Mid-Year Review & Outlook

I had a recession on the calendar and we didn't get it. I didn't have a "banking" crisis on the calendar, but we got one anyway. It has been that sort of a year.

The one thing that **I'm most excited about** right now is my belief that the Fed will not be one of the main market drivers (A Toddler Taking Their First Steps). Yes, the Fed will be important, but they have relatively high hurdles to hike further or start to cut and their actions will only occur in the face of persistent data pointing them strongly in one direction or the other.

At the other end of the spectrum, **I'm almost dreading** the prospect of D.C. and next year's election influencing markets going forward (from the largely "fake" debt ceiling debate to the largely "real" potential government shutdown issue for example).

The **most fascinating** "debate" will be to see if markets can be led by the same companies, we get a pullback, or if the laggards can catch-up.

China will remain a dominant theme for markets and corporations. With Blinken meeting his Chinese counterpart we could see some thawing of the relationship, but that is likely going to be short lived and will potentially just buy China some time as their long-term goals haven't changed. However, they are facing a domestic economy that has not had the spark that many expected after the "re-opening".

Academy got to discuss some of these topics and much more as a **guest host** on Bloomberg Surveillance on Friday morning (just hit play, as we are on right from the get-go).

Finally, **AI has taken corporate America and the markets by storm** (and not just in a few stocks). The broader theme is that addressing AI will affect every company no matter its size or its business. Academy is hosting a webinar (registration) on Thursday at 11:00am ET. I'm very excited to moderate what should be an amazing discussion with General (ret.) Groen and Admiral (ret.) Barrett. Both were leaders in the military in AI and cyber and are leaders in the field now as they work with companies and governments to shape their AI strategies. From the prep work that we have been doing in advance of Thursday's webinar, one theme keeps coming up:

"Every company is an information technology company".

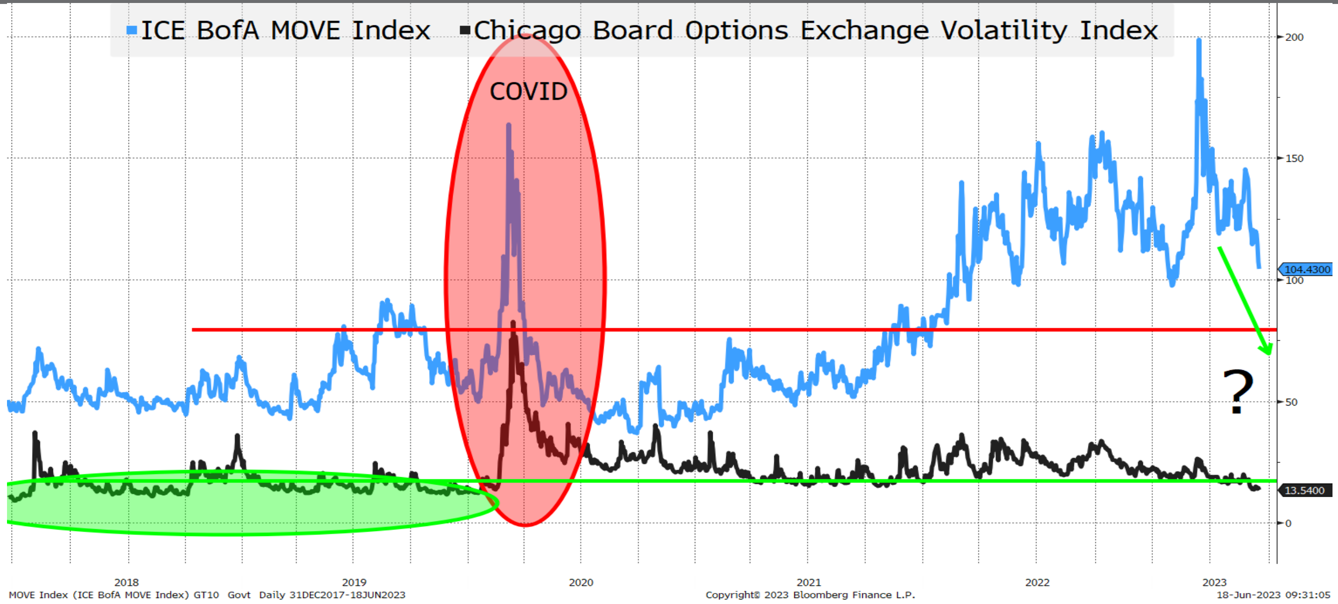
That may sound preposterous to some, but I think that what we are experiencing in this very early stage of the shift from "machine learning" to "artificial intelligence" will be transformational. AI will impact companies in many ways:

- AI and its role in shaping strategic direction for companies.
- AI and its role in improving day to day and tactical efficiencies.
- AI in the products developed and sold.

I've left out some ways and haven't scratched the surface on how it will impact society and foreign relations, but those too will be discussed in this webinar. This is likely just the first in a series as the topic of AI is so broad and transformative and Academy has several Advisory Board members heavily involved in the space.

Volatility

As I think about the reduced influence of the Fed on markets, the first thing that pops into my head is volatility (or more accurately, the lack thereof).

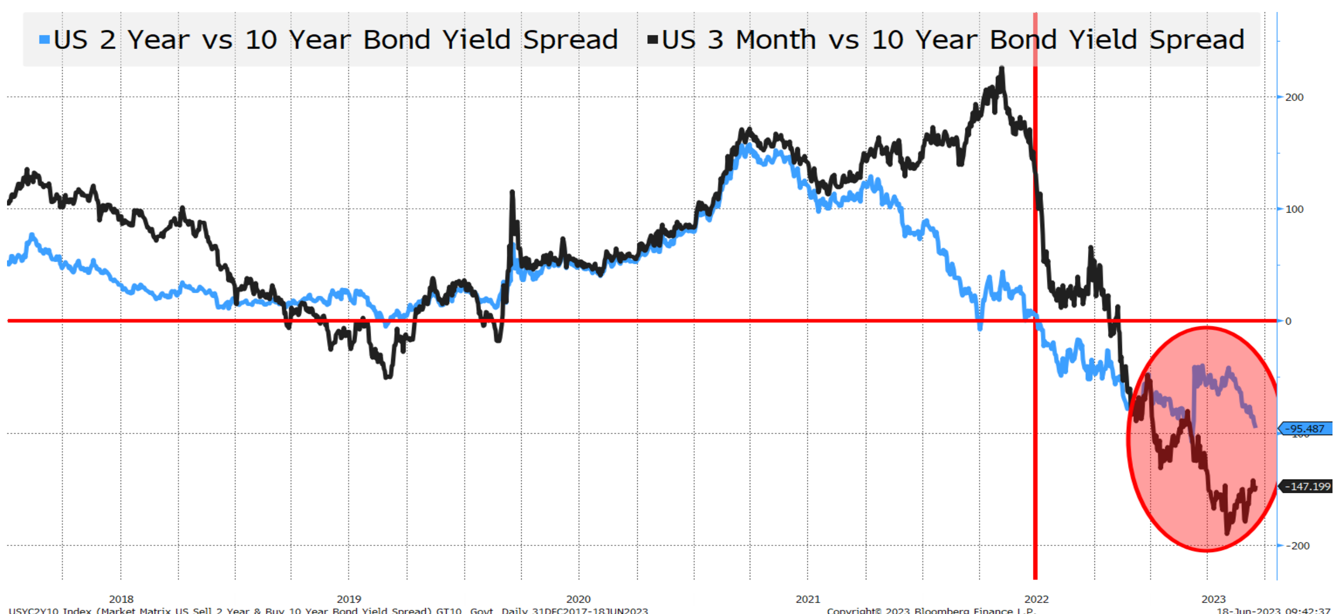


While the VIX seems low relative to recent times, we spent much of the two years prior to COVID at lower levels on the VIX. I'd argue that with more investors, traders, and risk managers turning to shorter dated options, there is no reason why VIX cannot trade lower for an extended period.

The MOVE index (a measure of implied volatility in Treasury markets) has started to decline, but it is still elevated relative to the past. I see no reason for this not to decline further given the current status of the Fed. While a little simplistic, the realized volatility on TLT (an ETF focused on 20 to 30-year Treasuries) is at its lowest level of realized volatility since the summer of 2021! That lower level of realized volatility makes sense and should help reduce volatility going forward as risk managers start thinking about a much more rangebound market for Treasuries across the curve.

If Treasury implied vol doesn't continue its decline to "normal" levels, then we could see some upward pressure on the VIX, but that is not my current base case (which is for a quiet summer).

Inverted Yield Curves



Pick your poison as a "recession" indicator – the 2 year vs 10 year or 3 month vs 10 year and the answer

is still the same - we are at ridiculously dangerous levels! However, while we first breached the inversion point well over a year ago, we aren't even at the most extreme levels (2s vs 10s got to -109 in March).

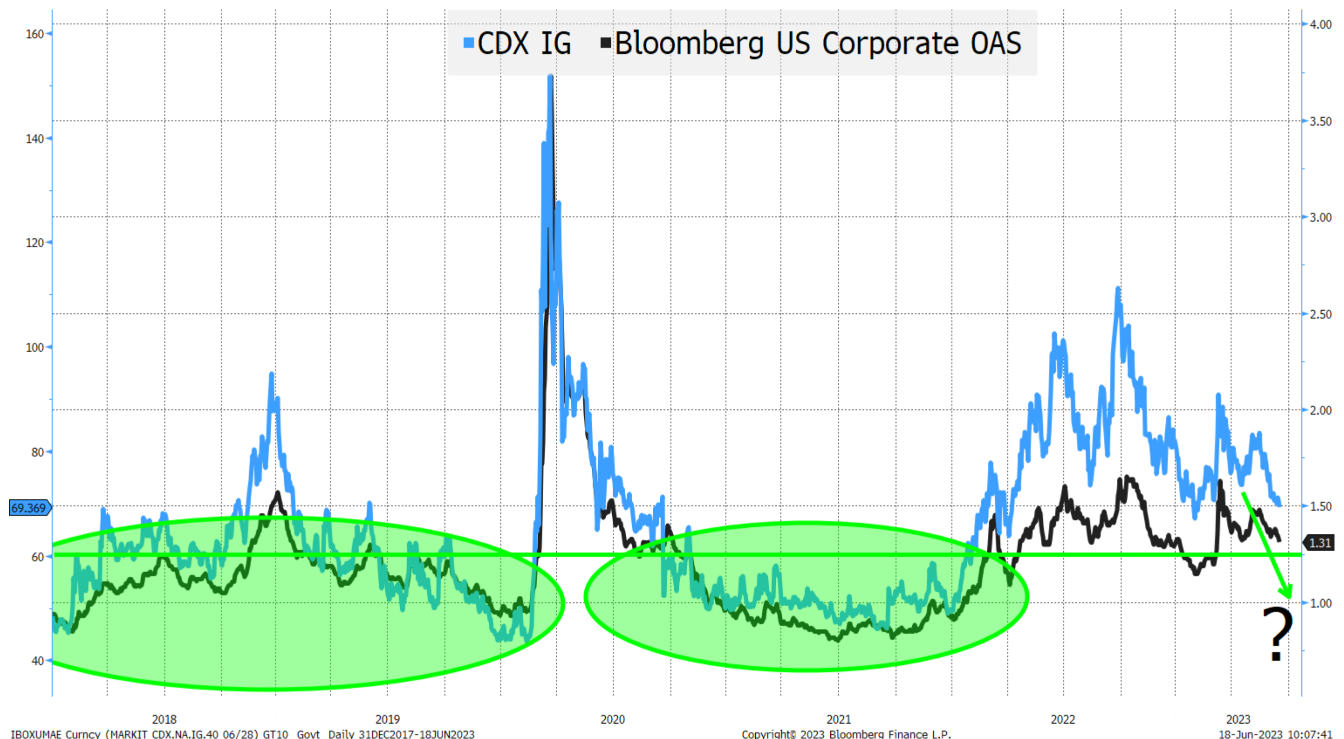
It certainly begs the question of whether or not this is really a recession indicator. While there is some argument to that, there are a few caveats:

- Never, to my recollection, has the Fed itself talked so much about its own Summary of Economic Projections (SEP) or the "dot plot". In fact, prior leaders at the Fed have told markets to largely ignore the dot plots. Now, not only do they highlight them, it also feels like they are making a strong effort to encourage participants to update their dot plots (if not outright telling them where to place their dots). When the Fed is providing their projection for rates four times a year (with less dispersion than they used to have), it makes sense for markets to listen. If the "terminal" rate is much lower than today's rate, it would be ludicrous for markets to price longer-dated bonds using a wildly different assumption**. So, the dot plots and their importance help create an inverted yield curve in a way that is more pronounced than it has been historically.**
- **No idea what QT does.** We still don't really understand what balance sheet reduction does to the shape of the yield curve. That is even more true when we briefly saw the balance sheet expand to deal with liquidity concerns at regional and small banks.

Inversion (especially at recent levels) is a concern, but it doesn't keep me awake at night. If anything, I think that we are overdone on inversion here and I expect the yield curve to become less inverted in the coming weeks.

Credit Spreads

The first question that comes to mind is **are investment grade credit spreads too wide?**



With all the recession talk (which we will get to next), that is still the first question that comes to my

mind. It might seem counterintuitive, but a few things have me thinking that way:

- Q2 2023, which has a few days left, saw $294 billion of issuance versus $286 billion for the same quarter last year. Yields across the curve were lower at the same time last year, so it wasn't a race to lock in low yields (that trade was so 2021), but it was a race to get financing in place ahead of any potential debt ceiling shenanigans. Away from banks, which will likely be pressured into issuing more longer-dated bonds (a direct consequence of government involvement during the so called "crisis" that seems to be over), we should see less supply this summer.
- IG credit spreads, particularly in the CDS space, tend to correlate well with VIX over time. As already discussed, VIX is back to levels where indicated credit spreads should be lower.
- While there might be valuation questions in equities, those issuers are generally rock-solid on the credit front and should not see their spreads move much even if we see some equity selling. I'm just not sure that (barring a major recession) there is any reason for material widening as so many companies have very healthy balance sheets after an extended period of the "nirvana" of low yields coupled with insatiable demand.

One question (more "theoretical" than anything) is the following: **do credit spreads have any element where we should be thinking of them as a percentage of Treasury yields, rather than as a spread to Treasury yields?** If T+50 looked attractive when T was 2%, does T+50 still look attractive when T is 4%? Is that extra 50 bps worth it when it drops from being 25% more yield to only 12.5% more yield? I think that is largely theoretical, but something to think about.

Even more theoretical (and far more fun) is **debating whether some U.S. based companies have less of a likelihood of defaulting than the U.S. Treasury.** Is there a sovereign ceiling for the U.S.? Does a technical default (from some future failed debt ceiling negotiation) even matter? Or are companies with global revenue streams, piles of cash, strong and transparent corporate governance, and competent/long-serving management teams with a strategic vision safer than Treasuries? So far, that is more of a "truly out of the box" thought experiment than a reality, but it is fun to think about.

There is some pushback on the high yield side of things.

- Traditionally IG tends to be most correlated to the S&P 500 while **HY tends to be most correlated with the Russell 2000**. The strength in high yield has diverged from the relative sluggishness of the Russell 2000. That is a bit of a concern, but the relationship is always tenuous and the nature of the industries and businesses in the two indices can also change over time. If anything, it makes me think that we should be seeing outperformance from small caps rather than a need for HY to sell-off.
- **How many high yield bonds have you traded on spread?** High yield has (and always will be) a yield product. It isn't called high spread, it is called high yield. Virtually every bond is still quoted as a dollar price rather than a spread to Treasuries (unlike IG which is quoted and traded as a spread to Treasuries). High yield is made up of callable bonds, making any conversion to spread tricky at best (though less true in an environment where most bonds trade below par due to interest rates). High yield bond holders tend to benefit from any increased M&A activity (change of control language helps and it is more common for a HY company to be bought by an IG company that decides to add some leverage). **While I don't completely ignore arguments talking about high yield being too tight on a spread basis, they currently aren't registering**

with me as a major warning.

- **Leveraged loans are still somewhat more concerning than the high yield bond market** as that is where the smaller/"less followed" companies issue and where surprises could lurk. But even here, the big banks have been working through some "tricky" commitments that they made during the heyday of ZIRP.

Nothing is crazy cheap right now, but I'm comfortable with credit.

Location, Location, Location

That has always applied to real estate and still does. The risks in real estate (particularly commercial) have been well identified, but will take time to play out. Workarounds may well be found for many troubled situations. Cities may also turn around in ways that attract (or re-attract) those who want to work from offices in downtown settings. But, I'm not here to talk about real estate (Stav Gaon opines on this regularly - Securitized Products Research & Strategy). I'm here to talk about "recession" risks.

Recession by Location

As discussed, the "unwind" in this economy is similar to what we saw in 2015-2016, except that **you can replace energy with "disruptive"**.

I have been very worried that problems in the "disruptive" space could hit the broader economy. However, this has not happened yet (at least not in a meaningful way).

On the other hand, we have seen and continue to see evidence of slowdowns in and around the "disruptive" space. Silicon Valley Bank, Signature Bank, and San Francisco real estate are all vying to be front and center of that story.

This concept of "recession by location" may also help explain how well homebuilders are doing. My experience as a high yield homebuilder trader (way back in the day) was that these companies do best when people are moving to "new" areas (at the time, Vegas and Phoenix). They can acquire desirable land at a reasonable price and build homes that people want. People moving from high cost/difficult to access new land areas (lots of metropolitan areas fit this description) to other parts of the country (the Southeast for example) likely suits the homebuilders. **It may also explain why data on a national level is less relevant if we are moving to a location based (or even isolated) recession model.**

I remain concerned about a bigger slowdown yet to come:

- An expansion from this "location based" problem to a "national problem".
- Problems arising for our companies as China shifts from a Made in China Strategy to a Made by China Strategy.
- A consumer that is under pressure and their budget is being stretched to the limit even if prices don't continue to rise (we are currently set on this path).
- The possibility that the economists got it right and the government jobs data is overstating the robustness there (A Quirky Report).

Bottom Line

Re-assessing the recession risk. With the Fed largely behind us and earnings season a few weeks ahead, we have plenty of time to drill down into the economy and try to figure out what is next. Do yield curves

carry a valid warning? Is the “location” based recession possible in a way that doesn’t impact us on a “national” level? All things to think about.

On **bonds**, look for lower volatility/rangebound trading (based on data, not Fed Speak) and less inversion.

On **credit**, look for stability or even tightening.

On **equities**, can the same trend continue? Can we keep seeing upward momentum in broad indices that is largely coming from a handful of companies? If not (and I don’t think it can), will we see lower indices across the board? Or will we see continued strength in broad indices with the leadership shifting away from the current front runners to a broader based group of stocks and industries? Can the small caps finally catch up? I’m leaning towards the latter, but scared of the former.

Finally, and this ties into AI, at what point do we move beyond rewarding the companies that benefit from others using AI to deciding that AI can increase efficiencies to the point that our indices should trade at much higher multiples than they currently do? Certainly, that would mean that we are due for higher stock prices, but the leadership will change. Definitely possible and would be consistent with reduced volatility in bonds (and stocks).

Enjoy the Juneteenth holiday and I really am looking forward to a market where we can largely dismiss the Fed!

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