MARKET COMMENTARY

A WARNING OVER SPECULATIVE DEBT

Last week, the European Central Bank (ECB) raised a red flag, saying some member banks have ignored warnings of risks associated with leveraged finance. The ECB hit a handful of European banks with capital charges in an attempt to encourage the banks to exercise greater caution. These actions come amid growing concern in Europe over a looming energy crisis, ongoing war in Ukraine, and struggles at some financial institutions.

Graph A

BLOOMBERG EURO-ZONE FINANCIAL CONDITIONS INDEX

Source: Bloomberg

Graph B

IFO PAN GERMANY BUSINESS EXPECTATIONS

Source: Bloomberg

These pressures are evident in both confidence indicators like business confidence (Graph A) and measures of financial stress (Graph B).

RISE OF LEVERAGED FINANCE

Leveraged finance is the use of high amounts of debt, instead of equity, to purchase assets. This type of financing often aims to increase an investment's potential return. An underlying assumption is that the investment increases in value faster than the cost of financing the investment. As interest rates rise and the economy slows, greater attention is likely to be paid to such arrangements. The Federal Reserve and other U.S. agencies have warned of risks associated with leveraged loans, especially those originated by hedge funds and others outside the traditional banking system.

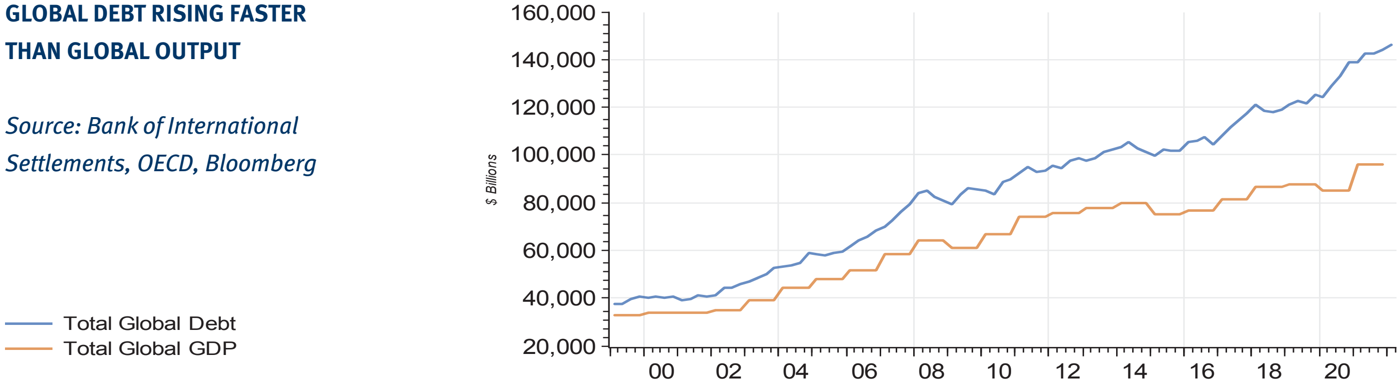
An extended period of low rates, low volatility, and risk appetite drove a global hunt for yield, and easy monetary policies encouraged heavy borrowing. Private equity and leveraged buyout activity hypercharged growth, resulting in more leverage and less bondholder protection. According to Moody's, leveraged finance is now $4 trillion in size globally, with $1.5 trillion borrowed in 2021.

Now, central banks around the world are pulling back support. Facing high inflation, they are raising interest rates and reducing programs that previously supported market liquidity. In effect, central banks have removed the "punch bowl," which likely means stricter business conditions and earnings pressure lies ahead.

Graph C

GLOBAL DEBT RISING FASTER THAN GLOBAL OUTPUT

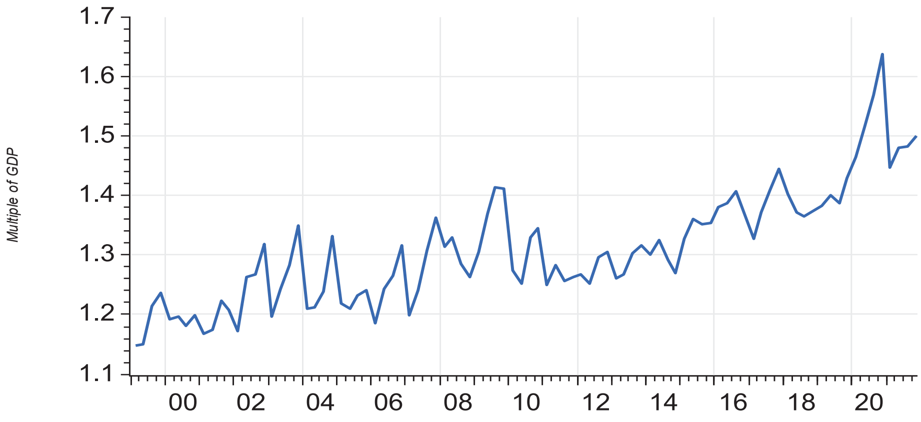
Source: Bank of International Settlements, OECD, Bloomberg



Graph D

GLOBAL DEBT TO GDP RATIO

Source: Bank of International Settlements, Bloomberg



WHY CARE?

We care about debt and leverage because they can amplify volatility. When a company or economy with high debt experiences a downturn or increase in borrowing costs, both of which are in the cards today, crisis and failure can easily follow. When debt burdens are lower, the business's and economy's periodic ups and downs are less life-threatening. Over the past decade, global debt increased by about 4.6% annually while the global economy grew an average of 2.7% per year, including inflation (Graph C). The result was a rise in total global debt to nearly $150 trillion, about 50% more than the entire planet's annual output (Graph D). The potential for greater volatility, more shocks, and a rolling crisis is significant if debt continues to grow faster than the economy.

CONCLUSION

It is increasingly important to focus on quality in a world of growing debt burdens. Should the months ahead bring lower earnings and higher funding costs, higher-quality companies with less debt should perform better than lower-quality, highly indebted companies.

Companies with greater flexibility, predictability, and durability make sense in such an environment. Therefore, our focus on asset profitability, lean balance sheets, and steady businesses will remain foremost in our minds.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.

S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.

S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher-quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees.

This commentary often expresses opinions about the direction of market, investment sector and other trends. The opinions should not be considered predictions of future results. The information contained in this report is based on sources believed to be reliable, but is not guaranteed and not necessarily complete. The securities discussed in this material were selected due to recent changes in the strategies. This selection criteria is not based on any measurement of performance of the underlying security.

Washington Crossing Advisors LLC is a wholly owned subsidiary and affiliated SEC Registered Investment Adviser of Stifel Financial Corp (NYSE: SF). Registration with the SEC does not imply a certain level of skill or training.

FOR MORE INFORMATION, PLEASE CONTACT US:

Washington Crossing Advisors

- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Senior Risk Manager | (973) 549-4028
- **Suzanne Ashley,** Internal Relationship Manager | (973) 549-4168

Municipal Fixed Income

- **Paul B. Clark, CFA,** Senior Portfolio Manager | (415) 364-2635

Sales and Marketing

- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

About Washington Crossing Advisors | Washington Crossing Advisors a wholly owned subsidiary of Stifel Financial Corp. (NYSE-SF). The WCA team has been helping individual and institutional investors build wealth for more than 25 years.

www.washingtoncrossingadvisors.com

WASHINGTON CROSSING ADVISORS