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Q3 2022 Economics & Fixed Income Outlook

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The first half of the year has been an annus horribilis for the global economy as the confluence of high inflation, war, commodity shortages, COVID, and central banks have combined to negatively impact growth.

Domestically, inflation hit the highest levels in four decades, gasoline and diesel prices hit all-time highs, and the Federal Reserve (Fed) rapidly pivoted to remove accommodative policies that had been in place since the start of the pandemic.

The U.S. May inflation (CPI) data saw inflation at a 40-year high, with the headline and core CPI running at 8.6% and 6% year-over-year, respectively. Historically, most economic recoveries have only been related to demand-driven inflation. However, the current recovery has seen inflation fueled by excess demand and by lower supply.

The demand side has been driven by the response to the pandemic-induced recession where ‘authorities’ not only over-stimulated the financial system with low rates and quantitative easing but also directly supported consumers with more than $1.5 trillion in stimulus. All told, there was over 3.5 times the amount of stimulus in 2020 relative to the total spent in the aftermath of the global financial crisis.

On the supply side, the U.S. economy is challenged with a lack of supply in three critical areas:

- **Labor** – roughly two million workers are ‘missing’ from the workforce due to early retirement and lower immigration. Furthermore, deglobalization is going to increase the cost of labor.
- **Housing** – Following the global financial crisis, the U.S. housing market has been undersupplied by roughly 3 million units. Meanwhile, the demand for housing has been increasing as millennials move into their prime years for single-family housing demand. Housing has a substantial impact on inflation, accounting for nearly 40% of core consumer price inflation (CPI).
- **Commodities** – Despite high energy prices, investment in new projects remains moderate as companies are fearful of overspending, regulations, and aware of the longer-term transition to ‘clean energy’.

There are some areas where inflation pressures are beginning to show signs of easing, including rising inventory levels, a decline in global transportation rates, as well as early signs of a moderation in the housing market, which over time will feed through to shelter inflation. While the moderation in inflation will be more protracted than initially expected, it is important to remember that the long-term trends such as aging demographics and high debt burdens – which have suppressed inflation for much of the past decade – are likely hibernating rather than reversing.

The U.S. consumer – which historically has represented nearly 70% of economic activity – has been a key driver of the COVID-era economic expansion. However, higher commodity prices act as a 'tax' on consumers and reduce real income, pushing down demand. High-frequency credit card data is showing a slowing in both goods and services spending and surveys are showing that consumer confidence is low. The savings rate, which was above 10% just 12 months ago, has declined to 4.4% - which is nearly 2% below the long-term median – as wage growth has failed to keep up with inflation.

The impact of the Fed's recent actions can already be seen in the economy. The housing market, which is one of the most interest rate-sensitive sectors of the market, is cooling. The combination of the substantial appreciation in home prices over the past 2 years and the recent sharp move higher in mortgage rates has pushed affordability to the worst level in history. It is important to differentiate between home prices and the impacts of housing on the economy. As discussed above, the U.S. has 'underbuilt' the number of required homes to keep up with demand since the financial crisis, which has resulted in a lack of housing supply. Therefore, while home prices are expected to moderate, it is unlikely prices will decline significantly.

There are two other important differences between today and the 2005-2008 period. First, by the end of the financial crisis, roughly 1 in 4 borrowers had negative equity in their homes, meaning the borrower owed more than the home was worth. Today, the average level of home equity is approaching 60%, the highest on record. Second, at the start of the financial crisis, 36% of mortgages were adjustable-rate (ARMs), meaning a borrower's monthly payment would reset to a higher rate if interest rates increased. Today, only around 8% of outstanding mortgages are ARMs, meaning for 92% of borrowers, the recent rise in mortgage rates has had no impact on their monthly payments.

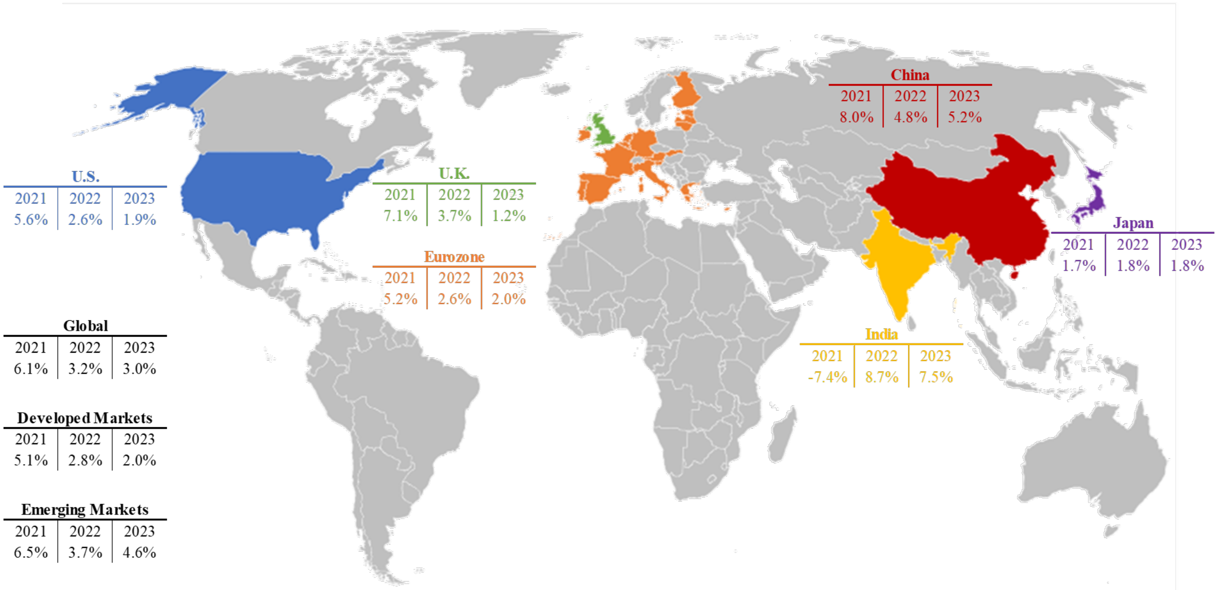
However, while people may not be forced out of their homes, as was the case in the aftermath of the financial crisis, stagnant home prices do negatively affect consumer confidence. Furthermore, the recent rise in mortgage rates means that many borrowers are "rate-locked" into their homes. In other words, they are unable to move because the increase in mortgage rates means they are unable to buy a home of similar value for a similar monthly payment.

The housing industry also has wider knock-on effects on the economy, fewer people moving or refinancing means that mortgage lenders are beginning to reduce headcount, and there will be less money spent on moving vans and new furniture, which in turn will have an impact on employment in those fields.

During the coming months, the potential outcomes of the U.S. mid-term elections will become a bigger topic of discussion within financial markets.

Overall, the odds of a recession over the next 12-24 months are elevated, reflecting the impacts of stubbornly high inflation that is reducing real household income and negatively impacting consumer and business confidence. In addition, the Fed's intense focus on curtailing inflation will continue to tighten financial conditions, which increases the chance of a policy mistake that tips the economy into a recession. This is different than prior periods of slowing growth when the Fed has been able to respond by easing policy. This was not a hard decision as inflation was below its 2% target. However, with inflation continuing to run significantly above target, central bankers will not be able to respond with stimulus.

<u>Median Global Economic Growth Forecasts:</u>



Source: Bloomberg as of 6.30.22

The outlook for the European economy has darkened since the start of the year. The region is bearing the brunt of the fallout from the war in Ukraine, inflation pressures are increasing, slower Chinese growth is impacting European exporters, the European Central Bank (ECB) has turned more hawkish, and peripheral risk has returned as the yield on Italian government debt has increased sharply.

Thus far, economic activity has remained resilient; however, both business and consumer confidence has fallen sharply with the spike in inflation cutting into households' purchasing power. Economic growth could be supported by a strong fiscal policy response, including increased defense spending and accelerated investments to secure viable alternatives to Russian energy. Many European governments have also introduced fiscal schemes to offset the impact on consumers of higher commodity prices.

In the near term, the chances of a recession have increased considerably. If Russia cuts off natural gas supplies to the region, the economy would almost certainly enter a recession.

The resignation of Boris Johnson as U.K. prime minister, following a series of scandals, is just one more item to add to the growing list of challenges the U.K. faces as the economy grapples with a combination of one of the highest inflation rates in the developed world and slowing growth. In addition, national insurance contributions have increased and Brexit-related idiosyncratic developments continue to create uncertainty.

In short, the combination of high inflation, central bank tightening, and profound risk of a policy error given the political turmoil suggest the U.K. economy will continue to slow and the potential for a recession is elevated.

The magnitude of inflation in Japan (1.2%) looks minor relative to the rest of the developed world. However, wages have remained stagnant, meaning that households are still seeing a compression in real income levels, which will be a headwind for the economic recovery. Meanwhile, the Bank of Japan (BoJ) has recommitted its intent to control the yield curve by purchasing 10-year Japanese government bonds whenever yields increase above 25 basis points. However, the market is questioning whether the BoJ will be able to sustain yield curve control. This skepticism has resulted in the Yen falling to a 24-year low. While a weaker Yen could be beneficial to Japan's export sector, it could result in unforeseen systemic risks in the future.

In China, stringent controls around COVID have caused significant interruptions to manufacturing and increased pressure on an economy that was already struggling with the effects of a real-estate downturn and a regulatory clampdown on certain industries.
In March, around 40% of the nation's gross domestic product, or an estimated 25% of the population covering over 40 cities, was in full or partial lockdown. The impact of the zero-COVID policy has had a significant impact on both domestic growth and global supply chains.

While authorities in China are implementing several policies to try to stimulate growth, the strength of the recovery will be highly dependent on the evolution of COVID. Less effective domestic vaccines, coupled with low natural immunity, leave the Chinese population vulnerable to infection and will likely continue to necessitate future lockdowns when outbreaks occur. The start-stop restrictions strengthen the case for global companies to diversify supply chains, a trend that was already in place.

Outside of China, many emerging market (EM) economies are going to feel the negative impacts of higher energy and food prices, softer global demand, and tightening global liquidity conditions. Food often accounts for more than 30% of the household spending basket in EM countries, compared to 15% or less in the developed world. The fallout from higher food prices may serve as a catalyst for political turmoil in certain regions, similar to the Arab spring uprisings in 2011-12.

The term "emerging markets" covers a broad and diverse group of countries with some – such as commodity-exporting Latin American countries – benefitting from higher prices. In addition, certain countries will benefit from the 'near-shoring' or 'friend-shoring' as companies diversify and relocate supply chains out of China.

Global economies are coming under a period of pressure from multiple fronts. Elevated inflation has prompted central banks to quickly shift from accommodative to restrictive policy in short order. The war in Ukraine has fanned a surge in energy and food prices and COVID lockdowns in China have both added fuel to the inflation fire. As a result, the global economy is entering a period of slower growth, which has the potential to result in a recession.

It is important to remember that recessions are normal parts of a business cycle and not all recessions are as painful as the financial crisis. In the U.S., household and corporate balance sheets are still relatively healthy, unemployment remains low, and the banking sector is safer, meaning there is less systemic risk in the U.S. economy compared to the years leading up to the global financial crisis.

We are also aware that risks evolve, and there are many 'unknown unknown' risks, which are the ones that have the largest impact on financial markets. Therefore, we remain vigilant to the changing macro environment and evaluate these evolving factors by stress testing and 'shocking' the playbook to understand the potential impact on financial markets and investment portfolios.

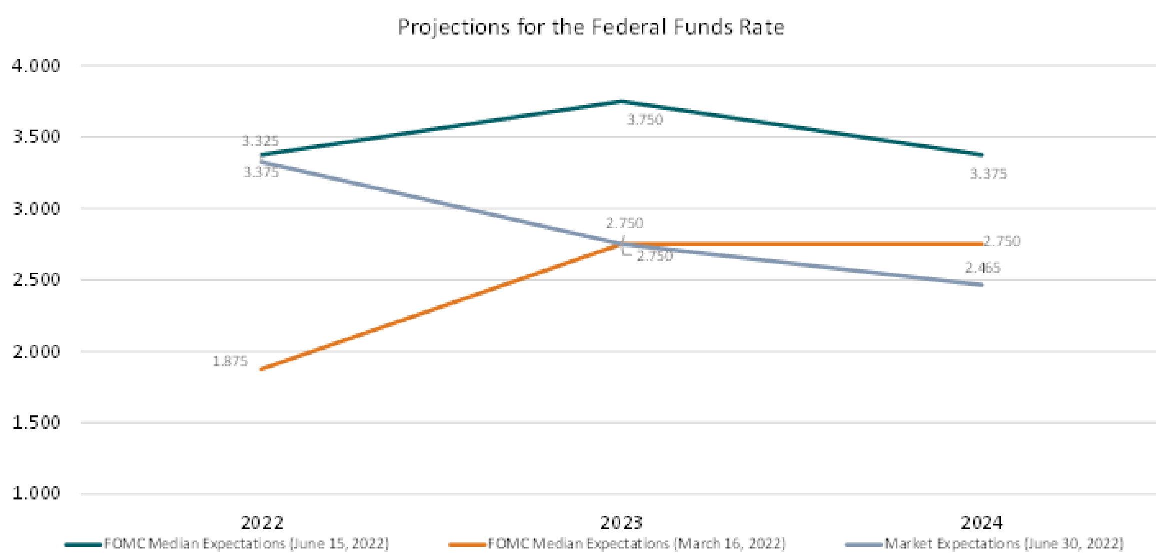
Fixed Income:

For bond investors, the first half of the year was the most challenging in at least fifty years. High inflation driven by the lingering effects of the global pandemic and Russia's invasion of Ukraine coupled with the subsequent monetary policy response resulted in sharp increases in interest rates, wider credit spreads, and negative returns across all fixed income sectors.

The silver lining of the bond market sell-off is that yields are now much more attractive. Future returns for bonds have historically been tied to starting yields. While rising rates resulted in price losses in the first half of the year, they also result in larger coupons in future years, which help offset those losses and over time lead to higher long-term returns.

At the June meeting, the Fed raised the policy rate by 75 basis points (bps), the largest policy rate increase since 1994, clearly reflecting its resolve to restore price stability and keep inflation expectations anchored. The move increased the Federal Funds Rate to 1.5-1.75%, up from a range of 0-0.25% at the beginning of March.

The Federal Reserve (Fed) also released its updated 'dot plot,' which provides projections for the level of the Federal funds rate at year-end through 2024 as well as an estimate of the neutral rate, as indicated by the median of their longer-run projections. The dot plot shows the Fed's expectation for the policy rate to double in the second half of the year to end 2022 at 3.4%, followed by modest additional tightening next year to 3.8% before anticipating rate cuts in 2024 back to 3.4%.



Source: Bloomberg as of 6.30.22

Interestingly, even with a more aggressive policy tightening path, the Fed's updated economic projections still imply a 'soft landing' where they tighten financial conditions substantially to bring down inflation without a meaningful rise in unemployment or a recession.

The Fed has also begun reducing the size of its balance sheet, a course of action known as 'quantitative tightening,' by ceasing to reinvest the proceeds of maturing bonds. However, the Fed has not yet chosen to take the more aggressive path of directly selling bonds.

Currently, the market is priced for another 75 bps hike at the July meeting, followed by 50 bps at both the September and November meetings and 25 bps at the December meeting. If this occurs, the policy rate would end the year at roughly 3.50%.

If the Fed does hike rates by 75 bps at the July meeting, it will have taken the Fed funds rate from 0% to ~2.5% - the Fed's estimate of the long-run neutral rate - in just 4 ½ months. From that point, additional rate hikes will shift from the removal of accommodation to outright restriction.

These actions follow the narrative that the Fed needs to bring down inflation by rapidly tightening monetary policy into restrictive territory, similar to the manner Fed chairman Volcker did in the 1980s. However, this misses the point that inflation today, similar to the 1980s, is being driven not only by increased demand but also by a supply shock.

A common fallacy is that aggressive rate hikes by Volcker in the early 1980s brought down inflation. However, in truth, Volcker's policies created two back-to-back deep recessions that merely served to interrupt inflation. It was not until he had the tailwinds of declining energy prices and corresponding supply-side fiscal policies that the back of inflation was finally broken.

While tighter monetary policy can decrease demand to a certain extent by increasing the cost of money and credit, it cannot fix the supply issues which are occurring in two critical inelastic areas – food and energy. Similar to the 1980s, the shortages need to be addressed by a policy that increases the productive capacity of the U.S. economy so that supply in these critical areas increases to meet demand.

In other words, supply and demand need to work together to bring down inflation permanently. The focus solely on tighter monetary policy through higher rates risks creating a recession and an environment where inflation may return once the economy begins to recover.

Given our view of a slowing macro environment, we have a more favorable view of U.S. Treasury bonds, which tend to outperform other fixed-income sectors when the risk of a recession increases. Treasury bonds also provide a source of funds during periods of volatility and bouts of illiquidity to take advantage of attractive opportunities that may present themselves in other sectors of the market.

An increase in interest rate volatility has been a strong headwind to Agency mortgage-backed securities (MBS). The sector also has been impacted by concerns that the Fed may begin selling Agency MBS from its balance sheet in the future.

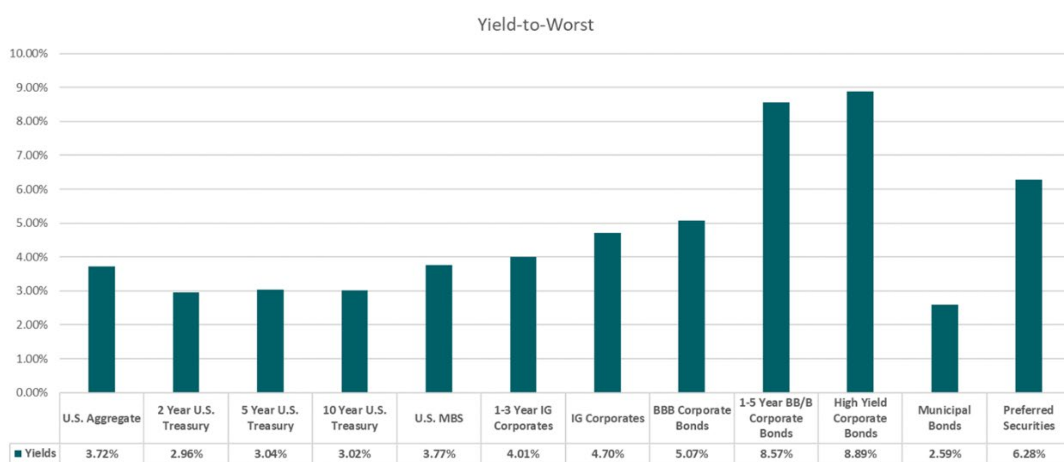
However, valuations in the space are approaching extremes with the risk premium, or spread, very wide to U.S. Treasurys on a historical basis. In addition to more attractive valuations, the convexity profile of Agency MBS has materially improved, mitigating a traditional headwind for the sector. This improvement has been fueled by the steep decline in prepayment speeds to historically low levels. An estimated 99.5% of U.S. borrowers have locked in mortgage rates below the current rate of 5.78%, and 96% of borrowers hold mortgages with a rate at least 1% below current rates. As a consequence, prepayment speeds are likely to remain low. Therefore, for the first time in many years, Agency MBS is attractive, particularly relative to Treasurys.

Corporate balance sheets entered the year in a strong position, having benefitted from the economic reopening and accommodative financial conditions that allowed debt to be issued or refinanced at low rates. However, the challenging macro backdrop of higher interest rates and increased recession risks impacted the corporate bond sector. Credit spreads of investment-grade (IG) bonds widened by 63 bps in the first half of the year, ending the second quarter at 155 bps. During recessions, IG spreads have historically traded to around 225-250 bps, meaning that spreads today are priced nearly mid-way between the non-recessionary average and the average level during a recession.

Companies are experiencing margin compression (albeit from peak levels) due to higher input costs (labor, raw materials, transportation) that have a corresponding impact on earnings. Large multi-national companies will also face the headwind from a strong U.S. dollar. Several companies revised their earnings outlook lower during the second quarter, and it seems probable that others will follow during the upcoming earnings season.

In structuring portfolios, we continue to see value in the BBB bucket of IG, particularly issuers that have an essential need to maintain an IG rating. Despite a slowing economic backdrop, we are thoughtful about exposure to companies with ratings of A or above. These bonds often have longer interest rate sensitivity (duration) and higher event risk – such as share buybacks, increased dividends, or merger and acquisition risks – as these issuers can more easily dilute valuations for bondholders without the risk of losing investment-grade ratings.

From a sector perspective, we are focused on selecting sectors that are broadly defensive, such as banks, communications, pipelines, and utilities while seeking to avoid or underweight sectors that are closely linked to the cyclicality of the economic cycle, such as autos and retail. Within sectors, individual credit selection will remain a key driver of performance with security avoidance being equally as critical as security selection.



Source: Bloomberg as of 6.30.22

We remain cautious about exposure to high-yield (HY) bonds. Despite credit fundamentals remaining sound thus far, geopolitical, inflation, and recession risks present tangible concerns.

In addition, the sectors are vulnerable to outflows and 'air pockets' created by periods when liquidity is constrained. Spreads have widened but the HY market is in uncharted territory as the Fed typically does not hike rates when credit markets are trading at 'stressed' levels.

While we expect a pickup in default rates within the HY market, we don't anticipate the type of dramatic spike that occurred during the 2000 dot-com bubble or the 2008-09 financial crisis, given the stronger credit fundamentals of borrowers today relative to prior periods. Overall, HY valuations are getting close to a level we view as an attractive entry point, one which we think compensates investors for the potential of a recession. One area within HY we do see some attractive opportunities is select short-duration, higher-quality (Ba / BB) bonds.

In the case of bank loans, the product has been viewed (and in many cases sold) as a panacea for rising interest rates. While it is true that the coupon is typically floating rate and resets as short-term interest rates move higher, the ability of the underlying borrower to make payments also has to be considered.

The benchmark rate for most floating-rate debt is 3-month Libor, which is highly correlated to changes in the fed funds rate. Corresponding to rate hikes by the Fed, 3-month Libor has increased by almost 200 bps since the start of the year, and the forward curve implies another 125 bps of increases over the remainder of 2022. This sharp increase in borrowing costs has the potential to create cash flow stress for companies, particularly against the backdrop of a slowing economy.

Securitized credit, particularly non-agency mortgages, remains compelling with attractive yields and solid credit fundamentals. The sharp appreciation in home prices over the past two years supports the underlying asset and the credit quality of borrowers.

As with other sectors in the fixed income market, preferred securities have experienced a meaningful price decline during the first half of the year. Despite the sell-off, the underlying fundamentals of banks (the main issuer of preferred securities) remain solid. The results of the recent Federal Reserve's 'stress test' highlighted the resilience of bank balance sheets to adverse economic and market scenarios.

Market volatility during the first half of the year resulted in discernibility across the preferred market segments and security structures with lower duration floating-rate and fixed-to-floating securities outperforming longer-duration fixed-for-life securities.

Despite the recent outperformance, 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 March, President Biden signed into law the Adjustable Interest Rate Act, which allows for the use of a replacement rate to Libor on all U.S. securities. This will ensure a smooth transition to an alternative floating-rate index for all legacy preferred securities that reference Libor.

After ending 2021 relatively 'rich' by historical standards, municipal bond investors experienced an unprecedented drawdown during the first half of the year. The decline in prices was driven by increasing Treasury yields and the negative technical combination of record-high outflows and substantial new issuance.

Despite the rocky start to the year, credit quality remains strong with underlying fundamentals having improved meaningfully – from already solid footing – since the outbreak of the pandemic. Government stimulus programs during the past two years provided muni entities with an estimated $1.2 trillion, and the passage of the $500 billion infrastructure bill in late 2021 will provide many of them with additional funding for several years. At the same time, tax revenues have risen to all-time highs, driven by increased consumer spending and higher home prices. Issuers have used this influx of cash to pay down debt, fund pension liabilities, and/or make deposits into 'rainy-day' funds.

On a relative value basis, 10-year AAA-rated munis are trading around 90% of the 10-year Treasury yield (muni yield/Treasury yield), which is in line with the longer-term median. However, the yield ratio between munis and Treasurys has been volatile this year, ranging from just 60% at the start of the year to as high as 105% in mid-May.

From an issuer perspective, we continue to focus on high-rated general obligation bonds, which benefit from the taxing power of the municipality and essential service (such as water and sewer) revenue bonds where services are truly 'essential' regardless of the economic environment, and the municipality acts as a monopoly.

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