MONTHLY MARKET UPDATE
August 2023

Highlights:

- The S&P 500 maintained its upward momentum, increasing 3.2% in July and bringing its year-to-date return to more than 20%.
- The economy showed positive signs with four quarters of economic expansion, lower core inflation, robust auto and home sales, and strong job demand.
- A recession in corporate earnings, softening retail spending, and the potential lagged impacts of rising interest rates remain grounds for caution.

Optimism reigned once again in July as the S&P 500 tacked on another 3.2%, pushing the year-to-date return over 20%. The positives weren't obscure. We've witnessed four quarters of economic expansion, with second quarter GDP up an annualized 2.4%. Core inflation ticked downward, and auto and home sales were robust. Job demand remained firm. Is it possible that the economy is adjusting rather smoothly to higher interest rates? Could the Federal Reserve have achieved its ideal result - a soft landing? It would certainly defy previous consensus expectations that the Fed's dramatic rate increases would trigger a significant recession.

But despite the stock market's results, the jury is still out. We've seen this story before as wide expectations of a soft landing in late 2000 and 2007 were soon upturned. With the exception of some notable technology firms, we are currently in a corporate earnings recession, with the year-over-year S&P 500 average earnings down some -7%. Consumers' Covid nest eggs are on the verge of being spent down, and we're seeing the impact as discretionary retail spending is softening. The waning of so-called "revenge spending" in the wake of pandemic lockdowns is being felt through the service economy, as indicated by dipping airfare and hotel rates. Part of the economy's resilience in the face of higher costs of borrowing can be credited to businesses doing a good job of locking in lower rates before the Fed hikes started. But these lower rate loans have expiration dates, and publicly traded companies will face steep increases as they refinance over the coming years. The cost of borrowing is already affecting business start-ups and is a primary reason existing home sales are stagnant. Slowing global economies have hurt U.S. exports. It's also likely that the impacts of the Fed's hikes have not yet been fully expressed since rate increases can take up to two years to filter through the economy.

So how should investors proceed? We lean toward prudence as we look at an overall market that seems priced for perfection with a price-to-earnings multiple north of 19 times. Locking in 5% returns in high-quality bonds remains an attractive alternative, particularly for investors prioritizing capital preservation. Careful and opportunistic stock picking is our preference, even though this year's market has been driven by a small number of hot technology firms. While keeping up with this narrow market without a significant share of these leaders can prove challenging, we like to remind our investors that in similar exuberant markets of the past, the real value an active manager can provide comes from protecting gains when the inevitable downturn occurs.

PORTFOLIO MANAGER Q&A - DREW JUSTMAN

Drew Justman, CFA
Portfolio Manager, Analyst

The S&P 500 is up almost 20% this year, yet dividend paying stocks are not participating in this rally. How would you describe what's happening in the equity markets?

The first half of 2023 was certainly an unusual market environment. The market was up about 17% through the first half of the year, now over 20% through July. Much of that was driven by multiple expansion, where the market's valuation expands, as opposed to earnings growth. Specifically, the S&P 500 ended 2022 trading around 16.5 times forward earnings estimates. Today, it trades closer to 19 times, well above its 15-year average of 17 times. It's been a very strong market environment for select sectors and groups of stocks. Most notably, Technology, Communication Services, and Consumer Discretionary were the top performing sectors in the first half of the year. Many sectors did not have such strong gains, and many of those sectors include dividend paying stocks.

How do you value dividend stocks, and what are valuations looking like now?

With the broad market's advance so far this year, the buzz around artificial intelligence within the technology sector, and, of course, interest rates at higher levels, dividend stocks have been pressured. We think the unusual relative underperformance versus the broad market has created an attractive opportunity for dividend stocks. We value dividend stocks by looking at the company's dividend yield divided by the market's dividend yield using the S&P 500. We look at that ratio over a company's history. When a company is trading at the high end of its relative yield historical range, that usually means its valuation is low, and there's a good margin of safety for that stock. Conversely, if a stock is trading at the low end of its historical relative yield range, that valuation is high, and there's not as much of a margin of safety.

Right now, dividend stocks, in general, are trading at very attractive relative yields. For example, the Madison Dividend Income strategy had a yield of 3% at the end of the second quarter, and the S&P 500 yield was closer to 1.5%. That's 2 times the dividend yield compared to the S&P 500, which is historically high – the highest since we've been managing the strategy, which dates back over a decade.

Dividend strategies are often compared to bond strategies based purely on yield. With bonds yielding more than the stock market average, how do you make the case for dividend strategies?

As we sit here today, the yield on the 10-year Treasury is 4%. So, investors can invest their money for 10 years and lock in a 4% interest rate guaranteed by the U.S. government. The Madison Dividend Income strategy is yielding 3%. Dividends are, of course, not guaranteed and can fluctuate. But on average, our companies increased their dividends by 8% over the past year. Increasing dividends is something that we look for in stocks. Another factor to consider is the historical make-up of returns. Selling a bond before maturity can result in price appreciation, especially with wide moves in interest rates, but for the most part, the income makes up the majority of total return. Historically, stocks have returned roughly 10% per year if you look at the S&P 500. The make-up of that return is roughly 7% to 8% from capital appreciation and 2% to 3% from dividends.

In addition to dividend yield, what other fundamental qualities are you looking for when selecting companies for this strategy?

Madison Dividend Income is a conservatively managed equity strategy. We want to own a high quality portfolio of above-average dividend stocks, trading at below-average valuations. And we try to define high quality objectively. For example, Standard and Poor's provides financial strength ratings for companies. 86% of holdings in the Dividend Income portfolio are rated A- or better by Standard and Poor's, which compares to just 32% for the S&P 500. So based on financial strength, we think we're objectively much higher. And that financial strength is important because stocks with the strongest balance sheets have tended to hold up the best in market corrections and bear markets. We focus a lot on protecting capital on the downside. We're willing to lag in strong up markets as long as we can protect capital in down markets. We believe limiting drawdowns in challenging market environments is the best way to generate attractive long-term returns. In addition to financial strength, we look at a company's sustainable competitive advantage. Morningstar provides moat ratings for companies, and "wide moat" is the highest rating they award. 67% of the portfolio holdings are rated "wide moat" by Morningstar compared to just 27% for the S&P 500. So based on that measure, we are higher quality.

From a dividend perspective, we want to find stocks with an above average dividend yield, and we defined above average as 1.1 times the S&P 500 dividend yield at the time of purchase. The last thing we look at is dividend growth. Our companies have grown their dividends 8% over the last year on average. We want to find companies with a good historical record of consistently growing their dividends.

U.S. EQUITIES (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	3.4	8.5	10.6	12.6	9.3	11.2
S&P 500	3.2	20.6	13.0	13.7	12.2	12.7
Russell 1000	3.4	20.7	12.9	13.2	11.9	12.4
Russell 1000 Value	3.5	8.8	8.3	14.1	8.0	9.0
Russell 1000 Growth	3.4	33.4	17.3	12.2	15.2	15.5
Russell Midcap	4.0	13.3	8.7	11.8	8.8	10.1
Russell 2000	6.1	14.7	7.9	12.0	5.1	8.2

U.S. EQUITY CHARACTERISTICS - S&P 500

	July	2022
Price/Earnings Ratio	24.2	19.1
Weighted Avg. Market Cap ($B)	691.0	417.5
Dividend Yield (%)	1.5	1.7

U.S. EQUITY SECTORS - S&P 500 (%)

	July	YTD	Weight
Communication Services	6.9	45.7	8.7
Consumer Discretionary	2.4	36.3	10.6
Consumer Staples	2.1	3.5	6.6
Energy	7.4	1.5	4.3
Financials	4.8	4.3	12.6
Health Care	1.0	-0.5	13.1
Industrials	2.9	13.4	8.5
Information Technology	2.7	46.6	28.1
Materials	3.4	11.4	2.5
Real Estate	1.3	5.1	2.5
Utilities	2.5	-3.4	2.6

INTERNATIONAL EQUITIES (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	3.7	18.1	12.9	10.4	8.2	8.6
ACWI ex USA	4.1	13.9	13.4	7.1	3.9	4.7
MSCI EAFE	3.2	15.3	16.8	9.3	4.5	5.2
Emerging Markets	6.2	11.4	8.3	1.5	1.7	3.5
China	10.8	4.7	1.8	-9.9	-2.8	3.7
Japan	3.0	16.4	15.1	7.3	3.7	5.5
Germany	3.1	21.5	29.3	4.6	1.5	3.7
United Kingdom	3.4	12.2	12.9	13.3	3.3	3.6
India	3.0	8.2	7.5	16.6	8.0	9.5

KEY ASSET PRICES

	July	2022
EUR/USD	1.10	1.06
USD/CAD	1.32	1.36
USD/JPY	140.72	132.78
GBP/USD	1.29	1.21
Bitcoin ($)	29,230.1	16,514.0
Gold ($/oz)	1,969.0	1,827.0
Crude Oil (WTI) ($/bbl)	81.8	80.4

FIXED INCOME (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	-0.3	1.2	-3.9	-5.2	0.5	0.9
Municipal	0.4	3.1	0.9	-1.0	1.9	2.8
U.S. Aggregate Bond	-0.1	2.0	-3.4	-4.5	0.7	1.5
Investment Grade Corporate	0.3	3.4	-1.3	-4.3	1.6	2.5
High Yield	1.4	6.8	4.4	2.0	3.4	4.4

U.S. TREASURY YIELDS (%)

	July	2022
3-Month	5.6	4.4
6-Month	5.5	4.8
2-Year	4.9	4.4
5-Year	4.2	4.0
10-Year	4.0	3.9
30-Year	4.0	4.0

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The Morningstar Economic Moat Rating represents a company's sustainable competitive advantage. Morningstar has identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

The Dow Jones Industrial Average® (The Dow®), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The S&P 500® Index is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 89% of the total market capitalization of the Russell 3000 Index.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

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Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index 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.

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International Equities Definitions
The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index – captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index - captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index - is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index - is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index - is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index - is designed to measure the performance of the large and mid cap segments of the Indian market.

Fixed Income Definitions
Government Bond - Bloomberg US Government Index - measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

Municipal - Bloomberg U.S. Municipal Index - covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg U.S. Aggregate Bond Index - is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg U.S. Credit Index - measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg U.S. Corporate High Yield Bond 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. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Definitions
Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share of stock in a portfolio.

Dividend Yield: the portfolio's weighted average of the underlying portfolio holdings and not the yield of the portfolio.

A basis point is one hundredth of a percent.