October 2023

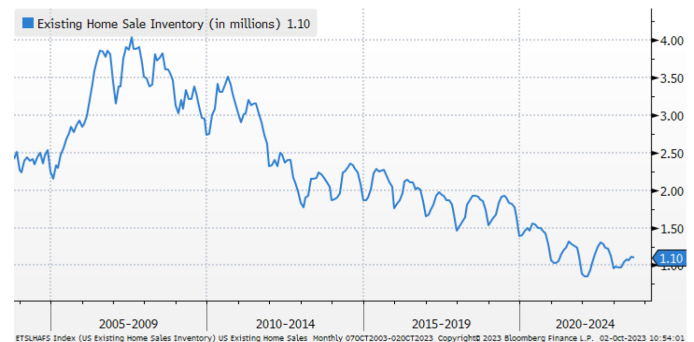
Q4 2023 Economic & Fixed Income Outlook

Economic Outlook

At the start of the year, the prevailing view amongst economists was the elevated chance for a recession as the impact of the most aggressive interest rate hiking cycle in four decades fed into the economy. However, the 'imminent' recession has been repeatedly postponed as economic data has been incredibly resilient – and in some cases has reaccelerated – driven in large part by the strength of the consumer, which has been supported by a robust labor market, remaining pandemic-related stimulus and a moderation in inflation.

The expansion of fiscal policy has also been a significant tailwind to the economy. Over the past year, the federal fiscal deficit has significantly increased, rising from 3.9% of GDP in August 2022 to 8.3% of GDP in June 2023. This expansion is bigger than what has typically been seen in prior recessions, let alone during a period of time when the economy is expanding.

Despite the substantial rise in mortgage rates, the housing market has been another source of positive surprise. The residential market has been supported by the chronic mismatch between supply and demand. The mortgage "lock-in" effect – where homeowners are unwilling to move and forgo their low mortgage rate – has exacerbated the mismatch and has resulted in a decrease in the number of existing homes for sale. The chart below shows the inventory of existing homes currently available for sale, which at 1.1 million units is near an all-time low (seasonally adjusted it is at an all-time low). This has forced buyers into the new home market, which has supported homebuilders, associated industries, and jobs, with U.S. construction employment near an all-time high.



The construction boom is also occurring in factories, warehouses, and data centers as American businesses re-shore supply chains. Investment in this area has been supported by billions of dollars in incentives and tax credits included in the CHIPS and Science Act, the Infrastructure Investment and Jobs Act, and the Inflation Reduction Act.

Looking ahead, the better-than-expected growth backdrop, combined with moderation in inflation pressures, has increased the odds that the U.S. economy will achieve a 'soft landing' where the economy and inflation cool enough to allow the Fed to lower rates and prevent a recession. Supporting this narrative is the lack of excess leverage on consumer balance sheets, which has historically driven deep economic contractions. The structural shortage of workers suggests that the labor

Craig Sullivan, CFA, CAIA®
Director of Fixed Income, External Managers, and Alternative Investments

Tia Simser
Fixed Income Portfolio Manager and Trader

Christopher Eckert
Fixed Income Portfolio Manager

Matthew Inman, CFA, CFP®
Senior Client Portfolio Strategist and Alternative Investment Analyst

market could remain strong, which would be a continued support for consumer spending.

While borrowing costs are rising for smaller and lower-rated companies – which often borrow based on floating interest rates, most large corporations took advantage of record low interest rates to term out their debt. Therefore, many companies have been able to maintain margins that are still in line with pre-COVID averages, despite rising labor costs and a higher short-term borrowing rate.

The headwinds facing the U.S. economy include tighter credit conditions, the resumption of student debt payments, and a shortage in several key categories, including housing and workers, which could see a continuation of inflationary pressures.

Furthermore, there is the auto-workers strike and the potential still for a government shutdown. At this point, it is impossible to predict how the autoworkers' strike will affect the economy. However, the economy will suffer if the dispute continues for several weeks or months and leads to the shutdown of a sizable portion of American auto production.

The level of inflation is possibly the most important factor affecting the economic outlook. While inflation should continue to moderate over coming quarters, the key question is how committed the Fed is to returning inflation to its 2% target. To achieve this, a rise in unemployment and an easing of wage pressures will be needed.

Our belief is that inflation will have a higher resting heart rate (2.5 – 3.5%) over the coming years than the sub – 2% rate that investors experienced between the financial crisis and the pandemic.

There are several factors that could keep the beat of inflation higher, including:

1) Structurally faster wage growth, especially on the services side of the economy, due to labor shortages, particularly in leisure, education, and healthcare.

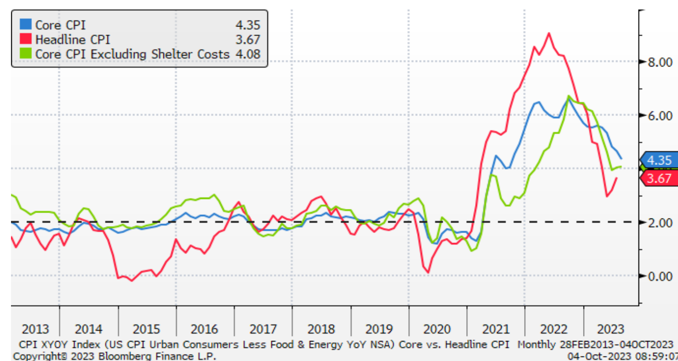
2) Shifting geopolitics that are resulting in deglobalization and less-efficient supply chains.

3) The fact that housing demand continues to exceed supply means that rental incomes, which make up a significant portion of inflation, are unlikely to decline as much this cycle.

4) The transition to renewable energy sources is inflationary in nature.

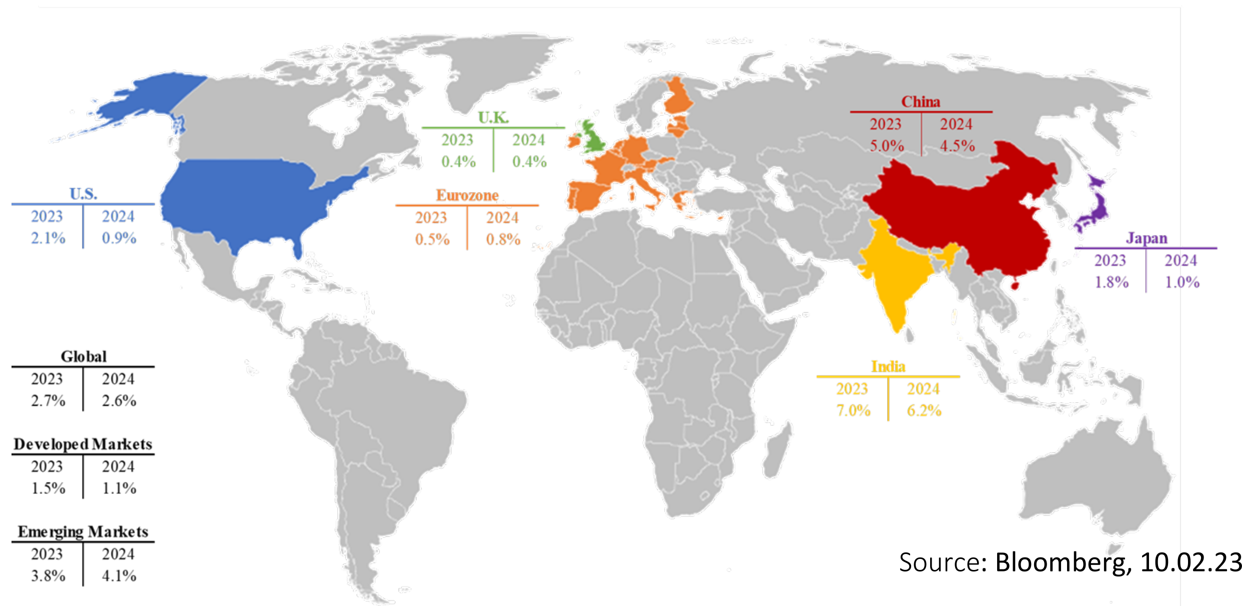
5) Finally, there is more fiscal impulse this cycle than in the past, including global defense spending, the Inflation Reduction Act in the U.S., the Green Act in Europe, etc.

Such an inflationary backdrop suggests that monetary policy won't be able to be as accommodative as it was in the interim between the financial crisis and the pandemic. During that period, inflation was contained at 2% or less, allowing the Fed to provide monetary stimulus to prolong the growth cycle. Furthermore, high government debt levels imply that financial stimulus will be less likely. Combined these factors suggest higher and more frequent bouts of volatility during this cycle.



Relative to the U.S., the outlook for many international economies is worse. Chinese growth has disappointed, slowing much more than forecast. The housing market, which has been a critical driver of Chinese growth over the past decade, has become a major drag on the economy. Furthermore, the labor market is weak, with rising unemployment, especially among the young.

In general, the backdrop for emerging market economies is not favorable, with a cyclically slowing global economy, a structural decline in China's demand, and higher interest rates for longer in the U.S.



Source: Bloomberg, 10.02.23

In contrast, the growth trajectory in India looks strong, with favorable demographics relative to most other parts of the world. In addition, it is a more domestically driven economy, which should insulate it from slower growth in China. The IMF expects India's economy to grow 6-6.5% per year over the next five years.

Europe remains burdened by high energy prices, the Ukraine war, and weak demand from China. Tighter monetary policy from the European Central Bank has resulted in a significant slowing of credit, which is impacting key sectors of the economy and the consumer. The potential for stagflation has increased, with subdued growth and elevated inflation.

In summary, the U.S. economy has – thus far – fared far better than many forecasters feared. Recession calls have been pared back in recent months with more economists increasing the odds of a soft landing. However, as the effects of the long and variable lags of monetary policy are reflected in the economic data, we anticipate that markets will continue to fluctuate between pricing in a soft landing and pricing in a recession.

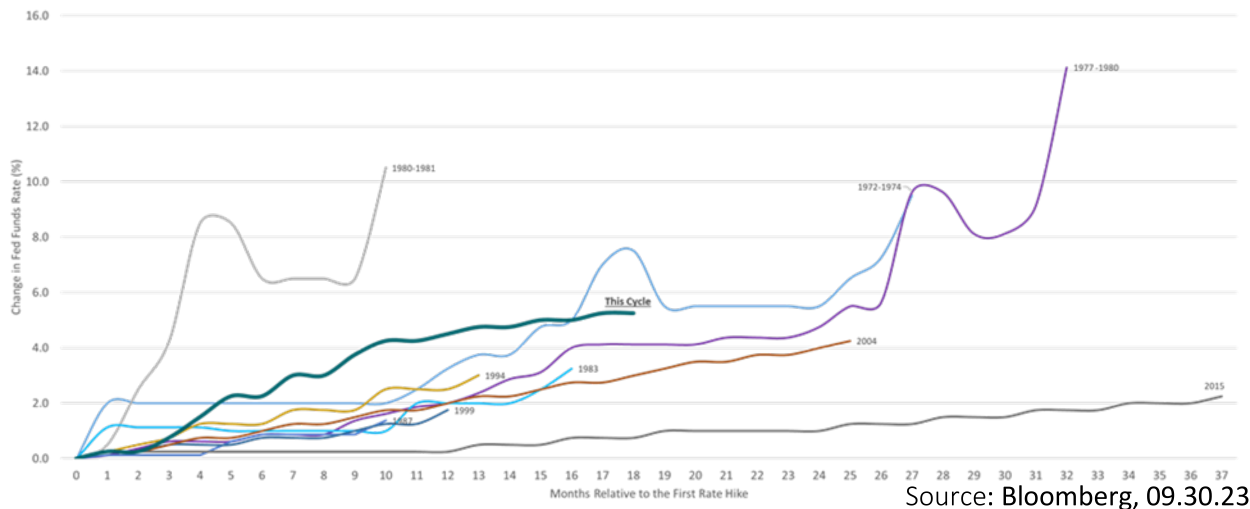
The upcoming quarters will be key in revealing global central banks' degree of success in bringing down inflation, the future path of monetary policy, as well as to what extent balance sheet resilience and fiscal programs may offset drags from interest rate and credit tightening.

While the odds of a recession have declined, the range of potential outcomes – including a recession – remains wide. In this environment, it is important to use a probabilistic, scenario-based approach to forecasting macro and market outcomes rather than constructing portfolios based on one potential outcome. The ability of active management to adjust positioning to adapt to quickly shifting market narratives will be a source of opportunities.

Monetary Policy

In an effort to get inflation back to its 2% target, the Federal Reserve (Fed) has increased its policy rate by 500 basis points (bps) since March 2022, making this cycle the most aggressive rate hike cycle in more than forty years.

While the Fed did not increase rates at its most recent meeting in September, it did communicate the view that policy rates are likely to remain elevated for some time and that the neutral policy rate (the rate at which the Fed is neither stimulating nor subduing economic activity) may be higher than previously projected. The 'higher for longer' narrative was conveyed through both Chairman Powell's press conference and the updated Summary of Economic Projections (SEP).



Source: Bloomberg, 09.30.23

The majority of Fed officials predict another 25 bps rate hike in 2023, according to the dot plot of the Fed's interest rate projections, which is consistent with its position at the June meeting.

The Fed did, however, update its projection for policymaking next year. The median dot, which now shows 50 bps of rate cuts as opposed to 100 bps in the previous forecast, highlights the ‘higher-for-longer’ outlook.

The forecast for policy action in 2025 still calls for 100 basis points of rate reductions, which means that the policy rate will end 2025 at 3.87%, 50 basis points higher (due to fewer reductions in 2024) than the projections released following the June meeting. The September SEP also included the first forecast for where the policy rate will end in 2026, with the median dot set at 2.875%.

Although the median longer-run rate remained at 2.5%, Fed officials seem more amenable to revising the neutral rate. During his press conference, Chairman Powell suggested that the neutral rate may have increased, and the short-run neutral rate may be higher than the longer-run rate depicted in the dot plot. The case for rate cuts next year may become less compelling if that viewpoint continues to prevail.

The Fed is also continuing to reduce the size of its balance sheet through a process known as quantitative tightening (QT). Despite receiving less attention, QT is an additional method of monetary tightening. When bonds mature off the Fed’s balance sheet without being replaced, the amount of reserves in the banking system decreases, tightening money availability in the economy and raising borrowing costs.

Chair Powell did make it clear that there is a collection of risks that will keep the Fed ‘data dependent’ and the future path of inflation and the labor market could result in changes to the outlook for monetary policy.

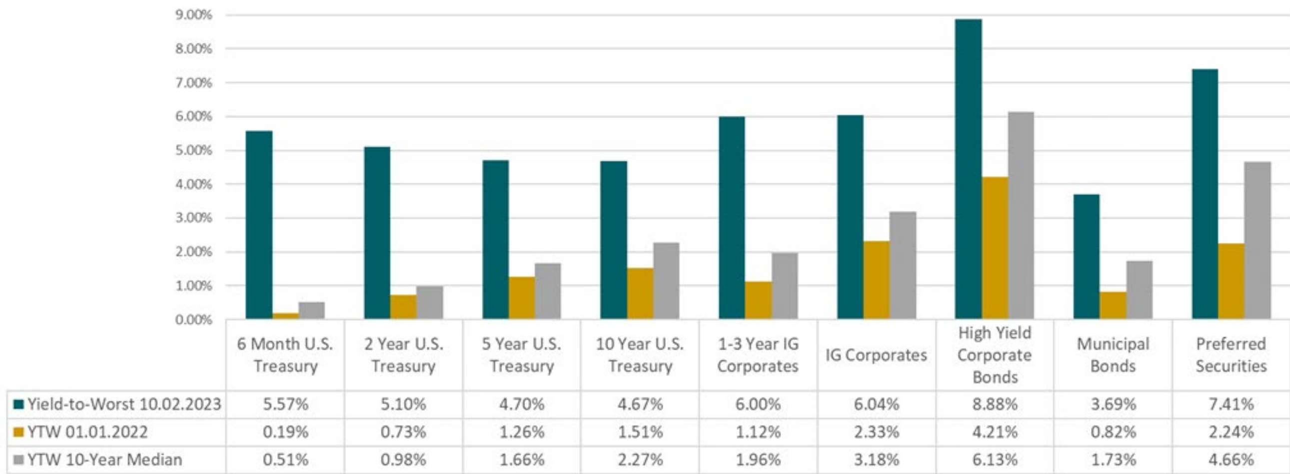
Fixed Income Outlook

The opportunity set available in the bond market is the most alluring it has been in more than a decade. The total return prospect has improved significantly thanks to the renaissance of higher yields, which will also allow them to function once more as a ballast during risk-off periods. In addition, a ‘soft landing’ and a recession are both good environments in which to own bonds.

Within fixed income portfolios, U.S. Treasury bonds serve as a source of liquidity and provide diversification from credit risk. Due to these qualities, investors can use them as a source of funds to capitalize on market dislocation.

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.

Our preference for short and intermediate-maturity bonds is a preference across all sectors of the fixed income market. The inverted yield curve provides bond investors a unique opportunity to earn higher yields while taking less interest rate risk. This is a fairly rare



	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 10.02.2023	5.57%	5.10%	4.70%	4.67%	6.00%	6.04%	8.88%	3.69%	7.41%
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	0.51%	0.98%	1.66%	2.27%	1.96%	3.18%	6.13%	1.73%	4.66%

Source: Bloomberg, 10.02.23

occurrence, in fact, in the past 31 years, the yield on the 2 year Treasury has exceed the yield on the 10 year Treasury for less than 9% of all trading days.

While the yields on intermediate-maturity bonds (5-10 years) are lower compared to bonds with lower maturities, they will benefit materially more when the Fed begins to cut interest rates and have lower reinvestment risk. Conversely, we remain cautious on longer-dated (those with greater than 10 years to maturity) bonds given the lack of additional yield pick-up for increasing interest rate risk. In addition, we could envision a scenario where longer-dated yields do not decline meaningful when the Fed reduces its policy rate. This is due to the belief that investors may begin to demand more of a premium (known as a term premium) for buying longer-dated securities following the recent period of elevated inflation and due to higher government debt levels.

The combination of higher interest rates, elevated volatility, and forced selling by investors and from the balance sheets of banks taken over by the FDIC 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.

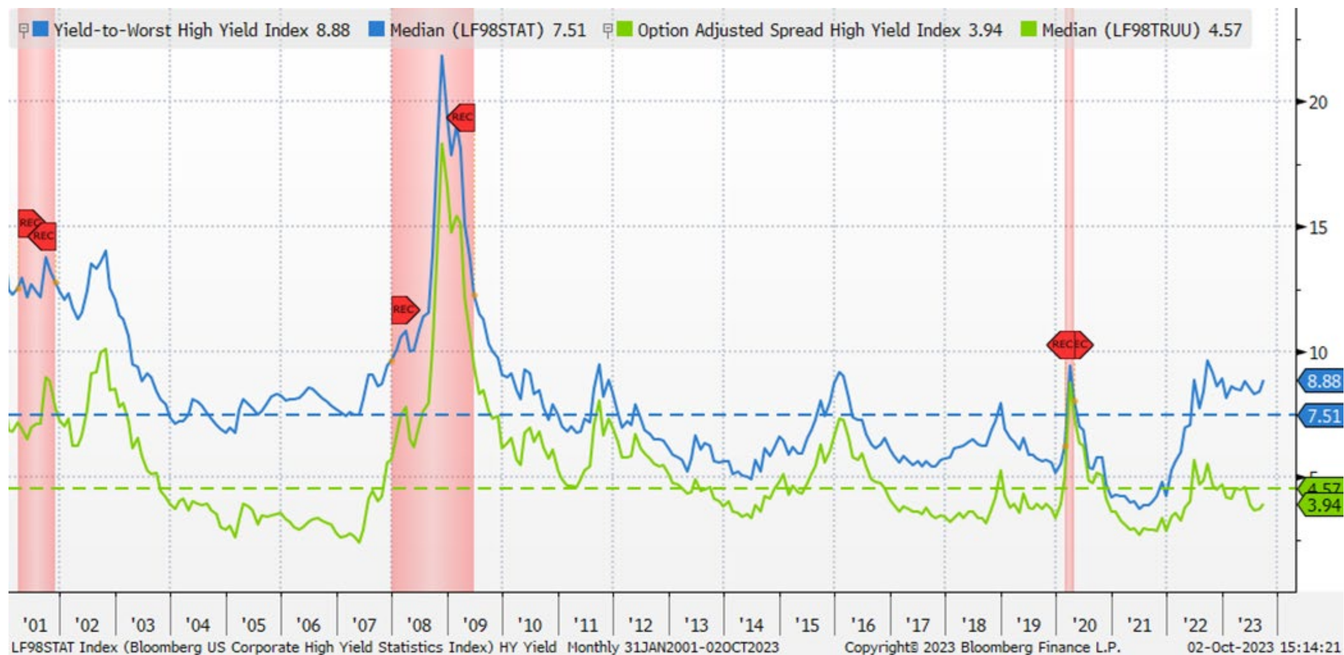
While supply has declined, so has demand, as both the Fed and large U.S. banks – previously the two largest

buyers in the sector – are no longer buying. Despite the loss of two major buyers, agency MBS valuations have cheapened to a level where we consider them to be moderately attractive due to the sector's strong liquidity, high credit quality, elevated spread levels, and diversification benefits relative to other risk assets.

Within mortgage credit, we continue to favor high-quality, senior non-Agency mortgages. The sector benefits from the high amount of underlying home equity, the supply-demand imbalance for housing, and the improved consumer credit profile.

Investment grade corporate bonds are offering the most attractive level of income in more than a decade. However, around 80% of the 6% yield on the investment grade index comes from the U.S. Treasury component, with only 120 basis points attributable to the risk premium earned for owning corporate bonds (the index yield is a combination of the yield on a U.S. Treasury + the risk premium demanded by investors for the extra risk of owning corporate (or other non-U.S. Treasury) bonds, which is measured by the credit spread).

The current credit spread is in line with the longer-term average suggesting that corporate bonds – at a general index level – have limited scope for spread compression at this point in the cycle. This backdrop suggests that generic, broad-based exposure to corporate bonds is unlikely to be the most effective manner to gain exposure to the asset class. Instead, the environment is



a good one for active management which can benefit from relative-value positioning and security selection (as well as avoidance).

From a sector perspective, we are focused on industries that are broadly defensive, such as communications, pipelines, and utilities.

Conversely, we have a more 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, and those that face potential M&A and obsolescence risk. We are also vigilant about very high-quality sectors of the market where valuations might be stretched and the risk of shareholder-friendly activities could be higher (i.e. where companies have ample debt capacity and appetite for stock buybacks or dividend increases).

In terms of individual securities, we are seeking companies with stable or improving credit metrics, pricing power, the ability to generate cash flow in an environment where inflationary pressures may remain sticky, and management teams that are focused on strong credit fundamentals. Many BBB-rated companies satisfy these criteria and offer additional yield but lower credit deterioration risk compared to higher-rated peers.

Like the investment grade market, the re-pricing of yields (blue line) in below-investment grade corporate bond market has been driven solely by the move higher in U.S. Treasury yields. In fact, credit spreads for the high-yield market have actually declined since the start of the year and are below their long-term averages.

This suggests that the current risk premium offered by high-yield bonds does not reflect the heightened potential for a recession or any left-tail risks.

Furthermore, U.S. banks continue to tighten lending standards which has historically been correlated with wider high yield spreads.

High-yield spreads typically widen in the lead-up to and during 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, there could be better entry points down the road.

In general, within corporate credit, we continue to advocate for ‘keeping it simple’ by moving up in the capital structure and not stretching on leverage, particularly at a time when EBITDA margins are starting to normalize.

Utilizing AAA-rated collateralized loan obligations (CLOs) is an attractive way to gain access to the high yields

available at the front end of the yield curve. Given how much financial conditions tightening has occurred through higher SOFR (the overnight financing rate), rather than via higher spreads, one can earn a very attractive yield in AAA CLOs without taking duration risk or a lot of credit risk. With floating rate coupons, the sector will also benefit in a higher-for-longer interest rate environment. We prefer deals with smaller reinvestment windows and shorter average life.

The preferred securities market has continued to bounce back following a volatile first quarter. Despite the recovery, the additional yield offered by preferreds remains above historical averages. Relative to BB-rated high yield bonds, valuations are historically cheap. Furthermore, preferred securities have historically provided better risk-adjusted return than HY bonds.

However, the confluence of interest rate volatility, recession risk and bank credit concerns means that price volatility could persist in the near term. While a compression in net interest margins (profitability) is more of a headwind to equity valuations, at times it could still result in periods of price volatility in preferred securities. Therefore, we are employing a more cautious stance towards the sector by lowering our allocation, but with the goal to opportunistically add exposure if the sector experiences an additional drawdown.

From a coupon structure perspective, we continue to find better value in floating rate or fixed-to-floating rate preferreds, as fixed-rate preferreds remain overvalued given relatively tight spreads and higher interest rate sensitivity.

In terms of issuers, our focus remains on large, high-quality, “national champion” banks in the U.S. – and in select cases Europe – that have benefitted from over a decade of regulatory-driven capital rebuild, balance sheet de-risking, and deleveraging. Furthermore, these institutions should continue to handle deposit funding pressure better than smaller ones.

During the quarter, Fitch Ratings recently became the second of the three major ratings agencies to downgrade the U.S. long-term debt rating to AA+, below the AAA rating currently assigned to twelve U.S. states, including North Carolina. While somewhat counterintuitive, this relationship is not surprising. U.S. states benefit from numerous structural strengths and constraints that encourage a fiscal discipline consistent with credit ratings higher than that of the sovereign. While states are impacted by the policies and performance of the U.S. government, the credit quality of states as a group is not constrained by the U.S. sovereign rating and we don’t expect the U.S. downgrade to have an outsized impact on muni bond valuations going forward.

The underlying fundamentals of municipal issuers continue to show improving credit momentum. States are experiencing improving credit metrics due to very strong tax revenues as the economy expands. On a local level, many cities are receiving surpluses from the state and are receiving additional tax revenue due to strong home price appreciation.

From a technical perspective, new issue supply has remained muted, creating a supply/demand imbalance and a tailwind for performance.

Valuations vary along the maturity spectrum, with some tenors more attractive than others. In general, bonds with 10 year or less to maturity are trading rich relative to taxable equivalents such as U.S. Treasurys. On the other hand, longer maturity muni bonds offer attractive value on a tax-equivalent basis.

At a sector level, our focus remains on high-quality general obligation and essential service revenue bonds.

In summary, the transition to a higher rate regime has been painful over the past 18 months. However, it means that the future income and total return potential of high-quality bonds have improved significantly. It also increases the potential for them to act as a ballast to portfolios should an adverse scenario materialize in this cycle.

Today, there are interesting opportunities across several different sectors of the market, but it will be necessary to invest selectively with judicious security selection. Unlike recent cycles, where with the support of monetary policy, all companies benefitted, going forward, active security selection and avoidance will be crucially important.

Private Assets

We continue to view private investments as a way to provide diversification and income, and, in certain cases, as a hedge against further inflationary pressure. Within private investments, our focus has been on private credit, and select areas of private real estate.

In a higher-for-longer rate environment, we see opportunities for investors to earn attractive returns in private credit. Compared to public bond markets, private credit involves directly providing loans to companies in privately negotiated transactions. The strategy can offer incremental income generation and greater resiliency during periods of heightened volatility.

Bank lending has become much tighter in the post-GFC world, and this trend was exacerbated by the regional banking crisis in March of this year. Private credit is currently filling this gap. While borrowers that have the scale to access the public bond market can potentially do so at a cheaper interest rate relative to private credit, there are regulatory hurdles that can be time intensive. Private credit offers speed and certainty of execution, at a premium that investors can reap.

Private credit has become more “crowded”, as there are many new inexperienced managers entering the space to capitalize on the opportunity. A proliferation of semi-liquid structures have come to market recently, making investing in the space more accessible and providing a lot of fresh powder to the asset class. We believe it is imperative to partner with experienced managers in order for investors to realize the full benefit of adding private credit to their portfolios.

In private real estate, values have fallen dramatically from their highs. Lending in this space has dried up, with regional banks having very limited appetites for making new loans. Private lenders are picking up some of the slack, but financing will likely be a key issue for commercial real estate for a prolonged period.

Commercial real estate is typically financed through short term interest-only loans, with balloon payments at maturity. As these loans are maturing, borrowers are faced with the challenge of lower LTV loans being offered, while values have simultaneously fallen, meaning more equity has to be put up by the borrower. In many cases this is resulting in the borrower “mailing in the keys” to the lender. These instances of forced selling are creating opportunities for managers with dry powder. Fresh pools of capital being raised in the real estate space may provide a chance to target the most attractive opportunities to access the market without the burden of legacy assets.

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