the 9:05
Bailard's Quarterly Review of Economic and Market Developments*
Q3 2022

Chat with the CIO: What is Normal, and When Will It Be Here?

Bailard's SVP and Chief Strategist - Wealth Management, Jon Manchester, CFA, CFP® and Chief Investment Officer, Eric Leve, CFA, tackle the global factors at play as we look to economic recovery.

Inside this Edition:

1 Chat with the CIO: What is Normal, and When Will It Be Here?
4 "One word... Benjamin: Semiconductors"
6 Double Materiality: Is It Coming to the States?
8 Closing Brief - Bailard's View on the Economy: It Will Cost You

Eric Leve, CFA: The Great Financial Crisis (GFC) stood as one of the global economy's worst shocks since the Great Depression and, seemingly, everyone became a macro forecaster trying to understand the root causes of what had transpired and what the entrails foretold for investors. Among the outcomes were that the underpinnings of the global economy were so rattled, the housing market in the U.S. was so impaired, and U.S. municipalities were so weakened, that economic growth was tepid and inflation was modest for the next decade.

Today we face what feels like another epochal transition for the global economy: geopolitics is becoming increasingly critical as companies move away from historically cheap, but politically volatile trading partners such as China; as Western Europe's historical supplier of natural gas (Russia) becomes a bitter enemy; and as what was termed transitory inflation appears to have much greater lasting power. So, with that preamble Jon, do you think "epochal" is an overstatement and, if so, how do you view the global landscape ahead of us? Put more simply, when do you think we'll get back to "normal" and what might that look like?

Jon Manchester, CFA, CFP®: I think history will be the arbiter of whether current events are epochal, but I do want to first dig into your comments

> continued on page 2

*Please see important disclosures on page 13.

> In both the Russian and Chinese cases, Europe and the U.S. will work to build newer, more stable supply chains that will likely come at a higher cost.

on Russia and China. The period prior to the GFC may prove a highwater mark for globalization for the next generation. Since that time, trade as a proportion of global economic output has declined from more than 60% in 2008 to close to 50% today, in line with levels seen in 2002. The rise of populist leaders around the globe hobbled long-held alliances (notably the UK and Europe), while historically independent autocrats have found common purpose (particularly Russia and China).

Although both nominally Communist, Russia and China were bitter rivals in the 20th century Cold War. More recently, they have developed a disturbing codependency. Russia can fill much of the gap in China's oil and gas demand and expand China's political reach to the Atlantic. China can provide desperately needed capital to a relatively poor Russia and, at the same time, distract Western powers with their aggressions up and down the western Pacific. Russia never grew wealthy, but its endowments of raw materials gradually made it a critical supplier to the Western world, especially in the aftermath of perestroika. 2022 has been a brutal wake-up call. European and broader dependence on Russia for oil, gas, nickel, and palladium is a dangerous and unreliable relationship.

China's scope for most of the Cold War was regional, but with a gradual opening beginning with Deng Xiaopeng, its economic ambitions became global and its cheap manufacturing replaced that of newly-rich Japan and South Korea as feedstock to the Western world. The past several years have heightened concerns of relying on China for goods, especially technology-related ones, as China's interests have become less mercantile and more militaristic.

In both the Russian and Chinese cases, Europe and the U.S. will work to build newer, more stable supply chains that will likely come at a higher cost. For the dependability this will bring, the cost is worthwhile, even if it means more expensive goods for consumers.

Eric: Your comments regarding Europe's dependence on Russian energy stand out to me. Western Europe's industrial core has been a beneficiary of several major world events: the movement of low-wage labor from southern Europe in the 1950s, the later influx of another source of cheap labor after the fall of the Berlin Wall, and for the past couple of decades, some of the most inexpensive natural gas in the world. With the prospect of higher costs for fuel in the future and a historical demographic benefit (younger, cheaper workers) becoming a demographic burden (fewer new entrants into the workforce as Baby Boomers retire), Europe will need to find a new source of competitive advantage.

Even as Europe leads the world in adopting alternative fuel sources, the region's manufacturing companies will need creative solutions to keep up with foreign competitors. For now, that means new relations with gas producers in Northern Africa and, in the future, a broader group among the Gulf States. But let's get back to the bigger question: what do we think the path out of this economic and market downturn will look like compared to the one that followed the Global Financial Crisis?

Jon: There is a stark contrast between the period following the GFC and our current experience. The GFC itself exposed systemic issues in housing and banking around the world that caused a deeper and longer recession that I expect this one to potentially be, but more critically, it left wounds that led to the relatively anemic economic growth in the decade that followed.

The current downturn was precipitated by a global pandemic that caused significant dislocations in supply and demand as well as historically-large fiscal and monetary responses by the major Western governments. Working down that accumulated debt will be a multi-year process and may point to marginally-higher interest rates. The greatest contrast though is that the forces coming out of the GFC were largely deflationary, and looking forward, inflationary pressures are more likely to challenge policymakers, corporations, and consumers.

There is a bit of a silver lining here though. Inflationary pressures tend to be a meaningful impetus for

technological change. Higher wage pressures motivate companies to develop technologies that enhance productivity and, at the margin, put greater emphasis on utilizing more capital than labor for production. In parallel with a similar process in the 1970s when the world enjoyed the incredible advances in semiconductors, the advent of personal computers, the large-scale business adoption of computing and internal networking and the birth of some of today's great technology giants, the investments that we are already seeing could result in another technological revolution. One which, like the previous one, could support higher margins for companies across essentially all sectors.

Eric: That said, the Federal Reserve's (the Fed's) current challenge to contain inflation should be considered in the context of the broader, generational issues we've been discussing. Baseline inflation is likely to be higher. Central banks including the Fed, the Bank of England, and the European Central Bank may consider higher inflation targets, possibly raising them from current levels of 2% to 3%. This would dramatically lower the burden of beating inflation and reduce the risk that central banks (on their own) throw economies into recession. There are various forces supporting this.

As a mass of Baby Boomers leave the workforce and a smaller number of Millennials enter it, higher wage pressures aren't simply a European phenomenon, but one that affects many of the world's largest and most developed economies. The prioritization of security of supply (over timeliness and cost) will translate into a high degree of onshoring of manufacturing globally. This will, by definition, come with higher costs. Finally, many technology and technology-enabled companies are dependent on an array of metals, suggesting that we may be on the cusp of another secular tailwind to commodity prices.

Jon: In many ways I see the recent, dramatic market moves as a fundamental reset that could restore the value of diversification in investment portfolios. For so much of the post-GFC era, the overriding mantra was TINA: as in, "there is no alternative" to stocks, and mostly to mega-cap tech stocks. Today we see bond yields at levels in line with those prior to the GFC. With the Fed Funds rate at 3.25% (and expected to go higher), cash is no longer "trash," and it reverts to a credible alternative to stocks. With higher yields, bonds have a greater ability to provide diversification to equity returns than they did when they offered near-zero yields.

The prioritization of security of supply (over timeliness and cost) will translate into a high degree of onshoring of manufacturing globally.

Within the equity universe, we are seeing greater dispersion in valuations relative to history, making areas outside of mega-cap growth compelling. Even international stocks, which have been the bane of investors for more than a decade, are enjoying an interesting reset. Dollar strength has hurt investment in this area over the past year, but that headwind can easily turn into a tailwind with dollar weakness. When that tailwind does come, exporters from countries with weaker currencies will look much more competitive Finally, the mix of sectors offered by international stocks is much more diversified than the basket of U.S. stocks. In a global recovery, this mix that includes higher yielding, more stable companies could balance some of the high growth that dominates U.S. indexes.

Eric: I couldn't agree more. I don't see the next ten years looking much like the post-GFC era. While U.S. stocks may provide returns comparable to what they've done over the long-term, I think, as you imply, that intelligent asset allocation will be critically important to good investment outcomes.

“One word... Benjamin: Semiconductors”

A well-rounded look at the state of the semiconductor industry as a component of technology investing from Chris Moshy, Senior Vice President of Equity Research.

If the classic 1967 film “The Graduate” was re-made today, the sage advice Dustin Hoffman’s character Benjamin Braddock received from a family friend would be undoubtedly updated to: “I’ve got one word for you, Benjamin: semiconductors.”

While plastics [1] are no doubt ubiquitous in today’s economy, the world could not function without semiconductors: small silicon-etched[2] integrated circuits found in everything from laptops and kitchen appliances to smartphones and self-driving vehicles. Undeniably, and for better or worse, innovation, product cycles, and device proliferation of all kinds are inexorably driving semiconductors deeper into the infrastructure of our daily life.

Think about the feature set of today’s vehicles—lane departure warning, blind spot detection, GPS mapping, adaptive cruise control, and performance-tuned engines—all semiconductor enabled. Electric vehicles are really supercharged computers with microchip-laden battery systems and software on wheels. The smartphone you may be using to read this operates primarily on semiconductors with its bright OLED[3] foldable screen, powerful digital camera, a super speedy and cool-running CPU, plenty of fast-swapping memory to manage and store apps, and is web-connected via a cell signal using a 5G millimeter wave chipset. Yikes! Where’s my rotary phone?

The comprehensive nature of the semiconductor industry underscores why we strongly believe the group is an integral component of a technology investment strategy. It is also an industry defined by rapid innovation, brutal competition, significant capital investments, and, as the current environment reminds us, one subject to substantial cyclicality.

By many measures the current business cycle for semiconductors has peaked and the retrenchment in stock prices has been painful. Over the past 12 months ending September 2022, the Philadelphia Semiconductor Index (SOX), a broad industry performance measure, is down 29.3% versus the S&P 500 Index, down 17.7%. On a ten-year basis, however, the SOX Index gained 528% vs the S&P500 at 153%; and a 20-year comparison shows the SOX Index up 682% vs S&P500 less than half that at 304%.[4]

The semiconductor industry is still expected to grow mid-single digits this year, and current estimates for 2023 reflect low-single digit declines in global semiconductor revenues. This is down from the 26% growth enjoyed in 2021.[5] After several years of above-trend demand, particularly in consumer durables during the pandemic, many end markets are now faced with excess customer inventories and buyers retracing their steps. PCs and smartphones sales have contracted meaningfully in 2022, as have other consumer products such as appliances, leisure equipment, and entertainment hardware. Even in areas showing good demand, think of the auto sector, component order rates are slowing as inventories fill up and the outlook for the global economy darkens.

Whether this downturn in the semiconductor sector will be short and shallow or more protracted is actively analyzed in the markets. Our current view is it will be early- to mid-2023 before visibility improves and industry recovery begins, but stock prices often anticipate a business upturn by a quarter or more. The depth

1 *The original piece of advice to Benjamin Braddock!*
2 *Germanium substrate is also common, and the latest generation chip designs incorporate gallium arsenide substrates*
3 *Organic light emitting diode*
4 *Philadelphia Semiconductor Index; SPDR 500 ETF; Bloomberg LP*
5 *Gartner Forecasts Worldwide Semiconductor Revenue Growth*

> This year has not been easy for technology investors and, once again, the semiconductor industry has proven its cyclicality.

and breadth of an economic recession of course will impact that forecast.

There are other issues at work that impact both the current business cycle and the long-term supply challenges. Some may be surprised to learn that many of the most recognizable consumer products in the world are dependent on very few regional suppliers. This includes the most advanced semiconductors and sophisticated electronic components that are at the core of flagship products. As Apple Inc. states in its annual 10k filing, "Substantially all the Company's hardware products are manufactured by outsourcing partners that are located primarily in Asia... A significant concentration of this manufacturing is currently performed by a small number of outsourcing partners often in single locations." This concentrated supplier risk is not limited to Apple; many leading semiconductor and consumer device companies[6] rely on the same narrow supplier channels for product manufacturing and assembly.

Recent supply chain disruptions, capricious government closures of regional manufacturing hubs, and China's increasingly menacing posture towards Taiwan has brought the issue front and center for business executives and members of Congress alike. Interestingly, Eastern Europe's unrest and Western Europe's unpredictable energy supply and expensive workforce makes the U.S. the location of choice for future semiconductor capacity additions. Of course, the effort will greatly benefit from the CHIPS Act, a bill signed into law this past summer that provides grants and tax breaks to companies building semiconductor manufacturing plants in the U.S. The CHIPS Act helps a select set of companies finance capacity expansions to build semiconductor facilities for their own operations or to provide outsourced fabrication services for others.

The CHIPS Act does limit companies from using funds to pay dividends or for share repurchases. Yet, it also improves the flexibility for companies to make capacity investments while maintaining capital return programs for shareholders—even during an industry downturn. In today's environment, semiconductor companies are aware of the industry's cyclicality and have learned to budget capacity growth based on demand forecasts and cost targets rather than the availability of capital. Understandably, with so much new investment capital and incentives entering the industry in coming years, it will be important to monitor the impact on industry supply discipline including the growth of outsourced capacity in the U.S.

Lastly, the rise of export restrictions on key technologies to China is a growing concern for companies and investors. Chinese firms are among the largest buyers of U.S. technology, including semiconductors, components, and fabrication equipment. Currently, most U.S. technology sales to China are considered "lagging" or "legacy" products and equipment, but still amount to 20%+ of sales for many companies, while sales of leading-edge products that tend to be restricted are in the low single digits. Without better policies around technology transfer, continued export restrictions will limit the long-run potential of the region's growth for U.S. companies.

This year has not been easy for technology investors and, once again, the semiconductor industry has proven its cyclicality. While we expect some pressure on business fundamentals through year-end, we are on the offensive for investments, including in the semiconductor ecosystem. It's an industry in which the most innovative and competitive companies are generally rewarded by successively higher revenues, profits, and stock prices with each business cycle. The industry is well-capitalized, and the CHIPS Act ensures continued growth investments in its manufacturing base. Market leaders in the technology industry can shift surprisingly quickly from cycle to cycle so investing in the sector requires attention (and patience), but the fascinating and rewarding opportunities justify the effort.

6 Qualcomm, Inc., AMD Corp., Nvidia Corp., Microsoft, Inc. and many other operate under similar "fab-less" manufacturing models

Double Materiality: Is It Coming to the States?

McKenzie Fulkerson-Jones, ESG Analyst, dives into the rise of conversations around double materiality as a two-pronged approach to ESG investing: evaluating risk ***and*** *impact.*

According to the Financial Accounting Standards Board (FASB), "the omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item." Put another way, financial factors are considered sufficiently important material when they risk affecting a company's financial performance and its ability to create economic value for investors and shareholders. FASB is the organization responsible for establishing accounting and financial reporting standards for companies in the United States and, with that, U.S. regulators subscribe to FASB's specific definition of financial materiality.

There is a rising sentiment that this definition of financial materiality is no longer adequate. This shift began in earnest over the past two decades when some of the largest asset owners began pushing Wall Street to focus on the importance of these risks not addressed by FASB—most notably climate change. These investors, largely insurance companies and pension funds, felt they owned all the "tail-risk" in the market as it related to the effects of climate change and other serious breaches in corporate governance. As the evidence of climate-related damage piled up, these large investors concluded that traditional Wall Street analysis was not doing enough to evaluate these risks.

These institutional investors helped fuel the growth of ESG investing, which is based on the idea that environmental, social, and governance factors – like climate change and poor corporate behavior – are financially-material risks. The growth of ESG investment products helped amplify the voices of smaller investors that also believed it was time for additional types of risks to be deemed material, as long as these factors pose a financial risk to the company and/or would affect investor decision-making. Such risk factors include things like:

- Climate change risk to operations: Risk to a company's facilities located in areas that according to climate change models will be negatively affected by climate change,
- Diversity, Equity, and Inclusion (DEI) performance risk: Poor performance in DEI has been linked[1] to poor long-term financial performance, and
- Climate change emissions regulatory risk: Emissions are considered a risk because of its high likelihood to be regulated by governments, which will have major financial ramifications for companies who are not yet making efforts to reduce their emissions.

Now what about double materiality?

This is perhaps a natural evolution of ESG but with a significant twist. Double materiality is a term that originated in Europe and includes two types of materiality: financial and impact. The latter, impact materiality, goes beyond risk mitigation; it refers to the impacts that a company's activities have on communities and the environment (formerly referred to as externalities). So financial materiality is about the inputs (both financial and ESG) that could lead to financial risk, and impact materiality is about the outputs that have an impact on society and the planet – combined, these two inputs and outputs are referred to as double materiality. The very existence of this term implies that both types of materiality should matter. Indeed, many

1 *"Why Diversity and Inclusion Matter: Financial Performance (Appendix)," https://www.catalyst.org/research/why-diversity-and-inclusion-matter-financial-performance/*

investors would like to have this type of information to inform their investment decisions.

Double materiality has gained traction in Europe, leading to it being codified in the EU Sustainable Disclosure and Taxonomy Regulations[2], and further clarified in the soon-to-be-effective EU Corporate Sustainability Reporting Directive[3]. Therefore, in Europe, publicly-listed companies with more than 500 employees must disclose[4] not only their ESG risks but also their ESG impacts. Furthermore, financial firms must indicate[5] whether or not an ESG investment uses the double materiality standard.

So what does this mean for us here in the U.S.? Given the global nature of financial markets, consistency on this matter could only be beneficial. Global standards that reference double materiality are indeed being developed, but currently only under the auspices of the International Financial Reporting Standards Foundation, which is used in 140 countries globally but not the U.S. As mentioned at the outset, U.S. accounting standards are set by FASB, which is not considering adopting double materiality at this time.

Despite the standards not changing in the U.S. yet, double materiality has already begun to break through domestically, as evidenced by its uptake from a very big financial player. JPMorgan Chase just launched its first double materiality product. Even without U.S. standards in place, other investment firms will likely follow suit.

With stateside adoption just beginning, we expect that U.S.-based ESG ratings providers—such as MSCI and Sustainalytics, which have so far been focused on rating companies based on the financial materiality of ESG risks—are likely rushing to develop double materiality ratings products.

However, it is important to note again that without U.S. regulation in place to mandate ESG disclosure, the accuracy and comprehensiveness of the data provided by investment firms or ESG ratings providers will be limited. SEC regulations that require disclosure of greenhouse gas emissions are coming, but that's just one slice of ESG. Additional disclosure and impact measurement requirements are needed to make double materiality data and ratings a broad reality.

---

2 *"Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088," https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852*

3 *"Questions and Answers: Corporate Sustainability Reporting Directive proposal," https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_1806*

4 *"Corporate sustainability reporting," https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en*

5 *"Sustainability-related disclosure in the financial services sector," https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en*

Closing Brief - Bailard's View on the Economy: It Will Cost You

In this quarter's closing brief, Jon Manchester, CFA, CFP® (Senior Vice President, Chief Strategist – Wealth Management, and Portfolio Manager – Sustainable, Responsible and Impact Investing) dives into the factors continuing to affect the economic environment.

The honeymoon appears to be over for FedEx newbie CEO Raj Subramaniam. Shortly after he ascended to the post on June 1, taking over for founder and long-time CEO Fred Smith, FedEx announced a 53% dividend hike and the appointment of two new board members put forth by activist investor, D.E. Shaw group. The stock soared over 14% on that day, its largest one-day increase since 1986. A couple of weeks later, Subramaniam and his management team hosted an upbeat Investor Day – the company's first such event in a decade – in which they laid out a set of ambitious targets for fiscal year 2025. Among those targets was the projection that FedEx would grow adjusted earnings per share (EPS) in the 14% to 19% range annually, aided by higher profit margins. It was a heady first month on the job for Subramaniam, although some analysts hoped for bolder structural changes for a business that has struggled to operate at the same profitability levels as its peer United Parcel Service.

Less than three months after providing the bullish Investor Day outlook, Subramaniam was forced to withdraw FedEx's fiscal 2023 guidance while warning that Q1-23 revenues would fall roughly $800 million short of expectations. He said "macroeconomic trends significantly worsened later in the quarter," and FedEx acknowledged that volumes declined faster than they could reduce costs.[1] Operating expenses remained high relative to demand, which is not a phrase that investors like to hear, particularly when it comes about 11 weeks after the company guided to improved profitability. The mid-September warning sent the share price plunging to a level roughly 20% below where it traded prior to the buzzy, shareholder-friendly moves. It also reverberated throughout equity markets, with *The New York Times* noting "As an economic bellwether, FedEx's troubles are a gloomy sign for the U.S. economy."[2]

Although FedEx fell short of first quarter revenue expectations, it still managed a 5% sales increase versus the prior year. Earnings, however, proved problematic. Adjusted EPS sank 21% year-over-year, and the adjusted operating margin declined 150 basis points[3] to 5.3%—a far cry from the 10% operating margin target identified in FedEx's fiscal 2025 plan. This atypical relationship between sales and earnings growth—with sales growth outpacing earnings—has been fairly common for companies this year due largely to inflation's impact on the cost of doing business. Firms attempt to pass along the elevated costs to consumers, but either there is a lag in implementation or they lack the pricing power to do so. As an example, Q2 2022 Standard & Poor's 500 Index sales per share growth was approximately 4.3% versus the first quarter, but operating earnings dropped 5% sequentially. Normally firms benefit from positive operating leverage in a healthy demand environment, with earnings growth running ahead of top-line growth. We are experiencing the other side of that coin currently, and investors are less willing to pay higher valuations for businesses which are incrementally less profitable.

Latest Obsession: Dot Plot

Former Federal Reserve (Fed) chairman Ben Bernanke is credited with spearheading the Fed's drive for enhanced transparency. He started holding quarterly press conferences to explain the Federal Open Market Committee's (FOMC) decisions, adopted a formal inflation target of two percent, and provided forward

1 *"FedEx Reports Preliminary First Quarter Financial Results and Provides Update on Outlook," www.investors.fedex.com , 9/15/22*
2 *"FedEx Slashes Earnings Forecast, Citing Slowdowns in Asia and Europe," www.nytimes.com, 9/16/22*
3 *A basis point (bp) is 0.01%*

guidance on short-term interest rates.[4] That forward guidance on the projected trajectory of the Fed Funds (short-term) interest rate was beefed up in 2012 via the introduction of the “dot plot” chart. The dot plot illustrates where FOMC members think the Fed Funds rate will be over the next four calendar years, plus a longer-run estimate. With 19 FOMC members, the estimates can vary considerably, which is why investors tend to focus on the median forecast. As of September, the FOMC’s median Fed Funds forecast for year-end 2022 was 4.375%, which suggests the Fed could hike the rate by another 100 to 125 basis points by December from the current 3.25% top-end target.

With inflation still running hot, the Fed seems to have little choice. TThe September 2022 Consumer Price Index (CPI) reading was up 8.2% year-over-year, trending lower from its recent peak of 9.1% in June. However, core CPI (excluding food and energy) has gone the other direction and at +6.6% is at its highest level since the early 1980s. Regardless of how you parse the data in search of signs of cooling prices, inflation remains uncomfortably high. FOMC members have repeatedly tried to make it clear that they intend to tighten monetary policy until inflation is firmly under control, more or less regardless of the consequences. Federal Reserve Bank of New York President John Williams said recently that the Fed Funds target rate needs to rise to around 4.5% over time, adding “Right now the focus is getting inflation back down to 2%.”[5] Minneapolis Fed President Neel Kashkari thinks “we’re quite a ways from a pause,” with respect to the Fed halting its rate hiking campaign.[6]

Investors can’t seem to shake the idea that the Fed will ride to the rescue. This has not escaped the attention of the Fed. Kashkari tried injecting a dose of reality: “I fully expect there are going to be some losses and there are going to be some failures around the global economy as we transition to a higher interest rate environment, and that’s the nature of capitalism.”[5] The latest job markets data hasn’t particularly helped the case for those hoping the Fed will pivot and abandon its tough love stance. Nonfarm payrolls rose 263,000 in September, and the unemployment rate dropped back down to 3.5%, as low as it has been since the late 1960s. The labor force participation rate remains stuck in the low 62% territory, in part due to demographic forces, which has put upward pressure on wages. Although the Fed won’t outright say they are rooting for the job market to soften, these monthly readings remain a key input in their assessment of how monetary policy is playing out in real life.

> To paraphrase one of New Jersey’s famous bands, Bon Jovi, there remains a cohort of financial markets participants who are “Livin’ on a Prayer” that the Fed will bow to pressure and reverse course.

Bad News is Good News

To paraphrase one of New Jersey’s famous bands, Bon Jovi, there remains a cohort of financial markets participants who are “Livin’ on a Prayer” that the Fed will bow to pressure and reverse course. We see this dynamic almost daily in equity prices, which tend to trade higher on disappointing economic news. This counter-intuitive trading pattern has been in place for a long time now. Mixed economic data in the U.S. has cut both ways in recent weeks, muddling the picture for the Fed and investors alike. The Conference Board’s Leading Economic Index (LEI) fell for a sixth consecutive month in August, prompting the Conference Board to “project a recession in the coming quarters” with LEI’s six-month annualized growth rate down more than 5%—a level which has coincided with recessions in the past.[7] In the housing market, the S&P CoreLogic Case-Shiller 20-city Index fell 0.4% in July, amazingly its first decline since March 2012. Nonetheless, housing prices clearly remain elevated, despite the spike in mortgage rates. The average rate for a 30-year

4 *“Ben S. Bernanke,” www.federalreservehistory.org*
5 *“Fed’s Williams Sees Rates Heading to Around 4.5% Over Time,” www.bloomberg.com, 10/7/22*
6 *“Kashkari Says Fed Is ‘Quite a Ways Away’ From Pausing Rate Hike,” www.bloomberg.com, 10/6/22*
7 *“US Leading Indicators,” www.conference-board.org/topics/us-leading-indicators, 9/22/22*

Daily National Average Gasoline Prices from the American Automobile Association (AAA)

Source: American Automobile Association (AAA) for the period 9/30/2017 to 9/30/2022; data sourced 10/11/2022.

mortgage hit 6.7% near the end of the third quarter, its highest since 2007.

One source of short-term relief for consumers amidst this inflationary wave has been gasoline prices. The U.S. average price of regular gasoline peaked at $5.01/gallon in mid-June before easing to $3.80/gallon by quarter-end, softening for 14 straight weeks before a late September bounce. The Organization of the Petroleum Exporting Countries and its allies (OPEC+) responded by announcing in early October that they intend to cut crude production by two million barrels per day this fall. Whether this pushes gasoline prices back up remains to be seen. According to the American Automobile Association, gas prices may not be impacted due to the combination of OPEC+ members already struggling to meet production quotas, the potential for a recession to weigh on crude oil demand, and a seasonal decline in driving.[8]

Following two straight negative growth quarters for U.S. real Gross Domestic Product (GDP), it appears the third quarter may flip back to positive. The Federal Reserve Bank of Atlanta's GDPNow model estimate for Q3 real GDP growth was 2.7% as of October 7. Goldman Sachs chief economist Jan Hatzius boosted his estimate to 1.9% in early October, citing stronger than anticipated economic data. Goldman Sachs still assigns roughly a 35% probability of a recession for the U.S. economy over the next twelve months. Consumer spending is facing stiff inflationary headwinds, and a growing number of consumers seem to be turning to debt to finance their purchases. According to Federal Reserve data, total credit rose $32 billion in August from the prior month, including the third-largest monthly advance on record for revolving credit (including credit cards).[9]

From a big picture perspective, it doesn't appear anything existential has arisen yet to threaten financial stability, outside of the madness of Vladimir Putin. Instead, we continue to experience this painful process of normalization, in which interest rates have moved swiftly back toward historical average levels. Inflation remains a significant and thorny issue, and the battle to take it off boil has the potential to further devalue financial assets in the near-term. Markets have suffered through a fairly major valuation correction, but corporate earnings and employment have thus far remained stubbornly strong. Morgan Stanley equity strategist Michael Wilson said the light at the end of the tunnel is an earnings recession train the Fed can't stop.[10] A bit dramatic, perhaps, but macroeconomic conditions don't appear particularly favorable for a sustained rally in risky assets.

---

8 *"Gas Demand Spikes, Contributing To Rising Pump Prices," www.gasprices.aaa.com, 10/6/22*
9 *"US Consumer Borrowing Rises More Than Forecast on Credit Cards," www.bloomberg.com, 10/7/22*
10 *"Weekly Warm-up: The Light at the End of the Tunnel Is an Earnings Recession Train the Fed Can't Stop," Morgan Stanley Research, 10/3/22*

Q3 2022 World Events

WITH THE **S&P 500 Index** AS THE BACKDROP

Source: Bloomberg, Bailard. Past performance is no indication of future results. All investments involve the risk of loss.

Market Performance
As of September 30, 2022

U.S. Interest Rates	12/31/2021	3/31/2022	6/30/2022	9/30/2022
Cash Equivalents				
90-Day Treasury Bills	0.04%	0.50%	1.67%	3.27%
Federal Funds Target	0.25%	0.50%	1.75%	3.25%
Bank Prime Rate	3.25%	3.50%	4.75%	6.25%
Money Market Funds	0.01%	0.17%	1.37%	2.80%
Bonds				
10-Year U.S. Treasury	1.51%	2.34%	3.02%	3.83%
10-Year AA Municipal	1.14%	2.49%	2.85%	3.67%

Source: Bloomberg, L.P.

U.S. Bond Market Total Returns (US$) through 9/30/2022	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
Bloomberg Barclays U.S. Treasury Index	-4.35%	-7.96%	-13.09%	-12.94%
Bloomberg Barclays U.S. Corporate Index	-5.06%	-11.95%	-18.72%	-18.53%
Bloomberg Barclays U.S. Aggregate Index	-4.75%	-9.22%	-14.61%	-14.60%
Bloomberg Barclays U.S. 1-15 Municipal Blend Index	-2.58%	-4.09%	-9.21%	-8.87%

Source: Bloomberg, L.P.

Global Stock Market Total Returns (US$) through 9/30/2022	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
S&P 500 Index	-4.89%	-20.21%	-23.88%	-15.50%
Morningstar U.S. Small Value Index	-4.80%	-16.68%	-14.94%	-10.32%
Morningstar U.S. Small Growth Index	-2.49%	-24.34%	-34.46%	-34.89%
Morningstar U.S. Large Growth Index	-2.75%	-31.74%	-40.99%	-38.87%
Morningstar U.S. Large Value Index	-6.78%	-14.09%	-12.39%	-5.41%
International Stocks				
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	-9.36%	-22.51%	-27.09%	-25.13%
MSCI Emerging Markets, net dividends	-11.57%	-21.70%	-27.16%	-28.11%

Sources: Bloomberg, L.P. and Morningstar Direct

Alternatives (US$) through 9/30/2022	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	4.77%	9.77%	17.86%	27.25%
Gold Spot	-7.99%	-13.92%	-7.43%	-4.08%
WTI (West Texas Intermediate) Crude Oil	-24.84%	-20.73%	3.25%	5.94%

Sources: Bloomberg, the National Council of Real Estate Investment Fiduciaries
**Q3 2022 data not yet released. The third quarter return assumed to be same as the Q2 2022 return.*

Past performance is no indication of future results. All investments have the risk of loss.

DISCLOSURES

the 9:05 is produced by the Asset Management Group of Bailard, Inc. The information in this publication is based primarily on data available as of September 30, 2022 and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.

This publication has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or solicitation of an offer to buy any particular security, strategy, or investment product. It does not take into account the particular investment objectives, financial situations, or needs of individual clients. Any references to specific securities are included solely as general market commentary and were selected based on criteria unrelated to Bailard's portfolio recommendations or the past performance of any security held in any Bailard account. All investments have risks, including the risks that they can lose money and that the market value will fluctuate as the stock and bond markets fluctuate. Asset class specific risks include but are not limited to: 1) interest rate, credit, and liquidity risks (bonds); 2) style, size, and sector risks (U.S. stocks); 3) increased risk relative to U.S. stocks due to economic or political instability, differences in accounting principles, and fluctuating exchange rates – with heightened risk for emerging markets and even higher risks for frontier markets (international stocks); and 4) fluctuations in supply and demand, inexact valuations, and illiquidity (real estate). Biotech stocks are not suitable for all investors and are significantly riskier than the stock market for reasons including the higher risks of investing in newer, less well-financed companies as well as the potential for clinical failures, regulatory approval setbacks, commercialization problems, and loss of exclusivity/patent expiration. Certain countries (particularly emerging and frontier markets) can have higher transaction costs and greater illiquidity than the U.S. The volatility of real estate may be understated due to inexact and infrequent valuations. Real estate has significant risks and is not suitable for all investors. There is no guarantee that any investment strategy will achieve its objectives. Charts and performance information portrayed in this newsletter are not indicative of the past or future performance of any Bailard product, strategy, or account unless otherwise noted. Market index performance is presented on a total return basis (assuming reinvestment of dividends) unless otherwise noted. **Past performance is no guarantee of future results. All investments have the risk of loss.** This publication contains the current opinions of the authors and such opinions are subject to change without notice. Bailard cannot provide investment advice in any jurisdiction where it is prohibited from doing so.

the 9:05 is published four times a year by Bailard, Inc., 950 Tower Lane, Suite 1900, Foster City, California 94404-2131. (650) 571-5800. www.bailard.com. Publication dates vary depending upon the availability of critical data, but usually fall in the first month of each new quarter.

ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

BAILARD, INC. ASSET MANAGEMENT GROUP

Chief Investment Officer

Eric Leve, CFA

Global Economics and Fixed Income

Linda Beck, CFA
Senior Vice President
Director, Fixed Income

Jeremy Wager-Smith
Fixed Income Portfolio Associate

Domestic Equities

Sonya Mughal, CFA
Chief Executive Officer

Osman Akgun, PhD, CFA
Vice President, Domestic Equities

Eric Greco
Portfolio Associate

Joanne Howard, CFA
Senior Vice President

Chris Moshy
Senior Vice President, Equity Research

Thomas Mudge, III, CFA
Senior Vice President
Director, Domestic Equity Research

Dave Harrison Smith, CFA
Executive Vice President, Domestic Equities

Ryan Vasilik, CFA
Equity Analyst

International Equities

Peter Hill
Executive Chairman

Anthony Craddock
Senior Vice President
International Equity Research

Eric Leve, CFA
Executive Vice President
Chief Investment Officer

Dan McKellar, CFA
Senior Vice President, International Equities

Real Estate

Preston Sargent
Executive Vice President, Real Estate

David Abramson
Real Estate Analyst

Geoff Esmail
Real Estate Associate

Tess Gruenstein
Senior Vice President,
Acquisitions and Portfolio Management

Jamil Harkness
Research & Performance Associate

Daniel Merhi
Real Estate Analyst

James Pinkerton
Senior Vice President,
Acquisitions and Portfolio Management

Juan Rascon-Borgia
Real Estate Analyst

Alex Spotswood
Vice President,
Acquisitions and Portfolio Management

Sustainable, Responsible and Impact Investing

Blaine Townsend, CIMA®
Portfolio Manager
Director, Sustainable, Responsible and Impact Investing Group

McKenzie Fulkerson-Jones
ESG Analyst

Jon Manchester, CFA, CFP®
Chief Strategist, Wealth Management
Senior Vice President

Frank Marcoux, CFA
Portfolio Manager
Senior Vice President

Equity Analysis

Raj Dutta
Senior Data Engineer

Amit Valia, CFA
Vice President, Financial Data Management

Trading

Glenn Davis, CFA
Senior Vice President
Head Trader

Tom Sikora
Trader

Performance Analysis

Yuji Miwa
Performance Analyst

NEWSLETTER PRODUCTION

Eric Leve, CFA
Executive Vice President
Chief Investment Officer

Erin Randolph
Vice President
Marketing, Communications & Client Services

Debbie Tanguay
Senior Marketing Program Manager

Bailard

© 2022 BAILARD, INC. FOSTER CITY, CALIFORNIA

Printed on 100% postconsumer waste (pcw) fiber