Quarterly Economic Update

June 14, 2023

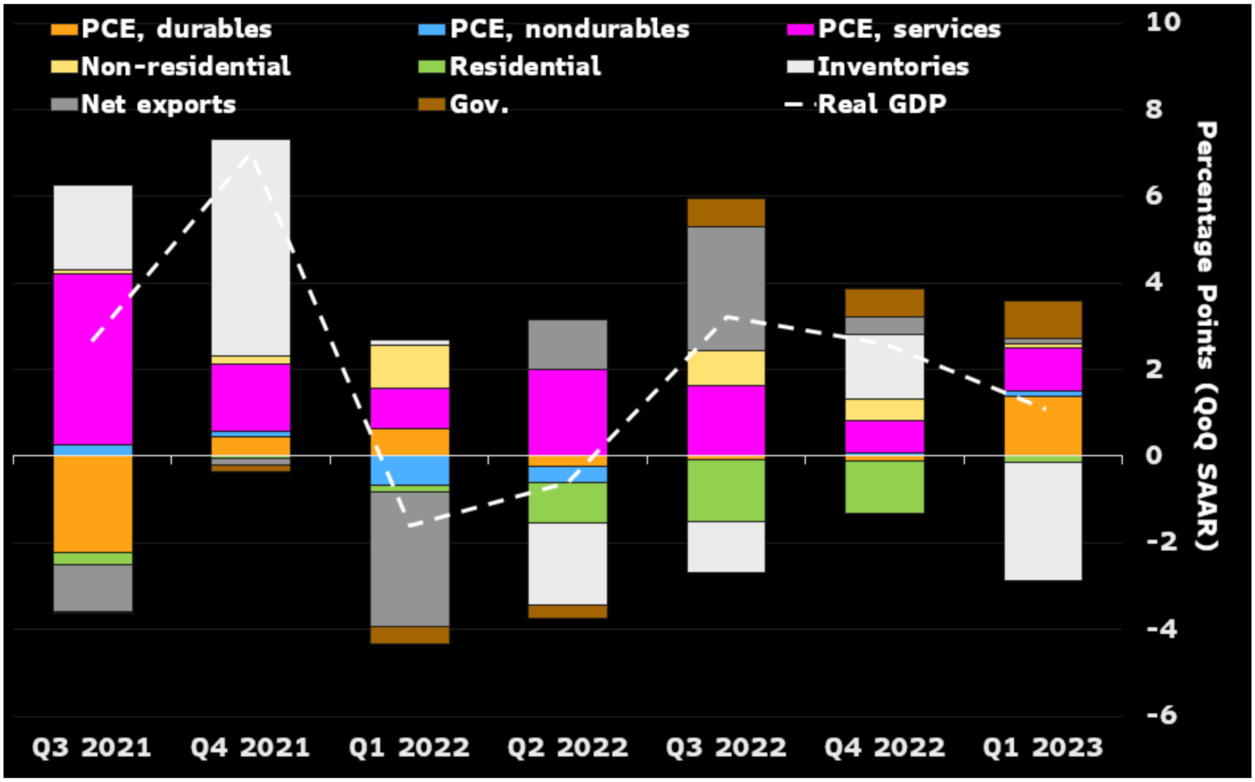
MACROECONOMIC COMMENTARY

Economic Outlook

By Bobby Long

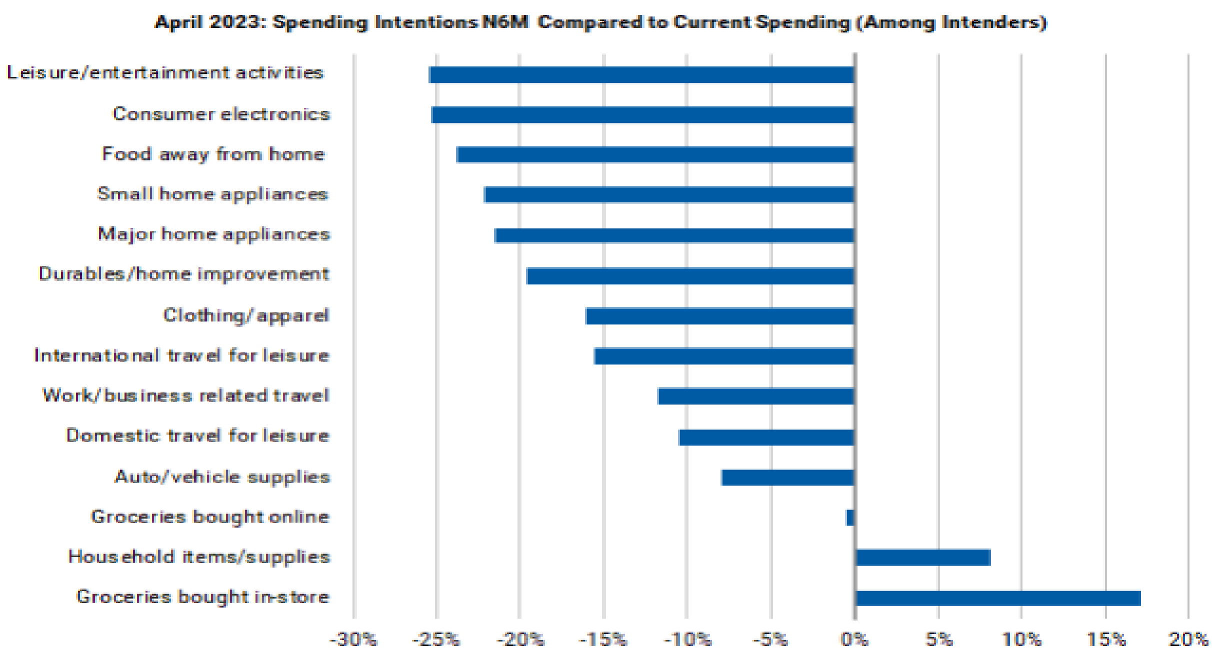
Despite increasing headwinds to economic growth in 2023 and an elevated risk of recession, economic activity has continued at a positive pace. With the Federal Reserve tightening policy and broader conditions less accommodating to stimulate economic growth, the “soft-landing” argument has been winning out and recessionary conditions have remained elusive. While economic data has been mixed more recently, it has not shifted in a decisively negative direction and indicates conditions remain supportive for expansionary economic activity. Some weaker data has surfaced, but at this time may only signal weaker growth ahead and not something more concerning.

First quarter Gross Domestic Product (GDP) grew at an annual rate of 1.3%, slower than the fourth quarter’s 2.6% and forming a decelerating trend over the past few quarters. Consumer spending across goods and services supported first quarter growth, increasing 3.8%. Government spending at the federal, state, and local levels were also a positive contributor to growth with an increase of 5.2% over the prior quarter. Inventory investment was weaker and a decline of 5.4% in residential investment was also a modest drag on the rate of growth. Nonresidential fixed investment increased 1.4%, with nonresidential structures up 11% and intellectual property products up 5.2%. This was offset by equipment investment falling 7%. The chart below shows how GDP has trended over the past several quarters and provides a breakdown of its components and their contribution to the quarter’s growth.



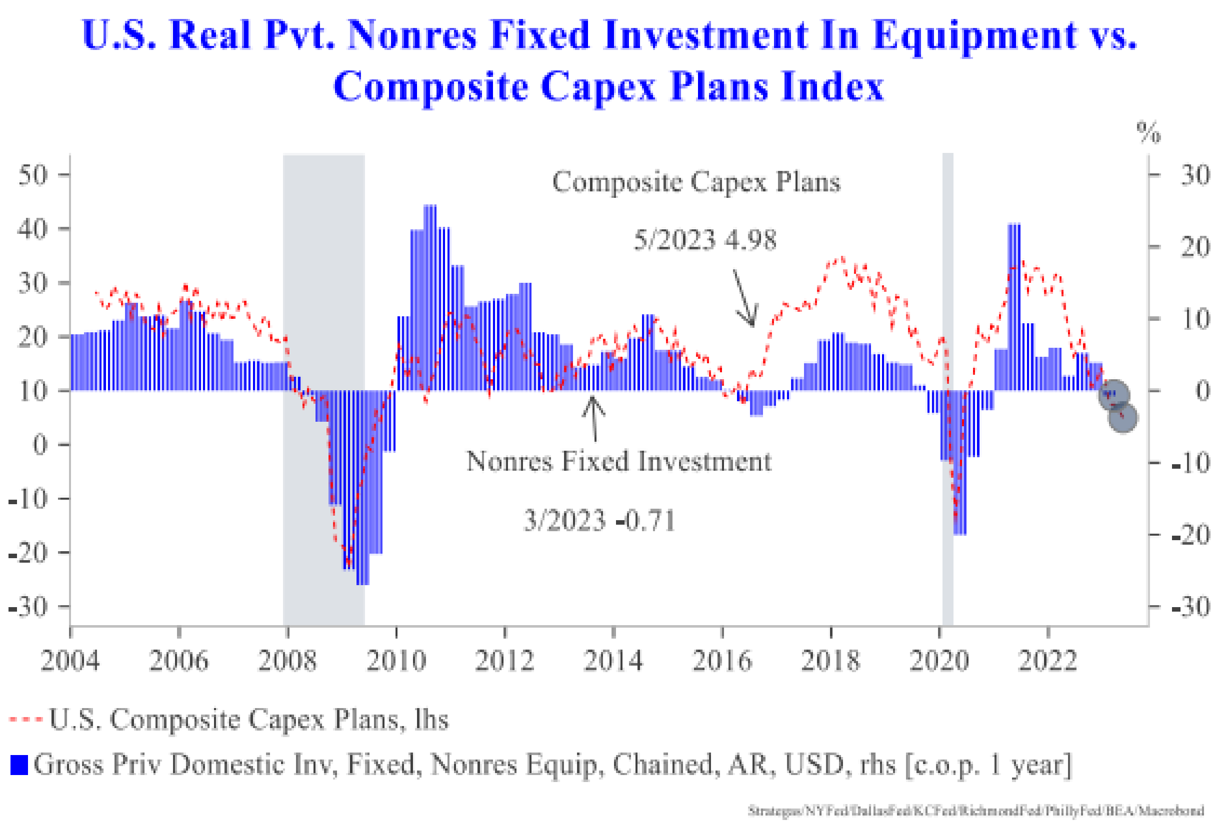
Source: Bloomberg, U.S. Bureau of Economic Analysis

Consumer spending has been resilient over the past couple of years on the other side of the initial Covid impact. Consumers first directed expenditures toward both durable and nondurable goods, spending significantly above longer-term trends. As pandemic restrictions were lifted and individuals became more comfortable resuming normal activities, spending on services picked back up and has outpaced goods over the past several quarters. The most recent quarter saw an uptick in both goods and services spending. The robust consumption patterns have been an integral component to economic growth and now leave us questioning how much longer these spending habits can hold up. We have previously discussed how a combination of excess savings, fiscal stimulus payments, low interest rates, and healthy labor conditions have been substantial tailwinds. These tailwinds are now fading and rising interest rates are a direct headwind that will dampen spending, especially impacting interest sensitive durable goods spending. The personal consumption expenditures (PCE) trend from 2012 to 2019 averaged 2.5%. With less excess savings, rising interest expenses, and declining disposable income, the above trend spending patterns are at least likely to revert to more normal trends and could run below trend over the next several quarters with increasing headwinds. Excess savings for lower-income households appear to have already been depleted. Middle and higher-income households still have a reserve, but may be less inclined to draw this down further as economic concerns rise. If consumers' net worth takes additional hits from declining financial markets or weaker housing prices, they are likely to rein in spending plans. The chart below represents a survey of spending intentions over the next six months and indicates a significant pullback on discretionary spending plans.

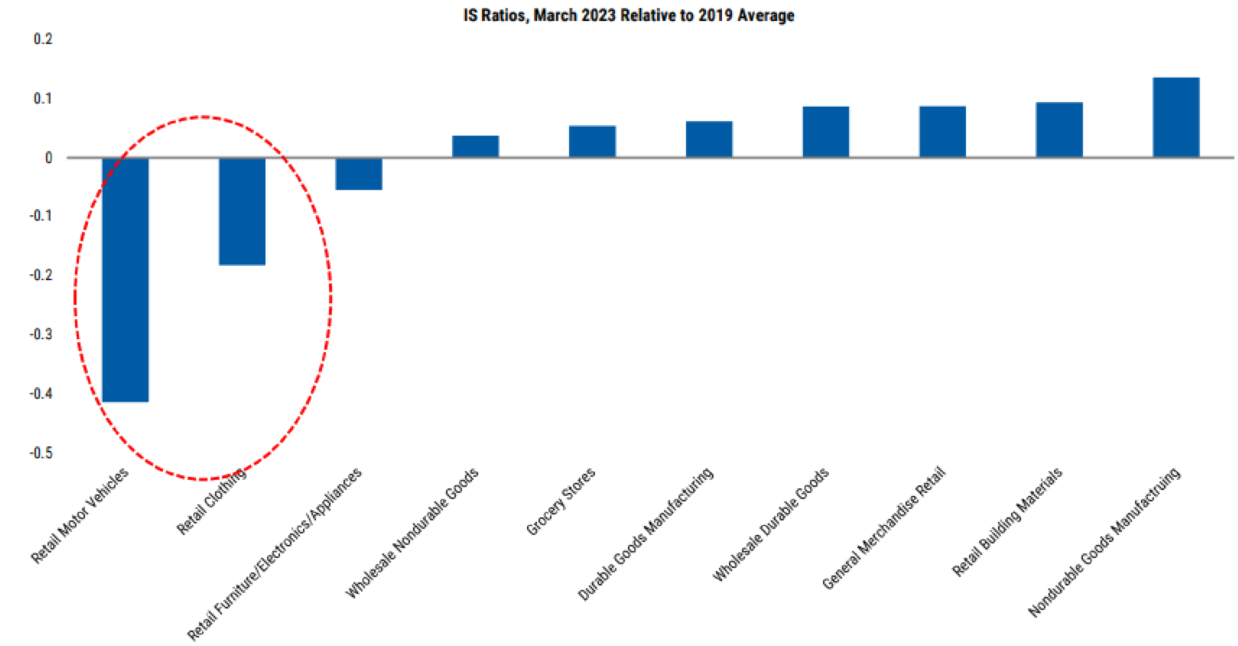


Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

Business investment has been okay but looks likely to slow through the year as weaker profits, higher interest rates, and tighter lending standards dampen capital expenditures. Banks have reported they are tightening lending standards to both small and large firms and have experienced a decline in demand for loans. Investment in nonresidential structures has been stronger the past two quarters, but this may reflect projects initiated in a more accommodating environment and higher interest rates going forward are likely to depress this activity. Intellectual property investment is a steadier source of positive investment; however the rate of growth has been trending lower for several quarters now. Equipment investment has been negative over the past two quarters. CEOs have indicated reduced capex plans more recently and we should expect real business investment to follow.



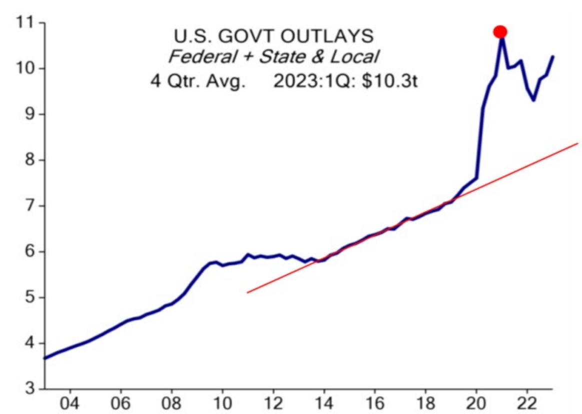
Inventory rebuilding is also less likely to be a significant contributor to additional economic growth. Inventories have largely been rebuilt with the inventory to sales ratio having normalized across most industries. There are still some industries such as motor vehicles and apparel that continue to have a significant imbalance as shown in the chart on the following page. This can be a source of positive economic growth, but these industries also carry a higher risk of declining sales should discretionary spending retreat. Motor vehicles, furniture, and appliances are also more interest rate sensitive goods, which when combined with tighter lending standards could see slower sales.



Source: Census Bureau, Morgan Stanley Research

Residential investment has been negative for the past eight quarters as rising interest rates and higher home prices have impacted affordability. There remains an undersupply of housing and the months' supply of existing homes available is below longer-term averages. This should provide some support to residential activity but is unlikely to be a catalyst with lingering affordability issues. Multi-family activity has remained strong, but the headwinds of higher interest rates and higher construction costs will likely make returns less attractive and slow new starts.

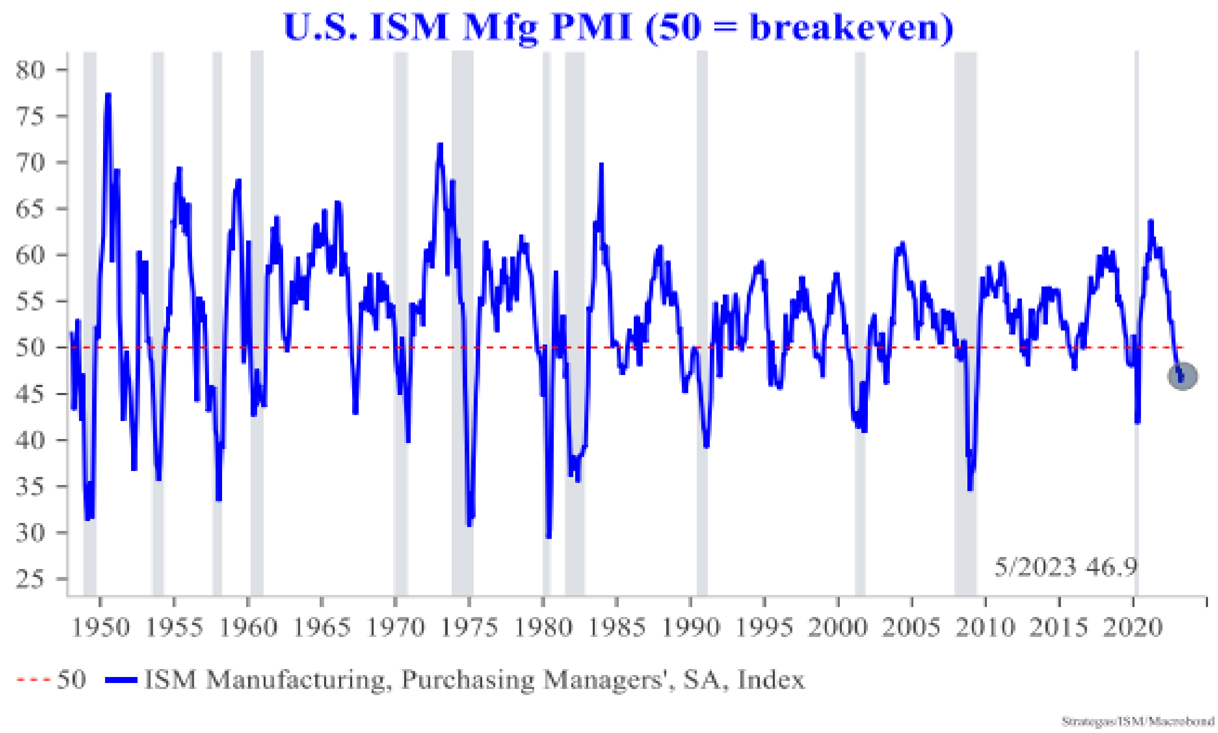
Government spending has been very supportive, down from its peak but still strong. Many state and local governments are just now deploying stimulus funds, so there is still a lot working through the system. It should be noted that this spending is significantly above trend and while continuing to have a positive impact, it is likely to revert to more normal levels.



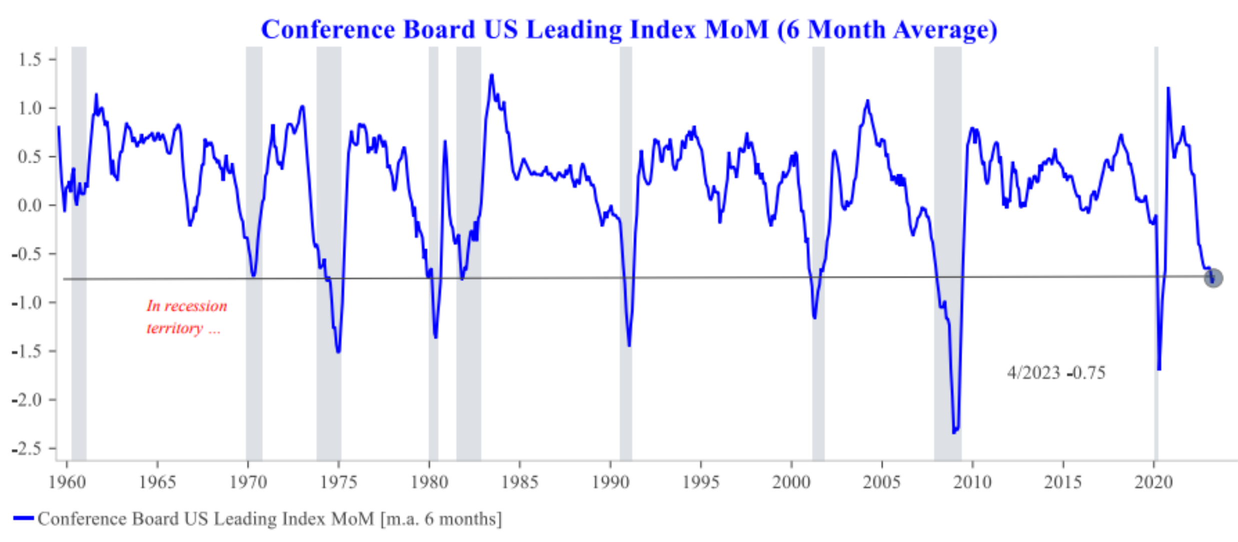
Source: Evercore ISI

Weakening trends outside the U.S. are also likely to depress exports and serve as a less supportive component to economic growth. Central banks across developed countries are also raising policy rates and this will restrict consumption and business investment.

The Institute of Supply Management's most recent U.S. Manufacturing PMI Index ticked back down to 46.9%, continuing a downward trend that began in June 2022. The index remains below the contractionary level of 50% where it has been since November. The New Orders Index also fell further to 42.6%. Out of 18 manufacturing industries, only four reported growth. The chart below shows the historical trend of the index and how it has correlated with prior recessions as indicated by the gray bars.



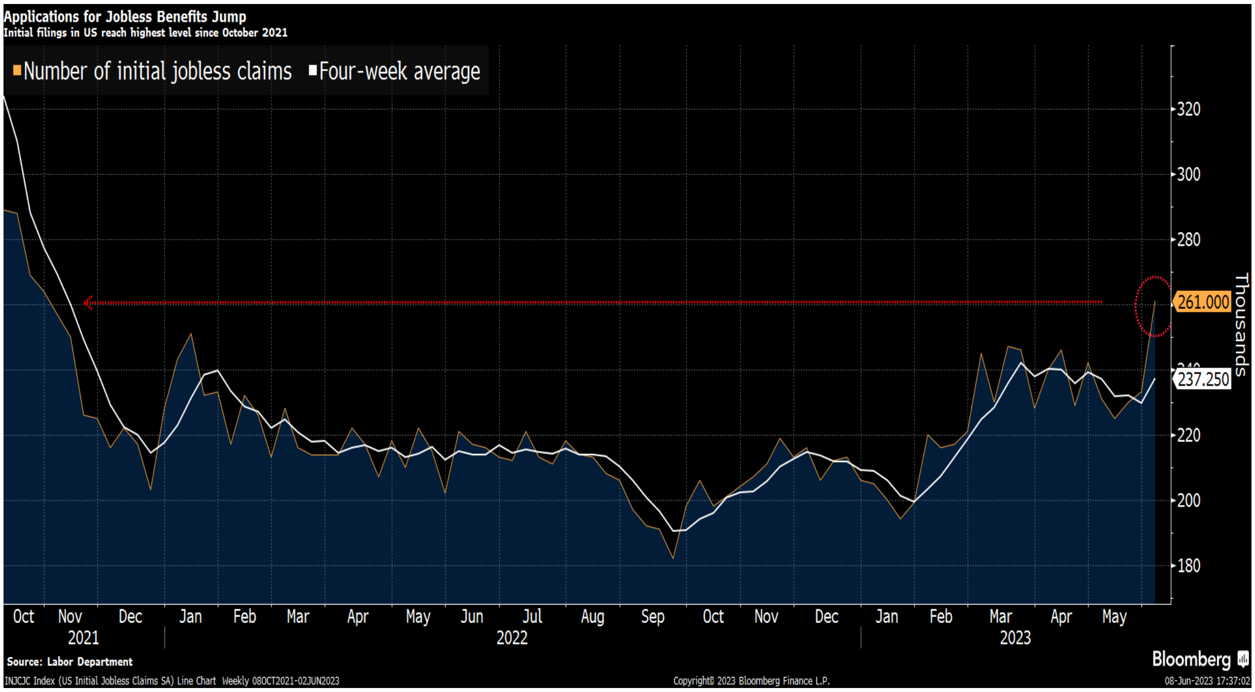
Several regional Fed manufacturing surveys have been weaker as well, providing some clear signs of weaker economic activity. The Conference Board's US Leading Index has also dipped into recession territory.



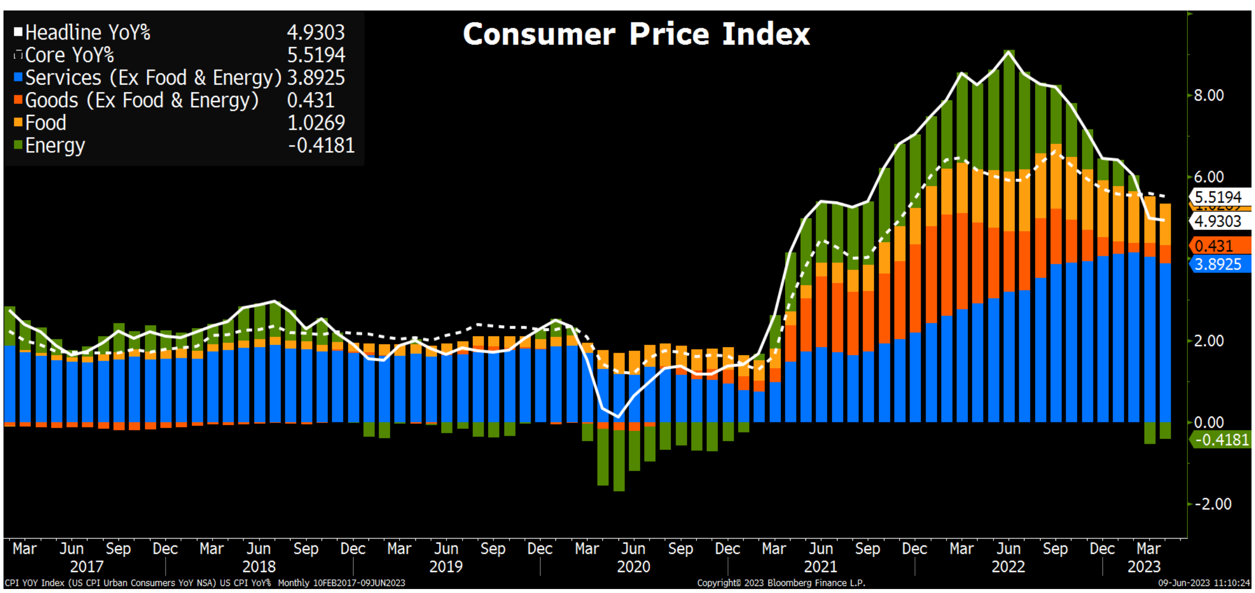
Labor markets continue to be a source of strength. The most recent nonfarm payrolls report for the month of May added 339,000 jobs and the prior month's payrolls were revised upward by 41,000 additional jobs. Positive nonfarm payroll growth continues to trend at a higher pace than pre-pandemic levels. The unemployment rate did move higher from 3.5% to 3.7%, a modest increase but still a very low rate of unemployment. The household employment survey also reported a decline of 310,000 jobs, providing a mixed signal for labor conditions with the two employment measures diverging. While labor conditions are still healthy, there are signs that the extraordinarily tight conditions are loosening. An imbalance continues to exist between labor demand and labor supply, however the number of job openings has been trending lower. The number of employees voluntarily leaving jobs is also declining, a sign of slacker labor conditions. The National Federation of Independent Businesses has reported that member surveys reveal the percentage of positions not able to be filled has been declining. Future compensation plans have also come down as NFIB businesses feel a less compelling need to compete with higher wages, which also has positive implications for business profits and inflationary pressures.

There has been an uptick in layoff announcements this year according to the Challenger-Gray Layoffs report. Employers announced 80,089 job cuts in May, bringing the total this year to 417,500 jobs. Excluding the 2020 pandemic-related layoffs, this is the highest total in the first five months of the year since 2009. They also report that hiring plans are down. The Conference Board's CEO Employment Plans survey shows that the number of CEOs planning to decrease their workforce over the next 12 months has been steadily rising, increasing from below 5% in 1Q2022 to 20% in the most recent report. The number planning to increase employment over the same time period has declined from above 60% to 33%.

Whether these are simply moderating conditions or signal that cracks in the labor market are forming is yet to be determined. As shown in the chart on the following page, the most recent jobless claims release reported initial jobless claims rising sharply, which is somewhat concerning given it is viewed as a leading indicator on employment. Initial claims had risen some over the first quarter of the year, but the recent increase is a clear uptick in post-pandemic claims. Continuing claims have remained steady and are still trending at relatively low levels, an indication that those losing jobs are able to find other employment rather quickly. Initial jobless claims should be monitored to determine whether the recent report was a one-off event or the beginning of a more negative trend. The weekly numbers can be volatile and this report was following a holiday period, so one should be cautious to rely too much on the single data point. However, any additional increases to initial claims and an uptick in continuing claims would be more alarming.



Most measures of inflation have been trending lower. The Consumer Price Index (CPI) for the month of April declined slightly to 4.9%. CPI excluding food and energy declined modestly as well to 5.5%, with lower energy prices having a positive effect. PCE inflation increased slightly for the month, with the headline rate reported at 4.4% and core PCE at 4.7%. Regardless of the monthly increase in PCE inflation, the broader trend is that inflation is coming down from its peak. The trend is encouraging, but the rate of inflation is still too high and needs to decline further towards the Federal Reserve's two percent target. The chart below provides a breakdown of the CPI's components and illustrates the moderating rate of inflationary pressures.



Consumer spending and employment will dictate the direction of economic activity as we move through the remainder of the year. Both remain supportive for continued economic expansion, but face increasing headwinds that weigh on the rate of growth. There is risk that consumer spending power deteriorates further as debt service costs rise. If student loan payments resume in September as scheduled, it would redirect an average of $400 per month from spending capacity to debt service for a meaningful percentage of consumers. We also have concern that higher consumption patterns over the past couple of years have pulled forward demand from future periods and consumers may retrench quicker in the face of deteriorating conditions. If job losses begin increasing, it will accelerate deteriorating conditions for consumers. Labor markets have loosened some but are still strong by most measures. There is risk this could change quickly. If corporate profits continue to shrink, capex reductions and layoffs will follow and kick off a negative cycle of weaker consumption, lower investment, and contracting economic activity. Evercore ISI economist Ed Hyman recently repeated the phrase "It's okay until it isn't", which has proven historically accurate heading into past recessions and may likely be where we are now. We continue to believe a "soft-landing" scenario of weaker economic growth is possible and a recession can be avoided if labor conditions hold. However, we remain concerned that the cumulative headwinds of higher interest rates, tighter lending standards, contracting money supply, and more persistent inflationary pressures may eventually become too heavy of a burden. We continue to believe expectations should account for weaker economic activity over the remainder of the year and acknowledge the elevated risk of recessionary conditions developing.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our previous meeting in March, interest rates had been climbing for a month with the 2-year Treasury yield reaching its near-term apex on the back of robust economic data. This environment dramatically changed on the March 9th, the day after our meeting, when stress in the U.S. regional banking system abruptly became the primary worry in financial markets. Silicon Valley Bank (SIVB) and Signature Bank (SBNY) were closed by regulators soon after. In Europe, Credit Suisse succumbed to the stress as well and was ultimately purchased by UBS on March 19th. To help combat the broad bank run, the Federal Reserve created a new funding facility, the Bank Term Funding Program (BTPF), which could make loans up to one year against Treasuries, MBS, and other qualifying assets per BofA Securities. The pledged assets would be valued at par. The Fed stated the program would be "an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress." While the Fed was providing liquidity to the banking system, they did go ahead and raise the target rate range for the federal funds to 5.0% at their meeting on March 22nd as a way to keep up their inflation fight.

During the main banking crisis period, Treasury yields fell precipitously as investors purchased safe haven assets in the midst of the banking storm. Investors also reassessed the future path of interest rates as BofA Securities said, the "potential for tighter lending standards at banks meant less need for the Fed to tighten financial conditions by raising rates." The 2-year Treasury yield fell from 5.08% on March 8th to 3.55% by March 24th. On the longer-end of the curve, the 10-year Treasury yield declined from 4.0% to 3.279% over the same time period. The 2s/10s curve materially flattened in this environment. For the month, Treasuries were up 2.894% and handily beat the 1.92% and the 1.948% returns in the agency debt and mortgage-backed securities sectors according to Bloomberg Fixed Income Indices. The Bloomberg US MBS Fixed Rate Average OAS widened from 46 bps at the end of February to 63 bps at the end of March and this contributed to the relative underperformance of the asset class.

Investment grade corporate bonds slightly underperformed Treasuries as well returning 2.784% versus 2.894%. Spread widening detracted from performance as the Bloomberg US Agg Corporate Average OAS rose from 1.24% to 1.63% mid-month and then ended at 1.38%. The longer duration of corporate bonds versus Treasuries did partially offset the impact of the negative spread movement. Among the corporate sectors, industrials performed the best at 3.563% while financials were the worst at 1.322% which is not surprising given the turmoil in the banking sector. While investment grade bonds performed reasonably well, high yield corporates lagged with a 1.069% return as its short duration stance combined with a widening in spreads weighed on performance.

After the volatility in March, markets experienced a period of calm in April with regional bank stock prices stabilizing and the S&P 500 posting a total return of 1.56%. Lower than expected inflation readings contributed to this environment as the U.S. Bureau of Labor Statistics reported a 0.1% increase in the Consumer Price Index for All Urban Consumer(CPI-U) for March on a month-over-month basis. CreditSights said the data "came mostly at consensus with promising downshifts in core services and shelter costs while core goods inflation remains sticky." The March nonfarm payroll results were benign as well. The U.S. Bureau of Labor Statistics said, "employment rose by 236,000 in March, and the unemployment rate changed little at 3.5%."

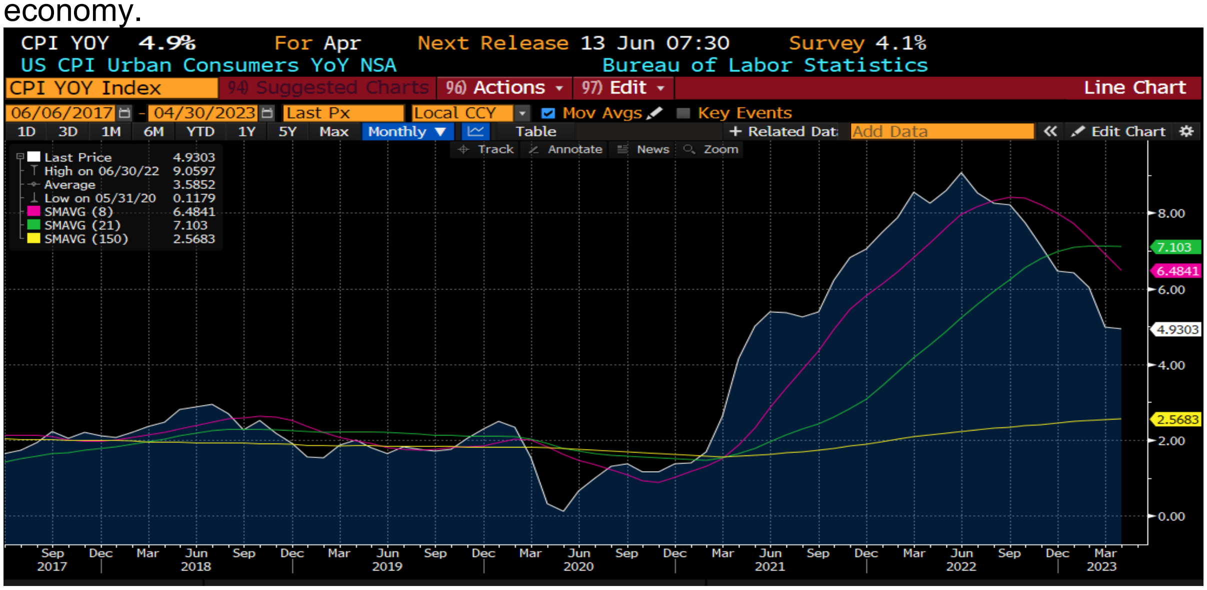
Most Treasuries made little headway during April as the 2-year yield fell 2 bps while the 10-year yield declined by 5 bps. The very front of the curve recovered some of the yield that was lost in March with the 6-month Treasury rising almost 15 bps. Bloomberg said the total return for the whole asset class was .536% which did outpace the .41% in agencies and the .518% in mortgages. The OAS in mortgages continued its widening trend, rising 3 bps to 66 bps. In spite of this incremental widening, the MBS market fared decently well given the fact the FDIC started liquidating the mortgages pools that were once owned by Silicon Valley Bank and Signature Bank. Outpacing all government-related sectors were investment grade corporates which returned .766%. The high-grade corporate OAS compressed by 2 bps to 1.36%. Utilities posted the highest sector return at 1.001% while industrials lagged the most with a .625% total return per Bloomberg. According to BofA Securities, investment grade new issue supply was weak totaling $69.4 billion which was down $43.3 billion from April 2022. High yield corporates were the best performing fixed income asset class with a .999% total return. The high yield OAS fell 3 bps to 4.52%.

May was characterized by regional bank volatility, strong US economic data, surging interest rates, and debt ceiling drama. At the beginning of the month, First Republic Bank failed. JPMorgan ultimately acquired the collapsed entity and as time went on, the downside pressure on the regional bank subsided which was very positive for financial markets. Labor market data came in strong with nonfarm payrolls for April increasing by 253,000 jobs with an unemployment rate of 3.4% per the Bureau of Labor Statistics. According to CNBC.com, Wall Street estimates were 180,000 jobs and an unemployment rate of 3.6%, so expectations were handily beaten. Another positive economic data point was the retail sales number from the Commerce Department which Forbes.com said "rose .4% in April, after two months of declines, with American consumers showing continued spending power in the face of interest rate hikes, inflation and economic uncertainty." These figures showed the US economy being stronger than anticipated and contributed to the upward move in interest rates. For example, the 2-year Treasury rose 40bps and the 10-year Treasury increased 22 bps for the month. The Federal Reserve continued raising the target range for the federal funds rate on May 3rd to 5.25%. The Fed said, "economic activity expanded at a modest pace in the first quarter. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated." Coloring the majority of the month was the drama surrounding the debt ceiling. There were a number of fits and starts with the process, but a tentative deal between U.S. President Joe Biden and House of Representatives Speaker Kevin McCarthy was struck on May 29th "to suspend the $31.4 trillion debt ceiling and cap government spending for the next 2 years" per Reuters. The debt limit deal was finally passed by the House of Representatives on May 31st and by the Senate on June 1st.
With interest rates rising, fixed income assets struggled with every asset class posting negative performance. Treasuries lost 1.161% while agencies and mortgages were down -.371% and -.733% respectively. Mortgage OAS tightened by 10 bps, but this couldn't offset the negative movement in rates. High grade corporates were the worst performer at -1.448% as their long duration impeded the returns even though spreads only widened by 2 bps. High yield returned -.916% per Bloomberg.

Beyond the Senate's passing of the debt ceiling bill, the main driver of markets so far in June was the blockbuster payroll report where the U.S. Bureau of Labor Statistics said nonfarm payroll employment rose by 339,000 in May. The number greatly exceeded expectations and put upward pressure on stock markets and interest rates.

In the terms of activity in RSA's fixed income portfolio, we made multiple adjustments to the Treasury sector. In early March, we sold some recently acquired 5-year and 10-year positions after yields dramatically fell in the midst of Silicon Valley Bank's failure. Beyond those sales, we have been purchasing Treasury securities across the maturity spectrum to raise our weighting in risk-free assets and extend the duration of the portfolio. This appears prudent given the uncertainty in the capital markets and because we are underweight risk-free assets and short duration versus the index.

The outlook for the Treasury market is that we are nearing the end of the hiking cycle. While the Federal Reserve was too slow in combating inflation coming out of Covid, it has been aggressive since 2022 with 500 bps of interest rate hikes. These actions have helped to slow inflation and one can see in the following chart that year-over-year CPI has fallen from a high of 9.05% to 4.93%. In considering what the Federal Reserve will do next, CreditSights says, "Taking in the latest inflation and labor market data, we expect a 'hawkish pause' in June as the shift in unemployment rate and lack of building wage pressure provide some evidence that recent tightening is working, though potentially at a slower rate than hoped," It seems reasonable that the Fed should pause and see how the future path of the economy develops. Tighter lending standards in the wake of the spring bank failures combined with waning fiscal stimulus will also be working to slow the economy.



Source: Bloomberg

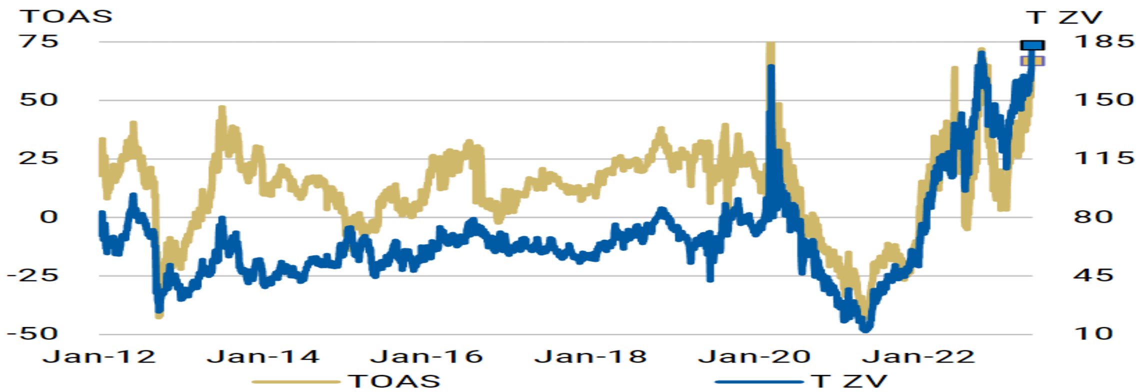
Currently, the Treasury curve appears to be predicting one final rate hike. The 6-month Treasury at 5.42% is the highest part of the curve and has recently reached nearly 5.50%. As seen in the chart from Bloomberg, interest rates are much lower farther out the curve which would indicate that front end rates are not expected to stay high for a long period of time. This type of environment usually predates a recession along with a drop in interest rates. This is why we have been increasing the allocation to risk-free assets and raising the duration of the portfolio.

Source: Bloomberg

We made a variety of changes to the mortgage portfolio over the last few months. An array of coupons from 30-year 2.0s to 30-year 6.0s were purchased to reinvest prepayments, add money to the space, and adjust duration depending on the perceived path of interest rates. One of the purchases was a 30-year 5.5% coupon pool with an estimated static yield of 5.623% and a spread of 147 bps over the 3-year Treasury. It had an option-adjusted spread of 66 bps and an option adjusted duration of 3.54 years. Wide spreads and higher interest rates made this trade particularly appealing.

Going forward, our view is that mortgages are an excellent place to deploy capital for fixed income investors. If you look in the chart below, ZV spreads and OAS levels appear very attractive relative to the previous decade. When these spreads are combined with elevated interest rates, the potential total return is among the highest it has been in many years. That being said, there are a number of headwinds for the mortgage market which could impede performance. First, the Federal Reserve is continuing their quantitative tightening campaign. Erica Adelberg at Bloomberg estimates the Fed's mortgage portfolio runoff to be around \$15-\$20 billion per month. Not having the Fed reinvest those paydowns is a clear negative for the space and we don't see an end to this reduction unless a hard landing scenario plays out in the broad economy. Second, the FDIC has been selling and will continue to sell the mortgage portfolios of Silicon Valley Bank and Signature Bank. In April, Kirill Krylov at Robert W. Baird estimated the total amount to be \$61 billion in agency MBS pools needing to be sold. As of May 30th, over 40% of the specified pools have been sold per Morgan Stanley, so there is still a sizable portion left to be sold into the mortgage market. Finally, high negative convexity in upper coupon mortgages is a real risk at this juncture in the interest rate cycle. Given where current mortgage rates are, a recession which causes interest rates to drop would induce a significant refinance wave and upper coupon pools would underperform. Regardless of these issues, we will be looking to increase our weighting in the space given where spreads currently reside.

Exhibit 1: Valuations on current coupon are at GFC-levels



Source: Morgan Stanley Research, Yieldbook

Source: Morgan Stanley

For the corporate bond sector, we purchased a myriad of bonds over the last few months. Examples include a May 2053 Travelers bond with a spread of 150bps, a June 2033 Southern Company note at a spread of 173 bps, and a May 2030 Meta Platforms note at 120 bps over the 7-year. Overall, we increased the duration of the portfolio to guard against a drop in interest rates. Going forward, we are compelled to continue to add high quality investments grade corporate bonds. Now is not the time to reach for yield down the credit spectrum. As one can see in the chart below, corporate spreads are not a bargain and if a recession scenario occurs, spreads could materially widen. In that environment, higher quality names should outperform financially weaker companies.

Source: Bloomberg

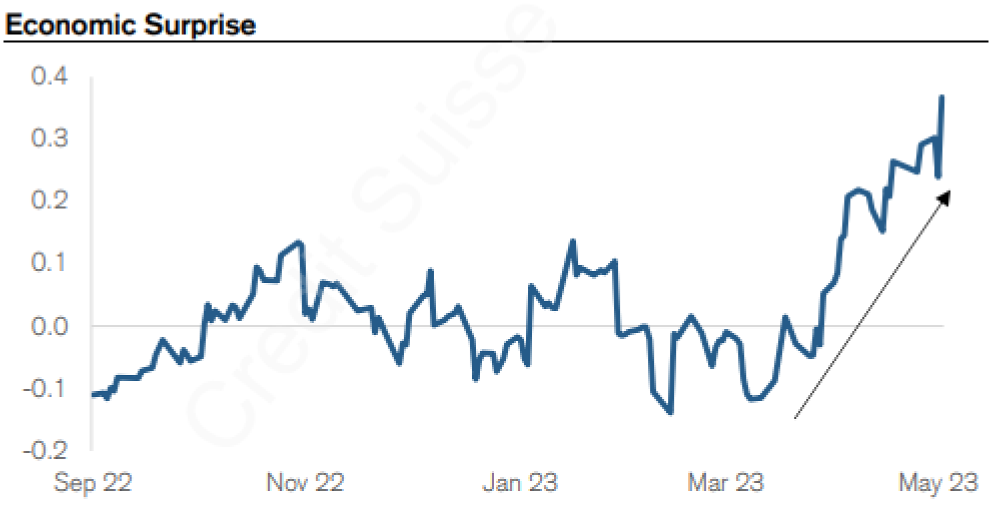
Domestic Equity Strategy

By Allan Carr

Since our last update on March 8, the market has continued to climb the wall of worry. The S&P500 digested three of the four largest bank failures in history and is now over 20% higher than the 3577 closing low from last October. By textbook definition this would indicate we have entered a new bull market. Yet bears say it's just a really long bear market rally and recession is imminent. It remains to be seen how things play out, but let's discuss how we got here.

Refer to the Economic and Fiscal sections of this update for detailed information, but to broadly summarize the last 6-8 weeks: the incoming economic data and outlook has improved (exhibit 1, CSFB), and the market correctly predicted the debt ceiling crisis being averted.

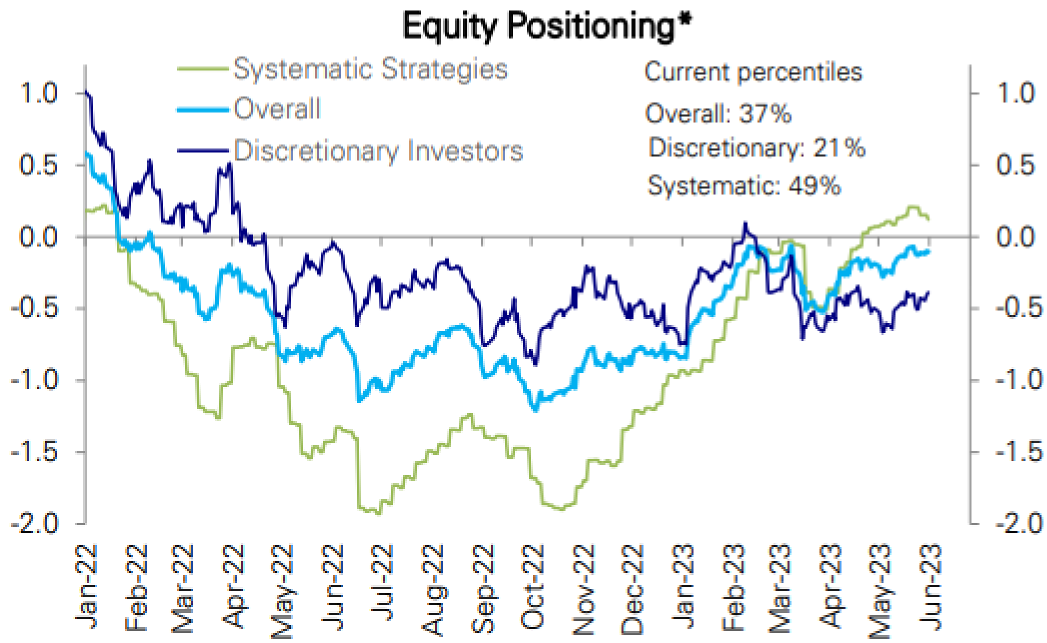
<u>Exhibit 1</u>



First quarter earnings were also better than expected, with over 80% of S&P500 companies surprising to the upside for a robust 6.5% beat versus estimates. The most notable takeaway was NVIDIA (NVDA) which guided its 2Q forecasted revenue to $11B, a staggering 50% higher than street estimates based on demand for their Artificial Intelligence focused chips. This added to the already hyped buzz around AI and resulted in a megatech rally into late May.

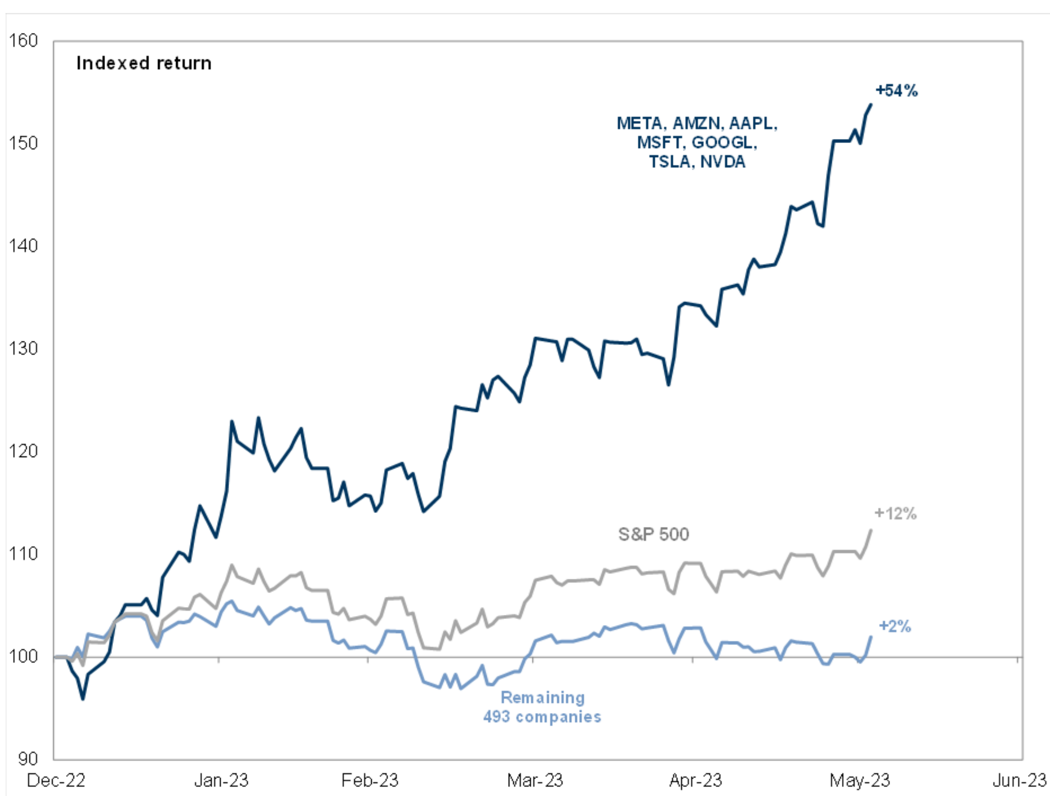
The S&P's strength has frustrated many in the investment community, which in aggregate had been positioned for just the opposite (exhibit 2, Deutsche Bank). Not surprising given lousy sentiment, but the first half of 2023 saw hedge fund net exposure in the bottom decile and record bearish bets placed by speculative traders via S&P futures.

Exhibit 2



A big reason for the strong returns is the megatech tech names that carry large weightings in the index (exhibit 3, Goldman).

Exhibit 3



A lot of attention is raised about these names and their outsized contribution to this year's rally. But don't forget they got bludgeoned in 2022 (exhibit 4) when growth went out of style, and their growth outlooks have improved (exhibit 5, Wolfe) from last year.

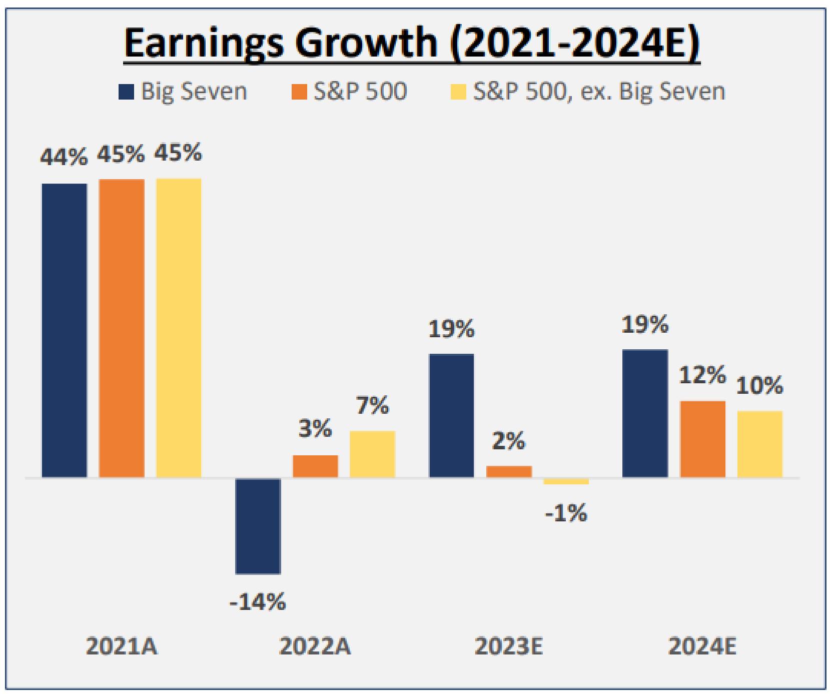
Exhibit 4

Range 12/31/2021 - 12/30/2022 Period Daily No. of Period 364 Day(s)

	Security	Currency	Price Change	Total Return
1)	TSLA US Equity	USD	-65.03%	-65.03%
2)	META US Equity	USD	-64.22%	-64.22%
3)	NVDA US Equity	USD	-50.31%	-50.27%
4)	AMZN US Equity	USD	-49.62%	-49.62%
5)	GOOGL US Equity	USD	-39.09%	-39.09%
6)	SPX Index	USD	-19.44%	-18.13%

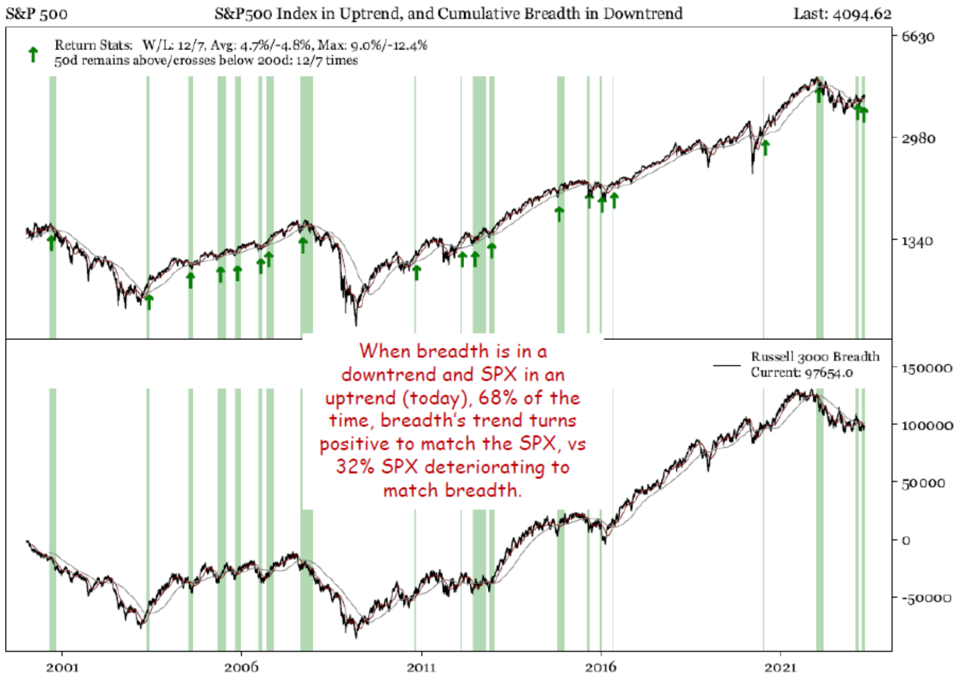
Exhibit 5

"Big Seven"
AAPL
AMZN
GOOGL
META
MSFT
NVDA
TSLA



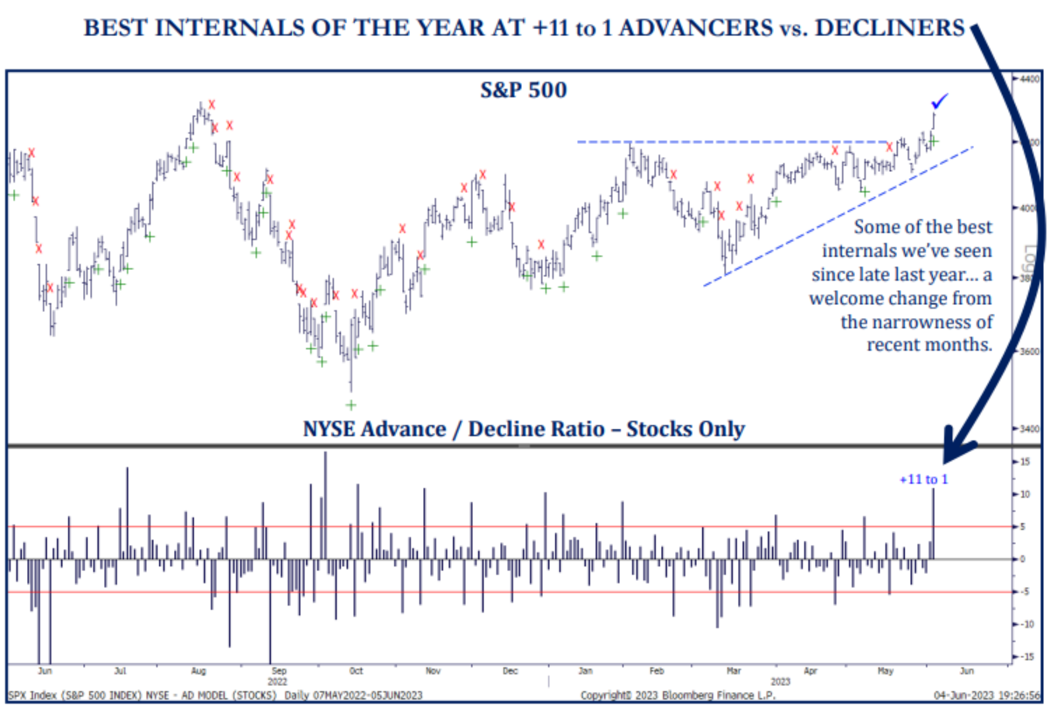
Discussion around the dominance of megatech has gone hand in hand with the lack of breadth in the move since March. Jeff DeGraff of Renmac was in our office in mid-May and showed that despite making some great calls on market tops (1999 most notably), breadth more often than not catches up with price (exhibit 6).

Exhibit 6



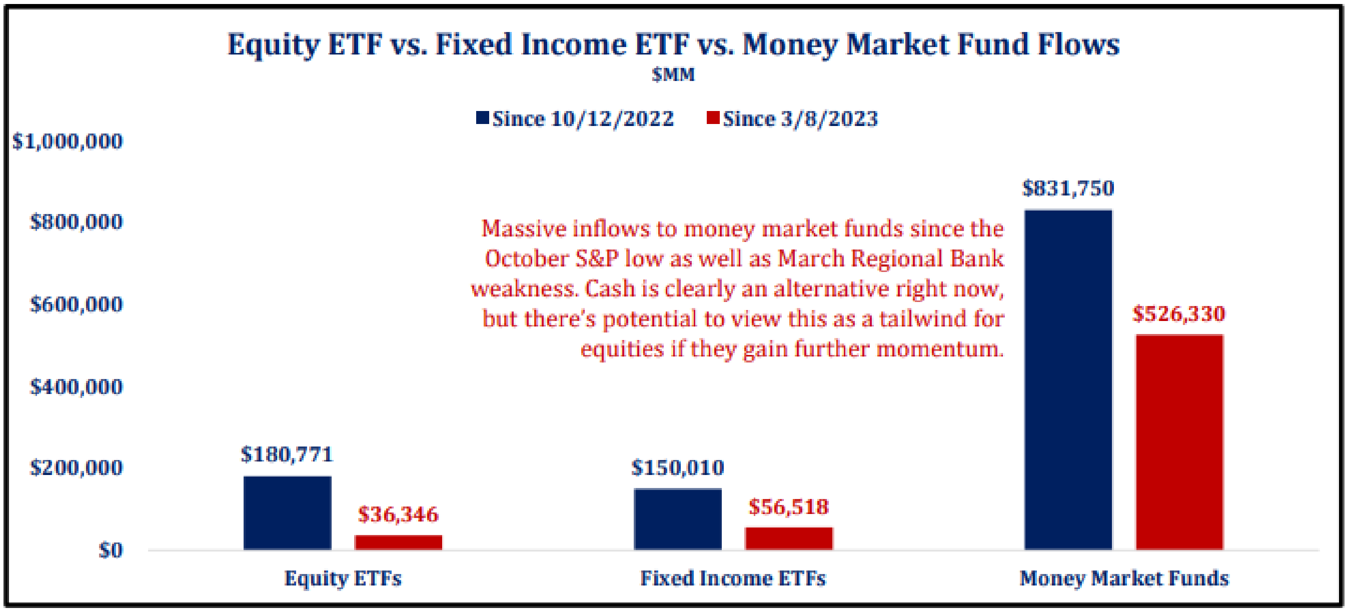
In the last 1-2 weeks, market internals have turned more positive (exhibit 7, Strategas) as names outside of megatech show signs of life, including the banks.

Exhibit 7



Sentiment, positioning (exhibit 2) and flows (exhibit 8, Strategas) are not flashing red at the moment either. More money has gone into bonds than stocks since the March bank fallout.

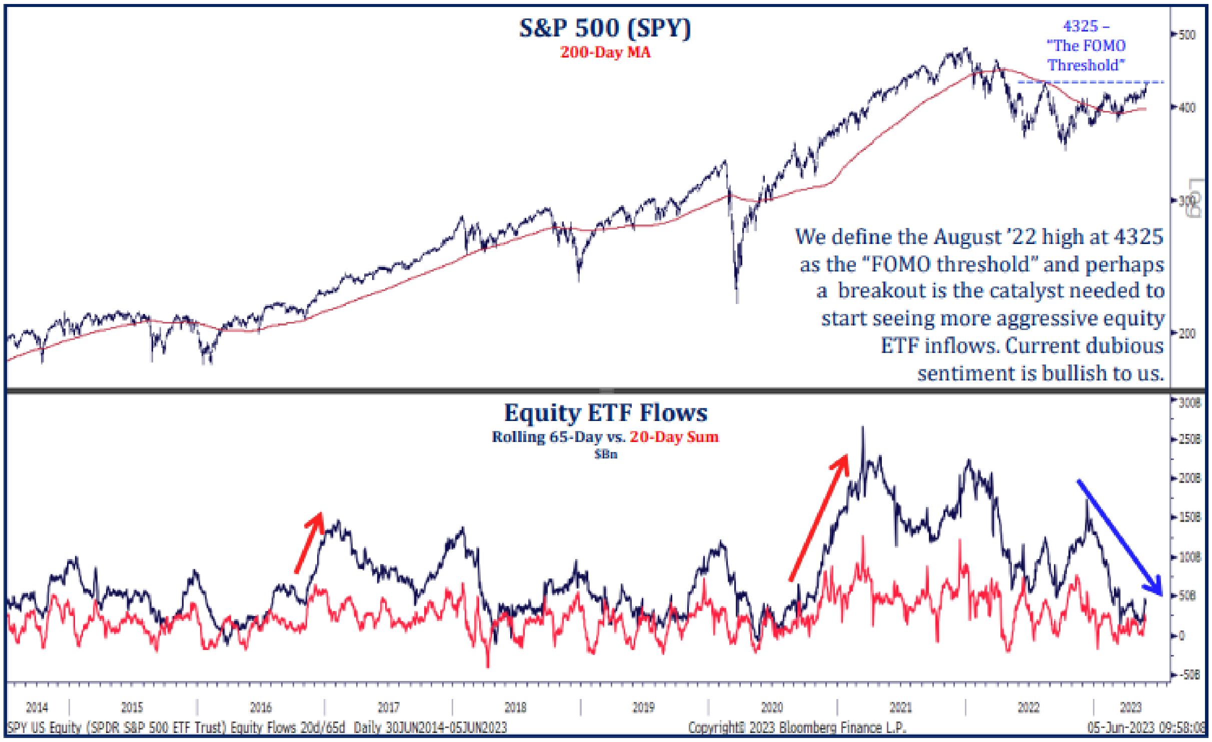
Exhibit 8



Given how long it's been since cash has been attractive, it's not surprising to see flows there, but 5x more has gone into cash than stocks since March. Bank of America's $3T plus in private client assets have posted 12 straight weeks of equity outflows, 20 straight weeks of bond inflows, and now hold a 12% cash position. Despite the growth/tech/AI buzz, QQQ's and ARKK have posted outflows this year. This is not the typical behavior associated with frothy market tops, and as Strategas suggests, the pain trade might well be higher if the S&P breaks through the August 2022 level of 4325 (exhibit 9). This narrative is gaining traction in recent days as bears throw in the towel.

Exhibit 9

FLOWS STILL LAREGLY APATHETIC WITH S&P NEAR AUGUST HIGHS



Where we go from here is hard to handicap. As left tail risk worries such as the debt ceiling and bank failures dissipated, the bar has been reset higher. Yet earnings estimates are still all over the place, with some at EPS in the $180 range for the S&P 500, while others are in the $240 range. The median economist puts nearly a 2/3 probability of a recession in the next year, but Goldman puts it at only 25%. The core bear thesis is still in play of the Fed choking out the economy fighting sticky inflation. This has been talked about for a year now and "the most well telegraphed recession in history" keeps getting pushed out. With companies having positioned for a coming slowdown for some time, the severity of a recession might not be as bad if it finally comes.

The upside call is a soft landing leads a catchup trade as growth and earnings estimates ratchet higher. The odds of this path have increased in recent weeks, but it's too early to sound the all clear. We are in the camp of roughly 4200 being fair value given what we know today. It has been months since we have had a selloff, so a reset or even a pause in the rally seems likely given history. On the same note, overshooting to the upside in a technical based rally wouldn't shock us either. One thing we do know is things can change in a hurry, and as noted economist John Maynard Keynes said "When the facts change, I change my mind. What do you do, sir?"

International Equity Strategy

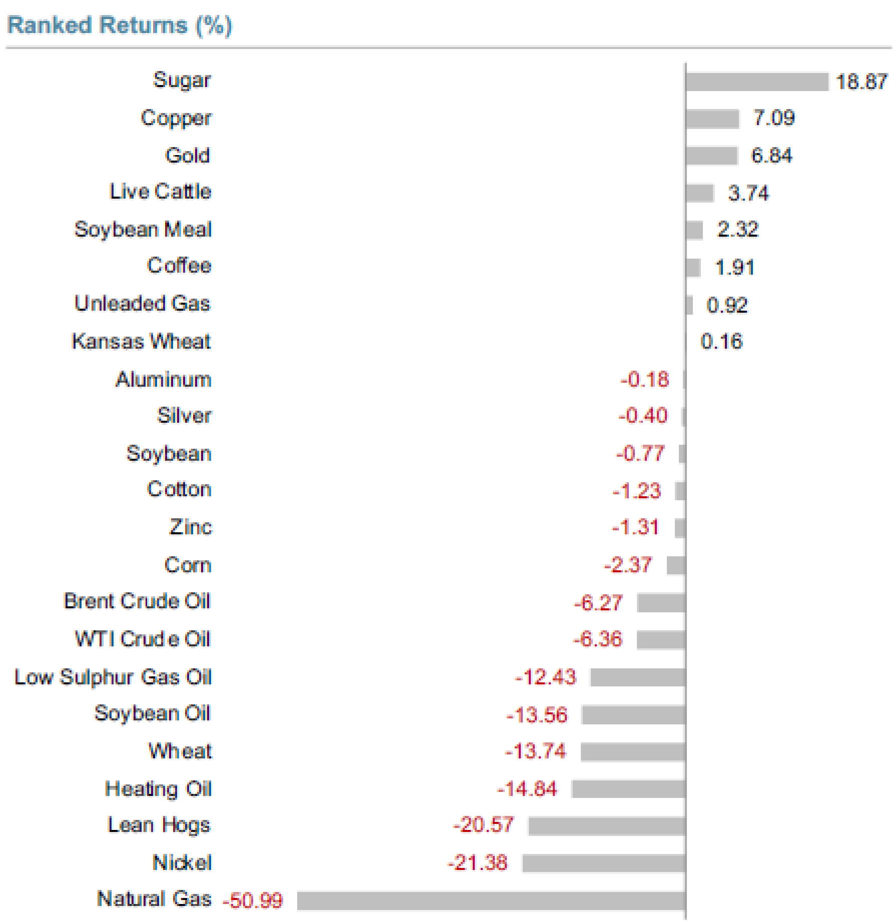
By Steve Lambdin

The first quarter of 2023 posted a very solid start to the year for global equities. We saw lower inflation levels, strong global employment levels, wage growth helping consumer spending, continued economic recovery in China, and an avoidance of an energy crisis in Europe due to a milder than expected winter. In addition, many key global economic data points held up a bit better than expected in the period. Also, we saw continued improvements in supply chains as many companies are very near normal inventory operations and fewer supply chain problems are being cited in quarterly earnings calls. But perhaps the biggest news for investors was the belief that many of the central banks around the globe could slow the pace of interest rate hikes in the coming months. This led to a further rally in equities, especially a rotation into growth stocks. However, not everything was rosy for investors in the period. Investors were shocked by the regional banking crisis in the U.S. as well as the near collapse of Credit Suisse Group in Switzerland. These banks saw accelerated deposit withdrawals as depositors moved assets to higher yielding money market funds. This created a situation where banks had to sell longer dated bonds at a loss as these realized losses affected their capital ratios, balance sheets, and profitability metrics. Ultimately, several regional banks in the U.S. failed as this sent concerns to the global equity markets in late February thru mid-March. But central banks moved quickly to act and keep investors calm, which seemed to work at least for now. On the geo-political front, the war in Ukraine continued to rage on with neither side making any significant territory gains in the period. Any major offensives have been met with stiff counter resistance. It seems like we saw some type of a grinding stalemate in the period. Also, U.S./China relations are still fragile as tensions remain high in the South China Sea over Taiwan and perceived neutral international waters. We still believe this remains a significant source of risk going forward for all investors as things can change in a hurry. But as we take all of this in, we have had a great first half in global equities and perhaps this can continue through the summer months.

	March 2023		1Q 2023	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	3.7	3.7	7.5	7.5
MSCI ACWI	3.1	2.4	7.3	7.0
MSCI ACWI ex USA	2.4	0.9	6.9	6.2
MSCI World	3.1	2.5	7.7	7.4
MSCI Emerging Markets	3.0	2.2	4.0	3.8
MSCI EAFE	2.5	0.5	8.5	7.5
MSCI Europe	2.4	0.1	10.6	8.6
MSCI Pacific	2.7	1.3	4.7	5.6

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +8.5% and +4.0% respectively during the first quarter of 2023 vs. +7.5% for the S&P 500 Index. This is the second quarter in a row of outperformance of large cap global equities vs. U.S. stocks. Investors seemed to be more comfortable with cheaper perceived equity valuations outside of the U.S. in the period. The U.S. dollar fell another -1.0% in the period, which enhanced returns for unhedged U.S. investors in the MSCI EAFE Index and, to a lesser extent, investors in the emerging markets. The European region was much stronger than the Asian region as the large European markets continued to attract investors with cheaper valuations as well as avoid the debt ceiling crisis unfolding in the U.S. Ten of the eleven sectors of the MSCI EAFE Index posted positive returns, with technology, consumer discretionary, and industrials stocks leading the way. Real estate was the only sector to post negative returns as anxiety grew over commercial real estate around the globe. Commodity prices fell in the period as the Bloomberg Commodity Index fell -5.36%, led by natural gas and nickel.



Sources: Arcadia Wealth Management

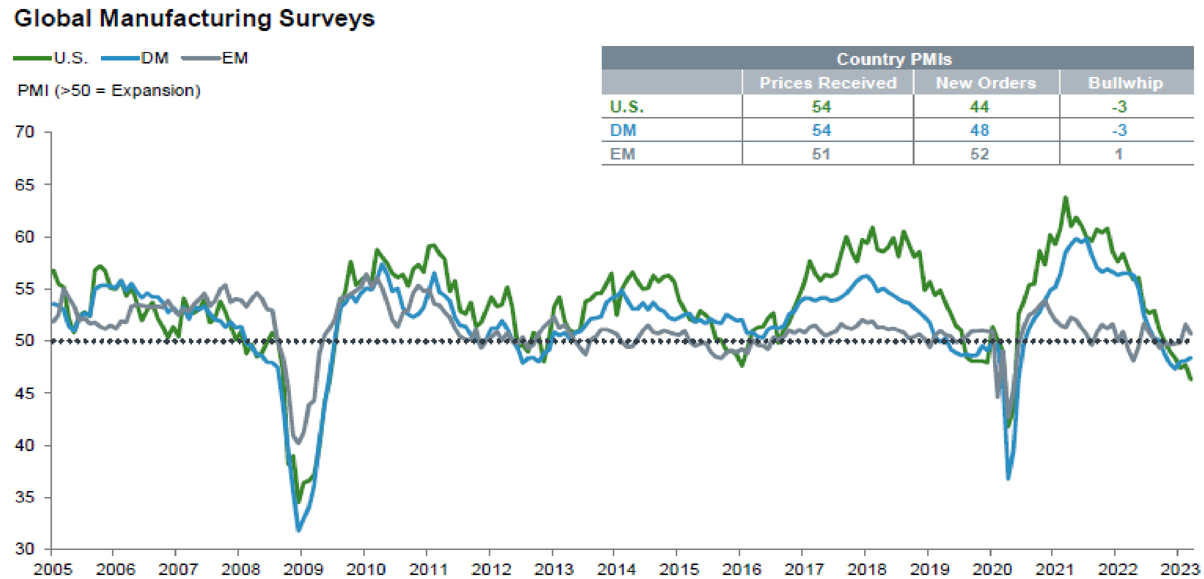
Quarter-to-date through the early June, the global equity markets have been in no clear pattern, but just oscillating based on current news flow mainly on the macro front debating the future recession/soft landing scenarios circulating in the marketplace today. But markets can continue to climb this wall of worry in the current climate. The MSCI EAFE Index and the MSCI Emerging Markets Index are up +1.80% and +1.0% respectively, while S&P 500 Index is up +4.50%. Things are looking good regarding equities eight months into our fiscal year!

So, what's on investors' minds at the present? These points below could hold the key to global equity market returns over the coming months.

Issues/Points:

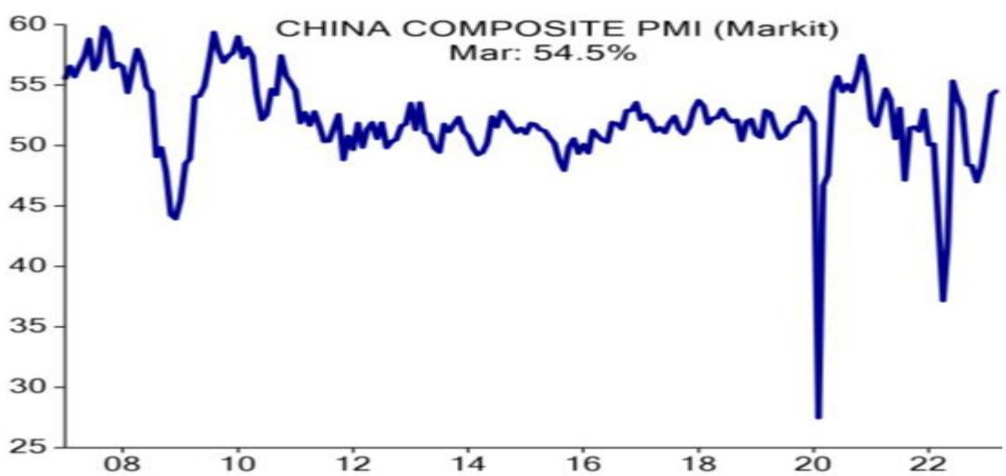
Recession/Soft Landing Debate – Investor sentiment is all over the place on this one. It seems to flip from month to month. As a result, we are probably stuck in a trading range until more clarity develops in the coming months. Investors shouldn't get overly enthusiastic near tops in the trading range, nor should they get too "beared up" near the bottoms. At the top, there may be too much optimistic news flowing around and at the bottom, some type of negative macro scenario is already priced into assets. As mentioned before, markets can simply climb this wall of worry and provide decent returns as this unfolds. This would not be a bad path to be in between now and the end of our fiscal year.

Source: Russell Investments



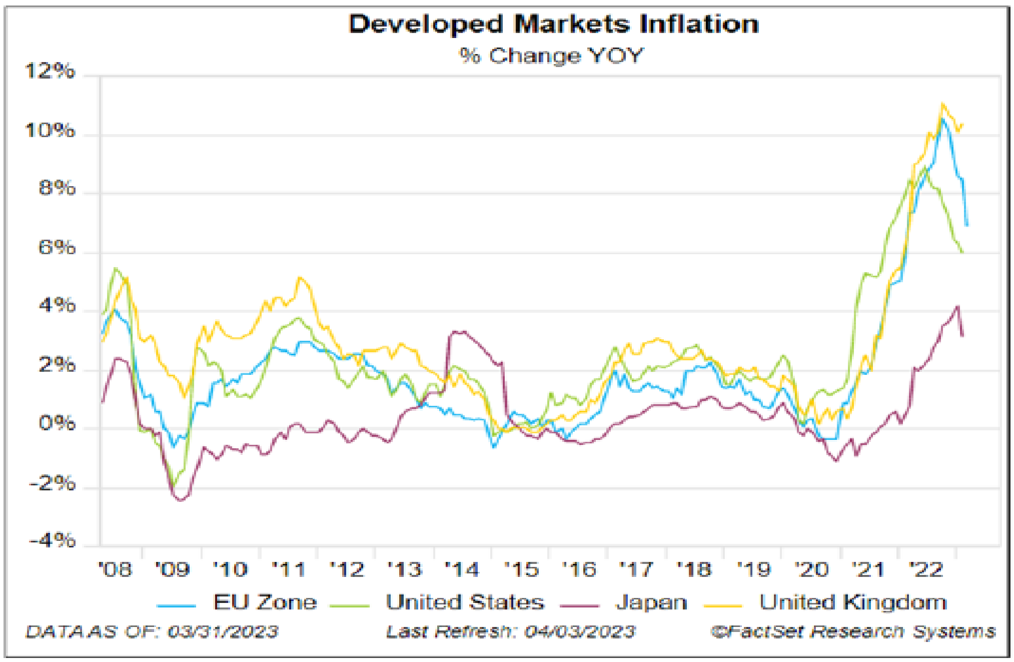
Sources: Fidelity Investments; Markit; ISM; S&P Global; Haver Analytics

China Re-opening? – We view this as a clear positive going forward. After posting the slowest growth in decades in 2022, the government has announced a growth target of 5% in 2023. If these growth targets are met, this would be a key pillar of global growth in 2023 and could keep the world out of any type of deep recession. However, this does hinge on the consumer spending some excess savings as well as a firming in the property markets. We do see this happening in a post-Covid environment as economic datapoints should rebound.



Source: Evercore ISI

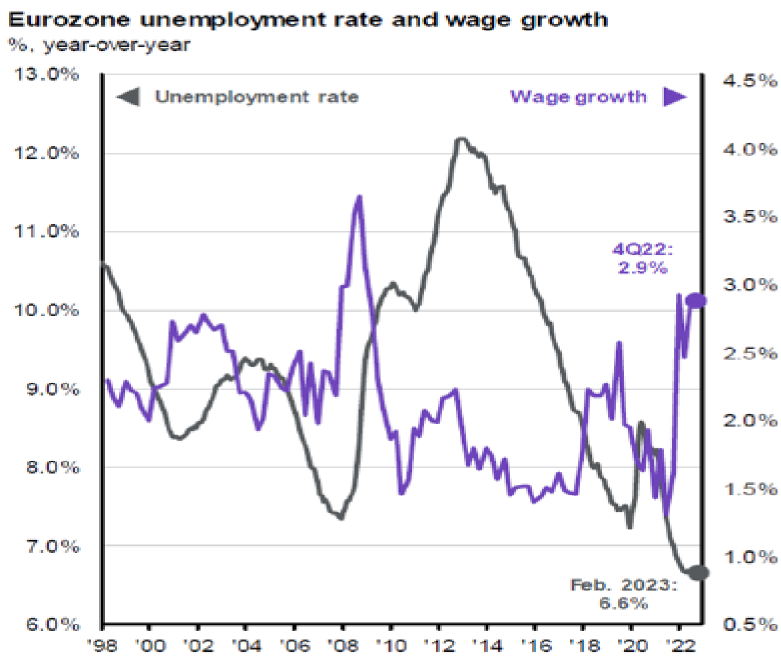
Inflation Falling – Inflation in most parts of the world is falling from peak levels seen in 2022. The International Monetary Fund (IMF) sees global inflation falling from 8.8% in 2022 to 6.6% in 2023, and even further in 2024. Past interest rate increases and falling commodity prices have served to cool inflation. This has certainly been positive for equities over the last six months. However, investors do need to see this trend continue and especially so with core inflation. Core inflation, which excludes food and energy prices, could be stickier than many expect.



Source: Eagle Global Advisors

Geo-political tensions?? – Unfortunately, this issue will be staying with investors for some time to come. The war in Ukraine continues as casualties grow on each side. We have seen little progress on any solution to this war over the last few months. Military armament continues to flow into Ukraine with more and more sophisticated western weaponry being used in combat as an example of further escalation of this war. Also, China continues to align itself with Russia, which further heightens tensions in the region. In addition, relations with China over Taiwan seem to be deteriorating as encounters with the Chinese military over neutral waters have increased over the last few months. This remains a key risk for the global equity markets going forward. However, at the same time, if we see any move toward peace talks in Ukraine, this could provide a quick positive catalyst for the equity markets.

Global Employment – the unemployment rate in most of the major regions around the globe remains at or very near historic or multi-decade lows. This is the case in the Eurozone, U.S., Japan, and the U.K. This is strengthening wage growth in these areas which helps consumers offset some of the effects of rising prices on their budgets. A strong consumer can provide a nice backbone for growth in an economy or help keep an economy out of a deeper recession. We see this as a positive data point for investors in the current environment.

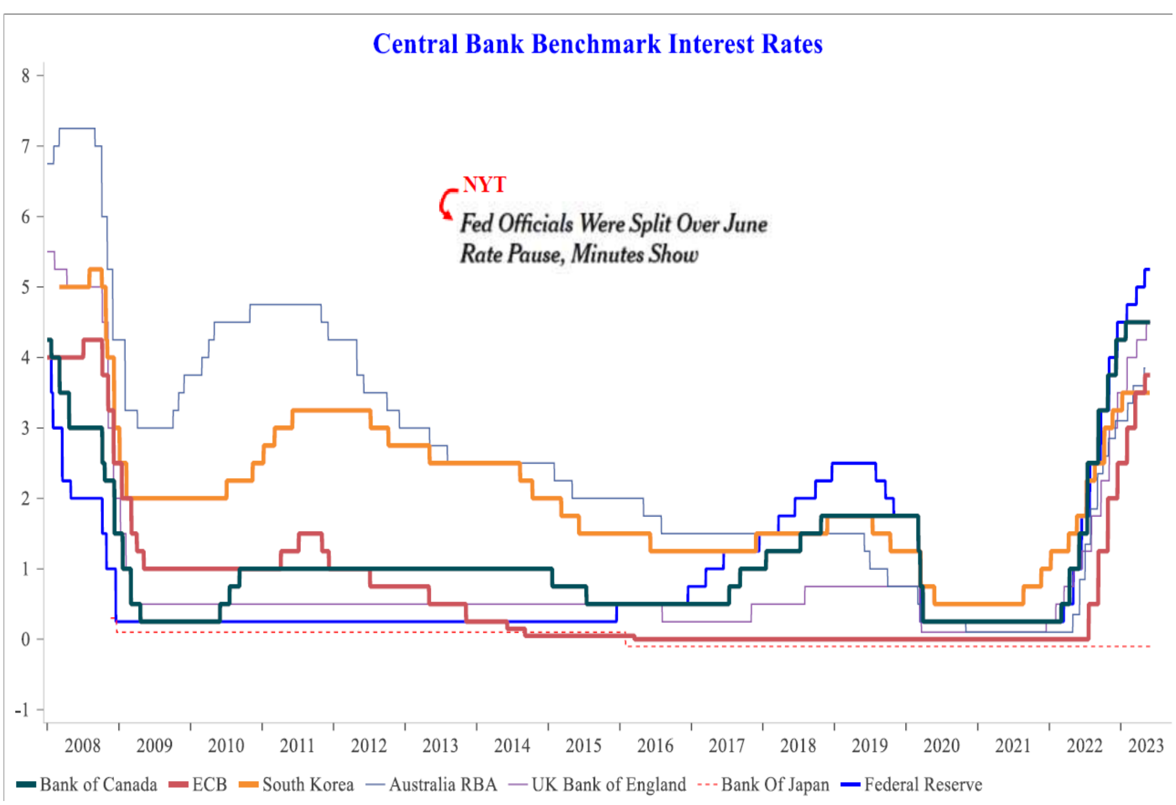


Source: Factset, JPAM, ECB, Eagle Global Advisors

Banking Crisis? – Following the collapse of a few regional banks in the U.S. and weakness at several other regionals, contagion fears migrated over to several European banks in the period. Credit Suisse Group nearly went bankrupt before an "11th hour" arranged acquisition by UBS orchestrated by the Swiss government saved them. Investors around the globe were left wondering if this was going to be the start of a tidal wave of other failures or if this was going to be contained to just a potential handful. So far, actions by regulators seems to have pushed this to the later as central banks are probably closer to being done with interest rate hikes than was generally perceived just a few months back. This should bring higher values to bond portfolios going forward. In addition, bank deposits have been more stable in Europe than the U.S. as depositors in the U.S. tend to chase higher yielding instruments rather quickly. This seems to show what can happen in a period when short term interest rates rise quickly. Investors in global equities will certainly remain watchful for developments on this front as well as commercial real estate markets around the globe for any fresh issues that might arise.

Central Bank Policy? – Investors are grappling with the positioning of the global central banks regarding any further interest rate hikes in the coming months. Are the U.S. Federal Reserve (FED), European Central Bank (ECB), and the Bank of England (BOE) expected to continue with more hikes or will they hit the "pause" button? If they pause, will it just be temporary or signal a complete end to the tightening cycle? Perhaps, they will even signal that cuts could be on the horizon later in 2023 and early 2024? These are key questions circulating in the marketplace now with answers that could dictate the direction of equity markets over the next several months. Our best guess now is the FED could pause in June, while the ECB and BOE continue to hike rates in June. We will see.

SOME CENTRAL BANKS ARE PAUSING (OR TRYING TO DO SO), BUT RESTRICTIVE POLICIES WILL HIT ECONOMIES WITH A LAG



Source: Strategas; Bloomberg; Marcobond

Valuations – With the recent good performance of global equities over the last eight months and some level of modest cuts to earnings expectations for 2023, most valuation metrics have expanded to a point where things look a bit full over the near term, barring any significant change in the macro investment outlook. Valuation levels look a bit better in the Emerging Markets than the rest of the world.

Final Thoughts/Summary

Looking out through the summer, investors will probably continue to debate whether a recession remains on the horizon or not in many of the large economies around the world. It seems like the pendulum swings in both directions as economic data points are released each week. We still see the U.S., European, and the U.K. economies posting growth in 2023 well below 2022 levels. However, we see Japan and China growth rates picking up from the continuing re-opening of the Chinese economy. What is clear to us, is the major central banks remain committed to fighting inflation, as recent interest rate increases sent a clear signal. But with inflation heading lower in most regions, we believe we could see some level of a stall in higher interest rates in the back half of 2023. Maybe this will be good for the global equity markets. Investors will also be watching for signs of further bank stress in the U.S. and Europe, as lending may become more difficult in the current environment. In addition, watchful eyes will remain on the geo-political front, monitoring develops in Ukraine as well as U.S./China relations. Any abrupt changes on these fronts could push global equities in either direction very quickly. All in all, we have been pleased with equity market returns thus far into our fiscal year. However, further gains over the near term may be a bit more difficult to achieve until investors gain further confidence in the issues mentioned above, especially regarding interest rates and inflation.

We continue to sell a few out of the money calls on the Emerging Markets Index in order to bring in some small income, as well as sell just a bit of exposure in a decent short-term rally if this happens. Premiums remain attractive in the current equity market. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.1% of total assets and approximately 11.9% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 15.0%. This is nearly at our target allocation within our investment policy statement. *(Credit is given to the following entities for charts provided: Strategas, Macrobond, IMF, JPAM, ECB, Eagle Global Advisors, Bloomberg, Evercore ISI, ISM, Haver Analytics, S&P Global, Markit, Fidelity Investments AART, MSCI, Factset, ISI, Russell Investments, Arcadia Wealth Management, RIMES, Capital Group)*

Rethinking the Relationship Between Interest Rates and Inflation

By Michael McNair

Economics, as a science, has long utilized regression analysis to explore the relationship between different economic variables. However, these equations only work if the ceteris paribus condition is assumed, but ceteris is never paribus for a complex adaptive system like the economy. The economy is constantly evolving, with the relationships between variables being non-stationary. One such variable is the interest rate and its dynamic relationship with inflation. The economic models used by the Federal Reserve (Fed) rely on the historically observed negative correlation between these two variables. Yet, as we will explore, this correlation can and does change over time.

The Negative Correlation Channel

The common narrative surrounding interest rates centers around its ability to curtail inflation – a reflection of a negative correlation between these two variables, and it is the primary channel that the Fed recognizes.

In the Fed's May news conference, a question was posed to Chairman Powell that succinctly summed up this approach: "What is the mechanism by which a higher federal funds rate is supposed to bring down inflation, if not by raising unemployment?" Powell responded, “There is a very, very tight labor market, tight to an unhealthy level. Our tools work as you describe … if you were moving down the number of job openings, you would have less upward pressure on wages, less of a labor shortage.”

Powell’s intentions are clear. Increase the cost and availability of credit so that businesses invest less, leading to a reduction in demand for labor, weakening labor’s bargaining power, and forcing labor to accept lower wages.

Though it's important to note that employment decisions are ultimately made by the private sector, the Fed's role is to subtly steer these decisions via its monetary policies. Its key strategy for cooling the labor market involves adjusting the Fed Funds Rate, the overnight lending rate between banks. A higher Fed Funds Rate is expected to trickle down to other interest rates, leading to stricter lending standards and discouraging business investment.

In summary, rising rates are expected to lead to tighter credit conditions and falling financial asset values, which should reduce borrowing, and in turn, reduce aggregate demand. Since inflation is a result of aggregate demand exceeding the production capacity of the economy, the Fed’s goal is to indirectly reduce demand.

Credit Growth and Inflation

A closer look at the mechanics of credit growth reveals its significant role in shaping demand growth, and by extension, inflation. Higher interest rates tend to suppress credit growth, which in turn reduces demand growth and subsequently dampens inflation.

The historical trend in the US has been that higher 10-year Treasury yields precede tightening cycles by banks, making credit less accessible.

Rising interest rates do not only affect the supply of credit, but also significantly dampen its demand. Recent observations show that demand for credit has fallen to levels usually seen during recessions.

The interplay between interest rates, credit availability, and credit demand is complex and only indirectly influences inflation. The Fed's approach only targets one facet of this intricate system, reinforcing the need for a comprehensive understanding of these interrelationships.

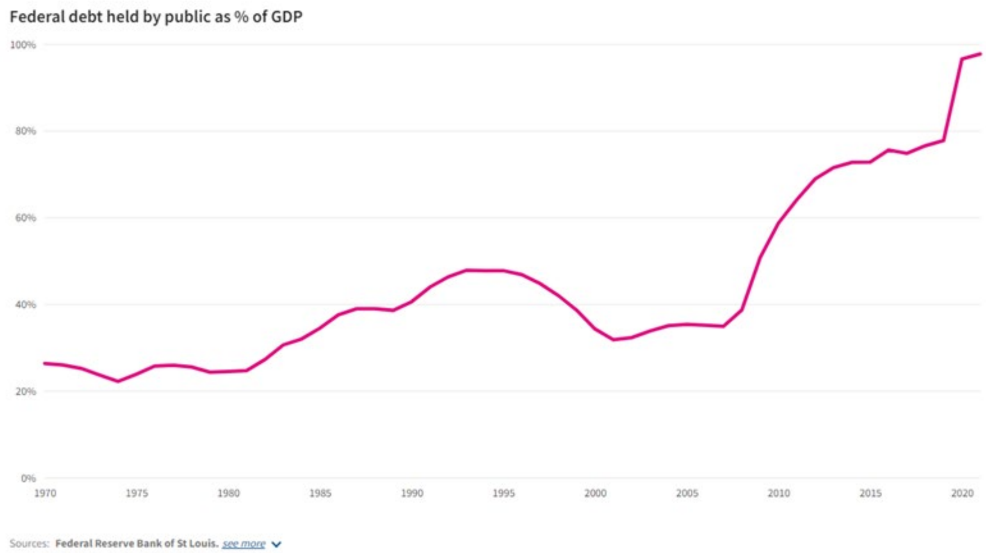
A Channel of Positive Correlation: Secondary Effects of Rising Interest Rates

In the realm of inflation dynamics, interest rates create secondary effects that can, in certain circumstances, drive inflation higher. This seemingly counterintuitive scenario represents a positively correlated transmission channel where higher interest rates lead to an increase in inflation.

The Role of Net Interest Income and Increasing Federal Budget Deficits

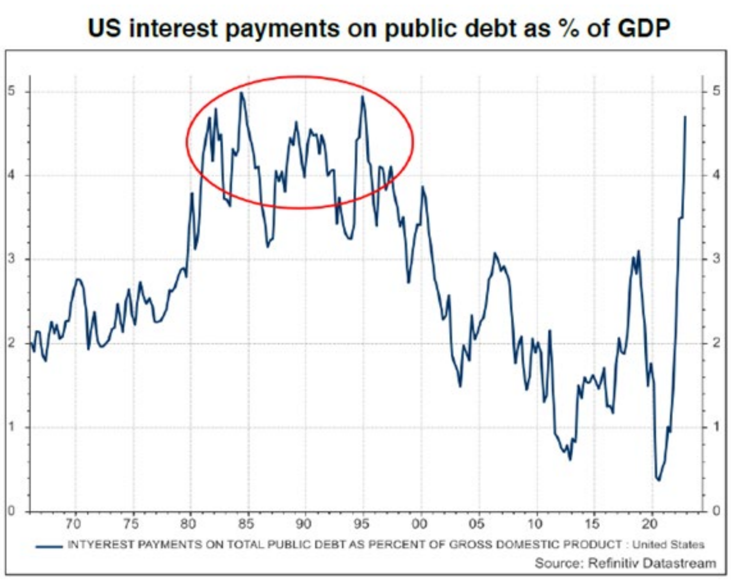
Traditionally, the influence of interest rates on inflation was viewed through the prism of income reduction. However, some economists, such as Warren Mosler, propose that we've witnessed a significant shift in our economic landscape over the past decade, requiring us to reevaluate our understanding of this relationship.

Historically, the government budget deficit has exhibited countercyclical behavior, shrinking during economic expansions and growing during recessions. However, this pattern seems to be changing due to the dramatic rise in federal debt held by the public – from less than 40% of GDP a decade ago to nearly 100% of GDP today.



Despite the robust economic growth over the past three years, the federal budget deficit has remained high, currently standing at around $1.4 trillion. While countercyclical natural stabilizers in the budget deficit still exist – such as tax receipts increasing as incomes and capital gains rise, and federal outlays decreasing as unemployment falls – the surge in net interest payments due to the rising stock of debt relative to GDP and the Fed's rapid interest rate hiking cycle is overwhelming these components and created a procyclical budget deficit.

Federal net interest payments are now annualizing at a staggering $1.3 trillion, representing over 20% of total federal outlays, which easily surpasses the size of the military budget. The Fed Funds Rate is currently 5.25% but federal net interest payments as a percent of GDP is at the level it was when the Fed Funds Rate was 20%.



The result is a persistent and sizable budget deficit (currently around 5% of GDP), which, contrary to traditional understanding, has provided a positive boost to spending and consequently, inflation. This scenario illustrates how the impact of rising interest rates can, under certain conditions, contribute to an increase in inflation rather than curbing it and how the relationship between interest rates and inflation evolves over time.

International Cases of Positive Correlation: Argentina and China

There are fascinating instances worldwide where the relationship between interest rates and inflation deviates from the standard negative correlation model. Argentina and China are examples of countries which have demonstrated a net positive relationship between interest rates and inflation.

The Case of Argentina: An Inflationary Vortex

In Argentina, government net interest payments have skyrocketed, reaching up to 30% of GDP. Consequently, when interest rates rise, so does the budget deficit, thereby driving inflation higher. This situation is particularly problematic as Argentine policymakers have erroneously treated the relationship between rates and inflation as negatively correlated. In response to escalating inflation, they've increased rates, unwittingly setting in motion a self-reinforcing cycle that has led to hyperinflation.

The Chinese Anomaly: Unusual Impact on Production and Consumption

China is another intriguing case where interest rates and inflation have exhibited a positive correlation. Professor Michael Pettis has consistently noted this unintuitive relationship, attributing it to the unique impacts on production and consumption in the country.

Most borrowing in China is conducted by the corporate and government sectors, which invest rather than consume. Such investment increases the production capacity of the economy, exerting a downward pressure on inflation. Lower interest rates encourage more investment, further depressing inflation, with the opposite effect occurring when rates rise.

Meanwhile, higher interest rates negatively affect Chinese households, primarily due to their savings being largely held in short-term bank deposits. When interest rates decrease, Chinese households must save a larger portion of their income to achieve the same level of savings, reducing consumption.

Further, the mechanism by which interest rates regulate lending in the US doesn't operate in the same manner in China, where the primary driver of credit growth is government-

mandated lending quotas. This unique dynamic has resulted in interest rate changes having a negative relationship with inflation in China for at least the past two decades.
These international examples underline the complexity of the relationship between interest rates and inflation, challenging conventional wisdom and offering unique insights into the diverse mechanisms that drive global economies.

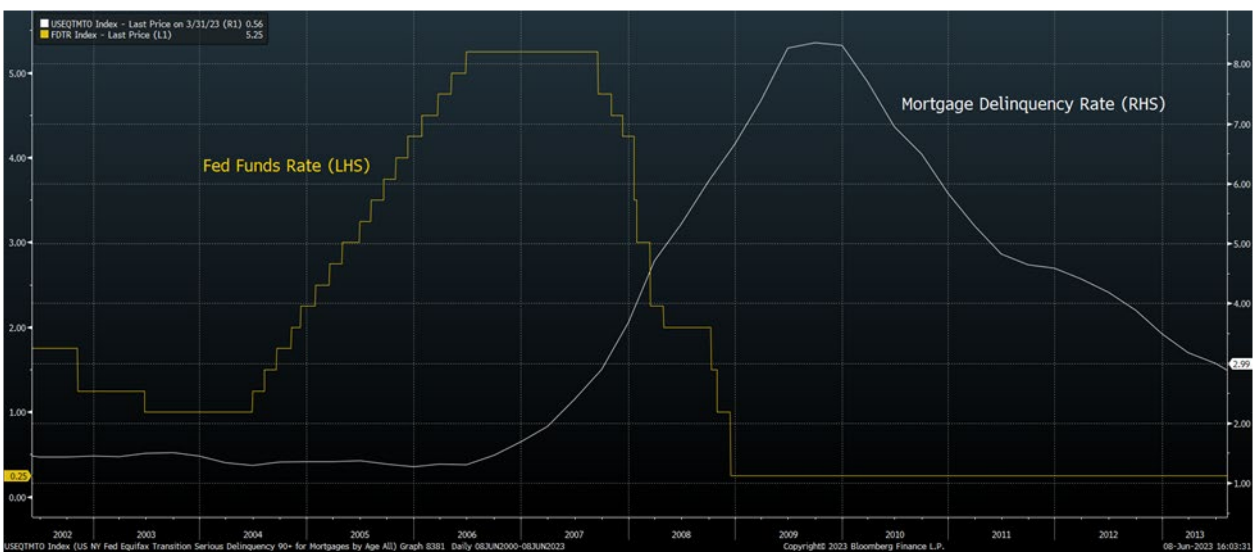
The economic risk isn't just related to the level of interest rates but the duration of their elevation

Increased government credit creation has offset the contraction in private sector credit growth and prevented aggregate demand from contracting in the face of the Fed's tightening cycle. While this resilience has led some to dismiss theories that higher rates and inverted yield curves lead to recessions, we believe that the recent economic resiliency heightens the risk of a financial crisis.

Beware of a Lagged and Non-linear Response: A Housing Crisis Analogy

The widespread belief that an economy with a high debt-to-GDP ratio would crumble under increased interest rates has been challenged, considering the limited financial turmoil even amidst a robust tightening cycle. However, it's essential to avoid complacency as the effects of higher interest rates on borrowers are not always immediate but often lagged. The lag is also variable, depending on the structure of the borrowers.

The housing crisis of the 2000s offers a salient example. Despite steadily climbing interest rates, housing prices continued to rise, and defaults remained low. Adjustable-rate mortgages (ARMs), which change periodically, gained popularity during this time. The mortgage delinquency rate remained below 2% until 2007 when a surge of ARMs reset at significantly higher rates, triggering the housing crisis.

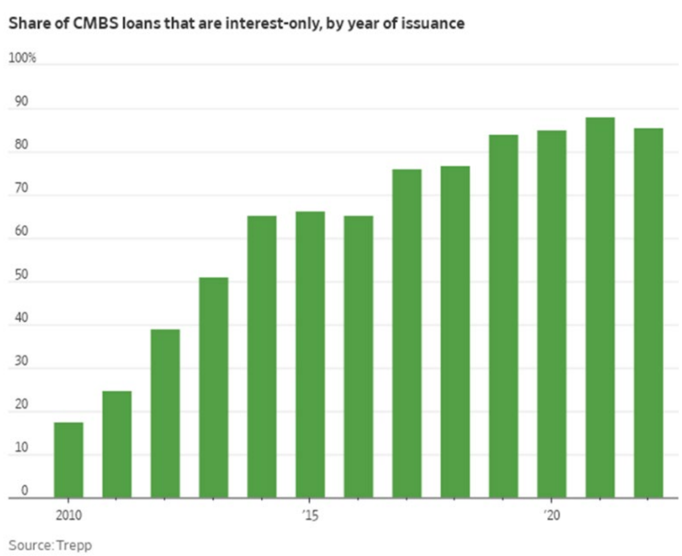


A Tectonic Shift in Leverage Dynamics

From March 2022 – 1989, there was only one month in that 395-month period that the 10-year treasury yield was higher than it was a decade prior. The sole month was December of 2018, and the yield was a mere 0.5% higher than it was in December of 2008. This secular decline in interest rates has allowed levered borrower to continuously refinance at increasingly lower rates. This scenario has now shifted dramatically.

The use of ARMs in the US mortgage market has fallen out of favor. Almost all mortgages in the US are now fixed rate mortgages which has prevented financial distress and forced selling in the housing sector. However, there is a large component of leverage in the economy, such as commercial real estate and private credit markets, that will have serious refinancing risk if rates continue to stay elevated.

Interest-only (IO) loans, which have refinancing characteristics that make them similar ARMs, now account for nearly 90% of commercial mortgage-backed security loans. A substantial $500 billion of maturing debt is due annually for the next five years, which equates to approximately 15-20% of CMBS debt. The majority of these loans maturing in the next year were issued in either 2018 or 2013. Despite the rise in values since then, the problem potentially triggering a wave of CMBS defaults is not loan-to-value ratios, but rather debt service coverage ratios (DSRs). Many of these transactions took place at low cap rates with financing costs around 6%. If rates stay at their current level these borrowers will be forced to refinance at ~12%. For many borrowers the economics will not work at such high rates, which could lead to a wave of distress and forced selling of assets reminiscent of the Housing Crisis.



Economic Resilience: A Double-Edged Sword

The economy's seeming resilience to high interest rates could inadvertently result in these rates remaining elevated for an extended period. The secular decline in rates from the

1980s – 2022, shifted the structure of private sector borrowing in the US, leading to borrowers insulating themselves from cyclical rate increases but exposing themselves to risks if rates move secularly higher.

The parts of the credit market that have already experienced financial distress, such as some regional banks, are the economic agents whose borrowing was not protected by a 'time lag' like most borrowers, as they were forced to mark to market their losses. As rates remain elevated, an increasing percentage of borrowers will be forced to mark their losses to market. Thus, the regional banking crisis should provide a red flag for what awaits the financial system if rates stay elevated.

The Fed's Conceptual Fallacy

The Fed has stated that it is data dependent. But the non-linear and lagged nature of the negative credit channel means that by the time the Fed sees financial distress in the data, it will be too late for loser monetary policy to prevent a cascading credit crisis.

According to the Fed's own FRB/US model, the peak effect of a rate hike comes about two years later and significant effects continue up to four years later. Therefore, the Fed's current rate hikes are setting policy for 2025, 2026, and 2027. If you have a tool that only works with a multi-year lag, then you need to know what the economic conditions will look like years in the future. Yet, by the Fed's admission, they can only successfully forecast economic conditions a few months in advance. Therefore, setting policy based on data dependency is logically flawed strategy for managing monetary policy.

Conclusion

Monetary policy is a tool that works, when it does, by lowering employment and wages; by reducing spending in a few interest-sensitive sectors of the economy, which may have little overlap with those where prices are rising; whose main effects take longer to be felt than we can reasonably predict demand conditions; and that is more likely to provoke a sharp downturn than a gradual deceleration.

The economy is a complex adaptive system. Higher interest rates might eventually reduce spending, wages, and prices. However, countless feedback loops will dampen or amplify the effect of interest rate changes. The idea of a “neutral rate” that somehow corresponds to the true inter-temporal interest rate is a fantasy.

Conventional monetary policy is a bad way of managing the economy and entails a bad way of thinking about the economy. We should not buy into a framework in which problems of rising prices or slow growth, or high unemployment get reduced to “what should the federal funds rate do?”