GW&K INVESTMENT MANAGEMENT

INVESTMENT REVIEW
2Q 2023

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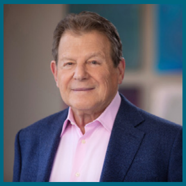
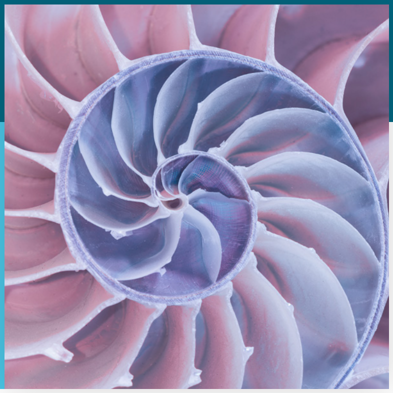
ECONOMIC COMMENTARY



BY HAROLD G. KOTLER, CFA

Founder-Chairman, Chief Investment Officer



Why are stock market indices hitting new highs? Most investors don't understand that the world is made up of two powerful forces: government/government policy and business/capitalism. Many would argue that the two forces are connected at the hip and as one goes, so goes the other.

I would argue that assumption is false and causes miscalculations. Both exert important influences from time to time, however, I believe that the government's influence on the private sector is cyclical and should be discounted.

One can say that the Federal Reserve's policy of increasing (or, for that matter, decreasing) short-term interest rates was critical to the economy. Looking at the immediate past, that would be correct, but over the longer term, the result is more muted. For example, very low or zero borrowing costs caused poorly managed businesses to get caught in a credit squeeze when rates were finally increased. Banks that forgot how to manage their balance sheets lost their business. Speculation, when rates were zero, collapsed when rates began to normalize. The Covid-era psychology of free money is not tenable in a normal business environment. All these and much more are short-term cyclical factors that are irrelevant to the long-term nature of the economy.

It has been three years since the stock market turned positive, which occurred only three months into the Covid era. Three months! No vaccine, total fear, lockdown — and in three months the market turned positive. Three years later, the S&P and DJIA are within sight of new all-time highs. Yet, we still face all this uncertainty — the war in Ukraine sadly continuing, inflation still too high for the Fed, and a political environment fraught with uncertainty with the presidential election just a year and a half away. Exacerbating all that, the mutual distrust with our major trading partner, China, has led to dangerous posturing on both sides over the status of Taiwan.

> *"The world markets are healing, changing, and definitely growing. Five years from now, it will be easy to look back and see why market values are hitting all-time highs."*

All of this could make a sane person crazy. How can one invest not knowing if the Fed's tightening policies are behind us, not knowing what will occur geopolitically and domestically? Where does one find the faith to invest? Well, if you don't invest you will miss the next bull market. The market turned bullish last fall — not all areas, but nothing happens in unison. However, it has turned. Why? Inflation has peaked. No, we don't know how low it will finally go, but that is just a number. The key point is — it has peaked. Long-term interest rates have peaked as the bond market discounted the next 10 years, while corporate earnings are on a temporary hiatus as markets are recovering from shortages, delays, inventory adjustments, and new buying habits.

Continued on next page

The biggest mistake in investing is poor timing, but the key to investing is directionality. The world markets are healing, changing, and definitely growing. Five years from now, it will be easy to look back and see why market values are hitting all-time highs. It's less easy to see in the moment. Faith in capitalism is crucial to investing. If you doubt it, then keep your money under the mattress; other than that, don't worry about the volatility or the political uncertainty.

Nothing you hear on the news or talk shows will give you the confidence to invest. But it is your money, not theirs (and do we really know what they do with their money?). Most "insight" is mere showmanship and unfortunately, negativity and fear often drive ratings.

There will be a million reasons to stay on the sidelines of investing and only one reason to invest — it's that simple.

Businesses around the world adjust to the political winds as capitalism freely changes and adapts. Good managers are not stuck. They're the ones that find solutions to problems. Like Moderna and Pfizer with their Covid vaccines that were in production a mere six months after Covid hit, good managers and entrepreneurs are able to keep fear out of the way of solving problems. Capitalism is freedom at its best and although government can sometimes make life difficult for business, it is businesses that are required to find solutions, and not to put their heads in the sand.

Take a deep breath and enjoy the next bull cycle.

Harold G. Kotler, CFA
Founder-Chairman, Chief Investment Officer

GW&K NEWS

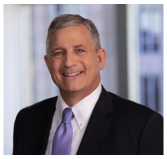
A MESSAGE FROM OUR CO-CEOS

As we wrap up our first year as co-CEOs, we wanted to take a moment to reflect on where GW&K's been and where we see the firm moving. Although we had worked together as co-presidents since 2006, we stepped into the co-CEO roles during a turbulent time for the markets and the world at large.

Yet, despite the challenges of the past 12 months, those who predicted light at the end of the tunnel in 2023 have been more right than wrong. The markets have improved, inflation is slowing, and the CDC declared an end to the Covid-19 public health emergency. Throughout it all, innovation and our client-centric approach have remained in sharp focus. We see endless potential for the firm and are energized and excited about its future.

We're confident that GW&K is well-positioned for future growth, and we're excited to see what the second half of the year and beyond brings in terms of new opportunities and new client relationships. Please visit our website under Our Firm/About Us to read our full comments.

Tom Powers & Bill Roberts



Thomas F.X. Powers
Partner, Co-CEO

T. Williams Roberts III
Partner, Co-CEO

60 INVESTMENT PROFESSIONALS

184 EMPLOYEES

$49 BILLION TOTAL ASSETS UNDER MANAGEMENT

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SECOND QUARTER 2023

ECONOMY

- The economy has been surprisingly resilient in the first half of 2023, with the Atlanta Fed estimating Q2 GDP growth of 1.9% following 2.0% for Q1.
- Recent banking strains have so far not created a noticeable credit crunch, and housing demand has remained solid despite relatively high mortgage rates.
- The Fed's favored measure of core inflation posted a 3-month annualized increase of 4.1% in May. That is down from 6.7% in mid-2021, but remains well above its 2% target.
- Most economists continue to forecast a mild contraction in GDP for the second half of this year based on the cumulative effects of aggressive Fed tightening since early 2022.

FED ACTION

- The FOMC raised rates for the 10th consecutive time in May, but paused in June. Officials now forecast two additional rate hikes for 2023.
- The Fed's median interest rate forecast for the end of this year was raised to 5.6% from 5.1% and was accompanied by upward revisions to its GDP and inflation projections.
- Market participants have also factored in a "higher for longer" interest rate path, with futures markets seeing the federal funds rate peaking at 5.4% in Q4 of 2023.
- Both the Fed and market participants anticipate monetary easing in 2024, with the Fed projecting a 2024 year-end funds rate of 4.6%, versus 4.2% for the futures markets.

BOND MARKETS

- Fixed income posted a small loss in Q2, giving back a portion of the banking crisis-inspired rally that occurred at the end of Q1. Sentiment was cautious at the outset, but as it became clear the failure of several regional lenders was likely to be contained, attention returned to the underlying strength of the economy and the stubborn persistence of inflation.
- Treasury rates shifted higher with stress in the banking sector receding and risk aversion dissipating.
- Corporates continued to signal a benign outlook for financial stability. Spreads in investment grade and high yield were tighter and substantially inside of wider spreads reached earlier this year.
- Municipal bonds posted modest losses in Q2, following the lead of the Treasury market, but outperforming the broader market thanks mostly to a strong technical environment in June.

DOMESTIC EQUITY MARKETS

- US equity markets advanced in Q2, with a narrow group of mega-cap Technology stocks pushing the market higher. While recession concerns remained elevated, moderating inflation, AI enthusiasm, May's debt ceiling resolution, still strong labor market readings, and resilient corporate earnings results increased prospects for a soft landing.
- Large cap stocks, as measured by the S&P 500, rose 8.7% and outpaced small and mid-cap stocks. The tech-heavy NASDAQ composite bested the S&P 500 gaining 13.1%.
- Information Technology, Consumer Discretionary, and Communication Services were the best performing sectors within the large cap market, while Utilities and Energy generated negative returns.
- Growth outpaced Value in the quarter, extending its year-to-date leadership. Investors also demonstrated a preference for low-quality factors.

INDEX PERFORMANCE — 6/30/23

	QUARTER	YEAR TO DATE
Bloomberg 10-Year Municipal Bond Index	-0.59%	2.16%
Bloomberg Aggregate Bond Index	-0.84%	2.09%
Bloomberg High Yield Index	1.75%	5.38%
Dow Jones Industrial Average	3.97%	4.94%
S&P 500 Index	8.74%	16.89%
Russell 2000 Index	5.21%	8.09%
MSCI EAFE Index	2.95%	11.67%
MSCI World Small Cap ex USA Index	0.49%	5.50%
MSCI World Index	3.22%	7.64%
MSCI Emerging Markets Index	0.90%	4.89%

GLOBAL EQUITY MARKETS

- Amid volatility non-US developed markets (DM) ended Q2 higher, with large caps in the lead. The MSCI World ex USA Index gained 3.0%, while the MSCI World Small Cap ex USA Index rose 0.5%.
- Large cap strength was partly due to Japan, where larger companies benefited from substantial investment flows, driving the TOPIX Index close to a 33-year high.
- Decelerating growth in China detracted from strong returns in several other emerging markets (EM). The MSCI Emerging Markets Index posted a modest 0.9% return, yet the MSCI Emerging Markets ex China Index gained 6.1%. Latin America was a standout, up 14.0%.
- Sector leaders included DM Information Technology and Industrials, and EM Energy and Financials. DM Materials and Communication Services, and EM Consumer Discretionary and Communication Services finished lower.

INVESTMENT STRATEGIES

MUNICIPAL BOND

We combine a rigorous, research intensive, credit selection process with active management. Our goal is to take advantage of market inefficiencies and find opportunities across the yield curve to protect and grow principal and income.

TAXABLE BOND

Our multi-sector approach takes advantage of the relative valuation among distinct bond sectors and the increased opportunities to generate income and capital appreciation. We build diversified yield advantaged portfolios that generate steady, incremental income and provide downside risk protection.

DOMESTIC EQUITY

We develop a deep understanding of the companies in which we invest through disciplined and intensive fundamental research. Our focus is on finding well-managed, quality companies, which are resilient.

GLOBAL EQUITY

We take advantage of market inefficiencies to find quality growth companies that may be undervalued, underappreciated, or under-researched. Our rigorous, bottom-up process focuses on a company's upside potential and downside risk.

MUNICIPAL BOND STRATEGIES

22 AVERAGE YEARS EXPERIENCE

17 MUNICIPAL INVESTMENT PROFESSIONALS

INVESTMENT TEAM

Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Brian T. Moreland, CFA	Partner, Portfolio Manager
Martin R. Tourigny, CFA	Partner, Portfolio Manager
Kara M. South, CFA	Principal, Portfolio Manager

GW&K MUNICIPAL BOND STRATEGIES

- SHORT-TERM MUNICIPAL BOND
- 2–8 YEAR ACTIVE MUNICIPAL BOND
- 2–8 YEAR ACTIVE MUNICIPAL BOND ESG
- MUNICIPAL BOND
- MUNICIPAL BOND ESG
- MUNICIPAL ENHANCED YIELD

Municipal bonds posted modest losses in the second quarter, following the lead of a Treasury market that finally stopped fighting the Fed. Coming into April, investors were confident that the central bank would be forced to reverse its tightening campaign before year end. But that conviction didn't last. Economic data stood firm against the torrent of rate hikes, defying predictions for a near-term recession. Regional banks earned back investor confidence, despite a third major failure. And while inflation slowed, it remained well above its 2% target, still threatening to become entrenched. Even when the FOMC stood pat in June, its first pause in 18 months of constant hiking, the committee refused to signal the all-clear, guiding for two more increases in 2023. The street got the message. Short-term rates spiked more than 80 basis points over the quarter while the futures market erased bets that cuts would come later in the year. Long-term rates rose less dramatically, leading the yield curve to nearly match its March inversion, the deepest in over 40 years. An eventual recession is still the market's base case, but exactly when or how deep remain open questions.

While unable to escape the forces that drove Treasury yields higher, municipal bonds outperformed the broader market, thanks mostly to a strong technical environment in June. New issue supply continued to slow, with second quarter origination down 16% from the same period in 2022. Even so, municipal bonds struggled in April and especially May, due to expensive relative valuations versus Treasuries and concerns that more regional banks could have their municipal bond portfolios seized and forcibly liquidated by government regulators. Neither of those issues derailed the market, however, as municipal bonds steadily cheapened and the banking turmoil eventually settled down. By June, retail investors were flush with cash from seasonally-high rollover flows and eager to lock in higher yields and cheaper ratios. While supply was still modest, there was enough variety to lure a broad range of demand, which provided the price discovery necessary to sustain the positive momentum. The SVB/Signature Bank portfolio was liquidated by the FDIC in an orderly fashion, ultimately proving of little consequence to overall sentiment. Municipal bonds posted solid gains to end the month even as the Treasury market limped into quarter end.

Higher rates in the second quarter offered better market entry points. With the municipal curve's lowest point of inversion located in the seven-to-nine-year maturity range, the best buying opportunities were found out past 10 years, where the curve was not only upward sloping, but steeper than its historical average. Ultimately, the problem with biting on short-term debt is that if you get the timing wrong and rates drop over your holding period, you've wasted a valuable opportunity to generate income over a longer haul. At this point in the economic cycle, that risk is particularly acute.

The prospects for municipal bonds entering the third quarter are encouraging. More attractive tax-equivalent yields are stoking demand just as the tailwinds from the summer technical environment are about to strengthen. In fact, over the next two months, coupon and maturity redemptions are scheduled to outpace issuance by close to $30 billion, creating a net negative supply dynamic capable of powering summer returns. Fundamentals remain solid. Most states begin the 2024 fiscal year expecting a normalization of tax revenues from the sky-high levels of the pandemic era. Forward looking budgets have anticipated a slowdown in growth, weaker capital gains and the end to the federal relief windfall. If events prove worse than forecast, record high rainy-day funds, built on years of surpluses, stand ready to bridge any gaps. One area of caution is valuation. The outperformance in June pushed ratios back toward historical tights, but if there were ever a time to pay a premium for municipal bonds relative to the rest of the fixed income space, it's hard to imagine a scenario that better aligns fundamentals with technicals, especially entering a period that may shower favor on high-quality asset classes with a reputation for stability.

"The prospects for municipal bonds entering the third quarter are encouraging. More attractive tax-equivalent yields are stoking demand just as the tailwinds from the summer technical environment are about to strengthen."

TAXABLE BOND STRATEGIES

20 AVERAGE YEARS EXPERIENCE

15 TAXABLE INVESTMENT PROFESSIONALS

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Portfolio Manager
Stephen J. Repoff, CFA	Principal, Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income

GW&K TAXABLE BOND STRATEGIES

- SHORT-TERM TAXABLE BOND
- INTERMEDIATE TAXABLE BOND
- CORE BOND
- CORE BOND ESG
- ENHANCED CORE BOND
- ENHANCED CORE BOND ESG
- TOTAL RETURN BOND
- CORPORATE BOND OPPORTUNITIES
- SHORT-TERM FOCUSED HIGH INCOME

The fixed income market posted a small loss in the second quarter, giving back a portion of the banking crisis-inspired rally that occurred in the closing days of March. Sentiment was cautious at the outset and investors sought haven assets on the possibility of contagion in the financial sector. But as it became clear that fallout from the failure of several regional lenders was likely to be contained, attention returned to the underlying strength of the economy and the stubborn persistence of inflation. The labor market gave only the slightest indications of softening, the buoyant housing sector continued to defy higher mortgage rates, and consumer spending once again proved irrepressible. Inflation showed limited progress on its path lower, plateauing at a level solidly above the Fed's 2% target. Against this backdrop, the FOMC endeavored to maintain restrictive financial conditions by raising rates and providing hawkish guidance. There has nevertheless been scant evidence of the Fed's success in curbing aggregate demand away from some narrow segments of the commercial real estate and consumer finance markets.

The Treasury market was under pressure throughout the quarter. With stress in the banking sector receding and risk aversion dissipating, rates across the curve shifted higher. The front end underperformed as the Fed raised the overnight rate by 25 basis points in May and then, despite choosing to pause in June, increased the projected terminal rate by 50 basis points. The movement in longer rates was comparatively staid, causing several key segments of the yield curve to retest levels of inversion last seen just before the first bank collapsed in March. Similarly, real yields once again approached post-Global Financial Crisis (GFC) highs, suggesting a resumption of a broader tightening trend. Meanwhile, inflation breakevens traded in a remarkably tight range, reflecting the market's unwavering confidence that the Fed will ultimately achieve its goal.

Corporate credit continued to signal a benign outlook for financial distress. Spreads in both investment grade and high yield were tighter on the quarter and substantially inside of wides reached earlier this year. First-quarter earnings showed revenues and margins coming in ahead of relatively downbeat expectations, lending support to the narrative that any downturn in profits is likely to be short and shallow. New issuance has been brisk and access to capital has been ready, with higher rates doing little to dissuade borrowers from coming to market. Mortgage-backed securities (MBS) also produced positive excess returns. The FDIC's liquidation of failed lenders' balance sheets was met with robust buyside participation, while nominal spreads at post-GFC wides created a compelling relative value proposition for asset allocators. Sentiment was further boosted by slower prepayment speeds, declining rate volatility and the Fed's evident reluctance to begin selling its MBS.

After an extended period of disconnect between the Fed's forward guidance and the market's expectations, the Fed has finally persuaded bond investors to follow its lead. The market has now completely priced out what at one point was an expectation of as many as four cuts by the end of 2023, with rates expected to be at or above current levels until mid-2024. Now investors must grapple with the lagged effects of hikes that have already occurred, the potential for yet more tightening and macroeconomic data that will have exaggerated influence as we approach this cycle's end.

> *"Our view of corporate credit remains somewhat cautious, particularly as the cycle advances and spreads sit inside their long-term averages. We recognize that companies have been successful limiting their sensitivity to rising rates by extending maturities and building liquidity."*

Our view of corporate credit remains somewhat cautious, particularly as the cycle advances and spreads sit inside their long-term averages. We recognize that companies have been successful limiting their sensitivity to rising rates by extending maturities and building liquidity. We also appreciate how resilient profit margins have been despite tightening financial conditions and fears of a slowdown. The consumer space stands out as an area where we're being especially selective, as the impulse from last year's fiscal stimulus fades and consumer savings dwindle. At the same time, we are finding attractive opportunities among blue chip borrowers, which continue to trade at attractive yields. We are also more upbeat on MBS in light of recent spread widening and following the removal of the overhang from bank wind-downs.

DOMESTIC EQUITY STRATEGIES

24 AVERAGE YEARS EXPERIENCE

13 EQUITY INVESTMENT PROFESSIONALS

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Joseph C. Craigen, CFA	Partner, Portfolio Manager
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Jeffrey O. Whitney, CFA	Partner, Portfolio Manager
Aaron C. Clark, CFA	Principal, Portfolio Manager

GW&K DOMESTIC EQUITY STRATEGIES

EQUITY DIVIDEND PLUS
DIVERSIFIED EQUITY
SMALL/MID CAP CORE
SMALL/MID CAP GROWTH
SMALL CAP VALUE
SMALL CAP CORE
SMALL CAP GROWTH

Equity markets were rather flat for the first two months of the second quarter. There was plenty to be concerned about, including fear of an impending recession, weak manufacturing survey data, the lagged effect of tight monetary policy, higher interest rates, and fear of a regional bank-induced credit crunch. Yet, the bulls could rightfully offset these concerns with signs of peak inflation, good corporate earnings, a strong labor market, resilient consumer spending, and improved housing demand. June, however, clearly favored the bulls, as economic data supported the soft-landing scenario. Equity markets were particularly strong for the month, resulting in solid mid-to-high single-digit returns for the quarter.

Large cap stocks were once again bolstered by the strength of mega-cap names within the Information Technology, Communication Services, and Consumer Discretionary sectors. The Artificial Intelligence (AI) growth theme drove the tech-heavy NASDAQ to a quarterly gain of 13.1%. The S&P 500 Index gained 8.7%, pushing its first-half return to 16.9%. It is worth noting that the S&P's strength has been quite narrow, with only about 30% of its names ahead of the Index. Laggards included the more defensive Utilities and Consumer Staples sectors, as well as Energy, which declined on weak pricing trends. Small cap stocks, as measured by the Russell 2000 Index, finally caught a bid in June, more than erasing its modest losses earlier in the year. Its 5.2% second-quarter gain pushed first-half returns to 8.1%. Sector performance was quite different down cap. While Information Technology remained strong, other leading sectors included Health Care, benefiting from a resurgence in biotech stocks, and the cyclical Industrials sector, which was aided by a better economic outlook and potential for higher spending under the Inflation Reduction Act. Laggards included the defensive Utilities sector and the regional-bank heavy Financials sector.

The market's growth bias, as evidenced by the outperforming sectors listed above, continued again in the second quarter, especially among large cap stocks. Growth indices led their value-orientated counterparts by a substantial amount so far this year. Style factors generally favored lower-quality characteristics, especially among small caps, with non-earners and low ROE names leading the pack.

The outlook for the economy and the stock market remains decidedly mixed. The heavily inverted yield curve suggests a recession remains the most likely scenario, while most manufacturing survey data remains in contraction territory. Yet, the timing and magnitude of a possible recession remain quite unclear. Several positive factors are worth noting, including better-than-expected corporate earnings reports, a declining rate of inflation, a stubbornly strong labor market, decent consumer spending, and a more buoyant housing market. While these factors did ultimately overwhelm the bears and contribute to the strong market in the second quarter, these are generally lagging or coincident indicators. The bearish case revolves around leading economic indicators where the impact on the economy has yet to be felt. Such factors include restrictive monetary policy, higher interest rates, and tighter lending standards driven by the regional banking crisis. In addition, while the Fed has finally taken a pause in pushing up interest rates, they have also made it clear that a couple more rate increases are in the cards. How this all plays out will generally be determined by the resilience of the economy in the face of these headwinds, and whether encouraging signs of disinflation will continue until we are down closer to the Fed's stated 2% inflation target.

> *"Several positive factors are worth noting, including better-than-expected corporate earnings reports, a declining rate of inflation, a stubbornly strong labor market, decent consumer spending, and a more buoyant housing market."*

We were premature in taking down earnings estimates last quarter, and have raised our expectations of S&P 500 earnings back to $210. Yet, given the strength of equities, the market now sells at about 21.2x 2023 earnings estimates, or an earnings yield of 4.7%. Given the continued rise in interest rates, with the 10-year Treasury bond now yielding over 3.8%, the ratio of equity to fixed income yields now stands at a rather low 1.2x.

As we get deeper into this economic cycle, our focus on quality only becomes more important, as 1) quality companies sell at more reasonable valuation levels as they have had a difficult time keeping up with the broader market averages, and 2) companies with quality attributes such as strong management teams and leading market positions tend to do best in periods like this where the outlook is anything but clear.

GLOBAL EQUITY STRATEGIES

24 AVERAGE YEARS EXPERIENCE

9 EQUITY INVESTMENT PROFESSIONALS

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Reid T. Galas, CFA	Partner, Portfolio Manager
Karl M. Kyriss, CFA	Partner, Portfolio Manager

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP

INTERNATIONAL SMALL CAP

> *"...Japan is massively underinvested in their own equity market versus overseas equities and domestic bonds. If inflation makes bonds less attractive and money returns from overseas, the flow into Japanese equities would be a huge tailwind for equity prices."*

On the surface, non-US markets had a relatively uneventful second quarter, with gains slowing a bit following a strong start to the year. The large cap MSCI World ex USA Index advanced a respectable 3.0%, while the MSCI World Small Cap ex USA Index gained a very modest 0.5%. Under the surface however, there was a bit of volatility with solid returns in April and June offset by a weak May. In addition, the local markets were better than they appeared, but a strong US dollar hurt reported returns by about 2%.

Regional returns were mostly muted with Europe and Asia offsetting some weakness in North America. Within Asia, Japan was the best market despite a weak yen, while Hong Kong sold off as China's reopening disappointed. Europe was mixed with some areas of strength such as Denmark and Italy, while the Nordics were weak, led by declines in Sweden. Sector returns also varied widely. Financials rebounded after last quarter's decline, joined by Utilities and Information Technology. Materials, Communication Services, and Real Estate were weak and may be implying concerns that interest rates will remain higher for longer, which has been our view for some time.

One region seeing some positive change and starting to attract investor interest is Japan. We have spoken piecemeal about our bullish view in the past, but this quarter will lay out what we see as the bullish case for the country's equity market.

Despite the common perception as a low growth market, since 2013, operating earnings growth for Japan (TOPIX) have outpaced those of other developed markets, including the US (S&P 500). The stock market has not done as well, but that is because of multiple expansion elsewhere and not slow earnings growth. Further, given that earnings are reported nominally, and Japan's inflation has been lower than other developed markets (e.g., since 1995 just 0.3%/year in Japan versus 2.5%/year in US), the real earnings growth in Japan has been underappreciated.

There is a positive macroeconomic case to be made as well. Long an area of concern (and still far from perfect) Japanese corporate governance, and in particular the focus on shareholder returns, is undergoing rapid improvement. The government and stock exchange are actually pushing companies to improve returns, which is showing up in rapidly growing buybacks and dividends. Unlike in some markets, these shareholder returns come from retained earnings and not through increased leverage. In fact, the shareholder yield on the TOPIX is now equivalent to that in the US or EU, but arguably with significantly more upside potential. Meanwhile, the central bank is running the loosest monetary policy of any major market. We expect some tightening this year, but it will remain very accommodative relative to others. At the same time, after so long in a deflationary funk, a bit of inflation will (at least initially) be seen very positively, driving wage increases to workers while providing cover for companies to increase prices, in some cases for the first time in decades. This policy has led to a weaker yen which has made Japan's production costs incredibly competitive with peers just as global supply chains are diversifying.

The Japanese market currently trades in-line with its 10-year average valuation, indicating that these positive changes are far from priced in. For example, all the flows that went into Japan during the Abenomics period had subsequently exited by the end of last quarter, so despite record foreign buying the last few months there is plenty of room to run. Finally, and most bullishly, Japan is massively underinvested in their own equity market versus overseas equities and domestic bonds. If inflation makes bonds less attractive and money returns from overseas, the flow into Japanese equities would be a huge tailwind for equity prices.

There are plenty of bearish arguments which could also be made, the most salient of which is that Japan traditionally has been highly correlated with global growth and susceptible to recessions. On balance though, we find the market quite attractive. Our core investment approach remains focused on bottom-up stock picking, finding specific businesses with strong fundamentals and balance sheets able to weather difficult markets. Japan offers a large number of these opportunities, but it is still best owned as part of a diversified, well-chosen, stock-specific portfolio.

EMERGING MARKETS EQUITY STRATEGIES

In the second quarter of 2023, emerging market (EM) equities had mixed and lackluster performance. The MSCI EM Index only gained 0.9%, significantly underperforming the MSCI World Index of developed market (DM) equities, which increased by 6.8% during the same period. So far this year, the MSCI EM Index has gained 4.9%, compared to a 15.1% gain for the MSCI World Index. The underperformance of EM equities can mainly be attributed to the poor performance of China's market, which makes up about one-third of the overall EM benchmark. China lost 9.7% in the second quarter and 5.5% year to date. However, if we exclude China, EM equities rose by 6.1% in the quarter and 14.7% year to date.

China's underperformance is due to ongoing geopolitical tensions with the US and evidence of a slower-than-expected reopening recovery. On the other hand, DM and EM excluding China benefited from the belief that the global economy could achieve a soft landing as inflation pressures ease. This perception was supported by the softening of global commodity prices, with the Bloomberg Commodity Index down nearly 4% for the quarter and 10% year to date. Despite several rounds of production cuts by OPEC+, oil prices also trended down, aligning with the overall decline in the Bloomberg Commodity Index.

While key DM central banks like the Federal Reserve, European Central Bank, and Bank of England have pushed "higher-for-longer" messages on interest rates in response to above-target core inflation rates, the Bank of Japan maintained its accommodative policies, and the People's Bank of China made modest rate cuts to support the economy. These policy divergences have been a challenge for Asian currencies, with the Japanese yen and Chinese yuan down 10.8% and 4.2% year to date, respectively. On the other hand, key Latin American currencies like the Brazilian real and Mexican peso have risen 10.1% and 15.2% year to date, supported by high real interest rates. Mexico is also benefiting from nearshoring by corporations reducing their exposure to China.

In the second quarter, EM Latin America was the best-performing region with a gain of 14.0%, followed by the EM region of Europe, the Middle East, and Africa (EMEA) with a gain of 2.7%. EM Asia was the poorest-performing region, posting a decline of 0.8%, as China's weakness masked solid returns in India, South Korea, and Taiwan. EM sector returns were also mixed, with the Energy sector performing the best due to production cutbacks by OPEC+. The Financial and Information Technology sectors also had solid gains. However, the EM Information Technology sector lagged its DM counterpart due to China's poor performance and concerns about tech restrictions.

The Consumer Discretionary and Communication Services sectors were the weakest in the quarter, posting declines of -6.4% and -6.8%, respectively. These sectors, along with Consumer Staples, Health Care, Materials, and Real Estate, were weighed down by China's poor performance. It is worth noting that the EM Value Index has outperformed the EM Growth Index by 3.3% year to date, in contrast to DM markets where Value has underperformed Growth by 9.1%.

EM valuations remain low, with the MSCI EM Index trading at a 21% discount compared to the MSCI World Index of DM stocks. Despite the recent disappointment in China's recovery, China has the potential to adjust its economic policy at the upcoming Politburo meeting in July. Additionally, it faces no inflation constraints in providing further economic stimulus. With many other EM central banks likely to cut interest rates soon, we believe leading EM nations are in a favorable business cycle position compared to key DM nations focused on combating inflation.

It is worth noting that global investors appear to be significantly underweight EM equities in global benchmarks. For instance, data from J.P. Morgan shows that as of mid-2023, global equity funds had only allocated 5.9% of their $25.8 trillion fund universe to EM. In comparison, the MSCI All Country World Index currently has a 10.7% weight toward EM. This suggests that investors in the J.P. Morgan global fund universe are underweight EM by approximately $1.2 trillion. Despite ongoing geopolitical risks and the potential for global equity markets to be impacted if major DM economies enter a recession, we maintain a cautiously optimistic view on EM equities.

28 AVERAGE YEARS EXPERIENCE

15 EQUITY INVESTMENT PROFESSIONALS

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Nuno Fernandes, CFA	Partner, Portfolio Manager
Thomas A. Masi, CFA	Partner, Portfolio Manager
Bradley J. Miller, CFA	Partner, Portfolio Manager
Pablo Salas	Partner, Portfolio Manager
William P. Sterling, Ph.D.	Global Strategist

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GW&K® INVESTMENT MANAGEMENT

www.gwkinvest.com

Boston Headquarters
222 Berkeley Street
Boston, Massachusetts 02116
617.236.8900

Other Locations
New York, New York
Winter Park, Florida