OUTLOOK ON

USA

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Outlook on the

United States

APR 2023

Summary

- Our equity team believes small and regional banks could continue to struggle in 2023 as inflation remains too high and deposit insurance rules remain ambiguous.
- Higher rates for longer remain our base case, particularly if inflation persists—but we believe regulators have the tools they need to safeguard the financial system against further financial stress.
- The debt ceiling represents one of our greatest concerns for the US and the global economy in 2023. This is a politically contentious issue that we will be watching closely throughout Q2.
- Our debt team continues to wave a red flag over the fixed income market's structural challenges. The team is also monitoring commercial real estate debt closely in Q2 as a potential source of stress.

Equity

Bank failures were the dominant story of the first quarter. Silicon Valley Bank (SVB), a regional bank known for catering to the venture capital and the tech world, saw US$42 billion of deposit outflow on 9 March, and US$100 billion was set to head out the next day. The frantic weekend that ensued upended US monetary and financial stability policy; it caused markets to reprice the terminal interest rate and price in rate cuts this year and renewed concerns about a financial crisis in both the United States and Europe, given the subsequent collapse of Swiss bank Credit Suisse and its acquisition by UBS.

Optimists will point to these institutions as being idiosyncratic in both the composition of their depositors and their risk management. In other words, the problems were unique to these banks rather than systemic.

It was clearly too much to expect that a historic hiking cycle, in which the Federal Reserve raised interest rates by 475 basis points (bps) over a period of 12 months, could occur without something breaking.

Yet following the collapse of SVB came two other regional bank failures—those of Signature Bank and Silvergate Bank—in rapid succession, raising the specter of a broader contagion. But despite major outflows from small and regional banks into large banks, and spiking borrowing from the Fed's discount window, financial panic in response to these events has been relatively muted. Still, it is important to be humble: "Idiosyncratic" should not become the next "transitory," language used to minimize serious structural problems by writing them off as quirks. Small and regional banks in the United States may continue to struggle as inflation remains too high and deposit insurance rules remain ambiguous. Even as markets believe the Fed is coming to the end of its hiking cycle, real interest rates will continue to tighten as inflation falls. Stress in the financial sector is not finished.

Against the fissures in the financial sector, persistent inflation, and a strong labor market, we review some of the key trends to watch for in Q2 2023 and beyond. With another two Federal Open Market Committee (FOMC) meetings to come in this next quarter, understanding the implications for the Fed and the economy is critical. While we may narrowly avoid a recession this year, we believe there are still far more downside than upside risks.

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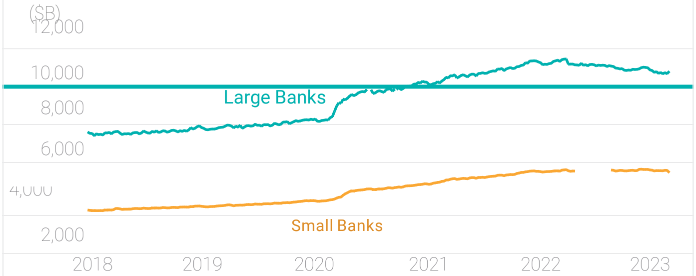
The Aftermath of SVB

It is too early to claim that concerns over financial stability are in the rear view mirror. In the week following the collapse of SVB, large banks saw inflows of US$120 billion, small banks saw outflows of US$107 billion, and money market fund assets, which are not insured by the Federal Deposit Insurance Corporation (FDIC), increased by US$238 billion as fears of financial instability pushed investors to move money into what they perceived as safer assets (Exhibit 1). At the heart of this fear is a straightforward question: Are deposits safe? The answer is complicated and ambiguous. Given the actions of the FDIC, the US Treasury, and the Fed, we believe that legislative action is required to end this uncertainty. That said, it seems as though the FDIC has, by stepping in to protect SVB depositors, made a similar implicit guarantee to most (if not all) depositors.

Exhibit 1
US Bank Fears Led to ~US$120 Billion of Deposit Inflows to Large Banks in One Week

Deposits of Largest 25 Domestically Chartered Banks, and Deposits of Domestically Charted Banks Ranked below Top 25 on Deposit Balances



As of 15 March 2023
Source: Bloomberg, Federal Reserve

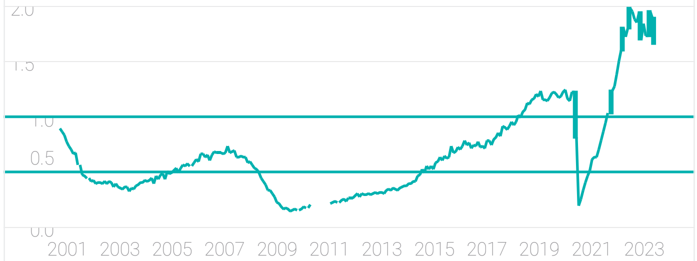
Fears of a 2008-style financial crisis are overblown, in our view. Systemic vulnerabilities were ameliorated, though not eliminated, by the Dodd-Frank Act and other reforms put in place after the Global Financial Crisis. The most stringent requirements to come out of Dodd-Frank did not apply to SVB and most other small and regional banks, which is why their stability has always been cause for concern. Regulatory procedures and processes will need to be revisited and refined given banking supervisory failures. Further bank stress is plausible as rates continue to tighten, but at least for now, we are cautiously optimistic that banking failures can be limited. Ongoing declines in credit and lending seem likely to continue into Q2, but that is by design: It is the explicit objective of rate hikes to slow the economy down during periods of high inflation. The question is whether the Fed will blink if its financial stability obligations conflict with its objectives to keep inflation under control.

Inflation and the Real Economy

As the financial sector stepped into the foreground, the background of the real economy, especially the labor market, exhibited significant strength. Abumper January for jobs growth added over 500,000 jobs; 2022 saw an average of 380,000 jobs added per month, and so far in 2023, the average is 404,000 jobs. In other words, far from a slowing economy. The result is twofold: First, a workforce that has more power than in the recent past, with approximately 1.67 jobs per unemployed

Exhibit 2
Workers Theoretically Have Leverage, with 1.67 Open Jobs per Unemployed Person...

US Unfilled Jobs per Unemployed Person

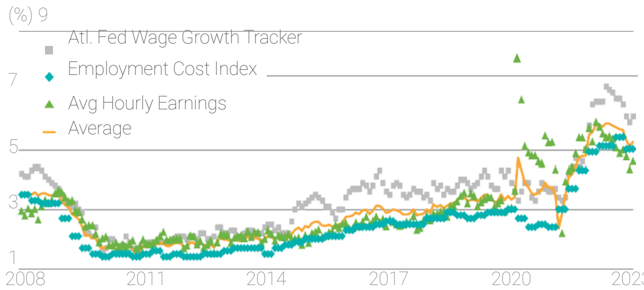


As of February 2023
Source: Haver Analytics, US Bureau of Labor Statistics

Exhibit 3
...But Wage Growth Appears to Be Decelerating

Average of Three Common Wage Growth Series

YoY, Change



As of February 2023 using Q4 2022 Employment Cost Index (ECI) value. The ECI rep-resents Wages & Salaries of Civilian Workers excluding Incentive Paid Occupations for average wage chart.
Source: Haver Analytics, US Bureau of Labor Statistics

person—high by historical standards but gradually softening (Exhibit 2). Second, growing fears that without a meaningful uptick in unemployment, inflation cannot be brought under control. The FOMC's own Summary of Economy Projections has unemployment rising by close to a percentage point in 2023 and Gross Domestic Product (GDP) growth close to 0%—nearly predicting, in other words, a mild recession.

The links between wages and employment are critical to this relationship. Yet there are signs that wage growth may be moderating even as it remains at high rates of growth historically, and as employment shows no signs of reversing (Exhibit 3).

Some rough contours of 2023 do seem more apparent now: Growth is likely to be muted both in the United States and globally, with a few exceptions. The labor market remains strong, demand and disposable income continues to grow, and inflation is far higher than the Fed can tolerate. We remain convinced that if a recession does occur this year, it will be mild. The difference between a mild recession and muted growth is more a difference of degree than in kind.

The looming shadow of inflation continues to afflict the American economy as demand has remained resilient even as rates have risen, pushing prices higher. While headline inflation, including food and energy, has decreased as energy prices have stabilized, core inflation is persistent, and declining rates of inflation growth toward the end of 2022 have paused or even reversed in some instances. The three drivers of core inflation that policymakers consider—shelter, core services excluding shelter, and core goods—are showing divergent trajectories (Exhibit 4).

Core goods prices still have some way to fall from the highs of 2021 and 2022, when inflation was driven largely by used car prices. Yet we are concerned that the declines from these high levels will be less significant than anticipated: The Manheim Index, a measure of used car prices, has increased every month since November 2022, adding to core goods prices. Persistent core goods inflation would cause concerns that even greater monetary tightening is needed.

There are good reasons to be optimistic about the pathway of shelter inflation. Private indices, such as from Zillow, and measures published by the Cleveland Federal Reserve, suggest that shelter inflation is already easing. Such data has typically lagged official data by around six months—but in the interim, it is plausible that continual shelter inflation causes stickiness in overall inflation data. In other words, this consistent shelter inflation may make rising prices harder to tame.

Core services excluding shelter remain the biggest concern. This bucket is a large, diverse one that is more linked to wage increases than other categories. Lengthy delays in appointments at the dentist or the doctor are commonplace as demand outstrips supply of these services, and this leads to persistent inflation. If wages continue to moderate, growth in prices for this category will too, but this will take longer than many hoped toward the end of 2022.

Headline inflation has moderated significantly since summer 2022, when inflation broke 9% year on year, and is now 6%. The decline in core Consumer Price Index (CPI) is far slower though, falling from 6.6% in September 2022 to 5.5% now. While the Fed is primarily concerned with core Personal Consumption Expenditure (PCE), which did moderate somewhat in March 2023, both PCE and CPI indicate ongoing persistence. Banking stress, signs of a slowly softening labor market, and gradually-moderating inflation means the case for a Fed pause is strengthening, but there is considerable uncertainty given high inflation.

Separation Principles and the Debt Ceiling

The Fed appears to be in another bind as it seeks to balance the goals of maintaining financial stability with controlling inflation. As the financial crisis showed, these objectives can conflict. But the Fed operates with what many term "separation principles," which enables it to pursue both objectives on parallel tracks. For this reason, we think rate cuts being priced in for later this year may be hasty. The cases in which the Fed cuts rates by the projected 50 bps or higher could indicate a much more severe recession than the Fed is projecting, and we broadly concur with this. But with financial stress and the debt ceiling creating major uncertainty, there are more reasons to be concerned than optimistic about Q2 and the rest of the year.

The debt ceiling represents perhaps the single most important and most damaging scenario for the US and the global economy in 2023. Estimates suggest the so-called "X-date," after which the US Treasury will default on some, or all, of its obligations, is between July and September 2023. We expect Q2 to see ugly back-and-forths between Republicans and Democrats, and we hope politicians do not ultimately push brinkmanship to a level that damages the economy by a self-inflicted wound. Any kind of breach of Treasury obligations would be an unprecedented catastrophe. While we hope we are wrong, we anticipate the debt ceiling will not be resolved until the last minute. We are watching these developments closely as Q2 will be pivotal.

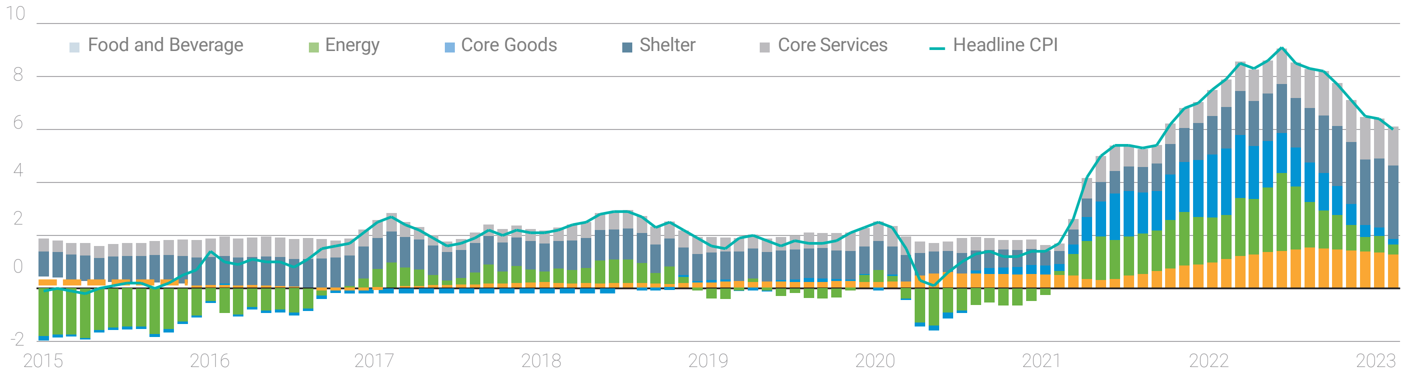
If inflation persists, higher rates for longer remain our base case, and if there is further financial stress, we believe that between the Fed, the Treasury, and the FDIC, the right tools are available to safeguard the financial system. But we accept that this view may be too optimistic. A prolonged ebbing of funds from small and regional banks could create further problems, and higher rates for longer will reveal additional fissures. These problems may take time to materialize, but if Q1 was anything to go by, we think investors should be cautious.

Exhibit 4

Shelter and Other Services Are the Primary Contributors to US Inflation

Headline Inflation by Category

YoY, Change (%)



As of February 2023

Source: Bureau of Labor Statistics, Macrobond

The preceding outlook reflects the views and analysis of Aura's US equity teams. The following outlook reflects the views and analysis of Aura's US fixed income team.

Debt

The first quarter of 2023 ended with a chain of events more dramatic than we have seen since 2008. In the first full week of March alone, a rapid acceleration of bank failures wiped out any sense of certainty surrounding the path of Fed rate hikes. On Tuesday, Federal Reserve Chair Jerome Powell reiterated to the Senate Banking Committee that the Fed may need to raise interest rates higher and faster than had been expected to tame inflation. On Wednesday, he reaffirmed this stance in front of the US House of Representatives Financial Services Committee. On Friday, Silicon Valley Bank (SVB), the nation's 16th largest bank, collapsed—marking the second largest bank failure in US history, surpassed only by the collapse of Washington Mutual in 2008—and the California Department of Financial Protection and Innovation appointed the Federal Deposit Insurance Corporation (FDIC) as Receiver.

The carnage was not over. Less than 48 hours later came the third largest bank failure in US history, as Signature Bank, the nation's 29th largest, was shut down by the New York State Department of Financial Services and placed under FDIC Receivership. The following week, Credit Suisse Group AG, a globally systemic important bank, was absorbed by Swiss rival UBS in a takeover orchestrated by the Swiss government. With these seemingly sudden series of collapses, questions swirled around whether the Fed should continue on with its rate hike regime to tackle inflation.

While the cascade of recent bank failures is indeed concerning, we believe the Fed and US Treasury were able to contain the problems at these particular institutions. Ultimately, we see these recent events as a reflection of poor risk management at individual institutions—not as an indicator of contagion. Thus, in our view, the Fed should not be deterred from their mission of maintaining price stability as inflation is well above the Fed's stated target and the underlying US economy is still firm.

Inflation Remains Elevated, Economy Remains Strong

Inflation is coming down, but remains above the Fed's stated target of 2%. February's Consumer Price Index (CPI) rose 0.4% month over month and 6% year over year, which was in line with market expectations. Importantly, Core CPI, which excludes food and energy prices, increased 0.5% month over month and 5.5% year over year, which were just above and in line with expectations, respectively. Additionally, Sticky Price Core CPI remains elevated at 6.6% year over year (Exhibit 5). This measure is calculated based on prices for specific goods and services within CPI that are considered less susceptible to change—including medical services, rent, public transportation, and motor vehicle fees—and therefore more likely to incorporate future inflation expectations by default. Thus, we were not surprised when the Fed raised the fed funds rate by 25 basis points (bps) to 4.75%–5.00% at its late-March meeting. After Powell's aforementioned testimony in front of Congress, there had been expectations of a 50 bps hike—but the subsequent banking failures had many traders and pundits considering the possibility of no hikes at all. Barring a black swan event or inflation

Exhibit 5

Sticky Price Consumer Price Index less Food and Energy

Seasonally Adjusted

As of 1 February 2023

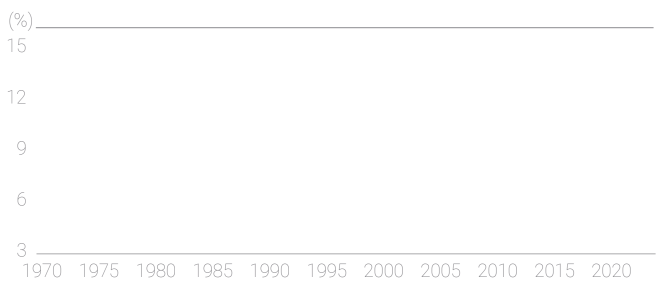
Source: Federal Reserve Bank of St. Louis

decelerating sharply over the next month, we would expect at least one more 25 bps hike to be announced at the Fed's next meeting in early May, followed by a subsequent pause.

The underlying US economy remains strong and continues to show signs of resilience. To begin, the labor market remains tight. The U-3 Unemployment Rate is at or near multidecade lows of 3.6% (Exhibit 6) and total non-farm job openings, reflecting all jobs available but not filled on the last business day of the month, are at or near multidecade highs and above pre-pandemic trends (Exhibit 7). As we noted last quarter, the labor force participation rate continues to trend lower, likely due to accelerated retirements catalyzed by the pandemic and the aging of the baby boomer generation. Unless labor productivity offsets the loss of workers, a shrinking workforce will pose a challenge to the Fed as labor costs will remain stubbornly elevated. Absent a material pick-up in the participation rate or an increase in productivity, the Fed will likely have to choose between wage price inflation and slower economic growth. Finally, US Nominal Gross Domestic Product (GDP) has recovered and remains above the trendline (Exhibit 8).

Exhibit 6

Monthly Unemployment Rate Near Multi-Decade Lows



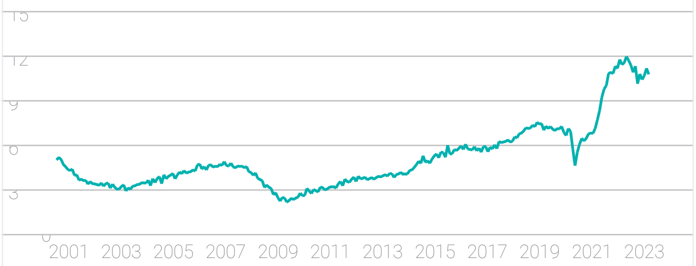
As of 1 February 2023

Source: Federal Reserve

Unless inflation gets to a 2% level and stays there—or unless there is a material break in the economy that becomes systemic and spreads to Main Street—we believe the most likely path for rate hikes is a pause in

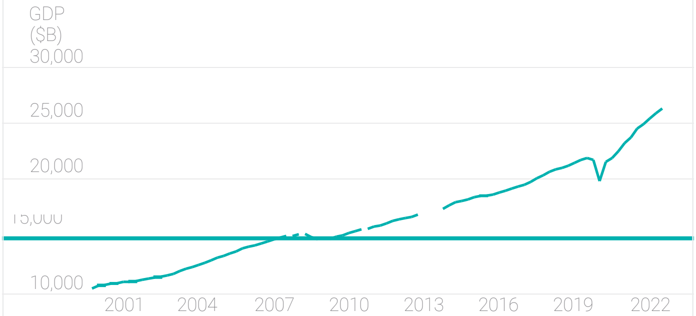
Exhibit 7
Total Non-farm Monthly Job Openings (Seasonally Adjusted)

(Thousands)



As of 1 January 2023
Source: Federal Reserve

Exhibit 8
Quarterly, Seasonally Adjusted Annual Rate



As of 31 December 2022
Source: Federal Reserve

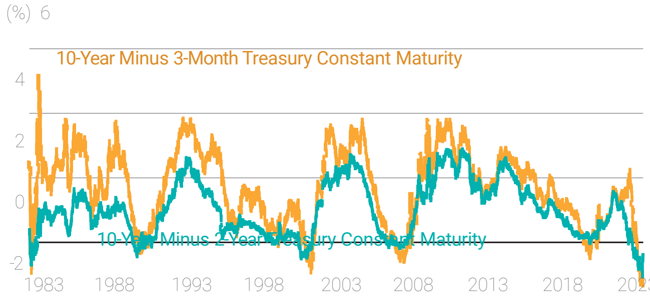
May following the Fed's last meeting before Memorial Day. This means markets may have to brace for higher rates for longer, though the yield curve indicates the Fed could blink and change course.

Markets versus Fed Showdown: What Could Go Wrong?

Indeed, the yield curve remains deeply inverted whether you look at 10-year versus 2-year yields or 10-year versus 3-month yields (Exhibit 9). This inversion has historically indicated that the markets believe the Fed is being too restrictive. Moreover, the 2-year yield precipitously fell to about 3.75% from a nearly 16-year high of 5.08% that was reached right after Powell's hawkish testimony to the House in early March. However, this current yield is more than 100 bps lower than the current fed funds effective rate of 4.83%—and after the banking fiascos of that month, traders are pricing in no further rate hikes, and the Fed may cut as soon as June with a total of 100 bps of cuts through year-end. Clearly, markets and the Fed are not on the same page and risks are still palpable.

The Fed and US Treasury are doing what they can through both policy and rhetoric to instill confidence in the security of the banking system. While we do believe that SVB's collapse was the product of poor risk management of an unhedged, overleveraged asset-liability mismatch, and that Credit Suisse's issues were years in the making, these events

Exhibit 9
Yield Curve Remains Historically Inverted



As of 24 March 2023
Source: Federal Reserve

naturally raise the question: How many other financial institutions out there are subject to similar bank runs? In a speech delivered to the Institute of International Bankers four days before SVB's collapse, FDIC Chair Martin Gruenberg revealed that there are an estimated US$620 billion in unrealized losses at US banks. These potential losses are concentrated largely in US Treasuries and Agency Mortgages that were purchased when rates were lower.

But if these "risk-free" assets need to be moved from Held to Maturity classification, and sold to satisfy withdrawing depositors, a significant if not fatal hole in a bank's equity could occur. Thus, banks with high levels of uninsured deposits, concentrated loan books to vulnerable industries, non-diversified depositor bases, and/or overall poor risk management will be scrutinized—perhaps unfairly in some instances. Markets have a way of testing weak points to inflict the most pain. In an environment where social media can influence public sentiment almost immediately, and where "one-click" banking on apps and websites makes snap decisions easier to make than ever before, self-fulfilling prophecies are more likely to occur. With this reality in mind, we expect Fed Chair Powell, Treasury Secretary Yellen, and other central bankers and governments to be tested even further.

Another area to watch is real estate. This is often the first place where the Fed's interest rate hikes are felt. While credit markets are generally nervous about real estate given the substantial amount of debt utilized in the market, there are important differences between different types of real estate when it comes to health and the ability to value underlying collateral relative to prior financial crises. For residential real estate and residential mortgage-backed securities (RMBS), underwriting standards have vastly improved since the 2008 Global Financial Crisis. Even within commercial mortgage- backed securities (CMBS), spread behavior has been orderly for the most part, so far, with widening in the last few weeks only partially reversing year-to-date gains—albeit amid low liquidity. However, the primary exceptions to this and the principal areas of concern are loans to, and securitized structures backed by, office properties with non-prime tenants and those with weaker credits. For instance, citing data from Trepp, the structured finance and real estate data provider, JP Morgan highlighted that banks, mostly regionals, hold on their

books about US$270 billion or about 60% of the nearly US$450 billion in commercial real estate loans maturing in 2023. Overall, smaller banks —those with less than US$250 billion in assets—hold 80% of commercial real estate mortgages held by all banks, or approximately US$2.3 trillion. Of note, many deals were financed in a 2%–4% interest rate environment; when this debt has to be rolled, the new rates will be 7%–10%, if not higher. Adding insult to injury, the increase in remote work has led to higher vacancies and lower asset values, across commercial office spaces. In February, Columbia Property Trust, an office landlord, defaulted on US$1.7 billion in loans tied to seven buildings across New York, San Francisco, Boston, and Jersey City. According to The Real Deal, a news outlet specializing in real estate financing, this portfolio was appraised at US$2.27 billion as recently as 2021. Columbia is now in discussions to restructure the floating-rate debt with its lenders, which include Goldman Sachs, Deutsche Bank, and Citigroup. Considering that much of the debt in this market is similarly floating, commercial real estate is worth watching as another source of stress on the system that could lead the Fed to quickly reverse course.

So what comes next? As we noted in previous commentaries, the Fed has been moving to get rates back to normal—which is a very healthy development, though markets appear to think the Fed is too tight. Financial markets are now normalizing to the conditions that existed prior to the era of financial engineering and the subsequent Fed repression. In our view, without financial contagion, the market should revert to a state of differentiated outcomes that favors active alpha over passive beta. One of the benefits for investors would be greater dispersion among credits, which can create opportunities for above-market returns. In a higher rate environment, some companies and structures simply fare better and others worse—in other words, there will be losers. By contrast, companies rarely faltered under ultra-accommodative Fed policy, so there was relatively little differentiation among credits in that environment. But beyond the current risks posed by poorly-managed financials—and lower-quality, highly- levered corporate balance sheets—we believe the low liquidity in the over-the-counter (OTC) fixed income markets remains a consistent material risk. In combination with the other aforementioned risks, we expect higher episodic bouts of volatility in the fixed income markets.

Liquidity Concerns

We continue to raise a red flag over the fixed income market's inability to absorb abrupt changes in trading flows. In our view, the OTC fixed income market has been structurally challenged since the implementation of post-Global Financial Crisis banking regulations and warrants extra vigilance as the Fed continues to unwind its extraordinary intervention. Based on our observations, the Fed's tightening cycle has exacerbated the existing liquidity risk in OTC fixed income markets, even including the Treasury bond market. As we noted in our last outlook, dealers continue to be less willing to take on the risk of market-making and inventory; in general, they are reluctant to accumulate inventory on their balance sheets given the combination of increased mark-to-market volatility and the backdrop of persistent regulatory capital constraints. As evidence, we cite the price action over recent weeks as markets digested the daily headlines around banks' health.

Buying and holding Treasury bonds is still easy to do, but with bids and offers on electronic platforms fewer in number or wider apart than normal, trading Treasuries on demand in response to new developments is becoming increasingly difficult, as we learned in March. This has prompted a return to the old-fashioned trading method of getting dealers on the phone and leveraging relationships to execute larger security trades in OTC markets in an orderly manner. To be clear, there is no concern with the demand and supply participation of end-buyers. The liquidity concern centers on traders' ability to trade, not on investors' willingness to invest. Also, because of these liquidity conditions and resulting higher transaction costs, investors are turning to the futures market to trade Treasury exposures, even though many institutional investors are prohibited from utilizing derivatives by their investment policy.

Investment Implications

We still believe that inflation will continue to moderate as base effects and tighter monetary policy take hold. This will continue to have a profound impact on the markets, and with lower liquidity, this may result in intermittent periods of elevated volatility and, by extension, opportunity for active managers. How much further the effects extend will almost certainly depend on the Fed's tightening trajectory, which in our view is at or near its end. Additionally, risks remain as lending standards tighten and rates remain high. Stresses can appear seemingly overnight, and we believe the authorities will continue to have their resolve tested as they try to tame inflation while simultaneously containing any potential systemic issues.

Despite our cautiously optimistic expectations for the US economy, and for credit fundamentals of higher quality issuers and structures, we remain deeply concerned about the potential for market liquidity disruptions. The Fed turned to its balance sheet with such force at the onset of the COVID-19 shutdowns three years ago to backstop the market and alleviate a severe liquidity crisis; without the Fed, the market mechanisms for clearing on-demand transactions simply failed, and this failure has still not been addressed. As we stated last quarter, we believe the market's ability to absorb abrupt changes in investment flows is structurally challenged. The disruptive events of March are a testament to this, as is the state of the Treasury market in recent quarters, as dealers continue to be reluctant to hold sizable inventory—even in the world's benchmark "risk-free" asset.

In our view, as the Fed continues to focus on price stability, it will be ready to change course if the data and circumstances change. Markets, as evidenced by the yield curve, feel they will need to pivot on short notice. Given the backdrop for the prospect of lower growth, risks in the banking system, let alone any "unknown unknowns," we expect continued volatility in markets overall.

The recent issues with SVB and Credit Suisse drive home a point we have been making for the better part of a year: As the global economy adjusts to monetary policy normalization amid an uneven recovery from the pandemic and geopolitical strife, dispersion in outcomes for obligors is likely to increase as the cheap money afforded to them by the capital markets dries up. Legacy business models and industries should be scrutinized for their sustainability going forward, resulting in lower valuations and higher default rates. Thus, we strongly believe that investors need to focus on lending to viable obligors over a long

term, scrutinizing whom they are lending to and under what terms and conditions. The importance of this last part was highlighted by the zeroing-out of the Credit Suisse AT1 bonds. In essence, not all bonds will behave as bonds: You must read the fine print, as yield equals risk, not return. As these times are demonstrating, investors should consider mitigating long-term liquidity risks by focusing on key security investment characteristics that institutional investors have historically relied on to protect portfolios during mark-to-market disruptions. Specifically, we believe investors should focus on securities and obligors with attributes such as:

- serving an essential economic or financial function
- issuing under standardized terms and conditions
- offering in institutional markets and institutional lot sizes
- exhibiting established transition markets that enable transactions after ratings downgrades
- qualifying for inclusion in major market indices

Published on 8 May 2023.

Outlooks provide a forward-looking view, over the short, medium, and/or long term, of asset classes, sectors, regions, or countries from the view of our portfolio managers.