Economic & Market Outlook

2023 Mid-Year Forecast

Investment Team Contributors

Brian Andrew, CFA
President & Chief Investment Officer

Ron Alberts, CFA
Senior Vice President, Director of Fixed Income Strategy & Portfolio Manager

Eric Bernal
Senior Vice President, Portfolio Manager

Annette Hellmer, CFA
Senior Vice President, Portfolio Manager

Jonathan Henshue, CFA, CAIA
Vice President, Director of Alternatives Strategy

Jason Herried, CFA
Senior Vice President, Director of Equity Strategy & Portfolio Manager

Brian Schaefer
Vice President, Portfolio Manager

Eric Trousil, CFA
Senior Vice President, Portfolio Manager

A Good Start to 2023 | 1
Equity Review & Outlook | 4
Fixed Income | 5
Alternative Investments | 7
Conclusion | 8

A Good Start To 2023

In our 2023 Outlook published in January, we shared a cloudier than normal outlook. We expected economic growth to continue—but grind lower—and the pace of inflation to decline but remain higher than desired. We also noted the silver lining to a cloudy near-term outlook: that the long-term outlook for portfolio returns had improved considerably due to lower valuations for stocks and higher starting interest rates for bonds.

As we pass the halfway point of 2023 the soft-landing (no recession) vs. hard-landing (recession) debate continues. However, we can say that economic growth has been more resilient than expected. A more detailed market recap follows, but suffice it to say that:

1. Better than feared economic data has supported stock prices;
2. A decline in inflation has allowed interest rates to stabilize, leading to solid returns in the bond market as well.

Through the end of June, bonds are up about 2%—in line with their income payout—and most parts of the stock market are up 5-10%. A handful of large technology related companies have driven the S&P 500 higher by 17% and growth indices higher by nearly 30% *[Figure 1]*.

While the long-term outlook for stock and bond returns remains good (in the 6-8% and 4-5% range respectively), the outlook for the next 6-12 months remains uncertain. We expect inflation to continue to recede and economic growth to be slower than the first half with recession a likely outcome.

In the year to date, the economy has been able to absorb higher interest rates reducing the odds of a severe recession. However, a significant upside surprise to growth appears unlikely given numerous headwinds. As a result, we are seeking opportunities to position portfolios in a manner that we expect will hold up better in a recessionary scenario.

Figure 1

Annual Return by Asset Type
as of June 30, 2023

FIXED INCOME	12.31.19 - 6.30.23	CY 2022	YTD	THREE MONTHS
Bloomberg U.S. Aggregate Intermediate	-1.2%	-9.5%	1.6%	-0.8%
Bank of America Merrill Lynch Municipals 1-12 Yr	0.3%	-4.9%	1.4%	-0.5%
U.S. EQUITY				
S&P 500	11.5%	-18.1%	16.9%	8.7%
Russell 1000 Growth	14.8%	-29.1%	29.0%	12.8%
Russell 1000 Value	6.7%	-7.5%	5.1%	4.1%
Russell 2000 (small-cap)	5.0%	-20.4%	8.1%	5.2%
INTERNATIONAL EQUITY				
MSCI ACWI Ex U.S. (international)	2.7%	-16.0%	9.5%	2.4%
MSCI EAFE (developed)	4.0%	-14.5%	11.7%	3.0%
MSCI EM (emerging markets)	-1.1%	-20.1%	4.9%	0.9%
COMMODITY/CURRENCY				
Bloomberg Commodity	8.0%	16.1%	-7.8%	-2.6%
U.S. Dollar Index	1.8%	7.9%	-0.6%	0.4%

Source: Morningstar Direct

A resilient consumer

Despite headlines warning of an impending recession for the past year, the U.S. economy has remained remarkably resilient. Parts of the economy have already slowed—particularly in manufacturing areas of the economy—but pent-up demand for travel and leisure activities have kept the services side of the economy in expansionary territory *[Figure 2]*.

Such consumer strength has been buoyed by a solid job market and excess savings from covid-era federal stimulus programs, which has buffered the consumer against the impact of higher interest rates and elevated levels of inflation. As a result, forecasts for a more significant slowdown in consumer spending have been pushed out to late-2023 or early-2024.

Expiring supports—but improving inflation

As the supports to consumer spending expire, we expect the economy to endure a mild recession due to the lagged effects of higher interest rates, tighter bank lending standards and reduced impact from covid-era fiscal stimulus. Interest rate increases work with long and variable lags, so the full effect of the interest rate increases are yet to be felt.

That said, considerable success has been made in lowering inflation with the May Consumer Price Index (CPI) reading reported at 4.0%, the lowest level since March 2021. This compares to the peak rate of 9.1% in June 2022 when the full impact of reopening demand and supply chain constraints were pressuring prices.

We expect inflation to continue to recede as the year progresses. Supporting this conclusion are clear signs of slowing in one of the stickier components of inflation, shelter costs. Shelter costs increased 8.0% over the past 12 months, but the Case-Shiller Home Price Index suggests that shelter costs have been declining. This implies that the progress of curbing inflation may be further along than CPI readings suggest. Historically, it has taken more time for the Bureau of Labor Statistics' calculations to reflect current market conditions due to their methodology for calculating this measure. Figure 3 shows that the Shelter component of CPI has lagged the change in the Case-Shiller Home Price Index by about a year.

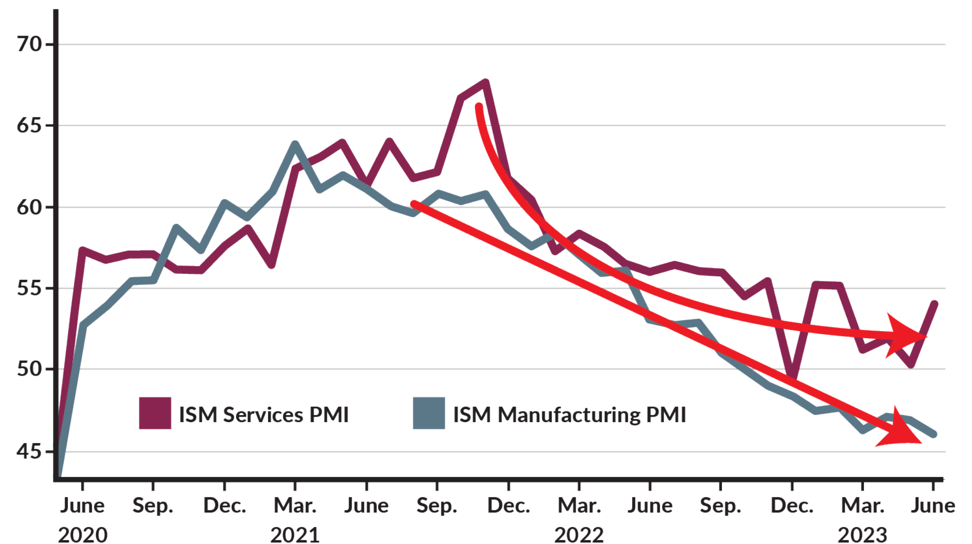
Portfolio positioning tilted toward negative scenarios

In addition to the Fed's increases in short-term interest rates, economic activity is being curtailed by other factors such as Quantitative Tightening (i.e., the Federal Reserve shrinking its balance sheet) as well as tighter lending standards by banks, which were exacerbated by recent stress in the financial sector. Corporate profits have sputtered in recent months, and historically profit weakness has been followed by layoffs and reductions in capital expenditures.

Figure 2

ISM Manufacturing and ISM Services Indices

July 2020 to June 2023

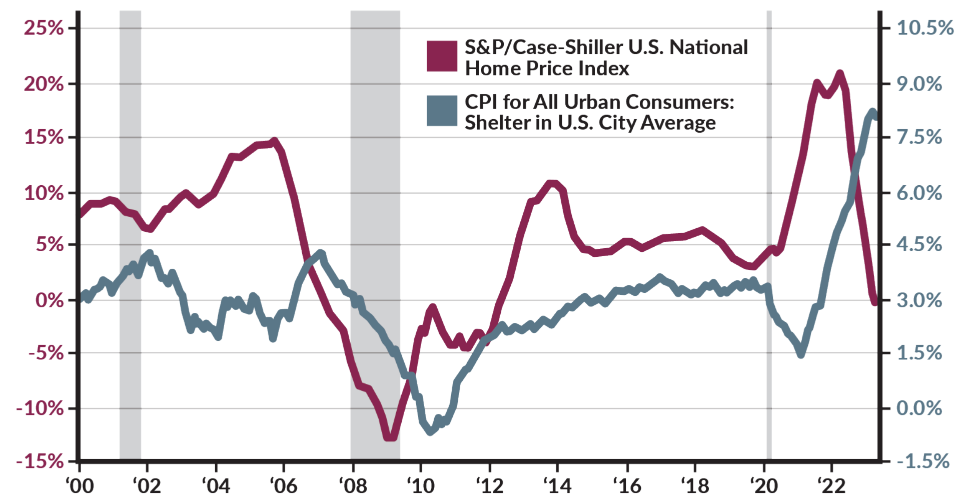


Source: Bloomberg

Figure 3

US House Prices and Shelter Inflation

Percent change year over year



Source: JPM Guide to the Markets - Europe. Data as of 5.31.23

Rather than if the U.S. will enter a recession, the more important questions may be when it comes, how deep will it be and how long will it last? Our risk analysis framework tests our portfolio allocations for a range of potential outcomes *[Figure 4]*. Our firm's Investment Committee has assigned higher probabilities to the negative scenarios (hard landing, mild stagflation) than the positive scenarios (soft landing, strong rebound). As a result, underlying investments in client portfolios are being structured with an emphasis toward downside protection. We accomplish this portfolio posture by focusing our equity investments in higher-quality companies with stronger competitive positions, more consistent growth and stronger balance sheets. In our bond portfolios, we've sought to reduce our exposure to corporate bonds. We nonetheless recognize that positive scenarios could unfold, or that a recession could be delayed. Therefore, we seek balance with a tilt toward defensive.

Although we make modest tilts in portfolios to reflect our views for the most probable outcomes during the next 12-18 months, we construct client portfolios with a goal of achieving outcomes over years or decades, not months.

Long-term return focus

Financial planning can help evaluate the overall level of portfolio risk that may be needed for the highest probability of success in achieving long-term goals. These are based on long-term capital market assumptions—basically, long-term risk and return expectations—for various categories of investments.

In recent years, we've seen a marked change in the return expectations for bonds following a prolonged period of near-zero interest rates. The adjustment to a higher-rate environment was painful to absorb as evidenced by the poor returns from bonds in 2022, but going forward the return prospects for fixed income are much improved with expected annual returns in the 4-5% range, long term, for investment-grade taxable bonds.

Studies spanning decades have demonstrated that over 90% of a portfolio's return is attributed to asset allocation—that is, the mix of stocks, bonds and alternative investments. Other contributors to returns like security selection and market timing contribute 5% and 2% respectively. Working with a financial advisor can help determine the optimal range of risk that is most appropriate for each client's unique needs and circumstances.

For this reason, it is important to remain invested in the right asset mix and not worry about trying to time the market. Market corrections are a normal occurrence and trying to predict them are generally ineffective. Right now, investors highly anticipate a recession and bear market. If everyone is waiting, then a substantial decline may never come. Currently a record amount of cash is sitting on the sidelines—over $5 trillion dollars—waiting for a pull-back to return to longer-term investments. Missing just a few of the best market return days can have a significant detrimental impact on returns *[Figure 5]*. It is also worth noting that the best days often occur in close proximity to the worst days, so the idea of stepping aside during turbulent times is problematic at best.

Figure 4

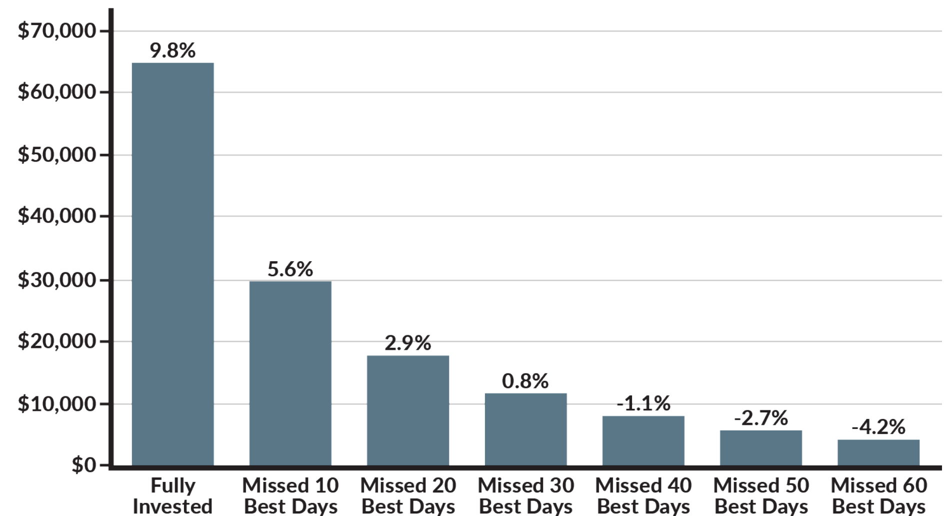
Soft Landing	Hard Landing	Mid Stagflation	Strong Rebound
• **Monetary policy** needs to remain **restrictive**, thus rate stay elevated • Relatively weak but positive economic growth in U.S. and E.U. • Stringer economic growth in China and India supports global demand • **No further downside risks** materialize	• Monetary policy **effectively curbs inflation** and Fed maintains credibility • Financial tightening (and potential instability) leads to **U.S. recession in 2023** • **Fed pivot** in response to recession weakens USD in 2023	• Monetary policy not sufficient to tame inflation, **eroding central banks' credibility** • **Inflation becomes entrenched** • High prices and rates **weigh on growth** for longer peroid • **USD strengthens**, putting pressure on EM economics	• **Inflation under control**, falls more than consensus • Economic **growth suprises on the upside** • Current global headwinds get resolved and supply chain issues ease

Source: MSCI - *Macro Scenarios: Soft, Hard or No Landing This Year?*

Figure 5

Returns of the S&P 500

Performance of a $10,000 investment between 1.1.03 and 12.30.22



Source: JP Morgan Asset Management - *Guide to Retirement*

Equity Review And Outlook

Compared to last year, 2023 has been much more pleasant for equity investors as interest rates have stabilized and recession timing continues to be pushed out. Through the end of June, U.S. stocks (S&P 500 Index) are up about 17% and international stocks (MSCI All Country World Index-ex US) are up about 10%. The only major bout of volatility occurred in March during the banking turmoil that saw several regional banks with concentrated deposit bases collapse due to rapid withdrawals of those deposits. As of now, the situation has stabilized, but we expect profit headwinds from additional regulatory headwinds and declining net interest margins as banks pay higher rates on deposits.

Pronounced divergence

The weak performance of the financial sector and continued recession concerns have weighed on the average U.S. stock, which is up about 7%. At the other end of the return spectrum, a handful of large technology companies representing more than a quarter of the index have exploded higher this year, further exacerbating the differential between the average stock and the broad market.

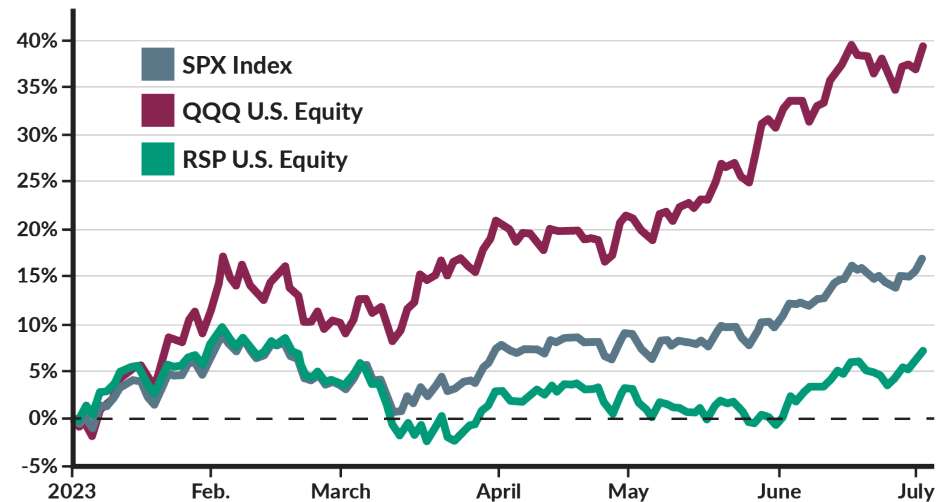
To illustrate the difference, Figure 6 reflects the year-to-date return of the Nasdaq 100 Index alongside the S&P 500 Index and the S&P 500 Equal Weight Index, with the latter representing the average stock. The contrast is stark: the 7% return for the average stock compares to a 39% return in the Nasdaq 100 Index, which is a proxy for the technology leaders of 2023 (Apple, Microsoft, Alphabet, Meta Platforms, Amazon, Nvidia, Tesla).

*Compared to last year, **2023 has been much more pleasant** for equity investors as interest rates have stabilized and recession timing continues to be pushed out.*

Figure 6

Year-to-Date Total Return

S&P 500 Index, S&P 500 Equal Weight Index, NASDAQ 100 Index



Source: Bloomberg as of 6.30.23.

Investor interest in these stocks has picked up as the year has progressed. Initially the group rallied as investors bought the 2022 laggards. In March, the banking turmoil led investors to seek out companies with strong balance sheets and less economically sensitive business models. The cherry on top was the opportunity that Artificial Intelligence, or AI, might bring to these companies.

AI opportunity is real ... but no quick fix to corporate earnings

We believe the AI opportunity is real, but profit upside is likely to come in over multiple years, leaving the profit forecast for the market as a whole largely dependent on the growth of the economy and the ability of companies to maintain profitability in the face of inflation.

So far the economy has been resilient and companies have been able to raise prices to pass on the majority of higher input costs, but unit volumes are lackluster with the majority of revenue growth attributable to higher prices (i.e., inflation). The end result has been a period of modest earnings declines in recent quarters. Analysts expect 5% earnings growth for all of 2023 due to strong 10% earnings growth in the fourth quarter *[Figure 7]*.

We think expectations for double-digit earnings growth in the fourth quarter and 2024 are optimistic in a low-growth economy let alone in a recessionary scenario. As a result, we have sought to position equity portfolios to focus on less economically sensitive large-cap stocks, while deemphasizing smaller companies, cyclical value and high-valuation growth segments of the market.

Fixed Income

Solid start amid volatility

Fixed Income has been far too exciting since the Fed began raising interest rates in March of 2022. That first hike turned out to be the first of ten consecutive rate increases, culminating in an effective Fed Funds rate over 5% today. 10-year Treasury yields soared during this period, peaking at about 4.25% in October of last year before retreating to a recent range of 3.50%-4.00%. Volatility soared as well, peaking in March of this year during a bank run largely attributable to a few banks mismanaging interest-rate risk.

Despite the volatility, year-to-date returns have been solid. Intermediate-term Investment Grade bonds are up about 2% and are yielding a little under 5%. Tax-exempt municipal bonds haven't quite kept pace on a total return basis, but credit conditions are sound, and second half returns look promising with valuations improving. Intermediate-term municipal bonds yield about 3.25%, translating into after-tax yields in the mid-5% range for investors in the highest tax brackets.

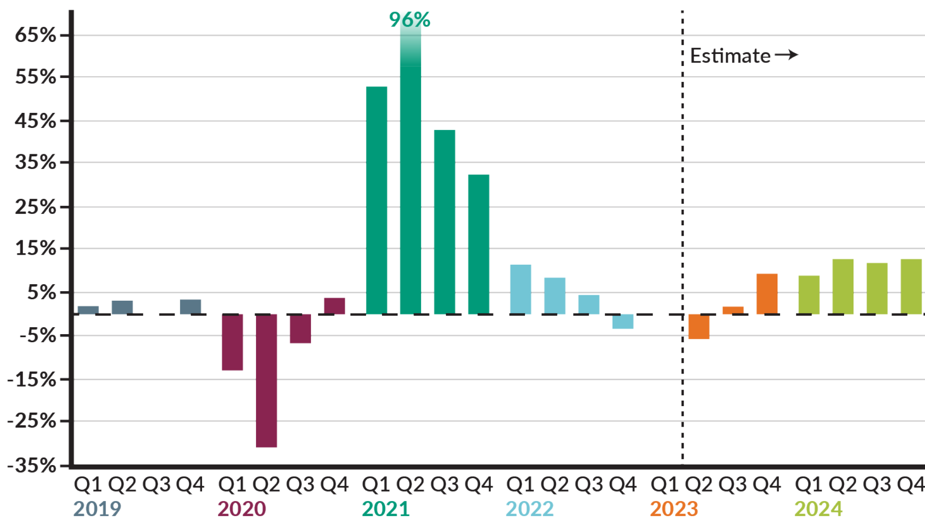
The Treasury yield curve remains inverted with the 3-month Treasury yield exceeding the 10-year Treasury yield by about 1.5 percentage points. Despite this, longer-term bonds have outperformed short-term bonds because long-term interest rates have declined modestly. This has benefitted emerging market bond indexes as well, where average maturities are longer than domestic indexes. Corporate credit spreads remain near historic averages despite elevated recession risks, resulting in excess returns for credit-oriented strategies.

The opportunity set for core fixed income is the most attractive in 14 years *[Figure 8]*. Starting yields are the best predictor of forward returns in fixed income, and today's yields imply long-term returns similar to the era before quantitative easing and zero interest rate policy depressed bond yields.

Figure 7

S&P 500 Operating Earnings Growth

Vs. one year ago peroid

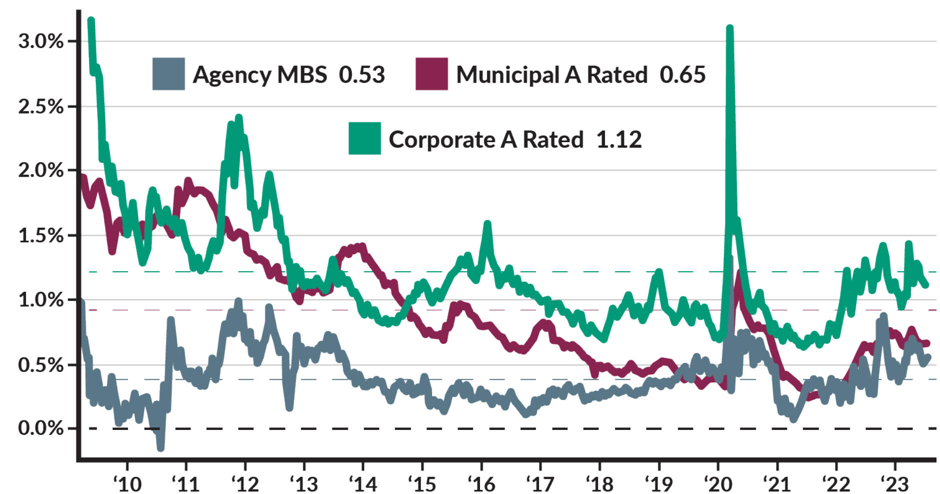


Source: Refinitiv as of 6.30.23

Figure 8

Credit Spreads

3.31.09 to 6.30.23



Source: Bloomberg

A pause or a pivot?

The Fed's streak of consecutive rate increases concluded with a pause at the most recent Federal Open Market Committee meeting on June 14. Fed officials held interest rates steady but signaled they were prepared to raise rates in subsequent meetings if the economy and inflation don't cool more.

The Fed released new projections, which included two more rate increases this year, while raising their expectations for growth and inflation. Investors are less convinced of the need for more rate increases, with futures markets pricing in one more rate hike before predicting cuts in early 2024.

While the Fed and the market disagree about the short-term policy path, both agree that we are close to a peak in short-term interest rates, and forward returns after past peaks have been strong. Figure 9 from Columbia Threadneedle shows average forward returns for different sectors of the bond market after the Fed pauses. Although this cycle is a bit different in that inflation may limit the degree to which the Fed cuts rates, we believe investors will be rewarded by stepping out of cash (represented here by 3-month T-Bills) and into bonds before the Fed's pause turns into a pivot to cutting rates.

*We believe **investors will be rewarded by stepping out of cash and into bonds** before the Fed's pause turns into a pivot to cutting rates.*

Figure 9

Average Forward Return After a Pause

	3 MONTH	6 MONTH	12 MONTH
3 Month T-Bills	1.5%	3.1%	5.6%
10 Year Treasuries	5.9%	8.9%	11.6%
Investment Grade	5.1%	9.4%	14.3%
High Yield	5.3%	8.7%	12.9%
MBS	4.7%	7.4%	12.4%
Munis	3.8%	6.0%	10.4%

Source: Columbia Threadneedle Investments, Bloomberg

Quality is cheap

Although we believe that we are nearing the end of this rate-hiking cycle, we know that monetary policy works with a lag. As the effects of 15 months of tighter policy work their way through the economy, recession risks remain high in our view. We believe that a recession would result in wider corporate credit spreads. As a result, we have chosen to pare exposure to below-investment-grade issuers this year while adding to high-quality sectors including government mortgage-backed securities (MBS).

With quality bonds offering the most attractive yields in 14 years, we are focused on positioning bond portfolios to take advantage of the opportunity set while remaining resilient if the economy goes into recession. For the first time in a long time, there is no need for investors to reach for yield to earn compelling returns.

Alternative Investments

Global markets have shown resilience despite ongoing uncertainties, such as geopolitical tensions and the lingering effects of the COVID-19 pandemic. While traditional asset classes like stocks and bonds continue to play a significant role in portfolios, alternative investments, such as real assets, private debt, and diversifying hedge funds, remain an important consideration for investors in this ever-evolving market environment.

The asset classes mentioned above are the primary areas in which we invest, and year-to-date, they have collectively outperformed bonds, though they have not kept up with the strong performance of equities. Considering our alternatives allocation is typically sourced from both equities and fixed income, this performance is in line with expectations and consistent with the contributions we believe alternatives can make in portfolios, including:

- Providing diversification benefits by exhibiting a lower correlation with traditional assets, which can help reduce overall portfolio risk.
- Offering the potential for attractive risk-adjusted returns, especially in sectors with limited public market exposure.
- Bringing opportunities to access niche markets and strategies, unlocking potential sources of alpha albeit with different, more unique risks.

Figure 10

2022 REIT Sector Breakdown

NEXT GENERATION	
Cell Towers	16%
Industrial	13%
Data Centers	8%
Self Storage	7%
Senior Housing	6%
Manufactured Home	2%
Single-family Rental	2%

TRADITIONAL	
Apartment	10%
Free Standing	6%
Speciality	6%
Office	5%
Shopping Center	5%
Regional Mall	3%
Hotel	3%
Timber	3%
Diversified	2%

Source: FTSE NAREIT Equity REITs Index, Cohen & Steers

Real estate fears

Recent financial media headlines have focused on real estate, stoking investor fears. Valuations in real estate have been under pressure, with publicly traded REITs selling off alongside equities during 2022. Private real estate returns, which often lag public markets, have also declined as buyers and sellers digest the new economic regime.

Negative sentiment has focused on declining demand for office properties due to the work-from-anywhere paradigm and the possibility of further tightening in real estate lending due to concerns about the stability of regional banks. These concerns, though legitimate, fail to recognize several mitigating factors.

- First, the office sector represents an insignificant part of the public REIT universe at just 5.0%. Meanwhile, sectors with strong secular trends, such as multi-family, industrial, and data centers, represent a large and growing portion of the commercial real estate universe *[Figure 10]*.
- Second, banks outside of the top 100 based on total assets have financed 15-20% of all commercial real estate (CRE) mortgages, diversified across 4,600 institutions nationwide, significantly reducing risks.

We also maintain a favorable view towards private debt in spite of concerns related to the direction of the economy. While we acknowledge that an economic slowdown is likely to place elevated stress on borrowers, the combination of double-digit starting yields and private equity sponsors' ability to support portfolio companies with their substantial pools of dry powder leads us to a favorable view of the asset class.

As we move further into the year, keeping a balanced approach that includes a prudent allocation to alternative investments can provide the potential for long-term growth and resilience in a dynamic investment environment. By carefully selecting and diversifying across different alternative asset classes, investors can potentially enhance their risk-adjusted returns and capture sources of return that may not be available through traditional avenues alone.

ASSET ALLOCATION

ECONOMY

Growth

Inflation

ASSET ALLOCATION

Equities

Fixed Income

Complements

Cash

CAPITAL ALLOCATION

EQUITIES

International

Small/Mid Cap

Value Style

FIXED INCOME

International

Duration

Credit

Conclusion

Although we expect slowing growth—and possibly a recession—we also remain optimistic for the long-term growth opportunities in the U.S. economy. Moreover, we welcome more attractive long-term return prospects from stocks, bonds and alternative investments relative to just a few years ago. We have sought to position the portfolio to be more resilient in the event of a recession. As always, we will closely monitor markets, economic indicators, and the performance of the third-party managers we engage on your behalf.

We thank you for your partnership and trust in Johnson Financial Group. We will continue working with you to navigate the ever-changing economic and financial market landscape in pursuit of your financial goals.

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. We understand these times can be very stressful but hope you take comfort in having an experienced and dedicated financial team working specifically for you. **Thank you for your partnership and trust in Johnson Financial Group.**

Any figures, opinions or investment strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of writing.

This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. Johnson Financial Group does not provide legal or tax advice to clients. Investors should make an independent assessment of the tax and legal implications and determine, together with their own professional advisers, if any investment strategy mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment.

Investment strategies are customized for Johnson Financial Group clients and client portfolios may not reflect the asset allocations or strategy changes discussed in this publication. Past performance is not a guarantee of future results. Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses. Investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and investors may not get back the full amount invested. Alternative or complementary investments may involve a substantial degree of risk, including the risk of total loss of an investor's capital, limited liquidity and leverage. Non-depository investment products offered through Johnson Financial Group are not FDIC insured, not bank guaranteed and may lose value.

REV 7.5.23