SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

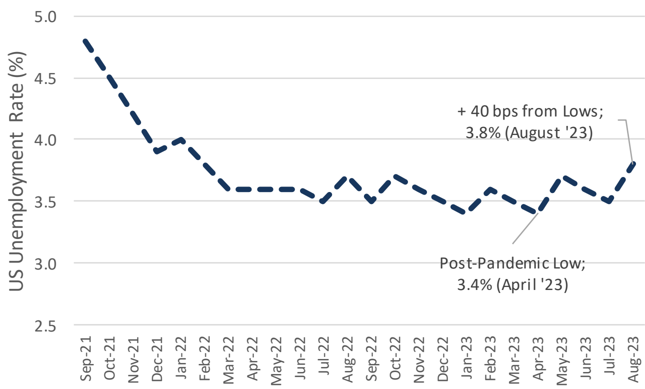
A Healthy Consumer

The US unemployment rate reached 3.8% in August, up 30 bps sequentially to its highest level in 18 months. At the same time, mortgage rates have breached the 7.5% threshold for the first time since September 2000, credit card debt is on the rise, and student loan payments will resume next month after a more than three year hiatus. With such pressures mounting, should investors be concerned about a turn in consumer confidence de-railing the "soft landing" narrative? In this *Weekly Briefing*, we put recent employment trends into context, and find that post-pandemic gains in wages should keep consumer balance sheets on solid footing.

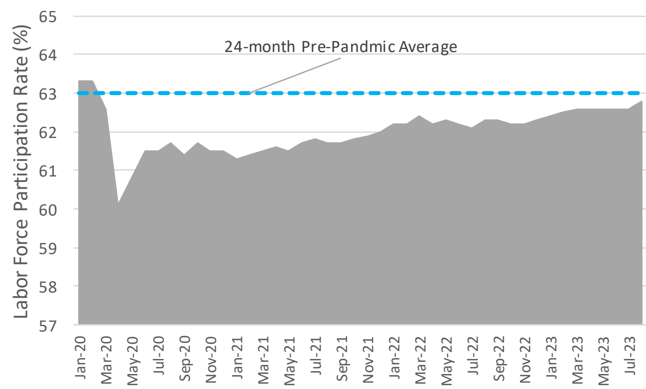
May the (Labor) Force be With You

Despite the addition of 187,000 jobs to the economy, the US unemployment rate reached 3.8% in August, 30 bps higher than both prior month and consensus expectations. **The surprise move bridged half the gap between July's rate and the Fed's 4.1% FYE23 estimate** (from the June Summary of Economic Projections), causing some concern that a more tenuous job market might imperil the economy as consumers tighten their purse strings. However, this somewhat unexpected jump appears driven by an increase in job seekers (the labor force grew by 736,000 in August), not job cuts. In fact, the labor force participation rate came in 20 bps higher than consensus expectations, hitting 62.8% and nearly getting back to pre-pandemic levels.

Unemployment Rate Ratchets up in August
trailing 24 months



Labor Force Participation Rate Nearly Back to Pre-COVID Levels
monthly data, since COVID

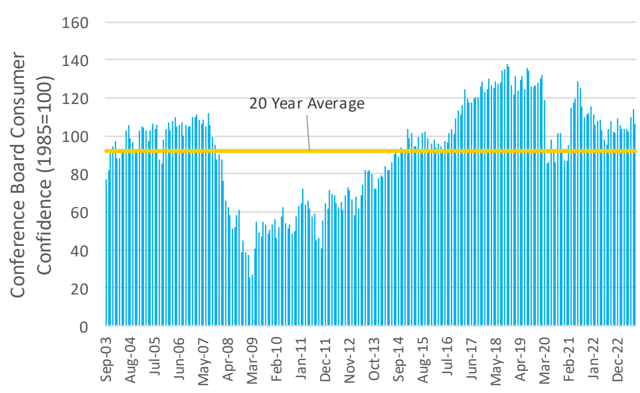


Source: SKY Harbor, Bureau of Labor Statistics, JP Morgan

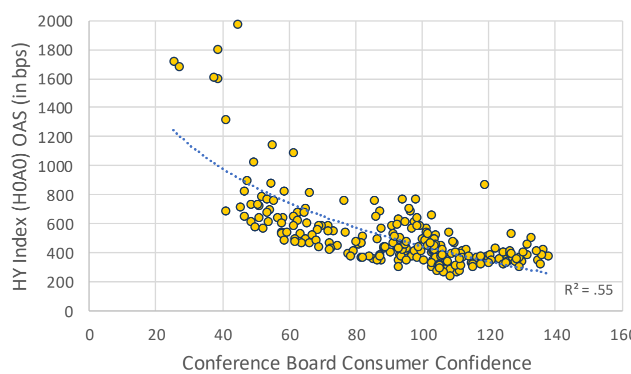
Down, But Not Out

August's Consumer Confidence reading declined more than economists had expected, coming in at 106.1 vs. consensus of 116.0 and a prior reading (revised) of 114.0. Both components of the reading worsened in August, with the Present Situation Index falling to 144.8 (from 153.0), and the Expectations Index declining to 80.2 (from 88.0). According to the Conference Board, **assessments of the present situation appear driven by less optimism around employment conditions, while write-in responses noted concerns surrounding price increases for groceries and gasoline**. However, results have historically been influenced by news flow and economic conditions at the time of the survey, and we noted in our most recent briefing (No Summer Lull) that the late July through August period was full of volatility-inducing events that may not persist (Fitch downgrade of US government debt, China import/export weakness, inflated treasury auctions, etc.). We also highlight that while confidence readings declined in August, they remain above long-run average levels, and the current reading is within 25 bps of implied high yield index spread fair value.

Confidence Declined But Remains Elevated
trailing 24 months



Spreads Consistent with August Confidence Reading
trailing 24 months



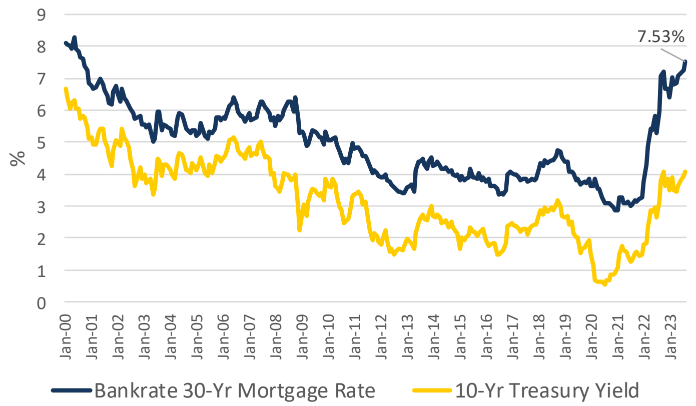
Source: SKY Harbor, Conference Board, Bloomberg, ICE Data Indices

Misleading Mortgage Rates

Mortgage rates have been on the ascent over the last 20 months, moving in tandem with 10-year Treasury yields. In fact, the 30-year fixed national average breached 7.5% in August, the highest level in over two decades. The impact to consumers, however, is path-dependent. **Lackluster new and existing home sales means that most existing mortgages were entered into when borrowing was less onerous, leading to an historically attractive 3.6% effective rate**. As such, the impact to consumer spending has, thus far, remained quite muted.

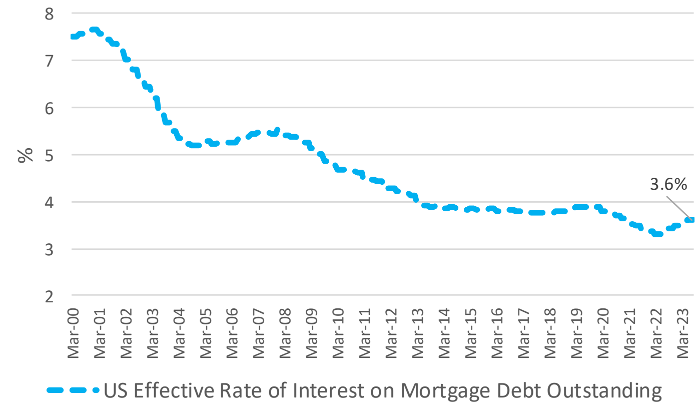
Mortgage Rates Hit Two Decade High

monthly data



Effective Mortgage Rate Far Less Concerning

monthly data



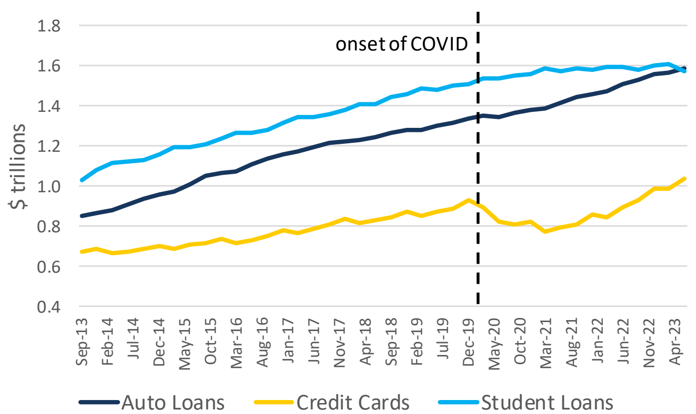
Source: SKY Harbor, Bankrate.com, Bureau of Economic Analysis, ICE Data Indices

Wage Gains Outpace Payments

According to the New York Fed's *Quarterly Report on Household Debt and Credit*, **credit card debt has for the first time surpassed the $1 trillion mark**. Undoubtedly influenced by inflation across most goods and services, this uptick also coincides with an increase in the cost to service debt, as further exemplified by the overall rise in auto loans (left chart below). Additionally, the moratorium on student loans will soon end, as payments are set to resume this coming October. Despite these pressures, **wage gains have positioned US consumers to better manage such obligations relative to recent history**. As demonstrated below (right side), debt service represents less than 10% of disposable income, 140 bps below the multi-decade average.

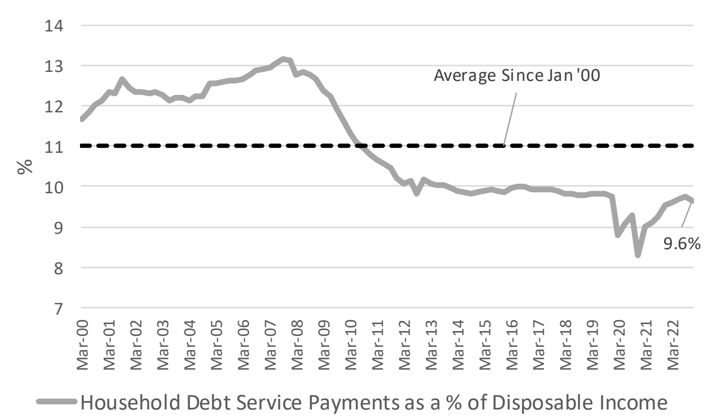
Non-Mortgage Debt on the Rise…

quarterly data



…But Debt Service Remains More Manageable Than Average

quarterly data



Source: SKY Harbor, Federal Reserve Bank of St. Louis, Business Insider, Federal Reserve Bank of New York

Plenty Left in the Tank

Consumer spending makes up approximately 70% of the economy, leading to fears that a recent uptick in unemployment, a multi-decade high in mortgage rates, credit card debt surpassing the $1 trillion mark for the first time in history, and resumption of student loan payments could derail current momentum. All things, however, are relative, and we therefore see the aforementioned headwinds as quite benign once placed into proper context. In fact, we see wage gains as providing consumers with an above-average ability to counteract such pressures over the intermediate term, and expect economic output to remain supportive for the high yield asset class in the coming quarters.

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