Quarterly Chartbook
2Q2022

Founder Comments

Since we began the process of putting this information together, stock and bond markets have rallied. U.S. stocks have recovered more than 8% of year-to-date losses and bonds and foreign stocks have also tacked on nice gains. The key driver has been a softening in intermediate interest rate expectations as the 10-year U.S. Treasury bond has retreated from a high of nearly 3.5% to less than 2.7%. Lower rates are a key factor in valuation models for stocks and, as we know, bond prices move inversely to rate movements. Unfortunately, the reason for lower rates is largely concern about the direction of the economy.

Over periods as short as one month, financial markets are highly unpredictable. We do not believe the big picture has changed much. We know that short-term interest rates will move higher in the near-term in order to rein in inflation. We also know that will be a drag on consumer activity and economic growth will be impacted. This means that the general posture we have taken in client portfolios has not changed. Broadly speaking, within equity and bond allocations we are maintaining risk averse positioning. We believe that is the most prudent strategy given the information in front of us. Our thoughts are detailed in the pages that follow.

Using the Table of Contents on the next page, if you would like to jump to a specific idea, you can click on any of the links and you will move right to it.

If you have any questions about the content presented, please reach out. We always appreciate your feedback and questions. We want this to be a valuable communication each quarter that provides transparency into the thinking and process we use to manage client portfolios. Your comments are critical to us improving the quality of this chartbook.

Enjoy the rest of your summer.

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Market Performance

Annualized % Returns (As of 06/30/2022)

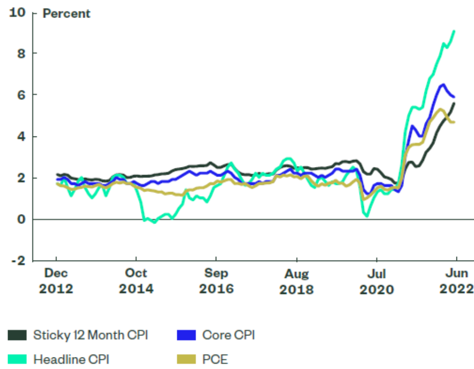
Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	-10.62	10.60	11.31	12.96
Russell 1000 Index	Mid/Large Cap Stocks	-13.04	10.17	11.00	12.82
Russell 1000 Growth Index	Growth Stocks	-18.77	12.58	14.29	14.80
Russell 1000 Value Index	Value Stocks	-6.82	6.87	7.17	10.50
Russell 2000 Index	Small Cap Stocks	-25.20	4.21	5.17	9.35
MSCI EAFE Index	Non-U.S. Developed Market Stocks	-17.77	1.07	2.20	5.40
MSCI Emerging Markets Index	Emerging Markets Stocks	-25.28	0.57	2.18	3.06
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	-22.45	2.94	2.55	6.22
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	-13.71	-0.36	1.51	4.08
Barclays Municipal Bond Index	U.S. Municipal Bonds	-8.57	-0.18	1.51	2.38
Barclays Aggregate Bond Index	U.S. Bonds	-10.29	-0.93	0.88	1.54
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	-7.28	-0.16	1.13	1.45
BofAML U.S. Treasury Master Index	Treasury Bonds	-8.91	-0.85	0.79	1.08
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	-9.10	-1.42	0.40	1.19
BofAML U.S. Corporate Master Index	Corporate Bonds	-13.83	-0.81	1.39	2.71
BofAML U.S. High Yield Master II Index	High Yield Bonds	-12.67	-0.07	1.94	4.40
BofAML Euro Broad Market Index	European Bonds	-22.94	-6.39	-2.57	-0.08
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	-15.62	-3.17	-0.26	-0.02

Calendar Year % Returns (YTD as of 06/30/2022)

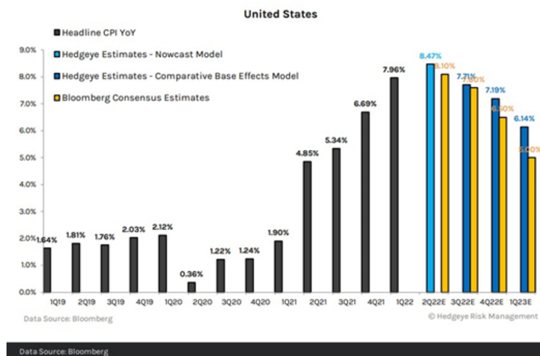
	YTD	2021	2020	2019	2018	2017
S&P 500 Index	-19.96	28.71	18.40	31.49	-4.38	21.83
Russell 1000 Index	-20.94	26.45	20.96	31.43	-4.78	21.69
Russell 1000 Growth Index	-28.07	27.60	38.49	36.39	-1.51	30.21
Russell 1000 Value Index	-12.86	25.16	2.80	26.54	-8.27	13.66
Russell 2000 Index	-23.43	14.82	19.96	25.52	-11.01	14.65
MSCI EAFE Index	-19.57	11.26	7.82	22.01	-13.79	25.03
MSCI Emerging Markets Index	-17.63	-2.54	18.31	18.44	-14.58	37.28
MSCI ACWI Ex USA Small Cap Index	-22.92	12.93	14.24	22.42	-18.20	31.65
BofAML Preferred Stock Fixed Rate Index	-13.92	2.24	6.95	17.71	-4.34	10.58
Barclays Municipal Bond Index	-8.98	1.52	5.21	7.54	1.28	5.45
Barclays Aggregate Bond Index	-10.35	-1.54	7.51	8.72	0.01	3.54
Barclays Intermediate U.S. Gov/Credit Index	-6.77	-1.44	6.43	6.80	0.88	2.14
BofAML U.S. Treasury Master Index	-9.19	-2.38	8.22	6.99	0.80	2.43
BofAML U.S. Mortgage Backed Securities Index	-8.76	-1.21	4.09	6.51	1.00	2.45
BofAML U.S. Corporate Master Index	-13.93	-0.95	9.81	14.23	-2.25	6.48
BofAML U.S. High Yield Master II Index	-14.03	5.35	6.07	14.41	-2.27	7.48
BofAML Euro Broad Market Index	-19.20	-9.66	13.35	4.11	-4.39	14.61
BofAML Local Debt Market Plus Index	-12.53	-6.53	4.50	16.44	-4.90	14.71

Source: Morningstar Direct

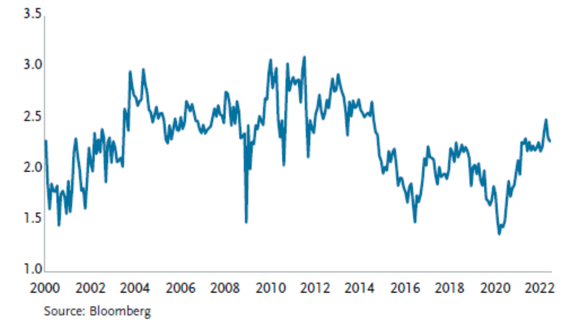
Fixed Income – Inflation



Source: Capital Group



Source: Hedgeye

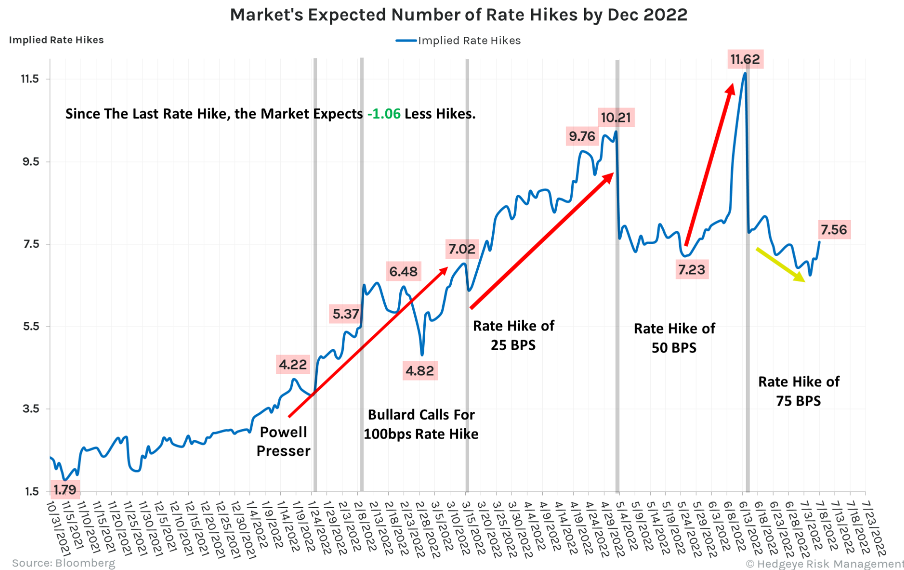


Source: TCW

Inflation rose to 9.1% year-over-year in the second quarter, upending the hope that peak inflation had developed early in the quarter. Not only did headline inflation continue to rise, but so did "sticky inflation" (a weighted basket of items that change price relatively slowly). It reached levels not seen since the early '90s, suggesting core inflation may stay above the U.S. Federal Reserve's (Fed) 2% target for some time after headline numbers start to subside.

On the bright side, there are several indicators signaling inflation will peak in 2022 and begin to moderate. These include long-term inflation expectations, monetary policy tightening, fiscal policy tightening, easing of supply bottlenecks and lessening of commodity price pressures.

Fixed Income – Interest Rates



Source: Hedgeye

Source: TCW

The Fed has committed to bring inflation down to around 2% using the primary tool they have available to them – higher rates. As of quarter-end, the Fed had raised rates 1.5% in 2022. Since quarter-end, the Fed added another 0.75%.

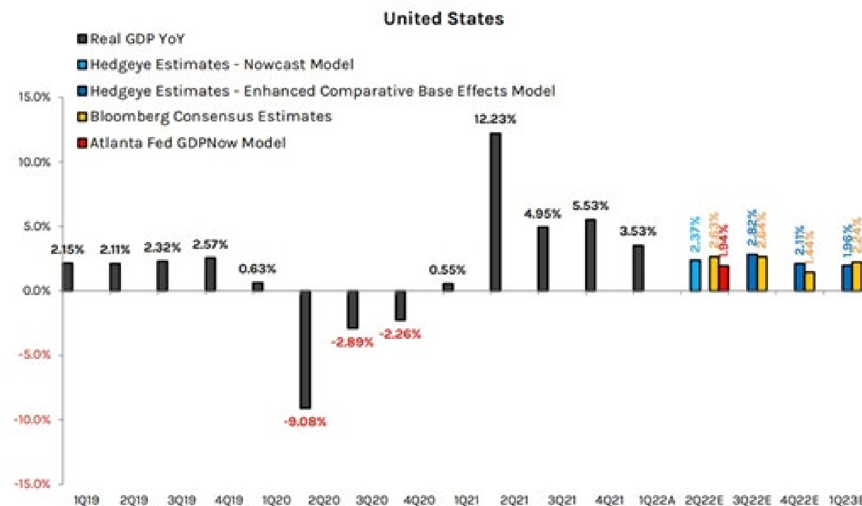
Most market participants expect the Federal Funds rate to end the year between 3.5% and 4%, which would reflect the fastest pace of tightening in over 40 years.

In addition to rate increases, the Fed has implemented a multi-year plan to reduce the size of its balance sheet by $50-$95 billion per month.

The question on everyone's mind is, "will that be enough?" Current pricing in the 10-year bond and the 2–10-year curve suggest it will. In fact, longer term rates imply that the Fed will need to begin cutting rates as early as 2023.

Fixed Income – Global Economic Growth

US Real GDP YoY Projections



Source: Bloomberg, Hedgeye

As the Fed continues an aggressive campaign to fight inflation, it is likely domestic and global growth will continue to slow.

Projections have varied, but the median estimate for GDP growth in the second half of 2022 is between 1-2%, which is a sharp drop from the previous year. If the Fed is forced to tighten more aggressively than currently projected to combat inflation, it may push the economy into recession.

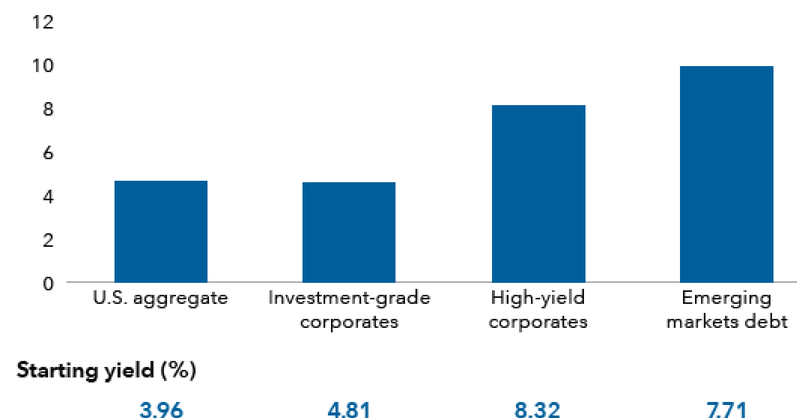
On the bright side, consumer balance sheets and employment are still at healthy levels, which may limit the severity of a recession if one were to occur.

If growth slows to a point that significantly impacts the employment market, it could be the catalyst for the Fed to stop raising rates.

Fixed Income – Yields & Spreads

U.S. Treasuries	Yield 6/30/2022	Yield 12/31/2021	Return 2022 YTD	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
2-Year	2.92%	0.73%	-3.05%	2 years	0.69	-0.32
5-Year	3.01%	1.26%	-7.15%	5	0.92	-0.29
TIPS	0.65%	-1.04%	-8.92%	10	0.58	0.24
10-Year	2.98%	1.52%	-11.71%	10	1.00	-0.26
30-Year	3.14%	1.90%	-23.57%	30	0.93	-0.25
Sector						
U.S. Aggregate	3.72%	1.75%	-10.35%	8.6	0.85	0.10
IG Corps	4.70%	2.33%	-14.39%	11.4	0.46	0.43
Convertibles	7.63%	3.66%	-19.41%	-	-0.23	0.87
U.S. HY	8.89%	4.21%	-14.19%	5.9	-0.20	0.74
Municipals	3.21%	1.11%	-8.96%	12.8	0.42	0.14
MBS	3.77%	1.98%	-8.78%	7.8	0.80	-0.04
ABS	4.38%	1.96%	-2.87%	2.4	-0.41	0.62
Leveraged Loans	8.83%	4.60%	-4.06%	2.6	0.06	0.03

Source: JPMorgan



Source: Capital Group

2022 has been the most difficult period for bond returns in decades as interest rate hikes, off essentially a base of 0%, have put pressure on prices. As the table on the left indicates, returns have generally been the most difficult for longer maturity bonds and lower quality bonds.

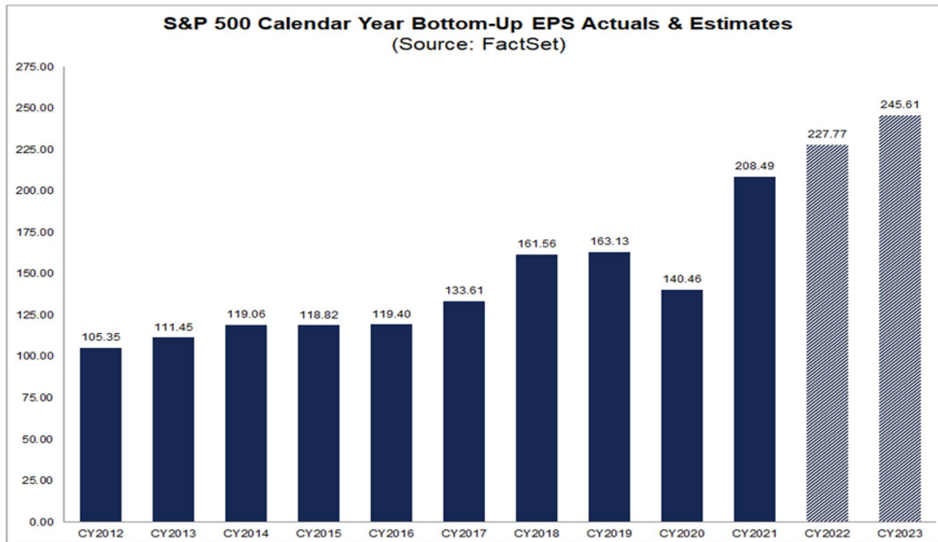
Historically speaking, higher yields tend to produce better forward-looking returns for bonds. With yields higher and spreads wider since the beginning of the year, the environment for bonds over the next five years has the potential to be much more attractive from this point.

Fixed Income - Positioning

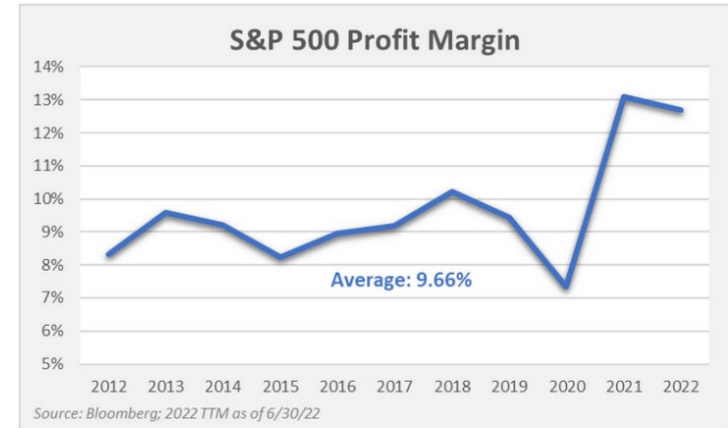
Bond Type	Positioning Notes Compared to Client Benchmarks
Government	We maintain a modest underweight to U.S. Treasury bonds. We prefer bonds that offer a higher yield than Treasuries but are using Treasuries as a risk mitigating holding if credit spreads widen in a poor economic scenario.
Securitized Asset	We continue to generate the bulk of our yield advantage from our overweight to securitized assets. In the current environment, securitized assets generally offer higher yield per unit of risk than other bonds.
Investment Grade Credit	We maintain an underweight to corporate bonds. Despite recent spread widening (yields higher compared to Treasuries), we continue to remain cautious on corporate debt given spreads are near long-term averages. We look to add corporate exposure when spreads are wide relative to history.
High Yield & Bank Loan	Small allocation. We rely on mutual fund managers to emphasize defensive credits and unique opportunities.
International	Small allocation. Negative rates in many non-U.S. developed countries make them uninvestable. Select emerging markets opportunities offer good relative value.
Municipal	We continue to be constructive on municipal securities in tax aware portfolios given strong fundamentals. The ratio of income that can be earned in municipal bonds compared to Treasuries is attractive.

Portfolios are broadly positioned to generate a higher yield than our benchmarks while taking similar interest rate risk. Due to yield curve flattening, we have a bias to add exposure to client portfolios in bond maturities in the 2-4 year range given higher relative yields. We remain cautious on investment grade corporates and high-yield corporate bonds. We prefer to gain our yield advantage through actively-managed mutual funds with an emphasis in securitized assets.

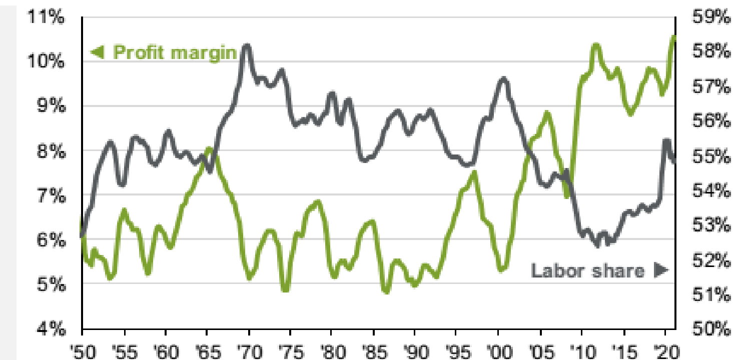
Equity – Earnings



Source: FactSet Earnings Insight – July 29, 2022



Source: Palm Valley Capital – That's the Ticket (July 18, 2022)



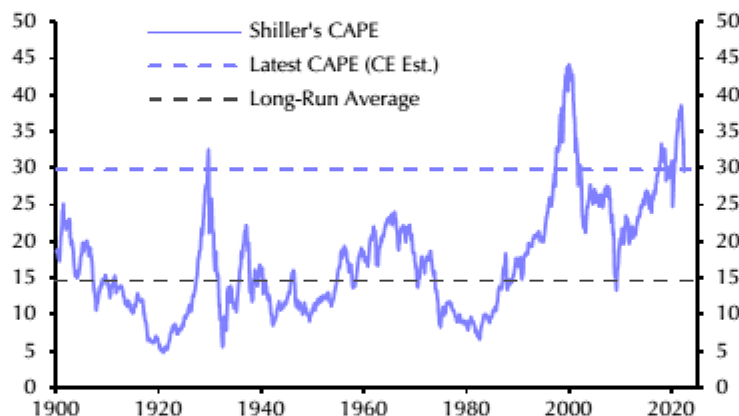
Source: JP Morgan Asset Management – Guide to the Markets 3Q 2022

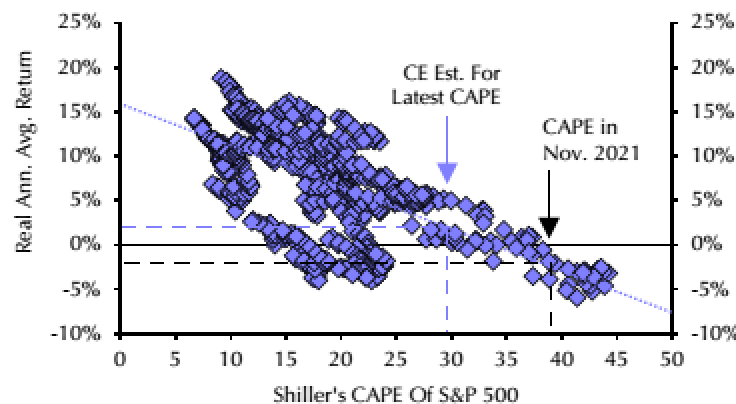
Analysts project S&P 500® earnings to grow for calendar year 2022 and 2023.

- Corporations were able to expand profit margins considerably following the pandemic shutdown in 2020 (upper right).
- Historically, as the labor share of income increased (wages), profit margins have declined. This decline has not yet occurred during the current stage of the business cycle (lower right).
- If corporate profit margins were to revert to the 10-year average, corporate profits may decline -25%.

Rising costs, notably wage growth, may lead to a larger decline in profit margins and earnings than currently expected.

Equity – U.S. Valuations





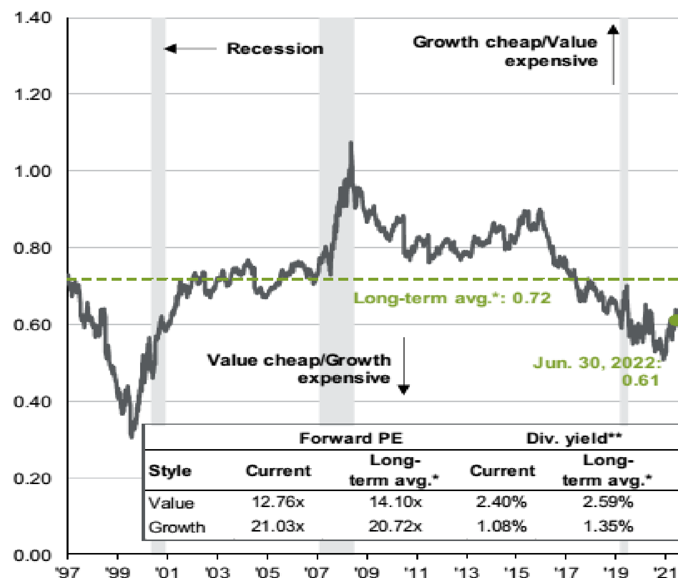
Source: Capital Economics – The Long Run (July 25, 2022)

U.S. valuation levels have declined from recent cycle highs, but remain elevated relative to history.

- The Shiller CAPE (cyclically adjusted price-to-earnings) is a valuation metric that uses long-term earnings (average of the last 10 years, adjusted for inflation) to smooth out the volatility of short-term earnings fluctuations. This measure hit a peak of roughly 39x for the S&P 500® in November 2021 but has since declined to under 30x as stock prices declined. Despite the decline, the measure remains well above its long-term average of just under 15x (top left).
- The recent equity market selloff (and corresponding decline in Shiller's CAPE) has improved future long-term return prospects. However, returns are projected to be relatively meager compared to the returns experienced for the U.S. equity market over the last ten years.

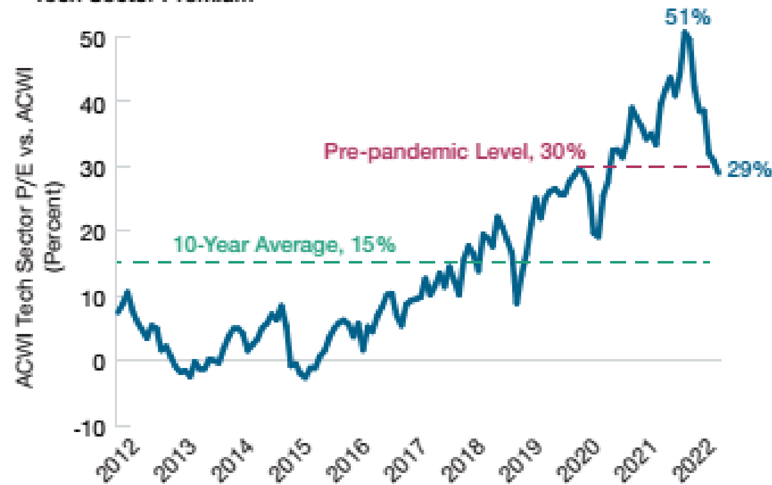
The selloff in equity markets over the first half of 2022 has resulted in more attractive valuation levels. However, if earnings were to erode more than anticipated (prior slide), valuations would not be as attractive. Our U.S. equity positioning remains relatively defensive in portfolios as a result.

Equity – U.S. Style



	Forward PE		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	12.76x	14.10x	2.40%	2.59%
Growth	21.03x	20.72x	1.08%	1.35%

Source: JP Morgan Asset Management – Guide to the Markets 3Q 2022



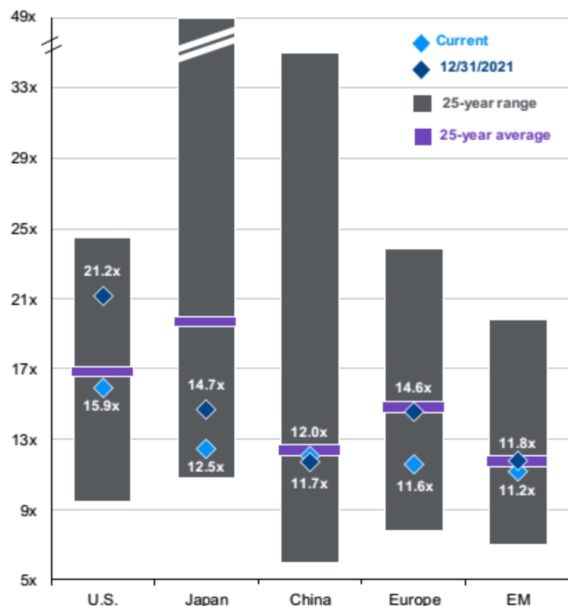
Source: T. Rowe Price – Asset Allocation Insights (July 2022)

U.S. growth stocks posted large losses over the first half of 2022, which improved relative valuation levels when compared to U.S. value stocks (upper left chart displays relative fwd P/E ratios of the Russell 1000® Value Index and Russell 1000® Growth Index).

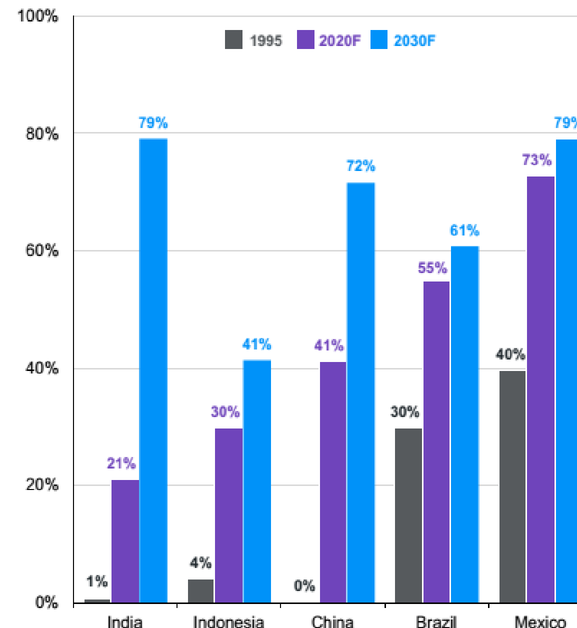
- Despite the relatively attractive returns from U.S. value stocks in 2022, these stocks continue to be less expensive when compared to U.S. growth stocks from a valuation perspective.
- The "premium" investors were willing to pay for technology stocks increased following the pandemic (upper right). This premium eroded as technology stocks registered large losses in 2022. However, even with the large selloff in these types of stocks, they remain priced at a significant premium to the rest of the equity market and relative to the 10-year average.

We believe U.S. value stocks have the potential to outperform growth stocks by a relatively meaningful margin over the short- to intermediate-term and may also provide better downside protection in volatile markets.

Equity – Non-U.S. Valuations



Source: JP Morgan Asset Management – Guide to the Markets 3Q 2022



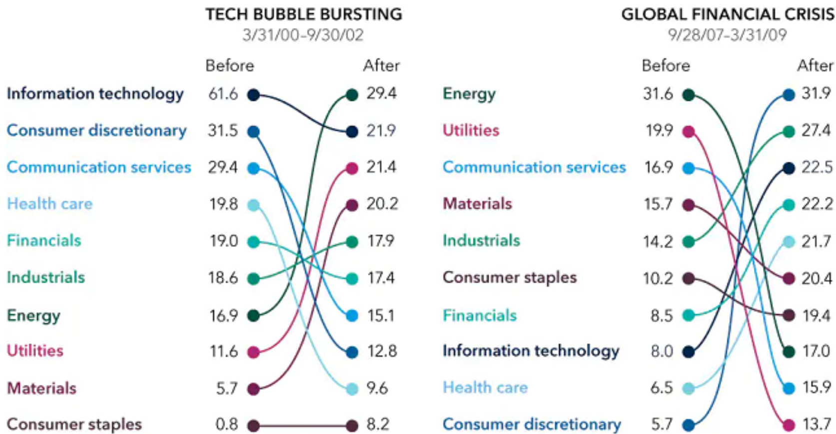
Source: JP Morgan Asset Management – Guide to the Markets 3Q 2022

Foreign equity markets, notably emerging markets, remain relatively attractive compared to the U.S. equity market (top left).

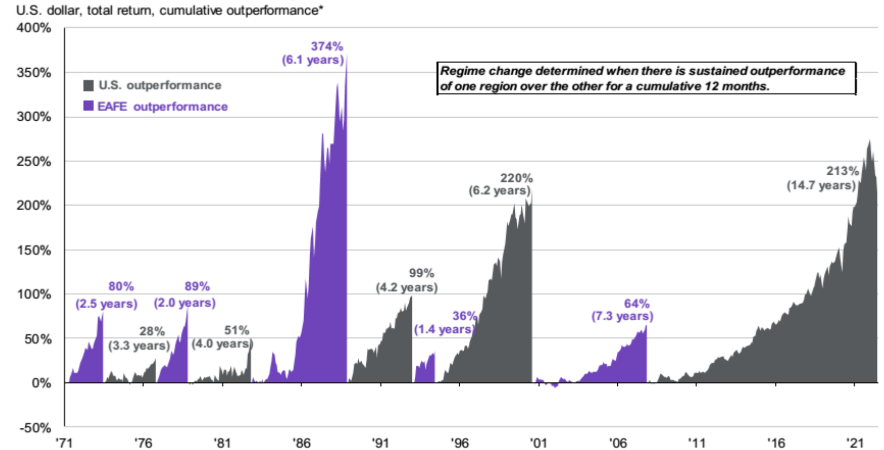
- Valuation levels for U.S. stocks have improved but remain elevated compared to other major global markets/regions including Japan, Europe and emerging markets.
- Emerging markets economies are expected to grow at a faster rate compared to the U.S. and other developed foreign countries over the long term. One of the primary drivers in emerging economies is expected to be rapid growth of the middle class over the next decade (upper right).

Based on attractive valuations, along with a positive macroeconomic backdrop, we believe emerging markets equities may provide investors with relatively attractive returns over the intermediate- to long-term.

Equity – Sector Leadership



Source: Capital Group – RIA Insider



Source: JP Morgan Asset Management – Guide to the Markets 3Q 2022

Historically, sector leadership has changed following major inflection points during market cycles.

- The graphic at the top left examines equity market sector leadership changes before and after the tech bubble and the global financial crisis. In general, during both periods leadership transitioned from growth-oriented sectors to value-oriented sectors and vice versa.
- U.S. stocks have outperformed developed foreign equities for an extended period (upper right). Note that leadership changes between U.S. stocks and foreign stocks also occurred in roughly the same timeframes as the tech bubble and the global financial crisis.

We believe we have entered a period when two long-standing cycles have (or will) transition to new leadership. We believe value-oriented equities will outperform growth-oriented equities and foreign equities (notably emerging markets) will perform relatively well compared to U.S. equities over the intermediate- to long-term.

Equity – Fed Tightening and Earnings

S&P 500® Quarterly Total Returns
(Mar. 1971 – Jun. 2022)

Profits \ Fed	Easing	Tightening
Accelerating	3.5% Avg return/ 26% Probability of a loss	3.9% Avg return/18% Probability of a loss
Decelerating	2.6% Avg return/ 29% Probability of a loss	1.7% Avg return/ 43% Probability of Loss

Source: Richard Bernstein Advisors LLC, FRB, S&P Global, Bloomberg Finance L.P.

Source: RBA Insights – July 2022

Historically, Fed tightening cycles have corresponded with the corporate earnings cycle. Interest rates generally increase as earnings improved or accelerated and then decline as earnings eroded. Said differently, rate increases were used to "cool" markets to prevent overheating and would then be decreased in order to provide support during periods of economic stress.

- There have been periods when the Fed raised rates into a softening earnings cycle, but it is uncommon.
- If corporate earnings do not hold up as well as currently expected, markets may be entering one of these periods.
- The matrix above examined periods under four different Fed/profit regimes. The weakest returns (average quarterly return) and highest probability of loss occurred when the Fed was tightening, and profits were decelerating.

The potential for Fed policy missteps are one of the reasons we continue to be positioned conservatively in U.S. equity markets.

Equity – Long-Term Focus

S&P 500 Index returns: Before, during, and after recessions

Recession Start	Length (Years)	12M Before	6M Before	During Recession	6M After	12M After	2Y After
08-31-1957	0.67	-5%	5%	-4%	18%	33%	25%
04-30-1960	0.83	-8%		17%	7%	10%	1%
12-31-1969	0.92	-11%	-6%	-5%	14%	8%	34%
11-30-1973	1.33	-18%	-9%	-13%	1%	23%	18%
01-31-1980	0.50	14%	10%	7%	6%	8%	-12%
07-31-1981	1.33	8%	1%	6%	-19%	20%	18%
07-31-1990	0.67	3%	8%	5%	3%	8%	20%
03-31-2001	0.67	-23%	-19%	-2%	-6%	-18%	-7%
12-31-2007	1.50	4%	-2%	-37%	21%	12%	44%
02-29-2020	0.17	6%	1%	-1%	12%	44%	?
Average Return		-3%	-2%	-1%	7%	16%	20%
% Positive Return Periods		45%	45%	45%	82%	91%	82%

Source: Invesco – Markets and Recessions

S&P 500® Index returns have varied greatly before, during and after recessions.

- In general, the weakest equity returns have been experienced in the lead up to, and during, recessions.
- On a positive note, the equity market has tended to perform quite well in periods following recessions. In fact, the market has averaged a return of approximately +16% in the 12 months following a recession and were positive roughly 90% of the time (green box).

Market downturns are a regular occurrence. The key for investors is to avoid the stress of daily headlines and instead maintain a focus on their investment plan and long-term goals.

We are an investment firm, founded by investors.

Bob Batchelor, CFA®, CFP® is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 23 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee. Bob has also earned the right to use the Certified Financial Planner™ certification.

Charles (C.J.) Batchelor, CFA® is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 18 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a voting member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee, where he currently serves on the Board of Directors.

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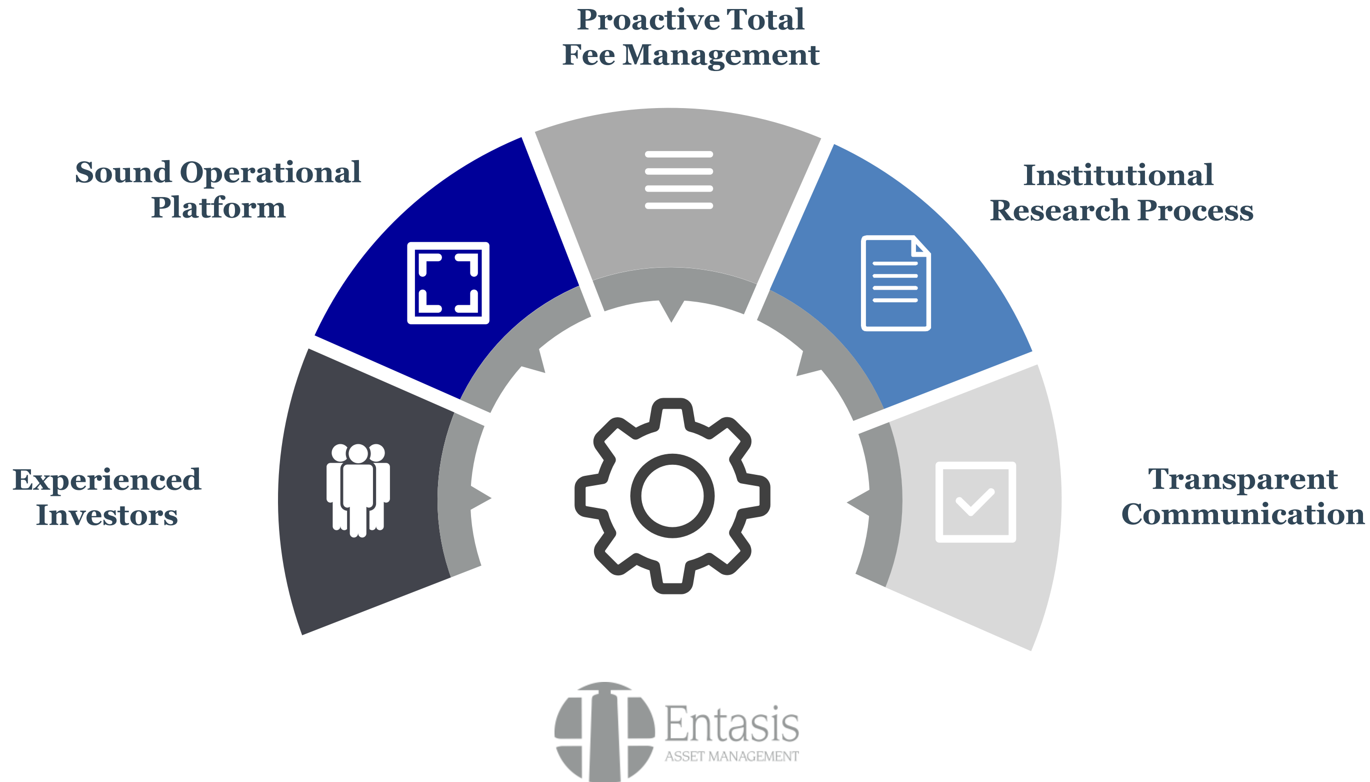
David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

The Entasis Difference



Disclosure

IMPORTANT INFORMATION

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The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S. The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year. The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries. Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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