INVESTMENT UPDATE

Return of the Bear

June 2022

Global financial markets are having a difficult year. After beginning 2022 at all-time highs, equity prices swiftly moved into correction by late-January, and eventually gave way to a full bear market by mid-June, with the S&P 500 now off 24% as of Thursday, June 16th. Fixed income has fared slightly better, with rising rates posing short-term performance challenges all across the yield curve. The Bloomberg Aggregate US Bond Index is off 8.9% year-to-date as of the end of May, providing little downside protection indeed.

What is most curious about the financial market weakness is the degree with which it stands in stark contrast to economic fundamentals. Consumer demand is still robust, and their balance sheets are mostly healthy. The housing market has been on fire. Businesses are investing, the labor market is in good shape, and previously stagnant wage growth is finally on the rise. Certain problematic areas aside, today's economic backdrop remains intact, with the same being true across most developed market economies.

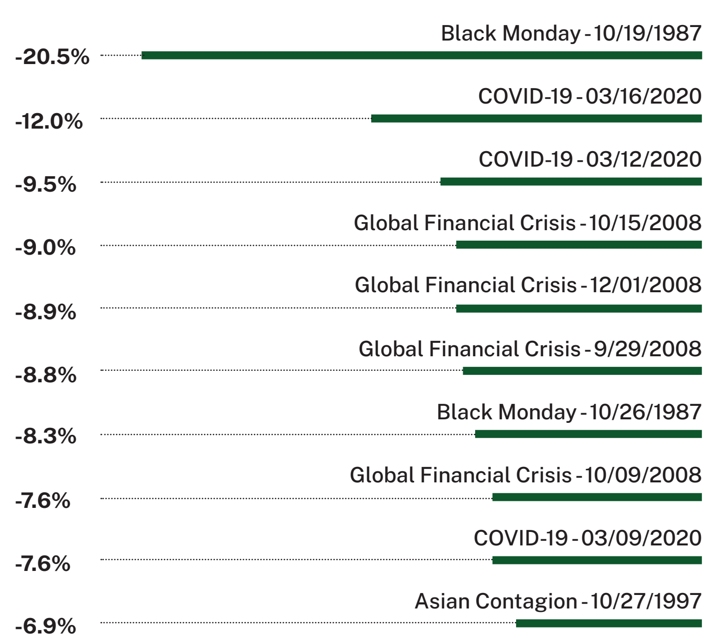
If anything, what is most unusual is not the economy doing well, but the speed with which it bounced back from the pandemic. While that is, in many ways, yesterday's story, it is worth reiterating lest it be forgotten: The historically quick downturn was met with unprecedented monetary easing and fiscal support, and we are now going through a dramatically accelerated economic cycle. So accelerated, that we believe the economy and financial markets are already exhibiting late-cycle characteristics.

An Eye on the Horizon

The catalysts are always different. What ultimately moves the economy from late-cycle to full blown recession changes with each cycle, and while the exact timing and reasons vary, the results are similar: A late-cycle economy followed by an inevitable recession, dragging down markets as well. This process, while always painful, is healthy. It resets risks and 'clears the deck' for the next economic expansion and market cycle, although the journey is choppy along the way.

Keeping Some Dry Powder
Economic recessions aren't fun, but they can be good for investors long-term. For example, the most difficult days in the market and economy are often followed by some of the best, and kick off great stretches for investors. Investing is about time-in the market, **not** timing.

The Stock Market's Worst Days...



...Are Often Followed by the Best!

The Great Recovery - 10/13/2008	11.6%
The Great Recovery - 10/28/2008	10.8%
Roaring 2020s - 03/24/2020	9.4%
Roaring 2020s - 03/13/2020	9.3%
90s Tech Boom - 10/21/1987	9.1%
The Great Recovery - 03/23/2009	7.1%
Roaring 2020s - 04/06/2020	7.0%
The Great Recovery - 11/13/2008	6.9%
The Great Recovery - 11/24/2008	6.5%
The Great Recovery - 03/10/2009	6.4%

Source: FactSet (12/30/1949 - 03/31/2022). The stock market is represented by the S&P 500 Price Return Index. Analysis: Manning & Napier.

In our view, the economy is showing late-cycle dynamics, and leading us to believe we are now in the riskiest part of the economic cycle. For investors, this outlook can spark fear and cause detrimental decision making for their long-term well-being. Some will see the economic worries on the horizon, get nervous, and start selling to try to avoid potential pain. Doing this is, effectively, throwing out your strategic asset allocation for trading and trying to time the market. This is ill-advised. Your strategic asset allocation, investment policy statement, and/or financial plan were made for a reason, and that reason is for achieving long-term goals, not short-term profits.

What we believe is advisable and is in the best interest of investor goals is the making of tactical asset allocation adjustments to manage risk. This means following investment disciplines and reducing risk across portfolios. For us, that is a process we began late last year as our outlook became more bearish. Most recently, we continue to execute on these views, further deploying the variety of tools at our disposal, such as making changes to not only asset allocation, but also sector and style positioning, and even to individual names as appropriate.

Markets have gone on to validate many of those decisions thus far in 2022. Inflation has remained hotter, longer than policymakers expected, leaving the Federal Reserve behind the curve and playing a rapid game of catch-up as they aim to quickly raise interest rates. The combination of tightening financial conditions, the fading away of post-pandemic fiscal support, and the various late-cycle dynamics showing up in the economy all are indications that the economy is inching closer to a tipping point.

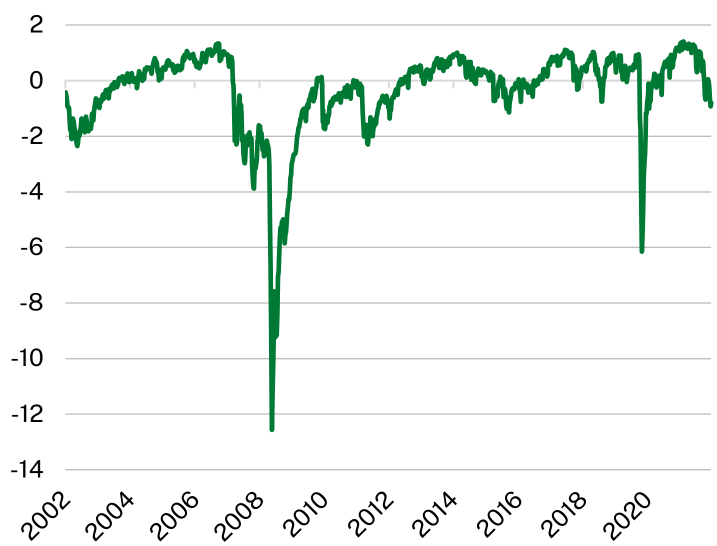
Different Paths, Same Endgame

It's too early for us to make a call that a recession is imminent, but we are acutely aware of its potential on the horizon. For us, we see two paths forward, one more optimistic than the other, but both ultimately leading to a similar conclusion.

Key Indicators are Flashing Yellow

Higher interest rates, quantitative tightening, and rising credit standards all amount to a worsening of financial conditions, a reliable indicator of impending economic stress. How the Federal Reserve manages inflation while maintaining economic growth will be the key question ahead.

Bloomberg Financial Conditions Index



Source: Bloomberg. Data is from 05/24/2002–05/13/2022. The Bloomberg Financial Conditions Index is a Z-score tracking the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit.

Starting with path one, what we see as the most direct and difficult story. Fearing inflation, in this outcome the Fed tightens financial conditions too much, too quickly, and consequently, stomps out the economic expansion in the process. The economy moves all the way from late-cycle to recession, and equity market performance remains rocky along the way. In this scenario, a defensive posture clearly makes the most sense.

The other potential scenario is one where the Fed and other global central banks ease off their brakes enough to tamp down on inflation without also driving the economy into recession. This goldilocks outcome, also known as a 'soft landing,' is the best case for the economy, but it isn't the kind of green light for financial markets that it may seem. Even if a soft landing occurs, today's late-cycle dynamics will linger. The labor market will stay tight, wages would probably keep rising and pressuring corporate profit margins, and financial market valuations would more than likely persist as a major challenge for investors. In this scenario, financial market performance is possibly okay, or at least better than outcome one, but there will remain a variety of serious challenges looming, each suggesting that a degree of caution is appropriate.

Playing the Long-Game

Looking at the past for keys to the future, we see inflation as the big change between today and other recent economic cycles. We believe it is putting markets in this damned-if-you-do, damned-if-you-don't position. This difficult backdrop, when combined with the much accelerated pace of the cycle, is warranting a more defensive posture in portfolios.

Inflation is Back

It's been forty years since the US has experienced inflation like this. While we believe some elements are transitory (e.g., supply chain pressures, etc.), we also have reasons to believe that at least some inflation will stick around. Higher inflation will constrain policymakers' ability to throw money at a potential downturn the way they have in other recent recessions.

Core Consumer Price Index (CPI)

Source: FactSet (12/1970-04/2022). Core referring to CPI less food & energy.

Throughout the past six-to nine-months, we've been continuously de-risking portfolios in anticipation for a choppy stretch in financial markets. This has been partially born out in 2022's correction, but not wholly. In contrast with what investors' have come to expect from our process, we have not been buying into recent equity market weakness. Our cautious outlook has, instead, led us to continue to trim cyclicality from portfolios, to help further insulate assets from the above outlined economic downturn scenarios.

To be clear, we continue to see some select pockets of opportunity in markets. For example, there are areas in certain growth-oriented industries (i.e., payments, cloud computing, and biopharma) that remain attractive to us as these businesses have the capability to continue delivering growth despite broader economic conditions. On the other hand, we have been reducing exposure to cyclical areas including in the energy sector and construction, while holding onto positions in areas such as consumer staples.

Patience is a Virtue

In general, investors can expect us to lean into the wind as sentiment deteriorates, and as fear begins to become more widespread. But despite the recent and significant stock market correction experienced, we believe markets have not yet reached the point where risks have cleared and the backdrop is attractive again.

Investors, clients, and financial professionals can expect us to continue to tactically adjust portfolios as market conditions evolve, while staying true to our time-tested risk disciplines, waiting for the right moment, the right entry point to eventually occur.

For our quarterly market update webinar, or additional depth on these topics and more, please visit **www.manning-napier.com/insights**

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The Bloomberg U.S. Aggregate Bond Index is an unmanaged, market-value weighted index of U.S. domestic investment-grade debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of one year or more. Index returns do not reflect any fees or expenses. Index returns provided by FactSet.

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