Semi-Annual
MARKET OUTLOOK
WINTER 2023-2024

Positive Expected Returns in 2024

As we put the finishing touches on another wild year for the global capital markets, we expect positive returns to continue in 2024, despite our expectations for a slowing economy. We find ourselves in a market shaped by both challenges and opportunities. The economic recovery from COVID has been nothing short of amazing, bolstered by innovative solutions and the adaptability of industry and businesses within every segment of the economy. Despite significant monetary policy tightening and the associated move higher in interest rates, the market has performed much better than people expected coming into this year. While equity performance has been particularly strong, the fixed income markets have performed admirably as well, especially the past several months as sentiment turned. While numerous headwinds exist, including geopolitical tensions and continued inflationary pressures, economic growth and expected returns across the capital markets, should remain positive in 2024, albeit at a much slower pace in general.

Market Indicator	QTD	YTD	1YR
US Fixed Income			
Treasury Bills	1.03%	4.72%	5.02%
Aggregate Fixed Income	4.43%	3.17%	1.74%
Investment Grade Corporate	5.72%	5.74%	3.76%
Corporate High Yield	4.10%	10.20%	9.08%
Equities			
S&P 500	6.42%	20.32%	17.33%
NASDAQ Composite	7.19%	36.25%	29.55%
Russell 2000	4.02%	6.63%	3.76%
FTSE Global ex US All Cap	4.55%	10.28%	8.95%
Thru 12/6/23 Source: Bloomberg Utilized Bloomberg FI Indices Equity Indices as referenced above			

Figure 1. Source: Bloomberg

Surprises will undoubtedly occur that we will not and cannot anticipate. Optimism over the soft-landing scenario has become deeply conventional. This cycle has certainly not been normal, not that they ever really are. The probability for an economic air pocket is elevated with the current economic, policy and market backdrop in our estimation. While our base case is for the US to avoid a recession once again next year with GDP slightly below 1%, there is a higher probability that the economic pullback is harder than the market currently expects. With inflation and consumption moderating, we believe the risk of stagflation and even higher rates is less likely, although such a surprise would prove significantly more painful and costly. Liquidity in the system remains a challenge and often doesn't get enough attention given its tough to measure. Supply and demand remain in flux in the rates market and dealer balance sheets and capital remain constrained. The continued reduction in the Fed balance sheet does not get much attention, but it is an increasingly important constraint. We wouldn't be completely surprised if the financial plumbing struggles to keep up next year, volatility continues, and something unexpectedly breaks in the rates market. The intraday and weekly realized volatility in the Treasury market has been unlike anything we've collectively experienced in the past four decades.

While there are long and variable lags to monetary policy, the good news is the impact of significantly tighter policy, and corresponding higher rates, is having the desired impact. The hard part is mostly over, and the medicine appears to be working. We have been able to bring down inflation and rebalance labor market without crushing the economy. We've seen this both in the United States and globally. Payroll growth has remained relatively strong, although we've seen this measure slowing the past few months.

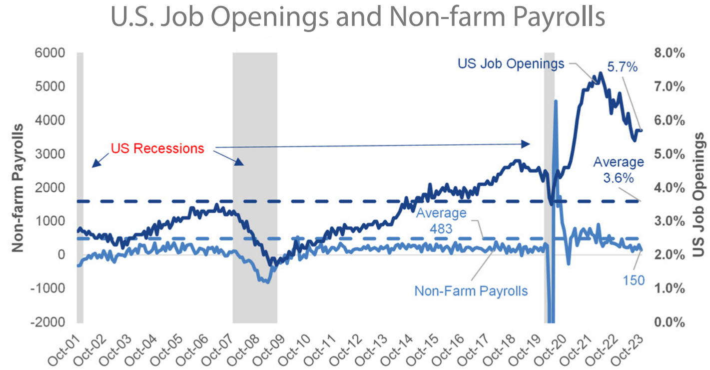


Figure 2. Sources: Bloomberg, Bureau of Labor Statistics, PMA Asset Management. Data as of 10/31/2023

Similarly, other labor market indicators, such as job openings, initial jobless claims and manufacturing employment surveys have remained firm, although weakening slightly here in November data. This labor market resilience is inconsistent with prior recessions. Should recent softening continue or accelerate, such as declines in payroll growth below the replacement rate of around 50k and an increase in the unemployment rate, this would allow the Fed to move rates lower at some point next year. We expect inflation to continue to come down with Core PCE starting to approach the Fed 2% target. There are a few areas of disinflation we are closely watching. The housing market will contribute to slow inflation as rents decline and represent a large component of both the CPI and Core PCE measures through owners' equivalent rent. In addition, as the labor market has started to rebalance, the quit rate has returned to 2020 levels, which should ultimately feed into softer wage growth. Finally, core good prices continue to come down and is expected to continue into next year.

Consumption still holds the keys to how the economic growth unfolds next year. People are still struggling with inflation, yet consumer spending keeps going. Stock of excess savings has diminished. Real disposable income is growing at very fast 4% growth rate, higher than real inflation levels. Consumer spending has remained very resilient this year. In 2022 we had a huge decline in real disposable income, but households were able to spend through it, due primarily to excess savings. That has now diminished.

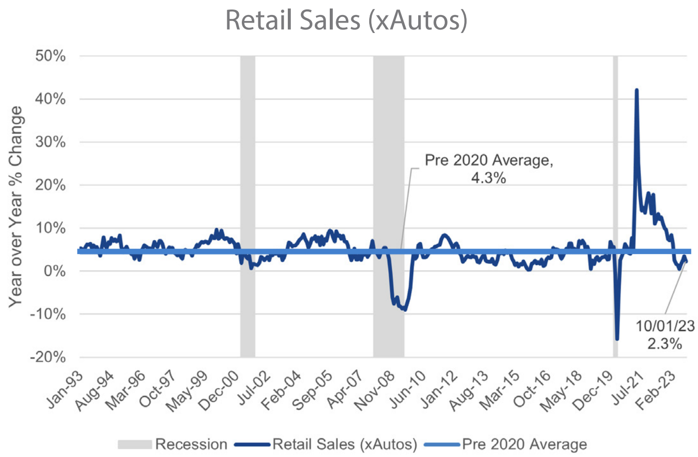


Figure 3. Sources: Bloomberg, U.S. Census Bureau, PMA Asset Management. Data as of 10/31/2023

Interest income is rising largely offsetting higher mortgage rates thus far, but each affects different segments of consumers. Consumer spending continues at around a 2% rate although retail sales have been softening somewhat. We expect consumption to soften next year.

That said, the Fed won't be in a hurry to cut rates, with nothing expected until summer or fall of next year here at PMA. The risk to the path of interest rates is to the downside from a yield perspective, as bond prices could pop if the economy falters. This environment sets up particularly well for bonds, as expected returns have increased with the higher rate environment. As a rule, we always tell our clients; invest with purpose; invest with a plan and stay invested. The past few weeks are a great example of how quickly things can change. Yields were galloping higher in September and October and then everything suddenly changed. Timing the market is dangerous for an investor's financial health. We've likely seen the peak in rates for this cycle in our view.

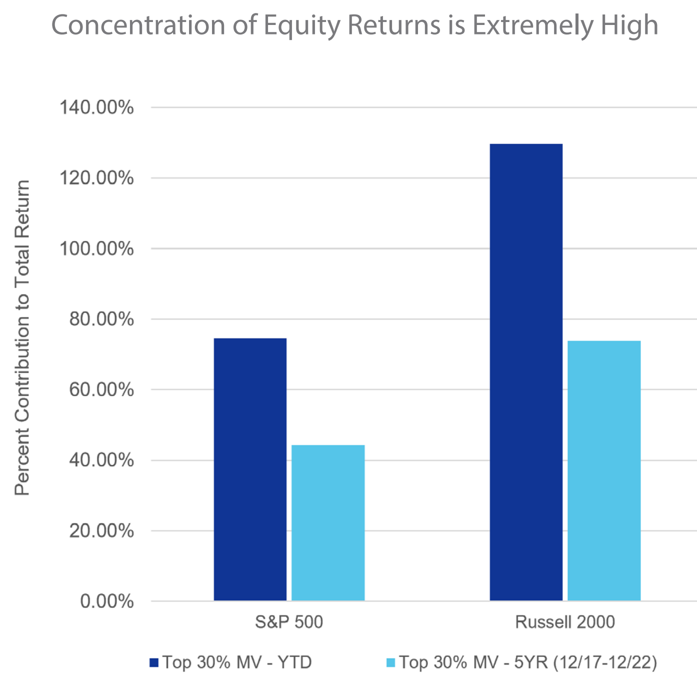
Equity Outlook

With less than a month left in 2023, equity market volatility has been driven largely by two factors: expectations for rates and economic growth. This spring it appeared that the Federal Reserve's tightening campaign had finally broken investors will, but it did not. The equity market spent the following months attempting to decipher when a dovish pivot by the Federal Reserve would occur. The seesaw pattern of equity prices as the market digested diverging economic data and Fed official commentary. A lather, rinse, repeat cycle. Ultimately, equities have been able to push higher the past several months as economic data has slowed furthering the markets anticipation for the Fed to pivot earlier in 2024.

In many ways, we find the market in a strikingly similar situation when we authored our mid-year outlook. Through November, the biggest companies still account for the lion's share of gains. The Magnificent 7 has accounted for 74.5% of the S&P 500's year to date gain. That trend extends to smaller capitalization stocks as well. The top 30% of the Russell 2000, just 148 of the 2000 names, has accounted for 130% of its total return. The remaining 1,850 stocks have cut the index's potential total return in half.

Looking ahead, we believe that there is a wider range of possibilities and potential volatility given recession uncertainty. Should the US economy avoid a recession, we expect gains for the S&P 500 to be in the 6-8% range.

We believe 2024 EPS growth estimates of 11.7% will fall over the next year given demand concerns, poor 4Q24 EPS guidance trends, inventory destocking, and wage growth. Headwinds aside, we believe earnings growth should be solid as we emerge from an earnings recession. In our view, 2024 returns will be driven by EPS growth while valuation multiples should remain relatively stable.



* Top 30% - The largest names that make up 30% of index market cap

Figure 4. Sources: Bloomberg, PMA Asset Management.

On the surface, equity valuations appear to be trading at a solid premium relative to history. The current S&P 500 forward price earnings ratio sits at 21X, three turns above its historical norm. However, it is important to note that the construction of the S&P 500 has changed significantly over the last 20 years. The largest companies now consist of high growth, strong balance sheet technology companies compared to long-time leaders, like GE, AT&T, and Exxon, that historically experienced much slower growth. We do not expect a catalyst for this to change in the coming year and expect the biggest names to continue to carry the index. The Magnificent 7 should continue to benefit from higher expected sales growth, stronger management teams, and better margins than their peers. A decrease in interest rates should also act as support for higher multiples.

If a recession were to occur, our base case expectations are for it to be mild and short. Given the size and flexibility of big tech and the Magnificent 7 to manage through slower growth, we do not see significant losses for equities in this scenario. We would expect a sell-off early in the year, to be mostly recouped in 2H24 as markets turn their attention to a growth rebound. We would expect S&P 500 returns to be flat to modestly lower if a mild recession ultimately did occur.

Finally, we assume that there will be no significant impact on equity market returns driven by the election year. In the four-year election cycle, the election year exhibits the second-best median return trailing only the year before an election. Since 1948, the S&P 500 has had a median return of 9.5% during election years.

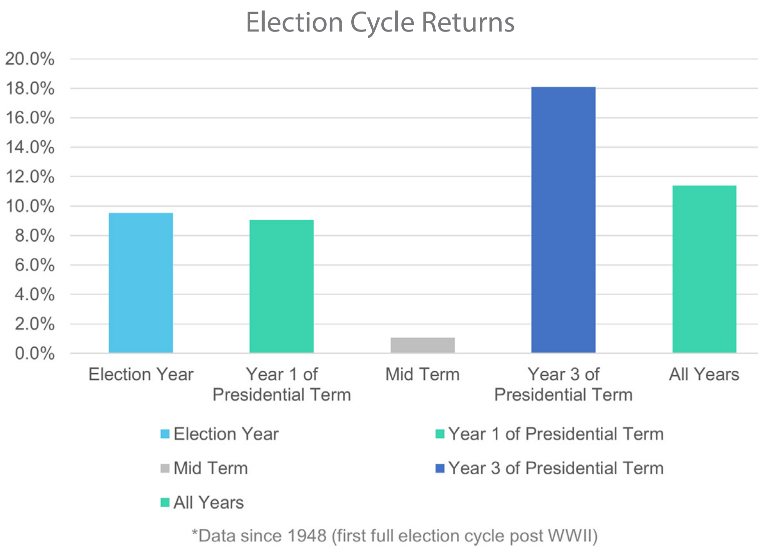


Figure 5. Sources: Bloomberg, PMA Asset Management.

We continue to prefer US equities to both developed and emerging market equities. The lower quality and slower-growth nature of foreign equities underpins our long-term preference for US equities. We also view an economic contraction more likely outside of the US, as some European countries are already flirting with recessions. Heightened geopolitical issues are more likely to cause growth headwinds and volatility for emerging markets dependent on commodities. On the other hand, with US rates appearing to have peaked – it is possible that a downtrend in the US dollar is established, a relative benefit for foreign equities.

We are also overweight large capitalization stocks, preferring them to small capitalization stocks. Aside from the benefits of the Magnificent 7 discussed earlier, the large capitalization group is higher quality, more likely to withstand a recession and are likely to draw money from small capitalization stocks in an economic slowdown. The expectation for decreasing interest rates will be a benefit for large growth and small alike. However, the benefit will be slightly greater for large growth companies as smaller capitalized companies cost of debt will not decline as rapidly.

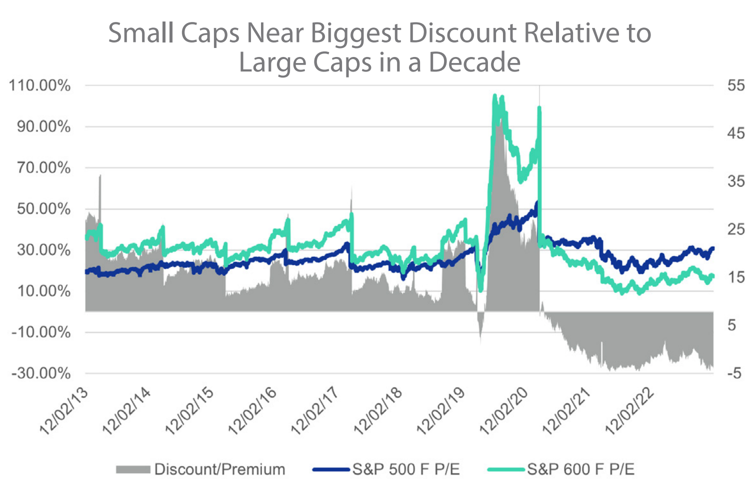


Figure 6. Sources: Bloomberg, PMA Asset Management.

That said, a 28% discount for small stocks relative to large should eventually give the group some relative performance in the medium to long term. However, we don't expect small caps to outperform in the next year given recession risk, higher interest expense, and less growth potential than larger peers.

We prefer growth to value, as we believe the primary factors propelling large capitalization stocks should also drive growth stock relative performance. Dividend stocks are wrapping up a difficult year as high dividend payers in the S&P 500 trail by 23.5%. As interest rates rose, capital fled dividend stocks for similar yielding, lower risk investments. We expect this trend should reverse itself somewhat in 2024. We remain encouraged by significant opportunities for active management. Today 73% and 81% of constituents are cheaper than the forward price/earnings of the market-weighted S&P 500 and Magnificent 7, respectively. The concentration of equity returns in 2023 that caused these valuation dislocations should normalize through time. Active management and stock selection will prove critical once again in the year ahead.

Fixed Income Outlook

With the Fed on hold and the tightening cycle likely complete, the forward-looking return outlook for the bond market has improved. Yields, while well off recent cycle highs, remain attractive relative to history and forward-looking economic indicators. The yield curve has made significant progress towards normalization following the recent underperformance of long-term rates versus short-term rates, further improving market prospects across the curve.

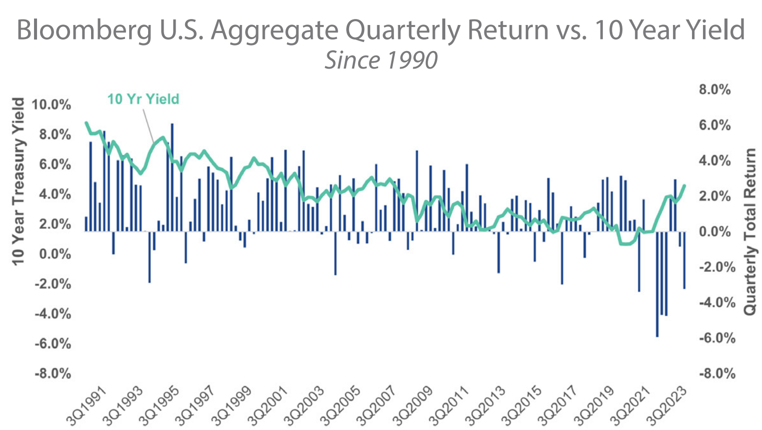


Figure 7. Source: Bloomberg. Data as of 09/29/2023

Although the Fed remains cautious about inflation progress and is still leaning hawkish, the market will continue to attempt to move ahead of the Fed, thus forward pricing can be volatile and may overshoot the path of policy rates. This is very typical for this part of the Fed cycle and highlights the importance for investors to remain focused on objectives and proper time horizons. Although the yield curve is still relatively flat to inverted, high real and nominal yields offer attractive opportunities to position for longer liabilities. As we emphasized this summer, 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. Market adjustments could continue to be sharp, as we have recently witnessed.

Carry will continue to be an important contributor to expected returns as most sector spreads are fair to modestly cheap, given the economic and financial market backdrop. 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. Tightening potential will be governed by expectations for relaxation of credit tightening by the Fed played off against expectations for economic prospects. Indications that the economy is tipping toward a hard-landing scenario presents a risk to spread sectors moving wider, particularly corporates. We view this outcome as relatively unlikely, but we remain alert to these risks. Quality is a key consideration at this point in the credit cycle as continued tight financial conditions impact credits and sectors, some more than others, including commercial real estate and banking. As a result, our bias is for an overweight to quality and liquidity across our portfolios.

Yields Well Above Cycle Averages

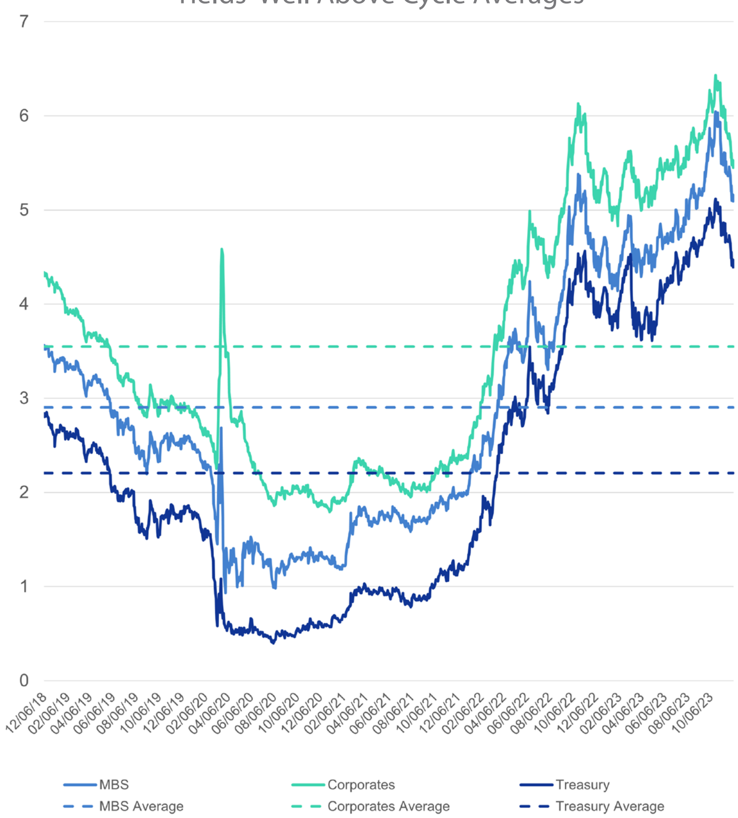


Figure 8. Sources: Bloomberg, PMA Asset Management.

Among securitized and government sectors, we see the best value in high quality ABS and Agency MBS passthroughs. After a very difficult start to the year, mortgages have performed very well recently. The turn in interest rates, the reshaping of the yield curve, and a decline in implied bond market volatility have all aided the sector. Despite this recent move, current valuations remain attractive versus high quality corporates and other spread sectors, particularly given our outlook for interest rates. Technicals in the sector have also improved, having recovered from the withdrawal of the Fed from the MBS market and clearing from heavy bank liquidation earlier this year. High quality ABS is very attractive in absolute spread terms as well as versus AA corporates. We target significant over weights to high quality auto and credit card ABS in applicable portfolios. Given relative valuations and diminishing supply, we view agency bonds as less attractive than other government sectors.

Corporate credit spreads have tightened meaningfully since mid-year, with investment grade spreads testing levels set early in the Fed tightening cycle. Long corporates have performed particularly well, amid solid credit fundamentals and demand for high quality long duration assets. At current levels, the market remains fair and has modest tightening potential due to fundamentals and the turn in the credit cycle. Nonetheless, we see the best value in the corporate market in short to intermediate maturities and in financial issuers. Credit spread curves are relatively flat and the risk tradeoff is more favorable in these areas. High yield spreads have continued to tighten this year and remain at the tighter end of their range during this Fed tightening. These valuations reflect the fact that this cycle has been driven by rate moves and general economic and financial pressure, rather than fundamental credit overextension and deterioration. Stressed industries or credits have underperformed broader corporates but have not been a source of systemic instability. Credit fundamentals continue to support an overweight to corporates and high yield, with an emphasis on credit selection as the cycle matures and rate pressures work through the system. 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 this year's wides, although they have not kept up with the performance of other spread sectors. Refunding and new money issuance have remained low, supporting valuations. While costs and expenditure needs may pressure some borrowers, most sub-sectors are well-positioned. While we favor other sectors, our outlook for municipals is neutral, with modest exposure to the municipals contributing to portfolio income and diversification.

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