fnbo

2020 OUTLOOK

2020 Outlook: Staying Disciplined in a Diversified Portfolio

In this year's Outlook, we begin with a description of the **Investment Principles** (pages 3–5) essential to build a portfolio tailored to each investor. This starts with an uncommon understanding of each investor's goals and risk tolerance. With this knowledge, we determine an appropriate asset allocation and diversify the portfolio within the agreed upon investment objective.

The second part of the Outlook examines our **Investment Process** (pages 6–10). We assess the primary opportunities in the markets and identify risks in the upcoming year. We evaluate the appropriate weighting towards stocks and bonds within each investment objective given market conditions. From there, we evaluate opportunities within equities and fixed income. Finally, we implement our investment strategy using our perspective on the economy and markets.

For each Investment Principle and step in the Investment Process, we share FNBO's Perspective and how it may impact portfolios at the top of each page.

FNBO PERSPECTIVE

An uncommon understanding of one's goals and risk tolerance creates the foundation for success.

Define Investment Goals | Understand Risk

Principle #1 | Goals

Through conversations, we learn what clients hope to accomplish in their lives. These can be widely variable; perhaps the goal is to take early retirement, have a vacation home, help family with education or donate to a favorite charity.

By knowing our clients' goals, we can determine the return required to achieve them. More ambitious goals may require a higher stock allocation. We recommend clients revisit their goals periodically as they will likely evolve over time.

Principle #2 | Risk

The amount of risk in an investment portfolio is determined by both **ability** and **willingness** to take risk.

Ability: A longer time horizon increases ability to assume investment risk, whereas a shorter time horizon limits it. Additionally, the option to take distributions from alternative income sources such as social security, pension or real estate provides flexibility to avoid liquidating investments in adverse market environments.

Willingness: Research indicates that individuals experience far more pain from losing money than pleasure from making money. The charts below show the average, worst and best returns of various equity and bond portfolios for a One Year and 10-Year time horizon. Discussing down markets is important in determining the comfort level with short-term volatility. As illustrated, the worst return over the 10-year period is significantly less for each allocation as compared to the one-year largest loss.

One Year Returns

January 1950 - December 2019

Portfolio Mix	Largest Loss	Largest Gain	Average Return	% Negative	% Positive
100% Stocks/No Bonds	-43.3%	61.2%	12.5%	21%	79%
80% Stocks/20% Bonds	-33.6%	53.4%	11.1%	19%	81%
60% Stocks/40% Bonds	-23.9%	45.7%	9.7%	15%	85%
40% Stocks/60% Bonds	-14.2%	37.9%	8.4%	10%	90%
20% Stocks/80% Bonds	-4.7%	30.1%	7.0%	4%	96%
No Stocks/100% Bonds	-3.9%	28.6%	5.7%	8%	92%

Sources: Crandall, Pierce & Company
Stocks: Standard & Poor's 500 Stock Index; Bonds: Intermediate Treasury Bonds;
Returns using Monthly Data (828 Observations)

10-Year Annualized Returns

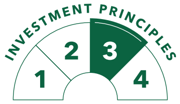
January 1950 - December 2019

Portfolio Mix	Worst Return	Largest Gain	Average Return	% Negative	% Positive
100% Stocks/No Bonds	-3.4%	19.5%	10.5%	3%	97%
80% Stocks/20% Bonds	-1.6%	17.7%	9.7%	1%	99%
60% Stocks/40% Bonds	0.2%	16.2%	8.8%	0%	100%
40% Stocks/60% Bonds	2.0%	14.7%	7.9%	0%	100%
20% Stocks/80% Bonds	3.7%	13.7%	7.1%	0%	100%
No Stocks/100% Bonds	1.6%	12.8%	6.2%	0%	100%

Sources: Crandall, Pierce & Company
Stocks: Standard & Poor's 500 Stock Index; Bonds: Intermediate Treasury Bonds;
Returns using Monthly Data (720 Observations)

FNBO PERSPECTIVE

We believe setting and adhering to an appropriate long-term asset allocation helps temper investor biases.



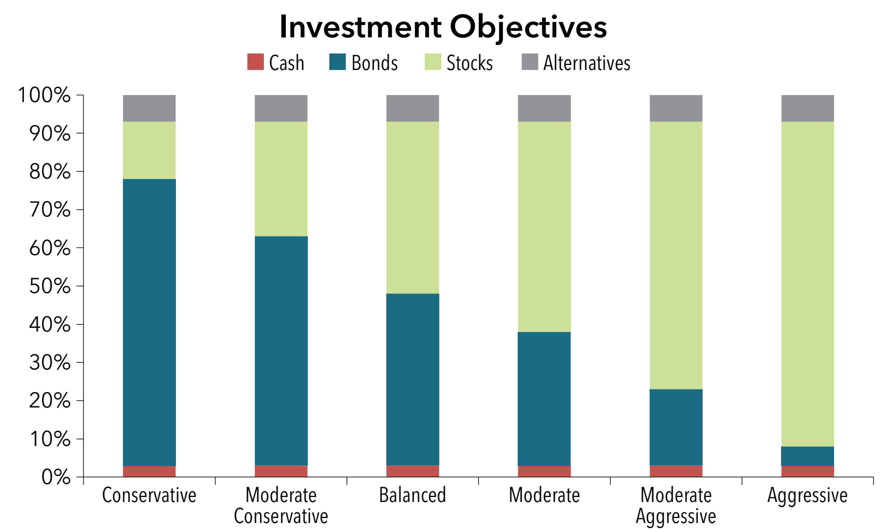
Set Asset Allocation

Principle #3 | Asset Allocation

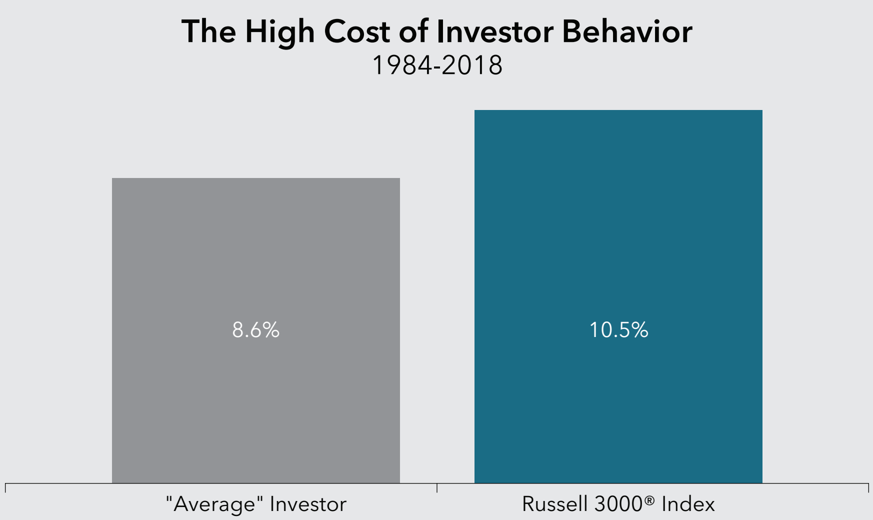
Advising on a long-term allocation entails working together to balance the personal return goal and risk tolerance. Sometimes these are in sync, whereas other times risk tolerance falls below the desired target return. Adjusting goals or becoming comfortable with taking more risk may be necessary.

The Investment Objectives chart depicts multiple asset allocations ranging from predominantly bonds to primarily stocks. These objectives are used as a starting point to determine the level of investment in each asset class.

Research shows that, if invested in a diversified portfolio, 88% of the variation of investment returns is due to the asset allocation decision.[i]



Source: First National Bank as of 12/31/2019



Source: Russell Investments

Once the long-term asset allocation has been agreed upon, market volatility can test an investor's resolve. The High Cost of Investor Behavior table depicts the difficulty individual investors have in maintaining their stock exposure in down markets. As illustrated, the "average" equity investor's long-term return is 1.9% less than the index.

Investors commonly allow personal beliefs and prior experiences to influence investment decision-making. Our role is to maximize the chances of success by helping clients stay objective and avoid these behavioral biases. One investor bias that we frequently see is using political views as a rationale either to invest or avoid investing altogether.

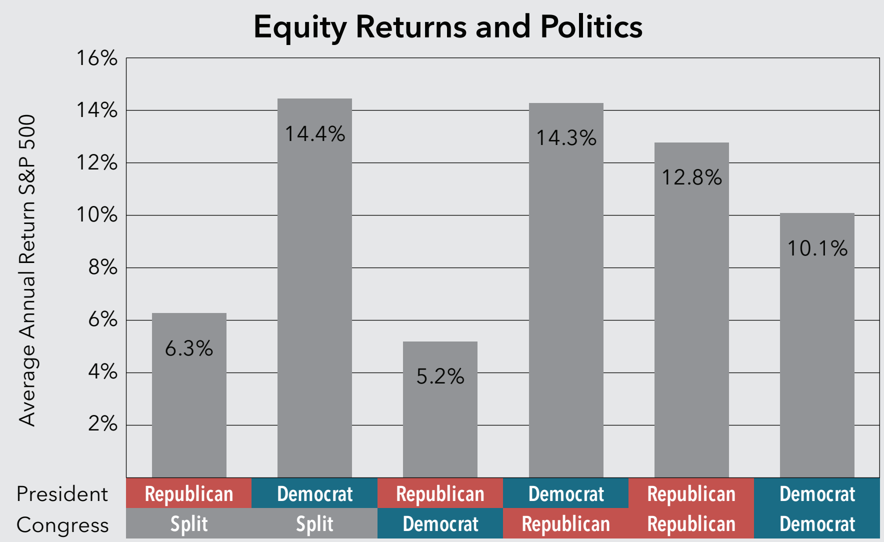
FNBO PERSPECTIVE

Owning a diversified portfolio helps mitigate risk and could provide peace of mind in a volatile political environment.

Diversify Assets

Agreement or disagreement with the current political environment is not a sound investment strategy. Most of the current political discussions are noise and insignificant from an investment perspective. Discussions of policy, such as trade, deficit spending, regulation and immigration are issues that could affect the broader economy.

A historical analysis of the impact of political parties on equity returns shows the market moves up regardless of the various iterations between the Presidency and Congress. As displayed in the Equity Returns and Politics table, the two highest and lowest return periods have occurred when there has been gridlock indicating that other factors outweigh politics.



Source: Factset; S&P 500 returns for the period 1/1/1944–12/31/2019

Principle #4 | Diversification

In an effort to achieve return goals with the least amount of risk possible, we invest in four primary asset classes: cash, bonds, equities and alternatives. Each of these provides different return and risk characteristics. Within bonds and equities, we further diversify into several sub-asset classes intended to either enhance returns or reduce overall risk. The alternative allocation, when paired with traditional investments, is intended to improve the portfolio's return and risk characteristics.

Within the selected investment objective, our team strives to add value by making opportunistic investments based on our economic and market views.

FNBO PERSPECTIVE

We believe the U.S. economy will grow around 2% in 2020, leading to a recovery of earnings growth.

Make the Stock/Bond Decision

Global Economic Growth

Region/Country	2018	2019 Est.	2020 Est.
World	3.6%	3.0%	3.1%
International Developed	2.3%	1.7%	1.5%
U.S.	2.9%	2.3%	1.8%
International Emerging	4.9%	4.4%	4.5%
China	6.6%	6.1%	5.9%

Source: Bloomberg Economic Forecasts; as of 1/2/2020

Process #1 | Stock/Bond Decision

The stock/bond decision starts with an evaluation of the global economy. A positive outlook for growth favors a higher stock allocation whereas a negative outlook for economic activity would lead to a lower stock allocation.

In 2019, disruptive trade policy had a negative impact on global growth, most notably on international countries that rely on manufacturing and exports. The latest news on various trade disputes is encouraging. The U.S.-Mexico-Canada ("USMCA") agreement and a phase one trade deal with China should reduce uncertainty.

As shown in the Global Economic Growth table, economists believe that central banks, including the Federal Reserve, have done enough to stop the deceleration. Our view is that manufacturing will stabilize leading to modest world growth of around 3%.

We believe long-term equity returns are tied to the earnings outlook of companies. Last year's positive results were driven primarily by higher valuations. As displayed in the Earnings Per Share (EPS) Growth table, profits disappointed over the last twelve months (LTM) in the U.S. and internationally, with only U.S. large-cap companies reporting positive growth.

For the next twelve months (NTM), profits appear optimistic with U.S. Mid-Cap, U.S. Small-Cap and International Emerging indices expected to produce over 10% earnings growth. We are skeptical of the magnitude but anticipate an increase in global earnings of 6–8%.

EPS Growth: Historical and Estimated

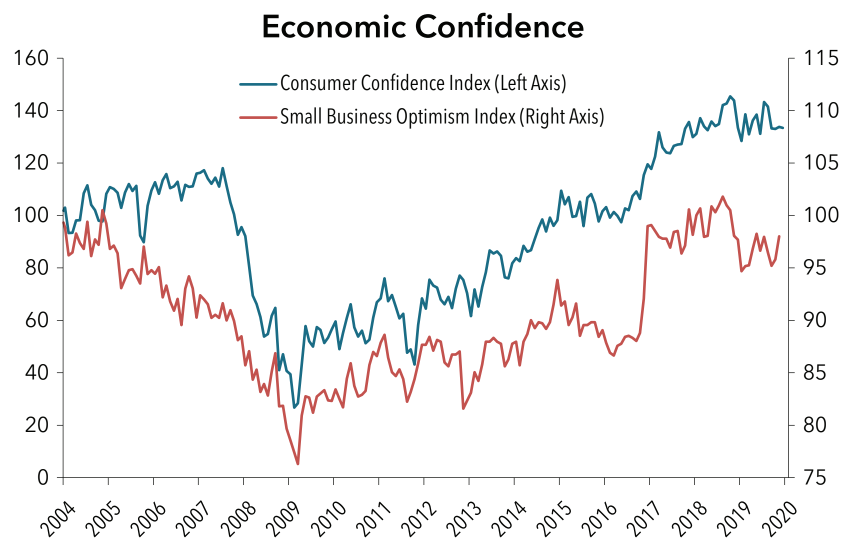
Asset Class	LTM EPS	NTM EPS
U.S. Large-Cap	0.4%	9.5%
U.S. Mid-Cap	-5.8%	12.3%
U.S. Small-Cap	-5.8%	14.9%
International Developed	-6.0%	6.7%
International Emerging	-11.7%	14.9%

Source: FactSet (calculation); as of 12/31/2019 for EPS Growth

High levels of consumer confidence underpinned by a strong labor market remain the cornerstones of our forecast.

1 2 3 4 INVESTMENT PROCESS

Make the Stock/Bond Decision



Source: Bloomberg data as of 12/31/2019; Normalized as of 12/31/2003

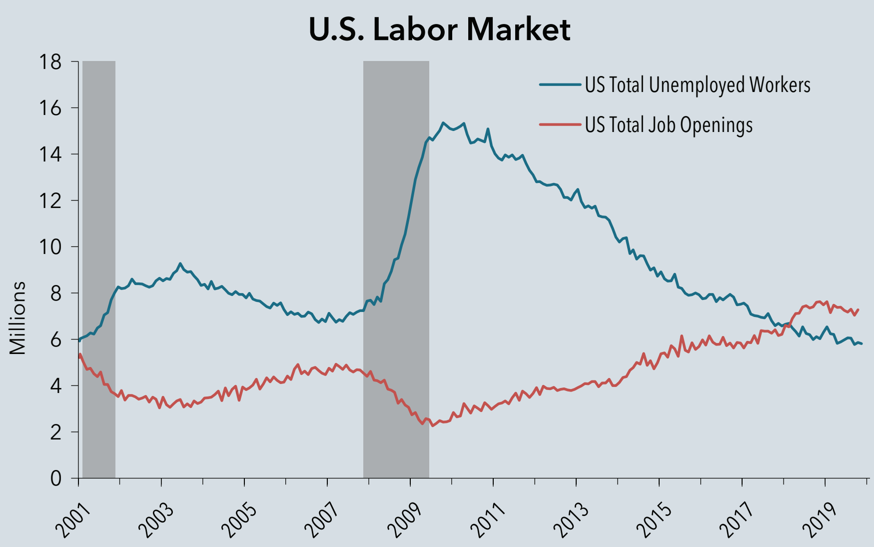
Economic data in the U.S. indicates a bifurcated economy, with businesses showing signs of weakness and consumers relatively strong.

Trade tariffs have negatively impacted profitability and business investment spending. As seen in the Economic Confidence chart, small business confidence is down from the 2018 peak, indicating some uncertainty about future economic growth.

Conversely, consumer confidence remains at fairly high levels compared to the last 15 years. Elevated consumer confidence reflects gains in personal income and may signify a willingness to spend.

Personal consumption represents around 68% of the U.S. economy and is vital to continued growth, making the labor market central to our outlook. Strong growth in private employment has led to a 3.5% unemployment rate.[ii] As illustrated in the U.S. Labor Market graph, job openings have risen to 7.3 million, indicating there are more jobs available than unemployed workers.

Wage growth has outpaced inflation, leading to an increase of 2.9% in real disposable personal income over the last year.[ii] Additionally, lower debt interest costs have led to stronger consumer balance sheets since exiting the last recession.



Source: Bloomberg Data as of 11/30/2019, Seasonally Adjusted

FNBO PERSPECTIVE

We are maintaining a slight overweight allocation in equities due to higher expected returns relative to bonds.

Make the Stock/Bond Decision

Entering 2019, all five asset classes traded at a price-to-earnings ("P/E") discount relative to their historic averages. The Stock Market Valuations table shows that U.S. and International equities have now moved to premium valuations.

In 2020, we expect earnings growth and low interest rates will allow P/E multiples to remain high and lead to positive returns. There does, however, remain downside risk to equities if company earnings disappoint.

Stock Market Valuations

Equities	2020 P/E	15-Year Avg P/E	P/E Premium
U.S. Large-Cap	18.2x	14.5x	25.0%
U.S. Mid-Cap	17.0x	15.7x	7.9%
U.S. Small-Cap	17.5x	16.6x	5.4%
International Developed	14.8x	13.1x	13.4%
International Emerging	12.9x	11.5x	12.7%

Source: FactSet (calculation); as of 1/1/2020 for NTM P/E's

Bond prices were up sharply last year, resulting in lower yields. As depicted in the Fixed Income Valuations table, short-term interest rates are close to their historic average whereas long-term yields are now below their 15-year average.

We expect U.S. government yields will continue to be subdued by global central bank liquidity as well as the approximate $11 trillion in bonds with negative interest rates.[iii] In this environment, bonds offer limited return potential, but provide portfolio protection in the event of a stock market correction.

Fixed Income Valuations

Bonds	2020 Yield	15-Yr Avg	Difference
Short-term Treasury	1.5%	1.3%	0.2%
Long-term Treasury	1.9%	2.9%	-1.0%

Source: Bloomberg; as of 1/1/2019 & 1/1/2020

Our preference within equities is U.S. over international, and in fixed income we are reducing risk.

Sector Allocation: U.S. and International

Sectors	U.S. Market	International Developed	Difference
Information Technology	22.5%	7.1%	**15.4%**
Communication Services	9.6%	5.2%	**4.5%**
Health Care	13.9%	12.2%	1.7%
Real Estate*	3.6%	3.5%	0.1%
Utilities	3.4%	3.7%	-0.4%
Energy	4.2%	4.9%	-0.7%
Consumer Discretionary	10.1%	11.6%	-1.5%
Basic Materials	2.9%	7.1%	-4.2%
Consumer Staples	6.9%	11.3%	-4.4%
Financials	13.3%	18.6%	**-5.3%**
Industrials	9.7%	15.0%	**-5.3%**
Total	**100%**	**100%**	

Source: FactSet (calculation); as of 1/1/2020; Real Estate Valuation P/FFO*
U.S. Broad Market S&P 1500; International Developed MSCI EAFE

Process #2 | Opportunities in Equities

Evaluating opportunities in equities begins with an assessment of domestic versus international.

U.S. stocks have outperformed international for the majority of the past decade with growth stocks outperforming value. In the current market environment, it makes sense to analyze equities on a sector level.

As seen in the Sector Allocation table, the U.S. equity market is more heavily weighted in Information Technology and Communication Services. Comparatively, International Developed markets are heavier in Financials and Industrials. Due to relatively higher exposure to slowing global economic activity, we believe U.S. equities offer a better risk/reward profile. However, we maintain exposure to international equities for diversification purposes, emphasizing small-cap companies and emerging markets.

Process #3 | Position Fixed Income

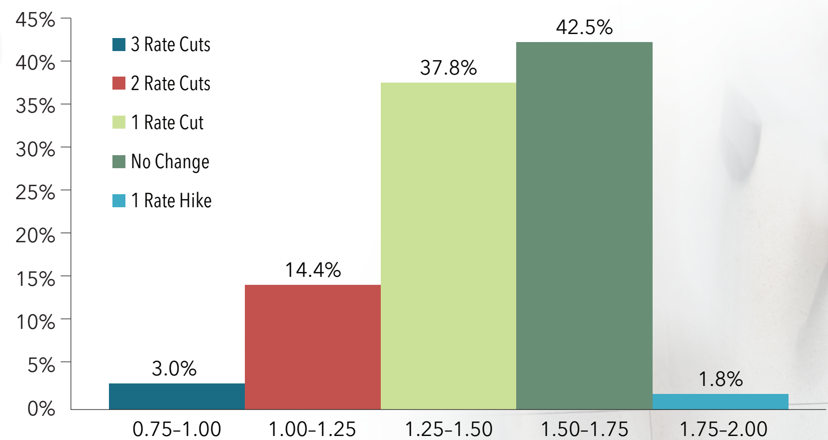
Positioning fixed income starts with an analysis of interest rates and credit spreads.

Federal Reserve Chairman Powell recently stated, "We would need to see a really significant move-up in inflation that's persistent before we would consider raising rates."[iv] As shown in the Fed Funds Rate Forecast chart, 80% of economists believe that short-term interest rates will end 2020 with no change or one rate cut.

Intermediate and long-maturity Treasury prices are determined on inflation expectations. With commodity prices contained and wage growth less than 4%, we see limited change in longer-dated yields.

Due to credit spreads tightening, we have been improving the credit quality of the portfolio by emphasizing government bonds and higher-quality corporates.

Fed Funds Rate Forecast (Dec 2020)



Source: Bloomberg data as of 12/20/2019

Investment success is predicated on staying diversified and rebalancing portfolios to target allocations.

Process #4 | Execute the Strategy

We implement our strategy to improve portfolio outcomes. Here is our current advice:

- **Policy matters, not politics:** As we assess the upcoming election, it is important to separate political noise from policy. Regulation, trade disputes and taxes are policy issues that could affect the broader U.S. and global economy. We make investment decisions based on our economic outlook, company profits and relative valuations among asset classes.

- **Stay disciplined in a diversified portfolio:** Low interest rates have resulted in global asset values rising. Equities offer the best long-term return potential, whereas bonds help portfolios mitigate risk and offer some income generation. Our alternative allocation provides a return and risk profile that is different from equities or bonds. We implement this exposure through a hedged equity mutual fund that provides participation in U.S. equities while offering some downside protection. It's important to stay fully invested and yet maintain discipline within the asset allocation.

- **Rebalance the portfolio:** In 2019, equities have moved from fear of recession to confidence in economic growth. A hypothetical portfolio of 55% equities and 45% fixed income would have changed to 60% equity and 40% fixed income due to market appreciation. After the strong run in equities, we believe it's prudent to take some profits and reinvest into fixed income and alternatives.

  As shown in the Moderate Portfolio Rebalancing Benefits table, the additional return of periodic rebalancing is limited, only +0.1%. The primary advantage stems from the significant -1.7% reduction in portfolio volatility.

Moderate Portfolio Rebalancing Benefits

	Buy and Hold	Annual Rebalance
Annualized Return	8.4%	8.5%
Standard Deviation	10.3%	8.6%
$500,000 Investment	$6.1 million	$6.2 million

Source: Russell Investments; 55% Equity, 45% Fixed Income Portfolio. Time period Jan. 1988 - Dec. 2018

An uncommon understanding of one's goals and risk tolerance creates the foundation for success. We believe setting and adhering to an appropriate long-term asset allocation helps temper investor biases. Owning a diversified portfolio helps to mitigate risk and could provide peace of mind in a volatile political environment. We believe the U.S. economy will grow around 2% in 2020, leading to a recovery of earnings growth. High levels of consumer confidence underpinned by a strong labor market remain the cornerstones of our forecast. We are maintaining a slight overweight allocation in equities due to higher expected returns relative to bonds. Our preference within equities is U.S. over international, and in fixed income we are reducing risk. Investment success is predicated on staying diversified and rebalancing portfolios to target allocations.

We believe the implementation of FNBO's Investment Principles and Process improves the likelihood of success.

Thank you for your interest in this year's Outlook and the trust you place with us.

Kurt Spieler, CFA
Chief Investment Officer

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For 2020 Outlook asset class definitions, key terms and model definitions, please visit www.fnbo.com/outlookdefinitions.

Sources:

i. *Vanguard*
ii. *Bloomberg*
iii. *Wells Fargo Securities*
iv. *Wall Street Journal*