Cliff Notes on the Economy

Economic Review & Outlook

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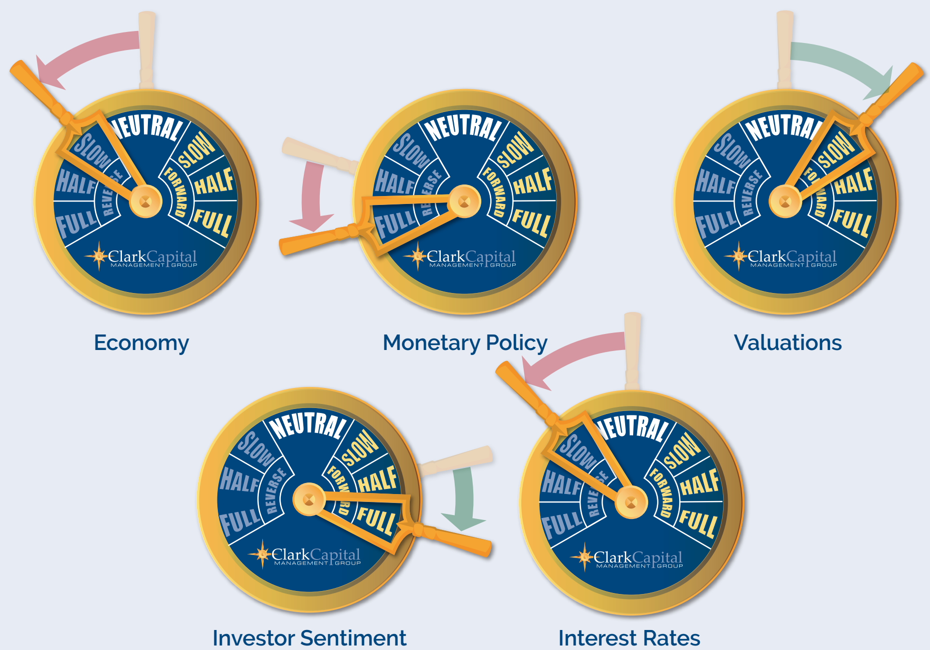
Third Quarter 2022

These five gauges drive our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative.

We believe that over the long term, stock prices are driven by two things, earnings and what people are willing to pay for those earnings. These gauges reflect our outlook for the five factors we believe drive stock prices. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, and anything to the left of 12:00 is negative.

The first three quarters of 2022 have proven to be challenging for both stock and bond investors. An aggressive Fed has resulted in slower economic growth and more volatile capital markets. Moving into the fourth quarter of 2022, we are adjusting all five gauges to reflect the current market environment. We are reducing the Economy Gauge one notch, putting it into the slow backward position as growth slows. The Monetary Policy gauge moves to full backward reflecting this very aggressive Fed rate-hike cycle. Equity market weakness allows us to put the Valuation gauge in a slow forward position as valuations have dropped sharply this year creating compelling opportunities. We are increasing the Investor Sentiment gauge by one step to the full forward position as pessimism and negative sentiment indicators mount. Finally, we bring the Interest Rate gauge back one notch to slow backward, reflecting rates moving higher in the third quarter along with elevated bond market volatility. Let's recap the gauges and review why we have them in their current positions.



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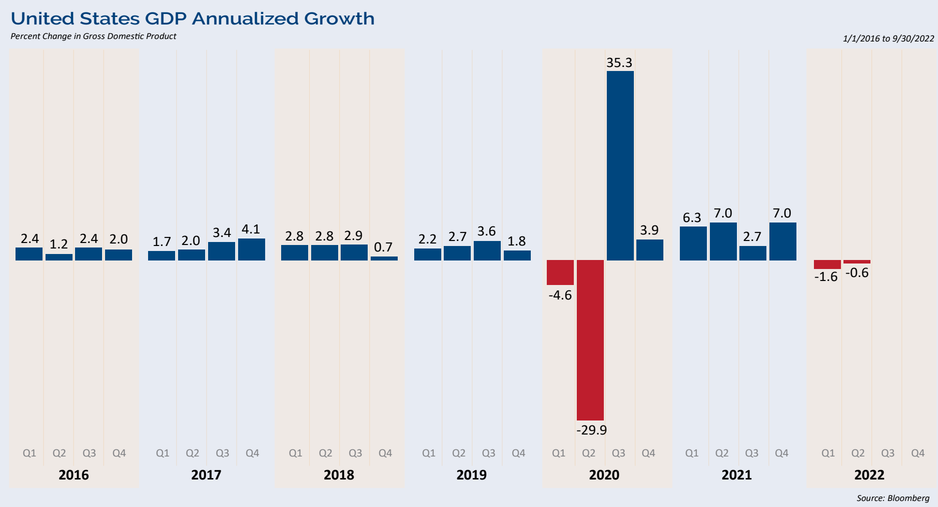
Economy

U.S. Economy

The first gauge covers the U.S. economy, and we move this back to a Slow Backward position. Consecutive back-to-back quarters of negative GDP in Q1 and Q2, along with declining PMI data compel us to move this gauge into negative territory. The National Bureau of Economic Research, the official recession watchdog, has not called a recession yet. We agree that we are not in a recession yet, but the odds of a mild recession are increasing with the Fed singularly focused on reining in inflation. It has raised interest rates and created tighter financial conditions in the economy, and this is a headwind to economic growth. The "V-shaped" recovery from 2021 has given way to a much slower growth environment and we believe we will move toward long-term trend growth of around 2%.



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The million-dollar question is how do we get to trend economic growth — via a soft landing engineered by the Fed or does the economy go through a mild recession? We believe the odds of a recession have increased through this aggressive rate-hike period with more rate hikes on the horizon. A soft landing is looking less likely, but we continue to believe that a mild economic recession has largely been priced into the stock market. One of the big shifts in 2022 has been the change in Fed policy as it began this rate hike cycle. Containing inflation has become the clear focus of the Fed and policy makers' talk has become increasingly hawkish since Powell kicked off the hawkish tone at the Jackson Hole Symposium in August. Ironically, as Fed talk becomes more hawkish and the market has been pricing in an increasingly aggressive Fed, there has been some initial progress made on inflation. For example, the Consumer Price Index reading for June hit 9.1% — the largest increase in prices in four decades. However, the last couple of readings have seen CPI move lower on a year-over-year basis.

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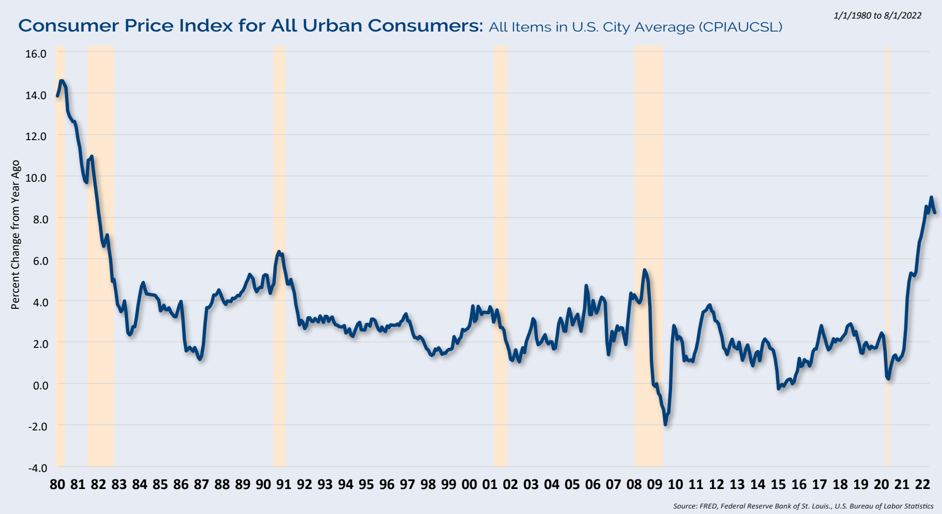

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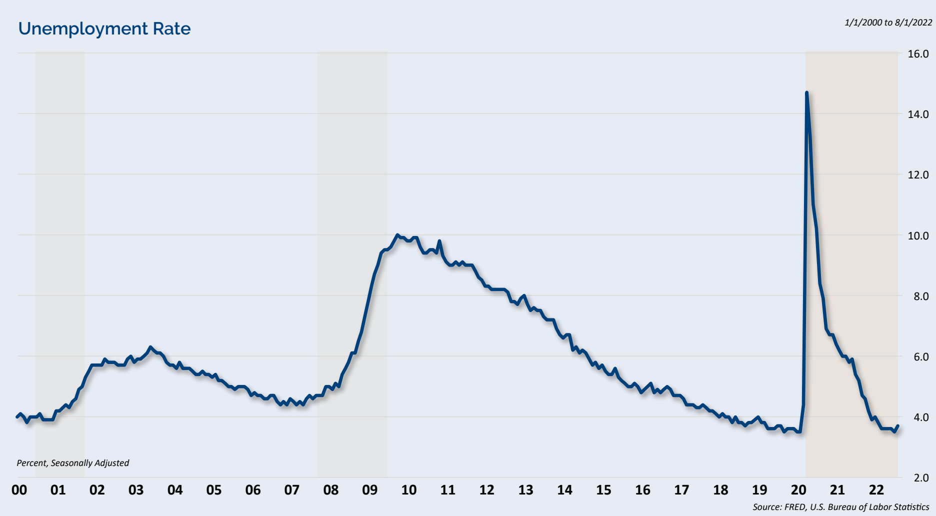
When the pandemic hit, the Fed was focused on the full employment side of its dual mandate as unemployment exploded to just below 15%. This focus came at the expense of its second mandate, price stability or inflation control. With the unemployment rate now at 3.7%, the Fed has steered its attention toward inflation. We stand at a point where there are millions more job openings (based on the JOLTS job opening report) than those seeking employment. This labor market strength is not typically a condition you see in a recession, and a primary reason we feel any contraction will be short and shallow. Importantly, while an economic recession is becoming more of a threat, earnings are holding up incredibly well. A decrease in the labor participation rate has not helped the situation, but that has improved from the lows following the pandemic. This mismatch in job openings and job seekers has driven wage levels higher, further exacerbating inflation concerns. The Fed clearly enjoyed success in getting Americans back to work following the shutdown of the economy in the spring of 2020, but distortions exist in the labor market that are still being worked out today. The Fed has also made clear that in order to curtail inflation, they are willing to let unemployment rise.



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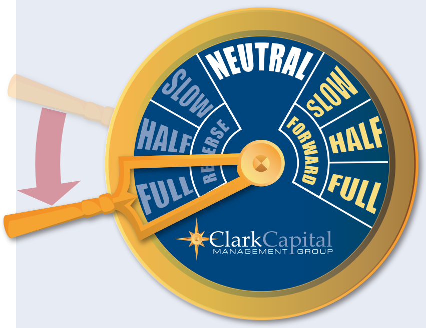
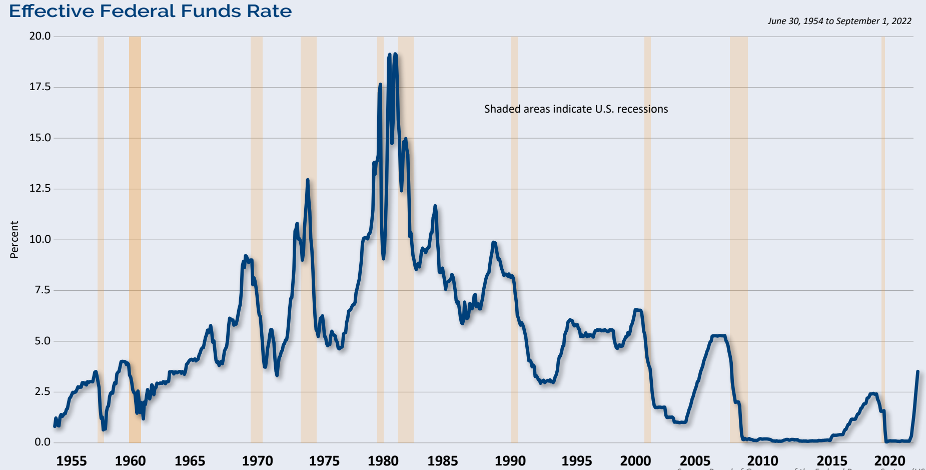


Monetary Policy

After a powerful economic rebound following the height of the pandemic, growth was expected to slow in 2022 and it has. Further exacerbating the naturally slowing economic growth has been a Fed that has embarked on an aggressive rate hike cycle. We recognize that the Fed raising rates will result in slower growth, and possibly a recession at some point. However, consumers, who represent about 70% of the US economy, have remained in good shape. Unemployment is currently low but it will likely drift higher as the Fed stays on the rate-hike course. Likewise, the housing market has started to see some initial weakening as mortgage rates went from under 3% to about 7% at its recent peak this year. Housing could start to slow more meaningfully in the months ahead. Inflation is still elevated and persistent, but some pricing data has started to show a move lower and if inflation continues to cool, it could lead to a Fed that can rein in its current aggressive monetary stance.

Monetary Policy

Effective Federal Funds Rate



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The aggressive rate hike cycle is in full swing, and we therefore move the Monetary Policy gauge to a Full Backward position. In a little over six months, the Fed has raised rates by 300 basis points. More rates hikes are expected in the fourth quarter of 2022 and into early 2023. The market seems to have been pricing in this aggressive rate hike cycle since about midway through the third quarter as equities and bonds turned lower and put in new lows to close out September. The hoped for "Fed pivot" looked less likely to materialize following comments from Powell and the market now expects an aggressive Fed in the near term.

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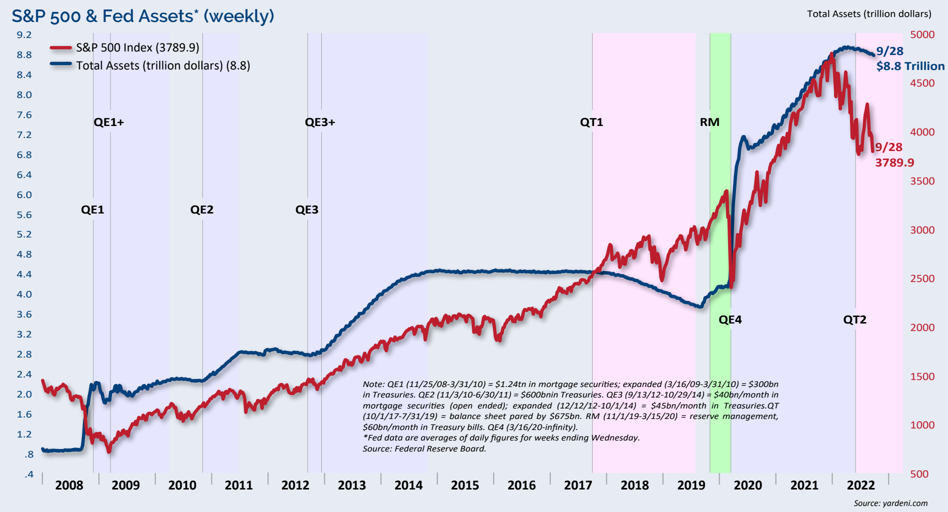

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In addition to rate hikes, the Fed is also starting to reduce the size of its balance sheet, which is known as quantitative tightening. The balance sheet, which stood below $4T prior to the pandemic, expanded to nearly $9T driven by the Fed's actions during that period. This clearly aided the economy and capital markets to get back on track including significant improvement in the job market. Clearly, as the Fed has raised rates and started to reduce its balance sheet, the market has been adjusting to this more restrictive monetary stance and resulting more expensive capital.

Due in part to these changes in Fed policy, the market environment will likely remain volatile as we have seen thus far in 2022. We know that one of the primary tools to deal with inflation is raising interest rates, which is having a negative impact on economic growth as well as creating tighter financial conditions. The challenging balancing act the Fed is trying to engineer, slowing inflation but not pushing the economy into a recession, is a lofty goal. However, the Fed has acknowledged that it is willing to see a recession to achieve its goal of bringing down inflation. The market and the economy will likely continue to face more volatility as this tightening cycle progresses, but we do believe we are closer to the end of this cycle than the beginning as we move into the fourth quarter. Historically, both stocks and bonds have hit their lows in prior rate hike cycles well before the Fed was done raising rates.

As the Fed raises rates, it has the impact of flattening the yield curve as well. Since the late 1960s, every recession the U.S. economy has gone through has been preceded by an inverted yield curve. For the record, we have had two inverted yield curves that did not lead to a recession. This year, parts of the yield curve inverted (primarily 2-year and 10-year Treasuries), but the measure we look at, the 3-month T-bill compared to the 10-year U.S. Treasury, has stayed in positively sloped territory. We will watch closely how rate hikes affect this relationship, but even once the yield curve goes inverted, there is usually a lag before the economy goes into a recession.

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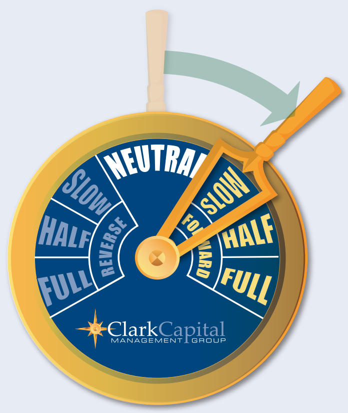
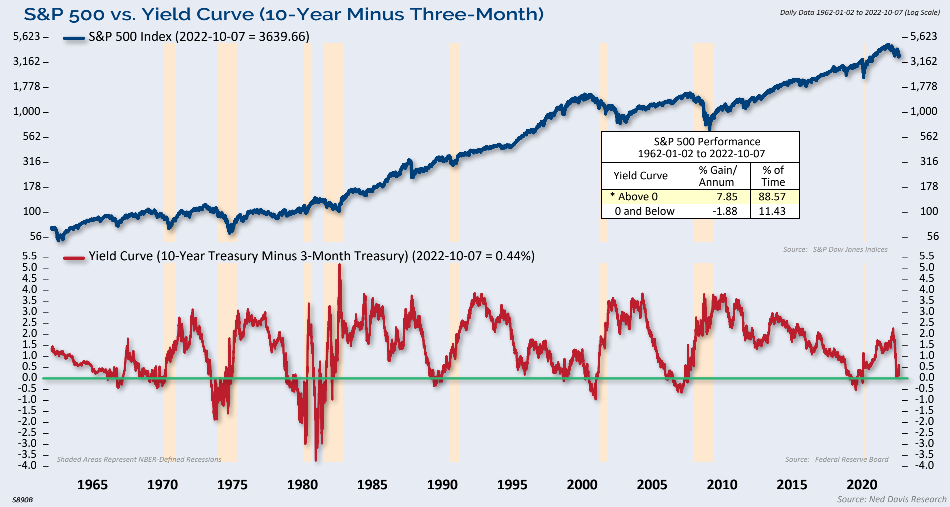


Valuations



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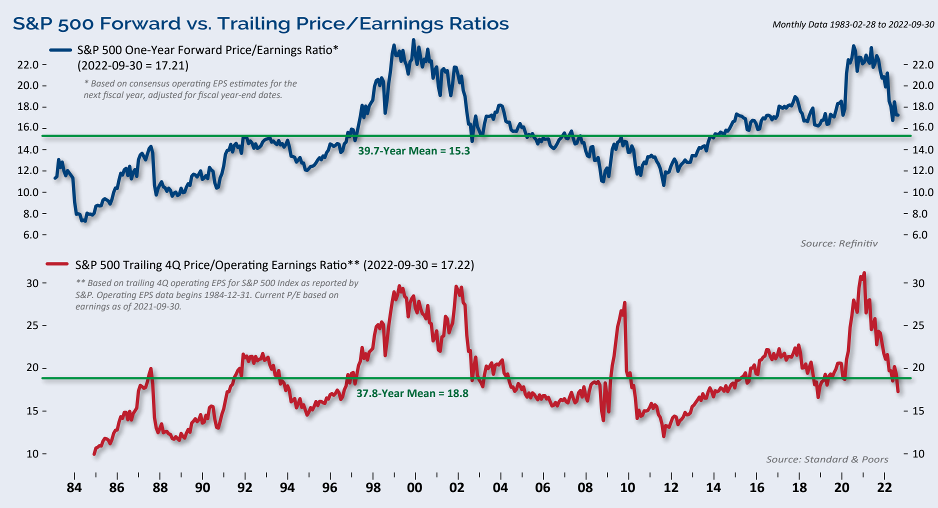
Valuations

The price to earnings or P/E ratio of the S&P 500 rose close to its highest level in about 20 years during the period following the market low in March 2020. However, as equity markets have declined this year and earnings have remained solid, valuations have improved. For the first time in a couple of years, we move the Valuation Gauge into positive territory in a Slow Forward position.



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Earnings revisions in recent months have brought down growth expectations for 2022 and they are currently showing no expected growth. Earnings are still expected to grow in 2023 and it does not appear we are facing an "earnings recession" at this point. It is likely that earnings estimates will be revised lower in the months ahead, although, one could argue the market is pricing in a more significant drop in earnings at this point. We will keep a close eye on those developments.

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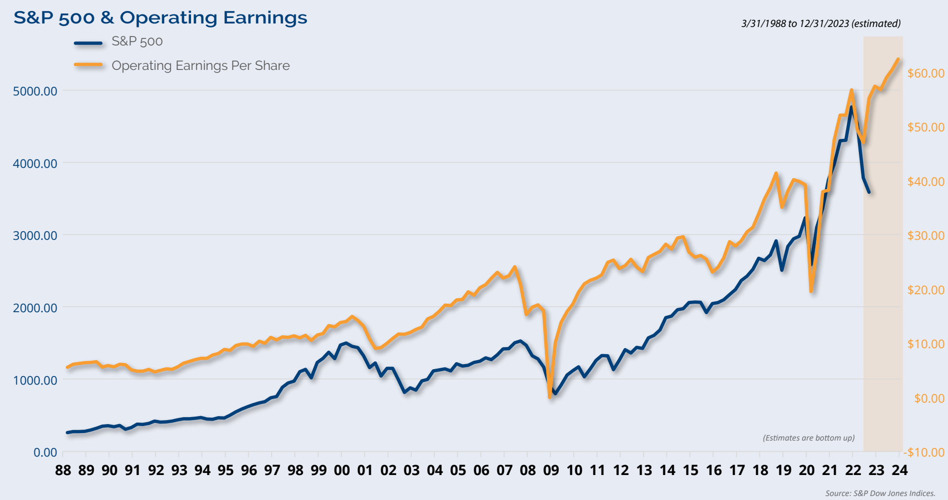

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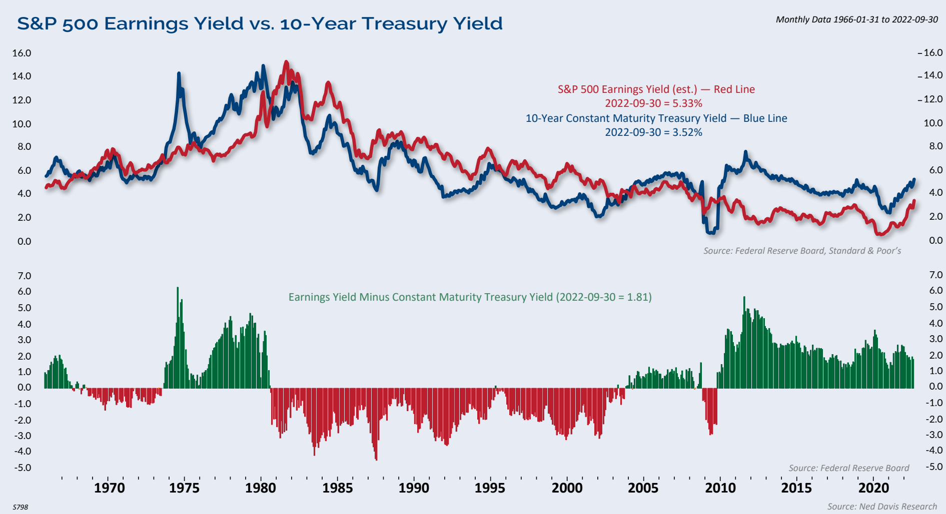
Low interest rates tend to drive stock valuations higher, and as rates have moved up in 2022, it is natural to see stock valuations come down. This has been particularly true for growth stocks, which are more interest rate sensitive, as growth stocks have struggled more dramatically than value stocks in 2022. From a longer-term perspective, rates are still at relatively low levels. We compare the earnings yield of the S&P 500 (which is the inverse of the P/E ratio) to the yield on the 10-year Treasury and it shows on a relative basis, stocks are still more attractive than bonds, but that differential has declined so far this year.



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We moved this gauge into the Slow Forward position because stock valuations have improved in 2022 and are reasonable given the current level of interest rates. As an active manager, we look at valuations on a company-by-company basis. The recent market volatility has provided us at Clark Capital an opportunity to seek out what we believe to be high quality companies at good prices and we continue to make very purposeful investments in both stocks and bonds.

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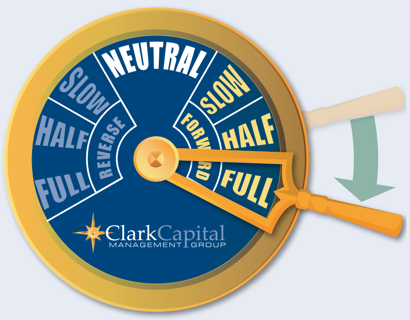


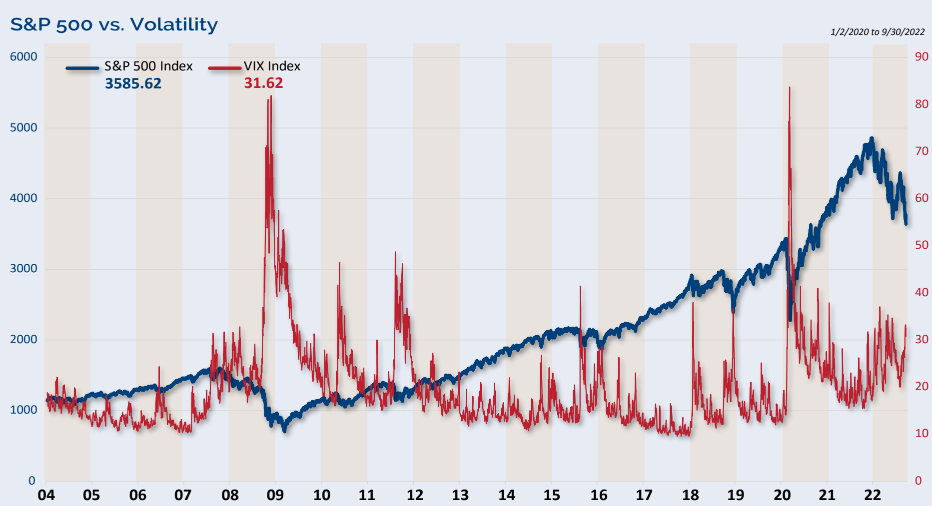
Investor Sentiment

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation or pessimism in the market. Recall, this gauge is a contrarian indicator, so extreme pessimism is a positive from a market perspective and extreme optimism is just the opposite. With that in mind, we move this measure into the Full Forward position as investors became more pessimistic and fearful moving through the third quarter as stocks hit a new low for the year.

Keep in mind, this gauge is very sensitive and can change quickly. However, as we moved through the third quarter, we saw the AAII hit its fourth lowest bullish sentiment indicator on record and the Investor's Intelligence reading shows more bears than bulls, which is rare. Ned Davis Research shows trading and crowd sentiment readings in very pessimistic territory as well. On top of this data, weakness in the stock market, inflation coming off generational highs and higher mortgage costs have led to consumers becoming more and more pessimistic. For example, the widely followed University of Michigan Consumer Confidence measure hit an all-time low in June.

Another important indicator, which we discuss often as a measure of fear in the market, is the CBOE Volatility Index or VIX Index. Volatility has been much higher in 2022 compared to 2021 and the historical average. In the middle of August, the VIX Index fell below 20 for the first time since April as stocks rallied. However, as concerns about a more hawkish Fed grew, stocks declined, yields soared, and the VIX rose higher. By the end of the third quarter, the VIX was above 30, at a similar level seen at the prior 2022 stock market lows in mid-June. Remember, as a contrarian indicator, the higher the VIX the more positive it is for the market as complacency has been replaced with some healthy market skepticism.



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Based on the cumulative data we analyze for investor sentiment, we believe we are seeing some extreme levels of pessimism. Therefore, we believe it is appropriate to move this gauge to the Full Forward position. We had been anticipating a more volatile 2022. The S&P 500 hit a 20% correction in mid-June, rebounded nicely, but moved lower once again in the third quarter hitting a new 2022 low. We continue to

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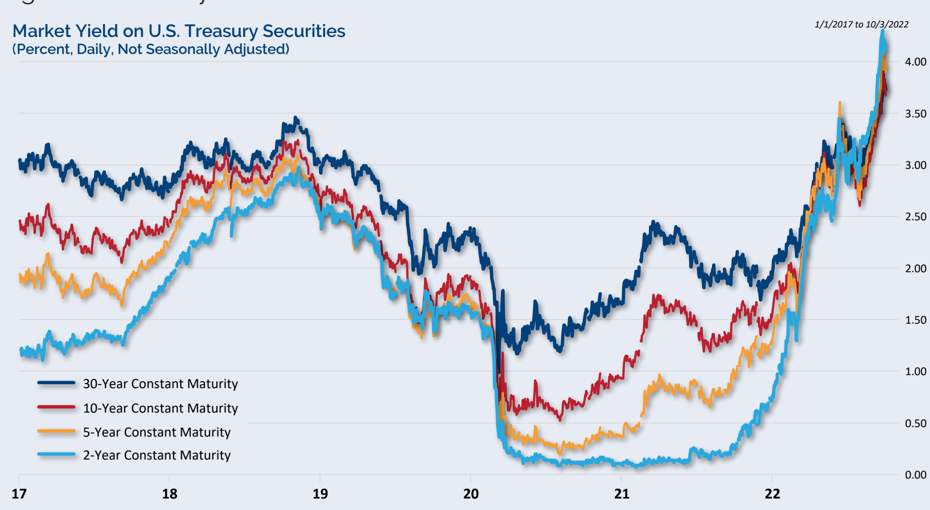
Interest Rates

believe it is important for investors to be prepared for volatility to remain elevated moving into the fourth quarter of 2022 as the Fed continues to raise rates, and by the way, midterm elections loom. As the market and the economy are dealing with much tighter financial conditions in 2022 driven by the Fed, elevated volatility should be expected. Seasonally, both from a calendar and mid-term election cycle basis, stocks should be entering a strong period as we move through the fourth quarter and into next year.

Interest Rates

Interest rates are the final gauge, and we move this to the Slow Backward position. As we have already discussed, the Fed has been engaged in restrictive monetary policy in 2022. Yields have shifted higher across the yield curve with new highs reached in the third quarter. For example, the 10-year rate rose just above 4% intraday in September, before moving modestly lower to close out the quarter at 3.83%. Recall, the 10-year had closed 2021 at 1.52% and ended the second quarter at 2.98%. Some yield moves on the front end of the curve are even more dramatic. For example, the yield on the 3-month T-bill closed 2021 at 0.06%, but it increased to 3.33% to end September. The 2-year yield, which has been looked at closely this year, ended the second quarter at 2.92% but rose to 4.22% by the end of third quarter. Once the Fed begins to raise interest rates, we typically see a flattening of the yield curve with short-term rates rising more rapidly than long-term rates. While the front end has seen a dramatic move higher, longer rates have moved up as well as there has been a shift higher across the yield curve in 2022.



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Overall, interest rates are still in a lower range from a historical perspective. However, the move higher in 2022 has been dramatic and is now impacting the broader economy. One clear example is the extreme rise in mortgage rates, which have more than doubled so far this year. Higher rates across the yield curve and continued rate increases by the Fed are expected for the foreseeable future. This leads us to move this gauge to the Slow Backward position. We do think the move higher in rates in 2022 has run its course and we expect the 10-year yield to move lower over the balance of the year. Remember that as the yield curve ultimately flattens, it is a less positive signal for stocks and provides unique opportunities for active bond management. Although this has been a historically challenging nine months for bond investors, it has also presented opportunities in the bond market (with higher yields and coupons) that we have not seen in some time. We believe we are positioned well at Clark Capital to navigate through this more dynamic time in the bond market.

Conclusion

We know these are challenging times in both the stock and bond market. The aggressive policy stance by the Fed is forcing slower economic growth and a more difficult environment for corporations and their earnings. The strong economic rebound we enjoyed post-COVID also led to inflation surging to multi-decade highs. The Fed is determined to bring down inflation even at the cost of higher unemployment and a potential recession. In this climate, we believe there will be volatility from both an economic and stock market perspective, but we think ultimately the fundamentals of the economy and high-quality companies are still solid. We also believe we are in the later innings of this rate hike cycle and the Fed will get to a point where they slow, and ultimately stop, raising rates. Investors have endured a challenging year, but we believe it will give way to a better market backdrop in 2023. We continue to urge clients to stick to their financial plans and not make decisions based on short-term movements in the market.

Please contact your Client Portfolio Management Team or your Investment Consultant to discuss how we can help you during this challenging time. We are here to support you and your clients in any way we can.

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Investing involves risk, including possible loss of principal. The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

Equity securities are subject to price fluctuation and possible loss of principal. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices. Certain investment strategies tend to increase the total risk of an investment (relative to the broader market). Strategies that concentrate their investments in limited sectors are more vulnerable to adverse market, economic, regulatory, political, or other developments affecting those sectors.

The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

The 3 Month Treasury Bill Rate is the yield received for investing in a government issued treasury security that has a

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maturity of 3 months. The 3 month treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

The VIX Index is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

The 10-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 years.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities

The price-earnings ratio, also known as P/E ratio, P/E, or PER, is the ratio of a company's share price to the company's earnings per share.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

The University of Michigan Consumer Confidence Index reflects a monthly telephone survey of 500 or so US households. The survey consists of two components: sentiment (40% of the index) and expectations (60%). Participants are asked about the current economic climate, where they think the economy as a whole is heading, and what they think about their personal financial situation.

The 2 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 2 years. The 2 year treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

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