



## Wealth Management

**Viewpoint | May 2023**



# Executive Summary

**- The one thing that separates amateurs and professionals, speculative gamblers from prudent investors, or the skilled from the lucky (Page 2),** is how they think about risk and/or probabilities.

**- Our best guess is that the debt ceiling is temporarily extended, likely in the 11th hour. (Page 3),** . . . And while we anticipate that a final deal would then be reached in September, we can't shake the nagging feeling that this debt ceiling showdown *feels* a little different than past episodes.

**- What we have is a lower probability, high impact outcome; an asymmetrical risk or one-way door. (Page 4),** . . . for most investors the fourth choice is the correct one; weather the volatility.

**- Q1 2023 real GDP growth was announced at 1.1%, annualized. (Page 6),** Down from 2.6% in Q4 2022 and below our forecast of 1.6%, but there is some nuance in this report.

**- There is evidence that these consumption patterns are easing and losing momentum, (Page 7),** especially as consumers' accumulated savings are eroded and a greater reliance on credit is needed to finance further consumption.

**- Bond investors have come into 2023 facing ongoing uncertainties with respect to the inflation outlook as well as the response from Fed policy. (Page 13),** Moreover, bond

investors have to add new uncertainties with respect to the U.S. debt ceiling and bank sector sagas to the mix . . .

**- Treasury securities in maturity closest to the so-called X-date will begin to trade with an "uncertainty premium." (Page 13),** Indeed, this is exactly what we have seen as the yield for the 4-week Treasury bill escalated significantly over the past week.

**- While we recognize the potential for volatility with respect to the coming twists and turns of the ongoing debt ceiling saga, (Page 16),** we are of the mindset that U.S. Treasury obligations ultimately remain "money good" and would caution against taking significant portfolio actions in an attempt to alleviate any associated fears that may exist.

**- We are adhering to our "close to home" strategy (Page 16),** of maintaining a duration position of 95% to 100% of the Bloomberg U.S. Aggregate Bond Index.

**- 1Q23 earnings season is off to an as-predicted start, (page 18),** with multiple companies reporting moderate year-over-year earnings declines and slow-to-no revenue growth.

**- Historically, stocks have led the economy out of economic weakness, (page 18),** typically bottoming during the middle of the downturn.

## Asset Class Outlook

Equity	Current	Previous	Fixed Income	Current	Previous
US Equity - Large Cap	Slightly Unfavorable	Slightly Unfavorable	Invest. Grade Credit	Neutral	Neutral
US Equity - Mid Cap	Neutral	Neutral	Treasury/Agency	Slightly Favorable	Slightly Favorable
US Equity - Small Cap	Slightly Favorable	Slightly Favorable	Mortgage Backed	Slightly Favorable	Slightly Favorable
Int'l Equity	Slightly Favorable	Slightly Favorable	Commercial MBS	Slightly Favorable	Slightly Favorable
Emer. Mkts	Slightly Favorable	Slightly Favorable	Asset Backed (ABS)	Favorable	Favorable
			High Yield	Unfavorable	Unfavorable
			Emer. Mkts. Debt	Slightly Unfavorable	Slightly Unfavorable
			Taxable Muni	Slightly Favorable	Slightly Favorable
			Tax Exempt	Unfavorable	Unfavorable
			TIPS	Neutral	Neutral

Real Assets	Current	Previous
Real Estate	Neutral	Neutral
Infrastructure	Neutral	Neutral
Commodities	Slightly Favorable	Slightly Favorable

## One-Way Doors

*“The essence of investment management is the management of risks, not returns.”*

-Benjamin Graham

Increasingly the debt ceiling debate is becoming a top-of-mind concern for more investors. And since the old Wall Street saw is that markets can only focus on one thing at a time, we outline our best “educated guess” on potential outcomes and market implications below.

But we also want to take this opportunity to discuss how investors should think about risk more broadly. The opening quote, initially shared by Ben Graham in his seminal *Intelligent Investor*, originally written in 1949 and praised by Warren Buffett as “by far the best book on investing ever written,” is a good place to start. (For what it is worth, this writer would still highly recommend Ben Graham’s book, which has been revised and reissued multiple times and is still available for sale today. With the exception of the Bible, *Intelligent Investor* is probably the book this writer most regularly returns to for re-reading in order to be reminded of important first-principles.)

After two decades of working with investment portfolios *and* investors, perhaps the one thing that separates amateurs and professionals, speculative gamblers from prudent investors, or the skilled from the lucky is how they think about risk and/or probabilities. Put another way, amateur investors think first and foremost about the *size* of the potential return. Prudent investors instead think primarily about risk (or probability and magnitude of outcomes) and if the risks/probabilities are appropriately priced.

For most investors this is applied through asset allocation for their retirement portfolio. Whether during the accumulation or disbursement phase, utilizing long term asset class deviations (market price fluctuations, or “risk”) and average historical returns a portfolio can then be constructed with target allocations for each major asset class. (This can be easily achieved with a solid financial planning tool like Blueprint, and with guidance from a qualified advisor/financial planner.) The goal is to improve the odds, the probability, of achieving life goals. But the process is risk-based; it is trying to reach the mark with the lowest possible level of risk.

When we think about single market events, like a debt ceiling driven default of U.S. Treasury debt, they can also be run through a risk/probability and return/magnitude decision process. One of the first steps is trying to ascertain if the risk is symmetric/balanced (what we might call a “two-way” door) or if the risk is unbalanced or asymmetric (a “one-way” door). The magnitude of the gain/loss is also an important component. A coin-toss is an example of a perfectly symmetric risk—a 50% chance of a favorable or unfavorable outcome. A lottery or Russian roulette are asymmetric: low odds of a particular outcome with hugely impactful positive payoffs or, conversely, devastatingly negative costs. (There are a number of books that speak to these probability mindsets, should you need an addition to your summer reading list. Favorites include Peter Bernstein’s *Against the Gods* and Nasim Taleb’s *Fooled by Randomness*. But one of the more popular, and fun to read, is Annie Duke’s *Thinking in Bets*.)

The specter of a U.S. debt default is shaping up to be a one-way door. If the debt ceiling is not raised—a function of congressional lawmaking signed by the President for enactment—this puts the U.S. Treasury in the position of no longer being able to issue debt to fund fiscal spending—also enacted law—which continues to run at a deficit. (The U.S. has, with the exception of a brief period in the late 1990s/early 2000s, continued to run a fiscal deficit since the 1970s.) Part of that spending is to pay interest on debt already accrued, as well as return of principal when U.S. debt matures. In other words, if the U.S. Treasury is not able to issue new debt, the ability to pay existing debt as well as other obligations is called into question. The U.S. is then likely to default on its debt, or at least certain tenors/maturities of its debt.

## Market Insights & Asset Allocation

*Clay Nickel, CPM®*

Treasuries are held widely by U.S. citizens and entities and non-U.S. based governments, businesses, investment funds, and individuals. Some of this is due to the worldwide desire for U.S. Treasuries as dollar denominated instruments and as a function of trade, but much is also attributed to the perceived safety and strength of U.S. government debt, the U.S. economy, and our strong adherence to the rule of law.

It is also important to understand the role of U.S. Treasuries in the global financial system. Treasuries debt, and short-term Treasuries in particular, are the preferred form of collateral for much of the short-term lending that facilitates money transfer, liquidity, and healthy functioning of the U.S. financial system (and economic systems by extension). We frequently refer to this as the “plumbing” of the U.S. economic structure.

No one knows for sure what a U.S. default might mean for all of the above. We do not have a template for it since we’ve never considered defaulting simply from an unwillingness to pay our debt. (The U.S. still has the capacity to pay. Unlike defaults from insolvent developing nations that can no longer pay—Argentina comes to mind—the U.S. retains the ability to pay, it just may decide not to as a result of political brinkmanship and/or ideology.) So we are left with our best educated guesses, but they are still guesses!

Currently, while nebulous and evolving, our best guess is that the debt ceiling is temporarily extended, likely in the 11th hour as we approach an estimated early June “X-date” when the U.S. Treasury will run out of money if they cannot issue new debt. Early anticipation is that the suspension or an increase would run to the end of September when a fiscal package would need to be put in place to fund government operations next year. (The U.S. Government’s fiscal year runs Oct. 1–Sept. 30.) It appears unlikely that the opposing sides in the debt ceiling/budget debate will be able to reach an agreement by June since our lawmakers have an ample vacation schedule over the summer and will only be in session for 7 or 8 days in May. (There is some comfort that congressional and White House staff members are meeting, as these deals tend to be hammered out in such close-door meetings with highly capable staffers.) And while we anticipate that a final deal would then be reached in September, we can’t shake the nagging feeling that this debt ceiling showdown *feels* a little different than past episodes due to a different make-up and ideological bents of sizable congressional factions.

So what would potential outcomes, or guesses at these potential outcomes, look like?

First, a default would cast a pall on the Dollar’s global hegemonic position as the premier reserve currency. But since there is not a viable alternative, any erosion in the U.S. Dollar’s standing might be at the margin only. Similarly, U.S. Treasury holdings may become less desirable going forward (even if the debt ceiling was raised and holders of defaulted U.S. Treasury debt were made money-good), and that could increase the interest rates going forward—our debt becomes more expensive to service. Again, this is also likely to be marginal since new alternatives to U.S. Treasuries are not readily available. Of course there could be a “tail event” that seriously erodes confidence in both the Dollar and U.S. Government debt that cannot be ruled out.

The real issue in our mind is the financial plumbing. Most of us don’t think about the web of counterparty collateral agreements within the U.S. and global financial systems. Just like we don’t think about the water and sewer pipes in our homes...unless we have a problem. And if you ever had a pipe break, or the sewer back up, you can’t think of anything else until it is resolved.

Likewise, without rock solid collateral backing counterparty risk, the inner workings of the financial system could seize up. This would not only affect Treasury prices, but every risk asset would also be in danger of steep price declines. While the cause would be different, the outcome might be similar to what we acutely experienced in the fall of 2008. One could assume that such a calamity would cause the Congress and the White House to quickly come to an agreement (fingers crossed!), but there would likely be some lingering repair for markets and financial institutions.



## Market Insights & Asset Allocation

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So, back to thinking in bets, the magnitude of the outcome given a U.S. debt default would be severe. But the probability? Here there is understandable uncertainty. Currently financial markets are pricing a low 3% probability of a default (based on an extrapolation of U.S. Treasury Credit Default Swap prices). But markets have learned that 11th hour deals are common, and so they don't seem inclined to panic until 11:59 and 59 seconds. Yet, reliable political analysts are placing as high as a 40% probability that an agreement, including a simple agreement to suspend the debt ceiling until later this year, may not be reached. (personally, anything north of 20% is uncomfortably high.)

Essentially, what we have is a lower probability, high impact outcome; an asymmetrical risk or one-way door. Normally the choices for an asymmetrical risk are to 1) avoid it—but this is not an option since a U.S. default would have wide reaching effects. 2) So we then look to insure against it. For investors who hold risk assets, derivatives, typically options, can be purchased to transfer the risk (albeit the price of such instruments have already gone up considerably). But these instruments can be complex and are not necessarily appropriate for most non-institutional investors (in other words, they are “don't attempt this at home” instruments).

The third choice is to mitigate the risk. For investors who require regular income from an investment portfolio, and particularly those who make principal withdrawals to fund regular living expenses, raising some extra cash in advance of a possible default X-date would be prudent. This is not a recommendation for a wholesale liquidation! Market turmoil as a result of a U.S. default would likely be resolved shortly and resulting market sell-offs could be estimated to be repaired in weeks or months, not years. As a result, for most investors the fourth choice is the correct one: weather the volatility.

If you have years left for your investment horizon, you take the other side of the low probability bet. You play it. Use any market weakness to rebalance (sell high/buy low) and let time in the market do its compounding work. If we are thinking in terms of probability, don't forget that in the long-game of investing, diversified risk assets go up more often than they go down, and by much more. Or in the words of legendary investor Peter Lynch:

***"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."***



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Clay is responsible for the strategic investment direction of advisory and trust department models and portfolios, which are managed by members of Arvest Wealth Management Portfolio Management and Research. He oversees the development of capital market assumptions, the development and management of asset allocations, research on mutual funds, ETFs and outside managers, and communication of investment strategy to Arvest Wealth Management associates and clients. A graduate of Wichita State University, Clay has completed Columbia University's Academy of Certified Portfolio Management and is a member of the Chartered Financial Analyst Institute and Kansas City Society of Chartered Financial Analysts.

## Current Economic Snapshot

### Quarterly & Fiscal Year GDP Growth (Average Annual)

Source	<u>FY23</u> (Forecast)	<u>1Q23</u> (Actual)	<u>2Q23</u> (Forecast)	<u>3Q23</u> (Forecast)	<u>4Q23</u> (Forecast)	<u>1Q24</u> (Forecast)
Bloomberg	1.10%	1.10%	0.10%	-0.90%	-0.30%	1.00%
AWM/IMG	1.16%	1.10%	0.80%	-0.55%	-0.60%	-0.10%

Sources: Bureau of Economic Analysis; Methodology: Average Annual Return; Bloomberg; Copyright 2022 Bloomberg Finance L.P.

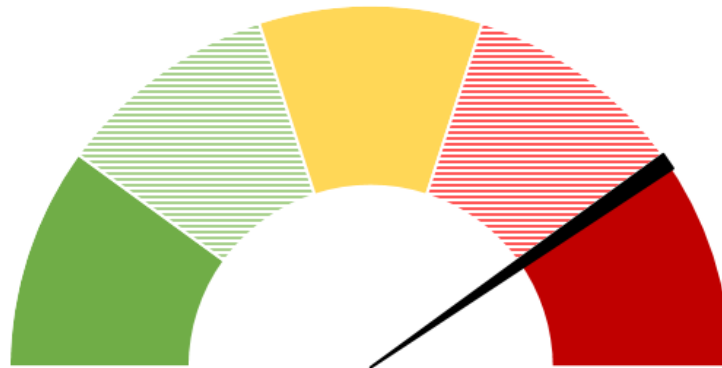
### Investment Management Group's Recession Indicators

Indicator*	Current	Previous	Short Term Trend	Long Term Trend
CB Leading Econ. Indicators	-7.80%	-6.50%	Negative	Negative
3-Mon./10-YR. Yield Curve Spread	-1.73%	-1.39%	Negative	Negative
New Orders-to-Inventories	-0.6	-3.2	Negative	Negative
Cap. Goods New Orders	+1.6	+3.0	Negative	Negative
Initial Jobless Claims	242k	228k	Neutral	Positive
New Building Permits	1,413k	1,524k	Neutral	Neutral

Sources: Bloomberg; Copyright 2022 Bloomberg Finance L.P.

\*See the Appendix for description of each indicator

### Investment Management Group's Recession Pressure Gauge



### Time for a Pause?

When we last published in April, Silicon Valley and Signature Banks had failed (a combined \$320B in assets, making them the second and third largest bank failures in U.S. history), were taken into FDIC receivership and their assets sold off to the highest bidder. At the time (and corroborated by usage of the Federal Reserve's discount window and bank term funding program) it appeared that these failures were idiosyncratic in nature given the proportion of these banks' uninsured deposits to total assets (as well as the proportion of the asset side of the balance sheet held in loans and held to maturity securities, which are carried at book value), making them particularly vulnerable to deposit flight.

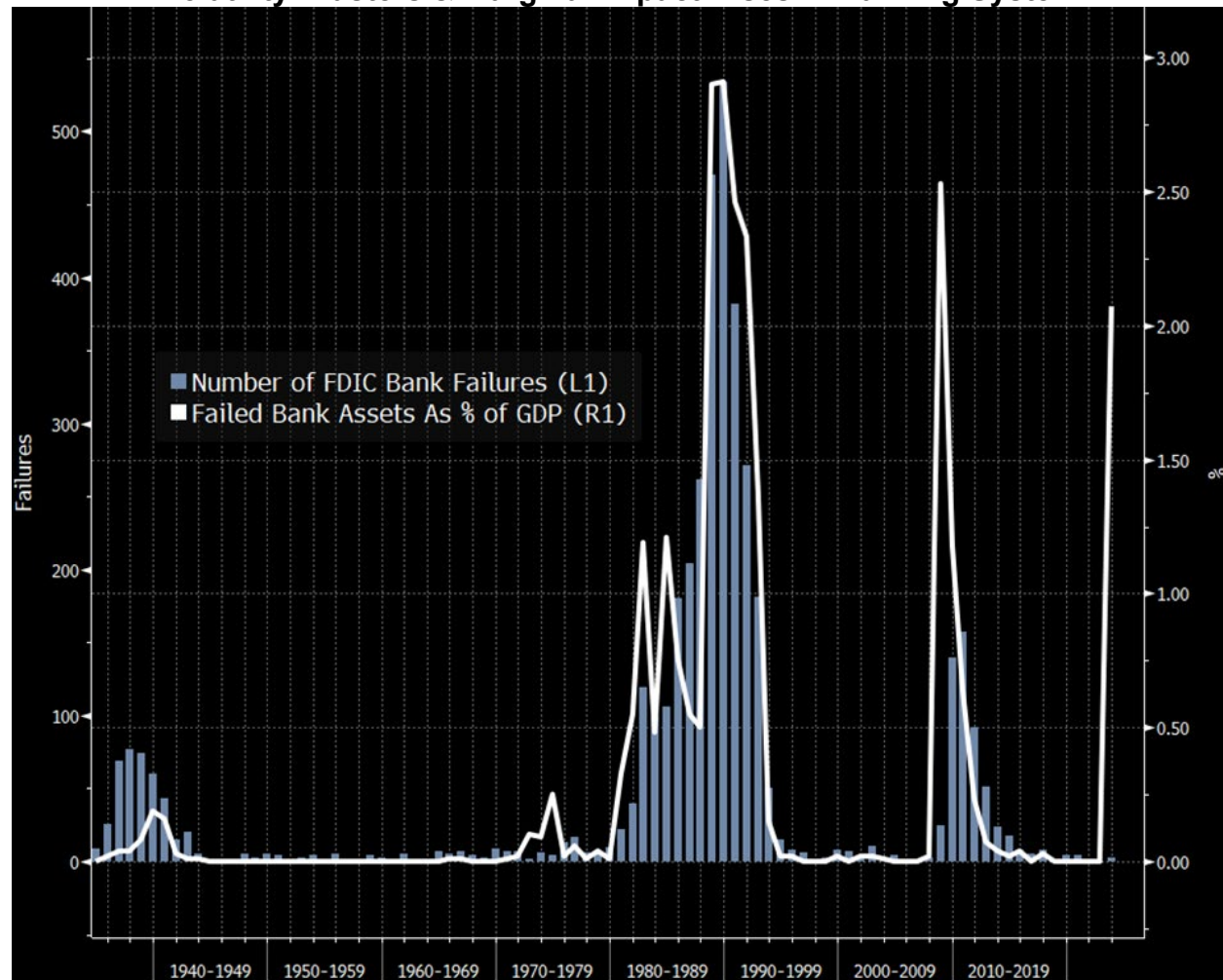
The calendar has flipped to a new month and the latest victim of the current monetary tightening cycle has been claimed. First Republic Bank was taken into FDIC receivership on May 1 and its assets (~\$40B) absorbed by JP Morgan. At the time of this writing, rumor is swirling that PacWest and Western Alliance Bancorp (which have seen their stock prices drop 80 and 63%, respectively since March 1) may be the next banks to fail (this is all before the risks from CRE holdings begin to materialize; see chart below). This is all taking place against the backdrop of a U.S. debt ceiling limit debate, which if breached without resolution, would cause untold harm to financial markets globally. My colleague, Dennis Whittaker, has put together a slide deck and talking points that

## Economic Indicators

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speak to facts. Please reach out to your advisor for a copy of either or both. Suffice to say that risks abound. Among them is a labor market that appears to be cooling, but is still quite robust, and a consumer that remains resilient despite weakening in household balance sheets and a tightening in credit conditions.

### Volatility Clusters & Marginal Impact Rises in Banking System



Source: Federal Deposit Insurance Corporation; Bloomberg; Copyright 2023 Bloomberg Finance L.P.

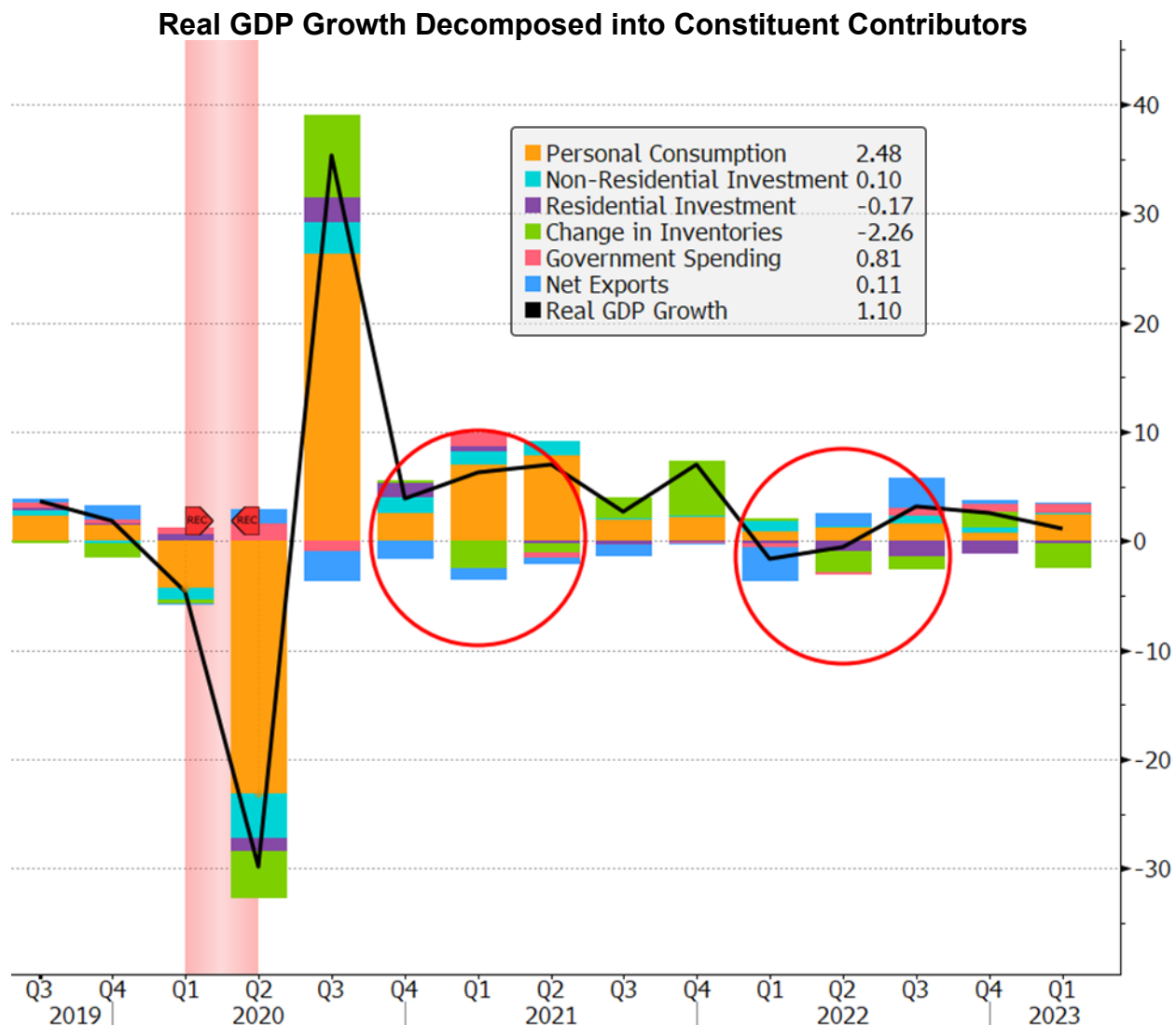
Q1 2023 real (inflation adjusted) GDP growth was announced at 1.1%, annualized. This figure was down from 2.6% in Q4 2022 and below our forecast of 1.6% (and consensus estimates of 1.9%), but there is some nuance in this report. The most obvious was that real consumer spending rose about 3.7% in the quarter, which contributed 2.5% to real GDP growth (nearly all this spending occurred in the first month of the quarter) and was a marked improvement from Q4 2022 where personal consumption only contributed 0.70% to GDP growth. Residential direct investment contracted 4.2%, the eighth consecutive quarterly decline in that segment. The remaining components were mixed, with government spending remaining consistent and net exports and non-residential investment increasing.

The major drag to GDP growth has once again metastasized in a significant draw down in inventories. Circled in the chart below, we observe that this has been something of a recurring theme. First occurring in the first two quarters of 2021 amid the scramble for goods and once again in the middle quarters of 2022. Businesses accumulated approximately \$137B of inventories in Q4 2022, however, inventory levels declined by approximately \$1.6B in Q1 2023. We believe that some of this effect may reverse as inventory cycles normalize in the quarters to come and could provide a boost to the headline GDP figure, but we also acknowledge that we

## Economic Indicators

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may be in the stage of the cycle where businesses elect to let inventories draw down. It is important to note that final sales to domestic purchasers (a measure that strips out the effect of inventories) increased a robust 3.2% in Q1 2023.

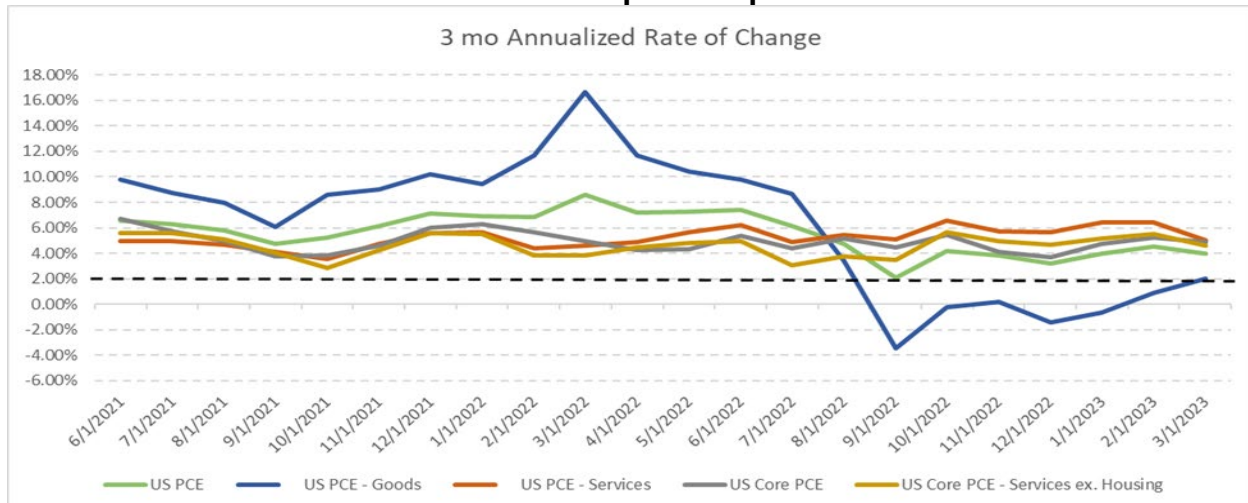


Source: Bureau of Economic Analysis; Bloomberg; Copyright 2023 Bloomberg Finance L.P.

It should be noted that while personal consumption did increase at a respectable clip, much of this consumption occurred in January (which was an abnormally warm month for portions of the Midwest, Southeast and Northeast), and there is evidence that these consumption patterns are easing and losing momentum, especially as consumers' accumulated savings are eroded and a greater reliance on credit is needed to finance further consumption (especially at a time when rates are near or at their cyclical highs). This is evidenced by the Personal Consumption Expenditure (PCE) figures in the chart below. Beside goods prices, which deflated quickly and have since recovered, we see the headline, core, and core services ex. housing (the Fed's preferred measure) figures all coalescing near the 4% mark on a 3-month annualized basis. This, of course, is not the 2% target that the Fed desires to see, and there is still a fair amount of debate over whether monetary policy is sufficiently restrictive to take prices down to 2%. Given the rapid deterioration in many leading economic indicators (please see the Recession Indicators chart on page one) and the knowledge that monetary policy works with long and variable lags, we are of the mind that monetary policy is indeed sufficiently restrictive (and has been so since late last year), going so far as to posit that policy makers may have overtightened conditions, not allowing the economy a reasonable amount of time for demand and supply to come back into equilibrium.



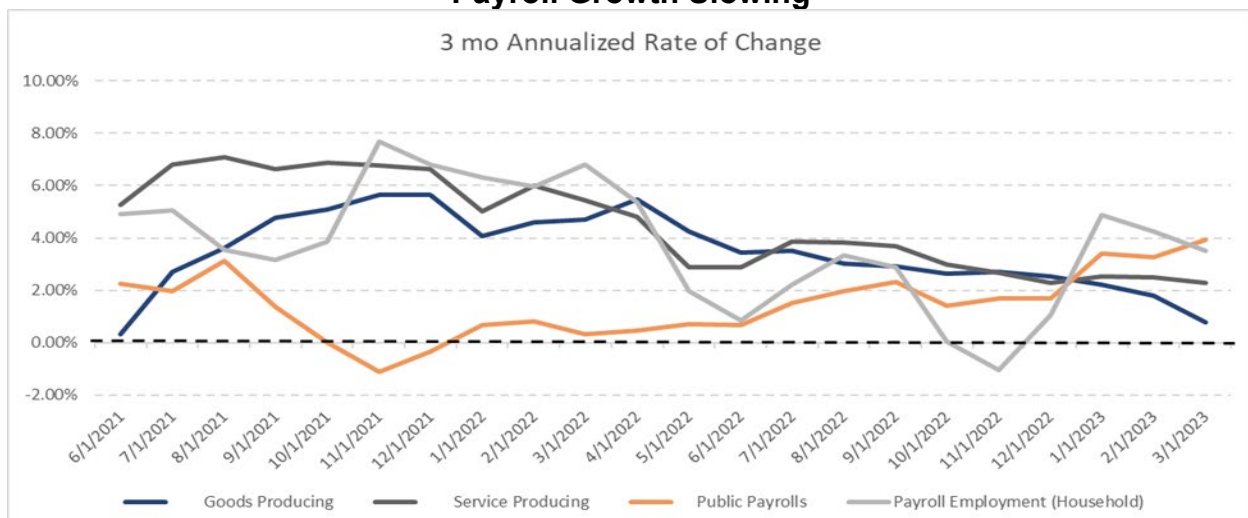
## Personal Consumption Expenditures



Source: Bureau of Economic Analysis; Bloomberg LP; Arvest Portfolio Management and Research

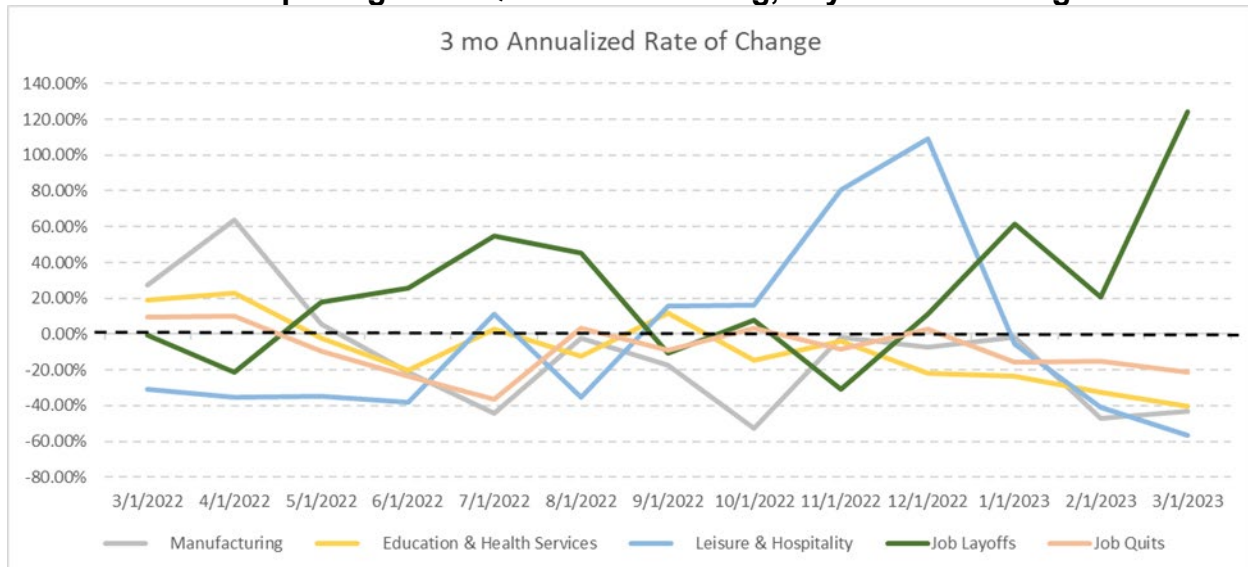
Much will depend upon how long the labor market can remain imbalanced (a topic we have discussed a number of times, but still bears revisiting every couple of months) and the proportion of excess savings/availability of credit and the overall health of consumer balance sheets. In the chart below, we see that the trend growth in payrolls, both from the Establishment Survey as well as the Household Survey is declining, albeit at a gradual pace with some volatility (The April Jobs report showed the economy added 253k jobs, but the February and March data were amended downward by a combined 149k jobs). In addition, we see that the prime age participation rate is now 0.20% higher than the pre-pandemic level (83.3% v 83.1%) and the 3-month annualized rate of change in part time workers is now -10.33%. If history serves as a guide, we do typically witness sizable revisions to job creation around significant pivot points in an economy, and we view the jobs figures presented in April (and revisions to February and March data) as well as the figures from January to fit this pattern.

## Payroll Growth Slowing



Source: Bureau of Labor Statistics; Bloomberg LP; Arvest Portfolio Management and Research

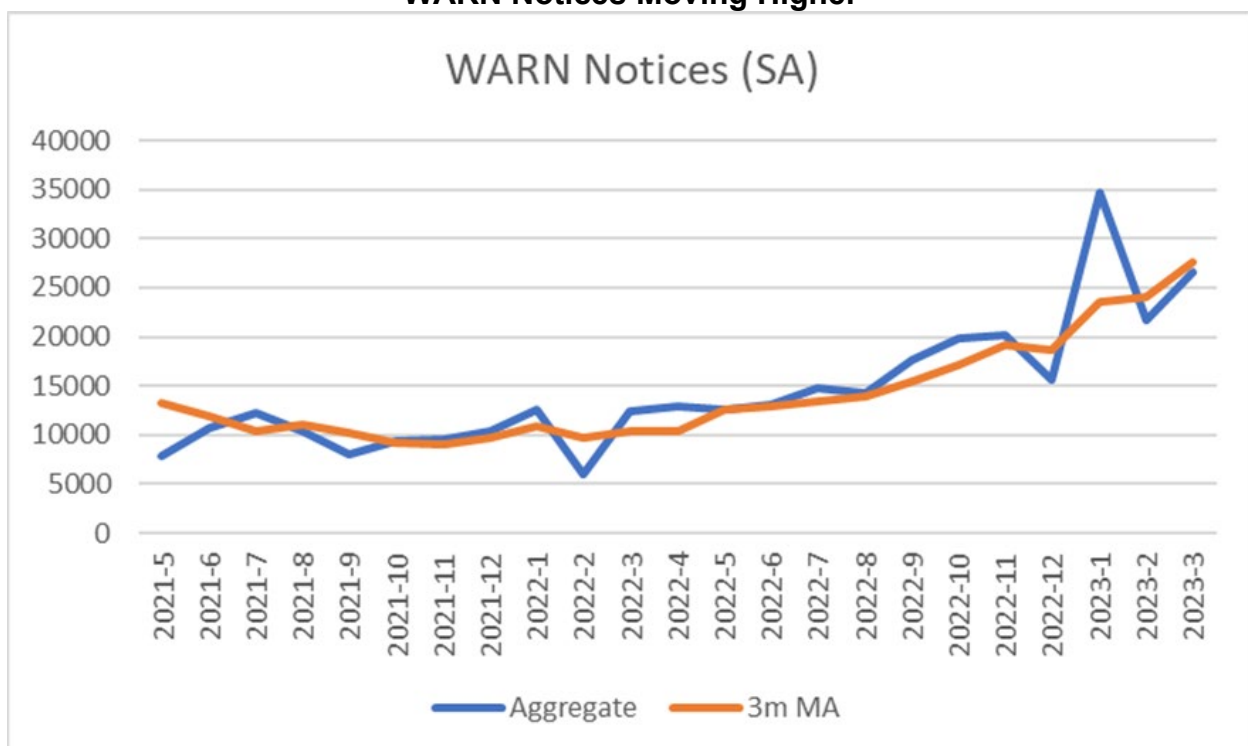
## Job Openings and Quits are Declining, Layoffs Increasing



Source: Bureau of Labor Statistics; Bloomberg LP; Arvest Portfolio Management and Research

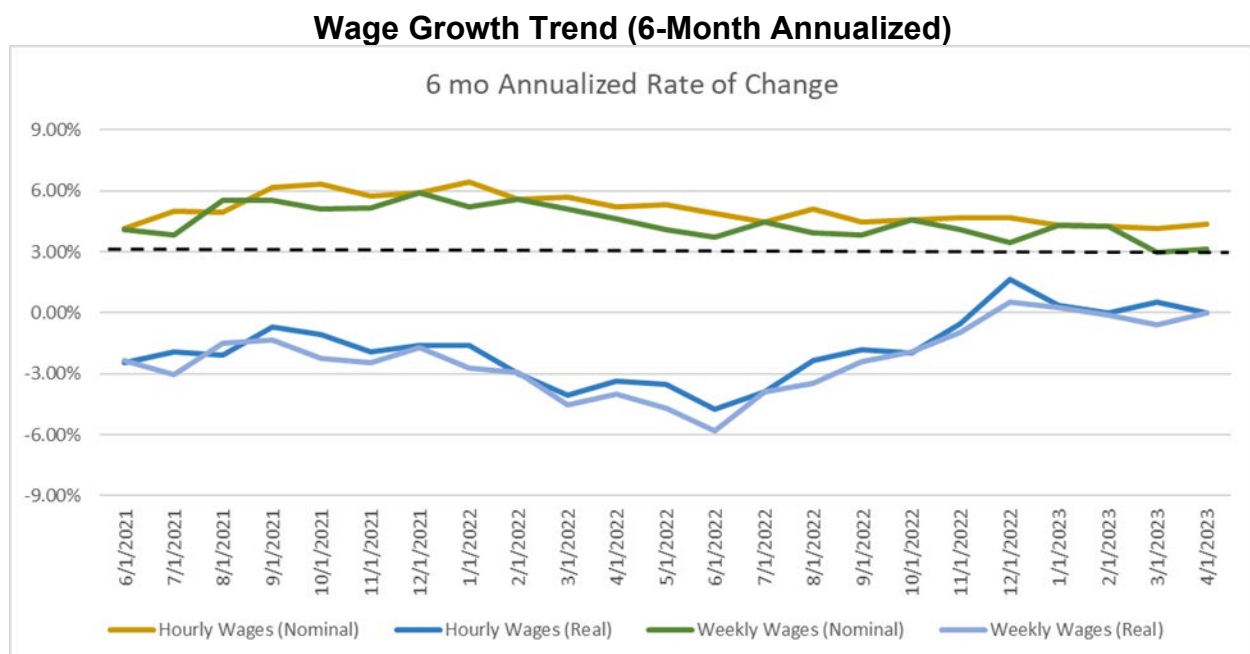
Additionally, we observe in the chart above that (and this was noted in the previous month's publication) job openings are declining in nearly all segments. Additionally, the level of quits is declining and the number of layoffs is increasing. Be mindful that while these figures appear large, they are meant to illustrate that even a slight change, while the labor market is this tight, will look sizable. Supporting this, we also note in the chart below that WARN (Worker Adjustment and Retraining) Notices have begun to tick noticeably higher in recent months. These notices are mandated by the U.S. Department of Labor and help to ensure that sufficient advance notice is provided to employees prior to plant closures and mass layoffs (which lead jobless claims by about 6 months).

## WARN Notices Moving Higher



Source: US Dept. of Labor; Federal Reserve Bank of Cleveland; Arvest Portfolio Management and Research

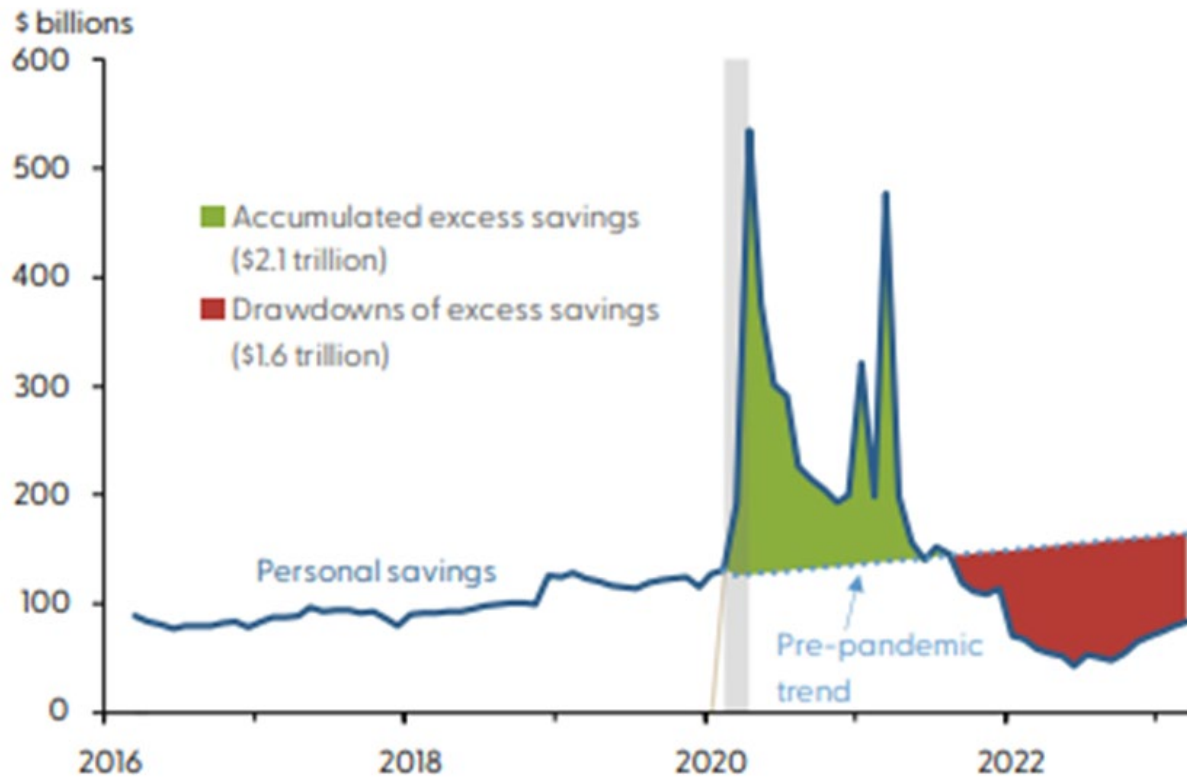
This is all to say that for monetary policy to tighten further, there needs to be substantial evidence presented to policy makers that the accumulated tightening (5% increase in the overnight rate over 14 months) has done little to dent the inflationary forces permeating through the economy. In the first chart on page 8 we display the impact to Core PCE ex. Housing, as this figure is seen historically to bear the largest correlation to wage growth (which would have to slow from a combination of unemployment or a stark decline in prices). While nominal hourly wages are still rising at about 4.3% on a 6-month annualized basis, we do see that the trend is declining. In his presser following the most recent meeting of the Federal Open Market Committee on May 3, Jerome Powell noted that the level of nominal wage growth that would be consistent with the Fed's 2% inflation target would be somewhere around 3%. We have highlighted that 3% line in the chart below using a dashed line. It is important to note that on a real (inflation adjusted) basis, the growth rate in both hourly and weekly earnings have been negative but increasing as inflation eases.



Source: Bureau of Labor Statistics; Bloomberg LP

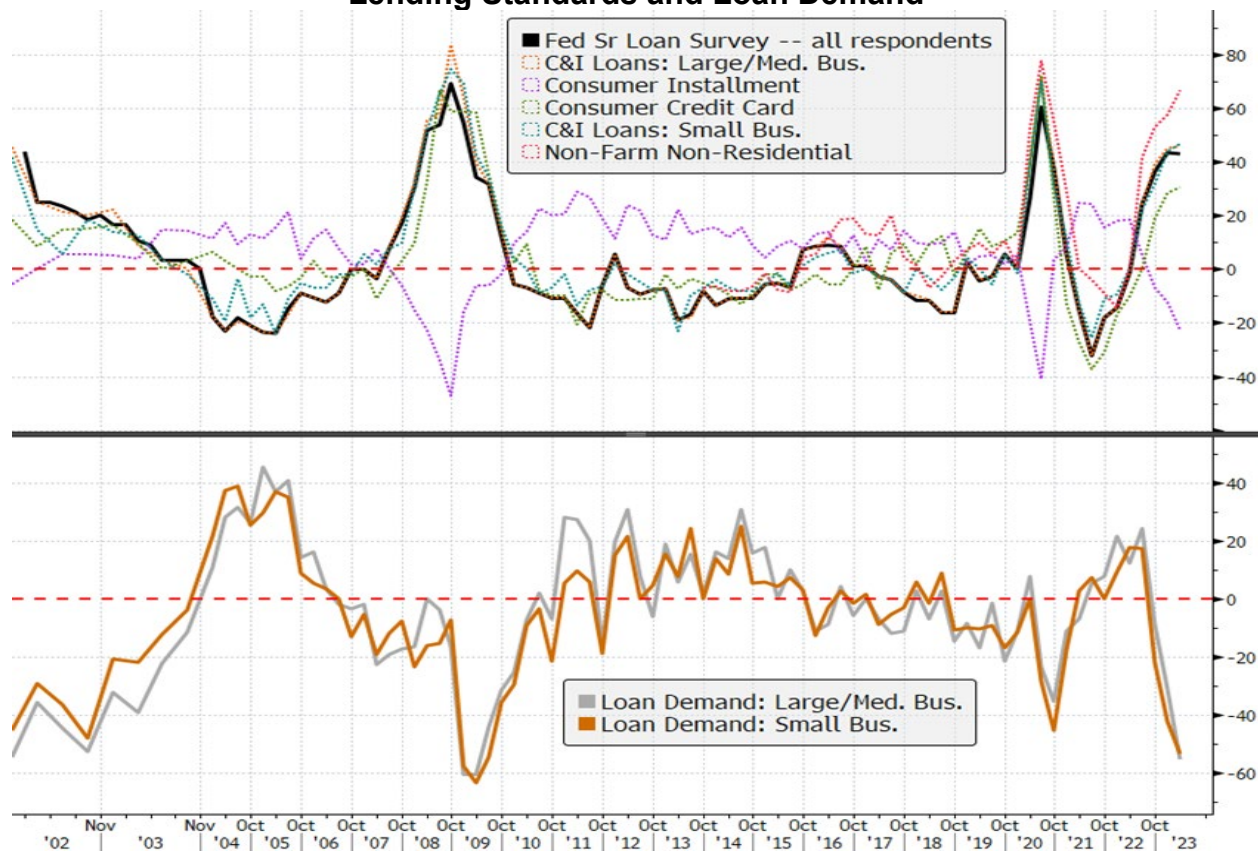
Buttressing consumption will not only require the demand conditions for labor to remain intact (thereby leading to more positive wage and disposable income growth), but also for the wealth effects generated from fiscal stimulus to cease to abate and the availability of credit to loosen. We have written previously that the amount of accumulated excess savings (this is the cumulative amount of savings that remains in the economy in excess of what would have been saved had the pandemic not occurred and fiscal stimulus payments not been provided) was about \$750B to \$1T. The Federal Reserve Bank of San Francisco published a follow up report on May 8 to the original report published on October 21, 2022, estimating that the level of cumulative excess savings in the economy is now at approximately \$500B (chart below). The authors of the report determined that consumers had been burning through excess savings at a rate of about \$100B per month in 2022, with this rate easing to \$85B per month in the first quarter of 2023. If this trend were to continue, all cumulative excess savings would be spent by about September of this year, which coincides with the average amount of months a recession typically begins following the inversion of the 2y/10y yield curve spread (which occurred in late July 2022). This usage of excess savings, all else equal, should act to truncate future consumption, but the large unknown remains the distribution of the excess savings (by income quintile, where the highest typically has a larger proportion of their worth in illiquid assets and the lowest has a larger proportion of worth in liquid assets like cash and deposits).

## Cumulative Excess Savings



Source: Bureau of Economic Analysis; Federal Reserve Bank of San Francisco

## Lending Standards and Loan Demand



Source: Federal Reserve Board; Bloomberg LP



## Economic Indicators

*Emil Suqi, CFA®*

We would be remiss if we did not additionally point to the results of the April 2023 Senior Loan Officer Opinion Survey (chart above), which display a continuation of many of the themes (consumer and commercial and industrial loan standards tightening and loan demand contracting sharply) in these survey results since the summer of 2021 and into 2022. Additionally, added to the chart and represented by the red dotted line is the Non-Farm Non-Residential Loan cohort, which we use as a proxy for non-residential commercial real estate lending standards (the Fed discontinued the use of the commercial real estate question in the survey in 2013, instead decomposing the question into standards for construction and land development loans, multi-family residential and non-farm non-residential). We observe that tightness in lending standards within this cohort has accelerated at a faster pace than the remainder and is approaching levels consistent with the pandemic recession of 2020 and Great Financial Crisis in 2008.

These factors, taken together and transposed against a backdrop of bank failures and a looming debt ceiling debate (or lack thereof), make a compelling case that monetary policy is indeed sufficiently tight, and while there is still strength in the labor market and excess savings in the economy, these conditions are deteriorating. During Q1 earnings season, a record 69% of consumer discretionary firms reported beating consensus sales estimates by at least one standard deviation (v 3% missing; also, a record low). I will not speculate as to the causes of the lower expectations going into earnings season, but the fact is that consumers continued to spend conspicuously in Q1. We believe that the conditions in the economy that exist now and into the future quarters will be such that this level of consumption cannot be sustained. Now would be a suitable time for policy makers to pause and take note of where and how quickly weakness materializes.



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Emil manages fixed-income separate account portfolios for Arvest Wealth Management Trust and Portfolio Management and Research clients. Additionally, he contributes to fixed-income investment strategy and outlooks, as well as client and advisor communications and presentations. A graduate of the University of Illinois, Emil is a CFA Charterholder, a member of the Chartered Financial Analyst Institute and CFA Society of Kansas City.

## Inflation, Banks and the Debt Ceiling! Oh My!!

Bond investors could be forgiven for believing their chosen asset class was no longer boring. After suffering through a miserable 2022 that was framed by one of the Federal Reserve's most aggressive tightening campaigns of the past forty years, (as a "friendly reminder", the Bloomberg Aggregate Bond Index (an index that is designed to provide a broad representation of U.S. bond market) experienced a negative total return of -13.01%, while the Bloomberg Municipal Bond Index registered a negative total return of -8.53% last year), bond investors have come into 2023 facing ongoing uncertainties with respect to the the inflation outlook as well as the response from Fed policy. Moreover, bond investors have to add new uncertainties with respect to the U.S. debt ceiling and bank sector sagas to the mix of issues that have the potential to influence total returns.

In our view, the potential impact upon investment performance related to the inflation environment and the regional banking saga can be evaluated under a more traditional rubric (i.e., faster inflation is generally detrimental to bond investors; turmoil in the banking sector would tend to be beneficial to U.S. Treasury securities, but may place pressure on corporate bond holdings), the impact from the debt ceiling drama is a bit more difficult to evaluate and suss out.

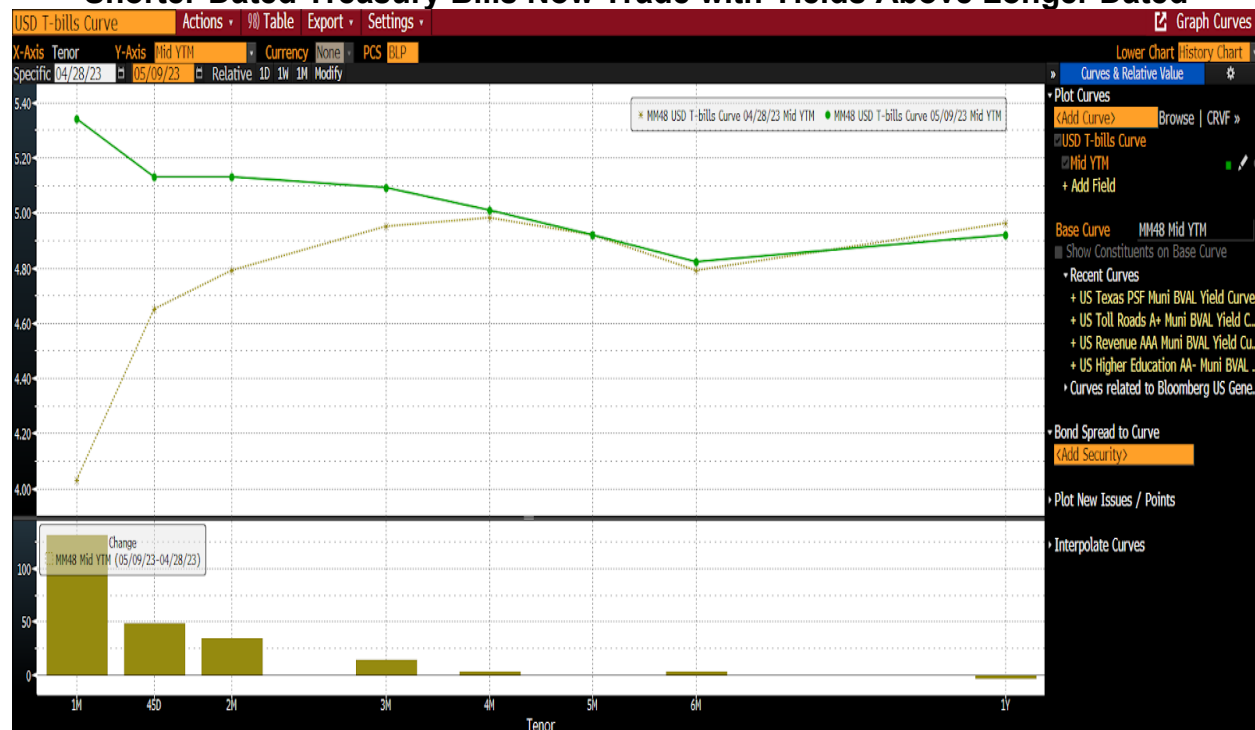
The most obvious element of the evaluation is that Treasury securities in maturity closest to the so-called X-date (i.e., the date upon which the U.S. Treasury department exhausts all of the extraordinary measures it has been implementing to maintain compliance with the current \$31.4 trillion debt ceiling limitation) will begin to trade with an "uncertainty premium." Indeed, this is exactly what we have seen as the yield for the 4-week Treasury bill escalated significantly over the past week as can be seen in the charts below

### Bloomberg Generic 1-Month T-Bill Yields Moves Higher on Debt Ceiling Jitters



Source: Bloomberg; Copyright 2023 Bloomberg Finance L.P.

## Shorter-Dated Treasury Bills Now Trade with Yields Above Longer Dated



Source: Bloomberg; Copyright 2023 Bloomberg Finance L.P.

The most immediate cause for the upward spike in the generic 1-month T-Bill yield in the past few trading sessions were the communications from both Treasury Secretary Yellen and the Congressional Budget Office (CBO) that the X-date for the debt ceiling could come as early as June. We note that the CBO had guided previously that the X-date could fall between July and September in its February estimate, but that disappointing tax receipt data had forced the CBO to push forward their estimate of when the Treasury Department would fully exhaust its capacity. Still, it is important to note that the X-date is not yet firmly fixed in time, as the CBO also stated that the "projected exhaustion date remains uncertain."

Moreover, there are any number of developments that could unfold over the coming days and weeks that may change the equation on the debt ceiling and its potential impact upon markets and the economy. Specifically, those involved in the negotiations could elect (ultimately) to extend the debt ceiling on a short-term basis to allow more time for a durable solution to be put into place. Nevertheless, we acknowledge that the path to a solution, either short- or long-term, may remain rocky and result in additional volatility within capital markets.

Additionally, those implications may not be similar for segments of the capital markets. Indeed, a breach of the X-date in which the Treasury Department acted to prioritize the interest payments on outstanding U.S. Treasury obligations could result in significant reductions in federal spending for a host of ongoing obligations that, in our minds, would have substantial macroeconomic consequences that might result in a decline in Treasury bond yields (i.e., bondholders stop worrying about non-payment, while a flight to quality ensues as market participants worry about a potentially sharp and severe contraction in the economy).

Along those lines, it is interesting to note that the yield for the benchmark 10-year Treasury note has managed to remain (mostly) within its broad trading range of 3.40% to 3.90% that has prevailed since early/mid-November. Indeed, the only violations of the prevailing trading range have been underneath the multi-month range; however, these violations have been shortly-lived and quickly reversed.

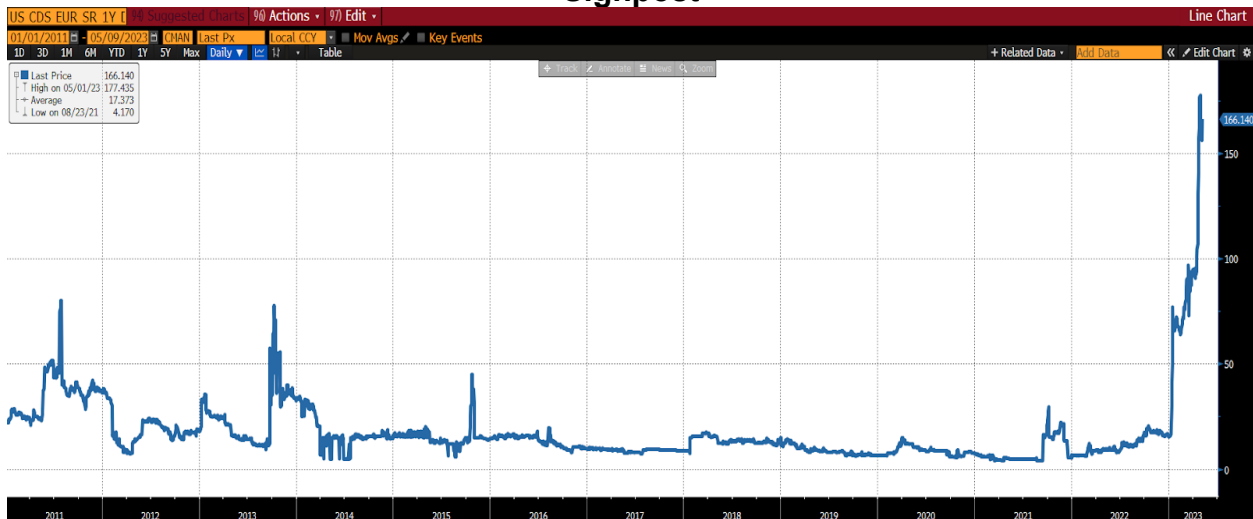
## 10-Year Treasury Staying Home on the Range



Source: Bloomberg; Copyright 2023 Bloomberg Finance L.P.

One item in the popular press that we have seen capture some attention recently is the movement in the one-year credit default swap (CDS) spread for U.S. Government debt. As can be seen in the chart below, the spread for one-year CDS has moved significantly upward in recent weeks, which all other things equal, implies the market perceives a higher likelihood of default by the U.S. Government on its bonded indebtedness. While we acknowledge the nervousness in the market with respect to a potential technical default on U.S. Treasury obligations have grown in recent weeks (i.e., notice the upward drift in the one-month T-Bill yield), we would also caution in interpreting the movement. Specifically, it is our understanding that the market for credit default swaps on the U.S. Government is relatively thin, especially in relation to the overall size of the Treasury market, which is in excess of \$20 trillion. Moreover, we believe if the market were overly concerned with an imminent default on U.S. Treasury obligations that the one-year CDS spread would be materially higher than its current trading level.

## 1-Year CDS Spread has Been Moving Upward, but be Cautious in Reading this Signpost



Source: Bureau of Labor Statistics; Bloomberg; Copyright 2023 Bloomberg Finance L.P.

As Emil details in his section on the economy, bank lending standards were tightening prior to the events of March, and we suspect that credit conditions have become more taught. Unfortunately, we will not have a good view of exactly how much additional tightening in credit standards



## Bond Market

*Dennis J. Whittaker, CFA®*

occurred until the Federal Reserve releases its updated Senior Loan Officer Opinion Survey (SLOOS).

### Strategic Implications

While we recognize the potential for volatility with respect to the coming twists and turns of the ongoing debt ceiling saga, we are of the mindset that U.S. Treasury obligations ultimately remain “money good” and would caution against taking significant portfolio actions in an attempt to alleviate any associated fears that may exist.

Nevertheless, we also recognize that the potential for additional volatility in the capital markets could have an adverse effect on more credit sensitive elements, especially as we remain of the mindset that corporate credit markets continue to offer investors an inadequate level of compensation for the myriad of economic risks that we believe abound. Note this is consistent with our past views of the sector and are influenced by more than concerns over the potential evolution of the debt ceiling debate.

Additionally, we believe that the current level of volatility and uncertainties that exist within the economy and markets means that making significant interest rate bets at this juncture is a difficult proposition. As such, we are adhering to our “close to home” strategy of maintaining a duration position of 95% to 100% of the Bloomberg U.S. Aggregate Bond Index (i.e., we seek to have a similar level of sensitivity to the changes in interest rates versus our premier passive benchmark) for the time being.

**Bond Market Considerations Table**

	5/9/2023	4/12/2023	Change	3/31/2023	Change	12/31/2022	Change
1-Year Treasury	4.82%	4.64%	0.19%	4.59%	0.23%	4.69%	0.14%
2-Year Tsy	4.02%	3.96%	0.06%	4.03%	0.00%	4.43%	-0.40%
3-Year Tsy	3.72%	3.69%	0.04%	3.79%	-0.06%	4.22%	-0.50%
5-Year Tsy	3.50%	3.46%	0.03%	3.57%	-0.08%	4.00%	-0.51%
7-Year Tsy	3.50%	3.42%	0.08%	3.53%	-0.04%	3.97%	-0.47%
10-Year Tsy	3.52%	3.39%	0.13%	3.47%	0.05%	3.88%	-0.36%
30-Year Tsy	3.84%	3.63%	0.21%	3.65%	0.19%	3.96%	-0.13%
3MO-10YR	-172.83	-167.88	-4.96	-133.68	-39.15	-53.02	-119.82
1YR-10YR	-130.40	-124.50	-5.90	-112.30	-18.10	-81.18	-49.22
2YR-10YR	-50.30	-56.70	6.40	-55.70	5.40	-55.10	4.80
3YR-10YR	-20.50	-29.80	9.30	-32.00	11.50	-34.90	14.40
5YR-30YR	34.30	16.30	18.00	7.70	26.60	-4.10	38.40
10YR-30YR	31.90	23.40	8.50	18.20	13.70	8.80	23.10
2YR BE	213.51	251.49	-37.98	268.21	-54.70	231.27	-17.76
5YR BE	222.59	235.76	-13.17	247.61	-25.02	238.27	-15.68
10YR BE	223.55	227.86	-4.31	232.21	-8.66	229.72	-6.17
30 Year BE	223.82	226.41	-2.59	224.04	-0.22	234.64	-10.82
IG OAS	146.00	139.00	7.00	138.00	8.00	130.00	16.00
HY OAS	466.00	459.00	7.00	455.00	11.00	469.00	-3.00
HY OAS/IG OAS	3.19	3.30	-0.11	3.30	-0.11	3.61	-0.42
USD FRA/OIS 3M	33.70	31.35	2.35	33.20	0.50	15.00	18.70
MBS OAS	63.00	63.00	0.00	63.00	0.00	51.00	12.00
MOVE	133.93	129.68	4.25	135.93	-2.00	121.61	12.32
ABS OAS	83.00	86.00	-3.00	85.00	-2.00	76.00	7.00
CMBS OAS	141.00	142.00	-1.00	142.00	-1.00	120.00	21.00
AAA Index	110.00	112.00	-2.00	113.00	-3.00	94.00	16.00
BBB Index	715.00	693.00	22.00	679.00	36.00	483.00	232.00
BBB/AAA	6.50	6.19	0.31	6.01	0.49	5.14	1.36
Non-Agency	214.00	216.00	-2.00	215.00	-1.00	179.00	35.00
Agcy	66.00	64.00	2.00	65.00	1.00	56.00	10.00
Taxable Muni OAS	114.00	119.00	-5.00	120.00	-6.00	128.00	-14.00
EM USD OAS	359.00	354.00	5.00	358.00	1.00	339.00	20.00
EM OAS/HY OAS	0.77	0.77	0.00	0.79	-0.02	0.72	0.05
IG OAS/Taxable Muni	1.28	1.17	0.11	1.15	0.13	1.02	0.27

Source: Bloomberg; ARVEST Wealth Management

## Bond Market

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Dennis is responsible for the construction and management of several fixed income portfolios. Prior to rejoining Arvest Wealth Management in 2006, he managed a tax-exempt mutual fund for an investment advisory firm and prepared all their fixed income research. Dennis has a BSBA in economics and holds the Chartered Financial Analyst designation. He is a member of the Fixed Income Analysts Society and the Board of Directors for the Southern Municipal Finance Society, previously serving as chair, and a former member of the Board of Governors of the National Federation of Municipal Analysts.

## U.S. Equity Market

Christopher Magee, Ryan Ritchie, and Bret O'Meara, CFA®

### Market Indices Performance

Index	Trailing Returns (Price + Dividends)					Forward P/E	10-Year Avg	2023 EPS Growth (est.)
	YTD	1-Month	3-Month	12-Month	Yield		Forward P/E	
S&P 500	9.16	1.56	2.71	2.64	1.70	18.2	17.6	-0.2%
S&P 400	2.98	-0.78	-5.72	1.28	2.18	13.8	17.6	-11.2%
S&P 600	-0.31	-2.78	-8.94	-3.91	1.89	13.5	18.0	-12.3%
MSCI World ex-US	11.39	2.93	2.93	7.75	3.35	13.3	14.5	-0.1%
MSCI EM	2.85	-1.12	-4.68	-6.15	3.08	11.8	11.7	-2.0%

Source: Bloomberg, I/B/E/S data from Refinitiv, as of 3/31/2023

The first-quarter earnings season has begun with a sigh of relief, as big banks and now regional banks are delivering results and guidance signaling that they have withstood the Silicon Valley Bank collapse and subsequent mini-crisis. More broadly, 1Q23 earnings season is off to an as-predicted start, with multiple companies reporting moderate year-over-year earnings declines and slow-to-no revenue growth.

The stock market in 2022 opened to a wide range of challenges including inflation, rising interest rates, and the supply-chain crisis. The war in Ukraine erupted in February 2022 and COVID-19 lockdowns in China and then elsewhere spiked across winter. These challenges led to severe stock weakness across most of 2022. Inflation, like the pandemic before it, is a global phenomenon. The U.S. cannot rein in Putin's territorial ambitions or influence China's COVID-19 policy, and that has partly blunted the effectiveness of the Fed's aggressive policy moves.

Stocks opened in 2023 into an environment that was less clearly toxic yet with a multitude of uncertainties, led by inflation that was wearing on consumers, and ever-higher rates. Mainly, investors and consumers worried that the timeline for recession, which had pushed out across 2022, might finally be coming into sight.

The first four months of 2023 confirmed that investors are preparing for a post-rate-cycle world, rather than dreading the rate hikes ahead as they were doing in the beginning of 2022. Adding to optimism: COVID-19 is clearly in the rear view for most U.S. citizens.

As 1Q23 ended, the economy was in much the same shape it was in immediately prior to the early-March banking crisis. People are employed; and rising wages, though lagging inflation, have helped consumers stay afloat amid higher costs for everything. U.S. economists have repeatedly pushed out their timeline for recession. The consensus now seems to be formulating around a short-and-shallow recession across 2Q23 and 3Q23. Six months ago, the same consensus was for a short-and-shallow recession in 4Q22 and 1Q23.

Historically, stocks have led the economy out of economic weakness, typically bottoming during the middle of the downturn. Since 1980, the S&P 500 has averaged annual capital appreciation of 10% (albeit in a wide range) while rising about 80% of the time. The market also has tended to rise after down years, although 2000-2002 was an exception. The stock market has made some progress in 2023, but has a long way to go to get back to past peaks attained late in 2021 and early in 2022. The S&P 500 is 15% below its all-time high in the low 4,800s set in January 2022. The DJIA and the Nasdaq Composite are 20% and 25%, respectively, below their all-time highs.

## U.S. Equity Market

*Christopher Magee, Ryan Ritchie, and Bret O'Meara, CFA®*



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Bret assists and supports the management of investment portfolios through research, analysis, and trading, specializing in equity securities. He joined Arvest Wealth Management in 2010 as a member of the Retirement Plan Services Group before transitioning to Portfolio Management and Research. Bret has a BSBA in economics and finance and MBA. He previously worked at a Northwest Arkansas bank for two years and taught courses in accounting and economics at Northwest Arkansas Community College for six years. Bret is a CFA charterholder and a member of the CFA Society of Arkansas.



### **Christopher Magee**

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Christopher is the lead manager of the Arvest Bank Group Equity Fund and the DIG Equity Portfolio and is responsible for construction of equity portfolios for institutional and retail clients, including equity research, security selection, sector weightings and trading. Prior to joining Arvest Wealth Management in 1992, he served as a trust investment officer at a national bank in Shreveport, Louisiana and a bank in Amarillo, Texas. He has a BSBA in finance, with an emphasis in investments, and is a graduate of Cannon Financial Institute's Advance Trust Investments School.



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Ryan is co-manager of the Arvest Bank Group Equity Fund and co-lead manager of the Investment Management Group Strategic portfolios and is responsible for the construction of equity portfolios for institutional and retail clients, including equity research, sector weightings, and trading. Additionally, he is responsible for directing the implementation of Arvest Wealth Management's equity strategy throughout trust and brokerage relationships. Ryan has a BSBA in finance with an emphasis in financial management. Ryan has been managing portfolios since 2002.



# Appendix

## **Portfolio Management & Research Group Team Members**

<i>Clay Nickel, Chief Investment Officer &amp; Strategist</i>	<i>Lee Musser, Portfolio Analyst</i>
<i>Christopher Magee, Sr Equity Portfolio Manager</i>	<i>Abbey Vibhakar, Fixed Income Analyst</i>
<i>Ryan Ritchie, Portfolio Manager</i>	<i>Jake Baker, Fixed Income Analyst</i>
<i>Bret O' Meara, Client Portfolio Manager</i>	<i>Curtis Jones, Fixed Income Analyst</i>
<i>Dennis Whittaker, Sr Portfolio Manager</i>	<i>Jennifer Tichenor-Turner, Adv Solutions Support Specialist</i>
<i>Emil Suqi, Fixed Income Portfolio Manager</i>	<i>Colton Nix, Advisory Solutions Support Specialist</i>
<i>Alex Jantsch, Portfolio Analyst</i>	<i>Dylan Goswick, Fixed Income/Equity Portfolio Specialist</i>
<i>Josh Warner, Portfolio Analyst</i>	<i>Charles Kurtz, Executive Assistant</i>

## **Description of Recession Indicators**

- Conference Board Leading Economic Indicators (LEI) - The indicator tracks the Year-over-Year percentage change in the Conference Board Leading Economic Indicators Index. The index is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables.
- U.S. Treasury Yield Curve (3-month to 10-year Spread) – This indicator measures the spread between the fixed income yields of the 3-month Treasury Bill and the 10-Year Treasury Bond. The lower this number, the flatter the yield curve is. The flatter the yield curve is, the less longer term investors are getting compensated over shorter term investors for the inherent interest rate risk. If the spread goes below zero, this means that the yield curve has inverted.
- ISM New Orders-to-Inventories Spread – This indicator looks at the spread of reported new order levels versus reported current inventories levels. The Institute for Supply Management (ISM) surveys 300 manufacturing firms on numerous manufacturing data points to get data points for both new orders and inventories.
- Core Capital Goods (New Orders) – This indicator tracks the Year-over-Year percentage change in the value of new orders received during the reference period. Orders are typically based on a legal agreement between two parties in which the producer will deliver goods or services to the purchaser at a future date.
- Initial Jobless Claims – This indicator tracks the number of initial unemployment claims of people who have filed jobless claims for the first time during the specified period with the appropriate government labor office. This number represents an inflow of people receiving unemployment benefits.
- New Building Permits – This indicator tracks the number of construction permits that have been issued and approved for new construction, additions to pre-existing structures, or major renovations.

DISCLAIMER: These are not the only indicators that the team looks at, and no decision should (or will) be made on any single indicator. These are simply what the team utilizes to help forecast potential for a recessionary environment.

# Disclosures

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