PARAGON INVESTMENT STRATEGY

July 2022

A Rare Double Bear Market: Stocks and bonds were both in bear markets at the same time in the second quarter, a very rare occurrence. Both experienced double-digit declines at the same time for the first time in history. All asset classes have seen valuations recalibrate for higher inflation and rising interest rates. At times like these, it's helpful to take a longer-term perspective. Over 10 years, the worst performance ever for a balanced portfolio of 50% stocks and 50% bonds was +16%, or +1.5% annually, which included the depths of the Great Depression.

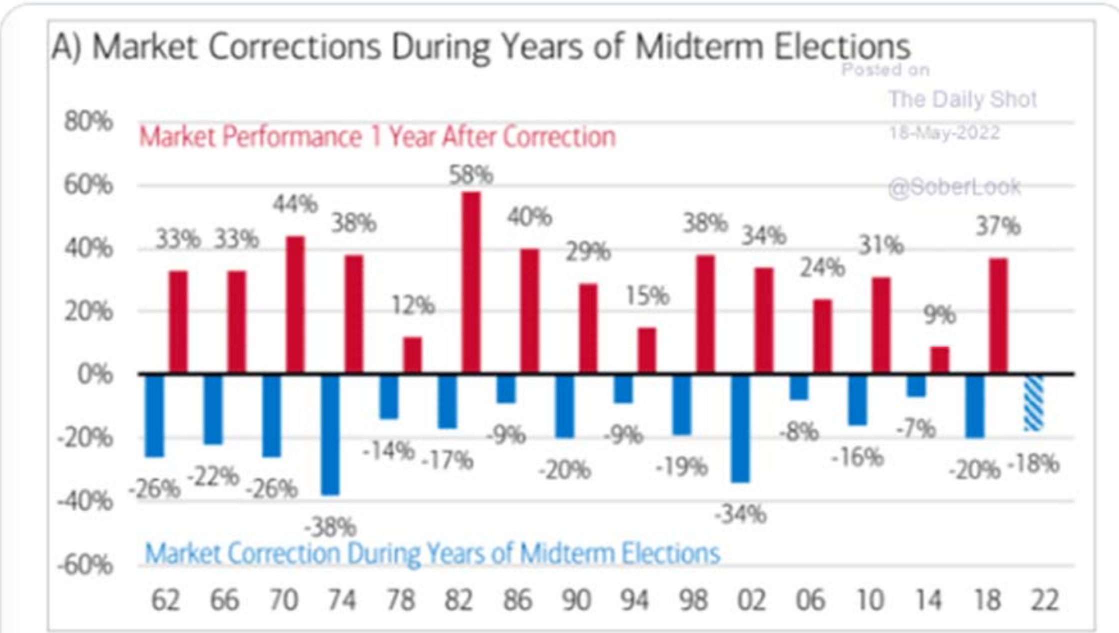
Bond Bear Market: Bonds have broken out of a 40-year bull market trend of declining interest rates, as shown below. However, we do not believe rates are heading back toward the much higher levels of the 1970s and 1980s, which was a historical anomaly. After the significant adjustment to rates this year, bond yields are getting more attractive, although they may still move higher.

10-Year Treasury Rate Since 1962

Source: Bloomberg

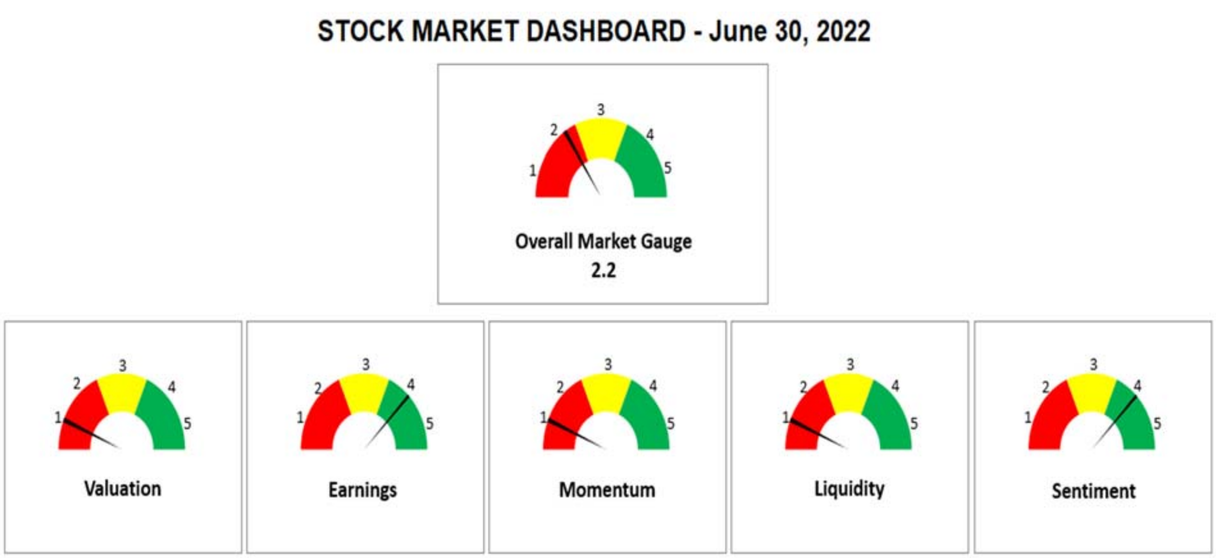
Stock Bear Market: Goldman Sachs defines the current environment as a "cyclical" bear market, one that is "typically a function of rising interest rates, impending recessions and falls in profits." According to Goldman's research, the average cyclical bear market over the past 200 years has seen a decline of 30% and lasts two years. The bottom of the cycle typically arrives 6 to 9 months before the trough in earnings and 3 to 6 months before the economic trough after inflation peaks. The turning point typically is when interest rate expectations begin to moderate. Based on these historical measures, we may not yet have seen the market bottom for this bear market. However, the Fed could pull back on rate hikes sooner than expected, so this cycle could be shorter than historical comparisons would suggest.

While there are several drivers for the decline in the stock market, such as high inflation, rising interest rates, the threat of recession, and a war in Europe, there is also some normal cyclicality to the decline. As shown below, every midterm election year over the past 60 years has seen a market decline, with an average of nearly 20%.



Source: Merrill Lynch

Paragon's Stock Market Dashboard shows a need for caution as momentum and liquidity indicators have declined, and valuations remain historically high despite this year's declines. On the bright side, earnings growth remains strong and sentiment has declined to very low levels (a contrarian positive market indicator).

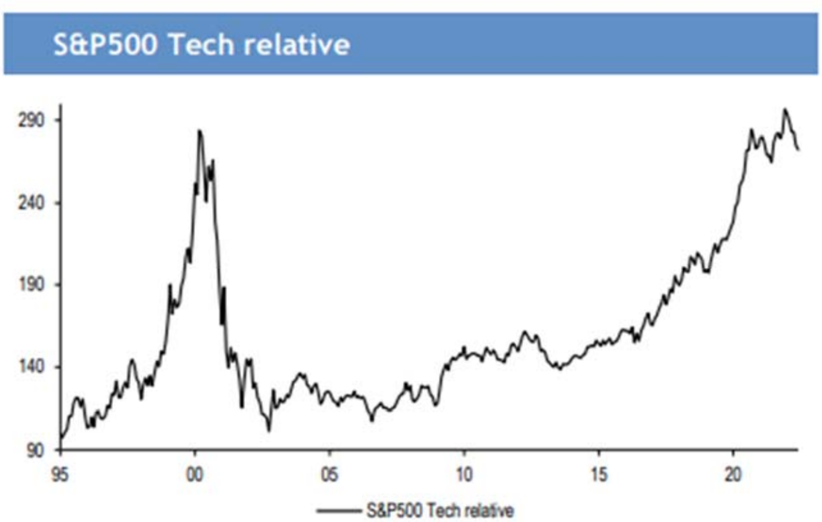


Source: Paragon Capital Management

<u>Technology Stocks</u>: Some sectors have taken the brunt of the stock market decline, and some are now particularly attractive. While technology stocks have underperformed the market in this downturn, much of the damage has come within the large group of unprofitable technology stocks, which as a group has declined by about 70% from its high.

Source: Goldman Sachs

Overall, technology stocks may have just begun to underperform the market, so we are continuing to underweight technology. The following chart shows technology stocks' strong performance over the past decade relative to the broader market and their recent retreat.



Source: JP Morgan

High-Quality Stocks: We are remaining invested in high-quality, dividend-paying companies with strong profit margins and balance sheets. More than 20% of stocks in the U.S. are so-called "zombie" companies, meaning that they do not have enough cash flow to cover their interest payments, kept alive only by easy monetary policy and ample liquidity. With rising interest rates and a slowing economy, many of these companies may be in trouble, putting a further premium on higher-quality companies. More than half of our domestic stock portfolio consists of high-quality stock ETFs.

Small Cap Stocks: Relative valuations of small company stocks are at a significant discount to historical levels, and near all-time lows. Small cap stocks have traded historically at a slight premium to the market, but are now at a 30% discount. A significant portion (about 20%) of our stock portfolio consists of small cap stocks, split domestically and internationally.

Chart 1: Relative valuations for small caps near historical lows

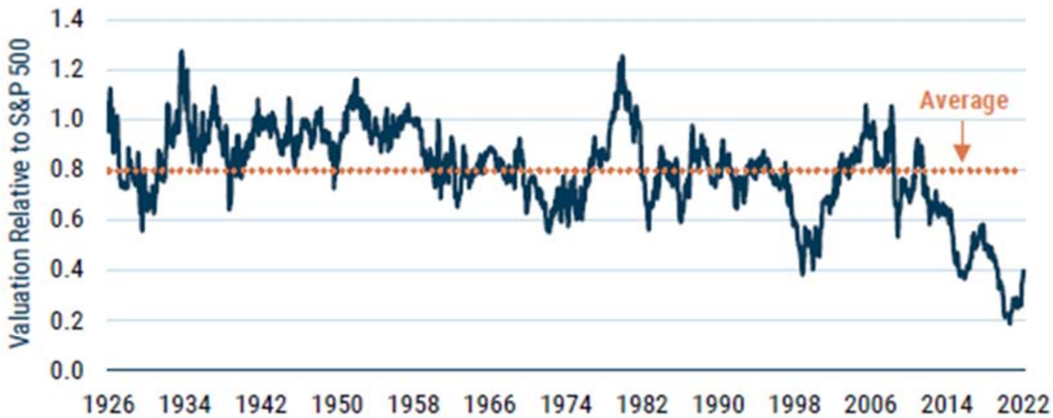
Small-cap relative to large-cap forward price/earnings (PE) ratio

Source: FactSet, Bloomberg, abrdn, March 31, 2022. Note: Excluding negative earnings. For illustrative purposes only.

Natural Resource Stocks: Relative valuations of natural resource stocks (such as energy, metals, and agriculture) are at even more historical extremes than small cap stocks. Over the past 100 years, natural resource stocks that have traded at an average 20% discount to the market are now at a 60% discount. We have only a slight overweight of natural resource stocks at this time. While we are intrigued by the valuation discount, heading into an economic slowdown is not an ideal time to have a significant overweight of these highly cyclical companies. We will continue to look for opportunities in the sector, as the valuation discount and structural imbalance present a compelling investment case.

EXHIBIT 4: RESOURCE EQUITIES CONTINUE TO TRADE AT DEEPLY DISCOUNTED LEVELS

Valuation of Energy/Metals Companies Relative to the S&P 500



As of 3/31/2022 | Sources: S&P, MSCI, Moody's, GMO
Valuation metric is a combination of P/E (Normalized Historical Earnings), Price to Book Value, and Dividend Yield.

Commodities: Similar to natural resource stocks, commodities appear attractive over the long term, but perhaps not during a period of slowing economic growth and a rising dollar. Longer-term, most commodities are faced with significant supply and demand imbalances. Some commodities, such as copper, are expected to have significantly higher demand over the next decade. Most newer technologies, such as electric vehicles, use several times more copper than older technologies. Despite increasing demand, supply is not keeping pace. This is due to underinvestment in recent years and because it takes several years to open a new mine and bring supply online. The chart below shows how significantly commodities have underperformed the stock market over the past decade.

FIGURE 12 Commodities vs. Dow Jones Industrial Avg.

Source: Bloomberg, G&R Models.

Source: Goehring & Rozencwajq Funds