Equity Outlook

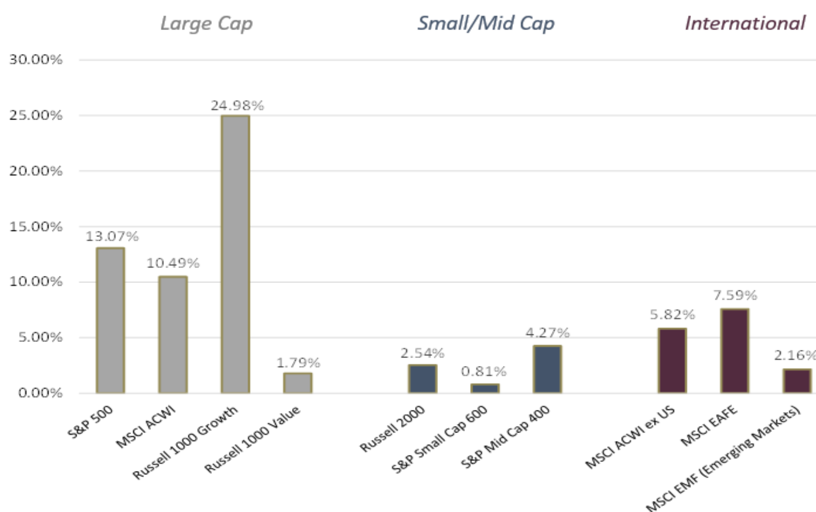
October 2023

FRANKLIN STREET PARTNERS

Despite a difficult third quarter driven by rising U.S. Treasury rates and a growing acceptance of a "higher for longer" rate environment, the benchmark S&P 500 has delivered a solid YTD performance, gaining +13.1%. The primary fuel for the S&P 500 has been well known large cap growth stocks, particularly the well-followed "Magnificent 7" of AAPL, MSFT, GOOGL, AMZN, META, TSLA, and NVDA. Smaller U.S. stocks trailed their larger counterparts for the year, but still have posted gains themselves, as the mid-cap S&P 400 and small cap Russell 2000 rose +4.3% and +2.5%, respectively for the first nine months of 2023. International stocks also advanced YTD, as the MSCI ACWI ex-U.S. index gained +5.8% while the MSCI Emerging Market Index was up +2.2%.

Driven by a robust labor market, declining inflation, fiscal policy tailwinds, and corporate profitability resilience, the U.S. economy has avoided the widely predicted recession that many forecasted in early 2023. However, while the odds of a U.S. recession have declined, a wide range of economic outcomes remains. Jay Powell and the Fed appear committed to driving inflation to its 2% target, implying a "higher for longer" interest rate environment as we move into 2024. In our view, the level of inflation is possibly the most important factor affecting the economic outlook.

In summary, the U.S. economy has – thus far – fared far better than many forecasters feared.



Source: FactSet 9.30.2023

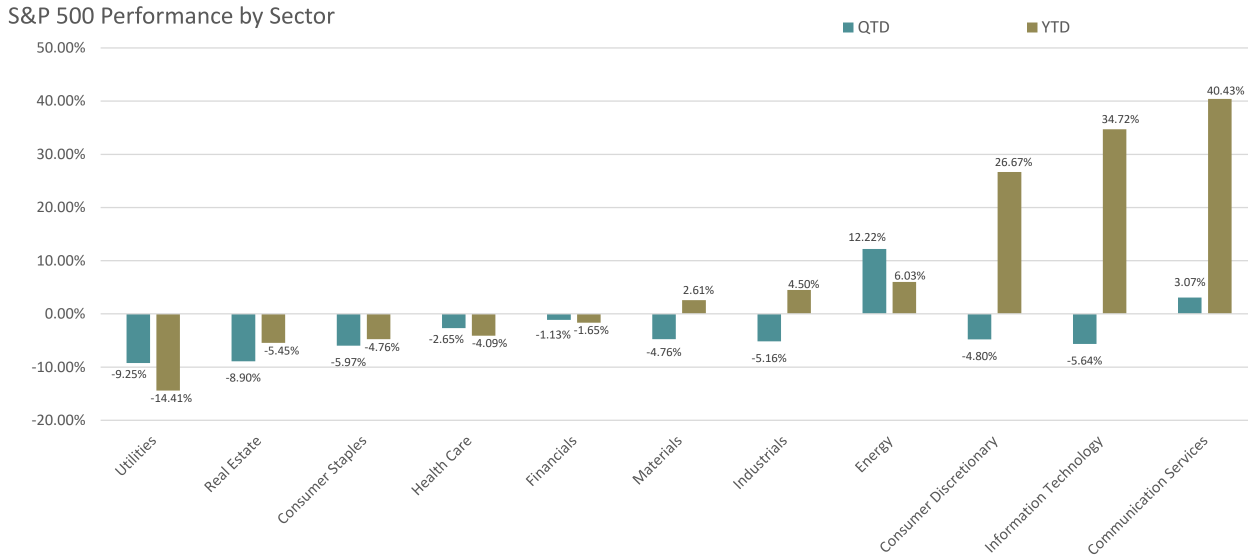
However, as the effects of the long and variable lags of monetary policy are reflected in the economic data, we anticipate that markets will continue to fluctuate between pricing in a soft landing and pricing in a recession. FSP's base case outlook includes moderating inflation, the Fed winding down its tightening program, and a range of economic outcomes in the United States over the next twelve months from soft landing to mild recession. Our opinion for a mild recession is predicated on the notion that the U.S. economy is structurally more resilient than in typical cycles. Households and corporations are also far less vulnerable to higher interest rates, compared to previous tightening cycles. This is not 2007-2008.

In equities, we anticipate volatility will rise as macroeconomic and corporate profitability data fuel the debate over the next leg for stocks. Our outlook, however, remains essentially unchanged from the beginning of the year – in which higher interest rates will foster an economic backdrop of slowing economic growth in 2024. The odds of an economic "soft landing" have improved despite the likelihood of a "higher for longer" rate environment. We believe longer-term corporate fundamentals remain constructive, particularly in the advantaged businesses we seek to own in client portfolios. Continued resilience in earnings will be crucial, particularly as attention will turn to 2024, in which current estimates project approximately +12% YoY EPS growth over 2023 levels. As of the end of September now, the S&P 500 was trading at a P/E multiple of 17.3x 2024 EPS estimates, below both 5 and 10 year averages.

Markets will continue to contend with a variety of concerns, but overall we believe attractive opportunities exist and continue to point to a year-end 2023 range of 4200-4600 for the benchmark. We believe active management, adhering to a disciplined investment process that balances risk and reward, and a focus on owning advantaged businesses are appropriate strategies in the current environment. In our asset allocation we continue to favor large-cap equities; a domestic bias; and a barbell approach with exposure to growth and value to take advantage of compelling valuations across the economic landscape.

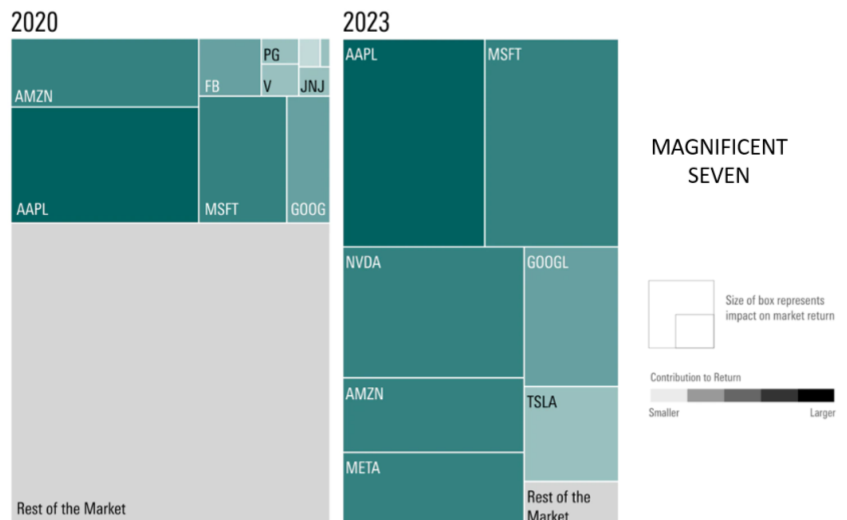
* The performance shown is for illustrative purposes only. Indices are unmanaged and may not be invested in directly.

YTD 2023 Returns: Following a brutal 2022 for growth stocks and significant outperformance from value counterparts, the reversal of fortunes for these two factors has been striking in 2023. On a year-to-date basis, the Russell 1000 Growth index has gained an incredible +25.0% versus a mere +1.8% return for the Russell 1000 Value index. Not surprisingly, the three most traditional growth sectors, technology, consumer discretionary, and communication services, were by far the best performing sectors through the first three-quarters of 2023. Conversely, the economically-cyclical, value-oriented sectors struggled through September – these included utilities, real estate, and consumer staples.



Most noteworthy in 2023 has been the extreme concentration of returns for the market generated by outsized contributions of the so-called "Magnificent 7" grouping of Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla, and Meta.

In aggregate, these seven companies comprise nearly 28% of the S&P 500's entire market capitalization; yet, they collectively account for +11% of the +13% YTD return for the index. The trend of hyper-concentrated returns isn't entirely new, but this year it's reached an unprecedented level.



According to Morningstar, the most recent previous high-water mark for concentration of stock market returns came in 2020 when the five largest stocks at the time (Apple, Microsoft, Amazon, Meta, and Tesla) contributed 37% of the overall market return. In 2023 so far, the concentration of returns coming from the five

largest stocks has been double that figure. Leading the way in total returns are NVDA (+197.8%) and META (+149.5%).

It is important to note that each of these seven names were down greater than the S&P 500 benchmark in 2022 with an average decline of -46%; the best performer, Apple, lost more than -26% itself. One of the most common questions facing investors regards the ability of the Magnificent 7 to maintain its leadership; we would suggest that each of the businesses has its own individual business drivers and have owned 6 of 7 in a majority of FSP internally-managed strategies throughout 2023.

Entering 2023, there were no shortage of worries facing equity investors – a perception of slowing economic growth, global central banks continuing to tighten monetary policy, U.S. debt ceiling concerns, etc. Adding to investor anxieties were the second (First Republic Bank), third (Silicon Valley Bank), and fourth (Signature Bank) largest bank failures in U.S. history, not to mention the failure of one of the world's largest diversified financial institutions in Credit Suisse. The list of concerns grew in recent weeks with the removal of the Speaker of the House of Representatives and the vicious Hamas attack on Israel and the potential for strife to spread to the rest of the Middle East.

Given all of the bricks in the "Wall of Worry," it's reasonable to wonder how global equity benchmarks have performed reasonably well in 2023. We would point to several important causes: 1) Oversold conditions entering the year lead to a powerful change in market leadership back to familiar giants. 2) Labor conditions have remained resilient, bolstering the consumer and delaying any potential recession. 3) The emerging theme of artificial intelligence (AI) has exploded faster than nearly anyone could have anticipated, as a nearer-term visibility of meaningful revenue and expectations of a new technology "super cycle" captured investor's enthusiasm, drawing them into that select group of giant companies, creating the narrowest leadership in modern investing history.

However, it is the relative resilience of corporate earnings that we believe is most important factor – and likely holds the key to equity upside through the remainder of 2023 and into 2024. Entering this year, we suggested that S&P 500 earnings estimates needed downward revisions to better match buy-side investor sentiment. This indeed occurred, as the 2023 EPS estimate moved from $229 a share to approximately $220 by the end of September. However, these downward earnings revisions have not proven to be as severe as some market prognosticators, who forecasted earnings below $200 a share, originally feared. Continued resilience in corporate earnings will be crucial, particularly as attention turns to 2024, in which current estimates project nearly +12% YoY EPS growth over 2023 levels. This growth may prove overly optimistic as well, but we also believe investor sentiment already considers that possibility.

What to Expect Moving Forward

Our <u>base case</u> outlook for stocks remains essentially unchanged from the beginning of 2023: higher interest rates will foster an economic backdrop of slowing economic growth in 2024. Further, we strongly believe the long-term environment for stocks remains healthy.

Equities - Outlook

- Strong first three quarters of 2023 in S&P 500 driven by growth giants; our Base Case considers continued slowing inflation; economic growth; and a paused Fed that fuels equities above our end of year range of 4200-4600.
- Est. revisions in 2023 S&P 500 EPS moved from $229 to $220 at end of 3Q, far better than worst case expectations at the outset of the year. In the absence of rates peaking, resiliency in corp. fundamentals into FY24 becomes the main driver of equity returns.
- S&P 500 currently trading at 17.4x 2024 EPS estimates; attractively priced for another year of above trend growth.
- In internally managed portfolios, we recommend a balance of growth and income to take advantage of compelling valuations across the economic landscape.
- We believe the end of a zero interest rate policy makes the environment particularly attractive for active equity management – owning advantaged businesses over the longer-term.

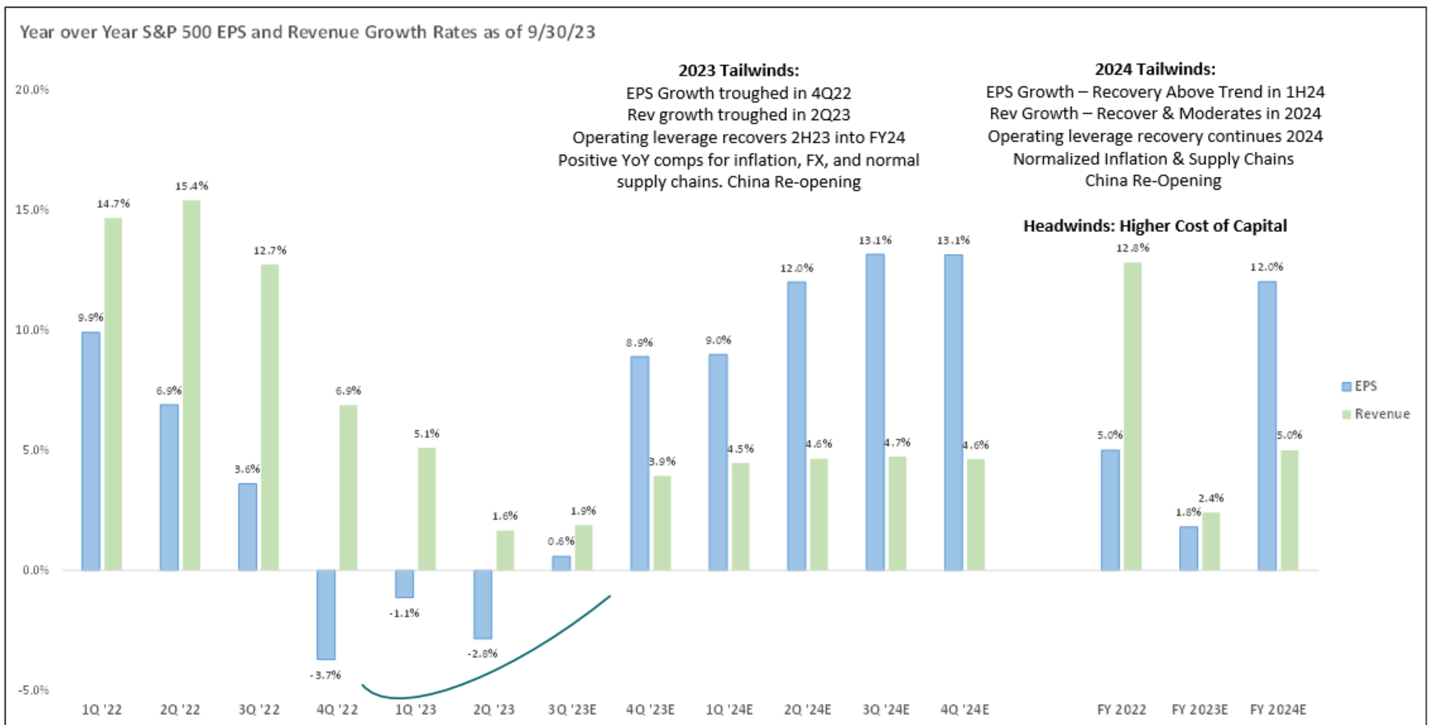
We are closely monitoring the all-important U.S. consumer. There have been countless attempts to call the end of U.S. consumer strength, most of which have been categorically wrong over a lengthy period of time. Based on both economic data and company reports, there is certainly some weakness in lower-income consumer spending, and the prospect of student loan payments

restarting is worth consideration. However, we continue to see solid spending trends in the companies we own in internal portfolios and believe that a tight U.S. labor market remains the best friend to the consumer.

Importantly, the U.S. consumer, on a whole, is not as levered as many might fear. Personal loan and credit card delinquencies are near pre-pandemic levels. The largest expense for most American consumers is housing, and according to Bloomberg, only 3% of outstanding U.S. home mortgages are adjustable rate versus higher than 26% at the peak of the 2008 housing crisis. While the "higher for longer" interest rate environment will be an adjustment for U.S. consumers, we do not believe it to be a fatal blow.

Earnings Matter…. The third quarter earnings season should provide new information about the continued resilience of solid corporate profitability and the ability for companies to navigate a higher interest rate environment. Consensus estimates suggest a YoY increase of approximately +0.6% for S&P 500 earnings per share, which would mark the first quarter of positive earnings growth following three consecutive quarters of year-over-year decline.

We continue to believe that earnings for the remainder of 2023 will prove stronger than the truly dire expectations of some market forecasters and will likely remain in a range between $215 and $220 per share. Perhaps more importantly, the estimate for 2024 has remained mostly stable, actually rising from $244 at the end of June to $246 at the end of the third quarter. While we believe there is a fairly high likelihood that the 2024 estimate will compress as we approach the end of this year, we also would suggest that this action will be broadly anticipated by most investors.

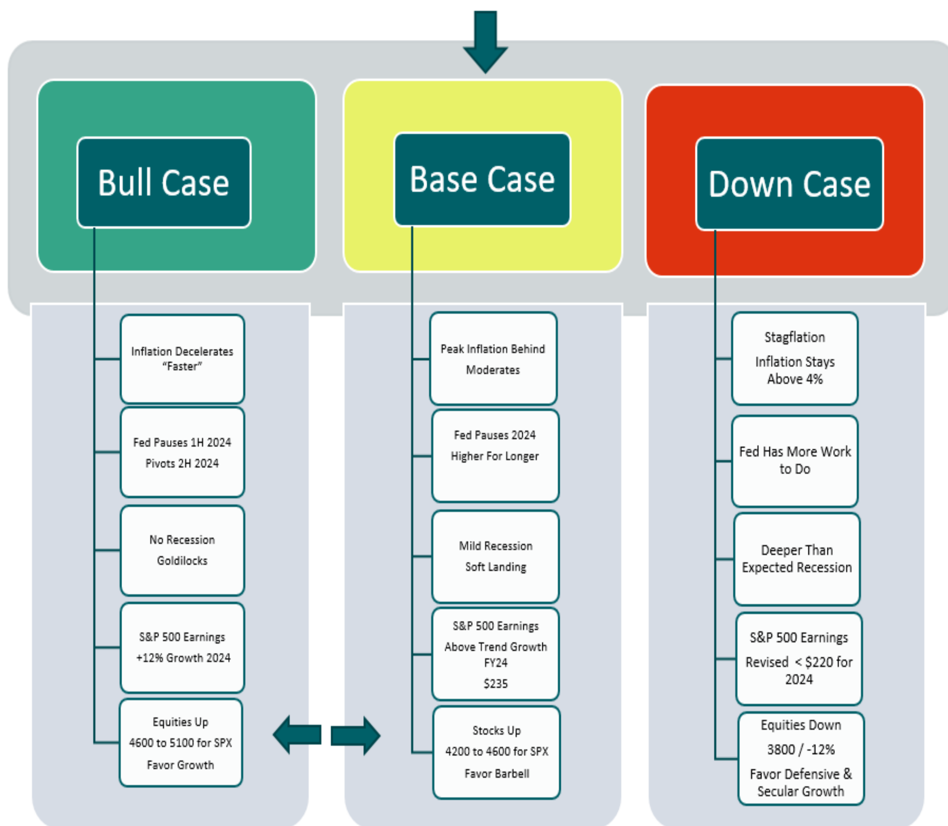


Source: FactSet as of 9.30.2023

Base Case: We continue to expect near-term volatility as equity markets digest continued economic and corporate data, but reiterate an S&P 500 range of 4200 – 4600 as a likely target for year-end 2023.

This forecast has not changed since we first issued it in early January of this year. As of the end of September, the S&P 500 was trading at a P/E multiple of 17.3x on 2024 forecasts; which is below both five and ten-year averages, according to FactSet.

What would cause downside to our base case scenario? Reacceleration of inflationary measures would be a clear headwind given the firm commitment from the Fed and other global central banks to reducing inflation; it seems very unlikely that the Fed would reverse course, and we believe the "higher for longer" narrative to be firm.



Further, any significant weakening in household spending activity could shake investor confidence given the importance of the consumer to U.S. economic activity.

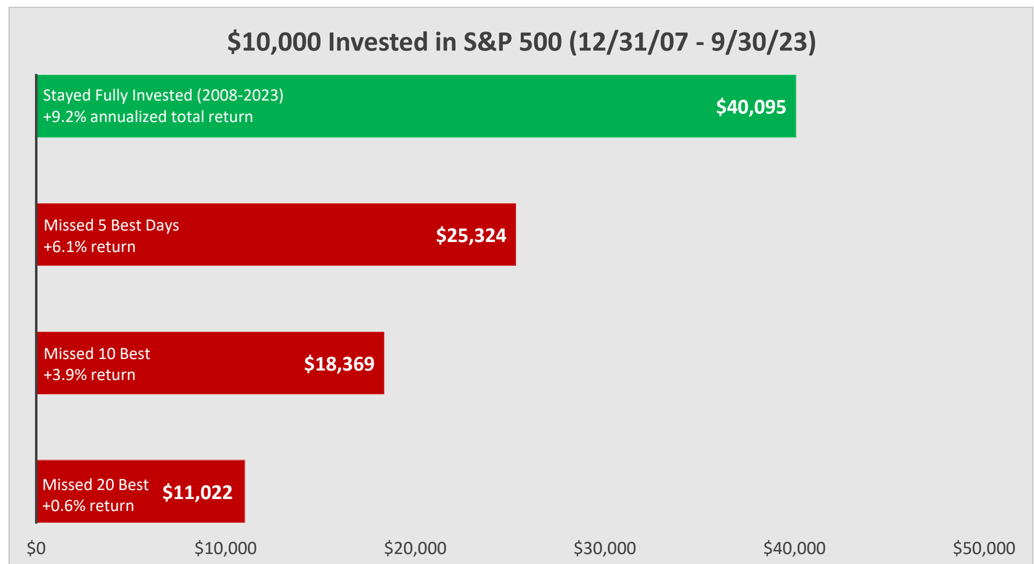
It is also important to consider catalysts for an upside case; in our opinion, a consistent, faster than expected deceleration of inflation measures combined with a resilient underlying economy and a cessation of global central bank tightening would be a scenario that could fuel a greater than expected response from risk assets.

Benefits of Investing for the Long Term

We have often discussed the benefits of remaining invested, of time in markets and not timing markets themselves. Between the end of 2019 and September, 2023, we've experienced the first global pandemic in over a century, the highest level of inflation since the early 1980s, two bear markets in the S&P 500, the largest one-year increase in the Fed Funds rate since 1985, the highest level of 30-year fixed mortgage rates since 2002, the highest level in WTI crude since 2008, and the first year EVER in which both the S&P 500 total return and the Bloomberg Aggregate indices were both negative. Despite all of that, between December 31, 2019 and September 30, 2023, the S&P 500 delivered a total return of +41.1%, or +9.6% annualized.

While veteran FSP clients understand well the power of longer-term investing and compounding returns, specific illustrations can be helpful over time. For example as the graph below shows, in the period between 2008 and the end of the third quarter of 2023 (3,964 trading days), an investor achieved an annualized return of +9.2% by staying fully invested over the entire period. This compares quite favorably to an investor who missed only the best ten days of S&P 500 performance over the entire period and achieved an annualized return of +3.9%. Over that same 2008-2023 stretch, nine of the ten best days occurred within two weeks of the ten worst days.

Importantly, the 2008-2023 span covered bear markets including the Great Financial Crisis (-56.8% peak to trough) and the 2020 Covid-19 pandemic (-35.4%). In fact, the period included two of the four worst (2008 and 2022) calendar year performances since the end of World War II.



Sources: Franklin Street Advisors, Bloomberg, 9.30.2023

In our opinion, it is essential for investors to understand that equities are leading, not lagging indicators, and that history has repeatedly illustrated equity markets bottom prior to meaningful improvement in underlying economic and corporate data.

During the Great Financial Crisis, the S&P 500 bottomed in early March 2009 and had gained approximately +37.9% by the NBER's declared recession end in June 2009. Likewise, the S&P 500 hit its pandemic low in March 2020 and gained +30.4% by the end of that brief recession in April 2020.

FSP Asset Allocation and Internal Equity Strategies

We believe Franklin Street's asset allocation process stands ready to respond to these differing outcomes. Our Asset Allocation Committee is all in our Chapel Hill headquarters and meets often to weigh the constantly evolving investment environment.

As a reminder, we have maintained a more conservative posture for some time now – we primarily manage to 3 differing risk models, with our Moderate allocation targeting 50% equities, 41% fixed income, and 9% alternative assets of the beginning of the third quarter relative to the traditional 60/40 portfolio commonly discussed in financial media. Included within the aforementioned allocation to alternatives is a dedicated position to strategic "cash." These funds are held in a liquid, short-term U.S. Treasury Bond ETF with an average yield to maturity in excess of 5%. Our Committee intends to deploy these assets into U.S. large equities on any significant pullback in the S&P 500 in excess of -10%.

Further, we remain strong advocates in active management and think a volatile rate environment supports that confidence. Entering the final quarter of 2023, we believe we have attractive active management opportunities at a number of different points – at the security level, at the asset class level, and at the overall asset allocation level.

Within FSP, we actively manage five primary large cap equity strategies with a range of return and risk objectives that represent style tilts to the S&P 500 benchmark – Strategic Growth, Partners Advantaged, Equity Income, Growth & Income, and Sustainable, Responsible Equity. Growth & Income uses a barbell approach, combining stocks from our core growth-oriented strategy (Strategic Growth) with our core value conservative strategy (Equity Income); and Sustainable, Responsible strategy is a thematic ESG approach to our Partners strategy.

In the actively managed, internal large cap equity strategies, we continue to focus on companies with distinct advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to favor advantaged companies with secular growth opportunities, strong balance sheets, high free cash flow generation, and capital flexibility. Advantaged businesses are uniquely positioned to potentially emerge as stronger competitors over the longer term as well as weather severe economic challenges. We believe 2023 and 2024 are years where active management and stock selection are key elements to help navigate equity markets.

We are mindful of maintaining a balance of holdings that have promising secular growth prospects along with others that provide downside protection if recession scenarios escalate. One of our favorite examples of a secular growth company is Alphabet Inc. (GOOGL/GOOG), better known as the holding company for Google. Over its history, GOOGL's primary source of revenue has been generated from advertising in its well-known Search business; in 2023, the company's digital advertising efforts have proven far more resilient than many observers believed, as Alphabet has a vast number of options to boost the advertising efficiency of its clients in Search, YouTube, and more. More importantly, GOOGL's fast growing Cloud segment has shown the ability to compete effectively with Microsoft's Azure and Amazon's AWS offerings, and Alphabet's long-time focus on A.I. should provide developers, creators, and partners with tools to benefit from the company's A.I. advances in coming years. We believe GOOGL's valuation does not accurately reflect its long-term cash flow generating power.

We balance our holdings in secular growers with companies that exhibit a solid dividend yield and more importantly, the capacity to grow their dividends significantly in coming years. We believe McDonald's Corporation (MCD) provides an attractive example of this combination; the global restaurant giant continues to position itself well for modern times with a determined focus on effective digital offerings including kiosks in restaurants, automated order taking, and a well-regarded mobile app that includes delivery options. MCD has focused on refranchising in recent years, and in September, the company announced its first hike in royalty fees for new franchisees in nearly three decades. MCD has proven its ability to offer value in a variety of economic environments, and we believe recent concerns that obesity medications may permanently harm long-term earnings power for fast food companies are likely premature. MCD's dividend yield of 2.7% is attractive relative to the S&P 500's 1.6%, and the company's 5-year dividend growth rate exceeds 50%.

Christy L. Phillips
Head of Equity Strategies and Director of Research

Dennis C. Greenway, II, CFA
Senior Equity Analyst and Portfolio Manager

Todd D. Young
Senior Equity Analyst and Portfolio Manager

Ron A. Zlatniski
Head of Equity Trading

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