RUBRICS

Macro Overview

The Unpredictability of Economic Certainty

Fixed Income Macro View

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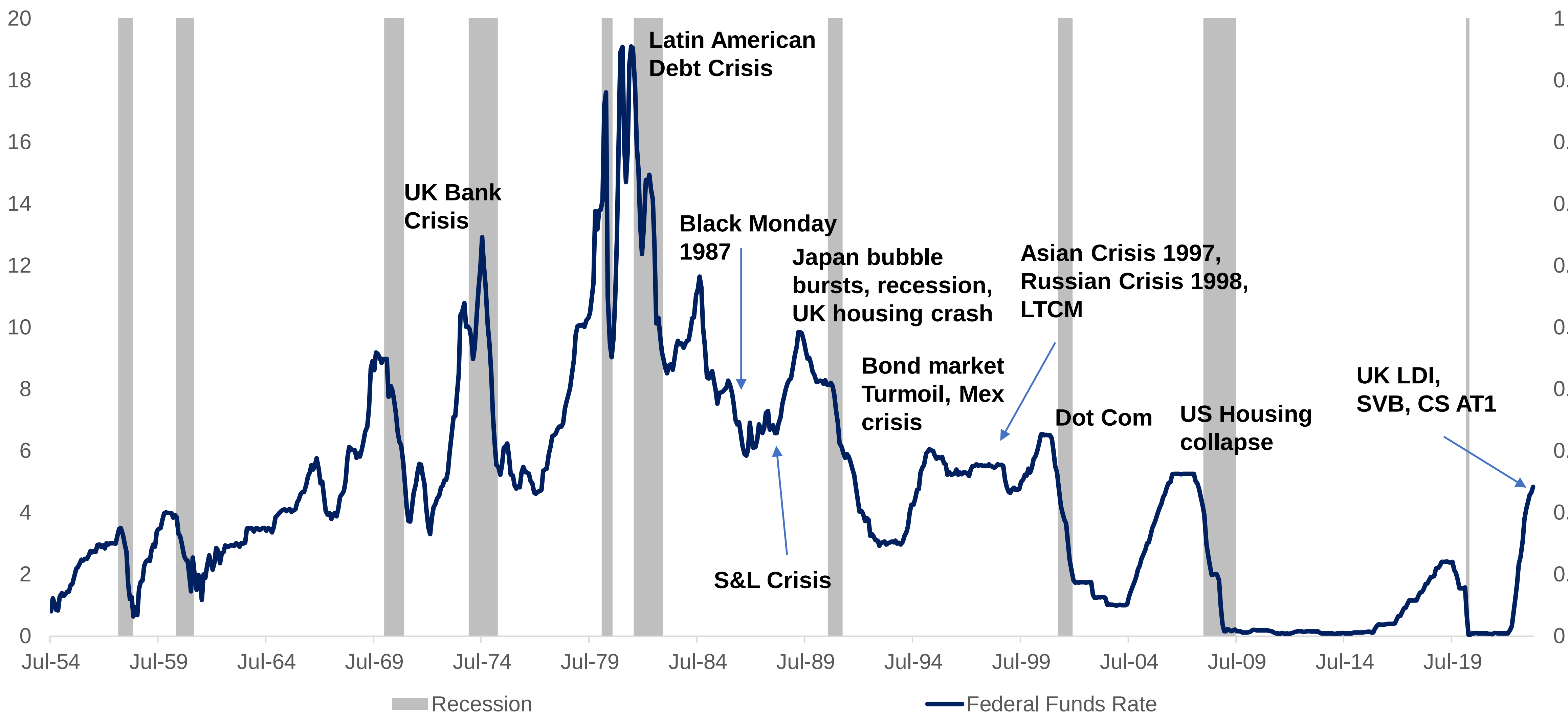
The Unpredictability of Economic Certainty

Monetary tightening, if executed sufficiently, can create the conditions for economic contraction and slower inflation. There are caveats to this of course but in a stable large economy with reserve status currency this theory should almost certainly hold. However, there is a great deal of uncertainty around how high interest rates need to go, when the impact will be felt and how much damage will be inflicted on the economy and financial markets. We are currently coming to the end of a global interest rate hiking cycle, all things being equal, and it is the next part of the process that is most difficult to predict. We will examine some of the factors which we believe will determine the speed and strength of the impact of the current tightening on the economy and financial markets.

Fed Funds Rate vs Recession

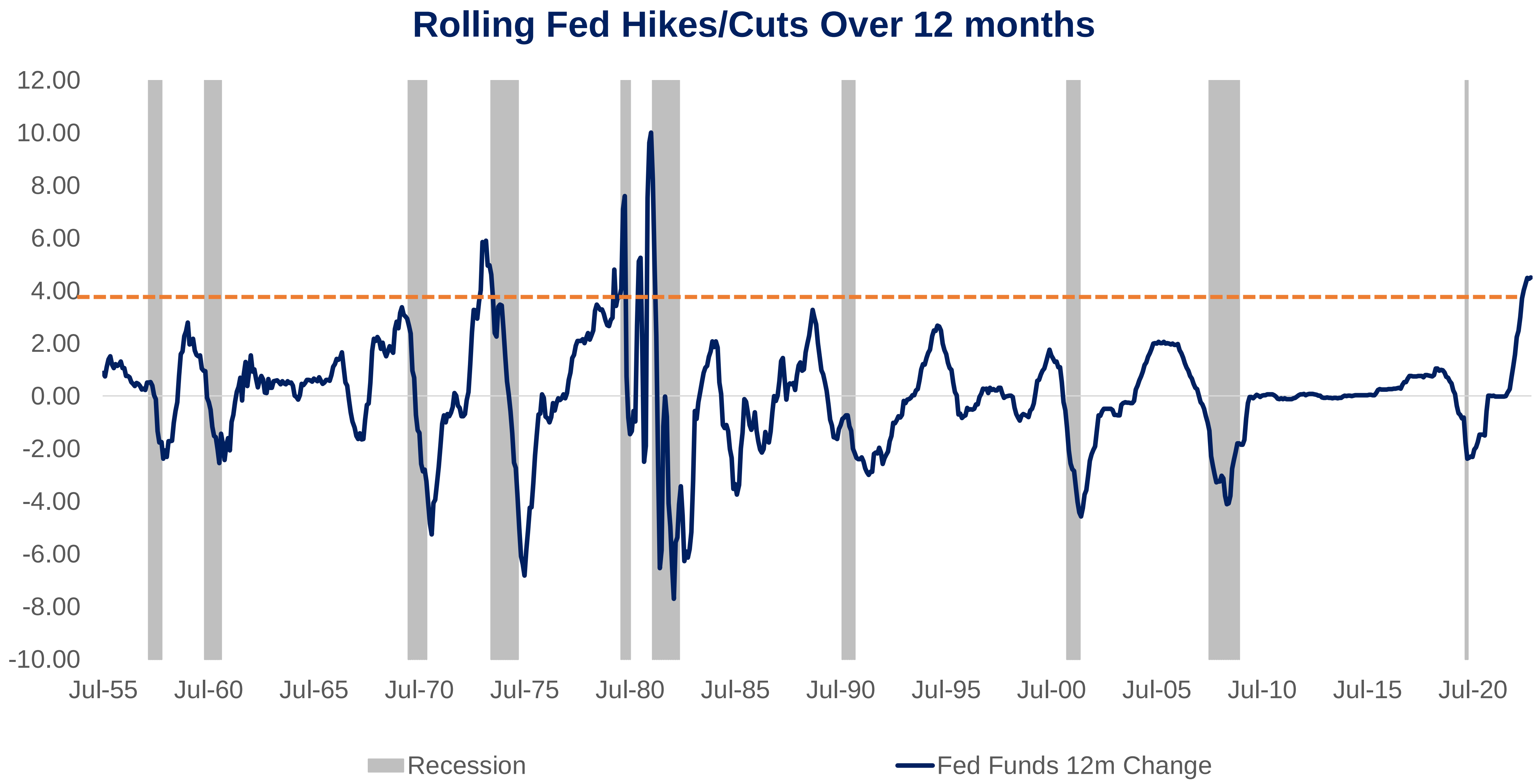


Source: Bloomberg as at 25/05/23

The extent to which rate cuts have been priced in and priced out of the 2023 Fed Funds forward curve is almost breath-taking. Global markets seem to be lurching between hard landing, soft landing and “no landing” at all with increasing regularity. With the Fed having hiked more aggressively than at any time since Volcker, many are surprised the economy is not yet on its knees. So what is going on? Simple answer - this is no ordinary cycle. We are still coming out of the back of a period of almost absurd levels of stimulus, labour supply in the developed world has seen disruption on an unprecedented scale while the remnants of COVID lockdowns continue to plague global supply chains. So yes the impact of rate hikes will eventually take hold, but there is clearly a strong lag effect at play.

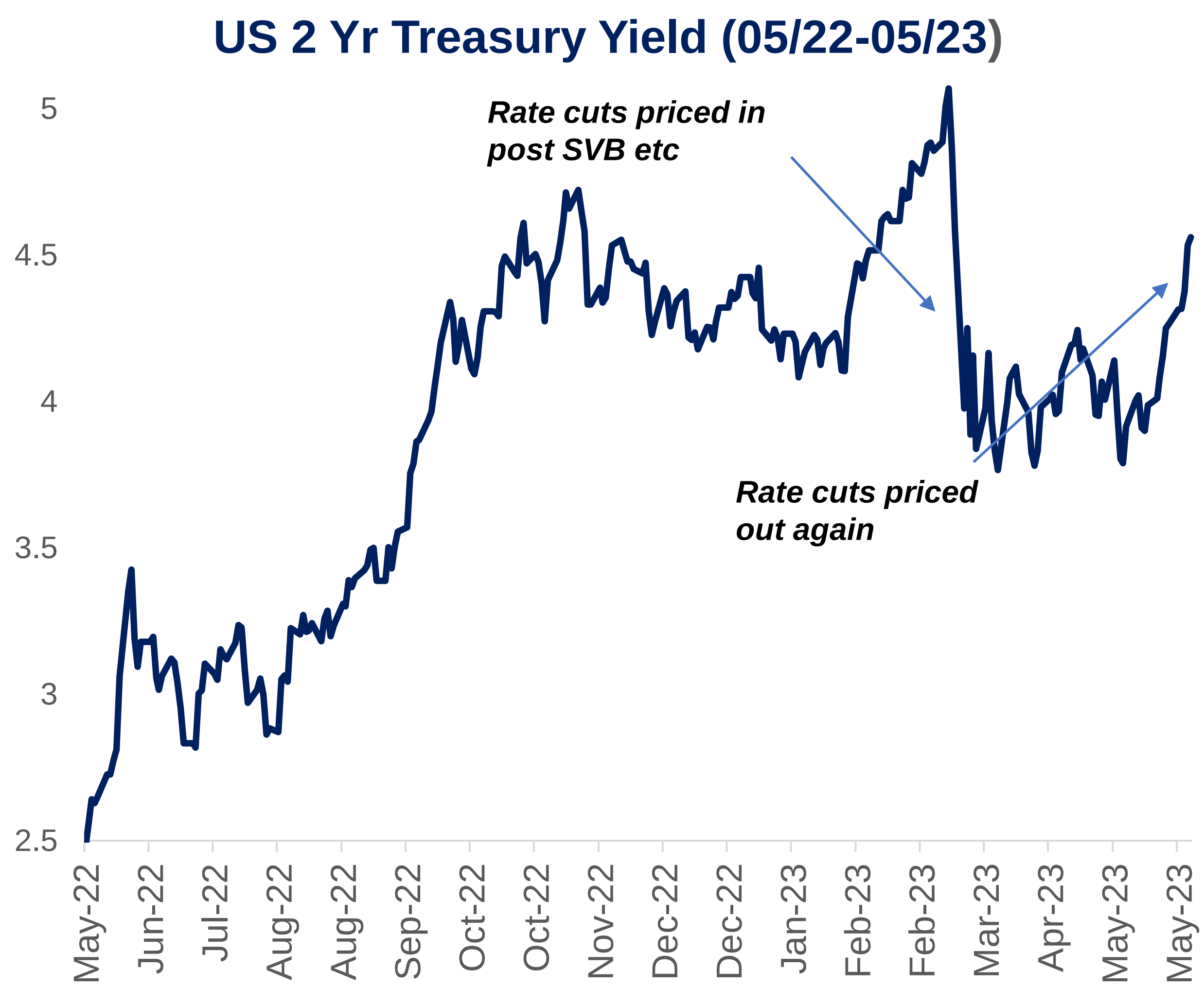
The Impact of Higher Interest Rates

Historical analysis of previous interest rate cycles predicts an extremely high correlation between hiking periods and economic recessions. Of course, as we saw in the 1980's the amount of hikes and the speed thereof are most telling. In addition, there are other factors such as the scale of the prevailing economic imbalances that can affect the size of the recession as we saw in 2008.



Source: Bloomberg as at 25/05/23

While short term interest rates are most closely linked to Central Bank hikes, the further along the yield curve you go interest rates increasingly act as a reflection of expectations for future economic conditions. At present there is a tremendous amount of uncertainty around the future path of interest rates which have oscillated significantly over the last 6 months. With conflicting economic data and no little amount of market volatility (banking system), rate cuts have been priced in and subsequently priced out with almost alarming regularity.

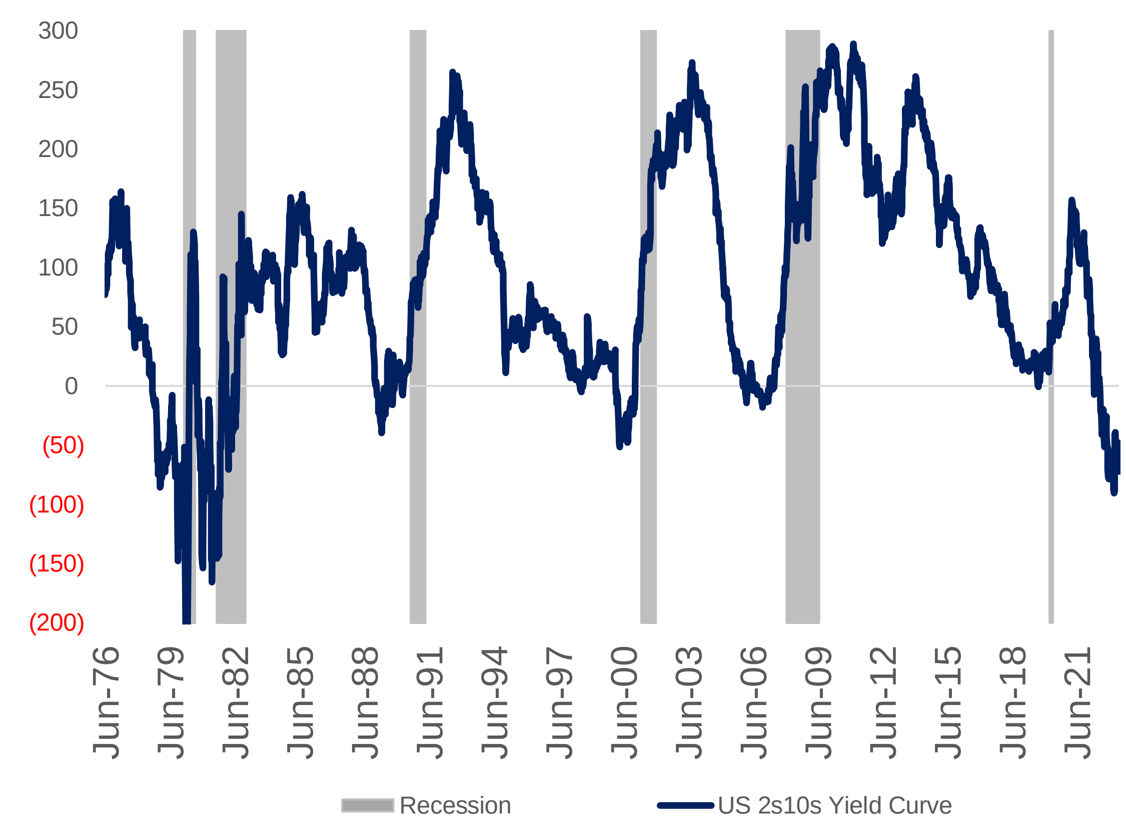


Source: Bloomberg as at 25/05/23

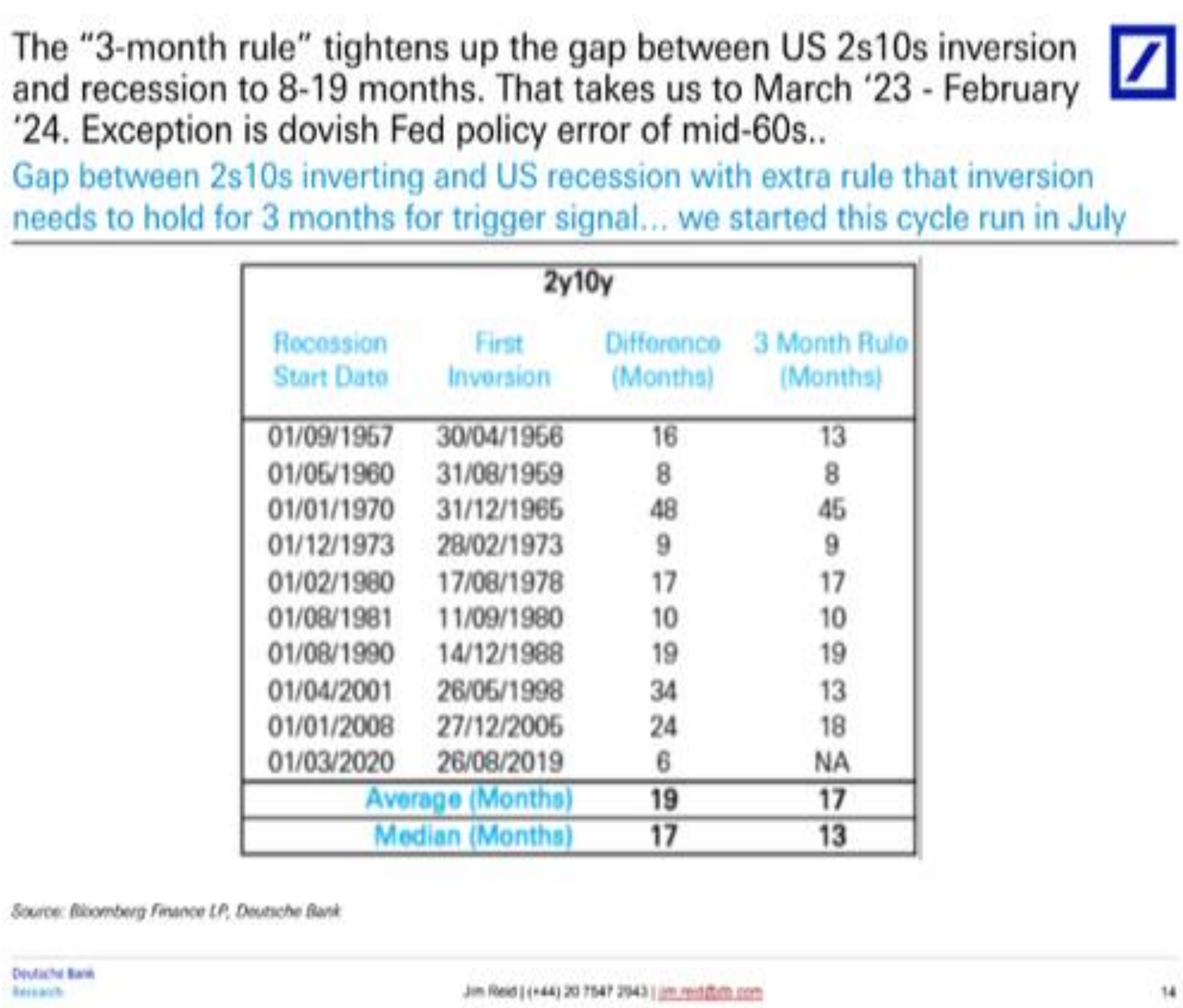
The Impact of Higher Interest Rates

The slope of the yield curve has traditionally been a reliable indicator of economic recession and once again is predicting one in the near future. Unfortunately recent QE programmes have likely reduced the efficacy of this traditional indicator due to the extent long dated bonds have been purchased by both Central Banks and financial institutions whose requirement for high quality collateral has grown exponentially post the Global Financial Crisis.

US 2s10s Yield Curve vs Recession



Source: Bloomberg as at 25/05/23



The "3-month rule" tightens up the gap between US 2s10s inversion and recession to 8-19 months. That takes us to March '23 - February '24. Exception is dovish Fed policy error of mid-60s..

Gap between 2s10s inverting and US recession with extra rule that inversion needs to hold for 3 months for trigger signal… we started this cycle run in July

2y10y

Recession Start Date	First Inversion	Difference (Months)	3 Month Rule (Months)
01/09/1957	30/04/1956	16	13
01/05/1960	31/08/1959	8	8
01/01/1970	31/12/1965	48	45
01/12/1973	28/02/1973	9	9
01/02/1980	17/08/1978	17	17
01/08/1981	11/09/1980	10	10
01/08/1990	14/12/1988	19	19
01/04/2001	26/05/1998	34	13
01/01/2008	27/12/2006	24	18
01/03/2020	26/08/2019	6	NA
	Average (Months)	19	17
	Median (Months)	17	13

Source: Bloomberg Finance LP, Deutsche Bank

Deutsche Bank Research

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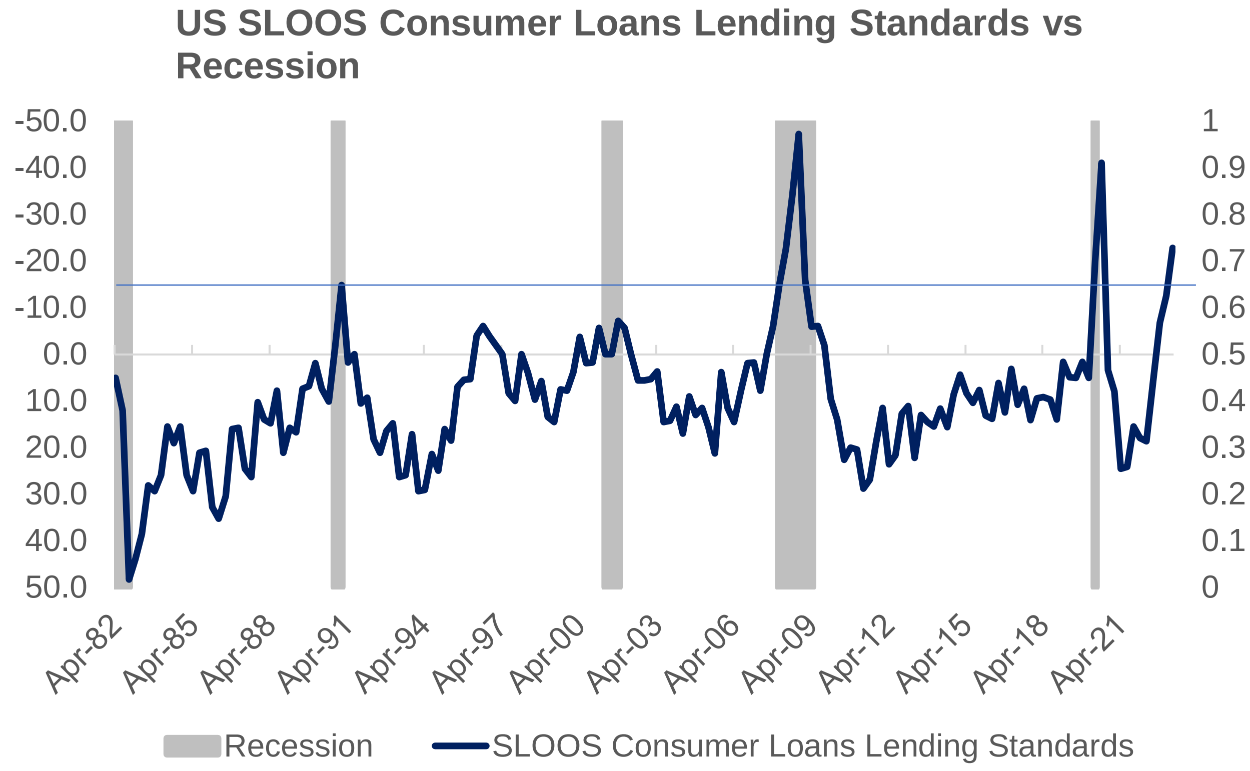
Deutsche Bank in the insert opposite have illustrated the relationship between the inversion of the 2s/10s US Treasury curve on both the likelihood of a recession and the timing as well. We believe this analysis is critical for Central Banks because it shows the dangers of taking the foot off the inflation break too early in the form of the potential length of time required to fight the unpleasant consequences of a renewed inflationary burst.

The uncertainty surrounding the rate hikes required and timing of their impact makes life very difficult for monetary policy makers and indeed asset managers. However, given the cost of doing too little is ultimately much higher than doing too much for the majority of the population, Central Banks have spoken frequently about their understanding and resolve to do what is necessary. Rate hikes in March through the banking crisis of SVB, Credit Suisse etc. were a key indication that they will force an economic contraction to slow inflation.

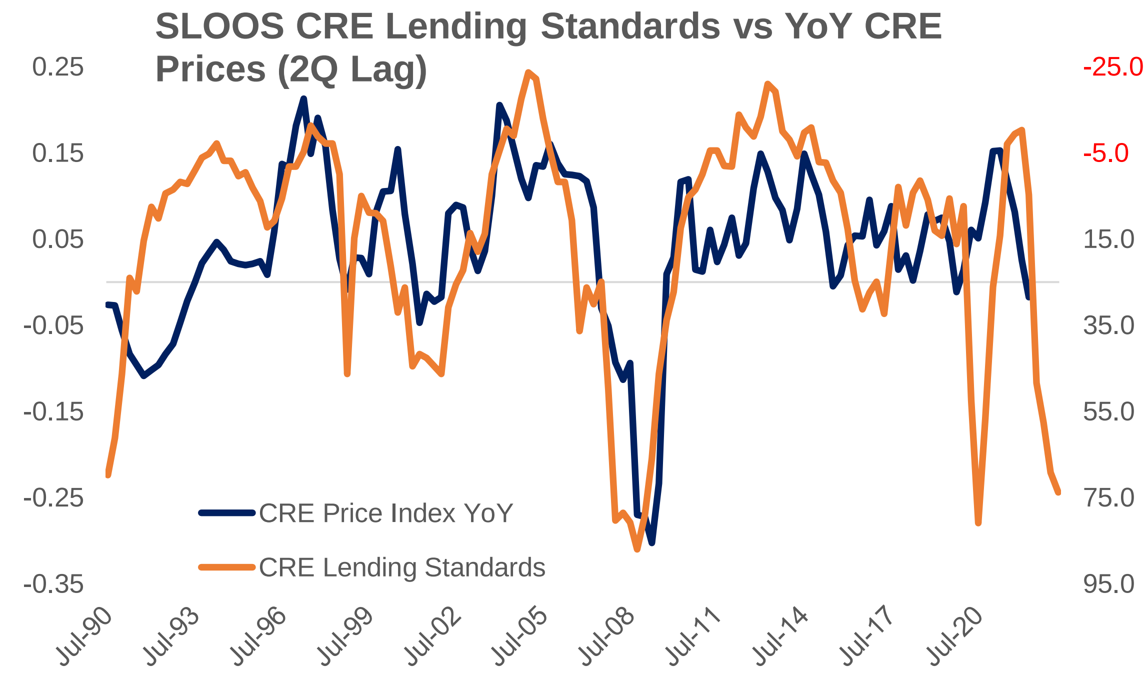
Higher Rates Lead to Tightening Credit Conditions

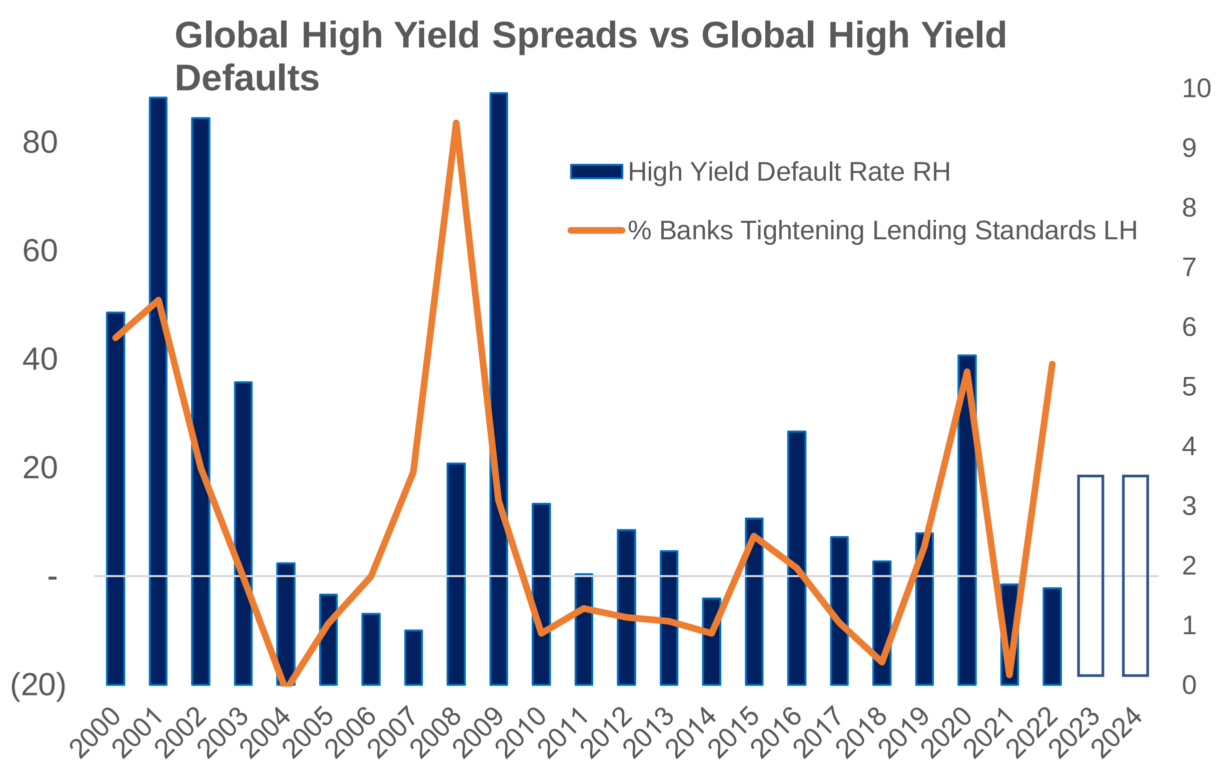
A critical element of the impact higher rates have on the economy is the tightening of credit conditions. Once access to credit is constrained it is nigh on impossible for an economy to work anywhere near its potential.



One of the key ways in which higher interest rates feed through is via tightening credit conditions. As debt becomes expensive and concerns over defaults grow, lenders (banks etc.) lend less and less and discerning borrowers are more reluctant to tap the debt markets.

Commercial real estate has been one of the first areas to be severely impacted by this current rate hiking cycle, exacerbated by a post COVID increase in “work from home”.



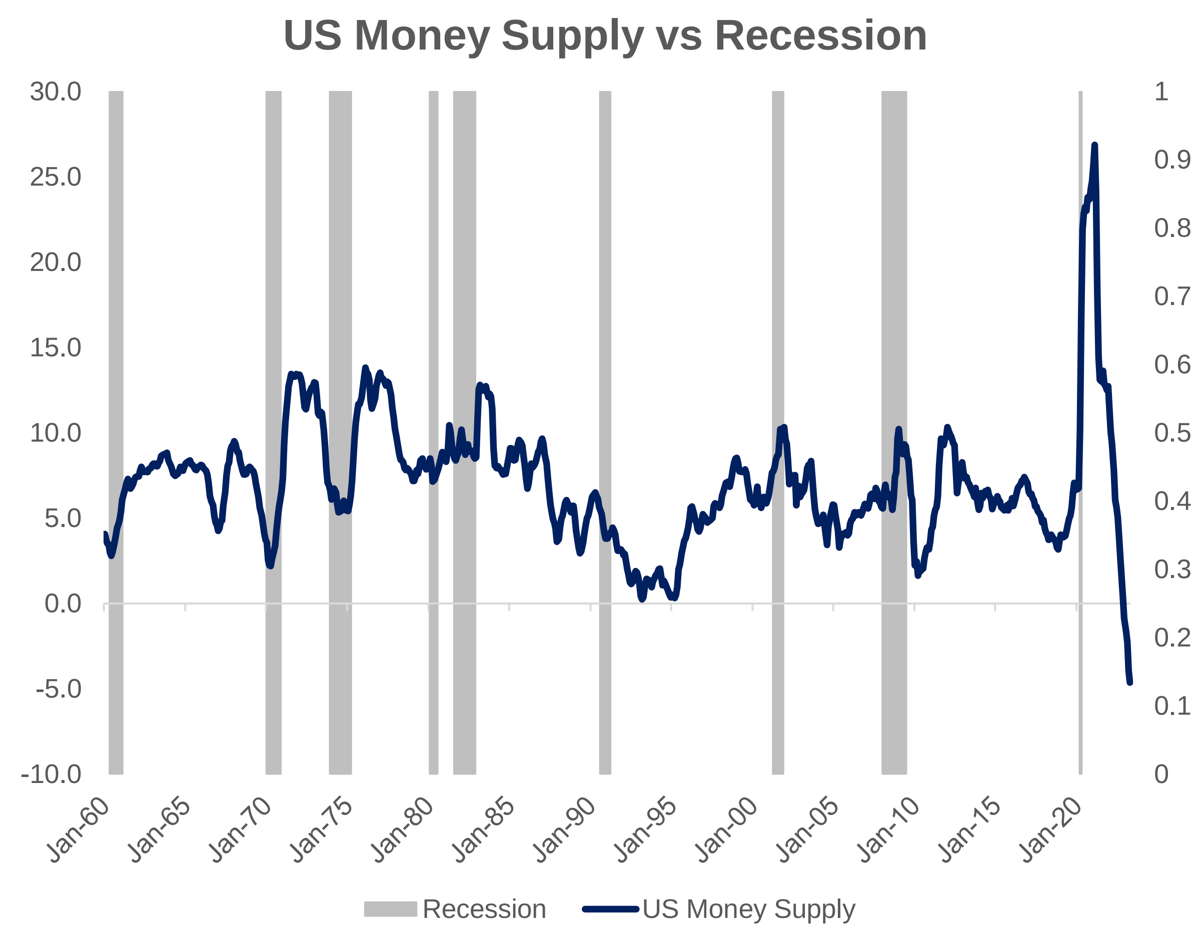


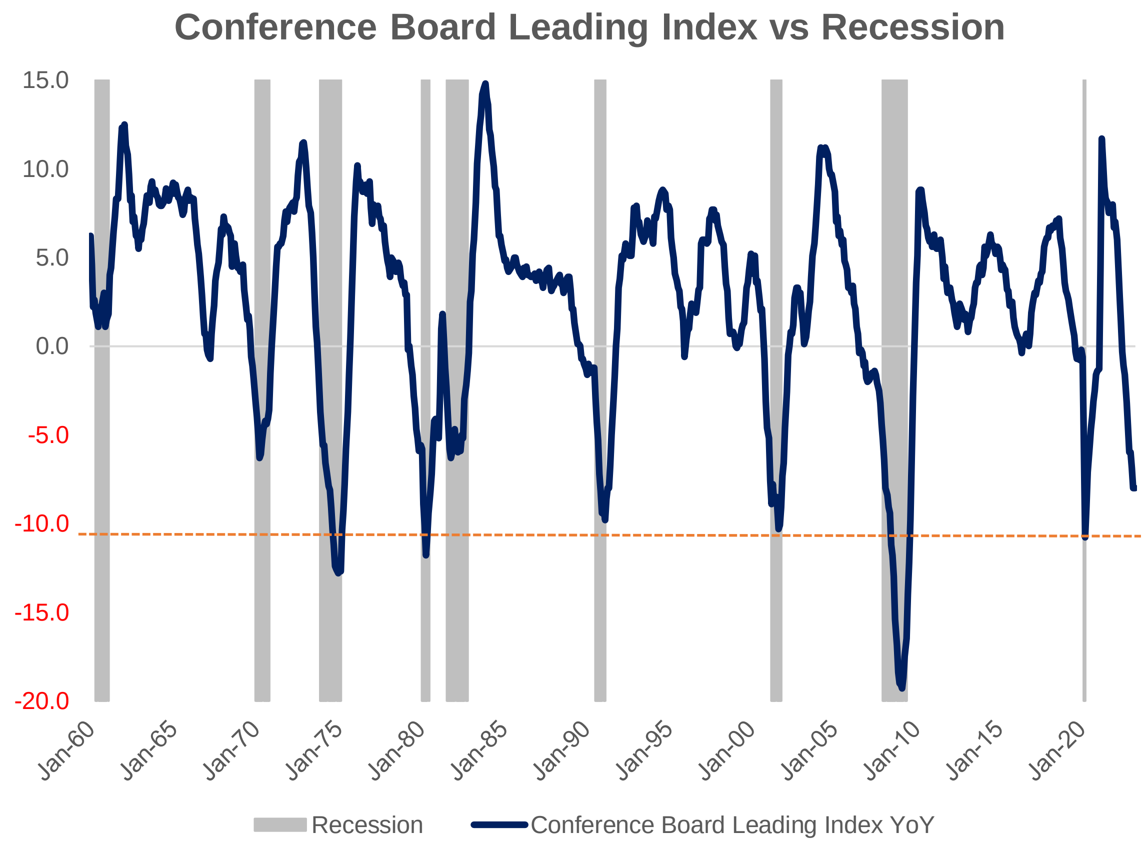
Bank tightening in lending standards has historically been associated with a rise in defaults as lenders reign in credit extension. While this relationship may work with a greater lag than seen historically (owing to disintermediation of risk from banks), we would still expect it to hold true in the medium to long term.

Source: Bloomberg as at 25/05/23

Slowing Money Supply Causes Recessions

Another key indicator of upcoming recession is the contraction in money supply. Indeed we are currently experiencing the fastest fall in money supply in over half a century. Economists point to the massive 30% fall in the money supply in the 1930s as one of the key causes of the Great Depression. Ben Bernanke in particular focused greatly on this cause of the Great Depression.





The confidence board leading index which factors in key elements which are directly affected by tightening credit conditions demonstrates today that higher rates are already having a real impact on the outlook for an upcoming recession.

Many of the key macro economic indicators are pointing to recession in line with historic evidence. However, given the unusual run up to this belated rate hiking cycle (Covid & experimental monetary policy), the timing and the scale of the impact are very difficult to predict.

Source: Bloomberg as at 25/05/23

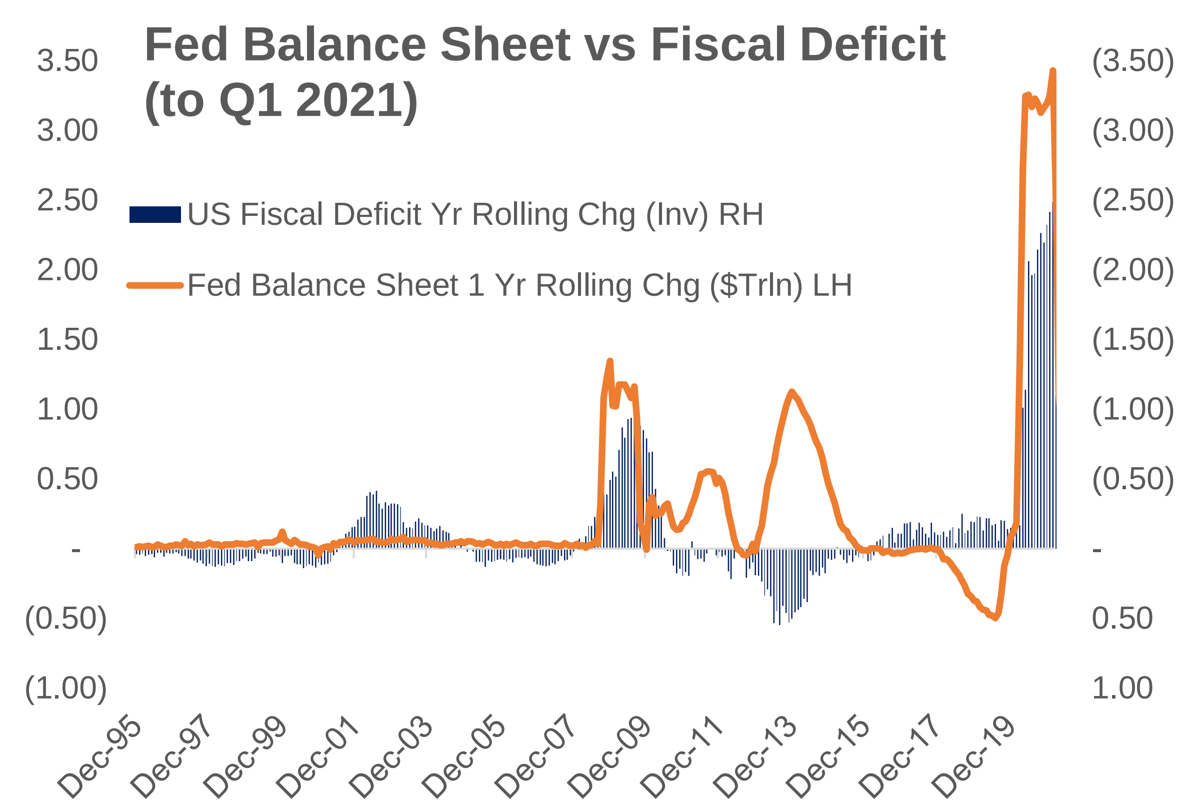
Rubrics Fixed Income Macro View

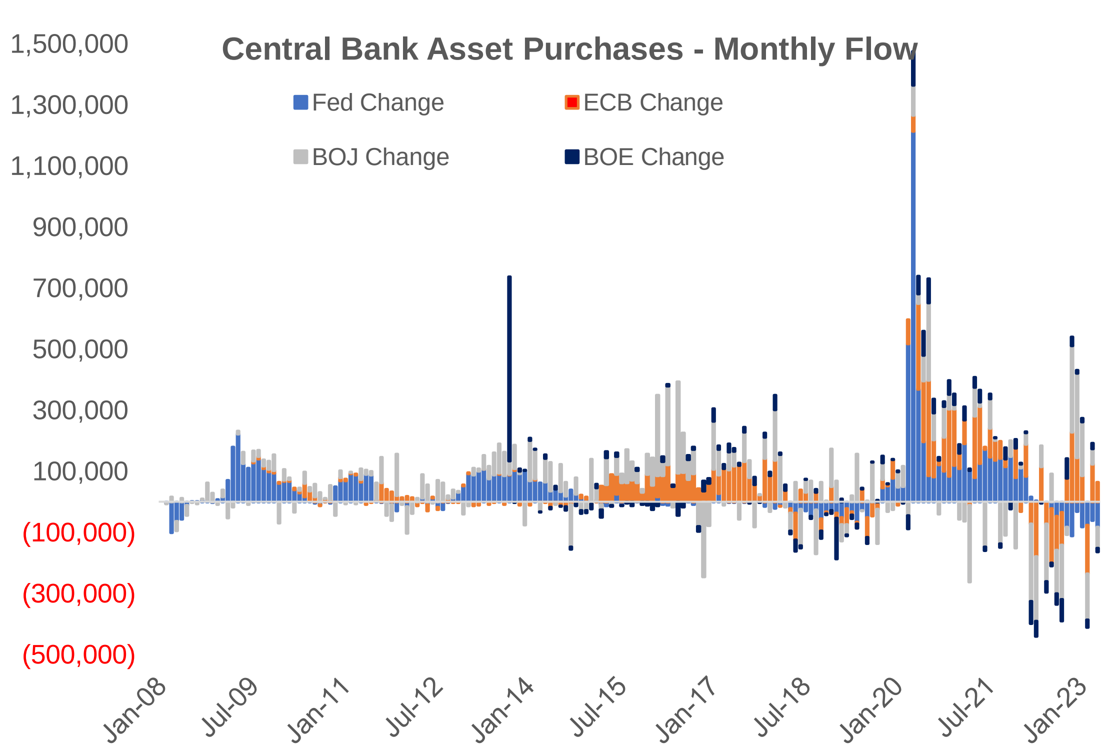
28 May 2023

Factors impacting the effectiveness of higher rates

Not only has the extended duration of debt outstanding caused a major delay in the impact of higher rates, other factors related to Covid policies have also played a significant role.

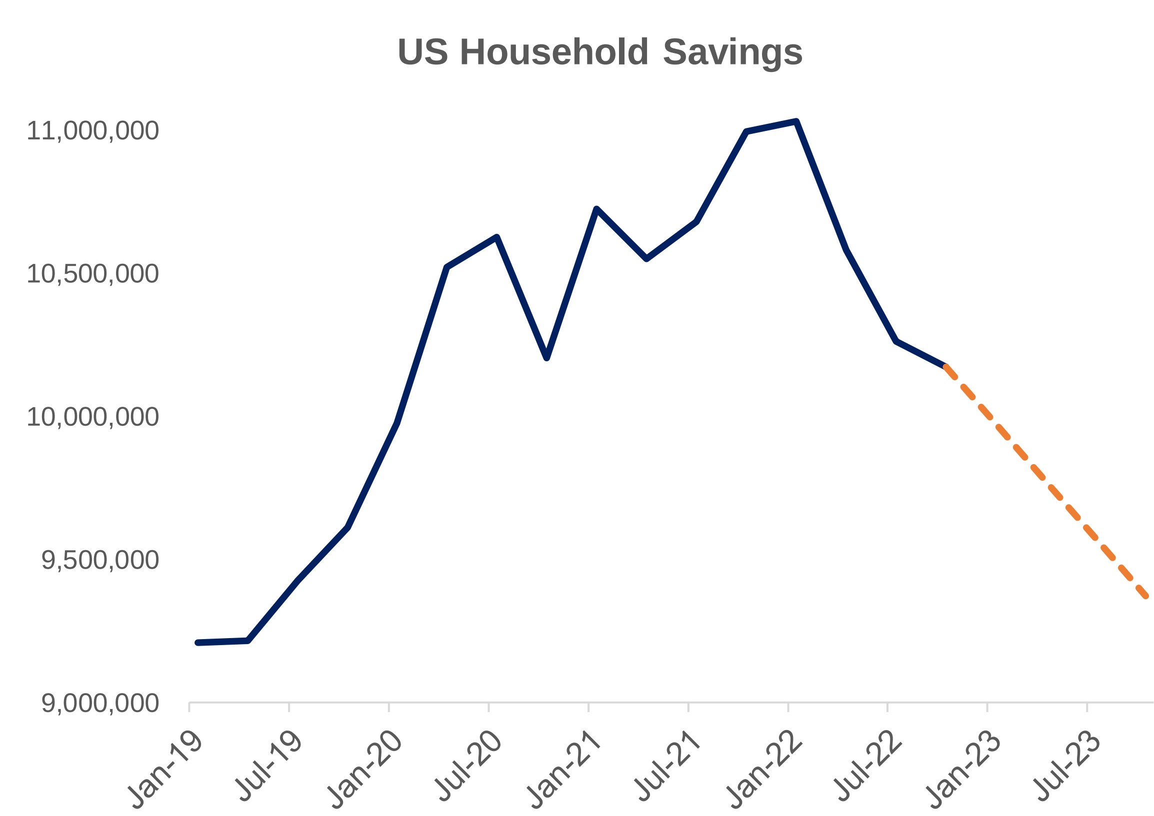
The legacy of the unprecedented levels of stimulus pushed into the economy and markets during Covid is that Central Banks will have to work harder than they ever expected. While the initial supply side constraints sparked an inflationary burst, the lasting impact is the imprudent levels of monetary and fiscal stimulus.





No only did the money supply increase by 40% over Covid, Central Banks today haven't completely pushed back on expansion of their balance sheets. The UK last Sept, Japan in Jan and the US in March all saw increases in their balance sheets, pushing back on the tightening brought on by higher interest rates.

Higher inflation would have its own impact in ultimately slowing the economy. As prices go up, demand quickly falls. However, due to the extent of excess savings we saw over the Covid period thanks to substantial fiscal transfers, the real impact of higher prices can be offset for a while at least.

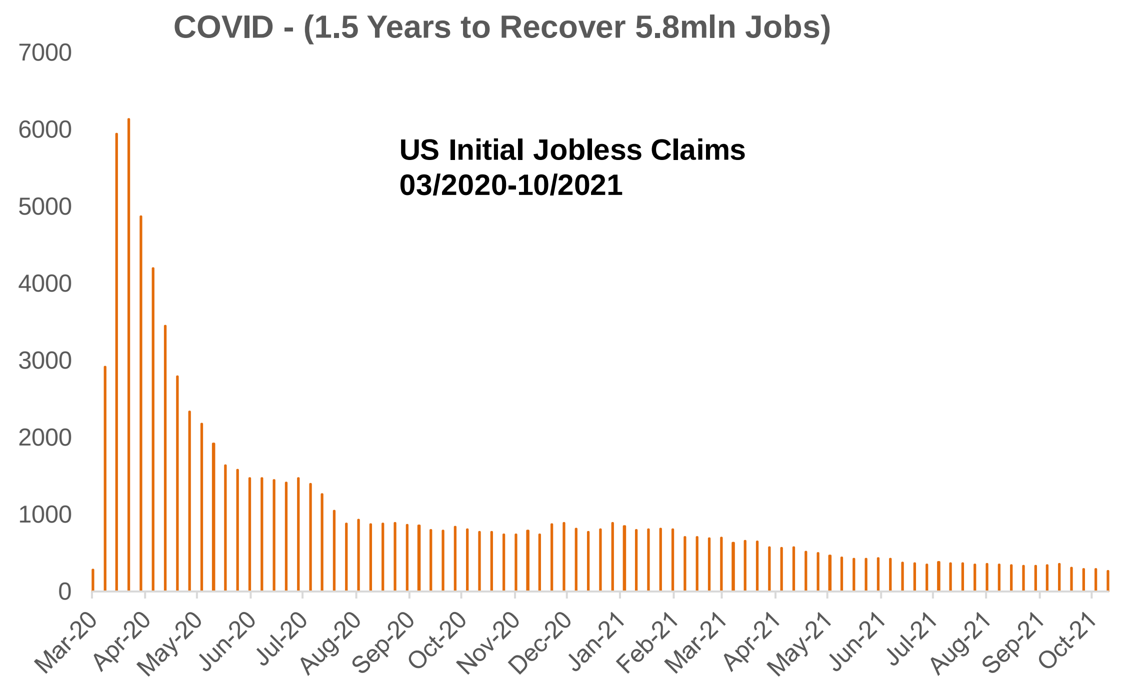


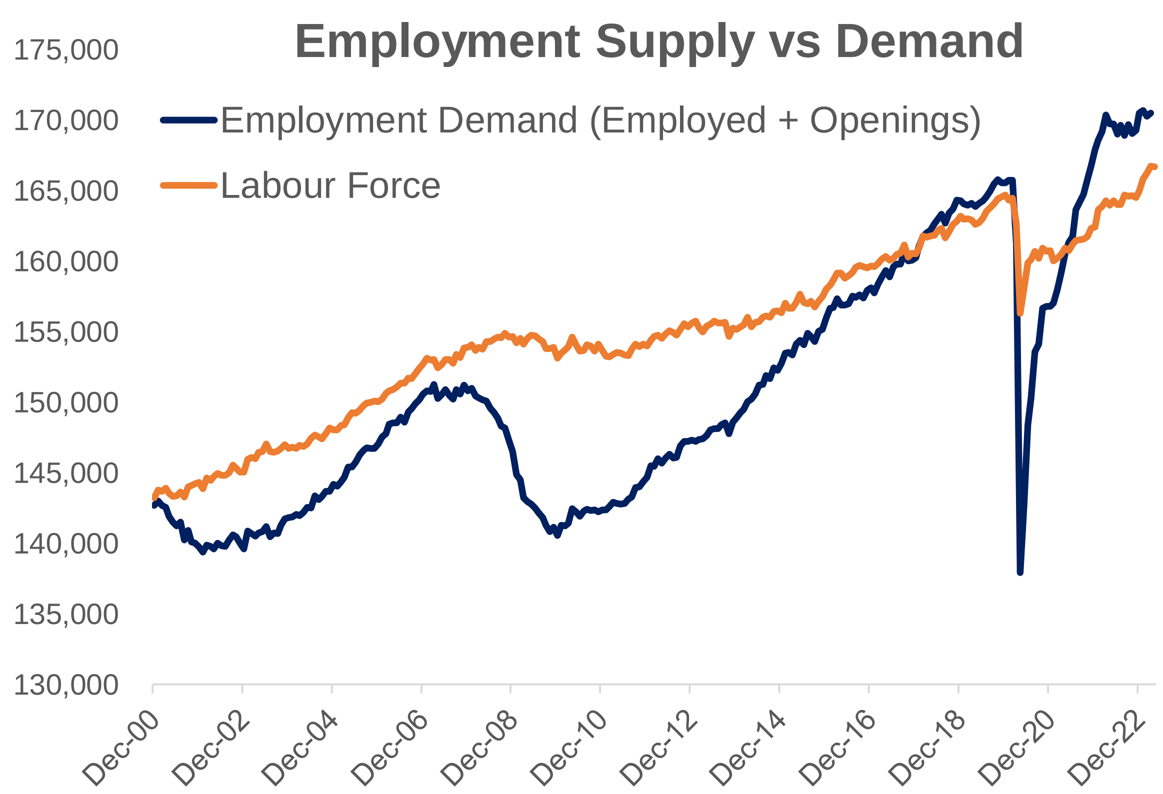
Source: Bloomberg as at 25/05/23

Structural impact on shifting labour market

Unlike post GFC the labour market post Covid has shifted dramatically. Due to fiscal policy growing bank deposits and not just reserves, the economy and jobs market bounced back extremely quickly – to record lows of unemployment. We also realised a great deal of the older generation left the workforce leaving the economy short of workers. Strong labour markets clearly underlining the strength of the economy.

Record growth in the jobs market due to massive demand of service based jobs post covid reopening. Unlike any of the monetary only market supports, fiscal policy plus massive pent up demand was incredibly effective.

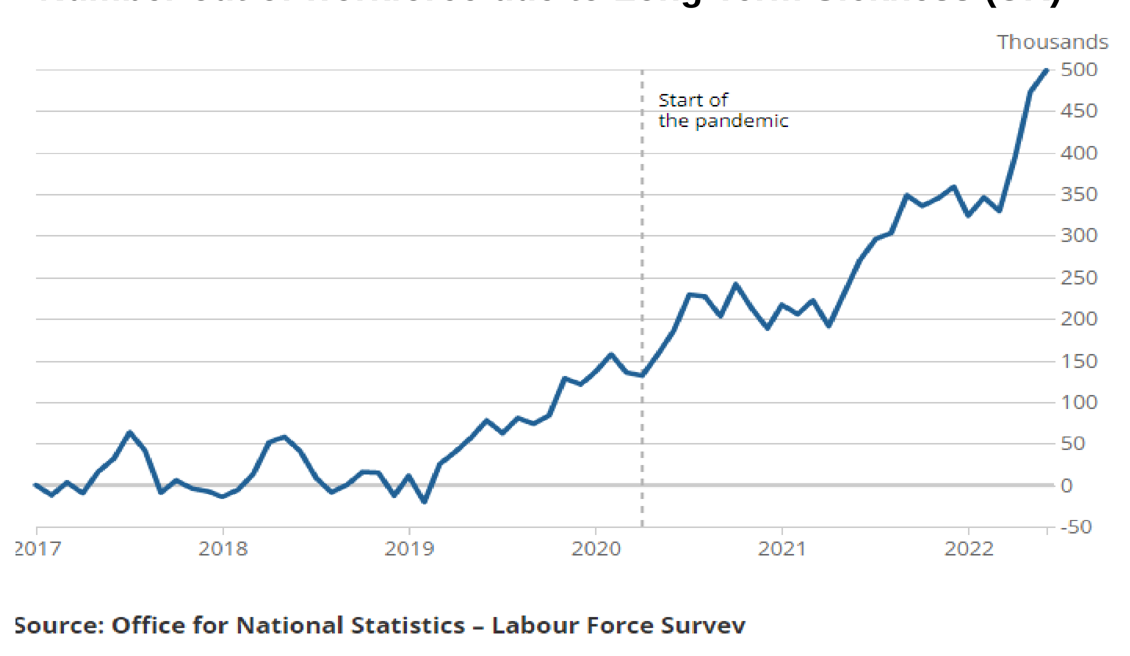




Post Covid the jobs market had over 2 jobs available for every unemployed person. The JOLTS job survey indicated an unprecedented mismatch of jobs available versus workers available, putting significant wage pressure on many employers particularly in service based businesses.

An aging workforce coupled with the fallout from Covid has increased the numbers of long term absentees from the workforce – reducing the labour supply still further. The ONS in the UK calculates approximately 500,00 workers inactive due to illness while in the US this number is purported to be anywhere between 2 and 4 million (Source: Brookings Institute).

Number out of workforce due to Long Term Sickness (UK)

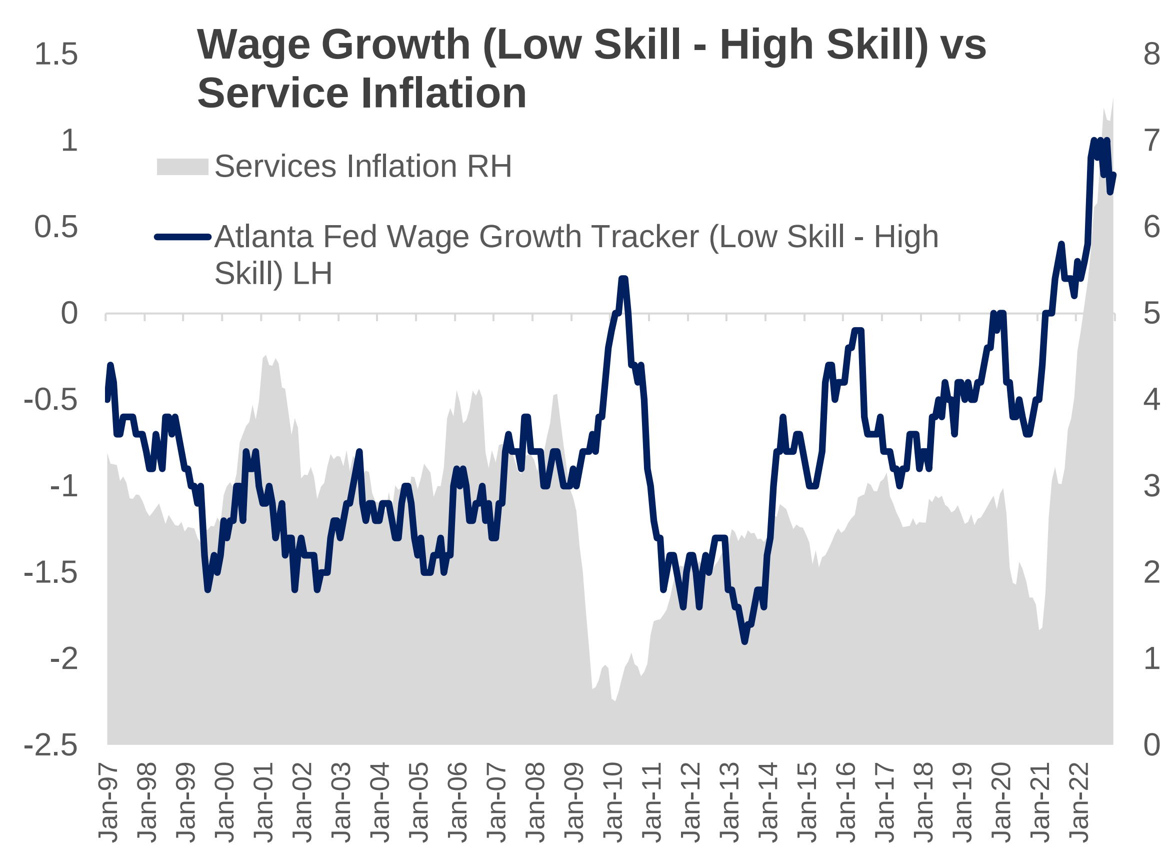


Source: ONS

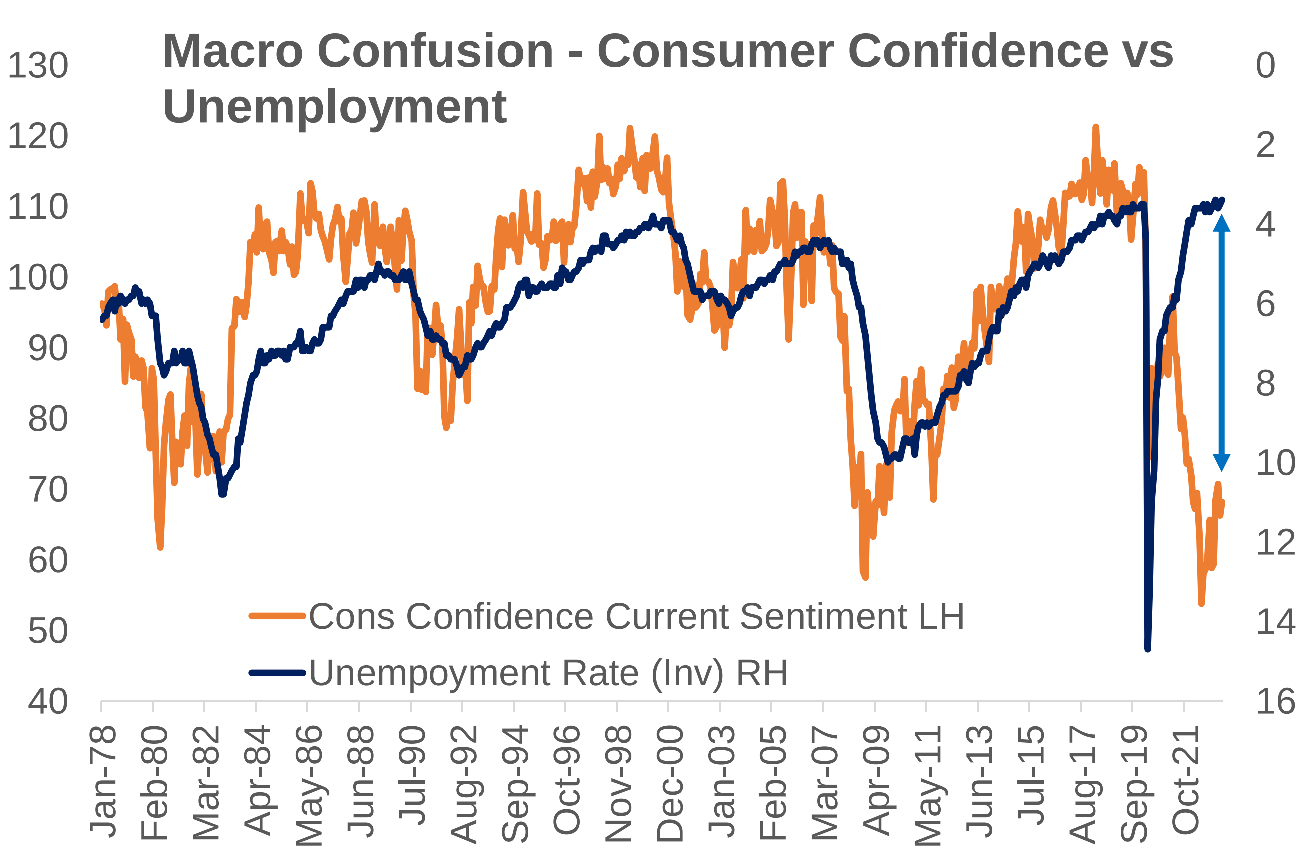
Changing labour market dynamics adding confusion

Over the last forty years the majority of wage growth has gone to a progressively smaller percentage of people at the very top. Currently we are seeing a significant shift in this paradigm as the bottom cohort of workers have belatedly begun to outperform in terms of wage growth. Given these workers have a much higher marginal propensity to consume, the impact of higher rates on spending patterns can likely take longer than if the traditional cycle of job losses had materialised.

While the improvement in wage growth equality started before Covid, the growth of that dynamic has been rapid in the past 3 years and not just for the bottom 25% but also the bottom 50%. Increasing equality is a critical element to a stronger more robust economy.



Source: Bloomberg as at 31/12/22

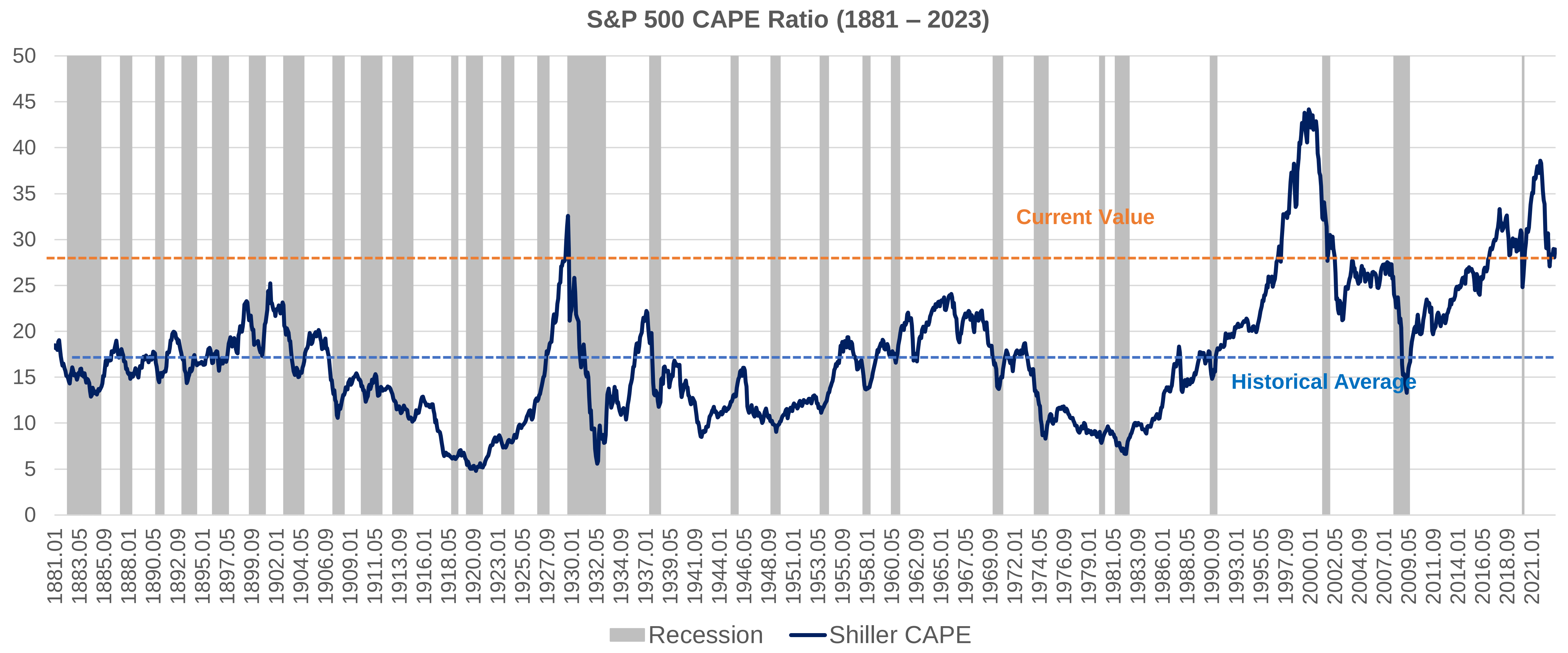


Source: Bloomberg as at 25/05/23

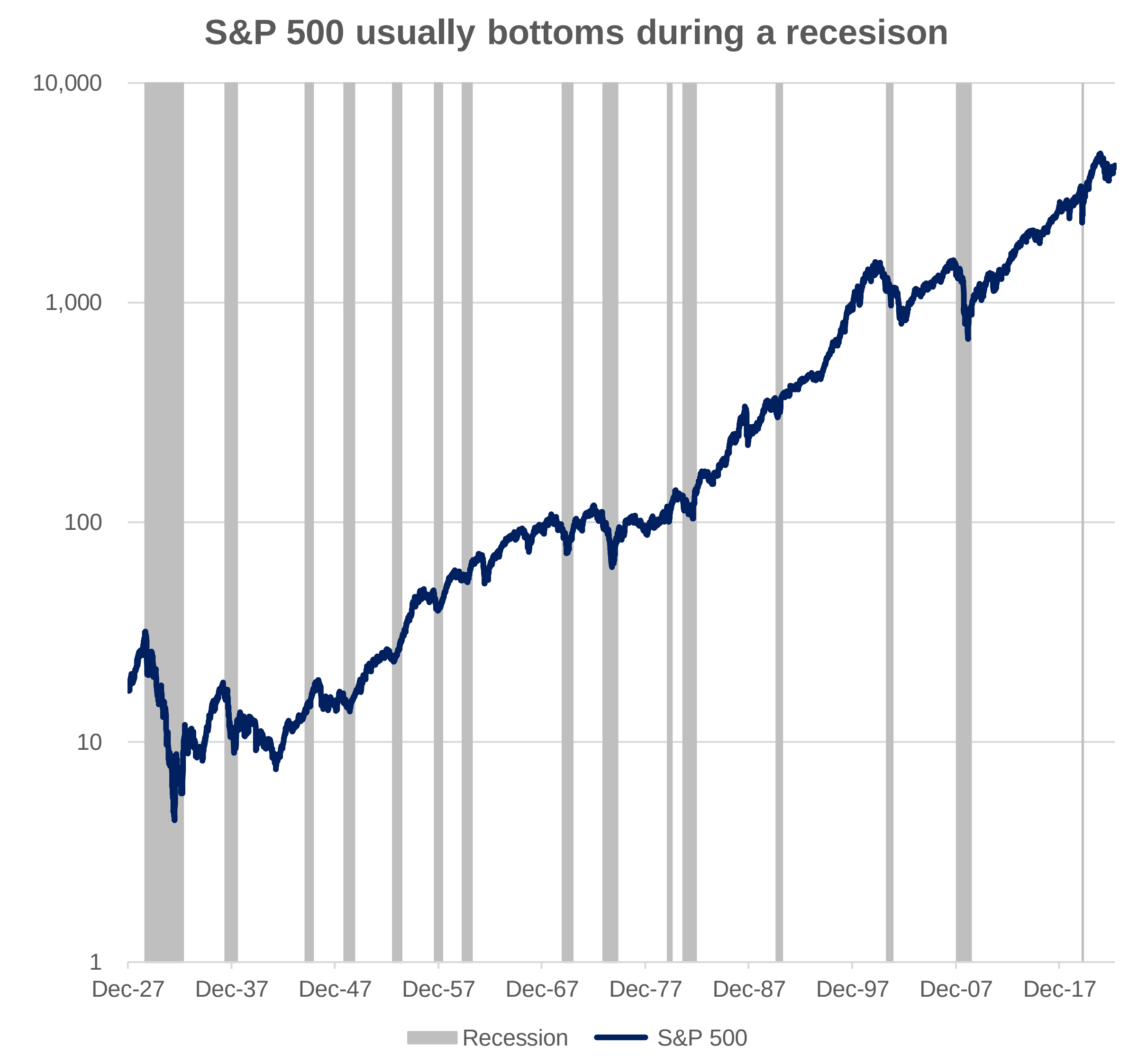
We have never seen such a disconnect between the jobs markets and consumer confidence as we do currently. Not only do we see a strong jobs market, we see solid wage growth for the bottom 50%. The downside however is that in real terms people are still getting worse off due to inflation. This is why Central Banks need to win the war on inflation, because without it real improvements are extremely difficult to achieve.

Risk assets rarely predict a recession

While it may be tempting to think the recession is now priced in after the drop that occurred in 2022, note that the starting valuation for that period was the highest on record outside of 2000.



History has shown us the depth of a recession doesn't have much impact on the extent of the associated equity market selloff. A mild recession such as that of 1960 or 1991 could still be bad for asset prices – a la the bursting of the Dot Com bubble in 2000. Typically the equity market bottoms during a recession, not before a recession has even started. It would be unusual for markets to have bottomed already if the economy is not yet in recession.

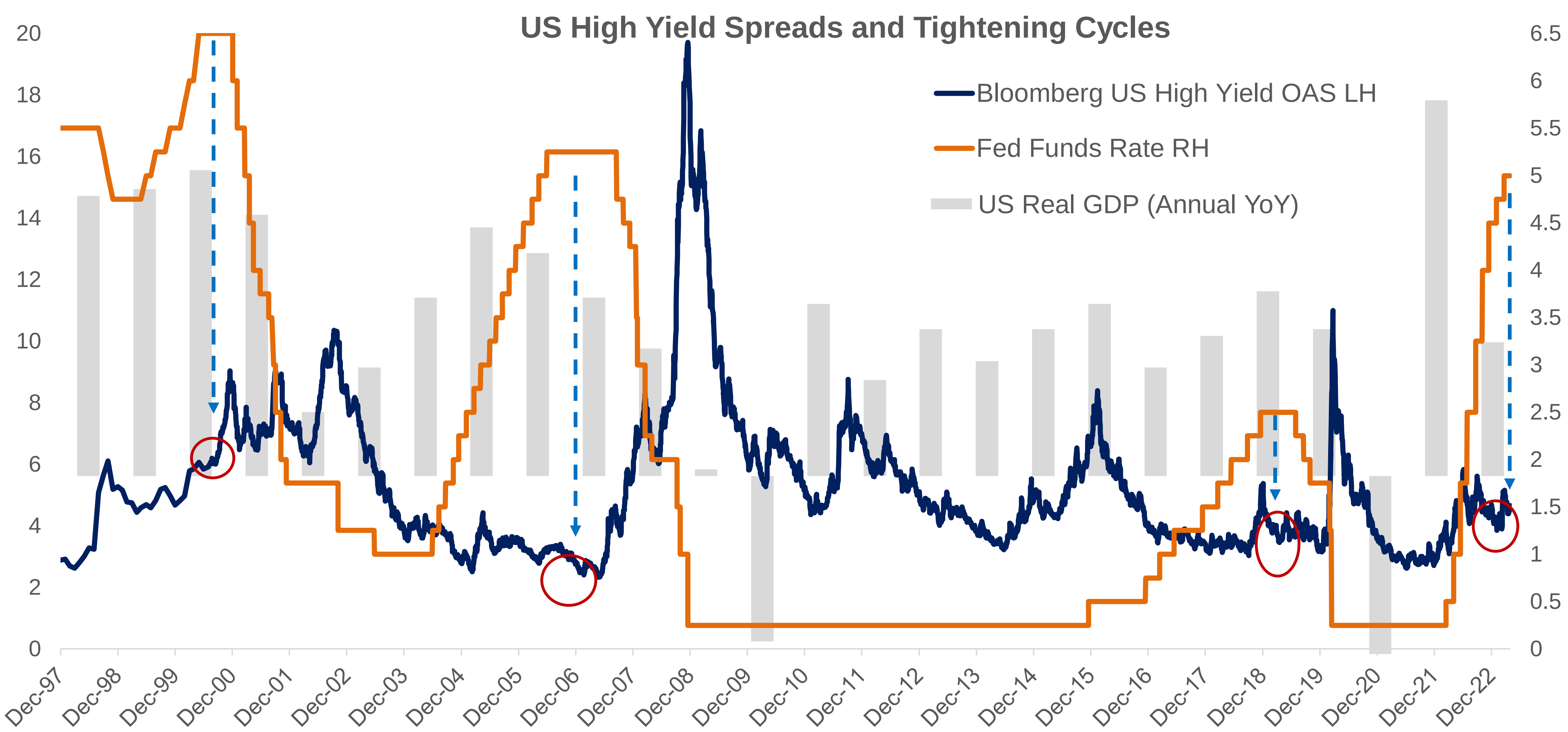


Source: Bloomberg as at 25/05/23

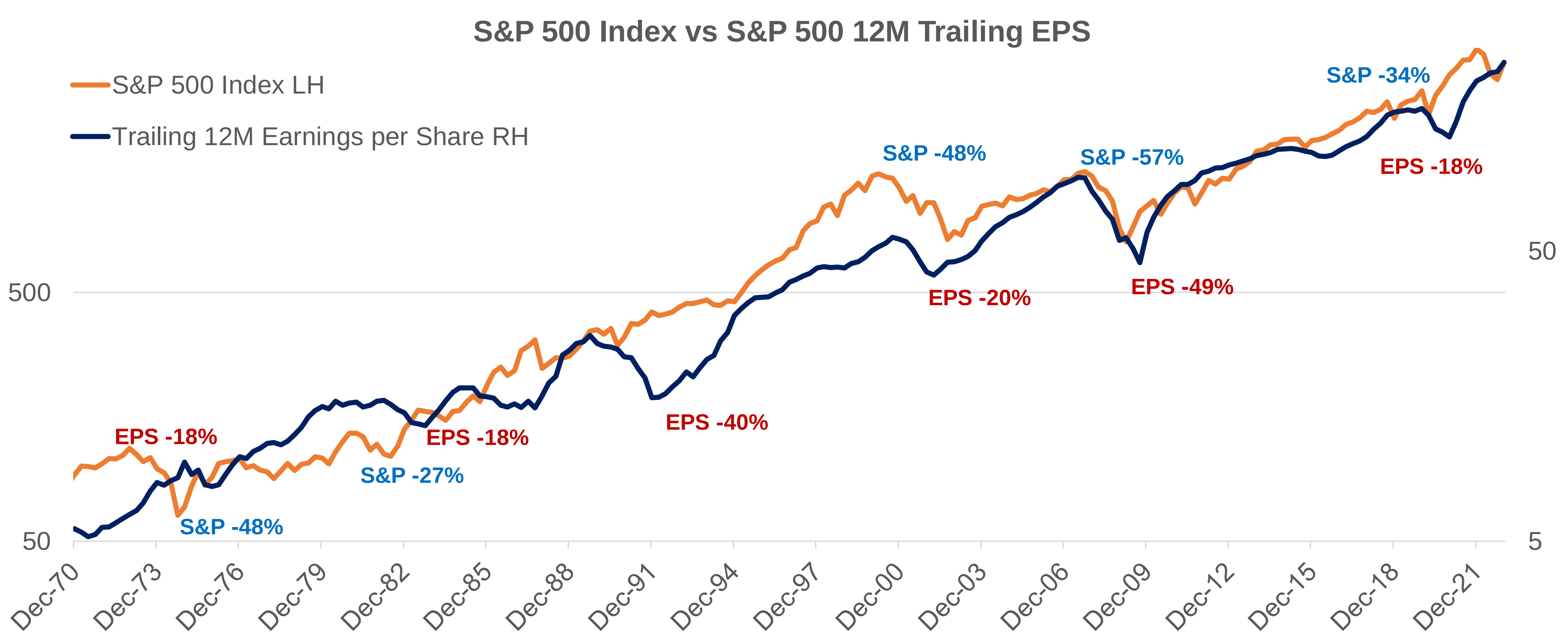
Risk assets react to a recession – don't predict one

History has shown us time and again that at the peak of the interest rate cycle risk assets like credit and equities usually respond less to interest rates but react aggressively to falling economic growth. While the inversion of the yield curve has historically been a reliable signpost to a potential drop in growth, it is not until the impact of higher rates is felt on growth/earnings that we see a repricing of risk assets. Today is no different. As we approach the end of this hiking cycle we must we aware of this historical pattern.

It's not the rate hikes (r) that cause excess damage to financial markets, but the drop in growth (g)



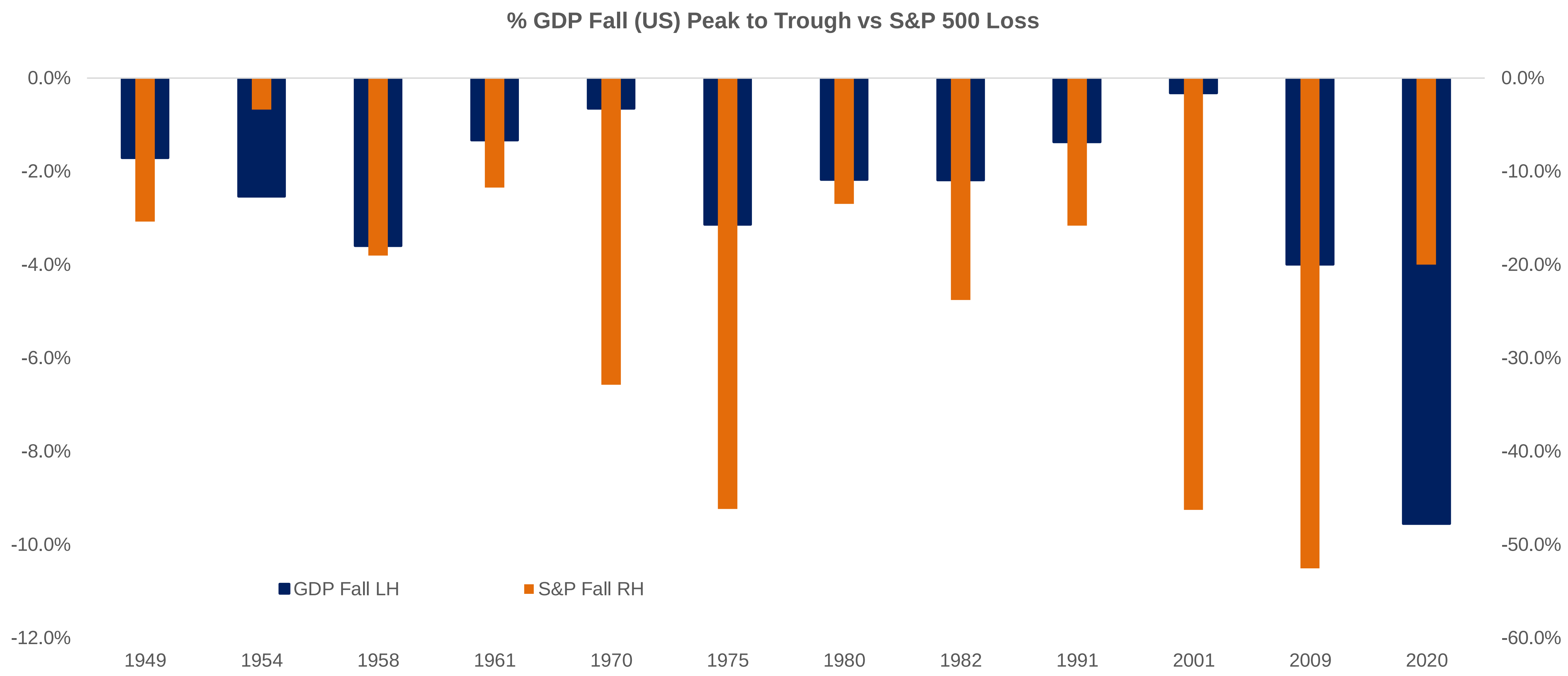
Source: Bloomberg as at 25/05/23



Source: Bloomberg as at 25/05/23

Extent of recession no indicator of size of market impact

We hear of hard landings, soft landings and even no landing for the economy. For markets however the scale of the 'landings' has little correlation on its potential impact on the financial markets. 2001 was a prime example where a 'soft landing' had an outsized impact on the equity market relative to the economy.



Source: Bloomberg as at 25/05/23

In fact it's the scale of the imbalances in the economy and financial markets that are critical in understanding the potential impact on financial markets. On the surface it can be argued that the global imbalances are not as great today as they were in 2008. While we believe that as a whole the banking system is better capitalised than it was in the pre-GFC period, and is a lot less leveraged, this does not mean risks no longer exist.

Since 2008, as has been well publicised, regulations have pushed much of the market risk to the asset management sector. Areas within the private markets in particular are more exposed to less liquid, longer duration and more credit risk than at any time in history. Added to this the immense growth in passive strategies where flow not fundamentals can present the greatest risk to clients capital in an environment of ever increasing volatility. If liquidity in the US Treasury market is at an all time low, it stands to reason that the rest of the financial markets are on a less than solid footing in this regard.

Conclusion

While central banks spent over a decade attempting to use monetary policy to push growth and inflation higher, it wasn't until the arrival of fiscal stimulus that they were actually successful. However, Paul Volcker proved definitively that monetary policy can, if used sufficiently, be successful in bringing down inflation. There are many structural elements to inflation, of which monetary policy is just one, but an important one when combined with fiscal policy. It is critical to understand that in the last decade monetary policy created an excess of bank reserves but little in the way of bank deposits - which underwrote financial assets but did little for the real economy. Today's efforts to reign in inflation, like the 1980's, can work but there is great uncertainty about how high interest rates need to go to take effect and what the lag (timing) will be between tightening and the inevitable economic contraction. Central Banks are very concerned about repeating the mistakes of the 1970's where they pivoted too quickly and inflation returned with a vengeance.

Given the history lessons we have had, particularly the 1970's, defeating 'excess' inflation which only feeds upon itself is a top priority. While direct and specific liquidity injections will be used to offset specific crises, we don't expect the typical "Fed Put" of the recent past. Central Banks will slow their economies to offset a growing tide of sticky inflation; it might take longer than most expect.

From our perspective, the key component of the potential decline in market confidence is heavily linked to the poor structure of asset markets and their over reliance on cheap money built up over years of QE related inflows. As in March 2020 when Central Banks needed to directly intervene in markets by purchasing ETFs, they will once again be needed to support an unbalanced market place exposed to extreme moves in both directions. Critically given the structural developments to the labour market, the decline in globalisation and climate change, the overall policy response might not be as market friendly as we have all come to expect. Being liquid and active enough to manage this process will be critical for delivering future market returns.

IMPORTANT INFORMATION

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