July 2023

Q3 2023 Economic & Fixed Income Outlook

Economic Outlook

Despite the most aggressive rate hiking cycle in four decades, turmoil in the banking sector, and a debt-ceiling standoff, U.S. economic growth remained more buoyant than anticipated during the first half of the year.

Meanwhile, inflation has remained recalcitrant, with certain goods prices reaccelerating and services inflation staying firm. A key driver of inflation has been the continued strength of the labor market, with the unemployment rate near the lowest level since 1969. The imbalances in the labor market are being driven by elevated labor demand at the same time that the labor force is structurally smaller than in prior decades. Diminished immigration, particularly over the course of the pandemic, and baby boomers reaching retirement age have left the economy short of workers.

In such a tight labor market, workers are able to demand higher wages and while the pace of wage gains has decelerated slightly from a pace of 6% late last year, it is still too high for the Fed's comfort level. Economic models suggest that for overall inflation readings to decline to the Fed's 2% target wage growth will need to moderate further from roughly 4.5% today to a 2.5-3% level. The connection between the unemployment rate and wage growth (known in economics as the Philips curve) suggests that a further moderation in wage growth may necessitate a weaker labor market (i.e. a higher unemployment rate).

Inflation readings in the second half of the year may actually see some reacceleration due to the base effect. Inflation for a respective month is measured against the inflation value for the same month in the prior year. During the first half of the year, the base effect applied significant downward pressure on year-over-year inflation readings. This was due to the fact that there was significant growth in inflation during the first half of 2022. However, during the second half of 2022, monthly inflation measures were very moderate, meaning just a small rise in inflation in a particular month could result in an increase in inflation on an annual basis. In the absence of an economic shock, it appears unlikely that inflation readings will fall below 3% by the end of the year

The resiliency of the U.S. economy has been driven by the strength of the consumer, which during the first half of the year was assisted by lower energy prices. There are fewer financial imbalances during this cycle both on corporate and household balance sheets, meaning there does not need to be a large deleveraging event. On aggregate, most companies and individuals took advantage of lower interest rates to term out fixed-rate debt which has damped the impact of Fed rate hikes.

The resiliency of the housing market, despite mortgage rates exceeding 6%, highlights the undersupply of housing. Currently, the total number of single-family homes for sale is just 1.3 million units, only 8.1% above its all-time low in February 2022. The supply/demand mismatch suggests that home building will remain more durable than in prior recessions.

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Longer-term, the accelerated adoption of artificial intelligence (AI) could result in material productivity growth. The influence of AI could be seen in areas such as autonomous driving, reduced switching costs for consumers, and improved information flow. In addition, AI could also increase human longevity, for example by speeding up medical breakthroughs such as immunotherapy cancer treatment using nanotechnology.

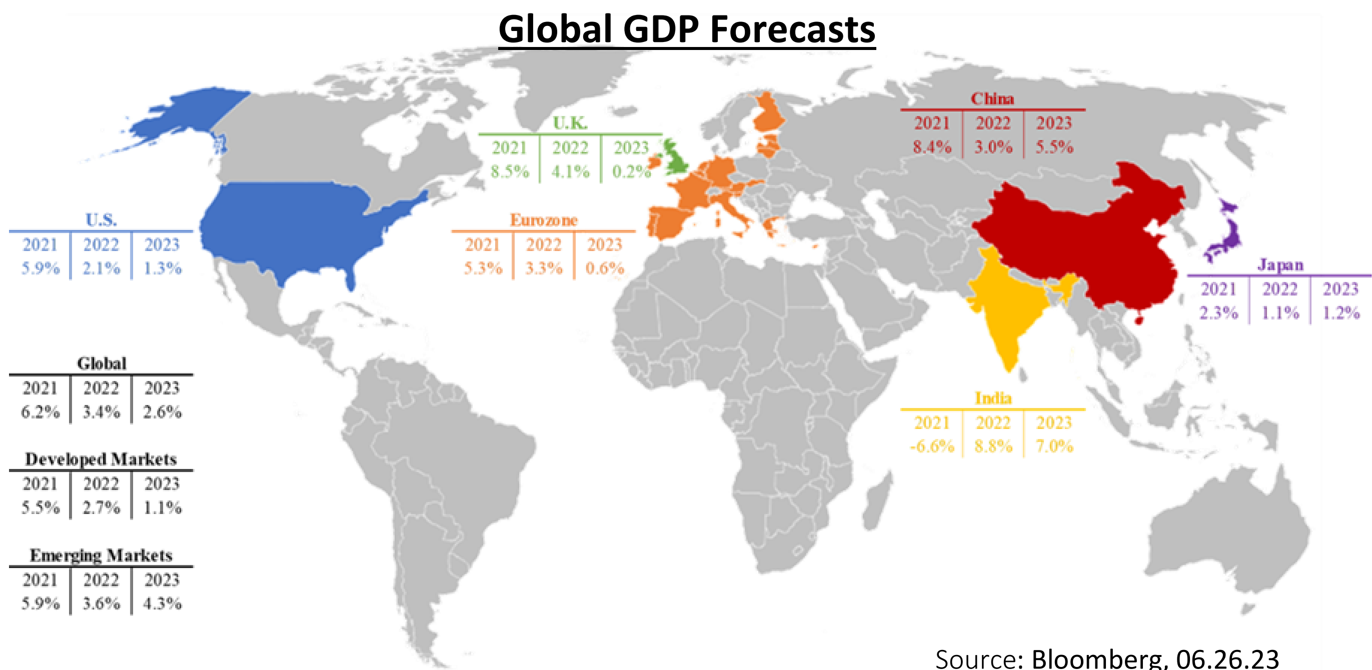
Moving into the second half of the year, there are signs of underlying vulnerability. Several indicators of future economic activity, including the slope of the yield curve, the index of leading indicators, tighter lending standards, and sentiment metrics, suggest the potential for a recession is elevated. Importantly, most economists expect that the contraction in economic activity will be milder compared to the last two recessions in 2008 and 2020, which saw large contractions in economic output and a significant weakening in labor markets.

However, the recovery may also be more muted as central banks have less ability and willingness to use monetary policy to stimulate the recovery following the battle with inflation. This will have ramifications for future policy, as playbooks that worked over the past 15 years may become less relevant.

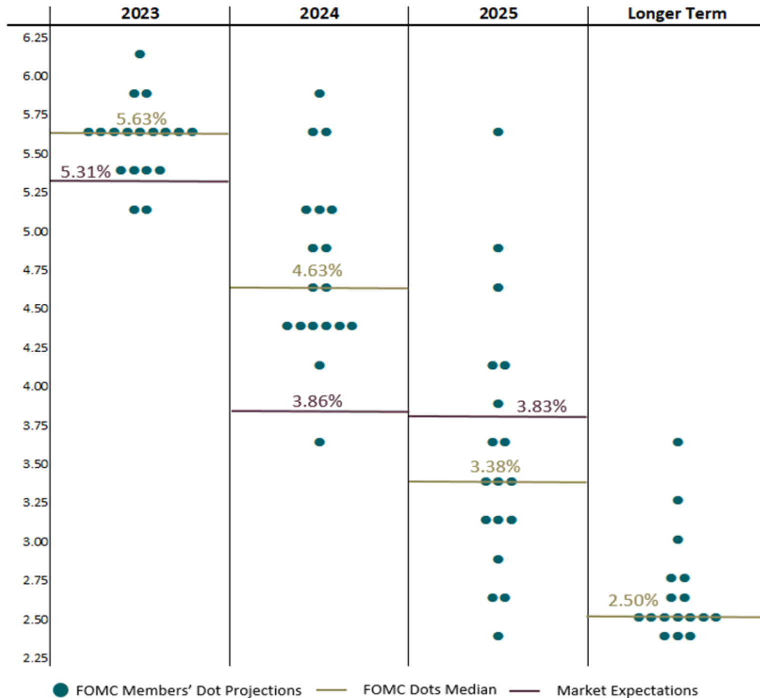
As always, we remain cognizant of the risks to our outlook and are vigilant to the potential impacts the changing macro environment may have on financial markets and investment allocations. The pressure in the banking system underscores how quickly the vulnerabilities of the economy to the rapid rise in interest rates can be exposed. On the other hand, the resilience of the U.S. consumer and wider economy thus far highlights the need to appreciate that the risks to a base case can be both positive and negative.

The Fed

After hiking its policy rate at 10 consecutive meetings since March 2022, the Federal Reserve (Fed) voted to leave the Federal funds policy rate unchanged at a target rate of 5.00%-5.25%. This "skip" had been well-telegraphed by Fed officials leading up to the meeting, and was driven by risk management considerations, namely the desire to buy time to better assess the lagged effects of the previous 500 basis points (bps) of tightening as well as the economic damage resulting from the stress in the banking system, which will result in an additional tightening in lending standards. However, the language contained within the post-meeting statement and press conference commentary clearly highlighted the Fed's view that additional rate hikes may be required.



The updated Summary of Economic Projections (SEP) included hawkish adjustments to the dot plot, with the median 2023 rate projection moving up by 50 bps to 5.6% compared to the FOMC's previous forecast released in March. All told 12 of the 18 Federal Open Market Committee (FOMC) expected at least 50 basis points (bps) of additional rate hikes this year. Consistent with the March projections, no member of the committee expects any rate cuts in 2023.



Both the Fed and investors expect rate cuts in 2024 and 2025 but to differing magnitudes with market pricing suggesting more rate cuts than the Fed projects.

Interestingly, several officials slightly increased their longer-run policy estimates – a proxy for the neutral rate of interest. While the median longer-run forecast remained unchanged at 2.5%, the upward revisions of some forecasts suggest these individuals may be considering whether the neutral interest rate – the theoretical policy rate that neither stimulates nor slows economic growth – has shifted higher post-pandemic.

During the post-meeting press conference, Chair Powell reinforced the view expressed in the SEP – the pause in rate hikes at the June meeting may be temporary. Furthermore, in his congressional testimony in late June, Powell noted that the Fed is "overachieving" on the maximum employment side of its dual mandate, but remains "very far" from reaching its price stability goal. In essence, Powell has stated the Fed's commitment to reducing inflation, even if it results in a period of contracting economic activity and a moderate rise in the unemployment rate.

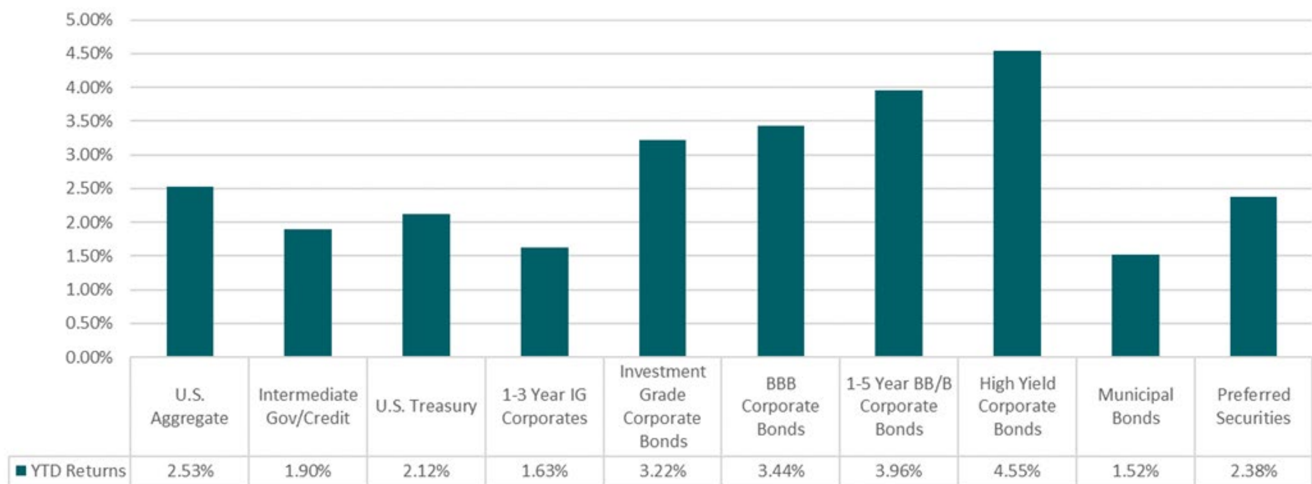
Fixed Income Outlook

While far less challenging than last year, the first half of 2023 saw a continuation of volatility in bond markets. The Fed continues its aggressive pace of rate hikes, while there was significant stress in the banking sector, concerns over the debt ceiling and a potential default on U.S. government bonds.

Fixed income returns were positive for all major sectors of the bond market during the first half of the year. Based on today's starting yield levels – which historically have a strong correlation with future returns – high-quality bonds may offer long-term, equity-like return potential with significantly less volatility and more downside protection than equities. As an example, the yield on the 5-Year U.S. Treasury note is roughly 200 bps higher than the dividend yield on the S&P 500 index, a wide differential relative to the 20-year average of 35 bps.

Overall, we remain neutral from an interest rate, or duration, risk perspective relative to the benchmark and would consider slightly increasing maturity profiles on a significant increase in yields. Economies are slow and the apparent commitment of the Fed to reduce inflation means the potential for a recession is increasing.

With the shape of the yield curve still inverted, Treasurys with less than 12 months to maturity continue to offer the highest yields. Given the limited duration, these securities generally exhibit less volatility, however, they do not provide the same diversification properties and ability to generate total return through price appreciation if yields decline, as has occurred in prior recessions, as Treasurys with intermediate or longer maturities. Investors with significant exposure in short-maturity bonds are always taking on a significant amount of reinvestment risk – or the risk that interest rates are



Source: Bloomberg, 06.26.23

lower when a bond(s) matures and an investor has to invest the proceeds in a lower yield security.

Intermediate maturity Treasurys – those with between 5 and 10 years to maturity – offer both a hedge against risk-off environments 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. Treasurys. The current shape of the yield curve means that investors are picking up very little, if any, yield for extending beyond 10 years to maturity. Furthermore, there are multiple factors which could result in investors demanding a higher yield premium for longer-maturity U.S. Treasurys relative to the past 15 years, including the government's debt-to-GDP ratio and the return of an inflation risk premium.

The yield and spreads on Agency mortgage-backed securities (MBS) are at the highest levels since 2008. However, the sector has numerous crosscurrents to contend with. Most challenging is the supply and demand technical with the Fed allowing mortgages to runoff its balance sheet, the FDIC selling Agency MBS which was held by banks that failed and lower bank demand.

Non-agency mortgages remain attractive, benefitting from the strong U.S. housing market, which – despite recent price declines – is supported by limited supply and strong borrower fundamentals.

With investment grade corporate bond market, investors will become more focused on the underlying credit fundamentals of companies and the resilience of business models given the elevated chance for a recession. Until this point, there has been very little dispersion between issuers in the investment grade market. This will change in the event of a recession as sectors and companies which are more sensitive to the business cycle will underperform.

At a credit rating level, select BBB-rated issuers remain attractive. 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 balance sheet leverage. Conversely, many higher-quality companies have the ability to undertake actions such as M&A or engage in shareholder-friendly activities that will lead to a deterioration in their balance sheet. From a sector perspective, we are focused on industries that are broadly defensive given the heightened potential for a recession. Conversely, we are cautious about the cyclical areas of the market as well as sectors that are more likely to pursue M&A or ones that face obsolescence risk.

Ultimately, we expect more idiosyncratic risk in the corporate bond market than at any time since the financial crisis, meaning that active management and accurate credit selection (and avoidance) will be rewarded.

High-yield corporate bonds have produced strong returns in the first half of the year. However, while yields in the sector are attractive, a large portion of that all-in yield is due to the higher U.S. Treasury base rate with the portion attributable to credit spreads at a level that is just in line with the long-term median. Issuers in the high-yield market are also more sensitive to the length of time that the cost of capital remains elevated due to the shorter weighted average maturity of their bonds relative to investment grade issuers.

Therefore, at current valuations, the risk premium for high yield bonds does not offer adequate compensation to investors for the potential of a recession and higher default rates.

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 expectations for the path of the Fed's policy rate re-price higher or the timing of rate cuts is pushed out further into the future.

The preferred securities market has seen a sharp increase in volatility since the failure of Silicon Valley Bank in early March. However, in contrast to the global financial crisis, the stress has not been the result of high leverage or poor asset quality. In fact, bank assets are generally invested in bonds issued by the U.S. Treasury and Government Agencies. Rather, the challenges have been created by depositor outflows which has resulted in a mismatch between assets and liabilities.

Profitability will remain compressed as banks are being forced to pay more for deposits to compete with money market funds and Treasury bills, which are paying over 5%. This will continue to pressure bank earnings until the Fed begins to cut interest rates and the shape of the yield curve normalizes.

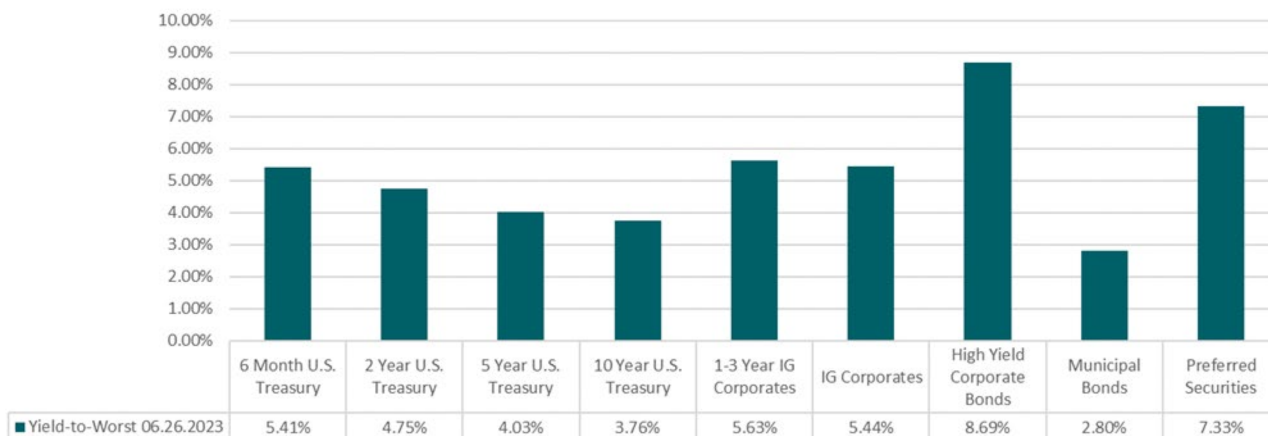
Our preference for larger U.S. banks remains. These institutions have business models that derive income from multiple lines of business, such as capital markets and wealth and asset management. These other lines of business can help insulate the bank from lower profitability in traditional banking services. Also, larger banks have been the beneficiary of the stress in regional banking, with savers actually moving money to these institutions since March.

Lastly, many regional banks also have larger exposures to commercial real estate and the weakness in the office space could challenge the capital levels of certain institutions.

Preferred securities issued by non-banks, such as energy and utility companies, were also caught up in the broader sell-off in March. Fundamentally, the regional banking stress will have relatively little impact on some of these issuers, therefore the decline in price of these securities may offer an attractive entry point.

Overall, volatility is likely to remain elevated and while the longer-term outlook remains good for preferred securities issued by the largest financial institutions, a patient approach is warranted in the near-term.

The outlook for municipal (muni) bonds remains favorable from both a fundamental and technical perspective. In general, municipalities are on a sound financial footing thanks to the combination of pandemic-



	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 06.26.2023	5.41%	4.75%	4.03%	3.76%	5.63%	5.44%	8.69%	2.80%	7.33%

Source: Bloomberg, 06.26.23

related stimulus, strong tax collections, and prudent savings.

While municipalities are not immune to the business cycle, governments taxing ability is a benefit over corporate bonds. In addition, muni issuers don't have exposure to pockets of venerability that exist in some other parts of the credit market, such as exposure to commercial real estate or prominent linkages to the banking system.

From a technical perspective, demand for munis has remained strong while supply continues to be muted.

Valuation in the space is more nuanced with variations along the maturity spectrum. In general, bonds with maturities inside of 7 years are expensive relative to U.S. Treasurys, even after factoring in the tax benefit. On the other hand, bonds in the 12-to-18-year maturity range remain attractive.

There is also value in parts of the taxable muni bond sector, which can offer some diversification benefit relative to corporate bonds.

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.

The new regime in which central banks will be slower to provide support for financial markets suggests an environment of higher macro and market volatility and will require investors to constantly assess what is being priced by markets. Paradoxically, it should be a great environment for active management and the potential to generate alpha as this backdrop will see dispersion across sectors, within rating categories, and between individual issuers. Investors should also consider liquidity buckets within portfolios that will allow them to opportunistically take advantage of dislocations.

Private Assets

Private markets continue to offer investors the opportunity to enhance returns, generate income and provide diversification in the context of an overall portfolio.

The private real estate market will likely be dislocated in the near term due to higher interest rates. In the post-Covid zero interest rate environment, many managers took on high LTV floating rate debt that will need to be refinanced at higher rates. This will lead to forced sales in some cases, which will provide an opportunity for managers with fresh powder and those who are more prudently capitalized. Outside of the office sector, property-level fundamentals are generally sound, with occupancy levels and rents at healthy levels. Prices on multifamily (apartment) properties have fallen from their peaks, after seeing dramatic gains over the past few years as rents rose at a much higher rate than wages. Decreasing housing affordability, however, should prevent large declines as many would-be home buyers have been priced out of the market, and the supply of housing remains limited. 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.

Private credit strategies stand to benefit from the recent stresses in the banking system which will impact capital formation. Banks are tightening lending standards, which will create a void that will need to be filled by private markets.

The amount of defaults and non-performing loans in the private credit space 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.

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