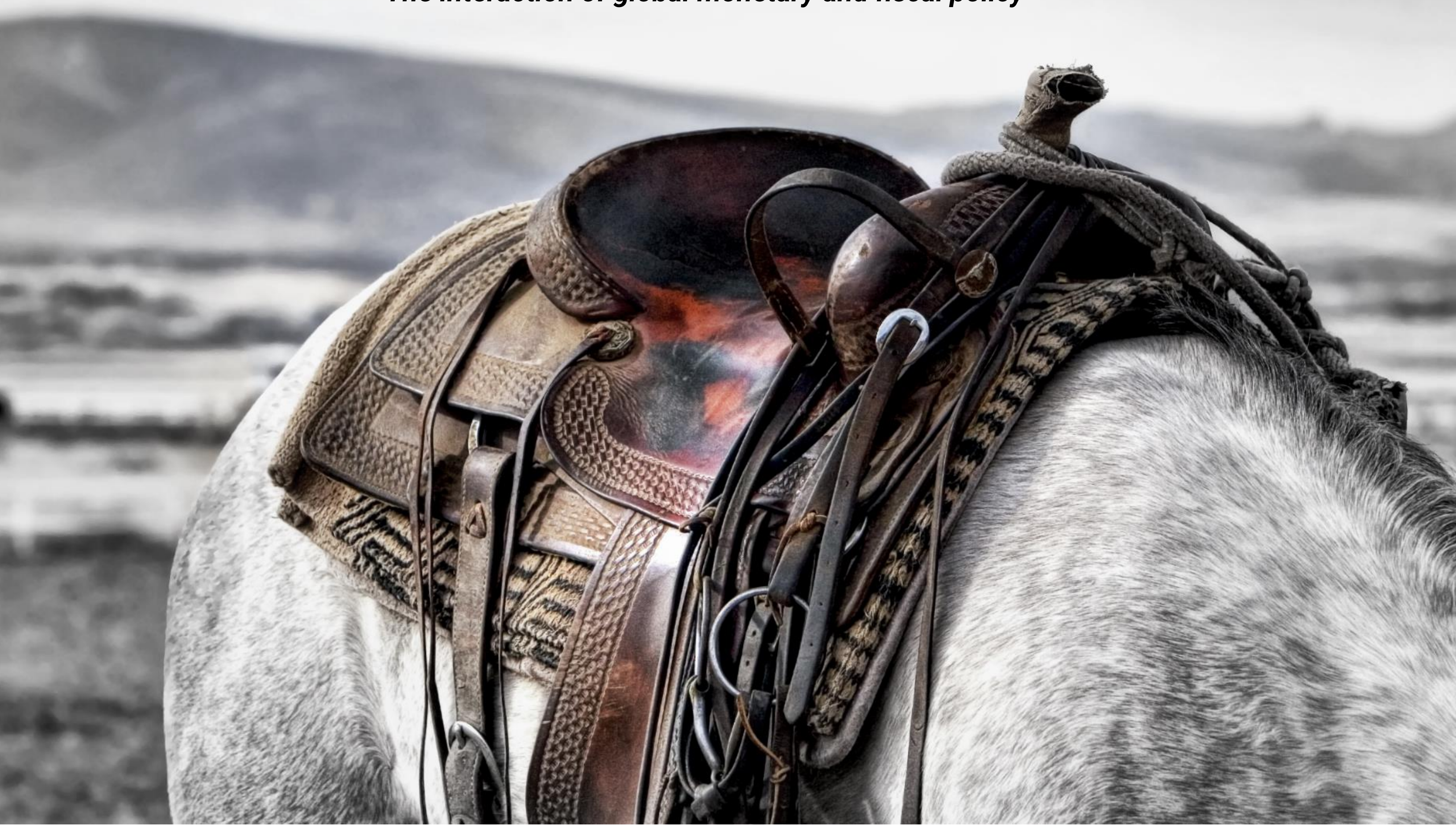
SMITH
CAPITAL INVESTORS

Dear Friends,

We extend a warm welcome to our latest 5x5 write-up, a compilation designed to shed light on the five elements of the market that have captivated our attention, as well as five key focal points that are central to our discussions. Our ultimate aim with this piece is to bridge the gap between our investors and our investment processes, emphasizing areas that may warrant more in-depth discussion.

At the beginning of this year, we underscored the five critical facets of the market that would be important for investors to consider in 2023:

- ***Yield Curve Management***
- ***Duration Management***
- ***Sector/Segment Management***
- ***Correlation***
- ***The interaction of global monetary and fiscal policy***



As we approach year end, many of these elements remain at the forefront of our considerations, but we also see a series of new opportunities and risks in front of us. In this report, we will touch upon some of these, along with their related factors.

In the wake of the Federal Reserve's aggressive 550 basis point increase in interest rates, attention now shifts towards the Fed's balance sheet and the complexities involved in the Fed's eventual exit from the mortgage market. This task is not without its challenges. Simultaneously, we find ourselves facing the lagged effects of this aggressive monetary policy. What once centered on the debate between a "hard" or "soft" landing has now evolved into discussions about a "no landing" scenario, and perhaps even an accelerating economy. It is amazing how sentiment can pivot so swiftly! With this in mind, concerns regarding inflation appear to have receded and the word "transitory" is no longer in question. The volatility of opinion stemming from a series of events with no historical precedent is truly remarkable, but it is this very dynamism that fuels our markets and instigates volatility. If inflation were to reverse course higher in the near future, we would expect even greater volatility and a dramatic shift in the consensus around rates and risk asset valuations.

Reflecting back to a decade ago, if I had shared my beliefs that:

1) the outstanding Federal debt would surpass 32 trillion dollars,
2) that the Government would be running multi-trillion-dollar deficits in both strong and challenging economic times, and
3) the Federal Reserve's balance sheet would expand to 9 trillion dollars,

…you might have questioned my sanity. Yet here we stand. Undoubtedly, there is a day of reckoning ahead, but for the near term, we must remain focused on the pressing issues before us.

We spotlight our concerns surrounding the large Government deficits and the overarching burden of outstanding debt. We dedicate time to examining Regional Bank matters, the impending default cycle, real rates, and developments in China. However, our focus now shifts to the issues we believe will shape our path forward: the resilience of the consumer, the evolving wage landscape, expectations surrounding volatility, the intricate dynamics between China and the United States, and the ever-important Leading Economic Indicators and Financial Conditions. We also provide a brief overview of the recent earnings season, a topic you can anticipate hearing more about from us in the future.

While there are other significant topics such as deglobalization, artificial intelligence, the green movement, and politics on the horizon, we have reserved those for future discussions.

This write-up serves as a succinct summary of our conversations. Our aspiration is for it to ignite your interest, provoke thoughtful contemplation, and spark curiosity. We are wholeheartedly prepared to delve deeper into these topics with you at your convenience.

In conclusion, I express my heartfelt gratitude to all our investors and the steadfast supporters who have joined us on this incredible journey. This year, our firm celebrated its fifth anniversary, and I am immensely proud to share that our team has expanded from six to eighteen members, with assets under management surpassing the three billion dollar mark earlier in the year. We eagerly anticipate reaching the four and five billion milestones with you by our side! We are excited about the best yield environment we have seen in fifteen years, but also recognize the importance of discipline in our active process due to the complexities that exist in today’s markets. Over the past five years, the most rewarding aspect of building this business has been cultivating new and deep relationships, both within and beyond our firm. It is our core value of service that fuels our passion, and the privilege of having individuals entrust us with their assets fills us with profound joy. We know we must earn that right to serve you every day. Thank you!

Our unwavering commitment remains steadfast, centered on Investing Excellence, Relationships/People, and Intentional Culture.

Warmly,
Gibson

Enjoy your exploration of the 5x5, and always remember, Let's Talk!

5

Events that Caught our Attention in 1H 2023

5

Events that We are Watching in 2H 2023

5 Events That Caught our Attention

in 1H 2023

1. Regional Banks: *Balancing Capital and Risk*

Post the Silicon Valley Bank and Signature Bank bankruptcies, regional banks have garnered much attention. We view the significant repricing of risk in this sector as both an opportunity and a warning sign. On the warning side of the ledger, there are spillover effects that will find their way into the macroeconomic outlook, as credit creation is likely hindered in the near term. But on the positive side, there are early signs that regional banks have moved into a much more creditor-friendly focus. Some of this focus is going to be aided by new regulatory oversight as well as management teams retooling their businesses for the new environment of a higher cost of capital, increased yield curve volatility, and the repricing of their legacy portfolios.

Aided by the structural tailwind of par accretion in security portfolios and new and existing liquidity tools, banks will be able to generate and defend capital positions with a more intense focus on retained earnings. Overall, the actions and focuses of the medium to large regional banks will prioritize credit profiles and therefore bondholders.

The 2Q23 U.S. regional bank earnings season went off without a bang, which many were bracing for. One theme across a large swath of these firms was a desire to either start or continue bolstering capital, namely Common Equity Tier 1 (CET1), through year end. To name a few, Truist Financial (TFC), Citizens Financial Group (CFG), Fifth Third Bancorp (FITB), U.S. Bancorp (USB), and Synovus Financial (SNV) all built and indicated a further desire to increase CET1 by means of retained earnings and/or balance sheet optimization/reduction. As investors interested in the entirety of a capital structure, we rarely expect capital allocation to favor creditors indefinitely. However, we recognize that when such times arise, they often serve as a temporal tailwind for credit spreads to tighten.

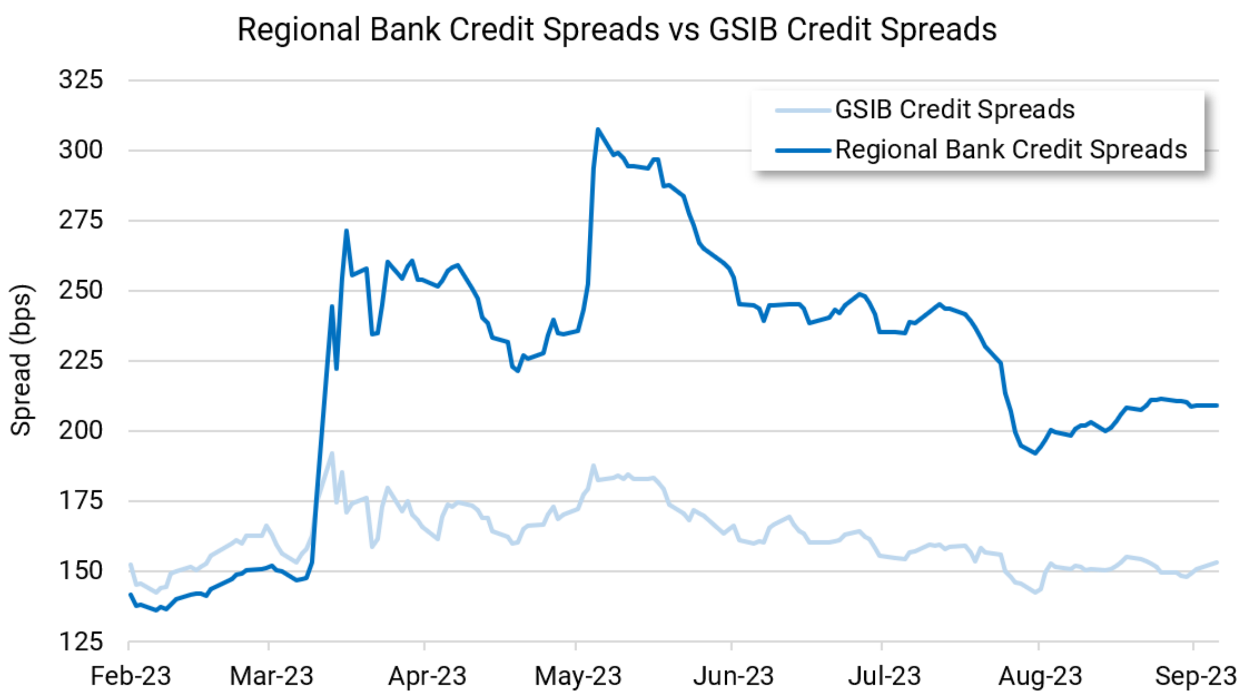
Banks have many deep sources of liquidity. The Fed's Bank Term Funding Program (BTFP) was created in the wake of the SVB collapse and allows banks to borrow with terms up to one year against the par value of pledged U.S. treasury, agency debt and mortgage-backed securities, and other similarly qualifying securities. The intention of this facility is to give banks another liquidity source by which the gap between unrealized losses on securities and the par value at which they will accrete back to is bridged. Not only does this serve a practical purpose but it also brings additional confidence, which is crucially important for the banking sector.

Speaking of par accretion, through our analysis we could see many bank securities portfolios reversing upwards of 40% of unrealized losses over the next one to two years. This should also serve as a tailwind from both a practical and confidence perspective for go-forward credit profiles (and therefore, spreads).

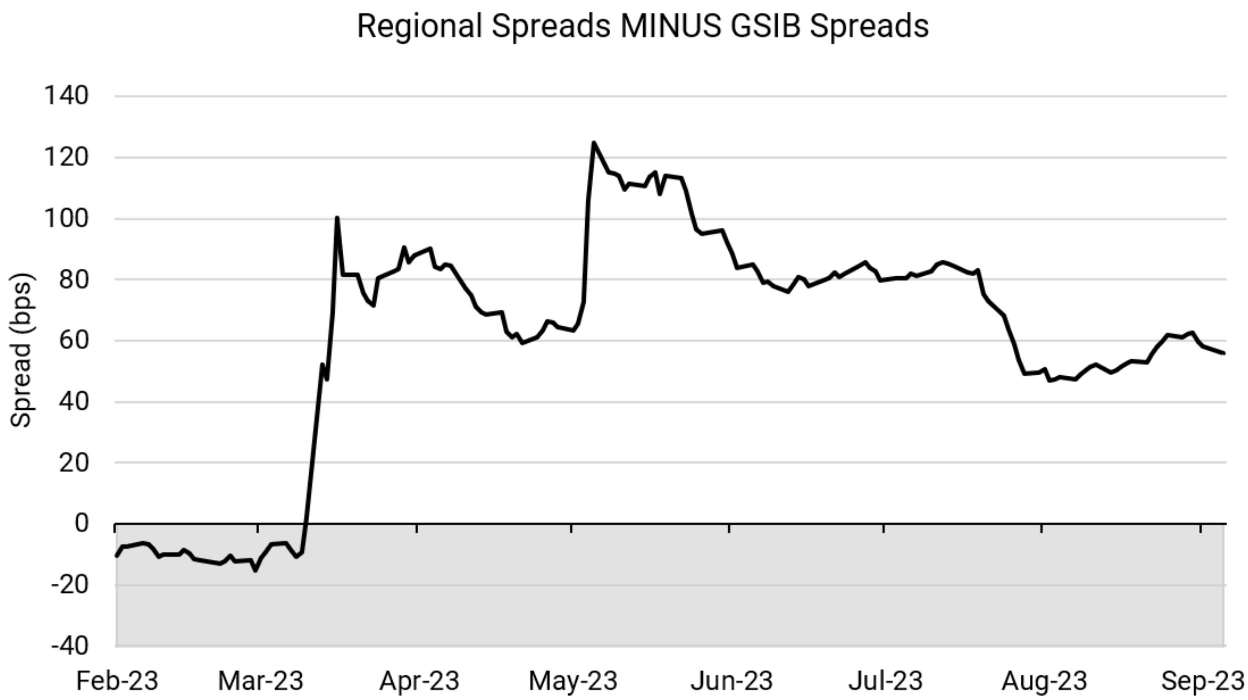
Regulatory changes are coming. One change encompasses an increase in the long-term debt (LTD) requirement on non-Global Systemically Important Banks (GSIBs), or category II, III, and IV banks. In the last week of August, the FDIC released a new Notice of Proposed Rulemaking (NPR) on LTD requirements. Targeted banks will need to hold minimum levels of LTD in relation to various measures of their size (percent of risk-weighted assets, total leverage exposure, or consolidated assets). This means we will see more bond supply from the regional banks. Overall, we do not anticipate the incremental bond supply to materially affect either margins or existing bond spreads. The FDIC estimates a net interest margin (NIM) impact of approximately 3bps. Additionally, the extended three-year phase-in compliance period and the lower-than feared bond requirements bolster our confidence that credit spreads will remain stable.

Finally, it is important to incorporate these factors into our valuation matrix for the space. As of 9/5/2023, U.S. Investment Grade (IG) Bank Spreads(1) traded approximately 22bps back of U.S. IG Industrial Spreads(2). Looking back over the last 10yrs, the average relationship between these two buckets has been Banks trading 17bps *through* Industrials. Digging deeper into this, an equally weighted basket(3) of select U.S. Regional Bank bonds with maturities of around 10yrs traded 56bps back of similar basket(4) of U.S. GSIB bonds. This spread relationship has collapsed materially from the wides post SVB collapse of 125bps but remains well wide of the relationship prior to SVB's collapse, which was closer to 10bps *through*.

<u>BOTTOM LINE:</u>
Bondholders will benefit as regional bank management teams shift their focus. These banks will prioritize generating, preserving, and building capital, scale back on shareholder returns, and direct heightened attention toward liquidity profiles and underwriting quality. Taken in totality, these factors will result in a more secure forward landscape for bondholders as compared to what many current bond spread valuations imply. Security selection and avoidance will be imperative.



Source: Smith Capital Investors, Bloomberg (9/5/23)



Source: Smith Capital Investors, Bloomberg (9/5/2023)

References:

(1) *Barclays Investment Grade Banking Index*
(2) *Barclays Investment Grade Industrials Index*
(3) *Custom basket of equally weighted regional bonds*
   - *KEY 5.0 01/26/33*
   - *MTB 5.053 01/27/34*
   - *HBAN 5.023 05/17/33*
   - *USB 5.85 10/21/33*
   - *FITB 4.337 04/25/33*
   - *CFG 3.25 04/30/30*
   - *BK 5.834 10/25/33*
   - *PNC 6.037 10/28/33*
   - *CMA 4.0 02/01/29*
   - *TFC 5.122 01/26/34*
(4) *Custom basket of equally weighted GSIB bonds*
   - *JPM 4.912 07/25/33*
   - *BAC 5.015 07/22/33*
   - *MS 6.342 10/18/33*
   - *GS 3.102 02/24/33*
   - *WFC 4.897 07/25/33*
   - *C 6.27 11/17/33*

2. Debt and Deficits: *A Ticking Clock*

The recent wranglings in Washington around the debt ceiling gave many of us a healthy reminder that the U.S. Government runs deficits in both good and bad economic times. Keynes is likely rolling in his grave at the cavalier approach Washington is taking today and the MMT believers must be getting a little nervous. After all, it is not just the Debt/GDP ratio that matters. We are approaching absolute levels of debt not imagined in the past, and one could argue, are not sustainable for long periods of time.

Similar to S&P in 2011, Fitch chimed recently in to remind us all that AAA isn't just associated with the largest economy in the world, but that fiscal discipline is imperative to be associated with the highest of all credit ratings. While the market didn't flinch on the downgrade, it serves as a warning sign to the politicians that lack basic economic principles around the importance of cost of capital when one has significant debt. We highlight the debt levels and interest expense below, cutting short so many other details that could take up this entire report.

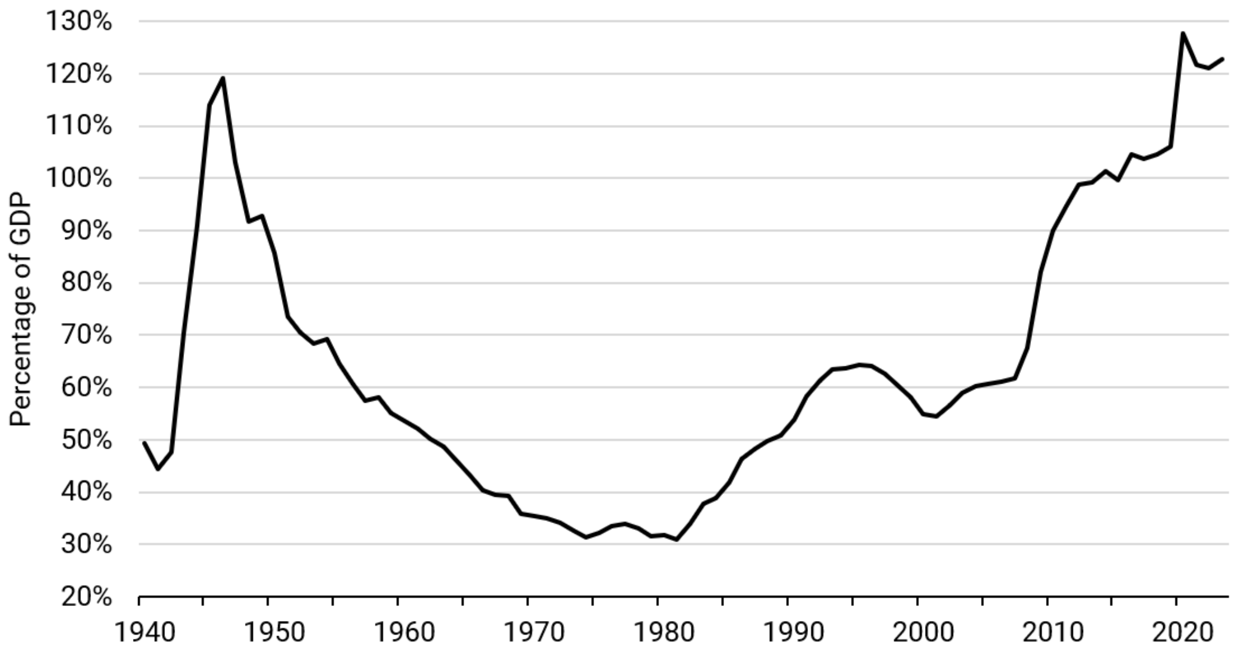
The simple equation equates to rising debt as we continue to run large deficits, with interest payments rapidly becoming a fiscal albatross. This condition is pushing the U.S. Government closer and closer into unstable financial territory at a time when strength and leadership are needed around the globe.

- **Interest payments on debt are almost equal to national defense spending**: The size of these interest payments constrain the federal budget, limiting flexibility in other crucial areas like education and healthcare.
- **Longer term CBO estimates indicate unsustainable growth in interest expenses**: Congressional Budget Office (CBO) projections point to a future where interest expenses could take up an increasingly larger percentage of the GDP, pushing the U.S. deeper and deeper into a weakened financial position.
- **Economic growth has not kept pace with the rise in debt**: The traditional safety valve where economic growth outpacing debt increases is faltering, intensifying the fiscal strain. While deficits may boost economic growth in the short term, the economy needs to be self-sufficient without fiscal intervention to truly facilitate debt reduction.

BOTTOM LINE:
The U.S. is on an unsustainable fiscal trajectory, with interest payments on federal debt evolving into a significant financial burden. The substantial issuance needed to finance the deficits will only serve to crowd out or raise the cost of capital on productive investment that is in dire need to fuel the long-term productivity of our economy. Longer term policy changes – either through fiscal tightening or changes in policies that stimulate GDP growth – are essential to avoid greater concerns around the financial state of the U.S. Government. The Fitch downgrade did not ignite much volatility or

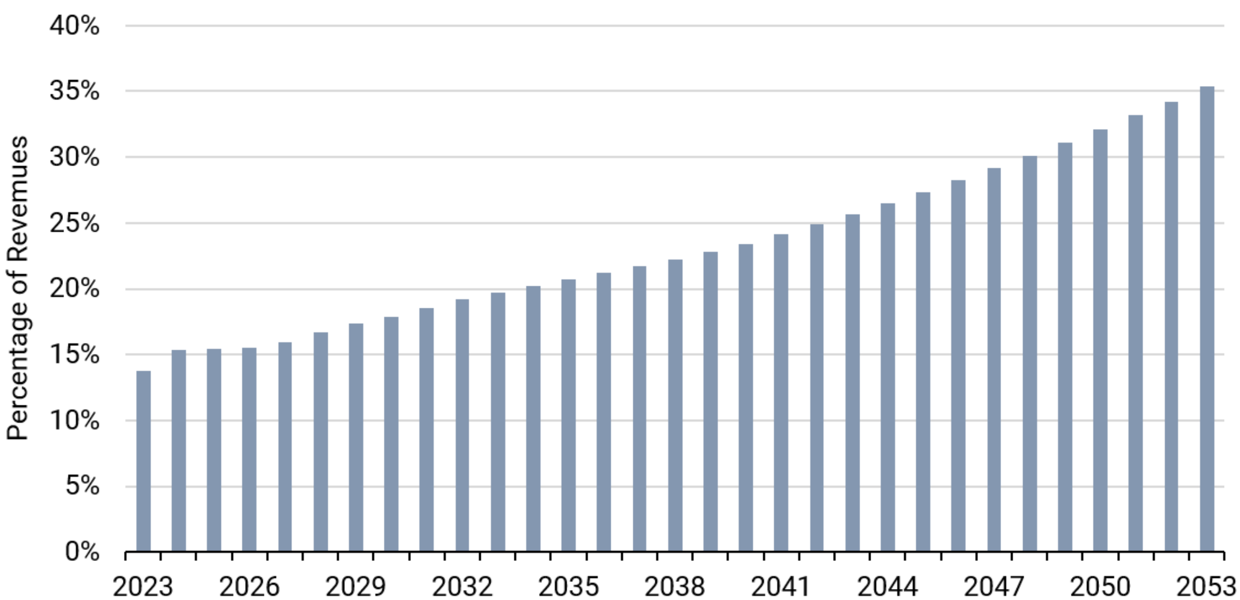
concern, but the warnings signs are worth noting. It is in times of complacency when we are most vulnerable.

Federal Debt as a Percent of GDP



Source: Smith Capital Investors, Federal Reserve Bank of St. Louis (3/30/2023)

Projected Interest Expenditures as a Percent of Total Federal Revenue



Source: Smith Capital Investors, Federal Reserve Bank of St. Louis (8/30/2023)

3. Forward Defaults – HY/LL and CMBS: *Risk on the Horizon*

After over a decade of minimal defaults across the U.S. credit markets, the forward outlook for stressed High Yield and Leverage Loan issuers as well as some CMBS sectors appears challenged. Declining fundamentals, cash flow, liquidity profiles, increased interest rates, and lower asset valuations will make debt repayment and refinancing a much bigger focus as the market approaches maturity walls over the next several years. We expect to see a gradual, but material pick up in defaults across asset classes going forward.

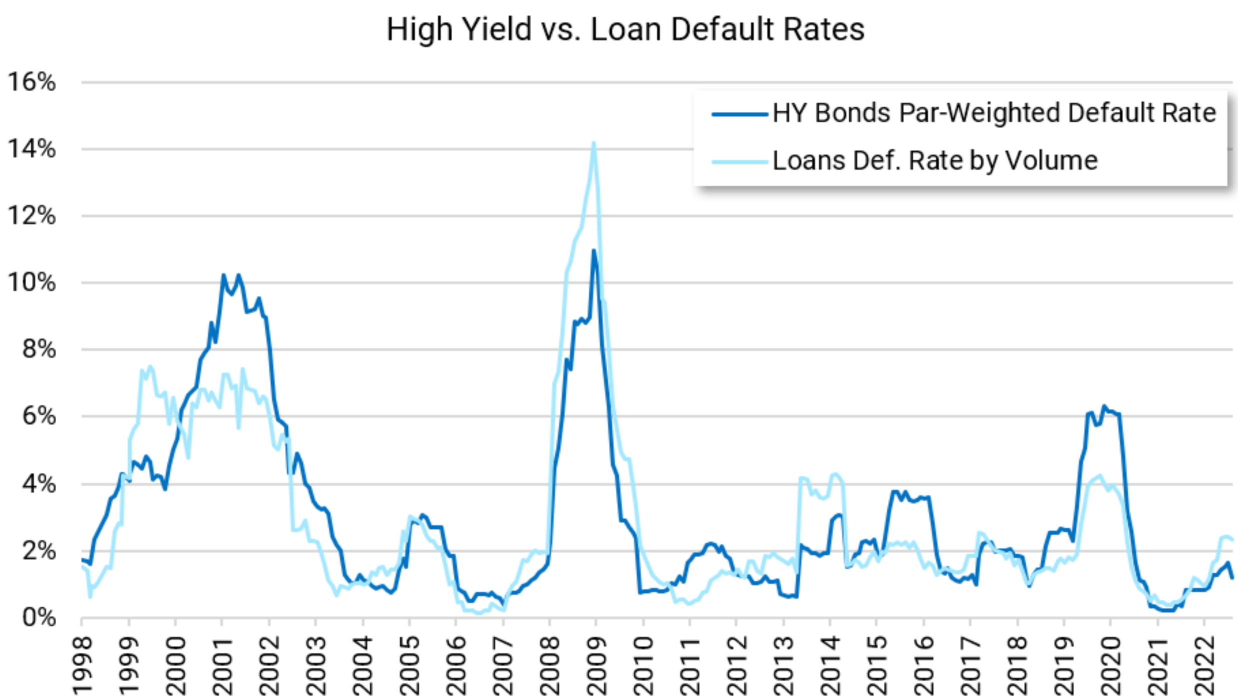
The last-twelve-month (LTM) default rate in High Yield is currently 2.4%, below the 30-year average of 3.2%. That said, we anticipate an uptick in the default rate due to deteriorating fundamentals. Specifically, interest coverage ratios – while still elevated relative to history – will continue to move lower as corporate interest costs reset to higher market rates, impacting the ability of companies to service debt. Another factor we consider is refinancing risks related to upcoming maturities. Following heavy refinancing activity in 2020 and 2021, near-term maturities were relatively small as a percentage of the market. That said, the recent rise in cost of capital has driven refinancing activity lower, resulting in $359bn of USD High Yield bond maturities over the next three years.

Leveraged Loan fundamental credit metrics are riskier on average than comparable High Yield issuers, with higher leverage ratios and lower interest coverage ratios. Due to the floating rate nature of Leveraged Loans, interest expense has risen much faster for loan-only capital structures than for bond-only issuers where interest expense is largely fixed until maturity. With riskier fundamental credit metrics, we would expect higher default activity in Leveraged Loans than in High Yield, a factor that can already be seen in the 2.92% LTM Leveraged Loan default rate. While the Leveraged Loan maturity wall looks slightly more benign than High Yield, with $343bn coming due over the next three years, we would caution that recovery rates upon default may be lower given elevated leverage levels. With CLOs accounting for around 65% of loan demand, the CLO market serves as a large source of liquidity for the market and can influence a company's ability to refinance their maturities. Watching CLO demand trends will be a key factor in determining refinancing risks in Leveraged Loans. That said, an estimated 50% of CLOs will be exiting the reinvestment period by the end of 2024. If new CLO originations are unable to fully offset this decline in demand, Leveraged Loan cost of capital and refinancing risk could increase.

The commercial real estate and CMBS markets have gained significant attention this year due to several pressing issues: declining asset values, rising cap rates, and looming higher financing costs as the maturity wall for the CMBS/CRE market begins to pick up in 2024. This clearly plays into our prior comments on regional banks given their higher exposure than their GSIB peers. These challenges are already leading to an uptick in early-stage delinquencies in commercial real estate. Different segments within this market are experiencing unique pressures. Notably, the office space sector is grappling with changing work trends and increasing vacancy rates. Additionally, we maintain concerns regarding the retail sector, particularly in non-prime locations, and the apartment segments. These concerns are rooted in the fundamental challenges mentioned earlier, along with evolving societal trends and a return to more realistic valuations after a prolonged period of inflated values. The market is beginning to reflect these concerns with the Bloomberg CMBS BBB rated Index trading at an OAS of 806 bps as of 9/5/23, almost in-line with the Bloomberg CCC High Yield Index at an OAS of 819 bps.

BOTTOM LINE:

Defaults are frequently preceded by unproductive capital allocation and unsustainable financial structures. They don't occur in a vacuum; they need a catalyst. The higher cost of capital in the system may just be that catalyst. Looking forward we see multiple headwinds for credit markets – upcoming maturity walls, challenged fundamentals, and revaluations. Highly levered companies and structures could be very vulnerable. The real question is not if, but when we will see default rates begin to accelerate. In this changing market environment, the importance of deep fundamental research, security selection, and avoidance will be critical for fixed income portfolio managers.



Source: Smith Capital Investors, J.P Morgan North America Credit Research (7/6/2023)

4. Real Rates and the Yield Curve: *The Fed's Balancing Act*

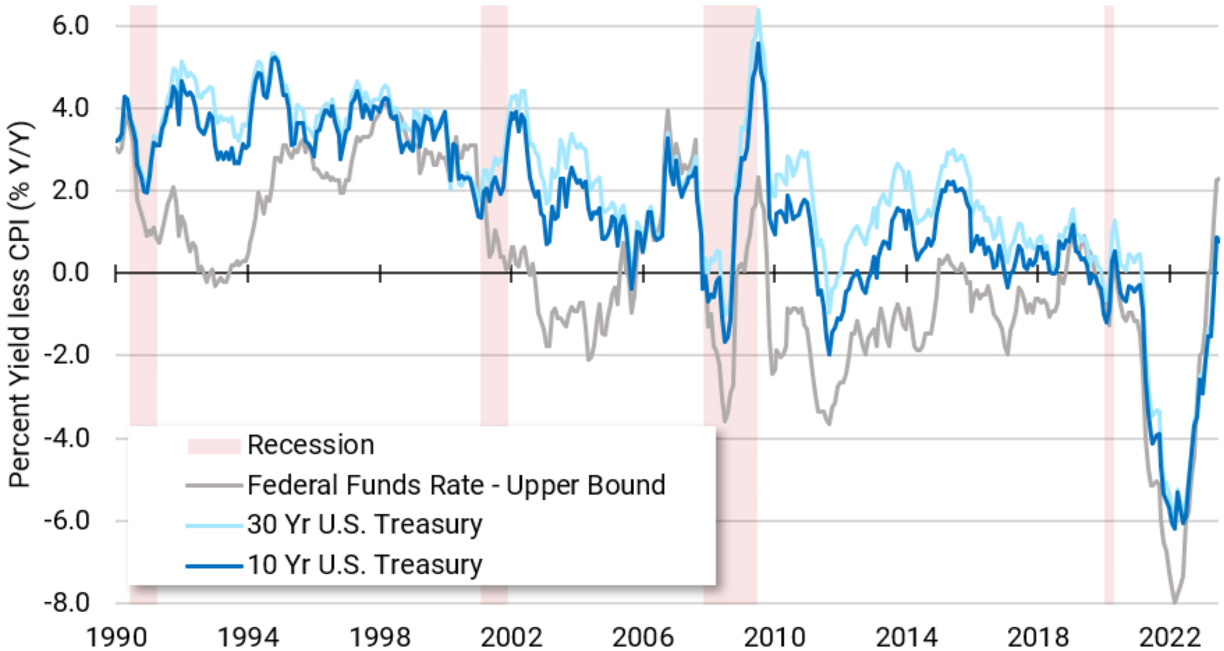
The reversal in The Federal Reserve's policies have ushered in a new era of positive real rates along the curve, offering new opportunities and challenges for individual investors and institutions. The reintroduction of positive real yield (on forward inflation) available in long duration securities has created one of the more attractive yield environments we have seen in fifteen years.

We find it fascinating that the end of the Central Bank's manipulation of bond markets – pushing negative real rates, inverting curves, and driving investors out the risk spectrum – has not triggered more pronounced volatility and lower valuations in risk assets as policy has shifted. Instead, the newfound positive real rates on government bonds have been met with even tighter spreads (see prior comments on default risk). Are positive real rates here to stay? We believe the answer lies in both technicals and fundamentals.

- **Positive real rates offer a better return profile and protection against changes in inflation expectations**: An environment of positive real rates gives investors the opportunity to earn higher returns on safer investments like government bonds. They also provide a shield against changes in inflation expectations.
- **Short Rates and QT**: The Fed, in addition to increasing short-term interest rates, has been reducing their balance sheet in an effort to tighten monetary policy and slow demand. This comes at a time when additional supply from the Fed is coinciding with growing needs for financing of large deficits, which is pressuring long rates. Elevated rates at a time when inflation is coming down has created the positive real rate environment.
- **An inverted yield curve poses challenges, particularly for banks**: An inverted yield curve can squeeze net interest margin (NIM), putting additional stress on bank profitability. In addition, higher rates can create short-term losses within portfolios, putting pressure on future lending activities. While the front end of the U.S. Treasury yield curve is anchored to Fed policy, the long end continues to flip between inflation and recession fears. The current inversion suggests a higher probability of recession, which is always subject to change. As inverted curves pressure various portions of the market, the risk of unintended consequences rises. This may be a future catalyst for a recession and could undo a lot of the Fed's work in bringing real rates into positive territory.

BOTTOM LINE:
As the Fed adjusts interest rates to control inflation, fixed-income markets are likely to experience increased volatility. The new era of positive real rates offers relief for individual investors but heralds more volatility and other challenges. The yield curve inversion creates distortions in the financial markets as it relates to funding costs and can create challenging outcomes for levered and yield-seeking investors. A careful eye on monetary policy and yield curve management will be crucial going forward.

Real Rates Since 1990



Source: Smith Capital Investors, Bloomberg (9/1/2023)

5. China: *Uncertainty and Opportunity*

While we have long been skeptical of the integrity of data from the Chinese Government, the recent economic setbacks and growing concerns about the country's leveraged expansion over the past two decades are hard to ignore. This leads us to wonder about the impact of developments in the world's second-largest economy on the U.S. economy.

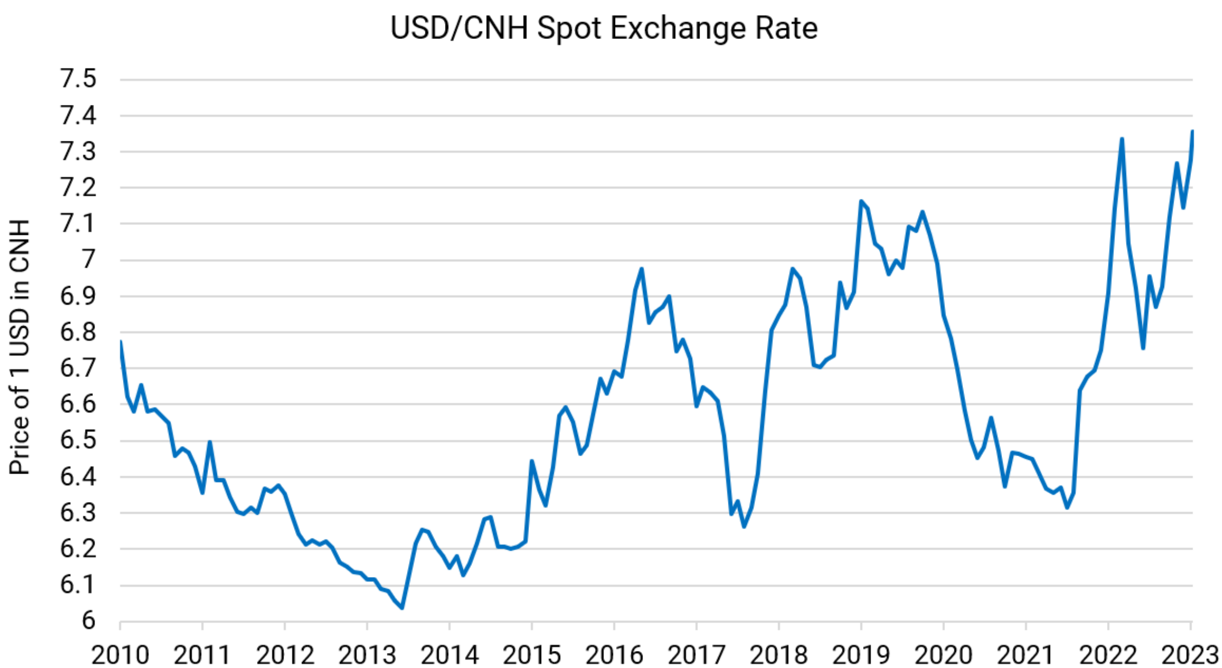
The mounting structural and demographic issues within China seem to be compounding its recent economic weakness, and the historical fiscal and monetary safety net provided by the Government has shown limited response. This has many market participants scratching their heads. The signs of strain created by a declining property market and increasing household debt are obvious to many today. These developments come at a time when the Yuan (RMB) is trading toward the lower end of its historical valuation band against the U.S. Dollar.

Avoiding a rapid currency depreciation is crucial for China. However, a slightly weaker currency benefits the Chinese Government as they address their post-Covid production and trading challenges. We see many risks but also offer avenues for course correction, both internally and externally.

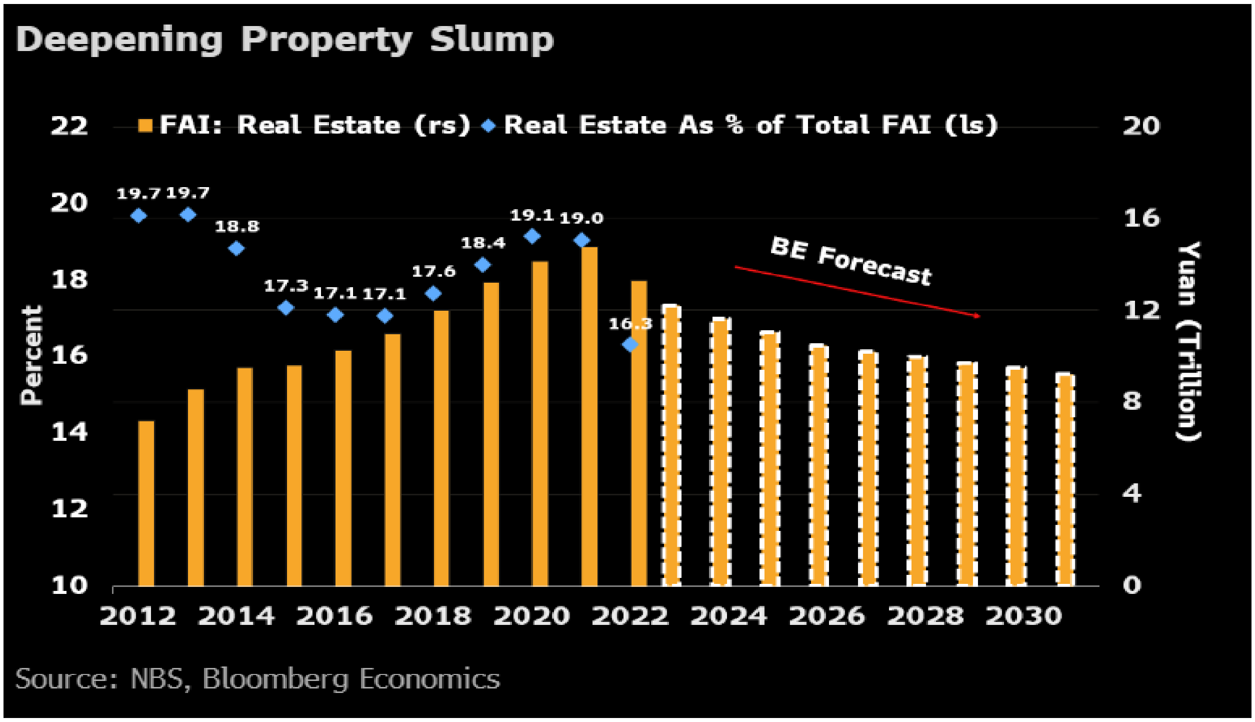
- **Declining property market and household debt are alarming signals**: The cooling of China's once-hot property market since 2021 is contributing to an economic slowdown. The onset of this slump was ignited by China's effort to reduce the economy's overreliance on real estate, estimated at ~20% of GDP, which resulted in tighter credit standards and lower mortgage underwriting. Fast forward to today, the result has been the failure of property developers and rising household debts, primarily mortgage debt, which is driving downward revisions in GDP growth forecasts.
- **Rising unemployment and decreasing exports highlight economic woes**: Key economic indicators such as unemployment and exports are showing troubling signs, suggesting that China's economic engine is sputtering. The employment outlook has quickly darkened, highlighted by the service sector shedding 12 million jobs between FY20-22, which was the driver of robust growth prior to the onset of the pandemic. Additionally, youth unemployment reached 21.3% in June before the government suspended the release of data (wonder why?).
- **The Government still has levers for stimulus and course correction**: As of today, China's government continues to retain multiple levers to boost stimulus back into the economy. Stimulus support remains below comparable levels to the GFC and onset of the pandemic. Currency management seems to be on the front burner for the Government, recognizing that there is a direct relationship to the currency and the attractiveness of the goods they produce for the world.

BOTTOM LINE:

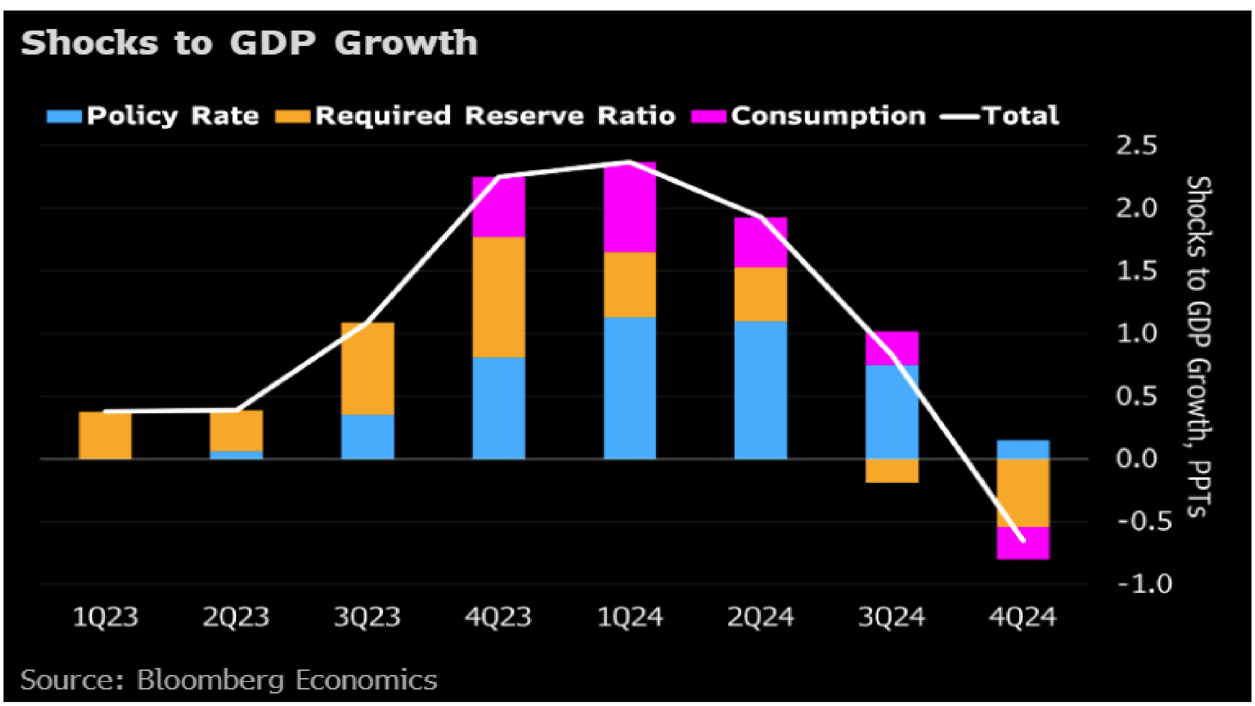
China's economy continues to grow, but remains constrained by failing property developers, rising debt levels, accelerating youth unemployment levels and increasingly cautious household spending. While integrity of the data released by China's government has come increasingly into question, it is clear there are many issues for China to navigate through the vast economic and social challenges ahead. And if not addressed, a currency issue likely lies in the future. On the positive side, China has been an excellent exporter of deflation, something almost all Central Bankers are seeking today. We are watching closely.



Source: Smith Capital Investors, Bloomberg (9/8/2023)



Source: Bloomberg China Insight (9/5/2023)



Source: Bloomberg China Insight (9/1/2023)

5+ Events That We are Watching
in 2H 2023

1. Real Wage Growth: *The Resilience of the American Consumer*

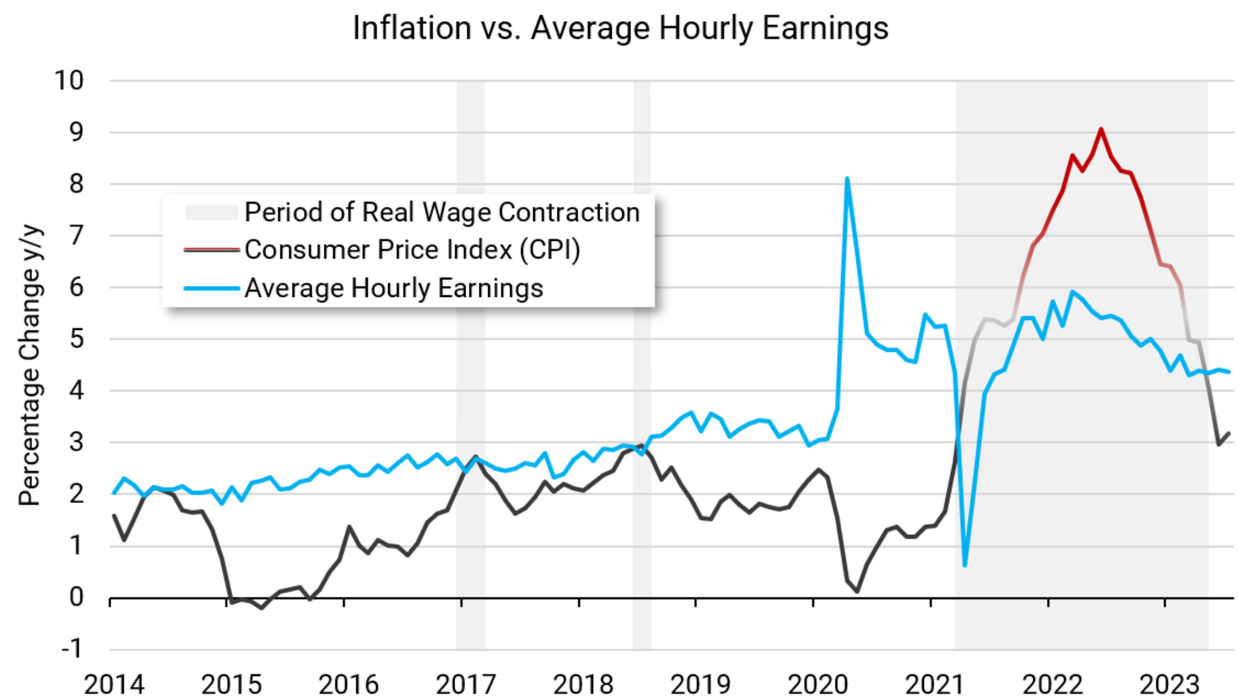
Real wage growth (the change in average hourly earnings, adjusted for inflation) has been a critical indicator through the post-Covid inflationary period and the monetary policy tightening cycle that followed. Typically, real wages should grow at a rate that at least matches inflation to facilitate a strong economy. However, from April 2021 to April 2023, inflation outpaced wage growth, leading to a period of decline in 'real' wages.

- The Consumer Price Index (CPI) and Average Hourly Earnings (AHE), both provided by the U.S. Bureau of Labor Statistics, serve as key metrics for assessing the real wage landscape. **Over the past two years, CPI has consistently exceeded the growth in AHE**, effectively eroding the purchasing power of the American consumer.

- Recent data, however, indicates a shift. **Real wages have begun to grow again** as inflation rapidly declined from its mid-2022 peak. Based on the latest reports from the U.S. Bureau of Labor Statistics, average hourly earnings increased by 4.3% from August 2022 to August 2023, while CPI grew 3.2% over the same period. As shown in the chart below, the deceleration of CPI has allowed for inflation-adjusted average hourly earnings to turn back positive, currently at 1.1%.

Looking at these dynamics back to the mid-2010s, we can see that the rate of growth in nominal wages for the U.S. worker has moved structurally higher, in a step-change from the pre-pandemic norm of a gradual ascent. With inflation on the decline, one would presume that the pace of wage growth will slow as well, but **the question remains: Can positive real wages – an important measure of the health and confidence of the consumer – be sustained?**

<u>BOTTOM LINE:</u>
The resilience of the American consumer has been tested over the past two years, with real wages falling behind inflation. While recent data indicates a positive shift, it does not necessarily signal a long-term trend. Each period of economic fluctuation is unique in its underlying causes, duration, and overall impact. The current uptick in real wages does, however, indicate that consumers are faring better in the short term – a potential catalyst that may influence broader economic policies. The steadiness in average hourly earnings, even as inflation rates begin to decline, offers a glimmer of hope but also calls for cautious optimism. If inflation continues to decrease without a corresponding increase in wages, the real wage dynamic could once again tilt unfavorably, putting the American consumer back at risk.



Source: Smith Capital Investors, U.S. Bureau of Labor Statistics (8/10/2023)

Source: Smith Capital Investors, U.S. Bureau of Labor Statistics (8/10/2023)

2. Labor Has the Upper Hand: *The Fed vs. The Worker*

Multiple labor strikes have recently settled with large wage gains for unionized workers, reflecting continued strength of the labor market. The early wins have spurred further action from union organizers, and labor negotiations have found their way across multiple industries including airlines, logistics, autos, and construction. We expect these recent labor negotiation outcomes to factor into Fed policy decisions.

Unraveling labor market dynamics reveal a distinct trend in wage increases stemming from successful negotiation outcomes across diverse sectors. The U.S. Department of Labor's proposal aims to broaden overtime pay protection, potentially impacting around 3.6 million additional workers making under $55,000 annually. In the aviation industry, American Airlines pilots' ratified contract paves the way for wage gains of up to 46% over the next four years, showcasing both the industry's resurgence and pilots' enhanced bargaining power. Notably, UPS averted a strike through a deal with the Teamsters Union, granting drivers an average of $170,000 in pay and benefits after five years. The United Auto Workers also presented a lofty 46% wage hike proposition in negotiations with Detroit automakers, mirroring a broader push for substantial wage increases. These major labor wins have spurred further activity among unions and workforces across the country as workers push for better pay and benefits. Even though Unions only represent about 11% of workers, there will likely be some pay gains that leak into other non-union industries, underscoring heightened worker influence amid a robust labor market.

Nancy Lazar of Piper Sandler summed it up brilliantly:
Unions Are Just 11% of Workers, So Big Wage Settlements Don't Matter.

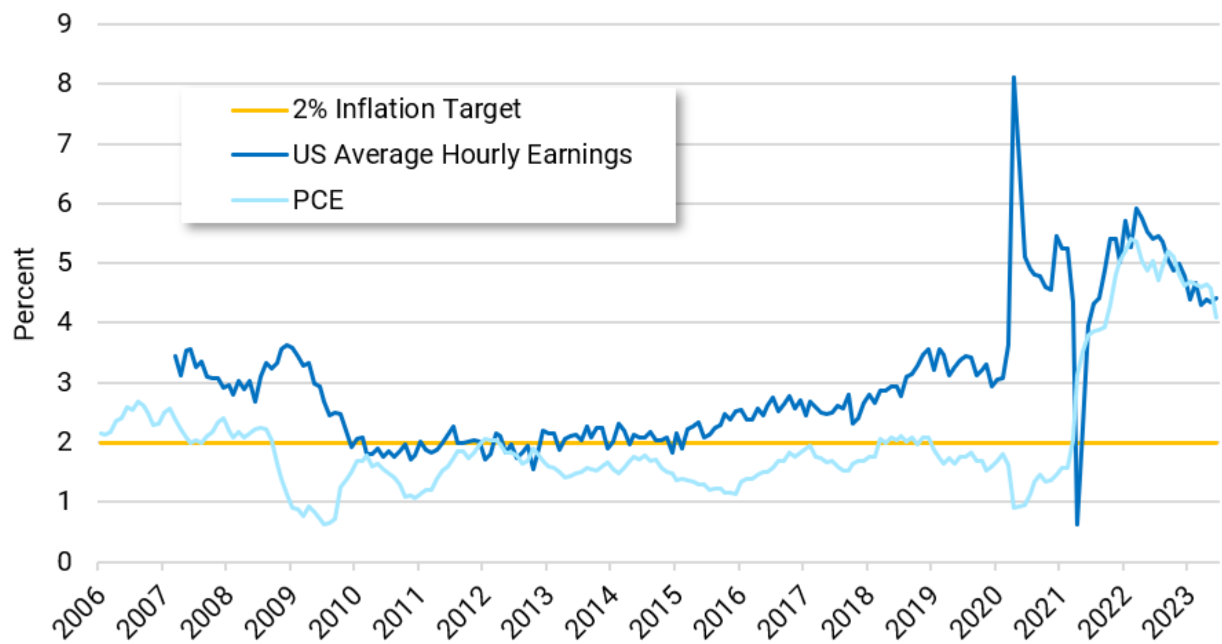
> *We're often asked what the biggest pushback is to our call, including our concern of sticky inflation. One is that unions represent just 11% of all employees, therefore their huge wage increases won't drive overall wage inflation. No question, non-union wages will NOT increase 10% y/y, which UAL & AAL pilots will see in each of the next 4 years... and the UAW is seeking. And August average hourly earnings rose just 0.2% m/m, but are still up at a 4.3% annual rate over the past 6 months, which is historically rapid, consistent with a still tight labor market.*
>
> *We'll just have to agree to disagree with those who aren't concerned about the huge union pay increases … companies are being forced to grant those big wage packages because labor is still tight. Some pay "contagion" to non-union workers is likely.*

To bring inflation back down to the Fed's 2% target, nominal spending needs to be brought back into line with the productive capacity of the economy. This can be accomplished by slowing wage growth, increasing savings rates, or a combination of the two. Wage growth, as reflected by U.S. average hourly earnings year over year change, continues to remain historically high at 4.3% y/y. U.S personal savings rate as a percentage of discretionary income has increased from lows in 2022, but remains historically low at 4.5%. Nominal GDP growth – 70% of which is driven by consumption – has moderated since peaking in 2021, but also remains higher than the pre-pandemic, post-GFC period. So far, the tightening cycle has failed to bring the softness to the labor market required to fully quell inflation, and expectations for corporate profits seem to argue against broader weakness in labor conditions. Forward 12-month S&P 500 EPS estimates indicate a 5.58% growth from current levels. Expected growth in corporate profits would suggest that labor market conditions are unlikely to soften to the extent necessary for the Fed to wave the 'all-clear' signal regarding its focus on bringing inflation down to its stated goal. Stickiness in the last few miles towards its 2% inflation target may warrant more restrictive actions to reduce demand and tighten financial conditions further.

BOTTOM LINE:

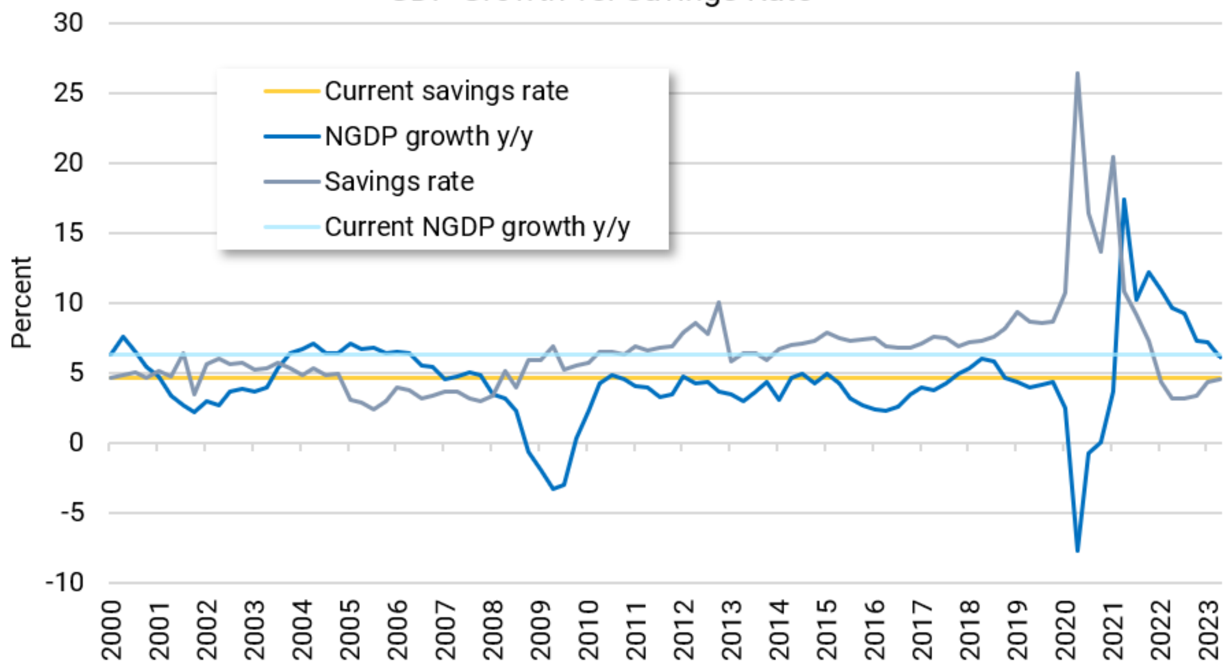
Fed Chair Jerome Powell has widely telegraphed the need to see softening in labor market conditions and a decline in consumption to gain confidence in seeing a sustained drop in inflation back to target levels (2%). The substantial wage gains won by unions and other segments of the economy could pose a threat to the Fed's fight against inflation as it fuels higher consumption via wage gains. Higher consumption amid a tight labor market would likely necessitate a continued hawkish stance until either the data begins to soften, or companies react by finding cheaper alternatives to human capital. Either way, it is unlikely that the Fed can successfully execute on its fight against inflation while keeping the labor market strong and unemployment at historic lows. We are preparing for inflation to settle out above the target rates in the near term, but question if a rising unemployment rate will provide the balance the Fed needs.

Wage Growth vs. Inflation



Source: Smith Capital Investors, Bloomberg (8/31/23)

GDP Growth vs. Savings Rate



Source: Smith Capital Investors, Bloomberg (8/31/23)

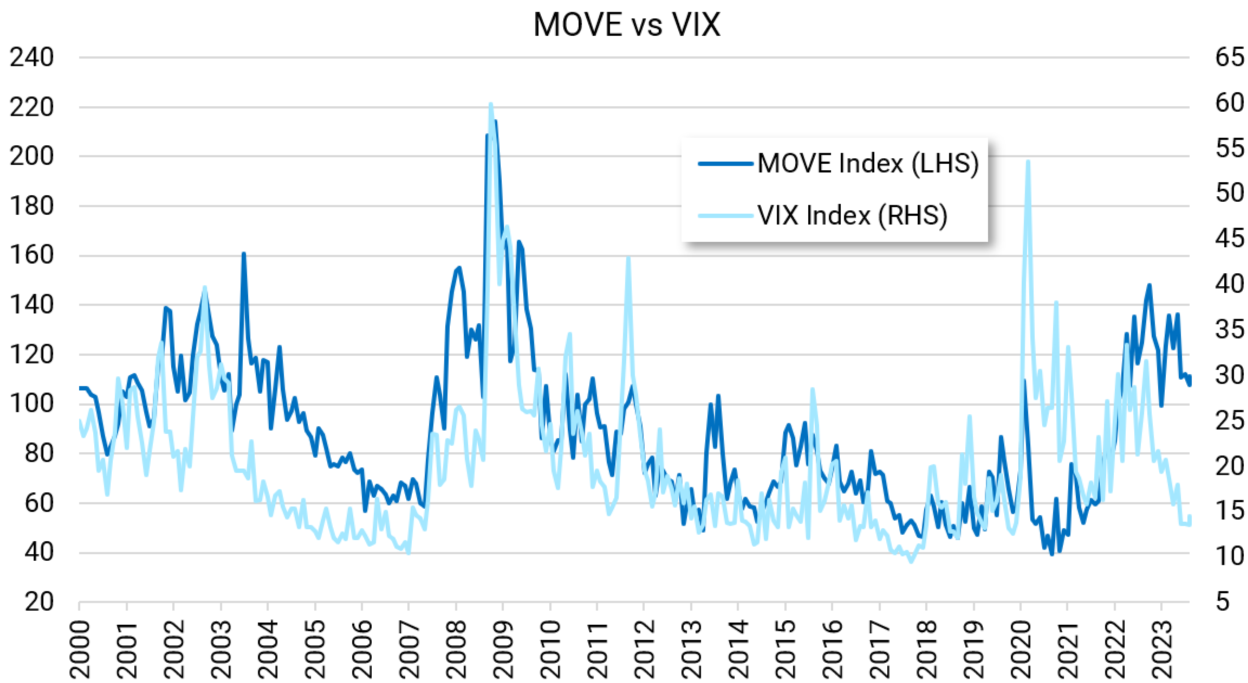
3. Volatility in Equities and Rates: *Higher For Longer?*

In 2023 thus far, we have witnessed a notable divergence between the MOVE index, consistently elevated above 100, and the VIX, which has settled in the low teens akin to the pre-Covid era. This stark contrast highlights the complexity and uncertainty in today's financial markets. Economic data remains volatile, fiscal deficits are a cause for concern, and the Fed's data-dependent policies – along with persistent inflation – add incremental layers of unpredictability. We see a high probability for volatility to remain elevated, particularly in the bond market, as we head into the back end of 2023 and into 2024.

- **MOVE vs VIX**: The divergence between the MOVE index, which measures volatility in bond markets, and the VIX, a gauge of implied stock market volatility, reveals disjointed perceptions of risk across financial markets. While the VIX has settled back in the low-teens pre-pandemic range, the duration the MOVE index has been above 100 has not been seen since the Great Financial Crisis.
- **Stock and bond correlation:** Given this disparity, investors need to consider changes in the correlations between stocks and bonds and the speed at which this can change in higher volatility regimes. Looking back to the collapse of Silicon Valley Bank in March, stock and bond correlations quickly flipped as we saw the flight to quality trade take hold. This was a welcome counter-trend shift to the largely positive stock and bond correlation we have seen since the settling of inflation and onset of the Fed’s tightening cycle.
- **Fed's Data-Dependent Policies**: As the Federal Reserve moves to a more data-dependent mindset, the frequent adjustments to their guidance – influenced by economic indicators – add another layer of uncertainty and complexity. Markets may react strongly to each data release, contributing to the volatile landscape.
- **Fiscal Concerns**: Adding to the complexity are current U.S. fiscal policies, especially in relation to deficits. High levels of government debt and deficit spending may have a pronounced impact on interest rates and equity markets, serving as a potential trigger for further increases in volatility.

BOTTOM LINE:

The path forward is going to be challenging to navigate in both fixed income and equity landscapes. Investors need to factor in higher levels of volatility and rapid changes in historical correlations into their asset allocations. This should result in higher liquidity premiums, creating new opportunities in the public markets and a forced re-evaluation of the liquidity premiums in private markets. It is in this uncertainty where active management stands to capitalize on the wider range of potential outcomes offered by heightened levels of volatility. We were also reminded during the SVB debacle that the U.S. Treasury market, with its newfound positive real rates, can serve as an insurance policy against unexpected events and volatility, providing a ballast to a portfolio.



Source: Smith Capital Investors, Bloomberg (9/6/23)

4. The Two Largest Economies: *Moving in Different Directions*

We have highlighted the importance of understanding China. Today, with these two major economies diverging in growth and monetary policies, as economic uncertainty rises, we question whether the increased interconnectedness will spill over into the U.S. and weigh on the global economy.

- **Interdependence**: The Trump Administration's trade war policies in 2018 significantly reduced U.S. imports from China. The COVID-19 pandemic also highlighted our dependence on China for essential goods. According to Bloomberg estimates, tariffed imports under Section 301 from China to the U.S. have declined ~37%, whereas tariffed imports from the U.S. to China have experienced a less significant drop of ~15% over the same period. Non-tariffed imports paint a different picture. While non-tariffed U.S. imports have surged in line with pre-trade war projections, China has actively reduced its broad-based reliance on the U.S., with non-tariffed imports from the U.S. dropping by an impressive ~17%.

- **Economic Warfare:** Over the past two decades, the U.S. has typically relied on sanctions to express its policy views on China. Recently, however, there has been a shift towards a new strategy: export controls aimed at limiting U.S. investment in China. These export control measures could function similarly to sanctions, potentially imposing a growing regulatory burden on a wider range of industries than before.

- **Global Trade:** The Wall Street Journal reported that China is estimated to have ~70% dependence on the U.S. to source over 400 products. Based on global trade data for FY22, the U.S. and its allies are positioned to potentially leverage their collective influence to counter Chinese economic coercion. As the U.S. and allies address China's economic practices and reduce supply chain dependence, we may see the implementation of additional economic restrictions. These could take the form of measures like targeting tax incentives, imposing penalties, and establishing early warning systems to discourage certain actions by China.

BOTTOM LINE:
While it may seem on the surface that the U.S. has been making progress in reducing its economic ties with China, a closer look reveals a more complex and concerning reality. Recent headlines might have instilled confidence in the steps taken to 'de-risk' the U.S. economy from China, but these actions also come with new risks. The initial wave of trade rebalancing policies initiated by the Trump Administration in 2018 and the recent shift toward higher-risk, targeted export restrictions have provided some reassurance. However, a broader perspective shows that, aside from tariffed imports, the U.S. remains reliant on China, just as China relies on the U.S. Recent tensions in this relationship have significant implications for the global economy and financial markets, demanding close attention. These issues highlight the interconnected nature of today's markets, where trade, deficits, inflation, and currency markets are all influenced by the relationship between the world's two largest economies. We closely monitor

developments in the RMB and the Dollar as they play a pivotal role in this complex relationship."

Source: Bloomberg China Show Signs of Decoupling from U.S. as FDI Trade Falls (9/7/23)

Source: Bloomberg China Show Signs of Decoupling from U.S. as FDI Trade Falls 9/7/23

5. Leading Indicators and Financial Conditions: *Is This Time Different?*

Leading economic indicators are a measure for the future health of the economy. We get relevant data from confidence, manufacturing reports, and hiring among other indicators. Historically these are great indicators for future recessions. An inverted yield curve has traditionally been a pre-condition to a recession and fairly accurate recession indicator. Many of these measures point toward a weakening in economic conditions and slower growth on the horizon. But is history on our side this time?

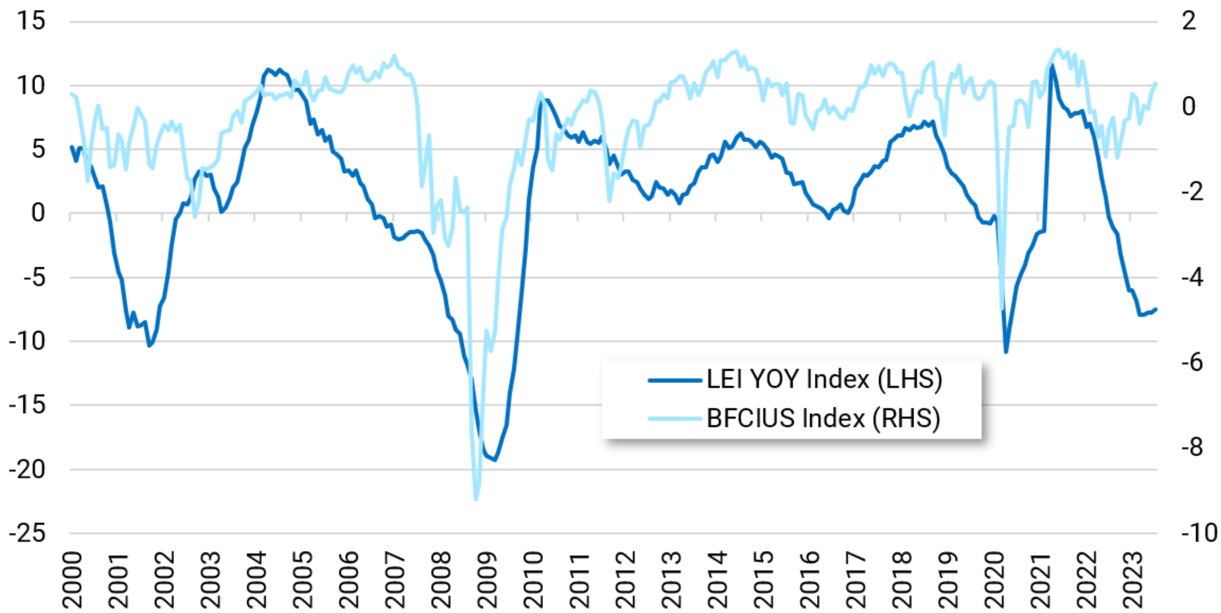
Financial conditions are another measure of our economic health utilizing metrics from interest rates, bond markets, and equity markets – tighter financial conditions suggest an attempt to slow demand/growth while looser financial conditions suggest support for growth. We are in a very mixed state where leading economic indicators and the yield curve both suggest a recession, while financial conditions remain fairly neutral, if not supportive of growth. We find it interesting that the Fed's attempt to tighten financial conditions has not put pressure on leading indicators in a manner historical patterns might have suggested.

- **Leading Indicators**: Current economic metrics present a complex picture, with some pointing towards a potential recession while others suggest robust growth. Overall, we have been pleasantly surprised at the strength of the economic foundation throughout the volatility generally associated with an aggressive Fed tightening cycle.
- **Yield Curve**: Traditionally a reliable predictor of economic trends, the U.S. Treasury yield curve may be losing its predictive power in the current economic climate with a still reasonably tight labor market, a strong underlying economic foundation, and the remaining post-Covid liquidity in the system. The question is whether stability can continue long enough to smooth the unintended consequences of the Fed's tighter monetary policy. The Fed and other global central banks' use of unconventional monetary policies (QE) is clearly having an impact on the curve and may just be the reason that the yield curve's predictable forecasting is being questioned today.
- **Financial Conditions**: Financial conditions are trending near historic averages and are holding up relatively well considering expectations around the economic backdrop. While we acknowledge that indicators like stock market performance, interest rates, and credit spreads may offer conflicting views, overall financial conditions are supportive of the economy in an environment where the Fed has raised rates over 500bps in 18 months.

BOTTOM LINE:
The question we must ask – is it different this time? We have had an unprecedented and swift move higher in the Fed Funds rates off a zero-interest rate policy with minimal damage, while still growing and creating jobs. Historical indicators are screaming recession; however, we recognize that we need to evolve in the way we read these,

acknowledging that this is a completely different economic backdrop than previous periods. This is a complicated period to be an economic forecaster. We find that we need to step back and remind ourselves that the economic data is all part of a mosaic. We must closely analyze what we are experiencing in real time and recognize that the introduction of unconventional economic policy that started during the GFC has forced us all to consider that *it might just be different this time*. Or maybe the timelines for economic cycles are dramatically different than in the past. We also must be careful in being guided by market-based indicators that may be misaligned with what is really playing out in the economy. It is easy to say, these are interesting times on the macro front.

Leading Economic Indicators vs. Bloomberg Financial Conditions



Source: Smith Capital Investors, Bloomberg (9/7/23)

Bonus - Post Earnings Themes: *Proceed with Caution*

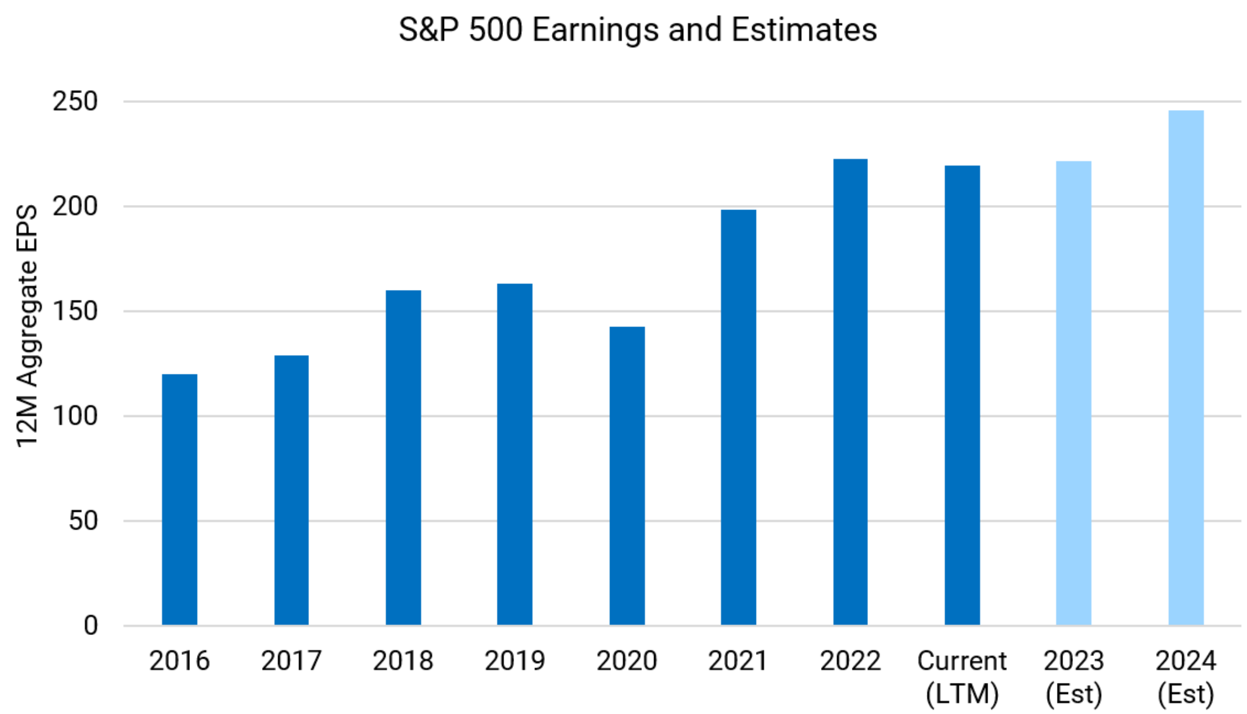
Following 2Q earnings we continue to believe that, while there are pockets of resiliency, corporate fundamentals are likely to deteriorate from current levels due to incremental pressures on revenue growth and margin pressures in the form of rising labor costs and higher cost of capital.

Consensus estimates currently call for 4-5% revenue growth for S&P 500 companies in the back half of 2023 and in 2024. While this type of growth may be achievable, we see potential for more headwinds than tailwinds. One of the main drivers of top line growth has been price increases, which are likely to slow and potentially turn negative as consumer savings dwindle, credit conditions tighten, student loan payments resume, and inflation for base goods and services eats into discretionary income. We see evidence of foot traffic declines and consumer trade-downs in 2Q retail earnings as reinforcing our skepticism here. For companies with international exposure, economic weakness abroad in Europe and China could also translate into lower demand.

Consensus estimates for 2024 S&P 500 earnings per share (EPS) call for margin expansion, with EPS expected to grow 10% from 2023. While margins may see year-over-year expansion due to lower commodity input costs, companies will have to contend with rising labor costs, a key component in our service-driven economy (U.S. average hourly earnings +4.3% in August). Companies will also be facing higher costs of capital, either through quarterly coupon resets on floating rate instruments or the refinancing of fixed rate debt at higher interest rate levels.

If revenue growth falters or margins contract, we could see pressure on corporate credit metrics such as leverage and interest coverage. In this scenario, we would expect management teams to pivot capital allocation priorities away from growth initiatives and share repurchases in favor of building resiliency and optionality – either by paying down debt or by increasing liquidity. We see many management teams that are starting to recognize the power in having a strong balance sheet.

BOTTOM LINE:
While we see evidence of storm clouds gathering for corporate fundamentals, consensus S&P 500 estimates see a much rosier outlook, currently calling for 10% growth in 2024 EPS. We believe this mismatch in expectations warrants caution in corporate credit – especially when considering lending to higher-levered entities. Businesses that need to grow into their capital structure seem vulnerable, and highly-levered entities will be significantly impacted by the higher cost of capital. That said, the resiliency of individual credits varies widely. As bottom-up fundamental credit investors, we believe our focus should be on businesses with higher margins, strong fundamentals, robust balance sheets, and management teams dedicated to deleveraging. This is a bond-pickers market.



Source: Smith Capital Investors, Bloomberg (9/7/23)

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SCI00396