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Market Review and Outlook

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Highlights

Equities continued their downward trajectory during the second quarter, as the S&P 500 Index notched another quarterly loss of -16.1% (-20.0% YTD).

Prolonged inflation, record gasoline prices and rising interest rates have spurred fears of recession—a high probability of which now appears to have been priced into the market.

Tight labor markets, still-healthy consumer/business spending, robust household/corporate balance sheets, resilient housing prices, and signs of decelerating inflation provide some level of comfort around economic stabilization, and could set the foundation for a recovery in equity prices.

Double-digit losses in the fixed income markets during the first half of 2022 marked the worst intra-year declines for bonds in over 40 years, but with prospective Fed rate hikes seemingly reflected in current bond yields, a more compelling outlook for the asset class is starting to take shape.

The risk-reward for both stocks and bonds looks favorable to us at current levels, as we see greater upside potential than downside exposure from here.

Market Review and Outlook

Global equities continued their downward trajectory during the second quarter, as the same concerns that pushed markets lower in the first quarter (surging inflation/energy prices, supply chain constraints, tighter monetary policy, and the conflict in Ukraine) elicited further losses in the second quarter. The S&P 500 Index suffered another quarterly decline of -16.1% (-20.0% YTD) and crossed into bear market territory. International stocks incurred similar downward pressure, with developed markets (MSCI EAFE) posting a second-quarter loss of -14.3% (-19.3% YTD) and emerging markets (EM) falling another -11.3% (-17.5% YTD).

Prolonged inflation, record gasoline prices and rising interest rates have spurred escalating recession fears among many investors. The 1.5% contraction in U.S. GDP reported for the first quarter—marking an abrupt reversal for an economy that was previously growing in the mid-single digits—caught most market observers off guard and provided further fuel to the argument that a sustained economic downturn may be forthcoming. Those predicting a looming recession point to the historic correlation between past Federal Reserve rate increase campaigns and subsequent economic downturns—noting there were 10 recessions associated with the last 13 rate hike cycles—which suggests a recession is more likely than a soft landing.

Meanwhile, the no-recession (yet) camp argues that economic fundamentals remain strong: labor markets are tight and unemployment levels are well below historical averages; consumer/business spending is healthy and additional energy infrastructure, automation and national defense spending is needed; household/corporate balance sheets are in the best shape in decades; housing prices remain resilient due to low inventories; and nascent signs of decelerating inflation have started to emerge.

Rather than trying to pinpoint when the next recession will begin, we find it more useful to look at past market downturns as a guide to assess how long and how deep markets could sell off in this cycle. The chart below indicates that modest market pullbacks (5-10% declines) and low double-digit corrections (10%-20% declines) are neither unusual nor typically long lasting. Even "crashes" of 20-40% have registered manageable recovery periods of just over one year. It's the rare, but more extreme bear market declines of 40%-plus (which have overlapped severe recessions) that take investors several years to fully recover their losses.

Declines in the S&P 500

(12/31/45 – 6/30/22)

Decline %	# of Declines	Avg. Decline %	Avg. Length of Decline in Months	Avg. Time to Recover in Months
5%-10%	86	-6.7%	1	2
10%-20%	28	-14.0%	4	4
20%-40%	9	-27.9%	11	14
>40%	3	-51.4%	23	58

Source: Guggenheim Investments

With the S&P 500 Index closing the first half of the year down 20% (the worst start to a year in more than 50 years), the market appears to have priced in a high probability of recession in the coming months. As illustrated in the following table, market selloffs that coincide with a recession tend to lead the economic contraction by an average of seven months and equity prices tend to bottom 5 months <u>before</u> the recession ends, on average.

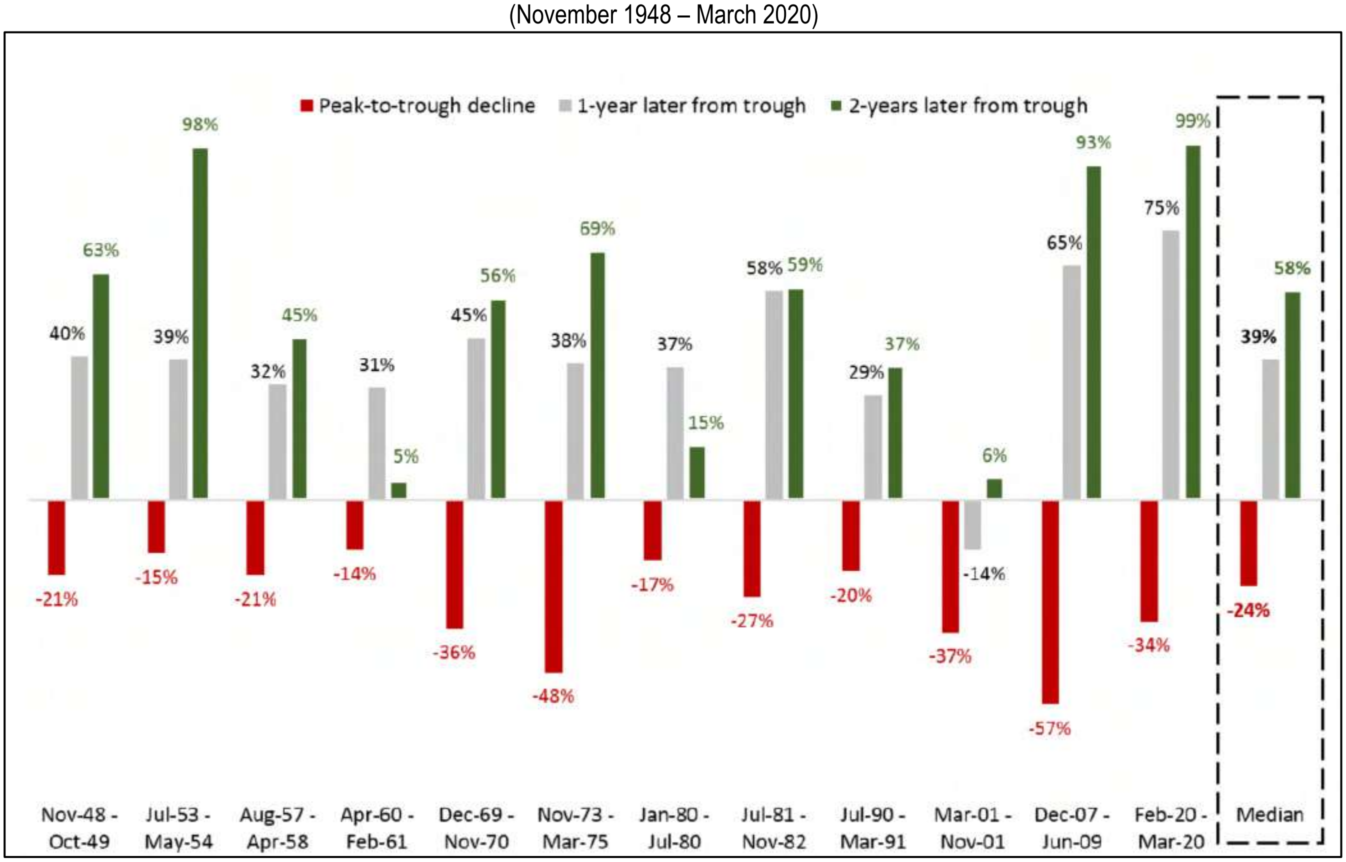
Market Peaks and Bottoms
(November 1948 – April 2020)

Recession Start	Recession End	Duration in Months	S&P 500 High	S&P 500 Low	# of Months Market Peaked Before Recession Start	# of Months Market Bottomed Before Recession End
Nov-48	Oct-49	10	Jun-48	Jun-49	6 months	5 months
Jul-53	May-54	11	Jan-53	Sep-53	7 months	8 months
Aug-57	Apr-58	7	Jul-56	Oct-57	11 months	6 months
Apr-60	Feb-61	9	Jul-59	Oct-60	9 months	4 months
Dec-69	Nov-70	10	Dec-68	May-70	12 months	6 months
Nov-73	Mar-75	16	Dec-72	Oct-74	11 months	5 months
Jan-80	Jul-80	6	Jan-80	Mar-80	0 months	4 months
Jul-81	Nov-82	15	Nov-81	Aug-82	8 months	3 months
Jul-90	Mar-91	8	Jun-90	Oct-90	1 month	5 months
Mar-01	Nov-01	7	Apr-00	Oct-02	13 months	11 months
Dec-07	Jul-09	17	Oct-07	Mar-09	2 months	3 months
Feb-20	Apr-20	2	20-Jan	Mar-20	1 month	1 month
				Average	**7 months**	***5 months***

Source: Glenview Trust, Bloomberg

While the median market decline during a recession is -24%, returns from the market bottom over the subsequent one- and two-year periods are typically up nearly 40% and 60%, respectively.

S&P Returns Around Recession
(November 1948 – March 2020)



Source: Truist IAG, FactSet, National Bureau of Economic Research (NBER)

It’s possible the current market drop proves more severe than the median decline and equities experience another sizable leg down from here. Based on historical trends, however, we are seemingly much closer to a market low than the high—even if we haven’t officially entered a recession yet.

In order for the market to find a bottom and start to recover, three things are likely required: (1) inflation needs to subside, (2) bond yields need to stabilize, and (3) corporate earnings need to continue to climb. While the latest inflation figures (CPI +8.6% annually in May) remain discouraging, resolution of some supply chain issues and a slowdown in global growth should ease inflationary pressures in the coming months. The Fed appears poised to raise interest rates through the balance of 2022 and into 2023, but with numerous rate hikes already priced into the fixed income markets, some stabilization in bond yields seems conceivable. The wildcard will be corporate profits. For now, consensus EPS growth estimates (+10% in 2022 and +9% in 2023) remain robust. The record profit margins generated in the preceding business cycle—from a combination of low inflation and low costs of capital—are seemingly at risk now, however, as those profitability tailwinds turn into headwinds from here. Thus, the key for sustained earnings expansion moving forward is for still-robust consumer spending strength to fuel sustained revenue growth.

Following the more than 20% peak-to-trough decline in equity prices during the first half of 2022, investors have become decidedly pessimistic about the near-term outlook. Though an economic slowdown seems inevitable at this point, the question remains whether we're headed for a mid-cycle slowdown or a deeper and more prolonged recession. The market has already priced in a high probability of a recession, which suggests that the stocks may be through the worst of the correction phase—even if economic conditions deteriorate further. That doesn't mean additional losses are off the table from here though, as we expect the investment climate to remain challenging with above-average volatility. Nonetheless, a swift and sustained recovery could ensue once the market finds a bottom—which historical trends suggest may be near.

Core Portfolio

During the second quarter, we sold our positions in Kraft Heinz and Pinterest.

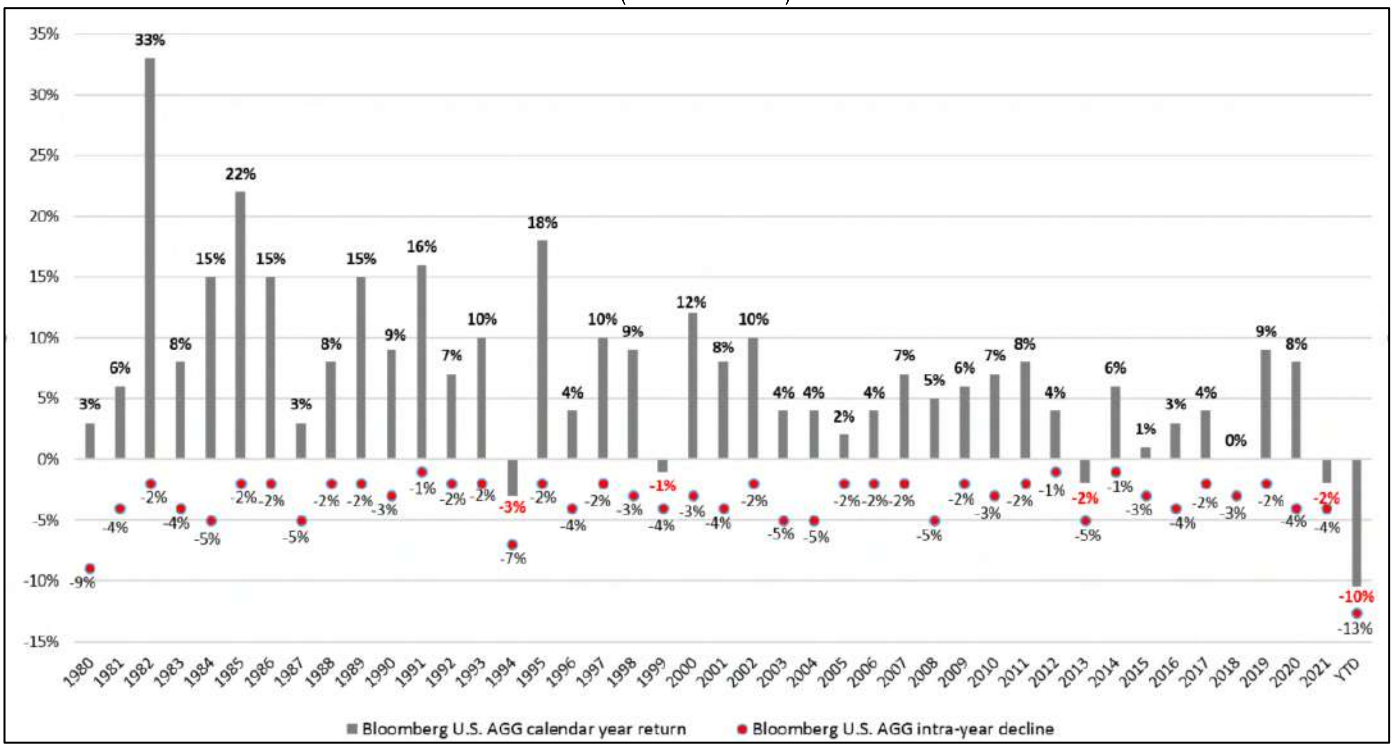
Kraft Heinz is the third-largest food and beverage manufacturer in North America (behind PepsiCo and Nestle) and the fifth-largest player in the world. We purchased the stock in early 2021, believing that food-at-home consumption could prove durable and lead to higher sales for the company going forward. Coupling this trend with the new management team's pre-pandemic operating efficiency and profit margin improvements, we saw Kraft as a respectable top- and bottom-line growth story trading at a relatively cheap valuation multiple. During the second quarter of 2022, investors piled into food and consumer staple names like Kraft as a defensive move amid deteriorating market and economic conditions. This pushed Kraft's stock price and valuation multiple to levels we no longer viewed as attractive—particularly with the company's high debt load. As a result, we sold our holding in Kraft to raise funds for future investment opportunities.

Pinterest is an online product and idea discovery platform that helps users gather ideas on everything from cooking recipes, to travel destinations, to home decorating projects. The company generates revenue by selling digital ads and is now rolling out more in-platform e-commerce features. While COVID lockdowns propelled Pinterest's monthly active user (MAU) base to more than 450 million people worldwide, MAUs have been declining recently as the economy reopened and people reduced the amount of time they spend in front of a screen. Also, while Pinterest has a differentiated use case versus other online-advertising platforms and ambitious monetization plans to capture more value from its users, those initiatives have been slow to transfer into actual profits. With MAUs projected to decline for another couple of quarters from their COVID-spurred highs and advertising revenue likely to become increasingly challenged by an economic slowdown/contraction, we believe the company's stock lacks a catalyst for near-term upside. Consequently, we decided to exit our holding.

Fixed Income

As the Fed hastily shifted toward a more assertive path of rate hikes to tame rampant inflation, the 10-year Treasury yield surged to 3.5% in mid-June—more than doubling its yield from the start of the year and swelling to its highest yield in over a decade—before settling back slightly below 3.0% by quarter-end. The spike in Treasury yields put downward pressure on bond prices, resulting in another 7% loss for the benchmark U.S. Aggregate Bond Index during the quarter. The index is now down 10% year-to-date and suffered its worst intra-year decline in over 40 years.

Bloomberg U.S. Aggregate Intra-Year Declines vs. Calendar Year Returns
(1/1/80 – 6/30/22)



Source: Bloomberg, FactSet, J.P. Morgan Asset Management
Returns based on total return. Intra-year drop refers to largest market drop from a peak to trough during the year.

The long-held argument for fixed income allocation is that bonds provide liquidity, portfolio diversification (offsetting equity volatility), and positive total returns. Those attributes are not assured all of the time, however, as fixed income securities also involve risks and at times, produce negative returns. It's important to remember though that bond coupon and principal payments are guaranteed (unless the issuer defaults) and will be the primary components of long-term total returns. The price volatility of bonds experienced recently doesn't affect those payments. And at current yields, the risk/reward for owning fixed income has improved considerably from the ultra-low yields of the past couple years.

While the Fed is still early in its rate hiking cycle, bond yields now seemingly reflect a material portion of those anticipatory rate increases. Thus, like equities, the deepest of the potential fixed income losses are conceivably in the rearview mirror. We still don't believe the real (after inflation) return profile for longer maturity bonds is attractive, but a more compelling outlook for short and medium-term bonds and the asset class overall is starting to take shape.

Final Thoughts

It has been a turbulent six-month period for investors, but market pullbacks are a normal (and healthy) part of investing. Rather than act on emotion, it's important to put these corrections in context. Since the dot-com bubble in 2000, investors in the stock market have lost about half of their money twice in significant bear markets; yet the S&P 500 Index today is up more than 2x from its 2000 peak. While the short-term market outlook remains clouded and prices could move lower from here, history shows that long-term investors who stay invested in challenging periods prosper on the other side. We expect this down cycle to be no different.

Thank you for the trust and confidence you continue to place in us as we all manage through this unnerving market phase.

Hang in there everyone!

Parkside Investments, LLC

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