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CAPITAL MANAGEMENT

Enhanced Equity Income
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

Income and Options Summary:

Total annualized income tracked at 7.2% at quarter end. Dividends contributed 3.8% to this sum, and options premiums 3.4%. Dividend growth in the portfolio remained attractive, as 41% of the current holdings have declared increases year-to-date, at an 8.9% average.

Although the value style continued to dramatically outperform growth during the quarter, call writing remained especially challenging, due to the exacerbation of many oversold positions and general lack of pricing strength. Although the strategy performed well during the quarter, capitulation in the Energy and Materials sectors in June further limited the choices for attractive call options. Every sector in the strategy and the S&P 500 recorded a negative return in June.

Boosted by call writing opportunities in Health Care, Consumer Staples, and other defensive names, EEI covered 40 positions during the 2nd quarter, at an average of 4% out-of-the-money. These writes returned a strong 18% annualized yield. The assignment rate continued to fall to 14% for the quarter and to 20% year-to-date.

Performance Analysis:

As speculation about the length, depth, and breadth of inflation continued throughout the quarter, the value style dominated, even as investors began to exhibit strong concerns about cyclical names and oil prices in June. The strategy outperformed its benchmarks during the quarter, returning -9.0% (net of fees), compared with -10.9% for the CBOE S&P 500 Buy-Write Index (BXM) and -10.7% for SPDR Barclays High Yield Bond ETF (JNK). Year-to-date returns were -6.6% (net) versus -10.2% and -14.9%, respectively.

Compared with the economic sectors of the S&P 500 Index, the underlying securities of the BXM, EEI's allocations outperformed most significantly with lighter weightings in Information Technology, Consumer Discretionary, and Communication Services. To a lesser degree, it was impacted by underperformance in the Materials sector.

Figure 1: Enhanced Equity Income Returns vs. Benchmark

June 30, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	Since Incept*
SCCM Enhanced Equity Composite (gross)	**-8.8**	**-6.1**	**-1.5**	**8.2**	**7.0**	**9.0**
SCCM Enhanced Equity Composite (net)	**-9.0**	**-6.6**	**-2.6**	**7.0**	**5.8**	**7.8**
S&P 500 Buy-Write Index (BXM)	-10.9	-10.2	-2.6	3.4	4.1	6.0
SPDR Barclays High Yield Bond ETF (JNK)	-10.7	-14.9	-13.8	-1.2	1.1	3.6
Russell 1000 Value Index	-12.2	-12.9	-6.8	6.9	7.2	9.9

12/31/2010. 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	Dividend Yield
High P/E	7.47 To 1.55	-23.2	-31.1	1.08	18.6	36	0.8
	1.55 To 1.15	-16.4	-20.1	0.90	32.8	22	1.2
	1.15 To 0.88	-11.9	-19.2	1.01	19.1	17	1.6
	0.88 To 0.60	-14.0	-12.9	0.98	16.2	12	2.3
Low P/E	0.60 To -3.86	-11.1	-8.0	1.21	13.2	8	3.1
S&P 500		-16.5	-20.6	1.01	100.0	16	1.6

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

High Dividend stocks have significantly outperformed the market in 2022 driven in part by the high concentration of Energy and Defensives stocks in the category. The highest dividend yielding quintile of stocks outperformed the lowest yielding quintile by 18.6 and 33.0 percentage points for the quarter and year respectively. 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 Changes:

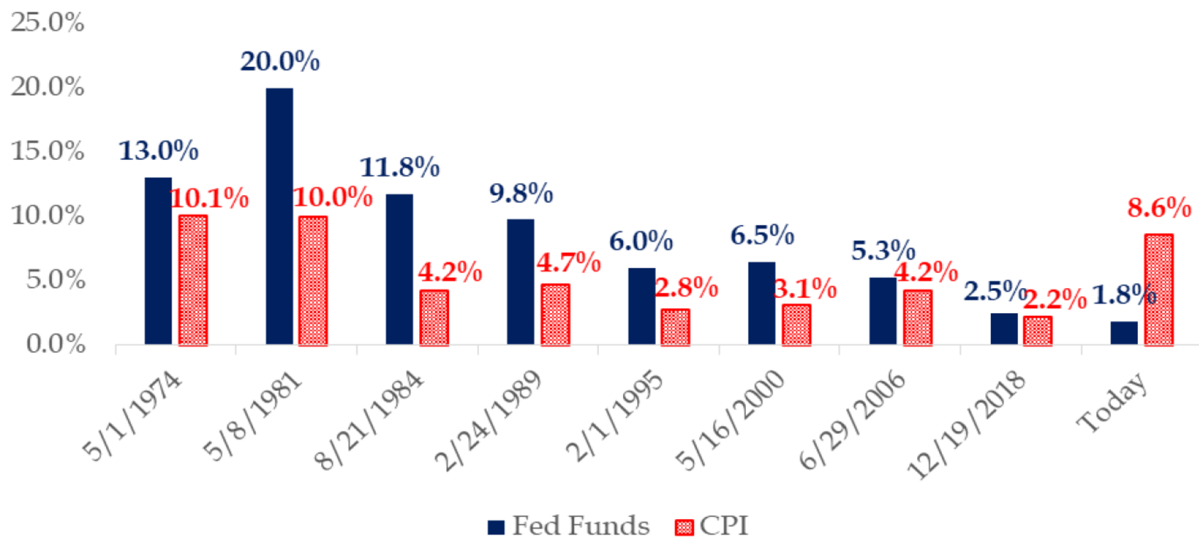
There were no purchases or sales in the second quarter.

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		TROUGH		BEAR MAGNITUDE	BEAR DURATION
DATE	CLOSE	DATE	CLOSE		
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.

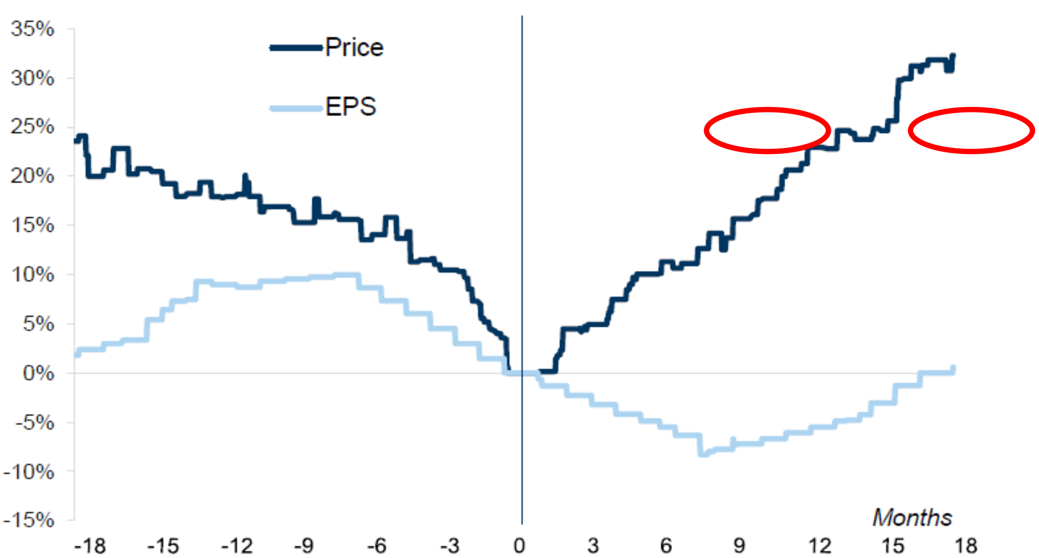
Figure 5: US Equity Bear Markets – Price/Earnings and EPS Contraction

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



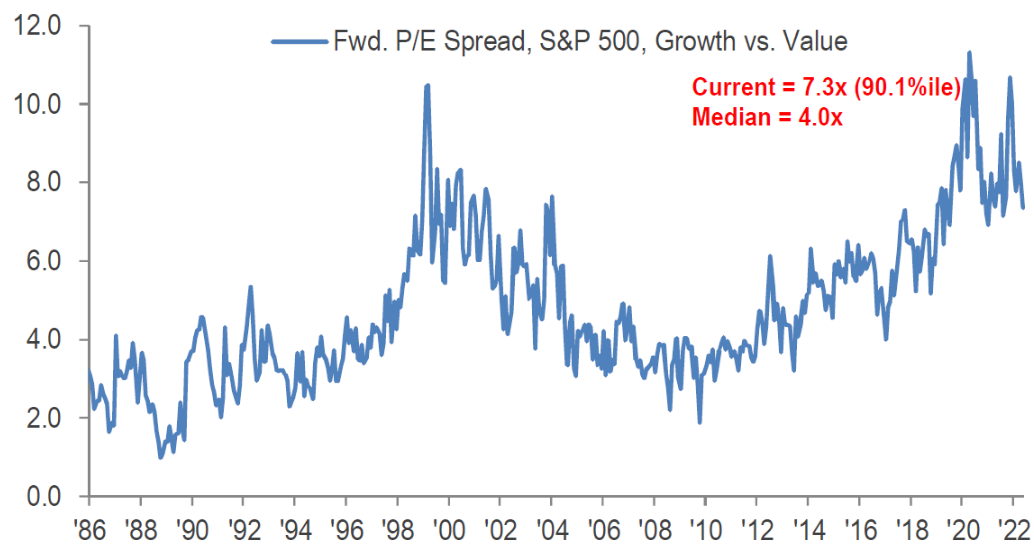
Source: Goldman Sachs Research, The Recession Manual for US Equities, 5/18/2022.
Time 0 = Bear market low, time in months (US bear markets since 1903).

The current environment where risks abound even as we move to an eventual market bottom, favors Value and High Dividend 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).
- Two years into a rate hike cycle, High Dividend stocks have outperformed non-Dividend stocks by an average 12% (Ned Davis Research, Dividend stocks during tightening cycles, 2/15/2022). The low-beta nature of high dividend payers is rewarded as the market gravitates towards quality and income.

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.

Given the incredibly strong equity returns generated this past decade combined with still elevated valuation levels, we believe dividends will likely be a more important contributor to total returns.

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

Respectfully,

Schafer Cullen Capital Management, Inc.

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