GW&K
INVESTMENT MANAGEMENT

INVESTMENT REVIEW
3Q 2022

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ECONOMIC COMMENTARY

BY HAROLD G. KOTLER, CFA

Founder-Chairman, Chief Investment Officer

As the most critical time of Covid passes we must ask ourselves, what is the long-term effect on our economy? Like with crises of the past, the permanent changes are not always obvious.

We all have experienced the impact of this pandemic in our own way, but now is the time to examine macro developments and imagine how events will evolve from here.

The impact of wages, employment, and inflation should be considered through a single lens. As a backdrop, we all know that US immigration policy was not designed to boost our workforce. We also know that our birth rate has dropped below the replacement level. So first and foremost, the supply side of labor is constrained. This was the case before Covid and it has only worsened. The shortage has been further impacted by a combination of events: workers 55-years and older dropping out of the available candidate pool, an explosion of entrepreneurship and the desire to work from home, particularly among white collar workers. Companies have needed to address employee desires and be sensitive to their attitudes and demands. The shift in the employee/employer relationship is not being forced by unions, which has often been the case the last 100 years, but by the fear of losing a competitive advantage in the face of a limited supply of talent. Thus, the impact of post-Covid worker attitudes has driven a new dynamic in the workplace.

So, what do workers do with this new power? They ask for higher wages and additional benefits. And how are these wages rationalized in a declining economic environment? The classic answer has been to raise prices and keep margins in place. Is that model still intact? Will employers be able to pass on price increases in a system that is not enjoying real growth? Obviously, it depends on several factors. In many industries, there is no room for price increases and the result will be that businesses will need to adjust margin expectations.

> *"As we look out five years, we will see this market correction as a wonderful opportunity. As I have often written, while we could stay in a trading range for a while, we are setting a new base for a bull market."*

If the global economy was as healthy as it was pre-Covid; pre-Russian invasion of Ukraine; pre-China's zero-tolerance policy, one could argue that businesses, as they have for the past 20 years, will find offshore opportunities to keep operating expenses in check. But in a post-Covid world, the opposite is true. Companies now seek more domestic solutions to avoid the challenges of supply-chain interruptions.

The magic bullet to margin pressures, of course, is higher productivity. Can businesses solve the growing tensions between their top and bottom lines by increasing efficiency, whether through technology or consolidation? The answer is

Continued on next page

that some can and will, while others will not be able. No doubt some companies will need to shrink to right-size their business models. We have been trained that bigger is better, but this is not true for all industries. Restaurants have shrunk square-footage, hospitals have eliminated services, airlines have scaled back flight routes. Even in the daily routine of home life, we have all experienced the shortage of contractors, plumbers, and electricians.

What does this mean for the stock market? Even looking past the next couple of years, after shortages disappear, inflation moves back toward baseline and short-term rates retreat, what is the long-term opportunity in a shrinking economy? Will we experience stagnation like Japan, or will we be different?

Inflation will decline but real growth will still be more difficult. For equity investors, this feels like one of those "stock picker's markets" we've seen so often in history, where results will come from identifying select opportunities rather than riding a great wave. Not such a bad environment. The bond market should also take on renewed interest, with intermediate and long-term bonds now at attractive levels. The Federal Reserve's resolve to curb inflation provides a great opportunity to begin to lock in decent cash flow.

As a true believer in capitalism I think there are always opportunities to make money, but it won't be as easy as the last 20 years, especially in the US. Speculation and unbridled risk amid zero interest rates were not sustainable. This next phase, however, should create a healthier base. I also believe in the need to invest overseas. While Western democracies try to stabilize after the free money era, Eastern economies will continue to grow as their populations enjoy the benefits of a more integrated world economy. The pace of globalization may have been slowed by the pandemic, but it is simply too strong a force to be held back completely. While diversification has always been important, in today's very complicated world, investment portfolios must supplement a foundation of domestic stocks and bonds with international exposure.

As we look out five years, we will see this market correction as a wonderful opportunity. As I have often written, while we could stay in a trading range for a while, we are setting a new base for a bull market.

For those of us who manage assets, it is a mistake to stare through the rearview mirror. The beauty of this business is that it is all about looking to the future and finding new opportunities.

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

GW&K NEWS

COMPANY UPDATE SEPTEMBER 30, 2022

185 EMPLOYEES

61 INVESTMENT PROFESSIONALS

$45 BILLION TOTAL ASSETS UNDER MANAGEMENT

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THIRD QUARTER 2022

ECONOMY

- The economy is expected to grow modestly in Q3 (Bloomberg survey projects +1.4% for real GDP) after two consecutive quarterly declines in the first half of the year.
- Consumer sentiment remains weak due to high inflation, but falling gasoline prices and robust wage gains have boosted spending on services while consumers pared back spending on goods.
- Even though gasoline prices have eased since June, broad-based inflation pressures pushed the Consumer Price Index (CPI) in August up by 8.3% from a year earlier.
- The Fed's aggressive response to inflation has raised the risk of recession. The interest-rate sensitive housing sector is a likely source of economic weakness as mortgage rates have surged to 6.7%.

FED ACTION

- Despite recent turmoil in global financial markets, Fed officials have reaffirmed their resolve to pursue a restrictive monetary policy until inflation is on its way back to their 2% target.
- A third consecutive jumbo rate hike of 0.75% in September brought the federal funds rate to the 3.0% – 3.25% range. The Fed projected a funds rate of 4.4% at the end of this year and 4.6% at the end of next year.
- The Fed also tightened liquidity in September by increasing monthly caps on its balance sheet runoff to the maximum $95 billion per month pace.
- The Fed projected the funds rate falling to 2.9% in 2025, assuming inflation falls to about 2%. In contrast, investors are pricing in a funds rate that remains close to 4% through 2025.

BOND MARKETS

- Fixed income markets were under extraordinary pressure as investors continued to adapt to restrictive monetary policy after more than a decade of accommodation. Stubbornly rising prices, hawkish central banks, and various geopolitical forces combined to tighten financial conditions and raise borrowing costs.
- Treasuries experienced one of their most volatile quarters in history in response to above-consensus inflation readings and policy response from the Fed. The yields on the 2- and 10-year notes hit their highest levels since 2007 and 2010, respectively, while the curve's slope experienced its deepest inversion since 2000.
- Corporates were relative outperformers within the universe of risk assets, with investment grade spreads only marginally wider and high yield spreads tighter.
- Municipal bonds shared the pain of the broader market slide with tax-exempt yields climbing to heights not seen in over a decade.

INDEX PERFORMANCE 9/30/22

	QUARTER	YEAR TO DATE
Bloomberg 10-Year Municipal Bond Index	-2.54%	-10.59%
Bloomberg Aggregate Bond Index	-4.75%	-14.61%
Bloomberg High Yield Index	-0.65%	-14.74%
Dow Jones Industrial Average	-6.17%	-19.72%
S&P 500 Index	-4.88%	-23.87%
Russell 2000 Index	-2.19%	-25.10%
MSCI EAFE Index	-9.36%	-27.09%
MSCI World Small Cap ex USA Index	-9.46%	-31.07%
MSCI World Index	-6.19%	-25.42%
MSCI Emerging Markets Index	-11.57%	-27.16%

DOMESTIC EQUITY MARKETS

- US equity markets closed the quarter lower leaving the major indexes in bear-market territory year to date. As the Fed further tightened monetary conditions, inflation levels stayed stubbornly high, reducing expectations of a near-term shift in Fed policy and raising concerns of a material economic slowdown.
- Large cap stocks, as measured by the S&P 500, declined -4.9% and lagged small and mid-cap stocks.
- Consumer Discretionary and Energy were the best performing sectors and only groups to generate a positive return. Communication Services and Real Estate suffered the steepest losses, falling over -10%.
- Growth stocks modestly outpaced Value for 3Q, though Value leads year to date. Quality factors were mixed in the large cap market though investors demonstrated a preference for low-quality factors within small caps.

GLOBAL EQUITY MARKETS

- Non-US developed markets (DM) remained under pressure this quarter amid Europe's deepening energy crisis and outsized interest-rate hikes in several countries. The MSCI World ex USA Index fell -9.2%, while the MSCI World Small Cap ex USA Index was down -9.5%.
- Much of the decline was due to currency weakness — the US Dollar Index reached another multi-decade high with a 7.1% gain.
- China's challenging economic backdrop saw the MSCI Emerging Markets (EM) Index drop -11.6%, while the MSCI EM ex China Index declined -5.6%. Brazil and India were among the few markets to post a positive return.
- Sector performance was broadly negative with steep losses in DM Communication Services, Real Estate, and Health Care. In EM, Real Estate, Communication Services, and Consumer Discretionary also saw heavy declines.

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

Municipal bonds posted heavy losses in the third quarter as hopes faded that the Federal Reserve would soon pull back on its aggressive tightening program. After an impressive rally in July, when it still seemed possible that a lowercase "R" recession might usher in an early-spring easing, bond yields soared over the following two months. The two major culprits were the labor market, which stayed extremely tight, and inflation, which remained broad-based and hovered near 40-year highs. Fed officials cited the data as evidence that more needed to be done, lest elevated inflation expectations become entrenched. The FOMC followed through by raising rates 150 basis points during the quarter, doubling the magnitude of hikes from the first half of the year. As importantly, committee members signaled more to come, forecasting a steeper policy path and higher terminal rate than traders had expected. Sentiment was also weighed down by geopolitical crosscurrents, including the ongoing war in Ukraine, Covid lockdowns in China and a brief but dramatic crash in UK government debt, which necessitated an intervention from the Bank of England. In late September, the yield on the 10-year Treasury touched 4% for the first time since 2008, before declining slightly to end the quarter at 3.83%.

Tax-exempt yields mirrored the roller coaster ride in the Treasury market. Rates rallied hard in July only to turn sharply higher in August and September, resulting in a third consecutive quarter of negative returns, the first time that has happened in over 40 years. Strong technicals did little to stem the tide. Treasury market losses overwhelmed the tailwinds from seasonally-high rollover demand and new issue volume that was down 25% from the third quarter of 2021. The front end of the curve took the brunt of the damage, as unsustainably low relative value ratios made that area particularly vulnerable to a backup. As a result, the municipal bond curve flattened substantially, with the spread between 2s and 10s ending September at 21 basis points, only a fraction of the level at which it started the quarter (77 basis points). Net redemptions out of mutual funds slowed in July before accelerating over the ensuing months, pushing year-to-date outflows over $90 billion for the first time ever. Limited issuance and thin trading desks led to weak price discovery, adding fuel to the slide.

But even as the pullback deepened, with the entire municipal bond curve ultimately eclipsing the 3% mark, trading activity never felt panicky. Buyers emerged in both the primary and secondary markets, drawn in by tax-equivalent yields that had risen to levels high enough to rival riskier asset classes. For those in the highest tax brackets, for instance, 10-year AA bonds trading at a 3.5% level translates into a tax-equivalent yield approaching 6%, even before any in-state exemption is considered. While the slope of the municipal curve has flattened significantly over the year, it is still upward sloping, a sharp contrast to the Treasury curve, which ended the quarter deeply inverted. The fundamental credit quality in the municipal bond space remains healthy, supported by strong revenue growth and record fund balances. While it is always difficult to call a bottom, there have been few entry points in the last two decades as attractive as the present situation. As a long-only market, municipal bonds are susceptible to oversold conditions, and if investors continue to pull cash from mutual funds, we can expect the momentum to remain negative. But every move higher in yields sows the seeds of a potential trend reversal. Locking in higher rates and wider spreads is the best way to prepare for that risk.

The rate environment in the third quarter provided an incentive to extend duration modestly. A steep credit curve is not unusual in the municipal bond space, but these extremes typically develop only in volatile environments, and when retail investors rush to the short end to take cover, we take advantage by tacking in the opposite direction. Given the high degree of uncertainty and potential for rate instability ahead, we continue to maintain plenty of flexibility to move in or out the curve.

22 AVERAGE YEARS EXPERIENCE

16 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

"The fundamental credit quality in the municipal bond space remains healthy, supported by strong revenue growth and record fund balances. While it is always difficult to call a bottom, there have been few entry points in the last two decades as attractive as the present situation."

TAXABLE BOND STRATEGIES

Fixed income markets were under extraordinary pressure in the third quarter as investors continued to adapt to restrictive monetary policy after more than a decade of accommodation. Stubbornly rising prices, hawkish central banks, and various geopolitical forces combined to tighten financial conditions and raise the cost of borrowing around the world. Defying expectations that it had peaked, inflation remained elevated and manifested across a broader and more entrenched collection of goods and services. The Federal Reserve also confounded expectations, projecting a more cautious outlook and a more aggressive path of hikes than most economists had anticipated. International pressures escalated as well, as currency market dislocations, political leadership changes in Europe and Asia, and multiple energy crises collectively drove a heightened sense of uncertainty. The variety and momentum of these forces suggest no near-term end to volatility, especially against a backdrop of increasingly expensive capital.

The Treasury market experienced one of its most volatile quarters in history in response to above-consensus inflation readings and the resulting policy response from the Fed. The FOMC raised rates 150 basis points during the quarter, bringing the total increase this cycle to 300 basis points. But of more consequence was the committee's Summary of Economic Projections. It guided to a steeper path of hikes and higher terminal level than markets had priced in, leaving little room to doubt the Fed's commitment to restoring price stability. The market reaction showed how starkly these updates shifted the prevailing narrative — rates rose significantly and the yields on the 2- and 10-year notes hit their highest levels since 2007 and 2010, respectively, while the curve's slope experienced its deepest inversion since 2000. Contributing to this weakness was a significant increase in real yields, which rose from deeply negative territory as recently as March to their highest level in more than a decade. Breakevens, meanwhile, have collapsed, highlighting investors' confidence that the Fed will achieve its 2% inflation target.

Corporate credit was a relative outperformer within the broader universe of risk assets, with investment grade spreads only marginally wider and high yield spreads tighter on the quarter. Credit fundamentals are broadly sound, with leverage well below its post-Covid peak, interest coverage near historical highs, and financial distress trending lower. Proximate catalysts for default are scarce, but the potential for volatility is elevated as earnings downgrades have begun to outnumber upgrades and banks have struggled to syndicate some of their riskiest new issues. Mortgage-backed securities have also been under pressure, lagging duration-matched Treasuries amid elevated rate volatility. Technicals in the space were challenged, given the termination of the Fed's MBS purchases, though spreads were spared the worst of it by the Fed's deciding against pursuing outright sales. Another bright spot was the significant slowdown in originations, a natural consequence of the sharp jump in mortgage rates.

Expectations of a Fed "pivot" have been relegated to the closing months of 2023, suggesting investors have become more comfortable with higher-for-longer monetary policy. Additionally, investors seem to have registered acceptance of the "pain" that Chair Powell has warned might be necessary to quell inflation. Rate volatility has consequently risen to levels last seen at the outset of the pandemic and, prior to that, the global financial crisis.

While our outlook for corporate credit is constructive from a bottom-up perspective — given years of prudent balance sheet management and robust profitability — we recognize the rising risks that macroeconomic factors pose to the sector. As such, our exposure is at the lower end of its historical range. Within corporates, we continue to prefer higher-quality names with less exposure to cyclical industries. We remain opportunistic with respect to idiosyncratic stories and have been active in credits that we expect to improve their leverage profiles or which have sold off unduly. Our outlook for mortgages has informed a neutral exposure, given potential event risk surrounding quantitative tightening and elevated rate volatility, even as recent underperformance has brought spreads to the wider end of their recent range.

19 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

"Expectations of a Fed "pivot" have been relegated to the closing months of 2023, suggesting investors have become more comfortable with higher-for-longer monetary policy. Additionally, investors seem to have registered acceptance of the "pain" that Chair Powell has warned might be necessary to quell inflation."

DOMESTIC EQUITY STRATEGIES

23 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

After a very strong start to the quarter on the back of the "peak Fed/peak inflation" narrative, US markets continued their downward trajectory as the Fed made it clear it would respond forcefully to stronger economic data and hotter inflation readings. By quarter end, interest rates had spiked upward and markets had more than given up their early quarter double-digit gains. Globally, markets were even weaker, with the war in Ukraine, Europe's energy and inflation crises, the UK's narrowly averted debt crisis, Japan's dovish monetary policy, and China's zero-Covid policy and real estate crisis. And all of these factors were only made worse by the strong US dollar. There were few places to hide — India and Brazil the rare exceptions — as these macro risks of economic slowdown, stubbornly high inflation and higher interest rates were exacerbated by continued geopolitical concerns.

Domestic large cap equities, as measured by the S&P 500 Index, fell -4.9% in the quarter, pushing year-to-date losses to -23.9%, its worst nine-month start to a year since the bursting of the internet bubble two decades ago. Only Consumer Discretionary and Energy sectors posted gains for the quarter, while losses reached double digits for the Communication Services and Real Estate sectors.

The Russell 2000 Index of small cap stocks fared slightly better, dropping by a more modest -2.2%, although its year-to-date decline of -25.1% still places the Index behind large caps. Sector performance was similar down cap, except for Health Care leading the list of small cap gainers.

Growth had a sizable comeback versus Value in the quarter, but the gain wasn't enough to offset Value's sizable lead year to date. Style factors favored lower quality this quarter, especially among smaller caps, as non-earners, lower ROE and higher-beta companies outperformed.

The litany of concerns, both economic and geopolitical, does not seem to get any smaller as we reach the home stretch for 2022 and turn our attention on 2023. Hotter inflation readings and a strong labor market have caused the Fed to double down on its aggressive plans for rate hikes and quantitative tightening. The resulting spike in interest rates has clearly reduced prices investors are willing to pay for equities, as the relative attractiveness of bonds has clearly improved. More importantly, higher rates are starting to show their impact on the economy; the most evident being a slowdown in housing as mortgage rates approached 7% at quarter end. While labor data including the unemployment rate and job creation remains strong, it is just a matter of time until job destruction becomes apparent. Of course, this is exactly what the Fed wants, as they have made it abundantly clear that getting inflation under control trumps any impact its policies may have on the economy. Global geopolitical worries, including Putin's war against Ukraine and China's more aggressive tone against the West, add further degrees of uncertainty to the global outlook.

> *"Our focus remains on finding companies that are well managed, are leaders in their industries, have solid financial characteristics, and sell at prices we consider reasonable for such quality. Whether the Fed gets it right or wrong, these are the types of companies we want to own for the long term."*

Yet, these risks seem well understood by the market which is already down 25-30% from the highs across most equity benchmarks. Extreme negative sentiment indicators suggest we are near the bottom. Valuation levels have also become more reasonable. The rate of growth in the money supply, which clearly played a role in the recent surge in inflation, has already slowed to under 5%. And signs of peak inflation have become much more evident, with many prices such as oil, lumber, and shipping rates falling dramatically from their highs.

Since the Fed's actions tend to work with a meaningful lag, the big question is whether inflationary signals slow enough for the Fed to reign in its aggressiveness before its actions cause the economy to overshoot on the downside. While the Fed doesn't have a great track record in this regard, there is a chance we get through this period of high inflation without pushing us into recession. But we would further note that our focus remains on finding companies that are well managed, are leaders in their industries, have solid financial characteristics, and sell at prices we consider reasonable for such quality. Whether the Fed gets it right or wrong, these are the types of companies we want to own for the long term.

GLOBAL EQUITY STRATEGIES

23 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

"While not yet at table-pounding buy levels, the opportunities we see in global equity markets are attractive for long-term investors."

After a sharp but brief rally in July, global equities resumed selling off in August and September. In the third quarter, the large cap MSCI World ex USA Index fell -9.2%, while the MSCI World ex USA Small Cap Index dropped -9.5%. A significant portion of this decline was again due to currency impact, as the US dollar strengthened 7.1%. Weakness in the Japanese yen continued, down -6.2%, but was surpassed this quarter by the UK pound, which hit all-time lows after falling -8.3%.

All sectors were lower with growth-focused Communication Services and interest-rate sensitive Real Estate declining the most. Energy and Materials did best, but still ended the quarter down. On a geographic basis the weakness was widespread with each region lower. Europe was off the most with more modest losses in North America, Asia, and the Middle East. At an individual country level there was more variance, but no developed market finished higher. Ireland and Israel did best, while Portugal and Germany led the declines.

Taking a closer look at the market's view on the current world situation, the US, as the largest economy, is in the midst of the fastest interest-rate hiking cycle on record, and the Fed will continue hiking until something breaks. China, the second largest economy, has closed itself off from the rest of the world at the same time its real estate bubble is at risk of bursting. Japan, coming in third, remains focused on ultra-loose monetary policy and yield curve control despite reaching policy goals. The fourth, Germany, has a severe energy crisis and a war next door. And the UK, as the fifth largest economy, is stumbling through a series of policy errors, showing up in high inflation and a weak currency. This view is correct, but it is also well known, and markets have had plenty of time to incorporate it into equity prices. We would actually go a bit further and note we expect an earnings recession as companies are forced to adjust to higher costs (materials, labor, interest rates) while facing lower post-Covid demand. We also think it likely that the market is consistently too optimistic on interest rates. Yet, despite these issues, we are bullish on the global equity opportunity.

During difficult periods, where the bad news is clearly expressed and constantly visible, investors sharply reduce the duration of business risk they are willing to endure. At the top of the market investors are willing to entertain even the most optimistic hopes and dreams as a sound investment case, whilst in a bear market even the best companies are treated as if business will never recover. Investing outside your home market adds the additional complication of currency fluctuation. However, the reason that equities offer a premium return over the long run is this requirement that investors endure these difficult markets.

For the first time since the global financial crisis, major economies are out of synch with each other. Japan for example, is finally breaking out of 30 years of deflation just as it also emerges from Covid. Demand for its automation equipment, chemicals, and electronics are high, while strong corporate and consumer balance sheets combine with a robust labor market to tee up positive domestic and export demand. In the UK, niche, but still world-class companies are selling at valuations last seen during the peak of the European debt crisis or the depths of the financial crisis. In Hong Kong, Singapore, and Southeast Asia we can now find asset-rich companies trading at a small fraction of the value of their high quality, cash generating, and growing assets. These opportunities are even better for those able to invest with a strong currency as inevitably today's foreign exchange headwinds will become tailwinds.

While not yet at table-pounding buy levels, the opportunities we see in global equity markets are attractive for long-term investors. Given the very real risks, we believe it is important to be able to pick and choose between the many discounted equities on offer. Our preference remains for high quality, profitable, and well-capitalized companies with a history of generating value for their owners.

EMERGING MARKETS EQUITY STRATEGIES

29 AVERAGE YEARS EXPERIENCE

17 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

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS

EMERGING WEALTH

Emerging market (EM) equities declined -11.6% in the third quarter, posting a fifth consecutive quarterly decline. That is the longest losing streak since the 1987 inception of the MSCI EM Index, with the string of losses reflecting both global factors like rising inflation and interest rates along with EM-specific factors like China's recurring Covid lockdowns and property sector crisis. The third-quarter EM decline compared to a loss of -6.2% in the MSCI World Index of developed market (DM) equities. EM's underperformance of DM is mainly due to a -22.5% loss in MSCI China, which accounts for almost one-third of the EM benchmark.

China's third-quarter weakness brought its loss for the year to date to -32.1%, compared to a -27.2% decline for the MSCI EM Index, and a -25.4% decline for the MSCI World Index. Notably, the drawdown in MSCI China since the peak in February 2021 has now reached -55.0%, compared to a drawdown of -26.7% in the MSCI World Index from its December 2021 peak. China's economic outlook remains clouded by multiple layers of uncertainty related to Covid policy, monetary policy, regulatory policy, property sector policy, and geopolitics.

While China's economy appears to have recovered from severe Covid lockdowns in the second quarter, recent economic data has come in on the low side of expectations amid sporadic lockdowns, weak exports, and a bruising property market retrenchment. In response, policymakers have rolled out fiscal stimulus measures of 1.2% of GDP while continuing to ease monetary policy.

Absent the China drag, the MSCI EM ex-China Index did slightly better than DM equities in the third quarter with a decline of -5.6%. From a regional perspective, the EM region of Latin America was the clear winner in the quarter with a gain of 3.6% fueled by a 19.9% gain in Argentina and an 8.5% gain in Brazil. The EM region of Europe, the Middle East, and Africa (EMEA) and Latin America also outperformed the MSCI EM benchmark in the quarter, with a loss limited to -2.6%. Despite a 5% decline in the price of Brent crude oil in the quarter, the oil-rich Gulf states outperformed.

The EM region of Asia ex-China was lifted by gains of 7.8% in Indonesia and 6.5% in India, but was weighed down by double-digit declines in the index-heavyweight markets of South Korea and Taiwan. Those tech-heavy markets have fallen this year in sympathy with weak global export trends. A common headwind for all EM regions was elevated global inflation and the increasing hawkishness of leading DM central banks like the Fed and the European Central Bank (ECB). In response, the hiking spree of EM central banks continued in the third quarter, with eight EM nations hiking rates by 50 to 150 basis points, while four hiked by 175 basis points or more. Among EM nations, only China and Turkey cut policy rates in the quarter.

EM sector performance was broadly negative in the third quarter, with the best relative performance coming from Energy, which was down -2.6%. Defensive sectors like Utilities and Consumer Staples also outperformed with respective declines of -4.3% and -4.5%. At the other end of the spectrum, China-heavy sectors like Information Technology, Consumer Discretionary, Communications, and Real Estate all posted declines ranging from -15% to -20%.

"With the MSCI EM forward price-earnings ratio now trading at 10.0x, valuations are approaching prior cycle lows. That should improve the reward-to-risk ratio of EM equities on a forward-looking basis."

The challenging environment for EM equities is evident in MSCI EM's new record for consecutive quarterly declines and in its 40% peak-to-trough decline since February 2021. With the MSCI EM forward price-earnings ratio now trading at 10.0x, valuations are approaching prior cycle lows. That should improve the reward-to-risk ratio of EM equities on a forward-looking basis. To be sure, the global backdrop remains turbulent as DM central banks continue to hike interest rates and as China still faces multiple layers of economic and political uncertainty. However, history shows that MSCI EM has troughed ahead of the S&P 500 in four of the 10 prior bear markets and on the same date as the S&P 500 on three occasions. Given that China is more likely to be stimulating their economy when other major nations are still curbing growth, we suspect that MSCI EM will trough ahead of DM markets in this cycle.

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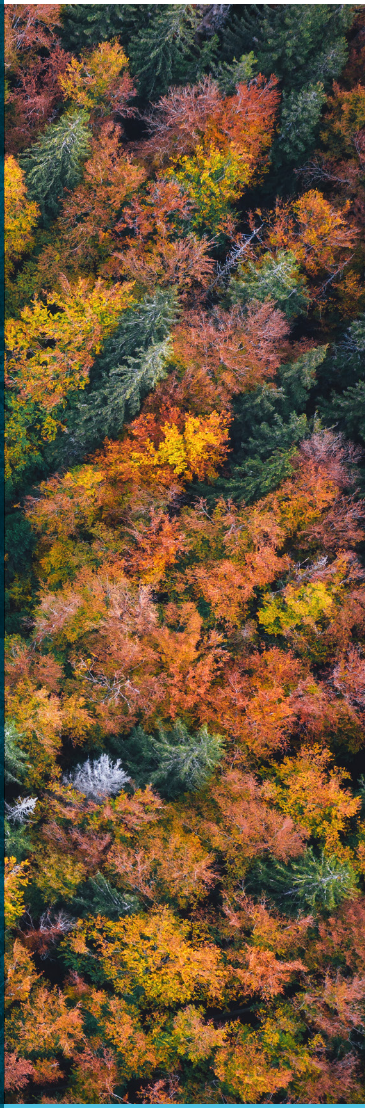

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