GALLIARD
Capital Management, LLC
ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

SECOND QUARTER 2023

July 6, 2023

Quarterly Key Points

- While the first quarter of 2023 was dominated by the bank liquidity crisis in March and accompanying market volatility, the second quarter can largely be summarized by a reversal of that volatility.
- For the time being, the economic engine in the U.S. continues to chug along. 1Q GDP growth was 2.0% q/q annualized on resilient consumer spending, stronger than expected government spending, and a positive boost from exports.
- The FOMC paused policy rate hikes at the June meeting amid some debate regarding why, and the disconnect that previously existed between market pricing and Fed messaging has moderated. It seems the Fed's message of higher for longer is finally taking hold.
- Across virtually all measures of inflation, headline numbers are showing steady improvement while core numbers are more stubborn. Still, inflation expectations trended lower throughout the quarter, with a more pronounced downward trajectory in shorter tenors.
- The labor market remains strong - job creation has averaged 314k per month so far in 2023, there are still ~10 million job openings, and the quits rate is only slightly above the pre-pandemic average of 2.3% in 2018-2019.
- Businesses activity remains subdued; however, the deterioration seems to have slowed, at least momentarily. Services activity, on the other hand, has shown more resilience.

Our View

- Recent economic signals give the Fed ample cover to continue with monetary policy tightening and, with an additional one to two rate hikes priced in for the remainder of the year, recession fears and ensuing policy easing have been pushed until well into 2024.
- As monetary policy becomes more restrictive, liquidity will continue to be a concern. The full impact of monetary policy tightening thus far and the associated credit tightening that started in the banking system earlier this year have been only partially realized.
- Our portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

2Q2023 – WHAT RECESSION?

While the first quarter of 2023 was dominated by the bank liquidity crisis in March and accompanying market volatility, the second quarter can largely be summarized by a reversal of that volatility. Although there was another bout of bank stress in May with the failure of First Republic Bank and the debt ceiling drama that played out until the 11th hour, measures of market volatility generally tracked lower during the quarter. The ICE BofA MOVE Index, the BofA Securities GFSI Liquidity Risk indicator, and the Goldman Sachs U.S. Financial Conditions Index have all improved since March. Market performance followed suit: the S&P 500 Index was up ~8% for the quarter, while the Bloomberg U.S. Aggregate Bond Index turned in 59 basis points (bps), or 0.59%, of excess return over the same period.

Meanwhile, the market has been awaiting a recession that is perpetually 1-2 quarters away. There has been an ongoing game of yield curve tug-of-war between the market, begging for a policy pivot, and the Federal Reserve, which has thus far stuck to its guns. Business activity has slowed, particularly in manufacturing, but there are signs of renewed activity. Consumers have proven remarkably resilient, fueled by a strong labor market and healthy wage gains that are catching up with inflation.

As the market moved past bank liquidity stress and embraced the Fed's message of "higher for longer," 2-Year Treasury rates sold off to 4.90%, 87 bps higher than at the end of March, whereas 10-Year Treasury rates are only 37 bps higher than last quarter at 3.84%. The net result is the curve inverting by another 50 bps, such that the 2s vs 10s inversion is back to 106 bps. The 10-year real rate is also meaningfully higher at 1.61% (up 48 bps over the quarter), almost exactly where it started the year, while inflation expectations are anchored at ~2.20%-2.30% across the curve.

For the time being, the economic engine in the U.S. continues to chug along. 1Q GDP growth was 2.0% q/q annualized on resilient consumer spending, stronger than expected government spending, and a positive boost from exports. Notably, the initial estimate of 1.1% q/q annualized growth was revised upward multiple times to arrive at the final tally. 2Q GDP growth is expected to be 1.0%-2.0% q/q annualized, with full-year 2023 now in the 1.2% - 1.5% range, slightly higher than previously projected. Although recession probabilities remain elevated, forecasts calling for a mild recession have been pushed out to late this year or early 2024.

DEBT CEILING DEBATE KEEPS INVESTORS ON THEIR TOES

After months of using "extraordinary measures" to operate without surpassing the debt ceiling and repeated warnings from the U.S. Treasury Department that funds could run out as early as June, Congress passed a debt ceiling resolution at the 11th hour on May 31st. The legislation suspends the debt ceiling until January 2025, effectively pushing off the next debate until after the 2024 elections. Importantly, suspension is different than setting a new debt ceiling in that it doesn't put a hard number on the debt limit. Rather, a suspension gives the Treasury the ability to fund the Government with as much debt as is necessary.

The trade-off for the suspension comes in the form of budget cuts and spending caps. Non-defense discretionary spending is frozen for two years, IRS funding has been reduced, unused COVID-19 funding is getting clawed back, the federal student loan payment freeze will end, and there will be increased work requirements for food stamps. Defense spending, on the other hand, will be increased. From what we've gathered, the net of all this is more symbolic than anything else.

Unfortunately, the game of brinksmanship that was played is not without consequence as Fitch placed the U.S. Government on watch in late May.

Additionally, the student loan forgiveness program initiated by the Biden administration last fall was voted down by the Supreme Court at the end of June. Recall that the plan included targeted debt cancellation of up to $20,000, depending on household income and Pell Grant status. Importantly, executive order was used to implement this plan and avoid the need for Congressional approval. Ultimately, this was the focal point of the Supreme Court's decision which specifically highlighted that the president had exceeded his power.

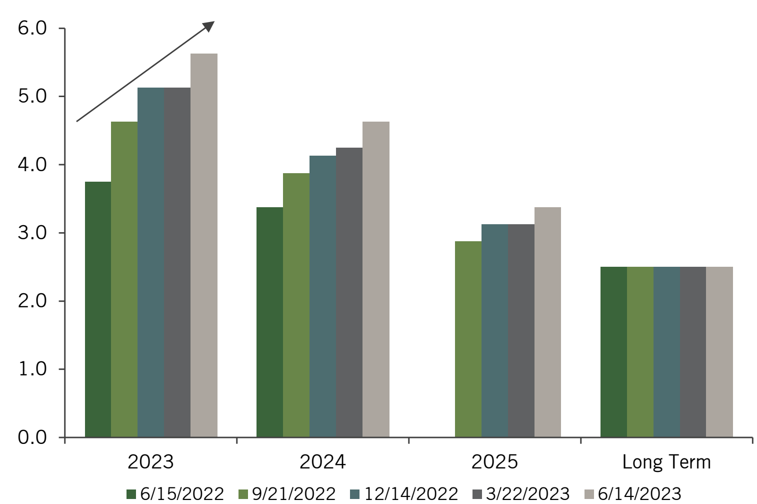
Amid the cross currents of tight labor markets, resilient consumer spending, stubborn inflation, and multiple bank failures, the Federal Reserve has slowed the rate of policy tightening thus far in 2023. At its meeting in May, Fed Chair Powell indicated a pause may be the FOMC's next move, while continuing to push back against the idea of rate cuts later this year. Delivering on this message, the FOMC paused policy rate hikes at the June meeting amid some debate regarding why: despite the market begging for a pause, there is little in the way of data regarding core inflation and labor markets to suggest that policy tightening to this point will be sufficient to bring core inflation closer to the Fed's target.

The official FOMC statement changed very little, but it did acknowledge that "holding the target range steady at this meeting allows the Committee to assess additional information and its implications for monetary policy." Perhaps a short breather is warranted considering the aggressive pace of policy tightening over the past year, the "long and variable lags" associated with such tightening, and the unknown impact of recent bank failures on credit creation. In the post meeting press conference, Fed Chair Powell highlighted this point in his opening statement, "We have covered a lot of ground, and the full effects of our tightening have yet to be felt. In light of how far we have come in tightening policy, the uncertain lags with which monetary policy affects the economy, and potential headwinds from credit tightening, today we decided to leave our policy interest rate unchanged and to continue to reduce our securities holdings. Looking ahead, nearly all Committee participants view it as likely that some further rate increases will be appropriate this year to bring inflation down to 2 percent over time."

The Summary of Economic Projections (SEP) updated at the June meeting reiterate that the Committee believes additional rate hikes will be appropriate. The median Fed projection for 2023 GDP now stands at 1.0% versus 0.4% in March, the median projection for the year-end unemployment rate is 4.1% versus 4.5%, and the median core PCE inflation projection for 2023 is 3.9% versus 3.6%. It should come as no surprise that the median Fed Funds rate projection at year-end 2023 is now 5.625% versus the previous projection of 5.125% in March (Figure 1). Indeed, 16 out of 18 "dots" indicate additional rate hikes between now and the end of the year.

Market expectations have also changed, at least for the time being. The disconnect that previously existed between market pricing and Fed messaging has moderated. At the end of the first quarter, the market was pricing in a terminal Fed Funds rate of ~5% by June followed by aggressive cutting soon after, commensurate with a sharp contraction in economic activity in the back half of the year. Today, the market is pricing in another rate hike later this summer with rates staying unchanged (more or less) into year end. It seems the Fed's message of higher for longer is finally taking hold.

FIGURE 1: FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)[1]



HEADLINE INFLATION SHOWS IMPROVEMENT BUT CORE REMAINS STICKY

Across virtually all measures of inflation, headline numbers are showing steady improvement while core numbers are more stubborn. Headline CPI increased by 4.9% y/y in April and 4.0% y/y in May, down from 6.5% y/y at the end of last year. Core CPI, on the other hand, increased

[1]Source: Federal Reserve

by 5.5% y/y and 5.3% y/y in April and May respectively, only slightly lower than 5.7% y/y at the end of 2022. Further, core CPI has measured 0.4% m/m in every month so far this year except for February when it registered a 0.5% m/m increase. A consistent increase of 0.4% m/m implies an annualized rate of ~4.9%. At a minimum, we can say that the downward trajectory in core inflation has leveled off for the time being, well above the Fed's 2.0% target.

PCE inflation numbers show a similar pattern, with year-over-year numbers suggesting improvement and month-over-month numbers proving sticky. Headline PCE fell to 3.8% y/y and only 0.1% m/m in May, giving the market hope that inflation is cooling. Unfortunately, core PCE is holding steady, coming in at 4.6% y/y and 0.3% m/m in May. Notably, core PCE has been 4.6% y/y to 4.7% y/y in every month since last December, suggesting little improvement. Alternative Fed measures of core inflation like the Federal Reserve Bank of Cleveland Median CPI, the Federal Reserve Bank of Cleveland 16% Trimmed-Mean CPI, and the Atlanta Fed Sticky CPI 12 Month figures measured 6.7%, 5.5%, and 6.1% y/y respectively in May.

Still, inflation expectations trended lower throughout the quarter, with a more pronounced downward trajectory in shorter tenors. 2-Year breakeven rates fell from 2.68% to 2.11% and the 5-Year fell from 2.48% to 2.19%, while 10-Year rates fell considerably less, moving from 2.32% to 2.23%. The 5yr 5yr forward breakeven was virtually unchanged during the quarter at ~2.21%. In our view, the change in short tenor inflation expectations is consistent with the current market consensus that the Fed is almost done with monetary policy tightening (perhaps two more hikes), the deeply inverted yield curve, and elevated recession expectations over the next 12 to 18 months.

CONTINUED DIVERGENCE BETWEEN STRONG CONSUMERS AND WEAKER BUSINESSES

The labor market remains strong, with another 294k and 339k jobs added in April and May respectively. Notably, job creation has averaged 314k per month so far in 2023, exceeding expectations in every month except March (which was only 7k below estimates). Unemployment remains low, measuring only 3.4% in April and 3.7% in May, while labor force participation has ticked up only slightly to 62.6% - just shy of the pre-pandemic trend. Additionally, weekly jobless claims in the mid-200k range are very normal historically speaking. The subtle uptick from ~230k in late May to ~264k in mid-June may or may not contain much information: a longer-term trend will need to materialize, in our view. There are still ~10 million job openings while the quits rate remained steady at 2.6% in May, only slightly above the pre-pandemic average of 2.3% in 2018-2019.

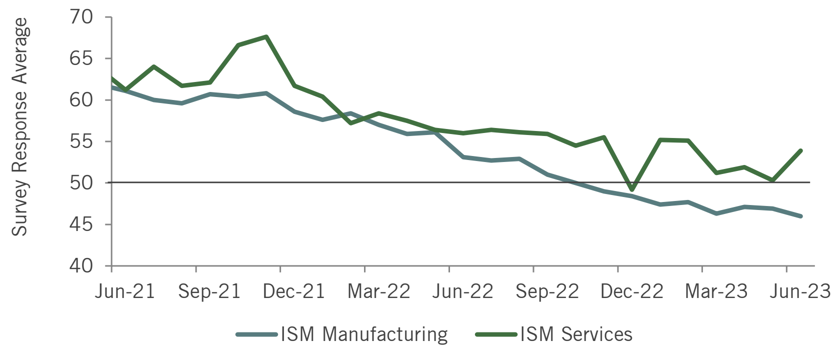
Personal income growth has been remarkably consistent since the beginning of the year, most recently measuring 5.5% y/y in March, April, and May. Measured year-over-year, nominal income growth declined to 4.3% y/y in May, matching the lowest year-over-year reading since the summer of 2021. Following an unrelenting string of negative monthly readings stretching all the way back to April 2021, year-over-year real hourly earnings growth finally turned positive in May, coming in at 0.2% y/y. Month-over-month real hourly income growth has also been positive as of late, measuring 0.2% m/m, 0.0% m/m, and 0.3% m/m in March, April, and May respectively.

The University of Michigan Consumer Sentiment Index remains stuck in the low-mid 60s (currently at 64.4), the result of problematic inflation, higher interest rates, and frequent headlines about possible recession. Headline retail sales improved during the quarter, up 0.4% m/m and 0.3% m/m in April and May respectively, and retail sales ex-autos also turned positive by 0.4% m/m and 0.1% m/m during the same time periods. Meanwhile, personal consumption expenditures growth, while still consistently positive, downshifted slightly after some large monthly increases during the first quarter. 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 May. While still lower than pre-pandemic, the savings rate has been trending higher. Consumer revolving credit has consistently grown at a double-digit annualized rate over the past year. The most recent measurement in April came in at ~14% m/m annualized.

Businesses activity remains subdued; however, the deterioration seems to have slowed, at least momentarily. The ISM Manufacturing PMI, for example, has been in contractionary territory since November, with recent readings coming in at 47.1, 46.9, and 46.0 in April, May, and June respectively. The ISM Manufacturing Report on Business New Orders has consistently been contractionary since early last fall, measuring 45.7, 42.6, and 45.6 in April, May, and June. The ISM Services PMI, on the other hand, has shown more resilience, generally hovering around 55 for most of the past year. With that said, the trend more recently has been lower, with the index measuring 51.9, 50.3, and 53.9 in April, May, and June (Figure 2). The unexpected dip to 49.2 in December appears to be somewhat of a fluke.

Other business measures have gained momentum, however, such as durable goods orders, which advanced 3.3% m/m, 1.2% m/m, and 1.8% m/m in March, April, and May respectively. Construction spending followed a similar pattern, resuming a healthy pace of 0.6% m/m, 0.4% m/m, and 0.9% m/m in March, April, and May. Industrial production and capacity utilization have both gained steam almost getting back to the highs of early 2022. Industrial production is back up to ~103, just slightly below the post-pandemic high point of 103.5 realized last year, whereas capacity utilization is hovering just below 80%.

FIGURE 2: ISM MANUFACTURING AND SERVICES[2]



Mortgage rates, as measured by the Freddie Mac Weekly Survey rate, drifted higher to end the quarter at 6.7%. Mortgage rates entered the quarter closer to 6% after the bank liquidity crisis induced rate rally in March, but then subsequently sold off with Treasuries in June as the "higher for longer" theme took hold. Existing home sales volume remains paltry, coming in at only 4.3 million units annualized in both April and May. Pending home sales and the MBA U.S. Purchase Index show similar trends. Both of those indexes have dropped back considerably since the beginning of 2022 to levels well below pre-pandemic. In contrast, new home sales have continued to fare relatively well, surging to a 763k unit annualized pace in May. For reference, the pre-pandemic trend was in the 600k to 650k range.

Despite transaction volumes plummeting, existing home supply remains very low at ~3 months; this is barely higher than the historic low point reached in early 2022. The supply of new homes, on the other hand, remains elevated at ~7 months of supply, which is well above pre-pandemic levels. The big difference between the market for existing homes and the market for new homes is that existing home listings have pulled back in lockstep with interest rate induced reductions in demand, whereas new home inventory has increased as builders slowly complete developments that were in the pipeline. This observation is consistent with existing home sales volumes stalling out while new home sales are surging once again.

LOOKING AHEAD

Liquidity stress in the banking system has abated for the time being, and with it the disconnect that previously existed between market pricing and Fed messaging regarding future interest rate increases. Measures of volatility, while still elevated, have fallen, as have inflation expectations. Recent economic signals give the Fed ample cover to continue with monetary policy tightening and, with an additional one to two rate hikes priced in for the remainder of the year, recession fears and ensuing policy easing have been pushed until well into 2024. Nevertheless, it is hard to ignore the deeply inverted yield curve indicating an economic downturn at some point.

As monetary policy becomes more restrictive, liquidity will continue to be a concern. Furthermore, the full impact of monetary policy tightening thus far and the associated credit tightening that started in the banking system earlier this year have been only partially realized. Higher volatility in risk assets could easily return and spreads could remain wide or get wider, reflecting fatter tails and the risk of unintended consequences. Our portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add spread where we see relative value. 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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[2]Source: Bloomberg

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