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Webcast Summary

4Q22 Market & Strategy Update

Financial markets in 2022 have seen extreme difficulties, exacerbated by persistently elevated inflation, global central bank policy-tightening and the war in Europe, among other factors. The extraordinary monetary and fiscal stimulus deployed to fight the Covid pandemic has been largely withdrawn. Reopening demand exceeded supply, which was further constrained by supply-chain bottlenecks. As a result, we've seen a significant downshift in global growth. While this slowing of growth should help reduce global inflationary pressures, key risks of central bank overtightening and geopolitical uncertainty remain at the forefront. We believe spread sector valuations are now extremely attractive, but the outlook is clouded by macro risk, so selectivity continues to be paramount.

Market Review

- In the US, the last few Consumer Price Index (CPI) prints have been disappointingly high and likely helped to postpone when the Federal Reserve (Fed) might be able to pause its rate hikes.
- US housing turned down sharply. The owners' equivalent rent component of the CPI index represents almost 40% of the total and has remained very elevated, even though prices are heading downward.
- Regarding supply chains, port backlogs have dropped sharply. Shipping costs are coming down significantly and manufacturing bottlenecks have eased.
- The US services sector has begun to come down from very high levels.
- US job growth is slowing and wage growth is decelerating.
- The US dollar in real terms is at almost a 40-year high—an important distinction when comparing the situation facing Jerome Powell today versus Paul Volcker in the 1970s.
- Global growth has downshifted, which should help reduce global inflationary pressures.
- The European Central Bank is facing the challenge of whether to tighten to fight inflation or hold off due to the weaker growth rate. This is exacerbated by the need for energy across Europe, and the possibility that supplies could be cut off by Russia due to the Russia-Ukraine war.
- Europe's rebound has been slowed by higher inflation and energy security risks—with weaker consumer demand and business uncertainty hampering investment, but jobs remain resilient for now.

Inflation

- While elevated inflation both globally and within the US remains, we believe that lagging indicators are making inflation appear worse than it actually is—as the forward-looking inflation indicators have made meaningful progress.

- The Fed has stated that its goal is to find a restrictive level for rates which it can hold (pausing future hikes), to allow inflation to work its way down and out of the system.
- We think the Fed's 2% inflation target is attainable over time and its expectations for 4% inflation this year, 3% in 2023 and down to 2% in 2024 is not overly heroic.
- Lower inflation is positive for all investment assets. We want lower inflation to be accompanied by a moderation in growth, which is declining from high levels. But the key is that the policy response has to be calibrated appropriately to allow that to happen over time in an organic fashion.

US Economic Outlook

- We expect the Fed to pause its rate hikes in 1Q23, but Fed overtightening remains a meaningful risk. An important factor for the Fed to pause is a weakening in the labor market. While still growing, the trend in the labor market is moving downward, with job openings falling and labor supply returning.
- We see encouraging signs for supply chains as port backlogs have dropped sharply. Shipping costs are coming down significantly and manufacturing bottlenecks have eased.
- The housing market is turning around from a period of excessive activity, due in part to a sharp increase in mortgage rates; prices have started to decline. We expect the impact of Fed actions on housing to be fairly straightforward.

Global Economic Outlook

- Global fiscal stimulus is set to turn to global fiscal drag as the challenges of global slack and debt burdens will constrict future growth.
- China's priority is to stabilize growth, but the depressed property sector will continue to serve as a drag. We believe drastic property easing measures are unlikely. New leadership appointees that will be made at the 20th Party Congress in October 2022 will shed light on a new long-term socioeconomic vision.

Investment Themes

- **Spread sectors:** Spread sectors are extremely attractive, but the outlook is clouded by macro risk. However, the possibility of much weaker growth is already priced into valuations.
- **Investment-grade:** The combination of higher rates, wider spreads and de minimis defaults makes a good case for owning investment-grade credit, even despite the macro concerns. Actual fundamentals at the corporate level are still very good given issuers' conservative approach to balance sheet management.
- **High-yield:** The quality of the high-yield market is the best it's been in decades. Fallen angels downgraded from investment-grade during Covid put a tremendous amount of BBs in the high-yield index. However, we continue to be extremely selective, choosing issues name by name. We also continue to favor investment-grade energy.
- **Bank loans:** We continue to see strong demand, given the floating-rate structure of bank loans, as central banks are raising their short rates. As a result, we believe valuations are more compelling.
- **Structured product:** Agency mortgage spreads widened significantly in the first half of the year as the Fed support diminished, and valuations are continuing to improve. With prepayment risk down as rates have gone up, we're less negative on this sector than we have been all year.
- **Emerging market (EM) debt:** The global growth environment for EM has been extremely difficult. But, EM central banks generally are much further along in their monetary tightening cycles than developed market (DM) central banks.

Q&A Highlights

- The key to getting inflation down is to get momentum on the downside. Then markets can start to believe that the policy rates in place are going to stay in existence for a period of time. And that should cause market volatility to be spectacularly diminished.
- While an inverted yield curve historically has been a very good predictor of weaker growth and indeed recession, we think the primary risk that could drive us into recession is if the Fed overtightens policy. We believe the long end of the yield curve is holding up much better because of the outlook for lower inflation down the road.
- Lower global growth rates are actually part and parcel of getting global inflation rates down. Policy response needs to be thoughtful in terms of pausing as that slower growth rate develops.
- The US dollar has shown extreme resilience during the Fed's tightening campaign, but its strength may soften if and when the Fed signals a pause to rate hikes.