MARKET UPDATE

Economic Market Update – Third Quarter, 2023

October 18, 2023

- The economy continues to be on solid footing, with growth surprising to the upside and a historically strong labor market
- Given the strength of the economy, the Federal Reserve is likely to keep interest rates higher for longer
- Asset prices adjusted in Q3 to this new normal, with both stocks and bonds falling; interest rate sensitive sectors were hit particularly hard
- The economy faces a number of headwinds in Q4, but the combined impact of these challenges is unlikely to push the economy into recession

Fulton PRIVATE BANK

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Early in the third quarter, markets were driven by relief that the most anticipated recession in history, despite all the bluster from Wall Street economists, did not lay imminently over the horizon. As the quarter progressed, however, markets began to reflect concerns about what higher than expected economic growth and inflation trending towards the Fed's 2% target means for interest rates going forward, ushering in a trend reversal that saw most asset classes struggle in August and September. The ultimate resolution of that question will determine where markets go in the months ahead. Does the recent trend merely represent a pause as expectations are reset, or is it the opening stages of a longer-term trend? Our base case is that the U.S. economy will slow in the face of several headwinds in the fourth quarter, though not enough to push the economy into recession. And while we may see some head fakes along the way, disinflation appears to have firmly set in, putting the economy on the path to a level of inflation consistent with the Fed's target. The combination of a slowing economy and a bumpy ride for inflation means that market volatility is likely to increase in the months ahead as headlines potentially drive short-term market action. Commodities and cash were the only major asset classes to end Q3 higher, with the 1.33% return on cash[1] representing the best quarterly return for the asset class since the fourth quarter of 2000. Cash may have been king in Q3 2023, but the long-term math does not favor its growth prospects. For those investors with extra cash on the sidelines, the potential volatility ahead in the final quarter of the year should offer opportunities to put it to work.

One of the biggest surprises this year has been the resiliency of the U.S. economy. As of October 2, the widely followed GDPNow estimate of economic growth produced by the Atlanta Fed estimates that GDP grew at a torrid 4.9% annualized pace in Q3. The actual figure may come in slightly lower, but thus far in 2023 GDP growth has far exceeded the estimates of professional economists, most of whom were calling for a recession at some point during 2023. The Fed's own staff economists had a base case that U.S. growth would stumble and push the economy into recession as recently as this summer, so the robustness of the economy, particularly while inflation continued to move toward target, has been a pleasant surprise.

While we continue to maintain a positive outlook for economic growth, the U.S. economy faces several headwinds in the fourth quarter. As we outline below, the resumption of student loan payments, the United Autoworkers (UAW) strike, a potential government shut down, and higher oil prices are all likely to weigh on GDP growth over the next three months. In total, however, we do not expect that the hit to growth from these areas will be enough to push the economy into recession, a fortunate side effect of the strength of economic growth we've seen thus far in the year. And it also bears remembering – slowing down economic growth is precisely what the Fed is attempting to do, and a slowdown in the months ahead is just what is needed for the Fed to pull off the much hoped for soft landing.

The resumption of student loan payments will certainly have an impact on consumption, which represents about 68% of U.S. economic growth, though we believe the hit will be smaller than perhaps initially anticipated. If upon resumption payments return to the pre-COVID trend, the hit would be around $70 billion (0.3% of disposable personal income). Several factors suggest the hit will not be as large however. A huge spike in recent payments represents individual borrowers paying down balances before interest begins to accrue again, perhaps indicating a one-time payment funded by savings built up over the last three years. To the extent that these balances are paid down in full, no more monthly payments will be required. Plus, some borrowers are unlikely to resume payments immediately, and other borrowers will qualify for the Biden Administration's revised income-based repayment plan, resulting in a lower impact to consumption than the baseline suggests.

[1] Represented by the Bloomberg 1-3 Month Treasury Bill Total Return Index

The second headwind to growth in the months ahead is a potential government shutdown. While a shutdown of the federal government would reduce GDP by about 0.2% a week, a shutdown is by no means guaranteed. As it stands, a last minute continuing resolution has given Congress another 45 days to negotiate. That said, a shutdown appears more likely than not at this stage given the recent ouster of Speaker of the House Kevin McCarthy. The longer the expected fight over the Speakership drags on, the less time available for negotiations. If history is a guide, any shutdown of the federal government would be short-lived. The average duration of the four previous government shutdowns was 14 days and the average impact on real GDP growth was only 0.16%. Should the government shutdown, not all government spending would be impacted. Federal outlays account for 24% of GDP; of that, only non-essential employee compensation would be hit, account for just 0.46% of overall GDP. While about four and a half million government employees would be furloughed, debt obligations and Social Security payments would continue to be made, limiting the overall impact to growth.

The third headwind to the economy in the final quarter of the year is the ongoing UAW strike, which we expect to lower GDP by around five to ten basis points for each week it lasts. Our base case is the ongoing strike will be relatively short-lived, but a longer strike is possible given that it appears to be highly targeted at these early stages and will likely continue to be ramped up over time. The bigger economic risk from the UAW strike is the potential impact on inflation. Since the COVID pandemic hit in March 2020, the United States has experienced a significant supply-demand mismatch in the auto market, resulting in a gap of about 14.5 million cars that would have otherwise been produced based on underlying demand. We saw this mismatch play out most starkly in the used car market, which saw a significant rise in prices. While price pressures in the used market had been abating for the last several months, recent auctions have indicated the upward momentum in prices has resumed. As the strikes expand to parts manufacturing facilities, we can expect pricing pressures to remain because of the short-term supply constraints the strikes will likely usher in. We believe the overall hit to economic growth from the strike will be manageable, however, especially because we expect that growth will rise in the quarter following their end by the same amount as the decline for both the government shutdown and the UAW strike.

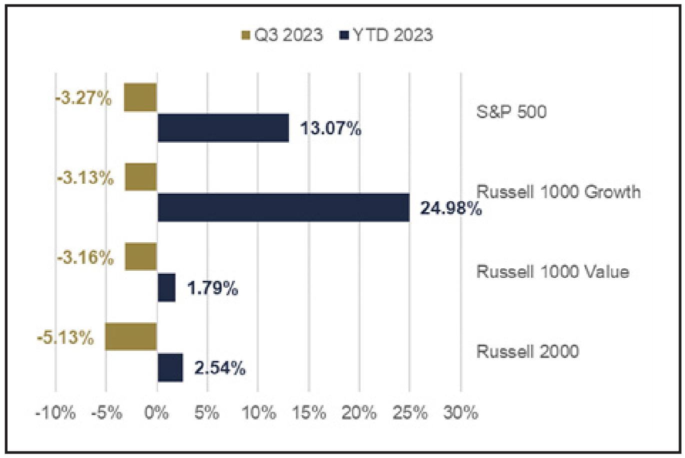
The final headwind to growth facing the US economy in the fourth quarter is oil prices. Prices have increased by about $20 a barrel since June, but despite this increase, we think the overall hit to consumption and GDP growth will be minimal. First, the overall increase in energy expenses for consumers will be relatively small once lower electricity prices are factored in. The energy intensity of the US economy has declined materially since the days of rationing and long lines at the gas station experienced in the 1970s. As of July 2023, energy represented just four percent of total consumption. Of that four percent, 2.3 percentage points are motor fuel. Energy futures and wholesale markets suggest that most of the expected increase in overall fuel costs has already occurred. The expected growth hit is estimated to be about 0.175 percentage points for the final quarter of 2023. On the other side of the energy equation, decreases in the price of coal and natural gas are expected to lower utility bills and provide a boost to consumption of around 0.1 to 0.2 percent, offsetting much of the impact from higher gasoline prices. Finally, the Fed has signaled that they are not likely to react in a knee-jerk fashion to short-term energy shocks, which Chair Powell reiterated during the press conference after the September Fed meeting. All told, the overall hit to growth from higher oil prices will likely fall somewhere between twenty and 30 basis points for the fourth quarter.

While the US economy is facing a number of headwinds in the months ahead, we believe that each will be manageable. Collectively we expect these headwinds will knock less than one percent off off GDP growth in the fourth quarter. And given that GDP growth is tracking exceptionally high for Q3, a slowdown in growth as we close out the year should help keep inflation on a downward path, increasing the likelihood of a soft landing for the Fed.

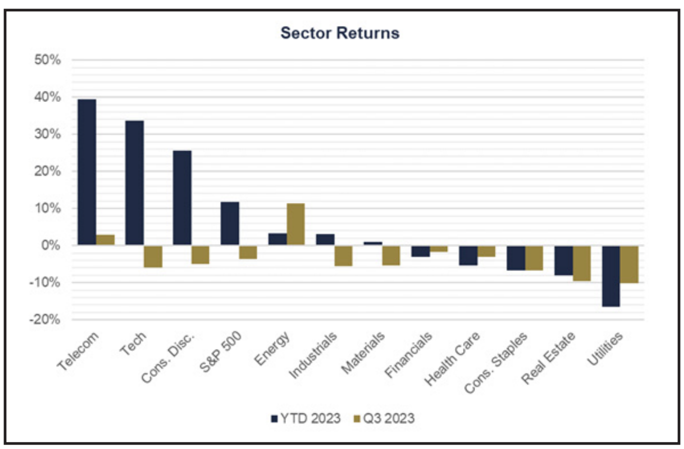
In spite of the declines in the third quarter, equity markets have still posted healthy gains year-to-date. The question is whether that recent weakness will represent a pause or an outright reversal in the longer-term trend. Since 1926, the S&P 500 has experienced ten years when stocks were up more than 10% in the first half of the year that was then followed by a third quarter pullback. Eight out of ten of those years saw the market charge higher in the final three months of the year by an average of 6.8%, well above the unconditional average return of 2.8% across all Q4s. While we expect a rocky ride, the stage is set for 2023 to make it nine out of eleven absent any deterioration in the risk factors facing the economy in Q4. Should that also coincide with a peak in rates, investors will likely find themselves ending the year on a happy note as 2023 comes to a close.

U.S. Equity Markets

After a great start to the year in the first half of 2023, U.S. stocks gave back some of those gains in the third quarter. The S&P 500 finished the quarter down -3.27% and now stands up 13.07 year-to-date[2]. Small-cap stocks were hit even harder, with the Russell 2000 Index down -5.13% for the quarter and now is up only 2.54% on the year. This pattern represents a reemergence of the traditional pattern for stock returns, as small-cap stocks tend to outperform in positive market environments and underperform during market declines. Despite a strong bull market in the first half of the year, small cap stocks lagged large caps as returns were heavily driven by the excitement over the potential of developments in artificial intelligence and the "Magnificent 7" stocks we've discussed throughout the year.



U.S. equity performance varied widely by style during the third quarter as well. The Russell 1000 Growth Index, which is comprised of both large- and mid-cap firms, was down -3.13% for the quarter and is now up 24.98% for the year through September vs. the -3.16% Q3 return and 1.79% year-to-date return of the Russell 1000 Value Index. The growth style led in small-cap as well – albeit by a narrower margin – with the Russell 2000 Growth Index giving back -7.32% in Q3 and now stands up 5.24% year-to-date vs. the Russell 2000 Value Index's return of -2.96% on the quarter and -0.53% on the year.

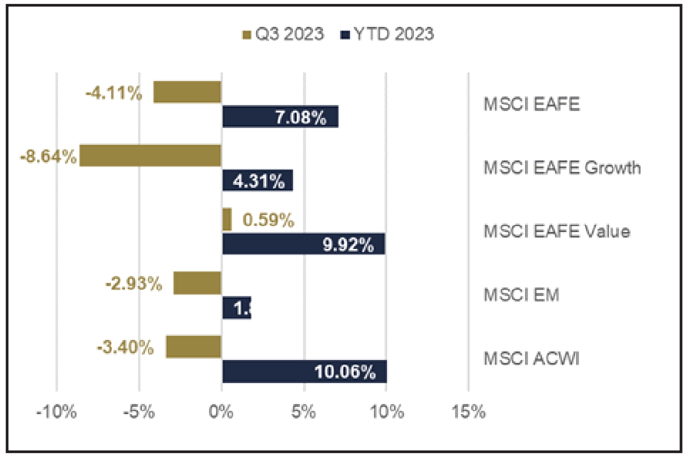


As to be expected when the divergence between growth and value is so wide, performance varied widely across sectors and industries in the Q3 as well. Growth stocks continue to lead the market year to date on the back of excitement around the implications for artificial intelligence, but higher rates began to bite in Q3, seeing sectors that are highly rate sensitive experience the biggest declines. Energy stocks were the best performers in Q3, gaining 11.33% in Q3 to now sit up 3.25% YTD after finishing the first half of the year in the red. Telecommunications stocks also continued to grind higher, lifted by "Magnificent 7" members Meta and Alphabet, returning an additional 2.84% on the quarter and the

[2]All returns are total returns unless otherwise stated; international returns are net returns in USD.

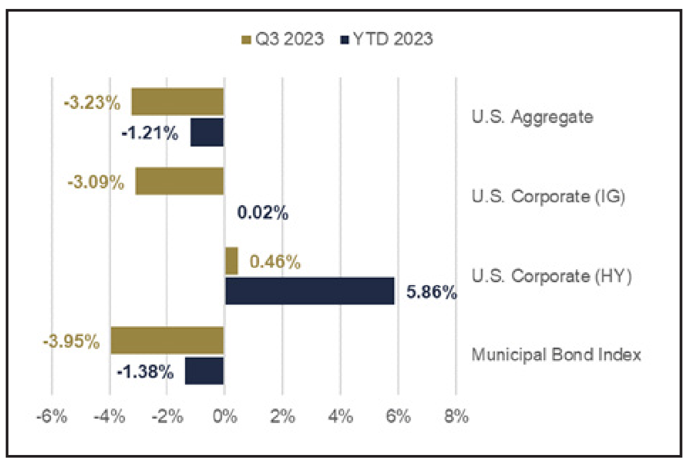
sector has now supplanted Tech as the strongest sector on the year, up 39.43%. Financials and Health Care were the other sectors that beat the S&P 500 Index overall for the quarter, down -1.60% and -3.06% for the quarter respectively. Tech stocks gave back -5.84% in Q3 but IT is still the second best performing sector year-to-date, up 33.76%. Real Estate and Utilities, sectors that are highly sensitive to interest rates, were the worst performing sectors on the quarter as rates rose materially. Real Estate fell -9.65% during Q3 and is now underwater for the year, down -7.98%. Utilities stocks also continued to struggle in the third quarter, finishing September down another -10.10% for the quarter and -16.54% year-to-date.

International Equity Markets



International equities have performed well year-to-date but also gave back some of those gains in the third quarter. The MSCI EAFE Index of major developed international equity markets was down -4.11% for the quarter and now sits up 7.08% for the year, trailing the S&P 500 by 0.84% in Q3 and 5.99% year-to-date. The growth/value trend was present internationally as well on the quarter and year-to-date, but in the opposite direction. The MSCI EAFE Growth Index lost -8.64% in Q3 and is now up just 4.31% year-to-date vs. a gain of 0.59% on the quarter and 9.92% gain on the year for the MSCI EAFE Value Index. Japan and the U.K were the two standouts amidst a broad decline in developed international stocks during Q3, which was only exacerbated by the strength of the dollar for U.S. based investors. Europe ex. the U.K continued to struggle in Q3, with France, Switzerland and Germany, which account for 61.2% of the index, all declining by mid-single digits on the quarter. Asia ex. Japan continues to be the weakest region, both in Q3 and year-to-date. Emerging markets saw more modest declines in Q3 than most developed market peers. Strong performance from Indian stocks offset weakness from China, Taiwan, and South Korea. ***Summing up equity markets globally for the quarter, the MSCI ACWI Index, a proxy for the global stock market, finished Q3 2023 down -3.40% and is now up 10.06% year-to-date.***

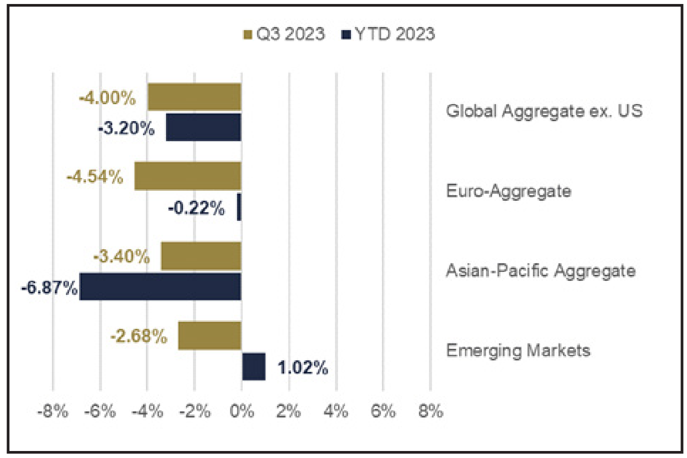
U.S. Fixed Income Markets



Bonds had the worst quarter of the year in Q3 as "higher for longer" became the dominant narrative for interest rates. While fixed income losses from July to September weren't as bad as the hit experienced in Q1 to Q3 of last year, Q3 2023 was the eighth worst quarterly return for U.S. fixed income markets dating back to 1976. The yield on the 10-year U.S. Treasury, which began the quarter at 3.85%, ended the third quarter at 4.57%. The broad increase in rates across the longer tenors of the yield curve hurt long bonds the most, with long-term Treasury bonds suffering the fourth worst quarter for performance on record dating back to 1926. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed income markets in the U.S., finished the quarter down -3.23% leaving it in the red on the year, down -1.21% YTD. Investment-grade corporate bonds fared slightly better, giving back -3.01% in Q3, though they still remain slightly positive for the year, up 0.03% YTD. The riskier part of the corporate bond market actually rallied in Q3, finishing the quarter up 0.46% and is now up 5.86% on the year. Municipal bonds remain ahead of taxable investment-grade bonds for the year despite a worse Q3 return, with the Bloomberg Municipal Bond Index falling -3.95% in Q3, leaving it down -1.38% on the year. Floating rate bonds, which have interest payments that adjust to the prevailing interest rate environment, have continued to shine. The Credit Suisse Leverage Loan Index rose another 3.37% in Q3 and is now up 9.91% on the year. In short, an improving economic outlook and an increasing belief from market participants that the Fed will hold rates higher for longer was a positive for credit and a negative for interest rates in Q3.

International Fixed Income Markets

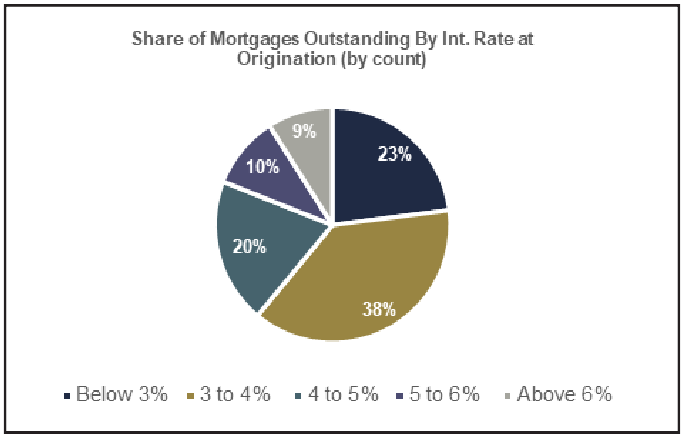
International fixed income performance continues to lag the U.S. on the year as monetary policy stances continue to diverge. The Bloomberg Global Aggregate ex. U.S. Bond Index, a proxy for the global investment-grade credit universe outside of the United States, finished Q3 down -4.00% and is now down -3.20% on the year. Regionally Asia-Pacific underperformed, losing -3.40% on the quarter, and now sits down -6.87% year-to-date. Europe performed worse on the quarter, finishing September down -4.54% for Q3, but remains well ahead year to date, down just -0.22%. Emerging market bonds, which are predominantly issued in U.S. dollars, also struggled in Q3. The JPMorgan Global Core Emerging Market Bond Index returned -2.86% on the quarter but remains positive for the year, up 1.02% YTD. ***Summing up fixed income markets globally for the quarter, the Bloomberg Global Aggregate Bond Index, a proxy for the global bond market, finished Q3 2023 down -3.59% for the quarter, leaving the index down -2.21% YTD.***



Recession Relief Gives Way to Interest Rate Anxiety

The economic news has been largely positive in 2023, with U.S. economic growth far outpacing expected predictions. Strong economic growth would normally be a tailwind for markets, so you may be asking why most asset classes struggled during a quarter of higher than expected growth. The answers lie in the baseline assumptions investors had baked in about the future – specifically the markets expectations for interest rate movements through year-end 2024. Market participants had been expecting that weaker growth would require the Federal Reserve to ease monetary policy materially over the course of the next calendar year. With growth well above expectations and inflation trending towards the Fed's long-term target, it has become more evident that the Fed is going to stick to its guns and hold rates higher for longer – which, for what it's worth, the Fed has been signally all along during this hiking cycle. Without stalling growth and rising unemployment, the Fed has no catalyst to spark a reversal in the current policy stance; the Fed will ease monetary policy when economic conditions warrant it and will otherwise remain on pause, holding interest rates higher for longer. Caught wrong-footed, investor expectations shifted to more closely match the likely reality and assets repriced for a more enduring high rate environment.

A key reason why rates may stay higher for longer is that in the current environment rate hikes may not impact the economy as much as they have in previous hiking cycles. One of the main transmission mechanisms through which interest rate increases slow the economy is the housing market. Housing costs are the most significant component of household spending. Prior to the onset of the current hiking cycle, the percent of outstanding mortgages that were adjustable rate was near an all-time low, meaning most households were not subject to higher housing costs as a result of higher rates. As of Q2 2023, 23% of outstanding mortgages had a rate lower than 3% and 61% had a rate lower than 4%. Only 9% of mortgages were above 6%. With prevailing mortgage rates now around 7.25%, most homeowners have no incentive to move, limiting the supply of existing homes for sale. But that also means that most homeowners are not feeling the pinch from higher rates on their biggest monthly outlay, allowing consumers to continue to spend during this cycle in a way that they have historically not been able to during previous hiking cycles. The bottom line is that rate hikes have not had an effect on the economy as strongly as they have historically, which likely leads rates to be higher for longer as it takes more time for rate increases to slow the economy and bring down inflation. It also could make engineering a soft landing more achievable for the Fed. Unless we see a material increase in unemployment and a sharp downturn in growth, the Fed is likely to stand pat. The Fed will cut rates because they have to in order to stimulate the economy, not simply because a certain amount of time has passed.



Once this new reality is digested by the market, we should start to see some stabilization occur. And while Q4 may see some heightened volatility, that will provide opportunity to put cash on the sidelines to work and rebalance portfolios to align with long-term goals and take advantage of future expected fixed income returns that are higher than we've seen in well over a decade.

We remain committed to focusing on your long-term financial goals and priorities by constructing portfolios designed to reach those goals while minimizing risk. As always, our clients' interests always come first, and our goal is to continue to separate the signal from the noise and focus on what truly matters in the economy and markets to help you achieve your investment goals. Should you wish to have a more in-depth conversation about the current environment and its impact on your portfolio and long-term financial plan, please reach out to your Fulton team.

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Matthew is the Chief Investment Strategist and Director of Institutional Investments for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.

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