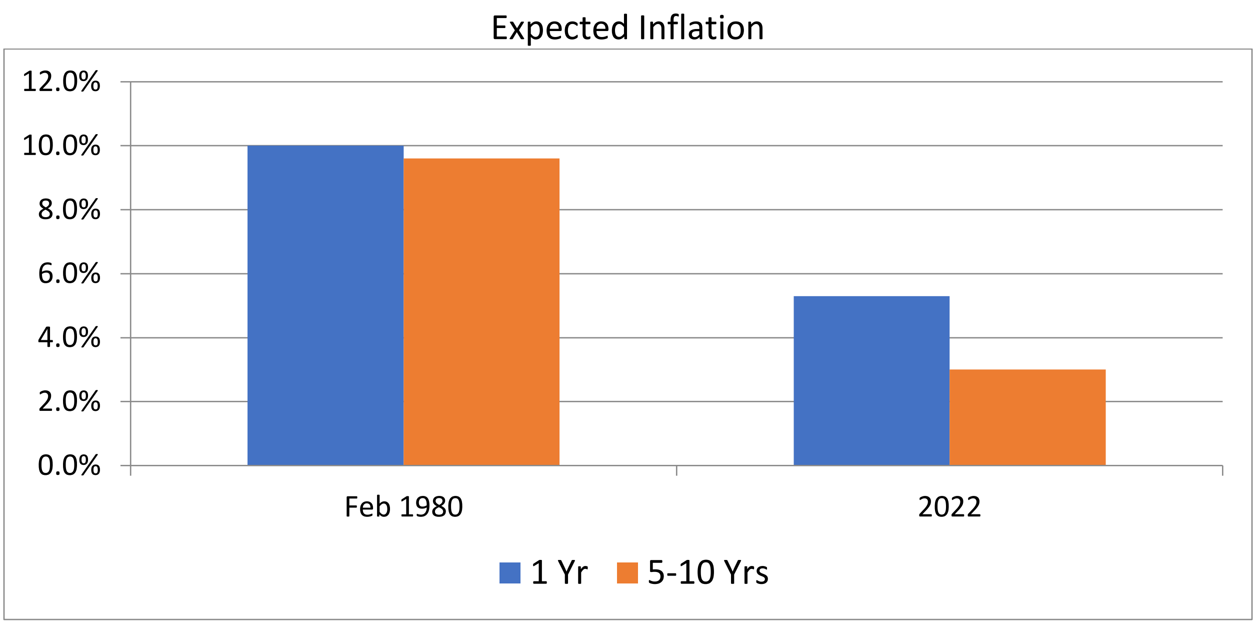
VANDERBILT Ave. ASSET MANAGEMENT

2nd Quarter 2022

VAAM forecasts that the real **GDP growth rate** will slowdown but not result in a recession. This is primarily due to the strength of the consumer sector which is 70% of U.S. GDP. The U.S. consumer is as large as China's economy (the world's second largest) and three times the size of Japan's economy (the world's third largest). A primary reason for the strength of the consumer is the exceptionally strong labor market. The labor market has gained back over 99% of the 22 million jobs lost during the pandemic. In addition, unemployment is at historic lows. The 2019-2021 period were the highest three years on record for gains in inflation adjusted wealth per household. Disposable income is close to $16 trillion driven by related government transfer payments and higher wages. In addition, consumers have $2.3 trillion of savings (10% of GDP). Consumers paid down debt during covid thereby strengthening their balance sheet. Current household revolving credit lines are only 20% utilized. Despite these strengths there are drags on growth. Our major trade partners in Europe and Asia have been impacted by the Ukraine war, Covid and high energy and food prices. Furthermore, pandemic related government sponsored aid payments are terminating. Federal Reserve monetary tightening will retard growth by raising interest rates to slow demand.

The course of **inflation** is critical because it will dictate Federal Reserve monetary policy. VAAM's forecast is that inflation will begin a gradual deceleration. The Fed is late in reacting to inflation and they have fallen behind the curve. The latest year-over-year inflation data for the CPI is up 8.6% and the PCE is up 6.3%. Core PCE (which excludes food and energy) is the Fed's preferred inflation gauge and is up 6.0%. All inflation measures are seeing upward pressure. A tight labor market is causing a cost push wage price spiral. Demand pull pressures are evident as aggregate demand recovers from the pandemic and runs into supply chain constraints. In addition, one off factors such as the Ukraine war has had an inflationary impact on global food and fuel prices. The shortage of available houses has driven prices higher and shelter will continue to contribute to inflation until supply increases. The largest difference between the CPI and PCE is the greater weight shelter has in the CPI. One-third of the CPI is driven by shelter related components. While stretched affordability will drive a deceleration in future house price appreciation, the short supply of homes available for sale could preclude a broad-based price decline in this sector.

Inflation is at levels not seen since the early 1980's. Is today's inflation similar to the 1980's? We think there are important differences between then and now. While the price of energy is rising rapidly, energy spending is a much smaller percent of household consumption thanks to more efficient forms of energy delivery. In 1979 inflation was at 9% and Fed Chair Volcker adopted a very tight monetary policy (the fed funds rate rose to 20% versus the current level of 1.75%) which led to a severe recession and a sharp rise in unemployment. The recession did reduce inflation to 4% but unemployment rose to 10.8% by 1982 and did not return to 1979 levels until 1987. The early 1980's inflation was deeply entrenched in the economy and the expectation was that inflation would remain high. Inflation today is expected to be high in the short-term and lower medium to longer-term thereby not resembling expectations during 1979-1980 (see graph below).



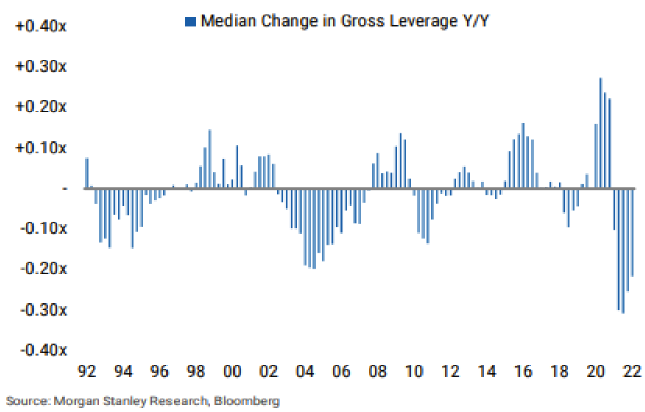
Inflation, not entrenched – *University of Michigan*

The **Federal Reserve** has a delicate balancing act. Due to inflation the Fed has adopted (as have a number of other central banks) a much tighter monetary policy. They recently raised the fed funds rate by 75 basis points which is the largest single increase since 1994. Higher rates make borrowing more expensive which weighs on consumer demand and business investment which cools economic growth and slows hiring. This can translate into weaker wage growth for households and less pricing power for companies thereby eventually pulling down inflation. The Fed would like to see job growth slow, labor force growth pick up and wage growth moderate. One measure the Fed will keep an eye on is productivity growth as a way to bring down unit labor costs. **(The balancing act the Fed has is reigning in the economy without sending growth tumbling and causing a recession).** The strength of the consumer, business sector balance sheets and a financially strong and healthy banking system should all help in achieving this endeavor.

Corporate Bond Commentary

While reported corporate earnings for three out of every four companies exceeded analysts' estimates, the volatility across all financial markets caused corporate bond spreads to widen throughout the second quarter. As the Federal Reserve tackled inflation at each meeting with continually increasing interest rate hikes, U.S. treasury rates, from the 2 year to the 10 year, increased by over 0.60% during the quarter and the 3-month rate was up well over 1%. This historical action by the Fed imposed concerns throughout financial markets, and in spite of the solid fundamentals, lead intermediate corporate bond index spreads to widen by 48 basis points.

Taking a deeper look into fundamentals, we continue to see a compelling case for corporate bonds. Over the last five quarters, leverage has continued to decrease, and interest coverage, which measures cash flow to cover debt payments has continued to increase. This along with robust earnings, as measured by EBITDA has placed companies on solid ground to face a slowdown in the economy.



Early in the third quarter, in anticipation of Federal Reserve interest rate increases, we added positions in floating rate corporate bonds to your portfolio. We purchased Cigna Corporation (A-/Baa1) and United Parcel Service (A/A2) floating rate bonds, whose coupons have increased with interest rates, and have served as a valuable hedge against fixed coupon bonds in this rising interest rate environment. An added benefit to your portfolio in this current volatile, spread widening climate has been an average credit quality that continues to exceed that of the benchmark.

One of the best performing investments in your portfolio since the beginning of the pandemic, and leading up to the growth in inflation, has been your position in Treasury Inflation-Indexed Securities ("TIPS"). TIPS adjust upwards in value when inflation expectations, as measured by the TIPS Breakeven Rate (shown below), increase in value. The Breakeven Rate measures the difference between the yield of nominal treasuries and inflation-indexed treasuries. As inflation has been running hot over the last two years, TIPS have been appreciating and have served as a valuable hedge against the fixed coupon bonds in your portfolio.