Grant Street Asset Management, Inc.

INVESTMENT ADVISORS

GRANT STREET ASSET MANAGEMENT, INC
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With the third quarter of 2022 in the books, investors are turning their focus towards year-end. A number of unanswered questions remain. Has inflation peaked yet? Will consistent consumer spending persist? Will corporate earnings prove resilient? Is the labor shortage improving? Will unemployment maintain its notable lows? Is the U.S. in a recession? What will the mid-term elections bring? When will there be a resolution to the Russia-Ukraine conflict? And so on and so on…

Investors struggle to invest with any level of certainty in such environments, so it is no wonder that the markets have struggled to find stable footing over the past quarter. Grant Street's process remains consistent throughout market cycles, and our task is to evaluate the driving factors that may answer the questions challenging investors today so that we may make informed decisions to drive long-term returns and protect capital.

The headlines (and markets) would suggest that economically, the U.S. is struggling if not drowning. It is simply not the case, and our Investment Committee has observed a number of recent datapoints that support both economic growth and slow-down. This contrasting data is not altogether a negative sign since the Federal Reserve remains focused on cooling the economy while hoping it can grow just enough to offset a recession.

- For example, the most recent jobs report showed a drop of over one million job openings in August, and the September report also missed expectations. This slowing may indicate a loosening of the historically tight labor market, but there is not yet evidence of that potential in the unemployment rate, which recently dropped to 3.5% in September. It is worth noting that the unemployment rate is one of the last data points to reflect economic transitions and impacts from monetary policy.
- On the flip side, the most recent inflation report was disappointing and indicated inflation was stronger in August (the most recent reading) after being flat in July. Consumers have been impressively resilient to higher prices as a result of excess savings, low debt levels and strong employment. While that is good news in terms of supporting GDP growth, these factors present a unique challenge for The Federal Reserve to lower prices.
- Another bright spot in the U.S. is manufacturing, which continues to expand and is very healthy. The Manufacturing Purchasing Managers' Index (PMI), which is used as a proxy for general manufacturing activity, registered 52 in September (a reading above 50 indicates expansion; below 50 indicates contraction). Industrial production is also at record highs.

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While these are just a few examples, we continue to find pockets of strength, reserves and solid economic activity to offset the brake pedal of higher inflation and interest rates. We expect economic growth to continue to slow and decade-high inflation to ease. With these broad activity metrics continuing to remain positive, we believe there is supporting evidence at this time that we are likely to avoid a sharp economic slowdown.

While the state of the economy may influence the performance of securities markets, we often see a timing disconnect between the two given that the markets are forward-looking while the economic data is backward-looking. As such, investors were quite pleased when year-over-year inflation figures dipped in July. That news started off the third quarter with an equity rally that was the fourth best performance on record, as measured by the S&P 500 Index (large companies). However, that was short-lived once the Federal Reserve emphasized its commitment to continuing to raise rates, and markets gave back those gains plus some in August and September. The third quarter was a sobering example of the power the Federal Reserve holds over equity and fixed income markets today. Its actions (increasing rates) and language (messaging and tone) can shift sentiment rather abruptly. Fixed income and equity markets, both domestic and globally, were negative for the third quarter. It is worth noting that while YTD figures are uncomfortably in the red, they follow above-average returns earned in the prior three years, as illustrated by the following table.

Equity Index	**3Q 2022**	**YTD**	**Last 3 Yrs thru 12/31 (Cum.)**
S&P 500 (Large Companies)	-4.9%	-23.9%	100.4%
Nasdaq 100 (Technology-heavy)	-4.4%	-32.4%	164.7%
S&P 400 (Mid-sized Companies)	-2.5%	-21.5%	79.0%
Russell 2000 (Small-sized Companies)	-2.2%	-25.1%	72.9%
MSCI EAFE (Europe, Australia & Far East)	-9.4%	-27.1%	46.4%
MSCI Emerging Markets	-11.6%	-27.2%	36.6%
MSCI ACWI (All Country World Index)	-6.7%	-25.8%	73.6%

Source: Morningstar Direct

Fixed Income Index	**3Q 2022**	**YTD**	**Last 3 Yrs thru 12/31 (Cum.)**
Morningstar US Core Bond	-4.8%	-14.6%	14.9%
U.S. 10-year Treasury	-6.2%	-16.8%	16.0%
ICE BofA 1-3 Yr. U.S. Treasury	-1.6%	-4.4%	6.2%
U.S. 3-month T-Bills	0.5%	0.6%	3.0%
ICE BofA U.S. High Yield	-0.7%	-14.6%	28.0%
ICE BofA 7-10 Yr. Municipal Bond	-2.6%	-10.5%	14.3%

Source: Morningstar Direct

Aside from the macroeconomic focus on inflation and interest rates, the story of 2022 has also been about the increased market volatility. 2021 was an unusually calm year for markets, and returns were robust. In contrast, 2022 volatility has been above historic norms. For example, during the full year of 2021, the S&P 500 experienced daily price moves of ± 2% just seven times. In contrast, thru August 31, 2022, the S&P 500 has experienced thirty-one daily price moves of the same magnitude. 2021 had no daily price moves of ± 3% or ± 4%, but 2022 has seen eight daily moves of ± 3% and one move of ± 4%. On one hand, we believe this heightened volatility demonstrates that investors are extremely uncertain in the current environment; sharp swings point to a fickle investor. On the other hand, amidst this volatility, the valuation on the S&P 500 has fallen below its 25-year average. We do not believe its possible to accurately time a market bottom, but investing below historic valuations brings a high probability of success for above-average returns for investors.

Turning to portfolio allocation, Grant Street has remained active in positioning portfolios in a rapidly changing environment. As the Federal Reserve has raised its target rate range to 3.0% - 3.25%, they have breathed new life back into traditional fixed income sectors, by way of yield, that investors have not seen in over a decade. For example, a 2-year Treasury note is now paying a coupon over 4%, a yield last seen in 2007. With current yields at these levels, investors now have an attractive alternative to equity that can help compensate for taking risk across the portfolio. During the quarter Grant Street increased the quality and shortened the duration (i.e. interest rate sensitivity) of our fixed income holdings in response to The Fed's comments, all the while maintaining a nearly equal yield. While we continue to favor equity exposure for long-term growth, especially at current valuations, fixed income may once again contribute to portfolio returns.

Within equities, we prefer U.S. equity to international equity exposure, given that the U.S. is in a better position to maintain slower growth in the months ahead compared to other developed countries. While the tense geopolitical landscape and underlying risks from Europe to Asia warrant a cautious outlook, we continue to hold some international equities given attractive valuations at multi-decade lows relative to the U.S. Additionally, even as the U.S. dollar strengthens to highs not seen in decades, once the U.S. dollar weakens (i.e. other foreign currencies strengthen) foreign stocks stand to benefit from a tailwind of returns.

We remain focused more than ever on setting aside the headline rhetoric to focus on data, trends and the real fundamental drivers of economic and market growth. We continue to leverage our dozens of research partners to synthesize information in a world of uncertainty. There is no shortage of wide-ranging opinions on where we go from here. We remain sensitive to The Federal Reserve's plans moving forward and are prepared to pivot our outlook and portfolio positioning if appropriate. Sentiment will indeed impact markets in the short-term, but as long-term investors, opportunities always arise in such environments. As always, we value your trust and confidence i n the Grant Street team.