Complimentary Report

MarketDesk

Featured Report *(starts on page 2)*

3Q 2022 Asset Allocator's Guide

Quarterly Roadmap to Enhance Investment Committee Decisions

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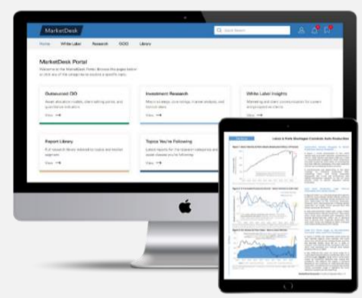

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3Q 2022 Asset Allocator's Guide

MarketDesk Research

Quarterly Report

July 6, 2022

Navigating the Eye of the Storm

Current Market Themes & Portfolio Implications

Consensus calls for a 2H22 bounce, but it's a difficult case to get behind. Price is a function of valuation multiples and earnings, and we don't see how either can set the stage for a +10% rally (i.e., consensus S&P 500 price target). Data indicates the risk is transitioning from P/E multiple contraction to corporate earnings contraction, and corporate profit margins are at 20-year highs. We place a low probability on P/E multiples expanding enough to counter profit margin contraction and negative earnings growth. Risk assets appear vulnerable ... But it's also difficult to get behind the bear case. The economy is deteriorating as the Fed frontloads its tightening schedule, but at this point it's difficult to gauge with any precision the depth or size of the economic contraction. As discussed in the ***6/24/22 Weekly Note*** (*Is the Juice Worth the Squeeze?*), we are left with a wide range of outcomes that are difficult to handicap. It's difficult to challenge the market in either direction when the risk/reward is so undefined.

This is where the *3Q22 AA Guide* title *Navigating the Eye of the Storm* comes into play. 1H22 was a Category 5 hurricane, EF-5 tornado, blizzard, or whatever your local storm variety may be, and markets are now in the eye of the storm, a period of relative calm within rough weather. Our base case is trading remains range-bound and choppy as bulls and bears battle over the market narrative and direction.

Where do you allocate your risk budget today? The first step is to identify what areas to avoid – weak credit quality (**page 11**), developed markets (**Figures 21-22**), and cyclical sectors and factors (**Figures 17 & 19**). Looking at the remaining categories, we favor spending our risk budget on long duration (**Figures 24-25**), emerging markets (**Figure 23**), and the growth factor (**page 7**). This preference is driving multiple rating changes, such as the EM upgrade to OW, DM downgrade to UW, Growth upgrade to Neutral, and Value downgrade to Neutral, and positioning changes, such as moving up the credit ratings spectrum within Corp HY and maintaining defensive sector OWs. Our 3Q22 roadmap consists of avoiding unnecessary risk and letting the market resolve its issues.

Notable Positioning Views

► **Large vs Small Caps:** Remain OW Large Caps due to EPS contraction risk (**Figs 12-14**)

► **Value vs Growth:** Neutral ratings stance as risk transitions to EPS contraction (**Figs 15-17**)

► **International:** Upgrade Emerging to OW (**Fig 23**); Downgrade Developed to UW (**Figs 21-22**)

► **Credit Duration:** Maintain Long Duration OW as credit quality becomes bigger risk (**Figs 24-26**)

► **Credit Quality:** Remain UW Corp HY & Upgrade Corp IG to OW (**Figs 27-28**); Reposition to BB within Corp HY (**Fig 29**)

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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 a bigger market impact on international 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		•	•	●	Risk shifting from duration to default after 1H22 selloff (3Q22 AA Guide Fig 24) & credit spread blowout (3Q22 AA Guide Fig 28)
EM Sovereign		•	•	●	Fed & EM central bank rate hikes already priced in; Favor local currency due to USD weakening; 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; Peaking yields & equity market rebound make more attractive in 2H22
Municipals		•	●	•	Decision to not raise individual & corp. 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 2022 as supply chains improve & base effect rolls off
High Yield		●	•	•	Credit spreads expanded back to 2020 levels; Concerned about late economic cycle dynamics (3Q22 AA Guide Fig 27)
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 weigh on valuations; Likely more attractive during 2H22
Comm Svcs		•	●	•	Mixture of Growth & low-beta telecom; Regulatory risk = social media headwind; Weak streaming industry fundamentals
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 = potential headwind; High-weight AMZN & TSLA = growth proxy
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; Prefer to use DIVB to benefit from rising buybacks
High Beta		●	•	•	Broad mixture of factor & industry exposure - Volatility shifting from Covid to 'Growth-style' volatility 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.

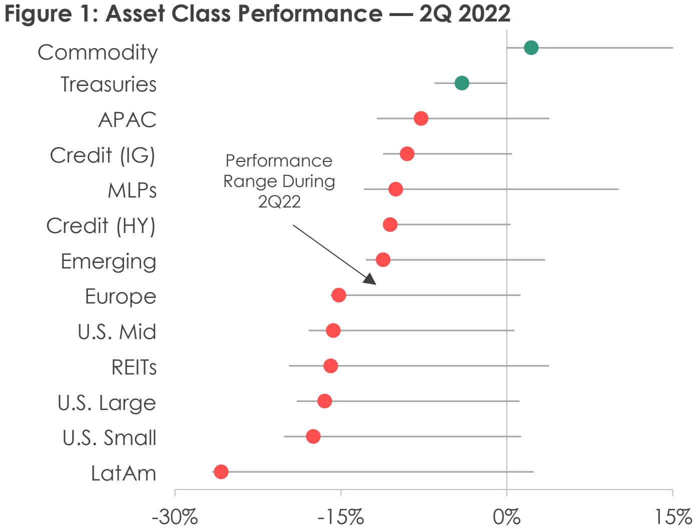
Asset Class Performance

Recap since last edition of the Asset Allocator's Guide

Asset Class	Total Return (%)			Valuation & Yield			Asset Flows[1]		Price Chart
Global Equities	**2Q'22**	**1Yr**	**3Yr**	**NTM P/E**	**P/B**	**Div Yld**	**2Q'22**	**Last 2Yrs**	**YTD**
U.S. Large Caps	-16.1	-10.6	35.2	15.8x	3.7x	1.6%	↑ 0.5%		
U.S. Mid Caps	-15.4	-14.8	21.2	11.4x	2.1x	1.3%	↑ 1.6%		
U.S. Small Caps	-17.3	-25.4	12.8	17.0x	1.9x	1.3%	↓ 2.5%		
Europe	-13.5	-18.4	5.3	12.5x	1.8x	4.4%	↓ 7.1%		
Asia-Pacific	-7.3	-25.0	4.3	12.1x	1.6x	2.6%	↑ 2.4%		
Latin America	-22.6	-20.2	-21.6	6.0x	1.4x	12.3%	↑ 8.3%		
Developed	-13.2	-17.4	4.0	11.8x	1.6x	4.9%	↑ 0.5%		
Emerging	-10.4	-25.6	-0.3	11.0x	1.7x	2.8%	↑ 5.8%		
U.S. Sectors									
Comm Services	-21.5	-34.0	11.5	16.1x	2.8x	1.2%	↓ 0.6%		
Cons Discretionary	-25.5	-22.5	18.6	20.9x	7.9x	0.8%	↓ 4.3%		
Cons Staples	-4.2	5.8	34.5	20.0x	6.0x	2.5%	↑ 5.4%		
Energy	-5.5	38.9	34.5	8.5x	2.2x	4.0%	↓ 6.2%		
Financials	-17.5	-12.7	21.4	11.4x	1.3x	2.1%	↓ 15.6%		
Health	-6.0	3.3	46.1	15.7x	4.8x	1.5%	↑ 7.5%		
Industrials	-14.8	-13.4	18.8	15.9x	4.6x	1.6%	↓ 10.8%		
Materials	-15.9	-8.8	33.8	12.5x	2.7x	2.2%	↑ 2.2%		
Tech	-19.8	-13.2	68.0	18.9x	7.9x	0.9%	↑ 2.5%		
Utilities	-5.1	14.3	29.5	19.6x	2.2x	2.9%	↑ 13.8%		
Fixed Income									
Treasuries	-3.7	-9.2	-3.0	-	-	1.2%	↑ 21.8%		
Invest. Grade	-8.4	-16.1	-4.1	-	-	2.8%	↑ 0.8%		
High Yield	-9.5	-12.8	-3.0	-	-	4.9%	↑ 5.3%		
Alternatives									
REITs	-15.4	-8.0	15.1	17.8x	2.6x	3.1%	↓ 2.8%		
MLPs	-8.2	2.6	-6.9	9.5x	1.7x	8.5%	↑ 4.7%		
Commodities	2.2	38.4	72.1	-	-	-	↑ 6.5%		

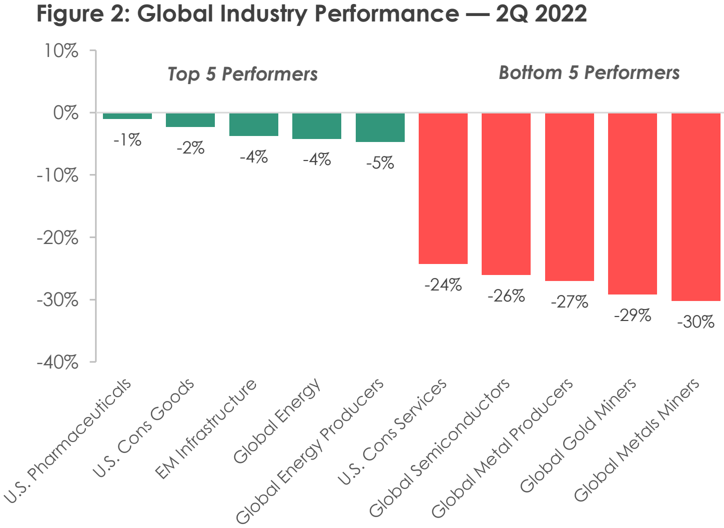
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

Figure 1: Asset Class Performance — 2Q 2022



Source: MarketDesk

Figure 2: Global Industry Performance — 2Q 2022

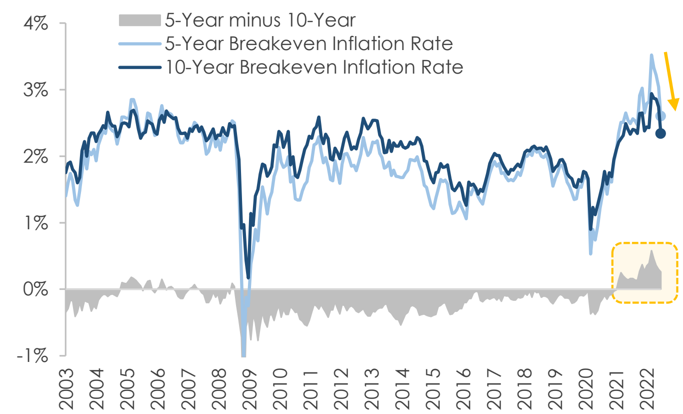


Source: MarketDesk

Charts That Will Shape 3Q 2022

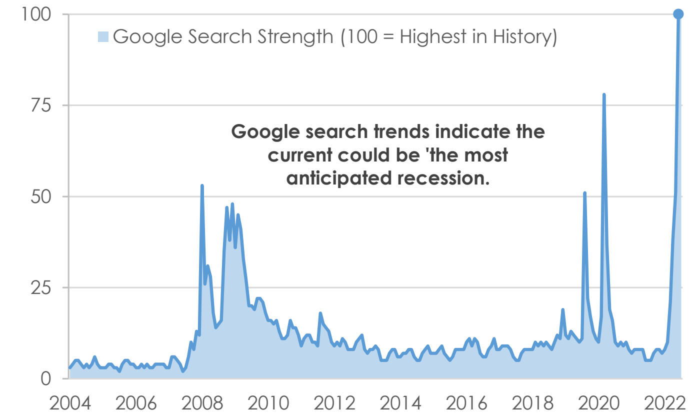
Six charts likely to drive the market narrative this quarter

Figure 3: Near-Term Inflation Expectations Fall During 2Q22



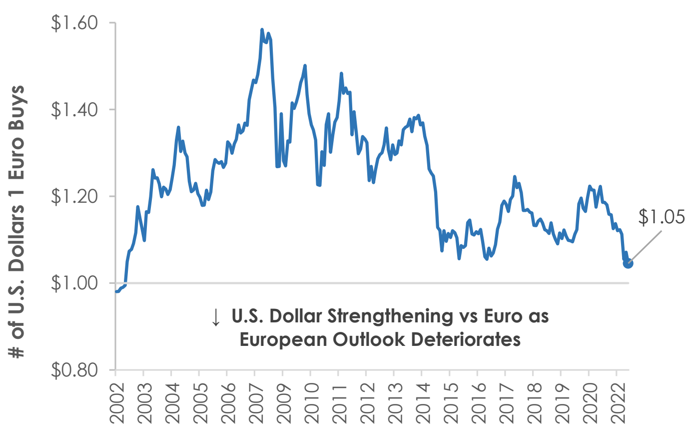
Source: MarketDesk, Federal Reserve

Figure 4: Google Search Trends for 'Recession'



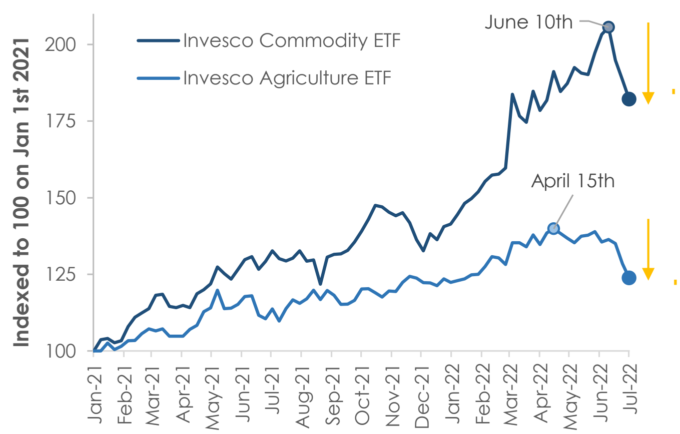
Source: MarketDesk, Google

Figure 5: EUR/USD Approaching Parity (First Time Since 2002)



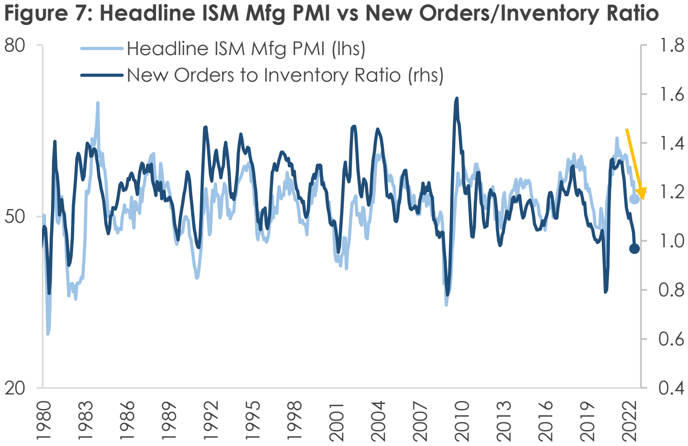
Source: MarketDesk, FactSet

Figure 6: Commodity Investors Rush for the Exits



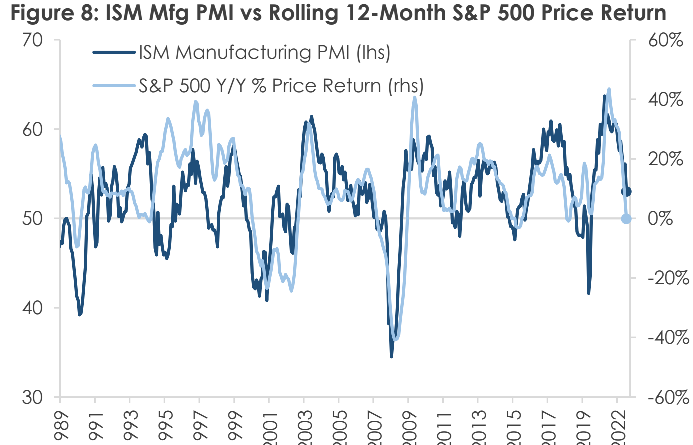
Source: MarketDesk, FactSet. Analysis is based on Invesco's DBA & DBC ETFs.

Figure 7: Headline ISM Mfg PMI vs New Orders/Inventory Ratio



Source: MarketDesk, ISM. Note: The New Orders / Inventory ratio is calculated as the New Orders subindex divided by the Inventory subindex and smoothed by a 4-month average.

Figure 8: ISM Mfg PMI vs Rolling 12-Month S&P 500 Price Return



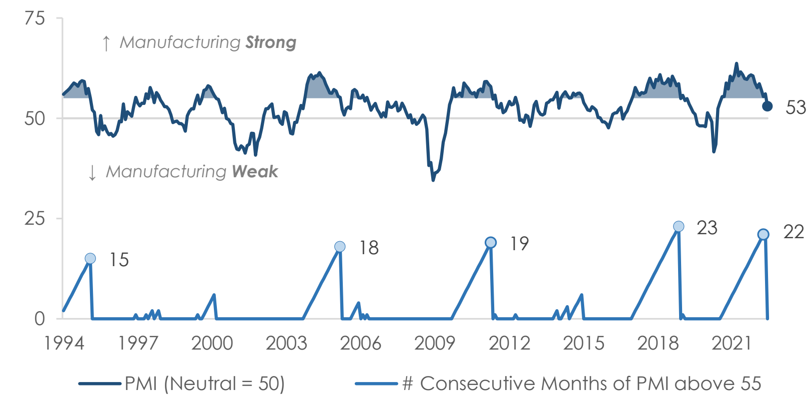
Source: MarketDesk, ISM. Analysis is based on price returns of the S&P 500 Index. S&P 500 y/y price return smooth by 4-week moving average.

Unfolding Economic Themes

► **Late Economic Cycle With Deflationary Pressures Emerging:** Economic data from the past 24 months tells the story of the post-Covid boom. Multiple datapoints highlight the consumer spending splurge, industrial production and manufacturing booms, and inflationary pressures as goods demand was pulled forward and capacity was stressed. Data released during 1H22 shows the reversion to the mean is occurring as housing cools, inflation drags down discretionary spending, and ISM Manufacturing PMI moves lower toward contraction.

► **Our Takeaway:** Investor focus is likely to remain on Fed policy during 3Q22, but economic data and corporate earnings will become more important as 2H22 progresses and Fed uncertainty fades. Our macro view – the economic cycle is late in the expansion phase, and potentially early contraction phase, as activity normalizes. The question – How deep and long will the contraction phase be?

Figure 9: ISM Manufacturing PMI Expansion Cycles (1994-Present)



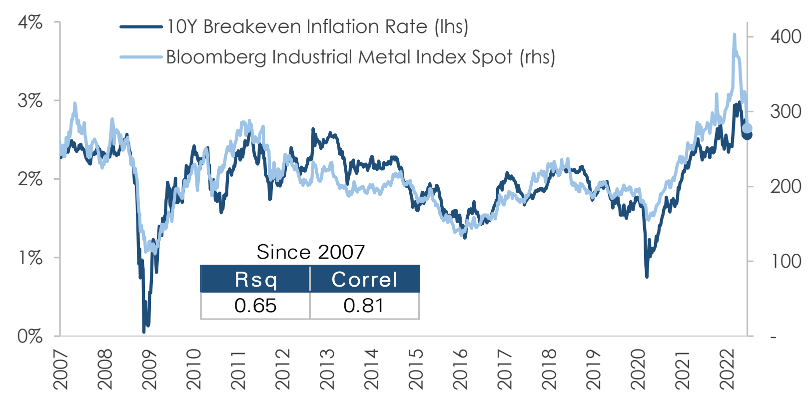
Source: MarketDesk, ISM

ISM Manufacturing PMI Drops Below 55 After 22 Consecutive Months > 55 …

● Figure 9 shows the ISM Mfg PMI fell below 55 during June after holding above 55 for 22 consecutive months. The drop below 55 officially makes the post-Covid Mfg PMI boom the second longest after the Jan 2017-Nov 2018 expansion.

● While the survey is not a scientific datapoint, it does continue to provide a useful measuring stick to gauge the current manufacturing expansion. We view it as a statistically significant event confirming the economic cycle's late stage, which is why this PMI chart and slowing economic activity remain top themes in this *3Q22 AA Guide* .

Figure 10: 10-Year Breakeven Inflation Rate vs Industrial Metal Spot Price



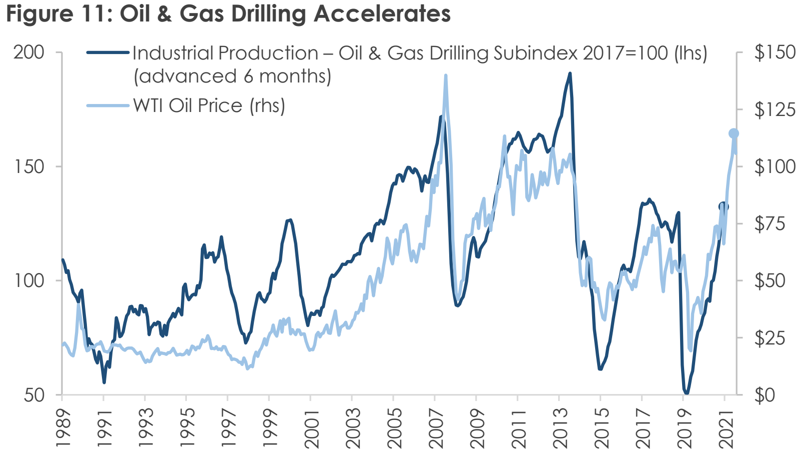
Source: MarketDesk, Federal Reserve, Bloomberg

Industrial Metals Plunge as Inflation Expectations Decline …

● Figure 10 charts the Bloomberg Industrial Metals Spot Index against the 10-year breakeven inflation rate, which represents the average expected inflation rate over the next 10 years. It shows industrial metal spot prices historically rise as inflation expectations rise, and vice versa.

● Figure 3 highlights the inflation expectations decline during 2Q22, a trend we forecasted in ***2Q22 AA Guide Figure 9*** . We attribute the decline to the Fed's accelerated tightening schedule driving recession fears. If inflation expectations continue to decline, there's a lot of 'hot money' to come out of industrial metals.

Figure 11: Oil & Gas Drilling Accelerates



Source: MarketDesk, Federal Reserve, FactSet. Note: Oil & Gas Drilling Subindex is advanced 6 months forward to emphasize relationship.

Consistent With Prior Cycles, Oil & Gas Drilling Accelerates as Oil Prices Soar …

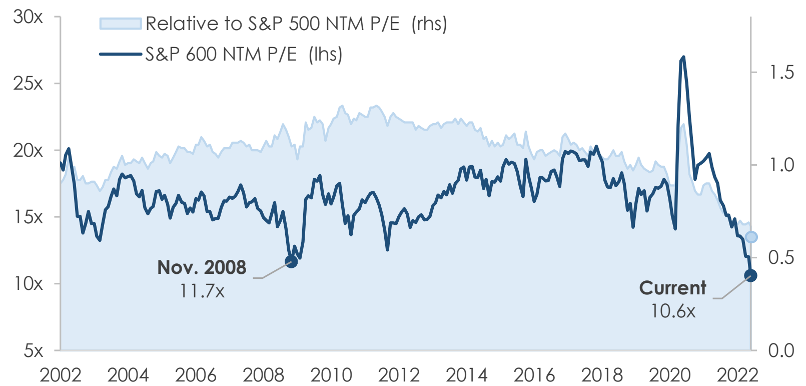
● Figure 11 compares the Oil/Gas Drilling subindex within industrial production against oil prices. It shows drilling lags oil prices by ~6 months and points to more drilling activity. We expect the increased drilling theme to gain traction in 2H22, although the price impact is highly uncertain.

● The current oil rally is based on underinvestment (i.e., ESG, cash return instead of growth) and geopolitics (i.e., Russia sanctions). However, history shows drillers are incentivized to increase oil supply, especially private companies not beholden to ESG pressures. For now, the takeaway is drillers are responding to rising prices with more drilling, a consistent theme across prior oil cycles.

Size — Large Caps vs Small Caps

► **Maintain Large Cap OW & Small Cap UW.** Equity markets' 1H22 performance was the worst start to a calendar year since 1970. The dominant theme was P/E multiple contraction as Fed tightening pushed Treasury yields higher, and there was no place to hide as both Large and Small Caps traded down -20% and -24%, respectively. As 2H22 starts, we expect the risk to shift from P/E multiple contraction to slowing, and potentially negative, EPS growth. Corporate profit margins are at 20-year highs (**Figure 13**), and a falling ISM Manufacturing PMI points to negative EPS revisions (**Figure 14**). The narrative may shift to 'Small Caps already price in a recession', but we aren't buying it. We remain OW Large Caps and UW Small Caps.

Figure 12: S&P 600 NTM P/E Multiple – Absolute & Relative to S&P 500



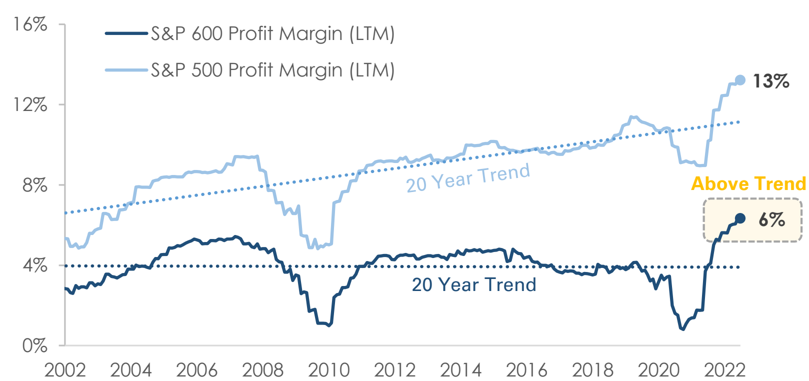
Source: MarketDesk. Analysis is based on the S&P 600 & S&P 500 indices.

Small Caps' Next 12-Month P/E Multiple Currently Sits Below 2008 Level …

● Small Cap valuation metrics are looking more attractive after this year's selloff. Figure 12 shows the S&P 600 currently trades at 10.6x its next 12-month earnings estimate, which is below the 2008 financial crisis trough of 11.7x during Nov. 2008.

● On a relative basis, the S&P 600's NTM P/E multiple is 0.67x the S&P 500's 15.8x NTM P/E multiple. The 0.67x represents a 20-year low, luring investors to wager that S&P 600 P/E multiples already price in a recession. However, we do not believe the risk/reward is attractive yet. Here's why...

Figure 13: Rolling Last 12-Month Profit Margins – Large vs Small



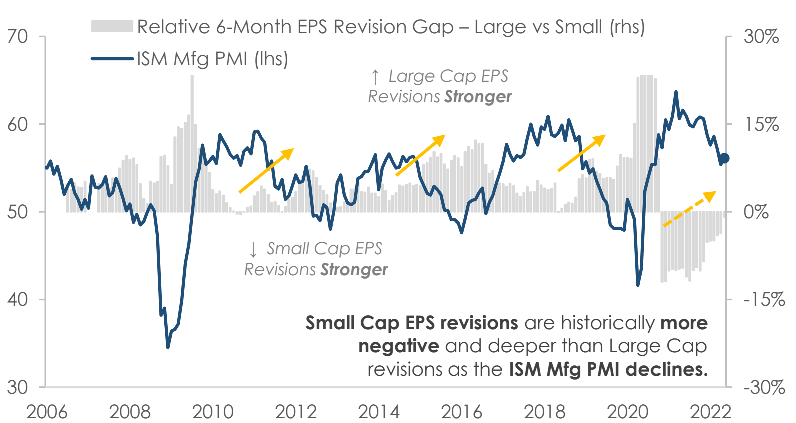
Source: MarketDesk. Analysis is based on the S&P 600 & S&P 500 indices.

Corporate Profit Margin Contraction is a Significant Risk …

● Figure 13 shows corporate profit margins soared to a 20-year high during the pandemic. Stimulus checks, increased savings rates, rising home and stock market prices, and low interest rates pulled forward demand, while pricing power allowed companies to pass through their increased costs.

● Profit margin contraction is a significant risk in coming quarters. Focusing on Small Caps, the pre-pandemic margin peak was 5.29% during 2H 2006 (vs today's 6.33%). If S&P 600 margins only contract back to 2006, the ~1% decline would translate into a -16.4% EPS decline and increase the NTM P/E multiple to 12.8x. It's still attractive, but ...

Figure 14: Manufacturing PMI vs EPS Estimate Revisions – Large vs Small



Source: MarketDesk, ISM. Note: EPS revisions gap is calculated as Large Caps' NTM EPS revision % change minus Small Caps' NTM EPS revision % change over the past 6 months.

… & Declining PMIs Point to Negative EPS Estimate Revisions in the Quarters Ahead

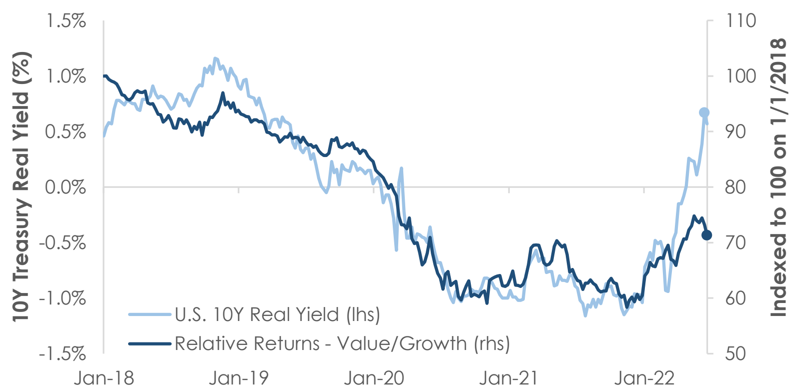
● … Negative EPS estimate revisions are another potential headwind. Figure 14 compares the Large vs Small NTM EPS revision gap against the ISM Mfg PMI. When the Mfg PMI is trending lower, Small's EPS revisions are historically more negative than Large. History points to negative EPS revisions during 2H22, with Small Caps the most vulnerable.

● Do Small Caps price in a recession? The S&P 600's NTM P/E multiple is attractive on an absolute basis. However, once the potential for profit margin contraction and negative EPS revisions are factored in, history indicates earnings are a moving target with downward momentum. The risk/reward is still unattractive in our view.

Navigating Growth vs Value – P/E Multiple vs EPS Contraction

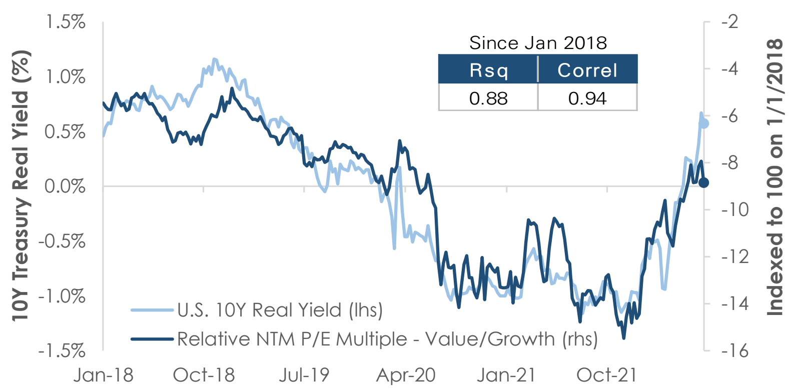
► **Upgrade Growth to Neutral; Downgrade Value to Neutral:** Our Growth/Value rating is at a crossroads after a prosperous 1H22. The question is which is a bigger potential headwind for client portfolios – Growth's forward P/E multiple contracting or Value's forward EPS estimate falling? Growth's P/E multiple contraction remains a potential headwind given Fed policy uncertainty, but the Fed's aggressive hiking and a slowing economy makes Value's EPS estimates a bigger risk during late 2H22. The tricky part is timing the jump from a Value OW to a Growth OW. The timing is not right yet in our view, but the switch is inching closer. 2Q22 earnings season will provide helpful information. Note: Clients at the start of this year will recall our 2022 roadmap called for a "switch back to Growth OW around mid-2022 once real yields normalize". Refer to the OCIO Models for the corresponding portfolio changes.

Figure 15: Value/Growth Price Return Gap vs Real Yields



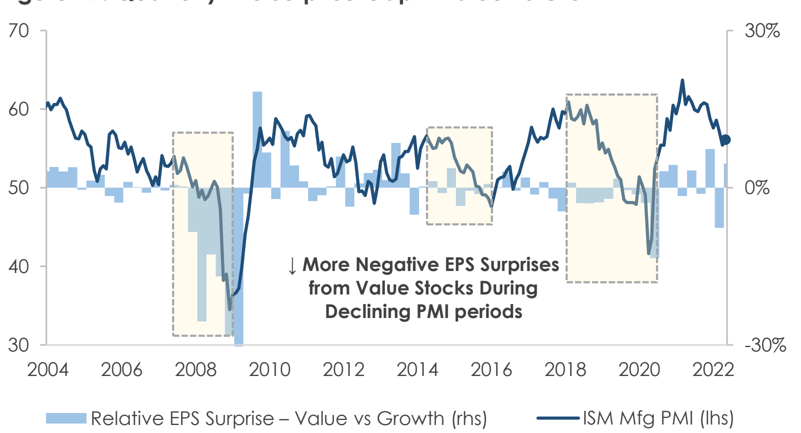
Source: MarketDesk, Federal Reserve. Analysis is based on the Russell 1000 Growth/Value.

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



Source: MarketDesk, Federal Reserve. Analysis is based on the Russell 1000 Growth/Value.

Figure 17: Quarterly EPS Surprise Gap – Value vs Growth



Source: MarketDesk, ISM. Analysis is based on the Russell 1000 Growth/Value indices. Calculated as Growth's % EPS surprise minus Value's % EPS surprise.

Value/Growth Return Gap Diverges From 10-Year Real Treasury Yield Increase, But …

• Figure 15 updates ***1Q22 AA Guide Figure 15***. The chart highlights the statistically significant relationship between the 10Y Treasury real yield and Value/Growth return gap and was a key catalyst driving our Growth double downgrade to UW and Value double upgrade to OW. Refer to the *1Q22 AA Guide* for additional commentary.

• Since the *1Q22 AA Guide,* Russell 1000 Value has outperformed Russell 1000 Growth by ~+15.5%. However, the updated chart shows the Value vs Growth return gap recently diverged from real yields. Is the relationship broken, or is there another factor at work?

… Growth vs Value Next 12-Month P/E Multiple Gap Follows Real Yields Higher

• Figure 16 looks at **Figure 15** through a different lens – Value/Growth NTM P/E multiple gap vs 10Y real yield. Unlike the return gap, the P/E multiple gap has not diverged from real yields, indicating P/E multiple contraction remains a bigger headwind for Growth stocks as real yields rise.

• Why the disparity? Margin expansion and EPS growth since 2018. Using Russell 1000 ETFs as proxies, IWF's (Growth) EPS grew +66.3% compared to IWD's (Value) +50.3% EPS growth. While the P/E multiple is in line with historical levels, the **Figure 15** price index layers on EPS growth. The relationship isn't broken, only distorted by EPS growth.

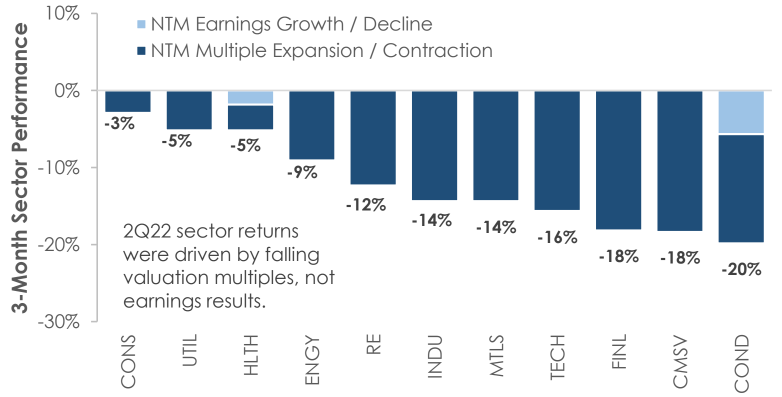
Where are the Hidden EPS Surprises? Falling PMIs Point to Value Stocks …

• Fed tightening and slowing economic growth raise the risk of negative EPS surprises. Where is the hidden risk? Figure 17 compares quarterly EPS surprises for the Russell 1000 Growth and Value factors against the ISM Mfg PMI. The chart shows a falling PMI historically leads to bigger negative EPS surprises for Value. Why? We attribute the link to Value's more cyclical sector exposure (**Figure 19**).

• Given the evidence, we are upgrading Growth to Neutral and downgrading Value to Neutral. Figure 16 indicates the P/E multiple vs real yield relationship is weakening as real yields pass above 0.50%, and Figure 17 shows Value faces a bigger risk of negative EPS surprises.

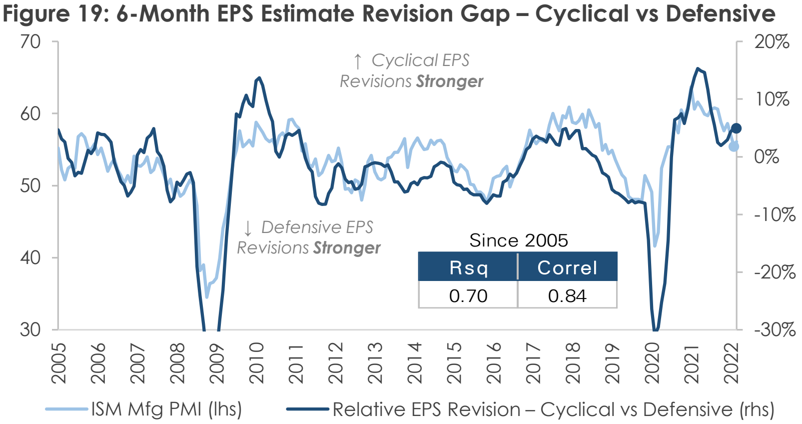
► **Maintain Defensive Sector Overweight:** The dominant market theme during 1H22 was P/E multiple contraction, with Growth-style sectors bearing the brunt of the market selloff (**Figure 18**). During 2H22, we expect the downside risk to shift from P/E multiple contraction to corporate margin contraction as economic conditions deteriorate (**Figure 19**). Given the shift, we maintain a preference for defensive sectors at the start of 2H22. At some point during 2H22, we envision rotating to the higher quality EPS of Growth style sectors, such as Tech, once the risk of P/E multiple contraction fades. Based on our current views, our base timeline for this occurring is late 3Q22 or 4Q22, but we emphasize this is only an estimate and subject to change based on market conditions.

Figure 18: 2Q22 Sector Performance Drivers – P/E Multiples vs Estimates



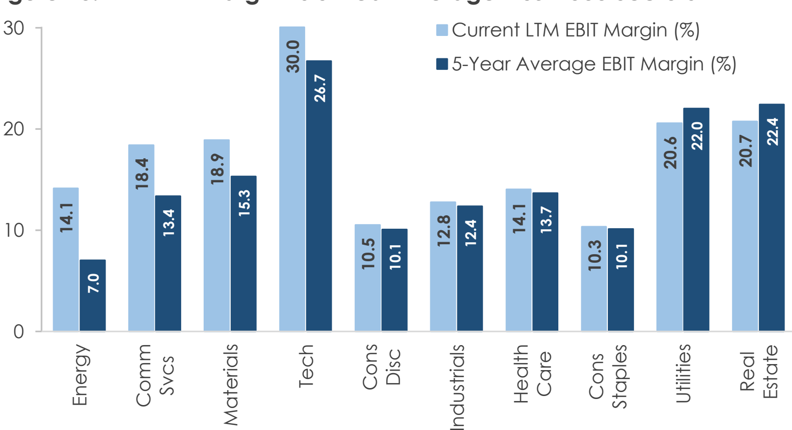
Source: MarketDesk, FactSet. Analysis is based on S&P 500 sectors.

Figure 19: 6-Month EPS Estimate Revision Gap – Cyclical vs Defensive



Source: MarketDesk, ISM. Note: Cyclical: Cons Disc, Financials, Industrials, & Materials. Defensive: Cons Staples, Health Care, Comm Svcs, & Utilities.

Figure 20: LTM EBIT Margin vs 5-Year Average – S&P 500 Sectors



Source: MarketDesk, FactSet

2Q22 Sector Performance Primarily Driven by P/E Multiple Contraction …

● Figure 18 spotlights **Figure 7** from the monthly *Sector* report, which compares each sector's performance contribution from NTM earnings estimate revisions against NTM P/E multiple movement. The chart perfectly depicts the valuation headwind for equities this year as Fed tightening and rising interest rates compressed P/E multiples across all sectors.

● Looking ahead, our base case is the investment regime will shift as the risk transitions from P/E multiple contraction to negative EPS revisions and surprises. **Figures 17 & 19** explain highlight the risk ...

Falling Mfg PMI Indicates Cyclical Sector EPS Estimates Have Further to Fall …

● Figure 19 is similar to **Figure 17** but compares the 6-month EPS estimate revision gap (instead of the quarterly EPS surprise gap) against the ISM Mfg PMI. The chart shows a clear relationship – cyclical sectors historically experience bigger upward EPS revisions than defensive sectors as the Mfg PMI rises, and vice versa.

● This work confirms the analysis in **Figures 18-19** of the ***2Q22 AA Guide***. We maintain our defensive sector OW and cyclical sector UW as 2H22 starts. Refer back to the *2Q22 AA Guide* for additional commentary and forward return statistics.

Comparing Margin Contraction Risk Across S&P 500 Sectors …

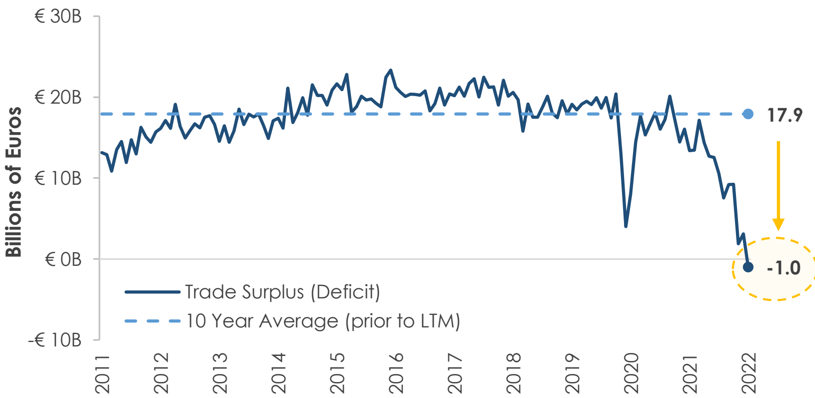
● Figure 20 compares the last 12-month EBIT margin for S&P 500 sectors against their 5-year averages. The chart uses EBIT margin as a proxy for operating margin to identify sectors that are vulnerable to corporate margin contraction as economic conditions slow (**Fig 19**).

● Energy, Comm Svcs, Materials, and Tech experienced the strongest margin expansion. Of these four, Energy and Materials are the most concerning due to their cyclicality and reliance on commodity prices. In contrast, defensive sectors, such as Real Estate, Utilities, Cons Staples, and Health Care, experienced either margin contraction or only slight expansion.

International Markets

► **Upgrade EM to OW; Downgrade DM to UW:** International equities' lower exposure to expensive Growth stocks helped the group outperform U.S. equities during 2Q22. At the mid-year point, MSCI EAFE and MSCI EM have outperformed the S&P 500 by +1.3% and +2.7%, respectively, YTD. Entering 2H22, a divergence is forming between DM and EM. Within DM, Europe faces headwinds from the ECB starting its tightening cycle and stagflation pressures, while continued BOJ easing is weakening the Japanese yen. The situation and risk/reward setup are more attractive in EM. China is relaxing Covid restrictions and officials are easing monetary policy to support the reopening, EM central banks are already +12 months into their tightening cycles, and USD strengthened +15% over the past 12 months. Refer to the OCIO Model for the corresponding portfolio changes.

Figure 21: Germany Monthly Goods Trade Surplus (Deficit)



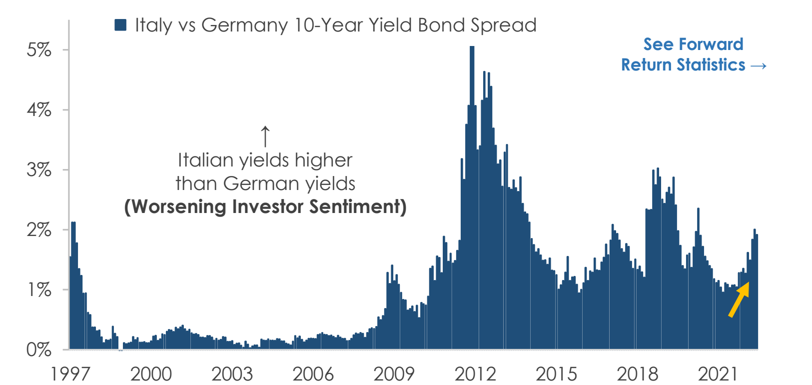
Source: MarketDesk, German Federal Statistics Office. Data is seasonally adjusted.

Germany's First Goods Trade Deficit Since 1991 Highlights Europe's Problems …

● Figure 21 shows Germany's monthly goods trade switched to a deficit during May, the first goods trade deficit since 1991. The deficit reveals the stress Germany's industrial sector, and broader Europe, face as rising commodity and energy prices take a toll on the region.

● Europe's economic outlook is under pressure, and the cloudy outlook is unlikely to lift until there is more clarity about regional energy issues (Russia is a key supplier) and inflation pressures. Like U.S. Small Caps (**page 6**), valuation levels are attractive, but we have concerns about profit margin contraction.

Figure 22: 10-Year Bond Yield Spread – Italy vs Germany



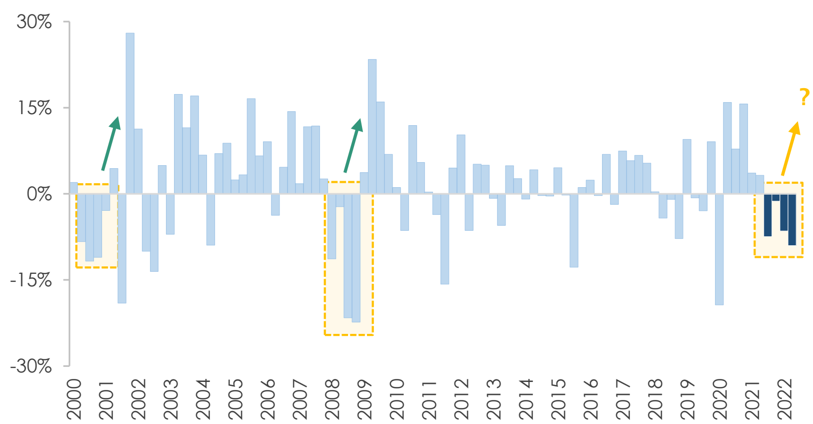
Source: MarketDesk, FactSet

Italy / Germany Bond Yield Spread Expands Back to Covid Levels …

● Figure 22 shows the spread between 10-year Italian and German government bonds sits at ~2%, back near early Covid levels. The spread between the two tends to spike during periods of macro stress as investors prefer Germany's higher credit quality over Italy's higher debt load.

● What does a 2% spread imply about forward returns? Historically, the forward 6- and 12-month returns and risk/reward setups are more attractive than the next 3 months. Current risks (i.e., ECB tightening, stagflation) also support a cautious stance in Europe during 3Q22. Click the popout to see more in-depth forward return statistics.

Figure 23: Quarterly Price Returns – MSCI Emerging Market Index



Source: MarketDesk, FactSet

MSCI EM's 2001 & 2009 Four Quarter Losing Streaks Ended After Four Quarters …

● Figure 23 charts MSCI EM's quarterly price returns since 2000. It shows MSCI EM produced negative price returns during each of the four most recent quarters, only the third string of four negative quarterly price returns since 2000. The prior two losing streaks ended the next quarter.

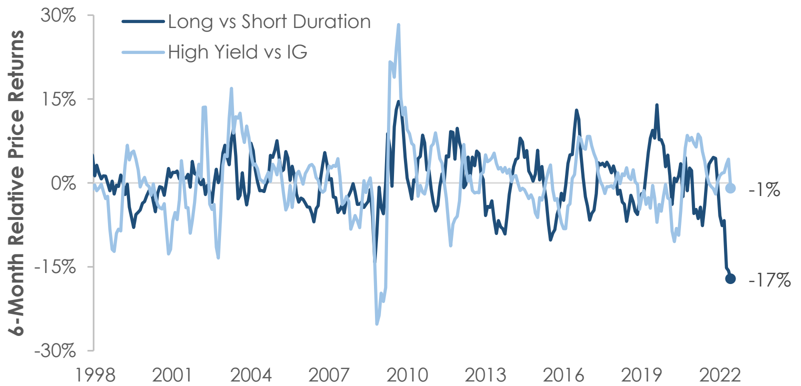
● EM's headwinds over the past 12 months are well-documented – China Covid lockdowns, EM central bank rate hikes, USD strength, and deteriorating economic data. Looking ahead, we favor EM over DM. China is reopening and easing, the EM tightening cycle is already +12 months old, Europe is a question mark, and the Japanese yen is weakening as the BOJ eases monetary policy.

Credit

Credit Duration — Long vs Short

► **Maintain Long Duration OW:** It's been a historic first half of the year in credit markets, and not in a good way. Year-to-date moves in the credit markets were primarily driven by duration as hawkish market sentiment pushed Treasury yields higher and bond prices lower (**Figure 24**). Looking ahead, history indicates the primary credit risk will shift from duration to default risk (**Figure 25**). The Fed's accelerated tightening schedule is likely to drive recession fears and provide another catalyst for Long Duration (**Figure 26**). The ***1Q22 AA Guide*** highlighted Long Duration's headwinds, but our upgrade to OW in the ***2Q22 AA Guide*** was early by 1 month. Given the themes highlighted in 2Q22 are now starting to play out (i.e., ISM Mfg PMI < 55, bonds -3 stdev oversold), we maintain a preference for Long Duration and favor tactically adding to Long Duration during pullbacks.

Figure 24: Duration vs Credit Risk – Rolling 6-Month Return Gap



Source: MarketDesk. Analysis is based on the ICE BofA U.S. Corporate (1-5Y) vs (+10Y) and the ICE BofA U.S. Corporate (IG) vs High Yield indices.

Duration Risk Outweighed Credit Quality Risk During the First Half of 2022 …

● The two lines in Figure 24 chart the rolling 6-month price return gaps between: (1) Long vs Short Duration and (2) Corp HY vs Corp IG. The gap between the two lines (i.e., Long Duration's relative return vs Corp HY's relative return), allows us to compare duration risk against credit quality risk in one chart.

● Long underperformed Short Duration by -17.2% the past six months, while Corp HY slightly underperformed Corp IG by -1%. The -16.2% gap between the two (i.e., -17.2% minus -1%) shows duration was clearly the bigger risk during 1H22.

Figure 25: Forward Return Statistics – Duration vs Credit Quality Risk

Statistics	Next 3-Months	Next 6-Months	Next 12-Months
Median	**1.5%**	**3.0%**	**1.2%**
Average	**1.0%**	**2.1%**	**2.0%**
Past Events (#)	30	30	30
Wins (i.e. Positive)	19	19	19
Win Rate (%)	**63%**	**63%**	**63%**
Max Return	8.7%	20.4%	18.3%
Min Return	-8.4%	-9.9%	-14.3%
Risk/Reward	**1.0**	**2.1**	**1.3**
Average Win	3.5%	6.5%	6.6%
Average Loss	-3.5%	-5.6%	-6.1%
Avg Risk/Reward	**1.02**	**1.16**	**1.08**

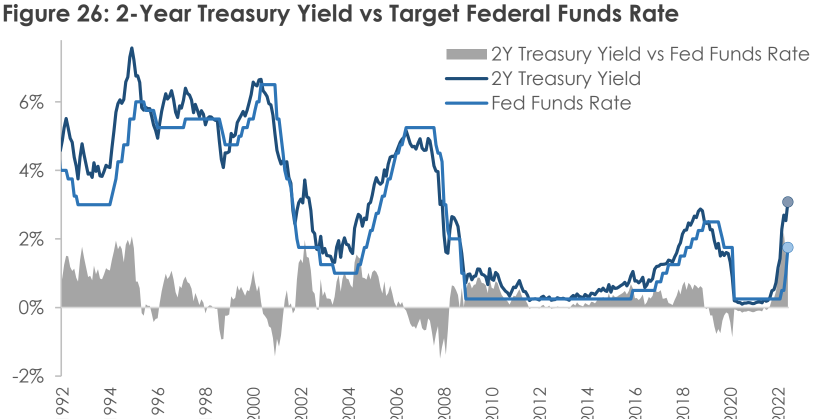
Source: MarketDesk, FactSet

History Indicates the Primary Risk for Bonds Will Shift from Duration to Default …

● Figure 25 shows forward return statistics when the Duration vs Credit Risk return gap (i.e., Figure 24) falls below -10%. Prior instances include periods like 2022 when Long Duration was a bigger performance drag than Corp HY.

● Forward return statistics indicate Long Duration becomes less of a headwind than Corp HY. While the median and average return gaps are not material (i.e., only single-digit percentages in favor of taking duration rather than credit risk), the +60% win rate signal mental frameworks should be reset to focus more on default risk.

Figure 26: 2-Year Treasury Yield vs Target Federal Funds Rate



Source: MarketDesk, Federal Reserve, U.S. Treasury. Calculated as the 2-year Treasury yield minus the target federal funds rate.

Fed's Newfound Hawkishness Increases Default Risk & Benefits Long Duration …

● Investors were more hawkish than the Fed during 1H22. Figure 26 shows the gap between the 2Y Treasury yield, which is sensitive to Fed policy, and the fed funds rate reached 2.2% at the end of April as the 2Y yield soared to 2007 levels.

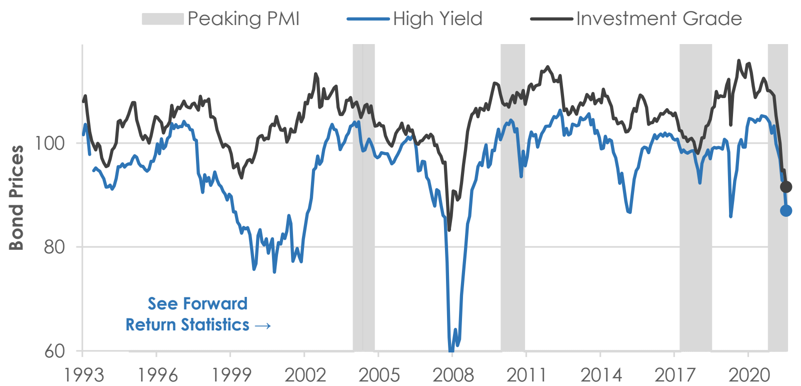
● The gap sits at ~1.3% after +1.25% of rate hikes and is projected to reach ~0.6% in July after a second straight +0.75% rate hike. The Fed signaled its intention to continue shrinking the gap when it unveiled an accelerated tightening schedule at the June meeting. Aggressive tightening is likely to drive recession fears and invert the yield curve, another catalyst favoring Long Duration.

Credit Quality — HY vs IG

► **Remain UW Corp HY; Upgrade Corp IG to OW:** Analysis on page 10 shows year-to-date credit market moves were primarily driven by duration and points to default risk as the next credit risk. Our team downgraded Corp HY to UW on page 12 of the ***2Q22 AA Guide*** and continues to favor an UW position. Credit spreads expanded during the second half of June after the Fed's accelerated tightening schedule ramped up recession fears, and history indicates additional credit spread expansion is a risk (**Figure 28**). Given our preference for higher quality credits, we are upgrading Corp IG to OW and moving up the quality spectrum within Corp HY.

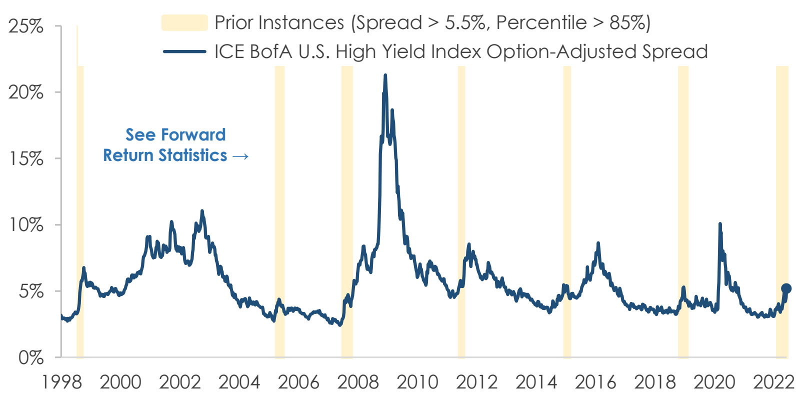
► **Reposition to BB Bonds Within Corp HY:** Refer to the OCIO Model for the corresponding portfolio changes.

Figure 27: HY vs IG — ISM Mfg PMI Falls Below 55 During May



Source: MarketDesk, ISM. Note: Shaded areas = ISM Mfg PMI >55 for more than 15 months. Analysis is based on the ICE BofA U.S. Corporate and High Yield indices.

Figure 28: Prior Credit Spread Blowouts Point to Corp HY Underperformance



Source: MarketDesk, FactSet. Analysis is based on the ICE BofA U.S. Corporate High Yield Index.

Figure 29: Forward Return Statistics (Broad Corp HY vs BB Bonds)

	Next 3-Months	Next 6-Months	Next 12-Months
Statistics	**All Prior Instance** (i.e., Weekly Datapoints Since 1998)		
Median	0.1%	0.1%	0.3%
Average	0.1%	0.2%	0.4%
Past Events (#)	1315	1302	1276
Win Rate (%)	54%	52%	55%
Statistics	**Past Events Similar to Today** (OAS <5.5%; Percentile >85%)		
Median	-0.2%	-1.2%	-1.7%
Average	0.0%	-1.1%	-1.6%
Past Events (#)	32	32	32
Win Rate (%)	38%	28%	25%

Source: MarketDesk, FactSet

Favor Corp IG Over Corp HY as Sustained ISM Mfg PMI Expansion Slows …

● Corp IG historically outperforms Corp HY as the ISM Mfg PMI declines. Figure 27 updates **Figure 30** from the ***2Q22 AA Guide***. Click the popout to see more in-depth forward return statistics.

● The forward return popout shows Corp HY's price returns steadily worsen vs Corp IG over the next 12 months. In addition, Corp HY's win rate vs Corp IG weakens to less than 10% over the next 6 and 12 months. As a reminder, this does not factor in the current HY vs IG 4.23% yield-to-worst differential, which will affect the total return gap. Is the extra +4.23% yield worth it? **Figure 28** says no.

Historical High Yield Credit Spread Blowouts Point to Underperformance …

● Corp HY's option adjusted spread (OAS) soared +1.5% during the two months leading up to mid-June. The sharp 2-month increase was a +1.16 stdev move and ranked in the 89th percentile based on weekly data since 1997.

● How does Corp HY historically perform after credit spread blowouts? Figure 28 charts Corp HY's OAS and overlays instances when the 2-month change ranked above the 85th percentile while OAS was still below 5.5%. Statistics show HY's forward price returns are negative, and the win rate drops significantly. Click the popout to see more in-depth forward return statistics.

BB Bonds Historically Outperform Broad Corp HY After Credit Spread Blowouts …

● One option to protect against credit spread expansion is to move up the quality spectrum within HY. Figure 29 shows BB bonds (i.e., highest rated HY group) historically outperform broad HY after prior spread blowouts (**Figure 28** yellow).

● Here's the math behind the 1.4% hurdle rate to replace broad HY with BB: broad HY offers +1.3% more yield, and iShares HYBB's 0.25% expense ratio adds +0.10% in management fees on top of USHY's 0.15%. It's a close call given BB's projected median and average outperformance is +1.6-1.7%, but our main priority in the current environment is to protect capital. As a result, we are replacing USHY with HYBB in the OCIO Model.

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