JAG CAPITAL MANAGEMENT LLC

Quarterly Comments

Looking Beyond the Risks

"When you see only problems, you're not seeing clearly."

- Phil Knight, Shoe Dog: A Memoir by the Creator of Nike

As we begin the final quarter of 2022, the markets and the economy are still facing numerous challenges from persistent, high inflation, ongoing Fed rate hikes, and geopolitical instability. The first nine months of 2022 represented the fourth-worst start for the S&P 500 in history, eclipsed only by 1931, 1974, and 2002 based on JAG calculations. It may seem difficult to see anything ahead but more problems. But as Nike founder Phil Knight pointed out in his memoir, the inability to see positives is an indication of misguided thinking. While the outlook for risk assets remains challenged, that reality should be considered in the context of a market that has declined substantially. Although it is an overused analogy, it is a true statement that "successful investing is a marathon, not a sprint." We believe the markets have effectively discounted a variety of potential fears, uncertainties, and challenges and could be poised to offer better risk/reward opportunities in both stocks and bonds in the coming months and years. Valuations on many quality companies are quickly approaching pre-pandemic levels, while the S&P 500 is trading at a level that could represent significantly better returns ahead. While every bear market is different, bull markets often follow when most least expect it.

A Silver Lining for Bonds

The storm of high inflation and aggressive Fed rate hikes has wreaked havoc on fixed income assets this year. As of 9/30/22, the Bloomberg Global Aggregate Bond Index had declined 23.8% from its all-time high on 1/04/21, logging its largest such drawdown ever. Although this has been a painful environment for existing bond investors, new fixed income investors can now capture the highest yields and total return potential in well over a decade.

JAG has decades of experience in managing institutional quality bond portfolios. Our strategies are well diversified, with short-to-intermediate term duration. We also offer clients the ability to customize their individual bond holdings in terms of credit rating, maturity/duration structure, and ESG/SRI restrictions. We now plan to incorporate more fixed-income exposure in many of our clients' portfolios in the coming months.

"I don't get it. First you can't sleep because you're not in the market and now you can't sleep because you are."

Source: Cartoonbank.com William Hamilton

Opportunities in Equities

As long-term investors, we are confident that this year's equity market volatility is creating attractive future opportunities. We continue to be attracted to the Health Care sector. We own companies in our portfolios that are on the cusp of launching groundbreaking treatments for obesity, cancer, and Alzheimer's disease. We are also positioned to benefit from what we believe will be a very powerful wave of spending over the next decade to upgrade the US electric grid to support the growth of the electric vehicle market and the continued evolution to renewable sources of energy. More broadly, we favor companies with leadership positions in their industries, strong brands, and durable pricing power. These types of businesses are likely to continue to weather inflationary pressures better than companies which are overly dependent on commodity prices. Along those lines, although many Energy sector companies have delivered extraordinary gains in 2022, we are not confident that oil and natural gas prices will remain permanently elevated. Within commodity markets, "the cure for high prices is high prices," either sooner or later. If history is any guide, high oil and natural gas prices will eventually spur producers to increase their production. All else being equal, higher production tends to result in both lower energy demand, softer commodity prices, and potentially lower revenue and earnings for oil and gas producers.

The extremely chaotic interest rate environment makes us more cautious than most on financial services companies whose economics rely on lending. Mortgage rates have roughly doubled over the past year, which is likely to significantly slow homebuilding, new automobile purchases, and demand for corporate lines of credit. Finally, we are less enthusiastic about the prospects for the Technology sector than we have been over the past several years. Although we remain big believers in the power of innovative technology solutions, the intermediate-term outlook for technology spending is cloudier than it has been since at least 2009. Consumers and enterprises are more cautious with big-ticket investments in smartphones, semiconductor chips, and software. This wave of belt-tightening, along with the significant increase in interest rates, has caused more share price volatility than we expected. We have reacted by reducing some of our technology and technology-adjacent holdings, and we are being more selective than ever with new purchases in this area of the market.

The Background: The Storm is Not Yet Over

Stocks fell again in the third quarter as inflation remained near multi-decade highs, geopolitical tensions escalated further, and the Federal Reserve continued to aggressively hike interest rates, signaling that future rate increases will be larger than previously expected. While the Fed has admitted that they were late to join the fight against inflation, we are concerned that their current rush to correct their previous mistake might lead to another error. Consider this analogy: a driver must get to the airport to catch an important flight. Unfortunately, he left his home a bit later than he had planned, and then he runs into a traffic jam that puts him even farther behind schedule. Our tardy driver has two basic options. He can continue to the airport at a safe speed and accept the potential of missing the flight and taking a later departure. Alternatively, he can ignore safety considerations and speed recklessly to make up for lost time. Most of us would strongly advise the driver to avoid the latter course of action. In our analogy, the driver is our Federal Reserve, making the decision to rush and aggressively raise rates over a period of just a few months. In our estimation, the Fed is moving too quickly, and as a result they risk causing an economic or market "accident." The Bank of England, too, has joined the rush, with consequences that extend beyond its borders. Within this context, we are especially cautious when evaluating financial-sector investments.

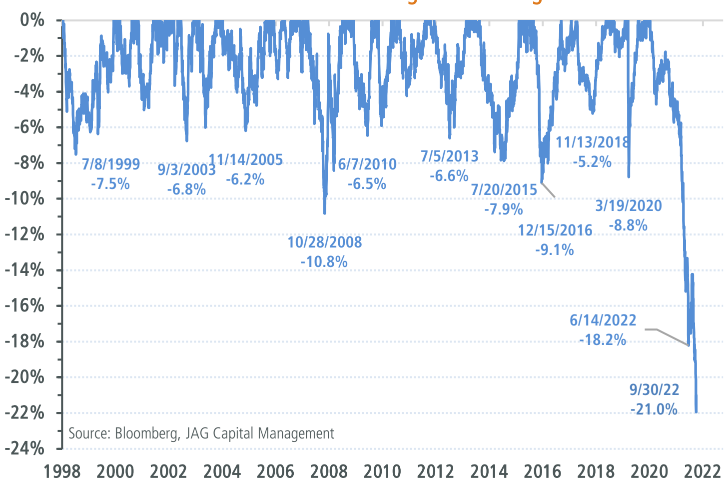
Last quarter started with a solid rebound in stocks and bonds that was driven by resilient corporate earnings, signs of a possible peak in the rate of inflation, and speculation that the end of the Federal Reserve's rate hiking cycle might come sooner than originally anticipated. Despite high inflation and lingering supply chain issues, the majority of Q2 earnings reports beat estimates, and that solid performance by corporate America showed investors that corporate earnings were holding up much better than expected, despite numerous macroeconomic challenges. Several survey-based economic reports showed price declines in June and offered hope that inflation pressures were peaking. Finally, in late July the Federal Reserve raised interest rates by another 75 basis points, and at the press conference Fed Chair Powell implied that the Fed may need to slow the pace of interest rate increases. Hope for a less-aggressive Fed, paired with resilient earnings and a possible peak in inflation, fueled a 9.2% gain in the S&P 500 in July, its best monthly return since November 2020.

Unfortunately, asset prices softened again in August and especially September. Chairman Powell's brief and hawkish remarks on August 26th at the Jackson Hole Economic Symposium, along with subsequent and similar messaging from other Fed governors, dashed any speculation of a near-term change in rate policy. Powell's warning that the US economy will likely feel some "pain" in the coming months raised concerns that the Fed could be willing to push the economy into recession to tame inflation. Reacting to the slight increase in prices in the August CPI report, the Federal Reserve again hiked interest rates by 75 basis points at their September meeting and reiterated their assertion that rates will continue to rise to levels higher than previously expected.

Geopolitical concerns also pressured stocks in September, as Russia escalated the war in Ukraine by holding referendums in occupied Ukrainian territory and announced a 300,000-person "mobilization" from the general Russian population. Finally, during the last few days of the month, global currency and bond markets saw a dramatic increase in volatility, as the Liz Truss-led government of the United Kingdom announced a spending package designed to stimulate the economy. But given that this stimulus package would likely add to inflation pressures, the announcement drove a spike in global bond yields and a collapse in the British pound vs. the US dollar. The unpleasant stew of fears weighed heavily on both stocks and bonds into the end of September, causing both markets to finish the quarter at or near their lows of the year. There have been few if any places for investors to hide in 2022. Global equities, commodities, and fixed-income assets all generated losses this past quarter. Within the S&P 500, only two of the eleven S&P 500 sectors finished the third quarter in the green. The retailer-heavy Consumer Discretionary sector ended the quarter with a 3.8% return, thanks to depressed valuations, better-than-feared earnings, relatively strong consumer spending, and still-low unemployment. The Energy sector finished the quarter with a slight gain as energy stocks benefitted from solid earnings and continued strength in natural gas prices. Energy is the only S&P 500 sector with a positive year-to-date return through 9/30/22.

Although commodities generated gains early in the year, they joined the bear parade over the last several months. A combination of a multi-decade high in the US dollar, growing fears of a global recession, and sharply rising real interest rates weighed on industrial commodities as well as traditional safe havens like precious metals. Oil prices fell in the quarter as concerns about future demand offset geopolitically based worries about supply. Even gold, despite its reputation as a so-called "inflation haven," logged solidly negative returns for the second straight quarter thanks to rapidly rising real yields, the surging dollar, and fading market-based inflation expectations.

BBG Global Aggregate Bond Total Return Index
Drawdown from Trailing 12-Month High



The epically poor showing by the bond market might be 2022's biggest and most unpleasant surprise. Most bond indices posted strongly negative returns for the third straight quarter. Although bonds have historically been much less volatile than stocks, the combination of historically low starting yields in 2020-2021 and dramatic increases in interest rates this year have resulted in the worst bond market performance in modern history. This has wreaked havoc on the performance of balanced equity/bond portfolios that were expected to dampen equity market volatility. However, the silver lining here is the more substantial total return cushion that higher yields provide to new bond investors in the months and years ahead.

Interestingly, multiple investor sentiment indicators have hit or are approaching levels that historically have represented extreme pessimism and bearishness. Poor investor sentiment can persist for some time, so this is not a precise "market timing" indicator. However, in our experience, widespread investor pessimism is a necessary if not sufficient condition for a more permanent equity rally to develop.

Outlook

We think it is highly likely that various inflation stressors are in the process of moderating. Multiple inflation indicators show a decline in supply chain price pressures. As just one example, according to the Freightos Baltic Index (FBX) shipping container costs from SE Asia to the US west coast have fallen from $16,241 on 3/16/2022 to a recent $2,515 on 10/4/2022, representing a decline of ~85%. While the Consumer Price Index remains far above the Fed's target of 2%, the combination of dampened demand and improving supply chains is alleviating price pressures in a wide range of goods. Assuming we are generally correct about the path of inflation, the Fed could soften its hawkish tone on rates as soon as the fourth quarter. According to the Fed's own estimates, interest rate increases will begin to slow in the coming months, and the last rate hike for this cycle could occur in March 2023 or sooner. If that turns out to be the case, and the Fed signals to markets that this rate hike cycle is approaching its end, that will likely be a materially positive catalyst for both stocks and bonds. There has certainly been historical precedent for strong rebounds after strong falls as the table below details.

In fact, even if inflation remains more stubborn than we expect, other factors could cause the Federal Reserve to ease up on the brakes sooner than many predict. Geopolitical tensions remain very elevated as Russia has recently escalated the war in Ukraine and the risk of a broader conflict simply can't be ruled out. But most Western countries remain united in their opposition to the Russian invasion of Ukraine and that will continue to be a powerful deterrent to Russian President Putin. Additionally, even some of Russia's most important economic allies, including China and India, have voiced concerns about the escalation of the war over

Drawdowns of 25% or more in S&P 500 Price Index*						Subsequent S&P 500 Performance*			
Peak Date	Trough Date	Peak Price	Trough Price	% Chg	# of Trading Days	1 year	3 year	5 year	10 year
12/12/1961	6/26/1962	72.6	52.3	-28.0%	135	32.7%	56.0%	74.5%	108.9%
11/29/1968	5/26/1970	108.4	69.3	-36.1%	369	44.5%	50.2%	28.5%	54.4%
1/11/1973	10/3/1974	120.2	62.3	-48.2%	436	34.6%	55.0%	75.5%	166.0%
11/28/1980	8/12/1982	140.5	102.4	-27.1%	430	57.7%	83.2%	214.5%	313.9%
8/25/1987	12/4/1987	336.8	223.9	-33.5%	71	21.4%	43.9%	92.1%	328.3%
3/24/2000	10/9/2002	1,527.5	776.8	-49.2%	637	33.7%	52.9%	100.1%	84.4%
10/9/2007	3/9/2009	1,565.2	676.5	-56.8%	355	68.6%	99.9%	176.1%	315.5%
2/19/2020	3/23/2020	3,386.1	2,237.4	-33.9%	23	74.8%			
1/3/2022	9/30/2022	4,796.6	3,585.6	-25.3%	187				
					Average	46.0%	63.0%	108.8%	195.9%

*Price only, not including dividends. Source: FactSet, JAG Capital Management the past month which has further isolated Russia from the global community. In our opinion, any reduction in geopolitical tensions would represent an upside surprise for global risk assets, including US stocks and bonds.

The upcoming US midterm elections are a potentially under-appreciated positive catalyst for the markets as we approach 2023. Historically, the first midterm election of a Presidential term has resulted in the incumbent President's party losing seats in Congress. This has tended to be true regardless of the President's party affiliation. New federal legislation always results in winners and losers in the economy, which can disrupt individuals and corporate planning. Therefore, unlike many of us as individual citizens, capital markets tend to favor the legislative gridlock that typically occurs when neither political party controls both houses of Congress and the Oval Office.

This is a difficult market and a complicated moment for the world, but history is clear: the best investment opportunities emerge out of periods characterized by fear and uncertainty. We are committed to helping our clients navigate this challenging investment environment and seeking the opportunities that will set the stage for future investment success.

Warm regards,

Norm Conley
CEO, Chief Investment Officer &
Portfolio Manager

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Disclosures

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Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/ expertise without substantial reliance on non-Veteran-owned businesses.

About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm with offices in St. Louis and Chicago.

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