Quarterly Economic Update

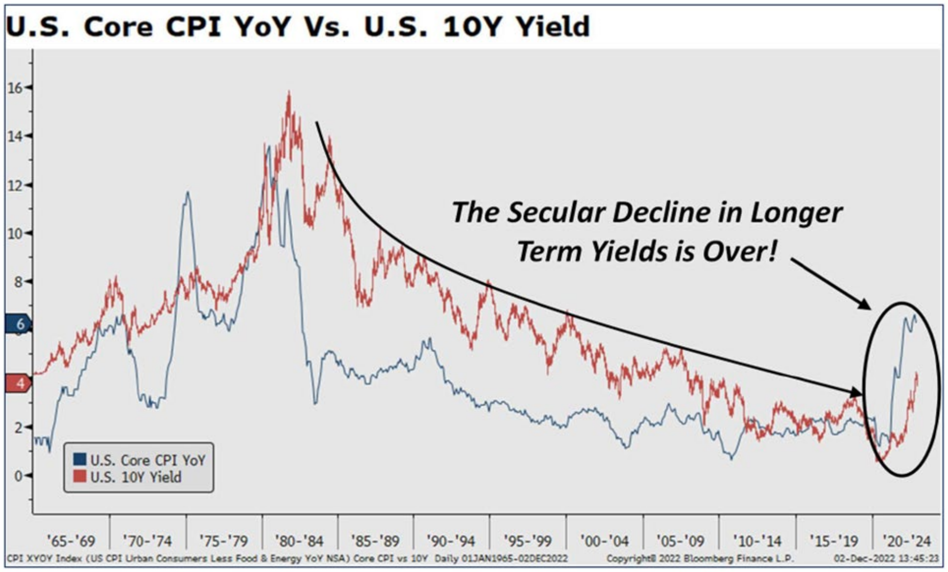
December 14, 2022

MACROECONOMIC COMMENTARY

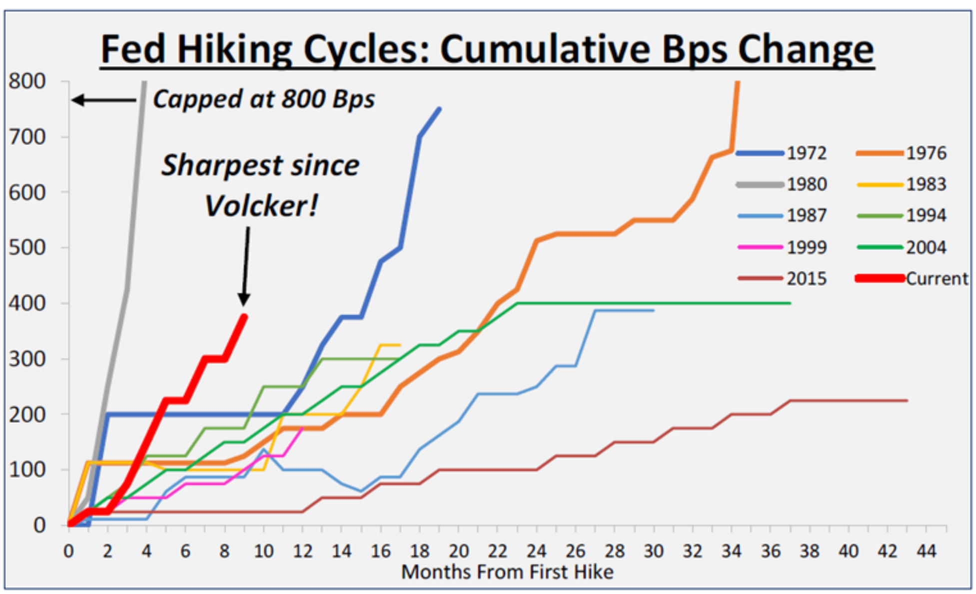
Fiscal/Monetary Policy

By Michael McNair

After a 40-year secular decline in inflation and interest rates, both the Consumer Price Index (CPI) and interest rates have broken out of their long-term down-trends.



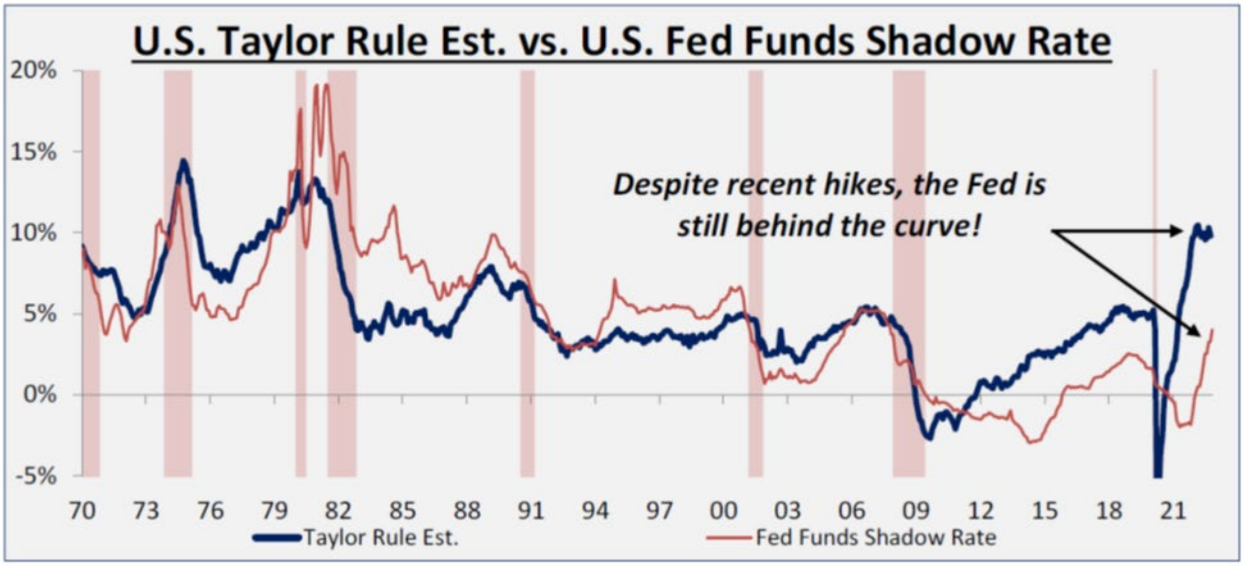
The Fed has responded to the highest inflation rate since the 80s by conducting the second sharpest tightening cycle in its history.



Source: Wolfe Research

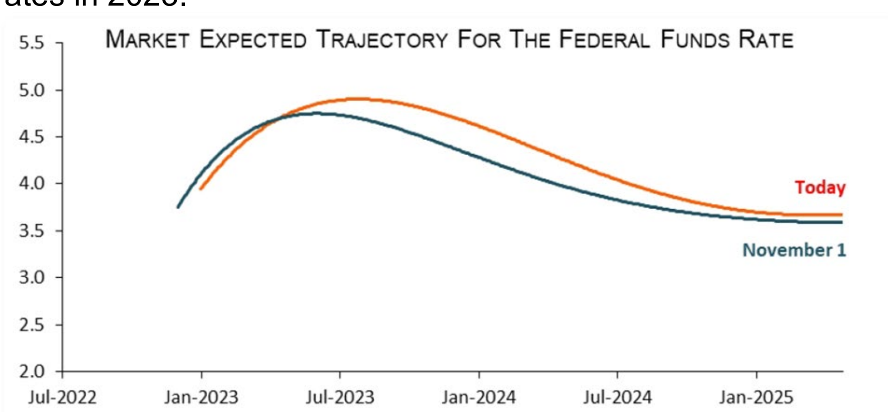
Despite the brisk pace of this hiking cycle, the Fed has many detractors who argue that the Fed rate hikes have not gone fast enough.

The Taylor Rule is a monetary policy framework developed by economist John Taylor. The rule provides a simple formula for determining the appropriate Fed Funds rate based on the deviation of inflation from its target level and the deviation of economic output from its potential level. Taylor rule has been widely used as a guide for central banks in setting monetary policy. Currently, the Fed Funds rate is at an unprecedented discount to the Taylor Rule, suggesting that the Fed is still behind the curve.



Federal Reserve Chair Powell and several other members of the FOMC have indicated that, as of now, the Fed plans to: 1) slow down the pace of interest rate increases, 2) reach a higher peak rate than originally anticipated, and 3) stay at that peak for a longer period of time than is typical.

In his recent speech at Brookings, Federal Reserve Chair Powell stated that "restoring price stability will require holding policy at a restrictive level for some time." The use of the phrase "some time" is intentionally vague, but it suggests that the Fed is planning to keep interest rates at their current peak for a longer period than has been typical in recent decades. Based on this information, we can infer that the Fed does not intend to cut interest rates in 2023.

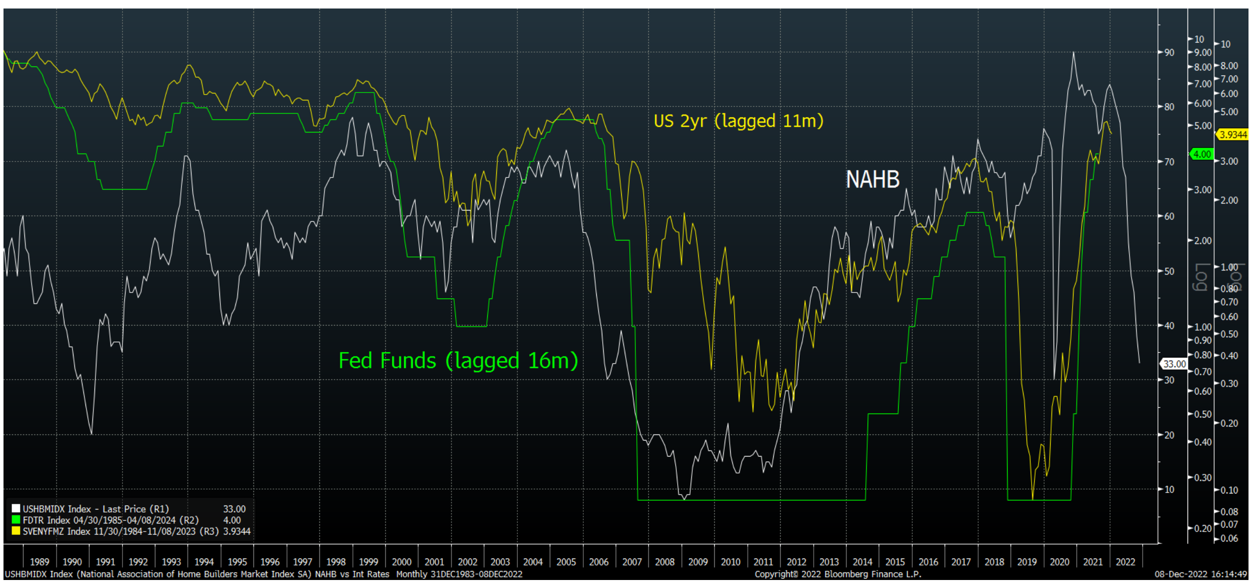


Source: Piper Sandler

According to the chart above, the market appears to have taken into account the first two points made by the Federal Reserve, but not the third – a pause in peak rates for longer than usual. Investors clearly do not believe that the Fed will be able to maintain peak rates for long, as the market is currently pricing in two Fed rate cuts in the second half of 2023.

In our base case we expect that the Federal Reserve will slow the pace of interest rate increases from 75 basis points to 50 basis points at its meeting next week. We then expect the Fed to either increase rates by another 50 basis points on February 1, or, if inflation data is relatively low, to further slow the pace of increases to 25 basis points. We anticipate that the Fed will make one final 25 basis point increase in March to reach a peak interest rate of slightly above or below 5%.

The biggest question is how long will the Fed be able to maintain peak rates?
The National Association of Home Builders market survey (NAHB) is one of our favorite housing leading indicators. Due to housing's importance to the economy, the NAHB is also the single best timing indicator for interest rates, leading the 2-year yield by 11 months, and the Fed Funds rate by 16 months.



If the historical time-lags between rates and the NAHB continue to hold, then 2-year yields have just now topped, and will be heading lower, while and Fed Funds will top in May. The NAHB suggests that the Fed will be forced to quickly reverse course and sharply cut Fed Funds by the end of 2023.

We believe the Fed is being forced to pay for its previous sin of being behind the inflation curve on the way up by being behind it on the way down. Since the Fed's reaction function to lower inflation and economic data is likely to be more delayed than it has in the past, Fed Funds will follow the NAHB with a longer lag than usual.

The two- to ten-year portion of the yield curve, at -82 bps, is the most inverted since the early 1980s. And even the six-month to two-year portion, which is often touted as the best predictor of recession, is 36 bps inverted. We believe that by the time the Fed reaches the peak in the spring of next year, the two- to ten-year portion of the curve should be inverted by significantly more than 100 bps, based just on the mechanics of Fed tightening.

In the chart below we have inverted the NFIB Business Hiring Plans survey in order to show the negative correlation between hiring (labor market) and the yield curve. NFIB (white line) is inverted in the chart; thus, a rise in the white line indicates a drop-in business hiring plans. Hiring plans have retreated from the record levels set in 2021. Based on the typical lead-time, the yield curve would already have started steepening (yellow line) – with the front-end of the curve declining in anticipation of rate cuts. However, the Fed likely has months to go before they can begin cutting rates. Therefore, the curve is likely to continue steepening, which illustrates just how behind the curve the Fed is.

Fed Liquidity and the Stock Market

The market rally since mid-October is largely the result of three factors; two predictable and one wild card. The predictable ones were: (1) the Pavlovian response to weakening data. Even though the Fed's "pivot" will almost certainly be significantly delayed and diminished relative to previous responses, the muscle memory is simply too ingrained to ignore; and (2) Timing: Guidance issued during Q4 earnings releases is likely to flick the inflation/earnings coin from heads to tails early in the new year but, in the meantime, real time inflation data has been buoying bond markets and, in turn, equities. The wild card (3) is the most interesting one, and that has been a huge positive surprise. The Fed liquidity gauge, which is simply cumulative Quantitative Easing/Quantitating Tightening (ie Securities Held) net of Treasury Cash (TGA) and Reverse Repos (RRP) has bounced significantly. Over the past 2 months, this has GROWN by $312 billion, with $231b in the last month alone. Not only have we not been getting Quantitative Tightening (QT), we've actually been having a huge Quantitative Easing (QE) program (at least in terms of liquidity). And yet again, if you look at the chart, you can see the market has correlated perfectly with this gauge.

While there has of course been QT, it still remains curiously below target, at just $67b per month vs the $95b target. This has helped to give the TGA & RRP tailwinds even more kick. Over the past 2 months the TGA has dropped $213b, so more than offsetting all the QT. Since its peak (6 months before the mid-term elections) the TGA has dropped a staggering $500b. Given that this is directly controlled by the Administration (the Treasury Dept), cynics might suggest the two are related but regardless, this is now set to increase again. The Treasury has stated a desire to get it back up to $700b by year end. That would be nearly mid-range for the year, so it sounds like a fair target and, if achieved, would see a liquidity withdrawal of $223b. As for the RRP, it's been relatively stable at around $2.25 trillion since QT started. For some reason, however, it's also witnessed a sharp recent drop, of some $255b over the past 2 months, taking it $125b below trend. And while it remains a wildcard to some degree, what we do know is that December is likely to see the biggest inflows of the year. Last December saw an increase of $477b. Even adjusting out the year end window dressing spike leaves a figure of +$270b. Therefore, if we assume a repeat of last year on the RRP ($270b) with the $223b from the TGA and $95b from QT, then December could see a liquidity reduction of $588b. If we're conservative and give that a 40% haircut, we'd still likely be testing the lows on the market if correlations continued to hold.

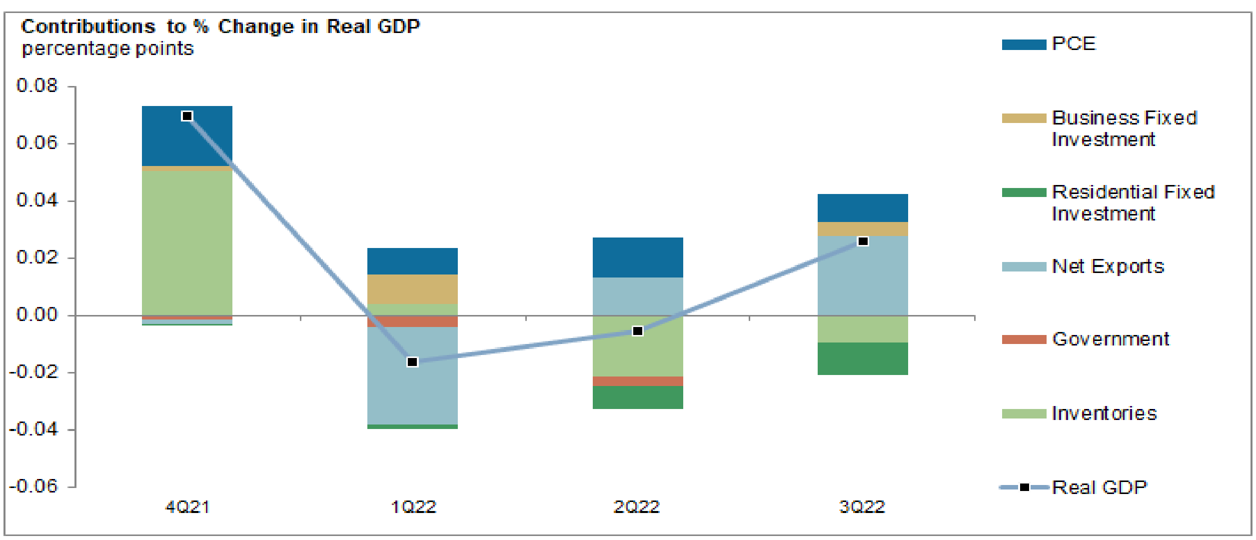
One final point on RRP, so far bank deposits have remained stable, but that cannot last when Money Market Funds offer over 4% rates and banks virtually nothing on their savings deposits. Either rates come down dramatically, or cash will start shifting out of deposits into Money Market Funds. And as MMFs do not have access to the Fed's IORB facility, they'll park it in RRP potentially draining vast amounts of liquidity next year.

Economic Outlook

By Bobby Long

No longer able to rely on easy money and facing the headwinds of more restrictive monetary policy, the path forward is much less certain and carries an elevated risk of activity slowing enough to push the economy into a recession. That said, conditions are still somewhat supportive with a relatively healthy consumer and tight labor markets. All economic cycles have different characteristics, however the current economic cycle is unique in light of how the COVID-related restrictions have impacted economic conditions. We made it through surprisingly well with the help of supportive monetary and fiscal stimulus provided directly to businesses and consumers, but this support did contribute to certain imbalances that now have to be addressed. Federal Reserve Chair Powell and the Federal Open Market Committee have clearly indicated that these imbalances are their focus now and they are committed to their dual mandate of maximum employment and price stability. With inflationary pressures having clearly put their price stability mandate at risk, they are aggressively tightening policy "to moderate demand so that it comes into better alignment with supply" with the intent to restore price stability. Chair Powell further stated in his November press conference that "reducing inflation is likely to require a sustained period of below-trend growth and some softening of labor market conditions." Economic conditions are driven by a wide number of everchanging variables that make forecasting incredibly difficult, but it seems like some confidence can be placed behind the actions and statements of FOMC members when they say they will continue to tighten policy and are willing to accept slower growth and weaker employment. They can still stick the "soft-landing", but it is looking like an increasingly difficult task. Expectations should account for weaker activity going forward and acknowledge the elevated risk that accompanies more persistent inflation and restrictive policy.

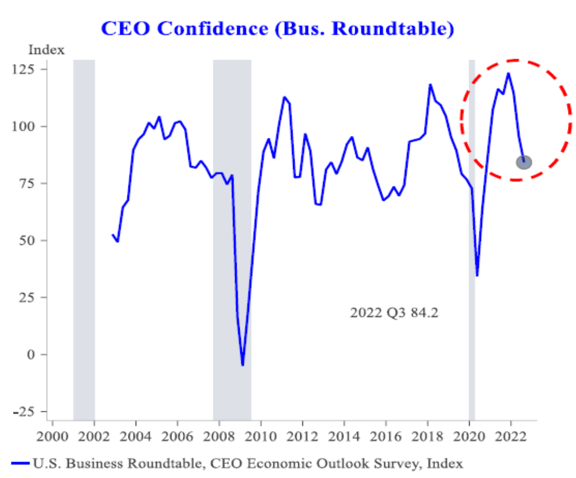
Following two quarters of negative growth that were driven largely by volatile trade and inventory components, third quarter Gross Domestic Product (GDP) growth came in at 2.9%. The chart below from Morgan Stanley Research provides a breakdown of the various components and their contributions over the past four quarters.



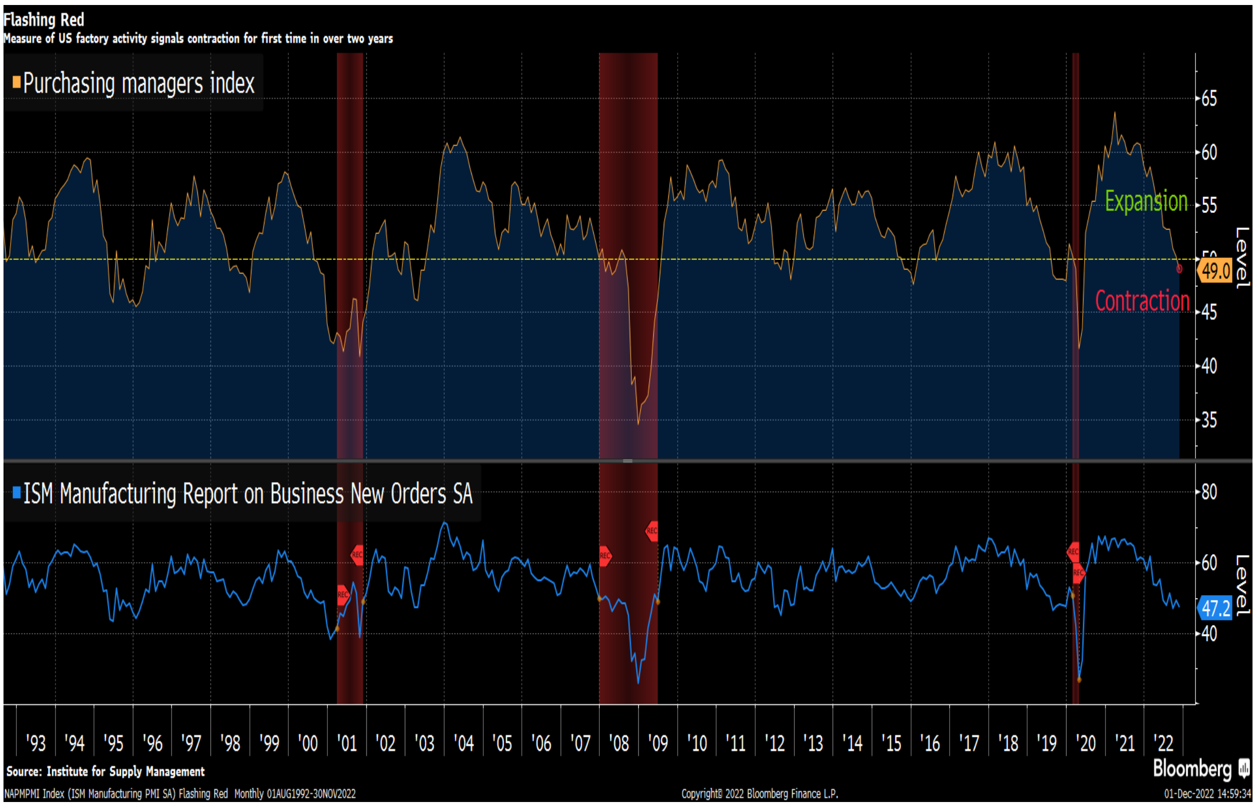
Personal consumption grew by 1.7%, slightly weaker than the prior quarter but still positive with spending on services more than offsetting a modest contraction of spending on goods. Both durable goods and nondurable goods spending declined over the prior quarter with a reduction of motor vehicle purchases representing the largest drag, followed by groceries and gasoline. Business investment grew with equipment increasing by 10.7% and intellectual property investment by 5.8%. Nonresidential structures declined over the quarter and residential investment represented an accelerating negative trend with a sharp decline of -26.8%.

The October retail sales report came in stronger than expected and indicates that consumer spending may not be faltering yet despite higher prices, rising interest rates, and a drawdown of excess savings. These headwinds will likely make it difficult for consumers to keep up this pace that has been so important to overall economic activity. However, while excess savings is declining, it is still elevated across higher income levels and labor markets remain tight. Interest rates have risen sharply and this will increase debt service costs for consumers on auto loans and revolving credit lines, however a large percentage of homeowners have locked in a low fixed mortgage rate. This may provide more cushion for a slower moderation of spending.

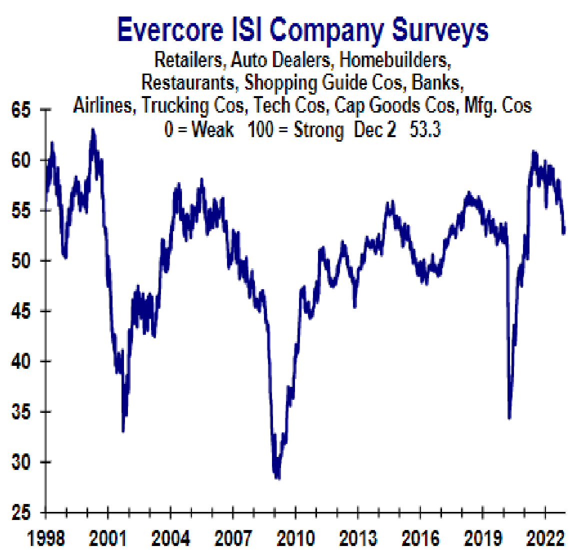
Corporate profits have been strong, and this has supported business investment and capex plans. As companies seek to gain more control over production and supply chains, management's efforts to reshore manufacturing capabilities may provide some longer-term support to capital spending. Weaker corporate profits would likely have a dampening effect on capital expenditures. While profits have remained high, the chart on the right shows a decline in CEO Confidence which could foretell a reduction in capital spending plans.



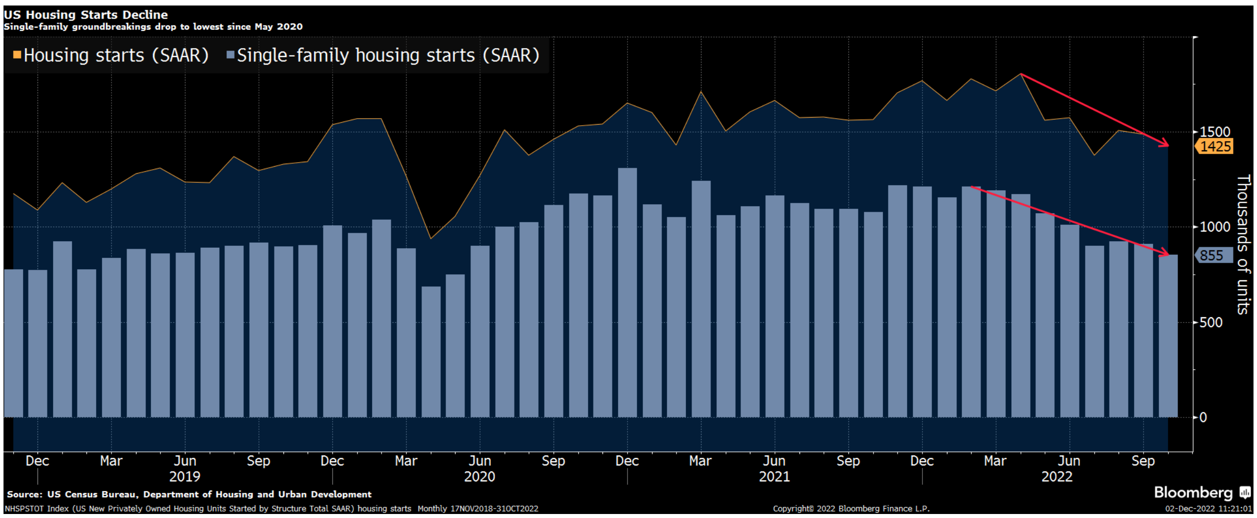
Manufacturing activity has benefitted from strong demand. However, the Institute of Supply Management's Purchasing Managers Index has been falling over the past 12 months and recently dipped below the 50 mark, signaling contraction. The chart below shows this decline along with ISM New Orders, which also declined this month but is showing some signs of leveling out. An uptick in New Orders or simply holding at these levels would be a positive signal of a slower growth scenario that could avoid a deeper contraction.



Evercore ISI's company surveys have also been falling. These weekly surveys across industries have stabilized some over the past few weeks, but have been trending lower off elevated levels. Trucking activity and homebuilder sales have shown an especially sharp contraction. Airlines have been strong and restaurant sales have also held up. Retail sales have been okay, but are trending below longer term averages for this time of year. Industrials have been weakening.

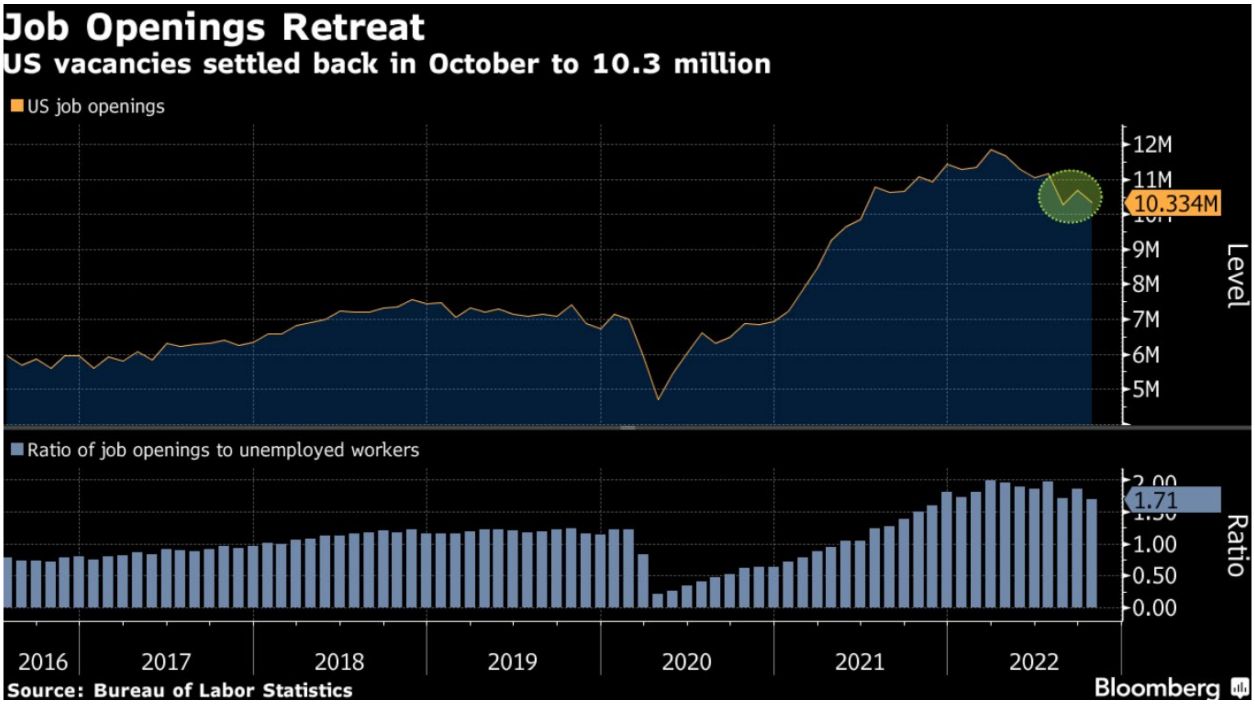


Housing has been weaker and will likely deteriorate further as higher mortgage rates and elevated home prices have impacted affordability. Demand may also have been pulled forward some over the past couple of years as individuals increasing sought out single family homes and took advantage of low mortgage rates. Existing home sales have dropped sharply. New home sales have picked up modestly over the past few months, but these had already been slower with supply chain issues weighing on construction. The chart below shows how housing starts have declined from earlier in the year. Building permits paint the same picture and indicate slower activity from this sector.



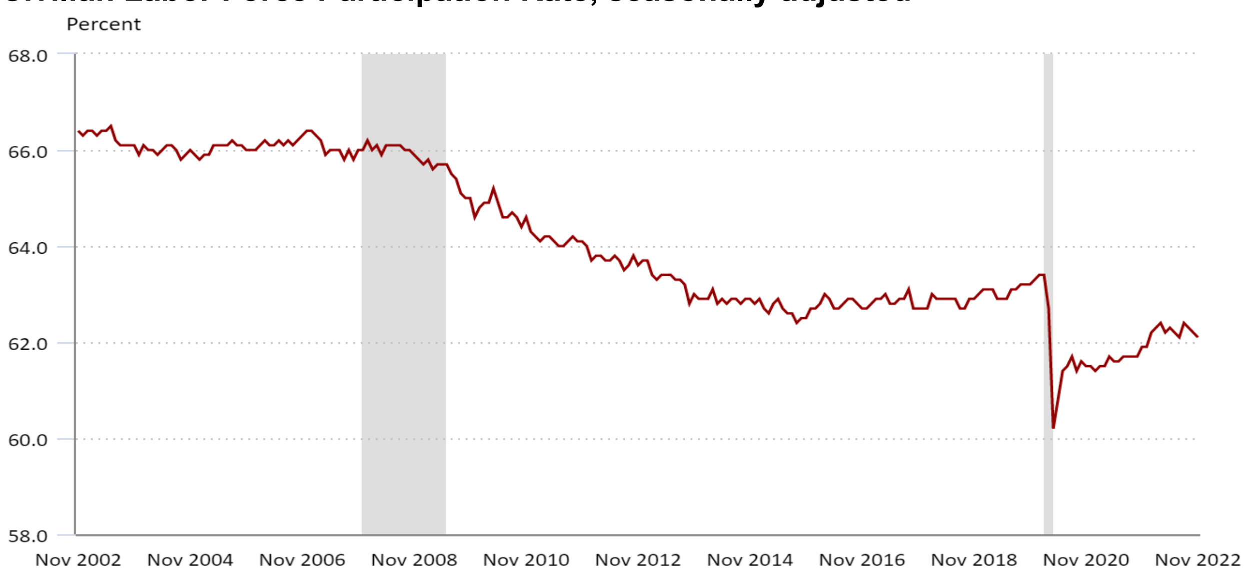
Mortgage applications to refinance existing homes have also dropped sharply with the move higher in mortgage rates. This has been an avenue for consumers to increase disposable income as they lower monthly payments, as well as draw on increased equity as home prices have risen, which has supported consumer spending and will likely be absent going forward.

Labor market conditions are still strong . . . maybe a little too strong. The November nonfarm payrolls came in higher than expected adding 263,000 jobs over the prior month and October’s number was revised upward to 284,000 additions. Expectations have been for payroll gains to moderate, but the past three months of +250k gains have shown conditions remain stronger than anticipated. The November unemployment rate also remained low at 3.7%. Continuing jobless claims have ticked up some since the beginning of October, but not enough to indicate a stronger trend developing. There has been an uptick in layoff announcements, but these have largely been concentrated in the technology and real estate related sectors. Real estate activity is undergoing a sharp contraction and technology staffs at high growth companies have likely been somewhat bloated with room to trim. The broader market has not seen an acceleration in layoffs yet and it does seem that workers who have lost jobs are finding other employment rather quickly. All indications are there remains a large undersupply of workers relative to jobs available. As the chart on the following page illustrates, job openings have fallen, but are still plentiful.



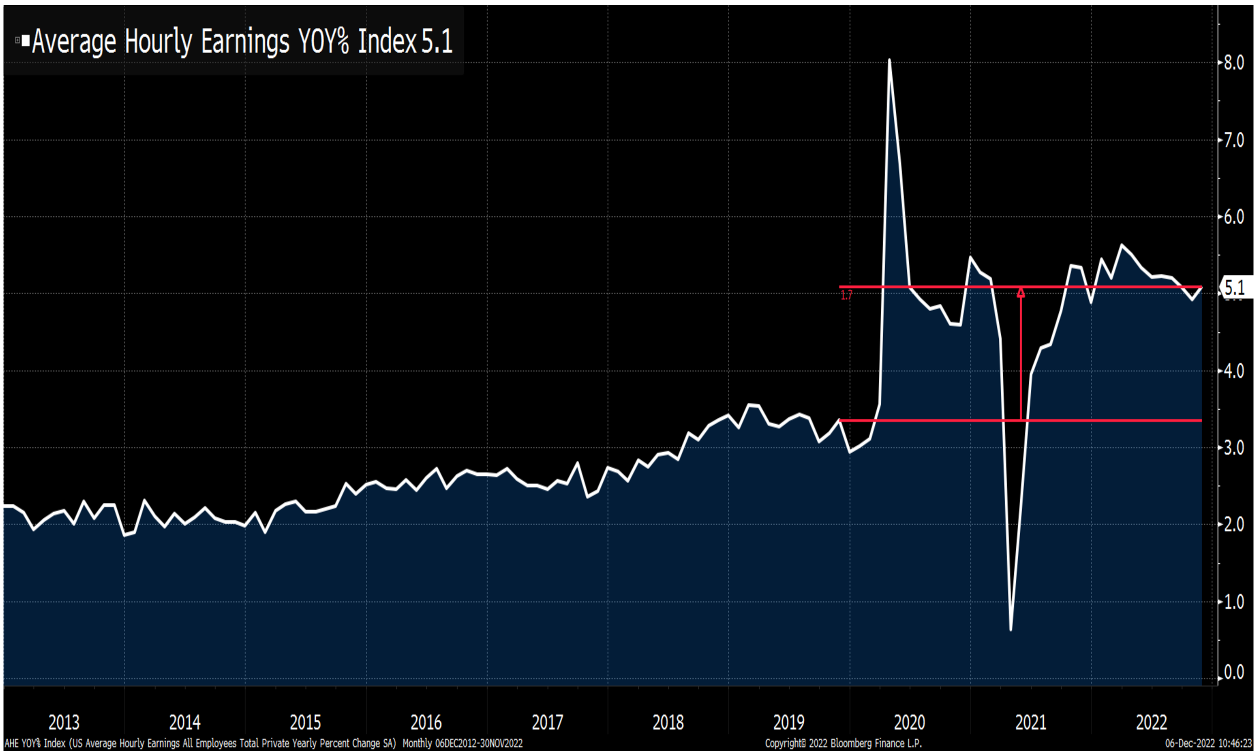
This large imbalance between the supply of workers available and job openings is keeping labor market conditions extremely tight. The demand for workers is a positive condition of strong economic activity. The undersupply of workers can be attributed in part due to a large number of workers who have left the workforce. The labor force participation rate has not recovered to pre-COVID levels and looks like it could be stalling according to the chart below. Demographic trends will keep downward pressure on the participation rate, but younger workers on the sidelines need to be drawn back in.

Civilian Labor Force Participation Rate, seasonally adjusted

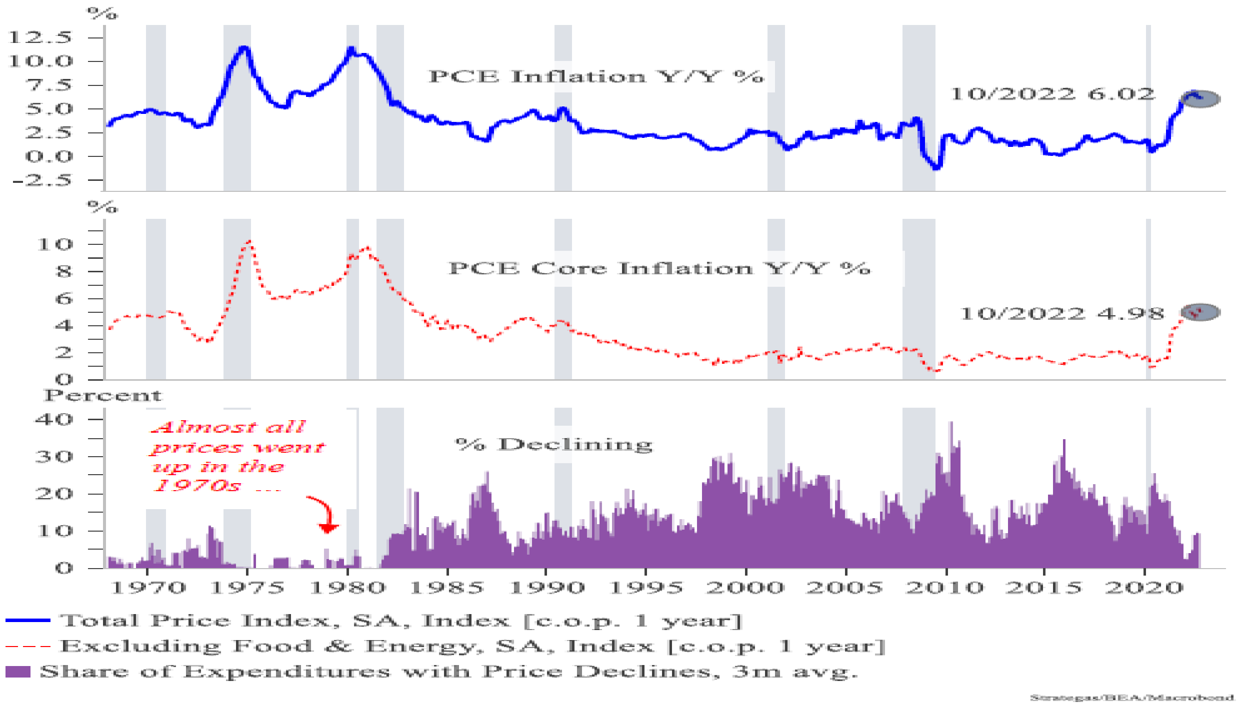


Source: U.S. Bureau of Labor Statistics

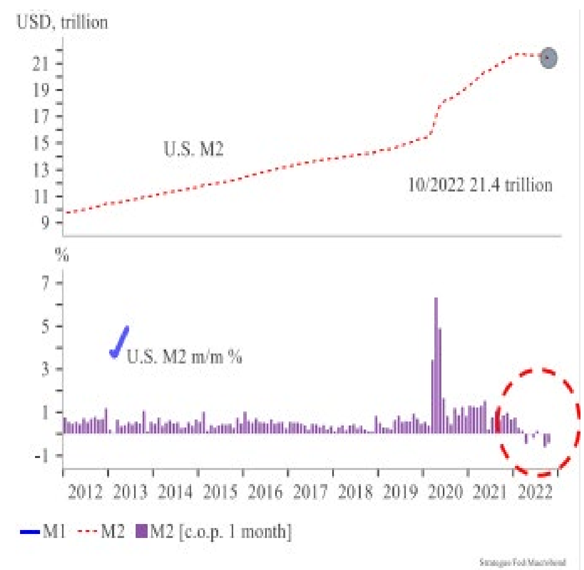
The gap that has developed between the supply and demand of workers is driving wage inflation. Average hourly earnings for the month of November came in above expectations at 0.6% over the prior month and 5.1% over the prior year. This was a step backwards on bringing wage inflation down to more sustainable levels. Higher wages are positive for workers and broader economic activity at certain levels during economic expansions that are accompanied by increased productivity, but the current pace is unsustainable and feeding into broader inflationary pressures, with real incomes for workers declining against inflation. As the chart below shows, growth in average hourly earnings is still well above pre-COVID levels.



There have been some signs that inflation may have peaked with most measures showing a small retreat from highs in the pace of inflation. Inflationary pressures from supply chain disruptions have been easing. As bottlenecks clear and inventories rebalance, we have seen both manufacturing prices and retailers pricing power fall, along with freight and shipping rates. More moderate growth and weaker activity in some sectors have helped also and signal the potential for further deceleration. Home prices are cooling and rents in many markets are declining after unsustainable increases. Inflation measures are still much too high and we need to see these fall further. CPI fell to 7.7% in October. PCE inflation fell to 6.02% and core PCE fell to 4.98%. The chart on the following page shows while the slight decline is positive, these levels are still very elevated. The bottom portion of the chart is somewhat encouraging in that it indicates broad inflationary trends appear to be weakening with some prices declining versus prior inflationary periods where almost all prices were rising.

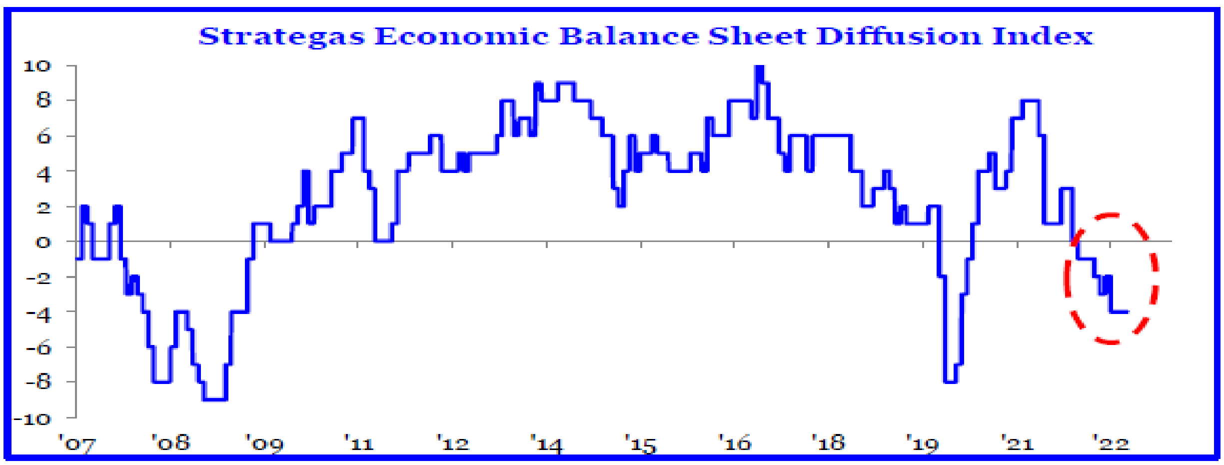


We have discussed in the past how extremely accommodative monetary and fiscal policy fueled a surge in money supply that has contributed to the inflationary pressures we are now fighting. The chart on the right illustrates the inflection in money supply above the historical trend that began in early 2020 when these policies were initiated. It also shows how money supply is now contracting. This will serve as a headwind for economic activity as policy is tightened and should assist cooling inflationary pressures.



With aggressive tightening and what appears to be a hard commitment to stay the course, Federal Reserve Chair Powell and fellow FOMC policymakers appear to have the will to bring inflation back in line. With early signs that inflation is slowing and the FOMC still showing resolve, this question of will seems to have been answered, although they have not had to stand firm in the face of any significant economic pain yet. The remaining question is whether they can tame inflation without pushing the economy into a recession. Policy works with a lag effect and in light of this is difficult to get right. Too much tightening, too quickly could plunge the economy into a recession with negative growth and job losses. Too little, too slow risks a protracted battle with inflation and enduring the deeper economic pain that comes with it. Many wonder have they done too much, too fast already? Inflationary pressures in the 1970s were met with tighter monetary policy that let up too soon, resulting in lingering inflation that weighed on economic conditions throughout the decade. Powell and FOMC committee members are mindful of this and appear determined not to repeat that mistake.

Economic conditions have weakened and downside risks are elevated. We include the chart below from Don Rissmiller with Strategas Securities, which attempts to provide a comprehensive measure of economic strength by quantifying broad economic conditions as assets or liabilities to the overall health of the economy. This index has trended lower as liabilities increasingly outweigh assets and highlight the weakening conditions. We need to see both wage and price inflation move out of the liability column. It is equally important that consumer spending and manufacturing do not shift to the right.



Assets	Neutral	Liabilities
Capex Eqp	Trade Deficit	Wage Inflation
Employment	Nonres Constr	Price Inflation
	Cons Spending	Business Conf
	Govt Deficit	Housing
	Manufacturing	Credit Environ
	Cons Conf	Int Rate Envr

With intentions made clear that slower economic growth and weaker labor markets are acceptable casualties in the battle to tame inflation, these should be expected. Ideally, impacts to the labor market will be met with a reduction in job openings versus widespread layoffs. If companies can pull these openings and find ways to meet these needs with their existing workforce, it could avoid job losses and ease wage pressures. Overall, economic data is mixed with strength remaining in some economic sectors, but also some clear weakening conditions. To use a weather analogy, clouds are gathering, but it is unclear whether they are bringing rain showers to cool off hot conditions or whether instability in the atmosphere could result in a more severe thunderstorm developing. We may not know until it is here, but with unstable conditions it is best to be prepared.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

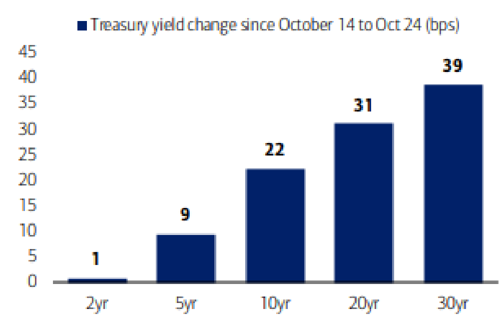
By Lance Lachney

At the time of our last meeting, the fund's fiscal year was coming to a close. Interest rates moved precipitously higher during the latter half of September. A stronger than expected August CPI report, an upward revision to the median forecast at the Federal Open Market Committee meeting, and the upheaval surrounding the UK gilt market helped push the 10yr treasury yield higher for the ninth consecutive week. For the month, yields increased approximately 70-75bps in the short and intermediate portions of the curve, with the long-end rising a little over 50bps. The Fed raised short-term rates by 75bps at its late September meeting, a third consecutive move of that magnitude. The subsequent discussion was interpreted as hawkish by investors and the market reacted accordingly. The abrupt rise in interest rate volatility was a negative for risk assets, pushing investment grade spreads 15-20bps wider during the month. Treasuries lost approximately 3.75%, while corporate bond losses eclipsed 5.25% in September. High yield debt fared slightly better due to its short duration profile. The 2022 fiscal year finally came to a forgettable end with the public fixed income portfolio shedding a little over 13%.

The beginning of the new fiscal year was fairly muted even as treasury yields climbed higher. Investment grade spreads tightened several basis points in the first week with high yield securities returning close to 1.5% on the heels of a strong September jobs report. The shift higher began to accelerate shortly after as headline inflation came in materially higher than expected. The core component of the index reached its fastest pace of the cycle with a 6.60% increase year-over-year. Consumer sentiment on inflation expectations over the next year also rose considerably. This, coupled with weak demand at the treasury auctions, pushed rates 15-20bp higher across the curve. Corporate spreads relinquished their gains from the previous week and essentially moved back to the wides of the year. Soon after, an abrupt steepening of the yield curve occurred with the long end moving 20-30bps higher as the front end remained essentially flat. Prime Minister Truss ultimately resigned, and the UK government abandoned its plan for unfunded tax cuts that had sent shockwaves across domestic and global bond markets. An article published by the Wall Street Journal towards the end of the month suggested that the Fed was open to smaller rate hikes after its November meeting. There were dovish remarks from a few policymakers and the current administration as well. On the economic front, housing market data was extremely soft in terms of pricing and activity. The manufacturing and service indices of the October S&P PMI slipped into contractionary territory, with manufacturing falling below 50 for the first time since June 2020. The Bank of Canada

Figure 5: 30yr Treasury yield jumped 39bps over the last week

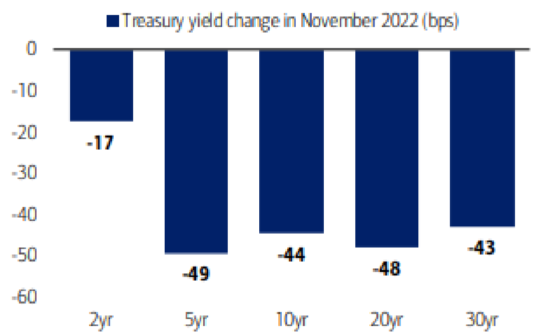
Treasury yields jumped the most in the back-end (+39bps for 30yr) since October 14, with smaller increases for 10yr (+22bps) and 5yr (+9bps).



Source: Bloomberg

raised rates by 50bps instead of the expected 75bps and the European Central Bank's action was accompanied with a dovish tone. The volatility index began to drop rather quickly, intermediate and long-term treasury yields collapsed 20bps, and just like that, the unofficial "pivot" had occurred and the peak in yields was a distant memory. This resulted in a further inversion of the 2/10s curve.

Figure 2: Treasury yields declined across the curve in November
5 to 30yr Treasury yields declined by 43 to 48bps in November.

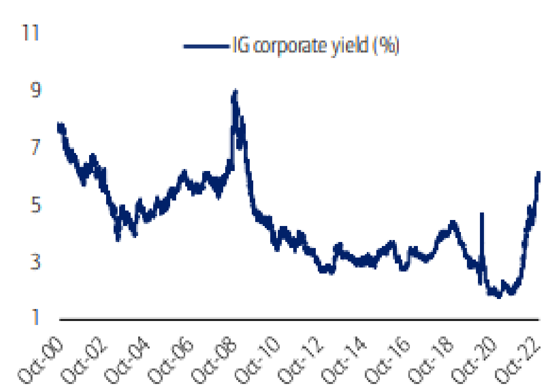


Source: BofA Global Research, Bloomberg

The downside run in treasury yields attempted to reverse in early November after the hawkish tone relayed at the November FOMC meeting. The front end of the curve surged 20bps or so as policymakers raised rates by 75bps at its fourth straight meeting. Risk assets were able to weather the storm as credit spreads tightened at the margin. The moment the market has been waiting for finally arrived the following week with the release of a better than expected CPI print. Treasury yields fell 35-40bps across the curve and the notion of a fifth consecutive 75bp move was swiftly removed from the playbook. Treasury securities improved 2% in a week and corporate debt outperformed once again, posting a 2.5% gain. The release of the FOMC minutes reaffirmed policymaker's embrace of a slower pace of monetary tightening going forward. The committee cited a "notable slowing" in some rate-sensitive sectors such as housing. Third-quarter earnings offered no huge surprises, and the decline in equity implied volatility provided further fuel for spread tightening. By the end of the month, investment grade spreads tightened approximately 25bps and the high yield index was trading around the 450bp level. There were positive returns across all fixed income sectors, with high grade corporate debt leading the way with a near 5% total return.

The RSA has been fairly active in the fixed income market during this volatile time. Within treasuries, the fund has added over $300mm across all funds under management. In mid-September, the focus was on the two opposite ends of the yield curve. By the end of the month, the fund started executing trades within the belly of the curve and continued to do so into mid-October, where we ultimately swapped out of a very short-term note and purchased a block of 7yr securities in the 4.35% area. The fund remains underweight the sector but added approximately 200bps of exposure during this time while extending duration at the margin. In the mortgage sector, the fund has put approximately $200m to work, less the minimal redemptions we have received. The September trades softened up the duration profile on the expectation of higher rates. The

Figure 12: IG corporate yields are the highest since the GFC
IG corporate yield reached 5.9% on October 28, well above 4.7% peak in 2020 and 4.3% peak in 2018.



Source: ICE Data Indices, LLC

October adjustments continued to position the portfolio for higher rates while deploying cash at yield levels not seen in quite some time. Last month's transactions were more duration-neutral in nature across the coupon stack and were executed to take advantage of attractive OAS spread levels. Most recently, the fund purchased a block of lower coupon notes to add duration should the economy continue to slow. The fund has continued to look for opportunities within the corporate sector. In the front end of the curve, the fund has been able to purchase names like DuPont and Nutrien at yield levels between 5.25-6.0%. In the intermediate part of the curve, the yield levels achieved have been approximately 5.75% in the household and tobacco sectors and near 8.00% in subordinated yankee banks. The fund was also able to lock-in a 6.75% yield in longer-dated Kraft issues. The short-duration profile has been extended after these purchases and the substantial number of notes that matured at the beginning of November. Activity has slowed somewhat given how far spreads and corporate yields have fallen over the last few weeks.

The downward trend in yields has continued in the early part of December. Ten-year treasury yields are floating around 3.50%, approximately 75bps lower than peak levels in late October. The 2/10s curve is currently inverted by 80bps, a level unseen in four decades. Energy prices have fallen over 20% in the last six weeks, dragging 10yr inflation breakevens down to 2.30%. Mortgage rates have fallen for four straight weeks. The warning signals of a recession are looming, with the market pricing in rate cuts in the back half of 2023. And yet, the complacency of spreads remains. Investment grade and high yield spreads are trading at levels of 130bps and 450bps over their respective treasury benchmarks. The FOMC meets again on December 13-14th and a 50bp rate hike has been penciled in. Chairman Jay Powell is likely to provide some near-term push back to market expectations and reiterate "higher for longer" regarding the funds rate. It may even become the new "transitory". While acknowledging that inflation has peaked, the labor market remains tight. Now, it's just a race to see if inflation can fall quickly enough before the economy rolls over.

Domestic Equity Strategy

By Kevin Gamble

The U.S. equity market roller coaster has continued into the new fiscal year with the S&P 500 rallying 14% in the first couple months of fiscal 2023. While this is certainly an encouraging start, the *Wild Times on Wall Street* described by Dr. Bronner in a recent *RSA Advisor* are likely not completely in the rearview mirror. The reality is that our economy and financial system are not designed to just “shut down” and “go home” as was the case during the Covid pandemic and we are now dealing with the aftermath of the fiscal and monetary measures taken to “prop up” the system. As we embark on the other side of the pandemic, we are all attempting to navigate and understand what the new normal entails for the economy and financial markets.

This pandemic aftermath includes the unfortunate side effect of inflation as we now have “too much money chasing too few goods” as described by the great Milton Friedman. The Federal Reserve has thus embarked on its most aggressive monetary tightening cycle since the early 1980s as they feverishly attempt to put the inflation genie back in the bottle. In other words, the automatic QE ride the Fed put financial markets on during its massive pandemic monetary expansion has now entered a “stick shift” period.

There are so many questions as we attempt to get back to “normal” following the global pandemic. How will the economy and financial markets adjust to the fact that a cost of money has now returned to the equation? What does the future of work look like and how will labor respond to the inflationary pressures? Can the Fed effectively rid the economy of its current inflation and land the proverbial plane back to its desired 2% inflation target without causing a recession?

Under the current unusual and mixed circumstances, what we felt best was to use this equity strategy update to lay out the top 5 reasons for optimism moving forward as well as the top 5 reasons for concern for the U.S. equity markets. We will conclude with our chosen equity strategy to best navigate this uncertain backdrop.

Exhibit 1: 2022 S&P 500 Performance

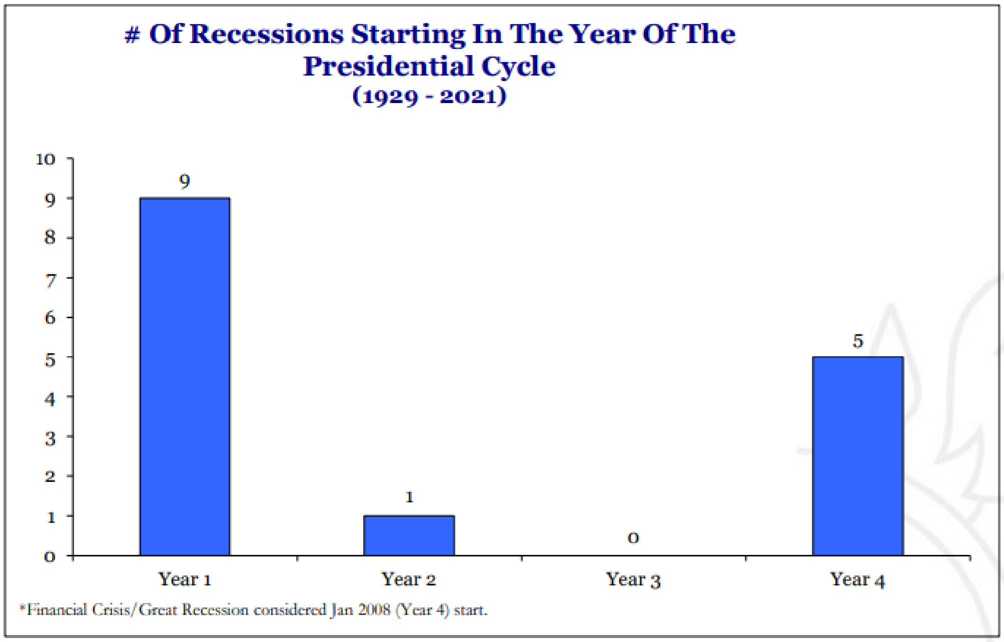
Source: Bloomberg

<u>RSA Top 5 Reasons for Optimism</u>

1) Post midterm elections through Year 3 of the Presidential Cycle Has Historically Been the Best Time for U.S. Equities

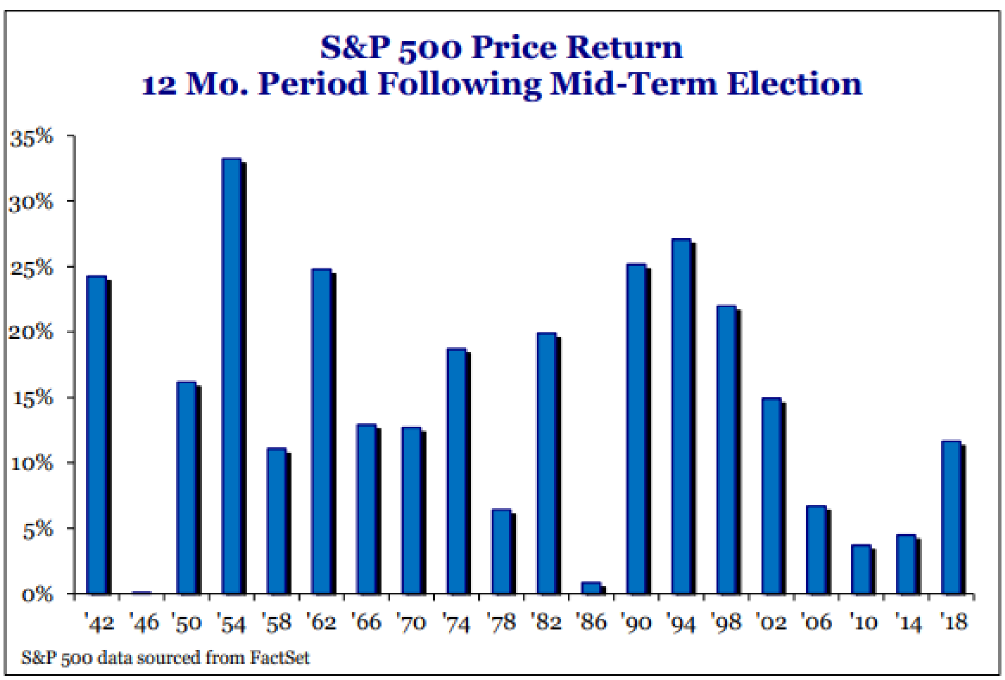
While there is a first time for everything, we have not had a recession in the post World War II era in Year 3 of the Presidential Cycle! In addition, the S&P 500 has delivered positive investment gains in each of the 12-month periods following the midterm elections since 1942. So, we are historically in the very best spot of political seasonality for U.S. equities with a long track record of success.

Exhibit 2: Recessions and the Presidential Cycle



Source: Strategas

Exhibit 3: Post Midterm Election (Year 3 Presidential Cycle) S&P 500 Returns

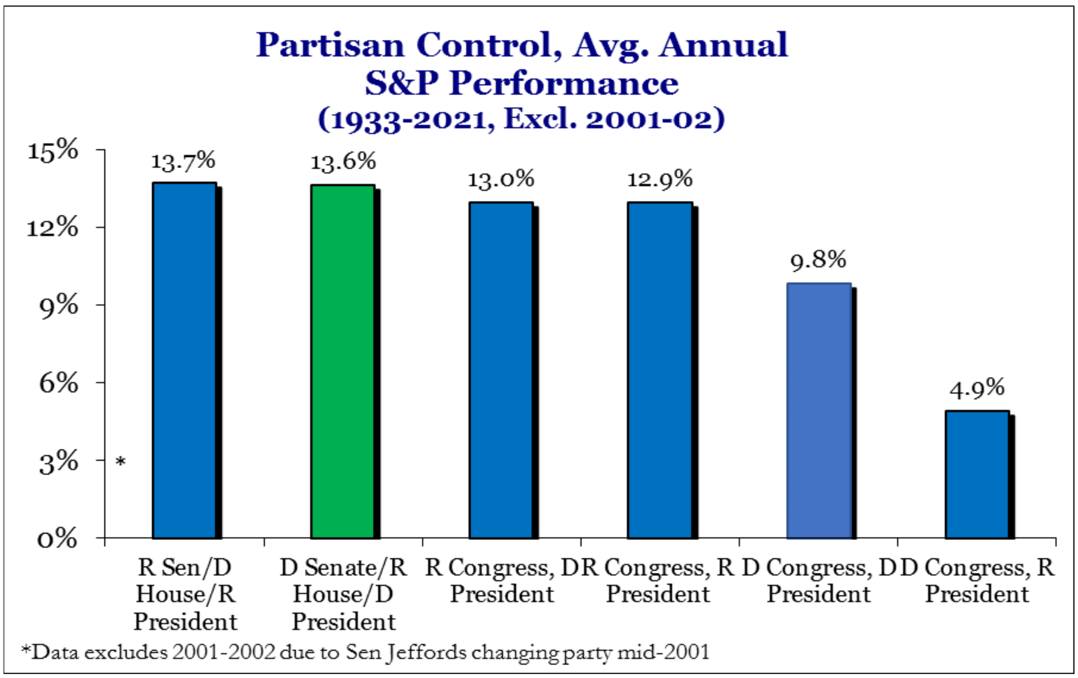


Source: Strategas

2) Divided Government is Typically Positive for U.S. Equity Markets

Divided government has historically led to the best investor outcomes. There are reasons for this including the notion that investors can get more comfortable that extreme policies are less likely as compromise and bipartisanship become a necessity for successful legislation. With Republicans barely taking control of the House of Representatives post the midterm elections, we now have a divided government with the Democrats holding the White House and retaining the Senate. Not only is the legislative branch divided by party but also neither side has a mandate as the majorities in both chambers are very slim!

Exhibit 4: Divided Legislative Branch Has Led to Best Investor Outcomes

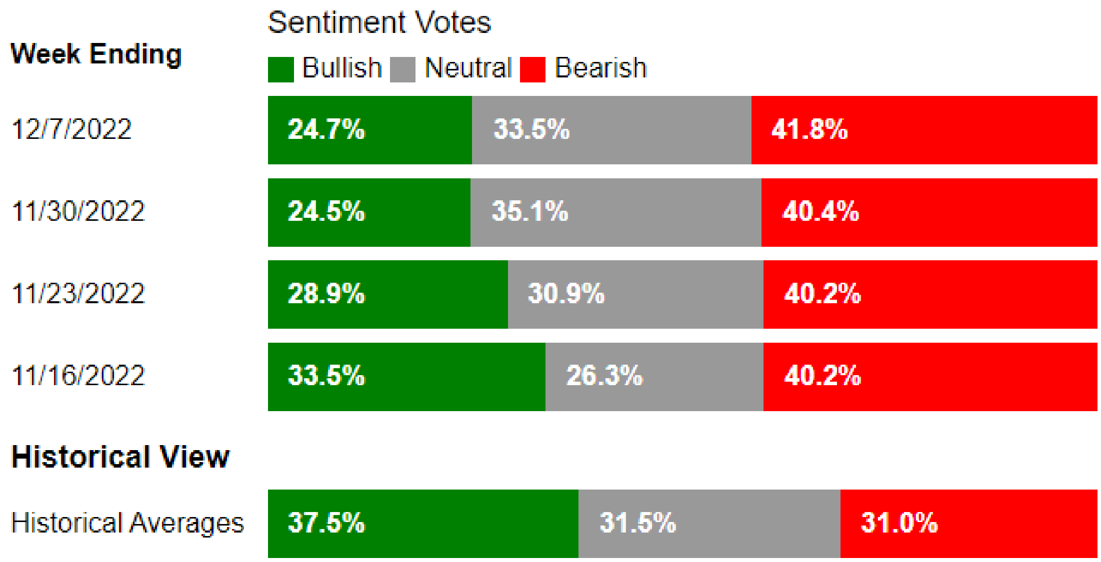


Source: Strategas

3) Investor Sentiment is Far from Euphoric

Investor sentiment could potentially be classified as complacent, but it is certainly not euphoric by any means. Investor sentiment has historically tended to act as a contrarian indicator with above average market returns following unusually low levels of sentiment. In the first week of December, the AAII sentiment survey showed individual investor optimism about the direction of the stock market fell to a six-week low. Bullish sentiment remains below its historical average of 37.5% for the 48th consecutive week, so cautious individual investor sentiment is entrenched with room for improvement.

Exhibit 5: AAII Investor Sentiment Survey

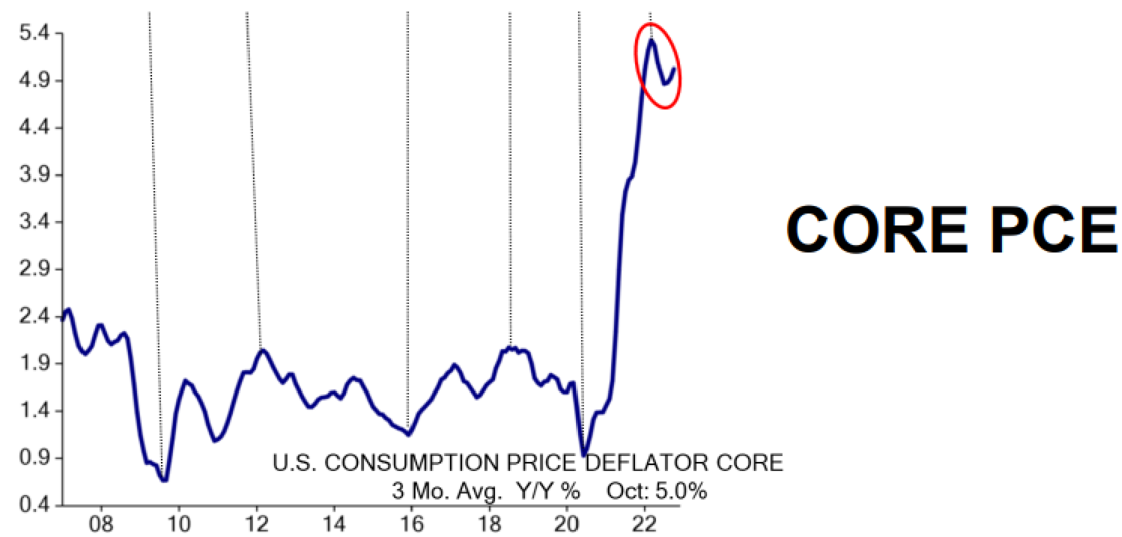


Source: AAII Investor Sentiment Survey

4) While Still Above Target, The Second Derivative of Inflation is Coming Down

While inflation is still above the Fed's target 2% rate, the rate of change of inflation is certainly coming down and moving in the right direction toward the Fed's ultimate target rate. Given this second derivative improvement combined with the knowledge that monetary policy works with a lag, equity market participants can now anticipate a terminal fed funds rate for this tightening cycle as well as the potential for a Fed pivot in the back half of 2023 should that become necessary.

Exhibit 6: Core PCE (Fed Preferred Measure of Inflation)



Source: Evercore ISI

5) Surprise Improvement in Geopolitics?

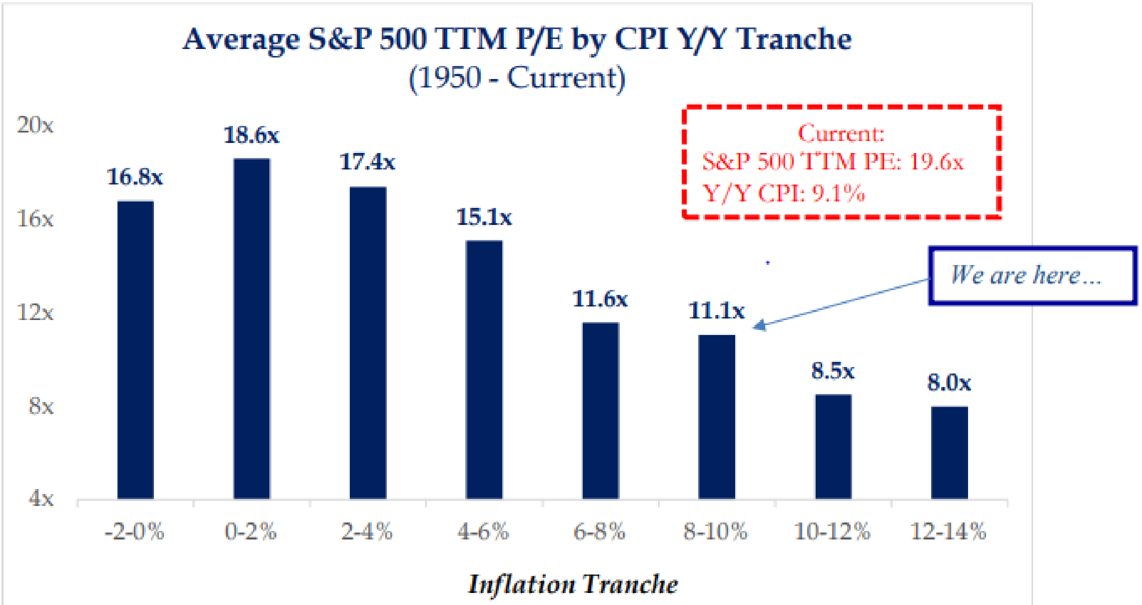
Geopolitics could admittedly move in either direction. There is undoubtedly a significant amount of concern priced into the current equity markets relating to the war in the Ukraine and its implications for energy and food supply chains. In addition, the market is concerned about the potential for Chinese/Taiwan relations to become a geopolitical issue. Any resolution or positive developments in the above could be a substantial catalyst for the global equity markets.

RSA Top 5 Reasons for Concern

1) Basic Rule of 20 Indicates the S&P 500 Could Still Be Overvalued

The Rule of 20 states that a reasonable "rule of thumb" earnings multiple for the S&P 500 is 20 minus the current rate of inflation. With the current trailing earnings multiple on the S&P 500 at roughly 20x (using the round 4000 index level and $200 of trough earnings projections for 2022), there is clearly room for multiple compression to account for the elevated level of inflation at the present time.

Exhibit 7: Average Trailing S&P 500 Multiple by Inflation Tranche



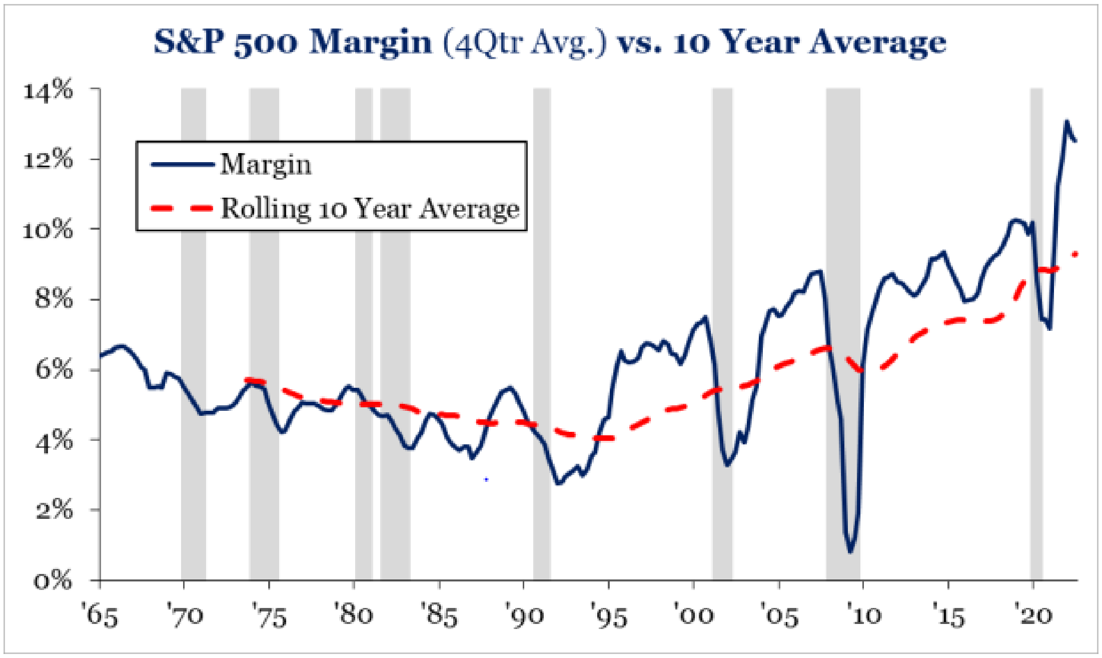
Source: Strategas

2) Profit Margin Tailwinds Have Turned into Headwinds

The big 4 trends which have driven profit margins on the S&P 500 to record highs over the last 2 decades have now all reversed.

1) Globalization to de-globalization
2) Falling interest rates to rising interest rates
3) Contained labor costs to rising labor costs
4) Just-in-time inventory to supply chain issues and the need to retain inventory

Exhibit 8: S&P 500 Profit Margin vs. 10 Year Average



Source: Strategas

3) Yield Curve is Now Inverted - Recession ahead?

With the latest Fed rate hike of 75bps in November, the yield curve is now inverted fed funds to 10-year yield which has typically preceded recessions in the past. Monetary policy works with “long and variable lags” and the Fed has a plan to continue to raise short-term rates into the foreseeable future despite this recent inversion which certainly introduces the risk that they will go too far. We are basically looking at the potential for an equal and opposite restrictive reaction to counter going too far on the expansionary front during the pandemic.

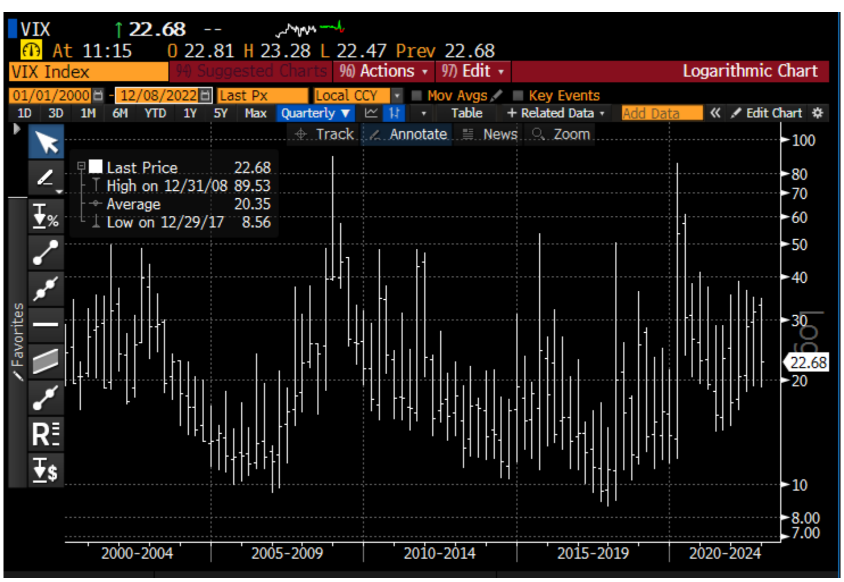
Exhibit 9: U.S. Yield Curve (10-Year Minus Fed Funds)

Source: Evercore ISI

4) No Real Capitulation Yet in the 2022 Equity Bear Market

Interestingly, the bear market in 2022 has really been fairly contained and orderly to this point. We have yet to see a “flash crash” or significant VIX spike or really any panic volume which would indicate a true capitulative bottom has been reached.

Exhibit 10: VIX – Volatility Index Has Stayed in Contained Range in 2022



Source: Bloomberg

5) Surprise Deterioration in Geopolitics?

Geopolitics is certainly something that could break in either direction and given the war in the Ukraine and the deteriorating relationship with China, it is certainly possible that events spread in a negative direction. Vladimir Putin standing with President Xi at the recent Beijing Olympics prior to the invasion of the Ukraine seems to be a relevant historical event potentially ushering in a Cold War 2.0 geopolitical backdrop. In addition, the recently imposed U.S. semiconductor export restrictions to China are a big threat to Chinese ambitions and their *Made in China 2025* agenda to be a leader in artificial intelligence, 5G wireless, and quantum computing. Taiwan is incredibly important as the global hub for semiconductor manufacturing and thus in the geopolitical crosshairs and warrants close monitoring.

Equity Strategy Moving Forward

Given the uncertain macro environment, we continue to focus on improving our micro equity selection which includes owning quality companies with strong balance sheets, resilient business models, dividend yields, and positive cash flows. Against a tightening liquidity backdrop, we want to actively avoid “zombie” companies which need access to the capital markets to stay afloat given their lack of cash flow.

We continue to see value-oriented equities as relatively attractive versus the longer-duration growth equity assets. Growth equity assets had a strong 14-year relative performance run which likely peaked with massive QE and negative real interest rates present during the pandemic. We think the relative leadership now resides with more value-oriented equities for the foreseeable future.

Following the strong absolute equity performance out-of-the-gate this fiscal year, we see an ideal setup to layer in put spread collar protection on top of our index holdings and have executed several tranches of protection which are designed to leave substantial upside in place for the remaining 10 months of the fiscal year while protecting some downside.

Our active funds continue to underweight the very top of the S&P 500 given the top-heavy nature of the index. This stance makes sense from a diversification standpoint given we have significant long exposure to these heavyweight names through our large, market capitalization weighted S&P 500 index holdings.

While fixed-income has not provided much competition for equity dollars in recent history (idea of TINA, or there is no alternative), it should be noted that the higher yields now present in the marketplace do provide some competition for equity dollars moving forward and asset allocators now have something to contemplate.

International Equity Strategy

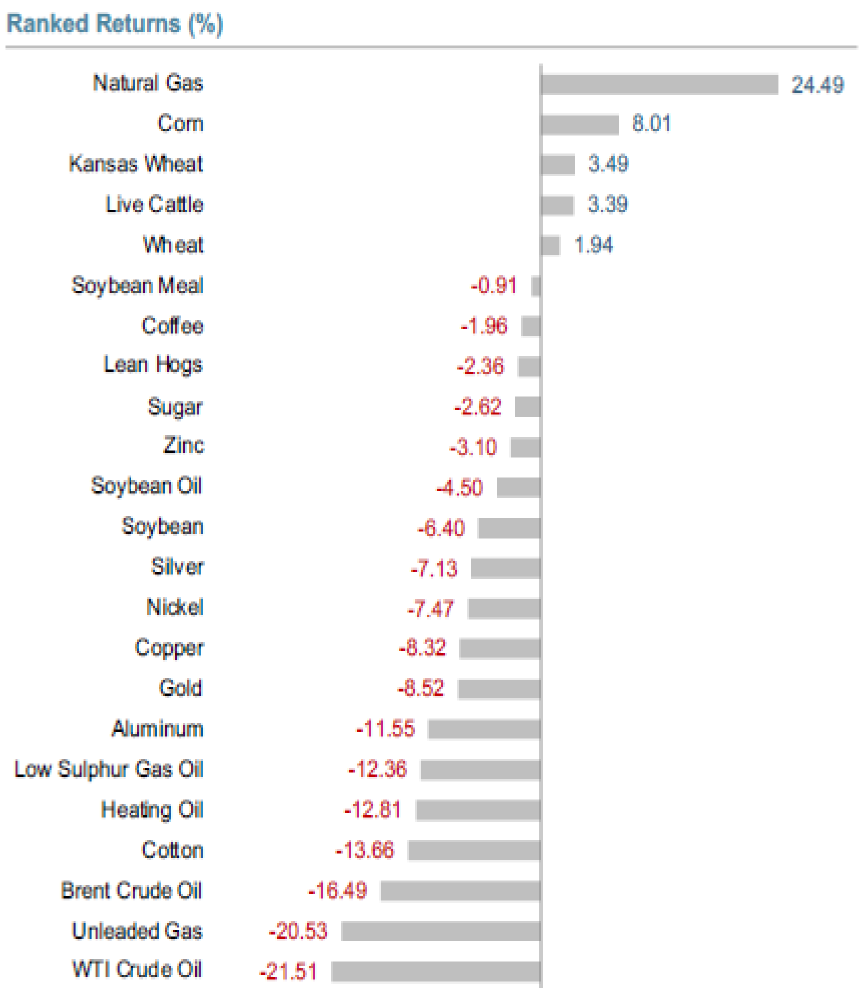
By Steve Lambdin

The global equity markets fell for the third quarter in a row as high inflation, rising interest rates, weakening economic growth, and an unstable geopolitical environment came together to rattle investors about midway through the quarter pushing equity markets to finish near the lows of the quarter. In addition, supply chains remain in a mess as we saw just "baby steps" in improvement as China's zero-tolerance Covid policies continued to play havoc on global businesses. The European energy crisis remained in full focus as disruption from the war in Ukraine pushed gas prices higher with little supply for the winter months ahead. No doubt this is a significant economic and humanitarian issue going forward. The hawkish tone from the U.S. Federal Reserve (Fed), The Bank of England (BOE), and the European Central Bank (ECB) pushed investors to de-risk investment portfolios causing a significant drop in the equity markets. In the quarter, the Fed raised interest rates by 150 bps, the BOE by 100 bps, and the ECB by 125 bps. We expect even more to come over the next couple of quarters. By the end of the quarter, inflation rates in Europe and the U.S. stood at the highest rates in forty years. Economic confidence readings fell in the period as global PMI's signaled an increasing chance of some level of a global recession coming in the next year. Many investors saw this as a base case as we ended the quarter. The war in Ukraine continued to escalate as Russian missile strikes increased in frequency and intensity. At this point, we see no end in sight to this conflict over the near term and investors remain on guard as this remains a key risk to the global markets. China's zero tolerance Covid policies remained very restrictive in the period as this stunted economic growth. Only 50% of the population here is fully vaccinated, well below its regional neighbors as well as Western countries. The Chinese government's stance on strict closures and bans has limited economic growth substantially. These issues have pushed global equity markets significantly downward over the course of our recent fiscal year. As we start our new fiscal year, investors remain on edge and watchful over economic data points searching for answers that perhaps can lead to some type of a rally in the months to come.

	June 2022		2Q 2022		YTD 2022	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	–8.3	–8.3	–16.1	–16.1	–20.0	–20.0
MSCI ACWI	–8.4	–7.4	–15.7	–13.6	–20.2	–17.7
MSCI ACWI ex USA	–8.6	–6.0	–13.7	–8.3	–18.4	–11.9
MSCI World	–8.7	–7.8	–16.2	–14.3	–20.5	–18.3
MSCI Emerging Markets	–6.6	–4.6	–11.4	–8.1	–17.6	–13.7
MSCI EAFE	–9.3	–6.3	–14.5	–7.8	–19.6	–11.3
MSCI Europe	–9.9	–7.7	–14.5	–8.7	–20.8	–13.6
MSCI Pacific	–8.1	–3.8	–14.4	–6.0	–17.1	–6.5

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -9.36% and -11.57% respectively during the third quarter of 2022 vs. -4.88% for the S&P 500 Index. The significant outperformance of U.S. stocks vs. other equity markets came as investors sought a degree of safety perceived with U.S. stocks vs. equity markets outside of the U.S. in times of uncertainty. Global returns were depressed as the U.S. dollar continued to rise in the third quarter and hurt returns by -5.8% for unhedged U.S. investors in the MSCI EAFE Index and to a lesser extent in the emerging markets. The Pacific region was a bit stronger than the European region as the Japanese equity market fell less than many of the large European markets in the period. Once again, all eleven sectors of the MSCI EAFE Index posted negative returns, with the energy sector being the least negative. Commodity prices continued to fall in the period, as the Bloomberg Commodity Index fell -4.11%, led by WTI Crude Oil -21.51% and Unleaded Gasoline -20.53%.

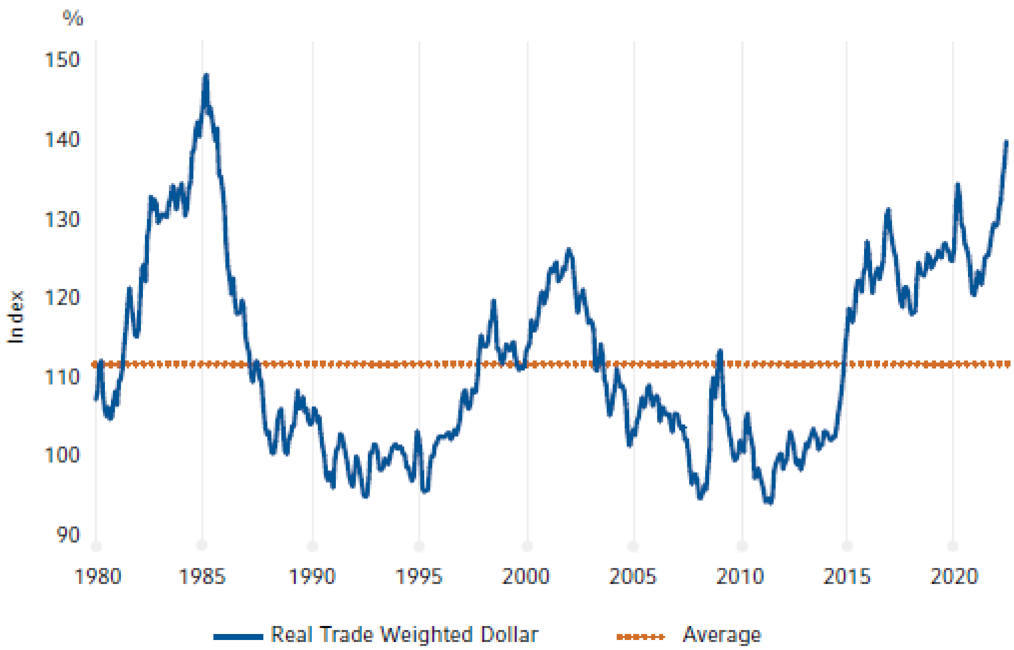


Sources: Arcadia Wealth Management

Quarter-to-date through the end of November, the global equity markets have staged a very quick and large rally as inflation readings may have peaked out and central bank rhetoric has been interpreted better on the margin by investors. Whether this is a “bear market bounce” or the beginnings of a new “bull market” remain to be seen. Either way, we like what we are seeing. The MSCI EAFE Index and the MSCI Emerging Markets

Index are up +17% and +11% respectively, while S&P 500 Index is up +14%. This is a great way to start our new fiscal year!

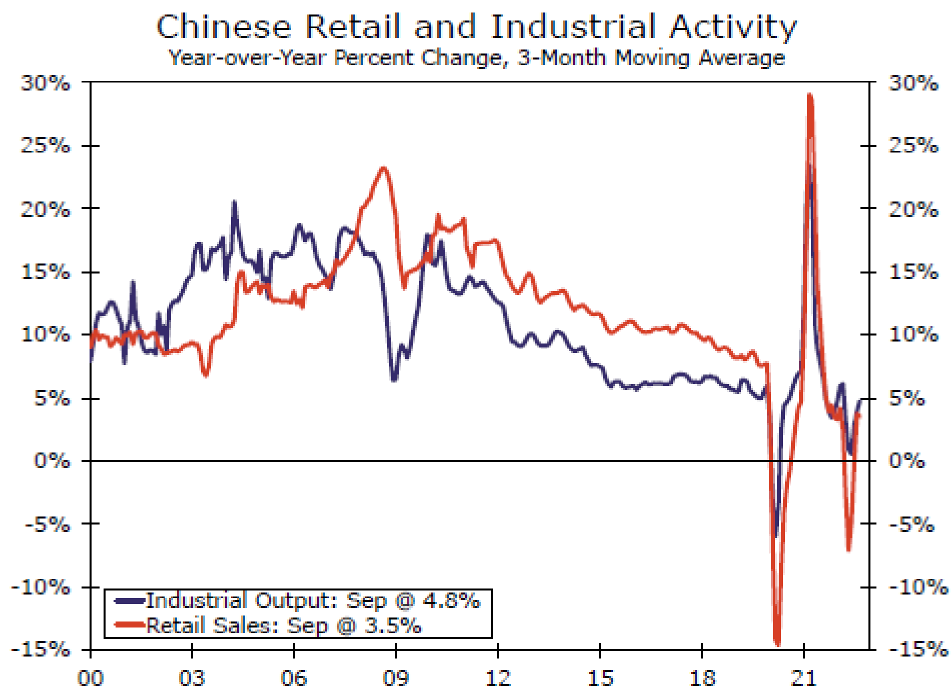
U.S. real trade-weighted dollar reaches highest level in decades



Source: Refinitiv; Datastream; Russell Investments

Asia Update

The Chinese economy managed to stop the recent slide in economic growth as third quarter GDP rose +3.9% from the previous quarter as well as from the previous year. The economy managed this growth even as strict Covid controls and a weaker global demand picture limited exports in the period. Most investors were expecting GDP to be much weaker. Industrial production surprised to the upside as September grew +6.3% from the previous year as steel products, motor vehicle production, and industrial equipment picked up substantially. Fixed asset growth edged up just slightly in September as infrastructure projects continue to move along. Exports trended downward throughout the third quarter as September rose only +5.7% from a year earlier as global demand shrunk from slowing economies. This was the weakest reading since April and we would not be surprised to see this fall even further in the months ahead. Retail sales growth also weakened in the quarter as September sales rose +2.5% from a year earlier, marking the weakest month since May. President Xi Jinping's zero-Covid policy made it very difficult to achieve any broad sales growth recently. We continued to see slower consumer inflation from the lack of domestic demand from Covid policies as October CPI rose +2.1% from the previous year. Food prices continued to fall from high levels of the last few months and served to keep a lid on the CPI. We still see inflation as not being much of an issue as other regions around the globe deal with the highest inflation rates in decades. We continue to see a high likelihood of a 50-basis point cut in the reserve requirement ratio by the People's Bank of China (PBOC) sometime over the next two months as the economy continues to weaken. Most economic indicators are supportive of this action. This action by the PBOC as well as a softening stance on the zero-Covid policy should be good news for investors and could crank up the growth engine in the region. Perhaps this could lead to equity market gains.

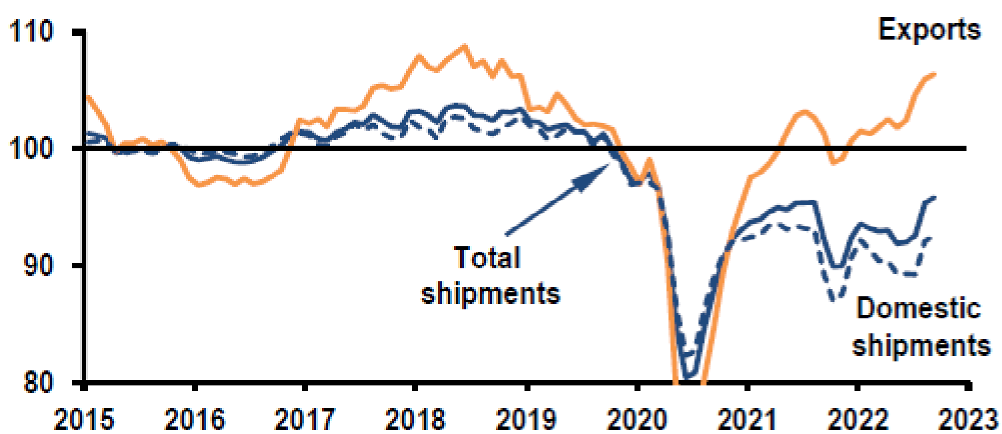


Source: Datastream; Wells Fargo Economics

The Japanese economy surprised most of us to the downside as third quarter GDP fell -.3% from the previous quarter, or -.8% from the previous year. This is the third quarter of negative growth out of the last eight quarters and indicates how tough the growth outlook is to maintain in the economy. Net trade continued to pressure the economy as surging costs for imports from a weak currency was too much to overcome. The government intervened in the currency market in late September in an effort prop up the Yen as it has shed 25% against the U.S. dollar through the end of September. Most of this plunge in the currency is probably attributed to such a drastic difference of sharply rising interest rates in the U.S. vs. Japan's miniscule rates. This puts companies in a difficult position of having to absorb rising costs while making it difficult to pass them along in exports in a slowing global economy. This is a classic cost squeeze with no easy way out. The region reported a trade deficit for the 15th month in a row as imports rose +53% in October from a year ago, as this is the longest streak since 2015. Industrial production declined -1.6% in September from the previous month even though production for the whole quarter was decent. Automakers still struggled with production plans as shortages of key components continued. However, this should improve on the margin as supply chains continue to loosen up in the coming months. Japan's leading economic index weakened throughout the third quarter as September finished at 97.5. This is the lowest levels in this index in over 1 ½ years. Consumer confidence also fell lately as November's reading fell to 28.6, the lowest level in over two years. Rising inflation, even from a low level, coupled with a slowing economy is not a good recipe for the consumer. The labor market was very stable in the quarter, as the September unemployment remained at 2.6%, while the jobs-to-applicant ratio rose further to 1.34. We expect the BOJ to continue with its very accommodative monetary policy stance over the coming months even in the face of harsh criticism. The BOJ still sees inflation as manageable over the long term even if its above their target of 2% now.

Figure 12: Japan shipments by destination

2015=100, sa, 3mma

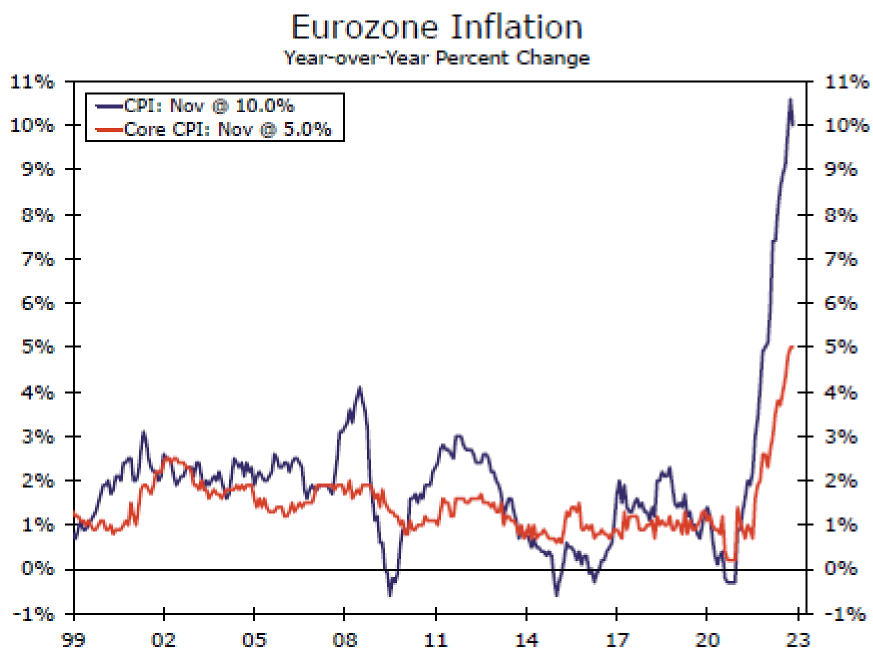


Sources: METI; JP Morgan

Europe Update

European equities continued to struggle in the third quarter as inflationary problems gained further traction, the war in Ukraine intensified, and political upheaval in Italy from the resignation of Mario Draghi. Energy prices have surged as households are looking at hefty heating bills for the upcoming winter months and this is expected to slow consumer spending. Perhaps some recently announced government support measures targeted at the energy crises will soften the blow. The Russian-Ukraine war seems no closer to any resolution and risks to further escalation are rising. These issues led to a -9.9% return for the MSCI European Index (ex U.K.) in the period.

The European economy came in about as expected as third quarter GDP rose +.3% from the previous quarter or +2.3% from a year earlier. This was a slight slowdown from the previous quarter. Investment spending was the main thrust in the period with some moderate help from household spending, while net trade was a detractor from growth. The key German economy picked up steam in the period as production bottlenecks loosened as supply chains were incrementally better in the period. We saw similar results in the other northern European economies of Norway and Sweden. Eurozone industrial production surprised to the upside as September production rose +.9% from the previous month, well above expectations. The strength was once again attributed to the manufacturing sector as we move past the pandemic and get back to more of a normalized production environment. The economic confidence index continued to move downward over the last few months as October fell to 92.5, which was the lowest level in two years. We see this important data point as a precursor to a likely European economic recession in 2023. Retail sales continued to struggle as third quarter sales fell -.7% from the previous quarter. Consumers are reluctant to spend in the face of an uncertain outlook in the next year. Inflation continued its upward trajectory as core CPI rose +5.0% in November from prior year levels and headline inflation, which includes food and energy, was reported at +10.0% in the month. This was a slight improvement from the record levels of the previous month as energy prices ticked down slightly in several of the Eurozone countries. We are not sure whether this is just temporary pause or if we have already reached peak energy price increases. The unemployment rate has been very steady recently as September’s reading remained at 6.6%, which is right at historic lows. We don’t expect to see much improvement in employment related measures if we are moving into a recession over the next few months. At this juncture, the economic picture looks rather bleak in the coming months as persistently high inflation will support more interest rate hikes. However, maybe this is the base case and already discounted in the marketplace. We will see.

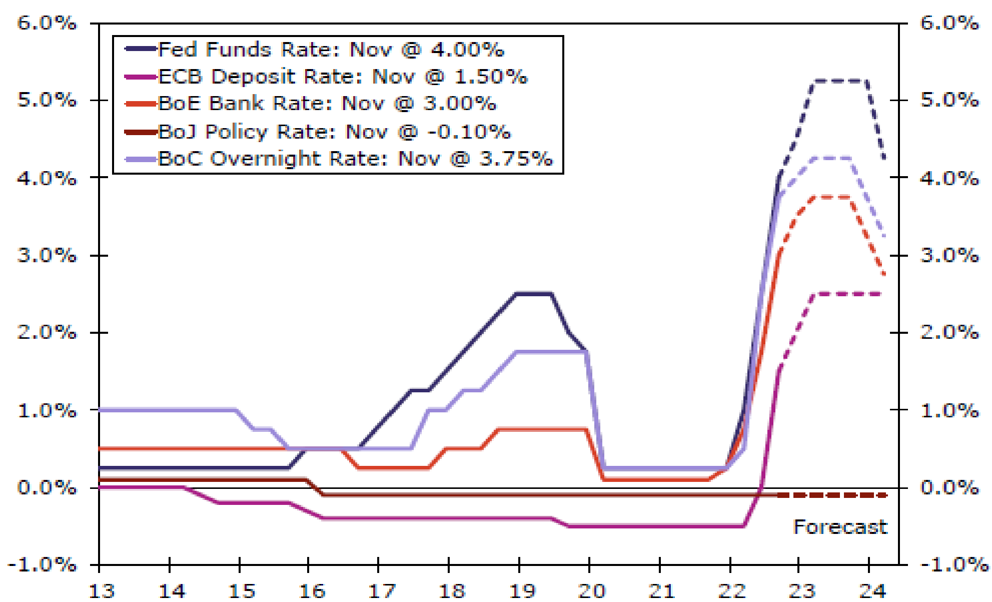


Source: Bloomberg; Wells Fargo Economics

The U.K. equity market struggled in the third quarter as this market was the worst performing major region in the MSCI EAFE Index. The equity market has struggled with the highest inflation of any of the major regions around the globe. Fueling this inflation are soaring natural gas prices as natural gas accounts for nearly 40% of energy use in addition to labor supply issues. Also, the political environment in the U.K over the last few months has been nothing short of a disaster. Prime Minister Boris Johnson left office in September after several scandals and was replaced by Liz Truss. However, Prime Minister Truss lasted less than two months in office as her large-scale tax cuts were reversed and led to a loss of confidence in her leadership. These issues led to a -10.8% loss in the MSCI U.K. Index in the third quarter.

GDP fell -.2% in the third quarter from the previous quarter but grew +2.4% from a year earlier. Many believe this is start of a multi-quarter downturn that could result in a more substantial recession than many are forecasting. We still see this as somewhat unlikely at this point. Industrial production was weak in July and August but managed a small gain of +.2% in September from the previous month. However, for the entire quarter, trends were very weak. Clothing, pharmaceuticals, and transportation equipment were areas of strength in the month, while all other categories displayed weakness. Retail sales struggled to gain any traction in the quarter as trends were negative throughout the period. September sales fell -1.5% from the previous month as household goods fell the most. Many stores were closed for several days for the Queen's funeral which unexpectedly impacted results a bit more than expected. However, we are not optimistic this improves much for the balance of 2022. Core CPI continued to move higher as September rose +6.5% from the year earlier period. Headline inflation was even worse at +10.1% vs. the prior year and remained at a 40-year high. Inflation is probably the single biggest issue in the economy at present. Food inflation remained a big problem as prices rose another +1.1% in September, or +14.8% from a year earlier. We still expect headline inflation to move even higher over the near term before peaking late in the year. Unfortunately, this will force the BOE to aggressively raise interest rates. At its September and November meetings, the Monetary Policy Committee (MPC) voted to raise its main benchmark by +.50% and +.75% respectively to 3.00%. We continue to expect to see more rate hikes in December and the first quarter of 2023 even though the magnitude of each hike may be smaller than past hikes. Most expect the benchmark rate to peak around 4.25% in mid-2023. Inflation has proved to be much more of a problem than anyone was expecting. The labor markets continued to be very tight as the third quarter unemployment rate fell to 3.6%, the lowest since 1973, and total employment stands at 834,000 above pre-pandemic levels. As a result, wage growth continued to move higher as regular wages grew +5.7% in September from a year earlier. We believe the U.K. economy has recently entered a recession and this could last for most of 2023. This should cool the labor markets as this plays out over the next year. We don't expect much from the equity market in the near term as investors begin to digest the harsh realities of what lies ahead.

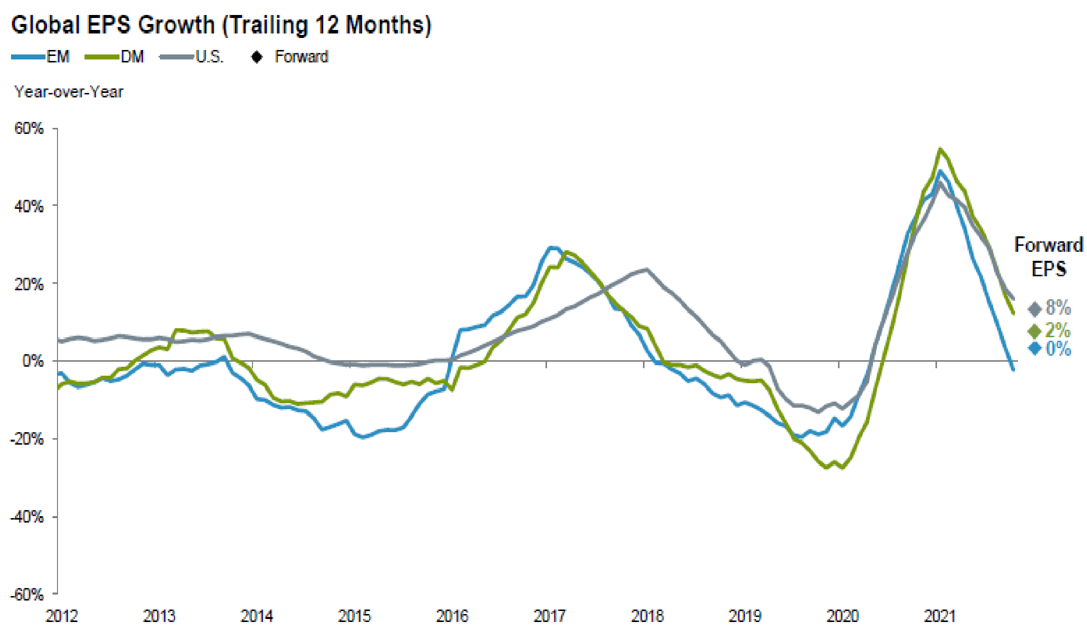
Major Central Bank Policy Rates



Source: Bloomberg; Wells Fargo Economics

Emerging Markets

Emerging market equities wound up be the worst performing region in the global equity markets in the third quarter as global recession worries and abundant geopolitical tensions took centerstage. China's economy slowed down from further Covid restrictions and this led to steep losses in the equity markets. Large internet companies and vehicle manufacturers were hit especially hard in the period as investors shunned these companies. The Chinese renminbi fell to the lowest level against the U.S. dollar since 2008, which led the PBOC to provide support to the currency. Taiwan equities continued to suffer from rising turmoil with China as well as slowing demand for chips used in a variety of electronic equipment. On a positive note, Brazilian equities rose as investors began to feel comfortable with the prospect of moderating inflation going forward and Indian equities were strong as evidence of a more resilient economy began to emerge in the period. Overall, the MSCI Emerging Markets Index fell -11.6% in the third quarter of 2022, a bit worse than the global developed markets. We would not be surprised to see some type of rally take hold with emerging market equities over the next few months if investors see inflation readings fall from peak levels and a cooling of negative rhetoric along the geopolitical front. However, this will have to be balanced with the potential for some level of a developing recession in Europe and the U.S.



Source: Fidelity Investments (AART), MSCI, Bloomberg

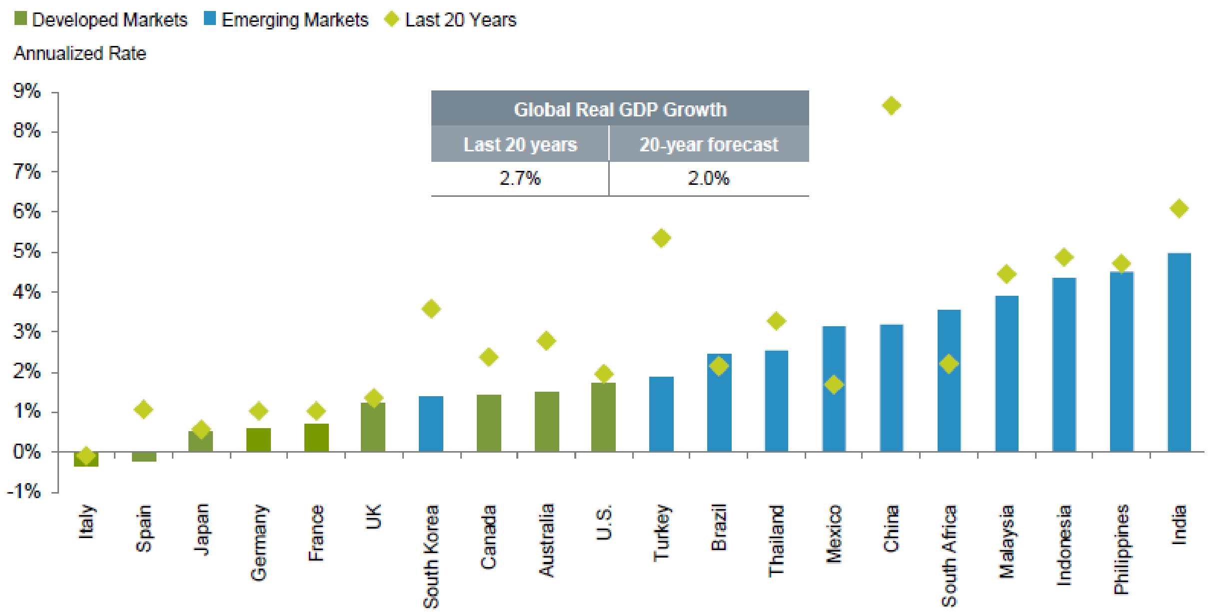
International Equity Activity/Strategy

As we look out into the near future, we see a multitude of issues which could shape the direction of equity prices over this time period. Topping the list are actions and messaging by the global central banks. The U.S. Fed, ECB, BOE, BOJ, and the PBOC all have enormous ability to change the direction of asset prices in the marketplace. Any remarks surrounding a change in the direction of interest rates or pace of interest rate hikes by the central banks should be well received and could push equity markets higher in a short time span as it gets digested in the marketplace. Central to this will be data points on inflation. If inflation can move downward and investors believe this is not temporary, we could get more friendly messaging from the central banks. Other key economic data points are PMI readings, confidence measures, and employment statistics. These need to show some stability for investors to feel comfortable toward riskier assets, such as equities. Also, we see a lot of risk on the geopolitical front at present. The war in Ukraine shows little signs of slowing as neither side wants to negotiate. Further escalation would not surprise most of us. China/Taiwan relations are tense as well and this could change in a hurry. Our base case is some level of a European recession in early/mid 2023. We see this as a higher probability than a few months ago as the energy crisis deepens in the region. Perhaps it will be shallow and short in duration. The U.S. could follow a short time thereafter, but this may not be as likely an event as in Europe. Another wildcard are the Covid lockdowns being mandated in China with its zero-tolerance policy. This is already causing China to miss its growth targets. However, we are optimistic this begins to clear in early 2023 as vaccination rates improve going forward.

We continue to sell a few out of the money calls on the Emerging Markets Index in order to bring in some small income as well as sell just a bit of exposure in a decent short-term rally if this happens. Premiums remain attractive in the current equity market and interest rate climate. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 2.9% of total assets and approximately 10.4% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Bloomberg, Fidelity Investments AART, MSCI, Wells Fargo Economics, METI, JP Morgan, Datastream, Refinitiv, Russell Investments, Arcadia Wealth Management, RIMES, Capital Group)*

Secular Forecast: Slower Global Growth, EM to Lead

Real GDP 20-Year Growth Forecasts vs. History



Source: OECD, Fidelity Investments AART