BRAMSHILL INVESTMENTS
February 2023

MONTHLY INSIGHTS

As the U.S. Consumer faces mounting pressures, we see opportunities in Structured Products

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Strong like Bull?

One of the greatest debates at the start of 2023 is in response to the question: “Is the U.S. economy going to experience a recession?” Furthermore, if a recession occurs, will it be comparable to the one last seen during the Great Financial Crisis or will it be one of the more sanguine varieties, as many market participants are predicting?

We feel that the main driver of this question, especially here for the U.S. economy, comes squarely down to the U.S. Consumer, and its resilience in continuing to spend. As seen in the chart below, Personal Consumption Expenditures relative to the U.S. Gross Domestic Product have recently bounced to higher percentages (when compared to lows observed during the midst of COVID-19 related lockdowns) to levels not seen since the Great Financial Crisis.

Personal Consumption Expenditures / Gross Domestic Product

Sources: FRED (St Louis Fed), U.S. Bureau of Economic Analysis

When tracking the U-6 unemployment rate in the U.S. (which we focus on more intently than the more broadly used U-3 unemployment rate since it also considers the portion of the labor force that is underemployed), we can see how strong the current level of employment is here in the U.S. and better appreciate what the U.S. Federal Reserve Bank (“U.S. Fed”) is contending with in their current battle to ebb inflation back to their target level of 2%.

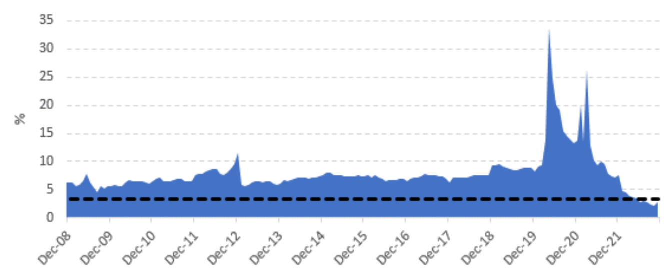
U-6 Unemployed & Part Time employed (underemployed) (Seasonally Adjusted)

Source: Bloomberg

Showing Cracks?

As we dive into the “resilience”, or current health of the U.S. Consumer, we want to first take a look at their Personal Savings rate as a percentage of their Disposable Personal Income. As seen below, the government stimulus provided to the U.S. Consumer resulted in a savings rate that jumped higher, to unprecedented levels. In fact, the savings rate was multiples higher versus the rate at any point in time since the Great Financial Crisis. However, the Personal Savings rate has most recently dropped precipitously and is now below its typical rate historically.

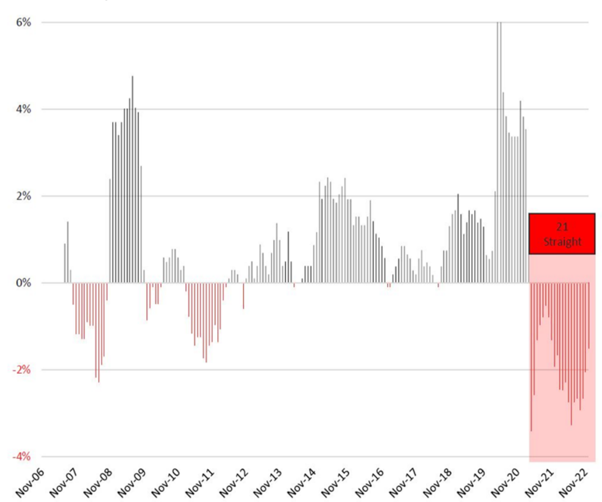
U.S. Personal Saving as a % of Disposable Personal Income



Source: Bloomberg

Once you take the extremely high rate of inflation in goods and services into account, Real Earnings Growth on a year-over-year basis has actually decreased for 21 consecutive months.

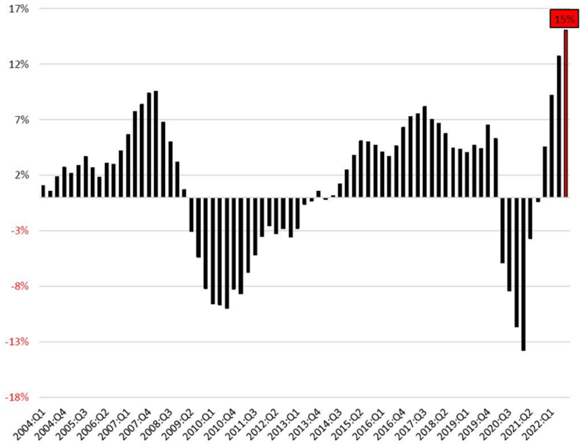
Real Earnings Growth, Year-over-Year %



Source: Hedgeye, BLS

When you combine depleting/depleted savings with lower real earnings growth, that leads to U.S. Consumer credit card balances rising at unprecedented year-over-year growth rates, even with credit card interest rates reaching historical highs due to higher overall costs of funds globally (U.S. Fed raising rates, etc.).

U.S. Consumer Credit Card Balances (year-over-year %)

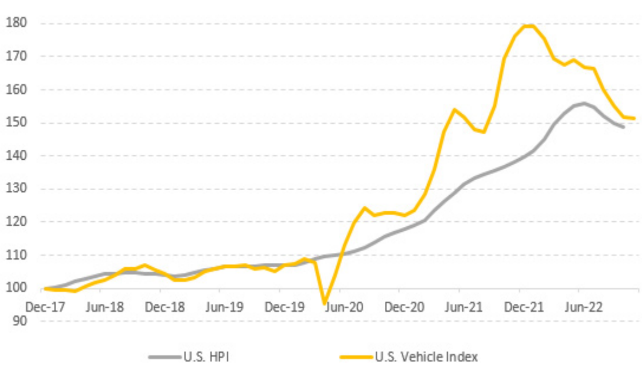


Source: Hedgeye, NY FED, FDIC

Bending and about to Break?

The glut of savings from government stimulus payments and low rates along with extremely low levels of unemployment in the U.S. caused assets such as homes and vehicles to increase in value at unprecedented rates versus pre-pandemic growth rates. This can be seen in the chart below as these indices for both homes and vehicles turned sharply higher in 2020 versus their growth from the previous few years. However, as savings and real wages have dissipated over the past year, these indices have also began their decent lower as well. Even though the declines of these indices initially lagged behind other metrics, you can see their declines should continue during this disinflationary cycle. We are cognizant of this and feel defaults on any loans originated during 2022 may have higher severities than projected by its originator.

U.S. S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index and Manheim US Used Vehicle Value Index SA since 2018

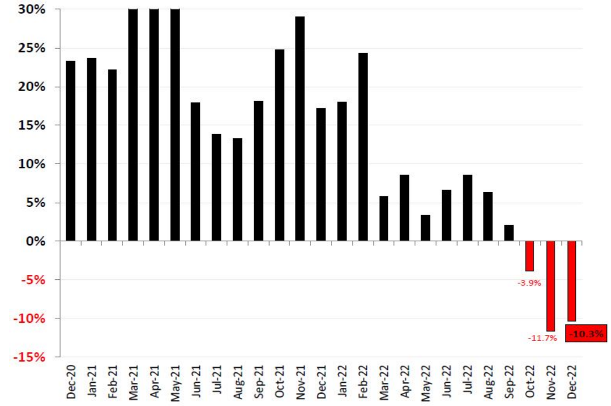


Source: Bloomberg

The negative effects of inflation raising the cost of living tends to affect lower income (which generally tend to be "subprime" quality) borrowers disproportionately and more quickly than it does higher income borrowers. As demonstrated below, the levels of delinquencies in subprime auto loans have already surpassed the Great Financial Crisis peaks of approximately 4.69%. The headwinds borrowers are facing with declining auto prices (from a major peak), lower savings rates, lower real wages, higher credit card balances have been mitigated, for now, by historically low unemployment and large excess savings accumulated from stimulus (transfer payments).

Therefore, if we are about to begin experiencing the rise of the unemployment due to the U.S. Fed's hawkish stance on rates (which they have repeatedly said they intend to hold) this will surely cause further deterioration in U.S. Consumer fundamentals (i.e. their ability to service their debt and prohibit them from borrowing more.)

Luxury Goods Consumption (Year-over-Year)
(PCE for Pleasure Boats, Aircraft, Jewelry and Watches)



Source: Hedgeye

In summary, we anticipate higher delinquencies and severities across all asset types should lead to greater than anticipated losses which will decrease profitability at consumer facing financial institutions. Along with that the destruction of demand of the U.S. Consumer (consumption being the largest component of the U.S. GDP) should continue for the time being and should put pressure on revenues for a majority of U.S. Corporations more than is anticipated as they are already coping with the onset of a profit recession cycle and eroding margins. In our view, the question is likely not, "Will there be a recession?", but rather, "When the impending recession does indeed occur, how staggering will it be historically?"

Taking all the risks and rewards into account we will be mindful of such deteriorating fundamentals and expect to focus on the following playbook going into 2023:

1) In the near term, as the fundamentals haven't fully flowed through as of yet, we will remain somewhat defensive and focus on investments that are secured by underlying assets with stronger borrowers such as prime auto and multi-family properties and stay high up in the capital structure and short in duration. ***Examples of these being 1-2 year duration seniors backed by auto receivables, and heavily cashflowing bonds backed by agency originated low LTV seasoned multi-family properties. While avoiding lower mezzanine/subordinate bonds as well as bonds backed by collateral originated to lower credit quality borrowers in sub sectors such as auto, credit cards, residential properties, etc.***

2) After the fundamentals flow through and "bottom out," we expect to see sellers of distressed assets at very attractive valuations. ***We will look to make opportunistic investments in either subordinate credits and/or lower credit borrowers in subprime auto, credit cards, residential, etc., that offer good risk-adjusted total returns that show promise of high single to mid-teens types of returns.***

We believe that all-in-all the backdrop of a weakening economy and a hawkish U.S. Fed (albeit in the later stages) will be a good foundation for most fixed income, especially in select Structured Products, and will help highlight that good asset selection resulting from a repeatable process with a long track record will allow Bramshill Investments to outperform our peers.

Contributors:

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About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over $4.4 billion in assets under management as of January 31, 2023.

Founded in 2012 and headquartered in Florida, with offices in California and New York, the firm offers an alternative to traditional fixed income investment management featuring a variety of strategies across various debt and fixed income markets and specializing in preferred securities.

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Firm Annoucements

Bramshill Named Subadvisor to Multi Strategy Income Fund

Liberty Street Advisors has named Bramshill Investments as subadvisor to the Braddock Multi-Strategy Income Fund (ticker BDKNX), which has been renamed to Bramshill Multi-Strategy Income Fund. The fund will continue to invest in asset-backed debt securities, primarily in residential mortgage-backed securities. Paul van Lingen and Ara Balabanian will be responsible for the fund's management and investment strategy.

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Disclosure