



The Great Re-Set

The pain continues in equity markets as we roll into the final quarter of 2022. As we foreshadowed in both our 1st and 2nd quarter letters, there was much to be concerned about, though even in our grumpiest moments, we continued to have some degree of optimism for a down market that would not affect equities so broadly and deeply. After a rally in July, both shares and bonds turned lower and registered negative returns for Q3. Any hopes of interest rate cuts were dashed as central banks reaffirmed their commitment to fighting inflation. The Federal Reserve (Fed), European Central Bank and Bank of England all raised interest rates in the quarter as did a host of other G20 central banks, all hoping to lessen the pressure on their markets as the Fed continued to tighten the screws of their inflation fighting campaign. The rally in July was helped by markets starting to price in interest rate cuts from the Federal Reserve in 2023, stoking hopes of a soft landing for the economy. However, in August, the Fed and other central banks reiterated at their Jackson Hole summit that their priority remains the fight against inflation rather than supporting growth.

"Reducing inflation is likely to require a sustained period of below-trend growth," Powell said in his prepared comments. "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

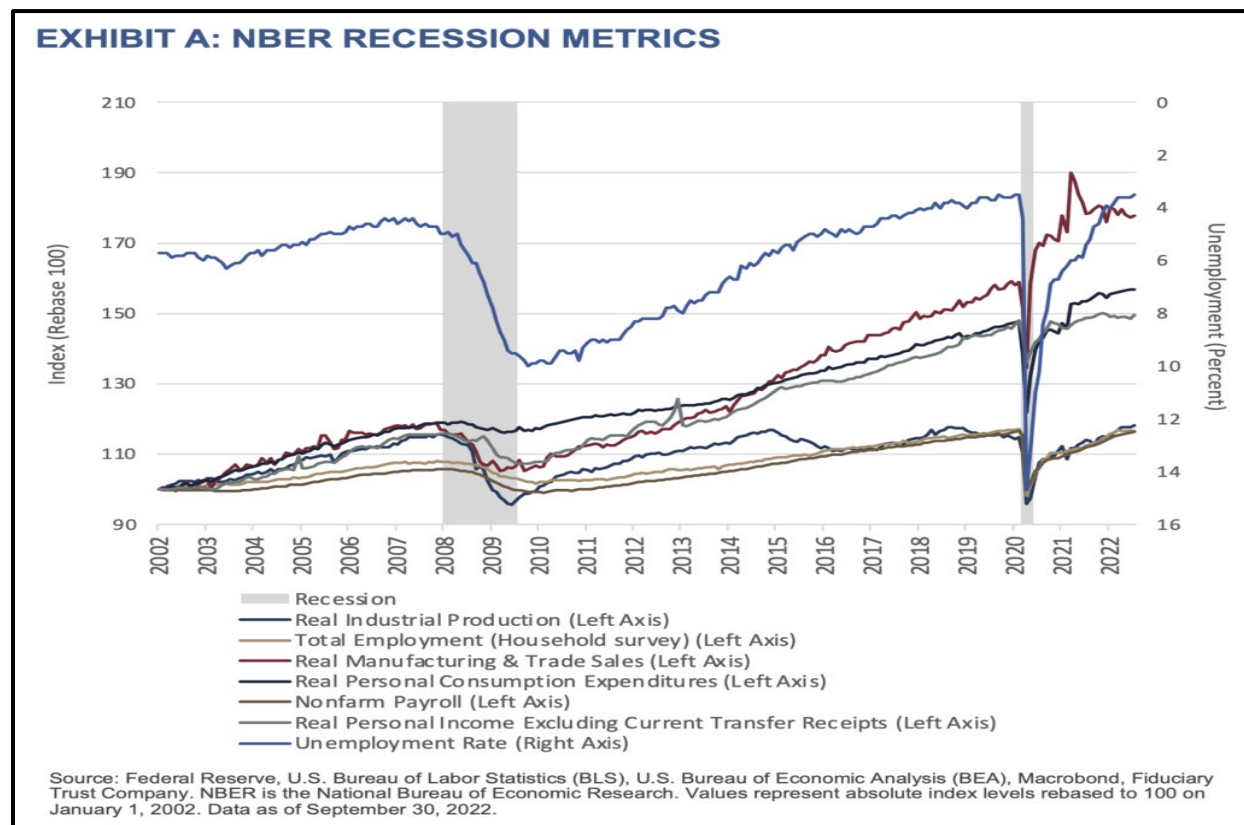
This was the primary driver of the sharp rise in bond yields and sell-off in stocks in the second half of the quarter. The damage is displayed below in full relief as the market bends and moans with the daily commentary of FED governors.

Index	12/31/21 Close	9/30/22 Close*	Change	% Gain/Loss Year to Date
DJIA	36,338.30	28,725.51	-7,612.79	-20.95%
NASDAQ	15,644.97	10,575.62	-5,069.35	-32.40%
S&P 500	4,766.18	3,585.62	-1,180.56	-24.77%
MSCI EAFE	2,336.07	1,661.48	-674.59	-28.88%
Russell 2000	2,245.31	1,664.72	-580.59	-25.86%
Bloomberg Aggregate Bond	2,355.14	2,011.06	-344.08	-14.61%

Source: Bloomberg

The Silver Linings Playbook

Even though the US economy has already recorded two consecutive quarters of negative economic growth this year and the University of Michigan's Consumer Confidence survey has dropped close to its lowest levels in 50 years, most economic data published in the third quarter continued to highlight the resilience of the US economy. This resilience has been reflected particularly for the US labor market, with the latest employment and JOLTS (Job Openings and Labor Turnover Survey) reports showing plenty of momentum in the US jobs market as 315,000 payroll jobs were added across the economy in August and job openings are hovering around 11 million. The tight labor market is also generating substantial household income gains, with wage and salary income rising by USD 1.04 trillion (or 10.0%) in the year ending in July, reflecting a 5.2% increase in average hourly earnings and a 4.1% rise in payroll jobs. Ironically, labor inflation is one of the factors most frequently cited by the Fed in its inflation fighting campaign. Indeed, across a number of relevant, coincident indicators of recession, it appears that while the U.S. economy is slowing, it is not close to the conditions that the Fed is looking to create.

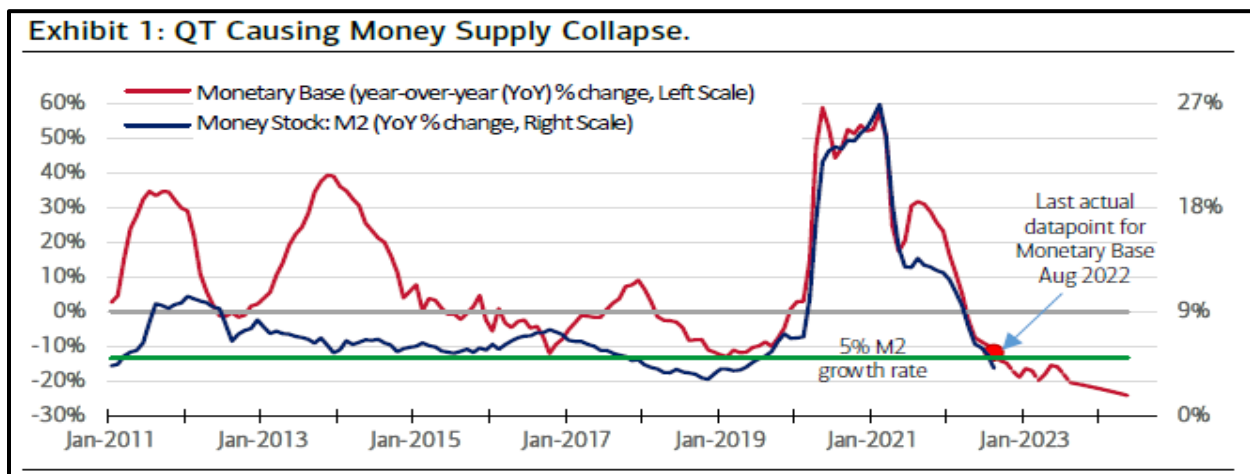


Upon examination, the criteria used by the arbiter of recessions, the National Bureau of Economic Research (NBER), reveals an economy not in immediate danger of a major contraction. Rather, it appears to remain in relatively good health. NBER peers through a wide lens to determine whether the economy is in recession

or not. The committee measures economic declines through consideration of depth, diffusion, and duration. The Bureau evaluates these features by examining real personal income less transfers, household and establishment (business) measures of employment, real personal consumption expenditures, wholesale and retail sales adjusted for price changes, and industrial production. It also uses gross domestic product and gross domestic income (two data sets that measure the same thing: economic output) to mark business cycle peaks and troughs. Surveying the data reveals that the economy does not appear to be in recession despite the declines in GDP during the first two quarters of the year. There can be no doubt that the Fed looks closely at the index numbers reported above nor that they see what is apparent; the U.S. economy remains strong and progress on lowering inflation will come slowly and with an extended period of tighter financial conditions. Adding a fine point to this is that the Fed clearly believes that achieving its policy goals will require pushing the economy into recession.

“If you’re going through Hell, keep going” – Winston Churchill

U.S. headline inflation may have peaked, but the Fed Funds Rate has not; indeed, according to the latest projections from the Fed, the peak rate (terminal rate) has been pushed up to 4.6% in 2023, suggesting another 1.25-1.50 basis points (bps) in additional hikes in the coming months. The current pace of tightening is the fastest since the 1980s, spooking many investors who believe the Fed is moving too fast and too aggressively in raising rates, boosting the odds of something “breaking,” à la the U.S. economy. Indeed, leading indicators of inflation are falling rapidly. The dollar’s strength reflects the tightening money supply situation as the Fed begins to curtail the monetary base with an unprecedented schedule of QT (Exhibit 1). Falling commodity prices are also a powerful sign of falling inflation pressures. Real interest rates have swung from sharply negative during the QE period to sharply positive during the QT period. Falling inflation, and possible deflation, will raise real rates even more if the Fed sticks with its QT schedule, further restraining the economy.

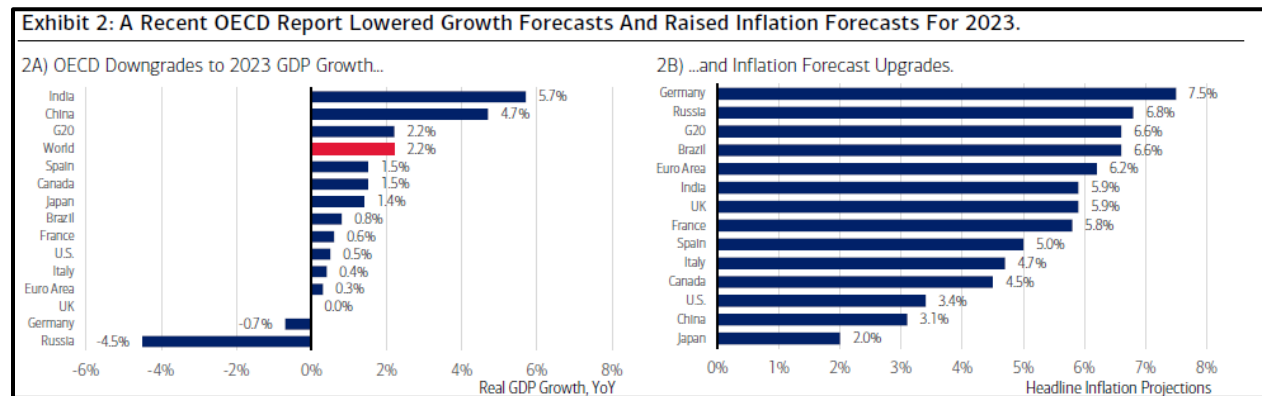


Source: Merrill Lynch Capital Markets

As if throwing gasoline on a fire, the Fed continues with its QT program, while central banks around the world have aggressively embraced the tightening mode of the Fed. The fear globally is that the cumulative effects of monetary tightening from all corners of the world will go too far and push the world economy into recession.

The risks of the latter have risen considerably over the past few months, with the Organization for Economic Co-operation and Development (OECD) recently lowering its 2023 world GDP growth to just 2.2%. The specific fear captured in the next chart is that due to the combination of quantitative tightening and conventional increases in the Fed-controlled 3 month rate, these actions

will cause the global economy to spiral into a synchronized recession while inflation remains stubbornly high.

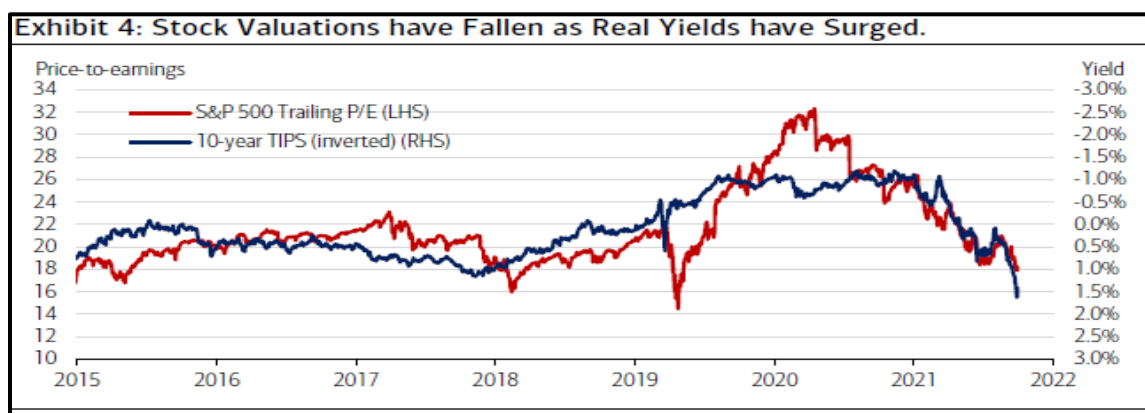


Source: OECD

Where the Rubber Meets the Road: Are Equities Cheap?

Stock valuations have fallen considerably from where they were at the start of the year. The S&P 500's trailing 12-month price-to-earnings (P/E) multiple at around 18x sits far below the roughly 26x at which equities were valued at the start of 2022. By that measure, equities have cheapened, but a few developing conditions may become additional tailwinds for valuations to potentially shift lower in the months ahead. Valuations could creep lower as earnings start to suffer. Consensus analyst earnings estimates for 2023 are still calling for S&P 500 earnings per share to improve to \$242 in 2023, or roughly 7.8% in earnings growth. But with inflation still running hot and the Fed proving its commitment to an aggressive monetary policy path amid a cumulative 300 bps in interest rate hikes so far this year, in addition to QT, the profit outlook looks set to weaken as rising costs eat into profit margins. The U.S. weekly earnings revision ratio, or the ratio of earnings estimate upgrades to downgrades, fell to 57% as of the third week of September, now the weakest earnings trend relative to other global regions.

Rising real yields are also pressuring valuations. The yield on the 10-year Treasury Inflation-Protected Securities (TIPS) flipped positive in May for the first time since before the pandemic and surged at a rapid clip, rising to 1.4% as the Fed shifted to its now hawkish stance. Climbing inflation-adjusted yields tend to challenge equity valuations as higher bond yields start to look more attractive and the opportunity cost of holding equities rises, especially for longer-duration companies, which are expected to generate earnings farther out in the future (Exhibit 4).



Source: Bloomberg

To the extent that real yields continue to climb, that is the Fed continues to tighten well through the current level and hold rates high well after inflation has started to fall, the potential for more

pain is clear. Adding to this risk is the possibility that earnings estimates have much further to fall in order to reach equilibrium with falling demand and rising input costs. Another way to capture the potential downside is to compare the current price level of the S&P 500 to the inverted value of the Goldman Sachs Financial Conditions Index (GSFCI). The GSFCI is a simple weighted-average of short-term interest rates, long-term interest rates, the trade-weighted dollar, an index of credit spreads, and the ratio of equity prices to the 10-year average of earnings per share. It's a simple but relatively powerful coincident (slightly leading) indicator of equity price levels. As is seen in the following chart, the relationship of the GSFCI with equity prices was quite close between 2018 and 2021 but has broken down since then. Anyone calling for an equity market bottom just yet should closely consider this chart as financial conditions are unlikely to ease substantially, most likely not before 2024.



Quarterly Performance

Our 3rd Quarter 2022 return for the Hahn Capital Management Mid-Cap Value Composite was -3.84% gross of fees. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 1.09 percentage points. The outperformance was driven equally by stock selection & sector selection.

Stock selection in Materials (Albemarle) positively impacted our relative performance. In addition, Keysight Technologies and Agilent Technologies (Information Technology) and Ross Stores (Consumer Discretionary) were positive contributors to performance. The most significant detractors to performance were Euronet Worldwide (Information Technology), Jacobs Solutions (Industrials), SLM Corp (Financials) and Mohawk Industries (Consumer Discretionary).

Hahn Capital Quarterly Performance Attribution – 3Q 2022

LINKED PERFORMANCE BY SECTORS											
BENCHMARK: Russell Midcap Value Index											
PORTFOLIO: Model Account											
	PORT	BENCH	DIFF	PORT	BENCH	DIFF	SECTOR	STOCK	ACTIVE	PASSIVE	TOTAL
GICS Sector	Weight	Weight	Weight	Return	Return	Return	SELECT	SELECT	CONTR	CONTR	CONTR
Financials	20.20%	17.91%	2.29%	-3.77%	-2.02%	-1.75%	0.05%	-0.33%	-0.28%	0.00%	-0.28%
Information Technology	20.13%	9.45%	10.68%	-3.72%	-5.69%	1.98%	-0.05%	0.33%	0.28%	0.01%	0.29%
Real Estate	16.84%	11.88%	4.97%	-9.34%	-9.43%	0.08%	-0.24%	0.03%	-0.21%	0.00%	-0.21%
Industrials	11.82%	14.81%	-2.98%	-4.21%	-0.48%	-3.72%	-0.12%	-0.45%	-0.57%	0.00%	-0.57%
Health Care	11.93%	7.17%	4.77%	-6.34%	-7.59%	1.26%	-0.12%	0.14%	0.02%	0.00%	0.02%
Consumer Discretionary	7.51%	9.77%	-2.26%	-3.45%	-5.64%	2.19%	0.01%	0.19%	0.20%	-0.01%	0.19%
Materials	3.53%	7.49%	-3.96%	26.71%	-6.75%	33.47%	0.05%	1.07%	1.12%	0.00%	1.12%
Communication Services	1.96%	3.52%	-1.56%	-7.83%	-9.40%	1.57%	0.07%	0.02%	0.09%	0.00%	0.09%
Energy	2.04%	5.01%	-2.97%	4.57%	-0.75%	5.32%	-0.12%	0.09%	-0.03%	0.01%	-0.02%
Consumer Staples	0.00%	4.03%	-4.03%	0.00%	-8.00%	8.00%	0.15%	0.00%	0.15%	0.00%	0.15%
Utilities	0.00%	8.98%	-8.98%	0.00%	-5.58%	5.58%	0.09%	0.00%	0.09%	0.00%	0.09%
Cash	4.03%	0.00%	4.03%	0.57%	14.98%	-14.41%	0.76%	-0.56%	0.20%	0.00%	0.20%
Total Portfolio				-3.86%	-4.92%	1.07%	0.53%	0.53%	1.06%	0.01%	1.07%

Relative Performance by Stock – Quarter Ended September 30, 2022

Quarter Ended 09/30/2022 - Portfolio vs Russell Midcap Value Index											
Top Four Holdings			Bottom Four Holdings				Top Four Sectors			Bottom Four Sectors	
Total Attribution			Total Attribution				Total Attribution			Total Attribution	
1	ALBEMARLE CORP	1.03%	1	EURONET WORLDWIDE INC	-0.71%	1	Materials	1.12%	1	Industrials	-0.57%
2	KEYSIGHT TECHNOLOGIES IN	0.83%	2	JACOBS ENGINEERING GROUP	-0.43%	2	Information Technology	0.29%	2	Financials	-0.28%
3	ROSS STORES INC	0.66%	3	SLM CORP	-0.33%	3	Not Classified	0.20%	3	Real Estate	-0.21%
4	AGILENT TECHNOLOGIES INC	0.39%	4	MOHAWK INDUSTRIES INC	-0.29%	4	Consumer Discretionary	0.19%	4	Energy	-0.02%

Year-to-Date Ended 09/30/2022 - Portfolio vs Russell Midcap Value Index											
Top Four Holdings			Bottom Four Holdings				Top Four Sectors			Bottom Four Sectors	
Total Attribution			Total Attribution				Total Attribution			Total Attribution	
1	ALBEMARLE CORP	0.99%	1	ADVANCED MICRO DEVICES	-0.53%	1	Materials	0.86%	1	Energy	-2.15%
2	GENPACT LTD	0.50%	2	PVH CORP	-0.53%	2	Not Classified	0.81%	2	Real Estate	-1.68%
3	LIBERTY MEDIA CORP-LIBERTY-C	0.43%	3	LABORATORY CRP OF AMER HL	-0.48%	3	Communication Services	0.71%	3	Utilities	-0.83%
4	KEYSIGHT TECHNOLOGIES IN	0.41%	4	CBRE GROUP INC - A	-0.45%	4	Industrials	0.44%	4	Financials	-0.75%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 09/30/2022	3Q 2022	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	-3.84%	-16.98%	4.39%	6.26%	7.81%	9.65%	13.08%
HCM Net of Fees	-4.09%	-17.85%	3.35%	5.21%	6.75%	8.58%	11.98%
Russell Mid Cap Value Index	-4.93%	-13.56%	4.50%	4.76%	7.67%	9.44%	10.71%
Russell Mid Cap Index	-3.44%	-19.39%	5.19%	6.48%	8.79%	10.30%	10.81%

[Link to: HCM Performance Disclosures](#)

PORTFOLIO ACTIVITY

New Positions

There were no new positions during the quarter

Positions Increased

There were no positions increased during the quarter.

Positions Reduced

There were no positions reduced during the quarter

Positions Sold

There were no Positions sold during the quarter

Outlook

As we enter the fourth quarter, we would expect the global economy should continue to slow while some economies could enter recession. The magnitude of this potential recession will partly depend on the effectiveness of measures deployed by policymakers to reduce the impact of the energy crisis on households and businesses. Central banks, confronted with the biggest inflation shock since the 1970s, will for their part probably continue to prioritize the fight against inflation over supporting growth. Overall, while the growth outlook remains challenging, many stocks are now already pricing in a relatively high probability of at least a moderate recession. Government bonds are now also pricing in a significant amount of further tightening. So, after a very difficult year so far for both stocks and bonds valuations now look more attractive for both.

Is this the new Normal?

The question before investors remains: Where will inflation settle? Market-based measures indicate investors believe inflation will fall to roughly 2.6% in five years' time, from the current 8%. Indeed, they expect a quick resolution, as two-year break-evens are 2.46%. Whether inflation can fall enough to meet expectations or not remains an open question. An aging labor market, slow population growth, low productivity growth, de-globalization, and wars of the hot and cold varieties will make the return difficult. Mr. Market is, as ever, an optimistic sort. The consequences of disappointing market expectations are severe as we illustrated in the body of this newsletter.

The historical perspective only further bolsters the view that valuations could still be at a premium level. The current S&P 500 trailing 12-month P/E multiple (20x) remains well above where it stood at the end of the 11 previous bear market cycles since 1954(average of 14x). Ultimately, however, the answer to whether Equities look cheap depends on who is asking. Long term investors with excess cash to deploy may find valuations at their current level a reasonable entry point. Given the resiliency of the U.S. economy, it may be rational to expect that the bleak earnings outlook will eventually improve, especially once the Fed pauses and reverses course. Stock valuations at that point will likely reprice higher as the market starts to discount a higher profit cycle. For now, investors with cash on the sidelines should remain disciplined and invest over time as opportunities arise, which is exactly what we will be doing.

A Stockpicker's Market?

We have been as guilty as many of our peers for using this phrase over our history, especially as we begged for the opportunity that now seems to be upon us. As anyone who has read our investment letters regularly may remember, we have been amongst the loudest complainers about Fed interest rate policy distorting the price of risk. So, what's different now? Importantly, the Fed finally shot itself in the foot so badly that it's in danger of losing the foot (inflation) and is retreating from that policy and allowing the market to price risk somewhat independently for the first time since Alan Greenspan uttered that he didn't believe there was a stock market bubble in 1998.

That repricing of risk has scattered returns dramatically across sectors and caused some of the widest divergences we have seen in valuations since the early part of the year 2000. What would define a good opportunity for picking stocks? If success means selecting stocks that increase more than the average stock, then a stock-picker's market would be when there is a wide range in how stocks are being priced, meaning more stocks than usual are selling at extremely high and extremely low valuations. The narrower the distribution (i.e....everything is expensive or cheap), the harder it is to differentiate returns via stock selection. One way to measure the opportunity is to look at the distribution of P/E ratios.

How does today's P/E distribution compare to history? Well, it turns out that the distribution of trailing P/E ratios for the S&P 500 is very instructive when you compare the 450th highest P/E to the 50th highest. Over the past 40 years, the 50th highest P/E has averaged 45 while the 450th highest averaged 11. So in about half of the years the highest P/Es were more than four times as large as the lowest and were less than four times in the other half of the years. Today the 50th highest P/E is above normal at 50 times, and the 50th lowest is below normal, under nine times,

for a ratio of 5.6. So, the P/E dispersion is about 40% wider than normal. As has often been the case, unusually high volatility leads to a high spread in valuations, which has been a good environment to add value via stock picking.

The focus of our research efforts has shifted significantly over the last year driven by several themes. The first is that inflation will prove highly intransitory over time as it is being driven by a lack of investment in tangible assets over the last half century. In 1950, investments in tangible assets was 11% of GDP across the globe. In 2021, it had fallen to 2%. This is unsustainable, ESG be damned. The world needs Oil, Natural Gas, Coal, Copper, Iron Ore, Steel, Aluminum, Phosphate, and a long list of other commodities for its very survival – much less prosperity. The second theme is that the world has become more volatile and dangerous now that central banks must finally unwind a generation of policy driven malinvestment and new strategic axes have been formed by foreign governments hostile to the Western world. A generation of falling interest rates and relatively general peace have caused supply chains to be optimized to the point of severe fragility, necessitating a re-thinking of the safety of supply chains rather than how a few extra basis points of margin can be squeezed out of them. On-shoring/re-shoring of critical manufacturing, protection of intellectual property and the underlying greater volatility of trade markets are all new megatrends (again) that we have been working on. As always, we will keep you abreast of our thinking as these research efforts translate into actionable ideas and changes in our portfolio of investments.

We remain focused for the long-term, on process and risk, with the goal of sustainable wealth creation. Without your understanding and support in this effort, it would truly be a fruitless enterprise, particularly considering the more volatile markets we are now experiencing. We wish you the best in the remainder of 2022.

Sincerely,



John Schaeffer
President and CIO



Michael Whitfield
Dir. of Research and Co-Portfolio Manager