

Equity market recap

SECOND QUARTER 2023

Notable themes

- **Not out of the monetary woods yet** – despite the Fed leaving policy rates unchanged at its last meeting, their rhetoric remains sharply hawkish and cautionary. This has been further reinforced by even more aggressive hikes in the UK, and a resumption of tightening in Canada.
- **Market breadth in the US is strikingly narrow** – prominent “mega cap” stocks have accounted for much of the S&P 500’s year-to-date gains driven by the common theme of their involvement (or aspirations) in “Artificial intelligence”. Conversely, interest rate and commodity-sensitive sectors have lagged.
- **Reshoring bearing fruit** – emerging countries in Latin America and Southeast Asia are garnering improving investor sentiment. Japan has become an early winner in the deglobalization of supply chains, while also making strong progress on governance and capital allocation.

Equity markets continued their 2023 ascent in the second quarter but not without skepticism as global Central Banks took center stage and broadly struck a more hawkish and cautionary tone surrounding inflation and monetary policy outlooks. Previous gains had been attributable to optimism about a “pivot” to more dovish monetary policy, but latest meetings painted a different picture.

For the first time since March 2022, the Federal Reserve (Fed) chose not to raise policy rates, instead keeping the benchmark rate at 5.00%-5.25%. However, the Fed still managed to deliver a hawkish message to markets. The latest dot plot shows a peak Fed funds rate of 5.6% this year, equivalent to two more 25 basis point (bps) hikes. However, Fed Chair Jerome Powell emphasized that, while the committee thinks it will be appropriate to raise rates further, considering how far and fast rates have already moved, it would be prudent to slow the pace of hiking.

The Bank of Canada resumed rate hikes following a period of pause while the Bank of England was even more aggressive with a 50bps hike with expectations for 25bps due to inflation running well above trend. Within the U.K., May inflation came in at 8.7% though expectations were for 8.4% led by food prices with its inflation reading standing at a staggering 18.3%. Core inflation (ex. food, energy) was +7.1%. Just a month ago rates were expected to peak at 4.75-5%. Now the expectation is for a peak of 6% in April 2024.

The European Central Bank (ECB) again raised its three key policy rates by 25 bps—the second occasion it has hiked by such an increment in a row. The ECB acknowledged that inflation is projected to remain high for the time being. With inflation projected to be still above the ECB’s 2% target at the end of their forecast period, a further rate hike will likely still be required at, and perhaps beyond, the

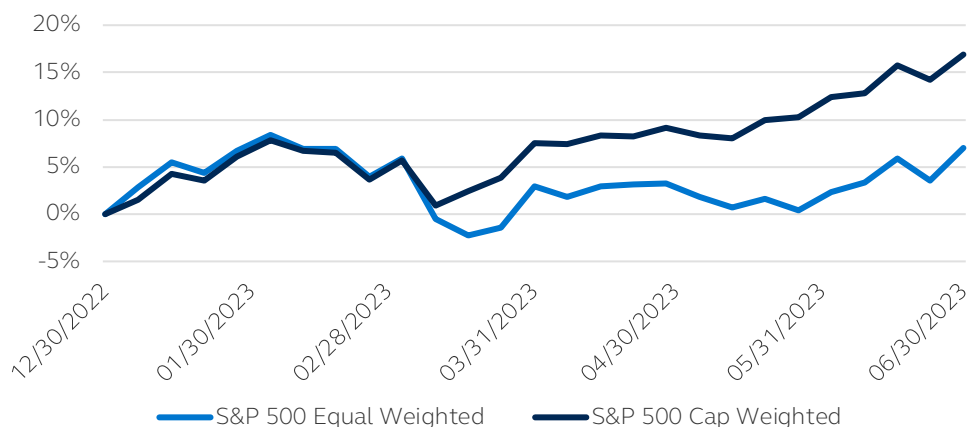
next policy meeting on July 27. The rate move now accumulates to 400 bps of rate hikes since July 2022.

Despite hawkish rhetoric and policy adjustments from the Central Banks, equity markets remained steadfast on building upon 2023 equity gains.

Global yields moved higher in sympathy with monetary adjustments. The United States 10-Year Treasury Yield opened the period at 3.36% and advanced throughout the quarter closing just above 3.8%. European yields largely moved in lockstep with their U.S. peers led by a nearly 100bps rise in the U.K. Gilt. The rise was a catalyst to the financials sector on prospects of better net interest income though a lack luster growth outlook capped further gains. Despite rate headwinds, the consumer discretionary sector was a top performer though performance varied dependent upon the region. A healthy housing market and brand recognition drove many of the winners in the Americas and Europe. Diverging consumer performance was witnessed within emerging markets, which posted negative returns, hindered by less fiscal stimulus during the pandemic and more conscientious spending as inflation remains elevated. Defensive and more yield-oriented areas of utilities and staples did lag overall amid still tightening conditions.

Artificial Intelligence (A.I.) commentary and popularity took to the headlines as Alphabet gave an update and outlook on the technology that surpassed investor expectations. Alphabet stock jumped more than 10% on the announcement ending the quarter up by more than 15%. Soon to follow was a strong week of earnings results, led by NVIDIA. The highlight of NVIDIA's results was Q2 revenue guidance came in 53% ahead of expectations and implied EPS ~90% ahead due to accelerated computing and generative A.I. This led to an almost 30% advancement in NVIDIA's share price following while pushing all companies intertwined in the A.I. ecosystem higher. Tangible evidence is being made by individual companies that the investment remains structural, and more companies will position themselves to benefit. As the quarter closed, the IT sector, based upon the MSCI ACWI Index, rose by almost 14% but fails to tell the whole story. Prominent "mega cap" U.S. companies carried much of the weight as NVIDIA closed higher by more than 50%, while both Microsoft and Apple were higher by 18%. Amazon and Tesla were entrenched in the gains as well with both posting returns of 26%.

Market breadth in the U.S. is strikingly narrow



As of 30 June 2023. Sources: FactSet, S&P

High-profile announcements of plans to increase the production of semiconductors in the U.S., Europe and Japan have begun to get announced. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China. Japan has become an early winner in the deglobalization of supply chains with further upside coming from the increased attention surrounding Artificial Intelligence. The Nikkei hit a 33-year high in the quarter. Further “green shoots” and a broadening of opportunities in Europe, Latin America and South-East Asia are also being witnessed.

On the other hand, the much-anticipated China reopening has disappointed to the downside, and local institutions have been “encouraged” to favor buying stocks of State-Owned Enterprises (SOEs) over private enterprises, another discouraging sign for foreign investors.

As global growth shows further signs of weakening, the commodity price complex has fallen in sympathy. Oil prices of West Texas Intermediate (WTI) and Brent have been on a notable downward trend. After peaking above \$120/bbl. in June of 2022, prices have almost halved hovering around \$70/bbl. as seen by WTI and Brent. The commodity is not alone as copper and other industrial commodity prices have deteriorated year-to-date as supply has overwhelmed demand prospects. Concerns remain for demand risk, in particular in China, as residential construction slows. Energy and materials landed towards the bottom of the sectoral tables posting flat returns.

With hopes of a “shallow recession” and better than expected earnings on the horizon, equity markets proved to be resilient. The MSCI All Country World Index posted a 6.4% gross total return for the quarter taking its year-to-date gains to 14.3%. This was comparable to the S&P 500’s quarterly gain of 8.7% and first half total returns of 16.9%. Style return dispersion was quite stark in the United States highlighted by the Russell 1000 Growth outperforming its Value Index peer by more than 8% in quarter and almost 24% for 2023 amid the flight to the “mega cap” stocks driven by the common theme of their involvement (or aspirations) in Artificial intelligence. MSCI Emerging Market Index lagged global peers moving higher by a meager 1.0% and 5.0% for 1H23. The re-shoring areas of Mexico and India helped to keep the returns in the green as China closed down by almost 10% in the quarter capping any gains. MSCI EAFE posted a gain of 3.2% led by strength in Japan. Unsurprisingly, smaller companies lagged their large counterparts globally but still managed to post a gain of 5.2% in the second quarter as evidenced by the Russell 2000.

The accompanying table summarizes regional and global sector aggregate performance on a USD basis, gross of cross-border tax withholding.

	3 months	YTD	12 months
MSCI World Index	7.00%	15.43%	19.13%
North America	8.50%	16.72%	19.00%
Europe	3.13%	14.21%	22.60%
Pacific	3.53%	8.54%	14.02%
MSCI Emerging Markets Index	1.04%	5.10%	2.22%
China	-9.71%	-5.46%	-16.82%
Asia Ex China	5.52%	10.67%	11.89%
Latin America	14.04%	18.52%	29.84%
EEMEA	2.74%	1.64%	1.79%
MSCI All Country World Index	6.35%	14.26%	17.13%
Communication Services	7.14%	25.61%	10.85%
Consumer Discretionary	8.36%	23.82%	19.66%
Consumer Staples	0.56%	4.07%	8.32%
Energy	1.05%	-1.84%	14.39%
Financials	5.45%	4.06%	12.28%
Health Care	2.38%	0.80%	6.21%
Industrials	6.49%	13.83%	25.88%
Materials	-0.66%	4.73%	12.67%
Real Estate	0.10%	0.82%	-6.05%
Technology	13.77%	37.11%	34.70%
Utilities	0.21%	-0.27%	1.60%

Sources: MSCI, Standard and Poor's in USD. As of 30 June 2023.

Looking ahead

Much of the equity market recovery from the October 2021 lows has been attributable to optimism about a “pivot” to more dovish monetary policy. Despite the Fed leaving policy rates unchanged at its last meeting, their rhetoric remains sharply hawkish and cautionary. This has been further reinforced by even more aggressive hikes in the UK, and a resumption of tightening in Canada. We are not out of the woods yet. Attaining pricing stability through further tightening of financial conditions remains key but that tightening does not necessarily need to come from Fed rate hikes, and instead, could come from credit conditions as banks tighten lending standards. Even with a renewed hawkish path in the near-term, we believe the worst is behind us and several positive factors, supportive of equities, remain in place, noted below:

- Decelerating inflation, albeit still elevated
- Final innings of rate hikes
- Improving supply chains
- Peak U.S. dollar
- Supportive valuations

These all contributed to healthy gains in the first half of the year with expectations for further opportunities ahead though there will be bumps along the way.

The second quarter concluded with inflation trending favorably in many parts of the world though still stubbornly high in pockets of the world. The Fed's primary inflation gauge, personal consumption expenditures price index, rose less than expected in May at 4.6%. This was helped by softer food and energy components. Euro Zone inflation data also fell more than expected at 5.5% with hope that ECB tightening is beginning to bear fruit. More will be needed in other parts of the world including the United Kingdom where the latest food inflation reading came in at a staggering 18%. The fight for pricing stability is far from over but the trend remains positive for most, and the expectation is for less central bank intervention ahead.

Over the long-term, inflation is going to be pushed higher by near-shoring initiatives. The war in Ukraine and escalating geopolitics elsewhere has many countries reassessing their supply chains and trading partners. Investments are ratcheting up for more domesticated production, semis, food, and energy, while aligning with trusted countries. This will also drive long-term structural change opportunities.

We believe we are in the midst of a generational change in global trade flows, as the West reduces its reliance on China and Russia. The U.S., Japan, and Europe should all experience expanding manufacturing bases. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to global companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China. Japan has become an early winner in the deglobalization of supply chains with further upside coming from the increased attention surrounding Artificial Intelligence.

Over the past decade, Japanese companies have made great strides in corporate governance and capital allocation. Former Prime Minister Shinzo Abe's push in 2012-13 to improve capital allocation in the corporate sector has had a lasting impact, driving more long-term, value-enhancing decisions by Japanese companies.

Continued progress on these fronts is primed to release shareholder value in the coming years. As companies focus on strengths and improve balance sheet efficiency, return on assets (ROA) will likely continue to improve given the tailwinds of reshoring and improving governance. Recent conversations with Japanese companies indicate a greater willingness to use strong balance sheets for modest share buybacks. In fact, they seem more attuned to the greater value accretion of counter-cyclical share buybacks (buying when shares are depressed) than U.S. companies—which tend to use traditional rolling buyback programs that don't emphasize buying for value. The early innings of this is coming to fruition in 2023 following years of engagement.

Artificial Intelligence is here to stay but following a significant valuation re-rating for many known to be "intertwined" in the opportunity, earnings growth will remain the key over the long run. As the technology improves and additional features / functionalities are developed, generative A.I. will be embedded across wide swaths of the economy. The total addressable market remains very large domestically and internationally with sizable monetization potential. Generative A.I. is highly compute-intensive from both an algorithm training and content creation perspective. This level of data creation necessitates the need for significantly more GPUs relative to other compute / training workloads. The long-term structural change remains relevant, but key will be picking the winners from the losers as so many have significant aspirations.

We are not out of the monetary woods yet. Importantly, the headline double-digit returns for the S&P 500 year-to-date masks much more anemic market conditions under the surface. This warrants a

degree of caution among equity investors in the near term, but also has created numerous and intriguing relative value and rebalancing opportunities across the capitalization spectrum, sectors and regions.

We appreciate your partnership and look forward to working with you in the year ahead.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility.

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MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI World Index is available upon request.

MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI Emerging Markets Index is available upon request.

MSCI AC World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI AC World NTR Index consists of developed and emerging market country indices and covers approximately 85% of the global investable equity opportunity set. Information regarding the comparison to the MSCI AC World Index is available upon request.

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