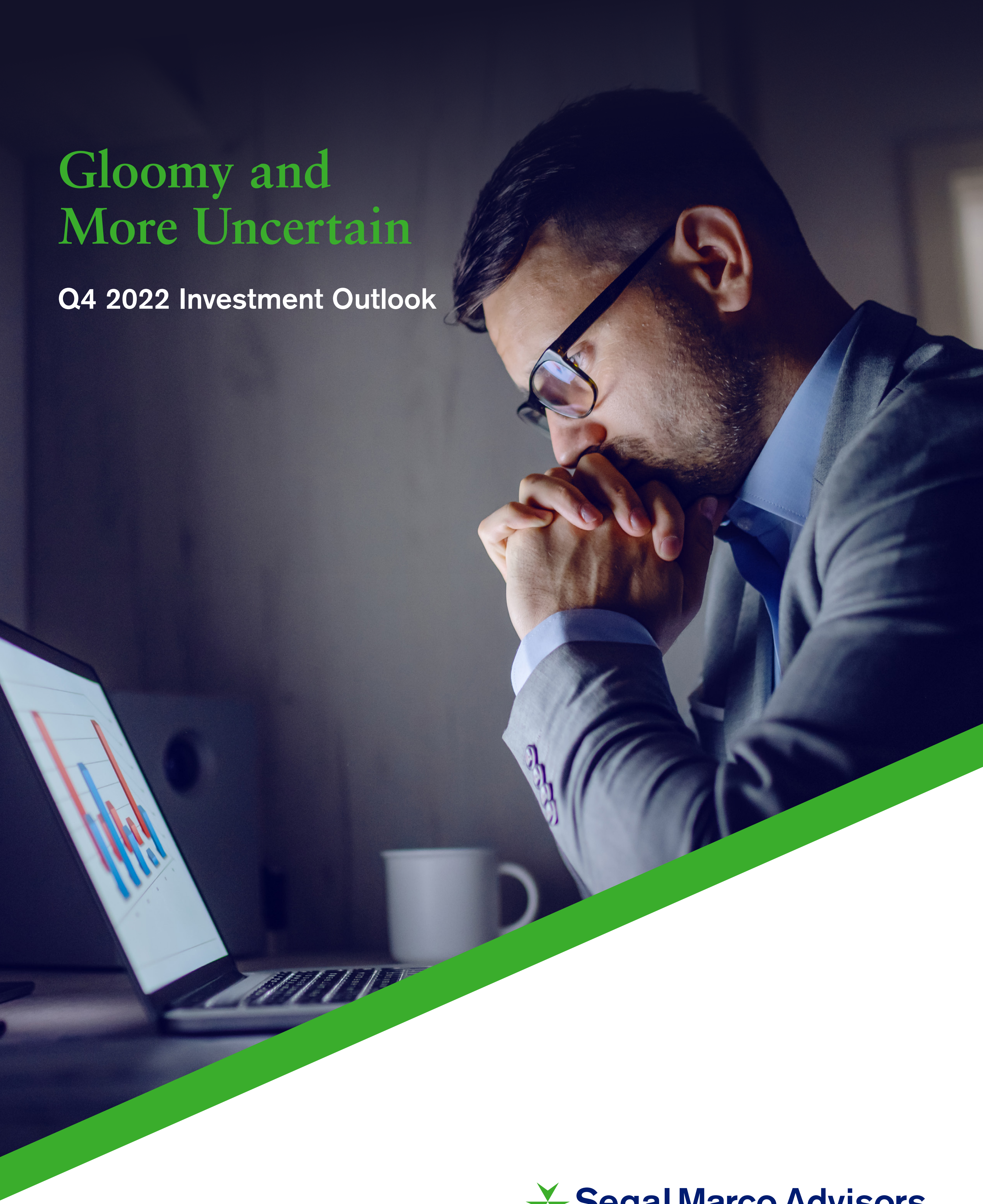
Gloomy and More Uncertain

Q4 2022 Investment Outlook



Segal Marco Advisors

Overview

The International Monetary Fund (IMF) update published in July, "Gloomy and More Uncertain," sort of sums up what most people feel about the markets in 2022. Despite a brief respite from negative numbers in July, September came in with a vengeance, bringing stock and bond markets back toward June lows. We have written all year about the changing regimes, both in financial markets and in the geopolitical landscape. As we sit here entering the dog days of year end, not much more is known and not much is more certain. These two facts alone did and will cause issues for financial assets.

We have also written about what may cause this environment to change, outlining the need for one or all of the following:

- Inflation peaking or sustained evidence of slowing
- The Federal Reserve (the Fed) slows/pivots, meaning interest rates have peaked and the path of uncertainty has changes
- Valuations so compelling that people want to buy

The interesting and good news about the current market environment is the lack of conviction on the outcome. This dichotomy of outlook provides a good basis for active management outperforming. When everyone believes the same thing, dispersion of outcomes becomes binary.

The second piece of good news to focus on is the current yield available on fixed income securities. It has been over a decade since bonds have yielded 5 percent or more. This is a long-term positive for the financial markets, though the pain in getting there is not easy.

The IMF reduced the forecast for global growth in 2022 to 3.2 percent, 0.4 percent lower than April's forecast, and reduced the forecast for 2023 to 2.9 percent. The report points to inflation, the Russia/Ukraine war, tighter financial conditions, China's COVID-19 lockdowns and the property-sector crisis as significant risks. Nothing new here; it's everything we have been dealing with this year.

What we find heartening about these global forecasts is that while the world is struggling with inflation and its consequences, the U.S. is better positioned to withstand this environment than most other countries (energy independence, strong consumer, financially strong banking system to name a few). This strength was evident in the third quarter GDP numbers, which were positive after two quarters of negative growth.

This *Investment Outlook* was written in November 2022.

But lest we get too optimistic, the third quarter GDP was driven by positive net exports and lower imports, and final demand numbers (less inventory, government investment and expenditures) were only 0.1 percent. Housing has turned down as mortgage rates increased above 6 percent. So, it appears the Fed is doing its job to decrease demand.

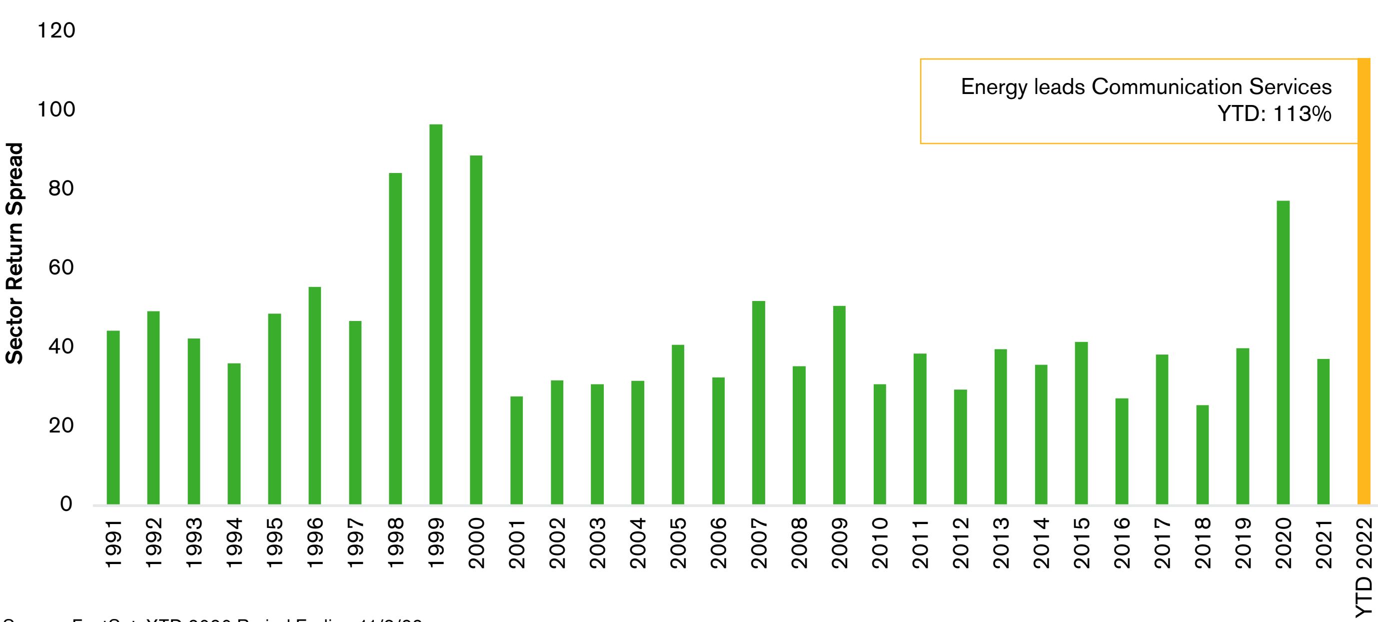
Equity markets

Global equity markets fell again during the quarter that ended in September, thanks, in large part, to the month of September declines, which challenged June for the worst month this year. (The S&P 500® was down -8.3 percent in the month of June versus -7.7% in the month of September). For the quarter that ended in September, the S&P 500® was down -16 percent, with all capitalizations and styles by and large negative in the quarter. (The exception, surprisingly, was a +0.2 percent return for small cap growth,)

Earnings in the quarter that ended in September had been adjusted down. That resulted in many positive "beats" versus expectations. With a majority of the S&P 500® companies reported, the earnings growth rate of 2.2 percent is positive, albeit the lowest growth since the pandemic. Margins continue to be pressured as costs continue to rise from both labor and materials. Whereas much of that cost had been pushed through to consumers earlier in the year, that is changing.

Eight of 11 sectors, including the communications sector, are on track to report a year-over-year (YOY) decrease in earnings. As the graph below shows, the spread between the best performing sector, energy, and the worst performing sector, communication services (think Amazon), is the highest in history.

S&P 500®: Spread Between Best and Worst GICS Sector Annual Returns



Source: FactSet. YTD 2020 Period Ending 11/3/22

Non-U.S. markets continued the negative returns seen all year, thanks in part to the strength of the dollar (USD). The story of the quarter was the UK, where the gilt crisis resulting from the proposed stimulative budget of the new (and short-lived) prime minister required the Bank of England to step in and shore up the bond market.

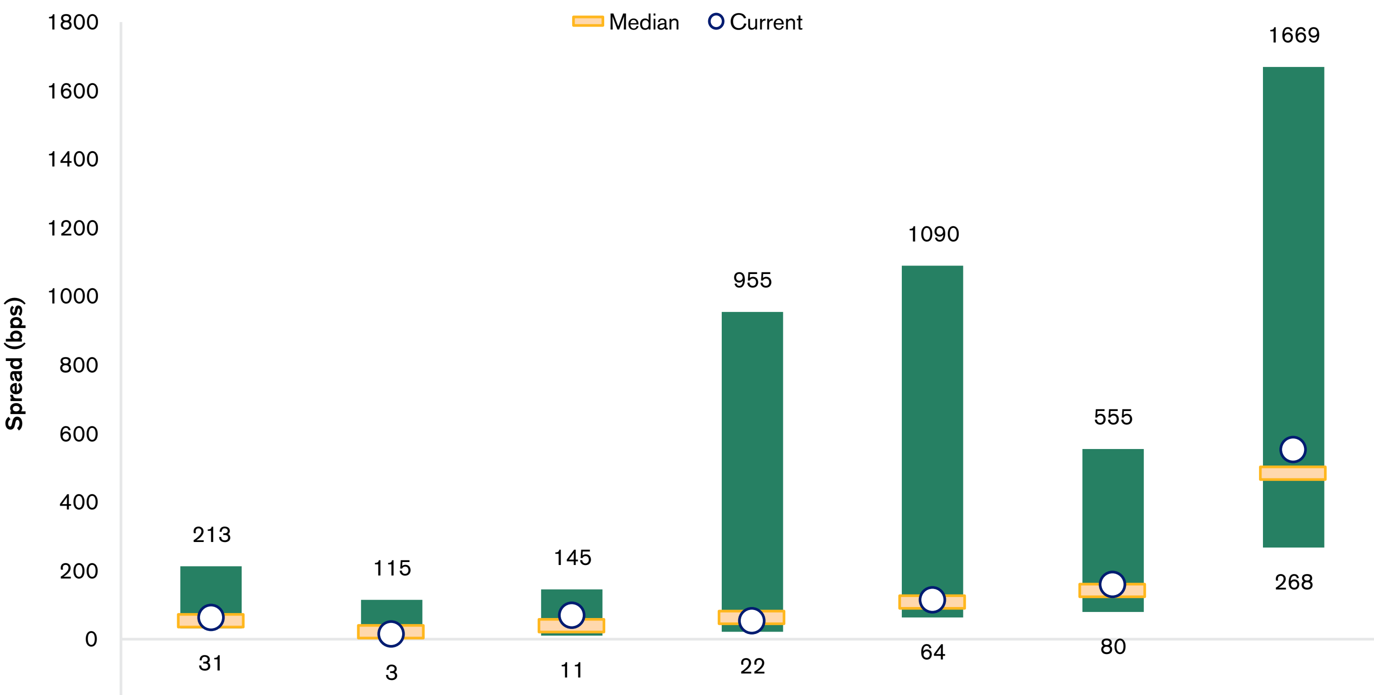
In emerging markets, where China dominates the index returns, the continuation of the zero COVID-19 policy and the consolidation of power in Chairman Xi's hands after the Communist Party Congress was the biggest news. Outside of China, many other emerging market countries, especially those that got ahead of inflation by raising rates, continue to perform well. Brazil was up +8.7 percent and India +6.7 percent, while China was down -22.4 percent. This highlights our theme of active management in emerging markets as the preferred investment option over indexing.

Fixed income markets

It was another negative quarter for the fixed income markets, with the Bloomberg U.S. Aggregate Index returning -4.8 percent, bringing the year-to-date return to -15.2 percent. It's unlikely that anyone investing in fixed income thought they could experience an almost 30 percent decline in bond, but 30-year Treasury bonds are down -29 percent year to date. However, with the speed of change in interest rates this year, it seems the entire rate-hiking cycle has been compressed into 2022. Given that there was no yield to cushion the price declines, it got ugly fast.

High-quality bonds are at compelling valuations, and positive real yields provide a path for more positive future returns. (See the graph below.)

Fixed Income Spreads



	Aggregate	Agency	MBS	ABS	CMBS	IG	HY
Max	213	115	145	955	1090	555	1669
Min	31	3	11	22	64	80	268
Median	53	21	39	62	108	141	483
Current	62	15	69	53	114	159	552
Previous	55	17	46	75	110	155	569

Source: FactSet

Within fixed income, most of 2022 had been a “nowhere to hide” environment with all fixed income securities, both U.S. and non-U.S., providing negative returns.

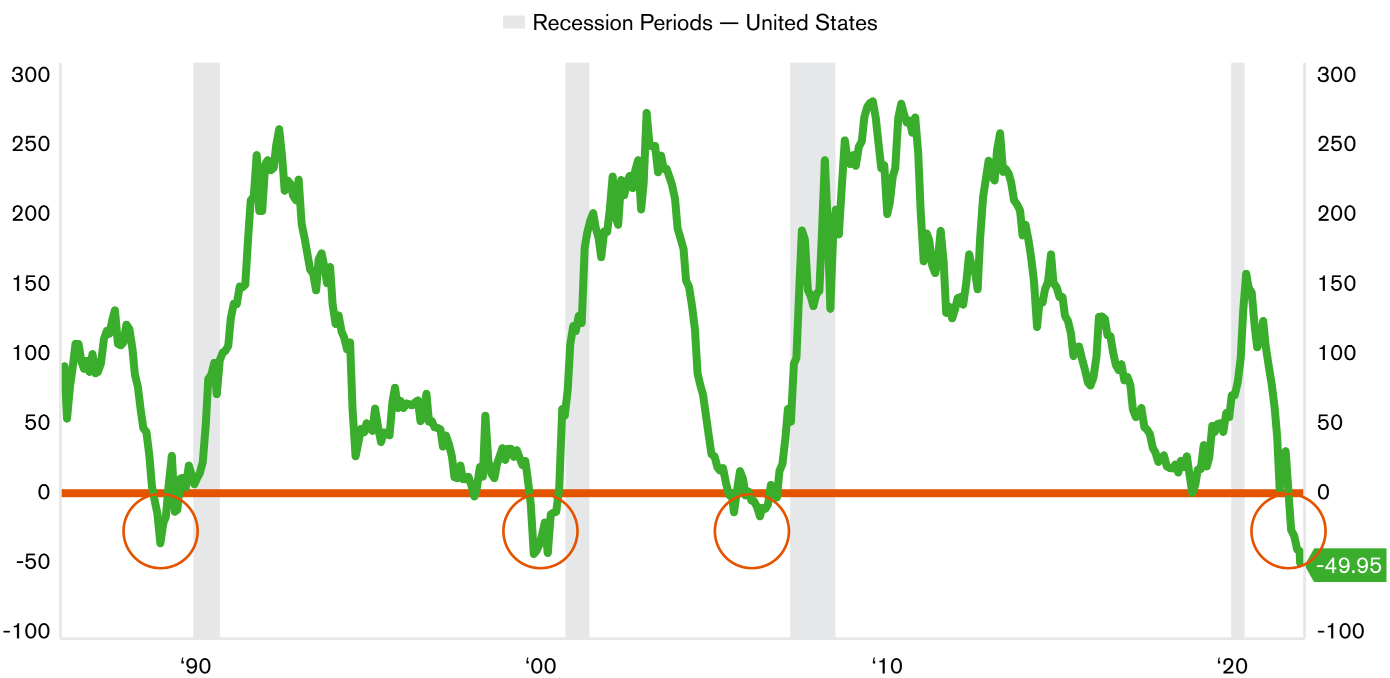
The questions for bond investors are:

- When will the markets embrace the Fed’s rate path?
- When will we see the expected terminal rate reached?

When we reach that point, we could see a trading-range environment, and we could begin to reap the benefits of higher yields.

As the graph below shows, we have exceeded peak inversion of interest rates and seem to be in the late innings in terms of duration.

Recession Periods – United States



	Jan 1989–May 1989	Feb 2000–Nov 2000	Aug 2006–Feb 2007	Jul 2022–Nov 2, 2022*	Average
Inversion Period (months)	5	10	7	5	7
Peak Inversion (bps)	-36	-44	-16	-50	-37

* Includes last close: November 2, 2022

Source: FactSet

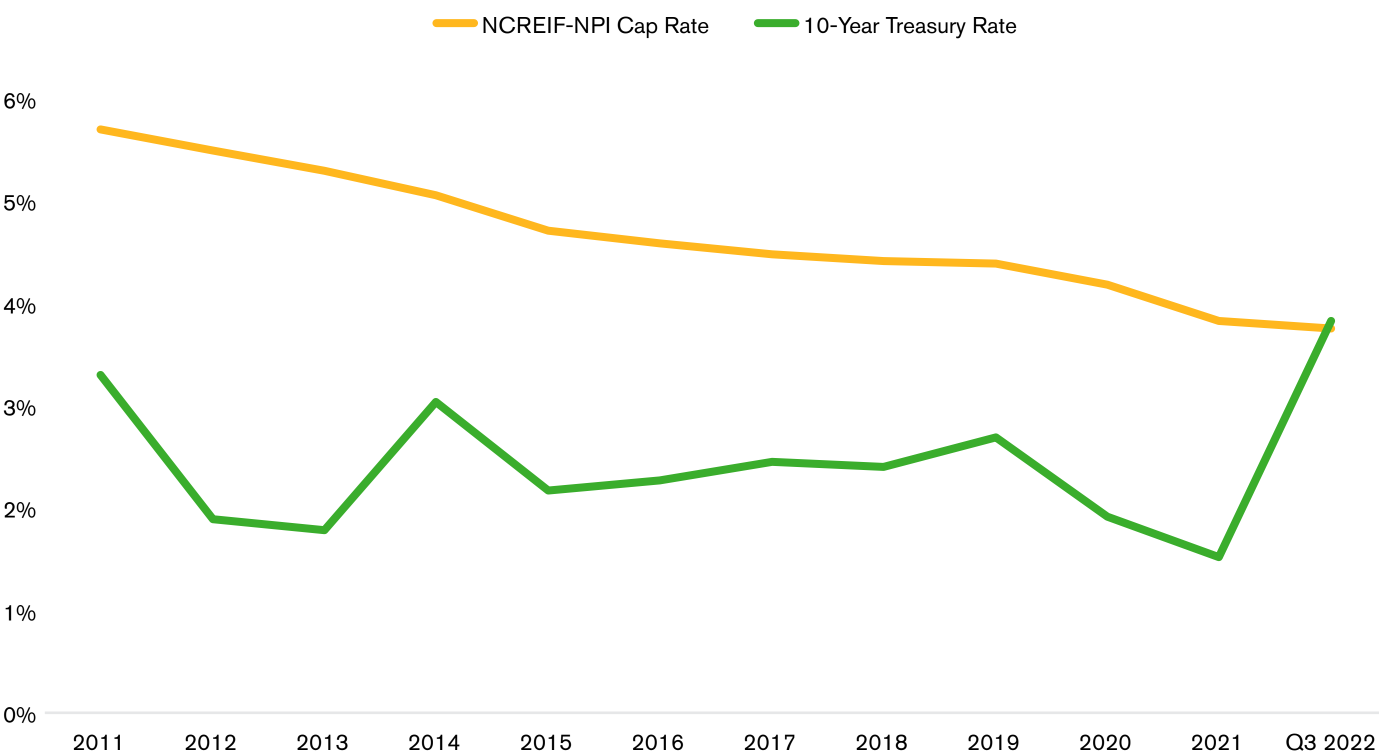
Private markets

While private markets have held up better in terms of prices throughout 2022, the first markdowns were visible in the third quarter (and second quarter final) valuations.

Real estate cap rates are now challenging bond yields, as shown in the following graph, and dispersion among property types continues. Multi-family, industrial and other specialty areas are stronger, while office and many retail sectors continue to be pressured.

A lack of visibility on transactions also weighed on market dynamics. This is the first quarter in over 10 years where the NCREIF index overall had zero appreciation in the quarter and was positive only due to the income component.

Capitalization Rates & 10-Year U.S. Treasury Rates



Source: National Council of Real Estate Investment Fiduciaries

Infrastructure continues to have positive tailwinds, with the Inflation Reduction Act providing capital to many underlying areas of the infrastructure landscape, including power, clean energy, renewables, manufacturing and transportation. Pricing and income both continue to provide positive returns in infrastructure assets.

Private equity had more headwinds in the quarter that ended in September, with no IPO market and the SPAC market closed. Still, relative to public markets, the valuation declines were small. A premium on dry powder and cash on balance sheets to support companies will be key to future success. In addition, the declines in public markets are providing opportunities to buy companies in strategic businesses at much better valuations than previous years.

Real assets still have tailwinds as inflation supports many areas, such as farmland. Also adding to the macro backdrop is food insecurity worldwide due to the war in Ukraine.

Absolute return is another area that is supported by the current market backdrop. Having the opportunity to go both long and short in this environment — as well as the dispersion between companies that are benefiting from the macro environment and those that are challenged — provides opportunity for return enhancement. In addition, global macro and CTA strategies are being rewarded by strong macro trends.

“Gloomy and More Uncertain” will change

With three quarters of the year in the books, gloom and uncertainty sum up 2022. It is hard to imagine the markets turning so bullish as to see a reversion from negative to positive territory for either stocks or bonds.

Having said that, it is also hard to imagine returns challenging the lows we have seen, barring a major geopolitical event.

As we start looking ahead to 2023, the positives of higher interest rates, better valuations and the strength of the consumer to buoy the economy underpin our outlook for growth. Our expectations continue to favor a shallower recession given the strength in employment and the consumer.

Outlook for Canada

Third-quarter GDP had not yet been released when this *Investment Outlook* was published, but it's estimated to come in around 1 percent annualized growth. August showed only 0.1 percent in growth, and the economy likely expanded another 0.1 percent in September, bringing total quarter on quarter growth to around 0.4 percent in the quarter that ended in September. Growth in oil and gas extraction, manufacturing and the public sector offset losses in construction enough to provide a positive GDP growth number, albeit lower than the 0.8 percent GDP growth figure from the first two quarters of the year. Canada's labour market is also weakening, losing almost 40,000 jobs in August, pushing the unemployment rate up to 5.4 percent.

Like almost all other developed countries, Canada is facing persistent inflation, and the Bank of Canada (BoC) is continuing to hike rates to confront it. Canada's policy rate reached 3.75 percent in October after the BoC hiked another 50 bps, its sixth increase this year. The pace of the hikes has slowed, however, from 1.00 percent in July to 75 bps in September to 50 in October. Canada's inflation rate was 6.9 percent in October, which is lower than the 8.1 percent rate over the summer, but still not low enough for the BoC to put the brakes on rate hiking. In addition, quantitative tightening began in April 2022, meaning that the BoC is reducing its balance sheet. This combination continues to put upward pressure on bond yields and mortgage rates.

Similar to other global equity markets, Canadian stocks were negative in the quarter that ended in September, with the TSE falling -8.2 percent. Bond prices also declined as the BoC aggressively hiked interest rates. Canadian equity performance is closely tied to commodity prices and as oil prices sank in the quarter, stocks fell in tandem. The real estate sector also struggled in the quarter.

Summary of Outlook Views

The tables on the following pages provide a snapshot of our forward-looking observations on the direction of specific asset classes.

Asset Class Signals and Outlook

There is a set of five signals for each asset class, represented by shaded circles ranging from an above-normal return outlook (dark green) to a below-normal return outlook (dark red), with the middle circle indicating a neutral outlook (gray). The views represented our 12–18 month perspective for each of the asset classes are *relative* to our longer-term expectations (10+-year capital market assumptions).

If our views on an asset class change from quarter to quarter, that change is represented by an arrow that stretches from the previous quarter's signal to that of the current quarter.

Return Outlook

Key: Below Normal · Neutral · Above Normal

Equities

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. large cap	○	●	○	○	○
Several lackluster indicators here, including negative fund flows and flagging consumer sentiment. Valuations look better than they did earlier in the year but are hardly screaming buys. Earnings strength is idiosyncratic, but market fundamentals are better as we see earnings "beats" being rewarded. Active management can help with selection of the right companies in this environment.					
U.S. small cap	○	●	○	○	○
Like large caps, but small companies may struggle more due to pricing pressures from inflation and higher financing costs. Valuations in small cap do look more reasonable than those of large caps now, adding to their appeal. They also perform well in risk on environments. Active management will be advantageous here, as well.					
Int'l dev. large cap (unhedged)	○ →	●	○	○	○
Non-U.S. stocks are still hindered by several challenges, including a strong USD, energy issues due to the ongoing war in Ukraine, and high inflation. However, there are a some (relative) reasons for optimism. While the USD is strong, it's not likely to get much stronger. The European Central Bank, the Bank of England and other central banks are hiking rates to combat inflation, and, if there can be some resolution to Russia's war, European stocks will be poised to benefit. With compelling valuations and pressure on currency easing, while not out of the woods, the outlook is somewhat better.					
Int'l dev. small cap (unhedged)	○ →	●	○	○	○
There are a greater headwinds than even U.S. small caps, including greater sensitivity to inflation and to other recessionary factors.					
Emerging markets (unhedged)	○	●	○	○	○
A strong USD is still a negative for countries with large amounts of dollar-denominated debt. China, which represents the largest portion of the EM index, has struggled due to its zero-COVID-19 policy, real estate industry and debt issues. Recent supply chain issues have subsided, but demand for commodities and other products has waned as the global economy has slowed. The end of the Chinese Communist Congress may provide a runway for some of the headwinds to wane.					

Return Outlook

Key: ● Below Normal ● ● Neutral ● ● Above Normal

Fixed income

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. core	○	○	●	○	○
Interest rates rose further in the U.S. during the previous quarter, and the yield on core bonds continue to be attractive. Investment-grade (IG) valuations are somewhat more appealing than those of high yield, and IG may fare better in a slowing economy.					
Non-U.S. core (hedged)	○	●	○	○	○
The economic backdrop for Europe continues to be lackluster, as the war in Ukraine continues and inflation persists. Nevertheless, the USD may have peaked relative to the euro and, with the European Central Bank and the Bank of England hiking rates, yields look better now than they did earlier this year. Defaults are still a risk in this uncertain environment, but overall, the picture is a bit brighter.					
Emerging market debt (hedged)	○	●	○	○	○
Given the uncertainty around the economic backdrop in emerging markets, it's tough to be overly positive. Currencies may remain volatile in this environment. A still-strong USD will continue to be a negative for countries with significant dollar-denominated debt. The level of yield is appealing, but the risks in emerging market debt remain significant.					
High yield	○	●	○	○	○
High yield has performed better than most other fixed income categories over the quarter, as corporate earnings remain solid and economic news has been relatively positive. Once again, spreads sit above the long-term median here, however, at a time when economic risks are building. Defaults could pick up if the global economy deteriorates meaningfully.					
Bank loans	○	○	●	○	○
Bank loans' floating rate feature still is a significant asset as rates continue to rise. Their senior position in the capital stack and typically secured status are also points in bank loans' favor. Like high yield, however, loans could face headwinds if economic woes increase.					
TIPS	○	○	●	○	○
Given the uncertainty around inflation expectations, the benefits of TIPS may provide some upside potential, with outperformance in unanticipated inflation regimes. Though TIPS are still negative thus far in 2022, they are not down as much as nominal bonds and thus have provided some protection.					

Continued on the next page

Return Outlook

Key: ● Below Normal ● ● Neutral ● ● Above Normal

Fixed income

Opportunity Set	Below Normal		Neutral		Above Normal
Private credit	○	○	●	○	○

Private credit funds have continued to weather market volatility fairly well, as the floating rate nature of loans insulates investors from the harmful impact of rising interest rates and in many cases actually benefits from that dynamic. While we have not yet seen large increase in defaults as balance sheets and income statements remain relatively strong, financing costs have significantly risen. Ultimately, the combination of higher interest and input costs will impact balance sheets. We remain cautiously optimistic on the asset class.

Opportunity Set	Below Normal		Neutral		Above Normal
Long bonds	○	○	●	○	○

In the quarter that ended in September, the yield for the long Treasury sector rose again by 67 bps to 4 percent, and the long Treasury sector returned -9.6 percent. This puts the year-to-date total return for the sector at an eye-opening -28.8 percent. Inflation repricing and term-premium dynamics further out on the yield curve were the most significant drivers in both time periods. Year-over-year inflation remains high, and expectations are for more price volatility to long bonds as capital markets accept the reality of rising rates. However, a great deal appears to be priced into the long-dated segments of the Treasury curve, creating opportunities in the next 12–18 months as more normal correlations are reestablished.

Opportunity Set	Below Normal		Neutral		Above Normal
Municipals	○	○	●	○	○

Following the strong post-pandemic rally, the taxable and tax-exempt municipal bonds tailwinds disappeared this year. Once again, the yield on the tax-exempt municipal bond index rose significantly to 4.0 percent for the quarter. This 83-bps yield increase follows a 61-bps increase experienced in the quarter that ended in July and 149-bps rise in the quarter that ended in March. However, as with Treasury bonds, the outlook is unclear, but, arguably, a lot of the negative performance damage has already taken place. Retail demand will always be high for these instruments, which creates a reliable bid, particularly as the muni/Treasury ratio becomes more compelling at these elevated yields.

Return Outlook

Key: Below Normal | Neutral | Above Normal

Alternatives

<table>
<tr><th>Opportunity Set</th><th colspan="2">Below Normal</th><th>Neutral</th><th colspan="2">Above Normal</th></tr>
<tr><td>Hedge funds</td><td>○</td><td>○</td><td>○</td><td>●</td><td>○</td></tr>
<tr><td colspan="6">Hedge funds continue to be supported in an uncertain environment. Long/short strategies are benefiting from dispersion in performance among companies, while global macro and CTA strategies are being rewarded by strong macro trends.</td></tr>
<tr><td>Multi-asset class strategies (MACS)</td><td>○</td><td>○</td><td>●</td><td>○</td><td>○</td></tr>
<tr><td colspan="6">Like hedge funds, multi-asset class strategies are in a good position as uncertainty persists in economies and markets. However, it remains important to emphasize managers and strategies that can best benefit in this environment. Strategies that can invest tactically across asset classes are good options in these conditions.</td></tr>
<tr><td>Private equity</td><td>○</td><td>○</td><td>●</td><td>○</td><td>○</td></tr>
<tr><td colspan="6">Public equity drawdowns have not yet been priced in comparable private market valuations and will likely be more impactful with second and third quarter marks. However, any reduction in valuations will provide more attractive entry pricing for strategic acquisitions and platform build-ups. Continued elevated interest rates will affect leveraged cost of capital, and buyout deals may require a greater equity contribution, which will moderate near term return expectations. Venture-backed growth companies that have completed recent financings at high multiples will encounter later-round re-valuation risk as market conditions soften, although promising early stage investments may demonstrate greater resiliency. Economic uncertainty and asset mispricings will be a tailwind for corporate stressed/distressed special situation strategies.</td></tr>
<tr><td>Real estate</td><td>○</td><td>○</td><td>●</td><td>○</td><td>○</td></tr>
<tr><td colspan="6">Cap rates, which now approximate bond yields, could reverse trend and start to expand as investors demand greater yield compensation for relative asset illiquidity. This increased valuation risk could create select buying opportunities, particularly for core properties. Specific property type outlooks will remain mixed. Despite macroeconomic headwinds, industrial remains positive due to low supply in key markets and growth in e-commerce distribution. Multi-family should remain resilient and in demand given single-family home buying affordability. Office is the least liquid sector and of most concern, while retail will struggle given impact of inflation and broader economic fears related to consumer spending. Wider bid-ask spreads will continue to affect transaction volume. Less correlated specialty niche sectors, such as storage, student housing and lab/R&D, are anticipated to be value additive.</td></tr>
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Return Outlook

Key: Below Normal — Neutral — Above Normal

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Infrastructure	○	○	○	●	○

Investor demand is expected to remain strong given attractive income generation, positive cash flows and inflation protection through cost-adjusting operating agreements. Dry powder remains elevated given strong fundraising and slower deployment due to wide bid-ask spreads and deal competition. However, pending larger transactions are anticipated to help absorb some of the surplus capital. Overall interest in infrastructure essential assets and positive tailwinds from the Inflation Reduction Act will be supportive of transportation, power, clean energy and renewable sub-sectors.

Opportunity Set	Below Normal		Neutral		Above Normal
Commodities	○	○	●	○	○

Agricultural commodity prices are expected to stay elevated given strong global demand, lower corn production and continued impact of the war in Ukraine war on supply. Weaker Chinese demand will pose headwinds. Despite the European energy crises, prices will generally remain relatively stable within a range, given programmatic OPEC production cuts targeted to offset any slack in demand from deteriorating economic conditions. As consumers tighten belts and the economy slips, precious and industrial metal returns are anticipated to moderate from slackening demand. However, should the Fed pause or slow rate rises due to an improving inflation outlook, a weaker USD will make metals less expensive for holders of other currencies, which could support demand.

Opportunity Set	Below Normal		Neutral		Above Normal
Energy	○	○	○	●	○

Outlook is positive, especially for North America, given overall healthy balance sheets for exploration and production companies. The mid-stream sector will benefit from tight asset supply during a period of increasing demand for energy distribution and storage. Focus on climate and net-zero carbon transition will continue to meaningfully propel annual renewables development and capacity. Solar and wind will experience supply chain cost challenges, but prices are anticipated to remain competitive with traditional hydrocarbon power sources.

Continued on the next page

Return Outlook

Key:

Below Normal		Neutral		Above Normal
●	●	●	●	●

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Timber	○	○	●	○	○
Elevated interest rates will continue to suppress single-family home construction demand and further negatively impact income-based returns for timber owners. Log prices should be supported by increased competition from expanded sawmill capacity. Additional gains forecasted from demand for packaging materials, along with land transactions and collateral sources of revenue from biofuels and carbon credits. Some timberland owners have reported liquidity pressures, which may offer attractive entry pricing opportunities for longer-term capital.					
Farmland	○	○	○	●	○
Positive fundamentals are expected to continue due to global demand for food and various supply constraints, which are expected to offset headwinds posed by higher input costs, supply chain issues and rising interest rates. Agricultural prices likely to remain elevated, especially for grains due to the ongoing war in Ukraine, that will continue to bolster land valuations which are already elevated. Farmland remains attractive and in demand from investors as a safe harbor and inflation-buffer during a time of economic uncertainty.					

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