INVESTMENT PERSPECTIVE

VAUGHAN NELSON

Quarterly Report

31 March 2023

Slowing economic growth, falling inflationary pressures, and developing stress in the banking system were dominant factors in the first quarter of 2023. These factors led to a divergence in equity markets with value indices materially underperforming growth indices across all market capitalizations. During Q1, the S&P 500 Index rose 7.50% while the Russell 2000 Value Index fell 0.66%. International equity markets outperformed U.S. equity markets during the quarter with MSCI EAFE Index rising 7.65%.

With sequential growth set to slow dramatically in both Q1 and Q2 of 2023, the U.S. earnings recession that began in Q4 2022 is likely to become a broader economic recession in the short- term. Typically, banking stress develops once we are well into a recession as the ability for borrowers to service debt becomes impaired. Given the rapid increase in interest rates, regional banks are already under tremendous pressure despite credit costs remaining well below historical norms. While we believe the Federal Reserve's interest rate hiking cycle is largely in the rear-view mirror, we suspect we are still in the early stages of experiencing rising credit losses. The developing strains in the banking system will only enhance the lagged effects of rising interest rates, which are set to materially impair economic activity and availability of liquidity during 2023.

Further risks to the economy and capital markets will be determined by the negative reinforcing elements of the pending recession, declining liquidity, and rising credit losses offset by any fiscal and monetary policy responses. Although inflation in the U.S. should decelerate to approximately 4% by Q3, sticky inflationary pressures and rising federal deficits may limit both fiscal and monetary policy responses should the economic slowdown or market stresses become severe.

The Bloomberg Aggregate Index returned 2.96% for the quarter and the ICE BofA 1-10 AAA-A Municipal Index returned 1.74%. During the quarter, the Federal Reserve raised the Fed Funds rate an additional 50 basis points (25 in February and 25 in March) bringing the target rate to 5.0%. The market is forecasting one additional 25 basis point increase in 2023 followed by two interest rate cuts before year-end.

Investment grade credit spreads were volatile but finished the quarter +129 basis points over Treasury yields, only 10 basis points wider than at the beginning of the year, as contagion fears following the Silicon Valley Bank and Signature Bank failures eased. We expect the markets to remain volatile in 2023, which should provide opportunities to generate alpha within spread sectors. We reduced our allocation to corporate bonds in 2022 given the relatively tight spread environment, but we anticipate adding to corporates in 2023 should spreads widen materially due to a weaker economic backdrop.

Continued on next page.

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Notably, we witnessed a significant shift in the market's expectations for the Fed's monetary policy following the bank failures in March. For instance, the market was pricing in three additional 25 basis point rate hikes by the end of February, implying a terminal rate of 5.5%. However, following the bank failures the market has discounted the Fed's ability, and willingness, to continue tightening financial conditions given investors' concerns around the stability of the banking sector. As such, the market is currently expecting the Fed's hiking cycle to come to an end sooner than initially expected.

We maintained a shorter average duration relative to the benchmarks across our fixed income strategies during this tightening cycle to reduce the impact on portfolio returns from rising interest rates. Now that inflation has peaked and with the Fed near the end of its tightening cycle, we are actively increasing duration to take advantage of this more favorable interest rate environment.

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