May Investment Outlook 2023

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Current Market Conditions

Markets Were Relatively Quiet in April

Stock markets were relatively quiet in April, with the S&P 500 up 1.6%, small cap U.S. stocks declining -1.8%, international developed markets rising 2.9%, and emerging markets falling -1.1%. Year-to-date returns remained relatively solid through the end of April, with the S&P 500 up 9.2%, small cap U.S. stocks up 0.9%, international developed markets up 11.8%, and emerging markets up 2.9%. The sizable divergence between large and small U.S. stocks this year is due to the outperformance of large technology companies like Microsoft, Apple, and Nvidia, and the outperformance of larger banks relative to their smaller regional peers.

Interest rates and bond yields remained stable in April, with the ten-year U.S. Treasury Note ending the month with a 3.4% yield to maturity and the two-year U.S. Treasury Note ending the month at 4.0%. Fixed income returns remained relatively flat as a result, with the broad measure of fixed income returns up 0.6% for April.

Interest Rates May Have Peaked Which Could Be a Tailwind to Capital Markets

We believe that an inflection point in the economic and capital markets cycle may occur. Between March of 2022 and May of 2023, the Federal Reserve (Fed) increased interest rates from 0% to 5.25% to tamp down runaway inflation. As a result of this action, inflation has begun to decline to more acceptable levels and towards the Fed's target of 2%. The Fed has made it clear that while inflation has started to come down and should continue to decline, it is still above its target. The Fed's recent statement indicated that it will not rule out further rate increases, though it has signaled that future interest rate increases are less likely going forward.

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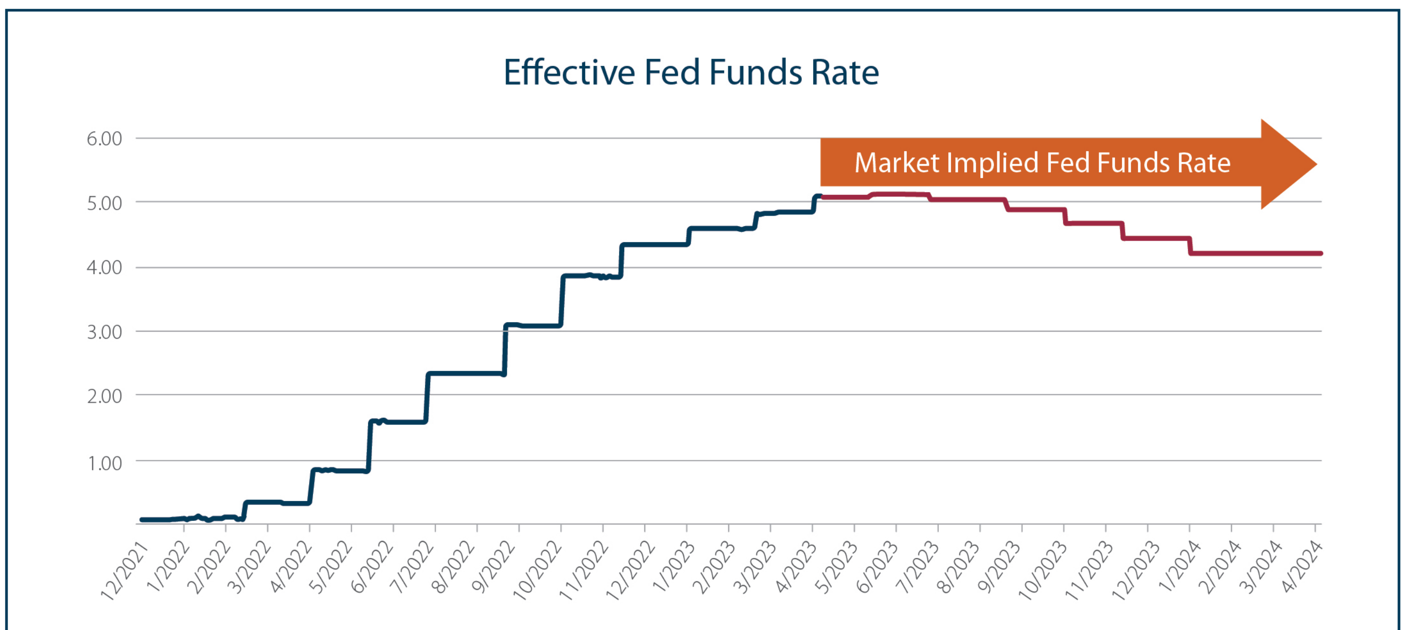
The chart below shows just how rapidly the Fed increased interest rates over the last year, and it also shows how the market is pricing in a modest decline in Federal Funds (Fed Funds) interest rates later this year. It is important to note that the Fed itself has not signaled a rate cut, though the market is pricing one in the second half of the year.

The trajectory of Fed Funds interest rates is important because over the last year or so it has strongly influenced capital markets returns. In periods of time when interest rates rose more rapidly than expected, returns on equities suffered. On the other hand, when rate fears subsided, equity markets performed better. Between January of 2022 and October of 2022, the markets consistently underestimated how much the Fed would need to increase interest rates to maintain its inflation target. As it became more apparent how aggressive the Fed would need to be, markets came under significant pressure, and the S&P 500 declined by approximately -22%. Since October of 2022, a better line of sight to the end of rate increases emerged, and the market rallied approximately 13%.

More predictability on the path of the Fed Funds rate is important, but another factor to consider is how the markets perform after the Fed stops increasing interest rates. As we can see in the chart on the next page, on average the markets perform well in the year after the Fed stops increasing interest rates. Our view is that rates have likely peaked for this cycle, which should be constructive for equity market returns.



Source: Bloomberg

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Fed Funds Hike Start	Fed Funds Hike End	S&P 500 Returns One Year Later
12/17/2015	12/20/2018	33%
6/30/2004	6/29/2006	20%
6/30/1999	5/16/2000	-11%
2/4/1994	2/1/1995	39%
Average		***20%***

Source: Bloomberg, https://www.federalreserve.gov/monetarypolicy/openmarket.htm

We are also entering the year before a U.S. presidential election, which historically has been positive for stock market returns, as shown in the chart below. The theory behind why this occurs is that the last year or two of a presidential election cycle is the time when generally more favorable policies are adopted, due to the upcoming vote.

	1971	1975	1979	1983	1987	1991	1995	1999	2003	2007	2011	2015	2019	Average
Pre-Election Year S&P 500 Returns	14.3%	37.2%	18.6%	22.6%	5.3%	30.4%	37.6%	21.0%	28.7%	5.6%	2.1%	1.4%	31.5%	**19.7%**

Source: Bloomberg

Economic Activity Relatively Soft, But Starting to Normalize and Become More Predictable

While there is ample evidence to suggest capital markets should do well when the Fed stops hiking rates, and that the year before an election is generally good for capital markets, one cannot ignore macroeconomic factors. There is significant debate as to whether the U.S. will enter a recession over the next year. The consensus view is that there will be some kind of recession or slowdown, although if one does occur, it is expected to be relatively mild.

As shown in the chart on the next page, Gross Domestic Product (GDP) growth is expected to continue to slow over the next couple of years but remain positive. Corporate profits have declined, and companies continue to cut costs and lay off employees in response to the weaker environment, but recent earnings reports have surprised on the upside. The regional banking crisis was a significant event, though regulators reassured depositors to stem the damage from spreading beyond a handful of banks. Inflation is expected to continue to slow down significantly from peak levels, which is quite important to the longer-term health of the U.S. economy. The employment picture remains very strong. The unemployment rate is near record low levels, but even if the current levels are not sustainable and employment weakens, it should still be "good enough."

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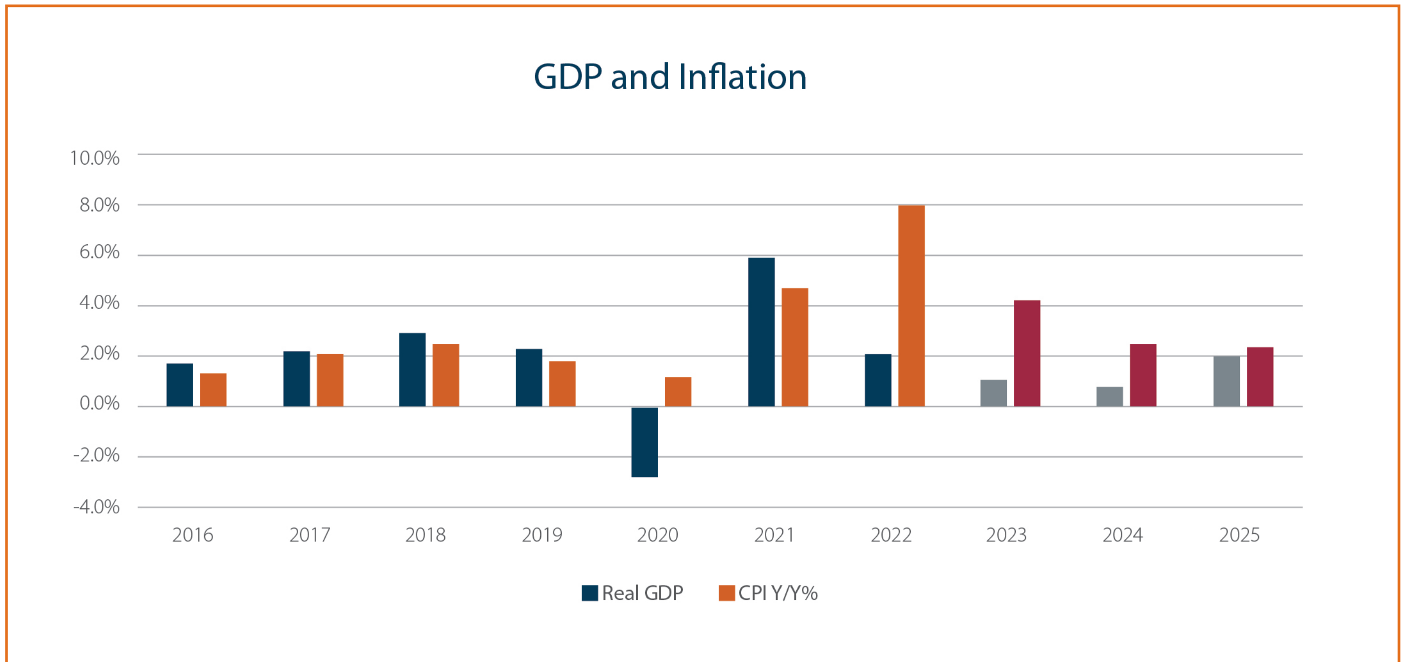

Source: Bloomberg

Investment Strategy and Approach

Overall, economic signals are mixed but generally weaker than longer term averages. Importantly though, there are signs of increasing stability and predictability in the data, which is critical for longer-term market sentiment. This may indicate that we are in the early stages of a bottoming process which will set the stage for a longer-term economic recovery, though volatility in capital markets is likely to remain for the near term. Given these considerations, we are not engaging in any significant strategic changes to our investment policy, though we continue to take advantage of market dislocations to add new managers and securities and improve the quality of our portfolios.

What We Are Watching

For some time now we have discussed how inflation and Fed actions to control it are key factors we are watching. While they remain of great importance, inflation has cooled significantly, and the Fed has signaled that they are likely to pause their rate increase program. We continue to monitor this area closely since, if inflation ignites again, it will have a deleterious impact on market sentiment and capital markets returns.

The flare up of the regional bank crisis in the U.S. was an unexpected shock to the market, but for the time being it seems to have stabilized. Credit Suisse, a massive global financial institution, also failed and

needed to be rescued by UBS. Despite these worrisome failures, the banking system has remained relatively stable and intact. Nevertheless, these events are concerning as the capital markets are very susceptible to instability in the banking system. Bank lending is also a key element for economic growth, so the health of the banking system remains an area of potentially significant risk that we are carefully monitoring.

The upcoming debt ceiling battle in Congress is a significant risk factor that bears close watching. While we believe cooler heads will prevail and work out a plan to avert a crisis, it is an acute area of concern as political wrangling could create serious fiscal problems and disarray in financial markets. Beyond the debt ceiling battle, there is no shortage of geopolitical tensions which could flare up at a moment's notice and create volatility in the capital markets. Finally, debate continues over the U.S. dollar's status as a "reserve currency," and while we do not believe there is an imminent challenge, longer term it will be a critical component to watch.

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