PARKSIDE INVESTMENTS

Phone: 312/778-7700
Web: parksideinv.com
Email: info@parksideinv.com

Market Review and Outlook

3Q22

Highlights

Equities sustained a third straight quarter of negative returns during the third quarter due to growing concerns about elevated inflation rates and the potential for a Fed-induced recession.

Household, corporate, and banking sector balance sheets all remain healthy, which should help to insulate the economy from the systemic stresses that often cause a severe recession.

Market P/E multiples and other valuation metrics are now back in line with (or below) historical averages.

Forward earnings estimates are likely to come down as higher interest rates slow down the economy, but we don't currently foresee a scenario where corporate earnings suffer the massive declines that typically accompany a deep/prolonged recession.

Fixed income securities suffered further price declines in the quarter, due to another surge in Treasury rate yields.

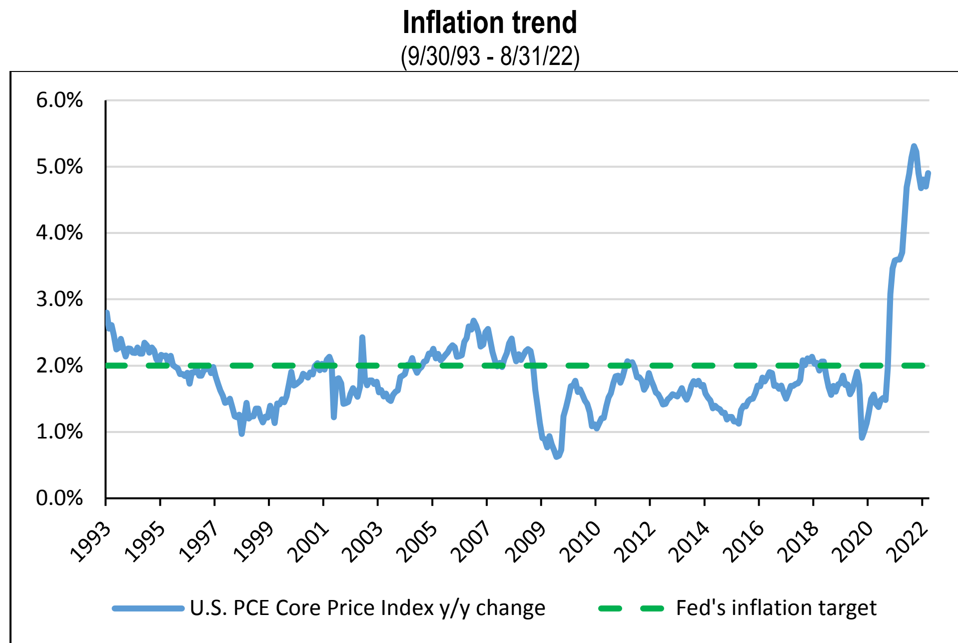
The majority of Treasuries now offer their highest starting yields in more than a decade, making the strongest case for investors to increase bond exposure (and duration) in a number of years.

The balance of 2022 could remain choppy, but we expect both equity and bond markets to steadily improve over the medium term.

Market Review and Outlook

Global equity markets extended their losses in the third quarter—marking three straight quarters of negative returns. While stocks initially rallied early in the quarter, the mid-summer recovery quickly eroded as it became increasing clear that central banks would continue to aggressively boost interest rates in an effort to tame rising costs. The S&P 500 Index dipped below its previous 2022 low set in June and closed the quarter down another -4.9% (-23.9% YTD). International markets incurred an even steeper selloff, with developed markets (EAFE) reporting a quarterly decline of -9.3% (-26.8% YTD) and emerging markets (EM) posting a third-quarter loss of -11.4% (-26.9% YTD).

Inflation remains the most important factor shaping the market backdrop, as its trajectory will directly influence the pace of monetary tightening and, in turn, economic growth. The year-over-year change in core personal consumption expenditures (PCE), the Federal Reserve's preferred measure of inflation, remains well above the Fed's 2% inflation target, suggesting that more restrictive monetary policy is likely to ensue in the coming months until inflation is brought back down to more desirable levels.



Source: FactSet

With commodity prices such as oil, copper and lumber falling more than 35%, 30%, and 70% from their respective peaks, there was hopeful speculation that inflation may be receding on its own. However, broader inflation measures continue to show demand-driven inflation has now proliferated in the wider economy—fueled by a strong job market that is boosting incomes. Escalating wages are forcing companies to increase prices to cover higher labor costs, while at the same time continuing to give more consumers the ability to spend. Consequently, the market has become increasingly concerned there is only one way for the Fed to slow robust consumer demand: aggressively raise interest rates in order to stymie corporate investment, increase unemployment, and potentially trigger a recession.

If a recession were to develop, it's reasonable to believe that it could be relatively short and shallow. Household, corporate, and banking sector balance sheets all remain healthy, which should help to insulate the economy from the systemic stresses that often cause a severe recession. Moreover, corporate

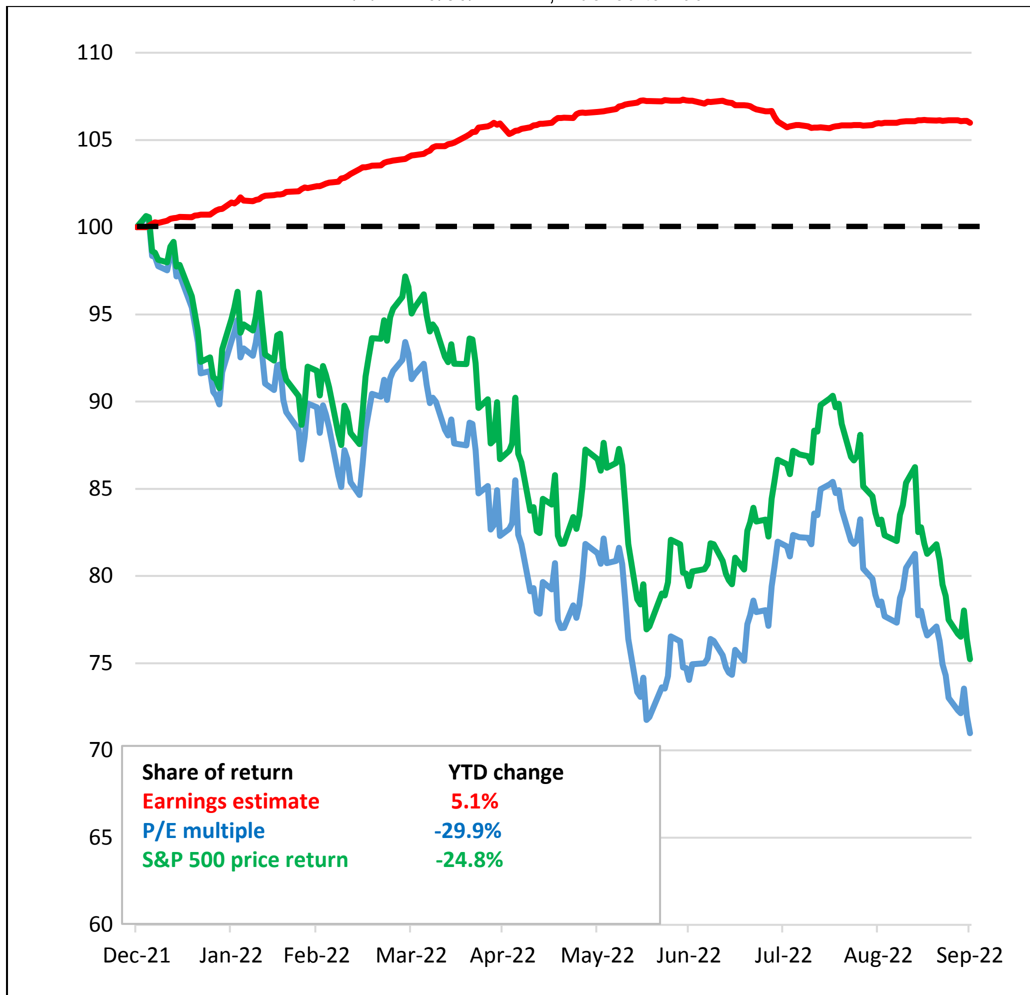
earnings erosion tends to be more modest during inflation-driven recessions versus credit-driven recessions. For example, during the inflation-driven recessions of both 1973-1974 and 1982-1983, S&P 500 profits fell 15% and 14%, respectively. This compares with a profit decline of 32% during the early-2000s tech crash and a 57% earnings plunge during the 2007/08 Great Financial Crisis.

During the first half of 2022, earnings proved surprisingly durable and are still projected to be up 7% for the full year. Looking out into 2023, S&P 500 EPS growth expectations have been dialed back slightly in recent months, but consensus estimates continue to forecast another 8% increase in earnings next year. However, the ongoing deceleration in global economic expansion certainly leaves current EPS growth forecasts vulnerable to additional downward revisions in the near term. We expect earnings estimates will indeed come down, but we don't foresee a scenario at this point where earnings suffer the massive 30%-plus declines that typically accompany a deep/prolonged recession.

Given that forward earnings projections are still 5% higher than where EPS estimates were at the start of the year, the market's year-to-date price declines can be explained entirely by valuation multiple compression.

Percent change in S&P 500, earnings and valuations

1/1/22 – 9/30/22 YTD, indexed to 100

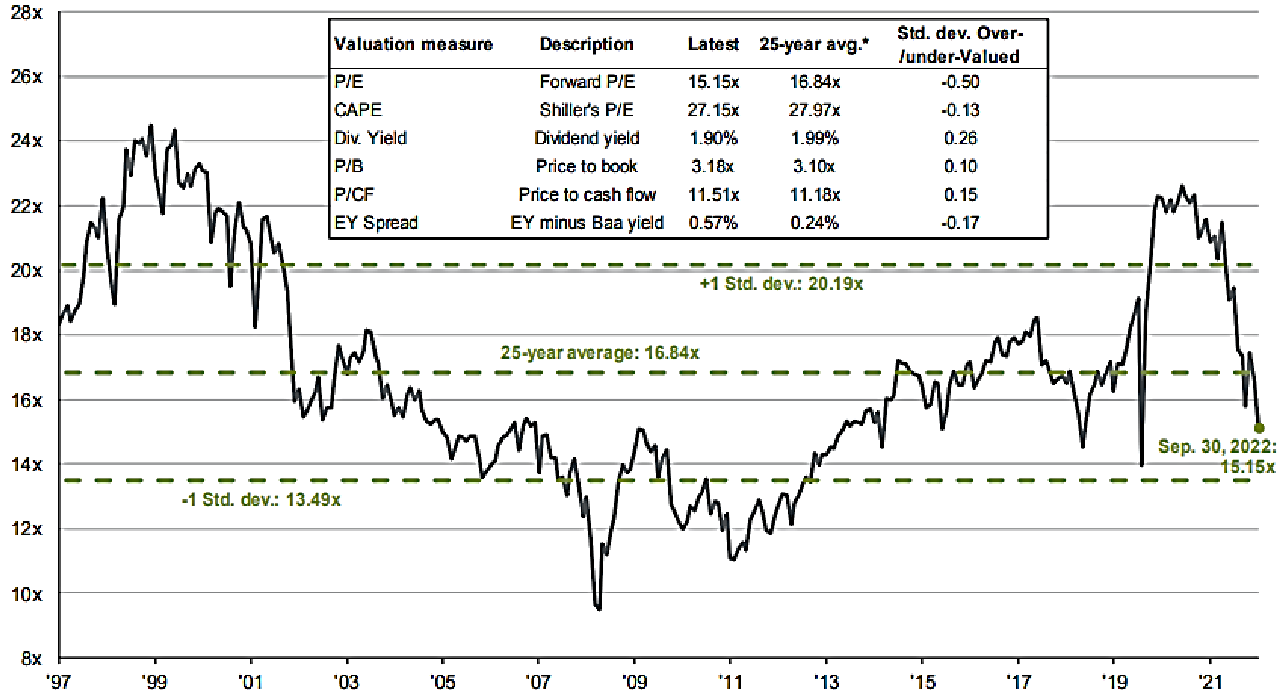


Source: FactSet, J.P. Morgan Asset Management

With the S&P 500 closing the third quarter trading at 15x forward earnings, the market's P/E multiple is now 10% below its long-term average. Other valuation measures have also moved back in line with (or below) normalized levels, as shown below.

S&P 500 Index: Forward P/E ratio (and other valuation metrics)

(12/31/97 - 9/30/22)



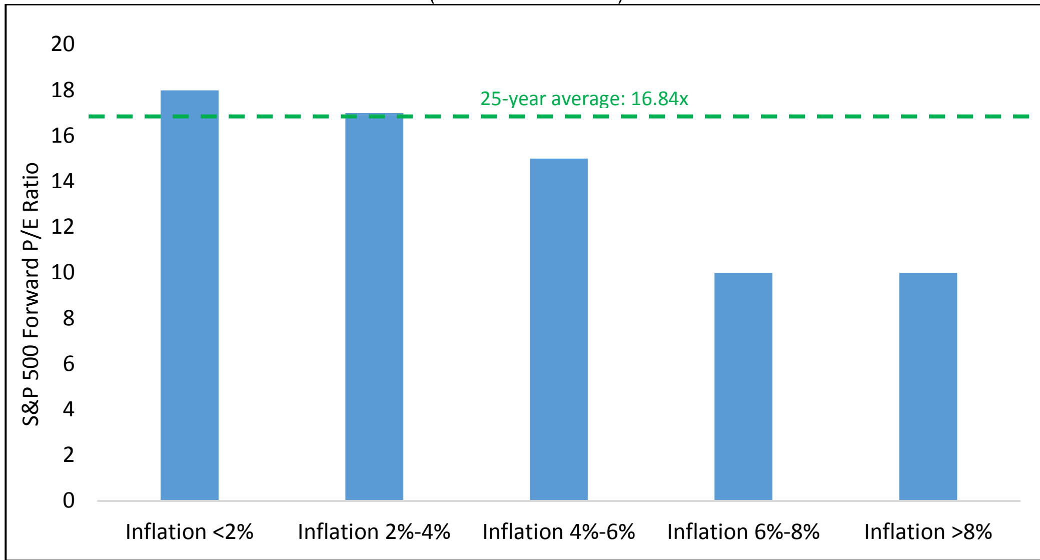
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.15x	16.84x	-0.50
CAPE	Shiller's P/E	27.15x	27.97x	-0.13
Div. Yield	Dividend yield	1.90%	1.99%	0.26
P/B	Price to book	3.18x	3.10x	0.10
P/CF	Price to cash flow	11.51x	11.18x	0.15
EY Spread	EY minus Baa yield	0.57%	0.24%	-0.17

Source: FactSet, FRB, Refinitive Datastream, Robert Schiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

Despite valuation multiples falling back in line with historical averages, further downside is possible for two primary reasons. As noted earlier, current earnings estimates used to calculate the P/E multiple could prove overly optimistic given prevailing economic headwinds. If EPS estimates move lower, stocks are likely to follow. We expect the 2023 EPS estimates to be particularly susceptible to downward revisions moving forward, as Fed rate hikes impact the real economy with a lag.

Even if corporate earnings were to prove resilient in the face of rising interest costs and higher labor expense, equity prices could compress further if inflation proves persistent. Historically, low inflationary periods (like the sub-2% inflation environment prior to 2022) typically translate into higher P/E multiples for stocks, while high inflationary periods (such as the current >8% inflation backdrop) are often characterized by much lower P/E multiples—as higher interest rates are needed to control inflation. Thus, it's plausible that market valuation multiples could compress further if inflation rates continue to trend in the mid-single digits or higher.

Average P/E ratio under various inflation scenarios
(12/31/62 – 9/30/22)

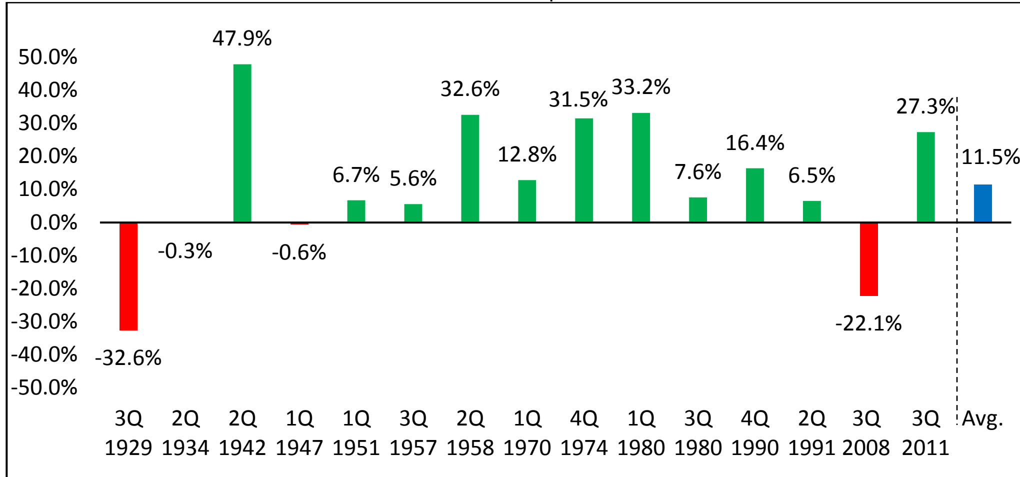


Source: LPL Research, Bloomberg (Data 1962-2022)
Inflation represented by annual change in the Consumer Price Index (CPI)

It remains debatable as to whether the U.S. is about to enter (or already in) a recession, but the persistence and breadth of inflation suggest that the road back to the Fed's targeted 2% inflation environment may be a difficult one. While the market has seemingly already priced in a fair degree of bad news and high probability of recession, a longer period of churning and volatility (with additional downside potential) could be in the offing until the Fed dials back its aggressive interest rate hiking posture.

That said, during periods of market anxiety—often when headlines appear dire and investor sentiment is diminished—early hints of an inflection point typically ignite a new bull market cycle well before the recession ends. There are already signs that: (1) the housing market is cooling; (2) labor market tightness is slowly easing; (3) supply chains are normalizing; (4) commodity prices are softening; and (5) consumer demand is moderating as the Fed's rate hikes slow the economy. Thus, there is reason to believe inflation will gradually reverse in the coming months and interest rates could stabilize in early 2023—which would provide a much needed catalyst for equity markets. Once consistent monthly data confirms peak inflation has been reached, equities typically deliver solid returns over the ensuing 12-month period.

Equity performance following prior inflation peaks
S&P 500 return 12 months after peak inflation, 1927-2022



Source: BlackRock

In the interim, investors should prepare for a choppy environment to continue for the balance of the year. Trying to time the market usually produces disappointing results, so we avoid placing short-term directional bets. Instead, we plan to stay disciplined against chasing speculative market rallies and will capitalize on oversold pullbacks by selectively allocating additional capital to the stocks where we have high conviction of long-term price appreciation. This should position portfolios well for whenever the macro picture turns less negative and the next bull market rally commences.

Core Portfolio

During the second quarter, we sold our positions in Bausch Health Companies and Bristol-Myers Squibb.

Bausch Health is a global specialty pharmaceutical, consumer health, and medical device company with a focus on branded products for the dermatology, gastrointestinal, and ophthalmology markets. While the company is a complex amalgamation of several distinctly different business segments, we saw value in the core Bausch & Lomb visioncare business (~45% of revenue) that was being distorted by Bausch Health's other less attractive businesses. We viewed management's proposed plan to spin Bausch & Lomb off into a separate, publicly-traded entity as an attractive value-enhancing strategy for shareholders. While we continue to like the long-term growth prospects of the Bausch & Lomb visioncare business, Bausch Health has encountered a number of issues (including a protracted patent dispute) that have already delayed—and could potentially derail—the company's separation plan. Given Bausch Health Companies' heavily levered balance sheet, the risk of waiting for the value-enhancing business separation to occur amid a deteriorating macroeconomic backdrop appeared to outweigh the potential upside opportunity. As a result, we decided to sell our stake in the company and reallocated the capital into existing holdings where we saw a higher probability of positive outcomes.

Bristol-Myers Squibb discovers, develops, and markets drugs for various therapeutic areas, such as cardiovascular, cancer, and immune disorders. We were initially attracted to Bristol-Myers due to its cheap valuation. The shares had been under pressure in recent years, as investors were concerned about generic competition to Bristol's blockbuster cancer-drug Revlimid ahead of its key patent expiration in March 2022. While Revlimid accounted for ~30% of Bristol's revenue, we believed a strong portfolio of other branded

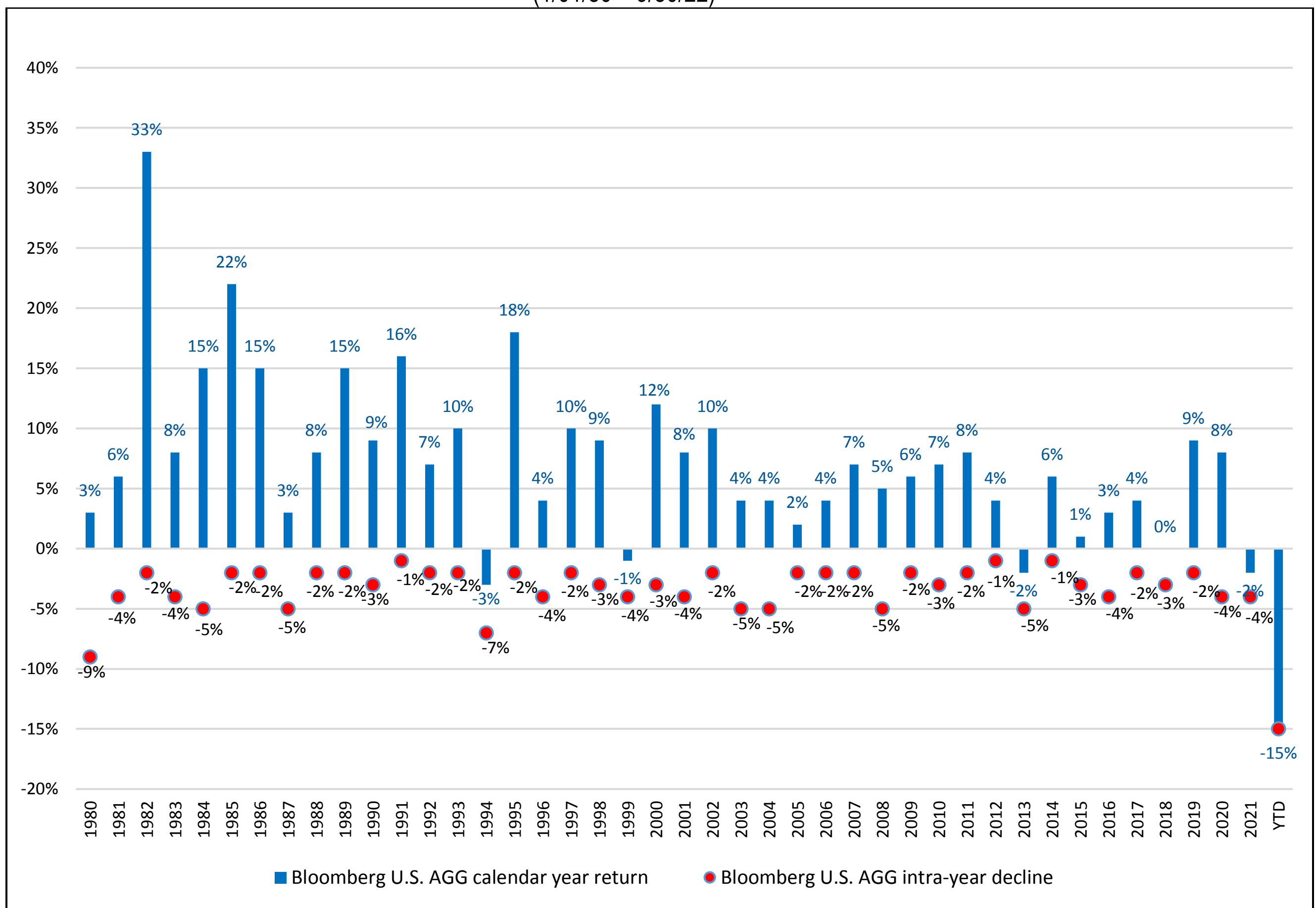
drugs with expanding applications and a promising pipeline of developmental drugs would more than offset the anticipated erosion of Revlimid sales that had already been built into Bristol's share price. That thesis has already partially played out, but we believe the shares could face several challenges moving forward. The recent release of disappointing trial results for a promising pipeline drug to treat secondary strokes prompted us to re-evaluate the increased risk of relying on new/unproven drugs to replace existing revenues. Although it is possible Bristol-Myers will successfully bridge declining Revlimid sales with revenues from new drugs, we would rather increase our ownership in businesses where we have substantially more confidence in the runway for future revenue/profit growth.

Fixed Income

Due to ever-increasing Fed rate hike expectations, the 10-year Treasury yield surged another 0.85% during the third quarter and has now increased more than 2.3% year-to-date (after increasing around 1.0% from the 2020-low during 2021). The more than 3.0% spike in yields that has already taken place this cycle is the biggest surge in yields since 1987. The move higher in yields continues to put downward pressure on bond prices. The benchmark U.S. Aggregate Bond Index reported another -4.8% loss for during the third quarter and is now down 14.6% year-to-date, marking its worst intra-year decline in over 40 years.

Bloomberg U.S. Aggregate intra-year declines vs. calendar year returns

(1/01/80 – 9/30/22)



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.

If there is a silver lining to the painful decline in bond prices (and rise in rates) this year, it is that fixed income securities now offer much better starting yields to generate income for investors. Across most of the spot Treasury rate curve, yields haven't been this high in more than a decade. Unlike equities, bonds provide guaranteed coupon and principal payments (assuming there is no default), which are the primary drivers of long-term total returns. While it's unusual to see the level of volatility (decline) in bond prices that has occurred this year, the price volatility doesn't affect those coupon and principal payments. Since we've emphasized fixed income investments in shorter duration instruments the past few years, we will be able to more quickly recoup our original principal and reinvest that capital at higher yields as those bonds mature. With more attractive yields further out on the maturity curve, we feel increasingly comfortable extending duration modestly to capitalize on those higher rates.

Final Thoughts

The past nine months have been a sobering period for investors, as meaningfully negative returns for stocks (and bonds) this year make the outsized equity gains reported over each of the previous three years seem like a distant memory. While market pullbacks are a natural and expected part of investing, it doesn't make the selloff any less painful or frustrating. We can't predict precisely when stocks and bonds will regain their footing, but we are confident they will in the not too distant future—as they have done following every market downturn that has preceded this one.

We appreciate your continued confidence and support as we navigate this challenging backdrop together.

Stay positive everyone…brighter skies will eventually peek through!

Parkside Investments, LLC

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