GW&K
INVESTMENT MANAGEMENT

INVESTMENT REVIEW
1Q 2023

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ECONOMIC COMMENTARY

BY HAROLD G. KOTLER, CFA

Founder-Chairman, Chief Investment Officer

In one way or another, this banking crisis has affected us all. With multiple explanations from talking heads, I think it is important to understand the basic facts in simpler terms. Banks have a straightforward task: pay interest on the deposits made by customers and extend loans to folks who need to borrow.

Very simple. Take money in and lend money out. The amount of interest paid to depositors should be less than the rate charged to borrowers. The resulting spread goes toward the earnings of the bank. What can go wrong? Well, in the 2008 banking crisis, the big problem was poor-quality loans — particularly subprime mortgages — and the damage was intensified by counterparty exposure across the entire global banking system. That is not the issue this time around. Today's loan portfolios are, for the most part, very solid.

A better comparison would be the Savings & Loan Crisis of the 1980s and 1990s, when a sharp rise in interest rates created a severe imbalance between funding costs and asset values, leading to the collapse of over a thousand thrift banks. The banks that failed in March got caught in a similar trap — they took in deposits and bought long-dated bonds to enhance the spread between what they were lending money for and what they could earn on their deposits. Their reasoning was simple — buy mostly safe, government-backed bonds, but juice the return by investing in longer duration (i.e., higher returning) maturities. As long as the securities were held to maturity, very little could go wrong. As we all know, however, the Federal Reserve began to aggressively raise short-term interest rates in an attempt to slow inflation. In response, the long end of the bond market sustained large mark-to-market losses. This had nothing to do with credit quality — when long rates rise, prices of all existing debt fall in value.

It didn't matter that banks were allowed to carry bonds at cost. Depositors focused on the fair value disclosed in the footnotes and grew concerned by what they saw. And in this era of instant communication, an interconnected customer base quickly magnified the growing anxiety. Silicon Valley Bank lost more than $40 billion in a single day after depositors concluded that its portfolio of bonds had depreciated so much that its available capital would be unable to meet withdrawal demand. In the end, the Fed's full-throttle tightening campaign transformed weak asset liability management into a full-blown banking crisis.

> *"Banking crises have been a part of the landscape my whole career. Whether caused by bad loans and excessive lending practices, as in 2008, or healthy but temporarily underwater asset values, as was the case this time around, there is always a Black Swan lingering out there."*

Even though the weaker banks had fabulous franchises, the big banks did not step in and rescue them. Why not? Because in the consolidation and rescue mission that took place during the

Continued on next page

global financial crisis, the "good" banks were dragged before Congress and had their heads taken off and, in some cases, had to pay fines for past transgressions of their acquisitions.

I hate to make this comparison, but I believe it is worth noting. Being responsible often leads to demise. If Muammar Gaddafi hadn't given up Libya's nuclear capacity, he likely would have remained in office. If Ukraine still had their nuclear bombs, Russia would not have invaded. Simple lesson — don't give up your nuclear arsenal. No country with nuclear weapons has ever been invaded.

Why do I speak about a financial crisis and nuclear weapons in the same letter? Because scrutiny of those who try to act in good faith can often backfire. No bank today wants to spend months in Congressional hearings and have their decision to do the "right" thing examined under a microscope. So, while the big banks may be willing to lend to other banks, they do not want to buy. Like the nuclear umbrella that allows governments to stay in power, keeping your business isolated from failing institutions, even at the risk of further systemic fallout, is considered a rational choice.

Banking crises have been a part of the landscape my whole career. Whether caused by bad loans and excessive lending practices, as in 2008, or healthy but temporarily underwater asset values, as was the case this time around, there is always a Black Swan lingering out there. I was reminded of this when watching the recent Bernie Madoff series on Netflix, which details the roots of his Ponzi scheme. It was interesting to see how many "crises" have occurred since the early 1960s when Madoff began his efforts. We have good times and then we come crashing down and then we have good times again. Maybe that's the story of capitalism. It works until it doesn't. Abusive policies, both private and governmental, create difficult periods. Eventually, we recover and expand again. It goes to my unwavering conviction that both this country and the economy bends, but does not break. Once again, we will find a way out of this mess.

Capitalism and democracy certainly have flaws, but there is a self-adjusting mechanism to both. Twenty years from now, people will refer to these as "the good old days," like we now say about yesteryear. But we all know those past years were full of fear and controversy. It is, it just is.

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

GW&K NEWS

GW&K ANNOUNCES NEW PARTNER

Gabriela L. Greenman
Equity Research Analyst

Gaby, who has spent more than a decade at GW&K, has played a significant role as an equity research analyst on the firm's domestic small cap equity team. This promotion underscores our commitment to build and maintain a strong team dedicated to excellence. With over twenty years of industry experience, focusing on the Consumer Discretionary and Consumer Staples sectors, Gaby's insight and commitment to our disciplined research process have played an important role in driving the success of our domestic small cap strategies and their long track records. In addition, she has been instrumental in our DE&I and Volunteer Committees helping to support values that are embedded in GW&K's culture. We look forward to Gaby's continued success.

59 INVESTMENT PROFESSIONALS

23 AVERAGE YEARS EXPERIENCE

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FIRST QUARTER 2023

ECONOMY

- The economy remained resilient in 1Q, with the Atlanta Fed estimating consumer-led GDP growth of 2.5% following 2.6% for the previous quarter.
- The Fed's favored measure of core inflation posted a three-month annualized increase of 4.9% in February, which remains far above the Fed's 2% target.
- Most economists are forecasting near-zero growth in GDP for the remainder of this year based on the effects of aggressive Fed tightening on interest-rate sensitive sectors like housing.
- Recent banking strains triggered a historic decline of bank deposits of $300 billion in the last two weeks of March — pointing to tighter credit conditions and declining inflation ahead.

FED ACTION

- Following the failures of Silicon Valley Bank and Signature Bank in March, the Fed introduced an emergency lending facility to address liquidity pressures in the banking system.
- The Fed raised rates by a quarter-point in February and despite uncertainty created by the banking crisis, proceeded with another quarter-point hike in March.
- Futures markets now expect, at most, one more quarter-point rate hike in May followed by rate cuts of 75-to-100 basis points in the second half of the year in response to economic weakness.
- In contrast, Fed officials in March projected holding the funds rate in the 5.0%-to-5.25% range through the end of this year while indicating that future rate decisions will be data-dependent.

BOND MARKETS

- Fixed income markets rebounded from their worst year on record. Much of the period saw a continuation of the tensions from 2022: inflation abated, but at a glacial pace; a moribund housing market and downbeat consumer had yet to reduce spending; and a record pace of rate hikes failed to cool a hot labor market.
- Treasuries posted a strong gain, as elevated macroeconomic uncertainty and concerns around financial instability caused rate volatility to spike.
- Corporate spreads traded in a wide range, but ultimately settled close to where they began the year. Even in the immediate aftermath of the bank failures, the risk premia for both investment grade and high yield didn't surpass their 2022 peaks.
- Municipal bonds posted solid gains in 1Q, piggybacking a strong, but extremely volatile, rally in Treasuries.

INDEX PERFORMANCE	3/31/2023
	QUARTER
Bloomberg 10-Year Municipal Bond Index	2.76%
Bloomberg Aggregate Bond Index	2.96%
Bloomberg High Yield Index	3.57%
Dow Jones Industrial Average	0.93%
S&P 500 Index	7.50%
Russell 2000 Index	2.74%
MSCI EAFE Index	8.47%
MSCI World Small Cap ex USA Index	4.99%
MSCI World Index	7.73%
MSCI Emerging Markets Index	3.96%

DOMESTIC EQUITY MARKETS

- US equity markets advanced in 1Q, showing resilience amid volatile trading and turmoil in the US banking industry. Cooling inflation data fueled a rally in risk assets in January, but expectations for a Fed policy pivot faded in February among higher inflation readings. Concerns of economic slowdown and contagion risk worsened in March as a regional banking crisis unfolded, though markets rallied into quarter end.
- Large cap stocks, as measured by the S&P 500, rose 7.5% and meaningfully outpaced small and mid-cap stocks.
- Information Technology, Communication Services, and Consumer Discretionary were the best performing sectors. Financials, Energy, Health Care, and Utilities generated negative returns.
- Growth dramatically outpaced Value in the quarter. Investors also demonstrated a mixed preference for quality factors.

GLOBAL EQUITY MARKETS

- Non-US developed markets (DM) advanced in volatile trading amid late quarter turmoil in the US and Swiss banking industries.
- Europe finished in the lead thanks to surprisingly positive fourth quarter earnings. The MSCI World ex USA Index gained 8.0%, while MSCI World Small Cap ex USA was up 5.0%.
- Emerging Markets (EM) also delivered a positive return led by nearshoring beneficiary Mexico and tech-heavy Taiwan and South Korea. China's modest gain provided further support, with the MSCI Emerging Markets Index up 4.0%.
- Sector performance varied widely with Information Technology a standout in both DM and EM. DM Consumer Discretionary and Industrials and EM Communication Services were also among the top performers. DM Energy and Real Estate and EM Utilities and Health Care declined.

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

23 AVERAGE YEARS EXPERIENCE

16 MUNICIPAL INVESTMENT PROFESSIONALS

Municipal bonds posted solid gains in the first quarter, piggybacking a strong, but extremely volatile, rally in Treasuries. Although interest rates ultimately finished lower for the quarter, each month produced wildly different results. In January, yields declined sharply as weak economic data fueled speculation of a Fed pivot. That notion gained more currency after the FOMC executed a slimmed-down quarter-point hike at its meeting on February 1. Two days later, however, a blowout jobs report undermined any thoughts of a slowdown, setting the stage for a violent reversal in rates. Worries over a recession faded, giving way to talk of a potential “no landing” scenario, where the economy continues to grow despite the Fed’s efforts to tame inflation. By early March, the yield curve had reached its deepest inversion in 40 years. The no-landing theory was ultimately done in, however, by the collapse of Silicon Valley Bank and subsequent turmoil in the banking industry. Rates plummeted into quarter end in a classic flight to safety, as investors worried that a pullback in lending posed a serious threat to future economic growth. As March ended, markets were anticipating multiple Fed cuts by year-end, even as central bank officials continued to forecast at least one more hike and no cuts until 2024.

Municipal bonds kept pace with the rally in Treasuries even though relative value ratios started the year at historically expensive levels. Two factors contributed to that outcome: 1) a significant drop in first quarter supply, and 2) little credit exposure to the banking mess. As to supply, new issue volume was down 27% on a year-over-year basis, extending a run of sparse issuance that had been in place since last summer. It helped that demand had finally stabilized, as mutual fund redemptions slowed to a trickle, a far cry from last year’s relentless and record-setting outflow cycle. On the credit side, when the banking crisis erupted, municipal bonds reaped the benefit of their haven status, drawing investment flows from other areas of the market more vulnerable to a run on the nation’s lenders. Since the 2008 financial crisis, improvements in cash management and debt structuring practices have greatly reduced the risk to municipal bond borrowers in the event of bank failures. Despite financial market distress and severe rate volatility, the latter leading to the first meaningful inversion of the tax-exempt curve, municipal bonds proved resilient in the first quarter, posting impressive gains and acting as a reliable source of stability.

We believe municipal bonds begin the second quarter in excellent shape. The technical picture should improve with a pickup in rollover demand amid still-sparse issuance. Meanwhile, municipal bond credit quality has rarely been better. Two years of unprecedented revenue growth has led to record reserves across the space. Even Illinois, once the epitome of political brinksmanship and pension mismanagement, has stabilized. During the quarter, the state was upgraded to the A-rating category after teetering on the brink of junk during the depths of the pandemic. The challenge for the market is that all this good news has been priced in. Relative value ratios stand near historical tights, leaving less cushion against the forces driving Treasuries. One consequence of that has been the front-end curve inversion, a novelty that has tempted some long-term investors to shorten up and grab the yield. That is likely a mistake. Reinvestment risk looms large, especially considering where we are in the current monetary cycle. Excess return from roll is not only still available in longer maturities but would increase exponentially in the event of a pivot to easing. And should the Fed stay higher for longer, investors will be well compensated by the attractive yields available at steeper segments of the curve.

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

> *“We believe municipal bonds begin the second quarter in excellent shape. The technical picture should improve with a pickup in rollover demand amid still-sparse issuance. Meanwhile, municipal bond credit quality has rarely been better.”*

TAXABLE BOND STRATEGIES

20 AVERAGE YEARS EXPERIENCE

15 TAXABLE INVESTMENT PROFESSIONALS

INVESTMENT TEAM

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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 experienced a solid rally in the first quarter, rebounding from their worst year on record. Much of the period saw a continuation of the tension that drove trading in 2022: inflation continued to slow, but at a glacial pace; a moribund housing market and downbeat consumer had yet to manifest as a slowdown in spending; and a record pace of rate hikes was unable to cool a stubbornly hot labor market. Investors also struggled to anticipate the Fed's reaction function amid the various crosscurrents, while Chair Powell's commentary offered few concrete insights beyond a firm resolve and data dependence. But the narrative shifted abruptly in the final weeks, as signs of systemic instability flared up amid a flurry of bank failures. The implications of this turmoil for financial conditions are not yet evident, but the stress in the banking sector is clearly a complicating factor for both the Fed and the bond market.

The Treasury market posted a strong gain, as elevated macroeconomic uncertainty and rising concerns around financial instability caused rate volatility to spike. Following Powell's hawkish congressional testimony in early March, there was a brief instant where every tenor of the yield curve was above 4%, as investors capitulated and accepted the Fed's "higher for longer" policy prescription. But within days, the collapse of Silicon Valley Bank and fears of contagion caused rates to collapse. Various segments of the curve reached new depths of inversion for this cycle, signaling a significant contraction of financial conditions and a dire outlook for the economy. Following the March FOMC meeting, at which rates were once again increased by 25 basis points, Powell acknowledged the potential for ructions in the banking system to tighten policy, but nevertheless, reiterated his belief that the terminal rate has yet to be reached.

Corporate credit spreads traded in a wide range, but ultimately settled close to where they began the year. Even in the immediate aftermath of the bank failures, when spreads gapped out to their wides for the quarter, the risk premia for both investment grade and high yield failed to surpass their 2022 peaks. This relatively benign price action highlights that, away from acute pressures in the banking space, the broader market remains clear of financial distress. The most recent earnings reports from across the industrial space points to a stable, if lackluster, outlook for profitability. The new issue market remains open to borrowers across the quality spectrum. The default rate continues to be subdued and sits at a low level by historical standards. The banking sector was a notable underperformer, of course, but several traditionally cyclical sectors in the consumer, capital goods, and basics sectors saw their spreads tighter on the year. The mortgage-backed securities space slightly lagged similar duration Treasuries. Spreads widened on elevated rate volatility and the possibility that banks could be forced sellers of MBS in response to deposit flight.

The disconnect between the Fed's Summary of Economic Projections (SEP) and the bond market's expectations for the path of rate hikes remains at extreme levels. The SEP's median estimate has the overnight rate at 5.1% at yearend; the bond market, meanwhile, not only assigns low odds to ever achieving that rate, but also reflects two 25 basis-point cuts by that time. Our view is that regardless of how this disconnect is resolved, it is likely to be accompanied by a broad re-steepening of the yield curve.

> *"Our fundamental view of corporate credit remains cautiously constructive, though we find valuations somewhat less compelling. We recognize the various recession signals being sent by the yield curve, economic data, and the Fed's own projections, so we continue to test our investment theses against downside shocks."*

Our fundamental view of corporate credit remains cautiously constructive, though we find valuations somewhat less compelling. We recognize the various recession signals being sent by the yield curve, economic data, and the Fed's own projections, so we continue to test our investment theses against downside shocks. Our outlook is also informed by our belief that corporations have come into this challenging environment from a position of greater strength than they have other recent bouts of volatility. This is particularly the case in the high yield space, where the quality of the average issuer is higher, interest expenses are better covered, and the reliance on capital markets is comparatively minimal. The investment grade market, for its part, is similarly well situated, with profitability among large and blue-chip issuers proving resilient despite tightening financial conditions.

DOMESTIC EQUITY STRATEGIES

24 AVERAGE YEARS EXPERIENCE

13 EQUITY INVESTMENT PROFESSIONALS

Equity markets started the year on firm footing amid optimism around economic growth, signs of declining inflation, and the approach of a peak in Fed policy initiatives. Such optimism was short lived, however, as inflation readings came in hot entering February compelling the Fed to raise rates aggressively; 2022 earnings reports underwhelmed and fears of recession rose. As the regional banking crisis emerged amid a deposit run and some high-profile bank closures, it appeared we were in for a difficult March — only to have interest rates fall dramatically and markets anticipate that the banking crisis may have done the Fed's work for them, potentially shortening the severity and duration of the Fed's tightening cycle. A more resilient consumer and a strong labor market also helped put some wind at the market's back. By quarter end, nearly all equity indexes had registered positive mid-single digit gains.

Domestic large cap stocks, as measured by the S&P 500, bolstered by the strength of mega-cap Information Technology, Communication Services, and Consumer Discretionary stocks, posted a gain of 7.5% for the quarter. Financial stocks were weighed down by the banking crisis, while Energy stocks also lagged amid a drop in oil and natural gas prices. The more defensive sectors of Health Care, Utilities, and Consumer Staples also lagged. Small cap stocks posted similar monthly trends to their large cap counterparts, although their decline in March, driven in particular by the collapse of regional banking stocks, was quite pronounced. What had been a sizable performance advantage over large caps turned into quite a rout, with the Russell 2000 gaining a more modest 2.7% for the quarter.

In contrast to last year's trends, the strong sectors mentioned above all possess a notable growth bias, while the laggards tend toward defensive and cyclical-value characteristics, propelling Growth stocks to a sizable performance advantage over Value in the quarter. The performance of style factors showed a slight quality bias, led by larger cap, lower beta, and higher ROE stocks.

The Fed remains determined to bring down inflation toward its 2% target, and their aggressive tightening actions, with their typical lags, seem to be slowing the economy and pushing inflation down. Weak ISM Manufacturing survey results and the bond market's inverted yield curve suggest the slowdown is occurring. Yet the economy's resilience, as seen in the strength of the labor market, consumer spending and household balance sheets, makes it less clear if steps taken to date are enough to accomplish the Fed's goal. Enter the regional banking crisis. While it had an immediate impact on smaller-cap bank stocks, the broader negative impact on the economy has yet to be felt. More stringent regulatory requirements and the outflow of deposits from regional banks, an important factor in corporate lending and economic growth, can't help but slow the economy, as funding availability will diminish, lending standards will tighten, and borrowing costs will rise. Such an impact may help the Fed accomplish its goal of slowing economic growth and taming inflation, albeit while increasing the likelihood of recession. Still, the slowing economy should bring us closer to the end of this tightening cycle and position us for the next phase of growth. Exactly when this happens, how severe the recession will be, and when markets will anticipate the next up cycle, is dependent on many factors making it difficult to predict with any precision.

At the very least, it is prudent to reduce 2023 S&P earnings estimates, reflecting a difficult finish to 2022 earnings reports as well as the greater likelihood of recession later this year. Assuming earnings of $200 in 2023, the market sells at about 20 1/4 times earnings, representing an earnings yield of 4.9%. With the 10-year US Treasury yield falling to 3.5%, the ratio of stock-to-bond earnings rose during the quarter to 1.4 times, leaving stocks still a bit expensive versus long-term averages. Nonetheless, there is still relative value in the market as smaller caps and non-US equities sell toward the lower end of relative valuation ranges versus domestic large caps.

Our continued focus on investing in quality companies is all the more relevant in these times of market and economic turbulence, as well-managed companies have a tendency to take advantage of the situation at hand, whether good or bad, for their long-term advantage.

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
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Jeffrey O. Whitney, CFA	Partner, Portfolio Manager
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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

"Our continued focus on investing in quality companies is all the more relevant in these times of market and economic turbulence, as well-managed companies have a tendency to take advantage of the situation at hand, whether good or bad, for their long-term advantage."

GLOBAL EQUITY STRATEGIES

23 AVERAGE YEARS EXPERIENCE

9 EQUITY INVESTMENT PROFESSIONALS

INVESTMENT TEAM

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Karl M. Kyriss, CFA	Partner, Portfolio Manager

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP

INTERNATIONAL SMALL CAP

"Despite expecting significant global economic slowdown in 2023, and a probable recession in some regions, we remain positive on equity returns in international markets. Nominal growth rates, which are what matter for companies, are positive and many of the Covid-era constraints are quickly fading."

Despite a bit of landing turbulence, global markets rallied in the first quarter with the large cap MSCI World ex USA Index advancing 8.0%. The MSCI World ex USA Small Cap Index also started the year off strong, gaining 5.0%, continuing last quarter's recovery. The US Dollar Index declined -1.0% in the quarter, providing a modest tailwind, but remaining historically strong.

All three major regions had positive returns with Europe leading, and all underlying countries were higher, with the exception of energy-heavy Norway. North America and Asia also saw widespread gains apart from resource-heavy Australia. Sector returns were mostly positive and continued to have a "recovery" bias as Information Technology, Industrials, and Materials more than offset weakness in Real Estate, Energy, and Financials. Performance in the Materials sector was supported by strength in value-added industries such as construction materials and containers & packaging, which were a key source of weakness at this time last year. The lag between input price inflation and price passthroughs has turned positive. In the first half of 2023, we expect those industries to show sharply improved margins as price hikes endure, while input prices and supply-chain shortages have faded. The weaknesses in Real Estate and Financials are due to tighter monetary policy in most countries and budding concerns over recession risk in the West. However, most countries lack the large number of small cap regional banks which are causing concerns in the US.

After being told for 15 years that the US bank system is the gold standard for resilience, how ironic that it is once again the focus of global financial stability concerns. There are some major differences between the US's unique regional and small banking system and those found in most other developed markets. Among these markets, only Japan and the UK have a system even remotely similar, but their hundreds of banks pale in comparison to the greater than 4,000 found in the US. In the past we have mentioned concerns about some Japanese small banks, which we still hold, but in non-US markets the risk is likely to show up in the large institutions. The recent near miss and subsequent takeover of Credit Suisse by UBS was received with relief by the markets and reinforced a belief that the global systemically important banks are too big to fail. However, have the Swiss created a bank that is now too big to save?

The global market rally in the first quarter is at least partially attributable to expectations that growing recession risks will result in an end to central bank tightening. Our base view remains at odds with that sentiment, expecting higher yields to last longer than expected, and worrying that any easing in monetary conditions will only come with a much less positive economic environment and potentially falling share prices. However, as previously discussed, the growing divergence of economic conditions provides the opportunity to sidestep some of the concerns and potentially benefit from the return of desynchronized economic cycles for the first time since the financial crisis.

During the quarter, Japan completed the transition to a new head of the central bank, but did not take any steps towards transitioning to a new monetary policy regime. This, however, is just a matter of time. The Bank of Japan would surely like the inevitable move away from zero interest rates and yield curve control policies to be gradual and controlled. The market may end up having other ideas, but a solid economy, improving wages, and so far resilient, yet modest, inflation provide them the perfect environment to make the attempt. After years of policy that drove banks further out on the risk curve it is not yet clear what surprises lurk on financial balance sheets.

Despite expecting significant global economic slowdown in 2023, and a probable recession in some regions, we remain positive on equity returns in international markets. Nominal growth rates, which are what matter for companies, are positive and many of the Covid-era constraints are quickly fading. A bumpy ride is likely, and the list of unaddressed global concerns is quite long, but we believe our continued focus on companies with good businesses and strong balance sheets holds us in good stead for the journey.

EMERGING MARKETS EQUITY STRATEGIES

28 AVERAGE YEARS EXPERIENCE

15 EQUITY INVESTMENT PROFESSIONALS

INVESTMENT TEAM

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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

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS

EMERGING WEALTH

"We maintain cautious optimism for EM equities, despite ongoing geopolitical risks and potential headwinds to global equity markets if major DM economies enter a recession."

Following five consecutive quarterly declines, emerging market (EM) equities continued their recovery from the fourth quarter of 2022 into the first quarter of 2023. The MSCI EM Index rose by 4.0% in the first quarter, although EM equities still underperformed compared to the MSCI World Index, which gained 7.7% during the same period. Gains in global equities came amid optimism that global inflation and the policy rates of major global central banks were close to peaking. This came against the backdrop of a regional banking crisis in the US that spread briefly to Europe. While the crisis had very limited contagion effects on EM markets, it raised the odds of a US recession which could create a challenging external environment for EM growth.

Central banks acted swiftly to address turmoil in the global banking system, resulting in a retreat of bond yields, with the US 10-year Treasury yield dropping 45 basis points to 3.5% in the quarter. The dovish market re-pricing of the fed funds rate fueled a surge in developed market (DM) growth stocks, outperforming their value counterparts by the largest margin (7.1 percentage points) in over two decades. In contrast, EM growth stocks only slightly outperformed their value counterparts, although Information Technology and Communication Services led sector performance in both EM and DM. Commodities saw mixed results, with recession fears weighing on energy prices and Chinese demand bolstering metal prices.

China's market climbed as much as 17% for the year in late January, driven by optimism that its departure from Covid-suppression policies would lead to a robust, consumption-led economic recovery. Although subsequent economic data confirmed that a recovery was underway in the first quarter, investor sentiment toward China was dampened by escalating US-China tensions over a spy balloon incident and concerns that China was considering providing weapons to aid Russia in its war against Ukraine. After losing most of its earlier gains in February, the MSCI China Index concluded the quarter with a 4.7% increase. A 0.25% cut in the reserve requirement ratio (RRR) in March provided optimism about China's credit cycle, while technology stocks soared as companies pursued break-ups to unlock shareholder value. China's currency also appreciated 1.2% against the US dollar, as confidence in the greenback weakened due to the US banking crisis.

Asia emerged as the top-performing EM region in the quarter, with a 4.8% gain. The region benefited from China's strong performance and double-digit increases in South Korea and Taiwan, driven by optimism about the global semiconductor cycle's potential bottom. However, India's market dropped -6.4%, impacted by allegations of fraud and stock manipulation at Adani Group companies amidst tighter monetary policy and slowing GDP growth.

EM Latin America ranked second in first-quarter performance, propelled by Mexico's 20.3% surge due to robust earnings reports and optimism about benefiting from nearshoring investments as corporations reduce reliance on China. Brazil, however, dragged the region's performance down by 3.2% as it introduced a new fiscal rule favoring increased taxation. The EM region of Europe, the Middle East, and Africa (EMEA) underperformed, with a -1.2% loss. While the Czech Republic and Greece saw strong gains, losses in South Africa, Qatar, and the United Arab Emirates offset them. Turkey's market declined -9.4% as the government removed the interest rate cap on an emergency savings plan to stabilize the lira.

EM sector performance varied widely, with Information Technology and Communication Services outperforming the MSCI EM Index. Utilities underperformed due to country-specific issues in India and Turkey, followed by Health Care, hampered by weak performance in Brazil and China. Materials, Industrials, Consumer Discretionary, and Consumer Staples achieved modest 2% gains, while Energy, Financials, and Real Estate saw slight declines of less than 2%.

EM valuations remain low, with the MSCI EM Index trading at 11.8 times forward earnings, a 20% discount compared to the MSCI World Index of DM stocks at 14.9 times. Despite the recent repricing of Fed rate expectations, China's reopening occurs amid very low domestic inflation, giving the leading EM nation a favorable business cycle position relative to key DM nations focused on combating inflation. We maintain cautious optimism for EM equities, despite ongoing geopolitical risks and potential headwinds to global equity markets if major DM economies enter a recession.

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