

2023 Outlook

Low Expectations Are Easier to Beat



Overview

After a turbulent year in both stock and bond markets, investors are looking forward to a new year that could see many of the headwinds from 2022 start to subside. Nothing is certain, and timing is always a question, but inflation is widely expected to ease at some point next year, and the U.S. Federal Reserve (Fed) would then follow suit by pausing and possibly lowering interest rates.

Before this happens, it looks as though we may see a recession.

Looking at leading economic indicators, the risk of a recession increases midway through 2023. The good news is that we expect a potential recession to be mild. Consumer balance sheets are strong and consumer debt levels are manageable. Also, the labor market, which will likely continue to weaken, remains strong. Currently, there are two job openings for every person looking.

Investors have already largely accounted for the possibility of a recession by discounting asset prices. Economic growth estimates and corporate earnings projections have been lowered, setting the bar for the economy and companies to exceed expectations.

This could ultimately create better entry points for investors for both stocks and bonds. Stock valuations were high going into 2022 and are now near their 15-year averages. If inflation does moderate, companies may choose not to lower prices as much and thus increase their profit margins as their costs may come down, but their prices stay stable.

Bonds also have better risk-and-return characteristics now. Bond indexes that track the overall bond market have lower duration and higher yields. This means lower interest rate risk and more compensation for that risk. If yields continue to rise, the higher yields can cushion more of the price declines. Likewise, if yields fall on lower inflation expectations, bondholders could see price appreciation of their bonds along with healthier yields compared to the start of this year.

Volatility is likely to remain in this Fed rate hike cycle. We will continue to look for clues in economic data such as moderating inflation, and pay close attention to what Fed officials are saying. However, it is possible that we could be nearing the end of the current tightening cycle. Inflation data is backward-looking, and there are signs inflation could slow more quickly in the future, raising the risk the Fed may be overtightening financial conditions.

At-A-Glance

The U.S. economy has seen growth stall since the Fed started hiking interest rates at its fastest pace since the 1970s.

The Fed had to be aggressive to fight inflation, which continued to come in higher than expected for much of the year.

Investors, economists, and analysts were forced to reprice assets and economic forecasts to account for higher interest rates, slower economic growth, and even a possible recession.

Volatility will likely remain into next year as recession risks continue to rise as the Fed is determined to keep a lid on inflation. Investors fear the Fed will overtighten into a slowing economy.

Going forward, expectations for corporate earnings are lower and bond risk-and-return characteristics are better.

If inflation data trends lower than expectations and the economy remains stagnant, we expect the Fed to pause rate hikes and even cut rates, perhaps in the second half of 2023. A pivot like this could provide investors with upside return potential.

Global Economy – Recessions and Central Bank Pivots

In 2023, we expect economic growth to be negative in developed economies. The Eurozone and the United Kingdom are likely to be the biggest drags on global growth, while the United States is expected to fare a bit better. Capital Economics, a UK-based economic research firm, predicts economic growth in the U.S. to be zero for the year. While not what we hope for, it is better than negative. We will talk more about this in both the equity and fixed income sections, but markets are forward looking, and low economic forecasts and expectations are factored into stock and bond prices already, so beating low expectations could be a theme for 2023.

The Fed is expected to continue to hike short-term interest rates in the near term, which may increase the risk of a recession if rates rise more than the economy can withstand. The Fed fears inflation more than a recession, and with the unemployment rate under 4%, it can fight inflation at the expense of the labor market. The Fed will likely remain the center of attention for the first half of 2023. Growing corporate inventories are also making a recession appear more and more likely, as excess inventories have traditionally been a key contributor to recessions. As an example, it was an excess inventory of homes that pressured the economy downward in 2008. In 2023, companies will have to make room for new inventories by selling off existing inventories at cost, or even below cost, and then cutting new orders.



Trying to time a recession is difficult, but if we look at the Leading Economic Index, which is comprised of many forward-looking indexes, it can give us some clues. This index dropped below zero on a year-over-year basis in July, which may be a sign a recession is coming. This tends to precede a recession by about 12 months, which increases the risk of a recession in the middle of 2023. Fed rate hikes also start to have more of an impact on the economy after 12 to 15 months, adding weight to this thesis.

Why a U.S. Recession Should Be Mild

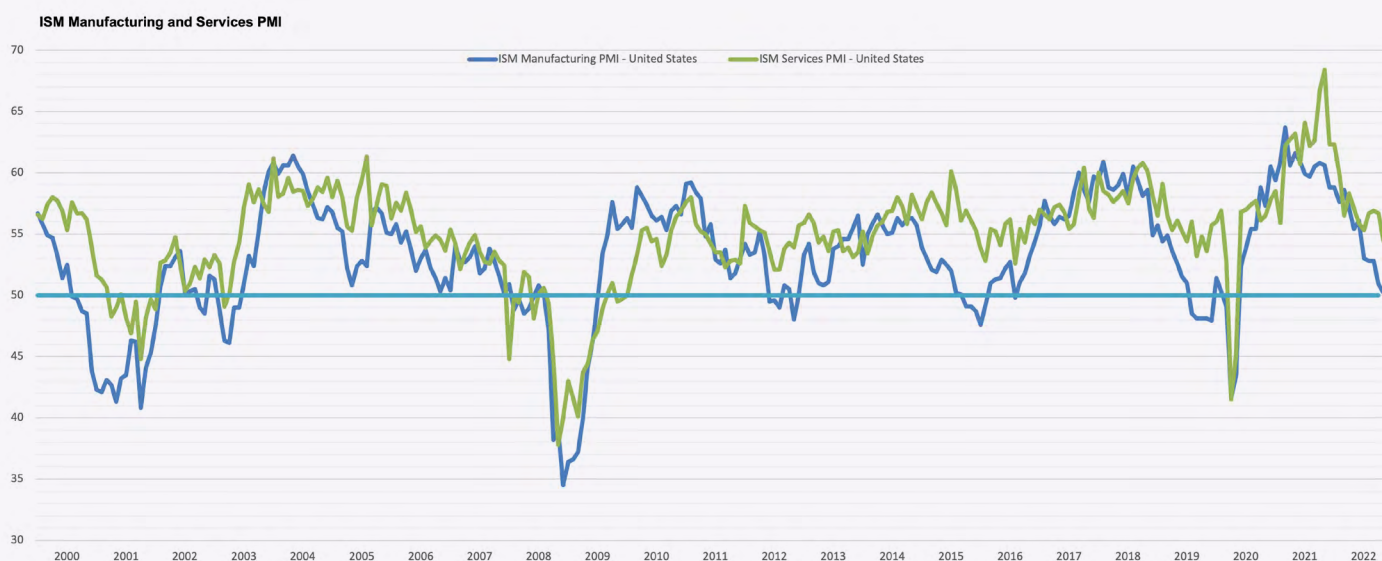
An official recession is determined by a government agency called the National Bureau of Economic Research (NBER) and is defined as a significant contraction in economic activity that is widespread. Whether economic activity is slightly negative, slightly positive, or zero, is probably not relevant to investors unless there is a material impact on corporate earnings. The reality is that economic activity is flat, and these numbers can be revised for up to five years. We don't expect a large contraction, and that is the important point.

There are various reasons why we do not foresee a deep recession in 2023. For starters, unlike in 2008, the balance sheet of homeowners is in much better shape. Homeowners have a lot of equity in their homes and current mortgage loans are not as creative as we saw in the 2000s with no-interest loans. About 90% of U.S. mortgages are now 15-year and 30-year fixed-rate amortizing loans. Debt servicing ratios (both mortgage debt and total debt to disposable income) are relatively low for most homeowners. Many homeowners were able to refinance at fixed, low rates early in the pandemic, so if homeowners remain employed, they should largely be able to afford their mortgages. They also have the most home equity to pull from if needed since the early 1980s, though higher borrowing costs may act as a disincentive to pull equity. With that said, the housing sector quickly reversed momentum after interest rates adjusted from all-time lows to 20-year highs of 7%. New housing starts are slowing fast, and existing home sales are the lowest since 2014, excluding the pandemic shutdown months of 2020.



With a slowing economy, we will see more layoffs, but the good news is that we are starting from a good place. There are roughly two job openings for every person looking for work and the unemployment rate remains low at under 4%. The labor market can absorb some job losses.

Figure 1: Service vs Manufacturing



Source: Cetera Investment Management, FactSet, Institute for Supply Management (ISM). Data as of 10/31/2022.

Another key factor is the weakening of manufacturing, which is near contraction. The 2020 shift from services to goods helped the manufacturing industry, but with local economies reopening, the shift back to services is inevitable. Forward-looking surveys like the ISM Non-Manufacturing Index indicate that service companies are still in expansionary territory and growing. This index has fallen from very high levels, but is still at a healthy level of expansion, as seen in Figure 1. Services make up over 75% of the total economy and labor force while manufacturing jobs as a percentage of the economy have been under 10% since 2007.

There are signs inflation could already be easing, which could make for a mild recession if the Fed hits the breaks in time. Used car prices rose nearly 50% last year but are down significantly in 2022. Year-over-year wage growth is the slowest since August 2021. More importantly, there are signs that asking rents, what landlords are asking for rent to prospective renters, are falling. While asking rents are up over 5% year-over-year, the annual pace is slowing. As we approach the end of 2022, the the rent category of the Consumer Price Index (CPI) is still trending higher. The Fed is already having an impact on the housing market and other areas of the economy, but there is a lag before many of these impacts can be seen in economic data. Oil and wheat prices are off their peaks and global shipping costs are falling. These can be seen as leading indicators of inflation, but there is also a lag as these factors make their way through the economy. In the previous chart, we spoke about manufacturing vs. service industries. We have seen more inflation in goods, but that is decelerating sharply now. Inflation in the service industry is accelerating, but at a slower pace.

Will the Fed Eventually Pivot?

Stock markets rallied for part of the third quarter in 2022 as hopes for a Fed pivot—in other words, a pause in rate hikes—materialized. Investors thought that inflation might be easing but were premature in their hopes. However, this thesis could still come to fruition in the latter half of 2023 if the Fed thinks that inflation is under control and starts to worry its actions could unnecessarily damage the economy. If this happens, the Fed could pause or even start to cut interest rates to spur economic growth once again. Before this happens, we could see investors put too much weight into a single inflation reading or Fed comment, pushing stocks higher, only to see them fall again. One economic reading or one Fed official will not determine the Fed's path forward and investors need to be patient.



A Global Recession Looms

While the NBER is responsible for defining a recession in the United States, a global recession is defined by the International Monetary Fund (IMF). Informally, the IMF has defined a global recession as annual economic growth below 2.5%. Capital Economics is forecasting 2023 global growth to be just 1.5% in 2023, which would indicate a global recession. The Eurozone and United Kingdom are forecasted to experience -1.8% and -1.5% growth, respectively. Japan is a bright spot for developed countries with projected growth of 1.3%. Emerging market countries are forecasted to grow 2.7%. China is a significant component of emerging markets and is expected to see growth of 2.5% (not using official Chinese data). The United States is projected to fare better than Europe because it is less dependent on energy and food from Eastern Europe.

We painted a picture of slow to negative growth next year, but not a severe contraction in economic growth. Risks to this mild recession outlook are: 1) inflation not showing signs of easing, and 2) the Fed continuing to tighten to contain this inflation. Additionally, new COVID strands and the public health responses to them remain a concern, especially in China which still has not abandoned its zero-COVID policies. Geopolitical events are always a risk, which may be heightened by the Russian invasion of the Ukraine and Chinese rhetoric around Taiwan.

On the positive side, much of this slow growth and pessimism is factored into economic forecasts, which leaves room for positive economic surprises. As a matter of fact, we are already seeing evidence of this in 2022. The Economic Surprise Index bottomed in June of 2022, and we are now seeing more positive economic surprises than negative economic surprises as we enter the new year (Figure 2).

Figure 2: Economic Surprise Index



Source: Cetera Investment Management, FactSet, Citi. Data as of 11/11/2022.

Equity Markets: Lower Expectations Are Easier to Beat

We've discussed low expectations and how economic data is starting to come in above expectations. Equity markets are no different. Earnings estimates have been revised down as investors start to anticipate a possible recession. The good news is that lowering the bar makes it easier to exceed expectations and that's what tends to drive stock returns.

If our base case scenario of a mild recession occurs, we could see equities fare better than expected. Since stock markets may have already factored in probabilities of a potential recession, a mild recession would be a relief. Keep in mind economic data and recessions are backward-looking and markets are forward-looking. We may not know we are in a recession until after the recession has passed and we may not even know it has passed at that time. And it is possible for stock markets to rise in the middle of a recession because investors are looking forward.

Comparisons could be made to 2001 and the dot.com bubble. In the late '90s and early 2000s, earnings estimates were revised higher on excitement around new technologies and price-to-earning (P/E) ratios swelled. The S&P 500's forward P/E ratio climbed to over 25 (Figure 3). After the "irrational exuberance" ended, to quote former Fed Chair Alan Greenspan, earnings estimates were revised lower and below the initial levels before the dot.com era began. P/E ratios are a better predictor of long-term return than short-term ones.

Figure 3: Forward Price/Earnings Ratios



Source: Cetera Investment Management, FactSet, S&P Global. Data as of 11/11/2022.

Similarly, when COVID-19 emerged valuations were pushed over a 24 P/E ratio after trillions of dollars in broad-based stimulus were authorized. Savings rates and spending on goods surged as a result. Additionally, low mortgage rates allowed many homeowners to refinance their mortgages close to 3%, giving them more discretionary income. Future earnings were pulled forward and valuations rose like they did during the dot.com bubble. Now, stimulus money has dried up and mortgage rates have climbed above 7%. Savings rates have plummeted. Earnings estimates need to be revised lower to reflect this new environment and that's why stock prices have fallen so much in 2022. It is quite possible these estimates will fall below pre-pandemic levels though, setting up a better backdrop for equity returns in 2023.



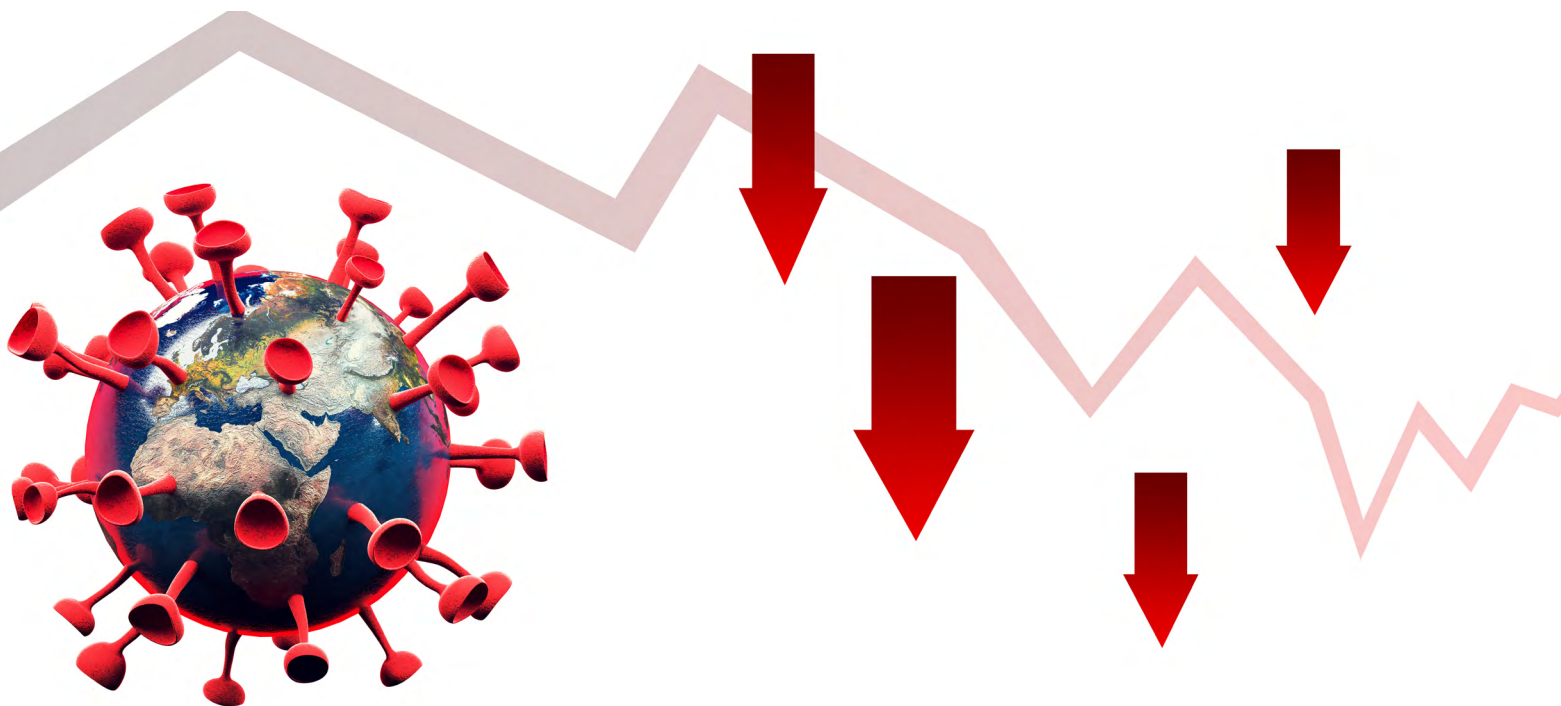
Inflation and a strong dollar continue to take their toll. Earnings growth has slowed for five straight quarters and FactSet has projected fourth-quarter growth to be negative. Inflation starting to ease, and a weakening dollar could be a tailwind for companies and their bottom lines. When inflation slows, companies will likely not drop their prices and give the entire benefit of lower input costs to customers, and this will increase corporate profit margins.

If we look at valuations from a market cap perspective, smaller company stocks are priced much more attractively. While large companies like those represented in the S&P 500 are trading near their 15-year averages relative to their earnings, smaller company stocks in the MidCap 400 and SmallCap 600 Indexes are near their 15-year lows.

Another factor to consider when investing by company size is revenue exposures. For instance, we highlighted that countries in Europe have lower economic growth expectations. S&P 500 companies get 13.6% of their revenues from Europe and nearly 40% of their revenues are from foreign sources (7.2% from China). By contrast, the S&P 600, which represents smaller companies, only gets about 20% of its revenues from overseas (6.1% from Europe and 2.8% from China). While valuations look attractive in the small cap sector, if the dollar does reverse and weaken, this could help larger companies more.

Looking at companies based abroad, international stocks have attractive valuations, too. The MSCI EAFE index, which represents international developed country stocks (excluding Canada), has P/E ratios near 15-year lows. Emerging Markets are also near 15-year lows. U.S. investors would once again benefit from a weakening dollar by investing in these international stocks. If we look at the MSCI EAFE as of the third quarter of 2022, the index was down close to 27%, but a little under half that loss was related to currency impacts from a stronger U.S. dollar.

Overall, though risks in international markets remain higher than in U.S., markets with Europe's reliance on Russian and Ukrainian energy and food, and the drag caused by China's zero-COVID policies. Additionally, the Fed will likely pause its rate hikes before the European Central Bank and the Bank of England do the same, because inflation pressures are higher in Europe. We still recommend diversification internationally and if some of these risk factors are mitigated, we could eventually see outsized returns abroad. We expect continued stock volatility as the Fed navigates this interest-rate cycle and investors continue to be hypersensitive to Fed officials' comments and economic data.



Fixed Income: Improved Risk-and-Return Dynamics

Bonds are on pace to suffer their worst year on record. While most widely used bond indices go back to the mid-1970s, we examined less followed indexes that go back to the mid-1920s and got the same results. Whether looking at intermediate-term bonds or long-term bonds, 2022 looks to be the worst year on record. For context, 1994 was previously the worst year on record for the Aggregate Bond Index. The total return that year was -2.9%. As of 10/31, the aggregate bond index had a year-to-date total return of -15.7%.

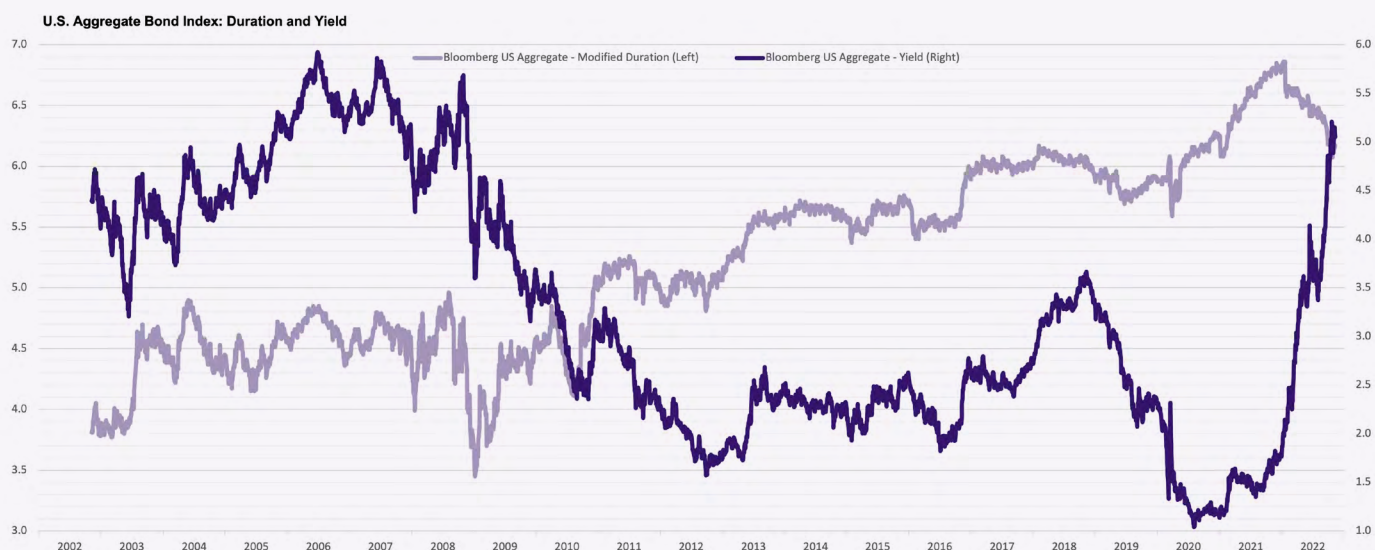


Understanding how this happened can help us understand why the future for bonds looks a lot brighter. During the pandemic and the 2008-09 Great Financial Crisis, the government issued many long-term bonds to fund trillions in stimulus support. This bond issuance caused duration in bond indexes to rise because indexes encompass the whole universe of bonds and there were suddenly more long-term bonds in the bond universe. Duration is a measure of sensitivity to interest rates. In simple terms, if a bond index has a duration of six years, a one percent rise in yields will cause a 6% decline price in the index. The opposite is true if yields fall, bond prices rise. So as the government issued more long-term bonds, the interest-rate sensitivity of the indices grew.

Additionally, the Fed started to engage in quantitative easing to keep mortgage and borrowing costs low to stimulate the economy through the Great Financial Crisis and the pandemic. This meant the Fed was buying long-term bonds to keep bond yields low. The result was a less than ideal risk-return relationship in bonds—high interest-rate sensitivity with low reward (yield) for taking that risk. The duration of the Aggregate Bond Index grew from 4.5 years before the Great Financial Crisis to nearly seven years at the height of the pandemic. Meanwhile, the yield went from over 5% prior to the Great Financial Crisis to around 1% at the height of the pandemic. Figure 4 highlights the recent move in duration and yields.

In 2020, with a duration close to 6 years and a yield close to 1% at the low, the Bloomberg Barclays Aggregate Bond index, which many bond funds and ETFs are benchmarked against, had increased risks. The index's yield soared above 5% recently as bond investors demanded more yield for increasing inflation. This led to significant losses this year.

The good news is that risk and return dynamics have now changed. Duration is down to six years and the yield to maturity is over 6%. If yields rise another 1%, the yield currently being generated can better buffer the depreciation in price. If inflation starts to ease, we could see yields fall and bond investors would benefit from the appreciation in bond prices in addition to collecting a healthier yield.

Figure 4: Falling Duration and Rising Yield

Source: Cetera Investment Management, FactSet, Bloomberg. Data as of 11/11/2022.

We previously recommended shorter duration bond portfolios for reasons discussed above, but as this risk/return relationship has changed, we now recommend adding more duration to portfolios, although we still suggest being underweight relative to the benchmark. The duration is still relatively high, and the yield curve is flat to inverted, so investors can benefit with more yield while taking less interest-rate risk.

How can this be? The Treasury yield curve is currently inverted, meaning shorter-term bonds like two-year Treasury bonds have higher yields than long-term bonds like 10-year Treasury bonds. Longer-term bonds inherently carry much more interest-rate risk, yet their yields are less. When this happens, it could be a sign a recession is approaching, which is consistent with what we outlined earlier. The Treasury bond market is signaling the same thing.

However, credit markets might point to a more optimistic outcome. Treasuries do not have default risk because they are guaranteed by the United States government. Corporate bonds are merely guaranteed by the companies that issue them and if the issuing company goes bankrupt, the bondholders become creditors and usually only get a portion of their money back. For this added risk, corporate bond holders receive an additional yield spread over Treasuries, referred to as credit spread. The more risk the company has of going bankrupt, the higher the spread, so below-investment-grade-rated companies offer the most yield for their bonds—also the most risk (floating rate loan or bank loan issuers also tend to have below-investment-grade ratings).

If we look at high-yield spreads, they are not signaling a deep recession. Currently they are under 5%, while during the dot.com bubble, the Great Financial Crisis, and the pandemic, they breached 10%, 20% and 8%, respectively. The current level is elevated from recent levels, but not enough to suggest a deep recession. With that said, if a recession does occur, spreads probably have more room to widen. Like duration rising, widening credit spreads would cause credit-sensitive bonds to fall in price. For this reason, we like higher grade corporate bonds, and are more cautious on below-investment-grade bonds (high-yield bonds). We should note, however, that there are some supply and demand issues in the high-yield market. High-yield issuance has been low, so there is a lack of supply. This causes high-yield investors to bid up the supply that comes to market, which lowers high-yield bond yields. So, one could make the argument high-yields spreads should be wider, but lack of new issuance is keeping a lid on spreads. Investment-grade bonds have seen more spread widening, so this supply and demand phenomenon does appear to be impacting the high-yield universe.

Lastly, we will discuss municipal bonds. These bonds can carry tax benefits and are issued by municipalities and funded by specific projects or the general taxing authority of the municipality. They tend to have lower yields than Treasuries because of their extra tax benefits. If we compare AAA Muni bond yields to Treasury yields, it can give us a valuation metric to determine if municipal bonds may be relatively overpriced or underpriced. Currently, the ratio suggests that municipal bonds are less attractive than their 10-year average. Municipal bonds are typically bought by retail investors, so supply and demand is even more important. Demand has been weaker for the category which has seen outflows of over \$100 billion year-to-date. Offsetting some of the weaker demand, supply has also been weaker than last year. Municipal bond issuance is down 16% from 2021. Municipalities saw fundamentals strengthened by the pandemic as many municipalities received stimulus money. Overall, municipal bonds can still make a lot of sense for taxable accounts. While we painted a broad overview of this market, there are a lot of individual factors to consider, so this category can be more individualized and discussed with your financial professional.



In summary, while bonds are having a rough year, the future is looking brighter. This asset class should benefit from higher bond yields and lower duration.

While the yield curve is inverted, pointing to a possible looming recession, credit spreads are not necessarily suggesting that. We remain cautious on high-yield bonds in case a recession does develop. While investors may be tempted to shun bonds after such a historically bad year, the risk and return relationship has changed and with this backdrop 2023 could be a good year for bonds if inflation eases and the Fed pivots. Bonds can also protect against equity volatility, so they should be evaluated in the context of a well-diversified portfolio.

The Bottom Line

When summarizing the year and the investment landscape for 2023, it is easy to be pessimistic. Stocks fell into a bear market in 2022 and bonds are on pace for the worst year on record as of this writing. We are still in a Fed rate hike cycle and a possible recession could be looming. With that said, stocks and bonds have already factored in much of this bad news and expectations have been lowered. Economic growth and earnings estimates have been lowered. This has led to lower stock market valuations which could prove to be better entry points for investors. Duration in bond indexes has fallen and yields have risen. If inflation starts to ease, the Fed may pause or even reverse course and lower rates. This perhaps has not been factored into markets.

While not necessarily a rosy economic picture, with a possible recession on the horizon, investing when there is uncertainty can prove more rewarding than when investing at the peak of a bull market. Expectations are low, so beating those expectations could prove easier. While no one has a crystal ball and history doesn't always repeat itself, the last six bull markets started with outsized gains in the first year, Figure 5.

Making our way through this Fed rate hike cycle, volatility is likely to remain into next year. We will continue to look for clues in economic data such as moderating inflation, paying close attention to what Fed officials are saying. We could be nearing the end of this Fed tightening cycle. Inflation data is backward-looking and there are signs inflation could slow more quickly in the future, raising the risk the Fed may be overtightening financial conditions.

While we expect volatility to remain in both stocks and bonds, stocks have better valuations and bonds have better risk and return characteristics compared to the start of 2022.

Figure 5: The First Year of the Last Six Bull Markets

Bull Market Start Date	1-Year Return (%)		
	Large Cap	Mid Cap	Small Cap
Aug-1982	68.3	73.2	99.1
Dec-1987	25.5	27.0	33.8
Oct-1990	36.2	44.1	50.4
Oct-2002	37.7	52.0	60.9
Mar-2009	72.8	94.5	93.5
Mar-2020	83.2	101.1	120.8
Average	53.9	65.3	76.4

Source: Cetera Investment Management, Morningstar, Russell Investments. Returns shown are total return, which includes dividends. Indices: Large Cap (Russell 1000 Index), Mid Cap (Russell Mid Cap Index), and Small Cap (Russell 2000 Index).

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Mutual Funds and Exchange-Traded Funds are sold only by prospectus. Investors should consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained directly from the company or from your financial professional. The prospectus should be read carefully before investing or sending money.

The return and principal value of fixed income securities fluctuate with changes in market conditions. If bonds are not held to maturity, they may be worth more or less than their original value.

The S&P SmallCap 600 seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

The MSCI EAFE is designed to measure large and mid cap equity market performance of 21 developed markets, including three regions (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted, covering 85% of the free float-adjusted market cap in each of the 21 countries

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life of around 8.25 years. This total return index is unhedged and rebalances monthly.

The Russell 1000 index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.

The Russell 2000 index is comprised of 2000 small-capitalization companies. It is made up of the bottom two-thirds in company size of the Russell 3000 index

The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe and is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.