MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

July 20, 2022

<u>2022 Q2 Investment Commentary</u>

During the second quarter, the US equity markets fell into cyclical bear market territory as investors swung from being concerned about inflation to pricing in recession. The S&P 500 and Bond markets' first half losses were the worst in over 50 years. During the quarter, every sector of the equity markets was down. Year to date, Energy is the only sector with positive returns. Inflation is the highest we have seen since the 80's. The USD rose over 10% against foreign currencies.

Valuation multiple contraction drove the entire selloff, as earnings remained positive. Equity valuations are now below long-term average multiples. The labor market continues to be strong and inflation expectations have pulled back from extremes. In the near- to intermediate-term, we see four primary drivers: inflation, the Fed, recessionary risks, and earnings performance. How resilient the economy proves to be under current stress will dictate performance in the second half.

Talk of recession is still premature as labor markets remain robust. The National Bureau of Economic Research (NBER), the determinant of an official recession call, defines it as significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A popular informal measure, known as a "technical recession", is two back-to-back quarters of negative GDP, which we have likely already experienced. GDP growth in the first quarter was negative and the Atlanta Federal Reserve predicts Q2 real GDP growth of -1.2%. Metrics cited in historical studies on recession refer to NBER defined events.

In the 12 instances since WW2, we have never had an official recession without significant job loss. Non-farm payrolls expanded over 300k in June, well above consensus, and average wages rose across industries. The unemployment rate has remained at 3.6% for four straight months. The 4-week moving average for initial unemployment claims is currently only ~240k, which would need to more than double to over 500k before reaching levels historically seen during recessions. Why is this so significant? Employed persons will reduce discretionary spending under duress but a significant portion of spending is maintained, funded by income stretched by savings, preventing a waterfall decline in demand.

In addition to labor, other key indicators while weakening remain above levels seen during past recessions. The Institute for Supply Management Purchasing Manager Indices (PMI), The Conference Board's Leading Economic Index (LEI) and Consumer Confidence Index (CCI), and ISM Manufacturing and Non-Manufacturing Indices are broadly consistent with above-trend economic growth.

Consumer activity also remains above the historical trend, but rising prices and interest rates have begun to bite. The surge in interest rates has dramatically impacted the housing market with mortgage demand hitting the lowest level in 22 years. Housing activity has slowed both in new starts and existing home sales as affordability has fallen. But consumer balance sheets remain in great shape. According to Moody's Analytics from the start of the pandemic to the end of 2021, U.S. households built up $2.7 trillion in extra savings, During the first half of the year, families have tapped about $114 billion of their pandemic savings. Most households have a cash buffer to navigate through the very high inflation for now.

Inflation has remained stubbornly high, but forward indictors of inflation have rolled over. Commodity prices, which are correlated to inflation expectations, have broken down sharply since peaking in June. This bodes well for inflation as lower prices make their way through supply chains. Monetary growth has also plummeted, and financial conditions have tightened dramatically. Forward looking Inflation expectations in the bond market also fell since June peaks. In early July, the 5-year TIPS breakeven fell back below 2.5% for the first time since September 2021, down from a high of ~3.8% (Chart 1).

The Federal Reserve followed through with their aggressive policy shift raising rates by .50% in May and then .75% in June, the largest increase in over 28 years. Current expectations are for another .75% in July and another .50% in September after their August break. They have been clear that their mandate to rein in inflation is the top priority, even at the risk of causing a recession. Despite this dramatic acceleration, official projections still show an expected range of 3.25%-3.50% by the end of 2022.

One red flag brought on by the Fed's actions has been another inversion of the yield curve as the 2-Year Treasury yield have exceeded the 10-year Treasury Yield. This is caused by the front end rising due to the Fed raising rates, and the long end falling due to economic slowdown concerns. This event has always preceded a recession, usually long before a recession occurs, but not in all cases. The inversion has not been confirmed by shorter maturities, T-bills vs 10-years, the spread of which remains over 2%.

According to Factset's Earnings Insight on July 15th, the S&P 500 year-over-year earnings growth rate for the second quarter of 2022 is expected to be 4.2%. Revenue for the quarter is expected to be 10.2%. Projected earnings for the full calendar year have been revised down to 9.9%, from 10.7% at the end of the prior quarter, but longer dated expectations actually rose, which may prove problematic. Valuations are now reasonable with the SP500 forward 12-month P.E valuation, 15.94, now below both the 10- and 25-year averages of 17.0 and 16.85, respectively.

Some good news when considering the year-to-date selloff is that historically, extremely weak first halves are almost always followed by strong second halves. Since WWII, after the S&P 500 fell at least 15% in a single quarter it has risen seven out of eight times in the next quarter, with the one exception being Q12009. Two quarters later, the S&P 500 has been up 100% of the time by a median of +13.0%. One year later, up 100% of the time and a +25.1% median gain. (Chart 2). The 2022 cycle composite, an average of performance over multiple calendar and presidential cycles, also points to a strong second half (Chart 3). The average decline for cyclical bears without a recession is -25.0%, which we have already exceeded. On the flip side, bear markets that overlap with recessions have an average decline of -34.6%, which if we ultimately fall into recession could mean another 10% lower. But Bear markets do not just end on their own… time will tell.

Our base case remains that the U.S. will undergo a moderate slowdown but is unlikely to fall into a severe recession this year. 2023 could go either way. The cushion provided by consumer and corporate balance sheets, historically high corporate profit margins, and strong labor markets should allow the economy to weather near term pressure. The key to a soft landing will be the duration of inflation extremes with damage increasing over time.

Sectors with structurally tight supply continue to remain attractive on recent weakness (energy, fertilizers, semiconductors) as issues from war, deglobalization and under investment show little signs of improvement. Long term growth and innovation sectors, (software, tech, medical equipment) remain dislocated from their long-term potential and are trading at attractive valuations. We continue to underweight sectors most exposed to a potential recession.

We are maintaining a defensive posture, balancing between high-quality growth at reasonable prices and businesses with economic moats and relatively stable free cashflow. Our playbook continues to focus on significant secular, cyclical and structural trends, and persistent above-average growth potential. We will continue adjusting portfolio risk according to the prevailing market environment and the shifting likelihood of recession.

Morse Asset Management Investment Team

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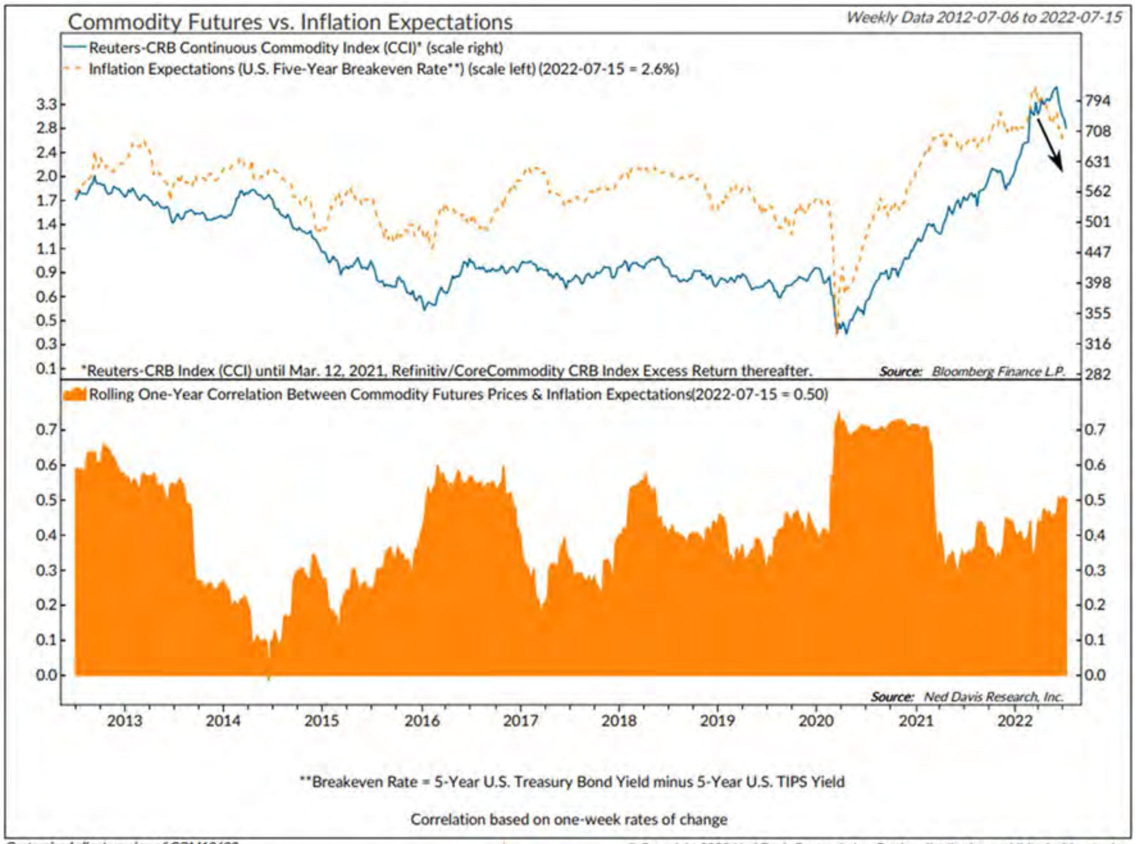

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After declines of more than 15% in a quarter, S&P 500 has tended to rebound

S&P 500 Performance After >15% Single Quarter Drops

Date	Previous Quarter % Change	Next 1Q % Change	Next 2Q % Change	Next 3Q % Change	Next 4Q % Change	Next 8Q % Change
12/31/29	-28.9	17.2	-4.6	-13.3	-28.5	-62.1
6/30/30	-18.6	-9.1	-25.0	-18.4	-27.5	-78.4
12/31/30	-17.5	8.8	-3.3	-36.7	-47.1	-55.1
9/30/31	-34.5	-16.4	-24.7	-54.4	-16.8	1.2
12/31/31	-16.4	-10.0	-45.4	-0.5	-15.2	24.4
6/30/32	-39.4	82.4	55.5	32.1	146.3	121.4
3/31/33	-15.1	86.5	68.0	72.7	83.8	44.8
12/31/37	-23.3	-19.4	9.6	16.0	25.2	18.4
3/31/38	-19.4	36.0	44.0	55.4	29.2	44.1
3/31/39	-16.9	-1.1	18.6	13.8	11.6	-9.3
6/30/40	-18.5	6.8	6.0	-0.2	-1.3	-16.8
9/30/46	-18.8	2.3	1.4	1.7	1.0	3.5
6/30/62	-21.3	2.8	15.3	21.6	26.7	49.2
6/30/70	-18.9	15.8	26.7	37.9	37.1	47.3
9/30/74	-26.1	7.9	31.2	49.8	32.0	65.6
12/31/87	-23.2	4.8	10.7	10.1	12.4	43.0
9/30/02	-17.6	7.9	4.0	19.5	22.2	36.7
12/31/08	-22.6	-11.7	1.8	17.0	23.5	39.2
3/31/20	-20.0	20.0	30.1	45.3	53.7	75.3
6/30/22	-16.5	??	??	??	??	??
All Cases						
Mean	**-22.0**	**12.2**	**11.6**	**14.2**	**19.4**	**20.7**
Median	**-19.4**	**6.8**	**9.6**	**16.0**	**22.2**	**36.7**
% Positive	**0.0**	**68.4**	**73.7**	**68.4**	**68.4**	**73.7**
Post WWII						
Mean	**-21.1**	**6.2**	**15.1**	**25.4**	**26.1**	**45.0**
Median	**-20.6**	**6.3**	**13.0**	**20.6**	**25.1**	**45.2**
% Positive	**0.0**	**87.5**	**100.0**	**100.0**	**100.0**	**100.0**
All Periods Mean	**2.0**	**2.0**	**3.9**	**5.9**	**8.1**	**16.0**

Source: S&P Dow Jones Indices

Ned Davis Research

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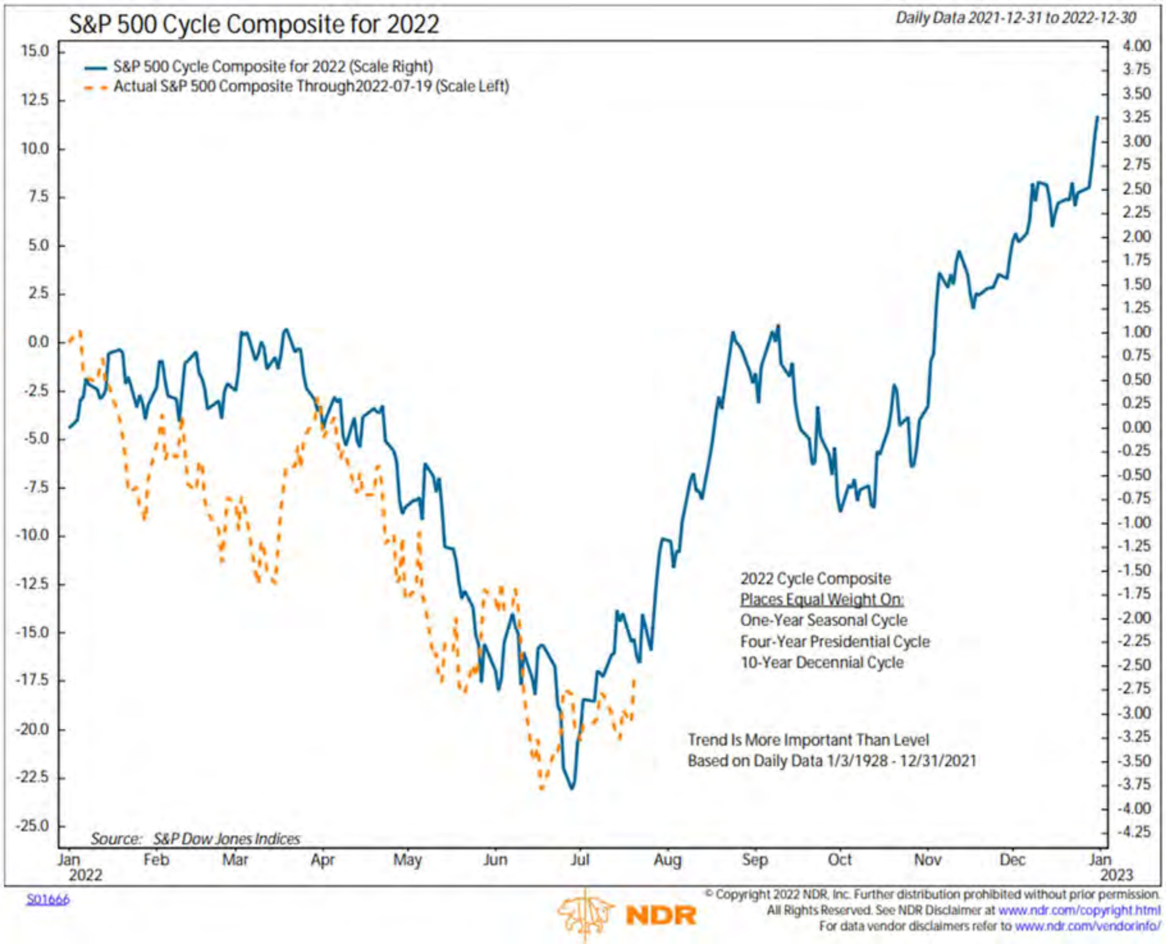
S&P 500 Cycle Composite for 2022
Daily Data 2021-12-31 to 2022-12-30
S&P 500 Cycle Composite for 2022 (Scale Right)
Actual S&P 500 Composite Through2022-07-19 (Scale Left)
2022 Cycle Composite
Places Equal Weight On:
One-Year Seasonal Cycle
Four-Year Presidential Cycle
10-Year Decennial Cycle
Trend Is More Important Than Level
Based on Daily Data 1/3/1928 - 12/31/2021
Source: S&P Dow Jones Indices
Jan 2022
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan 2023
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