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CAPITAL MANAGEMENT

Value Equity
Q2 2022 Commentary

Market Review:

The US equity market posted sharp declines in the 2nd quarter, as the S&P 500 was down 16.1% and the Russell 1000 Value was down 12.2%. Following a difficult 1st quarter, it was the worst 1st half of a year for the S&P 500 in sixty years, since 1962, and the second worst 1st half since 1935. It was a particularly difficult quarter for high-multiple Growth stocks. The Nasdaq Composite was down 22.3%, the worst quarterly loss for the index since the depths of the Financial Crisis in 2008. More speculative areas of the market that thrived during the Covid pandemic, including various cryptocurrencies and SPACs, also suffered substantial losses. The 1st half also marked the first time since 2001 that both stocks and bonds fell, as government and corporate bond prices declined sharply. The yield on the 10-year US Treasury began the quarter at 2.3%, increased to 3.5%, before ending the quarter at 3.0%.

From a global macroeconomic perspective, the dominant themes in the quarter were persistent inflation and the response from central banks. In the US, the Consumer Price Index eased slightly in the month of April to 8.3%, down from the 8.5% reading in March, leading many observers to surmise that inflation had peaked. However, this narrative was upended with a May reading of 8.6%, the highest level since 1981.[1] The Federal Reserve responded with a 75-basis point hike in the federal funds rate, following earlier hikes in the year of 50 and 25 basis points. The Fed also began its program of quantitative tightening, only three months after ending its program of quantitative easing. Chairman Powell said he sees inflation as the chief economic risk facing the US and controlling it as the central bank's top priority even if the process proves painful to consumers and businesses. Powell also said he could not guarantee a so-called soft landing for the US economy, with many economists and investors eyeing a potential recession.

All eleven market sectors finished the quarter in negative territory. Consumer Staples (-4.6%) and Utilities (-5.1%) were the best-performing sectors, as Defensive stocks led. Several prominent Staples companies reported better than expected ability to implement price hikes with minimal impact on volumes. Energy (-5.2%) was the next best performing sector, continuing a remarkable run that began in late 2020. The WTI oil benchmark increased sharply in the quarter, peaking at $122 per barrel, before finishing the quarter at $105. Consumer Discretionary (-26.2%) was the worst performing sector, as major retailers reported a sharp rise in expenses as well as a pullback in demand for discretionary goods. Communication Services (-20.7%) and Information Technology (-20.2%) were the next worst performers, as high P/E, long-duration equities saw substantial multiple contraction in the quarter.

[1] https://www.bls.gov/news.release/cpi.nr0.htm

Performance Analysis:

The Value Equity strategy composite returned -10.7% (gross) and -10.8% (net of fees) for the second quarter of 2022 versus -12.2% for the Russell 1000 Value and -16.1% for the S&P 500. Year-to-date, the strategy returned -11.8% (net of fees), outperforming the Russell 1000 Value and S&P 500 which returned -12.9% and -20.2%, respectively.

Figure 1: Value Equity Returns vs. Benchmark

June 30, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
Value Equity (gross)	-10.7	-11.6	-6.1	5.8	7.7	10.6
Value Equity (net)	-10.8	-11.8	-6.7	5.2	7.2	10.1
Russell 1000 Value Index	-12.2	-12.9	-6.8	6.9	7.2	10.5
S&P 500 Index	-16.1	-20.0	-10.6	10.6	11.3	13.0

Performance for periods greater than 1 year is annualized. ***Past performance is no guarantee of future results***

The broad-based second quarter market selloff left few winners - inflation beneficiaries including the Energy sector delivered positive returns YTD while Defensives (Utilities, Consumer Staples, and Healthcare) declined significantly less than the market. Though Cyclicals (Financials, Materials, and Industrials) were weak, they outperformed long-duration Growth sectors (Information Technology, Communication Services, and Consumer Discretionary). It was the strongest first half for Value over Growth in decades with the Russell 1000 Value (-12.9% total return) outperforming the Russell 1000 Growth (-28.1% total return) by 15.2 percentage points for the year and by 8.7 percentage points in the second quarter. The lowest Price/Earnings quintile outperformed the highest Price/Earnings quintile by 23.1 percentage points for the year (Figure 2).

Figure 2: Performance by Price/Earnings Quintile

S&P Relative Forward P/E Quintiles		Q2	YTD	BofA Adj Beta	Weight in S&P 500	Forward P/E Ratio
High P/E	7.47 To 1.55	-23.2	-31.1	1.08	18.6	36
	1.55 To 1.15	-16.4	-20.1	0.90	32.8	22
	1.15 To 0.88	-11.9	-19.2	1.01	19.1	17
	0.88 To 0.60	-14.0	-12.9	0.98	16.2	12
Low P/E	0.60 To -3.86	-11.1	-8.0	1.21	13.2	8
S&P 500		-16.5	-20.6	1.01	100.0	16

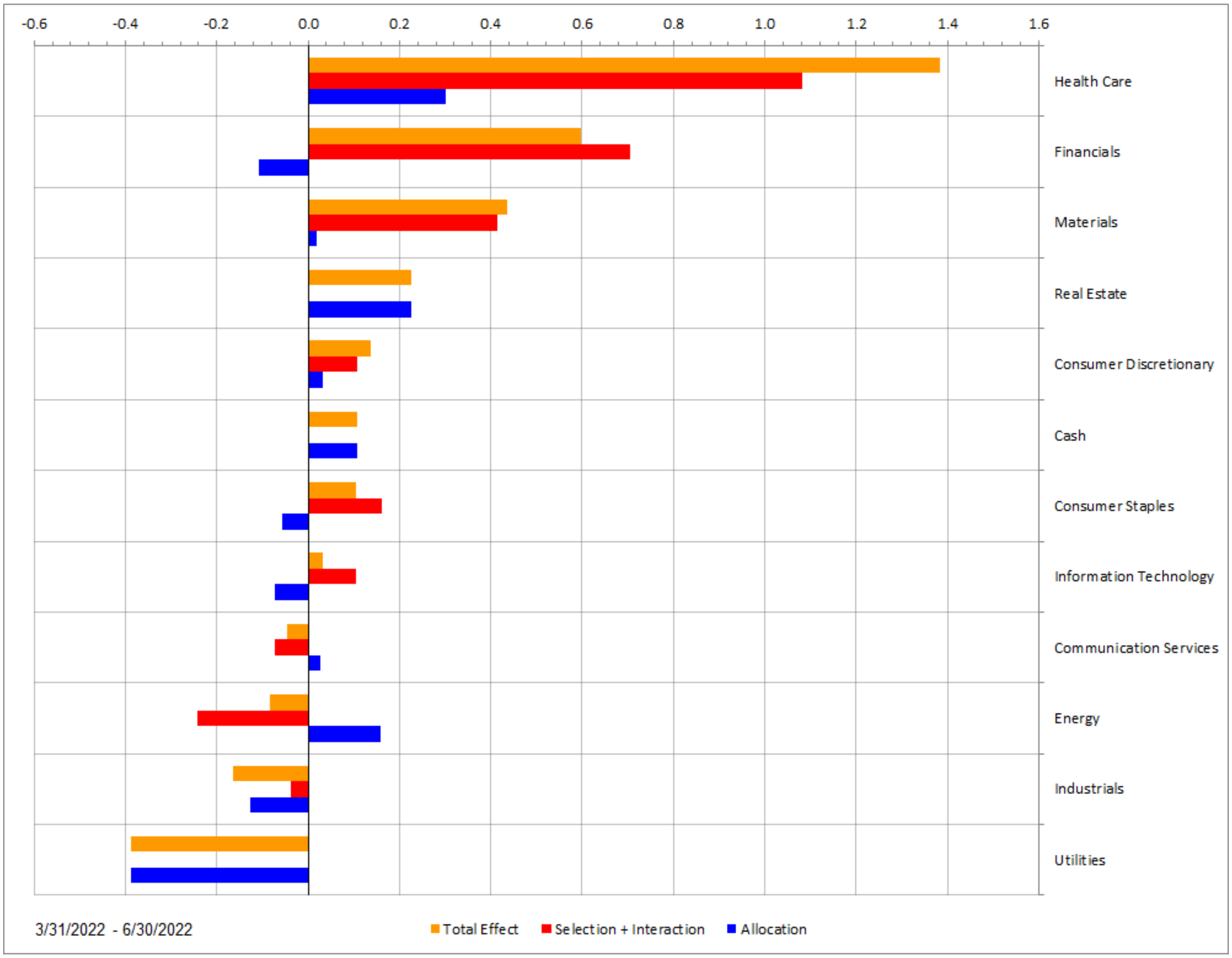
Source: BofA Research, US Performance Monitor, 7/1/2022.

Despite this relative outperformance, few areas of the market were immune to the indiscriminate selling late in the quarter as deleveraging, broad-based ETF selling pressure and systematic/algorithmic programs liquidating long equity positions overwhelmed markets.

As we look ahead to market opportunities and risks, we evaluate past tightening cycles, bear markets and recessions in the Market Outlook section of the commentary.

Portfolio Attribution:

Attribution Effects – Value Equity vs. Russell 1000 Value 3/31/2022-6/30/2022



Source: SCCM/Bloomberg, 6/30/2022.

The following attribution analysis of the Value strategy utilizes the Russell 1000 Value Index as the benchmark of comparison for the second quarter of 2022.

Our strong stock selection made ***Healthcare*** the largest contributor to performance. Bristol-Meyers Squibb (+19.0%) announced strong fourth quarter earnings for 2021, with revenues largely in-line and EPS slightly above consensus expectations. Opdivo, the company's blockbuster immunotherapy oncology drug, saw strong sales growth and continues to see label expansion into indications of lung cancer, renal cancer, and gastric cancer. Merck (+8.0%) posted solid quarterly results, with strong sales growth for its leading immuno-oncology drug Keytruda, as well as its HPV vaccine Gardasil. Medtronic (+7.9%) outperformed as management said they are seeing a rebound in elective surgical procedures following a delay brought on by the Omicron variant of Covid. Our underweight allocation made ***Real Estate*** the next largest contributor to performance. Real Estate underperformed during the quarter, as the potential for rising interest rates weighed on the sector. Our overweight allocation and strong stock selection within ***Energy*** contributed to relative performance. Energy was by far the top performing sector, as global supply and demand dynamics remained favorable, leading to higher oil and gas prices.

Prices spiked following the imposition of sanctions against Russia, which is the world's third-largest oil producer. Chevron (+40.2%) and ConocoPhillips (+39.6%) both reported strong cash flows enabling them to strengthen their balance sheets, cover capital expenditures, and pay their dividends. Our overweight allocation and stock selection within ***Financials*** contributed to relative performance. While many of the banks declined on global economic growth concerns related to inflation and the Ukraine crisis, other financial service companies, including Allstate (+18.5%), American Express (+11.1%), and Chubb (+11.1%) outperformed on the prospect of rising interest rates.

Stock selection detracted from relative performance in ***Communication Services.*** Disney (-11.5%) declined despite reporting strong quarterly results, with a notable 11.8 million net customer adds for Disney+. Comcast (-6.5%) declined on concerns over the pace of broadband net adds and account growth. Our underweight allocation and stock selection within ***Materials*** detracted from relative performance. Axalta (-25.8%) declined after the company adjusted its full-year guidance below the range it had issued in October of last year. Management noted higher than anticipated raw material inflation, primarily on the back of higher oil prices, as well as limited availability of certain materials impacted the full-year outlook. Stock selection within ***Consumer Discretionary*** detracted from relative performance. Shares of Lowe's (-21.5%) declined after posting outsized gains in 2020 and 2021. Home improvement trends have been particularly positive since the onset of Covid, with a strong housing market and stimulus funds fueling sales. While concerns have grown over how long these trends can continue, Lowe's is making continued gains in the professional contractor sales channel and increasing margins through improved operational efficiency. Finally, our underweight allocation within ***Utilities*** detracted from relative performance. Utilities outperformed, driven by a flight to safety and higher-yielding sectors of the market.

Portfolio Changes:

Purchases / Additions

There were no purchases in the quarter.

Sales / Reductions

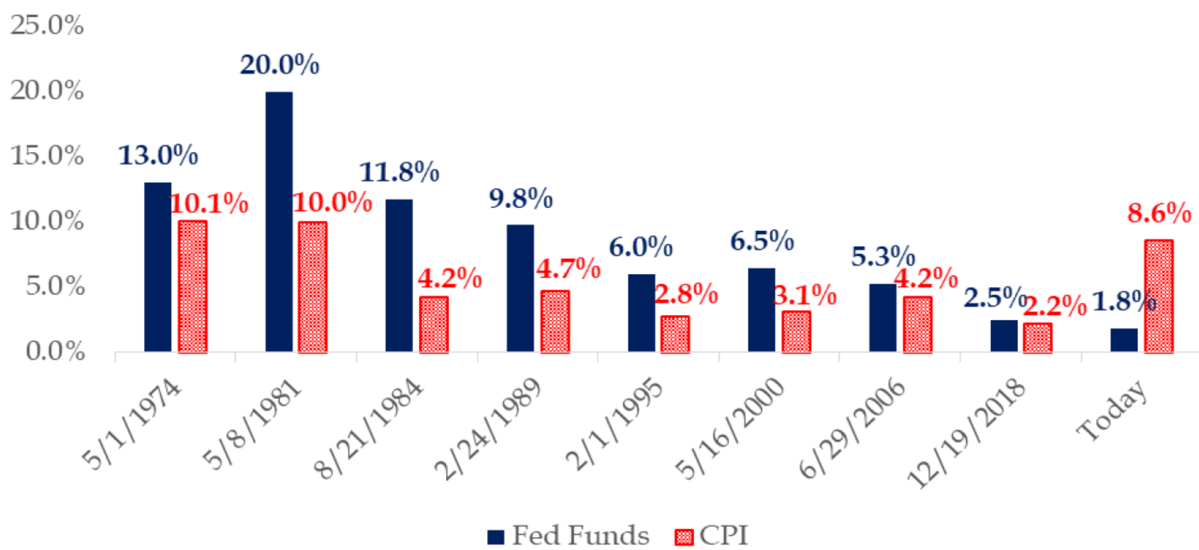
The position in **Skyworks Solutions (SWKS)** was sold in the quarter. The company provides semiconductors that facilitate wireless connectivity, including power amplifiers, filters and integrated front-end modules and plans to diversify its addressable market beyond handsets and into industrial and medical applications. With the rollout of 5G networks and 5G-enabled devices in advanced stages globally, we believe that Skyworks is likely to face rising pricing pressure from its two core customers, Apple and Samsung. Moreover, its high customer concentration leaves Skyworks vulnerable to in-housing risks, whereby its customers could develop robust wireless solutions internally, which would meaningfully reduce demand for its products. While its diversification strategy obviates some of these risks, we believe diversification will likely be more successful for players with a more diversified product stream, which allows for one-stop-shop solutions for customers

Market Outlook:

The equity market downturn that began in January 2022 hit bear market territory in the 2nd quarter as decades-high inflation, expected to peak by mid-year, has remained persistently high. As a result, global central banks accelerated rate hikes throughout the quarter serving to withdrawal liquidity and tighten financial conditions, pressuring almost all asset classes. All the while, the surging US dollar, widening credit spreads and increasing pockets of economic weakness have further raised alarm. Fears of a potential recession driven by a combination of monetary tightening and weakening growth soon shifted to concerns that the Federal Reserve will not be aggressive enough to bring inflation down. This view rests on the belief that a prolonged period of inflation will lengthen the Fed tightening cycle, increasing the odds of recession.

The track record of the Fed engineering a soft landing while raising interest rates is poor. That coupled with a multi-decade paradigm shift at the Fed clearly prioritizing price stability (inflation) over growth, suggests that the Fed will continue raising interest rates until inflation has broken convincingly low. Over the past half century of Fed rate hike cycles, the Fed Funds rate has ended at levels higher than CPI (Figure 3). There has only been once instance, during the 1994-1995 cycle, when the Fed tightened above the neutral rate that didn't result in recession. Today, given the wide spread between the Fed Funds rate and CPI, either inflation will need to fall significantly, or Fed tightening has a way to go. That being said, a recession could be short and shallow in nature given the strength of consumer finances, a well-capitalized banking system and market excesses that have already corrected considerably.

Figure 3: Fed Funds Rate and CPI at the End of Prior Tightening Cycles



Source: Strategas Research, Historical Tightening Cycles, 6/27/2022.

The current bear market at 6 months in duration with a 24% drawdown at its low point has digested the growing macro concerns and discounts a probable risk of a recession. Examining the historical profile of bear markets over the last half century (bear markets since 1968) in terms of duration and magnitude can aid investors in how far we are in the current cycle (Figure 4). Half of the bear markets over this time period (5 out of 10) have been relatively short at less than 6 months in duration while the other half of bear markets have lasted between 18-21 months. The median drawdown in these ten bear markets has been 34%, with the Price/Earnings multiples contracting by an average 18% and EPS declining by 18% (Figure 5). In this cycle, Price/earnings multiples have contracted by 24% as consensus S&P 500 EPS estimates call for positive year-over-year growth this year.

Figure 4: US Equity Bear Markets – Magnitude and Duration, 1968-2022

PEAK DATE	PEAK CLOSE	TROUGH DATE	TROUGH CLOSE	BEAR MAGNITUDE	BEAR DURATION
11/29/68	108.37	5/26/70	69.29	-36.1%	18 mos.
1/11/73	120.24	10/3/74	62.28	-48.2%	21 mos.
11/28/80	140.52	8/12/82	102.42	-27.1%	20 mos.
8/25/87	336.77	12/4/87	223.92	-33.5%	3 mos.
7/16/90	368.95	10/11/90	295.46	-19.9%	3 mos.
3/24/00	1527.46	9/21/01	965.80	-36.8%	18 mos.
1/4/02	1172.51	10/9/02	776.76	-33.8%	9 mos.
10/9/07	1565.15	3/9/09	676.53	-56.8%	17 mos.
2/19/20	3386.15	3/23/20	2237.40	-33.9%	1 mo.
1/3/22	4796.56	6/16/22	*3666.77*	*-23.6%*	*5 mos.*
			MEAN	**-36.2%**	**12.2 mos.**
			MEDIAN	**-33.9%**	**17 mos.**

Source: BCA Research, A Difference of Opinion, 6/27/2022.

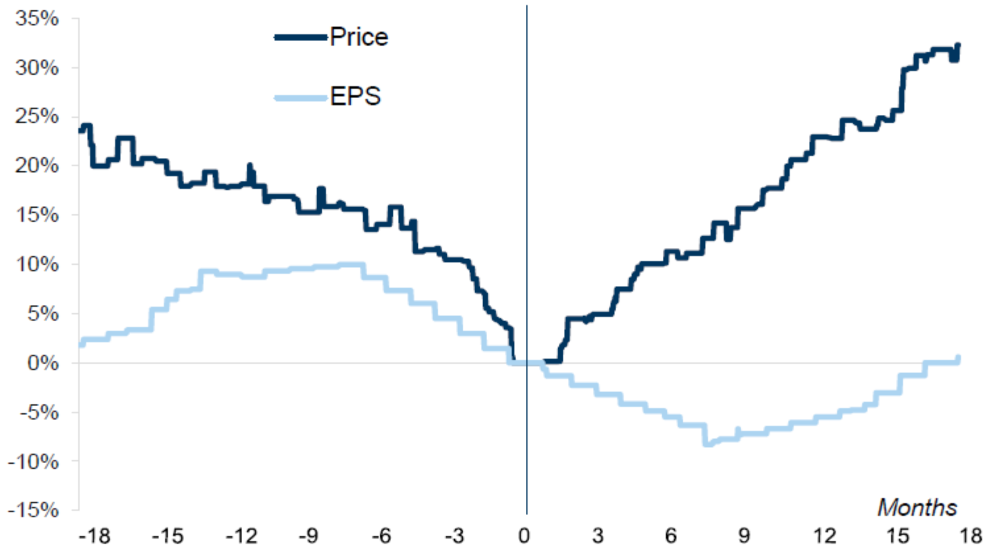
Figure 5: US Equity Bear Markets – Price/Earnings and EPS Contraction

BEAR MARKET DATES		DURING BEAR MARKET: INDEX DECLINE	DURING BEAR MARKET: TRAILING/FWD* 4-QTR EARNINGS	DURING BEAR MARKET: TRAILING/FWD* 4-QTR MULTIPLE	PEAK TO TROUGH: TRAILING/FWD* 4-QTR EARNINGS	PEAK TO TROUGH: TRAILING/FWD* 4-QTR MULTIPLE
11/29/68	5/26/70	-36.1%	-0.5%	-35.7%	-12.9%	-26.6%
1/11/73	10/3/74	-48.2%	41.9%	-63.5%	-16.0%	-38.3%
	MEAN	**-42.1%**	**20.7%**	**-49.6%**	**-14.5%**	**-32.5%**
11/28/80	8/12/82	-27.1%	-0.4%	-26.8%	-11.6%	-17.6%
8/25/87	12/4/87	-33.5%	4.8%	-36.5%	**N/A*** **	**N/A*** **
7/16/90	10/11/90	-19.9%	-0.2%	-19.8%	-7.5%	-13.5%
3/24/00 1/4/02	9/21/01 10/9/02	-49.1%	-8.7%	-44.3%	-18.0%	-38.0%
10/9/07	3/9/09	-56.8%	-36.2%	-32.2%	-39.9%	-28.1%
2/19/20	3/23/20	-33.9%	-3.1%	-31.8%	-21.3%	-16.1%
1/3/22	6/16/22	-23.6%	7.9%	-29.2%	**N/A*** **	**N/A*** **
	MEAN**	**-36.7%**	**-7.3%**	**-31.9%**	**-19.6%**	**-22.6%**
	MEDIAN**	**-33.7%**	**-1.7%**	**-32.0%**	**-18.0%**	**-17.6%**

Source: BCA Research, A Difference of Opinion, 6/27/2022.
Note: Separate dot-com bear markets consolidated for clarity. *Trailing metrics for the '68-'70 and '73-'74 bear markets.
**Summary statistics exclude current bear, which may not be over. ***Marked N/A if earnings did not decline.

When do bear markets turn? Typically, the market troughs one to two quarters before GDP bottoms and two to three quarters before EPS troughs (Figure 6). The bottoms in GDP and EPS are notoriously difficult to call but given leading economic indicators and S&P 500 earnings estimates are just starting to decelerate suggests we may not be near the bottom. Moving into 2023, however, markets could be supported by the several rate cuts being discounted into Fed futures as a result of higher recession probabilities and a likely shift in focus back to growth in a pre-election year.

Figure 6: Bear Market Price vs. EPS



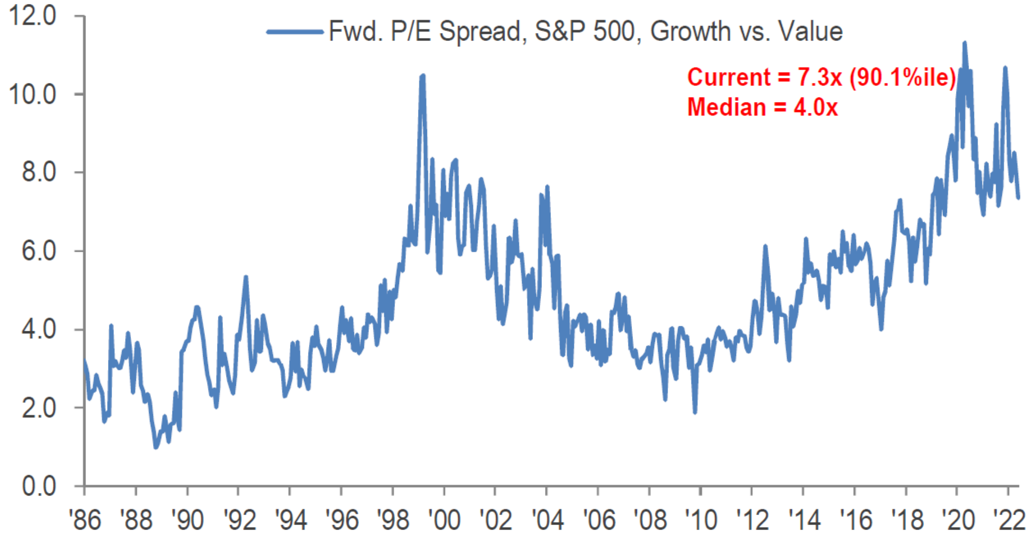
Source: Goldman Sachs Research, The Recession Manual for US Equities, 5/18/2022.
Time 0 = Bear market low, time in months (US bear markets since 1903).

The current environment where risks abound even as we move to an eventual market bottom, favors Value stocks.

- Considering the increasing odds of a US recession, Value stocks have historically led the market coming out of a recession - outperforming in all 14 out of 14 recessions since 1929. The outperformance of Value stocks over the S&P 500 has averaged +28% over approximately 12 months (BofA/ML, US Equity Strategy in Pictures, 4/29/2022).
- In the first year of Fed rate hike cycles, Value has been one of the best performing factors, outperforming the market by an average 7.0 percentage points (BofA/ML, US Equity Strategy in Pictures, 4/29/2022).

And despite the recent relative outperformance of Value stocks, the valuation spread between Growth and Value is still wide at 7.3x (90% percentile) vs. the long-term historical median of 4.3x (Figure 7).

Figure 7: Valuation Spread between Growth and Value stocks



Source: JPM Research, US Equity Strategy, 5/27/2022.

The current valuation of our portfolio remains attractive - the strategy trades at 12.9x 2022 earnings versus 16.6x for the Russell 1000 Value and 18.3x for the S&P 500 (Q2).

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Best Regards,
Schafer Cullen Capital Management, Inc.

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