2023 OUTLOOK

fnbo

Why Stay Invested

Trains take passengers to their intended destinations, traveling through varying terrain and weather conditions. Interestingly, passengers cannot see the train's last stop. Window views provide glimpses along the route, from rocky mountains to lush plains and from sunny skies to thick fog. Even when visibility is obscured, the train keeps chugging toward its destination.

Today's economic landscape is very similar. The highest inflation in 40-plus years contributed to a challenging market for financial assets. As a result of the price decline in bonds and equities, clients are asking questions like:

- **Are we headed into a recession?**
- **What changes should we make to protect our assets?**
- **Are we still on track to meet our investment goals?**

These questions and more helped us frame this year's Outlook. We also present information on how to help navigate this difficult market environment and provide context around the view from the economic train.

Although global inflation and heightened risk of a recession are potentially rerouting the train, we perceive current market conditions as a cyclical detour.

One factor in achieving investment success is the conviction to stay invested during volatile conditions.

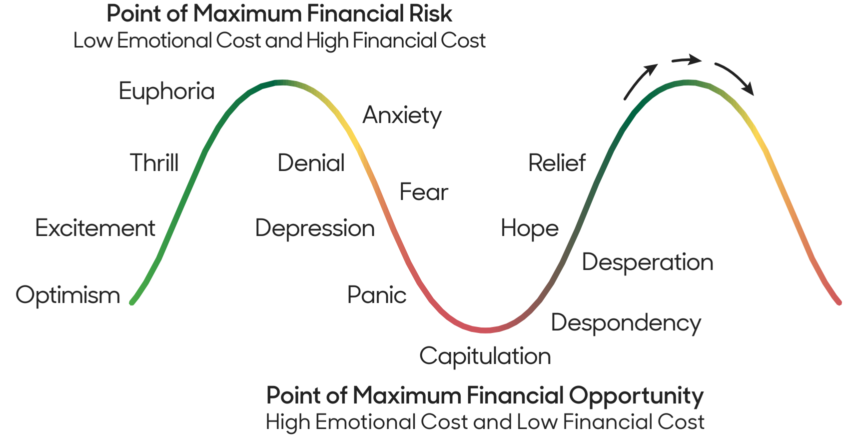
FNBO PERSPECTIVE

Contrarian investors who buy after market downturns may earn higher returns.

Behavioral finance is a field of research that outlines theories to explain bond and stock market trends. It focuses around the notion that investors don't always make rational investment decisions and may be influenced by their own biases. Early last year, markets were flush with liquidity and could be described as euphoric. Individuals who "follow the herd" tend to buy into the stock market after it goes up and sell when the market corrects. In extreme cases, these behaviors can lead to stock market anomalies, such as bubbles and crashes.

We believe the "Herd Mentality" graph demonstrates the emotions of investing in volatile markets. As the chart illustrates, the point of maximum investment opportunity is to buy when others are capitulating. Although a market bottom for bonds and stocks may not have occurred, we believe financial opportunities are being created.

Herd Mentality

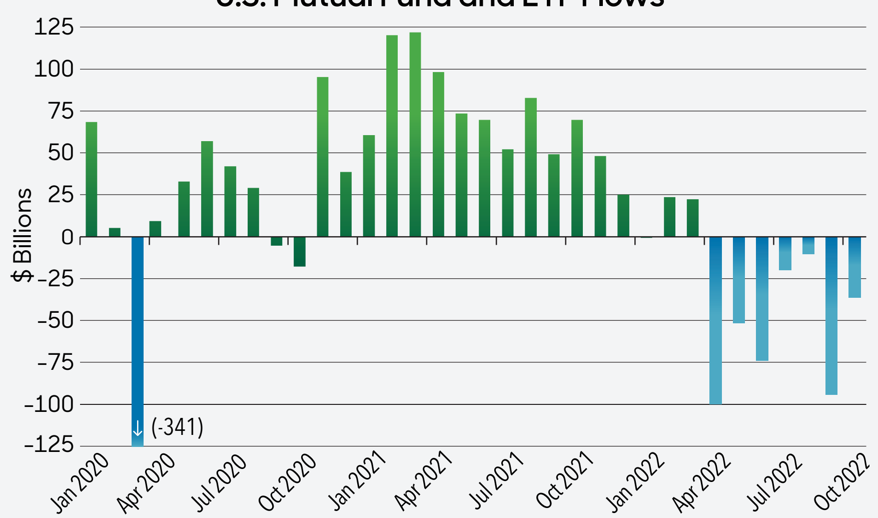


Source: www.Investing.com; Equities Could Go (A Lot) Lower

A review of investor cash flows into equity, bond and hybrid mutual funds and exchange-traded funds (ETFs) highlights behavioral biases that can be detrimental to portfolios. As portrayed in the "U.S. Mutual Fund and ETF Flows" chart, these funds experienced massive inflows in 2021 when most asset classes were generating positive returns. Investors were essentially chasing trends and overconfident that market conditions would persist.

Due to changes in the macro-environment, these trends did not endure, and markets abruptly declined last year. As illustrated, total fund flows turned sharply negative in April. Successful investors often take a different approach and focus more on the value of the asset than the underlying price change. As Warren Buffet famously said, "Be fearful when others are greedy, and greedy when others are fearful."[1]

U.S. Mutual Fund and ETF Flows



Source: Investment Company Institute; Data as of October 2022

FNBO PERSPECTIVE

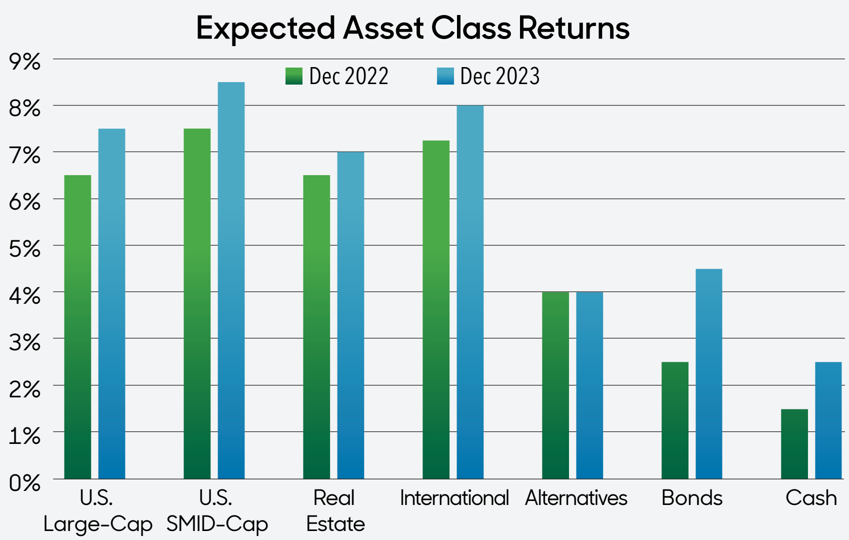
For investors seeking to lower portfolio risk, an opportunity has surfaced to revisit asset allocation.

In last year's Outlook, we highlighted how multiple asset classes were expensive and positioned client portfolios for higher volatility and lower returns. The price decline in bonds and equities have reduced valuations to more attractive levels. In setting long-term return assumptions, we primarily compare current asset class valuations to their history.

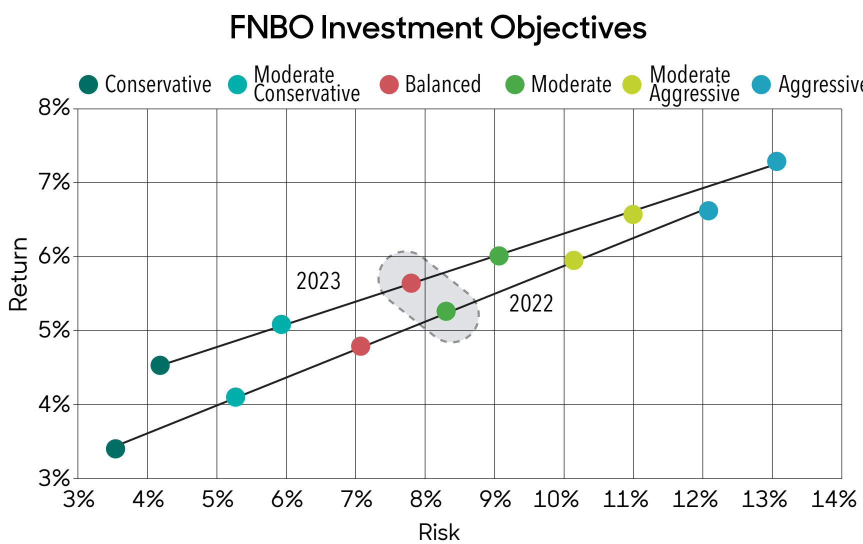
As demonstrated in the "Expected Asset Class Returns" chart, we have increased our forecasted returns for all major asset classes, except alternative investments. The largest change to long-term returns is within fixed income due to last year's increase in bond yields. In cash, we now expect to earn 2.5% annually over the next 10 years.

The asset allocation decision is an important factor in driving the investor experience. The "FNBO Investment Objectives" graph illustrates how our asset class return assumptions flow into higher expected returns for the respective investment objectives. The risk or standard deviation has also risen for each objective.

Market conditions have created an opportunity to discuss asset allocation with your Wealth Management team. We believe clients can now earn higher returns without taking on more risk. For example, the Balanced Objective (45% stock allocation) has a greater expected return with less risk as compared to the Moderate Objective (55% stock allocation) from one year ago. We recommend creating and/or updating a financial plan to confirm the long-term asset allocation.



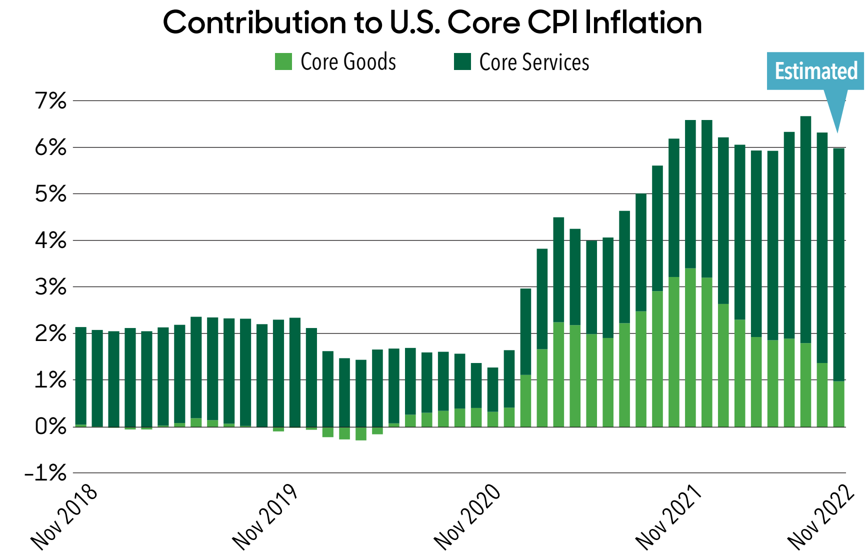
Source: FNBO Capital Market Assumptions for Next 10 Years as of December 2022 and 2023*



Source: FNBO Assumptions for Return; 10 Year Standard Deviation for Risk

FNBO PERSPECTIVE

Persistent inflation remains an economic headwind.



Source: FactSet Research Systems and Department of Labor; Data as of November 2022

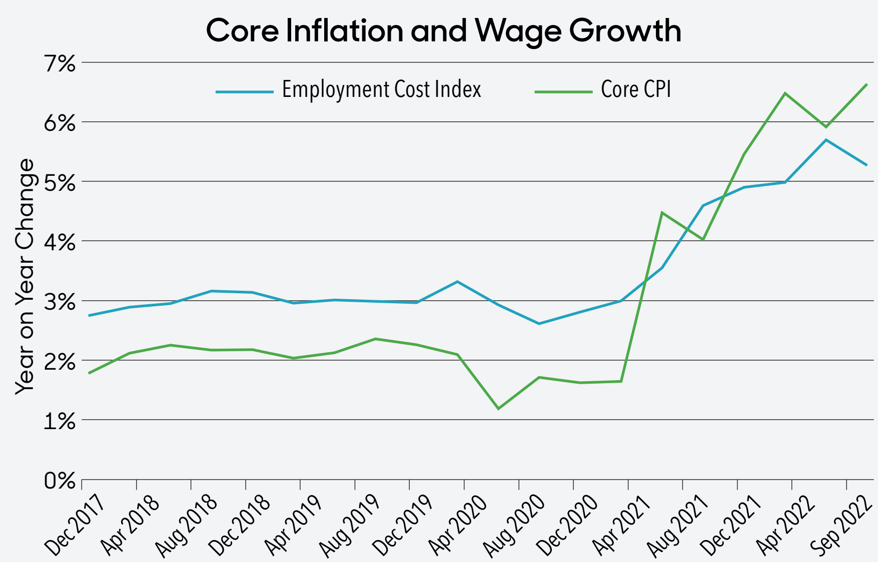
Our investment process begins with a review of global economic and market conditions. We assess economic indicators to determine whether the economy will likely grow or contract. These include financial indicators like equity returns, the Treasury yield curve and fixed income credit spreads. Inflation, employment trends, consumer expectations, manufacturing activity and global leading indicators are also analyzed.

Throughout 2022, inflation stayed persistently high, increasing the risk of an economic downturn. As shown in the "Contribution to U.S. Core CPI Inflation" graph, inflation initially surged in core goods. Over the last few quarters, goods inflation declined, likely due to lower demand and improvements in the supply chain. This positive change was offset by an acceleration in core services inflation, which is influenced by the amount of slack in the labor market.[2] In our opinion, the strength in private employment will keep inflation above 3.5%.

Labor market tightness has led to an increase in compensation as workers strive to keep up with inflation. The "Core inflation and Wage Growth" chart demonstrates the high correlation between the core Consumer Price Index (CPI) and Employment Cost Index (ECI). The latest data point shows wage growth of +5.2% and +6.3% in core CPI.

We believe inflation peaked in 2022 at its highest level in four decades and expect further deceleration throughout the year. A forecast for inflation below 5% is based on the following factors:

- Lower commodity prices
- Increases in supply of goods
- Declines in housing prices, leading to stabilization of shelter costs
- Increases in unemployment, resulting in lower wage growth
- Reductions in overall demand due to Fed monetary policy



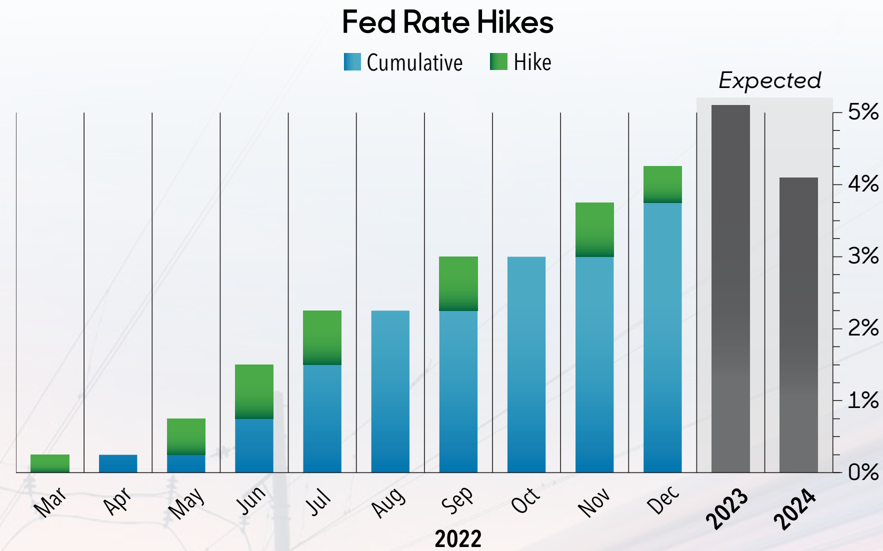
Source: U.S. Bureau of Labor Statistics; Data as of Q3 2022

FNBO PERSPECTIVE

The Federal Reserve aggressively increased interest rates as unemployment remains low.

Chairman Jerome Powell of the Federal Reserve Bank (Fed) can be viewed as the "conductor on the economic train" and has aggressively tightened monetary policy. The Fed increased interest rates and reduced the size of securities held on its balance sheet. The "Fed Rate Hikes" chart highlights the move from a 0% Fed Funds Rate to a target of 4.25% – 4.50% in December with further interest rate increases predicted in 2023. Monetary policy is now considered restrictive, as it resides above the 2.4% neutral rate.[3]

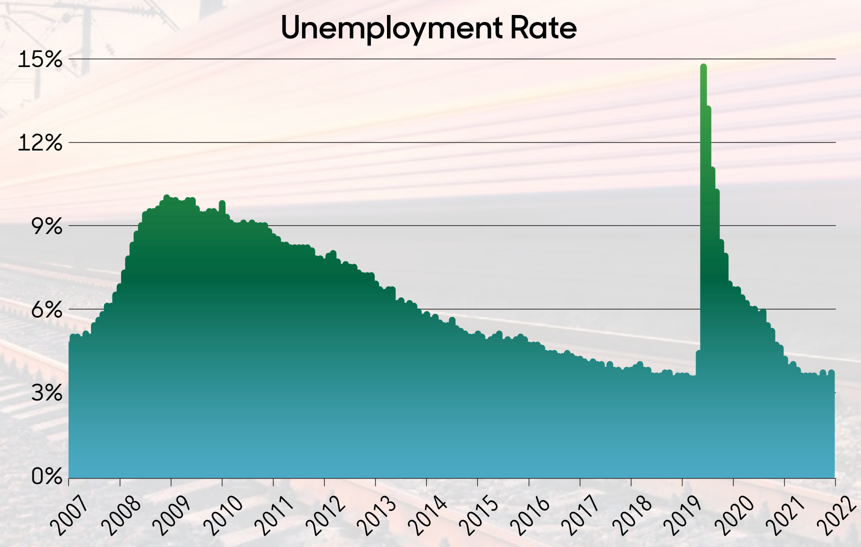
The latest data from the Bureau of Economic Analysis reveals that higher interest rates are affecting private residential investment. Existing home sales contracted during 2022, falling 35.4% year on year in November.[4] As monetary policy typically impacts the economy over time, the full effect of rate hikes is anticipated over the next one to two years. Fed actions have resulted in an inverted yield curve with the 10-year Treasury yielding 3.45% and the 2-year Treasury 4.24%.[5]



Source: Board of Governors of the Federal Reserve System as of December 14, 2022

Congress previously stated Federal Reserve goals are "maximum employment, stable prices and moderate long-term interest rates." These goals are now known as the Fed's dual mandate.[6] As illustrated in the "Unemployment Rate" graph, unemployment is extremely low relative to the last 15 years, which allows the Fed to emphasize fighting inflation over creating jobs.

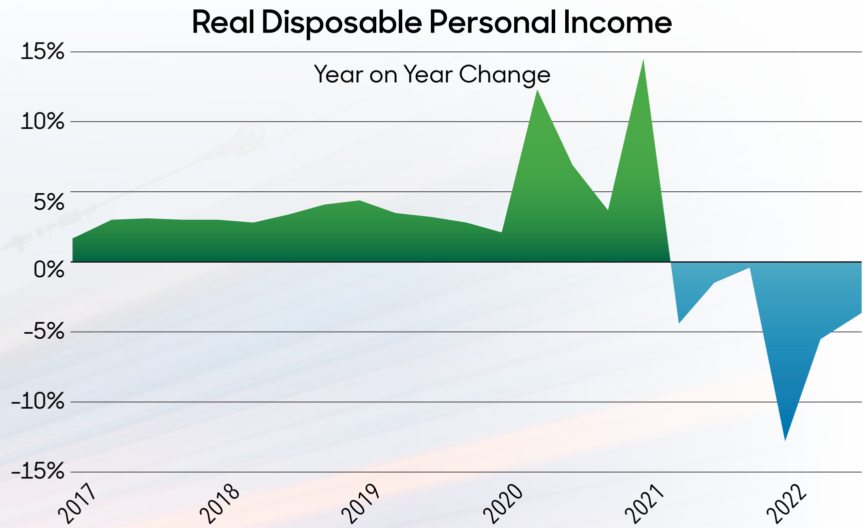
There are a few indicators that show a slight deterioration in the labor market. Unemployment claims and announcements of corporate layoffs are rising. In particular, the information technology sector has been negatively impacted by slowing worldwide growth. Tech companies, including Amazon, Meta, Hewlett-Packard and Cisco, announced layoffs in November. Companies are citing inflation, rising interest rates and lower sales in digital advertising as reasons.[7]



Source: U.S. Bureau of Labor Statistics; Data as of November 2022

FNBO PERSPECTIVE

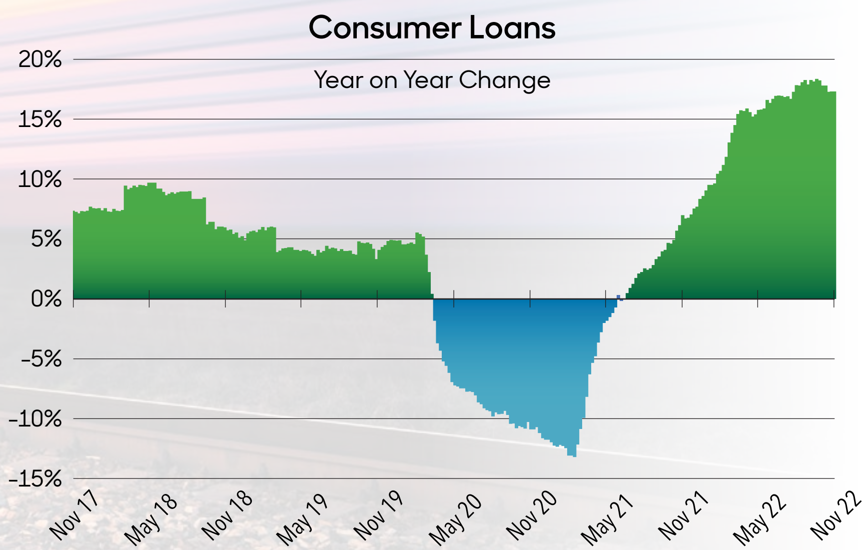
Consumption may soften due to negative real income and the risk in consumer credit.



Source: U.S. Bureau of Economic Analysis; Data as of Q3 2022

We believe consumer spending is interconnected with the change in real disposable personal income and net worth. Since the mid-1990s, consumption has been increasingly correlated to the wealth effect.[8] Households have felt "richer" from the accumulation of assets in their retirement plans and from home ownership. For most families, the largest asset they hold is their home, which has appreciated in value.

Disposable real income is defined as the annual change to income after inflation and taxes. Over the long-term, real disposable income has grown per annum around the 2% level, leading to increased consumer spending.[9] The "Real Disposable Personal Income" chart highlights the recent sharp decline in real income. Our expectation is real income will rebound to around 0%, which signifies individuals will continue to have limited cash flow to spend on discretionary goods and services.



Source: Board of Governors of the Federal Reserve System; Data as of November 2022

As a result of lower real income, consumers dipped into their savings and increased debt to finance higher spending. According to the Federal Reserve, personal savings of Americans hit $626 billion in the third quarter of 2022. Adjusted for inflation, savings are down 88% from their 2020 peak, which equates to a personal savings rate as a percentage of disposable income of 3.3%.[10] The potential recovery in savings could limit consumption this year.

Highly correlated with the savings rate is consumer credit. As shown in the "Consumer Loans" graph, individual usage of debt significantly expanded over the last year. Consumer loans include credit card and other revolving plans at commercial banks. We believe higher usage reflects inflation on essential goods from low- to middle-income earners and pent-up demand for services from high-income earners. The recent rise in credit card delinquency rates from low levels may indicate rising financial stress.[11]

FNBO PERSPECTIVE

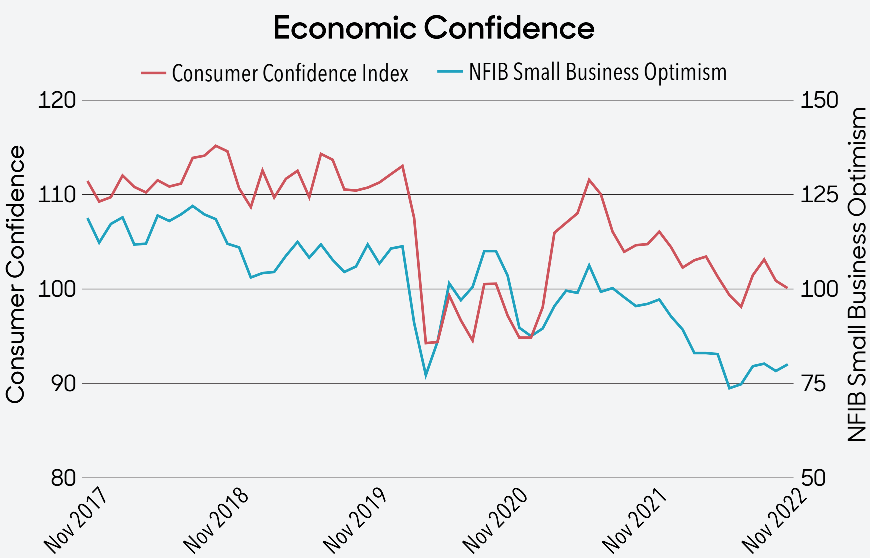
Economic deceleration is apparent in confidence and activity leading indicators.

We monitor economic confidence due to its historic correlation with consumption and investment spending. As portrayed in the "Economic Confidence" chart, consumer confidence declined over the last year. Consumers expect downward pressure on future income, while viewing inflation as stubbornly high. Individual inflation expectations are 6.7% for the next year, which could contribute to weakness in consumer spending.[12]

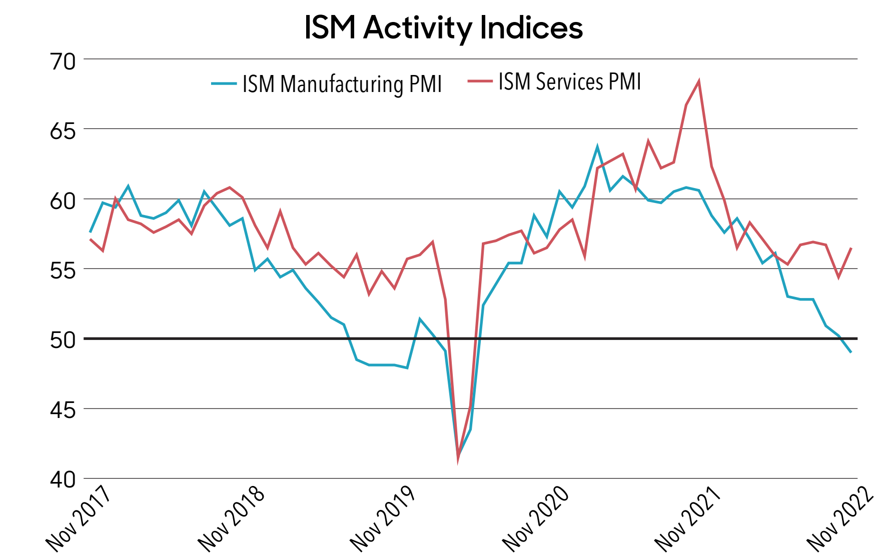
Small business optimism also deteriorated over the last five years, as illustrated. According to the National Federation of Independent Business (NFIB), 33% of businesses report inflation as their most important problem. As cited in the monthly jobs report, 46% of owners report job openings continue to be difficult to fill.[13] We anticipate increased pessimism will eventually result in lower spending by businesses.

The Institute for Supply Management (ISM), prepares a monthly report that is perceived as a leading economic indicator. The "ISM Activity Indices" chart shows the decline in Purchasing Managers' Index (PMI) for manufacturing and non-manufacturing (services). Above 50 is considered an indication of growth, below 50 a contraction. As demonstrated, economic activity in the manufacturing sector dropped to 49 in November. Of the 18 manufacturing industries surveyed, 12 industries reported a contraction in November.[14]

The outlook in the non-manufacturing industry is more positive with overall growth expected. The ISM's measure of new orders received by services businesses, however, is showing signs of weakness. Companies cited lower exports, likely due to slowing global growth and the U.S. dollar's recent strength. Consistent with the prior report that inflation was shifting from goods to services, businesses signaled higher input costs.



FactSet Research Systems; Data as of November 2022



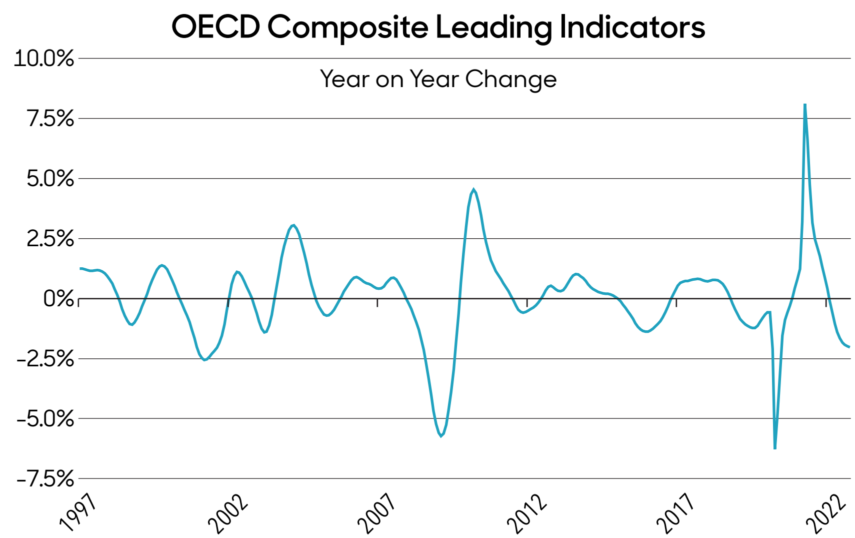
Source: Institute for Supply Management (FactSet); Data as of November 2022

FNBO PERSPECTIVE

We believe a U.S. and global recession is probable.

As we expand our economic assessment to other countries, continued global expansion is at risk. The Organization for Economic Co-operation and Development (OECD) consists of 37 countries that collaborate on economic policy. Members account for three-fifths of world gross domestic product (GDP). In their report "Confronting the Crisis," the OECD states that growth has lost momentum, high inflation is a global issue and global risks are prevalent.

As portrayed in the "OECD Composite Leading Indicators" graph, the year on year change has turned negative and is approaching levels that occurred in prior recessionary periods (2001, 2009, 2020). Europe is slowing sharply, partially due to energy supply shortages from Russia's war with Ukraine. Central banks globally are increasing interest rates, and government bond yields have turned positive following years of negative yields.



Source: Organization for Economic Co-operation and Development; Data as of October 2022

In conclusion, an economic downturn is likely in the U.S. as most economic indicators currently point to a deceleration at the minimum and/or probable contraction. Aggressive Fed monetary tightening and higher interest rates may negatively impact economic growth. The inverted Treasury yield curve is historically an accurate predictor of recessions. The labor market is showing early signs of weakness but remains a major positive.

U.S. economic activity will likely depend on the trends in inflation, unemployment, income and interest rates. Below we depict three economic scenarios; our base case is a mild GDP decline of -0.5%.

Soft Landing (No Recession)

INFLATION: **< 3.5%**
UNEMPLOYMENT RATE: **< 4.5%**
REAL DISPOSABLE INCOME: **> 1%**
FED FUNDS RATE: **< 4.5%**

Mild Recession (Base Case)

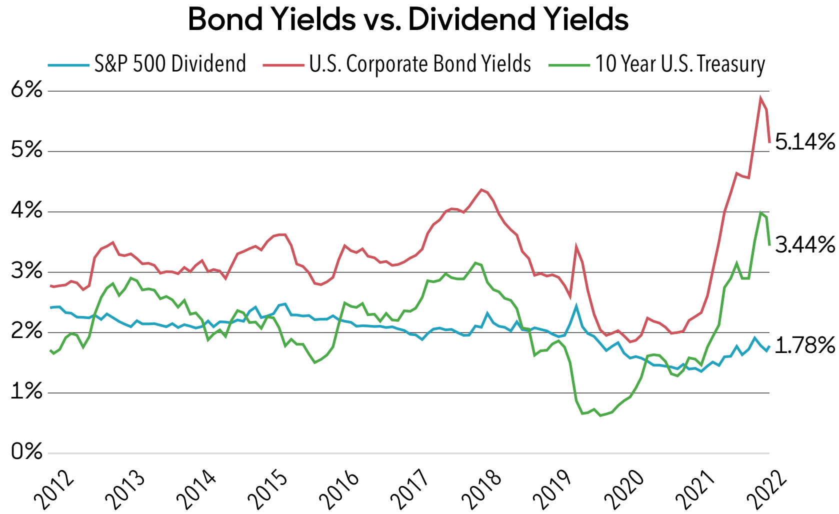
INFLATION: **3.5 to 5%**
UNEMPLOYMENT RATE: **4.5 to 6%**
REAL DISPOSABLE INCOME: **-1 to +1%**
FED FUNDS RATE: **4.5 to 5.5%**

Severe Recession (Worse Case)

INFLATION: **> 5%**
UNEMPLOYMENT RATE: **> 6%**
REAL DISPOSABLE INCOME: **< -1%**
FED FUNDS RATE: **> 5.5%**

FNBO PERSPECTIVE

For income-oriented investors, bond yields are at attractive levels.



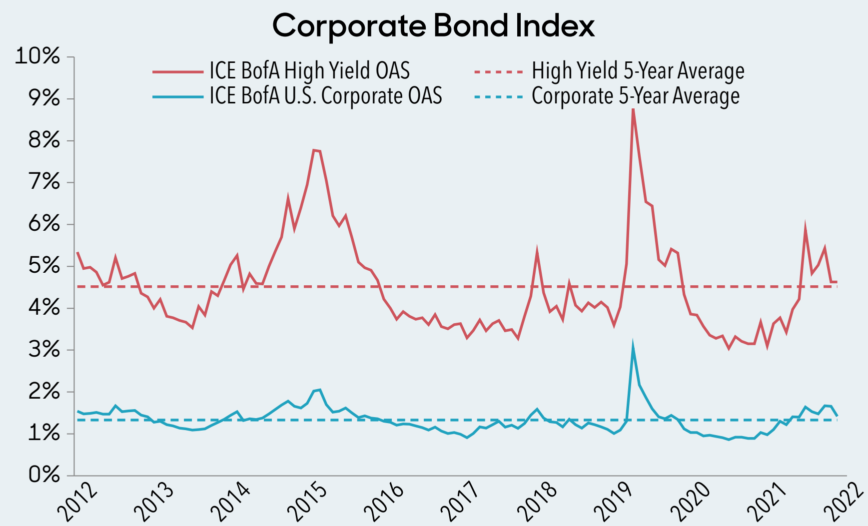
Source: Ice Data Indices, Federal Reserve Bank of St. Louis, S&P Dow Jones Indices (FactSet) as of December 15, 2022

We assess equity and fixed income markets for potential returns and risk. For much of the last decade, global markets have been in a zero-interest rate environment with limited return potential from bonds. As highlighted in the "Bond Yields vs. Dividend Yields" chart, the dividend yield of U.S. equities from 2012 to 2021 ranged from around 1.5% to 2.5%. The 10-year Treasury traded at similar yields of 1.0% to 3.0% in the same timeframe.

As interest rates rose, bond yields became more attractive relative to equity dividends. For investors willing to consider credit risk, the premium on investment grade corporate bonds has also expanded. With most of the rise in bond yields likely behind us, there may be renewed interest in fixed income.

The credit environment reveals a noteworthy divergence from the recessionary signal of the inverted Treasury yield curve. Credit spreads on corporate bonds continue to trade at low levels compared to prior economic downturns. We believe high corporate profitability margins and reasonable debt levels have contributed to low delinquencies and defaults.

The "Corporate Bond Index" graph illustrates that option-adjusted spreads for investment grade and high yield corporate bonds are trading in-line with their historic average levels. In the last 10 years, corporate spreads spiked during prior growth slowdowns and recessions. As a result, we remain cautious on the high yield sector and don't advocate a position. Our Institutional Core Fixed Income team is focused on quality and liquidity in building bond portfolios and expects better opportunities to add credit later this year.



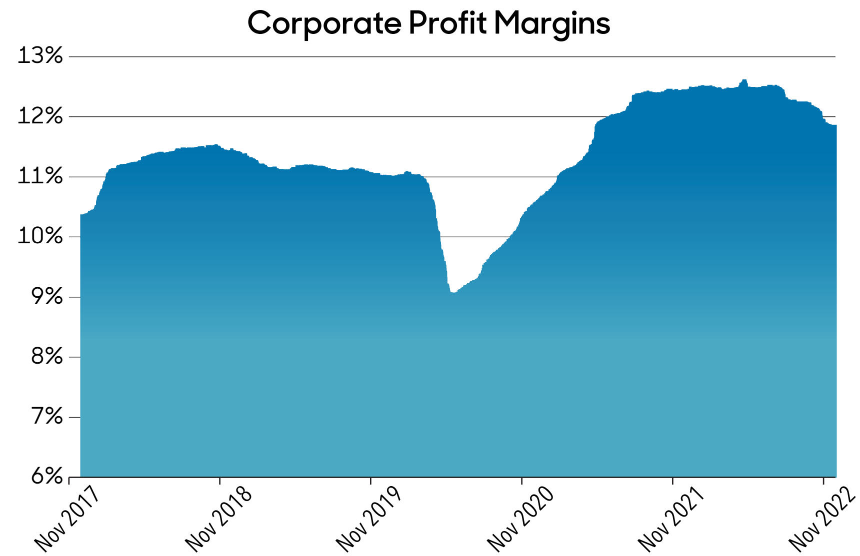
Source: Ice Data Indices, retrieved from Federal Reserve Bank of St. Louis; Data as of November 2022

FNBO PERSPECTIVE

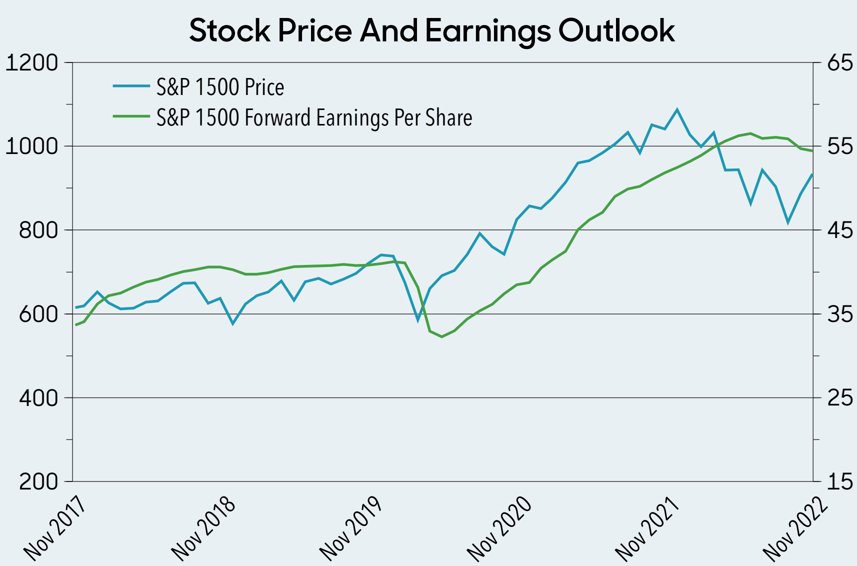
Corporate profits are displaying signs of weakness and are highly correlated with stock prices.

The macro-environment of elevated inflation and economic growth contributed to the highest net profit margins in the last 20 years.[15] Company profitability benefitted from price increases on goods and services sold, low debt costs and modest tax rates. The "Corporate Profit Margins" chart depicts the rebound in profitability after the COVID-19 recession. For much of last year, companies effectively offset cost of goods escalation and rising labor costs.

In the third quarter, multiple sectors reported a deceleration in earnings and reduced profit estimates for the upcoming year. While revenues will likely remain positive due to inflation, the key will be whether companies can defend operating margins if economic activity contracts. We expect further declines in profit margins as the year progresses.



Source: FactSet; S&P 1500 Net Profit Margins; Data as of November 2022



Source:FactSet; Data as of November 30, 2022

Our focus on company fundamentals is due to the belief that future earnings are an important determinant of equity returns. Major price declines typically coincide with recessions and a significant contraction in corporate profitability. We emphasize the Next Twelve Months (NTM) profit estimates. The close relationship between fundamentals and price is portrayed in the "Stock Price and Earnings Outlook" graph.

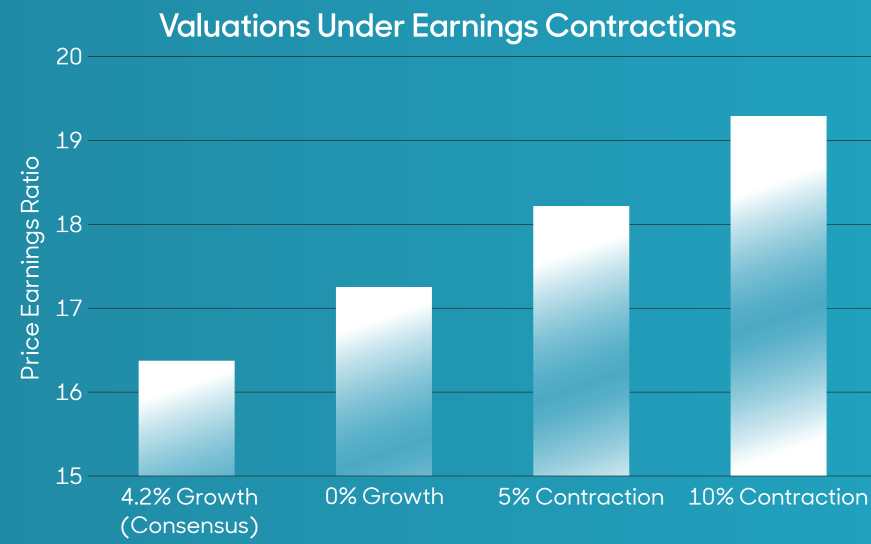
The 2022 bear market resulted from a painful valuation de-rating, and not a profit downturn. The recent profit margin contraction is reflected in the rollover in expected earnings. We believe an important factor in future equity returns is whether company earnings plateau at current levels or decline. The risk of lower profits could be offset if the Federal Reserve would "pivot" and reduce interest rates.

FNBO PERSPECTIVE

Equity valuations are reasonable if earnings are resilient.

On a valuation basis, the overall U.S. composite market remains somewhat expensive by historic standards. The price-to-earnings (P/E) ratio for the S&P 1500 declined from 19.9x to 16.4x, but still remains above average. As highlighted in the "Valuations under Earnings Contractions" chart, this P/E is based on 4.2% expected profit growth over the next 12 months.

In our opinion, U.S. equities are pricing in modest growth or flat earnings, but not a decline in profits. In the 5% or 10% earnings contraction scenario, the U.S. market is expensive, trading on a P/E range of 18.2x to 19.3x. We believe a single digit drop in earnings is a reasonable forecast in a mild recession. To put this in perspective, the median profit decrease was 13% in recessions tracked since 1949.[16]



Source: FactSet NTM EPS Growth as of December 15, 2022; S&P 1500; Earnings Scenarios

Stock Market Valuations and Earnings Growth

Equities	NTM P/E	15-Year Avg P/E	NTM EPS Growth
U.S. Composite	**16.4x**	**15.6x**	**4.2%**
U.S. Large-Cap	16.9x	15.6x	4.9%
U.S. Mid-Cap	12.8x	15.8x	-3.4%
U.S. Small-Cap	12.2x	16.7x	3.5%
International Developed	**12.5x**	**13.4x**	**1.8%**
International Emerging	**11.7x**	**11.4x**	**-0.5%**

Source: FactSet as of December 15, 2022, for Next Twelve Month (NTM) P/E & EPS Growth

As we assess global equity valuations and company fundamentals, certain sub-asset classes are relatively attractive. The higher profit growth in U.S. large caps is part of its premium valuation. As noted in the "Stock Market Valuations and Earnings Growth" table, U.S. small and mid-cap valuations are cheap relative to history and possibly pricing in a mild economic downturn. We continue to maintain an overweight allocation to this sub-asset class.

International developed and emerging markets also are trading at attractive valuations. As previously discussed, the outlook for the global economy is more negative than domestic activity. The U.S. dollar also significantly impacts investor results. After years of the dollar strength limiting returns, a trend reversal would provide a lift for international equities.

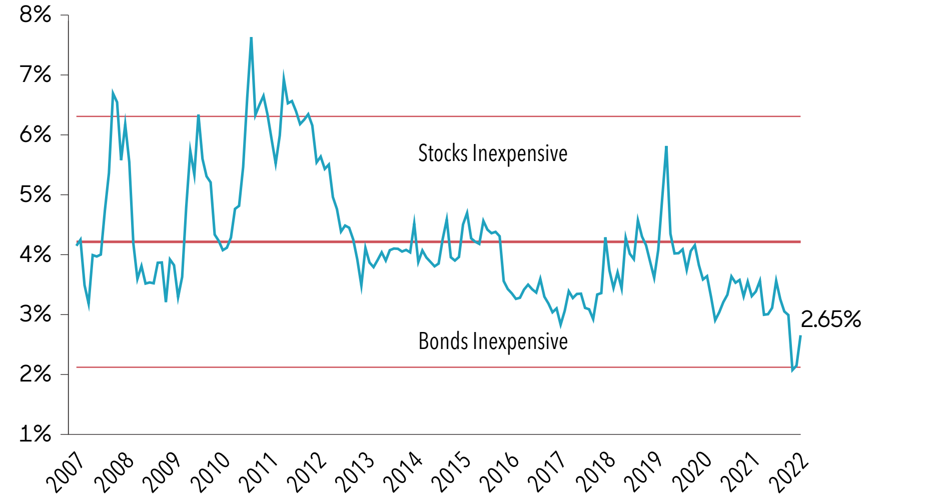
FNBO PERSPECTIVE

We prefer bonds over stocks but believe equities offer long-term return potential.

In evaluating the investment universe, we make tactical allocations for stocks, bonds, cash and alternative investments. The "Equity Risk Premium" graph compares the valuation of the U.S. stock market to 10-year Treasury yields. As illustrated, bonds are attractively valued relative to equities. We are taking advantage of this relative valuation and adding core fixed income to client portfolios.

Over the last few years, we have maintained an elevated allocation to alternatives due to the high valuations and limited return potential of equities and bonds. Our goal was to protect portfolios from inflation and higher interest rates. With equities and bonds providing more return opportunities, we are reducing the alternatives exposure. Cash has appeal as an asset class with money market yields over 4%.[17]

Equity Risk Premium



Source: FactSet as of December 15, 2022

Equity Returns Following Similar Price Declines

25% Price Decline (Time Period)	25% Price Decline (# of months)	1-Year Return (following 25% drop)	Length to New Highs (following 25% drop)
Dec 1961 - Jun 1962	6 Months	34%	15 Months
Nov 1968 - Apr 1970	17 Months	35%	22 Months
Jan 1973 - Apr 1974	15 Months	1%	75 Months
Nov 1980 - Aug 1982	20 Months	61%	3 Months
Aug 1987 - Oct 1987	2 Months	28%	21 Months
Mar 2000 - Mar 2001	12 Months	2%	74 Months
Oct 2007 - Sep 2008	11 Months	-5%	55 Months
Feb 2020 - Mar 2020	1 Month	62%	5 Months
Jan 2022 - Sep 2022	**8 Months**	**TBD**	**TBD**
Average	**10 Months**	**27%**	**34 Months**

Source: Goldman Sachs October 7, 2022; S&P 500 Index; Crandall, Pierce & Company

The strategy decision for equities remains difficult. For contrarian and long-term investors, the bear market is an opportunity to add exposure at more attractive valuations. As the "Equity Returns Following Similar Price Declines" table highlights, the average one-year return after this level of correction has been +27%. It has taken equities almost three years on average before reaching new highs.

Based on our assessment of the macro-environment, we expect continued volatility, and another downturn is possible before the market fully recovers. We continue to target a slight underweight to equities and expect to add to the allocation this year. The increased exposure would likely occur if the U.S. enters a recession and/or in anticipation of a change in Federal Reserve monetary policy.

2023

FNBO Perspectives Contrarian investors who buy after market downturns may earn higher returns. For investors seeking to lower portfolio risk, an opportunity has surfaced to revisit asset allocation. Persistent inflation remains an economic headwind. The Federal Reserve aggressively increased interest rates as unemployment remains low. Consumption may soften due to negative real income and the risk in consumer credit. Economic deceleration is apparent in confidence and activity leading indicators. We believe a U.S. and global recession is probable. For income-oriented investors, bond yields are at attractive levels. Corporate profits are displaying signs of weakness and are highly correlated with stock prices. Equity valuations are reasonable if earnings are resilient. We prefer bonds over stocks but believe equities offer long-term return potential.

We recognize that the market downturn is creating uncertainty and concerns about reaching your financial goals. Our role is to guide you to the appropriate asset allocation and ensure you stay invested through market cycles. Now is the ideal time to meet with your Wealth Management team to discuss any questions regarding the investment portfolio and confirm you're on track to meet your investment objectives.

Thank you for your interest and the trust you place in us.

Kurt Spieler

Kurt Spieler, CFA®
Chief Investment Officer

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*This is a hypothetical illustration and is not intended to reflect the actual performance of any particular security or investment. Asset allocations are presented as examples and are not intended as investment advice. Actual results will vary. Future performance cannot be guaranteed, and investment yields will fluctuate with market conditions.

Sources:

1. Berkshire Hathaway, Inc. "Chairman's Letter, 1986"
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11. FRED Economic Data: Delinquency Rate on Credit Card Loans as of Q3 2022
12. Visa Business and Economic Insights "American Mood Trend"; January 2023
13. NFIB "Small Businesses Struggle with Inflation, Labor Shortages"; November 8, 2022
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15. FactSet S&P 1500 Net Profit Margins; Data as of November 30, 2022
16. Goldman Sachs "2023 US Equity Outlook: Paradise Lost"; November 21, 2022
17. Goldman Sachs "Government Money Market Fund Effective Yield; December 20, 2022

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The ISM Manufacturing Index is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing companies.

The ISM Non-Manufacturing Index (now called the Services PMI) is an index used to assess the performance of services companies in the United States. The reading, published monthly, is based on surveys of more than 400 purchasing and supply managers in non-manufacturing (services) firms.

The Consumer Price Index is a measure of the changes over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Employment Cost Index, published by the U.S. Department of Labor's Bureau of Labor Statistics, is a quarterly measure of the change in the cost of labor, free from the influence of employment shifts among occupations and industries.

The Purchasing Managers' Index™ is a survey-based economic indicator designed to provide a timely insight into business conditions. It is widely used to anticipate changing economic trends in official data such as GDP, or sometimes as an alternative gauge of economic performance and business conditions to official data.

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