

U.S. Fixed Income Markets

## The Next Big Risk

- The February Russian invasion of Ukraine was one of the more notable market events in 2022 and it was mostly unforeseen.
- Our HilltopSecurities market experts weigh-in on the topics and themes that could be, “The Next Big Risk,” for financial markets.

### The Russian Invasion Was Mostly Unforeseen

Many thought the most recent Russian build-up of troops and equipment and then military maneuvers was still only saber-rattling even days after Russian soldiers marched and tanks rolled into Ukraine. Now, over six months after the latest escalation of the Russo-Ukrainian War we can be certain the February 2022 Russian invasion of Ukraine is in fact a major escalation, and one of the largest armed conflicts since World War II.

The costs in lives lost and lives upended has been significant. Almost 6,000 Ukrainian civilians are confirmed dead, but this number is more likely much higher. Ukraine has suffered 9,000 military losses and that tally is about 25,000 for Russia at least. The conflict

### The Next Big Risk According to HilltopSecurities' Analysts and Strategists

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Source: HilltopSecurities.

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has produced almost 7 million war refugees. The economic costs of the war have been significant and widespread as well. Commodity prices, especially those related to agriculture and energy have been upended as a result. Please [see Walter Kunisch's \(our Commodities Strategist\) commentary](#) for more on this topic generally. Just when we thought world supply-chains were on their way back to a more normal status they were again disrupted. And now, we are seeing the more meaningful negative (mostly) impact where global and national 2022 GDP growth rates are concerned. The Economist Intelligence Unit (EIU) revised its global GDP forecast to 2.80% (in July 2022) down from its pre-invasion Feb. 2022 forecast of 3.90%. The EIU also revised its 2022 GDP forecast for the U.S. lower, to 2.3% (July 2022), down from its pre-invasion (Feb. 2022) forecast of 3.4%.

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## The Cost of The Russian Invasion of Ukraine

Change in GDP Forecasts in July 2022 vs Feb 2022

Country	2022 Pre-invasion GDP Forecast (Feb 2022)	2022 Revised GDP Forecast (July 2022)	Change
Saudi Arabia	4.50%	7.50%	3.00%
World	3.90%	2.80%	-1.10%
United States	3.40%	2.30%	-1.10%
China	5.20%	4.00%	-1.20%
France	4.10%	2.20%	-1.90%
Germany	3.30%	1.30%	-2.00%
Russia	2.60%	-10.00%	-12.60%

Source: Economist Intelligence Unit and HilltopSecurities.

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This military escalation has been one of the more impactful events on global and U.S. financial markets that we have seen develop in 2022. And in most cases even geopolitical strategists did not believe it was likely. In other words, this was a big risk that many or most observers missed.

## The Next Big Risk

To that end, we have asked the market-experts, analysts and strategists at HilltopSecurities to opine on what they think could be the "Next Big Risk." The risk could be one that may impact their individual sector-coverage or the financial market(s) overall. The "Next Big Risk" could be seen or unforeseen. What the Hilltop thought leaders have come up with in some cases may surprise you and in other cases could reinforce opinions that have been forming already. Some of these pressures have been building for years, or even decades. Others are more recent developments. But, they all are included, together, so readers of different sectors can see what other sector-experts at HilltopSecurities think may soon boil over and become that "Next Big Risk." We hope you find the below informative and helpful. Please share your reactions with us when you have an opportunity to do so.

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## The Next Big Risk: Deflationary pressure

According to **Scott McIntyre**, Senior Portfolio Manager

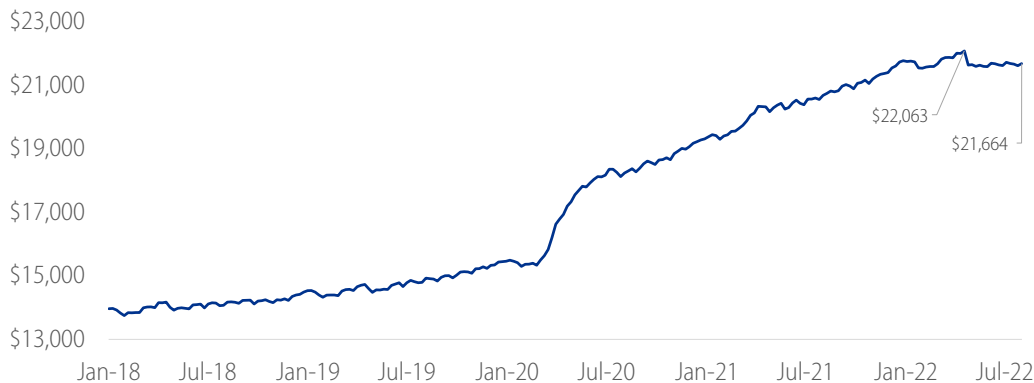
As the Fed battles the most severe inflation in decades, the risk of deflation has been pushed aside, but for a decade before the pandemic began, falling prices were the more dominant concern. The timing is uncertain, but the stage is being set for a reversal of the price narrative.

The inflation we're seeing now is unusual. It's the result of two broad and obvious factors:

- Pandemic-fueled demand, and
- A temporary inability for producers to respond with supply.

On the demand side, consumers are already feeling a lot of pain (or at least discomfort). The personal savings rate dropped to a 13-year low in June, M2 money supply has contracted -1.8% since April and the New York Fed reported that over the past year, credit card debt has soared by \$100 billion, or +13%, the biggest percentage increase in more than 20 years.

### M2 Money Supply Contracted Since April 2022



Source: U.S. Federal Reserve, \$ in billions.

The negative wealth effect associated with the stock market correction is tough to quantify but is a major contributor to the lowest consumer sentiment reading in the 44-year history of the University of Michigan survey. And of course, borrowing rates are higher, home sales have plunged, and the mortgage refi window is mostly closed.

All this represents rapid destruction on the demand side, and the Fed isn't done tightening. It doesn't feel like we're in recession now, but that doesn't mean we won't be at some point, and that's never positive for demand.

The supply side is fragmented, but otherwise improving. Many big box stores are actually awash in inventory. Items they'd ordered months ago finally showed up and have been marked down. Supply chain problems were amplified earlier in the year by COVID lockdowns in Shanghai. These have now ended, and production has since ramped up. The Global Supply Chain Pressure Index from the New York Fed is now down almost -50% from the high in December. Commodities prices are still elevated, but well off their highs.

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In short, demand is falling fast at the same time supply is accelerating. As global growth slows further, many countries will increase production of exports. The strongest dollar in decades will drive down the price of goods imported into the United States. Geo-politics will remain a big wildcard affecting food and energy, but the overall supply/demand imbalance is already beginning to swing the other way.

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## The Next Big Risk: Bracing for a U.S. housing market hard landing According to Mahesh Swaminathan, MBS/ABS Strategist

Market consensus calls for year-over-year home price appreciation to slow down to a low- to mid-single digit percent in 2023. This compares to a median year-over-year home price increase of 10.6% in July 2022 and down from a 26.1% increase in May 2021.

However, there is a real risk that home prices post actual year-over-year declines next year. At a macro level, weaker home prices and lower existing home sales could lower GDP as a result of a smaller contribution from the housing and real estate sectors, and weaker consumer spending by homeowners. In the mortgage market, both originations and MBS issuance are likely to decline sharply on the heels of reduced purchase activity and slower rate-term as well as cash-out refinances. We note that relatively small home price declines are unlikely to trigger large scale delinquencies or a foreclosure crisis and their related attendant problems.

U.S. Housing Finance Agency (HFA) MBS are likely to continue providing solid call protection and relative value in this environment. That said, large home price declines and/or significant job losses would pose the risk of correspondingly more damage to the mortgage market and the U.S. economy.

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### Existing Home Sales vs. year-over-year Price Change



Source: National Association of Realtors and HilltopSecurities.

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## The Next Big Risk: Higher-education costs and student loan debt

According to Justin Hoogendoorn, Head of Fixed Income Capital Markets Strategy and Analytics

President Joe Biden recently initiated an executive order to forgive \$10,000 of federal student loan debt for those making less than \$125,000 which includes up to \$20,000 of forgiveness for Pell grant recipients. Although the expected debt forgiveness may be viewed as a positive step towards lowering student debt, it simply transfers around \$300 billion from students to the tax paying public. In fact, student loan debt has grown from 3% of outstanding consumer debt to around 10% and will likely continue to grow as educational costs rise.

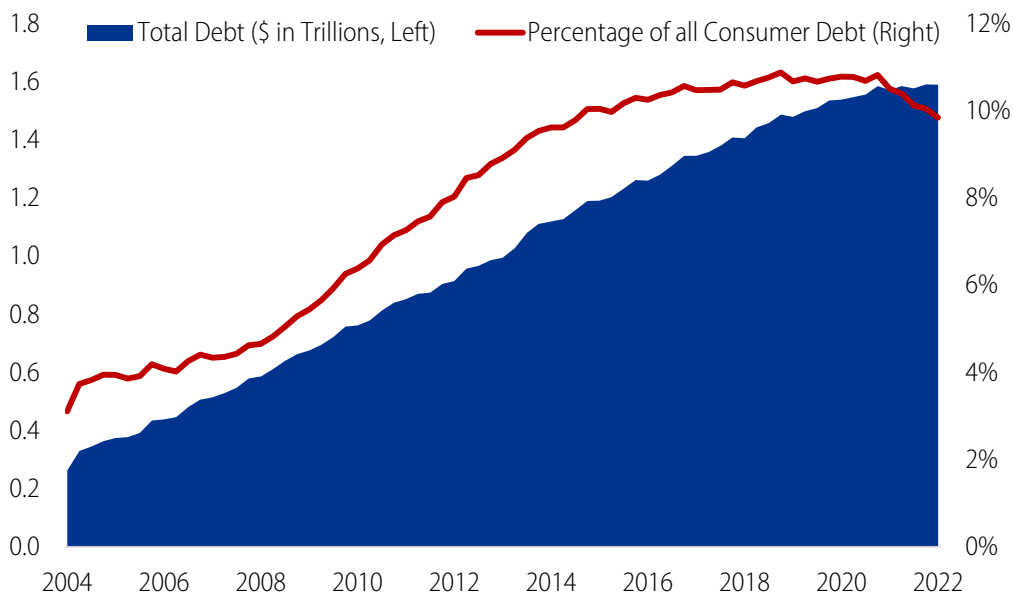
The cost of our educational system and the amount of debt taken on by students, schools and taxpayers for a quality post-secondary education complicates our educational efforts and debt markets tied to it. First, demographics are working against schools with the number of high school graduates projected to fall by nearly 10% between 2025 and 2030 (Nathan Grawe, Demographic Headwinds for Higher Education). Second, inflationary trends were well established in our educational systems prior to current inflationary trends, averaging nearly twice the level of overall inflation dating back to 1994 (4.5% vs. 2.4%).

While we might expect technology to turn this trend, it only creates more specialization in our educational system. We will continue to watch these trends and their impacts on key bond markets and credits.

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### U.S. Student Loan Debt Outstanding



Source: Federal Reserve Bank of New York and HilltopSecurities.

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## The Next Big Risk: Structurally tight domestic hydrocarbons and protein supplies may keep inflation elevated

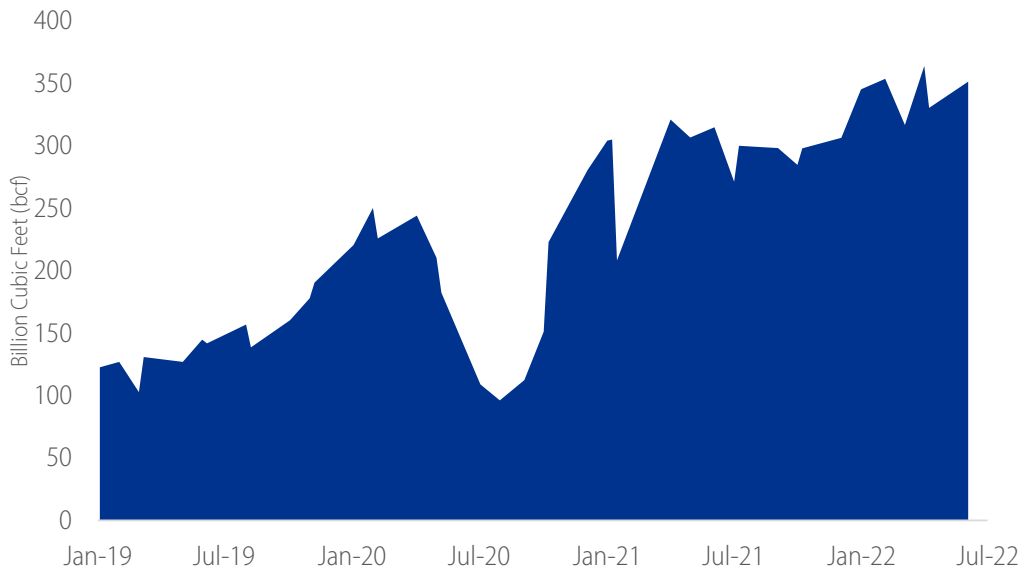
**According to Walter Kunisch**, Senior Commodities Market Strategist

Despite the Fed’s commitment to control inflation by slowing aggregate domestic demand, supplies of hydrocarbons (natural gas, reformulated gasoline, and distillates) and protein (cattle and hogs) should remain structurally tight.

First, the evolving global energy paradigm combined with the EU’s moratorium on Russian energy at the end of 2022 has forced the region’s end users to recalibrate relationships with suppliers. This has led to increasing U.S. energy demand, which is manifest through strong, and in some cases, record large exports of U.S. natural gas, gasoline, and distillates. While this scenario is well known, it is unlikely that the export pace of U.S. hydrocarbons will abate.

Second, a protracted and intractable drought in the southern plains and western U.S. has led to widespread culling of the domestic beef cattle herd. Acute slaughter of the upstream female breeding stock can create tight animal and beef supplies. High corn and soybean meal prices along with diseases have suppressed growth of the U.S. hog herd and poultry flock. While green shoots indicate that the domestic broiler flock is stabilizing, tight aggregate domestic animal supplies combined with robust demand may keep prices elevated.

### Monthly U.S. Liquefied Natural Gas Exports



Source: U.S. Dept. of Energy and HilltopSecurities.

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## The Next Big Risk: Potential higher costs of capital and lack of market access for project finance

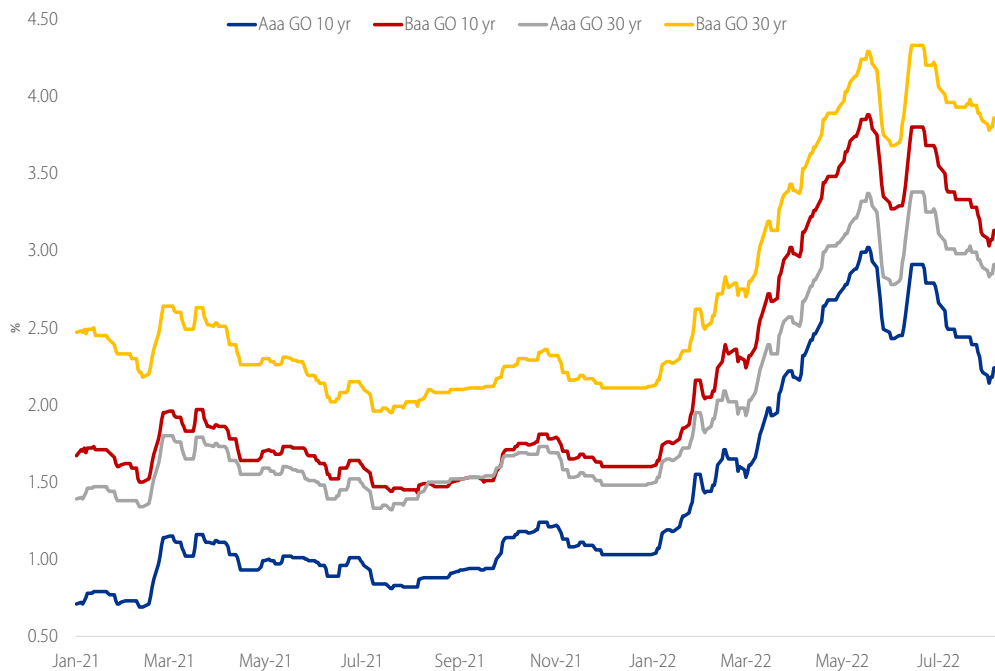
According to Yaffa Rattner, Head of Municipal Credit, Debt Capital Markets

In the current volatile market, credit has become critical with investors placing significant attention on project fundamentals. Transactions that may have been successfully placed last year, despite project risk, will often struggle in the current market environment and successful pricings may be 200 basis points higher than where they would have previously priced.

What does this mean? Within in the project finance space, including sectors such as senior living, hospitals, charter schools, industrial revenue bonds, and land secured projects, when project revenues underperformed original underwriting expectations, an issue that has been exacerbated by the labor and inflationary environment, one path toward correction was a refunding of the transaction at historically low rates, providing the opportunity for cost savings and default avoidance. In the current market, the heightened focus on credit coupled with the ramp on capital costs, has limited refundings and restructurings, which over the next 18 months may have a meaningful impact on default activity within these sectors.

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### Municipal Yields Rose Substantially Across the Credit Spectrum in 2022



Source: Refinitiv and HilltopSecurities.

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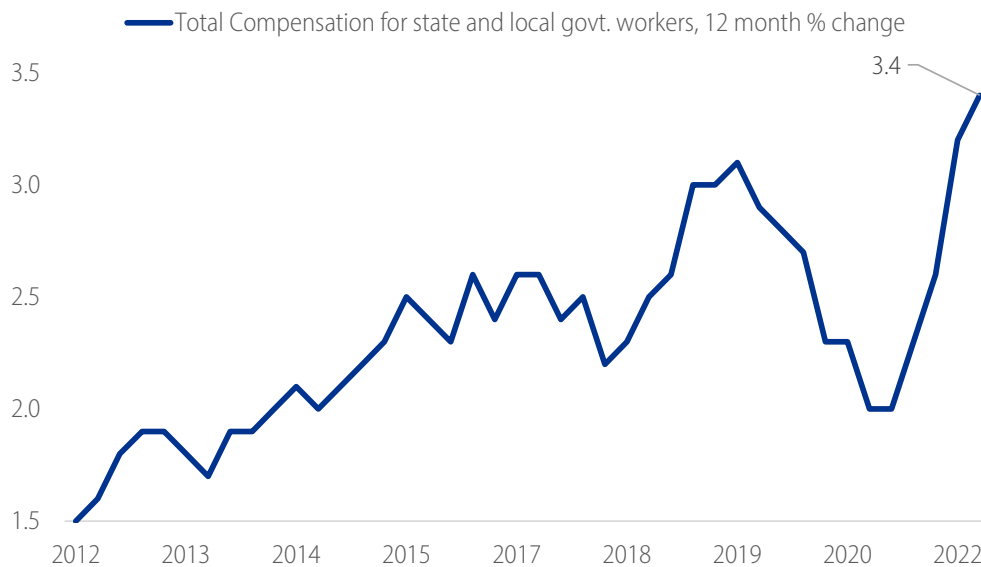
**The Next Big Risk: Public entities face growing risks from surging labor costs**  
**According to Phil Villaluz**, Municipal Credit Analyst in Fixed Income Capital Markets

While many public finance entities will likely avoid inflation-related credit deterioration through the remainder of this year, we think that governments and other public finance entities will eventually have to deal with pressure from surging labor costs. Indeed, many will continue to benefit from solid financial positions bolstered by huge distributions of federal aid and strong revenues. However, inflation and labor shortages are driving compensation expense growth across not only most facets of the public-sector workforce (police, fire, education), but also across revenue sectors such as healthcare and higher education where competition for workers is high and operating margins are already quite thin.

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The graph below illustrates that the growth rate of state and local government workers compensation has surged in the past 12 months, and is now growing at the fastest pace in the last 10 years. As reserves are spent, combined with decreased revenues from any potential economic slowdown, issuers may face heightened labor cost pressures within the next 18 months.

**Government Worker Comp is Rising Substantially Coming Out of COVID**



*Inflation and labor shortages are driving compensation expense growth across not only most facets of the public-sector workforce (police, fire, education), but also across revenue sectors such as healthcare and higher education.*

Source: BLS and HilltopSecurities.

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## The Next Big Risk: Washington could target the tax exemption

According to Tom Kozlik, Head of Municipal Research and Analytics

Two of the major events that have most significantly impacted U.S. public finance originated from Washington D.C. fiscal policy since 2017. In both cases a single party-controlled Congress. We envision several scenarios where the municipal bond tax-exemption could be negatively directly and indirectly targeted by future fiscal policy. There is the potential for a conservative wave to build in the mid-terms and potentially during the next Presidential election cycle. If this occurs, we believe that the threat to the municipal bond tax-exemption could rise. We have recently written more in-depth on this topic in [A New Decade & The Threat to the Municipal Bond Tax-Exemption](#), Oct. 22, 2021 and in pages 5-6 of [What the Inflation Reduction Act of 2022 Means for U.S. Public Finance](#), Aug. 12, 2022.

We do not expect the opportunity for an expansion of municipal bond friendly elements considering the above mentioned circumstances. In other words it will be not only unlikely but impossible for public finance to regain tax-exempt status for advance refundings or attain a taxable direct-pay infrastructure program again if there is a split Congress or if there is control of the executive and legislative branches by the Republican party.

That being said, a potential political scenario that has been mostly considered a longshot may now have at least a small chance of occurring is one where the Democrats keep control of the House and gain seats in the U.S. Senate in November of 2022. If this happens, the potential for an expansion of fiscal policy could appear. The elements of the 2021 Build Back Better progressive agenda that were not passed would reappear as possible. In this scenario there could be a very good chance for municipal bond related elements such as the reinstatement of tax-exempt advance refundings and a taxable direct-pay infrastructure program, to not only materialize in drafts of legislation, but to become law. That being said, there is also a small chance that a threat to the tax-exemption forms if lawmakers are looking for pay-fors for a potentially more substantial progressive agenda. We have not seen this type of hazard develop yet, and there has mostly been support from the Democrats for municipal bond elements and the tax-exemption, but there could be some unknown danger from a potentially more substantial progressive agenda.

Either way, it is important that state and local government related organizations, public finance industry groups, and related parties increase the amount of education currently being done in Washington to inform lawmakers about the policy implications of different scenarios related to the municipal bond tax-exemption.

### Breakdown of Party Government in the U.S. (114th Through 117th Congress)

Congress	House Majority	Senate Majority	Presidency	Party Govt.
119th (2025–2027)	Unknown	Unknown	Unknown	Unknown
118th (2023–2025)	Unknown	Unknown	Unknown	Unknown
117th (2021–2023)	Democrats	Democrats	Democrat (Biden)	Unified
116th (2019–2021)	Democrats	Republicans	Republican (Trump)	Divided
115th (2017–2019)	Republicans	Republicans	Republican (Trump)	Unified
114th (2015–2017)	Republicans	Republicans	Democrat (Obama)	Divided

Source: U.S. House Archives and HilltopSecurities.

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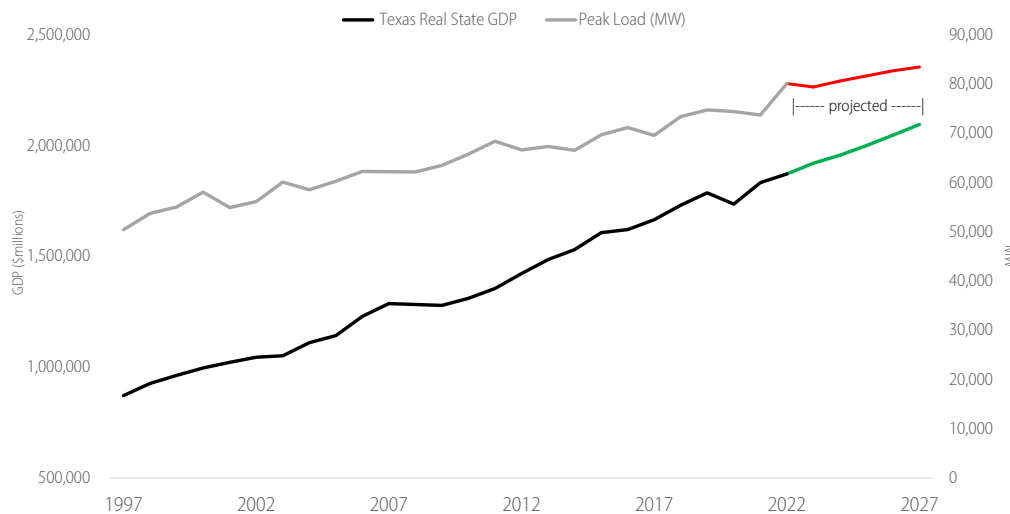
## The Next Big Risk: Potential for an energy shortage in energy-rich Texas

According to Ted Chapman, Municipal Credit Analyst in Public Finance

Will there need to be solar panels on Texas rooftops to keep the good times rolling? The second biggest economy in the U.S. is projected to continue to hum along. But will the Electric Reliability Council of Texas' (ERCOT) energy-only model reliably support that growth? Regulatory pressures, abundant natural gas and old-age have led to a decade of baseload coal unit retirements. Nuclear has been off the table since the 2011 Fukushima disaster in Japan. New baseload combined cycle gas plants take two to three years to bring online. Eventually the units that have been running full throttle through Texas' brutal summer of 2022 will have to go offline for maintenance, or risk a forced outage. Utility-scale solar and distributed generation projects are having a moment in Texas. But, even with a changing climate, the sun doesn't always shine and the wind doesn't always blow. While Texas is the nation's largest net energy producer, it takes energy to make energy and the oil & gas and electric utilities sectors paid over \$20 billion in franchise fees and property taxes to local governments in 2021.

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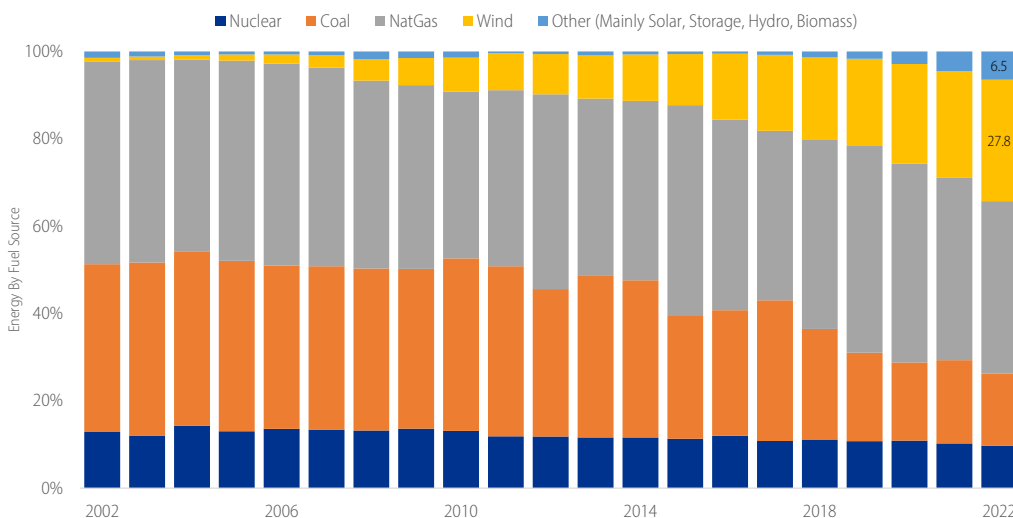
### As the Texas Economy Grows, so Does Electric Demand ...



*Utility-scale solar and distributed generation projects are having a moment in Texas. But, even with a changing climate, the sun doesn't always shine and the wind doesn't always blow.*

Source: FRED, ERCOT and HilltopSecurities.

### ... And ERCOT's Reliance on Wind and Solar Power



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Source: FRED, ERCOT and HilltopSecurities.

## The Next Big Risk: The drought in the western U.S.

According to Doug Nelson, Municipal Credit Analyst, Wealth Management

Recently, when government officials in the San Francisco Bay area approved a new housing development, they were warned that water was going to be an issue. Unfortunately, the ability to expand housing stock and promote commercial development throughout the western United States could be limited by the availability of water resources. The drought has put pressure on municipalities to supply affordable water to existing customers. Water agencies and local governments with water enterprises continue to encourage users to conserve water and to find more efficient uses of water.

The State of California has been using a portion of its budget surplus to mitigate the effects of the drought such as funding recycled water projects, desalination plants and reservoirs, plus rebates to replace lawns with native plant gardens or turf. California agriculture uses an estimated 80% of the state’s developed water supply. In 2020, California’s agricultural production and processing industries represented 2.8% of the total state GDP. California farmers produce over one third of the vegetables in the U.S. Many farmers are letting fields lie fallow due to water availability issues, which is having a negative impact on the economy. Droughts have lasting impacts and it takes time to recover from them.

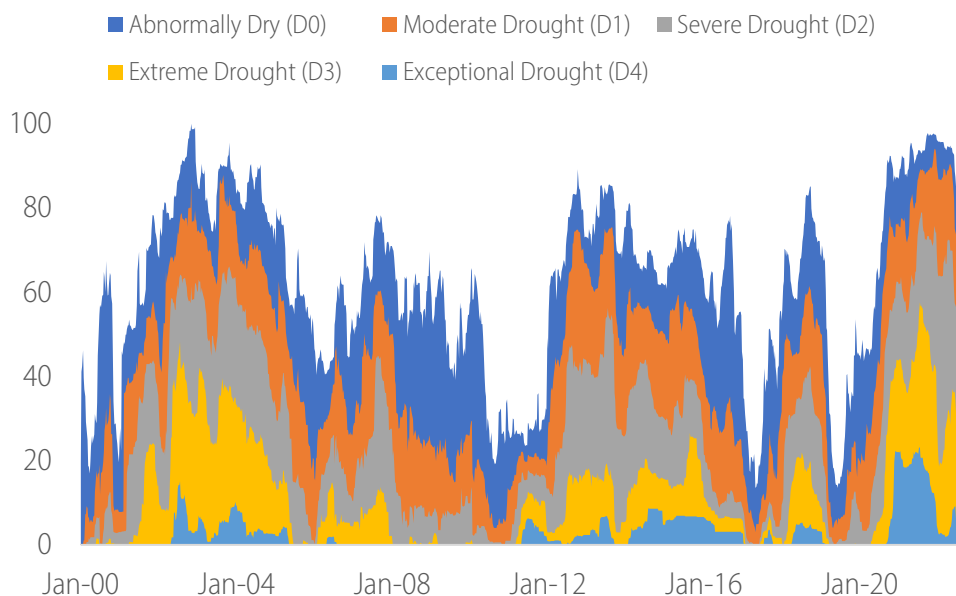
The below chart shows that the current drought started relatively soon after the previous drought, so full recovery did not occur. The bottom line is that state and local governments will have to factor in droughts and water availability into their budgets and growth plans in the future.

*The ability to expand housing stock and promote commercial development throughout the western United States could be limited by the availability of water resources.*

*Many farmers are letting fields lie fallow due to water availability issues, which is having a negative impact on the economy. Droughts have lasting impacts and it takes time to recover from them.*

### Western Drought Conditions

Percentage of area in drought



*The bottom line is that state and local governments will have to factor in droughts and water availability into their budgets and growth plans in the future.*

Source: National Drought Mitigation Center and HilltopSecurities.

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