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2023 Mid-Year Market Update and Outlook

July 2023

Please see page 9 for important disclosures.

Mid-Year Recap

Economic data has been flashing warning signs throughout the first half of the year, with many indicators posting declines suggestive of a coming economic slowdown. The US treasury yield curve remains inverted, with the yield of the three-month treasury bill exceeding the yield of the ten-year treasury note by 106 basis points, as of 06/30/2023.[1] Sharp declines in the Manufacturing Purchasing Managers' Index and consumer confidence measures, albeit from inflated post-pandemic levels, provide further evidence of a deteriorating economy. Nonetheless, the US economy has been remarkably resilient amid a historically aggressive Federal Reserve ("Fed") rate-hiking cycle. Consumer spending has remained robust, as elevated pandemic savings have allowed households to maintain consumption patterns despite high inflation. The labor market continues to display late-cycle tightness, with the unemployment rate at 3.7% as of 06/30/2023 and a Jobs-Workers gap of 4.01 million persons, representing a significant supply-demand mismatch in employment.[2] Developments in generative Artificial Intelligence ("AI") have provided hopes of a productivity boom that could prove to be the antidote to the current stagflationary environment. Forward-looking equity markets have surged through the first half of the year, with the S&P 500 closing the quarter up 16.87% year-to-date, helped by a significant liquidity injection in the wake of the regional banking crisis and debt-ceiling showdown.[3] Nonetheless, as we look forward, we believe the ultimate factor determining the health of the economy and capital markets will be the trajectory of inflation and global central bank's monetary policy decisions.

Monetary Policy & Inflation

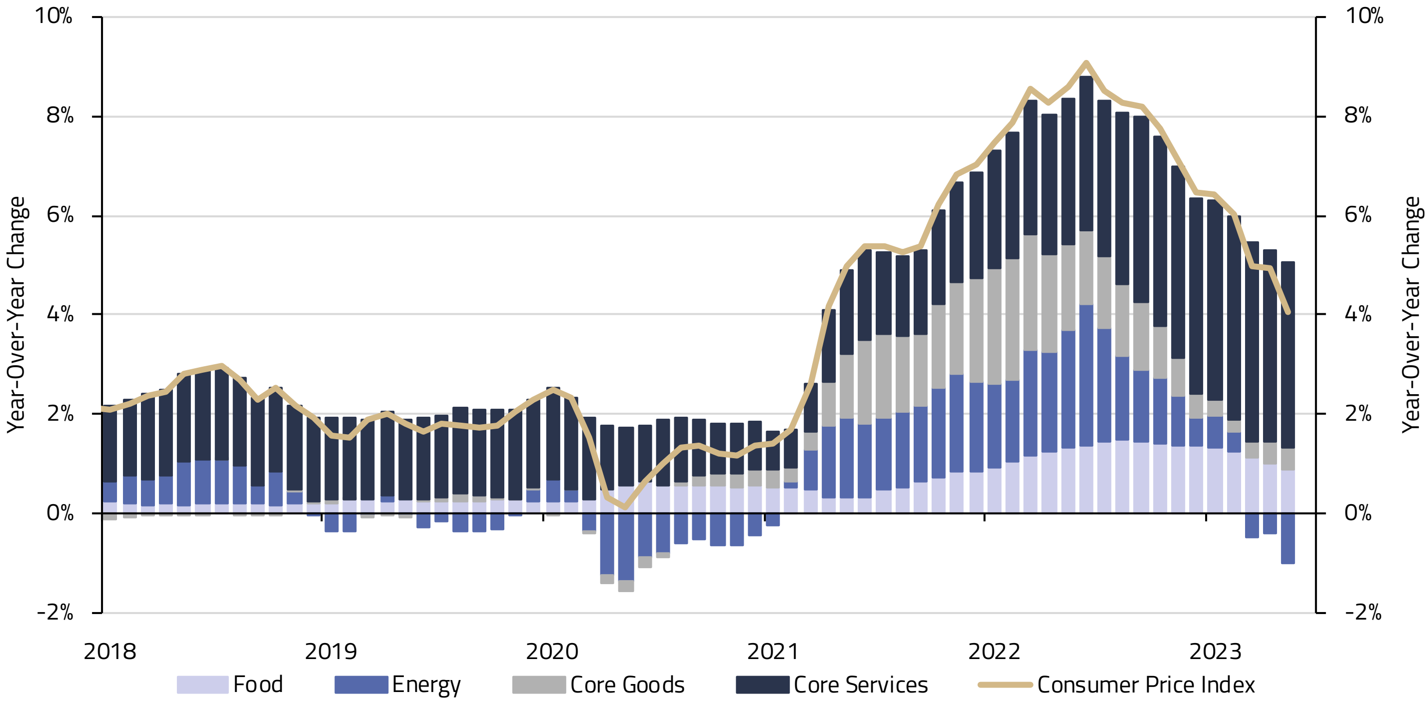
The Fed paused its rate-hiking cycle by deciding at its June meeting to hold interest rates steady after ten consecutive rate hikes beginning in March of 2022. Currently, the benchmark federal funds rate rests between 5% and 5.25%, a drastic increase from the 0% to 0.25% range that had been maintained prior to the first rate hike.[4] The Fed has been challenged with combating historically high inflation resulting from the surge in the money supply caused by the immense monetary and fiscal stimulus measures that were taken to support the economy during the pandemic.

Inflation has trended downwards from peak levels, with headline Consumer Price Index ("CPI") reaching 4.0% in May; however, much of this reversion is due to the base effect as food and energy prices were at elevated levels this time last year as a result of the war in Ukraine.[5] Core inflation readings, which exclude volatile food and energy prices, remain stubbornly high (see Exhibit 1). The Fed's preferred measure of inflation is the core reading, which will prove to be an important distinction going into the second half of the year as we expect continued divergence between the headline and core inflation readings. An overheated US labor market should continue to keep wage growth elevated, a major input in services inflation readings that are currently trending upwards. It will be difficult to rein in services inflation without significant labor demand destruction. With announcements from major corporations of increased layoffs, and jobless claims trending upwards, the cracks in the labor market seem to be forming.

We believe that the decision to maintain interest rates during the June meeting represents a "skip" rather than a "pause" as the Fed aims to dampen volatility on the heels of the regional bank crisis. We anticipate that the Fed will begin hiking again in July and project that by year-end the federal funds rate will be at least 50 basis points higher than its current level.

1. Bloomberg. Data as of 6/30/2023
2. Id.
3. Id.
4. Federal Reserve Economic Data (FRED)
5. Bloomberg.

Exhibit 1: US Consumer Price Index Breakdown



Source: US Bureau of Labor Statistics, Strategas, as of 05/31/2023

The economy's resilience has led us to increase the probability that we assign of a soft-landing scenario, where the Fed successfully defeats inflation without causing a major economic slowdown. Job Opening-Labor Turnover Survey ("JOLTS") data shows a labor market where job openings significantly exceed unemployed persons. There is a possibility that the Fed can reduce labor demand and, in turn, reduce services inflation, by narrowing this gap. So far, we have seen a notable decline in job openings without a sizable increase in unemployment. Simultaneously, evidence of an upward-trending labor force participation rate lends credence to the idea that the supply-demand mismatch in the labor market can be alleviated without a seismic increase in unemployment.

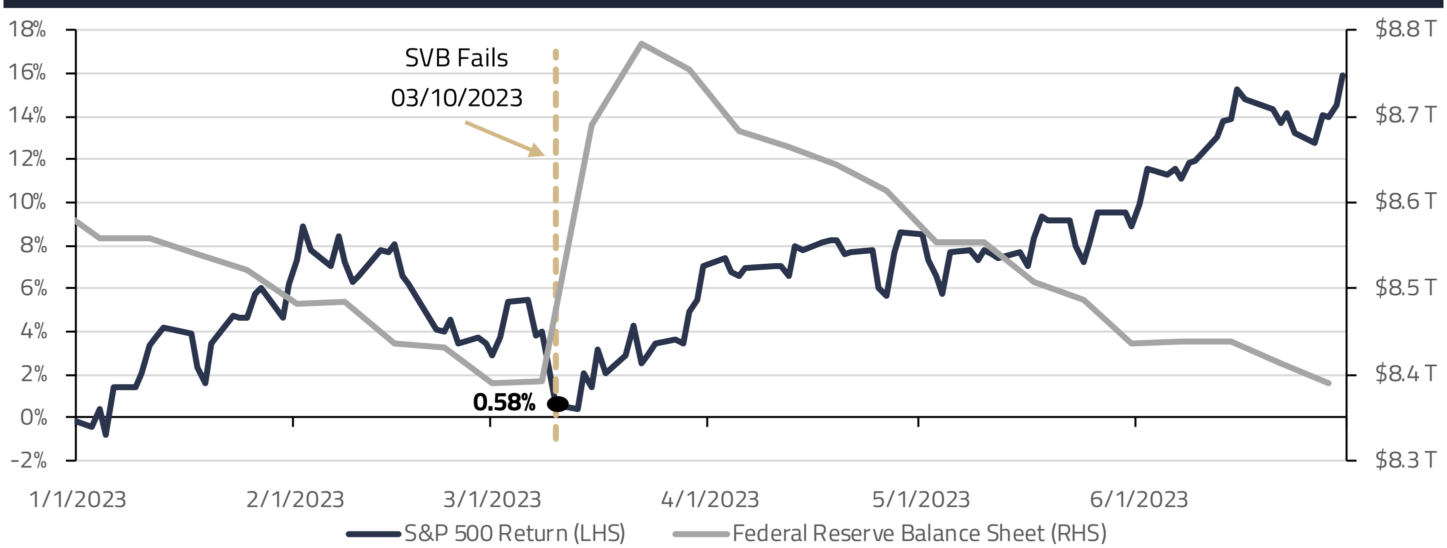
Second, housing inflation contributes roughly a third towards overall core inflation; however, this indicator is measured on a lag. Alternative rent and housing measurements indicate a reversal in housing prices and rent growth, which should filter into the CPI reading over the coming months. A significant reduction in shelter inflation should prove impactful in bringing overall inflation levels closer to the Fed's 2% target.

Lastly, rapid adoption of generative AI into enterprise workflows could create a productivity boom that would allow the economy to reaccelerate growth without creating significant inflationary pressure. However, we are skeptical of this outcome given corporate America's tendency to be slow in adopting new technologies. Our base case remains that the Fed will have to maintain restrictive monetary policy until a severe economic slowdown removes demand from the economy. Admittedly, the recession we expected has taken longer to materialize, but we still believe the odds favor a recession within the next twelve months.

Regional Banking Crisis

The economic resilience of the first half of 2023 has been surprising, but we remain cautious as monetary policy often works with a significant lag, and early effects of the Fed's tightening campaign have already surfaced during the regional banking crisis. In March of 2023, Silicon Valley Bank ("SVB") came under stress as long-duration bonds held on its balance sheet lost significant value when interest rates increased. Simultaneously, SVB customers with deposits exceeding the $250,000 FDIC-insured limit began pulling assets from the bank in fear of losing their deposits if the bank became insolvent, thus creating a run on the bank. At the time, it was estimated that 186 other banks were similarly vulnerable to a bank run, causing concerns of a possible systemic problem for the regional banking sector.[6] Signature Bank and First Republic Bank were two other regional banks that fell victim to the SVB spillover. In order to mitigate the panic amongst depositors, the Fed, FDIC, and Treasury department announced steps that provided unlimited depositor insurance for customers of SVB and Signature Bank. The Fed also created an emergency facility to help prevent other US depository institutions from falling short on cash, protecting consumers' deposits at all other banks. The Fed's response to the regional banking crisis led to an expansion of its balance sheet that partially reversed the effects of its quantitative tightening program. This injection of liquidity into the system created a strong tailwind for risk assets, as shown in Exhibit 2. Prior to the collapse of SVB, the S&P 500 was up only 0.58% on the year; however, the S&P rallied strongly alongside the Fed's growing balance sheet in the ensuing months.

Exhibit 2: S&P 500 Returns vs. Fed Balance Sheet Following Silicon Valley Bank Collapse



Source: Strategas, Bloomberg, as of 06/30/2023

The Fed averted a systemic banking crisis through its swift action, but we anticipate that the lagging consequences of the regional banking crisis will continue to negatively impact the economy. Credit availability appears to be diminishing rapidly, with the Fed's most recent survey of senior bank loan officers indicating that nearly half have tightened lending standards in the wake of the banking crisis. Tightening lending standards tend to precede increases in job losses, as shown in Exhibit 3, and we anticipate further credit tightness to weigh on the labor market going forward. Regional banks also serve as major lenders to many industries and sectors that we anticipate will be challenged. One area of particular concern is the commercial real estate market, where about 30% of loan assets are held at small-to-medium sized banks, with many of the loans set to mature in the near future.[7] Many of these loans were made to over-leveraged buyers who took advantage of a strong real estate lending market. Many investors took interest-only loans hoping to roll the final payment, including principal, into another loan. Since then, interest rates have skyrocketed, making new loans more expensive while demand for commercial real estate, particularly in

6. Matvos, Gregor, and Howard Berolzheimer. "Why U.S. Regional Banks Are Still in Crisis." Kellogg Insight, 21 June 2023, insight.kellogg.northwestern.edu/article/u-s-regional-banks-are-still-in-crisis.

7. Id.

the office sector, has collapsed. We believe it is likely that defaults on commercial real estate loans will rise in the second half of the year, which would put further pressure on regional and community banks. The aftermath of the banking crisis is likely to cause further issues, and we anticipate that the reduced availability of credit will ultimately prove detrimental to the broad economy.

Exhibit 3: US Bank Credit Tightening vs. Job Loss

Source: Strategas, Bloomberg, as of 05/31/2023

The Debt Ceiling & Federal Spending

The Treasury Department reached its debt ceiling of $31.4 trillion in January 2023 and, after months of debate, lawmakers voted in June to suspend the ceiling until January 2025. During this time, the federal government spent down the Treasury General Account ("TGA") to finance its activities, which injected liquidity into the system and created strong tailwinds for risk assets in the first half of the year. Money that is spent out of the TGA increases liquidity in the system because, unlike during normal times, treasury debt is not issued to take money out of the system. Looking forward, the US Treasury will need to issue an estimated $1.4 trillion in debt in the second half to cover deferred payments and restore cash reserves in the TGA.[8] Cash transfers into the TGA must be offset elsewhere on the Fed's balance sheet, essentially shrinking the US money supply. Heavy treasury issuance, a shrinking money supply, and further credit tightening could create a liquidity vacuum in the second half of the year that we believe will prove particularly detrimental to long-duration assets.

Federal spending will likely continue to be a key area of contention for lawmakers as debt servicing becomes a larger expense of the federal budget. Approximately half of the outstanding US sovereign debt matures in the next three years. The weighted average coupon of outstanding US sovereign debt stands at 1.91%, well below current treasury yields, meaning net interest costs are set to increase significantly over the next three years. Strategas opines that the US Treasury could experience roughly $2.7 trillion in added interest costs over ten years.[9] At the same time, approximately 60% of federal spending is inflation-linked, implying that current spending will systematically in-

8. Husein, Arif, et al. 2023 Midyear Market Outlook: Finding the Signal Through the Noise, 22 June 2023, ww.troweprice.com/content/dam/iinvestor/resources/insights/pdfs/finding-the-signal-through-the-noise.pdf.

9. Trennert, Jason De Sena. Investment & Economic Outlook: Playing the Odds While The Bill Comes Due, June 2023.

crease as it inflation-adjusts.[10] The federal budget will continue to be an area of contention in Washington over the next few years, and it is likely that fiscal stimulus in the form of additional federal spending will be smaller in magnitude from what was experienced during the pandemic era.

Artificial Intelligence & Narrow Market Leadership

The US stock market has had a strong start to the year, with the S&P 500 and Nasdaq returning 16.87% and 32.32% year-to-date, respectively.[11] The market responded euphorically as the "AI" wave began to gain steam. On November 30 of last year, OpenAI launched a generative artificial intelligence chatbot called ChatGPT, garnering immense attention from users with its human-like responses and ability to generate original content. We believe Open AI's ChatGPT will drive the adoption of generative AI across software enterprises, similar to how hyperscalers commercialized cloud infrastructure and platforms that accelerated the growth of Software-as-a-Service businesses. The integration of AI into the tech stacks of global corporations is projected to generate significant productivity gains for the economy, particularly for software-based companies. The Goldman Sachs Macro research team estimates that AI adoption could drive almost $7 trillion in global economic growth over a 10-year period, with productivity growth 1.5% faster annually over the same period.[12] We expect AI to continue to drive investment in various tech sectors, including semiconductors, hyperscalers, data, and storage. The innovation of generative artificial intelligence has been explosive, and it is likely that this revolutionary technology has the potential to generate strong economic growth in the intermediate to long-term. However, we are acutely aware that it takes years for new technologies to make their way into companies' operations. Thus, we are skeptical that generative AI will create a near-term catalyst that will help the economy avoid recession.

Exhibit 4: Annual S&P 500 Performance Contribution of 10 Largest Weights

Year	Top 10 Contribution To Total Performance	S&P 500 Price Return
2007	78.7%	3.5%
2023 YTD	**76.9%**	**15.9%**
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%

Source: Strategas, as of 06/30/2023

So far, the AI innovation wave has been most impactful on the stock prices of incumbent technology leaders at the top of the market capitalization spectrum. AI programs are capital intensive, playing into the strengths of the largest technology companies that have the resources to develop new AI applications and refine existing ones. We believe the concentration of the AI trend in the largest market-capitalization S&P 500 companies has been a major contributor to the narrow market breadth observed in the first half of the year. As shown in Exhibit 4, the top ten S&P 500 stocks contributed 76.9% of the S&P's return year-to-date, the second-highest reading in 30 years and second only to 2007, the year before the global financial crisis. The narrowness of the market has punished and frustrated investors who have strayed away from mega-cap technology stocks and market-cap-weighted indexes. However, a narrow market tends to be a vulnerable market. While we agree that further AI investment should continue to benefit these names over the long term, any reversal in AI euphoria should create significant headwinds toward the performance of US large-cap equity indexes going into the second half of the year.

10. Id.

11. Bloomberg.

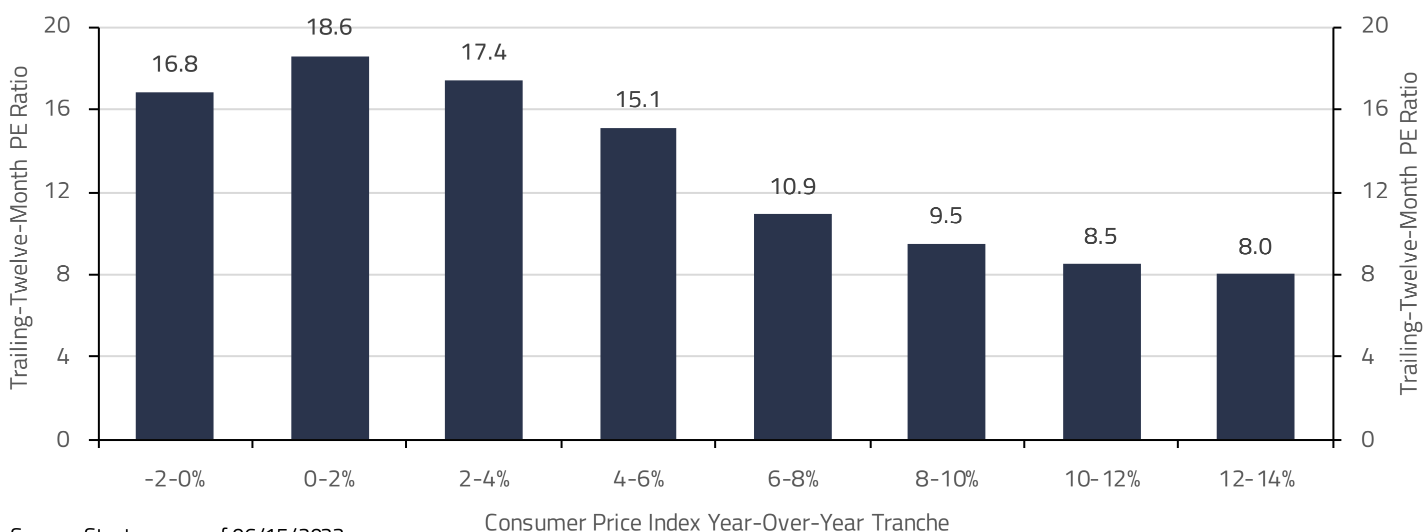
12. Rangan, Kash. Generative AI - Part I: Laying Out the Investment Framework, 26 Mar. 2023, publishing.gs.com/content/research/en/reports/2023/03/27/c9b5b425-9191-4588-a9ff-009fe202b4cc.html.

Corporate Earnings & Equity Valuations

Corporate earnings have held in admirably during the year even as increased input costs, such as labor and commodities, threaten to hurt the bottom line. We believe the strength in corporate earnings can be attributed mainly to companies' ability to push price increases on to the end consumer, which has been supported in turn by strong consumer spending and a tight labor market. Household savings soared during the pandemic as stimulus measures poured money into consumers' bank accounts faster than they could spend it. Elevated savings and strong wage gains allowed consumers to maintain their spending amid an inflationary environment. That said, US inventories have been building up throughout the year, pointing towards weaker consumer demand. Further, savings balances are trending downwards, and credit card utilization has been increasing, indicating that consumer spending is due to weaken. The end of the student loan moratorium on September 1 should also have a negative impact on consumer spending. A weakening consumer would hinder corporations' ability to push price, and we anticipate that corporate earnings will begin to suffer in the coming quarters as consumer demand softens.

At the time of this writing, estimated 2023 S&P 500 earnings sit at $220.68 per share, with sell-side twelve-month, forward-looking estimates for S&P 500 earnings at $240.89.[13] We believe that corporate earnings will decline over the next twelve months, suggesting the current forward-looking multiple on the S&P 500 of 18.47x appear quite expensive.[14] The twelve-month trailing multiple on the S&P 500 of 19.88x also implies an expensive market, especially considering the current inflationary environment.[15] Inflationary environments with high-interest rates tend to pressure valuation multiples. Exhibit 5 shows that the average S&P 500 trailing twelve-month ("TTM") P/E ratio when CPI is between 4% and 6% is 15.1x. This would imply a fair value for the S&P 500 at the end of the second quarter of 3,374, based on TTM earnings of $223.42.

Exhibit 5: Average S&P 500 Valuation Multiple by Inflation Tranche



Source: Strategas, as of 06/15/2023

Additionally, the equity-risk premium, the added expected reward for taking on the additional risk of holding stocks over bonds, points towards a US large cap equity market that appears more expensive than before last year's bear market. Equity risk premium calculates the difference between the earnings yield on the S&P 500, the inverse of TTM P/E, and the 10-year treasury yield. At the beginning of 2022, the TTM P/E of the S&P 500 was 24.00x implying an earnings yield of 4.17% versus a 10-year treasury yield of 1.51%.[16] The difference between the two yields led to an equity-risk premium of 2.66%. At quarter-end, the TTM P/E of the S&P 500 had fallen to 19.88, raising the earnings

13. Bloomberg.

14. Id.

15. Id.

16. Id.

yield to 5.03%, while the yield on the 10-year treasury rose to 3.83%. The current equity-risk premium sits at 1.20%, indicating the S&P 500 is significantly more expensive than before the 2022 equity sell-off. However, we do see some pockets of value in the US market, with many quality small and mid-cap ("SMID") stocks trading at significant discounts to their historical averages. While the S&P 500 TTM P/E is relatively expensive compared to historical averages, the opposite is true of the Russell 2000.[17]

Fixed Income Markets

Elevated yields and credit spreads near their 10-year averages presents better relative value in parts of the fixed income and credit markets vis-a-vis equities. On average, corporate balance sheets still have low leverage and ample debt service coverage, and the high yield bond market has improved in quality from previous cycles. Still, slower economic growth and higher rates are likely to push default rates up through year-end. Skillful active management in the credit space can help investors avoid "zombie" companies, companies on the verge of bankruptcy, and should mitigate the impact of a broad increase in credit defaults, protecting the yield premium of a credit allocation.

Bond markets are not without concern, however. Credits affected by the regional banking crisis, such as commercial real estate, are particularly troubling. Additionally, if the Bank of Japan allows its sovereign yields to rise, this could lead to an exodus of Japanese investment capital out of the US bond market. The Japanese have historically been a large investor in US fixed income markets, so that scenario would create a significant technical headwind. Further, the shadow banking system has seen tremendous growth throughout this cycle. These lenders are less regulated, less liquid, and more opaque than traditional bank lenders, and have yet to endure a full economic cycle. It seems plausible that trouble could emerge in this area of the market as we move through the cycle, especially considering the number of new entrants to the sector over the past few years.

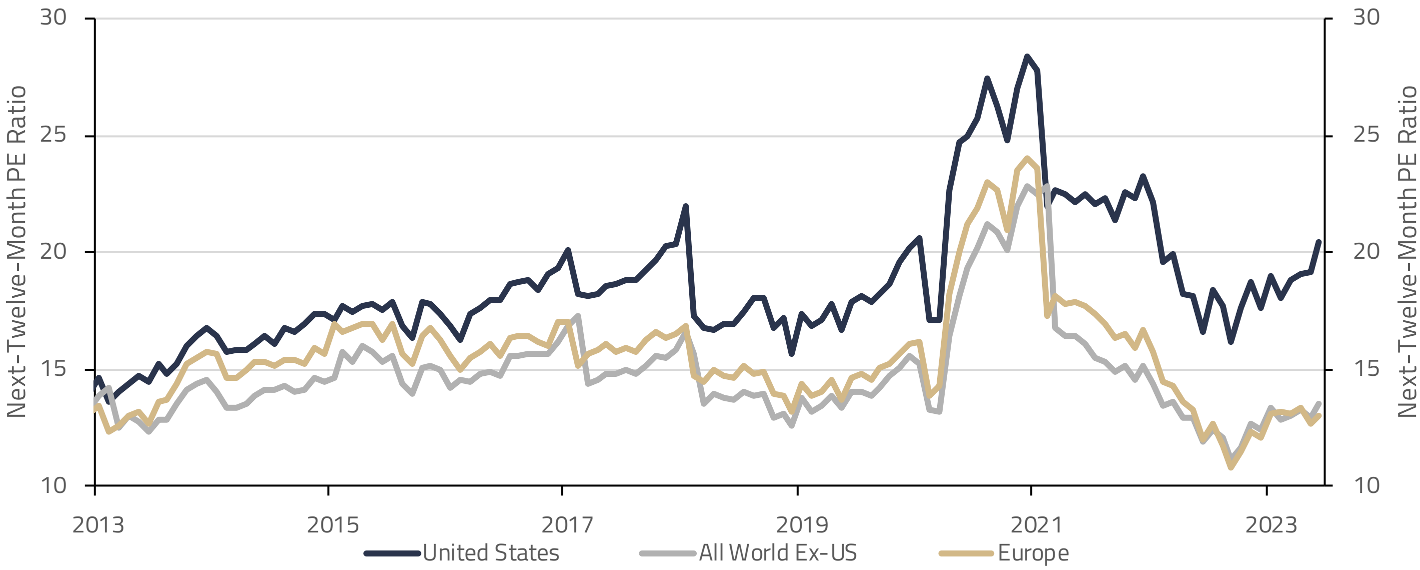
International Markets

Maintaining a domestic bias has rewarded US investors over the past cycle, but slowing economic growth and an elevated-interest rate environment may lend credence to the idea of increasing geographic diversification in equity portfolios. From the end of the global financial crisis through the end of 2022, the S&P 500 index posted significantly higher returns than the MSCI Europe, Australasia, and Far East (EAFE) index, a benchmark for developed markets outside of North America. Years of zero interest rate policy by the Fed and steady economic growth following the global financial crisis allowed the S&P 500 valuation multiple to expand to historic levels. However, a high interest rate, high inflationary environment should pressure multiples in domestic markets, causing global markets with lower valuations to appear more attractive. In Exhibit 6, we observe that most global ex-US markets continue to have significantly lower valuations as compared to US equities. Meanwhile, earnings growth estimates are higher for Japan relative to the S&P 500 while comparable for developed Europe.[18] Declining energy prices and a warmer-than-expected winter helped mitigate economic slowdown in Europe; however, the war in Ukraine continues to add a layer of volatility to European markets. While European economies were successful in reorganizing energy supply chains to meet demand, a tepid winter and elastic energy demand from European consumers helped prevent economic fallout in the region since the onset of the war. A cold winter still brings the risk of escalating energy prices that would likely spur a European economic slowdown and pressure equities in the region.

17. Id.

18. Husein, Arif, et al. 2023 Midyear Market Outlook: Finding the Signal Through the Noise, 22 June 2023, ww.troweprice.com/content/dam/iinvestor/resources/insights/pdfs/finding-the-signal-through-the-noise.pdf.

Exhibit 6: Global Stock Indexes Valuation Multiples



Source: Bloomberg, as of 06/30/2023

*United States represented by S&P 500 Index, All World Ex-US represented by MSCI ACWI Ex-US, Europe represented by STOXX 600 Index

Careful consideration of regional exposures will be essential for investors accessing global markets. In particular, we maintain a negative view of Chinese risk assets. Earlier in the year, China lifted COVID restrictions faster than expected, leading to an economic reopening that was anticipated to generate strong growth. However, that momentum has faded, and Chinese growth in the first half of the year has been disappointing. A sluggish recovery in consumer demand and an oversupply in the property sector has hindered growth. Fiscal stimulus that has historically allowed the Chinese Communist Party to catalyze growth in times of trouble has proven less effective this time around. With US-China tensions escalating over Taiwan and further restrictions on technology companies, the geopolitical risk for US investors in Chinese assets persists and remains difficult to handicap. Thus, China continues to be an area of the global market that we think prudent to avoid.

Summary

Fears of a deep global economic downturn have yet to materialize, with relatively strong nominal growth displayed across most economies. Major developed equity markets have posted positive first-half returns and default rates have remained low. Nonetheless, it is important to consider that the effects of monetary policy occur with a lag and the true impact on credit availability from the regional banking fallout remains to be seen. Therefore, we believe that the risk of a credit crisis leading to a recession is a strong possibility, and we remain cautious in our outlook for the global economy and capital markets. Resolution of the US debt ceiling dispute and regional banking fallout helped avoid a potential crisis that could have sent the US into recession; however, the response to these events is likely to tighten liquidity in the second half of the year. Low unemployment has helped support consumer demand, which has been positive for earnings but will likely elongate the battle to tame inflation. Ultimately, the outlook for the economy will be determined by the magnitude and duration of restrictive monetary policy as central banks continue to battle high inflation. Unprecedented money growth, deglobalization, the green energy transition, and a tight labor market spurring robust wage growth are just a few reasons why we believe inflation will remain sticky. Central banks' battle with inflation appears far from over and we anticipate higher interest rate policies will remain for longer than markets are expecting. Restrictive monetary policy should continue to work its way through the system creating an environment that we believe will be challenging for both the economy and markets in the second half of the year.

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