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MARKET REVIEW

NOVEMBER 2023

STUDENT LOAN PAYMENTS

– Last month, between 20 million and 25 million Americans resumed making student loan payments after a 3.5-year hiatus.

– Most estimates suggest the end of student loan forbearance could reduce U.S. GDP by 0.2%-0.4% over the next 12 months.

– Sales at retailers with a higher proportion of younger and female customers are likely to be most impacted by the resumption of payments.

On October 1, nearly 27 million Americans with a combined $1.1 trillion of federally backed student debt were required to restart payments after a 40-month forbearance period. The payment moratorium was initially implemented by the Trump administration in the spring of 2020. The suspension of student loan payments was extended seven times over the following three-and-a-half years (once by the Trump administration and six more times by the Biden administration). As part of debt ceiling negotiations with House Republicans in late May, the Biden administration agreed to a prohibition on another extension of the moratorium after the current one expired on September 1. About 3.6 million of these borrowers will continue to receive some form of student loan forgiveness based on a set of statuses including, low-income, disabled, and public sector employment.

On June 30, the U.S. Supreme Court rejected as unconstitutional the Biden administration's plan to bypass the upcoming end to the moratorium and permanently forgive up to $20,000 in federal student debt per eligible borrower without authorization from Congress. In response to the Supreme Court decision, the U.S. Department of Education implemented a 12-month "on-ramp" from October 1, 2023, through September 30, 2024, to help struggling borrowers. During this period, borrowers that miss payments on their student loans will not be considered delinquent, reported to credit bureaus, placed in default, or referred to debt collection agencies.

Most estimates project borrowers will collectively resume making $5 billion to $8 billion per month in federal student loan payments beginning in October, translating to an average monthly payment of between $200 and $300. That implies a roughly 0.2% to 0.4% reduction in U.S. gross domestic product (GDP) over the next 12 months. An analysis by Wells Fargo economists compares this to a pay cut of 4%-5% before taxes for the median U.S. household. For context, according to U.S. Census Bureau data, Americans spend about $35 billion per month on clothing and department store purchases.

The demographic prolife of Americans with federal student debt will be perhaps the most important factor in projecting the areas of the economy likely to be most affected by the resumption of loan payment. According to a survey conducted by UBS Research in March 2023 and reported in the *Wall Street Journal*, "the average student loan borrower is younger, more likely to be single, female and earn slightly less than the average U.S. consumer…" For many borrowers who graduated over the last three years, it will be the first time they have had to make loan payments.

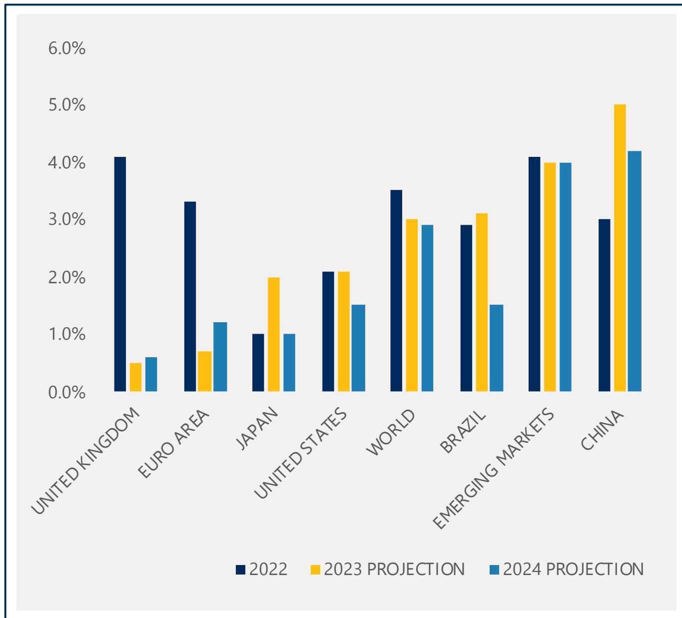
Retailers with a disproportionately high exposure to millennials (ages 27-42) and the oldest members of generation Z (ages 11-26) could face the strongest headwinds in coming quarters from the reinstatement of federal student loan payments. According to recent research by J.P. Morgan retail analyst Chris Horvers, this group includes home furnishings retailers Wayfair (W) and Williams-Sonoma (WSM), sporting goods chain Dick's Sporting Goods (DKS), cosmetics and fragrance retailer Ulta Beauty (ULTA), consumer electronics retailer Best Buy (BBY), and hypermarket Target (TGT).

Although the resumption of student loan payments after a more than three-year pause will probably curtail discretionary spending by younger Americans in coming quarters, it is unlikely to present a systemic risk to the U.S. economy akin to the subprime mortgage crisis of 2007-2009. Overall student debt of $1.6 trillion accounts for just 9% of overall household debt, which pales in comparison to outstanding mortgage debt of $12 trillion. Additionally, there is minimal contagion risk with student loans compared to the massive size of the mortgage-backed securities market leading up to the Great Financial Crisis. The overall size of the student loan asset-backed securities (SLABS) is estimated to be between $150 billion and $200 billion, less than 2% of the size of the $11 trillion mortgage-backed securities market.

> "RETAILERS WITH A DISPROPORTIONATELY HIGH EXPOSURE TO MILLENNIALS AND THE OLDEST MEMBERS OF GENERATION Z COULD FACE THE STRONGEST HEADWINDS."

A research paper published in May by University of Chicago economists Ching Tse-Chin, Michael Dinerstein, and Constantine Yannelis found that Americans with federal student loan debt substantially increased their credit card, mortgage, and auto loan debt during the 40-month forbearance period. So, while the return of mandatory student loan payments may not by itself create widespread economic pain, the additional stress on those who ramped up borrowing in other areas could be significant.

SLOWING GLOBAL GROWTH
U.S. GROWTH LEADS DEVELOPED COUNTRIES

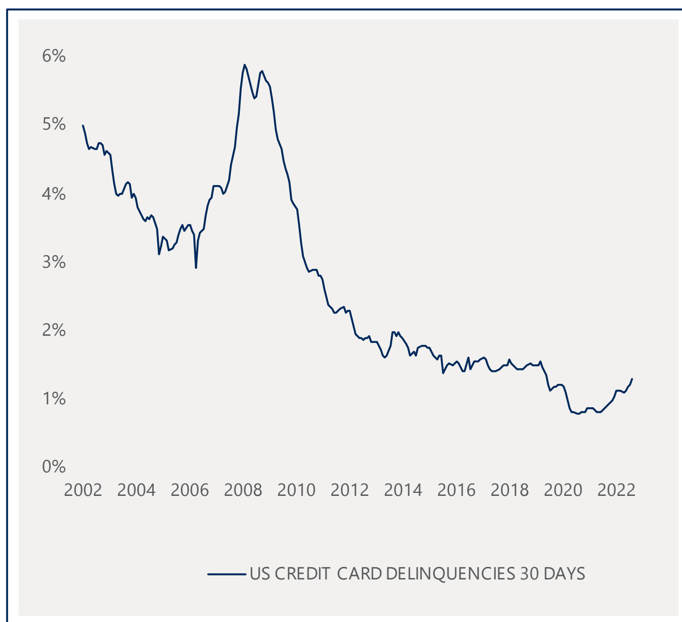


Source: International Monetary Fund. Past performance does not guarantee future results.

U.S. economic growth is on pace to lead most advanced countries this year as economists project resilient consumption and investment to propel the economy to achieve 2.3% growth. U.S. gross domestic product (GDP) grew at a blistering 4.9% pace in the third quarter, however economic growth is expected to slow sharply to 0.7% in the fourth quarter. Consumer spending, the largest component of GDP, is forecasted to weaken to 1.0% growth from 4.0% in the third quarter. U.S. economic activity is projected to remain subdued through the first half of next year and moderately improve in the second half of the year.

Economic growth in many countries is projected to be lower this year and next year compared to 2022 as their economies feel the lagging effects of tighter monetary policies. According to the International Monetary Fund (IMF), global growth is projected to slow to 3.0% this year and 2.9% in 2024, following 3.5% in 2022. Many emerging market economies proved resilient with cumulative growth estimated to be around 5.2% in 2023.

INCREASING CONSUMER HEADWINDS
CONSUMER DELIQUENCY RATES RISING

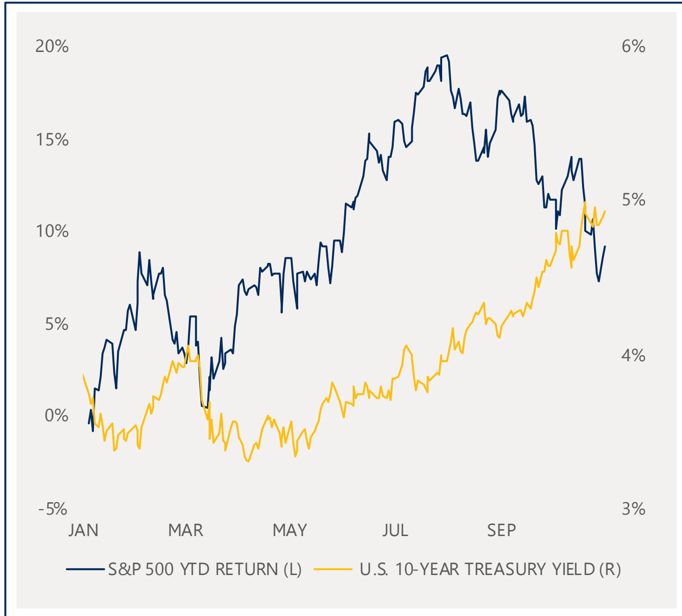


Source: Bloomberg. Past performance does not guarantee future results.

Despite higher inflation and interest rates, consumers have remained resilient so far with support from the healthy labor market and excess savings from pandemic stimulus bills. However, cracks are starting to emerge in the strong consumer narrative. The 30-day credit card delinquency rate has steadily risen since last summer. While the trend in missed payments is bad, the delinquency rate is coming off a historically low level and is not near concerning levels seen in past recessions. Lower income consumers are displaying greater signs of financial stress. According to the credit ratings agency Fitch Ratings, the delinquency rate on subprime automobile loans has risen above 6%, the highest level on record going back to 1994.

Consumers appear to be increasingly relying on credit cards to cover expenses as their excess savings dwindle and inflation cools from a high level. According to the credit bureau TransUnion, the average credit card balance has risen to a 10-year high over $6,000, up 15% from a year ago. Meanwhile, the Fed's rate hikes have led to the average annual credit card interest rate rising more than 5% to an all-time high of over 20%. Growing credit card balances, higher cost of debt, and student loan repayments resuming could create headwinds for consumer spending.

RISING YIELDS RATTLE INVESTORS
STOCKS DECLINE AMID HIGHER BOND YIELDS



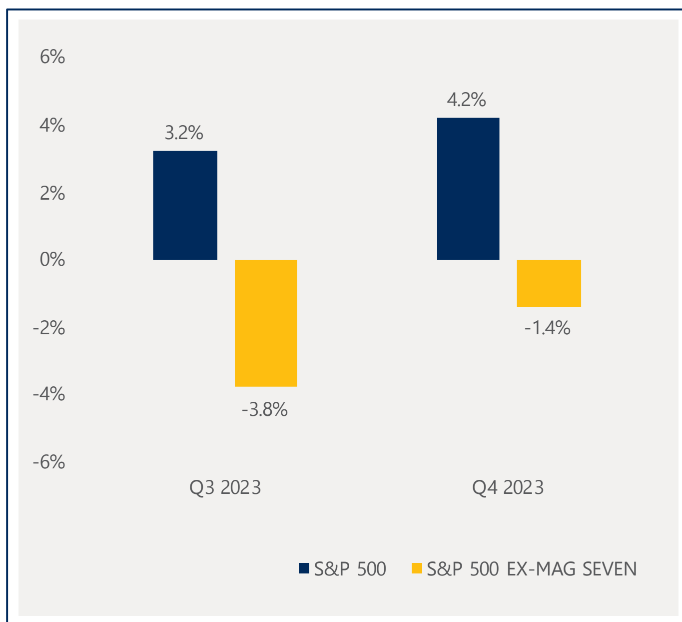
Source: Bloomberg. Past performance does not guarantee future results.

Global equities extended their decline for a third straight month in October. The S&P 500 fell 2.10% in the month, bringing the index's three-month drawdown to -8.25%. The U.S. 10-year Treasury yield rising to the highest level since 2007 and heightened geopolitical risk from the war in Israel dampened market sentiment.

The energy and consumer discretionary sectors led the S&P 500 lower with monthly declines of 5.97% and 4.47%, respectively. Lower oil prices weighed on energy stocks. The price of West Texas Intermediate (WTI) crude oil fell 10.76% last month amid signs the Israel-Hamas war will likely be contained and have limited disruption on oil supplies. Investors' appetite for consumer stocks waned after executives' third quarter earnings commentary suggested consumers are becoming more cautious with their purchases.

The MSCI China index sank to its lowest level in nearly a year last month due to investors' concerns about the country's lingering economic challenges. China's eight-day holiday, Golden Week, which takes place in early October and typically provides an economic boost, was disappointing compared to the government's optimistic projections for consumer spending and home sales.

S&P 500 EARNINGS RECESSION EX-MAGNIFICENT 7
PROJECTED S&P 500 EARNINGS GROWTH



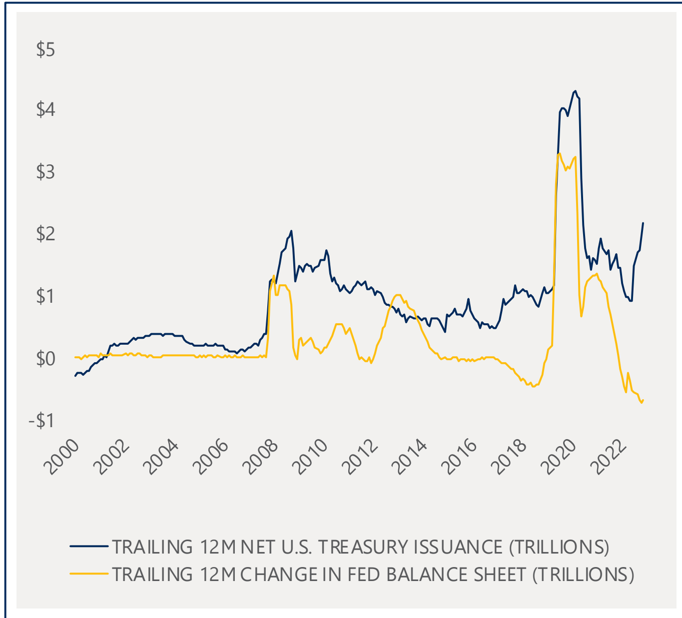
Source: Morningstar. Past performance does not guarantee future results.

S&P 500 earnings are on track to post a surprising recovery in the third quarter after three quarters of negative growth caused by margin pressure from higher costs and supply chain disruptions. 80% through the earnings reporting season, the index's earnings are on pace for 3.20% growth compared to analysts' projection for a 1.22% decline. 50.14% earnings growth from the magnificent seven which includes Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon (AMZN), Nvidia (NVDA), Meta Platforms (META), and Tesla (TSLA), provided a significant boost to the index's overall earnings. Excluding the magnificent seven, S&P 500 earnings would be down 3.80% in the quarter.

The sizeable earnings growth contribution from the magnificent seven is being partially offset by the energy sector's 37.6% earnings decline. Excluding energy and the magnificent seven, S&P 500 earnings growth is around 3.11%.

S&P 500 revenue growth is also on pace to exceed analysts' projection with 1.97% growth versus the 1.13% forecast. The percentage of companies reporting revenue below analysts' projections was 28.80%, the highest miss rate since the second quarter of 2020 and above the 24.77% five-year average.

U.S. TREASURY ISSUANCE AND FED BALANCE SHEET
NOMINAL TREASURY YIELDS ADJUSTED FOR INFLATION



Source: Bloomberg. Past performance does not guarantee future results

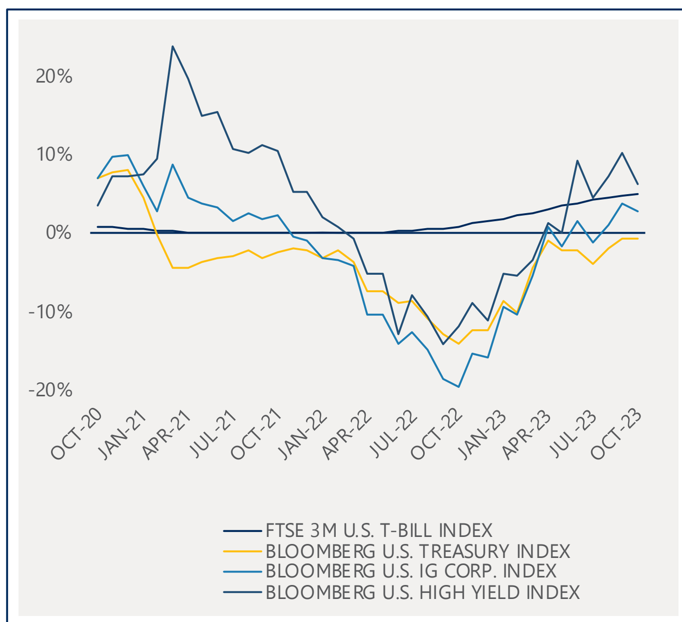
A growing number of market actors and commentators have pointed to concerns about widening U.S. fiscal deficits as a primary driver of the steep rise in yields on long-term Treasury yields in September and October.

Increased deficit spending is occurring at the same time the Federal Reserve has shifted from a net buyer of U.S. government debt during the period of aggressive balance sheet expansion from March 2020 through March 2022 to a net seller.

The U.S. Treasury has significantly increased its net issuance (new issues less maturities) of government bonds following the deal to raise the debt ceiling in late May after eight months in which the prior federal debt ceiling constrained government borrowing.

The surge in issuance has refilled the Treasury General Account and raised funds for higher levels of anticipated deficit spending related to several substantial spending packages passed by Congress over the last 24 months.

U.S. FIXED INCOME ROLLING 12-MONTH RETURNS
OCTOBER 2020 THROUGH OCTOBER 2023



Source: Bloomberg. Past performance does not guarantee future results.

The rolling 12-month returns of broad U.S. investment-grade and high yield bond indexes have reentered positive territory in recent months amid muted corporate issuance, still-modest default rates, and a general trend of narrowing credit spreads after the regional bank turmoil of March and April.

The foresight of many U.S. corporate management teams in years prior to 2022 to refinance into low fixed-rate debt and extend their average maturity profile has 1) reduced the need for issuance in 2023 and 2) likely created a better buffer to navigate any periods of potential economic weakness in 2024.

The divergence between flat-to-solid returns on short-term U.S. Treasury Bills and losses on longer term Treasury notes and bonds has been in place since the beginning of 2021. This gap was exacerbated by an aggressive Fed rate hike campaign that brought 525 basis points of policy tightening from March 2022 through July 2023.

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