Market & Economic Outlook 2022 – July Update: Bear Market Strategies

Major Indices	Value (6/30/2022)	2Q22 (3/31/2022 - 6/30/2022) Price Return	2Q22 Total Return	2022 YTD (12/31/2021 - 6/30/2022) Price Return	2022 YTD Total Return
S&P 500	3,785.38	-16.4%	-16.1%	-20.6%	-20.0%
Dow Jones Industrial Average	30,775.43	-11.3%	-10.8%	-15.3%	-14.4%
NASDAQ Composite	11,028.74	-22.4%	-22.3%	-29.5%	-29.2%
Russell 2000	1,707.99	-17.5%	-17.2%	-23.9%	-23.4%
MSCI EAFE (USD)	1,846.28	-15.4%	-14.3%	-21.0%	-19.3%
MSCI Emerging Markets (USD)	1,000.67	-12.4%	-11.3%	-18.8%	-17.5%
Bloomberg Commodity Index	117.05	-5.9%	-5.7%	18.0%	18.4%
Barclays U.S. Aggregate Bond	92.63	-5.3%	-4.7%	-11.6%	-10.3%

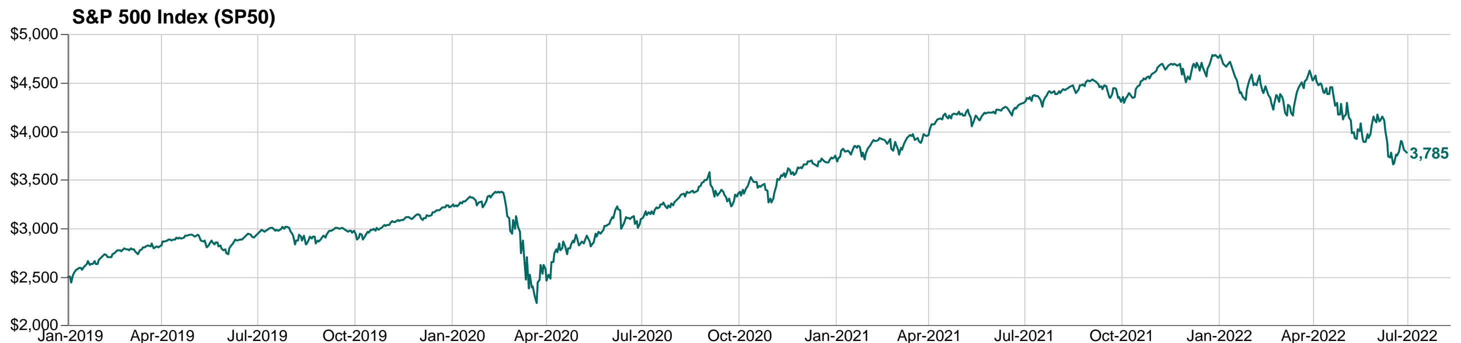
Data Source: FactSet through 6/30/22; Further discussion of market indices can be found in the Appendix section; Price Returns refer to the percent change in prices from the beginning of the period (3/31/2022) to the end of the period (6/30/2022); Total Returns include dividends paid.

Outlook Summary:

We remain cautious on U.S. equities entering the second half of 2022 as major factors driving negative investor sentiment in the first half persist, creating high levels of uncertainty that are likely to persist. We revise our S&P 500 fair value to 4,200 (from 4,800), which is 11.0% above the 6/30/22 index closing price, but 11.9% below the value at the end of 2021 (12/31/21). Prevailing investor concerns include high inflation readings, U.S. recession fears, and expected pressure on corporate earnings results. The U.S. Federal Reserve Bank (Fed) is addressing inflation pressure by removing excess monetary liquidity (hiking short-term interest rates and reducing its holdings of Treasury securities), but runs the risk of causing a larger-than-desired economic slowdown. At the same time, global sanctions on Russia have disrupted energy and grain markets, China's zero-COVID policy has shut down parts of its large economy and limited supply chains, and the U.S. and other countries must navigate a COVID-19 endemic that appears here to stay. U.S. economic growth has stalled in several key areas, as housing construction has slowed, demand for durable goods has weakened, and many retailers have reported excess inventories. We believe that these numerous economic and corporate headwinds were increasingly considered by investors in the second quarter and, to a large extent, are priced into the market. While we expect equity market volatility to continue, at least over the short term as companies adjust to slower growth and tighter Fed policy (and data could take a turn for the worse), we also see attractive entry points for many high-quality, market-leading companies, which can lead to solid long-term gains for investors.

The news is not all bad, however, as the U.S. labor market remains healthy with low unemployment, near-record job openings and rising wages, and business investment in software and equipment continues to grow. While consumer spending on goods has slowed, spending on services (travel, healthcare, and household consumption) has grown, largely reflecting substantial pent-up demand, but also representing a shift in activity as consumer patterns normalize. In this report, we will define and discuss the current equity bear market, the troubling trend of high inflation, the Fed's plan to tighten monetary liquidity to address inflation, the risk of a U.S. recession, and expectations for slowing earnings growth. We also discuss an equity bear market investment strategy that includes identifying high-quality companies, building a diversified portfolio, and adding stocks that pay regular and increasing dividends.

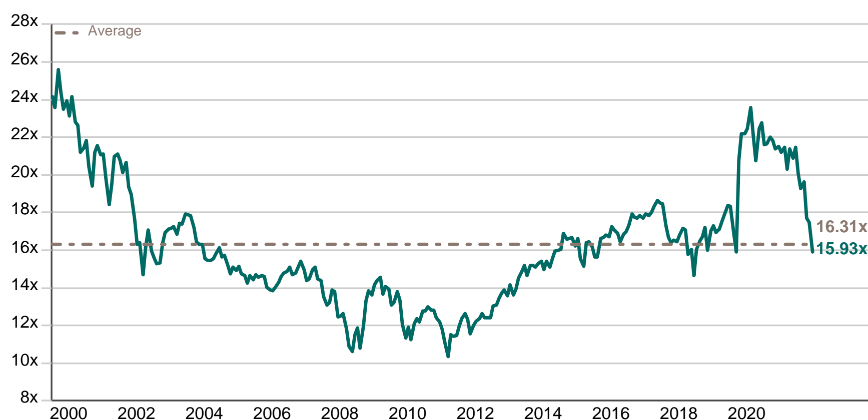
Second quarter and first half market review; a bear market takes hold. Major equity indices traded lower in the second quarter of 2022 (2Q22), significantly extending market declines from the first quarter. In 2Q22, the widely-followed, large-company S&P 500 index declined 16.1% (total return - includes dividends), which was the worst calendar quarter decline since 1Q20, the onset of the COVID-19 shutdown, when the S&P 500 total return was -19.6%. Following a -4.6% return in 1Q22, the first half total return was a dismal -20.0%. Other U.S. equity indices fared worse over the year's first half, as the growth-centric, large-company Nasdaq Composite posted a decline of -29.2%, and the small company Russell 2000 dropped -23.4% (total return). When the S&P 500 index closed at 3,750 on 6/13/22, it was down -21.8% from its all-time closing high (4,797) on 1/3/22. A few days later, on 6/16/22, the index closed at 3,667, down -23.5% from the peak (which was the lowest closing price of the first half of the year). This put the S&P 500 in a bear market, which we define as a peak-to-trough index decline of -20% or more, while a market correction reflects a decline between -10% and -20%. The S&P 500 joined the Nasdaq Composite and Russell 2000, which entered bear market territory in the first quarter on 3/7/22 and 1/27/22, respectively. Through 6/30/22, the S&P 500 index made daily moves up or down by 1% or more on 56% of the trading days, including 31% of all trading days with the index down more than -1%. This compares to 2021 when only 23% of days saw a 1% daily move, and only 8% of all trading days with the index down more than -1%.



Source: FactSet, S&P 500 Daily Closing Prices 12/31/18 to 6/30/22

Market Valuation. Our S&P 500 fair value estimate of 4,200 represents a P/E of 17.6x the FactSet consensus S&P 500 EPS for the next four quarters of $238 and 16.9x the 2023 EPS estimate of $248. Our fair value estimate is not a year-end target, as it represents a value that we believe can be achieved over the next twelve months, driven by an assessment of broad economic and earnings expectations in 2022 and 2023. We have made two adjustments to how we view future earnings expectations since we last adjusted our fair value estimate in early June. The first is that prevailing FactSet consensus earnings estimates remain too high, in our view. Since the end of March of this year, the FactSet consensus estimate for 2022 S&P 500 earnings per share (EPS) growth has moved modestly higher, and as of 7/8/22, is estimated to show an increase of 10% vs. 2021, while the estimate for 2023 S&P 500 EPS is 9% above the 2022 estimate. Estimates have held firm despite the ongoing war in Ukraine and the Federal Reserve Bank's (Fed) implementation of inflation-fighting tighter monetary policy (higher interest rates) that is intended to slow economic growth. Although 1Q22 earnings results exceeded expectations (9.3% Y/Y growth vs. 4.5% expected), we believe that earnings estimates for late 2022 and 2023 are likely to be revised lower. Secondly, the price-to-earnings (P/E) ratio for the S&P 500 index has trended lower over the past two years, peaking at 23.6x forward earnings estimates in August 2020, well above the index's average P/E of 16.3x over the past 22 years. As of 7/8/22, the S&P 500 traded at 15.9x consensus earnings estimates over the next four quarters. Over time, we believe the S&P 500 will trade in a forward P/E range of 14x to 19x (midpoint 16.5x), which was the range for the six years prior to the pandemic (2014 to 2019). If we assume that S&P 500 earnings grow 4% in 2022 and 2% again in 2023, which assumes growth in both years below current consensus estimates, then our 4,200 fair value represents an S&P 500 P/E of 19x 2023 EPS estimates. Going forward, we believe that future stock price appreciation will be more closely tied to earnings growth rates.

S&P 500 Next Twelve Months P/E



Source: FactSet as of 6/30/22. Daily index value divided by FactSet consensus EPS estimates.

The significance of a bear market. While market corrections (declines of -10% to -20%) happen relatively frequently (the S&P 500 experienced 15 corrections in the 13-year period 2009 to 2022), bear markets are rarer events. We calculate nine S&P 500 bear markets from 1960 to 2021; including this year, that is 10 bear markets in 62 years, or one every 6.2 years. With the last bear market just two years ago in 2020, there has been a bear market in two of the past three years. Bear markets are painful for investors, as asset values decline and equity portfolios fall in value. On average, bear markets play out over a longer time period than do corrections. In the bear markets from 1960 to 2020, the average number of months from the market peak (pre-selloff) to the ultimate bottom (which is only known after the fact), or peak-to-trough, was 14 months. The range was wide, however, as 2020 took just one month to make a market bottom, while in the 2000 to 2002 market decline, the peak-to-trough drawdown lasted 30 months. The 2022 drawdown is now in its seventh month. To rally and make a new high, the average bear market recovery was 27 months, but again the range was wide, from just three months in 1982 to 67 months from the 1974 trough date. The good news is that, at some point, we expect the S&P 500 to rally from market lows; we measured each bear market from the date the S&P 500 was down -22%, and found that one year later the index, on average, was 19.4% higher (positive returns in 7 of the 10 bear markets), and after three years the index was 29.0% higher (positive returns in 8 of 9 bear markets). Five years out from a -22% decline, all bear markets were higher with an average index gain of 53.5%. The 2022 bear market in the S&P 500 hit the down -22% level on 6/13/22. Our conclusion is to stay the course. Through 6/30/22, significant equity market and valuation damage has been done. While we expect ongoing volatility, which could take equities lower from current levels, we see many high-quality, industry-leading companies trading at attractive valuations.

Bear market strategies. We have advocated a sector diversification strategy in the current market environment. This includes reviewing portfolio holdings to assess a company's ability to navigate a period of elevated inflation and slowing growth. Does the company have pricing power? Does it have the ability to defend its market position? Focus on high-quality companies, which can be assessed by analyzing market share leadership, skilled management, solid profit margins and positive free cash flow in 2022, and strong balance sheets. Defensive sectors (Consumer Staples, Utilities, and Health Care), while negative in 2022, have performed relatively better than the S&P 500 index. While these sectors are likely to outperform if equities continue trading lower, we do not believe, with the S&P 500 down -20% YTD, most investors should get overly defensive at this time. We recommend investors remain broadly diversified across sectors with high-quality companies offering the potential for long-term gains. In addition, we advocate increasing exposure to dividend-paying stocks, especially companies that are able to increase dividend payments and return cash to shareholders. Investors should review sector allocations and rebalance as needed to either improve diversification or bring allocation back in line with the long-term plan.

Dividends become a larger percentage of total return in tough markets. Companies that pay dividends are using a portion of cash flow to return cash to shareholders. While dividends tend to remain relatively constant, the yield will fluctuate based upon the price of the stock. The dividend enhances shareholder returns as the total return of a stock is the combination of the dividend payment and the stock price change during the period. During periods of increased market volatility and lower price returns, dividends can be a stabilizing force in portfolios. As of 6/30/22, the dividend yield on the S&P 500 index was 1.7%, which doesn't seem like much compared to the index's -20.6% price decline over the first half of the year; however, the dividend yield has helped to offset some of the decline, and reinvestment of such dividends can act as a

built in dollar-cost averaging tool, creating a more meaningful benefit over the long term. When equity markets ultimately recover, in our view, we do not expect the annual double-digit percentage gains that we saw from 2009 to 2021. Over that 13-year, post-financial crisis period, the S&P 500 provided a compounded annual return (CAGR) of 16.0%, as monetary liquidity was very high and interest rates were very low. Looking forward, we expect annual returns to be closer to the 6.3% CAGR of the S&P 500 over the 22.5-year period 12/31/99 to 6/30/22. In the more recent, post-financial crisis period discussed above, dividends comprised just 15% of the annual total return of the S&P 500 index; however, over the longer 22.5-year period, dividends contributed 32% of the annual total return. In addition, we find that companies able to pay dividends from profits through various market cycles generally, in our view, demonstrate solid capital discipline and resilient business models. This is especially the case for companies that can increase annual dividends over many years, and keep the dividend payout (over time) at or below 50% of net income. Investors appear to have rewarded large company dividend payers over the first half of 2022 (at least on a relative basis). While the price return of the S&P 500 was -20.6% from 12/31/21 to 6/30/22, the index's non-dividend payers (22% of S&P 500 constituents) declined -28.4%, while dividend payers (78% of constituents) decreased only -13.3% (price return).

S&P 500 Annual Returns Over Time

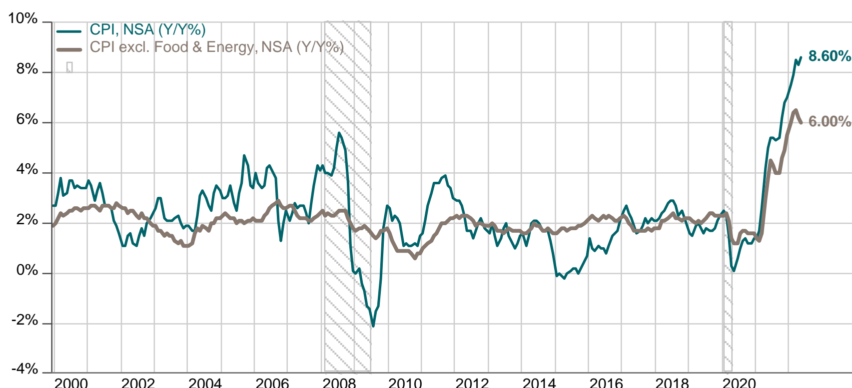
Period		Price Return CAGR	Total Return CAGR (includes dividends)	% of Annual Total Return Attributed to Dividends
12/31/08 - 12/31/21	13 years	13.6%	16.0%	14.6%
12/31/99 - 6/30/22	22.5 years	4.3%	6.3%	31.9%

Source: FactSet and D.A. Davidson as of 6/30/22. Using daily closing values of the S&P 500 index.

Headline inflation surges while core inflation moderates. The widely followed Consumer Price Index (CPI) increased 8.6% year-over-year (Y/Y) in May, the third-consecutive month above 8.0%, and higher than the April 2022 Y/Y increase of 8.3%. Not only was the headline Y/Y number higher than expected (FactSet consensus estimate was 8.2%), but the month-to-month (M/M) increase was 1.0%, as prices for food, gasoline, new and used vehicles, and airline fares all rose from April levels. The "core CPI," which excludes the impact of food and energy, increased 6.0% Y/Y in May, modestly lower for the second-consecutive month, but still the fifth-consecutive month above 6.0%. There was very little positive data in the May inflation report; while we expected upward pressure on the headline number due to surging oil and gasoline prices, we also expected signs of relief in other categories. That did not happen, as prices for shelter (rent and owners' equivalent rent) increased 5.5% Y/Y and medical care services rose 4.0%. Price increases in both of these categories are considered "sticky" inflation, which tend to build more slowly and remain entrenched for longer periods once price increases take hold.

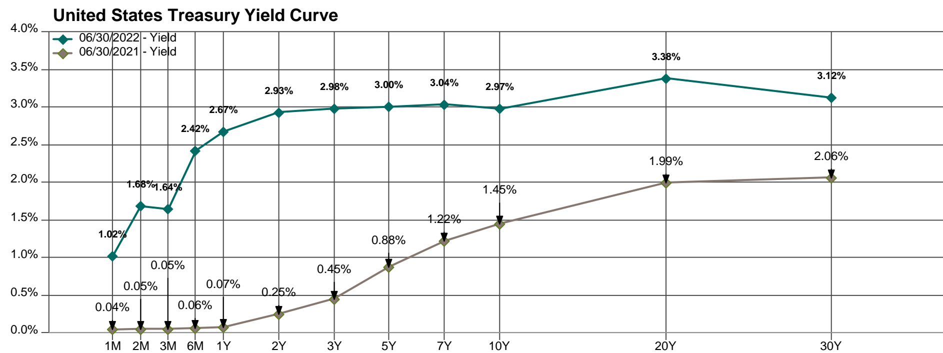
The June CPI release was scheduled for 7/13/22, and is expected to show further increases in headline inflation and some moderation on the core CPI. Since mid-June, prices for many commodities trended significantly lower, including U.S. oil (West Texas Intermediate, WTI) which declined -19.3% to $96 per barrel from 6/15/22 to 7/12/22. Over the same period, copper per metric ton decreased -17.7%, and cotton (priced in U.S. dollars per pound) decreased -24.7%. Prices for lumber futures (U.S. dollars per board foot), as of 7/12/22, were down -52.4% since 3/3/22. We attribute the decline in many key commodities prices to global recession fears, as constrained economic activity would lead to lower demand for many goods and services. While this creates challenges for corporate revenue and profits, we expect inflation trends to moderate in the third quarter. We do not expect inflation to return to the Federal Reserve Bank's 2% target anytime soon, however, as wage growth is elevated, and inflation in service sectors, especially travel-related (airlines, hotel, rental cars) and healthcare, has increased even as goods demand and pricing moderates. Wages are reported monthly by the Bureau of Labor Statistics (BLS); in June, average hourly earnings increased 5.1% Y/Y (vs. June 2021), modestly below the 5.4% Y/Y monthly average increase over the first five months of the year. The slight decline in June perhaps suggests the wage growth is moderating, but since wages have not kept pace with inflation in 2022 (CPI averaged 8.2% for the first five months of 2022), employee wage demands are likely to keep wage pressure elevated in the short-term. We can look at the U.S. Treasury inflation-indexed securities to calculate how investors are pricing in inflation expectations over the next five years. The St. Louis Federal Reserve Bank publishes the 5-Year Breakeven Inflation Rate, which measures current expectations of the average inflation rate over the next five years. As of 7/11/22, that expected inflation rate was 2.6%, compared to an expectation of 3.4% on 3/31/22. This reflects investors' expectation for a decline in inflation levels in the coming years, but opens the door for negative surprises if near-term inflation data remains elevated.

Consumer Price Index (Monthly)



Source: FactSet, Bureau of Labor Statistics as of 5/31/22. The consumer price index (CPI) is a measure of average change over time in the prices paid by urban consumers for a market basket of goods and services.

U.S. interest rates moved higher in 2022 through mid-year, but many rates peaked in mid-June, even as the Fed raised short-term interest rates. U.S. Treasury yields are higher across all maturity levels comparing 6/30/22 to 6/30/21, and the yield curve of U.S. Treasuries from 3-years to 30-years has become increasingly flat. This was largely the case at the end of 1Q22 as well, but by the end of June, U.S. Treasury rates at all maturities were even higher. For instance, the 10-year U.S. Treasury yield was 1.51%, 2.31%, and 2.97% on 12/31/21, 3/31/22, and 6/30/22, respectively. The shorter-maturity, 2-year U.S. Treasury yield was 0.73%, 2.29%, and 2.93% respectively over the same period. Similarly, the U.S. 3-month yield ended June yielding 1.64%, up from just 0.05% at year-end. Much of the rate movement at the short end of the yield curve (less than two years) we attribute to the Fed preparing the market for higher interest rates to combat inflation (the Fed began discussing a policy shift to a higher overnight fed funds borrowing rate target in November 2021, but did not ultimately increase that target rate until March 2022). Longer maturity interest rates (above two years) began trending higher in January as investors anticipated the Fed policy change, higher inflation, and positive economic growth. Interest rates move higher as bond prices (in this case Treasury securities) move lower, and the first half drop in bond prices caused poor bond returns for many investors in the first half of 2022. In late March, the U.S. yield curve briefly inverted (the yield on the 2-year Treasury exceeded the yield on the 10-year Treasury), sparking discussion of recession fears. The inversion was brief, and by early April the inversion reversed. As of early July, the yields on the 2-year and 10-year Treasuries have inverted again (on 7/12/22 the U.S. 2-year yield was 3.04% and the 10-year yield was 2.97%). This is once again (as in March) a recession signal, as a 2-year/10-year inversion has occurred prior to the each of the six U.S. recessions since 1980. In each of those prior recessions, the 3-month Treasury yield moved above the 10-year yield as well, and so far, with the 3-month yield at 1.99% on 7/12/22, that inversion has been avoided. The Fed has a difficult task ahead, as the central bank attempts to raise short-term interest rates enough to curtail inflation without pushing the economy into recession. The U.S. 10-year Treasury yield, currently at 2.97%, was 3.48% on 6/14/22, just three weeks ago. We attribute the recent drop in yield to bond investor concerns that the Fed will not accomplish a soft landing (no recession). If a hard landing (recession) occurs, the Fed would need to reverse course and lower short-term interest rates.



Source: FactSet as of 6/30/22.

The Federal Reserve Bank's overnight fed funds interest rate target was 1.50% to 1.75% at the end of June. After raising the low end of its fed funds target range to 0.25% from 0% in March, the Fed met two more times in 2Q22, raising the rate by 0.50% in May and another 0.75% in June. Following the June meeting, the Fed published its Summary of Economic Projections (often called the "Dot-Plot"), laying out the average estimate from all committee participants on a range of 2022 and 2023 economic data, including GDP growth, unemployment, and inflation. The summary reflected an estimated year-end 2022 target fed funds rate of 3.4% and year-end 2023 of 3.8%. This suggests an additional 175 basis points (bp) of rate hikes this year, which is more than the 150bp already implemented. The next Fed meeting ends on 7/27/22, and we expect another 75bp increase (taking the low end of the fed funds target to 2.25%). There is no meeting in August, so the Fed will wait until late September for the next meeting post-July. The "Dot-Plot" also shows expected PCE-price index inflation (an alternative measure of consumer inflation reported by the BEA, and used by the Fed) of 5.2%. This is higher than the Fed's group estimate in March, and highlights its more aggressive stance to combat inflation. In addition, the Fed's mean estimate for 2022 U.S. GDP growth is 1.7%, down from a 2.8% average in March, but not reflecting a recession.

According to the CME FedWatch Tool, which analyzes the fed funds futures market to determine probabilities that investors are assigning to changes in the fed funds rate, investors are assigning a 100% (as of 7/11/22) chance of a year-end fed funds target of 3.00% (suggesting 150bp of more hikes) and an 87% chance of a 3.25% target. Given the recent data reflecting slowing consumer spending and business investment, along with a steep decline in many commodity prices since mid-June, we believe the Fed will be data dependent starting in September. While Fed Chair Jerome Powell has indicated that, for now, controlling inflation has priority over economic growth (even risking recession), we would not be surprised to see the Fed pause rate hikes once the fed funds gets to 2.50%. In our view, the Fed will not want to raise the fed funds target to a level above the rate of the 2-year or 10-year Treasury yields.

U.S. Federal Reserve Bank "Dot Plot" as of 6/15/22*
Federal Open Market Committee (FOMC)

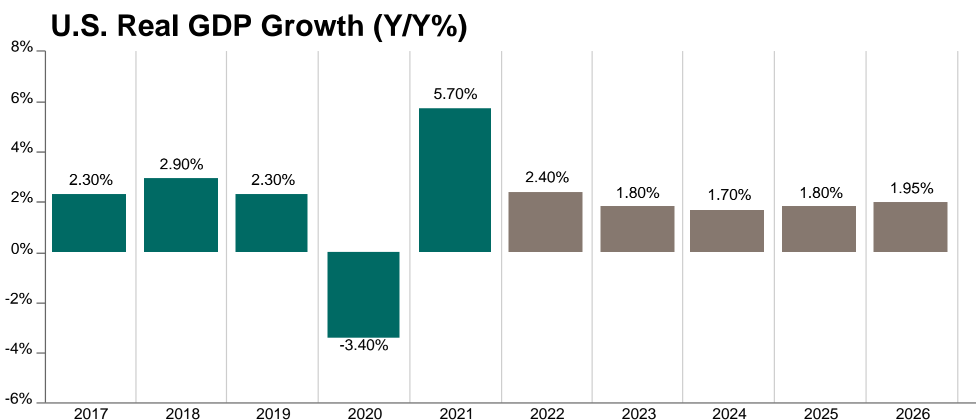
	2022-mean	2022-range	2023-mean	2023-range
U.S. GDP Growth	**1.7%**	1.0%-2.0%	**1.7%**	0.8%-2.5%
Unemployment Rate	**3.7%**	3.2%-4.0%	**3.9%**	3.2%-4.5%
PCE Inflation	**5.2%**	4.8%-6.2%	**2.6%**	2.3%-4.0%
Year-end fed funds rate	**3.4%**	3.1%-3.9%	**3.8%**	2.9%-4.4%

Data Source: federalreserve.gov, as of 6/15/22. The Summary of Economic Projections or "Dot Plot" is compiled from Federal Reserve Board members and Federal Reserve Bank presidents.

Following a surprise -1.6% decline in 1Q22 GDP, and 2Q22 data trending lower, the U.S. economy is slowing. The decline in first quarter output was surprising because both consumer spending (70% of real GDP in 1Q) and business investment (15% of real GDP) grew in the quarter and combined added 2.5% to GDP growth. The increase in consumer spending was accomplished despite headwinds created by the COVID-19 omicron variant, which drove high infection rates throughout January. The negative GDP growth was largely attributed to an unusual -3.2% adjustment from international trade. This was caused by an increase in U.S. imports (which is not that unusual, but detracts from U.S. GDP as imports are not produced domestically) and a significant decline in U.S. exports (exports add to U.S. GDP as those goods are produced domestically). We believe that weak demand for U.S. goods abroad in 1Q22 was exacerbated by Russia's invasion of Ukraine, as strained supply chains were further disrupted and demand softened across Europe.

Softer-than-expected May consumer data, including retail sales and personal consumption, along with rising weekly jobless claims in June, suggest that the largest component of the U.S. economy, consumer spending, ended the second quarter (2Q22) much weaker than it began. In addition, the June ISM manufacturing purchasing managers index (a survey to measure current and expected production levels) dropped to a two-year low, indicating a potential drop in business investment as well. We believe this latest data will lead to reduced estimates for U.S. economic growth this year (as measured by gross domestic product, or GDP), which already had been coming down. As of 7/8/22, the FactSet consensus estimate (from Wall Street strategists) for 2022 full-year GDP growth was 2.4% (it was 4.0% at the end of December), and the estimate for 2Q22 was 1.7%, down from a 3.0% estimate as recently as 5/31/22. An alternative GDP estimate, the GDPNowcast from the Federal Reserve Bank of Atlanta, which tracks the quarterly GDP rate as data is reported, on 7/8/22 showed the 2Q22 GDP growth is tracking negative at -1.2%, reflecting some of the weaker data points mentioned above. That trend could improve as June reports roll in, but more likely is that GDP growth will be disappointing. If 2Q22 GDP growth does end negative, following the 1Q22 GDP decline, many will declare a recession is already here. Recessions are rare when both consumer spending and business investment growth remain positive, but the decelerating trend is concerning. If economic activity continues to decelerate it will create a more difficult environment for corporate earnings growth.

Recession watch. We believe the chances of a U.S. recession have increased in recent weeks, but that it is more likely in 2023 (or later) than 2022. While many investors point to two consecutive quarters of negative U.S. GDP (gross domestic product) growth as confirmation of a recession, the U.S. government uses the definition from the National Bureau of Economic Research (NBER) as a better indicator. The NBER looks for a "significant decline in economic activity that is spread across the economy and lasts more than a few months." The NBER called a COVID recession in 2020 that lasted only two months, but we are comfortable saying that two quarters of negative GDP growth will most often be called a recession by the NBER. In our view, the next recession is likely to be led by a drop in consumer spending (and perhaps weakness in business investment), and we believe that it is too early to make that call. According to the BLS, monthly nonfarm payroll (jobs) gains averaged 457 thousand (K) through the first six months of 2022 (June was 372K), and monthly Y/Y wage gains averaged 5.4%. Add that to solid consumer balance sheets (household debt payments as a percentage of disposable income are below pre-pandemic levels - Federal Reserve, as of 3/31/22) and accumulated savings, and we see the ability to continue spending despite the very real headwind of inflation. As we move through 2022, ongoing elevated inflation and potential job losses would negatively affect consumer activity. In addition, businesses could face lower orders, affecting 2023 production and sales levels. This would increase the odds of a 2023 recession, and we need to see a few more months of data to assess how much of a slowdown is possible. Potential catalysts to help that scenario would be a post-lockdown China reopening, a reduction in inflation trends, and peace in Ukraine that could help the oil and grain markets.



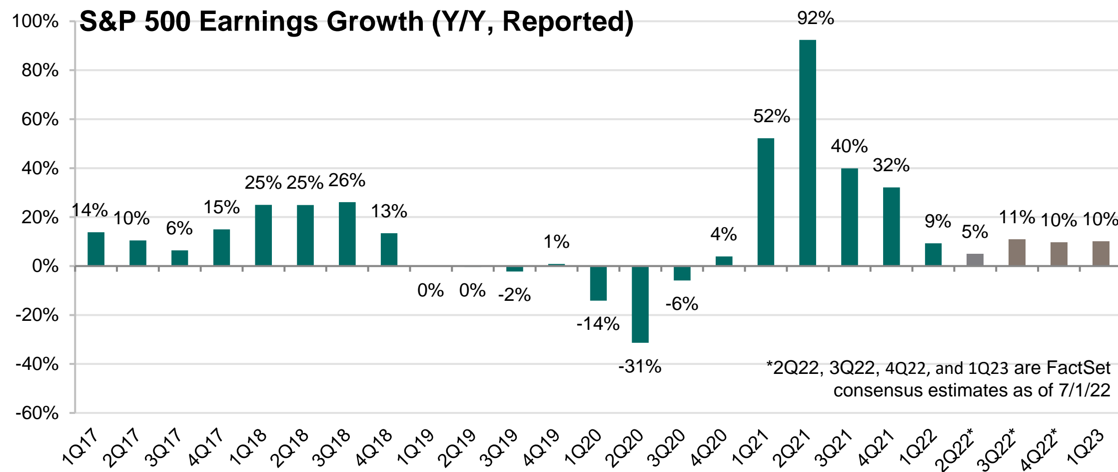
U.S. Quarterly Real GDP Actual / Estimates (Q/Q%)	
4Q21A	6.9%
1Q22A	-1.6%
2Q22E	1.7%
3Q22E	2.2%
4Q22E	1.8%

Data Source: FactSet consensus estimates and Bureau of Economic Analysis, as of 7/1/22 (green are actual reported numbers)

S&P 500 earnings growth is expected to slow in 2Q22, but full-year estimates have proved resilient. U.S. companies face an increasingly long list of business headwinds that could negatively impact revenue and profits. This includes inflation-driven pressures on raw materials and fuel costs, supply chain disruptions from Chinese COVID policies and labor shortages, wage pressure from a tight labor market, and weak global demand, especially in Europe due to Russian sanctions. Despite many of these constraints existing all year, 1Q22 S&P 500 financial results were strong. In the first quarter, S&P 500 revenue and EPS increased 13.7% and 9.3%, respectively, and the EPS results doubled the 4.6% FactSet consensus estimate. Nine of eleven S&P 500 GICS sectors reported Y/Y earnings growth (Financials and Consumer Discretionary were lower) as companies were able to address inflation headwinds by raising prices and managing costs where possible. With EPS growth lower than revenue growth, there were margin pressures that we expect that to continue over the second half of 2022. In our view, EPS growth estimates of 11% and 10% (respectively in 3Q22 and 4Q22) are aggressive, and we believe that markets are pricing in (expecting) a reduction of estimates in the second half of 2022.

The FactSet consensus estimate for S&P 500 2Q22 EPS growth is 5%. One year ago, in 2Q21, S&P 500 earnings increased 92%, which was the peak of the COVID recovery. This makes for a difficult comparison in 2Q22, and along with inflation-driven cost headwinds, it will be a challenge for companies to exceed estimates for the ninth-consecutive quarter. The sector composition of 2Q22 S&P 500 earnings will likely

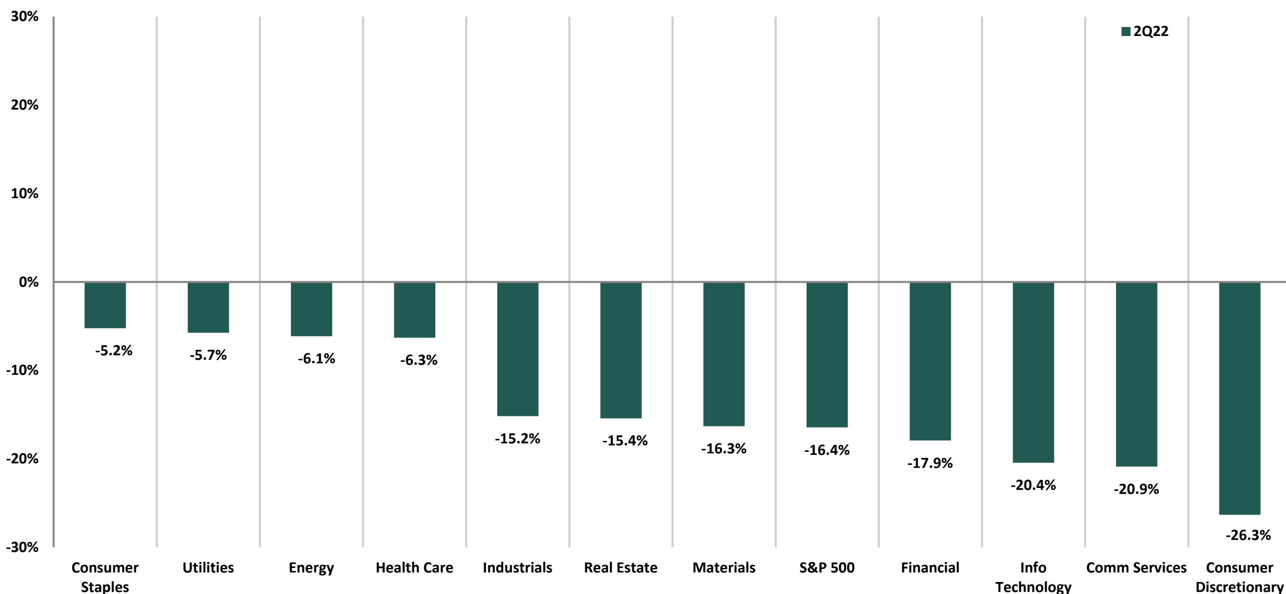
be more varied than in 1Q22, as 5 of 11 sectors are expected to show a Y/Y decline. Financials are expected to be the largest detractor to earnings in the quarter, as the banking sector faces a very difficult Y/Y comparison with 2021, when many of the large banks' earnings accelerated as they reduced loan loss reserves which were inflated during the COVID recession. The largest sector contributors to 2Q22 earnings growth, based on FactSet consensus estimates, are expected to be Energy and Industrials, which have benefitted from a strong pricing environment. We expect modest upside to estimates, but also cautionary commentary regarding the balance of 2022.



Data source: FactSet as of 7/1/22, earnings estimates are compiled by FactSet from Wall Street analyst estimates. Graph measures S&P 500 earnings growth (weighted average of all S&P 500 earnings results based upon market capitalization) of each quarter compared to the same quarter in the prior year.

All eleven S&P 500 sectors traded lower in the second quarter. The chart below shows the S&P 500 price performance (not including dividends) for the three-month period from 3/31/22 to 6/30/22 (the second quarter). While all 11 sectors showed quarterly losses, seven dropped less than the index's 16.4% price decline. Three of those relative outperforming sectors, Utilities, Consumer Staples, and Health Care, are traditionally "defensive" sectors, representing companies that should be less exposed to economic cycles. This is an indication that many equity investors have positioned for an economic downturn that includes a recession. The decline in Energy in 2Q (it was still positive YTD) also reflected economic concerns, in our view. At the other end of performance, the largest quarterly declines came from Consumer Discretionary, Communication Services, and Information Technology. Each are heavily weighted with technology-centric, large-company growth stocks, many of which have led market gains over the past few years. These stocks suffered in the quarter as investors became more disciplined in how much they were willing to pay today for future growth in revenue and earnings.

S&P 500 Sector Performance – 2Q22 Price Returns (3/31/22 to 6/30/22)



Data source: FactSet as of 6/30/22, S&P 500 GICS sector indices maintained by S&P Global & MSCI

We made no changes to our sector weighting recommendations in July, but updated some of the commentary in the table below. While there is much debate among professional investors about growth vs. value and cyclical vs. defensive, we see value in building broad exposure to high-quality "franchise" companies that can successfully navigate today's complex environment. This includes companies with strong market share positions, high-quality management leadership, strong balance sheets (manageable debt and access to capital), and resilient profitability (growth in earnings and cash flow despite inflation). While we have seen many favorite stocks trade substantially lower in 2022, creating a painful six months, a lot of bad news is priced into the market, in our view. Despite the first half strong relative performance of defensive sectors (and we advocate having defensive exposure), we caution against becoming overly defensive. Similarly, while growth is currently out of favor, we see value in some leading growth companies that have pulled back to lower valuation levels. Investors with long-term horizons (more than one year, preferably three to five years) should look to improve portfolio quality and improve diversification. We also are attracted to dividend payers, especially companies with low payout ratios (dividends that are 50% or lower as a percentage of earnings) and those that are able to increase dividends even during periods of volatility and uncertainty.

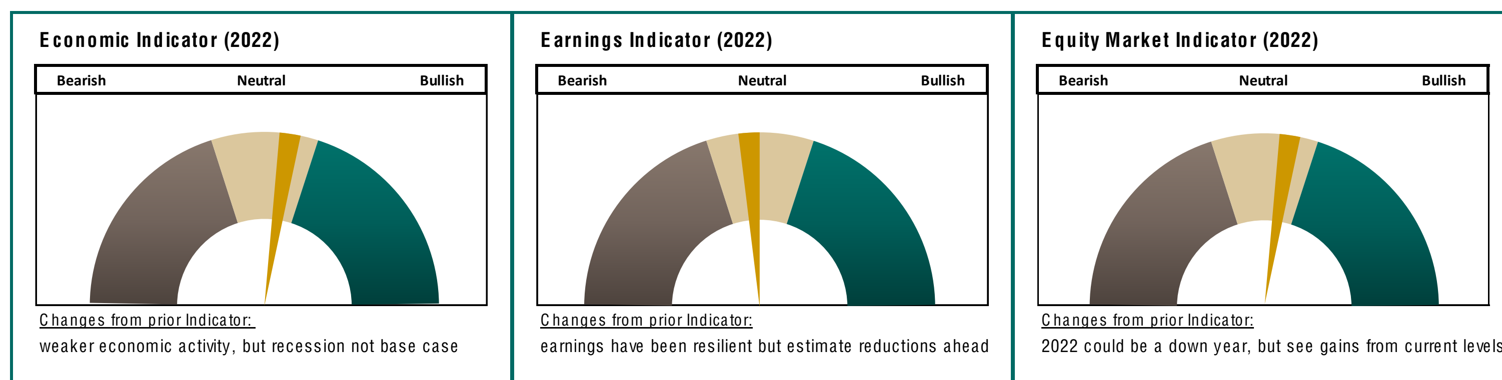
Our S&P sector recommendations and commentary are updated below.

S&P 500 Sector Recommendations - July 2022

GICS Sector	S&P 500 Weight by Market Cap	WM Research 2022 Outlook	Notes (reflect current expectations and are subject to change)	Change
Technology	27.2%	marketweight	sector could outperform in a recession led by large cap leaders	
Health Care	15.0%	overweight	still our favorite defensive sector	
Consumer Discretionary	10.9%	marketweight	watch inflation headwinds, favor services over goods	
Financials	10.7%	marketweight	should benefit from higher lending rates, but recession would hurt loan growth	
Communications Services	9.1%	marketweight	continues to underperform, but valuations interesting	
Industrials	7.6%	overweight	supply chain recovery helps margins, but inflation and Europe are headwinds	
Consumer Staples	6.8%	underweight	safe haven in down market, remain selective after YTD gains	
Energy	4.2%	marketweight	June weakness creates selective opportunity after big YTD gains	
Utilities	3.0%	marketweight	beneficiary of infrastructure & energy transition, valuations elevated	
Real Estate (REITs)	2.9%	marketweight	focus on faster turnover of assets where capacity is tight (limited supply)	
Materials	2.5%	marketweight	some winners in this group for companies that have pricing power	

Data source: D.A. Davidson Wealth Management Research as of 7/12/22.

Wealth Management Research Investment Cycle Gauge



Source data: D.A. Davidson & Co. as of 7/12/22

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Market Indices: The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Indices provide a general source of information on how various market segments and types of investments have performed in the past. Index performance (on a total return basis) assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. You may not invest directly in an index. Past performance is not an indicator of future results. The S&P 500 Index is a market cap weighted index that is designed to measure the US large-cap equity performance. The index is composed of the 500 leading publically traded US companies based on size, liquidity, industry, and profitability criteria. The Dow Jones Industrial Average is a price weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange (NYSE) and the NASDAQ. The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. Today the NASDAQ Composite includes over 3,000 companies. The Russell 2000® Index is a market cap weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The MSCI EAFE® Index (Europe, Austral, Asia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The Bloomberg Commodity Index is a broadly-diversified commodity price index that tracks the prices of futures contracts on 23 physical commodities across 6 sectors. The Barclays U.S. Aggregate Bond Index is a broad-based, market cap-weighted bond market index representing intermediate-term, investment-grade bonds with an outstanding par value of at least $100 million and at least one year until maturity.

Other Disclosures:
The forward S&P 500 price-to-earnings ratio (P/E) is a valuation measure, calculated by dividing the price of the S&P 500 index over the weighted average earnings per share (EPS) estimate of each company in the index. Earnings are based on "forward" consensus estimates expected over the next 12 months (NTM), using quarterly analyst estimates as provided by FactSet.
Fair value refers to a valuation method based on our view of the intrinsic value of an asset or index, determined by macroeconomic factors and earnings expectations rather than current market prices. This is our view of intrinsic value as of the date of this report.
Gross domestic product (GDP) refers to the monetary measure of the market value of all final goods and services produced within a country's borders within a specific time period.
FactSet is a data aggregation software utilized by D.A. Davidson's Wealth Management Research. The FactSet Consensus refers to the aggregate of all analyst estimates from firms that submit estimates to FactSet for a given financial metric.
The annual price returns of the S&P 500 index are calculated using index closing value on 12/31 of one year to 12/31 of the next year. 2022 returns are calculated as of 3/31/2022, although some charts used a date in early April. Intra-year peak-to-trough percentage declines are calculated using the index closing prices from an intra-year high date to a subsequent low date. Closing prices are provided by S&P Global through FactSet. Averages across years are calculated using the arithmetic mean.
The yield of the 10-year U.S. Treasury bond is a widely followed barometer of the current U.S. interest rate environment.
Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department, through FactSet.
S&P 500 earnings growth reflect the year over year change in operating earnings on a per share basis. Earnings data are aggregated for all S&P 500 constituents and are measured according to the relative market capitalization weights for each company. Estimated earnings are the combined FactSet estimates of analysts covering each company included in the index.
The Federal Reserve Bank's Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year. At these meetings, the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.
The Treasury yield curve displays the market interest rate across different contract lengths for U.S. Treasury bonds, indicating the relationship between the interest rate and the time ("term") to maturity.
U.S. Personal Consumption Expenditures (PCE) is an indicator of the growth in consumer spending and measures the value of goods and services purchased by persons who reside in the U.S. It is reported monthly by the Bureau of Economic Analysis.
The Federal Reserve Summary of Economic Projections (Dot-Plot) is sourced from federalreserve.gov, as of 3/16/22. Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rates of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The Summary of Economic Projections or "Dot Plot" is compiled from Federal Reserve Board members and Federal Reserve Bank presidents.
Consumer data includes: The Advance Monthly Sales for Retail is a survey of 5,500 employer firms by the U.S. Census Bureau. Its statistical analysis from the respondents is weighted and benchmarked to represent the complete universe of over three million retail and food service firms, as well as personal consumption expenditures from the Federal Reserve Bank. In addition. The Transportation Security Administration (TSA) reports the daily number of travelers that pass through its U.S. security checkpoints. It is used a measure to track daily airline passenger traffic across the U.S.
STR, a division of CoStar Group provides data analytics for the global hospitality industry. STR provides a weekly composite of hotel data across 25 top markets to measure, occupancy, average daily rates, and revenue per available room.
The Atlanta Fed GDPNow is not an official Fed forecast of GDP growth, but is a running estimate of real GDP growth based upon available economic data for the current measured quarter.

The Global Industry Classification Standard (GICS) is a four-tiered, hierarchical industry classification system. Companies are classified quantitatively and qualitatively. Each company is assigned a single GICS classification at the Sub-Industry level according to its principal business activity. MSCI and S&P Dow Jones Indices use revenues as a key factor in determining a firm's principal business activity.

The consumer price index (CPI) is a measure of average change over time in the prices paid by urban consumers for a market basket of goods and services. It is reported monthly by the U.S. Bureau of Labor Statistics.

The term "monetary policy" refers to the actions undertaken by a central bank, such as the Federal Reserve, to influence the availability and cost of money and credit to help promote national economic goals. The Board of Governors of the Federal Reserve System is responsible for the discount rate and reserve requirements, and the Federal Open Market Committee is responsible for open market operations. The Federal Reserve influences the demand for, and supply of, balances that depository institutions hold at Federal Reserve Banks and in this way alters the federal funds rate. The federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.

The CME FedWatch Tool is calculated by CME Group, to estimate probabilities of future changes in the Fed's fed funds rate, by analyzing publicly traded Fed Funds futures contracts.