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Q2 2023 Outlook

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03 April 2023

Red, White, and Overdue

By Michael Crook, Chief Investment Officer

On January 19, Treasury Secretary Janet Yellen notified US House of Representatives Speaker Kevin McCarthy that the outstanding debt of the US had reached its statutory limit, debt issuance would be suspended, and the Treasury had begun to use extraordinary measures to fund the US government. Current forecasts indicate the US will reach a technical debt default sometime during the summer or fall of this year. The default is considered technical because it is not caused by a lack of funds, but rather a failure to execute the payment process properly.

The US uses an unusual system to budget and issue debt. Prior to World War I, Congress approved every debt issue made by the Treasury. Over time, that process became infeasible, and Congress adopted a *debt ceiling* that allowed the Treasury to issue bonds without specific approval as long as the total amount of debt outstanding fell below the statutory debt ceiling (Fig. 1, next page). The debt ceiling rule created a disconnect between voting for appropriations and voting to fund them, but it wasn't until 1953 that Congress refused to raise the debt ceiling as needed to cover appropriations. The story then was the same as today — an attempt by a faction within Congress to use the debt ceiling to reduce deficit spending.

An accidental breach of the debt ceiling in 1979 led to the "Gephardt Rule," which automatically raised the debt ceiling when a budget was passed. This rule averted debt ceiling standoffs for 16 years but was repealed in 1995. The repeal led to debt ceiling problems in 1995, 2011, and now in 2023.

While it might be easy to assume that Congress will raise the debt ceiling before a default occurs, market participants are taking the potential for a technical default seriously. At the beginning of the year, the cost to insure US debt against default was about 30% of the cost to insure Mexican debt against default. Today, it costs double to insure US Treasury debt than it does to insure Mexico's federal debt (Fig. 2, next page).

Consequences of a Default

The debt ceiling crisis of 2011 provides a reasonable guide to what we should expect in the case of a technical default: substantial market volatility, elevated yields for Treasury debt maturing around the debt ceiling, and plunging investor and consumer confidence. Presumably Congress would sharpen its focus and raise the limit at that point, but even a last-minute solution can have negative long-term consequences aside from the acute market reaction. The US dollar will not lose its privileged role as the world's reserve currency, but Treasuries would be considered slightly riskier, leading to higher borrowing costs — costs that taxpayers are on the hook for.

There's evidence that the debt ceiling episodes of 1979 and 2011 resulted in higher borrowing costs for the US than would have otherwise been the case. Between 2013 and 2022, the US spent 5–8% of total outlays on Treasury interest payments (this is known as net interest outlays). About 10% of outlays will go toward net interest outlays in 2023, and the Congressional Budget Office (CBO) expects — as a base case — net interest outlays to represent 14% of total federal spending in 2023 (Fig. 3). Higher borrowing costs due to a debt ceiling debacle would further exacerbate this problem.

Debt, Deficits, and Do-Nothing Politicians

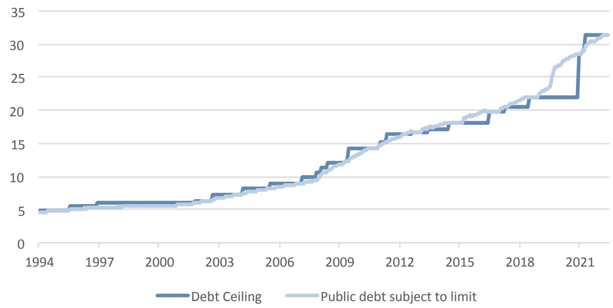
Refusing to raise the debt ceiling would be the economic equivalent of cutting off our nose to spite our face, but we also have a serious deficit problem that we have to find the political wherewithal to solve. If there's one question I've been asked by investors the most over the last 20 years, it has been: "Is our huge national debt a problem for markets?" I've always replied with some version of:

> "There are two important numbers to consider when thinking about the national debt: how much we have currently borrowed from the public and how much we have obligated ourselves to spend in the future. The size of the current national debt, $25–31 trillion depending on how you calculate it, is striking, but pales in comparison to the $116 trillion shortfall facing Social Security and Medicare over the next three decades. These programs, on their own, will create a budget deficit of 12% in 30 years.
>
> These are impossible numbers that require a political solution. Social Security and Medicare benefits are inflation-linked so we can't inflate our way out of the problem and discretionary spending is simply too small to make a difference."

All remains true, except COVID accelerated the timeline and higher debt service costs have worsened the problem. Federal spending increased from 18% of GDP in 1962 to a quarter of GDP last year (Fig. 4). In other words, the

Fig. 1: We are once again at the debt ceiling

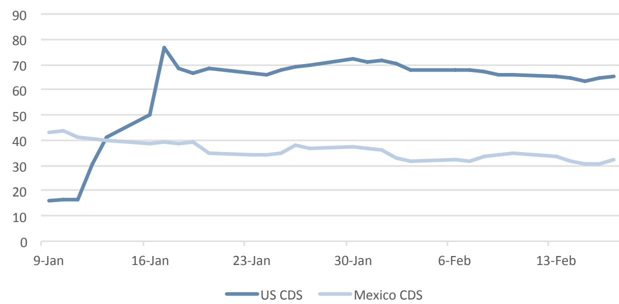
The US debt ceiling and US public debt outstanding, 1962–2022



Source: Bloomberg, Mill Creek.

Fig. 2: US credit default swaps are more expensive than Mexico's

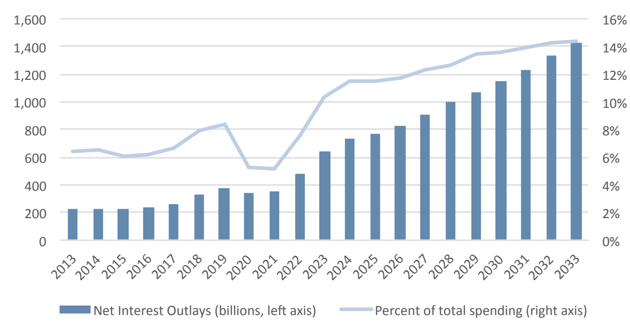
One-year credit default swap pricing



Source: Bloomberg, Mill Creek.

Fig. 3: Net interest outlays are expected to increase

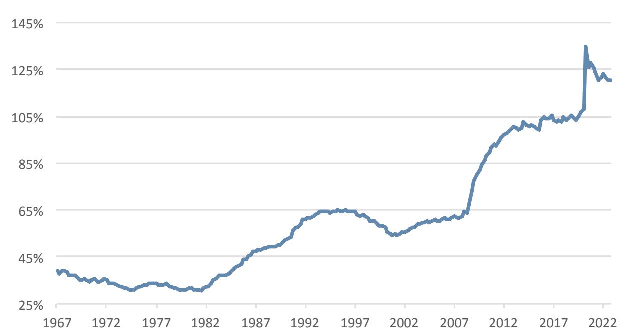
Annual net interest outlays



Source: Congressional Budget Office, Mill Creek.

Fig. 4: Debt accumulation has outpaced growth

US National Debt as a percentage of Gross Domestic Product (GDP)



Source: Bloomberg, Mill Creek.

Federal government now comprises a quarter of our entire economy (Fig. 5). During that period, mandatory spending — mainly Social Security, Medicare, and Medicaid — has grown from 4.8% of GDP in 1962 to 16.5% of GDP today.

All in, the CBO expects the annual deficit to increase from $1.6 trillion in 2024 to $2.7 trillion in 2033. Deficits of this size (in absolute terms or as a percentage of GDP) are unprecedented outside of the financial crisis and COVID (Fig. 6). Discretionary spending, which includes defense, education, and highway programs, is the loser — falling from 67% of total spending in 1962 to 26% today (Fig. 7). This trend might explain some of the vitriol in Congress: the DC pie has grown substantially, but the percentage available to negotiate over in Congress has shrunk considerably.

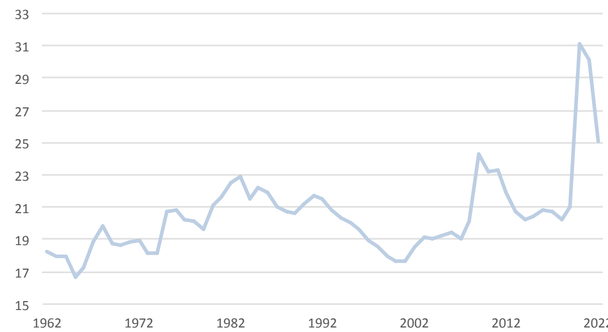
Running a crisis-level deficit in normal times has significant consequences, both for the economy and investment markets. In particular, higher deficits reduce private savings, leading to lower productivity and incomes. They also increase the risk of a financial crisis and reduce our fiscal ability to respond to unexpected events, like war or recession. Retired Adm. Mike Mullen, former chairman of the Joint Chiefs of Staff, warned in 2010 that a ballooning national debt was "…the most significant threat to our national security." At the time, the national debt was $13.5 trillion. Today, it is $24.2 trillion and expected to reach $46.4 trillion by the end of 2033.

Political solutions are outside our purview, but the most recent IRS summary of Federal Income Tax Data is instructive in regard to feasible solutions. Individual taxes, the federal government's largest revenue item, comprise about 40% of all federal revenue (Fig. 8). In 2020, the most recent year for which data is available, the top 1% of earners (based on adjusted gross income) earned 22% of all wages and paid 42% of total income taxes. The top 10% earned 50% of all wages and paid 73.7% of total income taxes. The bottom 50% earned 10% of all wages and paid 2.3% of total income taxes.

The highly progressive US income tax system (the top 1% currently pays an average tax rate 8x the rate paid by the bottom 50%) could become even more progressive, but even the most aggressive proposals for taxing the wealthy fall far short of raising the revenue needed for Social Security and Medicare. The non-partisan Tax Foundation found that a combination of (1) raising all personal income taxes by 50% and (2) raising the corporate tax rate to 35% would be insufficient to close the budget deficit over the next decade. Long-term budget stability will have to come from both increased revenue (i.e., higher individual income, corporate, and payroll taxes) *and* reduced federal spending on mandatory entitlement programs. Do-nothing politicians need to hurry up and *do something*. The time is overdue.

Fig. 5: Federal spending now comprises 25% of the US economy

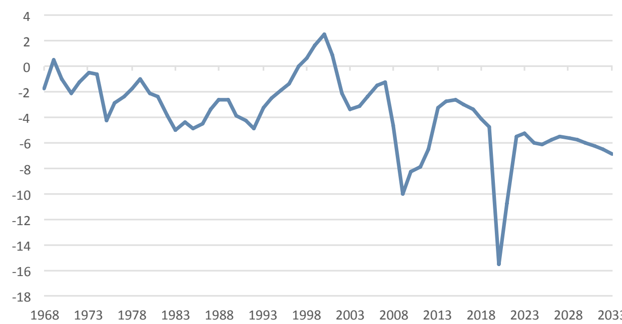
Federal spending as a percentage of GDP



Source: Congressional Budget Office, Mill Creek.

Fig. 6: The federal deficit is projected to remain at crisis levels

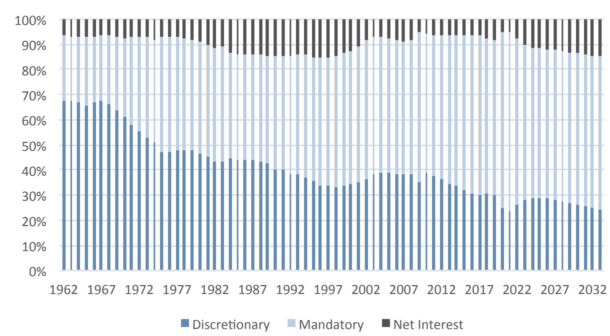
Annual deficit as a percentage of GDP



Source: Bloomberg, Congressional Budget Office, Mill Creek.

Fig. 7: Discretionary spending has been squeezed

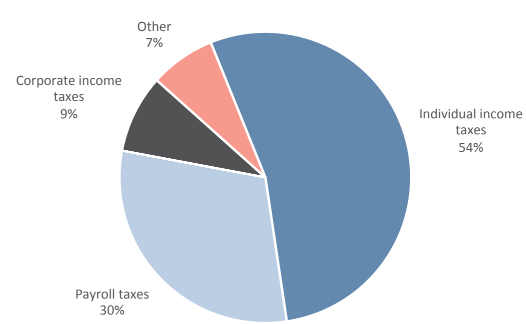
% of total spending by category, 1962–2032



Source: Congressional Budget Office, Mill Creek.

Fig. 8: Individual income taxes are the majority of federal revenue

2022 US federal revenue by category (%)



Source: Congressional Budget Office, Mill Creek.

House View Summary

Global economy

- We are in the latter innings of coordinated global central bank hiking. As a result, most major central banks are expected to slow or stop rate hikes during the first half of 2023.
- The Fed — along with other major central banks — would like to pause rate hikes and allow the "long and variable lags" of monetary policy to work through the economy. Fed policy is tighter than it has been since 2008, and interest rate–sensitive sectors of the economy, like real estate, have been hit hard.
- Inflation appears increasingly embedded around 5%. The European Central Bank (ECB) has made it clear that it will continue to fight inflation with rate hikes and use other policy tools to support financial stability. The Fed has become much more cautious and believes a tightening of credit conditions will do some of the Fed's own work.
- The path to a soft economic landing in the US is increasingly narrow. The Fed's current forecasts imply a significant decline in economic activity over the remainder of 2023 and credit conditions were already tightening prior to the recent bank crisis.

Market perspective

- The recent decline in interest rates has reduced some of the relative value in bonds, but real interest rates remain higher than at any point during the 2010–2021 period. We are neutral duration in our bond portfolios and have reduced credit risk.
- US large-cap earnings per share estimates have declined about 10% in inflation-adjusted terms since June 2022. Current valuations (17.4x on a forward 12-month basis) have priced in a softish landing outcome, but a recession would result in fair value 10–15% lower than current prices.
- Value and small-cap equities remain cheap versus growth and large-cap equities, respectively.
- A contraction in lending from regional and community banks will likely result in additional opportunities for private debt strategies.
- Private real estate valuations, which generally lag public valuations, fell 5% in 4Q22 and are likely to decline 10–20% this year.

Portfolio positioning

- We are neutral duration in our taxable and tax-exempt fixed income portfolios.
- Within equities, we are slightly overweight US equities, value equities, low-volatility equities, and high-dividend equities.
- We are overweight private debt and absolute return hedge funds versus fixed income.
- We recommend allocating a portion of equity exposure to private equity.

Risks we're watching

- Bank lending practices. Lending standards tightened and commercial and industrial loan demand declined during the 4Q22. Whether these trends accelerate following March's banking turmoil will play a large role in the path for economic growth and monetary policy.
- Additional geopolitical risk spilling out of China or Russia
- A technical default on Treasury securities due to political stalemate around the debt ceiling

Please click any link to access additional information and insights.

First Quarter 2023: Market Review

- **The first quarter was characterized by three different market regimes.**

  In January, market participants were bullish and expecting continued disinflation.

  Investors became more hawkish in February as the economic data showed inflation remains far too persistent.

  March's banking troubles led to market volatility, an easing of financial conditions, and questions about how quickly the Fed could keep raising policy rates.

- **Equity markets** performed well during the first quarter.

  International developed market equities and growth equities led, whereas emerging market equities, value equities, and small cap equities lagged.

- **Fixed income** also produced positive returns during 1Q23. Interest rates ended the quarter slightly lower than where they were at the beginning of the year.

Index Returns	Jan 2023	Feb 2023	Mar 2023	Q1 2023	1 year	3 years	5 years	10 years
Global Equities	7.2%	-2.9%	3.1%	7.3%	-7.4%	15.4%	6.9%	8.1%
US Equities	6.9%	-2.3%	2.7%	7.2%	-8.6%	18.5%	10.5%	11.7%
Large Cap US	6.7%	-2.4%	3.2%	7.5%	-8.4%	18.6%	10.9%	12.0%
Mid Cap US	8.3%	-2.4%	-1.5%	4.1%	-8.8%	19.2%	8.1%	10.1%
Small Cap US	10.7%	-1.6%	-2.8%	5.9%	-13.2%	17.9%	6.5%	9.2%
US Growth	8.4%	-1.2%	6.2%	13.9%	-10.9%	18.2%	13.0%	14.2%
US Value	5.4%	-3.5%	-0.9%	0.9%	-6.3%	18.1%	7.3%	9.0%
International Developed Equities	8.1%	-2.1%	2.5%	8.5%	-1.4%	13.0%	3.5%	5.0%
Emerging Market Equities	7.9%	-6.5%	3.0%	4.0%	-10.7%	7.8%	-0.9%	2.0%
US Taxable Bond Market	3.1%	-2.6%	2.5%	3.0%	-4.8%	-2.8%	0.9%	1.4%
US Municipal Bond Market	2.0%	-1.8%	1.8%	2.0%	1.9%	0.8%	1.9%	1.8%
Hedge Funds	1.7%	-0.5%	-1.4%	-0.2%	-3.3%	4.3%	1.6%	1.4%
Diversified Commodities	-0.5%	-4.7%	-0.2%	-5.4%	-12.5%	20.8%	5.4%	-1.7%
Gold	5.7%	-5.3%	7.8%	8.0%	1.6%	7.7%	8.2%	2.1%

Key Rates (as of stated date)	12/31/22	1/31/23	2/28/23	3/31/23	3/31/22	3/31/20	3/31/18	3/31/13
US 10-Year Treasury	3.9%	3.5%	3.9%	3.5%	2.3%	0.7%	2.7%	1.8%
Barclays Aggregate Bond Index	4.7%	4.3%	4.8%	4.4%	2.9%	1.6%	3.1%	1.9%
BBarc Muni 1-10Yr Blend (1-12) Index	3.0%	2.5%	3.2%	2.7%	2.2%	1.6%	2.3%	1.3%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Index rates are yield to worst.
Indices used to represent periodic capital markets returns include: MSCI ACWI (Global equities), Russell 3000 (US equities), Russell 1000 (Large Cap US), Russell Mid Cap US (Mid Cap US), Russell 2000 (Small Cap US), Russell 3000 Growth (US Growth), Russell 3000 Value (US Value), MSCI EAFE (International Developed), MSCI Emerging Markets Index (Emerging Markets Equities), Bloomberg Aggregate Bond Index (US Taxable Bonds), Bloomberg 1–10 Year Municipal Bond Index (US Municipal Bonds), HFRX Global Hedge Fund Index (Hedge Funds), Bloomberg Commodity Index TR (Diversified Commodities), and Gold Spot Price (Gold).

Investing in High-Quality Companies Matters for Long-Term Investors

By Sam McFall, Managing Director

Factor investing is an investment approach that seeks to tilt portfolios toward or away from certain companies based on quantifiable characteristics to generate excess returns over time. The most widely researched factors include value, momentum, size, and quality. Timing factor exposures is exceedingly difficult, but we believe a structural bias toward high-quality companies will reward long-term investors. Fundamental characteristics that make a business attractive over the long run include high profitability, stable earnings growth, and low leverage. Additionally, an active manager might make a subjective judgment about a company's management team and assess the sustainable competitive advantages a company might have over its peers. By investing in high-quality companies trading at reasonable valuations, an investor can potentially limit their downside risk by investing with a higher margin of safety.

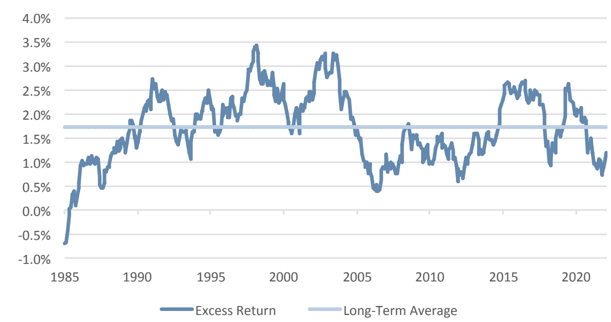
Utilizing a purely quantitative approach to assessing quality, MSCI has constructed an index of high-quality companies with high returns on equity, stable year-over-year earnings growth, and low financial leverage. The MSCI USA Quality index is a subset of the broader MSCI USA index and is representative of the types of companies we believe investors should be tilting toward in their equity allocations. Over rolling 10-year periods, the quality index has outperformed the broad market index 99% of the time, with an average annualized excess return of 1.7% per year[1] (Fig. 1). Investing in high-quality companies increases portfolio tracking error and is subject to periods of short-term underperformance. For example, over rolling 1-year periods, the quality index has outperformed the broad market index only 62% of the time. Despite an increasingly short-term investment world, we continue to believe that investing in high-quality companies increases an investor's probability of long-term success.

Equity investing is inherently risky and over shorter time periods or even at specific points in time, a certain strategy, style, or factor can be out of favor. Recently, high-quality investing has been out of favor, particularly in the post-COVID period where investors have favored more levered and cyclical companies that have benefited from the reopening of the global economy. High-quality investing is generally considered a more defensive approach given that investors tend to focus on balance sheet strength in periods of stress. Historically, those companies have outperformed and preserved capital in down years for the equity markets. Going back to 1976, the MSCI USA index has been down nine times, but for the first time since 1981, the MSCI USA Quality index underperformed the broad market in 2022 (Fig. 2). Rising interest rates led to an indiscriminate sell-off in growth equities, including many high-quality companies. In our view, the sell-off was overdone, and while we acknowledge there may be a short-term impact on earnings of these businesses, many will see improved long-term fundamentals as they gain market share when their weaker competition struggles or goes out of business.

[1] MSCI USA Quality index was launched in December 2012. Data prior to the launch is backtested and actual results may have varied during the specified time periods.

Fig 1: Rolling 10-year excess return of MSCI USA Quality index vs. MSCI USA index

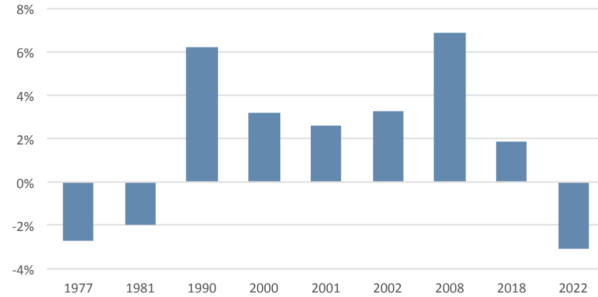
Long-term investors benefit from a strategic tilt toward high-quality companies



Source: Morningstar, MSCI, Mill Creek.

Fig 2: Relative performance of quality index vs. the broad market in down years

Quality underperformed in 2022 for the first time since 1981



Source: Morningstar, MSCI, Mill Creek.

Endowment Investment Trends

By Nora Pickens, Managing Director

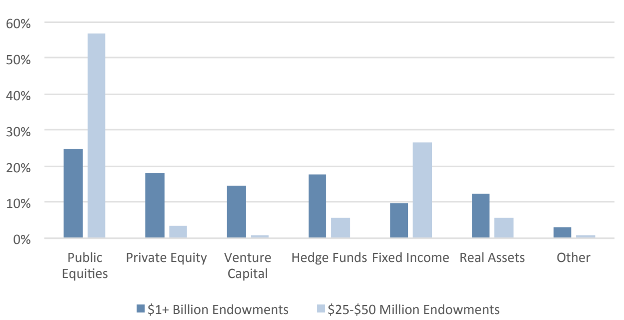
The 2022 NACUBO-TIAA Study of Endowments was released last month and the results point to the continuation of several investment trends, although we believe a few of them may begin to reverse moving forward. For background, the report is an annual survey of over 600 US-based universities, providing insight into their performance and asset allocation decisions. After reviewing 2022's results, we highlight three key takeaways[1]:

1) **Alternatives:** The most glaring change to the endowment asset allocation model over the past few decades has been the shift to alternative investments, specifically private equity and venture capital (PE-VC). It's hard to believe that endowments had only 1% of capital in PE-VC strategies in the '90s given their starring role in portfolios today, currently accounting for 30% of endowment portfolios on average. Premium returns, diversification benefits, and long-term value creation support the enhanced exposure.

One interesting outcome of this trend is that it leads to greater dispersion of returns between large and small endowments due to their noteworthy allocation differences. In 2022, institutions with $1 billion+ in assets under management (AUM) had 33% exposure to PE-VC, while those with $25–50 million in AUM had just 5% (Fig. 1).

Fig. 1: Large endowments target a high allocation to private assets

Asset allocation for endowment cohorts, FY 2022



Source: NACUBO Study of Endowments, Mill Creek.

Performance outcomes over the trailing 5-year period reflected the impact of this gap. The *lower* 25th percentile of returns for large institutions was 7.7%. By comparison, small institutions in the *upper* 75th percentile recorded a 6.5% return. In other words, the best-performing small institutions generated a return that lagged the worst-performing large institutions by 1.2%! Access to tier one PE-VC managers clearly played a critical role in investment outcomes, and we believe will continue to drive success over time.

2) **Fixed Income:** At a 10.6% allocation, 2022 marked college endowments' lowest average exposure to fixed income over the past 20 years (Fig. 2). The reasoning behind the decline is straightforward. The Federal Reserve's use of unconventional monetary policies starting in 2008 kept a lid on rates for over a decade and meant the risk-reward calculation for fixed income was less attractive.

Fig. 2: Endowment allocations to fixed income have steadily dropped

Endowments' dollar-weighted average allocation to fixed income

Source: NACUBO Study of Endowments, Mill Creek.

However, that dynamic drastically changed last year as the benchmark 10-year Treasury leaped above 4% for the first time since 2008. Not surprisingly, we have heard from several bond managers that institutions are using the higher-yield environment to rebalance fixed income allocations back to neutral from a tactical underweight position or increase exposure to 1–3-year maturity bonds to take advantage of the inverted yield curve. As a result, we believe 2022 could mark a turning point for fixed income allocations and anticipate next year's NACUBO Study will reflect a higher weighting to the asset class.

3) **Inflation:** Nominal return targets for endowments are determined by taking the sum of long-term inflation expectations, spending requirements of the college, and gross expenses incurred from running the investment office. For years, the industry standard hovered around 7.5%, composed of roughly a 4.6% spending target, 0.9% expense rate, and 2.0% inflation. However, the return hurdle jumped to 8.2% in 2022 with inflation being the primary driver behind the upward revision. We believe upside risk to inflation remains and next year's average target return will likely move closer to 8.5%.

[1] 2022 study reflects the responses of 678 instiutions and covers the fiscal year July 1, 2021–June 30, 2022.

PUBLICATION DETAILS

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