Capital Markets Commentary and Quarterly Report: 2nd Quarter 2022

Capital Markets Highlights

In Q2, 2022, the U.S. stock market[1] entered a bear market, falling by 16.10% in the quarter and breaching the down 20% threshold from its recent high. After declining 4.6% in Q1, the market continued its slide in April, stabilized in May, and then moved sharply lower in June after a higher-than-expected inflation number.

It was the worst quarter for the stock market since March 2020 and the worst first six months start to the year since 1970. No market sector was spared in the decline. On a relative basis, the Consumer Staples, Utilities, Energy, and Health Care sectors held up the best, all down mid-single digits, with Consumer Discretionary, Communications Services, and Technology showing the largest declines of 20% or more.

Most areas of the market were down sharply in the quarter with Small Cap, Mid Cap, and International, down in the mid to high teens. After years of market leadership, Growth was among the worst-performing areas of the market in the quarter, down more than 20%. Year-to-date through June 30, the declines in many areas were greater than 20%. Value and Dividend strategies were far more protective than Growth strategies in the quarter and year-to-date.

It was also another tough quarter for fixed income investments with interest rates rising across the yield curve. Even lower risk, shorter-term Treasuries showed a loss in the quarter while the Bloomberg U.S. Aggregate bond index (U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities) was down 4.7% in the quarter, bringing its loss to 10.3% year-to-date through June 30.

Oil prices were volatile in the quarter, running up to over $120 a barrel in early June but ending the quarter only modestly higher from March 31. Concerns over oil's impact on inflation, something the Fed cannot control, weighed heavily on both the stock market and fixed income prices during the quarter.

Our Thoughts Going into Q3

At the risk of sounding Pollyannaish, we think the economy is in better shape than the latest consumer confidence numbers indicate and that the stock market will likely end the year far better than its mid-year levels. As the market sell-off accelerated in June we have become more optimistic about the prospects for stocks for the next 6 to 12 months. Stock and bond prices have come down a lot and the recent economic data, while showing signs of slowing, looks OK to us. We think the Fed is getting what it is hoping for: some moderation in the economy's growth that should bring supply and demand into

[1] All references to the U.S. Stock Market are the S&P 500 unless otherwise noted.

better balance while still showing good job numbers and modest economic growth. If this continues to play out, the rate of inflation should start to decline without causing a severe recession (a soft landing). As evidence of the decline in inflation builds, we think the Fed may surprise investors later in the year by slowing or pausing its rate increases, giving a lift to stock prices.

Though growth in the economy is slowing (and hitting companies that benefitted disproportionately from the Covid economy, particularly hard) recent earnings calls in late June from three large companies representing a broad cross-section of the economy with real-time economic data, Accenture (ACN), Federal Express (FDX), and Paychex (PAYX) all reported good results and expressed confidence in their businesses outlooks[2]. Many super-regional banks conveyed a similar message in their June analyst meetings.

Below are excerpts from the ACN, FDX, and PAYX calls:

> From Accenture on June 23: *"We see continued strong demand going into the next quarter with another strong bookings quarter and another strong revenue quarter."*
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> From FedEx's earnings call, on June 23: *"Let me take a moment to discuss 2023. We anticipate consumers will keep spending and their spending will continue tilting toward services from goods. We expect more consumers to return to stores. Our fiscal '23 forecast assumes a normalized economic environment"*
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> From Paychex, June 29: *"Macroeconomic trends have been positive this year but with inflation at the 40-year high, there are concerns for the potential of a recession in the near future. We continue to monitor key leading indicators for any signs of a change in the macroeconomic environment but have not seen any signs of deterioration at this time. Typically, the first signs of a macroeconomic recession would be a decline in employment levels at existing clients, an uptick in non-processing clients, or a slowdown in sales activities. These indicators continue to trend in a positive direction. Job growth at U.S. small businesses remained strong…"*

We believe a recession, if we have one, may be mild. Technically, we may already be in one. The old but still common definition was two consecutive quarters of negative GDP. However, as reflected in the comments from ACN, FDX, and PAYX, even with all the current headwinds, the underpinnings of the U.S. economy are still healthy. Consumer and business spending, while moderating, remains positive. Unemployment is near historic lows and individual and business balance sheets remain solid with credit quality exceptionally high.

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[2] Accenture is a professional services company specializing in information technology services and consulting with over 700,000 employees. Federal Express provides daily package deliveries for businesses and consumers around the world. Paychex's business is human resource, payroll, and benefits outsourcing services for small- to medium-sized businesses. The company has more than 100 offices serving approximately 670,000 payroll clients in the U.S. and Europe. These three companies provide good insights into the economy because they see real-time economic data. Below are excerpts from their earnings call outlooks.

Economies here and around the world have reopened and are shifting into a different gear from a stay-at-home Covid world to a more normal demand for services economy. As long as jobs are plentiful, and people have the income to save and spend we believe that consumer behavior will be more supportive of a good economy than recent sentiment indicators suggest. Further, in recent business updates, many money-center and regional banks all noted that consumer balance sheets currently have more cash and are stronger than their pre-Covid levels. Credit card data shows pent-up consumer demand for activities curtailed during Covid with a strong pick-up in traffic at restaurants, entertainment, sporting events, and travel.

Inflation is a significant near-term problem, but we believe that it is a cyclical problem created by extraordinary fiscal and monetary stimulus during Covid, logistics problems, also a byproduct of the Covid economy, and then inflamed by the war in Ukraine. The Fed's recent policy actions to increase interest rates and reduce the money supply, coupled with an improving Covid-related labor market and logistics issues, will likely result in lower inflation rates by fall if not sooner. There are already signs that inflation may have peaked while employment remains strong. Retailers, like Walmart and Target with too much inventory in kitchen appliances, televisions outdoor furniture, and apparel are reducing prices.

Economically sensitive commodities like copper, steel, and lumber are well off their highs and housing price increases are slowing in response to the sharp rise in mortgage rates. Rental prices showed their first slowdown and, in some cases, declined in the past month. Supply chain disruptions are also an issue, but likely will be peaking before year-end. Gasoline and food prices are still high, held up by supply constraints, mostly caused by the war in Ukraine. If and when that war ends, food and energy prices should decline dramatically. Finally, the U.S. dollar has been very strong versus other currencies which lower the cost of imported goods for U.S. consumers, putting downward pressure on inflation. The powerful secular forces that kept inflation low for so many years, including global competition and rapid technological advancements, will inevitably reassert their gravitational downward pressure on inflation.

The U.S. economy is a very powerful engine of economic growth. Recessions[3] are a normal part of the business cycle, usually short-lived and followed by strong market recoveries. During the post-World War II period, a typical recession lasts about six to 12 months, although some were longer, and one was shorter (the most recent one after Covid lasted two months)[4]. If we have a recession, we expect it to be on the shorter and shallower end of historic norms as we don't see the excesses in the economy that usually accompany or cause deeper, long-lasting problems.

We think the chances are good that the economic picture may look much sunnier six months from now and the stock market, as it has done historically, will likely rise well before it becomes obvious that inflation is coming down and the worst fears about the economy prove to be exaggerated. The timing of

[3] Recessions as defined by the National Bureau of Economic Research.
[4] Mark Zandi, Chief Economist at Moody's Analytics CNBC interview June 24, 2022.

the next advance is unpredictable and sticking with an investment plan and not overreacting to current events or short-term market moves is critical to long-term success.

A lot is being made in the business press about poor consumer sentiment. The inference is that poor consumer sentiment and poor stock market performance are positively correlated. A study of the actual relationship strongly suggests that this is not the case and in fact, there is an inverse relationship and low consumer confidence is often followed by very favorable investment returns.

JPMorgan chief strategist David Kelly notes in their quarterly guide to the markets that The University of Michigan Index of Consumer Sentiment [5]stretching back over the past 50 years has eight distinct peaks and troughs. On average, buying at a confidence peak yielded a return of 4.1% in the following 12 months while buying at a trough returned 24.9%.[6] While we wouldn't look at this history as a forecast for the upcoming year, it does suggest that investors should not be overly concerned about negative consumer confidence headlines.

We do not know when the next bull market will start but it will inevitably begin while the majority of investors are bearish, worrying about another leg down in prices. Our valuation work on our investment strategies have reached levels that historically have been very bullish for the market in general and our portfolio strategies in particular.

Being invested in the early stages of a market rally is critical to good long-term investment results. In the last 40 years, for example, the best 10 days (out of more than 10,000) accounted for almost two-thirds of the stock market return for the entire period. In the last 20 years, the best 10 days accounted for 75% of the market's returns. Remarkably, the market tends to make its largest one-day jumps precisely when volatility is high, and the market is in chaos[7].

Half of the S&P 500 Index's strongest days in the last 20 years occurred during a bear market. Another 34% of the market's best days took place in the first two months of a bull market - before it was clear a bull market had begun[8].

From 1930-2021, there have only been five 1st half-year market declines of 15% or more. In 5 out of 5 times, the second half of the year provided a positive return, ranging from a low of 6% to more than 50%[9] with the majority of the outcomes around 15% or better.

In summary, we believe that the consensus is too negative about the U.S. economic outlook, inflation, and the stock market. In the near term, it is clear to us that there is a slowdown in parts of the economy

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[5] The University of Michigan Consumer Sentiment Index is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.
[6] JP Morgan Guide to the Markets June 30, 2022
[7] Forbes 5/5/22
[8] Source: Ned Davis Research, 12/21. The time period referenced is 12/16/01-12/15/21
[9] Source: First Trust and Bloomberg as of 6/30/2022.

that have been hot, but with a healthy job market, we believe there is a good chance that the Fed will succeed in bringing down inflation while the economy muddles through a period of slower growth before reaccelerating. A resolution to the war in Ukraine would also be very bullish for equities, although nothing seems likely in the near-term.

While we are very aware of the reasons investors are bearish, we are finding many good investment ideas in high-quality companies and historically that has provided outsized returns in subsequent periods. We expect the current downside volatility to subside as the year progresses and the stock market to end the year well above its current level.

As was the case in the first quarter, during Q2, we were more active than usual, locking in profits on names that reached our targets and redeploying funds in more attractive opportunities. At the same time, for taxable accounts, we have been proactive and started tax mitigation trades to lower capital gains where possible (more on this subject in the tax section at the end of this letter).

The major risks we see for the U.S. equity market are 1) the war in Ukraine spins out of control and becomes more global, and 2) we are misreading the economy and things get much worse than we currently foresee. We are hopeful that neither of these will play out.

We have modest expectations for fixed-income investments but after the sharp sell-off in bonds during the first six months of 2022, we believe a lot of the damage in high-quality short-term bonds has been done. We believe that short-term bonds in this environment now offer a reasonable interest rate and have an important place in balanced accounts. Our focus on high-quality, shorter-term fixed income instruments has mitigated interest rate risk and given us the flexibility to modestly extend maturities at higher rates. We continue to be wary about longer-term bonds.

Below we provide a full discussion of the portfolios, including purchases and sales during the second quarter.

Large Cap Value Portfolio (LCV)

After our very strong 2021, and a relatively good start to the year, our Large Cap Value portfolio sold off during Q2 in a market that continued to penalize last year's best performers, of which we had many. In Q2, the portfolio modestly outperformed the S&P 500 (gross of fees) but trailed the Russell 1000 Value Index. For the year-to-date, through June 30, the relative performance of the LCV portfolio was also modestly ahead of the S&P 500 (gross of fees) but behind the Russell 1000 Value Index.

Consumer Staples was the only portfolio sector with positive performance in the quarter. The greatest detractors of performance were the Technology and Communication Services sectors.

We were very active during this period of market volatility, selling and scaling out of positions into price strength and starting new positions or filling out existing holdings during selloffs. We also engaged in select swaps aimed at upgrading the quality and upside of the portfolio.

We started a new position in Bookings Holding (BKNG) a leading global online travel company. Bookings has the largest market share in the online travel agency business through its Bookings.com, Priceline.com, Agoda, Kayak, OpenTable, Rentalcars, and Etraveli franchises. Before Covid, BKNG was growing at a double-digit rate with earnings reaching $102 per share in 2019. The company's business was hit hard during Covid but remained profitable. As global economies emerge from Covid, the travel business and Bookings have recovered quickly but the stock has been a casualty of the NASDAQ sell-off. The company has a strong balance sheet and shareholder-oriented management. We think the share price decline provided a good entry point for this high-quality company in an industry with strong growth prospects.

We took advantage of price declines in the quarter to build out positions in Meta Platforms (the new name for Facebook), PayPal, Truist Financial, and Zimmer Biomet.

Favorable price movements provided the opportunity to take profits in Coca-Cola and Kellogg when they reached our price targets and were full sales. We also sold the position in Embecta, which we received as a spin-off from Becton Dickenson, and made a strategic swap out of State Street Corp. into Bank of NY Mellon when we had an opportunity to upgrade the quality of the portfolio in the custody bank area with a better-managed, more shareholder-oriented company.

At the end of the second quarter, the largest sector weightings in the LCV portfolio were in Technology, Communication Services, Financials, and Health Care. Technology and Communications Services have been two of the worst-performing market sectors this year. We believe the names we own in these sectors offer exceptional appreciation potential, their businesses are very profitable, and the valuations are historically low. Financial stocks have sold off even though the current environment of rising interest rates, loan growth, and good credit quality, should be very beneficial to their results. Finally, our Health Care investments provide relative stability with good upside potential.

We believe the Large Cap Value portfolio is well-positioned for upcoming periods as the businesses are operating at a very high level with strong earnings and cash flows, yet it sells at a very attractive valuation. As of June 30, the LCV portfolio’s 2023 estimated P/E multiple was 12.6 times earnings compared to the S&P 500’s estimated P/E multiple of 15.0 times earnings[10].

Matrix Dividend Income (MDI)

The Dividend Income portfolio navigated the second quarter market-sell off in good form, being more protective than the overall market (S&P 500) and the Russell 1000 Value Index. For the six months that ended June 30, the portfolio meaningfully outperformed both benchmarks (gross of fees).

Portfolio investments in the Consumer Discretionary, Consumer Staples, and Materials sectors all showed positive returns in the quarter. Financials and Technology were the two sectors detracting the most from the portfolio’s results in the quarter, both of which we believe have great upside potential from current levels.

[10] Source: Bloomberg

During the quarter, we took advantage of the market's large price swings to lock in gains on stocks that reached our investment objectives, while adding four new names and filling out several other positions.

We sold the entire positions in Kellogg and Merck when they reached our price objectives and trimmed the positions in AbbVie and Coca-Cola.

We started new positions in Air Products (APD), Morgan Stanley (MS), Paramount Global (PARA), and Starbucks (SBUX). We also used price weakness as an opportunity to fill in existing positions in Cisco, Medtronic, and Texas Instruments.

Air Products & Chemicals is a leading global industrial gas company with very stable returns. The company provides industrial gas in bulk liquid and compressed gas forms as well as via "on-site" dedicated facilities. Because many of its contacts are long-term take or pay agreements, the business is less cyclical than many industrial companies while benefiting during economic upswings. Air Products is a leader in hydrogen fueling systems and infrastructure, and the company sees great potential in the years ahead to extend its leadership. APD is a consistent dividend grower. Its current annual dividend of $6.48 provides a 2.7% yield on June 30.

Morgan Stanley is one of the world's leading investment banks and wealth management firms. As the company has grown its wealth management business its earnings have become more predictable and valuable. The management team is very shareholder-friendly, allocating funds not needed to grow the business to repurchase shares and raise their dividend. In late June, the company announced an 11% increase in its dividend and a $20 billion multi-year share repurchase program. The company's annual dividend of $3.10 per share provides a current dividend of 3.7% at the June 30 closing price.

Paramount is a leading entertainment company providing traditional TV, movies, and streaming services. We think the company is exceptionally well managed and very undervalued, either as a standalone company or as an acquisition for another company interested in expanding its media business. Even with heavy investment spending to grow its streaming business, the company is very profitable and pays a 96-cent annual dividend, a current yield of 3.9% on June 30. Shortly after we added the shares to the portfolio, Berkshire Hathaway announced it had acquired more than a 10% stake in the company.

Starbucks is a premiere global coffee brand supported by over 32,600 stores across the world. The firm has a long history of beverage innovation and strong employee/barista relations with the firm paying above-market wages and benefits. Starbucks has a strong balance sheet and finances. The company generates steady and consistent cash flow, selling millions of cups of premium coffee every day. The company's share price declined in part due to its large business in China which was largely shut down due to Covid restrictions and because of rising commodity and labor costs. We think the shares are attractively priced for a company that should grow 10% plus per year with a dividend yield of 2.6% at our average cost.

In Q2, 2022, five portfolio holdings raised their dividends by an average of 11.2%. For the first six months of 2022, 13 portfolio holdings have raised their dividends by an average of 7.7%. Looking forward, we expect further dividend increases in the portfolio in the second half of the year, and by year-end expect the vast majority of our holdings to increase their dividends for the year. These increases are all the more impressive in an environment where there are many questions about the strength and outlook for the economy.

On June 30, 2022, the portfolio had a 3.10% dividend yield, which compares very favorably with the 1.70% yield on the S&P 500, the 2.33% yield on the Russell 1000 Value, and the 3.02% yield on the 10-year Treasury.

At the end of Q2, 2022, the MDI portfolio's largest sector concentrations were in Financials, Health Care, and Technology. These large sector weightings provide a nice balance of economic sensitivity and stable earnings growth. Health Care has been a relatively good sector in a difficult market. We modestly cut back the sector weight in Q2, selling Merck at our target price and trimming the position size in AbbVie. Our other Health Care names have good upside potential. Our holdings in the Financial and Technology sectors are all very well-run companies with excellent prospects. It is hard to find high-quality Technology Investments that pay good dividends, but we think we have four standout names in the portfolio. We think Financials are very inexpensive and have excellent prospects in the current environment of higher interest rates, good loan growth, and solid credit quality. They also have very good and growing dividends.

On June 30th, the MDI portfolio's 2023 estimated P/E multiple was 13.6 times estimated earnings compared to the S&P 500's estimated P/E multiple of 15.0 times earnings.[11]

We believe the MDI strategy is ideal for conservative, income-oriented equity investors. The portfolio has provided more downside protection than the S&P 500 Index, defending well during periods of market turbulence, while still allowing for meaningful appreciation over time.[12] We also think the highly diversified, all-weather MDI portfolio is well-positioned to have good performance in the stronger economy and rising interest rate environment that we anticipate over the next few years.

Bonds

After a 40-year bull market in Bonds, 2022 has been a very painful year for fixed income investors. Interest rates rose across the yield curve in Q2 versus Q1 and are up sharply from year-end 2021. On the shorter end, the two-year treasury yield on June 30 was 2.96% versus 2.34% on March 31 and 0.73% on December 31, 2021. Similarly, the 10-year yield was 3.02% on June 30, versus 2.34% on March 31 and has doubled from 1.51% on December 31, 2021. The Bloomberg U.S. Aggregate bond index (U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities) was down 4.7% in the quarter, bringing its loss to 10.3% year-to-date through June 30. Losses were greater for longer maturities.

While our bond portfolios were lower for the quarter, they benefitted relatively from their focus on high-quality corporates, U.S. Treasuries, agencies, and municipals (where appropriate) with nearer-term maturities.

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[11] Source: Bloomberg.

[12] Since the inception of the MDI composite on January 1, 2011

With this conservative shorter-term positioning, our taxable bond and municipal portfolios performed in line to modestly better than their benchmarks for bonds with similar duration, and our declines were much more modest than the overall bond market.

With yields having risen so quickly, and signs that the economy's growth rate is moderating, we believe that current short-term high-quality bond prices largely reflect the anticipated Fed increases for the balance of the year. For the first time in years, we think there are good opportunities in short-term bonds. We continue to be wary of intermediate and longer-term bonds as we feel investors are getting the same income that short-term bonds are paying while taking on significantly greater principal and interest rate risk. We have used the rise in rates to be more active in buying bonds with 2-to-5-year maturities and selling some of the short-term ETFs that we were using as a short-term fixed income placeholder.

Balanced Accounts

This quarter was another highly unusual period when both stocks and bonds declined. More typically, bonds provide a cushion during periods when the stock market declines. We expect the long-term balance and diversification benefits between the two asset classes to return in upcoming periods.

With our expectation that the economic slowdown will be mild, that growth will continue in 2022, and that stock prices are at attractive valuations, we continue to believe that stocks are more attractive than bonds at current levels. Bonds play an important role in balanced accounts and as rates have moved higher, they now offer a reasonable income stream and should provide greater stability if stock volatility continues in upcoming periods.

Realized Capital Gains Outlook and Tax Mitigation for Taxable Accounts

We have been more active than usual locking in profits on relative strength in some names to upgrade the quality and future upside of the portfolios. These stocks have been strong performers in a difficult market. They did their job and were at or are close to our fair value/targeted upside. In a better market, we think they have much less upside than the new names we have been buying or the existing holdings we added to on price weakness.

While gains to date have been higher than usual, we do expect to be able to significantly reduce them through our tax mitigation activities in upcoming periods. We believe that many of the stock declines will be greatly reduced by year-end and started our tax trading early this year putting many trades in place in June and expect to reverse them in the next two months.

Some of the trading we did was to take losses now or be set up to take losses later while keeping the integrity of the portfolio intact.

For example, we doubled up on many names that were below cost and funded them with some that had modest losses or were in similar industries. We think these doubled-up names have great upside, but we wanted to be able to take the loss on higher-cost shares. So, if you see a lot of buying in a name and an outsized position in your portfolio, it is likely a tax double-up that we plan to bring back to normal size later.

So, between the combination of higher than usual purchase and sales and tax mitigation trades, portfolio activity was a lot higher than usual this quarter. After we reverse the tax trades, we expect it to return to more normal levels.

Finally, please note that effective this quarter, we have included a preliminary year-to-date capital gains report as part of the quarterly report. The report provides an approximate look at year-to-date through June 30 capital gains. You should continue to use your custodian/brokerage house 1099 form **only** in doing your year-end taxes.

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Thank you for your continued confidence in the Matrix team.

After a difficult first half of 2022, we are confident that the portfolios are well-positioned to fully participate in the better environment we expect as the year unfolds. If you have any questions about any parts of this commentary, our outlook, or your portfolio, please do not hesitate to call.

Stay well. Best regards.