Complimentary Report

MarketDesk

Featured Report *(starts on page 2)*

4Q 2022 Asset Allocator's Guide

Quarterly Roadmap to Enhance Investment Committee Decisions

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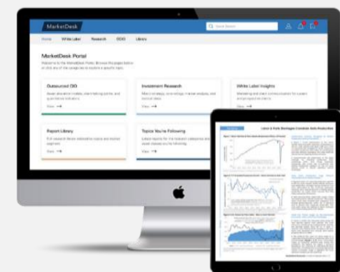

Client Testimonials

Founder at $170M RIA

" Every advisory team should be using MarketDesk if they want to spend more time growing their practice.

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" I was tired of being pitched the latest & greatest from wholesalers. MarketDesk increased our asset allocation conviction. Clients are happy. We're happy.

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" MarketDesk is the independent partner we've spent years searching for. It's already replaced multiple resources we previously used.

4Q 2022 Asset Allocator's Guide

MarketDesk Research

Quarterly Report

October 5, 2022

Remaining Patient as the Data Catches Up

Current Market Themes & Portfolio Implications

The path forward for both equity and credit markets is dependent on two uncertain and connected variables. Fed policy is the primary driver, which in turn places outsized importance on inflation. Markets spent 3Q22 trying to predict when the tightening cycle will end, how high the Fed will raise rates, and when the Fed's next pivot will occur. The market's focus made third quarter trading bumpy as investors priced in a shorter tightening cycle and 2023 interest rate cut but then unwound those views after August's inflation report and Fed Chair Powell's Jackson Hole speech.

Investors are celebrating June's +9% y/y headline CPI growth as peak inflation and using leading indicators to forecast lower inflation. The celebration overlooks the divergence in headline and core CPI during August (i.e., headline CPI decreased from June but core CPI increased) and a big tail risk – wage inflation. Data shows labor markets remain incredibly tight (**Figure 17**), and the pandemic has shifted power to employees and emboldened them to request higher wages. Employers are raising wages to attract and retain employees, and wage inflation is likely to be passed through via higher prices for goods and services. The risk is wage inflation keeps goods and services inflation high and forces the Fed to raise interest rates longer and higher. It's a big tail risk for risk assets.

We continue to favor a risk-off investment approach. The goal is to weather increased volatility and constantly changing trends as the market charts a path forward. Despite our risk-off stance, we favor capturing gains from defensive sectors and factors after the August / September sell-off. Sentiment is highly negative, and the market is vulnerable to a rally on positive news, such as the UK's decision to buy long-duration UK bonds to provide liquidity to UK pensions. While we would not be surprised to see a rally during 4Q22, we continue to view any bounce as a bear market rally. Macro data and themes, such as ISM Mfg PMI, housing, and quantitative tightening, and corporate fundamentals, such as earnings growth, have not bottomed yet. Remain patient as the business cycle takes time to play out and the macro setup deteriorates.

Notable Positioning Views

- **Large vs Small Caps:** Remain OW Large Caps due to EPS contraction risk (**Figs 12-14**)
- **Value vs Growth:** Remain neutral as risk transitions from P/E multiple contraction to negative EPS growth (**Figs 15-17**); Growth on upgrade watch
- **International:** Remain OW Emerging & UW Developed; Remain tactically UW Europe
- **Credit Duration:** Maintain Long Duration OW as credit quality becomes bigger risk; The longer rates are elevated, the more likely a recession, and the more attractive long-duration bonds
- **Credit Quality:** Remain UW Corp HY & OW Corp IG (**page 11**); Remain tactically OW BB bonds

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Core Asset Allocation Ratings

Long-term View & Rationale

- Overweight (OW) — Favor actively holding a higher weight than the broad index. Comfortable letting winners run and increasing exposure after selloffs.
- Marketweight / Neutral (N) — Market areas offering limited differentiation vs the broad index.
- Underweight (UW) — Favor actively holding a lower weight than the broad index. Potential areas of risk (i.e. underperformance, macro / thematic headwinds)

Asset Class	Allocation View				Rationale
	Chg.	UW	N	OW	
U.S. Equities					
Large Caps		•	•	●	Large Cap Growth OW still a headwind but less of a risk of profit margin contraction & negative EPS revisions than Small Caps
Mid Caps		•	●	•	Remain Neutral rated due to mixture of Large & Small Cap fundamentals
Small Caps		●	•	•	Higher risk of profit margin contraction (3Q22 AA Guide Fig 13) & negative EPS revisions (3Q22 AA Guide Fig 14) than Large Caps
International Equities					
Emerging		•	•	●	China lockdowns & regulatory policy = risks; Fed policy already priced in & USD strength = positive catalyst (2Q22 AA Guide Fig 21)
ACWI ex U.S.		•	●	•	Weak USD = positive catalyst (2Q22 AA Guide Fig 21); Geopolitical tensions have bigger impact on international than U.S. equities
Developed		●	•	•	Soaring energy prices = Europe headwind (3Q22 AA Guide Figs 21-22); Weak yen = DM Asia risk as Japan policy diverges
Fixed Income					
Long Duration		•	•	●	Historically outperforms short duration late in economic cycle & after -3 stdev drawdowns (2Q22 AA Guide Figs 27-29)
EM Sovereign		•	•	●	Fed & EM central bank rate hikes already priced in; Favor local currency; Refer to 4/22/22 tactical report
Investment Grade		•	•	●	Lower credit risk vs HY = Less risk of credit spread expansion as Fed tightens; More attractive in 2H22/1H23 as credit risk increases
Preferreds		•	●	•	Negatively impacted by rising rates & equity market selloff YTD; Further downside risk during 2H22 if equity selloff continues
Municipals		•	●	•	Decision to not raise individual & corporate tax rates decreases value of tax benefit
MBS		•	●	•	Less Fed purchases + negative convexity (slowing prepayments extend duration); Focus on managing duration, such as MBSD
TIPS		•	●	•	% Y/Y growth already at multi-decade high; We expect inflation to ease in 2H22 as supply chains improve & the base effect rolls off
High Yield		●	•	•	Risk shifting from duration to default after 1H22 selloff (3Q22 AA Guide Fig 24) & credit spread blowout (3Q22 AA Guide Fig 28)
U.S. Sectors					
Cons Staples		•	•	●	Defensive sector attractive late economic cycle (2Q22 AA Guide Figs 18-19) due to margin contraction risk (3Q22 AA Guide Fig 19)
Utilities		•	•	●	Defensive sector attractive late economic cycle (2Q22 AA Guide Figs 18-19) due to margin contraction risk (3Q22 AA Guide Fig 19)
Health Care		•	●	•	Another defensive sector option, but 2022 midterms could increase sector volatility
Financials		•	●	•	Headwinds > tailwinds — Late economic cycle + soaring interest rates = increased recession / default risk
Tech		•	●	•	Higher interest rates, rising real yields, & inflation could weigh on valuations; Likely more attractive during 2H22
Comm Svcs		•	●	•	Mixture of Growth & low-beta telecom; Regulatory risk = significant headwind; Streaming industry fundamentals weak
Energy		•	●	•	Drilling activity increasing as oil prices rise (3Q22 AA Guide Fig 11); Accelerated Fed tightening increases recession risk
REITs		•	●	•	Expect hard hit property valuations, such as hotels, offices, & retail, to improve as reopening resumes; Offers inflation hedge
Cons Disc		•	●	•	Consumer spending above pre-pandemic trend, but inflation & elevated recession risk = potential headwinds
Industrials		●	•	•	Historically underperforms after ISM Mfg PMI expansion (2Q22 AA Guide Fig 19); Heightened risk of profit margin contraction
Materials		●	•	•	Historically underperforms after ISM Mfg PMI expansion (2Q22 AA Guide Fig 19); Heightened risk of profit margin contraction
U.S. Equity Factors					
Growth		•	●	•	Rising real yields continue to weigh on NTM P/E multiple, but Growth factor risk of profit margin contraction is less than Value
Value		•	●	•	Trend of rising real yields weighs less on Value than Growth, but falling PMI points to negative EPS surprises (3Q22 AA Guide Fig 17)
Momentum		•	●	•	May 2022 rebalances leaves MTUM OW defensive sectors AFTER 1H22's selloff & UW Growth factor AFTER the factor's 1H22 selloff
Minimum Volatility		•	●	•	Protects against increased volatility, but no clear upgrade catalyst; Prior year Min Vol stocks (i.e., Growth) = 2022 high vol stocks
High Dividend		•	●	•	Sector exposure suited for current macro environment, which may not last
High Beta		●	•	•	Broad mixture of factor & industry exposure – Volatility shifting from Covid-19 to 'Growth-style' selloff & idiosyncratic events

Note: The ratings represent our asset allocation view for the next 6-12 months. Arrows indicate a positive (▲) or negative (▼) change in view since the prior report.

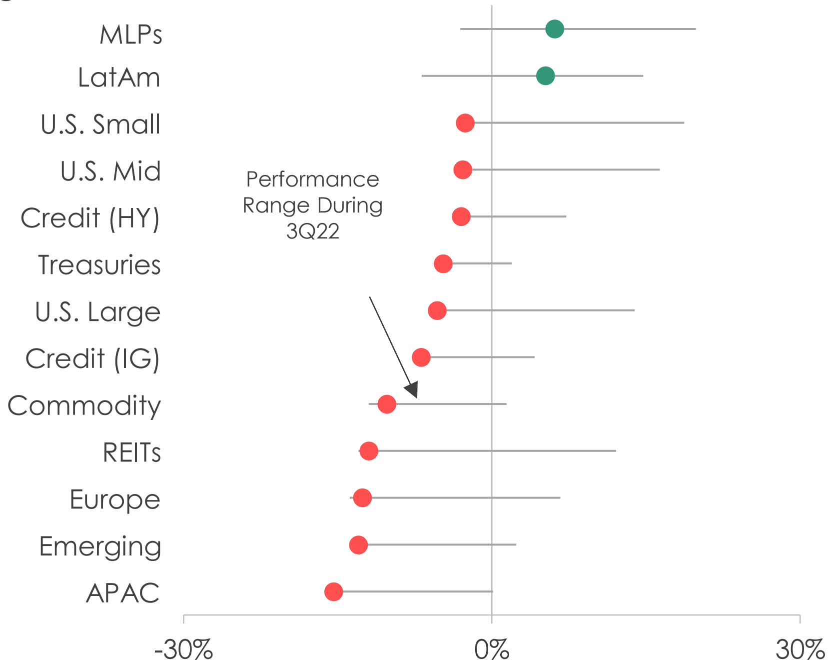
Asset Class Performance

Recap since last edition of the Asset Allocator's Guide

Asset Class	Total Return (%)			Valuation & Yield			Asset Flows[1]		Price Chart
Global Equities	**3Q'22**	**1Yr**	**3Yr**	**NTM P/E**	**P/B**	**Div Yld**	**3Q'22**	**Last 2Yrs**	**YTD**
U.S. Large Caps	-4.9	-15.5	26.4	15.1x	3.5x	1.7%	↑ 2.4%		
U.S. Mid Caps	-2.5	-15.4	18.5	11.2x	2.1x	1.4%	↑ 1.4%		
U.S. Small Caps	-2.1	-23.6	13.1	16.9x	1.8x	1.4%	↑ 0.9%		
Europe	-12.3	-27.1	-5.9	11.2x	1.6x	4.4%	↓ 23.2%		
Asia-Pacific	-15.4	-29.5	-7.1	11.2x	1.4x	3.0%	↑ 2.1%		
Latin America	5.2	-0.3	-11.8	6.4x	1.4x	10.6%	↓ 3.1%		
Developed	-10.4	-25.1	-6.0	11.0x	1.4x	5.3%	↑ 0.9%		
Emerging	-13.0	-29.1	-8.9	10.4x	1.5x	3.1%	↑ 0.5%		
U.S. Sectors									
Comm Services	-12.2	-41.0	-2.4	16.4x	2.5x	1.2%	↑ 1.4%		
Cons Discretionary	3.8	-20.0	21.2	21.6x	8.0x	0.9%	↓ 1.1%		
Cons Staples	-7.0	-0.6	17.6	18.4x	5.5x	2.7%	↑ 2.8%		
Energy	1.8	44.4	46.0	7.9x	2.1x	4.0%	↓ 6.8%		
Financials	-3.0	-17.5	15.5	10.8x	1.3x	2.2%	↑ 1.1%		
Health	-5.2	-3.4	41.8	15.0x	4.5x	1.6%	↑ 4.1%		
Industrials	-4.7	-14.0	12.3	15.2x	4.4x	1.8%	↓ 8.4%		
Materials	-7.1	-12.2	24.3	12.5x	2.5x	2.4%	↓ 14.1%		
Tech	-6.3	-19.8	52.0	18.4x	7.2x	1.0%	↑ 2.8%		
Utilities	-6.0	5.6	11.3	17.8x	2.1x	3.0%	↑ 6.5%		
Fixed Income									
Treasuries	-4.4	-13.1	-9.4	-	-	1.5%	↑ 16.4%		
Invest. Grade	-6.2	-20.9	-13.0	-	-	3.1%	↑ 3.7%		
High Yield	-1.7	-14.6	-5.9	-	-	5.2%	↓ 9.2%		
Alternatives									
REITs	-11.0	-18.7	-4.8	16.5x	2.6x	3.8%	↓ 3.6%		
MLPs	8.1	18.8	6.3	9.3x	1.8x	7.9%	↓ 0.5%		
Commodities	-10.2	18.5	61.5	-	-	-	↓ 5.6%		

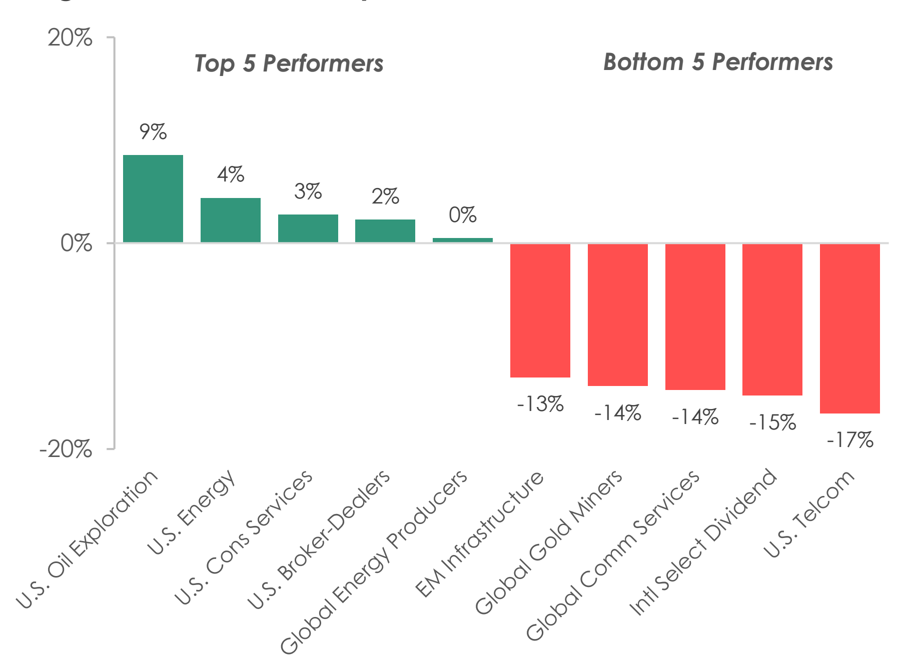
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

Figure 1: Asset Class Performance — 3Q 2022



Source: MarketDesk

Figure 2: Global Industry Performance — 3Q 2022

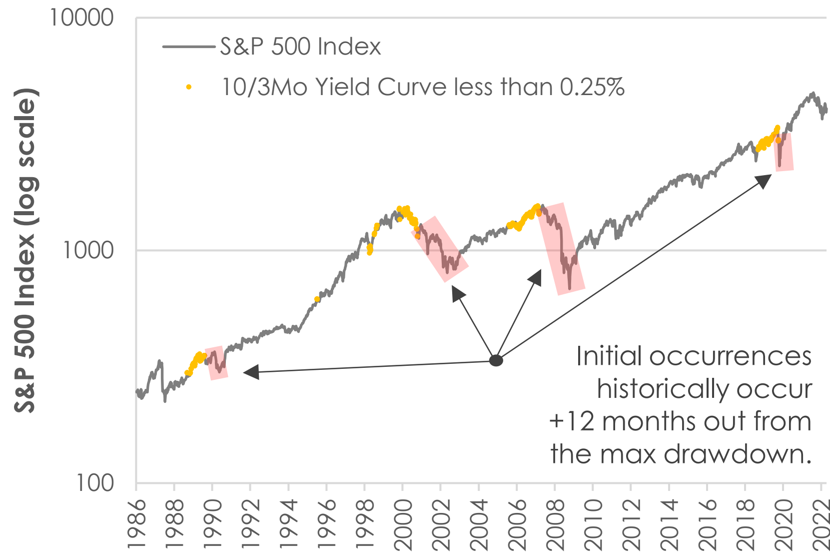


Source: MarketDesk

Charts That Will Shape 4Q 2022

Six charts likely to drive the market narrative this quarter

Figure 3: S&P 500 Performance Following 10Y-3Mo Inversion

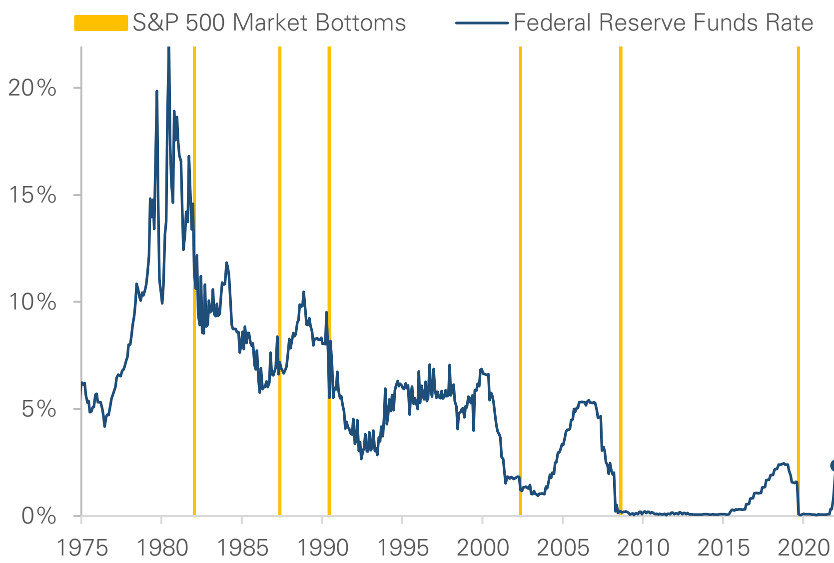


Source: MarketDesk, FactSet, U.S. Treasury

Figure 4: Bear Market Rallies During 2007-2009 Timeframe

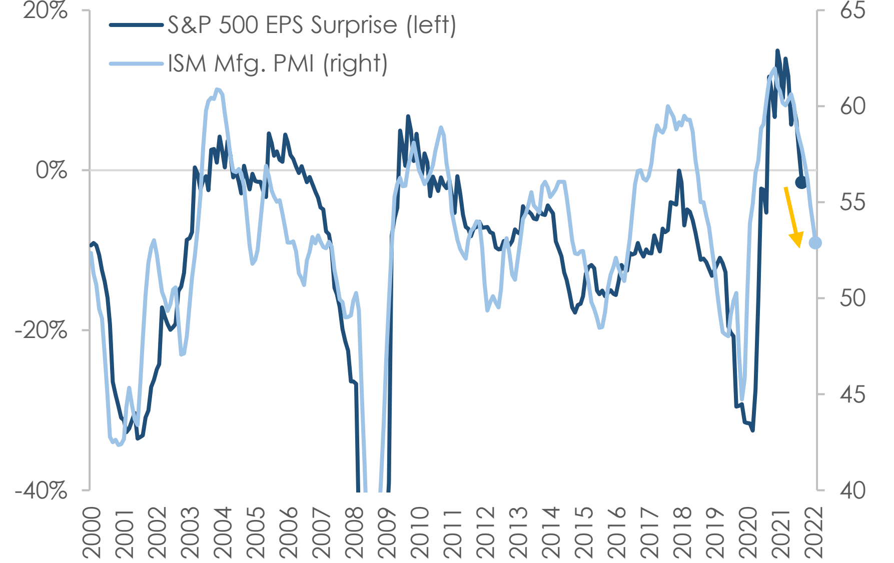
Source: MarketDesk, FactSet

Figure 5: Markets Typically Don't Bottom Until 1st Fed Rate Cut



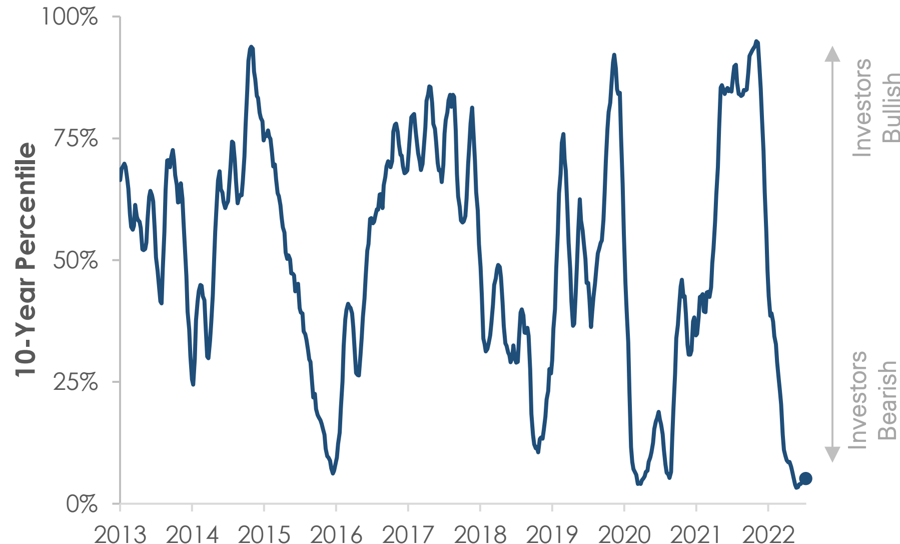
Source: MarketDesk, Federal Reserve

Figure 6: Expect Weak EPS Results over the Next 12 Months



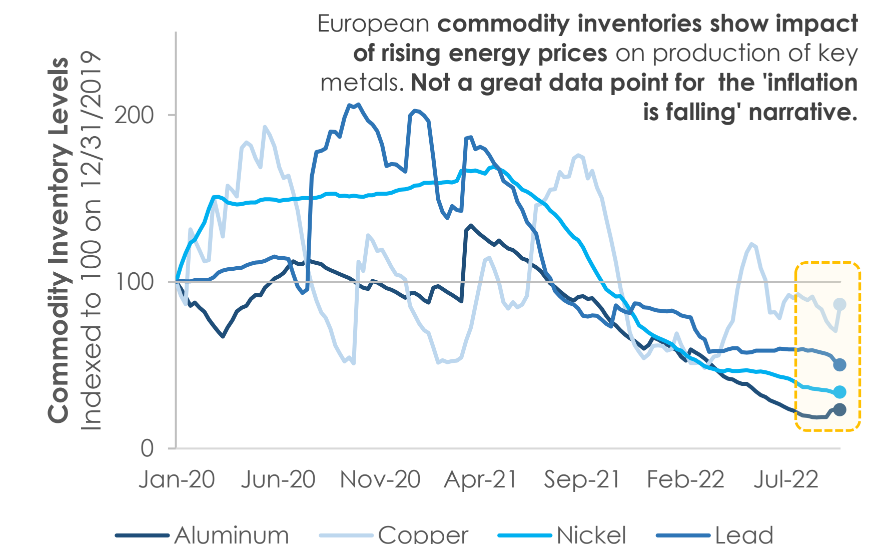
Source: MarketDesk. Surprise = Actual vs consensus estimate 1-Year ago.

Figure 7: MarketDesk Sentiment Indicator Near Deacde Lows



Source: MarketDesk. Note: Indicator smoothed with 8 week average.

Figure 8: Key Commodity Inventories Below Pre-Covid Levels



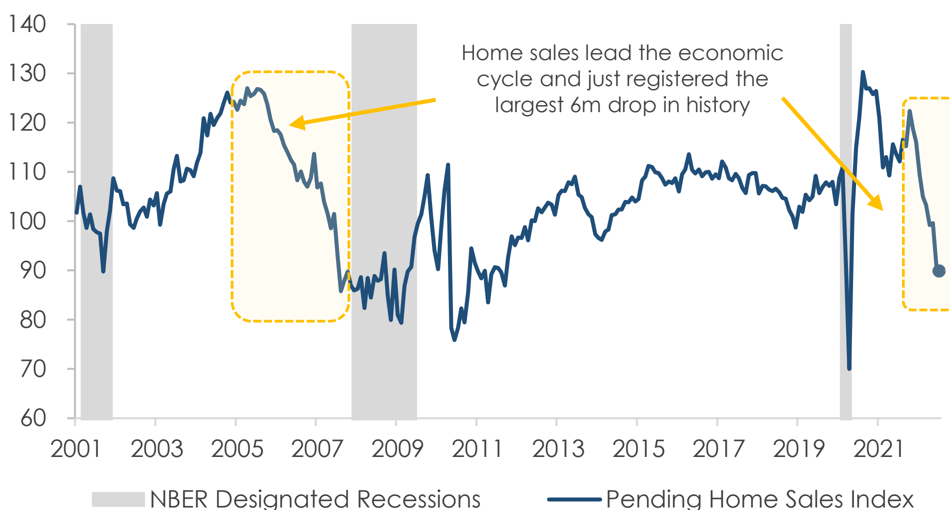
Source: MarketDesk, London Metal Exchange (LME)

Unfolding Economic Themes

► **Setting the 4Q22 AA Guide's Macro Tone:** Our team typically starts each edition of the *Asset Allocator's Guide* by developing our credit views (i.e., Duration & Quality) as a way to define the macro outlook. However, inflation and Fed policy uncertainty are making credit markets volatile and noisy as we write this edition. As an alternative, our team decided to define the macro outlook by starting with the *Unfolding Economic Themes* section. The charts below highlight the themes guiding our 4Q22 asset allocation decisions.

► **Data Points to Weaker Macro Backdrop:** Macro slowdowns historically evolve in stages. Housing is often one of the first economic segments to weaken, followed by other leading indicators, such as the ISM Mfg PMI. One of the last data points to slow is employment and job growth. The current environment indicates the slowdown is already in motion: (1) pending home sales are back at 2011 levels and (2) the ISM Mfg PMI is declining. Our focus is on the big picture, and we remain patient as the current macro cycle plays out.

Figure 9: Pending Home Sales Index Drops to 2011 Levels



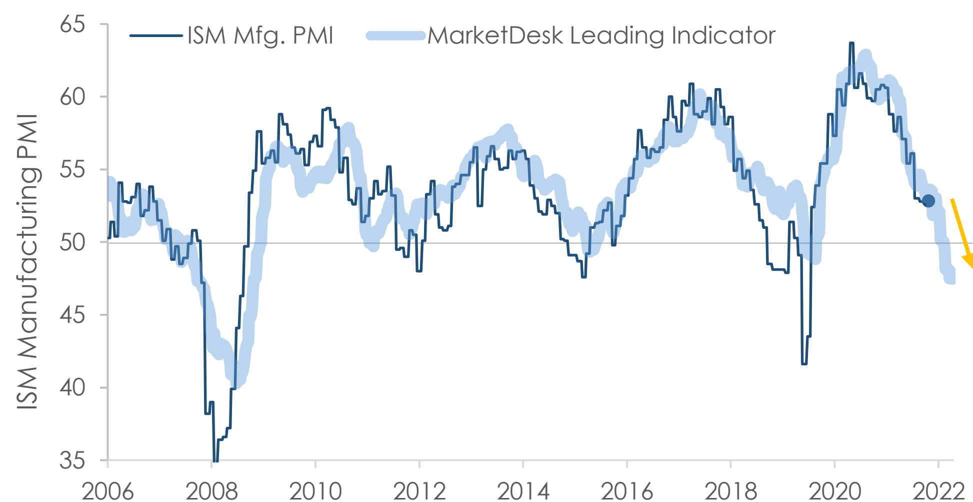
Source: MarketDesk, NAR. Note: Data is seasonally adjusted and indexed to 100 in 2001.

Housing Market Slows as Fed Tightening Leads to Higher Mortgage Rates …

● The average 30-year fixed rate mortgage is 7.50%, more than double 3.11% at the end of 2021. It's the highest level since 2008 and shows housing activity is dramatically slowing. Figure 9 shows the pending home sales index, which is a leading indicator for existing home sales by 1-2 months, currently sits at 2011 levels.

● The chart highlights housing's status as a leading indicator. Housing is historically one of the first economic segments to slow as macro conditions weaken, and recent data is a strong indication the economic cycle is slowing.

Figure 10: MarketDesk PMI Leading Indicator vs Actual PMI Readings



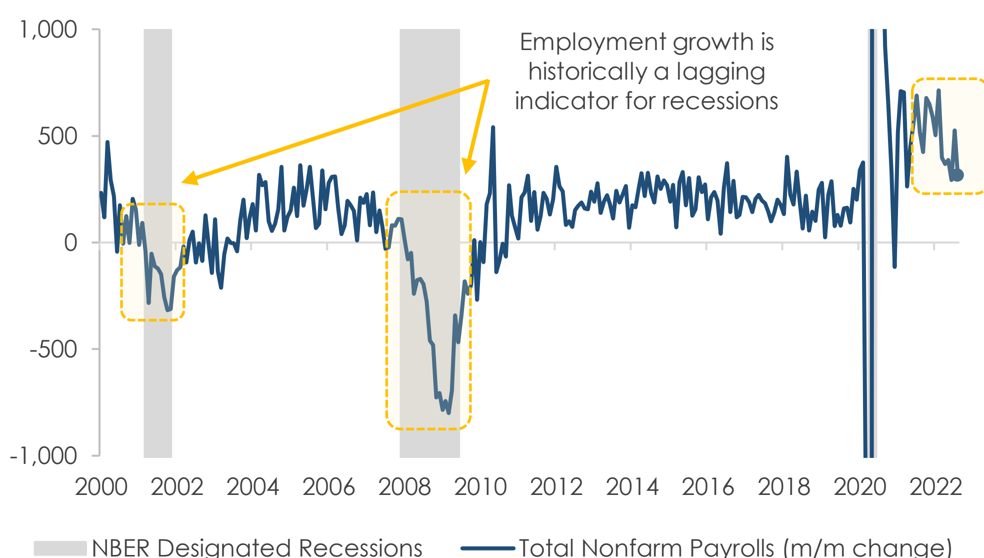
Source: MarketDesk, ISM. Note: >50 = Growing Economy, <50 = Contracting Economy.

MarketDesk PMI Leading Indicator Forecasts Lower PMIs …

● Non-housing leading indicators are historically the next leg of the economy to weaken. Figure 10 charts the MarketDesk PMI Composite against historical PMI readings. While pending home sales started slowing in late 2005, the Mfg PMI continued to signal expansion until 1Q 2008.

● What is the data saying now? The MarketDesk Composite currently projects PMIs will approach 50 during 4Q22 before dipping below 50 (i.e., mfg. contraction) during 1Q23. You can find the latest PMI forecast in the weekly *Quant Pack* and a primer in the ***9/16/22 Strategy Snapshot*** .

Figure 11: Monthly Nonfarm U.S. Payroll Growth



Source: MarketDesk, Bureau of Labor Statistics. Note: Data is seasonally adjusted.

Job Gains & Employment Historically Start Slowing as Recessions Start …

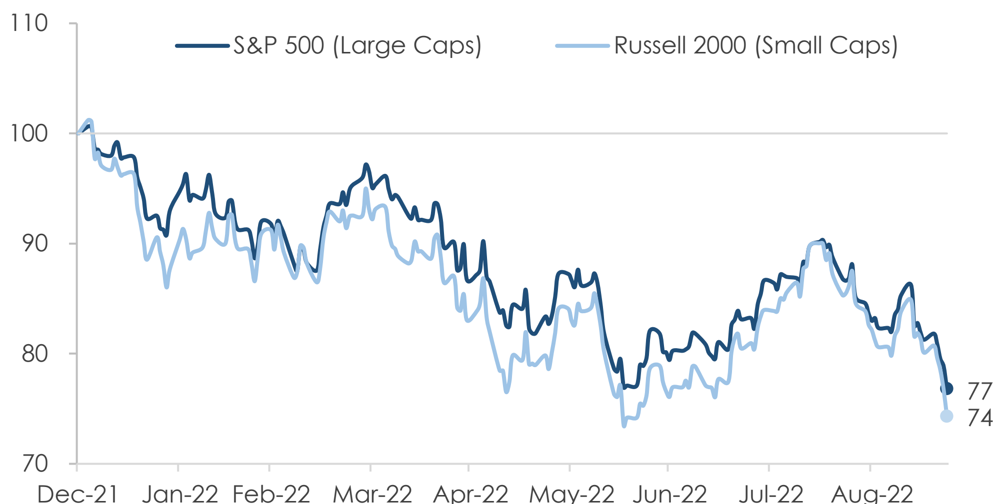
● Figure 11 charts monthly job gains since 2000 and overlays NBER recessions. The chart shows job gains historically remain positive leading up to recessions but decline rapidly as recessions start. The relationship is likely due to NBER's use of labor market trends as a recession measuring stick, but it still provides helpful information.

● Strong job gains during 2022 are another indication the U.S. hasn't entered a recession yet. However, the job gains are more a statement on the U.S. economy's strength today rather than a predictor of continued strength. 4Q22 and 1H23 labor market trends, whether it be continued strength or signs of weakness, will be informative.

Size — Large Caps vs Small Caps

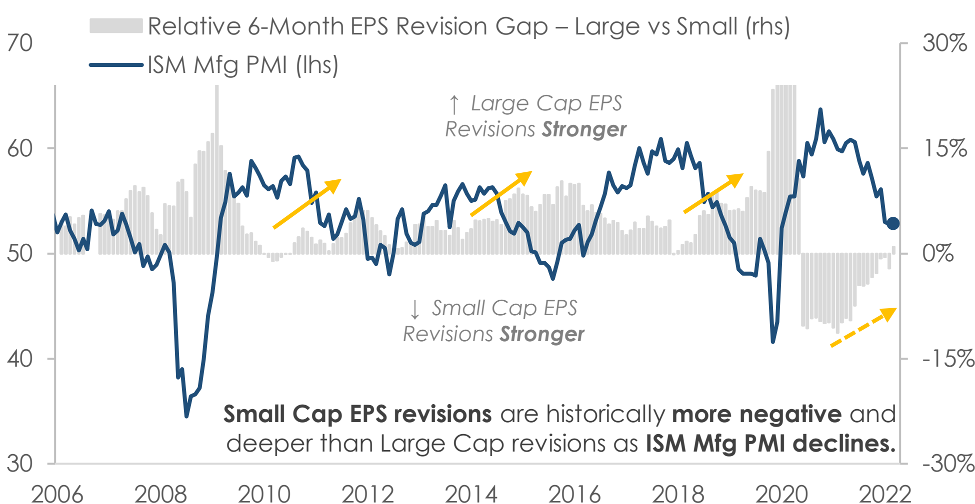
► **Maintain Large Cap OW & Small Cap UW:** Large and Small Cap stocks traded in unison during the first three quarters of 2022 (**Figure 12**). The result may not seem to fit with the current macro environment of an equity bear market and falling Mfg PMI, but Large Caps' OW exposure to growth stocks is the key to the limited divergence between Large and Small Caps. The first 9 months of 2022 focused on aggressive Fed tightening, rising nominal and real yields, and P/E multiple contraction. As the federal funds rate enters restrictive territory and the Fed's tightening cycle approaches the final rate hike at some point in early 2023, our base case is investor attention shifts back to corporate fundamentals and economic data. Small Caps face an elevated risk of negative EPS revisions and already-high percentage of unprofitable companies. We continue to favor Large Caps over Small Caps.

Figure 12: 2022 YTD Price Returns – Large vs Small



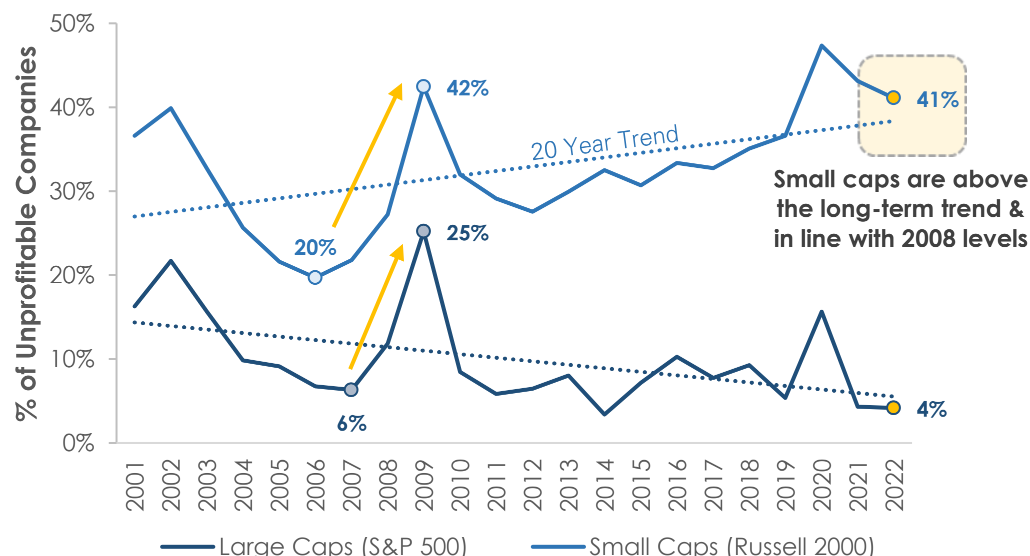
Source: MarketDesk, FactSet. Note: Price indexed to 100 on 12/31/2021. Analysis is based on the S&P 500 and Russell 2000 indices.

Figure 13: Manufacturing PMI vs EPS Estimate Revisions – Large vs Small



Source: MarketDesk, ISM, FactSet. Note: EPS revisions gap is calculated as Large Caps' NTM EPS revision % change minus Small Caps' NTM EPS revision % change.

Figure 14: % of Unprofitable Companies in Index – Large vs Small



Source: MarketDesk, FactSet. Note: Analysis is based on percent of companies in the index reporting negative EPS for the calendar year.

Large & Small Cap Stocks Produce Limited Divergence During 2022's Sell-Off …

- Figure 12 charts the S&P 500 and Russell 2000 indices' YTD indexed returns. It shows Large and Small Caps have returned -23.2% and -25.7% YTD, respectively, a 'surprising' statistic given the start of a bear market and weaker macro backdrop.

- What caused 2022's limited divergence? Fed tightening and rising yields drove the market narrative from 1Q22 to 3Q22. P/E multiples contracted as yields rose, with Growth taking the biggest hit (*1Q22 AA Guide Fig 15* & *3Q22 AA Guide page 7*). Large Caps are significantly OW Growth, which acted as a headwind and increased Large's beta as the market sold off.

History Repeats as Mfg PMI Declines & Small Caps See Bigger Negative EPS Revisions …

- Our base case is Large outperforms Small during 4Q22 and 1Q23 as the investment narrative and regime shift. Macro themes our team is monitoring include: easing inflation; peak hawkishness and guidance around final rate hike; and weaker corporate fundamentals / economic data.

- Figure 13 updates *3Q22 AA Guide Fig 14*. It shows Small's EPS revisions are historically more negative than Large as the Mfg PMI declines. The 6-month EPS revision gap swung in Large's favor during 3Q22, and history indicates Small remains more vulnerable to negative EPS revisions.

Small Cap Stock Index is More Exposed to Unprofitable Companies …

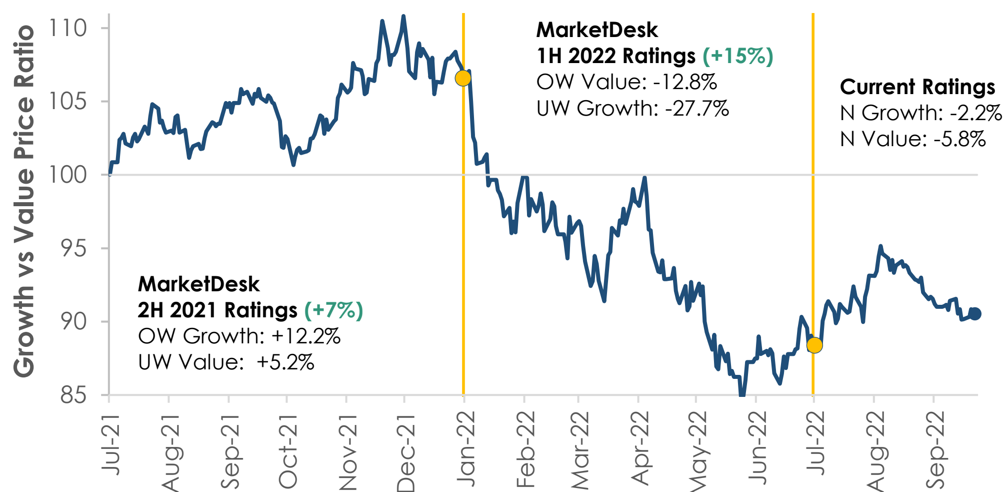
- Figure 14 charts the percent of unprofitable S&P 500 and Russell 2000 companies by calendar year. Only 4% of the S&P 500 was unprofitable during the last 12 months, a low number we attribute to the index's profitability screen. In contrast, ~41% of the Russell 2000 was unprofitable.

- Small Caps' higher negative EPS revision risk and % of unprofitable companies create significant risk. Macro data is weakening, and Small Caps' % of unprofitable stocks is already near the 2008 financial crisis peak. This leaves little room for error as a decade of accommodative monetary policy is reversed and economic activity slows.

Growth vs Value

► **Remain Neutral Growth & Value:** The Fed is deep into the current tightening cycle and starting to discuss when it should slow, and potentially stop, its rate hikes. Markets can sense the end, and the focus should shift from rising yields to Value's cyclical sector exposure and negative EPS revision risk (*3Q22 AA Guide Figure 17*). The two themes should relieve some of the selling pressure on Growth, a theme that is already gaining traction (**Figure 16**). While the setup favors Growth over Value, there is one big uncertainty holding us back from upgrading Growth to OW – inflation dynamics and the risk of an extended Fed tightening cycle. Data and reversion to the mean indicate inflation should ease in the coming months, but wage inflation and the threat of oil supply deficits could keep inflation elevated. This creates a significant tail risk for Growth – the Fed may have no choice but to raise interest rates longer and higher to destroy demand and relieve a tight labor market. There is no rush to call Growth's bottom.

Figure 15: Russell 1000 Growth / Value Trading Price Ratio



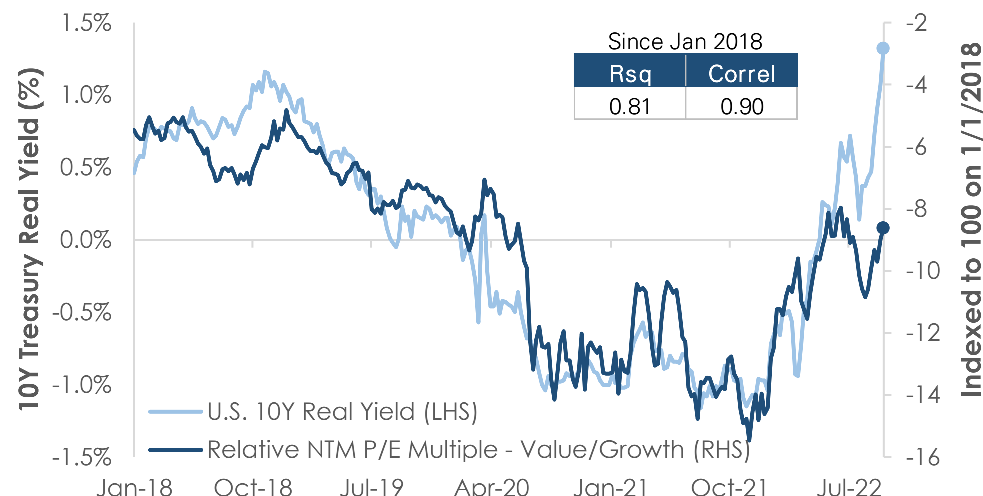
Source: MarketDesk, FactSet. Note: Analysis is based on Vanguard's Russell 1000 Growth (VONG) & Value (VONV) ETFs.

Mapping the Growth / Value Return Gap Against MarketDesk Ratings …

● Figure 15 charts the Russell 1000 Growth/Value trading price ratio and overlays MarketDesk rating changes (yellow). It shows three phases since July 2021: (1) Growth's outperformance during 2H21 despite soaring inflation and a consensus Value call; (2) Value's outperformance during 1H22 as the Fed aggressively tightened; and (3) mixed performance during 3Q22 as the market priced in and then unwound a Fed pivot.

● MarketDesk rating changes occurred near significant Growth/Value trend changes. What drove our team's rating changes? Real yields.

Figure 16: Value / Growth NTM P/E Multiple Gap vs Real Yields



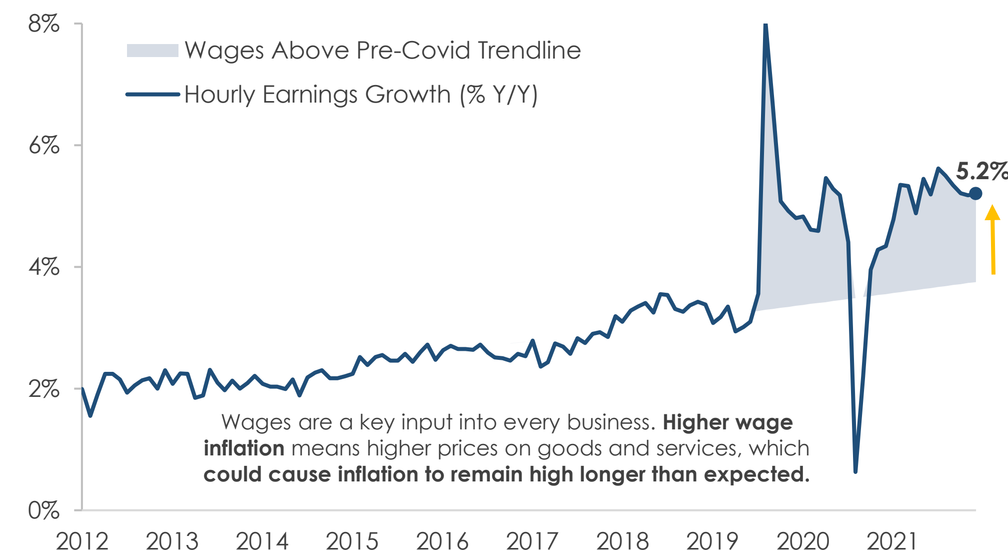
Source: MarketDesk, Federal Reserve, FactSet. Note: Analysis is based on Vanguard's Russell 1000 Growth (VONG) & Value (VONV) ETFs.

Growth vs Value Next 12-Month P/E Multiple Gap Diverges from Real Yields …

● Figure 16 updates *3Q22 AA Guide Fig 16*. The chart tracks the Value/Growth NTM P/E multiple gap against the 10Y real yield. While the chart shows the two continue to move in the same direction, the size of the move and strength of the relationship is weakening. The r-squared dropped from 0.88 in the *3Q22 AA Guide* to 0.81 today, while the correlation declined from 0.94 to 0.90.

● Our base case is the relationship continues to weaken as: (1) real yields rise off their extreme lows and (2) the NTM P/E multiple gap normalizes. Under this scenario, Growth should face less selling pressure, and the return gap should narrow.

Figure 17: Hourly Earnings Growth Accelerates as Labor Market Tightens



Source: MarketDesk, U.S. Bureau of Labor Statistics. Note: Data is seasonally adjusted.

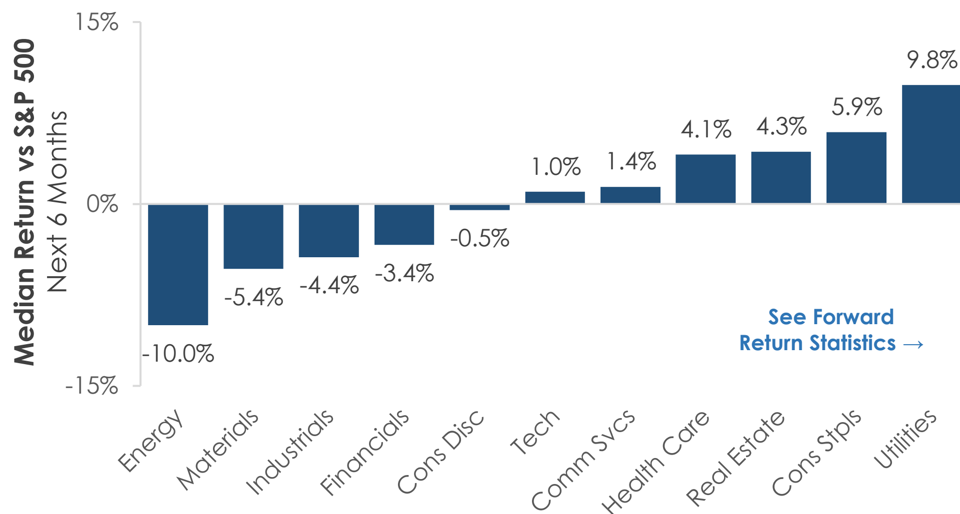
Continued Wage Inflation Prevents Us From Upgrading Growth to OW …

● Figure 17 shows hourly earnings grew +5.2% y/y during August, firmly above the last decade's trend. Continued wage inflation could cause inflation to stay higher for longer and force the Fed to be more aggressive, putting more pressure on Growth stocks as rates rise.

● Our concern is inflation's is shifting from supply deficits to labor deficits. Nonfarm payrolls totaled 152.7 million during Aug. 2022, only slightly above Feb. 2020's 152.5 million. August's labor force participation rate was 62.4%, a full 1% below Feb. 2020's 63.4%. Labor market growth has not kept pace with economic growth, and companies are paying more to attract and retain employees.

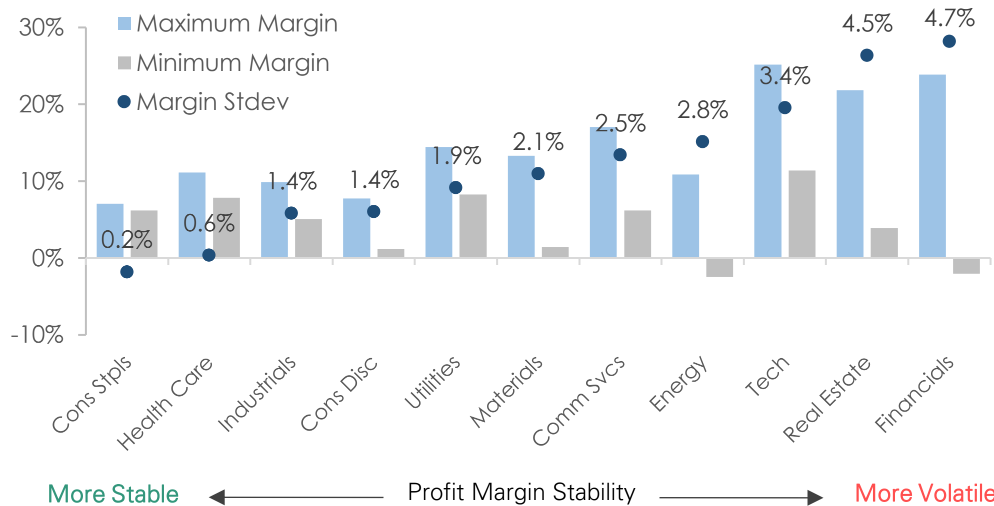
► **Maintain Defensive Sector Overweight:** With the macro backdrop deteriorating (**page 5**), our preferred positioning continues to be defensive over cyclical. The MarketDesk PMI Composite points to lower PMIs (**Figure 10**), which historically favors defensive sectors (**Figure 18**). Defensive sector margins are not only less elevated against their trailing 5-year average (***3Q22 AA Guide Fig 20***), but they are less volatile compared to cyclical sectors (**Figure 19**). History shows cyclical sectors face a higher risk of negative EPS revisions as the ISM Mfg PMI declines (***3Q22 AA Guide Fig 19***), a theme that is already occurring in markets (**Figure 20**). We maintain the tactical Consumer Staples position but favor capturing recent gains and rebalancing back to the initial weight. While fundamentals don't support a broad market rally, we would not be surprised to see a bear market rally during 4Q22.

Figure 18: Sector Performance — ISM Mfg PMI Above 55 for +15 Months



Source: MarketDesk, ISM, FactSet. Note: Data is based on price returns for S&P 500 sectors.

Figure 19: S&P 500 Sector Profit Margin Volatility



Source: MarketDesk, FactSet. Note: Data is based on the rolling last 12-month net profit margin across S&P 500 sectors.

Figure 20: S&P 500 3Q22 EPS Estimates (Change in Y/Y Growth Estimates)

Sector	As of June 30th	As of Sept 28th	Net Change
Energy	98%	115%	17%
Industrials	31%	24%	-7%
Real Estate	16%	16%	0%
Consumer Disc	25%	12%	-13%
S&P 500	**10%**	**3%**	**-7%**
Tech	5%	-4%	-9%
Consumer Staples	2%	-4%	-6%
Utilities	-5%	-6%	-1%
Materials	8%	-7%	-15%
Health Care	0%	-7%	-8%
Financials	-8%	-11%	-4%
Comm Svcs	0%	-13%	-13%

Source: MarketDesk, FactSet. Note: Analysis is based on the forecasted y/y quarterly EPS growth rate compared to 3Q21.

Favor Defensive Over Cyclical as Sustained ISM Mfg PMI Expansion Slows …

● Figure 18 highlights ***2Q22 AA Guide Fig 19***. It graphs sector performance following periods of sustained manufacturing expansion (i.e., ISM Mfg PMI > 55) and shows defensive sectors historically outperform cyclical sectors as the Mfg PMI normalizes. Click '*More Info*' to see more in-depth forward return statistics.

● The chart provided valuable positioning advice. Since the *2Q22 AA Guide* was published at the start of April, Utilities (-9.6%), Cons Staples (-10.7%), and Health Care (-11.1%) outperformed the S&P 500 (-21.4%), Materials (-23.9%), Financials (-22.4%), and Industrials (-19.8%).

Defensive Sectors Exhibit Less Profit Margin Volatility …

● Figure 19 compares rolling last 12-month profit margins across S&P 500 sectors since 2007. Three statistics are graphed: (1) maximum margin; (2) minimum margin; and (3) standard deviation.

● Cyclical sectors (i.e., Financials, Materials, & Energy) show wider max vs min gaps than defensive sectors (i.e., Health Care, Cons Staples, & Utilities). This leads to a second point – defensive sectors exhibit less margin volatility (i.e., lower stdevs). Given the weakening macro backdrop, we continue to prefer sectors with less margin volatility.

9 of 11 S&P 500 Sectors See Negative 3Q22 EPS Revisions During Third Quarter …

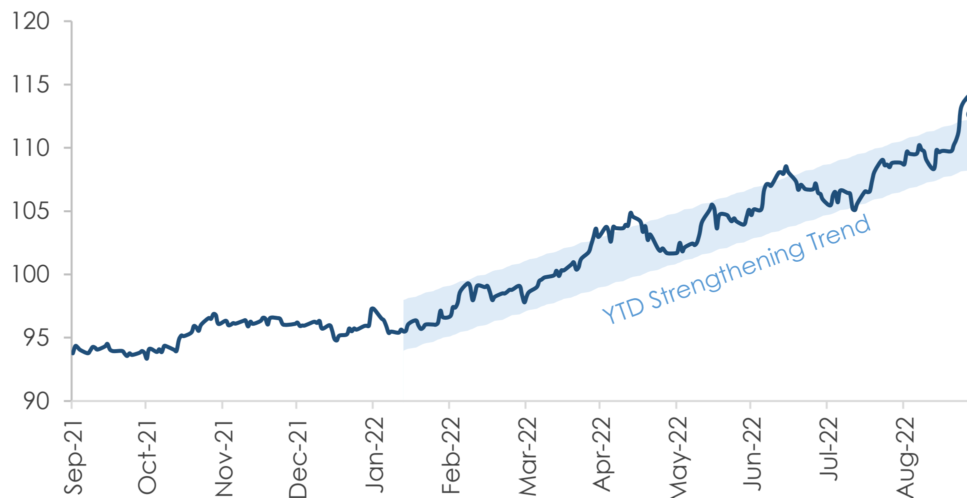
● Elevated profit margins (**Fig 13**) and negative EPS revisions (**Figs 14, 17, & 19**) were top themes in the ***3Q22 AA Guide***. Figure 20, which compares S&P 500 sector 3Q22 EPS estimates on 9/28 against 6/30, shows the theme is gaining traction.

● There are multiple trends to call out. First, 3Q22 EPS estimates were revised lower for 9 out of 11 S&P 500 sectors during the third quarter. Second, 7 out of 11 sectors are forecasted to post negative EPS growth. Third, while the S&P 500 is forecasted to post +2.75% y/y growth, Energy's +115% y/y growth appears to be the driver. Excluding Energy, 3Q22 EPS estimates are less impressive and could even be negative.

International Markets

► **Remain OW Emerging & UW Developed; Maintain Tactical DM Asia Position:** International equities face a lengthy list of headwinds, including Europe's energy crisis, China's struggle to return to growth after its Covid-zero policy, and tighter financial conditions and a soaring USD (**Figure 21**), caused by the Fed's aggressive tightening. Among these headwinds, our primary concern is Europe's energy crisis and its unknown effect. While Europe could bounce higher on positive news flow and lower energy prices, it's too difficult to handicap and model the energy crisis's impact on a region that is highly dependent on energy imports. As a result, there is no change in our international positioning as the above themes play out. We maintain the tactical DM Asia position and Emerging Market OW.

Figure 21: U.S. Dollar Index – Last 12-Month Price Movement



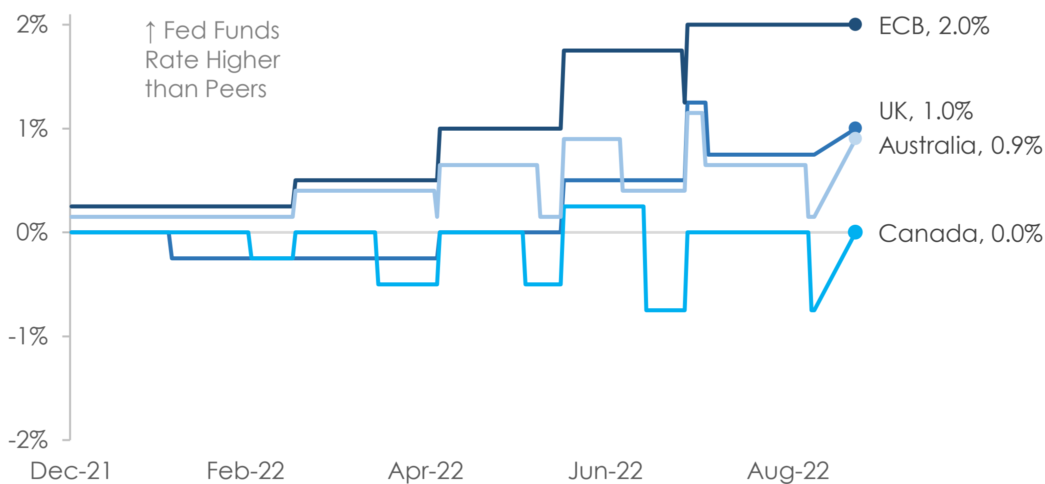
Source: MarketDesk, FactSet

USD Soars as Fed Leads Tightening Cycle & U.S. Economy Faces Less Headwinds …

- Figure 21 charts the USD index over the last 12 months and shows the well-defined strengthening trend. USD's strength can be attributed to two themes: (1) the Fed's tightening cycle outpacing central bank peers and (2) the U.S. economy facing less macro headwinds (i.e., Europe's energy crisis & China's Covid-zero policy).

- Where USD trades next to USD will impact global markets. A stronger USD will weigh on U.S. corporate earnings, potentially exacerbate inflation in non-USD countries (i.e., commodities priced in USD), and act as a drag on international equity returns, especially EM.

Figure 22: Comparing the Fed Funds Rate Against Central Bank Peers



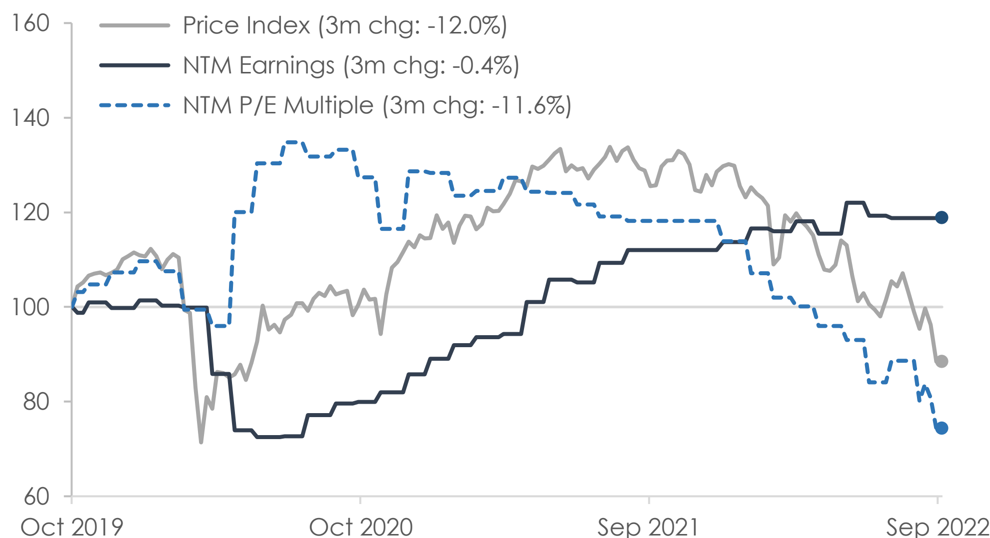
Source: MarketDesk, Various Central Banks

… But Could Reverse Lower as Central Banks Peers Aggressively Raise Rates

- Figure 22 charts the gap between the fed funds rate and benchmark rates across four DM peers. The Fed is leading among developed market central banks this tightening cycle, which gives the U.S. a yield advantage and strengthens USD.

- The chart highlights the widening U.S. yield gap during 2022 as the Fed's aggressive rate hikes outpace peers. However, the yield gap could narrow (1) as more central banks pursue more frequent and bigger rate hikes in response to persistent inflation and (2) the Fed slows its pace. A narrower gap could weaken a strong USD.

Figure 23: Europe Performance Drivers — Earnings Growth vs P/E Multiple



Source: MarketDesk, FactSet. ***Note:*** *Analysis is based on Vanguard's FTSE Europe ETF (VGK). Data is based on EPS estimates as of 8/31/2022*

Earnings Are the Next Potential Headwind in Europe …

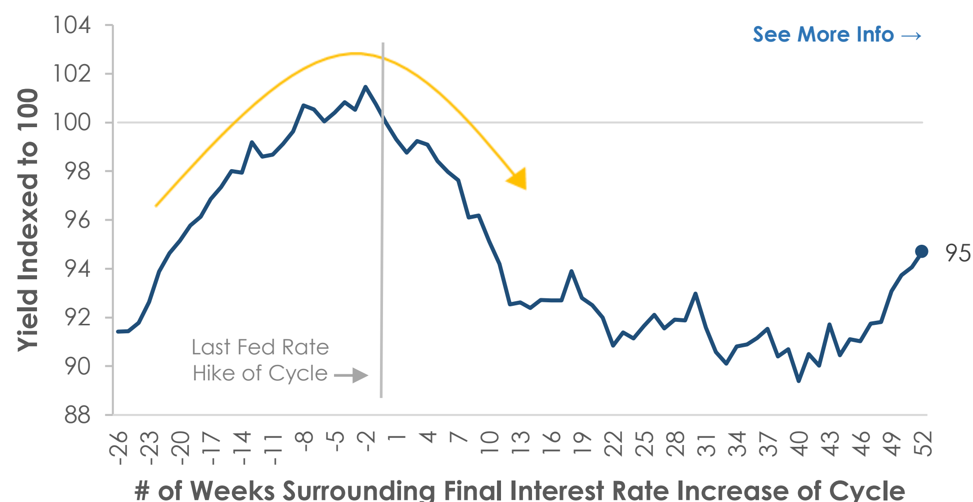
- Within DM, Asia has outperformed Europe by ~+6% YTD. Figure 23 decomposes DM Europe's performance into earnings growth and P/E multiple expansion. It shows Europe's YTD sell-off was primarily driven by P/E multiple contraction rather than negative EPS revisions.

- Our concern is Europe's EPS estimates will be revised lower as the effects of the region's energy crisis become known. Energy touches nearly every aspect of the economy, and a prolonged period of high energy prices risks slowing Europe's economic growth. The 2022 sell-off prices in some of the energy crisis, but the question is – how much?

Credit Duration — Long vs Short

► **Maintain Long Duration OW:** Credit market positioning remains difficult given the volatility created by persistent inflation and uncertain Fed policy. Rather than acting as a hedge during the equity market sell-off, Long Duration is underperforming equities YTD and worsening the pain felt across portfolios. The upward pressure on Treasury yields today goes back to the Fed's 2021 'transitory inflation' policy mistake, and now inflation's persistence is forcing the Fed and its central bank peers to set policy using the rearview mirror. History shows Treasury yields peak around the last interest rate hike of the cycle, suggesting rates could see more upward pressure. The key question is when will the current tightening cycle end. Complicating all of this is the fact monetary policy operates with a lag. The longer interest rates remain elevated and sit in restrictive territory, the more likely a recession, and the more attractive long-duration bonds become as a risk-off asset. The global economy is already showing strain and signs of early weakness.

Figure 24: 10-Year Treasury Yield Change – Last Rate Hike of Cycle



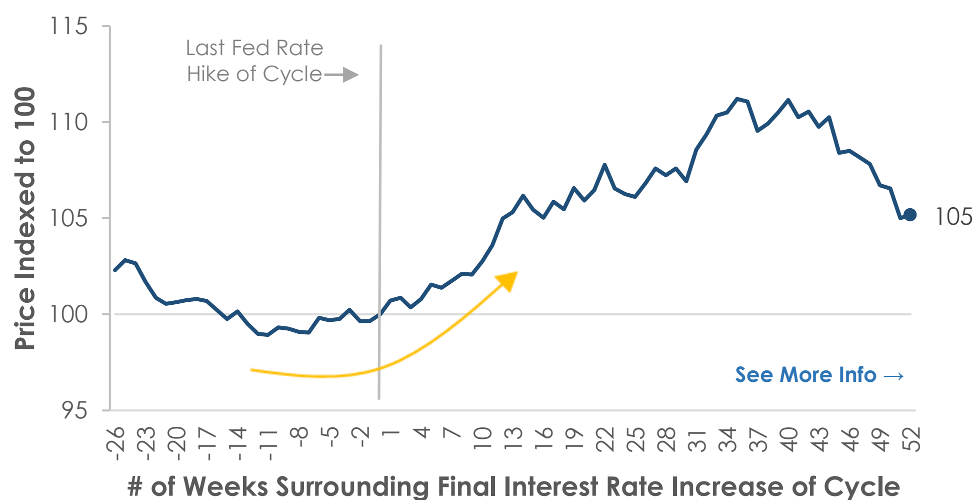
Source: MarketDesk, U.S. Treasury, Federal Reserve. Note: Analysis is based on the 1973, 1974, 1980, 1984, 1989, 1995, 2000, 2006, and 2018 cycles.

10-Year Treasury Yield Historically Reverses Lower After Last Rate Hike of Cycle …

● The federal funds rate has increased from 0.25% to 3% since the current tightening cycle started in mid-March 2022. Treasury yields have increased across the yield curve in anticipation of tighter monetary policy, and the Fed's determination to bring inflation down to 2% could extend the tightening cycle.

● When will yields peak? Figure 24 shows the 10Y Treasury yield historically peaks in the weeks leading up to the last interest rate hike of the cycle. Click *'More Info'* to see the 10Y yield's movement during each cycle.

Figure 25: Long Duration Treasury Price Returns – Last Rate Hike of Cycle



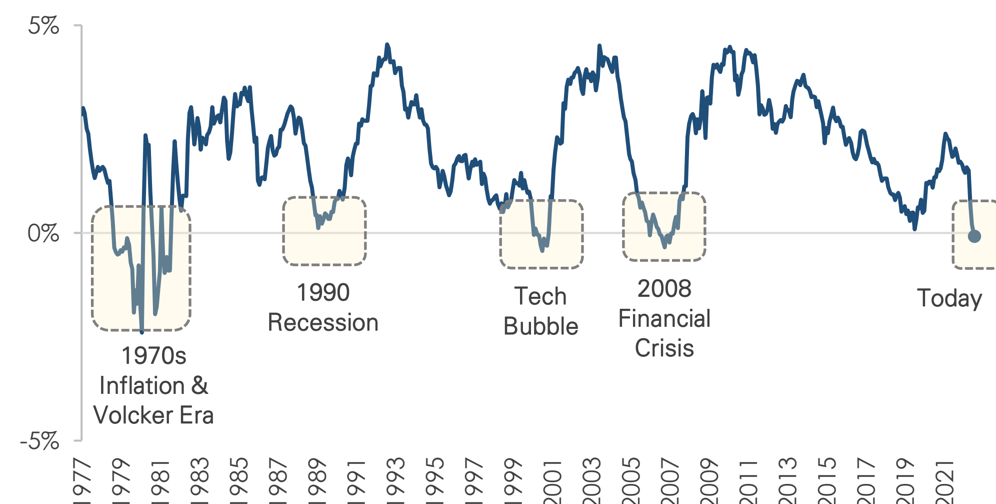
Source: MarketDesk, U.S. Treasury, ICE. Note: Analysis is based on the 1989, 1995, 2000, 2006, and 2018 cycles. ICE BofA U.S. Treasury (10+Y) Index.

Long Duration Treasuries Historically Outperform After the Final Rate Hike …

● Bonds entered a bear market during 2022 after a multi-decade bull market, with Long Duration bearing the brunt of the sell-off as yields surge. When does duration shift from a headwind to a tailwind? History shows Long Duration treasuries historically bottom as yields peak around the last rate hike of the tightening cycle.

● Figure 25 charts the price return of Long Duration bonds indexed to 100 the week of the last interest rate increase. It shows Long Duration historically outperforms by an average +10% during the 9 months after the last rate hike.

Figure 26: 30-Year Treasury Bond vs 6-Month Treasury Bill Yield Spread



Source: MarketDesk, U.S. Treasury. Note: Calculated as the gap between the 30-year Treasury bond and 6-month Treasury bill.

30Y-6Mo Treasury Spread Inverts as Market Prices in Tighter Monetary Policy …

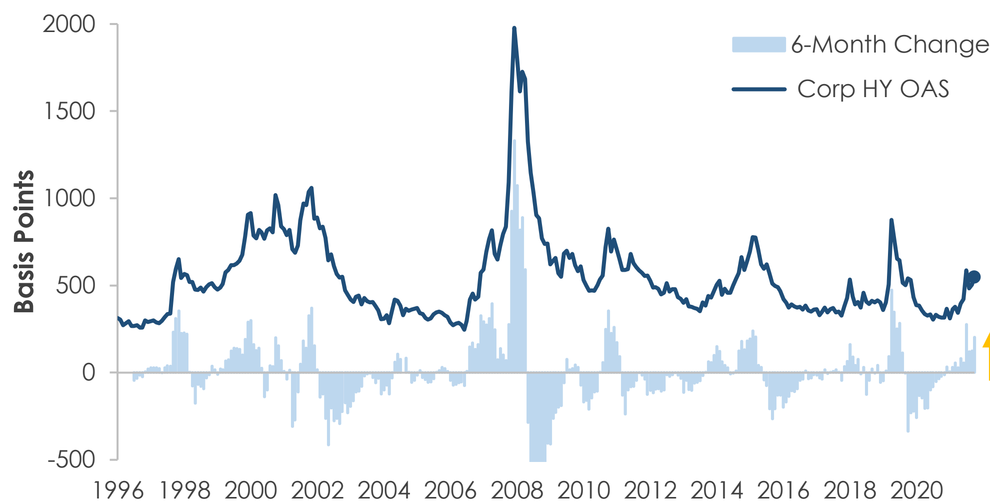
● Figure 26 shows the 30Y-6Mo Treasury yield spread sits at -0.09% after inverting during July. The 30Y-6Mo spread is historically positive as investors require a higher yield to lend for a longer period. Previous 30Y-6Mo spreads below 0.25%: Oct. 1978; March 1989; March 2000; and Feb. 2006.

● How long until the Fed cut interest rates after prior 30Y-6Mo inversions? The timeframes are varied and influenced by each period's macro environment: May 1980 (20mo) -- inflation forced the Fed to tighten again shortly after; June 1989 (3mo); Jan. 2001 (9mo); and Sept. 2007 (18mo). Despite the weak macro outlook today, we expect the Fed to delay rate cuts this cycle.

Credit Quality — HY vs IG

► **Remain UW Corp HY & Tactically OW BB Bonds:** There is an elevated risk of negative EPS revisions, financial conditions are tightening, and forward indicators point to a weaker macro outlook. On the monetary policy front, inflation's persistence is forcing the Fed to act more aggressively, which increases the probability of interest rate hikes lasting longer and ending higher. Each of the four macro themes increase credit risk, and there is little indication the four macro trends will reverse or improve during 4Q22. Our preferred positioning within High Yield continues to be higher quality credits. (Note: One option to maintain HY credit exposure is to shorten duration and own shorter maturity bonds. However, the risk is credit conditions rapidly deteriorate and lenders become concerned about near-term repayment, causing short-duration HY to underperform.)

Figure 27: ICE BofA U.S. High Yield Index Option-Adjusted Spread



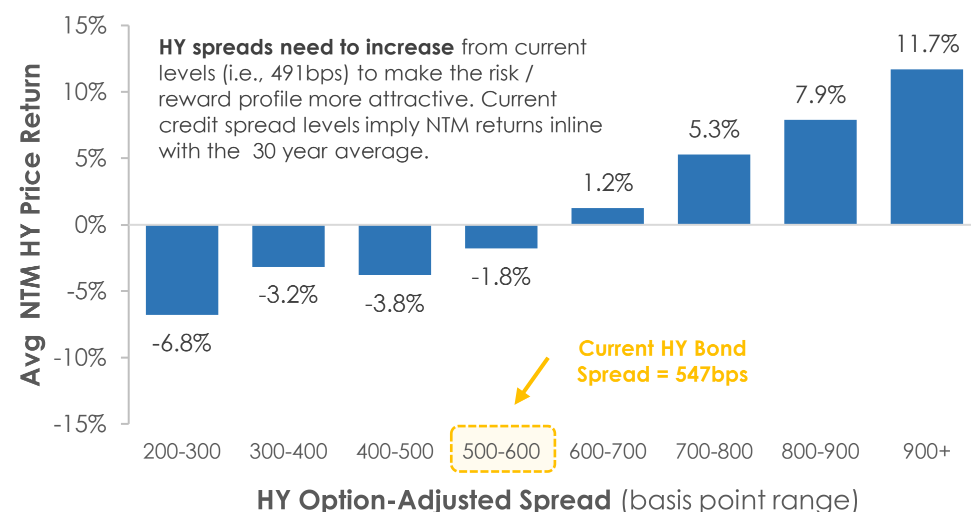
Source: MarketDesk, ICE. Note: Option-Adjusted Spread (OAS) is the difference between the yield of a bond and current U.S. Treasury rates.

Corp High Yield Option-Adjusted Spread Back Near Late 2018 Levels …

• Figure 27 charts High Yield's option-adjusted spread (OAS) rolling last 6-month change. The OAS sits at 547bps currently, which is near levels last seen during the 2015 industrial recession and late 2018 sell-off triggered by Fed tightening.

• Credit spread expansion and an increasing % of distressed HY bonds in iShares's USHY ETF (**Fig 23** monthly *Credit Strategy*) point to increasing credit risk. Fundamentals, including elevated profit margins, tighter financial conditions, and a deteriorating macro backdrop, support the view credit risk is rising.

Figure 28: Forward Corp High Yield Returns Based on Current HY OAS



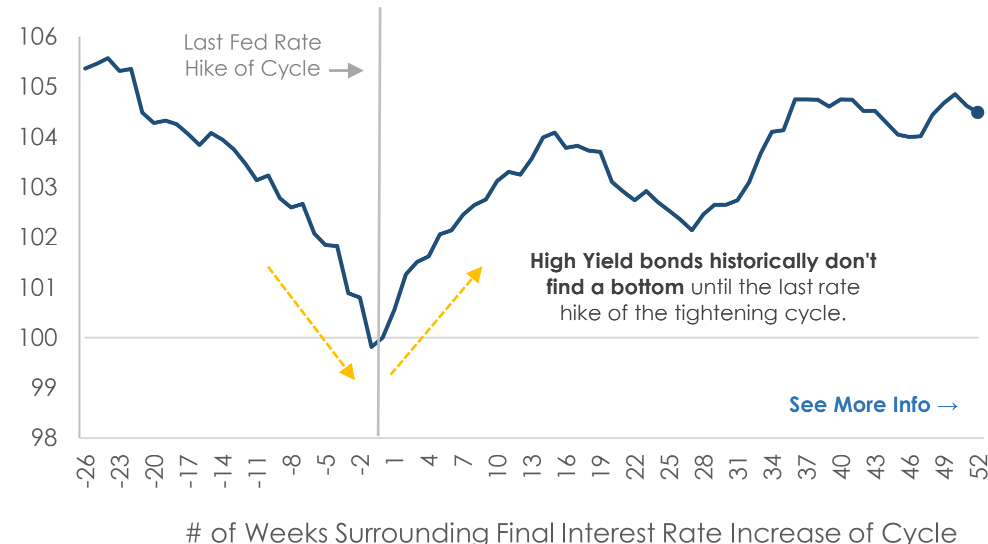
Source: MarketDesk, FactSet. Note: Forward returns based on monthly data since 1996.

High Yield Credit Spreads Are Not at Attractive Levels Yet …

• Figure 28 expands on **Figure 27** by graphing HY's average forward 12-month price return based on OAS level. It shows HY's forward returns are historically stronger following credit spread expansion, and vice versa. Is now the time to take on increased credit risk? History says no.

• There is a 0.54 r-squared (i.e., how closely data fits a regression line) between current OAS and forward 12-month returns. A 0.6 r-squared is generally considered relevant. What does HY's current 547bps OAS predict for a forward NTM price return? Flat to slightly negative.

Figure 29: Corporate High Yield Performance After Last Rate Hike of Cycle



Source: MarketDesk, ICE. Note: Analysis is based on price return of the ICE BofA U.S. High Yield index.

Corp High Yield Credit Historically Doesn't Bottom Until After the Last Rate Hike …

• Figure 29 graphs Corp HY's price return indexed to 100 the week of the last rate hike. It shows HY historically doesn't bottom until the last interest rate increase. One important trend – Figure 29 is the same concept as **Figure 25**, which examines Long Duration. On a price return basis, history indicates duration is more of a tailwind than credit quality after the tightening cycle ends.

• The historical trend of HY not bottoming until the final rate hike, as well as the high degree of uncertainty surrounding this tightening cycle are two catalysts supporting an UW Corp HY starting 4Q22.

MarketDesk

Website

www.MarketDeskResearch.com

Sales Team

+1 (646) 787-0394

Sales@MarketDeskResearch.com

Client Support

+1 (646) 787-0394

Support@MarketDeskResearch.com

Firm Brochure

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