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Q1 / 2023

Investment Management *and* Research Quarterly Update

Highlights

- Equities rose higher in the first quarter (Q1) despite weaker investor sentiment due to rising economic uncertainty and a Federal Reserve (the Fed) determined to bring inflation back down closer to its 2% target.
- Economic growth remained resilient in spite of high rates and inflation and a retrenching consumer. Consumer demand weakened but remained relatively strong despite high inflation, rising economic uncertainty and elevated geopolitical risks.
- U.S. inflation fell to 6% in February, year over year (YoY). While the decline in inflation is welcome, it remains well above the 2% target of the Fed. The Fed hiked interest rates by 25 basis points (bps) in January and March and is likely to slow, pause or cut rate hikes later in 2023 to ensure economic stability while seeking to bring inflation rates closer to its target.

Overview

U.S. equities ended Q1 mostly higher, showing resilience despite economic headwinds. The S&P 500 rose 7.5% this quarter, after increasing by 7.6% in Q4 2022. Bond markets slightly recovered this quarter, rising 2.5%, as measured by the Bloomberg U.S. Aggregate Bond Index. The U.S. Treasury yield curve inverted the most it has since 1981, as the 2-year yield fell to slightly above 4.05% and the 10-year yield fell to slightly below 3.5%. The dollar index fell by 1% in Q1, after falling by over 7.5% in Q4 2022.

As the economic backdrop continued to be challenged, market volatility remained constant (see Figure 1). Inflation began to moderate but remained persistently strong throughout the quarter, exacerbated by supply and demand imbalances and elevated commodity prices, despite their recent declines. These shocks continue to be challenged by the ongoing Russia-Ukraine crisis, the rise of Covid-19 infections in China as it reopens its economy, and tighter financial conditions. These headwinds have been a drag on consumer confidence and economic growth. However, China's reopening will likely benefit globally connected economies in the long run.

Figure 1 | **Bond volatility vs. S&P 500 Index volatility**
As of 3/31/2023

Sources: Bloomberg, First Republic Investment Management, as of March 31, 2023.

Market volatility was largely driven by the Fed's response to high inflation data throughout the quarter, as it continued to hike interest rates to restore price stability. The Fed slowed its pace of tightening in response to moderating consumer prices this year. Despite this slight moderation, high rates are clearly weakening what has been strong consumer demand and consumer confidence. High rates also caused stress in the banking system, which elevated market volatility. We expect these headwinds will continue to lower demand in 2023, slowing growth.

Nevertheless, there were bright spots in the economy:

- The labor market remained stable with low unemployment.
- Consumer demand remained relatively strong as the shift from goods to services spending continued and gasoline prices fell. This shift helped ease demand-side inflationary pressures on goods for the time being.
- Despite facing significant headwinds, the services sector remained resilient.

Going forward, the focus remains on the transmission of tighter Fed policy on the real economy, as it continued to tighten to restore price stability. While policymakers tried to engineer a "soft landing," the risks of a "hard landing" in 2023 have risen. Consumers have drawn down their pandemic savings, and credit is scarce. Supply chain disruptions have slightly eased but continue to cause delays, and financial conditions have become less accommodative for growth. We expect equities will remain volatile as corporate profit expectations deteriorate. In fixed income markets, we expect continued interest rate volatility and credit spread widening.

Economic Summary

The U.S. economy remained resilient while fighting multiple headwinds which slowed growth. It was supported by a resilient labor market and remaining pandemic-related fiscal stimulus, which kept consumer demand strong. Real gross domestic product (GDP) growth is expected to have increased by 1.5% in Q1 (estimated by the Atlanta Fed GDPNow model on April 5).

The main challenges facing growth have remained broad-based:

- Inflation moderated but remains higher than the Fed desires, weighing on consumer sentiment.
- Fed rate hikes continued to take their toll on demand, while real wages remain negative, leaving consumers with less purchasing power.
- The ongoing Russia-Ukraine conflict heightened price volatility for commodities, keeping gas and goods prices elevated.

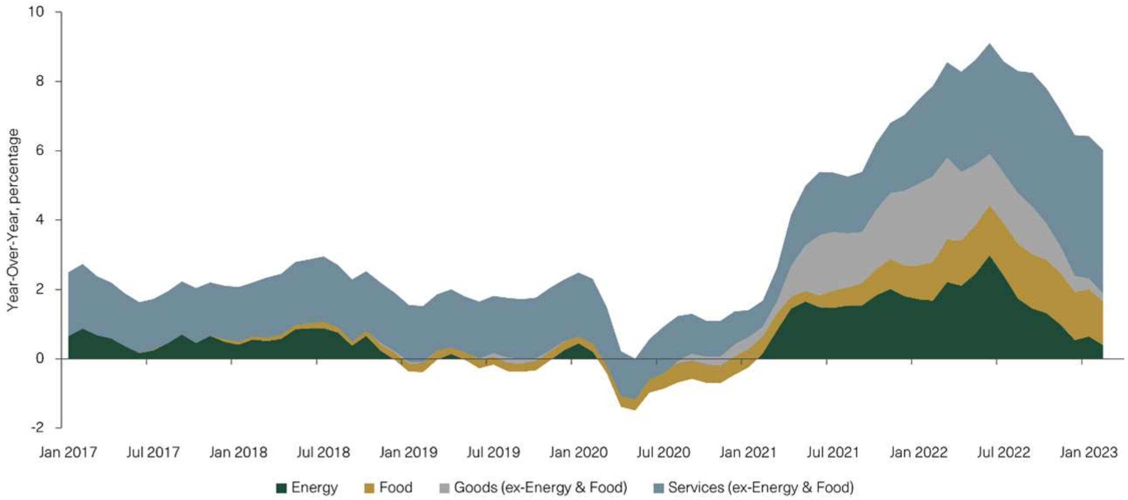
Stress in the banking sector grew this quarter as high interest rates took a toll on consumers. Banks endured stress from liquidity and funding pressures, intensified by the Fed's rapid rate hikes. As stress in the banking system looms and a restrictive Fed monetary stance persists, we expect economic growth to slow. However, the Fed voiced confidence that the banking system is resilient, and we believe it. Banks are well capitalized and there are more tools at policymakers' disposal to keep banks and financial markets stabilized. This gives us confidence that while volatility in the banking sector will remain elevated, there are tools to help mitigate any further risks to financial stability.

February's inflation release highlighted that inflation remain too high. While the increase in February was less than in January, inflation is still running above what the Fed is comfortable with. February's Consumer Price Index (CPI) rose by 0.4% month over month (MoM) at the headline level, after rising by 0.5% MoM in January, and rose by 6% YoY. Energy prices fell by 0.6% MoM, declining for the third time in the prior four months. The larger decline in household utility prices offset an increase in gasoline prices, and we anticipate energy prices will fall further in upcoming months. We expect inflation will moderate in 2023 but will take longer to get closer to the Fed's 2% goal.

Core CPI (excluding food and energy) increased by a stronger 0.5% MoM in February and by 5.5% YoY, following a 5.6% YoY increase in January. The shelter component drove most of the rise in core CPI; shelter was up by 0.8% in February, surpassing January's 0.7% gain. Shelter prices will soften in the second half of the year, as there's roughly a 9- to 12-month lag between market rents and the shelter component of CPI. Various market-based measures for rents point toward the CPI for rents declining in 2H 2023. We believe, in the second half (2H) of 2023, we'll see these declines in the shelter component of inflation trickle in and help move inflation closer to the Fed's target.

Core services inflation, which is the stickier side of the inflation picture that the Fed is now much more focused on slowing, remains resilient, driving the increase in headline inflation. Core services prices were boosted by a 0.8% MoM rise in the shelter component, after rising by 0.7% MoM in January (see Figure 2). The persistence of core services inflation will keep the focus squarely on the labor market. Services prices are largely determined by the domestic economy, particularly the labor market and nominal wage growth. Job growth momentum has moderated but isn't slow enough to cool services inflation meaningfully.

Figure 2 | U.S. CPI components
Percentage, as of 3/31/2023



Sources: Bureau of Labor Statistics and First Republic Investment Management; data as of March 31, 2023.
Past performance is no guarantee of future results.

Despite recent economic uncertainty, consumer confidence remained resilient, especially in regard to spending on services. Consumer confidence unexpectedly increased in March, as the tightness of the labor market offset recent concerns about financial stability. The Conference Board's Consumer Confidence Survey rose to 104.2 in March from 103.4 in February, following two consecutive monthly declines (see Figure 3). Consumers showed decreased confidence in present conditions, driven by weakening business conditions, but showed increased confidence in expectations for the next six months. Despite the rise in the headline confidence index, consumers are still scaling back plans to buy homes and major appliances, suggesting they expect to pull back spending as everyday items become more expensive given higher interest rates. While confidence remains relatively high for now, the growing headwinds from higher rates, exacerbated by the tightening of financial conditions, will eventually take a toll on the broader economy, likely slowing consumer spending in the second half of the year.

Figure 3 | Consumer sentiment vs. consumer confidence
As of 3/31/2023

Sources: Bloomberg, Conference Board, First Republic Investment Management, as of March 31, 2023.

The consumer in other parts of the economy showed a bit of weakness, but that is coming off historical highs. The largest near-term concern will be restricted lending by banks, particularly regional banks, as they will be less willing to extend credit to clients as they work to assure investors of strong balance sheets. Interbank borrowing will become more costly as well. Businesses will be less inclined to borrow given economic uncertainty and high costs. These developments are the main ingredients for a recession. While the depth to which economic headwinds infiltrate markets is still uncertain, but we believe there will be a recession in the U.S. economy likely in the middle of 2023.

The housing market continued to show cracks, as higher interest rates, and in turn mortgage rates, have significantly reduced housing demand. U.S. homebuilder sentiment improved, with the National Association of Home Builders (NAHB) / Wells Fargo Housing Market Index rising to 44 in March from 42 the prior month, the highest level since September 2022. Homebuilder sentiment on current sales conditions and expectations on the number of prospective buyers both rose higher, while sales expectations for the subsequent six months fell. The slight improvement in homebuilder sentiment reflects the fall in mortgage rates to 6.3% by the end of Q1, which improved affordability (see Figure 4). However, we don’t expect the rise in housing sentiment and activity will continue throughout 2023, as the impact from high rates on housing market data is significantly lagged. We expect to see more signs of weakness in the housing market going forward.

Figure 4 | U.S. mortgage rates and NAHB index
As of 3/31/2023

Sources: Bloomberg, Mortgage Bankers Association, National Association of Home Builders, First Republic Investment Management, as of March 31, 2023.

The decrease in mortgage rates helped drive an increase in new home sales, which increased to 640,000 in February from 633,000 in January. Homeowners remain cautious as mortgage and interest rates lowered affordability. We expect home sales will remain under pressure this year, held back by reduced affordability, weaker economic growth and a still-tight housing supply. However, a decline in mortgage rates could provide slight relief to homebuyers.

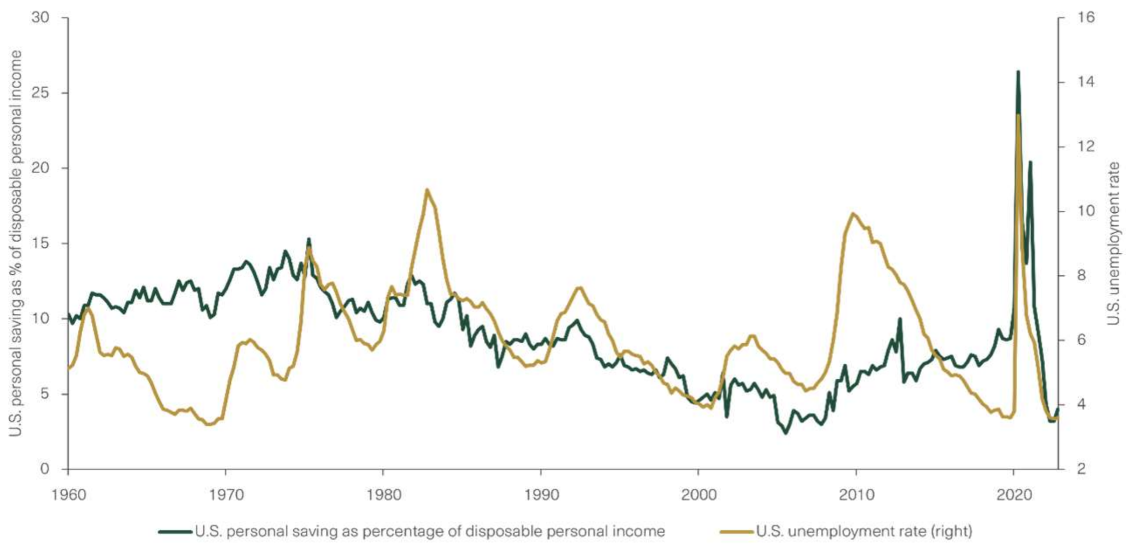
Home price growth continued to slow in January and, in our view, will further moderate in the upcoming months. The Federal Housing Finance Agency Home Price Index increased by 0.2% MoM and only grew by 5.3% YoY in January, after increasing by a stronger 6.7% YoY in December. Home price growth slowed more on the West Coast than on the East Coast. While this data release showed growth in housing prices, it is a lagging indicator because it's from January, when the economy was on more stable footing. While the recent stress in the banking sector could accelerate the decline in housing activity in the near term, we expect the slowdown in home prices to continue this year.

The labor market continues to have legs, but job growth in March did slow and will comfort the Fed that aggressive monetary policy tightening in over four decades is starting to yield results. The positives from the report show cooler job and wage growth alongside a minor downtick in the unemployment rate illustrate the U.S. labor market was more balanced in March. The stress in the banking sector has not had a major impact on jobs in March, but we think the future tightening in lending and credit standards will impact job creation.

March nonfarm payrolls rose 236,000, while job growth was revised lower by 17,000 total for the past two months. The gains in employment continue to be led by services with a 196,000 rise in payrolls in March. The most gains were from the leisure and hospitality sector. The unemployment rate fell to 3.5% in March from 3.6% in February (see Figure 5). In line with the trend in nonfarm payrolls data, the bottom line is that the labor market remains tight. The labor force participation rate moved higher to 62.6%, the highest since March 2020. The jobs data should keep Fed officials in the camp of a 25-bp hike or even a pause in May. We expect payrolls gains to slow throughout the rest of 2023, particularly as the probability of a recession has been pulled forward by the stress in the banking sector.

Average hourly earnings increased by 0.3% MoM, however base effects weakened the YoY data to 4.2% in March down from 4.6% in February. Earnings were strongest in the goods sector at 0.5% MoM, while wages in the services sector increased by 0.2% MoM. Average hourly earnings are heavily influenced by earnings growth for production and nonsupervisory workers who represent almost 80% of payroll employment, relaxed to 0.3% in March that is a decrease from February and helped lower the YoY trend as well. Overall, this report demonstrates that wage trends are heading in an encouraging direction though wage growth is still above the rate the Fed's inflation target. Lower wage pressures on the services front is welcome as that will be paramount to moving core inflation down to the Fed's target.

Figure 5 | U.S. personal savings rate vs. unemployment rate
Percentage, as of 3/31/2023



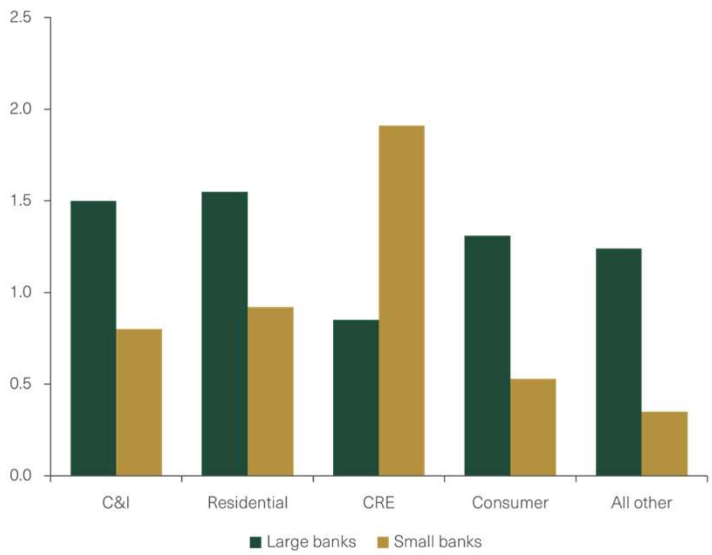
Sources: ASR Research, First Republic Investment Management, as of March 31, 2023.

Recent developments in job market data give the Fed breathing room to pause hikes. While the U.S. economy has so far remained resilient in 2023, adding 236,000 jobs in March after adding 311,000 jobs in February, central banks' aggressive rate hikes may cause unintended consequences as firms reel with higher labor and funding costs. Looking at the other side of the equation, many sectors have experienced job losses. According to Bloomberg, since October 2022, the technology sector has borne the brunt of job losses, while the consumer discretionary sector has had the second-most layoffs as demand has experienced some softening and sales have faltered. Going forward, the Fed will continue to monitor labor market data closely and look for moderation as a method to slow inflation.

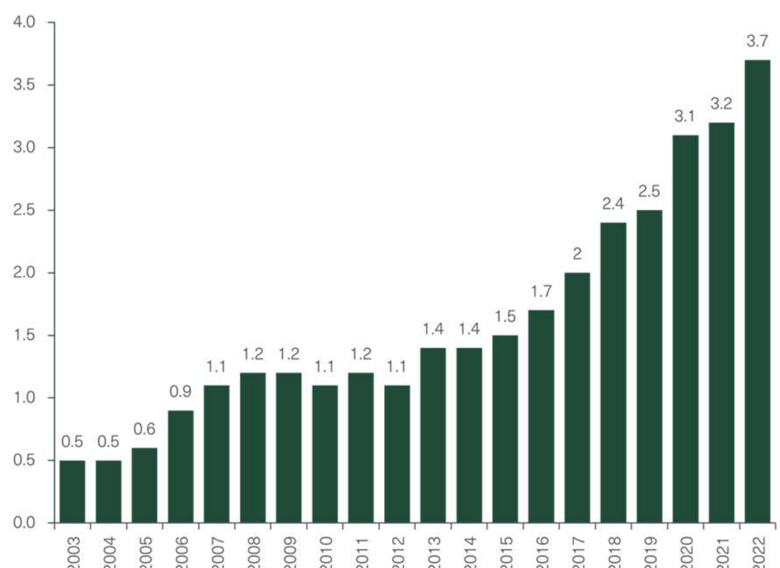
In late March, the Fed released its report that the U.S. money supply is falling at its fastest pace since the 1930s. The M2 money supply, the total measure of cash and cash-like assets present in the U.S. economy, fell by $130 billion in February and by 2.4% YoY. This sharp decline in money growth is important on the inflation front as less money supply historically drags down inflation. We expect that the M2 money supply will have continued to notably fall in March as bank deposits have also sharply declined. This will likely help lower inflation, although it should, in turn, increase financial instability and weaken economic growth. This could lead the Fed to slow or eventually pause the pace of rate hikes later this year.

Business loan growth followed a similar pattern, with February 2023 showing the first MoM decline since September 2021. Consumer spending also fell in February after soaring in January. On the supply side of credit, one of the best indicators to judge the minds of lending decision-makers is the Fed's Senior Loan Officer Opinion Survey, which is published quarterly. The January version reported "tighter standards and weaker demand for commercial and industrial loans" as well as "tighter standards and weaker demand for all commercial real estate loan categories" compared to the previous quarter's survey (see Figure 6). We expect the softening of consumer spending to accelerate in 2023.

Figure 6 | **Loan types of domestic commercial banks**
In USD trillions, seasonally adjusted, Dec 2022-Feb 2023 average, as of 3/31/2023



Value of dry powder of private equity companies worldwide from 2003 to 2022
In USD trillions, as of 3/31/2023



Sources: Bloomberg, J.P. Morgan, First Republic Investment Management, as of March 31, 2023.

In January the U.S. hit its debt ceiling of $31.4 trillion; while this is a concerning development, the U.S. has been in this position many times before. The debt ceiling has been successfully raised 45 times in the past 40 years. This event is important, as the debt ceiling sets the legal limit of all federal debt the government can accrue. The debt ceiling effectively caps the amount that the U.S. Treasury can borrow unless the debt ceiling is raised or suspended by Congress. A higher debt ceiling allows the government to fund new deficits and issue debt for bills previously authorized. This matters to U.S. creditworthiness and investors, as without a higher or suspended debt ceiling, the U.S. must operate on a cash flow basis using existing cash and any receipts to pay any obligations until an agreement on the debt ceiling is reached.

In our view, the most likely outcome is some sort of deal to raise the debt ceiling with a combination of spending cuts and tax increases that's acceptable to both political parties. However, any agreement likely won't be reached until the last minute. We also expect political rhetoric around this topic to increase significantly over the next few months. In our view, the political noise out of Washington shouldn't disrupt investors' long-term asset allocation.

Emerging markets (EMs) continued to be challenged by supply chain issues and high inflation. Central banks focused on slowing inflation, leading most to raise interest rates. The Russia-Ukraine conflict continued to exacerbate supply shortages as tensions intensified, keeping energy prices elevated and adding to cyclical inflationary pressures. However, energy prices fell in Q1 as the winter in Europe was warmer than usual, averting a global energy crisis from occurring. Inflation remained stickier than expected in Europe, while some tension grew in the banking sector near the quarter end. China continued to reopen its economy, leading to an increase in COVID-19 infections that slowed economic growth, but the reopening will likely benefit global economic growth and ease supply chains in the long-term.

In our view, U.S. growth will continue to slow in 2023 and enter a mild recession later this year, as the Fed tries to slow, pause or potentially even cut rates while balancing lowering inflation with financial stability. High prices and interest rates will likely remain uncomfortable for consumers, particularly in EMs, as food tends to be a large part of the inflation budget. As the impacts of high interest rates continue to trickle into the economy, the odds of a hard landing in 2023 increase.

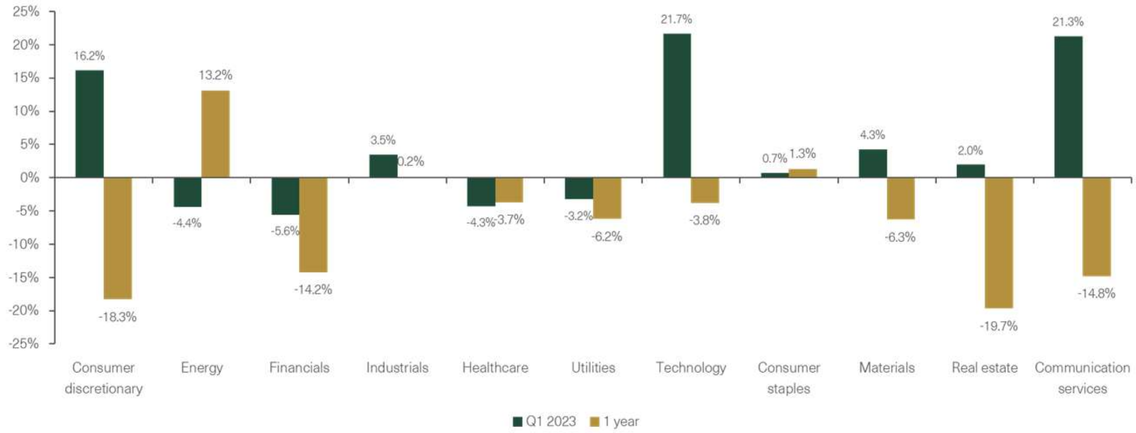
Global Equities

U.S. equities ended mostly higher in Q1, showing resilience despite increased economic uncertainty. The S&P 500 Index increased by 7.5% this quarter, after increasing by 7.6% in Q4 2022. The Nasdaq-100 Index rose by 17% in Q1 2023, the biggest quarterly gain since Q2 2020, ending four-consecutive quarters of declines. The Dow Jones rose by 0.9% in Q1.

During Q1, sector performance was mixed. The best-performing S&P 500 Index sectors were technology, returning 21.7%; communication services, returning 21.3%; and consumer discretionary, returning 16.2%. The underperforming sectors were financials, returning

–5.6%; energy, returning –4.4 %; healthcare, returning –4.3; utilities, returning –3.2%; consumer staples, returning 0.7%; real estate, returning 2%; industrials, returning 3.5%; and materials, returning 4.3% (see Figure 7).

Figure 7 | S&P 500 Index sector returns
As of 3/31/2023



Sources: S&P Dow Jones Indices LLC and/or its affiliate, First Republic Investment Management, as of March 31, 2023.

Equities started off the year particularly strong in January, fell in February, and rose again in March as economic headwinds mounted. In January, the S&P 500 Index rose over 6% MoM, its largest gain since October, while the Nasdaq-100 Index rose over 10.5% MoM, its largest gain in January since 2001. Equities were boosted by optimism that inflation would continue to meaningfully lower, stronger than expected economic data, a relatively stable earnings season, and an increased view that the Fed would be able to engineer a soft economic landing. In addition, the reopening of China and warmer-than-expected weather in Europe (which mitigated an energy crisis from occurring) drove equities higher.

Inflation and Fed policy remained the big drag on deteriorating risk sentiment in Q1, which weighed on equity markets. The Fed's commitment to restore price stability through higher interest rates and quantitative tightening has the dual effects of hurting corporate profits while making other asset classes relatively more attractive. Persistently high inflation continued to worry investors as it led the Fed to continue raising rates to restore price stability. Investors feared the economic and market cost of the rate hikes would take too much of a toll, lowering returns and increasing the odds of a hard economic landing. The continued inversion of the yield curve ignited looming concerns of an upcoming recession.

Near quarter end, stress in the banking system exacerbated investor concerns, sparking market volatility. Banks endured stress from liquidity and funding pressures, intensified by the Fed's aggressive rate hikes. In our view, if banking concerns prove idiosyncratic, it's unlikely that policymakers will need to cut rates as precipitously as the market currently expects. Tighter-for-longer policy will continue to pressure equity fundamentals as investors expecting a dovish pivot will face disappointment.

The credit and equities market appear to be signaling diverging views, as bond spreads have moved wider, but equity prices and valuations push higher. Credit appears to be signaling the potential for higher levels of default while equities are focused on projected rate cuts.

While the real economy powers on given the strength of the consumer shift toward services, the earnings power for equities has faded. S&P 500 earnings per share have fallen for two consecutive quarters and consensus estimates project earnings to continue their fall in Q1 2023, as economic growth is now concentrated in services as opposed to the more equity-tethered manufacturing side. In our view, reported earnings should come in above expectations for Q1 with segments exposed to consumer-based services likely to produce the strongest results.

Current sell-side estimates project a meaningful acceleration of corporate earnings later this year with a significant year-over-year increase of S&P 500 profits next year. This boost is largely attributable to a shift in expected profit margins, from a multi-quarter decline that sees margins bottom in Q1. That outcome does not align with a reasonable decline in the nominal economic backdrop and certainly would not reflect a recession. We expect these figures to move considerably lower.

Given our expectations that Q1 reporting season should provide a positive upside surprise, especially in consumer service-oriented segments, there should be a brief runway for cyclical equities to perform well. However, as markets turn their focus beyond the current profit tailwind toward a more perilous macro backdrop later this year, investors should consider a more uniform pivot toward defense.

So far, 2023 has been a year in which the consensus view has been squeezed again and again. In January, equity segments, which suffered most last year, sharply outperformed while those that had enjoyed leadership, such as energy, quickly deteriorated. February was a month of recalibrated de-risking, as more speculative segments settled down and stocks moved broadly lower, but quality and profitable growth continued to build leadership. Market consensus has now evolved to expect a bank funding-induced recession, which prompts policymakers to abandon their battle against inflation in favor of rate cuts to stabilize the economy. This view has led to a shift in positioning toward larger cap technology exposure with a defensive tilt. Now, investors are reluctantly being lured back into overall equity exposure, even at a higher price point, as the pain trade pushes stocks temporarily higher. On cue, we wonder if this consensus view will be challenged, as well.

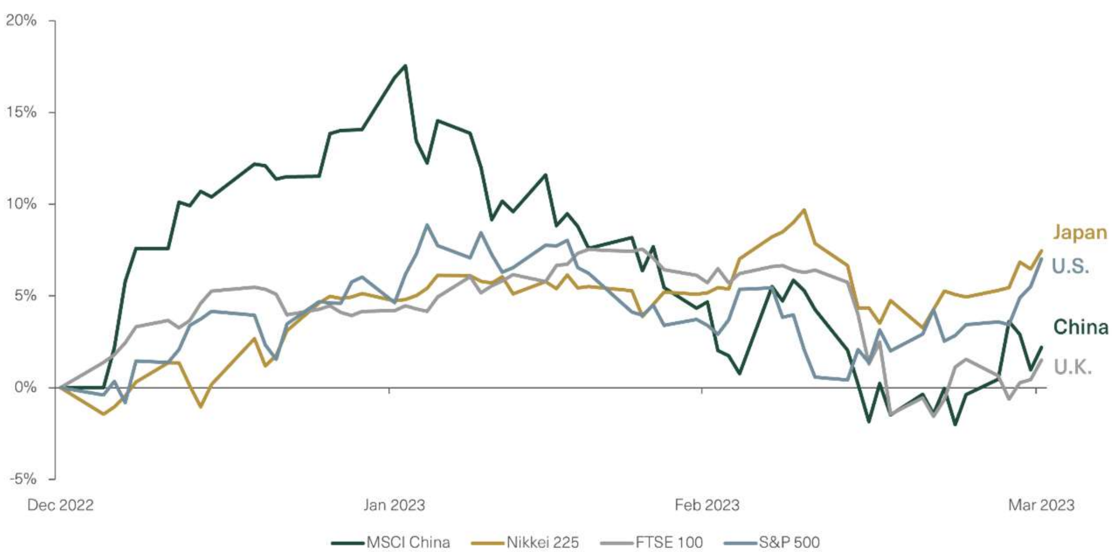
Going forward, we expect economic growth to moderate and inflation to decline for longer, which should stave off the need for policymakers to abruptly cut interest rates at the cadence the market currently expects. However, we ultimately do expect growth to succumb to policy effects later this year. As most growth components favor services over goods, corporate profits endure the double-edged sword of little policy relief and continued margin strain.

Some sources of traditional defensiveness may be vulnerable to higher rates, high absolute valuations and slowing earnings growth, while certain cyclical segments likely have an attractive runway to continue doing well before tighter policy ultimately chokes off consumption. Meanwhile, technology-related sectors appear overbought, but their higher quality and profitability characteristics do make them attractive in what might increasingly evolve toward a stagflationary environment.

Within the U.S., we favor an opportunistic blend of "Secular Growth" paired with sources of higher-conviction cyclicality, which provides an attractive blend of profitability, quality and upside exposure to nominal growth. We continue to favor large cap U.S. exposure relative to small cap and international equities.

Overseas, developed markets, EMs and Asia performed relatively well in Q1. This quarter, China's stock market returned 4.7%, as measured by the MSCI China Index; Japan's stock prices increased by 7.5%, as measured by the Japan Nikkei 225; and the U.K.'s stock market increased by 2.4%, as measured by the FTSE 100 Index (see Figure 8).

Figure 8 | Global equities first quarter performance
As of 3/31/2023



Sources: Bloomberg, First Republic Investment Management, as of March 31, 2023.

Geopolitical tensions remained elevated and heighted global market volatility. The Russia-Ukraine conflict continues to add to price volatility for commodities, keeping gas and good prices elevated, despite declining somewhat in the quarter. Europe's warmer-than-expected temperatures and government-led preparedness helped dampen the effects of an energy squeeze. Meanwhile, China's reopening should produce tailwinds for export-oriented economies. These developments, in addition to Developed International equities relative to the United States, lead us to view Developed International equities as a means to gain attractive, cyclical exposure to global reopening without the idiosyncratic risks associated with Emerging Markets. The region's equity markets have rallied and are vulnerable to a short-term pullback, but we're more constructive on an intermediate-term basis.

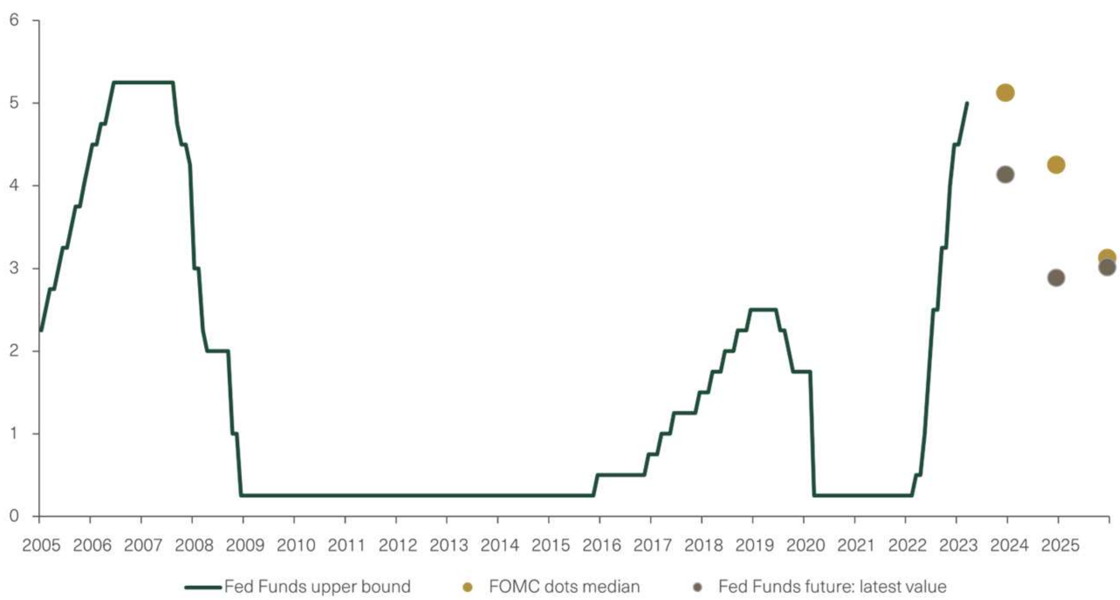
We expect 2023 to be volatile for equities that will prove more challenging as the year progresses. We'd avoid some of the short-term rallies in more speculative and unprofitable segments of the market while using this opportunity to rebalance portfolios toward sources of quality, lower volatility and consumer services-based consumption.

Fixed Income

Treasuries were slightly stronger this quarter as the yield curve further inverted. Bond markets increased by 2.5% in Q1, as measured by the ICE-BofA U.S. Aggregate Bond Index, and were very volatile. In Q1, the 2-year yield fell around 35 bps to slightly above 4.05%. The 10-year yield fell by 40 bps to slightly below 3.5%. The U.S. dollar index fell by 1% this quarter, after falling by over 7.5% in Q4 2022. Bond markets rallied towards the end of the quarter as the Fed voiced potential plans to end rate hikes to avoid materially slowing economic growth. The odds of a recession have risen considerably for mid-2023.

The change in the rates market over the quarter increased bond market volatility. The yield curve continued to invert throughout the quarter, as the 2-year to 10-year Treasury curve inverted the most it has since 1981 in early March. This reflects the Fed's intense tightening cycle (see Figure 9) and suggests that economic growth will continue to slow in 2023. We expect the yield curve to continue to invert in 2023.

Figure 9 | Market expectations vs. Fed forecasts
Percentage, as of 3/31/2023

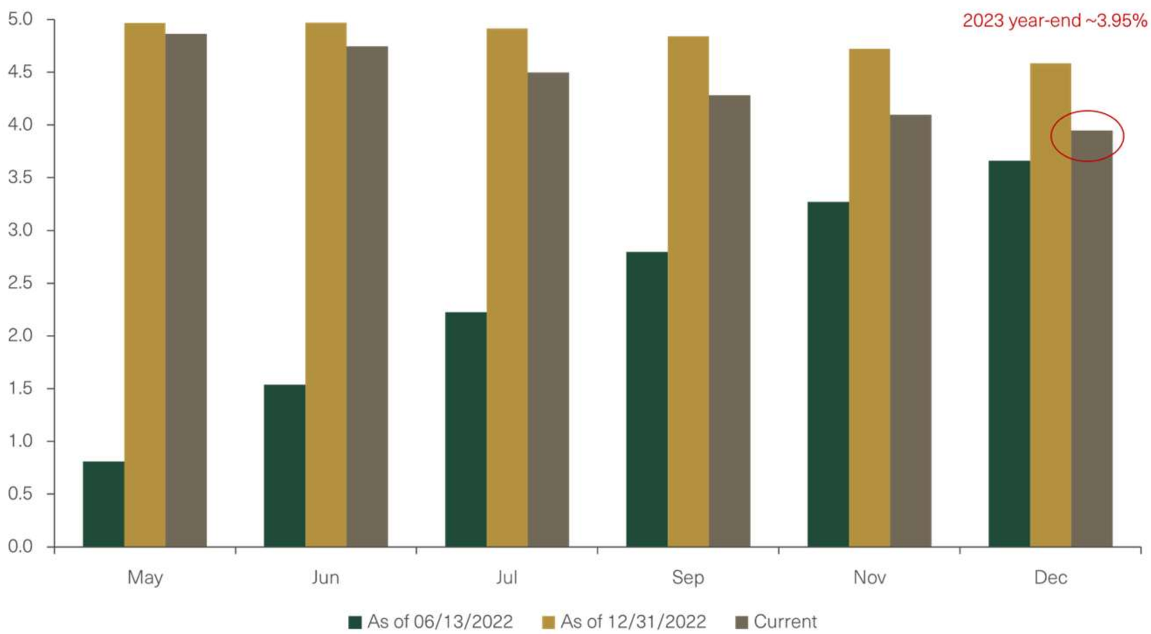


Sources: Bloomberg, First Republic Investment Management, as of March 31, 2023.

The Federal Open Market Committee (FOMC) increased the Fed funds rate by another 25 bps to 4.75%–5.00% in March, while acknowledging that problems in the banking system triggered by its previous rate increases are likely to weigh on the economy (see Figure 10). This is the second consecutive meeting in which the Fed has hiked rates by 25 bps.

In short, with March's additional hike, rates remain well into restrictive territory to help slow inflation.
We expect that the Fed will remain data dependent, as the recent February inflation report showed that inflation is starting to ease but is nowhere close to the Fed's 2% target.

Figure 10 | Fed Funds futures
Percentage, as of 3/31/2023



Sources: Bloomberg, Federal Reserve Bank, First Republic Investment Management, as of March 31, 2023.

The 25 bps hike was due to consistently sticky services sector inflation, in addition to a labor market that continues to be stronger than the Fed would like. Inflation data in advance of the meeting showed a deceleration of inflation from the previous month but is still well above the Fed's target. Fed Chairman Jerome Powell pushed back on the probability of rate cuts and acknowledged the likelihood that demand will need to weaken to contain non-shelter service inflation.

The March statement from the FOMC deviated from the February statement. The Fed replaced its prior reference to "ongoing increases in the target range will be appropriate" with "some additional policy firming may be appropriate" — a dovish pivot in our view. The official statement also added language around the current state of the banking system. The FOMC feels that the "U.S. banking system is sound and resilient." The Fed expects recent developments to cause credit conditions for households and to cause businesses to tighten and "to weigh on economic activity, hiring and inflation," adding that the "extent of these effects is uncertain."

Going forward, we flag the risk that Fed policy may keep rates high, as stress in the banking system looms while a restrictive monetary stance continues to slow economic growth. The biggest takeaway from the Fed's statements and March press conference was that the FOMC believes that tighter lending standards will ultimately act as a substitute for, or even exacerbate, rate hikes.

Going forward, we expect growth to keeping slowing, inflation to remain elevated for longer despite commodities moderating, and bond volatility to remain high due to central bank data dependence. The slowing of economic growth will lead many central banks to debate whether to continue to raise rates to slow inflation or to pause, slow or cut interest rates to avoid significantly hurting economic growth. We expect bond rate volatility to remain elevated, as markets will respond sharply to the Fed's policy changes and changes to inflation releases. Active fixed income portfolio management and fundamental credit selection will be key drivers of performance.

Investor Takeaways

Equity and bond markets will suffer through pockets of elevated volatility until there's a meaningful and consistent decrease in inflation, and the duration of higher rates is more certain as markets become comfortable with a "data-dependent" Fed that's now focused on the cumulative effects of rate hikes. We remain defensive in our positioning, and we'd look for opportunities to upgrade portfolios during market weakness.

Within equities, we continue to favor U.S. Large Cap exposure, since China's evolving COVID policies continue to weigh on manufacturing and growth. We've recently become more constructive on developed international equities, as the energy recession wasn't as severe as anticipated.

- U.S. large-cap equities provide an attractive blend of quality, yield and growth at a reasonable value, albeit at higher valuations, as earnings expectations continue to deteriorate.
- We remain defensive in our credit positioning, with at benchmark duration (and are considering potentially longer duration positioning as we believe we are close to peak rates) and higher in credit quality. We expect credit spreads will move wider to account for slowing growth and recession risks.
- In our view, there are thematic opportunities in credit, real estate, restructuring and U.S. reshoring.

Financial Market Returns

Total Return Index Performance as of 3/31/23			| ------- Annualized ------- |		
U.S. Equity	**Q1 2023**	**1 Year**	**3 Year**	**5 Year**	**10 Year**
DJ Industrial Average	0.9%	-2.0%	17.3%	9.0%	11.1%
NASDAQ Composite	17.0%	-13.3%	17.6%	12.6%	15.3%
S&P 500 TR Index	7.5%	-7.7%	18.6%	11.2%	12.2%
Russell 1000 Index	7.5%	-8.4%	18.6%	10.9%	12.0%
Russell 1000 Growth Index	14.4%	-10.9%	18.6%	13.7%	14.6%
Russell 1000 Value Index	1.0%	-5.9%	17.9%	7.5%	9.1%
Russell Mid Cap Index	4.1%	-8.8%	19.2%	8.1%	10.1%
Russell Mid Cap Growth Index	9.1%	-8.5%	15.2%	9.1%	11.2%
Russell Mid Cap Value Index	1.3%	-9.2%	20.7%	6.5%	8.8%
Russell 2000 Index	2.7%	-11.6%	17.5%	4.7%	8.0%
Russell 2000 Growth Index	6.1%	-10.6%	13.4%	4.3%	8.5%
Russell 2000 Value Index	-0.7%	-13.0%	21.0%	4.5%	7.2%
Total Return Index Performance as of 3/31/23			| ------- Annualized ------- |		
International Equity	**Q1 2023**	**1 Year**	**3 Year**	**5 Year**	**10 Year**
MSCI EAFE Index ($USD, net)	8.5%	-1.4%	13.0%	3.5%	5.0%
MSCI AC World Index ($USD, net)	7.3%	-7.4%	15.4%	6.9%	8.1%
MSCI AC World Ex US Index ($USD, net)	6.9%	-5.1%	11.8%	2.5%	4.2%
MSCI Emerging Markets Index ($USD, net)	4.0%	-10.7%	7.8%	-0.9%	2.0%
MSCI BRIC Index ($USD, net)	0.8%	-8.3%	1.7%	-2.9%	1.6%
Total Return Index Performance as of 3/31/23			| ------- Annualized ------- |		
Fixed Income	**Q1 2023**	**1 Year**	**3 Year**	**5 Year**	**10 Year**
Bloomberg Barclays US Treasury 1-3 Year Index	1.6%	0.2%	-0.8%	1.1%	0.8%
Bloomberg Barclays US Treasury 5-10 Year Index	3.2%	-4.0%	-4.2%	1.1%	1.0%
Bloomberg Barclays US Long Treasury Index	6.2%	-16.0%	-11.3%	-0.4%	1.5%
Bloomberg Barclays US Treasury US TIPS Index	3.3%	-6.1%	1.8%	2.9%	1.5%
Bloomberg Barclays US Govt/Credit Intermediate Index	2.3%	-1.7%	-1.3%	1.4%	1.3%
ICE-BofA Municipals 1-10 Year A-AAA Index	1.7%	1.6%	0.5%	1.7%	1.5%
Bloomberg Barclays US Corporate High Yield Index	3.6%	-3.3%	5.9%	3.2%	4.1%
ICE-BofA Preferred Stock Fixed Rate Index	3.3%	-5.4%	1.9%	1.9%	3.6%
JPMorgan GBI EM Global Diversified Index	5.2%	-0.7%	0.9%	-2.4%	-1.5%

Index Definitions

U.S. Equity

Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip U.S. stocks.

NASDAQ Composite Index is a market capitalization index of approximately 3,000 common equities listed on the NASDAQ exchange.

S&P 500 TR Index is a type of equity index that tracks both the capital gains of the equities in the S&P 500 and assumes any cash distributions (dividends) are reinvested back into the index.

Russell 1000 Index® measures the performance of the 1,000 largest companies in the Russell 3000.

Russell 1000 Growth Index® measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index® measures the performance of those Russell 1000 companies with lower price-to- book ratios and lower forecasted growth values.

Russell Mid Cap Index® measures the performance of the 800 smallest companies in the Russell 1000 Index.

Russell Mid Cap Growth Index® measures the performance of those Russell Midcap® companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000 Growth Index.

Russell Mid Cap Value Index® measures the performance of those Russell Midcap® companies with lower price-to- book and lower forecasted growth values. The stocks are also members of the Russell 1000 Value Index.

Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

Russell 2000 Growth Index® measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index® measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

International Equity

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

MSCI AC World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

MSCI AC World Ex U.S. Index captures large and midcap representation across 22 of 23 developed market countries (excluding the United States) and 23 emerging markets countries.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI BRIC Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance across the following four emerging market country indexes: Brazil, Russia, India and China.

Fixed Income

Bloomberg Barclays U.S. Treasury 1-3 Year Index measures the performance of U.S. Treasury securities that have a remaining maturity of at least one year and less than three years.

Bloomberg Barclays U.S. Treasury 5-10 Year Index measures the performance of U.S. Treasury securities that have a remaining maturing of at least five years and less than 10 years.

Bloomberg Barclays U.S. Long Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade and have $250 million or more of outstanding face value.

Bloomberg Barclays U.S. Treasury U.S. TIPS Index includes all publicly issued U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade and have $250 million or more of outstanding face value.

Bloomberg Barclays U.S. Govt/Credit Intermediate Index measures the performance of the USD- denominated U.S. Treasuries, government-related and investment-grade U.S. corporate securities that have a remaining maturity of greater than one year and less than 10 years.

Bloomberg Barclays U.S. Corporate High Yield Index measures the USD-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issues with an emerging markets country of risk, based on Barclay's emerging markets country definition, are excluded.

ICE BofAML Municipals 1-10 Year A-AAA Index is a subset of the BofAML U.S. Municipal Securities Index and includes all securities with a remaining term to final maturity of less than 10 years and rated AAA through A3, inclusive.

ICE BofAML Preferred Stock Fixed Rate Index is designed to replicate the total return of a diversified group of investment-grade preferred securities.

JPMorgan GBI EM Global Diversified Index is an investable benchmark that includes only those countries that are directly accessible by most of the international investor base. This index excludes countries with explicit capital controls, but it does not factor in regulatory/tax hurdles in assessing eligibility.

Chart sources:

1. Bloomberg, First Republic Investment Management, as of March 31, 2023.
2. Bureau of Labor Statistics and First Republic Investment Management; data as of March 31, 2023..
3. Bloomberg, Conference Board, First Republic Investment Management, as of March 31, 2023.
4. Bloomberg, Mortgage Bankers Association, National Association of Home Builders, First Republic Investment Management, as of March 31, 2023.
5. ASR Research, First Republic Investment Management, as of March 31, 2023.
6. Bloomberg, J.P. Morgan, First Republic Investment Management, as of March 31, 2023.
7. S&P Dow Jones Indices LLC and/or its affiliate, First Republic Investment Management, as of March 31, 2023.
8. Bloomberg, First Republic Investment Management, as of March 31, 2023.
9. Bloomberg, Federal Reserve Bank, First Republic Investment Management, as of March 31, 2023.
10. Bloomberg, First Republic Investment Management, as of March 31, 2023.