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MidWest*One*™ TRUST SERVICES

Neil Joss
319.356.5934

John McClain
563.585.9287

Kong Her
763.512.2561

Bill Neal
563.585.9266

Blake Wilkenson
319.248.5073

MidWest*One* 2023 Capital Market Outlook

Investors are eager for a new start in 2023, having endured the pain of the prior year where the historical benefits of diversification failed to emerge, as both equities and fixed income posted negative double-digit returns. However, the events of 2022 continue to darken the economic outlook. Despite trending lower, inflation remains at levels not seen in decades. In response to this, the Federal Reserve (FED) has not wavered in their aggressive policy actions, nor have they softened their language in forward guidance. Additionally, the ongoing Russia/Ukraine conflict continues to loom large not only over emerging market but also for developed economies, namely Europe. With these broad forces in motion, it is not difficult to envision an economic slowdown both domestically and abroad in the year ahead. While the capital markets have had a fast start through the first trading sessions of 2023, the year is long with many economic, market and geopolitical conditions yet to unfold.

Signs pointing to recession

The entity officially charged with declaring a recession is the National Bureau of Economic Research (NBER). While the abbreviated definition of a recession is two consecutive quarters of negative GDP growth, the NBER's determination is based on several economic factors. At present, a recession has not yet been declared. However, recent economic data is signaling an oncoming contraction. Since Q4 2022, services and manufacturing indices have fallen into contractionary territory. Further, forward guidance from corporate executives during recent earnings seasons continue to coalesce around the themes of rising expenses, slowing revenue, and softening profit margins. Additionally, the recession probability model maintained by the FED is now signaling an economic downturn as well. The graphic below charts the FED model's calculation relative to actual recessions dating back to 1960. Over that time the average probability prior to a recession is 25%, which is compared to the current calculation of 46%. Moreover, a recession occurred in 9 of the 11 cases where the FED model reached or exceeded a 25% probability. This data makes a compelling a case for an impending economic contraction.

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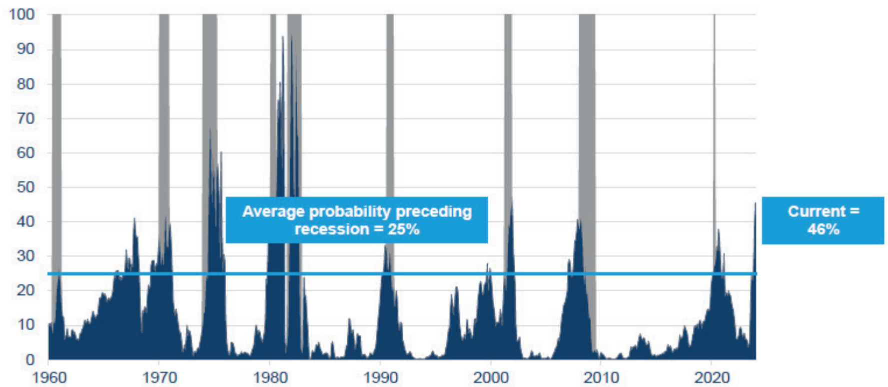
Federal Reserve Model: Recession Probability



Source: Federal Reserve Bank of New York, Bloomberg, as of 12/30/22. Parameters estimated using data from January 1959 to December 2009; recession probabilities predicted using data through November 2022. Grey-shaded periods indicate recessions.

Income quality moves to the forefront

Intuitively, equities are most challenged during recessionary periods. However, 2023 U.S. consensus earnings growth is still forecasted to be positive based on FactSet and MSCI data through 12/30/2022. This is in spite of the growing risk of recession during the year. Moreover, equity P/E levels have tended to rise as bond yields fall. With the FED arguably at the tail end of their interest rate hiking cycle, the case for declining bond yields following a peak in interest rates becomes a very real possibility in the latter half of the year and beyond. As such, a significant pivot away from equities is not advised in 2023.

That notwithstanding, not all equities behave similarly through market cycles, and market troughs in particular. Companies with the strongest revenue, cash flow, and profit margins generally weather economic downturns much better than companies with weaker income quality. The table below ranks the best performing equity factors during recessions and illustrates that high quality revenue and profitability are key determinants of superior performance during periods of market weakness.

► **During recessions, the best performing factors are Quality/Value: FCF to EV, EBITDA Margin, ROE and Forward E/P** (Ranking based on S&P 500 Cumulative Factor Returns, avg. %, during recessions)

Factors	Rank
FCF to EV	1
EBITDA Margin	2
ROE	3
Forward E/P	4
Earnings Quality	5
Share Buyback	5
OCF Surprise	7
Prior 1-Month Return	8
Price Momentum	9
Debt to Assets	10
Revenue Stability	11
Analyst Sentiment	11
Book to Price	13
LT Growth Rate	14
Size	15
Dividend Yield	16
Beta	17

Source: Columbia Threadneedle Investments. The recession periods considered are: Dot-com bubble (03/01-11/01), Global financial crisis (12/07-06/09) and 2020 pandemic (02/20-04/20). Green color is for top five performers and red for bottom five performers. **Past performance does not guarantee future results. It is not possible to invest directly in an index.**

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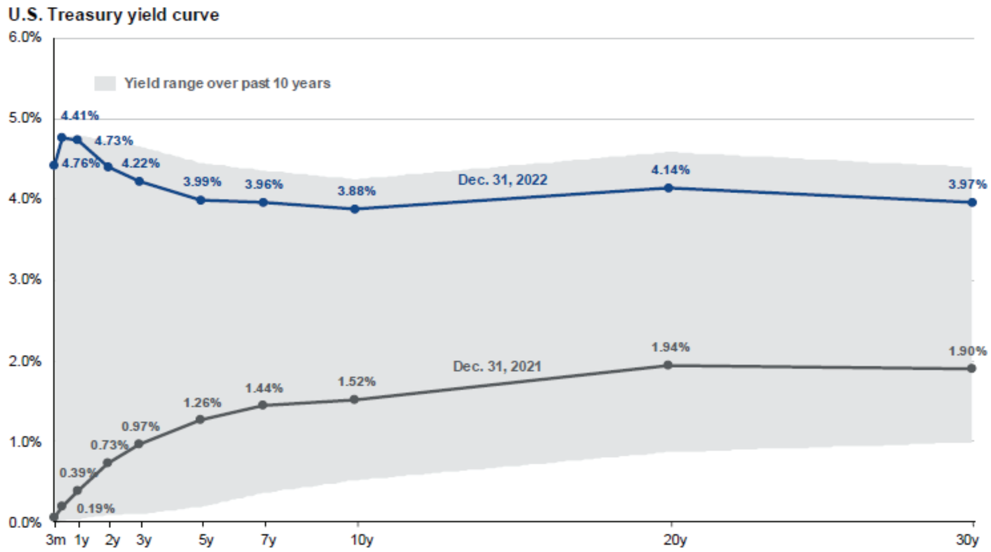
Fixed income poised to have their day

Bonds were the collateral damage in 2022 as the FED raised interest rates an astounding +4.25% in their battle to contain decades high inflation. The FED's interest rate policy actions last year were among the fastest and most aggressive campaigns in central bank history, with additional rates increases still expected in early 2023. Given the inverse relationship between bond valuations and the direction of interest rates, the fallout from such aggressive policies was the worst performance for bonds on record, categorically.

Yet, an upside does now present itself for bond and fixed income investors. While the dramatic increase in interest rates was certainly painful from a valuation standpoint, it also meant that the "income" aspect of fixed income instruments is back on the table. The income being generated from the current level of interest rates has not been seen in well over a decade, a fact driven by the FED's zero interest rate policy over that timeframe. The two lines in the graph below illustrates the change in US treasury rates across maturities between 3mos and 30yrs, i.e. the yield curve, and reveals the remarkable shift in interest rates over the course of 2022. Additionally, the shaded area exhibits the range of the yield curve over the past 10 years. With the curve currently hovering near the highs of the past decade, the likelihood of rate decreases going forward is much greater than rate increases. Of course, any declines in interest rates would be accretive to bond valuations. As it stands, bonds now present the dual opportunity of higher income generation along with the potential for positive price performance should interest rates fall.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of December 31, 2022.

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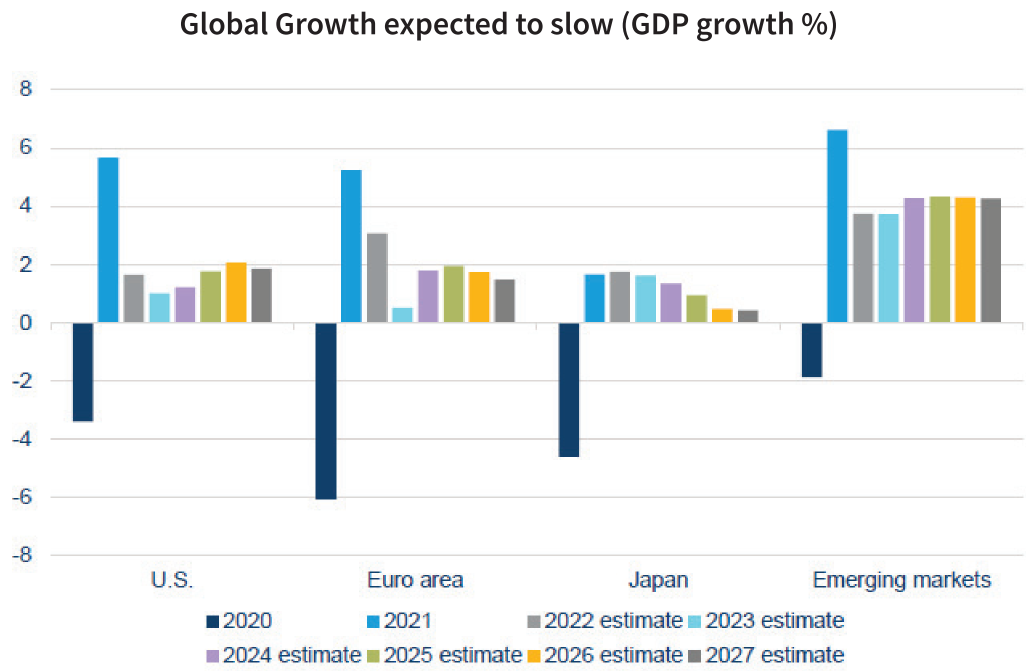
Global growth outlook is mixed

A scan across the global landscape shows uneven growth prospects over the next few years. The data below from the International Monetary Fund (IMF) illustrate this point. While GDP growth is expected to trail across the globe in 2023, growth estimates in the out years diverge meaningfully across the major regions. GDP growth trends for the Euro region and Japan are expected to decline in the latter half of this decade. Delayed interest rate policy actions on the part of the ECB and unexpected interest rate caps by the BOJ are very likely contributing to the expectations of slowing growth for those regions in the years ahead. In contrast, the US and EM economies are forecasted to expand post 2023, with EM economies expected to grow meaningfully. Specific to EM, the prospects for a renewed China growth story have improved substantially as the PBOC has begun to pivot away from their Zero Covid policy as well as indicated supportive central bank policy actions.



Source: IMF as of 10/22

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Tail risks on the horizon

While the views above reflect our assessment of forward-looking market conditions, we are mindful of tail risk scenarios which could materially impact the direction of the capital markets over 2023. A key risk is the disconnect between FED policy guidance and asset valuations at the start of the year. Both the equity and fixed income markets have rallied significantly, effectively pricing in supportive central bank policies in 2023. In direct contrast, the FED has repeatedly affirmed their stance that interest rates need to remain "higher for longer" in order to combat inflation. As those views cannot both be correct, adjustments must occur in earnest. The longer these opposing views are held, the greater the risk of a violent market correction when those views are forced to align. Additionally, the war in Ukraine continues to inject uncertainty into the capital markets. While the near-term effects of the conflict have largely been priced in, the lack of clarity around a resolution continues to weigh not only on the Ukrainian and Russian economies, but also on developed Europe and EM broadly. Further, the risk of escalation is ever present given the leadership of Russian President Vladimir Putin. Lastly, the compromise coming out the historic Speaker race in the US House of Representatives provides a great deal of power for rank-and-file House Republicans. Given the divisive state of US politics, upcoming debt ceiling decisions, and the power structure now in Congress, the risk of default by the US government on its debt obligations is a growing possibility. While debt ceiling politics has historically been relegated to political theater, the discord within Congress makes a US debt default scenario a very dangerous possibility.

While the outlook for 2023 is an improvement from the prior year, the speed at which the capital markets can shift requires diligent oversight along with the flexibility to act. Given the multitude of factors at play, it is reasonable to state that how we are positioned going into 2023 could look very different to how we position coming out of it.

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800.247.4418 MidWestOne.bank Email: trustservices@midwestone.com