ACIMA
PRIVATE WEALTH

ECONOMIC & INVESTMENT PERSPECTIVES

October 2, 2023

SEPTEMBER: NEGATIVE MONTH & QUARTER
FEDERAL DEBT, DEFECITS & SPENDING

Figure 1: 9/30/2023 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	3MO	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-2.6%	-3.2%	-1.0%	0.5%	-7.0%	0.9%
Investment Grade Corp Bonds	LQD	-3.6%	-4.7%	-0.6%	3.6%	-9.3%	3.7%
U.S. Treasury Bonds	GOVT	-2.3%	-3.1%	-1.3%	-0.8%	-6.8%	0.6%
U.S. 20+ YR Treasuries	TLT	-7.9%	-13.1%	-9.0%	-10.7%	-19.1%	1.8%
Muni Bonds	MUB	-2.6%	-3.3%	-1.1%	2.5%	-5.6%	1.2%
US High Yield	HYG	-1.6%	-0.3%	4.1%	9.4%	-4.7%	4.7%
Non-US Corp Bonds	IBND	-4.4%	-3.9%	-0.8%	9.9%	-8.3%	12.0%
Emerging Markets Bond LC	EMLC	-4.5%	-5.1%	2.5%	11.2%	-8.6%	6.7%
Global Equity							
ACWI Global Equity	ACWI	-4.3%	-3.7%	9.9%	20.8%	-7.2%	22.0%
ACWI Global Equity ex US	ACWX	-3.5%	-4.5%	5.0%	20.4%	-8.4%	21.1%
International Developed	EFA	-3.6%	-4.9%	6.9%	25.8%	-7.8%	26.2%
Emerging Markets	EEM	-3.1%	-4.1%	0.9%	11.3%	-10.8%	13.3%
Global Equity by Region							
United States	VTI	-4.8%	-3.2%	12.4%	20.3%	-7.2%	21.5%
Europe	IEUR	-4.4%	-5.6%	6.9%	29.4%	-9.4%	28.9%
Asia ex-Japan	AAXJ	-3.2%	-4.4%	-1.4%	10.4%	-12.9%	17.1%
China	MCHI	-3.6%	-3.2%	-8.0%	4.2%	-22.8%	24.2%
Japan	BBJP	-2.3%	-2.5%	11.9%	24.9%	-5.9%	26.0%
Latin America	ILF	-2.1%	-5.9%	13.7%	18.6%	-10.5%	17.5%
US Equity							
US S&P 500	IVV	-4.7%	-3.2%	13.1%	21.7%	-7.0%	22.9%
NASDAQ 100 QQQ	QQQ	-5.1%	-2.9%	35.1%	35.0%	-7.7%	40.9%
US Large Growth	IWF	-5.5%	-3.2%	24.9%	27.5%	-7.3%	31.6%
US Large Value	IWD	-3.9%	-3.2%	1.7%	14.1%	-7.5%	13.2%
US Eqwt S&P 500	RSP	-5.1%	-4.9%	1.7%	13.3%	-9.0%	13.4%
US Mid Cap	IJH	-5.2%	-4.2%	4.3%	15.5%	-8.9%	14.3%
US Small Cap	VTWO	-5.9%	-5.1%	2.6%	9.0%	-11.2%	8.9%

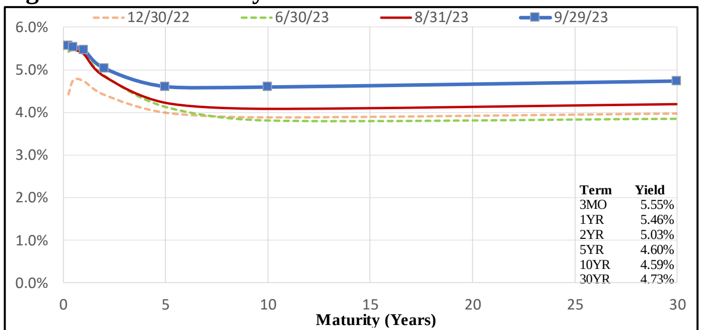
Markets were weak again in September as continued US economic resilience increased concerns that the Fed is likely to maintain higher interest for longer in order to tame inflation. As yields increased, bond prices fell, and equity markets moved lower for the second month in a row. Performance highlights for the month and quarter (Q3) are summarized below.

- Bonds: The US Aggregate index (AGG) was down 2.6% in September (-3.2% Q3) as interest rates moved higher. Long-term Treasuries (TLT), which are highly sensitive to interest rate changes, lost 7.9% (-13.1% Q3). Corporate bonds (LQD) fell 3.6% (-4.7% Q3), and high yield bonds (HYG) lost 1.6% (-0.3% Q3). Non-U.S. bonds (IBND and EMLC) under-performed this month and in Q3 as the US dollar strengthened.
- Global equities (ACWI) fell 4.3% in September (-3.7% Q3).
- U.S. Equity: The broad market (VTI) fell 4.8% (-3.2% Q3), and the S&P 500 (IVV) lost 4.7% (-3.2% Q3). Large growth stocks (QQQ and IWF) were down in September and Q3 but are still up 25-35% in 2023 while the average stock in the S&P 500 (RSP) is up just 1.7%. Small (VTWO) and mid-cap stocks (IJH) tend to be more sensitive to local economic growth and have under-performed all year. All sectors logged negative returns for the month and Q3 except energy (XLE), which rose 2.4% (+12.2% Q3) as oil spiked above $91 per barrel.
- Non-U.S. Equity: Developed market stocks (EFA) were down 3.6% (-4.9% Q3) with losses in Europe (IEUR) and Japan (BBJP). Emerging markets (EEM) fell 3.1% (-4.1% Q3); Chinese stocks (MCHI) lost 3.6% (-3.2% Q3) amid mixed economic news, while Latin American stocks (ILF) declined 2.1% (-5.9% Q3) but are still up 13.7% year-to-date.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. The Fed held short-term interest rates steady in September, but long-term yields moved higher as continued economic strength indicated that the Fed will keep rates higher for longer in order to tame inflation. The inverted curve (short-term yields higher than long-term yields) continues to warn of a growth slowdown. The 10-year Treasury now yields 4.59%, up sharply from 4.09% last month.

Figure 2: US Treasury Yield Curve

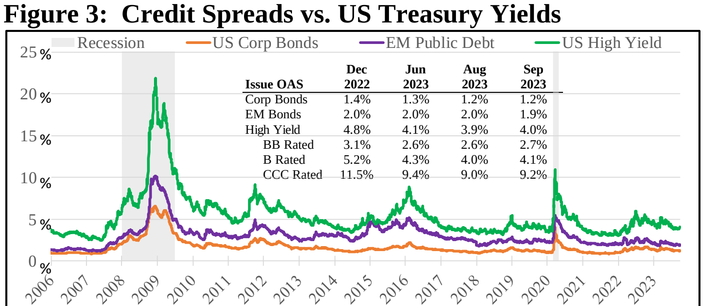


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads widened marginally again this month but remain at historically low levels.

- Investment grade corporate bond spreads were stable at +1.2% but have marched incrementally lower over the past year.
- High yield (non-investment grade) spreads widened to +4.0% in September but have come down from +4.8% this year. The riskiest bond (rated CCC & below) spreads have declined in 2023 but did widen to +9.2% over Treasuries this month.
- Emerging market bond spreads have been steady this year and now yield an average of +1.9% over US Treasuries. Returns on non-US bonds have benefitted from a weak US dollar in 2023 but under-performed this month as the dollar strengthened.

Figure 3: Credit Spreads vs. US Treasury Yields

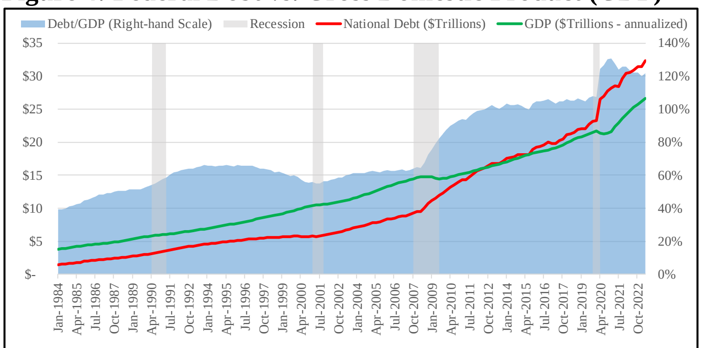


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Federal Debt, Deficits and Spending

Stock and bond market volatility resurfaced in the third quarter as investors grew increasingly concerned that strong economic growth and employment data would lead to further Fed tightening (higher interest rates for a longer period) to tame inflation. In addition to negatively impacting financial markets, higher interest rates have refocused attention on the unsustainability of annual federal budget deficits in excess of a trillion dollars and an ever-increasing federal debt burden (currently $32 trillion or 119% of US GDP). This has led to downgrades of US credit by the leading credit rating agencies as well as rancorous debate and brinksmanship in Congress (debt ceiling debate resolved in June, government shutdown temporarily averted this weekend). Given that the political drama is likely to continue with election season fast approaching, we have gathered some data to help frame our thoughts on government spending, taxes and debt, beginning with a summary of US federal debt in the context of GDP (Figure 4).

Figure 4: Federal Debt vs. Gross Domestic Product (GDP)

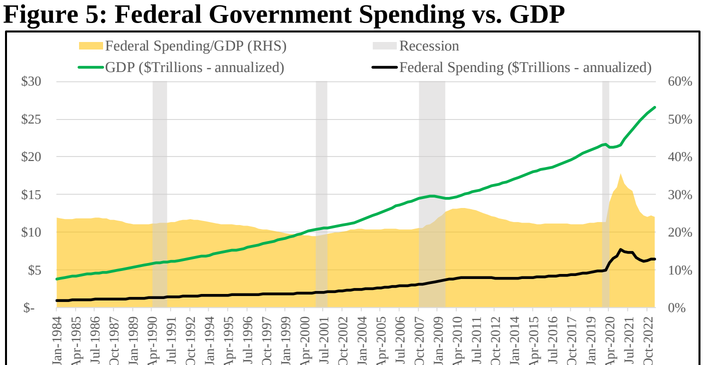


Source: US Treasury, US Bureau of Economic Analysis, NBER

Over the last 40 years, the US economy (GDP) has grown sevenfold from $4 trillion to $27 trillion annually. Over the same period, our national debt has grown from less than $2 trillion to roughly $32 trillion today. A growing economy can sustain and service more debt, and the ratio of debt-to-GDP remained fairly stable at around 60% until the Great Financial Crisis (GFC) of 2008. By 2012, our debt increased to more than 100% of GDP for the first time, surging to approximately 130% in 2020 as the government and Fed used fiscal and monetary policy aggressively to avert economic calamity in the wake of the pandemic. Today, the debt-to-GDP ratio is approximately 120%.

The dramatic increase in debt relative to GDP appears to be episodic in response to significant threats to the economy (GFC and COVID). Indeed, while government spending has increased to more than $6 trillion annually, it has remained stable at 20-25% of GDP in non-recessionary periods as shown in Figure 5.

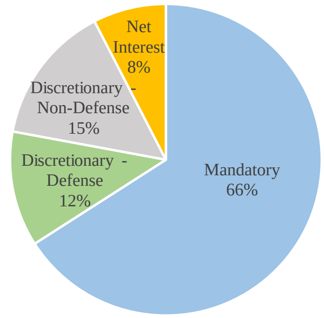
Figure 5: Federal Government Spending vs. GDP



Source: US Treasury, US Bureau of Economic Analysis, NBER

The US government spent $6.3 trillion in fiscal 2022. Federal spending is categorized as mandatory (governed by pre-existing law), discretionary (annual congressional approval required for defense and non-defense programs) plus net interest paid to service existing US debt. Figure 6 breaks down this 2022 spending.

Figure 6: US Federal Government Spending (fiscal 2022)



Federal Government Spending (FY 2022)

Category	$Billions	%
Mandatory Spending	$ 4,134	66%
Discretionary - Defense	$ 751	12%
Discretionary - Non-Defense	$ 910	15%
Net Interest	$ 475	8%
Total Gov't Spending	***$ 6,270***	***100%***

Source: Congressional Budget Office

- Mandatory spending (66% of total federal expenditures) is dominated by Social Security, Medicare and Medicaid but includes programs that are defined by law (food/nutrition, child and family support, unemployment, veterans' programs, etc.).
- Discretionary spending includes national defense, which accounted for 12% of all government spending in fiscal 2022.
- Discretionary Non-Defense spending represents 15% of total government outlays and includes a wide variety of programs (health, education, training, employment, social services, transportation, international affairs, justice, environmental, community & regional development, science, space, technology, etc.).
- Net Interest payments on US debt totaled $475 billion (8% of federal spending) in fiscal year 2022.

It is clear from Figure 6 that discretionary spending reform will only help address the debt dilemma at the margin. If all discretionary non-defense programs were eliminated (not going to happen), we would save at least $910 billion per year but would still have an annual deficit of nearly $500 billion. Since we must continue to fund our military and service our debt, real progress can only be made through entitlement reform (mandatory spending) and/or tax increases, but these politically perilous topics are not likely to be resolved soon, especially in an election year.

Bottom Line

Stocks and bonds were weak again in September as investors grappled with the likelihood that the Fed will maintain higher interest rates until inflation moves closer to their 2% target (or until the economy falters). Fed projections indicate maintaining target interest rates in excess of 5% through 2024, while the Fed Funds Futures curve forecasts that the economy will slow, prompting the Fed to begin to cut or normalize interest rates, ending 2024 at approximately 4.6%. Both estimates have risen significantly over the past few months, exacerbating market volatility.

In addition to the negative impact on stock and bond returns, higher rates make debt more expensive, bringing the sustainability of large federal deficits and the growing US government debt burden into question. It is impossible to predict the future, but it is unlikely that our divided government will be willing and able to solve the debt problem by tackling the hard issues (entitlements and taxes) with elections looming. Diversification is critical; attractive bond and cash yields are viable alternatives to stocks.

Disclaimer:

ACIMA Private Wealth LLC ("ACIMA" or the "Firm") is a federally registered investment adviser based in Richmond, Virginia since January 2016. The Firm is a fee-only investment advisory firm with the intent to provide exceptional service to high-net-worth individuals, families, trusts, charitable foundations and institutions. ACIMA's purpose is to implement integrated wealth management solutions that meet the financial needs and reflect the personal values of our clients. For additional important information regarding ACIMA, its investment management services, compensation, conflicts of interest, and other matters, is contained in its disclosure document, Form ADV Part 2A and Wrap Fee Brochure. A copy of which is available on through the Firm's website or upon request to the Chief Compliance Officer at (804) 422-8450.

The information and views contained in this document were prepared and compiled by ACIMA. The statements provided herein are based solely on the opinions of ACIMA and are solely for informational purposes only. It is not a research report, as such term is defined by applicable law and regulations, and is not a solicitation or an offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Any opinions provided herein should not be relied upon for investment decisions. The information contained herein was obtained from sources believed are reliable but has not been independently verified by ACIMA and for which no guarantee of accuracy is proffered.