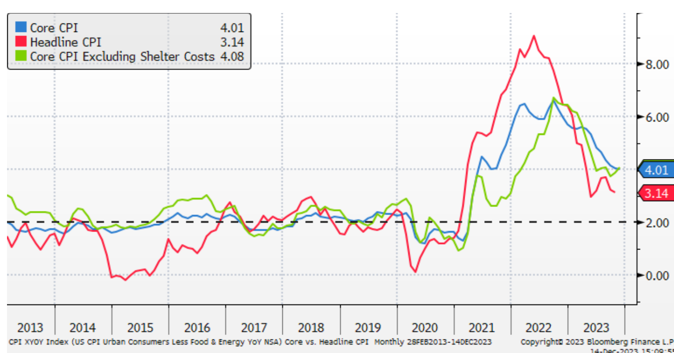
December 2023

2024 Economic & Fixed Income Outlook

Economic Outlook

Economic predictions for 2023 highlight that while the inevitable is certain, it is not always punctual. Entering the year, most economists and economic models predicted a recession. However, the most-anticipated recession in history did not arrive as 'scheduled' as the U.S. consumer, flush with excess savings and a willingness to use credit, continued to spend. Furthermore, the impact of tighter monetary policy was more than offset by very expansive fiscal policy.

After reaching a four-decade high in 2022, inflation moderated significantly in 2023. The healing of supply chains contributed to the decline in 'goods' inflation. Progress on 'service' inflation has been slower, as components such as the shelter category have remained sticky.



Paradoxically, the sharp rise in mortgage rates has supported home prices through reduced supply. Several factors have constrained supply, most notably the "lock-in effect" by which homeowners with low mortgage rates are reluctant to sell their current home to buy another home at a much higher mortgage rate. The supply/demand imbalance looks set to continue, which will continue to support home prices and rental income.

Looking ahead to 2024, several factors – most notably the large expansion of the fiscal deficit and the consumer's ability and willingness to tap excess savings – that drove robust economic growth in 2023 are unlikely to provide the same magnitude of boost.

On the fiscal front, the deficit roughly doubled to $1.84 trillion – approximately 7.4% of GDP – in fiscal 2023. Over the coming year, the deficit is forecasted to 'moderate' to 5.9% of GDP. While still a very large amount, it will be less supportive of economic activity relative to 2023. As fiscal support fades, the drag from tighter monetary policy will intensify.

Our more cautious attitude towards the consumer stems from the fact that the three sources of consumption – savings, borrowing, and income – are becoming more elusive. Savings rates have declined, credit card balances have increased, student loan repayments have resumed, and the labor market has softened slightly. Recent data has shown some cracks emerging in the low-end of the income spectrum. Banks are also drawing a distinction when lending to consumers, with a growing preference to lend to consumers with higher credit scores. In spite of this, the consumer entered this period without significant amounts of leverage and with the unemployment rate only forecasted to rise modestly,

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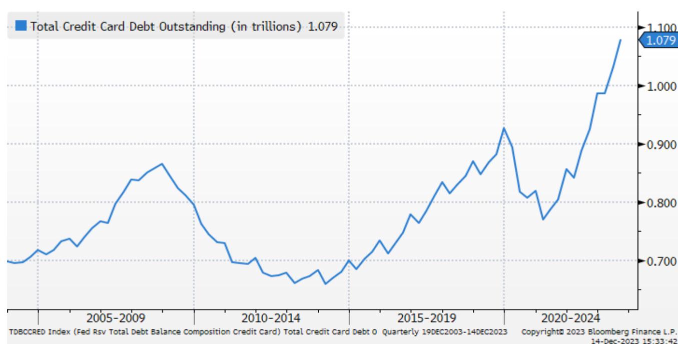


and consumer spending is likely to moderate but not fall drastically.

The Inflation Reduction Act, CHIPS, Science Act, and other subsidies and grants, along with the fervor related to artificial intelligence, could support capital expenditures on machinery, buildings, and intellectual property rights.

Inflation looks set to continue to moderate, but it is uncertain whether inflation will be able to return to the Federal Reserve's 2% target without a further slowdown in economic activity. There are also structural factors, including the lack of workers and rising production costs due to deglobalization, that suggest inflation may have a higher resting level compared to pre-pandemic.

Overall, the U.S. economy continues to be impacted by several counterbalancing factors. The very distinct characteristics of this economic cycle, and the Fed's reaction function to inflation and the labor market, have introduced greater uncertainty about a potential recession and its timing. It is also possible that no broad-based recession occurs, rather parts of the economy experience mini-recessions that impact various industries at different times.

Outside the U.S., economic paths across regions diverge, with growth prospects, inflation, and monetary and fiscal policies moving in different directions and speeds.

The Eurozone has been leading the growth slowdown among large economies due to the ongoing adverse effects of higher energy prices, a more significant drag from monetary policy tightening, and weak global industrial activity. Germany, the region's largest economy, has been acutely impacted by the slowdown in the manufacturing sector.

The contraction in growth during the third quarter could last through the first half of next year. Longer-term, Europe's debt dynamics remain an issue. Outside of the substantial investment needs associated with improvements in energy security and decarbonization policies, fiscal stability is again becoming a focus of the European Commission.

Since the start of the pandemic, China has increasingly been less synchronized with economic activity in developed market economies. After a strong first quarter, Chinese economic growth has disappointed this year. Several structural factors have weighed on activity, including a lack of consumer confidence, poor demographics, and a sharp downturn in the property sector. There is a risk that the Chinese economy could fall into a structural debt-deflation loop, creating an additional drag on economic activity. Such an outcome would have implications for growth across the rest of Asia.

To stimulate growth, the Chinese government has recently announced stimulus programs and additional policy support in areas such as infrastructure and manufacturing are possible. Furthermore, with inflation declining, there is scope for monetary support through rate cuts.

The Indian economy, which is diversified across numerous sectors, continues to perform well, benefitting from strong demographics and the desire of companies to diversify their supply chains away from China. Other countries, such as Mexico and Vietnam, are also benefitting from re-shoring. Estimates are that the Indian economy will become the third-largest economy before the end of the decade, overtaking Japan and Germany.

Broadly, a higher-for-longer U.S. interest rate environment and weaker global growth creates a more challenging backdrop for many emerging market economies.

2024 will be a year of elections. More than half of the world's population will vote in elections in 2024,

including, among others, Taiwan, India, Europe (European Parliament), and the United Kingdom. The Presidential elections in the U.S. will be particularly significant and will have meaningful impacts on the outlook for economics, geopolitics, and financial markets.

In conclusion, our base case is that the U.S. and global economy will slow to a below-potential pace but remain positive in 2024. As always, we consider alternative scenarios to our base case and remain vigilant about building portfolios to mitigate against both upside and downside macroeconomic and market surprises.

On the positive front, economic growth could remain above potential, with inflation moderating faster than expected without much of a rise in the unemployment rate. There is a strong structural demand for workers, particularly in the education, healthcare, leisure, and hospitality sectors. A strong labor market could allow the consumer – the engine of the U.S. economy – to continue to spend.

Over the intermediate term, the investment boom around Artificial Intelligence (AI) could spark a productivity boom that drives real growth above expectations, while also keeping inflation moderate.

Conversely, we are mindful that a slow-growing economy, like a slow-moving bike, is easier to topple over. Unlike the pre-pandemic era of easy monetary policy, low inflation, and comparatively stable geopolitical conditions, the current backdrop looks less stable.

Furthermore, central banks face tougher trade-offs with inflation and may be unable to respond to faltering economic growth with the same speed and conviction as they were pre-pandemic.

The extraordinarily aggressive and rapid tightening of monetary policy also increases the chance of a financial market 'accidents', such as the pension (LDI) crisis in the U.K. in the fall 2021 and the regional banking crisis in the U.S. last spring.

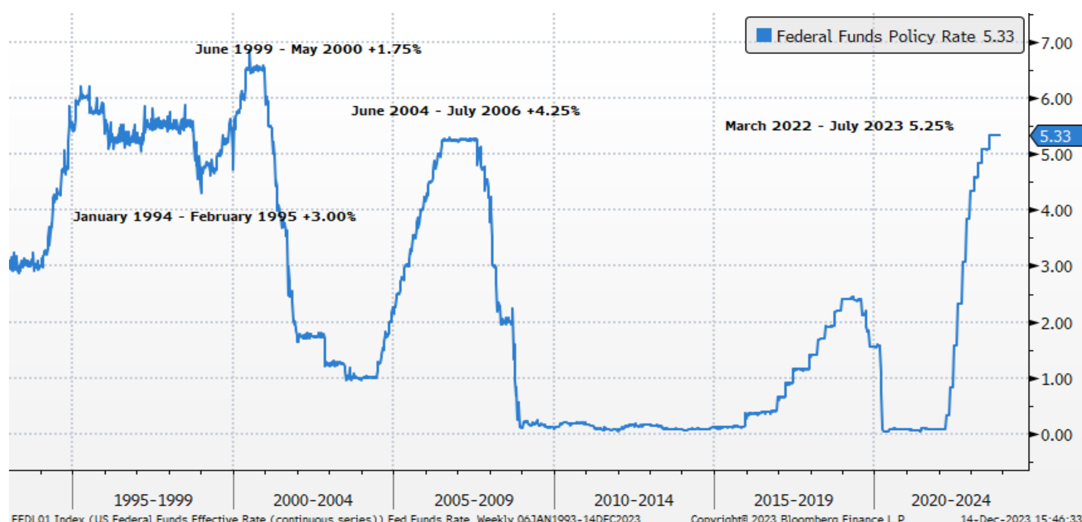
Given the wide range of potential outcomes, it is critical to take an active approach to asset allocation and portfolio construction, emphasizing diversification, risk management, and liquidity.

Fixed Income Outlook

The combination of cooling economic growth, a softer labor market, and moderating inflation all suggest that the last rate hike by the Federal Reserve (Fed) occurred at the July meeting.

However, the end of the hiking cycle does not necessarily mean that rate cuts are imminent. Interestingly, despite better-than-expected economic growth and inflation readings still above the Fed's 2% target, markets are pricing in a high probability that the Fed will begin cutting its policy rate in March.

One reason for this view is the belief that the Fed wants to keep the 'real' (after inflation) policy rate at the same level if inflation continues to decline. For example, if inflation falls by 0.50% over the next three months, then the Fed would need to cut its policy rate by 0.50% to maintain a constant level of restrictiveness, otherwise, monetary policy (as measured by the distance between the policy rate and the inflation rate) would be getting more restrictive. Such rate cuts would, therefore be fine-



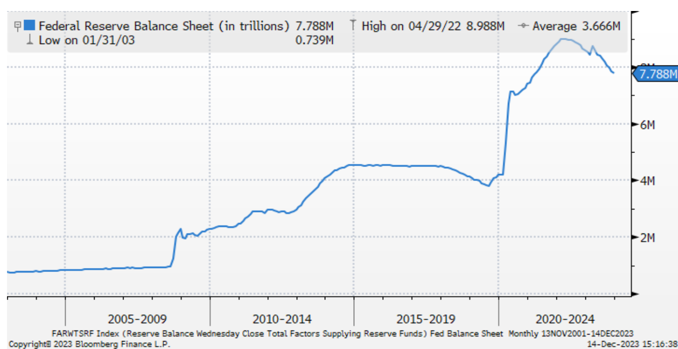
tuning how restrictive monetary policy is as opposed to an outright easing of policy.

While inflation has moderated, the Fed does not want to repeat the mistakes of the 1970s by cutting too early and risking the re-acceleration of inflation. In addition, despite hiking rates by 525 basis points (bps) between March 2021 and July 2023, economic growth has remained above potential, the labor market (and wage growth) has remained strong, and financial conditions easy. Therefore, we think a rate cut in the first quarter is not a foregone conclusion.

Longer-term, there are structural forces, including demographics, a shortage of workers, and deglobalization that suggest the economy's neutral rate (the Fed's policy rate that neither stimulates nor slows growth or inflation) may gravitate towards 3% (up from the previously estimated level of 2.5%).

We expect the Fed to continue reducing the size of its balance sheet, a process known as quantitative tightening (QT) through the first half of next year. The Fed has been shrinking its asset holdings since June 2022, allowing up to $60 billion in Treasurys and $35 billion in Agency mortgage-backed securities to mature each month without replacing them. Thus far, the size of the Fed's balance sheet has declined by roughly $1.2 trillion from a record peak of nearly $9 trillion in early 2022.

The only other time that the Fed trimmed the size of its balance sheet was from 2017-2019, when it allowed up to $50 billion per month to runoff. That round of QT abruptly stopped when unexpected funding issues began to occur in the financial markets.



It's not known how much more the Fed can reduce its balance sheet without similar repercussions. However, the combination of QT coinciding with a significant increase in Treasury bond issuance does heighten the potential for Treasury market dysfunction and liquidity issues within financial markets. Such issues would probably bring an end QT.

Globally, the actions of the Bank of Japan (BoJ) warrant investor attention. Since 2016, the BoJ has capped the yield on 10 year Japanese government bonds through a process known as yield curve control (YCC). It is expected that the BoJ will end this policy in early 2024 and begin to raise its policy rate. Higher interest rates in Japan, which is the largest holder of U.S. Treasurys, could entice Japanese investors to buy Japanese government bonds at the expense of U.S. fixed income securities.

While it is tempting to remain focused on the short end of the yield curve (less than 3 years to maturity), there is also value in owning intermediate-term (3-10 years to maturity) bonds which offer potential price appreciation if rates decline, have a lower reinvestment risk and typically offer a better hedge against equity volatility. Historically when the Fed cuts rates, the 3-7 year portion of the yield curve has experienced the best returns.

Conversely, we maintain a cautious view on longer-dated interest rates as investors are likely to demand 'sufficient' compensation for the uncertainties associated with holding bonds with more than 10 years to maturity. We expect a re-establishment of a 'term premium' (the excess yield that investors require to hold a long-term bond rather than a series of shorter-term bonds) due to a realization that inflation can still become unanchored, the large increase in Treasury supply necessary to fund the worsening Federal deficit, and the loss of key sources of demand – mainly the Fed, U.S. banks and foreign investors.

In aggregate, the credit quality of corporate balance sheets at the start of the Fed's hiking cycle (March 2022) was strong. However, following 525 bps of rate hikes, distinct marks have been left on particular sectors and issuers. Liquidity positions have seen significant erosion and are now below historical averages. Furthermore, the average funding cost will also increase as new, more expensive debt replaces older, cheaper debt. The speed and magnitude of this increase will depend on many

factors, including refinancing needs, capital management policies, and earnings growth. Following a muted year in 2023, there is also the potential for an increase in M&A and CAPEX activity in 2024.

Therefore, investors must be vigilant about the deterioration of corporate balance sheets and avoid the sectors and issuers where the impact of higher interest rates is having the most negative effects. Individual security selection (and security avoidance) will be paramount, as refinancing at higher coupon rates amid slower economic growth will create problems for some issuers, resulting in a larger dispersion in performance.

From the technical perspective, supply/demand should remain favorable with higher interest rates suppressing supply, as companies are incentivized to manage capital conservatively, and increasing demand with yields on corporate bonds near the highest levels in 15 years.

From a sector perspective within investment grade corporate bonds, we have a favorable view of regulated and less cyclical industries. Conversely, we have a more cautious view on many parts of the energy, food and beverage, and technology sectors. We seek to avoid companies that are overly focused on shareholder-friendly activities, in very cyclical industries, or trading at expensive valuations.

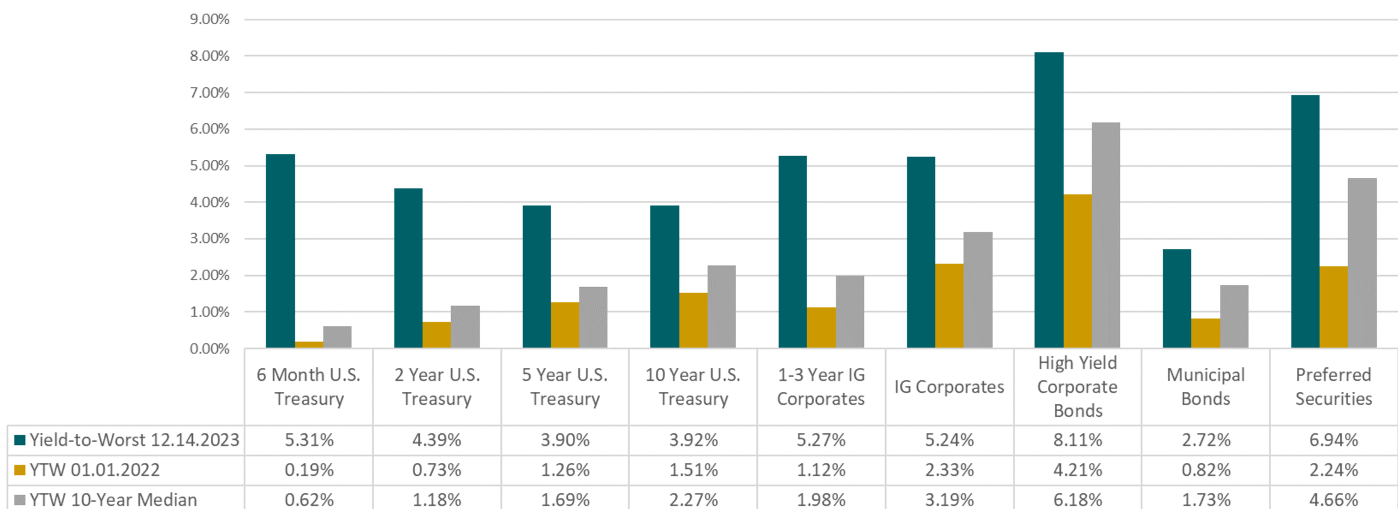
From a ratings perspective, we still find BBB-rated bonds attractive. Many companies in this ratings bucket have successfully de-levered their balance sheets and now have better credit metrics than higher-rated parts of the market.

The backdrop is more challenging for high-yield and leveraged loans. If economic growth is better than expected, then the Fed will hold rates higher for longer, which will have a sharper impact given the higher leverage and shorter liabilities of the sector. Conversely, if economic growth is worse than expected, or in the event of a recession, the smaller, more cyclical nature of this cohort leaves it more exposed.

Our base case is that the transition to a higher cost of capital environment will involve a further uptick in financial distress and defaults among issuers with over-leveraged and rate-sensitive balance sheets. While all-in yield levels are attractive, the risk premium (credit spread) offered by generic high-yield does not discount in the potential for a recession.

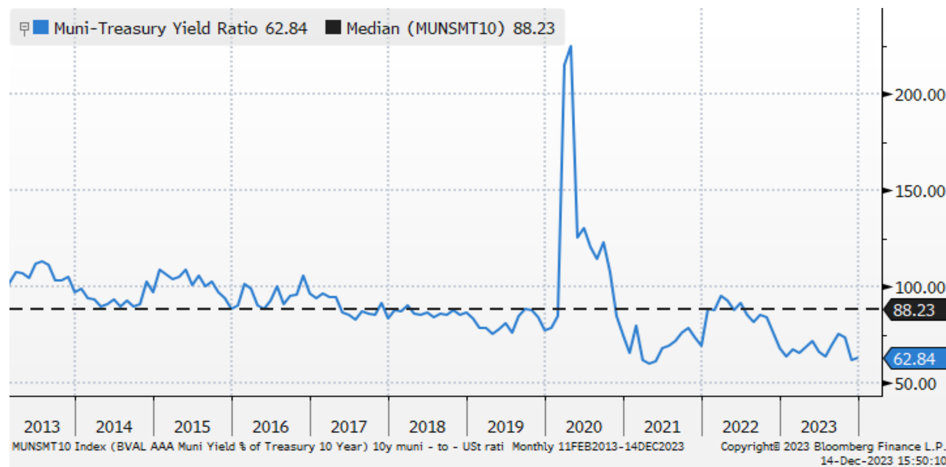
2023 was a volatile year for the preferred asset class. After a very strong January, the entire sector experienced a sharp drawdown in March due to the failure of several regional banks in the U.S. and the UBS takeover of Credit Suisse in Europe. In addition to idiosyncratic credit issues, the higher level of rate volatility during the year were a headwind.

Despite the volatility, overall total returns year-to-date have been attractive, particularly for preferreds with floating rate coupons. In contrast to the financial crisis, the asset quality and capital ratios of the banking system are strong. Rather, the stress in the banking system in 2023, was the result of asset/liability mismatch, induced by the sharp rise in interest rates over the past 18 months.



	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 12.14.2023	5.31%	4.39%	3.90%	3.92%	5.27%	5.24%	8.11%	2.72%	6.94%
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	0.62%	1.18%	1.69%	2.27%	1.98%	3.19%	6.18%	1.73%	4.66%

Source: Bloomberg, 12.14.23



Looking ahead, preferred securities offered compelling relative value when compared to other higher beta segments of the fixed income market.

As with other sectors, investors will benefit from being selective with the preferred sector, rather than simply having generic, broad-based, exposure. In general, we favor 'national champions' which are typically safer and less volatile. Furthermore, the different structural features (coupon, call/reset features, curve, etc) will drive performance variance between individual securities of the same issuers. We seek to avoid banks that are most at risk of funding issues resulting from depositor outflows as well as banks that have large commercial real estate exposures.

After several years of underperformance, U.S. Agency mortgage-backed securities (MBS) are trading at attractive valuations. Given the high-quality nature of these securities, they also tend to perform well during risk-off episodes and are highly liquid relative to other spread sectors.

Stable home prices, low prepayment activity, strong loan-to-value ratios and limited bond supply contribute to our positive view on non-agency residential mortgages.

We also see value in the senior positions (or tranches) of certain securities within securitized credit. Senior AAA-rated collateralized loan obligations (CLO) offer strong structural protections, and higher spreads relative to sectors with similar credit quality and typically have floating-rate coupons making them particularly attractive if rate cuts don't occur as early as the market is currently pricing.

Against the backdrop of a possible recession, the underlying fundamentals of state and local governments remain healthy. Federal government stimulus and the increase in tax revenue associated with strong economic growth and home price appreciation have boosted the coffers of municipalities.

A favorable supply/demand backdrop is expected to continue. Supply has been scarce as the municipalities that are flush with cash are waiting for lower rates to refund or issue new debt.

However, valuations are currently expensive with the yield ratio between 10 year municipal bonds and 10y U.S. Treasurys near its all-time lows.

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

In summary, following the transition to a higher rate regime, the outlook for bonds has improved substantially. Not only has income and total return potential increased, but there is now ample room for yields to decline – providing an additional boost to returns – if the economy hits an air pocket.

Higher interest rates will result in greater dispersion across sectors, within rating categories, and between individual issuers, which is a great environment for active management.

Disclosures:

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