



MarketPoint

An Economic & Market Commentary from Trust Point

First Quarter 2023 | Issue No. 41

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An Economic and Market Update from Trust Point

After a difficult year in 2022, equity and fixed-income markets rebounded in the first quarter of 2023. For stocks, better-than-expected economic activity led the rebound. For bonds, interestingly, it was the recent banking events that led to a flight to quality and higher bond prices. Balancing the economy, inflation, and now financial stability will prove challenging in the next several quarters. We continue to position portfolios with defense in mind. To learn more about what the rest of this year may bring, please read on.

Respect the Lagged Impact of Interest Rates on the Economy

It has been only three months but the narrative about the economy has already evolved multiple times in 2023. For the first six weeks of the year, optimism about a soft landing was prevalent. So prevalent, in fact, that the “no landing” crowd started to emerge in late February. Somehow, that group argued, the economy would be able to sail through the second-fastest tightening cycle in history unscathed. The argument was supported by stronger-than-expected economic data and a strong and resilient labor market. But then came March, which was dominated by fears of a banking

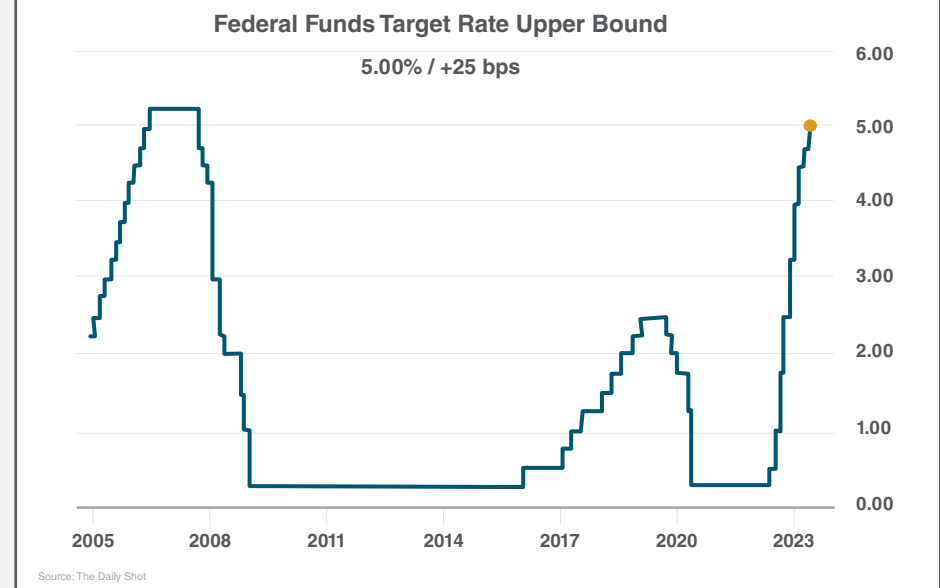
crisis in the United States and Europe. The failure of Silicon Valley Bank and Credit Suisse, in particular, heightened market concerns about the negative impact of ongoing U.S. Federal Reserve (Fed) tightening. But just as markets started to wonder if the Fed was going too far with ongoing rate hikes, it delivered another 25 basis point rate hike (Chart 1) at the Federal Open Market Committee (FOMC) meeting in late March, giving precedence to strong inflation data over negative developments in the banking sector.

KEY ECONOMIC DATA

	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Mar	102.5	103.5	98.3
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Mar	46.3	48.4	57.0
ISM Non-Manufacturing (>50 = Expansion)	Mar	51.2	49.2	58.4
Non-Farm Payrolls	Mar	236k	239k	414k
Unemployment Rate	Mar	3.5%	3.5%	3.6%
CPI Ex-Food & Energy (yoy)	Feb	5.5%	6.0%	6.4%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Mar	49.6	48.7	53
JP Morgan Global Services Index (>50 = Expansion)	Mar	54.4	48.0	53.4

Source: Bloomberg

Chart 1: Fed Funds Rate Up Another 25 bps



When There is an Accident on the Highway, Everybody Slows Down

For both Silicon Valley Bank and Credit Suisse, the speed of information on the Internet created a “react first, ask questions later” type of environment. For Silicon Valley Bank, a high dependence on uninsured corporate depositors (Chart 2) led to sudden deposit outflows as corporate CFOs and risk officers sought to limit exposures after the company announced a \$1.75 billion share sale. To avoid contagion, U.S. authorities stepped in quickly, seized the bank and created a new lending facility for all eligible banks to allow quick access to liquidity if needed. Although the measure clearly helped avoid a banking

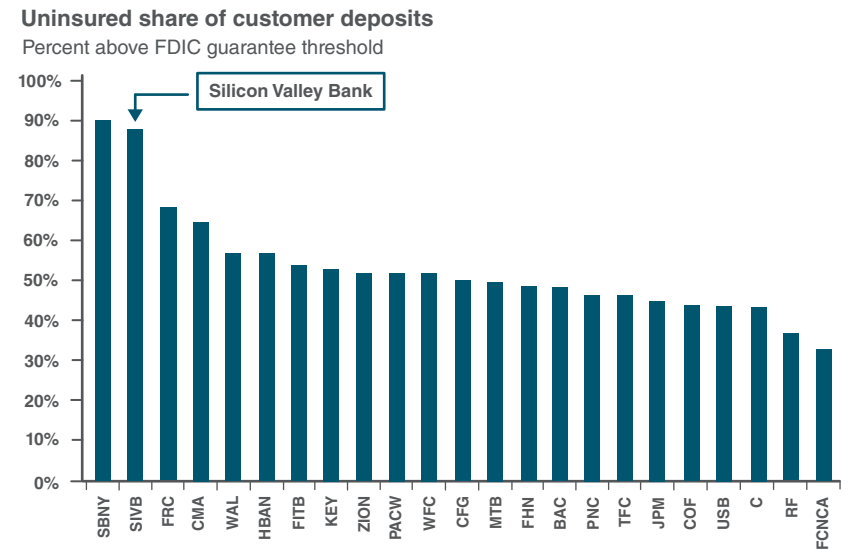
contagion, it is unlikely to prevent the banking system from reducing the flow of money to the economy, essentially making borrowing harder and more expensive for consumers and businesses. Many mid-size and regional banks are or will be impacted by headwinds, such as bank deposit outflows (moving to higher-yielding options) and increased regulatory scrutiny and supervision. In our opinion, this will lead to tighter lending standards across the banking industry, which in turn will weigh on economic growth and magnify the risk of a recession in late 2023 and early 2024.

Defense First Offers Some Protection

We continue to believe that the economy is headed into a recession. Recent events in the banking sector have not materially changed our view but they may accelerate the timing of the decline in economic activity (Chart 3). As we have mentioned several times in recent publications, the negative impact of higher interest rates is being felt over time and with a lag. The very first Fed rate hike from 0% to 0.25% was only about one year ago (March 17, 2022), and we continue to believe that economic fundamentals will deteriorate in the months and quarters to come. Our

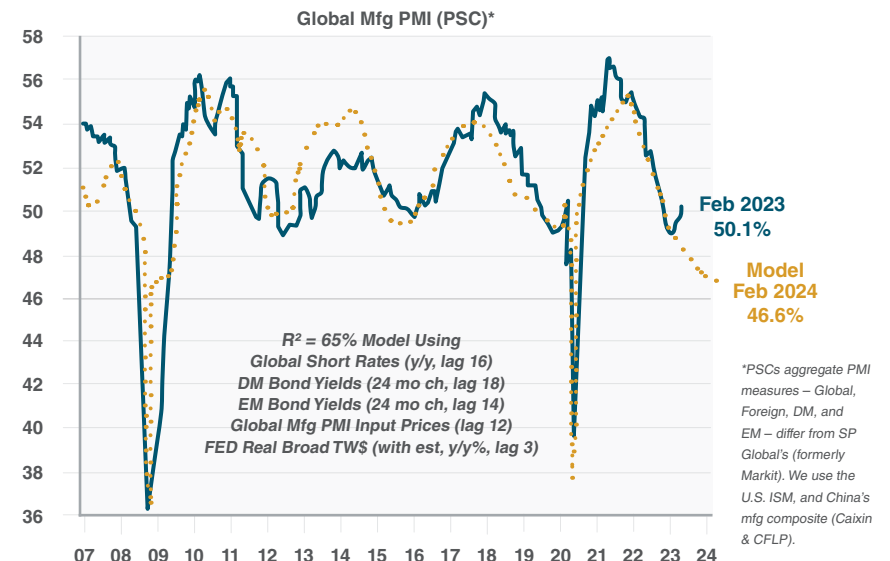
clients’ portfolios are well prepared for this. At multiple times over the past 12 months, we have taken advantage of bear market rallies to reduce exposure to equities, credit, cyclical and international stocks, using the proceeds to increase exposure to high-quality bonds and high-quality value defensive stocks. A more recession-resilient portfolio is preferred in the current environment and should provide some protection in what we believe may be another volatile year for markets.

Chart 2: High Dependence on Uninsured Deposits at Silicon Valley Bank



Source: JP Morgan Asset Management

Chart 3: Economic Fundamentals Likely to Deteriorate Further



Source: Piper Sandler & Co.

An Equity Market Update from Trust Point

Equity markets started with a bang in 2023 with global markets rising 7.2% in January. Stronger-than-anticipated economic data combined with continued improvement on inflation gave investors hope that a soft landing would be achievable. Optimism quickly faded in March and global equities ended the quarter up 7.8% as the banking sector came under stress and financial conditions tightened. Meanwhile, the corporate earnings outlook remains relatively bleak for the rest of this year. During uncertain environments, investors typically seek high-quality defensive companies as an area of relative safety.

Corporate Earnings at Risk of Further Declines

In the immediate aftermath of the pandemic, corporate earnings boomed. The combination of higher prices and stronger demand resulted in record sales and earnings for most companies. However, as companies released their 2022 Q4 earnings reports during the first quarter of '23, the results showed the beginning signs of weakening demand and slower price increases. The combined earnings growth rate of S&P 500 companies was -3.2% year over year, the first negative quarter since 2020. Looking ahead, the negative impact from the pull forward of demand over the last few years will worsen this

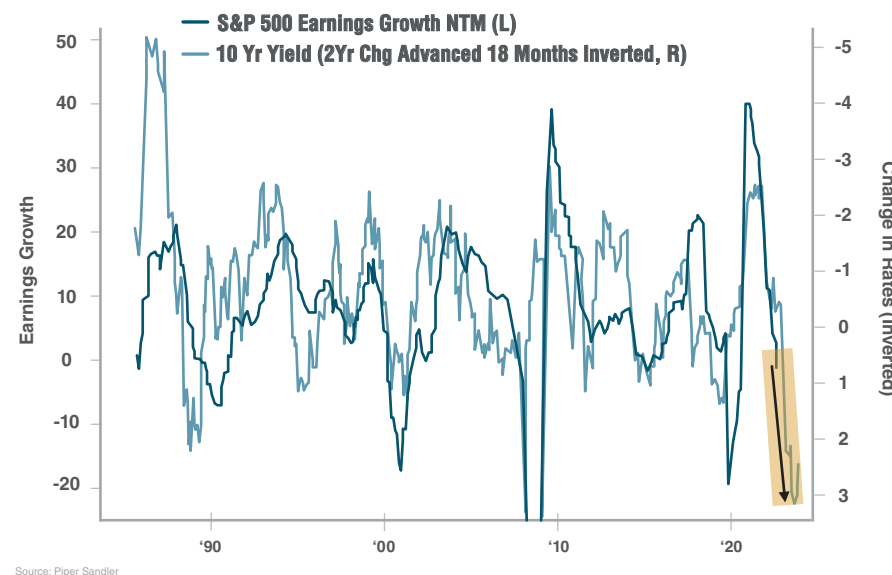
year, leading to further earnings declines. According to I/B/E/S data from Refinitiv, current estimates for 2023 Q1 and Q2 earnings growth are -5.2% yoy and -4.0% yoy, respectively. As is typically the case, analyst expectations are higher in later quarters, with estimates expected to rebound in the second half of the year and end 2023 with full-year earnings growth of 0.9%. In our opinion, it is likely that these more optimistic earnings estimates will be revised lower as analysts fully incorporate the impact of the lagged effect of interest rates on the economy (Chart 4).

EQUITY BENCHMARK TABLE

US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	4,109	3,840	4,530	3,756	2,641
Dow Jones Industrial Average	33,339	33,147	34,678	21,917	24,103
NASDAQ	12,222	10,466	14,221	7,700	7,063
Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	14.4%	14.4%	-10.9%	18.6%	13.7%
US Large Cap Value	1.0%	1.0%	-5.9%	17.9%	7.5%
US Mid Cap Growth	9.1%	9.1%	-8.5%	15.2%	9.1%
US Mid Cap Value	1.3%	1.3%	-9.2%	20.7%	6.5%
US Small Cap Growth	6.1%	6.1%	-10.6%	13.4%	4.3%
US Small Cap Value	-0.7%	-0.7%	-13.0%	21.0%	4.5%
International Large Cap Developed (US Dollar)	8.5%	8.5%	-1.4%	13.0%	3.5%
International Small/Mid Cap Developed (US Dollar)	4.9%	4.9%	-9.8%	12.1%	0.9%
Emerging Market (US Dollar)	4.0%	4.0%	-10.7%	7.8%	-0.9%

Source: Bloomberg, Morningstar

Chart 4: The Lagged Effect of Tightening Leads to Lower Earnings Growth



Rally Ongoing But Bear Market Likely Not at Bottom Yet

The September 2022 market trough remains the low point of this current bear market. From a historical perspective, the -25% peak-to-trough drawdown is in range of previous bear markets. That said, we believe that markets may have not yet experienced the low for this current bear market cycle. In fact, in the post-World War II era, there has never been a bear market that has bottomed before the start of a recession (Chart 5). Even though the U.S. economy weakened in 2022, it was not in a recession, indicating that the market bottom has likely not yet been reached. We still believe a recession in late 2023/

early 2024 is the most likely outcome. Historically, markets have bottomed an average of 5.3 months after the start of a recession. Additionally, bear markets typically hit bottom after the difference between the yield on the 10-year U.S. Treasury minus the 2-year U.S. Treasury (known as the 2/10 yield curve) begins to increase. This yield curve reached its low point of this cycle in early March, indicating the bottom is yet to come. Rallies are very common during these prolonged bear markets and it's likely that we are in the middle of one now.

Patience Needed for Equity Investing in Uncertain Times

Over time, equity markets are a proven investment to build and grow wealth. Since April 1, 1939, the S&P 500 index has achieved an annualized return, including dividends, of 11%. Over this 84-year time frame, there have been 12 bear markets, defined as a peak-to-trough decline of greater than 20%. The average maximum drawdown is 34%, with an average duration of 15 months. Bear markets are expected during the investment journey and those who are patient are ultimately rewarded. It's this history that gives us confidence that prosperous times

will return for equity investors as soon as the current bear market ends. In the meantime, equity portfolios can lessen the drawdowns by maintaining exposure to stocks that exhibit high-quality factors – such as companies with strong balance sheets, consistent cash flows, predictable earnings, high profitability, and lower debt levels – and minimum volatility factors. These factors have historically performed the best during periods of economic slowdown and recession (Chart 6).

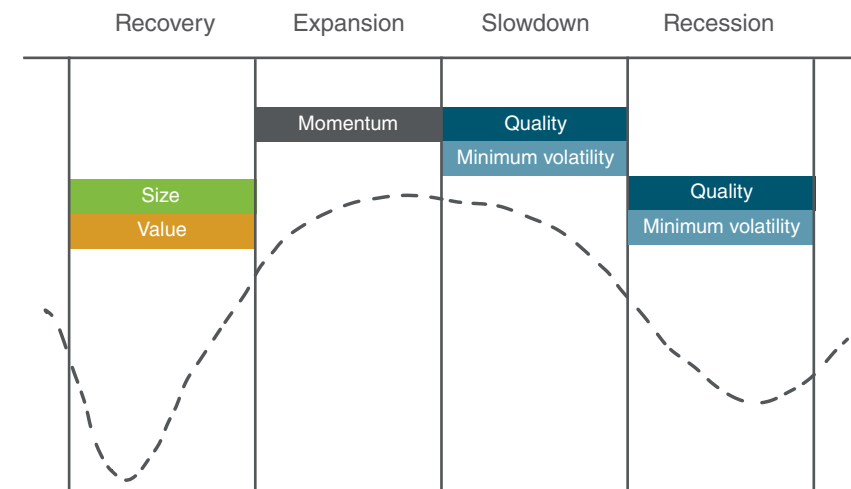
Chart 5: Bear Markets Have Always Bottomed After Start of Recession

Bear Market End	Recession Start	Recession Start to Bear End (months)
6/13/1949	11/30/1948	6.4
9/14/1953	7/31/1953	1.5
10/22/1957	8/31/1957	1.7
10/25/1960	4/30/1960	5.8
5/26/1970	12/31/1969	4.8
12/6/1974	11/30/1973	12.2
4/21/1980	1/31/1980	2.7
8/12/1982	7/31/1981	12.4
10/11/1990	7/31/1990	2.4
9/21/2001	3/31/2001	5.7
3/9/2009	12/31/2007	14.3
3/23/2020	2/29/2020	0.8
9/30/2022*	??	??
	Median	5.3
	% Positive	100%

Source: Ned Davis Research; National Bureau of Economic Research

*Current bear market low

Chart 6: Factor Leadership During Different Economic Cycles



Source: Blackrock

A Fixed Income Market Update from Trust Point

The bond market has adjusted to the aging synchronized global rate-hiking cycle. Higher policy rates are helping slow economic growth and cool persistent inflation. The work is not yet done, however, and interest rates are likely to remain elevated until further progress is made. For investors, the rapid rise in interest rates has created opportunities and restored value as high-quality bonds now come with attractive yields and greater diversification benefits.

The End is in Sight

The Fed raised interest rates by 0.25% in March, despite recent stress in the banking sector. The Fed has aggressively raised borrowing costs at the quickest pace since 1980 in trying to slow consumer spending and economic activity, with an ultimate goal of reducing inflation. Progress has been slow but steady as the Consumer Price Index has come down to 5% after peaking at 9.1% in mid-2022. Measures of core inflation, which exclude the more volatile food and energy components, have followed a similar trajectory. We think the Fed is nearing the end of rate hikes as it has made some

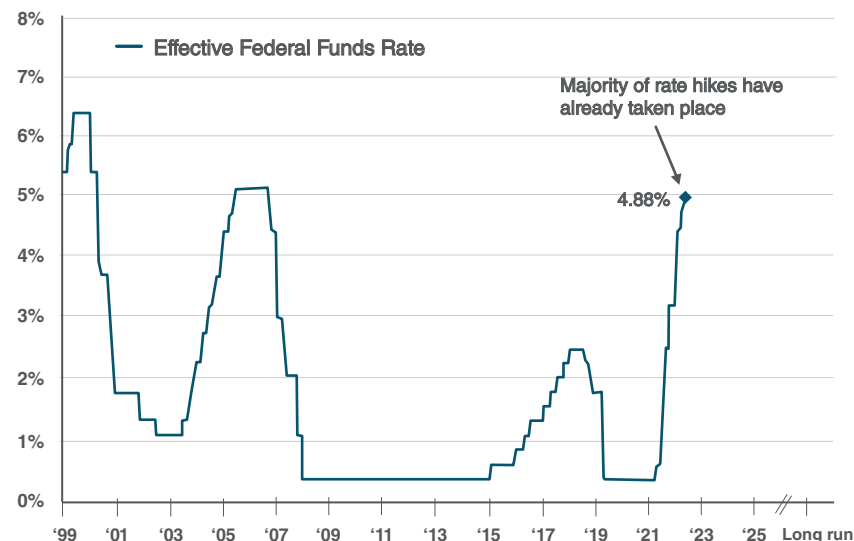
important changes to forward guidance. The Fed signaled that the tightening cycle is close to its peak and envisions only “minor policy tightening” instead of an “ongoing” series of rate hikes going forward. Put another way, most of the heavy lifting is done. It is difficult to predict the actual path of interest rates but we are confident that the majority of rate hikes are behind us as the Fed Funds rate has risen from near zero to almost 5 percent in only 12 months (Chart 7). The Fed itself anticipates another quarter-percent hike above the current level, likely to come in May, but then a pause until the end of 2023.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	4.7%	4.3%	48.2%	6.1%	1.7%
2 Yr US Treasury	4.0%	4.4%	2.3%	0.2%	2.3%
10 Yr US Treasury	3.5%	3.9%	2.3%	0.7%	2.7%
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	3.2%	3.2%	-4.1%	-4.2%	1.1%
US Treasury Inflation Protected Sec.	3.3%	3.3%	-6.1%	1.8%	2.9%
US Mortgages	2.5%	2.5%	-4.9%	-3.3%	0.2%
US Short-Intermediate T/E Munis	2.0%	2.0%	1.5%	0.5%	1.7%
US Investment Grade Corporates	3.5%	3.5%	-5.6%	-0.5%	1.6%
US Senior Bank Loans	3.2%	3.2%	2.5%	8.5%	3.6%
US High Yield	3.7%	3.7%	-3.6%	5.8%	3.1%
Int'l Bonds Ex-US (Hedged)	3.3%	3.3%	-5.4%	-2.9%	0.5%
Int'l Bonds (Unhedged)	3.0%	3.0%	-8.1%	-3.4%	-1.3%
Emerging Market Debt (US Dollar)	2.2%	2.2%	-5.9%	0.3%	-0.2%

Source: Bloomberg, Morningstar

Chart 7: The Majority of Rate-Hikes Are Behind Us



Source: JPMorgan

Bonds are Well Positioned

In the later stages of this tightening cycle, bonds have become a compelling component to portfolios. The current environment is offering the highest yields in 10 to 15 years out of high-quality, safe-haven securities. In addition, with yields at elevated levels, the income earned on bonds will offer a cushion if rates continue to rise, and provide an extra tailwind if rates fall in an adverse economic scenario, such as a recession. The difficult bond market in 2022 caused some investors to rethink their fixed-income allocation and the role bonds play in a diversified portfolio. However, we think higher

yields have set the stage in the bond market for a stretch of attractive returns. Historically, there has been a strong correlation between the starting yield on a bond and future returns (Chart 8). With yields at the highest levels in more than a decade, bonds are likely to provide forward-looking returns not seen in a while, and also provide more downside protection than last year. We continue to allocate to high-quality, short-term bonds, generating attractive income while maintaining the portfolio diversification benefits expected out of fixed income.

Risks Remain in Corporate Credit Markets

A shift is taking place as investors are starting to believe that the biggest risk in fixed income is not higher inflation but instead economic weakness. In our opinion, that trend will continue this year as inflation is expected to continue to fall, while monetary policy is likely to weigh on economic activity for some time. The recent banking stress has contributed to this shift in narrative as tighter credit and lending standards will put additional downward pressure on economic activity (Chart 9). It is difficult to know exactly how large of a headwind for credit and the economy this banking stress will ultimately present. However, risks are skewed to the downside as higher rates and tighter credit conditions

are going to negatively impact bonds that are more sensitive to economic activity. As such, we have taken a cautious stance in credit markets such as high-yield corporates, leveraged loans, and even investment-grade corporates as earnings are likely to remain challenged. High yield spreads, the extra yield investors require to hold these riskier bonds over Treasury securities, have more room to widen as corporate bonds are not pricing in a continuation of tighter financial conditions and economic weakness. Put another way, investors are not being paid enough to take on the extra risk in bonds that are more sensitive to economic activity.

Chart 8: Starting Yield Has Been a Good Indicator of 10 Year Future Returns

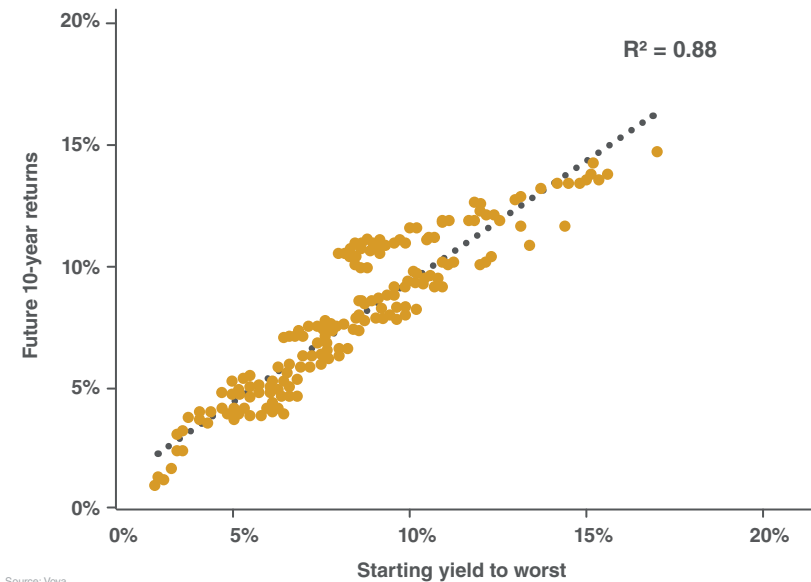
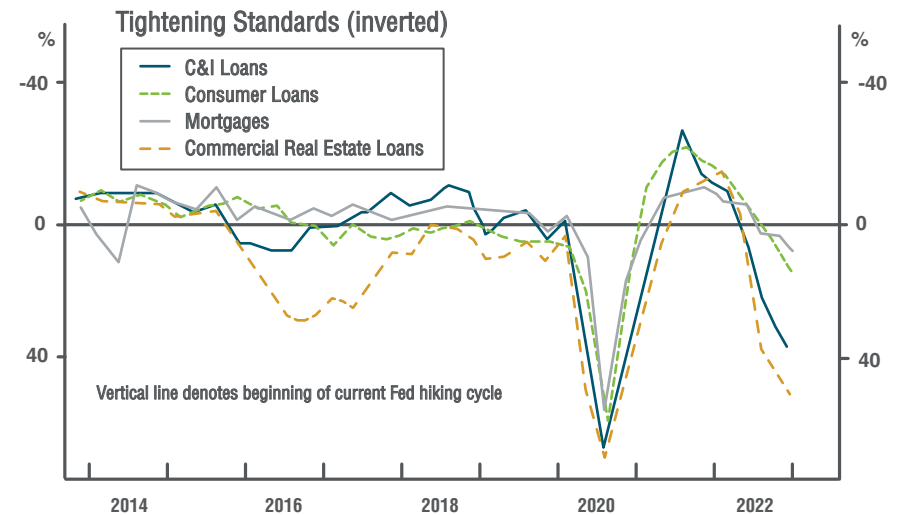


Chart 9: Tighter Lending Standards Could Intensify & Constrain Economic Activity



Key Investment Themes

Macroeconomics



- Structurally, **Debt**, **Demographics**, and **Deglobalization** may influence global growth and inflation for years
- **Cyclically, global growth should be slowing in the next 6-12 months but recession risks are not priced in**
- Structurally, healthier consumers & businesses (vs the 2010 decade) should lead to good growth long-term
- **Biggest wild cards: Inflation/Growth (and central banks' reaction to it) + possibility of a credit event**

Asset Allocation



- **Medium-term, the risk/reward outlook no longer favors equities**
- **Recent rise in bond yields & decline in equity valuations have improved the return outlook 3-5 yrs out**
- Global macro factors have important implications for various sub-asset classes/sectors
- Important to maintain a diversified approach and not let emotions dictate investment decisions

Fixed Income



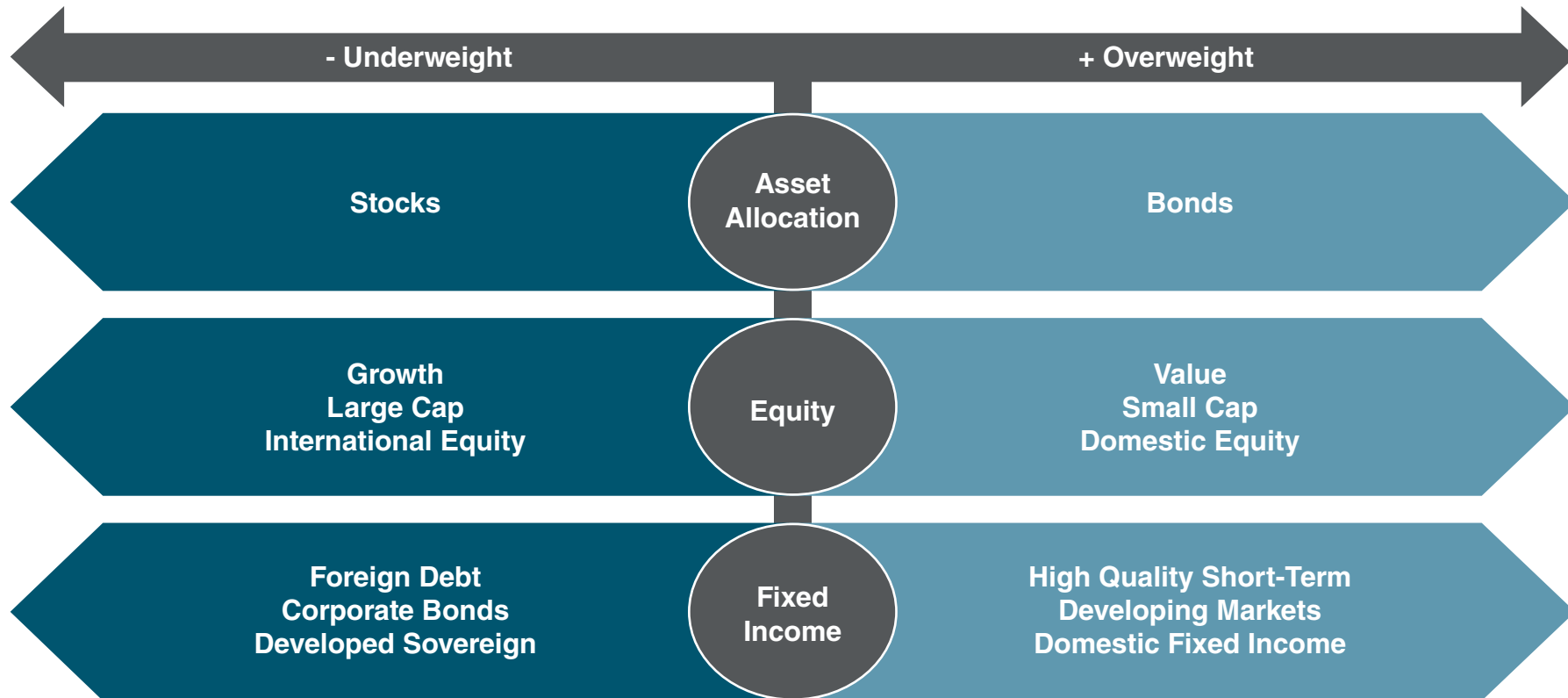
- **Government bond yields have risen and have become increasingly attractive (especially ST bonds)**
- Higher inflation is forcing central banks to normalize policies quickly
- Global uncertainty will allow the U.S. dollar to stay strong ST despite LT downward pressure
- **Healthy B/S and cashflows should allow defaults to stay relatively low. Favor credit structurally**

Equities



- **Equities are no longer benefiting from the “lack of alternatives”**
- Volatility has returned as investors question central banks' intentions and assess geopolitical uncertainty
- 2023 economic growth & earnings estimates have been trending lower and remain a risk for equities
- **High quality defensive stocks offer good relative value in the current environment**

Tactical Asset Allocation



Profile Summary

This is not the time to be aggressive, so we continue to position portfolios with defense in mind. From an asset allocation standpoint, we are maintaining an underweight position in stocks and an overweight position in bonds. The equity portion of portfolios has maintained a bias toward value stocks while continuing to favor defensive characteristics. All year, we have taken advantage of higher yields, adding to high quality short-term bonds as the Federal Reserve has forced interest rates higher as it attempts to reign in stickier inflation. We continue to position portfolios to ensure that we can provide the best risk-adjusted returns without taking unnecessary risks.



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MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment Management team. The individuals contributing to Market Point are pictured from left to right: Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA®, Steve Brudos, Brandon Hellenbrand, CFA®, Christine Doll, Nolan Gaffney and Matthew Wittenberg. Please feel free to contact any team member with questions.



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