2Q 2023: Economic Data Showed Signs of Softening

- After rates rose more than 5% from the lows in 2021, economic data finally weakened in the 2nd quarter with manufacturing PMIs well below 50 around the world, signaling a contraction in activity during the period.

- Similarly, the labor market in the US finally started to indicate a degree of slowing, with the unemployment rate hitting 3.7% in May, still low by historical standards but up 0.3% from the lows early in the year. Even though unemployment moved higher, job creation has been robust, with an average of over 300,000 new non-farm jobs created every month this year.

- Anecdotally, we have heard that companies are reluctant to cut headcount given the significant challenges they had replacing laid off workers after the pandemic lockdown eased. This could explain why there hasn't been a larger move in the unemployment rate to date, but may mean there will be a catch up effect with unemployment rising more quickly if it becomes clear a recession is underway.

- Like the labor market, the housing market has also been surprisingly resilient thus far, with home prices as measured by the Case-Shiller US National Home Price Index only down about 1.7% year-over-year through April, with the index recovering this year after a trough at the end of 2022. Though affordability is difficult with higher interest rates, demand remains strong, new home supply low, and existing housing turnover is low as current borrowers with low mortgage rates are locked in to their current homes.

Our View: The lagged impact of Fed action and tighter lending standards as a result of the recent banking crisis make an economic hard landing far more likely. We would typically expect a 4-6 quarter lag from the onset of tightening to the realization in the data, though that timeline may be extended due to COVID disruptions. Economic data has begun to slow, consistent with our outlook, but unemployment is key. We'll need to see a significant move higher in unemployment before the softening turns into a recession.

2Q 2023: Inflation Remains Elevated Around the World

- Though generally off the recent peaks, inflation numbers remain higher than desired in most parts of the world, particularly in the UK with core inflation still rising and headline inflation running at almost 9% year over year (though down from 10% in March). The US has also seen price levels drop, but relevant measures of inflation including headline CPI, core CPI, and the Fed's preferred Core PCE, are still over two times the Fed's targeted 2% level.

- Central banks around the world have been forced to respond to stubbornly high inflation with higher rates. The Bank of England has been talking tough, raising rates 75 bps in the 2nd quarter, with additional hikes expected. Similarly, the Fed and ECB raised rates in May and June respectively, with markets currently expecting at least one more hike from each this year. The two significant outliers on the central bank side are the Bank of Japan and People's Bank of China, both of which continue to provide support for markets in efforts to stimulate economies growing below their potential.

- With additional hikes priced into markets short rates have moved dramatically higher while longer rates have been slower to move. As a result, yield curves generally are inverted, with the difference between the 10-year and 2-year Treasury yields in the US at near record levels of almost -110 bps.

- Despite expectations for additional hikes in the 3rd quarter by the Fed, markets continue to expect modest rate cuts early next year, which have been steadily pushed back from later this year. These rate cuts are currently anticipated to happen very gradually, with a 25 bp reduction roughly every other meeting. Such a pattern would be inconsistent with prior experience, as historically, the Fed tends to cut faster than they hike, with both larger and more frequent moves than is currently priced into markets.

Our View: An inverted yield curve is still the single best predictor of recessions in the US. The higher cost of financing strangles economic activity and punishes levered trades, increasing the risk of another financial market accident (after the UK LDI and US regional bank crises). While we expect the Fed will keep rates as high as it can for as long as it can, once it becomes clear there is a recession at hand, it is likely to cut much more aggressively than is currently priced into markets, an event which could take several quarters to materialize.

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2Q 2023: Residential and Commercial Mortgage Demand Diverges

- Agency MBS struggled early in the quarter as the sector suffered from high Treasury market volatility and a glut of supply given the liquidation of Silicon Valley Bank's and Signature Bank's mortgage portfolios. Ultimately, sales were absorbed by the market relatively easily, and prices recovered somewhat, though yield spreads remain significantly wider than historical levels.

- Non-agency MBS saw spreads continue to narrow during the quarter as markets began to price in more optimistic scenarios, especially regarding the trajectory of home prices. Residential MBS generally has been supported by surprisingly resilient home prices, which have, in turn, been supported by consistent demand, despite higher mortgage rates and tighter lending standards. That consistent demand stems from three years between 2019 and 2021 where household formation was almost twice the level of housing completions, leading to a meaningful imbalance between the need for housing and its availability.

- Unlike residential MBS (RMBS), which benefits from significant demand, commercial properties, and office space in particular, has seen rising vacancy levels as the work from home dynamic becomes more entrenched. Reduced occupancy coupled with higher interest rates has seen building valuations plummet, with the biggest declines as high as 75% and typical declines of lower tier office buildings of around 40-50%.

- Commercial MBS (CMBS) investors have grown increasingly wary about potential risks with the market bifurcating into the "haves" and "have nots". The "haves" include deals with little to no office risk, or exposure to only the highest quality office properties, which are expected to hold up well through potential volatility, and have generally seen prices rise and spreads tighten. The "have nots" are those deals with higher office exposure generally, lower quality properties, or those with weaker structures or underwriting at issuance, and they have consistently underperformed in the current environment.

Our View: RMBS, both agency and non-agency, remain attractive in our view. Agency MBS looks particularly strong relative to corporate credit with wider spreads, better liquidity, and limited credit risk. Both agency and non-agency MBS prices assume very low prepayment rates perpetually, but at some point, those will pick up, providing attractive upside optionality for both sectors. On the other hand, CMBS represents a growing risk in the market. We anticipate years of negative headlines, defaults, and ensuing adjustments in the sector with abundant opportunities in the future. However, our preference is to be patient as there is always the potential for substantial volatility, especially if forced sellers emerge requiring a wholesale repricing of the market.

2Q 2023: Credit Markets Not Priced for Recession

- UBS formally acquired Credit Suisse in early June, seemingly marking an end to the banking turmoil that engulfed the world briefly in March. With markets quickly moving past the crisis and supported by still low unemployment, stronger than expected consumer data and expectations for a less aggressive Fed, investment grade credit spreads tightened in the 2nd quarter, as investors appeared comfortable with relatively low spreads given higher absolute yields.

- Despite easing fears about the banking system more broadly, spreads for large banks are still wider than overall credit markets. Nevertheless, the 2023 US Bank Fed Stress Tests underscored the health of the largest US banks. All banks passed, maintaining common equity tier 1 (CET1) ratios of at least 10.1% through onerous scenarios that include a spike in unemployment to 10%, GDP down 8.75%, a 45% drop in equities, and a 40% decline in commercial real estate.

- High yield credit, like investment grade, also saw spreads tighten during the quarter, ending inside of 400 bps as increasing investor complacency and ongoing demand for yield permitted more new issuance from a wider variety of businesses, with worse terms for investors. At the same time, default activity has picked up modestly this year from a low base, with default rates hitting a two year high in June.

- On the loan side, there has been a steady increase in the percentage of the universe that carries a CCC rating, now reaching almost 7%. Default probability picks up meaningfully as ratings decline, and while loan default rates remain relatively low by historical standards, they have increased and are expected to pick up further as high inflation and higher interest rates continue to pressure the floating rate asset class. Making those potential defaults even more challenging is dramatically lower loan recovery rates in recent years, with current levels around 30%, well below the 60-70% rates typically expected.

Our View: Credit markets generally are not priced for recession, with spreads too tight given the likelihood of an economic hard landing. While there are pockets of opportunity in certain sectors like money center banks, we are generally cautious, emphasizing more defensive sectors like communications, healthcare, and consumer non-cyclical sectors such as pharmaceuticals and food and beverage. Within high yield and loans, allocations remain modestly sized and similarly cautious, with a preference for higher quality, lower beta exposures and an expectation that those allocations will be ramped up significantly once market prices reflect the risk in the outlook.

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2Q 2023 Core and Core Plus Fixed Income Positioning Summary

We remain somewhat cautious overall given the likelihood of recession and the potential for additional volatility. However, we remain diligent in applying our disciplined process of using that volatility to add risk to the portfolio at more attractive levels to maximize long-term performance.

Characteristic	**Positioning**	**Comments**
Duration	Ended the quarter approximately 0.75 years long versus the benchmark	Rates do not reflect the likelihood of a hard landing, though they may stay high for a few more quarters
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 aggressively to support the economy
Governments	Underweight, with an emphasis on on-the-run securities	• On-the-run Treasury securities provide much greater liquidity • Modest position in TIPS given attractive breakeven inflation levels
MBS	• Agency MBS – overweight • Non-Agency MBS – increased allocation, with bias to add further	• Preference for agency MBS TBAs given attractive spread levels and strong liquidity • Maintain emphasis on high quality legacy non-agency MBS bonds • Look to add exposure in newer issues including securities backed by re-performing and liquidating loans, prime jumbo collateral, and credit risk transfer (CRT) deals, 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	• Cautious overall with an emphasis on super senior single asset single borrower non-agency CMBS holdings • Look to trim positions with potential for credit deterioration as markets weaken
Investment Grade Credit	Small Underweight	• Look to take advantage of volatility and add on weakness and trim into strength • Positioning remains concentrated in high conviction names, money center 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	Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation	Slowing growth and a tightening Fed has historically been a difficult environment for EM issuers

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All information is as of the date of this presentation unless otherwise indicated.

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