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# Investment Committee Review

## Q2 2023

SS&C ALPS Advisors is an open architecture boutique investment manager offering portfolio building blocks, active insight and an unwavering drive to guide clients to investment outcomes across sustainable income, thematic and alternative growth strategies.

### Q2 2023 Asset Class Reviews

- p. 2 **Introduction**
- p. 3 **Equities Summary**
- p. 5 **Fixed Income Summary**
- p. 7 **Real Estate Summary**
- p. 9 **Commodities Summary**

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## Introduction

### Second Quarter Review

After the apparently short lived banking crisis in the first quarter, markets, with the exception of commodities, returned to a “risk-on” posture in the second quarter. Driven by optimism around artificial intelligence (AI), equity markets were led higher by growth stocks. The best performing Fixed Income sectors were High Yield and Leveraged Loans. In Real Estate, performance was mixed reflecting the diversity of Real Estate assets. AI-driven data centers, Health Care and Residential were the best performers. Commodities generally lagged other risk assets as fears of recession weighed on Energy prices.

### Third Quarter Outlook

#### *Executive Summary*

The first half of 2023 was a story of concentration and relatively narrow markets led by investors becoming more optimistic about the path of economic growth and rates. Going forward, we would reiterate the importance of diversification. If the economic outlook remains favorable, we would expect market segments such as value stocks and commodities to participate more broadly. And if the outlook turns negative, a more diversified approach can provide exposure to defensive areas such as dividend paying stocks and long duration treasuries.

#### *Equities*

To say that the equity market in the first half of the year was concentrated would be an understatement. For example, the market cap weighted S&P 500 Index returned 9% in the second quarter, while the equally weighted S&P only returned 4% as the lion’s share of the gains were concentrated in very large growth stocks. Either scenario discussed above should bode well for better market breadth. If the economy continues to surprise to the upside, first half laggards such as cyclicals and Small/Mid Cap should benefit as growth becomes less scarce. If the economic environment becomes more uncertain, defensive stocks should do relatively well.

In either scenario, we believe investors should continue to focus on allocation to quality, profitable companies. Our work has shown that over the long term a quality overlay on equity portfolios can lead to attractive risk-adjusted returns.

#### *Fixed Income*

A more stable yield curve should continue to favor positive returns to fixed income. We still believe investors should:

- *Stay Invested* – the current conditions support continued returns
- *Stay Protected* – focus on quality and long Treasuries
- *Stay Flexible* – shorter duration assets can provide liquidity for opportunistic investors

Our preference for the second half of the year would be in rate sensitive fixed income such as Treasuries, Agency Mortgages and high-quality Investment Grade bonds. Along the yield curve we would favor shorter duration and longer duration assets over the “belly” of the curve.

#### *Real Estate*

Publicly traded Real Estate Investment Trusts (REITs) is a well-diversified asset class with many of its underlying sectors exhibiting relatively attractive characteristics. Data Centers stand to benefit from the growth of the Cloud and, in particular, artificial intelligence. Industrial REITs benefit from a continued build out and higher demand for e-commerce logistical needs, and Lodging REITs could continue to do well as the demand for travel continues to bounce back. Health Care REITs benefit from secular demographic trends as Baby Boomers continue to sustain their retirement years. These sectors generally exhibit strong balance sheet quality and attractive income growth opportunities.

#### *Commodities*

Our cautious stance on commodities in the first half of the year was warranted given the worries about recession that pervaded the market. That said, we’ve seen real wage growth turn positive which could keep inflation “sticky” going forward. As we’ve noted in previous quarters, there remains a dearth of investment into production capacity across the commodities complex.

If demand improves as recession fears recede, commodities could once again provide attractive opportunities, particularly in Energy and Precious Metals, and in our view remain an important part of a well-diversified portfolio.

### Summary

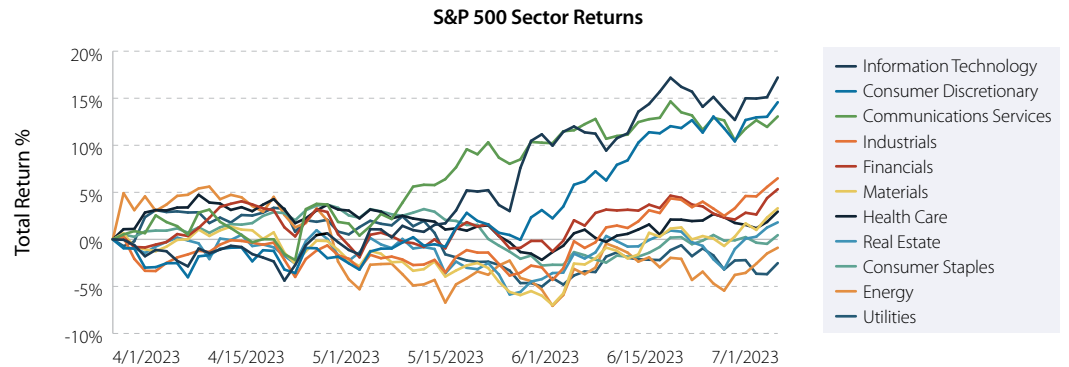
The positive returns in the first half of the year, particularly in Equities, took many investors by surprise. However, many segments of the market did not fully participate, suggesting to us that opportunities continue to exist. Broadly, we favor quality dividend-paying stocks, a barbell approach to fixed income, and areas of real assets with attractive supply/demand characteristics.

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## Equities Summary

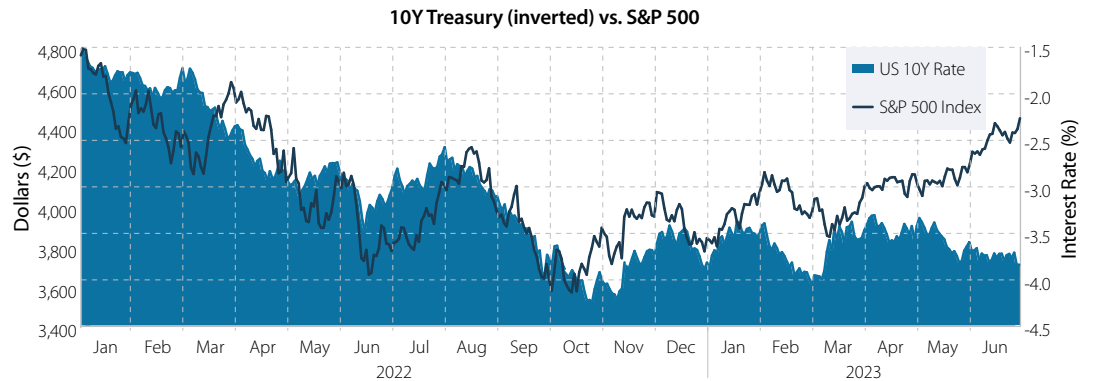
### Second Quarter Review

Following the government’s response to Q1 banking turmoil, markets rallied through June led by the growth sectors and the artificial intelligence (AI) animal spirits. The Nasdaq 100 Index ended the quarter with a 15.39% gain, followed by the S&P 500 Index with a 8.74% gain and the Dow Jones Industrial Average gaining 3.97%.<sup>1</sup>



Source: Bloomberg, as of 6/30/2023

While the Federal Reserve (Fed) continues tightening by raising rates and lowering its balance sheet, market participants remain unfazed. Disinflation, resilient growth and the appearance of a “Fed put” have overcome more ominous macroeconomic leading indicators. While 2022 saw the orderly decline of stock prices alongside rising interest rates, 2023 price action exhibits a fight against the Fed as prices rise alongside interest rates. Risk premia are now approximately 1.5 standard deviations below the mean relative to the last 20 years (<7% of observations); rising equity valuations seem to suggest either a reacceleration of earnings, future interest rate cuts or a combination of both.



Source: Bloomberg, as of 6/30/2023

### Third Quarter Outlook

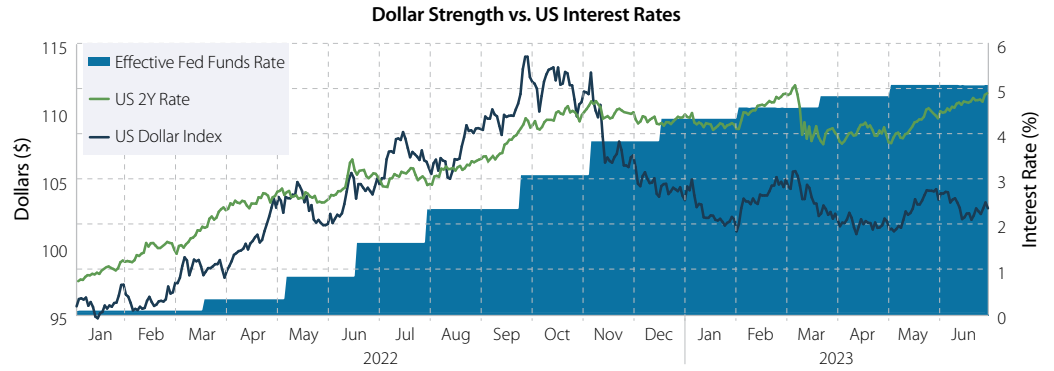
Going forward, we expect two possible scenarios could materialize:

- 1) The labor market remains tight and wage growth keeps inflation above the Fed’s target. Given the extended advance in growth stocks, this reflationary scenario (in which real growth accelerates and is no longer scarce) should favor the lagging cyclical, industrial and small-cap sectors very similar to the 2021 market.
- 2) The lagged effects of tightening manifest a credit cycle and recession. In this scenario, defensive quality will outperform.

<sup>1</sup> Source: Bloomberg, 3/31/2023 - 6/30/2023

The common denominator concerning these scenarios is a quality, dividend foundation regardless of sector. We view this positioning similar to a call option on growth: should it remain robust or accelerate, these stocks will benefit. However, if downside risks materialize, these stocks provide protection.

In addition, we broadly favor international exposure based on diversification benefits, better valuations and dollar weakness. A peak in the 2-year treasury rate may be signaling the end of the rate hike cycle and the dollar has responded by weakening. If this is the case, foreign exchange could potentially provide a tailwind for international markets.



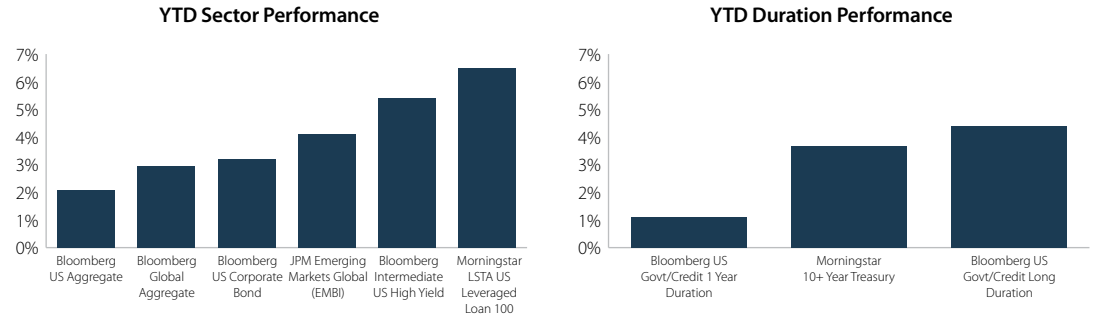
Source: Bloomberg, as of 6/30/2023

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## Fixed Income Summary

### Second Quarter Review

After an abysmal 2022, most Fixed Income investments have posted positive returns for the first half of 2023. The broad core bond market, as represented by the Bloomberg US Aggregate Bond Index, returned 2.09%. Some key credit sectors performed much better, particularly High Yield, as the US economy remained resilient, and credit losses did not materialize. The period was characterized by high rate volatility as markets quickly priced out a recession occurring in 2023. However, inflation continued to fall, and the prospect of the end of the rate hike cycle rewarded longer duration positioning.



Source: Bloomberg, total returns 12/31/2022 - 6/30/2023

### Third Quarter Outlook

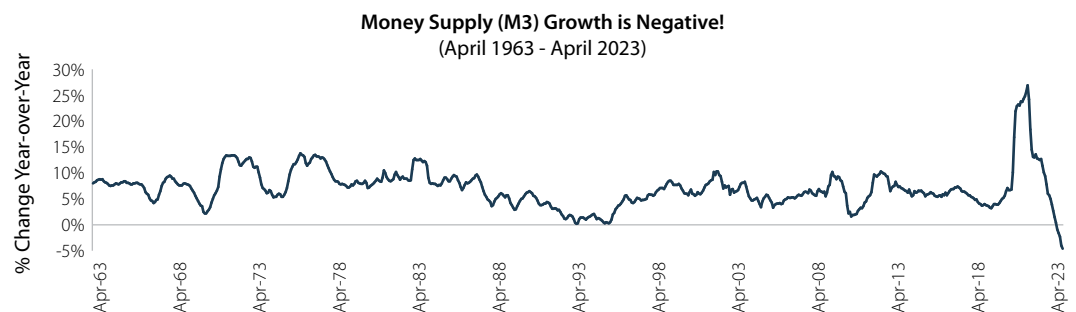
There are good reasons to expect positive returns to continue for the broader market. Chief among them is that the Fed and the bond market appear to finally be on the same page with respect to the projected rate and economic cycle. Another important factor is that coupon income continues to increase, which acts as a loss buffer over time. However, key risks remain with wage-related inflation, downside economic growth risks and the impact that previous rate hikes may have on credit markets. As a result, we reiterate the mantra—stay invested, stay protected and stay flexible:

- *Stay Invested* – slower economic growth, higher coupon income and moderating policy impacts can support continued returns to Fixed Income.
- *Stay Protected* – higher quality securities and some longer duration Treasuries can offer protection if a recession scenario materializes again.
- *Stay Flexible* – maintaining front end liquidity in the form of short duration assets can generate a relatively attractive real rate income stream while opportunities present themselves as the yield curve normalizes.

### Macroeconomic Thesis

Our basic slower-growth positioning is influenced by the Fed's ongoing restrictive monetary policy, which is intended to indirectly reduce aggregate demand through higher base borrowing rates. Additionally, the unwinding of the extreme levels of liquidity that were injected into the financial system during the COVID-19 pandemic also impacts the availability of credit and consumer spending. M3, a broad measure of liquidity in the system, has fallen into negative growth territory for the first time since this series has been tracked.

The extremely high levels of liquidity in the system during the pandemic resulted in higher inflation (due to a supply-demand imbalance) and higher real GDP. Now that the reverse is occurring, a potential tailwind for bonds exists as inflation falls, while consumer spending faces headwinds in the forms of higher borrowing costs and less availability of credit. While this transmission mechanism is not perfect, in general, an increase in the money supply increases GDP, and vice versa.



Source: FRED, Federal Reserve Bank of St. Louis, 4/1/1963 - 4/1/2023

***Credit Preferences***

For the second half of 2023, we prefer sectors that are more rate-sensitive, such as Treasuries, US Agency Mortgages and higher-quality Investment Grade Credit. These are traditional Core bond sectors that may benefit the most in a moderating rate regime or offer some protection if the economy materially slows down later this year. We are less favorable towards lower quality, more credit-spread sensitive sectors, which are not particularly cheap on a spread basis and could be more vulnerable in the above economic scenarios.

***Yield Curve Positioning***

The yield curve remains inverted, which has been an accurate predictor that rates will be lower in the future. However, some of the lowest rates along the yield curve are in the "belly" of the curve (roughly five years of duration). Given that uncertainty remains regarding the speed and ultimate trajectory of any declining rate scenario, we prefer a barbell positioning strategy. This entails holding shorter duration and longer duration assets while underweighting the middle part of the yield curve. This strategy could potentially offset the economic tail-risks—a more resilient economy than is anticipated by either the Fed or the markets, or a deeper recession that would drag longer rates down with it.

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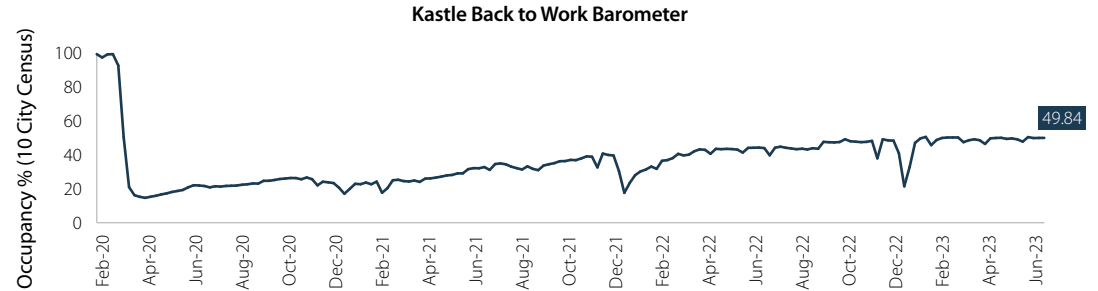
## Real Estate Summary

### Second Quarter Review

Real Estate Investment Trusts (REITs) (FTSE NAREIT All Equity REITs Index) returned 1.20% for Q2 and 2.97% for the first six months of the year.

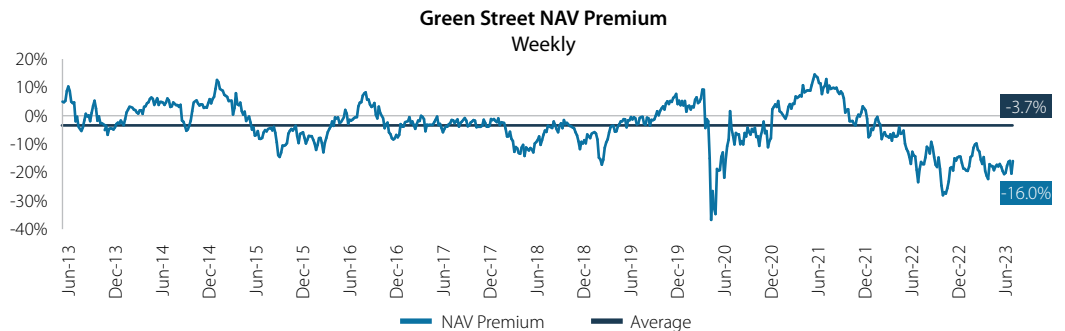
Data Centers (11.61%), Health Care (7.74%) and Residential (7.06%) sectors rallied, while Diversified (-10.01%), Cell Towers (-7.77%) and Self-Storage (-3.51%) were generally weaker.<sup>2</sup>

Office (-0.38%) was relatively flat for the quarter as the Kastle Back to Work Barometer stabilized to 49.84%, but the sector is a long way from recovering from the impacts of work-from-home as companies continue to shed office space.



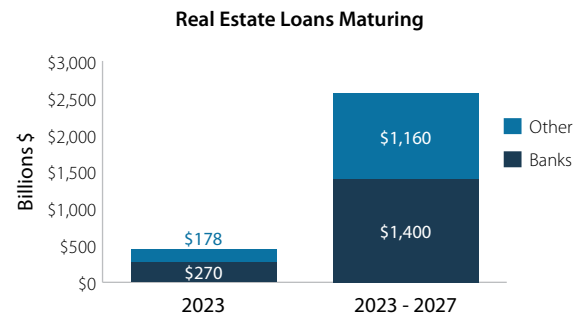
Source: Bloomberg, as of 6/30/2023

REIT NAV (net asset value) discounts remained near historic levels at -16.0%, which were significantly lower than the 10-year average of -3.7%. Office NAV discounts were -39.6% at the end of Q2, indicating a significant disconnect between public market and balance sheet valuations.



Source: Green Street, as of 6/30/2023

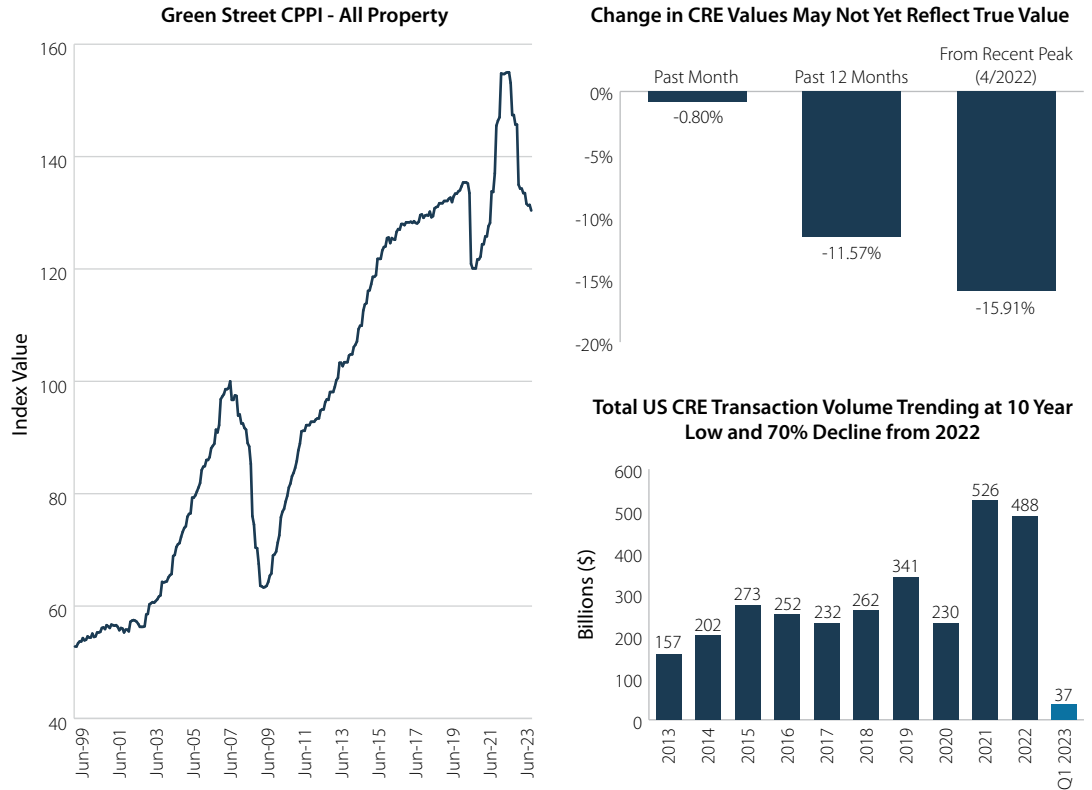
An important issue confronting Commercial Real Estate (CRE) investors is the dollar volume of loans that are scheduled to mature in the 2023-2027 time period. Almost \$450 billion is maturing in 2023, with approximately \$500 billion maturing in the subsequent four years. With higher interest rates, lower occupancies and valuations, secular headwinds and a slowing economy, many CRE owners, particularly private investors, face serious challenges in successfully restructuring balance sheets.



Source: Trepp, as of 3/31/2023

<sup>2</sup> Source: Morningstar, as of 6/30/2023

Also significant is the lack of price discovery in CRE transactions. Although the Green Street Commercial Property Price Index (CPPI) was down 11.57% over the past year and down -15.91% from recent peak in April 2022, the transaction volume year-to-date (YTD) was trending at a 10-year low and 70% decline from 2022. Weakening demand coupled with slowing revenue and the time-sensitive requirement to restructure balance sheets will ultimately narrow these historically wide bid-ask spreads.



Source: Green Street, as of 6/30/2023

**Third Quarter Outlook**

In contrast to much of the private real estate universe, publicly listed REITs appear to have relatively solid balance sheets, with low leverage ratios (25%-35%), a high percentage of fixed debt (80%-90%), long debt maturities with fixed rates (6-8+ years), low interest rates (3%-4%) and adequate margins to service their debt with manageable debt/EBITDA (earnings before interest, taxes, depreciation and amortization) ratios (4-6X).

Sectors of concern include regional malls, office and cell towers which have higher leverage, debt/EBITDA, shorter debt maturities and/or lower levels of fixed rate debt.

The relatively strong balance sheets for REITs provide significant optionality in what could become a volatile commercial real estate (CRE) market with potential for acquisitions at relatively attractive valuations.

Our preferred sectors within REITs include Data Centers, Residential, Lodging, Industrial and Health Care. All exhibit secular/demographic tailwinds, strong demand with muted supply growth, solid income growth, attractive valuations and strong balance sheets.

**Jimmy Wenger**  
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## Commodities Summary

### Second Quarter Review

The second quarter of 2023 was much like the first for commodities, with an overall slide lower. Industrial metals finally made a decisive move down, with the prices of copper and aluminum falling 8% and 11%, respectively.<sup>3</sup> The Organization of the Petroleum Exporting Countries+ (OPEC+) cut production again at the start of the quarter, reinforcing our belief that there is a bottom around \$70 on the price of West Texas Intermediate (WTI) crude. Oil quickly gave back the gains it made on the news and ended the quarter little changed from where it started, pointing toward continued growth concerns.

Hot and dry weather in the US caused a volatile quarter for the very expensive agriculture sector, and the drought contributed to a steady climb in livestock prices toward the end of the quarter.

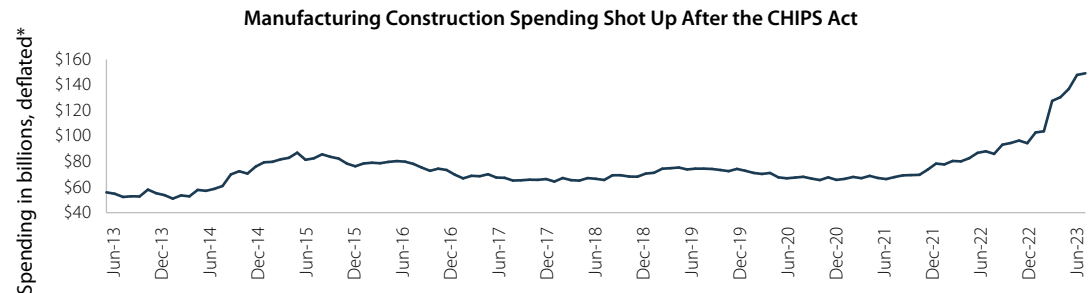
### Third Quarter Outlook

We are upgrading our broad commodities outlook to neutral weight. The key drivers for the upgrade are the possibility of resurgent US growth and sticky inflation in the back half of the year. Furthermore, given the recent underperformance of commodities and exceptional outperformance of equities, we believe commodities have less downside risk in the case of a market correction. Based on our growth and inflation expectations, we're particularly interested in energy and precious metals commodities heading into the second half of 2023.

#### Growth

While commodities, especially in the energy sector, have been trading as though the US is heading for a recession, the US economy has remained far more resilient than many predicted. We attribute this resilience primarily to lower than anticipated sensitivity to interest rates and higher than appreciated strength in balance sheets (both for consumers and businesses).

Going forward, we anticipate that recent wage gains and new retirees will put upward pressure on inflation, just as the Fed considers whether its dual mandate has been met. Construction spending, which shot up in January, may remain elevated as the US faces a housing shortage and government stimulus works its way into the economy.<sup>4</sup> This could cause inflation to be stickier than some are predicting.



Source: Bloomberg, 6/2013 - 6/2023

\* Deflated to 2013 dollars using the Consumer Price Index (CPI).

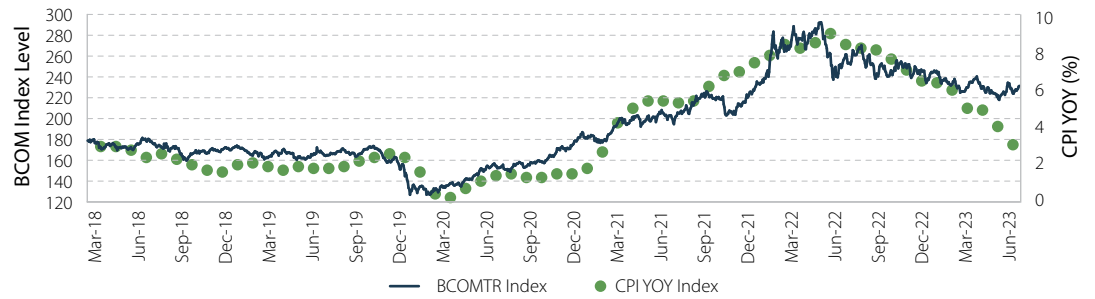
<sup>3</sup> As measured by the price return on the 3-month forward futures contracts, symbol HG3 for copper and LA3 for aluminum.  
Source: Bloomberg, 3/31/2023 - 6/30/2023

<sup>4</sup> Source: Bloomberg

**Interest Rates**

With year-over-year inflation at 3% and unemployment at 3.6%, some might believe the Fed's work is done. However, core Consumer Price Index (CPI) is still at 4.8%, and resurgent growth would put upward pressure on non-core inflation. We, therefore, believe investors may still be underappreciating the potential for additional rate hikes beyond the Fed's July meeting.

**Commodities Stayed Elevated as CPI Dropped**



Source: Bloomberg, 3/15/2018 - 7/12/2023

Each additional rate hike (and every additional day at elevated interest rates) increases the chance of a credit event, which could increase flows into safe haven asset such as precious metals.

**New Investment**

Investment in new production capacity has been stagnant for years, and requires years or even decades to come online. While there have been some new investments in capital expenditures (CAPEX) since the pandemic, they do not come near to making up for the underinvestment since 2015. Supply constraints remain a key focus of our research, particularly as it relates to the energy transition and all related commodities.

## Definitions

*Bloomberg Global Aggregate Bond Index: measures the performance of the global investment grade, fixed-rate bond markets, including government, government-related and corporate bonds, as well as asset-backed, mortgage-backed and commercial mortgage-backed securities from both developed and emerging markets issuers.*

*Bloomberg Intermediate US High Yield Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. The intermediate duration segment of the index includes bonds with maturities of 1 to 10 years.*

*Bloomberg US Aggregate Bond Index: a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency).*

*Bloomberg US Corporate Bond Index: measures the investment grade, fixed-rate, taxable corporate bond market.*

*Bloomberg US Govt/Credit 1 Year Duration Index: measures the non-securitized component of the Bloomberg US Aggregate Bond Index. It includes investment grade, USD-denominated, fixed-rate Treasuries, government-related and corporate securities. The 1-year duration segment of the index includes bonds approaching 1 year in maturity.*

*Bloomberg US Govt/Credit Long Duration Index: measures the non-securitized component of the Bloomberg US Aggregate Bond Index. It includes investment grade, USD-denominated, fixed-rate Treasuries, government-related and corporate securities. The long duration segment of the index includes bonds with maturities greater than 10 years.*

*Consumer Price Index (CPI): a measure of the average change over time in the prices paid by urban consumers for a representative basket of consumer goods and services.*

*Dow Jones Industrial Average: a stock market index of 30 prominent companies listed on stock exchanges in the United States. The DJIA is one of the oldest and most commonly followed equity indexes.*

*FTSE NAREIT All Equity REITs Index: a free-float adjusted, market capitalization-weighted index of US equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.*

*Green Street Commercial Property Price Index (CPPI): a time series of unleveraged US commercial property values that captures the prices at which commercial real estate transactions are currently being negotiated and contracted. Features that differentiate this index are its timeliness, its emphasis on high-quality properties, and its ability to capture changes in the aggregate value of the commercial property sector.*

*J.P. Morgan Emerging Markets Bond Index Global (EMBI Global): tracks total returns for traded external debt instruments in the emerging markets.*

*Kastle Back to Work Barometer: a measure of current average weekly (first time a day) swipe activity across a 10-city sample of commercial office buildings which utilize Kastle building security, compared to a weekly average from before office use dropped due to COVID-19. The 10-city sample includes: Houston, Chicago, Austin, New York, Dallas, Los Angeles, San Francisco, Washington D.C., San Jose and Philadelphia.*

*Morningstar LSTA US Leveraged Loan 100 Index: measures the performance of the 100 largest facilities in the US leveraged loan market.*

*Morningstar US 10+ Year Treasury Bond Index: measures the performance of fixed-rate, investment-grade USD-denominated Treasury bonds with maturities greater than ten years. It is market-capitalization weighted.*

*NASDAQ 100 Index: one of the world's preeminent large-cap growth indexes. It includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization.*

*Real Estate Investment Trust (REIT): companies that own or finance income-producing real estate across a range of property sectors. Listed REITs have characteristics of both the income potential of bonds and growth potential of stocks.*

*S&P 500 Index: widely regarded as the best single gauge of large-cap US equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.*

*US Dollar Index: measures the value of the US dollar relative to a basket of foreign currencies.*

*One may not invest directly in an index.*

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