

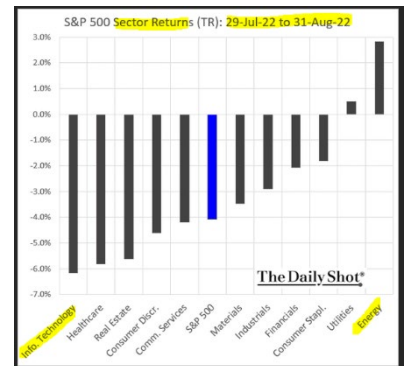
EQUITY MARKET UPDATE

As of 08/31/22 | Volume 11, Issue 8 | FFTAM.com

Stocks fell in August after Fed Chairman Jerome Powell reiterated the central bank was planning to raise interest rates briskly to tame inflation. Stocks had been rallying for six weeks prior to the speech in anticipation of a possible pivot on interest rates. The market remains hypersensitive to matters surrounding COVID-19, the war in Ukraine, inflation, and the Fed's response to inflation. Economic data shows the US economy remains on firm footing although momentum is slipping in some areas. The combination of high prices from inflation mixed with rising interest rates from central banks worldwide have investors worried about a possible recession in 2023.

Powell Throws Cold Water on the Hot Summer Rally

The S&P 500 fell 4.08% in August. The month could be divided into two parts. Prior to Mr. Powell's Jackson Hole speech, stocks were experiencing a broad-based rally led by technology names. At mid-month, the S&P 500 was up almost 5% in August on hopes we had seen the end of large interest rate increases from the Fed. At that point, the S&P 500 had also gained 19% from the June lows. After Mr. Powell's speech reiterating higher interest rates are still to come, the market shed nearly 10% in the final two weeks of the month. Losses were widespread with real estate (-5.61%), healthcare (-5.78%), and technology (-6.12%) seeing the sharpest declines. Energy (+2.83%) and utilities (+0.51%) were the only positive sectors. These numbers are symbolic of investors pricing-in the possibility of an upcoming recession as finance costs march higher. In 2022, the S&P 500 is down 16.15% with energy (+48.52%) and utilities (+5.45%) once again being the only positive areas.



The Dow Jones Industrial Average dropped 3.72% for the month. A higher allocation to financials and staples aided results versus the S&P 500. The Dow also has a lower allocation to technology. Year-to-date, the Dow is down 12.01%.

The NASDAQ sank another 4.64% in August. The index was crushed as investors continue to flee from companies that are unprofitable and poorly capitalized. The index has fallen every month so far in 2022 except for March and July. Year-to-date, the NASDAQ is the worst performing major index with a total return of -24.06% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, Amazon, and NVIDIA.

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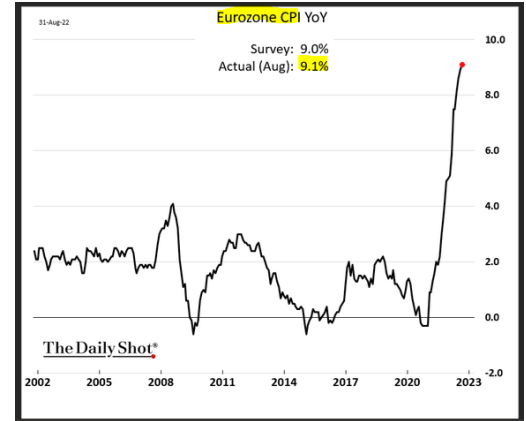
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Middle-to-small-sized companies fared about the same as the large cap indexes last month with the S&P 400 Mid Cap Index falling 3.12%, while the S&P 600 Small Cap Index was down 4.39%. So far in 2022, this area has slightly beaten its large cap peers with the S&P 400 Mid Cap Index dropping 13.60%, while the S&P 600 Small Cap Index is down 14.77%.

Europe on the Brink of Recession while China Cuts Interest Rates

The war in Ukraine continues to be the major source of price spikes in Europe. Inflation in the Eurozone reached a new record high of 9.1%. The acceleration came from large increases in the price of energy and food. Core inflation that removes the effects of food and energy was 4.1%. Businesses are unable to pass along the full extent of inflation, so profits are being squeezed. For example, Eurozone producer price inflation was 28.8%, just shy of the previous month's record reading of 29.6%. Obviously, consumer prices cannot rise that quickly without crushing demand. The inflation is pressuring economic growth. Eurozone Manufacturing PMI slipped for a seventh straight month to 49.6, while Services PMI decelerated for a fourth month to 50.2. Both readings signal Europe's economy has stalled and is on the brink of recession.



As I have discussed in the past, the European Union gets 35% of its total energy needs from Russia, so prices have skyrocketed as the region scrambles to find new sources. They have struck deals with the US, UAE, Qatar, and Canada. Unfortunately, none of these solutions provide an immediate fix, so Europeans face several years of elevated prices to wean itself off Russian energy. In the near term, Russia has continued to siphon off natural gas flows to Germany for "maintenance" reasons. With winter approaching, Germany has begun to ration the amount of energy citizens and businesses can use as they try to fill storage tanks for colder temperatures.

Persistently high inflation pressured the ECB to begin raising interest rates in July. This was their first interest rate hike in over a decade. Despite the weak economic data, the ECB must continue to hike rates to tame inflation. They are proceeding much slower than the Fed, and the interest rate differential has caused the Euro to plunge below parity versus the US dollar. The market is currently pricing-in the likelihood of a 0.75% interest rate boost at the ECB's next meeting in early September. They must proceed with caution since interest rate spreads between Italian and German bonds have widened. Unlike the Fed, the ECB faces the unique challenge of rate hikes disproportionately hurting highly indebted countries in Southern Europe. ECB Chairwoman Christine Lagarde unveiled a proposal to invest the roll-off from their bond portfolio into government bonds from weaker countries to hold down spreads.

The Chinese economy continues to struggle from the effects of extreme drought, constant lockdowns to combat the spread of COVID-19, and a depreciating property market. As the month ended, President Xi ordered the lockdown of megacity Chengdu, home to over 21 million people. Given the duration of the lockdown, global supply chains could suffer once again since the region is filled with factories for the electronics and automobile industries. Prior to this lockdown, China had been easing mobility restrictions, especially for foreign travelers. The reopening aided economic activity, but results remain soft. China's Manufacturing PMI edged higher but remained in contraction territory with a reading of 49.4. Meanwhile, service activity expanded slightly to 52.6. Job growth remains a challenge with youth unemployment hitting a record of 19.9%. That is very concerning considering China's shrinking workforce due to an aging population. With the economy stumbling, the Chinese central bank cut two key interest rates by 0.10%. The cuts were small because the government has resisted larger stimulus

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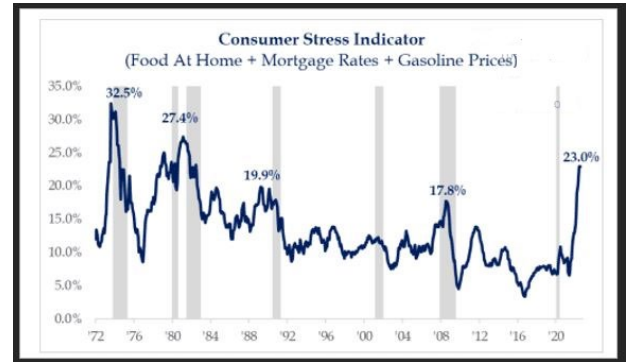
measures out of concern for inflation and ballooning deficits. Officials have dropped their 5.5% GDP growth target, but investors expect further stimulus measures from the Chinese government in coming months to reaccelerate the economy.

With many challenges facing international markets, investors are proceeding with caution. The MSCI EAFE Index lost 4.72%, while the MSCI Emerging Markets Index had a slight gain of 0.45%. Year-to-date, the two indexes are down 19.19% and 17.31%, respectively.

US Economy Grows, But Momentum is Slipping

The labor market remains strong. Last month, the economy added 315,000 jobs. The unemployment rate ticked up to 3.7% as 800,000 new people started looking for work. Average hourly wages grew 5.2% from one year ago, an amount that far exceeds pay raises seen pre-COVID. The JOLTS report showed there are still 11.23 million jobs available but unfilled. That equates to two job openings for every unemployed person—an all-time high. The demand for labor is far outstripping supply in most industries which signals the tightness in the labor force and the competition to recruit and retain employees. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.

Consumer inflation was less than expected with prices jumping 8.5% from one year ago. Unlike Europe, US energy prices tumbled 4.6% in August and was the largest detractor. Rising prices for homes and rent worsened. Core inflation that removes food and energy prices rose by 5.9%, in-line with the previous month. PCE data, the Fed's preferred measure of inflation, showed similar results with total prices climbing 6.3%, while prices ex-food and energy decelerated to 4.6%. The data presents a major challenge for the Fed. It shows that despite the strong labor market and higher wages, consumers are struggling to keep pace. Inflation adjusted income has declined in 8 of the last 12 months, while the savings rate has plunged to 5.0%, a 14-year low. Credit card balances have returned to the levels seen pre-COVID. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending rose 0.1% last month, its smallest increase this year. Much of the weakness was due to falling gasoline prices, while spending on services and cars remained brisk. This was also seen in the better than anticipated retail sales data, although the growth is coming from higher prices paid for goods and services rather than selling more products.



Business investment data is mixed. The ISM Manufacturing PMI slowed to 52.8, while new orders (51.3) expanded for the first time since May. Prices paid remained high with the producer price index (PPI) jumping 9.8% on a 12-month basis. The ISM Service PMI (56.7) was a stronger than its manufacturing cousin. Finally, housing starts and mortgage applications have fallen as the 30-year mortgage rate has doubled to 6% since the start of the year. The weakness in housing is the sole reason why 2nd quarter GDP was negative.



The Fed responded to the hot inflation data by raising interest rates by another 0.75% in late July. At his Jackson Hole speech last month, Chairman Jerome Powell

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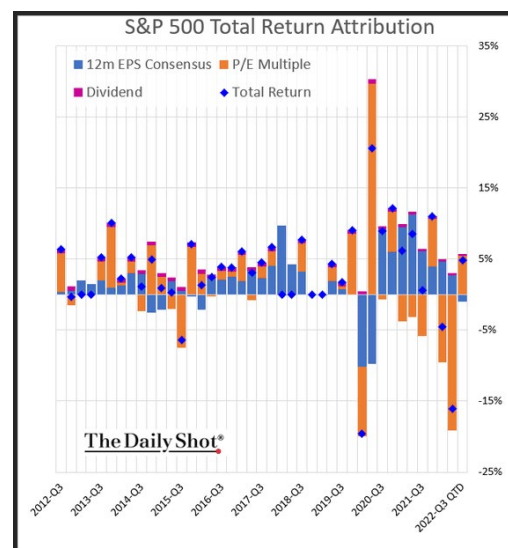
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signaled more increases are on the way. He stated the Fed is purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. He said the Fed would not waver even if unemployment rose. He added: "This will 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 blew-up the market's hopes that the Fed would consider cutting interest rates next year, and it forced the bond market to align itself more with the Fed's dot plots that indicate interest rates will be between 3.5% and 4.0% by the end of next year. They are currently 2.50%. This is on top of their quantitative tightening program that involves shrinking the balance sheet by \$47.5 billion per month in June, July, and August with the amount doubling to \$95 billion each month starting in September.

Market Sell-Off Lowers Valuation

The recent sell-off has the S&P 500 trading at 16.62x 12-month estimated earnings. This is far below the 5-year and 10-year average multiple of 18.63x and 17.19x, respectively. It is also less than the pre-COVID PE ratio of 19.4x.

We finished up another earnings season. Second quarter profits grew 6.3% from one-year ago. That was better than analysts' 3.9% forecast, but it marked the lowest growth rate since the fourth quarter of 2020. According to FactSet, four sectors (financials, consumer discretionary, consumer staples, and communications) have seen earnings decline from last year. Even the mighty technology sector, which many investors view as the ultimate growth sector and immune from economic challenges, only reported profit growth of 0.2% in the past 12-months. Earnings have been solely aided by energy, with year-over-year profit growth of 293.1%! If this sector was excluded, the S&P 500 would have seen profits decline 4.2% from last year rather than growth of 6.3%. The disheartening results have caused analysts to chop their profit estimates for the second half of the year. They now expect full year earnings growth of 7.9% with revenues increasing by 10.8%. This is less than their forecast of 10.2% (earnings) and 11.3% (revenues) growth just three months ago. The largest cuts to profit growth have occurred within the technology and communication sectors where earnings disappointments have been above average compared to the rest of the market. For 2023, analysts are now modeling earnings growth of 8.2%.



The market has finally gotten serious about the Fed and inflation by removing the premium valuation on stocks. Even though the current valuation appears attractive, it is based on profit growth estimates coming to fruition. The debate has intensified between economists that argue the economy is showing signs of peak growth and likely heading towards recession, while company specific analysts forecast continued prosperity for at least the next two years, although they are less bullish than a few months ago given the Fed's tough stance on interest rates. This tells me three things. First, stocks are ripe for continued price volatility, especially among the higher valuation growth names. Second, the market has already priced-in the likelihood that several companies will miss earnings estimates and will guide their future numbers lower. Finally, the market is telling you if a recession occurs, it will likely be shallow and short-lived; therefore, interest rates will not return to 0%. This last point is important to keep in mind since it means we will not see PE ratios for the overall market expand back to the 20s; therefore, most of the future total return for stocks will come from earnings growth and dividends paid.

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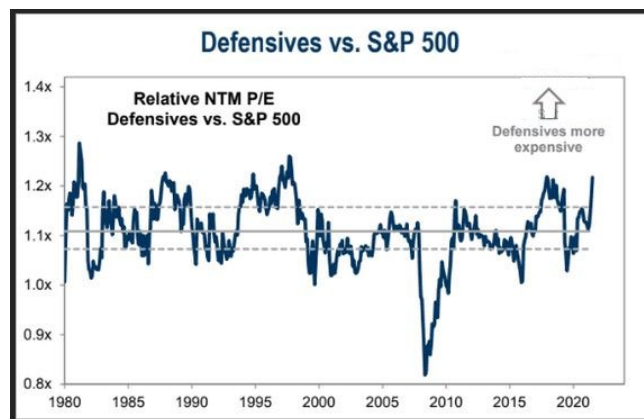
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Our Outlook & Strategy

The biggest challenge for stocks is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. Russia's invasion of Ukraine and global drought complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates raises the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

The best summary I have seen on how to navigate the upcoming environment is from Joe Zidle, Chief Investment Strategist at Blackstone. He said: "The path forward for investors will be more challenging as slower growth, higher inflation, and rising interest rates call for higher quality, greater selectivity, and a sharp focus on duration management for both equity and fixed income investors." This is historically a good environment for First Financial relative to the benchmark given our ownership of higher quality companies—those with consistent cash flows and less leverage—that trade at attractive valuations.

We believe the recent decline presents many opportunities. Several of the companies we follow now trade at valuations only seen in the depths of recession. This is most clear when looking at the difference in valuation between defensive and economically sensitive stocks. The current disparity indicates investors believe a Fed mistake and a soon coming recession is a certainty. We believe the Fed is right to raise interest rates quickly to address inflation; however, it appears the market is struggling to believe the higher rates can be left in-place for an extended period. Historically, stocks have bottomed when the Fed pivots from tightening interest rates to holding steady or cutting. Any indication that the Fed will not need to raise rates as high as the dot plots forecast will be viewed as a dovish signal and result in a rally for stocks, especially among select cyclicals and technology. Therefore, we are using this sell-off to invest some of our excess cash. We have also been slowly trimming our defensive holdings in consumer staples and utilities to boost select positions in industrials, financials, and real estate. We are also closely monitoring the energy sector as the pullback in oil prices have made select parts of the sector appear attractive.



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