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INVESTMENTS & FIDUCIARY SERVICES

QUARTERLY MARKET INSIGHTS

3RD QUARTER 2023

MIDDLE EAST CONFLICT

– The desire of Hamas and Iran to derail normalization of Saudi-Israel relations is seen as a primary strategic goal of the October 7 attacks.

– An escalation of the conflict that leads to a direct confrontation between Israel and Iran is the biggest long-term market and policy risk.

– Although this is the worst flareup of Israeli-Palestinian violence in 50 years, most geopolitical shocks create long-term market opportunities.

On October 7, the Gaza-based Islamist terrorist group Hamas launched a series of brutal, coordinated, surprise attacks on civilian communal villages and military bases across western Israel. Unarmed civilians, along with Israeli soldiers were taken hostage to the Gaza strip. In the wake of the attacks, Israel immediately declared war on Hamas and launched missile strikes against a wide range of targets in Gaza. The Israeli Defense Forces (IDF) called up 360,000 reservists from around the world and announced preparations for a ground invasion of Gaza.

Over the weekend of October 14-15, U.S. Defense Secretary Lloyd Austin directed the USS Dwight D. Eisenhower Carrier Strike Group to join the USS Gerald R. Ford Carrier Strike Group in the Eastern Mediterranean. The Pentagon's dispatch of two aircraft carrier groups to the region is widely viewed as an attempt to dissuade Iran-backed Hezbollah militias based in Lebanon from entering the fray in Gaza. On October 18, President Biden visited Israel to express U.S. support. He later called on Congress to approve a $100 billion spending package combining military aid to Israel and Ukraine, along with humanitarian assistance to Gaza and funds to bolster U.S. border security. Congress, however, has been temporarily paralyzed since the October 3 ouster of former House Speaker Kevin McCarthy. On October 19, the USS Carney, a Navy destroyer in the Red Sea, intercepted several cruise missiles and drones heading toward Israel believed to have been launched by Houthi rebels (another armed Islamist political organization supported by Iran) in Yemen. As of October 23 (more than two weeks after the initial Hamas attacks), Israel has not yet initiated a ground invasion of Gaza amid diplomatic negotiations to free hostages held by Hamas.

Many commentators have pointed to the desire of Hamas and Iran to derail the U.S.-led discussions to normalize relations between Saudi Arabia and Israel as a primary strategic rationale of the October 7 attacks. A multi-year thawing of tensions between Israel and Saudi Arabia had materialized due to the two nations' mutual hostility toward Iran and shared fears that a nuclear-armed Tehran could dominate the Middle East.

The two biggest market-relevant variables of the current conflict appear to be 1) Will U.S. and Israeli intelligence determine that Iran either planned or assisted in the Hamas attacks? and 2) Will Hezbollah, widely viewed as the foremost proxy of Iran's Islamic Revolutionary Guard Corps based in Lebanon, join the fight against Israel in what will likely be at least a targeted IDF ground invasion of northern Gaza?

Although the Iranian government celebrated the Hamas attack, it denied direct involvement. Both U.S. and Israeli officials indicated they have no clear evidence thus far that Tehran played an active role in the assault. The Biden administration's biggest strategic objective is likely to dissuade Israel from attacking Iran. The opening of a two-front war via engagement with Hezbollah in the north could be a particularly daunting challenge for the IDF. The Shiite militia group is much better equipped and more well-organized than Hamas. It is believed to possess an arsenal of more than 100,000 missiles and rockets, some of which are likely capable of reaching Tel Aviv in central Israel.

There has been a relatively muted reaction to the conflict across investment markets. In the days following the initial Hamas attacks, we saw higher oil prices, lower stock prices, lower bond yields, and a stronger U.S. dollar, which is the typical near-term playbook during past Middle East conflicts. These market moves stabilized, however, by the third week of October as other factors not related to the war have reasserted their influence. Defense and energy stocks caught a bid, but their gains have thus far been less dramatic than in the days surrounding Russia's invasion of Ukraine in early 2022.

> "THE OPENING OF A TWO-FRONT WAR VIA ENGAGEMENT WITH HEZBOLLAH IN THE NORTH COULD BE A PARTICULARLY DAUNTING CHALLENGE FOR THE IDF."

An escalation of the conflict that results in a direct confrontation between Israel and Iran, spurs higher oil prices, and leads to stickier inflation in the U.S. is probably the most significant longer term policy risk. As such, global oil prices are probably one of the most useful real-time barometers of the probability market actors place on the current hostilities escalating into a wider regional conflict that potentially includes Iran. In general, however, most geopolitical shocks have historically been buying opportunities for equity investors. Should this prove to be a short-term flare up that doesn't significantly escalate, near-term volatility could be followed by long-term opportunity.

SUMMER CROSSWINDS

EXECUTIVE SUMMARY

- The back up in U.S. Treasury yields has dented sentiment.
- "Higher for Longer" is the Fed's mantra (for now).
- Treasury supply and growing budget deficits are concerns.
- 3Q earnings and guidance might be an inflection point.

The third quarter was defined by a set of market, economic, and policy mixed signals that likely left many investors searching for answers. The Federal Reserve has raised its policy rate by 5.25% in 18 months, yet there have not been any major cracks in the labor market or consumer spending. Inflation has cooled substantially but long-term U.S. Treasury yields have moved sharply higher. Home prices in the U.S. have not fallen off a cliff despite the average rate on a 30-year fixed-rate mortgage eclipsing 7.5%. U.S. gross domestic product (GDP) growth in 2024 is expected to be around 1%, however, S&P 500 earnings per share are projected to grow 10% next year.

JULY HIGHS

July got off to a strong start following the first pause in the current Fed rate hike cycle on June 14. Consumer price index (CPI) data for June released July 12 that showed year-over-year headline U.S. inflation fell to 3.0%, the lowest reading since March 2021. Meanwhile, the domestic labor market and wage gains continued to expand at a pace indicative of a cooling but not a deteriorating hiring environment. This provided air cover for the Federal Open Market Committee (FOMC) to deliver a widely expected 0.25% rate hike on July 26 (which took the policy rate to a range of 5.25%-5.50%) and signal a willingness to forego additional rate increases in September and November. Finally, second quarter U.S. corporate earnings season was better than feared, boosted by resilient profits and upbeat guidance from many of the most prominent mega cap premium growth stocks.

LATE SUMMER CAUTION

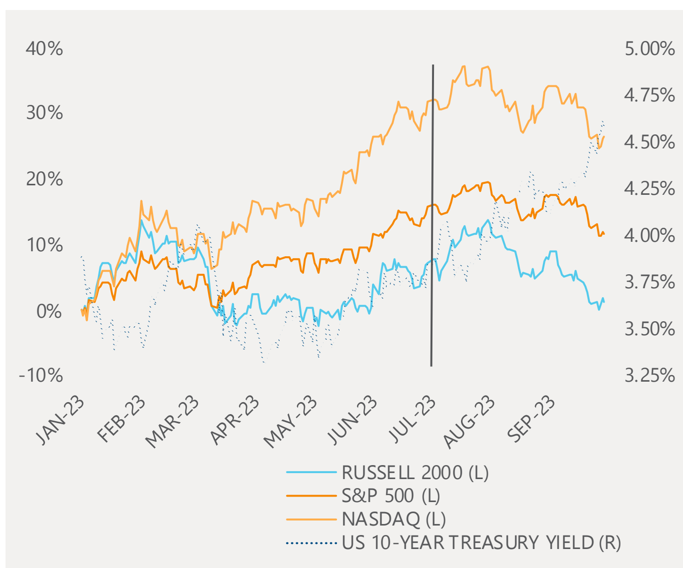
The background music shifted in August and September, however, as higher U.S. Treasury yields, weak economic data out of China, and a roughly 30% increase in crude oil prices from mid-June lows slowed the equity market rally. After gaining 3.2% in July to reach a 15-month closing high of 4,588.96 on July 31, the S&P 500 Index retreated 6.3% in the final two months of the third quarter. As seen in Chart 1, the small cap Russell 2000's even steeper 10.6% decline during the August-September stretch suggested investors were skeptical about a potential reacceleration in U.S. economic growth at this stage in the monetary policy and economic cycles. Signaling by Fed officials that their benchmark rate would remain near 5% until the end of 2024 at the September 19-20 FOMC meeting seemed to reinforce the "yields up, stocks down" market action that had been in place since early August. In the first half of October, the ouster of speaker of the U.S. House of Representatives Kevin McCarthy and the outbreak of war between Israel and Gaza-based terrorist group Hamas introduced additional risks which markets will need to price. Potential market pitfalls notwithstanding, investors should remember that the mid-August through mid-October period has historically been a weak stretch for stock market returns, with 5% to 10% broad market corrections commonplace.

HIGHER FOR LONGER

The rapid rise in longer term U.S. Treasury yields was perhaps the most prominent market storyline in the third quarter. The yield on the 10-year U.S. Treasury note climbed from 3.83% on June 30 to

CHART 1

HIGHER BOND YIELDS PRESSURED STOCKS IN 3Q

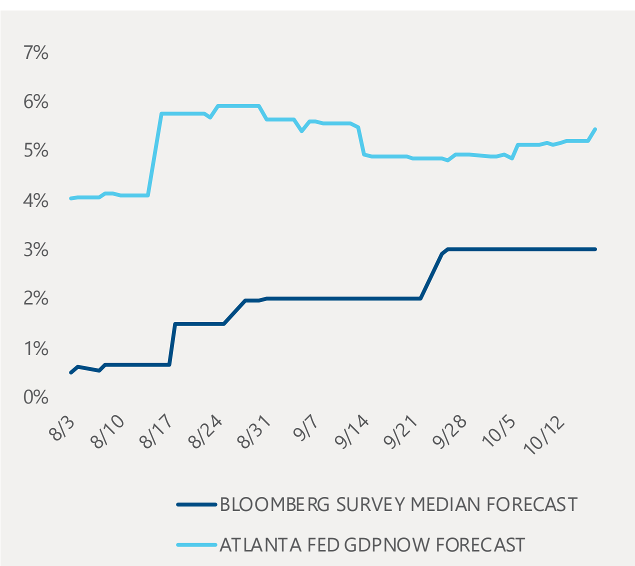


Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results. The vertical line denotes the beginning of the third quarter.

4.57% on September 30, approaching levels not seen since 2008. The shorter end of the Treasury curve was much more restrained, however, as yields on the 2-year maturity rose from 4.86% to 5.04% in the quarter. Smaller increases in shorter maturity yields likely suggest market participants expect the Federal Reserve to be nearing the end of its rate hike cycle. At the same time, larger increases in longer term yields could indicate markets have begun to embrace the Fed's "higher for longer" rhetoric, in which neither additional rate hikes nor rate cuts are likely to materialize in coming quarters. This was generally the market's reaction to the Federal Open Market Committee's (FOMC) "hawkish hold" coming out of its September 19-20 meeting as market-based expectations for this cycle's initial rate cut were pushed further back into the second half of 2024. Notably, several Fed officials in recent weeks have suggested the sharp increases in longer term bond yields may have served as an incremental 0.25% rate hike due to additional tightening in financial conditions they brought forth. Changes in longer term yields typically have a more significant impact on the real economy in part because they are often used as reference rates for mortgages, auto financing, and corporate debt issuance.

CHART 2

THIRD QUARTER U.S. GDP GROWTH FORECASTS



Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results.

WHAT RECESSION?

Economic data in recent weeks seems to have mostly vindicated the Fed's "higher for longer" stance, headlined by stronger-than-expected September payroll gains of 336,000 (plus net upward revisions of 119,000 in July and August). Increases in the consumer price index (CPI) and producer price index (PPI) during September were slightly ahead of estimates, suggesting the disinflationary trend of the last three or four quarters may be running out of steam. Finally, retail sales in September climbed 0.7%, ahead of all estimates in a Bloomberg survey. August retail sales were also upwardly revised to 0.8% from 0.6%. Despite pockets of weakness (industrial activity survey data, small business conditions and hiring survey data, office property woes, and challenges faced by many apparel and discount retailers), the overall economic picture appears to be one of surprising resilience in the face of higher interest rates. As shown on Chart 2, the median estimate in a running Bloomberg survey of economists for third quarter U.S. gross domestic product (GDP) growth rose from 0.5% in early August to 3% by the last week of September. Also shown in Chart 2 is the Atlanta Fed's GDPNow model, which has projected since mid-August the U.S. economy will grow at a 4.8% clip or better in the third quarter. The GDPNow figure is not the official forecast of the Atlanta Fed, but rather uses contemporaneous economic data to estimate the current quarter's GDP growth prior to its release. The initial estimate of third quarter U.S. GDP will be released Thursday, October 26.

REAL YIELDS

Importantly, market-based measures of inflation expectations have not been a meaningful driver of the recent backup in Treasury yields as the 2-year, 5-year, and 10-year TIPS breakevens have all stayed below 2.5% for the last seven months. Thus, it has been the "real" or inflation-adjusted component of Treasury yields that has done all the heavy lifting to the upside over the last several months. Real yields matter because interest rates are generally not considered restrictive until they are above the rate of inflation. As Chart 3 depicts, real U.S. 10-year Treasury yields broke above 2% in September for the first time since 2009. Although this sharp rise in long-term real yields represents tighter financial conditions, it should be noted that they have only been above 1% for about 12 months.

Some observers have pointed to stronger-than-expected underlying momentum in the U.S. economy as the primary driver of the upward reset in real rates. These folks tell a story of an uncomfortable, yet necessary re-normalization in market interest rates after 15 years of an artificially low cost of capital ushered in by the global financial crisis. Over the long run, the optimists view this as a positive development because a higher cost of financing might cleanse the system of unworthy borrowers with subpar business models that were kept afloat for years due to historically cheap financing. In our view, expectations of stronger growth in the U.S. probably explain a portion of the increase in inflation-adjusted Treasury yields, but not all of it. The other, perhaps more important, drivers of the backup in real yields are likely related to increased Treasury issuance, lower levels of demand from price-insensitive buyers, and creeping concerns about growing U.S. budget deficits.

SUPPLY-DEMAND SHIFTS

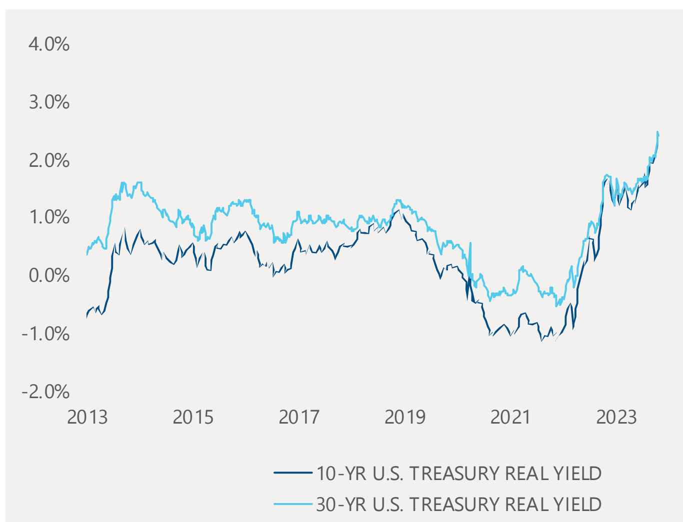
Last quarter, we wrote that lower levels of liquidity in the financial system could pose a challenge for further stock market gains as the U.S. Treasury ramped up its debt issuance to refill its General Account (TGA). The theory held that excess money in the system that otherwise would have been allocated to risk assets like stocks would be soaked up by an acceleration in issuance of new Treasury bills, notes, and bonds as the Treasury played catch up for the eight months (October through May) in which the prior debt ceiling prohibited an increase in federal borrowing. Reduced liquidity driven by more Treasury supply could have been a factor in the moderate third quarter losses of U.S. and international stocks. But it was the ramp up in federal debt issuance and coincident sharp increases in U.S. Treasury yields during the quarter that was the front-page headline. And so, perhaps the most evident market impact of a reversal in liquidity in the third quarter brought forth by heavy Treasury issuance was not lower stock prices but markedly higher yields on long-term government debt.

It may be useful here to think through some of the moving parts in what appears to be the shifting supply-demand dynamics of the U.S. Treasury market. On the supply side of the ledger, in recent months, there has been a noticeable acceleration in longer-maturity coupon issuance (as opposed to shorter-maturity bill issuance that occurred immediately following the debt ceiling extension in late May). The Treasury Department has likely prioritized issuance of longer-dated debt due to a lower cost of financing in an inverted yield curve environment. Put differently, the federal government probably prefers to borrow at 4% or 4.5% for ten years over having to repeatedly borrow at an annualized rate of 5.25% or 5.5% every three months. This would especially be the case if Treasury Secretary Janet Yellen and her colleagues believed the Federal Reserve might keep its policy rate near 5.5% for the foreseeable future.

On the demand side of the Treasury market, several price-insensitive buyers have stepped to the sidelines over the last 18 months. First, the Federal Reserve's balance sheet reduction (also known as quantitative tightening) has been humming along in the background at a monthly clip of about $100 billion, whereby the proceeds of maturing U.S. government bonds held by the Fed are not reinvested in new bonds. Additionally, commercial banks have almost certainly dialed back their purchases of longer-maturity Treasury securities in response to the balance sheet challenges and increased regulatory scrutiny coming out of this spring's regional banking sector turmoil. Finally, foreign central banks have probably been less eager to buy U.S. government debt over the last year-and-a-half for at least two reasons 1) a desire by central bankers in nations outside of the core set of U.S. allies to diversify their foreign reserve's away from the dollar following the implementation of rigid sanctions against Russia in 2022 and 2) periods of substantial dollar strength (like we saw in 2022 and again in the third quarter) causing foreign central banks to use dollar reserves to support their own currencies rather than purchase U.S. Treasuries. In July, the Bank of Japan (BOJ) raised the allowable ceiling of yields on Japanese government bonds to the highest level in nearly ten years. This has led to speculation that a considerable amount of Japanese money currently parked in U.S. Treasuries could be in the process of being repatriated to take advantage of higher yields in Japan. Ultimately, what we are likely seeing is a largescale reshuffling of the buyers and the sellers in the Treasury market. The

CHART 3

LONG-TERM U.S. TREASURY REAL YIELDS



Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results. The real, or inflation-adjusted, yield on a Treasury bond is determined by subtracting the yield on Treasury Inflation Protected Security from a traditional Treasury security with the same maturity.

Fed and many other central banks used to be enthusiastic, price-agnostic buyers, but are now net sellers. Meanwhile, individual U.S. investors, mutual funds, and hedge funds have become a larger portion of Treasury buyers. Crucially, this group may demand higher interest rates to compensate for risks ranging from elevated inflation to a growing gap between lower tax revenue and higher government spending.

FISCAL MATTERS

For a growing number of market actors, the fiscal policy component of the recent supply-demand imbalance in the U.S. Treasury market is where the rubber meets the road. As noted earlier, the Treasury Department's quarterly refunding in August included a significant increase in "coupon" issuance, which are securities with maturities greater than one year that make periodic coupon, or interest, payments. Treasury bills (or T-bills) are securities with maturities of less than one year that are issued at a discount to par and do not make periodic interest payments. Historically, larger amounts of T-bill issuance have been related to the federal government's short-term funding needs, while heavier coupon issuance was associated with longer-term spending. Some bond market participants appear to view the recent shift toward coupon issuance as the beginning of a trend driven by the Treasury's need to fund widening fiscal deficits. As seen in Chart 4, the U.S. federal budget deficit has risen to between 7% and 8% of GDP, an extraordinarily high level for an economy with an unemployment rate well below 5%. Federal spending has been increasing for decades but the pace has accelerated in recent years as massive legacy programs remain in place and new programs (March 2021 American Rescue Plan, November 2021 Infrastructure and Jobs Act, August 2022 Inflation Reduction Act) have been allocated. Meanwhile, federal tax revenues are expected to drop by roughly 10% in fiscal year 2023 largely due to a sizable decline in capital gains tax receipts. The non-partisan Congressional Budget Office estimates the federal budget deficit will be $1.7 trillion in fiscal year 2023, up from $1.0 trillion last year. The deficit is projected to be near $2 trillion in fiscal year 2024 as the rising interest expense on recently issued Treasury debt is likely to offset any reductions in other government spending programs.

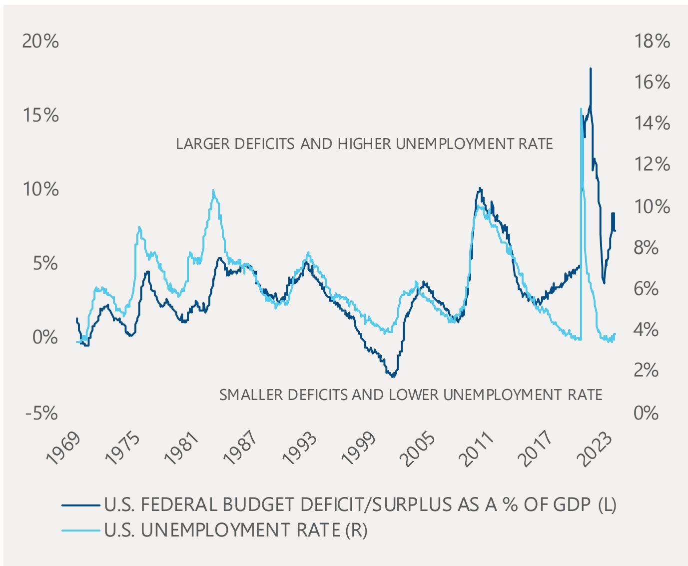
WHAT'S HOLDING UP THE U.S. ECONOMY?

The fiscal largesse of recent years is probably at least partly responsible for the surprising resiliency of the domestic economy in 2023. Except for those in the bottom 20% of the income scale, many Americans still have excess savings built up over the 12-month period bookended by the $3.4 trillion of relief funds allocated by the CARES Act and Response & Relief March 2020 and the $1.8 trillion American Relief Plan of March 2021. This spring and summer we saw a wave of spending on travel, concerts, movies, and other "experiential" categories that many Americans were likely to have fully or partially deferred over the last three years due to the pandemic. Because many homeowners in America locked up sub-4% mortgage rates for 15-year or 30-year fixed terms in 2020 and 2021, the transmission of sharply higher interest rates to the U.S. consumer is arguably more delayed than in previous cycles. The market for existing homes could probably be better described as "frozen" rather than "broken" or facing imminent pressure as was the case in the years leading up to the housing bust and global financial crisis of 2008-2009. Meanwhile, cooling inflation and steady wage gains have resulted in American workers enjoying positive real wages beginning in May for the first time since March 2021 (see Chart 5).

Several prominent risks that could cause a pullback in U.S. consumer spending and overall economic momentum in coming quarters include the end of student loan forbearance programs, higher gasoline prices in the wake of conflict in the Middle East, and the persistence of sharply higher financing rates for mortgages, and other big-ticket items like cars and household appliances. But

CHART 4

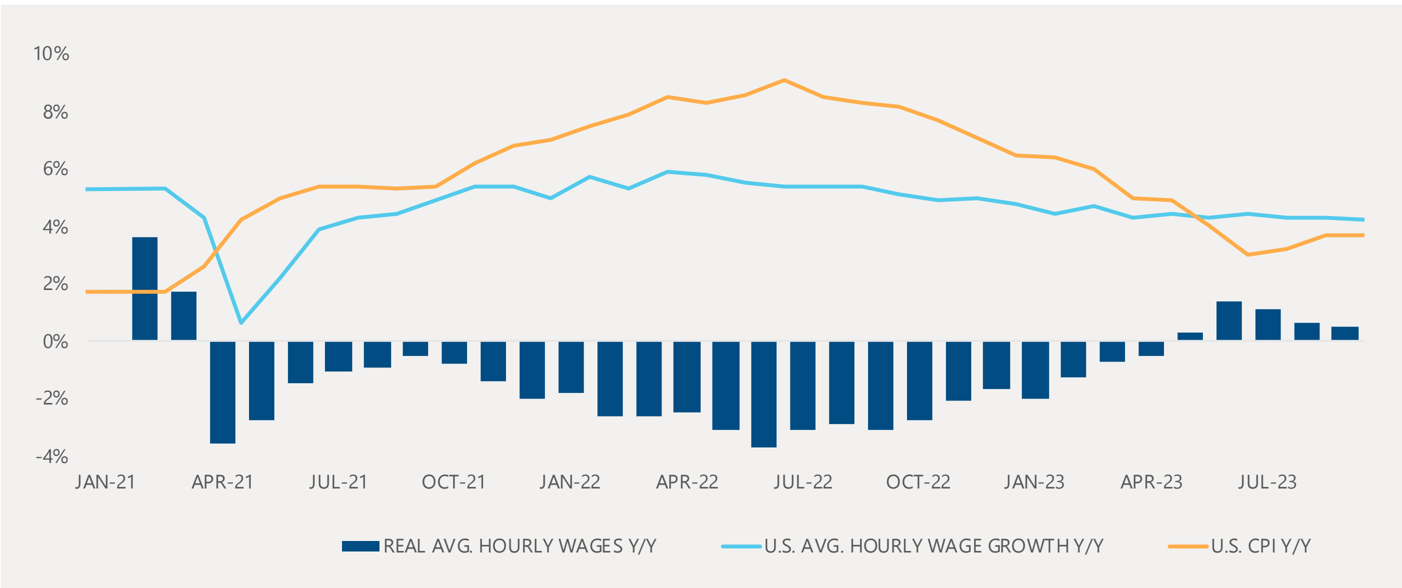
U.S BUDGET DEFICIT AND UNEMPLOYMENT RATE



Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results.

CHART 5

REAL AVERAGE HOURLY WAGES IN THE U.S.



Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results. Real wages are calculated by subtracting the year-over-year change in the consumer price index (CPI) from the year-over-year change in average hourly wages.

perhaps the biggest risk is that incremental fiscal support will likely fade as increased federal spending in 2024 seems unlikely given the growing budget deficit, higher borrowing costs, and the fracture of House Republicans that culminated in the October 3 ouster of Kevin McCarthy as speaker. Additionally, the widely held view that excessive fiscal stimulus played at least some role in fueling the inflation spike of 2021-2022 could constrain both the administration and Congress from pursuing more deficit spending.

PIVOTAL THIRD QUARTER EARNINGS SEASON

The internal workings of the U.S. stock market in the third quarter provided ammunition for those with both optimistic and pessimistic views on the trajectory of the domestic economy. The former might point to a better-than-feared second quarter S&P 500 earnings season boosted by solid-to-strong revenue, profit, and margin trends from many of the “Magnificent 7” mega cap premium growth stocks. This was most visible in rebounding digital advertising sales, stabilizing enterprise cloud revenue, and white-hot demand for semiconductors that support the processing of artificial intelligence-driven large language models. The underperformance of traditionally defensive S&P 500 utilities (-9.3%) and consumer staples (-6.0%) sectors in the third quarter compared to the broad index’s 3.3% decline could also be offered as evidence that a recession is probably not right around the corner.

Skeptics would argue that even with the Magnificent 7, S&P 500 adjusted earnings per share (EPS) still declined 6% in the second quarter compared to a year ago. Moreover, key cyclical areas of the stock market continue to trade poorly, including most banks, consumer finance firms, and many transportation-related companies. In contrast to apparent broad retail spending strength, second quarter results and management commentary from a group of U.S. retailers in July and August (Target, Dollar General, Dick’s Sporting Goods, Foot Locker) pointed to pockets of weak demand and continued challenges with organized theft, or “shrinkage.” Finally, the S&P 500 Equal-Weighted index (-4.9%) trailed the market capitalization-weighted version (-3.3%), extending its substantial year-to-date underperformance (+1.8% vs. +13.1%). This type of narrow market leadership is typically characteristic of late cycle environments, whereas stronger equity market breadth (i.e., a higher percentage of stocks participating in a rising stock market) often heralds more durable gains.

Given the wide range of sentiment heading into the end of the year, third quarter earnings season is viewed by many investors as an inflection point. This is because it could mark the end of a so-called earnings recession, which saw year-over-year S&P 500 adjusted EPS contract between 2% and 6% for three straight quarters. Currently, third quarter index-level profits are expected to be near flat compared to a year ago, but up 7% excluding the energy sector. As shown in Chart 6, index-level EPS expectations for 2023 have declined about 10% from a peak of $248 last April to $222 in recent weeks. This implies essentially zero profit growth in 2023 is currently baked into expectations. It should be noted, however, that this is a far better outcome than the 10%-20% profit contraction in 2023 that many of the most bearish strategists were predicting toward the end of last year. S&P 500 adjusted EPS growth is expected to resume at a clip of about 10% in 2024 led by the technology, communication services, and consumer discretionary sectors. This seems a bit ambitious to us given our expectation for an economic slowdown at some point over the next 12 months. Of course, double-digit profit growth next year could be driven by workforce reductions and other cost cutting. But an increase in layoffs probably would not be a good recipe for avoiding an economic downturn.

OUTLOOK AND POSITIONING

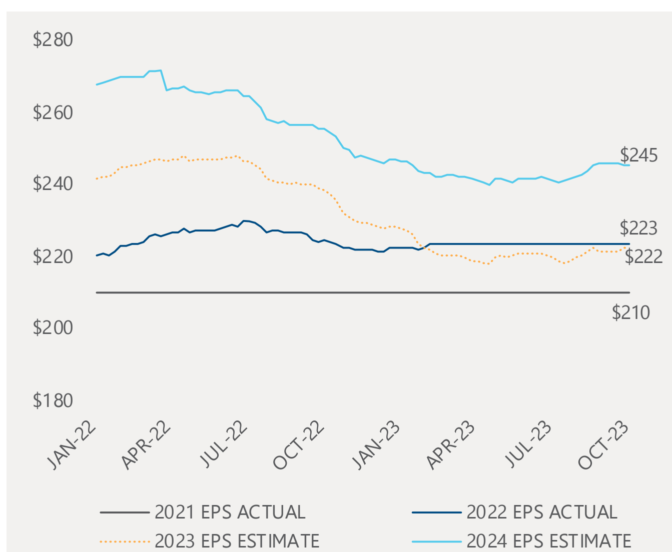
We recommend client portfolios adopt a neutral equity and credit stance and be ready to consider reducing risk in coming months if 1) markets begin to price unrealistically optimistic scenarios or 2) if substantial cracks begin to develop in the labor market or consumer spending. Although recession calls for 2023 have proven premature, we are not yet convinced the coast is clear for the U.S. economy to avoid a period of contracting growth next year. At between 18 and 19-times expected EPS over the next 12 months, the S&P 500 is moderately expensive compared to its long-term history. But it is even more expensive if one looks at periods in which U.S. Treasury yields were near 5% across the maturity spectrum. As mentioned earlier, consensus expectations for S&P 500 profits to grow 10% in 2024 are likely to end up being too optimistic.

Although we do not expect an imminent sharp contraction of the U.S. economy, the lagged impact of Fed rate hikes, and tighter bank lending standards are likely to constrain consumer spending and labor market growth in 2024. Additionally, sharp upward moves in long-term bond yields and crude oil prices over the last two months have tightened financial conditions. The recent outbreak of war between Israel and the Iran-backed terrorist group Hamas has created a risk that West Texas Intermediate (WTI) crude oil prices stay near $90 per barrel in coming months. Higher oil prices feeding into gasoline and diesel costs could lead to a reacceleration of U.S. inflation and potentially weigh on consumer sentiment heading into the holiday season.

Portfolios should be increasingly focused on quality in equity and fixed income sleeves. In equity allocations, the healthcare sector provides an attractive balance of near-term cash flow visibility, reasonable valuations, and relatively healthy balance sheets. Certain industries and companies in the cyclical energy, materials, and industrials sectors are interesting given the exposure they provide to important secular themes including automation, supply chain reshoring, data center buildouts, and energy grid expansion. Investors should prepare a shopping list of premium growth stocks across sectors with lofty valuations but strong secular opportunities in the event better entry prices materialize over the next 6 to 12 months. Although the sharp back up in bond yields in the third quarter has been painful, portfolios with longer-term time horizons should consider extending duration with yields on the U.S. 10-year Treasury note approaching 5% and additional rate hikes looking increasingly unlikely. Fed officials will likely keep their policy rate near 5.5% into the first half of 2024 without causing pain in the labor market. But this “no landing” scenario could begin to look shaky at some point next year as the economic and credit cycles take their natural course.

CHART 6

S&P 500 EPS (ACTUAL AND ESTIMATED) 2021-2024



Source: Bloomberg. Data as of 9/30/23. Past performance does not guarantee future results.

ECONOMIC OUTLOOK AND INVESTMENT POLICY

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	Consensus expectations for U.S. economic growth in 2H23 have increased substantially in recent months, boosted by strong consumer spending this summer.
Federal Funds Rate	As of October 20, fed funds futures markets are pricing in about 40% odds of one additional 0.25% Fed rate hike between early November and late January.
Inflation	For the last six months, TIPS breakeven rates have implied investors expect inflation to average about 2% over the ensuing two years, right in line with the Fed's target.
Employment	Stable continuing weekly jobless claims and only slight declines in temporary hiring suggest major cracks have yet to form in the broad U.S. labor market.
Consumer Confidence	Measures of U.S. consumer sentiment have risen from suppressed levels last summer amid cooling inflation, a resilient jobs market and strong stock market rally.
Oil	Extended production cuts by Saudi Arabia and Russia along with the recent outbreak of war in the Middle East could keep WTI crude oil above $80 per barrel in 4Q23.
Housing	A surprising increase in new home sales in 1H23 may be close to running out of steam as prospective homebuyers balk at 30-year fixed rate mortgages approaching 8%.
International Economies	According to forecasts aggregated by Bloomberg, India (6.2%), Indonesia (5.0%), China (4.5%) are expected to see the strongest GDP growth in 2024 among G-20 nations.

	MINIMUM		NEUTRAL		MAXIMUM
FIXED INCOME			●		
Core Bonds				●	
TIPS	●				
Non-Investment Grade				●	
International	●				

CURRENT OUTLOOK

In late September, we increased the recommended target weights for fixed income allocations by 1%-3% and shifted the composition of fixed income sleeves to reduce risk and expected interest rate volatility. Positions in a GNMA mortgage pass-through strategy and a multi-sector bond strategy were sold. Proceeds were reallocated to a combination of a new position in intermediate-term (3-7 years) U.S. Treasuries and an additional allocation to our short-term core bond manager.

We believe the back-up in yields across the fixed income universe over the last 18 months has made high-quality bonds a more attractive component for diversified portfolios with long-term investment horizons due to the combination of stability and income they have historically provided in periods of slowing economic growth. This contrasts with most of the period from 2009 to 2021, in which easy Fed policy and ultra-low yields suppressed the income component of bonds. Although recent concerns about a ramp up in Treasury supply and growing U.S. budget deficits deserve to be monitored, we would expect investor appetite for long-term Treasury yields above 5% to offset these worries.

Although the recent sharp upward reset in Treasury yields has been painful, portfolios with longer-term time horizons that have lower duration than their benchmark should consider extending duration with yields on the U.S. 10-year Treasury note approaching 5% and additional rate hikes looking increasingly unlikely. High yield corporate bond spreads narrowed by about 30 bps in 3Q23, supported by resilient economic data. As the tightening cycles of the Fed and other global central banks mature, however, we would expect the path of least resistance to be one of generally wider credit spreads.

	MINIMUM		NEUTRAL		MAXIMUM
EQUITIES			●		
Large Cap			●		
Mid Cap				●	
Small Cap		●			
Developed International			●		
Emerging Markets		●			

CURRENT OUTLOOK

In late September, we reduced our recommended target equity weights across investment objective-based portfolios by 1%-3%. This recommendation was based on our view that the U.S. economy is most likely in a late cycle environment. We expect the lagged effects of 525 basis points of Fed rate hikes and tighter bank lending standards to slow economic momentum in coming quarters.

In the third quarter, we updated our equity benchmark from the MSCI ACWI Index (which drifts based on geographical market capitalizations and is currently about 60% domestic and 40% international) to a static custom equity benchmark comprised of a 75% weighting to a broad U.S. benchmark (S&P 1500) and a 25% weighting to a broad international benchmark (MSCI ACWI ex-U.S. Index). We believe this updated benchmark composition is better aligned with the expectations and risk tolerance of our clients. In late September, we recommended a substantial increase in target weightings for U.S. large cap and reductions of target weights to domestic mid/small cap and emerging markets. The increased recommended weighting to U.S. large cap achieved a neutral exposure relative to our new custom blended benchmark.

Although recession calls for 2023 have proven premature, we are not yet convinced the coast is clear for the U.S. economy to avoid a period of contracting growth next year. At between 18 and 19-times expected EPS over the next 12 months, the S&P 500 is moderately expensive compared to its long-term history. But it is even more expensive if one looks at periods in which U.S. Treasury yields were near 5% across the maturity spectrum. Consensus expectations for S&P 500 profits to grow 10% in 2024 are likely to end up being too optimistic. This does not mean there cannot be another (perhaps final) sentiment-driven leg in the U.S. stock market rally in coming months. Price momentum and performance chasing have been powerful short-term factors in prior late cycle environments. Earnings expectations will be key in determining the path of stocks moving forward as further multiple expansion at the index level seems unlikely.

	MINIMUM		NEUTRAL		MAXIMUM
ALTERNATIVES*			●		
	CAP PRES	IWSG	BAL	GWSI	GROWTH
Gold		●	●	●	
Hedged Equity					
Arbitrage					

CURRENT OUTLOOK

Over the last 12 months we recommended hedged equity and merger-arbitrage strategies be sold in client portfolios and reallocated to a combination of short-term Treasuries and cash. The ultra-low interest rate environment of the post-global financial crisis world appears to be shifting to one in which market interest rates establish trading ranges substantially higher than existed for most of 2009 through 2021. In this environment, we expect the risk-adjusted return benefits of most alternative strategies to subside especially compared to assets traditionally viewed as risk-free including cash and U.S. Treasuries.

We believe gold deserves a moderate allocation in most client portfolios in the current late cycle environment. The current economic, policy, and geopolitical backdrops appear well suited for the precious metal. This view is based on our expectation that the Fed's rate hike cycle is likely nearing an end, but core inflation could remain above policymakers' 2% annual target for longer than expected. Additionally, many central banks in Asia and the Middle East have substantially accelerated gold purchases over the last 18 months, and the recent outbreak of war between Israel and Hamas has further raised geopolitical tensions. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH.)

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.

*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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