2nd Quarter 2023

VAAM is forecasting a soft landing for the **economy** with very slow growth. A recession will be avoided through the rest of 2023 and into early 2024. The reduction in inflation will continue and we will see better inflation data by year end. Since 1955 every recession has met with weak labor markets. On average, over the last 75 years, unemployment rose by 2.7%. Periods of weak labor markets in non-recessionary periods have not occurred over this time. As such it is a safe assumption that odds for a recession this year are very low unless the labor market weakens in a material fashion. The resilient U.S. economy in the face of rising interest rates (fed funds rate increased from virtually 0% to a 5-5.25% range) and numerous uncertainties is largely attributable to the consumer sector. The consumer comprises approximately 66% of the U.S. economy. Consumer spending continues to be supported by a strong and tight labor market. Workers have gained more than 1.5 million jobs so far in 2023. The labor market has gained 99.2% of the 22 million jobs lost due to the pandemic. Also supporting consumer spending is the fact that household revolving credit lines are only 50% utilized. Reflecting the strength of the consumer, final sales to private domestic purchasers rose 2.9% in the first quarter versus 0.0% in the fourth quarter.

There are headwinds to economic growth. The 3.6% unemployment rate in June is still near historic lows but up from the 3.4% level in April. Earnings growth held steady in May with average hourly earnings rising 4.3% from a year earlier. However, this is down from the brisk earnings growth recorded last year. Savings that some households built up during the pandemic have begun to dwindle and there are signs that companies are beginning to pull back on hiring. Credit conditions have tightened not only due to the rise in interest rates but also due to tougher regulatory requirements on the banking system in the wake of the regional banking crisis. Slowing growth and greater uncertainty about earnings and cash flow has caused the business sector to become more cautious about capital expenditures. Another headwind to growth is commercial real estate. In 2014-2019 construction spending growth was five times the rate of economic growth. Pre-covid the supply of commercial real estate was typically absorbed by demand. However, remote work has resulted in a growing vacancy rate of office space. Companies will continue to lease less office space. Some downtowns (San Francisco, Los Angeles) are being hollowed out with negative ramifications for investment, spending and governmental funding. $1.3 trillion in commercial mortgage debt will mature by the end of 2025. This debt will have to be refinanced at significantly higher interest rates.

Slower growth should help in reducing inflation. Core PCE, the Fed's preferred inflation gauge, rose 4.6% from a year ago. This rate has slowed from 5.5% in early 2022. Several supply chain issues have been resolved. Commodity prices are broadly lower. While prices for food, everyday household goods and energy have moderated, the prices for many services have continued to rise. Shelter costs, one-third of the Consumer Price Index, keep rising. Shelter costs rose 8% year-over-year in May. If you exclude shelter, the overall CPI would have been 2.1% with the core CPI (excluded food and fuel) up only 3.4% (versus the 5.3% actual reading). Due to a lag in reporting, we expect that rents and home prices will be more accurately reflected within CPI and will moderate in the future. While tightened monetary policy will continue to help bring down inflation, there is uncertainty due to the lagged and variable effects of monetary policy. Another uncertainty are the ramifications from credit tightening. A good sign is that inflationary average expectations are nowhere near the high levels of the 1980s. Consumer inflation expectations are 3.3% over the next year and 3.0% for the next 5-10 years.

The **Federal Reserve** recently paused their increase in the fed funds rate and maintained the level at 5-5.25%. We do not expect a pivot and reduction in rates until possibly early '24. Chairman Powell indicated a further 50 basis point increase in the funds rate is likely the second half of this year but is dependent on incoming data. Powell believes inflation reduction will be bumpy and gradual in attaining the 2% objective. Projections by Fed governors indicate a 4.5-4.75% funds rate by the end of 2024. While inflation and the economy are slowing, the Fed still faces a resilient economy, strong labor market and a vibrant consumer sector. While employers are still adding workers, other aspects of the labor market including a jump in unemployment and a slowing in wage gains muddle the signal coming from the data. Although the job market has cooled a bit, it is still quite healthy with unemployment low and plenty of job vacancies to be filled. As long as this is the case, even if inflation cools substantially, policy makers are not likely to cut rates. With debt ceiling fears now gone and the risks revolving around the regional banks diminished for the time being, the Fed's focus will stay on inflation that is still too high and a job market that is running stronger than they would like. We do not think the regional banking crisis has been fully resolved. For deposits more than the Federal guaranty threshold of $250,000, the guaranty is implicit rather than explicit. This raises the potential of further deposit withdrawals and dislocations. This, in turn, puts the Fed in a difficult position with respect to their inflation objective vis-a-vis a stable financial system.

Recently, there have been questions as to whether the **U.S. dollar** can continue to maintain its position as the leading global reserve currency. These questions have risen in the wake of the debt ceiling debate and China positioning the yuan to rival the dollar as an alternative reserve currency. We believe the USD will retain its status as the preeminent currency in global trade and finance. The USD is the most widely used currency in trade and financial transactions. It accounts for approximately 60% of Central Banks' official currency reserves. The U.S. Treasury market, a key market for USD investments, is a $24 trillion market and is the world's deepest and most liquid. The U.S. has a system of laws with an independent judicial system and an independent media. One of the numerous impediments to the yuan being more universally accepted is that China restricts monetary flows. The Chinese banking system and governmental entities are over levered with questionable real estate loans in a stagnant property market. The combination of the size and dynamism of the U.S. economy (China's economy is 70% the size of the U.S.), its unmatched military strength and diplomatic leverage, offer an environment where USD investments are protected. The USD value is decided by free markets and not by a government dictate. In 2021, the U.S. produced 2,572 PhDs in Computer Science alone and 177 of the top universities in the world are in the U.S. Furthermore, the U.S. has the most dedicated nano centers in the world, more than the next three countries combined (Germany, UK, and China).

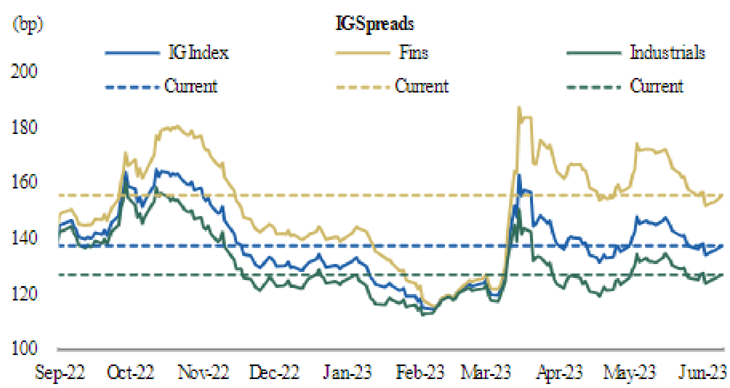
Corporate Bond Review

Although the Federal Reserve only increased the fed funds rate once in the second quarter of 2023, and then paused at the most recent meeting, interest rates increased across the board and the treasury curve has become more inverted. At the start of the quarter the 10-year treasury was at 3.46% and the 2-year treasury at 4.02%, an inversion of 0.56%. Rates traded in a tight range during the first half of the quarter but backed up to 3.837% on the 10-year treasury and 4.895% on the 2-year treasury, an inversion of 1.06%. This increase in rates occurred as economic data continued to indicate that the probability of an economic slowdown was further on the horizon, and Federal Reserve chairman Powell reiterated that, despite his pause to increase rates at the June meeting, an interest rate cut would not be in the cards for 2023. In fact, although consumer purchasing power has been diminishing due to inflation, and corporate investment progressively wrinkled with each interest rate hike, the labor market has remained tight and consumer spending on both goods and services resilient. As a result, the Federal Reserve has remained vigilant, signaling that future rate hikes are on the table, which is keeping interest rates high, particularly on the short end of the treasury curve.

An area of the economy whose strength continues to defy the odds is residential housing. Although mortgage rates have increased from 3% in 2021 to 6%-7% in 2023, lowering affordability for borrowers, prices of homes have not suffered. In fact, demand for single family homes, while softer in 2022, has picked up, and is being met with new home sales in the absence of existing home sales. Many existing homeowners have eschewed the idea of foregoing their existing low interest rate mortgage loan for a new higher loan rate, so they are unwilling to sell their homes into the growing demand from potential home buyers. As a result, that demand is being now met by real estate builders who have also started providing mortgage financing at discounted rates versus the rates offered by banks. This is keeping home prices on an increasing path.

High rates create a hurdle for corporate borrowers, making debt less affordable. This is primarily demonstrated in the form of a corporation's interest coverage ratio, a metric which reflects how well a company can pay interest on its debts. The interest coverage ratio is calculated by dividing EBITDA (earnings before interest taxes depreciation and amortization) by interest expense. As corporate debt maturity walls come into view in 2025, the anticipated interest expense under the current rate environment is poised to be drastically different (i.e. higher) than it was a few years ago, which will impact corporate profits, and should, by the Fed's design, slow down the economy.

Concerns about interest coverage ratios can spill over to corporate bond spreads, causing them to widen. During the regional banking crisis in March, corporate bond spreads across all industries widened. As illustrated in the chart below, they have since ratcheted back in but remain wider than they were before the crisis, particularly among financial issuers.



Source: Morgan Stanley Research, Bloomberg

Although there does not appear to be another regional banking crisis, commercial real estate borrowers, particularly office property owners, may default on their loans which are primarily adjustable rate. One measurement of commercial real estate viability is DSCR (debt service coverage ratio), which measures available cash flow by dividing debt service into operating income. Adjustable loans in this environment will jeopardize borrowers' DSCR as higher rates drive up debt service, thereby reducing available cash flow. Faced with the prospect of low operating income from empty office spaces, office property owners could potentially walk away from their loans, a risk to the banks who hold those loans on their balance sheets. While large money center banks have enough diversification to avoid this concentrated risk, some regional banks may fall victim to imminent losses. To guard against slowing economic growth, and especially the potential risk of banks, your portfolio's corporate bond duration is lower than that of the benchmark and of higher quality and is not invested in regional banks.