MORSE ASSET MANAGEMENT, INC.
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October 20, 2022

2022 Q3 Investment Commentary

During the third quarter, the US equity markets continued to be volatile, beginning and ending in bear market territory, with fresh lows for the year despite a notable countertrend rally in August. Inflation, dollar strength and recession concerns continue to overshadow any positives seen in corporate earnings, the labor market and consumer resilience. We are in a race against inflation and while the economy is holding up thus far, it is unclear how much longer it will before/if we reach a breaking point.

Bear markets are not only finite but are far less lengthy than bull markets. Yet the steady drum beat of down days is demoralizing. It can be hard to see past the valley, but bear markets eventually lead to bull markets. We are confident the inexorable growth of the U.S. Economy will be restored in time.

There continues to be few places to hide within portfolios. Year to date, Energy is the only equity sector with positive returns. Every sector of the bond market is down as rates continue to rise. Year to date performance of the bond market is currently the worst we have seen in over 100 years. The USD rose another 8% against foreign currencies, up nearly 20% for the year. Investor sentiment remains at extreme lows. Valuation multiple contraction continues to drive the equity selloff as earnings have remained positive. (Chart1)

The Economy is undergoing a moderate slowdown, but recession is not imminent. Labor markets remain robust, consumer spending is holding, and industrial production and real personal income remain positive (Chart 2). The Institute for Supply Management Purchasing Manager Indices (PMI) for Manufacturing and Services both remain expansionary. Surprisingly, the Atlanta Federal Reserve even now predicts Q3 real GDP growth of +2.9%. (Chart 3).

Consumer activity continues to be resilient. Nominal retail sales and household spending levels have held up, but the amount of goods that were purchased declined slightly in real terms. The Conference Board Consumer Confidence Index also rebounded to healthy levels in September. Credit usage has increased but debt service remains below pre-covid levels. Most households continue to have ample cash buffer to support their spending. (Chart 4)

Current inflation has remained stubbornly high, but forward expectations remain anchored and continue to trend lower (Chart 5). Flexible components, which are faster to change such as gasoline, peaked in June and have continued to fall. Sticky components, those slow to change like housing rents, continue to rise at a slower pace, (Chart 6). Flexible components are ~30% of CPI and Sticky components are ~70%. However, we have not seen nearly enough net improvement for the Fed to consider changing course.

As expected, in the most recent FOMC meeting, the Fed funds target range was raised by 0.75% to 3.00% to 3.25%, the highest since Q1 2008. It was the third straight three-quarter point increase and the fastest cycle of policy rate increases since 1980. The FOMC participant targets for year-end were also revised higher to 4.25-4.5%, indicating another 1-1.5% in additional hikes are expected over the next two months. Investors have priced in a fourth consecutive 0.75% move at the Fed's November meeting. We expect the Fed will continue raising rates until we see positive real yields, when bond yields are greater than the inflation rate, which should occur later this year (Chart 7). Over the last 100 years every bear market has bottomed around the turning points in rate policy.

According to Factset's Earnings Insight on October 14th, the S&P 500 year-over-year earnings growth rate for the third quarter of 2022 is expected to be 1.6%, down from 2.8% only two weeks prior. Revenue for the quarter is expected to be 8.5%. Projected earnings for the full calendar year have been revised down to 7.0% and 2023 expectations down to 7.6%. The S&P 500 forward 12-month Price to Earnings valuation, 15.5, remains below the 5-, 10- and 25- year averages.

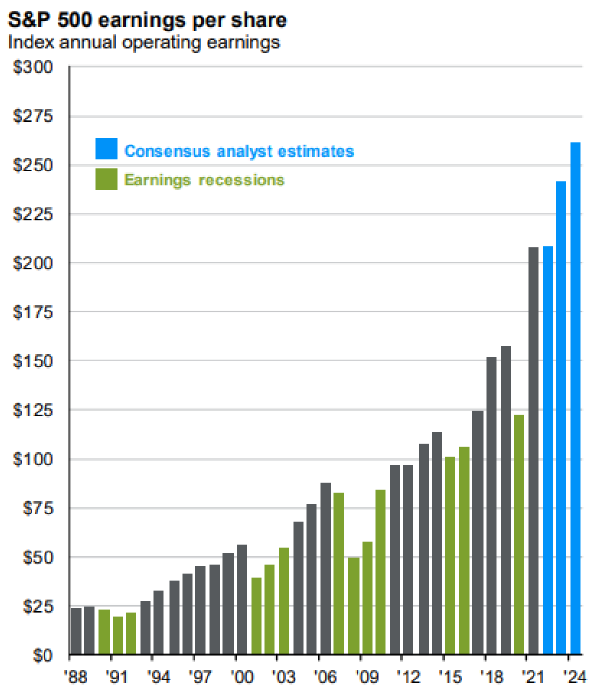
We continue to favor Energy and Healthcare sectors. Industries with structurally tight supply continue to remain attractive as issues from war, deglobalization, and under investment show little signs of improvement. Growth sectors remain dislocated from their long-term potential and are trading at attractive valuations, but these "long duration assets" will need rates to stop rising to see a sustained rally. We continue to underweight sectors most exposed to a potential recession and inflation sensitive. Short duration bonds yields have reached attractive levels, but further expected interest rate hikes may provide better entry points later this year.

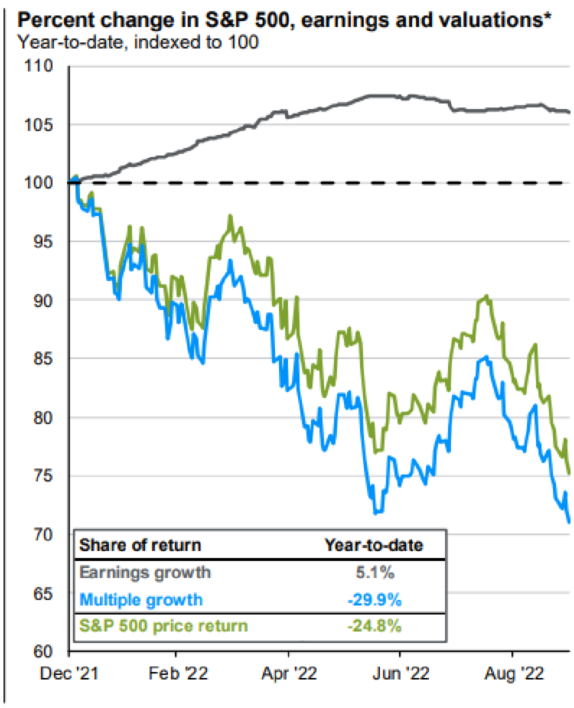
We are maintaining a defensive posture, balancing between high-quality growth at reasonable prices and businesses with economic moats and relatively stable free cashflow. Our playbook continues to focus on significant secular, cyclical, and structural trends with persistent above-average growth potential.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

Morse Asset Management Investment Team

Robert B. Morse, Jian Wang, James Cushing

1.

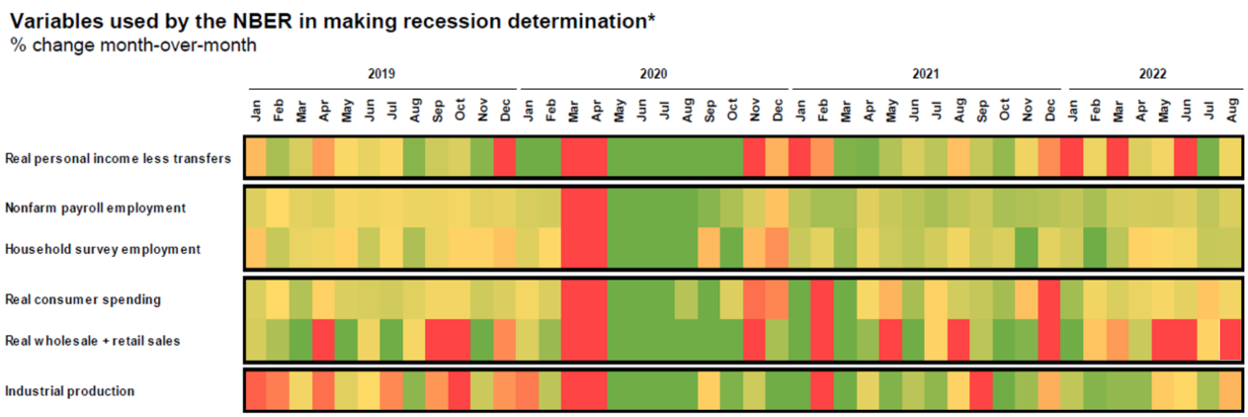


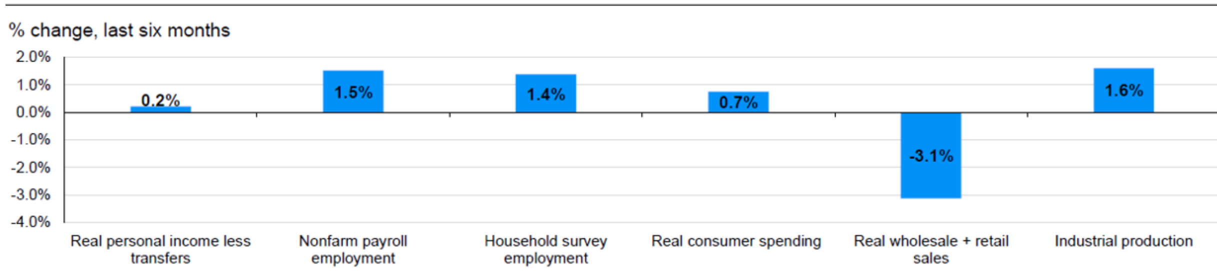


Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

2.

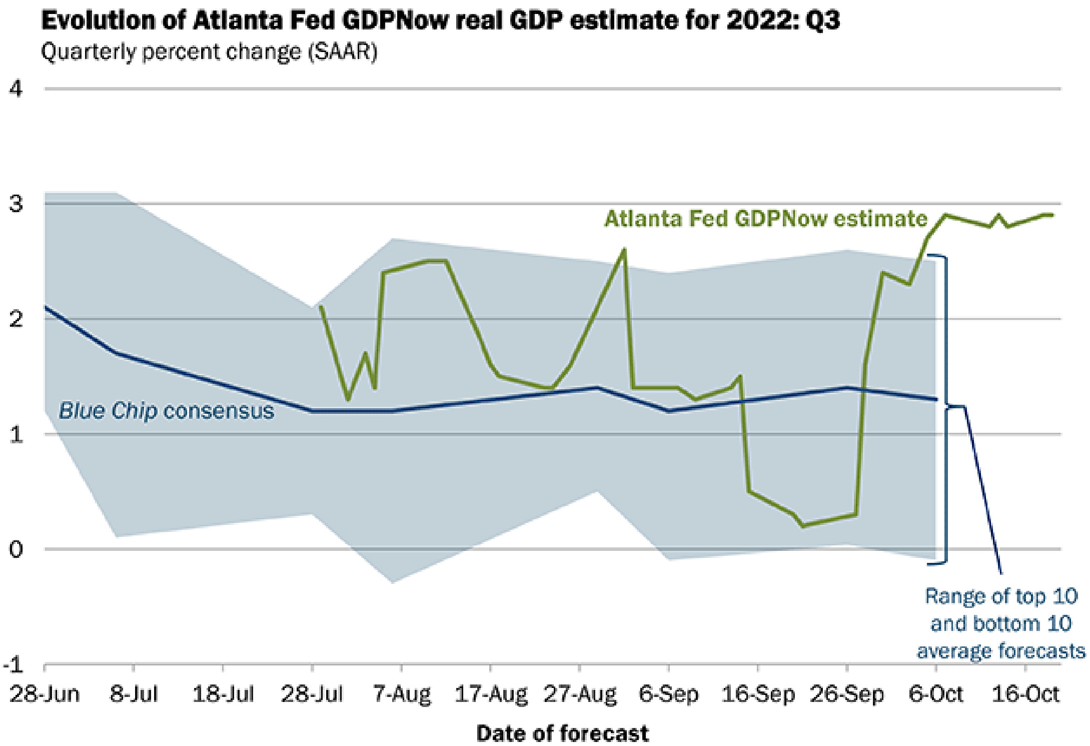
Recession determinants





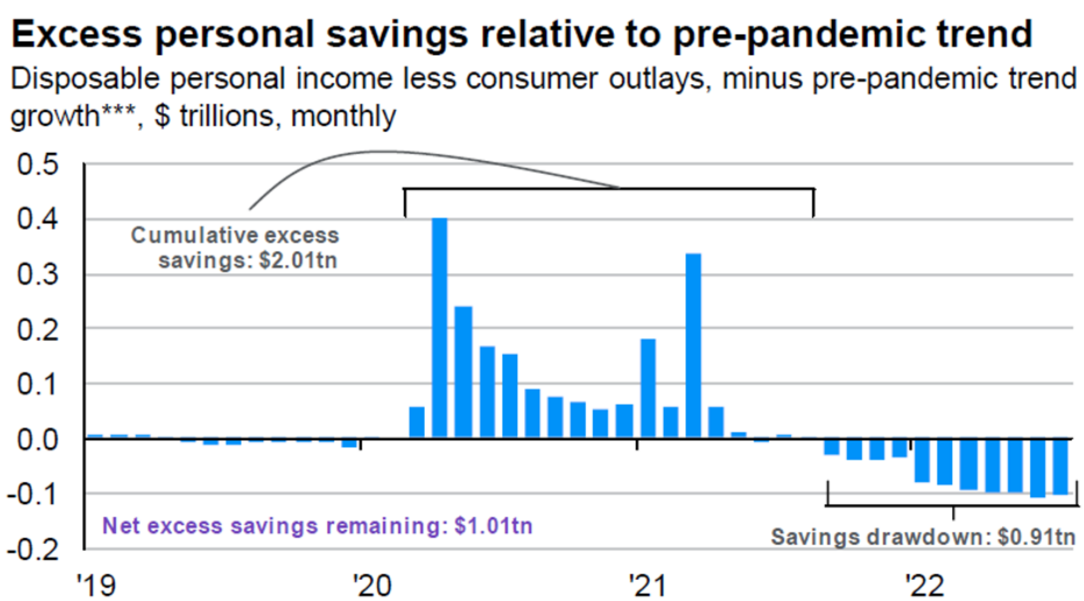
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Federal Reserve of St. Louis, NBER, J.P. Morgan Asset Management. Heatmap

3.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

4.



Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.

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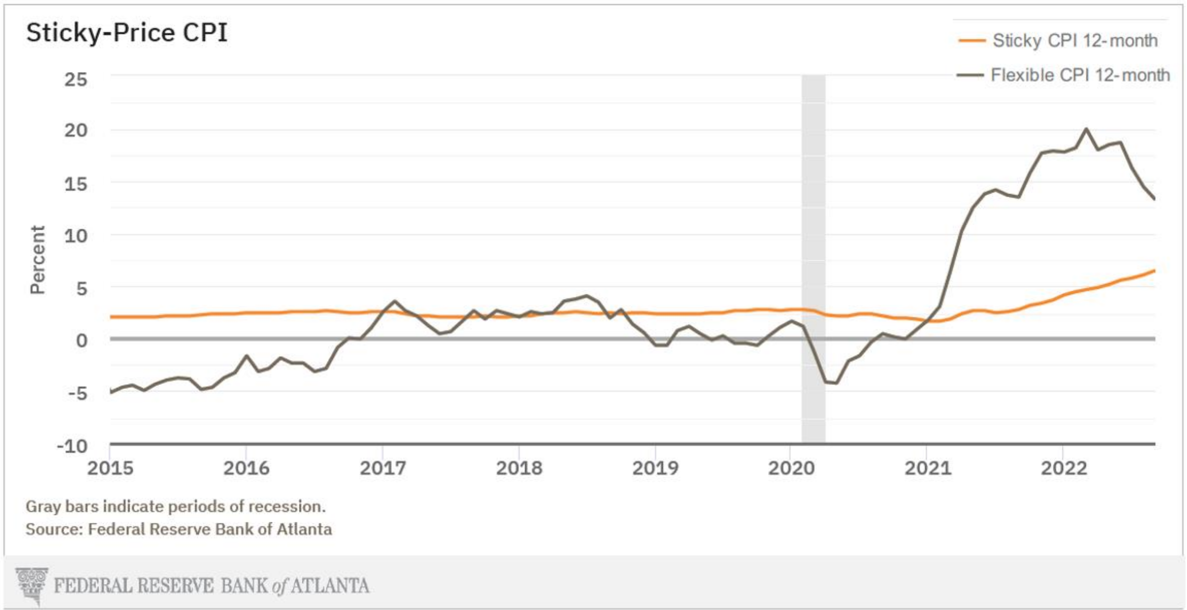
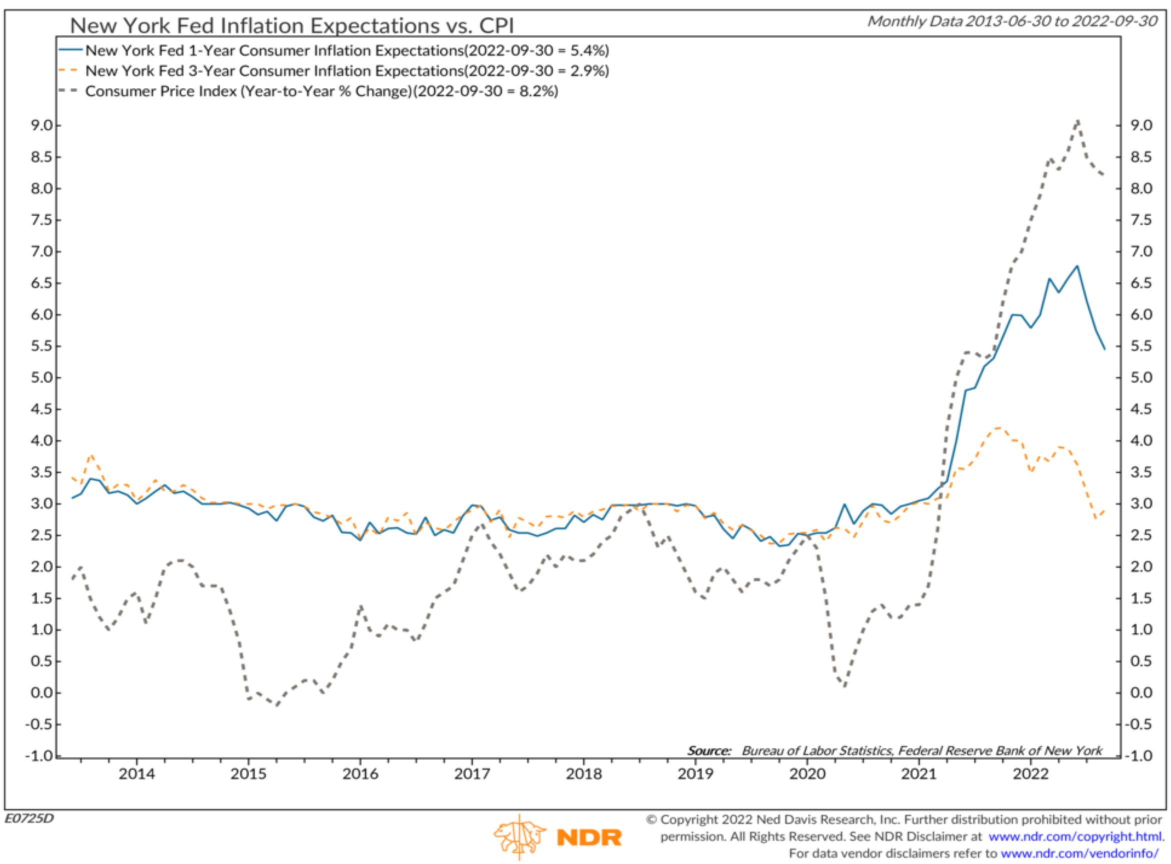

Sticky-Price CPI
Sticky CPI 12-month
Flexible CPI 12-month
Percent
25
20
15
10
5
0
-5
-10
2015
2016
2017
2018
2019
2020
2021
2022
Gray bars indicate periods of recession.
Source: Federal Reserve Bank of Atlanta
FEDERAL RESERVE BANK of ATLANTA

6.


New York Fed Inflation Expectations vs. CPI
Monthly Data 2013-06-30 to 2022-09-30
New York Fed 1-Year Consumer Inflation Expectations(2022-09-30 = 5.4%)
New York Fed 3-Year Consumer Inflation Expectations(2022-09-30 = 2.9%)
Consumer Price Index (Year-to-Year % Change)(2022-09-30 = 8.2%)
9.0
8.5
8.0
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
2014
2015
2016
2017
2018
2019
2020
2021
2022
Source: Bureau of Labor Statistics, Federal Reserve Bank of New York
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NDR
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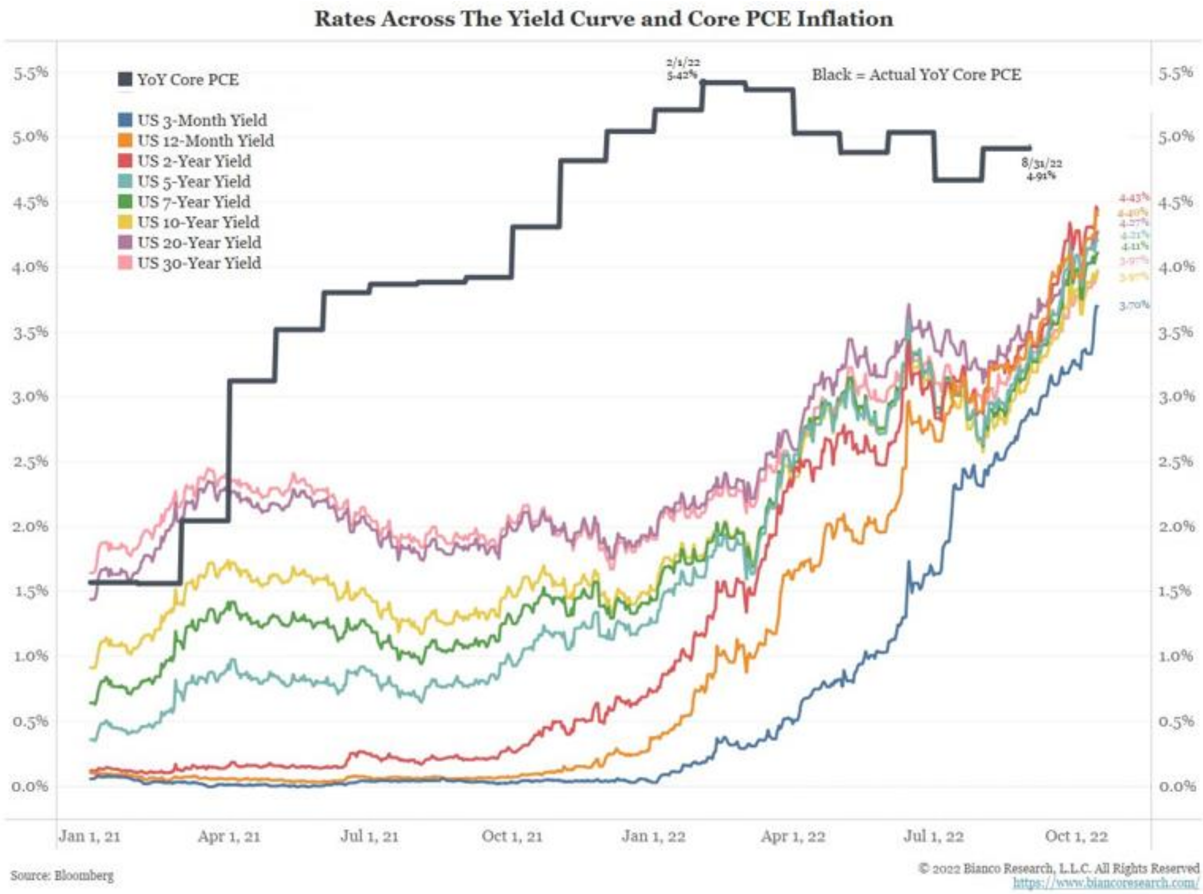
7.



Rates Across The Yield Curve and Core PCE Inflation
YoY Core PCE
US 3-Month Yield
US 12-Month Yield
US 2-Year Yield
US 5-Year Yield
US 7-Year Yield
US 10-Year Yield
US 20-Year Yield
US 30-Year Yield
2/1/22
5.42%
Black = Actual YoY Core PCE
8/31/22
4.91%
4.43%
4.27%
4.21%
4.11%
3.70%
5.5%
5.0%
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
Jan 1, 21
Apr 1, 21
Jul 1, 21
Oct 1, 21
Jan 1, 22
Apr 1, 22
Jul 1, 22
Oct 1, 22
Source: Bloomberg
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