

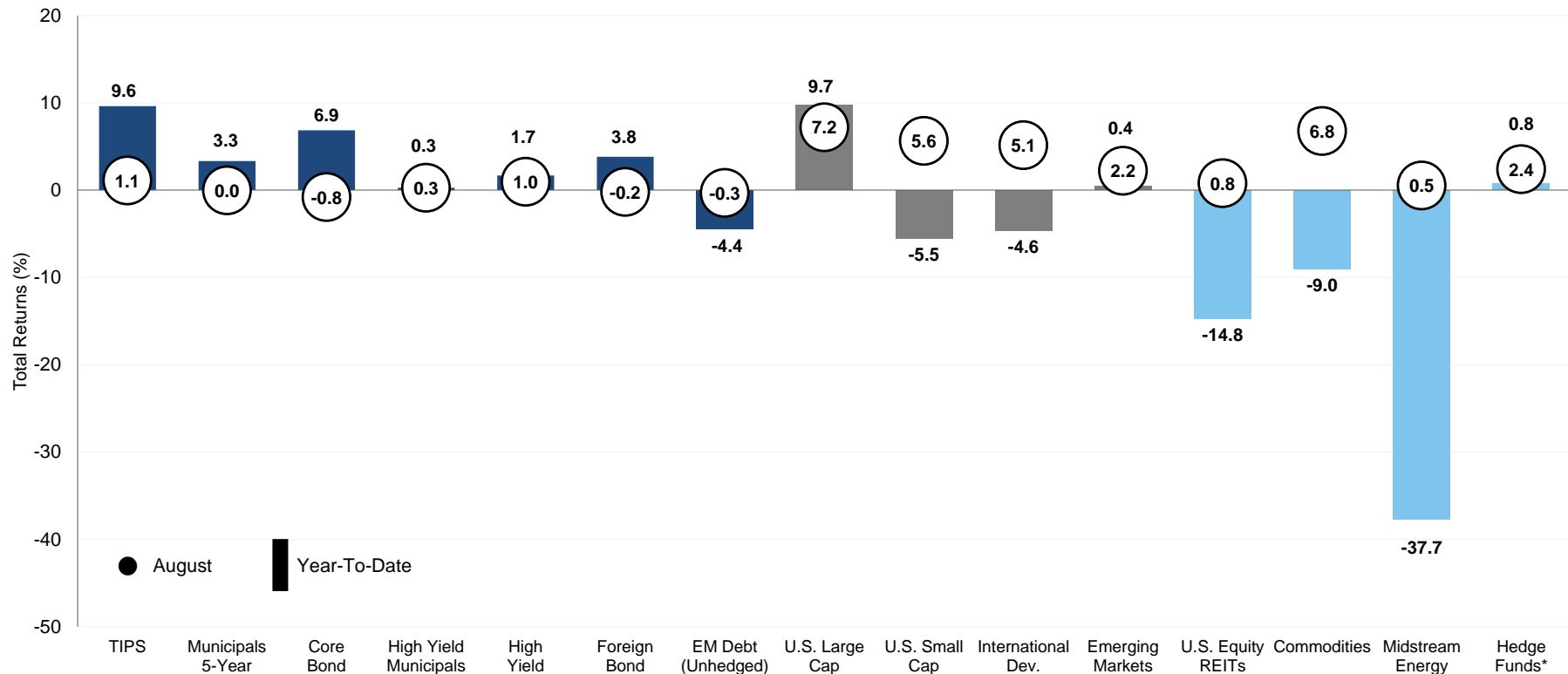
Market Recap August 2020

WEALTH MANAGEMENT

FNBC BANK & TRUST
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Asset Class Performance – August 2020



*Hedge Funds returns are lagged one month.

Sources: Bloomberg, J.P. Morgan, Russell, MSCI, FTSE Russell, Alerian.

Fixed Income (August)

- Treasury curve steepened as yields modestly increased on long-dated maturities
- + Credit spreads narrowed slightly
- + Inflation expectations rose faster than nominal yields, which benefited TIPS

Equities (August)

- + Slow growth outlook and accommodative Fed policy favored U.S. large cap growth stocks
- + U.S. dollar weakness aided returns on international and emerging market equities

Real Assets / Alternatives (August)

- + U.S. dollar weakness broadly benefited real assets
- + Elevated volatility environment was favorable for hedge fund managers

See disclosures for list of indices representing each asset class.

Financial Markets Performance

Total return as of August 31, 2020

Periods greater than one year are annualized

All returns are in U.S. dollar terms

Global Fixed Income Markets	MTD	YTD	1YR	3YR	5YR	7YR	10YR	15YR
Bloomberg Barclays 1-3-Month T-Bill	0.0%	0.5%	1.1%	1.6%	1.1%	0.8%	0.6%	1.2%
Bloomberg Barclays U.S. TIPS	1.1%	9.6%	9.0%	5.7%	4.6%	3.6%	3.7%	4.2%
Bloomberg Barclays Municipal Bond (5 Year)	0.0%	3.3%	3.5%	3.0%	2.9%	2.9%	2.7%	3.6%
Bloomberg Barclays High Yield Municipal Bond	0.3%	0.3%	1.0%	5.6%	6.4%	6.6%	6.0%	5.1%
Bloomberg Barclays U.S. Aggregate	-0.8%	6.9%	6.5%	5.1%	4.3%	4.1%	3.7%	4.4%
Bloomberg Barclays U.S. Corporate High Yield	1.0%	1.7%	4.7%	4.9%	6.5%	5.6%	6.9%	7.1%
Bloomberg Barclays Global Aggregate ex-U.S. Hedged	-0.7%	2.3%	0.7%	4.5%	4.3%	4.5%	3.9%	4.2%
Bloomberg Barclays Global Aggregate ex-U.S. Unhedg.	0.3%	5.4%	4.6%	2.8%	3.8%	1.8%	1.8%	3.1%
Bloomberg Barclays U.S. Long Gov / Credit	-3.7%	14.4%	10.9%	9.9%	9.0%	8.6%	7.3%	7.1%
JPMorgan GBI-EM Global Diversified	-0.3%	-4.4%	1.5%	0.7%	4.6%	0.9%	1.3%	4.7%
Global Equity Markets	MTD	YTD	1YR	3YR	5YR	7YR	10YR	15YR
S&P 500	7.2%	9.7%	21.9%	14.5%	14.5%	13.8%	15.2%	9.5%
Dow Jones Industrial Average	7.9%	1.3%	10.3%	11.6%	14.2%	12.4%	13.8%	9.6%
NASDAQ Composite	9.7%	32.1%	49.5%	23.7%	21.2%	19.9%	20.2%	13.3%
Russell 3000	7.2%	9.4%	21.4%	13.9%	13.8%	13.3%	14.9%	9.5%
Russell 1000	7.3%	10.4%	22.5%	14.6%	14.3%	13.7%	15.2%	9.6%
Russell 1000 Growth	10.3%	30.5%	44.3%	24.2%	20.7%	18.9%	19.0%	12.3%
Russell 1000 Value	4.1%	-9.4%	0.8%	4.5%	7.5%	8.1%	11.0%	6.6%
Russell Mid Cap	3.5%	-0.4%	8.7%	8.8%	9.7%	10.4%	13.1%	8.8%
Russell Mid Cap Growth	2.7%	15.5%	23.6%	17.9%	14.9%	14.3%	16.0%	10.7%
Russell Mid Cap Value	4.0%	-10.8%	-1.3%	2.5%	6.1%	7.6%	10.9%	7.3%
Russell 2000	5.6%	-5.5%	6.0%	5.0%	7.6%	7.9%	11.5%	7.3%
Russell 2000 Growth	5.9%	6.1%	17.3%	10.9%	10.4%	10.6%	14.1%	9.1%
Russell 2000 Value	5.4%	-17.7%	-6.2%	-1.4%	4.4%	4.8%	8.7%	5.2%
MSCI ACWI	6.1%	4.8%	16.5%	9.0%	10.2%	9.1%	9.9%	6.9%
MSCI ACWI ex. U.S.	4.3%	-3.1%	8.3%	2.6%	5.8%	4.5%	5.3%	4.6%
MSCI EAFE	5.1%	-4.6%	6.1%	2.3%	4.7%	4.5%	5.9%	4.2%
MSCI EAFE Growth	4.5%	5.3%	15.5%	8.0%	8.5%	7.3%	8.2%	5.9%
MSCI EAFE Value	5.9%	-14.4%	-3.2%	-3.4%	0.8%	1.4%	3.5%	2.4%
MSCI EAFE Small Cap	7.5%	-3.5%	10.7%	2.6%	6.8%	7.1%	8.6%	5.9%
MSCI Emerging Markets	2.2%	0.4%	14.5%	2.8%	8.7%	4.9%	3.8%	6.6%
Alternatives	MTD	YTD	1YR	3YR	5YR	7YR	10YR	15YR
Consumer Price Index*	0.6%	0.1%	1.0%	1.9%	1.7%	1.5%	1.7%	1.9%
FTSE NAREIT Equity REITs	0.8%	-14.8%	-12.9%	1.3%	5.2%	7.0%	8.7%	6.1%
S&P Developed World Property x U.S.	6.0%	-14.3%	-7.9%	0.4%	4.1%	4.3%	6.5%	4.8%
S&P Developed World Property	3.2%	-14.5%	-10.5%	0.8%	4.5%	5.4%	7.4%	5.2%
Bloomberg Commodity Total Return	6.8%	-9.0%	-3.9%	-3.1%	-3.1%	-7.1%	-5.1%	-4.3%
HFRI Fund of Funds Composite*	2.4%	0.8%	2.6%	2.7%	1.9%	2.9%	3.0%	2.7%
HFRI Fund Weighted Composite*	2.8%	-0.7%	1.8%	2.7%	3.0%	3.5%	3.8%	4.3%
Alerian MLP	0.5%	-37.7%	-39.8%	-16.6%	-11.9%	-9.7%	-2.2%	2.2%

Source: Bloomberg. (*) denotes reported with a one-month lag.

Disclosures & Definitions

INDEX AND BENCHMARK DEFINITIONS:

- **Bloomberg Barclays Treasury U.S. T-Bills-1-3 Month Index** includes aged U.S. Treasury bills, notes and bonds with a remaining maturity from 1 up to (but not including) 3 months. It excludes zero coupon strips.
- **Bloomberg Barclays Capital US Treasury Inflation Protected Securities Index** consists of Inflation-Protection securities issued by the U.S. Treasury.
- **Bloomberg Barclays Muni 5 Year Index** is the 5 year (4-6) component of the Municipal Bond index.
- **Bloomberg Barclays U.S. Aggregate Index** covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
- **Bloomberg Barclays Global Aggregate ex. USD Indices** represent a broad-based measure of the global investment-grade fixed income markets. The two major components of this index are the Pan-European Aggregate and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds and Canadian government, agency and corporate securities.
- **Bloomberg Barclays U.S. Corporate High Yield Index** covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included.
- **JP Morgan Government Bond Index-Emerging Market (GBI-EM) Index** is a comprehensive, global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.
- **The S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
- **The Dow Jones Industrial Index** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.
- **The NASDAQ** is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.
- **Russell 3000** is a market-cap-weighted index which consists of roughly 3,000 of the largest companies in the U.S. as determined by market capitalization. It represents nearly 98% of the investable U.S. equity market.
- **Russell 1000** consists of the largest 1000 companies in the Russell 3000 Index.
- **Russell 1000 Growth** measures the performance of those Russell 1000 companies with higher P/B ratios and higher forecasted growth values.
- **Russell 1000 Value** measures the performance of those Russell 1000 companies with lower P/B ratios and lower forecasted growth values.
- **Russell Mid Cap** measures the performance of the 800 smallest companies in the Russell 1000 Index.
- **Russell Mid Cap Growth** measures the performance of those Russell Mid Cap companies with higher P/B ratios and higher forecasted growth values.
- **Russell Mid Cap Value** measures the performance of those Russell Mid Cap companies with lower P/B ratios and lower forecasted growth values.
- **Russell 2000** consists of the 2,000 smallest U.S. companies in the Russell 3000 index.
- **Russell 2000 Growth** measures the performance of the Russell 2000 companies with higher P/B ratios and higher forecasted growth values.
- **Russell 2000 Value** measures the performance of those Russell 2000 companies with lower P/B ratios and lower forecasted growth values.
- **MSCI ACWI (All Country World Index) ex. U.S. Index** captures large and mid-cap representation across Developed Markets countries (excluding the United States) and Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the US.
- **MSCI ACWI (All Country World Index) ex. U.S. Small Cap Index** captures small cap representation across Developed Markets countries (excluding the US) and Emerging Markets countries. The index covers approximately 14% of the global equity opportunity set outside the US.
- **MSCI EAFE** is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
- **MSCI EAFE Value** captures large and mid-cap securities exhibiting overall value style characteristics across Developed Markets countries around the world, excluding the US and Canada. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The index targets 50% coverage of the free float-adjusted market capitalization of the MSCI EAFE Index.
- **MSCI EAFE Growth** captures large and mid-cap securities exhibiting overall growth style characteristics across Developed Markets countries around the world, excluding the US and Canada. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend. The index targets 50% coverage of the free float-adjusted market capitalization of the MSCI EAFE Index.
- **MSCI Emerging Markets** captures large and mid-cap representation across Emerging Markets countries. The index covers approximately 85% of the free-float adjusted market capitalization in each country.
- **FTSE NAREIT Equity REITs Index** contains all Equity REITs not designed as Timber REITs or Infrastructure REITs.
- **S&P Developed World Property** defines and measures the investable universe of publicly traded property companies domiciled in developed markets. The companies in the index are engaged in real estate related activities, such as property ownership, management, development, rental and investment.
- **S&P Developed World Property x U.S.** defines and measures the investable universe of publicly traded property companies domiciled in developed countries outside of the U.S. The companies included are engaged in real estate related activities, such as property ownership, management, development, rental and investment.
- **Bloomberg Commodity Index** is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification.
- **The Alerian MLP Index** is the leading gauge of energy Master Limited Partnerships (MLPs). The float adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis.

An Examination of International Equity Diversification

Now May be the Wrong Time to Abandon Non-U.S. Stocks

August 2020

Michael Degna, CFA, Research Analyst – Global Public Markets

Since the mid-1990's, the superior risk-adjusted returns investors once received from regionally diverse equity allocations has faded as domestic stocks have outperformed developed international markets and correlations have risen between each region.

Before 2009, U.S. and developed international market stocks saw similar periods of outperformance with U.S. leadership coinciding with the strength of the dollar.

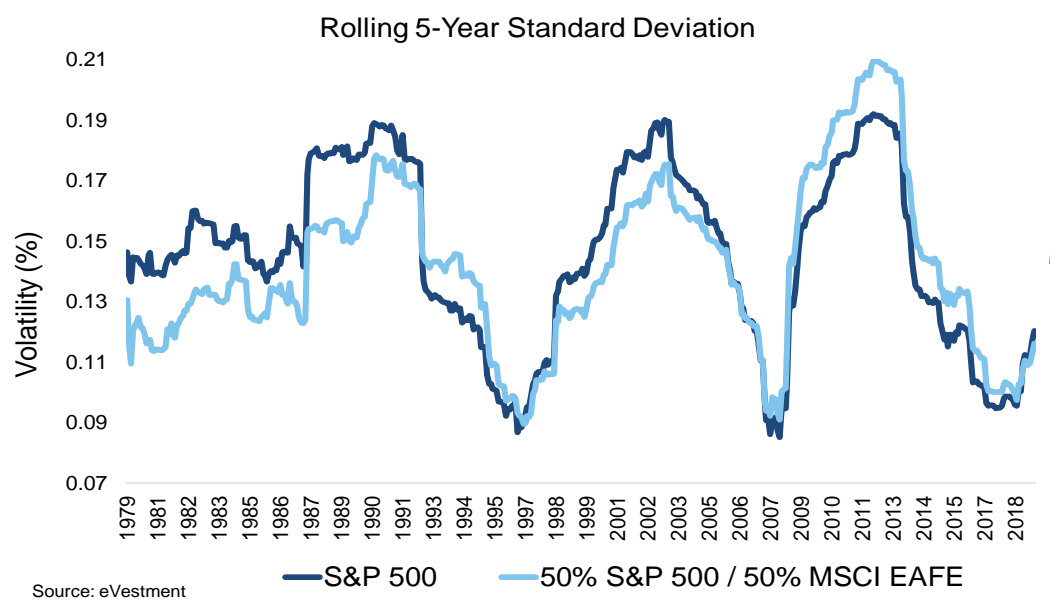
With international stocks trading at a significant discount to U.S. equities and the dollar bull market reaching the length in time, which marks a reversal historically, we believe the probability of international stocks returning to favor is increasing.

An allocation to developed international market stocks provides access to a majority of the world's most profitable businesses, attractive opportunities for active managers and greater sector diversification.

The father of Modern Portfolio Theory, Harry Markowitz, called diversification “the only free lunch in finance,” based on his finding that pairing assets with imperfect correlations improves risk-adjusted performance. Unfortunately, the “free lunch” for domestic investors broadening their equity allocations to include developed non-U.S. market stocks has not materialized in recent years as globally diversified equity allocations reduced returns and increased risk relative to U.S. equity allocations.

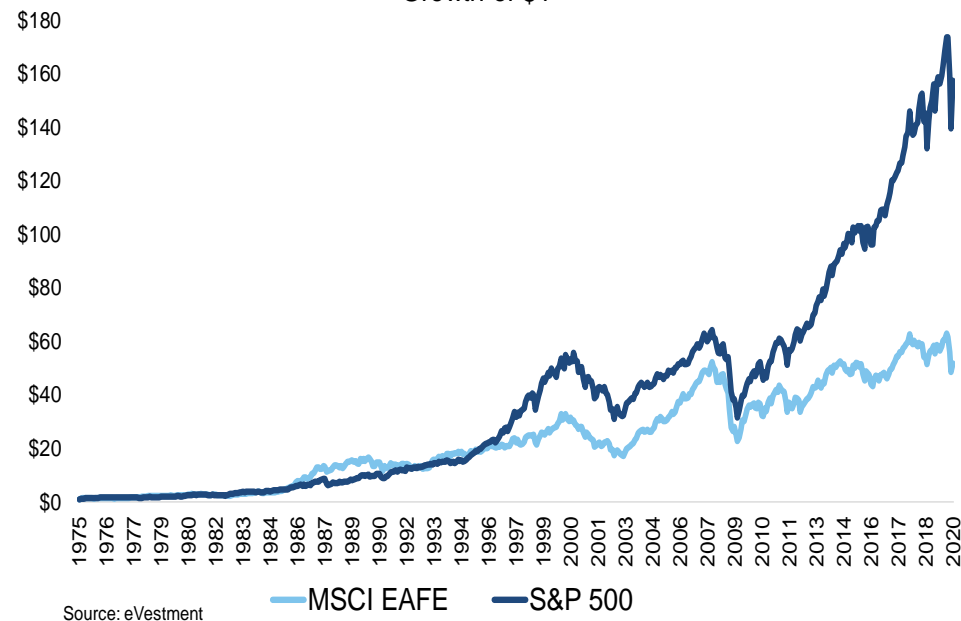
Historical Perspective – Risk, Return and Correlation

Throughout much of the history of U.S.¹ and international developed market stocks², pairing the two assets produced better risk-adjusted returns relative to a dedicated allocation to either region. Starting in 1975 through the mid-1990's, investors realized similar cumulative gains from U.S. and non-U.S. developed market stocks. Additionally, an equally weighted mix of the two markets saw less volatility relative to a stand-alone domestic allocation, illustrated in the chart below.



Source: eVestment

Growth of \$1

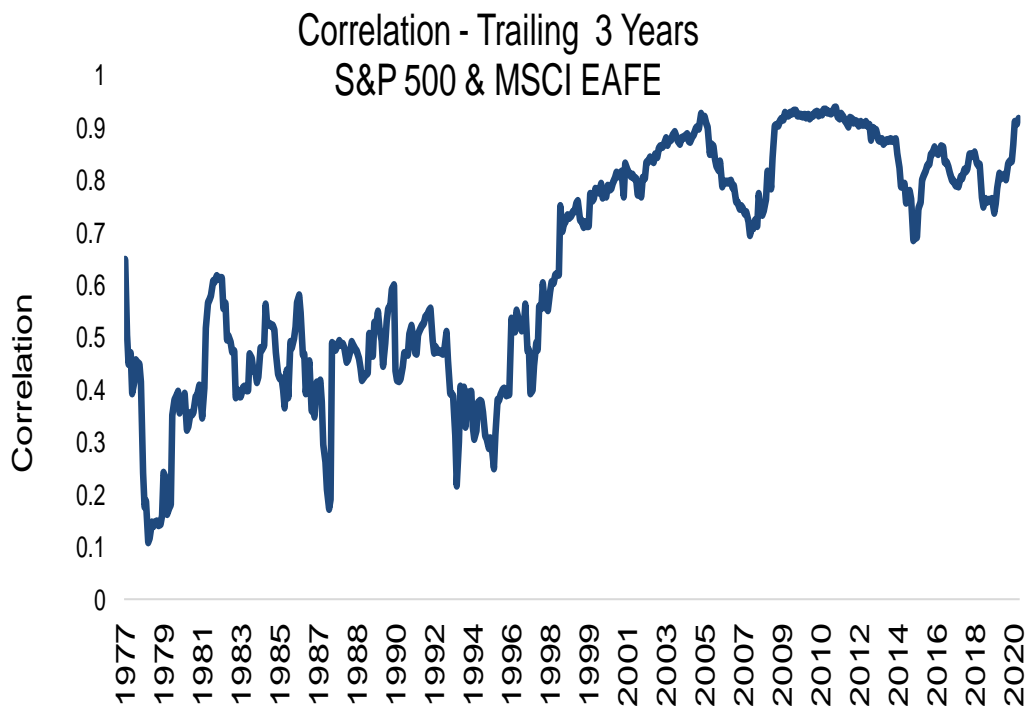


Source: eVestment

¹ Defined as the S&P 500 Index.

² Defined as the MSCI EAFE Index.

More recently, U.S. stocks have outperformed their international peers. As previously illustrated, cumulative gains among markets diverged following the period of relative outperformance by U.S. equities in the 1990's and the 424 percent total return domestic equities saw since the market bottom in March 2009 through May 2020; a 285 percent greater total return than developed international markets produced. Since the 1990's, the performance dispersion between U.S. and developed international stocks has been so large that while a \$1 invested in 1975 grew in both markets to \$18 by June 1995, it's risen to \$165 and \$54, for U.S. and international developed stocks, respectively, as of May 2020.



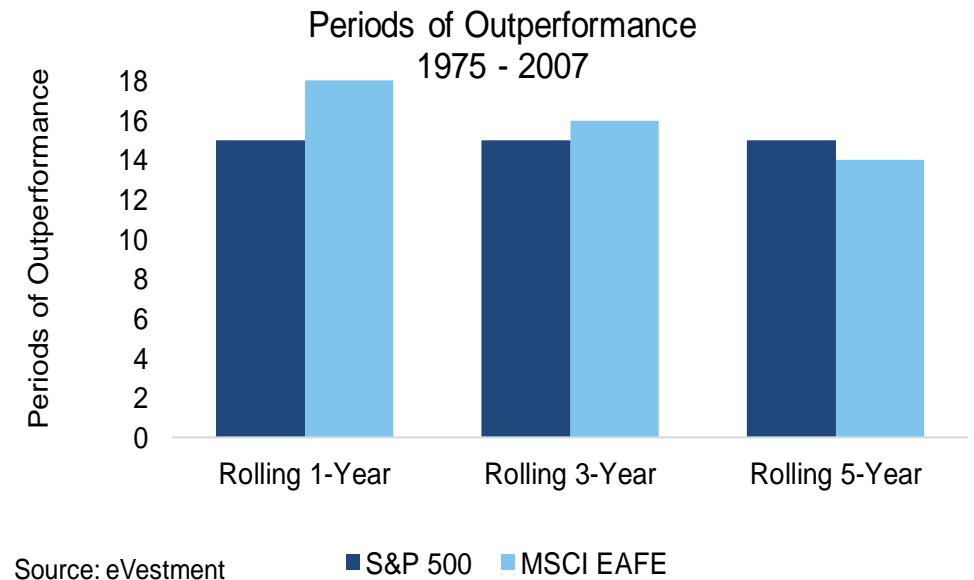
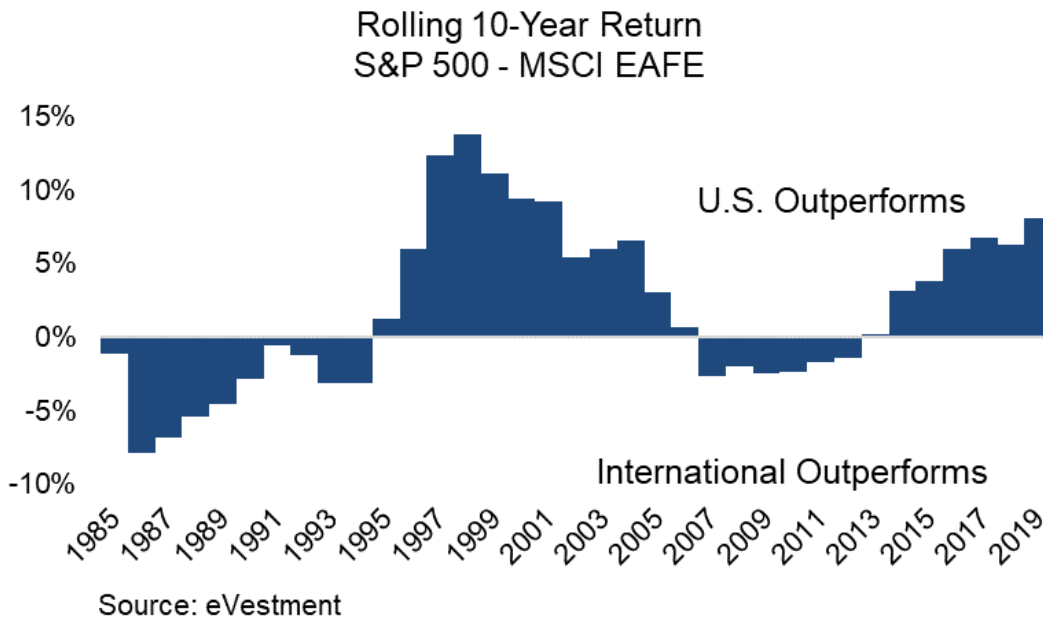
The diversification benefits of allocating to non-U.S. developed market stocks too has faded. The correlation between U.S. and international developed equities averaged 0.43 from 1975 through 1997 but rose dramatically to 0.83 from 1998 through May 2020. As the correlations increased, the addition of non-U.S. developed market stocks to portfolios with domestic equities no longer reduced risk as much as it did through 1997. In fact, since 1997 through May 2020, the average three-year standard deviation of an equally weighted mix of U.S. and international developed market stocks saw 0.15 percentage points more volatility than the S&P 500, compared to reducing volatility by 1.84 percentage points from 1975 through 1997.

Source: eVestment

The Cyclical Nature of U.S. and International Markets

Historically, patterns suggest investors should not abandon their non-U.S. developed market allocation. Domestic stocks have outperformed in nine of the past 12 years. However, in the 33 years prior, the total returns of international developed market equities exceeded that of U.S. stocks in 18 years and outperformed almost half-the-time when observing rolling three-, five-, and ten-year periods.

Periods of dominance from one market have been prolonged yet cyclical, with rolling ten-year returns showing international developed stocks outperformed from 1985 through 1995 and 2007 through 2013. We believe this exchange between markets signals international equities are due to return to favor after an extended period of strength by U.S. stocks since the financial crisis.



The Dollar's Impact

The relationship between the U.S. dollar and regional equity market performance is also cyclical.

Going back to 1973, examining an index of the trade-weighted dollar, we found periods of “dollar strength,” defined as intervals ranging from the dollar’s trough to its peak, and periods of “dollar weakness” using the inverse measurement. Dollar strength is equivalent to foreign currency weakness, which poses strong headwinds on the returns of assets denominated in foreign currencies when translated into U.S. dollars. For example, if a Japanese stock rises 10 percent, but the U.S. dollar strengthens 12 percent against the yen, the net return to a dollar-based investor is a negative 2 percent.

There was a clear relationship between periods of U.S. equity market outperformance and a strengthening U.S. dollar. In the three-dollar bull markets since 1973, U.S. equities have an average excess return of 120 percent over international developed markets, compared to a negative 89 percent average excess return during periods of dollar weakness.

Without forecasting the end to the current period of dollar appreciation that began in August 2011, we found this strengthening cycle reached 101 months at the end 2019 – slightly longer than the 99 month average length of dollar bull or bear markets. As this period of dollar appreciation grows long in the tooth, we believe U.S. equities could be at risk of losing a tailwind.

Start Date	End Date	Duration (Months)	Direction	Return		Excess Return
				MSCI EAFE	S&P 500	
10/1/1978	2/28/1985	77	Dollar Strength	67%	145%	78%
3/1/1985	3/31/1995	121	Dollar Weakness	405%	286%	-119%
4/1/1995	1/31/2002	82	Dollar Strength	15%	153%	138%
2/1/2002	7/31/2011	114	Dollar Weakness	96%	38%	-58%
8/1/2011	12/31/2019	101	Dollar Strength	53%	198%	145%
Average		99				
Average Return - Dollar Bull Markets				45%	165%	120%
Average Return - Dollar Bear Markets				250%	162%	-89%

Source: eVestment

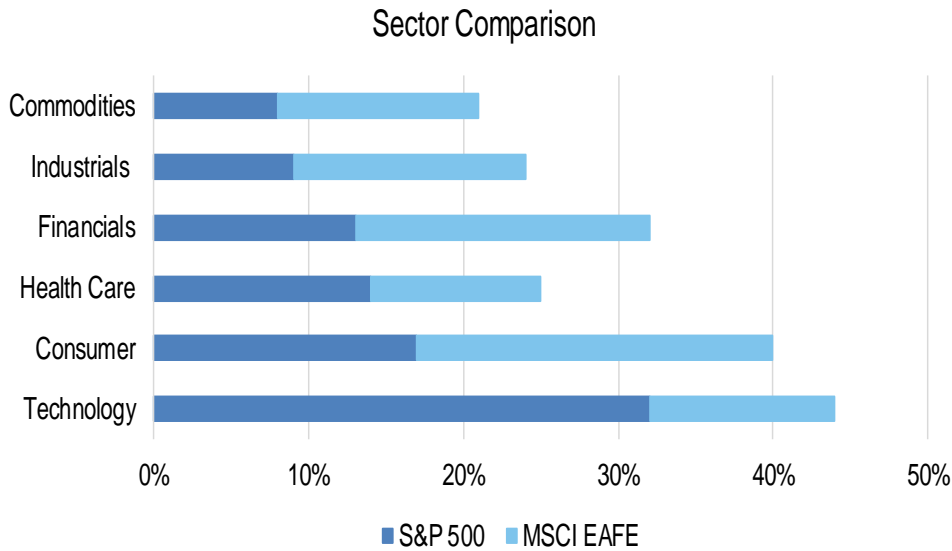
Looking Beyond Returns

An examination of the stock-specific opportunity set supports the case for an allocation to non-U.S. stocks. Investors restricting their portfolio to the domestic market are dismissing 45 percent of the global equity market capitalization and 9,806 of the 13,364 publically traded companies³. While U.S. stocks currently have superior fundamentals in aggregate, a number of global industry leaders are located abroad. Of the 20 most profitable companies across eleven sectors, in nine of them, more than half are located outside the U.S.⁴

³ Dimensional, Global Markets Breakdown (Q3 2019), 2.

⁴ Harding Loevner, Global Equity Perspectives (Third Quarter 2019), 6. Data from Factset, MSCI Inc., and the Holt database.

Introducing international developed stocks to a portfolio of domestic equities creates more balanced sector exposure with overseas markets holding larger allocations to the cyclical financials, industrials and commodity sectors. With the information technology and technology laden communication services sector representing 38.3 percent of the S&P 500, compared to 23 percent in 2009⁵, the U.S. stock market, increasingly, has become reliant on the performance of a narrow sub-set of industries.



Source: eVestment. As of 12/31/2019

Large differences in single stock concentration between markets has helped drive the relative outperformance of U.S. stocks. The five largest capitalization stocks in the S&P 500 contributed 58 percent of the index’s 21.8 percent return from January 2018 through June 2020⁶. Meanwhile, the average return for stocks in the index returned 6.1 percent⁷, illustrating the significant impact of the largest holdings. Strong relative returns have resulted in increased benchmark concentration, as the five largest securities in the S&P 500 rose to an all-time high weighting of 21.7 percent as of June 30, 2020⁵. Meanwhile, the MSCI EAFE Index shows broader diversification across holdings with an 8.1 percent weighting to its top five holdings.

Overseas markets have recently provided more attractive opportunities for active managers than their domestic counterparts. Looking at trailing five – and ten-year periods, the median U.S. Large Cap Core manager trailed the S&P 500 by an average of -0.72 percent and the median U.S. International Developed Core manager outperformed the MSCI EAFE Index by an average of 0.29 percent.⁷

⁵ S&P 500 Market Attributes (June 30, 2020)

⁶ Glenmede Investment Management, Quantitative Research Notes

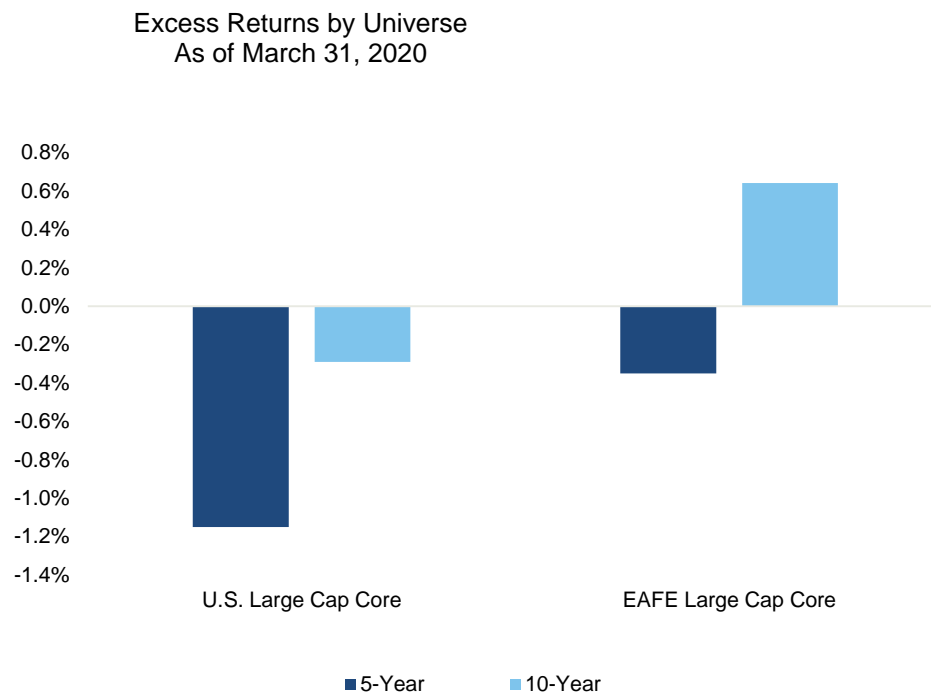
⁷ Data from eVestment. Past performance does not indicate future performance and there is a possibility of loss.

Potential Catalysts – Reversion in Fundamentals & Valuation

It is unclear if the superior fundamentals that have supported the United States' recent stock market dominance are sustainable. Since the Global Financial Crisis through 2019, earnings of the S&P 500 almost doubled from their trough in 2009, while international developed market companies have failed to recover profits to their pre-crisis level.⁸

The declining share of corporate profits captured by workers⁹, the long-term trend of globalization, and corporate tax reform in 2018 helped profit margins in the U.S. reach a near all-time high in 2019, and subsequently, supported superior earnings growth in the U.S. Meanwhile, an increase in stock buybacks – often funded with debt issuance – contributed to domestic equity returns, coinciding with an \$8 trillion increase in U.S. corporate debt – roughly three times the 2008 value.¹⁰

Excess Returns



⁸ J.P. Morgan, Guide to the Markets (4Q 2019), 46.

⁹ Josh Bivens, “The Fed Shouldn’t Give Up On Restoring Labor’s Share of Income and Measure it Correctly,” <https://www.epi.org/blog/the-fed-shouldnt-give-up-on-restoring-labors-share-of-income-and-measure-it-correctly/>, January 30, 2019.

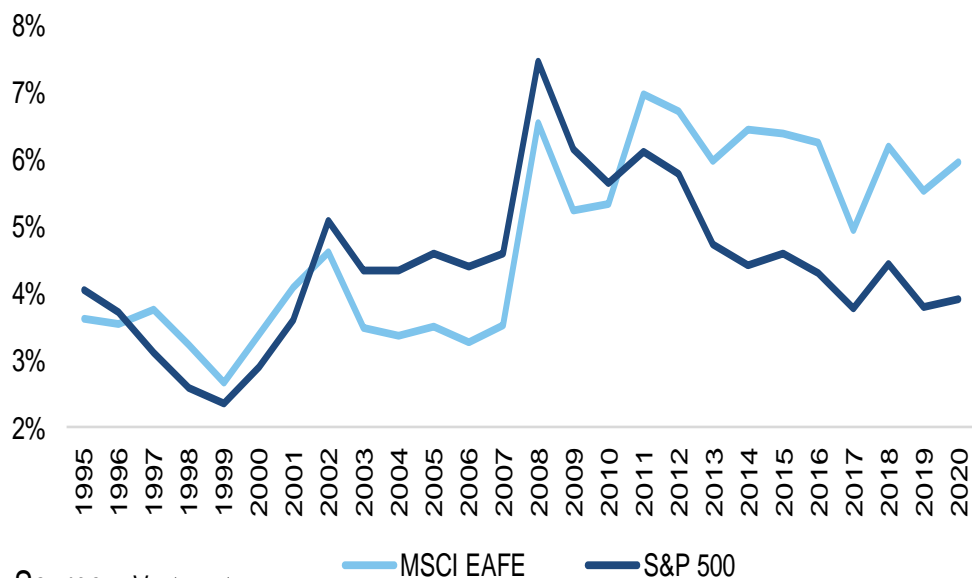
¹⁰ J.P. Morgan, “Stock Buybacks: Is Excess Cash Being Spent Wisely?,” <https://www.jpmorgan.com/global/research/stock-buybacks>, (August 15, 2019).

In the midst of the 2020 recession, profit margins of U.S. corporations have re-traced from their all-time highs. A number of hurdles may prevent domestic profit margins from reaching the prior levels that supported the post Global Financial Crisis recovery in earnings, including:

- A potential sweep of the 2020 elections by Democrats, leading to higher corporate tax rates and policy measures geared towards addressing income inequality through higher wages.
- A trend toward re-shoring manufacturing following Coronavirus related supply chain disruptions, resulting in higher production costs.

Stock buybacks may also struggle to reach their pre-2019 levels as debt-funded buybacks may become prohibitive given high levels of corporate leverage and corporations preserve cash to maintain balance sheet strength. Additionally, following the recent stress tests, the Federal Reserve has required all large banks suspend share repurchases.

Normalized Earnings Yield



Source: eVestment

A normalization in valuations has the potential to serve as another catalyst for international markets. As of May 31, U.S. large cap stocks registered a 10-year normalized earnings yield of 3.9 percent and dividend yield of 1.9 percent, compared to international developed stocks' earnings yield of 6 percent and dividend yield of 3.4 percent¹⁰. While it is logical for U.S. stocks to trade at a premium compared to their international peers given larger weightings to less cyclical and higher growth sectors, including technology and health care, U.S. stocks sit at a normalized earnings yield 52 percent lower than their international peers – 43 percent below the average since 1995.¹¹

¹¹ Eaton Vance, Monthly Market Monitor (June 2020)

Conclusion

You cannot blame investors for questioning their allocation to international stocks. U.S. equities have outperformed non-U.S. developed market stocks and correlations between the asset classes have risen, mitigating global diversification's risk-reducing benefits.

While the returns of domestic stocks have dominated their international developed market peers over the past two decades, leadership between the two regions has shown to be cyclical, with long periods of strength in one market followed by a prolonged period of dominance in the other.

It is our view this transfer will occur again with international developed stocks coming back in favor with attractive relative valuations and an aging dollar bull market being the potential catalysts. Eliminating non-U.S. allocations sacrifices investors' ability to invest in some of the world's most profitable companies, balance sector exposure, and access markets where, historically, active management has produced excess returns.

For more information, please contact any of the professionals at FNBC Bank & Trust.

Disclosures

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