LOOK AHEAD

Q2 2022

DISCLAIMER

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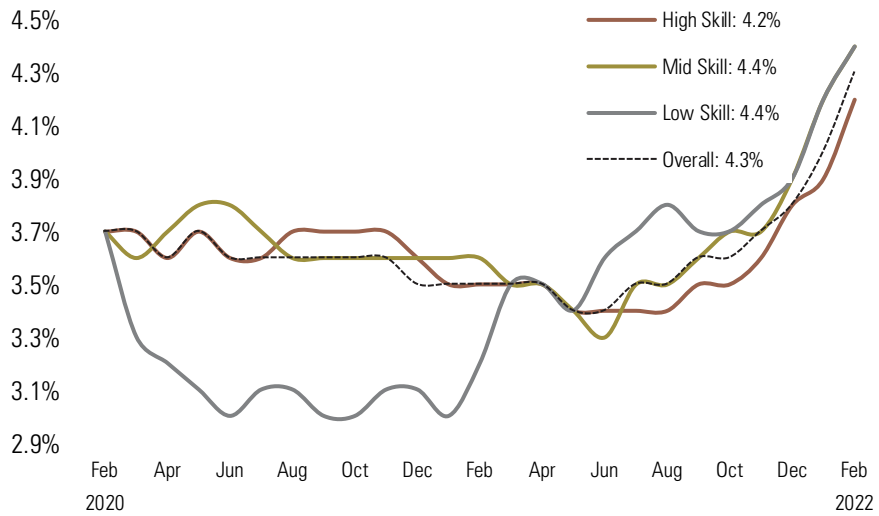
Consumer Strength Weakening

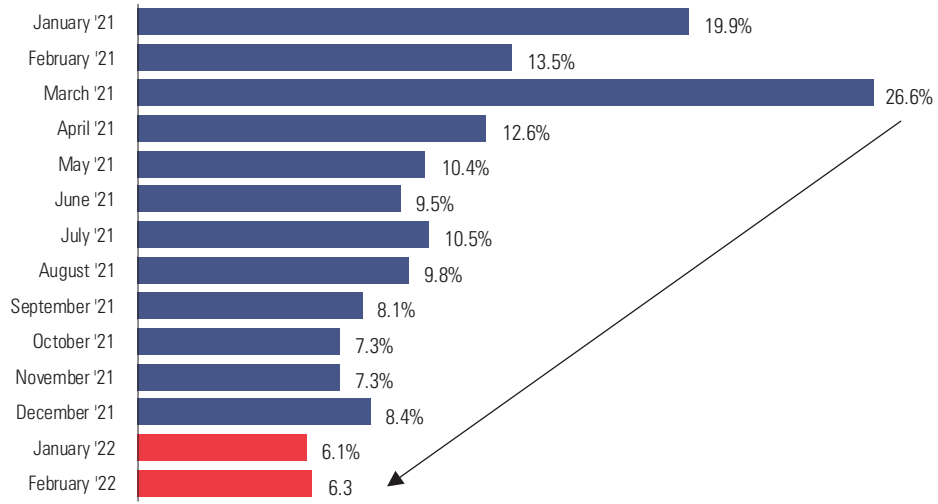
Current wage growth trends suggest the consumer should be in a strong position to continue to consume at high levels in the quarter to come.

Atlanta Fed's Wage Growth Tracker by Occupation



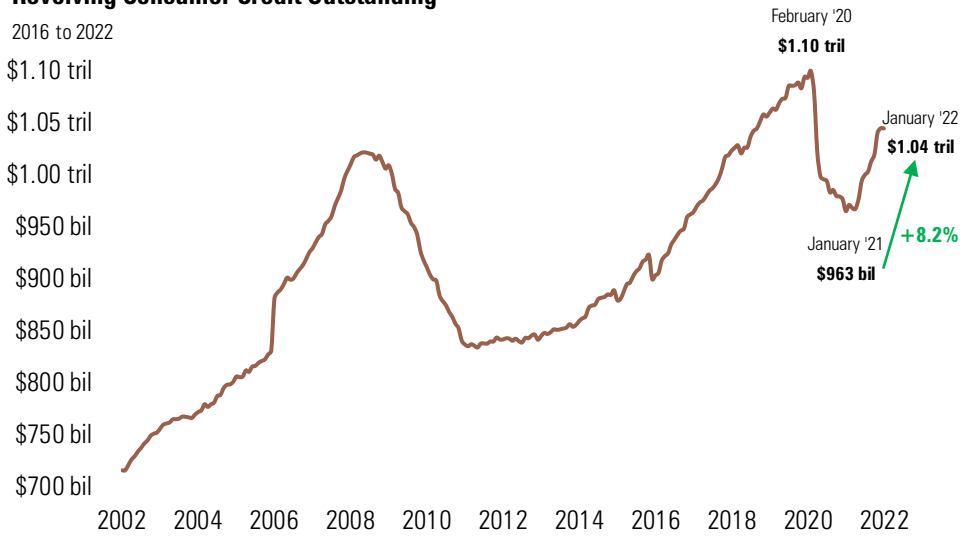
However, the consumer is being weened off Covid fiscal stimulus and spent down any precautionary savings.

Savings rate as a percent of disposable income



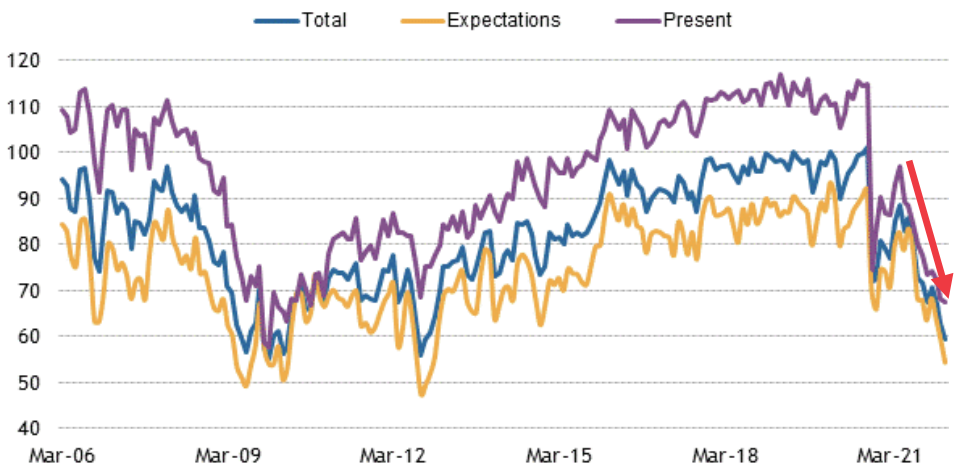
This is pushing consumers to look for alternative sources to support their consumption, mostly in the form of revolving credit.

Revolving Consumer Credit Outstanding



While rising wages should lift consumer sentiment, the spend down of savings and dipping into revolving credit adds to a souring mood for the consumer. Generationally high inflation, rising interest and a ground war in Europe are not helping an already dour consumer.

University of Michigan Consumer Sentiment



Data Sources: Atlanta Fed, Bureau of Economic Analysis, St. Louis Federal Reserve, University of Michigan

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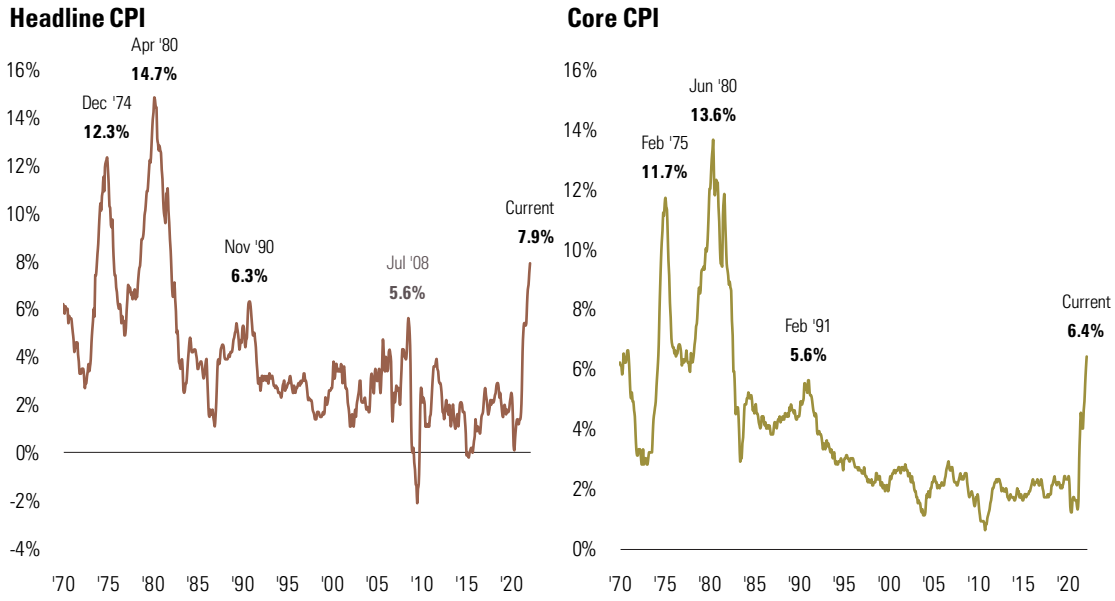
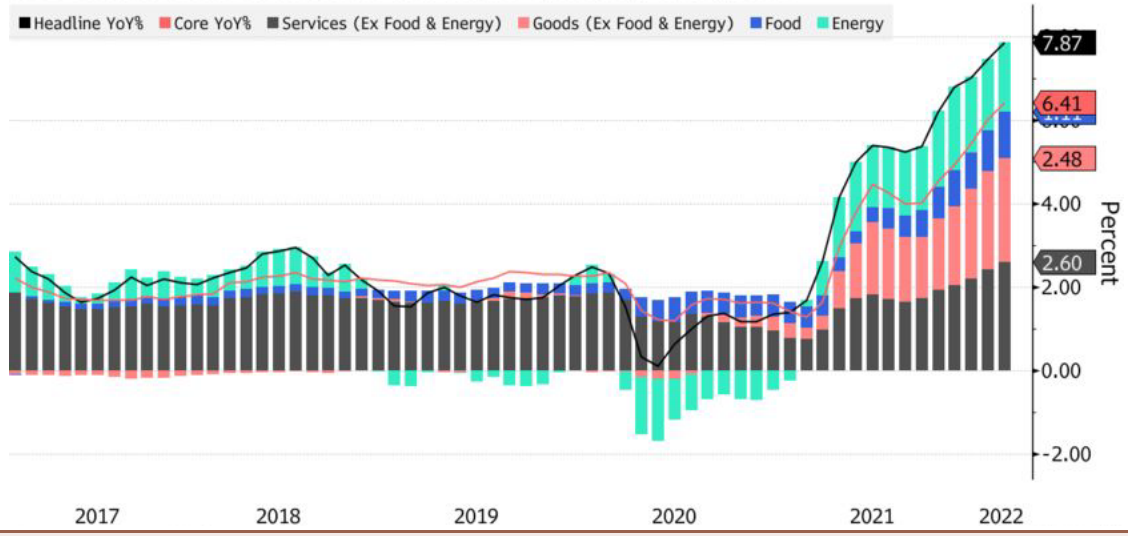
Inflation – Will it Transition?

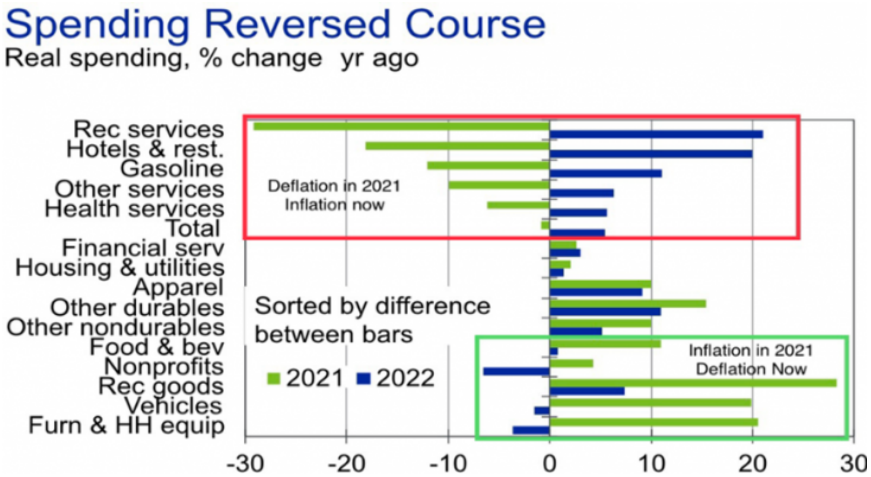
Inflation is running hot. The Consumer Price Index hit a 40 year high at the headline and Core CPI (ex-food & energy) is certainly elevated.



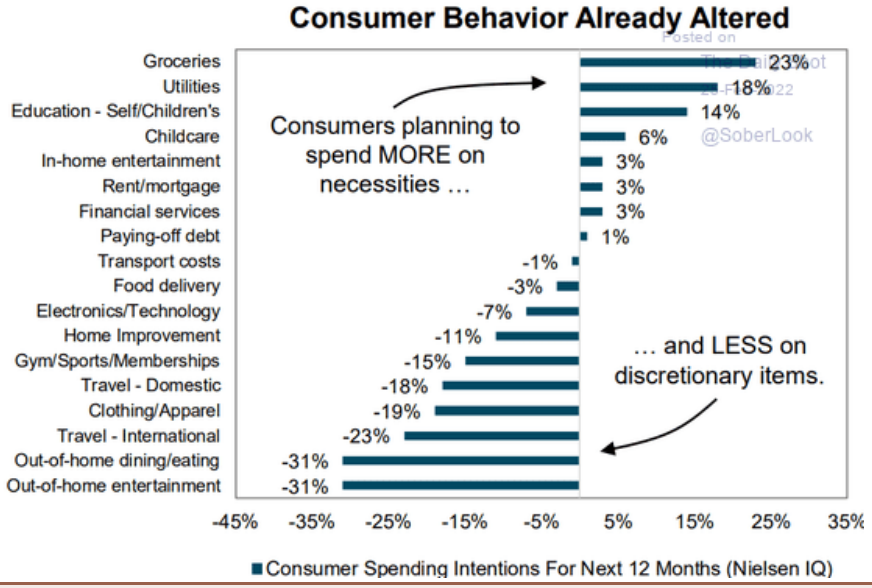
Much of the rise in inflation is being driven by higher gasoline, food, and housing costs; with inflation poised to rise even further following Russia's invasion of Ukraine.



The base effect is still a contributing factor.
Those areas that were deflationary last year are showing strong inflationary trends and vice-a-versa. This should moderate in the months to come.



Consumers are already shifting behavior from discretionary items to more staples.
If this persists, we could see a pull forward in recessionary headwinds.



Data Sources: Bureau of Labor Statistics, Moody's, Trahan Macro Research

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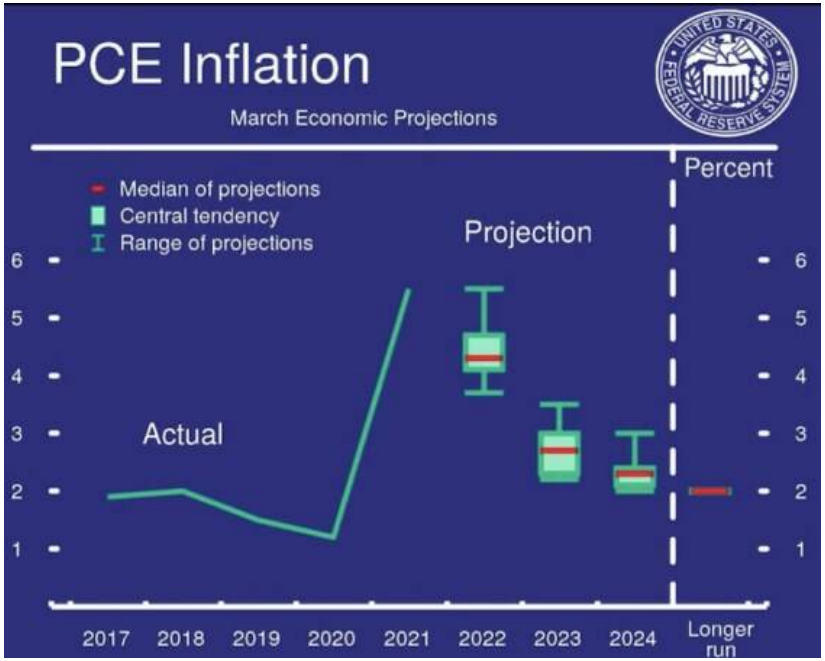
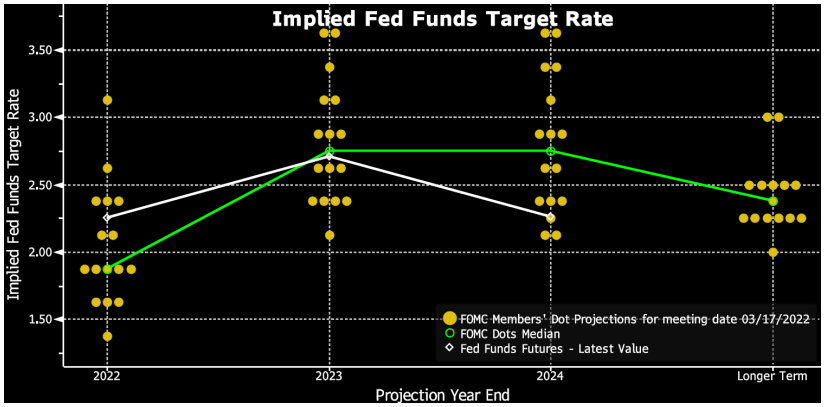
Federal Reserve – Policy Errors Growing

The Fed's PCE inflation forecast for 2022 was revised sharply up, with headline inflation raised to 4.3% from 2.6%, and core to 4.1% from 2.7%.

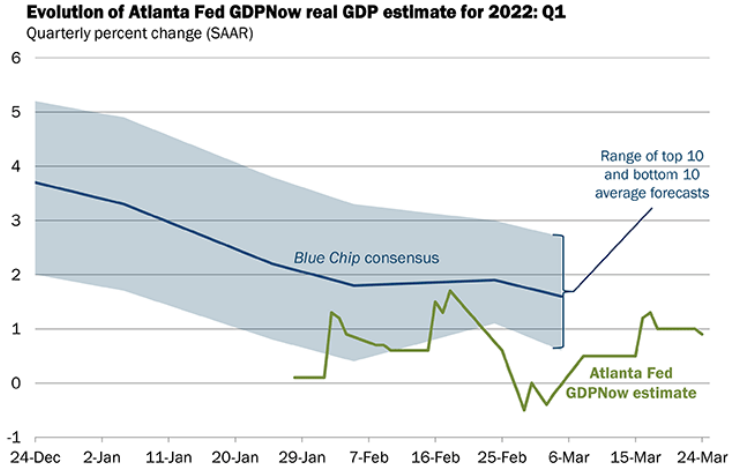
With the Fed's dual mandate of full employment and price stability around 2%, they are on full alert to tame the current 4% projections for 2022.



Given the large inflation revisions, the majority of FOMC participants now anticipate a steeper path of rate hikes than at the last meeting – seven rate hikes this year, four in 2023, and actually lower rates in 2024.

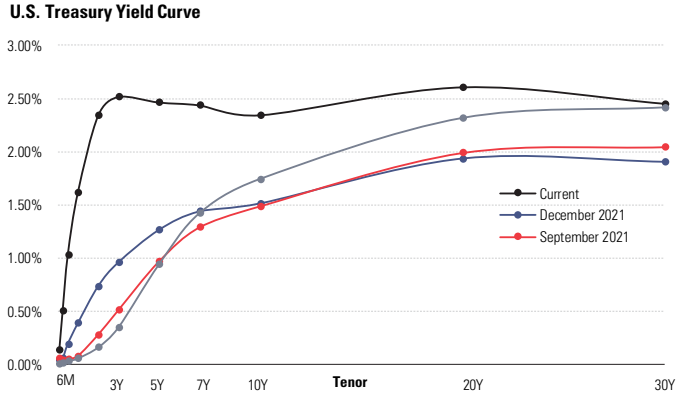


Q1 GDP, which is forecasted to be anemic, could downshift further with higher energy prices. The backdrop of a concerned consumer with rising interest rates could flatline the economy near the zero range.



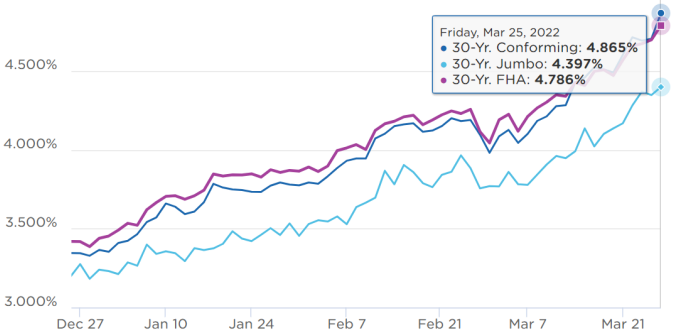
With the Fed front-loading interest rates, the yield curve has flattened at the long end.

This reflects the real possibility the Fed could induce a targeted, sector-driven recession later in 2022 and pose a real threat to the consumer.



Mortgage rates in the U.S. are soaring, surpassing 4.5% for the first time in almost three years.

A wave of homebuilder incentives (deposit waivers, free upgrades, closing cost credits) will be an early indicator of consumer concern.



Data Sources: Federal Open Market Committee, Bloomberg, Atlanta Fed, Optimal Blue

Federal Reserve – Central Banks & Recessions

Central banks throughout the world appear to be on a coordinated rate hike trajectory.

However, China is the only country is the only country cutting rates that have a positive real rate that is investable other than Indonesia.

Domestic inflationary pressures in China are muted, this combined with their 2022 GDP growth targets will allow the People's Bank to cut rates and stimulate while the U.S. tightens.

Global Central Bank Policy Rates

Country	Rate	Central Bank Rate (Today)	CPI YoY	Central Bank Rate	Last Move	Last Move Date
Turkey	Repo Rate	14.00%	54.4%	-40.4%	Cut	Dec-21
Argentina	Benchmark Rate	42.50%	52.3%	-9.8%	Hike	Feb-22
US	Fed Funds	0.38%	7.9%	-7.5%	Hike	Mar-22
Czech Republic	Repo Rate	4.50%	11.1%	-6.6%	Hike	Feb-22
Eurozone	Deposit Rate	-0.50%	5.8%	-6.3%	Cut	Sep-19
Denmark	Deposit Rate	-0.60%	4.8%	-5.4%	Cut	Sep-21
Canada	Overnight	0.50%	5.7%	-5.2%	Hike	Mar-22
Poland	Repo Rate	3.50%	8.5%	-5.0%	Hike	Mar-22
New Zealand	Cash Rate	1.00%	5.9%	-4.9%	Hike	Feb-22
Thailand	Policy Rate	0.50%	5.3%	-4.8%	Cut	May-20
UK	Bank Rate	0.75%	5.5%	-4.8%	Hike	Mar-22
Sweden	Repo Rate	0.00%	4.3%	-4.3%	Hike	Dec-19
Colombia	Repo Rate	4.00%	8.0%	-4.0%	Hike	Jan-22
Australia	Cash Rate	0.10%	3.5%	-3.4%	Cut	Nov-20
Norway	Deposit Rate	0.50%	3.7%	-3.2%	Hike	Dec-21
Switzerland	Target Rate	-0.75%	2.2%	-3.0%	Cut	Jan-15
South Korea	Repo Rate	1.25%	3.7%	-2.5%	Hike	Jan-22
Chile	Base Rate	5.50%	7.8%	-2.3%	Hike	Jan-22
Peru	Policy Rate	4.00%	6.2%	-2.2%	Hike	Mar-22
India	Repo Rate	4.00%	6.1%	-2.1%	Cut	May-20
South Africa	Repo Rate	4.00%	5.7%	-1.7%	Hike	Jan-22
Mexico	Overnight Rate	6.00%	7.3%	-1.3%	Hike	Feb-22
Philippines	Key Policy Rate	2.00%	3.0%	-1.0%	Cut	Nov-20
Taiwan	Discount Rate	1.37%	2.4%	-1.0%	Hike	Mar-22
Japan	Policy Rate Bal	-0.10%	0.5%	-0.6%	Cut	Jan-16
Malaysia	Policy Rate	1.75%	2.3%	-0.6%	Cut	Jul-20
Saudi Arabia	Repo Rate	1.25%	1.6%	-0.4%	Hike	Mar-22
Hong Kong	Base Rate	0.86%	1.2%	-0.3%	Cut	Mar-20
Brazil	Target Rate	11.75%	10.5%	1.2%	Hike	Mar-22
Indonesia	Repo Rate	3.50%	2.1%	1.4%	Cut	Feb-21
China	Loan Prime Rate	3.70%	0.9%	2.8%	Cut	Jan-22
Russia	Key Policy Rate	20.00%	9.2%	10.8%	Hike	Feb-22

Factoring in rising rates, markets tend to perform very well. The S&P 500 was up an average of 10.8% and was in positive territory 100% of the time twelve months after the first rate increase.

What Happens After the First Fed Rate Hike?
S&P 500 Index Future Returns

Date of First Hike	Next 3 Months	Next 6 Months	Next 12 Months
8/8/83	2.0%	-0.7%	2.1%
4/1/87	19.1	20.9	1.5
5/11/88	3.4	8.6	20.7
2/4/94	-5.9	-2.5	2.4
3/25/97	13.6	20.6	39.6
6/30/99	-7.6	6.6	6.0
6/30/04	-2.3	6.4	5.2
12/16/15	-1.1	0.1	9.1
Average	2.7	7.5	10.8
Median	0.5	6.5	5.6
% Positive	50.0	75.0	100.0

Even with recessions, markets tend to move higher in anticipation of economic recovery.
Lower expected rates, fiscal support, and capital anticipating a turn in the economy make equity bounces out of recessions powerful.

S&P 500 PERFORMANCE POST-RECESSION

Recession	Duration	GDP	Plus 1 Year	Plus 3	Plus 5
Feb 1945 - Oct 1945	8 Months	-12.70%	-7.30%	15.29%	57.82%
Nov 1948 - Oct 1949	11 Months	-1.70%	31.50%	88.00%	171.30%
Jul 1953 - May 1954	10 Months	-2.60%	35.92%	83.74%	502.67%
Aug 1957 - Apr 1958	8 Months	-3.70%	37.30%	66.30%	89.70%
Apr 1960 - Feb 1961	10 Months	-1.60%	13.61%	35.06%	68.41%
Dec 1969 - Nov 1970	11 Months	-0.60%	11.20%	20.60%	25.20%
Nov 1973 - Mar 1975	1 Year, 4 Months	-3.20%	14.37%	21.89%	55.16%
Jan 1980 - Jul 1980	6 Months	-2.20%	12.90%	55.90%	100.90%
Jul 1981 - Nov 1982	1 Year, 4 Months	-2.70%	25.40%	67.24%	103.23%
Jul 1990 - Mar 1991	8 Months	-1.40%	11.00%	29.80%	98.20%
Mar 2001 - Nov 2001	8 Months	-0.30%	-16.51%	8.44%	34.33%
Dec 2007 - Jun 2009	1 Year, 6 Months	-5.10%	14.40%	57.70%	137.00%
AVERAGES	11 Months	-2.40%	15.33%	45.84%	120.33%

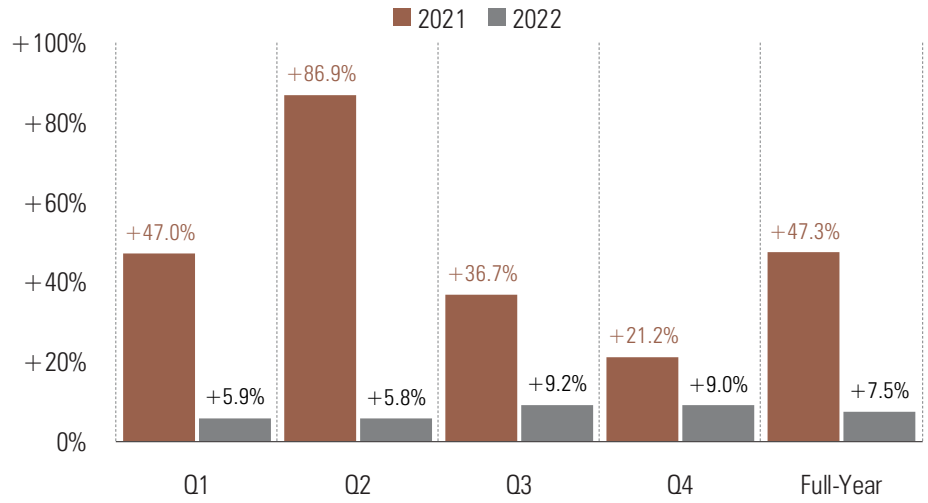
Data Sources: Compound Advisors, Bloomberg, Ritholtz Wealth Management

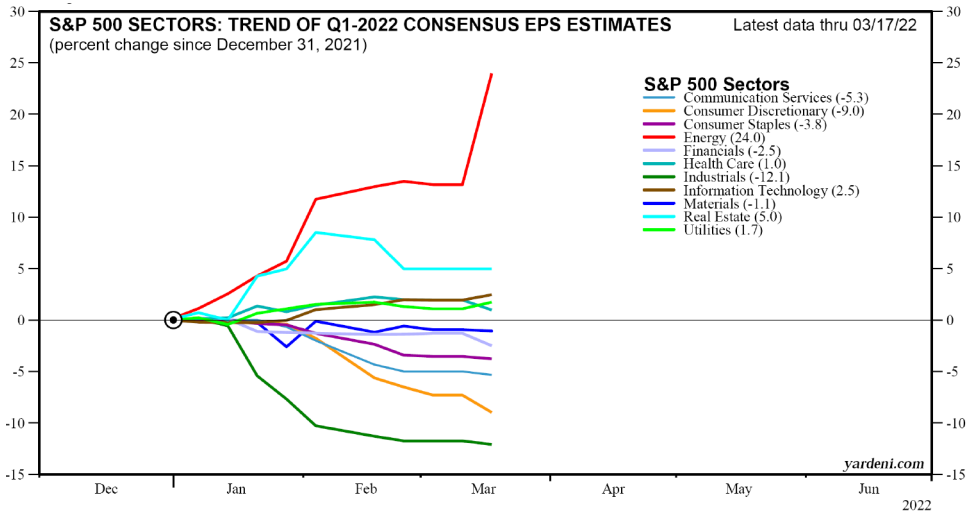
Earnings – Shaky Ground

With a rising interest rate environment, a near-flat line in GDP expectations for Q1—and consumer sentiment dipping—the risk of an earnings miss are growing.

In fact, S&P 500 earnings estimates have been revised down 2.36% (ex-Energy) since the beginning of the year.

S&P 500 Earnings Growth 2021 – 2022

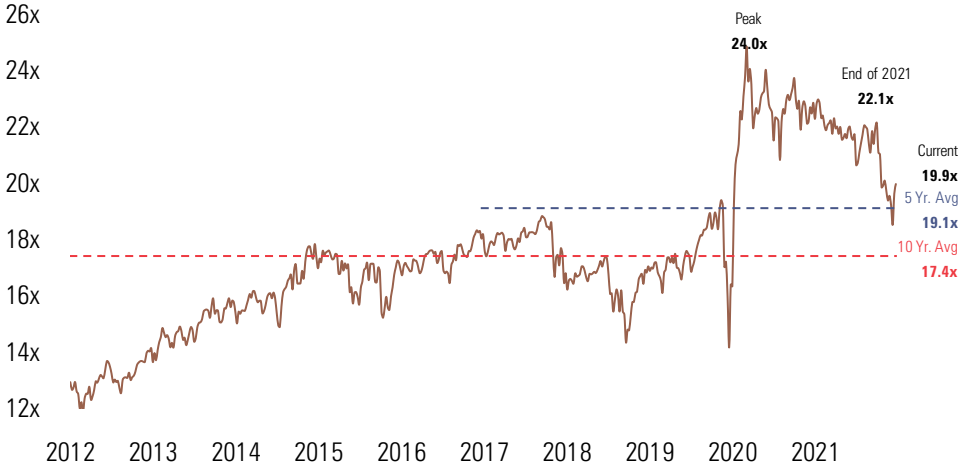




In Q1, the surge in commodity prices, rising real rates, and geopolitical uncertainty all contributed to the S&P 500's largest drawdown since September 2020 and subsequent valuation contraction.

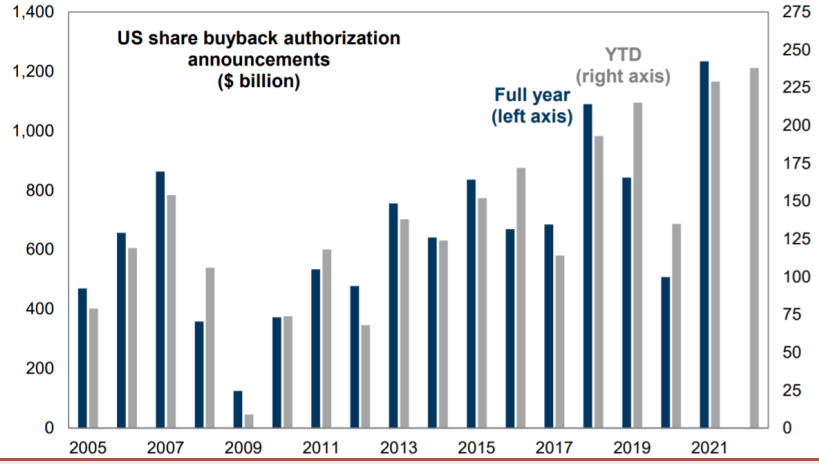
The S&P 500 forward P/E has dropped **10%** since the end of 2021 and is currently trading **4%** above the 5-year average and **15%** above the 10-year average.

S&P 500 Forward Price-to-Earnings



One boost to earnings should be a continuation of the buyback binge of 2021, as buybacks shrink shares outstanding and therefore help lift earnings per share.

So far this year, buyback activity stands near a historic high, with the number of active programs double the typical amount. Against tougher year-over-year comps we expect 2021 buybacks to provide an EPS lift throughout 2022.



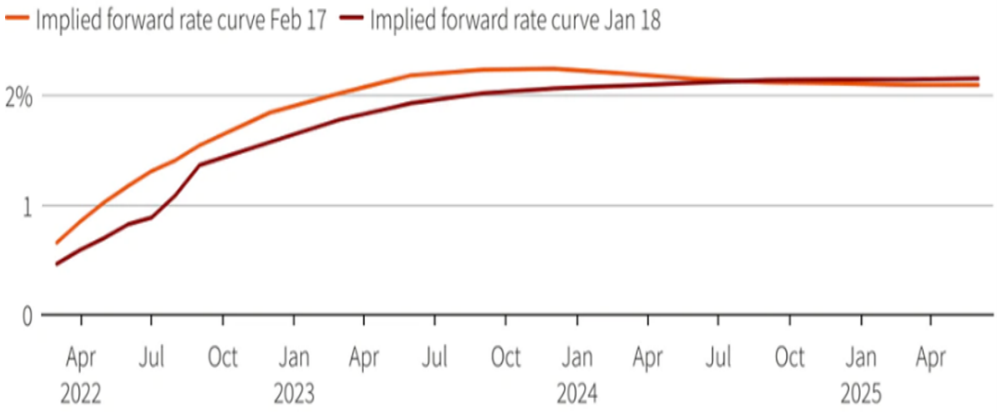
Data Sources: FactSet, Yardeni Research, Bloomberg, Goldman Sachs

Fixed Income – Nowhere to Hide

Hardest Hit Areas of Fixed Income This Year

Ticker	Name	Yield % Current	Return 2022 YTD	Duration (years)
EDV	Extended Duration Treasury Bonds	2.09%	−13.06%	24.48
VCLT	Long-Term Corporate Bonds	3.29%	−11.02%	14.17
TLT	20+ Year Treasury Bonds	1.83%	−10.63%	18.94
BLV	Long-Term Bonds	3.34%	−10.48%	15.45
TLH	10-20 Year Treasury Bonds	1.67%	−9.05%	14.72
LQD	Investment Grade Corporate Bonds	2.53%	−8.38%	9.46
PFF	Preferred & Income Securities	4.49%	−7.04%	–
CWB	Convertibles	1.61%	−7.03%	–
BOND	Active Bonds	2.83%	−6.57%	6.17
IEF	7-10 Year Treasury Bonds	1.36%	−6.37%	8.02
BIV	Intermediate-Term Bonds	2.13%	−6.24%	6.48
LEMB	Emerging Markets Bonds	4.13%	−5.89%	4.74
AGG	Core U.S. Aggregate Bonds	1.79%	−5.85%	6.01
BND	Total Bond Market	2.09%	−5.85%	6.96
MUB	National Muni Bonds	1.81%	−5.43%	4.47
IEI	3-7 Year Treasury Bonds	0.95%	−5.02%	4.66
MBB	MBS	1.60%	−4.90%	3.41
JNK	High Yield Bonds	4.66%	−4.88%	4.12
HYG	High Yield Corporate Bonds	4.86%	−4.73%	4.22
MINT	Enhanced Short Maturity Active	0.89%	−1.28%	1.86

How long will the Fed be raising interest rates?



- Seven rate increases are being baked into the base case for both equity and fixed income investments.
- If the Fed induces a recession in the short run, we could see a truncated rate increase cycle before 2024.
- That will provide some support for the fixed income portion of portfolios.

- Rising rates impact the discount rate and the equity risk premium for stocks and also negatively impacts fixed income investments.
- Active management has reduced some of the return drag, albeit still negative asset returns.
- We continue to focus on shorter duration higher quality credits.

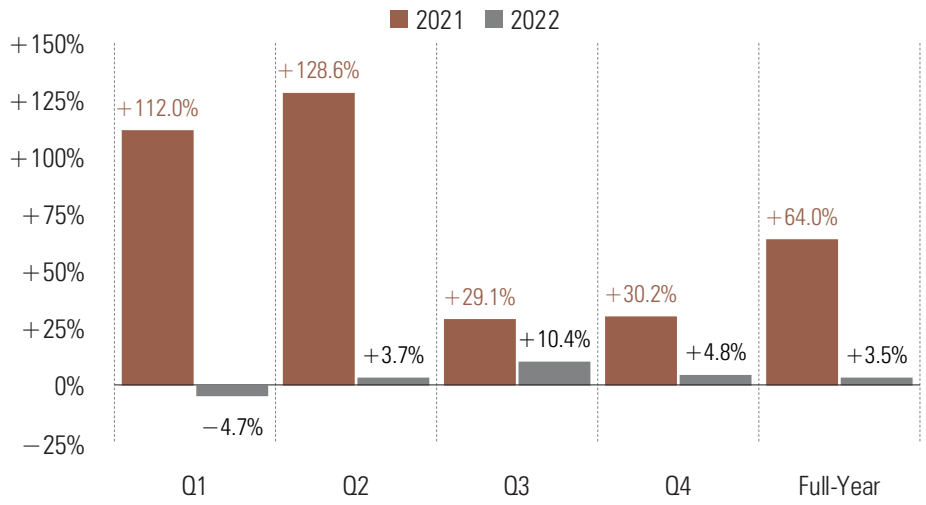
Data Sources: Bloomberg, Reuters

Developed Markets

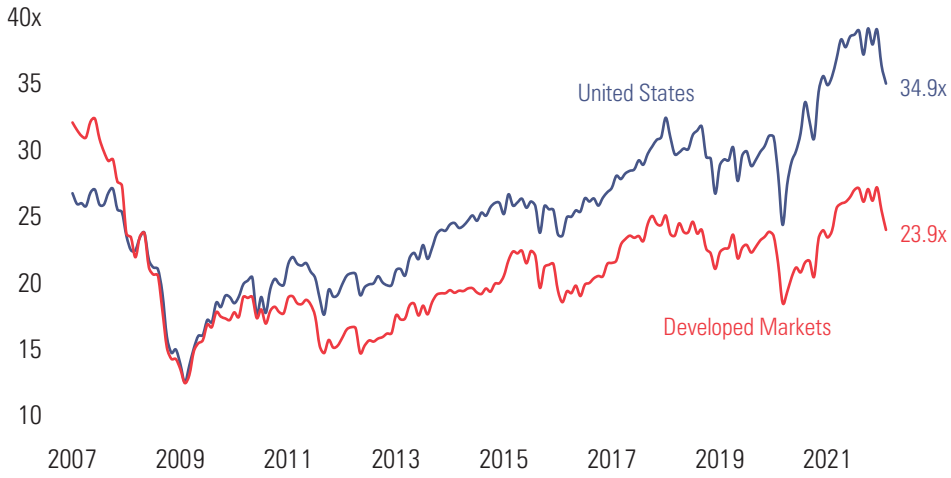
After strong earnings growth in 2021, the invasion of Ukraine by Russian forces presents signification implications for both consumer demand and supply in the Euro area.

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

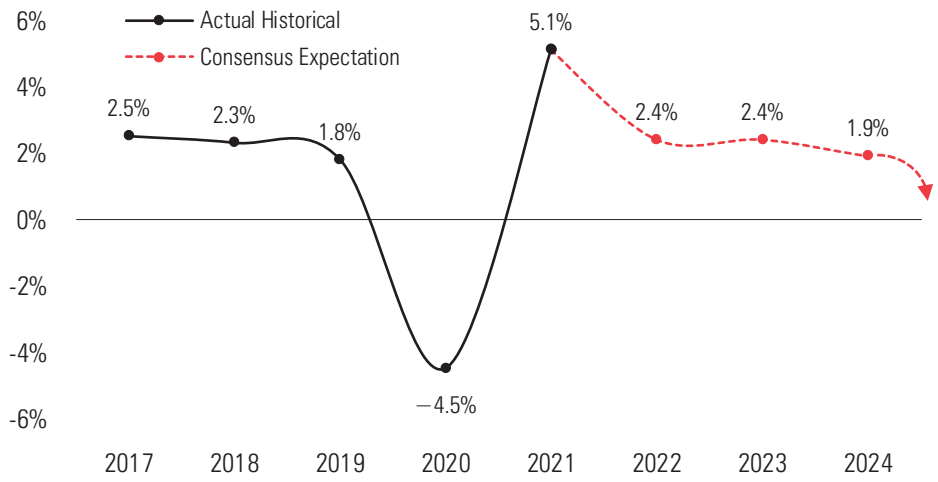


Developed Markets are currently trading at a 32% discount to the United States

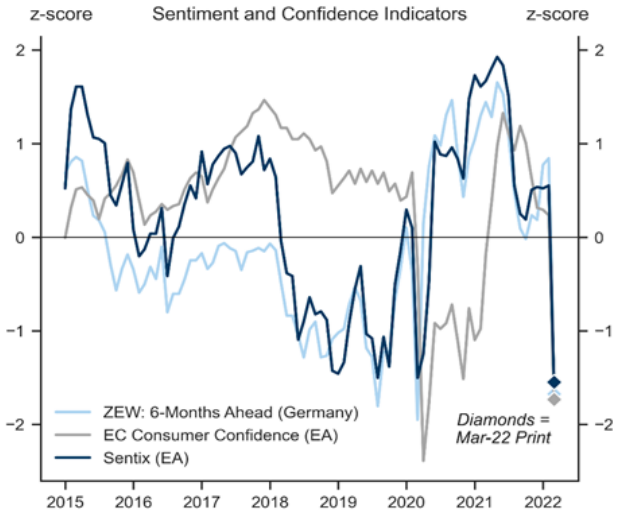
Developed markets growth could weaken substantially due to the spillovers from the Russia-Ukraine war, with full-year GDP growth of 2.4% (down from 4.1% before the war).

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



The Russia Ukraine conflict has cratered European consumer confidence to pandemic levels and will certainly impact consumption and corporate earnings.



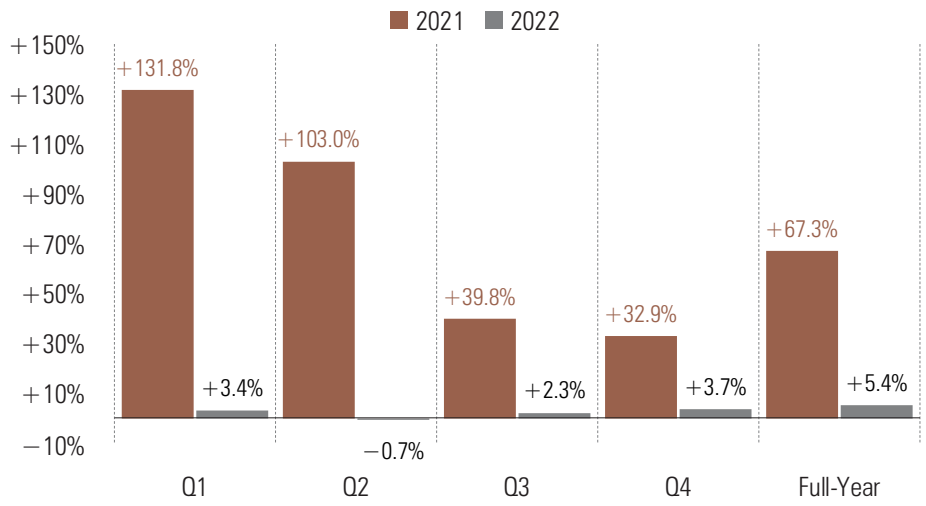
Data Sources: Bloomberg, Barclays, Goldman Sachs

Emerging Markets

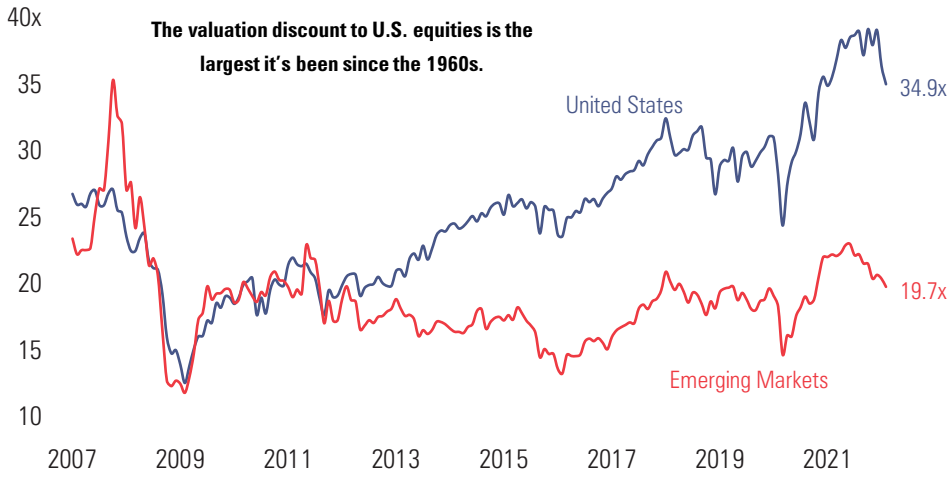
Over the past year, Emerging markets have grappled with higher real rates, a stronger dollar, and a slowdown in China growth.

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



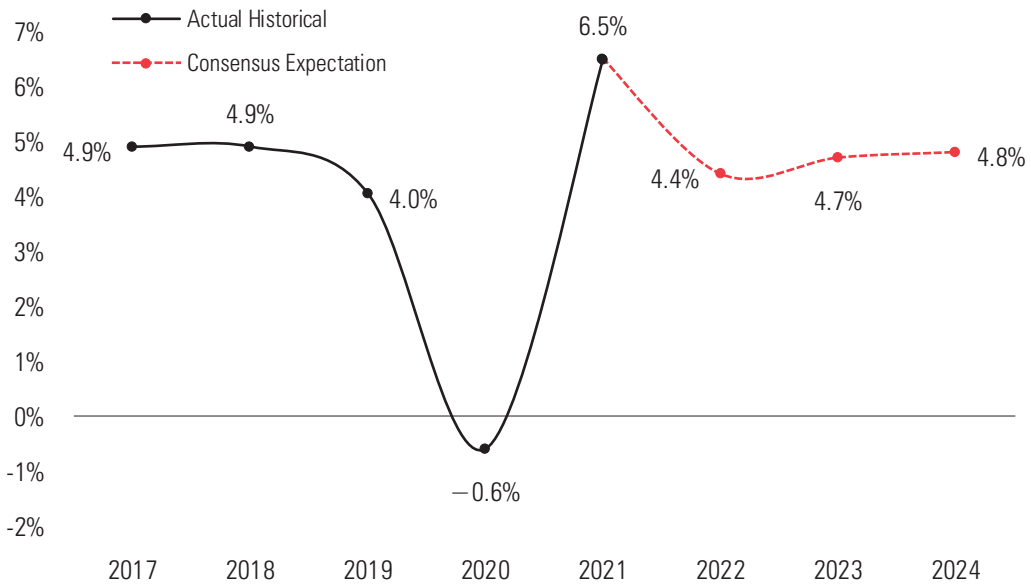
Historical CAPE Ratio Emerging Markets & United States



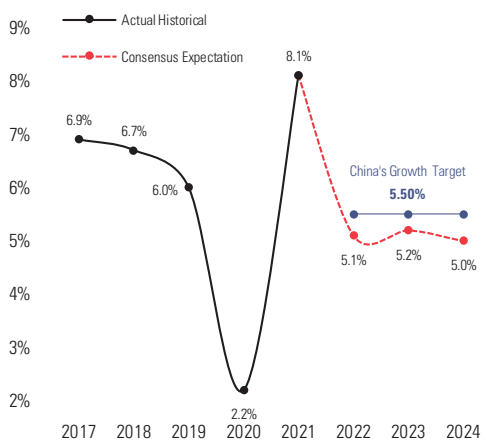
Emerging Markets are currently trading at a 44% discount to the United States

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

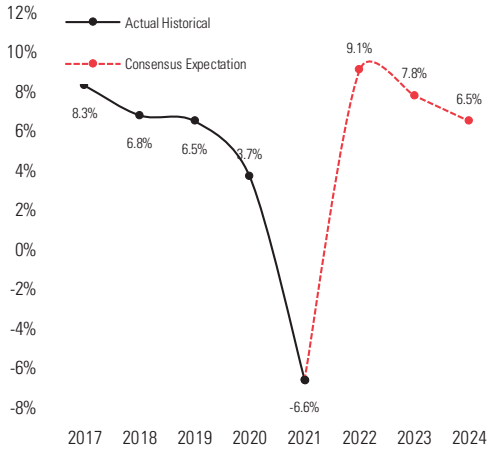
Emerging Markets GDP Growth



China GDP Growth



India GDP Growth

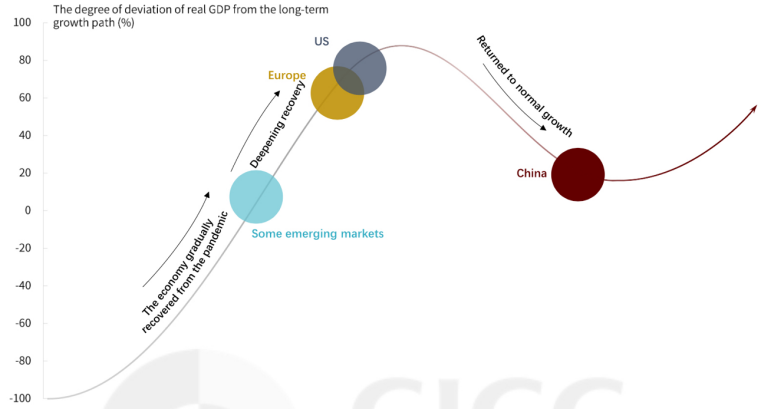


Data Sources: Bloomberg, Barclays

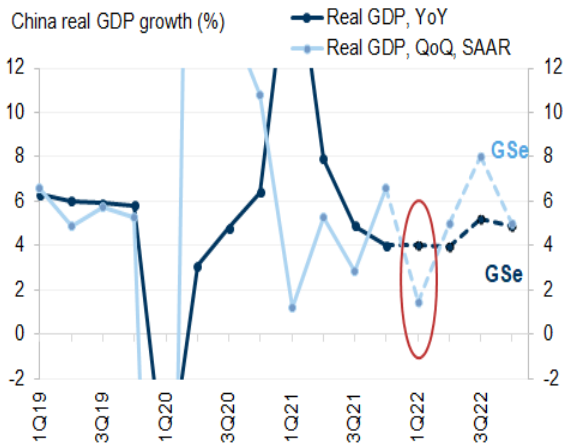
China

China is on a different economic and stimulus cycle than the U.S.

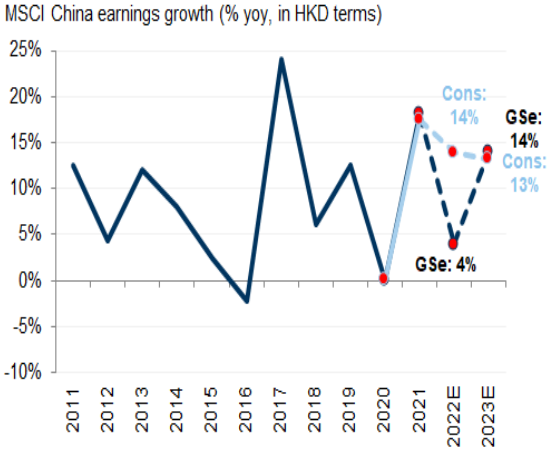
Figure 1: China has taken the lead in entering the stage of economic growth slowdown in the wake of the pandemic, whereas overseas countries might still be in the stage of rapid growth



Based upon current Q1 GDP expectations, massive fiscal and monetary stimulus will be used to inject growth into both the property and consumer segments of the economy.



With some moderating GDP growth, corporate earnings growth rates are modest. This leaves ample room for upside surprises.



China's recent Government Work Report suggests a few key themes:

1. GDP growth target of 5.5%. Deficit-to-GDP ratio set at 2.8% for 2022. Create 11 million new jobs in 2022. Maintain CPI at around 3%.
2. The government will provide 640 billion RMB to support infrastructure investment.
3. No clear plans regarding monetary policy but, further economic risk could make the PBoC cut rates.
4. To support exports the report stated solutions, such as expanding export credit insurance, export financing support, strengthened foreign exchange services, and export tax rebates.
5. Clear plans to promote small and medium-sized enterprises (SMEs) through tax rate reductions and rebates.

The implementation of the RCEP will fuel more high-quality export growth in the remaining quarters of 2022 and beyond.

Regional Comprehensive Economic Partnership

- In November 2020, China formed the Regional Comprehensive Economic Partnership, or RCEP, the largest trade bloc in history
- 15 countries
- 30% of World GDP
- 27% of global merchandise

Who's In & Who's Out?

- You can see there are compelling member nations, including some which have been at odds with each other over trade for many years. Japan, China, and South Korea are strange bedfellows yet, they formed a powerful trade alliance.

Data Sources: CICC, State Council of China, Goldman Sachs, China Briefing

Global Disruptions

China Picked a Side and It's China

The Russian invasion of Ukraine has ushered in another layer of tension between the United States and China and, in the spirit of "never waste a crisis," the United States turned their focus on China to support the sanctions imposed on Russia.

US/EU Imposed Sanction on Russia

Sector	Instrument	Action
Energy	Nord Stream 2	Suspend certification, which was awaiting regulatory approval from the German government Sanction Nord Stream 2 AG and its corporate officers
Energy & Commodities	Energy Trade	Further restrict trade of commodities and energy
Energy, Financial, Defense	Investment restrictions	Further restrict lending and investment in Russian firms The US applied financing prohibitions against 13 firms – 2 private entities, 11 SOEs
Financial	Blocking Banks	Block Russian banks from transacting with foreign entities
Financial	Currency Transactions	Coordinate to "limit Russia's ability" to transact in Dollars, Euros, Pounds, and Yen
Financial	Sovereign Debt	Prohibit transactions in Russian sovereign debt in the US/EU
Financial	SWIFT	Block Russia from using SWIFT system, making it difficult for Russian banks to transact overseas in any currency
Individuals	Property/Travel	Freeze assets and ban travel
Individuals	Property/Travel	Block Russian aircraft from using U.S. airspace
Tech, Defense, Aviation, Maritime	Export Controls	Restrict exports to Russia of US software, technology, and equipment Restrict exports to Russia from third countries if the "direct product" of US technology

China has taken a "support Ukraine and neutral on Russia" approach in an effort to keep energy supplies flowing, a desperately needed resource in China.

China's strategically ambiguous approach with Russia has led to a propaganda-like pressure campaign, which drove Chinese capital markets into a free fall.

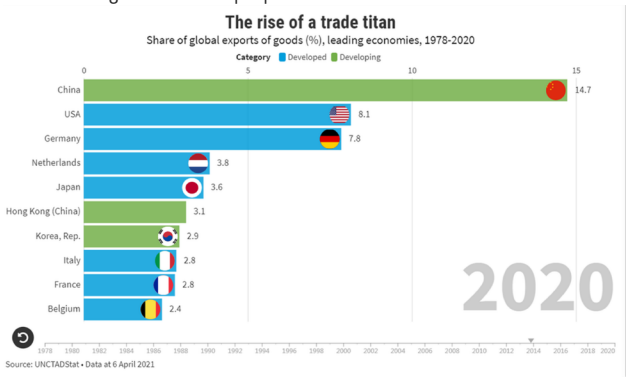
China responded by addressing some outstanding issues between the Chinese government and the capital markets, driving an epic rally not seen since mid-2020.

While this rally is a significant nod to the importance of capital markets in China, does it mean anything as it relates to sanctions that the United States might try to apply with China?

Therein lies the challenge for both superpowers.

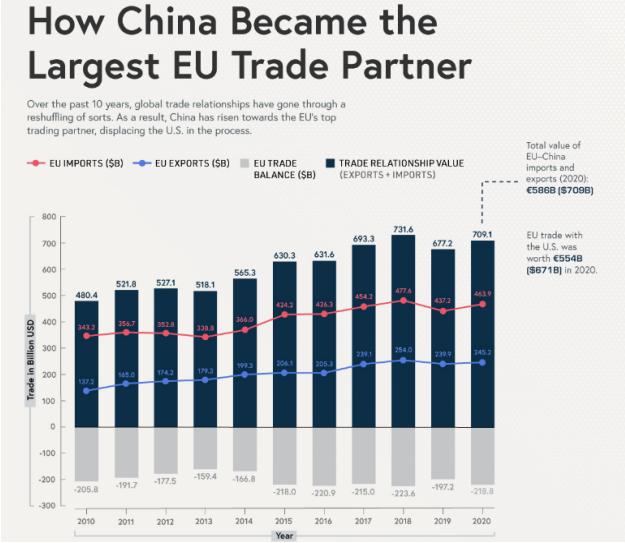
About 15% of all global exports come from China and exports represent over 18% of China's GDP.

Sanctioning that amount of global trade would devastate China but, could also depress global growth, crush supply chains, and drive us into a hyper-inflationary environment never before seen.



China is also the largest trading partner with Europe, representing 4% of China's GDP and 3% of Europe's GDP.

Trade in these large markets is not something either can lose without causing irreparable harm to each other.



For these reasons, it is hard to apply Russia-style sanctions on China.

Simultaneously, China does not want to lose hard fought and won trading relationships.

Sanctioning China in a way similar to Russia could be mutually assured economic destruction and thus, unlikely to occur.

Data Sources: Reuters, Bloomberg, China Daily, Visual Capitalist

Our View & Recommendations

Our View

- The current pace and trajectory of interest rate increases could induce a policy error driven recession in the coming quarters. Eroding consumer sentiment will pose a challenge to a straight-line Fed interest rate policy.
- Corporate earnings growth will be muted relative to year-over-year comparisons. This will create additional hyper focus on earnings and profit margins.
- The real risk of an inflationary consumer recession could occur in Q2 with the potential for a negative GDP print for the U.S. economy.
- Europe will flirt with a negative print on GDP growth in Q2 2022 induced by higher energy prices and a prolonged Russia/Ukraine war. Reduced consumption will pose a real threat to corporate earnings.
- Emerging Markets continue to offer the best growth-to-valuation opportunities relative to the United States.
- Interest rate volatility will create headwinds for the traditional balanced portfolio.
- Expect markets to trade on short-term conflict news until we move into corporate earnings season.

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 the continue to represent the best earnings growth to valuation prospects.
- Continue to use active management within fixed income as this important asset class is trading near all-time highs (yields near all-time lows). Active managers should help mitigate some of the total return drag to a blended portfolio.
- 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

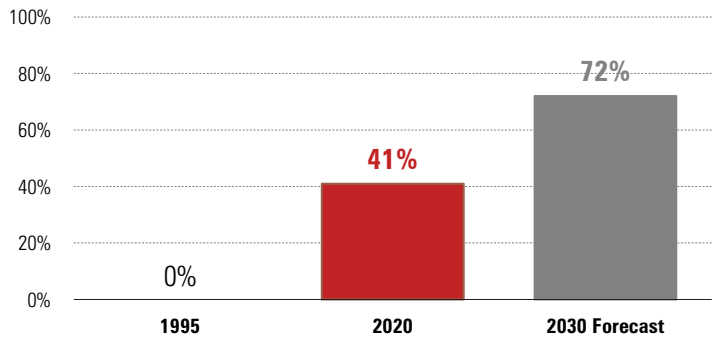
- Review our video with Goldmans Sachs' Global Head of Commodities Research Jeff Currie as he talks about the Commodities Super Cycle
- Review our video with Andrew Polk, co-founder and head of economic research at Trivium China our research partner and leading think tank, on China macroeconomic policy

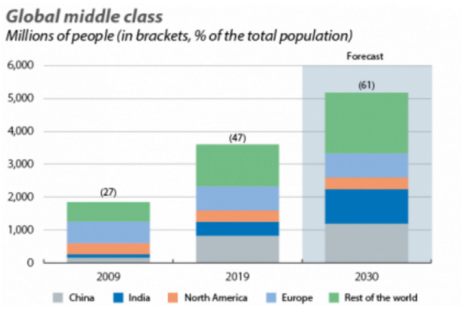
Appendix: Why We Invest in China

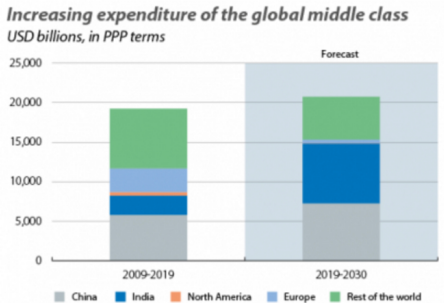
China's growing middle class represents one of the clearest global macroeconomic themes to take advantage of.

Growth of the Chinese Middle Class

Percent of Total Population







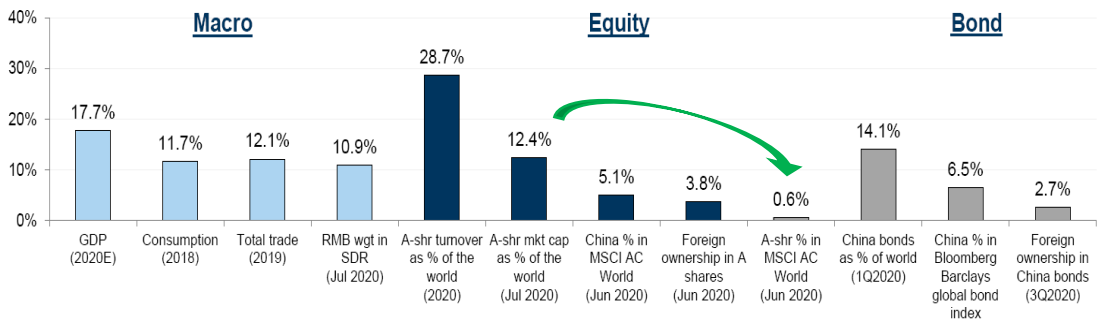
Combine the growing middle class, having the spirit to consume, with resources in the form of some of the highest saving rates in the world and you get a special recipe for consumption and, therefore, corporate earnings growth.

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



Data Sources: Bloomberg, Goldman Sachs

Mean Reversion Dashboard

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

Size	Style: Value	Style: Blend	Style: Growth
Large	110.5%	124.3%	144.5%
Mid	100.5%	108.5%	137.1%
Small	88.4%	94.9%	122.1%

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

Regions

World	Developed Markets	Emerging Markets
113.9%	93.8%	81.2%

Countries

United States	Germany	United Kingdom	China	Brazil	India	Russia
133.5%	78.8%	76.2%	72.3%	48.7%	146.1%	N/A

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
57.3%	80.8%	101.2%	134.3%	108.5%	84.3%	72.6%	124.0%	88.8%	109.0%	228.5%

Data Source: Bloomberg

THANK YOU

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Data Sources

Slide 2	**Consumer Strength Weakening** https://www.atlantafed.org/chcs/wage-growth-tracker https://www.bea.gov/data/income-saving/personal-saving-rate https://fred.stlouisfed.org/series/REVOLSL https://data.sca.isr.umich.edu/
Slide 3	**Inflation – Will it Transition?** https://www.bls.gov/cpi/ https://www.economy.com/ https://www.trahanmacroresearch.com/
Slide 4	**Federal Reserve – Policy Errors Growing** https://www.federalreserve.gov/monetarypolicy/fomc.htm Bloomberg https://www.atlantafed.org/cqer/research/gdpnow https://www2.optimalblue.com/obmmi/
Slide 5	**Federal Reserve – Central Banks & Recessions** https://compoundadvisors.com/ Bloomberg https://awealthofcommonsense.com/
Slide 6	**Earnings – Shaky Ground** https://insight.factset.com/topic/earnings https://www.yardeni.com/ Bloomberg https://research.gs.com/
Slide 7	**Fixed Income – Nowhere to Hide** Bloomberg https://www.reuters.com/business/finance/eurodollar-futures-market-betting-hawkish-fed-could-ease-rates-slightly
Slide 8	**Developed Markets** Bloomberg https://indices.barclays/IM/21/en/indices/static/shiller.app https://research.gs.com/
Slide 9	**Emerging Markets** Bloomberg https://indices.barclays/IM/21/en/indices/static/shiller.app
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Slide 11	**Global Disruptions** https://graphics.reuters.com/UKRAINE-CRISIS/SANCTIONS/byvrjenzmve/ Bloomberg https://www.chinadaily.com.cn/a/202104/28/WS6088d1e8a31024ad0babafe9.html https://www.visualcapitalist.com/china-displaces-u-s-as-the-eus-largest-trade-partner/
Slide 13	**Appendix: Why We Invest in China** Bloomberg https://research.gs.com/
Slide 14	**Mean Reversion Dashboard** Bloomberg