



Economic Review & Outlook

FOURTH QUARTER | 2023

Budgets, BRICS, and Bubbles, Oh My!

Many big-picture macroeconomic questions remained unanswered in the third quarter of 2023. Where and when will the U.S. Federal Reserve's (Fed's) interest-rate-hiking cycle end? Will the recession that's been predicted for months arrive, and if so, how deep and long will it be? Is artificial intelligence (AI) the next big thing with the power to drive earnings and markets higher still, or are the rising valuations of the AI-theme winners signaling a bubble that's about to burst? As investor sentiment oscillated with day-to-day headlines, these lingering uncertainties made it an interesting time to invest.

On the other hand, there was plenty of positive news. Despite a third-quarter decline, equities remained up year-to-date, seemingly shaking off much of what worried investors earlier in 2023, from the banking sector's troubles to the last-minute, debt-ceiling solution. The U.S. economy continued to show remarkable resilience. Inflation cooled off meaningfully, although there were continued signs of how difficult it is to contain rising prices. The labor market remained strong, while the Fed and many other observers upgraded future economic growth expectations. Even the initial public offering markets started showing some signs of life.

With so much up in the air, we're continuing to monitor these macroeconomic events while making sure we're focusing on the long term and avoiding any drastic changes in the middle of an uncertain environment.

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Economic Overview

FINDING STRENGTH AMID A GROWING DEFICIT, A GOVERNMENT DEBT DOWNGRADE, AND A POTENTIAL SHUTDOWN

In August, Fitch Ratings downgraded its U.S. long-term credit rating to AA+ from AAA, citing expected fiscal deficits over the next three years, the growing debt burden, and an “erosion of governance” exemplified by repeated debt-limit standoffs and last-minute agreements. The impact of the move was fairly limited. Some stocks broadly declined, and Treasury yields rose, underlining the concerns of some investors that the deficit and interest-rate hikes could have a significant impact on consumers and economic growth. Fitch expects the deficit to rise to 6.3% of gross domestic product (GDP) in 2023, up from 3.7% in 2022. It forecasts that the U.S. is on track to spend 10% of federal revenue on interest by 2025, compared with just 1% for the average AAA-rated country and 4.8% for AA-rated states. That said, the dollar’s status as the world’s key reserve currency, together with the size and safety of Treasury debt, gives the U.S. government unprecedented borrowing ability.

As the U.S. gross national debt reached an all-time high north of \$33 trillion in September, all eyes were focused once again on Congress as the September 30 end of the government’s fiscal year approached, raising the potential of a government shutdown on October 1. House Speaker Kevin McCarthy was tasked with the job of uniting a disparate Republican party in which a sizable group of representatives wanted to cut spending beyond the level that McCarthy and President Joe Biden signed off on earlier this year. Many of the required bills were unsigned as the end of the quarter approached.

Ultimately, lawmakers reached a last-minute agreement to avoid a shutdown. However, that short-term stopgap bill merely kicked the can down the road to mid-November. After McCarthy cobbled together the votes needed from both parties to pass the funding bill, he was abruptly ousted from his position as Speaker of the House.

CHINA SLOWS DOWN, AND THE “BRICS” BLOC ATTEMPTS TO STEP UP

When China lifted its zero-COVID restrictions at the end of 2022, expectations were its economy would return to strong progress. Instead, growth has slowed, weighed down by continued weakness in the property market, negative economic performance, and deflation concerns. President Xi Jinping has consolidated power and control, and investors are wondering whether China’s long-running solutions to economic issues—cheap credit, infrastructure building, and stimulus for the property market—will work this time. China is facing other setbacks as its population declined in 2022 for the first time since 1961, and tensions with the U.S. are heating up again.

Meanwhile, the BRICS’s presence in the news also signals China’s geopolitical tensions. “BRIC” is an acronym coined by Goldman Sachs in 2001 to group Brazil, Russia, India, and China together. In 2010, it expanded to “BRICS,” with the addition of South Africa. The bloc held its 15th summit in August and invited Saudi Arabia, Iran, Ethiopia, Egypt, Argentina, and the United Arab Emirates to become member states. At the meeting, the president of Brazil called for a common BRICS currency for intrabloc trade and investment as a way to mitigate the countries’ vulnerability to the movements of the U.S. dollar, which remains the world’s de facto reserve currency and dominates cross-border trade.

NVIDIA AND OTHER AI-FUELED NAMES CONTINUE TO DRIVE MARKET GAINS

Nvidia, the semiconductor company whose computer graphics processing unit (GPU) chips have become the standard to power generative AI systems such as ChatGPT, has been one of the biggest winners in 2023’s AI-driven rally. The company’s advanced GPUs, previously primarily used for graphics-heavy video games, are the tools used to run the algorithms at the heart of AI’s recent breakthroughs and enjoy almost boundless demand from the data centers that train AI systems. Nvidia shares hit an all-time high at the end of August—marking a year-to-date gain of nearly 240%—before declining in September amid concerns about its valuation, rising bond yields, and tensions between the U.S. and China.

Nvidia’s second-quarter data center revenue rose 141% sequentially and 171% year over year. The company also sharply raised future guidance, prompting Goldman Sachs to raise its Nvidia revenue estimates for 2023, 2024, and 2025 by more than 40% each. Nvidia’s market capitalization surpassed the \$1 trillion mark, making it one of the top five stocks in the S&P 500 Index. Nvidia and six other technology companies (Apple, Microsoft, Alphabet, Amazon, Meta Platforms, and Tesla) tied to AI have been responsible for approximately 70% of the S&P 500’s total return in 2023.

Asset Class Performance

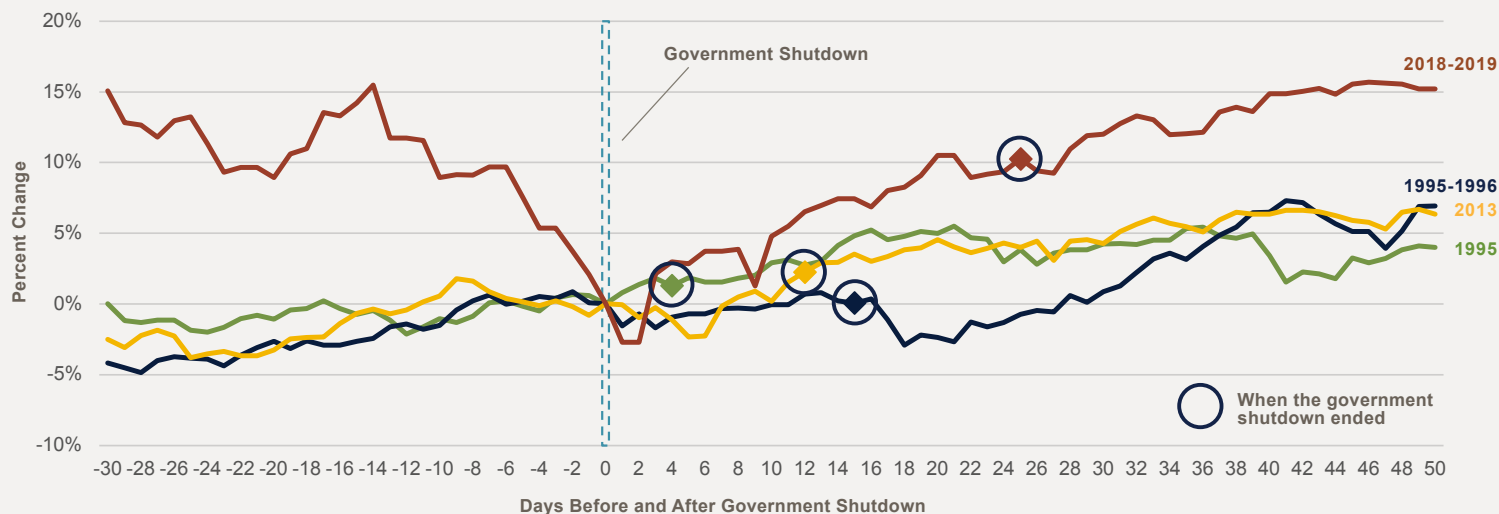
Equities declined modestly during the third quarter. The S&P 500, which broke a string of three consecutive quarterly gains, remained up 13.1% year-to-date, and the MSCI World Index also held a double-digit gain. Still, emerging markets were essentially flat for the first nine months of the year, primarily due to the weakness in China. Generally, better-than-expected corporate earnings and expectations that the Fed is nearing the end of its interest-rate-hiking cycle supported U.S. stocks during the third quarter. In light of concerns about higher-for-longer interest rates, U.S. Treasury yields increased to levels not seen since before the Global Financial Crisis of 2007-2008.

Q1	Q2	Q3	YTD
Int'l Developed Stocks 8.6%	U.S. Stocks 8.7%	Commodities 4.7%	U.S. Stocks 13.1%
Gold 8.1%	Int'l Developed Stocks 3.2%	Emerging Markets Stocks -2.8%	Int'l Developed Stocks 7.6%
U.S. Stocks 7.5%	Emerging Market Stocks 1.0%	Diversified Bonds -3.2%	Emerging Markets Stocks 2.2%
Emerging Markets Stocks 4.0%	Diversified Bonds -0.8%	U.S. Stocks -3.3%	Gold 1.3%
Diversified Bonds 3.0%	Gold -2.5%	Gold -3.9%	Diversified Bonds -1.2%
Commodities -5.4%	Commodities -2.5%	Int'l Developed Stocks -4.1%	Commodities -3.4%

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.

WHAT A GOVERNMENT SHUTDOWN COULD MEAN FOR INVESTORS

(PERCENTAGE CHANGE IN THE S&P 500)



Source: FactSet. Data as of 9/30/23. Before 1980, the government did not shut down but continued normal operations through funding gaps. Since 1981, 10 funding gaps of three days or fewer have occurred, mostly over a weekend when government operations were only minimally affected. www.crfb.org/papers/government-shutdowns-qa-everything-you-should-know/howmanytimes

Fitch Ratings' downgrade of U.S. long-term credit and the potential government shutdown also weighed on equity markets in August and September after a rally in July, fueled by earnings and rising optimism that the U.S. economy would find the elusive soft landing. Annual inflation in the U.S.—as measured by the headline Consumer Price Index—accelerated in both July and August after slowing for 12 consecutive months, pushed higher by housing and energy prices. European stocks failed to keep pace as concerns about slower economic growth and a growing threat of recession continued. The European Central Bank hiked interest rates for the 10th consecutive time in September, though unemployment remained at a record low. Emerging-market equities declined more sharply than their developed peers, weighed down by Chinese stocks.

The Bloomberg U.S. Aggregate Bond Index declined 3.2% in the third quarter, finishing with a year-to-date return of -1.2%. Inflation data in July and August caused some people to worry that the Fed and other central banks might need to prolong their monetary tightening campaigns. Credit spreads tightened in July—despite the Fed raising the benchmark federal funds rate to a 16-year high after a June pause—amid investor optimism about a soft landing and a potentially quick end to interest rate hikes.

Investor sentiment deteriorated somewhat across the rest of the quarter, and interest rates across the U.S. Treasury (UST) curve increased, especially for longer-term maturities. The closely watched yield curve between the 10- and two-year UST notes has remained inverted since July 2022. That current status represents the longest inversion since 1980, with the gap in yield repeatedly reaching multidecade depths. The August credit rating downgrade of the U.S. government created less volatility in fixed-income markets than some feared. Commodities, meanwhile, traded higher in the quarter, powered by rising energy prices. West Texas Intermediate crude oil prices rose more than 20% during the quarter, driven by concerns about a tightening market amid efforts by Saudi Arabia and Russia to constrict supply.

Our Perspective

DOWNGRADES AND SHUTDOWNS: WE'VE BEEN THERE BEFORE AND CAME OUT ON THE OTHER SIDE

We don't view the U.S. credit downgrade and the continued threat of a government shutdown as major events for the economy or the markets, at least beyond the short term. We believe the shutdown is much less toxic than the debt-ceiling issue from earlier this summer, which could have put government debt payments at risk.

This shutdown is not a unique situation. Since 1976, there have been 20 such funding gaps and four government shutdowns that lasted more than one business day. In late 1995 and early 1996, President Bill Clinton and the Republican Congress could not agree on spending levels, leading to two shutdowns totaling 26 days. A standoff over Affordable Care Act funding resulted in a 16-day shutdown in 2013. From December 2018 to January 2019, a dispute over funding for the border wall led to a shutdown that lasted 35 days. For the most part, whether these events played out quickly or lingered, investors were unfazed. According to data compiled by CFRA Research, the S&P 500 was essentially flat across the 20 funding gaps, and in the case of extended shutdowns, the index advanced.

That said, this time around may have more significant implications, especially if a deal drives Treasury yields higher. If reduced government spending has an outsized impact on economic growth during a fragile period, or if the situation lingers and impacts the Fed's efforts to balance higher interest rates with avoiding a recession, it could add strain to the market amid higher-for-longer monetary policy.

Maybe more importantly, both the downgrade and the shutdown highlight some key underlying issues, namely our growing yearly deficits and debt-to-GDP ratios, especially in a rising-interest-rate environment. Fitch was not the first rating agency to downgrade U.S. credit; S&P Global Ratings made a similar downgrade in 2011 and has not reversed the move.

Investment Implications: Spend less than you earn is one of Ronald Blue Trust’s fundamental financial planning principles. We are apprehensive about the record-high federal deficit and would like the government to be more fiscally responsible. Fitch’s downgrade did not, as some feared, lead to the forced sale of Treasuries. Still, interest rates are rising, especially at the long end of the curve. That reality means the government is paying more for debt and increasing the cost of interest as a percentage of GDP. Government deficits tend to shrink during periods of low unemployment, which has not been the case this time.

We are also concerned that the high cost of government debt could negatively impact spending and investment or leave policymakers with less flexibility in the event of another crisis. Nonetheless, even after the credit downgrade, the U.S. government enjoys some of the world’s highest credit quality. Fitch acknowledged that “several structural strengths underpin the United States’ ratings. These include its large, advanced, well-diversified, high-income economy, supported by a dynamic business environment. Critically, the U.S. dollar is the world’s preeminent reserve currency, which gives the government extraordinary financing flexibility.” With all of this in mind, we are not planning to make any immediate portfolio changes as a result of the downgrade.

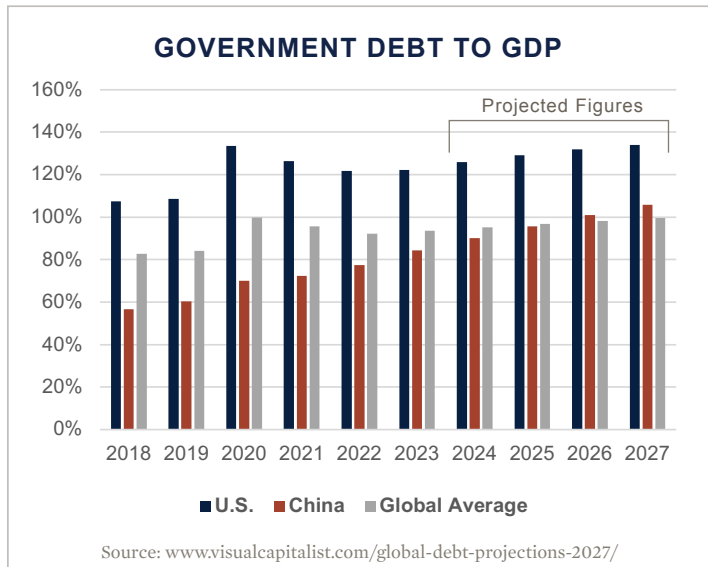
including an August 2023 executive order restricting U.S. investment in Chinese technology and a series of diplomatic meetings.

As for the BRICS situation, we do not believe that the U.S. dollar’s status as the world’s key reserve currency is in jeopardy. The BRICS currency may come to fruition—after all, the euro has flourished—but more than 80% of cross-border trade transactions utilize the dollar. We believe that the far-ranging political and fiscal systems of BRICS would make creating a regional central bank a significant challenge and that any unified currency would be difficult to manage.

Investment Implications: The question on many people’s minds is simple and direct: Is China still investable? We believe it is, but we are underweight compared with the MSCI Emerging Markets Index. It’s interesting to note that the weight of Apple in the MSCI All Country World Index is larger than the weight of the Chinese market and that the weights of Japan and the United Kingdom are also larger than China’s weight. At the same time, U.S. stocks continue to make up a majority of the global index. It’s important to remember that, like all countries, the Chinese economy and market offer risks and opportunities. While China’s growth is undoubtedly slowing and the economy faces a lot of headwinds, the country will almost assuredly grow faster than many of its developed-market peers, and it will remain among the most important markets in the world—economically, technologically, and geopolitically. Given all that, along with the ongoing big-picture trends of deglobalization and decoupling of China and the U.S., Chinese equities remain an important tool for portfolio diversification, especially over the long haul.

AI: BALANCING OPPORTUNITY AND RISK AS VALUATIONS SKYROCKET

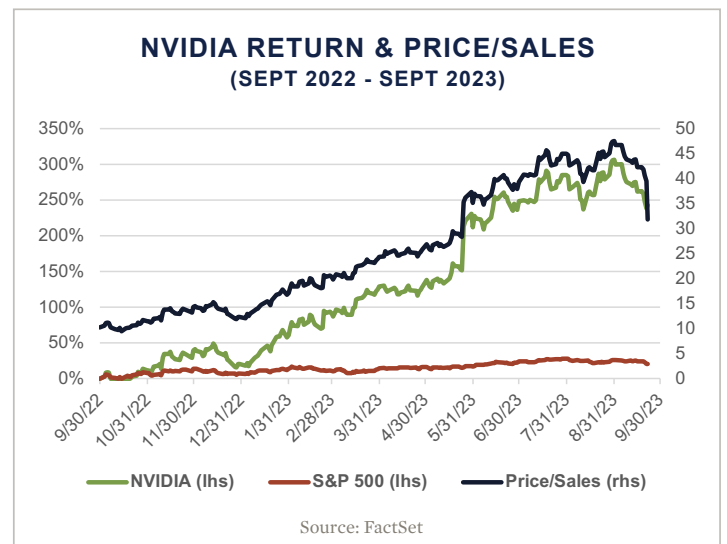
Nvidia and its AI brethren have drawn much praise in recent months, earning comparisons with the internet and smartphones—transformative technologies that have proved to have a far-reaching and lasting impact on the global economy and markets. That kind of optimism, bolstered by the excitement surrounding ChatGPT, fueled the broader AI theme that dominated equity markets in 2023, driving year-to-date gains for the S&P 500. Investors clearly believe that AI can change markets and drive growth in certain sectors and companies while disrupting or displacing others, making it a long-term investing opportunity with the potential to run for years and even decades. The technology’s near-universal potential is evident, and companies across the entire business landscape are investing in AI, even before it shows up in increased revenues.



THE THREAT OF SLOWER GROWTH IN CHINA AND ASSESSING THE BRICS

After rapid growth for several decades, the Chinese economy has been slowing, and the potential impact on regional and global markets is concerning. Overbuilding in real estate is now causing issues for property developers and investors. One-party rule and Xi Jinping’s consolidation of power may hamper the flexibility needed to navigate a return to growth. Meanwhile, U.S. manufacturers are shifting manufacturing away from China. While China’s large labor pool and infrastructure will make it difficult to avoid the country completely, recent developments underline the tensions between the U.S. and China.

Since China joined the World Trade Organization in 2001, trade between the two countries has exploded, to the benefit of consumers and companies in both places. In recent years, concerns surrounding U.S. job losses, national security, China’s subsidies and state-owned companies, currency manipulation, and human rights violations have turned up the tension between the two superpowers. The U.S. has responded with negotiations, disputes, heightened investment scrutiny, and tariffs,



Nvidia, which has benefited from a shortage of GPUs, stands out as a “picks and shovels” winner because it sells the tools that help build AI algorithms. The name refers to a strategy of investing in the tools of the 19th-century gold rush, as opposed to mining for gold or investing in miners. During a technological shift such as this one, picks-and-shovels stocks tend to outperform early. Here’s a fun fact: FactSet data shows that 177 of the S&P 500 constituents cited AI during second-quarter earnings season and that those who did performed better, on average, than those that didn’t on both a quarter- and year-to-date basis.¹

Investment Implications: One of our core investment principles holds that human productivity creates wealth. AI and companies such as Nvidia fit neatly under that banner as they promise to drive efficiency, cost savings, and, eventually, new ways to generate revenues. We think it’s valuable to have some exposure to AI from that perspective.

Inherent value is another one of our core principles because if an asset is overpriced, the opportunity for future growth is limited. In the case of Nvidia, we have concerns that its valuation is high, which makes us wonder about the sustainability of the opportunity. We think it is critical to ask whether the stock’s price is justified based on expectations for growth or whether investors are overpaying. We realize winners and losers will likely become clear over multiple decades as the AI race continues, however, for now, Nvidia is a clear picks-and-shovels winner. We see many others that may also do well over the longer term, including megacap names such as Google, Microsoft, Amazon, Meta Platforms, and even IBM. The key is finding the balance between fundamentals, growth potential, and valuation over time to avoid chasing returns and participating in a market bubble that will likely burst.

Conclusion

In times that feel clouded by uncertainty, we take comfort in and gain confidence from Ronald Blue Trust’s core foundation of principles-based investing. We know investors can fall victim to emotional and behavioral biases that impact their judgment, driving decisions that could hurt investment outcomes. Whether we achieve a soft landing or fall into a deep and prolonged recession in the coming months, we know that we will face periods of underperformance and heightened stress. The long-term goal is to increase the probability of success by seeking opportunistic returns and mitigating risk.

As we head toward the end of 2023 and look ahead through today’s clouds, we turn to the principle of inherent value. It tells us that markets are not always rational and that investors’ eagerness to realize gains or avoid losses can drive mistakes that push them toward bubbles or crashes. Today’s environment feels fraught with both possibilities. Still, we know that a disciplined valuation process can help us find an investment’s inherent value and protect investors from either outcome.

Likewise, the principle of instability can help us manage risk. We know that markets and economies are unstable and that the provisions we take against uncertainty can fail. In our view, the best way to manage risk is to follow a diversified, well-thought-out philosophy—no matter what is happening in the market—through short-term oscillations and the news of the day. Now is the time to stay the course, follow the principles, and take comfort in knowing God is ultimately in control.

¹ As of 09/07/2023

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