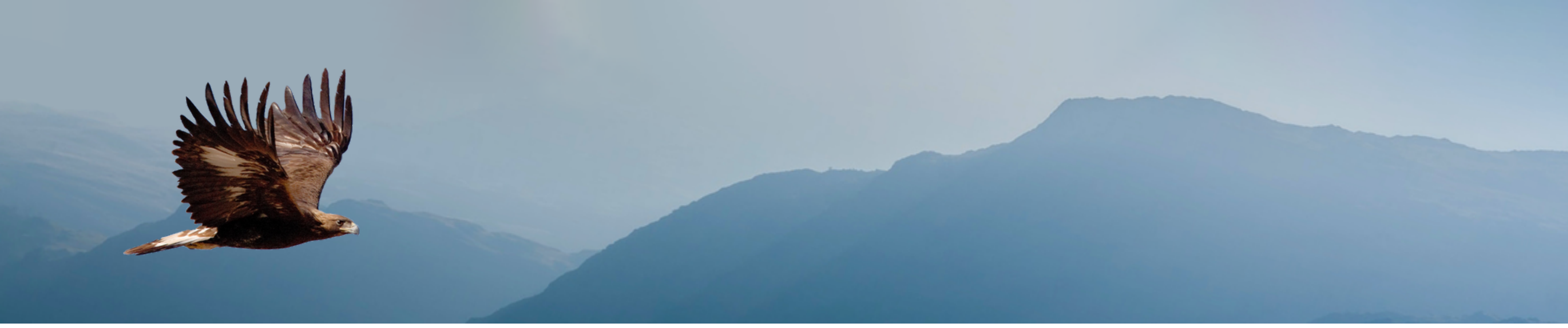

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B Capital Commentary and Outlook Update 3Q 2022

Over the summer the focus everywhere has been all about inflation and what central banks, especially in the US, will do to tame it. At the late September meeting, the Federal Open Market Committee (FOMC) raised the Fed Funds Target Rate by 75bps (3% - 3.25%). Although there had been some market discussion in the previous week about the possibility of a 100bps hike following a strong August core CPI reading, the Fed stayed with 75bps. This marks the third 75bps hike in as many meetings.

The Federal Reserve's "quantitative tightening" (as opposed to years of "QE") program should now start to approach the target of $95bn of balance sheet reduction per month, of which $60bn will be in Treasuries and $35bn in mortgage-backed securities (MBS). While the balance sheet declined very little over the summer, the impact of future reductions should start to become clearer within a few months as various reinvestment and trade settlement issues for MBS are resolved.

The Fed adjusted 2022 projected median core inflation up from 4.3% to 4.5%, while inflation forecasts for 2023 were adjusted higher from 2.6% to 2.8%. Importantly, the FOMC repeated its comments yet again that "inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures." The Committee also referenced the Ukraine conflict again stating that "the war and related events are creating additional upward pressure on inflation weighing on global economic activity."

The projected unemployment rate slightly increased from 3.7% to 3.8% for 2022, and from 3.9% to 4.4% for 2023. The eventual increase in the rate of employment losses going into the year-end will likely be a key factor in the Fed's calculus on when it will end its rate-hiking cycle, and perhaps temper the last rate cuts somewhat.

The projection for real GDP growth in the US sharply declined 1.7% to 0.2% in 2022 and also decreased from 1.7 to 1.2% for 2023. These are now much lower growth forecasts than a few months ago but given that they are still positive also indicates that the Fed will still try to maintain higher rate levels.

The FOMC statement also said again that it was "strongly committed to returning inflation to its 2% objective", keeping up the hawkish tone from the Jackson Hole speech. To many, this is the Fed now trying to catch up after waiting too long to start the return to higher rates and monetary tightening measures. The inflation genie is out of the bottle and it is going to be harder to contain because the Fed was slow off the blocks, but we think it is quite possible that peak inflation is around the corner. Markets have yet to be convinced and pessimism abounds.

Chairman Powell noted in his press conference after that: "price stability is the responsibility of the Federal Reserve and serves as the bedrock for our economy". Powell also said that "ongoing increases will be appropriate" in the policy rate, and that the Fed sought a return to "sufficiently restrictive" rates and keeping those rates restrictive "for some time", noting that the FOMC was split between 100 and 125bps in additional hikes for the year. A further key point that Powell made is that the labour market remains "out of balance", and that The Fed's tightening will bring "labour market pain."

Equities sold off after Chairman Powell's press conference ended. Yields at the front end have edged up, with the 2y Treasury now at 4.1%, while the 10y yield is at 3.60%. The curve is quickly becoming more and more inverted from the 2yr to the 10yr point, with inversion now at -44bps. This is the most inverted these yields have been since 2001. While the curve has been inverted since July, as recently as early September it was only inverted by 20bps, so this is fairly precipitous move. Historically every time this indicator has been so deeply inverted, a recession has occurred within 6-18 months. The re-rating of equities markets that has already happened in 2022 offers an argument that the likely recession is now already priced in.

Overall, the FOMC statement and dot plot projections were slightly more hawkish than expected by the market, especially given the new information that the Fed would try and keep Fed Funds above 4.5% for 2023. Chairman Powell's press conference did not deviate from the hawkish tone, where he said "we would want to be very confident" that inflation was moving back down to 2% before considering reducing rates. We can see now that the Fed will accept an economic slowdown, rising unemployment and a fall in US property prices in order to reverse the ascent of inflation and this hawkishness has depressed valuations, for now at least.

More economic sectors will likely follow housing going into 2023 and a recession, be it short and shallow or longer and deeper, now looks most likely around the turn of the year. Once again, we favour a mild recession outcome in the US but see a weaker picture for Europe thanks to energy supply issues linked to the ongoing war in Ukraine, and this dictates a heavier weighting to US stocks at this stage in the cycle.

Expectations for a more aggressive Fed in the face of lingering high prices is clearly a negative for future profits next year. Surging inventories reduce the need for new goods orders. A cooling job market will also pressure real demand. Even with inflation running higher than normal – which is supportive for nominal sales growth – falling volumes will pressure firms' profitability per unit.

The Fed likely will need to see some combination of decreasing inflation, increasing unemployment and sharp deceleration in other economic indicators (what the Fed calls "sub-trend growth") before it pauses in raising rates towards the new "terminal rate". Employment however is typically the last economic indicator to fall and is coincident with an actual onset of recession, so perhaps a decline in inflation and other slowing economic data may give the Fed some room to slow its hikes by the end of the year, though it probably will need to be accompanied by some amount of rising unemployment. Despite a recent swoon in economic indicators in the middle of the summer however, recent economic data in aggregate has been slightly better than expected if not particularly strong, so the precise timing for when this deceleration really begins is as yet unclear, which may lead to more volatile market ranges as investors react to each new economic data release.

With the now quite strong likelihood of a recession in the US and potentially deeper downturn in Europe one might be thinking about bailing out of stocks completely. That however can be a poor decision based on historic data and remembering that stocks are forward looking, often beyond the near-horizon. The question is how long a trough might last for and whether stocks will start to price in a recovery even as a recession becomes a fact. Looking back, data shows us that during pre-recessionary periods when the yield curve has been inverted, the US stock market has, on average, gone up by 3%. However, in the 6 and 12 months after a recession has begun, stock performance has been negative 5% and 3%, respectively, with a wide range of outcomes

Looking at the S&P500 Index as a major contributor to portfolio construction, we note the aggregate analysts' EPS forecast stands at $230 for the next 12 months. At the end of the quarter the price earnings ratio stands at 15.6X which means that the market is trading cheaper than historic multiples and either the earnings will come down from the current forecasts or the Index will rise to a typical forward-looking ratio nearer 18X. The aggregate earnings growth is forecast to be +12.68% with growth continuing beyond this at between 5% - 8%.

Earnings Estimates Overview

Measure	Actual	F12 Est	Growth	Y+1 Est	Growth	Y+2 Est	Growth
Earnings Per Share	203.95	229.81	12.68%	241.92	5.27%	262.87	8.66%
EPS Positive	209.19	229.97	9.94%	241.92	5.20%	262.87	8.66%
Cash Flow Per Share	289.56	337.19	16.45%	329.32	-2.34%	357.45	8.54%
Dividends Per Share	66.31	68.48	3.27%	69.71	1.79%	74.94	7.50%
Book Value Per Share	993.38	1056.57	6.36%	1169.32	10.67%	1297.20	10.94%
Sales Per Share	1655.09	1754.97	6.03%	1794.64	2.26%	1876.29	4.55%
EBITDA Per Share	337.08	380.21	12.80%	389.35	2.40%	412.90	6.05%
Long Term Growth	--	11.19%	--	--	--	--	--
Net Debt Per Share	409.04	457.55	11.86%	420.52	-8.09%	341.84	-18.71%
Enterprise Value Per Share	4115.82	4081.24	-0.84%	4044.22	-0.91%	3960.91	-2.06%

Fig 1 - S&P500 Index, Earnings Forecasts
***source: Bloomberg**

If earnings forecasts are to be believed, then the likelihood is that the equity market is undervalued, and equities will rise in the short term. If our view that peak inflation will be seen in the near term then it's also likely that the worries over climbing yields (and therefore borrowing costs) will lessen, which in turn will boost equities. It's not a prediction but the current levels for stocks look too pessimistic and some +10% revaluation upwards would be a good possibility. For this reason, we are keeping our allocation to equities and have confidence that the outcome as we head to year end will be better.

Fixed Income now needs more attention as yields have finally sprung back to interesting levels. Investment grade bond yields have moved higher almost entirely due to higher Treasury yields, as credit spreads after an initial jump have remained stable for most of the year. At over 5.25%, IG index yields now offer substantial compensation over longer-term inflation breakevens for investors.

In high yield, credit stress is much more apparent and will likely become more so if rates remain elevated and companies are forced to refinance at much higher yields. But other than certain highly-leveraged companies with challenged business models, most high yield issuers and sectors have continued to trade in line with index spread movements. HY spreads usually tightly correlate with equities during periods of stress, so lately index spreads have been trading near the top of their YTD range as equities remain on the defensive, but so far the market is not yet exhibiting major distress, especially in the “BB” rated portion of the index. The emerging market credit index spread is recently performing somewhat better than HY, as it combines a blend of investment grade and high yield issuers, and also is heavily weighted to countries with large commodity exports. These exports may in part explain the EM index outperformance even as the US Dollar climbs higher against major G-7 currencies.

We remain convinced that short-dated bonds of investment grade quality is the still right place to be and we have avoided the significant selloff in longer dated issues. The Global Aggregate bond index is down -16.5% year to date which is very challenging for long-only portfolio managers with a universe of equities and bonds to choose from. Normally one could rely on fixed income smoothing volatility and propping up sagging equity prices but this year both have been substantially negative. The 20-year bond index is down -30% year to date, which is an eye opener to duration risk and highlights the effect of the Fed's actions on the bond markets.

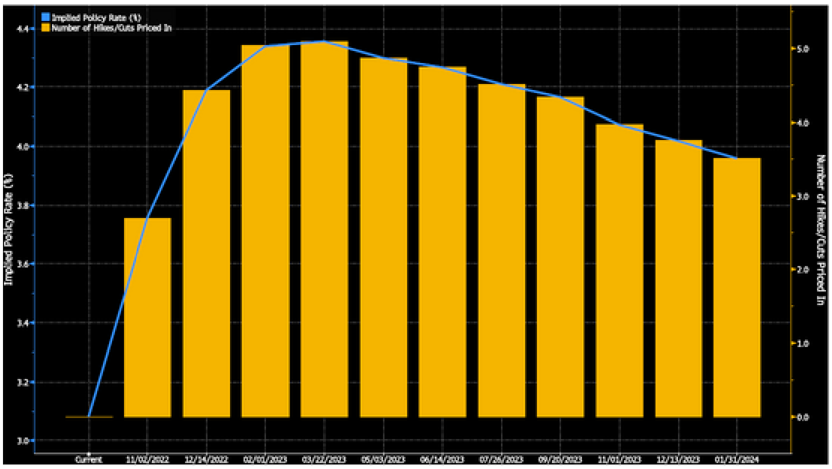

Fig 2 - US Interest Rate Expectations
***source: Bloomberg**

On 13 October 2022 the next CPI data will be released in the US and will give us a sense of whether the recent rather dramatic interest rate rises have started to cool inflation and to some extent may guide us to the rate rises ahead. It is likely that the hikes in the last quarter will be imposed so that inflation is properly checked and starts to head back towards the 2% target rate. We think however that this may take years to achieve and next year one should expect elevated inflation levels around 5%, which will mean that yields will remain higher than any time over the last decade. That is in our view a healthy state of affairs as savers and investors start receiving a fair return on deposits and bonds, companies that are growing and well-managed can pay higher borrowing costs but weaker firms that have relied on very cheap debt will disappear or be taken over. Start-ups with long periods to reach breakeven will have to think again as capital becomes dearer and across the board, and all companies will generally need to be leaner and more careful. This ultimately strengthens the economy and prepares balance sheets for any future headwinds. Higher yields also are a welcome addition to portfolios after a long absence.

Lorne Baring
Managing Director