INVESTMENT STRATEGY INSIGHTS

What's in Store for H2 '22?

July 5th, 2022

Earnings Holding Up for Now

- If earnings begin to turn over, there may be further downside in this bear market, justifying an underweight to risk

Economy: Rising Recession Risks

- Given rising recession risks, investors should actively seek opportunities to reduce portfolio risk on market strength

Fed: Laser Focused on Inflation

- The Fed will likely maintain a firm tightening path in order to re-establish its inflation-fighting credibility

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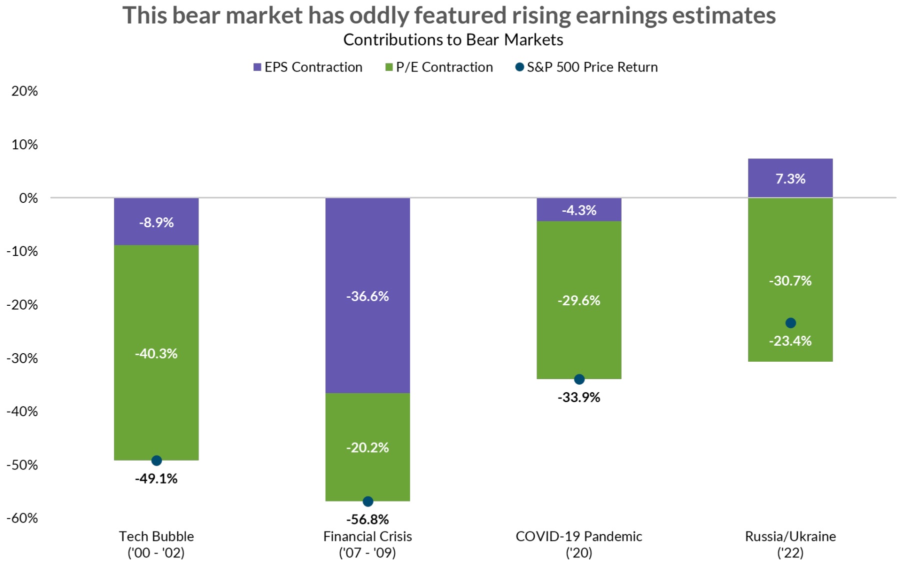
Earnings Holding Up for Now

- **Q2 Earnings Season Preview.** With the second quarter in the rearview mirror, investors are eagerly awaiting the first glimpses at profit trends through the first half of 2022. Consensus estimates project 4.5% year-over-year earnings growth for the S&P 500 in Q2, a deceleration from Q1's 9.2% annual growth pace. The driving forces for growth are likely to be inflation-sensitive sectors such as energy, industrials, materials and real estate.
- **Still-Rosy Earnings Outlook.** Despite the economic uncertainty surrounding the Fed's campaign to cool inflation, earnings estimates have so far appeared relatively unphased. For example, consensus earnings per share for the S&P 500 in 2022 remains near its all-time high of $230. However, Glenmede's Leading Economic Indicator, which tends to directionally inform on the path of corporate profits on a forward 6-month basis, has dipped into negative territory, suggesting there may be downside risk to earnings as the odds of recession rise.
- **Multiple-Driven Bear Market.** So far, the ongoing bear market is the first of the millennium to feature rising earnings estimates. In each of the other three, the peak-to-trough decline in the S&P 500 could be attributed to a mix of falling earnings estimates and falling valuation multiples (e.g., price-to-earnings ratios) that are applied to those estimates. However, as the macroeconomic environment becomes more challenging, earnings estimates may face negative revisions. As a result, the ongoing bear market may have further room to fall as cheapening valuations begin to share the reins with earnings in pushing risk assets lower, justifying an underweight risk posture.

> *If earnings begin to turn over, there may be further downside in this bear market, justifying an underweight to risk*

Chart of the Week:



Source: Glenmede, FactSet Data through 6/29/2022

Shown is a breakdown of contributing factors to the past four bear markets for the S&P 500 Index. The blue dot represents the peak-to-trough price return of the S&P 500 during each of those bear markets. The purple bars represent the contribution from declining (or rising) earnings per share estimates on a next-twelve-month basis and the green bars represent the contribution from declining price-to-earnings ratios. The S&P 500 is a market capitalization weighted index of large cap stocks in the U.S. Actual results may differ materially from expectations. Past performance may not be indicative of future results. One cannot invest directly in an index.

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Economy: Rising Recession Risks

- **Ending On a Bear Market Note.** U.S. stocks fell last week as markets struggled to sustain a rebound from bear market lows. The S&P 500 ended Thursday's session down 20.6% year-to-date, capping its worst first-half return since 1970. Notably, the index was down 16.4% for Q2, marking its worst quarterly performance since the height of the pandemic in Q1 of 2020.
- **Non-Negligible Recession Risk.** The U.S. economy contracted at an annualized pace of 1.6% in Q1, slightly revised from its preliminary reading of -1.5%. Accordingly, Glenmede's Recession Model, which seeks to estimate the probability of recession within the next 12 months in the U.S., currently sits at 32%, up from its near 0% reading to start the year. The Atlanta Fed's forecast for GDP growth in the second quarter of 2022 currently sits at -2.1%, also recently revised from its previous estimate of 1.3%. This puts the U.S. economy at risk of a technical recession, defined as two straight quarters of negative GDP growth.
- **Consumer Sentiment Dips.** Consumer sentiment fell to its lowest point on record, headlining the list of indicators that point to a slowing economy. The University of Michigan's gauge of consumer sentiment reached a final reading of 50 in June, down from both a preliminary reading earlier in the month and May's 58.4 print. While consumer spending has remained relatively resilient, the broad deterioration of the index may be a sign that consumers intend to pull back from spending amid increasing fear of a more challenging economic environment on the horizon.

Given rising recession risks, investors should actively seek opportunities to reduce portfolio risk on market strength

Fed: Laser Focused on Inflation

- **Fed's Commentary.** Following the Fed's 0.75% rate hike in June, July's meeting will likely involve a debate among FOMC members about whether to opt for a 50 or 75 basis point increase. Cleveland Fed President Mester noted last week that she would advocate for another 75 basis point rate hike if current economic conditions remained the same, which was further backed by New York Fed President Williams. Though the Fed will likely remain reactive to unfolding economic conditions, it appears many continue to advocate for a rapid return to neutral interest rates.
- **Moving Past Neutral**. With the Fed now well along in its rate hike cycle and the balance sheet runoff underway in the background, monetary policy is approaching neutral and may surpass it by the end of 2022. The recently revised dot plot shows the Fed expects rates will end the year at 3.4%, a level that closely resembles neutral. The fed funds futures market currently prices in a path that takes rates beyond this neutral level, reflecting an expectation that the Fed will do this to contain inflation despite the impact on economic growth/markets.
- **Inflation Expectations.** The Fed is likely targeting bringing realized inflation down to a ~0.2% monthly growth pace, the equivalent of 2.4% annually. Notably, May's core PCE inflation, excluding food and energy prices, rose at a moderate 0.3%, roughly in line with prior readings. Inflation expectations have begun to show signs of easing, with 5-year inflation, as implied by TIPS and inflation swaps, hitting 2.6% at the end of last week, down from its peak in April of 3.5%. However, survey-based expectations remain elevated, as consumers are not yet convinced inflation has turned a corner.

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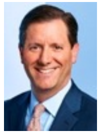
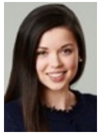


JASON D. PRIDE, CFA
Chief Investment Officer - Private Wealth
Responsible for formulating investment policy and strategy
Serves as a leading member of the Investment Policy Committee
B.S. from Massachusetts Institute of Technology

MICHAEL T. REYNOLDS, CFA
Vice President, Investment Strategy
Responsible for supporting the development of investment strategies, policy and portfolio construction methodologies
Is an active member of the CFA® Society of Philadelphia
B.S. from the Wharton School of the University of Pennsylvania



ILONA V. VOVK, CFP®
Investment Strategy Officer
Responsible for supporting the development of investment strategies, policies and portfolio construction methodologies applied to Private Wealth client portfolios
B.A. and B.S. from Drexel University

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