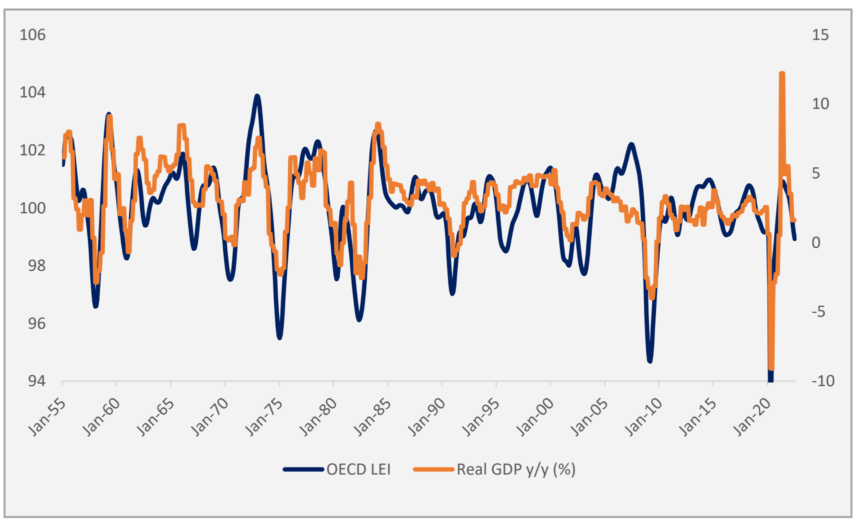
ECF Endowment Management Third Quarter 2022

More Market Volatility Ahead?

Volatility continues to plague both equities and fixed income markets. In the backdrop are concerns about higher prices for products and rising borrowing costs. But the ultimate worry is economic growth, which is starting to slow under the combined weight of soaring inflation and higher interest rates. The US GDP shrank at a 1.6% annual pace in the first quarter of 2022 and 0.9% in the second quarter. Weaker re-

Chart 1: US Leading Economic Indicators point to a decline in near term economic activity



Source: OECD, Bureau of Economic Analysis (BEA), as of 8/31/22

tail sales and a bigger trade deficit (which detracts from the GDP but isn't necessarily a sign of weakness) contributed to the weak GDP readings. In addition, a decline in Leading Economic Indicators (see Chart 1), suggests weak economic activity could continue to inhibit growth during the next quarter. Market volatility is likely to continue as long as uncertainty around inflation and economic growth continues.

Interest Rates Are Important

Higher interest rates are often needed to keep higher inflation at bay. With more expensive borrowing costs, consumer spending often slows. This approach is at the center of the Federal Reserve's policy decisions. In a head-on fight against inflation, the Fed sped up its plan to raise interest rates to slow demand.

Cont'd on Page 2

Endowment Tip

Today's investment committee members oversee endowment funds during a time of remarkable market volatility. One key responsibility under all conditions is to recommend a prudent spending rate that provides current income while preserving the purchasing power of the funds for future generations. Another key responsibility is to set a spending calculation method that reduces the impact of market volatility. Is it time to review how your committee calculates distributions from your organization's endowment?

$$\textbf{Annual Distribution (\$)} = \text{Spending Rate (\%)} \times \frac{\text{(Q1 Val + … + Q12 Val)}}{12}$$

To calculate an annual distribution, most organizations multiply their spending rate (say 4%) by the value of their account. But instead of using an account value at one point in time, we recommend that you use the average account value over the most recent 12 or 20 quarters to reduce the impact of market swings. Then, we recommend that you take your annual distribution in four quarterly draws to minimize the chance of withdrawing funds when markets are down. Please let us know if we can help you establish an updated spending calculation method or prepare specific calculations for your approval.

The Fed Funds rate (benchmark rate) remained at 0.00-0.25% throughout 2021 and into Q1 2022. Since March, the Fed has raised interest rates by 3.00%, placing the benchmark at a range of 3.00%-3.25%. This included three consecutive 0.75% increases, the most aggressive monetary policy tightening since 1988.

The Fed hopes these actions lead to lower inflation. Although there may be signs of an inflation slowdown in some areas, the Fed has signaled a continuation of hikes until inflation eases substantially. Ultimately, the Fed may continue to raise interest rates until inflation is on a firm path back to its goal of 2%.

Is Inflation Rising or Falling

With rising inflation driving interest rates, analysts are closely watching prices across different categories. Specifically they are looking for signs of substantial easing of inflation across all areas. A recent look at the dashboard suggests easing inflation in some areas but rising in others.

During the first half of 2022, inflation continued to climb, with the Consumer Price Index (CPI) reaching 9.1% year-over-year in June but falling back only slightly to 8.3% year-over-year in August. And across sub-segments of the economy, inflationary readings are also not clearly rising or falling (see Chart 2).

Five other closely watched areas for inflation readings include:

- **Energy prices** – Oil prices reached a peak in May with prices falling during the last several months. Supply chains struggled to re-gain the efficiency of pre-pandemic days. The Russian/Ukraine war further disrupted supply chains.
- **Food** – After a period of falling prices, they are on the rise again. Agricultural products faced limited supplies from Russia and challenges from climate change. Higher energy costs are an additional barrier to agriculture.
- **Housing** – Falling home sales, but rental costs remain high. Owners' equivalent rent continued to increase by 6.3% (year over year) in August.
- **Labor costs** – Costs remain high with a tight labor market. This is a closely watched metric by the Federal Reserve as a decline in labor costs could suggest a substantial ease in inflation. Unemployment remains around 3.7%, fueling a tight labor market.
- **Durable goods** – Prices peaked in April and have declined during the last several months. Earlier this year, supply chain disruptions and rising energy costs fueled inflation for "durable goods" – products such as autos, home appliances and computers. Easing in these areas has helped lower prices of durable goods.

More Uncertainty Than Inflation

While the uncertain path of inflation contributes to volatility, other uncertainties are also a factor. Three areas to watch:

Hard vs soft landing: Policymakers are walking a tightrope as they try to adjust interest rate hikes while avoiding a recession. If they succeed, we will have a "soft landing," but the Fed's track record for soft landings has been weak, and five of the last six hike cycles resulted in a recession, or "hard landing." A slowdown in rate hikes could help ease the economy into a "soft landing". However, the Fed is committed to its fight. Markets just digested an additional 75-basis-point rate hike (0.75%) this week, and are expecting 75 basis points in November, and 50 in December. This path would bring the Fed Funds rate to the 4.25%-4.50% range by the end of 2022.

Quantitative Tightening: Quantitative Easing (QE) was a tool introduced for the first time by the Fed after the Credit Crisis in 2008. This policy involved the purchase of bonds to help

Chart 2: Inflation in some categories may have peaked while it continues to climb in others

Category	Metric	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Inflation	CPI y/y (%, y/y)	7.50	7.90	8.50	8.30	8.60	9.10	8.50	8.30
Infl ex Food & Energy	Core CPI (%, y/y)	6.00	6.40	6.50	6.20	6.00	5.90	5.90	6.30
Energy	WTI Crude Oil ($/barrel)	88.15	95.72	100.28	104.69	114.67	105.76	98.62	89.55
Food	S&P GSCI Agriculture	464.78	511.04	542.26	571.59	562.85	474.53	456.95	564.73
Housing	Owners Equivalent Rent (%, y/y)	4.09	4.31	4.54	4.79	5.09	5.48	5.83	6.29
Housing	Existing Home Sales (SA)	109.40	105.00	103.30	99.20	99.60	90.70	89.80	
Labor	Average Hourly Wages ($)	31.56	31.60	31.75	31.86	31.98	32.12	32.27	32.36
Labor	Unemployment (%)	4.00	3.80	3.60	3.60	3.60	3.60	3.50	3.70
Durable Goods	CPI - New Vehicle Price (%)	12.19	12.38	12.55	13.21	12.62	11.43	10.44	10.05
Interest Rate	Fed Funds Rate (%)	0-0.25	0-0.25	0.25-0.50	0.25-0.50	0.75-1.00	1.50-1.75	2.25-2.50	2.25-2.50

Source: Bureau of Labor Statistics, Refinitiv, Natl Assoc of Realtors, as of Sept 2022 ; Note: y/y= year-over-year

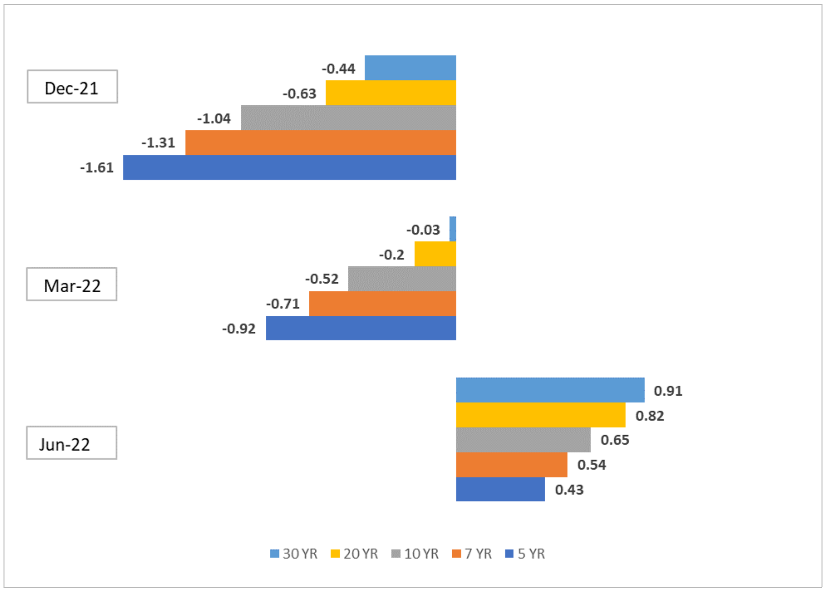
Cont'd on Page 3

Cont'd from Page 2

reduce interest rates. Recently the Fed began a reversal of Quantitative Easing (QE), called Quantitative Tightening (QT). This involves selling these bonds into the open market. By the Fed's own admission, their understanding of QT is still evolving. However, they've had one round of QT experience, during the tightening cycle from 2015 to 2018, and are keen to keep a close eye on the ripple effects.

Mid-term elections: On November 8, the U.S. faces mid-term elections, which can create volatility in markets. However, markets can perform well in the 6-12 months after midterm elections when the uncertainty lifts, regardless of which party "wins". And markets are generally receptive to a "gridlock" outcome (split branches of government by party), as there is less risk of new legislation.

Chart 3: Treasury real yield (%) turned positive in June



Source: U.S. Treasury, as of 6/30/22

Market Implications

Competing forces of elevated inflation, a strong labor market, along with other uncertainties can result in continued market volatility.

Equities: After a 20% decline in the broad US equity market (S&P 500) during the first half of 2022, US equities entered the second half with more reasonable valuations. Price-to-earnings are now down 20% to 30% at roughly 16.8, below the 10-year average of 17.0. Having said this, valuations are reasonable but not cheap, especially considering the risk of an earnings downturn. Slower economic growth may fight off inflation but could also dent earnings and leave US equities in a vulnerable spot.

Fixed Income: As for fixed income, fears of a recession quietly changed the expected path of interest rates. Real yield – the interest generated once inflation is taken into account – has been negative since early 2020. Negative real yield makes investments such as US Treasuries less attractive and encourages investors to move up the risk spectrum. In the wake of slowing inflation, real yield, across all maturities, has now turned positive (see Chart 3). With this turnaround, US Treasuries may draw more attention from investors.

ecf Endowment Management

Carsten Sierck
(347) 803-9389 | csierck@ecf.org

Aline Sun
(212) 870-2842 | asun@ecf.org

Josh Anderson
(212) 870-2841 | janderson@ecf.org

Brad Roberts
(212) 870-2857 | broberts@ecf.org

Juliette Acker
(800)-697-2858 | jacker@ecf.org

Anne Richardson
(800)-697-2858 | arichardson@ecf.org

Welcome to Anne Richardson

ECF's Endowment Management team continues to expand. In September, we welcomed Anne Richardson as Senior Program Director for Investor Relations. Anne has held senior roles at institutional investment advisors and most recently served as development director at her Episcopal church. At ECF, Anne will provide investment and other strategic guidance to endowed organizations.

NEW Webinar: Leave a Mark: Legacy Society Events that Make an Impression

Join ECF's Endowment Management Program on:
Weds, October 12, 2:00 to 2:30 pm (ET)
for a free webinar on creating Legacy Society events that make a lasting impression. This webinar is the first in a three-part series focused on sustainable endowment giving ministries.

(Register here: https://bit.ly/legacysocietywebinar)