Beneath the Surface

December 2023

SIGNET

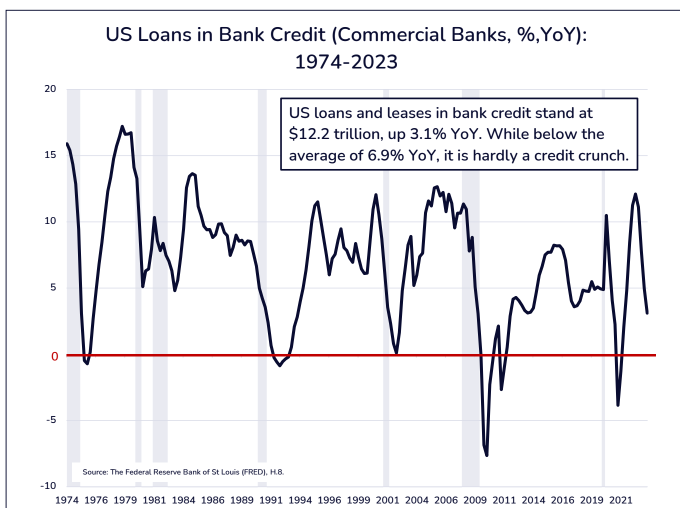
Murdered by the Fed?

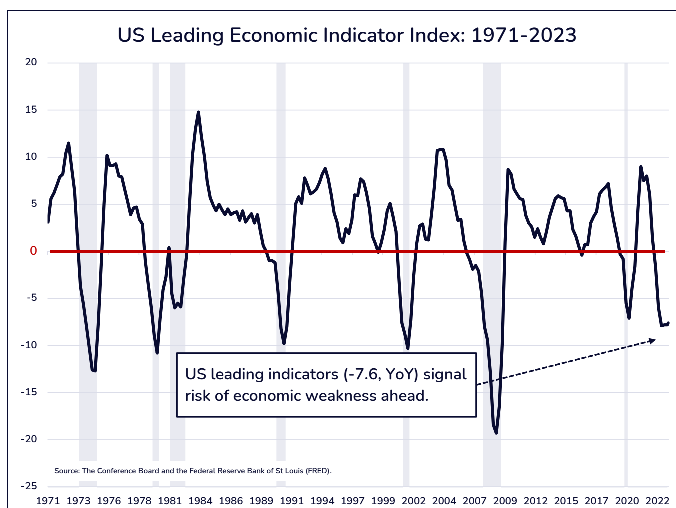
- Predictions of recession have been early. While economic data appears to be weakening in Europe and Asia (RoW), there remains optimism for the US, largely because of the factors we've highlighted over 2023. Specifically, improved liquidity and sentiment have provided useful tailwinds for economic performance. As we head into 2024 the expectation for central bank rate cuts, on the back of improving inflation dynamics, are driving consensus opinion for steady earnings and economic growth. More factually, the second reading of US Q3 GDP came in at a feisty 5.2% annualised, and US CPI (YoY) has declined to 3.1% from 6.4% a year ago, which bodes well for 2024, for the moment at least. And if the US doesn't sneeze?

- A key factor in economic growth is bank credit creation. In a modern economy, whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account (the bank's liability), thereby creating new credit (the bank's asset). Some headlines in the second half of 2023 have expressed concern for a US recession, on the grounds of a highly unusual declining rate of total US Bank Credit (currently -1.2% YoY). Critically, however, the Fed's tightening of interest rates since March 2022 has not actually led to a contraction in bank lending – and this matters. The large inflow of deposits generated by the pandemic-related quantitative easing were put into 'Reserves' first, and then added to 'Securities', such as Treasuries and MBS. It is the sub-component of total US Bank Credit 'Securities in Bank Credit' that has taken the hit and fallen 10% (YoY). The YoY change in the all-important sub-component 'Loans and Leases in Bank Credit' is still positive at 3.1% (chart below left) and it is not currently signaling alarm. In other words, banks have responded to quantitative tightening by trimming their holdings of 'Securities' in 2023, rather than pulling back on lending and they have therefore continued to support economic growth.

- The Federal Reserve has tightened interest rates aggressively since March 2022, hiking rates 11 times from the 'zero bound' to 5.5%. Monetary policy works with long and variable lags, estimated at one-to-two years. If a recession is late this time, it might be because of the post-Covid excess savings and because the Fed Funds rate was still negative in real terms until April of this year. There is an additional consideration this cycle: the problem with interest rates at current levels isn't the cost of nominal credit, per se, but the starting point in all of this. The global debt accumulation was fostered during the years at the 'zero bound' and the repressed hurdle rates turned bad investments into potentially good investments. It is the prior misallocation of capital that might come back to haunt us now with higher rates. Corporate debt has been structured for a world of ultra-lax monetary conditions and today's tighter policy environment may result in serious stress, with likely adverse implications for investment and growth unless it is reversed quickly. Historically, on average, it takes eight months from the last Fed hike to the first Fed cut.

- Caution for 2024. Can we see dark clouds forming? Yes. The Conference Board (US) Leading Economic Index (LEI) provides an early indication of significant turning points in the business cycle; a compass for the US economy in the near term. The LEI, comprising ten financial and non-financial indicators, has been negative since September 2022 and is signaling caution. The LEI is a predictive variable that anticipates turning points in the business cycle by around seven months. It is currently -7.6% YoY (chart below right). As an aside, anecdotally and from a global perspective, world trade volumes continue to flash red. World trade volume, according to the CPB World Trade Monitor, continues to deteriorate and is currently -3.5% YoY; a contracting rate has always been associated with recessions.





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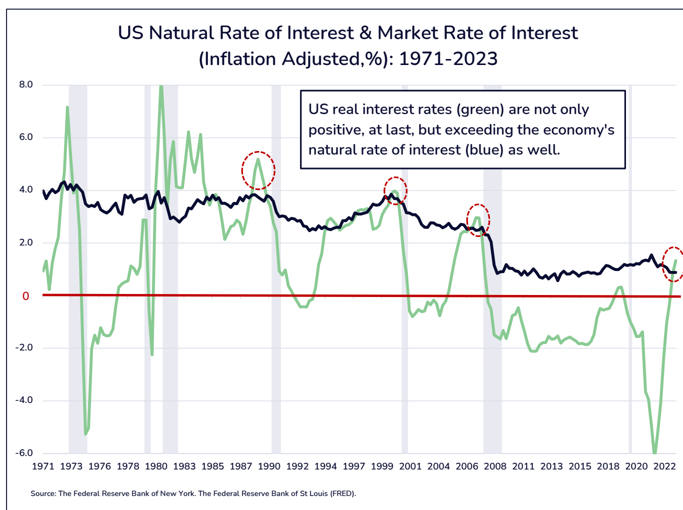
Murdered by the Fed? (cont.)

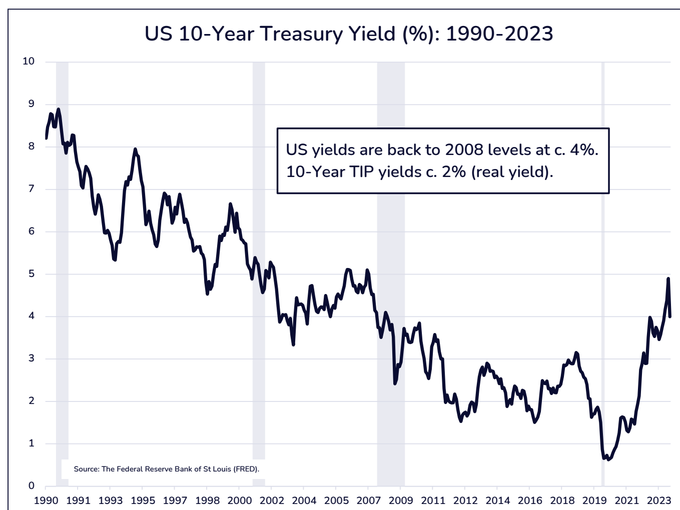
- A big-picture macro indicator re-emerged in 2023. The Federal Reserve Bank of New York suspended their estimates of the Natural Rate of Interest (R-Star) in 2020 during the Covid pandemic, and it recently announced that it has resumed regular publication of this key macroeconomic concept. R-Star is not easily measured and it can only be estimated: it is a neutral, inflation adjusted interest rate for an economy in its natural growth state. It is driven by secular forces such as productivity, demographics, savings and debt. We can view R-Star as the central bankers' guidepost: market interest rates held above an economy's natural rate (R-Star) contract economic activity and lead to lower prices. Market interest rates held below the R-Star have an opposite effect: they stimulate economic activity and prices. Therefore, the estimated position and direction of R-Star is important.

- There had been hope that the 20-year trend in lower R-Star estimates had been broken during the Covid pandemic episode. However, recent publications from central banks and the IMF seem to show that the trend in R-Star is once again heading lower, as the chart (below left, blue line) now shows. John Williams, president of the New York Fed, was one of R-Star's creators and he summarised the Fed's calculations recently: "*according to the model estimates, the main longer-term consequence from the pandemic period is a reduction in potential output…Importantly, there is no evidence that the era of very low natural rates of interest has ended.*" This expression of secular stagnation tells us something about the likely trajectory of nominal interest rate activity in the event of a recession.

- While this is something of a 'heavy', and perhaps controversial, subject, a simple analysis of R-Star against market interest rates (chart below left) might elicit a useful leading indicator of economic pressure building (R-Star data exists for other regions as well, and it is similarly downbeat). The first observation of the chart, as already mentioned, is that interest rates, adjusted for inflation, have only just gone positive in the US; the global economy has endured an extended period of financial repression. The second observation is that the US economy is certainly not in the clear yet: the chart clearly shows us that positive real rates, combined with market interest rates above R-Star, are a useful leading indicator of potential financial stress. The ultimate implication of all this, once the dust has settled on all the successive shocks of the last four years, is that if R-star is declining to the pre-pandemic levels, we might expect inflation expectations and interest rates to meaningfully fall once again. This has repercussions for investment advice.

- At this time, let us not forget the wisdom of Rudi Dornbusch in 1997: "*None of the post-war expansions died of old age. They were all murdered by the Fed.*" Every recession since 1945, except for the 2020 recession perhaps, was preceded by a notable rise in inflation that forced the central bank(s) to raise interest rates. As we close out 2023, the pre-conditions for 2% Inflation in the US are mostly in place. We might now be leaning towards the idea that by the end of 2024, the Fed will be worrying about inflation falling too far in 2025. In that case, they will respond by easing rapidly and the attractive market yields of today will be nothing but a memory (chart below right).





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