LEVEL FOUR®
Capital Management
A DIVISION OF CARR, RIGGS & INGRAM CAPITAL, LLC

QUARTERLY NEWSLETTER

MARKET BOTTOM… ARE WE THERE YET?

3Q • 2022

Chart 1. Index Performance as of 06.30.2022

INDEX PERFORMANCE

Returns as of 06.30.2022

S&P 500 (SPX)	-16.45%
Dow Jones Indus. Avg (INDU)	-11.25%
Bloomberg 1K Growth	-20.04%
Bloomberg 1K Value	-10.65%
Bloomberg Developed Ex North America & Mid Cap	-15.41%
Bloomberg World Index	-15.89%
U.S. Corp High Yield	-9.83%
Alerian MLP	-9.07%

Chart & Performance Numbers Source: Bloomberg as of 06.30.2022

Where does the market bottom? It is a question we have spoken about and addressed many times. In short, the market is very hard, if not impossible, to time and therefore we cannot definitively say. No one can. That said, in the current environment, while our short-term view is less certain, longer-term (1-3 years out) we believe stocks will be higher. There is no doubt, we could see more volatility and an intermediate bottom before we make way for an eventual new high. The timing and magnitude of another move down in equity markets and the eventual new high will most likely be determined by the current earnings season and future growth expectations contained within.

MARKET CORRECTIONS – A CLOSER LOOK

Currently, we have had Part One of a typical correction; a ***price-to-earnings (P/E) contraction***, with P/E ratios contracting roughly 40% on a trailing basis. On a historical basis, the median P/E contraction for the last four recessions is about 28%, so it would be reasonable to conclude that we are close on Part One. Part Two is usually ***earnings contraction***. As mentioned above, we believe this earnings season will shed light on the market's future path. We are currently in S&P 500 earnings season for the 2nd quarter 2022, and if we look to the large Financial sector companies that have reported thus far as an indication, the market is looking very good in our opinion. That said, we have many more earnings reports to digest, including the all-important big Tech names. Current trailing twelve-month earnings per share (EPS) for the S&P 500 is $199.01, and the 1-year forward Bloomberg consensus estimate is $228.98, or about a 15% increase. If that earnings estimate holds, it would put the market at 16.8 times forward earnings, which is not bad considering the market peaked at 21.16 times forward earnings, or a 26% contraction (The average has been 26.82% for the last four recessions on forward estimates).

Why are we seeing earnings slow down? We are most likely in a recession and therefore expect earnings to slow; however, the important question is how much? This will ultimately determine if we experience a mild or deep recession. There are two main reasons we believe there is a high probability we are in a recession, Dr. Copper and Mr. Market. First, let's look at copper and why it has been viewed as a leading indicator of recessions. In 2014, the Dutch bank ABN AMRO published a study showing a strong correlation between copper prices and oil prices, gold prices, world trade, as well as regional GDP growth in China, the United States and the European Union. The metal's wide-ranging application in many industries and products makes it particularly sensitive to business activity. In fact, market participants coined the term "Dr. Copper" to personify its ability to accurately predict turning points in economic cycles. Copper prices slid over 21% in the second quarter amid slowing demand, a strengthening dollar and rising interest rates.

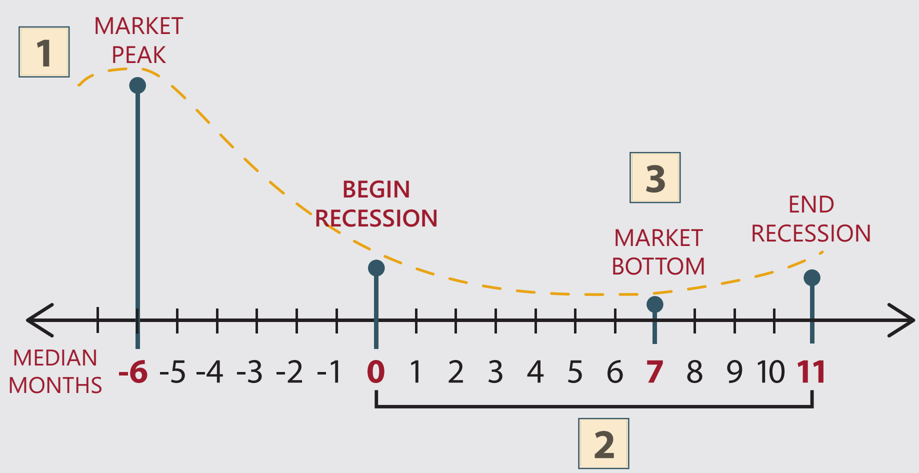
And now, Mr. Market. The popular definition of a bear market is the S&P 500 being 20% off its high. Mr. Market is currently in a bear market and therefore signaling a recession having been in bear market territory or down 23.55% peak to trough, and currently down about 20%. If prices lead fundamentals, then we should see the economy also finding a bottom soon, if it has not already. In the 2010 paper "*Consistency Of The Stock Market In Anticipating Economic Cycles*", by Laurence W. Franz (Chart 2). Mr. Franz analyzed the 13 recessions according to NBER, from 1929 to 2009. We can summarize his findings to help us better understand recessionary cycles.

1 - Mr. Franz found that the median stock market peak was 6 months prior to an economic downturn. (NOTE: Post World War II, the metrics shifted somewhat to a range of 1 to 6.7 months and the median increased to 8 months.)

2 - The median length of recession looking back to 1929 and post-World War, is 11 months.

3 - The stock market anticipated the eventual upturn in the economy with a median lead time of 4 months.

Chart 2. 1929 - 2009 Recession Median Months



Source: Data extracted from "*Consistency Of The Stock Market In Anticipating Economic Cycles*", by Laurence W. Franz.

With this historical information as a backdrop and to help put the current environment into context, to-date the market peak was on 1/3/22 at $4796 and the market low to-date was set on 6/17/2022 at $3637. Only time will tell if this was indeed the bottom for 2022, we see three possible scenarios:

Mild Recession: First, and the base case at the moment, is that we have entered a mild recession, which would mean a 4-5% hit to S&P 500 earnings and a probable visit to the bottom, plus 5-8% more to the downside. This would probably be quick and driven by final capitulation, if that previous bottom is extended.

No Recession: Second, that there will be no recession, an average forward estimate change and we are back to risk-on, with a more U-shaped rather than V-shaped recovery.

Recession: And finally, the worst case, that we will have a recession with median earnings downdraft of 20%. In this case we would see 7-10% additional downside risk.

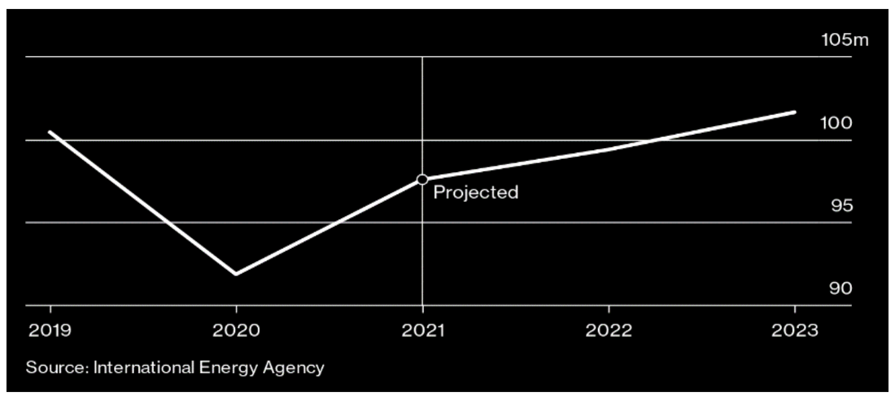
INTERNATIONAL

Looking abroad, volatility across asset classes jumped due to geopolitical tensions, growth forecast revisions and a shift in monetary policy. The Bloomberg World index dropped 15.89% last quarter, which is the worst quarterly performance since the first quarter of 2020. The Bloomberg Commodity index soared 40% during the same period, skewing consumer prices to the upside. Policy makers reacted differently to rising inflation, as fiscal authorities also took proactive steps to help consumers deal with higher gas prices. Global Manufacturing PMI edged down as rising raw material costs softened demand. Equity multiples quickly compressed, and bond yields broadly rose, offering attractive entry points for long-term investors.

RISING GEOPOLITICAL RISKS

The Russian invasion of Ukraine reshuffled the geopolitical deck, with countries looking at their self-interest to mitigate war-induced inflation and avoid social unrest. For instance, China doubled Russian energy imports with a $7.5 billion order of crude oil in May, despite NATO sanctions against Russian oil. India also ramped up Russian oil purchases due to the lack of reliable alternative source of energy. According to Bloomberg, sanctions placed on Iran helped increase Russia's oil share of India's energy imports to 25%. Brazil also decided to maintain its relationship with Russia to secure energy imports. President Jair Bolsonaro is facing stiff competition in its reelection bid as former President Lula leads opinion polls. Bolsonaro is willing to negotiate energy deals with Russia if it means lower domestic prices and increased popularity. The positioning of these three major economies regarding Russia is creating a multipolar dynamic that has been absent for decades. Emerging markets currencies weakened last quarter as the dollar strengthened.

Chart 3. Global Oil Demand (Barrels per day)



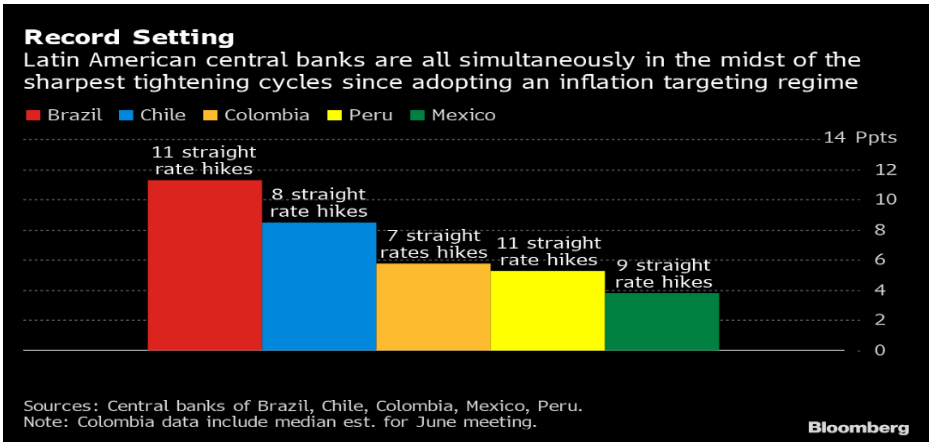
Source: Bloomberg as of 06.30.2022

In Europe, leaders have conceded that Vladimir Putin could send the continent into a recession by cutting oil and gas supplies. Russia displayed its bargaining power by mandating and obtaining gas payments in rubles from European companies and countries. In late April, European gas prices soared after Russia's Gazprom cut natural gas supplies in Poland and Bulgaria due to their non-compliance to payment in rubles. Earlier in the month, OPEC warned European countries that it is not possible to replace potential Russian oil supply loss as it would represent more than 7 million barrels per day. In late May, the European Commission published a plan aiming at ending the European Union's (EU) dependence on Russian fossils fuel and accelerating the green transition. A few days later, EU leaders agreed on a partial ban on Russian oil imports into the bloc that should effectively cut close to 90% of oil imports from Russia to the EU by the end of the year. Energy was the best performing sector in the Euro STOXX index last quarter, up 2.64%.

INTEREST RATES ADJUSTMENTS

The energy shock and ongoing supply chain disruptions stemming from COVID-19 pushed policy makers to be more hawkish. In Latin America, central banks were particularly aggressive from late 2021 and delivered record hikes to stay ahead of the curve. For instance, in Brazil, Central Bank of Brazil delivered 11 straight hikes as policy makers bet the booming economy supported by strong commodity exports could absorb the tightening. Despite these hikes, consumer prices remain elevated with a CPI print rising from 11.30% in March to 11.89% in June. The Brazil Composite PMI climbed from 56.60 to 59.40 during the same period due to healthy demand for goods and services. The Brazilian Real tumbled over 10% during the quarter as global investors found refuge in the dollar in a context of heightened volatility. In Chile, the Central Bank took a similar approach with 8 straight hikes to put a lid on the demand side of inflation. The Chilean peso collapsed 16% last quarter, mainly attributed to the political regime change.

Chart 4. Record Setting



Source: Bloomberg as of 06.30.2022

Despite inflation concerns, China decided to ease financing conditions amid slowing growth and COVID-19 flareup. The COVID-zero policy had devastating effects on retail businesses due to strict lockdowns, pushing governments to allocate subsidies to businesses and households. Retail sales fell as much as 11.10% in April, and Manufacturing PMI sank to 47.40. Furthermore, the Renminbi lost 5.66% last quarter versus the US dollar as regulatory risks and growth deceleration amplified outflows. The common prosperity agenda promoted by the government is unintentionally capping global expansion ambition of Chinese mega-cap companies. Consequently, many money managers have written off this market. The announcement of business-friendly measures could quickly change market sentiment. In Japan, Bank of Japan (BOJ) also decided to prioritize growth and COVID-19 recovery despite rising consumer prices. As a result, the BOJ maintained its key rate at -0.10%. The currency market strongly reacted by sending the yen to multi-year low versus the dollar. LFCM is ready to take advantage of market dislocations.

ASSET ALLOCATION VIEW – "BEYOND THE 60/40"

In our previous newsletter, we discussed the long-term performance of the 60/40 portfolio. Traditionally, diversification between stocks and bonds offers a less volatile investment mix as those two asset classes typically do not trend the same way at the same time. However, in the 2nd quarter of 2022, the 60/40 decline continued, with both stocks and bonds exhibiting negative returns. Given this performance, what can be done to further diversify a portfolio?

ALTERNATIVE INVESTMENTS

Alternative investments, whether liquid or less liquid, can be added to a portfolio to further reduce volatility, especially during periods of market decline. Alternative assets can be viewed as those assets that are not public equity or public fixed income, i.e. non-traditional assets. The graph below compares the 2022 YTD returns of equity, fixed income, and liquid alternatives benchmarks.

Chart 5. Equity/Fixed Income/AlTs Performance

Source: Bloomberg as of 06.30.2022

As you can see in Chart 5, although still negative, the liquid alternative benchmark has outperformed both stocks and bonds in the first half of 2022.

What exactly are alternative investments? In a nutshell, alternative investments are anything that is neither public equity nor traditional fixed income. Public equity is ownership of a publicly traded company and over time is the best way to create wealth as the owners of companies share in the success and profits of those companies (ownership). Fixed income is a loan, often to those same companies, and is repaid including a rate of interest (loanership). Historically, long term, returns from "ownership" have exceeded returns from "loanership." Alternative investments (Alts) are simply anything else.

Characteristics of Alts can be viewed in two ways. An investment would be classified as an Alt by the type of investments it holds, how it manages investments or a combination of both. Alts may also feature daily liquidity or may be more illiquid to take advantage of less liquid investments. Many Alts will also reference their holdings as long (a holding is profitable when the price goes up) or short (a holding is profitable when the price goes down). Below is a list of alternatives; this listing is not exhaustive. Often the best use of alternatives in a portfolio is a sleeve which may employ several of these alternatives.

SOME EXAMPLES OF ALTERNATIVES:

- Managed Futures – These strategies can take long or short positions in the futures markets, thus gaining the desired exposure to equities, bonds, currencies, commodities, interest rates, or practically anything that trades in the futures market, and is allowed by the prospectus of the individual investment. As these can go long or short, they can achieve a profit (or loss) regardless of the directionality of the markets.
- Long-Short Equity – As the name implies, these strategies can take long or short positions in publicly traded companies. Most of these investments hold a mix of long and short equity positions simultaneously.
- Options based strategies – These strategies may use various options exclusively or more often will use options in conjunction with equities to reduce risk in the underlying holdings.
- Commodities – These products can hold individual or a basket of commodities. These most often access the commodities markets via the futures markets. Commodities may do well during inflationary conditions.
    - Gold – This is an exception to above. Funds and ETFs that hold gold typically hold the physical gold in a secure location. Many investors employ gold as a portfolio diversifier.
- REITs – (Real Estate Investment Trusts) REITs invest in various types of real estate. These can either be publicly traded (liquid) or non-traded (less liquid).
- Various types of private investments, such as private equity, private credit, and various specialty investments – These often offer higher returns than similar liquid investments due to an "illiquidity premium". Investors seeking investments in these may have to fulfill certain income/wealth requirements and should understand that these investments can only be liquidated under the terms of the subscription agreement.

ALTERNATIVE INVESTMENT CONSIDERATIONS

- Understand the costs – Many alternative investments have higher fees than typical stock and bond investments due to the higher cost of investing in those areas, so be aware of that cost.
- Understand how an Alt improves a portfolio - An effective Alt sleeve should either improve the return or (most often) reduce the volatility of a portfolio. Investors in Alts should understand this relationship.
- Finally, and most importantly - Understand the benefits and risks of a given alternative strategy. While many alternative investments are intended to be risk reducers and have less volatility than the public equity markets, some strategies can be extremely risky. For example, a few years ago, there were a few alternative strategies that were short market volatility. This was a profitable investment during times of low volatility, but then collapsed when volatility rose, often resulting in a total loss.

In summary, alternative investments can be a valuable addition to a stock and bond allocation, especially in times of market volatility; however, care must be taken to construct the best sleeve of alternatives to meet an individual investor's needs provided that such investments are in the best interest of the investor given the investor's experience, investment objectives and risk tolerance.

CURRENT ASSET ALLOCATION POSITIONING:

The second quarter of 2022 reflected a continued response of financial markets to increased inflation, the increase of the federal funds rate, the beginning of quantitative tightening, and emerging recession worries. We are closely watching the effects of these changes while still keeping aware of ongoing economic activity and government policy.

IN ACCORDANCE WITH THIS VIEW, WE CURRENTLY SEE THE FOLLOWING INDICATIONS FOR ASSET ALLOCATION:

General Allocation – In the 2nd quarter, markets declined sharply with our equity benchmark down 16.18% while our fixed income benchmark declined, 4.69%. In the fixed income markets, interest rate spreads widened significantly by about 250 bps on high yield debt, contributing to an approximate 10% loss during the month in high yield (junk) bonds. We recommend a quality core of equity focusing on companies with strong balance sheets and strong cash flows and a good balance between growth and value. For fixed income, we recommend a mix of core, multisector, and floating rate/inflation protected allocations. As the Fed tightens monetary policy to combat persistent inflation, we have seen volatility in the fixed income markets increase, both in terms of overall interest rates and spreads. However, as interest rates and spreads have increased and equity prices have declined, valuations for both areas have become more reasonable. However, we continue to support an allocation to non-correlated alternative assets in mixed equity/fixed income models. We are closely monitoring the rate of changes in monetary policy the Fed will implement. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and the market environment dictate.

Equity Allocation - We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks, we are currently equal weight equities relative to our benchmark. We are neutral US equities versus international. We note that although trading more cheaply that US equities, Europe faces an energy shortage, recession and increase inflation to due to Russia/Ukrainian conflict. In the event of a resolution of this conflict, we will monitor Europe for opportunities.

We are neutral regarding select small/mid-cap equities. We continue to emphasize high quality and high cash flow equities as those type of companies should continue to offer value in the current uncertain economic conditions. We are cautious regarding emerging markets as China continues to employ a "zero-covid" policy along with the possibility of a worldwide recession.

Fixed Income Allocation – As rates have risen and spreads have widened, we are seeing more opportunities in the fixed income area. Important aspects of fixed income performance include such items as current peak inflation, inflationary expectations, and a possible future recession. These often cause conflicting movements in the various areas for the fixed income markets, providing both additional risks and opportunities. All of this indicates a more tactical approach of fixed income management. Longer term, rates may simply respond to changes in the economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. We will continue to monitor and interest rate movements and spreads closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

Liquid Alternatives – As earlier discussed, liquid alternatives have been helpful in reducing portfolio volatility and improving risk adjusted returns. We recommend considering alternatives as an option to reduce portfolio volatility provided that such investments are in the best interest of the investor given the investor's experience, investment objectives and risk tolerance.

As always, we are working hard on "best ideas" to take full advantage of any over index moves. We believe that our focus in all of our portfolios is on quality and value, and they are positioned even better in an inflationary environment. Inflation and uncertainty usually leads to more dispersion in returns and more focus on picking high quality and well-run companies at great prices, versus long-term intrinsic value.

Thank You,
Level Four Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

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The Bloomberg US 1000 Value and Growth Indices (B1000V & B1000G) are screened from the Bloomberg US 1000 Index (B1000) and are constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. For detailed information, review the index methodology document.

Bloomberg Developed Markets ex N. America Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

Bloomberg World Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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