Quarterly Market Review

First Quarter 2024

First Business Bank.

Executive Summary

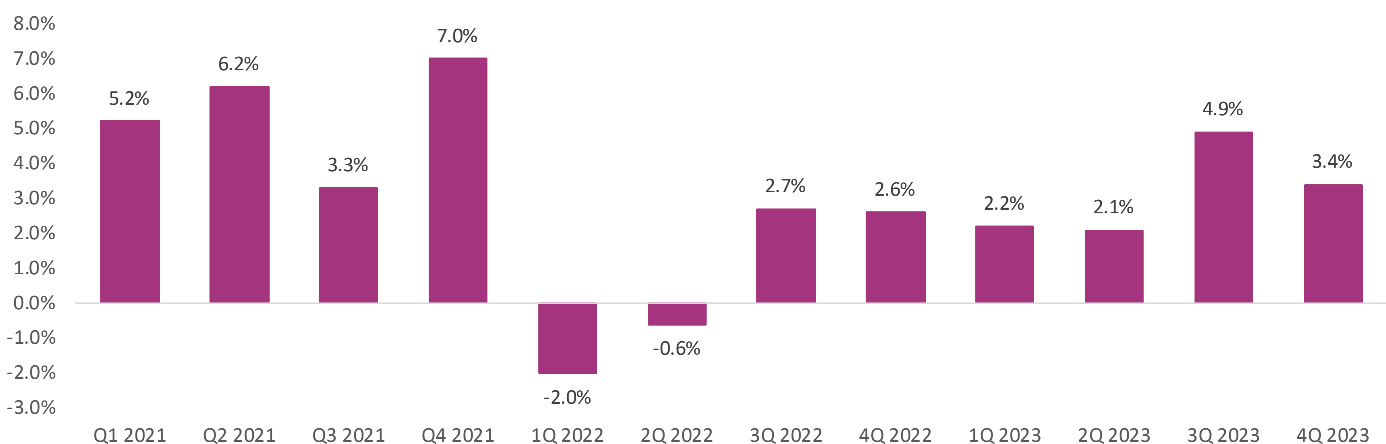
The macro backdrop remains resilient despite higher rates and a stall in declining inflation. Recession worries receding, corporate profits remaining solid, enthusiasm remaining strong around artificial intelligence capital expenditures (CAPEX), and expectations that the Federal Reserve is still on track to cut interest rates have given investors plenty of reasons to celebrate.

In the final quarter of 2023, the U.S. economy expanded at an annualized rate of 3.4%, a deceleration in growth from a strong third quarter. Unemployment continues below 4%, and wage growth and rising interest income are translating into higher personal income. The wealth effect is strong, as stock prices and home values are still elevated.

Equity investors shrugged off concerns about the uptick in inflation and the delay of lower interest rates to finish the quarter on a high note, with many equity indices posting all-time highs. Large cap markets continued to dominate but positive returns were posted by all the major domestic and international indices in the first quarter. Bond yields were modestly higher.

U.S. Economy Ends 2023 On Strong Footing

In the last quarter of 2023, the U.S. economy expanded at a robust annualized rate of 3.4%, although this growth rate represented a slowdown compared to the strong performance in the preceding third quarter. The underlying details looked healthy with consumer consumption, of both goods and services, again fueling economic growth and accounting for 2.2% of the 3.4% increase. The largest single portion of the increase in real Gross Domestic Product (GDP) was consumer spending on services, which accounted for 1.54%. The remainder was due to increases in state and local government spending, fixed investment on structures and intellectual property, exports, and residential fixed investment that were partly offset by a decrease in private inventory investment. Imports, which are a subtraction in the calculation of GDP, increased. Compared to the third quarter of 2023, the deceleration in real GDP in the fourth quarter primarily reflected a downturn in private inventory investment and slowdowns in federal government spending and residential fixed investment. In 2023, the real GDP growth rate was 2.5%, which represents an improvement compared to the 1.9% increase observed in 2022.



The most recent measures of economic activity in the first quarter of 2024 suggest that growth continues to be positive, but with some deceleration anticipated from the fourth quarter of 2023. Based on data received through March 28, the Atlanta Fed's GDPNow model projects a 2.3% growth rate for the first quarter. This outlook seems to be supported by several key leading indicators, such as the Consumer Confidence Index, initial jobless claims, durable goods orders, and building permits, all of which are signaling modest growth. The Conference Board's Leading Economic Index (LEI) serves as a reliable leading indicator of economic trends, and its movements often precede shifts in the overall business cycle. Notably, in February 2024, the LEI experienced a 0.1% increase, marking the first rise since February 2022.

Manufacturing PMI Hits 21-Month High Amid Potential Supply Chain Challenges

The Federal Open Market Committee (FOMC) left rates unchanged for the third consecutive time at its December meeting, keeping the federal funds rate at a target of 5.25% to 5.50%. The post-meeting statement from the FOMC surpassed market expectations in terms of its overall dovish tone. As inflation trends show a significant deceleration, Fed officials have signaled more rate reductions on the horizon. The median FOMC member projection takes rates to 4.6% by the end of 2024, down to 3.6% by the close of 2025, and 2.9% at the end of 2026. Moreover, updated FOMC projections showed lower inflation forecasts without material revisions to the growth or employment forecasts, which implies a soft landing. The futures market, which can be viewed largely as the midpoint expectations of market participants, has even more dovish expectations than the Fed and is currently indicating six interest rate reductions in 2024. This could mean market participants are more sanguine about inflation or perhaps more concerned about recession than the Fed. The cure for higher inflation is often the disease for economic growth and vice versa.

Federal Reserve Holds Rates At A 23-Year High

In late March, the Federal Reserve voted unanimously to hold rates steady for the fifth straight meeting. The target rate remains at 5.25% to 5.50%, its highest level since 2000. The key update from the FOMC meeting was the Summary of Economic Projections, which now forecasts stronger GDP growth, lower unemployment, and higher inflation compared to projections made in December. Despite the upward risks to growth and inflation highlighted in the revisions, the Federal Reserve's projection for three interest rate cuts this year remained unchanged. There are a few key takeaways from the March meeting and press conference. First, the Fed is willing to tolerate higher near-term inflation. While inflation data is moving in the wrong direction to start this year, the Fed believes the prevailing trend will be lower and that the uptick in early 2024 may be seasonal. Second, the Fed seems firm in its intention to cut interest rates this year. The Federal Reserve has said that they will remain "data dependent" and would not speculate on the timing of the rate-reduction cycle. As of the end of the quarter, 30-day fed funds futures pricing data indicates a 61% probability of the first rate cut coming at the June 12 meeting.

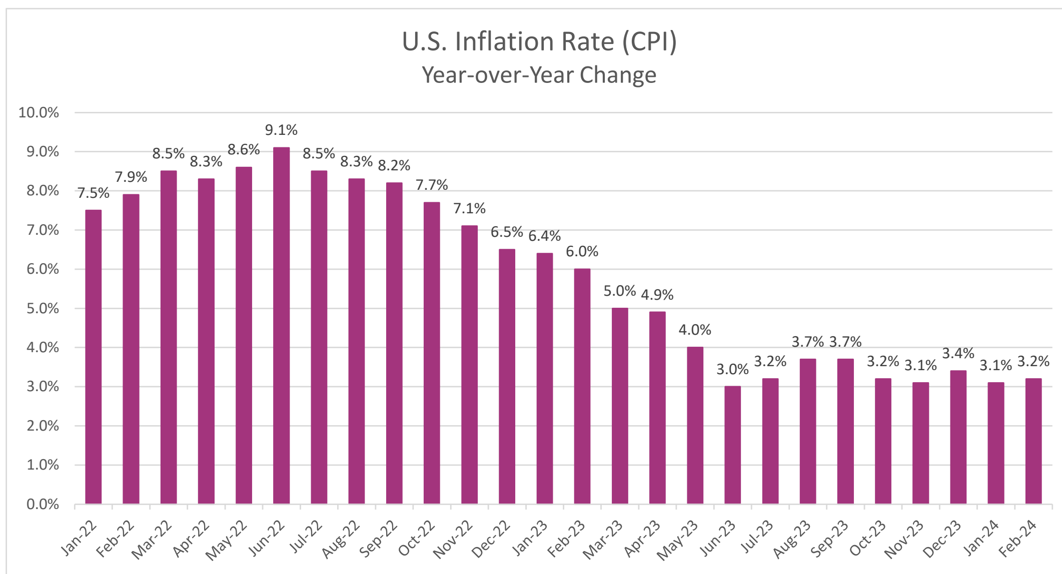
The Fed's ultimate goal is to bring rates down to a level that would neither stimulate nor slow growth. But it is highly uncertain what that so-called neutral rate actually is. Last week's interest-rate projections showed that officials' median forecast for where rates will settle in the "longer run" was 2.6%.

The Federal Reserve's Fight With Inflation Is Not Quite Finished

The February Consumer Price Index (CPI) report showed that inflation is still gradually receding, but the slope of the downward trajectory has flattened more recently. Headline CPI rose 0.4% from the previous month and 3.2% for the year. In the details, gasoline prices spiked after four consecutive declines, while food prices held steady. Across core services, owners' equivalent rent rose 0.4%, a moderation compared to last month but still above its pre-pandemic pace, while transportation services remained elevated. Importantly, with improved supply chains, moderating wage growth, and shifting consumer preferences, inflation could continue to trend toward the Federal Reserve's 2% target.

While the CPI garners significant attention as 'the' inflation report, it is essential to recognize that the Federal Reserve primarily relies on a different

metric. The central bank bases its 2% inflation target on data from the Personal Consumption Expenditures Price Index (PCE), which is part of the Commerce Department's monthly report on income and spending. The biggest difference between the CPI and the PCE price indexes is their composition. The price weights for different items in the CPI depend on how much of their spending consumers say they devote to various categories, based on annual surveys. The PCE, on the other hand, derives its price weights from actual spending data provided by the Commerce Department. It captures where money is truly being spent, so it factors in how consumers substitute more expensive goods for less expensive goods. When the central bank adopted a 2% inflation target in 2012, it specifically referred to PCE inflation.



In February 2024, the annual PCE inflation rate in the United States edged up by 0.3%, reaching an annualized change of 2.5%. This increase followed January's rate of 2.4%, which was the lowest since February 2021. The core PCE price index increased 2.8% on a 12-month basis and was up 0.3% from a month ago. While the Federal Reserve looks at both measures when making policy, it considers core PCE to be a better gauge of long-term inflation pressures. The primary reasons for this preference are that core PCE, which extracts the more volatile "commodity-like" components of food and energy, is less volatile, has superior predictive value, and helps to better distinguish between transitory and persistent inflation. The Fed targets 2% annual inflation; core PCE inflation has not been below that level in three years.

The Producer Price Index (PPI) for final demand, which captures prices further up the pipeline, was higher in the first two months of the year. Despite recent increases, the year-over-year price change is a modest 1.6%, well below the long-term average of 3.08%. The PPI reached a peak of 11.7% in March of 2022.

Housing Market Rebounds

The housing market was brutal in 2023 as home sales fell to the lowest levels in nearly 30 years. Since 2022, higher mortgage rates, elevated home prices, and limited inventory have suppressed sales. As the spring homebuying season gets underway, existing home inventory has increased slightly, and new home construction has picked up. Despite elevated rates, homebuilders are displaying renewed confidence in the housing market, focusing on the fact that there is a good amount of pent-up demand, an ongoing supply shortage, and expectations that the Federal Reserve will cut rates later in the year. In March, homebuilder sentiment achieved a significant milestone, improving for the fourth consecutive month and hitting an eight-month high. This positive trend is driven by a lack of existing inventory that continues to push buyers toward new home construction. Housing starts rose by 10.7% in February after declining by 12.3% in January, suggesting that January's freezing weather impacted that downturn. The number of single-family housing starts surged by 35.2% since a year ago, an indication that last year's tightening-induced slowdown is fading.

Existing home sales unexpectedly soared 9.5% to a seasonally adjusted annualized rate of 4.38 million units in February 2024, the highest level in a year. This marked the first time in more than two years that sales have increased for two consecutive months. Among the four major U.S. regions, sales jumped in

the West, South, and Midwest, and were unchanged in the Northeast. Total housing inventory was 1.07 million units, up 5.9% from January and 10.3% from one year ago. Meanwhile, the median existing home price for all housing types in February was $384,500, an increase of 5.7% from the prior year.

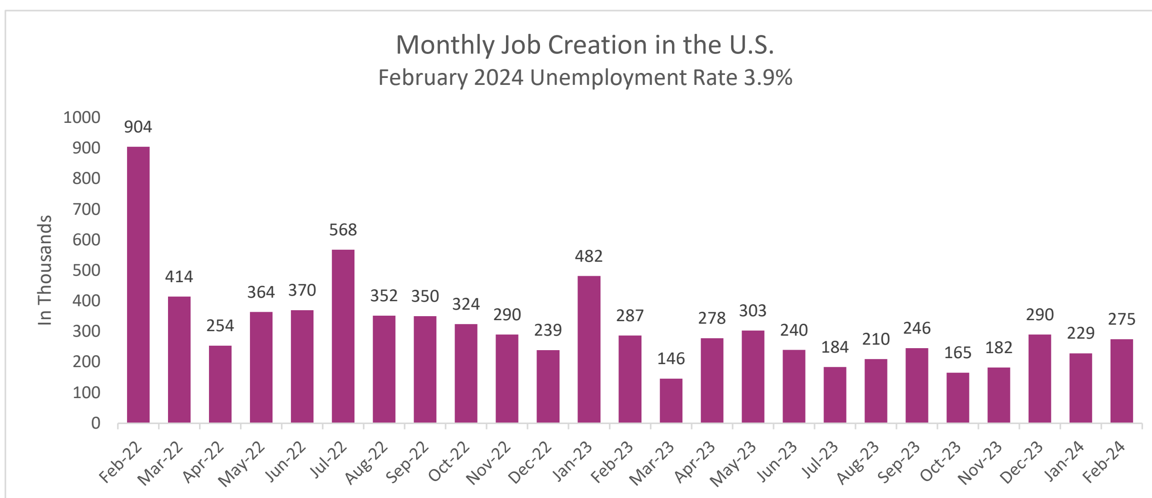
After retreating from a February high of 6.94%, mortgage rates are once again on the upswing. Closing the quarter at 6.79%, up from 6.32% a year ago, these rates reflect a dynamic market. Over the years, the 30-year mortgage rate in the United States has seen significant fluctuations. It averaged 7.73% from 1971 until 2024, reaching a staggering high of 18.63% in October 1981 and a record low of 2.65% in January 2021. The recent peak of 7.8% in October 2023 was a level not witnessed since October 2000. It is worth noting that a 30-year mortgage rate below 5% was unheard of until March 2009, at the tail end of the Great Recession. The current rate of 6.74%, which is more than 1% lower than the peak in October 2023, has sparked increased interest among buyers. Even small declines in interest rates have had disproportionately positive effects on potential home purchasers.

Jobs Market Remains Solid

Total nonfarm payroll employment rose by 275,000 in February, above the average monthly gain of 230,000 over the prior 12 months. In the first two months of 2024, health care and social assistance saw the largest hiring gains of 177,300 jobs. Leisure and hospitality also saw robust growth, adding 66,000 jobs. Retail picked up 33,900 jobs, and construction gained 42,000 jobs. Transportation and warehouse employment fell by 9,200 despite a strong gain of 19,700 jobs in February. Meanwhile, manufacturing gained only 4,000.

The February Jobs report provided some evidence that the labor market is easing. Downward revisions removed 167,000 jobs from the prior two months. The unemployment rate rose to a two-year high of 3.9% in February, and the number of persons unemployed for fewer than five weeks jumped from 2.1 million to 2.3 million. A separate report showed that the U.S. Quits Rate remained at 2.2% for the fourth consecutive month in February, the lowest level since August 2020. The falling U.S. Quits Rate indicates that employees are less confident in voluntarily quitting and finding a new job. Average hourly earnings for all employees on U.S. private nonfarm payrolls have increased by 4.3% year over year in February 2024, after a downwardly revised 4.4% rise in the prior month.

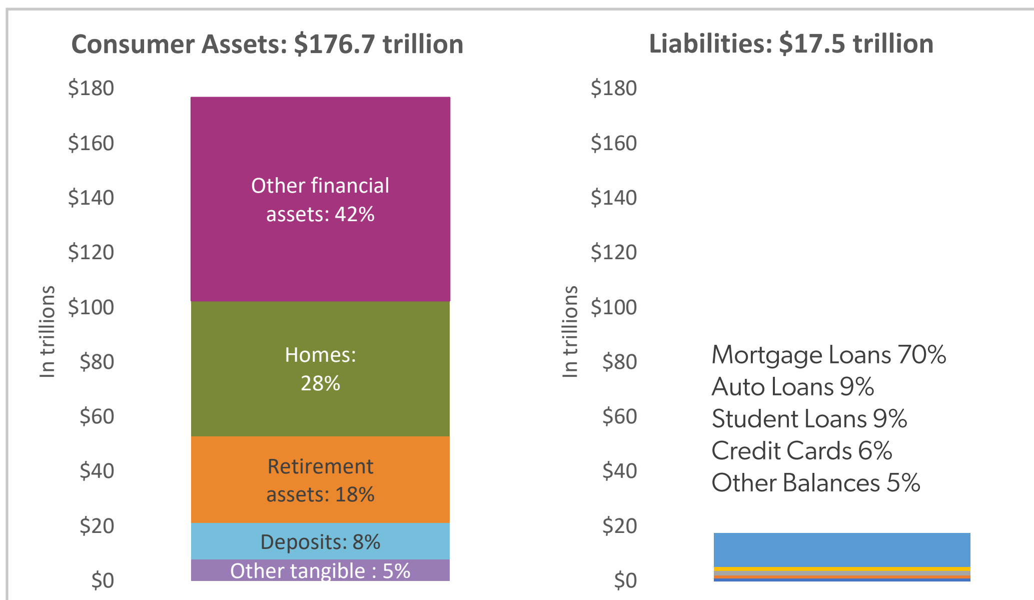
In 1977, Congress legislated the Federal Reserve's "dual mandate," under which the FOMC is required to pursue both maximum employment and stable prices, with both objectives on an equal footing. Since late in 2021, the Federal Reserve has been focusing primarily on curtailing inflation. Rising unemployment could cause the focus to shift to the other half of its dual mandate: full employment. One dynamic that has helped to keep unemployment under 4% is early retirements, with over five million people leaving the workforce during the pandemic and not returning. This rise in the number of individuals classified as "Not in the Labor Force" has caused the labor market to remain tight. Overall, continued strong job gains and easing wage pressures should bolster confidence in the Fed's ability to manage a soft landing, even with a slower pace of policy easing.



U.S. Consumers Spending

The advance estimate of retail sales in the U.S. was up 0.6% month over month in

February, following an upwardly revised decline of 1.1% in January. The relatively modest increase, combined with a larger decline in January, may suggest a potential slowdown in consumer spending. Retail sales rose 1.5% on a year-over-year basis in February. The U.S. Bureau of Economic Analysis (BEA) assesses consumer spending using the PCE metric. In February 2024, personal spending in the U.S. surged by 0.8% month over month, marking the most substantial gain since January 2023. This increase amounted to $111.8 billion in spending on services, primarily in financial services, insurance, transportation, and housing. Additionally, consumption of goods rose by $33.7 billion, driven mainly by motor vehicles and parts. When adjusted for inflation, consumer spending still showed a solid advancement of 0.4%. The monthly report on how consumers are spending or pulling back is viewed as a harbinger of the state of the U.S. economy. Many economists believe that Americans are close to spending down their pandemic-buffered savings and are feeling stretched by inflation, which has impacted the prices of everyday essentials from groceries to rent.



As of December 31, 2023

A surge in household debt has sparked concerns about the financial health and the potential impact on future spending for consumers. According to the latest Federal Reserve Bank of NY, total household liabilities climbed by a substantial $212 billion, reaching $17.5 trillion in the fourth quarter of 2023. Credit card balances increased by $50 billion to $1.13 trillion, while mortgage balances rose by $112 billion to $12.25 trillion. Mortgage loans, as referenced in the chart below, are the largest liability category at 70%. Auto loan balances rose by $12 billion to $1.61 trillion. Delinquency rates have increased for all debt types except for student loans, which will not be reportable until September 30, 2024. Despite the mounting debt, there is a silver lining as consumer assets have also appreciated. As of the 2023 year-end, consumer assets are estimated at $176.7 trillion (see chart).

When it comes to future spending, consumer expectations play a pivotal role in shaping behavior. In March 2024, the University of Michigan's Consumer Sentiment Index for the U.S. rose slightly to 79.4, the highest reading since July 2021. A strong job market remains the most crucial factor for the consumer as long as asset valuations remain stable. Employment data will be crucial for understanding fluctuations in consumer spending. Inflation expectations for the year ahead are 2.9%, and those for the five-year outlook are 2.8%. A strong job market remains the most crucial factor for the consumer as long as asset valuations remain stable. Employment data will be crucial for understanding fluctuations in consumer spending. Inflation expectations for the year ahead are 2.9%, and those for the five-year outlook are 2.8%.

Global Growth Poised For Improvement

According to the World Economic Outlook from the International Monetary Fund (IMF), global economic growth is poised for a modest upturn in 2025. This expected uptick is primarily attributed to emerging economies, with India and China leading the charge. Additionally, there is an optimistic outlook regarding global inflation, which is expected to moderate. In its recent report, the IMF highlights that "inflation

is falling faster than expected in most regions." However, while the world economy is on the right trajectory, the projected growth rates of 3.1% in 2024 and 3.2% in 2025 fall short of the long-term historical global growth rate of 3.8%.

Key Rates

	12/31/2022	12/31/2023	3/31/2024
2-yr U.S. Treasury	4.37%	4.25%	4.63%
10-yr U.S. Treasury	3.88%	3.88%	4.21%
30-yr Fixed Mortgage Rate	6.42%	6.61%	6.79%
Fed Funds Target Rate (upper)	4.50%	5.50%	5.50%
U.S. Dollar Index	103.49	101.38	104.53
Crude Oil	$80.51	$71.33	$83.12
Gold	$1,830	$2,072	$2,255
Unemployment Rate	3.50%	3.70%	3.90%*

*As of February 2024 | Source: *The Wall Street Journal*

In 2024, industrialized economies are projected to experience a modest 1.5% growth, followed by a slightly higher rate of 1.8% in 2025. Meanwhile, emerging economies, including China, India, Russia, Brazil, and Saudi Arabia, are expected to exhibit more robust growth. Forecasts indicate a growth rate of 4.1% in 2024, rising to 4.2% in 2025 for these nations. India and China are anticipated to be the clear leaders in economic expansion. In 2024, India is expected to achieve an impressive average growth rate of 6.5%, driven primarily by its population growth. Meanwhile, China, which has been a powerhouse in recent years, is projected to slow down slightly to 4.1% in 2025, with productivity growth as its primary driver.

China's central government is ready to load up on debt to help the economy. Beijing is planning this year to issue $139 billion of ultralong special treasury bonds, a crisis management tool that will now become a regular source of funding, at least for the next few years. The move will take part of the burden for funding the country's economic growth away from heavily indebted local governments, many of which are facing severe strain after years of heavy borrowing.

Market Commentary

The S&P 500 closed out the quarter at an all-time high, rising by 10.5%. In fact, the large-cap market notched 25 new highs over 61 trading days in the first quarter. This marks the best first-quarter gain for the S&P 500 since 2019 when the index rose by 13.1%. For the trailing one-year period through March 31, 2024, the S&P 500 is up a whopping 29.9%. NVIDIA was the largest single contributor to S&P 500 performance, with a return of 83%. Apple and Tesla, two heavily weighted stocks in the index, were the biggest detractors, with price declines of 11.3% and 30%, respectively.

Small-cap stocks, as represented by the Russell 2000, were up 5.2% for the quarter and 19.7% for the last year. Developed international markets closed the quarter 5.8% higher as recent inflation data continues to show that inflation pressures are cooling. The trailing 12-month results show a solid 15.3% increase. Emerging markets were modestly positive at 2.4% for the quarter and 8.1% for the trailing 12-month period.

The MSCI All-Cap World Index (MSCI ACWI) is a comprehensive index that provides a broad measure of global equity market performance, including both developed and emerging markets and large and mid-cap constituents. Like the S&P, the ACWI is market-weighted, so the largest companies have a greater impact on performance. This index is commonly used as a benchmark for globally diversified asset allocation portfolios. The MSCI ACWI was up 7.7% for the quarter and 22.3% for the trailing year.

Unlike 2023, it has not been just a small group of mega-cap stocks that are participating in the early 2024 rally. The first quarter brought some leadership rotation as the energy sector, last year's worst performer, posted a strong 13.7% increase. Technology, financials, industrials, and materials were strong, following low double-digit returns in 2023. Communication services was the top-performing sector and continued to build on last year's powerful performance, up 15.8% for the quarter. Real estate is the laggard so far in 2024, with a return of negative 1.1%.

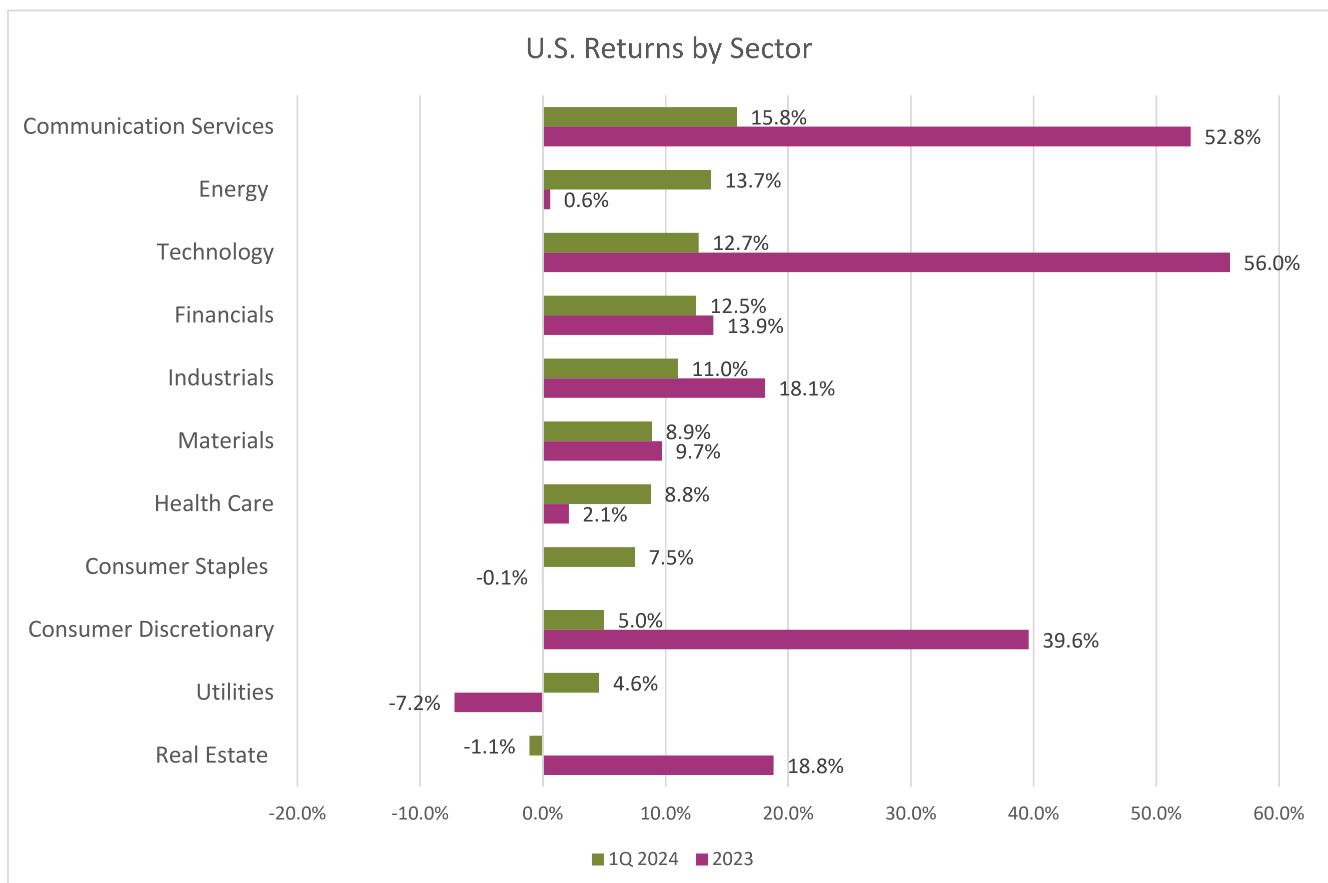
Large-cap growth stocks continued to dominate, returning 11.4% in the quarter compared to large-cap value stocks at 9%. Growth has outperformed significantly over the last ten years, but a different story emerges when looking at relative results since January 3, 2022, the start of the most recent bear market. Over that span of time, growth sectors maintain just the smallest margin of gain over value sectors at 11% versus 10.55%.

The share of the S&P 500 market capitalization held by the largest five firms is a whopping 24.3% now. Those firms are, in order of market capitalization, Microsoft, Apple, NVIDIA, Amazon, and Meta Platforms. The last time the top five were collectively this large was in the early 1970s. At that time, the five firms in market capitalization order were IBM, AT&T, GM, Eastman Kodak, and Exxon.

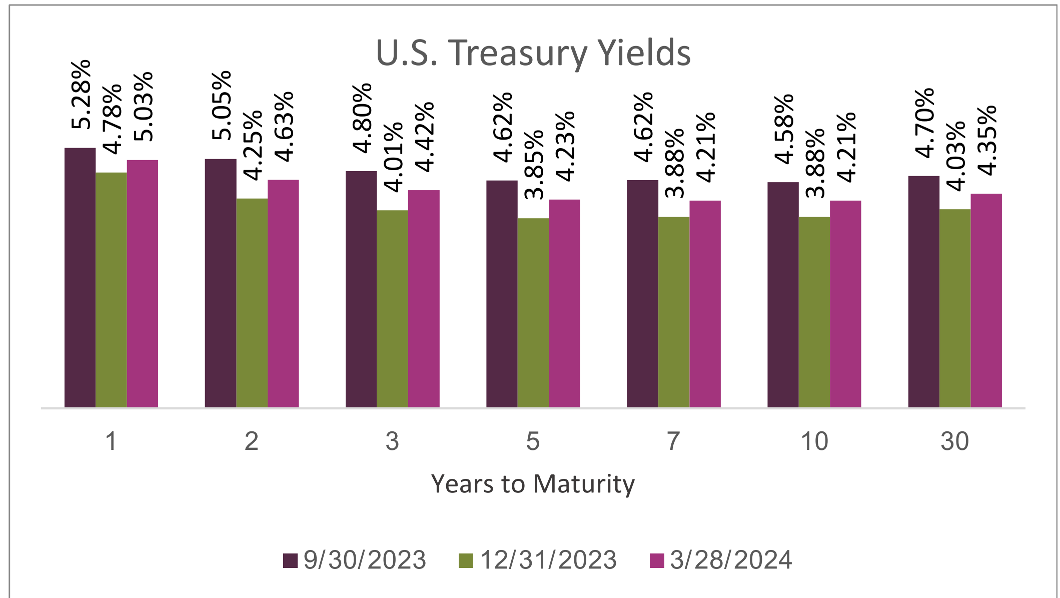
The consensus expectation is that S&P 500 earnings will grow at 10.7% in 2024. What remains encouraging for equities is that the 2025 growth is expected to be 13.3%. Another positive for the fundamentals is that operating margins continue to expand to 16.9%. This is the highest profit margin since 2008 outside of the immediate post-Covid recovery.

Yields on U.S. Treasurys, which rise when bond prices fall, largely reflect what investors think the Fed's benchmark short-term rate will average over the life of a bond. Such yields have risen in recent weeks on concerns over stubbornly high inflation and the "higher for longer" view of the FOMC. Meanwhile, corporate bond yields have risen, but not as rapidly as credit spreads have also tightened, and investors remain optimistic about the potential for economic and profit growth — and thus lower default rates. Municipal bond yields have been restrained by strong demand and short supply. Total returns for the bond indices were modestly negative in the quarter due to rising yields. The Bloomberg Aggregate Bond index fell by .78%, and the Bloomberg Municipal dropped by .39%.

As of quarter end, the yield on the benchmark 10-year U.S. Treasury note was 4.21%, up from 3.88% at the end of last year. Coming into 2024, investors expected the Fed to cut that rate six times this year, bringing it down to 3.75%—4%. After an uptick in inflation readings in January and February and economic growth that has proved more resilient than prior expectations, investors reduced their expectations for rate cuts this year. Now, futures markets expect rates to end the year between 4.5% and 4.75%.



Election season is moving into full swing, and investors often fixate on how results may impact markets. Stocks have done well historically under just about every combination of partisan control in Washington. The best-performing combination, at 15.7% annually, is the current combination of a Democratic President, Republican House, and Democratic Senate. As the election approaches, investors will be laser-focused on sectors and companies that can experience a meaningful change in their earnings based on policies enacted post-election.



At the outset of the year, equity markets have experienced an impressive surge. While historically rising interest rates have often acted as a headwind for equity markets, an intriguing phenomenon has unfolded: despite a 33-basis-point increase in U.S. 10-year Treasury yields year-to-date, stocks have rallied by 10% over the same period. Initially, this dynamic might appear counterintuitive, as rising interest rates traditionally signal weaker equity market performance. However, in today's market landscape, this conventional relationship appears to have shifted. Investors now interpret the upward trajectory of interest rates as a positive indicator—a reflection of resilient economic activity and expectations for robust profit growth.

As we peer into the remainder of the year, our investment team will be closely monitoring several key themes and potential risks. Here are some areas of focus:

Themes:

1. Fixed Income Appeal: Amid rising yields and easing inflation, fixed income investments provide appealing real income and act as a safeguard against economic downturns.
2. Equity Success Factors: Solid profit growth and reasonable valuations will be crucial to identifying attractive long-term opportunities within the equity market, especially in a higher-rate environment.
3. Global Opportunities: Long-term growth prospects, a weakening dollar, and favorable valuation discounts make international equities an appealing choice.

Risks:

1. Rate Cut Uncertainty: The pace of rate cuts may not align with expectations, posing challenges for both stocks and bonds.
2. Economic Vulnerability: A sluggish economy remains susceptible to unforeseen shocks.
3. Valuation Concerns: Elevated valuations in certain market segments could trigger volatility and short-term corrections.

South Central Wisconsin:
401 Charmany Drive
Madison, WI 53719

Southeast Wisconsin:
17335 Golf Parkway
Brookfield, WI 53045

Northeast Wisconsin:
3913 W. Prospect Avenue
Appleton, WI 54914

Kansas City Metro:
11141 Overbrook Road
Leawood, KS 66211

First Business Bank's Private Wealth investment team is looking forward to sharing exciting developments regarding our proprietary portfolio construction and rebalancing methodologies . We believe our proprietary FOLIObuilder™ and FOLIObalancer™ models will significantly enhance diversification and improve risk-adjusted performance going forward. Our disciplined proprietary processes, meticulously honed over the past two decades, aim to enhance returns while mitigating risk. At its core, this method relies on our Ten-Year Capital Market Assumptions as building blocks, thoughtfully explained in a report by Matt Rice, our Chief Investment Officer.

As we venture further into 2024, we are grateful for our continued partnership with you. Please reach out to your Portfolio Manager, Wealth Advisor, or Trust Advisor at any time with any question, big or small.

Index Total Return	1Q 2024	Last 12 Months	Last 3 Years (annualized)	Last 5 Years (annualized)
MSCI All-Cap World Index	7.68%	22.33%	6.21%	10.53%
S&P 500 Index	10.56%	29.88%	11.49%	15.04%
Russell 2000	5.18%	19.71%	-0.10%	8.10%
MSCI EAFE Index	5.78%	15.32%	4.78%	7.32%
MSCI Emerging Markets Index	2.37%	8.15%	-5.05%	2.22%
Bloomberg 1-3 Year U.S. Treasury	0.28%	2.94%	0.01%	1.13%
Bloomberg U.S. Aggregate Bond	-0.78%	1.70%	-2.45%	0.36%
Bloomberg Municipal Index	-0.39%	3.13%	-0.41%	1.59%

Source: Morningstar Direct

Quarterly Market Review written by
Nancy Johnshoy, CFA, Senior Vice President - Portfolio Manager & Market Strategist
Matt Rice, CFA, CAIA, Chief Investment Officer

First Business Bank strives to provide its clients with responsive and creative investment management solutions in an atmosphere of professionalism, integrity, and reliability. Whether you work with us already or are new to our investment process, please know that we always welcome the opportunity to discuss the changing economic climate and its effect on your personal financial situation. Please call us at 608-238-8008 or 1-866-432-3247 to set up an appointment to discuss investment options customized to meet your personal goals and objectives.

Financial Planning, Investment Management, Trust & Estate Administration, Company Retirement Plans, Investment Portfolio Services, and Asset Liability Management solutions are NOT FDIC INSURED, NOT BANK GUARANTEED, and MAY LOSE VALUE. First Business Bank is not a tax advisor and recommends you consult your tax advisor before making tax-related investment decisions.