April 26, 2023

We invite you to listen to our quarterly conversation with Harold Kotler, Bill Sterling, and moderator Dan Fasciano, as they review events from the first quarter of 2023 and discuss how they might affect investors over the near and intermediate term, including:

- Higher equity markets, led by Europe, Australasia, and the Far East (EAFE) and the US
- The transitional period we're in now, from higher interest rates to lower interest rates
- What the Fed is likely to do at the next Federal Open Market Committee (FOMC) meeting
- The US economy, including the recent banking turmoil, the debt ceiling, and the health of US consumers
- Opportunities with intermediate and longer-term bonds
- Asia's growth and the effect it may have on the global economy

We are available to answer your questions and address any concerns you may have so please do not hesitate to contact us.

Edited transcript

Dan Fasciano: Welcome to the First Quarter Conference Call for GW&K Investment Management. This call represents the views and opinions of GW&K Investment Management and does not constitute investment advice, nor should it be considered predictive of any future market performance.

My name is Dan Fasciano. I am the Director of Private Wealth here at GW&K. Joining me on today's call is Harold Kotler, GW&K's Chairman and Chief Investment Officer, as well as Bill Sterling, our firm's Global Strategist.

Harold, I'm going to begin with you. It's been an interesting start to the year. Equity markets are higher globally, led by EAFE and US; interest rates are lower. Now that we're almost a third of the way into 2023, what themes are you focused on and what should clients be thinking about?

Harold Kotler: Well, we're in a transitional period, from high inflation to lower inflation; from an economy that was struggling with all the effects of Covid, to one that now is getting normalized. And after the correction of last year, and interest rates spiking, we are finding our way and finding our footing. So, in my letters I have, and I still say, it's a transitional year — and maybe next year as well — where we'll have ups and downs, but no major concerns. And then the direction of all these assets, they're becoming more attractive all the time. So I'm very positive about the markets — I'm not assuming any incredible returns, but setting a base for future returns.

Dan Fasciano: Bill, the Fed's hiked at the last nine consecutive meetings. They've raised the fed funds rate from less than 0.25% Q1 of last year to 4.75% – 5%. The next FOMC meeting is May 3 — just a week or so away here. What's the market been pricing in for that meeting, and for the rest of 2023? More importantly, what's your view?

Bill Sterling: Well, the upcoming Fed meeting looks like it will see one more rate hike, hopefully the final rate hike in the cycle to take the upper end of the fed funds target range to 5.25%. That's what the market's pricing in, and that's what I think is most likely. The market's also pricing in two to three rate cuts by the end of the year, which could take the upper end of the range down to about 4.5%. That seems about right to me. If I look back at history, it's typically taken the Fed about four months, on average, from their last rate hike to the beginning of a rate cutting cycle. And there are enough signs that the economy is slowing pretty significantly here that this does look like it's going to be the last rate hike of the cycle, and that we can be on a glidepath towards 2.5% type inflation rates by the first half of 2024. So, I think the market's got this about right.

Dan Fasciano: That's helpful, and we're far enough into 2023 to start talking about 2024, aren't we? I guess while we're on the topic around debt in general, you know, what are your thoughts about the current debt ceiling situation? And I guess alongside that what should clients be looking at or for?

Bill Sterling: Clearly the market is concerned that, as we saw in 2011 or 2013, and then again in 2015, this could go to the wire before the politicians come up with some sort of solution to raise the debt ceiling. You know Kevin McCarthy, on the GOP side, has been proposing a $1.5 trillion increase in the debt ceiling in exchange for tighter spending controls. That may be a non-starter so far on the democratic side of things, so you know, we saw in 2011 they had only hours to go before they were on the brink of a technical debt default, and that was associated with fair amount of market volatility. That could happen this time around. Nobody knows. Eventually, though, they usually solve these things, and for long-term investors, it hasn't paid to pay a whole lot of attention to it. But this one looks tricky for sure.

Dan Fasciano: Harold, you know we're talking here about the Fed, and the debt ceiling and, potentially technical default. I guess that begs the question, you know, do you think the US is going to go into a recession? Alongside that, how much should it matter for investors?

Harold Kotler: I like the second part of the question better than the first. Look, I can't argue that it might be two quarters in a row of down GDP, which is the definition of a recession. I really don't care about that so much as what it looks like, and what does it mean? So, there may be a probability we may have that technical recession, but that's not where the focus should be. The focus should be: What does it mean? And I suggest that it means there is a bottoming position for the economy, lower inflation, and if the market does decline a bit, it's just a further buying opportunity. You just can't get bogged down in the short-term economic cycles when we can look forward to a healthier economy two to five years out, and it's just all about opportunity. I see all this providing great opportunity. Of course there's disruption, of course there will be some failures. Of course there are frustrations in the banking industry. But, for a diversified investor, it's only trying to be sure that you have your commitments and looking in the further view over a decent period out two to three years.

Dan Fasciano: Bill, 70% or so of GDP is consumption and we talked about the Fed, but with prices of goods and services higher for sure, year on year, and obviously a more restrictive Fed in that last 12 months, I mean, how would you describe the health of the consumer right now?

Bill Sterling: Well, the first quarter was surprisingly good, Dan. It looks like consumer spending will be in the 3% – 4% range the first quarter. But most of that was front loaded in January, and when we look at the monthly data, there's no doubt there's been a slowdown, and consumers have been zipping up their wallets. The Fed wants to see that consumer spending rate, and economists believe it's going to slow to about 1.5%, maybe even 1%, which is sometimes called "stall speed" for the overall economy. But when we look at consumer confidence surveys, they've been pretty weak in general, which is consistent with that big slowdown in the economy. But one thing I'd point out that's important to keep in mind is that consumer balance sheets are still quite healthy. Net worth is well about what the pre-pandemic trend would have would have suggested, even with the bear market we've had, in particular, in 2022 in equities and fixed income. And also, households are flush with cash. I estimate that there's about $4 trillion dollars in excess liquidity in the household sector. Primarily in the high income, high net worth sectors; but that suggests that the recession, if it comes, could be a fairly shallow one. We have nothing like the degree of household leverage that we had say, in the 2005/2006 episode, when so many people got upside down in their mortgages, and it had a big flushing out of economic activity because of the mortgage crisis. If anything, we have the highest sort of equity positions in housing that we've ever seen right now. Along with a lot of that cash, and you know that suggests this cycle could be a fairly shallow one.

Dan Fasciano: Harold, when you think about US interest rates and the curve, what do you make of opportunities with intermediates and longer-term bonds right now?

Harold Kotler: It's very funny, Dan: In the last 5 – 6 years, people were sucked in to buying 10-year paper at a very marginal rate versus zero, which is what got the banks in trouble. And now, with short rates being so attractive, the inclination is to keep all your money short, because it's a very attractive return and disregard the intermediate and long. In my whole career, all these years I've been teaching people third grade math: Rate times time equals distance. So, although the rate is attractive for one year, it's one year. It's only one year. And if in fact inflation is coming down, and if the economy does slow up and long rates continue to decline, as they have been, people will miss the long end of the market once again, and the opportunity that the long end provides. So, I'm a big proponent of making sure you've got 7- to 12-year maturities, and don't focus all your money on the short end, however attractive it might be.

Dan Fasciano: For those clients who are saying, "Listen, I've got 4.5% cash right now, why would I extend that out, and maybe get something less?" Really the practical experience of an inverted curve: You're saying don't sit on too much cash right now — would that be a fair thing to say?

Harold Kotler: The short end is short. Which means if we get into a recession, the Fed is going to start to reduce short rates and those returns will decline. So, everything is always changing. So to bet on any moment in time as being consistent, is a huge mistake. And that short end is incredibly volatile, as we've seen. I mean, that's what killed the banks, right — from zero to 4.5%? Now, it won't go back to zero. But what if it went back to 1.5% – 2%? Your one-year paper will mature, and your reinvestment rate will be 2%. And unless you're investing, or you're thinking about dying in a year, you have to have a long-term focus on the internal rate of return. And the internal rate of return on short paper is very short. Therefore, you have to be willing to commit to a longer piece, to lock in an internal rate of return. Not with all your money — you can keep some

money short. But it's like the Venus flytrap: It'll suck you in, you'll feel comfortable, and then bang! Your rates go down by 2% – 3%.

Dan Fasciano: I'm going to remember that. Rates as a Venus flytrap. I like it, and if I use it, I'll give you full credit here. Bill, we've just talked a little bit about opportunities here in the US, particularly rates. I want to steer your attention in China. When we last sat down, the three of us, China was just reopening. Now that we've got a quarter under our belt, are there any deeper takeaways that you're getting at this stage? What's your view on growth in that region?

Bill Sterling: I think the brutal lockdowns in China last year put their economy in a totally different business cycle position than the rest of the world. They had a very significant slowdown in 2022, but all the evidence since they got rid of those Covid restrictions late last year is that the economy has come back strongly in the first quarter and first four months of the year, for that matter. So, all the high frequency data, whether it's on domestic travel, road congestion, subway riding, all that has been booming in the first four months of this new year. They reported first quarter GDP up 4.5% year on year, compared to 4% expected. But that was 9% at an annual rate, and most economists are looking at a continuation so for the full calendar year, you're likely to see 5.5% – 6% growth in China. And remember, other major economies in Asia are also doing well. India is expected to grow close to 7% this year. Indonesia, which is a trillion dollar plus economy with 250 million people or so, is expected to grow around 5% this year as well. So, I think the Asian growth story is really quite encouraging right now, and very distinct to the kind of concerns about slowdown/possible recession in the US or Europe.

Dan Fasciano: Well, I'm going to take your kind of Asian momentum here and bring your attention to Europe. Heading into the winter for sure we were talking about the threat of higher energy prices on Europe. That seems to have not really manifest in EAFE, in particular — it's been a great performer year to date. When you cast your attention on Europe as a region, what's your thinking going into the summer months?

Bill Sterling: Well, I think the big thing that happened in Europe, and you touched on it, is that energy prices have come down a lot, especially the natural gas. Natural gas was the equivalent of $550 barrel oil last August. That's come down to around $75 barrel oil, comparable to prices everyone in the world's facing. That's an 87% drop from the peak. And as those natural gas prices drop, people's perception of the European economy has been marked up substantially. So, it looks like on a fourth quarter to fourth quarter basis, by the end of this calendar year, Europe may be growing 1% where the US is closer to zero, according to consensus forecast. And that's been reflected in the EAFE market outperforming. Japan, too, is expected to grow more on a four-quarter calendar year basis than the US, believe it or not. So, Europe and Japan are the key components of the EAFE (non-US equity) Index, and that's been reflected in better performance in that index than in the S&P 500 this year.

Dan Fasciano: Harold, in your most recent economic commentary you talked about the Silicon Valley Bank failure, and you did a really exceptional job weaving that into a larger context of what successful banks do. You even reflected back upon prior crises, particularly the global credit crisis in 2008, the savings and loan crisis in the late eighties/early nineties. Do you think the situation

we're currently looking at with Silicon Valley Bank and Signature Bank will be isolated to a few institutions, or do you think it's part of a broader theme? Is this something larger afoot? What do you make of it?

Harold Kotler: I'm going to answer the question, and then I will go into detail. I do not think this is going be a major problem across the whole banking industry. Many regional banks are there for the local people, and it's incredibly important for them to survive. The banks that failed had large deposits of mostly institutional investment companies and venture capital firms, and they had the vulnerability of having those people really having outsized positions. But the other factor that we have to now think about, is that the Black Swan wasn't their portfolio — that was part of it, they made mistakes in their put forward by going too long and not matching the loans to their asset base; that was a mistake. The other mistake, unbeknownst to anybody, was the internet.

We're all growing our understanding of how the internet is changing our lives in so many areas. To lose $75 billion dollars in two days can only be done if something goes through like a wave, totally unexpected at any other time in the history of this country. So now banks have to realize they are vulnerable. Not just banks, by the way — I think many businesses had better be careful, because one mistake that really becomes part of the genre of the time is incredibly risky. And that's what happened. Part of me feels very bad for these banks. They were doing their job. They should have matched the liability; they reached for more interest. They could have stayed much more within the scope of their loan portfolio, and they didn't. No one really paid that much attention to it because no one thought you could lose $75 billion in two days.

So it's a new beginning, a new awareness. I do not think it's going to affect basically the smaller banks around the country. They don't have those kinds of serious, large deposits and probably not as many sophisticated investors. The big banks are well capitalized. I'm not saying there's not going to be one or two more banks that might fail, but it's not going to be a contagion. It's not something that you have to worry about. Obviously, you should keep your deposits within a half a million dollars for a couple — there's no reason to go above that. But for most regional banks, probably, their average deposit is much less than that.

Dan Fasciano: I was writing down as you were talking, mobile transactions shortening up liability durations — really just an exogenous event. That's pretty powerful.

Bill, Saudi Arabia and fellow OPEC+ nations earlier this month announced surprise production cuts. WTI initially popped on the news — I think it went up to $83 a barrel — but it's since come back to the high seventies. We're heading towards the summer travel season. What do you make of the price of energy? And if you want maybe a few words about inflation as well.

Bill Sterling: I'm pretty optimistic that energy prices are going to stay in a range, because those production cuts, on paper, were meaningful. But the problem with cartels is there's always incentives to cheat. Already there are reports that Russia is pumping out more than they should, based on that agreement, and there are also demand jitters, concerning the potential slowdown in the US economy that have been keeping the price of oil down as well.

I think one possible wild card is if Asia's comeback is better than expected — particularly Chinese travel, jet fuel demand, and so on — that could give some upward price to the energy side. But at the end of the day, commodities depend on Fed policy tremendously. US money supply growth is now contracting 4% year on year, as of March, and what we were just talking about with the banking system. That's hardly inflationary from the point of view of what it means for commodity prices in general, but also that includes energy. So I'm pretty optimistic that Fed policy has put us in a place where we can begin to see overall inflation come back close to its target over the next 6 to 12 months, and that would be supported by energy prices moving sideways.

Harold Kotler: And that means short rates will come down.

Bill Sterling: Yes, that gets back to your point earlier: Short duration is short duration.

Dan Fasciano: Well, that's great. And as always guys, I want to thank both of you for sharing your thoughts with all of us. For everyone listening in, we want you to have a safe and happy rest of your spring and early summer, and we'll be back next quarter. Thanks very much for listening and stay well.

Disclosure

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