



Economic Review & Outlook

THIRD QUARTER | 2023

Bridging Debt, Breaking Banks, and AI's Power Play: Navigating the Evolving Economic Landscape

The second quarter of 2023 was interesting, to say the least. Despite ongoing concerns about a potential recession, worldwide monetary policy tightening, U.S. debt ceiling negotiations, and more turmoil for regional banks, markets generally advanced—further recovering from the pullback of 2022. Artificial intelligence (AI) coverage increased across mainstream media, touting technological advancements once only imagined in science fiction. AI as an investing theme drove key equity indexes higher, fueling both excitement and worries about the long-term impact of this technology on jobs and society itself.

These events together with the issues that continue to shape investor sentiment—persistent inflation, unsettled geopolitical events, and the forthcoming path of central bank policy—leave high levels of uncertainty as we look to the second half of 2023 and beyond. What will the U.S. Federal Reserve (Fed) do with its tightening cycle? Could the banking sector's issues lead to more trouble for the broader economy? How concerning is the global economic growth picture? There aren't answers to these questions right now, only predictions, leaving investors torn between watching for the next aftershock and eagerly looking ahead.

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Economic Overview

WE HAVE A DEAL

In January, the U.S. government reached its borrowing limit, known as the debt ceiling, of \$31.4 trillion. The debt ceiling is a legislative mechanism that caps the amount of money the U.S. can borrow to fund the government. Lifting (or suspending) the limit does not authorize new spending; instead, it allows the government to spend money only on programs Congress previously approved. The U.S. generally runs budget deficits by spending more than it takes in and borrows to pay its bills. In essence, the government reached its credit limit in January.

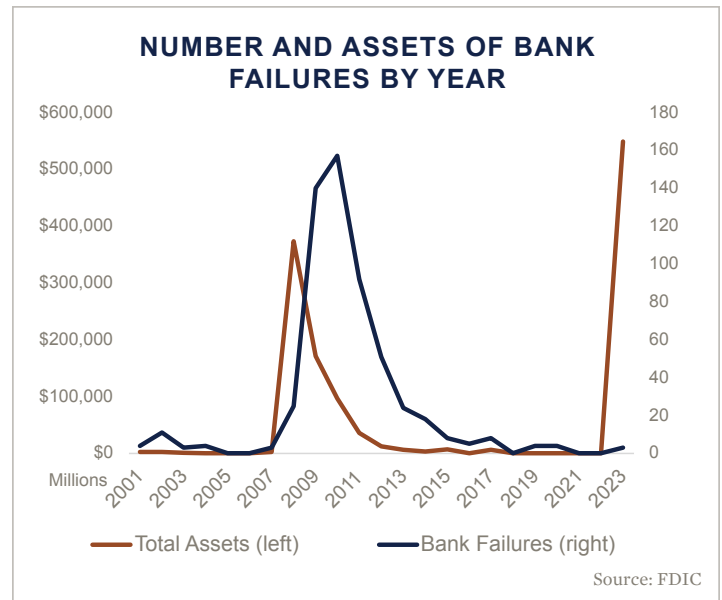
It's important to remember that this event occurs regularly: Congress has permanently raised, temporarily extended, or revised the limit nearly 80 times since 1960, often with a routine vote. Each increase comes with an "X date," when the government can no longer meet its obligations in a timely fashion, triggering the potential for defaults. This year's projected X date was June 5, and concerns swelled as the date approached, exacerbated by today's particularly high political tensions.

After months of worry and weeks of negotiations, President Joe Biden and Republican Speaker of the House Kevin McCarthy reached an agreement on May 29. The U.S. House of Representatives passed the bipartisan-supported bill on May 31, and the Senate passed it on June 1. On June 3, Biden signed the new law that suspends the U.S. debt ceiling until January 1, 2025, and allows the government to borrow as much as it needs to pay its bills during that period. It modestly reduces non-defense discretionary spending for the 2024 fiscal year and sets caps on spending increases for fiscal 2025. It also cuts some funding for the Internal Revenue Service, imposes new work requirements on some recipients of safety net programs, ends the suspension of federal student loan payments, rescinds \$27 billion of unspent funds from pandemic programs, authorizes a natural gas pipeline from West Virginia to Virginia, and aims to speed the permitting of some energy projects. Economists predict the planned spending reduction will likely have minimal effect on U.S. gross domestic product (GDP), thus limiting its impact on national debt levels.

From mid-April on, yields on one-month U.S. Treasury bills, considered among the world's safest investments, surged from below 3.5% to more than 5.5% and briefly surpassed the interest payments on longer-termed Treasury bills. These events underscored investors' concerns that the government would not pay back the principal on short-term bonds on time if the U.S. defaulted.

BANKING TURMOIL CONTINUES

In May, San Francisco-based First Republic Bank became the second-largest bank to fail in U.S. history when the Federal Deposit Insurance Corp. (FDIC) seized the lender and arranged for its sale to JPMorgan Chase. The situation was similar to the March collapses of Silicon Valley Bank (SVB) and Signature Bank, the third- and fourth-largest U.S. bank failures behind Washington Mutual, which failed in 2009 at the height of the Global Financial Crisis (GFC).



YIELDS ON TREASURY BILLS



Source: www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

The March banking turmoil helped drive a massive withdrawal of funds by First Republic depositors (\$100 billion in the first quarter, according to the bank), seeking to protect their funds and find better returns elsewhere as the Fed raised interest rates. Rising rates siphoned value from the bank's loan and investment portfolio as—much like SVB and Signature—First Republic experienced significant losses (mostly unrealized) and lost deposits from customers, especially large accounts that were above the FDIC-protected level of \$250,000, ratcheting up pressure on the bank's balance sheet.

While these banks had somewhat unique business models that catered mainly to wealthy clients and their uninsured deposits, many regional banks are feeling similar pressures and experiencing widespread stock sell-offs. These regional banks are significant lenders to local businesses and commercial real estate interests, and tightening lending standards or a slowdown in loans could further pressure the broader economy.

AI DOMINATES THE HEADLINES (AND EQUITY MARKETS)

The concept of AI isn't novel. Ivy League academics and business leaders coined the phrase "artificial intelligence" in 1955. Once merely the inspiration for forward-looking books and movies, AI has become a presence in our everyday lives through familiar technologies such as Siri and Alexa and across industries like healthcare, finance, and transportation, where AI is used to automate tasks, infer relationships, or make recommendations.

New AI applications create content, such as text and images. These generative AI tools, such as ChatGPT, have drawn a lot of interest from

a wide spectrum of companies and investors, fueling the growth- and technology-oriented market rally of 2023. Organizations from start-ups to some of the world's largest companies are pouring money into AI. More than 20% (110) of the companies in the S&P 500 Index cited AI in their first-quarter 2023 earnings reports—even fast-food-restaurant operator Wendy's—and nearly 10% (46) mentioned the term "generative AI."¹ On the flip side, AI has many people worried about the threat it could pose to society, from widespread job losses to reinforcing social biases. Many, including some leaders in the AI space, have called for regulation of AI, or at least taking time to slow down and adopt some common standards.

As of June 30, the S&P 500 was up 16.9% year-to-date. However, the contribution to return from the FANNGMA stocks and information technology sector, which includes many of the AI-powered stocks in the index, has positively skewed returns and cast doubts on the strength of the rally.

Asset Class Performance

Equities broadly advanced in the second quarter across major global regions, with the U.S. outperforming its developed- and emerging-market peers, a continuation of a trend from the first quarter. Investors balanced ongoing inflation with mixed economic signals, such as slowing but positive U.S. GDP growth and consecutive quarters of GDP contraction in the eurozone. Investor sentiment shifted throughout the period based on anticipation of a global monetary tightening cycle, expectations that the cycle could soon come to an end, and fears that persistent inflation and robust employment and wage growth could lead key central banks to tighten further, which would likely slow economic growth. Likewise, corporate earnings generally exceeded lowered expectations. Still, fears of a recession and some disappointing earnings or guidance reports, concerns around turmoil in the banking sector, and the U.S. debt ceiling negotiations sometimes weighed on stocks.

In May, amid a resurgence for the U.S. dollar, some commodity prices fell to their lowest levels since 2021, which helped drive moderating inflation. Gold eased during the quarter as inflation decelerated and interest rates remained firm. However, holding onto its year-to-date gains befit its status as a safe haven amidst worries about global growth and market volatility. Those concerns, together with changing expectations around the path of monetary policy, also weighed on bond markets in the second quarter. Key fixed-income indexes, however, advanced for the first half of 2023, bolstered by higher yields and expectations for declining interest rates.

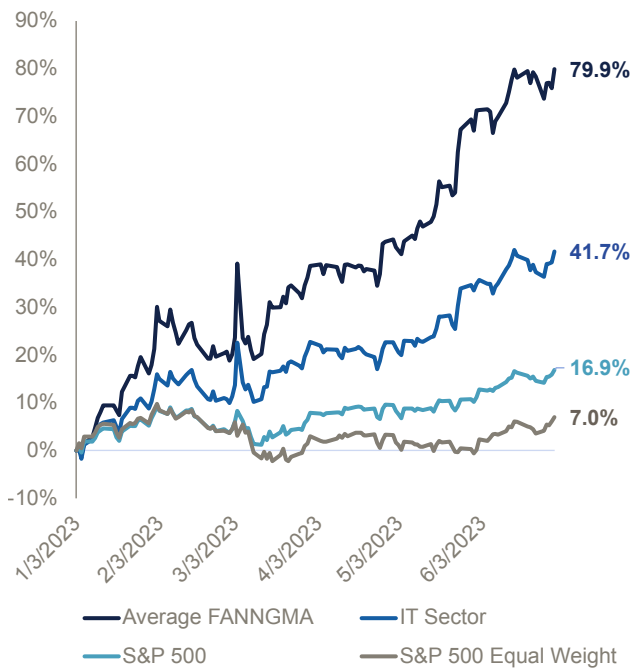
Our Perspective

A DEBT CEILING DEAL WAS REACHED, BUT LARGER ISSUES CONTINUE

Although Republicans and Democrats were able to reach an agreement to avoid the potential ramifications of a U.S. default, neither party got exactly what they wanted. The Republicans wanted significant spending cuts, while the Democrats wanted to raise the debt ceiling without concessions. Unfortunately, the solution of suspending the debt limit to a future date doesn't solve the fundamental issue. It merely sets us up for a potential repeat in January 2025. The benefits of the new spending cuts and clawing back of funds previously allocated to certain programs are debatable and vary based on your convictions. The Congressional Budget

¹ Source: FactSet

TECH STOCKS HAVE DRIVEN TOTAL RETURNS YEAR-TO-DATE



Source: FactSet. Meta (Facebook), Apple, Netflix, Nvidia, Alphabet (Google), Microsoft, and Amazon represent FANNGMA; the "IT sector" is represented by the Technology Select Sector SPDR Fund (XLK); the "S&P 500 Equal Weight" is represented by Invesco's S&P 500 Equal Weight ETF (RSP). Data as of 6/30/23.

MAJOR ASSET CLASS PERFORMANCE

January	February	March	April	May	June	Q2	YTD
Int'l Developed Stocks 8.1%	Int'l Developed Stocks -2.1%	Gold 7.6%	Int'l Developed Stocks 2.9%	U.S. Stocks 0.4%	U.S. Stocks 6.6%	U.S. Stocks 8.7%	U.S. Stocks 16.9%
Emerging Market Stocks 7.9%	U.S. Stocks -2.4%	U.S. Stocks 3.7%	U.S. Stocks 1.6%	Diversified Bonds -1.1%	Int'l Developed Stocks 4.6%	Int'l Developed Stocks 3.3%	Int'l Developed Stocks 12.1%
U.S. Stocks 6.3%	Diversified Bonds -2.6%	Emerging Market Stocks 3.1%	Gold 1.0%	Gold -1.3%	Commodities 4.0%	Emerging Market Stocks 1.1%	Gold 5.4%
Gold 6.0%	Commodities -4.7%	Int'l Developed Stocks 2.6%	Diversified Bonds 0.6%	Emerging Market Stocks -1.7%	Emerging Market Stocks 3.9%	Diversified Bonds -0.8%	Emerging Market Stocks 5.1%
Diversified Bonds 3.1%	Gold -5.2%	Diversified Bonds 2.5%	Commodities -0.8%	Int'l Developed Stocks -4.1%	Diversified Bonds -0.4%	Gold -2.5%	Diversified Bonds 2.1%
Commodities -0.5%	Emerging Market Stocks -6.5%	Commodities -0.2%	Emerging Market Stocks -1.1%	Commodities -5.6%	Gold -2.2%	Commodities -2.5%	Commodities -7.8%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Bloomberg Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Office projects the national debt will be \$45.2 trillion (115% of U.S. GDP) in 2033, down from its pre-deal forecast of \$46.7 trillion (119%).

One of Ronald Blue Trust's financial planning principles is to spend less than you earn. It's not always easy, and the idea is much more complex for the federal government than for an individual. Still, we would like for the government to embrace this philosophy and become more fiscally responsible, even if it requires some painful cuts to spending.

Investment Implications: The debt ceiling deal helps eliminate fears that the government cannot repay the principal on short-term U.S. Treasuries on time. Their superior credit quality (they are, theoretically, among the most "risk-free" investments in the world), combined with yields on short-term T-bills being near 20-year highs, Treasuries are still very attractive as part of a diversified portfolio and can help protect against a recession.

Some investors, especially leading up to the debt limit's X date, have been concerned about the potential devaluation of the U.S. dollar and its future as the world's reserve currency. The debt ceiling deal reduces that risk, but we'd argue that in the short to medium term, the risk was low in the first place. If and when the dollar slips from its current standing, we believe the situation will unfold over a long period, rather than being triggered by a specific event or happening quickly. (For more on this issue, check out our recent blog: "[Is the U.S. Dollar in Jeopardy?](#)") Still, with foreign governments trading in other currencies, central banks diversifying its currency holdings, and the sheer size of the U.S. national debt, we do see the dollar as overvalued from a purchasing power perspective. Consequently, we see international equities as currently more attractive than U.S. equities.

The U.S. debt level remains a concern. The national debt nearly doubled from 2013 to 2023 and stands as the largest in the world, more than twice that of China, according to the Institute of International Finance. Still, the rate of increase was well below that of China's developing economy, and the debt-to-GDP ratio, which measures the debt against the size of the economy, puts the U.S. (116.1%) well below that of several countries, including Japan (239.1%). So it's a concern—offering another reason to diversify internationally—but not an overwhelming concern.

LESSONS LEARNED FROM THE BANKING TURMOIL

Likewise, the failure of regional banks is a concern but not as detrimental as some might think. The last banking crisis, during the GFC of 2007—2009, resulted from banks investing in bad assets—especially subprime mortgages—and a credit crisis. This time, the turmoil is liquidity driven, as rapidly rising interest rates exert pressure on bond and loan prices (as well as bank margins) amid justified concerns that people will withdraw their deposits. First Republic and SVB invested in longer-term bonds and loans, while their deposits were mostly non-FDIC insured. We do not believe the current turmoil will lead to widespread contagion, although we will continue to monitor the impact of interest rate moves and bond losses.

Investment Implications: This year's banking turmoil is a cautionary tale for individual investors: Investments should match an investor's expected cash flow needs, a cornerstone of our time-based approach. The banks that struggled were funding long-term investments with short-term deposits, which turned out to be a poor business decision. From an investor perspective, it's a stark reminder of the importance of matching your portfolio to your time horizon and risk tolerance level.

At Ronald Blue Trust, we work to maximize our clients' returns and meet their future financial goals by minimizing risk across the associated time horizon. By assigning a time horizon to our clients' goals—whether buying a new car, funding children's college education, or saving for a comfortable retirement—we can ensure that a portfolio's asset allocation adjusts to provide the best chance of meeting those goals. We also monitor the current economic environment to make any necessary portfolio adjustments. For example, the banking turmoil could lead to tightening credit standards, removing some support for economic growth. In addition, different areas of the economy are more sensitive to interest rate hikes and movement than others. Currently, commercial real estate is under a lot of pressure, especially office buildings. Rising rates have increased costs for landlords at a time when office buildings are losing tenants in a post-COVID, work-from-home environment. (You can learn more about the state of commercial real estate in our recent blog: "[The State of U.S. Commercial Real Estate: Risks and Opportunities](#)").

AI OUTLOOK: BALANCING FEAR AND HIGH VALUATIONS WITH OPPORTUNITIES

The question isn't really whether AI is here to stay. It is here to stay; the question is, how will it impact the future? That answer isn't simple or clear yet, but AI will likely replace certain tasks and some jobs. That sounds scary, but technology has driven growth throughout history—in both social and economic ways. It promotes productivity and replaces the previous way of doing things, and we adapt. We build new skills, tackle new challenges, and find new opportunities.

AI won't just eliminate jobs; it will also augment tasks, boost efficiency, and create new challenges for us. For example, AI can help lenders measure creditworthiness, making lending decisions and approvals quicker. It can also improve risk management by helping to identify and prevent fraudulent activity through a deep, analytical dive into transactions, customer behavior, and network activity. It can streamline and improve processes, help with personalized customer support, and help provide advice and insight for a wide array of client needs.

Investment Implications: Human productivity is one of our core investment principles. We believe that growth will most likely occur in markets more conducive to greater human productivity. AI's potential to boost that productivity puts it on our radar, and thus, we believe it's important to gain exposure. However, it's important, especially in today's market, not to over allocate to a developing, somewhat unproven field. Fear of missing out, or FOMO, can fuel the emotionally driven decision to pile into a particular area of the market that's doing

well, exhibiting a herd mentality and chasing returns, which leads to market bubbles that eventually burst. We believe investors are chasing returns in AI, and while we want exposure to technology's growth, we also want to be sure that strong fundamentals support our investments.

Conclusion

Investors have many questions with very few answers. Ronald Blue Trust's principle of uncertainty means acknowledging that we don't know what will happen going forward. This unpredictability is why we need to plan, save, and invest for the future. Our principle of applied wisdom tells us that the world is uncertain but not chaotic. It reminds us that applying time-tested principles can improve the probability of successful investing outcomes. So, how do we do that?

It's simple, though not always easy, given the relentless headlines and predictions that engulf us daily. The straightforward answer is to follow a diversified, thoughtful investment strategy that balances risk with reward across your specific time horizons through the market's ups and downs. That approach means understanding the relationship between risk and reward, the trade-offs associated with your chosen strategy and portfolio, and sticking with the plan that's right for you. We believe that staying the course, even during periods of discomfort or heightened uncertainty, can help limit losses during down markets and increase returns when markets rally. In our opinion, that is the best way to increase the probability of future success over the long haul.

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