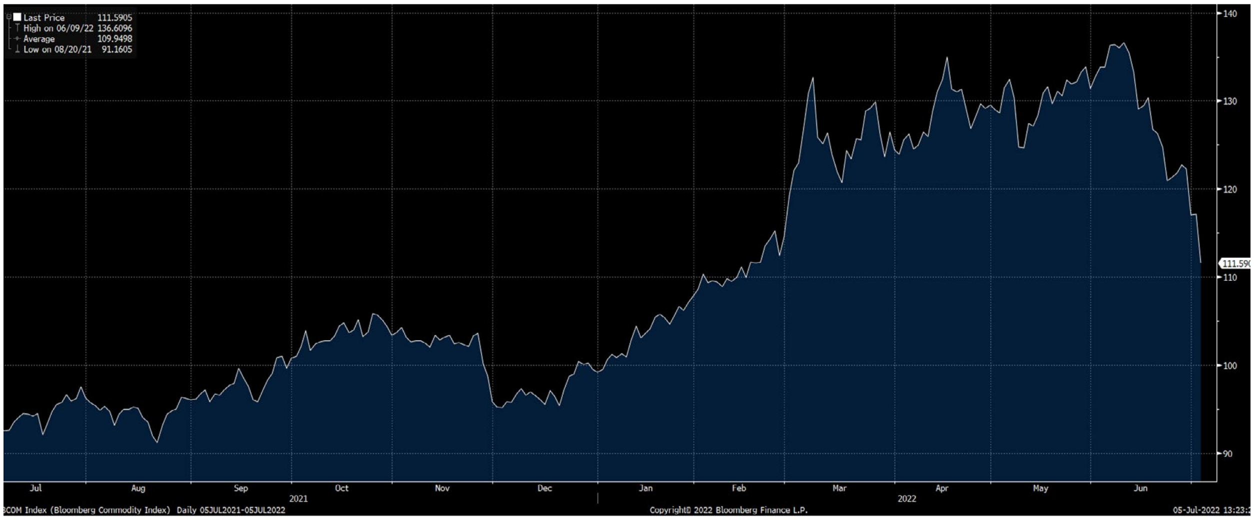
Inventory Change vs Same Week in 2021, 2020 and 2019 (Source: Altos)



Source: Calculated Risk

We also are seeing signs that some commodity prices are stabilizing. The chart below of the Bloomberg commodity index below shows a significant decline during the past month.

Bloomberg Commodity Index peaked on June 9th:



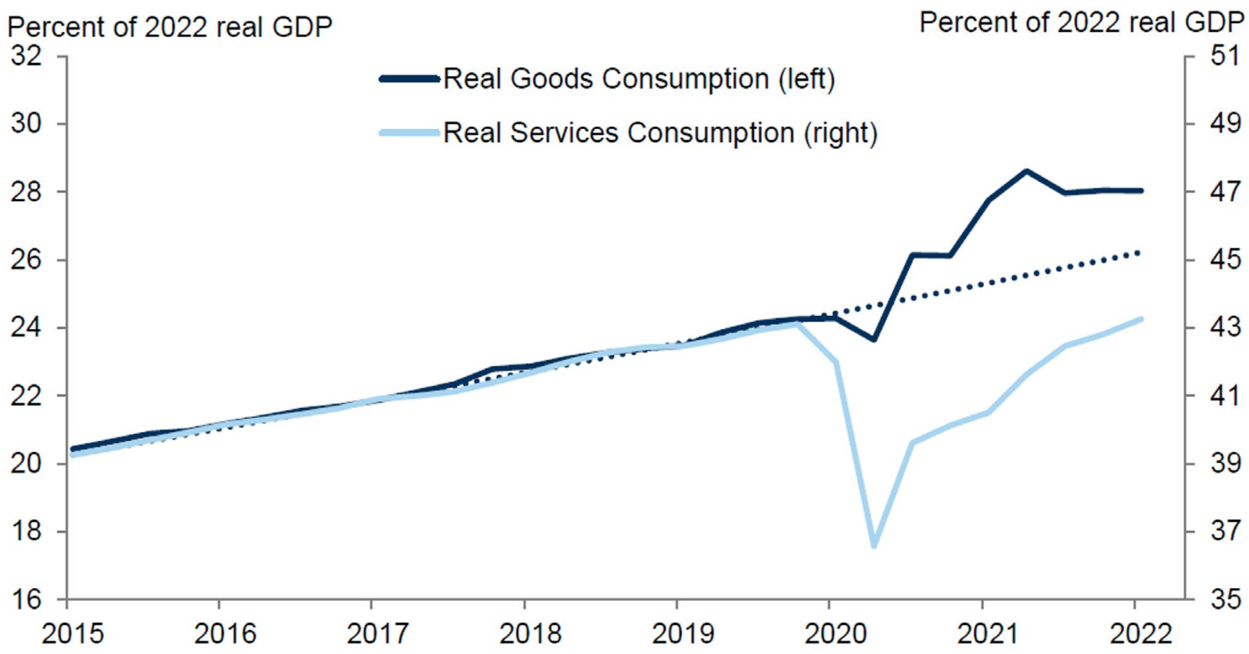
Source: Bloomberg

In addition, the Shanghai Shipping container freight index – which tracks the cost of transporting goods from China – is down approximately 16% from its peak in January. These are all indicators that the rate of inflation may have peaked. We think inflation needs to be below 3.5% before the Federal Reserve will resume actively supporting the economy by limiting rate increases or reducing rates.

2. Earnings: We remain concerned that investors are not fully anticipating the impact of any economic slowdown. We are pleased that company price-to-earnings multiples are below long term averages, but the future earnings level of companies is a cause for concern. Earnings estimates for the aggregate market remain steady for 2022 and 2023 at a year-on-year growth rate of approximately 10%. We think this is overly optimistic, since company margins are at long term peaks and economic activity is indeed slowing. Even in a mild recession, we would expect earnings to decline year-on-year. As a result, we believe the market is vulnerable to downward earnings revisions and that makes it less likely that market prices will rise in the near term.

3) Consumption rebalancing: Continued fallout from the COVID pandemic further complicates this analysis. For example, this Goldman Sachs chart highlights that the pandemic has sharply altered household purchase patterns. These dislocations are ongoing.

Bloomberg Commodity Index peaked on June 9th:



Source: Haver Analytics, Goldman Sachs Global Investment Research

How will this be seesaw be resolved? Will we see a sharp slowdown in goods purchases or will services grow faster and lead to a "positive" rebalancing? These questions will have a significant impact on equity prices because the market share of goods producers in the stock market is higher than the share of goods consumption in the broader economy, making the stock market more sensitive to the consumption of goods than the economy at large.

In addition, unemployment is very low with very few signs of weakness. Industries that proactively cut jobs in the pandemic are struggling to regain lost workers (e.g. airlines and hotels). Will companies choose to keep employment high even in the face of a demand drop?

Lastly, China is emerging from COVID lockdowns, and Russia's war on Ukraine war shows no sign of relenting. These two variables have enormous importance and create uncertainty for investors.

In summary, this remains a very challenging time for investors with significant volatility in both stocks and bonds. We continue to work proactively to manage risk while we look for signs of future opportunities. We will be happy to discuss your specific portfolio with you at any time.

For more information

Choate Investment Advisors offers objective, independent, institutional-quality investment management tailored to the needs of each client.

Choate Investment Advisors offers comprehensive, integrated wealth management to high net worth individuals and families, providing a range of well-diversified investment strategies across the risk spectrum. Our open-architecture approach and substantial assets allow us to select from a wide array of asset classes and to work with the highest quality investment vehicles. As a subsidiary of Choate Hall & Stewart, our clients receive world-class estate tax planning and other family office services.

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The S&P 500 is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized unmanaged index of common stock prices.

The Bloomberg US Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.