Market Summary

U.S. Equity Markets (%)	3Q'22	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500	-4.9	-23.9	-15.5	8.2	9.2	11.7
Russell 1000 Growth	-3.6	-30.7	-22.6	10.7	12.2	13.7
Russell 1000 Value	-5.6	-17.8	-11.4	4.4	5.3	9.2
Russell 2000	-2.2	-25.1	-23.5	4.3	3.6	8.6
Russell 2000 Growth	0.2	-29.3	-29.3	2.9	3.6	8.8
Russell 2000 Value	-4.6	-21.1	-17.7	4.7	2.9	7.9

Top/Bottom Sectors (%)	3Q'22	1 Year
Cons. Discretionary	4.3	-21.1
Energy	2.4	45.9
Financials	-3.1	-17.6
Materials	-7.3	-12.3
Real Estate	-11.0	-16.5
Comm. Services	-12.7	-38.6

Price Comparison (in USD)	Sep. 30, 2022	Sep. 30, 2021
Oil (WTI spot)	$79.74	$75.03
Natural Gas	$6.83	$5.87
Gold	$1,668	$1,757
Fed Funds Rate (Upper Target)	3.25%	0.25%
10-Yr Treasury	3.83%	1.49%
VIX	31.62	23.14

Non-US Equity Markets (in USD) (%)	3Q'22	YTD	1 Year	3 Years	5 Years	10 Years
MSCI AC World Ex U.S.	-9.9	-26.5	-25.2	-1.5	-0.8	3.0
MSCI EAFE (Developed)	-9.4	-27.1	-25.1	-1.8	-0.8	3.7
MSCI Emerging Markets	-11.6	-27.2	-28.1	-2.1	-1.8	1.1

Non-US Regions (in USD) (%)	3Q'22	1 Year
Developed Americas	-7.7	-12.3
Developed Asia	-7.9	-25.6
Developed Europe	-10.0	-24.4

Non-US Regions (in USD) (%)	3Q'22	1 Year
Emerging Americas	4.0	0.7
Emerging Asia	-13.9	-29.1
Emerging EMEA	-5.3	-33.3

Source: MSCI, S&P Global, FTSE Russell; Refinitiv, St. Louis Federal Reserve Bank; Periods greater than one-year have been annualized

Market Review:

U.S. equity markets finished the third quarter just under 5% lower, extending the period of extreme volatility that has gripped the markets since the S&P 500 Index crested on January 3, 2022. Year-to-date, 49% of trading days have seen absolute market moves, as measured by the S&P 500 Index, in excess of 1%, relative to an average of 21% of trading days for the prior 10-years. Even more significant is the greater than 2% absolute moves on almost one in five days which is 3.8 times the level of the prior 10-years. For the quarter, the S&P 500 fell 4.9%, and growth stocks modestly outpaced value stocks with the Russell 1000 Growth returning –3.6% relative to –5.6% for the Russell 1000 Value. Small caps did manage to fare slightly better with the Russell 2000 Index returning –2.2%. Non-US equities trailed as the MSCI All-Country World ex-US Index fell –10.4% for the quarter. Like equities, commodity prices ended the quarter lower with the Bloomberg Commodity Index falling 4.8% for the period, despite at one point rallying over 13% off its July 6th closing low.

To Peak or Not to Peak?

"There is nothing permanent except change." - Heraclitus. A year ago markets were beginning to become concerned with a rising inflationary and interest rate environment, yet inflation expectations were still firmly anchored at 2.5%, up from 1.8% one-year prior, and the yield on the 10-year Treasury sat at 1.49%. A short nine-months later the year-over-year change in the U.S. Consumer Price Index hit 9.0% before modestly retreating to 8.3% over the next few months, the 10-year Treasury yield has risen to 3.83% and the S&P 500 has retreated 25.2% from its Jan. 2022 high. There is no debate that inflation is back with a vengeance - the debate is now around how quickly inflation fades, to what level will it fade and what are the second order effects on economic growth, corporate earnings and other factors. Since 1950 there have been no less than 12 distinct inflation peaks in the U.S., not including the current period. Over those periods, the year-over-year change in the U.S. Consumer Price Index peaked at 6.1%, on average, before retreating 54% over the coming 12-months to 2.9%. Exhibit 1 examines the six periods in which year-over-year inflation topped

Exhibit 1 *(Source: S&P Global, Refinitiv, St. Louis Federal Reserve Bank)*

Month of Peak YoY Change in CPI	YoY Change in CPI at inflation peak	YoY Change in CPI - 12M post peak	YoY Change	S&P500 Return - 12M post peak	10Y Tsy Yld at inflation peak	10Y Tsy Yld - 12M post peak	10Y Tsy Yld Chg. (bps)	YoY Change in S&P 500 Earnings - 12M post peak
Mar-51	9.4%	1.8%	-7.6%	13.9	2.60	2.72	0.12	-10.3%
Jan-70	5.9%	4.7%	-1.1%	12.8	7.75	6.09	(1.66)	-7.5%
Nov-74	11.2%	6.6%	-4.7%	36.2	7.64	8.14	0.50	-11.7%
Mar-80	13.5%	9.5%	-3.9%	40.1	12.64	13.13	0.49	-0.9%
Oct-90	6.0%	2.6%	-3.3%	33.5	8.65	7.47	(1.18)	-18.6%
Jul-08	5.5%	-1.8%	-7.3%	(20.0)	3.99	3.52	(0.47)	-77.5%
Jun-22	9.0%				3.01			
Average	**8.6%**	**3.9%**	**-4.7%**	**19.4**	**7.21**	**6.85**	**(0.37)**	**-21.1%**
Median	**7.7%**	**3.7%**	**-4.3%**	**23.7**	**7.70**	**6.78**	**(0.18)**	**-11.0%**

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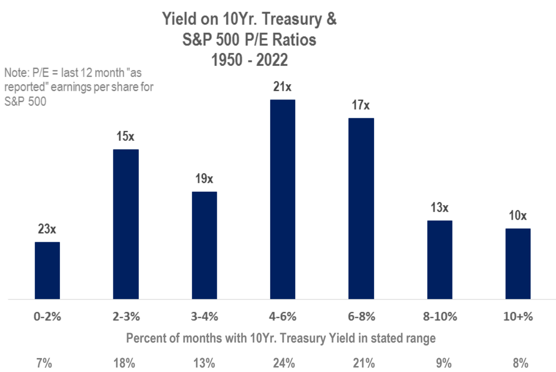
out at over 5%. During these periods inflation peaked at 8.6% on average and retreated 4.7%, or 60%, to 3.9% over the following twelve months. Should the current period follow the historic average, and if the 9.0% CPI reading of June 2022 is the current inflationary peak, then by mid-summer 2023 inflation will have fallen to a year-over-year reading of 3.6%, well below the current University of Michigan Consumer Inflation Survey estimate of 5.2%[1].

While periods of high inflation have significant follow-on effects for the economy and corporate earnings, inflationary peaks have not necessarily spelled trouble for equity returns. Although, as has been seen in 2022, the market begins pricing in the follow-on effects well before they may actually surface. Of course, if it is the unexpected that unsettles the markets, then an inflationary "peak" may just provide a level of solace to market participants that better days are ahead, even if the lagging effects from tighter monetary policy may only be starting to be felt. The S&P 500 has averaged a price return of just under 14% for the 12-months following prior inflationary peaks, with the best returns generally experienced after the highest inflation readings. Of the 12 inflation peaks, only two have been followed by market levels lower one-year out. Of concern though is that those both occurred this century, following the bursting of the Tech Bubble in the early 2000's and the Global Financial Crisis of 2007-2009.

Exhibit 2 *(Source: S&P Global, Refinitiv)*

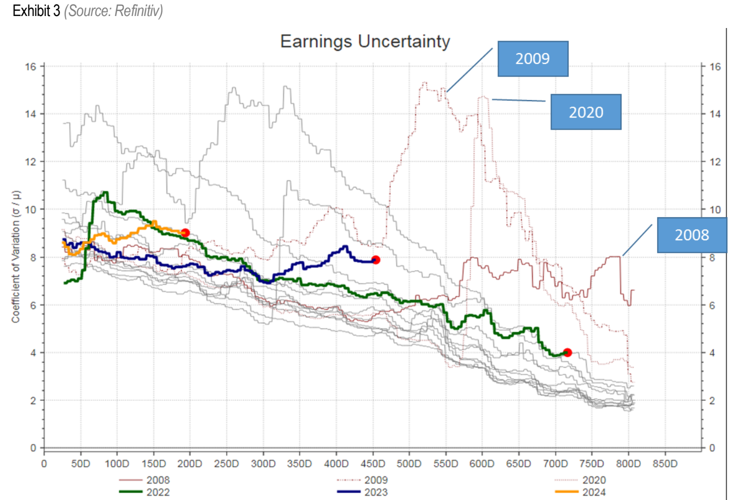


Over the past 12 months U.S. equity markets have experienced a meaningful downdraft and a re-rating of price multiples across a wide swath of the stock market, most notably in the most expensive stocks. For the broad market, price-earnings multiples are down by more than 30% over the past year. As the Federal Reserve continues its fight against inflation, market participants are turning to what is the terminal interest rate and the terminal price-earnings multiple for the markets. While there are myriad considerations for the "right" multiple for the market, interest rates are the most significant as interest rates provide the base rate upon which future earnings are discounted. Exhibit 2 provides a rough outline of the market multiples at differing interest rate regimes from 1950 to present. If history is any guide, and if the current 3.8% yield on the 10-yr Treasury is a reflection of the terminal rate, then an expected market multiple would likely be in the 15 -19 times earnings range.

As mentioned, inflationary peak periods have historically signaled trouble for corporate earnings as margins are squeezed by differences in producer prices and consumer prices, rising wages and rising interest rates. For the 12 inflationary peaks since 1950, S&P 500 earnings have fallen 15%, on average, with a median drop of 9%, over the coming 12-months. For the highest inflationary peaks, earnings have dropped in excess of 21% on average, but this is skewed by the almost 80% collapse in earnings from the Global Financial Crisis; therefore, the median drop of 11% is likely a better historic figure for analysis. Current 2022 earnings for the S&P 500 are forecast to be $224 per share, up from $208 in 2021. In our June 30, 2022 letter we discussed that earnings expectations for the current bear market were not following the typical pattern of past market downturns and were remaining surprisingly resilient. Despite the "elevated level" of earnings estimates, the second quarter reporting season (earnings reported during third calendar quarter) was quite robust with 78% of S&P 500 companies besting earnings expectations, by an average of 5.5%, and 70% besting revenue estimates, by an average of 2.5%. This equated to year-over-year earnings growth of 8.4% and revenue growth of a staggering 13.6% (of course revenues had a 9% inflationary tailwind to help them along).

While estimates may not be signaling an earnings slowdown, the market reaction to earnings misses and beats has resembled that of prior economic and earnings recessions. Stocks are reacting very aggressively to earnings reports and the performance spread between companies that beat estimates and raise guidance and those that miss estimates and lower guidance is at the fourth highest level of the past 15 years. Prior extreme periods like the current environment were generally associated with downturns in corporate earnings. The uncertainty among sell-side analyst on the outlook for earnings is also at levels traditionally associated with a forthcoming downturn in earnings. Exhibit 3 looks at the coefficient of variation of analyst earnings estimates for companies in the S&P

Exhibit 3 *(Source: Refinitiv)*



500 for fiscal year periods 2007 through 2024. Disagreement among analysts is always high as estimates for far out fiscal periods are first posted but as more information is gained, and companies provide updated guidance, analysts tend to merge their earnings forecasts. The level of disagreement in estimates for 2023 and 2024 are both near their highest levels, indicating a growing level of uncertainty about the outlook for earnings among sell-side analysts.

Conclusions

Howard Marks, Co-founder of Oaktree Capital and author of "The Most Important Thing: Uncommon Sense for the Thoughtful Investor," wrote *"We conclude that most of the time, the future will look a lot like the past, with both up cycles and down cycles. There is a right time to argue that things will be better, and that's when the market is on its backside and everyone is selling things at giveaway prices. It's dangerous when the market's at record levels to reach for a positive rationalization that has never held true in the past."* Whether current market valuations fully reflect giveaway prices can only be known in hindsight, but we can know that current market valuations reflect far greater bargains than could be had a year ago. The U.S. economy has seen two consecutive quarters of negative growth and further downturns are likely. At Smith Group we are more concerned with the potential for a downside recessionary surprise than further upside inflation surprises. Long-term inflation expectations appear relatively firmly anchored and the Federal Reserve appears quite vigilant in assuring that remains the case, including tolerating a recession to avoid a double top in inflation. The global economy seems headed for a period of below-trend growth as tight monetary policy constrains economic activity. This below trend growth will almost assuredly lead to at least a modest adjustment in the outlook for corporate earnings, but that comes off much lower market multiples than have been seen for quite some time. Given the uncertainties of the next year and the fallacies of economic and interest rate forecasts as a practice, we remain focused on longer-term earnings potential of businesses in which we invest and seeking to buy those earnings at attractive multiples.

[1]: *Source: St. Louis Federal Reserve Bank*