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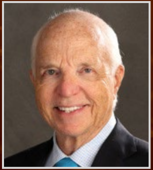
OVERSHOOTING: THE FED USUALLY TIGHTENS UNTIL SOMETHING BREAKS



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QUARTERLY CAPITAL MARKETS OUTLOOK: OCT 2022

The Market Will Stop Panicking Once the Fed Stops Panicking

1) Fixated on Volcker: Fed is likely making a policy error

- Hawkish Jackson Hole speech: To quash the summer rally
  - Vol soared & liquidity evaporated: Financial conditions tightened across the tape

2) When will the Fed stop hiking?

- <u>Option A</u>: Confident wage growth is declining
  - Expected to occur in the next few months
- <u>Option B</u>: Something systemic breaks
  - Financial accidents: A feature of Fed tightening, not a bug

3) EPS typically declines 20% during recessions

- 2023 EPS growth forecast (8%) is delusional: Negative revisions have just started
- Valuations appear fair: Earnings rather than multiples will now drive equities

4) After market trough, typical 6M SPX return is 25-30%

- Rally will likely be front-loaded: Bearish sentiment, light positioning
  - Best sectors are usually: INFT, COND, FINL, INDU

5) Markets to remain choppy for next few months

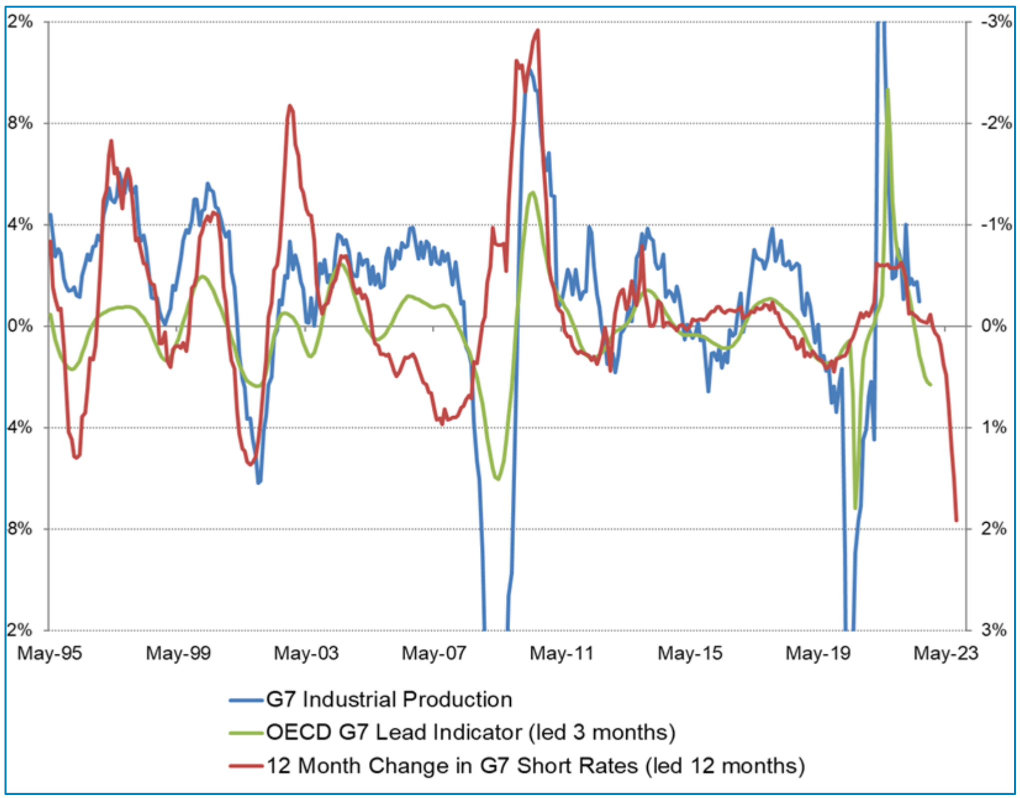
- USD: Strongest since Reagan, headwind for SPX EPS
- China's multiple challenges: Set to keep underperforming
- Europe already in recession: Cheap is its only attraction

Is the Fed Making a Policy Error?

Higher interest rates dampen growth and inflation by tightening financial conditions

- This means lower stock prices, higher private borrowing costs & a stronger USD
    - Reduces lending & liquidity, increases volatility and typically ends when something breaks

Monetary policy: Leads real economy by 12-18 months



Source: Bloomberg, OECD, Ed Hyman

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Three Reasons to Believe the Fed is Overshooting

1. **The Fed is focused on lagging indicators**

- <u>Lagging</u>: Job openings & wage growth
- <u>Leading</u>: Yield curve, M2, volatility, ISM new orders, commodity prices, freight rates, …

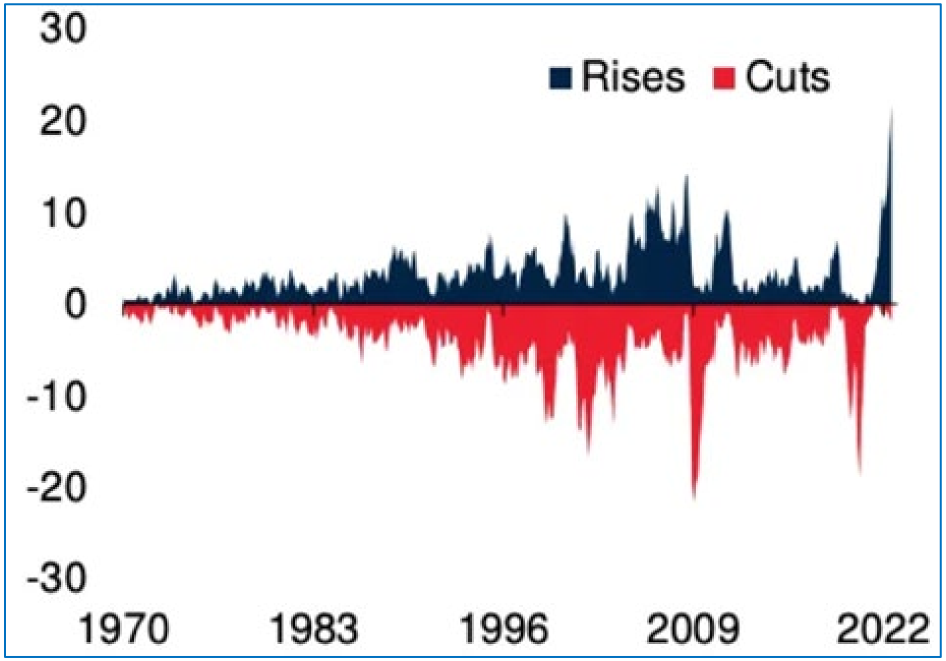
2. **Most aggressive cycle since the late-70s**

- Fast and furious: 4.5% of hikes in 2022e

3. **Uncoordinated global central banks**

- Largest # of hikes ever

Number of global policy rate hikes & cuts



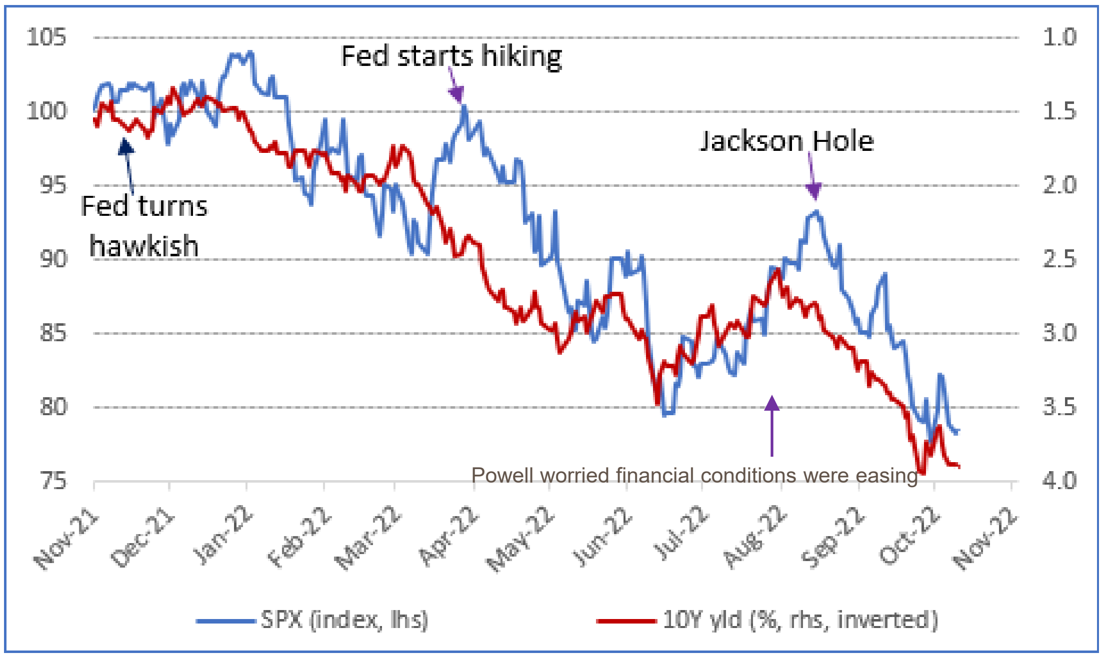
Source: World Bank, The Economist

Jackson Hole: Fed's Hawkish Response to Summer Rally

Tightened financial conditions across the tape

- Year-end FFR futures: Rose 70 bps
- 10Y yield: Increased 80 bps
- USD: Up another 6%
- SPX: Declined 14%

10Y bond yield: Driving SPX bear market



Source: Bloomberg

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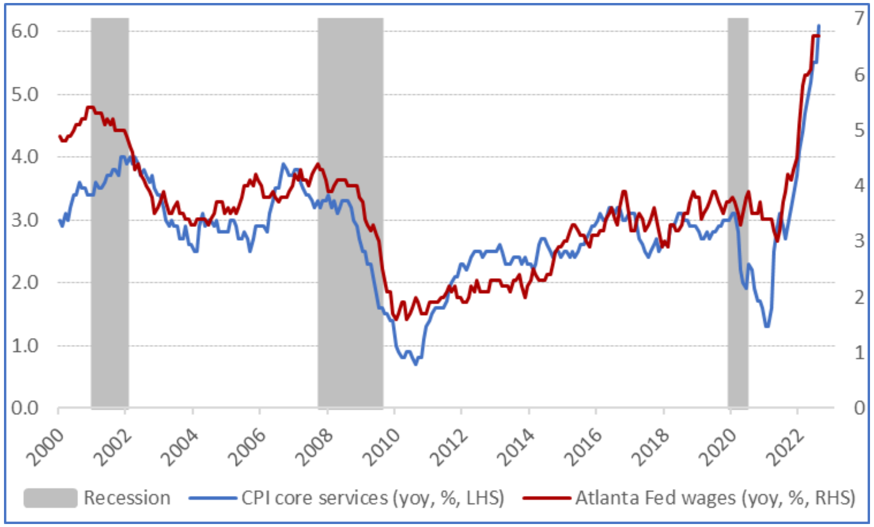
When Will The Fed Stop Hiking? It's All About Wages

Services inflation & wages: 83% correlated



Source: Bloomberg

When will Fed stop hiking?

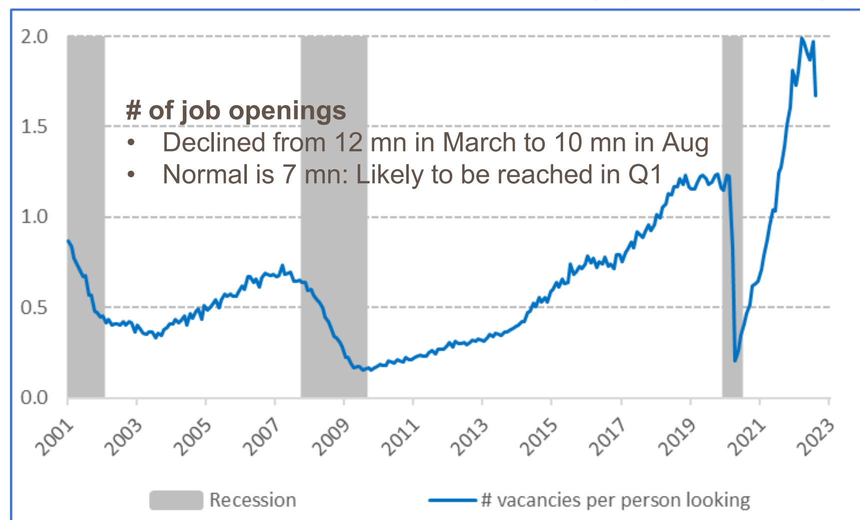
Option A: Inflection in services CPI & wages

- Likely Jan to March
- If AHE continues @ 0.3% mom (Aug & Sept)

Option B: Financial accident, something breaks

- Fed's prime directive: Financial stability

Powell's favorite chart: Too many job openings



Source: Bloomberg

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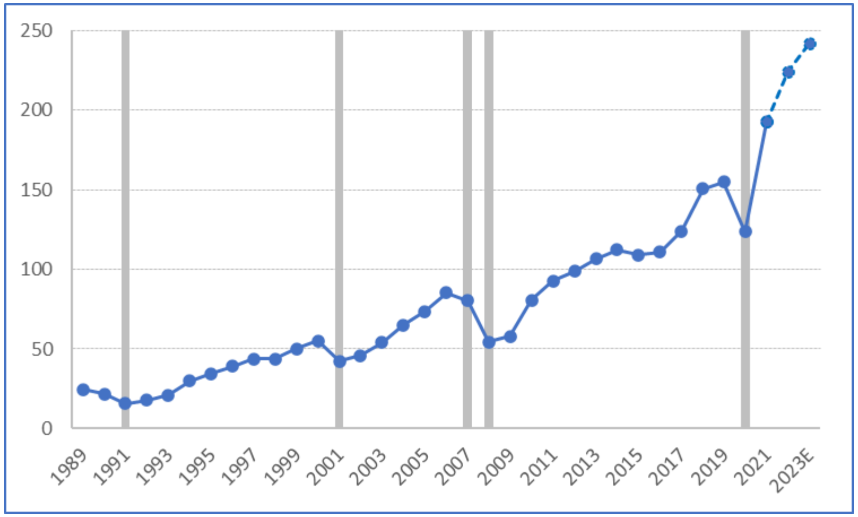
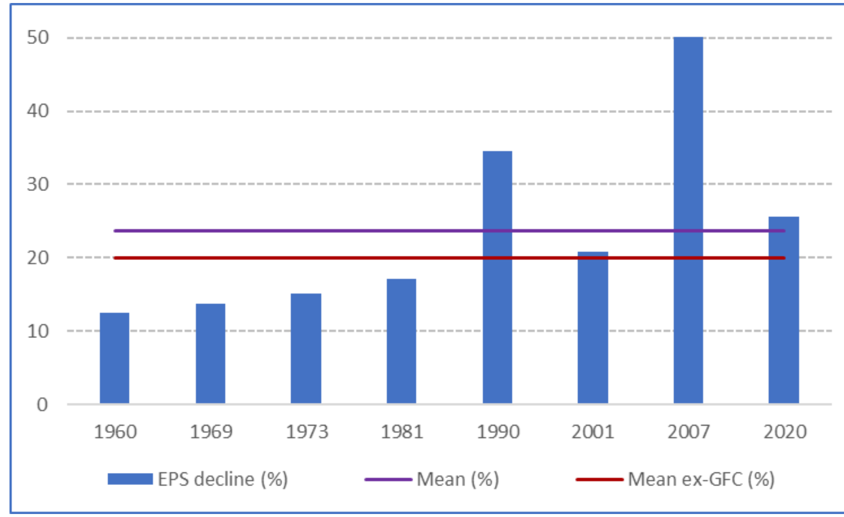
Earnings Recession: Not Yet Priced In

Consensus EPS forecasts: Delusional



Source: Bloomberg

Mean EPS decline during recessions: 20%



Source: Bloomberg

Bottom-up consensus

- 2022e: $224 (7% growth)
- 2023e: $241 (8% growth)

Implies continued margin expansion

3-month earnings revisions

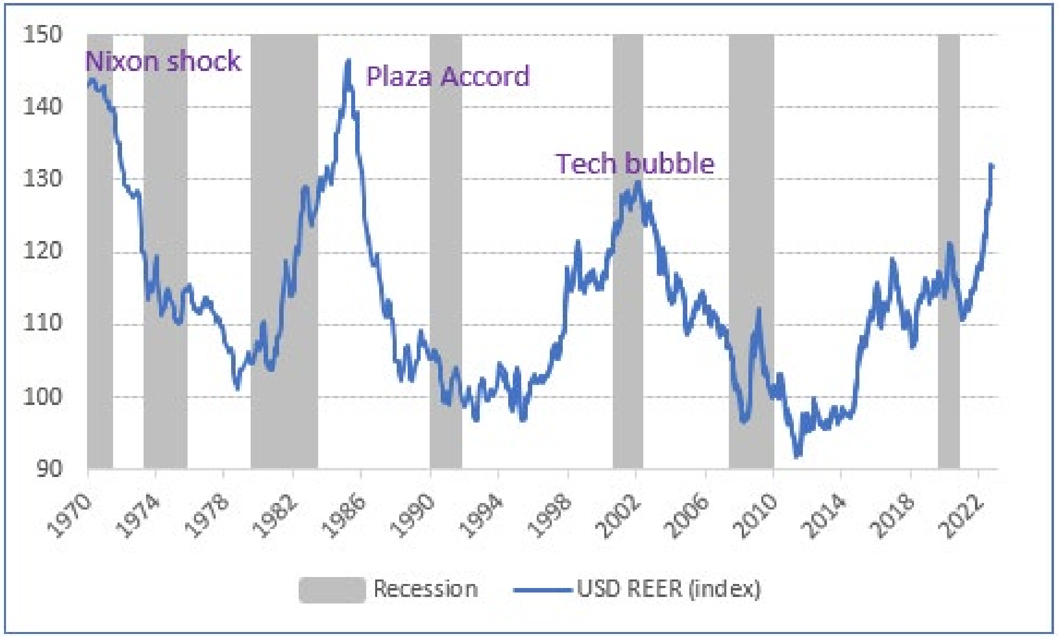
- Most negative: MATR, COND, COMM
- Only positive: ENRS, with UTIL flat

Negative revisions just started

- Weak top-line growth
- Expect to hear a lot more from companies: "The dollar ate my profits"

USD: Headwind for Earnings

USD: Strongest since Reagan



Source: Bloomberg

Four drivers of USD

1) Aggressive hiking
2) Most resilient growth
3) Net energy exporter
4) Best liquidity during market stress

50% of SPX companies have cited a negative Impact from FX on Q3 earnings calls

- 40% of SPX revenues is from abroad
  - Highest: INFT (58%), MATR (55%)

10% rise in USD: Reduces both CPI & GDP by 0.3 ppts

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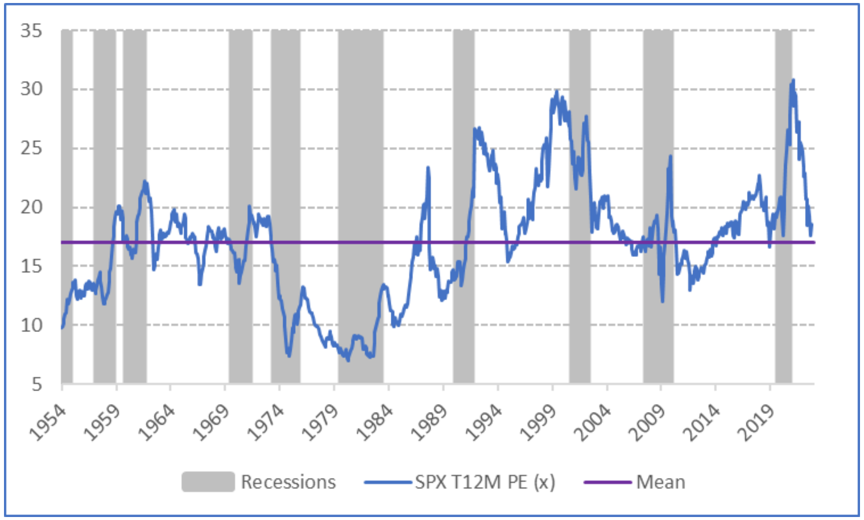
Have Valuations Bottomed?

Close to 70Y mean



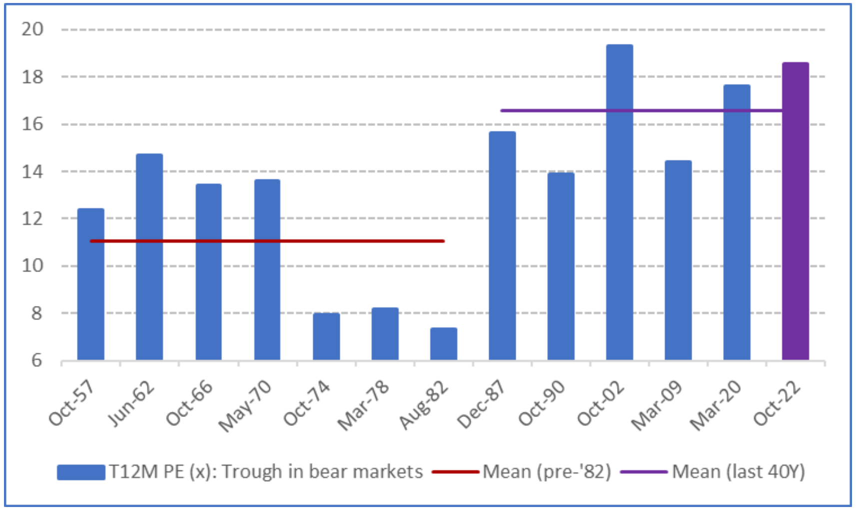
Source: Bloomberg

T12M PE appears fair, but

- EPS typically declines 20% in recessions
  - Negative revisions have just started

Earnings rather than multiples will now drive equity markets

Trough valuations during bearing markets



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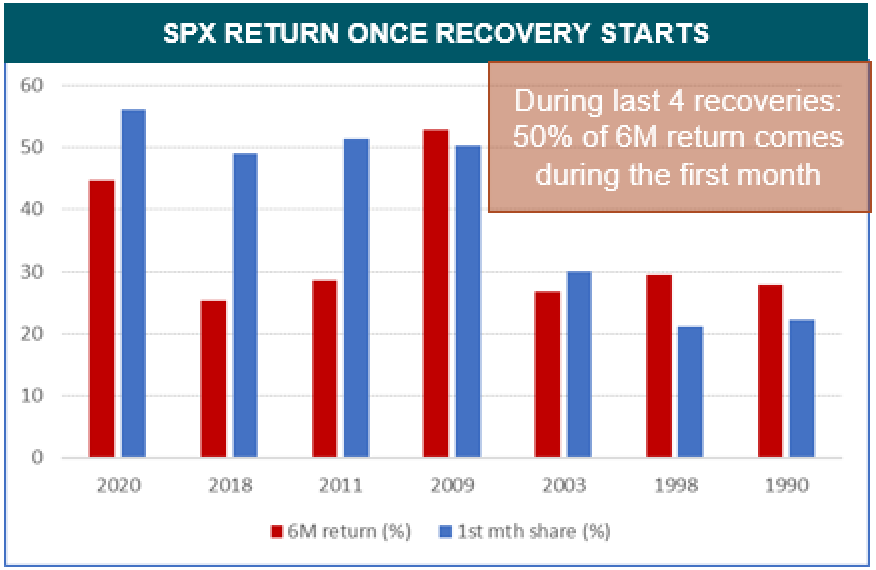
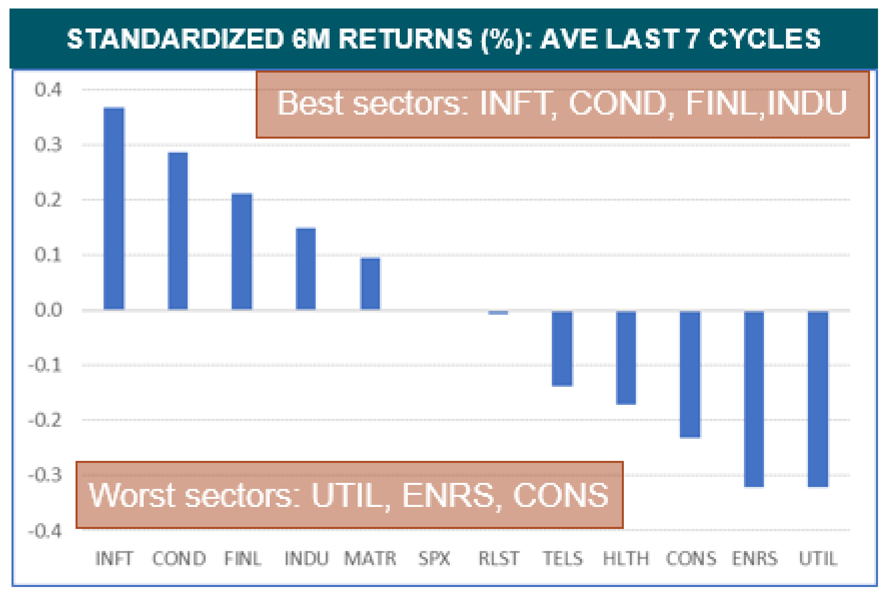


Source: Bloomberg, Epoch Investment Partners

After the Market Troughs
- Typical 6M SPX Return is 25-30%

Front-loaded recovery
- Bearish sentiment & light positioning

Signs the market has troughed
- Services inflation: Heads back to target
    - Watch: Wage growth
- Early cyclicals: Begin to outperform
- Valuations: Rebound, anticipating rising EPS



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Thank You

QUESTIONS?

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Greenflation: The Energy Transition Will Prove Inflationary

The transition to net-zero emissions (NZE) involves a fundamental change in the structure of the economy and will likely be messy. Further, inflation and nominal interest rates will probably be higher and more volatile. This has not yet been priced into markets.

Reflation and the 3 Ds

Until recently, we had been living in a disinflationary environment that started in the 1980s. We believe three factors – Deglobalization, Demographics and Decarbonization – have led us to a secular reflationary environment. As a result, the next decade is going to look quite different than the 2010s, with critical implications for investors.

This is Why We Can't Have Nice Things

Of late, people are blaming a variety of economic ills on an unlikely villain: the desire of investors to earn good returns on capital. But, no industry can be expected to survive if it is not creating value for the investors in that industry. Earning good returns on capital is not an obstacle to satisfying consumer demands; it's what enables companies to continue to satisfy those demands.