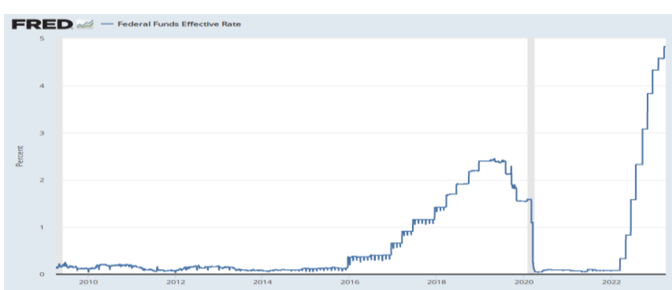
First Quarter 2023

The inflation outlook is critical because it will play a major role in determining monetary policy. Inflation has peaked but it will take a while to achieve the Federal Reserve's 2% policy objective. The gradual decline in inflation, in contrast to a rapid deceleration, is partly attributable to continued strength in the labor market which supports consumer spending (approximately 70% of GDP). For the 12 months through February, the CPI increased 6.0% marking the smallest year-over-year gain since September 2021. For the 12 months the core gained 5.5% which was the smallest advance since December 2021. The core PCE (the Fed's preferred inflation metric) rose 4.6% year-over-year through February, which was less than expectations. There are signs the Fed tightening is working in at least some parts of the economy-housing has slowed, manufacturing is down and prices on several goods have stabilized. Since last March the Fed has raised the benchmark fed funds rate from near zero to a 4.75%-5% range. Fear of contagion from the banking crisis will cause the Fed to slow the pace of rate increases and implement a pause sooner than expected. The Fed wants to see weakness in the labor market as a condition to reaching their 2% goal. While the labor market is still tight there are some preliminary signs of weakness-a higher unemployment rate, a slowdown in wage growth and fewer hours worked. The Fed's tightening will slow aggregate demand which in turn will impact the wage/cost cycle. Productivity enhancements will also help in the inflation battle.

The combination of volatility across asset classes and the fastest increase in interest rates by the Federal Reserve in 40 years has exposed vulnerabilities in the financial system. Silicon Valley Bank, Signature Bank and Silvergate Bank all experienced very large deposit withdrawals in a short period of time, significant realized losses on sales from their investment portfolio to meet withdrawals, not enough shareholders equity to absorb these losses and the lack of effective regulatory oversight. They previously saw rapid deposit growth and invested these funds in longer-term Treasury and agency MBS securities. A large portion of these investments were made prior to the beginning of the Fed's rapid increase in interest rates in March 2022. To garner yield in a low yield environment, the banks extended out on the yield curve. A year later these securities had large unrealized losses that became realized losses as sales had to be made to fund deposit withdrawals.

The Federal Reserve, regulators and bank management all had roles in these failures. The Fed kept rates too low for too long and then increased rates at too fast a pace.



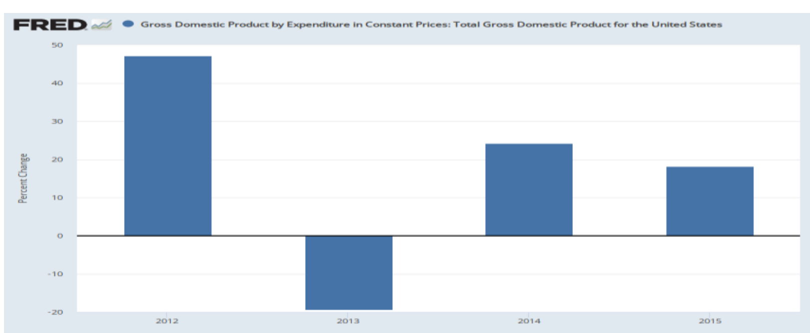
Regulators were lax vis-à-vis the regional banks and did not follow up on their urgent memo recommendations to these banks. Regulators were aware that unrealized losses in the banks' security portfolios could lead to trouble but took little to no action. Senior management at these banks did not react to warnings from regulators. They did not monitor the close inter-correlation of their deposit base and the large contingency of deposits greater than $250,000, especially in the case of Silicon Valley Bank and Signature Bank. Regional banks typically have 'sticky' money, however, this clearly was not the case at Silicon Valley Bank and Signature Bank. To control the contagion from these deposit withdrawals, Federal authorities guaranteed all deposits at these three banks (only a maximum of $250,000 in deposits is normally guaranteed) but creditors and shareholders of these institutions absorbed large losses. The Federal Reserve established an emergency one-year lending window whereby banks can borrow against their U.S. Treasury and Agency MBS securities as collateral. This enables banks to monetize these assets to meet withdrawals without having to sell them and realize large losses.

The Federal authorities are hoping the situation calms down over time. VAAM does not believe the risk has been fully resolved. The government has implied they will guarantee deposits if there is a systemic risk to the system. The problem is this is not a blanket explicit guarantee for all deposits and leaves a large amount of uncertainty. In 2008 when money market funds began to experience large withdrawals that threatened the financial system, the Fed guaranteed all money market funds and this alleviated the threat. Due to the uncertainty, there have been continuing deposit outflows from the regional banks to the large banks, to other regional banks with amounts below the $250,000 insured limit, to U.S. Treasury money market funds and to direct investment in short term U.S. Treasury securities. The larger banks are more insulated from contagion due to a more diversified deposit base, greater regulatory oversight, and a much-improved financial condition vis-à-vis the 2008 crisis (Capital Ratios and Loan to Deposit Ratios are healthy). There will be more regulatory oversight of the industry (particularly regionals) and more conservative lending standards. There should be a requirement to mark these U.S. Treasury and Agency MBS securities to market value rather than categorize them as held-to-maturity which allows them to be carried on the balance sheet at amortized cost. These securities are extremely liquid and have readily verifiable market prices. A mark-to-market approach would give a much more realistic picture of asset value and shareholders equity on the balance sheet (please note that footnotes in a bank balance sheet indicate a mark-to-market approach utilization). Greater regulation and tightened lending standards will be a headwind to economic growth. Recent developments are likely to result in tighter credit conditions for households and businesses and to impact economic activity, hiring and inflation.

The Fed recently raised the funds rate another 0.25% but indicated the pace of increases will slow and a pause is more likely to occur sooner rather than later. Another uncertainty to contend with is the lagged and variable effects of the 9 rate increases in the last 12 months. The effects from tighter credit conditions that will ensue (a slowdown in GDP growth) can be thought of as being the equivalent of a rate hike that helps to attain the inflation objective. The Fed is trying to thread a needle. They will use rate increases to attain their inflation objective and bank supervision and intervention to control any bank related contagion.

The government's **debt ceiling** is a very important issue that has flown under the radar due to the banking crisis news. The government is in danger of breaching the current debt ceiling limit of $31.4 trillion sometime this summer (perhaps as early as June). Raising the debt ceiling requires Congressional approval and in the past legislation has been approved to raise the ceiling. This year the House Republican majority wants significant spending reductions (the current year's budget deficit is estimated at $1.2 trillion) in return for raising the ceiling. The Biden Administration has said they will not reduce spending or negotiate vis-à-vis the ceiling. If no accord is reached, the government will default on its obligations and will be unable to issue debt to fund the current year's deficit. The consequences of a default would be catastrophic- both the U.S. and global financial systems would implode, and economies would fall into a deep recession. However, the U.S. has been here before, 22 times in fact. Each time, the debt ceiling was raised, sometimes at nearly the last possible moment, most notably in 2011. Therefore, there is a high likelihood of an accommodation being reached to avoid default. In 2011, default would have occurred in early August if a deal had not been reached. The stock market sold off in a significant fashion and 10-year Treasury rates topped out near 3.75% in Q1 2011. Rates then plummeted and continued to decline even after a deal was struck.

The crisis can be avoided if Republicans and Democrats reach an agreement. If not, then there are the remedies, like payment prioritization, premium bonds or even a trillion-dollar platinum coin. Even so, investors should prepare for the risk of default. During the 2013 shutdown, Standard & Poor's, the financial ratings agency, stated on October 16th that the shutdown had "to date taken $24 billion out of the economy "and "shaved at least 0.6 percent off annualized fourth quarter 2013 GDP growth.

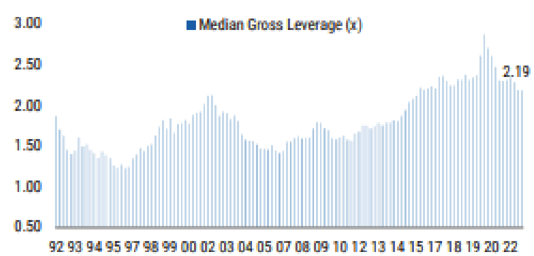


In either case, a large spending reduction or no agreement would be a significant negative to a potentially fragile economy.

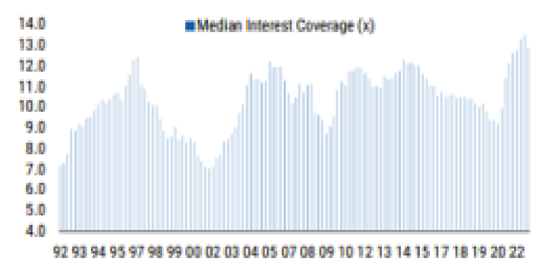
Corporate Credit Summary

Volatility in interest rates hit a high note in the first quarter of 2023. Rates across the curve took large daily swings, peaking in early March at 4.06% on the 10-year treasury, 4.35% on the 5-year treasury, and 5.07% on the 2-year treasury, with the expectation that the Federal Reserve was on course to continue increasing rates “higher for longer”. The banking crisis at Silicon Valley Bank, Credit Suisse and others rattled interest rates and the expectations for future hawkish actions by the Federal Reserve, moving rates lower across the curve, and especially on the 2-year treasury, which is down by well over 100 basis points. Since the yield on the 2-year treasury has decreased by a greater amount than the yield of the 10-year treasury has, the interest rate curve has started to become less inverted and is suggesting that there is a possibility of a gradual economic slowdown/recession soon.

The corporate bond market is also exhibiting signs of a slowdown in growth, which may be attributed to lagging effects resulting from Federal Reserve policy tightening. For example, the charts below show that median gross leverage (total debt divided by earnings), which has been declining each quarter after Covid, has flat-lined, suggesting that earnings growth has started to slow down. At the same time, interest coverage (earnings divided by interest payments) has declined from its peaks, although remains well above pre-Covid levels. This too points to expenses, as measured by interest payments, growing relative to earnings.



Source: Morgan Stanley Research, Bloomberg

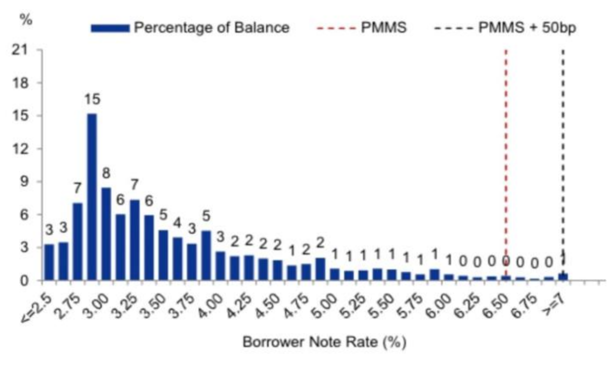


Source: Morgan Stanley Research, Bloomberg

Pressure on future ratings and earnings is also emerging. 2022 saw many investment grade companies boast rating upgrades, whereas in February 2023 downgrades were about 1.5x upgrades. Earnings growth slowed down in the 4th quarter of 2022, and with tighter credit, earnings estimate for the next quarter have generally been revised downward. After the first seven Fed interest rate hikes, growth was on the cusp of slowing as we entered 2023, and the debacle that unraveled in bank regulations will likely expedite the slowdown as credit will become tighter to obtain and consumers will possibly be more hesitant to spend.

Throughout the fluctuations in interest rates, residential housing has managed to remain standing, with owner equivalent rents contributing heavily to persistently high Consumer Price Index levels. While housing prices have mediated in the west and northeast of the country, this has not been the case in the south, an area of increased migration that has maintained elevated house price levels. As we mentioned in previous quarters, the strength of the housing market can be attributed to the mismatch in supply and demand of homes. Demand for single family residential homes has been driven heavily by generational demographics. Millennials, who represent the largest generation, have reached home buying age, but according to the 2020 census, they have the lowest home ownership rates within the population. The supply of homes, or rather the undersupply, can be attributed to several factors. After the financial crisis in 2008, many builders went out of business, and construction of new homes never caught up with population growth. Additionally, during the Covid pandemic, household formation was increasing while supply shortages of labor and materials exacerbated the undersupply of homes. As a result of the growing millennial demand and insufficient supply of homes, prices of homes escalated upwards in the last three years.

When the Federal Reserve started increasing interest rates one year ago, mortgage rates began to creep up, and by mid-year demand for homes softened due to higher monthly projected mortgage payments. However, this did not lead to the collapse in home prices that many had anticipated, because supply, which was already low, decreased at an even greater rate than demand did. U.S. homeowners, over 90% of whom have fixed rate mortgages, had locked in low rates in the last decade, and were unwilling to forego these low rates for the current higher market rates (note, this is unlike other parts of the world, where many borrowers' mortgage rates fluctuate with interest rates). The chart below shows that 99% of existing borrowers carry a fixed rate on their mortgage that is below the current primary mortgage market survey rate, visually demonstrating their unwillingness to sell their homes. With limited supply of homes for sale by homeowners, the few buyers who hoped for prices to drop, were disappointed to find that the prices of homes only declined marginally, and regionally.



Source: eMBS, Goldman Sachs Global Investment Research

If, however, in the coming months, we witness a slowdown in growth and interest rates begin to decrease, existing mortgage-holding homeowners may be more willing to sell, while lower growth expectations may qualm household formation, thereby slowing down buyers' demand for homes. In essence, lower interest rates may have the opposite effect on mortgage demand than would be expected, causing home prices, along with inflation, to decrease as housing supply begins to increase while demand slows.