IN THIS ISSUE

MARKET REVIEW

SEPTEMBER 2023

SMB Trust Services

FITCH DOWNGRADES U.S. CREDIT RATING

– Fitch downgraded its U.S. credit rating due to the perceived erosion of governance and unaddressed fiscal challenges.

– Growing budget deficits are projected to raise the federal debt balance and interest burden.

– The CBO projects escalating interest payments will account for 20% of U.S. government revenue by 2033 from 9.72% last year.

Two months after Congress reached a debt ceiling deal to narrowly avoid a government shutdown, credit ratings agency Fitch downgraded its rating of U.S. government debt one notch to AA+ from AAA on August 1. Fitch cited a few reasons for their rating downgrade. First, Fitch noted an erosion of governance standards regarding fiscal and debt matters, highlighting “the repeated debt-limit political standoffs and last-minute resolutions (that) have eroded confidence in fiscal management.” Second, Fitch projects growing government deficits and debt will lead to an increasing percentage of government revenue used to pay interest payments and ”increasing the vulnerability of the U.S. fiscal position to future economic shocks.” Lastly, Fitch noted medium-term fiscal challenges are unaddressed including rising costs for Social Security and Medicare as the population ages. Additionally, the government faces a potential tax revenue hit if the 2017 tax cuts, which are set to expire in December 2025, are not extended.

The downgrade put a renewed focus on forecasts for the U.S. government’s looming fiscal challenges. The Congressional Budget Office (CBO) projects the federal budget deficit will be 5.8% of GDP this fiscal year ending September 30 and expand to 6.9% of GDP by 2033, nearly double the 3.6% long-term average since 1973. The CBO’s growing deficit forecast is driven by rising costs for Social Security, Medicare, and interest payments. The expanding deficits are projected to cause federal debt held by the public to rise to 115% of GDP by 2033 from 97% last year. The CBO estimates that escalating interest payments will exceed a staggering $1 trillion per year by 2033, surpassing defense spending as the top expense behind entitlement programs and accounting for 20% of government revenue from 9.72% last year.

This is the second time a major credit ratings agency lowered its U.S. rating. Standard & Poor’s (S&P) downgraded its rating in August 2011 following a debt ceiling standoff. Similar to Fitch, S&P said its downgrade reflects the rising costs of Social Security and Medicare, the government’s growing debt burden, and the weakened "effectiveness, stability, and predictability of American policymaking and political institutions.” Unlike the stock and bond markets’ negative reaction to S&P’s downgrade, the markets’ reaction to Fitch’s downgrade was somewhat muted, reflecting the stronger economic environment today and investors prior experience with a U.S. downgrade. The U.S. economy is widely viewed as being in better health now compared to 2011 when investors were concerned about a potential U.S. double dip recession, a U.S. unemployment rate at 9%, and the European debt crisis. The third major credit ratings agency, Moody’s, still gives the U.S. its highest rating.

The timing of Fitch’s downgrade drew criticism from some economists given the economy’s current strength and expectations that the federal government has some runway before fiscal challenges become more pressing later this decade. Treasury Secretary and Former Fed Chair Janet Yellen called the downgrade “entirely unwarranted” and said in May the government’s fiscal situation “is not something to feel we’re in a catastrophic situation.”

Many economists believe the increasing cost of entitlement programs and growing debt burden will create tough fiscal decisions for future White House administrations and Congress. The ongoing wave of baby boomer retirements and decline in birth rate the last few decades to below the replacement rate is endangering the long-term solvency of Social Security and Medicare. Social Security’s trust fund reserves are projected to run out in 2034. After that point, the program’s income is forecasted to only cover 80% of the costs, likely causing beneficiaries scheduled benefits to be reduced by around 20% unless Congress takes action to reform the program. Similarly, the trust fund for Medicare Part A (hospital insurance) is expected to run out in 2028.

> "THE CBO’S GROWING DEFICIT FORECAST IS DRIVEN BY RISING COSTS FOR SOCIAL SECURITY, MEDICARE, AND INTEREST PAYMENTS."

Members of Congress have proposed Social Security and Medicare changes to improve the programs’ finances. The Social Security proposals include increasing the Social Security payroll tax rate, raising the retirement age to 70 from 67, and raising the income amount subject to payroll taxes to $250,000 from $160,200. Meanwhile, the proposed Medicare changes include raising the eligibility age to 67 from 65 and combining some parts of Medicare into one premium. Reforming the programs are a problematic topic in Washington given expectations that it could be unpopular with many voters. To keep the programs solvent long term and avoid cutting benefits, Congress will likely need to address the topic down the road.

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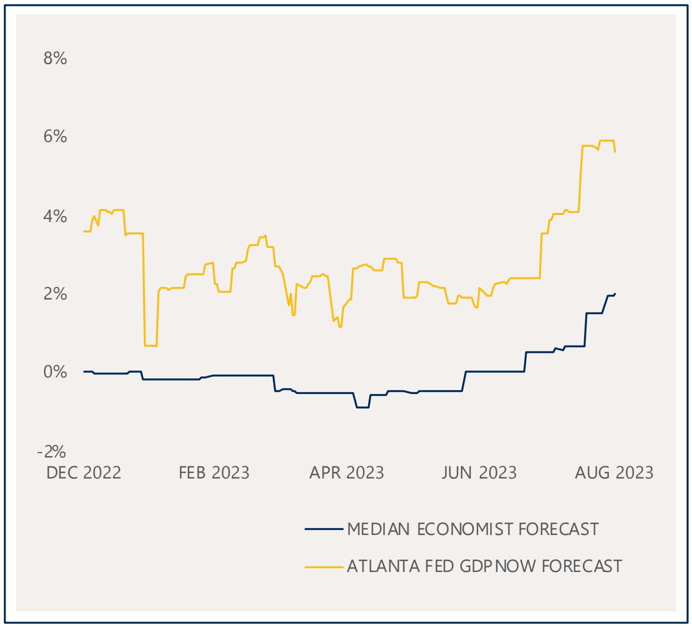
ECONOMY

U.S. GROWTH FORECAST REVISED HIGHER

Q3 U.S. GDP GROWTH FORECAST



Source: Bloomberg. Past performance does not guarantee future results.

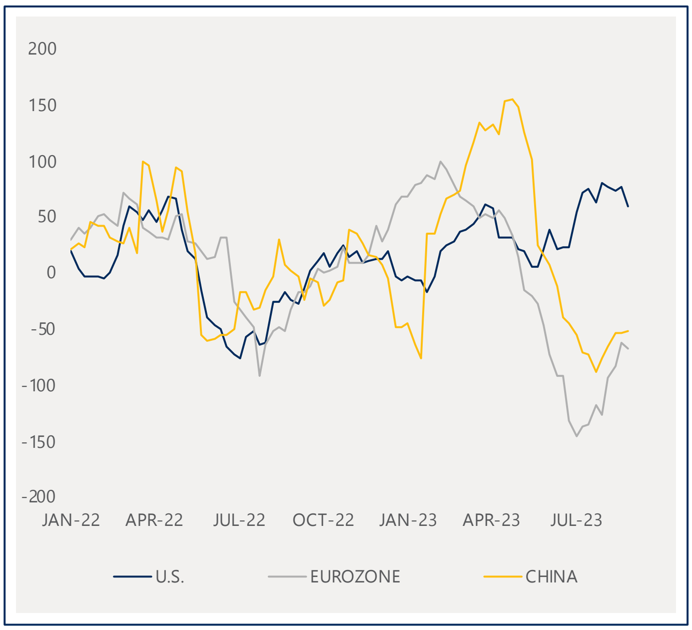
The resilient U.S. economy has been strong enough so far to withstand the Fed's interest rate hikes without a significant slowdown as previously expected. Many economists predicted earlier in the year that the Fed's rate hikes would tip the economy into a recession by year end. However, the economy continues to grow much stronger than expected.

Third quarter economic growth forecasts have seen steady revisions higher in recent months from negative growth to healthy growth. According to the median economists' estimate compiled by Bloomberg, third quarter GDP is projected to expand at a 2.0% annualized rate. This is up from the June forecast for a 0.5% contraction in the quarter.

The Atlanta Fed's GDPNow model has drawn a lot of attention for its lofty forecast for 5.6% GDP growth in the quarter. The model is not an official forecast of the Atlanta Fed but rather a running estimate of GDP growth based on available economic data for the current measured quarter. The model has historically experienced sizeable revisions as more economic data gets released.

DIVERGING ECONOMIES

CITI ECONOMIC SURPRISE INDEX



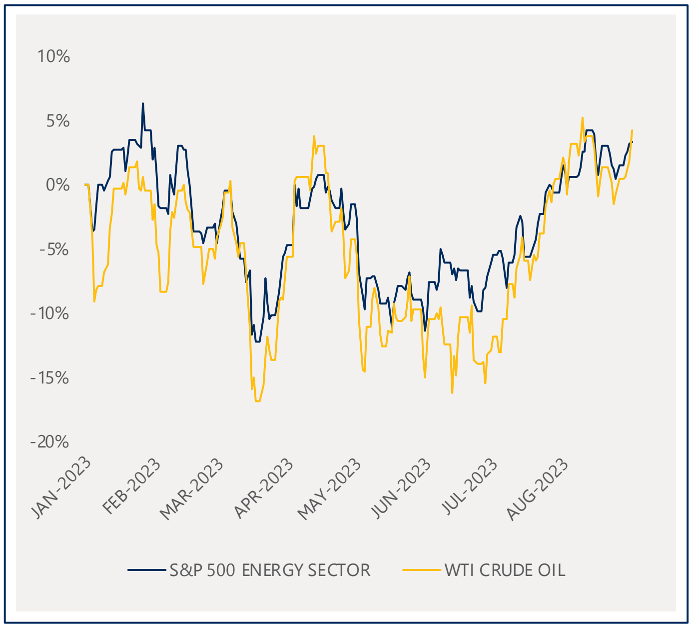
Source: Bloomberg. Past performance does not guarantee future results.

The Citigroup Economic Surprise Index illustrates the recent divergence between the resilient U.S. economy and increasingly challenged economies of the Eurozone and China. The Citigroup Economic Surprise Index represents the difference between official economic results and economists' forecasts, with a reading above zero indicating data releases were stronger than expected.

The U.S. surprise index has been consistently positive since February and strengthened since May to the latest reading of 59.9. Slowing wholesale price data and lower-than-expected jobless claims are some of the recent positive contributors.

The Eurozone and China surprise indexes have been negative the last few months. The Eurozone Composite Purchasing Managers Index (PMI) fell deeper into contraction territory in August to 46.7 from 48.6 in July. The downturn spread from manufacturing to services, with output in both sectors falling for the first time this year. After a short-lived rebound to start the year, China's economy stalled in the second quarter amid declining exports, weaker consumer spending, youth unemployment above 20%, and property market slump.

OIL PRICE REBOUND BOOSTS ENERGY STOCKS
YEAR TO DATE RETURN



Source: Morningstar. Past performance does not guarantee future results.

After the best start to a year since 1997, the S&P 500 index produced its second monthly decline this year in August. Despite solid economic data and better-than-expected second quarter corporate earnings, the stock rally cooled last month amid bond yields rising to multi-year highs and concerns the Fed could keep interest rates higher for longer.

Ten of the 11 S&P 500 sectors fell in August. The yield sensitive utilities sector dropped 6.16% in August as the U.S. 10-year Treasury yield rose to the highest level since 2008. Energy was the only sector with a monthly gain. Moderate oil production cuts by Saudi Arabia and Russia, and improved oil demand expectations driven by U.S. economic resilience have fueled a nearly 20% rally in oil prices over the last two months. The price of West Texas Intermediate (WTI) reached a ten-month high around $86 per barrel at the end of August. The energy sector leads the S&P 500 over the last three months with a 16.61% gain.

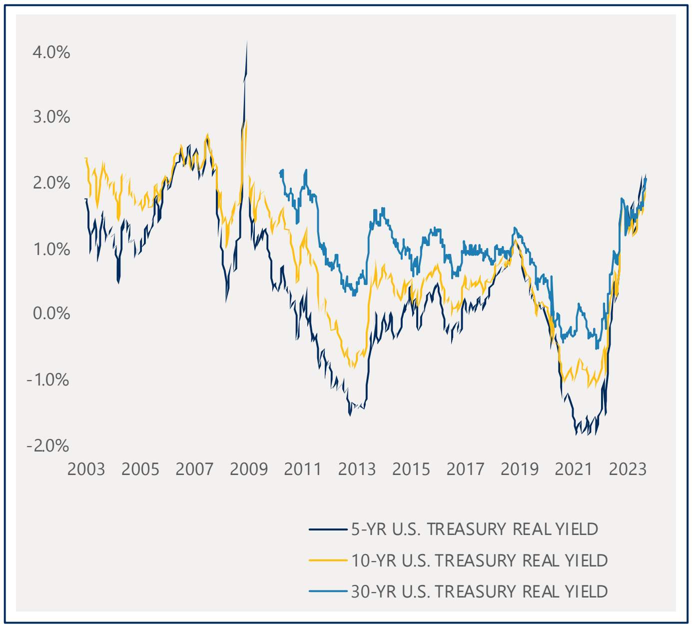
CHINA ECONOMIC WOES PRESSURE STOCKS
YEAR TO DATE RETURN

Source: Morningstar. Past performance does not guarantee future results.

Disappointing Chinese economic data and mounting stress in their property sector applied brakes to the country's recent stock rally. The MSCI China index plunged 8.96% last month, reversing most of the index's 10.79% gain in July. The country's July economic data showed slower economic activity including weaker growth in consumer spending, industrial output, and fixed asset investment. Chinese authorities' efforts to boost economic activity have been unsuccessful thus far and have failed to improve investor sentiment. Beijing has withheld large scale stimulus given the country's large debt and commitment to avoid restoking previous excesses in the property market.

China's property market slump deepened in August. Concerns about spillover effects to other sectors intensified following missed debt payments by China's largest surviving property developer Country Garden Holdings and Zhongrong International Trust, a unit of one of the country's largest wealth managers Zhongzhi Enterprise Group which has over $100 billion in assets. China's $2.9 trillion trust industry is fueling contagion fears given the ailing property sector accounts for around 10% of the industry's assets.

REAL YIELDS HIGHEST SINCE 2008
NOMINAL TREASURY YIELDS ADJUSTED FOR INFLATION



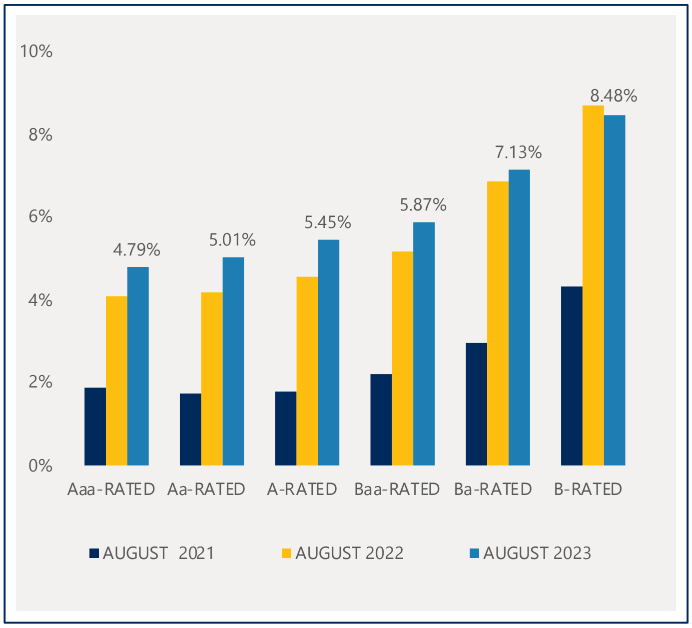
Source: Bloomberg. Past performance does not guarantee future results

Yields on U.S. Treasury securities adjusted for inflation (commonly referred to as real yields) reached their highest levels in August since December 2008. About 90% of the 100-basis point increase in the yield on the 10-year U.S. Treasury note, from 3.30% on April 6 to 4.34% on August 21, was driven by its real yield, while roughly 10% was due to a slightly higher inflation breakeven.

The U.S. economy's resilience despite an overabundance of recession forecasts earlier this year, reduced inflation expectations, and an expectation of increased Treasury issuance in coming months have combined to put upward pressure on real and nominal yields. Higher real yields are generally viewed as a tightening of financial conditions as they reflect borrowing costs of governments and corporations, excluding the effects of price increases.

In recent months, Fed officials have increasingly discussed rising real yields, which could be an indication they believe their policy tightening has progressed enough to begin considering how long restrictive policy should remain in place before rate cuts are considered.

CORPORATE BOND YIELDS DOUBLED SINCE 2021
CORPORATE BOND YIELD TO WORST



Source: Bloomberg. Past performance does not guarantee future results.

Available yields across most of the U.S. corporate bond landscape have more than doubled over the last 24 months as the rate hike campaigns of the Federal Reserve and many other global central banks have led to sharply higher borrowing costs for governments and corporations.

Credit spreads, or the extra yield investors require in excess of a similar maturity Treasury security, are near 15-month lows as of the end of August. As seen in the adjacent chart, the 8.48% yield-to-worst on a B-rated U.S. high yield bond as of August 31 is only about 4.5% greater than the roughly 4% yield on a 10-year U.S. Treasury note. In periods of acute market stress over the last 20 years, this yield spread was 8% or greater.

Although most U.S. banks have tightened lending standards and increased loan loss provisions in recent months, the credit cycle has not shown any clear signs of turning over. The U.S. high yield corporate default rate of 2.5% in August remains historically low, supported by reasonable leverage and interest coverage across most corners of the below-investment grade universe.

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NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			