Beneath the Surface

May 2023

SIGNET

A Conflict in the Numbers

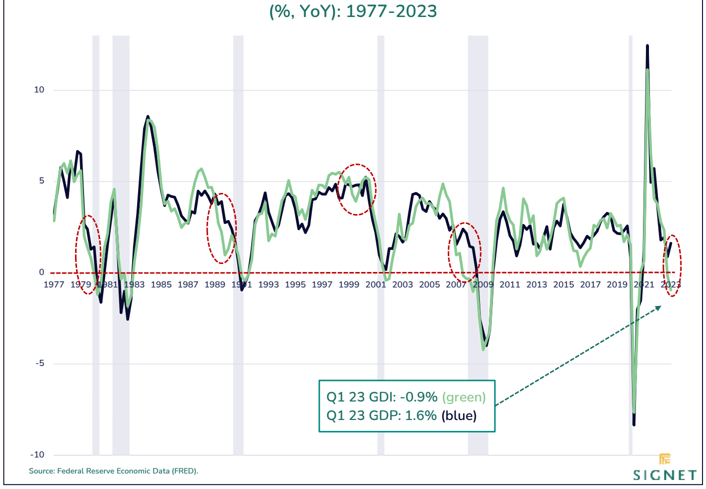
- The equity markets have mostly shrugged off the aggressive interest rate hikes we've witnessed over the last six months. The leading economic indicators might be urging caution, with the US Leading Economic Index down 4.3% over the last six months, but the equity markets are certainly not - the S&P 500 equity index has gained 10% so far in 2023.

- While there are plenty of reasons for optimism, we believe a false sense of security may have taken hold. Anecdotally, in the US, the 'household' survey of employment has recently shown conflict with the 'establishment' survey of employment; in the most recent BLS release, the 'household' unemployment rate increased from 3.4% to 3.7%, while the 'establishment' nonfarm payroll figure simultaneously surprised with an increase of 339,000 workers. Gross Domestic Product (GDP) data has begun to conflict with Gross Domestic Income (GDI) data. GDP should equal GDI, theoretically, but in practice they can diverge. With US Q1 2023 GDP coming in ahead of expectations at 1.6% (YoY), like the 0.9% print for Q4 2022, it is notable that US GDI declined by 0.9% in Q1 2023 and by 0.2% in Q4 2022 (chart, below left). Contradictions like these might flag up changes in the economic cycle.

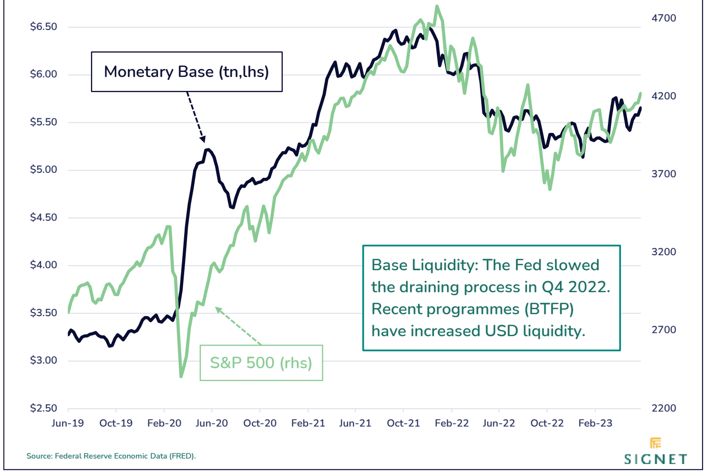
- The appeal of exploiting the information in GDI to date recessions is simple: it is as comprehensive as GDP, but it may capture information about the economy missed by the GDP measure. Federal Reserve economist Jeremy Nalewaik explored the differences between GDP and GDI in greater detail and he argued that GDI might be a better indicator, as advance estimates of GDI are closer to the final estimates of both measures. For example, GDI may capture informative variation in income and employment data not fully reflected by GDP. In other words, the GDI metric of economic growth often turns lower more rapidly, relative to GDP, as an economy heads into recession. This can be seen in the recent decades covered by the first chart: in 1989, 2000, 2007 and – critically – now in 2023. The corporate profits component of GDI has played a particularly important role in flagging downturns.

- So, why are equity markets up? Post-Covid 'excess' savings, which are still being spent, may have something to do with it. And base liquidity. The Fed's quantitative tightening (QT) programme may appear – on the surface at least – to be draining liquidity as promised, with the Fed's System Open Market Account (SOMA) contracting by over 5% in 2023 so far. However, beneath the surface, US Reserve Balances have increased by over 10% in 2023, and this additional liquidity, through new credit extensions such as the Bank Term Funding Program, seems to have supported banks and the sentiment for riskier investment. A rather crude, but interesting, attempt at identifying the recent relationship between the equity markets and base liquidity can be seen in the chart below right.

US Real Gross Domestic Income & Gross Domestic Product (%, YoY): 1977-2023



US Monetary Base & S&P 500 (2019-2023)



- **Therefore:** We remain cautious so remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity. Equities: target quality but there's no rush. Commodities: target precious metals.