

Slow Train Coming

As we enter the second half of 2023, the economy has remained surprisingly resilient despite the massive tightening in monetary policy and higher borrowing costs. Consumers continue to spend aggressively, buoyed by full employment and rising wages, despite materially higher prices for goods and services. Corporate earnings have also outperformed expectations so far this year, with sales and earnings growth beating

Employment

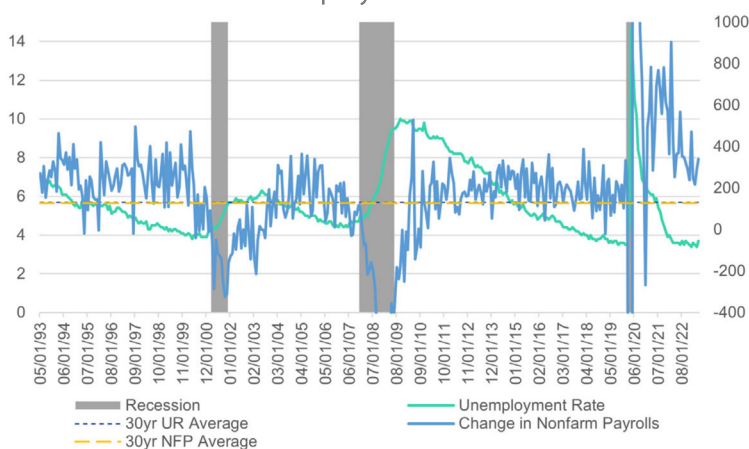


Figure 1. Sources: PMA Asset Management, Bloomberg.

consensus expectations through 1Q23. While we expect economic growth will continue to moderate, with a strong possibility for negative growth in upcoming quarters, we are not predicting an economic hard landing. The consensus recession predictions have been a slow train coming for much of the past year. If a recession ultimately does occur, it will be one of the most well-telegraphed recessions in modern economic history. From our perspective, without a significant deterioration in the labor market, it will be difficult for the economy to suffer a decline in economic activity typically accompanying a true recession in the next year. The current unemployment rate of 3.7% is well below the 6% long term average rate of unemployment. In addition, the current unemployment rate is well below levels historically evidenced ahead of recessionary periods. Similarly, monthly nonfarm payroll numbers continue to remain strong (339k jobs in May 2023 vs historical average of 129k jobs) and are significantly higher than any other recessionary periods evidenced over the past four decades. Despite COVID, significantly tighter monetary policy and crushing levels of inflation, consumption has held in relatively well thus far. Until we evidence significant trends toward a weakening labor market, the impact of a potential recession will be relatively mild given the strength of the labor force. Certainly, aging demographics, both here in the U.S. and abroad, is a source of concern for our longer-term investment thesis, but not at present. While we expect the labor market to soften slightly in the year ahead, strong household balance sheets and continued tightness in the labor market should continue to support consumption and economic growth. That said, the cumulative drags from more restrictive monetary policies and tighter credit conditions will have an offsetting impact on economic growth in the year ahead.

Tighter policy and credit conditions will also allow inflation to moderate, although we expect inflation to remain above levels that will allow the Federal Reserve and other global central banks to ease policy rapidly in the year ahead. While COVID-related negative supply shocks and commodity inflation pressures continue to abate, the shift in wage and price setting behavior will likely remain persistent in the near term. Most companies have been able to pass on higher input costs to consumers without a significant decline in demand. Ultimately, continued restrictive monetary policies, lower liquidity levels and tighter credit conditions should start to compress margins, causing companies to retrench and labor conditions to soften. It typically takes 12-18 months for policy changes to make their way into the real economy, so we are at the beginning stages of seeing the impact of the historic tightening cycle we are experiencing.

CPI and Wage Growth

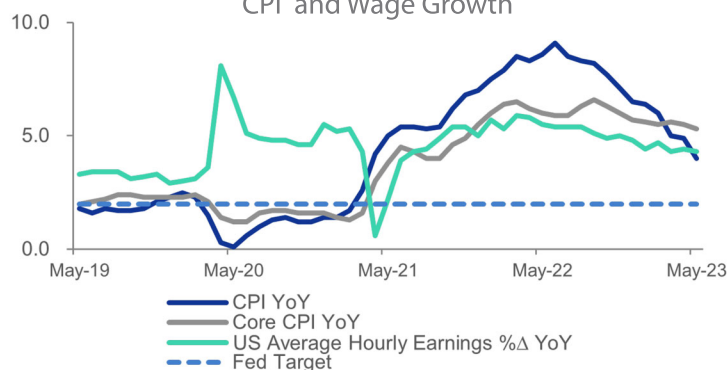


Figure 2. Sources: PMA Asset Management, Bloomberg.

That said, some cracks are developing, and the probability of a recession remains elevated in our view, including weaker business fixed investment and retail sales levels. Despite improving new home sales so far this summer, we have seen most major housing markets experience declines over the last year, the largest declines since 2012. (Figure 2) Existing home sales level fell to 4.3M in May, significantly below the 5.3M average over the past 20 years, and similar to levels we saw during the great financial crisis.

Case-Shiller Home Prices

| Case-Shiller US Home Price Indices | | | | | | | | | | |
|------------------------------------|----------|----------|----------|-----------|-----------|-----------|--------------------|------------------|-----------------------|--|
| City | 1-Year % | 3-Year % | 5-Year % | 10-Year % | 15-Year % | 20-Year % | All-Time High Date | Months From High | % Below All-Time High | |
| Miami | 7.71% | 59.93% | 72.66% | 155.38% | 90.63% | 172.62% | 07/31/22 | 8 | -1.2% | |
| Tampa | 4.85% | 60.84% | 78.71% | 160.70% | 99.21% | 172.22% | 07/31/22 | 8 | -3.0% | |
| Charlotte | 4.70% | 50.31% | 64.70% | 115.01% | 93.46% | 136.03% | 07/31/22 | 8 | -2.7% | |
| Atlanta | 4.49% | 46.09% | 59.81% | 128.07% | 80.68% | 97.44% | 07/31/22 | 8 | -0.7% | |
| Chicago | 4.16% | 28.10% | 31.92% | 62.45% | 20.43% | 44.37% | 03/31/23 | - | 0.0% | |
| New York | 3.41% | 33.72% | 38.21% | 67.47% | 37.52% | 83.24% | 06/30/22 | 9 | -1.1% | |
| Cleveland | 2.02% | 31.98% | 43.50% | 67.38% | 57.01% | 53.35% | 08/31/22 | 7 | -0.8% | |
| Detroit | 1.19% | 30.82% | 40.11% | 102.47% | 73.98% | 46.65% | 05/31/22 | 10 | -0.9% | |
| Boston | 0.76% | 32.65% | 43.97% | 90.56% | 86.91% | 100.83% | 06/30/22 | 9 | -2.8% | |
| Minneapolis | 0.48% | 25.12% | 36.41% | 80.47% | 56.60% | 63.72% | 06/30/22 | 9 | -1.1% | |
| Washington | -0.27% | 25.69% | 33.85% | 55.33% | 44.83% | 102.28% | 05/31/22 | 10 | -2.1% | |
| Dallas | -1.19% | 46.32% | 54.81% | 129.96% | 134.97% | 150.44% | 06/30/22 | 9 | -5.9% | |
| Los Angeles | -2.99% | 35.28% | 42.49% | 110.00% | 88.43% | 166.52% | 05/31/22 | 10 | -5.2% | |
| Denver | -3.63% | 35.10% | 45.64% | 122.68% | 135.77% | 143.69% | 05/31/22 | 10 | -6.0% | |
| Phoenix | -4.52% | 51.79% | 74.23% | 136.43% | 83.35% | 160.25% | 07/31/22 | 8 | -8.4% | |
| Portland | -4.56% | 29.43% | 39.41% | 117.73% | 81.68% | 175.90% | 05/31/22 | 10 | -7.4% | |
| Las Vegas | -5.10% | 34.93% | 52.34% | 146.68% | 57.66% | 117.08% | 06/30/22 | 9 | -9.0% | |
| San Diego | -5.42% | 45.67% | 54.26% | 130.61% | 107.79% | 144.66% | 05/31/22 | 10 | -7.1% | |
| San Francisco | -11.29% | 23.02% | 28.51% | 113.61% | 94.59% | 133.27% | 05/31/22 | 10 | -12.9% | |
| Seattle | -12.49% | 31.50% | 42.17% | 135.47% | 91.54% | 194.99% | 05/31/22 | 10 | -13.4% | |

Figure 3. Source: Case-Shiller.

The broader health of the commercial real estate market is an ongoing source of concern for our team as well. We expect defaults to continue to increase and losses could prove painful within the already stressed regional banking sector. As the economy slows, we expect it will feel more like a growth recession than a typical recession. In this environment, higher borrowing costs, tightening lending standards and continued structural changes in the economy will have an uneven impact on different sectors and industries. Active management will be a key component of returns and capital preservation in this environment.

Treasury yields have risen markedly from their lows in March when the first U.S. bank failures since 2008 triggered a safe haven rally and the market priced in hefty rate cuts. Potential rate cuts are now looking more like a theme for next year as Fed Funds futures have priced out that potential for the remainder of 2023. The Fed's most recent dot plot forecast delivered another half point of tightening to a peak of 5.6% this year, higher than their previous forecast in March. (Figure 3) The Fed increased their economic forecasts as well during their June meeting, indicating their acknowledgement of a resilient economy.

Fed and Market Rate Expectations

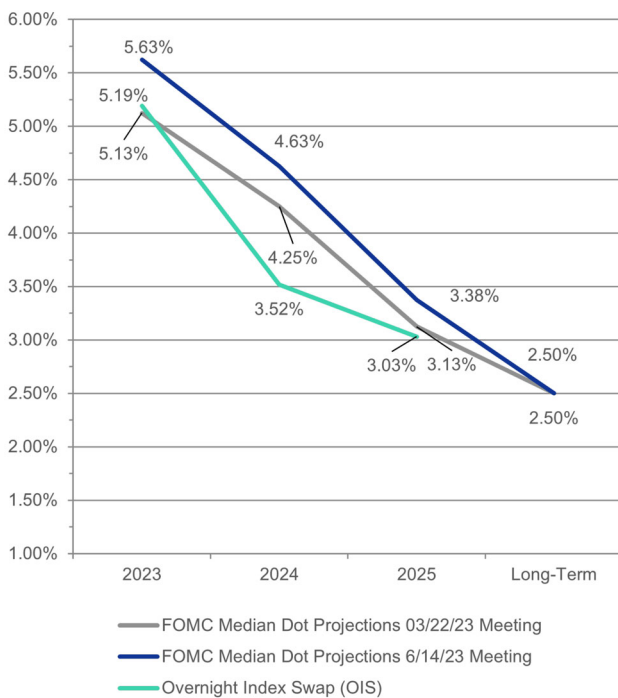


Figure 4. Source: PMA Asset Management.

GDP growth was revised to 1% in 2023, a modest level for sure, but one that is significantly higher than their 0.4% estimate in March. Many market participants anticipate the economy will soon weaken sharply from the tighter monetary policies put in place over the past 15 months. The yield curve remains deeply inverted, historically a good indicator for a recession in the year ahead, but not such a great predictor thus far. As we have discussed, while the economy and inflation will slow, providing the Fed room to ultimately pause and ease at some point, we've been skeptical of the markets pricing assumptions to date.

The curve has been inverted for most of the past year, and the market has clearly been wrong regarding their recession and market predictions during this time. For example, a year ago, the future market implied Fed policy would be around 3.25% today versus 5.0%-5.25% range we find ourselves in at present.

Positive Returns Expected in the Year Ahead

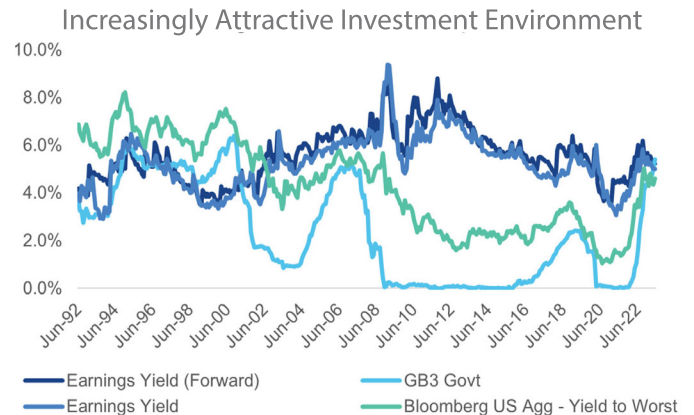


Figure 5. Sources: PMA Asset Management and Bloomberg as of 05/31/23.

Despite the massive draw down in the equity markets during 2022 and subsequent rally year to date in the equity market, corporate profitability has been resilient and forward earnings yields remain reasonably attractive on a historic basis. However, the rise in bond yields over the past 18 months and commensurate spread widening we've experienced in the fixed income market make bonds a very compelling alternative to equities for the first time in decades. (Figure 4) Short term government bonds and investment grade corporate bonds now earn higher yields compared to the earnings yield of the S&P 500 index. Yields for the U.S. investment grade market are nearing 5% and the U.S. high yield indices hover near 9%. At this point in the Fed's tightening cycle, the inherent value of bonds versus equities within a capital structure should the economy experience a harder landing, as well as the safe haven "flight to quality" characteristics for government bonds, we remain overweight in fixed income for the year ahead with an expected return of 5-7%. While cautiously optimistic on equities in the year ahead given the lack of breadth to the rally, we remain neutral on equities overall with an expected return of 3-6% over the next 12 months.

Fixed Income Outlook

While the Fed continues to focus on its inflation fight and recently has underscored this commitment by highlighting its expectations for additional rate hikes this year, the bond market is increasingly "looking over the hill" of rate peaks as it factors in likely future economic weakness and policy normalization. We don't doubt the Fed's commitment to push on rates higher and/or longer if inflation develops demand, but current rhetoric is focused on keeping financial conditions and market rate expectations in check, rather than indicating a likelihood of significant additional tightening. Our base case is for a terminal Fed Funds rate not much higher, but for the policy rate to remain elevated for somewhat longer than the market is pricing. A key driver for us is our expectation that despite disinflationary momentum, measures of inflation may take longer to subside, while underlying strength in the economy is likely to give the Fed room to be slow, lacking recessionary urgency.

In this latter phase of the rate cycle, yields and spreads are attractive, particularly at the short to intermediate portion of the curve given high yield and spread per unit of duration, as well as the ability to lock in yields and participate in gains should rates turn more quickly. We expect income from spread sectors to drive outperformance and see the potential for a total return tailwind from a modest tightening in spreads on a 1-year horizon. Issue selection remains critical for credit quality and liquidity. The yield curve continues to press near record levels of inversion between 2-year and 10-year notes, driven by the dynamics discussed above as well as investor flows

and demands for high quality duration at historically high nominal yields. This condition places particular importance on managing exposures along the yield curve in addition to overall duration. While we see scope for moderately higher yields in the near term and possible bouts of volatility, at current valuations, we don't want to be far off interest rate alignment with client benchmarks. For clients, this inversion also highlights the importance of investing with a long-term focus and understanding the timing of liabilities, cash flows and risk tolerance. History in the bond market has shown many times that an inverted yield curve can be a false inducement to invest shorter than appropriate late in the cycle, setting up significant reinvestment risk misalignment. As we move through the rate cycle in coming quarters, market adjustments could be sharp.

Among securitized and government sectors, we see the best value in high quality ABS and Agency MBS passthroughs. In recent quarters, mortgages have suffered under the weight of sharply rising rates and high interest rate volatility, and recently from liquidation pressures from FDIC selling bank portfolios. With interest rate volatility moderating and technical selling pressures abating, MBS have seen improved performance. Current valuations remain attractive versus high quality corporates and other spread sectors, particularly given our outlook for interest rates and positive technicals in loan originations. High quality ABS is very attractive in absolute spread terms as well as versus AA corporates. Credit fundamentals for both cards and prime autos remain solid with delinquencies within historical trends and consumer credit continues to benefit from firm employment and income. The agency CMBS sector offers selective opportunities, with spread income likely to provide outperformance versus treasuries over time. Given relative valuations and diminishing supply, we view agency bonds as less attractive than other securitized sectors.

Corporate credit spreads tightened during the quarter, with investment grade pulling back from spread levels, which are typically seen during a sharp credit crunch. At current levels, the market still has an attractive premium for recession risk and fundamental risks associated with tightening credit. High yield spreads, though well-off cycle tight, have not approached recessionary-type levels in this cycle, but are appropriate to fundamentals. These valuations reflect the fact that this cycle has been driven by rate moves and general economic and financial pressure, rather than by fundamental credit overextension and deterioration. Declining liquidity and tighter credit conditions have repriced credit wider. Stressed industries or credits have under performed broader corporates but have not been a source of systemic instability. Historically high all-in yields for below investment-grade credit have helped support the market, buffering spreads and in the absence of meaningful upward pressure on default rates. Credit fundamentals continue to support an overweight to corporates and high yield, with an emphasis on credit selection as the cycle matures. Within credit, we favor large U.S. banks for their high capital, liquidity and financial flexibility, particularly given recent cheapening versus industrials. Telecom, pharma, health insurers, high quality technology companies and select industrials are among our top credit over-weights. We are under-weight in energy and basics given cyclical and commodity risk. We are cautious on the REIT sector as interest costs and cap rates are headwinds and property type selection are key. Across all sectors, we are paying close attention to the impact of tighter conditions on individual companies and industry segments.

Municipal credit fundamentals are stable, and spreads have recovered somewhat from last year's wides. Higher rates will reduce refunding and new money issuance, supporting valuations. Many borrowers have increased tax receipts and reserves, which helps offset recession risk, but hiring and inflation cost pressures remain, particularly in healthcare. We remain cautious with smaller healthcare entities,

small higher education institutions with weak demand and asset bases, senior living /skilled nursing facilities, and public transit systems. Our outlook for the sector is neutral, with modest exposure to the sector contributing to portfolio income and diversification.

Yield to Maturity at Cycle Highs



Figure 6. Source: PMA Asset Management.

Equity Outlook

The first half of 2023 has been a whirlwind of ups and downs in the equity market. Significant banking stress in March seemed like it could derail the entire year. Continued rate pressures, persistent inflation, decreasing corporate margins and growth slowdown worries caused concern. Nonetheless, those headwinds were met by one unstoppable force of nature: big tech and artificial intelligence (AI). As of 6/29/23, just seven stocks have served up a whopping 79.7% return YTD on an equal-weighted basis compared to 6.4% on the remaining 493 constituents. That translates to the top seven accounting for 79% of the entire return of 14.9% for the S&P 500 this year.

Top 7 vs Bottom 493 Equal-Weighted Returns

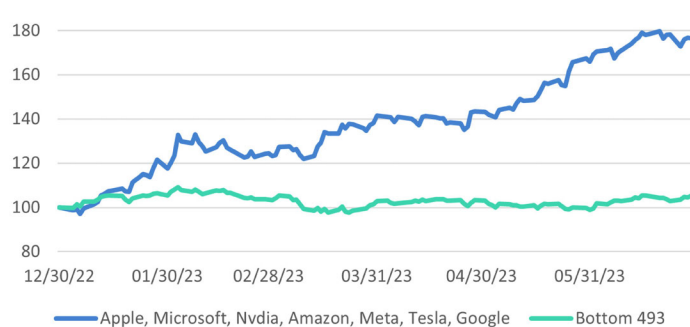


Figure 7. Source: PMA Asset Management.

The S&P 500 (+22.3%) and NASDAQ-100 (+38.3%) are now both in technical bull markets from lows set during the final quarter of 2022. Volatility has been surprisingly low given the concerns the market has faced this year. The VIX index has spent the better part of the year south of 20, indicating a low-risk environment and currently hovers around 13, well below its long-term average of 19.8. We would expect volatility to increase in the year ahead. As a result of the performance strength since the market lows last fall, we are neutral on U.S. equities over the next year. However, in the near-term, we expect recent market momentum to continue to carry equities higher. New bull markets can propel equity markets further. In fact, data since 1950 show that in 100% of new bull markets, S&P 500 returns had continued higher in the twelve months following. Additionally, mega-cap leadership and quick starts to a calendar year have portended to positive returns one year out.

▶ PMA ASSET MANAGEMENT MARKET OUTLOOK SUMMER 2023

SPX Returns - 1 yr Technical Bull Market Confirm

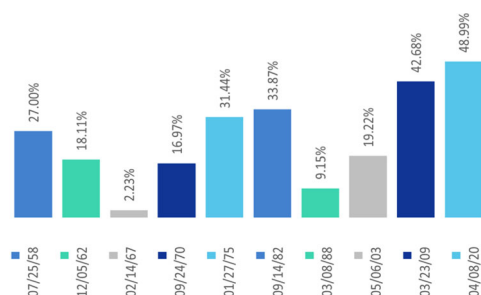


Figure 8. Source: PMA Asset Management.

That said, headwinds persist in the equity market. The concentration of the rally leads to heightened drawdown risk. Additionally, margin pressure, liquidity concerns and poor buyback fundamentals are all leaning on sentiment and earnings, and therefore returns. Given the expectations for fundamental weakness and market exuberance, we do not anticipate large returns, but a more modest low to mid-single digit return with downside risk more likely. These expectations are driven by solid earnings growth expectations, which the street has set at roughly 12% in the forward year and a recession our team expects to be delayed versus consensus. It is likely that the earnings growth estimates decrease over the course of the year, but should remain reasonably strong, given earnings will be lapping the weaker growth we are currently experiencing.

Forward P/E (Price to Earnings) multiples are still relatively high at around 19x for the S&P 500, which we believe should cap returns over the next year. A higher for longer rates environment, general negative market sentiment and a potential drawdown from the recent rally could pressure multiples back to long-term levels of 16-17x.

We continue to remain underweight with both international developed and emerging markets within the equity market. Fundamentally, it is more difficult to find companies offering high quality, strong operations, earnings reliability and growth. We expect international markets to continue to lag the U.S. over the course of the year for a handful of reasons. Most foreign central banks, outside of China, are likely to be more restrictive than the Federal Reserve, driving domestic returns relatively higher. Additionally, a higher out-of-favor value and dividend exposure, higher political and regulatory volatility, higher geopolitical risk, and for emerging markets, a higher exposure to commodities, will pressure relative returns.

Within U.S. equities, we prefer large capitalization stocks over their smaller peers. In the face of a possible recession and persistent inflation, large capitalization companies should be able to manage their operations more efficiently, retaining pricing power while achieving cost-cutting measures as needed. We are of the viewpoint that fund flows will benefit larger versus smaller companies as the economy gets closer to a recession. Large capitalization companies' fortress-like balance sheets and secular growth prospects are likely to draw in capital during weaker economic periods. An additional concern for smaller cap sector is its higher relative exposure to under performing small and regional banks. With higher regulatory capital costs and the coming commercial real estate debt cliff closes, we may see highly exposed regional banks drag down small cap indices.

We looked to valuations to soothe our concerns over small capitalization stocks, but did not find much relief. The forward P/E on the Russell 2000 is trading at just a 3% discount to its 20-year average, while the forward P/S (Price to Sales) is trading at a 9% premium to its 20-year average. Admittedly, shorter term valuation averages show multiples are currently cheap, but we lack trust in recent multiples that were heavily distorted during and following the COVID pandemic.

In 2022, value significantly outperformed growth as interest rates continued to surge to fight inflation. This year, we have seen an astounding reversal of that trend. Growth stocks have outperformed their value counterparts by more than 23%, nearly wiping value's 2022 excess performance off the table. Unfortunately for value, this trend seems set to continue. The Federal Reserve is now much closer to a peak in interest rates, which historically has been when equities perform their best. Extrapolating that further, we expect growth to benefit the most from a pause given a higher portion of earnings in the future, making them more sensitive to interest rates. Additionally, growth sectors of the market are much more exposed to secular growth trends like AI, IoT, EVs and cloud computing. A final concern for value stocks is a higher exposure to dividend paying stocks. With rates set to be higher for longer, lower volatility and higher yielding investment products are likely to compete for flows with high yielding stocks.

Given the growth recession environment impacting sectors and industries quite differently over the next year, we believe active management will prove especially important during this next phase in the cycle. Beneath the surface of the index, a plethora of great opportunities still exist.

75% of SPX Constituent Discounted to the Market-Weighted F P/E

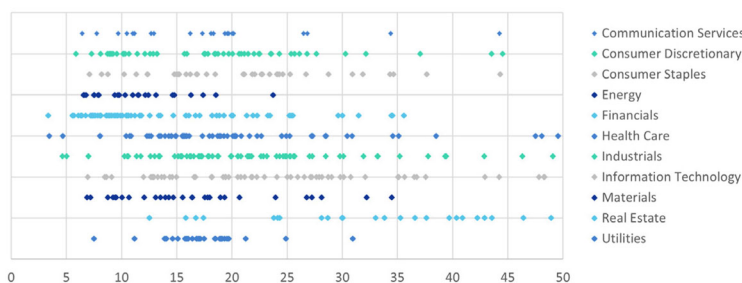


Figure 9. Source: PMA Asset Management.

Roughly three-quarters of S&P 500 constituents are trading at discount to the index level on both a forward P/E and P/B basis. We believe that the importance of selection over the next year will be critical. PMA's core philosophy and processes lead us to companies that have solid management capability, generate strong cash flows, have sound balance sheets, consistent earnings, and trade at reasonable valuations relative to their growth prospects. We believe these characteristics will be rewarded as the economy gradually slows and market participants turn toward higher quality investments.



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