**“What got you here, won’t get you there.”**
*– Marshall Goldsmith*

# 2022 Second Quarter Commentary

## ECONOMIC RECAP AND MARKET SUMMARY

Economic growth momentum rapidly eased during the quarter as inflation pressures weighed on both consumer sentiment and spending. As a result, inventory gluts made themselves more evident than we projected in our previous commentary. This was confirmed by disappointing earnings guidance and results from several major retailers during the period. While an inventory surplus may suggest the start of disinflationary dynamics across goods, we take a more cautious view on overall inflation. We would point out that inflationary risks did not subside as the latest May 2022 headline CPI print came in above expectations. The report revealed prices rising 8.6% from a year ago, notching in the fastest increase since December 1981. Unfortunately, the data also revealed that core inflation remained hot and that stickier measures of the CPI basket continued to rise. Such components include rent, insurance, medical services, and education, the prices of which are generally less volatile and less likely to roll back. Furthermore, the May 2022 US wage growth tracker revealed that wage inflation continued its trend higher, rising by 6% from a year ago. In summary, the inflationary transition continues from goods to services which will limit how quickly a downshift in inflation is reflected in the data.

We continue to find ourselves having to navigate an environment characterized by multiple challenges: a geopolitical conflict in Europe, a shortage in the world energy supply and an economic slowdown that is being engineered by central banks globally to combat inflation. This is all happening while consumer savings rates are falling, and credit card debt levels are rapidly increasing. Perhaps one of the few constructive economic data points was the unemployment rate which remained near historical lows at 3.6%. With that said, on balance, the data paints a sluggish growth trajectory for the second half of the year, and unfortunately, places us in what feels to be squarely in a stagflationary/recessionary backdrop. Over the last 18 months, our investment committee exercised a great deal of focus on pivoting portfolios for upside risks to inflation. Today, our objective is to prepare portfolios to endure a potentially longer-lasting slow growth period. The Fed has signaled to the market that it plans on tamping down inflation aggressively and that it will prioritize this objective over economic growth. (They are now in the hot seat, pun intended). Demand destruction should temper inflation, but also increase the unemployment situation. This cycle's end is nearing its conclusion in our view, and it is best to play defense today as assets continue to reprice for a transition of significant wealth destruction and higher capital costs.

### EXHIBIT 1

| Total Returns | 2Q 2022 | YTD 2022 |
|---|---|---|
| **US Fund Systematic Trend** | 5.43 | 16.25 |
| Bloomberg US Treasury 3-10 Yr TR USD | -2.48 | -7.73 |
| **US Fund Multistrategy** | -2.98 | -3.99 |
| Bloomberg US Agg Bond TR USD | -4.69 | -10.28 |
| Bloomberg Commodity TR USD | -5.66 | 16.55 |
| ICE BofA US High Yield TR USD | -9.97 | -12.88 |
| MSCI EM NR USD | -11.45 | -17.94 |
| iShares 20+ Year Treasury Bond ETF | -12.74 | -22.50 |
| S&P 500 TR USD | -16.10 | -17.45 |
| Russell 2000 TR USD | -17.20 | -20.65 |
| NASDAQ Composite TR USD | -22.28 | -25.42 |
| **Source: Morningstar, as of 6/30/2022** | | |

Second quarter performance across asset classes reflected this new reality. During the quarter, fixed income assets as measured by both Treasury bonds and the Bloomberg US Aggregate Bond Index delivered the least negative returns compared to all other major asset classes. Yet, it still yielded negative returns for the period given that inflationary pressures dominated market uncertainty. It was not until the last two weeks of the quarter did bonds find a bid as investors transitioned their focus toward growth concerns. Riskier asset classes like credit and equities experienced heavy selling during the quarter as both rising yields and earnings growth concerns sapped risk appetite from the market. As a result, commodities also fell in sympathy alongside other risk assets as demand destruction worried investors. Alternative strategies, as represented by the Morningstar US Fund Multi-strategy peer group (which serves as a general proxy for alternative strategies), have held up far better year to date against traditional stocks and bonds, and are down only -4% for 2022 through the second quarter. That said, we highlight that there are strategies that can do quite well in market regimes such as the one we are in today, as noted by Systematic Trend index returns. With the ability to go long and short, managers within this index delivered +5.43% for the second quarter and are meaningfully outperforming on a YTD basis with a +16.25% 2022 return for the first half of the year. We cover more in depth on why such strategies are attractive to own alongside traditional stocks and bonds in the "Alternatives" section below.

Inflation remains center stage in guiding the direction of asset markets. Going forward, we see financial assets continuing to reprice towards longer-term average multiples, and markets assigning stronger attention to underlying cash flows and realistic growth expectations. We would highlight that global corporations are combating three major systemic challenges:

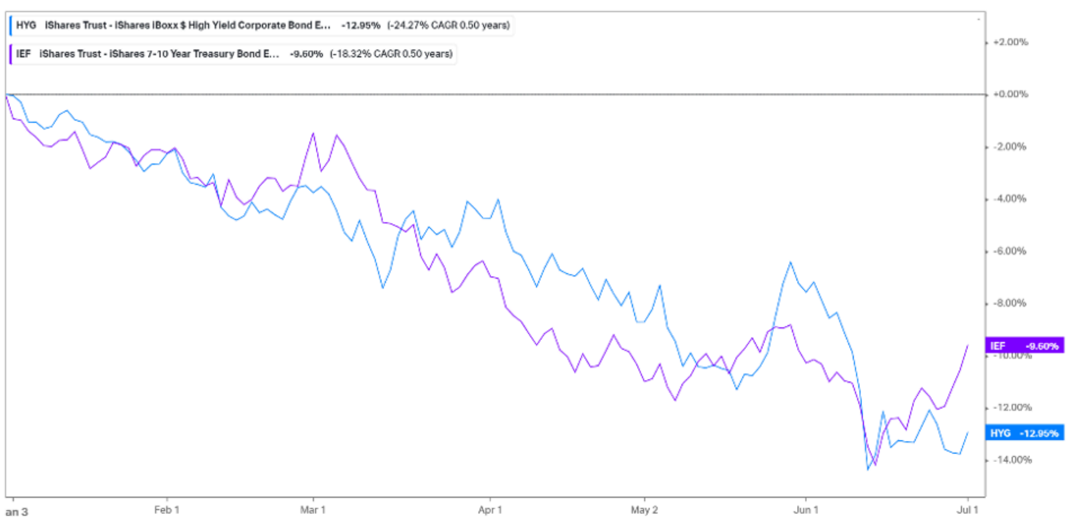
1. FAR HIGHER COSTS OF CAPITAL
2. STRUCTURALLY HIGHER INPUT COSTS FOR RAW MATERIALS
3. INCREASING WAGE GROWTH

While speculative bubbles may have popped, the capital reallocation process is still far from over given the difficult balancing act assigned to markets today. Below is our usual recap on various asset classes and commentary around how we look to navigate each asset class's unique challenges.

## FIXED INCOME AND CREDIT MARKETS

Fixed income markets faced another challenging quarter, as represented by the Bloomberg US Aggregate Bond Index, posting a -4.69% return during the period. Until the last two weeks of the quarter, fixed income investors who owned benchmark exposure gave up nearly five years of return in just over two quarters. The poor returns were largely a function of repricing for inflation surprises and a hawkish Fed. Corporate credit, as represented by the HYG ETF (junk bonds), also performed poorly during the quarter, posting a near -10% return for the period. Notable price action was on display during the last two weeks of the quarter when we began to see a striking divergence of return between credit (as represented by the HYG, a high yield bond ETF), and duration (as represented by the 7–10-year Treasury bond ETF); see exhibit 2.

### EXHIBIT 2




Source: Koyfin

YTD as of 6/30/2022, ETFs in the graphic are intended to illustrate bond and credit returns, and do not represent securities bought, sold or recommended by AlphaCore.

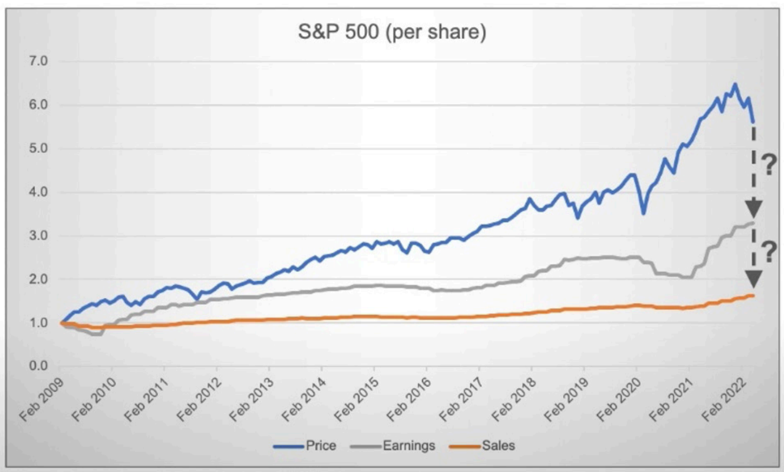
Recessionary fears took hold of the market during the back half of the quarter, and rising yields made a sharp U-turn as investors rushed into bonds to position for a global growth slowdown. This pricing suggests that the market hears the Fed's hawkish messaging and views that its tightening policies will likely result in a recession. An important question that remains is, "Just how high will the Fed take the Fed funds rate?" Currently, it sits below the neutral rate of 2% even after the +150bps of hiking seen year to date. This will largely be a function of the pace at which inflation recedes and ultimately the absolute level that inflation levels off to over the next several quarters. Many investors believe that the hikes that have already been priced into the bond market will be enough to cool down inflation to "acceptable" levels. Our positioning in portfolios continues to express our view that rates markets are still offsides on the inflation front-underappreciating structural forces that may keep inflation higher than the approximately 1.5-2% levels we have all experienced in the last decade. If inflation were to fall to 3-4%, we would argue the 10-year nominal bond yield would still need to reprice higher. In such a world, total return prospects from bonds still look unattractive—and while a recession may create a shorter-term rally in bonds, mechanically, they still look like an insurance policy rather than a compelling total return asset when one considers real yields and total returns in their allocation equation.

## EQUITIES

Equity returns during the period were deeply negative as represented by the S&P 500 Index, which posted a -16% decline. The Nasdaq 100 Index, which has served as this past cycle's market darling, delivered a -22% decline. The Nasdaq's steeper decline appears to be indicative of investors' reassessment of future growth expectations in a higher cost of capital world. This brings each index's YTD returns to -20% and -29%, respectively. Despite the strong US dollar all year, emerging market equities have held up better than US equities during the period.

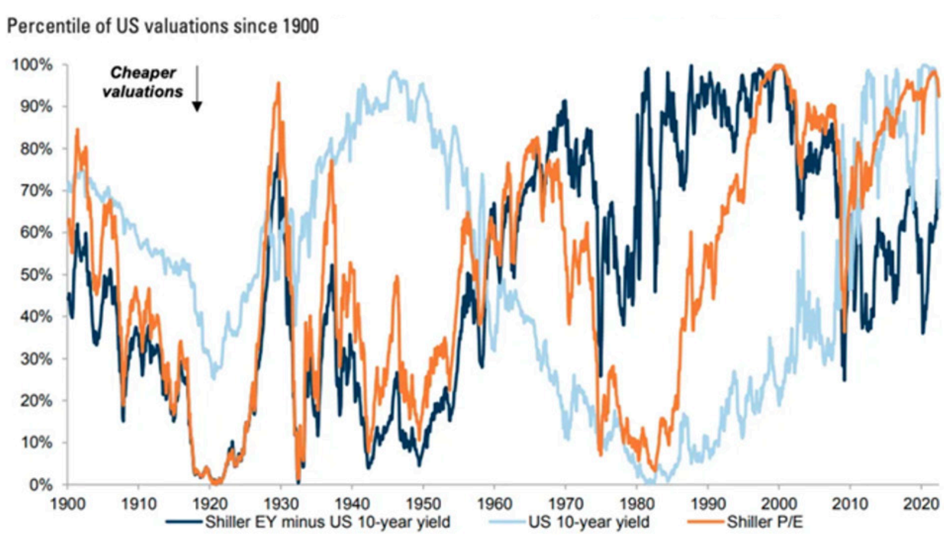
Equities today are certainly more attractive than they were six months ago, but we are not yet outright bullish. The following metrics should help provide the context behind our view. Since the great recession of 2008-2009, aggregate S&P 500 sales have increased roughly 1.5 times, met with a corresponding approximately 3 times in earnings, yet price more than 6xed as of April 2022; see exhibit 3.

EXHIBIT 3



Source: Bloomberg. Updated through 4/30/2022.

EXHIBIT 4




Source: Goldman Sachs

The sustainability of price appreciation/existing price multiples in our view is questionable, even from the lower levels that we find ourselves at today. If one subscribes to the idea that, over the long term, US corporate earnings growth is linked to US GDP output, then the current situation does not look good for equity returns going forward. Recall, long-term US real trend GDP tracks to something around 2% annualized growth. With S&P profit margins already having peaked in Q1 2022, we see few reasons to believe that the tapped-out US consumer has much ammunition left to keep earnings growth alive during this cycle. With the stimulus-led surge in spending now behind us, inflationary challenges remain, and recessionary hurdles are now front and center for the US economy. Corporate cost structures are drastically different, and we believe Wall Street and most investors are not pricing in a true earnings recession in the coming quarters. Overall, we believe it is more prudent to remain skeptical about the robustness of corporate profitability.

What to do in this environment? We advocate being more reliant on active approaches to investing. We believe that in the years ahead, capital access will be more challenging, and growing a business will now have a true economic cost associated with it. In this type of environment, we potentially see many unsustainable businesses going away. Avoiding such traps in one's portfolios will be key in generating strong returns. With that said, after the bursting of the first technology bubble, standout businesses surfaced from the wreckage. From these depressed levels, there will certainly emerge a new generation of winners (plenty had access to easy capital over the last cycle), and we feel confident several teams have built strong foundations for running robust and profitable businesses in the years to come. We believe investors will need an active compass more than ever to navigate this new regime in order to identify these new winners; partnering with skilled active stock pickers will lead to stronger risk-adjusted returns moving forward.

## ALTERNATIVES

After another volatile quarter for markets, we continue to rely on alternative portfolios to diversify traditional stock and bond exposure and provide the ballast that we need to repurpose capital for tomorrow. The changing financial market mechanics we have covered in our commentaries over the past year or so are not going to be, in our opinion, short-lived episodes like of the past. Rather, these appear to be longer-lasting structural changes.

On balance, our hedge fund portfolio outpaced both stocks and bonds again this period. Standout performers that produced positive absolute returns include a trend-following manager and an all-cap, value-biased, long-short equity manager. More underwhelming performance came from event-driven, convertible arbitrage, and credit-focused managers, yet they still outperformed traditional bond and credit markets for the period. Less eventful exposures were our line-up of multi-strategy, multi-manager hedge funds that generally were flat for the period.

With that said, alternatives are not immune from the business cycle. Private credit valuations saw modest repricing lower due to overall spread widening in the corporate credit markets. Given the changing interest rate environment, we fully expect both private real estate and private equity exposures to also reprice lower in the coming few quarters. Depending on the length and depth of an impending downturn, private assets too will likely deliver more muted returns going forward.

Where we remain most optimistic are alternative strategies that can go long and short assets. We emphasize trend-following/managed futures investing strategies in this type of high volatility regime, with the objective of generating positive absolute returns. Macro/managed futures strategies look to generate returns by taking long and short positions through futures contracts across commodity, currency, equity and fixed income markets. They are not only highly diversified from a cross-asset standpoint but are also highly diversified within each asset class given that they are able to go long and short various futures contracts at the sub-asset class level. For example, within commodities, a managed futures strategy may be long natural gas, but short cotton and wheat. In this way, they can be highly dynamic even within a single asset class and offer investors a differentiated risk exposure versus traditional stocks and bonds.

## CONCLUSION

The tightening cycle is now well underway. Central banks certainly could pivot from their hiking stance if financial conditions were to deteriorate too rapidly, but we are of the view that this will be a longer-term endeavor given inflation is much higher and unemployment much lower than past cycles. A new regime of tighter monetary policy will mean a much lengthier period of heightened volatility and presents a daunting situation for investors who have become used to the "everything rallies" mentality of the past. We continue to see a market environment characterized by both higher cross-asset and intra-market dispersion (i.e., between sectors and individual companies). We remain steadfast in our approach and will rely on our alternative toolbox even more in the years to come. In practice, this means investors first need to acknowledge this new reality. Doing so means departing from the old ways of allocating and looking to become more creative and willing to implement unconventional and contrarian investment strategies (i.e., refrain from the recency bias and de-emphasize backward-looking returns).

Admittedly, the counterargument to our approach to investing often cites a major human bias—the overextrapolation of recent shocks to the global system and their impacts on the market going forward—which we would say is a call to stay the course via the old 60/40 playbook. We couldn't disagree more with this idea. The refusal to acknowledge the failures of the financial excesses coming through the data highlights extreme complacency. Furthermore, not repositioning portfolios for major macro changes and trends could eat away at the prior wealth that was created during the last cycle. To look at the current liquidity-driven drawdown and call an "all clear" at this stage would be rather naïve in our opinion. We've operated in a world of free money for nearly 15 years, and during this period, almost every corporate earnings recession (aside from the localized energy sector recession) has been plugged with more and more money. Inflation is here, and consumers are in pain. Thinking that we have somehow mastered the business cycle to avoid recessions sounds all too similar to the external narratives that were being shared in the not-too-distant past defending all things technology/growth at any price. Inflation is very much the proof of this complacency at the macro level. We want to be prudent and valuation aware with our investment approach, and trust that you will be confident in our differentiated views over the coming years.

Please reach out to me or our advisors if you have any questions.

Best,

Johann Lee
*Director of Research*

• **BLOOMBERG BARCLAYS CAPITAL US AGGREGATE BOND INDEX:** The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.

• **ICE BOAML HY INDEX:** The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market.

• **RUSSELL 3000 INDEX:** The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

• **RUSSELL 2000 INDEX:** The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

• **MSCI ACWI (ALL COUNTRY WORLD) INDEX:** The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.

• **MSCI EMERGING MARKETS INDEX:** The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The index tracks mid-cap and large-cap stocks in 27 countries, dominated by Chinese, Taiwanese, and South Korean companies.

• **S&P 500 INDEX:** S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

• **NASDAQ 100 INDEX:** The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks.

- **PURCHASING MANAGERS' INDEX (PMI):** PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

- **ISM MANUFACTURING INDEX:** The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).

- **THE BLOOMBERG COMMODITY TOTAL RETURN INDEX:** The BCOM TR Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (3 Month) U.S. Treasury Bills.

- **CBOE VOLATILITY INDEX (VIX INDEX):** The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

## MORNINGSTAR CATEGORIES

**MORNINGSTAR MULTI-STRATEGY:** This is a Morningstar alternative strategy category. For a multi-asset strategy to qualify in an alternative category, greater than 30% of a strategy's gross exposure must be allocated to alternative substrategies. Alternative substrategies should provide an 'alternative' exposure to the dominant risk factors found in traditional indices, and as standalone strategies, would generally fall into one of the other Morningstar alternative categories: Equity Market Neutral, Event Driven, Macro Trading, Options Trading, Relative Value Arbitrage, and Systematic Trend.

**MORNINGSTAR SYSTEMATIC TREND:** This is a Morningstar alternative strategy category. Systematic trend funds mainly implement trend-following, price-momentum strategies by trading long and short liquid global futures, options, swaps, and foreign-exchange contracts. Strategies invest across geographies and assets, including equities, fixed income, commodities, currencies, and more.

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