2Q 2023 I June 30, 2023

Quarterly Market Update – 2Q, 2023

Market Summary & Outlook

VIRTUS CAPITAL

Recap

- **Stocks Climbed as Inflationary Pressures Eased –** Global economic expansion has promoted a generally disinflationary trend and a more favorable economic backdrop for risk-assets during Q2. However, core inflation pressures continue above the Fed's targeted goal, as late-cycle framework in the U.S. business cycle continues to support slowing economic activity.
- **U.S. Large Caps Outpace Broader Market Rally –** Growth oriented stocks pushed equity prices higher after a broad-based downturn for investors in 2022. The rebound has been most pronounced in the hard-hit tech sector from previous year, with U.S. growth stocks rising over 28% YTD, as of June 30th.
- **Narrow Leadership in Equity Market Rebound –** Despite the sharp rise in U.S. growth stocks, the market rally in 2023 has been quite narrow, with the top 10 market-weighted U.S. stocks rising nearly 40%. While the remaining 490 stocks in the S&P 500 have posted only modest gains, YTD.
- **Global Business Desynchronization May Moderate Expansion –** Continued monetary tightening, increased manufacturing input costs, and persistent consumer inflation have constrained global economies. China may benefit from its post-COVID reopening, easing tensions in the Russia-Ukraine war would benefit Europe's energy stability, however, the U.S. is experiencing tightening credit conditions which is constraining liquidity and leading to a higher probability of slowing ahead.
- **Structural Headwinds for China's Economic Reopening –** The economic reopening in China showed positive momentum in 2022 but has since slowed during Q2, 2023. Policy makers may choose to increase fiscal stimulus and advocate for additional policy easing to address structural imbalances in excess manufacturing capacity and financial leverage, particularly in the large property sector.
- **Deeply Inverted Yield Curve Typical of Late Cycle –** Again, typical of late-cycle, inversion of the 10-Year and 3-Month yield curve for U.S. Treasuries has been a historically reliable indicator of recession, but with variable timing. The 10-Year minus 3-Month as of June 30th is the most inverted since 1981.
- **Fiscal Tightening Likely to Pressure Market Liquidity –** Major central banks continued to shrink their balance sheet during Q2. This typically reduces financial market liquidity, however, new U.S. treasury issues with higher yields and FDIC banking support has offset some of the liquidity drain effects. With these one-off tools exhausted, the underlying liquidity backdrop appears more challenging for the remainder of 2023 and may contribute to increased market volatility.

ABOUT THE FIRM

Virtus Capital is an independent investment advisory firm serving high net-worth individuals, families, and business owners.

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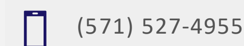

Performance

Equity Benchmarks	Returns as of 6/30/23 3 Month	YTD
S&P 500 PR	8.30%	15.91%
DJ Industrial Average PR	3.41%	3.80%
Nasdaq Composite PR	12.81%	31.73%
Vanguard Balanced Composite	4.68%	10.53%
MSCI AC World Index ex USA Net	2.44%	9.47%
FTSE Emerging Index	0.71%	3.68%

Bond/Commodity Benchmarks	Returns as of 6/30/23 3 Month	YTD
Bloomberg US 1-5 Year Treasury	-0.90%	0.95%
Bloomberg US 5-10 Yr Treasury	-1.71%	1.42%
Bloomberg US Long Treasury	-2.30%	3.72%
Bloomberg US 5-10 Yr Corp	-0.48%	3.14%
Bloomberg Municipal Bond	-0.10%	2.67%
Bloomberg Commodity Index TR	-2.56%	-7.79%

*Data Source: Morningstar and Vanguard Funds

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Discussion

Equity Markets

Global disinflation and continued economic expansion (albeit somewhat muted) pushed equity markets higher in Q2, with the tech-heavy Nasdaq index eclipsing the 13,700 mark and is now up over 31% YTD, as of June 30. Equity investors have enjoyed a robust up-market in the first half of 23', as the Fed's interest rate hiking cycle appears to be reaching an end or perhaps slowly to an incremental crawl. The stock market rally has been sharp but narrow, with the top 10 market-weighted U.S. stocks accounting for the lion's share of the indices' gains, YTD. Combined, through end of Q2, the top 10 S&P 500 stocks were up nearly +40%, while the equal-weight S&P 500 index – which applies the same weight to each stock - was up only +7.03% during the same period, highlighting the narrow market leadership. However, tightening monetary policy and shallowing liquidity in capital markets has raised the odds for the return of volatility. The VIX index - a broad indicator of volatility in the equity markets – has been unusually subdued in 23', as previously mentioned in our Q1 recap. The average S&P 500 VIX reading since 1990 has been around 20. Since June 1 of this year, the VIX has been range bound between 13-15, indicative of a narrowly traded market and orderly buying/selling. However, the tranquil sea of volatility that long positioned investors have enjoyed in H1, 23' may not carry through the remainder of the year, as market liquidity has begun to slow due to tightening economic conditions. Fortunately, for the U.S. economy, structural strengths in housing, goods consumption, and employment have helped prolong a late-cycle expansion and curb a global growth slowdown. The U.S. consumer and corporations are still in good overall financial shape relative to recent history, with Household Credit/GDP at 74% in 2023 vs. the 2000-2019 average of 85%, implying lower credit utilization. Similarly, a comparative liquidity gauge for corporations would be their interest coverage ratio – a company's ability to cover their interest expense on outstanding debt – which stands at a healthy 7.2x vs. 2.9x for the same time period. This backdrop of healthy financial conditions for consumers and corporations bodes well for equity markets in the near term, as this leads to more manageable and maneuverable balance sheets and access to capital. A cross current here though is the generally tighter and stricter lending standards that banks have implemented since early-22' to protect against credit losses in a slowing economy and increasing interest rate environment. So, even though the U.S. consumer and corporations have managed well in 23', banks may not be willing to lend without more restrictive and financially punitive terms, even to tier-1 borrowers. Speaking of credit, the overall resilient financial health of the U.S. consumer may, impart, be owed to mortgage debt service being held down by low fixed-rate mortgages that were sourced over much of the last decade. As of the end of Q2, the consumer had an excess savings of $1T and a mortgage debt service as a percent of disposable income of only 4% vs. 7% in 2007, prior to the GFC, according to the Federal Reserve Bank of Atlanta and Haver Analytics. This equates to less household disposable income being spent on debt-interest, which creates a push force for additional spending on discretionary goods, perhaps impart, helping to prop-up core-inflation for longer – much to the chagrin of the Fed and FOMC. The top 3, Q2 equity sector performers were Info Technology (+17.2%), Consumer Discretionary (+14.6%), and Communication Services (+13.1%), with the next closest performer, Industrials, at a distant (+6.5%) – underscoring the narrow nature of the rally. We expect asset markets to broaden their sector performances in the second half of the year, as stable financial conditions persist and YoY earnings growth expectations (24', +11%) continue to promote domestic growth, encouraging investors to seek companies with positive earnings trends priced near or at fair value.

Fixed-Income Markets

Central bank tightening was the prevailing theme in 2022 and has continued through H1, 23'. The average Federal Funds rate – the base interest rate that the FOMC meets on 8 times per year to set – was 0.08% in 2021, 1.68% in 22', and now stands at 4.80%, as of June 30 - the fastest pace of increases in over 40 years (1977-81). The dramatic increase in rates has a dynamic effect on asset markets and global economies. At the consumer level, increased costs of borrowing (especially mortgages and autos) dampens demand and increases supply, causing producers to slow production as inventories accumulate. Residential housing supply, however, remains historically low and the Fed's historic rate increases have done little (so far) to increase supply

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and cool prices, as monthly supply currently sits at 3 months vs. the previous 20-year average of 6 month's supply. This implies (impart) the Fed may be compelled to continue its hiking cycle for longer than expected, after the FOMC decided on a brief pause in June only to resume with a 0.25% increase at their recent July meeting - the target rate currently stands at 5.25-5.5%. The Fed's dual mandate of low unemployment and inflation has been met with lingering pandemic induced, cyclical, and geopolitical challenges in 23'. The Fed has casually signaled that their current hiking cycle may level-off in late 23' or early 24'. However, if the economy begins to sputter a pivot to quantitative easing (QE) may be necessary and thus prove more challenging for the fed to reach its labor and inflation targets. An intermediate effect of fast-paced tightening can lead to pressures on market liquidity, as the Fed is reducing its balance sheet rather than expanding it. This action applies pressure on market participants to facilitate adequate buying/selling to maintain liquidity and transactional flow – instead of relying on the Fed to buy securities. The current quantitative tightening (QT) program is aimed at addressing persistent inflation, but shallowing liquidity is likely to impact financial markets. For example, market liquidity between Oct 2022 – May 2023 gained $350B and is now estimated to drop by $600B in H2, 23' – increasing chances of rising market volatility. The "volatility" canary in the coal mine may first show itself in the U.S. bond market. The bond market is multiple times larger than the stock market and moves quickly when liquidity shallows. Transactional friction felt in fixed-income would likely spill over into equity markets, as risk-premiums adjust from expanding credit spreads, which reflects investor's risk/reward trade-off of fixed-income to equity securities. The Fed was caught a bit off-guard with the recent regional bank "mini-crisis", as three well-known U.S. banks became insolvent, due largely impart to realized losses in long-term, fixed instruments reeling from the rapid rise in interest rates and the subsequent fall in prices. In March, Silicon Valley Bank (SVB) made headlines with its sudden collapse, closely followed Signature and First Republic Bank. The financial factors that lead to their troubles are nuanced, so much perhaps that even the Fed did not expect that their rapid rate hikes could stress banks to the degree it did. When depositors came looking to withdraw, the liquidity was not there, so cash equivalents (short duration fixed income) were the first to go, followed by the longer-dated debt instruments – of which the latter, is what ran SVB into trouble. Fixed-income total return in Q2 was a mixed bag of results. The leveraged Loan segment performed best, posting a +3.1% gain, while government treasuries (such as TIPS) lagged with a -1.4% return. On the year, however, most all fixed-income returns are in the black – a welcomed change from the historic double-digit losses in 22', that owns a spot in the history books as the single worst year for bonds in modern history, since 1926.

Outlook

The consensus economic view at the end of 22' was for a U.S. economic recession in 23', which has not materialized to date. As discussed in both our Q4, 22' and Q1, 23' outlooks, we have cautiously shared an out-of-consensus view with that of Goldman Sach's Chief U.S. Economist, David Mericle. Mericle, pointed out in mid-22' that the negative effects of the Fed's tightening cycle on equity markets and subsequent drop in GDP may have already largely been priced into asset markets, and that 23' could see valuations return to (or rise above) historical averages, as corporate top-line revenues continue to show resilience and earnings expectations outperform. Mericle has been mostly correct thus far and the U.S., along with most global markets, have chugged higher, YTD. We expect to avoid an economic recession in 23' and that earnings growth will expand YoY in 24'. Research provided by Bloomberg, LP and AART forecast a YoY S&P 500 earnings growth of 11% in 24', and despite rising production costs and lower profit margins, corporations should (in large part) be able to return adequate value to shareholders. Investors may find opportunities in emerging markets where valuations and currency tailwinds support potentially outsized growth profiles, relative to U.S. equity markets. Rising yields on fixed-income securities also represent an increasing value proposition to stocks, as equity market valuations steadily tick above long-run averages, increasing the likelihood of an overbought scenario. Virtus Capital's investment management strategies continue to highlight portfolio diversification and strategic asset allocations to quality companies that possess long-term competitive advantages, with a slight tilt towards defensive sectors. Our investment philosophy focuses on a long-term approach to portfolio diversification and security selection. So far in 2023, many of our investors have taken the opportunity to build their cash reserves in money market instruments. We help investors take advantage of near-term opportunities in our actively managed portfolios. Virtus Capital's H2, 23' market outlook calls for a disciplined and thoughtful approach to portfolio construction, that aims to deliver greater long-term value through our risk-adjusted and customizable investment management strategies.

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Q2, 2023 Quote:

"The most important quality for an investor is temperament, not intellect."

-Warren Buffet

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