DIVS

Review of Q2 2023

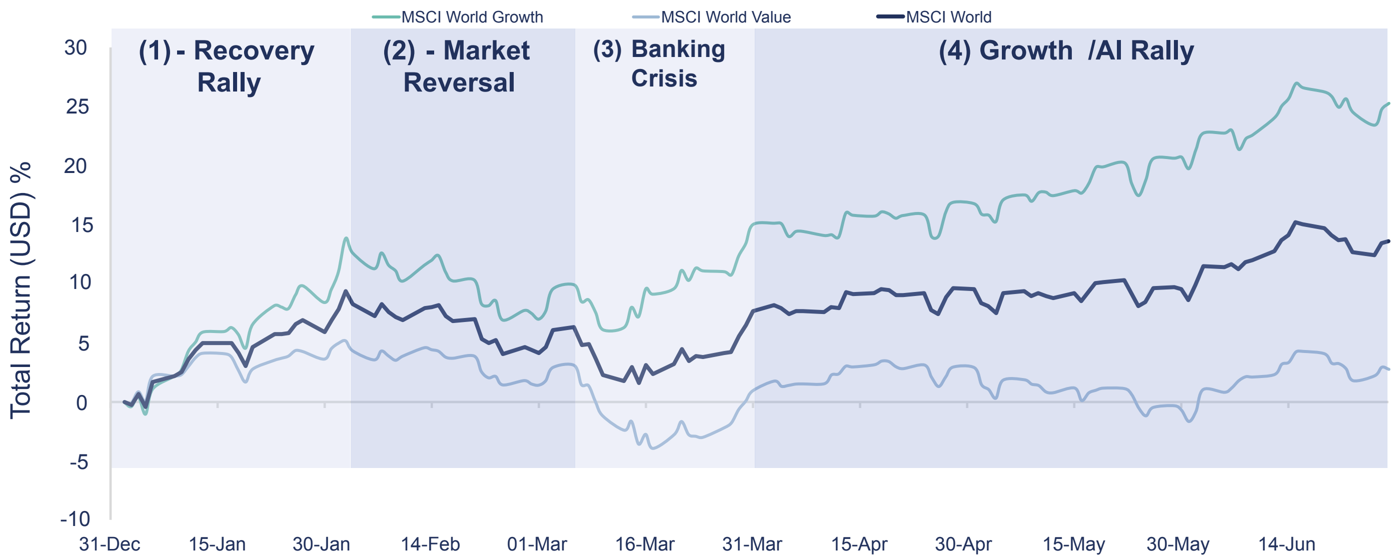
July 2023

SmartETFs

Right Brain, Left Brain Investing

Review of Q2 2023

MSCI World - 2023



Source: MSCI. Data as of June 30, 2023.

Year to Date Performance Summary

(1) Recovery Rally: Over the start of 2023, equities rallied hard with the growthiest parts of the market significantly outperforming. Higher beta areas performed particularly strongly as did the lowest quality areas of the market, as the factors which had performed worst over 2022, saw a strong reversal and led the market higher.

(2) Market Reversal: The positive sentiment that had driven markets, quickly unwound. The rally had been led by a small number of seemingly fragile data points, but as new data emerged, investors reassessed their inflation expectations and the outlook became markedly more hawkish. With the prospect of higher rates for an extended period of time, longer duration assets were impacted the hardest, and markets retreated.

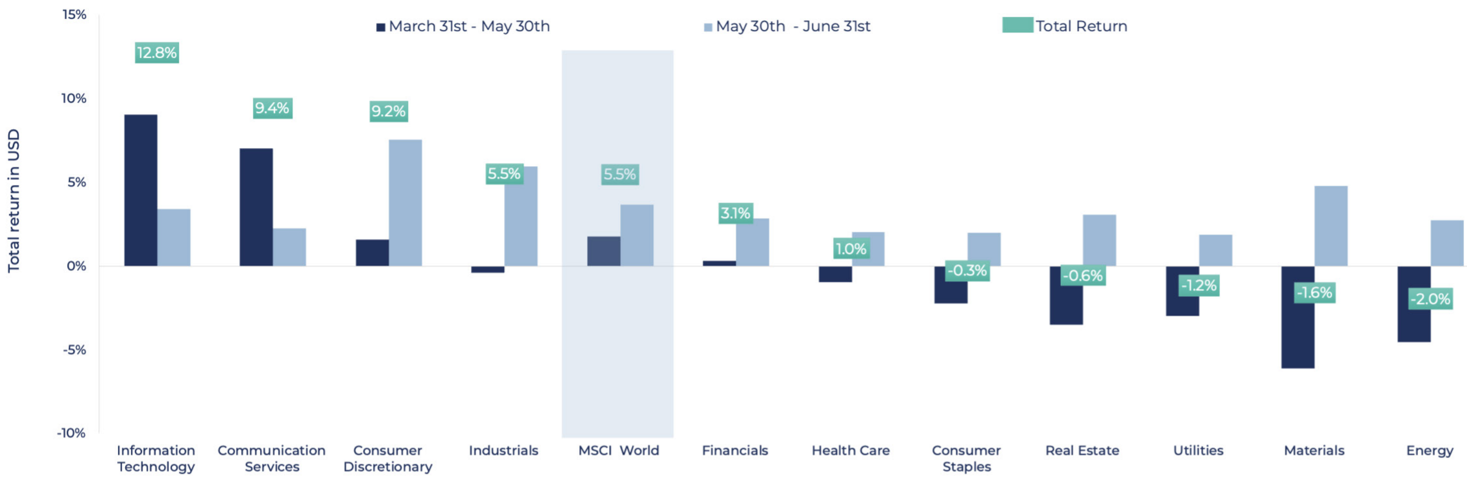
(3) Banking Crisis: Three large bank failures in the US and the Credit Suisse rescue in Europe showed growing stress in the banking sector and highlighted the impacts of a historically stringent monetary tightening cycle. However, after a short sell-off in early March, volatility abated, and risk aversion retreated as swift liquidity support by central banks (and several takeovers) prevented a widespread escalation. Over this period, the Financials and Energy sectors performed particularly poorly, but other parts of the market (notably Healthcare & IT) saw positive performance.

(4) AI Induced Rally: Since the end of March, a focus on Artificial Intelligence, and more specifically its potential use cases for a range of business cases, caused a sharp market rally. The largest gainers were the semiconductor names within the IT sector, as well as a range of associated sectors which have tangential exposure. It is worth noting that AI is not a new phenomenon, but the launch of ChatGPT in early 2023 was the first consumer facing AI application and has therefore drawn attention to the technology. The number of S&P 500 companies citing AI on their earnings call has more than doubled over the last 6 months and, in many cases, has been richly rewarded by the market. More specifically, the optimism surrounding AI has focused on a handful of large cap names, which have driven the majority of performance. There is growing concern that such lack of breadth is not a stable base for an enduring bull market as the largest ten names in the S&P 500 have accounted for nearly all the index's returns until the end of May.

Where are we now? A broadening rally.

On the whole, H1 2023 was a record low for US equity market breadth. Just 32% of US stocks outperformed the market, highlighting the sharp concentration of winners. EU stocks have fared slightly better, with 45% of stocks outperforming as of half-year end, but this is still well below historical averages. That said, over the month of June, the rally broadened out somewhat. As has been the case for much of the year, the technology sector continued to run (+6.2%), but positive performance was shared more equally amongst other sectors including Consumer Discretionary (+10.5%), Industrials (+9.0%) and Materials (8.3%).

MSCI World Sector Performance Q2 2023



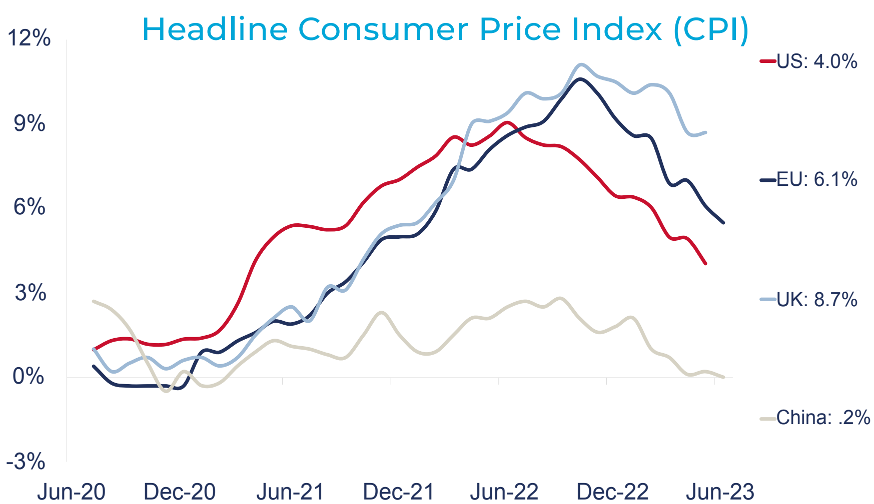
Source: MSCI. Data as of June 30, 2023.

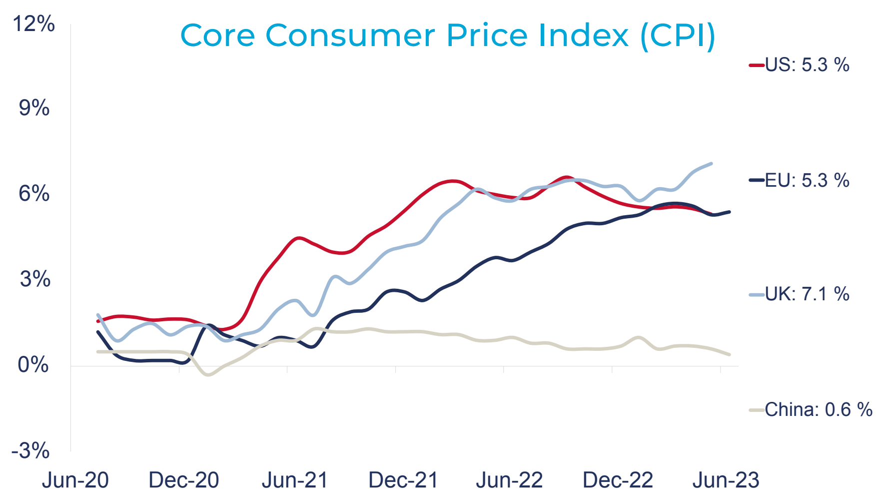
- Up until June, much of the AI rally had been driven by a narrow group of names, but as the macro conditions evolved and the market pricing of a recession diminished, cyclical sectors faired particularly well, allowing for a more widespread market. The consensus that a soft landing may still be possible gained conviction over June, with new data pointing to an increasingly robust US economy. Goldman Sachs now see just a 25% chance of a US recession in the next 12 months, as the regional banks have stabilized, deposit outflows have slowed, and lending volumes are up. This has been compounded by recently released data which shows that everything from GDP to new home sales and durable goods orders all beat consensus estimates. This domestic US strength gives the Fed additional room to slow the economy through further monetary tightening in an effort to get inflation under control, whilst still maintaining some economic growth and avoiding a hard landing.

Signs of Caution Emerge

Despite markets ending both the month and the quarter higher, a sense of caution emerged over the latter two weeks of June, as investors questioned the widespread optimism that has been driving the latest rally. There is no doubt that the economy has shown surprising resilience and the risks of a hard landing may well have decreased, but there are still multiple question marks that weigh heavy on the market. The yield curve remains strongly inverted, which has predicted the vast majority of prior recessions. Monetary policy remains tight across the US, Europe, and parts of Asia, and the full impacts of such quantitative tightness is yet to fully emerge given significant lagging effects. Additionally, the AI theme trade has driven strong equity market performance, but valuations have been led by multiple expansion on earnings that, on an index level, are generally flat to down (see commentary below). The culmination of these factors has caused investors to pause and return their focus to the issues which faced markets earlier in the year.

Inflation: What is the Data Showing?





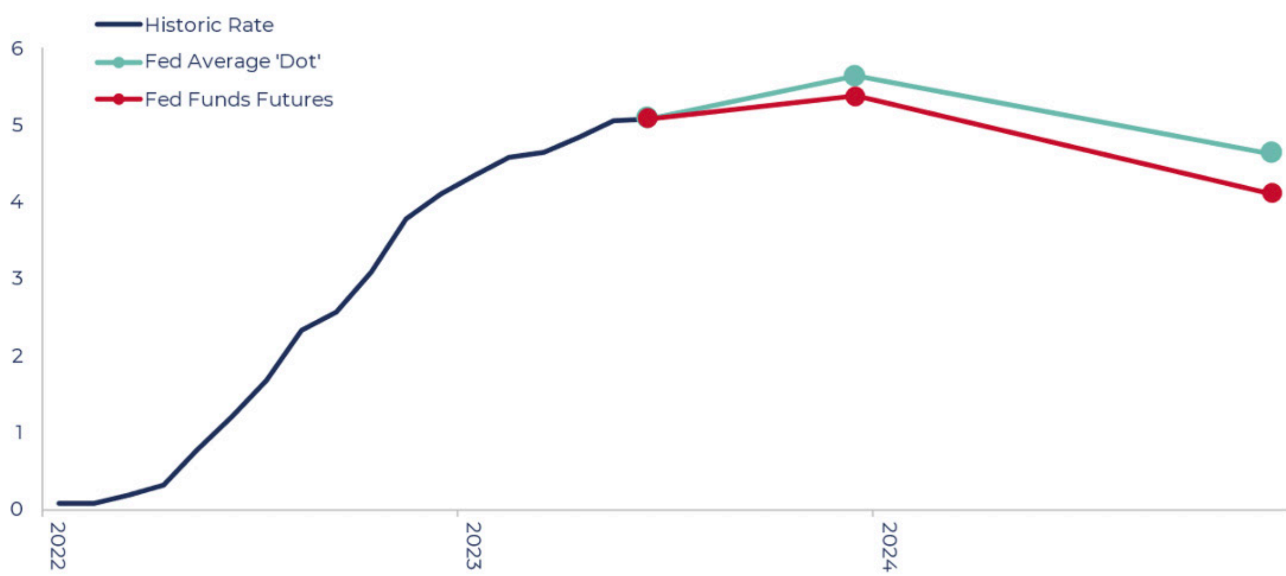
Source: Bureau of Labor Statistics (US), Office for National Statistics (UK), Eurostat (EU), National Bureau of Statistics (China). Data as of June 30, 2023.

- **Summary:** Headline inflation is falling but core inflation is not declining fast enough.
- **Headline CPI:** The headline figure is coming down as energy & food costs continue to retreat from exacerbated levels. Europe will benefit from favorable base effects as the large gains in energy and food prices seen this time last year start to drop out of the annual calculation.
- **Core CPI:** Core is being driven by **a)** an historically tight labor market **b)** sticky services inflation, and **c)** the large weighting of high priced shelter.
  - The US jobs market is still red hot with a 4.44m person job gap (total vacancies – total unemployed). The tightness of the labor market and ongoing pressure on wages will also keep labor costs high until a recession hits. Demand for services remains buoyant with households still seemingly intent on making up for the lost experiences in Covid times. Finally, shelter makes up 44% of core US CPI, and with a tight housing market and high rent prices, shelter continues to drive inflation higher.

A Bearish Pause

With US interest rates now at positive real levels (i.e., above core PCE inflation), the US Federal Reserve decided to hold rates at current levels, but it was a decidedly hawkish pause. The Fed suggested more rate hikes could be coming soon and an early Fed pivot seems firmly off the table for the time being. When looking at market expectations, the terminal rate has moved higher, and consensus now anticipates tighter monetary policy for longer. The Fed's dot plot chart shows an anticipated two more rate hikes this year and, during his press conference, Fed Chair Jay Powell shared that "nearly all" committee members think further tightening this year is needed. He also added that, as things stand, the US wouldn't be returning to pre-pandemic rates for a "good while." While the Fed may be bluffing, in effect releasing a hawkish dot plot to stop the market from getting ahead of itself and easing financial conditions, it seems likely that the questions discussed early in the year will return to the fore. A focus on the path of rates, the impact of tight lending conditions, and the outlook for growth (& equity valuations) is increasingly being scrutinized. The chart below shows that the Fed average dot plot rate, prices in 2 more 25bp hikes before year end, although the futures market is still pricing in a lower terminal value, in effect, not buying the Fed's latest rhetoric.

Fed Funds Rate



Source: MSCI. Data as of June 30, 2023.

Are Earnings Expectations Too Far Ahead?

Amid the uncertain macroeconomic backdrop discussed above, the market has maintained a cautiously optimistic outlook, as shown by S&P500 EPS estimates. For 2023, the market consensus is for ~$219 of earnings, which is relatively flat year-on-year (YoY) (2022 EPS was $221). However, as illustrated by the chart below, Q1 2023 earnings were down YoY and Q2 earnings are also expected to come in lower. Therefore, in order to get to year-on-year earnings that are broadly flat, it would imply that the latter half of 2023 will see solid positive earnings growth. While a more buoyant economy and a strong consumer may continue to surprise to the upside (thus enabling earnings growth), there is also a risk to the downside, namely that the market is too bullish. There are a range of potential headwinds on the horizon, with sticky inflation, the lagging effects of the fastest rate hiking cycle in history and an increasingly debt-laden US consumer, that may well slow. If earnings are revised downwards in a recessionary scenario, this would be bearish for markets, especially as such risks don't seem to be adequately priced in at present.

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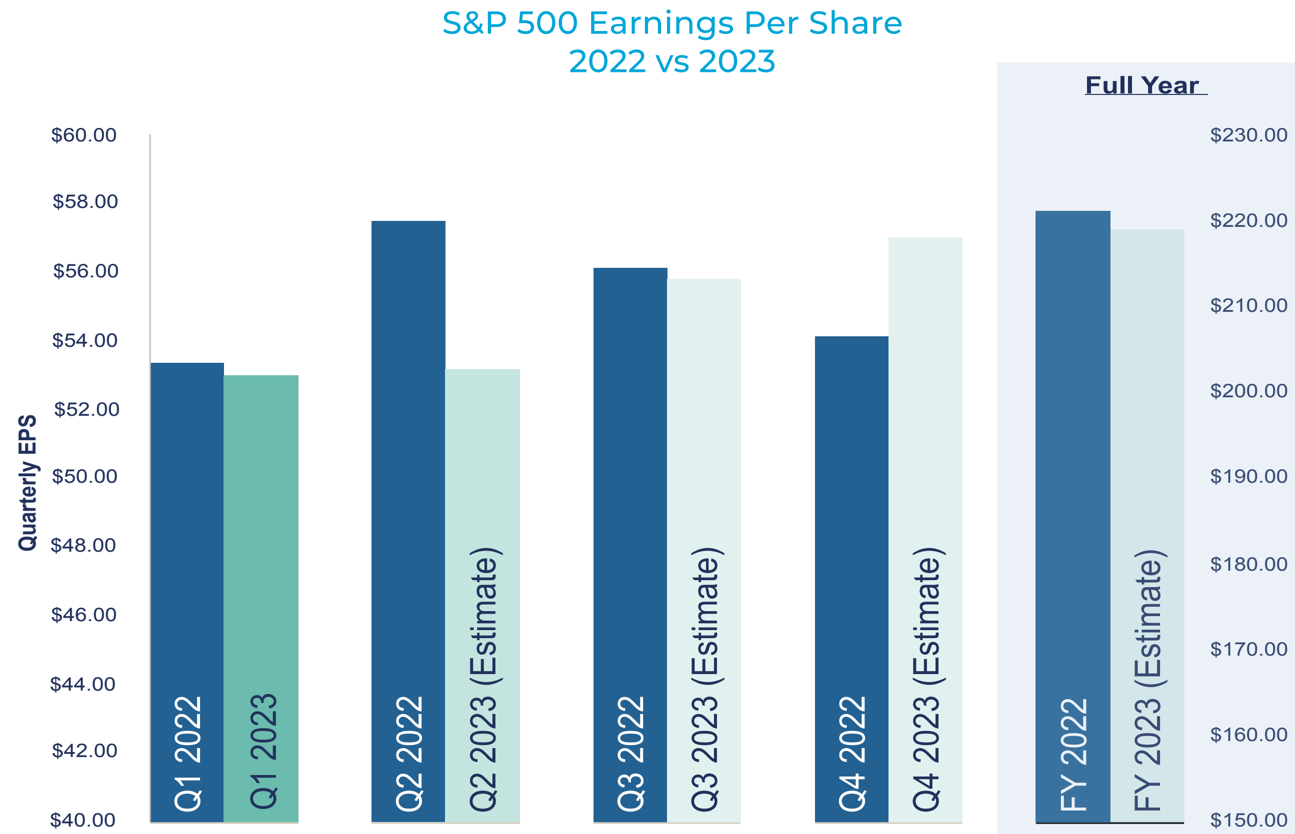

Source: Bloomberg. Data as of June 30, 2023.

Why this leaves DIVS Well-Placed

Global equity markets remain in a delicate situation, with the outlook increasingly uncertain as new data on inflation, growth and interest rates paints an ever more nuanced picture. Given this uncertainty, a strong case can be made for quality as a factor, given its focus on well run businesses, with consistently high returns on capital, and whose defendable market positions & competitive advantages should enable them to earn above-market returns over the long run. This is especially valuable in both a volatile and a lower growth environment because the stable earnings profile helps to avoid significant drawdowns and mitigates broader market fluctuations.

Important Information

MSCI World Index captures large and mid cap representation across 23 Developed Markets countries. With 1,583 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Basis Points (BPS) refers to a common unit of measure for percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

S&P 500 is a market-capitalization-weighted index of 500 leading publicly traded companies in the United States.

Beta is a measure of volatility of a security compared to the market as a whole.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Investors cannot invest directly in an index.

Earnings Per Share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

The Fund invests in securities that pay dividends, and there is no guarantee that the securities held by the Fund will declare or pay dividends in the future, or that dividends will remain at current levels or increase. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. Investing in securities involves risk and there is no guarantee of principal.

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