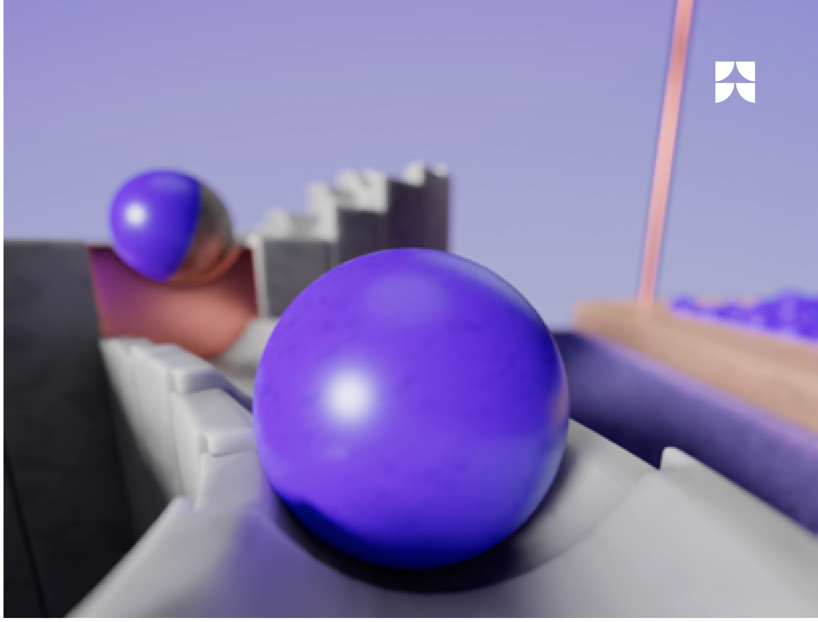
2023 MIDYEAR OUTLOOK

GETTING AHEAD OF RECOVERY

Equities from 10,000 feet up



ANN MILETTI
+ Chief Diversity Officer, Head of Active Equity

A *lot* has happened in the economy and equity market in the first six months of 2023. The Federal Reserve (Fed) continued raising its key interest rate, and while the inflation rate declined following those moves, it's still pushing up costs for businesses and prices for consumers. March brought us the banking crisis, which shocked financial markets, weakened stock prices, and added to worries over the economy. Now, as we reach the year's midpoint, I think many equity investors are concerned and wondering: What's in store for us for the rest of this year?

I've been reflecting on this question, taking into account key economic and equity data and consulting with members of our team. As investment professionals, it's essential that we develop educated estimates of what the market's future could hold—for equities overall and for the equity styles, market capitalizations, and countries in which we invest. Below are trends we believe will be evident during the second half of this year.

WE'RE LEANING TOWARD THE PROBABILITY OF A COMING U.S. RECESSION.

While it may not be a deep recession, it could be longer-lasting than some predict, led by the delayed impact of rate increases totaling 500 basis points (bps; 100 bps equal 1.00%) over such a compressed period of time. Inflation is retreating, but it won't be a smooth decline. It's likely that deflation will be seen in many areas of the economy where supply constraints are less problematic—like autos and energy—but it will remain a bit stickier in other areas like housing.

WEAKENING IN COMMERCIAL REAL ESTATE (CRE)—A HUGE MARKET—IS LIKELY TO CONTINUE.

The Fed's rate increases in the latter part of 2022 and thus far in 2023 have led to weakening in the CRE market. Two key reasons for this are that rising rates have reduced the present value of commercial properties—particularly office real estate—that have fixed cash flows and they've made it harder to finance CRE purchases. With a slowing economy, there's less demand for goods and services, and some employers have reduced employment as a result—especially in the information technology sector. While reduced demand for office space has been observed nationwide, locations known as tech centers—like San Francisco and Seattle—have seen some of the highest vacancy rates. It's possible, too, that hybrid work schedules maintained by many employers following the pandemic could play a major role in how much demand there'll be for office space going forward.

ONGOING TURMOIL WITH REGIONAL BANKS COULD LEAD TO PRESSURE ON CREDIT.

Although the U.S. government has acted to support the financial system in the wake of the banking crisis, the environment is now tougher for regional and smaller banks. Despite not being large, these banks play an important role in the U.S. economy: They account for about 50% of U.S. commercial and industrial lending, and many of their loans support small/midsize businesses. Their size, unfortunately, means these banks also carry higher risk: If new deposits decline (due to depositors' concerns from the banking crisis, for example), their lending ability also declines—and subsequently, they'll need to tighten lending guidelines. Tighter guidelines, in turn, could constrict the ability of many small and midsize clients to obtain loans they need to maintain and grow their companies. As a result, quality differentiators among small/midsize companies will matter more now than they did in recent years. To be clear, small and midsize companies are quite interesting from an investment and valuation perspective, but now is not the time to own the entire index.

DESPITE ALL THE RISKS, THERE ARE STILL POTENTIALLY PROMISING INVESTMENTS TO BE FOUND.

Emerging markets, for example, may be one area to look for investment opportunities this year. Emerging market central banks are close to the peak of their respective rate cycles, which historically has heralded strong emerging market returns. Growth in the U.S. is slowing at the same time it's accelerating in China and other emerging markets—another tailwind for emerging equities. Nearshoring (moving supply chains out of China to other countries) appears to be gaining momentum, which we believe should benefit Southeast Asia, India, and Mexico in the medium term.

Wherever investors choose to look, it's important to me to emphasize what I've said elsewhere recently: Now is the time to be selective. Investors should know more about the companies they are investing in at this part of the cycle. Do those companies have:

- Healthy balance sheets (the right capital structures)?
- Strong free cash flow per share?
- Management teams with good risk controls and experience through difficult times?

Next, Tom Ognar and Eddie Cheng share their thoughts on important questions for equity investing in the second half of 2023.

GETTING AHEAD OF RECOVERY: GROWTH EQUITIES

What are you expecting for the second half of 2023?

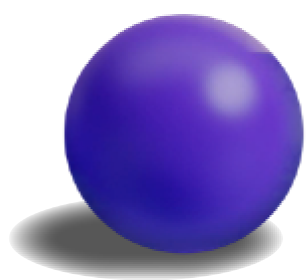
TOM OGNAR
+ Managing Director, Senior Portfolio Manager
+ Dynamic Growth Equity

Given the wide range of possible outcomes for the U.S. economy, we don't believe we'll see a straight-line recovery. The economy appears to be in solid shape: Employment has remained strong, consumers in the upper half of incomes have continued spending at a robust rate, and China's reopening has been a boost for the global economy. However, we think the banking sector's issues likely increase the probability of a recession as credit becomes scarcer in the market.

We believe 2023's second half will be a tug between macroeconomic factors and earnings. Stocks don't necessarily have to go down when earnings weaken. Declining discount (interest) rates can support equity multiples even if we see an earnings slowdown. Historically, secular growth stocks have outperformed when growth was scarce—typically, in a slower-growth economic environment. If that's what materializes in the second half, we believe growth stocks are primed to sustain the recovery we've seen so far.

What potential risks and/or surprises do you think could lie ahead in the next six months?

The Fed got surprised by inflation's persistence, and the repercussions of its resulting massive interest rate hike cycle are still playing out and not fully known. This increases uncertainty and risk—specifically in the banking sector, which provides critical support to the economy. If credit losses mount, the markets could be at significant risk. Another key risk is geopolitical: the evolving dynamics of a precarious relationship between China and the U.S. that may deteriorate further. We'll also be watching how U.S. consumers navigate the higher interest rate environment. One thing to remember is that even though borrowing costs have risen, the higher costs are being somewhat offset by consumers' increased earnings on their savings due to the higher rates. A resilient consumer could be a positive surprise.



> " A resilient consumer could be a positive surprise.

What potential opportunities do you see for investors in the second half?

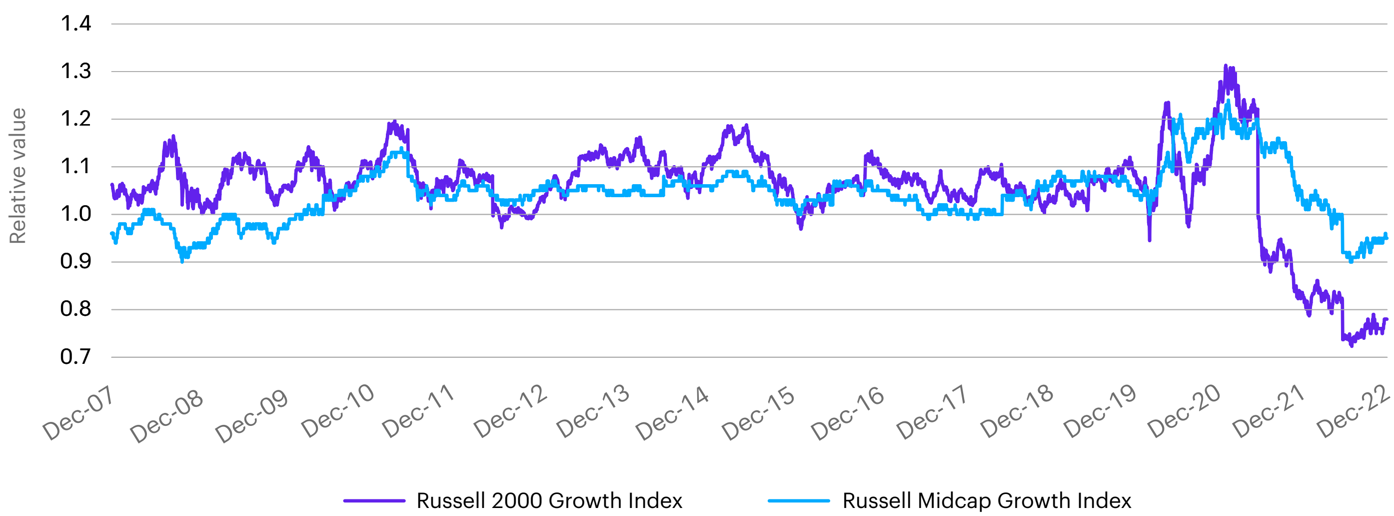
Now that we are out of an era of ultralow interest rates, investment decisions cannot be solely focused on growth—valuation and how a stock is pricing for future growth expectations of cash and earnings will be critical. The environment for much of the past decade provided a huge tailwind for growth stocks, leading many investors to deemphasize diversification, portfolio construction, and risk management. We expect investors will have a renewed focus on these attributes, which are ingrained in our philosophy and investment process. We believe the current environment will show the benefits of this discipline, and we remain balanced and diversified in our approach.

The area that looks the most incrementally interesting to us in the growth equity space is a bit down the market cap. While we aren't excluding large- and mega-cap stocks from our portfolios, we're very attuned to the valuation discounts currently being afforded to small- and mid-cap stocks after protracted periods of underperformance relative to large-cap stocks. The chart below shows the potential opportunities for both small- and mid-cap growth stocks as their valuations have remained discounted relative to large-cap equities on a historical basis.

At the sector level, spending on health care appears to be accelerating and normalizing after health care utilization dipped because of COVID. There appears to be some pent-up demand flowing into the health care system.

SMALL-CAP GROWTH AND MID-CAP GROWTH RELATIVE VALUATIONS ARE AT DECADE-PLUS LOWS

RELATIVE VALUATIONS OF MID- AND SMALL-CAP GROWTH TO LARGE-CAP GROWTH; ENTERPRISE VALUE/EBITDA* (NTM**)



*EBITDA = earnings before interest, taxes, depreciation, and amortization
**NTM = next 12 months
Source: FactSet, as of December 31, 2022. **Past performance is not a reliable indicator of future results.**

GETTING AHEAD OF RECOVERY: SYSTEMATIC EQUITIES

What are you expecting for the second half of 2023?

EDDIE CHENG, CFA
+ Head of International Portfolio Management
+ Systematic Edge Multi-Asset

While there seems to be consensus around a U.S. recession, it's worthwhile to differentiate between a *profits* recession and an *economic* recession. In recent quarters, we've seen a series of earnings declines across different companies and industries—for example, in the U.S. financials and communication sectors—providing strong evidence that a profits recession has already started. However, what's key for us to monitor now is when earnings start to rebound, as equity markets often stage a profits recovery before the economy starts recovering. Considering that many industries have already experienced a profits recession, it's possible we'll see market multiples and credit spreads pointing toward recovery before the reality of an economic recession sinks in.

While inflation has trended down, the path to lower inflation may not be a straight line, as Ann noted earlier. Finding a balance between taming inflation and maintaining economic growth is always hard and leaves plenty of room for surprises. With this in mind, we see higher potential for downside risk in equity markets with possible upside surprises.

What potential areas of opportunity do you see for investors in the second half?

In an environment where we experience some form of recession while inflation stays higher for longer, we believe a more cautious and defensive positioning is warranted. Depending on different preferences and portfolio characteristics, investors may wish to consider approaches that we use to adjust equity exposures to be more defensive:

Looking for income?

We believe an enhanced equity income approach could fit well in this environment given its dual focus on income and total return. The income approach we use strongly emphasizes stable and sustainable businesses that can support their dividend policy. Those types of businesses have proven more resilient during recessionary environments. As we witnessed in 2023's first quarter and many other periods in history, a dampened economic outlook might not always translate into a disappointing equity market. Should there be any market upside, we think a total-return focus may allow investors to retain higher upside capture.

Concerned over higher stock and bond correlations going forward?

We feel that diversifying these exposures is more important than ever. A long/short equity approach offers the potential to provide equity-like returns with lower volatility and, importantly, preserve capital during market downturns. Over the long term, we've seen high-risk segments of the market frequently underperform their low-risk counterparts. High-risk stocks tend to fall farther during market downturns. This trend, called volatility drag, means they have a harder job to regain lost ground, and it's led to underperformance of high-risk stocks over the long term. We witnessed this most recently in 2022, when high-risk stocks underperformed low-risk stocks by 26%. By shorting high-risk stocks, losses may be mitigated during down markets while retaining attractive upside potential.

Seeking more explicit risk management strategies?

One approach is to use options, which may provide more certainty on the hedging outcome but also can be costly. Another possibility is to consider a more flexible and futures-based dynamic risk-hedging approach. Its goal is to provide protection based on a consistent, systematic assessment of the market. A dynamic risk-hedging approach is activated only when deemed necessary, which may help preserve capital at a more affordable cost. This type of approach does not offer guaranteed protection but may provide a meaningful cushion during market downturns.

With possible downside risk on the horizon, a combination of diversifying and defensive equity approaches can be an attractive way to potentially improve the probability of achieving positive outcomes.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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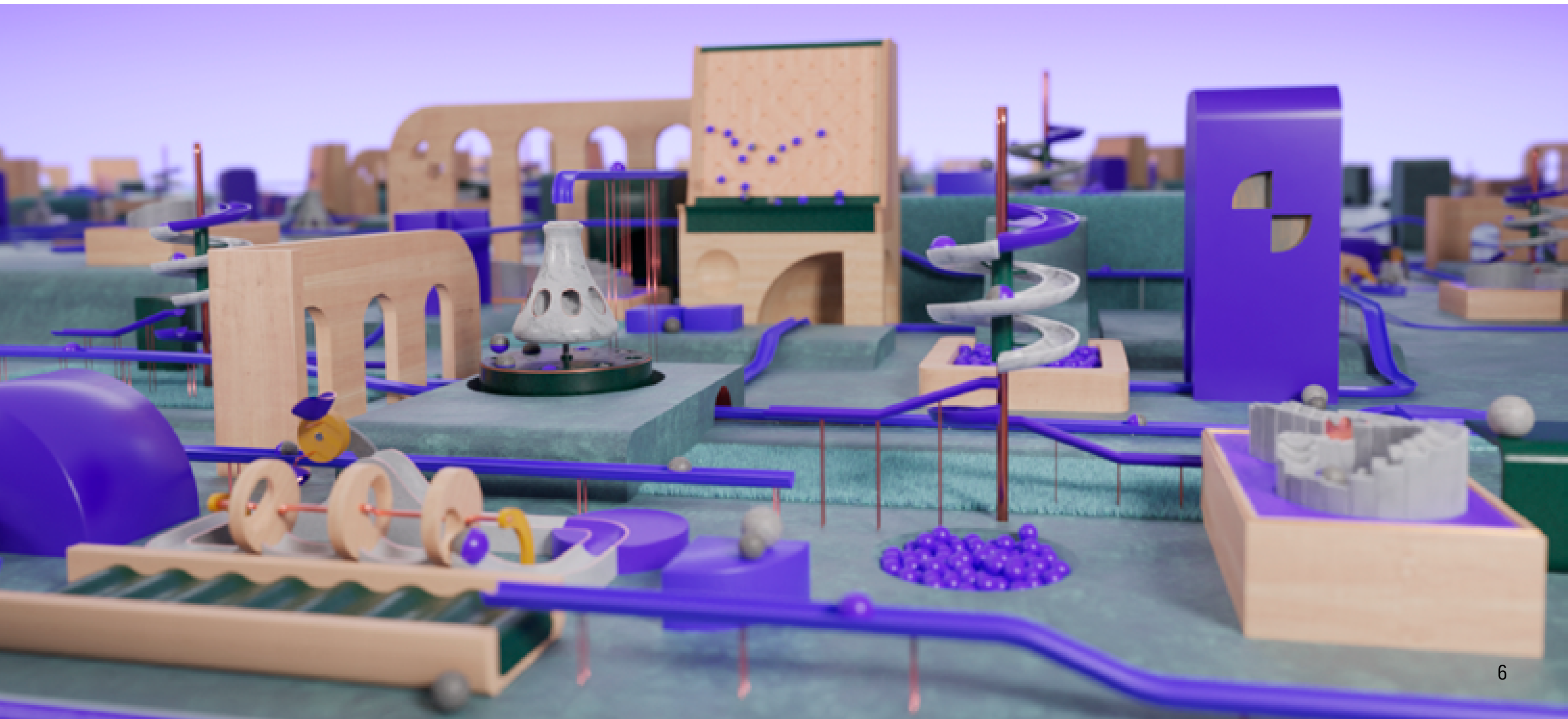
- For retail clients, contact your financial advisor.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at **1-888-877-9275**.
- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at **AllspringInstitutional@allspringglobal.com**.
- To reach our U.S.-based retirement professionals, contact **Nathaniel Miles**, head of Global Client Strategy at Allspring Global Investments, at **nathaniel.s.miles@allspringglobal.com**.

FOR NON-U.S. INVESTORS ONLY

- To reach our non-U.S.-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.



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