INVESTMENT OUTLOOK 2023

THE MARKET SHARE

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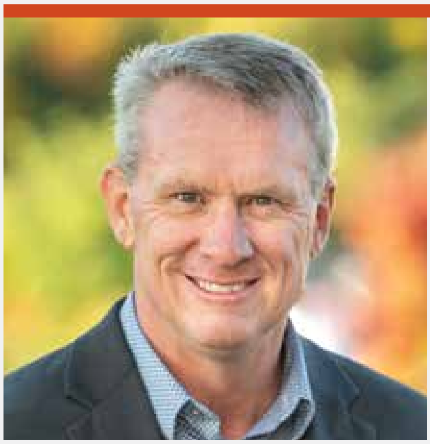
CONTENTS



Paul W. Gifford, Jr., CFA
Chief Investment Officer

EASING INTO 2023

Difficult, challenging and frustrating are a few of the many words that investors, consumers and business owners have used to describe the investment and economic backdrop in 2022. With a winding-down pandemic, meme stocks in the news, supply-chain disruptions, Russia's war in Ukraine and a multi-generation high in inflation, everyone seems to be on edge and wondering what may be next. After the third worst year for investment performance in the last 100 years, investors want to know when conditions in the financial markets will improve. In this 2023 Market Share Outlook, we seek to provide a framework for what might lie ahead for investors in the coming year.

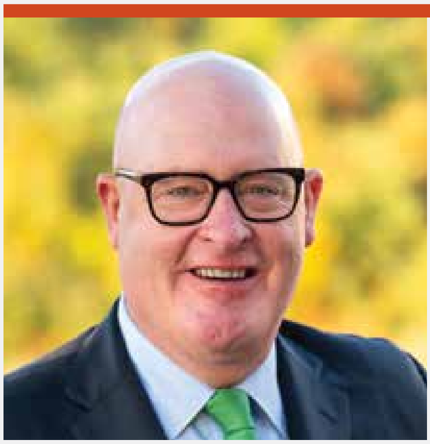
In last year's Outlook (published at the end of 2021), we wrote about the evolution of the financial markets and adjusting to the shifting landscape. Going into 2022, the COVID-19 pandemic was easing as vaccines were becoming more widely available. Inflation was rising and the U.S. Federal Reserve (the Fed) was starting to realize that interest rates would likely need to be raised to contain it. The situation has continued to develop throughout 2022 as we've seen economies, consumers and corporations impacted as central banks, including the Fed, have increased interest rates to reign in inflation. The Fed's actions have caused the U.S. dollar to surge, which has the effect of reducing the investment returns of assets denominated in foreign currencies. Moreover, geopolitical challenges have resulted in high energy prices and a natural gas shortage in Europe this winter. While these challenges appear daunting, might we expect some easing of extremes in 2023?

For the 12 months ended in September, the inflation rate was running at around 8%. The Fed has raised interest rates multiple times in 2022, at an unprecedented pace, as it tries to bring inflation down to its 2% target rate. In this Market Share Outlook, Senior Fixed Income Manager Erik Clapsaddle, CFA, CFP®, covers inflation and how rising interest rates have altered the interim outlook for investors. He'll also present his thoughts on the direction of inflation, interest rates and the Federal Reserve in 2023. Fixed-income investors, for the first time in more than 15 years, will start the year with yields of over 4% for money markets and many U.S. Treasury bonds—a significant improvement compared to the start of 2022. Erik will also cover the outlook for the U.S. economy, which has been anemic in 2022 after the pandemic recovery in 2021.

During 2022, equity investors saw corporate earnings challenged by inflation, a slowing economy, and ongoing supply-chain issues. Our Director of Research, Rob Romano, CFA, will discuss the 2023 outlook for corporate earnings and the potential impact higher interest rates will have on equity valuations. In addition to the challenges mentioned above, the record-setting year for U.S. dollar strength has added to pressures on corporate earnings. Rob will explain how these factors might impact the equity markets in 2023.

But first, Portfolio Manager Pete Cahill, CFA, dives into topics related to behavioral finance. Pete shares insights from this relatively new field of economics, which studies how individuals react to changes in the markets and the effect on an investor's long-term financial goals.

In the current investment climate, geopolitical risks continue to cast a shadow over equity markets globally. Most of the time, geopolitical events add to the markets' short-term volatility (and to the downside) much to the consternation of investors. Over time, however, these events become temporary blips on longer-term market trends, something investors should keep in mind when the markets turn downward due to geopolitics. In 2023, we expect that geopolitical issues and the associated challenges will remain top of mind for investors. ■



Peter Cahill, CFA
Vice President and Portfolio Manager

INVESTING IN UNCERTAIN TIMES

At 1st Source, our mission is to help clients achieve financial security, build wealth, and realize their dreams. Our advice to clients is an important element in the accomplishment of our shared mission. This past year has been extremely tumultuous with both the stock and bond markets having declined significantly. In times like this, it is common for emotions to be elevated. Our advice during this unsettling period has been centered on helping clients understand the relationship between emotions and financial decision-making.

Emotions are one of the wonderful aspects of being human. The late, great basketball coach Jimmy Valvano once famously said, "If you laugh, you think, and you cry, that's a full day. That's a heck of a day." We agree. Investing and emotion, however, go together like oil and water—they don't mix well. Reacting emotionally to the market's gyrations can lead to chasing performance at market peaks and getting out at market bottoms. We've found that emotion-driven behaviors are the opposite of what serves an investor's ultimate financial interests.

Behavioral finance studies the effects of psychology on investors and financial markets and the findings are illuminating. An example is Prospect Theory, which was developed by Daniel Kahneman and Amos Tversky in the late 1970s and further developed in the 1990s. Prospect Theory asserts that investors value gains and losses differently.

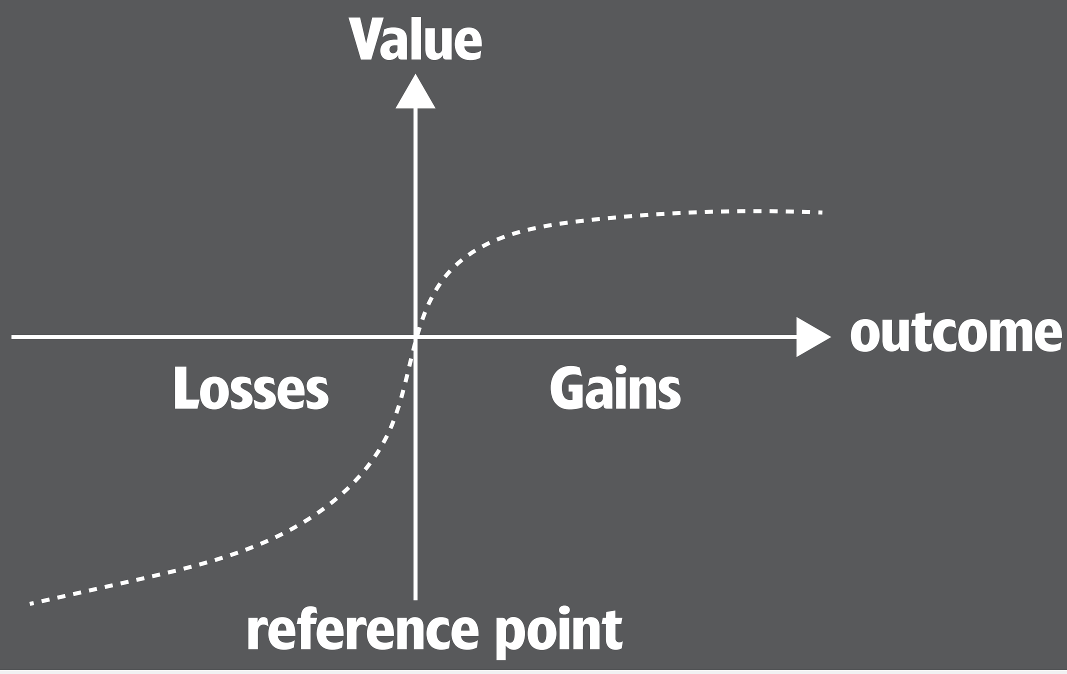
The illustration of Prospect Theory shows that we tend to feel twice as much pain when we incur a loss as we do pleasure with a gain. Losing money is painful, doubly painful it turns out. Market downturns can be difficult periods for investors to endure. Going to cash and getting out of the market ends the pain. But, as counterintuitive as it may seem in a declining market, ending the "pain" may throw an investor's long-term plan to achieve financial security off-track.

Equities have produced significant capital appreciation over the long term—capital appreciation that's often required to meet one's financial objectives. The rub with the stock market is that in the short term, the market can and will go down. Historically, the market has gone down roughly 30% of the time over the course of a calendar year. Over a period of 10 years, the market has historically experienced positive returns 95% of the time. Over any 20-year period, historical market returns have been positive 100% of the time. The key for investors striving to achieve financial goals is to take a long-term view and stay invested through the market's ups and downs.

At 1st Source, we're here to help. As seasoned investment advisors, it's our job to help clients arm themselves with a well-thought-out financial plan. The commitment to stick to a plan can help take the emotion out of investing, which is especially important during times of market turbulence. ■

"The illustration of Prospect Theory shows that we tend to feel twice as much pain when we incur a loss as we do pleasure with a gain."

Biases Explained In the Prospect Theory



Erik D. Clapsaddle, CFA, CFP®
Vice President and Senior Fixed Income Manager

FORWARD LOOKING

From a return perspective, the 2022 bond market will be one of the worst on record. Prior to 2022, the bond market's worst year since 1980, as measured by the Bloomberg U.S. Aggregate Bond Index, was in 1994 with a loss of 2.92%. During 2022, Federal Reserve officials have been in a precarious position trying to balance what they are mandated to do—maintain price stability and full employment—with what investors have perceived them to be doing since 2009, which is driving the value of risk assets higher. In 2022, the Fed has raised the federal-funds rate from a range of 0%-0.25% early in the year to 3.75%-4.00% on November 2. The target range is expected to be over 4% by year-end. The Fed's rate hikes have sent the value of almost all assets tumbling during the year.

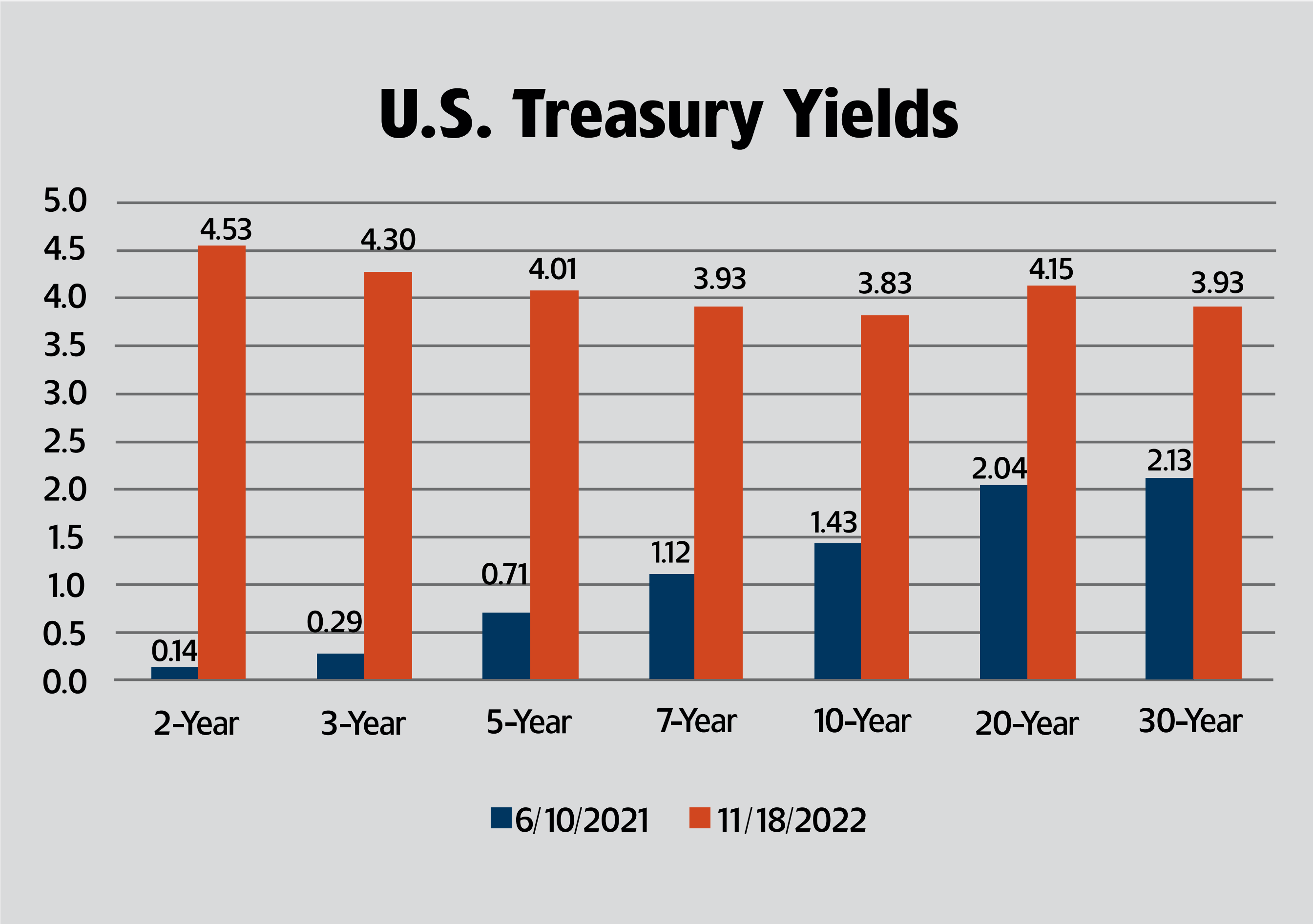
As we move into 2023, we are starting to see much greater opportunity within the fixed income asset class. We expect that potentially better returns on fixed income investments will allow us to reduce risk in our portfolios while maintaining returns at levels similar to those we have experienced since the Great Recession in 2009. Moreover in 2022, we allowed cash to accumulate and also added to the cash position in our portfolios throughout the year as interest rates have risen. Holding more cash in a portfolio has the benefit of

	FIXED INCOME RETURNS 2.0%	FIXED INCOME RETURNS 4.5%
Needed Equity Return	10.3%	8.7%
Total Return	7%	7%
Desired Return	6%	6%
Equity Allocation Needed	60%	36%

increasing liquidity, maintaining a defensive posture in a time of uncertainty, and has allowed for gaining exposure to higher rates of return on fixed income securities as the Fed has raised rates. We think it is likely that the Fed will stop raising rates in early 2023, assuming inflation continues to trend downward. If this is the case, we would expect to start reallocating cash and cash flow back into bond and stock allocations.

In an environment where fixed income securities yield 2% or less on average we would need a 10.3% return from equities in a portfolio holding 60% equities and 40% fixed income securities to produce a 7% annual return from the overall portfolio. In a fixed income environment where the average yield is around 4.5%, we only need equities to earn 8.7%, which is lower than the S&P 500® Index's annualized return since 1927 (includes similar large company stock indexes prior to 1957).

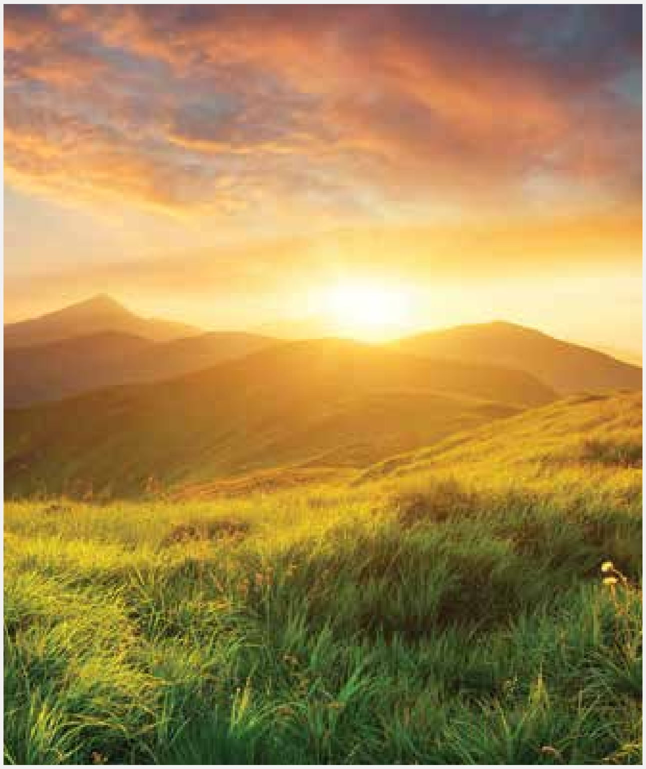
If an investor's desire is to earn 6% annually, that investor could now reduce the equity allocation of their portfolio from 60% to 36%, assuming an 8.7% average annual return in equities. This is shown in the table on page 6, which is followed by the bar chart below tracking movements in U.S. Treasury bond yields since their recent lows in mid-2021. When looking forward, we are warming up to fixed income as a viable alternative to potentially buoy portfolio returns with less risk than stocks. ■



THE SILVER LINING

Erik D. Clapsaddle, CFA, CFP®

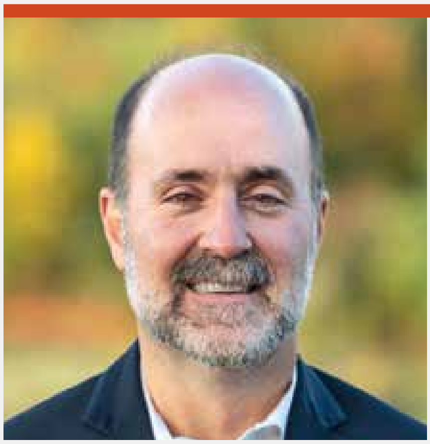
Regardless of whether the United States economy is in expansion or recession (or in the little-to-no-growth area), the most important measures of how the economy is faring are individuals and small businesses (i.e., consumers and corporate America). In 2022, inflation has been a growing concern and the Fed's efforts to bring it under control will continue to affect consumers and companies as we move into 2023. Because interest rate increases usually have a lagging effect, it has historically taken six to nine months for the economy to start responding. Interest rates, which the Fed began raising in March of 2022, are already having an impact on consumers and businesses and are slowing the economy as we end 2022.



Housing stands out as a sector that is being affected by higher interest rates. The 30-year fixed mortgage rate reached 7.16%, which is the highest since 2001. Home prices have started to level off and in some places, they are even experiencing modest declines. While home affordability reached a multi-decade low, we saw the beginning of a crack in the housing market in July 2022 as the S&P CoreLogic Home Price Index showed that home prices declined in value for the first time since March 2012. We expect declines to continue, albeit gradually. Additionally, existing home sales declined by approximately 24% year-over-year in September. Rental costs, which have been increasing at the fastest rates in decades, could also decline as consumers make different housing choices and as the supply of apartments continues to grow.

In the current economic landscape, we see consumers as the silver lining. They are resilient and entrepreneurial. Moreover, they have confidence that the decline in long-term economic growth that the U.S. has experienced, and the end of rising home prices will only temporarily put the brakes on the economy. It is strange, but to some extent individuals had already retrenched while the U.S. economy was expanding. They have increased savings and maintained high savings balances amid fiscal stimulus received to help them cope with the "stay-at-home" atmosphere prevalent during the pandemic. The consumer drives the U.S. economy, and that will not change any time soon. ■

"In the current economic landscape, we see consumers as the silver lining. They are resilient and entrepreneurial. Moreover, they have confidence that the decline in long-term economic growth that the U.S. has experienced, and the end of rising home prices will only temporarily put the brakes on the economy."



Rob Romano, CFA
Vice President and Director of Research

CHALLENGES STILL EXIST

In 2022, equity markets suffered their worst nine-month start to a year since 2002. The S&P 500 Index declined 23.93% in the first nine months of 2022. The Russell 2000® Index of small-company stocks declined 25.13% and developed international markets, as measured by the EAFE, fell 27.2%. Emerging markets, represented by the MSCI Emerging Markets Index, with its 31% allocation to China were down 26.32% overall. Chinese markets have remained under pressure as China's zero-COVID policy continues to slow their economy. Investors are also showing increasing concern over China's regulatory tightening and growing tensions with Taiwan. Over the last four years, equity markets entered bear market territory (generally defined as a drop of 20% or more in stock prices over at least a two-month period) on three occasions: the fourth quarter of 2018, the pandemic of 2020, and in 2022. This is much more frequent than history has experienced.

Equity markets faced several headwinds in 2022 from inflation hitting its highest level in four decades, along with monetary tightening and the fiscal-policy actions of the Fed and other central banks, to the strongest U.S. dollar in 20 years.

The resiliency of U.S. consumers and corporate America in one of the most difficult recent economic environments has been impressive, but as these trends persist the weight of these pressures will further erode consumer and business confidence along with corporate earnings. While the path forward in 2023 for the equity markets will depend on several economic and market factors, we believe two major influences will be the primary drivers—U.S. monetary policy and corporate profits.

Massive fiscal and monetary stimulus were the catalysts for the equity markets during the pandemic. As government spending slowed and the Fed reversed course, interest rates rose quickly from historical lows. Quantitative tightening, the process by which the Fed reduces its balance sheet, further drained excess liquidity from the economy and markets. As interest rates increased in 2022, the yield on the 10-year U.S. Treasury bond rose above 4% this fall, and the equity markets declined and entered a bear market. Higher interest rates reduce the value of future cash flows of corporations, and the old cliché, "Don't Fight the Fed," reminds investors of the influence Fed policy has on the equity markets.

Not only do higher interest rates reduce the value of future corporate cash flows, but they also have an inverse correlation with equity price-to-earnings (P/E) ratios (the price of a stock divided by its earnings per share). In general, when interest rates have been low, P/E ratios have expanded and when interest rates have increased, P/E ratios have declined. Over the past few years, the yield on the 10-year U.S. Treasury bond remained low by historical standards, making stocks more attractive investments by comparison. This allowed P/E ratios to expand (north of 20 times earnings in 2021). When the 10-year Treasury yield has been over 3% (where it is now) stocks' P/E ratios have historically averaged 15. As of November 18, 2022, the average P/E ratio for S&P 500 companies was 18 times next year's earnings. We believe the Fed will be forced to keep interest rates higher to tame inflation. Therefore, the average P/E ratio of S&P 500 companies will likely be range-bound between 14 and 18 times next year's earnings.

The stimulus-induced growth of the past two years is fading and ushering in a period of slower economic growth, which we expect will impact corporate earnings in 2023. Analyst expectations for 2023 S&P 500 earnings have started to decline from a peak of $250 per share to the current level of $231. As an example, Microsoft has seen its consensus earnings expectations for 2023 decline from a high of $10.77 to the current level of $9.55. In recent conference calls, Microsoft and other U.S. multinational companies have highlighted global macro headwinds and strength in the U.S. dollar as reducing their revenue and earnings visibility. The U.S. dollar has surged to its highest level in 20 years which not only reduces revenue for U.S. multinationals, but also makes their goods more expensive versus those of foreign competitors. Johnson & Johnson cut its guidance for the year as the global healthcare company warned that strength in the dollar will reduce revenue by $4 billion. The U.S. technology sector

2023 S&P 500 Earnings Estimate

DATE	EPS	EARNINGS GROWTH (%)	PE (X)
05/31/22	250.25	10.1	16.5
06/30/22	249.35	9.6	15.2
07/29/22	243.06	8.5	17.0
08/31/22	241.77	8.4	16.4
09/30/22	240.14	8.3	14.9
10/31/22	232.62	6.1	16.6
11/07/22	231.48	6.0	16.3

CHALLENGES STILL EXIST continued

Rob Romano, CFA

will feel the greatest impact from the strong dollar as roughly 55% of the sector's revenue comes from international markets. We believe the equity markets have not fully priced in the possibility that 2023 earnings might decline from recent levels if economic conditions were to deteriorate.

If we take current 2023 S&P 500 earnings expectations of $231 and apply the current P/E ratio of 18, the S&P 500 would trade at levels around 4,158. If the 10-year Treasury yield were to remain higher than 3%, a P/E ratio around 15 would be more likely, which would equate to the S&P 500 trading at levels around 3,500. As of November 21, the top 10 companies in the S&P 500 traded at a P/E ratio of 24 while the remaining 490 companies traded at a more reasonable P/E ratio of 14. Our consensus view is that equity markets will be in a wide trading range until there is further evidence that the Fed has finished its rate-hiking campaign. ■

OUR INVESTMENT PHILOSOPHY

- Our investment philosophy is focused on the needs and objectives of our clients.
- We place a high value on long-term consistent investment returns.
- We believe in broad diversification as a way to manage risk, grow assets and preserve wealth within each client's investment portfolio.
- Economic and financial markets are cyclical. Therefore, we believe value can be added through tactical adjustments to a portfolio's asset allocation.
- We track measures of investor sentiment to look for indicators which help us make prudent investment decisions on behalf of our clients.

OFFSHORE TO ONSHORE

Rob Romano, CFA

The U.S. government's support for domestic manufacturing with the passage of the CHIPS Act will provide significant funding for the development of several semiconductor manufacturing foundries. Intel announced a $20 billion investment in Ohio to expand chip making capacity. Micron has said it will invest $15 billion in Idaho to develop a leading-edge memory manufacturing facility. Although the U.S. is a leader in the research and design of semiconductors with companies like Qualcomm and Nvidia, the United States only manufactures 12% of the world's semiconductors. Building additional capacity in the U.S. will take time as a semiconductor foundry takes years to build and equip with highly engineered manufacturing systems. The CHIPS Act is an example of the offshore-to-onshore theme that allows Original Equipment Manufacturers (OEMs) like Apple to gain more control over their supply chains. We believe the trend of bringing highly engineered manufacturing back to North America will continue and provide significant benefits for the U.S. labor market and manufacturers alike.

Major corporations have learned many lessons from the pandemic. An important one is the need to have more control over their supply chains. The benefits of globalization are being upended by increasing risks such as higher freight/logistic costs, geopolitical events, and the complexity of supply-chain networks. For

many companies, greater control will be achieved by diversifying their supplier base and having their supply chains located closer to their production facilities rather than having materials or supplies shipped from across the world. Many OEMs are now demanding that their supply chain be in the same region as production. As an example, 50% of aluminum wheels for North American auto production are imported to the United States from foreign countries. We believe this will change drastically over the next several years. Recently, a major Japanese auto manufacturer producing vehicles in the U.S. requested a local supplier of wheels rather than using a supplier in Asia. ■

"Major corporations have learned many lessons from the pandemic. An important one is the need to have more control over their supply chains."

IN CLOSING

We are regularly reminded of the resilience of consumers and corporations. Consumers adapt to changing economic conditions by modifying behaviors and figuring out how to make ends meet. Entrepreneurs and businesses, particularly in the U.S., are adaptable and can act to help them remain successful and weather challenging times.

Over the past 20 years, we have been formally sharing our annual economic outlook with 1st Source clients. During that time, we've been there through tough investment environments, including a tech bubble, the Great Financial Recession, and the COVID-19 pandemic. In 2023 and beyond, we will still be here helping clients manage their expectations as together we face high inflation for the first time in four decades. Difficult markets are not new to 1st Source and we will continue to be here for you. ■

Jason Cooper; John Ross Haley; Marie Alvarez; Cody Petrowsky; Paul Gifford, CFA; Erik Clapsaddle, CFA, CFP®; Chris Davis, AIF; Rob Romano, CFA; Peter Cahill, CFA; Noreen Kazi.

EXPERIENCED.

Our Investment Management team brings over 200 years of combined professional experience to our clients. A local decision-making team with accessible portfolio managers sets 1st Source apart from other investment advisors. Our team continues their pursuit of learning and achieving elevated distinctions to add value to client relationships. Five of our investment staff members hold the Chartered Financial Analyst designation, three have earned MBA degrees and one is a CERTIFIED FINANCIAL PLANNER™ professional. By working directly with clients, they can tailor portfolios to meet the individual needs of their clients. ■

Marie Alvarez
Investment Coordinator

Marie has over 35 years of banking and investment experience. She currently serves as our investment coordinator responsible for client presentation material, report writing and assisting with trades and execution.

Jason W. Cooper, MBA
Vice President and Portfolio Manager

Jason began his 1st Source career in 1999 as a member of the Corporate Training Program. He was promoted to Investment Analyst in 2000 and to Portfolio Manager in 2002. He serves as portfolio manager for individually managed accounts and assists with the analysis of stocks.

John Ross Haley
Investment Analyst

J.R. is responsible for the execution of equity and fixed income securities and assists Portfolio Managers by gathering client reports and providing investment market research.

Cody Petrowsky
Investment Analyst

Cody brought six years of banking experience to 1st Source from working in both a banking center and a loan operations department. Cody executes trades and provides research assistance for the investment team.

Peter Cahill, CFA
Vice President and Portfolio Manager

Pete has nearly 30 years of investment experience, predominately managing equity portfolios. He shares his insights into the investment markets and assists the investment team with providing outstanding client service.

Chris Davis, MBA
Vice President and Portfolio Manager

Chris has over 25 years of diverse portfolio management experience. He has developed and implemented tailored portfolio asset allocation strategies for a wide array of clients with a large range of financial instruments.

Noreen A. Kazi, MBA
Vice President and Portfolio Manager

Noreen has experience working in Personal Trust, Funds Management and with the Office of Financial Planning & Analysis. She currently serves as Portfolio Manager for individually managed accounts and assists with the analysis of stocks.

Rob Romano, CFA
Director of Research, Vice President and Portfolio Manager

Rob has spent nearly 30 years in the investment management profession. He manages both fixed income and equity portfolios, providing due diligence and equity analysis for the research team. Rob earned the right to use the Chartered Financial Analyst designation in 1999.

Erik Clapsaddle, CFA, CFP®
Vice President and
Senior Fixed Income Portfolio Manager

Erik brings nearly 20 years of investment experience to the team. His work has focused on credit analytics, valuation, interest rate strategies, and macro-strategy. He develops portfolio asset allocation focused on fixed income for a wide array of clients. Read Erik's perspective in each edition of *The Market Share* e-newsletter.

Paul W. Gifford, Jr., CFA
Senior Vice President and
Chief Investment Officer

Paul leads the investment team's strategy, construction and implementation of client portfolios. Since beginning his investment career in 1998, Paul has gained the portfolio management experience needed to align the team with our investment philosophy.

Matt Noll, CFA
Portfolio Manager *(not pictured)*

Matt joined 1st Source in 2022 bringing 16 years of investment experience to the team. Matt is a holder of the Chartered Financial Analyst designation. He is responsible for asset allocation, equity and fixed income selection and trading.

1st Source Bank

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