



October 2023

Economic Update

A Review of Third Quarter 2023

The U.S. economy continues to hold up better than many expected it would, as third quarter GDP is expected to be very strong. The labor market remains robust. The recent Artificial Intelligence boom has given a boost for business spending and consumers also have maintained a willingness to continue their spending as well, even it means taking on more debt to do so. As of this writing, the Atlanta Fed predicts that the third quarter saw 4.9% annualized GDP growth.

Yet, despite this surprising strength of the economy, the U.S. stock market has struggled as of late. This is likely due to stubborn inflation and more importantly the Fed's response to that inflation. Three months ago, many market observers thought that the current Fed rate might be the peak and that rates would be coming down soon. Now, the Fed has indicated that there could be one more increase in the near future and that rates may stay elevated for longer.

A high Fed rate serves to intentionally dampen economic growth as a tool to limit inflation. This is why, despite strong current growth, many market forecasters continue to be concerned that a recession could still be on the horizon.

U.S. Economy

After two quarters of negative growth in the first half of 2022, the U.S. economy has posted strong GDP gains in the five quarters following that.

The current Fed rate range now sits at 5.25 to 5.5%. The Fed expects that range to increase to 5.5 to 5.75% by year end before they eventually begin to cut rates in 2024 and beyond. Inflation readings will continue to drive that decision. After peaking at 8.9% year over year in June 2022, inflation has been in a downtrend since then. The most recent reading as of August was 3.7%. Still, this is a higher number than the Fed's long-term target of 2.0%, so expect Fed rates to stay relatively high as long the U.S. economy can tolerate it.

The labor market continues to be strong. Per the Bureau of Labor Statistics, the U.S. economy added 236,000 net jobs during July, 227,000 in August and 336,000 in September. They also reported that the total number of unemployed persons is 6.4 million and the unemployment rate is 3.8%. The participation rate for adults aged 25-54 is now fully recovered to pre-pandemic levels. The participation rate for adults aged 55+ has remained low, but that likely is due to our aging baby-boomer population, as this group continues to permanently leave the workforce.

Employers continue to be mildly pessimistic, although confidence has been increasing as of late. The Institute for Supply Management Manufacturing PMI registered 49.0 in September. Readings below 50.0 represent a suggestion of future economic contraction. Note, however, that while still technically still indicating contraction, the Manufacturing PMI is now at its highest level since November 2022.



Consumers also remain relatively pessimistic. While the latest reading of University of Michigan Consumer Sentiment still remains in an uptrend, registering 68.1 in June, this still represents a fairly low reading by historical standards as it is well below the 100.0 level normalized in December 1964.

International Economy

Similar to the U.S., other developed international economies have also been subject to recent rate hiking from central banks. European Central Bank President Christine Lagarde reinforced her commitment to bring down inflation by setting interest rates at “sufficiently restrictive levels for as long as necessary.” Inflation remains above target at 4.3% year-over-year in September. This has been driven by rising food and energy prices as well as strong wage growth.

Composite PMI, which is a measure of economic health for the manufacturing and services sectors, was 46.7 in August. Readings below 50.0 represent a suggestion of future economic contraction. This economic stagnation is expected to drag on well into next year. S&P currently expects eurozone GDP growth to be just 0.6% annualized for 2023 and 0.9% annualized in 2024.

Asia appears to be in better shape than Europe. Japan GDP grew at an annualized 6.0% rate in the second quarter. This follows 2.7% annualized growth in the first. Strong retail sales and elevated local consumer sentiment show that domestic consumption remains solid, and exports were up 3.2% in the second quarter.

China’s reopening after the lifting of COVID restrictions has been slower than expected. The IMF predicts 2023 GDP growth of 5.3%, 2024 growth of 5.0%, and less than 4% average growth years after that, much slower than the historical trend. Lower projected growth puts the focus back on the commercial property sector, which should continue to remain challenged for the foreseeable future following years of overbuilding in the past.

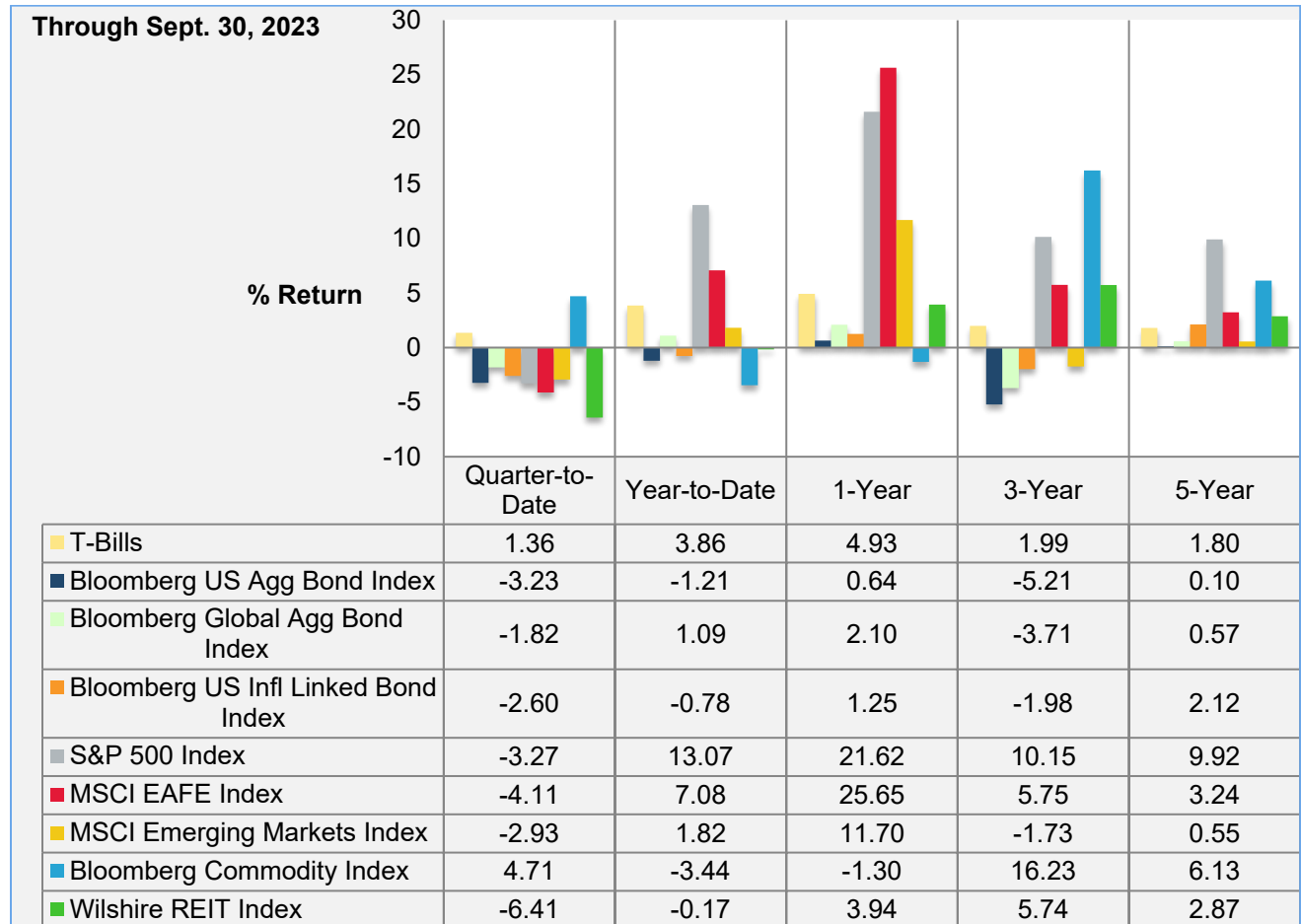
Markets

Equity markets retraced some of their previous gains during the past quarter but are mostly still positive for the year as a whole. U.S. large-cap equities, as represented by the S&P 500 Index, lost 3.27% during the quarter but are still up 13.07% year-to-date. Developed international equity markets, as represented by the MSCI EAFE Index haven’t fared as well. That index was down 4.11% for the quarter but still up 7.08% for the year. The Wilshire REIT Index was down a little more, posting a 6.41% loss during the last three months. It is now down 0.17% year-to-date.

Bond indexes also had a rough quarter as a result of the continued increase in interest rates. The Barclays U.S. Aggregate Bond Index was down 3.23% in the last three months and is now down 1.21% year-to-date. The Barclays Global Aggregate Bond Index lost 1.82% during the quarter but is still up 1.09% year-to-date. The Barclays U.S. Inflation-Linked Bond Index was down 2.6% during the last three months and is now down a total of 0.78% for the year as a whole.

The MSCI Emerging Markets Index fared a little better than developed markets, but still finished the quarter down 2.93% overall. They are up 1.82% year-to-date. Commodities were the only major asset

class to buck the trend. The Dow Jones UBS Commodity Index rebounded with a 4.71% gain in the third quarter but it is still down 3.44% for the year so far.



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Outlook

Equity markets posted poor third quarter results and investor sentiment seems fairly negative to start the fourth. Note, however, that investor sentiment can change very quickly. In the near term, much seems to depend on upcoming inflation readings and the Fed's reaction to that data. Positive inflation data could spark new market optimism should the Fed begin to show signs of becoming more accommodative in the near future.



However, also note that the economy is beginning to show some signs of weakness, despite being surprisingly resilient thus far. Jobs growth is still positive, but wage growth has slowed of late. Business sentiment is trending a little better, but still somewhat negative. Consumer sentiment is also negative by historical standards, and this may not fully include the impact of student loans restarting after a three-year break. As always, we recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity IndexSM and Bloomberg Commodity Index Total ReturnSM the DJ-UBSCISM family includes both the BSCISM, which is calculated on an excess-return basis, and the BSCITRSM, a total return index based on the BSCISM. The



former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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