January 2023

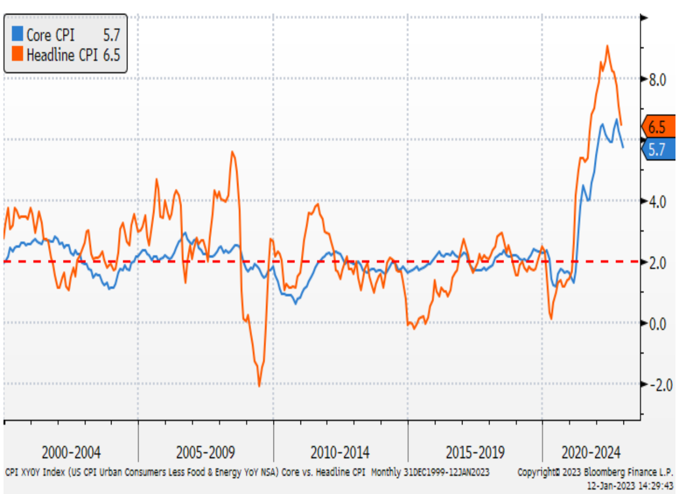
2023 Economic & Fixed Income Outlook

Economic Outlook

2022 was a year in which COVID, a war in Europe and an associated energy crisis, and high inflation roiled financial markets and slowed the global economy.

Although the U.S. economy slogged through a technical recession, with very slight contractions in economic activity during the first and second quarters of 2022, overall activity remained remarkably resilient. As we start 2023, the majority of economists expect a shallow recession in the U.S. during the year, as the impact of tighter monetary policy, which famously works with 'long and variable lags', continues to reverberate through the economy. The Federal Reserve (Fed) has been clear that economic contraction, resulting from demand destruction, is potentially the price that needs to be paid to reduce inflation.

Inflation – Core and Headline CPI



So far, the housing market is one of the few areas of the economy where the impact of higher interest rates can be clearly seen. The rate for a 30-year mortgage, which started 2022 at 3.11%, rose to over 7% in October before declining slightly into the end of the year. Higher mortgage rates, combined with home prices that, even after recent declines, are still ~40% higher than they were at the start of 2020, have sent home affordability to the worst levels since the 1980s. The result has been the first monthly decline in home prices since 2011.

While the current shortage in housing supply and better mortgage structures today make a sharp decline in home prices less likely, the real estate market looks set to continue to cool through 2023. Given the importance of housing, which has made up nearly 20% of GDP in recent quarters, any moderation in housing activity will be a drag on economic growth.

Conversely, the labor market has, thus far, remained remarkably resilient due in large part to the imbalance between the demand for and the supply of workers. The Fed estimates that the labor force has a shortfall of roughly 3.5 million workers due to health-related factors, an acceleration in retirements, and low rates of immigration over the past several years.

A slowdown in economic activity should moderate the demand for workers over time, increasing layoffs and slowing wage growth. The Fed's own forecasts show an expectation for the unemployment rate to rise to 4.6% by the end of 2023, an increase of roughly 1% from its current level.

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Despite experiencing significant price pressure in a broad range of goods and services in 2022, consumer demand remained robust given the ability to draw on the excess savings that were built up during the pandemic. However, the combination of lower savings, higher interest rates, lower real incomes, and rising unemployment suggest that 2023 will be a tougher year for the consumer.

The outlook for corporate spending is mixed. Corporate confidence is low and the recent tightening of bank lending standards for commercial and industrial loans suggests spending will slow in 2023. In fact, several large companies have already announced reductions in technology spending, which had long been an area of steady growth. However, funding from the CHIPS Act, the infrastructure bill, and the Inflation Reduction Act should provide some support to business spending. The war in Ukraine has also boosted demand for defense spending and exports of energy and food.

Despite the obvious headwinds outlined above, there are positives. First, the challenges outlined above are well anticipated by financial markets and therefore are to some degree already reflected in market prices. Second, the recent moderation in inflation readings means that the Fed can slow the pace of rate hikes, which in turn reduces the chance that they significantly over-tighten financial conditions. Furthermore, current market pricing suggests that the Fed will not hike rates after the first quarter. Third, the economy enters this period on stable footing, with a healthy labor market, the banking sector in a strong fundamental position, decent corporate earnings, and still some residual excess household savings. Lastly, inflation may decline faster than expected if production and supply chain constraints continue to alleviate, which would allow central banks to ease off the battle against inflation.

Overall, the potential for the U.S. economy to slide into a recession is elevated. The depth and duration of a recession will in large part be driven by the path of inflation as well as the monetary and fiscal response to an economic slowdown.

The outlook for Europe has improved over the past several months, yet a recession is still more likely than not over the coming year. The improvement has been due to the region's ability to increase natural gas storage and the mild start to winter which has reduced the likelihood of energy rationing and alleviated fears of forced shutdowns in energy-intense industries. However, energy security will be a multi-year concern for Europe which was heavily dependent on Russia for energy prior to the invasion of Ukraine.

Global Economic Forecasts

	2022	2023	2024
United States	1.9%	0.4%	1.3%
China	3.0%	4.8%	4.9%
Developed Economies	2.7%	0.4%	1.4%
Emerging Economies	3.1%	3.9%	4.4%

Source: Bloomberg 1/12/23

Concerns over the availability of energy and record-high inflation have combined to impact both business and consumer confidence, which are at low levels. Meanwhile, the European Central Bank (ECB) is tightening monetary policy in an effort to combat inflation, adding an additional headwind to near-term economic growth.

The UK experienced a tumultuous 2022. The combination of soaring inflation, rising rates, political turmoil, a fiscal policy crisis, and historic volatility in the government bond market have likely pushed the UK economy into a recession during the second half of 2022.

As the New Year approaches, there is a growing strain on British households which are being pinched by higher energy bills, food costs, and mortgage rates, while wage growth has failed to keep up with inflation. Based on data back to the 1950s, British citizens are experiencing the sharpest decline in living standards on record. The result has been a growing wave of labor unrest, with nurses, railroad workers, and postal workers striking over demands for higher pay.

Business confidence is also low and the impacts of Brexit continue to be felt, with business investment still 8% below its pre-Brexit referendum level.

Given this challenging backdrop, economic activity is expected to contract further in the first half of the year.

China, as the world's second-largest economy, demands focus as it relates to global growth as well as how it plays in the stressful world of geopolitics. The strict implementation of the zero-Covid policy, a downturn in the property market, and regulatory crackdowns on the technology sector have all contributed to slow economic growth.

In early December, the Chinese government reversed its policy on zero-covid in response to nationwide protests against lockdowns. Despite the fact that the Chinese economy will benefit longer-term from the removal of widespread lockdowns, the process of reopening - based on the experiences of other countries - is unlikely to be straightforward, as there will be a rapid increase in the number of cases and hospitalizations. The recent protests may have further reaching implications. Chinese citizens appeared not just to be protesting for the end of the zero-Covid policy, but also for democracy and an end to censorship rules.

It is unlikely that the Chinese economy will return to pre-covid economic growth rates because of the aging population, the Chinese government's handling of covid and of the 'common prosperity' initiative, and the rapid decline in the demand for Chinese goods from the west. Lastly, geopolitical tensions, such as Taiwan's democracy and the recently passed U.S. export controls on AI and semiconductors, could create additional drags on economic activity in China.

Outside of China, growth is forecast to be relatively strong in India, some of the commodity-exporting countries as well as parts of emerging markets that will benefit from global re-, near-, and friend-shoring, such as Mexico.

As always, we are closely monitoring the risks – both positive and negative – to our outlook and clients asset allocations. These include inflation, the increased potential for a mistake by central banks, geopolitical, and the impacts of deglobalization.

The risks around inflation, particularly in the U.S., have wide tails. Weaker global demand and easing supply chains could lead to a faster-than-anticipated decline in inflation. Conversely, tight labor markets could result in persistent, elevated inflation, requiring central banks to hike rates more than expected.

We are also cognizant that outlooks require modification as the environment changes. Investors need to look no further than last year to see how wrong forecasts can be. Heading into 2022, market pricing did not have the Fed funds policy rate reaching 2% during this economic cycle (it ended 2022 at 4.325% and is now forecast to reach over 5%) and the consensus forecast by economists was that U.S. inflation would end 2022 below 2%.

The concept of 'radical uncertainty', where uncertainty can't be qualified by statistics, but rather is unmeasurable and represents the 'unknown unknowns' must also be appreciated. Often it is the unknown risks that have larger impacts on financial markets and investor confidence.

Regardless of the source of risk, we will consider their impacts on financial markets as they deploy and will look to tactically adjust asset allocation if and when the situation warrants.

Fixed Income Outlook

A series of outsized rate hikes by the Federal Reserve in 2022 resulted in an unprecedented sell-off for fixed income investors. However, as a result of last year's challenges, the opportunities in the bond market are the most attractive in more than a decade.

The renaissance of higher yields has also restored the balance to the asset allocation mix with bonds once again able to act as ballast against risk-off events.

The focus of central banks, particularly the Federal Reserve (Fed) in 2022 has been squarely on inflation, with much less regard for the potential damage to economic growth or financial markets. After labelling inflation as 'transitory' through 2021, the Fed began acknowledging at the start of 2022, that inflationary pressure may actually be more persistent than its research had previously suggested. The Russian invasion of Ukraine added fuel to the inflation fire.

The Fed began its rate hiking cycle in March, increasing its policy rate by 25 basis points (bps), a speed that was consistent with the magnitude of rate hikes during the past two hiking cycles. At the May meeting, the Fed picked up the pace, hiking by 50 bps. By June, with inflation at the highest level in 40 years, the Fed raised its policy rate by 75 bps for the first time since 1994. After hiking by 75 bps at its next two meetings, it closed the year with a 50 bps hike at the December meeting.

All told, the Fed increased the Federal funds rate by 4.25% over a period spanning just 9 months, making it the most aggressive rate-hiking cycle in more than 40 years.

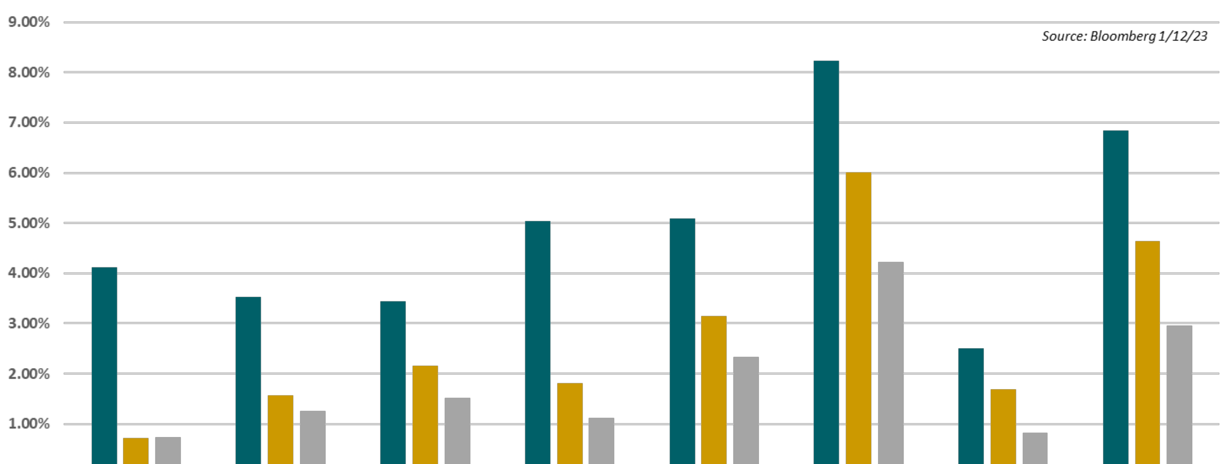
Fed Funds Policy Rate

The updated summary of economic projections, published following the December meeting, suggests the median expectation, among committee members, for another 75-100 bps of rate hikes in 2023. Their forecast has the policy rate remaining at level (5.00% to 5.25%) for a period of time as they assess the impact previous rate hikes have had on the economy and whether financial conditions have tightened enough to bring aggregate demand back in-line with aggregate supply.

Market pricing points to the policy rate peaking in the first quarter at roughly 5%. The view of investors then diverges from that of the Fed, with market participants predicting that the Fed will begin to cut its policy rate in the second half of the year.

In addition to rate hikes, the Fed is also reducing the size of its balance sheet through a process known as quantitative tightening (QT). Despite the fact that QT has received less attention, it is an additional means of monetary tightening. When bonds mature off the Fed's balance sheet without being replaced, it decreases the amount of reserves in the banking system by an equal amount, which in turn, tightens the availability of money in the economy, raising borrowing costs and slowing economic growth.

With the Fed's policy rate moving into a restrictive territory and the continuation of quantitative tightening, the risk of a market accident or liquidity shock is elevated. In fact, liquidity conditions within the U.S. Treasury market have already deteriorated to a level last seen in March 2020 at the onset of the pandemic when the market breakdown was so acute that the Fed had to step in to buy Treasurys. The decline in market liquidity



	2 Year U.S. Treasury	5 Year U.S. Treasury	10 Year U.S. Treasury	1-3 Year IG Corporates	IG Corporates	High Yield Corporate Bonds	Municipal Bonds	Preferred Securities
Yield-to-Worst 01.12.2023	4.12%	3.53%	3.44%	5.03%	5.09%	8.23%	2.50%	6.84%
YTW 10-Year Median	0.71%	1.56%	2.15%	1.81%	3.14%	6.01%	1.69%	4.64%
YTW 01.01.22	0.73%	1.26%	1.51%	1.12%	2.33%	4.21%	0.82%	2.95%

exacerbates price swings across fixed income markets with an even larger impact on non-Treasury sectors.

Another benefit of holding U.S. Treasury is as a diversifier to credit risk. While this relationship broke down in 2022, with inflation driving interest rates higher and increasing risk premiums (credit spreads), we expect the negative correlation relationship to re-establish itself following the recalibration to high U.S. Treasury yields.

With this backdrop, short-and-intermediate maturity Treasurys offer a hedge against a risk-off environment as well as a source of liquidity to take advantage of market dislocations.

We remain cautious on longer-dated (those with greater than 10 years to maturity) U.S. Treasurys given the lack of additional yield pick-up for extending maturities from 10 to 30 years. The 'richness' of longer-maturity Treasurys is driven in part by the demand of large asset pools – such as pension funds and insurance companies – for long-duration bonds (assets) to match their longer-dated liabilities. However, over time investors may increasingly require more compensation for long-term government bonds due to higher debt levels, increasing supply, lower foreign demand, and the potential for higher inflation.

The surge in interest rates and implied volatility, as well as forced selling, has repriced Agency mortgage-backed securities (MBS) to the most attractive valuations in more than a decade. From a supply perspective, new home mortgage originations are set to decline further given the sharp increase in mortgage rates, the lack of affordable housing, and the seasonal slowdown in housing activity. Refinancing activity is virtually non-existent as less than 0.5% of all mortgages are eligible to refinance at today's rates. While supply has declined, so has demand, as both the Fed and large U.S. banks – previously the two largest buyers in the sector – are no longer buying. Despite the headwinds, agency MBS valuations have cheapened to a level where we consider them to be an efficient way to gain exposure to duration.

While the risk premium (credit spread) on investment-grade bonds has increased, spreads are not yet at levels consistent with the elevated potential for an economic slowdown. Therefore, we are cognizant that spreads may widen over the coming months, with the potential for the magnitude of the move to be amplified by poor liquidity conditions. We would look to add exposure to investment grade corporates during such periods given the limited scope for credit rating downgrades, record low dollar prices and the attractive all-in yields.

In the meantime, we are tilting exposures to short-maturity IG corporate bonds. This segment of the market is offering yields over 5% and has a lower degree of sensitivity to spread widening relative to longer-maturity bonds.

IG Corporates 1 – 3 Year: Yield-to Worst

At a ratings level, while the yield pick-up has compressed, we still have a favorable view on BBB rated companies over higher-rated bonds. In addition to the incremental yield pick-up, many BBB rated companies are in rating preservation mode, meaning they are less likely to pursue activities that will actively increase leveraging, such as M&A, share repurchases or dividend increases. Conversely, many higher-quality companies have the ability to undertake actions that will lead to a deterioration in their balance sheet but still maintain investment grade ratings. In other words, higher-rated companies don't have the disincentive of potentially losing their investment grade rating to discourage them.

It is important for investors to remember that the credit risk premium they receive when paying a bond reflects that company's credit risk at that time, it generally doesn't compensate them for the potential future deterioration.

From a sector perspective, we are focused on industries that are broadly defensive, such as banks, communications, pipelines, and utilities. Whether the Fed is successful in achieving a soft landing or not is up for debate, however, it is likely that growth will be, at best, sluggish and company profit margins will be pressured. These factors result in our cautious view on sectors that are closely tied to the business cycle (i.e. cyclical sectors), such as autos, home builders, and metal and mining companies.

In terms of individual securities, we are seeking companies with stable or improving credit metrics, pricing power, the ability to generate cash flow in a slowing economy, and management teams that are focused on strong credit fundamentals. Many BBB-rated companies satisfy these criteria and offer additional yield over their higher-rated peers.

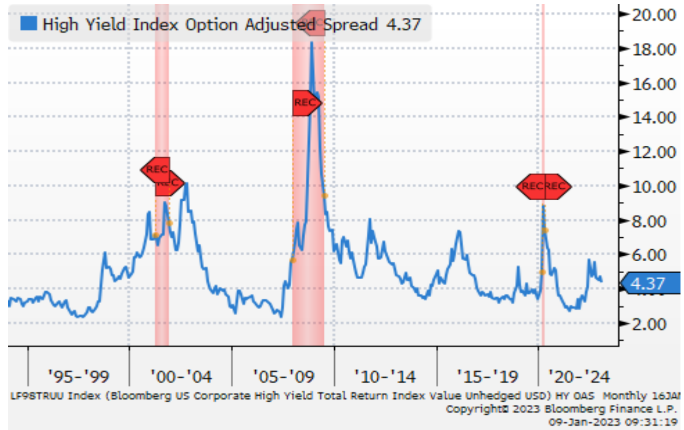
The current macro backdrop suggests that generic, broad-based exposure to corporate bonds is unlikely to be as effective as it has been over the past 10 years. Instead, the environment is a good one for active management which can benefit from relative-value positioning and security selection (as well as avoidance).

Strong credit fundamentals have sustained low U.S. high-yield default rates, however, we remain cautious in light of the Fed's aggressive pace of tightening, elevated inflation, and increased recession risk.

While all-in yields for high-yield bonds are elevated, the increase has been driven mostly by the rise in U.S. Treasury yields. Conversely, the credit spread component has not increased meaningfully, remaining below the long-term average. This suggests that the current risk premium (as measured by the credit spread) offered by high-yield does not reflect the heightened potential for a recession or any left-tail risks.

As the chart below shows, high-yield spreads typically widen in the lead-up to, and during the first part of, a recession (previous recessions indicated by red shaded areas). Typically, in a recession scenario, spreads will overshoot and become wider than what's justifiable. Given this view, we believe there could be better entry points down the road.

High Yield Spreads



The backdrop of slower economic growth, higher interest rates, and muted earnings is concerning for the bank/leveraged loan market where coupon rates 'float' based on short-term interest rates.

While refinancing needs are low for the sector in the near term, the floating rate nature of the sector means that the average coupon will have more than doubled since 2020. While many companies will have hedges in place, it is unlikely that they will have hedged all floating rate exposure. This means the transition towards a higher funding cost environment will be faster and more abrupt for issuers in this sector, regardless of their refinancing needs.

In addition, the bank loan universe has a lower quality rating composition than it has at any time in recent history. Furthermore, we anticipate that recovery rates from defaults will be lower than in the past. Given this backdrop, we have an unfavorable view of the sector.

Unlike high-yield bonds and bank loans where the price of a bond can be capped by issuer-owed call options, convertible bonds still offer the potential for price appreciation since the value of a convertible bond can rise if the issuer's common stock price increases. The sector also offers the opportunity to allocate to issuers, particularly technology and biotech companies that often don't issue bonds in the more traditional areas of the corporate bond market. This is a sector we are monitoring closely for potential entry points.

Banks, the largest issuers of preferreds, remain well-positioned to withstand slower economic activity. Bank earnings have been bolstered by higher interest rates. The growth in net interest income (the spread between asset yields and funding costs), the most significant contributor to bank earnings, has accelerated at the fastest pace since 1976. The increase in earnings, along with already strong capital and loan loss reserve levels, will provide banks with ample capacity to withstand any future loan losses.

Outside of banks, we see select opportunities in preferred securities issued by pipeline companies. Many of the issuers in this space have limited direct exposure to changes in commodity prices and have business models which generate a significant amount of free-cash-flow. Furthermore, management teams have been focused on deleveraging balance sheets.

Compared to other sectors of the credit market, preferreds offer a compelling yield pick-up over investment grade corporate bonds, with lower sensitivity to interest rates (duration). While high-yield bonds offer a small pick-up in yield, preferreds have a higher average credit quality at both the security and the parent level. Furthermore, for taxable investors, some preferred securities pay qualified dividend income (QDI) which increases the value of the after-tax yield paid by preferreds.

Despite the outperformance of $1000 par fixed-to-float securities in 2022, we continue to find them attractive relative to $25 par fixed-for-life coupon structures. However, within fixed-to-float structures, the repricing of interest rates provides an attractive opportunity to extend duration by purchasing securities that have a longer period of time until the coupon resets to a floating rate. We also see value in securities trading at a deep discount that have the potential to move back towards par.

The municipal bond market has not been immune from the drawdowns experienced in other bond market sectors. However, looking ahead, the outlook for munis is favorable given the resilience of the sector historically to slower economic growth, good underlying fundamentals, and constructive technicals.

From a fundamental perspective, the influx of pandemic-related stimulus, strong tax collections, and prudent savings practices have left municipalities on a very strong financial footing.

Additionally, munis look set to benefit from a favorable supply/demand technical. While the sharp increase in interest rates – and the related decline in muni prices – in 2022 has resulted in investor outflows from the sector, it has also impacted supply, which is down almost 20% this year. The near-term outlook for supply is expected to remain limited, while the amount of money that needs to be reinvested in the sector due to maturities or interest payments will create demand. Additional demand may also come in the shape of investors re-entering or increasing allocations to munis given the higher yields now available.

Valuations vary along the maturity spectrum, with some tenors more attractive than others.

Security selection within the municipal market will remain critical. Our focus remains on high-quality general obligation and essential-service revenue bonds. Conversely, we continue to avoid bonds tied to entities such as airports, health care, toll roads, and stadiums.

While select opportunities exist in emerging markets, we continue to view the sector as unattractive given the additional volatility it can introduce to a fixed income portfolio for a small yield enhancement.

While spreads in fixed income have widened in 2022, valuations are generally still not at levels that fully acknowledge recession probabilities. Moreover, volatility is likely to remain elevated relative to low levels experienced between the financial crisis and the pandemic, in part because central banks are likely to be hesitant to intervene to support financial markets going forward.

Taken together, we believe these trends justify a more defensive stance that includes allocations in intermediate-maturity U.S. Treasurys, short-maturity investment grade corporate bonds, and high-quality municipal bonds. In addition, an allocation to short-dated U.S. Treasury bonds provides an attractive current income as well as a source of funds when opportunities emerge.

As a result of this framework, active management will also be more attractive given a need for a more granular approach to sector allocation and security selection rather than broad, aggregate exposures. We believe the coming year will provide ample opportunities for relative value, with elevated dispersion between sectors and individual issuers.

Alternative Investments

Private investments generally outperformed publicly traded securities last year, and provided diversification to balanced portfolios. The markets on private investments are generally not driven by public market gyrations—managers often use inputs such as appraisals and private market transactions to determine their prices. As a result of this outperformance, many institutional investors have become overweight private investments and are trimming their allocations to comply with their investment policy statements. Some widely used products have had to prorate liquidity offered to redeeming investors, through a so called "gate", which is designed to prevent funds from having to sell large amounts of illiquid investments at once. This is a normal function of private structures that offer periodic liquidity to investors, but many media outlets have mischaracterized this as a "run on the bank".

Some sectors of private real estate may see a softening of returns this year. 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.

In private credit, the amount 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.