July 2023

2023 Mid-Year Capital Markets Forecast

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Executive Summary

Creating forecasts in a world that regularly surprises remains humbling. March of 2020 brought COVID, while February of 2022 had Russia unexpectedly invading Ukraine. And March 2023 saw unanticipated—though perfectly logical—stressors on regional and local banks in the US. In our Mid-Year Capital Markets Update, we revisit persistent though declining inflation, the aggressive monetary policy taking on those rising prices, and the surprisingly resilient economic growth in the US and around the world. While we are not making across the board allocation changes or recommendations, the Syntrinsic Investment Committee has made a few modest changes in near-term sentiment.

- We are upgrading our near-term sentiment for Core bonds to Neutral/Positive from Neutral based on improved yields and likelihood that interest rates are closer to peak than they were at the beginning of 2023 across most of the yield curve.
- We are upgrading our near-term sentiment for Real Assets to Neutral from Neutral/Negative given that real estate prices have materially adjusted to better reflect adverse conditions and that some opportunities in infrastructure may be emerging over the next few years.

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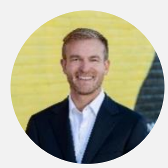

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Across the other asset classes and market segments, our team maintains the same sentiment as we reported in January's 2023 Capital Markets Forecast. While the failure of a small number of regional banks in the first half of 2023 was meaningful in a highly localized way, it does not appear to represent a harbinger of financial dislocations to come. Our team explored the topic in some depth back in April, in Banks: Moving Forward, and while stock prices of many publicly traded regional banks are (rightly or wrongly) 30-40% off their previous highs, we do not anticipate this situation evolving into a widening banking or financing crisis.

Outside the US, we see continued geopolitical uncertainty due to Russia's invasion of Ukraine and tensions caused by actual and potential changes in China's policies toward domestic economic activity and its relationships with Taiwan and other neighbors. But these geopolitical issues are well established and much of that risk likely priced into public markets. In short, while the human dimensions of these and other geopolitical issues are significant, we do not feel it appropriate currently to further modify our investment sentiment in response.

In the pages ahead, Syntrinsic's research team has produced three related pieces to contextualize the issues we see materially impacting markets in the coming months.

Senior Analyst, Matt Kukla, in **“Despite its Downward Trend, Inflation Remains Sticky”** reminds us that the fight against inflation in the US has made significant process since its peak in June 2022. Still, 4-5% global inflation hurts, especially more price sensitive businesses and low-to moderate income people who spend a larger percentage of their income on necessities. Globally, and particularly in Europe and the United Kingdom, there is more inflation-fighting work to be done, with Brexit and energy dependence making for a more difficult path.

In response to these persistent inflationary pressures, in his piece, **“US Monetary Policy Progress: Tightening Clashes with a Resilient US Economy,”** Senior Analyst, Robin Meyer, CFA, revisits the significant efforts of the US Federal Reserve to brake (without breaking) the US economy. Robin also considers how Fed policy has dramatically and rapidly changed the relative value of domestic fixed income markets from both a risk management and return perspective.

These pieces flow naturally into the piece by Senior Analyst, Jared Hobson, CFA, **“Economic Growth Set to Moderate after Stronger Start to 2023,”** which focuses on the factors that drive economic growth rather than getting lost in the less helpful debate about whether there will be a recession. He also looks under the hood of the US equity market to better understand its recent dependence for return on a very small number of the very largest companies. Given an equity market that has risen significantly from mid-October 2022 lows, this measured perspective provides an important reality check.

As we move into the second half of 2023, we expect that rhetoric and recriminations in the public square will only intensify due to an increasingly hostile domestic and international political climate. In the face of anticipated hyperbole and disagreements about the veracity of even basic information, we continue our long-standing practice of gathering data objectively from numerous sources, considering a wide range of perspectives and analytic frameworks, and positioning portfolios for long-term success despite near-term uncertainties.

We appreciate your confidence, welcome your questions, and look forward to our next conversation.

Sincerely,

Ben Valore-Caplan
Co-President
Syntrinsic

Near-Term Sentiment Overview

Asset Class/Segment	3Q 2023 Near-Term Sentiment	1Q 2023 Near-Term Sentiment
Global Equities	**Neutral/Positive**	**Neutral/Positive**
US	Neutral/Positive	Neutral/Positive
Non-US Developed	Neutral	Neutral
Emerging Markets	Neutral	Neutral
Global Fixed Income	**Neutral/Positive**	**Neutral/Positive**
Short-Term Bond	**Positive**	**Positive**
Core Bond	Neutral/Positive	Neutral
Core Plus Bond	Neutral/Positive	Neutral/Positive
Non-US Developed Bond	Neutral/Negative	Neutral/Negative
Emerging Markets Bond	Neutral	Neutral
Real Assets	**Neutral**	**Neutral/Negative**
Real Estate	Neutral	Neutral
Commodities	Neutral/Negative	Neutral/Negative
Hedge Fund Strategies	**Neutral**	**Neutral/Negative**
Private Equity	**Neutral/Positive**	**Neutral/Positive**
Private Debt	**Neutral/Positive**	**Neutral/Positive**

Global Macroeconomic Themes

Theme	Syntrinsic Perspective	Allocation Effects
Persistent But Falling Inflation	We anticipate US inflation continuing its gradual move toward a "normal range of 2-3% over the next 18 months. Inflation likely will be stickier for longer in Europe and the United Kingdom.	• Maintain focus on US equities with a style-neutral bias towards quality and income generation. • Remain fully invested to avoid real return losses. • Same as 1Q 2023.
Tightening US Monetary Policy	We expect the US Federal Reserve to raise the target interest rate until wage and employment data confirms that inflation is under control.	• Maintain lower duration exposure to capture yield on front end of curve. • Maintain allocation to floating rate debt in both public and private markets, though with even more intensive risk management. • Same as 1Q 2023.
Moderately Positive Economic Growth	While US consumers have kept the economy humming, the last of the excess cash from COVID-related stimulus will be drawn down this year, adding another headwind on economic activity, though not necessarily leading to recession.	• Maintain focus on US equities with a style-neutral bias towards quality and income generation. • Maintain overweight US equities vs. non-US equities. • Maintain senior secured private debt investments. • Same as 1Q 2023.

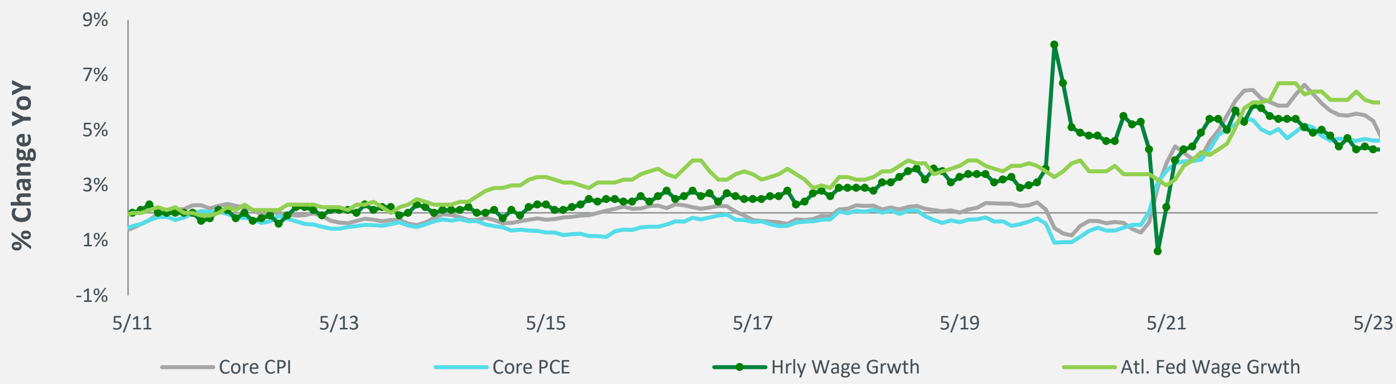
Theme: Despite its Downward Trend, Inflation Remains Sticky

Author: Matthew A. Kukla, Syntrinsic Senior Analyst

The key macro-economic factors impacting financial markets continue to be the interplay between inflation, US Federal Reserve (Fed) Policy, and economic growth. Put simply, if inflation remains above the Fed's 2% target, then the probability of a rate hike increases, which translates into expectations of slower economic growth and an increased prospect of a "hard landing," or recession. The converse is also true. Should the Fed's rate hike cycle cause inflation to trend closer to or reach its 2% target, then this increases the likelihood that the Fed could pause rate hikes, likely encouraging continued moderate economic growth and a possible "soft landing," or no recession. Either way, until there is a clear indication that the Fed has reached its 2% inflation target, we believe uncertainty likely will lead to continued volatility in the financial markets.

US inflation as measured by the Consumer Price Index (CPI) continues to trend downwards to 3.0% year-over-year (YoY) in June 2023 from its 9.1% peak in June 2022.[1] Still, inflation remains elevated, driven primarily by rising housing, used vehicle, and food prices, as well as wages.

Consumer Price Index



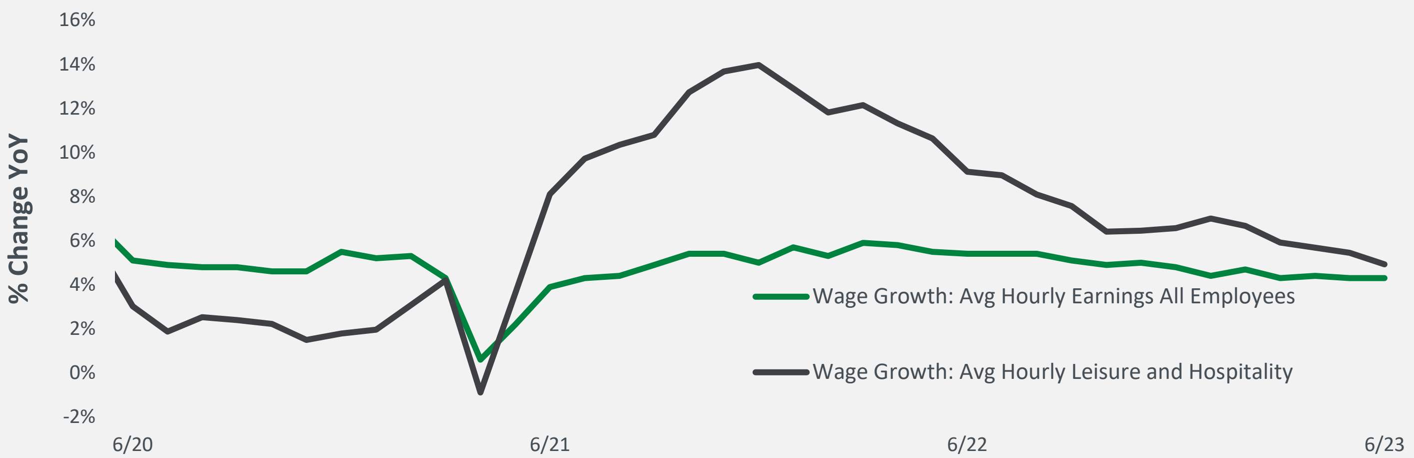
Source: Bloomberg

Rather than look solely at headline CPI data, it is important to peel back the layers to understand what has driven inflation to date and why it remains sticky or hard to combat.

To offset the decline in demand from COVID-19 in 2020 and 2021, the US government simultaneously enacted monetary and fiscal stimulus that stimulated inflation as consumers shifted their purchases from services to goods during the lockdown. Russia's invasion of Ukraine in early 2022 exacerbated the already intense supply-chain and supply-side shocks that drove energy, food, other commodities, and goods inflation higher.

As the pandemic became normalized and lockdowns were lifted, consumers shifted their purchasing power back to services. Since services are much more labor-intensive and given an unusually tight labor market, wages have continued to increase.

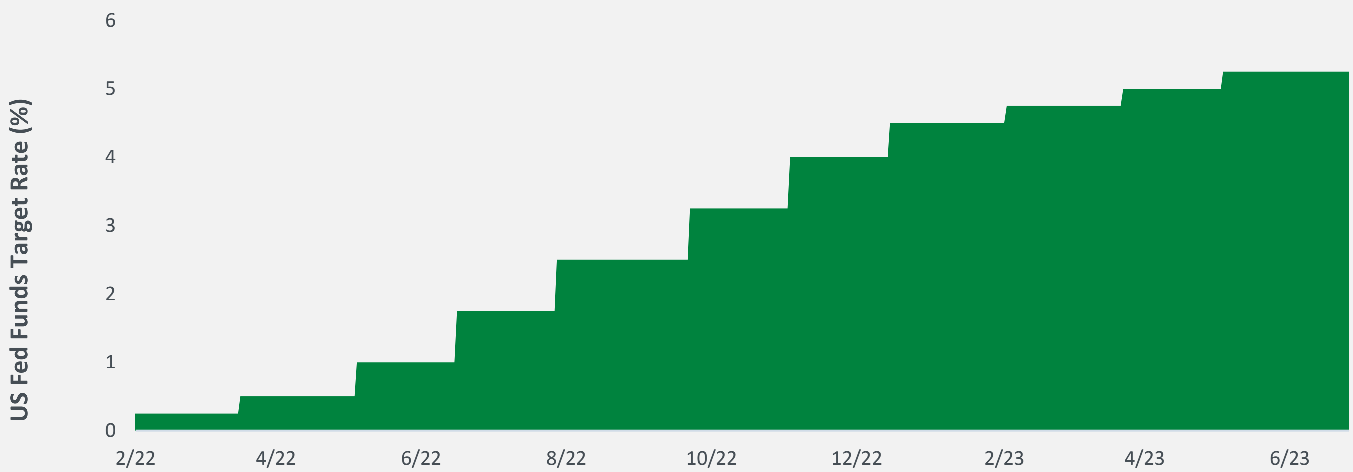
US Wage Growth



Source: Bloomberg

The combination of continued wage gains and the drawdown in household savings that had ballooned due to fiscal stimulus has allowed inflation to remain sticky and above the Fed's 2% target, despite 10 consecutive increases in interest rates and subsequent lag time to ripple through the economy.

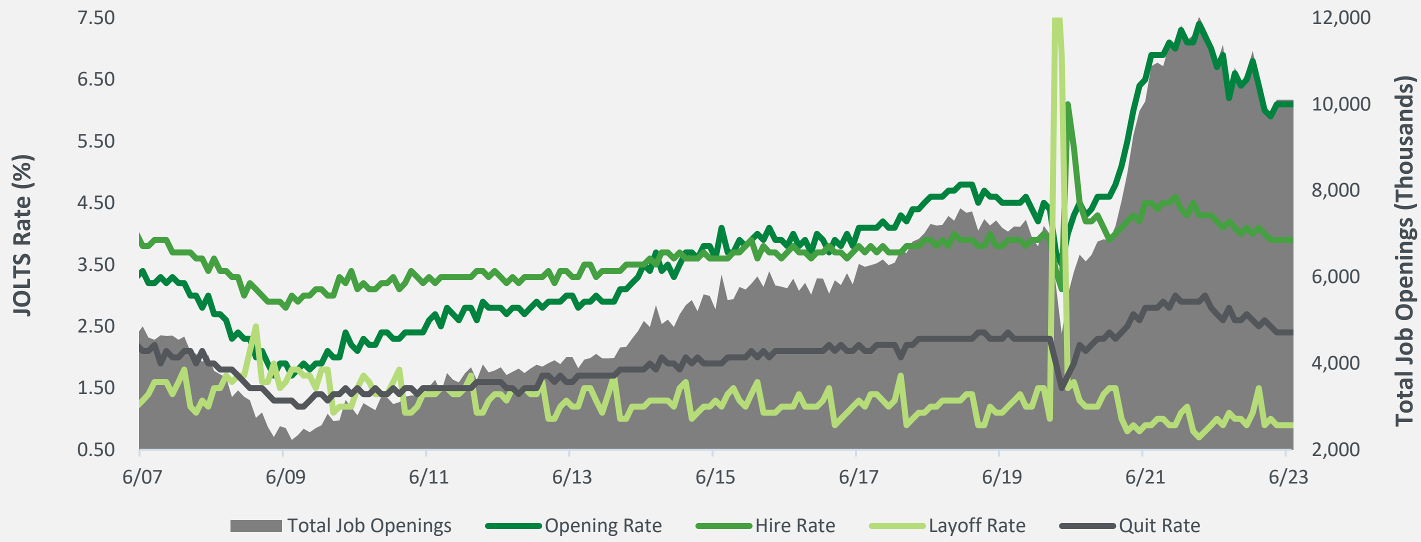
US Federal Reserve Target Rate



Source: Federal Reserve Bank of St. Louis, FRED

While the primary objective of the Fed is to maintain price, employment, and financial stability, its core focus at this juncture has shifted to reducing employment, and rightly so, as wages are underpinning continued inflationary pressures. However, peeling back the onion further reveals that if the supply and demand mismatch in the labor market persists, so will inflation, despite the Fed's efforts. Yet, there are signs that the Fed's decisions have had an impact on the labor market at the margin as job openings have declined to about 10.1 million in April 2023 from a peak of 12.0 million in March 2022, even though the unemployment rate remains at a near 53-year low of 3.6% year-over-year in June 2023.[2,3]

Job Openings and Labor Turnover Survey (JOLTS) Rate

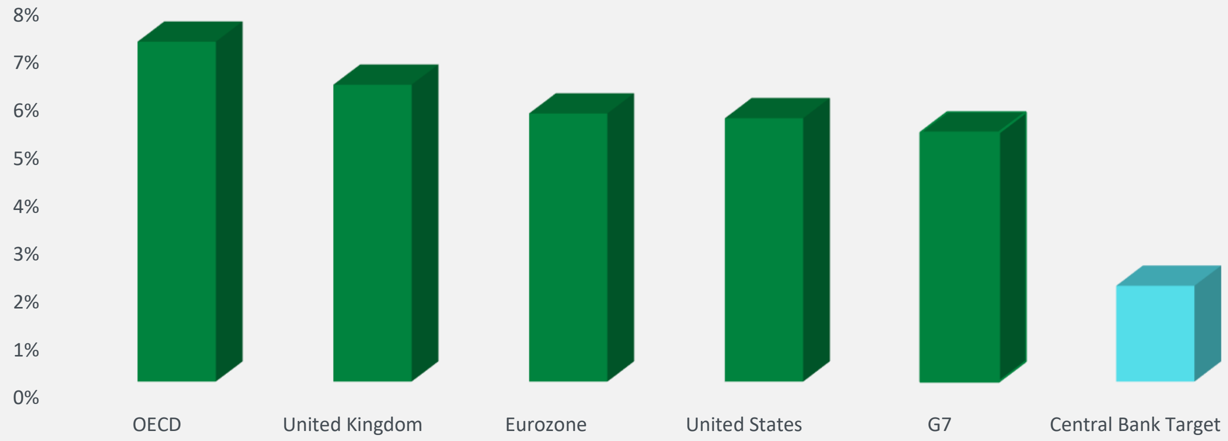


Source: Bloomberg

Despite politicization of inflation in the US, it has, in fact, been a global phenomenon that was driven by the same initial supply-chain and supply-side shocks with varying degrees of stickiness across global economies caused by the COVID-19 pandemic based on fiscal and monetary stimulus measures enacted by those respective governments and their subsequent monetary policy responses. Russia's invasion of Ukraine has exacerbated the situation, particularly in Europe which is more economically linked to both Russia and Ukraine.

The most recent comparable core inflation data (excluding food and energy) as of April 2023 indicates that inflation in the OECD, UK, Eurozone, US, and G7 was 7.1%, 6.2%, 5.6%, 5.5%, and 5.2%, respectively, and above Central Banks' 2% target.[4]

Global Core Inflation as of April 30, 2023



Source: OECD

As a result of this global inflationary pressure, Central Banks have been increasing rates at various speeds, levels, and durations across the globe to combat inflation by increasing the cost of capital and, in turn, reducing demand. The greatest risk in this scenario is that policy missteps among Central Banks could lead to a global recession. Still, such a risk is not the base case as the International Monetary Fund (IMF) still projects global growth of 2.8% in 2023.

While there was great fanfare that global growth would increase due to China lifting its Zero-Covid policies, demand in China has remained lackluster stemming from slower global growth and idiosyncratic risks in China including high debt levels, a property slump, high youth unemployment, and reluctance to spend amongst both households and businesses. While most Central Banks are increasing target interest rates, the Bank of China is doing the opposite to spur demand and combat deflationary pressures. Some would argue that the larger political environment in China is not conducive to stimulating business investment and associated economic activity.

The resiliency of emerging market economies in the face of higher inflation and interest rate tightening among advanced economies has been particularly surprising. In the past, monetary tightening among advanced economies would typically lead to financial stress or even crisis in emerging markets as higher credit and currency risks in emerging markets would cause capital flight among foreign investors. However, emerging market reforms over the past couple of decades have lowered credit and currency risks. Many emerging markets' Central Banks benefit from greater independence than in the past from the whims of executive leadership. In addition, many emerging market economies now experience greater exchange rate flexibility, improved policy transparency, well-capitalized banks, and improved macroprudential frameworks that provide countercyclical measures against advanced economies tightening cycles.

Overall, we believe investors will continue to adjust their interlinked expectations for inflation, Fed policy, and a "hard" or "soft" landing. We believe that financial markets will remain volatile until there is a clear indication as to what direction the economy is headed. That said, should the economy head for a "soft" landing, then there will likely be a greater appetite for "risk on" assets such as equities or real assets, whereas a "hard" landing scenario would cause investors to have a more defensive posture and seek safe haven assets such as cash and fixed income. Currently, as evidenced by narrowing junk-bond spreads, strong performance in the equity markets and decline in the Chicago Board Options Exchange (CBOE) Volatility Index year-to-date (YTD), it appears that many investors expect inflation to trend down towards the Fed's 2% target, for interest rates to decline slowly over the next two – three years, and for the economy to achieve a "soft" landing with a "risk on" sentiment.

Theme: US Monetary Policy Progress: Tightening Clashes with a Resilient US Economy

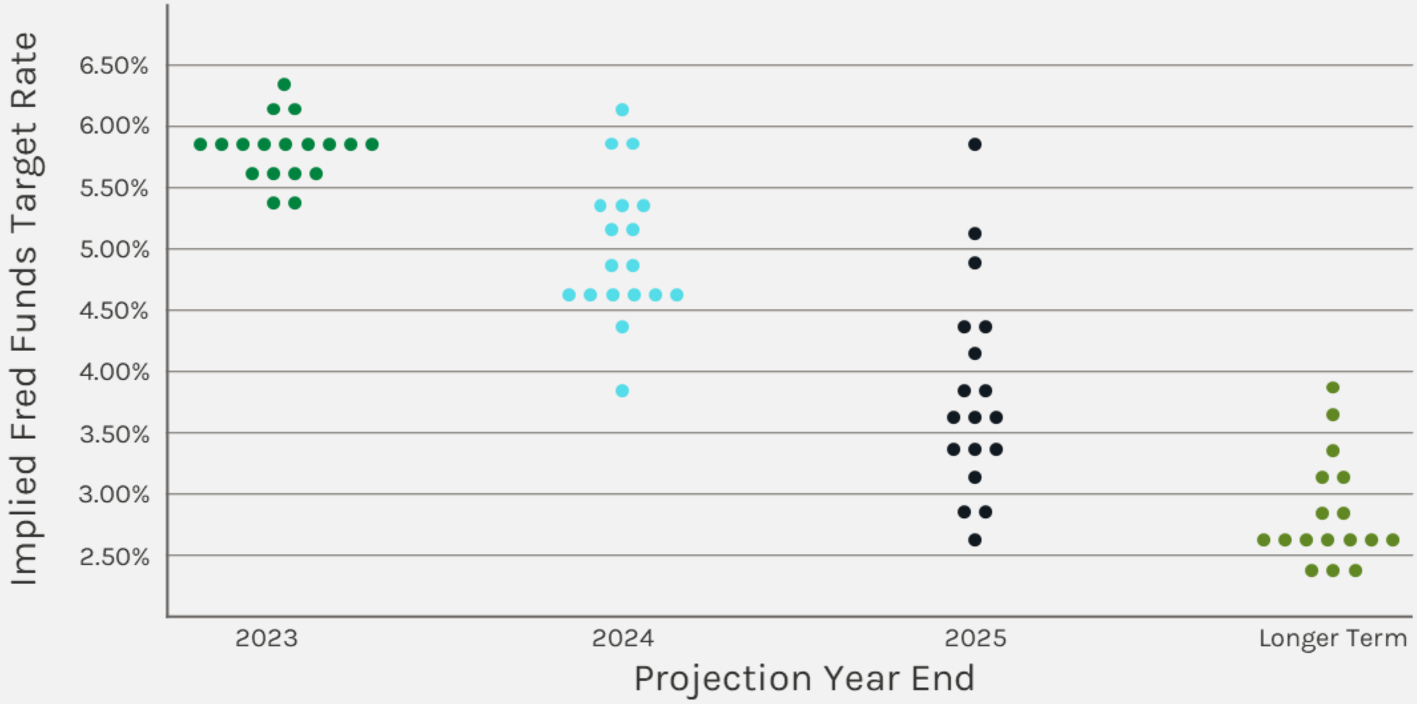
Author: Robin Meyer, CFA, Syntrinsic Senior Analyst

The second half of 2023 is underway with a US Federal Reserve (The Fed) situated precariously at a lull in its monetary tightening cycle, leaving policy interest rates unchanged at its June 2023 meeting following interest rate hikes during each of the last 10 consecutive Fed policy meetings. The swift path from a Federal Funds Rate of 0.0% in March of 2022 to 5.25% as of June 14, 2023, has been surprisingly well-absorbed by many measures of economic and market health (e.g., Gross Domestic Product (GDP), unemployment, financial market performance, etc.). Even the substantial decrease in mortgage affordability has had only a muted impact on housing prices and home sales volume.

During its most recent meeting, the Fed continued to convey hawkishness and an intention to conquer inflation through additional rate hikes, if necessary. The Fed's June Summary of Economy Projections (SEP) shows an upward revision among voting members for the median Fed Funds Rate at the end of this year to be 5.6%[1], an additional 0.35% higher than the current level.

Markets seem finally to be listening to the Fed's message over recent weeks and have all but priced out any likelihood of interest rate cuts in 2023.

New Federal Reserve Dot Plot as of June 2023



Source: US Federal Reserve, Syntrinsic

Elsewhere within the Fed's June SEP, 2023 GDP projections were revised upward by Fed members while the year-end projected US unemployment rate was revised downward, clashing with ongoing whispers of a looming economic slowdown. We take Federal Reserve Chair, Jerome Powell, at his word regarding being data-dependent when thinking about forthcoming policy decisions over the four remaining Fed meetings in 2023.

The tug-of-war between tightening monetary policy and the health of both consumers and corporations endures. There are residuals of COVID-19 fiscal stimulus and supply side constraints that continue to factor into ongoing consumer behavior and sustained upward price pressures. Higher consumer prices spanning goods and services thus far have been tolerated, thereby fueling the top line of corporate earnings. Meanwhile, corporations with astute CFO suites or structurally long liabilities continue to benefit from a low cost of capital built up prior to 2022's interest rate hiking cycle. Conversely, corporations with floating interest rate liabilities or near-term maturity/refinancing needs are starting to struggle with the prospects of new financing at elevated levels.

These dynamics reflect the slow progress by which monetary policy changes impact the real-time economy, as originally studied by economists Milton Friedman and Anna J. Schwartz over 70 years ago. Friedman's often-quoted reference to the "long and variable lags"[2] in this relationship seems particularly relevant as we enter the sixteenth month of monetary tightening. While pockets of weakness among consumers and corporations have started to emerge, a resilient US economy trudges along.

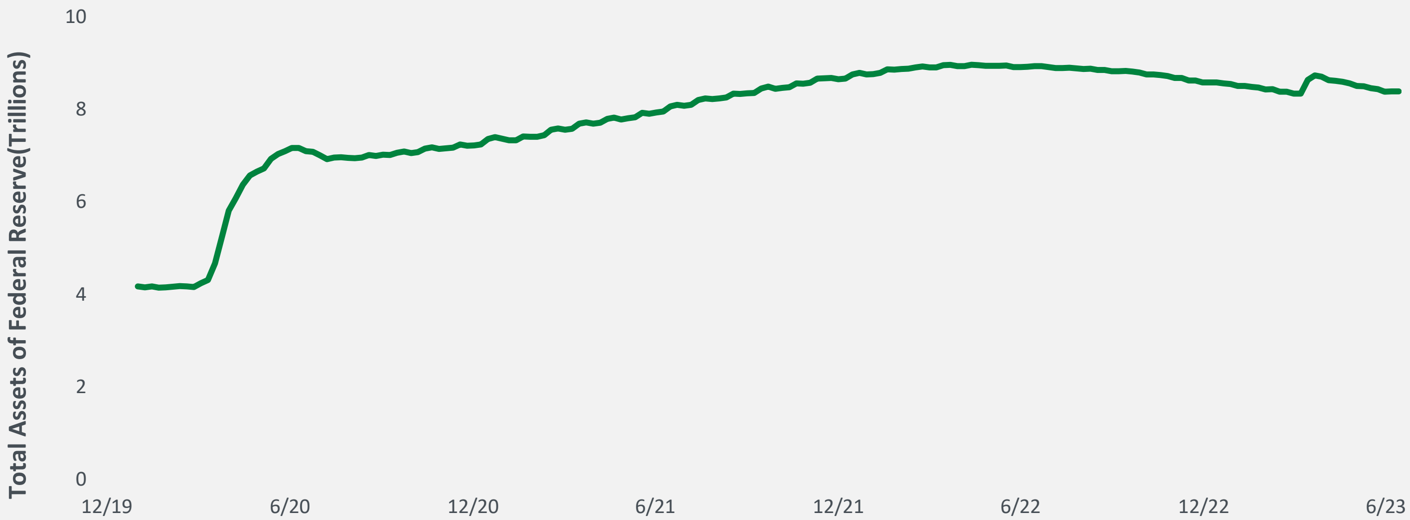
Fed Balance Sheet

The Fed's balance sheet ballooned in March-June of 2020 as the emerging COVID-19 pandemic shifted the Fed's focus to its role in ensuring the stability of financial markets. Federal Reserve purchases of US government debt (actions popularly known as quantitative easing) quickly saw the Fed's balance sheet eclipse $7 trillion by mid-2020 and peak at just under $9 trillion by early 2022.[3] The goal of the Fed's quantitative easing was to complement Fed Funds Rate cuts in implementing a policy of accommodation during times of crisis. In the long run, however, the Fed, "intends to hold no more securities than necessary to implement monetary policy efficiently and effectively."[4]

As the Fed shifted policy from accommodation to the tightening of financial conditions in the spring of 2022, Fed Funds Rate hikes were the primary focus of market participants. At that same time, the Fed also announced intentions to begin "Balance Sheet Normalization" a process through which the Fed would begin reducing its holdings of US government debt. This process commenced on June 1, 2022.

The progress of balance sheet normalization was interrupted in March of 2023 during the US banking turmoil as the Fed yet again stepped in to manage a crisis, this time to backstop bank assets. This led to a brief uptick in the Fed's balance sheet as can be seen in the accompanying graph.

Federal Reserve Balance Sheet Assets



Source: Federal Reserve Bank of St. Louis, FRED

Outside of March's activities, the well-telegraphed, consistent pace of allowing maturing Treasury securities and Agency Mortgage-Backed Securities (MBS) to expire has continued without garnering much interest from market headlines. The current pace counts $60 billion of US Treasuries and $35 billion of US Agency MBS securities removed from the Fed's balance sheet every month, equating to a balance sheet reduction in excess of $1 trillion over the course of a calendar year. While attention to the Fed's balance sheet remains of seemingly secondary importance to interest rates, we perceive ongoing reductions in the Fed's balance sheet as incrementally positive for the overall health of the US financial system and the US dollar. Absent any unforeseen stress under the Fed's scope, we expect this program of passive reduction to continue.

Bond Market Sentiment

Broad sentiment toward bonds has improved across market participants. Ongoing, higher US Treasury rates with opportunities for even higher yields among credit investments has drawn interest from investors as indicated in the following table:

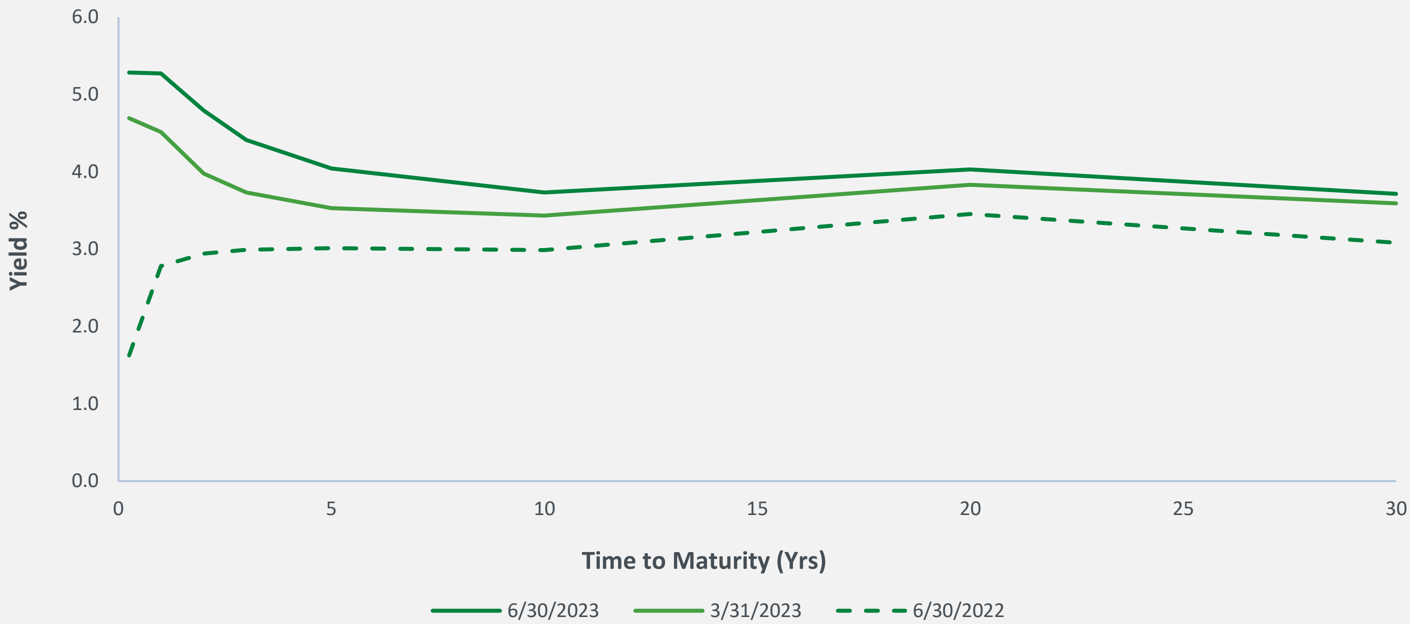
Net Mutual Fund Asset Flows YTD as of May 31, 2023

Asset Class	Est. Net Flow ($Mil)*
US Equity	(95,266)
Sector Equity	(13,972)
International Equity	(28,138)
Asset Allocation Funds	(32,719)
Taxable Bond	32,266
Municipal Bond	2,776
Alternative Investments	(7,656)
Commodities	(1,177)
Nontraditional Equity	1,199
Miscellaneous	(134)

Source: Morningstar, All US Open-End Mutual Funds (excl. Money Market)

We remain positive on the broad opportunity set within fixed income exposures. We are further increasing Syntrinsic's sentiment of Core bonds from Neutral to Neutral/Positive reflecting the ever-increasing attractiveness of US government guaranteed debt at elevated yields. Our Core Plus sentiment remains Neutral/Positive, reflecting the balance of higher yields to be earned through a higher risk profile. Core bonds are comprised of exclusively investment-grade quality debt, while the Core Plus bond segment expands composition to include exposure to below investment-grade quality debt opportunities across global markets. We continue to prefer active management in these exposures as credit underwriting/selection skills become of increasing importance. We also remain positive on Short Term Bonds overall, particularly with what we think will be a sustained US yield curve inversion. Market rates on short-term debt exceeding those of identical intermediate or long-term debt is a rare offer from markets. We continue to be positive on the role of Short Term Bonds within most portfolios.

US Treasury Yield Curve



Source: Bloomberg

Interest rate risk remains of critical importance to the fixed income asset class, particularly if there are further upward revisions to the expected Fed Funds terminal rate. However, we believe interest rate risk is well-contained relative to the unprecedented behavior in 2022. The overall risk-adjusted prospects for the public fixed income asset class remain favorable and we retain a positive view of fixed income's role within a diversified portfolio.

Our expectation is for ongoing, above-average bond market volatility for the remainder of the year as the forward path of Fed rate decisions remains unclear. Some upward pressure on credit spreads is a possibility amid further credit tightening, but higher coupons earned are helping drive positive total returns across debt exposures.

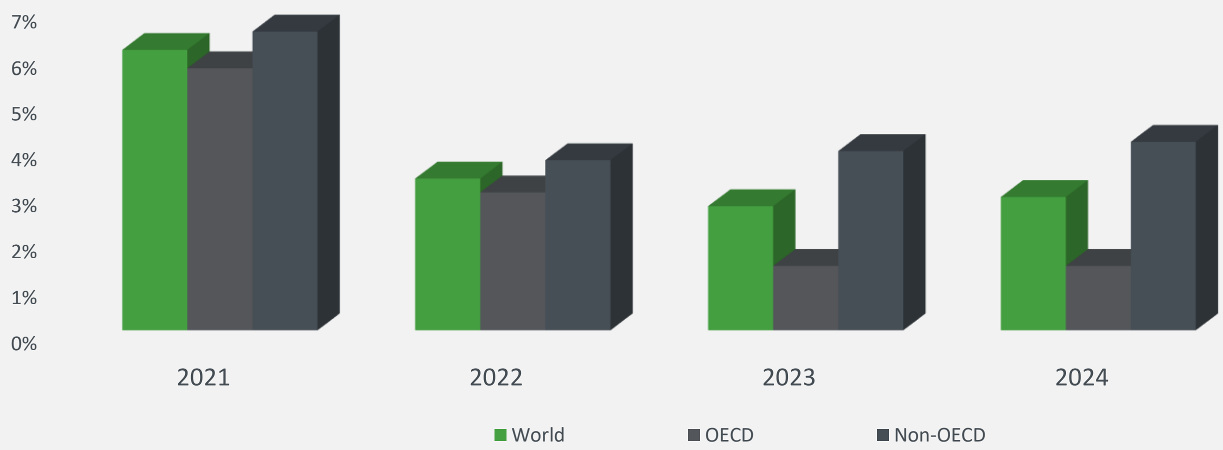
Theme: Economic Growth Set to Moderate after Stronger Start to 2023

Author: Jared Hobson, CFA, Syntrinsic Senior Analyst

The global economy has proven resilient in the face of significant headwinds over the last 18 months, from commodity price shocks due to the Russian invasion of Ukraine to surging inflation that has led to the most rapid interest rate increase since the early 1980s. Exiting 1H 2023, the US economy is likely growing in the low-single digit range, with European growth flat to just slightly positive. The May 2023 S&P Global Purchasing Managers Index (PMI), a survey of over 27,000 companies and 40 economies, registered its highest level since November 2021 at 54.4. This implies global real Gross Domestic Product (GDP) growth of 4% based on historical correlations.[5] However, as rate hikes impact economies with a lag, it is likely that global economic growth will continue to moderate as we move through 2023, with some developed markets possibly entering a mild recession. The June S&P Global Flash PMI, an early look at current economic trends, indicated a modest slowdown from May levels.[6]

Despite these concerns, there is reason for optimism as we look out beyond the next 12 months. Commodity prices are stabilizing, supply chains are back to normal, disinflation is now a global theme, and most central banks are at or near the end of their respective rate hike cycles. The June 2023 Organisation for Economic Co-operation and Development (OECD) Economic Outlook projects 2.7% real global GDP growth in 2023, slightly accelerating to 2.9% in 2024, an improvement from its November 2022 forecast of 2.2% and 2.7%, respectively. The developed markets making up the OECD are projected to grow 1.4% in both 2023 and 2024, with the non-OECD countries expected to grow by 3.9% and 4.1%, respectively.

Global Real GDP Growth

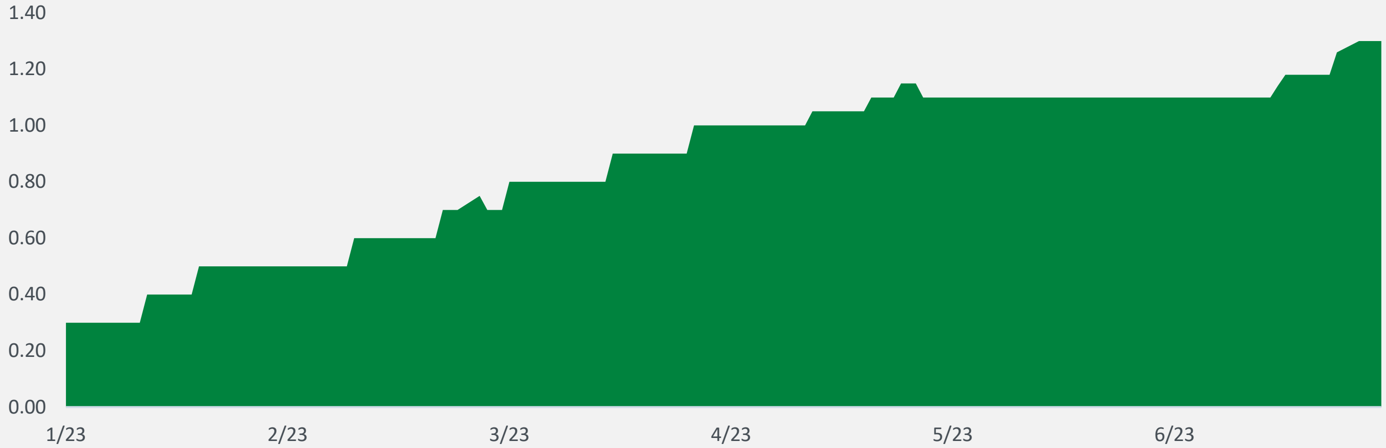


Source: June 2023 OECD Economic Outlook (2021 and 2022 Actuals; 2023 and 2024 projections)

US Economic Growth

Halfway through 2023, the US economy is growing at a faster pace than many anticipated entering the year. Bloomberg's most recent survey of economic forecasters estimates full year 2023 real GDP growth of 1.3% compared to a forecast of just 0.3% entering the year, with 2Q GDP growth forecasted at +1.2% versus +0.5% in its prior survey. The Federal Reserve Bank of Atlanta publishes a GDPNow[7] model on its website that uses broad economic reports to provide a 'best guess' for current economic growth. The measure is constructed by aggregating forecasts of 13 subcomponents that comprise GDP, including consumer spending, residential investment, net exports, nonresidential fixed investment, change in private inventories, and government spending. As of June 30, the Atlanta Fed estimated 2Q real GDP growth is tracking at +2.2%. If accurate, this would be slightly above the +2.0% 1Q growth rate that had been revised in late June from the government's previous estimate of +1.3%.

2023 US GDP Forecast Trend



Source: Bloomberg

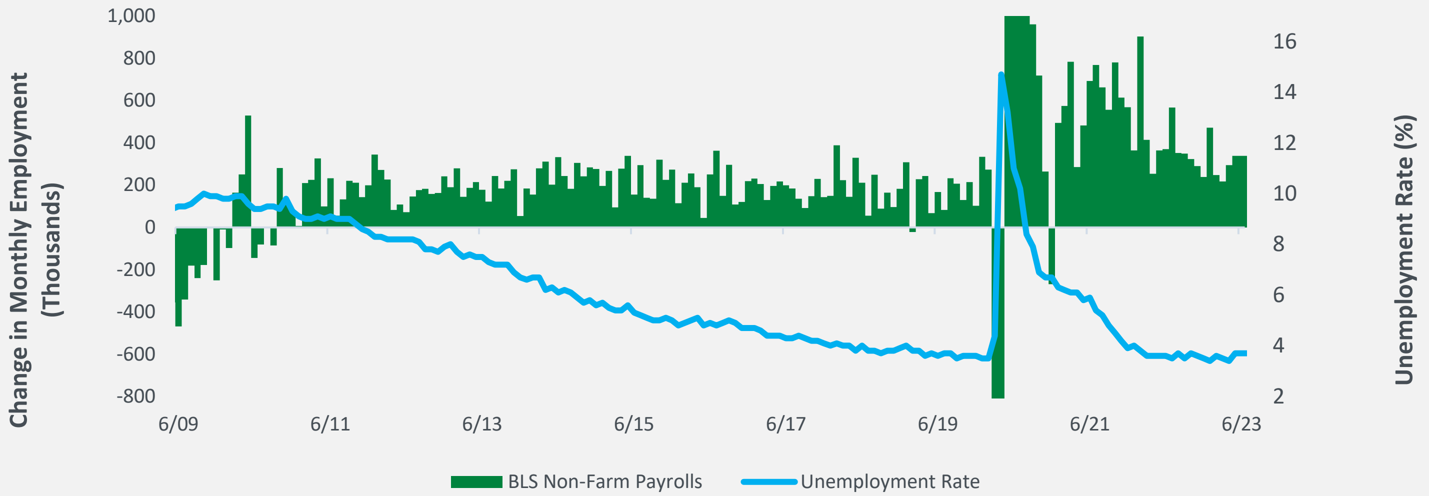
In mid-June, the Fed lifted its 2023 real GDP growth forecast to 1.0% vs. its previous expectation of 0.4% reflecting this improved start to the year.[8] The Fed's May 31 Beige Book report provided valuable insight on current economic conditions and offered a mixed message. Economic activity as measured by positive consumer spending and stable manufacturing had not deteriorated despite the regional bank headwinds caused by higher interest rates and wary depositors. Residential real estate activity had picked up in most regions despite near record low inventories. However, commercial real estate and construction were soft, and financial conditions have become tighter. Also, continued high inflation in core goods and services was negatively impacting low- and moderate-income households. On the employment side, trends remained positive, but the rate of change is slowing.[9]

With the most recent interest rate increase pause in June, the Fed is cognizant that its previous hikes will ultimately slow the economy despite the solid first half numbers. The March regional bank crisis was a wakeup call that its policy decisions could not just isolate the elevated core services inflation at this phase of the cycle. As such, the current Fed 2023 GDP forecast implies that the economy will slow to just slightly positive 2H growth, with 2024 rebounding to only +1.1%, a decrease of 0.1% from prior expectations.

Consumer spending will likely moderate

With domestic consumption making up over 2/3 of US GDP, monitoring the health of the US consumer is vitally important. Although layoffs have thus far been more pronounced in white collar jobs like technology, the higher-end consumer is benefiting from the year-to-date recovery in risk assets as well as previously locked in low mortgage rates. Although jobs data is a lagging economic indicator, the unemployment rate as derived from household surveys remains well below trend even after increasing 0.3% in May to 3.7%. The May nonfarm payrolls report, a self-reported hiring survey from companies, shows a robust labor market with the US economy adding 339,000 jobs in May. As a result of these stronger trends, in mid-June the Fed lowered its year-end unemployment rate forecast to 4.1% from its previous estimate of 4.5%.

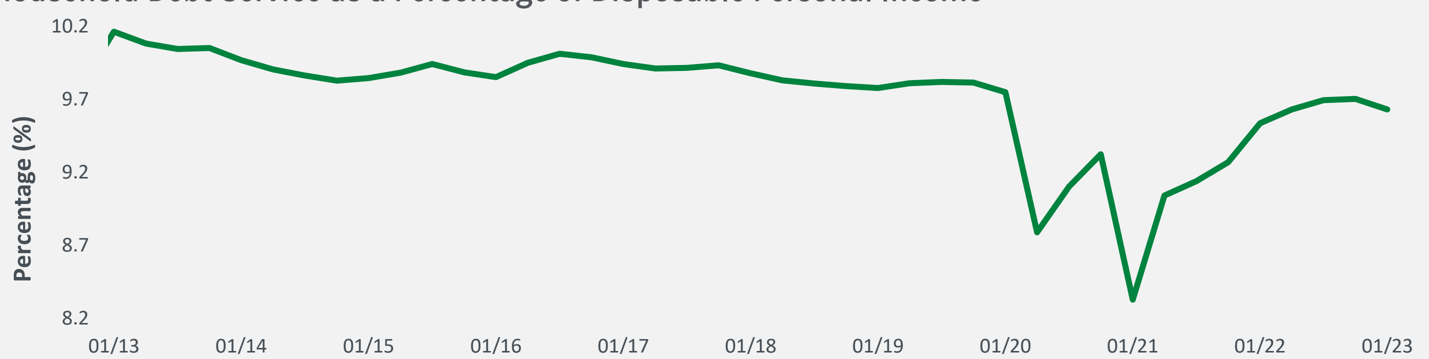
US Monthly Payroll Change and Unemployment Rate



Source: Bloomberg; US Department of Labor

Consumer balance sheets in the aggregate remain healthy, although some metrics are normalizing as high inflation and negative real wage growth have begun to exact their tolls. Household debt service payments as a percentage of disposable personal income have ticked back up but remain below pre-COVID levels.

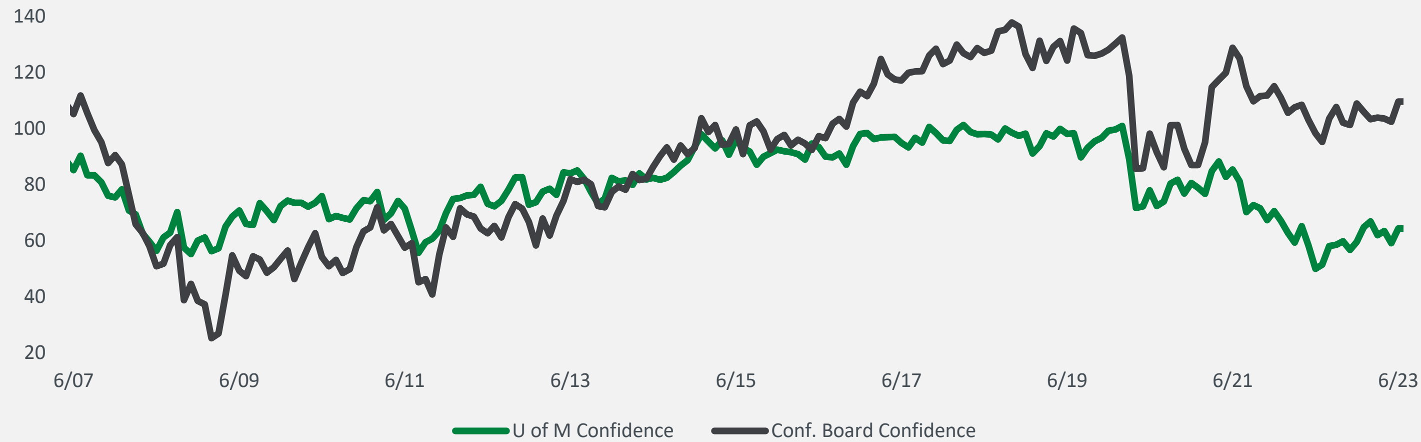
Household Debt Service as a Percentage of Disposable Personal Income



Source: Federal Reserve Bank of St. Louis, FRED

Anecdotally, recent quarterly earnings calls from publicly traded retailers and consumer staples companies indicate that the low/mid-end consumer is being disproportionately affected by continued high inflation in basic necessities. For example, in May, Costco referenced seeing some protein trade down with increased demand in lower cost chicken and pork versus more expensive beef and steak. Consumer confidence remains muted, reflecting these pressures.

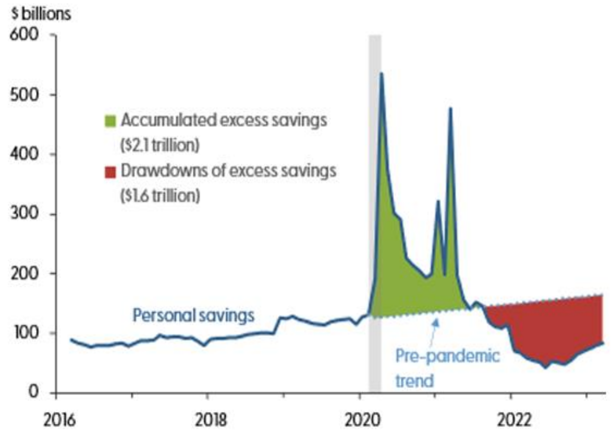
US Consumer Confidence



Source: Bloomberg

An illuminating May 2023 paper from the Federal Reserve Bank of San Francisco[10] examines how the historical build-up of household savings during COVID has bolstered the economy during 2022 and YTD 2023. The San Francisco Fed estimates that these accumulated excess savings peaked in August 2021 at $2.1 trillion. Since then, consumers have drawn down $1.6 trillion of these excess savings. It estimates that the remaining $500 billion will be spent down over the course of 2023 which may result in incremental economic headwinds as consumers pull back later this year into 2024.

Aggregate Personal Savings Versus Pre-Pandemic Trend

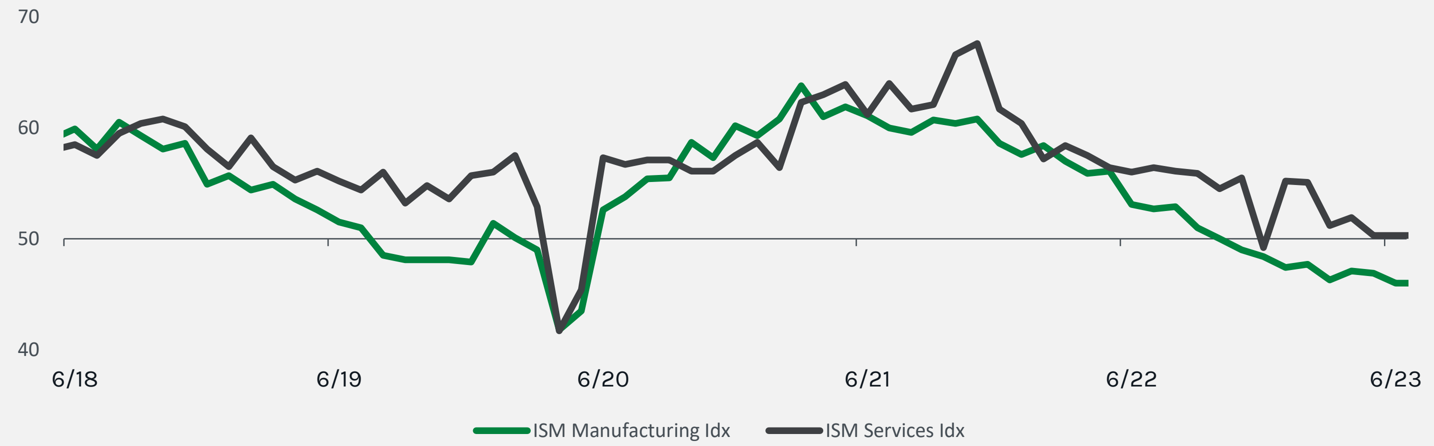


Source: Federal Reserve Bank of San Francisco

US services economy expansion is slowing

The US services economy continues to expand, although the pace of expansion has slowed exiting 2Q as the May Services PMI moderated and the late June S&P Flash US Services Business Activity Index release confirmed.

US Manufacturing and Services PMIs



Source: Bloomberg

As small businesses are key drivers of the services economy, the latest survey of small businesses from the National Federation of Independent Business (NFIB) showed continued pessimism as its Small Business Optimism Index registered 89.4, the 17th consecutive month below the survey's almost 50-year historical average of 98.[11] According to the survey, the top two concerns plaguing small businesses are inflation and an inability to fill open jobs. However, only 4% of survey respondents cited financing as their single most important problem. Despite the hand-wringing that these small businesses would ultimately bear the brunt of tightening bank lending, the May ADP National Employment Report indicated that of the 278,000 jobs added in May, 235,000 were added by firms with less than 50 employees.[12] This compares to the previous 12 months small business monthly job growth of just over 40,000.

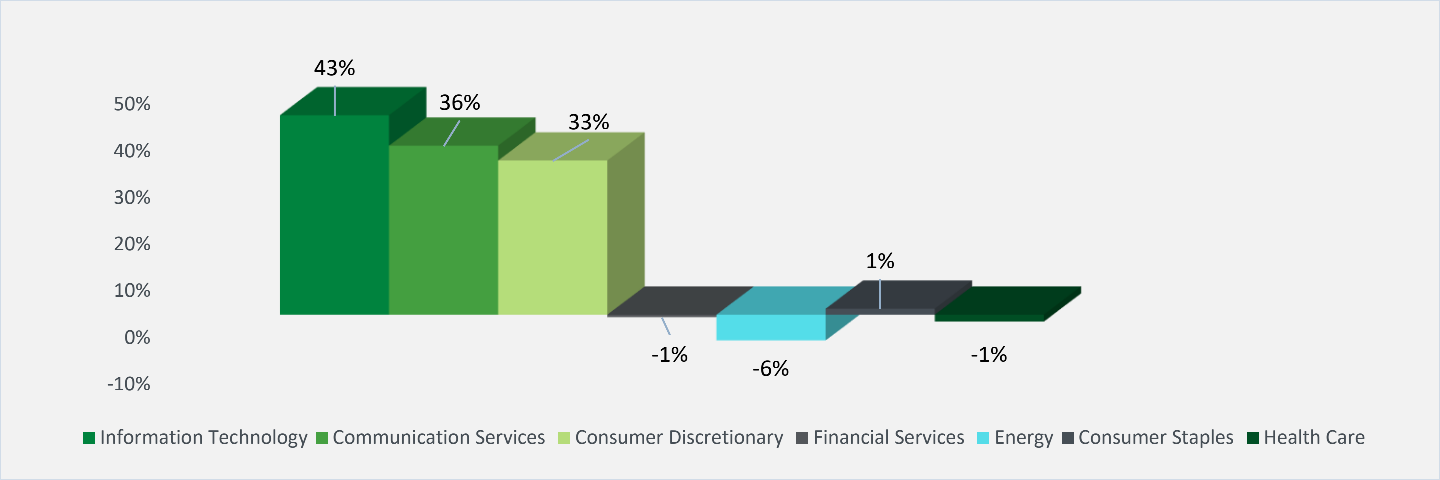
US stock market is also sending mixed signals on future economic growth

It is important to distinguish between the performance of the S&P 500 index and the earnings growth of the companies that constitute that index. The earnings of the companies in the S&P 500 have remained resilient, only declining a few percent in 1Q23 as large corporations have been either able to pass on cost increases or improve efficiency. Through late June, analyst estimates for 2Q S&P 500 company earnings have been lowered by 2.3% compared to the average intra-quarter decline of 3.8% over the previous twenty years, or 80 quarters. In addition, the bottom-up full year 2023 S&P 500 earnings estimate of $221, representing 1% annual growth, has increased since mid-April after having been cut by over 10% the last year.[13] With easier year-over-year comparisons in the second half of 2023, current forecasts are assuming an acceleration of earnings growth exiting the year, which may be optimistic but do not portend an earnings recession.

As a forward-looking indicator of future economic prospects, the stock market itself can be a useful gauge to assess the direction of the economy. Although the S&P 500 index advanced over 16% in 1H23 in the face of numerous macroeconomic pressures, wide sector and market cap divergence provides some reasons for concern. Market breadth was quite narrow, with growth sectors like Information Technology (+43%), Communication Services (+36%), and Consumer Discretionary (+33%) significantly outperforming every other S&P sector.

Market return leadership was narrowly led by a few mega caps even within these sectors, as semiconductor artificial intelligence (AI) beneficiary Nvidia gained 190% in 1H, social media company Meta (Facebook) increased almost 140%, and electric car-maker, Tesla, rose over 110%. On the other hand, more cyclical value sectors like Financial Services (-1%) and Energy (-6%) were left behind during 1H23 as were traditional stable, high quality sectors such as Consumer Staples (+1%), Health Care (-1%), and Utilities (-6%).

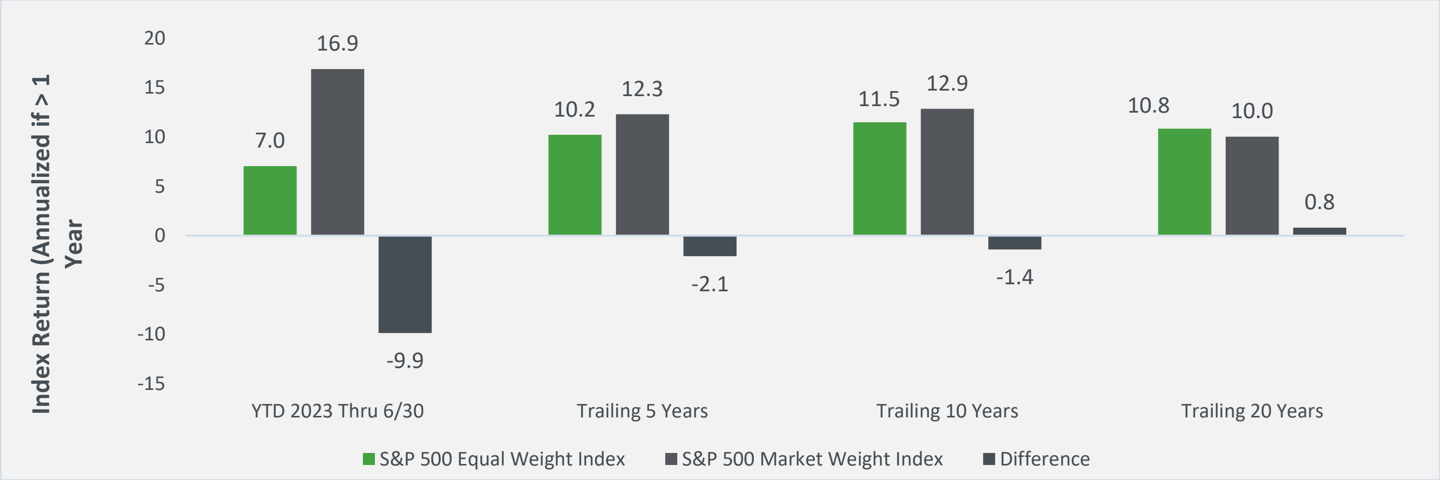
1H23 S&P 500 Returns by Sector



Source: S&P Global

This divergence is perhaps best shown by comparing the market cap weighted S&P 500 to the S&P 500 Equal Weight Index. The market cap version of the index tilts heavily to the largest companies by market capitalization, while the equal weighted index treats all 500 companies the same. The equal weighted index increased only 7% in 1H23, trailing the S&P 500 market cap weighted index by almost 10%.

S&P 500 Equal Weight Versus S&P 500 Market Weight Performance



Source: Morningstar

These indices have similar annualized return profiles since the equal weight index came into existence 20 years ago. However, over shorter time frames relative performance can be more volatile. For example, the equal weight index outperformed by over 6% in 2022 while the market cap weighted index outperformed by over 5% in 2020.

Small cap stocks, as measured by the S&P SmallCap 600 Index, also faced relative performance challenges in 1H23, returning just 6%. However, both the equal weight index and small caps closed the performance gap in June, each outperforming the S&P 500 by over 1%. This broadening of the equity market recovery may be signaling that investors are becoming less pessimistic about the economy. As shown by forward price to earnings metrics, small cap valuations remain quite attractive relative to their large cap brethren, and we remain positive about the small cap asset class despite 1H23 performance challenges.

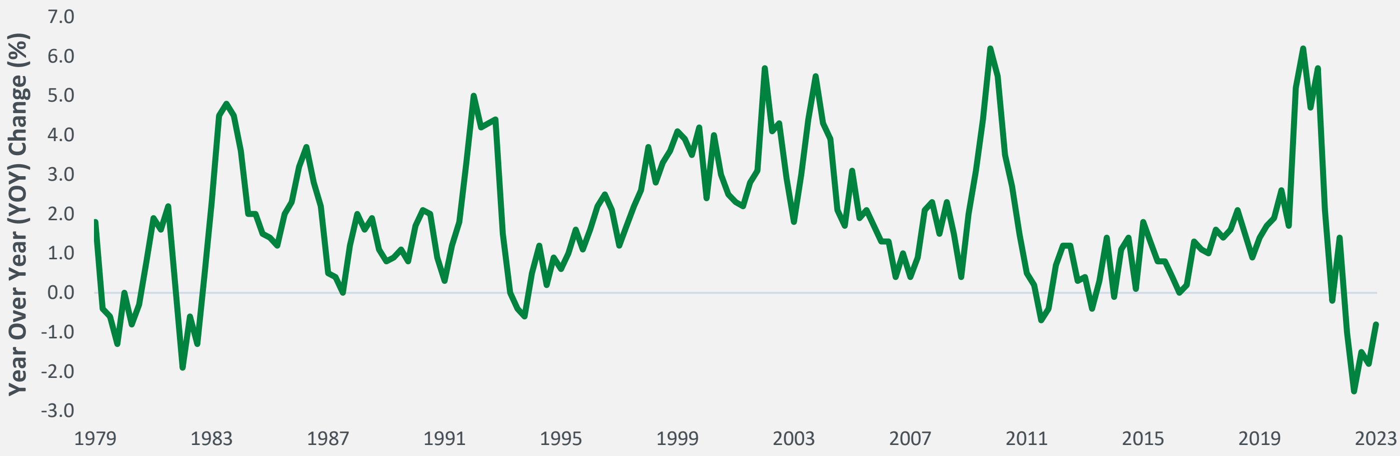
US Equity Forward Price to Earnings Ratio

Source: Bloomberg

Productivity improvement needed to accelerate future economic growth

US labor productivity, or output per hour, is measured by dividing an index of real output (GDP excluding government output and other items) by an index of hours worked in the economy. (Source: Department of Labor) Increased productivity is a key component in sustaining outsized economic growth as a more efficient workforce can increase the overall output of the economy. Theoretically, it can also lead to higher wage growth as workers can hopefully share in corporations' increased profits. Increased productivity also creates a self-reinforcing loop by incentivizing businesses to take a longer-term growth mindset by investing in research & development and capital projects. However, post the Great Recession, US productivity growth has been below historic trend, which has resulted in sub-par economic growth. The revised 1Q23 nonfarm business sector labor productivity report released in early June showed that US productivity contracted, the first time since the data began being reported in 1948 that productivity has been negative for five consecutive quarters.[14]

US Labor Productivity



Source: US Bureau of Labor Statistics; Federal Reserve Bank of St. Louis, FRED

There is no one definitive explanation for this below-average productivity, but several reasons have been cited, including an aging population, a skills gap in the US workforce, moderate corporate capital investment, as well as possible issues in measuring productivity in this digital age made even more difficult by COVID.

Low productivity growth is not just a US phenomenon, as many countries are experiencing similar challenges. However, there are reasons for optimism as disruptive technological changes in the form of automation, including artificial intelligence (AI), may be the catalyst to re-accelerate productivity growth and, thus, economic growth in the years to come. In an April article, investment bank Goldman Sachs made the bullish case that AI is the savior to bring about the next wave of productivity growth, estimating that annual global labor productivity could grow by 1.5% over a 10-year period.[15]

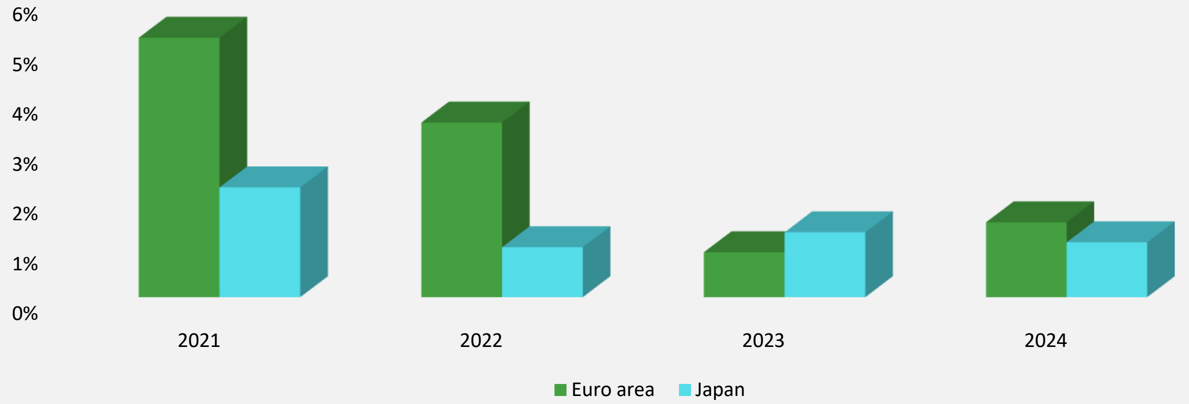
Non-US Developed Economic Growth

After dipping 0.2% in 4Q22, the European Union (EU) grew a meager 0.1% in 1Q23 according to Eurostat, the statistical office of the EU. As consensus predictions entering the year had called for a broad regional recession, these results were better than expected, which led to 1Q23 outperformance in European equities. The European Central Bank's (ECB) May Economic Bulletin discussed the better-than-expected economic growth in the region, citing lower energy prices, the easing of supply bottlenecks and fiscal policy support for firms and households being incremental tailwinds. Like the US, manufacturing is soft, but the services sector remains healthy, buoyed by continued strength in the labor market. However, risks remain as high inflation is forcing the ECB to raise rates despite this tepid growth, and the region will continue to be vulnerable to more volatile energy prices due to its import reliance. Although the region's more stringent banking regulations shielded it from what US regional banks have encountered, lending conditions are also tightening according to the April Euro area bank lending survey.[16] Both the ECB and OECD forecast 2023 and 2024 Euro area real GDP growth of 0.9% and 1.5%, respectively. Based on 1H23 trends and continued ECB rate hikes, the 2023 outlook appears aggressive.

As the largest economy in the EU, Germany is dragging down growth in the region. It was officially declared to be in a recession after the late May release of 1Q23 GDP which indicated the economy contracted 0.3% after a -0.5% print in 4Q22.[17] The country continues to feel the negative impact of being forced to scramble in 2022 to obtain new sources of energy due to its over-reliance on Russian gas and oil. As a result, German inflation remains high, with both consumer and its vital industrial economy feeling the pinch. The OECD forecasts flat real GDP growth for Germany in 2023, rebounding to +1.3% in 2024.

In the United Kingdom (UK), consumers are dealing with identical issues as the US, with interest rates climbing over 4% in less than 18 months, the largest increase since the 1980s. The UK consumer is feeling the impact of high inflation, but the unemployment rate remains low with the OECD projecting a 4.2% rate in 2023, up from 3.7% in 2022. However, unlike the US, there remains a large percentage of UK homeowners whose mortgages will need to reset to higher mortgage rates in the years to come, which will likely pressure consumer spending.[18] The OECD is currently forecasting 0.3% real GDP growth in 2023 for the region, improving to 1.0% in 2024.

Non-US Developed Markets Real GDP Growth



Source: June 2023 OECD Economic Outlook (2021 and 2022 Actuals; 2023 and 2024 projections)

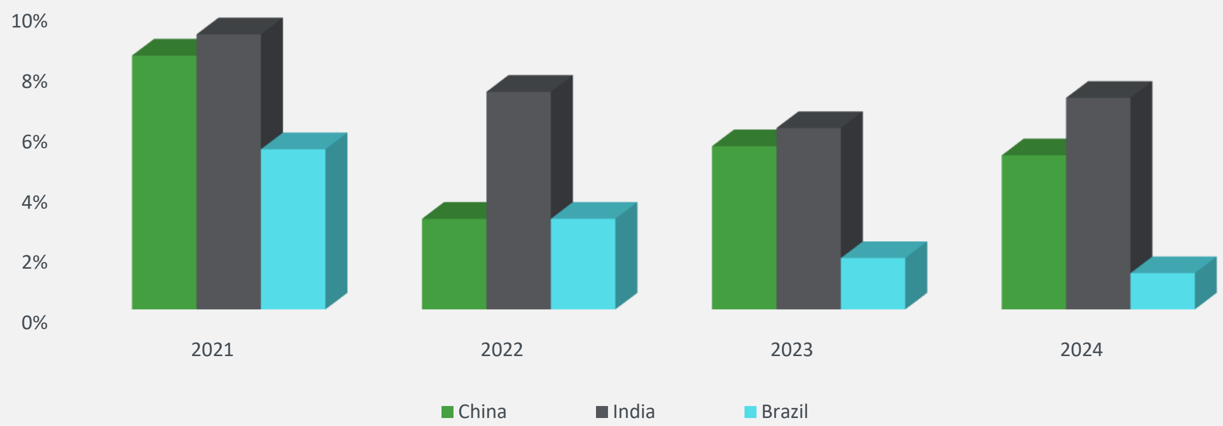
Japan has quietly delivered impressive recent results, with 1Q23 real GDP growing 2.7%, the second highest growth in the G7 behind Canada. The OECD projects 2023 and 2024 real GDP growth for Japan of 1.3% and 1.1%, respectively, as monetary policy remains accommodative. With unemployment below 3% and wage gains a recent positive phenomenon in the country, the outlook for the Japanese consumer is favorable. This is offset somewhat by softer export growth due to the stagnant global manufacturing economy.

Emerging Markets Economic Growth

Emerging markets remain the growth engine of the global economy. However, perhaps the biggest question pertaining to future global economic growth concerns China's prospects. The OECD currently forecasts 2023 and 2024 China real GDP growth of 5.4% and 5.1%, respectively. With year-to-date exports weak, including a decrease of 7.5% in May on the heels of declining 0.1% in 1Q23[19], growth will need to come from increased consumer demand following the country's COVID re-opening. China's May PMI reading of 55.6 was its highest level since December 2020, indicating that its economy is recovering, albeit at a slower pace than hoped for entering the year.[20] One area of large concern related to the future health of the Chinese economy surrounds the country's youth unemployment rate, as urban unemployment among 16 to 24 year-olds increased to a record high of 20.8% in May.[21] The government recognizes it needs to improve job prospects and recently announced a plan which included expanded support for skills training and increased hiring at state-owned enterprises.

Unlike China, India's growth prospects appear robust. The OECD currently forecasts 2023 and 2024 real GDP growth of 6.0% and 7.0%, respectively, for the country. According to United Nations projections, India has overtaken China as the world's most populous country with over 1.4 billion residents. With favorable demographics and a pro-growth government, the Indian economy is poised to continue its above-average economic growth.

Key Emerging Markets Real GDP Growth



Source: June 2023 OECD Economic Outlook (2021 and 2022 Actuals; 2023 and 2024 projections)

Latin America remains mired in below-average emerging market economic growth due to higher inflation and interest rates as well as being tied to more volatile commodities markets. The OECD currently forecasts 2023 and 2024 Brazil real GDP growth of 1.7% and 1.2%, respectively. With Brazilian interest rates remaining elevated at 13.75%, consumers are facing tight credit conditions and the country's export-led commodities industries are feeling the impact of lower prices. For Mexico, the OECD currently forecasts 2023 and 2024 real GDP growth of 2.6% and 2.1%, respectively. Similar to Brazil, interest rates are relatively high with the most recent read at 11.25%, where it is expected to remain over the course of 2023. A very low unemployment rate of 3.3% in 2022 is forecasted by the OECD to reach 3.1% in 2023, supporting the outlook for healthy consumer spending.

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