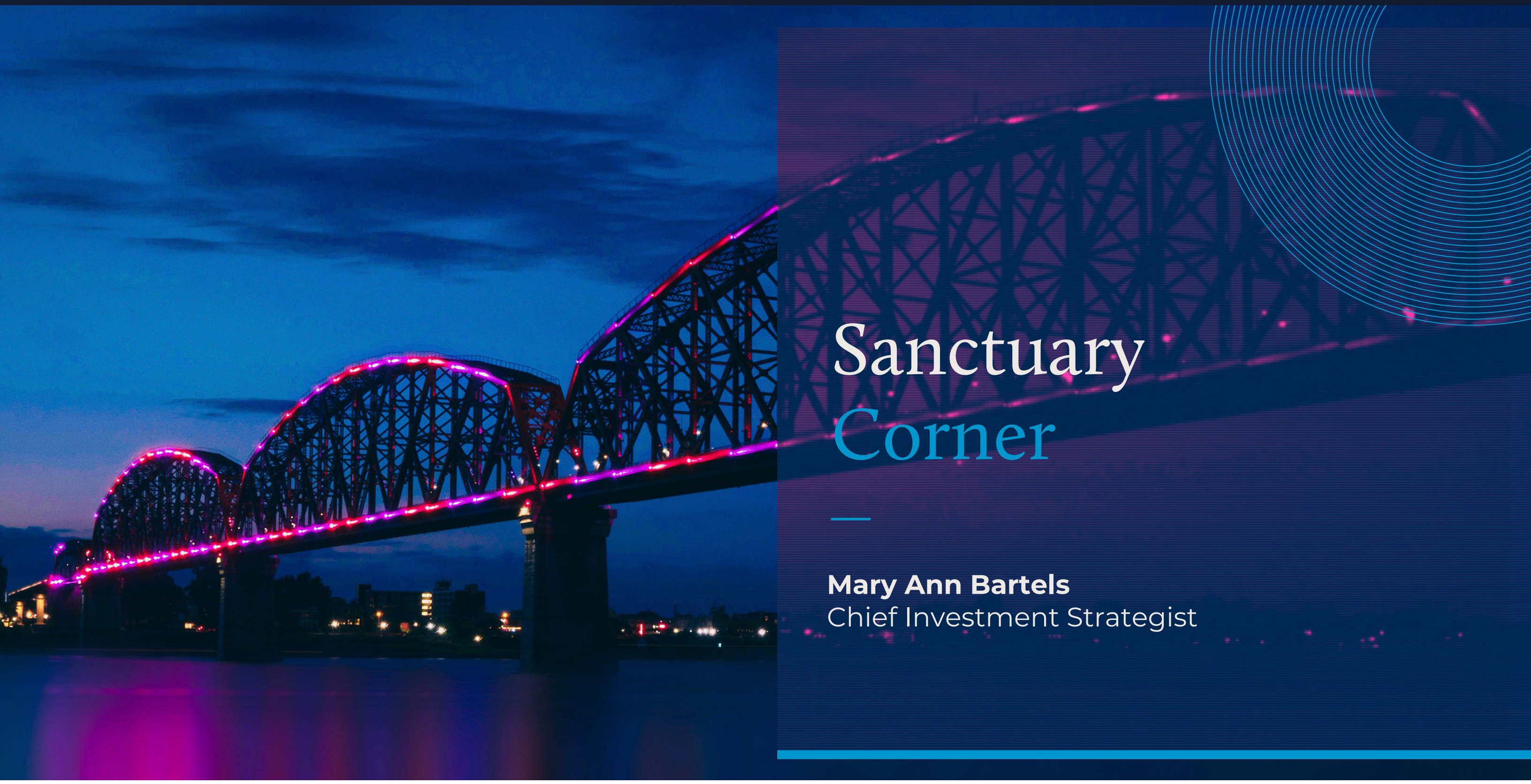
SANCTUARY



Sanctuary Corner

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Executive Summary

As we entered the final quarter of the year, stocks are down sharply with the S&P 500 down 21%, the small cap Russell 2000 index down 22%, and the technology heavy Nasdaq down 30%. But with stocks so oversold and sentiment in the trash bin, the market found its footing and has rallied sharply. October was unseasonally strong with the Dow Jones Industrial Index up 14%, the best October on record and the best month since 1976, while the S&P 500 was up 8% and NASDAQ up 4%.

Bonds – which in normal times would cushion a stock market downside – are off sharply as well, down 20% as the Federal Reserve moved from a zero-rate policy in March to an aggressive rate hike plan, jacking interest rates up by 300 basis points (3%) within just six months.

As we enter Q4, the market is expecting the Fed to raise rates in November by 75 basis points and again in December by another 50 basis points. Rates are also expected to rise in early 2023, expecting a terminal rate or final rate of 4.6%-5%. The Fed is expected to then keep rates steady in the hope we have signs that inflation is falling to the Fed's target rate of 2%. While it's been one of the worst years ever to own stocks and bonds, what has worked in 2022 is the US Dollar and Energy stocks.

'Tis the Season To Rally

With the midterm elections just days away, we thought it worth noting that, should the House and Senate both shift to the Republicans, the equity markets would view this shift of power as a positive. Why? A Democrat President and a Republican Congress would create gridlock in Washington and "nothing will get done" – perversely that's something markets like. Current polls suggest the House will likely shift to the Republicans, but the Senate races are too close to call. So, with midterm elections historically preceding a rally and November and December seasonally positive, the markets can continue to rally – even if the Tech sector remains under pressure. But with such a strong rally in October, one might question if some of the strong seasonals of November and December came a bit early.

Midterm elections tend to be met with a strong rally, which is coincidental to the seasonally strong quarter for stocks in November and December. The S&P 500 can rally as much as 15% off the low or perhaps test resistance at 4100-4150. To call a bottom, we first need capitulation – so risk to around 3200 remains in place. Remember, for capitulation, we likely need the VIX index to get to 50. Supporting this equity rally, we would expect bond yields to fall. But again, we don't believe interest rates have peaked yet.

Commodities fall sharply but Energy can Firm

Commodity prices increased at a record pace leading to inflation at a 40-year high. Over all commodities including industrial metals and energy have rolled over and copper is still down. If we were to expect a sign of economic recovery, we need "Dr. Copper" to rally. We do anticipate energy prices to firm up during the winter months with supply cuts and seasonal demand increasing.

As we head into the winter months, we do anticipate energy prices to firm up during the winter months with supply cuts and seasonal demand increasing. This will lead to an uptick in energy prices. So with energy still the cheapest sector, we're bullish on the energy complex overall.

Earnings Update - FANG went BANG

Big cap technology, namely FANG+ stocks earnings were a disaster for most of them. Amazon took it on the chin, while Apple held up better. Microsoft and Alphabet also had bad quarters. The FANG+ area of tech is basically broken at this point and there are indicators for further weakness. A common theme among the tech names was the weakness in advertising spending which is a good leading indicator of economic growth. This is just another sign of the coming weakness in the economy next year.

Third quarter earnings have not been as weak as many had expected, but earnings have not been great either. As of now there have been 264 companies of the S&P 500 have reported (68% of the index). So far earnings are tracking 1% below consensus. According to FactSet: "The blended (year-over-year) earnings growth rate for Q3 2022 is 2.2%, which is below the 5-year average earnings growth rate of 14.6% and below the 10-year average earnings growth rate of 8.8%. If 2.2% is the actual growth rate for the quarter, it will mark the lowest (year-over-year) earnings growth rate reported by the index since Q3 2020 (-5.7%). Four of the eleven sectors are reporting year-over-year earnings growth, led by the Energy, Real Estate, and Industrials sectors. On the other hand, seven sectors are reporting a year-over-year decline in earnings, led by the Communication Services, Financials, and Materials sectors."

Sunny Days Ahead for 2023

The key to surviving bear markets is patience. Once the Fed reaches its terminal rate, the market will sense we're closer to rates going down, so both stocks and bonds will respond. According to Ned Davis Research, the S&P 500 delivered a median return of 11.8% one-year after the Fed made its final rate hike of the tightening cycle, 16.1% one year after the Fed's first interest rate cut, and 23.7% one-year after the Fed launched Quantitative Easing. Bonds will also rally strongly on a peak in rates.

Q4 Outlook into 2023

The equity markets are very oversold and sentiment is the most bearish in over a decade. Equity markets traditionally rally strongly in November and December – and historically, they rally following the uncertainty caused by midterm elections. So the stars are aligned for rally at this time of year. But the obstacle could be the elusiveness of a bottom – so any bad news could rattle both the bond and stock markets. What do we recommend to do? Take a more defensive position until we have a clear bottom in the markets. What will this look like? Normally, when something goes wrong, policymakers begin to panic, so they step in to help the markets. We also get a form of capitulation where stocks sell off sharply in the morning but begin to recover and close on the high for the day with explosive volume. How explosive? We're talking possibly double of the average daily trading volume. So policymakers panicking and capitulation would be signs indicating a bottom. Then after the bottom, we should begin the healing process and trade sideways for months, which will include a test of the lows. This can take up to six months. So again, investors will need patience. But that patience will pay off when, by mid-to-late 2023 , the BULL should be back in full force for both stocks and bonds, in our view.

Positioning

We continue to believe that large cap, high P/E technology and growth names will remain under pressure as long as the Fed is raising interest rates. We like Value over Growth, small-mid caps over large caps and favoring the Energy and Industrial sectors. We also like dividends. For bonds, we like duration up to the 3-5 year range and for the first time in many years find bonds attractive. Cash is also back with yields in the 3-4.5% range which are much more attractive than the yield on the equity market near 1.7%. We favor US Treasuries, Corporates and select Municipals. Stay with Quality in all asset classes.

It's All About The Macro

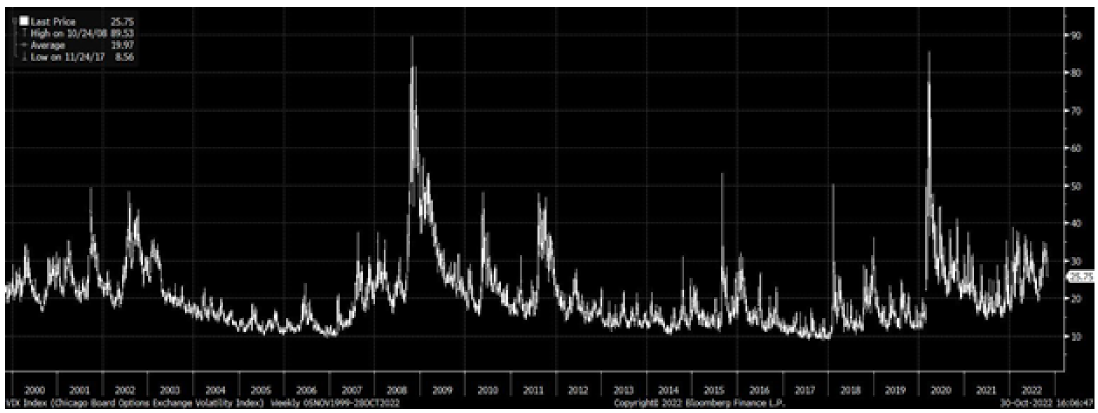
With interest rates rapidly rising, episodic volatility has hit both the stock and bond markets. We measure bond volatility via the ICE BofA MOVE Index. Volatiltiy is the highest since '08-09 and 1998. Risk is that volatility still needs to move higher before we peak in interest rates. Risk is to 175-200. This may not be seen until 2023.

Source: Bloomberg – 10/28/22

Equity Volatility Expected to Remain Elevated

We don't believe that equity volatility has peaked yet. Risk is the VIX needs to trade up to 50 to reach capitulation.

VIX Index



Source: Bloomberg - 10/28/22

Commodities Rise the Fastest in History

Commodities had the fastest rise in history rising over a 2-year period which has help to lead us to the highest inflation rate in 40-year. Prices have begun to roll over and need to be monitored to determine if a peak has been formed. The Energy complex will likely have a big determination on the future direection of commodities as they represent the largest component also along with any continued supply contraints.

Reuters/Jefferies CRB Index

Source: StockCharts.com – 10/28/22

Industrial Metals Correct with Risk of Rising Again

Industrial Metals broke out of 16-year range which is most impressive. Prices have peaked and rolled over, but we need to watch the next direction given the breakout. Risk is prices resume the rally. Firming prices should benefit the Industrial sector.

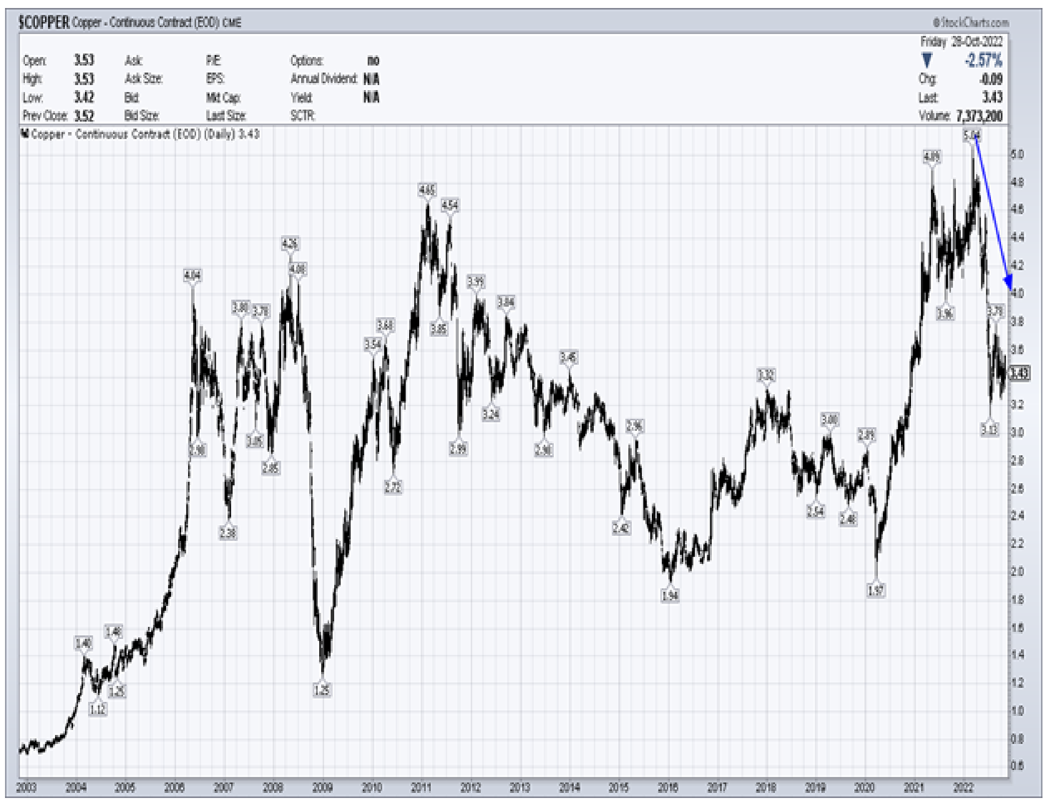
GSCI Industrial Metals Index

Source: StockCharts.com - 10/28/22

Dr. Copper Still Showing Future Economic Weakness

We believe we're currently three-fourths of the way through this bear market. What are the support levels within the marketplace? First support is the June low near 3600 but given the downside risk to earnings for Q422 and next year, we believe this level will not hold. The next range of support is 3500-3200. As you can see in the chart below, the uptrend in effect since the lows Of 2009 would still be intact if the S&P 500 went as low as 3200. Essentially, the market will be given back the Covid stimulus rally. As we know: bears are painful. And while that pain will continue, we're three-fourths of the way through, with only about six months to go.

Meanwhile, we also continue to enjoy a secular bull market, meaning that when we complete this bear market, we will again see all-time market highs. So, it's not a time to panic, but to be patient.



Source: StockCharts.com - 10/28/22

A Brighter Road Ahead for Energy

Crude oil has had a sharp decline, but as we move into the winter months of high demand we are likely going to get firmness in prices again. As OPEC + has cut supplies it is very likely that energy prices will be managed to stay firm for sometime. The risk is that WTI crude oil rallies back to $100-$110.

WTI Light Crude Oil

Source: StockCharts.com - 10/28/22

Energy Stocks Hitting Record Highs in a Bear Tape – Showing New Leadership

Energy accounts for only 5% of the S&P 500. In fact, the entire energy complex is smaller than Apple (about 7% of the S&P 500). Energy is a scarred sector under ESG because of fossil fuels – but it's a double edge sword, because it's the sector among integrated stocks that's spending the most on research for a greener future. Energy is loaded with cash and still cranking out dividends, and has the best performance in 2022 up over 50%.

Energy Sector SPDR (XLE)

Source: StockCharts.com - 10/28/22

XOM: Multi-Year Breakout

CVX: Multi-Year Breakout

COP: Multi-Year Breakout

VLO: Mult-Year Breakout

Source: StockCharts.com - 10/28/22

Technology Still at Risk

The tech sector represents the bulk of the market and where you'll find the highest PE multiples. Prices will likely come down as interest rates continue to rise. The Covid-19 bubble is popping, bringing prices back to pre-Covid levels. Semiconductors are the leading indicator for tech and demand remains strong; but their bubble is also likely to pop. Digital is the new era so technology will heal and remain an important area of the market, but for now it's a source of funds.

SPDR Technology Sector (XLK) – Risk -20%

Source: StockCharts.com - 10/28/22

Semiconductor Index (SOX)

Source: StockCharts.com - 10/28/22

ON Semiconductor (ON)

The only tech company trading well is ON Semi-conductor, a reflection of the high demand for chips in electric vehicles.

Source: StockCharts.com - 10/28/22

Banks Remain Attractive on Valutions but Could Still Face Headwinds

Banks have shown great earnings but their risk is increased loan loss reserves especially if we head into a recession. Loan loss provisions negatively impact earnings.

Finanical Sector SPDR (XLF)

Source: StockCharts.com - 10/28/22

JP Morgan (JPM)

Bank of America (BAC)

Charles Schwab (SCHW)

Goldman Sachs (GS)

Source: StockCharts.com - 10/28/22

Wars Rocket Aerospace & Defense Higher

The defense sector is not getting the attention it deserves. During a war, this sector outperforms. We are starting to see investors buying aerospace and defense stocks, but this move has been under the radar so far. Pun intended!

Source: StockCharts.com - 10/28/22

Northrup Grumman (NOC)

Lockheed Martin (LMT)

Raython Technologies (RTX)

General Dynamics (GDX)

Source: StockCharts.com – 10/28/22

S&P Pharmaceuticals SPDR (XPH)

Simply put, the market will continue to favor pharma as a defensive yield play. The fundamentals remain strong with high demand for vaccines and the demand increasing for medication as the baby boomers in particular age. Select stocks like Merck are hitting new record highs even in a bear market.

Merck (MRK)

Bristol-Meyers Squibb (BMY)

Source: StockCharts.com – 10/28/22

Recession Means a Win for Sin (Stocks)

When an economy moves into a recession, it's all about "drugs and alcohol" (and now maybe cannabis!) as consumers look to ease their pain. This has been a pattern going back since markets began.

Tobacco

Philip Morris International

Altria (MO)

Source: StockCharts.com - 10/28/22

Spirits

Molson-Coors (TAP)

Diageo (DEO)

Source: StockCharts.com - 10/28/22

Small Caps Outperforming Showing Leadership

The small cap area of the market is currently the cheapest part of market in capitalization – already down to pre-Covid levels – and the sector will likely to be at the front of the pack once the bull is running again. Small caps are trading 14x price earnings multiples based on 2023 earnings forecasts. Leaders tend to show their true colors prior to a bottom in market and small caps are showing signs of outperforming large caps.

iShares Russell 2000 Small Caps (IWM)

Source: Stockcharts.com - 10/28/22

Rates – Up Up and Away

With both the 2-Year and the 10-Year Treasuries rates rising sharply there's still no sign of a peak in rates... not with the expectation that the Fed's magic number seems to be 5%.

2-Year Treasury Yields

Source: StockCharts - 10/28/22

10-Year Treasury Yields

Source: StockCharts - 10/28/22

Yield Curve 10-2 year Treasuries

The yield curve is still strongly inverted, clearly signaling a recession.

Source: StockCharts - 10/28/22

Economic Data Beginning to Show Softening

GDP for 3Q came in slightly stronger than expected but we are beginning to get softness in some of the recent economic releases. Pending home sales fell 10% in September, which was much worse than expected. The S&P Global Flash U.S. for both manufacturing and services dipped below the 50 level – traditionally a sign of a pending recession. The Durable Goods Orders also showed weakness across the board. But the all-important Personal Consumption Expenditures (PCE) data remained elevated and consumer spending remains strong. This leaves us with full expectations that the Fed will raise rates again for the fourth time by 75bps, and the market is already pricing in another 50bps in December.

Last Words

Slow and Steady wins the race…slow implies patience. The bear will go back into hibernation and the bull will return likely in 2023. Stay with Quality investments favoring Value, Small- and Mid-Caps and Dividends. Cash now has a return and can be a buffer or temporary holding place in portfolios. Asset Allocation is back. For fixed income we like short duration and no more than 3-5 years in the Treasury, Corporate and Municipal markets. For High Yield we don't think you are getting paid for the additional risk.

Thank you.

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