
IN THIS ISSUE



# MARKET REVIEW
MARCH 2022

SMB Trust Services

MARKET BRIEF

# GOVERNMENT DEBT SUSTAINABILITY

The COVID-19 pandemic led to the largest surge in U.S. federal debt held by the public, excluding intragovernmental debt owed to its agencies, since World War II. The rise in debt accompanied an expansion of the U.S. fiscal deficit to a multi-decade high of around 15% of Gross Domestic Product (GDP) in 2020. This deficit expansion was, in turn, driven by massive amounts of fiscal stimulus to support the economy combined with a reduction in tax revenue during the first half of 2020. U.S. federal debt held by the public surpassed $23 trillion in the fourth quarter of 2021, an increase of nearly $6 trillion since the beginning of the pandemic. Many economists agree that the government's massive borrowing during the pandemic made sense in the short-term to support the economy. However, the swelling debt level renewed concerns among some economists that the trajectory of debt growth and deficits are not sustainable on a long-term basis. For example, the International Monetary Fund (IMF) recently expressed concerns that high debt levels among some countries, including the U.S., could weigh on economic growth and impede governments' ability to adequately respond to future recessions. Meanwhile, some economists and Federal Reserve officials argue that the U.S. government can afford to service its current debt level in part due to low interest rates, strong investor demand for U.S. debt and the dollar's status as the global reserve currency. Fed Chairman Jerome Powell said last year, "the current level of the debt is very sustainable and there's no question of our ability to service and issue that debt for the foreseeable future."

## DEBT AFFORDABILITY

The conventional measure of the U.S. government's financial leverage, its debt-to-GDP ratio, reached 100% in 2020 for the first time since World War II. As the U.S. debt-to-GDP ratio surpassed 100% for only the second time in recorded history dating back to 1790, some investors have wondered out loud if the country's debt is approaching a breaking point. Harvard economic professors Larry Summers and Jason Furman, however, argue that debt-to-GDP ratios "are a misleading metric of fiscal sustainability" because they do not reflect the reduced cost of debt from lower interest rates. The economists propose focusing instead on the debt service-to-GDP ratio which measures the government's net interest payments relative to GDP.

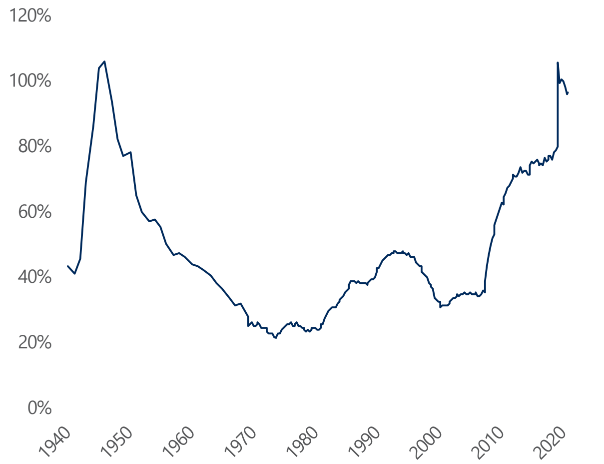
The U.S. debt service-to-GDP ratio was 1.53% in 2021, which is below the long-term average of 1.76% since 1950. Additionally, the ratio's current level is also below the cost of debt seen throughout the 1980s and 1990s when debt-to-GDP was below 50%. The steady decline in interest rates over the last few decades led to a sharp decline in the debt service-to-GDP ratio from around 3.0% in the mid-1990s to 1.3% in the mid-2000s. Summers and Furman believe policymakers do not need to worry about debt sustainability if the debt service-to-GDP ratio remains in line with its historical range. The Congressional Budget Office projects the debt service-to-GDP ratio will gradually rise over the next decade to 2.7% by 2031, which is below the historical peak of 3.2% in 1991.

Another useful measure of debt affordability is comparing the U.S. government's net interest payments to total federal spending. This measure depicts a somewhat sanguine debt sustainability picture like the debt service-to-GDP ratio. Interest payments were 5.17% of total federal spending last year and averaged 6.67% over the last five years. This is below the long-term average of 9.04% since 1950. The Congressional Budget Office projects interest payments will gradually rise to 11% of total spending by the end of the decade, which is below the levels seen throughout the 1980s and 1990s. History suggests that once interest payments as a proportion of total federal spending reach a mid-teens percentage range, signs of fiscal stress may begin to emerge. The last time interest payments reached such a level was in the late 1980s and early 1990s. Among other factors, this likely played a role in Republican President George H.W. Bush going back on his campaign promise to not raise taxes.

## SHRINKING THE DEBT BURDEN

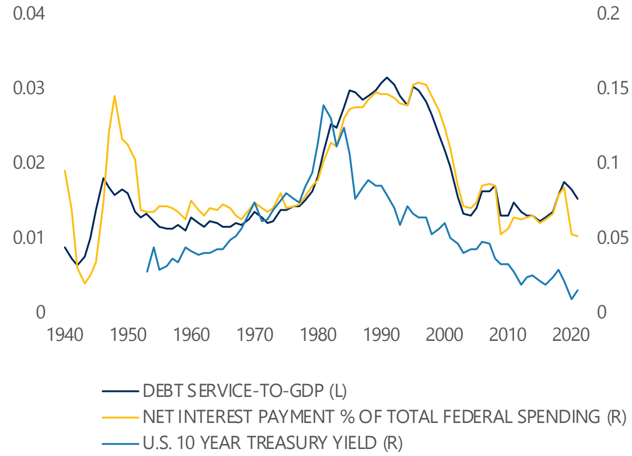
Since 1871, U.S. economic growth has exceeded the level of interest rates two thirds of the time. Summers and Furman highlight this notable trend because economic growth exceeding the level of interest rates means the economy can outgrow its debt and interest obligations over time, assuming additional borrowing stays in check. This dynamic played out in the U.S. following World War II as domestic borrowing to fund the war effort caused the debt-to-GDP ratio to spike to 106% in 1946 from 41.5% in 1941. The post-war economic boom dropped the debt-to-GDP ratio to 55.8% by 1955 as the rate of economic growth exceed the level of interest rates. Elevated inflation is another factor that

CHART 1
## DEBT-TO-GDP
FEDERAL DEBT HELD BY THE PUBLIC % OF GDP




Source: Federal Reserve Bank of St. Louis & Congressional Budget Office.
Past performance does not guarantee future results.

CHART 2
## DEBT AFFORDABILITY
NET INTEREST PAYMENT % OF GDP & FEDERAL SPENDING




Source: Federal Reserve Bank of St. Louis.
Past performance does not guarantee future results.

helped reduce debt-to-GDP following World War II since higher inflation increases nominal GDP while the value of debt is unchanged by inflation. If the long-term relationship in the U.S. of economic growth generally exceeding interest rates holds into the future, that could help reduce the debt level relative to the economy. This interplay will likely be less impactful moving forward, however, since U.S. economic growth has moderated in recent decades.

Some economists and Biden administration officials advocate for the government taking advantage of low interest rates by borrowing for public investment that can theoretically pay for itself over time such as infrastructure, research and development, and early education. According to research from the IMF, well-calibrated increased public investment financed with debt can boost economic growth and reduce debt-to-GDP since the rise in GDP can be larger than the debt borrowed to finance it. The IMF also found that debt-financed investments have a greater impact on expanding the economy compared to budget neutral investments financed with raising taxes or cutting spending elsewhere.

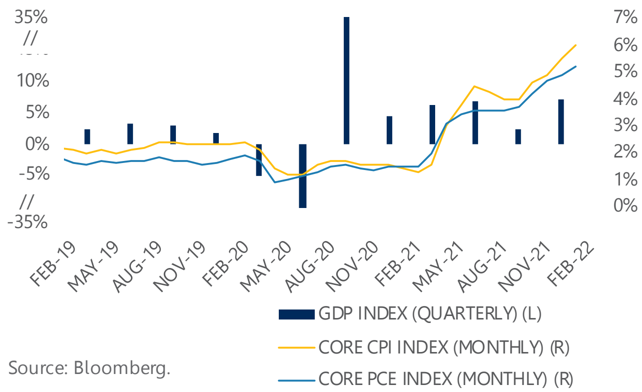
Debt-financed public investments can also be beneficial for the debt service-to-GDP ratio because certain types of public investments generate rates of return in terms of expanding the economy that exceed the cost of debt. For example, research from Brookings Institution economists Isabel Sawhill, Jeffrey Tebbs, and William Dickens concluded that investing in early education, through universal preschool for three- and four-year-old children, would likely increase GDP by between 1.0% and 3.5%, depending on the time period. The hypothetical boost to economic growth was driven by increased worker productivity and spillover effects from higher wages. Similarly, research from other economists concluded that public investments in infrastructure and research and development in critical industries can generate rates of return for an economy above the cost of debt.

### POPULATION AGING COULD LEAD TO HIGHER DEBT
The U.S. population is growing older as the baby boomer generation ages, life expectancy rises, and fertility rates decline. Some economists believe an aging population will create significant fiscal challenges for policymakers as spending rises for age-related entitlement programs such as Social Security and Medicare. Furthermore, research from the IMF found that fiscal stimulus in countries with older populations is less effective at supporting their economies during recessions due to weaker fiscal multipliers. Economies with older populations are less responsive to fiscal stimulus because the working age cohort accounts for a smaller percentage of the total population. The working age population benefits more than retirees from stimulus because increased corporate hiring and higher wages have a directly beneficial impact on workers compared to a much more marginal impact on retirees. The IMF's findings suggest that aging countries including the U.S. may require larger fiscal stimulus financed with debt to support their economies during future recessions.

### CONCLUSION
Measures of debt affordability including debt service-to-GDP and net interest payments as a percent of total federal spending depict a more benign debt burden situation than the more commonly cited debt-to-GDP ratio, which recently neared the all-time high set during World War II. U.S. federal debt appears to be sustainable over the next several years as low interest rates have made interest payments more manageable. However, the debt sustainability outlook could deteriorate if interest rates rise substantially. From a longer-term view, increased federal spending associated with an aging population could create fiscal challenges for policymakers, but that could be mitigated with policy reform for entitlement programs.

# ECONOMY

## GDP AND CONSUMER PRICES
JANUARY 2019 THROUGH JANUARY 2022



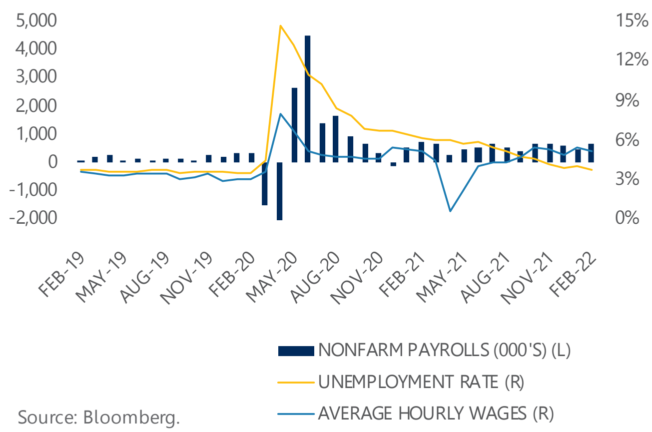

Source: Bloomberg.

Fourth quarter U.S. economic growth was revised up slightly to an annualized pace of 7.0% from the initial estimate of 6.9%. Growth in the first quarter is expected to slow sharply to 1.5%, according to the median economists' estimate compiled by Bloomberg.

Consumer prices continued to rise in January as the Core Consumer Price index was up 0.6% for the month, and 6.0% over the last year. Rising costs for shelter and home furnishings led the increase.

The Core Personal Consumption Expenditure index, which excludes food and energy prices, increased to 5.2% in January from a year ago. Fed Chairman Jerome Powell indicated the Russia-Ukraine War has added some uncertainty, but still sees rate hikes coming.

## LABOR MARKET
FEBRUARY 2019 THROUGH FEBRUARY 2022



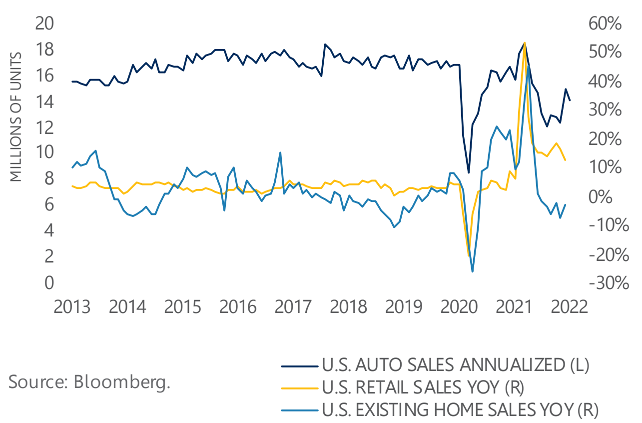

Source: Bloomberg.

Strong demand for workers and robust consumer spending helped the U.S. labor market add 678,000 jobs in February, the largest increase in seven months. Leisure and hospitality employment rose by 179,000 jobs, led by a gain of 124,000 jobs in restaurants and bars.

The unemployment rate fell to 3.8% from 4.0% in February, the lowest since the pandemic began. The labor force participation rate ticked up to 62.3% from 62.2% as workers re-entered the labor market.

Wage growth eased in February but remained elevated over a longer term period. Average hourly earnings rose 5.1% last month on a year-over-year basis, which was a deceleration from the 5.5% increase in January.

## HOUSING, AUTO AND RETAIL SALES
FEBRUARY 2013 THROUGH FEBRUARY 2022




Source: Bloomberg.

U.S. vehicle sales lost some momentum in February following the strong gain in January. Sales declined to a seasonally adjusted annualized rate of 14.1 million units, a 4.6% drop from the prior month.

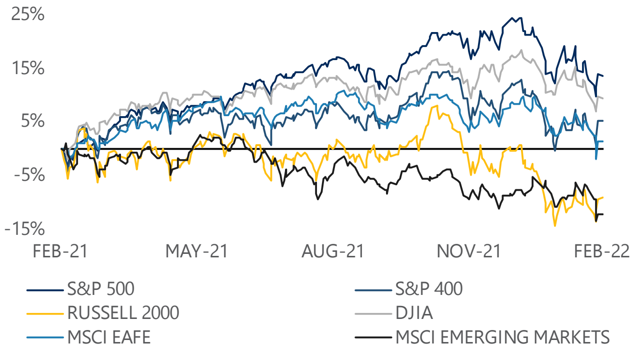
U.S. retail sales bounced back in January with a 3.8% monthly increase after a 2.5% decline in December. On a year-over-year basis, retail sales increased 13.0% driven by gasoline station sales surging 33.4%.

Existing homes sales rose 6.7% in January despite rising mortgage rates and inventory falling to a new all-time low in December.

# EQUITY

## TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, FEBRUARY 2021 THROUGH FEBRUARY 2022




Source: Bloomberg. Past performance is no guarantee of future results.

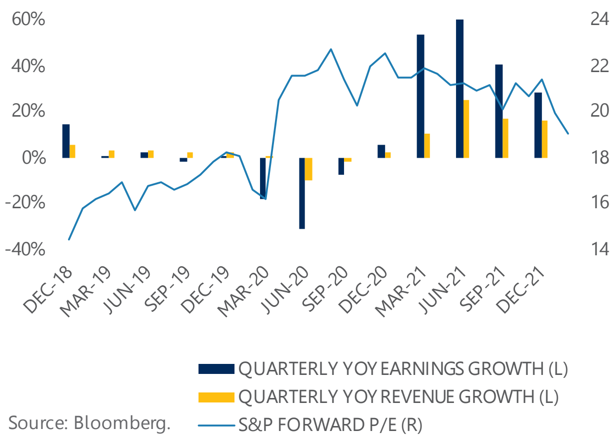
February marked a second consecutive monthly decline for global equities as investors assessed the potential economic impact from Russia invading Ukraine and sanctions imposed on Russia. The S&P 500 fell into correction territory near month end.

Equities in some European countries, such as Germany, underperformed the U.S. because of the region's large exposure to Russian energy imports. According to JP Morgan's Global Market Strategist Jai Malhi, Russia accounts for around a quarter of the European Union's crude oil imports and 40% of its natural gas imports.

U.S. mid and small capitalization stock indexes posted positive returns in the month due to their lower revenue exposure to Europe.

## S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, DECEMBER 2018 THROUGH FEBRUARY 2022



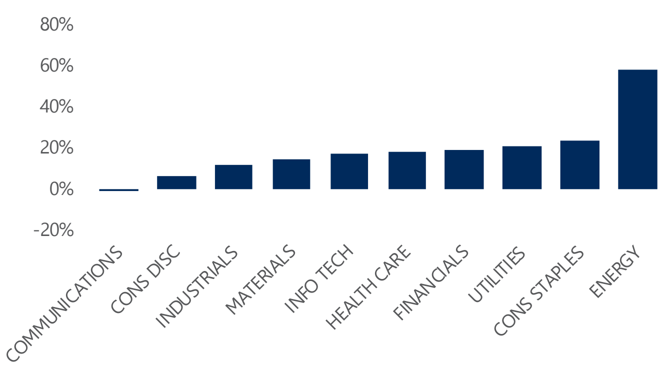

Source: Bloomberg.

Fourth quarter earnings season is almost complete with 493 S&P 500 companies reporting results. S&P 500 earnings are on pace for 28.8% growth compared to analysts' initial projection for 19.8% growth. Analysts project a sharp deceleration to single-digit growth in the current quarter due to tougher year-over-year comparisons.

Around 75% of the S&P 500 companies to report thus far have exceeded analysts' earnings estimates, which is slightly below the five-year average beat rate of 76% and 83.67% average over the last four quarters.

## S&P 500 SECTORS 12-MONTH PRICE RETURNS

FEBRUARY 2021 THROUGH FEBRUARY 2022




Source: Bloomberg.

Energy was the only sector with a positive return in February. The price of West Texas Intermediate (WTI) crude oil continued its rise this year with an 8.59% gain in February, bringing its increase this year to 27.27%. Russia's invasion of Ukraine has created uncertainty surrounding the future of Russian oil exports.

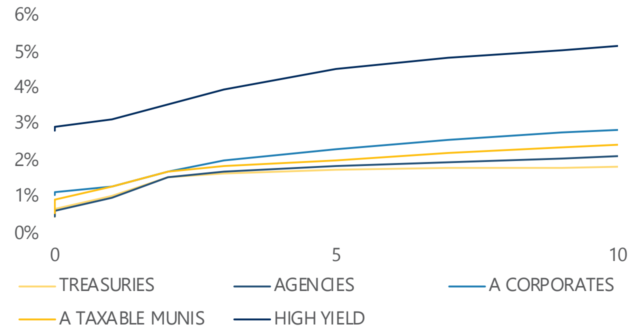
Defensive sectors, including consumer staples and utilities, held up better than other sectors in the month, with both sectors losing less than 2%.

Consumer discretionary was among the worst performing sectors in the month as higher energy prices posed a potential headwind for consumer spending.

# FIXED INCOME

## CURRENT YIELD CURVES

YIELD CURVES AS OF FEBRUARY 2022




Source: Bloomberg. Past performance is no guarantee of future results.

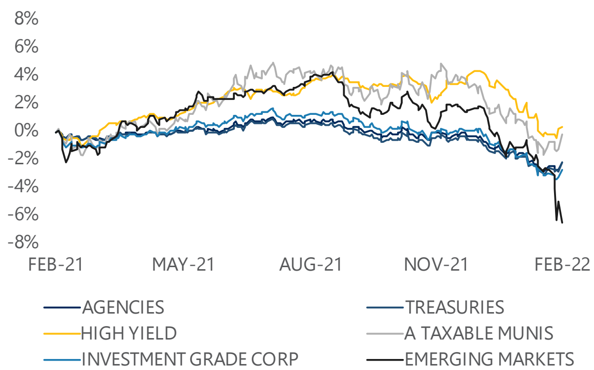
In February, the U.S. Treasury curve continued to shift higher and flatten in response to a more aggressive Federal Reserve policy outlook. According to Bloomberg's U.S. interest rate probability model, money market futures as of February 28 projected the Fed's policy rate will be 1.34% at the end of 2022 compared to projections of 1.23% only a month earlier.

Yields on the 2-year U.S. Treasury note rose 0.21% in February to finish the month at 1.43%, while yields on the 10-year note climbed 0.04% to 1.83%. Both maturities closed the month at their highest levels since January 2020.

The yield spread between single A-rated corporate bonds and U.S. Treasuries at the 2-year maturity mark is noticeably tight at 0.19%.

## 12-MONTH RETURNS, TAXABLE BOND SEGMENTS

FEBRUARY 2021 THROUGH FEBRUARY 2022




Source: Bloomberg. Past performance is no guarantee of future results.

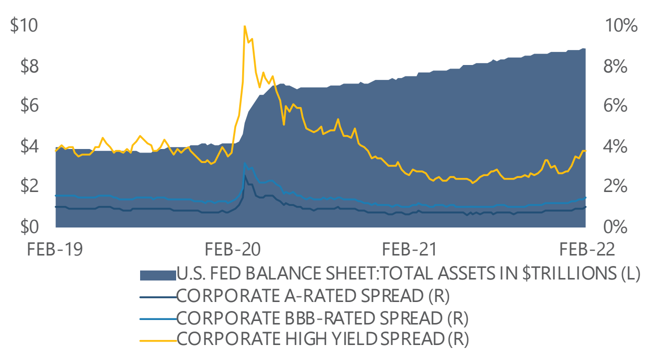
With the exception of high yield, every bond segment shown in the accompanying chart posted a negative 12-month return amid increased expectations for higher rates. In broad terms, portfolios with more exposure to shorter duration and lower credit quality areas of the market were among the best positioned over the previous 12 months.

Domestic high yield corporate bonds significantly outperformed emerging market bonds despite both segments exhibiting similar credit quality. Relative dollar strength in the past 12 months has contributed to the considerable performance difference.

Above-trend economic growth, an accommodative policy backdrop and a larger coupon cushion have enabled lower quality domestic bond segments to outperform their higher quality counterparts over the last 12 months.

## FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

FEBRUARY 2019 THROUGH FEBRUARY 2022




Source: Bloomberg.

The Federal Reserve's balance sheet has expanded by roughly 112% during the pandemic to $8.9 trillion in February 2022 from $4.2 trillion in February 2020.

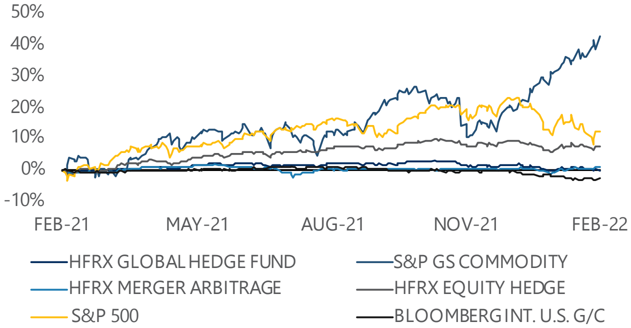
Federal Reserve Chairman Jerome Powell indicated in his press conference following the January 25-26 Federal Open Market Committee (FOMC) meeting policymakers "…(have) reaffirmed their plan as announced in December, to end asset purchases in early March." Powell cited labor market improvements and elevated inflation as the main reasons to remove "sustained high levels of monetary support."

U.S. corporate high yield, BBB-rated, and single A-rated credit spreads have widened modestly in recent months and remain significantly lower than their widest levels at the start of the COVID-19 pandemic.

# ALTERNATIVES

## ALTERNATIVES, 12-MONTH RETURNS

FEBRUARY 2021 THROUGH FEBRUARY 2022




Source: Bloomberg. Past performance is no guarantee of future results.

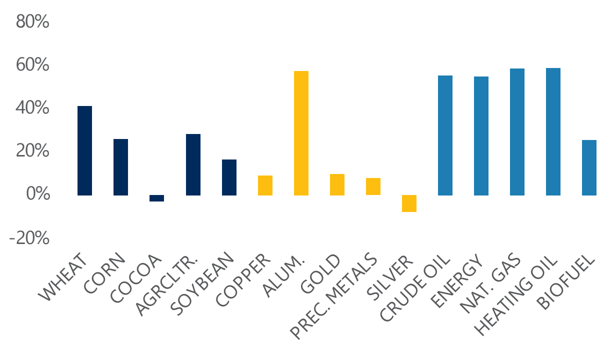
The S&P GSCI Index, a broad measure of investment performance in commodity markets, outperformed the S&P 500 by a staggering 27.95% in the first two months of 2022. In recent weeks, the Russia-Ukraine war has amplified the effects of low inventories and supply bottlenecks across a large swathe of energy, industrial metal and agricultural commodities.

The HFRX Global Hedge Fund Index fell 0.36% in February, holding up better than both the S&P 500's 3.00% drop and the Bloomberg Intermediate Government/Credit Index's 0.66% monthly decline.

The HFRX Equity Hedge Index and the HFRX Event-Driven Merger Arbitrage Index advanced 0.34% and 1.36%, respectively, in February.

## COMMODITIES, 12-MONTH SPOT RETURNS

FEBRUARY 2021 THROUGH FEBRUARY 2022




Source: Bloomberg. Past performance is no guarantee of future results.

U.S. West Texas Intermediate (WTI) crude oil futures climbed 8.6% in February to $95.72 per barrel after surging 17.2% in January. Mounting concerns about Western sanctions against Russian energy imports and counter sanctions from Moscow have amplified upward pressure on crude oil and European natural gas prices in recent weeks.

North American farmers may become the primary beneficiaries of a sharp drop-off in Russian and Ukrainian grain exports and a poor South American growing season. The S&P GSCI Agricultural and Livestock Spot Index rose 12.9% in the first two months of the year.

Gold prices rose 6.2% in February to $1,909 an ounce as the precious metal's appeal as a safe haven asset and inflation hedge boosted demand.

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