Syntax

Interest Rates and Inflation and AI! Oh My!

Quarterly Commentary

Second Quarter 2023

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- **Central banks continue to fight inflation**
- **Tourism stocks are back from vacation**
- **The artificial intelligence (AI) boom throws the market a lifeline**

Introduction

In recent decades, global investors have witnessed numerous episodes of rampant inflation, including in the U.S. from 1973 to 1982, due to two surges in oil prices. While inflation has been a minimal factor in the developed markets until recently, that has not necessarily been the case in developing markets. For instance, in Zimbabwe from 2007 to 2008, the government declared inflation illegal after prices surged over a billion percent. In 1975 and again today, inflation in Argentina has soared, due to economic downturns, recurring currency crises and high-interest payments on the national debt.

The latest U.S. inflation report showed that the Consumer Price Index (CPI) climbed 4.0% and 3.0% in May and June, respectively, steadily declining from its 9.2% peak a year ago. While supply chain constraints have eased and the labor market has cooled due to announced layoffs, particularly in the technology sector, the Federal Open Market Committee (FOMC) has only recently paused its aggressive monetary policy tightening, which began in March 2022 and has resulted in 10 consecutive hikes totaling 5.0% through May 2023. During the FOMC's June meeting, it cited the need for more time to assess the economic outlook while strongly indicating that it plans to continue to raise rates until the end of the year. While increasing interest rates has helped to somewhat curb inflation, the FOMC's rate hikes have also come at a cost, almost resulting in a banking crisis (e.g., Silicon Valley Bank) in the U.S. and exacerbating recession fears.

While the first quarter ended with banking sector instability threatening to erase market gains, U.S. equity markets recovered, and the Syntax US 500 Large Cap Index rose 8.9 % in Q2, driven predominantly by an AI-induced rally.

Exhibit 1: Syntax Core Index Performance Summary

Index	Ticker	Q2 2023 (%)	12 months (%)
Syntax US 500 Large Cap Index	SY500	8.9%	19.5%
Syntax US 1000 Large and Mid Cap Index	SY1000	8.6%	19.4%
Syntax US 2000 Small Cap Index	SY2000	4.7%	12.1%
Syntax US 3000 Index	SY3000	8.4%	19.0%
Syntax US 200 Mega Cap Index	SY200	10.0%	21.1%
Syntax US 400 Mid Cap Index	SY400	4.2%	15.6%
Syntax Stratified SmallCap Index	SYSCTR	2.7%	9.5%
Syntax Stratified LargeCap Index	SYLCTR	3.9%	14.4%
Syntax Stratified MidCap Index	SYMIDTR	5.0%	18.1%

Source: Syntax. Performance as of 30 June 2023. Total return performance does not reflect fees or implementation costs, as an investor cannot directly invest in an index.

The Syntax 3000 Index ended the quarter up 8.4%, while the Syntax US 200 Index rose 10.0%, extending its rally from Q1 and consequently outperforming the broad market. The Syntax US 500 Index beat the market by 50 basis points. The Syntax US 1000 Index slightly outperformed the broad market, ending Q2 with an 8.6% return. Despite underperforming the market, the US 2000 Index ended the second quarter up 4.7%. Our more diversified Stratified Weight Indices underperformed the market but still ended the quarter up 2.7% for the SmallCap Index, 3.9% for the LargeCap Index, and 5.0% for the MidCap Index. This relative underperformance is expected during periods of high momentum, as observed year to date; the Stratified Weight Indices slightly outperformed equal weight measures of these same universes year to date.

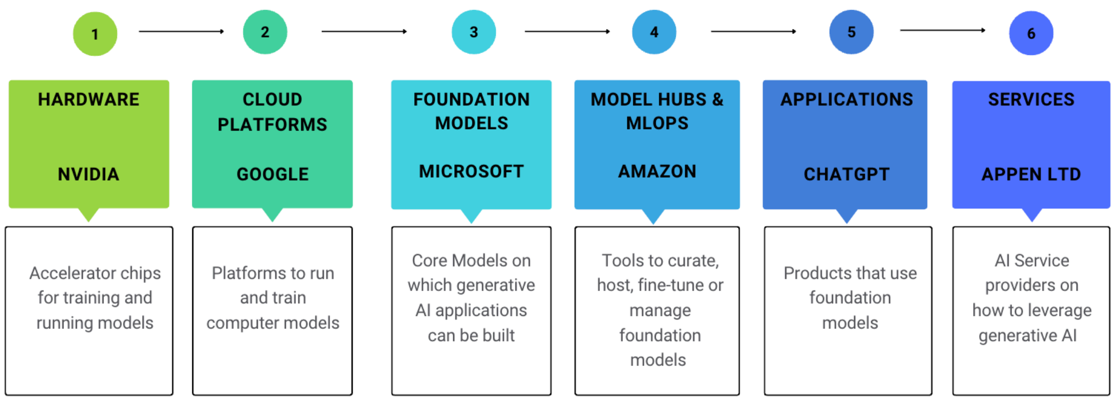
Last quarter, we noted that seven companies generated over 50% of the market's 7.5% rally. In comparison, its equally weighted counterpart returned only 2.9%. This trend persisted in the second quarter when NVIDIA, the computer graphics processor and chip manufacturer, which has benefitted from the rapid adoption of AI, joined the trillionaires club and became the seventh U.S. company with a capitalization of over $1 trillion.

While these "Magnificent Seven" companies – Apple (+49.7% YTD), Alphabet (+36.3%), Amazon (+55.2%), Microsoft (+42.7%), Nvidia (+189.5%), Meta (+138.5%), and Tesla (+112.5%) – have significantly outperformed year to date, that has not been the case for the rest of the S&P 500; the average stock excluding these seven is up merely 7.7% over the same period. While robust economic data has put some recession fears to rest, investors should be cautious about interpreting the market's headline returns without understanding the underlying performance drivers.

Exploiting Investment Opportunities in the AI Value Chain

While the Magnificent Seven have been the primary beneficiaries of the emergence and adoption of AI, other companies can also be well-positioned to take advantage of this theme. Exhibit 2 breaks down the AI value chain into various components, illustrating potential opportunities that investors can pursue to gain exposure to the AI trend. For example, companies focused on computer hardware and cloud platforms have been among the first to reap the benefits of the recent AI boom. Additionally, foundation models, such as ChatGPT, have been widely adopted by end-users, model hubs (on which applications are built), and access models – all of which could offer potential opportunities for investors, particularly when considering the range of industries that leverage or plan to leverage AI technology to deliver applications and services for their clients.

Exhibit 2: Generative AI Value Chain



Source: McKinsey and Syntax. The graphic above has been adapted from https://www.mckinsey.com/capabilities/quantumblack/our-insights/exploring-opportunities-in-the-generative-ai-value-chain. Company names are provided as non-limiting examples of companies engaged in various parts of the AI Value Chain. MLPOs are machine learning operations.

Affinity Thematic Lens

Using the Syntax Affinity® Platform, investors can view the market through a wide range of unique thematic lenses and analyze the performance of groups of relevant companies. Themes are often persistent in the markets for several months or quarters; related stocks can persistently out (or under) perform. During the second quarter, the following emerged as themes to watch:

<u>Leaders</u>

Tourism
While the covid pandemic halted travel globally, this year's tourism projections indicate that the travel industry has rebounded. The Affinity Tourism lens was up 20.9% for the second quarter. The Cruise Ship and

Airline groups, whose businesses were brought to a near standstill in 2020, rallied significantly, with returns as high as 68.7% and 24.0% in Q2. Cruise ship companies such as Carnival Corporation, Norwegian Cruise Line, and Royal Caribbean are among the top performers, each returning above 50% for the quarter.

Technology Revolution
Our Q1 commentary discussed how the AI revolution fueled outperformance in companies like NVIDIA, Advanced Micro, and Intel. This trend persisted in Q2 when NVIDIA reported higher-than-expected revenue ($7.19 billion vs. $6.52 billion) and higher-than-expected earnings per share ($1.09 vs. $0.92) for Q1, attributing the results to increasing demand for its Graphic Processing Units (GPUs).

Infrastructure
The Biden Administration's Infrastructure Investment and Jobs Act and Inflation Reduction Act mandated that $1.25 trillion be invested across the transportation, energy, water resources, and broadband sectors over the next five to 10 years. This legislation has resulted in large investments in companies specializing in construction materials, such as aggregates, concrete, and cement which returned over 30% in Q2.

Laggards

Banking
Q1 was marked by substantial losses in the banking sector that were linked to the Fed's aggressive rate hikes and resulted in the loss of investor confidence in the sector and the broader market. Sentiment regarding banks improved as they posted modest losses in Q2 (-4.6%) versus the -28.3% loss for Q1. Real Estate Banking and Real Estate Financial products, however, continued to underperform, returning -40.7% and -35.8%, respectively.

Agriculture
High inflation numbers resulted in negative returns within commodities, particularly agricultural commodities. Falling wheat and corn prices due to increased supply resulted in negative returns in groups such as Agricultural Seeds and Chemicals (-10.7%) and Agricultural Equipment and Suppliers (-9.2%) in Q2.

Hope on the Horizon?

Cooling inflation numbers and expectations of the Fed ending its course of interest rate hikes at the end of the year have boosted investor optimism about the market. However, the most notable market driver has been the recent excitement about AI and its expected benefits, which have resulted in the Magnificent Seven stocks leading the market and accounting for half of its gains in Q2. It is too soon to determine whether AI will live up to the hype, be another passing trend, or somewhere in between. Investors should be cautious about balancing the fear of missing out on the AI trend with paying attention to valuations and the various drivers of the macroeconomic outlook.

Exhibit 3: Affinity Thematic Lenses – Q2 2023 Leaders and Laggards

	3M	6M	1Y	5Y
Tourism				
Airlines	24.0%	32.4%	37.8%	-21.6%
Casinos	-0.3%	25.8%	57.4%	-20.1%
Cruises	68.7%	107.0%	136.9%	-43.2%
Hotels	6.1%	20.6%	28.7%	29.4%
Tourism	20.9%	40.5%	57.0%	-3.7%
Tourism-based Transportation	24.0%	32.4%	37.8%	-21.6%
Web-Based Travel Retailing and Distribution Platforms	7.3%	30.0%	35.4%	18.9%
Technology Revolution				
5G-enabling Technology	19.5%	24.9%	50.6%	174.6%
Cybersecurity	10.9%	19.8%	10.1%	127.9%
High Performance Compute & Artificial Intelligence	15.9%	36.0%	10.2%	114.5%
Robotics	8.0%	10.5%	38.6%	66.6%
Technology Revolution	4.1%	14.0%	20.9%	101.8%
Infrastructure				
Infrastructure	5.2%	7.8%	21.9%	81.2%
Aggregates, Concrete, and Cement Construction Materials	30.7%	32.7%	56.6%	91.3%
Construction and Engineering	9.5%	17.6%	22.4%	49.8%
Infrastructure Materials	12.3%	22.1%	51.3%	142.4%
Infrastructure Suppliers	4.5%	11.3%	43.6%	129.5%
Transportation Infrastructure Operators	7.5%	0.3%	4.3%	71.2%
Commodities				
Agricultural Commodities	-6.9%	-10.6%	64.1%	82.7%
Agricultural Equipment and Supplies	-9.2%	-10.6%	104.4%	120.8%
Agricultural Producers	-6.6%	-14.6%	-13.7%	-3.6%
Agricultural Producers and Processors	-3.4%	-10.8%	10.8%	28.1%
Agricultural Seeds and Chemicals	-10.7%	-11.7%	94.5%	107.8%
Sector				
Banking	-4.6%	-28.3%	-27.7%	-23.7%
Real Estate Banking	-40.7%	-96.5%	-97.4%	-97.5%
Real Estate Financial Products	-35.8%	-82.1%	-85.2%	-85.4%
Banking, Insurance, and Investment Technology	-4.7%	4.8%	12.2%	70.8%
Consumer Financial Services and Banking	-2.7%	-18.7%	-15.7%	-2.9%

Source: Syntax, Affinity, S&P Dow Jones Indices. Performance is calculated as the weighted average total return of the subset of the S&P 500 Equal Weight Index constituents who are members of the Affinity Theme. 3M, 1Y, and 5Y show total return for the 3-, 12- and 60-months ending 30 June 2023 Since inception reflects total return from 31 December 1991. Performance does not reflect fees or implementation costs.

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