HAVERFORD

QUALITY INVESTING

2023

Haverford Annual Economic Outlook

As we enter 2023, many of the causes of last year's declines have begun to resolve themselves: inflation appears to be trending down, as are pandemic era lockdowns, even in China. Yet worries remain. Chief among them is whether the Federal Reserve has already tightened interest rates so much as to choke off economic growth.

Our 2023 Economic Outlook can be summed up in several broad themes.

- Powell won't be fooled twice.
- The most predicted recession may be a benign recession.
- The consumer will come under more stress.
- Investors will reward product, profit, and pricing power.
- Diversification will finally work.
- For the first time in over a decade, interest rates are compelling.
- Quantitative tightening will result in more volatile markets.
- 2023 is likely to bring slower growth, but better markets.

Powell won't be fooled twice.

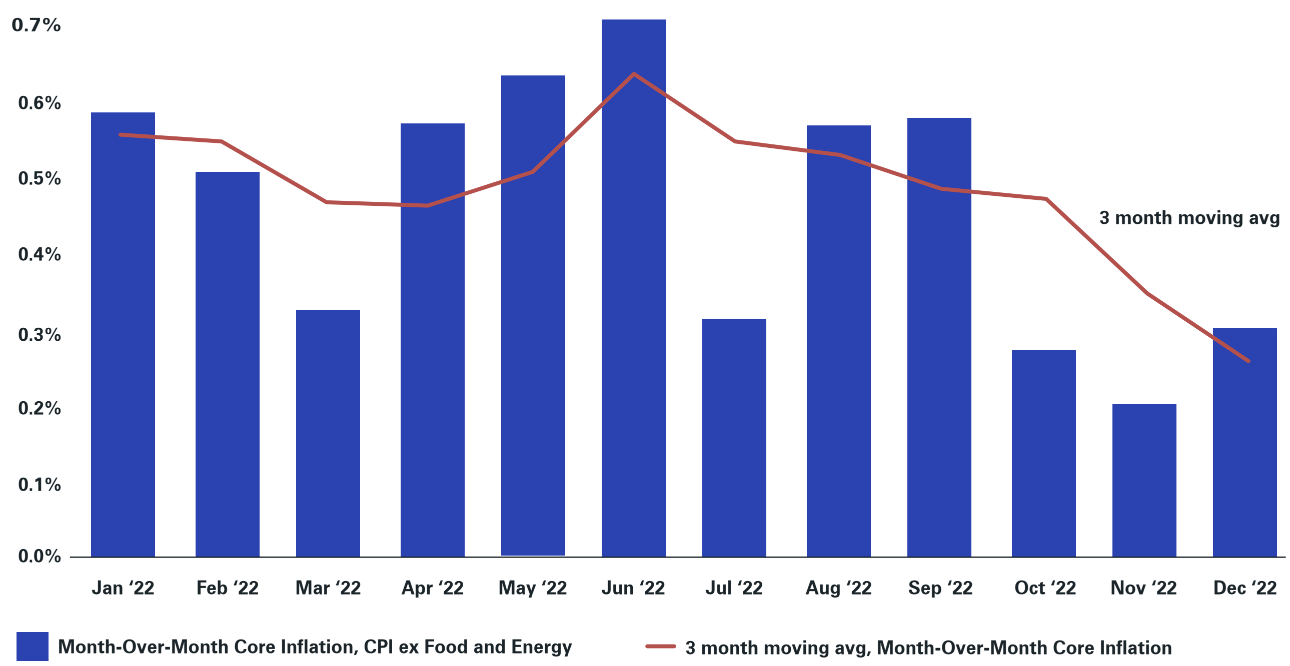
Jerome Powell and the Federal Open Market Committee (FOMC) have made it clear that they want to snuff out inflationary expectations. After dismissing early inflation as transitory and waiting too long to tighten monetary conditions, the FOMC has raised rates at an extraordinary pace. Investors have rightly been focused on how quickly rates have risen, and the expectation still exists that once rates hit their pinnacle in early 2023, the FOMC will almost immediately begin cutting rates.

We believe the more likely scenario is for rates to remain at their peak level for much of 2023. After presiding over the worst 18 months of inflation in more than 40 years, Powell does not want his legacy to include the ushering in of a new decade of inflation. Therefore, we believe he and the committee will be patient in looking for considerable evidence of waning price pressures and slower wage growth. It will likely take three to six months of annualized core inflation below 3%, plus decelerating wage growth (from above 5% to closer to 4%), before the Fed begins to consider claiming victory over inflation and moderating policy.

Evidence of Peak Inflation

- The 3-month moving average of core **month-over-month inflation has fallen to 0.35%**, the lowest level in a year
- **Hourly earnings** have been **dropping**
- Bloomberg Commodity Index **down 20% from peak** in March 22.
- Gas prices back to **$3.20 a gallon** (US City Average), down 37% from peak in June 22.
- Manheim Index of used vehicle values **down 13%** from May 2022
- Global Container prices **down 79%** from Sept 2021
- Apartment rents down **three consecutive months**, according to RealPage
- Zillow reported the largest ever month on month drop in rents, **down 0.4%**
- Beef **down 5% YoY** in latest CPI data

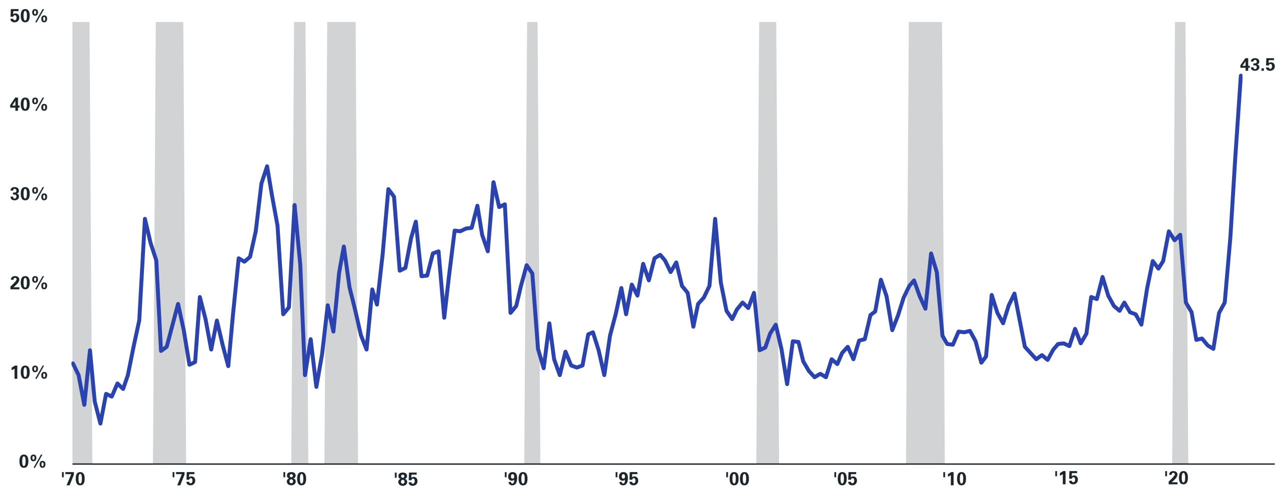
Month-Over-Month Inflation



Source: Factset, Dec 31, 2022

The most predicted recession may be a benign recession.

Probability of Recession in the Next Four Quarters, Survey of Professional Forecasters



Source: Factset, Dec 31, 2022

According to a data series published by the Philadelphia Federal Reserve, the expectations of a recession have never been so consensus. Recessions do not have to mean economic catastrophe, and we believe there are several reasons why this most anticipated recession could be more benign than previous downturns.

The jobs market is what will ultimately determine the depth and duration of a recession in 2023. Job insecurity is what makes consumers lose confidence and start to reign in their spending. In recent weeks, many high-profile tech companies have announced layoffs and hiring freezes. Yet job openings remain near record highs and the unemployment rate is near record lows at 3.7%. There is a chronic shortage of labor, driven by changing demographics and immigration patterns, that is unlikely to resolve any time soon. Surveys show that many businesses are loath to let people go, knowing how difficult it has been to hire.

Furthermore, we are unlikely to experience a "balance sheet" recession, where debt-burdened consumers are forced to cut back because of a sharp rise in interest rates. The percentage of income that homeowners are spending on mortgage interest has fallen to historical lows, and home equity levels are near all-time highs. When mortgage rates spike, affordability becomes an issue, and transactions slump. So even though home prices will likely correct in coming quarters after rising 40% during the pandemic, we are unlikely to see the level of foreclosures and forced sales experienced during the 2008 era.

The fact that a recession is highly expected will likely alter the nature of the recession. It appears we are all preparing for an economic slowdown. When businesses and households anticipate good times ahead, they spend freely and take on more debt. However, at present, there are few signs of financial excess. Unlike during the Great Recession of 2008 when banks were at the epicenter, today's U.S. banks are more prepared for a pullback, much better capitalized, and subject to much tighter regulatory oversight.

The consumer is absorbing higher prices, for now.

Despite the typical household being comfortably employed and sitting on a cushion of home equity with locked-in mortgage rates, there are a few areas of concern we are watching closely. The deterioration in personal savings rates and pressures on purchasing power could determine the path of consumer spending in the year ahead.

According to Federal Reserve data, before consumers' post-lockdown year of revenge spending, it is estimated that they accumulated more than $2.3 trillion (about $7,100 per person in the U.S.) of excess savings. The savings rate peaked in 2020 at more than 30% of disposable income, a stunning level well above the 8% savings rate that was typical during the past decade.

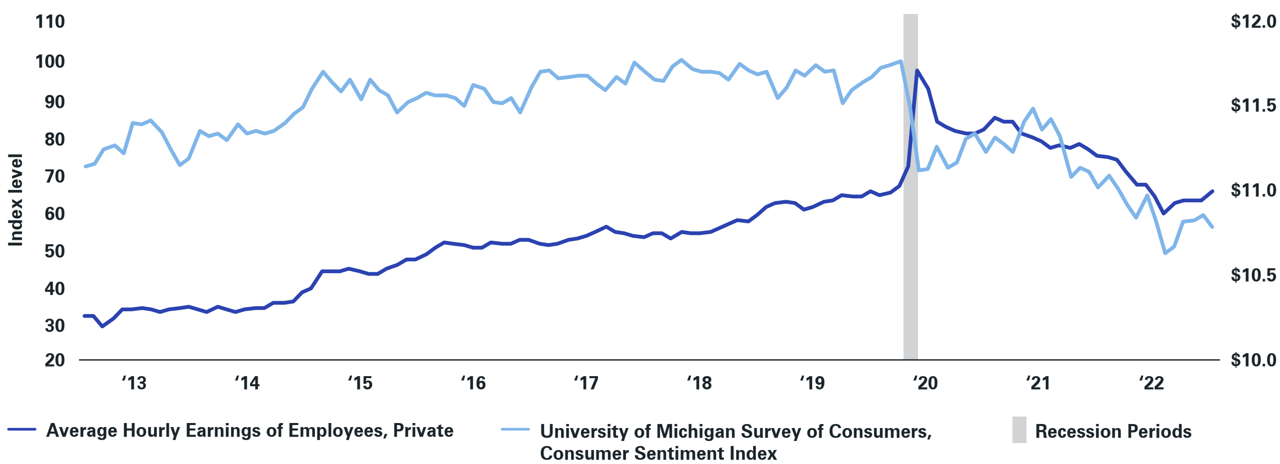
Some economists speculate that consumers are living beyond their means, with inflation taking a bigger bite out of household budgets. This is demonstrated by:

- the personal savings rate has declined in recent months
- rising prices have eroded most wage gains
- there is initial evidence of increased credit card balances
- consumer sentiment surveys plunged early in 2022

However, other data indicates a more resilient consumer. Despite their post-pandemic spending spree, consumers have only used about a third of that excess savings. Household checking accounts remain at record levels, up nearly 5X the 2019 levels. Clearly this cash on hand is skewed to wealthier households, but even lower income savers have twice the level of pre-pandemic cash. Also, while credit card balances are on the rise, delinquency rates remain low.

Perhaps most importantly, real hourly earnings, wages that are adjusted for inflation, are growing again and reversing a very unusual period of steep decline. That reversal in real wages is most likely responsible for another encouraging data set: consumer sentiment turned upwards in June 2022. Americans have been hyper focused on inflation and a lack of purchasing power has weighed on consumer sentiment for almost two years. On that front, the worst may be behind us.

University of Michigan Consumer Sentiment and Real Hourly Earnings



Source: Factset, Dec 31, 2022

Investors will reward product, profit, and pricing power.

Companies with proven business models that sold their products profitably performed well in 2022. In a future that includes more normal economic conditions, (i.e., short-term interest rates not at zero), we expect this trend to continue.

During 2022, companies that paid dividends and those with strong earnings visibility outperformed. Amid inflationary pressures and a rapid increase in interest rates, the companies that performed best had the ability to pass along higher costs through pricing, had secular—rather than economically-sensitive growth, or offered superior services or products. They were also trading at reasonable valuations. Investors were no longer willing to bet on the future and ascribe sky-high valuations to companies without present-day earnings and cash flow.

As we turn to 2023, we expect an ongoing divergence in performance favoring companies with resilient earnings. Despite the myriad pressures companies are under, there are several earnings drivers that will support growth. Companies that took price increases or cost savings should have a profit cushion in 2023. Cost relief could come from a weakening dollar or easing of supply chains and inflationary pressures. In more economically sensitive sectors, companies with large backlogs will have greater insulation against lower capital spending outlooks. Recurring revenue and subscription models are another source for earnings visibility.

Looking back on past bear markets and the bursting of various bubbles, it is difficult to find an example when the pre-bear leaders re-exerted leadership after the bear market was concluded. We believe the next leaders will outperform due to earnings growth and cash returns with far less reliance on multiple expansion. In addition, we anticipate that the average stock will continue to fare better than the market indexes in the coming year.

Diversification will finally work.

After trading at a premium to U.S. large cap stocks for much of the post 2008 era, small cap valuations began to decouple from large cap in 2019, a de-rating which has persisted through today. Small caps, represented by the Russell 2000, now trade at a price to forward earnings of 12X, or roughly a 26% discount to the S&P 500. Small cap stocks have not been this cheap since late-2000.

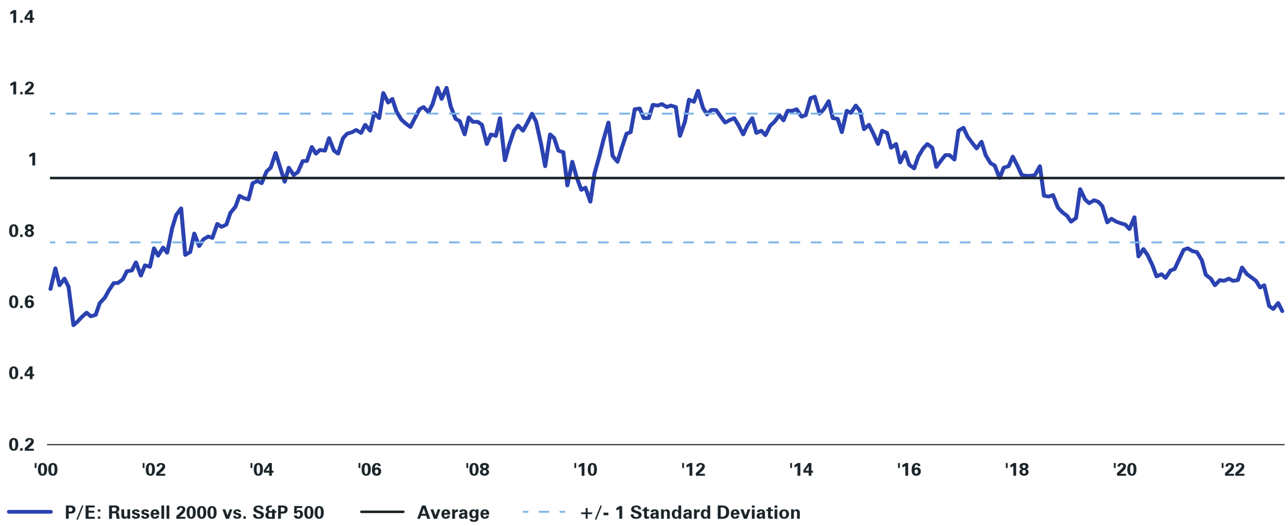
Historically, small companies have outperformed the broader market over a long investment horizon, due to their potential for higher earnings growth as they grow and mature. This outperformance comes with higher risks – small cap stocks are known to be more volatile with lower liquidity and are typically more highly leveraged with greater uncertainty in their business models. But at today's valuation discount, we believe investors are being attractively compensated. Further, while small cap company earnings are generally hard hit during challenging economic environments, they typically recover sooner than large caps as the economy recovers, adding to their attractiveness.

Investing outside of the U.S. is another way to potentially improve risk-adjusted returns . The peak in inflation and the end of the Fed rate hike cycle should spell the end of the U.S. dollar's outperformance, with the caveat that it is notoriously difficult to forecast currency trends. The dollar's dominance and reliability in an increasingly uncertain environment, both economically and geo-politically, attracted investors in 2022. The dollar gained 8% last year (2022) and is up more than 30% over the past decade, knocking 3% per year off annual returns. International equity investors were already hurting from 10 years of underperformance even before currency losses. However, we believe there are still attractive opportunities in overseas markets, over and above the diversification benefits, with a decline in dollar strength potentially adding to international returns going forward.

Over the past two years, rising geo-political tensions in Europe and the ongoing impact of Covid-19 policies have kept U.S. investors on home soil. For large institutional investors, allocations to international equities are at all-time lows. The economic data across Europe has turned starkly negative, with Consumer Confidence and Purchase Mangers' Surveys at levels comparable to the 2008 lows. Consensus is that a recession is a near certainty. And with no resolution to the Ukrainian war on the horizon, investors could scarcely be more negative. In fact, this negative sentiment has historically been a turning point for markets, with strong outperformance in the twelve months following a bottom in sentiment indices. Economies in Japan and other Asian markets may prove to be more resilient than Europe, given lower inflationary pressures and the expected post-pandemic re-opening tailwinds that are mostly over in Western economies.

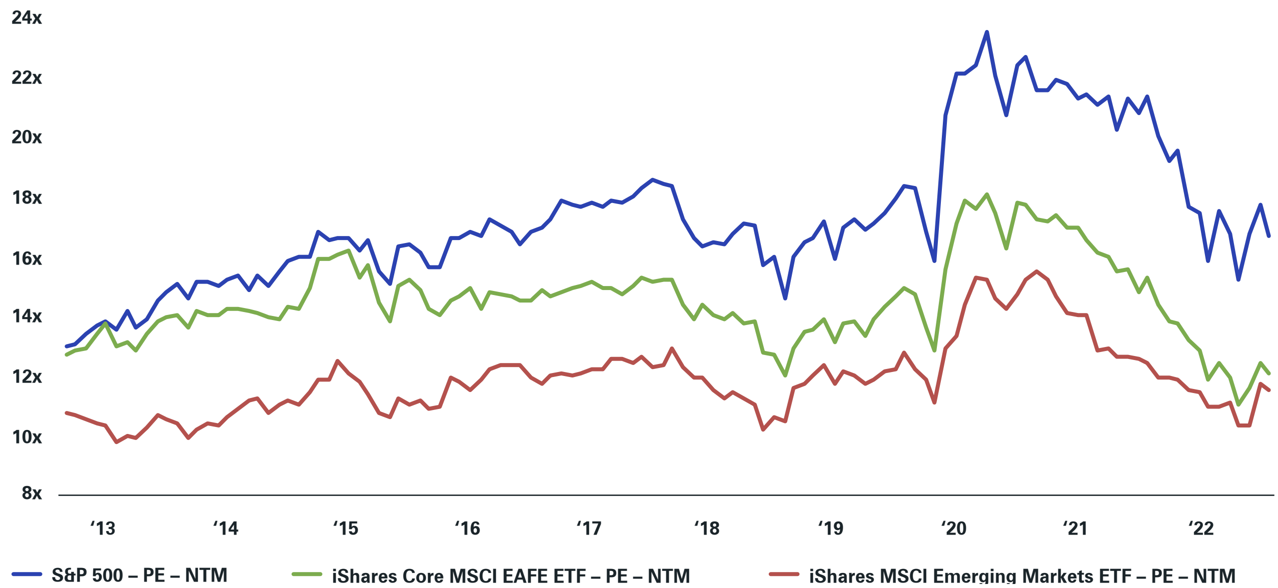
After a decade of underperformance, stocks in developed markets outside of the U.S. are trading at record lows, on an absolute level and relative to U.S. valuations. At just 12.2X price to earnings, the MSCI EAFE index trades at a 27% discount to the S&P 500, the steepest discount in a decade. Just as we have seen in 2022 with the reversal in growth stocks, markets tend to move in cycles, often reaching extreme levels.

Relative Valuations: Small Cap vs. Large Cap



Source: Morningstar, Nov 30, 2022

Price Earnings Ratios – Next 12 Months



Source: Factset, Dec 31, 2022

For the first time in a decade, interest rates are compelling.

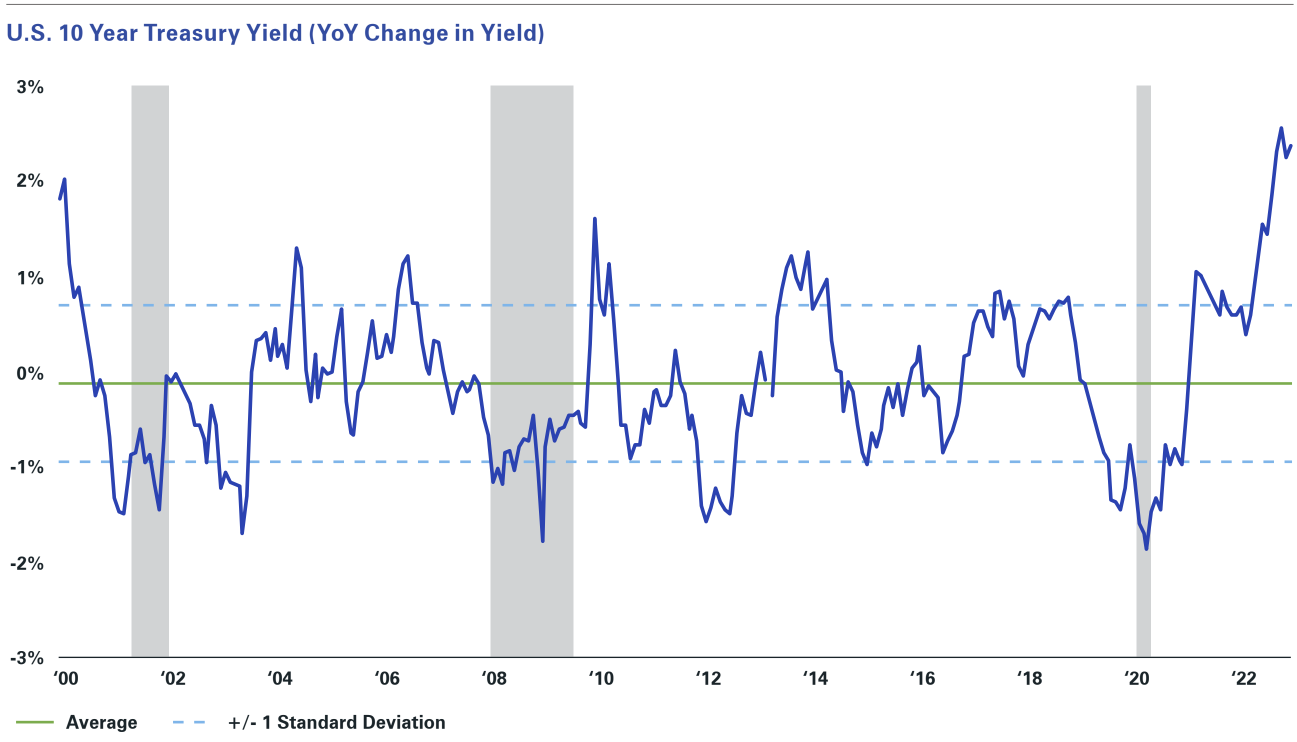
Over the past year, fixed income yields have risen more than 250 basis points. Higher yields translate to an improved ability to meet cash flow needs, while actively managing portfolio exposures can generate even more income. As an example, Intermediate Corporate bonds currently yield 5.4%, which would enable a nonprofit to meet a 5% spending target solely using Investment Grade corporate bonds with maturities between 1 and 10 years. These higher yields also offer far better protection against future inflation. The November Core Personal Consumption Expenditure Index was 4.7% and the inflation expectation for the next 5-10 years was only 2.9%. This is one of the very few times in the past decade when current bond yields offer an ability to meet spending needs and protect against inflation. While getting to these higher yields has been an unpleasant journey, investors should not ignore the opportunity higher yields provide.

The end of Quantitative Easing, and beginning of Quantitative Tightening, will result in more volatile markets.

The bond markets are likely to be more volatile with the Fed no longer buying these assets. The probable dispersion of future rates is wider than at any time in recent memory. This may not be an earth-shattering conclusion as the Fed stopped buying assets several months ago, but the implications are still not widely recognized by market participants, many of whom have never experienced a market without the Fed buying bonds.

We anticipate greater fluctuation in bond yields occurring with more frequency than in the past decade. There were several entire calendar years in the past ten years when the range from high to low in yield was less than 80 basis points. We have had three moves in less than six months that each were more than the market experienced over full calendar years as demonstrated by this yield change chart.

This increased fluctuation of yields can increase the volatility of mood swings for market traders. They will have more days when they feel good about their positioning and more days when they feel bad about their positioning. For long-term investors such as Haverford Trust, this can result in more frequent opportunities to purchase high-quality bonds at attractive yields. The more volatile the market, the more important it is to own high quality, liquid bonds. Taking more risk to get extra yield becomes even less attractive as volatility increases.



Source: Factset, Dec 31, 2022

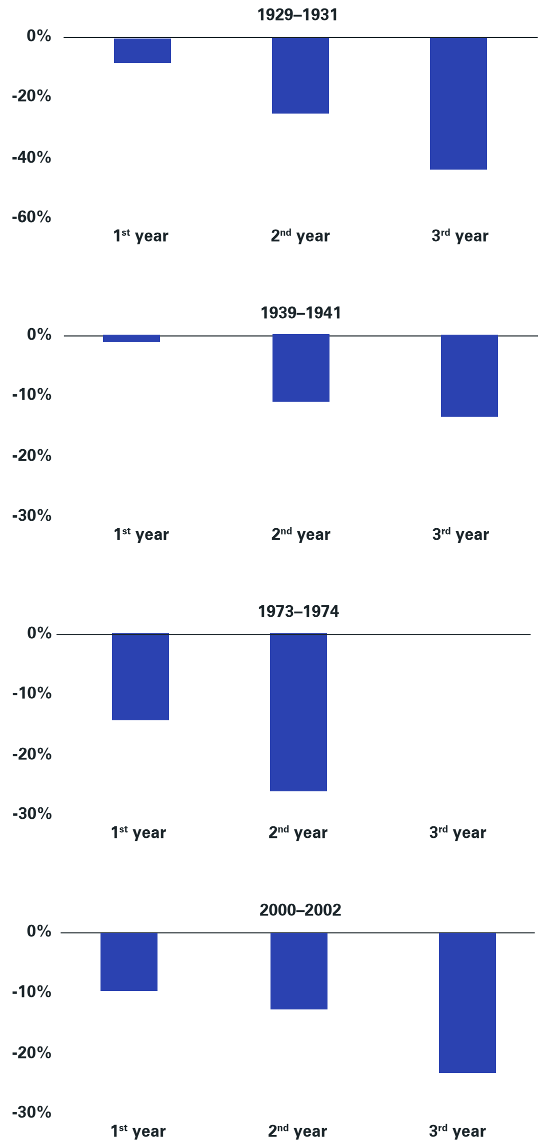
2023 is likely to bring slower growth, but better markets.

The prevailing consensus among Wall Street strategists is that the first half of 2023 will bring more market tumult and a testing of last year's market lows before clouds clear in the second half. So, while increased volatility should be expected alongside quantitative tightening, we also know that consensus expectations are often proven inaccurate.

There are many reasons to be optimistic stocks will end the year in the black. Inflation is receding, the Fed is close to the end of its tightening cycle, and with the battering stocks took in 2022 more attractive valuations and muted sentiment provide a positive set-up for equities in the year ahead.

In closing, we believe that by the end of 2023, the Fed will be closer to lowering rates either because inflation has slowed dramatically, or because we are in the midst of a mild recession. Central banks around the world would likely follow suit and equity prices would react positively. Looking ahead it is likely that many of the headwinds of 2022 and early 2023 will have dissipated and even morph into catalysts for growth. The future is rarely reached in a straight line, and markets are rarely negative two years in a row – that has occurred only four times in history. The odds favor a positive 2023 return.

Historic Double Downs



Five Reasons to Be Optimistic

1. The Federal Reserve is serious about their mandate and will do everything in their power to quash inflation and not repeat the mistakes of the 1970s.

2. Bear markets increase forward return expectations. Investors during previous bear markets have witnessed positive returns a year later 85% of the time.

3. After every mid term election since 1942, the 12 month returns have been positive.

4. Sentiment is very pessimistic. In fact it hasn't been this sour since 2009. Sentiment is often a contrary indicator.

5. Valuations are not stretched. The S&P 500 is trading at 16.7x expected earnings. The equal weight S&P 500 is trending at 13x, while the small cap S&P 600 is at 12.2x.

Our commitment to *Quality Investing* remains.

Amid a softening economy with rising rates, and softer earnings, we expect investors to favor companies with higher returns, better earnings predictability, and strong balance sheets. In other words, quality companies with earnings visibility and growing dividends should be rewarded. Investing in quality companies has seen us through prior periods of volatility and we are confident this is the right approach for the current environment.

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INDEX AND ETF REFERENCE GUIDE

The Bloomberg Commodity Index is composed of 22 futures contracts on physical commodities. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. The contracts that make up the index include energy, metals, livestock, and agriculture commodities and are equally weighted.

The Russell 2000 Index is a small-cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

The S&P 500 Index is a market capitalization weighted index of large cap stocks.

The MSCI EAFE is international developed markets excluding the U.S.

The MSCI Emerging Market is an index of developing countries.

Index and ETF returns are provided for illustrative purposes only. It is not possible to invest directly in an index. Index performance assumes dividend reinvestment, but does not assume transaction costs, taxes, management fees, or other expenses. Investing outside the United States entails additional risks such as political and economic risks and the risk of currency fluctuations.