

Level Four Capital Management



WEEKLY INSIGHT

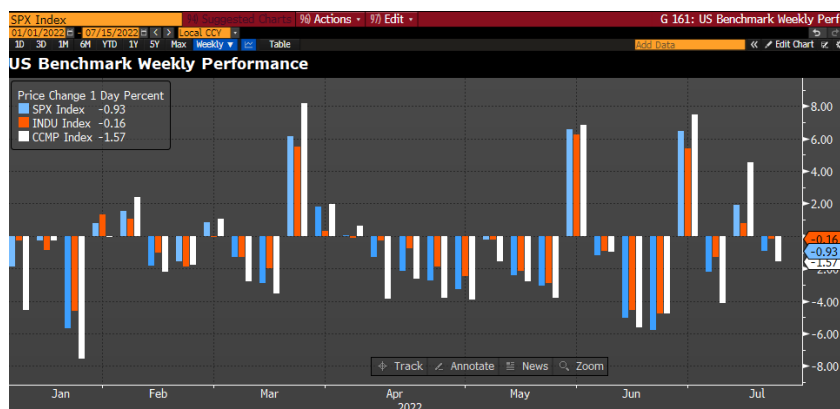
Highlights

- Domestic equities moved lower on the week, snapping a five-day losing streak on Friday, after inflation data came in hotter than expected, registering a new 41-year high.
- Headline CPI surged to 9.1% y/y, while core (Ex Food and Energy) continued to roll-over, declining to 5.7%. However, both came in higher than expected.
- Following the release of inflation data, the probability for a 100bp hike at the July meeting jumped to 90% before trailing off to 30% by Friday afternoon. Fed fund futures are pricing in a 75bp hike at the upcoming July 26th and 27th meeting.
- Growth lagged value following its 400bp+ week of out-performance the week before.
- Energy came under pressure with oil declining below \$100/barrel. This was short lived with oil popping back up above the \$100 mark on Monday after Saudi oil ministers insisted that supply would be dictated by market logic.
- U.S. equities posted net outflows for the first time in three weeks, with \$1.6B being yanked from domestic funds. Additionally, U.S. equity funds net assets shrank by \$2.1T to \$9.2T for the quarter ending in June, which was the largest quarterly drop ever.
- Bank estimates were better than feared, with earnings season ramping up this week. 61% of S&P 500 companies are expected to report.
- Multiple strategists including Bank of America's Savita Subramanian, UBS's Keith Parker, and Piper Sandler's Michael Kantrowitz cut their year-end S&P 500 price targets.
- Bank of Canada surprised markets with a 100bp rate hike in a bid to curb inflation.
- In Chile, the Central Bank announced a \$25 billion foreign exchange intervention program to defend the Chilean Peso.

Market Commentary

U.S.

Domestic equities finished the week lower, although they did bounce off their worst mid-week levels on Friday to avoid a six-day losing streak. The NASDAQ and Russell 2K once again led declines, both, which fell more than 1.40%. Predictions for the S&P 500 remain the widest on record (multiple strategists cut their targets this week), with volatility remaining elevated as the index has now swung more than 5% in four of the last eight weeks. The week also registered the first U.S. equity net outflow in the last three weeks according to Bank of America, with total redemptions in equity products totaling \$1.6B.



Source: Bloomberg as of 07.12.22

The pullback was primarily driven by the release of June's CPI, however, other factors that weighed on stocks throughout the week included:

- A possible steeper expected Fed rate path
- Persistent inflation fears
- Growing recession odds (which now stand near 50% in the next 12 months according to a survey of 34 economists)
- Narrative that earnings estimates still need to be adjusted downward for the 2H of this year, as well as 2023

Despite the less than optimistic tone underpinning markets, there were still some talking points that support the bullish narrative, including:

- Oversold conditions
- Contrarian views given bearish bets are at their highest levels since 2016
- Rolling over of commodity prices

Growth lagged its value counterpart on the week, following its 400bp+ outperformance the week before. Communication Services was the worst performing sector on the week with gaming (Take-Two, Activision, Electronic Arts), media (Paramount, Dish Network) and large tech (Meta, Google) all coming under outsized pressure.

Energy stocks also came under pressure, declining more than 3% on the week with crude settling down 6.9%, falling back below \$100/barrel. This did reverse on Monday to start this week, with Oil rallying above \$100 after the Saudis declined to make any promises regarding future output increases. Following President Biden's visit last week, Saudi oil ministers insisted that oil policy would be dictated by market logic and with an agreement from the coalition (OPEC+).

Although there were few bright spots, outperformers included defensive sectors Staples, Utilities, Healthcare and Real-estate, as well as airlines, home builders, restaurants and hotels (Southwest Airlines, Delta Air Lines, American Airlines, Alaska Air).



Source: Bloomberg as of 07.19.22

CONSUMER PRICE INDEX (CPI) & THE FED

The biggest news on the week was the release of inflation data on Wednesday. Both June's headline and core CPI came in hotter than expected, above the already elevated expectations. Headline CPI registered a 9.1% y/y increase, versus the expected 8.8% rise, while core jumped 5.9% y/y versus an expected 5.7%. The headline gains once again roared to a fresh 41-year high as higher energy, shelter, and food costs caused a fourth straight month where the headline annual figure topped estimates.

Core CPI, which excludes food and energy, has been driven higher by new vehicle prices and used cars and trucks. While the year-over-year increases should not come as a surprise, given everyone's heightened level of awareness regarding the cost of living, core CPI has in fact started to slow from the record highs this March, continuing its divergence from headline CPI.

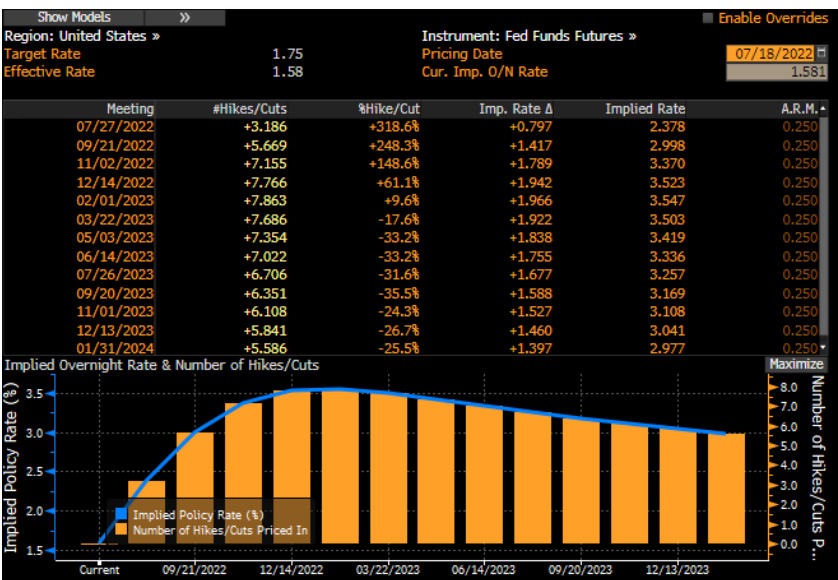
The more important question now plaguing investors is, what will the Federal Reserve's next move be, following the higher CPI print? With headline inflation remaining persistent and core inflation declining ever so gradually, the probability for an outsized rate hike ticked even higher. Initially, the hot print led the market to price in a 90% chance of a 100bp hike following the July meeting (and potentially mimicking

CPI XY0Y 5.9%		For Jun	Next Release 10 Aug 07:30	Survey --
US CPI Urban Consumers Less Food & Ener...		Bureau of Labor Statistics		
CPI XY0Y Index		Export	Settings	
US CPI Urban Consumers Less Food & Energy YoY NSA		High	6.5 on	03/31/22
Range		Low	.6 on	10/31/10
Market		Average	2.1	2.1
View		Net Chg	3.7	168.72%
Date	Last Price		Survey Me...	
12/31/22				
11/30/22				
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Source: Bloomberg as of 07.19.22

Canada's move last week), but those expectations tapered off late in the week, falling below 30% on Friday after numerous reports the Fed would likely not deviate from their pre-choreographed hike.

Multiple Fed speakers (Waller and Bullard) pushed back against a 100bp hike, saying their base cases called for a 75bp raise next week following the FOMC meeting, which is currently being priced in with little uncertainty according to fed fund futures.



Source: Bloomberg as of 07.19.22

EARNINGS

Earnings season officially kicked off last week with big banks announcing results that were largely better than feared.

JP Morgan (-1.2%) was the main outlier after reporting a miss on the top line and announcing they would temporarily suspend buybacks as they rebuild capital following the annual Comprehensive Capital Analysis & Review (CCAR) requirement changes.

Microsoft (+1.7%) also missed estimates, but were defended by some analysts who believe the quarter could be a trough.

Citigroup (+6.8%) was the big winner on the week with second quarter revenues that gained 11% after strong beats in their trading division offset a 46% decline in Investment Banking revenues. Overall, revenues rose to \$19.64B coming in well ahead of analyst estimates which called for \$18.22B.

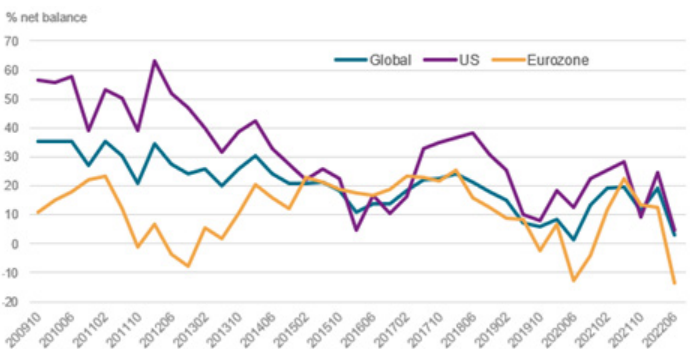


Following the release of earnings, the largest U.S. bank stocks posted their strongest two-day rally since January of 2021. A Bloomberg Intelligence gauge which tracks the performance of the six largest lenders, including JPMorgan Chase & Co, and Morgan Stanley (both of which lagged their peers), has surged about 8% over its past two sessions. This was a result after strong trading from Goldman Sachs and Citigroup as well as a positive net interest income outlook from Bank of America helped push the index higher again on Monday.

Source: Bloomberg as of 07.19.22

With Q2 earnings season about to kick off in full swing and 61% of the S&P 500 expected to announce results this week, expectations are for earnings to grow at 4.2% y/y in the second quarter, which according to FactSet would represent the smallest expansion since the 4Q of 2020. While there have been broad concerns that earnings expectations need to be revised down to take into account tighter financial conditions, along with headwinds from FX markets, the trend has been "better than feared" early on into earnings.

EARNINGS ROLL - of the 7% of S&P 500 companies that have reported so far, 60% have beaten earnings expectations, below the average of 77% over the past five years, according to FactSet. Since the end of March, analysts have lowered their quarterly profit growth estimates to 4.2% from 5.9%, WSJ reports.



Source: S&P Global as of 07.19.22

Whether it be on purpose or by coincidence, investors also saw multiple strategists cut their year-end price targets, including:

Bank of America Managing Director Savita Subramanian cut her year-end S&P 500 target to 3,600 from 4,500 (noted 3,000-3,200 in a recession).

UBS Strategist Keith Parker cut his target to 4,150, seeing modest upside with slowing growth and no recession.

Chief Investment Strategist Michael Kantrowitz of Piper Sandler cut his year-end target to 3,400 from 4,000, believing that earnings expectations will weaken with the economic slowdown.

U.S. equities on Monday turned sharply lower after Apple (which slid more than 2% for its worst day in over three weeks) announced their plans to slow hiring, which added to investor worries that the Federal Reserve's campaign against inflation will ultimately send the economy into a recession. The S&P 500 finished near its worst levels of the day, with healthcare leading the drop.

INTERNATIONAL

European equities ended off their worst level but still broadly down with the STOXX down 0.8%. Euro zone Recession worries, inflation, Italian political instability, and depressed Chinese macro news kept indices from staging a recovery.

Based on projections from The European Commission, the Euro's rebound will be weaker than expected due to the continued macroeconomic pressure of Russia's war in Ukraine and the looming threats of permanent energy disruption as a result. Already the potential of a full halt to Russian gas has depressed previous GDP outlooks by 1.5% by some of the worst estimates. Downgrades for European earnings are expected as this larger effect filters through the economy.

The largest challenge the region faces is heating homes during the winter season if a suitable substitute for Russian gas is not secured as temperatures begin to drop. EU winter energy reserves are currently at typical levels, which only provides for 46 days of normal consumption. Nord Stream 1, which was projected to be supplying 65% of its full capacity after sanctions, is only supplying 40% from pre-war levels. Whether this is in retaliation for Western sanctions or due to supply difficulties, stemming from Russia's difficulty in maintaining their previous capacity without the aid of western specialized industrial components is not known. Currently, the pipeline is completely closed for repairs and it is unknown if and when repairs are done what the new capacity will be. Bloomberg Economists have said that even without Russia artificially disrupting pipelines a recession in the EU is inevitable.

The Italian Prime Minister Mario Draghi has been asked to retake office after he tendered his resignation late on Thursday. This comes after a vote of no confidence by his party, a coalition government named "The Five Star Movement". Italy has been plagued by high inflation and energy prices much like the rest of the EU after COVID-19 and fallout from Russia's invasion. However, his party boycotted Draghi's wide-ranging \$26B policy package aimed at helping Italian families cope with soaring inflation. He threatened to resign if he was unable to secure support for his bill, which featured additional borrowing on top of already \$2.5T Italian debt level. As of Thursday, he has officially followed through with his threat leaving his country without a prime Minister for the time being. Without the approval of the budget, Italy is unable to access the \$200B COVID-19 recovery fund set aside for Italy.

The spread between 10-year Italian bonds and their German counterparts has soared past 200bps, a higher spread than was thought possible, because of this upheaval, which may put additional pressure on the European Central Bank (ECB) to become more aggressive in their hiking schedule. The ECB is expected to continue to hike rates to combat inflation with a 25bps hike expected next Thursday.

APAC

China and Japan see increased COVID numbers with both markets reporting losses for the week.

China has confirmed 580 locally transmitted cases of COVID, which is the highest number of daily infections in the last two months during the lockdowns. Most cases were focused in Lanzhou in the Gansu district, which is in the Western mainland region of China sharing a border with Mongolia. In response, the regional government announced an extension of its temporary lockdowns to July 24th. Entertainment business such as bars and karaoke sites are to remain closed, and capacity limits are to be enforced at restaurants, cinemas, and gyms. Shanghai has reported the first case during the lockdown that was found to be outside the local quarantine zone. City health officials have stated the situation remains relatively severe.

In Japan, Kyodo News reported that case numbers have topped 110,000 for the first time since their previous record of 104,000 cases, amid their seventh wave of COVID. Friday the government, along with urging citizens to be vaccinated and tested, made clear that existing medical capacity is sufficient to handle increased demand of this current wave.

Severe cases are approximately one in every 1000 new cases, which is a distinct difference from previous waves when this was ten times more than current levels. The government has stated they are not considering restricting people's movements and they will seek to balance potential disruptions of socioeconomic activities with any new measures to keep the infections in check.

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