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MARKET REVIEW
DECEMBER 2022

SMB Trust Services

CHINA'S DEFLATING HOUSING BUBBLE

China's housing boom over the last decade led to the country's residential real estate sector swelling in value to $55 trillion in 2021 according to an analysis by MSCI Research. This valuation was larger than the U.S. housing market and nearly half the size of the global equity market. The surge in property construction was accompanied by rising leverage among real estate developers as they funded projects with credit. The debt-to-equity ratio of 21 large Chinese real estate developers listed on the Hong Kong stock exchange doubled between 2011 and 2020, while their interest coverage ratio, which measures operating profit to interest expense, decreased to a third of its previous level. Chinese regulators implemented policy changes in 2020 aimed at improving developers' financial health and reining in the country's increasingly speculative real estate market. These policy changes in combination with strict COVID-19 lockdown policies caused a steep housing downturn this year. Housing sales among the country's 100 largest property developers fell 28.2% year over year in October, a record ninth straight monthly decline and worse than the 20.6% drop during the depths of the 2008 global financial crisis. The worst of China's real estate slump appears to be over after the government stepped in to support the market in November. However, China's housing market may experience a slow and protracted recovery as demand remains weak.

INFLATING HOUSING BUBBLE

The inception of China's housing bubble dates back two decades. Prior to the late 1990s, only a third of Chinese citizens lived in cities. Most urban residents lived in subsidized housing provided by their employer, and private real estate sales were tightly controlled by the government. In 1998, the government radically changed its policies. Employer subsidized housing was ended due to its significant financial burden, while the housing market was loosened to allow many people to purchase and rent homes. The opening of the real estate market coincided with the country's urbanization trend which included hundreds of millions of people flocking to cities from rural areas. Property construction and real estate prices boomed as the emerging urban cohort grew to account for around two-thirds of the country's population by 2021.

The rapid rise in housing prices, which skyrocketed sixfold over the last 15 years, attracted speculative purchasers that viewed real estate as an attractive and safe investment. According to the China Real Estate Information Corporation (CRIC), home purchases as an investment may have accounted for up to 40% of new home sales over the last three years. In an example of the frenzied housing market activity, a new building in Shenzhen, China's technology hub with a population of 13 million people, sold all of its 288 units online in less than eight minutes in March 2020. Some of the country's popular cities, such as Shenzhen, have become more expensive than New York on a price-to-income basis. The bubbling housing market captured the attention of government officials who adopted the mantra "houses are built to be lived in, not for speculation" from a 2017 public statement by Chinese President Xi Jinping. The government's attempts to deflate the bubble over the last several years were often undermined by its own willingness to reverse measures designed to curb excesses in the real estate market to stimulate the economy during moments of weakness.

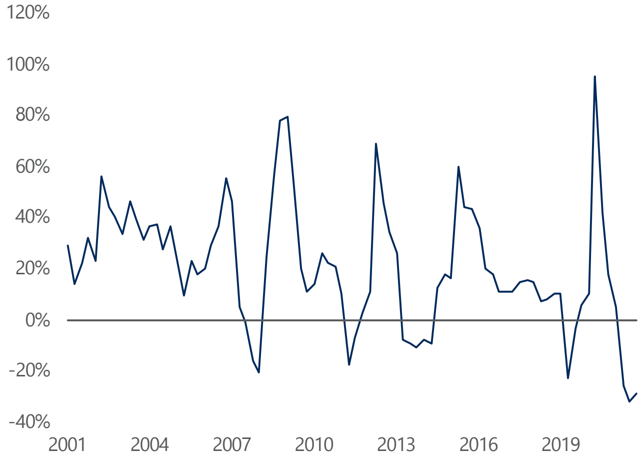
BEIJING'S RESPONSE

To curtail the freewheeling housing market and reduce the risk of a widespread financial crisis, regulators imposed strict borrowing limits for real estate developers in mid-2020. The tougher policy is called the "three red lines" in reference to its three debt limits. These debt limits state that liabilities cannot exceed 70% of assets, net debt should be less than equity, and cash must be more than short-term debt. Developers' ability to increase their debt was constrained by how many lines they crossed. Regulators also implemented rules for state-owned banks in early 2021 to reduce their real estate loan exposure to below 40% of their loans and limit mortgage lending to 32.5% of their outstanding credit. Reduced funding for developers led to less property construction, increased defaults, and higher credit losses for banks. Since 2021, more than 30 developers have defaulted on their bonds worth over $50 billion. Developers' deteriorating financial health led foreign investors to sell their bonds. The CRIC China Property Developers Leading U.S. Dollar Bond Index declined 45% this year through early November, before rebounding in response to the government's intervention. The plummeting value of developers' bonds to record lows made it difficult for them to raise capital through new bond issuances, which added to their financing challenges.

CHART 1

RECORD DECLINE IN CHINA HOUSING SALES

CHINA HOME SALES YEAR-OVER-YEAR GROWTH

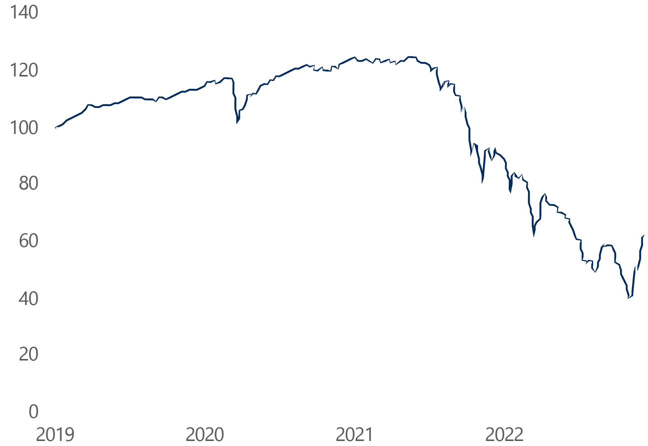


Source: Bloomberg.
Past performance does not guarantee future results.

CHART 2

REAL ESTATE DEVELOPERS' BOND PRICES PLUMMET

CRIC CHINA PROPERTY DEVELOPERS U.S. DOLLAR BOND INDEX



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

As the housing market pain mounted this year, the government initially took piecemeal steps designed to stabilize the sector which included lowering down payment requirements and distributing cash incentives. Chinese regulators eventually rolled out a more comprehensive 16-point plan in mid-November that directed financial institutions to help the property market's liquidity challenges. The initiatives included temporarily easing the 2021 restrictions on banks' real estate lending, extending developers' bank loan and bond payment dates, and relaxing down payment requirements for mortgages. Chinese authorities also told banks to lend 400 billion yuan ($56 billion) to real estate companies in the final two months of the year, on top of the $86 billion banks were told to lend in September.

CHINA'S HOUSING OUTLOOK

Real estate developers' bond prices rebounded from distressed levels in response to the 16-point plan as investors anticipated the rescue package will help the sector's liquidity problem and reduce the risk of a severe housing market crash. While the real estate package lifted investors' sentiment, China's housing market likely faces a long recovery due to developers' significant amount of debt hampering construction activity, homebuyers' weak confidence in the market, and a potential structural decline in housing demand.

Chinese developers have $238 billion in debt payments in 2023, down around 25% from this year. Despite the lower debt payments next year, real estate companies may still face financial pressure given their cash flow challenges. The rescue package will primarily help financially stronger developers. One of the 16 points aims to reduce moral hazard by encouraging asset management companies to pursue bankruptcy or restructuring for financially weaker developers. This likely means the government will not bail out over-levered developers. Goldman Sachs' analyst Kenneth Ho projects a 45% default rate for developers' bonds with non-investment grade credit ratings.

Homebuyer sentiment has deteriorated amid COVID-19 lockdowns, declining home prices, and developers' financial woes causing delivery delays for pre-sold homes. Bloomberg economists estimate that developers failed to complete 48.5% of the homes scheduled to be delivered in 2021 and the first half of this year. Significant delays in completing construction for pre-sold homes led to homebuyers boycotting mortgage payments for over 300 properties this summer. A CRIC survey in September showed 70% of Chinese citizens are deferring their home purchase plans beyond 12 months, up from 22% in February.

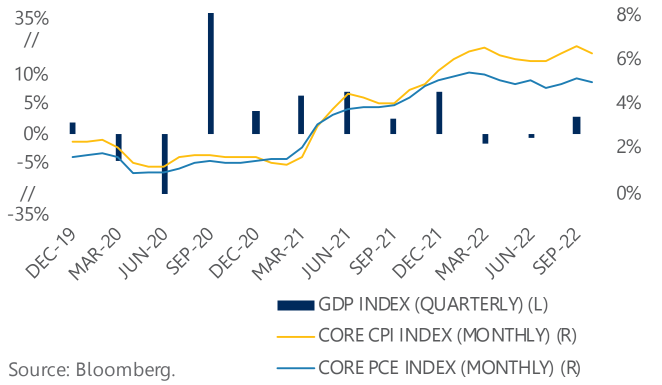
Bloomberg economists project China's housing demand will steadily decline over the next few years amid the maturing urbanization trend and low population growth. Around two-thirds of Chinese citizens live in cities, which mostly satisfies the government's goal of a 65% urbanization rate by 2025. Several of the country's more developed provinces in the south have over 70% of their population living in cities, not far from the 83% urbanization rate in the U.S. The considerable slowdown in the migration from the countryside to cities led to population growth in Chinese cities falling below 2% last year for the first time since 1977.

ECONOMIC DRAG

A slow housing market recovery could turn one of the economy's main growth drivers of the last decade into a moderate economic drag. Prior to the recent slump, the country's residential real estate market activity accounted for around a quarter of economic activity. Bloomberg economists forecast that a structural decline in housing demand will lead to a painful adjustment. They expect housing investment to decline 2.5% per year over the next decade and estimate the drop in investment will result in a 0.3% drag on economic growth per year.

ECONOMY

GDP AND CONSUMER PRICES
DECEMBER 2019 THROUGH OCTOBER 2022



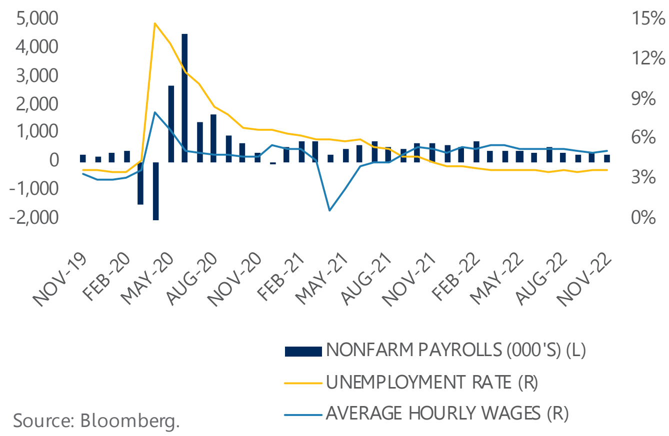
Source: Bloomberg.

The U.S. economy surprised to the upside during the third quarter with GDP growth revised up to 2.9%. Upward revisions to consumer and business spending lifted GDP from the initially estimated 2.6% growth.

The Core Consumer Price Index (CPI), which excludes food and energy, slowed to 0.3% growth in October from 0.6% growth in the prior two months. Year-over-year Core CPI decelerated to 6.3% from 6.7%. The weaker inflation report spurred hopes that inflationary pressures could be easing.

The Fed's preferred inflation gauge, the Core Personal Consumption Expenditures index also slowed in October. Core PCE increased to 5.0% in October from a year ago, down from 5.2% in September.

LABOR MARKET
NOVEMBER 2019 THROUGH NOVEMBER 2022



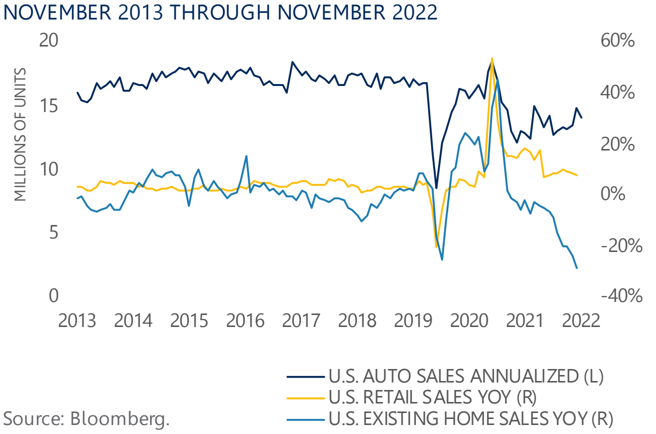
Source: Bloomberg.

The U.S. labor market added 263,000 jobs in November, exceeding the median economist forecast for 200,000 jobs. Monthly job growth in 2022 has averaged 392,000, significantly lower than the torrid 562,000 monthly average in 2021 when the labor market recovered pandemic job losses.

The unemployment rate remained at 3.7% for a second consecutive month after rising in October from 3.5% in September. Average hourly earnings growth accelerated to 5.1%, following two months of slower growth.

The November employment report complicates the outlook for Fed rate hikes since the labor market's resilient job gains and wage growth support consumer spending and can contribute to inflation.

HOUSING, AUTO AND RETAIL SALES
NOVEMBER 2013 THROUGH NOVEMBER 2022



Source: Bloomberg.

U.S. vehicle sales fell to an annualized rate of 14.14 million units in November, a 6.5% drop from October's nine-month high of 14.90 million units. Strong sales in October were driven by easing supply chain shortages.

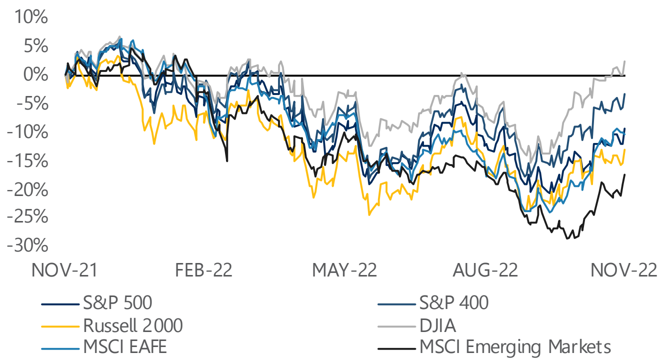
Retail sales rose 8.3% from a year ago in October, a slight decrease from the 8.6% growth in September. On a month-over-month basis, retail sales jumped 1.3%, the largest increase in eight months as consumer spending remained resilient despite elevated inflation.

Housing market weakness continued in October as existing home sales dropped for a record ninth straight month. Existing home sales were down 28.4% year over year, a further deterioration from the 23.8% decline in September.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, NOVEMBER 2021 THROUGH NOVEMBER 2022



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

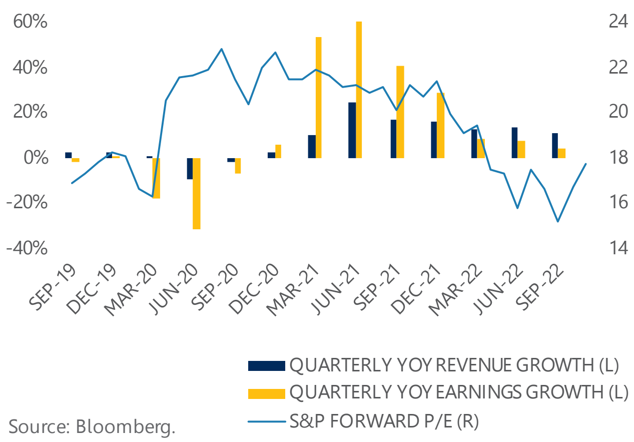
The recent equity market rally continued in November amid investors' ongoing hopes for slower inflation and less aggressive Fed tightening policy. The S&P 500 gained 5.59% in November, following its 8.10% rise in October. The index rebounded 14.06% since its mid-October low.

The weaker U.S. dollar helped the MSCI EAFE index rise 11.28% in the month. The index gained 6.44% in local currency terms, which removes the dollar's impact.

The MSCI Emerging Market index jumped 14.85% higher in November. China's easing COVID-19 lockdowns early in the month propelled the MSCI China index 29.72% higher after losing 33.79% in the prior two months.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2019 THROUGH NOVEMBER 2022



Source: Bloomberg.

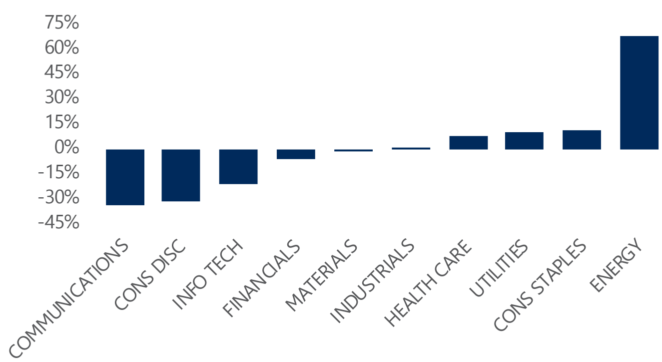
S&P 500 earnings growth of 4.6% in the third quarter surpassed analysts' forecast for 2.6% growth. Excluding outlier growth in the energy sector, earnings posted a second consecutive contraction with a 3.2% decline. Earnings fell in four sectors, including communications, financials, materials, and technology.

Analysts forecast flat to slightly negative earnings growth in the next three quarters. Earnings are projected to rebound in the second half of next year, driven by an earnings recovery in communications, technology, and financials sectors.

Sales are holding up better than earnings. S&P 500 sales grew 11.3% in the third quarter and are projected to maintain positive growth throughout next year.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

NOVEMBER 2021 THROUGH NOVEMBER 2022



Source: Bloomberg.

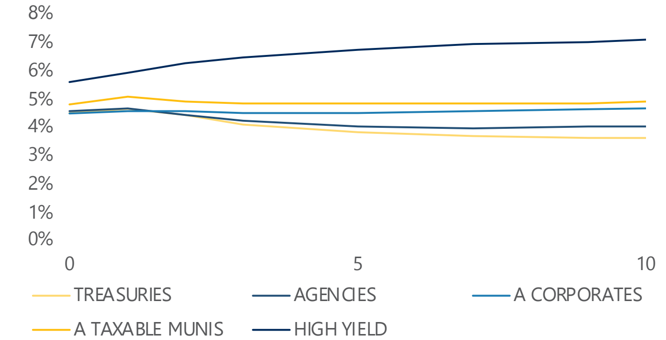
All 11 S&P 500 sectors had positive returns for a second consecutive month in November, led by an 11.76% gain in the materials sector. Materials stocks received support from China easing COVID-19 lockdowns early in the month spurring expectations for stronger industrial metal demand. The Bloomberg Industrial Metals index rose 14.53% in November.

The energy and consumer discretionary sectors produced more muted monthly gains of 1.26% and 0.99%, respectively. The consumer discretionary sector was weighed down by the 5.76% decline in shares of the sector's largest company, Amazon (AMZN). AMZN declined after the company's management projected that its holiday sales would grow between 2% to 8%, its lowest holiday growth rate ever.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF NOVEMBER 2022



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

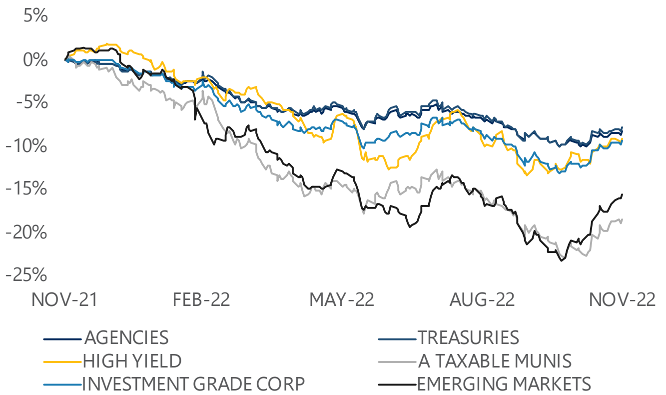
The 2-year to 10-year portion of the U.S. Treasury yield curve moved further into inversion territory during November as investors priced a slightly higher peak Fed policy rate and weaker economic growth in coming years. Yields on the 2-month Treasury note fell from 4.48% to 4.31%, while yields on the 10-year maturity declined from 4.05% to 3.61%.

Fed funds futures as of November 30 indicated investors expect the Fed's effective policy rate will peak at 4.92% in May 2023, slightly lower than projections for a peak of 4.98% a month ago.

The Fed's preferred recession probability indicator, the yield spread between 10-year Treasury bonds and 3-month Treasury bills finished November deeply inverted at roughly -0.80%, marking the steepest inversion since December 2000.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

NOVEMBER 2021 THROUGH NOVEMBER 2022



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

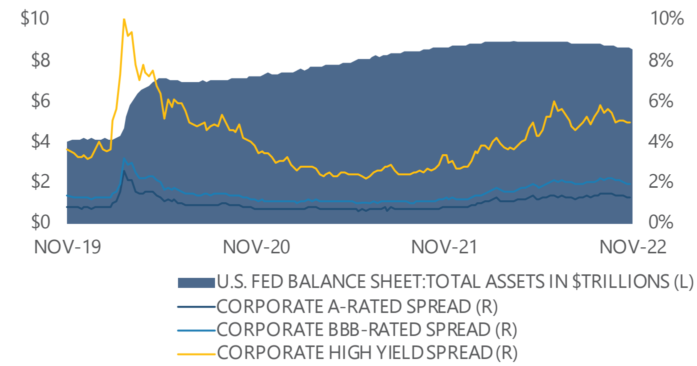
Aggressive Fed rate hikes and sharply higher interest rates across the fixed income universe have caused all bond segments shown in the accompanying chart to suffer negative total returns between -7.7% and -18.5% over the twelve months ending November 30.

A stretch of U.S. dollar weakness has pushed emerging market bonds higher over the last several months. Recent gains followed a long period of weakness driven by a powerful rally in the dollar from May 2021 through September 2022 and sharply higher policy rates in many emerging market nations.

The two highest quality bond segments in the accompanying chart, intermediate-term U.S. Treasuries and U.S. Agencies, have held up best so far in 2022 as they were not weighed down by widening credit spreads.

FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

NOVEMBER 2021 THROUGH NOVEMBER 2022



Source: Bloomberg.

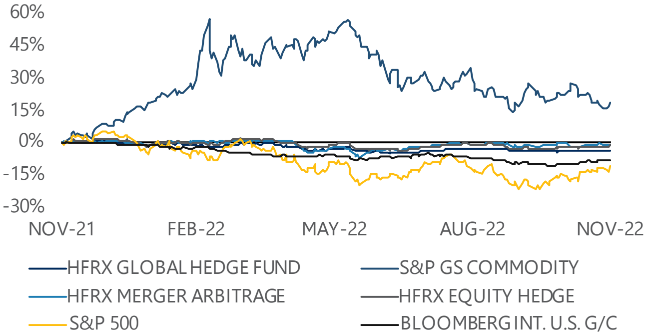
The Fed's balance sheet has shrunk by about $380 billion over the last seven months after expanding by 112% from $4.2 trillion in February 2020 to nearly $9.0 trillion in April 2022.

According to the Fed's projections, its balance sheet will be reduced by $522.5 billion this year to roughly $8.375 trillion, a modest 5.9% decrease. If policymakers keep the pace of quantitative tightening unchanged, the balance sheet is projected to shrink by another $1.14 trillion (or 13.6%) in 2023 to around $7.235 trillion.

U.S. corporate high yield, BBB-rated, and single A-rated credit spreads narrowed modestly in November as signs of widespread stress in credit markets failed to emerge. All three spreads are roughly double the lows reached in mid-2021.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
NOVEMBER 2021 THROUGH NOVEMBER 2022



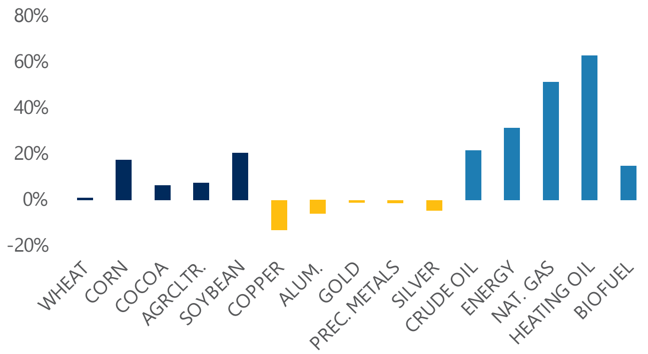
Source: Bloomberg. Past performance is no guarantee of future results.

A slowing global growth backdrop put further pressure on most commodities in November, with the notable exception of precious metals. After surging 45.9% from January 1 through June 8, the S&P GSCI Spot Index has given up roughly 80% of those gains over the next five-and-a-half months.

Year to date through November 30, the HFRX Equity Hedge Index (-3.13%) and HFRX Event Driven Merger Arbitrage Index (-1.11%) have held up better than both the S&P 500 (-13.12%) and the Bloomberg Intermediate Government/Credit Index (-8.07%).

This year has seen a wide dispersion of returns across hedge fund styles. Managed futures and other macroeconomic-focused strategies have generated the best returns, while cryptocurrency strategies and credit-focused strategies have delivered the weakest returns.

COMMODITIES, 12-MONTH SPOT RETURNS
NOVEMBER 2021 THROUGH NOVEMBER 2022



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

West Texas Intermediate (WTI) crude oil fell from near $90 per barrel in the first days of November to roughly $80 per barrel by the end of the month.

A tight supply picture in worldwide oil markets has been more than offset by concerns about China's COVID-19 policies constraining global growth and market interventions by various governments to limit the political damage of high gasoline, diesel, and heating gas prices.

Gold climbed 8.3% in November to $1,768.52 per ounce after seven straight monthly declines, retracing roughly one-third of the 20.9% drawdown from March 8 through September 26. The precious metal was boosted in November by concerns about slowing global growth, signs of a slowdown in Fed rate hikes, and a weaker U.S. dollar.

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NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			