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MARKET REVIEW
AUGUST 2023

SMB Trust Services

CHINA'S ECONOMIC REBOUND LOSES MOMENTUM

– After a short burst of stronger growth in the first quarter, China's economy lost momentum in the second quarter.

– China faces several headwinds including weaker consumer spending, ongoing property market slump, and high local government debt.

– Some economists are skeptical whether large scale stimulus seen in past slowdowns is coming given the country's large debt.

Optimism was high at the start of the year for a strong rebound in China's economy. Beijing's policy pivot last December to end the country's aggressive COVID-19 lockdowns seemingly paved the way for an unshackled economic recovery. After a short burst of stronger growth in the first quarter, China's economy lost momentum in the second quarter amid a confluence of headwinds including weaker consumer spending, a prolonged property market slump, declining exports, and local government debt pressures. Economists have reduced their growth projections for the world's second largest economy over the next few quarters as concerns grow that the recovery is failing to gain traction.

China's economy grew 6.3% in the second quarter year over year, up from 4.5% growth in the first quarter. However, the rosy-looking growth acceleration was supported by a favorable comparison to a notably weak period in 2022 when the country's largest city, Shanghai, was under a stringent two-month COVID lockdown. China is projected to still reach the government's 5% annual growth target this year given the comparison to weakness in 2022. Bloomberg economists estimate the country's economic growth will be around 3% this year excluding the strong boost from the favorable year-over-year comparison. A growth rate around 3% would be less than half the country's pre-pandemic average annual growth rate and its second worst year on record behind last year's 2.9% growth.

From a quarter-over-quarter perspective, China's economy slowed sharply to 0.8% growth in the second quarter from 2.2% growth in the first quarter. That was half the 1.6% average quarterly growth over the 5-year pre-pandemic time span from 2015 to 2019. Weakening domestic and foreign demand led to a sharp slowdown in retail sales and decline in exports. Slowing growth in some developed economies has reduced demand for Chinese exports, which were a consistent source of growth during the pandemic as housebound western consumers shifted spending toward goods.

In its July statement, China's Politburo, the Communist Party's policymaking committee, called out weak confidence as the main cause of the country's disappointing economic activity. The China Consumer Confidence Index rebounded early in the year, but subsequently experienced a reversal this spring to a level near the three-decade low reached last November. The lingering slump in China's property market, which accounts for around a quarter of economic activity and 70% of its consumers' wealth, has weighed heavily on consumer confidence. The country's property market has been unable to build a sustainable recovery since the government implemented policy changes in 2020 aimed at cracking down on heavily indebted property developers and reining in increasingly speculative activity.

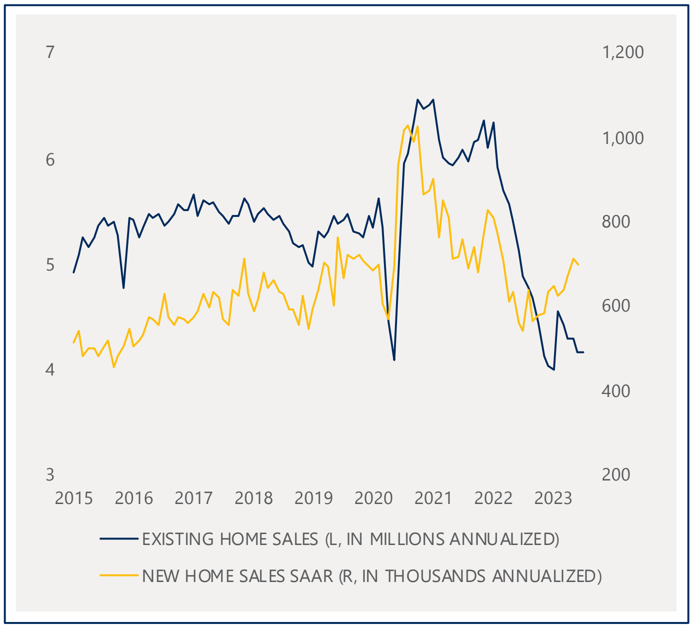
Another source of consumer weakness is record high youth unemployment. The unemployment rate among Chinese workers between the ages of 16 to 24 soared to 21.3% in June, nearly three times higher than the 8% youth unemployment in the U.S. Joblessness among one in five Chinese youths is being partly blamed on Beijing's regulatory crackdown on large technology companies and other burgeoning sectors such as private education in 2021. China's once swaggering technology industry has scaled back its workforce to adjust to more modest growth prospects, removing one of the country's most lucrative career paths. Increasing higher education enrollment has further exacerbated the unemployment problem as more than 28 million college graduates entered the labor market during the last three years, accounting for around two-thirds of labor supply growth. Many young people are reportedly not interested in blue-collar industries such as manufacturing which have a shortage of workers.

> "THE UNEMPLOYMENT RATE AMONG CHINESE WORKERS BETWEEN THE AGES OF 16 TO 24 SOARED TO 21.3% IN JUNE"

After years of heavy borrowing, China's local governments are facing financial pressures that could constrain growth for quarters or possibly years. Municipal debt built up over the last decade bolstered the economy by funding infrastructure projects that created jobs. Municipalities were able to carry their swelling debt load by generating ample income from selling land to quickly expanding property developers. Land sales became the biggest income source for many local governments. This source of income has declined substantially amid the property market slump. S&P Global estimates that two-thirds of local governments are in jeopardy of breaching the threshold of debt exceeding 120% of income set by the Ministry of Finance to signal excessive leverage. Some economists are concerned the high debt might lead to spending cuts and delay growth-boosting projects.

China's Politburo announced a plan in late July to provide moderate financial support for the economy. Some economists are skeptical whether large scale stimulus seen in past slowdowns is coming given the country's large debt and commitment to avoid restoking previous excesses in the property market.

NEW HOME SALES REBOUND
EXISTING AND NEW HOME SALES DIVERGE

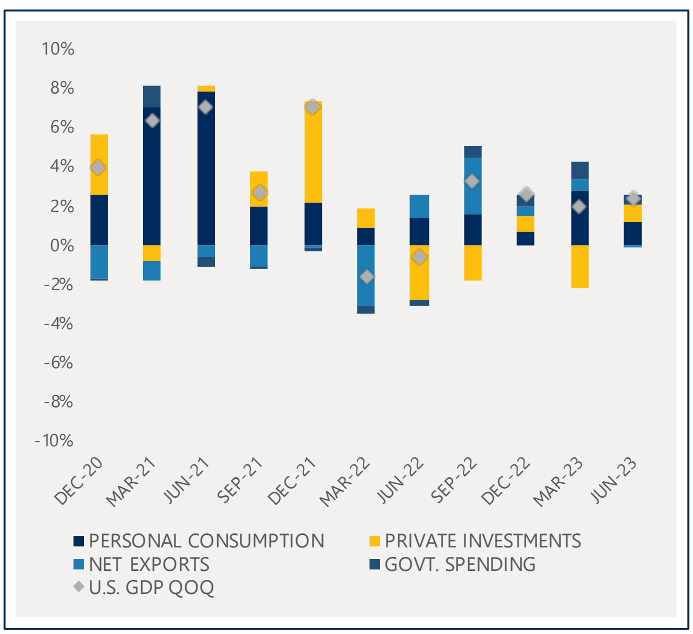


Source: Bloomberg. Past performance does not guarantee future results.

The U.S. housing market appears to be adjusting to higher mortgage interest rates as some housing data are showing tentative signs of a rebound. New home sales have risen to levels this summer that were last seen in early 2022 before the Fed began hiking interest rates. Meanwhile, homebuilder sentiment for single family home sales rose for the seventh straight month in July to a 13-month high. Builders say low inventory of existing homes is supporting demand for new home construction.

Existing home sales have remained subdued after reaching the lowest level in over a decade in January. The brief rebound in existing home sales at the start of the year quickly lost momentum as low inventory constrained sales. The inventory of existing homes for sale is at a record summer low with 1.08 million homes on the market in June. Many homeowners have delayed plans to switch homes amid the jump in the average 30-year fixed interest rate mortgage last year to a 20-year high around 7% from the record low rates below 3% in 2021.

U.S. ECONOMY STRONGER THAN EXPECTED
CONTRIBUTIONS TO % CHANGE IN GDP, 4Q20 THROUGH 2Q23



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

The U.S. economy has been surprisingly resilient in the first half of the year despite the Fed's aggressive rate hiking campaign. Second quarter GDP rose at an annualized rate of 2.4%, above the median economist estimate for 2.0% growth. First quarter growth was revised up to an annual rate of 2% from the prior estimate of 1.3%, boosted by positive revisions to exports and consumer purchases. Economists project economic growth will slow to 0.7% and -0.2% in the third and fourth quarters.

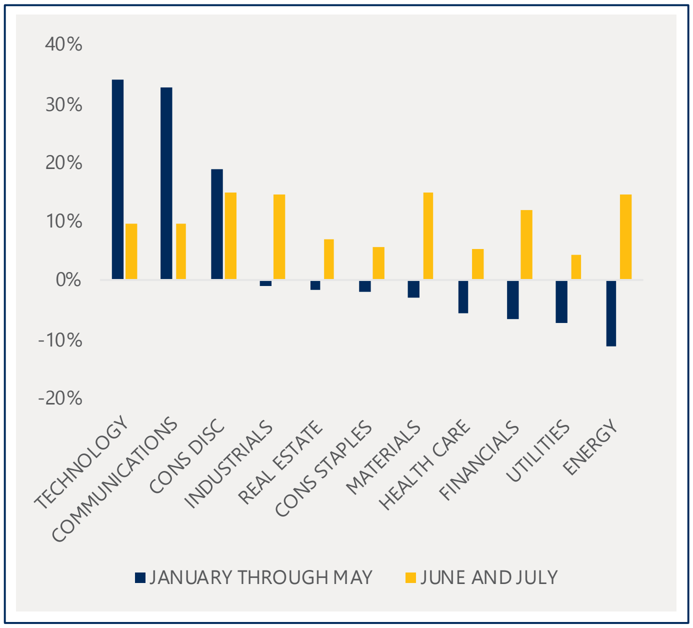
Contributions to the second quarter's strong growth were widespread. Gross private investment increased by 5.7% after tumbling 11.9% in the first quarter. Government spending increased 2.6%, including a jump in defense expenditures.

Personal consumption, which accounts for around two-thirds of economic activity, increased a solid 1.6%, although it was a pullback from the 4.2% rise in the previous quarter. Softer consumer spending was driven by lower sales for big-ticket items including vehicles and durable goods such as appliances.

EQUITY

BROADENING STOCK MARKET RALLY

S&P 500 SECTOR PERFORMANCE IN 2023



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

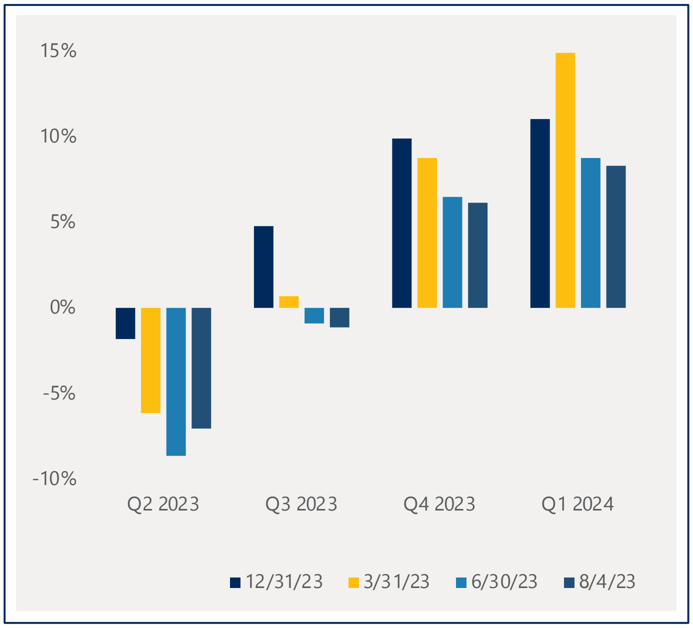
The global equity rally continued in July with the S&P 500 index rising 3.21% in the month. The S&P 500 is up 20.65% this year, its best first seven months of a year since 1997. Improved investor sentiment has been supported by cooling inflation and resilient economic growth in the U.S. fueling hopes for a soft landing.

While mega-capitalization technology stocks were responsible for the majority of stock market gains during the first five months of the year, the market's rally has broadened over the last two months. The U.S. economy's surprising momentum helped cyclical sectors, including energy, financials, industrials, and materials, lead the market over the last two months with each sector returning over 10%. Additionally, small capitalization stocks, which are more economically sensitive, have also seen a summer resurgence as the Russell 2000 index gained 14.25% in the last two months.

Emerging market stocks outperformed developed markets in July. The MSCI China index jumped 10.86% in the month amid talk of additional government stimulus to support China's slowing economy.

ANALYSTS REDUCE THEIR EARNINGS OPTIMISM

S&P 500 QUARTERLY EARNINGS GROWTH FORECAST



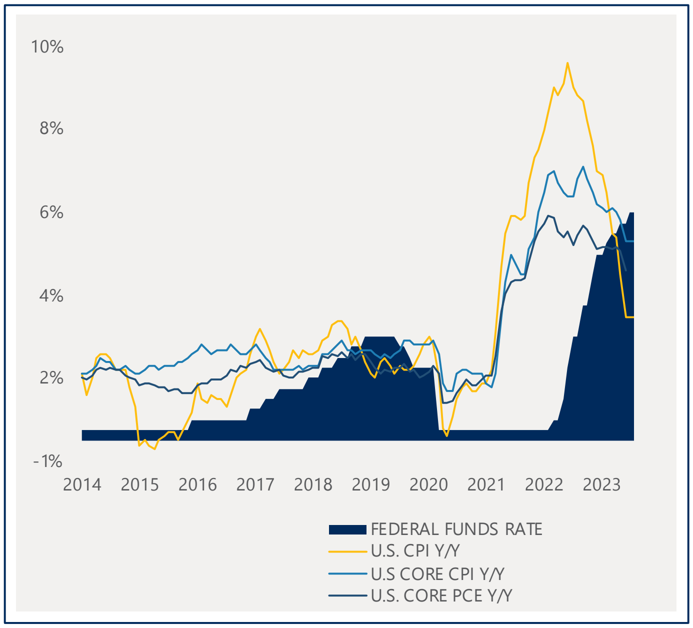
Source: Bloomberg. Past performance does not guarantee future results.

Second quarter earnings reporting season is winding down after over 400 companies in the S&P 500 reported earnings through early August. Earnings are on track for a 6.74% decline compared to analysts' forecast for a steeper 8.96% contraction. Excluding the energy sector's outlier 51.5% earnings contraction driven by lower oil prices, the S&P 500 index is on pace for a 0.33% earnings decline. Energy, materials, and health care are the only sectors with earnings contractions. Net income and operating margins were slightly worse than analysts' estimates and declined year over year as higher costs continue to pressure margins.

Analysts' projected earnings recovery in the second half of the year is moderating as growth estimates continue to be revised lower. Earnings are forecast to decline 1.20% in the third quarter, followed by 6.10% growth in the fourth quarter.

Sales are holding up better than earnings with 4.65% growth, excluding energy, versus analysts' estimate for 2.93% growth. Strong double-digit sales growth in financials and consumer discretionary was offset by negative growth in energy, materials, and utilities.

U.S. INFLATION MEASURES AND FED FUNDS RATE
JANUARY 2014 THROUGH AUGUST 2023



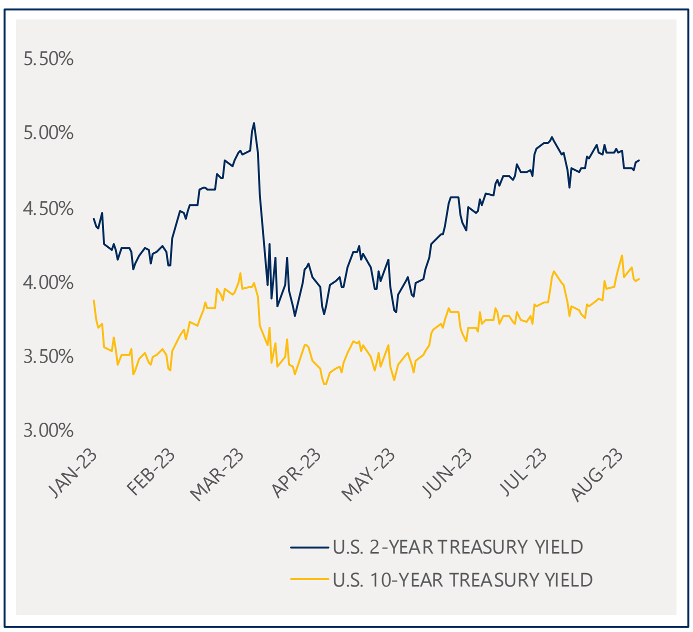
Source: Bloomberg. Data as of 8/11/23. Past performance does not guarantee future results

Disinflation (price levels rising at a decelerating pace) has become one of the dominant U.S. economic trends in recent months as the favorable base effects of sharply higher energy prices in the spring of 2022 have fallen out of the year-over-year calculations. The annual consumer price index (CPI) peaked at 9.1% in June 2022 and declined for 12 straight months to 3.0% in June 2023.

The Fed's preferred inflation gauge, the core personal consumption expenditures (PCE) index, has been stickier, however, with readings of 4.6% or 4.7% for seven straight months spanning November to May before dipping to 4.1% in June. Several other measures of core services inflation excluding housing have stayed between 4% and 5% amid a combination of wage pressures and strong consumer demand in sectors like leisure and hospitality.

On July 26, Fed officials hiked their policy rate by another 25 basis points to a range of 5.25% to 5.50% but signaled a willingness to pause in September given the recent disinflationary trend and signs of modest cooling in the labor market.

TWO-YEAR AND TEN-YEAR U.S. TREASURY YIELDS
JANUARY 2023 THROUGH AUGUST 2023



Source: Bloomberg. Data as of 8/11/23. Past performance does not guarantee future results.

The inversion of the 2-year to 10-year portion of the U.S. Treasury yield curve intensified to nearly 110 basis points (bps) in early July but pulled back to 70 bps by the first week of August. Yield curve inversions have generally been reliable (though not bullet proof) signals of economic slowdowns whereby the Fed is compelled to cut rates to boost growth in an impending downturn.

The policy-sensitive U.S. 2-year Treasury yield has failed to break out above 5% several times in the last six weeks as market participants seem increasingly confident the Fed is near the end of its rate hike cycle.

The 10-year U.S. Treasury yield, which is more sensitive to longer term growth and inflation expectations, has pushed above 4% in recent weeks. A pickup in Treasury issuance, the Fitch downgrade of U.S. debt, and signs of a less dovish Bank of Japan, have combined to put upward pressure on longer term yields since mid-May.

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