TRUSTPOINT

MarketPoint

An Economic & Market Commentary from Trust Point

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An Economic and Market Update from Trust Point

After a difficult start to the year, equity and fixed-income markets rebounded slightly in the fourth quarter of 2022. The key story for the year was the aggressive tightening cycle that central banks embarked on after initially missing the inflationary backdrop. This year will likely be characterized by growing economic concerns due to the lagged effect of rising interest rates. This is not the time to be aggressive so we continue to position portfolios with defense in mind. To learn more about what the rest of 2023 may bring, please read on.

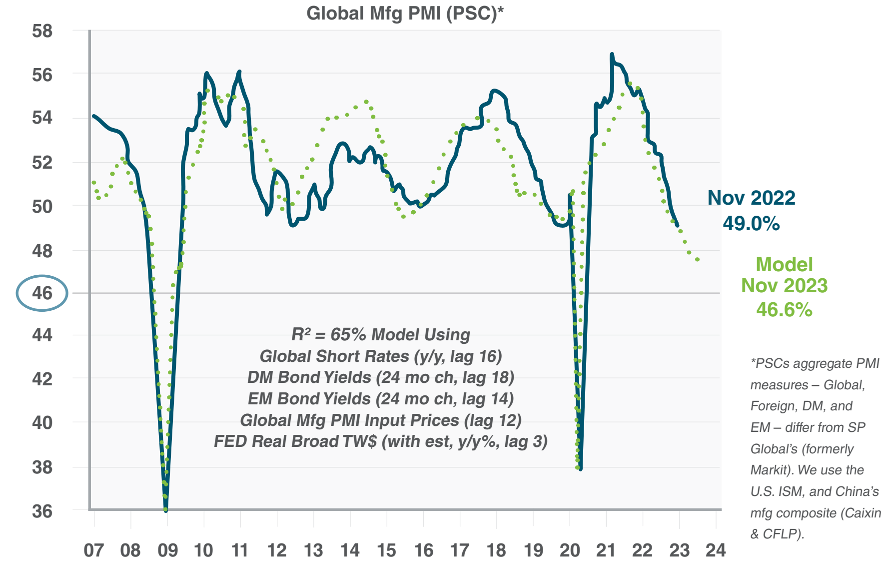
KEY ECONOMIC DATA	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Dec	103.5	112.1	95.7
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Dec	48.4	50.9	58.8
ISM Non-Manufacturing (>50 = Expansion)	Dec	49.6	56.7	62.3
Non-Farm Payrolls	Dec	223k	269k	588k
Unemployment Rate	Dec	3.5%	3.5%	3.9%
CPI Ex-Food & Energy (yoy)	Nov	6.0%	6.3%	4.9%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Dec	48.6	49.8	54.3
JP Morgan Global Services Index (>50 = Expansion)	Dec	48.1	50.0	54.7

Source: Bloomberg

Global Recession Very Likely in 2023

Higher than expected inflation led to sharply rising interest rates in 2022 which, with a lag, will negatively impact economic growth in 2023 (Chart 1). Globally, both services and manufacturing firms are reporting a decline in new orders, which is negatively impacting business confidence and will soon lead to lower production and profits as well. Deteriorating fundamentals will ultimately force firms to shed workers. Higher unemployment will create the necessary slack in the labor market for wage inflation to slow and services inflation in the broader economy to ease. Only then will the U.S. Federal Reserve be able to call victory, but at the likely cost of a recession. Could this slow dance to a recession be avoided altogether? Yes, but the odds are slim. We would need inflation to come down quickly (including wage inflation) and the Fed to quickly pivot while consumers continue to spend. Although possible, that scenario is unlikely. However, our expectation is that the U.S. economy will perform better than the global economy this year as excess savings accumulated during the pandemic remain above $1T (Chart 2), providing ongoing support for U.S. consumption.

Chart 1: Slower Economic Growth Ahead



Source: Piper Sandler & Co.

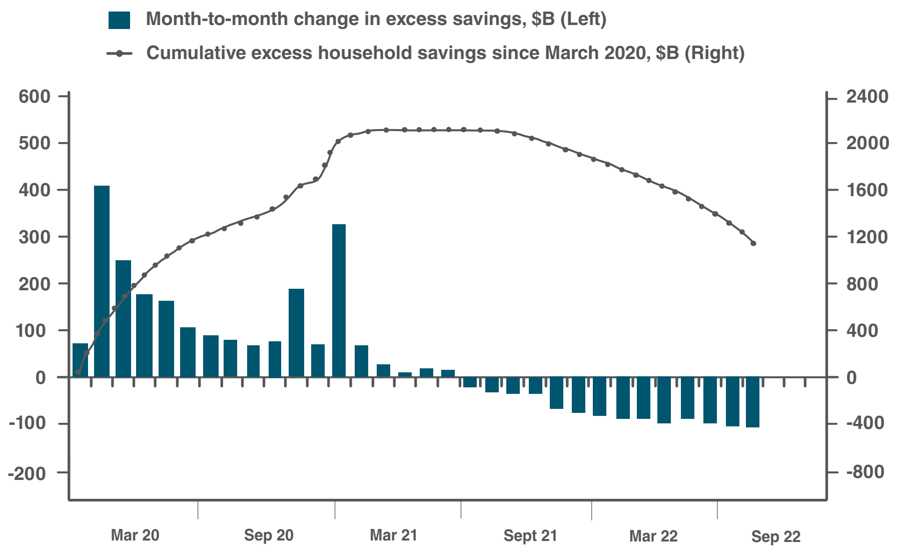
Inflation, Interest Rates Key to 2023 Outlook

Inflation and interest rates are likely to remain important factors in determining the trajectory of the economy and asset markets in 2023. On inflation, disrupted supply chains from the pandemic have returned to some normalcy, allowing goods inflation to come down. However, the labor market is still too tight to bring wage inflation down, meaning that services inflation may not ease materially this year (Chart 3). On interest rates, the Fed is likely going to continue to have an outsized impact, especially on the short end of the curve. As the Fed is working to regain its credibility (after calling inflation "transitory" for too long), we think their voting members should be taken seriously when they say they intend to raise rates "until the job is done." Turning "dovish" too soon may lead to a repeat of what happened in the 1980s, a scenario the Fed likely wants to avoid at all costs. For these reasons, a quick Fed pivot is unlikely and the risk-free interest rate over the next several years may be closer to the 2-4% range rather than the 0-2% range that prevailed through the period from 2009 to 2021. With that change comes important implications for portfolio positioning going forward.

Finding Value in Otherwise Challenging Markets

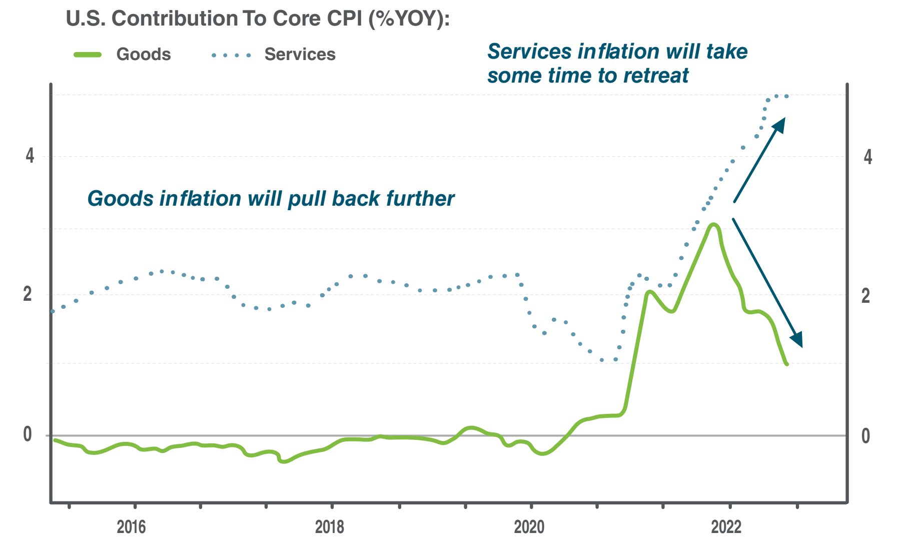
Even if the U.S. avoids a recession this year, that doesn't mean U.S. stocks are safe. Since about a third of the S&P 500 revenues are generated from abroad and the return of the S&P 500 is more correlated to global economic activity than domestic growth, finding refuge in U.S. equities may not provide the safety net desired. Selectivity is going to be very important in 2023. In our opinion, consensus estimates for earnings remain too high for too many companies. Within equities, we would favor lower beta names, defensive and quality companies with strong balance sheets. Furthermore, investors don't have to take on unnecessary risk to achieve return targets, which was the case for most of the period following the global financial crisis of 2008-09 as yields offered by bonds were often not even compensating investors for inflation. The sharp rise in interest rates in 2022 has made bonds look favorable relative to equities. High-quality bonds can offer relative stability and greater income. From a macroeconomic perspective, bonds historically tend to be resilient in a recession, making bonds a tactically good investment as well.

Chart 2: U.S. Consumers Have Chosen to Run Down Pandemic Savings



Source: Pantheon Macroeconomics

Chart 3: Goods & Services Inflation Diverge



Source: MRB Partners, U.S. Bureau of Labor Statistics

An Equity Market Update from Trust Point

In 2022, the S&P 500 index declined 18.1% while the MSCI ACWI ex-US index fell 16.0% (USD). Equity prices fell considerably from valuation multiples contracting as interest rates rose quickly. Growth-style stock sectors, including Tech, Communication Services, and Consumer Discretionary stocks, were the biggest losers given their higher sensitivity to changes in interest rates and expectations for a demand slowdown. Value-style stock sectors, including Energy (up 41%!) benefitted from concerns over oil and natural gas inventories in Europe while Consumer Staples and Utilities served as safe havens for equity investors.

Expect Another Bumpy Year in 2023

The continuing concern over a global recession does not bode well for stocks in 2023. Similar to 2022, much will depend on the actions of the Fed and what it does with interest rates. Although unlikely, a quick pivot by the Fed could provide support for stocks as they have historically bottomed only a few months after the Fed stops raising rates (Chart 4). However, until then the sharp rise in interest rates in 2022 has greatly increased the likelihood of an economic slowdown, which is not yet fully priced into stocks. The current backdrop also includes China beginning to reopen its economy after its long-standing zero-COVID policy. Chinese economic activity will pick up in 2023 as mobility increases for the world's second largest economy. But in the short term, infections and hospitalizations are on the rise and acting as a deterrent to the reopening. The Russia-Ukraine conflict also slogs on with no end in sight. This will continue to force European nations to be prudent with energy use, given their Russian dependence, and only adds to rising global geopolitical risks.

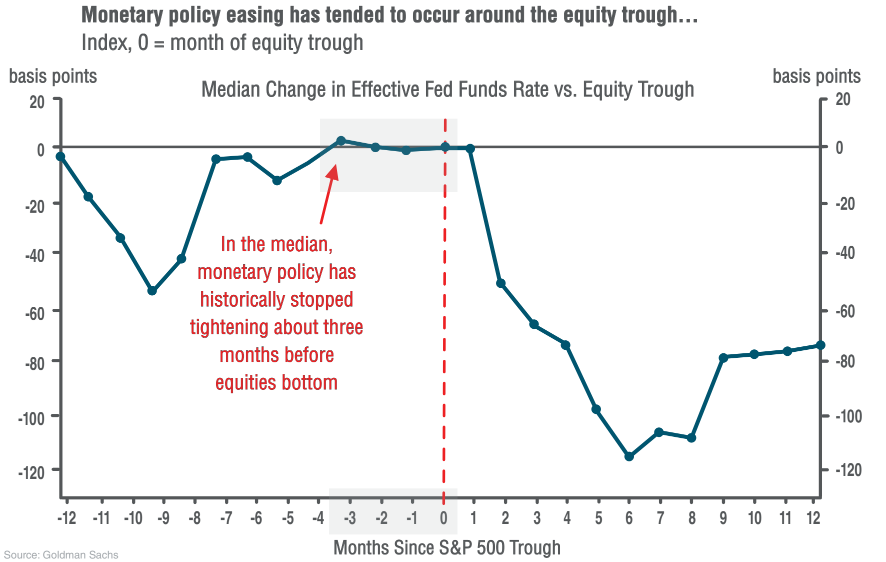
EQUITY BENCHMARK TABLE

US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	3,840	3,586	4,766	3,231	2,674
Dow Jones Industrial Average	33,147	28,726	36,338	28,538	24,719
NASDAQ	10,466	10,576	15,645	8,973	6,903

Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	2.2%	-29.1%	-29.1%	7.8%	11.0%
US Large Cap Value	12.4%	-7.5%	-7.5%	6.0%	6.7%
US Mid Cap Growth	6.9%	-26.7%	-26.7%	3.9%	7.6%
US Mid Cap Value	10.5%	-12.0%	-12.0%	5.8%	5.7%
US Small Cap Growth	4.1%	-26.4%	-26.4%	0.6%	3.5%
US Small Cap Value	8.4%	-14.5%	-14.5%	4.7%	4.1%
International Large Cap Developed (US Dollar)	17.3%	-14.5%	-14.5%	0.9%	1.5%
International Small/Mid Cap Developed (US Dollar)	15.8%	-21.4%	-21.4%	-0.9%	0.0%
Emerging Market (US Dollar)	9.7%	-20.1%	-20.1%	-2.7%	-1.4%

Source: Bloomberg, Morningstar

Chart 4: Equity Markets Tend to Bottom After The Fed Stops Raising Rates



Source: Goldman Sachs

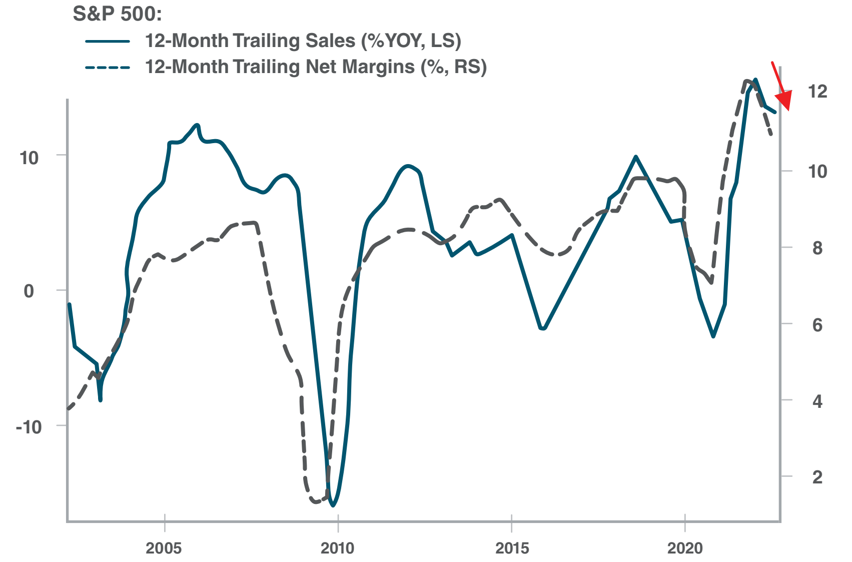
More Profit Margin Compression Ahead

Last year high stock valuations collapsed, leading to lower equity prices. We believe the next shoe to drop is earnings growth, which is already descending from peak levels. Corporate sales growth and expense management, of course, drive profits and earnings. Going back to the early days of the pandemic, massive monetary and fiscal stimulus supported the stay-at-home spending bubble, which led to a surge in profit margins to unsustainably high levels (Chart 5). Importantly, corporate sales benefited from inflation as customers willingly paid higher prices. Today, order reports tell us unit demand is slowing amidst higher inventory levels. Moving forward, a confirmed rollover in inflation will mean prices are coming down. Lower prices combined with slowing unit demand mean sales should also continue to meaningfully slow. As sales growth slows and combines with fixed costs and higher wages from a tight labor market, there will be further downward pressure on corporate profit margins, to the detriment of earnings. Earnings, as the fundamental driver of stock prices, will come down and stocks are likely to follow. If this indeed plays out, investors will have experienced the valuation multiples contraction in 2022 followed by an earnings recession in 2023, which is the recipe for stocks to complete the recessionary cycle and start building a foundation for better returns in the long term.

Tactical Positioning is Important

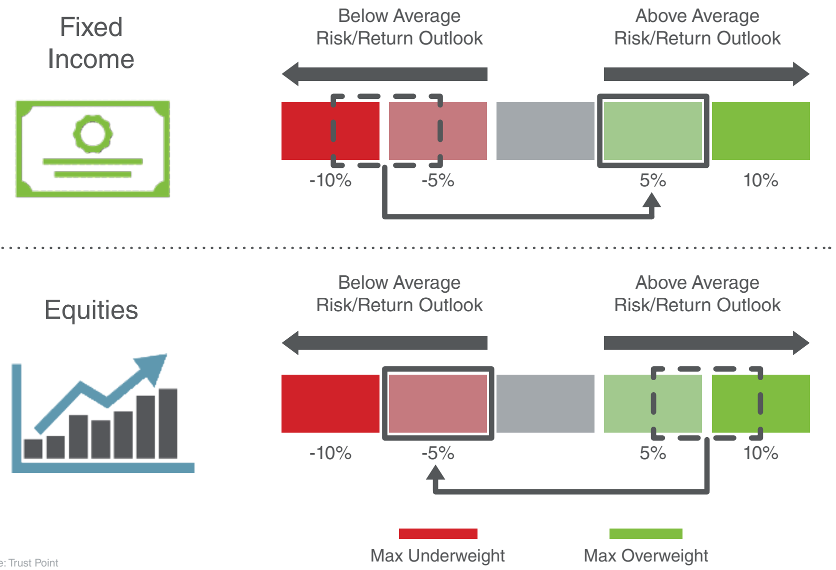
Throughout 2022 we have consistently taken advantage of bear market rallies by reducing risk exposure in client portfolios. Decreasing equity exposure and increasing fixed-income exposure reflected our views of a worsening market backdrop. In Chart 6, we demonstrate the changes we made last year to transition equities from a 7.5% overweight allocation to a 5% underweight allocation relative to our broad market benchmark, which is our tactical asset allocation recommendation today. The timing of the changes worked favorably in client portfolios as the market resumed its sell-off after each of the changes were implemented. Additionally, within equity portfolios, we have added greater exposure to high-quality factors (such as companies with strong balance sheets, consistent cash flows, and lower debt levels) and lower beta factors (such as Consumer Staples and Healthcare sectors). This has allowed equity portfolios to experience less volatility and better performance relative to the broad equity market in 2022.

Chart 5: Watch Sales as the Key Driver to Margin Compression



Source: MRB Partners

Chart 6: Tactical Asset Allocation Changes in 2022



Source: Trust Point

A Fixed Income Market Update from Trust Point

Rising policy rates in 2022 were used as a tool to slow down economic growth, with a goal of cooling off persistent inflation. The rapid rise in interest rates has been a headwind for the bond market but has also restored value in that higher-quality bonds now come with higher yields and more diversification benefits than any time over the last 10-plus years.

FIXED INCOME BENCHMARK TABLE

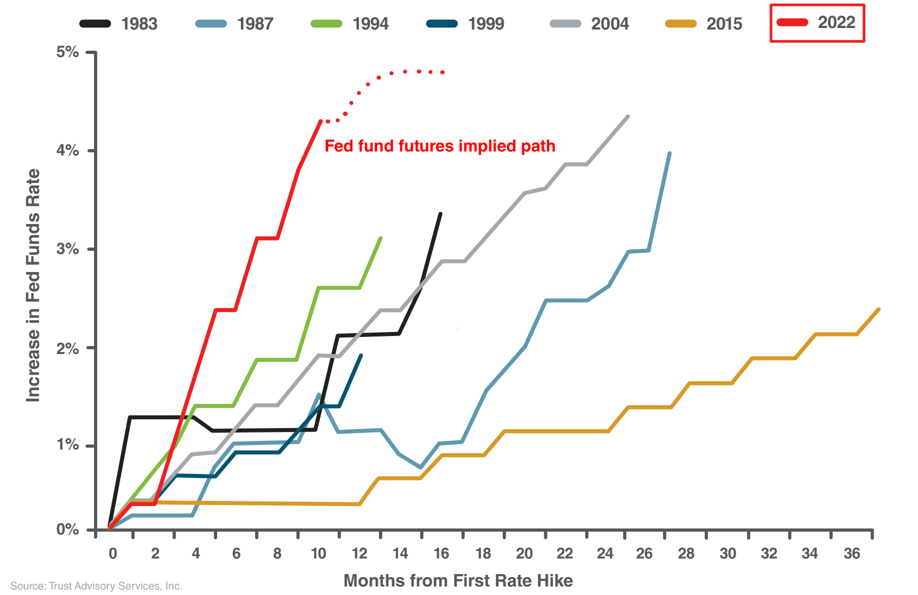
US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	4.3%	3.2%	0.0%	1.5%	1.4%
2 Yr US Treasury	4.4%	4.3%	0.7%	1.6%	1.9%
10 Yr US Treasury	3.9%	3.8%	1.5%	1.9%	2.4%
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	1.2%	-12.6%	-12.6%	-2.6%	0.1%
US Treasury Inflation Protected Sec.	2.0%	-11.8%	-11.8%	1.2%	2.1%
US Mortgages	2.1%	-11.8%	-11.8%	-3.2%	-0.5%
US Short-Intermediate T/E Munis	3.0%	-5.4%	-5.4%	-0.4%	1.2%
US Investment Grade Corporates	3.6%	-15.8%	-15.8%	-2.9%	0.5%
US Senior Bank Loans	2.7%	-0.6%	-0.6%	2.5%	3.3%
US High Yield	4.0%	-11.2%	-11.2%	-0.2%	2.1%
Int'l Bonds Ex-US (Hedged)	-0.8%	-12.1%	-12.1%	-3.5%	0.1%
Int'l Bonds (Unhedged)	4.5%	-16.2%	-16.2%	-4.5%	-1.7%
Emerging Market Debt (US Dollar)	7.4%	-16.5%	-16.5%	-4.5%	-1.0%

Source: Bloomberg, Morningstar

Change Creates Opportunity

The past year has been shaped by the Federal Reserve taking dramatic steps to restrict economic activity and keep inflation from becoming entrenched at elevated levels. The Fed has accomplished this through an impressive and historic interest rate hiking cycle. The Fed funds rate has moved from approximately 0% to 4.25% in 10 months, the quickest pace of rate hikes in 40 years (Chart 7). As a result, borrowing costs have soared as everything from higher mortgage rates to credit card rates have helped slow consumer spending, resulting in weaker economic growth. The Fed has communicated that there is more work to be done, but there is growing evidence that this year's move in rates is having the desired impact, with inflation slowly coming down from the highest levels since the early '80s. This rapid adjustment to higher rates has been painful, but at the same time has created many opportunities which we are taking advantage of in our portfolios. Yields across many fixed income sectors are multiple times higher than this time last year, and expected returns in the years ahead have been given a meaningful boost. In addition, recharged yields are likely to add to the diversification benefits of owning bonds. If equity market volatility persists in the year to come, fixed income is likely to add to portfolio resiliency.

Chart 7: Most Aggressive Fed Tightening in 40 Years



Source: Trust Advisory Services, Inc.

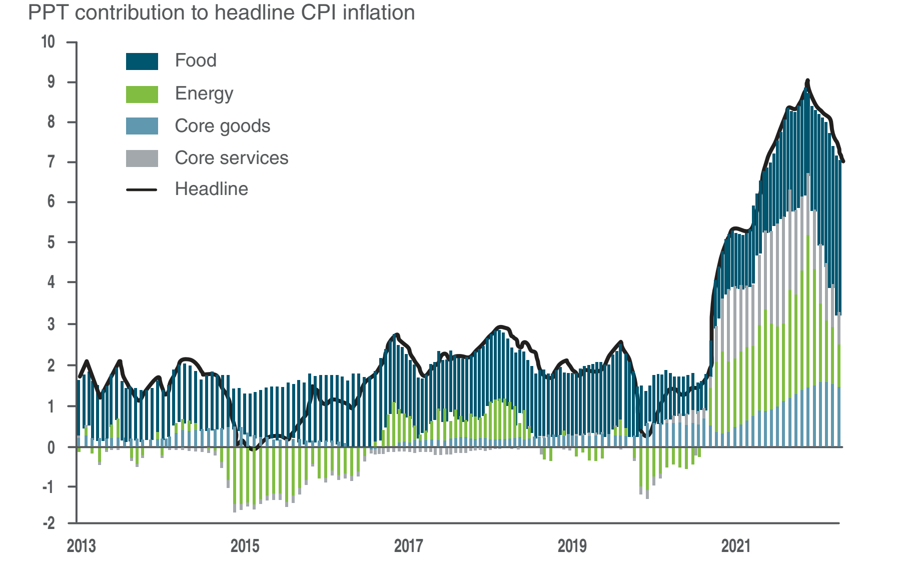
Moderating Inflation Sows New Seeds

Inflation has been at the heart of market turmoil all year long. Higher prices have impacted nearly everything in the basket of components that comprise the Consumer Price Index (CPI). As mentioned above, the impact of higher interest rates has begun to take hold and there is growing evidence in goods, food, and energy prices that the worst of inflation is behind us. Headline inflation has fallen from a peak of 9.1% in early summer to last month's reading of 7.1%, which is the lowest level since December 2021 (Chart 8). It is unlikely that inflation will fall all the way to the Fed's target in 2023, but a continued trend of moderating inflation will help sow the seeds for the Fed to eventually pivot. Services inflation has remained a concern because it is heavily influenced by wages and high shelter costs. A component that we are closely watching is owners' equivalent rent (OER), which is the single largest piece of CPI at roughly 24%. OER tends to lag home prices by 6-12 months and although home prices have fallen dramatically, rents are still elevated and are not yet coming down in the headline or core CPI readings. We believe this will ultimately subside as new rent measures from Zillow or Apartment List indexes are indicating that rents are already turning lower and suggests that CPI shelter costs should be coming down this year (Chart 9).

Rate Hikes Restore Value in High-Quality Bonds

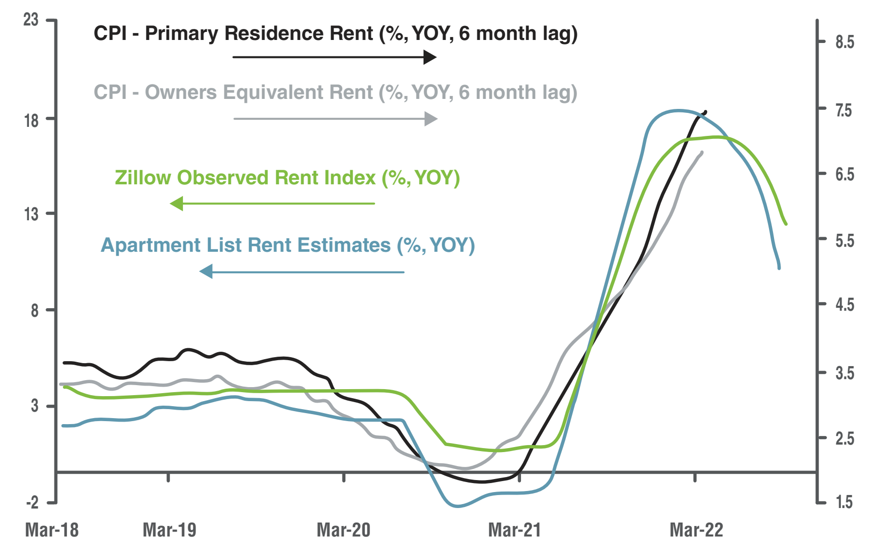
Last year was dominated by defensive fixed-income portfolio positioning. A cautious approach was warranted as the Fed was embarking on a tighter monetary policy. Looking ahead, a massive move higher in short-term interest rates resulting from aggressive rate hikes has made high-quality, short-term bonds very compelling. We have increased allocations in this sector of the bond market as we can prioritize safety and preservation of capital while still collecting substantial income. Although rate hikes have an immediate impact on yields, it takes time for the lagged effect of rate hikes to flow through the economy and impact growth and corporate profits. Because of this, we believe the rapid rise in rates will continue to impact corporate credit markets in 2023. We conclude that a better entry point will become available in sectors of the bond market which are more credit sensitive or tied to economic activity. We continue to maintain a globally diversified portfolio with exposure to inflation hedges and higher yielding areas of the market while maintaining a defensive bias. We remain flexible to take advantage of opportunities in the year ahead. A great deal of value has been restored to the bond market this year, and we are likely to experience more gains and less pain in the coming quarters.

Chart 8: Headline Inflation Has Fallen From a Peak of 9.1% to 7.1%



Source: Oxford Economics/Haver Analytics

Chart 9: CPI Shelter Costs May Be Coming Down in Early 2023



Source: Zillow, Apartment List, BLS, Piper Sandler

Key Investment Themes

Macroeconomics

- Structurally, Debt, Demographics, and Deglobalization may influence global growth and inflation for years
- **Cyclically, global growth is clearly slowing. Recession risks are rising**
- Structurally, healthier consumers & businesses (vs the 2010 decade) should lead to good growth long-term
- **Biggest wild cards: Inflation (and central banks' reaction to it) + geopolitical uncertainty**

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

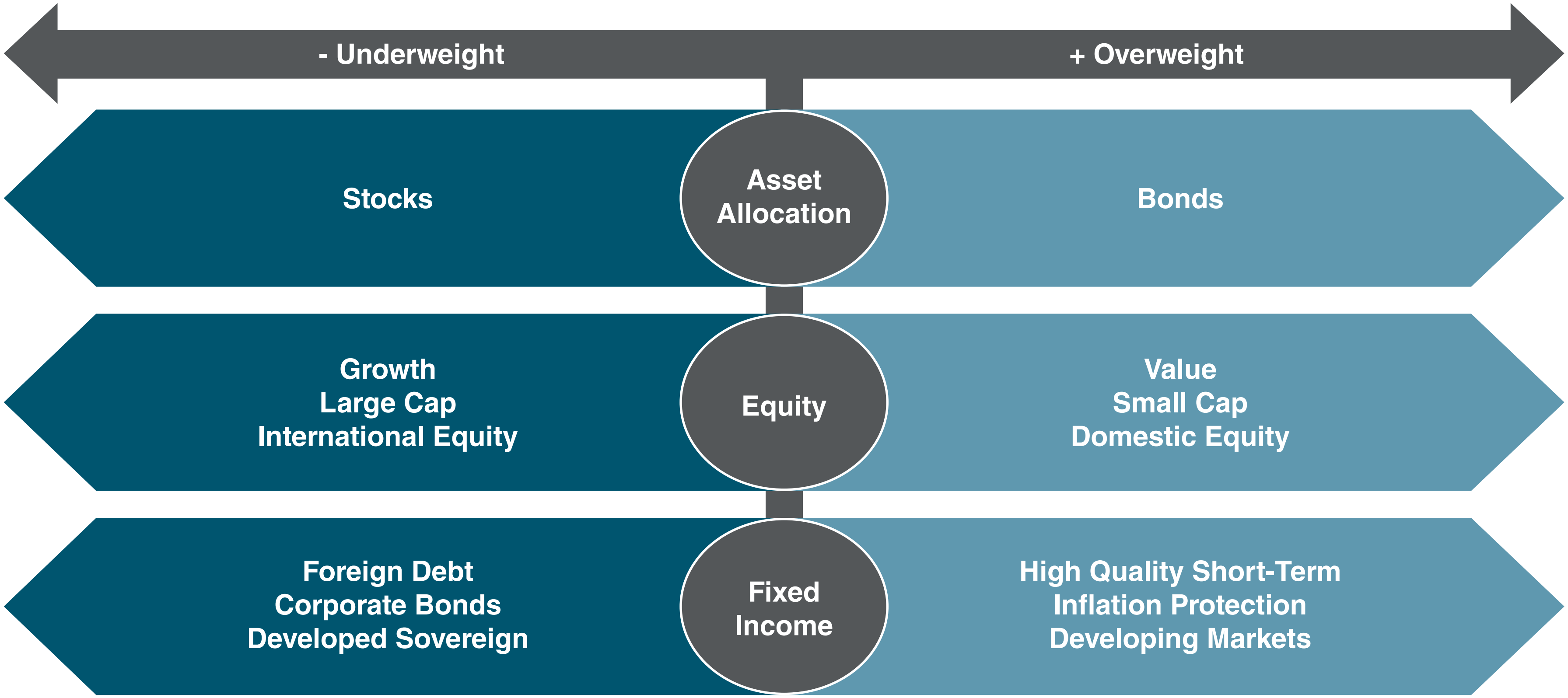
Fixed Income

- **Government bond yields have risen and have become increasingly attractive (especially ST bonds)**
- Higher inflation is forcing central banks to normalize policies quickly
- Geopolitical 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
- **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

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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®, Ryan Bergan, MBA, Steve Brudos, Brandon Hellenbrand, CFA®, Christine Doll and Nolan Gaffney. Please feel free to contact any team member with questions.

      

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