Quarterly Market Review
Fourth Quarter 2023

Executive Summary

In the unpredictable story of 2023, the overall mood started the year rather gloomy as concerns loomed over the economy, casting a shadow on the financial markets. The consensus had been a cautious anticipation of a possible, if not likely, recession by year end, with many of the more optimistic prognosticators expecting only modest economic growth. By the end of 2023, perhaps the key storyline was ultimately the unexpected twist that relentlessly strong economic growth had averted or postponed the recession.

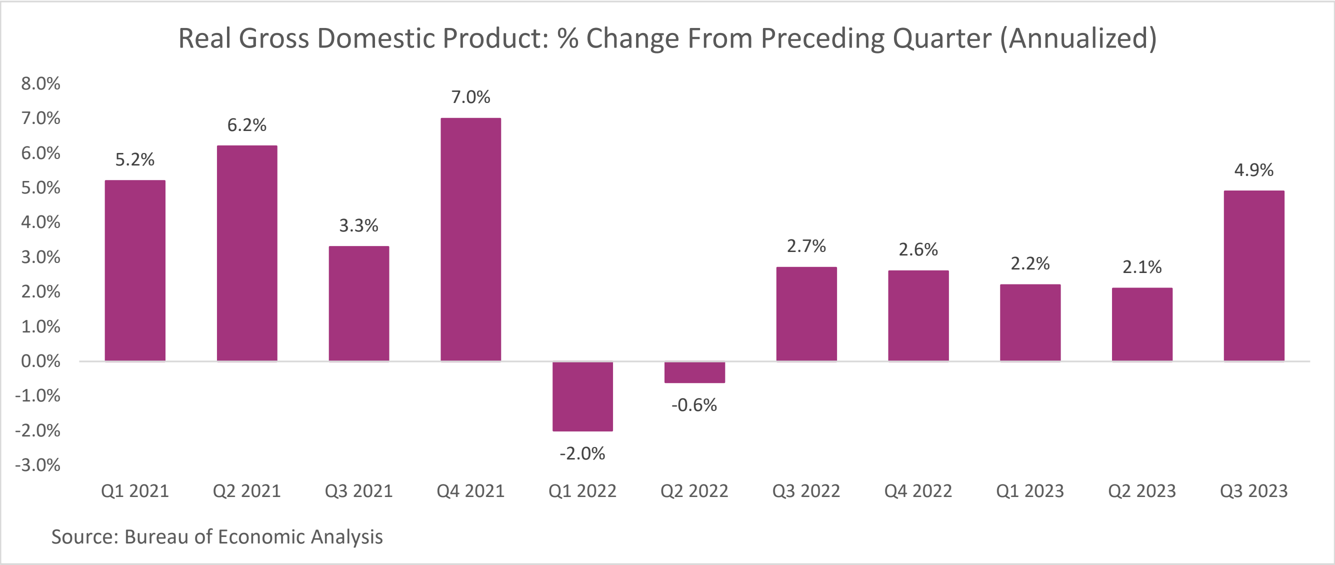
During the third quarter of 2023, Gross Domestic Product (GDP) registered a blistering annualized growth rate of 4.9%—a marked acceleration compared to the previous quarter and the most vigorous since Q4 of 2021. However, current economic indicators suggest a looming deceleration, hinting at the likelihood of the U.S. economy gracefully transitioning into a "soft landing."

The final quarter of the year also brought holiday cheer to investors with strong performance across the board. Markets rallied broadly following a modest inflation reading in November, as well as a dovish Federal Reserve report. The S&P 500 Index, Russell 2000 Index, MSCI EAFE Developed International Index, and Nasdaq, all posted double digit returns before the year ended. Bond yields fell and the yield curve flattened boosting returns for bond investors during the quarter.

Despite the general overall pessimistic mood of many in early 2023, First Business Bank maintained an overweight to "risk-on" positioning in portfolios throughout 2023, which ultimately proved beneficial to our clients and their performance for the year.

U.S. Economy Angling Toward A Soft Landing

The third-quarter GDP surge was largely driven by consumer spending, which accounts for more than two-thirds of U.S. economic activity and contributed 2.11% to the GDP in this quarter. Private investment also showed strong performance, contributing an additional 1.74% to the GDP. A notable portion of this increase can be attributed to fluctuations in private inventories, a typically volatile component of the GDP. Government spending added another 0.99% to the GDP, with upticks in federal, state, and local expenditures. Despite facing numerous challenges, the economy showcased its resilience and adaptability, underscoring its foundational strength.



Per the most recent economic data, the economy is still on an upward trajectory, though the pace has slowed compared to the third quarter. As of December 22, 2023, the Atlanta Fed's GDPNow model projects a 2.3% growth rate for the fourth quarter. In contrast, the Blue Chip Economic Index, a monthly survey of top business economists, predicts a more substantial slowdown, possibly to around 1%. These statistics suggest slowing economic momentum. However, the Conference Board Leading Economic Indicators (LEI) forecasts a brief and mild recession for the U.S. economy in the first half of 2024. The LEI, which can signal significant shifts in the business cycle and the economy's near-term direction, fell by .5% in November, following a downward revision of -1% in October. Furthermore, the ISM Manufacturing Purchasing Managers Index (PMI) was 46.7 in November, which indicates a modest contraction in the manufacturing sector.

Federal Reserve Holds Rates Steady

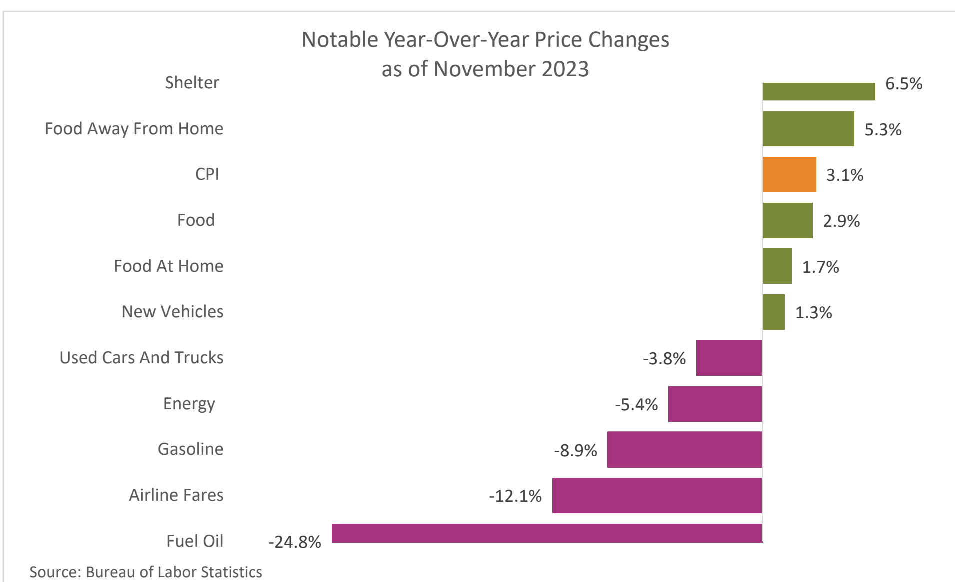
The Federal Open Market Committee (FOMC) left rates unchanged for the third consecutive time at its December meeting, keeping the federal funds rate at a target of 5.25% to 5.50%. The post-meeting statement from the FOMC surpassed market expectations in terms of its overall dovish tone. As inflation 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.

U.S. Budget Deficit: FY 2023 Forecasting Challenges

The U.S. government has consistently operated under a budget deficit, with an average of about 3% of GDP over the three decades before the pandemic. The fiscal landscape became more complex with changes to tax and spending laws during the pandemic, making the budget deficit for fiscal year 2023 particularly difficult to predict. The Congressional Budget Office (CBO) is instrumental in providing current fiscal year projections for federal revenues, expenditures, and deficits, aiding in planning and decision-making. However, unexpected legislative changes and other factors can create significant variances between projected and actual figures. For fiscal year 2023, the budget deficit swelled to an estimated $1.7 trillion, a figure significantly higher than the CBO's projected $980 billion, pointing to a considerable forecasting error in both receipts and outlays. While no forecast can be entirely accurate, it's noteworthy that the CBO has historically overestimated the deficit about two-thirds of the time, making last year's underestimation atypical. This underestimation necessitated additional financing, which was obtained through the issuance of Treasury bonds. The larger-than-anticipated supply of these bonds played a role in rising bond yields.

Decline in Energy Helps Tame Inflation

The consumer price index (CPI) was up 3.1% from a year ago, which was another decline from 3.2%

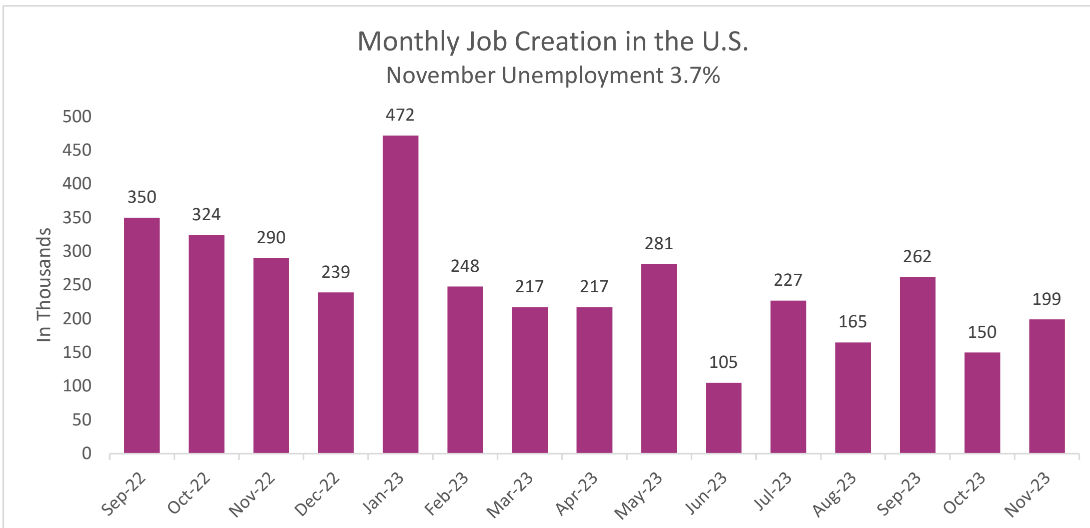


a month earlier. The overall annual rate of inflation has declined sharply since peaking at 9.1% in June of 2022, driven largely by a decline in many of the energy categories.

The Personal Consumption Expenditures (PCE) price index, which is the Federal Reserve's preferred measure of inflation, increased 2.6% year-over-year. When excluding food and energy, often referred to as the "core" PCE price index, there was an increase of 3.2% year-over-year.

Housing Market Trends

The U.S. housing market has seen some interesting trends recently. According to the NAHB/Wells Fargo Housing Market Index, sentiment improved for the first time in five months, rising to 37 in December from 34 in November, which was the lowest in nearly a year. This improvement was driven by a decline in mortgage rates to 6.61% from an earlier peak of 7.8%. This decline sparked interest among potential buyers and raised expectations for future home sales.



Housing starts in the U.S. jumped 14.8% month-over-month to a seasonally adjusted annualized rate of 1.56 million in November 2023, marking the biggest increase in six months. Home sales also saw a slight uptick of 0.8% in November to a seasonally adjusted annualized rate of 3.82 million units. However, the inventory of homes for sale remains low, with high mortgage rates making homeowners reluctant to sell. It is estimated that 75% of all outstanding mortgages have rates of less than 4%, and this limited supply is a major factor driving up home prices across much of the country.

Interestingly, rents for single-family homes are rising more than apartment rents this year, largely due to tenants paying higher prices for homes they increasingly can't afford to buy. The average mortgage payment is now more than 50% higher than the average monthly rent check. The National Association of Realtors Housing Affordability Index (HAI), a widely used measure of home buying affordability, is currently near its lowest level since 1985. This has pushed many potential buyers out of the market. According to the Department of Housing and Urban Development, the number of homeless individuals in the U.S. has reached historic levels, increasing by 12% this year.

Jobs Market Remains Firm

In November, U.S. payrolls saw an increase of 199,000, factoring in a rebound from the auto strike, with only minor adjustments to previous months. This presents a robust image of the labor market, with the unemployment rate dropping to 3.7%, a resurgence in hours worked, and wage growth maintaining a steady rate of 4%. As businesses grapple with cost fatigue and the prospect of a deceleration in demand growth, we might witness strategic resizing decisions. However, considering the challenges to add and retain workers following the pandemic, businesses could be more reluctant than usual to reduce headcount in a slowing economic environment. Even so, less hiring activity could cause the unemployment rate to tick modestly higher in 2024. Already-slowing wage gains should slow further in the context of a softer labor market.

The healthcare sector is experiencing a hiring surge, which is helping to counterbalance weaker job growth in other sectors of the softening U.S. economy. Given the aging population and the impact of COVID-19 leading to widespread worker shortages and increased demand for healthcare services, the industry could serve as a significant job creator for years to come.

Previous Quarterly Market Reviews have underscored the aging trend in the American workforce. According to the 2020 census, the U.S. population aged 65 and over expanded nearly five times faster than the total population over the century from 1920 to 2020. This older demographic reached 55.8 million, accounting for 16.8% of the U.S. population in 2020. In that year, approximately one in six people in the U.S. were aged 65 and over, a significant increase from less than one in twenty in 1920.

This aging of the population signifies a major societal shift globally, as almost every country is witnessing an increase in both the number and proportion of older individuals. This trend has far-reaching implications for various sectors, including labor and financial markets, as well as the demand for goods and services like housing and transportation.

In China, the aging process is occurring at a much faster pace compared to other developing nations. China has the world's largest elderly population, with over 280 million people aged 60 and above. Consequently, businesses that once targeted infants are now shifting their focus toward Chinese seniors. This demographic shift presents both challenges and opportunities for economies worldwide.

U.S. Consumer Spending Insights

Insights from the 3rd quarter GDP reveal a rise in consumer spending. As of Q3, there was a notable uptick in expenditures on both goods and services, culminating in an overall spending surge of 3.1% from the preceding quarter. Durable goods outpaced other categories with a robust increase of 6.7% over Q2. Personal consumption, contributing 2.11% to the GDP, was evenly distributed between goods and services.

For more recent data, the Johnson Redbook Index serves as a reliable source. This index, which measures year-over-year same-store sales growth among a sample of large US general merchandise retailers, represents approximately 9,000 stores. Consistent sampling indicates a higher retail sales volume this holiday season, particularly during the weeks of Thanksgiving and Christmas.

Without a doubt, consumers are facing difficult choices regarding discretionary spending. It's estimated that the average household is spending nearly $1,000 more per month on the same goods and services compared to 2019. Looking ahead, consumer spending in 2024 and 2025 could be impacted by factors such as cost fatigue, escalating debt service obligations, and stricter credit conditions. Notably, despite high interest rates, credit card balances increased 15% year-over-year to set a new record at $995 billion at the end of Q3 2023. The average balance per consumer also increased by double-digits year-over-year, up 11%, to $6,088. This represents the highest average balance per consumer in the last ten years.

Throughout the year, consumer sentiment has been predominantly pessimistic and has shown signs of further weakening. A significant proportion of consumers have consistently given the economy low ratings in various surveys. In May, the University of Michigan's Index of Consumer Sentiment hit a low not seen since the Global Financial Crisis, a period marked by high unemployment, widespread home foreclosures, and substantial wealth loss. While the current situation is not a direct parallel, the prevailing consumer sentiment mirrors the gloom of that period as Americans grapple with the realization that the era of low inflation and low interest rates from the 2010s is unlikely to return. Nevertheless, December marked a significant boost in sentiment, primarily fueled by a more hopeful perspective on declining inflation. Expectations for inflation in the forthcoming year dipped to 3.1% from November's 4.5%, hitting the lowest level since March 2021. Despite this improvement, consumer sentiment remains significantly below the pre-pandemic levels observed in February 2020.

Political Elections And Their Impact On The Markets

Indeed, the impact of an election year on the stock market is a complex issue and is often a topic of extensive analysis. While it's impossible to predict with certainty how this cycle will unfold, we can glean some insights from historical patterns.

Since 1952, the S&P 500 has not experienced a decline in any year when an incumbent president was seeking re-election. Interestingly, in this cycle, both potential candidates are incumbents. There have been instances of stock market declines during presidential election years, but these occurred in years when no incumbent was running (1960, 2000, and 2008). If Republicans nominate Donald Trump, the 2024 election will be the first since 1892 (when Grover Cleveland ran against and ultimately beat Benjamin Harrison) in which a president and a former president face off against each other as major party nominees.

Sitting presidents generally want to be reelected and aren't shy about using all the tools at their disposal to stimulate the economy during election years. History shows that every president who managed to avoid a recession two years prior to their re-election went on to win re-election. Conversely, every president who experienced a recession in the two years before their re-election ended up losing.

The stock market has been favorable overall in 20 of the 24 election years from 1928 to 2020, only showing negative returns four times. The year leading up to an election typically shows lower returns. However, in the 12 months after an election, the market's performance has tended to be stronger than usual, regardless of which party wins.

Key Rates

	12/31/2022	9/30/2023	12/31/2023
2-yr U.S. Treasury	4.37%	5.05%	4.25%
10-yr U.S. Treasury	3.88%	4.58%	3.88%
30-yr Fixed Mortgage Rate	6.42%	7.31%	6.61%
Fed Funds Target Rate (upper)	4.50%	5.50%	5.50%
U.S. Dollar Index	103.49	106.17	101.38
Crude Oil	$80.51	$90.77	$71.33
Gold	$1,830	$1,864	$2,072
Unemployment Rate	3.50%	3.80%	3.70%*

*As of November 2023 | Source: *The Wall Street Journal*

Global Growth Expected To Slow

The International Monetary Fund (IMF) predicts that the global economy will grow by 3.0% in 2023 and 2.9% in 2024, following a growth of 3.5% in 2022. This forecast is notably lower than the historical average of 3.8%, primarily due to the effects of higher interest rates and inflation.

For advanced economies, growth is expected to decelerate from 2.6% in 2022 to 1.5% in 2023 and further to 1.4% in 2024 as the impacts of tighter monetary policy start to manifest. The U.S., according to the IMF, is projected to see growth of 2.1% in 2023, which is expected to decrease to 1.5% in 2024. This outlook is slightly more optimistic than previous forecasts.

Emerging economies, including China, India, Russia, Brazil, Saudi Arabia, and others, are forecasted to grow by 4.0% in both 2023 and 2024. China and India are expected to lead this growth, with average growth rates for the two years projected at 4.6% and 6.3%, respectively. However, the drivers of growth differ between these two nations: population growth is the main driver in India, while productivity growth is the key factor in China, leading to increases in GDP per capita.

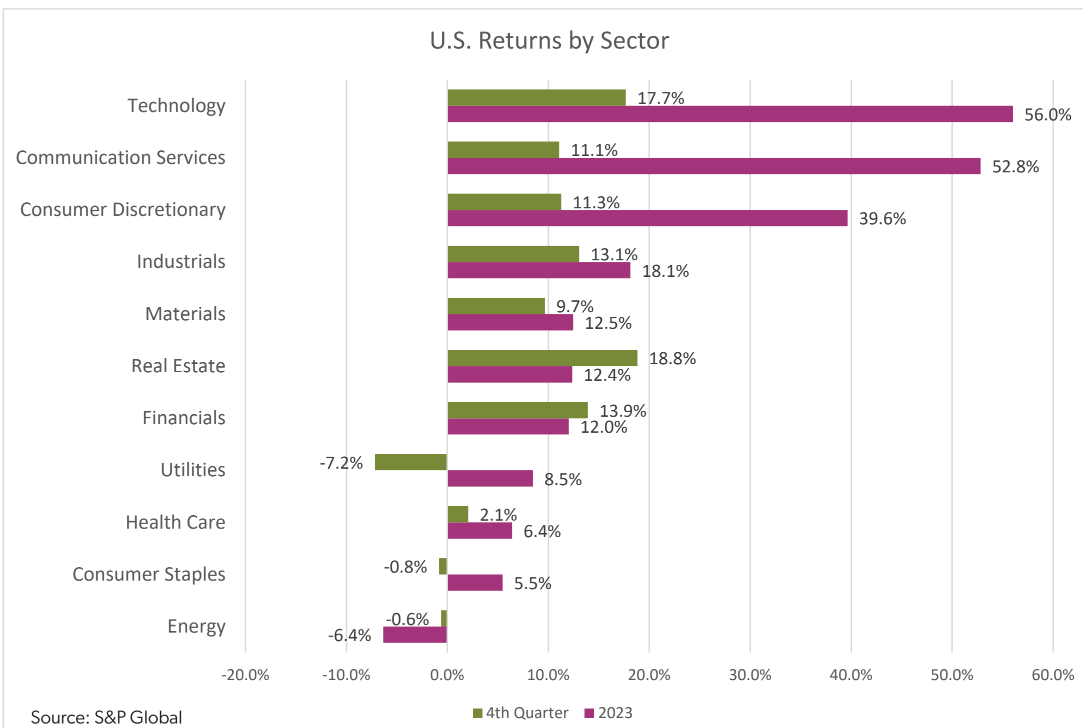
Global inflation is forecasted to decline steadily, from 8.7% in 2022 to 6.9% in 2023 and further to 5.8% in 2024. Core inflation is generally projected to decline more gradually, and most cases are not expected to return to target levels until 2025.

Market Commentary

The S&P 500 is riding a nine-week winning streak to finish the year. Just as the third quarter is historically rough for the markets, the fourth quarter has historically been the best for the U.S. stock market, with the S&P 500 Index up nearly 80% of the time dating back to 1950. With a total return of 11.69%, the S&P 500 posted its best quarter since the second quarter of 2020. The index rose in 40 of 63 sessions in the final quarter, including nine days with gains greater than 1%. Finishing the year on the brink of an all-time high, the S&P 500 total return was 26.29% for the year. The Russell 2000 Index posted a huge quarter, up 14%, bringing the total for the year to 16.93%. The tech-heavy Nasdaq had one of its best years since 2003, posting a return of 44.64%.

In 2023, developed international markets showed resilience, as reflected in the MCSI EAFE index, which returned +18.24%. In contrast to the preceding two years, currency fluctuations played a minimal role in influencing returns. The U.S. dollar, having peaked at its highest level in two decades in 2022 due to the Federal Reserve's assertive tightening measures, began to reverse its trajectory. This shift bolstered non-U.S. equities. Meanwhile, emerging markets also demonstrated positive performance, achieving a commendable return of 9.83% for the year.

By December 19, 2023, the S&P 500 fully recovered to the price level last seen on December 31, 2021, a round trip of 492 trading days that saw a trough of -25%. As of year-end, including dividends, the cumulative total return since the start of the bear market is 3.15%. As of year-end, the MSCI EAFE Developed International Index has fully recovered from the bear market, and the Russell 2000 Index is within 5%. The Nasdaq made a dramatic round trip that included a decline of 35% to close this year 6.5% below the record high in November 2021.

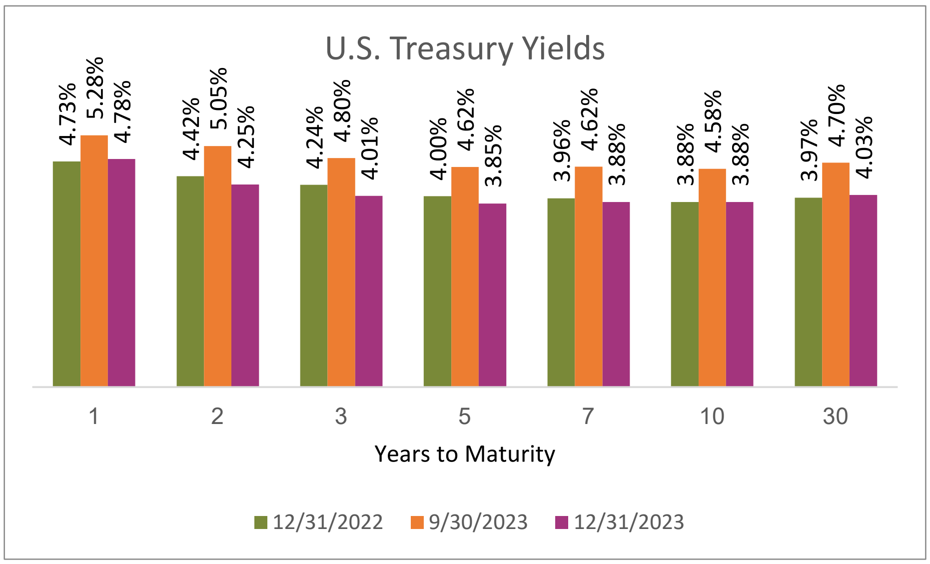


Source: S&P Global

No 2023 market recap would be complete without mention of the "Magnificent Seven," which includes Alphabet, Amazon, Apple, Microsoft, Meta Platforms, Nvidia, and Tesla. These seven stocks, which account for 28% of the S&P 500, generated a significant portion of the Nasdaq and S&P 500 Index returns in 2023. This group contributed 15.5% of the S&P 500 gain in 2023, while the other 493 stocks added just 10.8%. Excitement over the business potential from emerging artificial intelligence technology helped propel some of the mega-caps, including Nvidia and Microsoft, which climbed 240% and 58%, respectively. Another factor is profitability: the Magnificent Seven are expected to post a 39.5% aggregate earnings increase in 2023 against a 2.6% decline for the rest of the S&P 500. Their earnings growth is expected to outperform again in 2024, albeit to a lesser extent. One of the other persistent themes of 2023 was underperformance from the market's traditional defensive corners and yield proxies … energy, utilities, consumer staples, healthcare, and REITs.

Corporate profits in the United States rose by 3.7% from the previous period in the third quarter of 2023. Undistributed profits soared by 15.3%, and net cash flow with inventory valuation adjustment rose by 4.4%.

U.S. Treasury yields fell in the quarter as investors considered the outlook for monetary policy and financial markets for the coming year. Many investors have interpreted recent economic data, including the November U.S. personal consumption expenditure price index, as a sign that the Federal Reserve would adhere to its monetary policy expectations for next year. After peaking at just over 5% in October, a rate not seen since July of 2007, the 10-year Treasury note yield retrenched to close the year at 3.88%. This 116 basis point decline in yields drove a positive return for the Bloomberg Aggregate index of 6.82% for the quarter and 5.53% for the year. The short end of the curve also saw a significant move, with the 2-year falling from a peak of 5.29% on October 4 to close at 4.25% on the final trading day of 2023 – a 104 basis point decline. The Bloomberg 1-5 year U.S. Treasury index notched a 3.21% return for the 4th quarter and was up 4.37% for the year.



The 60/40 portfolio, which traditionally consists of 60% stocks and 40% bonds, has been a topic of debate among financial experts, especially given the market dynamics in recent years. This narrative has shifted as bonds offer more attractive income-generating potential than at any time in recent memory. The 10-year US Treasury note, which now yields 3.88%, averaged a yield of only 2% in the ten years ending in 2021. And, with inflation trending lower, bonds once again offer a positive inflation-adjusted, "real" return.

What Lies Ahead

The possibility of the U.S. economy entering a recession in the next 12 months remains elevated. While a continued deceleration in economic growth seems almost certain, a recession is not a foregone conclusion. More than three-fourths of economists — 76% — said they believe the chances of a recession in the next 12 months is 50% or less, according to a December survey from the National Association for Business Economics. After tracking a better-than-expected real growth rate north of 2.5% in 2023, the consensus view is for weaker, below-trend results in 2024. Consumer spending is likely to rise at a more tepid pace next year, while fiscal spending could swing from a positive contributor in 2023 to a modest drag. Notable drops in business investment and housing activity in 2023 set the foundation for improved performance in 2024, even if the outlook remains muted amid higher interest rates; 2023 strength in the services sector is likely to soften.

Index Total Return	**2022**	**4Q 2023**	**2023**
S&P 500 Index	-18.11%	11.69%	26.29%
Russell 2000	-20.44%	14.03%	16.93%
Russell 3000 Index	-19.59%	11.94%	25.36%
MSCI EAFE Index	-14.45%	10.42%	18.24%
MSCI ACWI (Global Index)	-18.44%	11.13%	21.46%
MSCI Emerging Markets Index	-20.09%	7.86%	9.83%
Bloomberg U.S. Aggregate Bond	-13.01%	6.82%	5.53%
Bloomberg U.S. Treasury 1-3 Year	-3.82%	2.56%	4.29%
Bloomberg U.S. Treasury 5-7 Year	-11.23%	5.44%	4.53%
Bloomberg Municipal Index	-8.53%	7.89%	6.40%

Source: Morningstar Direct

'Tis the season when market strategists engage in the age-old tradition of projecting the financial landscape for the upcoming year. Yet, the task of predicting capital market returns entails navigating a complex maze of variables — economic growth, inflation, investor sentiment, and geopolitical factors, to name just a few. Achieving the precision required for a credible one-year forecast in

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this intricate web of variables remains a challenging endeavor; as Yogi Berra wittily remarked, "It is difficult to make predictions, especially about the future." However, amidst this inherent uncertainty, we hold firm to the belief that projecting longer-term returns can be approached with a heightened level of accuracy. As we embark on the strategic journey of positioning portfolios for the new year, our focal point shifts to the foundation of our Ten-Year Capital Market Assumptions. Rooted in quantitative forecasts, these assumptions offer a rational outlook on risks and returns across major asset classes for the next decade. Beyond mere prognostications, these forecasts serve as a cornerstone for critical portfolio management decisions. For deeper insights into our 2024 Ten-Year Capital Market Assumptions, stay tuned for their formal release to clients this January.

As we bid farewell to 2023 and welcome the New Year, we want to express our heartfelt gratitude for your continued trust and support. The past year has been filled with unique challenges and opportunities for investors and for businesses. Through it all, we've strived to provide you with the best advice possible, and we're committed to doing so in the future. As we step into 2024, we look forward to a year of continued collaboration and prosperity for our clients. Our commitment is to deliver exceptional service that empowers you to fulfill your aspirations. May the New Year bring you happiness, health, and success in all your ventures.

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