Market Commentary

Q2 – 2023

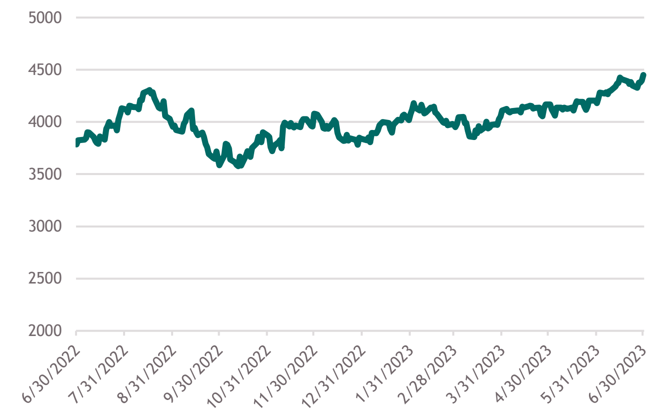
U.S. Equities Market

A (Very) Pregnant Pause

Equity markets turned in a very strong performance in the second quarter with the S&P 500® Index returning 8.7%. Artificial Intelligence (AI) mania gripped the market as Technology stocks, especially those of the largest companies, led the market with returns of over 17%, followed by equities in the Consumer Discretionary and Communication Services sectors at 14.5% and 13%, respectively. Defensive stocks, such as those in the Utility and Consumer Staples sectors, badly lagged the overall market. Since the beginning of the year, dividend paying stocks have underperformed their non-dividend paying counterparts by 14% and Utility stocks exhibited their worst semi-annual relative performance in 35 years. In the quarter, growth stocks outperformed value stocks by nearly 9% and large company stocks outperformed smaller company stocks by over 3%. Despite such positive headline market returns, the economically-sensitive Energy sector was weak, finishing the quarter in negative territory as market participants worried about the pace of global economic growth, particularly as the Chinese economy's re-opening post-COVID has been quite underwhelming. Also, despite a historically strong labor market, U.S. industrial production has declined for eight consecutive months, reaching its lowest point since the Great Financial Crisis. This discrepancy between market returns and the industrial economy has certainly caused confusion among some investors, especially with the headwind of the highest short-term interest rates in decades.

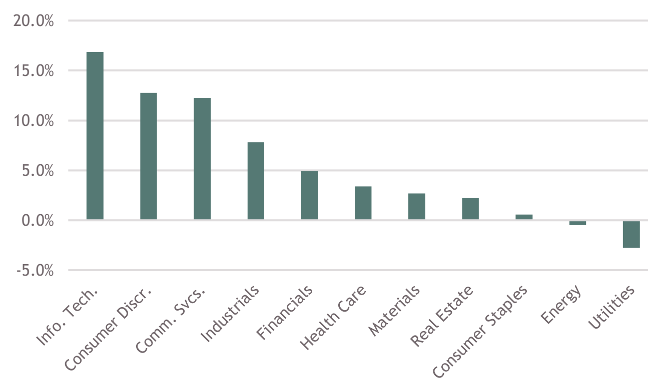
After raising the Fed Funds Rate from nearly zero to over 5% in the past fifteen months, the Federal Reserve (Fed) stood pat at its latest meeting in June but indicated it would resume raising short-term rates perhaps as early its next meeting in July. For a market that, until recently, had been predicting an end to the tightening cycle and possible rate cuts in late 2023, this news was indeed a hawkish surprise. Meeting notes indicated that the terminal rate (the rate at which benchmark Fed Funds will peak) increased from 5.1% to 5.6%. Logically, yield-oriented investments sold off, but unlike last year, growth stocks and other risk assets rallied. Such market behavior is difficult to reconcile, but perhaps in a slowing economy, investors are simply willing to pay more for growth. With labor and material costs continuing to rise – albeit at a slower pace – corporate margins are likely to be declining from historical highs, thus causing slower earnings growth in the future. The equity market has yet to reflect this, preferring to focus on positive consumer sentiment, a stable housing market and robust demand for labor. However, the bond market, as evidenced by the most inverted yield curve since the early 1980s, is predicting recession. Though hard to predict which will be proven correct, it is difficult for some to imagine an equity market that will finish 2023 stronger than how it began.

S&P 500® Index



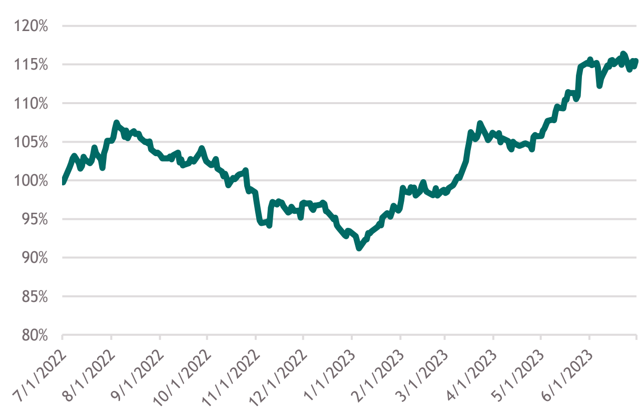
Source: Bloomberg

Q2 2023 Russell 3000® Index
Returns by Sector



Source: Bloomberg

Russell 1000® Growth/Russell 1000® Value



Source: Bloomberg

Market Commentary

Q2 — 2023

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U.S. Taxable Fixed Income Market

Focus on Inflation

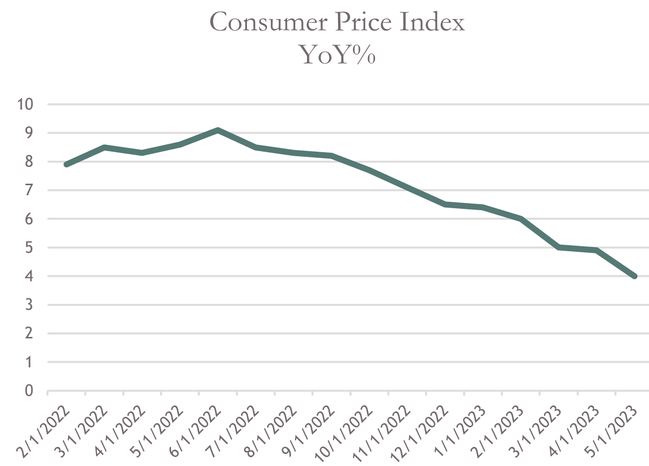
The Bloomberg Intermediate Government/Credit Index fell 0.8% in the second quarter of 2023. When considering the backdrop of bank failures and the threat of a technical default by the U.S. government, perhaps the negative returns from the quarter should be taken in context. Among the headwinds to returns in the quarter, were higher interest rates (the U.S. 10-Year Treasury rate increased to 3.84% from 3.47%) which are inversely related to bond prices.

As we sit halfway through 2023, forecasting models that try to predict recessions suggest the likelihood of a recession within the next 12 months remains above average. A major driver behind these models is the inverted yield curve, which is characterized by higher yields being offered for shorter-maturity bonds relative to longer-maturity bonds. This inversion, to some degree, is a product of uncertainty around the Federal Reserve's monetary policy. What actions will the Fed take with respect to the Fed Funds Rate? Will they raise 0.25%, raise 0.50%, or cut? Like the Fed, we believe the answer lies with the actual path of inflation.

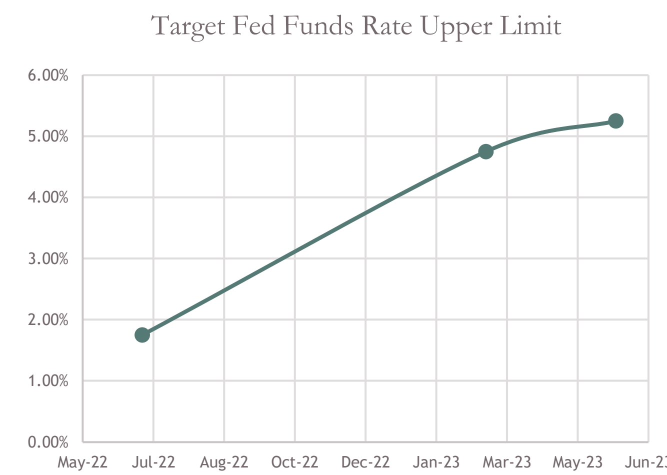
Headline inflation as measured by the Consumer Price Index (CPI) has fallen 5 percentage points from its peak and is down 2 percentage points since the end of February. This happened as the Fed Funds Rate only increased 0.5% since the end of February. Said differently, 40% of the decline in CPI from its peak has occurred since February, while only 10% of the rate hikes in this cycle have been implemented in that period. To us, this is an indication that monetary policy lags are still working their way through the economy.

There are many reasons to believe that inflation is likely to continue to trend lower in the coming months, even without further rate hikes from the Federal Reserve. Year-over-year money supply growth is falling, inflation expectations continue to decline, lending standards remain tight, and the labor market has made progress on rebalancing.

Should inflation continue its descent in the coming months and quarters, we would expect the Fed to reverse course and start to cut interest rates sometime within the next year to a level that is more consistent with lower economic growth and lower inflation.



Source: Bloomberg



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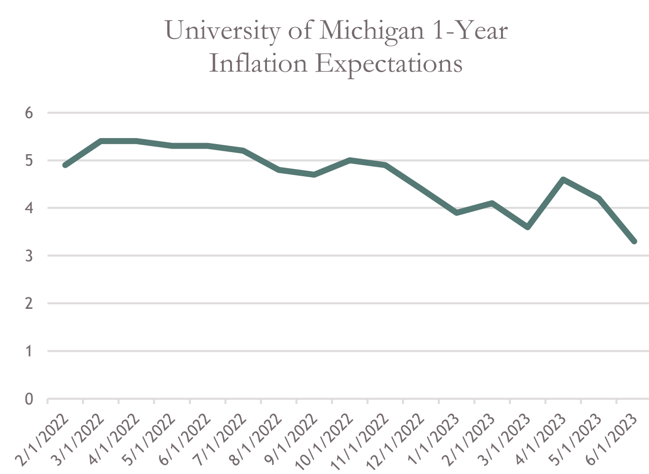


Source: Bloomberg

U.S. Municipal Fixed Income Market

In A World Of Their Own

Munis continue to defy expectations with record performance in June, outpacing U.S. Treasuries. However, June's strength still fell short of overcoming the weakness seen in April and May, resulting in a -0.5% return for the Bloomberg Municipal 1-10 Year Blend Index in the second quarter and a positive return of 1.5% for the first half of the year. The main tailwind supporting muni returns has been constrained supply and the lack of new deals. The established trend of reduced issuance versus historical averages continues unabated. We are trending at less than 80% of last year's year-to-date issuance. On the other hand, outflows from muni mutual funds have approximated about $54.9 billion over the last 12 months. While January 2023 saw a large inflow of $8 billion, much of that has been whittled down to a year-to-date amount of approximately $5.3 billion. If we break down muni returns along ratings groupings, lower-rated munis continued to outperform higher-rated munis. This can be mostly attributed to their higher yields, an over 60 basis point difference between AAA and A. Some single-notch upgrades and improved outlooks also contributed to their better performance, as did spread narrowing. Credit spreads declined 9 basis points since year end, on an aggregate basis, between the A and AAA indices.

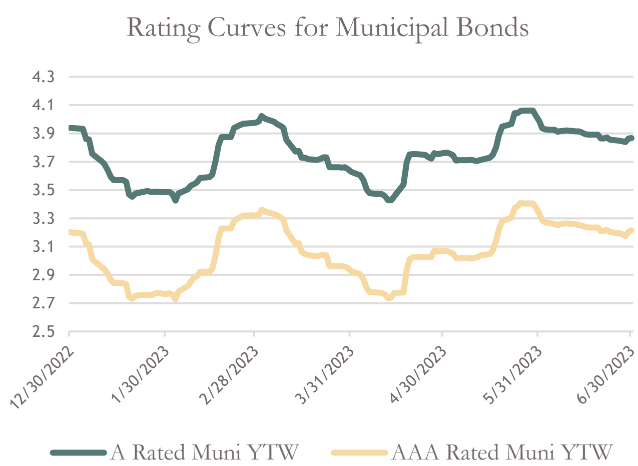
Projecting the path of future interest rates has been fraught with challenges this year. A majority of market participants were anticipating that the Federal Reserve would not move as quickly as they have. There is still a reluctance by market participants to believe that the Fed Funds Rate will go as high as the Federal Open Market Committee members have indicated in their dot plot projections and post-meeting commentary.

The dynamic between a higher Fed Funds Rate, higher Treasury yields, positive fund flows and the lack of new issuance has complicated our muni outlook. Demand spikes due to maturity dates on the 1st and 15th of the month have tended to be short-lived. We still see muni yields rising, if the pace of inflation declines slowly, halts, or reverses. However, we do believe that the absolute level of muni yields looks attractive for most investors. Over the long term, a 4% tax-free yield should provide a reasonable cushion against the Fed's long-term inflation goal of 2%. The issue of the de minimus tax rule will likely raise its head again for 4% coupon bonds as muni yields approach 4%. The de minimis tax rule typically applies in an environment of rising interest rates; during such periods, the price of bonds fall and they are offered at discounts or deep discounts to par. This could provide for some great buying opportunities, but one still needs to remain cautious and quite selective when investing along an inverted yield curve.

Municipal Fund Flows (in $ million)

	2023	2022
Jan	$8,033	($3,556)
Feb	$1,755	($10,487)
Mar	($2,515)	($14,669)
Apr	($733)	($24,448)
May	($1,953)	($20,171)
Jun	$713	($14,892)
YTD:	$5,300	($88,223)

Source: ICI



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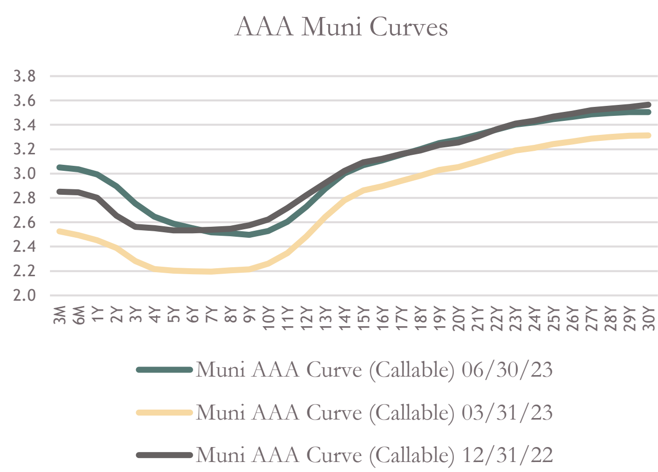


Source: Bloomberg

International Equities Market

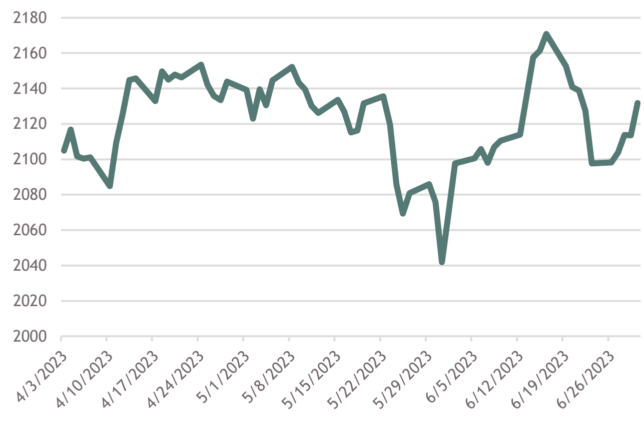
The Persistent Fight

International equities lagged domestic equity performance during the second quarter. Developed international markets, represented by the MSCI EAFE Index, returned 3.0% for the quarter, whereas emerging markets returned 0.9% as represented by the MSCI Emerging Markets Index. The dollar was a slight headwind to investment performance, appreciating modestly over the period.

The two issues international investors wrestled with this quarter were the sluggish rebound relative to expectations in China and the slow decline in inflation. When China's central bank unexpectedly trimmed two key lending rates, investors began to worry that its recovery was not going according to plan. China's property segment continues to struggle, and confidence is waning due to high debt levels and high youth unemployment. Some are drawing parallels to Japan, when weakened confidence after a real estate bubble burst in the 1990s and contributed to weak economic growth and deflation that lasted for decades. Investors should take comfort with the central bank's quick action, but it is disconcerting that they had to act so soon after COVID restrictions were lifted. It is important to note that China is still growing, but its economy's recent performance is causing some to question if it can grow at the expected 5% rate.

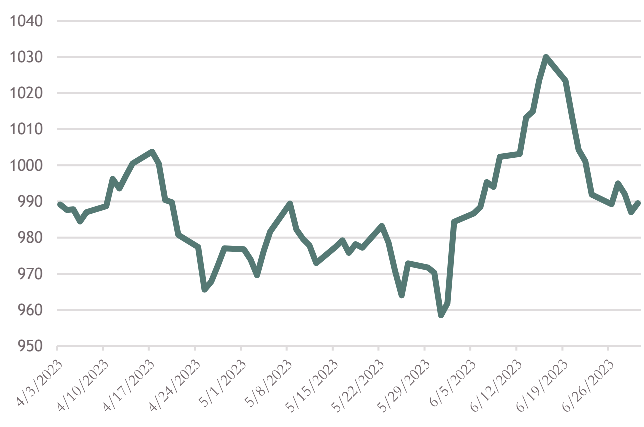
Regarding inflation, like the U.S., it remains stubbornly high globally despite the rapid increase in short-term interest rates. Inflation rates are decelerating but not as quickly as expected. Consequently, central banks are continuing to increase interest rates to ensure inflation expectations do not get out of control. So far, their actions have been successful in controlling those expectations, but that comes at a cost for investors. Higher rates dampen valuations, which could hinder investment performance. Fortunately, since central banks are raising rates around the globe, international investors are not at a relative disadvantage versus other markets – all else being equal.

MSCI EAFE Index



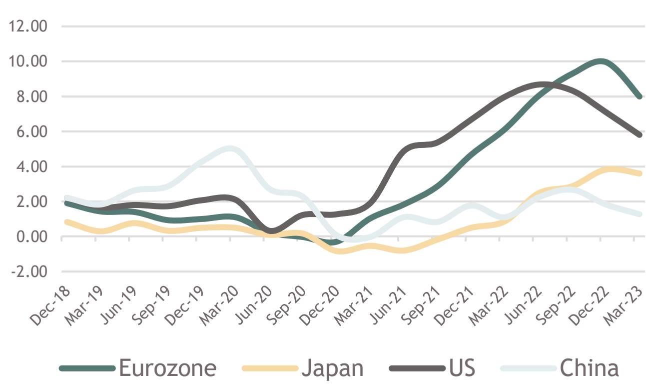
Source: Bloomberg

MSCI Emerging Markets Index



Source: Bloomberg

Global Consumer Price Indices
(YoY%)



Source: Bloomberg

Disclosures

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The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Bloomberg Intermediate Government/Credit Index measures the performance of U.S. Dollar-denominated U.S. Treasury bonds, government-related bonds (i.e., U.S. and non-U.S. agencies, sovereign, supranational and local authority debt) and investment-grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than 10 years.

The Consumer Price Index (CPI) represents changes in prices of goods and services purchased for consumption by households. This is a proxy for inflation.

The Federal Funds Rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

University of Michigan Inflation Expectations Index tracks 1-year inflation expectations for representative U.S. households (excluding Alaska and Hawaii).

The Bloomberg Municipal 1-10 Year Blend Index measures the performance of short and intermediate components of the Municipal Bond Index – an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market.

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The BVAL Muni AAA curve is the baseline curve for BVAL tax-exempt munis. It is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P. The yield curve is built using non-parametric fit of market data obtained from the Municipal Securities Rulemaking Board, new issues calendars and other proprietary contributed prices.

The BVAL Muni A curve is populated with U.S. municipal bonds with an average rating of A from Moody's and S&P.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.