Fourth Quarter 2021 Economics & Fixed Income Outlook

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September 2021

Economic Outlook:

Following a sharp recovery from the pandemic-induced recession, global growth appears to have peaked. Looking ahead, economic growth is set to moderate, although it will remain above trend in a number of countries.

The U.S. economy has recorded four quarters of significantly above-trend growth beginning in the third quarter of last year. During the next phase of the recovery, growth is likely to be more modest. Many business and economic sentiment indicators peaked in the second quarter and have been declining since then, even if they are still at elevated levels relative to history.

The rapid spread of the Delta variant during July and August resulted in a pullback in service-oriented spending, such as restaurants, airfare, and hotels and appears to have been a major factor in the sharp decline in consumer confidence. However, the economic impact of infections appears to be *less* adverse than previous virus waves, in large part due to rising vaccination rates, which has altered the link between infections and hospitalizations.

Business investment continues to grow rapidly, particularly in IT equipment and software, and is now in excess of its pre-pandemic level.

Household balance sheets have improved substantially since the beginning of the pandemic as consumers took advantage of various government stimulus programs and lower mortgage rates to increase savings. The personal savings rate – reported by the Bureau of Economic Analysis to be at 9.6% in July – is almost 3% higher than its long-term average. This stockpile of excess cash should continue to support consumer spending over the coming quarters. However, while the U.S. consumer is flush with cash, supply chain disruptions will limit their ability to spend on goods and may weigh on economic growth in the fourth quarter and into the new year.

Unlike most recessions, the conversation around the labor market today is not about people looking for jobs but rather about employers looking for workers. Economists have suggested several reasons why businesses are experiencing trouble hiring workers, including the additional unemployment benefits (this ended in all states at the beginning of September), the buildup of savings from fiscal stimulus, child care (which should be helped by the reopening of schools), health risks, and a decline in the labor force participation rate among people 55 years and older.

Slow labor force growth and continued high demand had already created conditions that required companies to offer higher wages to lower-skilled workers and to be more imaginative about hiring.

The combination of tighter supply chain disruptions and the rapid appreciation in home prices have resulted in inflation remaining elevated for longer than forecast. The pace of wage gains will play an important role in the persistence of inflation in the medium term and will have implications for Fed policy.

On the fiscal front, there are a number of uncertainties emanating from Washington, including the need for a funding bill to avoid a government shutdown, two infrastructure packages and the need to raise the debt ceiling.

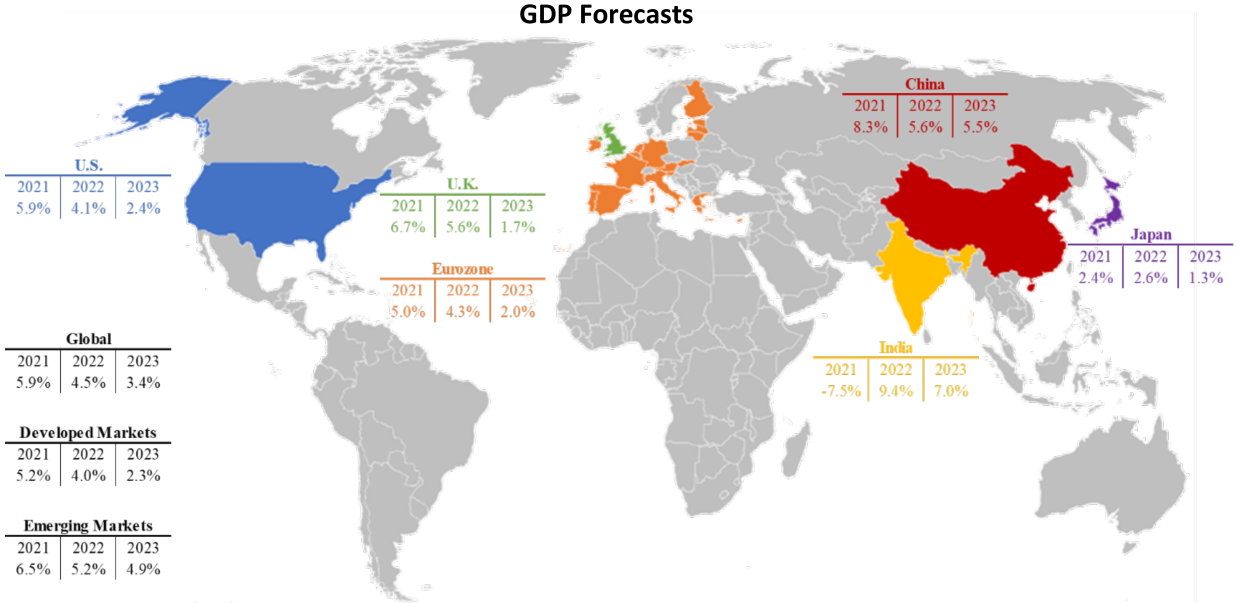
The bipartisan infrastructure package looks set to be signed into law as a $1 trillion spending package to rebuild and upgrade aging infrastructure and to fund new climate initiatives.

The second infrastructure package, the so-called "human infrastructure" package is currently being worked on in the senate and will likely have to clear that chamber by way of congressional reconciliation (a simple majority vote) as it is unlikely that enough senate republicans will vote in favor of the bill. The exact makeup of the bill in terms of scope and scale are still unknown; however, it is likely that it will be smaller than the $3.5 trillion that was initially discussed. In order to pay for the bill, there has been a number of proposals on potential tax increases across both individual and corporate tax rates.

Concerns over the federal debt limit are mounting as Congress prepares for a showdown over raising the debt ceiling ahead of October 18 – the approximate date by which the Treasury expects to have exhausted the extraordinary funding mechanisms that allow it to stay below the statutory debt limit. Congress has adjusted the debt ceiling 78 times since 1960, and we ultimately expect Congress will reach an agreement to raise or extend the debt limit, but likely not until right before the Treasury has exhausted its borrowing capacity.

Overall, the headwinds from the Delta variant, supply chain constraints and lower consumer confidence have resulted in a slight downward revision in the median forecast for economic growth in the third quarter.

GDP Forecasts



Bloomberg: 09/28/21

Since the easing of restrictions in the spring, economic activity in the European Union (EU) has exceeded expectations and high-frequency data collected during the third quarter suggests that the growth momentum has continued. Following a sluggish rollout, the pace of vaccinations increased sharply during the summer months, and Europe now has one of the highest vaccination rates globally.

Looking ahead, accumulated household excess savings remain significantly higher than before the pandemic, suggesting that consumption still has room to increase. Growth should also be supported by ample monetary and fiscal accommodation. The European Union's pandemic recovery fund is only beginning to disburse stimulus. While this program will provide support broadly across the region, it will be particularly beneficial to countries in the Southern region. The chance of additional fiscal stimulus, if needed, has increased as a result of the German elections. While the final coalition may take some time to form, it is expected that the new government will be more supportive of fiscal stimulus than previous German governments, regardless of the eventual party mix.

Against this backdrop, economists have increased their forecasts for economic growth in the EU for 2021 from 4.6% at the start of the year to 5.1% currently.

However, an evolving headwind for European growth is the recent rise in energy prices. Over the past month, natural gas prices in Europe have reached record highs, rising in price to more than four times their pre-pandemic levels. The sharp spike in prices is the result of very low inventory levels, which suggests that prices will remain elevated for the next several quarters, with the risk skewed to the upside if the region experiences a colder-than-usual winter. The increase in prices has already led to some companies temporarily closing factories, which will further exacerbate the supply shortages and result in further price inflation in certain products (e.g., the reduction in output from certain fertilizer plants is expected to lead to an increase in food prices). A sustained increase in the price of energy and other goods will erode a portion of the consumer's disposable income / savings and could call into question the European Central Banks' ability to maintain its extremely accommodative policy stance.

The combination of an extended state of emergency to combat the pandemic and persistent supply constraints have resulted in the Japanese economy growing at a slower pace than was expected at the start of the year. However, growth is expected to get a shot in the arm as rising vaccination rates improve mobility and reduce the risk of further lockdowns. This should help boost consumer confidence, unlocking a portion of the large excess savings. Newly elected Prime Minister Fumio Kishida has pledged tens of trillions of yen in spending and to focus on helping the middle class.

The pace of economic growth in China slowed during the third quarter. Policy tightening, self-imposed restraints (e.g., zero tolerance Covid-19 policy), de-carbonization and the global chip shortage have all contributed to the slowdown. Consumer and business sentiment has also been negatively impacted by sudden and far-reaching government regulation in the tech, education and entertainment sectors of the economy. These actions show the shift in China's long-term strategy from one focused on growth to one focused on 'common prosperity.'

The Evergrande saga has highlighted the large amount of leverage within some sectors of the Chinese economy, with the company having difficulties servicing its huge debt pile. While Chinese authorities may intervene to prevent a disorderly wind down, the situation is likely to strengthen Beijing's commitment to cooling the housing market and deleverage the financial system, which will create additional headwinds to economic growth.

Outside of China, emerging market economies are benefiting from a stronger-than-expected economic growth during the first half of the year, accelerating vaccination rollouts, and a low tolerance for renewed restrictions on economic activity.

Overall, we expect the global economic recovery to continue into 2022, albeit at a more modest pace. However, we are also closely monitoring several risks that could disrupt the expected path of economic growth, including COVID infection rates, supply chain issues, a variety of policy uncertainties in Washington, elevated inflation, the potential for a policy error by a central bank, cyberattacks and geopolitical tensions – most notably between the U.S. and China.

We are also aware that there are many unknown risks, and it is often the emergence of these risks that have the largest impact on financial markets. Therefore, we remain vigilant to the changing macro environment and evaluate these evolving factors to understand their impact on financial markets and investment portfolios.

Fixed Income Outlook:

The headline from the Federal Reserve's (Fed) September meeting was the announcement that it intends to *announce* plans to begin trimming its asset purchases – known as quantitative easing, or QE – at its next meeting in November. During his press conference, Fed Chair Jay Powell noted that the committee expects its asset purchase program to fully wind down by the middle of 2022, which is consistent with a reduction in the amount of purchases by $10 billion of Treasurys and $5 billion of Agency mortgages per month.

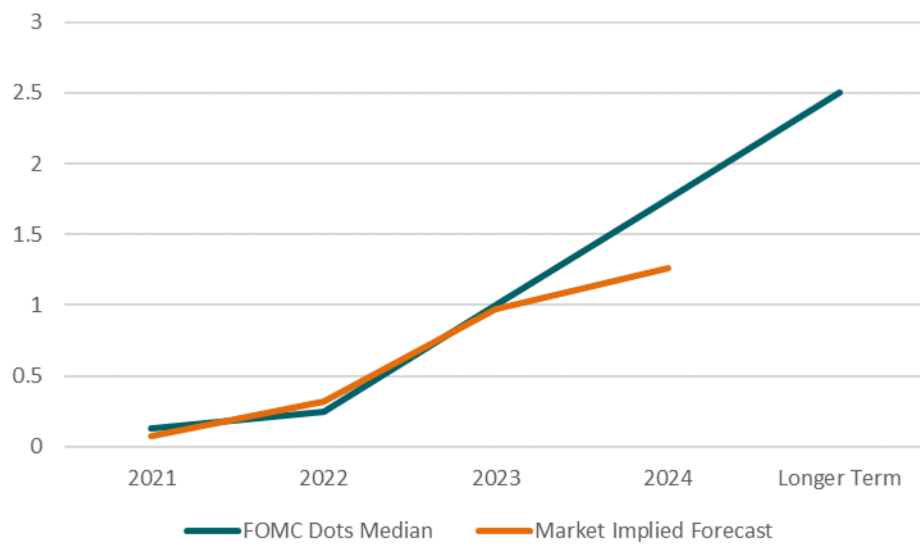
However, with the U.S. Treasury debt ceiling likely to become binding around the time of the Fed's November meeting, we believe there is the potential for a delay in the start of the tapering process until December, as the Fed will not want to contribute further to what could be a period of elevated volatility.

Unlike the "taper tantrum" experience, the market has already priced in a portion of the upcoming reduction in asset purchases. Therefore, we do not expect the same magnitude of market dislocations that occurred in the spring of 2013 when 10-year nominal yields rose by 95 basis points. That being said, we do expect volatility to pick up from very low levels as the Fed goes through the tapering process.

The Fed also published a new summary of economic projections, which included a substantial upward revision to the Fed's core inflation forecast for 2021 and a similarly substantial increase in the median expected policy rate through 2023. Despite revising its 2021 inflation forecast higher, the new forecast continues to signal its expectation that the current elevated level of inflation will fall back toward its longer-term target of 2% in 2022.

Nevertheless, with this year's elevated inflation readings appearing to be more persistent than many Fed officials initially expected, the updated dot plot showed a higher projection for the path of the policy rate, with the most dovish members moving their expectations for the first rate hike to 2023, and the more hawkish members adding further hikes in 2022. Market-implied forecasts suggest investors are now expecting the first rate hike to occur in late 2022.

Fed’s Dot Plot



Bloomberg. 09/24/21

Relative to our view at the beginning of this year, we think the potential for a more sustained period of inflation, averaging between 2-3%, has increased. The change in the outlook is due in large part to the continuation of global supply chain disruptions and the impact that the sharp rise in home prices will have on inflation readings over the next 9-12 months. However, beyond 2022, inflation will continue to face the same longer-term structural forces – including aging demographics, high levels of public and private sector debt and the deflationary impact of technological advancements – that have kept inflation averaging below 2% since the global financial crisis.

With this backdrop, we expect interest rates to be biased slightly higher in the near term. However, from a portfolio construction perspective, we believe it’s important not to focus on specific yield forecasts and the directional strategies they can result in, preferring to keep duration decisions in a portfolio context. Rather, our primary focus is on other sources of investment return, such as sector allocation and security selection, which are more sustainable drivers of solid risk-adjusted returns.

The third quarter saw corporate credit markets in a ‘Goldilocks regime’ (neither too hot nor too cold), with spread levels remaining low and volatility muted.

In general, companies in the investment grade (IG) market have reported earnings that have shown stellar revenue growth, strong profitability and robust liquidity. This earnings backdrop, combined with management teams that have remained disciplined around capital deployment, has resulted in an improvement in corporate balance sheets and fundamentals. Meanwhile, demand for U.S. IG bonds has been robust given the low yield environment in other parts of the market.

However, current valuations have already priced in much of the good fundamental and demand news. The additional risk premium, or credit spread, investors are receiving for owning IG bonds rather than U.S. Treasurys is near the lowest level since 2007. Furthermore, valuations appear more stretched after adjusting for the longer duration and lower credit quality metrics of the market today compared to 2007. While valuations are not in themselves a correction catalyst, they do frame the risk-return skew.

Uncertainty surrounding regulatory, anti-trust, and tax policies may create headwinds for IG corporate credit. An increase in the corporate tax rate would lower post-tax income, as well as lower the incentive for companies to decrease leverage as the tax shield benefit from debt would be increased at higher tax rates.

Another headwind may come from shareholder-friendly activities. A combination of economic optimism and low funding costs could drive an increase in dividends, share buybacks and M&A. These activities typically weaken a company's balance sheet and, to the extent they are funded with debt, bring additional supply to the market.

Lastly, there are several catalysts, including the prospect of the Fed tapering and economic data surprises that could result in periods of higher volatility. While an increase in volatility can pressure spreads wider over the short term, it can also provide attractive opportunities.

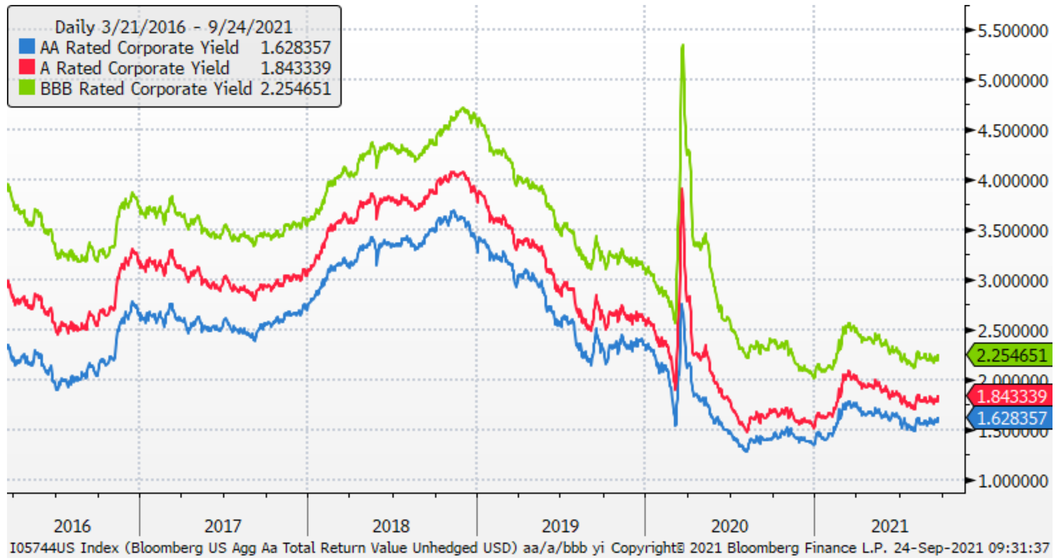
Overall, we continue to find IG corporates relatively attractive in the context of very low global government bond yields. At an aggregate level, additional spread compression will be limited, meaning that the majority of returns will come from coupon income.

At a more granular level, there are opportunities in select issuers that possess the potential for spread compression. We are focused on companies with high barriers to entry, pricing power, strong asset coverage and management teams that favor bondholders.

At a ratings level, we believe BBB-rated bonds continue to be the sweet spot in the credit ratings spectrum, offering a healthy yield pickup over A-rated bonds and management teams that are taking a more conservative approach to managing their balance sheet. At a sector level, we are finding opportunities in short-dated autos, banks communications, housing-related issuers, select technology companies, and pipelines.

Security avoidance will also be critical. Against a backdrop of stretched valuations, we seek to purposefully avoid companies that are pursuing more aggressive financial policies, resulting in a deterioration in the strength of their balance sheets.

Investment Grade Bond Spreads



Banks, the main issuer of preferred securities, have continued to reported stronger-than-expected improvements in earnings, credit quality and capital markets activity. The results of the Federal Reserve's 'stress test' also showed the strength of bank balance sheets. Even assuming severe stress in commercial real estate, consumer and corporate loans, the stress test results suggested all major U.S. banks would likely maintain capital ratios well above the minimum requirements.

In addition to strong fundamentals, the technical backdrop is also supportive. Robust new issuance has been more than offset by redemptions, while the search for yield continues to bring investors to the sector.

While the yield on preferred securities is lower than pre-pandemic, the decline has been driven by lower U.S. Treasury yields rather than a compression in risk premium. The favorable fundamental and technical backdrop suggest credit spreads could compress from current levels, which are at similar levels to the beginning of 2020.

We continue to find better value in fixed-to-floating rate preferreds compared to fixed-rate preferreds due to more attractive valuations and lower sensitivity to interest rates. In addition to U.S. preferreds, we find selective opportunities in preferreds issued by European banks.

In high-yield, credit spreads widened 20 bps during the quarter but remain close to the lowest level since 2007. An increase in M&A activity (with investment grade companies acquiring high-yield companies), a decline in defaults, strong corporate earnings, improved credit metrics, and a market that is of a higher average credit quality today than it was before the crisis are among the factors that could drive further spread compression.

The credit quality of the high-yield market has improved due to many of the weaker credits having been purged by the pandemic, while a high percentage of fallen angels and a preference by equity sponsors to fund lower-quality credits in the loan market has contributed to a rising share of BB-rated bonds.

Municipal bond valuations remain historically rich, with 10Y AAA yields at only 70% of U.S. Treasury yields. For a fundamental perspective, the overall credit quality of the muni market continues to exhibit considerable strength, with revenues for many state and local governments exceeding projections. In addition, municipalities have benefitted from strong equity market returns that have improved the outlook for many public pension plans.

While reinvestment income from coupon income, calls and maturities continues to exceed new issuance (i.e., negative net supply), demand for munis remains robust, creating a very strong technical backdrop for the sector.

10Y AAA Municipal Bond Yields as a Percentage of U.S. Treasury Yields

Within the muni market, our focus remains on high-quality, general obligation bonds, which benefit from the taxing power of the municipality and essential service revenue bond sectors – those backed by utilities, such as water and sewer. Most utilities tend to have significant liquidity, the ability to raise rates, and strong operational and financial performance throughout the business cycle. This is due to the fact that their services are 'essential,' and their structures are monopolistic.

While non-agency mortgages have largely recovered to pre-pandemic levels, we continue to believe that the sector presents one of the most attractive risk-adjusted opportunities within fixed income markets. Fundamentally, these securities have benefitted from a very strong housing market, which has seen prices increase by over 19% year-on-year – an all-time record. The boom in home prices has been driven by a combination of affordability from historically low mortgage rates, low housing supply and increasing demand from both the millennial generation (the largest U.S. demographic cohort in history) and evolving work-from-home dynamics. Furthermore, conservative underwriting standards since the global financial crisis have helped delinquency and default levels to remain low.

Conversely, the agency residential and commercial mortgage sectors appear unattractive. The combination of the Federal Reserve's asset purchase program and strong demand from commercial banks has pushed valuations to very expensive levels. Looking ahead, both the Fed and banks appear set to reduce their purchases in the coming months, which will remove a major support to the current elevated valuations in the sector.

Today's backdrop of historically low yields, compressed valuations and higher sensitivity to changes in interest rates (duration) has increased the importance for investors to actively manage their fixed income portfolios rather than passively allocate to the asset class.

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