NewEdge WEALTH®

August Market Update

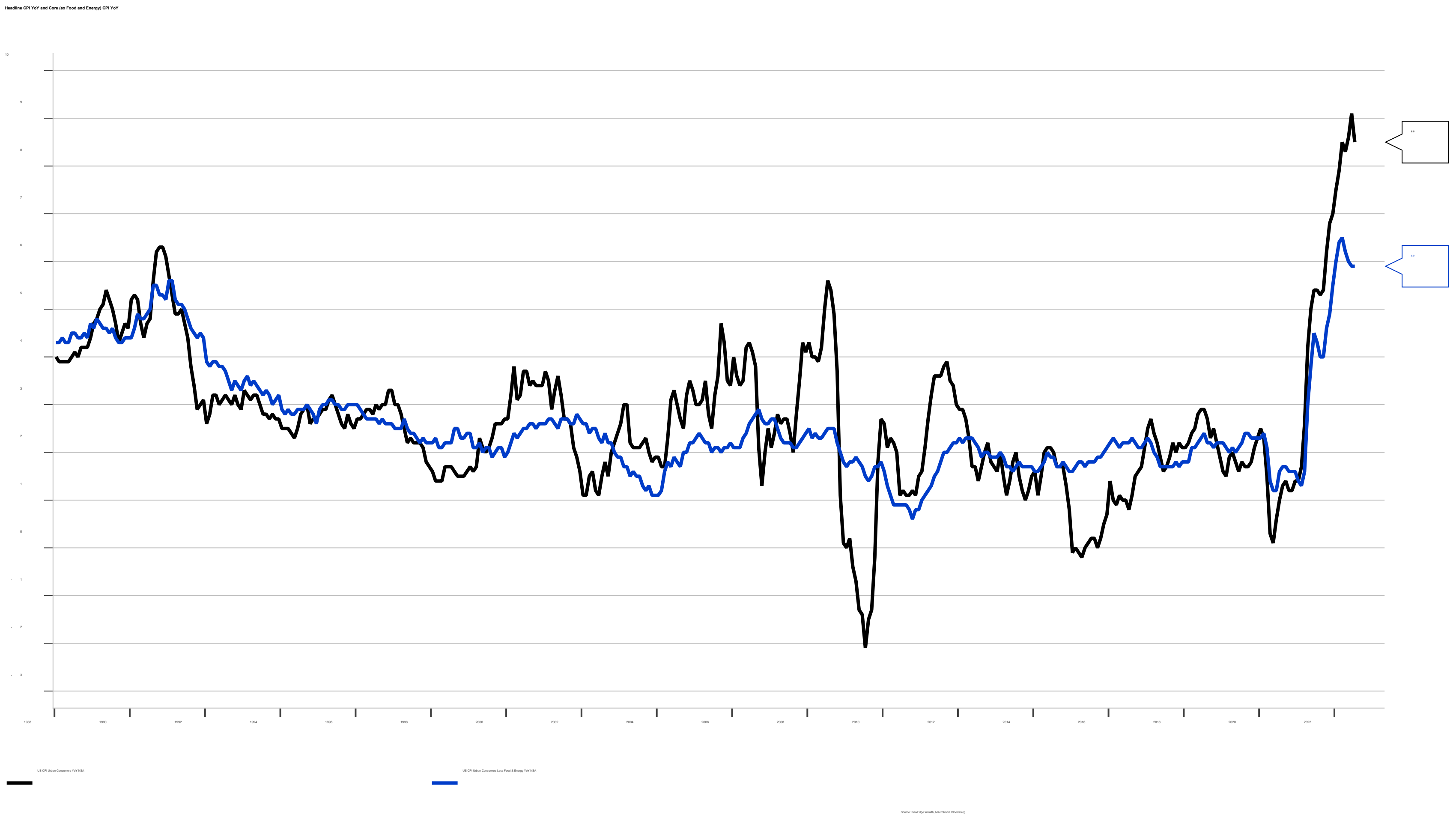
August 10, 2022

CAMERON DAWSON, CFA®
CHIEF INVESTMENT OFFICER

Peak Hour:

Is the inflation peak finally here?

Peak Hour: Headline Inflation Moderates in July



As of: 8/10/22

Finally, the much longed for peak in headline inflation emerged in the July CPI data, which fell to a still-blistering 8.5% YoY from 9.1% in June.

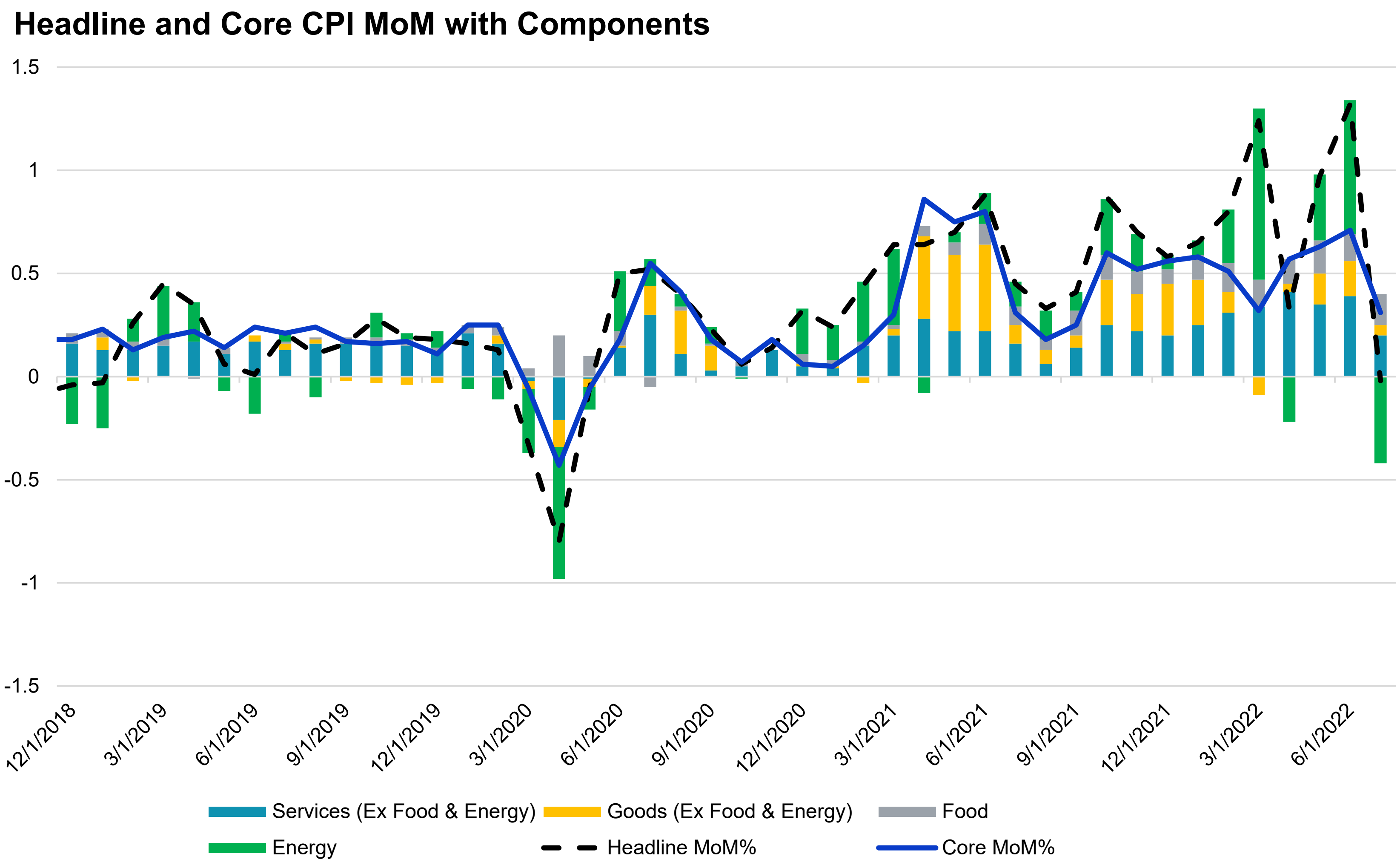
Core inflation (ex food and energy) was flat vs. June at 5.9%.

Both of these measures remain well above the Fed's 2% target and likely do not represent "clear and convincing" evidence of inflation moderation.

All that is wrong
No time to be won
Only to do
What can be done
Peak hour!

-The Moody Blues

No Acceleration in Inflation in July



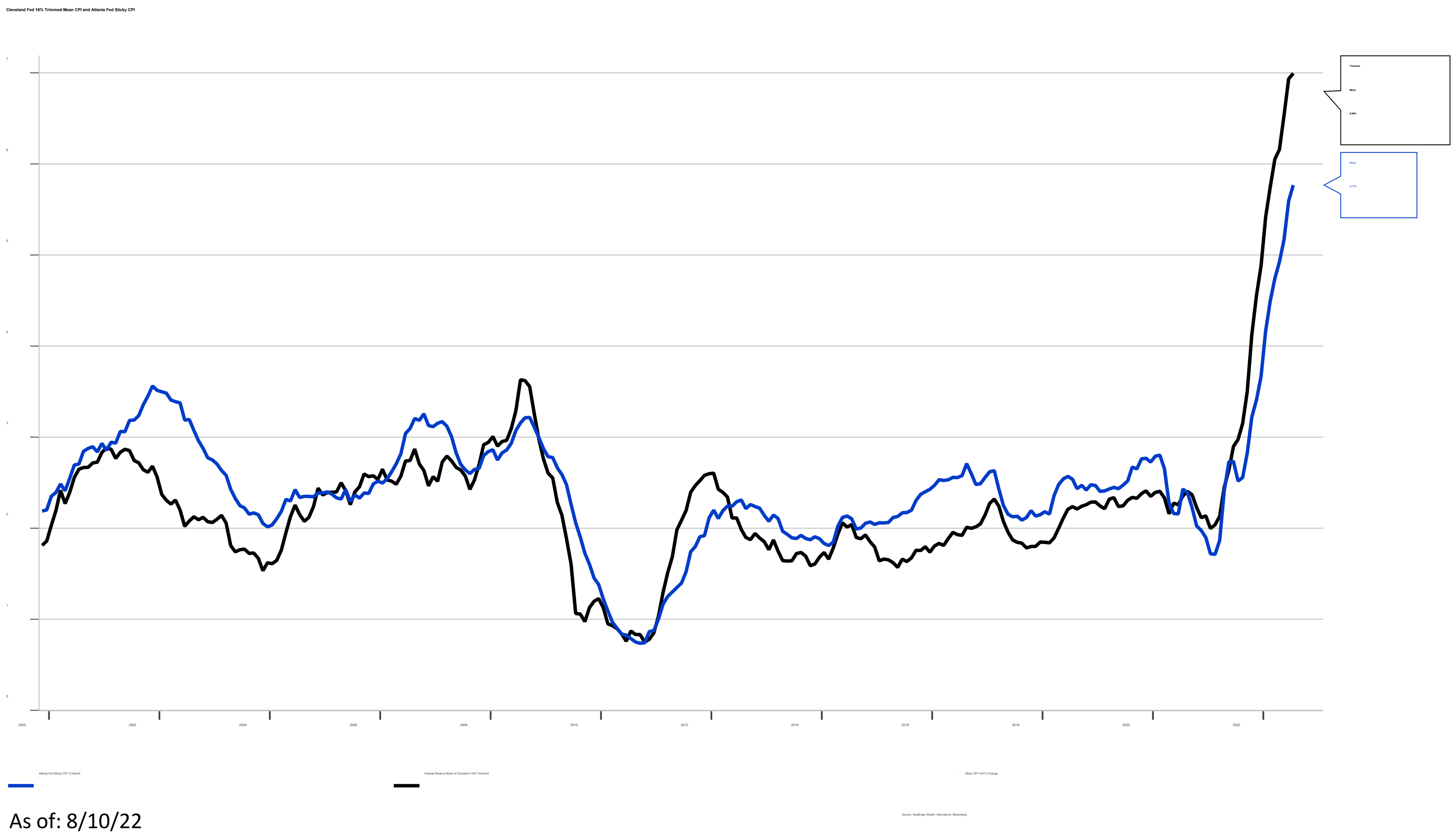
Source: Bloomberg, NewEdge Wealth, as of 8/10/22

On a Month over Month basis, inflation did not accelerate from June into July (Headline +0% vs. +1.3% in June; Core +0.3% vs. +0.7% in June).

Energy was a big driver of this. After contributing over 60 bps to MoM inflation in June, Energy was a -40 bps drag on MoM inflation in July.

We also saw deceleration in Goods (thanks to key items like Used Car Prices) and Services (thanks to airline fares, while rent inflation remained elevated).

Too Soon for Victory? Trimmed Mean CPI and Sticky CPI Did Not Peak

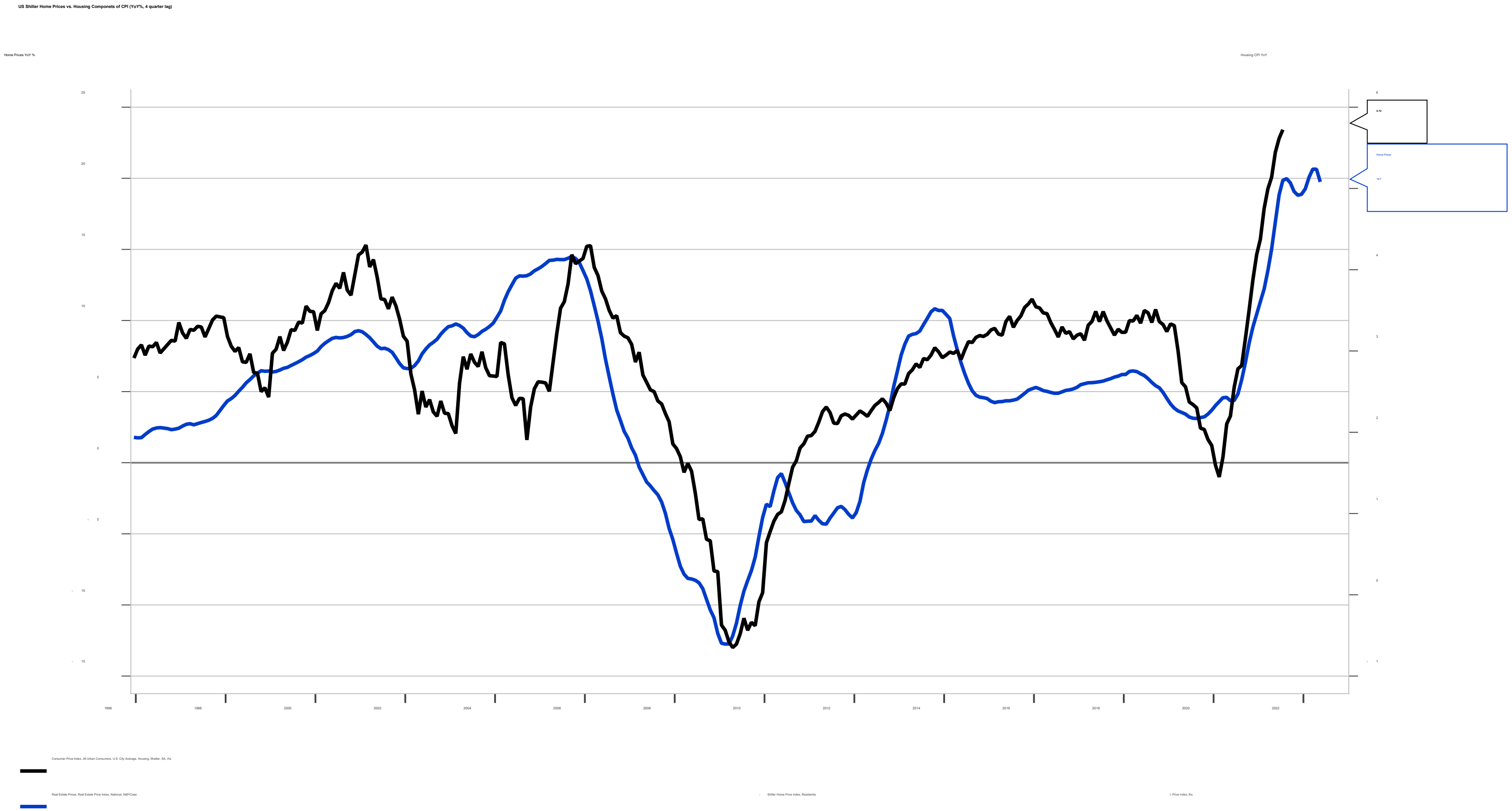


As of: 8/10/22

Despite the peak in headline inflation, we did not see a peak in Trimmed Mean inflation (captures inflation breadth by throwing out extreme readings on the high and low end) or in the Sticky CPI (measures slower moving components).

This is the challenge for the Fed in getting inflation back to its 2% target. If Headline inflation is brought lower by a small number of volatile components, but inflation remains sticky and broad, will the Fed be able to claim victory?

Sticky Example: Housing Costs Keep Inflation Elevated



As of: 8/10/22

Source: NewEdge Wealth, Macrobond, Bloomberg U.S. Bureau of Labor Statistics (BLS), S&P Dow Jones In

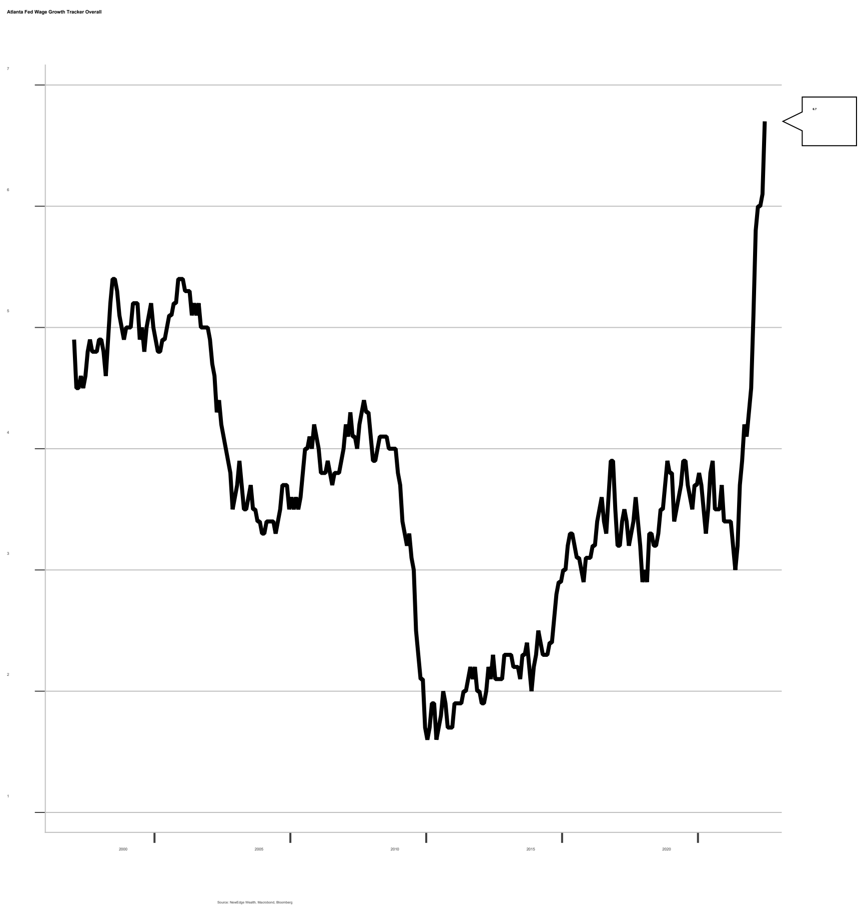
Shelter components make up ~30% of the CPI and are now running at ~5.72% YoY.

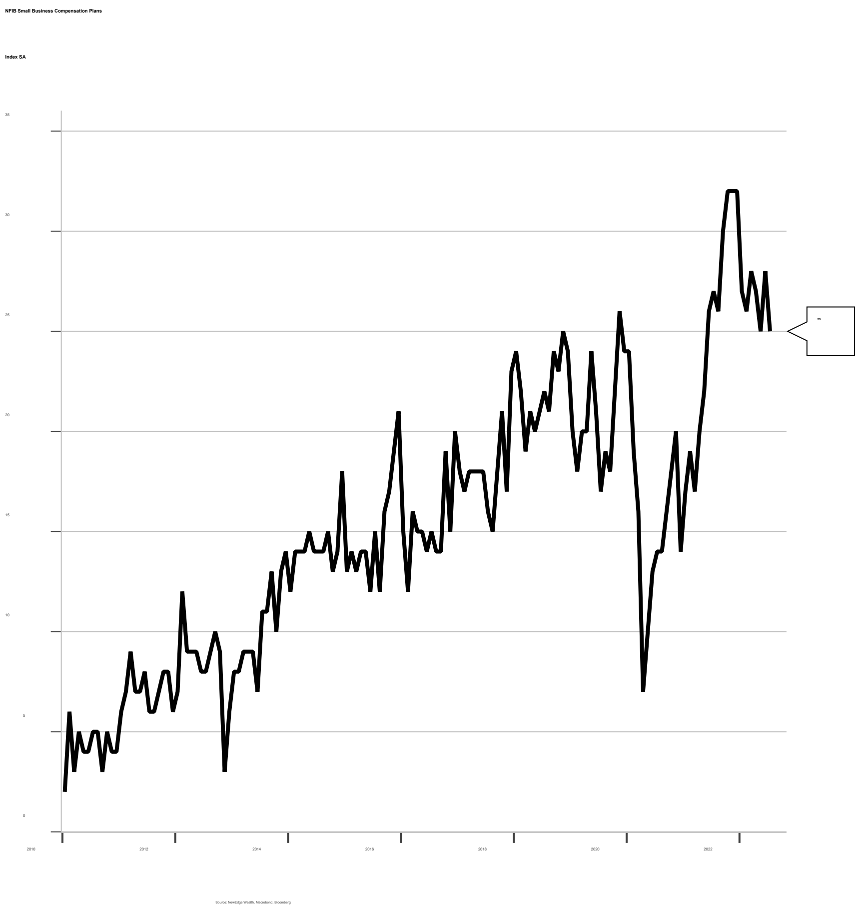
Importantly Shelter CPI lags home prices (as measured by the Case-Shiller Index) by about 4 quarters.

This means that CPI is just starting to feel the impact from the surge in home prices post-pandemic; and that Shelter CPI will lag an eventual deceleration in home price gains.

Interestingly, despite a slow down in housing activity and pockets of price weakness, national home price gains have not slowed yet.

More Stickiness from Wages





The Fed watches this Atlanta Fed Wage Growth Tracker, which has not peaked and is running well above the Fed's 2% inflation target. Wages are sticky and feed into higher prices.

There are some signs that wage increase plans are starting to slow, but we are not seeing this show up in slower wage gains yet.

Despite some signs of easing in the labor market (tick up in initial jobless claims), the labor market remains incredibly tight, supporting wage gains.

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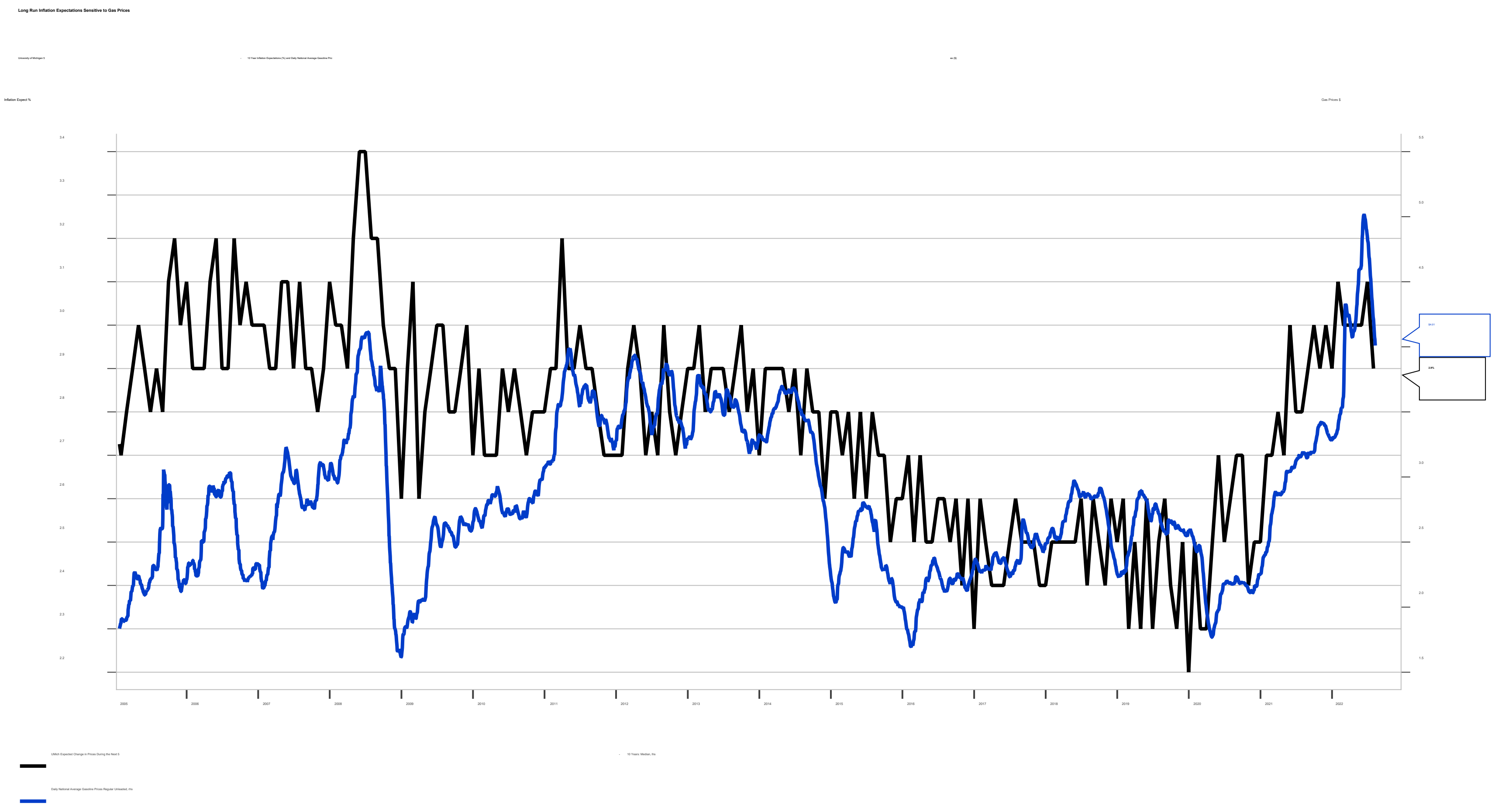
Lower Gas Prices Provided Relief to Inflation Expectations



As of: 8/10/22

Source: NewEdge Wealth, Macrobond, Bloomberg

Lower gas prices in the survey period tempered the long-run inflation expectations in the University of Michigan Consumer survey.

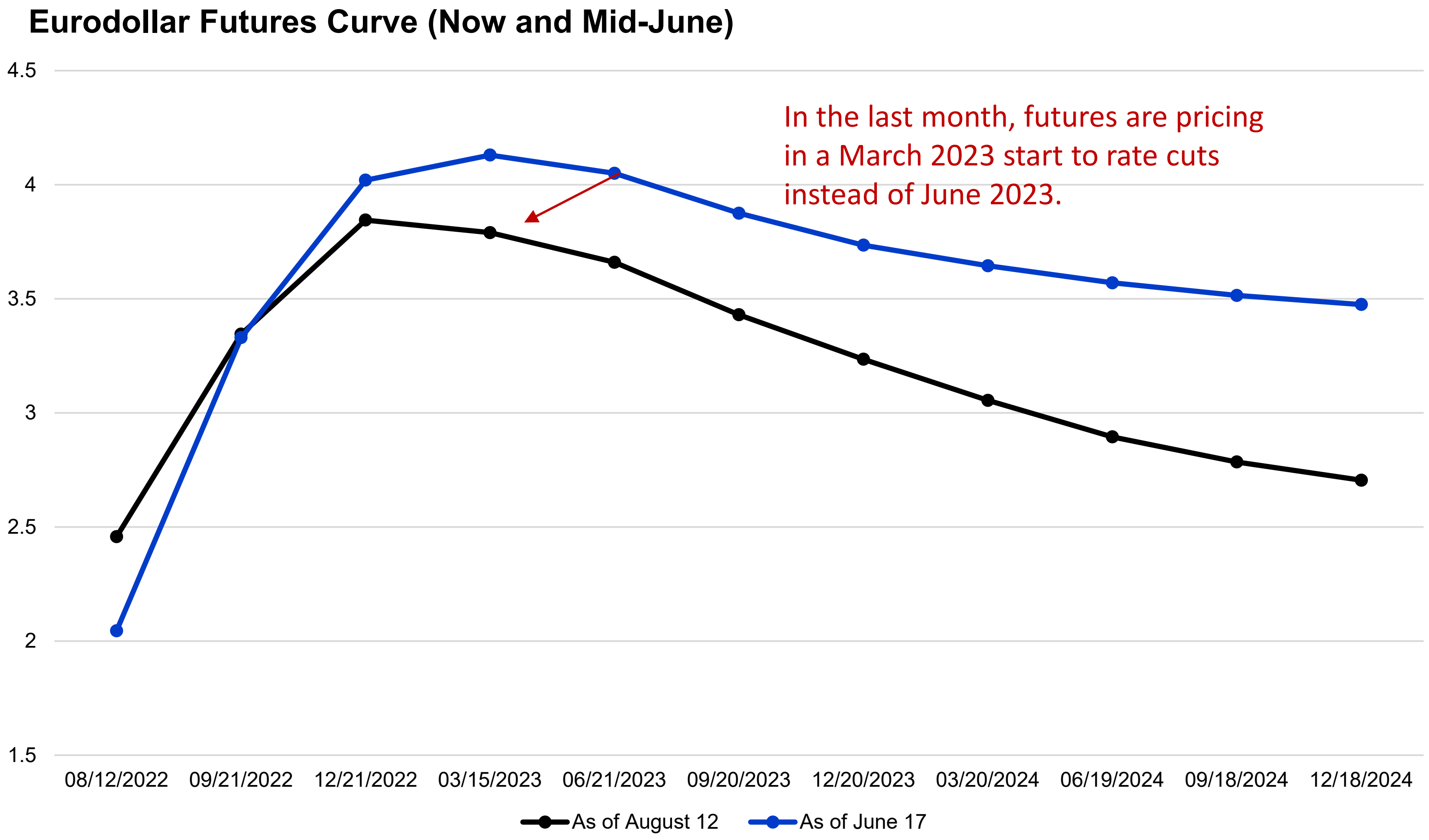
Inflation expectations fell to a 1 year low in the July report. This sparked the rally in risk assets as they priced in a less aggressive Fed.

Of course, the risk is if gas prices resume their ascent, inflation expectations could tick back up, restoring fears of an aggressive Fed, and halting this risk-on rally.

High Stakes Chicken:

Markets betting on dovishness dares the Fed to talk tough

Eurodollar Futures is Pricing In an Earlier Start to Rate Cuts



As of: 8/10/22

In the past 2 months, we have seen futures pricing of rate cuts shift from a June 2023 start to March 2023.

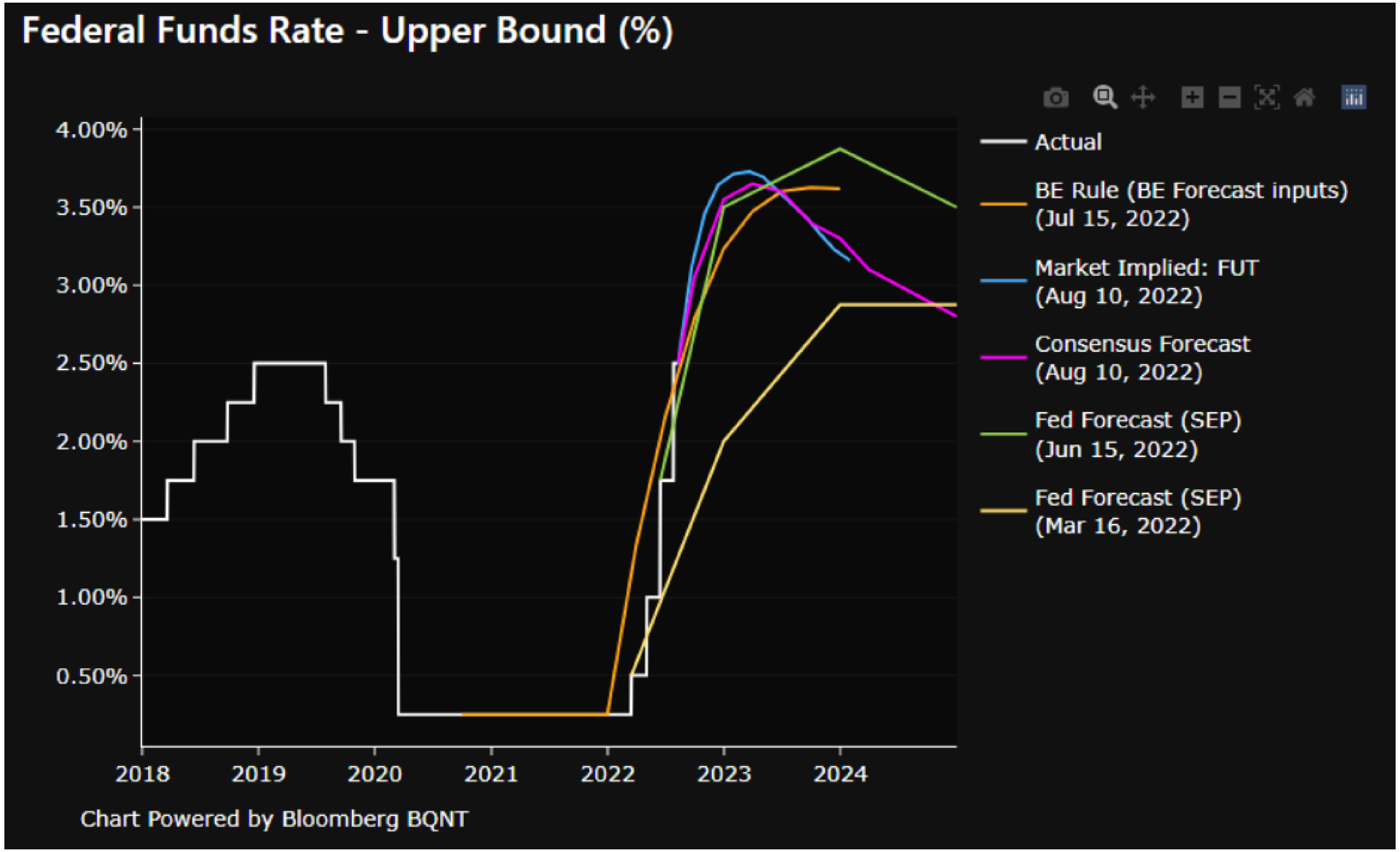
Eurodollar futures are not predictions per se, but instead reflect the hedging activity of large banks and companies against changes in yields.

The earlier drop off in the Eurodollar futures could reflect growing worries about the economy, with a potential for a bad enough economic scenario that the Fed would need to cut rates.

But as risk assets rally on the prospect of cuts, remember that the economy likely has to get much weaker in order for the Fed to justify cutting rates (mostly if inflation remains above their 2% target).

The Fed is saying that is does not want to cut rates in early 2023

Diverging Forecasts: The Fed is the Most Hawkish



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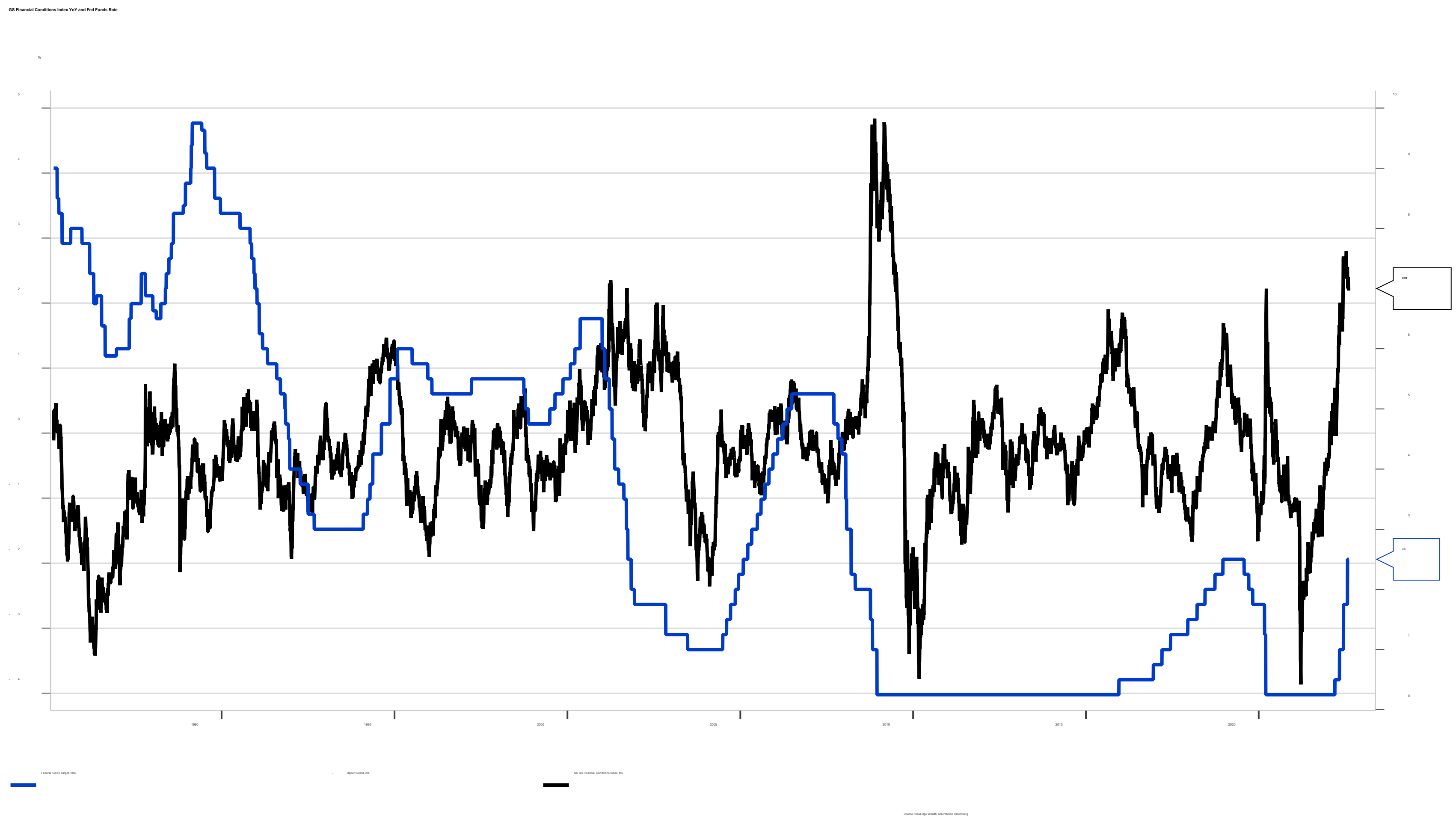
Since the Fed updated its forecasts in for rates in June (green line), showing a much more aggressive path to rate hikes than expected in March (light yellow line), the market and analysts have been making the opposite bet.

The market implied path for rates shows over 50 bps of rate cuts starting in early 2023, while consensus has rates getting cut by 100 bps by the end of 2024.

The Fed continues to push back on this notion of rapid rate cuts in early 2023. Will the data get bad enough or will inflation cool fast enough to allow the Fed to support rate cuts?

The Most Rapid Tightening of Financial Conditions During a Rate Hike Cycle



As equity markets have sold off (equity valuations have fallen), credit spreads have widened, and interest rates have soared higher, we have seen a rapid tightening of financial conditions.

It is the most rapid change in financial conditions on a YoY basis ever during a rate hike cycle.

This speaks less to the absolute level of financial conditions (see next slide) and more to the ultra-easy, ultra-accommodative starting point.

This is what happens when you remove intervention after aggressive financial easing/repression.

As of: 8/10/22

The Fed Wants Tighter Financial Conditions, Which Remain Below Prior Peaks

As of: 8/10/22

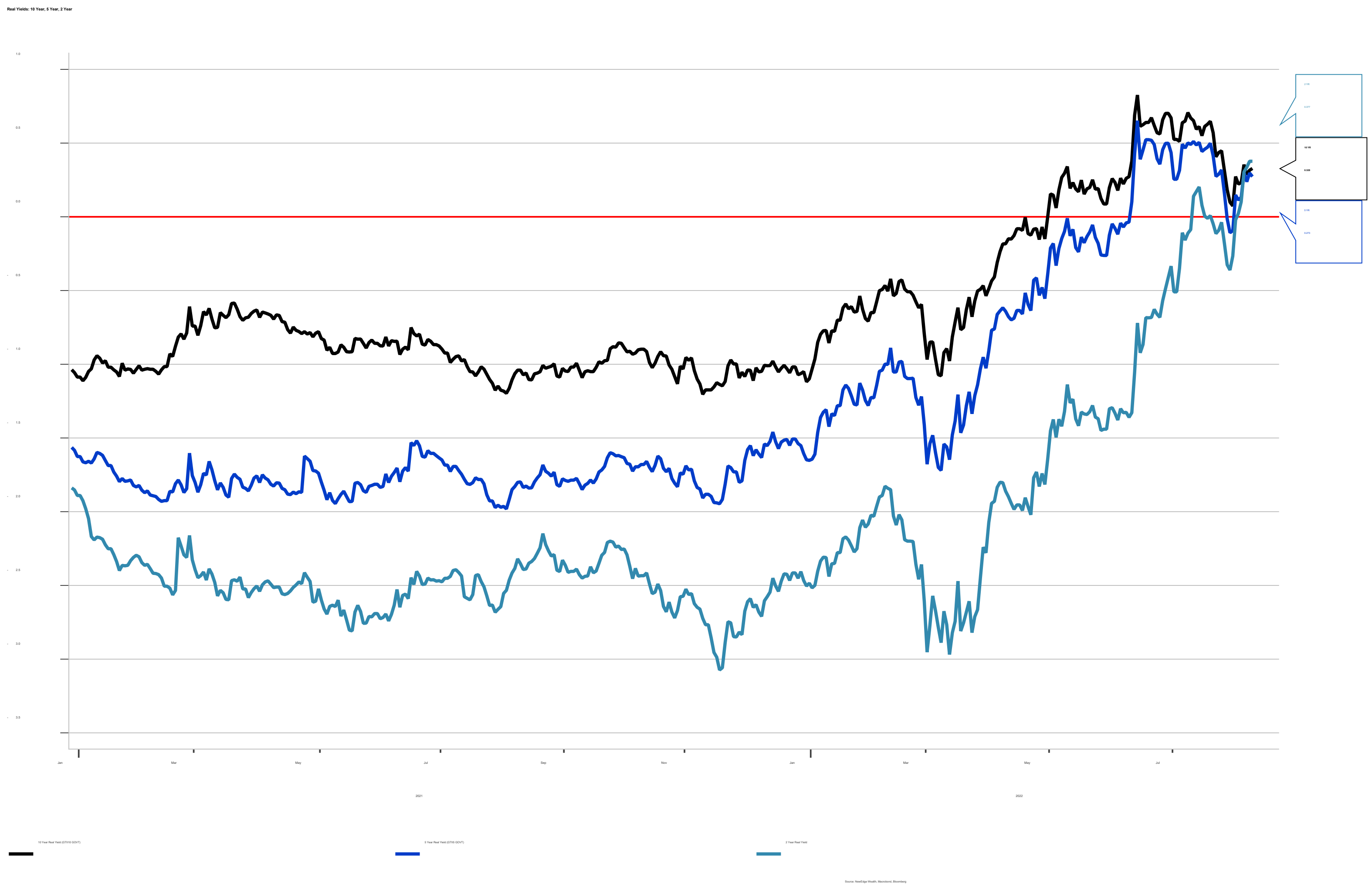
Though financial conditions have tightened rapidly and are far more elevated than they were to start 2022, on an absolute basis, conditions remain about remain on the easier end compared to prior cycles and well below prior peaks that got the Fed to pivot.

The Fed says it wants tighter financial conditions in order to slow the economy and flight inflation.

They are getting the opposite now, with financial conditions easing.

Note: financial conditions are a mashup of equity valuations, credit spreads, interest rates, and currency.

The Wants Higher Real Yields… Will They Get Them?



As of: 8/10/22

The Fed has said that real interest rates are what is important in order to tighten liquidity and get control of inflation.

But following the June and July Fed meetings, real interest rates fell and even went into negative territory (which is *stimulative,* instead of the restrictive policy the Fed wants).

Real interest rates have now rebounded back to positive territory.

This has important implications for equities in the next section.

Watch the 2 Year Closely for Signals on the Fed's Path

S&P 500 Daily with Moving Averages

As of: 8/10/22

In response to Wednesday's lighter CPI print, the 2 Year yield initially fell, but then rallied back higher to end the day.

If the market was much more confident about near term interest rate cuts, we would likely see a breakdown in the 2 Year.

For the 2 Year is holding above its 50 DMA.

So, You're Telling Me There's A Chance:

Unpacking the equity rally and can it continue?

S&P Surges Through Resistance, Next Stop 200 DMA?

S&P 500 Daily with Moving Averages

As of: 8/10/22

The S&P 500 has staged a powerful rally off of the June lows.

Short positioning and bearish sentiment set the stage for the rally, while expectations for an easier/more accommodative Fed in the next 6 months added fuel to risk-on sentiment, drove interest rates lower, and boosted PE multiples. Better economic data (namely continued strong job gains), relieved fears of an eminent hard landing.

The market thinks it can have its cake and eat it too: no hard landing AND an accommodative Fed.

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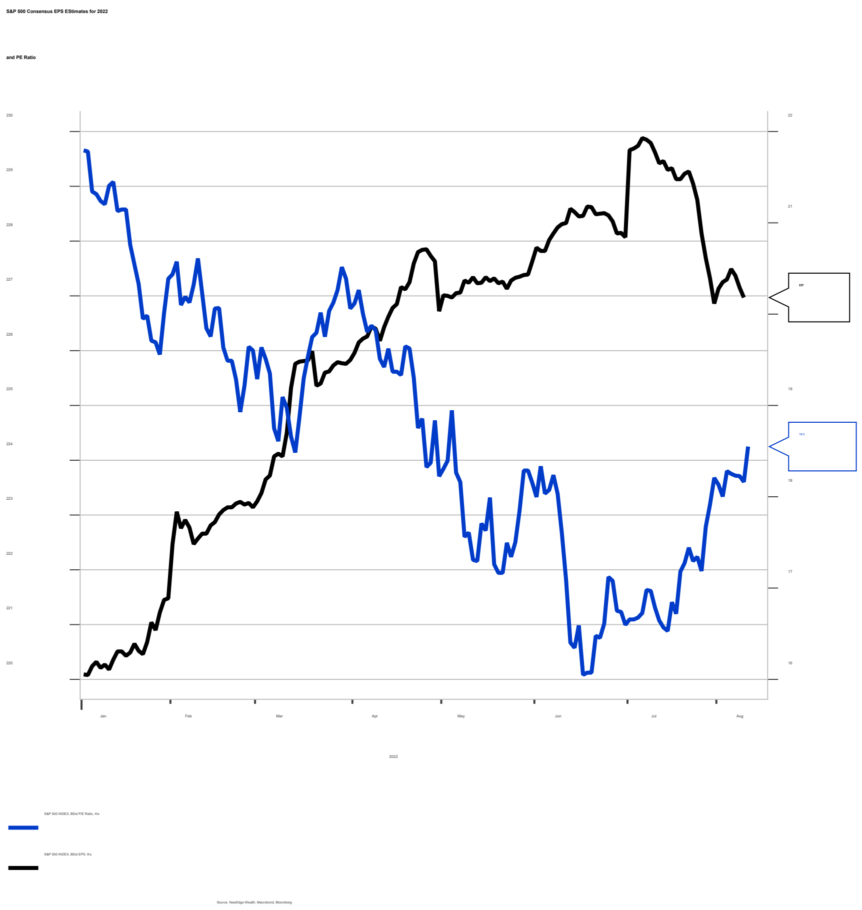
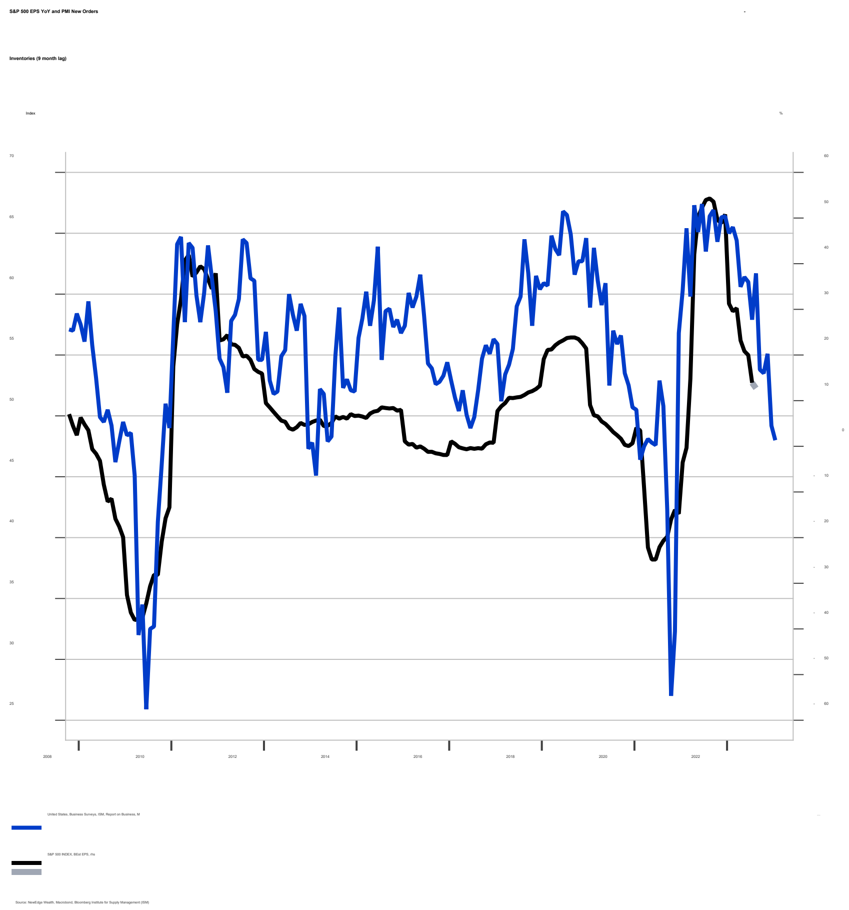
Rally Driven Entirely By Multiple Hopes, while EPS Estimates Still Elevated, At Risk





Valuations have been the driver of the recent equity rally (no surprise there- valuations always are the first leg of any rally).

But EPS estimates remain elevated, despite growth fears. These estimates are being buoyed by Energy sector EPS growth.

The growth backdrop is pointing to weaker earnings growth in the coming months. A leading indicator of the Manufacturing PMI (New Orders – Inventories) may point to a marked slow down in EPS growth.

As of: 8/10/22

Rally Driven Entirely By Multiple Hopes, while EPS Estimates Still Elevated, At Risk

As of: 8/10/22

Street is at $227 for 2022 earnings and $244 (+8%) for 2023 earnings.

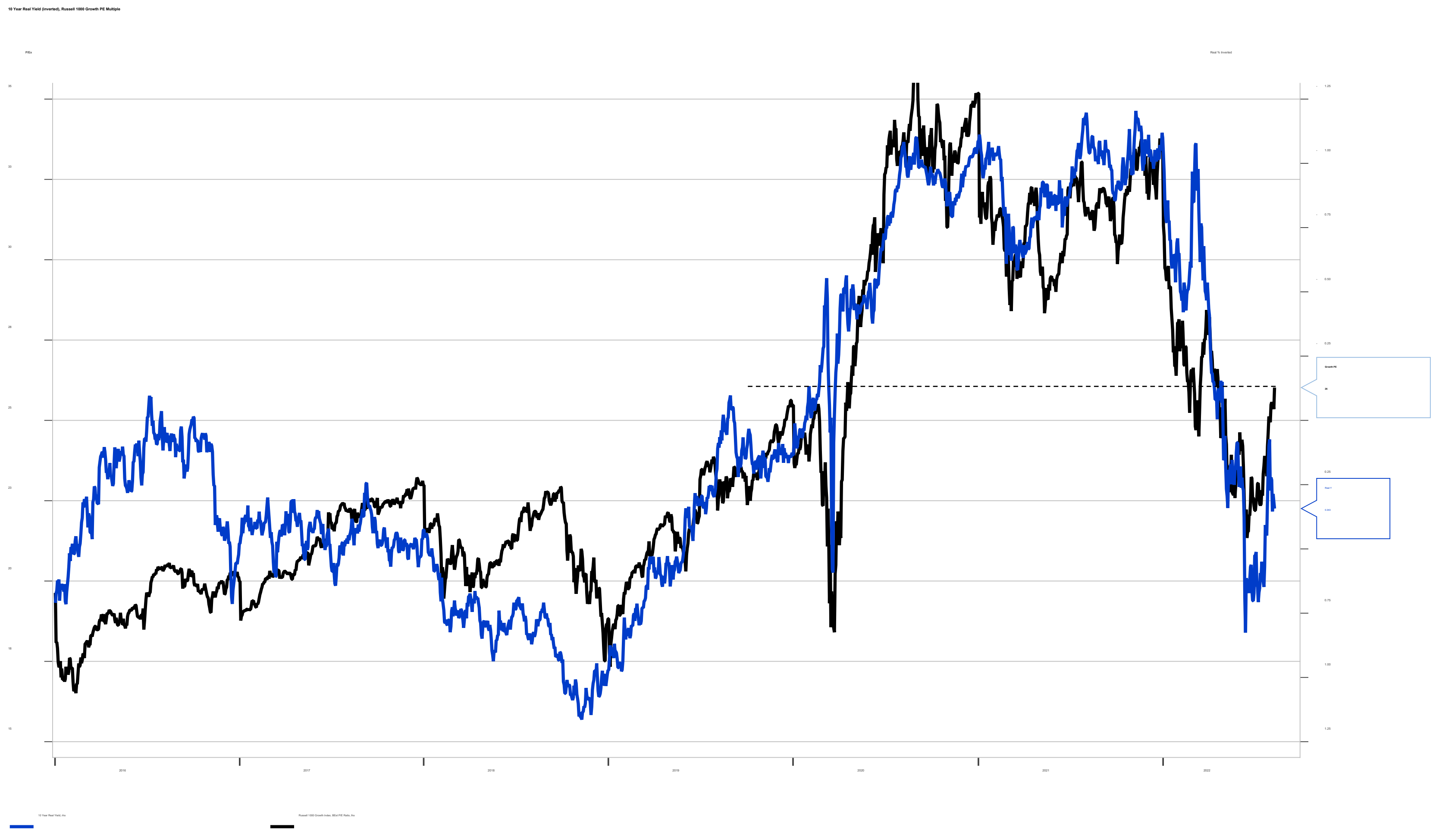
A rally to 4,300 brings us to 19x 2022 earnings; 4,400 goes to 19.5x earnings.

We think these are unsustainable/unattractive multiples given the tightening cycle that is still at play.

Multiples peaked out at 20x in early 2018 (melt-up) and early 2020 (Fed cutting rates).

Multiples do rebound before earnings, but without earnings estimates getting cut or going negative, there isn't much to rebound from (example, earnings grew 50% in 2021, offsetting all of the multiple compression).

Growth is Back to Being Expensive



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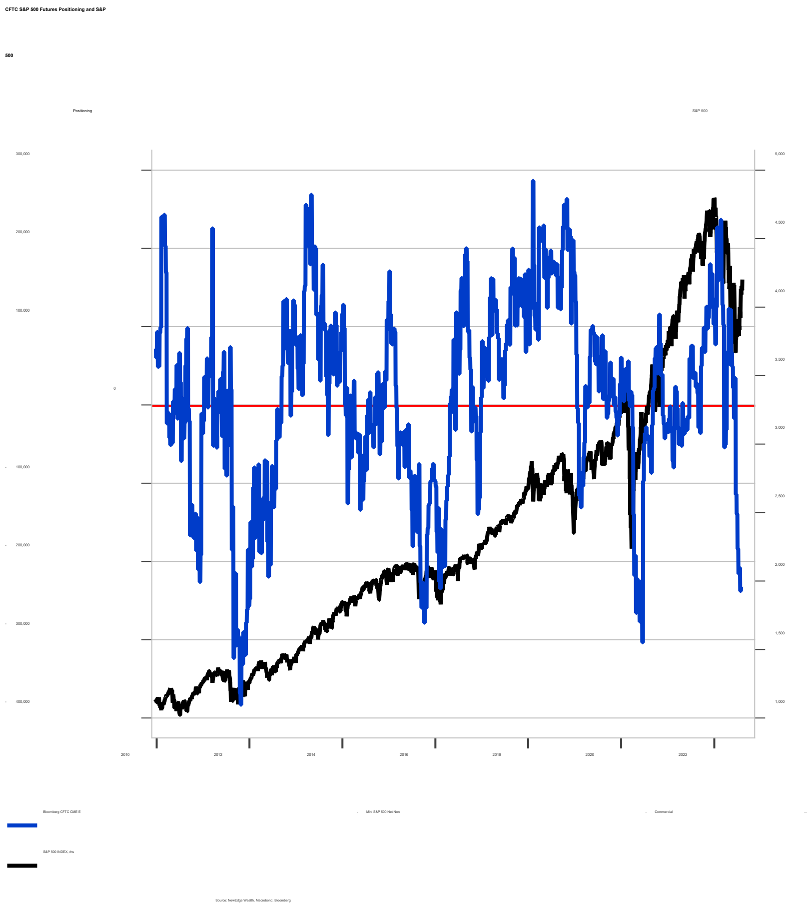
Growth PE multiples have rebounded vigorously in this rally, thanks to the movement lower in real yields (Growth PE's and Real Yields are inversely correlated).

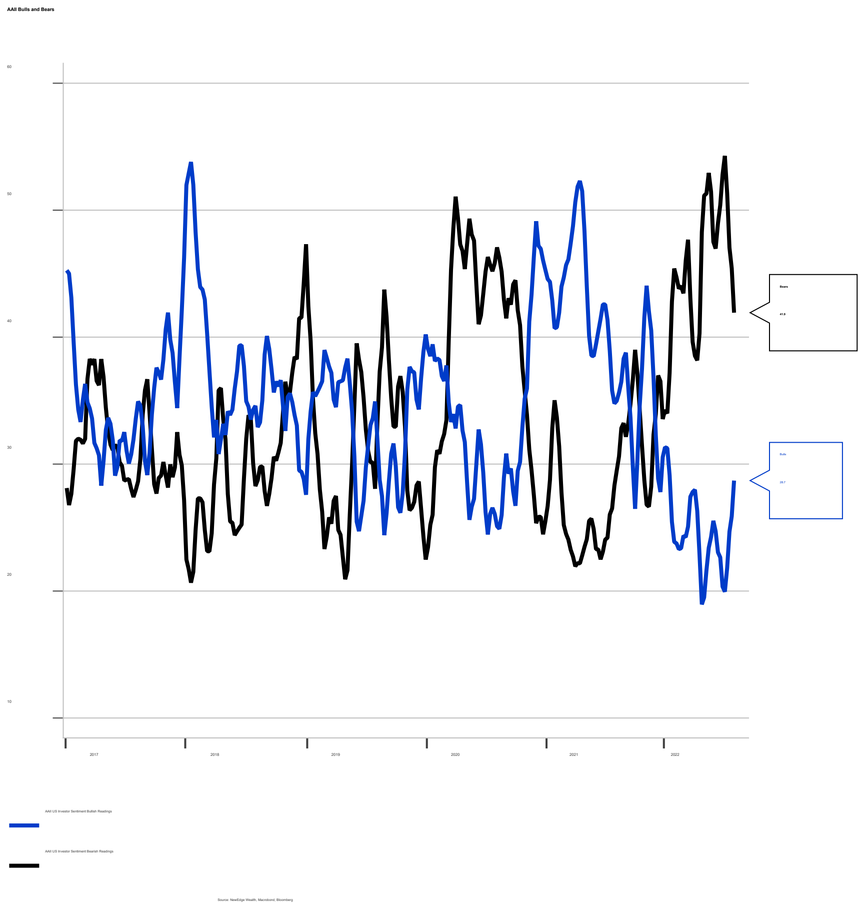
Growth now trades at 26x earnings, above the pre-pandemic peak in valuations in late 2019. Recall the Fed was cutting rates and real yields were plummeting in 2019, boosting Growth valuations.

These heady valuations are at risk *if* real yields move higher (as they have been in the past week).

We do not want to anchor to 2020 and 2021's bubble valuations.

Short Term Positioning and Sentiment Have Supported the Bounce



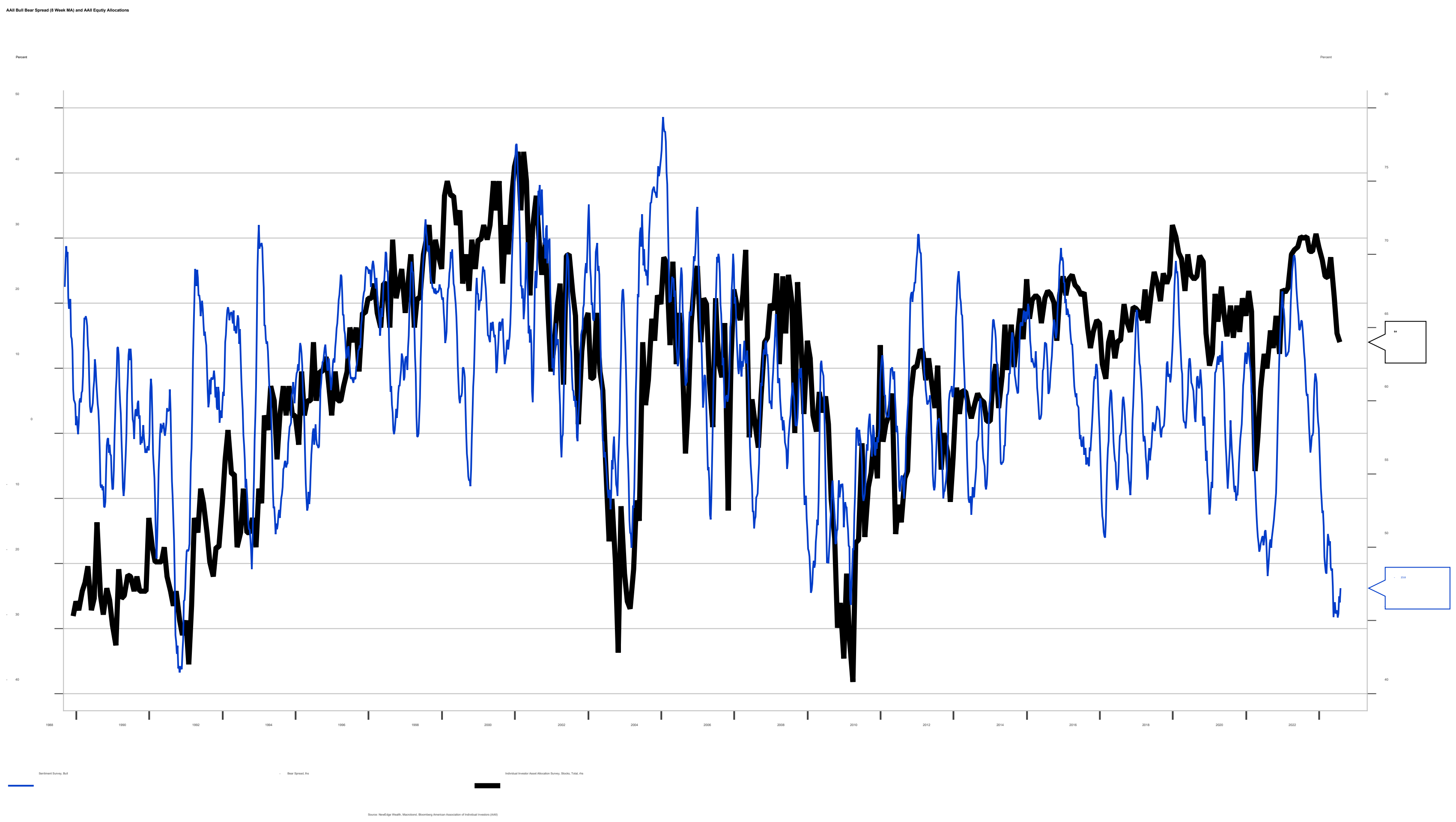


During the June gloom, positioning swung short (the shortest since COVID 2020), while other measures of positioning showed an overall bearish posture by institutional investors (hedge fund net exposure, etc.).

This set the market up for a relief rally, as positioning and expectations became too one-sided.

As of: 8/10/22

Individual Investors are Starting to Reduce Equity Exposure



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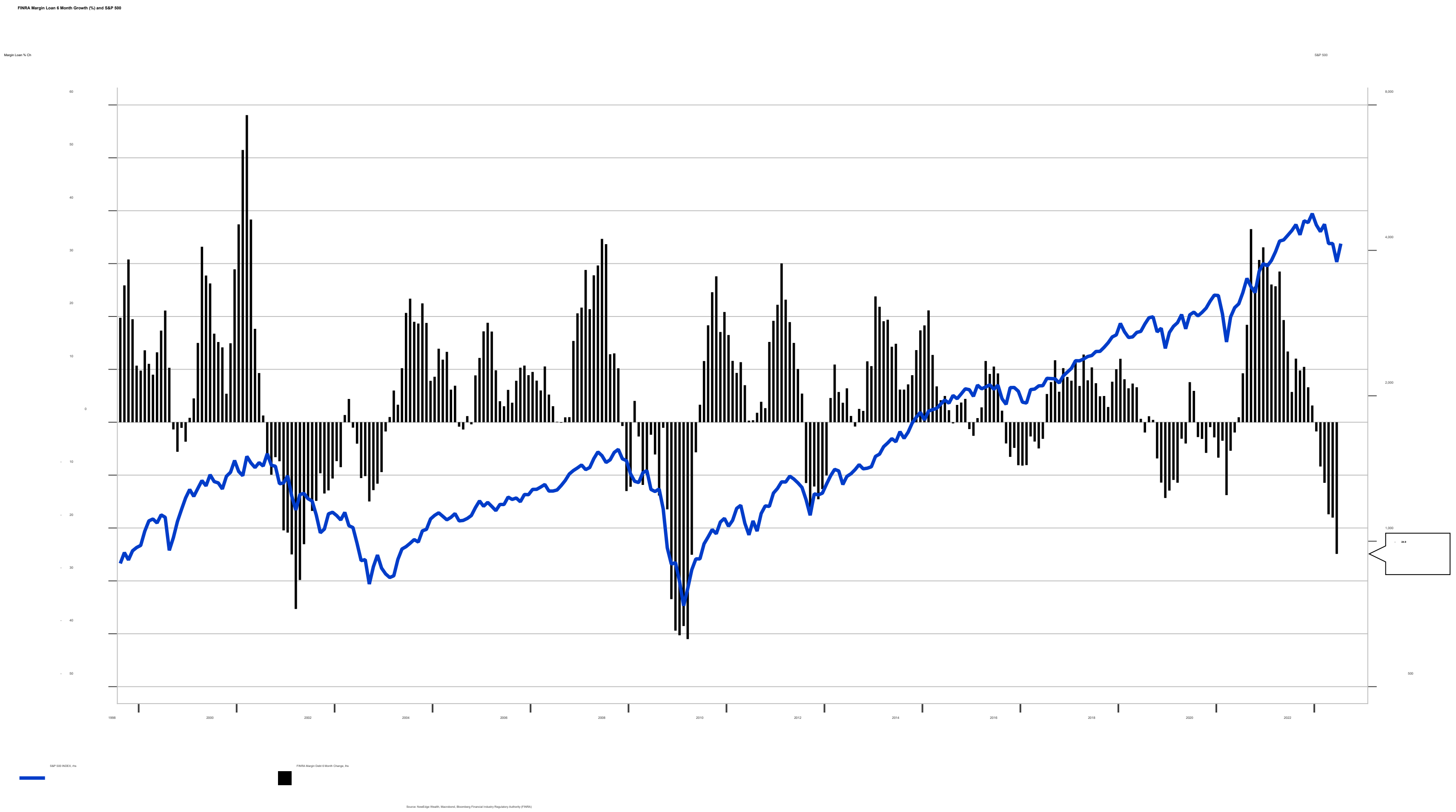
Investors have reduced their equity exposure, but it is nowhere near prior major bear-market lows.

There is no reason why this allocation *has* to or will go lower, but it is good to remember that the lower this allocation goes, the higher the wall of worry will be built, meaning the stronger and longer the following equity rally could be.

Answer the Margin Call: Leverage Finally Exiting the System



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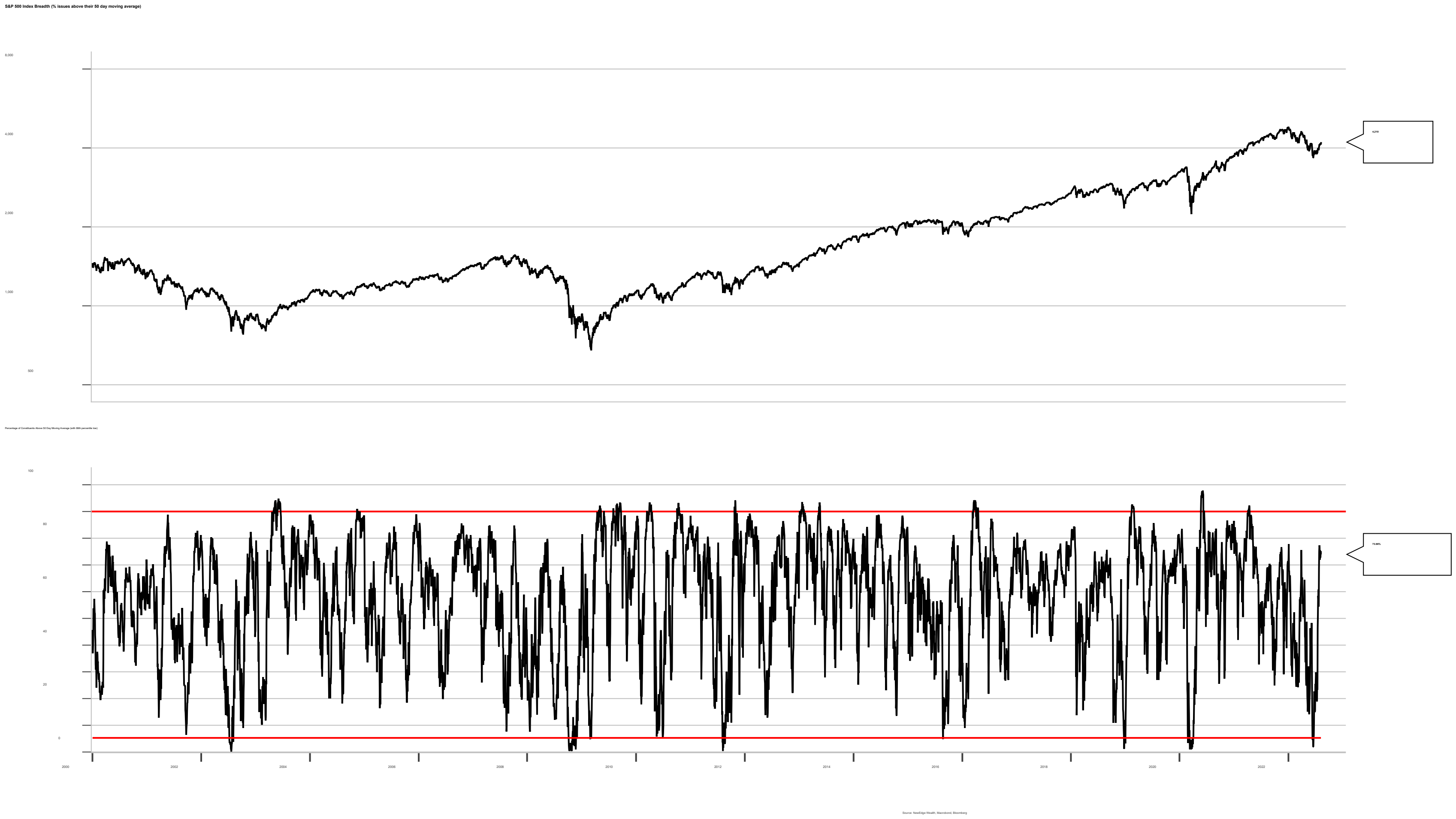
Equity weakness has forced individual investors to reduce their margin loan balances by 25% in the past 6 months.

This is a good sign of froth exiting the market, though if this retail-darling rally continues (risk appetite is alive!) we could see margin pick back up.

Breadth Has Improved, Not to the "All-Clear" Yet on % Above 50 DMA

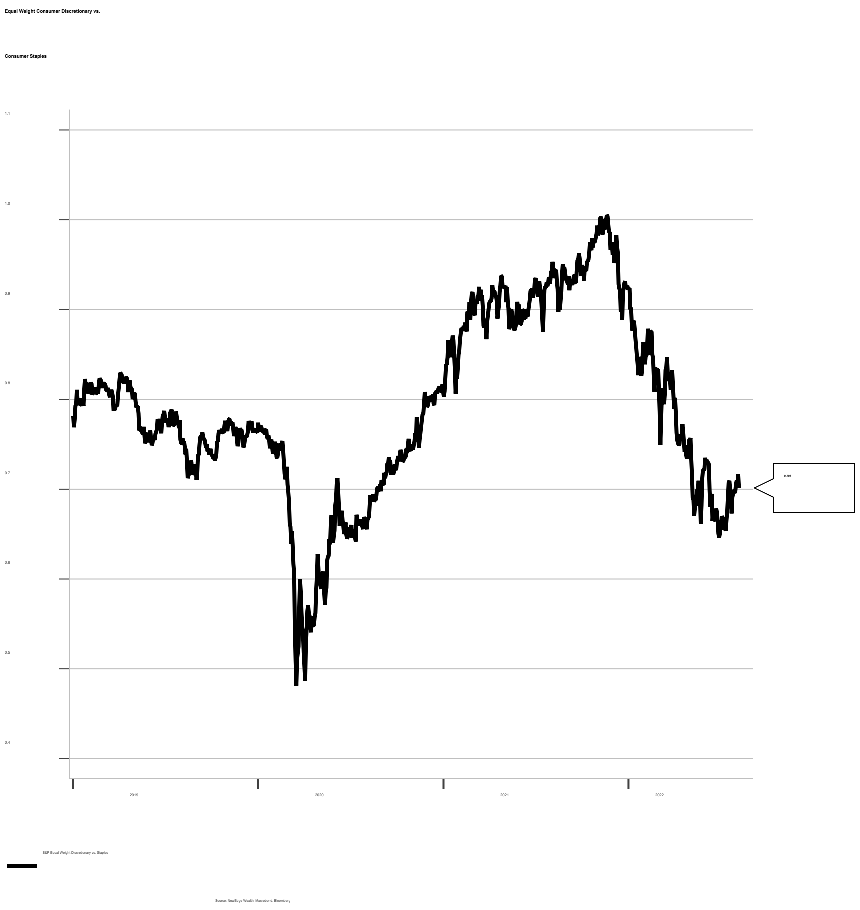


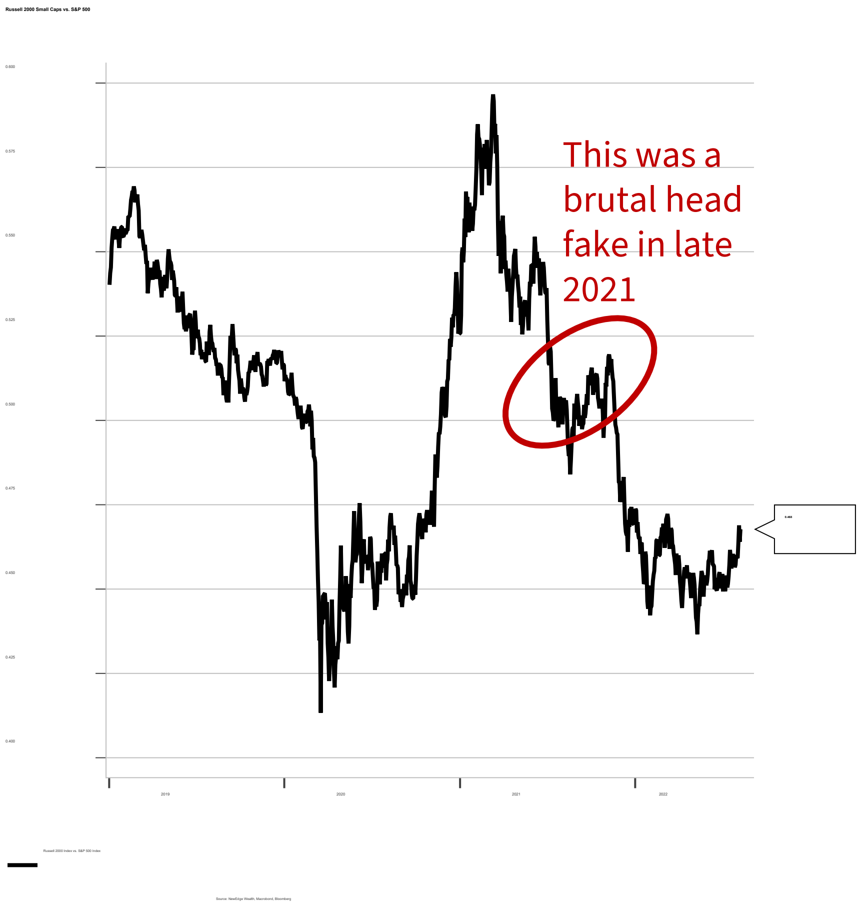
Coming out of major lows, we typically see a surge in breadth, where the % of issues trading above their 50-day moving average goes above 90%. We have not seen that yet (still at just 74% today).

Other measures, such as the % of names above their 20-day moving average, have surged to levels consistent with better forward returns.

As of: 8/10/22

Looking for Signs of Cyclicality and Risk Appetite Improving





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Coming out of a bottom, you want to see signs that cyclicality and risk-on parts of the market are leading the charge higher in order to judge the sustainability of this move.

Equal weigh Consumer Discretionary vs. Consumer Staples (cyclical vs. defensive) has been outperforming since the June low, while Small Caps have been outperforming vs. the market since May.

We are aware of head fakes here, like in late 2021 when small caps began outperforming and lulled many into a false state of confidence that the 2021 rally would continue in 2022.

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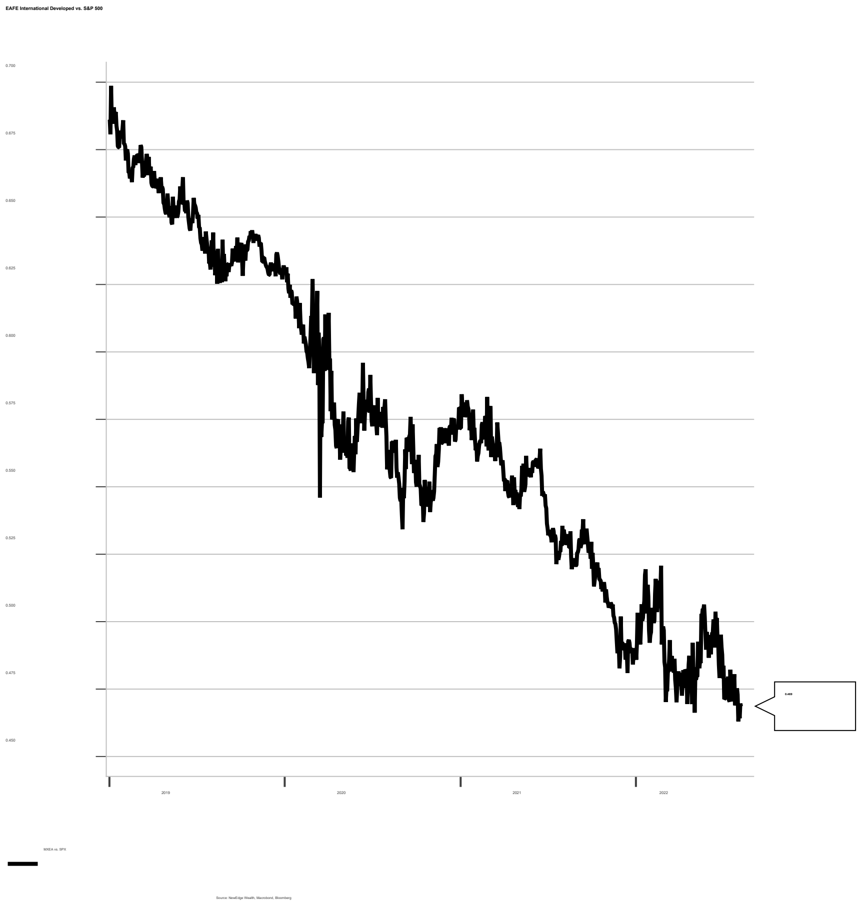
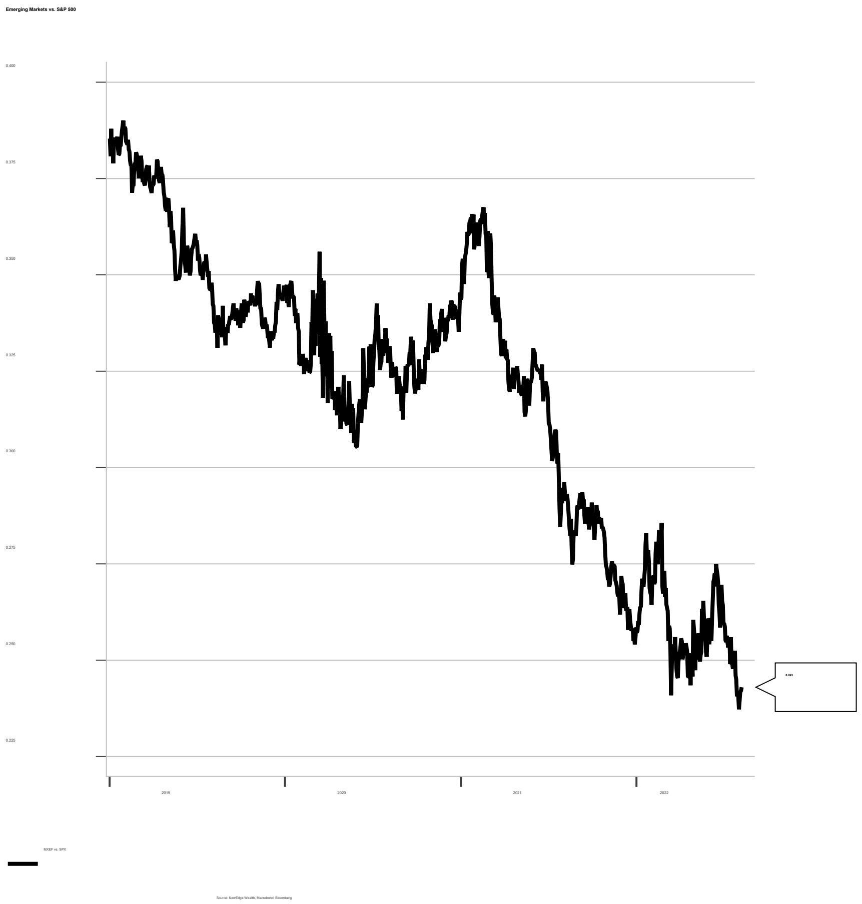
The World is Not Enough:

Non-US Equities Continue to Struggle

International and EM Continue to Make New Relative Lows vs. U.S.





These charts show relative performance (line going down means international is underperforming the US).

Despite all of the arguments for cheap valuations, performance mean reversion, sources of GDP growth, international and EM continue to have weak performance relative to the US.

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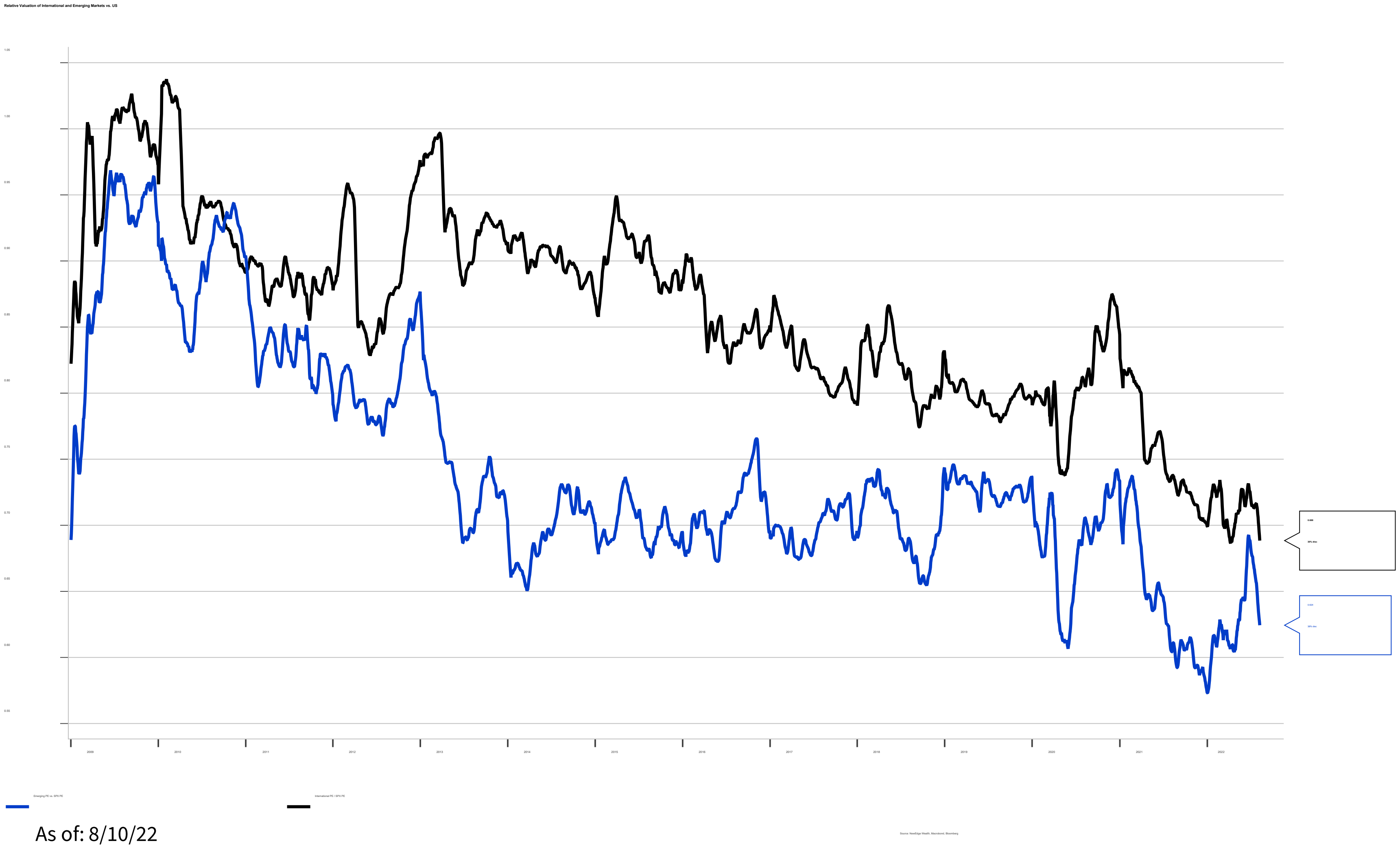
Cheap For Awhile and a Reason



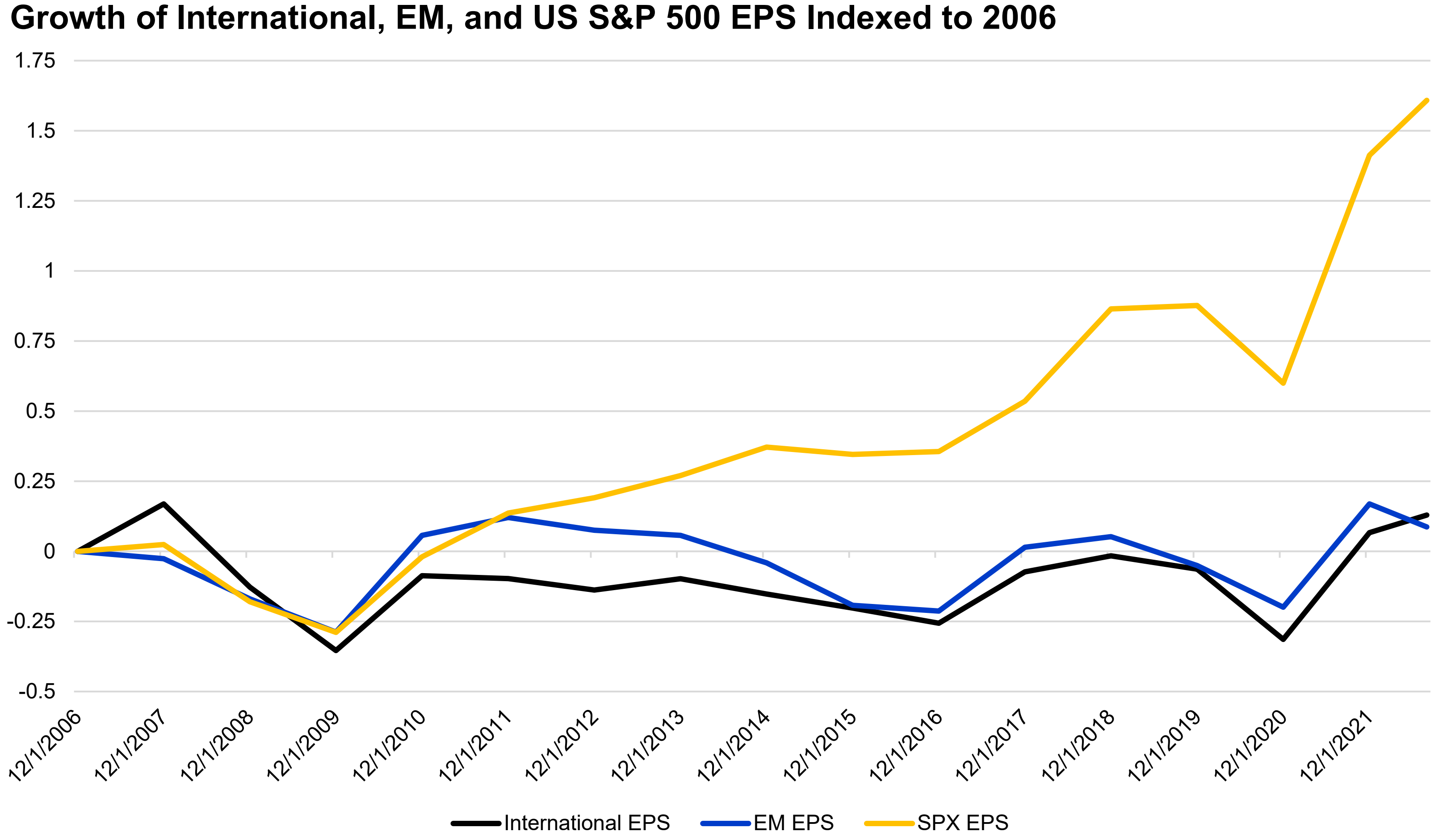
As of: 8/10/22

VALUATION IS NOT A CATALYST!

Though the discounts of International and EM stocks are wide, they have been cheap vs. the US for years, and have only gotten cheaper in recent years.

One day this may turn, but we wait for a catalyst. That day is not today.

U.S. Outperformance Driven by Better Earnings Growth

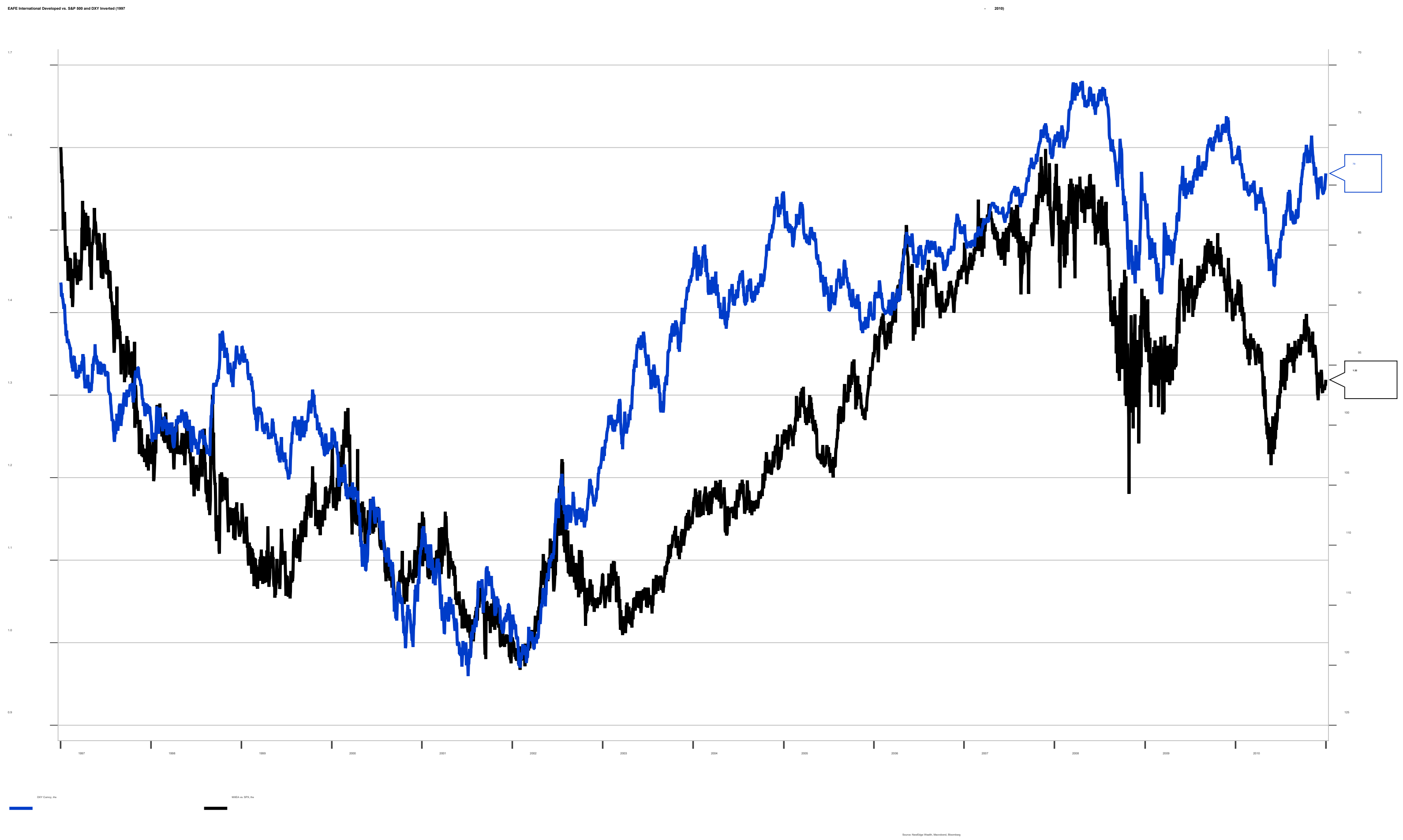


As of: 8/10/22

Since 2006 (peak of the last international/EM dominance cycle), the US S&P 500 has grown earnings over 150% in total, while the international and EM indices have generated less than 10% EPS growth in total since that time.

Without a fundamental driver for non-US EPS outgrowth, the US is still the best house on the block.

A Weak USD is Necessary for Sustained International Outperformance



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The 40% depreciation of the USD between 2002 and 2008 was the fuel behind the huge outperformance of International and EM over the US.

It's a chicken and egg, but capital leaving the US and going elsewhere in the world spurred and solidified both of these trends.

The industrialization of China and the resulting huge demand for commodities was critical to these trends.

Other factors like the disenchantment with US stocks post the tech-bubble and the meme-ification of BRICs as an investing strategy played an important role.

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DXY Losing Some Steam, but Still in an Uptrend

DXY Dollar Index

The USD weakened following the lower July CPI print, but remains in an uptrend.

Without a prolonged and pronounced weakening in the USD, non-US equities may continue to struggle vs. the US.

As of: 8/10/22

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TIPS: Bloomberg Barclays Global Inflation-Linked: U.S. TIPS Total Return Index Unhedged
Municipals 5-Year: Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return Index Unhedged USD
Core Bond: Bloomberg Barclays US Agg Total Return Value Unhedged USD
U.S. MBS: Bloomberg Barclays US MBS Index
High Yield Municipals: Bloomberg Barclays Muni High Yield Total Return Index Value Unhedged USD
High Yield: Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
Foreign Bond: Bloomberg Barclays Global Aggregate ex-USD Total Return Index Value USD (50/50 blend of hedged and unhedged)
EM Debt (unhedged): J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD
U.S. Large Cap: S&P 500 Total Return Index
U.S. Small Cap : Russell 2000 Total Return Index
International Developed: MSCI EAFE Net Total Return USD Index
Emerging Markets: MSCI Emerging Markets Net Total Return USD Index
World: MSCI ACWI Net Total Return USD Index
U.S. Equity REITs: FTSE Nareit Equity REITs Total Return Index USD
Commodities: Bloomberg Commodity Total Return Index
Midstream Energy: Alerian MLP Total Return Index
Hedge Funds: Hedge Fund Research HFRI Fund of Funds Composite Index
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REITS Industrial: FTSE Nareit Eqty Industrial Total Return Index
REITS Lodging/Resorts: FTSE Nareit Eqty Lodging/Resorts Total Return Index
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REITS Data Centers: FTSE Nareit Equity Data Centers Total Return Index
REITS Specialty: FTSE Nareit Equity Specialty Total Return Index
Real Assets Agriculture: Bloomberg Sub Agriculture Total Return Index
Real Assets Industrial Metals: Bloomberg Sub Industrial Metals Total Return Index
Real Assets Precious Metals: Bloomberg Sub Precious Metals Total Return Index
Real Assets Energy: Bloomberg Sub Energy Total Return Index

Any questions?

Contact:

2200 Atlantic Street, Suite 200 • Stamford, CT

855.949.5855

cdawson@newedgecg.com