April 2023

Q2 2023 Economic & Fixed Income Outlook

Economic Outlook

Entering the year, our view was for slowing economic activity in the U.S., with an elevated potential for a recession occurring during the year. This view was driven in large part by the material tightening in financial conditions as a result of the aggressive series of rate hikes by the Federal Reserve. However, economic data released in January data positively surprised expectations, both in the U.S. and globally. Domestically, the labor market remained robust, and declining energy prices helped support the consumer. Europe avoided a significant energy crisis – helped by unseasonably warm weather, and the surprise re-opening of the Chinese economy provided a boost to global growth.

By the end of January, the narrative in financial markets had shifted to a view that an economic 'soft landing' was possible. In other words, a recession could be avoided even as the Federal Reserve (Fed) continued to tighten monetary policy. The outlook once again began shifting in early February as the January employment report highlighted the continued tightness of the U.S. labor market, and elevated wage growth. It was in this context that financial markets began to price in the need for more interest rate hikes than previously thought.

Then came the failure of Silicon Valley bank and two other U.S. regional banks, along with the shotgun wedding of UBS and Credit Suisse in mid-March. The challenges to the U.S. banking system were brought on by a combination of depositor outflows, as savers could purchase higher-yielding U.S. treasury bonds, and losses on bank balance sheets as holdings in U.S. Treasury and Agency bonds suffered price declines as interest rates rose over the past 12 months.

However, the current tumult in the banking sector is different from the 2007-08 financial crisis, when bank balance sheets were highly leveraged and had very substantial exposures to low-quality assets (subprime mortgages). The recent dislocation for banks has been driven by price declines in high-quality full-faith and credit (U.S. Treasury bonds and Agency Mortgages) assets. These securities have seen a decline in price due to higher interest rates, not due to massive credit impairments.

Nevertheless, the recent events will put additional pressure on the economy at a time that it is already dealing with elevated inflation, the fastest tightening cycle since the early 1980s, declines in personal savings, and a slowing global economy. Even prior to the failure of SVB, bank credit standards were tightening and loan growth was slowing as a result of tighter monetary conditions, this trend will accelerate and be a headwind to economic growth.

The stress in the banking sector also adds yet another layer of complexity to the Fed's job. While inflation has moderated, it remains well above the Fed's 2% target. Certain hotspots which drove inflation last year, such as commodity prices and supply chain pressures, have eased. On the other hand, the level of shelter inflation remains elevated, but this is due in large part to a lagged reality as rent prices have generally stagnated for new

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leases. Consequently, the remaining problem is the price pressure in the service components of the inflation measure (excluding housing), a measure that Fed Chair Powell often refers to when discussing inflation pressures. The main driver of this component of inflation is labor dynamics – not enough workers to fill jobs – which is keeping the unemployment rate around the lowest level since the late 1960s and resulting in higher wages.

The failure of three regulated U.S. banks has also created another opportunity for finger-pointing and blame-shifting in DC. Congress appears set to take the government to the brink of default on the national debt with earnest negotiations yet to begin on raising the debt ceiling. If the debt limit remains unchanged, the government's ability to borrow using extraordinary measures will be exhausted sometime between July and September.

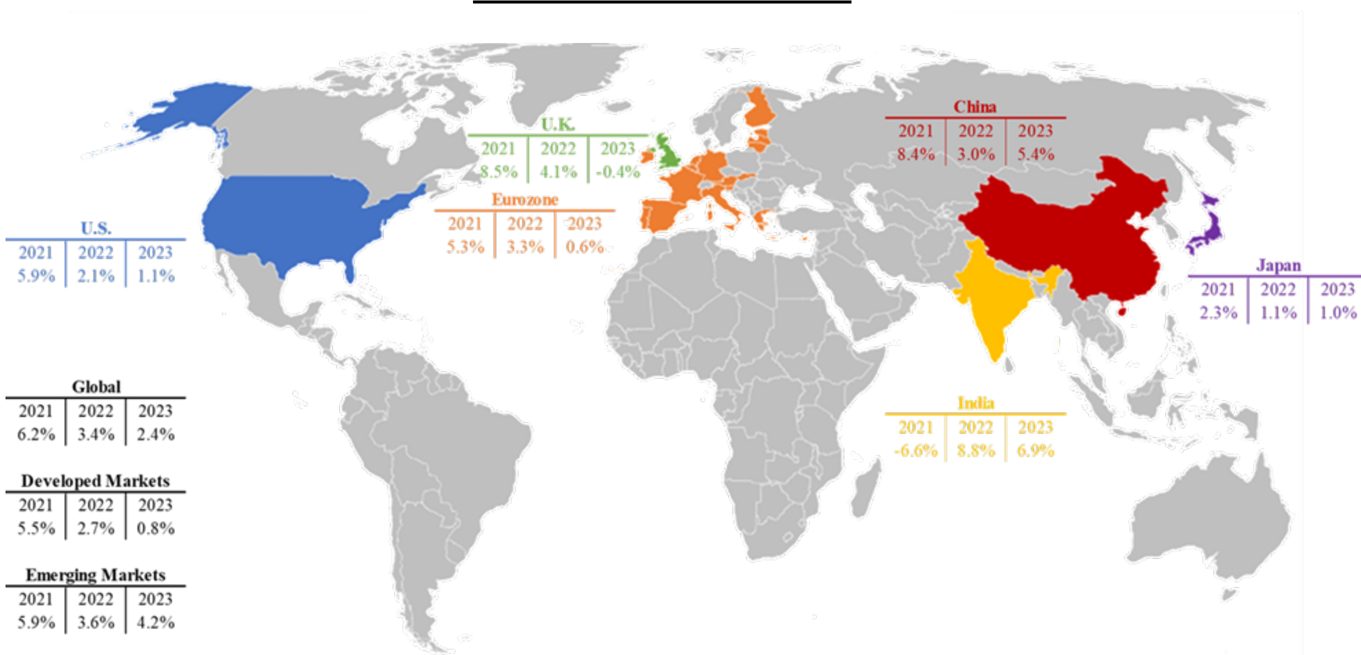
The U.S. has never defaulted because of Congress' failure to raise the debt ceiling (it did technically default once in 1979 due to a computer backlog), presumably because the stakes associated with default are so high. Similarly, we do not expect a default on this occasion, however, we do think this episode will be drawn out and could come uncomfortably close to the deadline.

Outside the U.S., Euro area growth held up better than anticipated over the winter, partly due to unseasonably warm weather. Looking ahead, lower energy prices and fiscal tailwinds are supportive of growth in Europe. Above-target inflation means that the European Central Bank (ECB) will attempt to further restrict monetary policy. A sharp tightening in lending standards will be a headwind to growth, given the heavy reliance on the banking system for credit availability by European businesses and households.

The outlook for the UK remains challenging, with inflation remaining stubbornly high. Interest rate increases from the Bank of England have caused monthly mortgage payments to double or triple in some cases as mortgages in the UK are largely floating rate. Combined, these factors have driven consumer confidence to rock bottom levels.

While emerging markets are typically grouped together, there are meaningful variations across regions and countries. Countries such as Mexico could benefit from shifting trade winds as global corporations look to near- or friend-shoring production from China. India, the world's fifth-largest and fastest-growing economy, also aspires to be a viable contender for relocated global manufacturing and sourcing.

Global GDP Forecasts



In China, economic activity rebounded swiftly after the authorities fast-tracked the re-opening of the economy from its extreme Covid lockdown policy. Inflation in China is still low, so policymakers have the potential to support growth. Longer-term, challenges for the Chinese economy – especially aging demographics and property – remain.

At the start of the year, the term “soft landing” was a common refrain from both policymakers and investors. However, despite the most aggressive Fed rate hiking cycle since the 1970s, growth has remained robust, while inflation has cooled slightly but remains well above target. The possibility that central bankers might have managed to thread the needle by bringing down inflation without damaging growth initially pushed recession forecasts out to 2024. However, recent stress in the banking sector implies tighter lending standards ahead and, with them, a higher and more immediate risk of a recession.

Monetary policy works with a lag, meaning that policymakers don’t know the exact magnitude of the impact of rate hikes until they are already impacting the economy. It is clear now that tighter financial conditions are having an increasing effect on the banking sector, and by extension on economic activity, demand, and eventually inflation. The Fed faces a ‘trilemma’ of trying to manage inflation, financial stability, and employment. Nevertheless, the old playbook of the Fed acting early to cut interest rates to support the economy is unlikely to be used during this cycle, since inflation remains well above their 2% target.

The current environment is a difficult one, not only for policymakers but also for investors as the distribution of potential outcomes is exceptionally wide. As always, we are closely monitoring the risks – both positive and negative – to our outlook and client’s asset allocations.

Fixed Income Outlook

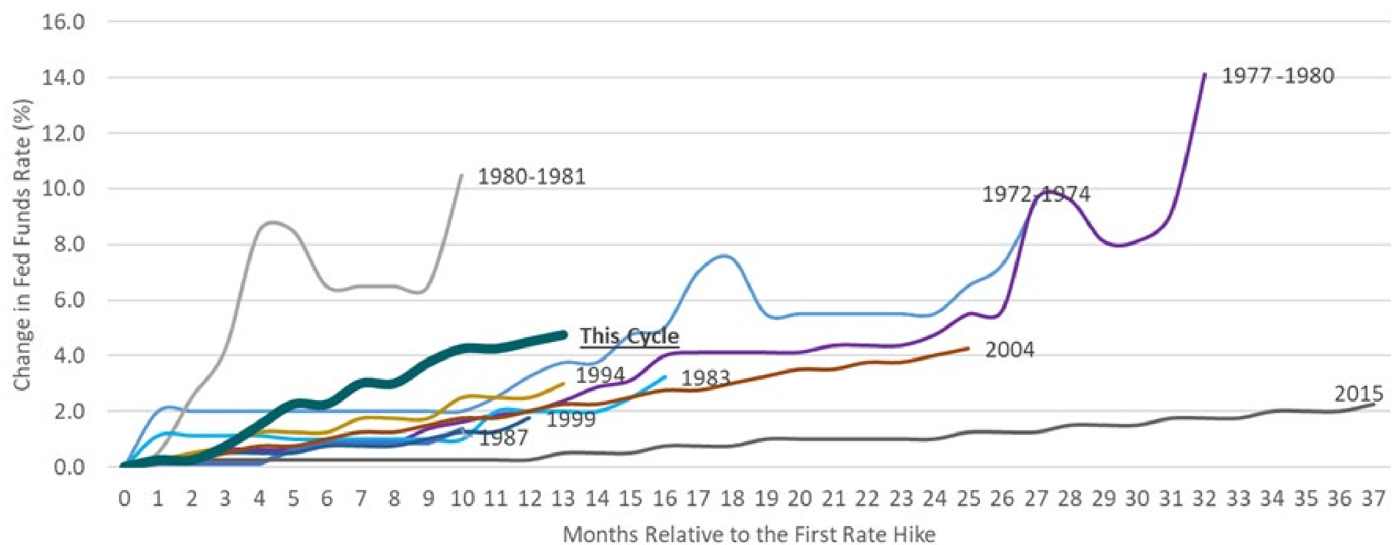
The Federal Open Market Committee (FOMC) increased the Fed funds policy rate by an additional 25 basis points (bps) to a target range of 4.75% - 5.00% (an effective rate of 4.875%) at its March meeting. In total, the Federal Reserve (Fed) has now increased the policy rate by a staggering 4.75% since March 2022.

The updated Summary of Economic Projections (SEP) reflected a more dovish picture of slower economic growth, slightly higher inflation but a slightly lower unemployment rate. The updated “dot plot” rate outlook, showed that committee members see an end to rate hikes soon, but don’t expect rate cuts this year. The median projection for this year was unchanged, with the expectation that the policy rate will end the year at 5.125%, just 25 bps higher than the current policy rate. The Fed’s forecast does call for rate cuts in 2024, with the median projection for a 4.3% funds rate at the end of next year.

Following the meeting, Chair Powell acknowledged that banks would be tightening lending standards and that if the tightening was significant, the trajectory of the Fed’s policy could be impacted. While the Fed did not quantify how much of an impact they thought tighter credit conditions would have, several economists have estimated that the effect will be equivalent to another 25-100 bps of rate hikes.

Chair Powell pushed back on the notion of rate cuts this year, highlighting the committee’s resolve to reduce inflation and pointing to the lack of progress in non-housing services inflation. The Fed chair also emphasized the separation between financial and price stability goals and tools, a view shared by other major global central banks, such as the European Central Bank (ECB). Specifically, central banks will use their policy rates to influence financial conditions and attempt to guide inflation back to target. Meanwhile, they will use their balance sheets and other tools to create a variety of facilities to provide financing and liquidity to ensure financial stability.

Despite Powell’s efforts, markets have been quick to price in rate cuts as a result of the volatility in the banking sector. The ultimate timing and speed of any rate-cutting cycle will depend on how inflation and financial stability risks evolve over time.



As the chart above shows, the current rate hiking cycle has been the most aggressive since the early 1980s, which resulted in record declines for bond markets in 2022. The good news is that the price declines of last year resulted in a reset higher in yields. Today, bonds are back, providing opportunities for income and diversification at attractive yield levels.

From an interest rate sensitivity (duration) perspective, our position is broadly in-line with the duration of a portfolio's respective benchmark.

In prior outlooks, we highlighted the potential for market accidents or liquidity shocks due to the magnitude of monetary policy tightening (both through rate hikes as well as a reduction in the size of the balance sheet (quantitative tightening)) over the past year. The recent turmoil in the banking system highlights such an incident with lower levels of liquidity accentuating the price swings.

The potential for pockets of volatility remains, highlighting the importance of constructing portfolios with the flexibility to take advantage of such dislocations.

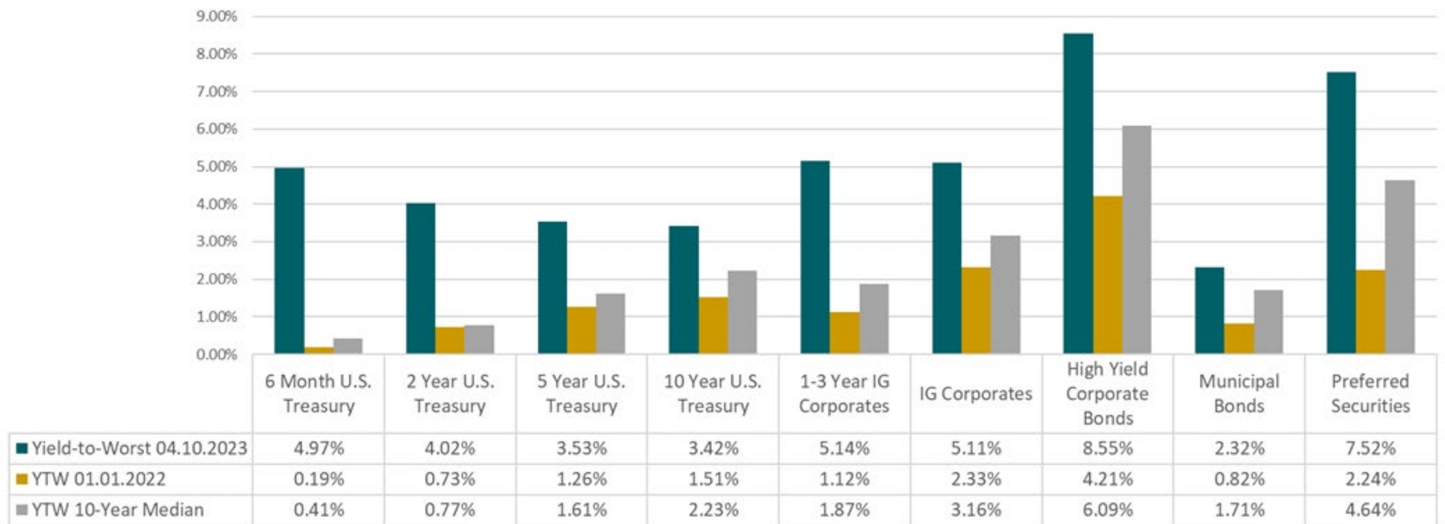
Currently, short-term Treasurys offer the highest yields across the maturity range due to the inverted shape of the yield curve. Given the limited time to maturity, these securities generally exhibit less volatility. However, unlike bonds with longer maturities, short-term bonds will not provide the same diversification properties and ability to generate total return through price appreciation if yields decline, as has occurred in prior recessions.

Intermediate maturity Treasurys offer both a hedge against risk-off episodes in the credit market and a source of liquidity to opportunistically take advantage of these air pockets.

We remain cautious on longer-dated (those with greater than 10 years to maturity) U.S. Treasuries given the lack of additional yield pick-up for extending maturities from 10 to 30 years. The 'richness' of longer-maturity Treasuries 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 inflation to remain persistently higher than it did during the prior 15 years.

Within corporate credit, investors will become more focused on the underlying credit fundamentals. While company balance sheets are in a stronger position than at the start of prior recessions, corporate fundamentals will weaken as economic activity slows.

Currently, the dispersion in risk premium (credit spreads) between different issuers (companies) in the investment grade corporate bond sector is very limited, implying that market pricing is not reflecting the divergent



	6 Month U.S. Treasury	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 04.10.2023	4.97%	4.02%	3.53%	3.42%	5.14%	5.11%	8.55%	2.32%	7.52%
YTW 01.01.2022	0.19%	0.73%	1.26%	1.51%	1.12%	2.33%	4.21%	0.82%	2.24%
YTW 10-Year Median	0.41%	0.77%	1.61%	2.23%	1.87%	3.16%	6.09%	1.71%	4.64%

impacts that different sectors and issuers will experience in the event of a downturn (e.g. companies in sectors which are very sensitive to economic growth will typically underperform companies whose business models are less reliant on economic growth).

This lack of dispersion presents an opportunity to reposition portfolios ahead of a likely recession. As we move into this next phase of the credit cycle, dispersion should increase materially to reflect varying degrees of credit deterioration.

From a sector perspective, we are reducing exposure to cyclical industries, lower conviction issuers, and companies that are sensitive to higher interest rates. Ultimately, active management and accurate credit selection (and avoidance) will be rewarded as volatility continues and economic activity slows.

Currently, the credit spread offered by the high-yield sector is insufficient given the heightened odds of a recession and tighter bank lending standards. Credit spreads are currently offering an additional 4.5% yield over the yield on U.S. Treasury bonds. We expect that credit spreads could increase to above 7% over U.S. Treasurys in the event of a recession, which would result in price declines for high-yield bond holders. Therefore, we maintain limited exposure to the sector.

However, while we are cautious about high-yield we don't expect the default rate to be as severe as in some previous downturns due to the favorable positions of most issuers, with strong debt serviceability and favorable maturity profiles. Furthermore, the market is of a higher credit quality today than in prior cycles.

We view AAA-rated collateralized loan obligations (CLO) debt as compelling. In addition to attractive yields, these securities have strong structural protections that will help insulate them from dislocations in the credit market. The coupon is floating rate, which provides diversification benefits to portfolios, and will help protect portfolios if the market re-prices expectations for the path of the Fed's policy rate higher.

Following a very strong start to the year, preferred securities came under substantial pressure as a result of three regional bank failures in the U.S., and the Swiss avalanche (the purchase of Credit Suisse by UBS).

Valuations have widened considerably on both an absolute and relative basis with the preferred index yielding more than the BB-rated high-yield index despite the higher credit quality. In fact, the spread between the yield on the preferred index and the high-yield index is close to the highest level in the past decade. The yield difference between an issuer's senior bonds and preferred securities has also increased substantially.

The European preferred market, known as contingent capital or CoCo bonds, has been damaged by the erratic behavior of the Swiss regulator (FINMA) in orchestrating

the takeover of Credit Suisse (CS) by UBS, including an undisclosed weekend emergency law change that granted them the ability to write off the CS CoCo securities, despite CS equity holders receiving $3.3 billion. The story may continue with the possibility of litigation from investors who held these securities.

Numerous bank regulators across the world, including the ECB, BOE, Hong Kong Monetary Authority, among others, have clearly distanced themselves from the Swiss government, reiterating their commitment to the longstanding legal priority of claims waterfall. The structure of preferred securities in the U.S. is different and does not contain a conversion feature.

In the U.S., regional bank preferreds came under the most pressure. Our focus has always been on the largest money center U.S. banks which fared well relative to other portions of the preferred market. Looking ahead, with the elevated potential of a recession, we are selective on companies with elevated exposure to weaker commercial real estate and to subprime consumers.

While volatility may continue in the near term, we remain confident in the preferred securities sector over the intermediate and longer term. The sector is already pricing in a significant amount of risk compared to other fixed-income asset classes.

The outlook for municipal bonds (munis) is favorable given the resilience of the sector historically to slower economic growth, good underlying fundamentals, constructive technicals, and reasonable relative valuations.

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 will benefit from a favorable supply/demand technical. Valuations in the sector were pressured last year as rapidly rising rates – and the related decline in price – resulted in large outflows from the sector. Looking ahead, the muni market should see strong demand, as investors re-enter the space to capture higher yields, and interest and principal payments need to be re-invested. Meanwhile, supply has declined, currently running 25% lower than last year.

Valuations vary along the maturity spectrum, with some tenors more attractive than others. In general, muni valuations are particularly attractive relative to U.S. Treasury bonds in the 12 to 18-year maturity range.

With a potential recession on the horizon, investors must be selective. 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.

Within private credit markets, we are starting to see attractive opportunities in *newer* deals, but prices of existing assets have been slower to adjust compared with public markets. The tightening in bank lending may provide a structural tailwind to private credit, where asset managers can offer certainty of execution in exchange for a premium in pricing / yield. The hunt for yield by investors over the past 15 years is transitioning into a hunt for capital from borrowers.

Disclosures:

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