

AUGUST 23, 2022

ON THE RADAR

FAQs on the Markets and Economy

Has inflation peaked?

It appears so. The yearly change in the consumer price index (CPI) fell in July to 8.5% from 9.1%, which was the highest in 40 years.

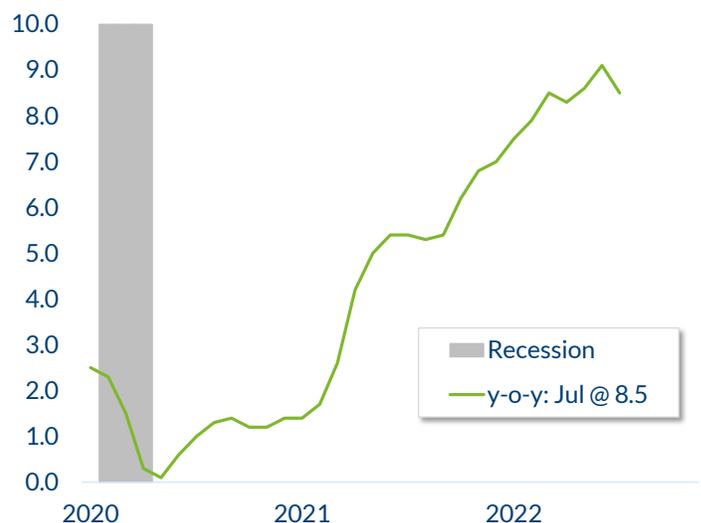
A big chunk of the pullback came from dropping gasoline prices, which fell 7.7% month over month but are still up 32.9% year over year (YoY). The cost of a gallon of gasoline has fallen by \$1.05 since peaking in mid-June at \$5.01/gallon. It was \$3.62/gallon when the war in Ukraine started.

The drop reflects several factors:

- Weaker demand due to the higher cost of driving
- The decline in global oil prices brought on by the fear of a worldwide recession
- The suspension of gasoline taxes in a handful of states

The level of inflation is still sky high, and the Federal Reserve (Fed) remains concerned. Fed chair Jerome Powell has been clear for some time that the Fed needs to see clear evidence of a sustained slowdown in inflation before it pivots on monetary policy. The softer pace of inflation in July, along with the expectation of another weak inflation report for August, is important news for the Fed as it makes plans for its next interest rate hike in September.

Consumer Price Index
Percent change, y-o-y, seasonally adjusted



Source: Bureau of Labor Statistics

KEY QUESTIONS

- When will the Fed stop raising interest rates?
- What does the Inflation Reduction Act mean for the economy and markets?
- What are the credit implications of drought on municipal water utilities?

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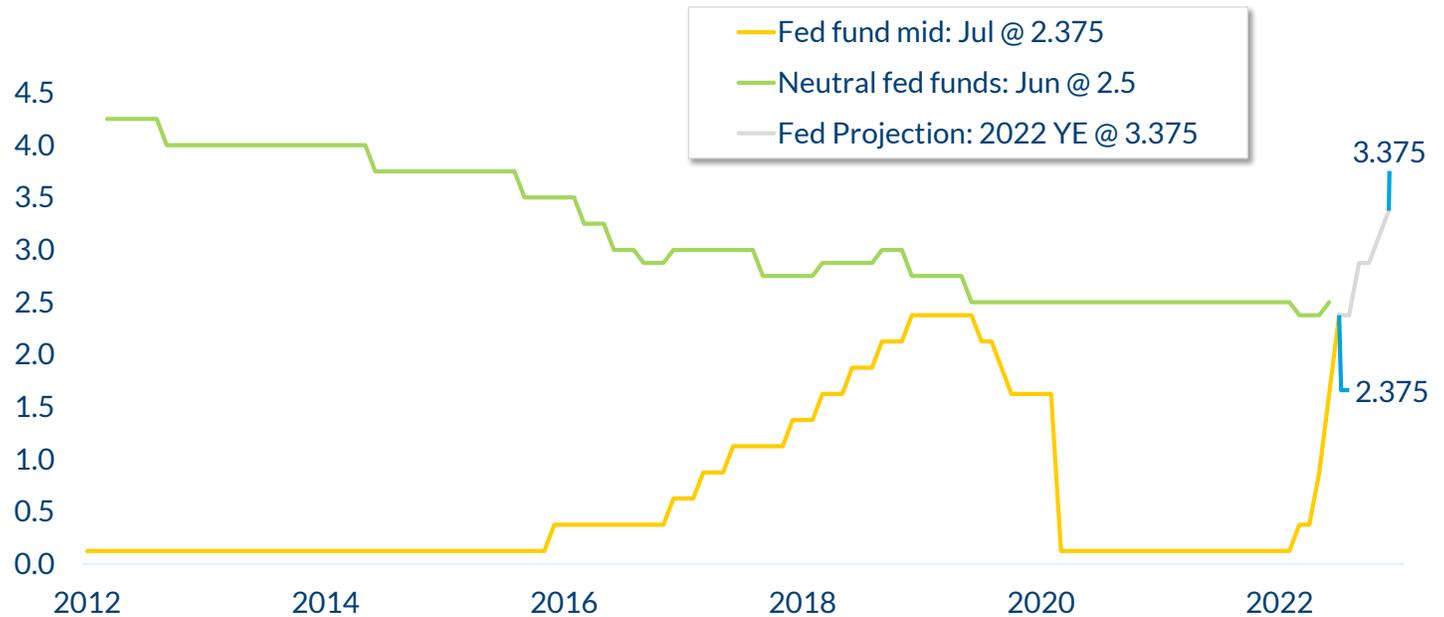
When will the Fed stop raising interest rates?

It doesn't appear to be soon. Based on its projections in June, it still plans to raise interest rates by another 100 basis points (bps) this year.

The last two interest rate increases were 75 bps each. Those were unusually large increases, something the Fed had not done since 1994. Now that the federal funds rate is near the neutral territory (see chart below), Fed officials are growing sensitive to the economic impact their rate hikes will have on the economy. They want to make sure they do not cause unwarranted economic weakness. But at the same time, they know they need to raise interest rates enough to slow the pace of economic growth, which should cause inflationary pressures to drop.

The next Federal Open Market Committee (FOMC) meeting is on September 21st, and another labor and CPI report will be released before that meeting. Data from those reports, and the Fed's analysis, will help the Fed decide if it should raise rates by 50bps or 75 bps.

Federal Funds & Neutral Federal Funds (%)



Source: Federal Reserve

What does the Inflation Reduction Act mean for the economy and markets?

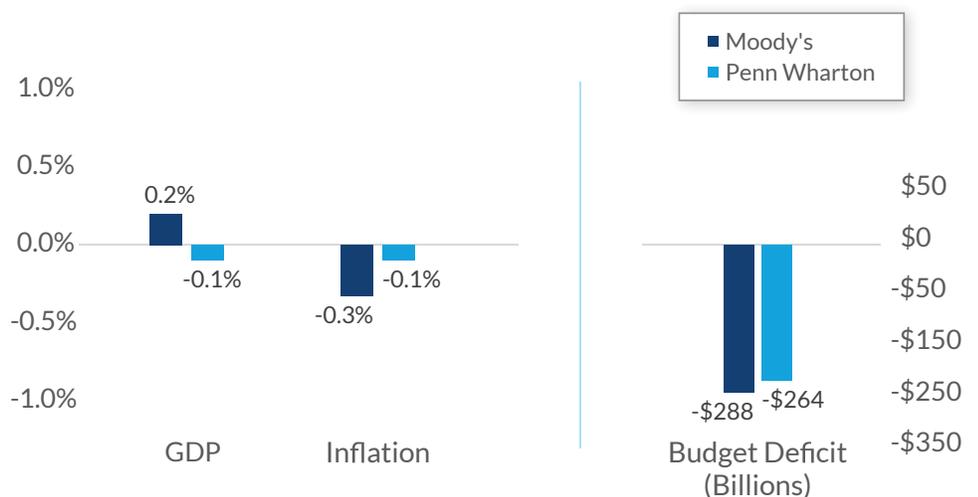
After over a year of political wrangling, President Biden and the Democrats have successfully passed the Inflation Reduction Act (IRA), a climate-, tax- and health-focused bill.

Overall, the IRA is expected to raise approximately \$737 billion in revenue over 10 years through a 15% corporate minimum tax on companies earning over \$1 billion in profits, a 1% tax on stock buybacks and greater IRS enforcement and by allowing Medicare officials to negotiate directly on prescription drug costs. The IRA provides for spending over \$430 billion over 10 years to reduce carbon emissions and extend health insurance subsidies related to the Affordable Care Act.

Despite its name, the IRA is expected to have little impact on reducing current and long-term inflationary pressures. Even the touted step of allowing Medicare to negotiate the prices of some drugs doesn't begin until 2026 and will have small effects thereafter on overall inflation. Likewise, the impacts on growth are likely to be marginal. Together with the recently passed CHIPS and Science Act and Facilitating American-Built Semiconductors Act, US Gross Domestic Product (GDP) is expected to increase over the next decade by a modest 0.2%-0.3%.

The IRA is expected to reduce the deficit by about \$300 billion over the next decade. While this would

**Inflation Reduction Act of 2022 Analysis
Impact Over 10-Year Budget Window**



Sources: CBO, Moody's, Penn Wharton Budget Model

represent just a tiny proportion of the next decade's projected \$16 trillion in budget shortfall, it's a step in the right direction, improving federal finances and leaving enough budget space to avoid reaching the debt ceiling until 2024.

Overall, the bill will likely prove a modest headwind to corporate profits, with analysis suggesting the 15% minimum corporate tax rate would be a 1% drag on S&P 500 earnings per share (EPS) in 2023. It's estimated that fewer than 150 companies will be affected by the new rate, with

sectors facing notably higher tax bills including chemical manufacturing, technology, healthcare and real estate. The pharmaceutical sector will also be negatively affected since Medicare is now allowed to negotiate on key drug prices. Companies and sectors that should benefit from the IRA Act are those dealing with climate change mitigation efforts, such as electric carmakers and renewable energy, while the CHIPS Act includes tax incentives for semiconductor equipment and manufacturing facilities investment.

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What are the credit implications of drought on municipal water utilities?

Media outlets continue reporting on drought conditions affecting many regions of the country, particularly the western states, where severe drought (or worse) is stressing the ecosystem as water supplies diminish.

Hydrological volatility is not a new phenomenon, particularly for states like California, which is experiencing its third consecutive dry year, with 2022 having the driest conditions to date in at least 128 years, per the U.S. Drought Monitor. While western states are familiar with periods of above- and below-average precipitation, climate change is causing drought to occur more frequently, last longer and have a higher intensity than historical patterns. Despite some relief in recent weeks for some areas like Arizona and Nevada, abnormal heat and dryness are forecast to continue for most western states into 2023. In response, municipal water utilities must not only carefully plan near-term contingencies but also consider longer-term capital strategies that balance water supply access and customer demand.

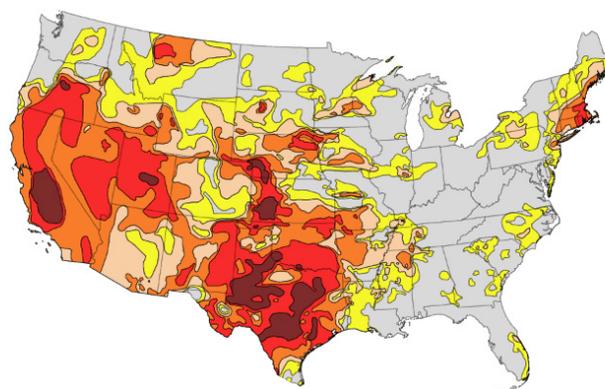
Recent conditions have pulled forward critical legislative discussions and developments around policy directives to broaden investment in water supply projects and increase conservation efforts (i.e., imposing voluntary or mandatory water restrictions). For example, California Governor Gavin Newsom released a plan outlining several initiatives to protect and expand the state's future water supply, such as streamlined permitting for recycled water infrastructure and local water agency financial support grants. Arizona, impacted most significantly by the recent

U.S. Bureau of Reclamation water shortage declaration in the Colorado River Basin, is investing further in groundwater recharge and is planning drought-tolerant supply alternatives. In recent years, we've observed municipal water utilities execute agreements that allow water transfers in the event of supply shortages. Also, customer rates have been increasingly designed to recover service costs, often leading to revenue durability that strengthens their ability to repay debt more comfortably.

Municipal water utilities' financial and operational performance will vary based on local supply conditions and enterprise-specific considerations, like rate-setting practices.

We expect drought and hydrology planning to become more embedded in climate adaptation strategies. Maintaining adequate financial capacity and flexibility is paramount in the analysis of credit quality for water utilities. Preserving balance sheet liquidity and consistently generating a healthy debt coverage cushion while addressing drought risk reflects management stewardship – an essential factor in our criteria. State and federal government involvement is likely to grow, as evidenced by the recent passage of the Inflation Reduction Act, which included \$4 billion to help fund various drought resiliency measures, like conservation.

U.S. Drought Monitor



U.S. Drought Monitor Category

- D0 - Abnormally Dry
- D1 - Moderate Drought
- D2 - Severe Drought
- D3 - Extreme Drought
- D4 - Exceptional Drought

% of U.S.*

- 56.2%
- 41.2%
- 29.1%
- 14.5%
- 3.3%

*Percentages are cumulative, so D0 shows the percent of the U.S. in D0 or worse (D0-D4)

Sources: NDMC, NOAA, USDA. Updates weekly - 08/16/22

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the USD denominated, high yield, fixed-rate corporate bond market.

CPI: A consumer price index (CPI) is a price index, i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

CBO: A collateralized bond obligation (CBO) is a type of structured debt security that has investment-grade bonds as the underlying assets backed by the receivables on high-yield or junk bonds.

Moody's: Moody's Corporation (MCO) is the holding company that owns both Moody's Investors Service, which rates fixed income debt securities, and Moody's Analytics, which provides software and research for economic analysis and risk management. Moody's assigns ratings on the basis of assessed risk and the borrower's ability to make interest payments, and its ratings are closely watched by many investors.

Penn Wharton Budget Model: Penn Wharton Budget Model's (PWBM) tax policy simulator allows policymakers, members of the media, and the general public ("users") to see the impact that potential reforms to tax policy will have on many the economy and the federal budget.

NDMC: National Drought Mitigation Center (NDMC) The National Drought Mitigation Center's mission is to reduce the effects of drought on people, the environment and the economy by researching the science of drought monitoring and the practice of drought planning.

NOAA: The National Oceanic and Atmospheric Administration (NOAA) is an American scientific and regulatory agency within the United States Department of Commerce that forecasts weather, monitors oceanic and atmospheric conditions, charts the seas, conducts deep sea exploration, and manages fishing and protection of marine mammals and endangered species in the U.S. exclusive economic zone.

USDA: The United States Department of Agriculture (USDA) is the federal executive department responsible for developing and executing federal laws related to farming, forestry, rural economic development, and food.