ITASCA BANK & TRUST

ECONOMIC OUTLOOK AND INVESTMENT POLICY

Q4 2023

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	Several gauges of U.S. consumer sentiment showed Americans became more pessimistic amid rising prices for groceries and fuel and higher interest rates.
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 six- to twelve-month horizon and are those of the MainStreet Advisors Investment Committee.

*Cap Pres: Capital preservation; IWSG: Income with some growth; Bal: Balanced; GWSI: Growth with some income

Important Disclosure Information

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