TCW

4Q 2022: Drought of Recession or the Inferno of Inflation?

4Q 2022: 2022 Year in Review

- With inflation running dramatically higher than the Fed's 2% target at the start of the year, 2022 was characterized by a rapid and significant increase in the Fed Funds rate, which drove interest rates higher across the curve and led to record poor performance for fixed income markets.

- The yield curve flattened significantly, then inverted as the front end priced in aggressive action by the Fed, while the long end was weighed down by recessionary fears as the year wore on.

- Volatility levels were on average much higher during the year, but 2022 was characterized by several periods of relative calm and complacency on the part of markets, only for volatility to come roaring back as economic data (typically higher than expected inflation) caused markets to once again reprice expectations.

- Corporate credit spreads started the year at very narrow levels and widened over the course of the year given the ongoing volatility, with meaningful dispersion across sectors, but finished the year tighter than their long-term average, and well below levels that are typically associated with an economic slowdown.

- Agency MBS suffered early in the year on extension risk due to rising rates, elevated interest rate volatility, and fears of outright Fed sales of bonds from their balance sheet, driving spreads to levels not seen since the Great Financial Crisis. The sector recovered somewhat towards the end of the year as the risk factors abated, though spreads remained relatively high.

- Financial conditions tightened dramatically over the course of the year, creating challenges across numerous parts of the economy. The S&P500 was down almost 20% for the year as Fed tightening took a toll. In such an environment, perhaps not surprisingly, Bitcoin, one of the darlings of the media in the previous run-up fell to earth, dropping over 75% from its late-2021 peak, with the price collapse culminating in the bankruptcy of FTX, a large cryptocurrency exchange.

Our View: 2022 was an exceptionally challenging year and further challenges likely lie ahead. However, while 2022 was difficult primarily due to interest rate volatility and its effects, 2023 is likely to be difficult due to the lagged impact of higher rates and inflation. So, while the story of 2022 was higher rates, the story of 2023 is likely to be less about interest rates and more about the impact of wider credit spreads.

4Q 2022: Higher Rates Start to Bite

- While unemployment remains low near 3.7%, there are emerging signs that the labor market is starting to cool, with job openings off their highs, average weekly hours worked declining across most industries, and a spike in job cuts, which has historically preceded increases in the unemployment rate.

- There have been reports of "labor hoarding" by companies, with many unwilling to lay off workers that were and continue to be hard to find after the pandemic. While it's reasonable that companies will try to hang on to workers longer this cycle, a sustained slowdown could lead to a rapid increase in unemployment as the prospect of holding onto underutilized workers becomes more and more untenable.

- Higher rates have also had an impact on the housing market with existing home sales down roughly 35% year-over-year through the end of November. With the slowdown in activity, home prices have started to ease as well, though based on Case Shiller home price estimates, they remain well above year-ago levels.

- Consumer spending has held up well through the end of 2022, although survey data of consumer confidence remains weak. High inflation likely plays a role in this as real spending (adjusted for inflation) has fallen, and consumers in the weakest cohorts have largely eaten through all of their COVID-era excess savings. Consistent with this theme, credit card balances are on the rise, suggesting additional challenges for the most vulnerable consumers.

Our View: The effects of higher rates and tighter financial conditions will continue to be felt into 2023, with a recession the most likely outcome. However, unlike the last two recessions, this one won't be caused by a crisis (subprime meltdown or pandemic) but rather by the Fed, which suggests this version may look different than what we have seen in the recent past. In particular, we expect this recession to be shallower with unemployment in the 5% to 6% range and growth in the -2% to 0% range, though potentially somewhat longer as the Fed may be reluctant to cut rates and bolster the economy as long as inflation remains above target.

4Q 2022: The Fed Keeps the Pressure On

- After 4 consecutive 75 basis point (bp) increases followed by an additional 50 bp bump in December, the Fed Funds rate stood at 4.5% at the end of the year, with another approximately 50 bps of increases expected early in 2023. Markets expect short rates to peak around 5%, which is largely consistent, though somewhat lower than the official expectations ("blue dots") released by the Fed after their December meeting.

- Where Fed expectations diverge from those of the market is in the path of rates following the peak: while the Fed predicts rates to stay above 5% for all of 2023 with cuts occurring some time in 2024, markets expect those cuts to occur much sooner – before the end of 2023.

- Along those same lines, based on inflation breakeven rates from the TIPS market which are generally between 2.25% and 2.40% from two years out to thirty years, markets expect inflation to come down fairly quickly and remain low into the future. Clearly, the Fed has maintained the market's confidence in its ability to manage inflation, with expectations the Fed will have to reverse course quickly after overtightening.

- The path of inflation remains the largest unknown facing markets. While several indicators suggest that peak inflation has passed, labor markets remain tight, and as long as that is true, realized inflation and fears of future inflation are likely to remain elevated. However, it is difficult to generate meaningful inflation through a slowdown, particularly with rents and home prices falling significantly.

Our View: The U.S. has likely passed peak inflation, though of course, risks remain. Even so, given the probability of a recession, we expect that inflation will continue to decelerate. As markets begin to price that outcome into expectations, we anticipate that the yield curve will steepen significantly, with the two year rate dropping quickly to reflect an easing Fed. Longer term rates should also fall, but to a lesser extent given what will likely be modestly higher overall inflation for the next 10 years, relative to the previous 10 years due to fundamental changes in the economy like higher inventory levels, on-shoring, and de-globalization.

4Q 2022: Global Markets Face Similar Challenges

- With the notable exceptions of Japan and China among major economies, central banks acted to bring down inflation around the world, with rate hikes from the ECB, BoE, RBA, BoC, among many others.

- European economies have had even more extreme price pressures than the U.S., exacerbated by extremely high energy prices given the reduction in supply of natural gas from Russia. Not only does this create additional inflationary pressure, but the limitations on energy and the uncertainty created by the conflict in Ukraine act as a drag on manufacturing and GDP, and encourages more debt issuance to fund relief programs for citizens and businesses.

- The Bank of Japan reiterated its commitment to easy monetary policy, but widened the allowable trading range of the 10 year government bond to +0.5%, double where it was previously. The higher yields make investing in overseas, i.e. non-Yen denominated bonds less attractive for Japanese investors, particularly considering the high currency hedging costs (USD to JPY) currently.

- As the Fed neared the anticipated end of its hiking cycle, and with Japanese investors likely moving to the sidelines, and the ECB still facing higher inflation, the USD weakened into the end of the year, though remains significantly stronger over the full year. Indeed, only a handful of the so-called expanded majors – Russia, Brazil, Mexico, and Peru – appreciated versus the dollar in 2022.

- China is also dealing with multiple difficulties as well. Home sales plunged as investors lost confidence in the property markets and developers, throwing into disarray the primary driver of wealth creation for citizens and the funding mechanism for local governments. Efforts to revive the industry have fallen short so far, though the government has committed to additional support next year.
  That support will come in an environment of great uncertainty as the reversal in China's longstanding COVID zero policy makes it difficult to predict outcomes in the near-term.

Our View: There are no obvious engines of growth around the world in 2023, making recessions that much more likely. Further, with geopolitical risks seemingly higher now than they have been for a while, additional risks to the downside loom. With the U.S. likely to post growth numbers that are weak, but still better than most of the rest of the world, the dollar should remain reasonably well supported going forward. Additionally, the uncertainty in the macro outlook makes most of the emerging markets a challenging allocation, despite nominally attractive spreads, but like high yield, there is the expectation there will be better opportunities in the year ahead.

4Q 2022: Credit Markets Not Priced for Recession

- Credit markets lagged in 2022 as spreads widened in both the investment grade and high yield markets. Even so, markets rallied into year end as a lack of liquidity, little supply, and investors optimistic that the Fed was nearing the end of its hiking cycle pushed prices higher.

- Investment grade spreads around 125 bps are moderately tighter than their long-term averages and substantially narrower than they have been in recessions, suggesting there is room for them to widen further in 2023 if we do see a recession. However, dispersion is relatively high across markets and there are certain sectors, like large banks, that offer spreads significantly wider than long-term averages.

- High yield investors have cautiously embraced a soft-landing scenario, though the comfort seems tenuous as any negative surprise brings punishing price actions, while upside surprises don’t engender similar price increases. Valuations have been further supported by much lower issuance, with total issuance this year almost 80% lower than last year.

- On the flip side, the bank loan market has benefited from active CLO issuance, keeping demand high and issuance relatively strong. Wider spreads on CLO tranches could put pressure on the arbitrage for issuers, leading to less demand for loans next year, which, when combined with the abundance of lower quality, covenant light issuance this year and a potential economic slowdown, could create additional challenges in the loan market.

Our View: No part of the credit market is priced for what we believe to be a likely recession. As such, we continue to be fairly cautious in our credit allocations, emphasizing those sectors and issues that we believe will be more resilient through difficult times, with the expectation that as the recession unfolds, we will migrate from those higher quality issues to those that offer higher beta, more spread, and higher risk at much more attractive entry points.

4Q 2022: Residential MBS Offers Compelling Value

- Both agency and non-agency residential MBS underperformed in 2022, with spreads widening substantially in both sectors. Unlike the corporate credit market, agency MBS spreads reached levels similar to where they were in 2008, while non-agency spreads reflect far more dire economic conditions than are indicated by credit markets.

- After a remarkable streak of home price increases, valuations appeared to peak in the middle of 2022 before heading lower in the last part of the year. With affordability at historic lows due to both high mortgage rates and higher home prices, further declines in home prices are likely in 2023.

- Despite lower prices, given the quality of underwriting over the last several years and the requirement for reasonable down payments, loan to value (LTV) ratios have been improving and even a 10% decline in home prices wouldn't result in negative equity for the vast majority of borrowers, even those who purchased a home since the pandemic.

- Despite the overall sound fundamentals, non-agency mortgage issues saw spreads widen substantially in 2022 as liquidity needs, higher rates, and overall financial market stress weighed on sentiment. This was a change from previous bouts of volatility that have occurred since the financial crisis, during which non-agency spreads tended to be far more stable.

Our View: Unlike credit markets, both agency and non-agency MBS markets are priced much more in line with a higher likelihood of economic recession, and both represent attractive value at this point. That being said, there is likely to be ongoing stress in the non-agency market, particularly if growth slows and unemployment rises. We have been judicious in our additions in these sectors, and similar to credit will look to reduce our higher quality holdings and use those proceeds to migrate down the quality spectrum as valuations improve.

4Q 2022: Other Structured Products Highlight Risks

- The work from home dynamic has added an additional complication to the already established stress in brick and mortar retailers, which has translated to gradually weakening performance in commercial real estate and an increasing percentage of CMBS collateral loans being placed in special servicing.

- In particular, Tier 2 and Tier 3 office space has been under increasing pressure as escalating vacancies have encouraged tenants to move to newer buildings with more amenities, better environmental certifications, and more attractive locations. As more employers re-evaluate their office footprint needs in the wake of the shift to work from home, this is a trend that is expected to continue, especially in a recessionary environment.

- On the ABS front, early signs of stress are also starting to appear, with loss rates in unsecured consumer loans well above those seen pre-pandemic, and delinquency rates in those sectors more exposed to the highest risk borrowers moving higher as well. While consumer balance sheets overall remain fairly healthy, consumer debt has continued to rise, reducing flexibility as we are likely entering a recession.

- The student loan forgiveness program announced earlier this year has hit several snags on the road to implementation, chief among them the indication that FFELP student loans wouldn't be eligible for the forgiveness. The entire program is held up in the courts and details remain fuzzy, but any program at all would likely be at least a small positive for the student loan market as borrowers try to refinance their FFELP loans into loans that may be eligible for forgiveness down the road.

Our View: The CMBS market is likely to experience stress in 2023 as rising delinquencies ultimately filter through to restructuring, defaults, and losses. Given that likelihood, our holdings remain focused on high quality, single asset single borrower deals where we can target our exposures to those high quality buildings that are better positioned to weather the storm. Like other sectors, our ABS exposures are higher quality and in those off-the-run sectors that offer more attractive yields than the more traditional credit cards and auto receivables, with the goal to move down the quality spectrum as opportunity unfolds during the year.

4Q 2022 Core and Core Plus Fixed Income Positioning Summary

Risk budgets expanded throughout the year given better valuations. Despite challenging performance, we believe there is significant value in current portfolios and further volatility will allow for even more attractive opportunities. High yields and wide spreads set the stage for strong long-term performance once volatility subsides.

Characteristic	Positioning	Comments
Duration	Ended the year approximately 0.5 years long versus the benchmark	Rates already reflect an aggressive Fed, with the 10-Year yield above our estimate of long-term sustainable levels
Curve	Expectations for a steeper curve	• Overweight to the 2-Year and 5-Year part of the curve given expectations that the Fed will overshoot and have to ease to support the economy
Governments	Underweight, with an emphasis on on-the-run securities	• On-the-run Treasury securities provide much greater liquidity • Maintained a small position in long TIPS
MBS	• Agency MBS – overweight • Non-Agency MBS – increased allocation, with bias to add further	• Preference for agency MBS given attractive spread levels, with an emphasis on highly liquid TBAs • Maintain emphasis on high quality legacy non-agency MBS bonds • Look to add exposure in newer issues including RPLs, NPL, prime jumbo, and CRT, especially those with embedded home price appreciation
ABS	Small Overweight	• Prefer AAA and AA rated CLOs given better liquidity, robust structures, and attractive spreads • Maintain modest position in senior and subordinate FFELP student loan ABS
CMBS	Neutral	Emphasis on super senior single asset single borrower non-agency CMBS holdings, while continuing to look for opportunities down the capital structure
Investment Grade Credit	Small Overweight	• Look to take advantage of volatility and add on weakness and trim into strength • Positioning remains concentrated in high conviction names, intermediate banks, and defensive sectors like communications and non-cyclicals, particularly healthcare • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Small allocation – bias to add	Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation – bias to add	Slowing growth and a tightening Fed has historically been a difficult environment for EM issuers

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