



MarketPoint

An Economic & Market Commentary from Trust Point

Third Quarter 2023 | Issue No. 43

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An Economic and Market Update from Trust Point

During the third quarter, stocks and bonds both posted negative returns. The weakness was mostly attributed to the U.S. central bank's recent message that interest rates will likely stay higher for longer, which put downward pressure on both stocks and bond prices. From a macroeconomic perspective, we continue to believe that tighter monetary policy combined with tightening lending standards and high/sticky inflation have made the economic outlook highly uncertain.

Is the "Soft Landing" Scenario Legit?

It is no surprise that the Federal Reserve has so far given no indication it is ready to remove its tightening bias. Maintaining price stability is clearly the responsibility of the Federal Reserve. As Fed Chairman Jerome Powell said during a press conference on Sept. 20: "People hate inflation. Hate it." Cyclically, the key question for investors is: Can the Fed bring down inflation to a sustainable 2% without creating a recession? To start with, we must recognize that the last few inflation reports were "good" as they showed moderating inflation. However, most of the easing so far has come from goods, which are still unwinding pandemic supply-chain related distortions. Of great importance, the inflation rate for services—excluding the more volatile components such as food, energy,

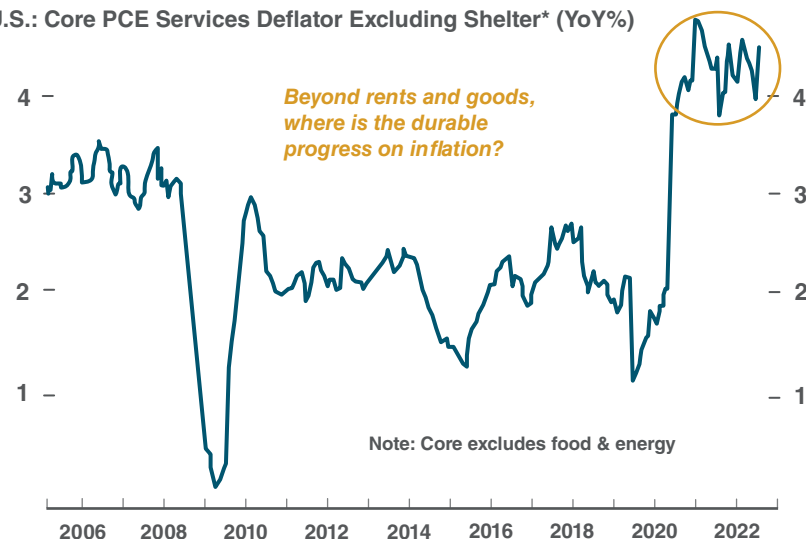
and housing, known as "supercore inflation" – remains very sticky and above 4% (Chart 1). "Supercore inflation" is particularly important because it better measures the true underlying inflationary pressures in the economy, which is the inflation that correlates most closely with wages and the state of the labor market. In a perfect world, the Fed would look to create just enough slack in the labor market to bring "supercore inflation" closer to 2% without causing a recession – the "soft landing" argument. The problem is that, historically, when the first signs of labor market slack emerge, more and more slack (and a recession) quickly follows as consumers and businesses rapidly adopt a more cautious approach to spending (Chart 2).

KEY ECONOMIC DATA				
	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Sept	106.2	102.9	112.1
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Sept	49.0	46.0	51.0
ISM Non-Manufacturing (>50 = Expansion)	Sept	53.6	53.9	55.9
Non-Farm Payrolls	Sept	336k	105k	350k
Unemployment Rate	Sept	3.8%	3.6%	3.5%
CPI Ex-Food & Energy (yoy)	Aug	4.3%	5.3%	6.3%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Sept	49.1	48.7	49.8
JP Morgan Global Services Index (>50 = Expansion)	Sept	50.8	53.9	50.0

Source: Bloomberg

Chart 1: Labor-Market Sensitive Component of Inflation Still High

U.S.: Core PCE Services Deflator Excluding Shelter* (YoY%)



Note: Core excludes food & energy

Source: MRB Partners

* Source: U.S. Bureau of Economic Analysis & MRB Calculation

China: Cyclical or Structural Issues? Or Both?

As China abandoned its zero-COVID policy in the fall of 2022, expectations were running high that the country would experience a surge in economic activity. It did ... but only for a few months. A confluence of short-term and long-term factors have led to disappointing growth ever since. To start with, China is facing a number of structural issues, including a shrinking labor force, an ongoing dispute with the U.S., and a leadership that appears to increasingly prioritize national security over economic growth. Cyclically, the major concern has been the deepening real estate crisis. A consistent and reliable source of economic growth for the country (and wealth for its people) for years, real estate activity and

prices in China (Chart 3) remain depressed. Major homebuilders and investment products backed by real estate investments have defaulted or missed payments, accelerating a crisis of confidence among property developers and real estate owners/investors. At the same time, policy support for the sector has disappointed as the authorities are increasingly concerned about large debt loads and speculative/low-return real estate projects. Given the importance of the real estate sector in China and the significance of China in the world economy, a material growth slowdown in the country would very likely also become a drag for global economic activity.

Stay Defensively Positioned

Despite better than expected economic data year-to-date, the global economy remains in the “late-cycle” phase and recession risks remain elevated. As a result, we continue to recommend an underweight position in stocks versus bonds. Within equities, we favor domestic equities over international or emerging market stocks. We also prefer defensive equity sectors versus cyclical ones. Quality, profitability,

and larger capitalizations are also equity factors we favor in the current environment. Within bonds, the focus continues to be on higher quality bonds over riskier credit while we are also taking advantage of rising yields to slowly add to duration. Longer duration in bond portfolios should provide higher potential returns and also greater diversification in an increasingly challenging macroeconomic environment.

Chart 2: Watch for a 0.5% Rise in the Unemployment Rate

U.S. Unemployment Rate Relative to its Trough*

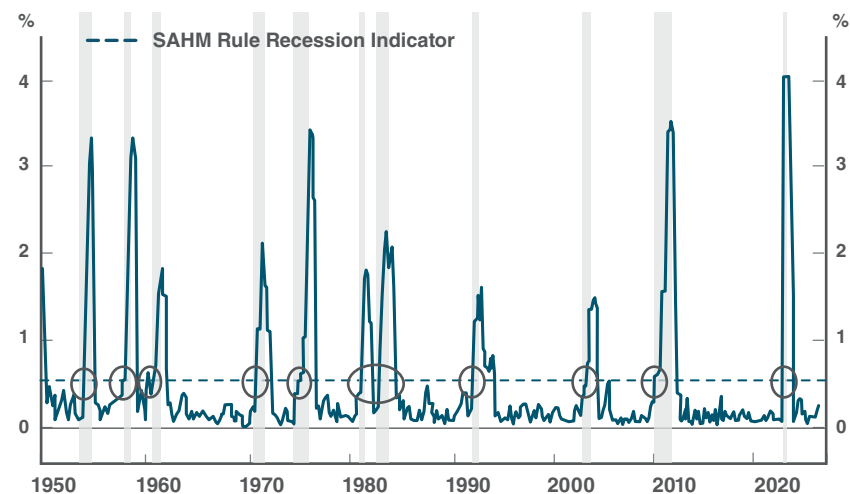


Chart 3: Home Prices in China Are No Longer Increasing

Average Home Prices** (%YoY):



An Equity Market Update from Trust Point

Most investors are told the stock market is forward looking and always pricing in what the future might hold. But a forward-looking market does not mean investors aren't reacting to the present. In fact, we would argue that market performance year-to-date has been focused on both the future (artificial intelligence optimism) and the present (inflation and interest rates). During the past quarter, however, concerns around the present dominated and thus equity markets sold off.

Stock Markets Take a Pause in the Third Quarter

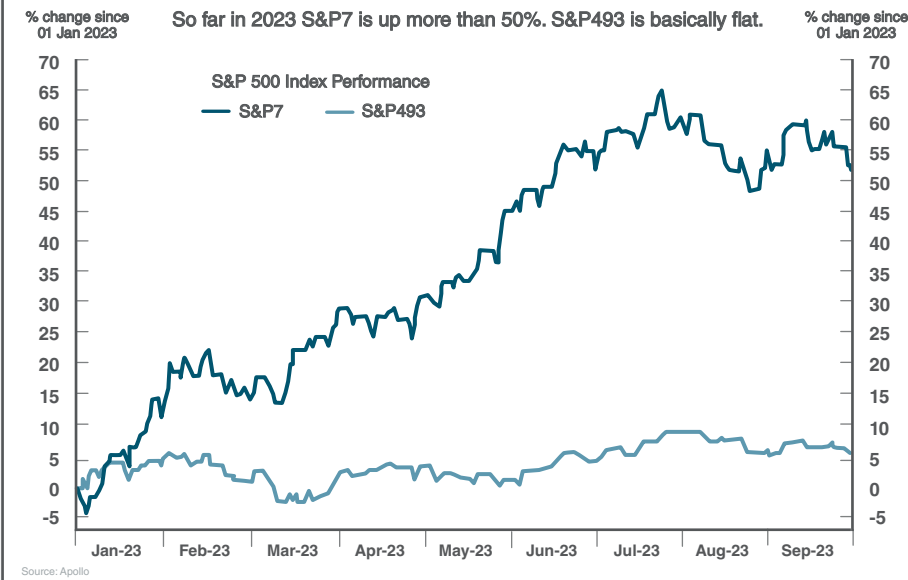
After a strong 14% return for the first half of the year, global stock markets took a pause in the third quarter with a return of -3.4%. The story for the first half of the year was stronger than expected economic data, moderating interest rate hike expectations, and the growing buzz over artificial intelligence. All in, markets were optimistic and pricing in the soft landing scenario. The third quarter brought the realization to equity investors that the resilient economy means stickier inflation with high interest rates for a longer period. As bond investors pushed interest rates higher throughout the quarter, stock investors revalued

stock prices lower (just like we saw for most of 2022). The worst performers during the quarter included long-duration stocks, which are most sensitive to higher interest rates. Long-duration stocks are companies that are expected to generate most of their cash flows in the future, rather than the present. These future cash flows are discounted by current interest rates, meaning higher rates result in lower current values. Going forward, we would expect market leadership to shift to more defensive areas of the market as investors digest higher interest rates and a weakening global economy.

EQUITY BENCHMARK TABLE					
US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	4,288	4,450	3,586	3,363	2,914
Dow Jones Industrial Average	33,508	34,408	28,726	27,782	26,458
NASDAQ	13,219	13,788	10,576	11,168	8,046
Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	-3.1%	25.0%	27.7%	8.0%	12.4%
US Large Cap Value	-3.2%	1.8%	14.4%	11.1%	6.2%
US Mid Cap Growth	-5.2%	9.9%	17.5%	2.6%	7.0%
US Mid Cap Value	-4.5%	0.5%	11.0%	11.0%	5.2%
US Small Cap Growth	-7.3%	5.2%	9.6%	1.1%	1.6%
US Small Cap Value	-3.0%	-0.5%	7.8%	13.3%	2.6%
International Large Cap Developed (US Dollar)	-4.1%	7.1%	25.6%	5.8%	3.2%
International Small/Mid Cap Developed (US Dollar)	-3.5%	1.8%	17.9%	1.1%	0.8%
Emerging Market (US Dollar)	-2.9%	1.8%	11.7%	-1.7%	0.6%

Source: Bloomberg, Morningstar

Chart 4: S&P 500 Returns Driven by Top 7 Stocks



Not Your Typical Bull Market Rally

The S&P 500 hit its lowest point on October 12, 2022. From that point to its recent high on July 31, 2023, the index has returned over 28%. For many market pundits, a rally of at least 20% signifies a new bull market. This technical phenomenon has led many to believe that the 2022 bear market is over and the worst is behind us. Taking a closer look, however, we would argue this has not been your typical start of a new bull market. First, market leadership has been very narrow. The S&P 500, for example, has been driven by the returns of just seven stocks, which are up over 50% in aggregate. The other 493 stocks are roughly flat for the year (Chart 4). Second, the start of the new cycle is typically led by cyclical, value, small cap, and international stocks. Cyclical

stocks have outperformed defensives since the October low, but aren't a market leader, which is claimed by technology and communication services. From the October 2022 low, growth has significantly outperformed value, and small caps have been a significant laggard (Chart 5). Lastly, after a strong start to the year, international stocks are now lagging U.S. stocks. In our view, it is a false signal to use the fact that markets have rebounded more than 20% from the recent low as confirmation of a new bull market. We continue to prefer cautious portfolio positioning in line with typical economic slowdowns and will look for more confirmation of a new cycle before repositioning equity portfolios for a new bull market.

Are Stocks Overvalued?

The recent spike in bond yields has removed one of the most positive valuation arguments for stocks. For the first time in 14 years, the earnings yield on the S&P 500, which is the aggregate dollar value of earnings divided by the price, is now less than the yield on 10-year Treasuries. Additionally, the yield on cash and short-term bonds are more than three times the dividend yield on stocks. This means the era of "TINA" or "there is no alternative" to stocks is over. Investors now can invest in high-quality government or corporate bonds and receive an interest rate not far below the long-term expected return of

stocks with little to no risk. Since 2017, the valuation level of the S&P 500 (as measured by price to earnings ratio or P/E) has tracked closely to the inverse direction of real bond yields (Chart 6). The year-to-date rally in stocks is at risk as the breakout in real bond yields has further increased the spread between yields and stock valuations. Given the uncertain outlook for the global economy, we are comfortable with our current portfolio positioning towards high-quality bonds relative to stocks and will look for more attractive relative valuation levels as a sign to add to equity allocations.

Chart 5: U.S. Small Cap Relative Performance Doesn't Show Signs of New Bull Market

Russell 2000/ Russell 1000 Around the Start of U.S. Cyclical Bull Markets

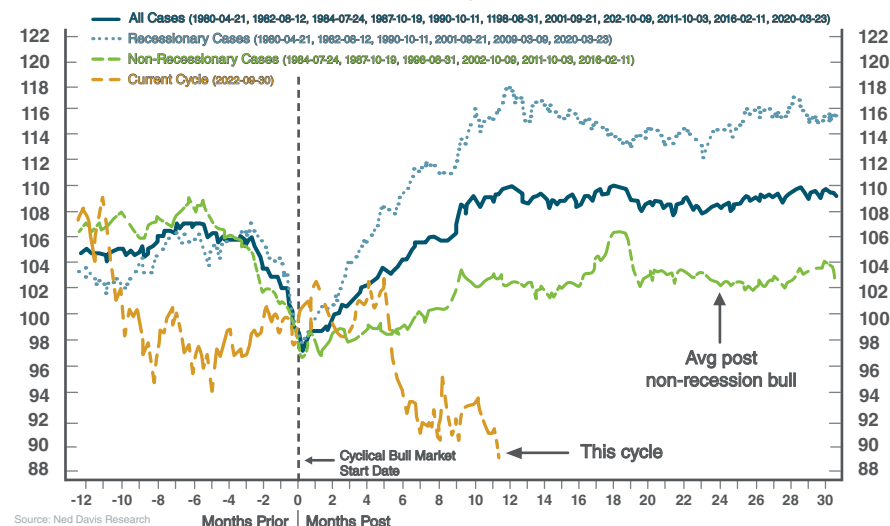
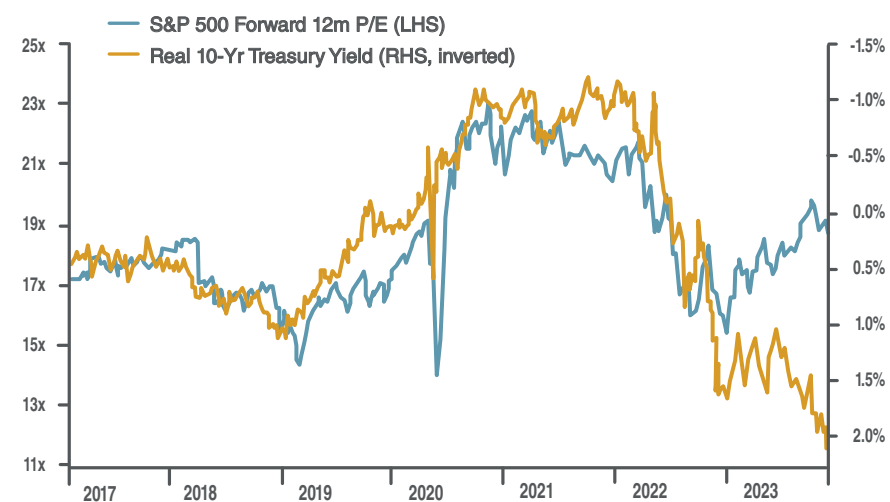


Chart 6: Higher Bond Yields Are a Risk to Stock Valuations

Stock Valuations & Real Rates



A Fixed Income Market Update from Trust Point

Global bond values declined as interest rates rose for most of the third quarter. In the U.S., upside surprises to economic data caused the market to price in additional tightening from the Federal Reserve. This means a more restrictive path of higher policy rates for longer is being forecasted to continue to slow the economy, bring down inflation and sustain it at the Fed’s target level (around 2%). For the last few years, we have maintained less interest-rate exposure than the broader U.S. market, but valuations are now looking compelling.

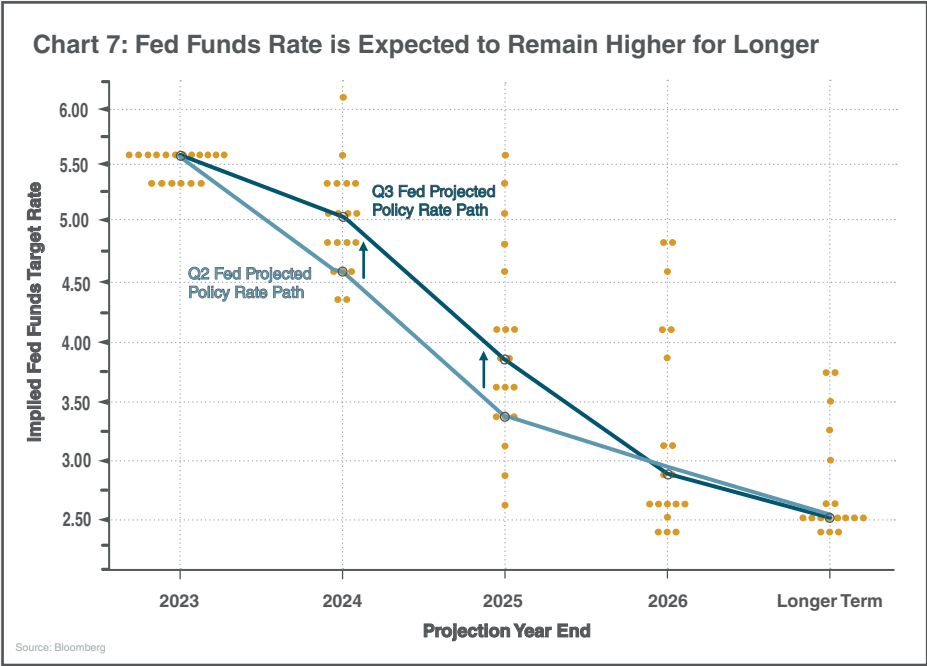
Higher For Longer

The Federal Open Markets Committee uses its policy rate, known as the federal funds rate, as a tool to achieve its mandate of price stability. The Fed has aggressively hiked the fed funds rate from zero to 5.25-5.5% in 18 months, the quickest pace of tightening since 1980. These aggressive rate hikes have been successful as inflation is moving lower and is forecasted to continue falling in the coming quarters. However, the combination of a strong labor market and a resilient U.S. consumer has led some areas of inflation to remain elevated and sticky, forcing the

committee to project higher policy rates for longer. The third quarter was characterized by the Federal Reserve communicating a message to markets that its work was far from over. The path of the fed funds rate is expected to remain over 5% for all of 2024 before it starts to fall more materially in subsequent years (Chart 7). This was a shift higher from the previous expectations released in the second quarter and means borrowing costs on everything from mortgages to auto loans are likely to remain elevated for longer than initially expected.

FIXED INCOME BENCHMARK TABLE					
US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	5.4%	5.3%	3.2%	0.1%	2.2%
2 Yr US Treasury	5.0%	4.9%	4.3%	0.1%	2.8%
10 Yr US Treasury	4.6%	3.8%	3.8%	0.7%	3.1%
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-3.1%	-1.8%	-0.6%	-6.2%	0.2%
US Treasury Inflation Protected Sec.	-2.6%	-0.8%	1.2%	-2.0%	2.1%
US Mortgages	-4.1%	-2.3%	-0.2%	-5.1%	-0.8%
US Short-Intermediate T/E Munis	-2.1%	-0.9%	2.1%	-1.7%	1.0%
US Investment Grade Corporates	-3.1%	0.0%	3.6%	-4.9%	0.9%
US Senior Bank Loans	3.5%	10.2%	13.1%	6.1%	4.5%
US High Yield	0.5%	6.0%	10.2%	1.8%	2.8%
Int'l Bonds Ex-US (Hedged)	-0.8%	2.8%	3.0%	-2.6%	0.8%
Int'l Bonds (Unhedged)	-3.6%	-2.2%	2.2%	-6.9%	-1.6%
Emerging Market Debt (US Dollar)	-2.9%	0.6%	8.7%	-5.1%	-0.5%

Source: Bloomberg, Morningstar



It's All About the Labor Market

So far, we have not seen the unemployment rate move meaningfully higher during this tightening cycle. Typically, when policy rates are hiked into restrictive territory, hiring and the economy will slow, leading to a higher unemployment rate. In fact, there have been 13 rate-hiking cycles going back to the 1950s. The unemployment rate surged in 10 of the 13 cycles, which led to further slowing of the economy and a recession. In the three tightening cycles when the unemployment rate did not rise meaningfully, there was a common theme: inflation was low and banks were easing lending standards. This is certainly not the case today,

as core measures of inflation remain elevated and sticky while bank lending standards are extremely tight, similar to previous recessionary periods (Chart 8). In our opinion, for the Fed to make sustained long-term progress on core inflation, it needs to see further weakness in the labor market through a higher unemployment rate. Simply put, if the job market is weakening, consumers are less willing to pay higher prices, and thus inflation slows. If the Fed is serious about winning the war against inflation (and we think it is), it will come at the expense of labor market slack and higher unemployment.

Treasury Yields Break Out to Highest Levels in Over a Decade

This “higher for longer” narrative in which the Fed is forecasting policy rates above 5% through 2024 has continued to have a material impact on bond yields. Across all of the Treasury curve, interest rates have broken out to the highest levels in over a decade (Chart 9). We have remained cautious in portfolio interest-rate sensitivity, as we felt sticky inflation and a commitment to rate hikes from the Fed would pose a risk of further downside for bonds. As such, relative to the broader U.S. bond market, we have maintained an underweight exposure to long-term bonds and interest-rate

risk, known as duration. As yields have risen to the highest levels in over a decade, valuations in the bond market are becoming compelling. Savers are finally being rewarded with high levels of income and diversification benefits. In addition, when the tightening cycle has historically hit peak levels, this has been a turning point and a tailwind for bond prices. The current rate-hike cycle is approaching or is at peak rates and as a result, we will look to tactically add to longer-term bonds. Catalysts such as labor market weakness and slower economic growth will be important signals for us in the months to come.

Chart 8: Bank Lending Standards are Deep in Recessionary Territory

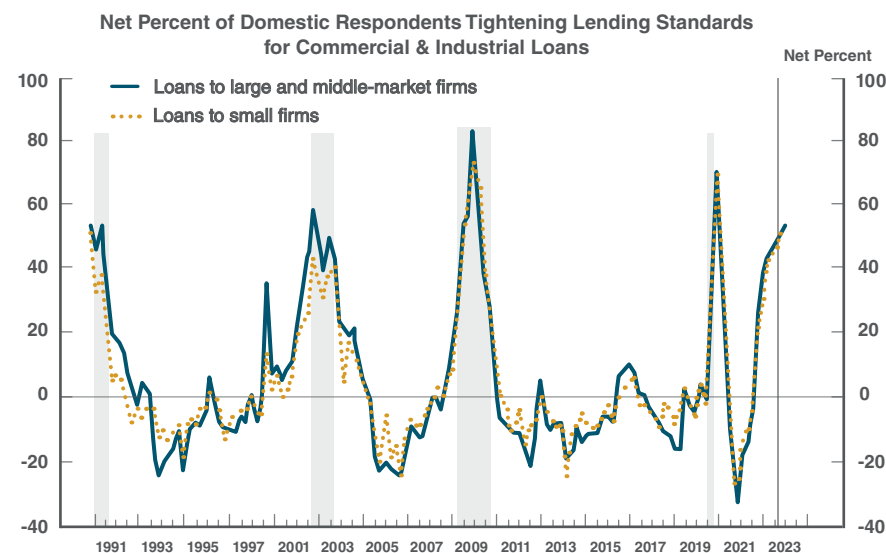
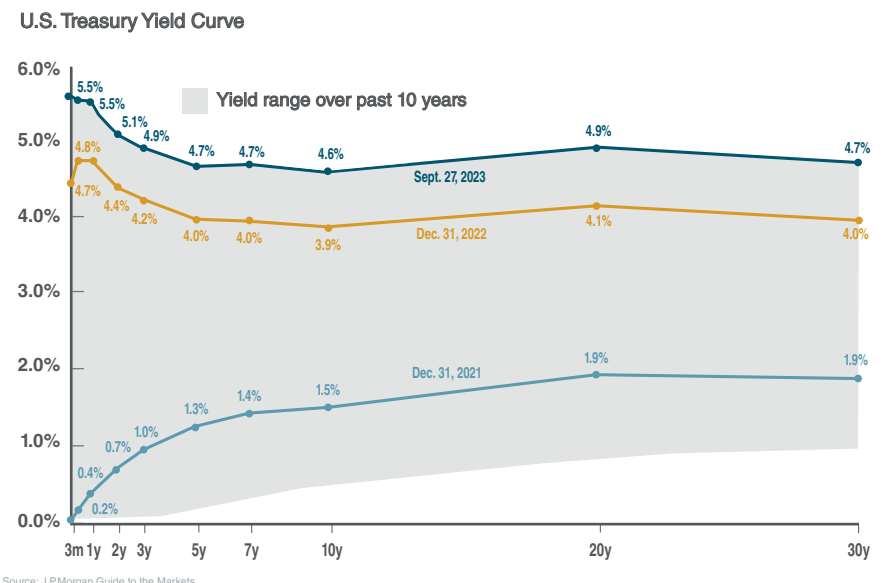


Chart 9: U.S. Treasury Yields Rise to Decade Highs Across the Curve



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



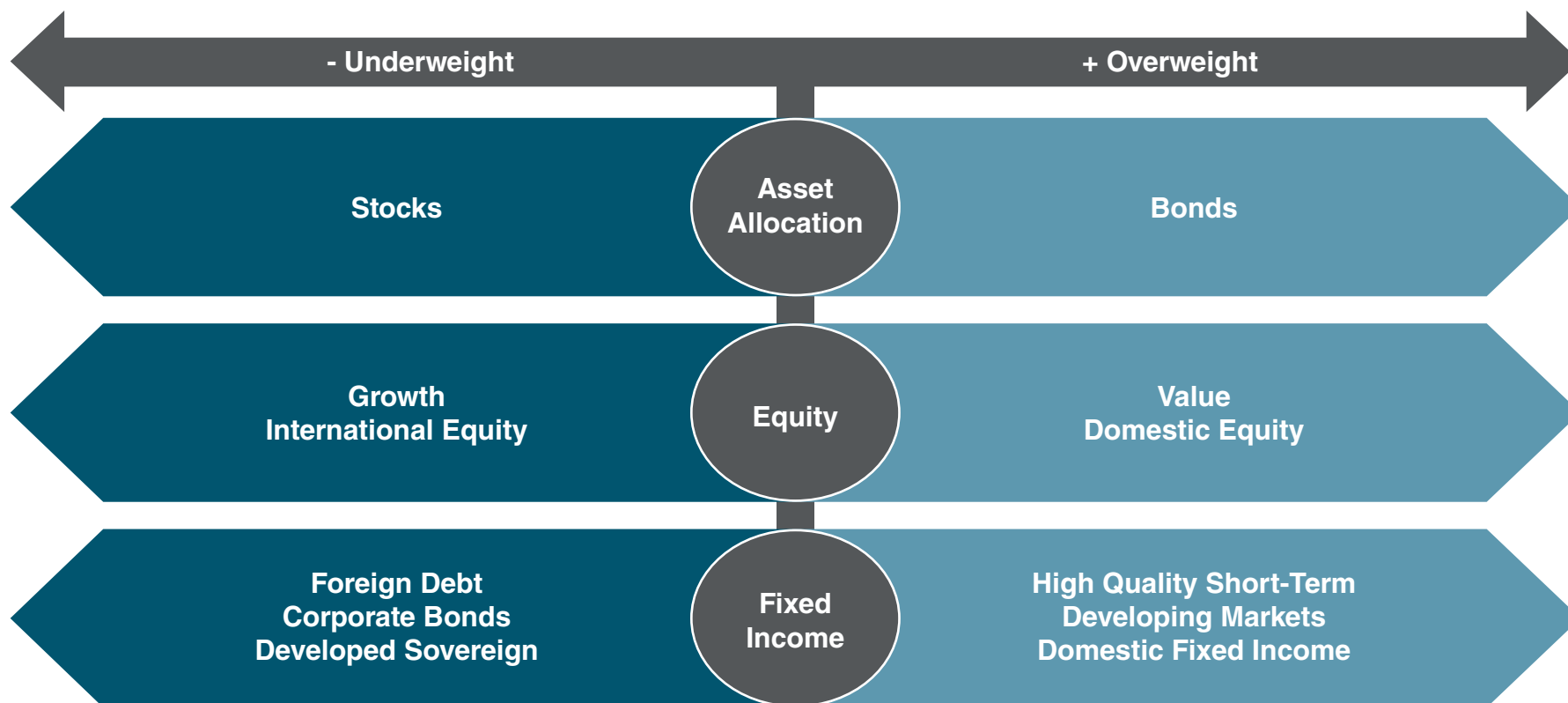
- **Government bond yields have risen and have become increasingly attractive**
- Higher inflation has forced central banks to normalize policies quickly but the end to monetary tightening is close
- Global uncertainty will allow the U.S. dollar to stay strong ST despite LT downward pressure
- **Healthy 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

Despite better than expected economic data year-to-date, the global economy remains in the “late-cycle” phase, and recession risks remain elevated. As a result, we continue to recommend an underweight position in stocks versus bonds. Within equities, we favor domestic equities over international or emerging market stocks. We also prefer defensive equity sectors over cyclical ones. Quality, profitability, and larger capitalizations are also equity factors we favor in the current environment. Within bonds, the focus continues to be on higher-quality bonds over riskier credit, while we are also taking advantage of rising yields to slowly add to duration. Longer duration in bond portfolios should provide higher potential returns and also greater diversification in an increasingly challenging macroeconomic environment.



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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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