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Investment Insights Quarterly

From The Investment Strategy Committee
July 2023

Are We There Yet?

Everyone who has ever taken a road trip has had the experience of someone in the vehicle repeatedly asking the question, "Are we there yet?" That question seems appropriate now as it relates to the U.S. Federal Reserve (Fed) after a 500-basis point increase in the federal funds rate, and a pause after 10 consecutive meetings with an interest-rate increase. The Fed meets the last week of July, and fed funds futures are currently pricing in a 94% chance that the rates will increase again. Could that be the last increase for this cycle?

The Fed currently has a dual mandate of pursuing the economic goals of maximum employment and price stability. On the first goal, the Fed emphasizes that maximum employment is a broad-based and inclusive goal and reports that its policy decision will be informed by its "assessments of the shortfalls of employment from its maximum level." Maximum employment can be thought of as the highest level of employment that the economy can sustain over time and one that is not inflationary. The Fed does not have a numerical target. Instead, it operates under the assumption that maximum employment varies over time with business conditions, demographics, labor market regulations and other factors.

The Fed has targeted 2% core (excluding food and energy prices) inflation (as measured by personal consumption

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expenditures [PCE]) over time as price stability. The Fed has noted that, "following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." This change was made in 2020, after a period when core PCE had been less than 2% almost nonstop for more than 12 years.

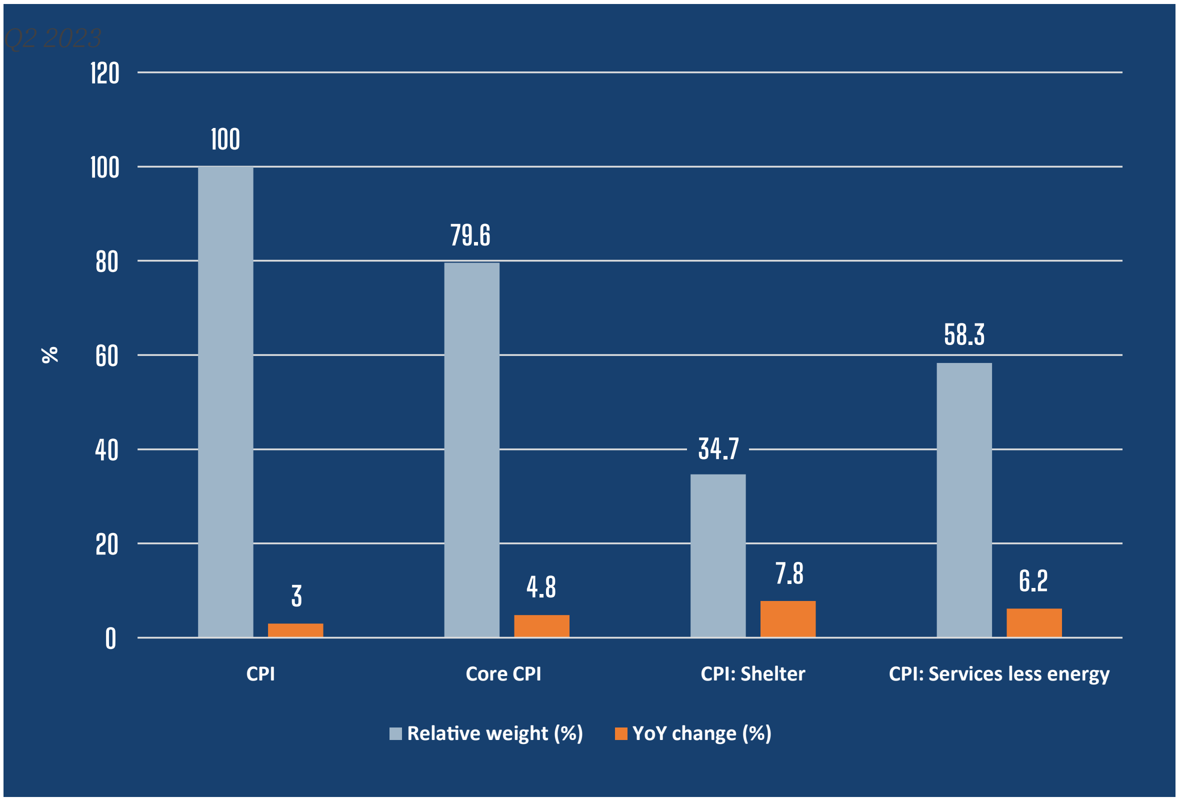
Despite 10 consecutive interest-rate increases—the most aggressive and fastest Fed hiking cycle in decades—the labor markets have not experienced any significant weakening in terms of the unemployment rate or monthly payroll growth. And while real wages have been negative, wage growth itself has been relatively robust. Currently, the unemployment rate is 3.6% after bottoming at 3.4% this spring. In looking at the last six U.S. recessions, they were preceded by or coincident to tighter monetary policy, and the unemployment rate rose 2% or more in those cases. To date, the change in the labor markets is more consistent with a soft landing than a recession.

The conventional wisdom for this cycle is that the Fed would need to tighten aggressively enough to tip the economy into recession to bring inflation back toward the 2% goal. That has not been the case, despite concerns such as the inverted yield curve and the weakness in the index of leading economic indicators (which have been lower for 14 consecutive months). What has happened is that the Fed has made significant progress in the fight to bring inflation under control. It took 15 months for the Consumer Price Index (CPI) to go from under 3% to over 9%. It's taken just 12 months to go from over 9% to 3% for the first time since March 2021.

So, the question remains, "Are we there yet?" The answer, in our opinion, is not quite, primarily due to the work that still needs to be done on the inflation front. June (reported in July) marked the first month of what is expected to be a three-month period of relatively favorable price data. Services (less energy) account for over half of CPI, and monthly gains in that measure remain relatively strong as they do for core CPI.

Our fear is that as fall approaches, the impact of the base effect (relatively "friendly" year-over-year comparisons) lessens and, unless the monthly changes in the inflation data decline meaningfully, it will remain above a level the Fed is comfortable with. That outcome could result in the Fed leaving rates "higher for longer." These concerns are somewhat mitigated by the fact that the cumulative effects of the aggressive tightening are still being felt, and signs that shelter, the largest component of CPI and a lagging indicator, is starting to roll over. Shelter accounts for 35% of CPI and was up 7.8% vs. a year ago in the latest report, after peaking at 8.2% in March (see chart on the following page).

Consumer Price Index: Selected Components Relative Weights and Inflation Rates
June 2023



Source: Haver

To date, the markets appear as if they have embraced the soft-landing scenario that inflation will continue to moderate, the Fed is near a pivot to neutral/easier monetary policy, and that consumers and businesses will be resilient enough to absorb the cumulative effects of tighter monetary policy. We think that the first assumption is strongly influenced by the second, and the third is still unfolding. Futures are priced for one more interest-rate increase at the July meeting, while the Fed's own projection materials from June show a consensus around two additional moves from here. The Fed's rhetoric also indicates additional rate increases.

Concerns that the inflation fight isn't over, coupled with the Fed's views and tendency to overshoot on monetary policy, lead us to believe the odds are greatest of at least two additional rate hikes with the possibility of three more. That leaves us more cautious on equities in the second half of the year—particularly large-cap domestic stocks. Those fears could be somewhat mitigated by this earnings season, which has started out on a positive note. The S&P 500 is up more than 18% year to date, primarily on multiple expansion and narrow participation from the tech sector, leaving it trading at 19 times forward earnings and vulnerable to disappointing news.

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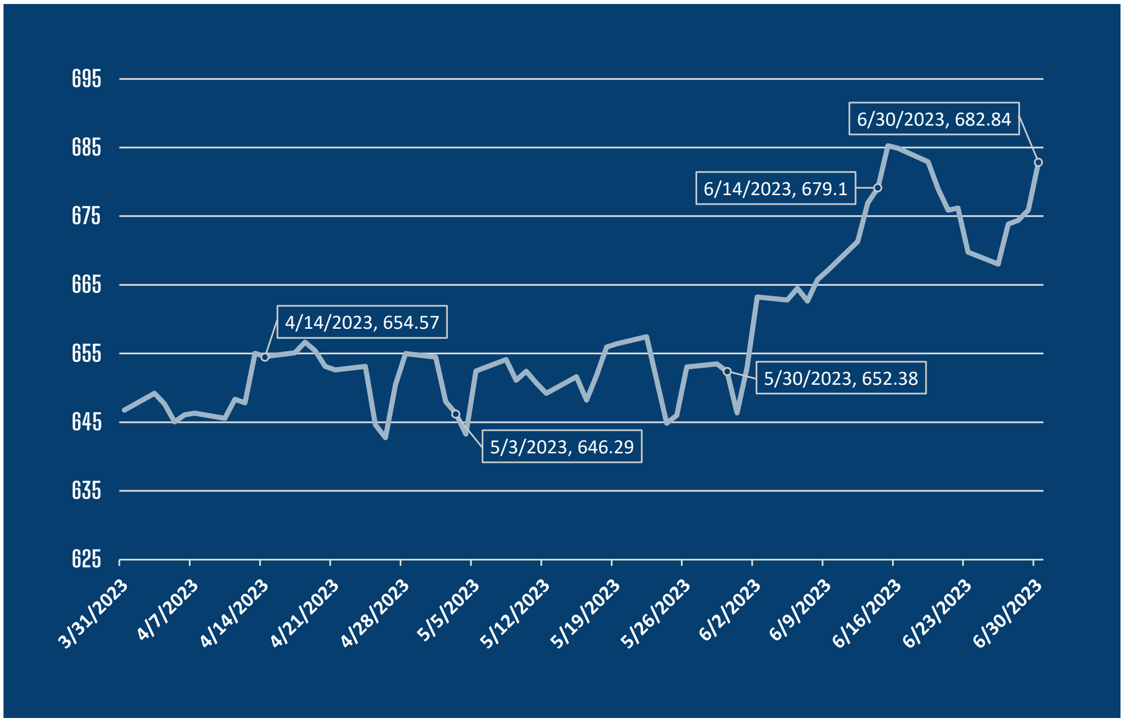
Key Q2 Dates

- April 14 – 1st Quarter S&P 500 earnings and guidance came in better than expected, dampening some of the concerns about the need for a meaningful reset to 2023 consensus estimates.
- May 30 – With a potential default looming on the 5-June "X-date," both sides announced an agreement in principle on 27-May that would suspend the debt ceiling until January 2025 and hold nondefense discretionary spending roughly flat over the next two fiscal years.
- June 14 – Cooler-than-expected May headline CPI and PPI prints bolstered investor sentiment on disinflationary environment.
- June 14 – Fed paused and declined to raise rates for the first time in 10 meetings.
- June 30 – Nasdaq rallied 17% during the second quarter for best start to the year since 1983.

Global Stock Market
MSCI ACWI in USD



Source: Bloomberg

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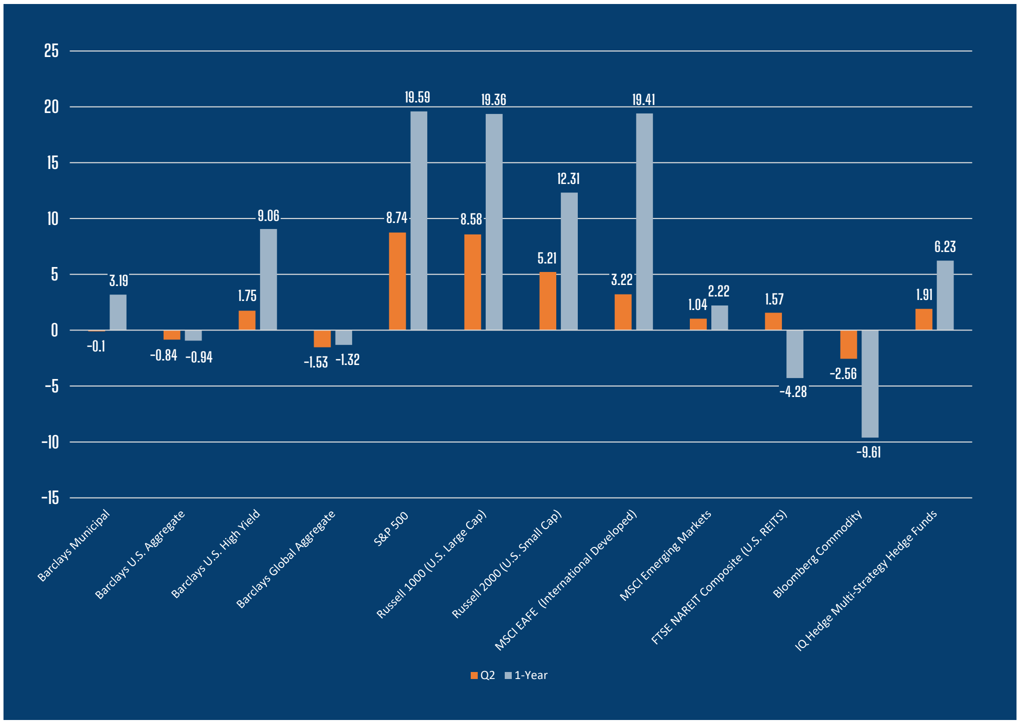
Asset Class Returns

Q2 2023



Source: Conway

Fixed Income

- Yields moved higher in June, leading to modest losses in core fixed income. Municipal bonds bucked the trend, fueled by a rebound in technical factors such as supply and demands.
- Spreads tightened rather significantly last month, and this generated strong gains for high yield, floating rate loans and emerging market debt.
- Bonds outside the U.S. posted mixed results with U.S. dollar weakness being offset by the move higher in interest rates.

Equities

- U.S equities posted strong results in June led by a rebound in small- and mid-cap stocks.
- While there was little dispersion between growth and value within large caps, growth beat value by 35 basis points within small caps.
- Markets finally showed signs of broadening out in June as the Russell 2000 posted a strong gain of 8.1%.
- Non-U.S. equities posted solid gains last month led by European stocks and the weaker U.S. dollar.
- Unlike what occurred in the U.S., large caps beat small caps and value stocks led growth stocks by a wide margin.
- Emerging market equities rose nearly 4% last month led by strength in Latin America and Eastern Europe. China and Asia exhibited relative weakness, and small caps lagged large caps.

Alternatives

- Real estate was very strong in June and is now positive for the year. REITs were aided by a growing confidence that recession could be avoided.
- Commodities continue to struggle despite strength in June. The broad basket is lower for the year and the quarter, with energy (crude oil) particularly weak.

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Fiscal and Monetary Policy Highlights

Fed Funds Futures - Then and Now

Meeting Date	March 31, 2023	# of 25 bps hikes/cuts	June 30, 2023	# of 25 bps hikes/cuts
7/26/2023	4.83%	+.05	5.28%	+0.811
9/20/2023	4.67%	-0.57	5.34%	+1.051
11/1/2023	4.50%	-1.232	5.41%	+1.34
12/13/2023	4.35%	-1.859	5.38%	+1.207
1/31/2024	4.17%	-2.57	5.29%	+0.861

Source: Bloomberg

- After increasing rates at 10 consecutive meetings, the Fed paused in June.
- Expectations of the terminal rate and pivot to easing continue to evolve with major economic data releases. At the beginning of Q2, the market (as priced by futures) expected the Fed to stop with the upper bound at 5% and pivot at the end of 2023.
- By the end of Q2, futures now are priced for a 5.50% upper bound and no likely pivot in 2023.
- In speeches, members of the Federal Open Market Committee continue to indicate they believe rates need to continue to rise to combat inflation.

Business Cycle Indicators

10 Leading Indicators

Monthly Contribution to Index	April	May
Average Workweek	0.06	0
Initial Jobless Claims	-0.01	0.06
Manufacturers' New Orders: Consumer Goods	-0.06	0.01
ISM New Orders	-0.21	-0.28
Manufacturers' Orders: Nondefense Capital Goods	0.06	0
Building Permits	-0.04	0.15
Stock Price Index: S&P 500	0.16	0.03
Interest-Rate Spread: 10-Year Less Fed Funds	-0.17	-0.19
Consumer Expectations	-0.26	-0.29
Leading Credit Index	-0.13	-0.09

Source: Federal Reserve

- Leading economic indicators have been negative for 14 consecutive months (through May).
- This historically has been a good indicator of recession.
- Despite this, market participants are increasingly embracing a soft landing as the most likely outcome.

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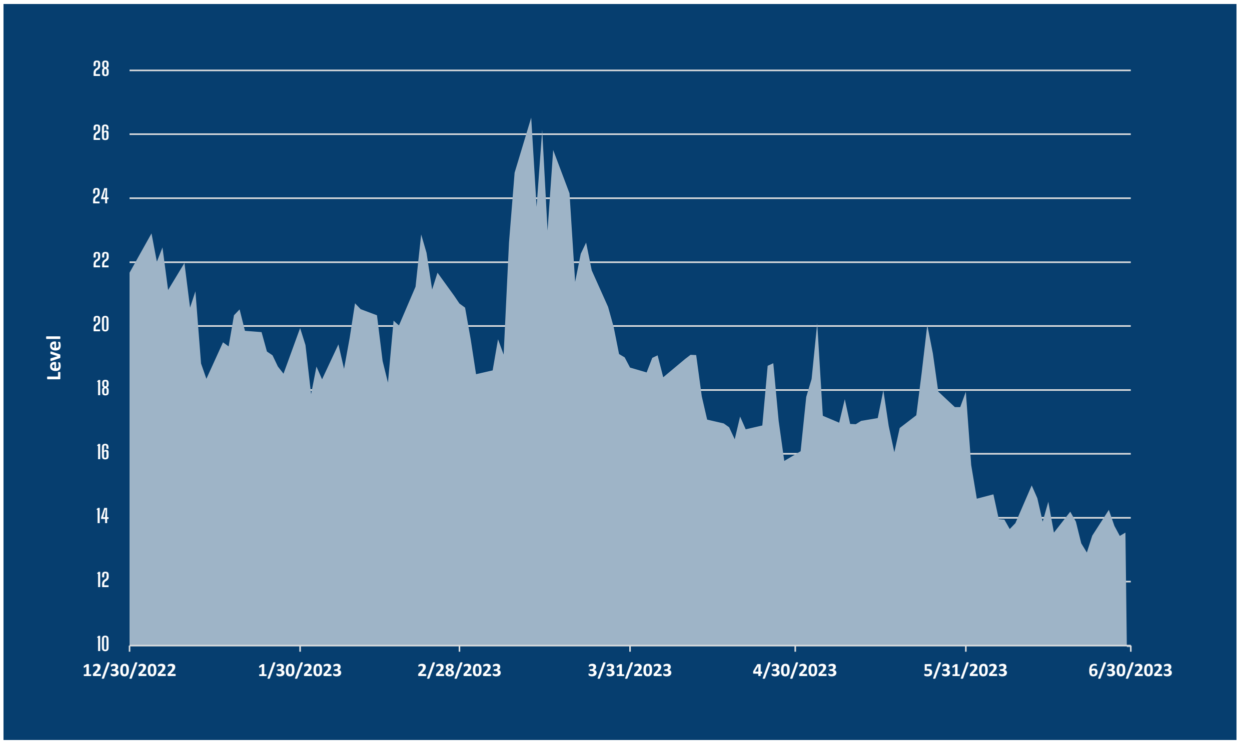
Volatility

Chicago Board Options Exchange Volatility Index (VIX)
2023 YTD



Source: Bloomberg

- The VIX Index is a financial benchmark designed to be an up-to-the-minute market estimate of the expected volatility of the S&P 500 Index and is calculated by using the midpoint of real-time S&P 500 Index (SPX) option bid/ask quotes.
- Market volatility has drifted lower over the first half of the year.
- This complacency persists despite many investors concerns over a recession.

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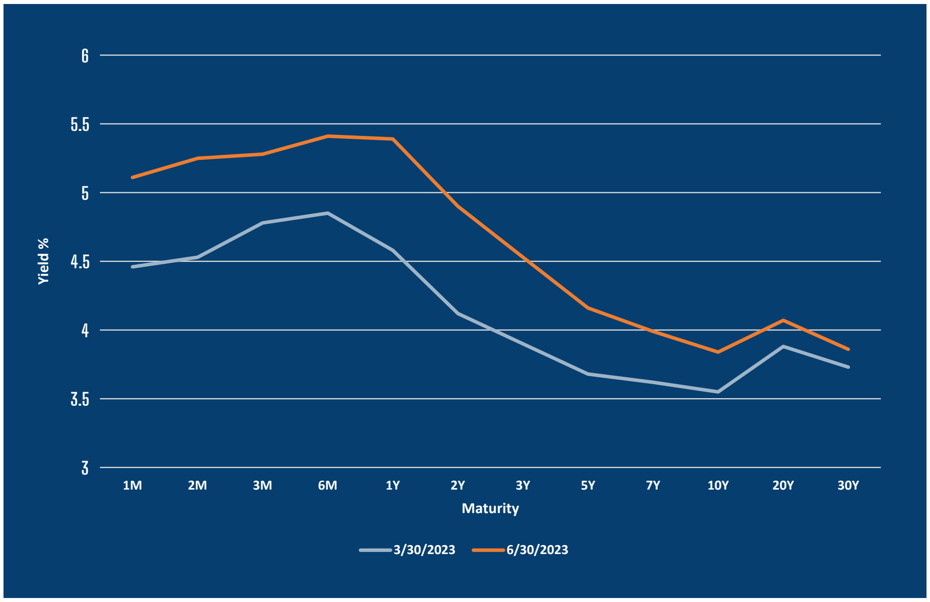
U.S. Treasury Curve

Yields moved higher across the maturity spectrum during the second quarter and the yield curve remains deeply inverted.

Treasury Yield Curve



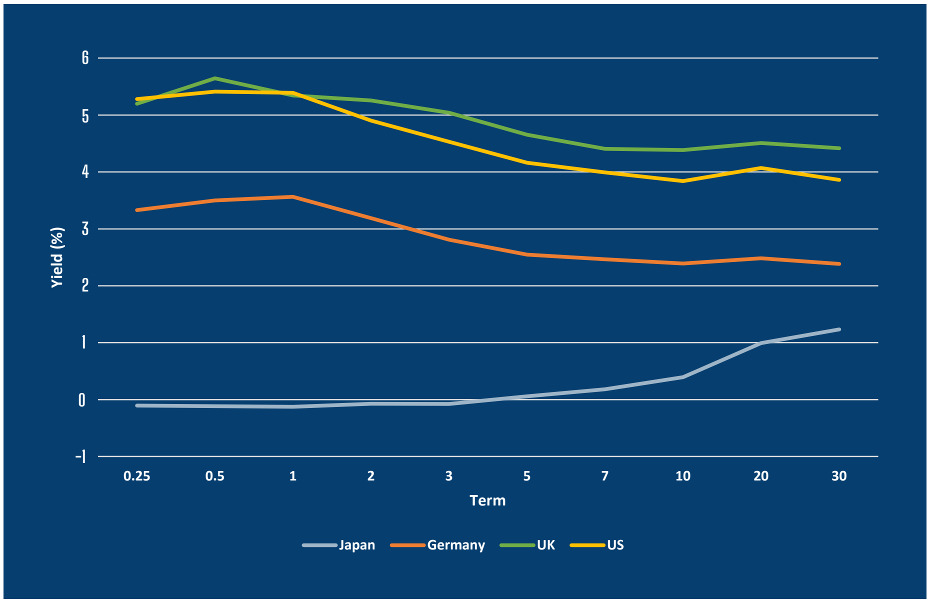
Source: Bloomberg

Government Bond Curves

Yield curve inversions generally deepened across the globe. Japan's sovereign yield curve remains upward sloping in contrast with most other developed countries.

Government Bond Yield Curves

End of Q2 2023



Source: Bloomberg

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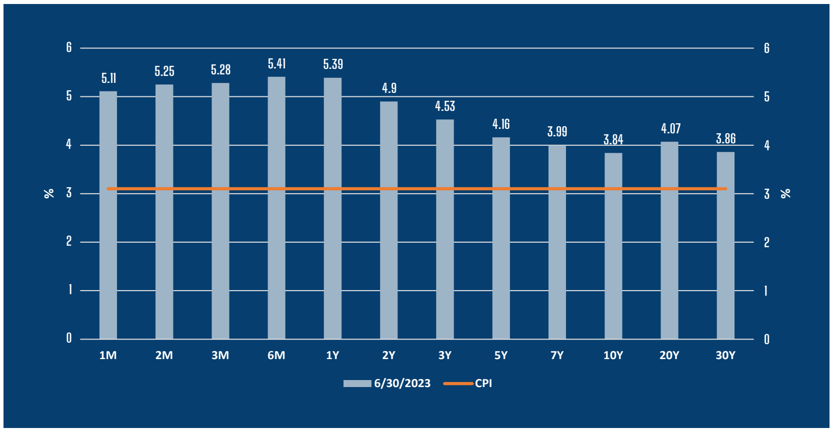
Real Yields

With the increase in bond yields across the maturity spectrum and declining inflation, real yields are now positive across the yield curve. Real yields were negative (financial repression) for more than a decade after the Global Financial Crisis.

Treasury Yields vs. Inflation

Q2 2023



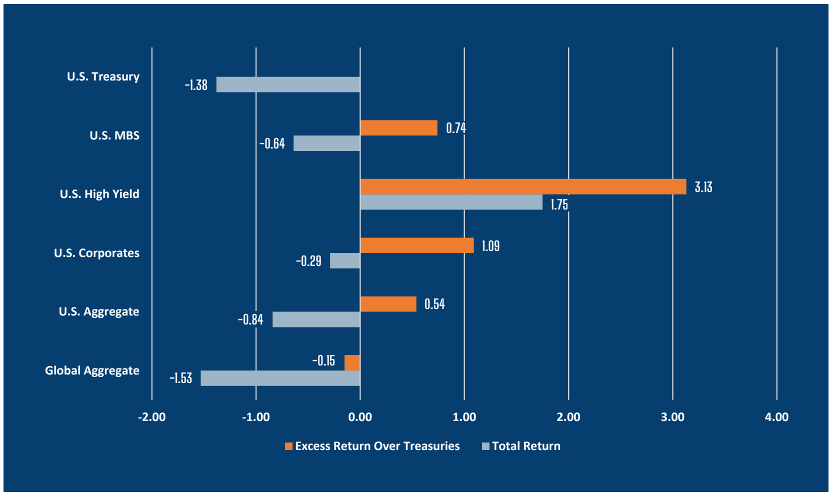
Source: Bloomberg

Fixed Income Performance (Q2)

Yields moved higher during the quarter providing a strong headwind for bond prices. Credit spreads narrowed in sympathy with stronger equities, particularly benefitting high yield bonds. Global Treasuries were the poorest performing fixed income sector.

Fixed Income Performance

Q2 2023



Source: Bloomberg

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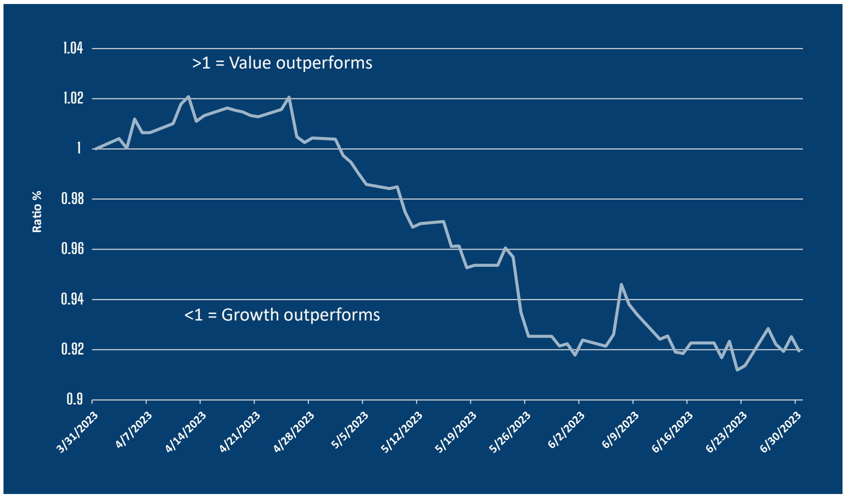
Equity – Value vs. Growth

Growth outperformed value during Q2.

Large-Cap Value/Large-Cap Growth – Q2 2023

Russell 1000 Value/Russell 1000 Growth



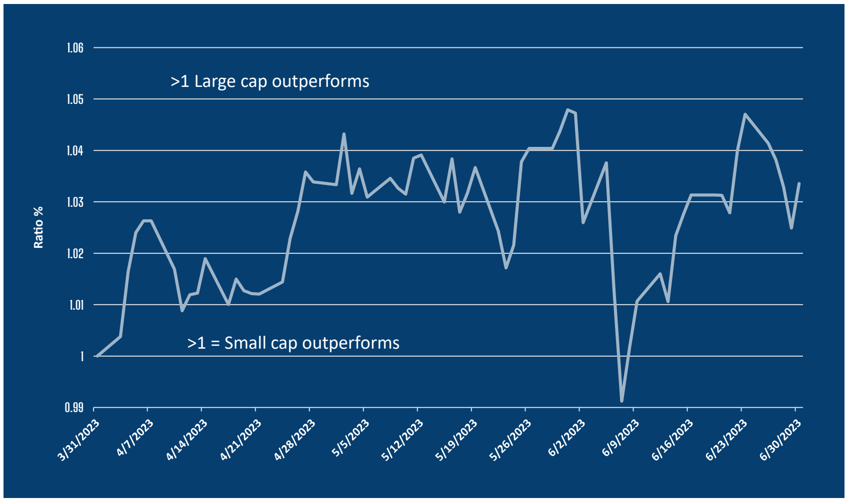
Source: Bloomberg

Equity – Large vs. Small

Large cap outperformed small cap during Q2 as mega-cap growth names continued to lead the market.

Large-Cap/Small-Cap – Q2 2023

S&P 500/Russell 2000



Source: Bloomberg

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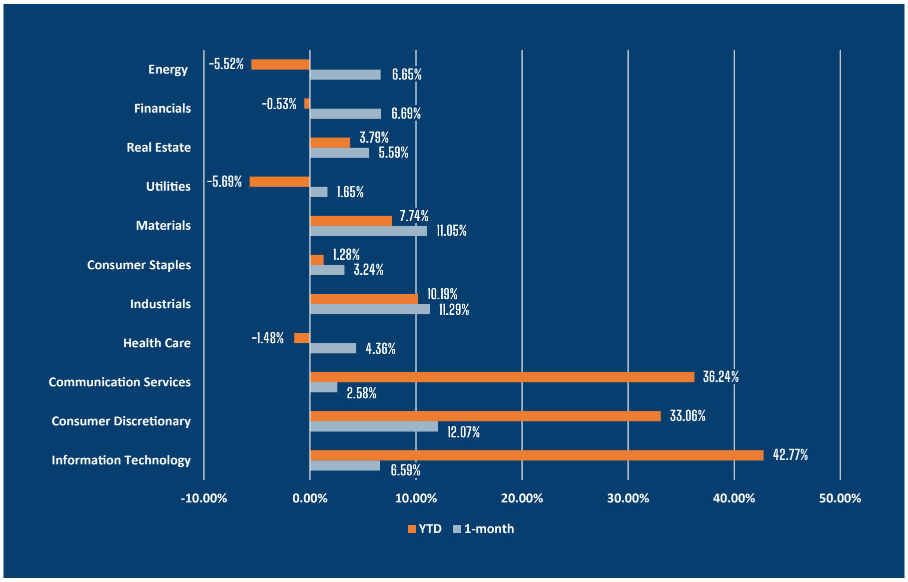
U.S. Equities – Return by Sector

Equities finished the second quarter strongly, with all sectors of the S&P 500 higher in June. Growth sectors lead for the year with interest-rate sensitive and defensive sectors generally lagging the overall index performance.

S&P 500 Sector Returns

Q2 2023

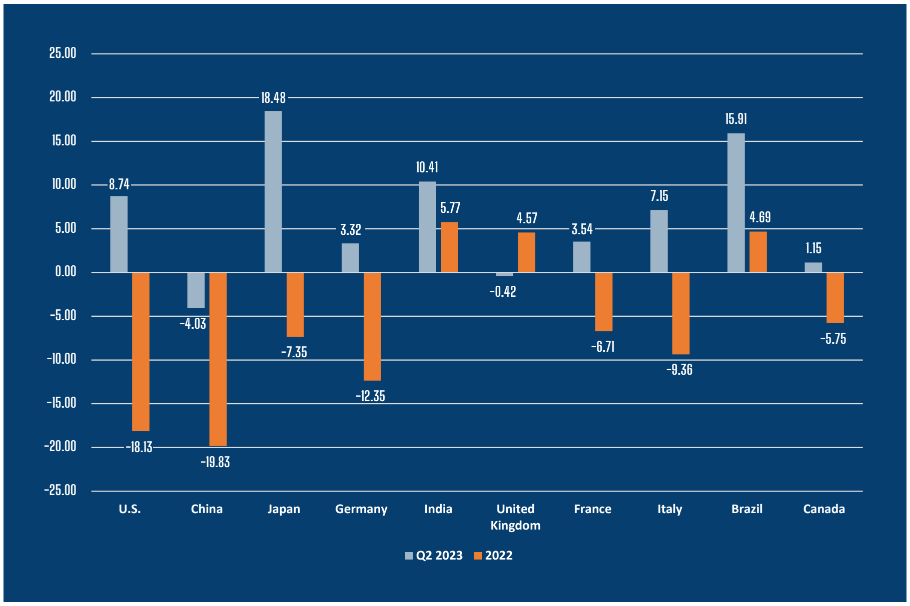


Source: Conway

Country Total Returns (%) – 10 Largest Economies

Global equities were generally higher in the second quarter, led by Japan and Brazil. The U.S. currency was stronger point-to-point for the quarter, providing a headwind for U.S. investors in international equities.

Country Total Equity Market Returns



Source: Bloomberg

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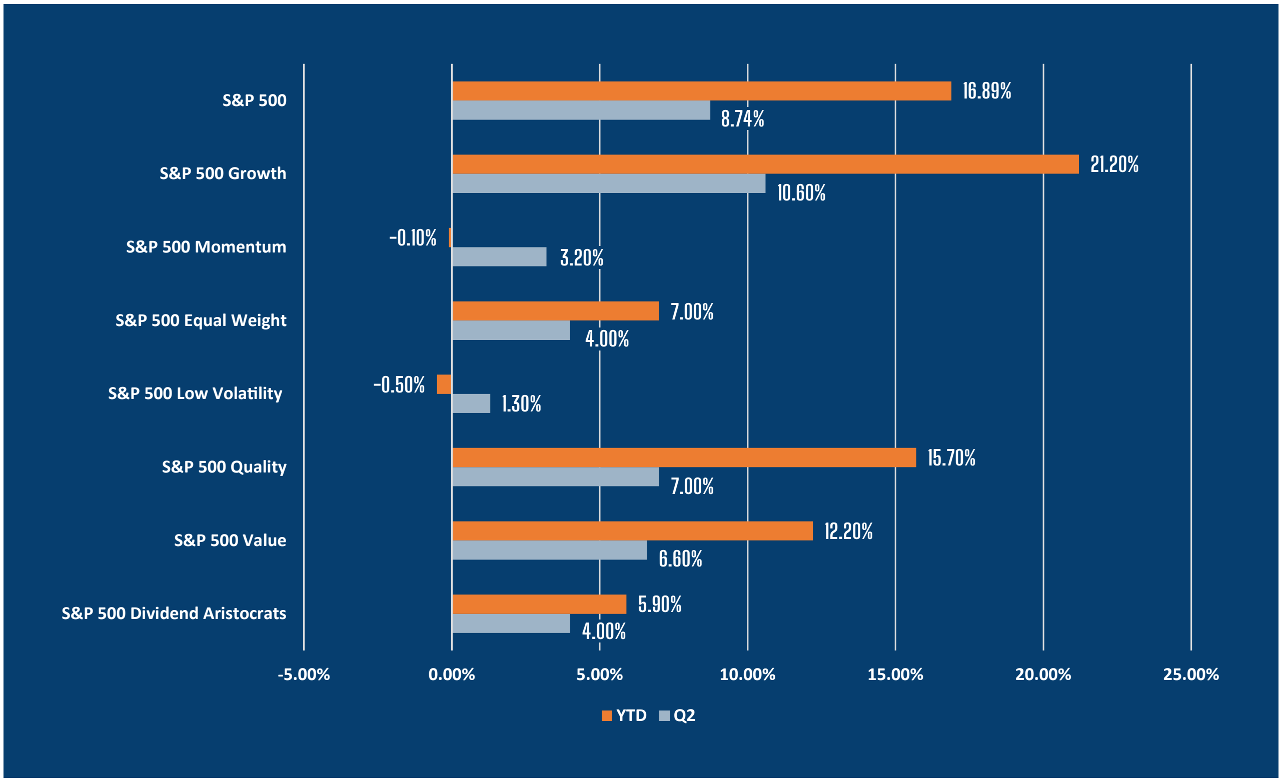
U.S. Equity Factors – Total Return (Q2)

Consistent with the broader markets, most of the core factors were higher in Q2. Mega-cap growth names have led the market this year, and their large weight in the index has driven its large gains as evidenced by the outperformance vs. the S&P 500 equal weighted index.

Total Return: Core Factors
Q2 2023



Source: S&P

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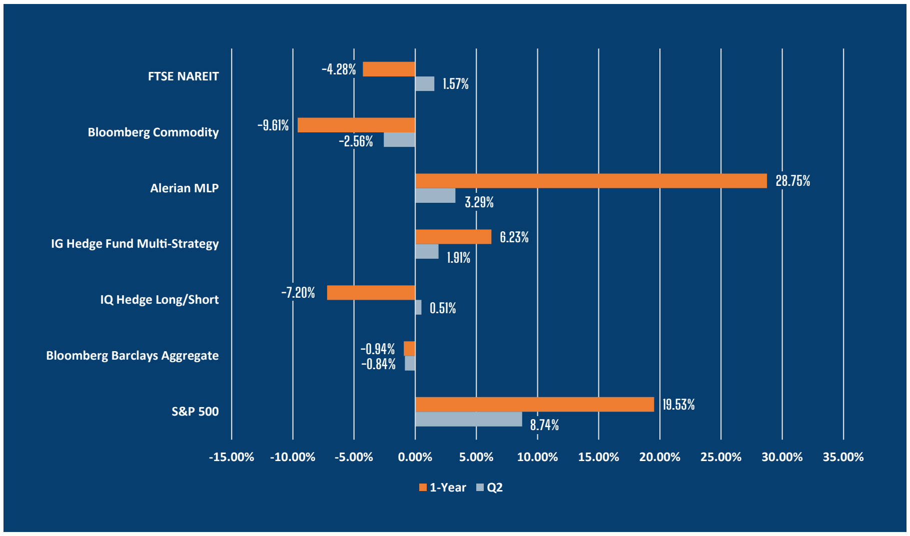
Alternative Returns

Alternative strategies and asset classes were mixed to higher in Q2 and generally lagged domestic equity returns.

Alternative Returns

Q2 2023



Source: Conway

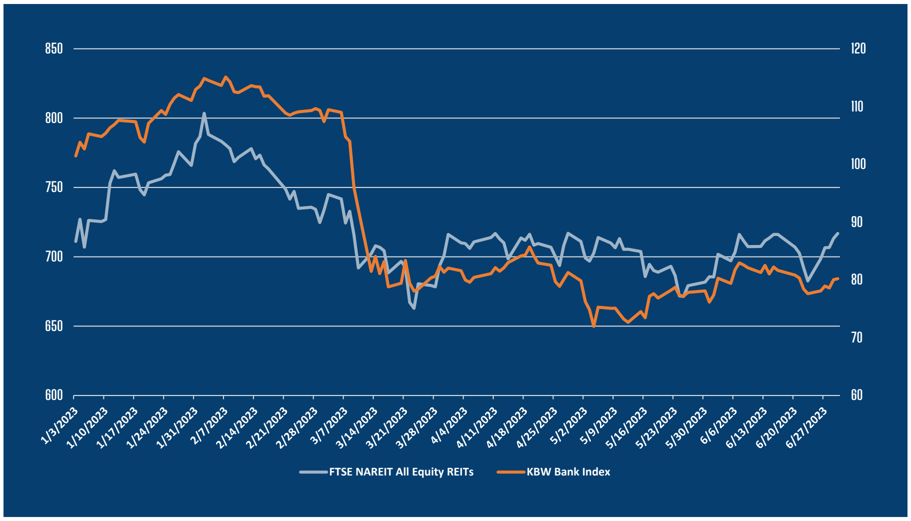
REITs vs. Banks

REITs and the bank index have similar trading patterns this year as concerns over commercial real estate are weighing on banks.

REITs vs. Banks

NAREIT All Equity REIT Index vs. KBW Bank Index

2023 YTD



Source: Bloomberg

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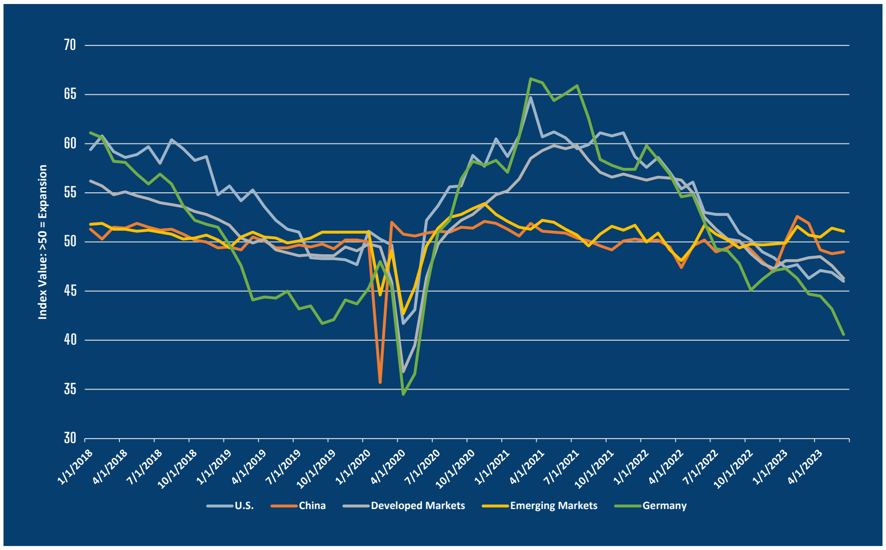
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. Global economies have been generally softening while emerging markets (including China) have shown more resiliency.

Global Manufacturing Surveys



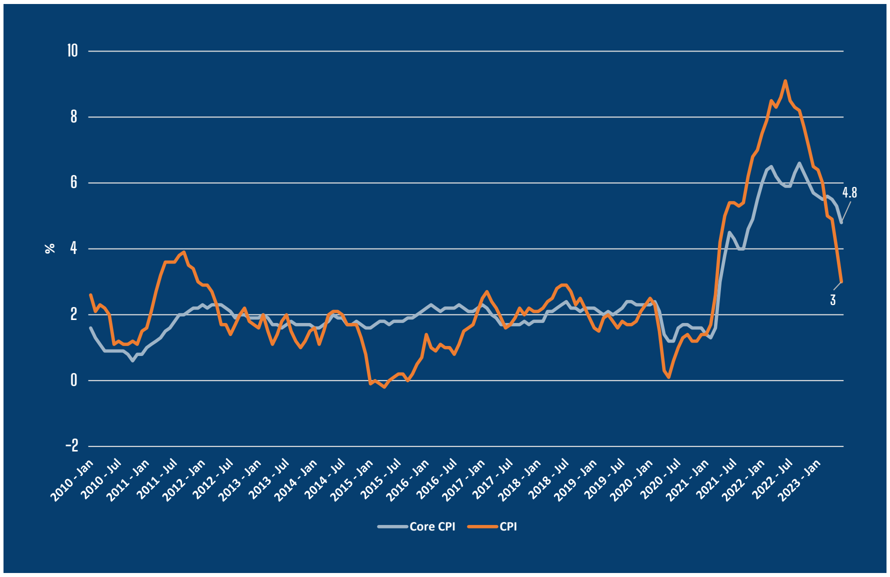
Source: Bloomberg, Haver

Inflation

The decline in inflation from last year's peaks accelerated in Q2. Overall CPI fell below 4% for the first time since March 2021. Core inflation (excluding food and energy prices) remains stubbornly higher than the Fed is comfortable with.

Inflation: Core and Overall

CPI-U Core vs. CPI-U



Source: Haver

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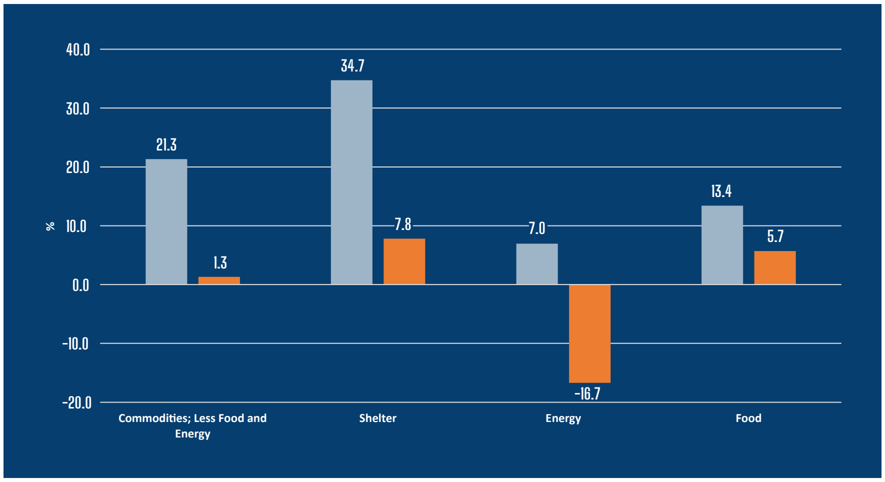
Inflation

Inflation by any measure has rolled over. Shelter remains the largest weight in the CPI and is a lagging indicator.

Selected CPI Components
Weights and YoY Change
Q2 %

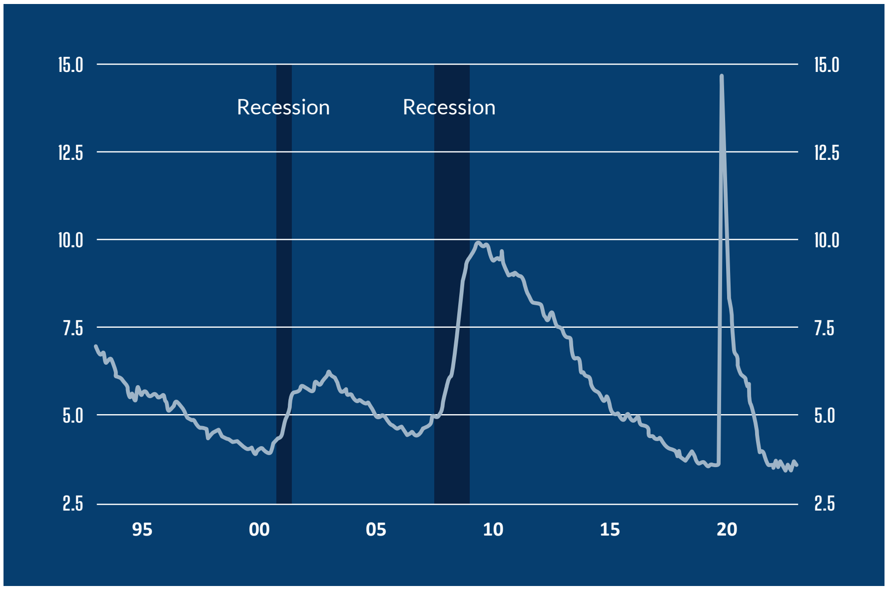


Source: Haver

Employment

The last six recessions were preceded by or coincident to tighter monetary policy, and the unemployment rate has increased significantly (more than 2% in each cycle) in those cases. In this cycle, the Fed has increased rates 5%, and the unemployment rate to date has increased from 3.4% to 3.7%.

Civilian Unemployment Rate: 16 yr. +
SA, %



Source: Bureau of Labor Statistics, Haver

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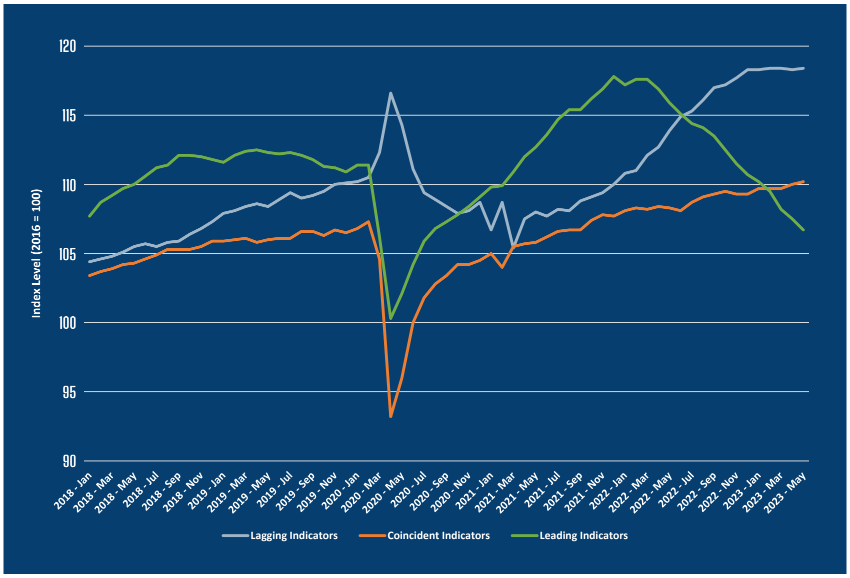
Leading Indicators

Coincident and lagging indicators are still rising while leading indicators (down 14 consecutive months) paint a picture of a slowing economy. Leading indicators are consistent with what has been previously observed in recessionary environments.

Leading, Lagging and Coincident Indicators



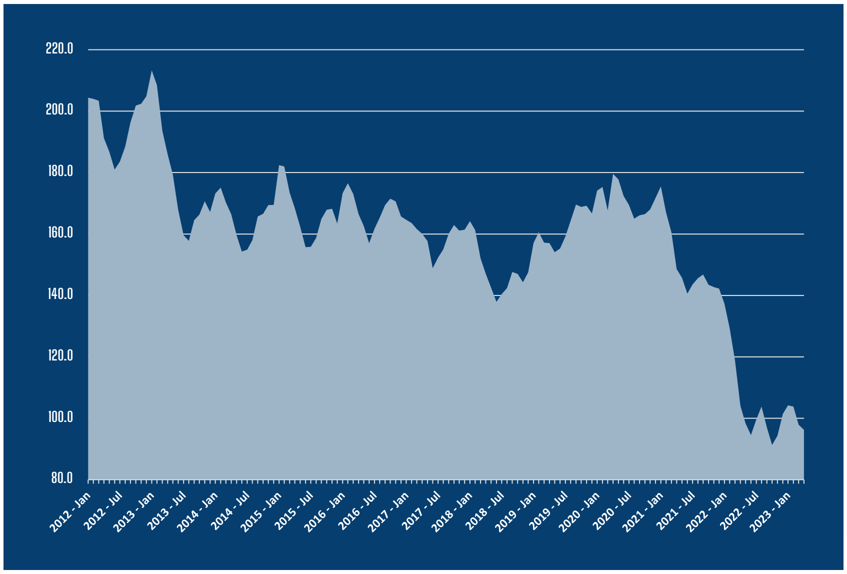
Source: Haver

Housing

Housing affordability has declined as home prices and mortgage rates have increased post-Covid. Housing affordability is the lowest in almost 40 years.

National Association of Realtors Housing Affordability Index

100+ = More Affordable



Source: Haver

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June 30, 2023	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.43%	1.22%	2.33%	3.72%	1.31%	1.53%	0.96%
Barclays Municipal	1.00%	-0.10%	2.67%	3.19%	-0.58%	1.84%	2.68%
BBgBarc U.S. Govt/Credit Intermediate	-0.41%	-0.37%	1.13%	0.52%	-0.88%	1.13%	0.99%
Barclays U.S. Aggregate	-0.36%	-0.84%	2.09%	-0.94%	-3.96%	0.77%	1.52%
Barclays U.S. High Yield	1.67%	1.75%	5.38%	9.06%	3.13%	3.36%	4.43%
S&P/LSTA Leveraged Loan	2.26%	3.15%	6.48%	10.71%	6.31%	4.13%	4.07%
Barclays Global Aggregate	-0.01%	-1.53%	1.43%	-1.32%	-4.96%	-1.09%	0.20%
JPM GBI EM Global Diversified	3.26%	2.51%	7.79%	11.38%	-1.42%	0.29%	-0.56%
U.S. Equity Indices							
DJ Industrial Average	4.68%	3.97%	4.94%	14.23%	12.30%	9.59%	11.26%
S&P 500	6.61%	8.74%	16.89%	19.59%	14.60%	12.31%	12.86%
NASDAQ Composite (Price)	6.59%	12.81%	31.73%	25.02%	11.08%	12.92%	15.02%
Russell 1000	6.75%	8.58%	16.68%	19.36%	14.09%	11.92%	12.64%
Russell 1000 Growth	6.84%	12.81%	29.02%	27.11%	13.73%	15.14%	15.74%
Russell 1000 Value	6.64%	4.07%	5.12%	11.54%	14.30%	8.11%	9.22%
Russell Mid Cap	8.34%	4.76%	9.01%	14.92%	12.50%	8.46%	10.32%
Russell 2500	8.52%	5.22%	8.79%	13.58%	12.29%	6.55%	9.38%
Russell 2000	8.13%	5.21%	8.09%	12.31%	10.82%	4.21%	8.26%
Russell 2000 Growth	8.29%	7.05%	13.55%	18.53%	6.10%	4.22%	8.83%
Russell 2000 Value	7.94%	3.18%	2.50%	6.01%	15.43%	3.54%	7.29%
Non-U.S. Equity Indices							
MSCI World	6.09%	7.00%	15.43%	19.13%	12.71%	9.63%	10.09%
MSCI ACWI	5.85%	6.35%	14.26%	17.13%	11.51%	8.64%	9.31%
MSCI ACWI Ex-U.S.	4.54%	2.67%	9.86%	13.33%	7.75%	4.01%	5.24%
MSCI EAFE	4.58%	3.22%	12.13%	19.41%	9.48%	4.90%	5.91%
MSCI EAFE Growth	3.54%	2.94%	14.47%	20.61%	6.62%	5.80%	6.81%
MSCI EAFE Value	5.67%	3.54%	9.89%	18.25%	12.08%	3.59%	4.76%
MSCI Europe	4.82%	3.13%	14.21%	22.60%	11.36%	5.82%	6.32%
MSCI Japan	4.11%	6.45%	13.24%	18.62%	6.09%	3.51%	5.59%
MSCI AC Asia	3.29%	1.59%	6.77%	5.82%	3.08%	2.04%	5.05%
MSCI EAFE Small Cap	2.93%	0.80%	5.89%	10.71%	6.15%	1.72%	6.59%
MSCI ACWI Ex-U.S. Small Cap	3.49%	2.25%	7.17%	11.50%	8.64%	3.06%	6.17%
MSCI Emerging Markets	3.89%	1.04%	5.10%	2.22%	2.72%	1.32%	3.33%
MSCI EM Asia	2.81%	-0.64%	4.19%	-0.46%	1.56%	1.57%	5.03%
MSCI China	4.02%	-9.65%	-5.39%	-16.69%	-10.13%	-5.14%	3.22%
MSCI EM Eastern Europe	12.17%	20.29%	25.32%	35.65%	-32.08%	-20.27%	-9.89%
MSCI EM Latin America	12.11%	14.30%	18.92%	30.68%	16.99%	5.23%	1.51%
MSCI EM Small Cap	4.60%	6.53%	10.73%	13.93%	14.28%	5.40%	5.02%
MSCI Frontier Markets	2.29%	2.32%	5.57%	-1.87%	4.17%	1.14%	3.02%
Hedge Fund Indices							
IQ Hedge Long/Short	-0.07%	0.51%	0.51%	-7.20%	3.28%	2.30%	--
IQ Hedge Multi-Strategy	1.92%	1.91%	5.01%	6.23%	1.43%	1.77%	2.73%
Real Assets Indices							
FTSE NAREIT Composite	5.65%	1.57%	3.16%	-4.28%	6.17%	4.38%	6.60%
Alerian MLP	2.07%	3.29%	7.52%	28.75%	30.59%	5.59%	0.86%
Bloomberg Commodity	4.04%	-2.56%	-7.79%	-9.61%	17.82%	4.73%	-0.99%
S&P Global Infrastructure	3.03%	-0.12%	3.82%	4.17%	10.65%	5.31%	6.67%
Other							
Oil Price Brent Crude	1.89%	-7.20%	-13.83%	-37.25%	21.75%	-1.00%	-3.21%
CBOE Market Volitility (VIX)	-24.25%	-27.33%	-37.29%	-52.66%	-23.56%	-3.32%	-2.13%

Source: Morningstar

One North Brentwood Boulevard, Suite 850
St. Louis, Missouri 63105
TF (855) 382-1600
www.benjaminfedwards.com

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