Fourth Quarter 2022 Economics & Fixed Income Outlook

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As we begin the fourth quarter, inflation remains the dominant macroeconomic factor for most regions around the world. Domestically, inflation has not only continued to exceed expectations but also has become broader-based with 84% of the underlying components running above the Federal Reserve's (Fed) 2% inflation target in the August consumer price inflation (CPI) report. Furthermore, the composition of the factors driving inflation has shifted from the more transitory, volatile components – such as used car prices – to more persistent components, like shelter, which is a particularly influential component of CPI.

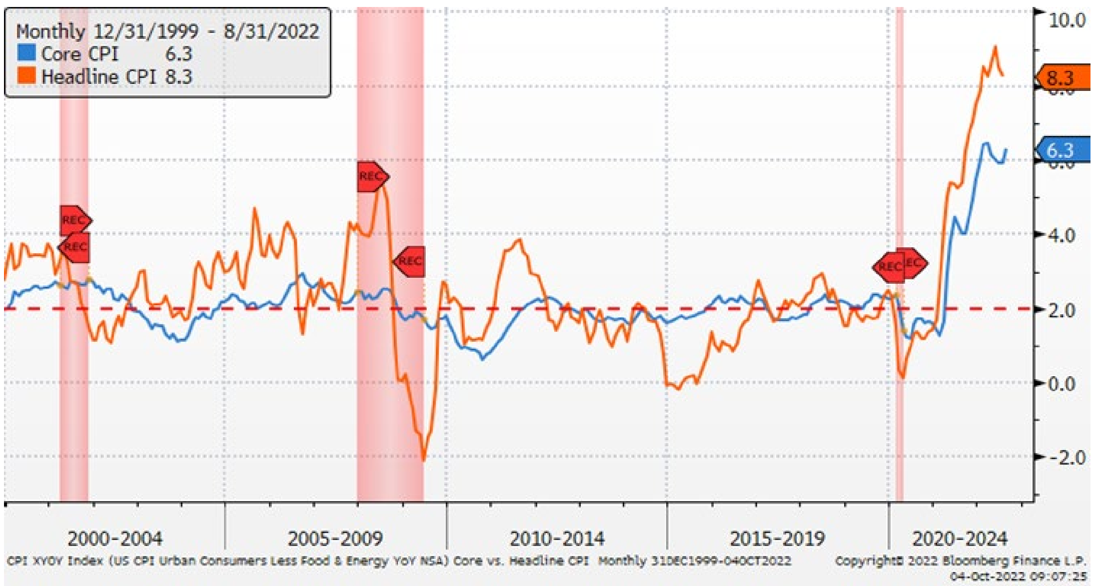
In response, the Fed has acted aggressively, hiking rates by 300 basis points (bps) between March and September and forecasting another 125 bps of rate hikes over the remainder of the year. The message from the Fed (thus far) has been clear: they are willing to tolerate some economic pain to bring inflation down.

Some impacts of the Fed's rate hikes are already showing up in the economy. The interest rate for a 30-year mortgage has more than doubled since the beginning of the year. Higher mortgage rates, combined with the large increase in home prices over the past 18 months, have left housing affordability at the lowest level since 2006. The importance of residential home building – with its many knock-on effects on other industries – means a slowdown will be a drag on economic growth.

However, despite a decline in construction and transactions, a significant slowdown in the real estate market appears unlikely due to the historic underinvestment in residential single-family since the financial crisis, with an estimated current shortage of around 3 million units.

While the number of job openings has declined, the unemployment rate remains near an all-time low. The tightness of the labor market has resulted in hourly wages increasing by double the amount it was pre-pandemic. However, despite the solid pace of nominal wage growth, real wage growth (after inflation) has been negative. The decline in real purchasing power has shifted household buying patterns and in turn, has left businesses with increased inventory as demand for more discretionary goods has fallen.

The Fed's determination to tackle inflation will likely lead to an increase in the unemployment rate over the coming year, with the cooling of nominal wage growth a requirement for inflation to return to the Fed's target.



While the energy self-sufficiency of the U.S. will insulate it from the power crisis many other parts of the world are experiencing, impaired trade flows and supply chain disruptions will be an additional stagflationary shock to the economy. Less than 5% of inputs in overall goods and services consumed in the U.S. are sourced in Europe, but the pandemic demonstrated how a shortage of small value-add components can have large ripple effects through the supply chain.

The U.S. mid-term elections in November have taken a backseat for financial markets given the plethora of other issues to focus on. Regardless of the outcome, we expect that economic fundamentals – rather than any particular election outcome – will play a greater role in market performance over the intermediate to longer term.

The U.S. Dollar (USD) has been one of the best performing financial assets in 2022, on track to produce one of its strongest showings since 1973. The strength of the USD has mixed implications for the U.S. economy. On the one hand, it should help dampen inflation as the cost of imports for U.S. consumers is lower. However, it will serve as a drag on real economic growth by increasing the trade deficit. As the world's reserve currency, a stronger USD has global ramifications ranging from profitability headwinds for U.S. multinationals to the ability of emerging market borrowers to service their USD-denominated debt.

Declining home sales, increasing inventories, rising unemployment, and tighter monetary and fiscal conditions indicate the likelihood of a recession is elevated, but one that is relatively shallow due to:

- The strength of household and private sector balance sheets,
- Excess labor demand
- Healthy banking system,
- The fact that debt constraints ease in inflationary environments (i.e., inflation helps erode fixed rate debt).

However, such a recession could be longer in duration – particularly when compared to March 2020 – as the willingness and ability of fiscal and monetary authorities to provide stimulus will be reduced given the current inflationary environment. In other words, a recession might be more like a Scottish summer with light but steady rain rather than a brief, heavy storm.

After an expeditious recovery from the pandemic, the European economy has literally and figuratively run out of gas. The supply of natural gas – which accounts for around one-third of Europe's energy supply – has increasingly been weaponized by Russia, most recently 'suspending' flows through the Nord Stream 1 pipeline to Germany. These actions have sharply increased natural gas prices in Europe and introduced the prospect of energy rationing this winter.

Governments around Europe have already announced nearly €400 billion in support measures in response to the energy crisis. The European Union (EU) has announced a plan for 10% in energy savings and an EU-wide price cap that will be funded in part by a windfall tax on energy producers. Price caps and subsidies may have the unintended consequence of keeping demand for energy elevated at a time when supply is limited.

Despite the support measures, the rise in energy costs is weighing on both the household and corporate sectors and negatively impacting economic activity. Given that backdrop, it is hard to envision the region not experiencing at least a mild recession, with the prospects for a deeper recession if the winter season turns out to be colder or more prolonged than usual.

While the U.K. is less reliant on Russian energy, it is nevertheless a net importer of energy, and as such is sensitive to soaring global costs. The first executive action of the new Prime Minister, Liz Truss, was a plan to cap household energy prices at £2,500 for the next two years. While this is still a notable increase from roughly £1,000 last year, it is significantly lower than where prices would have been set in the absence of a cap (estimated to be £5,000 per household).

However, by capping energy costs, the U.K. government has effectively taken a massive short position in the gas and electricity wholesale markets. Should wholesale prices rise because a cold winter increases demand, or Russia further squeezes supply, the cost of this package will also increase – without a ceiling!!!

Additional support for the U.K. economy was announced by the new Chancellor of the Exchequer, Kwasi Kwarteng. The package included substantial tax cuts for both individuals and businesses. However, the announcement was met with skepticism by financial markets due to concern that the stimulus may spark additional demand and inflation at an inopportune time. This raised questions about the sustainability of government financing.

The package also created tension within the Conservative Party, with many members unhappy that the tax cuts will be funded by borrowing at a time when the government is already increasing its debt level to cap energy costs and that the reduction in the top tax rate gave the appearance that the government is prioritizing the wealthiest earners over those on lower incomes. The threat of a rebellion in the ruling party forced the Chancellor into scrapping the plan to cut taxes for the top tax bracket.

In short, constrained energy supply and the resulting higher prices will impact both consumers and businesses this winter. The potential for blackouts will hinder industrial production and in turn exports. Lastly, central banks are tightening monetary policy as they are focused on reducing inflation. Combined, these factors are likely to tip both Europe and the U.K. into a recession.

Japan is unique among the global economy as one of the few with a benign inflation backdrop and a central bank that is not hiking interest rates. However, the divergence in monetary policy between Japan and the U.S. has resulted in a sizable decline in the value of the yen. In response, the Japanese government intervened in the currency market for the first time since 1998 to support the yen, which had fallen to a 24-year low against the U.S. dollar.

The Chinese economy has weakened significantly in 2022 as the authorities continue to follow the COVID zero playbook, resulting in a series of rolling lockdowns throughout the year. China's megacities, those with more than 10 million residents, have seen more lockdowns in 2022 than in the previous two years. This policy has significant implications for the Chinese and the global economy. The restrictions on mobility have severely dampened demand for goods and services domestically and caused further dislocations in the global supply chain.

Economic growth has also been negatively impacted due to a sharp downturn in the property market and power shortages, resulting from droughts in parts of the country, which has impacted manufacturing. China's increasingly complex relationship with the U.S., with frictions around technology and finance as well as escalating tensions over Taiwan, creates additional uncertainty.

The Chinese central bank (PBOC) and the government have stepped in to try to support economic growth by cutting borrowing costs and providing fiscal stimulus. A more durable recovery will likely require a softer stance on the COVID-zero policy; however, the timing of such a change is very uncertain. Given this backdrop, economists have steadily downgraded the outlook for China's economic growth this year, with the most recent Bloomberg survey showing a median forecast of 3.5%. If realized, this would represent the slowest growth rate of the Chinese economy – outside of 2020 – since 1976.

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 catalyze political turmoil in certain regions, similar to the Arab spring uprisings in 2011-12.

The strength of the U.S. dollar will also be a headwind to emerging markets since two-thirds of emerging market debt, foreign exchange, and global securities are denominated in U.S. dollars. A stronger dollar makes debt repayment more expensive in local currencies. However, it is important to remember that the term "emerging markets" covers a broad and diverse group of countries with some – such as commodity-exporting Latin American countries – benefitting from higher commodity prices.

Significant uncertainty clouds the outlook as the global economy continues to confront elevated inflation, tightening monetary policy, and geopolitical tensions including a partial unwind of globalization. Such a backdrop implies a greater divergence in economic conditions across the world.

The predominant risk we are monitoring is that central banks overtighten monetary policy resulting in a recession and/or causing ruptures in financial stability. The risk of a financial market 'accident' is higher when central banks, using the blunt interest rate and balance sheet tools, have to slow demand. There are also second-round effects from these policy actions that can take time before the full impacts are felt.

We are cognizant of "Knightian uncertainties," which are essentially unmeasurable and represent the unknowable unknowns – that always exist.

Together, the current elevated level of 'known' risk factors, as well as, the 'unknowable unknowns' that always exist, highlight the importance of an active and flexible strategy around asset allocation and portfolio construction. The quote from American author and Pastor John Maxwell "be stubborn about your vision, but flexible with your playbook" is particularly apt at this time.

Q4 2022 Fixed Income Outlook:

Faced with the continuing challenge of the highest inflation rates in four decades, the Federal Reserve (Fed), as was widely expected, delivered a third 75 basis point rate hike at its September meeting. This increased the policy rate to a midpoint of 3.125% (range of 3.0-3.25%).

The messaging through Chair Powell's press conference and the updated summary of economic projections (SEP) were clear: the Fed is fully committed to reducing inflation and will raise rates to the point where demand, particularly labor demand, declines to be more in balance with constrained supply, even if that process takes its toll on economic activity. Chair Powell has also recently highlighted the Fed's focus on avoiding a repeat of the 1970s when the Fed reversed its policy too quickly and inflation returned. In other words, the Fed will be slower to step in and support financial markets through interest rate cuts than it has been over the past 15 years.

The updated 'dot plot' – which provides projections for the level of the federal funds at year-end – highlighted a more hawkish view. The median expectation for where the fed funds rate will end this year was 4.4%, up from June's expectation of 3.4%. This suggests another 125 bps of rate hikes this year. The outlook for the peak level in the funds rate also increased from a median expectation of 3.8% after the June meeting, to 4.6%.

	Policy Rate			
	2022	2023	2024	2025
June	3.375%	3.750%	3.375%	N/A
September	4.375%	4.625%	3.875%	2.875%
Current Market-Implied Pricing	4.23%	4.04%	3.17%	2.85%

	Unemployment			
	2022	2023	2024	2025
June	3.7%	3.9%	4.1%	N/A
September	3.8%	4.4%	4.4%	4.3%

	Core Inflation			
	2022	2023	2024	2025
June	4.3%	2.7%	2.3%	N/A
September	4.5%	3.1%	2.3%	2.1%

	Economic Growth			
	2022	2023	2024	2025
June	1.7%	1.7%	1.9%	N/A
September	0.2%	1.2%	1.7%	1.8%

Source: Bloomberg, 9/21/2022

The Fed also revised the expectations for unemployment, inflation, and economic growth. While the Fed projections do not forecast a correction in economic activity over the next three years (it would be hard for any central banker to admit that is what they were aiming for), it appears increasingly likely that a recession, and a more meaningful increase in the unemployment rate, may be needed to bring down inflation, which has become increasingly broad-based. Investors are also having to negotiate the implications of quantitative tightening (QT), as the Fed reduces the size of its balance sheet and effectively takes liquidity out of the economy.

Except for Japan and China, every other major global central bank is also hiking policy rates, signaling the end of the era of cheap liquidity as inflation has become a prominent risk.

The real dilemma for global central banks is going to be balancing the need to tighten monetary policy with the need to maintain financial stability. The recent price action in the U.K. gilt (government) bond market, and the Bank of England's (BOE) response, highlight this tension. The BOE has been raising interest rates to combat inflation but was forced to buy longer-dated gilts at the end of September to restore orderly market conditions – akin to pushing the brake and accelerator at the same time. Recent yield spikes in Italian government bond yields suggest this type of intervention may not be a one-off.

Across bond markets, there has been a notable decline in liquidity, which is amplifying price movements. Credit markets have been particularly susceptible to this volatility with risk premiums (in the form of credit spreads) frequently changing more than the underlying fundamentals would warrant. Understanding this dynamic is critical in portfolio construction given the elevated uncertainty about the global economic environment.

Within core fixed income portfolios, we are taking several steps to increase the liquidity of portfolios including adding short-and-intermediate maturity U.S. Treasury bonds, reducing positions in more economically sensitive sectors, and holding more short-maturity (3 years or less to maturity) corporate bonds. The goal is to increase the resiliency of portfolios and provide flexibility to tactically maneuver if opportunities arise.

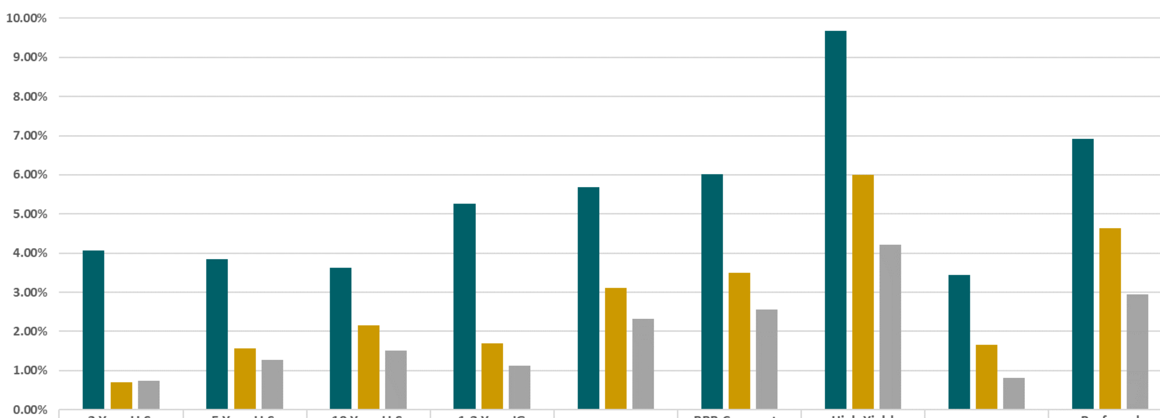
Following the significant recalibration in yields, 1-year U.S. Treasurys ended the quarter with a yield of nearly 4%. The short time to maturity limits price volatility, and these securities are among the most liquid across global financial markets, meaning that they can be a source of funds to pursue opportunities that may arise.

Further out on the yield curve, intermediate-maturity (5-10 years to maturity) U.S. Treasury bonds, are at the highest nominal and real (after inflation) yields since 2008. In addition to providing attractive income, today's prices provide Treasury bonds with a better opportunity to act as a ballast and provide diversification in a portfolio context, which is important given the elevated potential of a recession.

For investment grade (IG) corporate bonds, the double whammy of higher Treasury rates and increasing risk premiums (credit spreads), has resulted in the worst first nine months to a year on record, with the index declining about double the amount it declined during the first nine months of 2008. The sell-off has been particularly acute in the longer-duration (10+ year to maturity) portion of the market, where we have very little exposure.

Looking ahead, the yield-to-worst on the IG index is now above 5.69%, the highest yield since June 2009. The increase in yield since the start of the year means that the income generated will provide a better buffer against any further price decline resulting from higher interest rates or wider credit spreads.

Short-maturity (1-3year) IG corporate bonds look especially attractive on a risk-adjusted return basis with yields over 5% and lower sensitivity to changes in interest rates.



	2 Year U.S. Treasury	5 Year U.S. Treasury	10 Year U.S. Treasury	1-3 Year IG Corporates	IG Corporates	BBB Corporate Bonds	High Yield Corporate Bonds	Municipal Bonds	Preferred Securities
Yield-to-Worst 09.30.2022	4.07%	3.84%	3.62%	5.26%	5.69%	6.01%	9.68%	3.44%	6.91%
10-Year Median YTW	0.71%	1.56%	2.15%	1.70%	3.12%	3.50%	5.99%	1.67%	4.64%
YTW 01.01.22	0.73%	1.26%	1.51%	1.12%	2.33%	2.55%	4.21%	0.82%	2.95%

Source: Bloomberg, 9/30/2022

In terms of sector positioning, we have a preference for industries that exhibit resiliency to rising rates, such as banks and insurance companies, and for segments of the market that may be better insulated from an economic slowdown such as communications and utilities. Conversely, we are cautious on more cyclical sectors of the economy as well as those that face regulatory, M&A, and/or obsolescence risk.

In terms of security selection, we are keenly monitoring capital management policies laid out by companies, particularly the use of cash. Management teams that decide to pursue overly aggressive shareholder-friendly activities – such as stock buybacks or higher dividend payouts – will jeopardize the creditworthiness and ratings of the company. The penalty for companies with AA or A credit ratings to pursue re-leveraging transitions is typically lower since an intra-IG rating downgrade has less impact on a company than a ratings downgrade from IG to high-yield. Therefore, we maintain our preference for BBB-rated issuers over companies with higher credit ratings, given the higher yield and lower likelihood of detrimental capital allocation.

On an issuer level, the quality of corporate balance sheets has – on aggregate – peaked for this cycle. This means that security selection, and avoidance, will be critical over the coming quarters. In general, our approach emphasizes companies with the ability to generate cash flow over a variety of economic environments, with resilient fundamentals and a management team that is focused on balance sheet strength.

The increase in U.S. Treasury yields and credit spreads have combined to push the yield-to-worst (YTW) of the high-yield index significantly higher. While it is impossible to time the credit cycle perfectly, at these valuations, the high-yield complex looks attractive with yields over 9.5%, which is a level that is in line with the annualized return of the S&P 500 index over the past 30 years. Due to pull-to-par dynamics, the income that is being generated will buffer further price volatility.

Since the inception of the Bloomberg HY index in 1987, there have been 48 prior occasions when the yield on the index was between nine and ten percent at month-end. The return for the index was positive 83% (40/48) of the time over the subsequent 12 months, with a median return of 12%.

Due to their subordinated position within a company's capital structure, preferred securities tend to have a higher volatility profile relative to other portions of the fixed income market. In addition, a sizable portion of the market is comprised of securities with a fixed-rate coupon, which combined with their perpetual life, makes them very sensitive to rising rates.

Our preference for more 'defensive' structures – those with fixed-to-floating or floating rate coupons – has been beneficial, especially when compared to the fixed-for-life part of the market.

Underlying fundamentals for preferred issuers – mainly banks and insurance companies – remain attractive, with capital levels near all-time highs. In addition, bank profitability will benefit from higher interest rates, all else equal.

However, following this year's re-pricing across fixed income markets, the yield advantage offered by preferreds is lower than its longer-term average. While this tighter spread to other sectors can be partially explained by the sound fundamentals of banks, it does suggest that preferreds now offer less cushion against a widening in credit spreads.

Senior AAA-rated collateralized loan obligations (CLO) offer strong structural protections, and higher spreads relative to sectors with similar credit quality and typically have floating-rate coupons making them attractive given the current macro backdrop.

Given the additional volatility the sector can introduce into fixed-income portfolios, we remain wary of international and emerging market debt. The events in Russia serve as a reminder of how rapidly drawdowns in EM debt can occur. Furthermore, with such attractive yields available in domestic credit markets, there is little need to own foreign bonds.

The municipal bond market has not been immune from the bouts of volatility experienced in other sectors of the bond market. The sharp rise in interest rates has resulted in retail investors reducing their allocations to the sector, with selling most acute in longer-maturity bonds. This selling pattern has created a dynamic where the best relative value across the maturity spectrum is in bonds with 10 – 15 years to maturity. The ratio of a 10-year AAA tax-exempt muni relative to a 10-year U.S. Treasury is around 81%, roughly in line with the long-term median.

Despite the selling pressure, the underlying fundamentals of state and local governments remain healthy. Federal government stimulus provided through the CARES and ARPA Acts provided $500 billion in aid. In addition, strong economic growth with robust employment trends and deep-seated home price appreciation bolstered tax revenues.

From a technical perspective, we expect higher yields and the elevated potential for a recession to slowly attract buyers back into the muni market.

Security selection within the municipal market will remain critical. Our focus remains on high-quality general obligation and essential-service revenue bonds. We continue to avoid bonds tied to entities such as airports, health care, toll roads, and stadiums.
The sharp rise in interest rates has resulted in – by a significant margin – the worst drawdown for broad-based fixed income benchmarks since their inceptions in the early-to-mid 1970s.

Longer term, the recalibration in yields has created a *much* healthier outlook for future returns. Since its inception in 1973, the correlation between the starting yield (YTW) on the Bloomberg Intermediate Gov/Credit (IGC) Index and the subsequent return over the next 4-year period (roughly the duration of the Index) has been 0.96. In other words, the starting YTW for high-quality bonds has historically been a good proxy for future returns. At the start of last year, the YTW of the Bloomberg IGC Index was 0.59%. As we start the fourth quarter, the YTW of the Index is 4.61%.

Alternative Investments:

In real estate, there has been a significant bifurcation of returns in public markets compared to private markets. Publicly traded REITs have a high correlation to stocks, especially during times of distress in public markets, which may present buying opportunities. Private real estate returns have been very strong and have been a ballast for balanced portfolios this year. However, some sectors of private real estate may see a softening of returns. For example, multifamily (apartment) returns have been fueled by quickly accelerating rents which have outpaced wage growth over the last several years, but recent data shows rents, are cooling nationally. Decreasing housing affordability, however, should prevent large declines in rents as many would-be home buyers have been priced out of the market. We continue to see tailwinds in the industrial space, particularly in logistics/warehouse facilities where the re-shoring of inventories and supply chains will create demand for these properties. Across sectors of the private real estate market, many fund managers have been caught off guard by the rapid increase in interest rates and did not have adequate hedges in place, making some deals uneconomical for them. This has created opportunities for prudent managers.

In private credit, returns have been stable relative to public credit markets. The number of defaults and non-performing loans continues to be very limited. In previous cycles, private credit has seen lower credit losses relative to the public markets. Private lenders can offer flexibility to their borrowers and control the default process and can ultimately take control of the business if necessary, which can lead to better recoveries. However, public market yields have repriced significantly higher and may compensate investors adequately for default risks, but forward returns will likely be volatile.

Private equity and venture capital have seen a significant pullback in deal flow this year. This space will be challenged in the near term as the market favors companies with current earnings rather than distant future earnings. For investors with a high-risk tolerance and the ability to lock up capital for long periods, this may create a buying opportunity.

Disclosures:

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