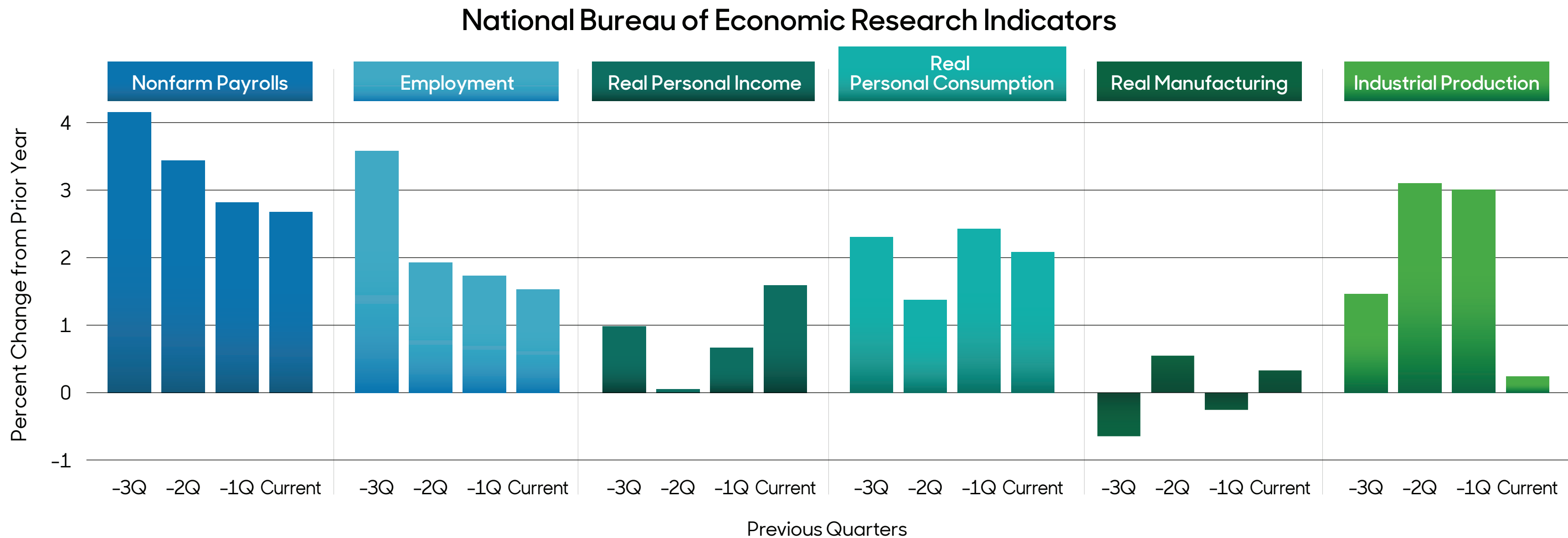
2023 MID-YEAR INVESTMENT UPDATE

Economic Growth vs. Recession

In our 2023 Outlook released in January, we opined that "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." We also cited that the labor market remains a positive but was showing signs of normalization due to increased corporate layoffs.

The National Bureau of Economic Research (NBER) is responsible for determining economic expansions and recessions. NBER emphasizes that a recession involves a significant decline in economic activity spread across the economy that lasts more than a few months. To make this determination, its Business Cycle Dating Committee evaluates six primary economic-wide measures of activity. As illustrated in the "National Bureau of Economic Research Indicators" graph, all indicators signal expansion at low levels of growth.



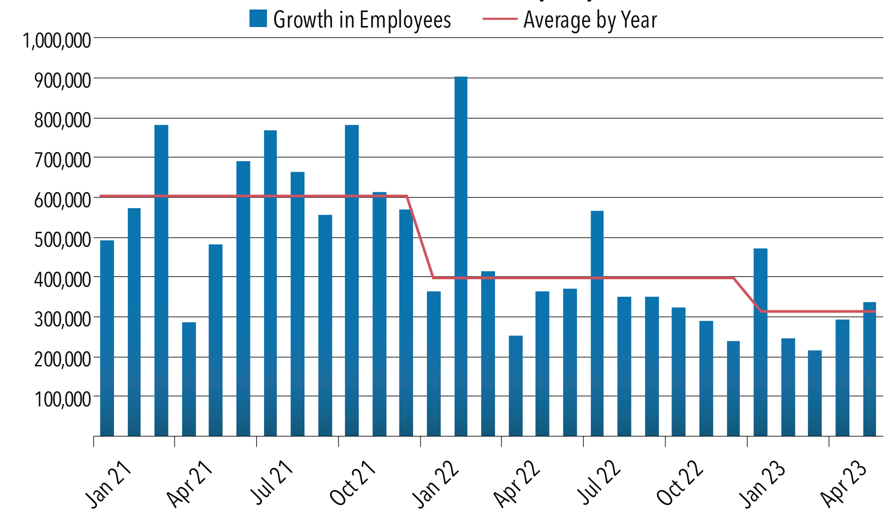
Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Board of Governors of the Federal Reserve System, retrieved from FRED, June 30, 2023

In this year's Mid-Year Investment Update, we start with an in-depth review of the NBER Indicators and then evaluate government spending, debt, the banking industry and housing. Across the U.S. economy, our expectation is for slower growth in demand, jobs, profits and inflation. Recession is not certain, however, as some areas of the economy may remain strong while other sectors contract. This is sometimes referred to as a 'rolling recession', which may describe economic activity for the next few quarters. After this evaluation, we assess the stock market and review investment strategy.

Nonfarm Payrolls

Strength in the labor market remains a major positive for the U.S. economy as 1.57 million net jobs have been created this year.[1] Job gains occurred in professional and business services, government, health care, construction and warehousing. Nonfarm payrolls surprised to the upside for 14 consecutive months with the average increase around 100,000 higher than estimates.[2]

There are indications that the labor market is stabilizing from a period of extreme tightness. Insured unemployment claims have risen since December with claims rising in the majority of states. The "Growth in Private Employment" graph, which depicts the monthly increase in jobs, is lower on average in 2023 as compared to the prior two years. Even with this decline, growth remains above the necessary amount to keep unemployment low. Evercore ISI estimates that growth of 80,000 to 100,000 net jobs per month is required to maintain equilibrium in the labor market.[3]

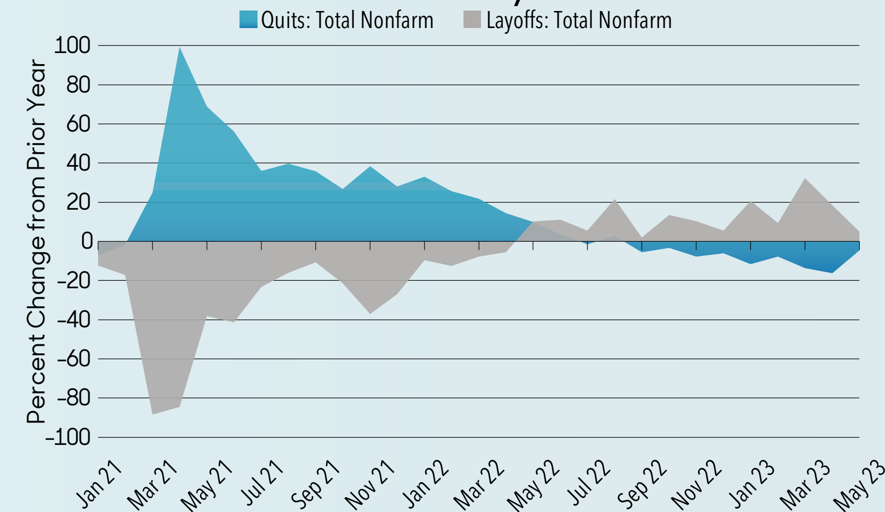


Source: U.S. Bureau of Labor Statistics, retrieved from FRED, June 6, 2023

Employment

The national unemployment rate is the best-known statistic produced from the household survey. Although it remains extremely low by historic standards, the unemployment rate slightly rebounded to 3.6% in June.[4] As illustrated in the "Quits and Layoffs" chart, total nonfarm layoffs have trended higher over the last two years. The U.S. Department of Labor reported initial unemployment claims rose to their highest level since October 2021.[5]

We believe the number of workers quitting their jobs is a measure of labor market slack. The quits rate has trended lower and is now close to the pre-COVID average.[6] Workers likely feel less confident about obtaining another job or that the quality of jobs available is declining. If this trend continues, wage growth may slow, which could help lower the level of inflation.

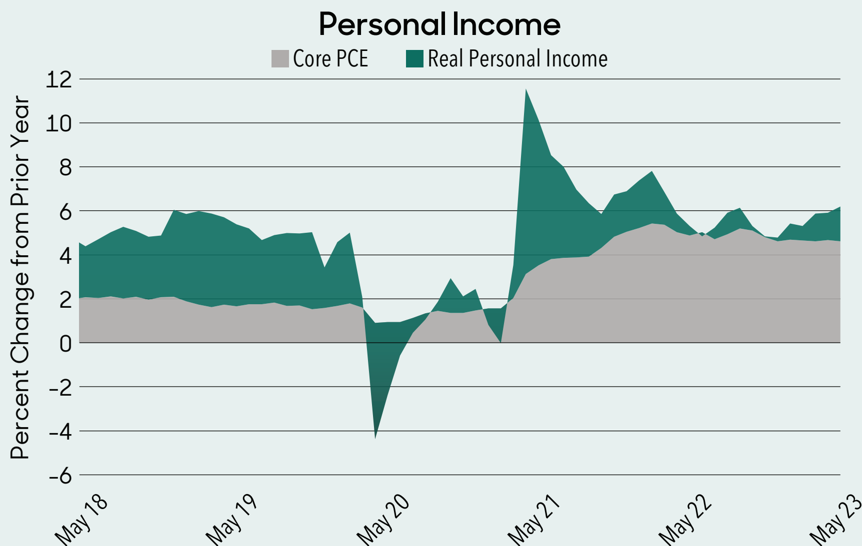


Source: U.S. Bureau of Labor Statistics, retrieved from FRED, July 6, 2023

Real Personal Income

Real income measures the growth in compensation after subtracting inflation and historically has been highly correlated with consumer spending. As portrayed in the "Personal Income" graph, real personal income improved marginally over the last year. Working individuals benefitted from the tight labor market, and retirees were aided by the increase in Social Security benefits and other federal programs.

Even with the Federal Reserve's effort to reduce inflation by increasing the Fed Funds rate to 5.00% – 5.25%, inflation is staying stubbornly high. As shown, the Core PCE deflator is 4.6%, which is well above the Fed's 2% target. There are encouraging signs of a deceleration in inflation, but its persistency remains a major risk to U.S. economic expansion.

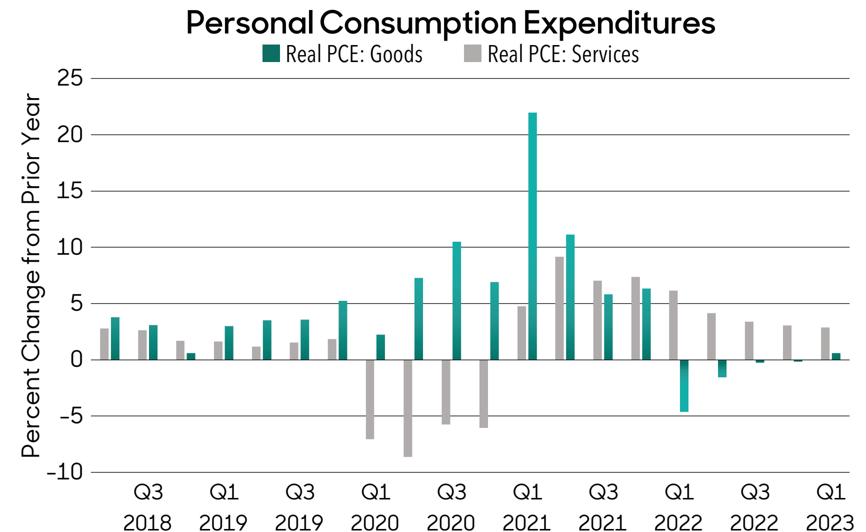


Source: U.S. Bureau of Economic Analysis, retrieved from FRED, June 30, 2023

Real Personal Consumption

Consumer spending continues to exceed expectations and defy predictions of a downturn. Explanations include the improvement in real disposable income, excess household savings, access to credit and the wealth effect. Sustainability is a major question as excess savings decreased from over $2 trillion in 2021 to $602 billion in May.[7] The utilization of total consumer credit remains elevated with delinquency rates rising. The likely resumption of student loan repayments may add to consumer stress.

The global pandemic changed our saving and spending habits with consumption oscillating between goods and services. As shown in the "Personal Consumption Expenditures" chart, the services sector was strong over the last two years. Recent consumer data shows support for spending on experiences (e.g., travel, concerts or sporting events) rather than physical goods (e.g., clothing or jewelry).[8]

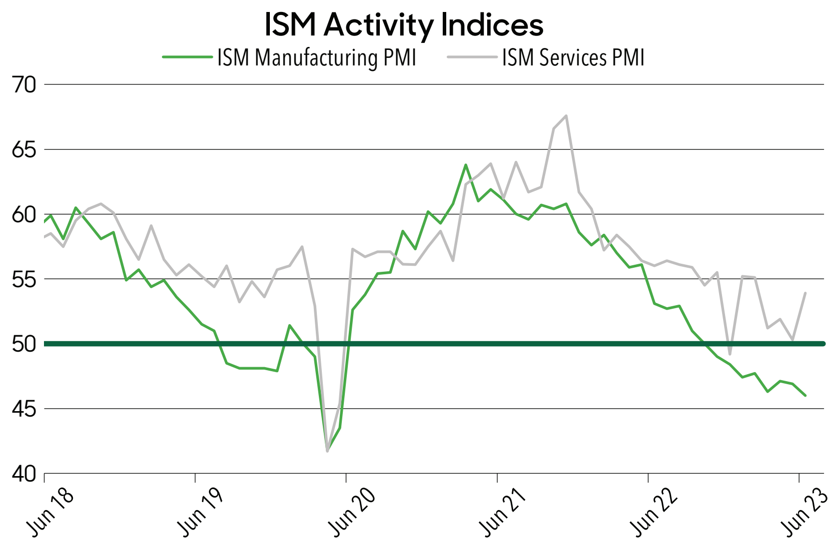


Source: U.S. Bureau of Economic Analysis, retrieved from FRED, June 30, 2023

Real Manufacturing

The manufacturing industry provides broad data in domestic retail trade, wholesale trade and manufacturing activities. The "ISM Activity Indices" graph suggests a contraction in manufacturing as the current reading is under 50, the level that indicates a downturn. The sector is likely impacted by high prices and elevated borrowing costs. While pent-up demand for automobiles could help cushion the decline, overall low demand will likely roll through the sector. Historically, a decline in manufacturing new orders leads to a profit recession.

Reflecting the ongoing demand for non-manufacturing, the ISM Services PMI remains above the 50 level, which indicates the service industry is in expansion. In the May ISM report, most respondents indicated that business conditions were currently stable, but expressed concerns relative to the slowing economy.[9]

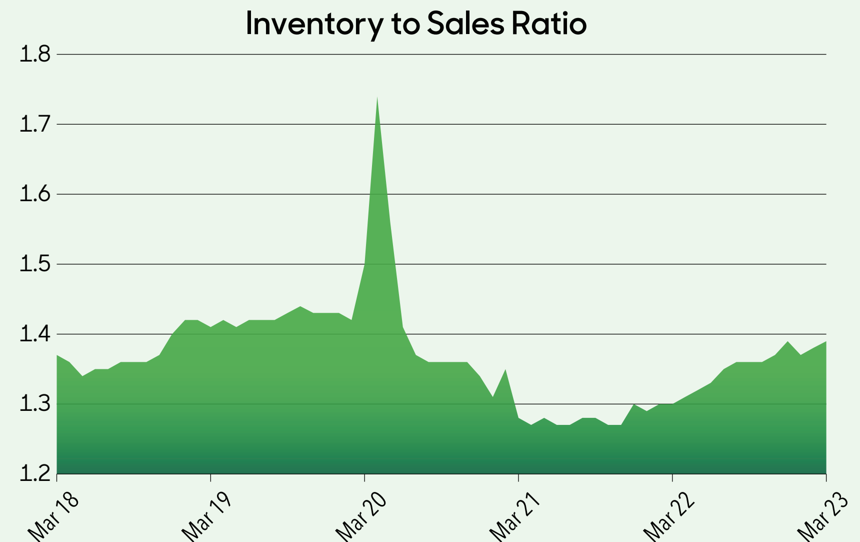


Source: Institute for Supply Management, retrieved from FactSet, July 6, 2023

Industrial Production

The industrial sector includes manufacturing, mining and utilities with demand considered sensitive to interest rates and consumer demand. In May, industrial production grew 0.2% as compared to one year ago, boosted by a strong increase in the output of motor vehicles and parts.[10] Production was offset by the decline in demand for heating due to mild temperatures.

Industrial production growth is historically correlated to the levels of inventory. As illustrated in the "Inventory to Sales Ratio" chart, inventory steadily recovered over the last two years to pre-COVID levels. Retailers are reporting an improvement in inventory levels whereas semiconductor companies remain oversupplied. The rebound in inventory levels may be a constraint on future production.

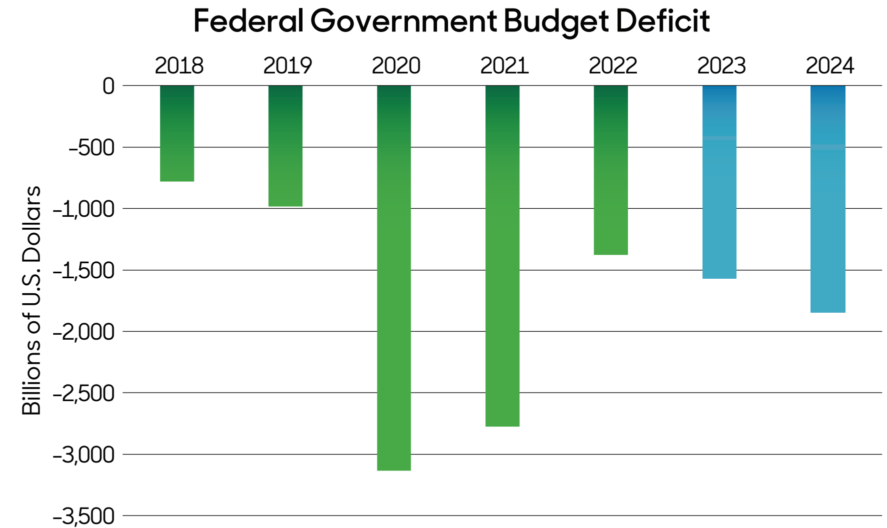


Source: U.S. Census Bureau, retrieved from FRED, June 8, 2023

U.S. Fiscal Policy

Government expenditures are up 10% year-on-year, which helps explain the resilience of the U.S. economy.[11] The Congressional Budget Office (CBO) predicts that deficits will nearly double over the next decade, growing from $1.5 trillion (5.9% of GDP) in fiscal year 2023 to $2.9 trillion (7.3% of GDP) by 2033.[12] The recent debt ceiling deal did not address the federal government's unsustainable level of spending.

The "Federal Government Budget Deficit" graph depicts a higher deficit next year than in 2023. The increase in interest rates to combat inflation and deficit levels are impacting the cost of debt. In February, the CBO projected that annual interest costs would total $640 billion in 2023, rising to $1.4 trillion in 10 years.[13] Government spending may keep the economy growing in the short-term, but higher debt costs will be a constraint in the long-term.

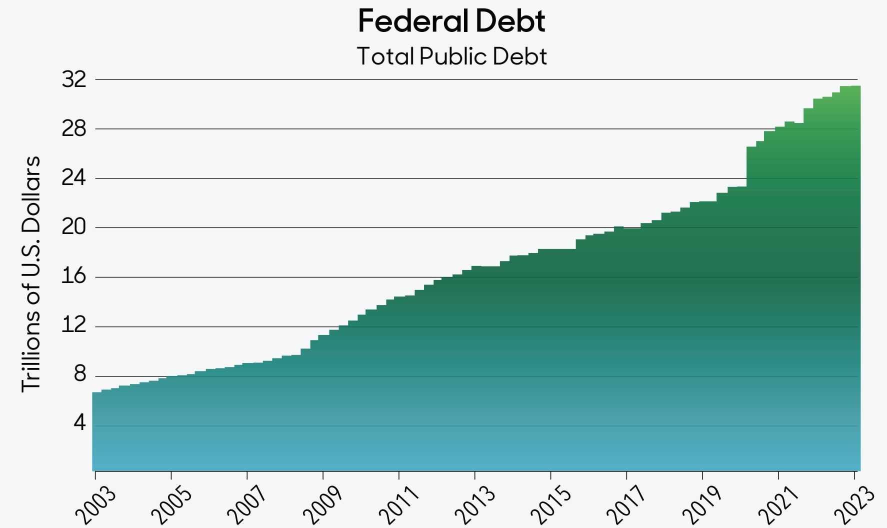


Source: U.S. Office of Management and Budget, retrieved from FactSet, June 8, 2023

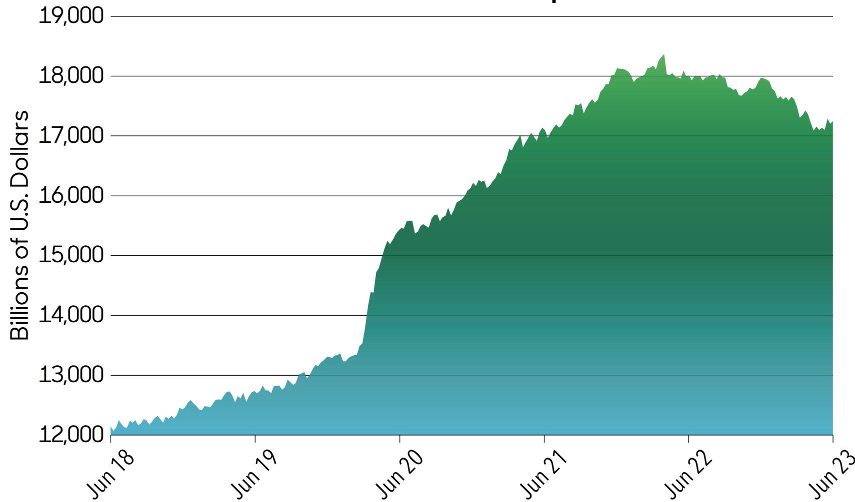
U.S. Fiscal Debt

As a result of excess government spending, the national debt grew significantly to $31.4 trillion. As shown in the "Federal Debt" chart, debt has nearly doubled since 2012 and approximately tripled since 2008. As of December 2022, the holders of U.S. Treasuries include the domestic public (37%), foreign public (24%), U.S. government accounts (21%) and Federal Reserve (18%).[14] As part of quantitative tightening, the Federal Reserve continues to trim its Treasury holdings.

Economists evaluate debt per economic output to compare countries and identify risks. In the first quarter, the U.S. debt to GDP ratio was 119%.[15] Although we don't expect an imminent fiscal crisis, our assessment of high debt countries reveals consistent low economic growth. Future generations will be responsible for repaying debt and may have less opportunities for wealth advancement.



Source: U.S. Department of the Treasury, retrieved from FRED, June 11, 2023

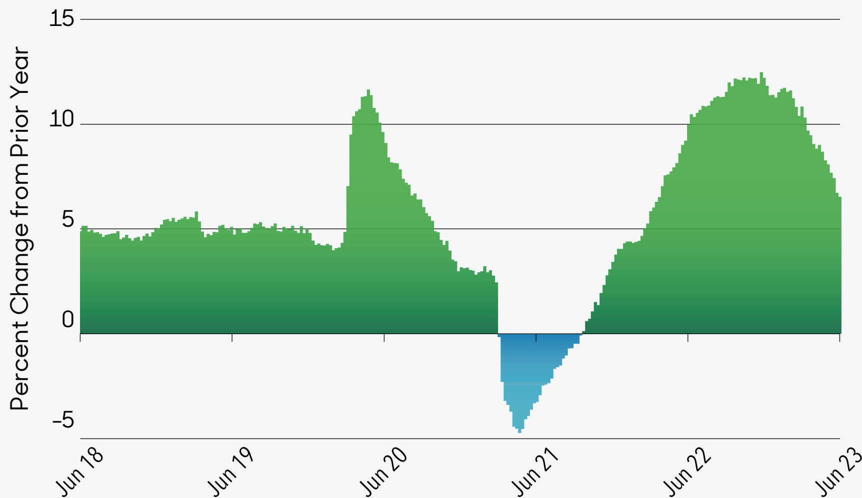


Source: Board of Governors of the Federal Reserve System, retrieved from FRED, June 30, 2023

Commercial Bank Deposits

The banking industry recently experienced three of its largest failures in U.S. history — Silicon Valley Bank, Signature Bank and First Republic Bank. We believe these banks failed because management didn't adequately address deposit concentration, interest rate and liquidity risks. The failure to manage these risks was exacerbated by excessive pandemic-era growth. Although additional bank failures are possible, we don't anticipate systemic issues in banking.

In the aggregate, deposits across the banking sector steadily declined by over $1 trillion from its peak in April 2022. As illustrated in the "Commercial Bank Deposits" graph, total banking deposits remain $5.1 trillion above their June 2018 levels. In response to recent outflows, banks increased their interest rates on deposits to compete with higher money market fund yields.



Source: Board of Governors of the Federal Reserve System, retrieved from FRED, June 30, 2023

Commercial Bank Loans

Banks incrementally tightened lending standards over the past year, well before stress in the banking system emerged. As a result, industry loan growth decelerated from high levels last year. The "Commercial Bank Loan Growth" chart highlights year-on-year growth in loans were up 6.5% in June. The expectation is for further deceleration in loan advancements.

Higher interest rates and economic uncertainty are viewed as negatively impacting commercial real estate (CRE) prices. Economists are concerned about upcoming maturities in the office sector, which account for 23% of debt maturities in 2023 and 2024.[16] Stress in this industry could adversely impact banks, insurance companies and private debt funds due to their high CRE exposure. We believe the lower level of liquidity and tightening bank lending standards are major economic stories that may weigh on growth.

Residential Real Estate – Prices

The U.S. housing market experienced strong price appreciation from 2020 through 2022. Demand for homes remains high as ownership has consistently risen over the last seven years, reaching 66% in the first quarter.[17] The surge in prices and higher mortgage rates have recently impacted prices and selling activity.

Unaffordability in real estate remains an issue, especially for low- and middle-income earners.[18] As shown in the "U.S. Home Affordability" table, the monthly payment has risen by $1,061 for a median house purchase, an increase of 89% over the last 29 months. Our forecast calls for level prices as affordability conditions are offset by the lack of supply.

U.S. Home Affordability

Two individuals purchased a home at the exact U.S. median price and average mortgage interest rate at the time.

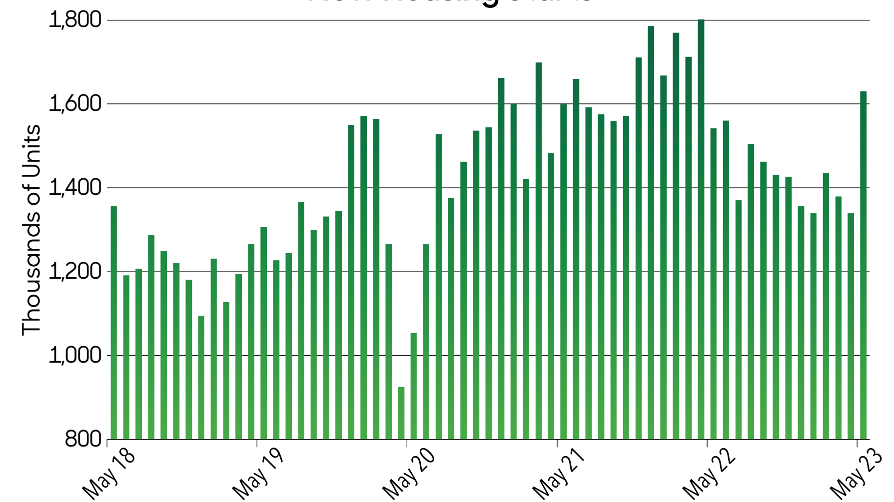
January 2021	Purchase Date	June 2023
$369,800	Purchase Price	$436,800
2.65%	Mortgage Rate	6.69%
$73,960	20% Down Payment	$87,360
$1,192	**Monthly Payment**	**$2,253**

Source: Personal Finance Club, June 2023

Residential Real Estate – Supply

Existing homeowners are discouraged from listing their properties for sale, as many of the houses were financed in the last decade of ultra-low interest rates. The "New Housing Starts" chart highlights that through May, privately-owned housing starts averaged 1.4 million per month. This level represents a 16% decline from the average 1.7 million in the same period last year.

Housing was the first industry to undergo a downturn, due to the impact of higher mortgage interest rates. With long-term Treasury yields recently plateauing, builder sentiment improved and single-family permits increased.[19] The industry seems to have adjusted to the current level of interest rates, but likely needs lower mortgage costs and improved affordability before a complete recovery occurs.



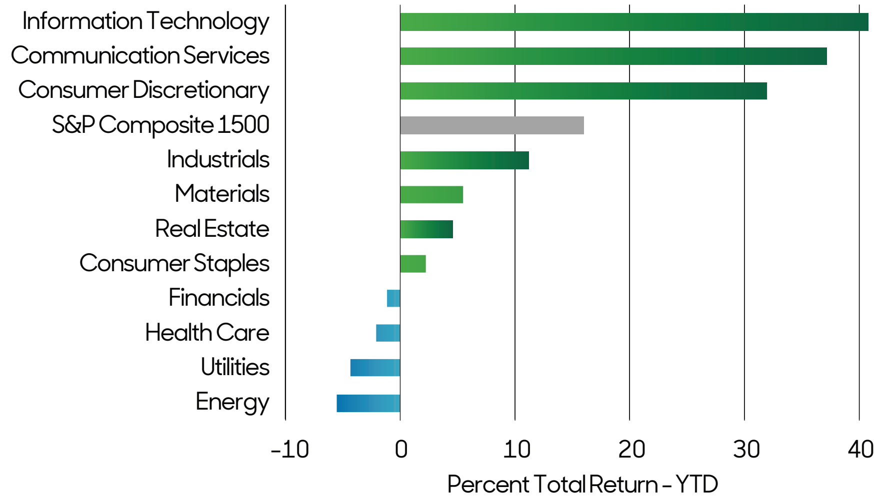
Source: Census, HUD, retrieved from FRED, June 20, 2023

To summarize, the U.S. economy has been resilient with a contraction first occurring in housing and now 'rolling' through manufacturing. If unemployment remains at low levels, a recession may be avoided due to continued growth in consumer spending. Our base case, however, remains a mild economic downturn due to our expectation of a weakening labor market.

Stock Market Returns

Moderating economic growth, resilient corporate earnings, and optimism that the Federal Reserve may have completed its interest rate hikes contributed to solid first half equity returns. The U.S. composite index is up 16.0% year-to-date as illustrated in the "S&P 1500 Sector Return" graph. Market leadership is from the information technology, communication services and consumer discretionary sectors, with four sectors negative.

The lack of market breadth is a risk to the U.S. stock market. Apple, Microsoft, NVIDIA, Tesla, Meta, Amazon and Alphabet account for most of the positive returns. After a difficult start to the year, small- and mid-cap stocks rebounded in June, contributing to the market advance. International equity returns are positive for developed (+11.6%) and emerging markets (+6.5%).[20]



Source: S&P U.S. Indices, retrieved from FactSet, June 30, 2023

Stock Market Fundamentals

On a valuation basis, the overall U.S. composite market remains expensive by historic standards. The 19.1x price-to-earnings (P/E) ratio for the S&P 500 is a 21% premium to the long-term average of 15.8x. The "Equity Valuations and Profit Growth" table highlights the relative valuation discount and attractiveness of U.S. small- and mid-cap stocks as compared to large-caps. International equity markets are trading close to average valuations.

The stabilization of company fundamentals in a decelerating global economy has been well received by the market. Although Next Twelve Month (NTM) profit growth is low, estimates increased for each sub-asset class since December. We have identified the following risks to further market appreciation: Persistent inflation could lead to higher interest rates and lower valuations; and corporate profitability may contract if a mild recession occurs.

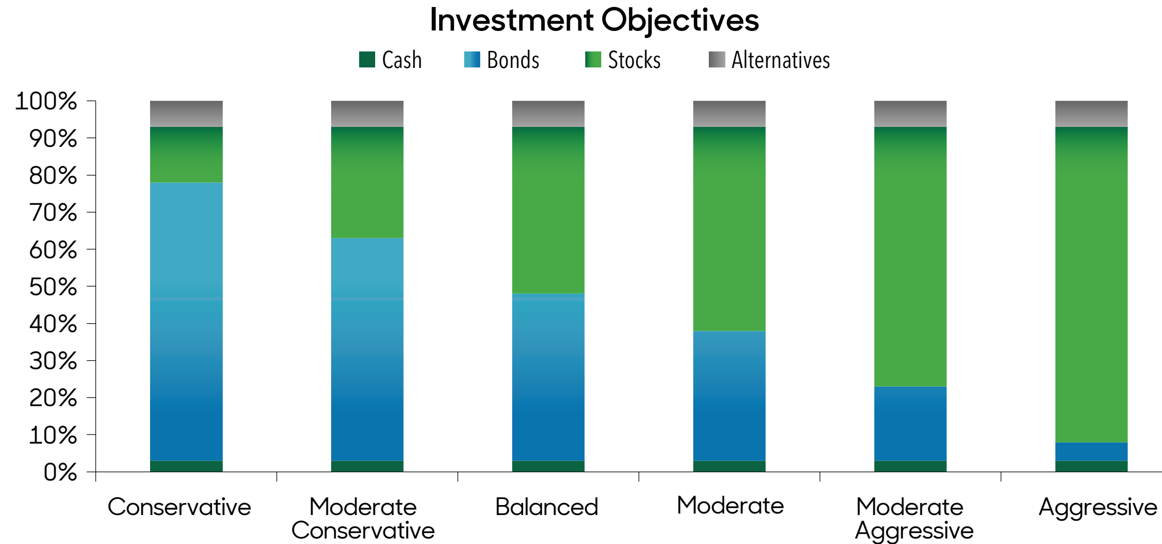
Equity Valuations and Profit Growth

Equities	NTM P/E	15-Year Avg P/E	NTM EPS Growth
U.S. Composite	**18.6x**	**15.8x**	**5.7%**
U.S. Large-Cap	19.1x	15.8x	6.1%
U.S. Mid-Cap	13.7x	15.8x	1.3%
U.S. Small-Cap	13.5x	16.6x	3.0%
International Developed	**13.1x**	**13.5x**	**5.2%**
International Emerging	**12.3x**	**11.7x**	**4.6%**

Source: FactSet data for Next Twelve Month (NTM) P/E and EPS Growth as of June 30, 2023

Investment Strategy

The strategic asset allocation, or the weightings of cash, bonds, equities and alternatives, is a primary factor in the investor experience. Finding the right asset mix for your portfolio is a personal decision based on return goals and risk tolerance. The "Investment Objectives" table depicts multiple asset allocations ranging from predominantly bonds to primarily stocks. We invest within a predetermined range for each asset class.



Source: FNBO Internal Weightings

In an effort to help achieve return goals with the least amount of risk possible, we advise clients to stay invested in a diversified portfolio. Within the selected investment objective, our team strives to add value by making opportunistic investments based on our economic and market views.

- **Asset Allocation:** With the uncertain macro-environment, we have maintained a defensive position with a slight underweight to equities.
- **Stocks:** We continue to favor U.S. small- and mid-cap equities due to their attractive valuations and have recently added to the international weighting on the potential for U.S. dollar weakness. Our global real estate position has been trimmed due to the assessment of risk in office and retail properties.
- **Bonds:** Our fixed income team remains focused on quality and liquidity in building portfolios as core bond yields remain attractive. Due to the potential for corporate spreads to widen, we remain cautious on the high-yield market, expecting better opportunities to add credit later this year.
- **Alternatives (ALTs):** We believe ALTs deliver a diversification benefit that improves the portfolio risk/return characteristics. Our primary holding is a hedged equity mutual fund that provides exposure to U.S. equities while offering some downside protection through options. We have trimmed our commodity fund as demand may weaken in a global economic downturn.

We hope you find this year's Mid-Year Investment Update insightful. During times of change and volatility, we recommend checking in with your advisor team to review financial goals and ask questions about the markets and portfolio strategy.

Kurt Spieler, CFA®
Chief Investment Officer

Contributors: Kurt Spieler, Scott Summers, Rick Frevert, Matt Veenker, Jeff Burgher, Shannon Peterson

Sources:

1. JP Morgan Asset Management; Weekly Market Recap, release June 5, 2023
2. Evercore ISI; Fed and the U.S. Labor Market, release June 6, 2023
3. Evercore ISI; Fed and the U.S. Labor Market, release June 6, 2023
4. U.S. Bureau of Labor Statistics; Unemployment Rate, release July 7, 2023
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6. JP Morgan Asset Management; Weekly Market Recap, release June 5, 2023
7. Wells Fargo; Economic Indicator, release May 26, 2023
8. Visa Business and Economic Insight; American Mood trend, release May 2023
9. Trading Economics; ISM Services PMI, release June 5, 2023
10. Board of Governors of the Federal Reserve, release June 15, 2023
11. Evercore ISI; It's Just a Matter of Time, release June 5, 2023
12. CBO; Budgets and Projections, release May 12, 2023
13. Congressional Budget Office; The Budget and Economic Outlook, release February 15, 2023
14. JP Morgan; U.S. Equity Strategy, release May 22, 2023
15. U.S. Office of Management and Budget, Federal Debt, release May 26, 2023
16. Goldman Sachs Global Investment Research; SNL Financial, release May 2023
17. U.S. Census Bureau; Home Ownership Rate in the U.S., release May 3, 2023
18. Markets Insider; "Housing has become so unaffordable", release June 12, 2023
19. Mortgage Professional; "US housing affordability eases somewhat in Q1", release June 13, 2023
20. FactSet; YTD returns for MSCI EAFE and MSCI Emerging Markets as of June 30, 2023

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Indexes:

Securities indexes assume reinvestment of all dividends and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

The S&P 1500® index combines three leading indices (the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®), to cover approximately 90% of U.S. market capitalization. The S&P 500® index measures the performance of 500 leading publicly traded U.S. companies from a broad range of industries.

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 nonmanufacturing (services) firms.

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