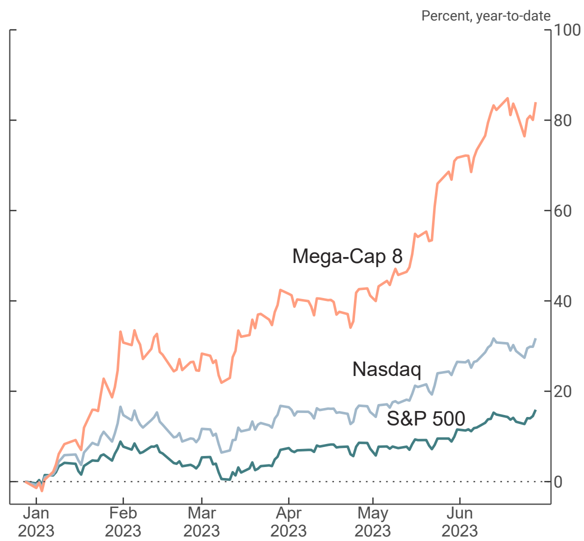
PUBLIC EQUITIES

Figure 6. Mega-Cap 8 outperform over the quarter

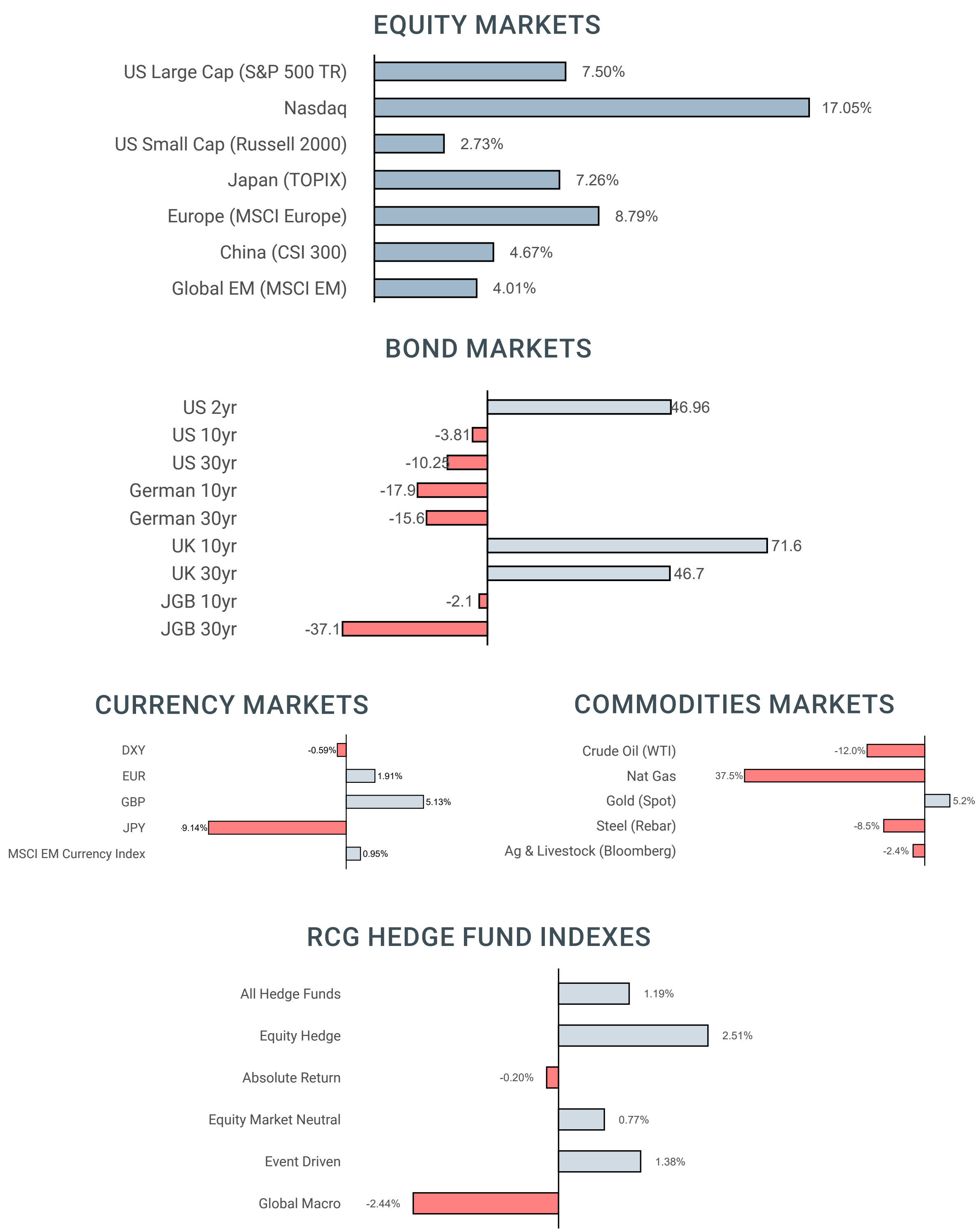


Source: Bloomberg Finance LP.

A strong second quarter return of 8.3% pushed the S&P 500 up 15.9% year-to-date and more than 24% above its October low, thus ushering in a new bull market. The Nasdaq did even better, returning 12.8% for the quarter, bringing it to 31.7% YTD. However, the narrowness of the rally and resulting bifurcation between the best and worst performing stocks has been staggering. A collection of top tech-oriented companies by market-cap (Tesla, Amazon, Nvidia Microsoft, Meta, Apple, Alphabet, Netflix) – coined the Mega-Cap 8 – returned an average of 28.3% for Q2 and 81.6% YTD. By comparison, the broad market, as measured by the S&P 500 on an equal-weighted basis, was up only 3.5% for the quarter and 6.0% YTD. The quarter was marked by low stock correlations, which usually suggest a stockpicker's market, but with large caps driving the gains, there was little room left to pick winners.

The Russell 2000 gained 4.8% for the quarter, bringing its YTD return to 7.2%. The relatively modest returns further down the market-cap spectrum illustrate that this has not been a typical bull market led by riskier assets. The emphasis has been on safer companies with deep moats,

TABLE 1. ASSET RETURNS Q1 2023



BOX 3. CRYPTOCURRENCY ASSETS

It was a challenging quarter for crypto exchanges. In early June, the SEC filed more than a dozen charges against Binance, the largest cryptocurrency exchange in the world, and its founder Changpeng ("CZ") Zhao. Among its charges were claims that the company was operating an unregistered securities exchange and a more troublesome claim that Binance and CZ were misappropriating customer funds. A day later, the SEC brought similar, albeit less nefarious, charges against Coinbase. While the charge against Coinbase also accused the exchange of operating illegally, Coinbase CEO Brian Armstrong was not named personally in the suit. Coinbase stock fell more than 12% on the news, but this development should not have come as a total surprise to investors, as a Wells notice was issued to Coinbase back in March, leading to a very public response from the company.

Core to the SEC's lawsuits is the question of whether crypto tokens are securities (and therefore whether or not crypto exchanges are even legal). This has been a longstanding philosophical debate amongst various industry stakeholders, and further clarity on this issue should be welcomed. The filing specifically names Solana's SOL token, Filecoin's FIL, Algorand's ALGO, and Axie Infinity's AXS, among others, as tokens that should be considered securities, while the largest crypto token by market cap, Bitcoin, is not referenced. According to a report from Mizuho Securities, the tokens that were named may represent more than 30% of Coinbase's revenue. The outcome of this case will be a close watchpoint going forward. As others have mentioned, thoughtful regulation will be required for the crypto asset class to truly scale within institutional portfolios.

It's important to note that after Q2 closed, a U.S. federal judge ruled that, while institutional sales of Ripple's XRP token "constituted an unregistered offer and sale of investment contracts," secondary sales, or "programmatic sales," of XRP on crypto exchanges, did not. Coinbase's share price appreciated on the news, as investors appear to believe that this ruling portends positively for Coinbase.

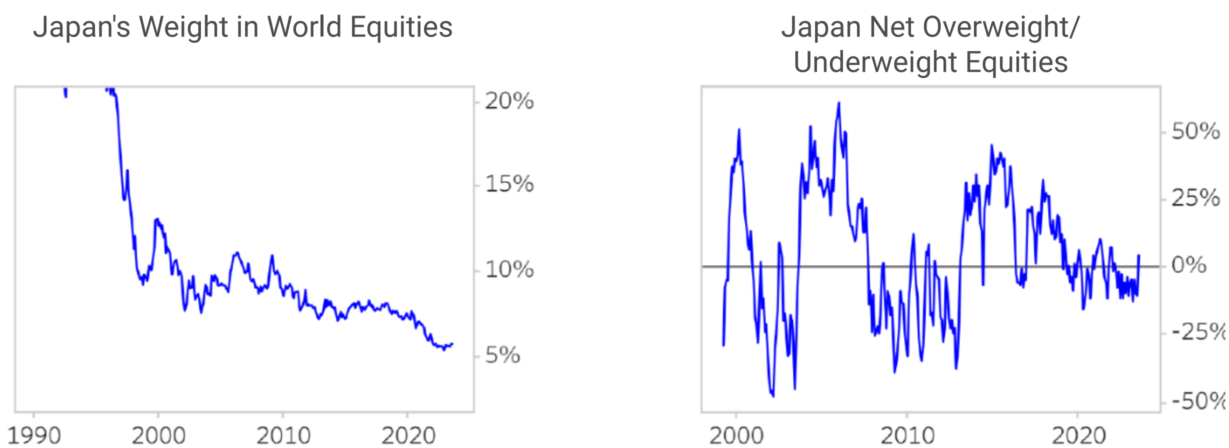
balance sheet flexibility, and promising AI-related growth drivers. The strong recovery in domestic and international travel has been another pocket of strength. The Defiance Hotel Airline and Cruise ETF for example gained 18.7% for the quarter and is up 34.3% YTD; however, most other sectors, including financials, energy, utilities, and health care, have been largely left behind.

With the S&P 500 sitting at approximately 19.6x forward earnings, it is difficult to envision much multiple expansion from here, given elevated inflation still forcing the Fed to maintain its hawkish stance. It would not be surprising to see some reversion from this year's winners due to profit taking and for some of the higher quality companies in the left-behind sectors to do some catching up. Multiples for small-cap and cyclical stocks could catch up to the mega caps, but such a move into riskier investments would not be typical of the late cycle. Such a move would require some consensus as to whether we've achieved a soft landing or avoided any landing at all.

It's more likely that we'll see a range bound market in which stock picking will be key to generating strong returns.

One market that investors have coalesced around is Japan. During the second quarter, investors were treated to plenty of positive corporate guidance and solid economic data across the manufacturing and retail sectors. The Nikkei 225 surged another 18.4% in Q2 and is up 27.2% YTD. Foreign investors' purchases of cash equities, which accelerated around mid-May, have been

Figure 7. Japanese equities maintain cheaper valuations



Source: Bridgewater Associates LP, Bank of America Global Managers Survey.

concentrated in Japan's blue chips, leading to a slightly similar but much less pronounced market-cap effect as in the US. The TOPIX, which is a much broader representation of the market and is less concentrated in Japan's biggest companies, has underperformed the Nikkei by more than 600 basis points YTD. Nevertheless, the TOPIX has posted six consecutive months of positive performance during the first half of the year.

Japan's current rally is looking a little long-in-the-tooth from a technical standpoint, having outperformed other markets by a wide margin so far this year. News out of Japan is also expected to be quiet until the TSE's next corporate governance report, expected to come out in the Fall. In the meantime, Japan remains fairly valued slightly cheap versus other developed countries on key valuation measures. Japan is also still a relatively modest weight in most global

Table 2. Japan remains underweight in global equities

Equity market	CAPE	Forward P/E	Trailing P/E	P/B	Dividend yield
US	28 (17%)	19 (14%)	22 (9%)	4.1 (44%)	1.6 (25%)
UK	14 (4%)	10 (-19%)	12 (-18%)	1.6 (-8%)	4.0 (-4%)
Europe ex. UK	19 (17%)	13 (-6%)	15 (-9%)	1.9 (9%)	3.1 (4%)
Japan	14 (-15%)	14 (1%)	17 (5%)	1.3 (4%)	2.4 (-14%)
EM	11 (-21%)	12 (1%)	13 (-4%)	1.6 (-4%)	3.4 (-20%)

Key:	<-25%	-25% to -15%	-15% to -5%	-5% to 0%	0% to 5%	5% to 15%	15% to 25%	>25%
	Cheap			Neutral		Expensive		

Note: Valuations versus 15-year medians.
Source: Schroders Strategic Research. as of May 31, 2023.

investors' portfolios. Over the second half of the year, investors are likely to look past Japan's blue chips and increasingly towards the recent laggards. Opportunities for activism to unlock value in a conservative corporate culture, like we've seen recently in high profile situations such as Fujitec and Toshiba, will also continue to exhibit outperformance.

In contrast to Japan, Europe was a considerable laggard this quarter. There was some optimism towards the region at the start of 2023, and we saw strong outperformance by luxury brands, which were expecting to see a strong pick-up in demand from China. However, as China's recovery faltered, the war in Ukraine continued to drag on, and core inflation remained far above targets in major economies like the UK and Germany, investors began to sour and pull capital. The STOXX Europe 600 gained just 0.9% for the quarter, though it remains up 8.7% YTD. Europe has historically performed the best in the early cycle when economies are emerging from a trough. With central banks continuing to battle persistent inflation, the outlook for European equities remains muted. However, there may be opportunities for patient investors given Europe's discount to the US is close to its lows once again, share buybacks have been strong, and corporate earnings have generally surprised to the upside.