LOOK AHEAD

Q3 2022

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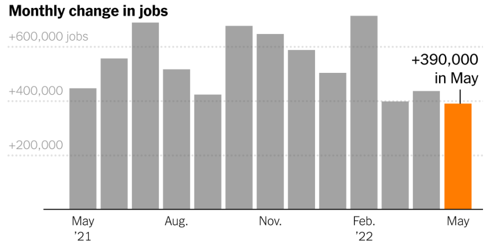
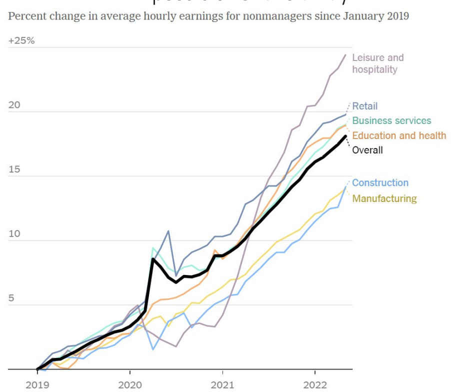
Consumer Strength – Still Resilient

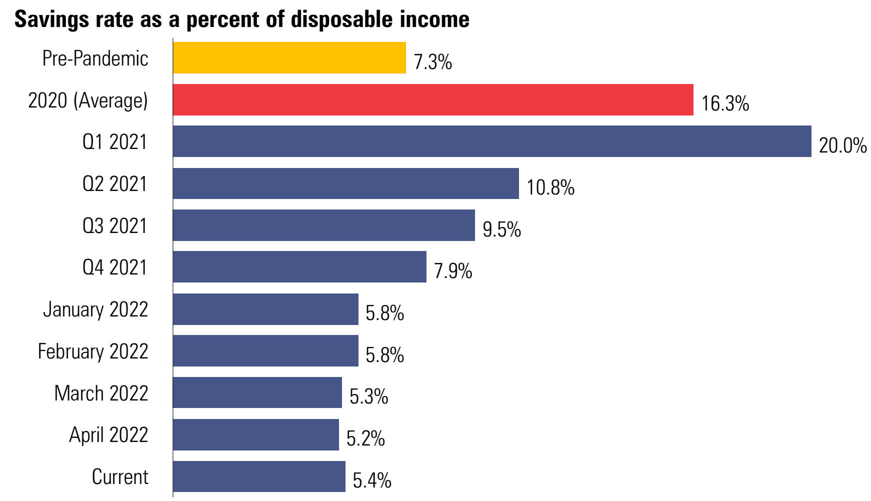
Jobs are abundant with the U.S. economy adding another 390k people to the workforce in May, with an average of over 500k jobs being added per month over the last year.



Wages are substantially higher than pre-pandemic levels and we all know wages, once paid, are nearly impossible to take away.

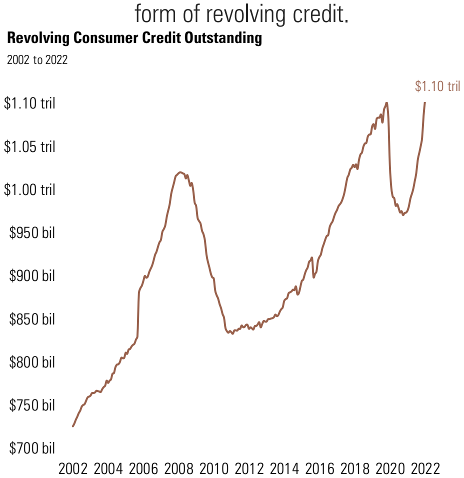


However, the consumer continues to be weened off Covid fiscal stimulus and has spent down personal savings to below pre-pandemic levels.

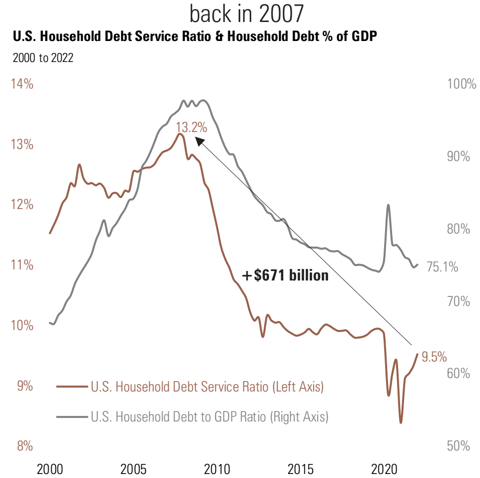


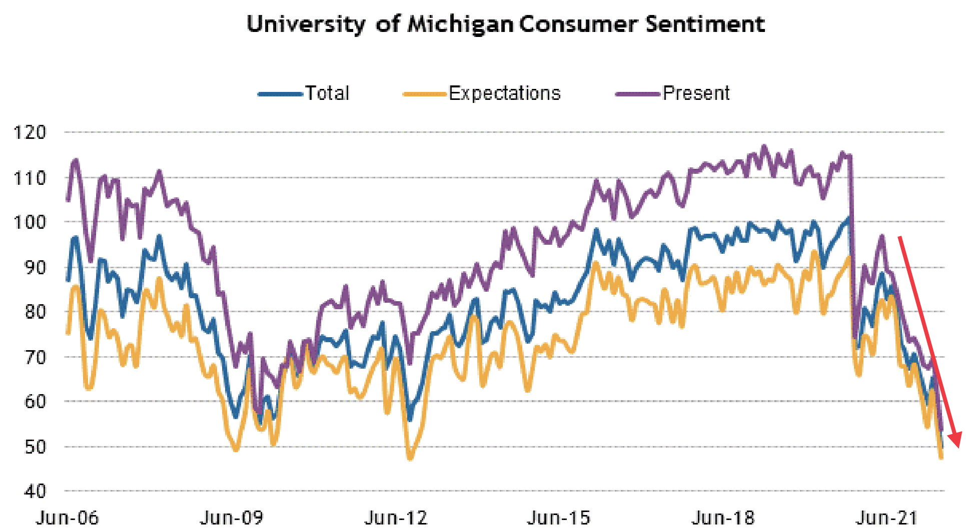
While rising wages and abundant jobs provide for a strong consumer, the erosion of savings and other macro factors has consumer sentiment souring.

This is pushing consumers to look for alternative sources to support their consumption, mostly in the form of revolving credit.



However, household debt service levels remain in very strong shape, still well-below the all-time high seen back in 2007





Data Sources: U.S. Bureau of Labor Statistics, Federal Reserve, University of Michigan

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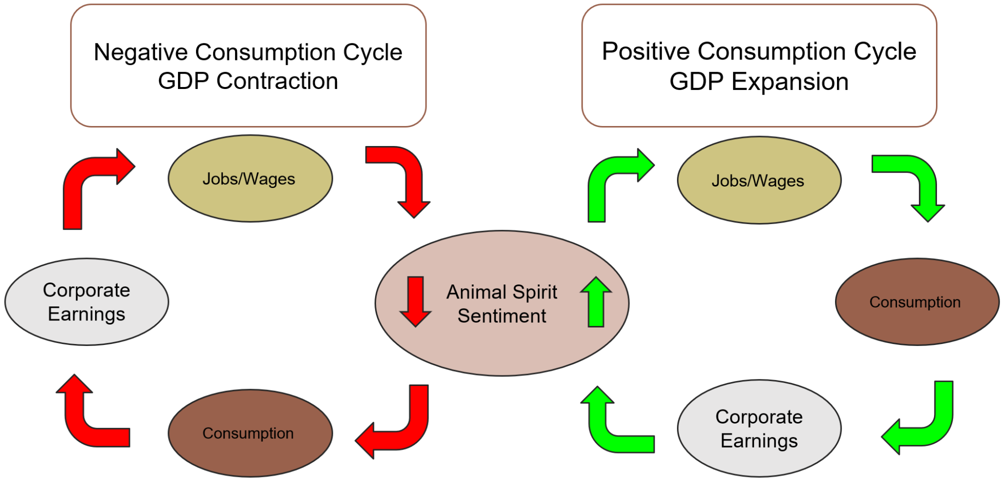
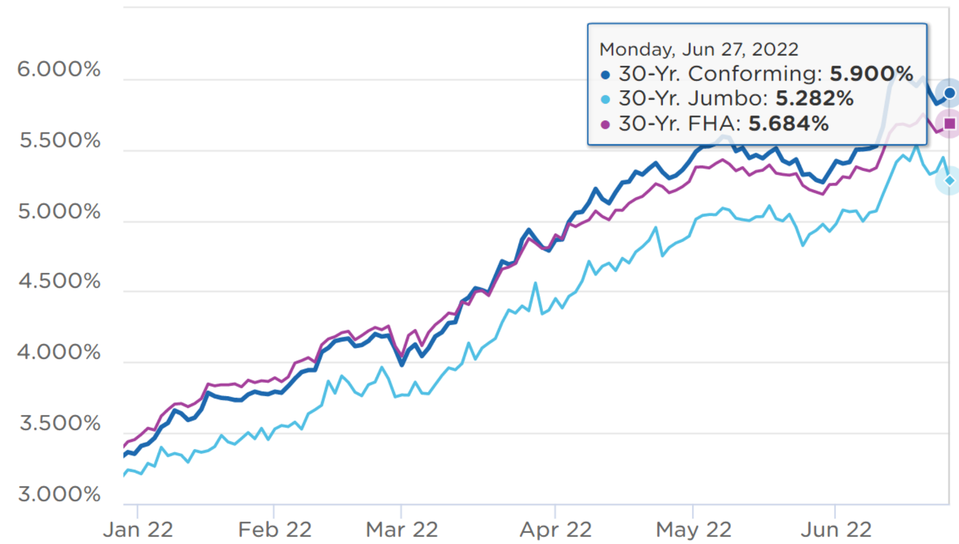
Cycle Detour – Demand Destruction From the Fed

Front-Loaded Pain Testing Consumer Health



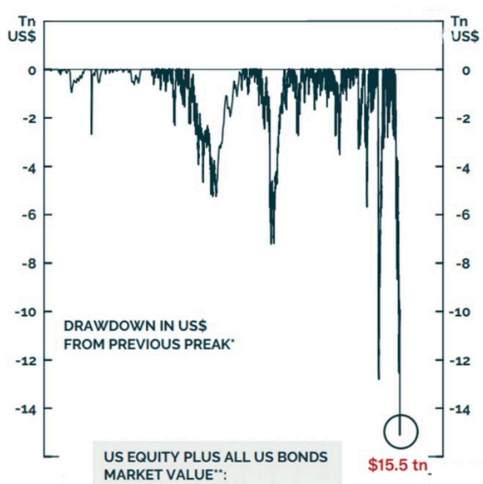
Uncertain/doubtful consumers create doubt about corporate earnings and valuations.

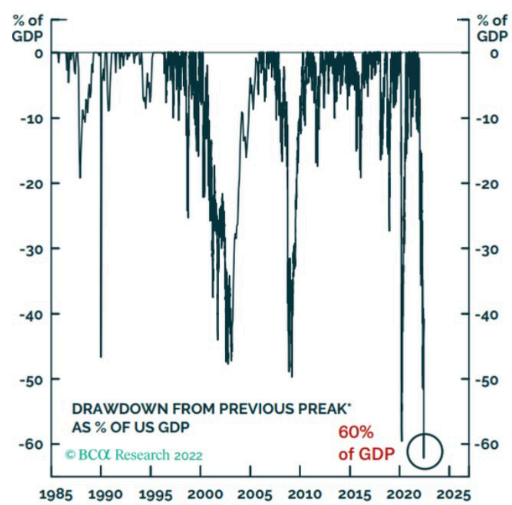
Mortgage rates in the U.S. are soaring, surpassing 5.8% and almost doubling from the record low in January 2021.



A record $15.5 trillion of wealth has been destroyed in stocks and bonds this year.

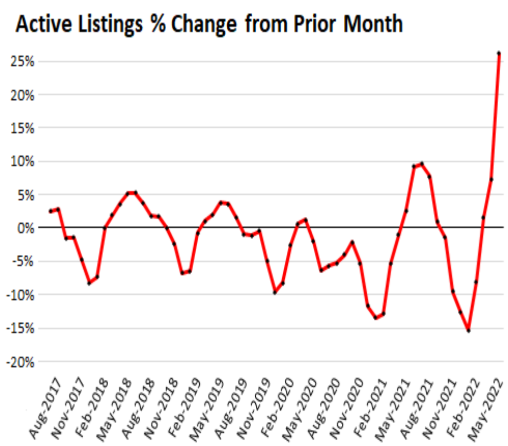
Add to that the ~$1.3 trillion in wealth that has been destroyed in crypto assets, and it brings total wealth destruction to $16.8 trillion, or 65% of GDP.

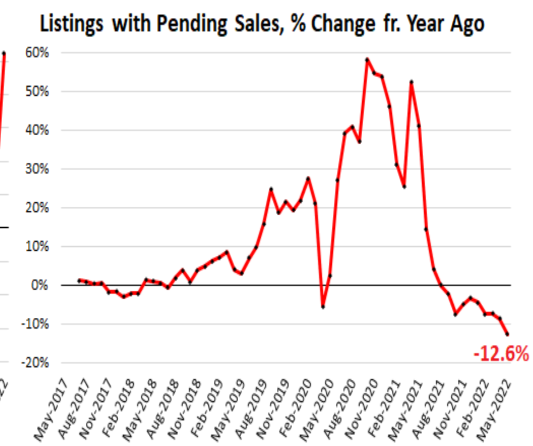




Rising interest rates can squash demand for housing, rents, recreation, appliances, clothing, and a whole host of other consumables. Take a look at what just a 1% increase in the Fed Funds rate did to housing.

Active housing listings in some select markets are up over 25% on a year-over-year basis and listings with pending sales are down almost 13%





Data Sources: BCA Research, Optimal Blue, Realtor.com

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Inflation – More Supply Than Demand

The Federal Reserve Chair Jay Powell already said they have little impact on food and energy prices…

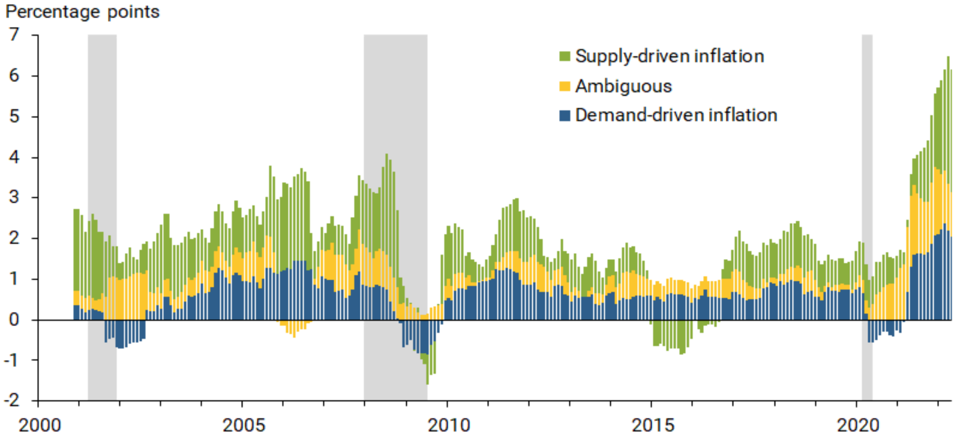
"Core inflation is most relevant to our tools. Non-core is outside our tools. We can't have that much effect (on food and energy inflation), but we are responsible for fighting inflation."

He further stated they have limited impact on supply constraints…

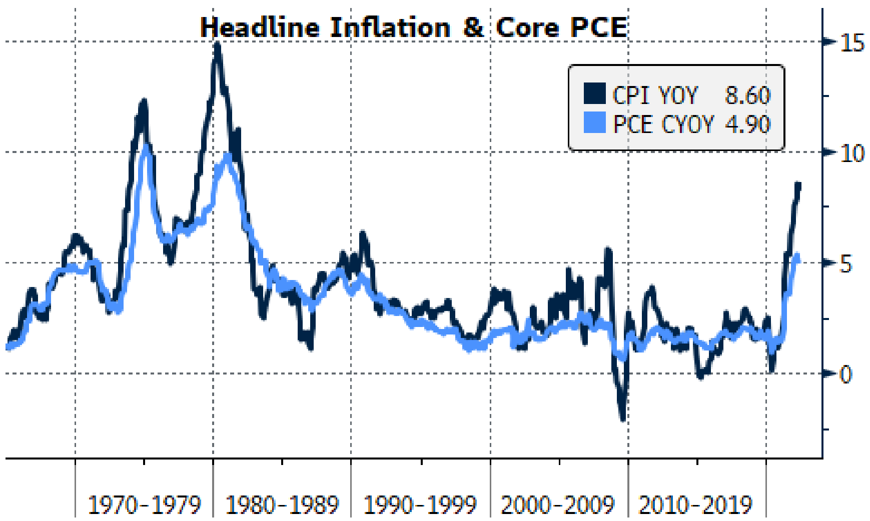
"What [the Fed] can control is demand, we can't really affect supply with our policies…"

Many smart economists have been calling out the Fed for being behind the inflation curve. Indeed, they may be. However, it's my view that the political economy can and must address inflation as it relates to food and energy.

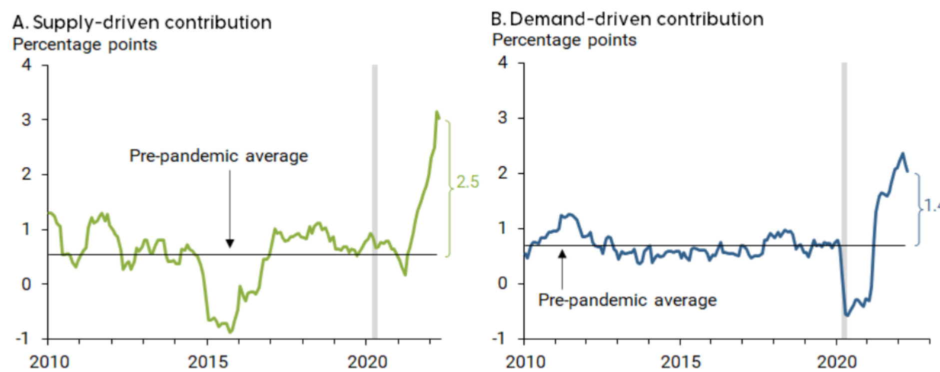
How much inflation is driven by supply and demand?
According to a recent Federal Reserve Board of San Francisco study the supply side is a major driver.



The consumer price index rose by 8.6% on a year-over-year basis in May and core PCE was up 4.9% year-over-year. These are record levels not seen since the 1980s.

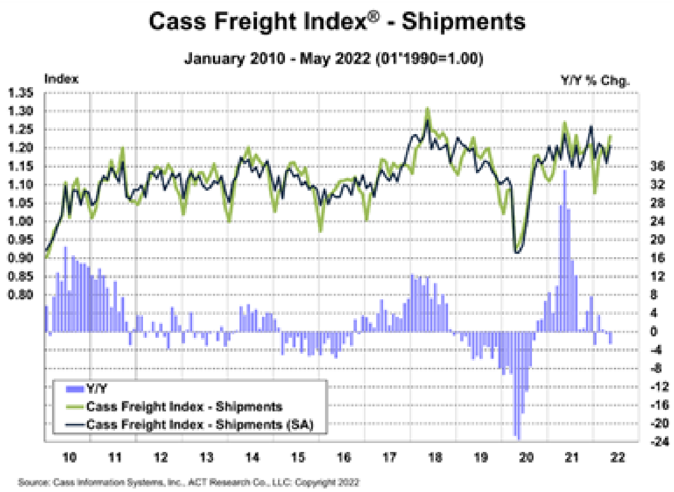


In fact, less than 33% of current inflation can be attributed to demand side impacts.
4.8% of current inflation above pre-pandemic levels is driven by supply-related issues, much of which are out of the reach of interest rate policy



Supply Side – Easing

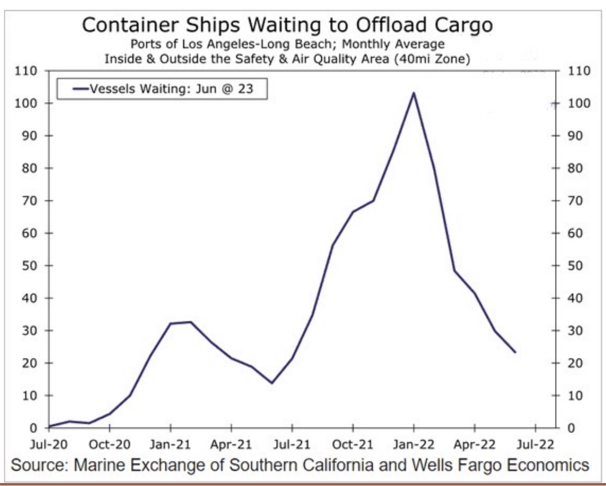
Supply chain disruptions are being resolved, as noted by Gene Seroka, the Executive Director of the Port of Los Angeles, who suggested "we are in the bottom of the fifth inning when it comes to the shipping backlog."



The dwell time (time cargo sits around) is being dramatically reduced according to Seroka:

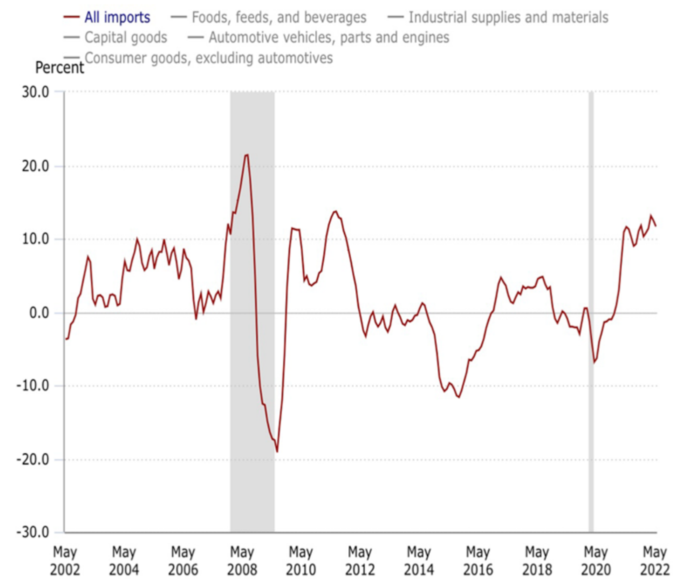
Dwell Times at Port of Los Angeles

Waiting for trucks (66% of all cargo)	Currently at 4 days, down from 12 days (very close to pre-pandemic levels)
Cargo waiting on rail	Currently at 6 days and moving back to 2 days
Cargo in warehouses onshore pending delivery	Currently at 8 days, moving back to 3 days



Import prices are showing some small signs of abating. This is all good news for resolving supply chain issues and lowering some costs to the consumer.

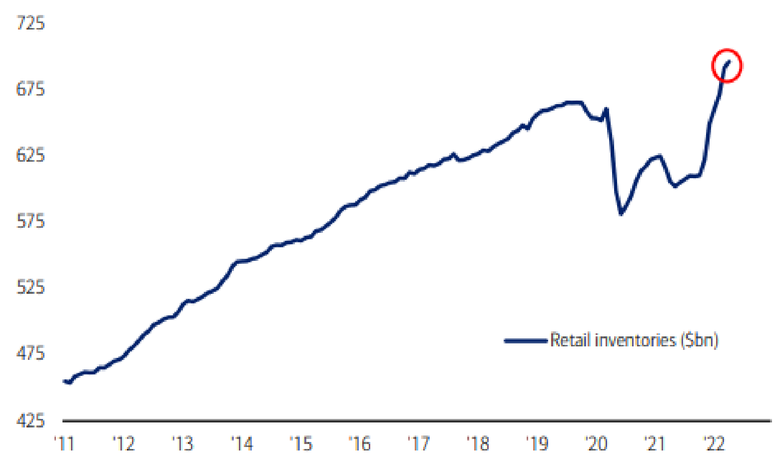
U.S. import price indexes for selected categories, 12-month percent change



With ample inventory, prices should continue to moderate from a supply side standpoint.

Chart 8: Retail inventories now surpassing pre-COVID level

US retail inventories



Data Sources: Cass Information Systems, U.S. Bureau of Labor Statistics, U.S. Census Bureau

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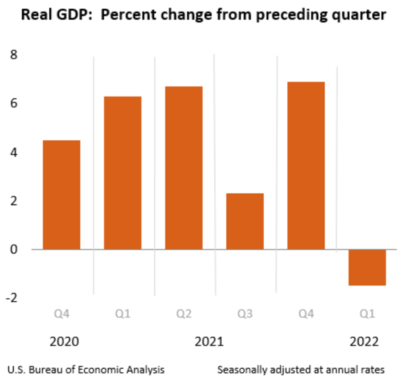
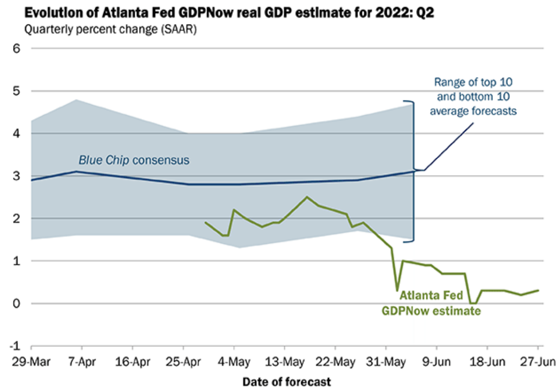
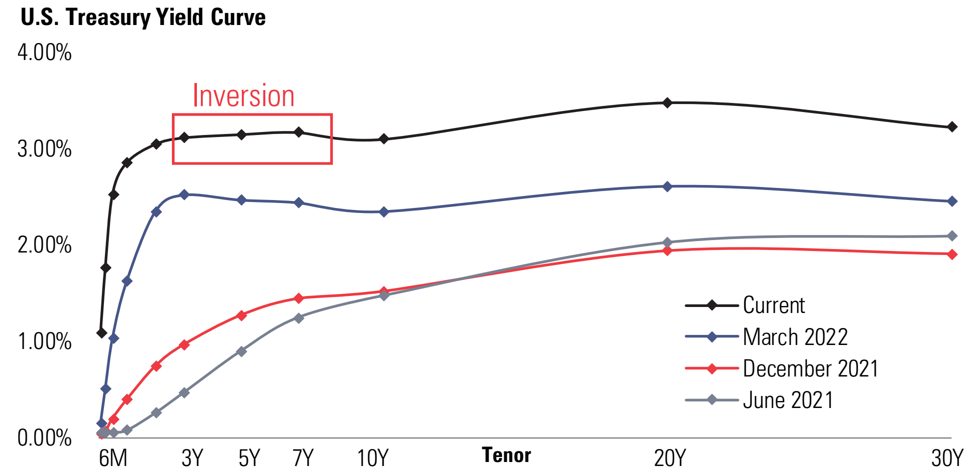
Federal Reserve – Recession Risks Growing

Soft Landing Ahead

We are on the precipice of, or in, a recession now. The Atlanta Fed's GDP Now forecast is calling for no growth in Q2 and likely a contraction. Combine that with the negative Q1 GDP print and you have a classic recession.

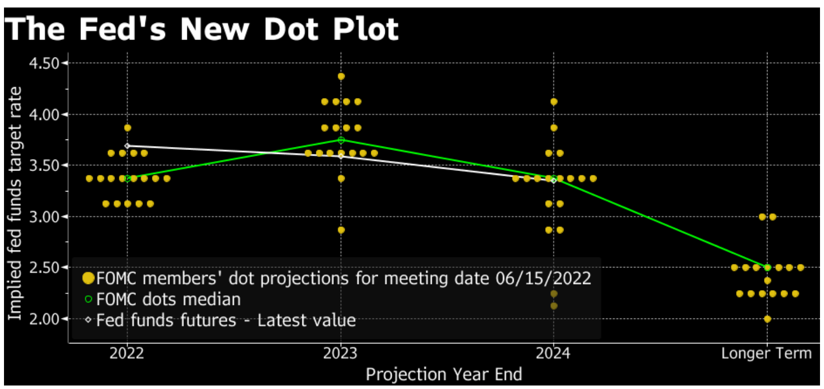






In response to non-core inflation the Fed raised interest rates by 75 basis points—that was no surprise. The real headline is in the forward rate expectations by members of the rate setting committee (FOMC).

It's clear the Fed expects interest rates to continue to rise in the coming year. The median is for the Fed Funds rate to end the year at 3.4% and top out at about 3.8% by the end of next year.



An economic soft landing is possible. If the Fed moves fast, they can stem the damage to jobs. With household balance sheets in great shape our view is a soft landing should be the base case.

Hard and soft landings[1] — Table C1

	Variable	Soft landings	Hard landings
Conditions at the start of the tightening cycle	Inflation (%)	2.6	4.1
	GDP growth (%)	2.6	2.7
	Real policy rate (%)	1.4*	0.4*
	Change in household credit-to-GDP (% pts)[2]	2.8*	6.4*
Conditions during tightening	Real policy rate increase (% pts)	0.8	1.3
	Average quarterly real rate increase (% pts)	0.2	0.2
	Tightening duration (quarters)	4.9*	5.9*
Conditions after tightening[3]	Change in inflation (% pts)	–1.1	–0.2
	Change in GDP growth (% pts)	–0.7*	–3.8*
	Real policy rate (%)[4]	1.6	–0.4
	Stock price growth (%)	3.1*	–7.7*

While both Wall Street and the Fed are forecasting rates to end 2022 in the 3.25-3.8% range, we forecast a much more muted escalation of rates. Perhaps something like:

FOMC Meeting	Start Rate (%)	Rate Hike (basis points)	Implied Rate (%)
July '22	1.75%	+75 bps	2.50%
September '22	2.50%	+50 bps	3.00%
November '22	3.00%	+0 bps	3.00%
December '22	3.00%	+0 bps	3.00%

Data Sources: Federal Reserve Bank of St. Louis, Federal Open Market Committee, Bank of International Settlements

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Fixed Income – Nowhere to Hide

Much of the portfolio headwind is being driven by raising rates and the Fed's policy to combat inflation. Bonds typically act as an anchor to falling stocks, but not during rising rate periods.

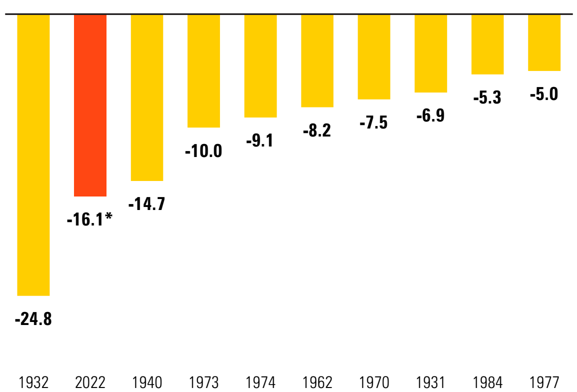
Hardest Hit Areas of Fixed Income This Year

Ticker	Name	Yield % Current	Return 2022 YTD	Duration (years)
EDV	Extended Duration Treasury Bonds	2.85%	−28.80%	24.35
TLT	20+ Year Treasury Bonds	2.19%	−22.56%	18.16
VCLT	Long-Term Corporate Bonds	4.33%	−22.49%	13.49
BLV	Long-Term Bonds	3.61%	−21.86%	14.73
CWB	Convertibles	2.39%	−21.04%	–
TLH	10-20 Year Treasury Bonds	2.25%	−19.09%	14.23
LQD	Investment Grade Corporate Bonds	2.99%	−16.33%	8.96
PFF	Preferred & Income Securities	5.32%	−15.02%	–
JNK	High Yield Bonds	5.63%	−14.66%	4.61
HYG	High Yield Corporate Bonds	5.00%	−13.72%	4.44
LEMB	Emerging Markets Bonds	4.48%	−13.08%	4.66
BOND	Active Bonds	3.16%	−12.29%	7.16
IEF	7-10 Year Treasury Bonds	1.53%	−11.24%	7.97
BIV	Intermediate-Term Bonds	2.21%	−11.07%	6.44
BND	Total Bond Market	2.37%	−10.73%	6.70
AGG	Core U.S. Aggregate Bonds	2.21%	−10.56%	6.52
SJNK	Short-Term High Yield Bonds	5.31%	−9.20%	2.71
MBB	MBS	2.01%	−9.11%	6.02
TIP	TIPS Bonds	14.39%	−8.96%	7.18
MUB	National Muni Bonds	1.84%	−8.20%	5.51

It's been a nasty year for portfolios, especially those traditionally considered conservative like the 60/40 stock/bond portfolio.

Worst ever start to a year for a 60/40 portfolio

Since 1926, total return for 1/1-5/31 each calendar year



* 2022 return through 6/29/22

With some limited pain, a recovery in conservative portfolios could be just months away.

Returns following the 10 worst starts to a year

Since 1926, plus returns for the next 7 and 12 months

Year	First 5 months	Next 7 months	Next 12 months
1932	-24.8	31.2	66.9
1940	-14.7	11.7	6.1
2022	-16.1*	?	?
1973	-10.0	-5.2	-13.9
1974	-9.1	-19.1	9.6
1962	-8.2	5.7	14.7
1970	-7.5	23.1	34.8
1931	-6.9	-21.5	-41.0
1984	-5.3	16.0	31.3
1977	-5.0	2.0	4.9
Avg.	*-10.8*	*4.9*	*12.6*

* 2022 return through 6/29/22

Data Sources: Bloomberg

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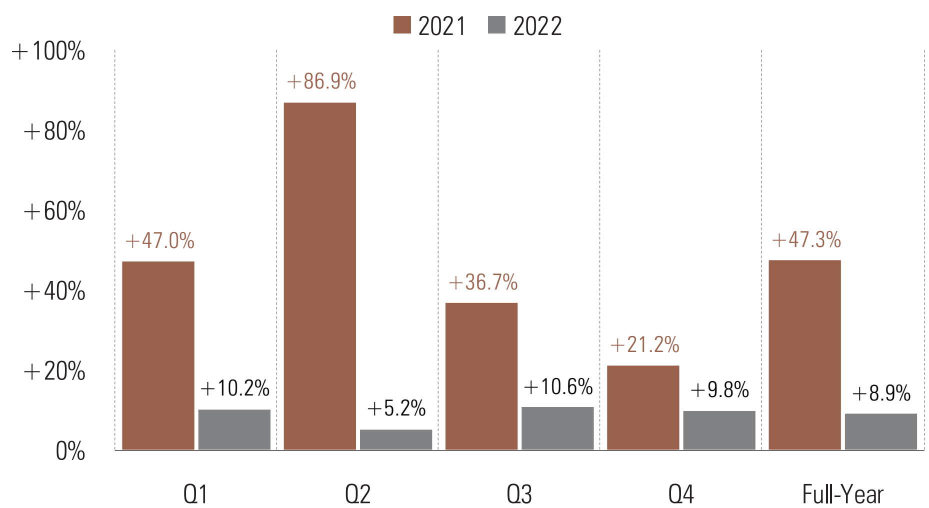
Earnings Still Matter

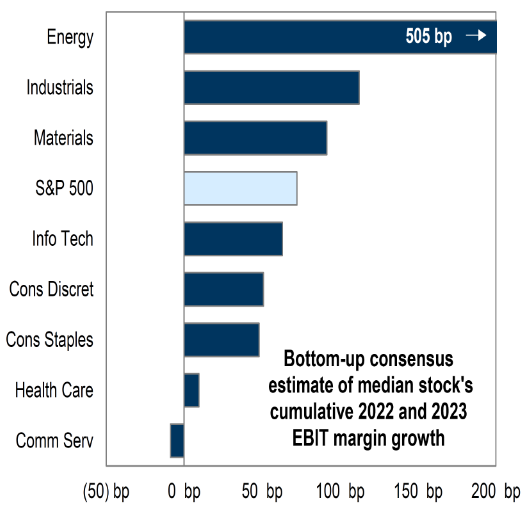
While equity valuation multiples and share prices have declined, consensus earnings estimates only recently ceased climbing higher.

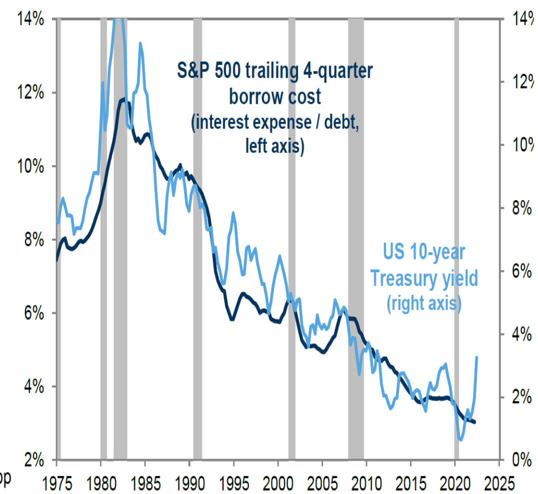
In aggregate, bottom-up consensus expectations for S&P 500 2023 EPS have risen by 3% YTD.

S&P 500 Earnings Growth 2021 – 2022



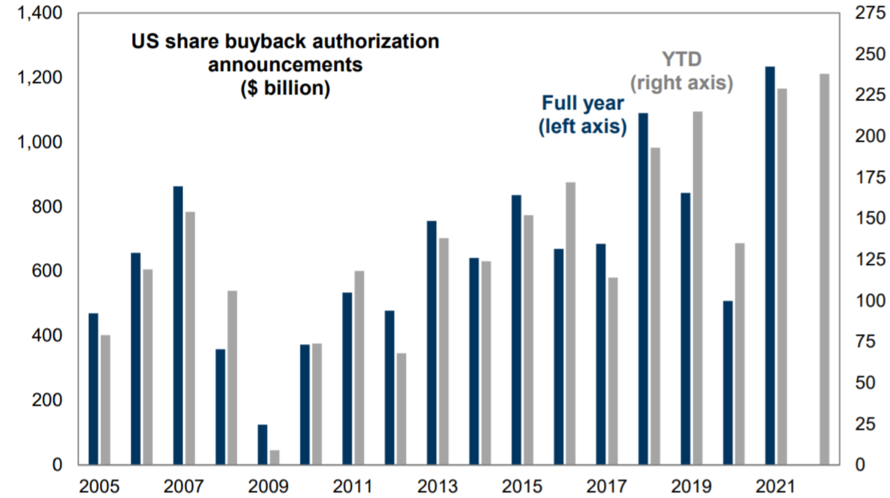
Despite tightening financial conditions, persistent input cost headwinds, and slowing revenue growth, analysts continue to forecast a rise in profit margins driven by strength in the U.S. Consumer.





One tailwind to corporate earnings will be the record level of stock buybacks in 2021.

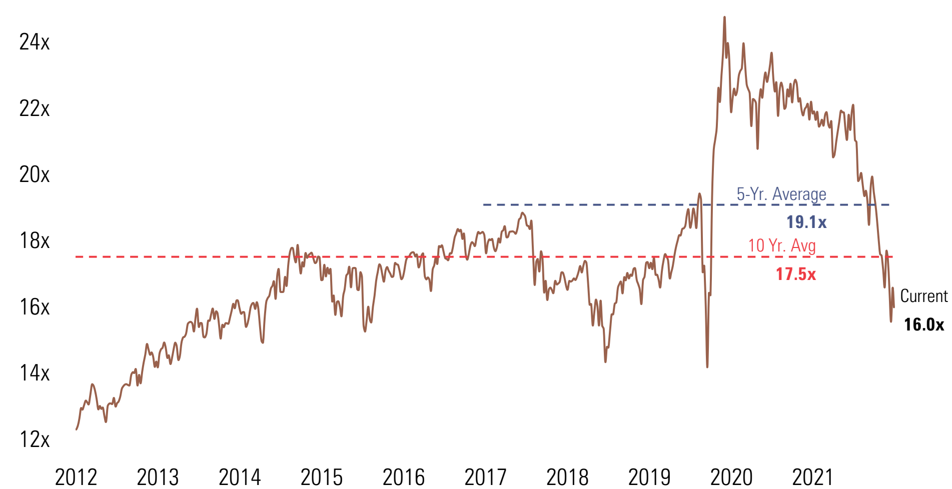
That should translate into a boost to earnings per share in 2022 with fewer shares outstanding.



The S&P 500 decline this year has been driven entirely by rising interest rates.

The consensus forward P/E multiple has compressed by 25% since the start of 2022, from 22.1x to 16.6x. This decline in valuations has effectively matched the rise in real U.S. Treasury yields.

S&P 500 Forward Price-to-Earnings



Data Sources: FactSet, Goldman Sachs, Bloomberg

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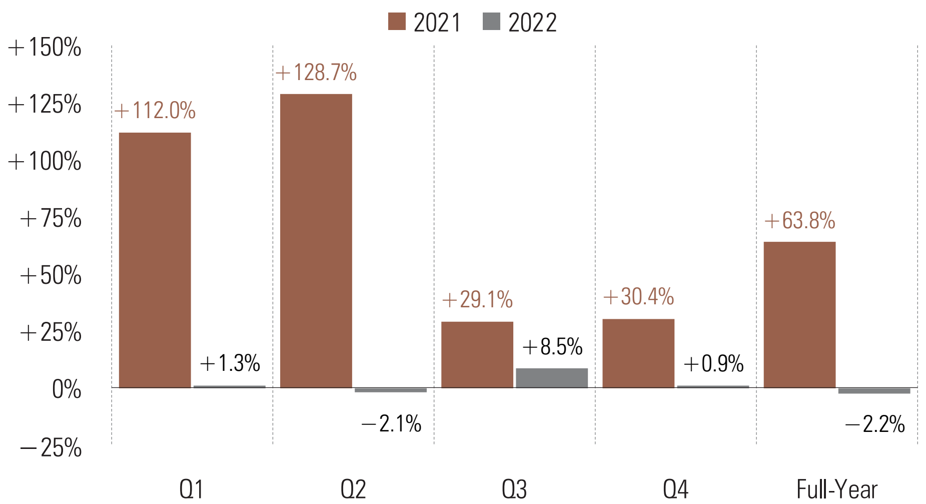
Developed Markets

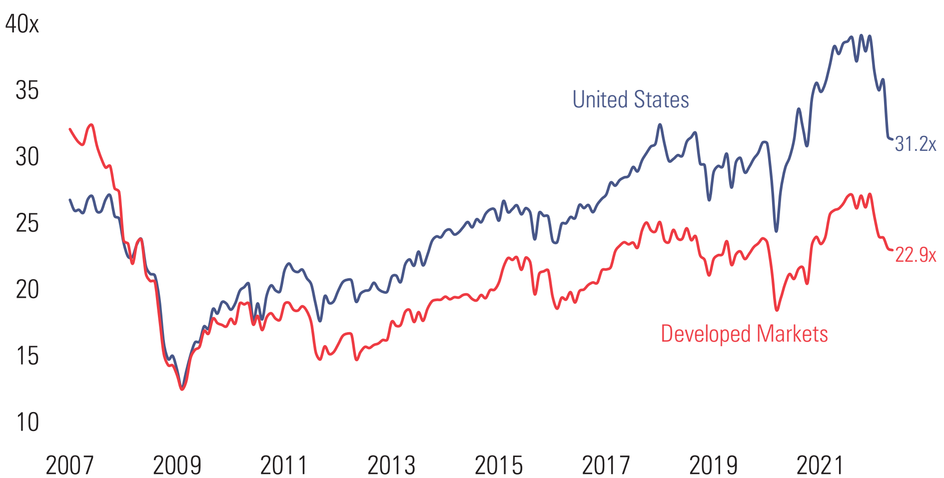
After strong earnings growth in 2021, the invasion of Ukraine by Russian forces presents signification implications for both consumer demand and supply in the Euro area.

Sharply rising energy bills, weaker consumption, supply disruptions, shipping costs, and potential gas disruptions will weigh on both revenues and net income margins.

MSCI EAFE Earnings Growth: 2021 vs. 2022



Historical CAPE Ratio Developed Markets & United States

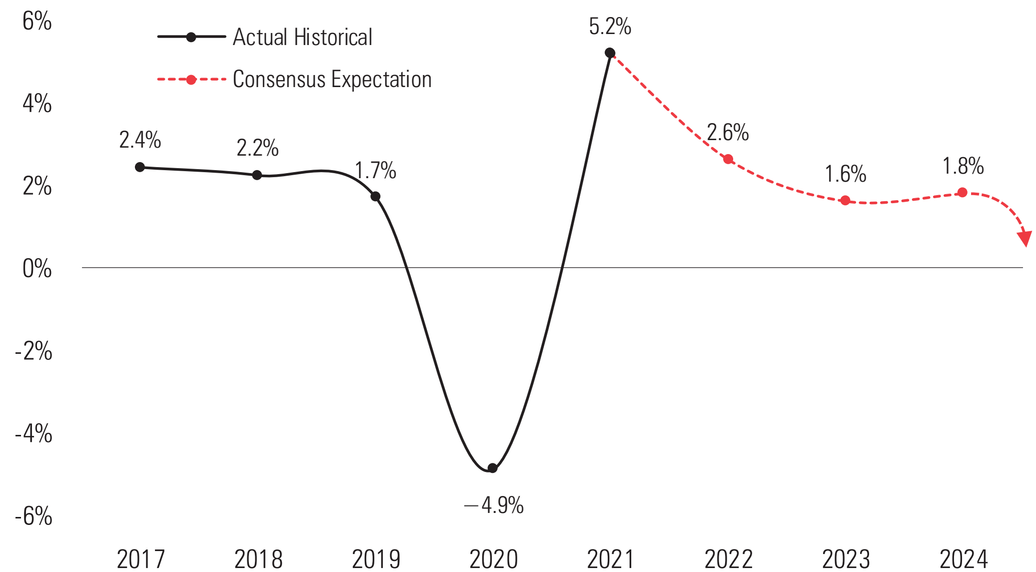


Developed Markets are currently trading at a 27% discount to the United States

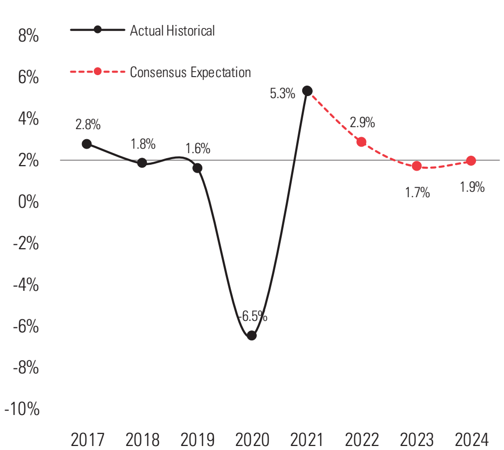
Developed markets growth could weaken substantially due to the spillovers from the Russia-Ukraine war, with full-year GDP growth of 2.4% (down from 4.1% before the war).

The uncertainty around the outlook, however, remains high. It would not be surprising to see zero growth in Developed Markets (Europe) and perhaps a recession in late 2022 or 2023.

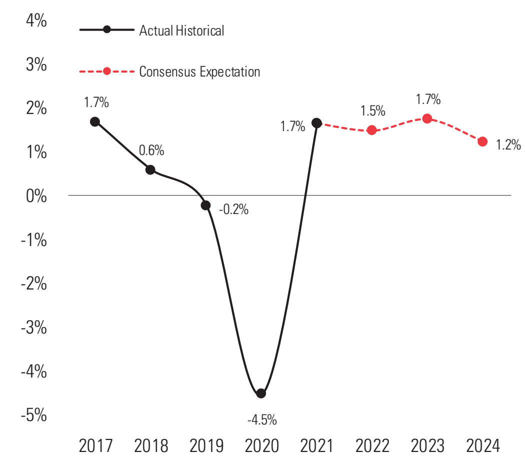
Developed Markets GDP Growth



Euro Area GDP Growth



Japan GDP Growth



Data Sources: Bloomberg

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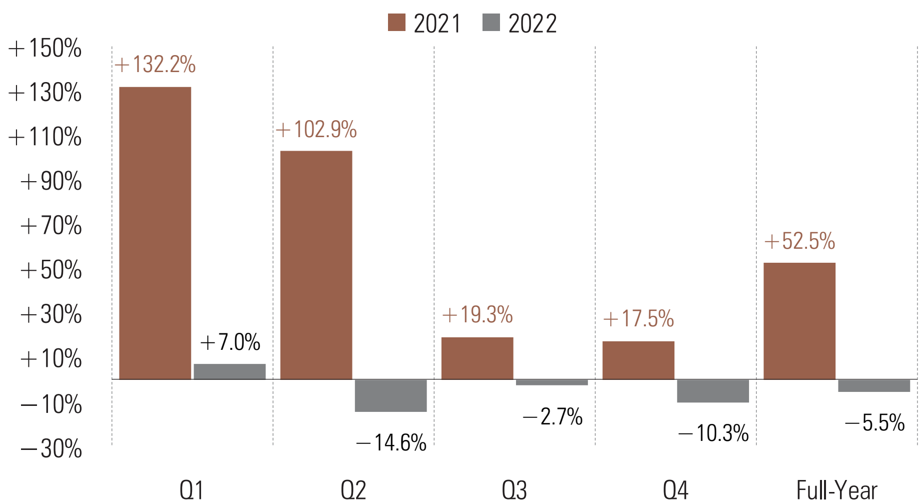
Emerging Markets

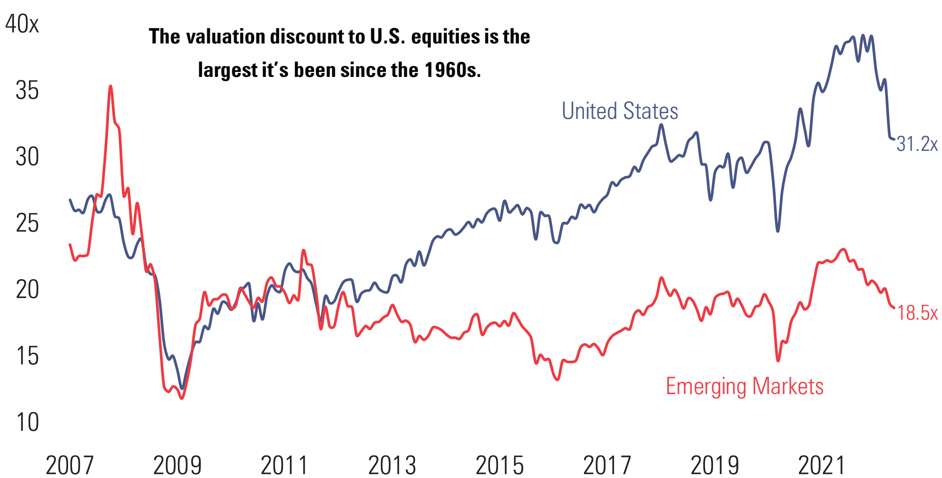
Over the past year, Emerging markets have grappled with higher real rates, a stronger dollar, and a slowdown in China growth.

The current heightened geopolitical tensions have various channels of impact across the EM landscape, but in aggregate, Emerging Markets remain "high-beta" to these risks.

MSCI Emerging Markets Earnings Growth: 2021 vs. 2022



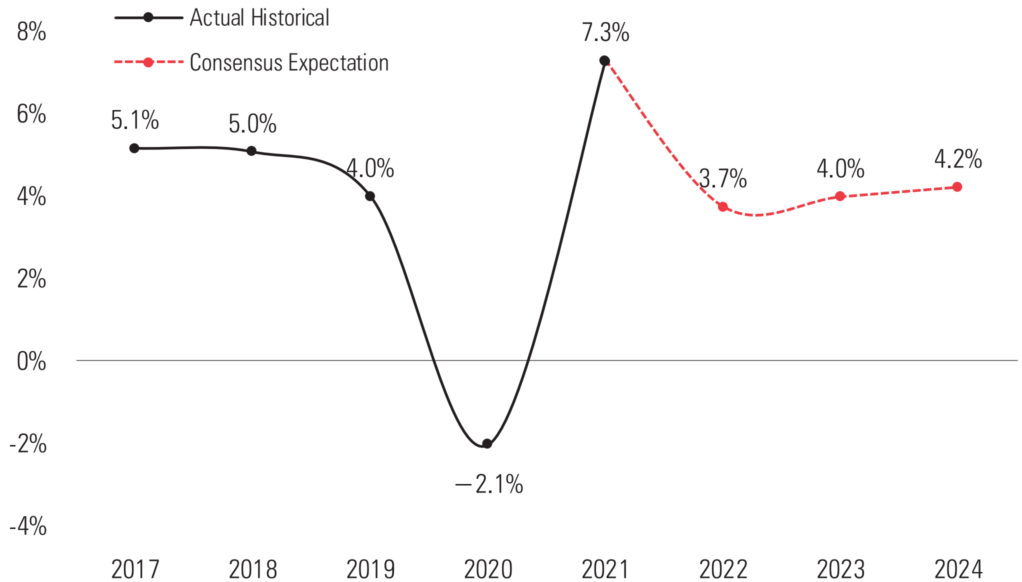
Historical CAPE Ratio Emerging Markets & United States



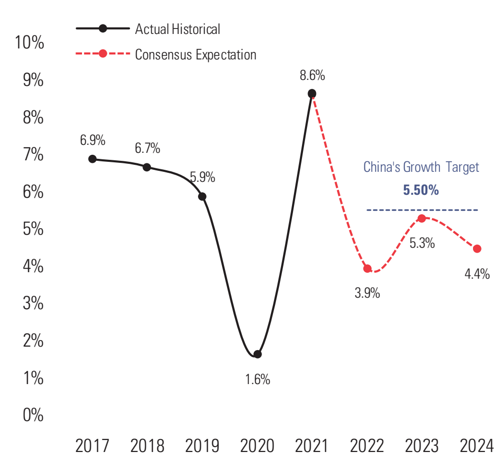
Emerging Markets are currently trading at a 41% discount to the United States

While GDP growth in emerging markets could moderate around the 5% level, China and India should present stronger growth in 2022 and 2023.

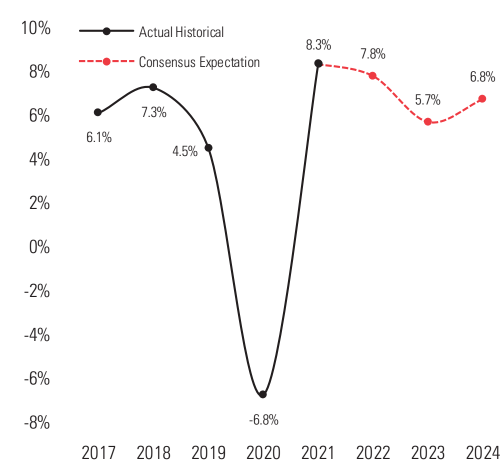
Emerging Markets GDP Growth



China GDP Growth



India GDP Growth



Data Sources: Bloomberg

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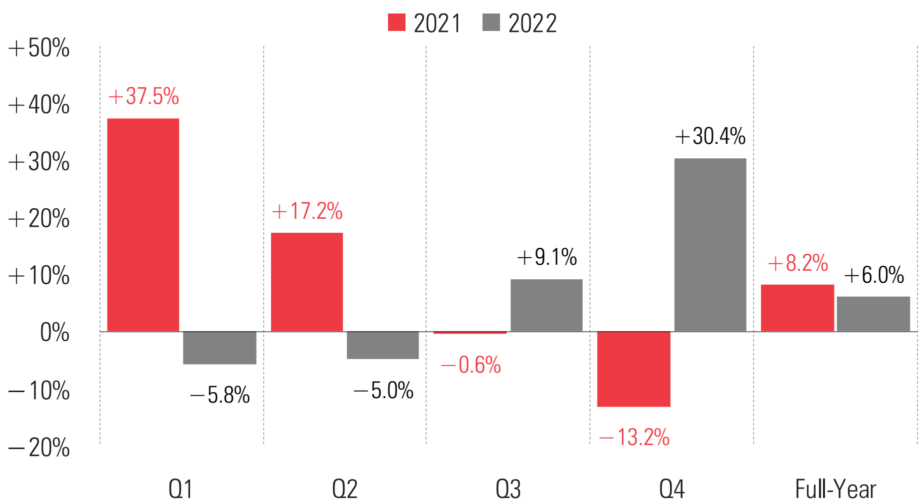
China

Q2 earnings expectations should mark the trough for China's contraction cycle.

As the impact of COVID-19 resurgence weakens and the pro-growth policies start to take effect, earnings growth should recover.

MSCI China A Earnings Growth: 2021 vs. 2022



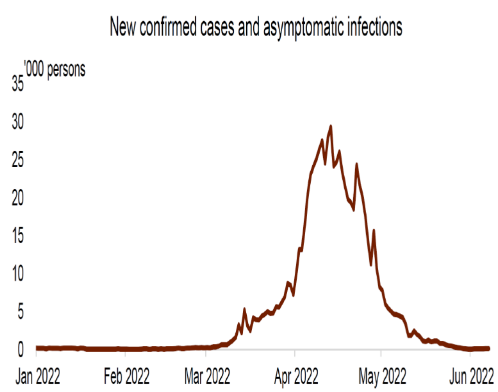
Full year 2022 GDP is targeted for 5.5% to rebound from the Zero Covid lockdown in Q2.

Economic Data Forecast

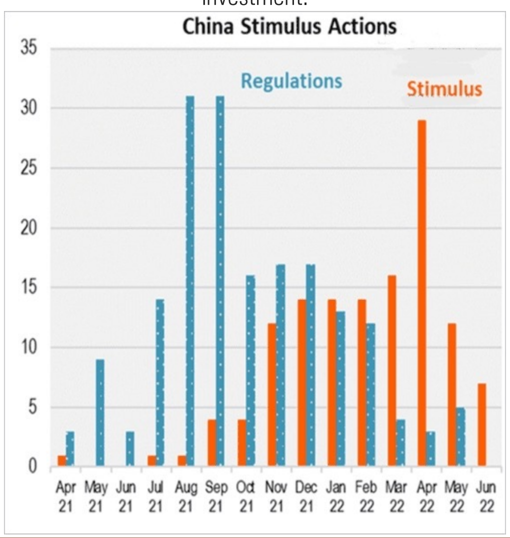
		2021	2022E	2023E
Economic activities				
GDP YoY	%	8.1	4.3	6.7
GDP QoQ	%			
Total retail sales of consu	%	12.5	3.5	7.5
Invesment in fixed assets	%	4.9	5.8	5.9
Manufacturing	%	13.5	5.3	5.7
Infrastructure	%	0.2	8.0	4.3
Real estate	%	4.4	0.5	9.0
Inflation				
CPI YoY	%	0.9	2.1	2.5
PPI YoY	%	8.1	5.5	2.4
GDP deflator YoY	%	4.7	3.3	2.4
Trade				
Export YoY	%	29.9	5.2	3.0
Import YoY	%	30.1	4.2	4.0
Monetary finance				
New private financing	Rmb trn	31.4	34.0	-
Private financing YoY	%	10.3	10.5	-
New loan	Rmb trn	19.9	20.8	-
Loan YoY	%	11.5	10.8	-
M2 YoY	%	9.0	9.6	-

China's Zero Covid policy created significant economic headwinds in Q2.
With Covid cases near zero and a very reluctant CCP, we should see significant economic growth for the remainder of the year.

Number of daily new COVID-19 cases in the Chinese mainland YTD (as of June 3, 2022)

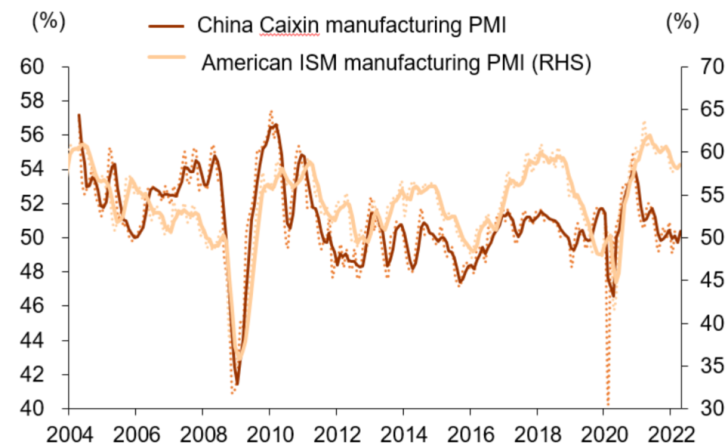


We expect a rapid reduction in regulations and significant stimulus to drive consumption and planned investment.



China is on a different economic cycle than the United States, offering some lower correlation opportunities. China is in a stimulative cycle while the US is in a restrictive cycle.

Correlation between Chinese and US economic cycles



Data Sources: Bloomberg, CICC

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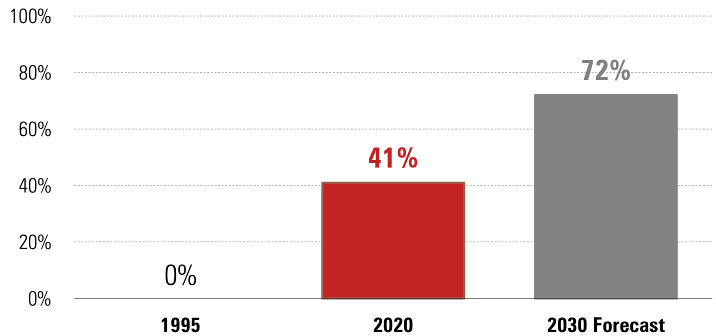
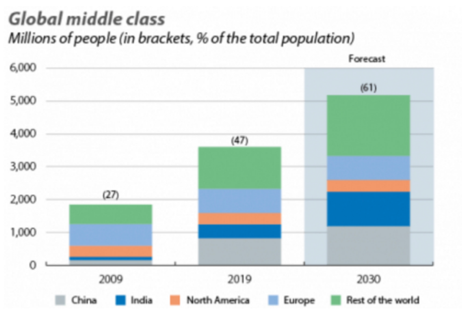
Why We Invest in China

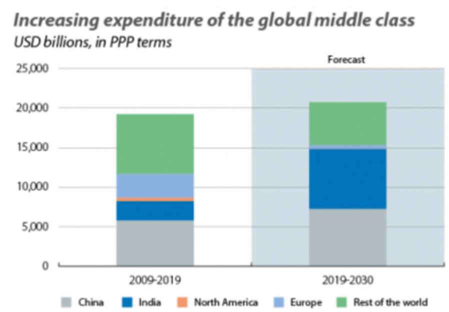
China's growing middle class represents one of the clearest global macroeconomic themes to take advantage of.

Growth of the Chinese Middle Class

Percent of Total Population

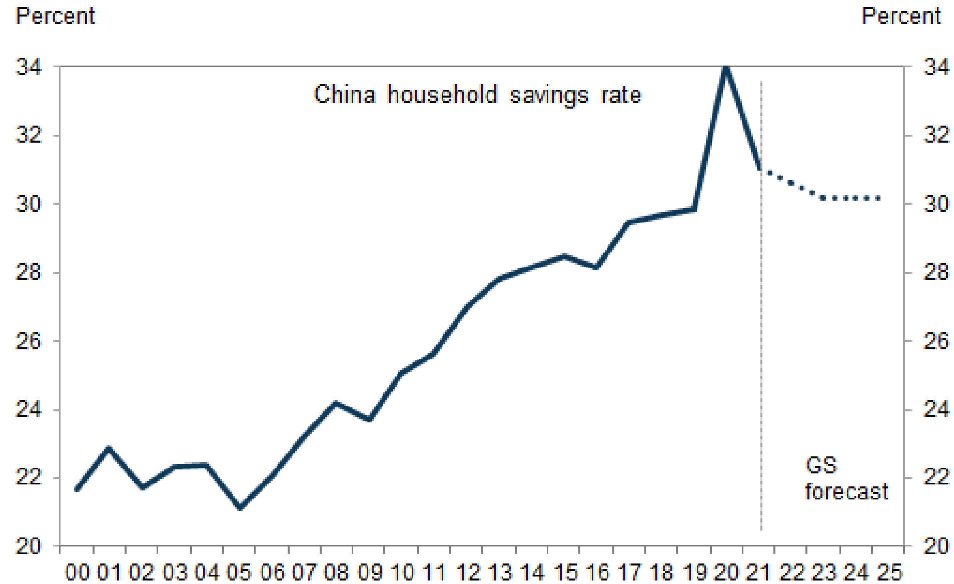






Combine the growing middle class, having the spirit to consume, with resources in the form of some of the highest saving rates in the world, and you get a special recipe for consumption and, therefore, corporate earnings growth.

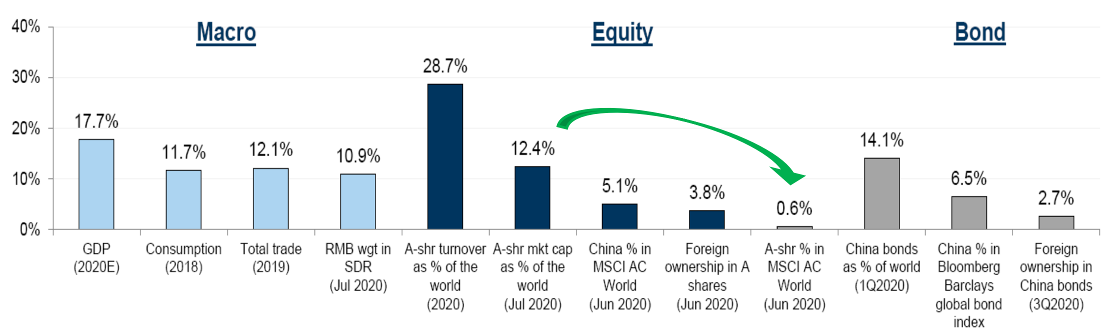
China Household Savings Rate



With China being the second largest equity market in the world, combined with under representation in major indexes, it is not hard to fathom additional capital inflows to China over the long-term.

China is Under-Owned by Nearly Any Measure

China as a percentage of the world



How Long Will It Last?

When it comes to bear markets or recessions it's critical to realize "this too will pass." We entered a bear market on June 14th and the median days to end the 20% drawdown is 43 days.

Historically, the next year has had a market recovery of approximately 24%. Not too dissimilar to recessions and market recoveries.

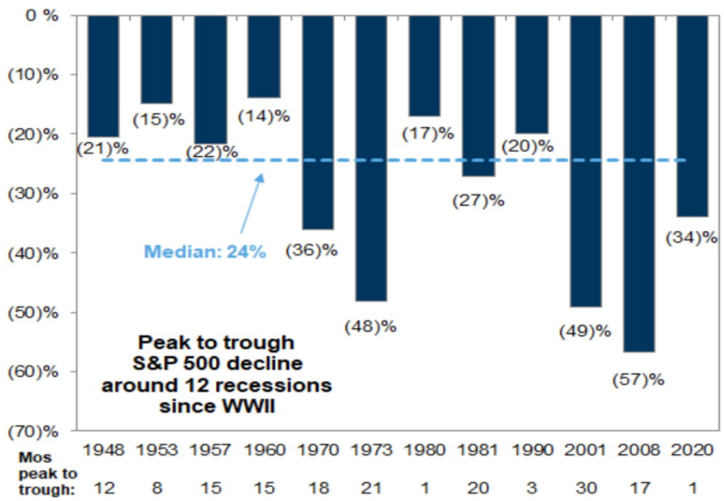
Post-WW2 S&P 500 Bear Markets*

Start	-20%	Days to Bear	End	Days from -20% to End	% Chg from -20% to End	Full Bear % Chg	Full Bear # of Days	S&P 500 % Change Once -20% Threshold is Hit: Next Week	Next Month	Next 3 Mths	Next 6 Mths	Next Year
5/29/46	9/3/46	97	5/19/47	258	-8.20	-28.47	355	-2.73	-0.13	-3.40	2.73	2.20
6/15/48	6/13/49	363	6/13/49	0	0.00	-20.57	363	3.84	9.08	16.16	22.80	42.07
8/2/56	10/21/57	445	10/22/57	1	-0.43	-21.63	446	3.24	3.40	5.49	9.66	30.96
12/12/61	5/28/62	167	6/26/62	29	-5.73	-27.97	196	3.19	-1.96	5.93	11.93	26.14
2/9/66	8/29/66	201	10/7/66	39	-1.78	-22.18	240	3.88	2.39	7.90	16.44	24.62
11/29/68	1/29/70	426	5/26/70	117	-19.14	-36.06	543	0.25	4.45	-4.53	-8.93	11.89
1/11/73	11/27/73	320	10/3/74	310	-34.92	-48.20	630	-2.20	2.13	0.73	-7.44	-26.92
11/28/80	2/22/82	451	8/12/82	171	-8.22	-27.11	622	1.54	1.06	2.96	1.28	30.37
8/25/87	10/19/87	55	12/4/87	46	-0.41	-33.51	101	1.26	6.76	10.89	14.71	23.19
3/24/00	3/12/01	353	9/21/01	193	-18.16	-36.77	546	-0.79	0.28	6.41	-7.42	-1.24
1/4/02	7/10/02	187	7/23/02	13	-13.34	-31.97	200	-1.57	-1.29	-12.66	0.77	7.41
10/9/07	7/9/08	274	11/20/08	134	-39.55	-51.93	408	0.05	4.15	-26.90	-28.47	-29.08
1/6/09	2/23/09	48	3/9/09	14	-8.99	-27.62	62	-5.72	10.71	19.33	38.05	47.26
2/19/20	3/12/20	22	3/23/20	11	-9.81	-33.92	33	-2.87	12.46	22.60	34.68	58.96
1/3/22	?	161+	?	?	?	?	?	?	?	?	?	?
	Average	244		95	-12.05	-31.99	339	0.10	3.82	3.64	7.20	17.70
	Median	238		43	-8.60	-30.22	359	0.15	2.89	5.71	6.19	23.90
	% Positive	--		--	--	--	--	57.1	78.6	71.4	71.4	78.6
Avg. All Periods Since 1945								*0.30*	*1.01*	*2.42*	*4.88*	*9.89*

Recession	Recession Length	Prior 6 Months	During Recession	Plus 1 Year	Plus 3 Years	Plus 5 Years
8/1929 - 3/1933	43 months	14.0%	-74.5%	92.0%	192.1%	84.8%
5/1937 - 6/1938	13 months	-2.4%	-24.2%	-1.8%	0.9%	44.3%
2/1945 - 10/1945	8 months	8.6%	27.7%	-7.3%	15.3%	57.8%
11/1948 - 10/1949	11 months	9.8%	4.1%	31.5%	88.0%	171.3%
7/1953 - 5/1954	10 months	-6.5%	27.6%	35.9%	83.7%	144.8%
8/1957 - 4/1958	8 months	9.3%	-6.5%	37.3%	66.4%	89.7%
4/1960 - 2/1961	10 months	-1.0%	18.4%	13.6%	35.1%	68.4%
12/1969 - 11/1970	11 months	-7.8%	-3.5%	11.2%	20.6%	25.2%
11/1973 - 3/1975	16 months	2.9%	-17.9%	28.3%	22.0%	55.3%
1/1980 - 7/1980	6 months	7.7%	16.1%	12.9%	55.9%	100.9%
7/1981 - 11/1982	16 months	-1.0%	14.7%	25.4%	67.2%	103.2%
7/1990 - 3/1991	8 months	3.1%	7.6%	11.0%	29.8%	98.2%
3/2001 - 11/2001	8 months	-17.8%	-7.2%	-16.5%	8.4%	34.3%
12/2007 - 6/2009	18 months	-2.3%	-35.5%	14.4%	57.7%	137.0%
2/2020 - 4/2020	2 months	18.4%	-13.7%	43.6%	–	–
AVERAGE	**13 months**	**2.3%**	**-4.4%**	**22.1%**	**53.1%**	**86.8%**

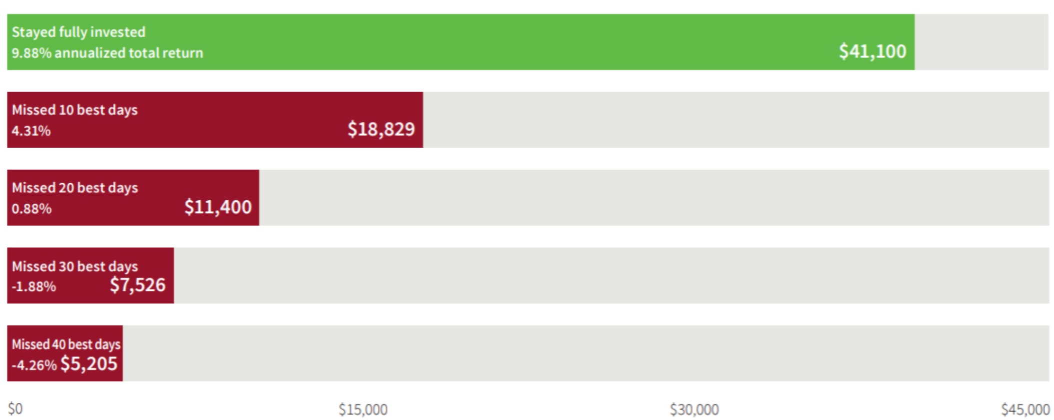
The current S&P 500 drawdown has been much more dramatic than average. The average length of time from market peak to recession start is seven months vs. our current ~5 months, assuming we are in a recession now.

Historically, we are likely closer to the end of the market drawdown than the beginning. According to Goldman Sachs, the median drop in the S&P 500 is 24% compared to our current 20% drop in the S&P 500.



Markets move in brief bursts, miss just a few days and you lose all the advantage

$10,000 invested in the S&P 500 (12/31/05–12/31/20)



Data Sources: Bespoke, Bloomberg, Capital Group, Goldman Sachs

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Our View & Recommendations

Our View

- The current pace and trajectory of interest rate increases could induce a policy error driven recession. Eroding consumer sentiment will pose a challenge to a straight-line Fed interest rate policy.
- The Federal Reserve will likely pause rate increases before they reach their target for 2022 and 2023, motivated by a weaker economic backdrop. A soft landing is well within the range of outcomes that can lift equity prices in the months to come.
- The U.S. consumer will remain resilient as strong jobs and wages provide a positive backdrop.
- Europe too will be very close to a recession as they face higher food and energy prices as well as extreme consumer pessimism.
- Emerging markets continue to offer strong growth to valuation opportunities in the second half of 2022.
- China will offer a counter-cyclical opportunity to the U.S. as it's in a stimulative economic posture.

Recommendations

- Reaffirm your investment strategy and maintain strategic liquidity to cover spending needs and provide opportunities for cost averaging.
- Underweight Developed Markets as the ground war in Europe poses a real risk to consumption habits and earnings growth.
- Maintain an overweight to Emerging Markets and China as they continue to represent strong earnings growth to valuation prospects.
- Capture shorter duration fixed income opportunities as the yield curve is flat from 3yr-10yr.
- Continue to shift to Base Metals and Health Care. Base metals offer a hedge against inflation and take advantage of a commodities super cycle. Health Care offers tremendous pricing power and a better corporate earnings outlook in an inflationary environment.

Homework

- Review our latest video with Best Selling Author of *Psychology of Money*, Morgan Housel. See what's more important that investment returns.

Mean Reversion Dashboard

Style Forward P/E as a % of 20-Year Average

Size	Value	Blend	Growth
Large	93.2%	100.8%	113.8%
Mid	83.9%	87.8%	96.7%
Small	84.0%	78.2%	65.5%

Regions & Countries Forward P/E as a % of 20-Year Average

Regions

World	Developed Markets	Emerging Markets
96.8%	89.1%	98.9%

Countries

United States	Germany	United Kingdom	China	Brazil	India	Russia
102.0%	80.3%	84.8%	104.0%	56.3%	112.9%	—

Sector Forward P/E as a % of 20-Year Average

Sectors

Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Technology	Telecom	Utilities	Real Estate
45.3%	79.6%	96.9%	109.0%	115.7%	102.3%	91.1%	105.2%	91.1%	126.7%	81.9%

Data Source: Bloomberg

THANK YOU

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