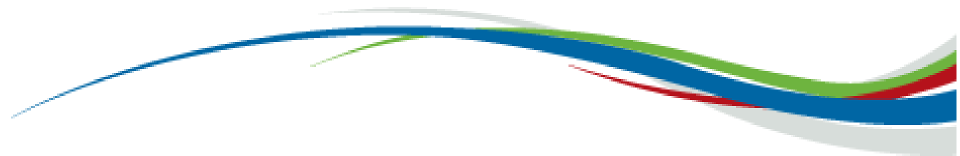
Market Outlook & Strategy

First Quarter of 2023

Leigh Bivings, Ph.D., CFP®

Scott Gillespie, CFA



Artemis Financial Advisors LLC

115 Newbury Street, Suite 302
Boston, MA 02116
617-542-2420

Executive Summary

- Despite some major turbulence, markets finished the 1st quarter higher with both stocks and bonds posting gains. Markets rose despite a number of worries this quarter, with the banking crisis at the forefront and mixed economic data.

- For the quarter the U.S. market ended up +7.2%, developed international equities were up +8.0%, emerging markets gained +4.0%, and our bond market proxy was up +2.7%. A larger dispersion occurred within the U.S. market segments, as value (+0.9%) underperformed growth (+14.3%), and small companies (+2.7%) underperformed large companies (+7.5%).

- Many have been wondering why markets are going higher if problems in financial markets are emerging and the economy seems to be signaling that a slowdown or recession is on its way. From what we see, there are three main reasons why markets are looking past the bank sector's stress and recent recession indicators: shifting interest rate expectations, a warm winter, and China reopening after Covid.

- We are encouraged by the market's resilience. But we expect it will continue to be a very choppy ride in 2023 with markets seesawing based on data that either increases recession and inflation fears or reduces them. A shallow recession or growth stall-out is likely, but the timing and impact on markets are very much up for debate.

- In this report, we try to see past the short-term fog and focus on what we believe to be promising investment themes for the coming decade. We review our updated approach to thematic investing and summarize some new investments we have made in clean technology and services and in innovation in healthcare. Next quarter we will dive into the other areas of our refashioned thematic lineup.

- **Artemis Strategy.** While we plan to make a few rebalancing moves to even out our positioning in the large cap space, we are largely staying the course with a more balanced and higher-quality tilted equity market exposure, a refashioned thematic innovation lineup, and conservatively positioned fixed income portfolios.

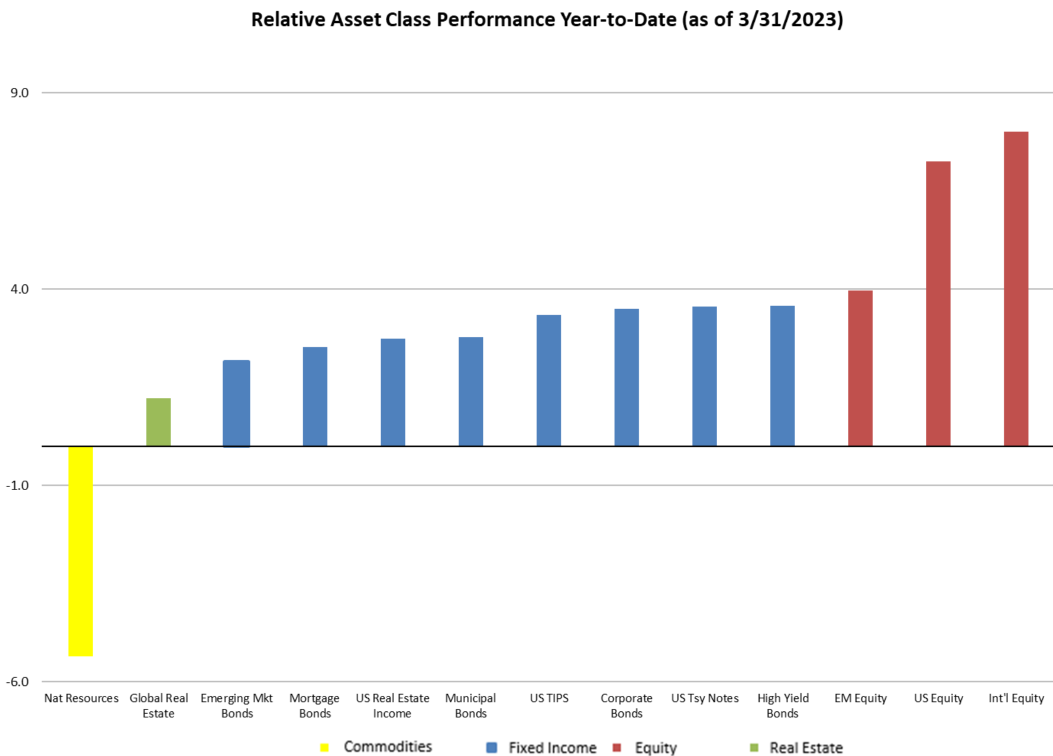
Artemis
FINANCIAL ADVISORS LLC

Markets in Review – Q1

Despite some major turbulence, markets finished the 1st quarter higher with both stocks and bonds posting gains. Markets rose despite a number of worries this quarter, with the banking crisis at the forefront and mixed economic data. The failure of Silicon Valley Bank, Silvergate, and UBS's acquisition of Credit Suisse were startling developments and made it clear that the Fed's rapid interest rate increases are creating some stress points in the economy.

For the quarter, the U.S. market ended up +7.2%, developed international equities were up +8.0%, emerging markets gained +4.0%, and most bond segments were up +2-3%. A larger dispersion occurred within the U.S. market segments, as value (+0.9%) underperformed growth (+14.3%), and small companies (+2.7%) underperformed large companies (+7.5%). These market segments continue to shift quickly and remain extraordinarily volatile (as they have been for the past 18 months) as markets try to find their footing in an uncertain and fast-changing environment.

Figure 1. Asset Class Returns in USD for Q1 2023 (%)



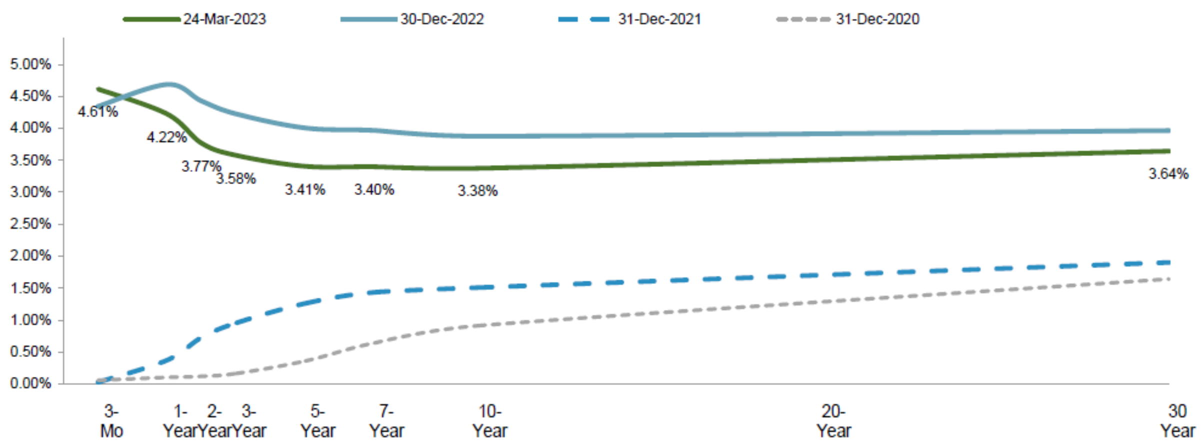
Many investors have been wondering why markets are going higher if problems in financial markets are emerging and the economy seems to be signaling that a slowdown or recession is on its way? From what we see, there are three main reasons that markets are looking through the bank sector's stress and recent recession indicators:

1. Interest rate expectations – There's increasing consensus that the Fed is nearly done raising interest rates.
2. Warm winter – Europe was saved from a potential energy crisis by a warm winter, and now demand for natural gas will drop as temperatures rise.
3. China reopening – This global growth engine could be reigniting as the country lifts most of its Covid restrictions.

Interest rate expectations. Up to this point, investors have been fearful of a "Fed mistake" in which the Fed raises interest rates too far and too fast, thus causing a larger economic slowdown than is necessary to bring inflation back down to its target of 2%. However, with banks now under stress and tightening lending standards, the market now believes that the Fed is more likely to stop its rate hikes earlier than planned. As shown in Figure 2, the current lower yield curve reflects this new sentiment.

Figure 2. U.S. Treasury Yield Curve Changes (%)

The 2023 change is shown by the difference between the green March 2023 yield curve and the blue December 2022 curve. This chart plots the Federal Funds Rate on the vertical access and years to maturity on the horizontal access.



Source: Fidelity Investments

In addition, inflation continues to moderate, weakening the case for sustained interest rate increases. Lower rates would be a net positive for the economy and decrease the odds of a harsher recession, which is part of the reason the market has been going up. Lower interest

rates would also boost returns for bonds and long-duration stocks (growth-oriented businesses), and we saw those areas gain in Q1.

Warm winter. A concern entering this past winter was that due to the ongoing war in Ukraine, Europe was particularly susceptible to an energy crisis because of its dependence on Russian natural gas. However, the average temperature in Europe this winter ended up 1.4 degrees Celsius (~2.5 degrees Fahrenheit) above the 30-year average, making it tied for the second warmest winter on record.

The warm winter allowed the Europeans to avoid the worst outcomes of a cold winter; i.e., having to restrict manufacturing and industrial output and pay high costs for emergency energy imports, both of which would likely have tipped the region into a recession. The warm winter, while concerning from a global warming perspective, forestalled this outcome and was very positive for European economies.

China Reopening. In a surprise move this past winter, China's leaders declared an end to their Covid lockdowns. The economic reopening by itself is a big milestone as China's contribution to global GDP is 2nd only to the United States, and in 2023 it is projected to contribute nearly 18.3% of global economic output. The Chinese Communist Party has also signaled its commitment to accelerating economic growth. This stimulus plan and commitment to capital market strength should enable a speedier re-entry for China.

Our Take. We are encouraged by the market's resilience. But we expect it will continue to be a bumpy ride in 2023 with markets seesawing based on data that either increases recession/inflation fears or reduces them. A shallow recession or growth stall-out still seems likely, but the timing and impact on markets are very much up for debate. As such, we are avoiding positioning for any one outcome exclusively and instead focusing on opportunities for long-run outperformance. We discuss two such opportunities in the next section.

Looking Past the Noise – Promising Themes for the Next Decade

For those of you who follow our investment approach, you will know that starting almost five years ago we began dedicating a small portion (5-15%) of every client's equity exposure to investments focused on the broad theme of technology innovation. We built our exposure over time, but the lineup eventually included biotechnology, genomics, robotics, artificial intelligence, cloud computing, and cybersecurity. The premise of our approach was that investment outperformance in the long run will be driven by companies and sectors that are focused on themes that are reshaping national and international economies. We believe such themes include not only technology innovation, but also climate change and resource scarcity, demographics and social change, emerging global wealth, to name a few.

After a rough start in late 2018 (due to the Christmas-time sharp market sell-off that year), the investments we made outperformed broad benchmarks very nicely until mid-2021 when inflation took hold and investors began to believe it might take sustained action by global central banks to rein it in. Such action took place throughout 2022 with interest rates rising at their fastest pace since the late 1970s. This so-called 'regime change' was very unfavorable to growth stocks, especially those focused on innovation.

In spring 2022, we moved quickly (never quickly enough) to sharply reduce – and in some cases eliminate – our overall exposure to some of our more speculative investments (e.g., small biotechs) and rethink how we access these thematic opportunities.

In the end, we decided to 'refashion' our approach to thematic investing and broaden our coverage to include climate change and resource scarcity and demographic forces. We also decided to focus more of our exposure on more established, profitable technology players who are less prone to wide valuation swings when market sentiment changes.

In this section, we highlight two new investments we have made in the last year that exemplify our refashioned approach. We plan to talk about our remaining investments in our summer edition.

Impax Global Environmental Markets Fund

We have been wanting to build exposure to companies with promising solutions to climate change for some time, but as such firms' prices were bid up around the time President Biden was elected, we didn't see an attractive entry point. The market decline in 2022 provided that opportunity and now all Artemis investors have exposure via an actively-managed fund focused on global environmental technologies and services.

We think there's a lot to like about the Impax Global Environmental Markets Fund. The fund is actively managed by a team at a U.K.-listed firm called Impax Asset Management – one of the largest and longest established investors dedicated to investing in the transition to a more sustainable economy. The goal of the fund is to invest globally in a broad array of mostly large and mid-sized proven companies (many of which are industrial companies) that are deemed to be developing innovative solutions to a wide range of resource challenges. The fund is fossil-free and we especially like the fact that the fund is not narrowly focused on a single area such as wind or solar, but rather looks across the spectrum of sectors where new technologies and services can mitigate resource challenges or help to create a cleaner, more sustainable environment. See Figure 3.

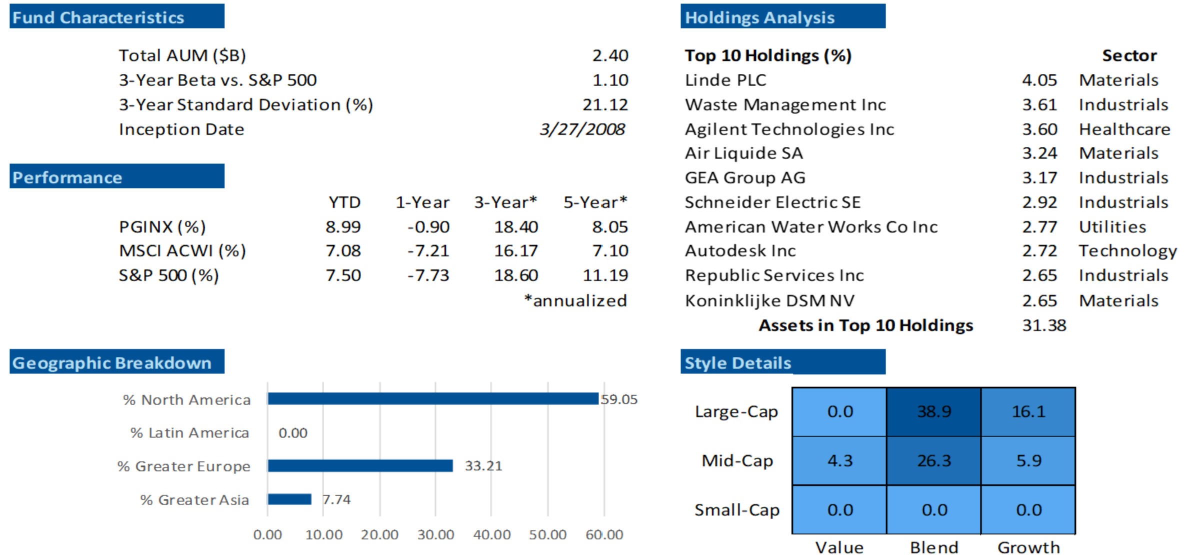
Figure 3. Scope of the Impax Global Environmental Markets Fund

We also like the fact that the fund has performed well, particularly since its longest-tenured manager joined the management roster in May 2013. Since then, through March of this year, the fund's annualized gain of 9.1% has outpaced the MSCI ACWI's return of 8.5% and the fund has done even better in more recent years (see Figure 4 next page).

Blackrock Health Sciences Opportunities Fund

Our second new investment is in the Blackrock Health Sciences Opportunities Fund, which focuses on investing in healthcare companies deemed to be well positioned to capitalize on the needs of aging populations in many developed countries and ongoing technological innovation, with a balanced exposure to the four main industry groups within healthcare. See Figure 5. The fund focuses on companies that are consistently profitable, growing, and have solid balance sheets; although this eliminates more speculative firms in the sector (e.g., unprofitable but potentially promising biotech companies), it also reduces volatility.

Figure 4. ImPax Global Environmental Markets Fund – Key Facts (as of March 30, 2023)



Fund Characteristics

Total AUM ($B)	2.40
3-Year Beta vs. S&P 500	1.10
3-Year Standard Deviation (%)	21.12
Inception Date	*3/27/2008*

Performance

	YTD	1-Year	3-Year*	5-Year*
PGINX (%)	8.99	-0.90	18.40	8.05
MSCI ACWI (%)	7.08	-7.21	16.17	7.10
S&P 500 (%)	7.50	-7.73	18.60	11.19

*annualized

Holdings Analysis

Top 10 Holdings (%)		**Sector**
Linde PLC	4.05	Materials
Waste Management Inc	3.61	Industrials
Agilent Technologies Inc	3.60	Healthcare
Air Liquide SA	3.24	Materials
GEA Group AG	3.17	Industrials
Schneider Electric SE	2.92	Industrials
American Water Works Co Inc	2.77	Utilities
Autodesk Inc	2.72	Technology
Republic Services Inc	2.65	Industrials
Koninklijke DSM NV	2.65	Materials
Assets in Top 10 Holdings	31.38	

Geographic Breakdown

% North America	59.05
% Latin America	0.00
% Greater Europe	33.21
% Greater Asia	7.74

0.00 10.00 20.00 30.00 40.00 50.00 60.00

Style Details

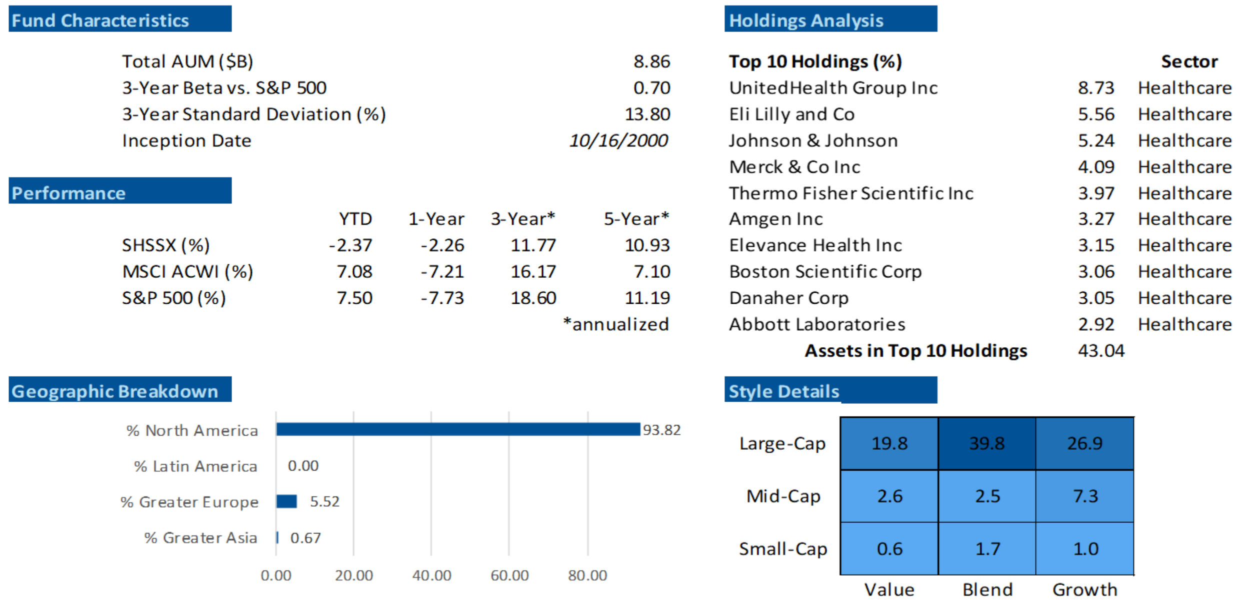
	Value	Blend	Growth
Large-Cap	0.0	38.9	16.1
Mid-Cap	4.3	26.3	5.9
Small-Cap	0.0	0.0	0.0

Figure 5. Blackrock Health Sciences Opportunities Fund - Coverage

We like this Blackrock fund for a number of reasons. First, as just mentioned, it tilts in favor of high-quality stocks, those that have demonstrated low financial leverage and solid return on equity. This orientation helps it weather periods of economic stress better than most of our other thematic investments. We also like the fact that the investment team is well-grounded in science from biochemistry, molecular medicine, and biomedical engineering.

Finally, we also like that the fund's performance has been solid in recent years, outperforming in most periods (see Figure 6 below), while underperforming broad benchmarks when high-growth companies are in favor. This will help dampen the overall volatility of our thematic sleeve going forward, one goal we had in mind when we were doing our research.

Figure 6. Blackrock Health Sciences Opportunities Funds – Key Facts (as of March 30, 2023)



Fund Characteristics

Total AUM ($B)	8.86
3-Year Beta vs. S&P 500	0.70
3-Year Standard Deviation (%)	13.80
Inception Date	*10/16/2000*

Performance

	YTD	1-Year	3-Year*	5-Year*
SHSSX (%)	-2.37	-2.26	11.77	10.93
MSCI ACWI (%)	7.08	-7.21	16.17	7.10
S&P 500 (%)	7.50	-7.73	18.60	11.19

*annualized

Holdings Analysis

Top 10 Holdings (%)		**Sector**
UnitedHealth Group Inc	8.73	Healthcare
Eli Lilly and Co	5.56	Healthcare
Johnson & Johnson	5.24	Healthcare
Merck & Co Inc	4.09	Healthcare
Thermo Fisher Scientific Inc	3.97	Healthcare
Amgen Inc	3.27	Healthcare
Elevance Health Inc	3.15	Healthcare
Boston Scientific Corp	3.06	Healthcare
Danaher Corp	3.05	Healthcare
Abbott Laboratories	2.92	Healthcare
Assets in Top 10 Holdings	43.04	

Geographic Breakdown

Style Details

	Value	Blend	Growth
Large-Cap	19.8	39.8	26.9
Mid-Cap	2.6	2.5	7.3
Small-Cap	0.6	1.7	1.0

In summary, our refashioned approach to thematic investing relies more heavily on managers to select companies deemed to be innovators in their respective areas. And we are selecting managers who favor companies with solid financials. We are not entirely abandoning investing in smaller, less proven companies for some areas; this will be the topic of our next report.

Artemis Strategy

Given all of the uncertainty around the trajectory of inflation and interest rates, we continue to find the arguments against a protracted recession only modestly more compelling than those in favor of one. (See last quarter's report in which we summarized the bear and bull cases for the markets in 2023.) In an environment such as this, markets are likely to continue to flip quite sharply between favoring assets that do well as interest rates decline (growth stocks and long-duration bonds) and those that do better when interest rates are high and inflation sticky (dividend-paying stocks and short-duration bonds). As such, we are concluding that positioning for any one outcome is unlikely to be a winning strategy. Broadly speaking, therefore, we are working on hueing more to the middle by holding a balanced position between growth and value, focused on quality, and staying this course until the fog lifts. We also plan to maintain our conservatively-positioned fixed income stance.

Despite this broad view, we do see a few opportunities worth pursuing. First, we plan to modestly increase our exposure to developed international markets as the dollar is set to weaken this year due to decreasing interest rates spreads between the U.S. and the rest of the world. But this is more of a tactical move, and we still have only a modest exposure overall, given that Europe and Japan (which make up the vast majority of international equity indices) face real long-term structural headwinds in terms of low productivity, declining populations, and fractured politics.

We also plan to increase our investments in the very areas we just summarized in the prior section because we believe they will outperform broad market returns over the next decade.

Finally, we recognize that the market swings have been more dramatic of late and that your head can start spinning if you are trying to track these daily/weekly moves. The best course when the markets are this volatile is to remember that the most successful investment strategies are those that stick to a plan, focus on the long-term, and are geared toward helping you achieve your goals.