INVESTMENT PERSPECTIVE

Quarterly Report

30 June 2022

Market Overview

U.S. equity markets continued their decline during the second quarter with the S&P 500 falling 16.10% and the Russell 2000 Value falling 15.28%. International equity markets also declined with the MSCI EAFE decreasing 14.32%. Risk assets continued to be pressured by accelerating inflationary pressures, decelerating economic growth, and tightening financial conditions. Inflationary pressures in the U.S. have moved from goods to services and housing, in the form of owner's equivalent rent. Inflation will ease as we move through the third and fourth quarter but will remain elevated entering 2023. While interest rates have shifted materially higher, the yield curve has flattened with the M2 money supply decelerating materially. The rapid slowdown in economic growth and tightening financial conditions are creating a recessionary environment in the U.S., Europe, and most export led economies.

Capital markets are signaling recessionary conditions becoming a greater concern than inflation. The greater recessionary concern is evidenced by the rapid decline in commodity prices, flattening yield curves, widening credit spreads, and an inverted Eurodollar futures curve. In prior slowdowns, the market and economy were quickly supported by the Federal Reserve's action that loosened financial conditions. During this cycle, the Federal Reserve will be procyclical as it continues to tighten financial conditions despite the recessionary warnings.

The Federal Reserve's top priority is to ensure the U.S. Treasury remains solvent while funding federal deficits. At quarter end, should the prevailing yield curve remain in place, annual interest costs for the U.S. Treasury would equal approximately 20% of annual tax receipts. Such a level is unsustainable even without considering trailing tax receipts are inflated by excess capital gains. Beyond taming inflation, the Federal Reserve needs to create conditions that drive the U.S Treasury close to 2% across the curve so the U.S. Treasury can remain solvent. If market forces will not bring sovereign rates to acceptable levels, the Federal Reserve may be forced to implement yield curve control with open ended quantitative easing.

The Bloomberg Aggregate Index finished the quarter down 4.69% and the ICE BofA 1-10 AAA-A Municipal Index declined 0.70%. During the quarter, the Federal Reserve raised the Fed Funds rate by 125 basis points (50 in May and 75 in June). Currently, the market is forecasting at least seven more interest rate increases in 2022 implying a 3.5% Federal Funds rate at year end. In preparation for higher rates, we continue to maintain a shorter average duration relative to the benchmark across our fixed income strategies.

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Vaughan Nelson Investment Management
600 Travis Street, Suite 3800, Houston, Texas 77002-2928 713.224.2545 888.888.8676 713.247-9534 fax www.vaughannelson.com

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Investment grade credit spreads widened by approximately 35 basis points to +143 basis points over Treasury yields. Credit spreads have widened from last year's historically tight levels as the market started to price in an economic slowdown. With the Fed reducing its monthly bond purchases and raising short-term interest rates, liquidity conditions are tightening, leading to elevated interest rate volatility and wider spreads.

While the adjustment to higher interest rates negatively impacts bond returns, long-term total returns should improve as compared to when Fed Funds rates were at 0%. For instance, the yield-to-maturity (YTM) on the 2-Year Treasury was 0.3% last June versus 2.9% today and the YTM on U.S. investment grade corporate bonds was 2.0% last June versus 4.8% today. As a result, for long-term buy-and-hold investors, these higher yields have presented an opportunity to significantly increase the reinvestment rate in their bond portfolios across all major sectors of the fixed income market.

CEO and CIO
Chris Wallis, CFA, CPA

President
Steven Psaledakis

Equity Investments
Dennis Alff, CFA
Benjamin Carrier, CFA
Stephen Davis, CFA
James Eisenman, CFA, CPA
Chad Fargason, PhD
Tyler Fry, CFA
Sundeep Khanna, CFA
Masa Matsumura, PhD
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Corrine Richter
Kevin Ross, CFA
Scott Weber, CFA
William Wojciechowski, PhD

Fixed Income Investments
Matthew Caire, CFA, CMT, CFP®
Blanca Garza
Michael Hanna
Steven Henriksen

Marketing/Business Development/Client Service
Danika Cline, CFP®
Mark Farrell
George Holewyne
Daniel Hughes

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