ECONOMIC UPDATE

FIRST QUARTER 2023

April 6, 2023

Quarterly Key Points

- Liquidity stress in the banking system has been calmed for now; however, many questions remain. Additionally, regional bank stress, and the resulting impact on credit creation and the broader economy, muddies the waters for monetary policy and the ongoing inflation fight.
- The Fed decided to move forward with another 25 bps hike rather than pausing in the wake of bank system stress. The SEP median dot indicates that the fed funds rate will remain above 5% at the end of 2023. This is in stark contrast to market pricing that now incorporates a strong likelihood of policy rate cuts starting as early as June.
- Inflation regained strength in the first quarter, reversing the downward trend observed at the end of 2022. Headline CPI jumped up by 0.5% m/m in January and 0.4% m/m in February, while core CPI increased by 0.4% m/m and 0.5% m/m in the same time periods. With things stabilized for the time being, inflation expectations have climbed back up modestly.
- For now, the economic engine in the U.S. remains intact. 4Q GDP growth registered 2.6% q/q annualized, primarily on inventory building and better than expected net trade effects. The labor market remains hot, with another 504k and 311k jobs added in January and February respectively. However, with inflation still problematic, higher interest rates, and frequent headlines about possible recession, it comes as no surprise that consumer confidence remains subdued.
- Overall, housing activity remains muted and business activity continues to be soft. Mortgage rates ended the quarter at 6.2%, but not before rising to 6.7% in late February on hot inflation data. The ISM Manufacturing PMI has been in contractionary territory since November, falling to 46.3 in March.

Our View

- Despite persistent labor market strength and a possible resurgence in inflation, the Fed is expected to proceed with caution until the impact of tighter credit conditions is revealed. The market believes a Fed pivot is close at hand; however, the recent Summary of Economic Projections and Fed messaging suggest otherwise.
- Going forward, we will continue to opportunistically add value given spreads remain relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions

1Q2023 – IN LIKE A LAMB, BUT OUT LIKE A LION

The first quarter of 2023 can be summarized in one word: volatility. We ended 2022 with consumer spending slowing into the holiday season, business activity pulling back, inflation finally trending lower, and the Federal Reserve downshifting to a slower pace of monetary policy tightening. The market was anxiously awaiting a pivot, supported by a deeply inverted yield curve, despite Fed messaging that suggested otherwise. We noted the gap between market expectations and Fed forecasts as a potential source of volatility in the new year. Consumer spending sprang into action in January and, unfortunately, so did virtually all measures of inflation. By late February, broader economic trends supported continued policy tightening and the market had come around to the Fed's "higher for longer" position. The curve sold off in dramatic fashion with 2-year Treasury rates reaching 5.07% on March 8, leaving 10s vs. 2s inverted by a whopping 108 bps.

Only a few days later, stress in the banking sector resulted in multiple bank failures in the U.S., including Silicon Valley Bank on March 10 and Signature Bank on March 12. By March 13, the 2-year Treasury yield had fallen 109 bps since the March 8 high, and the 10s vs. 2s inversion had dropped to only 41 bps. Interest rate volatility, as highlighted by implied volatility in the swaption market, spiked to the highest level since the fall of 2008. 2-year Treasury rates swung violently by 30-40 bps per day over the next week as the market priced the path forward. Then, after years of strategic missteps, Credit Suisse found itself on the brink of collapse. On Sunday March 19, the Swiss government arranged a bailout resulting in UBS buying Credit Suisse for only $3 billion.

Both Silicon Valley Bank and Signature Bank succumbed to a "run-on-the-bank" mentality among depositors. Large withdrawals forced the banks to sell high-quality assets, like longer dated U.S. Treasuries that are currently priced at deep discounts, in order to raise liquidity. This eventually led to insolvency, and the FDIC and Fed stepping in. Interestingly, the regulators made it explicit that both insured and uninsured depositors would be protected at both of these banks, sending a strong signal in order to ward off contagion. In order to protect depositors further, the Fed initiated the Bank Term Funding Program (BTFP) which allows banks to borrow money for up to one year against U.S. Treasury securities, Agency MBS, and "other qualifying assets." Importantly, banks can borrow against the full par value of eligible securities and not the discounted market value. The interest rate on borrowed funds will be 1-year OIS + 10 bps. Only securities purchased prior to March 12 are eligible for this liquidity program. The Fed also adjusted the discount window to have substantially similar terms as the BTFP. Furthermore, the Federal Home Loan Banks continue to extend lines of credit to banks, as they always have, in order to provide needed liquidity.

Liquidity stress in the banking system has been calmed for now; however, many questions remain. Additionally, regional bank stress, and the resulting impact on credit creation and the broader economy, muddies the waters for monetary policy and the ongoing inflation fight. Labor market strength and persistent inflation prior to March supported the Fed message of "higher for longer"; however, the market disagrees. Will the Fed capitulate? Only time will tell!

FED OPTS TO STAY THE COURSE

After briefly slowing into year end, consumer spending and inflation turned higher in January, giving the Fed leeway to continue tightening financial conditions. The slower pace of rate hikes continued in February, with another 25 bps rate increase. The Fed hiked rates by another 25 bps

in March in the wake of the aforementioned bank failures. However, this has been interpreted as a "dovish hike." Despite a tightening of the policy rate, the official FOMC statement acknowledged that "recent developments are likely to result in tighter credit conditions" that will weigh on economic activity and that "the extent of these effects is uncertain." In the post meeting press conference, Fed Chair Powell stopped short of quantifying the impact of recent bank failures on credit tightening and also suggested that the committee did discuss pausing hikes altogether. On the flipside, Powell also stated that the committee does not anticipate cutting rates by the end of the year and that additional policy firming may be appropriate.

Although the Fed decided to move forward with another 25 bps hike rather than pausing in the wake of bank system stress, the March Summary of Economic Projections (SEP) was virtually unchanged from December. This was much different than what was expected only weeks before. By the end of February, the market had come around to the Fed's hawkish message, as reflected in fed funds futures. The policy pivot was pushed out later into the year, and additional hikes up to 100 bps were being priced in. Now, despite its dovish interpretation, the SEP median dot indicates that the fed funds rate will remain above 5% at the end of 2023. This is in stark contrast to market pricing that now incorporates a strong likelihood of policy rate cuts starting as early as June, with fed funds winding up at something closer to 4.25% by the end of the year. Clearly the market expects the Fed to reverse course in the face of economic weakness in the not too distant future.

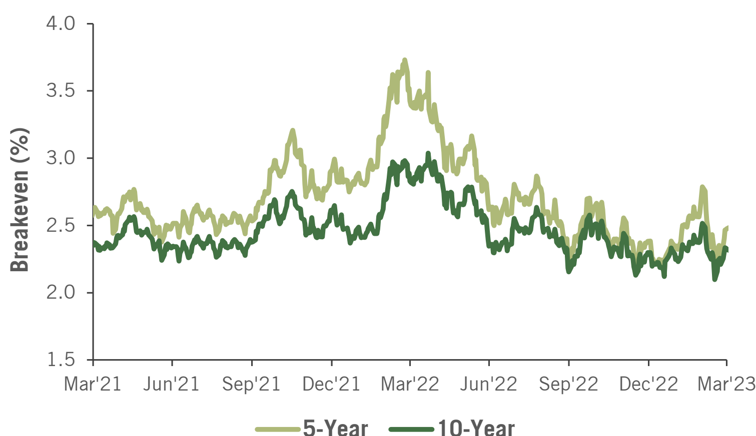
On a separate note, the debt ceiling debate is back. As of January 19, the U.S. government has reached its approved $31.4 trillion debt limit. Since then, the U.S. Treasury has been using extraordinary measures in order to borrow additional funds and continue to operate without surpassing the debt ceiling. According to Treasury Secretary Yellen and the Congressional Budget Office, the U.S. government can continue to operate this way until sometime this summer. Experts warn of the catastrophic consequences of a U.S. government default and we expect brinksmanship will be on full display come late spring.

HIGH INFLATION STILL A CHALLENGE

Inflation regained strength in the first quarter, reversing the downward trend observed at the end of 2022. Headline CPI increased by 6.4% y/y in January and 6.0% y/y in February, whereas core CPI increased 5.6% y/y in January and 5.5% y/y in February. At this point, year-over-year numbers create the illusion that inflation continues to improve; however, we would argue that month-over-month and rolling 3-month numbers are a stronger signal of the current trajectory. Headline CPI jumped up by 0.5% m/m in January and 0.4% m/m in February, while core CPI increased by 0.4% m/m and 0.5% m/m in the same time periods. These are the highest month-over-month readings for both of these measures since early fall of last year. On a rolling 3-month basis, headline CPI has remained at 0.3% m/m, implying an annualized rate of ~3.7%, whereas core CPI has increased to 0.4% m/m, implying an annualized rate of ~4.9%. At a minimum, this suggests that the downward trajectory in inflation has leveled off for the time being, well above the Fed's 2% target.

PCE inflation numbers show a similar pattern, with year-over-year numbers suggesting improvement and month-over-month numbers proving sticky. Headline PCE measured 5.3% y/y and 0.6% m/m in January, and 5.0% y/y and 0.3% m/m in February. Core PCE increased to 4.7% y/y and 0.5% m/m in January before falling back to 4.6% y/y and 0.3% m/m in February. On the bright side, headline producer prices continue to come down, despite some monthly volatility, and core PPI has been on a steady path downward. On a year-over-year basis, core PPI measured 4.4% y/y in February while headline PPI registered 4.6% y/y. Both of these year-over-year numbers are the lowest readings since spring 2021.

FIGURE 1: 5-YEAR & 10-YEAR U.S. TIPS BREAKEVEN RATES[1]



[1]Source: Bloomberg

GALLIARD Capital Management, LLC

Inflation expectations bounced around throughout the quarter. Readings briefly shot higher in February on stronger than expected inflation data and the Fed's slower pace of policy tightening, as some worried that the Fed was once again behind on the re-ignited inflation fight. Then in March, during the bank liquidity episode, inflation expectations fell rapidly. With things stabilized for now, inflation expectations have climbed back up to 2.48% and 2.32% for 5-year and 10-year breakeven rates respectively (Figure 1). The 5-year, 5-year forward breakeven showed a similar pattern of volatility, although more muted, to wind up at 2.21%, roughly where it has been since the beginning of the year.

SLOWING ECONOMIC GROWTH SUPPORTED BY STRONG LABOR MARKET

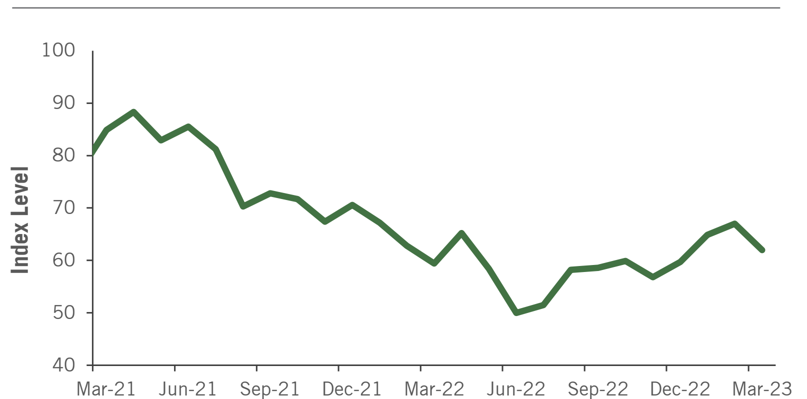
For the time being, the economic engine in the U.S. remains intact. 4Q GDP growth registered 2.6% q/q annualized, primarily on inventory building and better than expected net trade effects. Notably, the initial estimate of 2.9% q/q annualized growth was revised downward multiple times to arrive at the final tally. On the year, GDP growth measured 2.1% in 2022. 1Q GDP growth is expected to be 1.0%-2.0% q/q annualized, with most forecasts calling for a recession to begin sometime over the next several quarters. At present, the Bloomberg recession probability stands at 65%.

The labor market remains hot, with another 504k and 311k jobs added in January and February respectively. Notably, job creation in every month since January 2022 (including revisions) has exceeded expectations with only two exceptions in spring of last year. Unemployment ground down to only 3.4% in January before rising back to 3.6% in February. However, job openings fell below 10 million in February for the first time since June 2021. The job openings number will get increased attention, as it will likely be the canary in the coal mine that labor markets are beginning to correct. Job openings will begin to fall as employers pull open requisitions from the market before unemployment creeps up. Additionally, the quits rate has retreated to 2.6%, only slightly elevated relative to the pre-pandemic average of 2.3% in 2018-2019.

Personal income growth jumped up to 0.6% m/m in January before falling back to 0.3% m/m in February. Year-over-year measurements followed a similar pattern reaching 6.4% y/y and 6.2% y/y in January and February respectively. Nominal hourly earnings growth slipped to only 0.3% m/m in January and 0.2% m/m in February after a string of 0.4% m/m readings throughout last fall. Unfortunately, after months of positive momentum, month-over-month real hourly income growth turned negative again in January and February measuring -0.3% m/m and -0.1% m/m respectively. This is consistent with an uptick in inflation measurements that further erode income gains.

With inflation still problematic, higher interest rates, and frequent headlines about possible recession, it comes as no surprise that consumer confidence remains subdued. The University of Michigan Consumer Sentiment Index remains stuck in the low-mid 60s (currently at 62, Figure 2). After slipping into negative territory during the November and December holiday season, retail sales spiked by a whopping 3.2% m/m in January, but then quickly retreated by -0.4% m/m in February. Retail sales ex-autos and personal consumption expenditures followed a similar pattern of slower growth throughout the holiday season and then accelerating higher to start the year. After plummeting in 2022 to the lowest point since 2005, personal savings measured as a percentage of disposable income climbed back to 4.6% in February. Consumer revolving credit has consistently grown at a double digit annualized rate over the past year. While month-over-month annualized measures have been volatile as of late, the growth rate measured 11.1% m/m annualized in January.

FIGURE 2: UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT[2]



[2]Source: Bloomberg

HOUSING AND BUSINESS ACTIVITY CONTRACTING

Overall, housing activity remains muted. After bottoming out at only 4.0 million units annualized in both December and January, existing home sales increased to a 4.6 million unit annualized pace in February. Although the increase looked big, it is worth noting that this is still a very low level of existing home sales. In contrast, new home sales have fared relatively well. While much lower than the >800,000 unit annualized pace at the onset of last year, a reading of 640,000 units in January is right on pre-pandemic trend. Despite transaction volumes plummeting, existing home supply remains very low at 2.5 months. The supply of new homes on the other hand, remains elevated at ~8 months of supply. The big difference is that existing home listings have pulled back in lockstep with demand whereas new home inventory has increased as builders slowly complete developments that were in the pipeline.

Mortgage rates ended the quarter at 6.2%, but not before rising to 6.7% in late February on hot inflation data. This combination of higher mortgage rates and home prices that have gone up considerably since the onset of the pandemic have made the cost of housing substantially more expensive. After turning negative for the first time in over ten years in July, the S&P CoreLogic Case-Shiller 20 City Composite City Home Price NSA Index has registered seven consecutive months of negative month-over-month change. On a year-over-year basis, home prices grew at only 2.5% in January, the lowest reading since before the pandemic. Notably, these numbers are published on a two-month lag and could trend lower over the coming months.

Businesses activity remains soft with a number of measurements continuing on a downward trend. The ISM Manufacturing PMI has been in contractionary territory since November, falling to 46.3 in March. The ISM Manufacturing Report on Business New Orders Index has consistently been contractionary since early last fall as well, measuring 44.3 in March. This is considerably lower than readings of >60 for most of 2021 and early 2022. The ISM Services PMI, on the other hand, has rebounded. After dipping unexpectedly to 49.2 in December, the index registered 51.2 in March. Clearly the services industry is in a different state than manufacturing.

After a relatively strong reading of 5.1% m/m in December, U.S. durable goods new orders turned sharply negative, contracting by -5.0% m/m and -1.0% m/m in January and February respectively. Industrial production and capacity utilization have both rolled over after rising to well past pre-pandemic levels. Industrial production is currently at 102, which is down just slightly from 103 in late fall, while capacity utilization has slipped back to 79% from a high of almost 81%. The slowing of these measures may signal a pullback, commensurate with slumping manufacturing. Indeed, measured month-over-month, industrial production has been negative in five of the past six months.

LOOKING AHEAD

Liquidity stress in the banking system has shifted the landscape and sent ripples through capital markets. Markets have stabilized at present, but the damage may have already been done. The resulting flow of funds through the financial system disproportionately impacts regional banks, as depositors seek safe liquidity and better yield. The resulting fight for depositors will lead to tighter credit in the system, exacerbating a trend that had already emerged last year. On one hand, tighter credit is the natural result of monetary policy tightening, but on the other hand, an acute liquidity crisis would throw a wrench in the Fed's monetary policy plans.

Despite persistent labor market strength and a possible resurgence in inflation, the Fed is expected to proceed with caution until the impact of tighter credit conditions is revealed. The market believes a Fed pivot is close at hand, commensurate with a pending recession; however, the recent Summary of Economic Projections and Fed messaging suggest otherwise. This disconnect has returned after a brief marriage in late February, bringing with it elevated volatility. The curve remains deeply inverted and it would seem there are fewer options available to avoid a recession.

With reduced liquidity and an elevated risk of recession, volatility in risk assets has persisted, reflecting fatter tails and the risk of unintended consequences. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value given spreads remain relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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