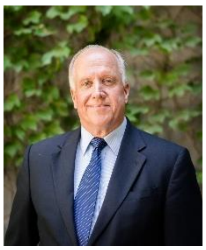
2022 – 2nd Quarter Review & Outlook

Economic and Investment Review

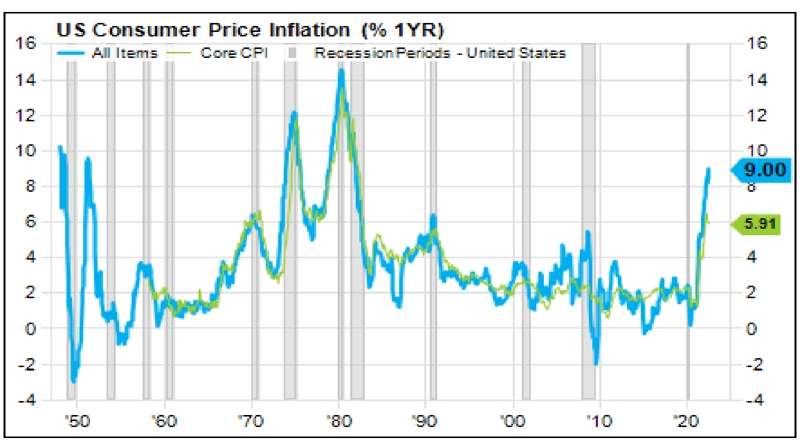


Mark Anderson

Chief Investment Officer

Economic Growth: There is significant discussion about the possibility of recession sometime in the next 12-24 months. Goldman Sachs puts the probability at 30% that the U.S. will enter a recession in the next 12 months and a near 50% probability that a recession will start in the next 24 months. However, their central forecast is that below-trend growth through 2022 and 2023 will gradually restore labor market balance without an outright recession. Raymond James puts the odds at 60% that there will be a recession during Q2-Q3 of 2023. If the U.S. does experience a recession, it will likely be the result of the Federal Reserve increasing interest rates aggressively in an effort to fight inflation.

Inflation: Inflation is at the highest level in 40 years. The Consumer Price Index rose 9.1% y/y in June.



Source: FactSet

Food rose 10.4% y/y. Energy was up 41.5% and gasoline was up 59.9% y/y. The spike in inflation is the result of increased demand for goods and services and constrained supply.

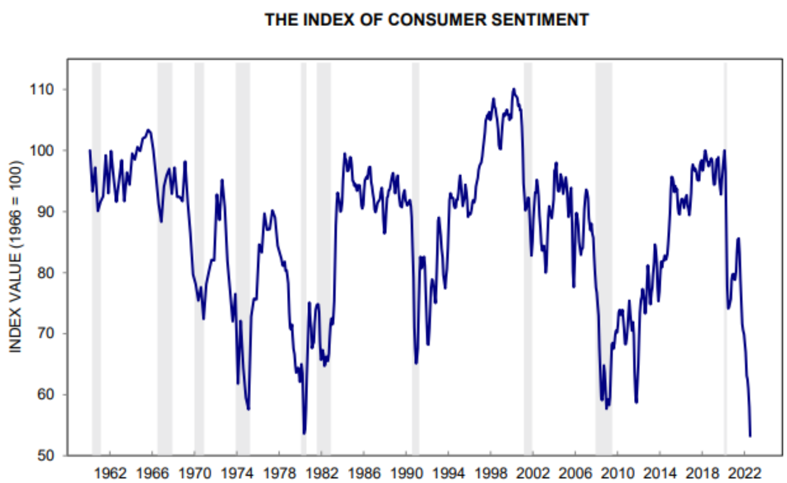
Increased demand was the result of the economy opening up after COVID and massive government spending. In an effort to reduce demand, the Fed is tightening monetary policy or increasing rates and shrinking their balance sheet. The Fed expects to raise the Fed Funds target rate from 1.75% currently to near 3.5% by year end. Rate hikes increase borrowing costs which will result in reduced economic and business activity. Rate increases have already led to higher mortgage rates, reducing demand by pricing many potential buyers out of the housing market.

Fed action can have significant impact on demand; however, demand is only part of the inflationary equation. Supply is the other part of the equation and the Fed has very little control over it. COVID was a major disruptor of the supply chain, which has still not fully recovered, and continues to be impacted by related ongoing shut-downs in China.

The Russian invasion of Ukraine is also a major disruptor and has resulted in a significant reduction in global food and energy supplies. More restrictive Biden administration energy policies have also impacted potential supply. Disruption in energy supply and restrictive policies have resulted in much higher gasoline prices. Rising gas prices act as a tax on consumers, hindering buying power. An increase in U.S. and OPEC production would likely move prices lower but peace in Ukraine and Europe finding alternative energy sources to Russian oil and natural gas are likely necessary for prices to move significantly lower.

It is generally expected that slower growth/reduced demand combined with a better functioning supply chain should lead to declining inflationary pressure in the second half. If inflation does begin to decline, the Fed may be able to engineer a soft landing and avoid a recession. If we do have a recession, it is likely to be relatively short and shallow given the good relative strength of corporate balance sheets and strength of the consumer.

Consumers continue to spend, but appear to be starting to pull back or at least alter spending habits because of inflation and declining confidence levels. The University of Michigan Consumer Sentiment Index measures how optimistic consumers feel about their finances and the state of the economy.



Source: University of Michigan

The index is currently at its lowest level in 50 years of data. The 12-month economic outlook component of the index has declined markedly. Personal expenditures for motor vehicles, housing related equipment and recreational goods and vehicles all declined in May but the retail sales index was up 1.0% in June. However, the component with the greatest percentage increase was gasoline stations.

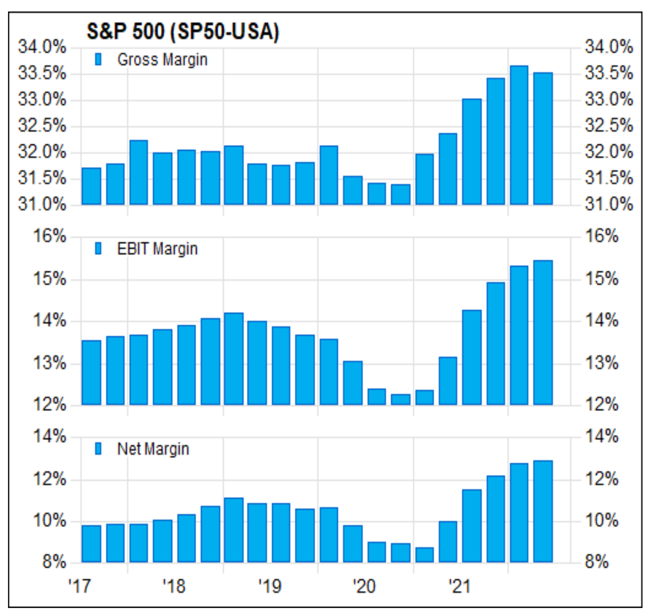
Unemployment remained at 3.6% in June and remains near what the Fed would term full employment, giving them the flexibility to raise rates. Unemployment will likely tick up as interest rates are increased and economic growth slows. Initial unemployment claims have been inching up but remain at an historically low level. Average hourly earnings continues to increase but at a slower pace.

Industrial Production declined by -0.2% m/m but was still up 4.2% y/y in June. The monthly decline was minimal but it was very broad, involving most segments of the economy other than energy. The ISM report indicates that manufacturing continues to expand but at a slowing rate.

The midterm elections are just over five months away. The prospect for a divided government looks highly likely given the low approval ratings for the Biden administration. Any significant spending program or tax increases are unlikely to be passed prior to the elections.

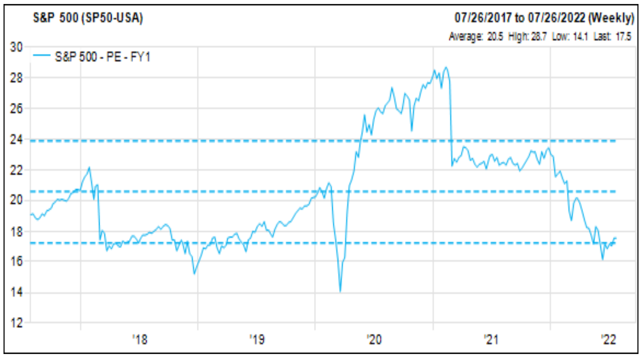
Equity Markets

The S&P 500 closed at 3785 on June 30, down -19.97% YTD and down -16.11% for Q2. Equity markets have hit the reset button in response to ballooning inflationary pressures, the Fed increasing rates, margin pressure and slower economic growth. However, corporate profitability has been resilient through the recent challenges. Companies are trying to maintain margins through price increases and efficiency measures.



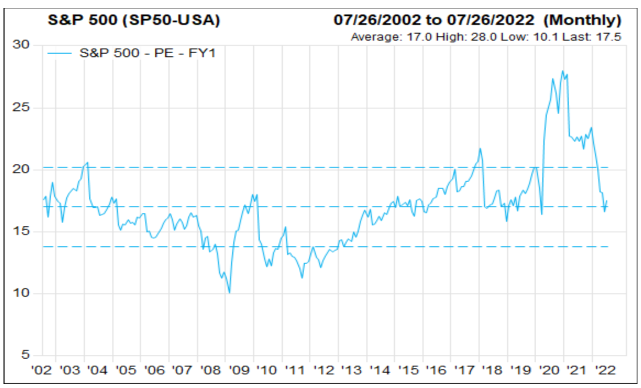
Source: FactSet

Valuations have adjusted down to PE multiples well below the 5-year average.



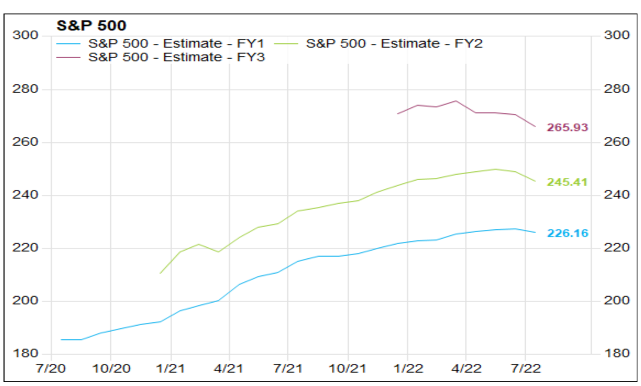
Source: FactSet

However, even with the equity market correction and entry into bear market territory, valuations have just moved back to near the 20-year average.



Source: FactSet

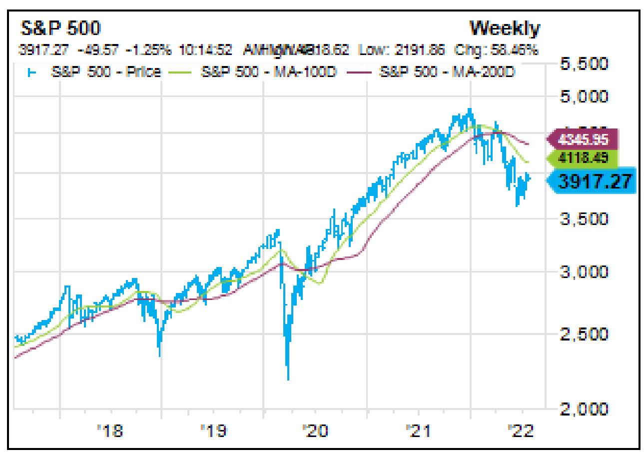
If the U.S. is able to avoid recession, the consensus estimates for S&P 500 earnings are expected to increase from 206.19 in 2021 to 226.16 in 2022 and 245.41 in 2023. The EPS numbers indicate growth rates of 9.7% in 2022 and 8.5% in 2023. However, estimate revisions are beginning to flatten out and even trend down recently.



Source: FactSet

FactSet reports that the second quarter earnings season for the S&P 500 continues to be weaker than normal. Both the number of S&P 500 companies reporting positive earnings surprises and the magnitude of these positive surprises are below their 5-year averages. However, the index has a higher earnings growth rate for the second quarter today relative to the end of the quarter mainly due to continued upward revisions to EPS estimates for companies in the Energy sector.

The consensus EPS estimates may be overly optimistic. Consequently, we have reduced our EPS growth expectations further to 8.6% for 2022 and 8.1% for 2023. Combining these reductions with near long-term PE averages, we expect to end the year near 3900 for the S&P 500. Goldman Sachs maintains a forecast of 4300 for year-end. The Raymond James base case forecast for year-end is 4180, but when considering the possibility of a recession they post a probability weighted forecast of 3942. A recession could temporarily collapse earnings growth leading to lower PE multiples. A PE multiple of 14x would result in the S&P 500 falling to 3150 with 2023 earnings of 225.



Source: FactSet

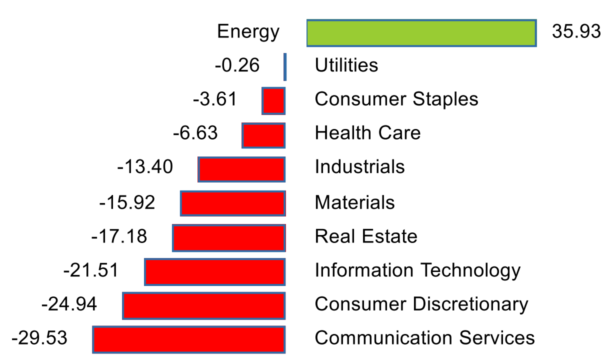
There has really been no place to hide in the equity asset class so far this year. Growth has suffered the most and value has suffered the least but nothing has been beneficial. The differential between large cap, mid cap, small cap, developed international and emerging international has been minimal. Greater differential has occurred for longer periods of time. U.S. large cap has declined less than other equity sub-classes over a 1-year period and continues to lead for 3 years and longer. Developed international and emerging markets have lagged over 1 and 3 years.

2022 Q2 Returns				
EQUITY	Q2 2022	YTD 6.30.22	1 Year 6.30.22	3 Years Annualized
S&P 500	-16.11	-19.97	-10.64	10.57
S&P 500 Value	-11.32	-11.48	-5.08	8.23
S&P 500 Growth	-20.86	-27.62	-16.41	11.64
Dow Jones Ind Avg	-10.78	-14.44	-9.05	7.24
S&P Mid Cap 400	-15.42	-19.54	-14.64	6.87
S&P Small Cap 600	-14.11	-18.94	-16.81	7.30
MSCI EAFE	-14.51	-19.57	-17.77	1.07
MSCI Emerging Mkts	-11.45	-17.63	-25.28	0.57

Source: FactSet

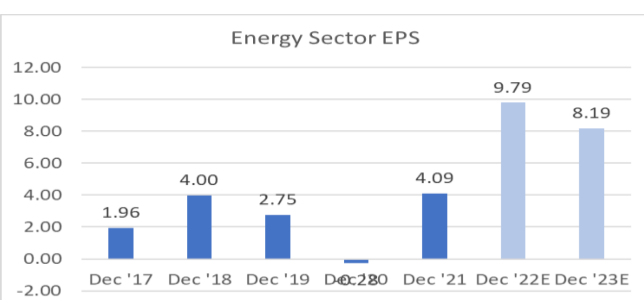
Energy is the only sector with a positive return so far this year. Defensive sectors, Utilities, Consumer Staples and Health Care declined less than other sectors during the period. Communication Services, Consumer Discretionary and Information Technology were the worst performing sectors.

YTD Total Return Change - Top/Bottom 5



Source: FactSet

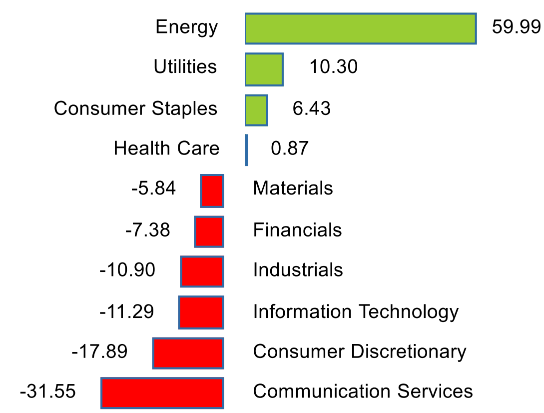
Energy is benefiting from higher prices and spiking EPS.



Source: FactSet

The same trends carry over to the 1-year chart except that Utilities, Consumer Staples and Health Care have positive returns for the period.

1 Year Total Return Change - Top/Bottom 5



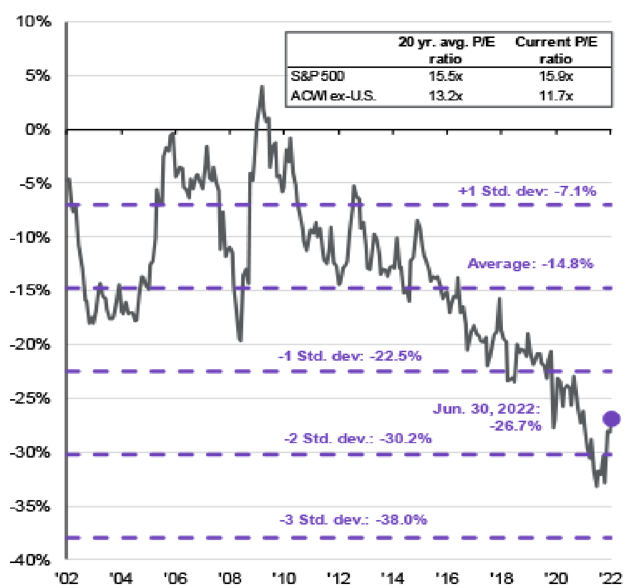
Source: FactSet

Cyclical sectors would likely take the greatest brunt of a recession. Consumer Discretionary, Industrials and Materials may suffer the most. Defensive sectors including Utilities, Consumer Staples and Health Care have historically been able to continue to grow earnings in a recession.

International equity typically trades at a discount to U.S. equity. However, it is trading near its greatest discount in 20 years.

International: Price-to-earnings discount vs. U.S.

MSCI AC World ex-U.S. vs. S&P 500 Indices, next 12 months



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2022.

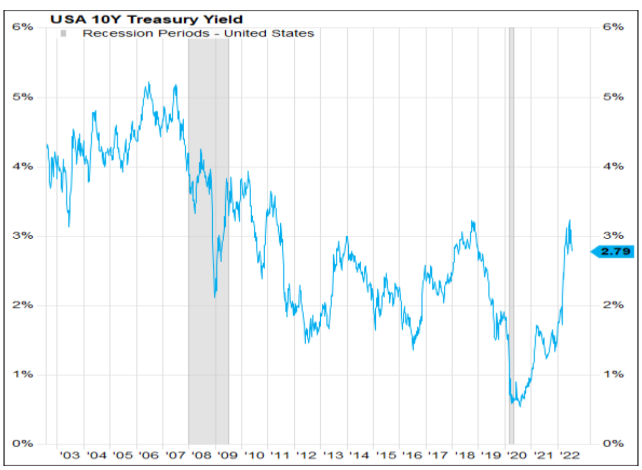
There are a number of reasons for the discount:

- U.S. based investors exhibit more home market bias than investors outside of the U.S.
- U.S. markets have benefited historically from a greater percent of equity markets and the economy in the technology sector.
- Currently, Europe and other developed areas are more exposed to issues related to Russian energy and Russia's invasion of Ukraine than the U.S.

At some point the discount should normalize, allowing international investments to close the gap on U.S. based investments.

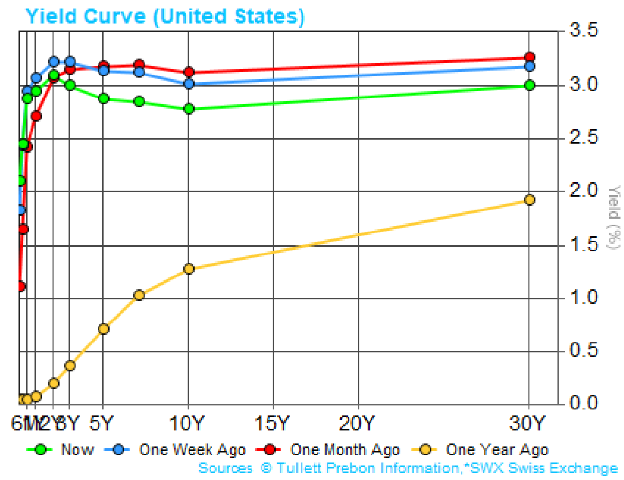
Fixed Income Markets

The Fed Funds target rate has been increased from 0.00 -0.25% to 2.50% so far this year in an effort to slow the economy and to suppress inflation. The 10-year U.S. Treasury yield has moved up from about 1.5% at the end of last year to the 2.75-3.25% range currently.



Source: FactSet

It is anticipated that the Fed will raise the target rate by an additional 1.0% to 3.5% by the end of the year. If inflation stays high, the 10-year Treasury may match or exceed the target rate. If inflation begins to show signs of moderating or if a recession appears imminent or is declared, then rates will likely decline. The yield curve remains inverted beyond 2-year maturities. As the Fed continues to increase the target rate, the inverted yield curve may initiate with the shortest of maturities.



It is important to maintain high credit quality during economic downturns and recessions. Credit spreads have been widening and would likely widen considerably further in a recession. Also, default rates could increase for lower quality credits.

The municipal bond market remains stable. Most state budgets have benefited from strong revenue collections recently. Additionally, many states have built up their reserve accounts from the surplus revenues leaving the majority of state rainy day funds at historical high levels, providing states a crucial tool if economic conditions become more challenging.

Bond prices have suffered from the increase in rates. Returns for investment grade bonds (Barclays U.S. Aggregate Index) were down -4.69% in Q2, -10.35% YTD and -10.29% for 1 year through June. Municipal bonds were down -2.70% for the quarter, -8.23% YTD and -7.84% for 1 year. High yield bonds were down -9.89% for the quarter, -13.83% YTD and -12.63% for 1 year.

2022 Q2 Returns				
FIXED INCOME	**Q2 2022**	**YTD 6.30.22**	**1 Year 6.30.22**	**3 Years Annualized**
B B US Agg Bond	-4.69	-10.35	-10.29	-0.93
ICE AMT-Free Nat'l Muni	-2.70	-8.23	-7.84	-0.02
Markit iBoxx USD Liquid High Yield Index	-9.89	-13.83	-12.63	-0.63

Source: FactSet

Real Assets

Real Estate Investment Trusts (REITs) are often used to provide exposure to real estate. The advantages of REITs over hard real estate include:

- much better liquidity
- much lower transaction and holding costs

The disadvantages of REITs compared with hard real estate and non-traded REITs include:

- much higher volatility
- much higher correlation to equities

Of course, it should be noted that publicly traded REITs trade on an exchange and are valued on an ongoing basis as opposed to hard real estate and non-traded REITs that are valued on a much less frequent basis.

The Dow Jones U.S. Real Estate index is a benchmark for Real Estate Investment Trusts (REITs). The benchmark was down -14.43% in Q2, -20.01% YTD and -7.52% for 1 year.

2022 Q2 Returns

Real Assets	Q2 2022	YTD 6.30.22	1 Year 6.30.22	3 Years Annualized
Dow Jones U.S. R/E	-14.46	-20.01	-7.52	4.48
S&P GSCI	2.01	35.80	45.05	14.69

Source: FactSet

Commodities were up for the quarter but declined from earlier peaks as the fear of a possible recession was factored in. The S&P GSCI Commodity-Indexed Trust was up 2.01% in Q2, 35.80% YTD and 45.05% for 1 year. The benchmark is primarily driven by energy as it represents nearly two thirds of the index.

Asset Allocation

There were no tactical asset allocation changes in Q2. If the probability of a recession increases there will likely be greater fund flows toward investment grade fixed income and out of high yield fixed income and commodities. We will monitor the situation as Q3 proceeds.
