Madison INVESTMENTS

Market and Economic Review

Client Communication for the Fourth Quarter 2023

Table of Contents

- Executive Summary 2
- Equity Markets 3
- Fixed Income Markets 4
- Macro Commentary 5-6
- Disclosures 7

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EXECUTIVE SUMMARY

Another Volatile Year in the Books

- After declining 28% peak to trough during 2022, the S&P 500 Index advanced over 26% in 2023 and is hovering near its January 2022 peak. Valuation multiples expanded in 2023, as earnings did not grow, adding pressure on the stock market to produce profit growth in 2024.
- After a rapid decline in intermediate and long-term interest rates in the fourth quarter, bonds finished 2023 with a respectable 5.5% annual return for the Bloomberg Aggregate Bond Index. With inflation below 4%, bonds are positioned to produce real returns in 2024, particularly if the Federal Reserve starts cutting the fed funds rate in the latter half of 2024.
- The jury is still out on whether the economy will see a recession or the soft landing Wall Street is hoping for. Economic history would suggest not enough time has passed since the Federal Reserve's aggressive rate hiking cycle to determine whether the economy has successfully navigated higher interest rates.

The most expensive vehicle to operate in 2023.

Notable 2024 Tax Updates:

- The annual gift tax exclusion increases to $18,000 per recipient, up from $17,000 in 2023.
- The estate tax exclusion amount per person is inflation adjusted up to $13.6 million per person from $12.9 million in 2023.
- The standard deduction for a married couple filing jointly increases to $29,200, up from $27,700 in 2023.
- The taxable income threshold for long-term capital gains to be taxed at a 20% federal, rather than 15% rate, increases to $553,850 for a married couple filing jointly, and $518,900 for a single filer.

EQUITY MARKET

Eighth consecutive calendar year the S&P 500 has swung more than 20% within the calendar year

After an official bear market in 2022, the S&P 500 Index came roaring back in 2023 with a 26% gain. The two-year cumulative return for the index now stands at +3.4% after the roller coaster down in 2022 and the rebound back up in 2023.

The continued large swings in the equity markets underscore the challenge of market timing. If we compare two hypothetical investors who entered the stock market in 2022, one in January at the top, the other in October at the bottom, the investor who entered in January 2022 is still seeing a negative return, while the investor who entered near the October 2022 bottom has now seen a gain of over 35%.

Year	Date	S&P 500	Intra-Year Change
2016	02/11/2016	1,810	
	12/13/2016	2,278	26%
2017	01/03/2017	2,245	
	12/18/2017	2,686	20%
2018	09/21/2018	2,941	
	12/26/2018	2,347	-20%
2019	01/03/2019	2,444	
	12/27/2019	3,258	33%
2020	02/19/2020	3,380	
	03/23/2020	2,192	-35%
	12/31/2020	3,770	72%
2021	01/04/2021	3,663	
	12/30/2021	4,809	31%
2022	01/04/2022	4,819	
	10/13/2022	3,492	-28%
2023	01/03/2023	3,794	
	12/28/2023	4,793	26%

What will 2024 bring?

Currently, S&P Dow Jones is predicting S&P 500 earnings to rise from 214 in 2023 to 242 in 2024, a 13% growth, after earnings were relatively flat in 2023.

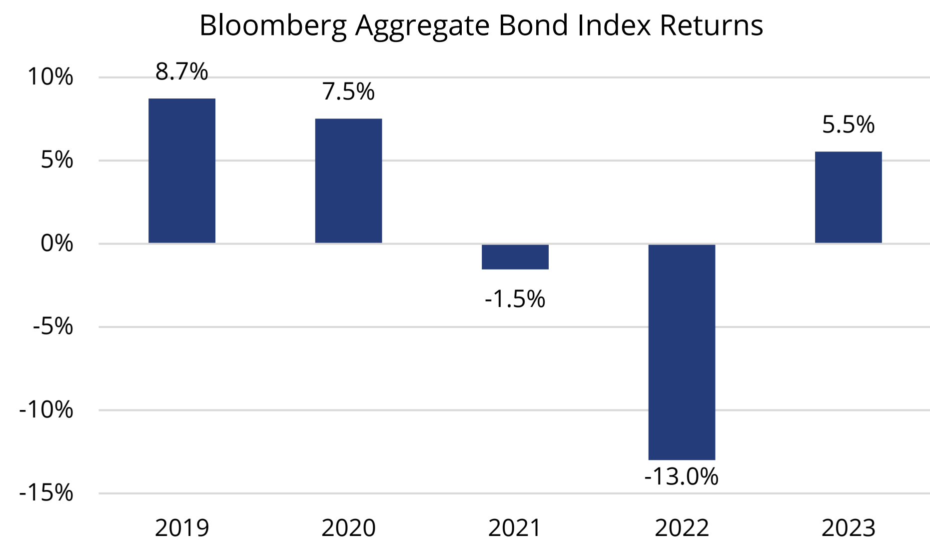
The market is currently trading at a price to earnings multiple above its long-term average. If the market can generate 13% earnings growth and maintain its current multiple, then the upside in 2024 could be in the 10-15% range.

Conversely, if earnings disappoint, leading to a reset of expectations, the market could see a valuation contraction leading to double digit declines.

	S&P 500 Price	S&P 500 earnings*	Trailing Price to Earnings multiple	% Upside (Downside)
2023 Year end	4,770	214	22.3	
2024 upside scenario	5,397	242	22.3	13%
2024 downside scenario	3,852	214	18.0	-19%

* 2023 earnings include Q1-Q3 actual earnings plus estimate for Q4 2023; 2024 earnings are based on hypothetical scenarios.

Sources: spglobal.com



Bonds produced solid returns in 2023

The Bloomberg U.S. Aggregate Bond Index was up 5.5% in 2023 after a two-year cumulative decline of 14.4% from 2021 to 2022.

With inflation down to 3.1% as of the November Consumer Price Index, bond yields are now producing positive real returns for investors.

Corporate Bonds: Potential Scenarios for 2024

	Interm. Corp. Index (YE 2023)	Yields fall 1%	Interm. Corp. Index (YE 2023)	Yields increase 1%
Modified Duration	4.0		4.0	
Coupon	3.8%	3.8%	3.8%	3.8%
Yield to maturity	4.9%	3.9%	4.9%	5.9%
Potential Price Appreciation (Decline)		3.8%		-3.6%
Potential Total Return with Coupon		7.6%		0.2%

Bonds appear well-positioned to produce another solid year in 2024

With investment grade corporate yields in the neighborhood of 5% across the yield curve, bonds appear to be well-positioned to produce solid returns in 2024 and serve as a volatility dampener, or ballast, against a volatile stock market.

If rates decline in 2024, corporate fixed income returns could be in the 6-10% range. Conversely, interest rates would need to go up more than 1% from their current levels before corporate bonds would see declines in 2024.

Source: Bloomberg

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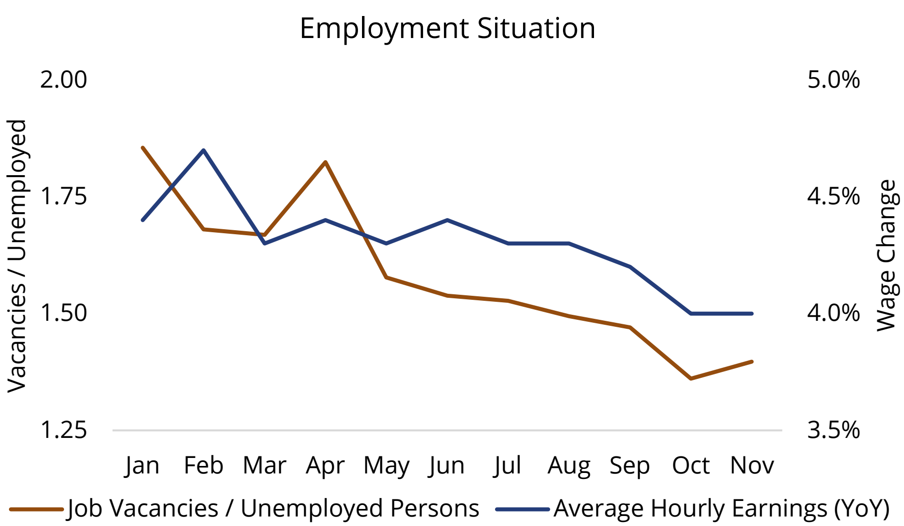
Economy not out of the woods yet

With inflation declining, consumer spending remaining robust, and continued low unemployment, optimism has increased that the Federal Reserve can engineer a soft landing for the economy without causing a recession. Time will tell, but based on other recessions in modern times, it is still too early to predict. Even in a digital economy, interest rate increases take time to filter through loan rates and negatively impact spending and demand, particularly when consumers were flush with cash from Covid stimulus heading into this tightening cycle.

Peak fed funds rate & date	Onset of recession: months after peak fed funds rate	Fed Funds rate at onset of recession
6.5% July 2000	March 2001: 8 months	5.3%
5.2% July 2006	December 2007: 17 months	4.2%
5.5% July 2023	TBD July 2024: 12 months Dec. 2024: 17 months	??

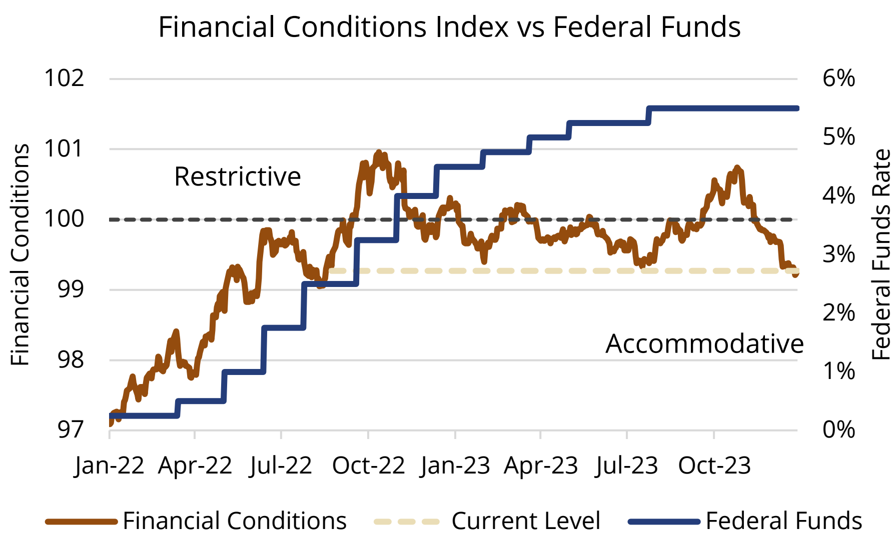


Strong job market continues to power the economy

One argument in favor of why “this time is different,” despite the unprecedented speed and magnitude of the Federal Reserve’s rate hikes, is that unemployment continues to remain near record low levels; and a tight labor supply means there are still more job openings than workers to fill those openings.

If the labor market remains tight, this factor bodes well for the strength of consumer spending and a soft landing that could avoid a recession.

Source: St. Louis Fed, FRED Economic Data; Bloomberg



Financial conditions eased in the 4th quarter

Despite higher policy rates and continued quantitative tightening, financial conditions began to ease at the end of October.

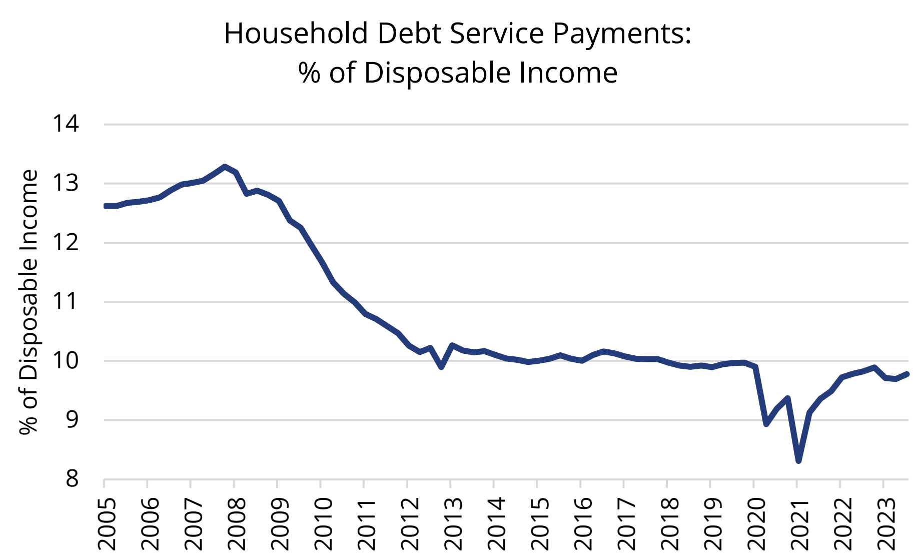
Corporate credit spreads have tightened, longer-term interest rates have fallen, and the US dollar has weakened, giving way to financial conditions ending the year at an accommodating level last seen in the summer of 2022 when the Fed funds rate was three percent lower.

The Fed may need to push back given the extent that conditions have eased. This could shift the yield curve higher in early 2024, sending financial conditions back toward equilibrium.

What is the capacity of consumer spending in today's interest rate environment?

Because excess Covid savings are depleted, consumers are turning to credit to support spending. Credit card balances are accelerating at a concerning rate. However, when we view household debt payments as a percentage of disposable income, consumers are not yet at distressed levels.

Because of the magnitude of the Covid stimulus, household debt burdens fell to modern-day lows during 2020 and 2021 and are just now approaching the pre-pandemic trendline. Whether the ratio of debt payments to income breaks above the pre-pandemic trendline will be determined by consumers' willingness to absorb higher interest loans, whether lenders keep tightening credit, and the strength of the job market. The continued strength of the consumer will be a key factor determining whether the economy achieves a soft landing.



Source: Factset; fred.stlouisfed.org

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