BRYN MAWR TRUST
A WSFS COMPANY

The Storm Before the Calm

2023 Economic & Market Outlook Summary – January 14

Market catalysts are often hard to recognize without the benefit of hindsight (i.e., the pandemic). However, we believe the most historically reliable market signals suggest a difficult environment in 2023. 2022 was an inflation and interest-rate-driven bear market. Although both will remain front and center, investors are shifting from worries about rising inflation and interest rates to worries about economic and earnings growth.

On the following pages, you will find two tables summarizing our overall outlook as well as our investment positioning. Afterward, we provide a more detailed analysis of our outlook along with the impact on our portfolios.

Summary of Macroeconomic Views

BUSINESS CYCLE INDICATORS	ASSESSMENT	TAKEAWAY
ISM Manufacturing PMI	Key leading indicator with high correlation to earnings. Broke into contractionary territory in November. Meanwhile, weaker New Orders paired with growing Inventories will likely put downward pressure on the headline number in 2023.	NEGATIVE
ISM Services PMI	On more solid footing than manufacturing, as consumer spending shifted from goods to services. However, we think the Services portion of the economy will decelerate as the impact of higher interest rates filters through the economy.	NEUTRAL
Average Hours Worked	Manufacturing weekly hours are trending lower, a sign that layoffs could be forthcoming as cutting hours is typically the first step toward eventual layoffs.	NEGATIVE
Jobless Claims	Initial jobless claims remain at a stubbornly low level despite a recent move higher in Q4. Thus far, technology layoffs are not showing up in the data, but this is something worth watching going forward.	NEUTRAL
Durable Goods Orders	New orders for Nondefense Capital Goods Excluding Aircraft continue to trend higher.	NEUTRAL
NAHB Housing Market Index	Homebuilder confidence is in free fall, as rising rates and high labor costs weigh heavily on housing demand.	NEGATIVE
Yield Curve	Yield curve - our preferred measure being the 3mo/2yr - is in negative territory. An inverted yield curve like we are seeing today is typically a harbinger for an economic recession.	NEGATIVE
University of Michigan Consumer Sentiment	With a focus on personal finances, this consumer measure has collapsed because of high inflation. This signals softer consumer demand as higher prices, and a lower stock market, weigh on confidence.	NEGATIVE
Conference Board Survey	With a focus on employment, a robust labor market makes this measure look more resilient. However, the labor market is often the final area of weakness prior to a recession. For now, consumer demand is solid, but savings are being spent and we've seen an uptick in credit card usage.	NEUTRAL
Senior Loan Officer Survey	Tighter lending standards for Commercial and Industrial Loans suggest more financial stress.	NEGATIVE
NFIB	Small businesses are pessimistic on both top-line and bottom-line growth in the near term.	NEGATIVE
EQUITY FUNDAMENTALS	**ASSESSMENT**	**TAKEAWAY**
Valuations	On a P/E basis, S&P 500 is trading at 17.6x (2022 consensus earnings estimates) and 16.8x (2023 consensus earnings estimates). This measure of valuation looks reasonable, but we have some concerns about earnings estimates being too high, meaning valuations are perhaps less attractive than they appear.	Neutral
Earnings Estimate Revisions	Earnings revisions have been falling and will likely be a major headwind as we move into 2023 as companies cut their guidance.	NEGATIVE
Profit Margins	Record operating profit margins peaked in 2022 and are still above pre-pandemic levels. We don't expect a precipitous drop in profit margins but anticipate a lower level - more akin to the pre-COVID-19 era.	NEGATIVE
Leverage	Various measures of financial leverage (total debt/equity, interest coverage, etc.) do not signify corporate sector debt poses a significant risk to the economy and financial markets.	POSITIVE
EQUITY TECHNICALS	**ASSESSMENT**	**TAKEAWAY**
S&P Put/Call Ratio	Rising ratio tells us that the market is hedged for any negative events, which serves as a bullish signal in the short-term. As investors "buy insurance" in the form of put options, it signals negative market sentiment which is often a good contrarian indicator.	POSITIVE
Bullish/Bearish Sentiment	Rising ratio tells us that pessimism may be overdone, signaling a buying opportunity in the near-term.	POSITIVE
High vs. Low Beta	This ratio bottomed in late June 2022; however, it has moved in an oscillating, non-trending, manner over the past few months. Low beta (or low risk) areas of the market outperform when risk remains high.	Neutral
Small Cap vs. Large Cap	For the first 4 1/2 months of 2022, small cap stocks materially lagged large cap equities (clear sign of "risk off"). Relative performance improved through early November ("risk on") but has been negative over the past 2 months of the year.	Neutral
	CONCLUSION	
Mild-Economic Recession	Leading indidcators highlight the forthcoming economic slowdown as tighter financial conditions work their way through the system. Fundamentals are shakey at best, and we would not be surprised to see earnings estimates revised lower as companies take a hit to profit margins as inflation cools and productivity remains stagnate. The strong labor market and general resiliency of consumer spending are current economic bright spots. Strength in these areas may delay (probably not stop) more acute economic weakness. Longer-term, an economic and valuation reset will help lift forward return expectations.	NEGATIVE

Sources: *ISM® Report On Business®, US Bureau of Labor Statistics, US Employment and Training Administration, US Census Bureau, National Association of Home Builders, FactSet, University of Michigan, The Conference Board, Board of Governors of the Federal Reserve System, AII Investor Sentiment Survey*

 See important disclosures on page 12

Summary of Asset Allocation Positioning Entering 2023

Equities vs Fixed Income/Cash	**Neutral**	For investors holding a mix of stocks and bonds, we do not recommend any tactical tilts away from longer term strategic allocations. While we think that a retest and possible breach of the 2022 stock market lows are possible (if not likely), we think the appetite for risk assets may improve over the back half of 2023 as investors start looking past the impact of a 2023 recession. Our bias is toward believing interest rates will fall in 2023 in response to lower inflation and economic growth (positive for bonds), but there are countervailing forces (less bond buying from the Fed/internationl investors; higher supply) that will pressure bond prices (push rates up). The net result may be a range bound rate environment, with opportunity for income focused investors. The risks to price appreciate/decpreciation are generally balanced.
Relative Weight within Equities		
US	**Overweight**	The U.S. equity market, in our opinion, is still the best house in a bad neighborhood. The combination of economic, geopolitical, and regulatory risk (mainly in Emerging Markets), makes the risk/reward for international markets somewhat less attractive.
International Equities (Developed Markets)	**Equal Weight**	Many countries in Europe are on the precipice of recession or are already in one, while central banks in both Europe and Japan will increase rates meaningfully to battle inflation. We want to see leading economic data bottom and inflation cool further before we make changes to our positioning, but we are aware of the economic cycle dynamics (these regions may exit recession before the US) and the valuation advantage of many developed international markets.
Emerging Markets	**Underweight**	We think its prudent to maintain an underweight position entering 2023 given the possibility of a global economic hard-landing and the everpresent regulatory risk in China. That said, our underweight is relatively small, given likely stimulus in China and less strength in the U.S. Dollar.
Style & Market Cap	**Tilt towards Large Cap &Growth**	The dramatic increase in interest rates in 2022 had a severely negative impact on growth stock valuations. Although more speculative areas of growth will continue to struggle, in our view, the major headwind to quality growth company valuations is behind us. Value and small caps are more "cyclical" and appear more vulnerable if our "weaker economy" thesis proves accurate. Although we maintain a slight overweight to mid/small cap and Value stocks (we think they outperform over the long run), we've reduced those weights dramatically in order to insulate our returns from a further deterioration in economic growth. We are looking for more opportunities to add quality growth to our portfolios, both via asset allocation and individual stocks.
Relative Weight within Fixed-Income		
Duration	**Tilt towards longer duration**	We have modestly increased the duration of portfolios we manage in an effort to take advantage of our view that interest rates will likely decline in 2023 - a positive for bond prices.
Yield Curve	**Not Overlooking Shorter Maturities**	While we have increased our average maturity to lock in higher yields, the interest rate environment (short-term rates greater than long-term rates) presents compelling opportunities for investors searching for income. Shorter maturities are yielding more than 4.0% while longer dated maturities remain comfortably above 3.0%. Shorter-dated maturities provide capital flexibility and less interest rate risk for investors looking for near-term liquidity.
Credit Quality	**Tilt towards higher quality**	We believe there is room for credit spreads to widen in 2023. Throughout 2022, we lightened up on our credit exposure, thus becoming more defensive. We think this position is still warranted as we head into 2023.

 See important disclosures on page 12

A Top-Down View – The Economy & Financial Markets

Heading into 2022, we thought that waning fiscal stimulus, rising prices, and higher global interest rates would negatively impact the pace of economic growth, particularly in the second half of the year. The slower growth narrative played out as we expected. However, we did not think inflation would be so persistent; and therefore, did not anticipate that the Fed would raise interest rates by 425 basis points. The impact of this level of monetary tightening is only beginning to hit the real economy.

On the positive side of the ledger, there is evidence inflation peaked in 2022 and is coming down at a reasonable pace – U.S. small businesses reported less price pressure, import prices have declined, industrial commodity prices have fallen, and the New York Fed's measure of supply chain stress showed improvement. In addition, inflation reports (CPI, PPI, PCE, etc.) last October and November were below consensus estimates. Although it's premature to declare victory, we believe that the worst of the inflation/higher interest rate narrative that plagued financial markets in 2022 is behind us. As a result, a material compression of valuation multiples on stocks (like we saw in 2022) is a waning risk.

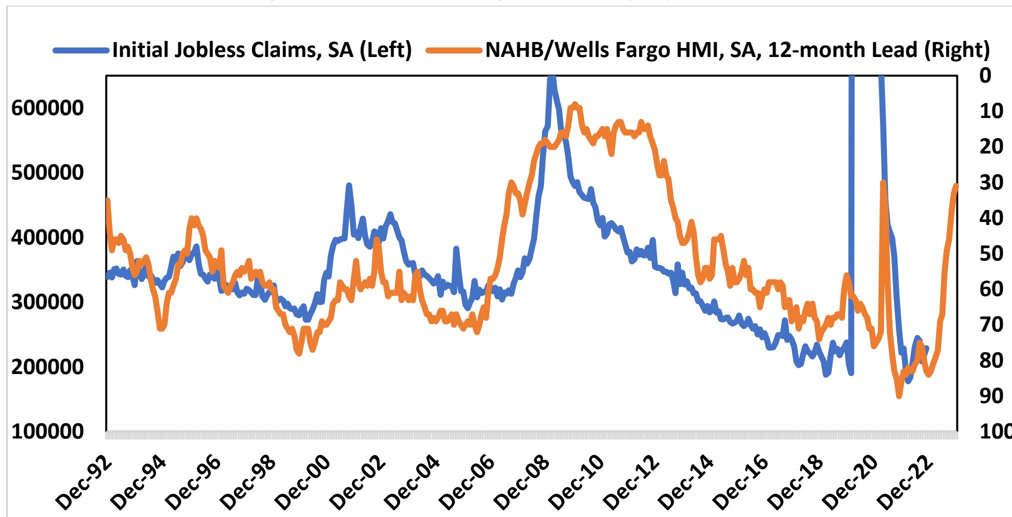
While this is an unquestionable positive, we are concerned about the near-term prospects for the United States (U.S.) economy and the subsequent impact on corporate earnings. Historically, inflation is a lagging economic indicator. We pay considerably more attention to various leading economic indicators that have historically done a much better job projecting the future direction of the business cycle – in our opinion the most impactful near-term driver of financial markets.

Leading economic indicators started to roll over in 2021, well before the peak in stock prices. Continued weakness in these indicators in 2023 is a key component of our view that the economy and financial markets will face pressure in the coming year. What we are watching:

- **Yield Curve Inversion:** short-term rates are higher than long-term rates. While some economists have downplayed the relevance of an inverted yield curve, short-term rates have not exceeded long-term rates to this magnitude without the economy going into a recession. In fact, the yield curve usually *re-steepens* prior to an economic recession as the bond market anticipates rate cuts in response to an economic contraction. With the curve still deeply inverted, we think economic growth will continue to deteriorate.
- **Housing**: It is often the most interest rate sensitive area of the economy and was the first leading indicator to show weakness. The impact of higher interest rates on affordability has caused homebuilder confidence to plunge, which is often a good indication of coming weakness in the labor market (see Chart 1).
- **The US ISM Manufacturing PMI ("PMI")** slipped into contractionary territory, and signs point to a continued move lower in 2023. As you can see from the chart below (see Chart 2), there is an inverse relationship between the rate of change in interest rates and the manufacturing segment of the economy 18 months later. This means that higher rates are a harbinger of slower growth. PMI is also highly correlated with corporate earnings. If PMI continues to fall, which we think it will, history indicates a further reduction in earnings expectations.
- **The U.S. consumer** may face additional challenges if/when the labor market materially weakens, and accumulated saving is drawn down. The Fed wants to see weakness in the labor market before they will be comfortable that their job is done.

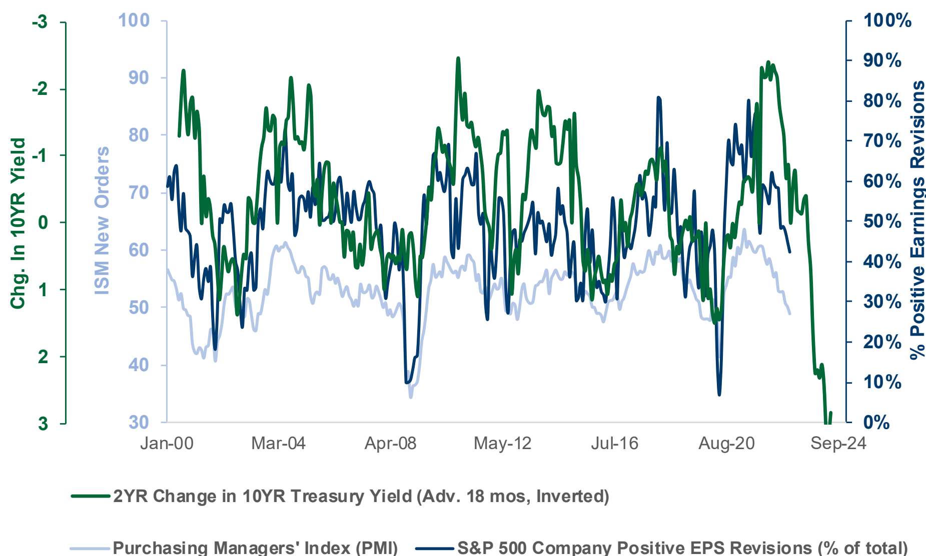
- **Small business** surveys indicate a pessimistic near-term outlook for both revenues and earnings.
- **The labor market** recently announced layoffs at several notable companies are beginning to find their way into the data, posing a headwind for consumer demand going forward.

Chart 1: Weak Housing Data Forecasts Higher Unemployment



Source: FactSet

Chart 2: Sharply Higher Interest Rates Forecast Lower Economic Growth & Earnings



Source: FactSet

To be clear, however, there are credible risks to both the upside and the downside. For starters, the U.S. economy has meaningful momentum, both in terms of the consumer and labor market. For example, the U.S. economy has almost two job openings for each unemployed person, and households are sitting on nearly $1.3 trillion in excess savings. If the Fed is lucky enough to have calibrated monetary policy properly (a big if) these elements may allow the US economy to

narrowly avoid recession or mitigate the impact of an economic contraction. Our views of possible economic outcomes are reflected in Table 1.

In our view, whether the economy experiences a more significant recession is going to depend on whether the Fed has "guessed correctly". Monetary policy is always a guessing game because it impacts the economy with a long lag. In high-inflation cycles, it usually takes a recession to get prices under control. The question today is what level of rate increases was necessary to accomplish that goal in the current cycle. We won't know until after the fact. For this reason, there is a nontrivial risk that the Fed has overcorrected to the point of driving a more significant contraction in the economy.

Table 1: Economic Scenarios

Forecast	Macro Scenario	Probability
Base Case	Mild-Economic Recession	60%
Upside Risk	Soft-Landing/Expansion	20%
Downside Risk	Hard-Economic Recession	20%

Source: Bryn Mawr Capital Management.[1]

Overseas Macro Backdrop Looks Worse

Leading indicators such as Manufacturing PMIs moved into contraction territory many months ago, signaling a contraction is already underway. Risks remain for a further economic slowdown across many European countries as geopolitical tensions continue to cloud the picture, creating uncertainty for investors. Japan is a country in flux as recent inflation developments are forcing their central bank to reexamine current monetary policy, which entails yield curve controls. As evidence, the Bank of Japan will now allow their 10-year yield to float as high as 0.50%, up from 0.25%. This may seem insignificant, but it is a departure from current policy and adds additional pressure to a large (and already slow-growing) economy. All that said, we think it's likely that overseas economies will trough and begin to expand ahead of the U.S., which could create some investment opportunities over the latter part of 2023.

When it comes to emerging markets, the focus is on China. The impact of potential changes to their "zero-COVID" policy lockdowns should not be understated as China represents a large part of global demand and international supply chains. We expect some combination of fiscal and monetary policy easing in 2023, which would also support the near-term growth picture. As a countervailing force, the constant overhang of potential government meddling as well as the ongoing housing meltdown creates tail risks that are hard to precisely estimate.

Finally, investors bid up the value of the U.S. Dollar in response to meaningful interest rate differentials between the US and other major countries (higher rates in the U.S. attracted US Dollar investment), and multiple "flight to quality" episodes over the course of 2022 also drove U.S. Dollar demand. Interest rate differentials will become a headwind to future dollar appreciation as global central banks become more hawkish than the Fed in 2023. However, higher rates abroad may continue to drive significant economic weakness in those regions, leading to an additional flight to U.S. Dollar assets. The net impact of these opposing forces is hard to predict, but we believe the result may be a U.S. Dollar that is somewhat rangebound, although biased higher.

[1] Qualitative probability estimates to demonstrate our opinion of the likelihood of each scenario.

 See important disclosures on page 12

Relative Macro-Level Positioning within Equities

Overweight US Equity Markets
As previously stated, the earnings environment for U.S. stocks will pose a headwind in 2023. Our modest overweight to U.S. stocks relative to international equities (mainly Emerging Markets) is that there is a possible (not probable) hard landing for the global economy in 2023. We believe that such an environment would pose a significant tail risk that will have a more deleterious impact on riskier assets (i.e., Emerging Markets).

No Change to International Developed
When specifically looking at valuations for Europe compared to the U.S., it appears that markets have priced in an upcoming economic downturn for the region, reaching relative valuations levels not seen since the Global Financial Crisis (2008/2009). Technically speaking, certain countries within that region have broken through channel resistance on the upside and seem to be forming a more neutral price pattern. Despite attractive valuations and relatively stronger-than-expected price action, we feel risks remain heightened in the European region from monetary, fiscal, and geopolitical variables and remain neutral on the space for the time being. When leading indicators bottom or reach extreme levels, coupled with attractive valuations, there is potential to increase our current market weight.

Underweight Emerging Markets
Due to the high level of uncertainty, a higher risk premium (lower valuations) seems necessary to invest in the region. However, calculating fair value is a challenge due to the inherent unpredictability of key risks – government regulatory risk, specifically. Nevertheless, valuations have moved lower from the beginning of 2022 and could provide a promising entry point if uncertainty abates, a stimulus is introduced, and the U.S. dollar remains rangebound. Overall, we came into 2022 with an underweight position to emerging markets as a whole and we feel the factors listed above support maintaining that underweight with a keen eye on events in China.

Tilt towards Large-Cap & "High Quality" Growth Stocks
Entering a period where valuations matter and quality companies can survive, we feel the plot of the markets will shift from a monitoring of Fed policy to an earnings impact story where market participants will look to invest in companies that generate higher, more sustainable, earning growth. That typically points us to companies classified in that growth factor. We do not believe the lower-quality areas within growth will perform well in the first part of 2023 if our economic base case comes true. We think higher-quality growth companies that generate sufficient return on equity and excess earnings growth relative to the overall market will lead the market, at least over the first half of 2023. From a market capitalization perspective, we have been surprised by the relative resilience of mid and small-cap companies. Typically, small-cap companies outperform large-cap companies coming out of recessions or economic downturns. We think this backdrop is at least several months away at this juncture. Also, small-cap and value securities are more economically sensitive and appear more vulnerable as economic conditions deteriorate.

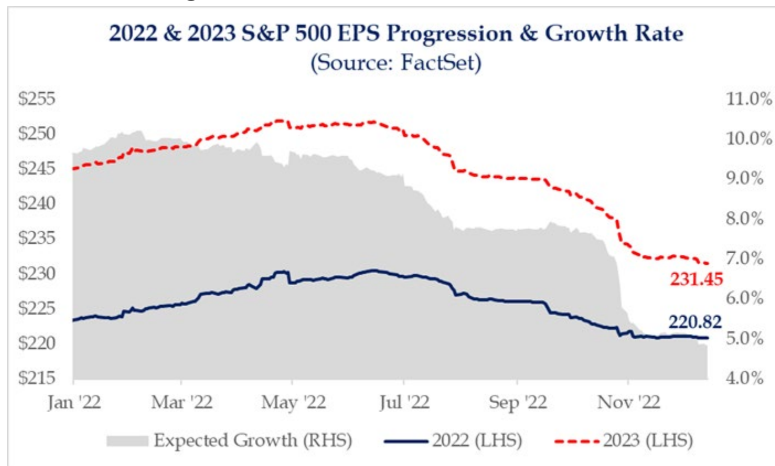
Outlook for U.S. Stocks - Earnings Estimates Too High but Valuation About Right

Entering 2023, we believe consensus earnings estimates for the S&P 500 are still too high. These estimates, which stood at over $250 per share mid-year, have trended lower over the back half of 2022. As the chart below (compiled late last

December) shows, expectations are for roughly $232, or earnings growth of ~5.0% for the coming year. Taking this a step further, the 5% earnings growth is the combination of ~3% sales growth and margin expansion.

This seems overly optimistic, mostly due to the massive interest rate increases put forth by the Fed, which are generally believed to take 12-18 months to be fully reflected in the economy. As a reminder, the Fed only started to move away from its ZIRP (Zero Interest Rate Policy) in March of 2022. Since that time, the Fed has increased rates five more times, resulting in a target Fed Funds rate of 4.25-4.50%.

Chart 3: Earnings Estimates 2022 & 2023



Source: Strategas Research Partners

A more realistic assessment of S&P earnings, we believe, is nearer to the $199.50 estimate put forth by Strategas Research Partners. If the ~$200 EPS number for the S&P 500 Index is accurate, it would imply a ~10% decline in earnings as opposed to current consensus estimates of an increase of 5%. Given our assessment of the underlying company drivers, something closer to this figure seems far more likely considering the mounting monetary headwinds the economy is facing. For perspective, even the lower $200 per share earnings forecast for 2023 would imply a 5% compounded annual EPS growth rate since pre-pandemic (2019), which isn't far from the 6.9% compounded annual EPS growth witnessed since 1960.

From a market standpoint, the good news is that the current multiple paid for the S&P's earnings appears appropriate, as it already declined from 21x at the outset of 2022 to its current level of roughly 17x. Putting the two together, lower earnings coupled with a relatively stable multiple paid for those earnings means that the market in aggregate is going to have a difficult time making progress to the upside in the new year and that the old all-time highs are unlikely to be challenged in 2023.

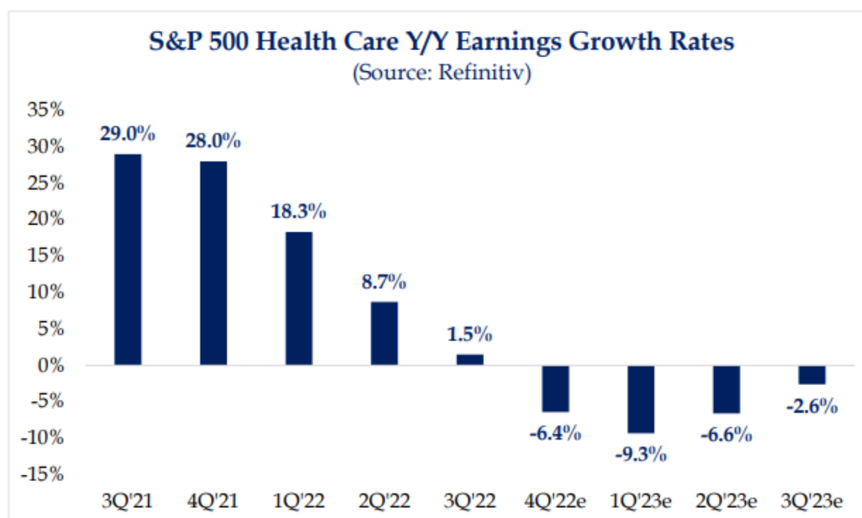
Views from a Sector Perspective

We believe Information Technology earnings should decline in 2023 because of lower demand and pricing for semiconductors and other offerings following record-setting demand fueled during the pandemic. Communication Services also seem poised for a slowdown as over half the sector's weight is in Alphabet [Google] and Meta [Facebook]. Each of these companies derives most of its earnings from the sale of advertising, often one of the first expenses

companies cut when facing economic challenges. Finally, looking at financials, banks are likely to face headwinds due to moderating loan demand, an uptick in non-performing loans, and higher borrowing costs. On this last point, we believe the rates available on competing products will force banks to respond and increase deposit rates, thus squeezing net interest margins.

As always, however, we will be looking for attractive stocks to buy, even in a market that will be earnings-challenged. One area which we believe is particularly well positioned is Health Care. In general, Health Care was a huge beneficiary of the COVID-19 pandemic, with certain companies seeing massive increases in revenue from testing.

Chart 4: A Look at Health Care Earnings



Source: Strategas Research Partners

As testing revenues faded, however, so too did the earnings boost that they provided, resulting in sharply declining earnings growth rates over recent quarters. Year-over-year earnings growth for this sector is actually forecast to go negative in the final quarter of 2022, with the low point then coming during the first quarter of 2023. After that date comparatives are slated to improve, and in spite of the forecasted headwinds, we believe this is one of the few sectors which could display earnings growth for all of 2023. That growth will come from the defensive nature of health care, supported by demographics, more normalized hospital staffing, and a lack of COVID-19 testing revenue distortion. Reflecting our positive leaning toward this sector, we are generally overweight health care across our individual equity Strategies.

Another area we may look to add selective exposure to is Information Technology, despite the expected decline in sector earnings. Info-Tech will enter the new year having severely lagged the broader market in 2022, as higher interest rates and slowing earnings extracted a big penalty. We are generally underweight to neutral Technology across our individual equity strategies at present, but readily acknowledge the attractive long-term fundamentals of certain companies within this sector. While more bad news on the earnings front likely lies ahead for many of these names, valuations have been greatly pared back, and as the year progresses, we should be presented with compelling opportunities to add exposure to a sector with strong secular tailwinds.

Capital Will Continue to Have a Cost

In retrospect, the excess liquidity provided by the Fed during the pandemic clearly created distortions within the equity market. With capital effectively available at very low-interest rates, "meme stocks" and growth at any cost companies were the darlings. This ended abruptly in 2022 as liquidity dried up and many of these companies saw their share prices decline by well over 50%. Given the damage inflicted on these stocks last year, the relative underperformance is likely to moderate. That said, we continue to think these companies will underperform as the market rewards firms with sound balance sheets, profits, and self-funding operations. Simply put, capital, whether it comes from the equity market or from the issuance of debt, will be far more expensive and create a headwind for the companies that need to access it over the foreseeable future.

Fixed Income FOMC – Light at The End of The Tunnel

The U.S. Federal Reserve (Fed) embarked on a very aggressive rate hiking campaign in 2022 to combat the highest levels of inflation since the 1970s. In this past year, we observed increases in the federal funds target range from 0.00% - 0.25% to 4.25% - 4.50%. Given Fed commentary and continued high levels of inflation, we believe additional rate hikes are likely in the cards for 2023, but to a much lesser extent.

The speed of rate hikes experienced in 2022, consisting of four consecutive 75bps jumbo rate hikes, is likely behind us as the Fed reassesses the current economic impact of its policy decisions. Smaller adjustments of 25bps and potentially 50bps are certainly fair game given pockets of persistently high inflation and an extremely resilient labor market.
Today's higher borrowing costs are already having a notable impact on the housing and manufacturing sectors as U.S. economic growth clearly slowed from the prior year. We anticipate continued softer U.S. economic growth this year that will put downward pressure on inflation and give the Fed more flexibility when setting monetary policy in the back half of 2023.

We aren't expecting an immediate shift in policy rates but believe the Fed will hold the line after potentially adding another two-three 25bps rate hikes in the first half of 2023 to ensure inflation is moving towards the Fed's goal of 2.00%. This would imply a roughly 5.0% terminal rate that is obviously well above the Fed's current neutral rate of 2.50% and comfortably in the economically restrictive territory. Market pricing is in the same neighborhood which is roughly in line with the Fed's most recent December Summary of Economic Projections.

Interestingly, based on federal funds futures markets, investors are anticipating a shift in monetary policy in the latter part of 2023 with rate cuts priced in during the second half of the year. Although weaker inflation and economic growth will give a reason for a Fed pause, we would stop short of suggesting any rate cuts are likely given the Fed's worry about easing policy too early.

Recent commentary from Fed Chair Powell has deferred to history and the lessons learned from loosening policy too soon. Specifically, the "stop-start" monetary policy of the 1970s is to be avoided. The Fed risks its credibility if inflation is not fully under control. The Fed will want to see convincing evidence of this (several month-over-month readings) before a shift in policy.

U.S. Treasury Yields Heading Lower but Opportunities for Income Will Remain

U.S. Treasury yields increased across the yield curve last year as high inflation and tighter central bank policy contributed to a notable drop in bond valuations. Through November 30, 2022, the U.S. Bloomberg U.S. Treasury Index was down roughly -12.00%. Short-term yields easily outpaced longer-term yields as front-end maturities focused on higher policy rates whereas longer-dated maturities kept an eye on increased recessionary fears. The U.S. Treasury yield curve ended November at its most severe inversion level since 1981. If it becomes clear the market will not get the rate cuts it expects in the second half of 2023, we will likely see additional yield curve inversion during the first part of the year.

Chart 5: Two-Year and 10-Year U.S. Treasury Yield Bond Spread (December 31, 1981 – November 30, 2022)

Source: Bloomberg, Inc.

Looking beyond the next three-four months, we expect a more pronounced shift in investor focus from stubbornly high inflation to economic growth concerns. As we closed 2022, the shift had already begun and U.S. Treasury yields, although still elevated, gave up some of their gains on the year.

We expect this trend will continue throughout the year as softer U.S. economic growth will weigh on U.S. Treasury yields in 2023. We believe the Fed will become more dovish as the year progresses although we stop short of predicting any interest rate cuts. Regardless, a more subdued Fed and the prospects of the U.S. recession will be enough to weigh on U.S. Treasury yields along the curve with shorter maturities, in our view, the most susceptible to declines given their sensitivity to monetary policy. Overall, this will lead to a steeper yield curve by year's end.

From an investment perspective, we believe the interest rate environment will continue to present compelling opportunities for investors searching for income. Shorter maturities are yielding more than 4.0% while longer-dated maturities remain comfortably above 3.0%. Increasing the maturity profile of fixed-income portfolios is something we did throughout 2022 and may continue to do so in 2023. If the yield curve eventually steepens (with short-term rates falling), locking in higher rates further out on the mature curve protects investors looking to generate income over a multi-year period. The key risk to our 2023 outlook would be an economy that displays resilience resulting in inflation remaining stickier, monetary policy more hawkish, and short-term U.S. Treasury yields higher.

Corporate Spreads Have Room to Widen on Economic Growth Concerns

We believe credit spreads have room to widen further in 2023 as higher policy rates will weigh on economic growth. Corporate profits held up reasonably well in 2022 but will likely face a more challenging economic backdrop this year. Softer consumer and business spending should put downward pressure on corporate profitability while firms adjust to

higher borrowing costs. Company balance sheet management will be a key focus for us as inventory accumulation can be an early sign of customer buying behavior and company cash flow management.

Throughout 2022, we lightened up on our credit exposure, thus becoming more defensive within our fixed-income strategy positioning. As we begin 2023, we continue to believe a defensive position is an appropriate stance given our expectations of a more pronounced downward shift in U.S. economic activity than is currently reflected in credit markets. However, we will actively be searching for credit exposure when the tide turns, and valuations become more in line with our company earnings expectations. After many years of navigating subpar bond yields, the sharp yield repricing presents a favorable environment to opportunistically add duration and credit exposure.

Chart 6: Bloomberg U.S. Investment and High Yield Corporate Avg OAS (December 31, 2021 – November 30, 2022)

Source: Bloomberg Inc.

Municipal Bonds Should Benefit from Healthy Fundamentals and More Benign Valuations

Municipal bonds held up reasonably well in 2022 relative to other fixed-income sectors but nonetheless succumbed to higher bond yields across the curve. Fundamentals held up reasonably well as municipal issuers continued to reap the benefits from prior fiscal stimulus initiatives. We believe last year's price decline and poor performance were more of a higher interest rate story than a deterioration in credit quality. Through November, the Bloomberg Municipal Bond Index 1-10yr Aa+ Index was down 4.52%.

This year, we will continue to look for opportunities to extend out on the yield curve and take advantage of today's higher interest rates. Within the General Obligation universe, the strong housing market sustained in prior years should keep property taxes in check while the healthy labor market supports income taxes. A weaker economic backdrop will put issuer fundamentals more in focus although we believe the municipal sector is well positioned to absorb a slowing U.S. economy.

Conclusion – Take the Long View

Although much of our outlook is negative, as investors, we always aim to focus on the "big picture" in terms of prudently growing our client's wealth over the long term. We think mentally preparing for the idea that things may get a bit worse before they get better will help investors weather the storm. Although we don't know the precise moment things will get better…they will get better. Beyond the next 12 months, we believe it is likely the Fed cuts rates as inflation and

growth decline and unemployment rises. This creates the next foundation for economic expansion and stock market appreciation.

For those looking to put cash to work, note - large stock market declines lead to higher-than-average future returns. Historically, stock market performance after a 25%-plus market decline is far better than average looking out 1, 3, 5, or 10 years. You are far more likely to regret buying stocks after a 25% increase versus a 25% decrease.

For those fully invested, note - investors have enjoyed a long period of above-average returns (an average of 17% per year from 2009-2021). We are now simply reverting to a more normalized return trend. Volatility is the price we pay for the returns offered by stocks.

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