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MARKET COMMENTARY

2Q 2022

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Market Monitor 2022	Q2%	YTD%
MSCI ACWI Total Return Index	-15.7%	-20.2%
S&P 500 Total Return Index	-16.1%	-20.0%
Bloomberg U.S. Agg. Bond TR Index	-4.7%	-10.3%
Bloomberg Commodity TR Index	-5.7%	+18.4%

Performance is not correlated to portfolio holding period.

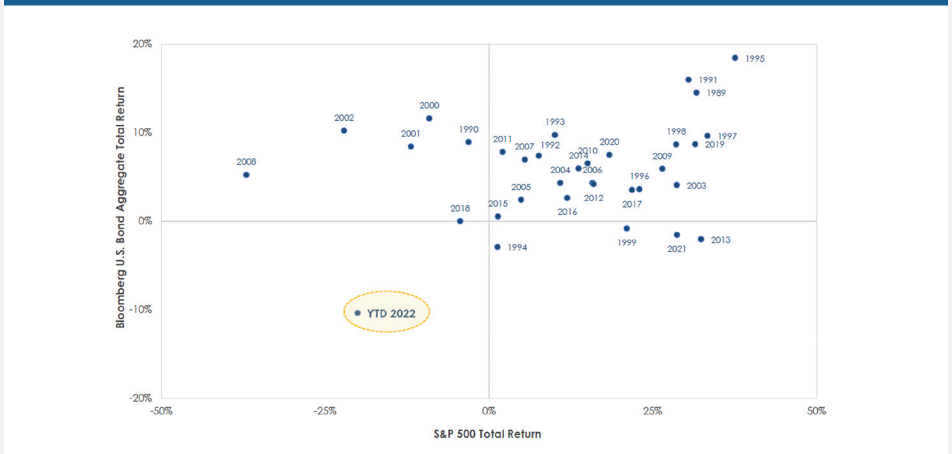
Historic Market Events In 2Q Bedevil Investors

The second quarter of 2022 was marked by a rapid increase in interest rates in response to elevated inflation readings and a steep fall in market multiples. These market dynamics led to a number of "historic" data points to the chagrin of both equity and credit investors. As a sampling:

- U.S. inflation reached successive 40-year highs in April, May and June.
- The Fed increased rates by 75bps at its mid-June meeting, a first since 1994.
- The S&P witnessed its worst decline (-20%) for the 1st half of the year since 1970.
- The traditional 60/40 stock/bond portfolio fell 17%, its worst 1st half since 1932.

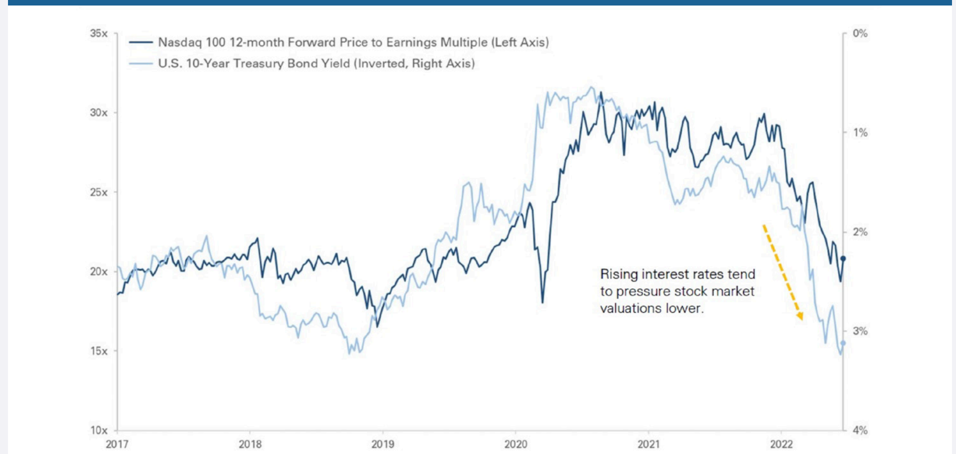
To underscore the last point, we are truly in a unique market environment when both equity and fixed income assets sell off meaningfully. Historically, negative returns in both stocks and bonds have only occurred in 4% of 6-month periods from 1926-2022.[1]

Year-to-Date Stock & Bond Returns Highlight 2022's Unique Environment



Source: MarketDesk.

Higher Interest Rates = Lower Stock Valuation Multiples



Source: MarketDesk.

[1]Goldman Sachs, Datastream.

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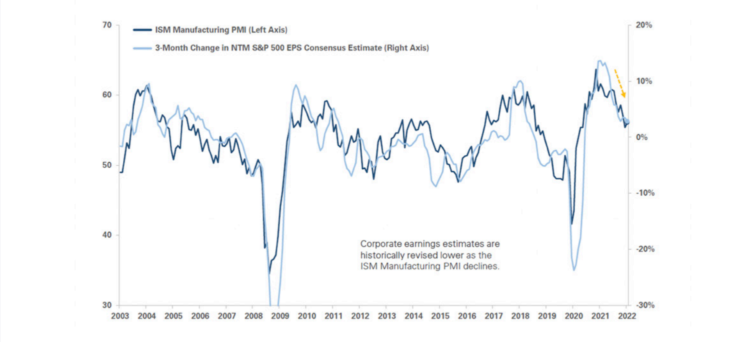
With Multiples Compressed, All Eyes on Corporate Earnings

Furthermore, the decline in domestic equities year-to-date has been entirely due to falling valuations which have moved in-line with rising interest rates. The S&P 500's P/E multiple has fallen 24% from 21x to 16x forward P/E, as markets have been caught in a vise-like feedback loop, oscillating between inflation worries and recession fears that growth will slow too much from the Federal Reserve's actions. With its dual mandate, the Fed is seeking a Goldilocks scenario as it tamps down demand to tame inflation without pitching the economy into recession. It is clear though that growth will diminish in any landing scenario and the question remains on how hard the landing will be. Many expect that profit margins and earnings are the next shoe to drop and many investment managers caution against buying the dip until there is clarity on both inflation trends and the depth/breadth of earnings revisions for corporates to come.

International equities were not unscathed in the quarter either with the MSCI ACWI ex-US falling 13.5% and MSCI EM sinking 11.3%. An additional anchor to these numbers has been the relentless rise of the U.S. dollar which appreciated 6.5% on the quarter and mitigated any relative outperformance of international markets relative to the U.S. Recession risk is greater in European markets than in the U.S. leading us to be underweight the region in client portfolios as a growing energy and geopolitical crises in Europe continue apace.

In Asia, China's onshore and offshore markets notably outperformed in the quarter (flat to up 4.5%, respectively) as the country's strict Covid lockdowns began to relent and policymakers signaled a détente in regulatory reform for home-grown technology companies. With Xi Jinping making the case for a 3rd presidential term this fall, fiscal and monetary resources stand at the ready to support economic growth through year-end. Unlike other large economies around the globe, China is not hemmed in by inflation should it turn the spigots on.

Corporate Earnings Estimates Could be Revised Lower

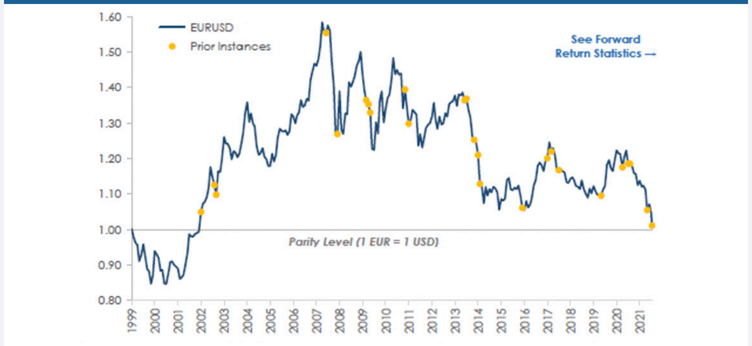


Source: MarketDesk.

Google Search Trends for "Recession"

Source: MarketDesk, Google.

Euro per U.S. Dollar Multiples



Source: MarketDesk, FactSet.

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Challenging Backdrop Calls for Different Investor Toolkit

With a challenging macroeconomic backdrop and wide spread of scenarios from growth slowdown to recession to stagflation, how should investors position themselves? As a starting point, we favor a diversified portfolio that allows a client to play offense even in uncertain times.

- In domestic equity, we are taking a more cautious approach, maintaining balanced exposure to both value and growth names and watching the stickier components of inflation, corporate earnings guidance, and the Fed's intended rate path before buying the dip. We are also cognizant that at some point the worst case gets baked into markets as the peak-to-trough drawdown of 24% YTD represents 80% of the 30% P-T average drawdown in the 12 U.S. recessions since 1947.[2]

- In international markets, we are underweight Europe given the aforementioned amplified recession risk due to heightened inflation and energy prices resulting from the Ukraine/Russia war. Though valuations in emerging markets look compelling at 11-12x P/E, it is difficult to make the case that EM can decouple from the tightening liquidity and slowing growth picture in the U.S. and Europe. Active country selection in EM is paramount given the diversity of markets and economies under the EM moniker.

- An allocation to hedged equity managers provides a low-beta entry point for clients to add to their growth asset allocation and selectively take advantage of cheap valuations. As a play on increased market volatility and dispersion post the market drawdown, skilled hedged equity managers should deliver differentiated returns, particularly when the big question in the U.S. is short-to-medium term earnings growth and hedged equity managers are not constrained to matching an index. In a market defined by sector/factor rotations and indiscriminate selling, the hedged equity strategy is primed to take advantage of the resulting mispricing of individual stocks.

- As we noted at the beginning of the year, in the face of market uncertainty, we still believe investors should lengthen their time horizons, look through the noise, and seek out private market opportunities. Those markets remain inefficient and those inefficiencies only grow as liquidity and capital availability tighten, favoring private equity managers with dry powder to deploy. As a reference point, since 1995, the average annual return on global growth buyout funds launched a year post a peak in public equities has been 18.6%.[3]

[2]Goldman Sachs, Datastream.
[3]Cambridge Associates, UBS.

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Promising Healthcare Theme Lies Beneath

The current environment also leads us to favor the healthcare sector (mid-term 2022 elections aside) as the group is more cycle-resilient and has grown earnings during each of the last six recessions.[4] We also like healthcare specialists as the space offers opportunities across asset classes:

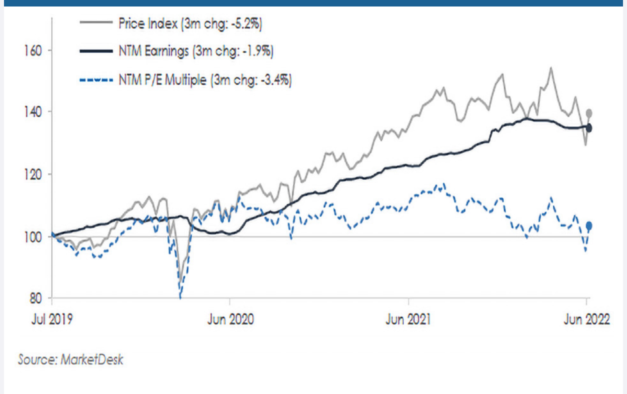
- Aside from the defensive qualities of healthcare earnings, long-only specialists can take advantage of the massive derating in the biotech sub-sector to pick the next leaders in therapeutic and pharmaceutical innovation on the cheap. As an example, 30% of publicly traded SMID biotech companies are trading below cash value today.[5]

- Healthcare-dedicated hedged equity managers enjoy a wide playing field to pick winners and losers due to the creative destruction and destructive creation dynamics of the healthcare sector.

- The withdrawal and general lack of capital in the biotech subsector provides an opening for private credit managers to structure compelling risk/return payoffs.

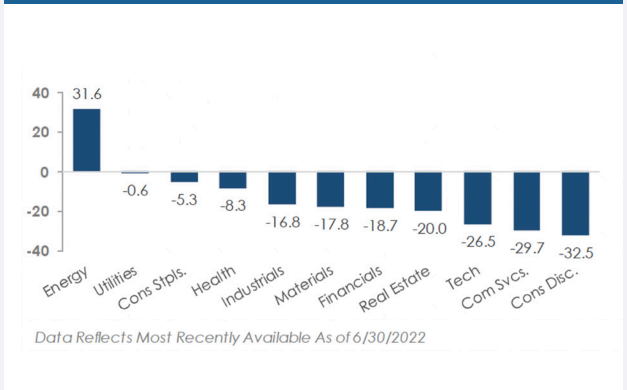
- Healthcare-focused private equity managers can step in to support the "picks & shovels" companies that ultimately manufacture and commercialize the wave of advances in gene therapy and cellular biology that are still in their earliest innings. Private equity managers are also backing innovative approaches to healthcare delivery such as value-based care models. None of these factors depend on the Fed's next move or the timing of when peak inflation will hit.

Healthcare Earnings Growth Steady while Multiples Contract



Source: MarketDesk.

Wide Spread in U.S. Sector Returns (YTD%)



Source: MarketDesk, FactSet. Analysis is based on Invesco's DBA & DBC EFTs.

[4]Goldman Sachs.
[5]Jeffries.

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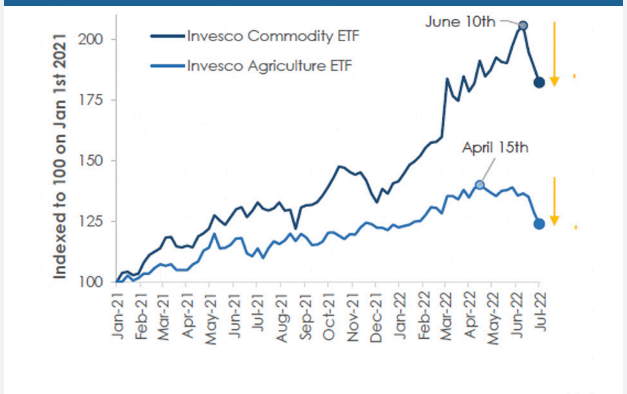
Better to be Balanced vs. Concentrated in Current Environment

Finally, the energy sector and commodities complex have been the only bright spots on a year-to-date basis (S&P Energy +31.6%, WTI +40.6%, BBG Commodities +18.4%), though the collective group gave back some gains late in the quarter as recession worries grew. We argue to maintain allocations to commodities and real assets in client portfolios even in the face of the pullback and slowing global growth. A real assets allocation still serves as a hedge against persistent inflation and a stagflation economic scenario where both equities and fixed income falter. In many segments of commodities, demand continues to exceed supply as there has been a lack of investment over the past five years. Meanwhile, the decarbonization/net-zero trend is gaining traction across corporate supply chains and will underpin demand for both green metals and traditional fuels as companies and power grids navigate the transition to a greater usage of renewables.

Simply put, it is better to be balanced vs. concentrated in the current environment—this provides the steady hand one needs to parse through the "historic" headlines to source attractive investment opportunities.

Commodity Investors Rush for the Exits



Source: MarketDesk, FactSet. Analysis is based on Invesco's DBA & DBC EFTs.

Disclosure

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