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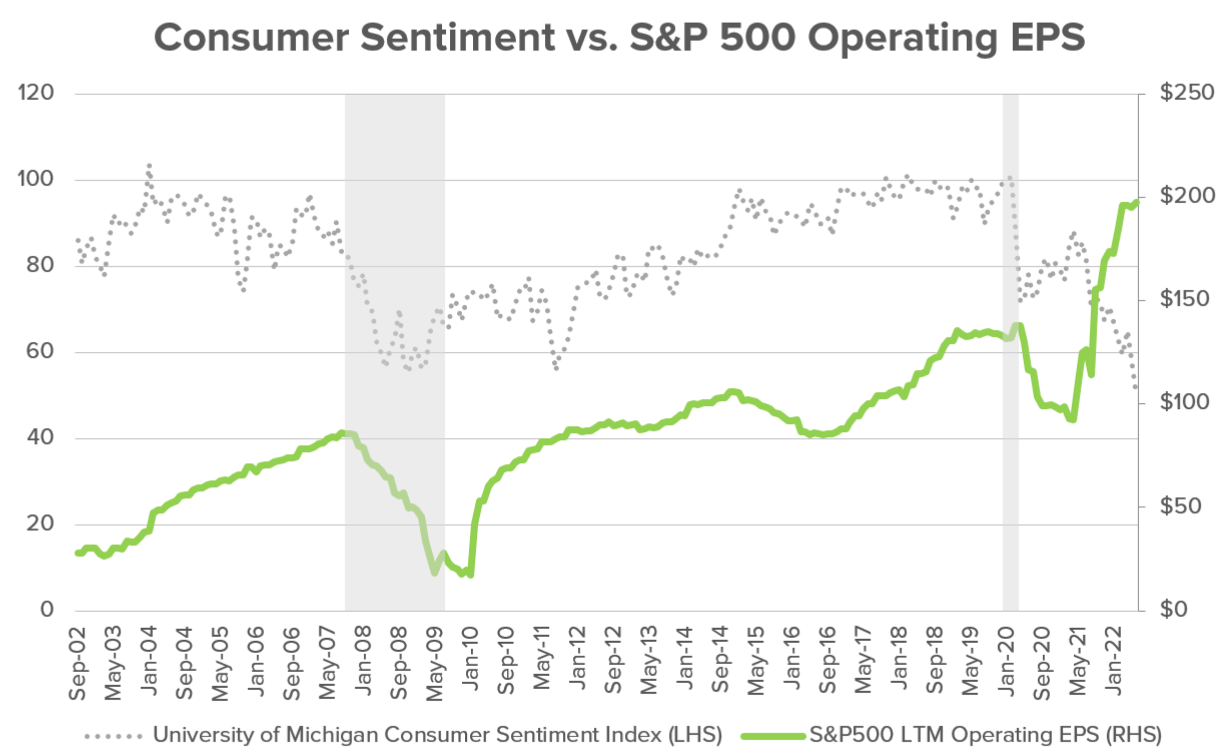
Questions of Value – The most anticipated recession of all time?

Questions of Value is a series of memos in which we address common questions from our clients about the Partners Fund and Value investing. We welcome your feedback and suggestions for future memos.

A large gap has emerged between economic sentiment and corporate earnings, with measures of the former signaling recession and measures of the latter indicating continued growth. Fears of an economic slowdown are top of mind for not only the investor class but most American families as well. In July, the University of Michigan consumer sentiment index continued to hover near the record low reading of 50 from June. The highest inflation in 40 years, rapid increases in interest rates, declines in the stock market, a war in Europe, and continued uncertainty regarding COVID-19 have combined to leave most Americans feeling wary and pessimistic. Recent surveys of CEO business confidence have also gapped down and inflation adjusted "real" gross domestic product growth has now registered two quarters of slight contraction. To the surprise of many investors, however, second quarter earnings reports and guidance updates for most companies in the S&P 500 Index were better than expected. According to S&P Capital IQ, consensus expectations are for 8% growth in S&P 500 Operating Earnings Per Share (EPS) in 2022 to over $220 per share. In this memo, we explore two scenarios for the economy and share our thoughts on navigating unpredictable economic trends.



Source: Federal Reserve Economic Data, S&P Capital IQ, Poplar Forest Capital
**Shaded areas indicate recessions. LTM means last twelve months.*

The Bull Case – Goldilocks, S&P 500 earnings grow 5-10% in 2023

With the stock market having recently rallied 10%+ from the lows in late June, it is worth contemplating the bull case for stocks. As we discuss below, one of the biggest risks to the economy is the Federal Reserve making a mistake and triggering a recession by being too aggressive in raising interest rates. Conversely, a bull case for the stock market is one in which inflation consistently declines, labor markets gradually soften, and the Federal Reserve sees a path to their long-term goal for 2% inflation without triggering a recession. This scenario is often described as a soft landing and characterized by slowing, but still positive, economic growth. An economic soft landing could enable many businesses to generate earnings per share (EPS) growth of 5-10% in 2023. With the forward P/E multiple for the S&P 500 at 17x 2023 EPS, one could argue that the market's current valuation is reasonable relative to expectations for 5-10% EPS growth. A stable valuation multiple for the S&P 500 would imply that total returns for the market would net out somewhere between 6-12% and track the combination of annual EPS growth (5-10%) and dividend yields (1-2%). Returns could be amplified by a favorable resolution of the war in Ukraine and/or a successful exit from China's zero-COVID policy.

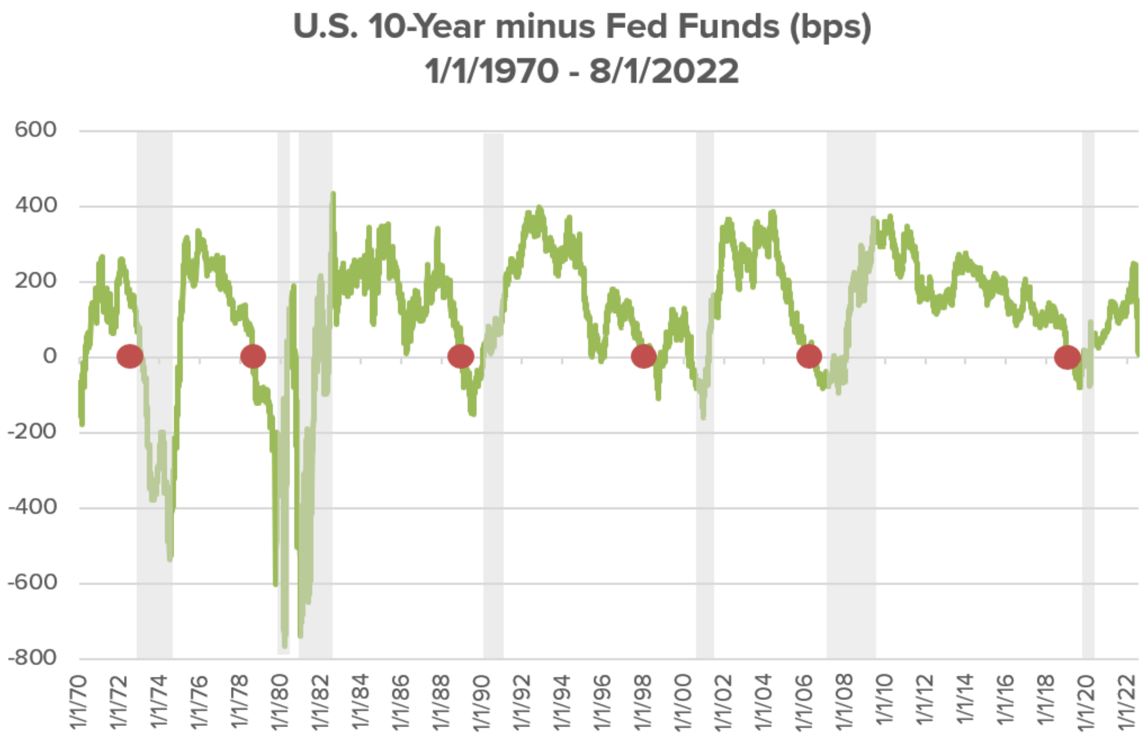
The Bear Case – A Fed Fumble, S&P 500 profits decline 10-20% in 2023

Three commonly cited reasons for believing a recession is imminent are: (1) restrictive monetary policies coinciding with reduced fiscal stimulus; (2) record lows in consumer sentiment; and (3) a flattening/inverted yield curve. We briefly explore these points below.

History suggests that it takes at least 12 months for increases in interest rates to impact economic growth which implies that, in isolation, the Federal Reserve's first rate hike back in March won't meaningfully impact the economy for another eight to nine months. Beyond interest rate increases, the Federal Reserve has also begun shrinking its balance sheet which will negatively impact the country's money supply. We believe it is likely that the Federal Reserve's current policies will succeed in suppressing economic growth which may help tame runaway inflation. Pandemic related fiscal policies that provided various forms of economic support to individuals and companies are also being eliminated or reduced. A majority of investors would likely agree with our view that the current combination of more restrictive monetary and fiscal policies will slow the economy. The debate isn't so much about whether economic growth will decelerate, but rather about the magnitude of the slowdown.

A recession scenario could emerge if inflation fails to subside during the second half of 2022 and the Federal Reserve is compelled to overshoot with aggressive interest rate hikes well into 2023. With Republicans expected to win back at least one house of Congress in the mid-term elections, a bearish market observer might also argue that Congress will have a harder time implementing fiscal policies to offset potential mistakes by the Federal Reserve. Higher than expected inflation trends in the second half of 2022 would do little to improve consumer sentiment which is already at recessionary levels. If employment trends were to meaningfully deteriorate in the midst of higher than expected inflation, a consumer-led recession could unfold over the next 12-18 months.

Another closely watched indicator for recession risks is the yield curve which has flattened over the last month. As shown in the chart below, when the difference between the 10 year government bond (10YR) and the Fed Funds (FF) rate turns negative, history suggests a recession is likely to ensue. On August 1, the difference between the 10YR and FF fell to a paltry 8 basis points. With the current spread between the 10 year and 2 year interest rates on government bonds already negative, many bearish investors note that the yield curve has been partially inverted for months.



Source: Evercore ISI, Poplar Forest Capital
**Shaded areas indicate recessions.*

To summarize, a bearish investor might argue that a recession may have already begun and will persist well into 2023 as the lagged effects of interest rate increases slow economic growth. Since the Federal Reserve has already made mistakes in underestimating the magnitude and duration of current inflationary pressures, the odds are high they will continue to make mistakes and trigger a recession. If we assume a 2023 recession results in a 10-20% decline in S&P 500 earnings and the market's valuation multiple falls to 15x, that would suggest the S&P 500 Index could decline 25-35% from current prices around $4,150.

Caution is warranted

We don't believe we have an edge in predicting whether or not there will be a recession but we do think there is wisdom in evaluating what sort of earnings growth expectations are embedded in current business valuations. The recent 10%+ rally in the market from the June lows suggests that the stock prices for many businesses don't reflect a recession-driven decline in corporate earnings.

Given the Fed's aggressive posture with regard to monetary policy, we believe it is prudent to take a conservative approach to risk management in the Partners Fund. For example, our base case financial forecasts currently assume a mild recession in 2023 with recovery in the following years. We acknowledge that any specific estimate we make about macroeconomic variables is likely to be precisely wrong, so we also evaluate more bullish and bearish outcomes to stress-test our investments. By evaluating multiple future scenarios for the economy and limiting our portfolio to only those investments that we estimate offer the most compelling ratios of reward as compared to risk, we believe we have positioned the fund for compelling multi-year returns regardless of whether or not the economy slows.

Selectivity can be an advantage for long-term investors when conflicting economic signals abound. While we don't have a strong view on the direction of the next 10% move in the market, we do have high conviction in the companies which meet our strict investment criteria for discounted valuations and underappreciated earnings growth potential.

For instance, over 50% of the Partner's strategy is currently invested in companies which have depressed margins relative to history. We believe the profit improvement plans these companies are pursuing will translate into earnings growth which isn't dependent on narrow predictions about the economy. With many companies and industries reporting margins which are closer to historical peaks than troughs, we believe our focus on under-earning businesses with unique self-help opportunities will serve our clients well should economic trends deteriorate. We also own a healthy mix of more defensive businesses in the Healthcare, Consumer Staples, and Utility sectors whose business fundamentals are less influenced by economic cycles. If growth in the economy and corporate profits decelerates in 2023, our analysis suggests our portfolio is still capable of generating high-single digit EPS growth.

As shown in the table below, the Partners Fund is valued at a significant discount to both the S&P 500 and the Russell 1000 Value Indices, which may limit valuation risk in the event of an economic slowdown. From current prices, if there is no change in our portfolio's valuation, we would expect future returns to trend towards the combination of earnings growth and dividend yields, which could exceed 10%. Should there be no slowdown in the economy, the more economically sensitive businesses in our portfolio would generate better earnings growth than we assume. In this more bullish scenario, the estimated earnings growth for our portfolio companies would likely exceed our estimates for high-single digit growth and trend closer to Wall Street consensus estimated earnings growth of 20% shown in the table below.

Partners Fund Statistics

As of 6/30/2022

	Partners Fund	Russell 1000 Value	S&P 500
P/E	9.07	12.86	16.07
P/B	1.62	2.17	3.52
P/CF	7.52	13.92	18.85
Est. Earnings Growth-NTM	18.56	19.54	14.19
Wtd. Avg. Market Cap ($B)	63.3	148.6	484.1
Number of Holdings	32	846	504

Source: S&P Capital IQ

Let's Discuss — We'd Love To Hear From You

Please contact Drew Taylor (**dtaylor@poplarforestllc.com** or **(626) 304-6030**) or your Poplar Forest relationship manager with feedback and suggestions for future Insights. Follow us on LinkedIn where we commonly post useful and informative material.

DISCLOSURES

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information and can be obtained by calling 1-877-522-8860 or by visiting www.poplarforestfunds.com .Read it carefully before investing.

Mutual fund investing involves risk. Principal loss is possible. The Fund may invest in debt securities which typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater in emerging markets. Investing in medium sized companies may involve greater risk than investing in larger, more established companies because medium capitalization companies can be subject to greater share price volatility. The Fund may invest in options, which may be subject to greater fluctuations in value than an investment in the underlying securities. When the Fund invests in other funds and ETFs an investor will indirectly bear the principal risks and its share of the fees and expenses of the underlying funds.

Diversification does not assure a profit, nor does it protect against a loss in a declining market.

Past performance does not guarantee future results. Index performance is not indictive of fund performance. To obtain fund performance, visit www.poplarforestfunds.com or call 1-877-522-8860.

Poplar Forest Capital, LLC (the "Adviser") is the investment adviser to the Fund. Poplar Forest funds are distributed by Quasar Distributors, LLC.

Value stocks typically are less volatile than growth stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice. Fund holdings and sector allocations are subject to change and should not be considered recommendations to buy or sell any security.

Earnings growth is not a measure of the Fund's future performance.
Basis points (BPS): A unit of measurement that denotes a change in the interest rate of a financial instrument and is equal to $1/100^{th}$ of 1%.
Dividend Yield: Represents the trailing 12-month dividend yield aggregating all income distributions per share over the past year, divided by the period ending fund or stock share price. It does not reflect capital gains distributions.
Earnings Growth: The annual rate of growth of earnings typically measured as Earnings Per Share Growth.
Earnings Per Share (EPS): The net income of a company divided by the total number of shares it has outstanding.
An exchange traded fund (ETF): Is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same way a regular stock can.
Forward P/E: A version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation.
Inflation: Is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over a period of time. Often expressed as a percentage, inflation indicates a decrease in the purchasing power of a nation's currency.
Next Twelve Months (NTM): The selected metric is based on the project's performance in the coming twelve months.
Price to Book (P/B): Compares a company's market value to its book value.
Price to Cash Flow (P/CF): A stock valuation indicator or multiple that measures the value of a stock's price relative to its operating cash flow per share.
Price/Earnings (P/E) Ratio: Is a common tool for comparing the prices of different common stocks and is calculated by dividing the earnings per share into the current market price of a stock.

Russell 1000® Value Index: Measures the performance of the Russell 1000's value segment, which is defined to include firms whose share prices have lower price/book ratios and lower expected long/term mean earnings growth rates. The Index is unmanaged, and one cannot invest directly in the Index. Data for the index has been drawn from the iShares Russell 1000 Value ETF.

S&P 500 Index: Is a market value weighted index consisting of 500 stocks chosen for market size, liquidity and industry group representation. The Index is unmanaged, and one cannot invest directly in the Index. Data for the index has been drawn from the SPDR S&P 500 ETF Trust.

University of Michigan Consumer Sentiment Index: Rates the relative level of current and future economic conditions.

Yield Curve: Is a line that compares the yield of bonds of equal quality but different maturity dates. In general, bonds with longer maturity dates offer higher yields than bonds with shorter maturity dates, thus producing an upward sloping yield curve.