Centier

# FINANCIAL PARTNERS

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IN THIS ISSUE



QUARTERLY MARKET INSIGHT
2ND QUARTER 2022

SPOTLIGHT

## BEAR MARKETS AND RECESSIONS

The U.S. stock market is struggling to get out of first gear, while the domestic economy has been forced to navigate choppy waters. Google Trends data showed more people in the U.S. searched the word "recession" in the week of June 13-19 than at any time since 2004. High gas prices and acutely elevated measures of broad-based inflation have weighed mightily on U.S. consumer sentiment. More recently, a rapid increase in mortgage rates has raised questions about housing-related spending in the second half of 2022. With the U.S. Federal Reserve ramping up its rate hikes to tamp down inflation, fears have grown that corporate defaults will escalate, economy activity will slow, and the unemployment rate will shoot higher. The roughly 20% year-to-date decline in the S&P 500 (and an even deeper drawdown for the technology-heavy Nasdaq) reflects these worries.

### HOW IS A RECESSION DEFINED?

The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) is the official arbiter of U.S. recessions. This group's definition of a recession is "a significant decline in economic activity that is spread across the economy and lasts for more than a few months." A rudimentary rule-of-thumb used by the financial media and many investors for measuring recessions is two consecutive quarters in which real gross domestic product (GDP) contracts. Importantly, the NBER does not solely identify economic activity with real GDP. It utilizes a broader set of criteria to determine peaks and troughs in the economic cycle including real personal income less transfers, the household employment survey, and real personal consumption expenditures. It typically takes the NBER between 4 and 21 months after a recession has ended to declare a peak and trough in economic activity. The initial estimate for second quarter real U.S. GDP growth is scheduled to be released July 28. Although a negative second quarter GDP reading would fit the loose definition of a recession following a 1.6% contraction in the first quarter, it might not be sufficient to meet the NBER's criteria. To a large extent this is because recent labor market data indicate a relatively healthy environment for U.S. jobseekers.

### WHAT IS A BEAR MARKET?

A bear market in stocks is generally characterized by a period of at least two months when a broad market – as measured by an index like the S&P 500 – declines by 20% or more. Not all steep declines cleanly fit this definition. In the earliest weeks of the COVID-19 pandemic, the S&P 500's 33.9% drawdown from 2/19/20 to 3/23/20 was too short of a period to meet the above criteria. According to data compiled by Invesco, there have been eleven S&P 500 bear markets from 1960 through 2020 with an average decline of 34% and an average duration of 12 months from peak to trough. Four of these bear markets (1961-62, 1966, 1987, and 2018) did not coincide with a recession as defined by the NBER.

Significant declines in broad-based stock indexes and periods of negative economic growth often go hand in hand. This relationship makes sense considering the equity market is supposed to reflect the outlook for growth in corporate revenues, profits, and margins. If the economy appears on the cusp of a contraction, investors tend to reduce their expectations for overall corporate profit growth. A sharp cut in expected profits at the index level can drag major equity averages sharply lower. Looking back to the global financial crisis, analysts estimated on 9/30/07 that S&P earnings per share over the next 12 months would be $94.33. On 3/31/09, estimates for S&P 500 profits over the ensuing twelve months were $58.96, a 37.5% decline in forward 12-month profit expectations. From 9/30/07 to 3/31/09, the S&P 500 declined 47.7% in price terms, implying that the cut in profit expectations accounted for roughly 80% of the benchmark's drawdown.

### WHERE DO WE STAND?

There have not been any recessions in the post-World War II era without an accompanying bear market in stocks. But there have been four instances of bear markets without recessions. Thus, we can say roughly two-thirds of all bear markets either preceded or ended in a recession. The first-half decline of 20.0% in the S&P 500 represents approximately 60% of the average decline for bear markets that occurred from 1960 through 2020. The S&P 500's forward 12-month price-to-earnings ratio decreased 25% in the first half of this year from 21.5 to 16.1, which is very close to its long-term average. While we expect elevated equity market volatility over the next 3 to 4 months, we struggle to see the emergence of a protracted recession given the relatively healthy state of aggregate consumer and corporate balance sheets. If this turns out to be the correct view, a substantial portion of the equity market losses historically associated with a mild recession, or a mid-cycle slowdown, are probably priced into markets.

## NAVIGATING A SOFT LANDING

The U.S. economy disappointed in the first quarter as gross domestic product (GDP) contracted at a 1.6% annualized rate, well below estimates of 1.5% growth compiled by a Bloomberg survey of 60 economists in early April. A diverse set of variables weighed on the U.S. economy in the first quarter, including a slowdown of inventory builds, higher mortgage rates and a widening trade deficit. Sharply higher costs for goods and services weighed on consumer spending (the largest component in the calculation of U.S. GDP) which was revised lower in the first quarter to 1.8% annualized from an initial reading of 3.1%. The war in Ukraine and related sanctions against Russia put upward pressure on most energy and agricultural commodity prices, exacerbating inflation in the U.S. and abroad. China's zero-COVID policy squeezed supply chains and likely led to some demand impairment as rolling lockdowns were enacted in response to rising case counts in several major population centers including Shanghai.

These growth headwinds persisted in the second quarter to varying degrees. New to the mix, however, was a commitment by the U.S. Federal Reserve to embark on an aggressive tightening campaign to bring down inflation even at the risk of slowing economic growth. Economists surveyed by Bloomberg in the first week of July projected U.S. GDP will expand 2.5% in 2022, down from December projections of 3.9% growth. The highly fluctuating Atlanta Fed's GDPNow measure, which tracks relevant economic data in real time, recently showed second quarter U.S. GDP contracting between 1.0% and 2.0% on an annualized basis. The first official GDP estimate will be released by the Bureau of Economic Analysis on July 28.

| ECONOMIC INDICATORS | LATEST | 3MO PRIOR | CHANGE* |
|---|---|---|---|
| REAL GDP (QoQ ANNUALIZED) | -1.6% | 6.9% | ▼ |
| TRADE BALANCE | -85.5 | -88.1 | ▲ |
| UNEMPLOYMENT RATE | 3.6% | 3.6% | - |
| NON-FARM PAYROLLS | 372K | 398K | ▼ |
| ISM MANUFACTURING | 53.0 | 57.1 | ▼ |
| ISM NON-MANUFACTURING | 55.3 | 58.3 | ▼ |
| RETAIL SALES (LESS AUTOS) | 0.1% | 1.2% | ▼ |
| INDUSTRIAL PRODUCTION | 0.1% | 0.8% | ▼ |
| HOUSING STARTS | 1549M | 1777M | ▼ |
| CONSUMER PRICE INDEX (YoY) | 9.1% | 8.5% | ▼ |
| CONSUMER CONFIDENCE | 98.7 | 107.6 | ▼ |
| EXISTING HOME SALES | 5.41M | 5.93M | ▼ |
| CONSUMER CREDIT | 22.34B | 34.36B | ▼ |
| CRUDE OIL PRICE | $100.28 | $ 73.47 | ▼ |

Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results. *The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to aggregate U.S. consumer spending.

In the first quarter, the Federal Open Market Committee (FOMC) began its rate-hike campaign by lifting its policy rate on March 16 by 0.25% to a range of 0.25% to 0.50%. In the second quarter, the FOMC hiked rates by 0.50% in early May, and then again on June 15 by 0.75% to a range of 1.50% to 1.75%, marking its largest single increase since 1994. Fed officials were most likely set to hike by 0.50% in June but decided on a more aggressive hike in response to hotter-than-expected May consumer price index (CPI) data (see Chart 1). According to the Bureau of Labor Statistics, headline CPI rose 8.6% year over year. Most Fed officials (and many market commentators) thought annual CPI would continue to fall after declining to 8.3% in April from 8.5% in March. A significant portion of the dramatic surge in inflation over the last twelve months has been driven by sharp price increases in goods and energy. Both components have been significantly affected by pandemic-related supply chain factors.

Rising costs and monetary policy tightening have certainly increased recession fears. Some economists and investors believe a slowdown is more likely than a significant economic contraction. This group points to relatively strong consumer balance sheets and reasonably strong labor market data as reasons the Federal Reserve could still manufacture a "soft landing" which avoids a sharp recession.

## EMPLOYMENT AND MANUFACTURING

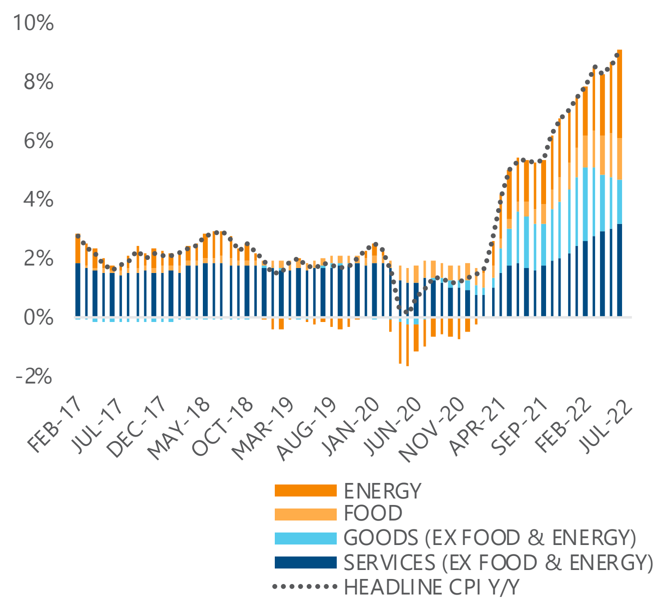
The U.S. labor market steadily added jobs in the second quarter of 2022, but at a slower pace than in the first quarter. Nonfarm payrolls increased 368,000 in April, 384,000 in May, and 372,000 in June. Job growth has averaged over 450,000 per month in the first half of 2022 and the unemployment rate has declined to 3.6% from 3.8% in January. The U.S. labor force participation rate (the share of the U.S. working-age population that is employed or looking for work) was 62.2%, which is 1.2% below its immediate pre-pandemic high of 63.4%. Average hourly wages climbed 0.3% in June from May and have risen 5.1% from a year ago.

Manufacturing sector activity expanded at a slower rate in June. The Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) slipped to 53.0% in June from May's 56.1%. Although this was the lowest reading since June 2020, the index posted its 25th consecutive month of expansion despite persistent supply chain challenges. PMI readings above 50% indicate expansion.

## HOUSING

Rising mortgage rates, higher home prices, and low inventory levels led to a fourth consecutive monthly decline in existing home sales in May. Existing home sales were down 8.6% in May from a year ago. The average 30-year fixed mortgage rate has increased by 2.4 percentage points over the last year to 5.3%. The median price for existing homes sold last month was up 14.8% from a year ago to $407,600. Sales of new single-family homes in May came in at a seasonally adjusted annual rate of 696,000 units, according to estimates released by the U.S. Census Bureau and the Department of Housing and Urban Development. This is 10.7% above April's revised annual rate of 629,000 units but 5.9% below the annual rate of 740,000 units a year ago. Most economists believe the U.S. remains in a housing shortage, which should continue to support home sales even if rising mortgage rates cut into home affordability. Construction companies could continue to see increased demand by capitalizing on the growing build-to-rent market, even if the broader housing market slows slightly.

CHART 1
COMPOSITION OF U.S. INFLATION




Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results.

# EQUITY

## STOCKS ENTER BEAR MARKET

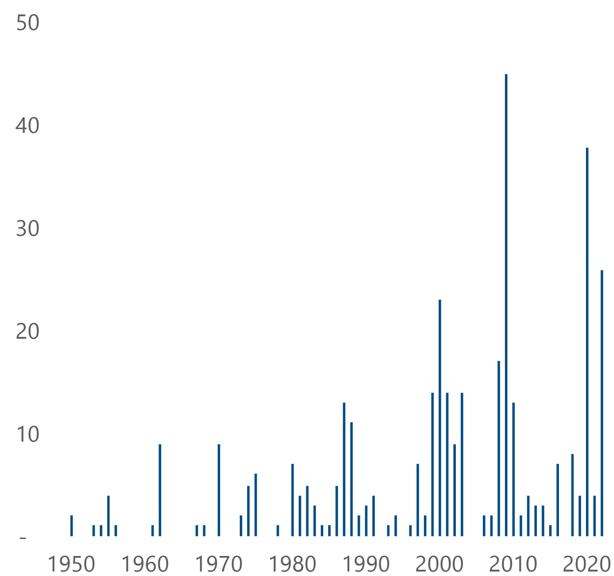
Global equities remained under pressure for another quarter and experienced one of the worst first six months of a year in several decades. Investors grappled with growing recession concerns late in the quarter as persistently high inflation and hawkish Fed communication led market participants to price in more Fed interest rate hikes this year than previously expected. At the end of the second quarter, fed funds futures indicated investors were pricing in the Fed to hike rates up to nearly 3.5% by year end, compared to expectations on March 31 for the fed funds rate to end the year around 2.5%.

Major U.S. equity indexes fell into a bear market late in the quarter for the second time in just over two years. The S&P 500 finished the quarter with a 16.10% loss and a year-to-date decline of 19.96%, marking the benchmark's worst first half of a year since 1962. The technology-heavy Nasdaq posted a 22.28% quarterly loss and 29.23% decline year-to-date, while the small capitalization Russell 2000 fell 17.20% in the quarter and 23.43% so far this year. Sharp declines were accompanied by an unusually high level of volatility. The S&P 500 experienced 26 days in the first half of the year with a daily move greater than 2%, positive or negative. That was the third highest number of daily moves greater than 2% in the first half of a year over the last 70 years, behind 45 days in 2009 and 38 days in 2020 and was well above the 70-year average of just 6 days. Even within a clear downtrend in the second quarter, the S&P 500 experienced two sharp countertrend rallies of 6.58% from May 20 through May 27, and 6.68% from June 16 through June 24.

At the S&P 500 sector level, areas of the market traditionally viewed as defensive, including consumer staples, utilities, and health care, held up best during the drawdown and posted quarterly declines less than 6%. The energy sector also fared better than most other groups with a 5.17% quarterly loss. The price of West Texas Intermediate (WTI) crude oil was on pace for a second consecutive double-digit quarterly gain until it fell nearly 8% in June. Oil prices surged almost 10% in May amid discussion of the European Union potentially banning imports of Russian oil and improving oil demand outlook from China loosening COVID-19 lockdowns. Those gains were almost fully reversed in June, however, as the demand outlook weakened due to growing recession concerns and the imposition of COVID-19 lockdowns in Shanghai and other major population centers in China. Despite the energy sector's second quarter loss, it still booked a gain of 31.84% in the first half of 2022 due to its impressive 39.03% return in the first quarter.

CHART 2

NUMBER OF FIRST HALF S&P 500 DAILY MOVES > 2%




Source: Morningstar. Data as of 6/30/22. Past performance does not guarantee future results.

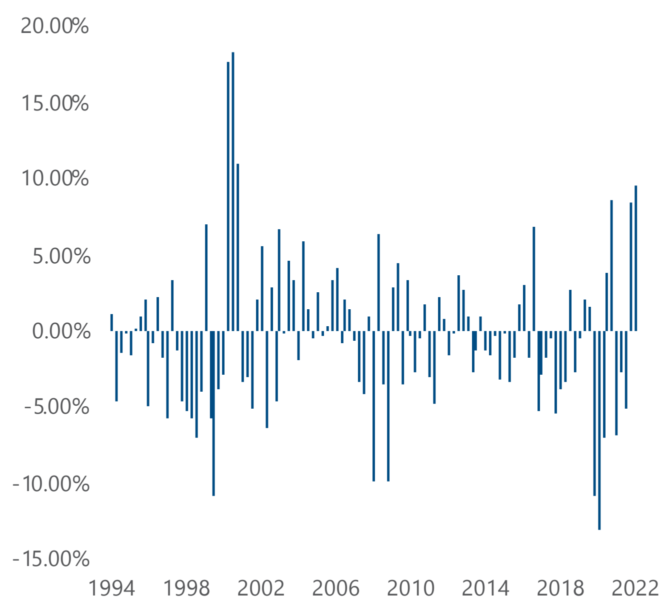
Higher growth sectors, including technology, communications, and consumer discretionary suffered the steepest drawdowns in the quarter as growth stocks were impacted more by higher interest rates. Each of these three S&P 500 sectors fell over 20% in the quarter. Consumer discretionary stocks were also pressured by the risk of weaker consumer spending in a recession scenario. Recent underperformance in higher growth sectors has led to the S&P 500 Value index's widest quarterly outperformance versus the S&P 500 Growth index since the technology sector bubble burst in 2000. The S&P 500 Value index's 11.27% decline in the quarter was 9.55% above the S&P 500 Growth index's 20.81% loss. Expectations for weaker economic activity led to non-energy cyclical sectors also suffering large declines in the quarter. The S&P 500 financials, industrials, and materials sectors each posted a quarterly loss around 15% or more. Over the last month, these three sectors saw the largest revisions lower in analysts' 2022 earnings projection, in addition to the consumer discretionary sector which had the largest revision lower. The sharp reversal in economically sensitive commodity prices weighed heavily on the materials sector. The Bloomberg Industrial Metals index fell 26.35% in the quarter after gaining 22.73% in the first quarter and 30.34% in 2021.

Foreign developed and emerging market stocks lost less ground than U.S. stocks in the quarter. The MSCI EAFE index declined 14.29%, while the MSCI Emerging Markets Index fell 11.34%. Foreign developed equities outperformed their U.S. counterparts partly due to having less exposure to higher growth technology stocks. The MSCI EAFE index has an 8% weight in the technology sector, while the S&P 500 has around a 27% weight in the technology stocks. China was the only major country to generate positive performance in the quarter which helped the emerging markets index hold up better than other areas of the stock market. Chinese equities started the quarter under pressure from COVID-19 lockdowns but rebounded as lockdowns eased intermittently and economic data improved.

Analysts' expectations for S&P 500 earnings per share (EPS) aggregated by Bloomberg in 2022 and 2023 are $231 and $248, respectively. Following EPS of $211 in 2021, this implies expected index-level profit growth of 9.5% this year and 7.4% next year. A growing number of market commentators have argued these expectations are too optimistic amid elevated cost pressures and signs of slowing demand. This makes the results and management guidance of the upcoming second quarter earnings season particularly important for determining the short-term direction of equity markets.

CHART 3

S&P 500 VALUE MINUS GROWTH QUARTERLY RETURN




Source: Morningstar. Data as of 6/30/22. Past performance does not guarantee future results.

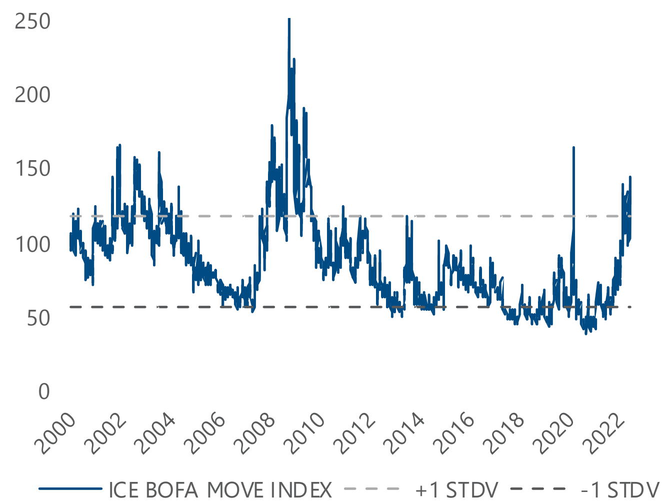
## BOND MARKET VOLATILITY SOARS

The biggest headlines in bond markets during the second quarter were two Fed rate hikes totaling 1.25%, the refusal of broad-based inflation readings to roll over, and a sharp widening in corporate credit spreads. These developments helped drive a substantial increase in volatility across most fixed income markets. For over ten years the Federal Reserve has been able to provide relatively reliable short-term forward guidance on the direction of its policy rate decisions. A swell of volatility across rate markets in the second quarter suggested market participants have begun to question policymakers' foresight over even short time periods. As seen in Chart 4, the ICE BofA MOVE Index, a measure of implied volatility across a range of one-month U.S. Treasury option contracts, spiked to a 13-year high in the first week of July. Over the twelve trading days spanning May 30 through June 14, yields on the U.S. 2-year, 5-year and 10-year Treasury notes surged 0.95%, 0.87% and 0.74%, respectively. These moves marked the largest twelve-day changes in yield (in either direction) since 1985 for the 2-year maturity, since 2001 for the 5-year, and since 2003 for the 10-year.

A chief driver of elevated bond market volatility in recent months has been a tug of war between generationally high inflation pushing interest rate expectations higher and rising recession risks pulling them lower. Against this backdrop, Fed officials have struggled to provide dependable projections on the path of the central bank's policy rate. Some observers have suggested the Fed has a credibility problem after waiting too long to begin hiking rates and then surprising markets with a 0.75% hike in mid-June, the largest single increase in nearly three decades. In the press conference following the Federal Open Market Committee's (FOMC) June 14-15 policy-setting meeting, Chairman Jerome Powell admitted he and his colleagues were caught off guard by two data points in the second week of June. Surprisingly high May consumer price index (CPI) data released on Friday, June 10 and an unexpected increase in long-term (5 to 10 years) annual inflation expectations in the University of Michigan's preliminary consumer sentiment index data for June pushed policymakers toward a 0.75% increase.

As the quarter progressed, market participants priced in a steeper path of Fed rate hikes in 2022. As of the first week of July, fed funds futures markets (as represented by Bloomberg's World Interest Rate Probability function) projected the Fed's benchmark rate will climb to roughly 3.38% by the end of 2022. This implies policymakers will front-load another 1.50% to 1.75% of rate hikes in 2022. On March 31, fed funds futures markets projected a policy rate of approximately 2.40% by year end.

CHART 4
U.S. TREASURY MARKET VOLATILITY




Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results. The ICE BOFA MOVE Index is a weighted index of the implied volatility on 1-month U.S. Treasury options across various maturities.

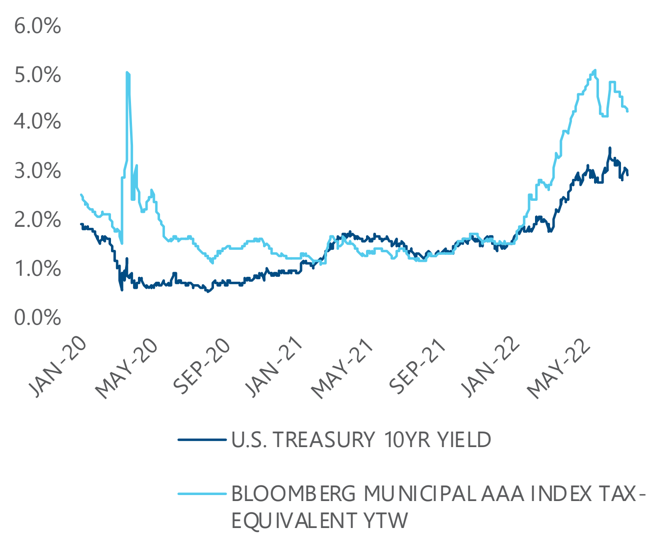
As its rate hike campaign got underway, the Fed also began to reduce the size of its balance sheet. At its May 4 meeting, the FOMC announced the central bank will begin reducing its holdings of treasury, agency and agency mortgage-backed securities beginning June 1. According to its own projections, the Fed's balance sheet will be reduced by $522.5 billion in 2022 to roughly $8.375 trillion, a modest 5.9% decrease. In 2023, the balance sheet is projected to shrink an additional 13.6% to around $7.235 trillion.

The U.S. Treasury yield curve bear flattened during the quarter largely in response to a steeper trajectory of Fed rate hikes. A bear-flattening occurs when shorter dated Treasury yields increase more than their longer dated counterparts. The 3-month U.S. Treasury bill increased 1.13% during the quarter from 0.50% to 1.68% while the 10-year note climbed 0.66% from 2.34% to 3.00%. The 2-year, 5-year, and 10-year Treasury notes finished the quarter within just 0.06% of each other. Yield curve flattening generally indicates investors anticipate an economic slowdown.

Municipal bonds and high-yield corporate bonds have cheapened dramatically in 2022. In the last week of June, tax-exempt 10-year AAA-rated municipal bonds yielded roughly 1.50% more than at the end of 2021. As seen in Chart 5, the tax-equivalent yield-to-worst (assuming a 37% marginal tax rate) of the Bloomberg AAA-rated municipal bond index was 1.49% on December 31, roughly in-line with the 1.51% yield on the U.S. 10-year Treasury note. As municipal bond prices came under pressure over the first half of this year in the face of Fed rate hikes and heavy outflows from municipal bond funds, the municipal-treasury yield differential changed substantially. On June 30, the tax-equivalent yield-to-worst of the Bloomberg AAA-rated municipal bond index was 4.51%, compared to the U.S. 10-year Treasury yield of 3.01%. The credit spread on the Bloomberg Barclays U.S. Corporate High Yield Bond Index widened from 3.62% on March 31 to 5.91% on June 30 amid increased concerns about the economic outlook. This compared to an average of 3.98% in 2019, 5.26% in 2020 and 2.67% in 2021.

Fixed income portfolios should continue to benefit from keeping duration modestly below benchmark in 2022 as interest rates remain low compared to longer term historical ranges. If market interest rates begin to overshoot realistic expectations for Federal Reserve rate hikes this year, it may make sense to selectively add duration exposure depending upon a portfolio's objective. Treasuries are preferred over agencies given compressed spreads in the agency market. Treasuries are favored over corporates when purchasing maturities less than one year, given corporate illiquidity in this maturity range.

CHART 5
MUNICIPAL BOND TAX-EQUIVALENT YIELDS




Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results. Tax-equivalent YTW (Yield to Worst) incorporates embedded call features and assumes a marginal 37% tax rate.

## HAVE MARKETS PRICED IN A RECESSION?

Last quarter, we questioned whether domestic inflation had peaked or was about to peak. Those with inflation fatigue may understandably dismiss the difference between a 9% and 7% year-over-year change in the consumer price index (CPI). But for investors the direction of inflation remains a critical factor in projecting the likely trajectory of monetary policy, U.S. Treasury yields, corporate credit spreads and equity market valuations. As discussed in the Economy section, predictions of so-called peak inflation in the second quarter were premature. Year-over-year U.S. CPI dipped to 8.3% in April from 8.5% in March. It then increased to 8.6% in May and 9.1% in June driven by the services and energy components. Various measures of core inflation (which strips out energy and food prices) have begun to decelerate yet remain way too high for the comfort of Fed Chairman Jerome Powell and his colleagues. Hotter-than-expected May CPI data gave Fed policymakers the airspace to deliver a hawkish surprise with a 0.75% policy rate increase following their June 14-15 policy-setting meeting (See Fixed Income section).

With the Federal Reserve and many other central banks in clear tightening mode, growing fears of an impending recession have overtaken anxieties about runaway inflation, and the war in Ukraine as investors' foremost concerns. Of course, all three of these items are linked to a certain extent as the war tends to exacerbate inflation and harden the resolve of Fed policymakers to hike rates.

As inflation anxiety evolved into recession fears in May and June, U.S. equity markets have likely priced in a substantial portion of the declines that have historically coincided with an economic contraction. The S&P 500 fell 19.96% in the first six months of 2022, driven exclusively by a contraction in the multiple investors place on the benchmark's expected profits. The S&P 500's forward 12-month price-to-earnings ratio decreased 25% in the first half of this year from 21.5 to 16.1, placing the valuation measure right in the middle of its 30-year range. As seen in Chart 6, this was the worst first half of a calendar year for the S&P 500 since 1962. We also see in Chart 6 a wide range of second half return outcomes across the nine other years shown with an average second half return of 0.85%. The second half of 2008 saw a 28.48% decline in the S&P 500 as Lehman Brothers defaulted and the global financial crisis gripped the world. On the other hand, the S&P 500 surged 31.74% in the second half of 1982 as inflation declined sharply and the Economic Recovery Tax Act of 1981 (i.e., the Reagan-Kemp-Roth tax cuts) was implemented.

Equity bear markets (defined as a 20% drawdown in the S&P 500) and Federal Reserve policy tightening cycles typically precede or coincide with a recession. Seven of the last eleven equity bear markets heralded a recession. The four examples of equity bear markets without an accompanying recession were S&P 500 declines of 28%, 22%, 34% and 20% in 1962, 1966, 1987, and 2018, respectively. According to data compiled by Brian Levitt at Invesco, the average peak-to-trough decline of the S&P 500 in the ten U.S. recessions in the post-World War II era is 31.8%. As Chart 7 shows, seven of the eleven past Fed rate hike cycles resulted in a "hard landing" defined by a multi-quarter

CHART 6

TEN WORST FIRST HALVES FOR S&P 500 SINCE 1950

| YEAR | 1ST HALF RETURN % | 2ND HALF RETURN % | FULL YR RETURN % | RECESSION THAT YEAR | NEXT YR RETURN % | RETURN 2 YRS LATER % |
|---|---|---|---|---|---|---|
| 1962 | -22.23 | 17.44 | -8.66 | NO | 22.76 | 16.43 |
| 2022 | -19.96 | ? | ? | ? | ? | ? |
| 1970 | -19.46 | 28.99 | 3.89 | YES | 14.22 | 18.96 |
| 2002 | -13.16 | -10.30 | -22.10 | NO | 28.68 | 10.88 |
| 2008 | -11.91 | -28.48 | -37.00 | YES | 26.46 | 15.06 |
| 1973 | -10.36 | -4.80 | -14.67 | YES | -26.31 | 37.14 |
| 1974 | -10.14 | -17.99 | -26.31 | YES | 37.14 | 23.81 |
| 1982 | -7.77 | 31.74 | 21.50 | YES | 22.46 | 6.22 |
| 1966 | -6.85 | -3.41 | -10.02 | NO | 23.89 | 11.04 |
| 2001 | -6.70 | -5.56 | -11.89 | YES | -22.10 | 28.68 |
| AVERAGE | -12.85 | 0.85 | -11.69 | | 14.13 | 18.69 |

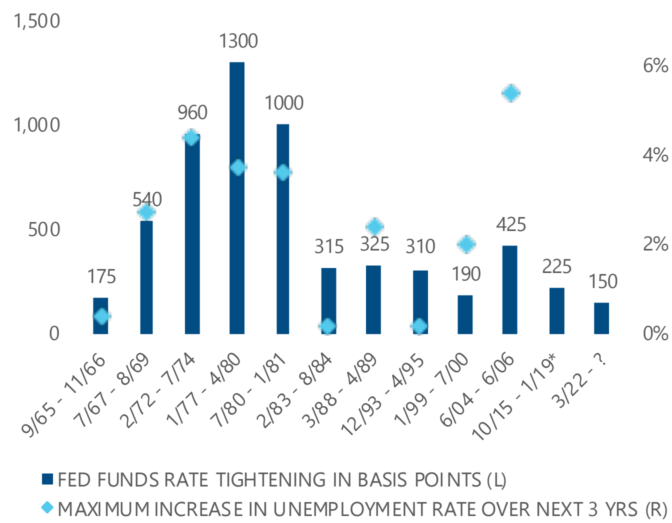
Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results contraction of Gross Domestic Product (GDP) and an increase in the unemployment rate between 2% and 5%.

Historical data shows Fed tightening cycles and equity market drawdowns of 20% or more occur alongside a recession about two-thirds of the time. We still feel confident in stating there is a decent (albeit shrinking) probability that a recession over the next 12 months is avoided. Even if a recession is in the cards, it could be relatively shallow like those in 1991 and 2001. Assuming we are already in a recession, or on the cusp of one, a good portion of the expected equity market declines have already occurred. As mentioned above, the current S&P 500 decline of roughly 20% represents about 63% of the 31.8% average decline associated with the ten U.S. recessions since 1945.

We expect elevated equity market volatility throughout the third quarter and into October given near-term uncertainty about the path of inflation and the Fed's subsequent reaction. We will most likely see a continuation of the "good news is bad news" paradigm in coming months in which strong economic data is greeted negatively by markets for fear that it could lead to a higher Fed policy rate target. Ultimately, we expect consumer inflation to cool at some point this summer and allow Fed policymakers to slow the pace of rate hikes. Given the generally healthy state of aggregate consumer and corporate balance sheets, we struggle to see how a protracted recession could occur within the next six months. We may very well see two consecutive quarters of negative U.S. GDP growth followed by two straight quarters of GDP expansion to close out the year. At these valuations, we recommend client portfolios remain overweight equities relative to fixed income and cash over the next 6 to 12 months. We will most likely reconsider our moderately pro-risk positioning if we see a sharp expansion of equity market multiples, or if inflation does not subside in coming months. We expect areas of the equity market that exhibit strong pricing power and better earnings visibility to outperform in the current environment. We believe fixed income portfolios should continue to benefit from keeping duration modestly below benchmark with an incremental preference for government bonds over corporate issues.

CHART 7

FED TIGHTENING AND THE UNEMPLOYMENT RATE




Source: Bloomberg. Data as of 6/30/22. Past performance does not guarantee future results. *The 10.8% increase in the unemployment rate from 2/29/20 to 4/30/20 is not shown due to scaling.

# ECONOMIC OUTLOOK AND INVESTMENT POLICY

| ECONOMIC FACTORS | CURRENT OUTLOOK |
|---|---|
| U.S. GDP Growth | The median estimate for 2022 U.S. real GDP growth in a Bloomberg survey of forecasters taken in early July declined to 2.1% from 3.9% at the beginning of the year. |
| Federal Funds Rate | Fed funds futures markets currently project Fed officials will increase the policy rate to roughly 3.50% by the end of 2022 and implement several 0.25% rate cuts in 2023. |
| Inflation | Market-based expectations for average annual inflation over the next two years have sank from roughly 4.40% in mid-June to about 3.00% in the second week of July. |
| Employment | U.S. initial weekly unemployment claims hit an 8-month high in early July, yet 11.25 million U.S. job openings in May suggest the domestic labor market remains tight. |
| Consumer Confidence | High gasoline prices and accelerating inflation in the spring drove May's University of Michigan's Consumer Expectations Index to its lowest level since 1980. |
| Oil | A deferred reopening of the Chinese economy and key middle eastern OPEC producers' limited extra capacity could offset a period of weaker oil demand. |
| Housing | Sharply higher mortgage rates will likely cool home buying activity in coming quarters in the hottest markets of recent years including Phoenix, Tampa, Miami, and Charlotte. |
| International Economies | Real GDP is expected to grow in 2022 by 2.7% in the euro zone, by 3.4% in the U.K., by 4.1% in China, and by 1.8% in Japan based on a recent Bloomberg survey of forecasters. |

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| FIXED INCOME | | ● | | | |
| Core Bonds | | | ● | | |
| TIPS | | | | ● | |
| Non-Investment Grade | | | | ● | |
| International | ● | | | | |

CURRENT OUTLOOK

Sharply higher U.S. Treasury yields and the increasing likelihood of a multi-quarter economic slowdown have made us revisit our fixed income underweight recommendation in recent months. For now, we still think a moderate underweight to bonds in a diversified portfolio is appropriate given the U.S. Federal Reserve seems committed to hike its policy rate until substantial signs of a slowdown in inflation emerge. We would be likely to increase our recommended target fixed income weighting if U.S. Treasury yields overshoot our projection of a reasonable federal funds rate-hike trajectory over the next 6 to 12 months. Additionally, signs of a substantial deterioration in U.S. labor market data or corporate profits would most likely lead us to advocate higher target weights to fixed income in client portfolios.

We believe fixed income portfolios should continue to benefit from keeping duration modestly below benchmark with an incremental preference for government bonds over corporate issues. Our allocation to Treasury Inflation-Protected Securities (TIPS) is under review given signs of a potential peak in inflation expectations. We are considering a moderate reduction in the size of our recommended allocation to non-investment grade bonds as the credit environment has become more challenged in recent months and short-term U.S. Treasury yields have approached levels we believe provide compelling relative value on risk-adjusted basis.

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| EQUITIES | | | | ● | |
| Large Cap | | | | ● | |
| Mid Cap | | | | ● | |
| Small Cap | | | | ● | |
| Developed International | | ● | | | |
| Emerging Markets | | ● | | | |

CURRENT OUTLOOK

We believe a moderate overweight to equity is still warranted at current valuations despite signs of a slowing global economy and the current Fed rate hike cycle. The sharp compression in the S&P 500 forward 12-month price-to-earnings ratio from 21.5 in the first week of January to 16.1 by quarter end likely discounts most of the economic and profit damage associated with a mild recession. Current valuation levels in broad-based U.S. equity averages are likely to be looked back upon favorably if a recession does not materialize. Relatively healthy aggregate corporate and consumer balance sheets and a strong domestic labor market should provide a buffer against any demand destruction related to higher interest rates and sharply elevated inflation.

We expect elevated equity market volatility over the next 3 to 4 months given uncertainty about the path of inflation and the Fed's subsequent reaction. We will most likely see a continuation of the "good news is bad news" paradigm in coming months in which strong economic data is greeted negatively by markets for fear that it could lead to a higher Fed policy rate target. We expect areas of the equity market that exhibit strong pricing power and better earnings visibility to outperform in the current environment. We would reconsider our equity overweight recommendation if we see a sharp expansion of equity market multiples, or if inflation does not subside in coming months.

| | MINIMUM | | NEUTRAL | | MAXIMUM |
|---|---|---|---|---|---|
| ALTERNATIVES* | | | | ● | |
| | CAP PRES | IWSG | BAL | GWSI | GROWTH |
| Global Real Estate | | | | | |
| Global Infrastructure | | | | | |
| Gold | | ● | ● | ● | |
| Hedged Equity | ● | ● | ● | ● | ● |
| Arbitrage | ● | ● | ● | | |

CURRENT OUTLOOK

Our allocation to hedged equity and arbitrage strategies are under review given the upward reset in short-term U.S. Treasury yields. The ultra-low interest rate environment of the last 12 years appears to be shifting to one in which market rates establish trading ranges meaningfully higher than existed for most of 2009 through 2021. In this environment, we expect the risk-adjusted return benefits of most alternative strategies to subside especially compared to safe haven assets including short-term U.S. Treasury notes.

Although gold did not produce positive absolute returns in the first six months of 2022, it did help limit the downside of diversified portfolios with exposure to sharp equity market drawdowns. We continue to believe a moderate allocation to gold should benefit portfolios over the next 6 to 12 months based on its tendency to behave as a safe haven asset in periods of equity market stress and benefit from inflationary regimes. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH).

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.
*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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| NOT A DEPOSIT | NOT FDIC INSURED | MAY LOSE VALUE | NOT BANK GUARANTEED |
|---|---|---|---|
| NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | | | |