June 13, 2022

June 2022 Market Strategy and the Importance of Stable Earnings™ Discipline in Uncertain Times

Major U.S. stock indices ended lower on Friday, June 10th following the U.S. Labor Department Consumer Price Index (CPI) inflation gauge reaching a new 40-year high in May. A second bad inflation report was released on Friday, June 10th when the University of Michigan survey of consumers' long-term inflation expectations increased to the highest level since the Great Recession.

While inflation may be in the process of peaking, we feel it is far from under control and anticipate rising costs to materially erode U.S corporation profit margins starting with the Q2 2022 reporting season.

Commodity Prices – The Supply Side CPI and PPI Conundrum

The Covid era of 2020 brought varying degrees of lockdown responses from countries around the world, causing global supply chain bottlenecks and driving commodity prices to record highs. Supply chain constraints have been further exacerbated by the war in Ukraine and China's zero Covid policy stance.

After a brief reprieve in commodity price pressures at the end of 2021, oil and other commodity prices have again surged because of disruptions caused by the worst European conflict since World War II. Surging commodity prices are being felt around the world and are threatening global recession as central banks are raising benchmark interest rates along with other forms of quantitative tightening to curtail demand and fight inflation.

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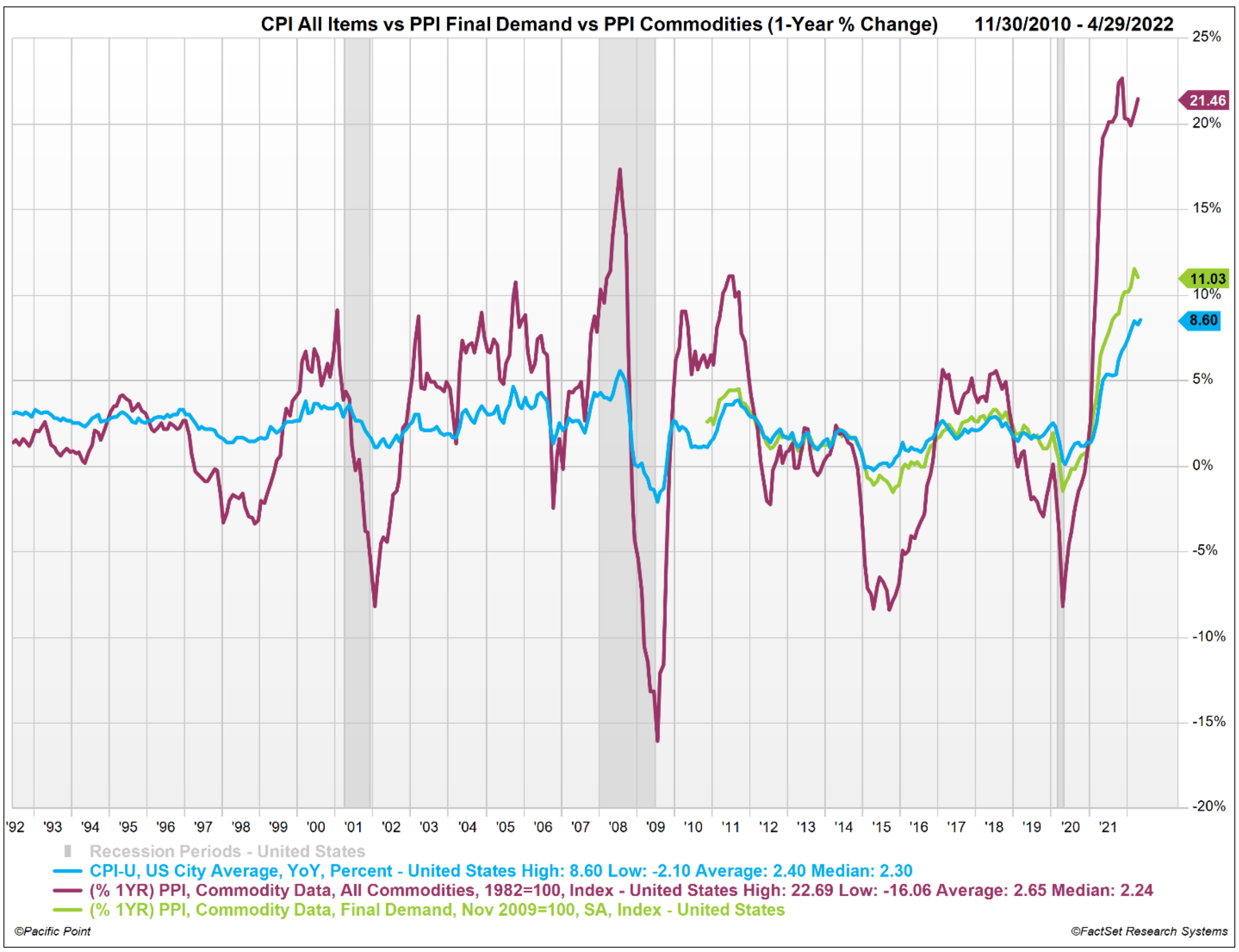
The chart below shows the 30-year history of the Producer Price Index, the Producer Price Commodity Index and the Consumer Price Index All Items. On June 10th, 2022, the U.S. Bureau of Labor Statistics reported May 2022, annual CPI increase of 8.6%. Important to note that the most recently reported April 2022 PPI increase of 11.0% occurred against the backdrop of a PPI Commodity Price Index increase of 21.5% from the year ago period.

The chart below illustrates the degree to which commodity prices drive annual changes in PPI and CPI. ***It is important to note that Federal Reserve monetary policy has limited influence on the supply side of inflation issues.*** Instead, the Federal Reserve is tasked with reducing demand commensurate with existing supply levels until the annual rate of inflation meets the Fed target of 2% all while maintaining full employment.



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Source: FactSet

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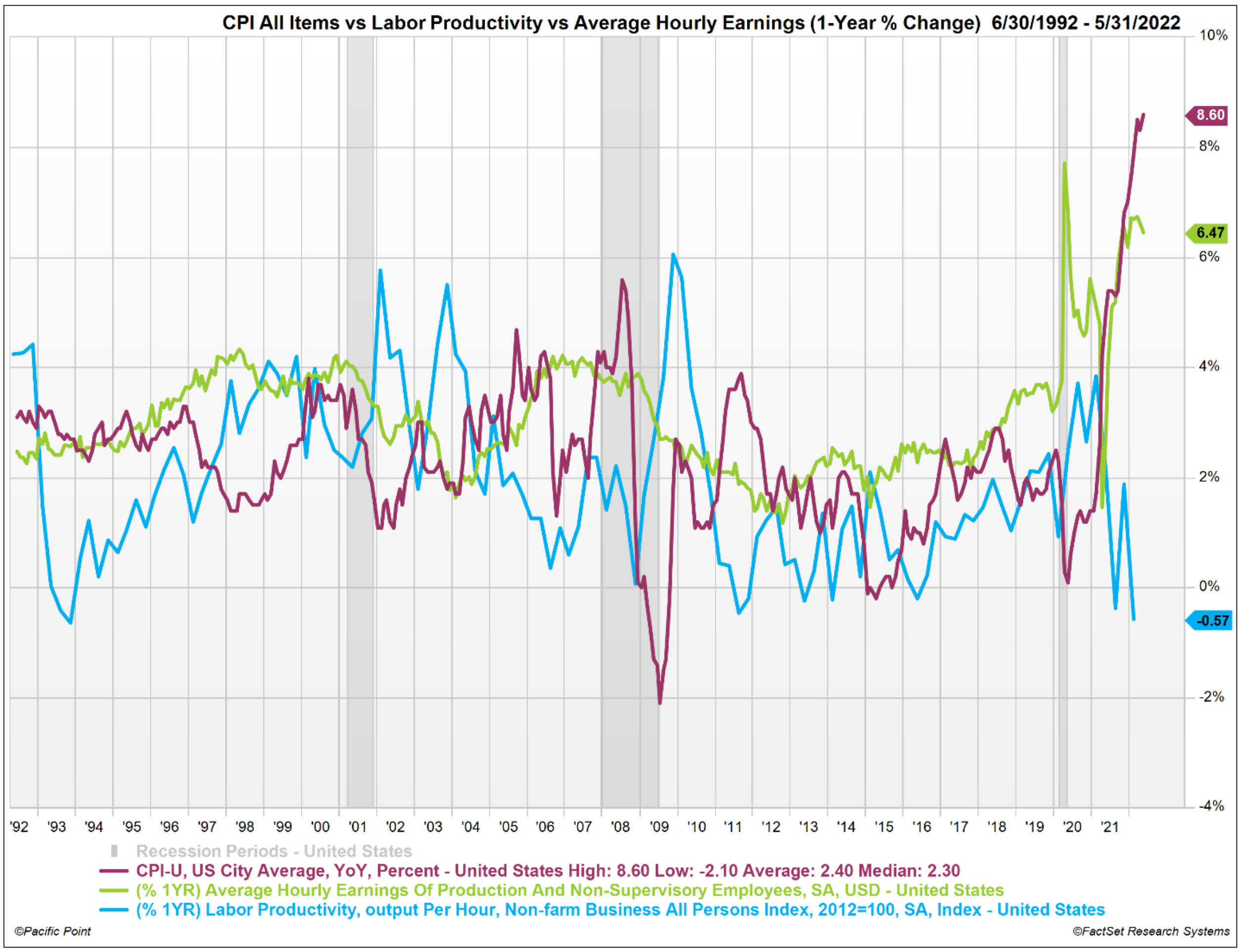
<u>Rising CPI – Reducing Real Wage Gains and Threatening Corporate Profit Margins</u>

The chart below shows the 30-year history of Consumer Price Index All Items, Labor Productivity and Average Hourly Earnings. ***Starting in October of 2021, the annual rate of CPI increase began outpacing the increase in Average Hourly Earnings resulting in the reduction of real wage gains.*** For corporations, the Average Hourly Earnings inflation starting in 2021 came at the expense of Labor Productivity which notched near 30-year lows in April 2022. ***Increase in Average Hourly Earnings paired with a decline in Labor Productivity translates to corporations paying more per unit of declining labor output***. Stated differently, this translates to higher labor costs and lower operating (EBIT) margins.



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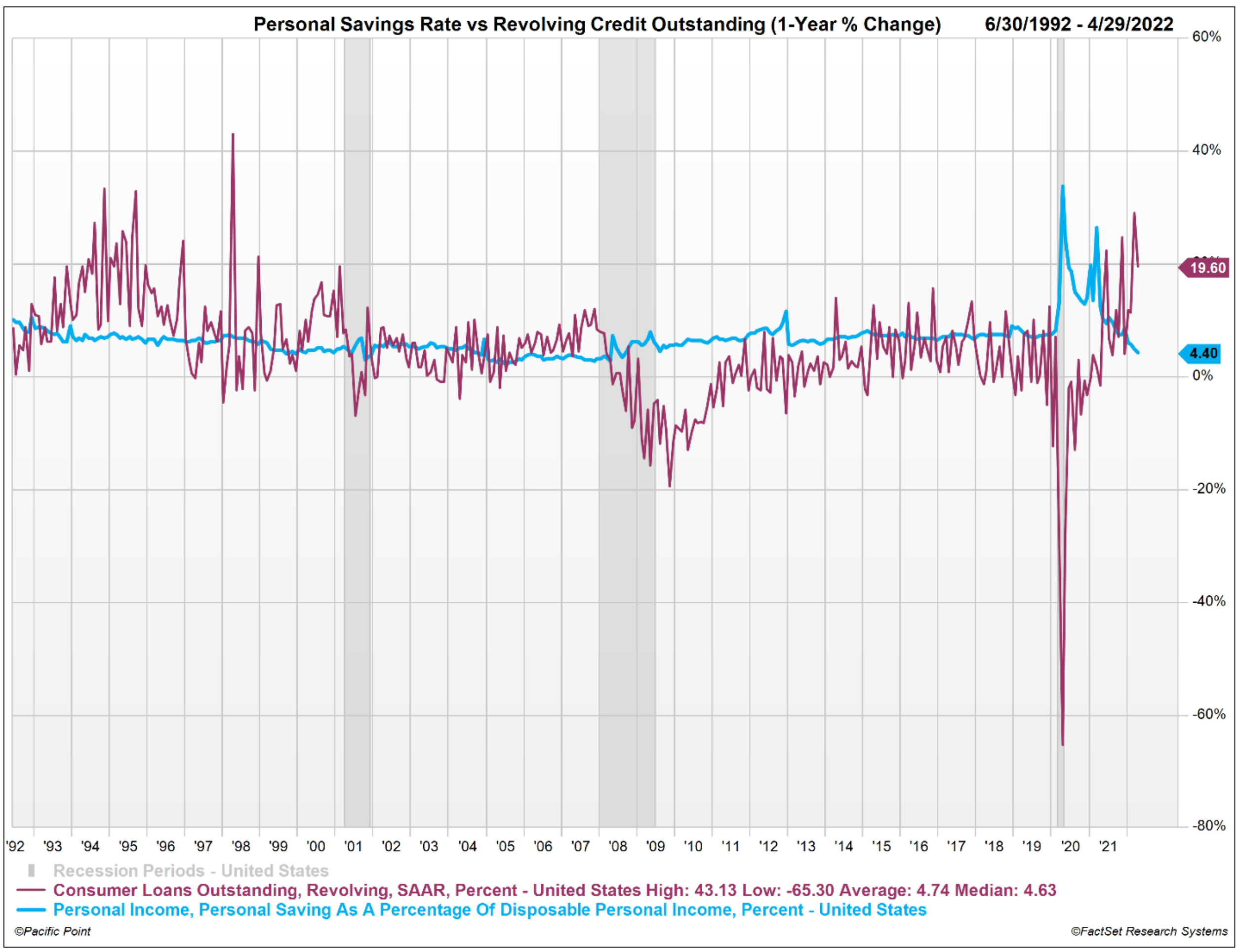
Decline in Real Wage Gains, Personal Savings Rates and Consumer Credit

The chart below illustrates the 30-year history of annual change in the Personal Savings Rate versus the annual change in Consumer Revolving Credit Outstanding. The Personal Savings Rate has dipped to 4.4%, to levels not seen since the 2008-09 Financial Crisis, as annual wage gains have failed to keep up with annual change in CPI. ***The annual increase in Consumer Revolving Credit Outstanding of 19.6% is offsetting the decline in the Personal Savings Rate suggesting that many consumers are stretched and using savings and credit cards to make household purchases.***



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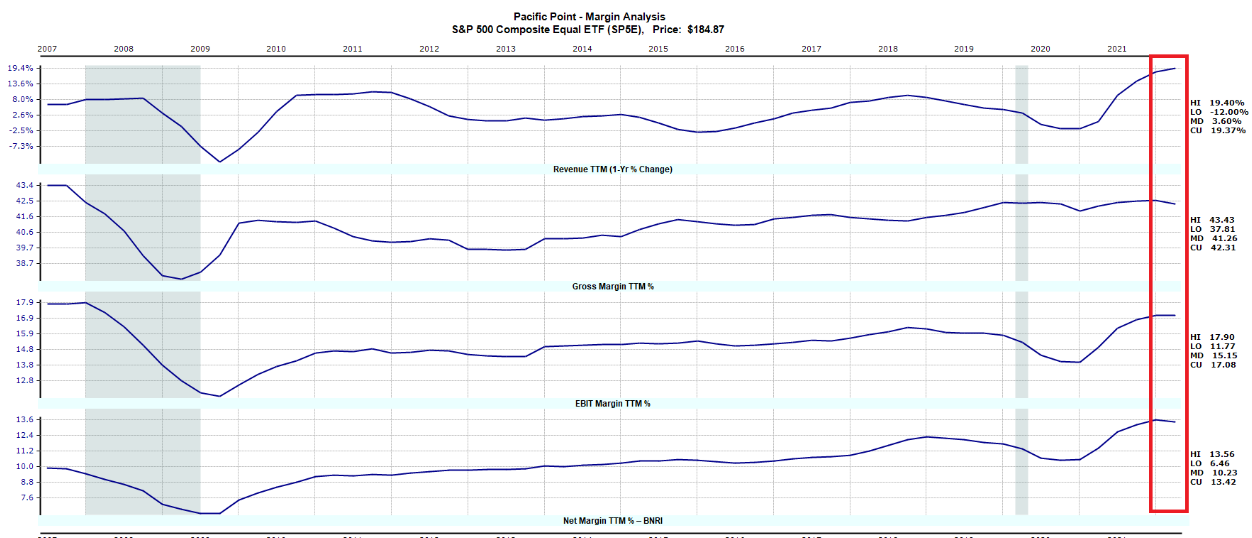
Quantitative Tightening Starting with Corporate Margins at Cyclical Peak Levels

On Wednesday June 1st, the Federal Reserve began reducing its ~$9 trillion portfolio to supplement rate hikes and reinforce the central bank's fight against inflation. The Fed began reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities by a combined $47.5 billion per month and will do this for three months. After this, the total amount to be reduced goes up to $95 billion a month, with policy makers prepared to adjust their approach as the economy and financial markets evolve. ***In short, the economy is anticipated to cool, and yields are likely to rise, both of which makes stocks less attractive at a time when corporate margins are at cyclical peak levels.***

The chart below illustrates the 15-year history of profit margins for the equal weighted average S&P 500 composite with current points for the 1-year % change in Revenues, Gross Margin Operating (EBIT) Margin and Net Margin all sitting at 15-year cyclical peak levels. As the economy begins to cool, we anticipate the 1-year % change in Revenues to rollover starting in Q2 of 2022. As revenues growth begins to cool, we expect margins to begin declining at all levels of Gross, Operating and Net Margins. ***Analyst EPS estimates have yet to reflect the anticipated margin compression due to slower economic growth resulting from rising rates and quantitative tightening.***



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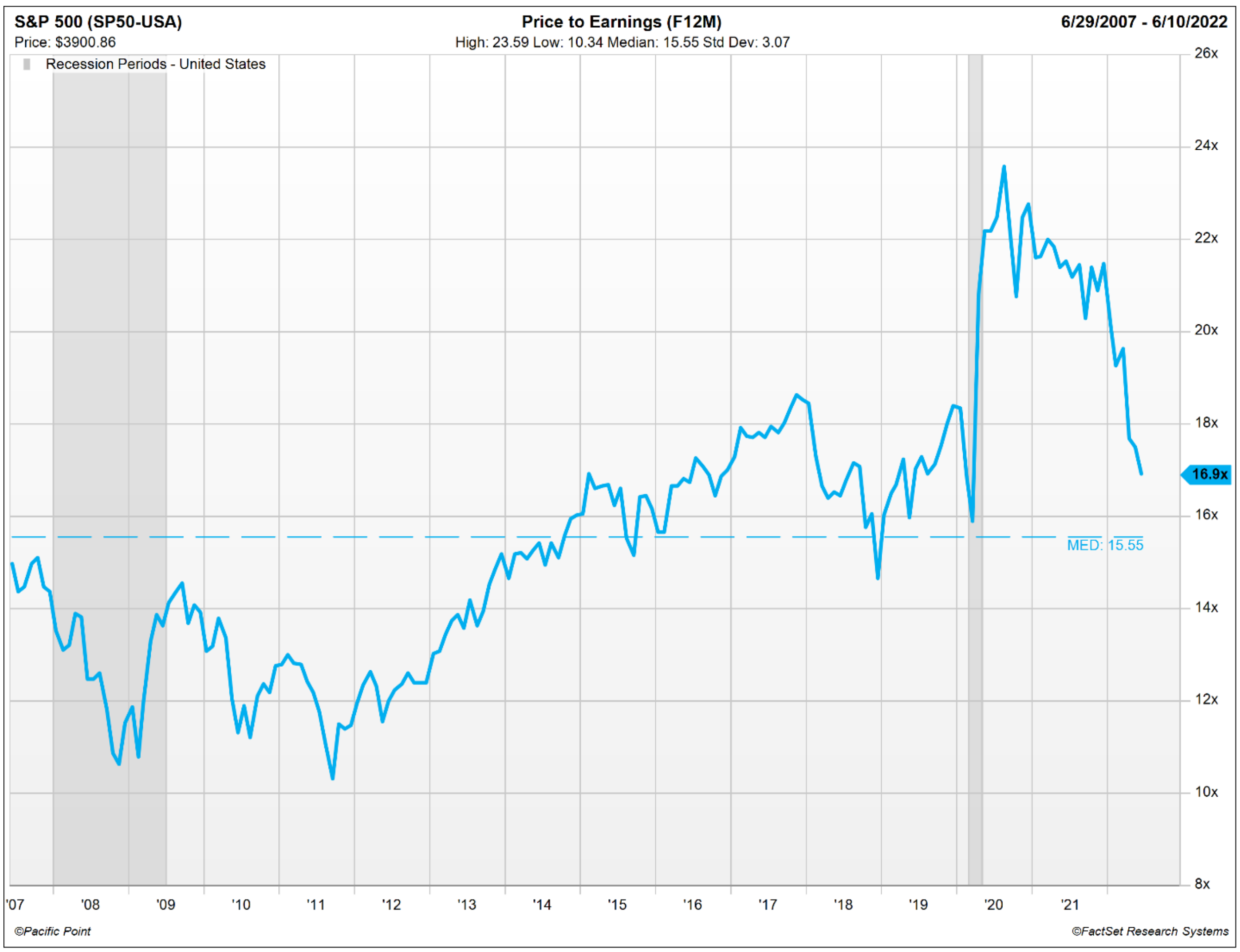
S&P 500 PE F12M Trading at Premium to 15-Year Median with Slowdown Looming

To date, the 2022 market selloff has come from PE multiple compression in anticipation of rising rates and quantitative tightening with little consideration for what we believe will be declining EPS estimate revisions resulting from a broad-based slowdown in U.S. economic growth. The S&P 500 price to forward EPS multiple has fallen from 20x at the start of 2022 to 16.9x on June 10th, 2022.

The chart below illustrates the S&P 500 price to forward EPS multiple of 16.9x remains elevated from its 15-year median trend of 15.5x and significantly elevated from forward earnings multiples of 14.5x experienced during the last Fed tightening cycle from 2017 to 2019.

Based on current, elevated levels of S&P 500 EPS F12M forecasts, a 14.5x price to earnings multiple represents a 14% S&P 500 decline to $3,346 from current the price of $3,900.



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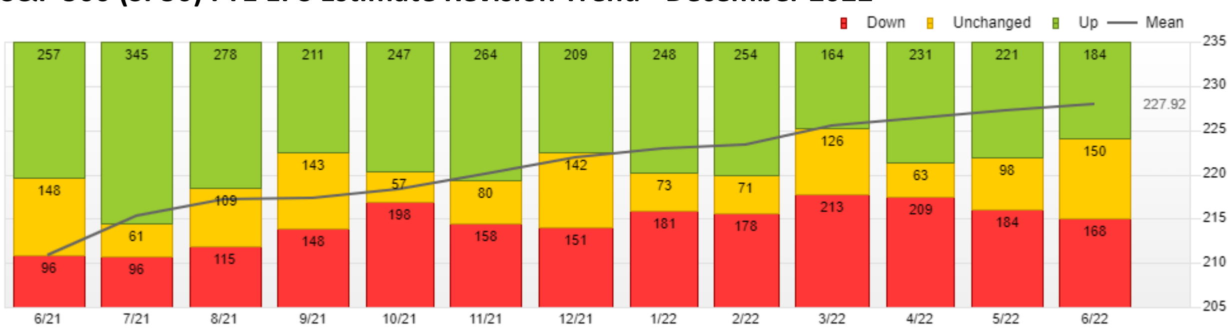
The charts below illustrate the 12-month history of S&P 500 FY1 and FY2 EPS estimate revision trends. Note that S&P 500 EPS estimates for both FY1 ($227.92) and FY2 ($249.95) remain at peak levels of revision. It is our belief that sell-side analysts, as a consensus, tend to be late revising estimates *down* into a recession and late revising estimates *up* out of a recession.

Stocks may appear to be approaching 15-year median PE F12M levels, but valuations are being derived on EPS estimates that may be subject to downward revision given the current macroeconomic backdrop. The average recession sees corporate profit margins decline more than 20% from peak levels. How much additional risk to the downside is there if EPS forecasts are revised down from current levels?

S&P 500 (SP50) FY1 EPS Estimate Revision Trend - December 2022



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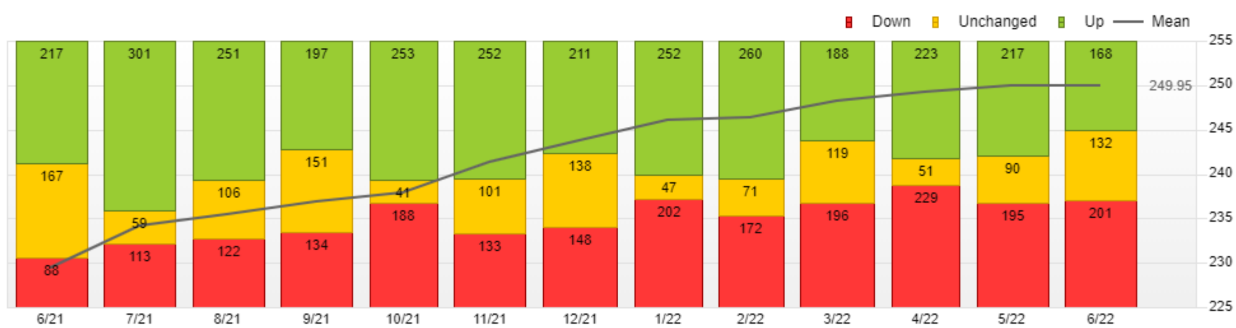
Source: FactSet

S&P 500 (SP50) FY2 EPS Estimate Revision Trend - December 2023



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With all the Macroeconomic Uncertainties – Are you Still Trying to Time the Market?

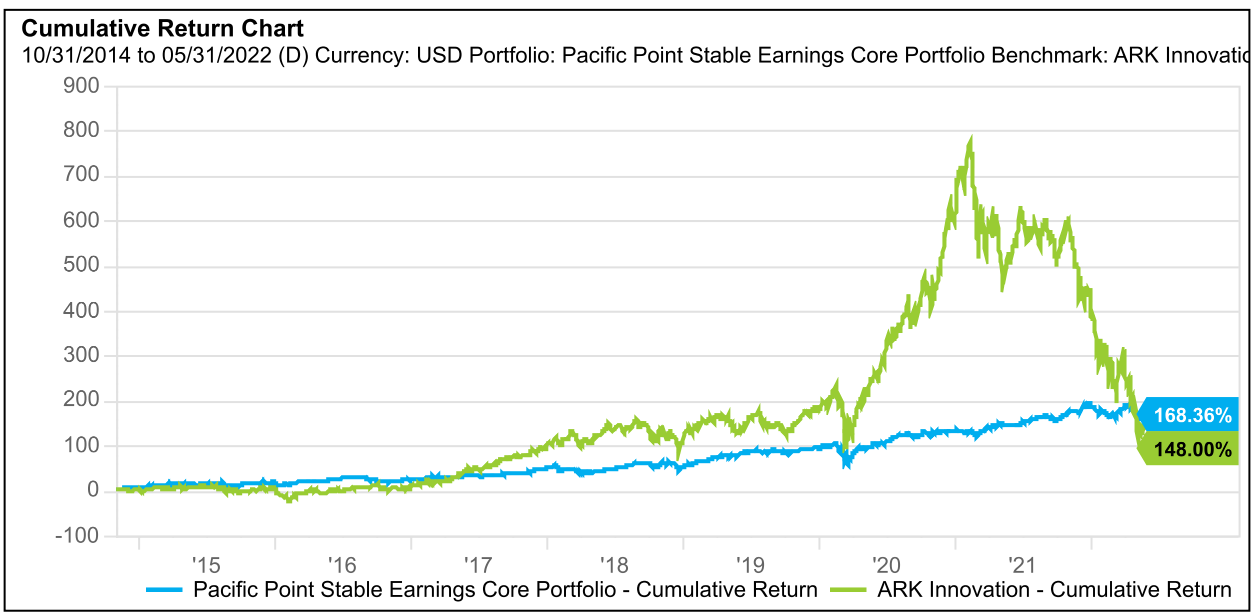
Media Influence and The Fear of Missing Out is the trap that most advisors and investors alike fall prey to as they feel pressured to chase market trends and performance. Media outlets bombard advisors and investors each day with a small number of 'experts' who appear to have made all the right moves while most are left holding yesterday's trade. ***This is where a disciplined, all-weather approach can pay off in the long run as most investors and advisors cannot consistently time market cycles over the long term regardless of what the media wants you to believe!***

Did you and your clients miss the Covid stimulus induced Ark Innovation ETF (ARKK) rally of 2020/2021? Consider the following performance since ARKK inception through May 31, 2022. Would you rather have the volatility of the ARK Innovation ETF with a drawdown of 71.58% from all-time highs reached on 2/12/2021? Or the long-term performance of a well-disciplined strategy like the Pacific Point Stable Earnings™ Core Portfolio with a gain of 17.69% over the same timeframe? With Stable Earnings™ Core cumulative return from 10/31/2014 to 5/31/2022 outperforming the ARK Innovation ETF by a steady 20.36%, which strategy would allow you and your clients to sleep better at night?

***Cumulative Total Return from ARKK Inception 10/31/2014 through 5/31/2022**

Pacific Point Stable Earnings™ Core Model Portfolio = 168.36%

ARK Innovation ETF = 148.00%:



*Hypothetical Model Returns as of 10/31/2014. Net return of .5% advisory fee. See disclaimers 1, 2, 3, 4, 5, and 6 Source: FactSet

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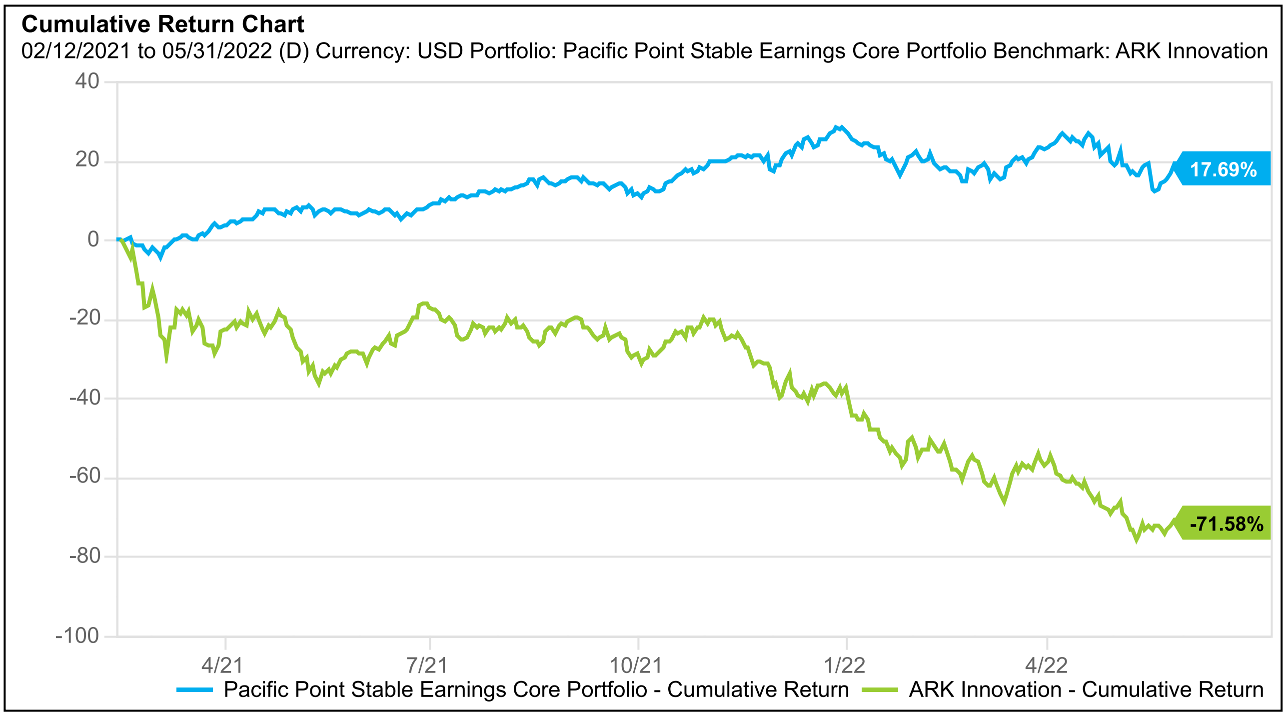
*Cumulative Total Return from ARKK Peak on 2/12/2021 through 5/31/2022

Pacific Point Stable Earnings™ Core Model Portfolio = 17.69%

ARK Innovation ETF = -71.58%



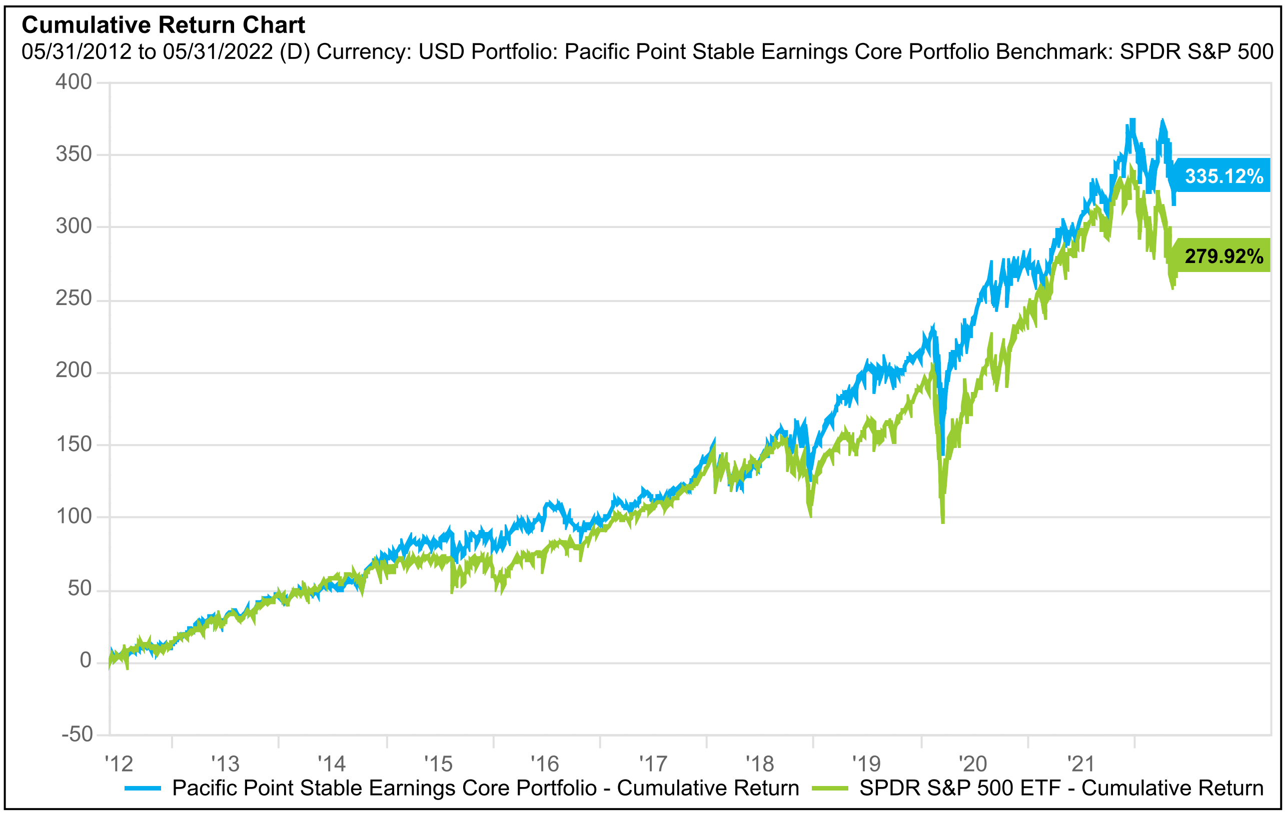
*Hypothetical Model Returns as of 2/12/2021. Net return of .5% advisory fee. See disclaimers 1, 2, 3, 4, 5, and 6 Source: FactSet

The cornerstone of the Pacific Point family of funds is the Stable Earnings™ family of core equity portfolios. The Stable Earnings™ family represents concentrated, carefully selected stock portfolios whose consolidated earnings have been stable over a long period of time, 25+ years. Consolidated earnings stability at the portfolio level may provide downside protection against loss of capital during periods of economic recession and unforeseen, black swan events.

***10-Year Cumulative Total Return 5/31/2012 – 5/31/2022**

Pacific Point Stable Earnings™ Core Model Portfolio = 335.12%

SPDR S&P 500 ETF Trust = 279.92%



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Our Discipline, Your Strength

All Stable Earnings™ portfolio companies have a demonstrated 25-year history of capital efficiency, profitability, and overall fundamental quality. Management of the Stable Earnings™ family of equity portfolios is a well-defined discipline that seeks consistent application of the strategy through economic cycles.

Client Focused | Performance Driven | Technology Enabled

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To learn more about Pacific Point's Stable Earnings™ portfolios, please contact one of the Founders, Jay Winship or Mike Licosati.

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