

Economic and Market Outlook – Second Quarter 2023

Soft landing? Hard landing? No landing?

Last quarter we noted multiple signs of financial stress, including multiple significant bank failures and the forthcoming negotiations on the U.S. Federal debt ceiling. While fears of broad-based bank instability have receded, and Congress managed to avoid the debt ceiling, the world still faces multiple risks, and those risks still skew to the downside. The war between Ukraine and Russia rages on, including the escalated use of cluster munitions. A revolt and march on Moscow by the mercenary Wagner group, which has been on the front lines for much of the combat with Ukrainian forces, likely escalates the complexity and danger spawned by this war. China continues to rattle sabers at Taiwan; tensions continue between the U.S. and China, with escalating tit-for-tat trade restrictions. OPEC+ cuts in production have been unable to lift the price for West Texas Intermediate oil above \$75, indicating slowing worldwide economic activity. The Central Bank tightening cycle continues, as Central Banks face higher than desired inflation rates and, as yet, little effect on labor markets. The immediate risk of financial contagion from regional bank failures or a U.S. Treasury default has faded, and the economy appears to be fairly resilient.

During the quarter, labor market, housing, and personal income and spending data continued to be soft, but slightly better than expected. Consumer spending is slowing; consumers have largely spent the excess savings from Covid-related relief programs, are beginning to increase their savings rate, and will be facing the resumption of student loan payments in August. Headline inflation slowed modestly, primarily due to declining energy prices, but core inflation readings showed no clear trend persisting at a 5.2% annualized rate for the last 4 months. Super core inflation, which is core services minus housing inflation, has been persistently elevated running at a 4.4% annualized rate for the year-to-date. This stronger-than-expected economic data, combined with diminishing concerns about an imminent collapse of the regional banking system and an intermediate-term suspension of the U.S. debt ceiling, appeared to strengthen the Federal Reserve's (the Fed) hawkish resolve resulting in repeated messages from the Fed that inflation was not yet sufficiently subdued. In response, investors marked down their expectation of an imminent economic meltdown and upwardly revised the estimated terminal Federal Funds rate, from 5.0% on March 31, to 5.1% on April 30, 5.3% on May 31, and 5.4% on June 30.¹

Icebergs Ahead

"The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought," (Rudiger Dornbusch, economist, interviewed on the PBS show Frontline, April 8, 1997). We agree. While the U.S. economy has thus far been resilient, we note that icebergs lurk mostly underwater. We continue to see many risks, with a wide dispersion of potential outcomes. Last quarter we anticipated deteriorating profits, rising unemployment, more volatile asset markets, and recession risks rising across the developed world as already tightened monetary policy takes hold. Forward earnings for S&P 500 sectors have declined from their peaks over the past year by 8% for Industrials, Communication Services, and Information Technology; 12% for Health Care, 15% for Real Estate, and 18% for Financial Services. Company managements are guiding earnings outlooks lower, while also indicating that lower-income consumers are showing signs of stress. Unemployment remains at very low

¹ Source: Bloomberg World Interest Rate Probabilities function as of 6/30/23

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levels, but both new unemployment claims and continuing unemployment claims have begun to rise, and the Job Openings and Labor Turnover Survey (JOLTS) shows job openings are down 18% since March of 2022, a signal that typically precedes a recession. Once recessions begin, the unemployment rate typically jumps sharply. The Institute for Supply Management (ISM) Purchasing Managers Index Manufacturing series show that Manufacturing Employment, New Orders, and Prices Paid are all in contractionary territory. The ISM Services Indexes are still in expansionary territory indicating that spending on services is supporting the economy. Commercial real estate, particularly for downtown office buildings, will likely come under increasing stress as office leases negotiated before the start of Covid come up for renewal in the next few years; companies have been negotiating for better amenities and smaller space, leaving even Class A space vulnerable if it is of an older vintage. Further support for our view that recession is near comes from The Conference Board's surveys of year-over-year leading and coincident economic indicators, which are now at or below the levels consistent with every U.S. recession since 1970.

Second Quarter Performance

Strong U.S. equity returns were generated by a very narrow market, focused on mega-capitalization Information Technology, Consumer Discretionary, and Communications Services companies that arguably would benefit from enhanced generative Artificial Intelligence (AI). The top ten companies, including two classes of the Google parent Alphabet's stock, accounted for 6.59% in return for the quarter, or 75% of the 8.74% return for the S&P 500; the top 25 companies accounted for 7.87%, or 90% of the S&P 500 Index return. Growth outperformed Value, with the Russell 3000 Growth Index returning 12.47% and the Russell 3000 Value Index returning 4.03% in the quarter. Nine of the eleven S&P 500 sector indices rose, led by Information Technology (+17.20%), Consumer Discretionary (+14.58%), and Communication Services (+13.07%), with eight of the top ten companies in these three sectors. Consistent with a "higher for longer" interest rate scenario, the Utilities sector returned -2.53%, while the Energy sector dropped by -0.89%. Other S&P 500 sectors ranged between a 0.45% return for Consumer Staples and a 6.49% return for Industrials. Large capitalization stocks did better than smaller, with the S&P Small Cap Index gaining 3.38% and the S&P Mid Cap index returning 4.85%. The MSCI ACWI Net and the MSCI World Net gained 6.18% and

6.83%, respectively. The 2-Year Treasury Note increased by 0.87% to 4.90%; the 10-Year Treasury yield increased by 27 bps to 3.84% at quarter end. The U.S. Government/Credit Intermediate Index returned -0.81%, while the Bloomberg Intermediate 1-10 Year Municipal Bond Index lost -0.53%.

Valuation and Positioning

The strong rally brought the S&P 500 forward P/E ratio up to 19.13 times, and above its 25-year average of 16.79 times, and the cyclically adjusted price-to-earnings ratio (CAPE) to 30.79 times, 0.47 standard deviations above its 25-year average of 27.81.² The earnings yield of the S&P 500 decreased to 5.23% during the quarter, while 10-Year Treasury Inflation-Protected Security yields increased to 1.62%. This suggests that stocks will return about 3.6% more than bonds over the next year, down from last quarter's reading of 4.1%, although the range of possible outcomes remains quite high.

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We continue to favor stocks over bonds as a strategic allocation. We acknowledge that bonds can provide a diversification benefit to portfolio construction. We also recognize that stocks may have considerable additional risk over the immediate horizon. Nonetheless, the rapid recoveries of equity markets at the end of bear markets suggests caution in reducing equity holdings, and the earnings growth capabilities of stocks are expected to ultimately support their valuation in both inflationary and deflationary environments. We prefer to position for equity market downside by adjusting portfolio composition to reflect our cautious stance rather than moving below an appropriate strategic allocation.

² Source: JPMorgan 'Guide to the Markets' as of 9/30/22

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As declining unit growth squeezes corporate profit margins, layoffs are likely to rise further. As unemployment begins to rise, consumer income will decline, leading to declining business and consumer confidence and additional market downside, via reduced corporate earnings. Our research suggests a potential decline in S&P 500 earnings in the range of an additional 15% to 20%, potentially unfolding by June 2024. The rally since October 2022 has stretched valuations from a forward 12-month price/earnings ratio of 15.2 to 19.1 at the end of June 2023.

We anticipate not only retracement of this increase in valuation, but additional price-to-earnings compression; prior bear markets have resulted in trough forward price-to-earnings ratios between 10 and 14. In this historical context, the worst-case scenario, a 20% downside in earnings coupled with a trough price-to-earnings ratio of 14, would imply potential downside of 41% from current levels. We anticipate a less dramatic outcome, but stress that both the size of the decline and the timing are uncertain. The decline in earnings and valuation may happen quickly, or it may be drawn out over several quarters. It is also possible that either earnings or valuation may not fall as far, which would limit the downside. Recovery from bear markets is generally sudden and sharp, so that attempts to time the market are usually unsuccessful. Overall, we believe that our domestically oriented equity strategies have been making active portfolio construction decisions to be appropriately positioned for a more risk-off equity market. In these strategies, for either a slowing growth or a recessionary environment, we expect that our focus on quality, lower-leverage, profitable companies with steadier earnings and revenues will be protective of portfolio value.

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We continue to avoid positioning for extremes and acknowledge that a likely recession, combined with high uncertainty about the exact course of that recession, means an increased likelihood of rapid rotation, particularly as investors lean heavily on small changes in weekly and monthly data releases. In such an environment, thoughtful analysis of company management, strategies, and prospects assumes added importance. We remain committed to our long-term focus and investment in high-quality and sustainability-centered companies seeking to meet the challenges of this year of recovery and transition, and beyond. We continue to seek out companies that acknowledge the ongoing climate crisis and which are setting their own targets for greenhouse reduction. This is becoming ever more important; June 2023 was the hottest June on record, with average temperatures more than 2.5 degrees Fahrenheit over June temperatures in the late 1800s.³

Where to from here?

We are in challenging times, as the Supreme Court hacks away at the political and social compact of the past 50 years; chipping away at the Voting Rights Act, limiting the ability of the Environmental Protection Agency to regulate air and water pollution, limiting reproductive freedom, and severely constraining colleges' available policies to increase campus diversity and inclusion. Even as the Biden administration pursues environmentally and socially supportive social and industrial policies such as student loan debt relief and the Inflation Reduction Act, the Supreme Court's ongoing destructive agenda will likely lead companies to de-emphasize or dismantle programs aimed at improving environmental, social, diversity, equity, and inclusion outcomes. We believe longer term that companies will be rewarded for the quality and integrity of their management, and by management's attention to evolving social and environmental considerations. We seek companies with business models that emphasize resilience across a range of possible scenarios, rather than ones that seek to maximize profit in a single best-case scenario. We expect companies held within our portfolios to act with integrity and purpose, and to take leading roles in creating alternative mechanisms, through legislation or internal policies, to protect the needs and concerns of their employees, communities, and planet.

³ Source: NPR.org 'This week has had several days of the hottest temperatures on record,' as of 7/6/23



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