PPMAMERICA

The Push And Pull Of Higher Rates On Fundamentals

MACRO INSIGHTS - DECEMBER 2023

KEY TAKEAWAYS

> As investors look ahead to financial markets in 2024, economic fundamentals could be a dominant factor in the outcome

> Apart from the soft-landing debate, understanding the health of households and corporations could be necessary to determine how higher interest rates are likely to impact fundamentals

> For consumers, we believe today's elevated mortgage rates will have a limited effect in 2024, but interest rates on auto loans and credit cards could weaken household balance sheets

> For corporations, we believe higher interest rates will start to bite in 2024 given the need for both new and refinanced debt, but expect only a measured increase in distress and defaults, not a spike

The US economy saw stronger-than-expected growth in 2023, driven by a resilient consumer and pent-up demand following the COVID pandemic.[1] These factors were enough to overcome the impacts of higher interest rates on consumers and corporations, including tighter lending standards and a dip in loan demand.

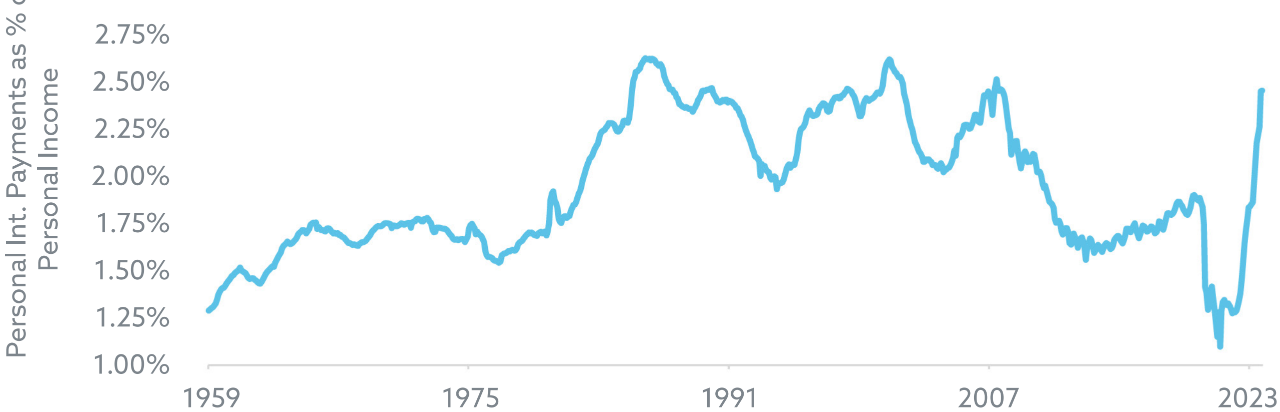
Or at least that's how the story goes. Looking deeper, the consequences of higher interest rates have not been as straightforward. Households and corporations have both assets and liabilities. They were able to quickly invest assets at higher interest rates through vehicles such as money market funds. But household and corporate liabilities did not immediately reprice higher. Many liabilities have long durations (e.g., 30-year mortgages, 10-year corporate debt), and the effects of today's higher rates will only be felt over time.

To say it another way, the current hiking cycle has been slow in restraining economic activity, as interest rates have yet to significantly weaken growth. Conversely, as witnessed by asset class volatility in 2023, the market is attempting to price in a much faster cycle. Participants have been prematurely predicting an easing cycle, perhaps in the hope the true impacts of a higher interest rate regime will never be felt. This phenomenon has actually been one of our most profound takeaways from 32 years of investing – we believe the volatility of market prices exceeds the volatility of asset values – and has led to our philosophy that this mismatch creates opportunities for a fundamental, relative value investment framework.

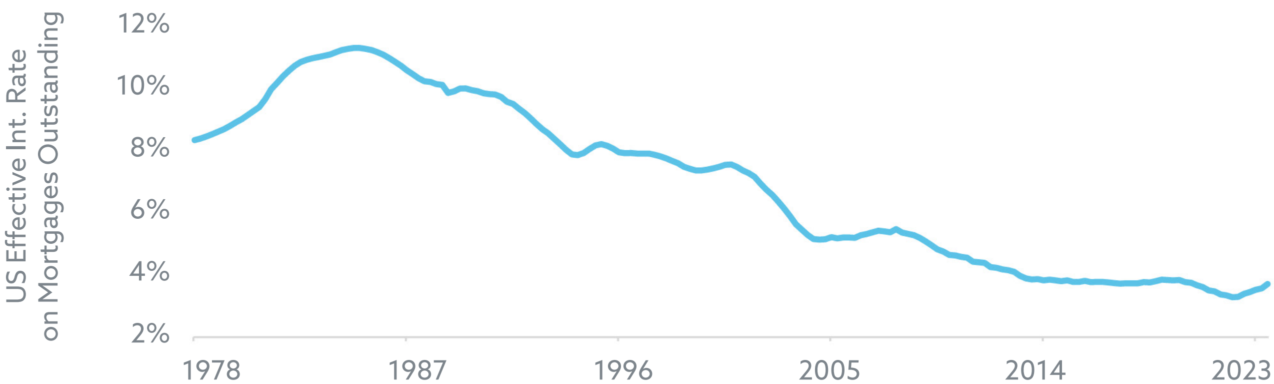
As an accompaniment to our 2024 asset class outlooks, this report quickly runs through an analysis of household and corporate fundamentals.

Households have felt the effects of higher interest rates in specific areas, such as credit cards and auto loans. Interest payments spiked in 2022/2023, nearing the highs of previous cycles. However, mortgage rates approaching 8% have had much less of an impact. The effective rate on outstanding mortgages is near its historical low, given most mortgages are fixed rate and many were issued at lower rates. Redfin recently noted 40% of homeowners do not even have a mortgage and, among those who do, 92% have a rate below 6%, 82% have a rate below 5% and 62% have a rate below 4%.[2]

HOUSEHOLDS PAYING MORE INTEREST EX. MORTGAGES[3]

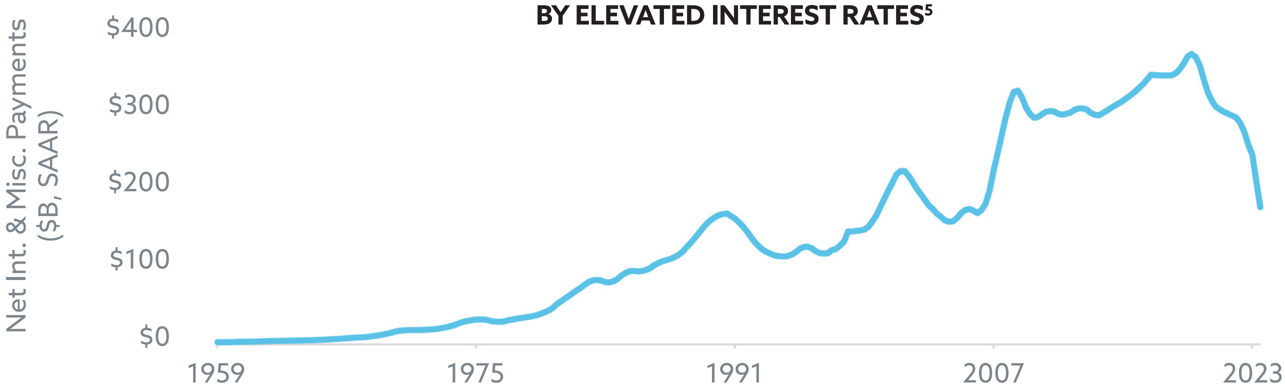


HOUSEHOLDS BROADLY NOT IMPACTED BY ELEVATED MORTGAGE RATES[4]



Corporations have seen net interest expense – the money owed on debt less the income generated from interest-bearing accounts – come down over the last four years, even after rates spiked. Companies were able to issue historically high amounts of debt in 2020 and 2021 at low yields/coupons and then issue less debt at today's higher yields/coupons. They kept some of the cash raised from issuance on balance sheets, which were then invested at higher rates in 2022 and 2023.

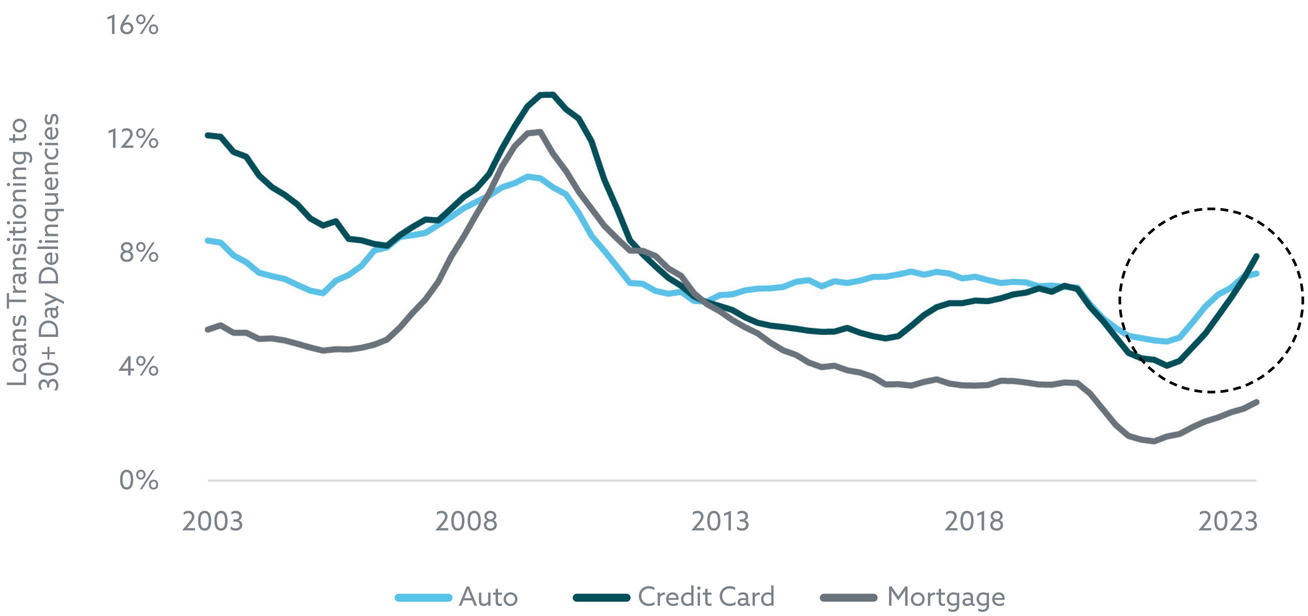
CORPORATES BROADLY NOT YET IMPACTED BY ELEVATED INTEREST RATES[5]



(2) Redfin. "Nearly Everyone With a Mortgage Has an Interest Rate Below 6%, Prompting Many to Stay Put." 14 June 2023. (3) FactSet. Personal interest payments consist of non-mortgage interest paid by households. Monthly data through October 2023, the latest available. (4) Bloomberg. Quarterly data through Q3 2023. (5) Bloomberg. Quarterly data for net interest and miscellaneous payments, gross value added, for nonfinancial corporates through Q3 2023. Consists of interest paid by domestic private enterprises and rent and royalties paid by private enterprises to the government, according to the BEA.

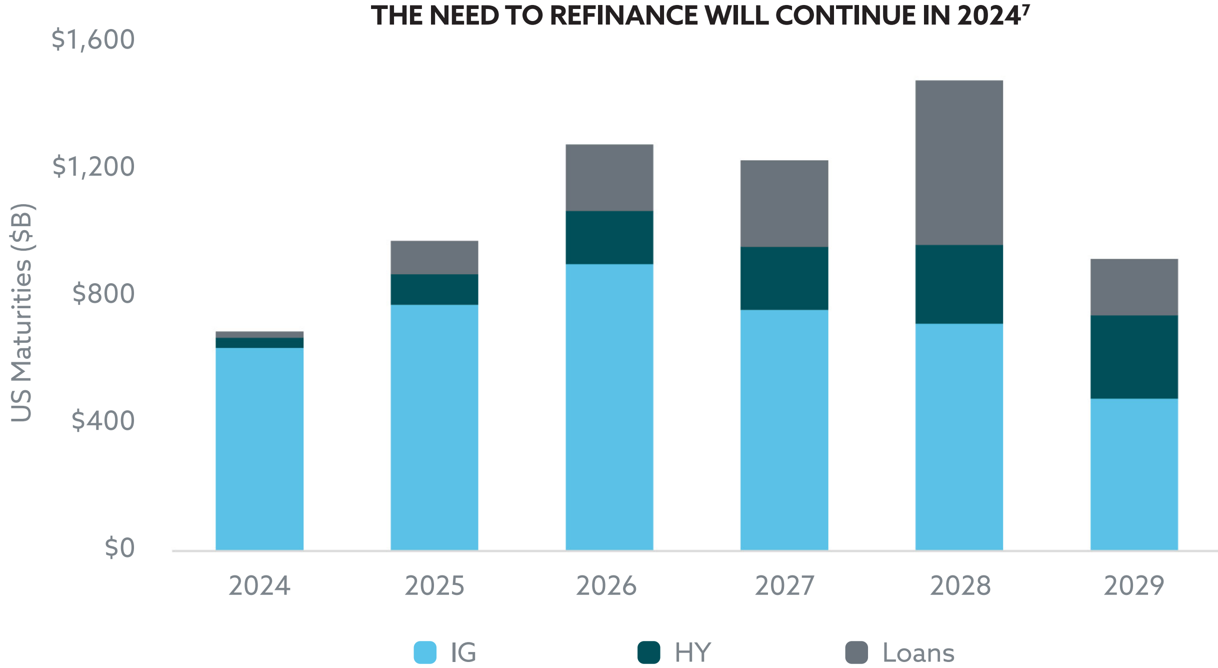
Looking ahead, we believe the fundamental trends for consumers will be maintained in 2024. Current mortgage rates are unlikely to be a broad issue for consumers, given lower locked-in rates deter moving. But interest expense outside of housing is likely to continue to remain elevated, if not increase further (e.g., as more auto loans roll over). We have already seen early-stage delinquencies (30+ days) increase, and this could lead to serious delinquencies (90+ days) and higher credit card/auto defaults in 2024.

DELINQUENCIES ARE CLIMBING, LED BY CREDIT CARDS, AUTO LOANS[6]



We do not believe corporate net interest expense can continue to go down in 2024. Companies are already investing the asset side of their balance sheets at today's higher rates, so there is little room for gain there. But companies will have to roll over maturing debt. This will force them to replace older debt at lower yields/coupons with new debt at today's higher yields/coupons. Further, specific sectors such as banking are [facing increased regulations] that are likely to increase their funding needs. However, since high yield companies have minimal amounts of bonds and loans maturing in 2024, we only expect distress and defaults to increase at measured paces next year and not spike.

THE NEED TO REFINANCE WILL CONTINUE IN 2024[7]



(6) NY Fed Consumer Credit Panel/Equifax. Quarterly data through Q3 2023. (7) BofA Global Research. 1 December 2023.

ABOUT PPM AMERICA

Our mission is to be seen by clients and their advisors as a consistently reliable partner to help them achieve their long-term value goals.

PPM is a US-based institutional asset manager with $69.21 billion in assets under management as of 30 September 2023.[8] Established in Chicago in 1990, PPM exists to consistently support institutional clients in achieving their long-term value goals. We offer our Midwestern mentality of hard work, straight talk, full transparency and humility. Our success is supported by a team-based culture that encourages debate, collaboration and consistency. At the center of our belief is the fact that our best ideas to date have and can come from any team member anywhere in our firm. We believe the success of our investment culture is best demonstrated by the strong retention of our clients and investment professionals.

(8) AUM includes committed but unfunded capital for PPM's private equity and commercial real estate businesses.

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