MACRO & MARKET
PERSPECTIVES

4TH QUARTER PREDICTIONS
A FIRST LOOK

SPECIAL REPORT:
UNDERSTANDING THE NATIONAL DEBT

FACING HEADWINDS:
WHAT "HIGHER FOR LONGER" MEANS FOR ALL OF US

FACING TAILWINDS:
THE RESILIENCE OF THE U.S. JOB MARKET

OAKWORTH CAPITAL BANK

3Q
ECONOMIC OUTLOOK & OVERVIEW

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FOURTH QUARTER PREDICTIONS

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A letter from our

CHIEF ECONOMIST

After an extremely strong start to the year in the stock markets, a pullback during the 3rd quarter was to be expected. While red ink is never fun, the sell-off during the quarter wasn't anyone's worst-case scenario. In fact, it sort of made sense.

- Interest rates continued to climb higher.
- The economic data remained enigmatic.
- Analysts still wondered how many more rate hikes the Fed had up its sleeve.
- The money supply was basically stagnant, thanks to sluggish bank lending activity.
- Energy prices accelerated.

The 3rd quarter is historically the worst for stock prices. While the financial industry refers to this market seasonality, you could also call it the summertime blues.

Despite the headwinds facing the U.S. economy, the labor markets have remained strong and given consumer spending a tailwind. Further, despite the slowdown in traditional banking, the mountain of cash sloshing about insurance company and private equity firms' balance sheets has provided enough liquidity to keep activity going.

In so many ways, we ended the quarter in about the same place we started it, albeit a little lighter in equities. Clearly, that is no one's definition of a worst-case scenario.

However, the question remains: How much longer until higher interest rates start to impact consumption patterns?

To date, the Federal Reserve has significantly increased the price of money over the past 18 months, and the economy has continued to grow. Is this monetary policy magic a delayed reaction, dumb luck or are things just different this time around?

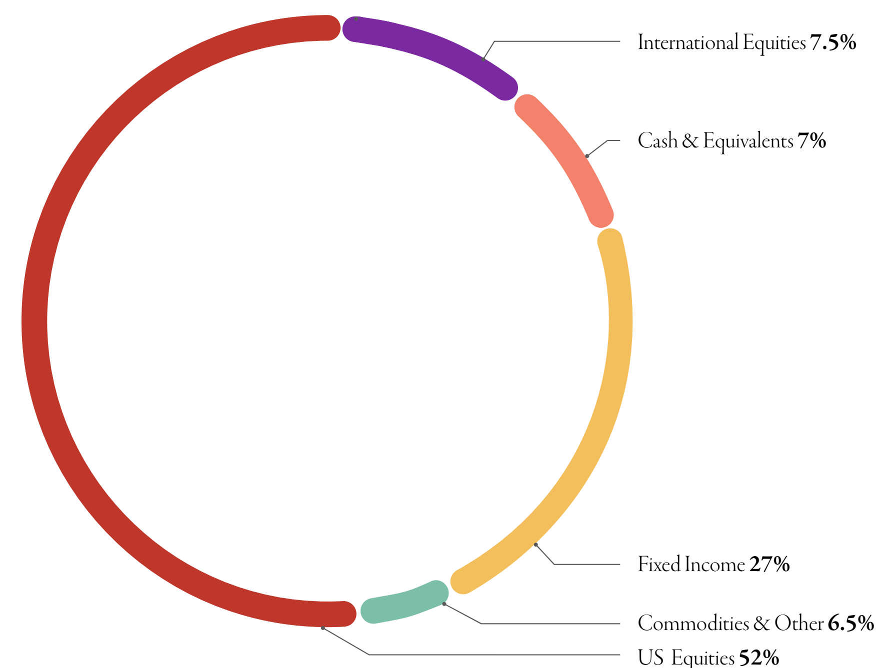
The truth is this: 3rd quarter Gross Domestic Product (GDP) will likely be surprisingly high thanks to strong consumer spending. After that, however, we expect the official growth rate to start to slow for the next couple of quarters. As for the monetary policy magic? Perhaps the answer to that question is a little bit of all of it.

In the end, this past quarter was to be expected. It wasn't a lot of fun, but the summertime blues rarely are. Do you want to know what is fun? The fall. It is my, and the markets', favorite time of the year, and I am really looking forward to it.

Thank you for your continued support,

John Norris
Chief Economist

Our Investment Committee distributes information on a regular basis to better inform our clients about pending investment decisions, the current state of the economy and our forecasts for the economy and financial markets. Oakworth Capital currently advises on approximately $1.9 billion in client assets. The allocation breakdown is in the chart below.



SAM CLEMENT

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3RD QUARTER

KEY TAKEAWAYS

As the quarter drew to a close, the U.S. economy faced major labor strikes, a potential government shutdown, the resumption of student loan repayments and higher energy costs. This on top of higher interest rates.

THE STOCK MARKET

After a surprisingly strong start to the year, the stock markets came back down to earth during the 3rd quarter. Seasonality coupled with higher rates, continued confusing economic data and uncertainty about the Fed's next move led to negative returns.

RISING INTEREST RATES

Longer-term interest rates continued to rise during the quarter, thanks to several different reasons.

- First, increased energy prices caused an uptick in primary inflation gauges during August.
- Second, the U.S. Treasury continues to dump massive amounts of supply on the financial system.
- Third, the Federal Reserve and Asia have been the buyers of last resort for the last decade, and currently don't appear to be willing. As a result, there was nowhere for rates to go but up.

BANK CREDIT

Loans and leases in bank credit barely budged during the quarter, thanks to the persistent inverted yield curve. This sluggishness in credit extension has caused the money supply to essentially stall in 2023. Intuitively, this doesn't bode well for continued economic growth.

CLIMATE CHANGE

No matter where you stand on the climate change debate, there was no arguing the 3rd quarter was a scorcher throughout much of the country, especially the Southeast. Given our energy use during the blistering summer months, it makes one wonder what would happen to the grid if everyone were driving EV (electronic vehicles).

THE PUBLIC VS. PRIVATE SECTOR

From dams collapsing in Libya to massive wildfires in Maui, it seems bad things often happen when people rely too much on the government to perform as efficiently as the private sector.

LABOR MARKETS

Despite all the challenges facing the economy, employers are still having difficulty finding quality workers to fill entry-level and semi-skilled jobs. Moving forward, the United States is simply going to have to rely even more heavily on its massive migrant workforce to take these "legitimate" jobs.

UKRAINE

As the war in Ukraine drags on, it has been largely relegated to the back pages in the U.S. media. Depending on which poll you consider, it appears U.S. public opinion is almost evenly split as to whether to continue to arm the Ukrainians.

CONSUMER PRICE INDEX

At the start of 2023, we replaced gaudy monthly CPI numbers from 2022 with lower ones in the equation. However, the monthly CPI data for the last 6 months of the past year was actually pretty normal. This means we are replacing like data with like data, at best.

FEDERAL FUNDS RATES

As we started the 3rd quarter, the overnight rate was 5.25%, and the Street thought it might go to 5.50%. Three months later, the rate is 5.50%, and investors now think 5.75% is a real possibility. The lesson learned? The more things change, the more they stay the same.

TREASURY BILLS

When in doubt, investors still like the safety of U.S. Treasury bills. They like them even more when the 3-month and 6-month T-bills have a yield to maturity of 5.50%.

CASH

For over a decade, it was bad form to keep cash in your investment portfolio. With yields at or barely above 0.0%, you lost purchasing power in keeping any "dry powder." However, when yields are north of 5.0%, cash magically becomes a legitimate asset class again. Weird.

GAS PRICES

No matter how much we hear and read about EV, most people and businesses around the country still rely on fossil fuels to move themselves and their products around. At the start of the year, global supply outstripped global demand. However, by the end of the quarter, a slight uptick in Chinese usage coupled with production cuts from OPEC and Russia, and Americans were feeling pain again at the pump.

CONSUMER STRENGTH

According to most data series, the U.S. consumer remained surprisingly resilient during the 3rd quarter. This despite the uptick in inflation. It remains to be seen how much longer this will continue. Will a tailwind from the strong labor markets be enough to help the United States avoid a major recession? That is a great question.

The question now is: what can the economy do for an encore in 2024?

ECONOMIC OVERVIEW

John Norris

Even if the Gross Domestic Product (GDP) report for the 3rd quarter ultimately looks different than it did the first two quarters of 2023, **the economic data felt very similar in a lot of ways.** The regional purchasing managers indices were unimpressive, if not depressing. Traditional borrowing and lending continued to be sluggish, just as they were during the 2nd quarter.

EXISTING CONCERNS

- The money supply, as defined by the M2 index, barely budged.
- Leading economic indicators have been negative for the past 17 consecutive months.
- Inflation is still higher than the Federal Reserve's traditional 2%, and the Fed might have another 25-basis point rate increase up its sleeve.

I feel like I could have written that three months ago, even if I didn't.

Regardless, the labor markets remained surprisingly strong given the weakness elsewhere.

- Job openings, although lower than they had been, were still plentiful.
- The Labor Force Participation and Employment to Population ratios both ticked up during the quarter.
- Finally, the unemployment rate was a miserly 3.7% in August.

This is important, because personal consumption expenditures drive the U.S. economy. They constitute roughly 70% of the GDP equation. So, it is fair to say "how goes the U.S. consumer is how goes the U.S. economy." And what do you create when you create jobs and grow the workforce? That's right... consumers.

> IN A LOT OF WAYS, IN BEST DESCRIBING THE 3RD QUARTER OF 2023, YOU COULD SAY "THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME."

So much so, many of the conversations I had during the quarter were more about larger picture topics than the actual economic data. It seemed, or seems, a lot of people have the same questions and concerns. Essentially, the present can take care of itself, but what about the future?

FUTURE CONCERNS: THE NATIONAL DEBT

Of particular concern is the continued growth in the national debt, with no apparent end in sight. Certainly, this will ultimately crush economic growth and the U.S. Treasury will have to default on its debt. Right? At $30+ trillion and growing, how could it not?

1. First things first: the United States will never have to involuntarily default on its debt. By never, I mean just that, never. Not in my lifetime or the lifetimes of anyone reading this sentence. The reason is simple: the U.S. Treasury borrows in its own currency. It doesn't borrow in euro, yen, British pounds, Swiss francs or Brazilian reals. It doesn't have to do so.

With this in mind, what could, or would, the Treasury do if it ever got to the point that it simply couldn't repay the public debt? That's right. It would turn on the proverbial printing presses, and create money out of thin air. To be sure, this would be inflationary, and the dollar would decline in value, but the Treasury wouldn't have to default.

2. Second, the United States collects far more revenue than its debt service, as in trillions of dollars more. Therefore, the Treasury can continue to service its debt obligations, almost until Doomsday. On the other hand, this would mean other forms of spending would have to get the ax, and they would. While this would be politically unpopular, it would be a much better alternative than the sharp global depression a U.S. default would engender.

In essence, it is currently hard to imagine a scenario where the United States would involuntarily default on its debt. Any default would be voluntary, and would lead to disastrous economic results, ruinous even.

> BUT WILL THIS AVALANCHE OF DEBT ULTIMATELY CRUSH DOMESTIC ECONOMIC ACTIVITY? THE SHORT ANSWER FOR THAT IS NO. IT WON'T CRUSH IT, BUT IT COULD SLOW IT DOWN SIGNIFICANTLY.

Recently, I have been using the following analogy to describe the ultimate impact the debt will have on U.S. growth.

Imagine I am in a 100-meter footrace with Usain Bolt, the fastest man in history. You have to bet $100 of your own money on the winner. Do you choose me or Bolt? Clearly, you would be wise to bet on the Jamaican. Now, how about Bolt has to wear 5-pound ankle weights? Still him, right? 10-pound weights? 20-pound, assuming he doesn't tear his Achilles or ACL? You are probably still better against me, aren't you?

Now, imagine Usain Bolt has to wear 40-pound ankle weights on each ankle and carry a teenager on his back. How would you wager? While I am sure some of you would continue to bet on the fastest man in the world, even under those conditions, I would probably start getting some money.

The same could be said about how the debt impacts the economy. It slows it down, but it doesn't stop it altogether, at least not yet. Bolt can still beat your average 50-something man in a footrace wearing 30-pound ankle weights. However, he won't be doing it in under 10 seconds.

The reason is twofold.

1. The more money the Treasury has to pay to service its debt, the less it has to stimulate the economy in other ways. As a result, and as the debt service constitutes an even larger percent of Washington's spending, there will be less money for other stuff like roads, tanks, buildings, computers and a whole host of other things. Stated simply, the debt will ultimately constrain fiscal policy.

2. Secondly, the more Washington has to borrow, the more it will likely have to pay to do so. Over the past fifteen years or so, the Federal Reserve and foreign investors have been more than willing to gobble up our debt. According to Bloomberg, official foreign holdings of U.S. Treasury debt at the end of 2008 were $3.1 trillion. As of July 2023, they were just under $7.7 trillion.

The Numbers:

- The Federal Reserve's balance sheet was roughly $2.24 trillion in December 2008.
- The most recent observation, September 20, 2023, had it at $8.02 trillion, and shrinking at a $700-800 billion annual pace.
- When you combine the two, foreigners and the Fed have gobbled up close to $10 trillion in U.S. government debt, including mortgage-backed securities, over the last 15 years.

Can we count on them to continue to do so? The quick answer is probably not. The private sector is going to increasingly finance our public debt moving forward. But at what price? The artificially low sub-2% yields where the Fed had an appetite? Again, probably not.

INTEREST RATES

As a result, longer-term interest rates will remain higher, absent a black swan event, and that could put a ceiling on overall activity. See our special report on page 18. After all, investors would be financing prior fiscal mismanagement in Washington rather than allocating resources to higher and better uses.

REGARDLESS, NONE OF THIS NECESSARILY SIGNALS ECONOMIC RUIN, AS MUCH AS BELOW-POTENTIAL GROWTH. WHILE NOT FUN, THAT ISN'T A WORST-CASE SCENARIO, EITHER.

THE U.S. DOLLAR

Another frequent concern or question I get is about the status of the U.S. dollar as the world's primary reserve currency. At some point the dollar is going to collapse, and we are all going to be spending pre-1965 coins for currency. That was when President Johnson approved the Coinage Act of 1965, which took silver out of circulating coins.

This one is a little more difficult. At some point in the future, the U.S. dollar will probably cease to be the world's primary reserve currency. The Dutch guilder, Spanish silver dollar, French franc and British pound were all at one point the primary global currency, and accepted largely everywhere Europeans conducted commerce.

And then, they weren't.

However, no one reading this needs to lose a minute of sleep about this happening any time soon. The simple reason being there isn't currently a viable alternative. What would it be? The Chinese renminbi? What about lack of convertibility do you like? Also, is the Chinese financial system truly liquid and transparent enough to handle the volume of daily trading? Finally, is Beijing fully committed to protecting the individual property rights of foreign investors? Great question.

What about the euro? While a strong second place contender to the dollar, do the disparate economies and countries in the Eurozone make one wonder about its future construction? After all, what do the Cypriots really have in common with the Dutch? The Irish with the Slovenes? The Portuguese with the Latvians? The Finns with anyone?

This is important, because what happens when some of the lesser, and weaker, economies in the Eurozone realize they can't control their fiscal policy because they can't control their monetary policy? Frankly, after the turmoil of the last decade, it is nothing short of amazing that Greece hasn't punted the euro and inflated a new drachma to pay its bills. The same could ultimately, or will, be said of all of the smaller Southern and Eastern European countries within the bloc.

To that end, per capita GDP in Greece is about where it was two decades ago. So, it is hard to argue the euro has greatly benefited the Hellenic Republic's economy.

GOLD

Finally, what about gold? The quick response is what about it? The longer response is that it simply doesn't make much sense.

- There isn't enough of it.
- It is too cumbersome, being a block of metal and whatnot.
- Further, it is unevenly dispersed, extremely so.

For instance, according to gold.org, the United States has gold reserves of 8,133.46 metric tonnes. Conversely, our friends to the north in Canada have none, like zero, as do the Norwegians. Interestingly, the Afghans have 21.87 tonnes of the shiny stuff, whereas Ireland has only 12.04 tonnes. If gold were the answer, Afghanistan would have double the reserves of one of the wealthiest countries in the world.

Frankly, it just isn't practical given the sheer size of daily global currency transactions, even if gold can be a good long-term store of value in an investment portfolio.

THE BANKING SYSTEM

A final investor concern seems to be the health of the U.S. banking system. It seems the meltdowns earlier in the year of Silicon Valley Bank and First Republic spooked a lot of people, and with good reason. However, were these failures isolated or the start of a greater trend?

The answer to that question is neither.

There is little argument that higher interest rates have had a negative impact on bank balances.

After all, there is an inverse relationship between interest rates and bond prices. When one goes up, the other goes down. As such, the values of bank bond holdings have gotten the whammy as interest rates have gone up.

Thinking back to your Accounting 101 class in college, what happens to company equity, or capital, when asset values go down while liabilities remain the same? Remember deposits are liabilities for banks. That's right, equity goes down. That is important, because banks lend out money based on their capital, or equity, base.

THE LESS CAPITAL A BANK HAS, THE LESS MONEY IT CAN LEND. AS A RESULT, HIGHER INTEREST RATES HAVE NEGATIVELY IMPACTED A LOT OF BANKS' ABILITY TO LEND MONEY. IN FACT, SOME MIGHT BE STUCK IN A ZOMBIE STATE FOR AN EXTENDED PERIOD OF IT.

While that sounds scary, the problems are more company-specific than system-wide. To that end, the nation's money center banks, the systemically important and too-big-to-fail firms, remain flush with cash and capital. This will almost assuredly prevent another 2008 fiasco.

But smaller lenders with which you might not be familiar? That is a different story.

Over the next three to ten years, many of the nation's roughly 2,400 banks with assets under $500 million will waive the proverbial white flag. That doesn't necessarily mean they will fail or the FDIC will have to swoop down and find a suitor. Many, if not most, won't.

It means their balances sheets will prohibit them from making loans and growing, at least to the degree where it makes sense to stay in business. As a result, we should see a large amount of small bank consolidation, especially in more rural or micro-politan areas. This will allow the combined companies to eliminate redundancies, otherwise known as cut costs, in order to grow the bottom line.

Economic growth could be slowed across many geographic locations while this consolidation happens. Obviously, this could also exacerbate the economic disparities between the nation's urban and rural settings. As difficult as that might be for many, it should not be a system collapse and a widespread panic.

CONCLUSION

In the end, the data during the 3rd quarter was just as weird as it was during the first two quarters of the year. **Despite all of the negative news and apparent sluggishness, the economy has been very resilient in creating jobs.** This has created enough of a tailwind to help us continue to grow and avert everyone's worst-case scenarios.

However, it hasn't been enough to placate all of our long-term fears.

Hopefully, this quarter's economic overview helped to salve some frayed nerves. In summary,

- It doesn't appear the banking system is going to collapse.
- The dollar is not endangered of losing its reserve status.
- Gold, the euro and the renminbi simply aren't the answers.
- Further, the United States will never have to involuntarily default on its debt. That doesn't mean Washington's profligate ways won't slow economic growth — they will. Fortunately, they won't crush it.

Finally, Usain Bolt is much faster than I am until you put 40-pound ankle weights on each leg and a teenager on his back. If the visual of me huffing and puffing down the track being chased by a man laden down with all of that stuff doesn't give you a smile, nothing will.

SPECIAL REPORT: UNDERSTANDING THE NATIONAL DEBT

Ryan Bernal

THE NATIONAL DEBT ($33.44 TRILLION AS OF 10/1/2023) IS THE TOTAL AMOUNT OF OUTSTANDING BORROWING BY THE U.S. GOVERNMENT ACCUMULATED OVER THE NATION'S HISTORY.

After some political theatrics in Washington, D.C., earlier this year, lawmakers finally agreed to raise the debt ceiling and avoid a catastrophic U.S. debt default that would have had unseen economic effects. While politicians may have been confident that a deal would be reached, credit rating agencies were not so convinced. Fitch soon after downgraded the U.S. Long-Term Foreign-Currency Issuer Default Rating from AAA to AA+.

While this may not seem like a big deal, the downgrade comes as many questions loom on the horizon for fiscal policy makers.

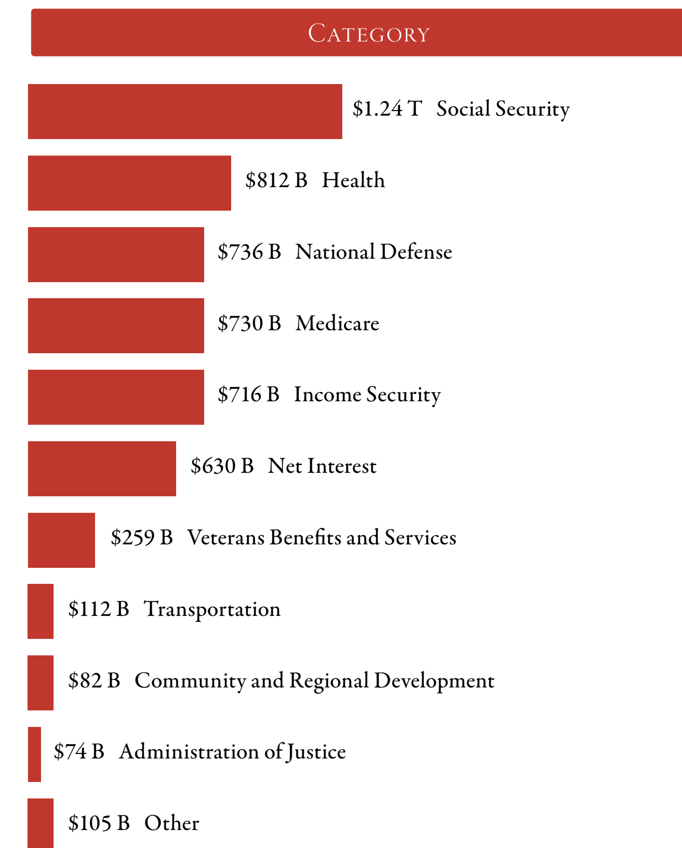
Why the massive amount of debt accumulation in such a short amount of time?

The purpose of the federal government, according to the U.S. Constitution, is "to establish Justice, ensure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity." To achieve this goal, the government funds social programs, subsidizes important economic drivers, and spends money on public projects. To pay for this, the government uses tax revenue.

But in times of war and significant hardship (such as WWII and COVID-19) this revenue isn't enough to foot the bill. This means the government must borrow money, which it can do in two ways: either through selling marketable securities to the public (such as treasuries or other loan structures) or through intergovernmental borrowing (such as the Social Security pool).

WHERE DOES IT ALL GO?

U.S. Government Spending, FYTD 2023

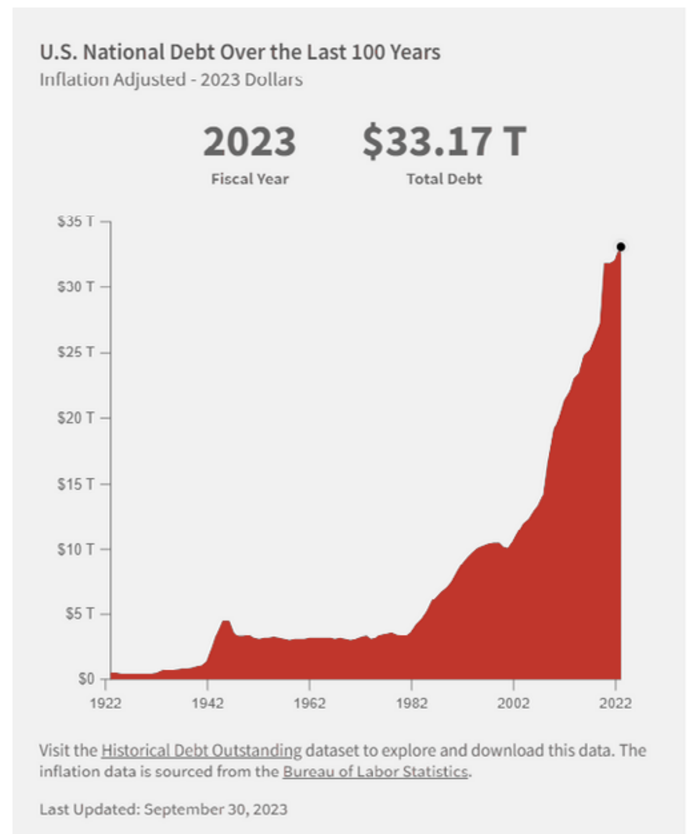


Source: Treasury.gov

When did it all begin?

Federal debt started accumulating shortly after the birth of the nation, as U.S. revolutionaries had to pay for equipment to fight the British.

- As early as 1791, the U.S. national debt hit a level of $75 million. To ensure the U.S. government would pay for this debt and assist a post-Revolutionary War economy, Alexander Hamilton created the United States Treasury, as well as the National Bank of the United States.
- The national debt fell until Thomas Jefferson's Louisiana Purchase. Debt then began to accumulate once again until Andrew Jackson paid off all interest-bearing debt in 1835 by liquidating the Second National Bank.
- The Civil War (1861) plunged the nation back into debt, which continued to steadily increase with the onset of the Great Depression, WWI and WWII. At the end of WWII, the national debt was somewhere in the range of $260 billion, with this number increasing to a staggering $33 trillion in the present day.



Source: Treasury.gov

> *Over the past 100 years, the U.S. federal debt has increased from $404 B in 1923 to $33.17 T in 2023.*

How did we end up here? If the last budget surplus was in 2001, how did national debt get so out of hand?

THE DOT-COM BUBBLE

Starting in 2000, Americans faced new economic and social challenges. The dot-com bubble imploded, which saw millions of dollars in online growth stocks evaporate overnight. Internet companies were burning through cash at an unseemly rate. When paired with federal funds rate increases, most of these companies had to pack up shop and close after once enjoying huge valuations. The government immediately began spending again, in an attempt to offset the economic downturn brought on by the crash.

9/11

Soon after, the world would change forever as members from the Al-Qaeda terrorist group committed the deadliest terrorist attack ever seen on U.S. soil on September 11, 2001. This exacerbated turmoil in domestic markets, causing another sharp drop in equity prices. Government spending once again increased as rebuilding efforts went into effect, but this also led to various new programs being formed to dissuade or prevent attacks like this again, which required additional funding. The TSA was created in 2002 with a budget of $1.3 billion. By 2003 that budget had increased to $4.8 billion. Additionally, Congress fought to seek justice for the attacks on America, and began military operations in Afghanistan in October 2001. Estimates by Brown University have put the total cost of U.S. military operations in the Middle East at around $8 trillion.

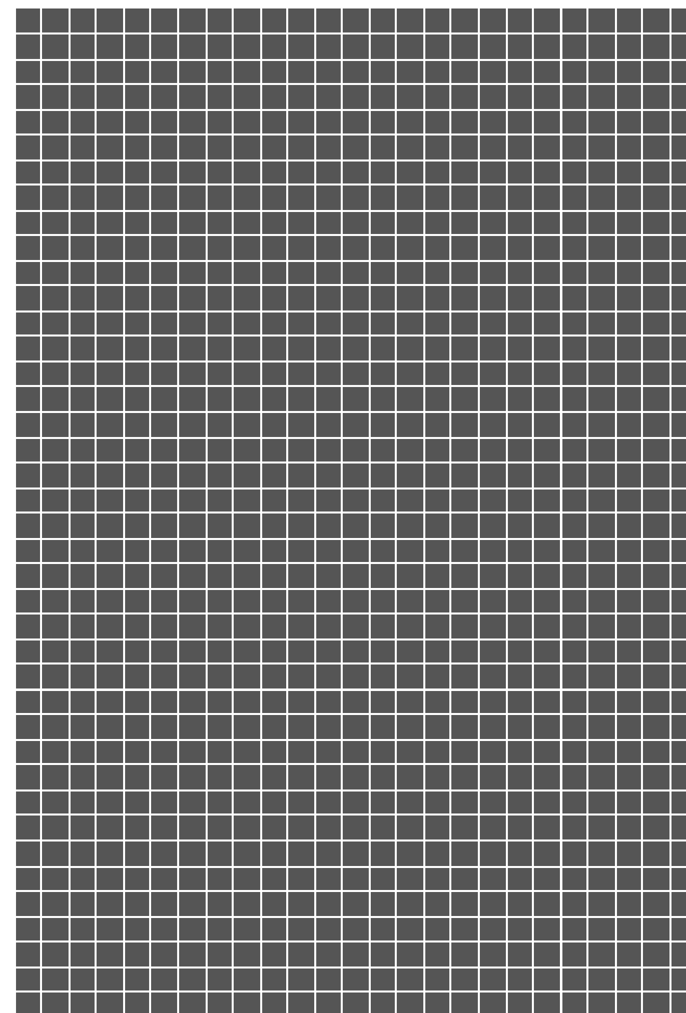
THE GREAT RECESSION

To briefly summarize, the federal funds rate steadily increased in 2006 and 2007, and homeowners with adjustable-rate mortgages (almost a third of all Americans) saw their monthly payments skyrocket. To compound this, the largest concentration of these adjustable-rate mortgage holders was in the subprime space (issued to borrowers with less-than-ideal credit). Many Americans defaulted on their mortgage payments, rupturing many mortgage-backed securities and other collateralized debt obligations. Banks that had significant exposure to these now-defunct mortgage-backed securities and CDOs faced solvency issues. To prevent the U.S. from sliding into economic catastrophe, Congress issued emergency funding to keep some of these banks afloat. It created the Troubled Asset Relief Program, which was a bailout for these banks, with a price tag of $700 billion.

Visualizing the debt - How much is $34 trillion dollars?

If this is 1 billion: ■

Then this is 1 trillion:



(1000 squares drawn to scale.)

Today's debt is $33.5 T. That's 33,513 squares!

COVID-19

Fast forward to 2020. From about 2009 to 2020, the country saw unparalleled growth and equity appreciation thanks, in part, to a historically low Federal Funds rate. The S&P 500 returned 257% over this time frame, with no apparent end in sight. Until the COVID-19 pandemic hit. Not since the Spanish Flu of 1918 was there such chaos caused by an outbreak of a viral disease. The economic impact of Covid-19 was immense, and investors panicked. Beginning in March 2020, the S&P 500 index fell more than 16% over the course of the month.

Several measures were taken in response to the pandemic:

- The federal government pass the Coronavirus Preparedness and Response Supplemental Appropriations Act on March 6, providing $8.3 billion in aid to fight the pandemic. Tax revenues, however, had actually decreased, so this was piled onto the national debt.
- The Families First Coronavirus Response Act was passed ($192 billion), along with the CARES act ($1.8 trillion), adding to the increasing mountain of debt.
- Then there was the Payment Protection Program or PPP, another $800 billion, in which only about 35% went directly to workers.

Federal spending increased by 45% in the 2020 fiscal year. This brings us right up to present day, where we can see the total national debt nearing .... drumroll please...... $33 trillion!

WHEN INTEREST RATES REMAIN LOW OVER TIME, INTEREST EXPENSE ON THE DEBT PAID BY THE FEDERAL GOVERNMENT WILL REMAIN STABLE, EVEN AS THE FEDERAL DEBT INCREASES. AS INTEREST RATES INCREASE, THE COST OF MAINTAINING THE NATIONAL DEBT ALSO INCREASES.

THIRTY-THREE TRILLION DOLLARS $33,000,000,000,000

$33 TRILLION IS ROUGHLY THE VALUE OF THE ECONOMIES OF

COMBINED

AND AMOUNTS TO

IF EVERY U.S. HOUSEHOLD CONTRIBUTED $1,000/MONTH toward paying down the national debt it would take over **21 years.**

Where do we go from here?

Like many things in politics, it's just not that simple. Plenty of politicians have tried to reign in this spending over the years, but legislators seem to focus on what gets them reelected, and cutting social programs is a surefire way to lose to a new candidacy come November. So, what would be a morally responsible way to solve the debt crisis? Well, there are a few ways to look at it.

- The first would be to exponentially grow the tax base. This involves holding interest rates lower to spur significant growth in both corporate earnings, and consumer spending.

- To do this though, the government would have to stop the increases in spending each year, which it seemingly is unable or unwilling to do.
- The second option is to broadly reduce spending across the board.

How do we cut spending?
If Congress decided to cut spending by 26% across all programs tomorrow, we would be able to balance the budget.

- Defense: While some might say this is an easy fix, others might argue that we need to keep up defense spending to protect U.S. interests overseas, and take care of said veterans. That means cutting all spending, excluding defense and Veterans Affairs, by 33%. This is not a huge leap in cuts, but it quickly begins to add up.
- Social Security: Who wants to cut down income checks retirees receive? With that argument in play, we would have to cut spending by 51% if we didn't want to touch defense, Veterans Affairs, or Social Security. Fifty-one percent is significant, and we would really start to feel the economic impacts of the reduced spending.
- Medicare: In an ideal world we would want to keep Medicare, too, right? So without touching defense, Veterans Affairs, Social Security OR Medicare, we would have to cut spending by a whopping 85%.
- Education: Education is a long-term investment, and cutting programs in this category would have significant consequences down the road.

What does a realistic plan for moving forward look like? Taking everything into account, we can see that the most practical approach would be somewhere in between the two options listed above, with lawmakers coming up with a concerted bipartisan effort to grow the tax base and reduce wasteful spending. Politicians owe it to their constituents to act as careful stewards of our tax dollars, and so far, it seems they have failed us. The current path we are on is unsustainable – the interest on our debt alone is estimated to cost $808 billion (or 15% of the federal budget) in 2023. Until then, we will have to deal with the theatrics of arguing about a debt ceiling raise every few years, even though it is in everyone's best interest for the United States to pay its debts. Maybe Congress can come together to figure out an answer.

Did I mention the possible government shutdown?

We'll see what happens in November.

HOW IS THE DEBT CEILING DIFFERENT FROM A GOVERNMENT SHUTDOWN? GOVERNMENT SHUTDOWNS OCCUR WHEN ANNUAL FUNDING FOR ONGOING GOVERNMENT OPERATIONS EXPIRES, AND CONGRESS DOES NOT RENEW IT IN TIME.

OAKWORTH CAPITAL BANK

SAFETY & SOUNDNESS

After the largest capital raise in the state of Alabama, we opened our doors to the public on March 31, 2008. Over the years, we have developed a reputation as one of the safest banks in the United States. In 2016 we expanded our markets in Alabama, adding a South Alabama office in Mobile.

In 2020, we expanded to the State of Tennessee, opening a Middle Tennessee office in Brentwood. Now, in 2023, we are excited to open our doors in the Central Carolinas.

In November 2022, Oakworth began trading on the OTCQX Best Market under the trading symbol OAKC, enabling a more elevated trading experience for our shareholders. All managing directors and the majority of our associates directly own shares of the company. We believe this instills a strong business-owner mentality throughout the company.

In addition to your client team, our bank's leadership team consists of experienced and well-versed individuals, allowing us to offer a wide range of Commercial and Private Banking, Wealth Management and Advisory Services. Our core values and overall mission are building blocks for the long-term success of our clients, associates, shareholders and communities.

HIGHER FOR LONGER

David McGrath and Sam Clement

The Impact of Higher Rates on the Economy and Financial Markets

The phrase "higher for longer" is getting a lot of air time and press lately. What exactly does it mean? Why now? and How will it affect the economy and financial markets going forward?

What it means: the Federal Reserve will be forced to keep the fed funds rate at a **higher** level, for **longer** than most economists were expecting.

How this impacts us: This will keep borrowing costs elevated for both consumers and businesses. Everything from mortgage loans to credit card balances become more expensive.

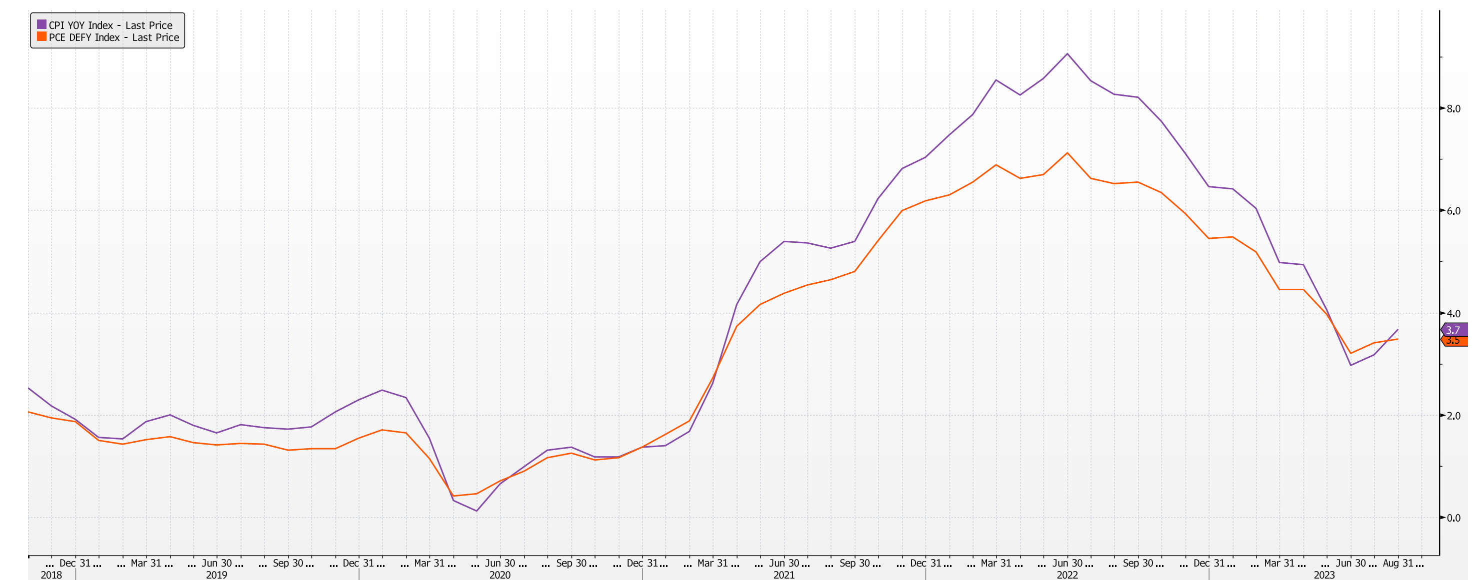
Why now: The Fed only has two mandates: 1) maximum employment and 2) price stability. The maximum employment part is easy to understand, but what exactly does price stability mean?

How this impacts us: In the eyes of the Fed, this means keeping core inflation at (or near) their target of 2%.

INFLATION

So far this year, inflation has been falling rapidly. Is this not enough for the Fed to start to bring interest rates down? Headline Consumer Price Index (CPI) inflation has fallen from just over 9% last summer to a current level of 3.67%. The other main inflation gauge, Personal Consumption Expenditures (PCE), has fallen a similar amount.

HEADLINE INFLATION



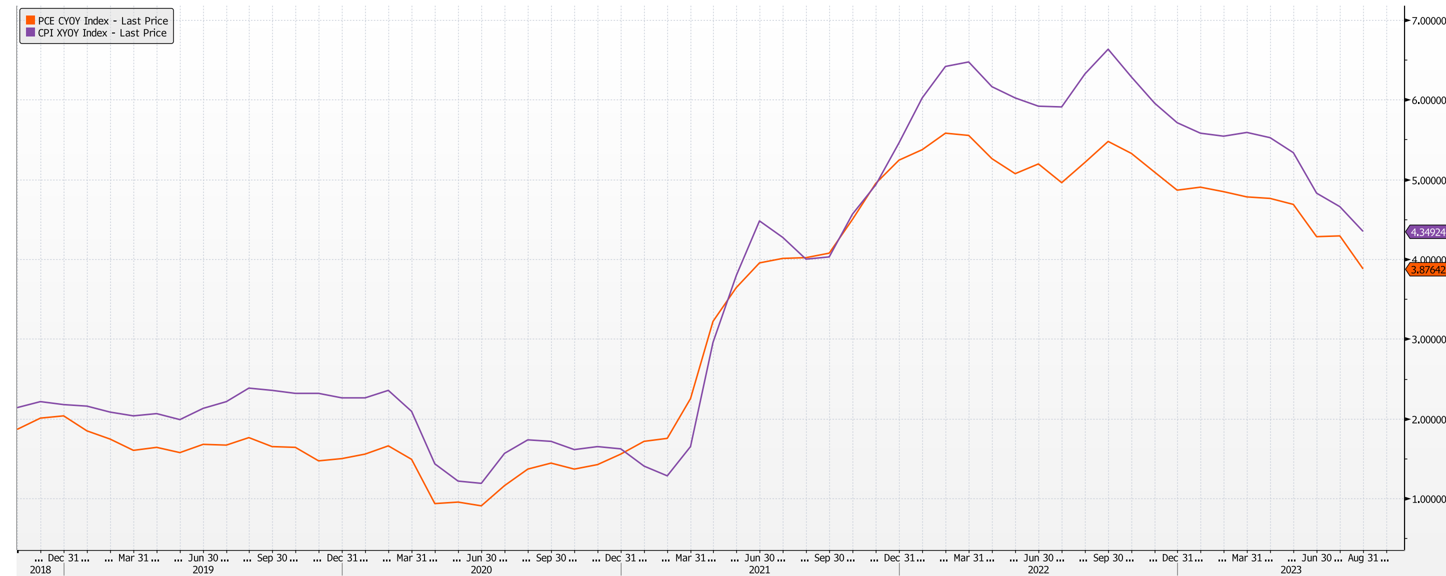
Source: Bloomberg Financial

These are "headline" inflation numbers, and they can be dominated by two things: changing energy and food prices. No doubt everyone spends their hard-earned cash on both energy and food, but these prices can also be extremely volatile. The Fed wants to have a look at a more stable price indicator, **so they strip out energy and food prices to have a more stable inflation gauge to aid their longer-term planning.** This is called core inflation, and these are the inflation numbers that the Fed places more weight in to see if prices are rising near their 2% target.

As you can see, the core inflation numbers did not climb to the same heights that the headline inflation numbers, but have also remained higher than the headline numbers. The Fed wants these numbers to drop to 2%, and this may require more time. Put another way, higher for longer.

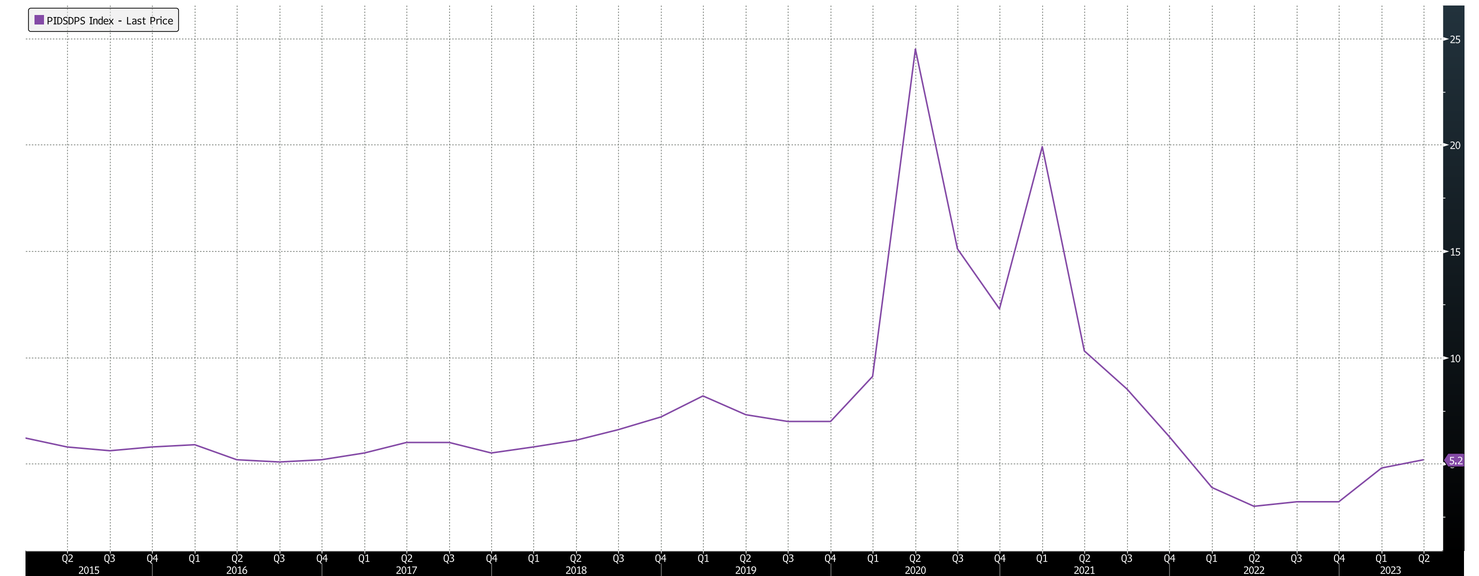
CORE INFLATION = CHANGE IN PRICE OF ALL GOODS AND SERVICES – CHANGE IN PRICE OF ENERGY AND FOOD

CORE INFLATION



Source: Bloomberg Financial

PERSONAL SAVINGS RATE



Source: Bloomberg Financial

HIGHER INTEREST RATES

Why would the Federal Reserve want to make it more expensive to borrow money? Higher interest rates slow down the economy and bring elevated core inflation numbers down to their target of 2%.

- Corporations tend not to grow as quickly (or hire as many people) with higher interest rates.
- Consumers tend to borrow and spend less with higher interest rates.

CONSUMER SPENDING

The Fed has been raising interest rates for some time now, so why has consumer spending remained so strong? The next chart may give us an answer to that question. When COVID hit, just about everyone who could work from home did. There was very little eating out, very few vacations and far less need to fill up the tank and drive anywhere. The average personal savings rate for the consumer jumped from an average of 7% all the way to a peak of 26.4% in the summer of 2020. As the economy slowly reopened, that savings rate started to decline. That rate bottomed at just over 3% last summer, and has only recently started to come back to a more normal level.

So why did higher interest rates not slow down the consumer over the past 15 months? The answer is consumers have been spending saved money, not borrowed money. That saved cash is just about gone, and now the higher borrowing rates should start to have more of an impact on consumer spending. We are seeing credit card debt start to expand, and the consumer is starting to change how, and where, they are spending their money.

As long as inflation was in check, the Fed could do whatever they needed to in order to have maximum employment.

THE FEDERAL RESERVE

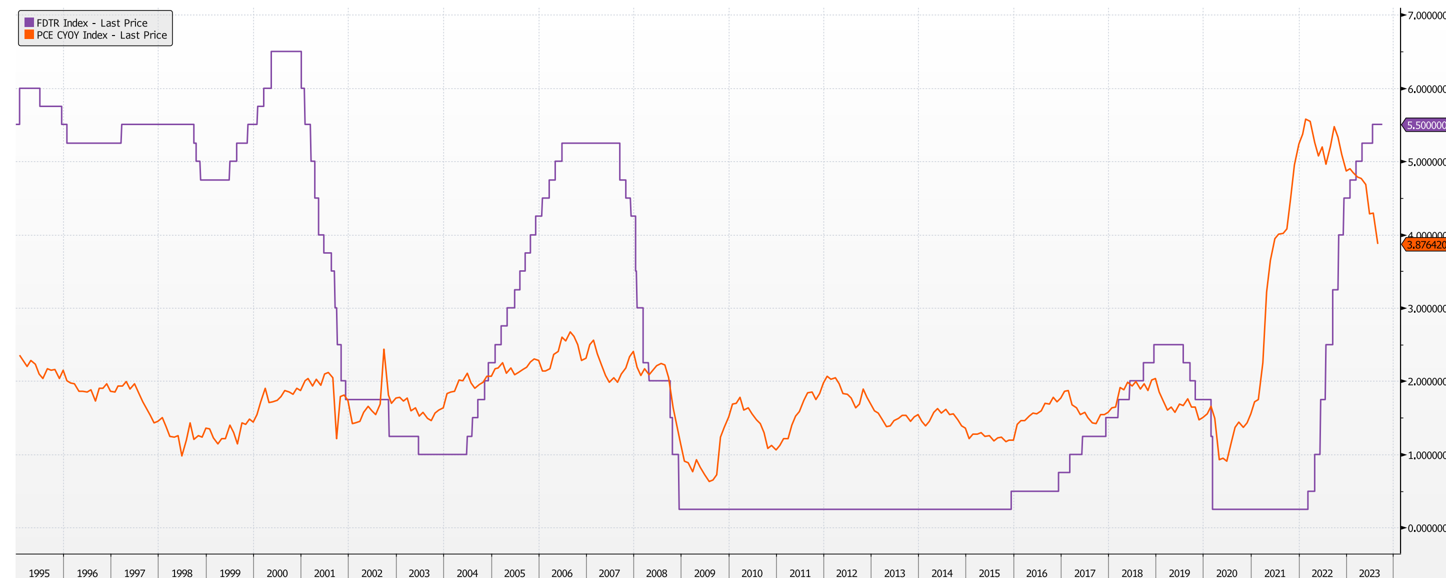
Over the past 25 years, when we faced an event that was going to have a negative effect on the economy (and the labor market), the Fed has been able to drop interest rates dramatically to help support the economy.

The three most obvious events were:

- The terrorist attacks from Sept. 11, 2001
- The housing/financial collapse of 2008
- The onset of the COVID-19 pandemic in 2020

Each time, the Fed had the ability to drop the fed funds rates dramatically. Why? Because core inflation was at or below their 2% target.

FEDERAL FUNDS RATE



Source: Bloomberg Financial

In all three of these situations, there was clear and present economic danger. Inflation was in check, and there was good reason to be hyper-focused on the slack in the labor market. Fast forward to our current situation – as murky as some economic forecasts are, the current situation is not nearly so shabby.

- Currently the unemployment rate is 3.8%, which is below many economists' expectation for what full employment is.
- The Federal Reserve's recent forecast shows expectation for unemployment to reach 4.5%. In this forecast, and with that unemployment rate, they still did not forecast any rate cuts.

That leads me to my question: If the Federal Reserve is amenable to unemployment creeping up to 4.5% and not cutting rates, why on earth would they cut rates with inflation still nearly double their target? It's a hard question to answer. It may (or may not) mean no more hikes, with policy now restrictive by most estimations, however it likely means the Fed is going to be willing to hold policy restrictive for some time. You guessed it, higher for longer.

With core inflation between 4.2% and 4.3%, the Fed will not have the same playbook available to them and, based on their own words, would likely not come into play until unemployment is higher than their own projection. They may be able to lower the fed funds rate some to help ease the pressure, but it is hard to envision dropping that rate to near zero again given the current environment.

CAPITAL MARKETS

Higher interest rates will also have an effect on the capital markets.

The Bond Market

First, as interest rates have moved higher, the bond market is able to provide fixed income investors a higher yield on their investments. All else being equal, you should expect a higher current income from a bond portfolio.

The Stock Market

Higher interest rates for longer can have an opposite effect for equity returns. As borrowing costs increase, corporations will tend to grow at a slower pace than in a lower interest rate environment. The higher costs can also lead to lower profit margins, and lower earnings. That slower growth, both from a company level and slower economic growth, can lead to a stock market with a lower valuation level. A company with a higher growth rate will typically trade with a higher multiple to those earnings, and a slower grower will have a lower valuation.

WITH BOND YIELDS HIGHER AND EXPECTED STOCK RETURNS COMING DOWN, IT WOULD BE EXPECTED TO SEE INVESTORS SHIFT THEIR ALLOCATION MIX TO SLIGHTLY HIGHER FIXED INCOME AND LOWER STOCK ALLOCATION.

THE IMPACT OF HIGHER RATES ON CORPORATIONS AND CONSUMERS

As higher interest rates become the new normal, both corporations and individual consumers will stop waiting for lower rates to make important decisions. If one company is looking to buy another company, for example, they may have been waiting for a lower interest rate environment to make the offer. If rates are not expected to drop much from current levels, a company may just accept the higher borrowing costs to make sure the deal still happens.

The housing market will also adjust to the higher interest rate environment. Those who were able to take advantage of the 3% 30-year mortgage market a few years ago may not look to sell any time soon, so inventory levels may remain lower than normal for an extended period of time. But life changes and families will once again be downsizing, upsizing and moving. A 6% or 7% mortgage rate was the norm 20+ years ago, and it probably will be again.

While "higher for longer" seems to scare investors, there actually can be some positives. Higher interest rates mean a higher bar for what is considered a good investment. It makes sense. Why would I risk my capital for 6% when I can get a guaranteed 5% in a treasury note? The free money of the last several years created an environment that almost rewarded undisciplined investing. Excess risk for a marginal return. This undisciplined environment is not only unsustainable, but also unhealthy.

While it may take a little pain to get there, if getting to the other side means more disciplined capital allocation, it may not be the worst thing.

Welcome to the next "new normal."

MEET THE NEWEST MARKET BOARD

In October, we opened the doors in our newest market: the Central Carolinas. With this opening we also welcome four dynamic members onto our market board. The Oakworth board is comprised of successful leaders from a multitude of industries who exemplify our core purpose of helping people succeed while demonstrating exceptional leadership.

Here's what these leaders are saying about why they believe Oakworth will thrive in such a bustling financial center:

Morrison Creech

Retired Wells Fargo Private Banking Executive

"Charlotte is full of banks. Many are good, none are great and none have the client-centered focus of Oakworth. Oakworth has all of the services and capabilities of larger institutions – commercial, private, investment management and advisory services – but has the capacity to meet the vast majority of the needs of their clients. This is unparalleled among most banks. The Oakworth model and approach will be well received in the Central Carolinas and I look forward to helping them grow."

Blake Evans

President & CEO of Salem Capital, LLC

"Oakworth has impressive organic growth that has been achieved in a sound and risk-focused manner, emphasizing strong asset quality and capitalization. Most of the big banks have reached their size by acquiring other banks. And as banks consolidate, people get lost in translation and the personal, high-touch relationship structure is removed. Not at Oakworth. Another defining factor is their internal culture. Oakworth gets behind its associates. Their 96% associate retention rate speaks to the team-based culture."

Kimberly Mize

Owner, Kimberly Mize Consulting

"I am excited about the true boutique service that Oakworth will be able to provide in Charlotte and the greater Carolinas. Our city is booming with growing businesses and successful professionals who are looking for a more curated experience, with deeply personalized services. They want associates who know their name when they walk into the lobby. Oakworth is not only poised to fill an immediate need, but will also stand up as a valuable community partner. I look forward to helping this bank become a bigger part of our community."

Steve Smith

President of The McAulay Smith Firm

"Oakworth will be a huge success in the Central Carolinas – people crave the personal attention and professionalism that Oakworth's team provides. Their continued growth is unique and can be attributed to the people and culture who make up the very heart of the bank – very good people who are empowered to do the right things. Business is all about people, and Oakworth Capital completely understands and embraces that. They have already made a positive difference in Charlotte and the surrounding areas and I look forward to watching them grow."

JANET BALL
Managing Director
Central Alabama

LUKE FARGASON
Client Advisor
Central Alabama

JOHN T. HENSLEY
Managing Director
South Alabama

CLIFF NAIL
Client Advisor
Central Alabama

HERE TO SERVE YOU

Meet Our Wealth Advisors

Managing both the broad view and the complexities of our clients' wealth management and trust needs is our hallmark. Our holistic approach allows us to manage assets not just for today, but for generations.

Your client advisor works to understand deeply your values and goals, then coordinates an elite, multidisciplinary team of financial experts to preserve your invested dollars, provide a readily accessible stream of liquidity and generate a competitive rate of return – all based upon a statement of investment policy we have defined uniquely for you.

We advise clients on the appropriate asset allocation and execute this strategy through the use of an open-architecture investment platform. We then work closely to achieve their generational financial objectives.

Learn more about our wealth team at:
oakworth.com/our-team/wealth-team

Learn more about our wealth services at:
oakworth.com/our-approach/wealth-management

Investment Management | Wealth Strategies | Fiduciary Services

LEE BANKS
Client Advisor
South Alabama

SCOTT HEGGEMAN
Associate Managing Director
South Alabama

RICHARD LITTRELL
Associate Managing Director
Central Alabama

GREER REDDEN
Managing Director
Middle Tennessee

CATCH MORE FROM OUR INVESTMENT COMMITTEE EXPERTS

EQUITIES: Earnings vs. Economic Recession - Why Record Consumer Spending Has Not Produced Record Earnings.

In August and September, we began to see the effects of "higher for longer" (see page 18) rates, coupled with losses across all equity markets. The Fed's target for inflation is 2%; we have a long way to go to get there. Technology and consumer discretion struggled, energy stocks soared, and utilities invalidated the acronym TINA. Could we have a 4th quarter rally? Companies are resilient, and the defensive posture most have taken will hopefully help prevent equity pain from becoming unbearable.

Scan to Read More About Equities

BONDS & ALLOCATION: Volatility, Uncertainty and How We Will Continue to Remain Nimble in a Higher for Longer Setting.

Higher interest rates can have a headwind effect, making it important for us to continue overweighting the equity markets and economies that are the strongest. Bonds, however, don't fare well in a "higher for longer" rate environment, and it's best to keep bond portfolio durations short, which we will continue to do. We also continue to capitalize on cash, which has a higher yield as interest rates rise, enabling us to generate an increased income stream for our portfolios without added risk.

Scan to Read More About Bonds & Allocation

WHAT ARE QR CODES?

QR stands for quick response. It's like a barcode that links to additional articles, videos, and information! To use, simply open your camera app and use your screen to hover over the code. Tap the banner that appears for more insight from our Thought Leadership team!

TRADING PERSPECTIVES

WITH JOHN NORRIS & SAM CLEMENT

OAKWORTH CAPITAL BANK

HAVE YOU LISTENED TO OUR PODCAST?

Two insightful personalities; two valuable viewpoints. Each week John Norris (Chief Economist) and Sam Clement (Associate Managing Director) come together and exchange perspectives on current events that are impacting our economy and influencing our investment strategies. Always relevant, always entertaining, and always available.

CHECK OUT OUR LATEST EPISODES HERE:

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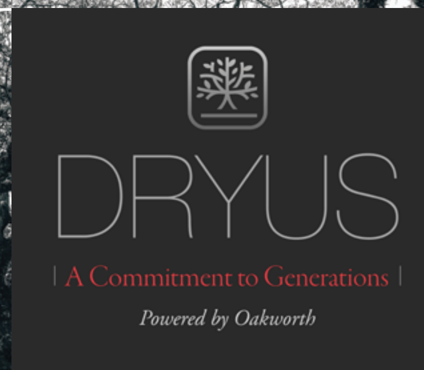


Oakworth designed the Dryus Group to address the complexities that families with generational wealth often experience. Our knowledgeable teams of financial professionals provide a heightened level of service and skills, which help our clients succeed… not just for today, but for generations to come.

We discovered a desire by our female clients to have their own deeper understanding of financial matters on a broad spectrum of topics - business planning, networking, death of a spouse, divorce, to name a few. DEPTH applies to the unique needs of our female clients in the form of programming, conversation circles and individualized consulting.

4TH QUARTER

PREDICTIONS

Cooling growth rates, reduced consumer spending, elevated prices and mushrooming debt service may be on the horizon as we near the end of another year.

- If past performance is indicative of future results, and we are supposed to say it isn't, **seasonal factors will push the stock markets a little higher during the 4th quarter.** Investors might not make up all of their losses from the 3rd quarter, but a little green ink is always a lot better than red.

- **Consumer spending will likely slow from the 3rd quarter's brisk pace.** Initial indications are that so-called "aspirational" luxury expenditures have fallen, as upper quartile income earners regroup after a long-term spending spree.

- **The official inflation gauges likely won't get to the Fed's preferred target of 2.0% for a while, perhaps a long while.** While inflation for some goods has slowed considerably, the lack of housing inventory, a tight labor market and higher energy prices are keeping prices elevated a little more than the Fed would like.

- Despite higher mortgage rates, **housing prices have remained firmer than many had predicted.** This will continue into 2024 due to extremely low levels of existing home inventories. After all, if you sell your home, you have to buy another one.

- **Crude oil, diesel, jet fuel and gasoline prices will continue to be higher than consumers would like,** unless OPEC and Russia have a sudden change of heart and increase production. For a number of reasons, many political, the United States simply is not able to produce enough crude oil, especially the heavy kind, on its own to drive down global energy prices.

- **The political parties in Washington will play around with yet another government shutdown.** Any stoppage won't be long lasting, and the Treasury isn't going to default on its debt. As Yogi Berra might have said, it will be like déjà vu all over again.

- **The resumption of student loan repayments likely won't be as catastrophic to the economy as many feared,** in aggregate. However, it will likely be disastrous for many small business owners, especially food and beverage establishments, who cater to the younger demographic.

- **Domestic public support of Ukraine will continue to wane.** The United States has enough problems of its own, and few people have a good grasp on exactly how the war there is progressing. Are we prolonging the inevitable or actually giving the Ukrainians a chance to win? The average American doesn't know..

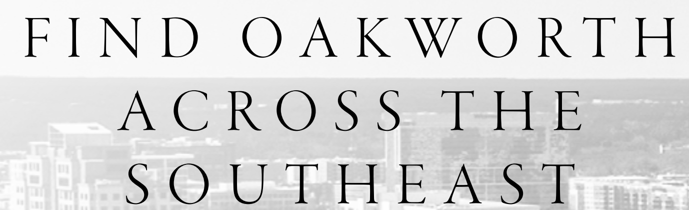
- If not by the end of the 4th quarter, then certainly by the end of 2024, **it will become very apparent to Americans that Asia doesn't care about the war in Ukraine and Europe doesn't really care about a potential Chinese invasion of Taiwan.** Further, South America and Africa don't seem to care about either. So, can the U.S. really do it all alone?

- **Continued mismanagement of the public coffers in Washington will cause the nation's debt service to mushroom.** This will put a ceiling on Federal discretionary spending and U.S. fiscal policy moving forward.

- **Longer-term interest rates will stay "higher" for longer in the United States.** This is due to the massive supply of U.S. Treasuries the markets will have to absorb moving forward coupled with the not-so-stunning realization that investors really do like positive real interest rates. Basically, if the Federal Reserve and Asia aren't going to backstop the U.S. Treasury market at yields less than inflation, don't expect domestic investors to do so.

- Because of higher interest rates shrinking the market value of bond investments, and consequently bank capital, **there will be significant consolidation in the financial industry, especially among minor firms.** This could have an outsized negative impact on smaller towns, widening the wealth divide between urban and rural America.

- After posting a surprisingly high headline GDP during the 3rd quarter of 2023, **the U.S. economy will cool to a slower growth rate for the next several quarters.**



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