



Q3 2023 investment outlook:

Resilient consumers shrug off doubters, propelling most risk assets higher



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Executive summary

Rumors of the global economy's and historically riskier asset classes' demise have so far proved premature. As consumer and business activity remain healthy, we now turn to a period where consensus estimates are for a shrinking global economy in 2023's second half. We came into this year concerned about how consumers would withstand interest rate increases from global central banks including the U.S., Europe, the United Kingdom, Canada and other major economies still experiencing uncomfortable inflation trends. Higher interest rates mean higher borrowing costs for businesses, consumers and governments, potentially thwarting spending plans. U.S. consumers remain anchored by strong personal balance sheets and a still-robust labor market, with inflation-adjusted wage gains on a steady uptrend since June 2022 despite central banks remaining biased to tighten liquidity to stave off inflation.

In addition to higher interest rates as a concern for this year, liquidity measures — the amount of capital flowing through the economic system — presented another challenge for spending and corporate profits. Now that Congress suspended the domestic debt ceiling until after next year's Presidential election, the Treasury Department is actively restocking its depleted coffers by issuing bonds, and that action takes capital out of the hands of private investors. Further, the banking system has avoided additional flare-ups at the individual bank level, which has provided some relative calm, although investors remain focused on sector-level issues like commercial real estate loans coming due and any deposit issues at individual firms.

We have upgraded our outlook on the path forward for diversified portfolios but retain a careful eye on several variables, including the labor market, central bank policy, an overly exuberant lift to certain sectors in the global equity market and liquidity trends as the year

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unfolds. Historical valuations for global stocks are registering close to longer-term averages despite very high interest rates competing for investor dollars. Commodities, the strongest outperforming macro asset class last year, have been the opposite this year, with some market observers suggesting their weakness points to foreboding economic activity. We would characterize our forward-looking views as skeptical participants seeking further confirmation that the durable trends reflected in global stock and riskier bonds are sustainable, and as always, we will keep you updated with our developing views.

Global economic views

Aside from elevated inflation in most regions, global economic activity remains heterogeneous.

The U.S. economy continues to slow but appears likely to avoid recession for now based on viewpoints from our U.S. Bank economics team. Japan is a surprise story for the first half of the year, accelerating out of recession, while China's reopening is disappointing so far, thanks to ongoing indebtedness at the consumer and business levels. Europe has just entered a recession, led by contractions in Germany and Ireland. Slow growth likely remains the story for the global economy into 2024 with global central bank interest rate hikes and still-elevated inflation as headwinds. Pockets of strength could emerge if Japan continues to recover and China engages in stimulus to generate a consumer recovery late this year. U.S. fiscal risks are likely behind us, but U.S.-China trade relations and the ongoing Russia-Ukraine conflict are risks to the global economic outlook. More aggressive inflation fighting from global central banks could also dampen our economic future.

Consumer spending and services highlight the resilient U.S. economy.

Post-pandemic consumer spending, which accounts for nearly 70% of U.S. gross domestic product, continues to benefit from a strong labor market, rising wages and accumulated savings. Spending on services remains robust, with leisure and hospitality companies projecting solid activity into the fall. However, the adjustment to higher interest rates remains a likely headwind for consumers, especially those with higher credit balances. Higher costs remain a headwind for most all companies, though surveys of services businesses indicate activity remains strong while manufacturing remains weak, with new orders trending lower.

Inflation, coupled with Federal Reserve (Fed) interest rate increases to raise borrowing costs and dampen economic activity to reduce inflation to its long-term 2% target, remains an important factor. Certain key costs, such as food and energy, appear to be moderating from relatively high levels, but shelter costs and other prices, supported primarily by wage gains, remain elevated. We anticipate year-over-year inflation will slow into year-end but will remain well above the Fed's 2% target. The primary challenge for the Fed remains tight labor markets. Labor data is likely to moderate over this period as well, with job openings falling from levels well above the total number of unemployed and the rate of unemployment ticking slightly higher.

Developed foreign economies continue to battle inflation, with Japan a bright spot.

The European Central Bank and the Bank of England are following the Fed in raising interest rates to battle their

Gross Domestic Product Growth

Source: U.S. Bank Asset Management Group analysis, Bloomberg, December 31, 2020-March 31, 2023.

Country/Region								Forecast Growth		
	Dec-20	Dec-21	Mar-22	Sept-22	Dec-22	Mar-23	Dec-Mar	June-23	Sep-23	Mar-Jun
United States	-1.5	5.7	3.7	1.9	0.9	1.6	▲	1.9	0.9	▲
Eurozone	-4.1	4.7	5.5	2.5	1.8	1.0	▼	0.1	0.2	▼
United Kingdom	-9.2	8.9	10.6	2.0	0.6	0.2	▼	0.2	0.4	▼
Japan	-0.5	0.9	0.5	1.5	0.4	1.9	▲	0.6	1.2	▼
China	6.4	4.3	4.8	3.9	2.9	4.5	▲	7.7	5.0	▲
India	1.6	5.2	4.0	6.2	4.5	6.1	▲	6.9	6.0	▲
Brazil	-0.4	2.1	2.4	3.6	1.9	4.0	▲	1.1	0.8	▼

own inflationary pressures. Inflation remains elevated in this region as wage gains work through the economy. However, recession is so far limited to Germany and Ireland. Purchasing manager surveys indicate manufacturing remains a headwind. Surveys of services companies, which remain a major part of the European economies, indicate still-positive growth, which should help this region lift growth modestly into year-end. However, energy costs remain a key swing factor as the region seeks alternatives to supplies of Russian natural gas for the winter heating season.

Japan's growth has been a bright spot for the global economy, emerging from a short recession early this year. In contrast to other global central banks, the Bank of Japan has held interest rates steady, instead welcoming some reflation in their economy after decades of deflation. The economy appears likely to sustain a modest pace of real economic growth into year-end with this support.

China's reopening is key to emerging markets.

After a strong start to the new year, China's reopening from COVID-19 restrictions fizzled in subsequent months. Business surveys indicate modest activity with little pent-up demand in new orders. Loan growth and retail sales remain modest. The housing market remains a slight headwind as consumers work to free savings from that market. However, as consumers restock their savings, spending is likely to normalize, supporting modest economic growth. While recovery in China is likely to continue, its rate of growth is likely slower than the pre-pandemic economy with a greater reliance on consumption over government driven investment.

Other emerging market economies remain more dependent than China on global trade and economic activity. South Korea and Taiwan are cyclically oriented and therefore sensitive to global trade and manufacturing. Global manufacturing business surveys continue to indicate slowing activity and weak new orders activities, indicating economic activity is likely to remain modest at best, unless China's economic recovery accelerates. Other major economies, such as Brazil, depend heavily on natural resources. Slow global economic growth is a headwind to global natural resources demand, and commodity prices are generally flat.

U.S. equity markets

U.S. equities forged higher in 2023's first half, with enthusiasm around artificial intelligence (AI) companies bolstering growth-oriented sector performance.

The promise of AI is fueling speculation of a new technology super cycle, favorably impacting technology-related companies and sectors and driving broad market gains. Strong performance among the Information Technology (up 42.1%), Communication Services (35.6%) and Consumer Discretionary (32.3%) sectors helped the S&P 500 end the second quarter up 15.9% for the year so far. However, market performance breadth remains narrow, meaning not all sectors and companies are performing as well. The remaining eight S&P 500 sectors ended the quarter up less than 10%, with five posting losses, which underscores defensive and dividend-paying stocks' lagging performance.

Persistent inflation, elevated interest rates and uncertainty regarding 2023 and 2024 earnings growth continue to stoke volatility while challenging recent equity price gain durability.

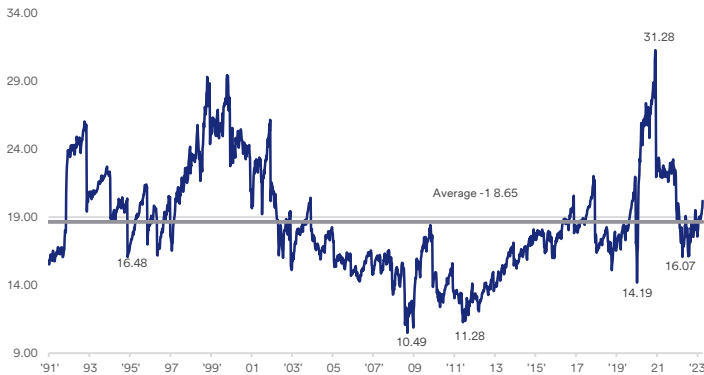
Elevated inflation and associated higher interest rates erode the purchasing power of earnings streams and future dividend payments. Equities trended generally higher in the first half with key economic indicators suggesting that inflation may be decelerating, fueling speculation that the Federal Reserve will soon conclude its rate hiking path just as earnings projections appear to be stabilizing. As of June 30, the S&P 500 trades at approximately 20 times consensus current year earnings projections of roughly \$220 per share and 18 times the projected 2024 estimate of \$243, reflecting projected year-over-year earnings growth of approximately 10%. While the actual earnings will be contingent on the economic environment in the second half of 2023 and 2024, at present, we regard current valuations to be within a "zone of okay," neither at high nor low extremes.

Companies are reporting robust but slowing consumer spending, while continuing to invest in productivity-enhancing technology.

A key takeaway from the first quarter corporate reporting period is that consumer spending, particularly on experiences, remains robust, indicating consumer balance

S&P 500 price/earnings ratio

Sources: Bank, Bloomberg, June 16, 2023.



sheets remain in relatively good shape. However, an increasing number of companies have recently noted that consumer spending has slowed, a sign that Fed interest rate hikes are having their desired impact. This elevates uncertainty and potential for increased volatility around the second quarter reporting release period, beginning in mid-July.

A second key takeaway from the first quarter release period is that business customers, on balance, continue steady spending on productivity-enhancing technology. This supports our observation that fast is getting faster, and speed, scale and efficiencies do not occur without technology. AI and data security-related spending remains solid as companies look to leverage the opportunities associated with accelerated computing, while also ensuring a robust cybersecurity infrastructure. However, companies are stretching sales cycles, particularly for cloud-based companies, as they look to optimize their cloud spending in response to the challenging economic environment. This, in our view, elevates the risk of select companies issuing disappointing results during the second quarter reporting season beginning in July.

The tug-of-war between bull and bear camps is balanced.

Recent economic indicators suggesting that inflation's pace is waning, increased likelihood that the Fed will soon pause its rate hiking campaign, mounting prospects for only modest economic slowing toward year-end, removal of the debt ceiling overhang, better earnings growth, AI-induced

growth drivers and resilient consumer spending trends are among factors supporting a durable U.S. equity rally. However, other factors indicate caution, including increased competition from bonds given higher interest rates, narrow index and sector performance leadership, persistent inflation and a likely "higher-for-longer" Fed stance, and the potential for economic and corporate earnings pressures to emerge later in the year. This balance of potential bull and bear outcomes implies continued macroeconomic uncertainty and increased price volatility and supports valuations remaining near historical averages versus at high and/or low extremes.

Traditionally defensive, dividend-paying equities offer near-term appeal when weighing the prospects for a growth slowdown or recession, while secular growth sectors remain well-positioned for longer-term growth. Dividend-paying equities afford investors both income and growth potential during times of uncertainty, which helps offset the increasingly attractive bond yields. The 10-year Treasury yield remains elevated, ending the quarter at 3.8%. The S&P 500 ended the quarter with a dividend yield of 1.5% and with a three-year dividend growth rate of approximately 5.0%.

Foreign equity markets

Europe and Japan alternated foreign equity market leadership in 2023's first half. Blended together, we view foreign developed equities' forward risk and return prospects as reasonably well balanced.

Europe avoided a winter energy crisis, accumulating sufficient natural gas supplies through alternative sources for the region's 2022-2023 winter season heating and industrial needs while a historically warm winter reduced business and consumer heating demand. First quarter equity performance reflected this positive outcome, with the MSCI Eurozone Index rising 13.7%, pacing foreign developed equities' 8.7% overall gain. However, muted second quarter performance reflects the stalling economic recovery across the euro region as the European Central Bank continues to battle persistently elevated inflation.

Meanwhile, Japan took the foreign developed equity leadership baton in the second quarter, rising 15.5% following the first quarter's 7.4% gain. Above-trend economic growth, according to our proprietary Japan

Health Check assessing nearly 90 economic indicators, provides positive support for corporate fundamentals. Meanwhile, ongoing fiscal and monetary policy stimulus has helped Japan reverse 20 years of deflation, with a return to positive inflation corresponding to positive equity performance.

Broad-based sector performance and reasonable valuation supports our cautiously optimistic outlook for foreign developed equities.

In contrast to U.S. large-cap equities, year-to-date foreign developed equity performance as measured by the MSCI EAFE Index (representing 21 developed market countries across the world, excluding the United States and Canada) has been broad based, with 10 of 11 sectors and 10 of 11 top individual country allocations delivering positive gains. Broad-based participation across sector and geography factors increases our confidence that the recent rally can be sustainable rather than an ephemeral bounce.

Meanwhile, valuation, or the price investors are willing to pay for projected earnings, remains below the long-term average, suggesting investors have already priced in a more challenging forward scenario for foreign developed equities. Analysts' earnings estimates for full-year 2023 have stabilized in recent weeks. Stabilizing earnings estimates providing support for valuation to return to the long-term average is a potential catalyst unlocking further price appreciation, informing our cautiously optimistic view.

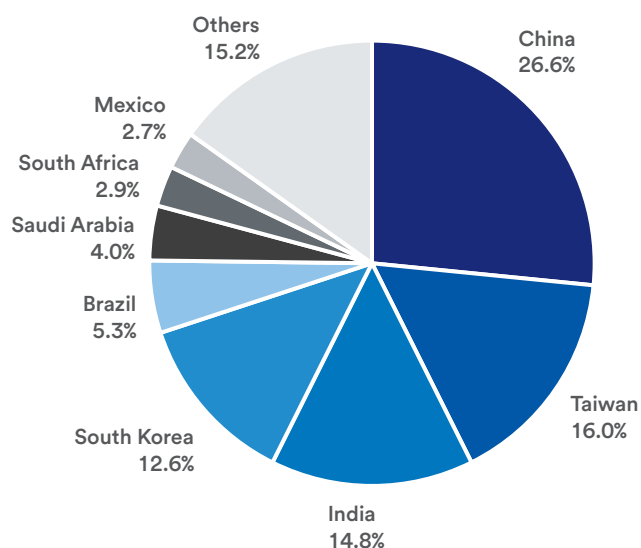
Diverse conditions and market drivers inform our balanced forward outlook for emerging market equities.

According to Bloomberg, China, South Korea, India and Taiwan comprise more than two-thirds of constituent companies' country exposure in the iShares MSCI Core Emerging Markets ETF. As of June 30, China represents the largest individual share at approximately 25%, with the country experiencing a choppy reopening after abruptly reversing COVID containment policies toward the end of 2022.

Authorities ended quarantines, close contact identification and border checks while shifting to voluntary (versus mandatory) testing. In response, Chinese equities initially rallied on reopening optimism, with the MSCI China Index rising nearly 60% from October 31 to January 27. However,

Emerging markets country exposure
iShares Core MSCI Emerging Markets ETF

Sources: Bloomberg and iShares, 6/15/2023.
Percentages do not total 100 due to rounding.



consumer sentiment has been slow to recover, and COVID spread's recent resurgence has clouded China's near-term outlook, with Chinese equities retreating 20% from January's high. China's large platform companies (blending media, internet, gaming, finance and online shopping) comprise the largest holdings, according to iShares. Traditionally, authorities have employed infrastructure spending to support economic growth, but direct fiscal policy support will likely be key in facilitating a virtuous circle of employment, income growth and consumer spending in order to drive China's consumer-oriented equities higher in 2023's second half.

Together, South Korean and Taiwanese companies constitute approximately 30% of emerging markets' country exposure, according to iShares. Leading companies are global franchises spanning growth sectors such as Technology (semiconductors, electronics, computers), Consumer (auto manufacturers) and Materials (chemicals, iron and steel). The Fed has slowed its interest rate hiking pace and appears to be nearing the end of its policy tightening campaign, while we are seeing better-than-expected growth impulses in various global economies. Concurrently, the globally sensitive MSCI Korea and Taiwan equity indices have rallied approximately 20% in 2023's

first half, and a broadening and durable global economic recovery driving further fundamental improvement is a potential catalyst for continued strength in the quarters ahead.

Finally, India comprises approximately 15% and the country's growth catalysts differ from China indices' large consumer orientation and South Korea's and Taiwan's correlations to global growth. India has a large, young and growing working age population and the country is evolving from a traditionally agrarian society to a diversified services economy. Compared to China, Korea and Taiwan, the MSCI India's constituent companies are more diversified across sectors with Consumer Staples, Consumer Discretionary, Energy, Financials and Technology all representing at least 10% share according to iShares. While year-to-date returns have been muted (4.4%), India's focus on building infrastructure, increasing domestic consumption and alleviating poverty provide a differentiated growth driver balancing emerging market equities' risk and reward opportunity.

Fixed Income

High-quality bonds offer compelling return opportunities with less sensitivity to business cycle risk.

Yields on high-quality bonds are near their highest levels in 15 years, creating competitive income generation opportunities versus riskier assets. Two important headwinds to bond prices appear to be subsiding: Inflation is gradually decelerating and investors anticipate the Fed may be nearing or at the end of their interest rate hiking campaign. However, the risk that inflation may remain sticky and keep additional rate hikes on the table remains a threat to bond prices.

Ten-year Treasury yield

Source: Bloomberg. June 15, 2023.



Central banks expect to hold their target interest rates near peak levels to allow restrictive policy settings to work through the economy.

The Fed rapidly tightened monetary policy with the intent of cooling inflation, raising rates from near 0% to more than 5% in just over a year. Treasury yields indicate investors expect the Fed is nearly done increasing interest rates, lessening headwinds to bond prices that move in the opposite direction of yields. Meanwhile, the Fed continues to unwind its bond holdings, weighing on liquidity. Since September 2022, the Fed has allowed up to \$95 billion of Treasury and mortgage bond holdings to mature per month without reinvesting the proceeds to reduce its balance sheet holdings. Private investors must step in to purchase new government issuance of Treasuries, which may reduce their investment in other assets, constraining liquidity and tightening financial conditions. The U.S. Treasury drained its cash reserves as it awaited Congress's suspension of the debt ceiling and limited new Treasury issuance in the second quarter. As the Treasury increases issuance to replenish the government's cash holdings to normal levels, market liquidity may present another incremental headwind as private investors purchase the debt.

Fair valuations on high-quality corporate and municipal bonds offer opportunities to generate incremental income over Treasuries.

The extra yield paid by investment-grade bonds are near long-term averages, fairly compensating for credit risk as long as corporate and municipal bond issuer fundamentals remain strong. Higher borrowing costs are starting to drag on weaker issuers' ability to cover interest payments, but high-quality issuers typically have lower debt burdens that support their ability to meet obligations as the economy slows. Normal exposures to high-quality corporate and municipal bonds that are less sensitive to the economy's fluctuations can help diversify portfolios while maintaining meaningful potential income from their improved yields.

Riskier bonds offer normal compensation for credit risk against an increasingly challenging operating environment. In aggregate, riskier issuers' ability to pay back debt is still better than historical averages, but the Fed's commitment to slowing inflation with higher rates risks damaging issuer fundamentals. Instead of refinancing or issuing new debt, riskier high yield corporate and municipal bond issuers used cash reserves over the past year, bringing them to average

long-term levels, but reducing their flexibility to finance operations amid this economic slowdown. This extra cash cushion has helped keep defaults infrequent over the past year, but a gradual increase in defaults may drag on riskier bond valuations. Incremental yield offered by high yield corporate and municipal bonds relative to Treasuries remain meaningful and compensate for credit risk, but if defaults trickle higher, dampening investor sentiment could hurt riskier bond prices.

Mortgage bonds not backed by the government and insurance-linked bonds offer attractive income with unique return sources.

Cautious investor sentiment toward a slowing housing market creates opportunities to earn high income with strong fundamental tailwinds in the mortgage bond market not backed by the government. Most home loans originated before 2022 remain well-secured by the value of the homes collateralizing them, even if home prices moderate. Investor sentiment and deteriorating liquidity remain the largest near-term risks. Reinsurance, also referred to as insurance-linked securities, continues to offer compelling yields. Insurance premiums (minus insured losses from natural disasters) drive returns and remain uncorrelated with typical economic cycles that drive stock and bond returns.

Real asset markets

Public real estate markets faced mixed factors but could hold up well after a challenging first half of 2023.

Publicly traded real estate securities underperformed the broader market 7.5% in the second quarter, with elevated inflation and rising interest rates, in addition to tighter lending conditions, offsetting positive property market fundamentals. Many property types now trade at significant discounts to the net asset value of properties owned. Moderating inflation and interest rates could serve as tailwinds to the real estate investment trusts (REITs), despite the slowing growth environment.

Nationally, overall vacancy rates continue to decline across most property types and income continues to grow at an above-average pace. However, income growth is decelerating and is likely to fall toward average levels as we progress through 2023. Income relative to property

values increased in the publicly traded REIT market due to declining prices while lagging in the private market, making the public market more attractive on a relative basis.

Looking to the third quarter, slowing economic growth may act as a headwind for property prices, which is one reason for the discount priced in to publicly traded real estate stocks. Property appraisals have been slow to adjust to the shifting economic tides. This is especially true of the office properties, where remote and hybrid work is trimming demand. Although publicly traded REIT funds remain well-diversified with relatively small exposure to the office category. We believe REITs can perform okay through decline in property market fundamentals due to decelerating growth if interest rates fall. Real estate offers diversification within investment portfolios and currently offers value due to the embedded cushion against further price declines.

A slowing economy may support infrastructure assets paying consistent dividends.

Infrastructure trailed the S&P 500 by 9.7% during the second quarter. Positive sentiment toward growth stocks, especially in the Technology sector, hurt the more defensive Infrastructure sector underperformance given their more defensive characteristics. Investors hit the most defensive stocks within Infrastructure and Utilities hardest during the quarter.

As we enter the third quarter, infrastructure can benefit if economic growth and inflation decelerate, with the midstream energy sector providing solid earnings growth. Revenue and earnings growth rates are likely to decelerate further but remain at levels well above long-term averages for the industry. The Utility sector's defensive characteristics and stable earnings growth indicate performance may hinge on the macroeconomic environment, with stronger relative performance if economic conditions deteriorate. Utilities stocks comprise about half of most infrastructure benchmark indexes.

Decelerating economic growth and declining inflation are bearish for commodities.

The backdrop for commodities remains challenging amid decelerating economic growth and slowing inflation. Positive catalysts for higher prices, such as limited

inventories, the Russia/Ukraine conflict and OPEC production cuts, are well known and likely already priced in, although weaker demand could still damage prices. The potential for an economic slowdown remains a key risk for the commodities.

Over a much longer time horizon, we see reason to be more positive on commodities. Several years of limited investment in productive capacity for numerous commodities is hurting supply resilience. Additionally, government and investor policies are material disincentives to invest in productive capacity. At the same time, the transition to green energy networks may require a material increase in demand for fossil fuels and various metals for an extended period.

Alternative investments

Hedge fund managers are positioning for opportunities amid macroeconomic uncertainty.

Hedge funds have generated modest returns in 2023, but the market backdrop is positive for many strategies. Managers navigated banking turmoil, commodity weakness and technology stock bounces in the first half of the year that required agile portfolio positioning. Hedge funds pursue investments to both buy long and sell short, and manager appetite for risk has generally increased this year as measured by leverage and overall net exposure to the markets (the difference between total long positions and total short positions). We are seeing managers make diverse decisions in midyear positioning amid myriad complex macroeconomic and geopolitical risks. With uncertainty surrounding interest rates' forward path and recession concerns somewhat elevated, we anticipate managers will be more defensively positioned in the year's second half and shift their focus to individual security selection, such as stock-specific short selling. We expect additional market pullbacks may also encourage some managers to position portfolios for upside volatility.

Hedge funds that stay nimble and appropriately size the risks in their portfolios stand to perform well in this

environment. As we noted last quarter, we expect higher interest rates may improve long and short investing opportunities in credit markets due to spread widening (higher yields compared to Treasuries) and dispersion (the range of potential outcomes among investments). Attractive opportunities may be emerging for managers focused on idiosyncratic debt due to a greater number of high yield bonds and leveraged loans trading at distressed levels. We also see select fundamentally focused strategies improving, including in the biotechnology sector. Macro strategies have not performed especially well this year, but we continue to see opportunities for long-short investing among changing economic growth rates, interest rate levels and currency values. We find macro strategies' prospects intriguing in the current environment given their flexibility and the breadth of asset classes in which they invest.

Private markets

Diverging venture capital and buyout strategy performance reflects diversity across private markets.

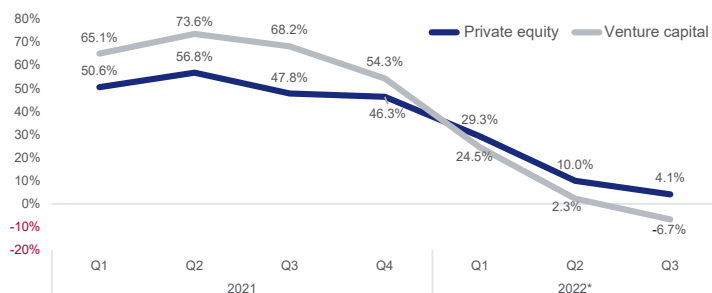
Median venture capital strategy performance lagged buyout strategies in 2022. However, mid-stage venture capital, widely known as growth equity, has recovered some value in 2023. Traditional buyout strategies take ownership of mature companies that have stable existing cash flows, whereas venture capital and growth equity strategies invest in companies with potential for larger future cash flows. Higher interest rates reduce the current value of future cash flows more than they reduce the current value of existing cash flows. While interest rates increased, economic activity remained resilient through 2022 and continues to exhibit resilience to date. Therefore, asset prices have primarily reflected a drop in valuation, or the price investors are willing to pay for future cash flows due to discounting higher Federal Reserve interest rates. Performance variation among strategies is an important reminder for investors to take a diversified approach to investing in private markets. Private market valuations currently reflect higher interest rates but positive fundamentals; if business fundamentals deteriorate, we see the potential for further downward pressure on prices.

Rolling one-year internal rates of return

The internal rate of return is the annual rate of growth that an investment is expected to generate.

Sources: U.S. Bank Asset Management Group, PitchBook.

*2022 performance is through September 30, 2022.



The outlook for unprofitable startups and for venture capital remains unclear. Higher interest rates and tightening lending standards have constrained funding and we expect further consolidation among startups. Based on our internal analysis, nearly 50% of the companies that listed on public exchanges in 2020 and 2021 are trading below the total value of investor capital raised by these companies. As a result, private market investors are now more cautious in providing funding for unprofitable startups that are expected to remain unprofitable in the medium term. This has led to a raft of layoffs within the technology industry to cut costs and preserve cash, thereby delaying their need to raise additional funding from hesitant investors. If the valuation of recently listed public companies remains depressed, or if the economic activity further deteriorates, we expect many startups will choose to shutter their operations or to be acquired by a larger company at sharply discounted prices.

One positive factor is the breakthrough in AI. Industry observers expect AI to add significant productivity gains to

knowledge work and investor sentiment could turn bullish in the near term on the promise of AI, leading to a recovery in valuations and providing renewed interest in emerging technology companies in the short to medium term. Meanwhile, our long-term conviction on the prospects of technological innovation remains strong.

Private debt presents compelling opportunities despite headlines suggesting that defaults are expected to rise.

Recently, Moody's and Fitch cautioned that they expect the default rate on leveraged loans — debt issued to acquire a company — to rise. Our internal research leads us to a more nuanced outlook than a categorical rise in default rates across such loans. Three broad categories comprise the leveraged loan market — high yield bonds, broadly syndicated loans and direct lending — totaling to \$4.7 trillion, according to Preqin, the ICE BofAML High Yield Index and S&P Global Leveraged Loan Index. Direct lending represents \$580 billion of the total leveraged loan market size and is a category that we focus our efforts on within private market investing. Direct lending involves investing in private debt funds that provide capital to private equity investors who in turn use the debt to acquire businesses. The debt issued in these situations is bilaterally negotiated between the interested parties and it is typically held by one to three private debt lenders. Debt levels are conservative, and this is usually the only form of debt on the balance sheet of the acquired company. The terms for this type of private debt are quite robust and provide for several avenues of recourse if the business runs into challenges. Comparatively, high yield bonds and broadly syndicated loans are typically held by multiple parties (20 to 50 different investors), have weaker terms and the acquired business holds other forms of debt and liabilities on the balance sheet. In the aggregate, we believe these combined factors suggest investing in private debt opportunities with a seasoned manager provide the potential for attractive risk-adjusted returns.

This commentary was prepared June 2023 and represents the opinion of U.S. Bank Wealth Management. The views are subject to change at any time based on market or other conditions and are not intended to be a forecast of future events or guarantee of future results and is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable but is not guaranteed as to accuracy or completeness. Any organizations mentioned in this commentary are not affiliated or associated with U.S. Bank in any way.

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Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. The value of **large-capitalization stocks** will rise and fall in response to the activities of the company that issued them, general market conditions and/or economic conditions. **Stocks of small-capitalization companies** involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies and may be expected to do so in the future. **Growth investments** focus on stocks of companies whose earnings/profitability are accelerating in the short term or have grown consistently over the long term. Such investments may provide minimal dividends, which could otherwise cushion stock prices in a market decline. Stock value may rise and fall significantly based, in part, on investors' perceptions of the company, rather than on fundamental analysis of the stocks. Investors should carefully consider the additional risks involved in growth investments. **Value investments** focus on stocks of income-producing companies whose price is low relative to one or more valuation factors, such as earnings or book value. Such investments are subject to risks that their intrinsic values may never be realized by the market, or such stocks may turn out not to have been undervalued. Investors should carefully consider the additional risks involved in value investments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in **high yield bonds** offer the potential for high current income and attractive total return but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in **real assets** such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults). **Hedge funds** are speculative and involve a high degree of risk. An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem or transfer interests in a fund. **Private capital investment funds** are speculative and involve a higher degree of risk. These investments usually involve a substantially more complicated set of investment strategies than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales, which can magnify potential losses or gains. Always refer to a Fund's most current offering documents for a more thorough discussion of risks and other specific characteristics associated with investing in private capital and impact investment funds. **Private equity investments** provide investors and funds the potential to invest directly into private companies or participate in buyouts of public companies that result in a delisting of the public equity. Investors considering an investment in private equity must be fully aware that these investments are illiquid by nature, typically represent a long-term binding commitment and are not readily marketable. The valuation procedures for these holdings are often subjective in nature. **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies.