

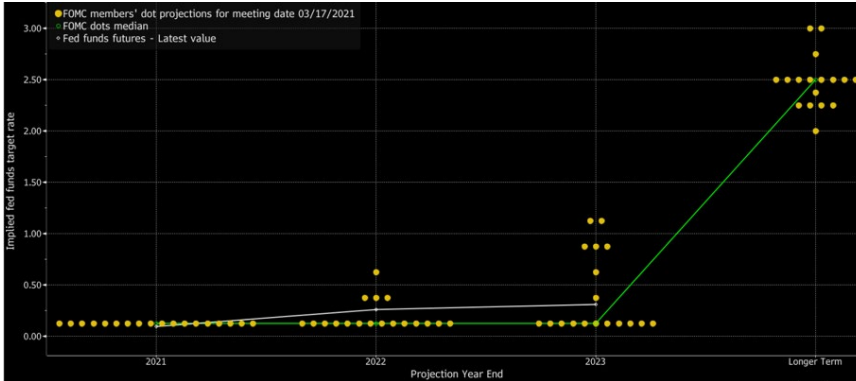
SKYView: Threading the Needle

All eyes were on Jerome Powell this past week, with market unease building ahead of his March 16 Federal Open Market Committee (FOMC) press conference. In what some strategists have called the most critical policy meeting for some time, Powell seemingly struck a delicate balance, expressing confidence in the economic recovery without stoking fears of a sharp uptick in inflation that could necessitate an earlier than expected liftoff. In this *Weekly Briefing*, we review the key takeaways of the most recent FOMC meeting, and analyze the potential impact new stimulus checks – now being distributed as part of President Biden’s recently passed \$1.9tn relief package – may have on consumer spending trends.

Powell soothed bond markets last Wednesday, downplaying the risk of inflation and maintaining an overall dovish tone. **The FOMC voted to keep rates at essentially zero and will maintain the pace of asset purchases, alleviating fears of the start of an unwind.** While the Fed’s new dot plot displayed some shifts (7 of 18 officials predict higher rates by the end of 2023, up from 5 of 17 at the December meeting), median expectations remained unchanged. At the same time, **the Fed appeased equity markets by ratcheting up 2021 GDP growth expectations and decreasing year-end unemployment estimates**, all while maintaining that rates are likely to stay near zero through 2023.

The Fed's New Dot Plot

FOMC member projections for meeting date March 17, 2021



Key Data Points

FOMC member projections

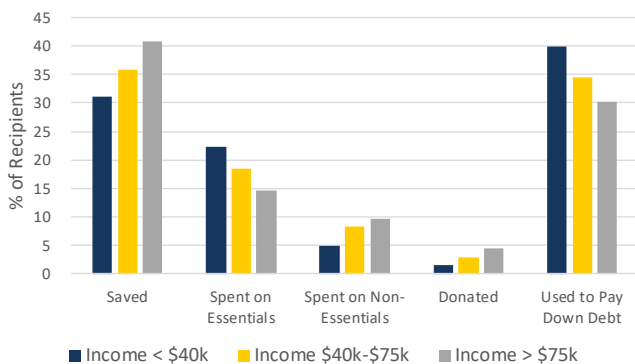
- * Fed Funds target rate unchanged
- * Size of asset purchases unchanged
- * Economic activity outlook increased
 - '21 GDP growth to +6.5% (from +4.2%)
- * Median unemployment estimate decreased
 - 4.5% by end of '21, 3.5% by end of '23
- * Temporary boost in inflation upon reopen (~ 2.4%)
- * Inflation back down to ~ 2% in 2022
- * Housing markets have more than fully recovered
- * Business investment and manufacturing picking up
- * Recovery has progressed more quickly than anticipated
- * Decision was unanimous

Source: SKY Harbor, Bloomberg, Federal Reserve

With the FOMC meeting now out of the way, we suspect attention will revert to stimulus spending, particularly as a wave of \$1,400 checks to qualifying Americans (as a result of Biden’s recently passed \$1.9tn stimulus bill) hit bank accounts (~ \$242bn of funds have already been distributed as of March 16). How is this money likely to be spent, and what might the impact be to the economy? To answer this, we first look back at spending patterns following the first round of stimulus checks (issued after the CARES Act was signed into law in late March '20). According to a survey conducted by the Federal Reserve Bank of New York¹, **the marginal propensity to consume (MPC) was quite low, as only a relatively small share of stimulus payments (~29%) was used for consumption by the end of June 2020.** By contrast, approximately 35% of proceeds were used to pay down debt, while 36% went into savings. An even lower marginal propensity to consume was expected for a then theoretical second round of payments, with August 2020 survey results implying that the savings rate would increase even further. At the time, it was believed that “unprecedented high uncertainty about the duration and the economic impact of the pandemic, the social distancing rules and restrictions on in-person shopping, and delayed rent payments (which economists count as consumption) may all have contributed to the small MPC estimates.”

How Americans Spent Their First Round Stimulus Payments

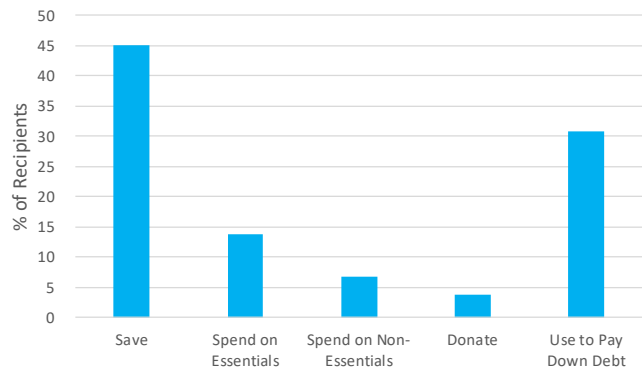
\$1,200 per qualifying adult via CARES Act (March '20)



Source: SKY Harbor, Federal Reserve Bank of New York / Liberty Street Economics

How Americans Expected to Spend Round 2 Stimulus Payments

survey results from August '20



The personal savings rate – defined as the percentage of disposable personal income remaining each month after accounting for taxes and spending – reached an all-time high in April 2020, far surpassing the previous record of 17.3% (May 1975), and has since remained well above the long-run average. According to a Congressional Research Service report² this response appears highly consistent with past periods of elevated uncertainty, as individual

¹ <https://libertystreeteconomics.newyorkfed.org/2020/10/how-have-households-used-their-stimulus-payments-and-how-would-they-spend-the-next.html>

² <https://fas.org/sgp/crs/misc/IF10963.pdf>

savings rates typically rise during recessions “to provide a buffer against reduced income (caused by job loss, for example) in the near future.” During the pandemic, government stimulus payments and the inability to spend due to social distancing provisions likely played a role in boosting savings rates as well. These trends, however, may be poised to change. **Both the Philadelphia Fed Business Outlook Survey and the US Empire State Manufacturing Survey surpassed consensus expectations in March, and consumer sentiment continues to gain traction**, as demonstrated below:

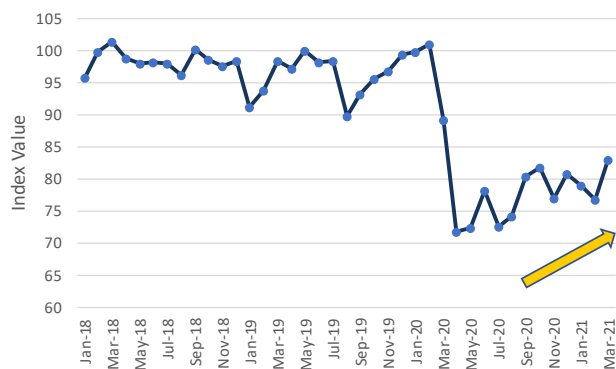
Pandemic Uncertainty & Stimulus Checks Boosted Savings

Personal Saving Rate, monthly data



Consumer Sentiment Gaining Traction

University of Michigan Consumer Sentiment Index

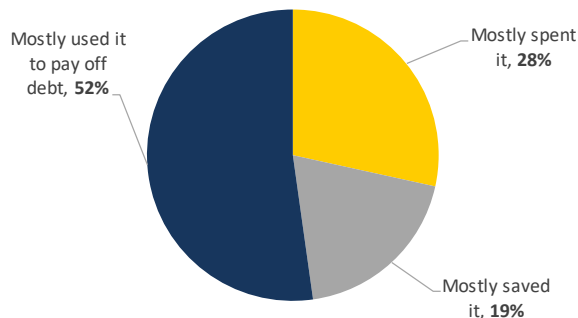


Source: SKY Harbor, US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, University of Michigan

In fact, we are already beginning to see signs of an increasing marginal propensity to consume. Based on US Census Bureau data, over 110 million Americans received a stimulus payment in Week 25 of the Household Pulse Survey (ended March 1, 2021). Of those recipients, 28% of respondents “Mostly spent it,” 19% of respondents “Mostly saved it,” and 52% “Mostly used it to pay off debt.” Several other datapoints have been similarly supportive of an uptick in consumption and a reduction in savings rates. **On Sunday, March 14, the Transportation Security Administration (TSA) screened 1.34 million people, 86,000 more than the same day one year ago, and airline bookings continue to accelerate as lockdowns end and the newly vaccinated seek travel options after spending the last 12 months homebound.** Sales of electronics & appliances, furniture & home furnishings, and food & drink continue to improve as well, increasing confidence in an economic boost as the population becomes vaccinated and businesses resume more normalized activities.

US Census Bureau Household Pulse Survey

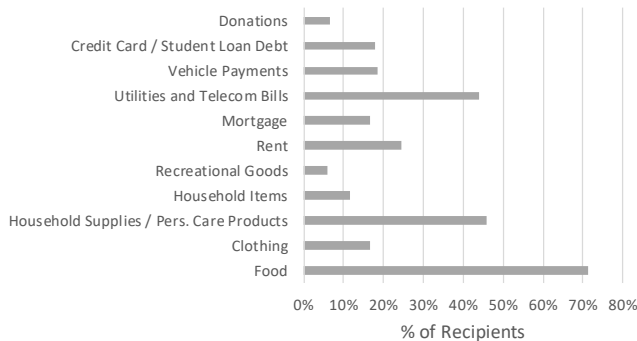
Feb 17, 2021 to Mar 1, 2021



Source: SKY Harbor, US Census Bureau

Use of Proceeds For Those Who "Mostly Spent It"

Feb 17, 2021 to Mar 1, 2021



Despite a more dovish than expected message from the Fed, we find it hard to imagine a scenario in which rates decline meaningfully over the intermediate term. This, coupled with less than full absorption of recent Treasury moves by high yield index constituents, continues to leave us biased away from the most rate-sensitive portion of the market (duration over 8, highest quality bonds with yields in the 0% to 5% range). At the same time, a resumption of consumer spending should further improve the outlook for credit fundamentals, historically a tailwind for lower-quality names as default risk drops, and we seek to further add to names that stand to benefit from a re-opening yet still trade wide of pre-COVID levels (transportation, leisure, retail, and portions of capital goods and basic industry levered to an uptick in business investment). Finally, with high yield index OAS nearly 50 basis points (bps) above our revised year-end target, our overweight to the shorter duration portion of the market is being funded by higher-yielding securities with less than average convexity.

In conclusion, Fed Chairman Powell managed to walk a fine line in remarks that following the March FOMC meeting, reiterating that accommodative policy measures would remain in place for the foreseeable future while still managing to upwardly revise economic growth expectations. Having avoided the more hawkish pivot that many market participants feared, we expect investor attention to now shift toward the benefits of stimulus spending and a normalization of consumer behavior. In our view, relatively low MPC readings and the associated surge in the personal savings rate that followed issuance of stimulus checks in April '20 is unlikely to be repeated, largely the result of a more clear path to a sustained re-opening that has already begun to put upward pressure on consumer sentiment. As a result, we continue to view consensus GDP growth expectations for 2021 (+5.6% at the time of publication) as being too low, and expect high yield spread tightening to resume as the benefits of stronger economic activity (higher EBITDA growth, lower net leverage, lower defaults) are incorporated into OAS fair value estimates.

Definitions

Basis points (bps) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

EBITDA is earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

Option-Adjusted Spread (OAS) is the measurement of the spread of a fixed income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

Important Disclosures and Disclaimers

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