

Market Commentary

Three Reasons to be Optimistic About U.S. Equities

October 2022



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Key Observations

September saw losses across just about every segment of the equity, bond and commodities markets. There are, nonetheless, three good reasons we believe for investors to be optimistic about U.S. equities:

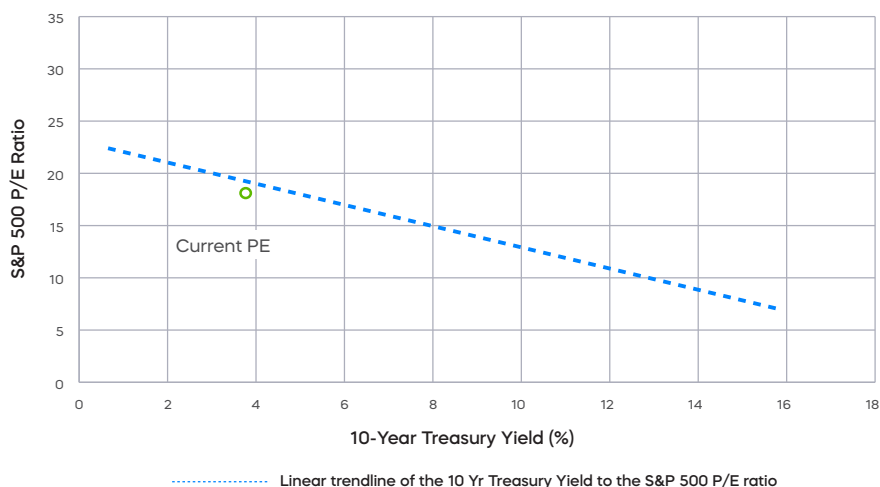
1. Valuations are generally reasonable.
2. The Federal Reserve may be achieving their objectives.
3. The U.S. economy is relatively well positioned.

Let's take them one-by-one:

Valuations: The S&P 500 is currently trading at a trailing price-to-earnings (P/E) multiple of just under 18. That appears to be about fair for today's level of interest rates.

Chart of the Month

Current S&P Price-to-Earnings Valuations Are in Line with Interest Rates



Source: Bloomberg data from 12/31/62–9/30/22. The price-to-earnings ratio shows how much investors are paying for a dollar of a company's earnings. Past performance does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

Consensus estimates call for an additional 10-15% growth in earnings for 2022. Since we are close to the end of the year and 18X lies near this trend line, you could conclude that the S&P 500® is priced for no further earnings growth this year—or to potentially miss expectations by 10-15%. With that information, it appears valuations are reasonable. (Source: Bloomberg)

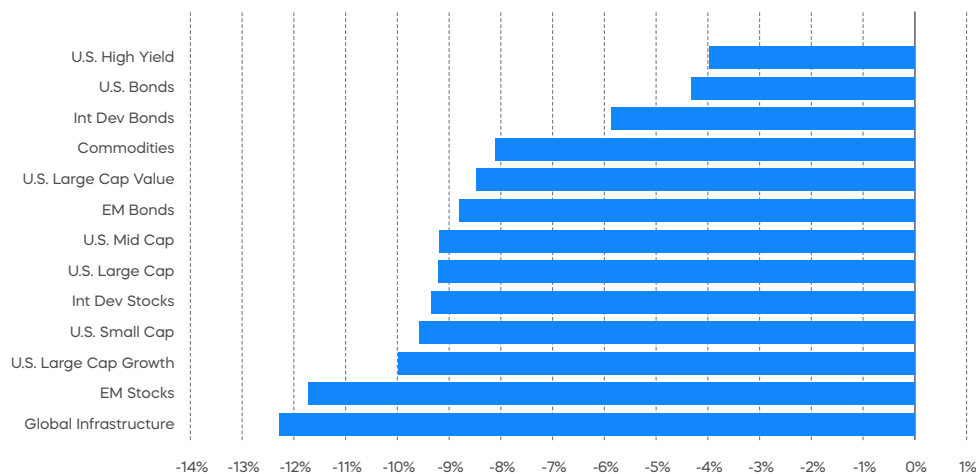
The Federal Reserve: There has been a pervasive refrain that the Fed was late, and it won't be able to get inflation under control. Here is a data point that counters that narrative. The two-year breakeven inflation rate—a measure of the markets expectation for inflation two years in the future—was 1.98% at the end of September. That's right on the Fed's 2% target and down from a peak of nearly 5% in March. So, the Fed may be achieving its objective. (Source: Bloomberg)

The U.S. Economy: While near-term prospects for the U.S. economy may not be robust, they are better than much of the rest of the world. Consensus estimates for U.S. GDP growth for 2023 stand at 0.8%. That compares to 0.2% for a Eurozone challenged by war and negative 0.2% for a United Kingdom challenged by Brexit and political instability (Source: Bloomberg). The U.S. economy could experience a competitive boost resulting from European weakness, increasing the odds of a soft landing, at least domestically.

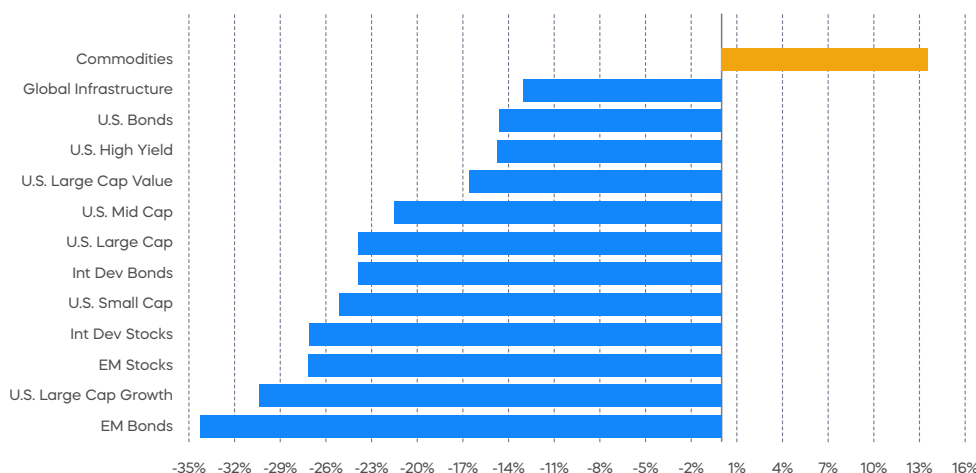
Performance Recap

Market segment returns were red across the board in September.

Asset Class Returns—September 2022



Asset Class Returns—Year to Date



Source: Bloomberg. September returns 9/1/22–9/30/22; YTD year returns 1/1/22–9/30/22. Past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

Economic Calendar

Here's a list of upcoming key economic releases, which can serve as a guide to potential market indicators.

Date Time	Event	Prior
10/12/2022 08:30	PPI Ex Food and Energy YoY	7.30%
10/12/2022 08:30	PPI Ex Food and Energy MoM	0.40%
10/13/2022 08:30	CPI Ex Food and Energy MoM	0.60%
10/13/2022 08:30	CPI Ex Food and Energy YoY	6.30%
10/14/2022 08:30	Retail Sales Advance MoM	0.30%
10/14/2022 10:00	U. of Mich. Sentiment	58.6
10/14/2022 10:00	U. of Mich. 1 Yr Inflation	4.70%
10/14/2022 10:00	U. of Mich. 5-10 Yr Inflation	2.70%
10/18/2022 09:15	Capacity Utilization	80.00%
10/19/2022 08:30	Housing Starts MoM	12.20%
10/19/2022 14:00	U.S. Federal Reserve Releases Beige Book	—
10/20/2022 10:00	Existing Home Sales	4.80m
10/20/2022 10:00	Existing Home Sales MoM	-0.40%
10/25/2022 10:00	Conf. Board Consumer Confidence	108
10/26/2022 10:00	New Home Sales	685k
10/26/2022 10:00	New Home Sales MoM	28.80%
10/27/2022 08:30	GDP Annualized QoQ	-0.60%
10/28/2022 08:30	PCE Core Deflator MoM	0.60%
10/28/2022 08:30	PCE Core Deflator YoY	4.90%
11/01/2022 10:00	ISM Manufacturing	50.9
11/02/2022 14:00	FOMC Rate Decision (Lower Bound)	3.00%
11/02/2022 14:00	FOMC Rate Decision (Upper Bound)	3.25%
11/03/2022 10:00	ISM Services Index	—
11/04/2022 08:30	Change in Nonfarm Payrolls	—
11/04/2022 08:30	Unemployment Rate	—
11/04/2022 08:30	Average Hourly Earnings YoY	—

Source: Bloomberg, as of 10/1/22.

Equity Perspectives



By Kieran Kirwan, CAIA
*Director,
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Is There More Pain Ahead?

Last month's equity market performance did nothing to alter September's historical record of producing the market's weakest returns. Much of the cause this time sits with a steadfastly hawkish Fed, which delivered its third consecutive hike of 75 basis points to the Fed Funds rate. Where it all ends remains to be seen, but more rate hikes seem likely for what is turning out to be one of the most aggressive tightening cycles on record. As a result, certain segments of the economy, like housing, are already slowing significantly. And we believe more economic pain will follow.

The markets take their own distinct path in the face of rising rates, so some historical perspective may be useful for investors.

Equity Market Performance During Prior Rate-Hike Cycles

Despite market weakness since the Fed started hiking rates in March, 2022, stocks can and have performed quite well during previous cycles. There have been four rate-hike cycles—periods in which the Fed has raised the Federal Funds Rate on multiple occasions over an extended time—during the past 30 years. While each had different circumstances, examining the performance of different market segments during those cycles may offer clues to investors who want to reallocate their portfolios or put new capital to work.

Historical data provides some basis for optimism. Markets have tended to move lower in the months immediately following the first increase in the Fed Funds rate of a cycle, but they have also recovered quickly and done fine over the full cycle.

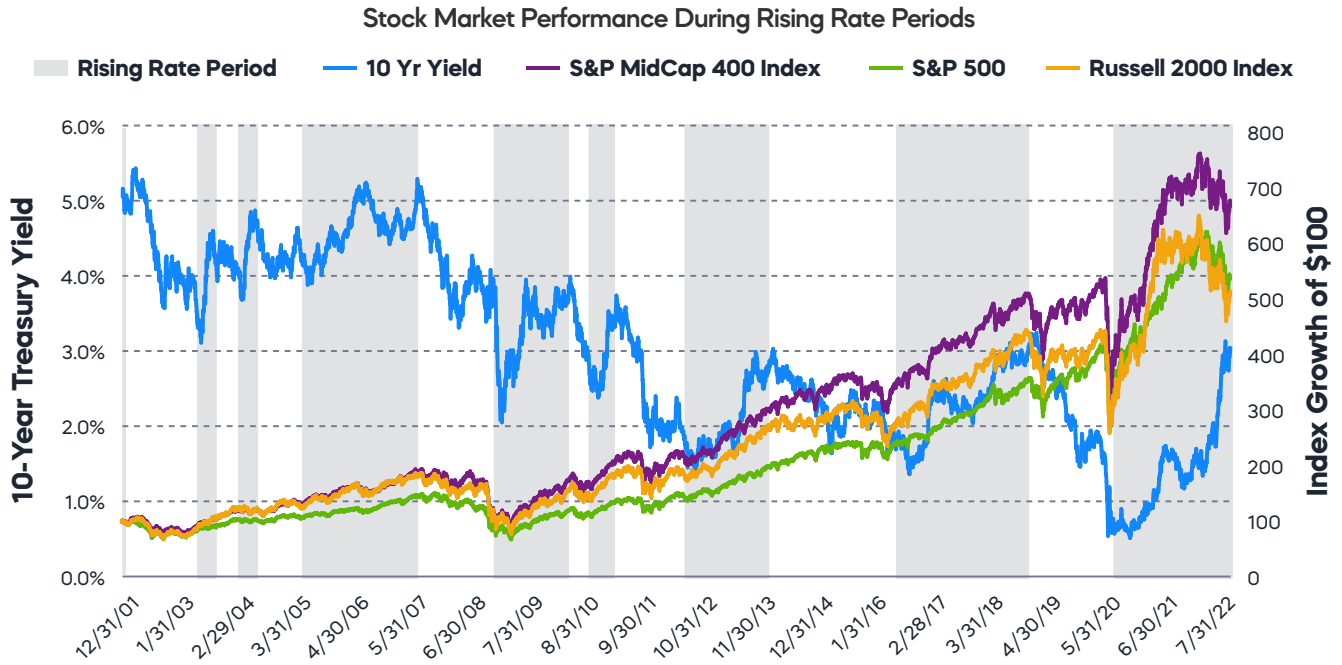
The table below shows the performance of large-cap (S&P 500), mid-cap (S&P MidCap 400) and small-caps (Russell 2000 Index) equities during the last four Fed hiking cycles. In most cases, stocks across the capitalization spectrum delivered positive performance over the full cycle, and the performance of mid-cap and small-cap stocks is particularly noteworthy. Despite a perception that smaller-cap stocks underperform when rates move higher, mid-cap and small-cap stocks outperformed large caps during the years after the first hikes.

Tightening Cycle	Number of Hikes	Performance Over the Cycle			Performance 1 Year After 1st Hike		
		Large Caps	Mid Caps	Small Caps	Large Caps	Mid Caps	Small Caps
Feb 4, 1994 – Feb 1, 1995	7	0.7%	-4.6%	-6.1%	2.5%	-2.6%	-4.8%
June 30, 1999 – May 16, 2000	6	9.7%	19.0%	12.6%	8.0%	19.8%	14.4%
June 30, 2004 – June 29, 2006	17	7.8%	13.7%	11.5%	7.5%	15.5%	10.7%
December 17, 2015 – December 20, 2018	9	8.1%	6.9%	6.3%	11.3%	20.2%	20.6%

Source: Morningstar, Federal Reserve Board.

Mid Caps Have Led When Treasury Rates Moved Higher

Another way to assess equity market performance during periods of rising rates is to examine periods when the 10-year Treasury yield has spiked. While there is overlap in the time periods, this approach paints a similar picture—smaller caps have been a solid investment.



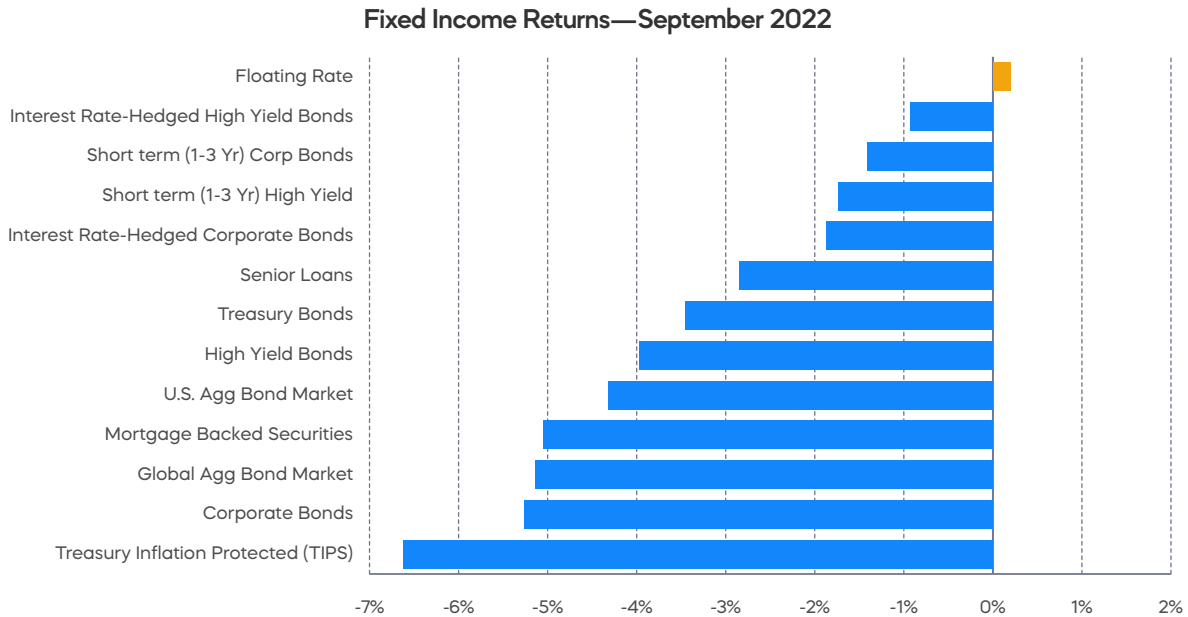
Source: Bloomberg, data from 12/31/01–8/31/22. Periods of rising rates indicated by shaded bars and are based on monthly changes in yields. Past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

Investors may want to be selective with their mid-cap allocations in what remains a difficult equity environment. A potential solution worth consideration is a dividend growth strategy, which has a history of weathering market turbulence. Akin to their large-cap peers, the S&P MidCap 400 Dividend Aristocrats are high-quality stocks that have grown their distributions for at least 15 consecutive years. And the S&P MidCap 400 Dividend Aristocrats Index has outperformed the S&P MidCap 400, delivering an attractive combination of upside and downside capture that may be just right for the times (Source: Morningstar, 2/1/15–9/30/22).

* “Up capture ratio” measures the performance of a fund or index relative to a benchmark when that benchmark has risen. Likewise, “down capture ratio” measures performance during periods when the benchmark has declined. Ratios are calculated by dividing monthly returns for the fund’s index by the monthly returns of the primary index during the stated time period and multiplying that factor by 100.

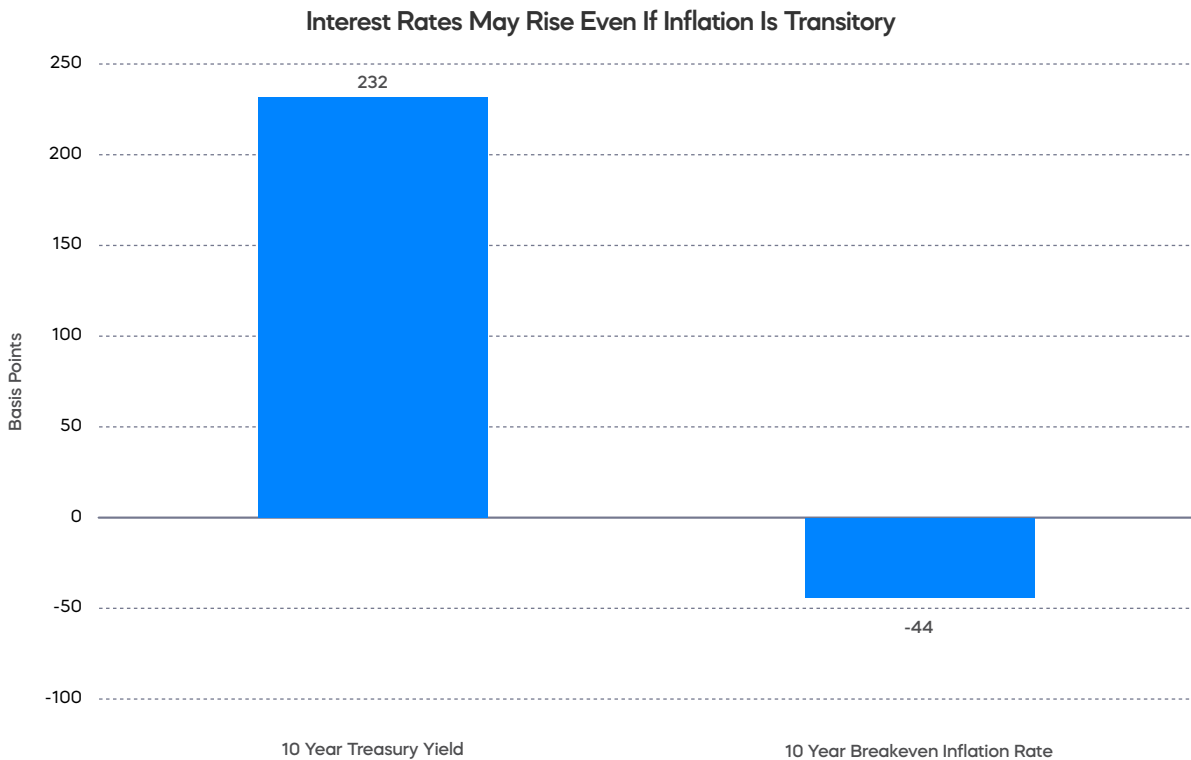
Fixed Income Perspectives

Rising Treasury yields put all but one fixed income segment in the red for the month of September.



Source: Bloomberg, data from 9/1/22–9/30/22. Past performance does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

In previous sections, we noted that there was some good news and reasons for optimism. Inflation expectations have come down. Here’s the challenging news: Interest rates may continue to rise.



Source: Bloomberg, data from 1/1/22–9/30/22. Breakeven inflation rate is calculated by subtracting the real yield of the inflation-linked maturity curve from the yield of the closest nominal Treasury maturity. The result is the implied inflation rate for the term of the stated maturity.

Quantitative Tightening removes the artificial suppression of longer-term treasury yields. Even as inflation recedes, and even if shorter-term Treasury yields like the two-year yield may have peaked, longer-term Treasury yields—five-year, 10-year and 30-year—may have further to go. It may be too early to become complacent regarding interest rate risk in the bond market and to rely on long-term Treasuries to provide meaningful upside in the event of a less-than-soft landing.

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Important Information

Sources for data and statistics: Bloomberg, FactSet, Morningstar, and ProShares.

The different market segments represented in the performance recap charts use the following indexes: U.S. Large Cap: S&P 500 TR; U.S. Large Cap Growth: S&P 500 Growth TR; U.S. Large Cap Value: S&P 500 Value TR; U.S. Mid Cap: S&P Mid Cap TR; U.S. Small Cap: Russell 2000 TR; International Developed Stocks: MSCI Daily TR NET EAFE; Emerging Markets Stocks: MSCI Daily TR Net Emerging Markets; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Composite; Commodities: Bloomberg Commodity TR; U.S. Bonds: Bloomberg U.S. Aggregate; U.S. High Yield: Bloomberg Corporate High Yield; International Developed Bonds: Bloomberg Global Agg ex-USD; Emerging Market Bonds: DBIQ Emerging Markets USD Liquid Balanced.

The S&P 500 is a benchmark index published by Standard & Poor's (S&P) representing 500 companies with large-cap market capitalizations. The S&P MidCap 400 is a benchmark index published by Standard & Poor's (S&P) representing companies with mid-cap market capitalizations. The S&P MidCap 400 Dividend Aristocrats Index targets companies that are currently members of the S&P MidCap 400 that have increased dividend payments each year for at least 15 years. The Russell 2000 Index is a benchmark index published by FTSE Russell representing the smallest 2,000 stocks in the Russell 3000 Index of the U.S. market. **THESE ENTITIES AND THEIR AFFILIATES MAKE NO WARRANTIES AND BEAR NO LIABILITY WITH RESPECT TO PROSHARES.**

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