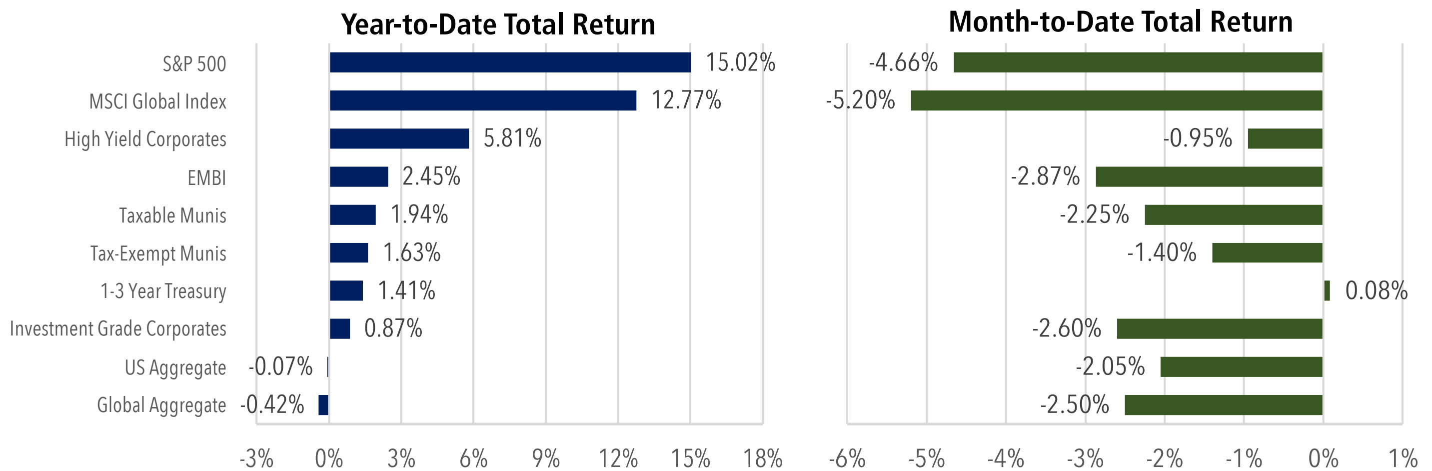
Week Ending: **August 18, 2023**

Importing Deflation?

Economic Overview:

This week, media reports drew attention to the seemingly periodic news that China invested too heavily in real estate and now faces a protracted reallocation of resources, which will affect global demand. For context, residential investment in China reached 8% of GDP in 2013 and has hovered there since, while U.S. residential investment as a share of GDP hit 6.7% in 2006 before cratering to 2.4% by 2010. More pertinent for global investors, what does a struggling Chinese economy mean for the world? One potential impact is that the rest of the world might import deflation from China. Unfortunately, the recent track record shows that repeated deflation in goods imported from China had little impact on underlying inflation in the United States. Why might that be? First, goods imports are a small slice of overall U.S. consumer spending (16.6%), and Chinese imports are an even smaller portion of spending (2.2%). Second, domestic drivers like service sector inflation—where labor market tightness has led to rising input costs—often dwarf external price pressures.

Total Returns by Asset Class



Source: Bloomberg

Highlights of the Week:

High Yield: Thanks to the rapid pace of investment-grade upgrades and the much slower pace of new issue over the course of the past year and a half, the amount of high-yield bonds outstanding has fallen back to the pre-covid level of $1.2 trillion after peaking above $1.6 trillion in 2021. Shrinking supply should serve as a technical tailwind for the asset class.

Corporates: As Treasury yields spiked higher, investment-grade corporate spreads followed suit, rising five basis points on the week to an Option Adjusted Spread (OAS) of 124 as of Thursday's close. The rise was partly due to high-grade funds seeing $433 million in outflows per EPFR data after a streak of 20 weeks of inflows totaling $57 billion. This week, $12 billion of supply was priced on the new issue front. The bulk of new issuance arrived Monday, and the market tone grew weaker as the week progressed.

Equities: The US equity market fell for the third consecutive week as higher interest rates in the US, and growth concerns in China increased the risk of a global economic slowdown. All sectors posted negative returns, with consumer discretionary, communications, and real estate the worst performers, while energy, information technology, and health care were the best.

Securitized Products: Agency mortgages remain under pressure from an investor buyer's strike as robust economic reports drive long-term interest rates to 15-year highs. Rate volatility has increased mortgage risk premiums (spread) back to cycle-high marks (190 basis points vs. the 10-year US Treasury). According to Freddie Mac, the market's turbulence has lifted the primary 30-year mortgage rate to a two-decade high at 7.22%. A level that adversely impacts affordability and housing demand.

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