

Q1 2023

Quarterly Market & Economic Perspective



Keeping a Balanced Approach

SUMMARY

- Mostly positive Q1 returns for equities, though last one-year returns are negative
- Fed continued to raise interest rates with 25 bps increases at both Feb and March 2023 meetings
- There will be unintended consequences of Fed action (or inaction)
- Banking crisis brought volatility to stock and bond markets in March

POSITIVE SIGNALS

- Inflation still appears to be fading
- Economic data continues to suggest US economy is not currently in a recession
- Continued decline in US Dollar is good for non-US equity returns; MSCI EAFE outperformed Russell 1000 in Q1

REASONS FOR CONCERN

- Globally, inflation is still stubbornly high, still coming more from services than from goods in the US, specifically shelter-related measures
- With a yield curve still inverted, low consumer confidence, and more potential rate hikes, is a recession looming?
- Will the Fed be able to pull off a soft landing?
- Are there more shoes to drop in the banking crisis?



SOURCE: MORNINGSTAR; RUSSELL, MSCI, DOW JONES, BLOOMBERG, ICE BOA ML BENCHMARKS SHOWN; PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

COMMENTARY

March Madness

It seems appropriate to kick off this quarterly review with a reference to March Madness, though we won't be talking much about the basketball tournament other than to congratulate the LSU Tigers and the UConn Huskies on winning the women's and men's tournament. Actually, the March madness we were referring to relates to the banking crisis we witnessed in March with the collapses of Silicon Valley Bank and Signature Bank in the US to Credit Suisse being acquired by UBS in Switzerland. Now, while the failures of each of these banks were for different reasons, it brought back the systemic risk questions and fears of contagion that we remember from the 2008 Great Financial Crisis. While we are currently not expecting there to be a similar crisis (e.g. banks have better balance sheets today), we are also not comfortable suggesting there won't be other bank issues along the way as banks feel the impacts of Fed policy from the last year of rate hikes.

Fortunately, our central bank as well as those of other nations seem determined to not let banks default while hurting ordinary depositors or allow the risk of contagion to spread to the point where confidence in the banking system is lost.

As Exhibit 1 shows, the Financial Services sector was hit hard in March by this banking crisis. Of the bottom ten contributors to the Russell 1000 return in March, nine of them were in the Financial Services sector, with relatively similar results in the Russell 2000 and MSCI EAFE indexes (not shown).

EXHIBIT 1

Russell 1000 Bottom 10 Contributors		
<i>Name</i>	<i>Contribution</i>	<i>Return %</i>
Charles Schwab	-0.11	-32.78
Bank of America	-0.11	-16.07
JPMorgan Chase	-0.11	-9.10
Wells Fargo	-0.10	-20.08
First Republic Bank	-0.06	-88.63
Truist Financial	-0.05	-27.37
U.S. Bancorp	-0.04	-23.45
PNC Financial Services Group	-0.04	-19.52
CVS Health	-0.03	-11.05
Morgan Stanley	-0.03	-9.02

Source: FactSet, TCW Portfolio Analytics Group

Why did this banking crisis occur?

While we are not going to dive into the variety of issues that plagued each of these banks, it is safe to say that continued rising interest rates were at least part of the problem. For one, depositors have been withdrawing money from bank accounts as they are now able to receive higher yields in other vehicles like money markets. Plus, as interest rates rose, the value of the banks' long-term bond holdings dropped, creating losses for them as they went to sell the bonds to cover the withdrawals.

Where does this leave the Fed and other central banks?

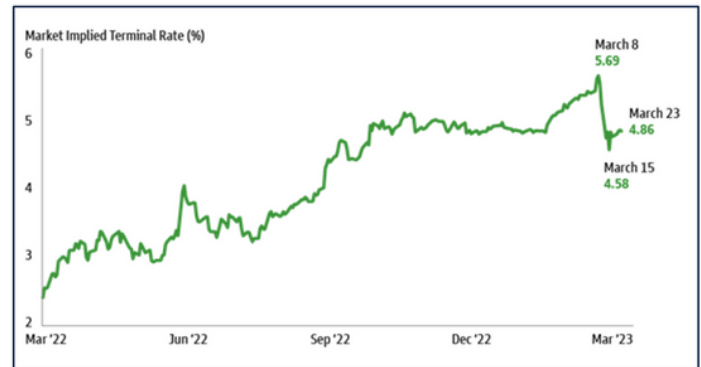
In short, central banks across the globe are between a rock and hard place. Last quarter we spoke about the three P's of pace, pause, and pivot. We had noted the Fed's pace of rate

increases has slowed as the last several increases have only been 25 bps. We also noted that there is a lag in the amount of time when these increases occur to when it's actually seen in the data.

At the same time, there is no easy way out for central banks as there are going to be some unintended consequences of any action, or inaction. If central banks continue to increase rates, the potential for more issues with banks increases. However, if they pause, inflation may remain high and will continue to be an issue they want to combat. Unless there is some major economic issue, it is not clear we will see central banks pivot to lowering rates in the very near future.

In the end, the Fed is working towards what is referred to as a soft landing, which essentially occurs when they achieve their dual mandate of full employment and stable prices without causing a recession. Many economists, however, are concerned about a hard landing, which is when the Fed pushes too high with rates, slowing growth, leading to a recession and/or higher unemployment. Ultimately, inflation is still too high today, and the Fed will continue working to bring it lower.

EXHIBIT 2



As we noted above, at least part of the banking crisis has stemmed from the aggressive monetary policy hikes we have seen over the last year. In early March, with inflation still higher than the Fed would like, the Fed's terminal rate (considered to be the peak rate of the hiking cycle) was 5.69%, above the current Fed Funds rate of 4.75%-5%. However, later in the month and after the initial stages of the banking crisis, the terminal rate fell to 4.86% later in the month (see Exhibit 2). Therefore, it is possible this crisis actually helped the Fed in some ways, and that the Fed is closer to the end of the tightening cycle than the beginning. So while the pace of rate increases has slowed, will we see the Fed hit the pause button soon?

Will a recession be avoided?

That is a common question among investors today and candidly, we really wish we were able to provide a solid answer with a bunch of conviction. For what it's worth, economic projections are quite varied. What we can say, though, is where we sit today, looking at the variables that are used by the NBER to

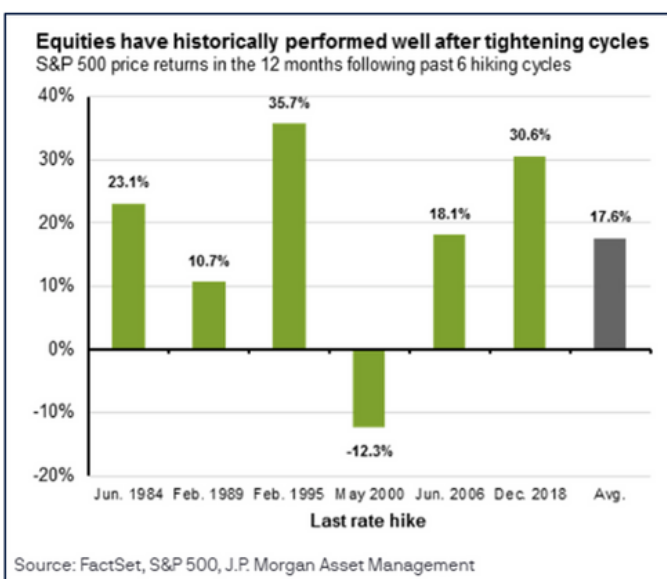


determine when a recession starts (e.g. unemployment, consumer spending), the indicators are currently not flashing red, meaning it doesn't appear we are in a recession. Of course, circumstances can change quickly, and it is something we will be monitoring.

U.S. Equity

The first quarter of 2023 brought mostly positive returns for US stocks, with the exception of small cap value which was at least partially impacted by the banking crisis and fell -0.7%. In contrast to small cap value, large cap growth stocks led the way with a double-digit gain of 14.4%. Still, over the last 12 months, all US stock indexes shown on the first page remain in negative territory.

EXHIBIT 3



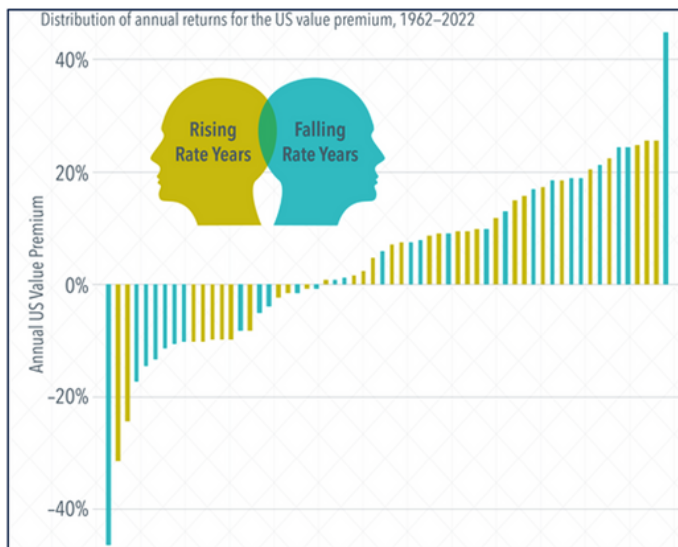
One of the pieces of advice we consistently provide is to not merely focus on and follow the headlines, simply because the headlines are often misleading or wrong. For example, recent headlines about higher interest rates suggest equity investments are expected to be less attractive because investors can get higher returns elsewhere (e.g. fixed income). However,



when you look at the history of past rate hiking cycles as shown in Exhibit 3, the S&P 500 saw double digit returns in five of the last six 12-month periods following hiking cycles with only one period having negative returns. In other words, the average return of 17.6% over those six periods clearly says that stocks may not perform poorly when rates rise.

One of the other headlines we consistently see suggests that there is a direct link between the value premium and interest rate activity; specifically, that value stocks do better (worse) when interest rates are rising (falling). Exhibit 4 charts the return of the US value premium in periods of rising and falling rates and as you can see, there is not solid evidence of what the headline suggests. While Exhibit 4 looks at periods of rising and falling rates, we dug deeper to ask the question as to whether the value premium is connected to high or low rates (rather than rising or falling rates). The data on this supports the argument that the value premium is not impacted by whether rates are high or low, but that the returns of growth stocks do seem to suffer when rates are high vs. low.

EXHIBIT 4



SOURCE: DIMENSIONAL FUND ADVISORS. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS. RETURNS ARE NOT REPRESENTATIVE OF ACTUAL PORTFOLIOS AND DO NOT REFLECT COSTS AND FEES ASSOCIATED WITH AN ACTUAL INVESTMENT. US VALUE PREMIUM DEFINED AS THE RETURN OF THE FAMA/FRENCH US HML RESEARCH FACTOR, AVAILABLE FROM THE DATA LIBRARY OF KEN FRENCH. EACH YEAR IS CATEGORIZED BY RISING (FALLING) RATES IF THE 10-YEAR US TREASURY YIELD AT THE END OF THE YEAR IS HIGHER (LOWER) THAN THE YIELD AT THE END OF THE PREVIOUS YEAR. TREASURY DATA AVAILABLE FROM THE FEDERAL RESERVE BANK OF ST. LOUIS. THE FAMA/FRENCH FACTORS REPRESENT ACADEMIC CONCEPTS THAT MAY BE USED IN PORTFOLIO CONSTRUCTION AND ARE NOT AVAILABLE FOR DIRECT INVESTMENT OR FOR USE AS A BENCHMARK. EUGENE FAMA AND KEN FRENCH ARE MEMBERS OF THE BOARD OF DIRECTORS OF THE GENERAL PARTNER OF, AND PROVIDE CONSULTING SERVICES TO, DIMENSIONAL FUND ADVISORS LP.

Non-U.S. Equity

International developed large cap (8.5%) and small cap (4.9%) outperformed their US counterparts for the second consecutive quarter. International developed large and small cap stocks have also outperformed their US counterparts over the last 12 months too. As we have previously mentioned, one of the reasons for the recent outperformance can be attributed to the decline of the US Dollar, something that had been a serious headwind for most of the previous decade. Specifically, the British Pound, Euro, and Singapore Dollar were a few of the major currencies to advance vs. the US Dollar over the first quarter.

EXHIBIT 5

	20-yr avg. P/E ratio	Current P/E ratio
S&P 500	15.5x	17.8x
MSCI ACWI ex-US	13.1x	12.6x

SOURCE: FACTSET, MSCI, STANDARD & POOR'S, J.P. MORGAN ASSET MANAGEMENT. GUIDE TO THE MARKETS - U.S. DATA ARE AS OF MARCH 31, 2023.

Another potential reason for international stocks outperforming US stocks is due to relative valuations. Per Exhibit 5, not only are current valuations lower for non-US stocks vs. US stocks, non-US stocks are also cheaper vs. their 20-year average where US stocks are currently more expensive than their 20-year average.

Within developed markets, it was somewhat of a mixed bag from a country return perspective as some of the countries with larger weights in the MSCI EAFE underperformed US large cap markets (e.g. Japan=5.8%, UK=5.9%) while others outperformed (e.g. Germany=14.5%, France=14.4%).

As we have previously noted, China remains roughly 1/3 of emerging markets, so its performance has a meaningful impact on the overall results of EM indexes. For the quarter, China returned only 4.3%, an important component of the underperformance relative to US and developed market non-US returns.

Source: Dimensional Fund Advisors, Country returns are the country component indices of the MSCI All Country World IMI index

Global REITs

Global REITs, as represented by the Dow Jones Global Select REIT, gained 1.9% for the quarter, with US REITs moving up by 2.8% while non-US REITS fell by -0.8%.

Diving deeper into the YTD sector returns for the FTSE NAREIT US index (a REIT index that provides sector returns publicly), the office space sector was the worst performer of the quarter, declining -16.0% with the

infrastructure sector falling -3.2%. In contrast, the self-storage sector gained 13.2% and the data center sector appreciated by 7.0%.

Source: NAREIT

Global Fixed Income

The fixed income indices we follow were all positive for the quarter with 5–10-year US corporate bonds leading the way with a 3.6% return. Munis continue to be a compelling opportunity for high tax bracket investors, as the 1-5 year and 5–10-year muni indexes generated positive returns over the last 12 months, whereas other major fixed income indexes were still in the red, as they are still offering strong tax-equivalent yields.

There was tremendous volatility in Treasury rate movement during March as a direct result of the banking crisis (Intermediate and Long-Term Treasuries are often a very good risk-off investment). For example, the 10-year Treasury started off March at 3.92%, went as high as 4.08% on March 2, but fell to as low as 3.38% later in the month.

EXHIBIT 6



Source: Avantis, Bloomberg, March 31, 2023

Last quarter we mentioned the acronym TARA (there are real alternatives), highlighting that investors have moved some assets from stocks to bonds to take advantage of the higher rates.

Interestingly, we are still in a situation where the yield curve is inverted (e.g. short term Treasury rates are higher vs. longer term Treasury rates, see Exhibit 6). With the inverted yield curve we have today, it is reasonable for investors to consider parking more money in cash or other short term instruments that they might have otherwise invested in riskier assets like stocks or bonds as CD and money market rates are relatively attractive to other intermediate term bonds. However, by keeping assets in cash (essentially zero duration assets), are you taking on other risks? The simple answer is potentially yes, though it may seem



counterintuitive. It is true that by sitting in cash today, you are earning a higher rate of return than you would further out on the curve. But can you expect those higher cash rates to stick around tomorrow and the day after that? This is known as reinvestment risk. Let's use the Treasury curve as of quarter end as our example where 3-month Treasuries were yielding a whopping 4.90% while 10-year Treasuries were yielding a lower 3.43%. On the surface, the 3-month Treasuries are more attractive today. However, if we are indeed near the end of the rate hiking cycle and if the Fed does indeed pivot to lower rates, it is expected 3-month Treasury yields will fall. By investing in 10-year Treasuries, for example, you would be able to lock in the 10-year rate, avoiding the reinvestment risk of a 3-month Treasury. Plus, by being more intermediate duration vs. cash, you would be better able to take advantage of capital appreciation if the intermediate bonds were to fall in yield. Third, intermediate bonds have historically provided more negative correlations to stocks, so they are better positioned to diversify a stock portfolio.

Municipal bond performance was also positive for the quarter across the municipal yield curve. For clients in the higher tax brackets, tax equivalent municipal bond yields are equivalent or better than investment grade corporates across various parts of the yield curve.

We continue to view fixed income as a method of reducing overall portfolio risk (as measured by standard deviation), given that equities are expected to have much higher volatility. Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration government and corporate bonds, where default risk has historically been relatively low.



AUTHORS



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Mario is the Chief Investment Strategist for XY Investment Solutions and the President & Founder of East Bay Financial Services.

Mario began his investment career in 1999 with Vanguard mutual funds in Valley Forge, PA, where he consulted institutions and financial advisors on investment policy, portfolio construction, and Exchange-Traded Funds (ETFs). He also held roles as a research analyst, a municipal bond fund specialist, among others, during his tenure. In 2003 he earned the Chartered Financial Analyst designation, and he continues to mentor aspiring Charter candidates and young investment professionals.

Mario is Past President of CFA Society South Carolina and Former Chairman of the College of Charleston Finance Department Advisory Board. His approach to investments and the industry has been featured in Investment News, NAPFA Advisor Magazine, South Carolina Public Radio, and other publications and media outlets.



Eric Stein, CFA

Prior to joining East Bay, Eric worked for a variety of firms, both large and small. This includes 7+ years with Goldman Sachs Asset Management where he held roles in areas such as performance measurement, client service, risk analysis, and portfolio construction. During his tenure there, Eric had the opportunity to cover many different types of asset classes, vehicles, and client types.

Eric also worked at RSM U.S. Wealth Management for 10+ years, serving as the Chief Investment Officer while providing strategic leadership and solutions for their national investment platform.

As a Partner at East Bay, Eric serves a select group of financial advisory firms as their outsourced Chief Investment Strategist. Responsibilities of this role include continuous oversight of advisor clients' investments, bespoke strategies for unique situations, client communications, and more.



YOUR XYIS TEAM

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An investor should consider a portfolio’s investment objectives, risks, charges and expenses carefully before investing. The underlying funds’ prospectus contain this and other important information. Please read any applicable prospectus carefully before investing.

Benchmark descriptions: MSCI ACWI Index, MSCI’s flagship global equity index, is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets, covering approximately 85% of the free float- adjusted market capitalization in each market. Russell 3000 Index is a market-capitalization-weighted equity index that tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities. Standard & Poors 500 is an index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices. Russell 1000 Index is an index of approximately 1,000 of the largest companies and is a subset of the Russell 3000, comprising approximately 90% of total market capitalization of all listed US stocks. Russell 1000® Growth Index is a market capitalization weighted index that measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000® Value Index is a large-cap value index measuring the performance of the largest 1,000 U.S. incorporated companies with lower price-to-book ratios and lower forecasted growth values. Russell 2000® Growth Index measures the performance of the Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 2000® Value Index is an unmanaged, market-value weighted, value-oriented index comprised of small stocks that have relatively low price-to-book ratios and lower forecasted growth values. MSCI EAFE (Europe, Australasia, Far East) Index is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. MSCI EAFE Small Cap Index captures small cap representation across Developed Markets countries around the world, excluding the US and Canada. MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries and covers approximately 85% of the free float-adjusted market capitalization in each country. MSCI Frontier Markets Index captures large and mid cap representation across 29 Frontier Markets countries and covers about 85% of the free float-adjusted market capitalization in each country. Dow Jones Global Select REIT Index is designed to measure the performance of publicly traded REITs and REIT-like securities and is a sub-index of the Dow Jones Global Select Real Estate Securities Index (RESI), which seeks to measure equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally. The index is designed to serve as a proxy for direct real estate investment. Dow Jones U.S. Select REIT Index tracks the performance of publicly traded REITs and REIT-like securities and is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index. Dow Jones Global ex-US Select REIT Index is designed to measure the performance of publicly traded REITs and REIT-like securities traded globally ex-US. ICE BofAML 3-Month T-Bill Index is an unmanaged index that measures returns of three-month Treasury Bills. ICE BofAML 1-5 Year US Treasury, Corporate and Municipal Indexes are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Indexes including all securities with a remaining term to final maturity greater than or equal to 1 year and less than 5 years. ICE BofAML 5-10 Year US Treasury, Corporate and Municipal Indexes are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Indexes including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 10 years. ICE BofAML 10+ Year Treasury, Corporate and Municipal Securities Index are subsets respectively of ICE BofAML US Treasury, Corporate and Municipal Securities Indexes including all securities with a remaining term to final maturity greater than or equal to 10 years. Bloomberg Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets (one version shown with its currency hedged back to the USD and is noted as such). Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed- rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency). J.P. Morgan Global (ex-US) Government Bond Index: Is the standard unmanaged foreign securities index representing major government bond markets outside the US markets (one version shown with its currency hedged back to the USD and is noted as such). ICE BofAML US Inflation-Linked Treasury Index tracks the performance of U.S. dollar denominated inflation linked sovereign debt publicly issued by the U.S. government in its domestic market. Qualifying securities must have at least one year remaining term to final maturity and no more than 5 years to maturity. Bloomberg Barclays U.S. Corporate High Yield Bond Index is a total return performance benchmark for fixed income securities having a maximum quality rating of Ba1.
