Palouse Capital Management, Inc.
2Q22 Commentary
July 2022

2Q22 Recap

2Q22 was a quarter to forget. The S&P® 500 index ("SPX") returned -16% in the quarter and -20% in the year to date time frame. All eleven sectors were down in the quarter. The best sector was consumer staples, which was down about 5%. The worst sector was consumer discretionary, which was off 26.2%. Some of the key culprits in the consumer discretionary wipeout were Amazon.Com, Inc., NIKE, Inc., Starbucks Corporation and Target Corporation. For the second quarter in a row, the S&P® 500 Value index outperformed the S&P® 500 Growth index by a substantial margin. Small caps underperformed large caps in 2Q22.

2Q22 Top Down Analysis

Based on my regular news reviews, Covid-19 and the war in Ukraine have essentially dropped out of the investor worry universe – except for the fact that many people blame the war in Ukraine for the inflation problem and supply chain problem. Inflation has remained as a big threat to equity markets and that situation got worse during the quarter. June's CPI annual inflation rate came in at 9.1%, a very ugly number and the highest level of inflation since 1979. Overall annual food inflation was over 10%, with major contributors including chicken, cereals, baked goods and eggs. Eggs were up 33% year over year. Butter and margarine were also up sharply. Gasoline inflation was a major contributor to inflation once again, as anyone who drives a car would expect. Shelter was also a major component of inflation, as expected.

Energy prices have remained as a major factor in the current level of inflation, although there could be some relief in the near future. The price of crude oil rose about 30% between the beginning of the quarter and early June. Since then, however, crude has dropped by about 21% - and that ought to provide some inflation relief soon if that trend continues. Interestingly, the average retail price of gasoline has only declined slightly since early June. It will take awhile for dropping crude prices to cause a drop in gasoline prices, but logic might suggest that it will happen in the near future. Natural gas prices have also fallen dramatically since early June. Both the gasoline and natural gas price drops ought to provide some inflation relief in upcoming months.

Domestic crude production has barely moved since the end of March, although domestic drilling has improved slowly and steadily to almost pre-pandemic levels. It will take time to get all of those new wells online, but hopefully production will increase significantly by the end of the year – and that should really help the inflation situation.

As one would expect, interest rates rose again during 2Q22. The yield curve flattened materially, which is often a harbinger of recession. Mortgage rates increased significantly in 2Q22 and 1H22; the average mortgage rate peaked at about 6% at the end of the quarter, the highest level since the end of the housing crisis. Housing starts and building permits both dropped about 10% during 2Q22.

Not intentionally saving the worst for last, I think that the biggest thing on investors' minds right now is the risk of recession. You cannot turn around without hearing somebody talk about it. After the 1Q22 recessionary GDP report, all eyes will be on the 2Q22 advance GDP figures that will come out at the end of the month.

Market Model and Outlook

Our market upside model, which is based only on average sell side target prices, now suggests a 27.4% one year upside potential to the all cap market, a high number, especially considering that analyst downgrades continued at a good clip last week. I am calculating the market's forward P/E multiple at 15.5x, a low number relative to

Bryn Harman, CFA ✧ Palouse Capital Management, Inc. ✧ 509-220-4253 ✧ bharman@palousecap.com
2026 N. Washington Street, Spokane, WA 99205

recent experience. About 97% of the Top 1,000 are showing positive upside to targets, about average.

While inflation and recession risk (i.e. stagflation) are the most serious worries in the market right now, I think that this earnings season is going to be especially important since public company management teams are probably more dialed into their businesses than economists are. I think that earnings prospects, as always, will be the determining factor in investor action in the near future. Stocks generally look pretty cheap here, even if there is a recession, given how much stocks have dropped in the past six months. It is important to remember that the equity market usually leads the economy.

Weekly Report, Conference Call and Podcast

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All analysis in this report was provided by Bryn Harman, CFA, PCM's Chief Executive Officer and Chief Investment Officer. Mr. Harman can be reached directly at 509-220-4253 or bharman@palousecap.com.

If readers have any questions about anything mentioned in this report please feel free to contact us any time at 800-624-3833. Readers can also refer to our website, www.palousecap.com, for more information and can email PCM's Chief Investment Officer directly at bharman@palousecap.com with any questions. Readers should not assume that any investments in the securities mentioned in this program were or will be profitable or will continue to be held in the future. Pursuant to Rule 206(4)-1(a)(2)(A) we will provide a list of all trades made on behalf of clients in the past year upon request.

The data used to create our reports is provided by Bloomberg L.P., Standard & Poors, The U.S. Energy Information Administration, The U.S. Federal Reserve, The U.S. Department of the Treasury, The U.S. Department of Energy, Baker Hughes Company, The American Automobile Association, The U.S. Securities and Exchange Commission, The U.S. Bureau of Economic Analysis, The U.S. Bureau of Labor Statistics, The U.S. Bureau of Land Management, Bankrate.com and the U.S. Centers for Disease Control unless otherwise indicated.

The PCM market model examines the universe of the 1,000 largest actively traded equities trading in the United States (referred to as the "Top 1,000"). The "Price to Earnings Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total estimated net income (from sell side estimates) for the respective market capitalization range or sector. The "Price to Book Value Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total last reported shareholder's equity for the respective market capitalization range or sector. "Upside to Target" is calculated using float adjusted market capitalization weightings and the one year upside potential to the average sell side target price for each security.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"DI" means our Diversified Income Strategy.

"SPX" refers to the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P® High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX. The S&P SmallCap 600® index is a capitalization weighted index that measures the performance of 600 small capitalization stocks.

The Russell 3000® Index is a float-adjusted, market capitalization weighted index comprised of equities of the 3000 largest domestic companies. The Russell 2500® index is a subset of the Russell 3000 index comprised of the 2500 smallest cap equities in the Russell 3000 and represents the SMID segment of the domestic equity market. The Russell® 2000 Index is a subset of the Russell 3000 index comprised of the 2000 smallest cap equities in the Russell 3000 index and represents the small cap segment of the domestic equity market.

Bryn Harman, CFA ✧ Palouse Capital Management, Inc. ✧ 509-220-4253 ✧ bharman@palousecap.com
2026 N. Washington Street, Spokane, WA 99205