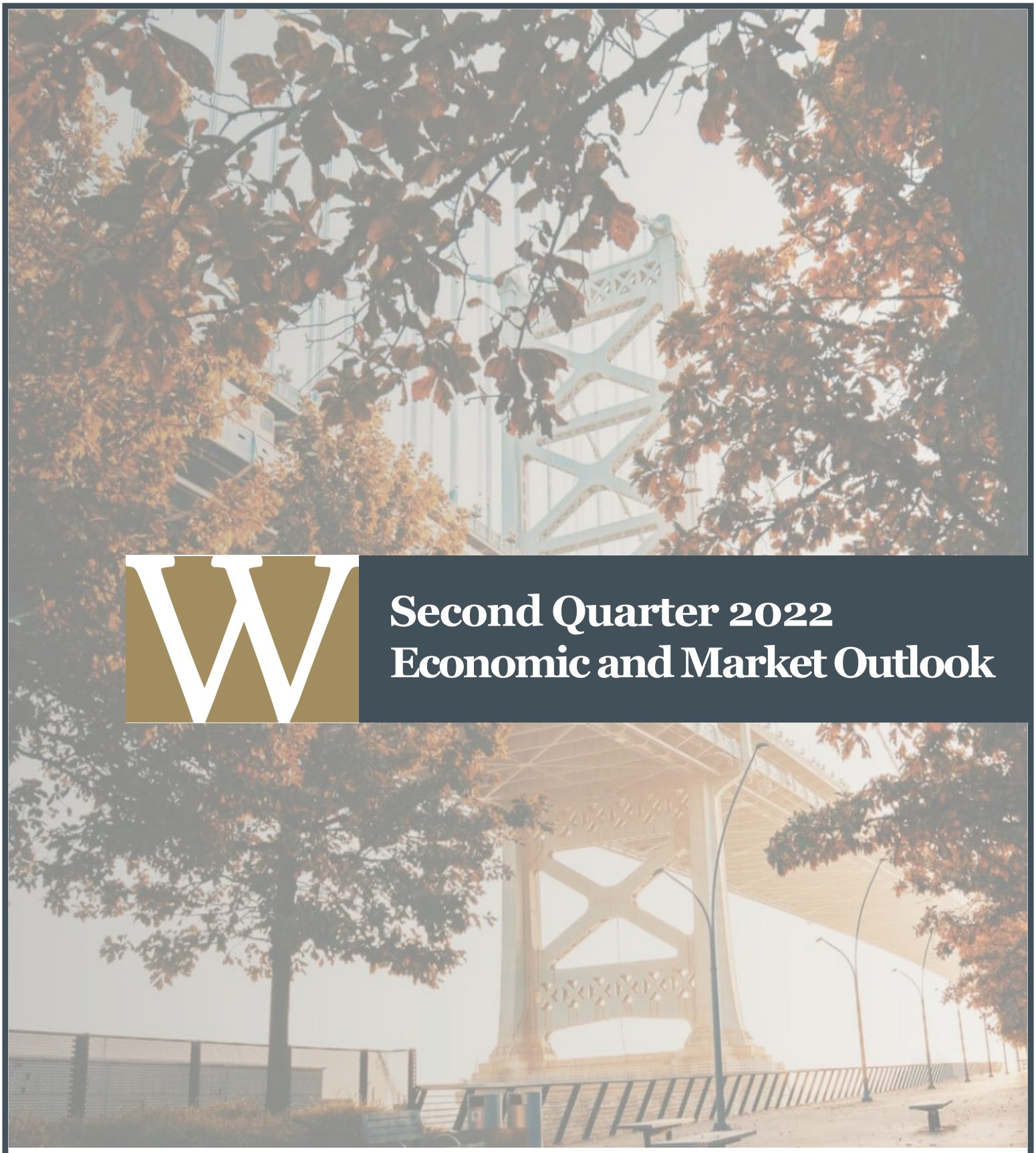

Second Quarter 2022 Economic and Market Outlook

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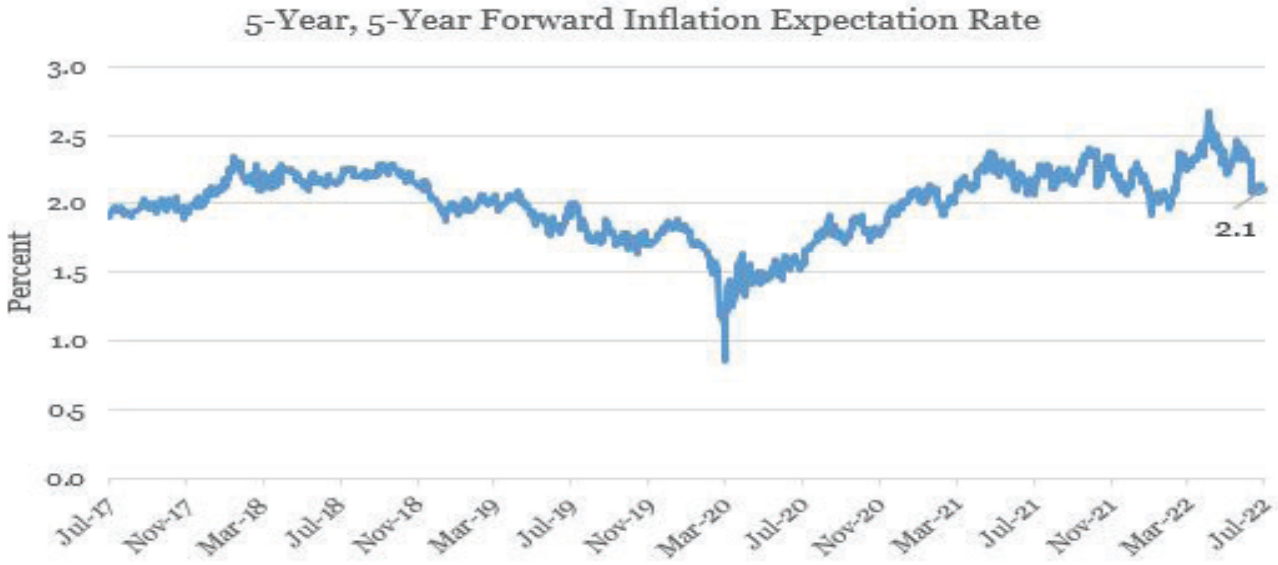
The post-pandemic economic recovery will continue to face inflationary headwinds until global supply and demand find an equilibrium. The expected shift in spending from durable goods to services, such as travel and leisure, is underway but lingering supply chain disruptions and the ongoing Russian/Ukrainian conflict has made the situation worse. This has forced the U.S. Federal Reserve and other Central Banks to aggressively raise rates in an effort to contain further price increases. These actions are designed to slow economic growth and have increased the odds of a global recession as a result.

As the global economy continues to emerge from the COVID-19 Pandemic, there are signs that the worst may be behind us. The virus and its variants are still present, but the consequences of infection for many have diminished. We see this as an important factor behind our view that the U.S. will avoid a severe recession despite the economic disruption and market volatility experienced so far this year. While U.S. GDP growth may be negative for two consecutive calendar quarters (a technical definition of recession), we expect that inflation will eventually ease from its highs, allowing consumer confidence and spending to rebound.

Peak Inflation for Now?

While inflation remains elevated, we note that prices for some of the key components of the headline Consumer Price Index, or CPI, have moderated. Oil prices peaked at over $123 per barrel in March, but have since fallen to below $100 per barrel as increased supply comes online. The national average price for regular gasoline, which reached $5.00 per gallon in June, has also come down from its highs and futures markets suggest that prices are likely to fall further. These and other commodity prices are beginning to roll over which is a good sign for the economy and the financial markets. In addition, both consumer-based and market-based measures of future inflation remain in check. One example of this is shown in the chart in **Figure 1**, which illustrates what expected inflation will be over the five-year period that begins five years from today.

Figure 1: Market-Based Inflation Expectations Remain In Check



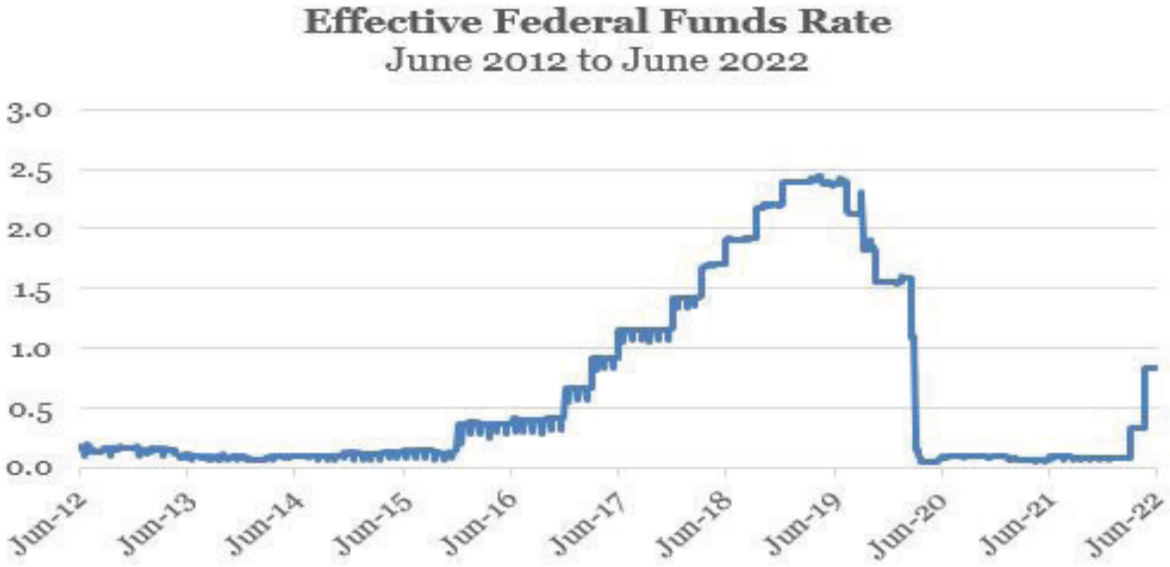
Source: Federal Reserve Bank of St. Louis, 5-Year, 5-Year Forward Inflation Expectation Rate [T5YIFR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T5YIFR, July 20, 2022.

The fact that this measure of expected inflation has come down from its high of 2.7% and is currently at 2.1% suggests that, while short-term inflation may be problematic, it is likely to come back down to a level well within the Federal Reserve's comfort zone in time. In addition to the market-based data shown in **Figure 1**, consumer expectations also remain anchored. According to the University of Michigan Survey of Consumers, which has provided valuable insights on spending and sentiment trends for over 75 years, long-term inflation expectations rose to a median of 3.3%. While this is modestly higher than in prior surveys, it is still much lower than current levels.

Inflation, Interest Rates and Valuations

While inflation rates will most likely decline from their current heightened levels in time, we do expect that future inflation will be modestly higher than it has been in the past. As a result, the era of zero interest rate policy is most likely over. The Fed began to normalize their monetary policy rate before the onset of the Pandemic, but had to cut rates quickly in light of the sharp fall-off in economic activity that followed as illustrated in **Figure 2**.

Figure 2: The Federal Reserve Begins to Normalize Monetary Policy (Again)



Source: Federal Reserve Bank of New York, Effective Federal Funds Rate [EFFR], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/EFFR, June 28, 2022.

With the most recent interest rate hikes by the Federal Reserve and more expected, the areas of the market that benefited most from this zero or low-interest rate environment have come under pressure. This includes the highly-valued tech sector in the U.S. as well as smaller, fast growing companies that could borrow cheaply to fund investment or grow via acquisition. When borrowing costs rise, the ability for these companies to keep up that pace becomes more difficult. As a result, earnings expectations have been revised down, driving price multiples lower for certain sectors and stocks.

A higher interest rate environment tends to lead to a re-rating of growth stocks and we are seeing evidence of this in both the large and small-cap sector of the public markets and in venture capital private equity markets as well. With the rate increases this year, some of the valuation froth is coming off those growth names. But we would differentiate the large-cap, high-quality growth companies that generated significant earnings throughout the pandemic from some of the more speculative names that have a long-duration nature to their earnings, and favor the higher-quality companies.

Figure 3: Stock Market Sell-Off Restores Some Value

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.94x	16.85x	-0.27
CAPE	Shiller's P/E	28.74x	28.01x	0.11
Div. Yield	Dividend yield	1.76%	1.99%	0.70
P/B	Price to book	3.36x	3.10x	0.32
P/CF	Price to cash flow	12.14x	11.16x	0.45
EY Spread	EY minus Baa yield	0.93%	0.22%	-0.36

Source: JP Morgan Guide to the Markets as of June 30, 2022 Past Performance is Not a Guarantee of Future Performance. Please see important disclosures at the end of this document.

The stock market tends to anticipate the future and prices move based on new information and changes in investor sentiment. The market sell-off in 2022 has been rapid and driven mainly by sentiment (i.e. price declines) rather than deteriorating fundamentals such as earnings. While modestly higher interest rates and inflation may in fact put pressure on corporate profits, we have not seen evidence of this yet. In fact, average earnings growth for the constituents of the large-cap index (S&P 500) is +6.7% through the first half of 2022. Going forward, we do expect earnings growth to slow given higher input costs, but we do not expect a severe earnings recession.

The fact that the S&P 500 Index fell by over 20% in the first half of 2022 and average earnings have increased modestly means that valuations at 15.9X are much more reasonable than they were in the midst of the pandemic. The chart in **Figure 6** shows the current valuation of the market index (based on forward price earnings ratios) is now below its 25-year average and has quickly returned to its pre-pandemic levels. While not cheap, the multiple contraction we have seen this year has brought the S&P 500 Index back to a more sensible level.

We are also seeing some value restored in the bond market. Treasuries, high-quality corporate bonds, mortgage-backed securities and even short-term money market funds are beginning to offer more attractive returns following many years where these bonds offered little to no yield. With risk-premiums restored, active fixed income investors have the opportunity to evaluate the risk and return trade-off in credit markets in an effort to add value. Balanced portfolios are now able to benefit from the higher income generation potential of the bond allocation.

Our Outlook

We argued in previous commentaries that challenges faced by the real economy in 2020 and 2021, burdened by COVID-19 restrictions, was out of synch with the record breaking strength of the U.S. stock market. We were concerned about the valuations in the growth market in particular and the impact that rising rates would have on those names. This disconnect was not sustainable in our view, especially because the market leaders were major beneficiaries of the accelerated move to online shopping and remote work.

In 2022, we are seeing a reversal of sorts, as the real economy recovers and the stock market gives back some of those gains. Now that the market has sold off, we are beginning to be interested in adding to our larger, higher-quality growth positions as part of our normal rebalancing process.

Wescott's portfolios are built to withstand market volatility. While market volatility cannot be avoided, it is important to remember that Wescott maintains a high-quality emphasis in stock and bond components of our balanced strategies.

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since June 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $235. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability. Guide to the Markets – U.S. Data are as of June 30, 2022.

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