



MarketPoint

An Economic & Market Commentary from Trust Point

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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 half of 2023. During the second quarter of this year, a combination of better-than-expected economic data and excitement over the long-term potential of AI (artificial intelligence) led equity indices higher. Bonds posted mixed returns over the last three months.

A Surprisingly Resilient Economy

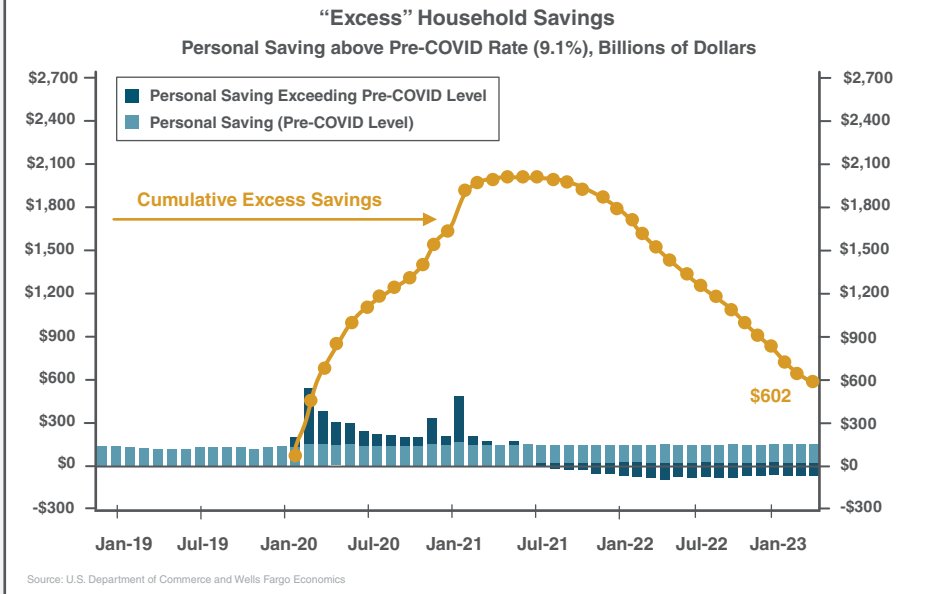
The global economy remains resilient and as a result, riskier assets such as equities have performed better than expected so far this year. Falling energy prices, strong labor markets, and excess savings accumulated during the COVID-19 pandemic have contributed to ongoing strength in consumption despite rising interest rates. With private sector balance sheets generally in good shape, there is an argument that tightening credit conditions have mattered less in this cycle because easy credit conditions have not been the reason for good economic growth in the first place. During the pandemic, households at all income levels (especially in the U.S.) were provided with generous monetary support from various government

programs. With consumers unable to spend all the influx of funds due to restrictions and constraints created by the spread of the virus, excess savings accumulated. Estimated to still be above U.S. \$500B (Chart 1), the savings have provided a buffer, a reason for consumers to continue to spend. On the employment front, there has been no evidence of a spike in unemployment, although we have started to see signs that job openings are coming down. To be clear, the strong labor market is not the reason a recession has not occurred yet as employment is always the last shoe to drop in an economic cycle. But for now, because companies have not faced a sharp enough decline in demand, they haven't been forced to shed workers.

KEY ECONOMIC DATA				
	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Jun	102.9	102.5	104.7
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Jun	46.0	46.3	53.1
ISM Non-Manufacturing (>50 = Expansion)	Jun	53.9	51.2	56.0
Non-Farm Payrolls	Jun	209k	217k	370k
Unemployment Rate	Jun	3.6%	3.5%	3.6%
CPI Ex-Food & Energy (yoy)	May	5.3%	5.5%	5.9%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Jun	48.8	49.6	52.2
JP Morgan Global Services Index (>50 = Expansion)	Jun	54.0	54.4	53.9

Source: Bloomberg

Chart 1: Cumulative Excess Savings Still Exceeding \$500B



Don't Fight the Fed

On the flip side, the ongoing imbalance between the low supply and high demand for labor has contributed to elevated and sticky inflation, especially in the services sector. In the U.S., getting inflation down to 4%-5% was relatively easy (Chart 2) but tamping it down further to the Fed's 2% target will take both time and slower growth. The Fed understands that and as a result, it remains hawkish and has continued to signal more rate hikes ahead. "Don't fight the Fed" is a commonly used phrase in financial markets and

refers to the idea that it is generally unwise to bet against the actions of the Federal Reserve because of the influence it has on the economy by largely controlling the quantity and cost of money for consumers and businesses. Historically, in a tightening monetary policy environment such as we are in today, especially when inflation is elevated and sticky and the banking sector is tightening lending standards, it has been wise to favor more defensive investment strategies.

Defense First as Recession Looms

As we have mentioned several times in recent publications, the negative impact of higher interest rates is felt only over time and with a lag. Since the first Fed rate hike from 0% to 0.25% was just over a year ago (March 17, 2022), we continue to believe that economic fundamentals will slowly deteriorate in the months and quarters to come. In fact, in our opinion, the economy is likely headed into a recession with a start date in late 2023 or early 2024. Many leading indicators, including the U.S. leading economic indicator from the Conference Board (Chart 3), are clearly pointing in that direction. At

multiple times over the past 12-18 months, we have taken advantage of bear market rallies to reduce exposure to equities, credit, cyclical and international stocks and used the proceeds to increase exposure to high-quality bonds and high-quality defensive stocks. A more recession-resilient portfolio is preferred in the current environment and should provide some protection in what we believe could be a more volatile environment for markets going forward. In short, signs continue to accumulate that the economy is slowly getting worse, not better.

Chart 2: Headline CPI Down But Core CPI Remains Sticky

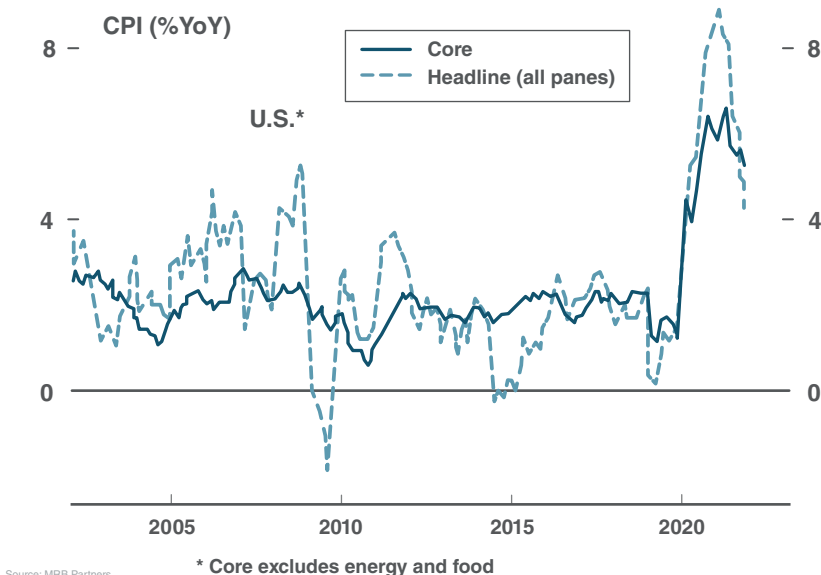
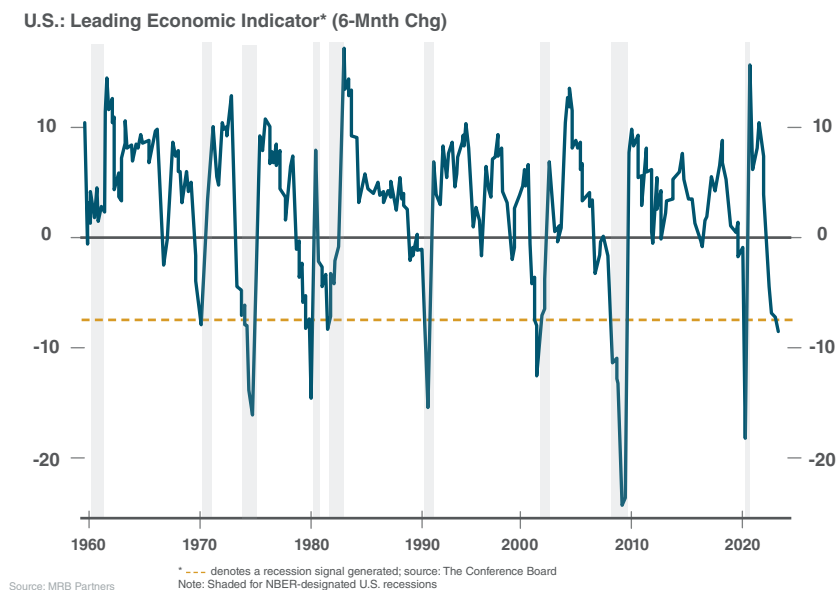


Chart 3: Leading Indicators Are Flashing a Cyclical Warning



An Equity Market Update from Trust Point

Market returns in Q2 were concentrated to primarily U.S. large cap growth and technology related companies. More broadly, the macroeconomic backdrop is still a challenge for equities to sustain this rally while leading economic indicators are pointing toward continued weakness into year-end and the outlook for earnings also leans negative. Portfolio positioning continues to remain cautious with an emphasis on defensive and hedged positions.

A Bull Market Driven by Artificial Intelligence

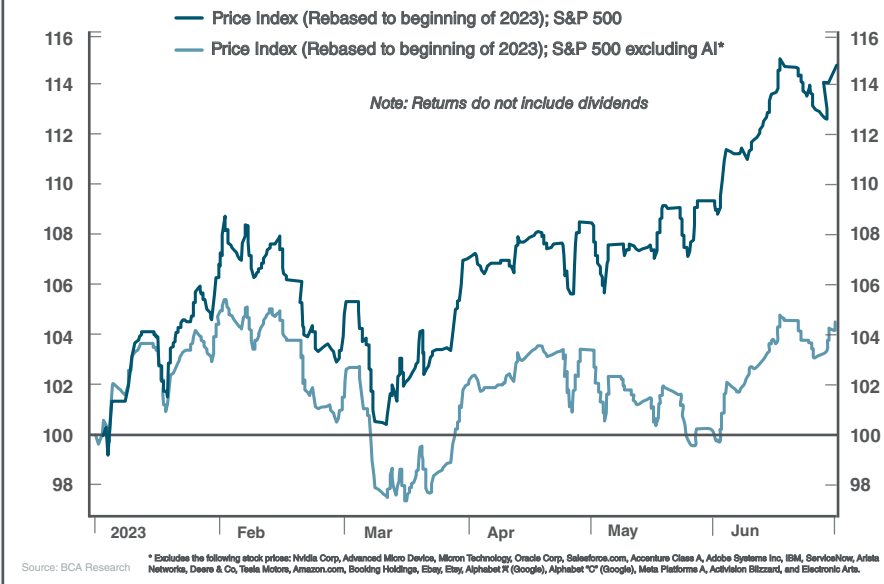
The first half of the year has brought extreme divergence in performance across the market. U.S. markets have outperformed international developed and emerging markets, with the S&P 500 index up 16.9%. However, the equal-weighted index is up only 7.0% and about 50% of the Russell 3000 stocks are negative year to date. From a sector perspective, the predominately growth-oriented sectors of technology, consumer discretionary and communication services are up in the 30% range while all other sectors are closer to flat for the year. Much of the concentrated performance can be attributed to

the optimism over AI. During the second quarter, exciting news from Microsoft backed ChatGPT, Google's Bard, and the blowout earnings report from leading AI chip maker Nvidia all helped fuel the optimism. However, if you strip out the performance of AI-related stocks from the S&P 500 (Chart 4), returns are up only about 5.0%. Though concentrated stock market performance is not uncommon, it's typically not an indicator of the start of a sustained bull market. It is our view that the narrow participation will likely lead this rally to deteriorate as we move toward year-end and the initial AI optimism dwindles.

EQUITY BENCHMARK TABLE					
US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	4,450	4,109	3,785	3,100	2,718
Dow Jones Industrial Average	34,408	33,274	30,775	25,813	24,271
NASDAQ	13,788	12,222	11,029	10,059	7,510
Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	12.8%	29.0%	27.1%	13.7%	15.1%
US Large Cap Value	4.1%	5.1%	11.5%	14.3%	8.1%
US Mid Cap Growth	6.2%	15.9%	23.1%	7.6%	9.7%
US Mid Cap Value	3.9%	5.2%	10.5%	15.0%	6.8%
US Small Cap Growth	7.1%	13.6%	18.5%	6.1%	4.2%
US Small Cap Value	3.2%	2.5%	6.0%	15.4%	3.5%
International Large Cap Developed (US Dollar)	3.0%	11.7%	18.8%	8.9%	4.4%
International Small/Mid Cap Developed (US Dollar)	0.6%	5.5%	10.2%	5.7%	1.3%
Emerging Market (US Dollar)	0.9%	4.9%	1.7%	2.3%	0.9%

Source: Bloomberg, Morningstar

Chart 4: YTD Stock Performance Driven by AI Craze



Corporate Earnings Expected to Decline

The macroeconomic backdrop continues to lean toward weakness in the second half of the year, which should have a negative impact on corporate revenues given the tight correlation with economic activity. Additionally, as inflation continues to ease, it will be more challenging for companies to pass on price increases to their customers. The combination of lower unit sales from weaker demand with smaller price increases from eroding pricing power will put downward pressure on profit margins and ultimately earnings. In fact, corporate earnings for S&P 500 companies are expected to be negative on a year-over-year basis

for Q2 (Chart 5). Globally, economic models indicate earnings could continue to be weak into year-end. We believe this expected weakness is not fully reflected in analyst expectations, which are currently forecasting a rebound in earnings growth over the next 12 months (Chart 6). In our view, this disconnect between what the macroeconomic models indicate for earnings growth and what analysts are currently expecting creates downside risk to stock prices. The recent rally in stocks has been fueled by price-to-earnings (P/E) ratio expansion but we remain skeptical of the current investor optimism of future earnings growth.

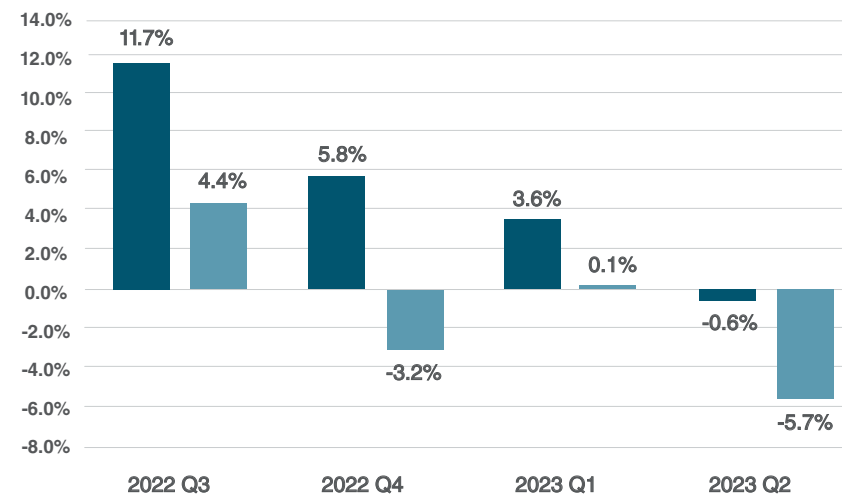
Cautious Positioning Still Warranted

Our investment philosophy focuses on building investment portfolios that can deliver on our clients' long-term goals. This has allowed us to maintain exposure to stocks within a client's investment objective range, benefiting from the stock market recovery since the low in October 2022. We never chase fades or the latest hot investment trend just to achieve short-term performance. As a result, we have not been increasing our exposures to technology and other AI-related growth stocks, though all equity portfolios have some exposure to AI stocks through our broad passive exposures. Instead, as we have

discussed in recent Market Point newsletters, in the last 12-18 months equity portfolios have been adjusted to emphasize more caution. We are maintaining overweights to high-quality defensive stocks with proven track records of outperformance during economic downturns. Emphasizing companies in sectors of the economy that are less affected by broad economic downtrends should result in lower volatility and less drawdown than the market. Going forward, as we constantly evaluate markets and opportunities, we will adjust portfolios appropriately.

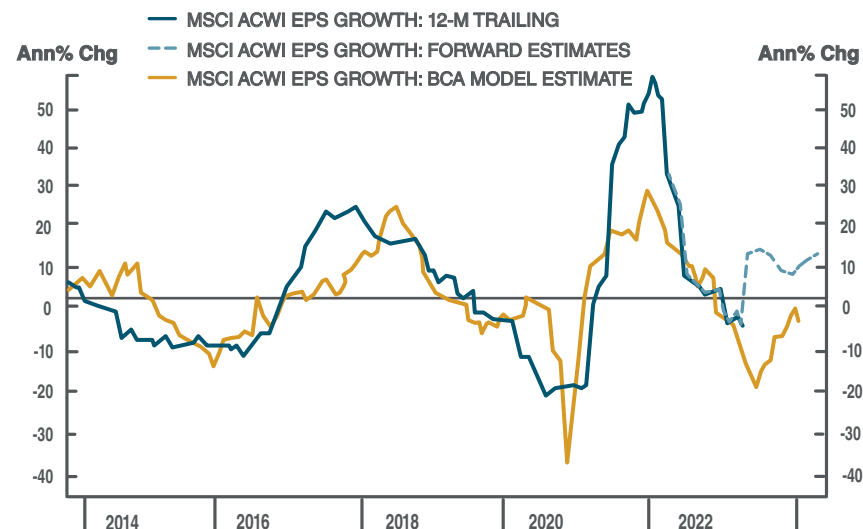
Chart 5: S&P 500 Year-Over-Year Revenue and Earnings Growth Estimated to Decline in Q2

Estimates as of 6/30/23



Source: I/B/E/S data from Refinitiv

Chart 6: Disconnect Between Fundamental Model and Analyst Expectations for Future Earnings



Source: BCA Research

A Fixed Income Market Update from Trust Point

After a rapid rise last year, global bond yields have begun to stabilize as central banks around the world are in the later stages of tightening monetary policy to ease inflationary pressure. There is evidence that global inflation is beginning to moderate, but at a slower pace than anticipated. In the U.S., and like the rest of the world, a resilient economy and tight labor market have been the key ingredients for sticky inflation, prolonging the tightening cycle. Although most of the heavy lifting is done, central banks are maintaining a hawkish stance for the time being.

Why The Fed Is Not Quite Done

For more than a year, the U.S. Federal Reserve has been contemplating interest rate hikes to address the strong economic growth and subsequent inflationary pressure. Although we have seen significant improvement with inflation moderating from peak levels, price pressures remain elevated as the economy and labor market continue to show strength. The Fed's mandate to lower inflation can be difficult if jobs are plentiful and wages are increasing because consumers have the capacity and willingness to pay higher prices for goods and services. The best way for the Fed to bring inflation down is to create slack in the labor market

and continue to slow economic growth. As such, policymakers are not likely to change their stance until employment starts to weaken and inflation returns closer to target level. We expect at least one more rate hike from the Fed this year and possibly two if the economy continues to perform well, alongside a tight labor market (Chart 7). The narrow focus from the Fed to slow the economy only increases our outlook for a continued economic slowdown. In this environment, we have increased allocations to bonds that will provide a cushion and defensive characteristics during a weakening economic backdrop.

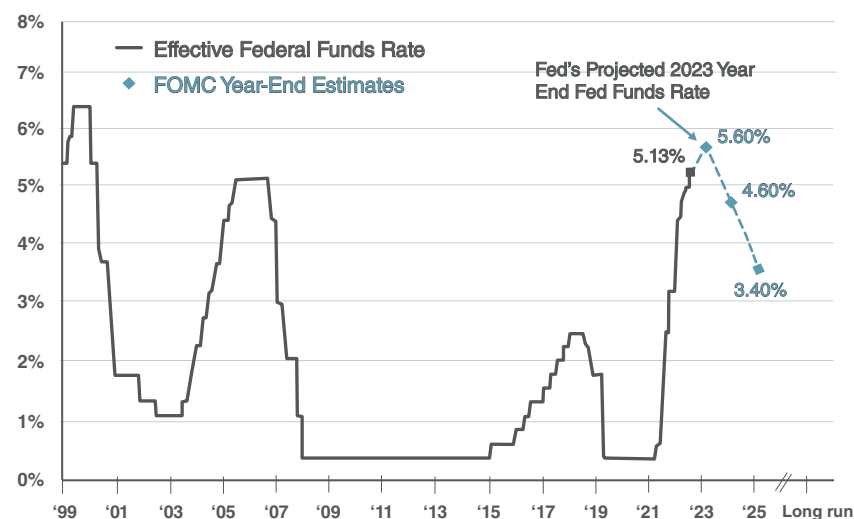
FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	5.3%	4.7%	1.6%	0.1%	1.9%
2 Yr US Treasury	4.9%	4.0%	3.0%	0.2%	2.5%
10 Yr US Treasury	3.8%	3.5%	3.0%	0.7%	2.9%

Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-1.7%	1.4%	-2.4%	-5.0%	0.7%
US Treasury Inflation Protected Sec.	-1.4%	1.9%	-1.4%	-0.1%	2.5%
US Mortgages	-0.6%	1.9%	-1.5%	-3.7%	0.0%
US Short-Intermediate T/E Munis	-0.7%	1.2%	1.6%	-0.7%	1.4%
US Investment Grade Corporates	3.5%	3.5%	-5.6%	-0.5%	1.6%
US Senior Bank Loans	3.1%	6.5%	10.7%	6.3%	4.1%
US High Yield	1.6%	5.4%	8.9%	3.2%	3.2%
Int'l Bonds Ex-US (Hedged)	0.1%	3.5%	-0.7%	-3.3%	0.4%
Int'l Bonds (Unhedged)	-1.5%	1.4%	-1.3%	-5.0%	-1.1%
Emerging Market Debt (US Dollar)	1.5%	3.8%	6.8%	-2.7%	0.8%

Source: Bloomberg, Morningstar

Chart 7: The Fed is Not Quite Done, But the Majority of Rate-Hikes Are Behind Us



Source: JPMorgan

Looking Ahead – Will Cash Still Be King?

With our money market paying over 5% and a stable price in both up and down markets, holding cash can feel very comfortable for many investors. This has been an attractive and viable place to park funds as investors have awaited clarity about the economy, while clipping nice income. However, the Fed is beginning to shift from a hiking cycle to more of a sideways rate path as it contemplates pausing rate hikes later this year. During these transition periods, the performance of cash starts to take a back seat to other fixed-income asset classes. History suggests that longer-term bonds

and high-quality, short-term debt has outperformed cash in periods following rate hikes (Chart 8). These securities collect coupon payments but will also see price appreciation in a deteriorating economic environment as longer-term yields fall to reflect a more benign inflationary and growth outlook. Money market rates will also fall in lockstep with cuts to the federal funds rate, but cash does not get price appreciation as yields fall. In portfolios, we have been slowly extending interest-rate exposure (duration) while maintaining a high-quality bias in portfolios.

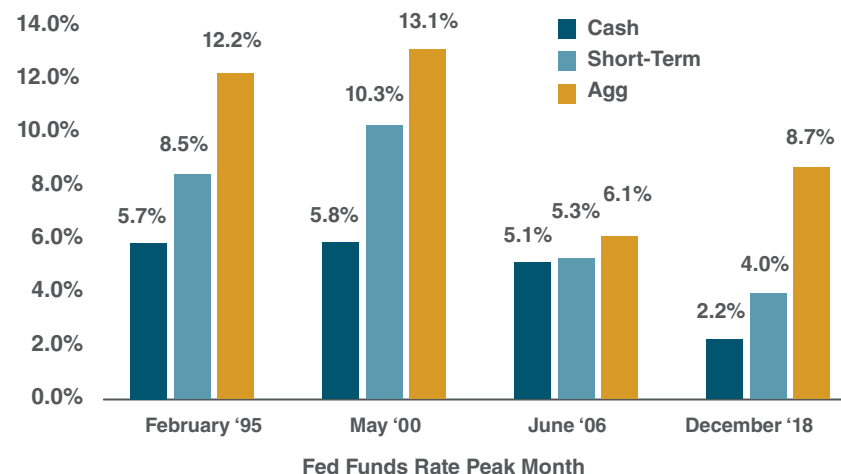
Credit Cycle Checkup

Corporate spreads represent the extra yield investors require to hold corporate bonds over Treasuries, or risk-free securities. Spreads are currently quite low and are sending a message of a very benign environment in which corporations remain very profitable. U.S. corporate bonds have performed well over the past few months despite a backdrop of deteriorating credit fundamentals. Typically, investors will require much more yield to hold riskier corporate debt when manufacturing activity is at levels similar to today. As measured by the Institute for Supply Management, U.S. manufacturing activity is well below the 50 threshold,

which indicates contraction in the manufacturing sector of the economy. Historically, as this measure of economic activity has fallen, corporate spreads have widened as investors require additional yield to compensate them for heightened risks in a weakening economic environment (Chart 9). Given the current backdrop, we feel that current corporate spreads are pricing in too much optimism. We remain cautious with credit exposure and corporate bonds as investors are not being paid enough to take on the extra risk in segments of the bond market that are more sensitive to economic activity.

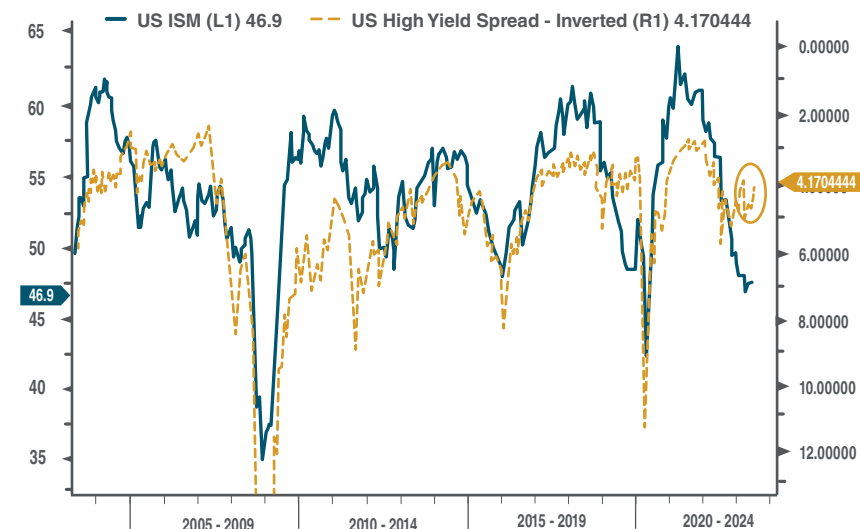
Chart 8: Cash Has Underperformed in Flat or Falling Interest Rate Environments

Next 12 Month Return After Peak Fed Funds Rate



Source: FactSet, Morningstar Direct, Fiducient Advisors calculations. As of May 31, 2023.

Chart 9: High Yield Spreads Are Not Pricing In Weak Manufacturing Activity



Source: Bloomberg

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)**

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
- **Favor capital preservation over return maximization as a portfolio goal**
- Important to maintain a diversified approach and not let emotions dictate investment decisions

Fixed Income



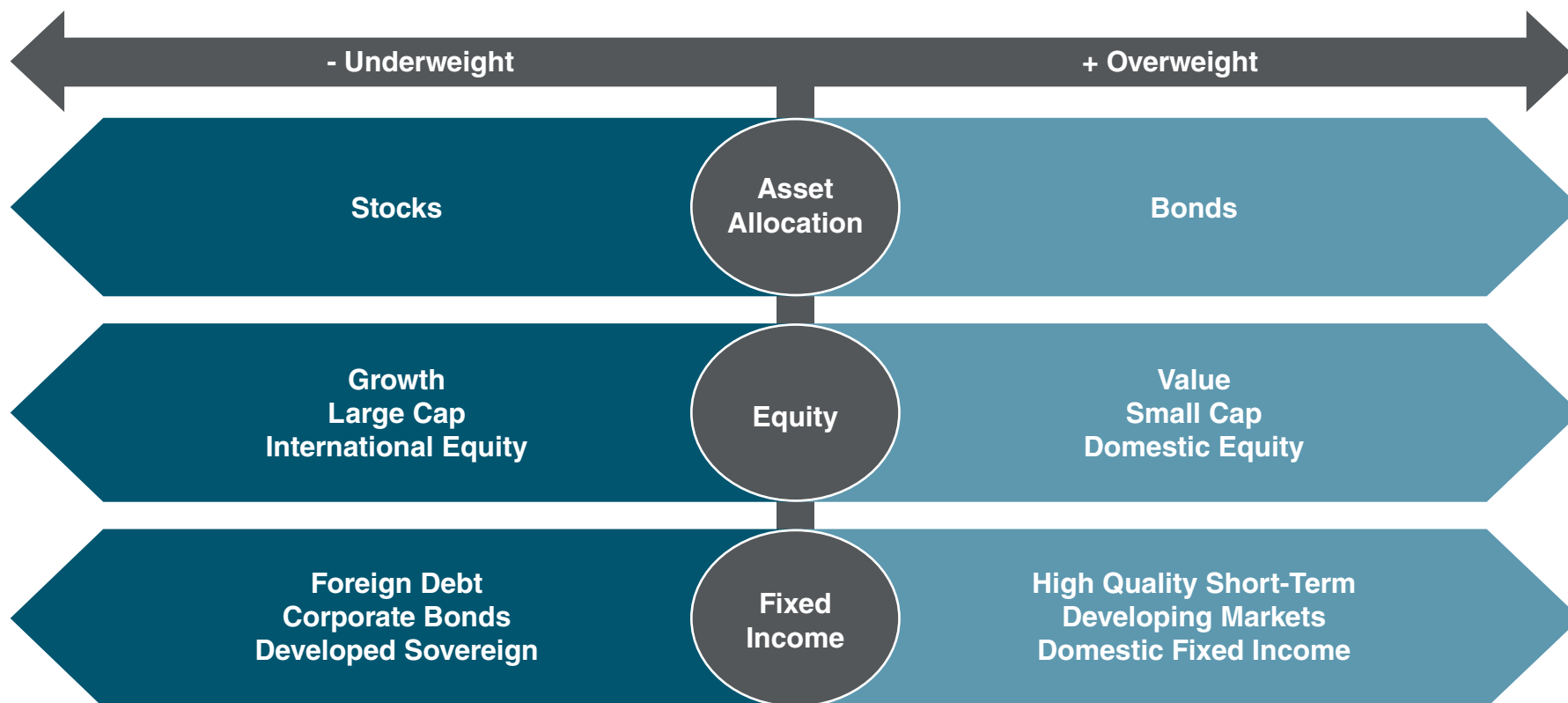
- **Government bond yields have risen and have become increasingly attractive**
- Higher inflation has forced central banks to normalize policies quickly but the end to monetary tightening is close
- Global uncertainty will allow the U.S. dollar to stay strong ST despite LT downward pressure
- **Healthy B/S and cashflows should allow defaults to stay relatively low but credit spreads remain too tight**

Equities



- **Equities are no longer benefiting from the “lack of alternatives”**
- Volatility should remain elevated as investors question central banks' intentions and assess the economic outlook
- Earnings estimates have been mostly trending flat/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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Weekly Market Update

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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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