Macro Overview

Hubris Exposed

Fixed Income Macro View

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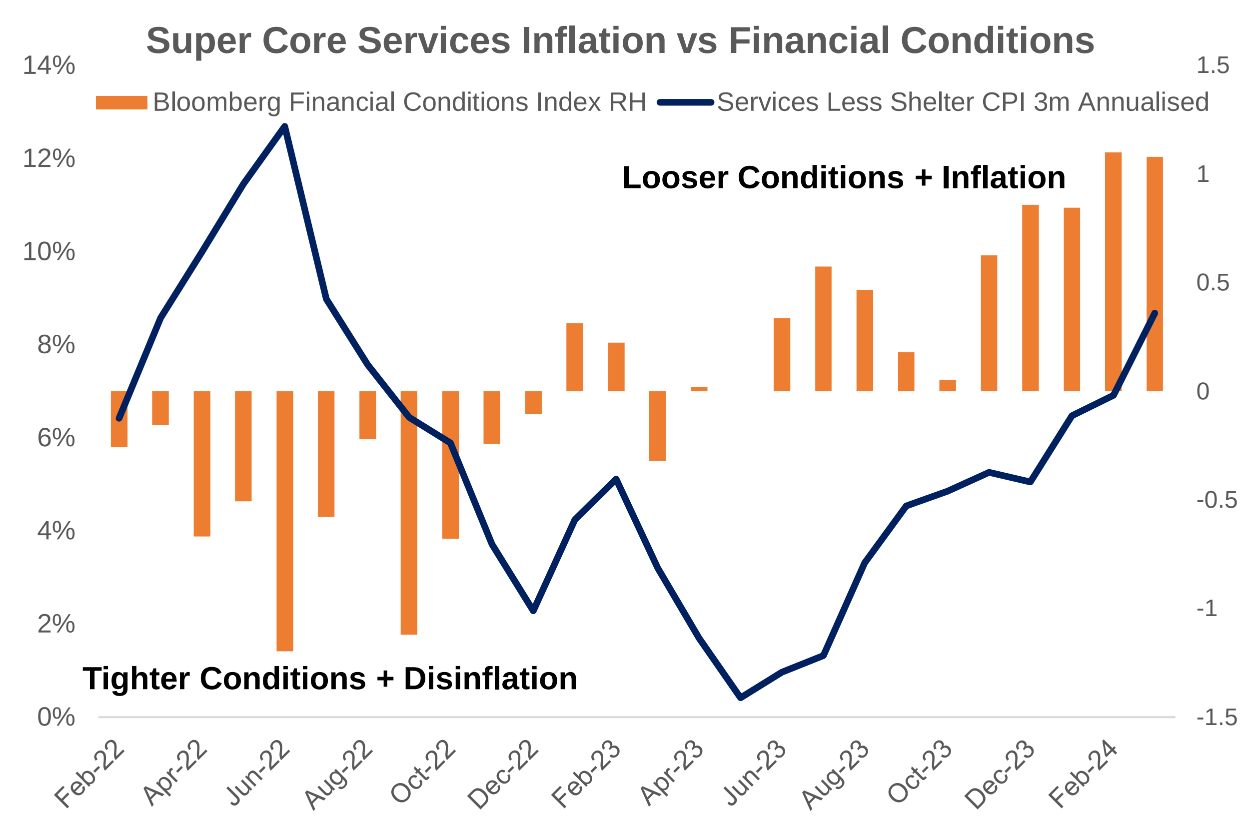
Hubris

The discernible pick up in US inflation witnessed throughout 2024 is a direct result of actions taken by the Fed and the US Treasury. It is almost 5 months to the day that Powell declared victory in the war against inflation - what must now be viewed as one of the more infamous calls in (recent) Fed history - while it was only last month that Powell was trying to reassure us that January and February inflation data was a mere blip. Hubris or incompetence? Perhaps both.

Record loosening in financial conditions coinciding with market increase in short term inflation trajectory

Loosening Financial Conditions and Increased Inflationary Momentum

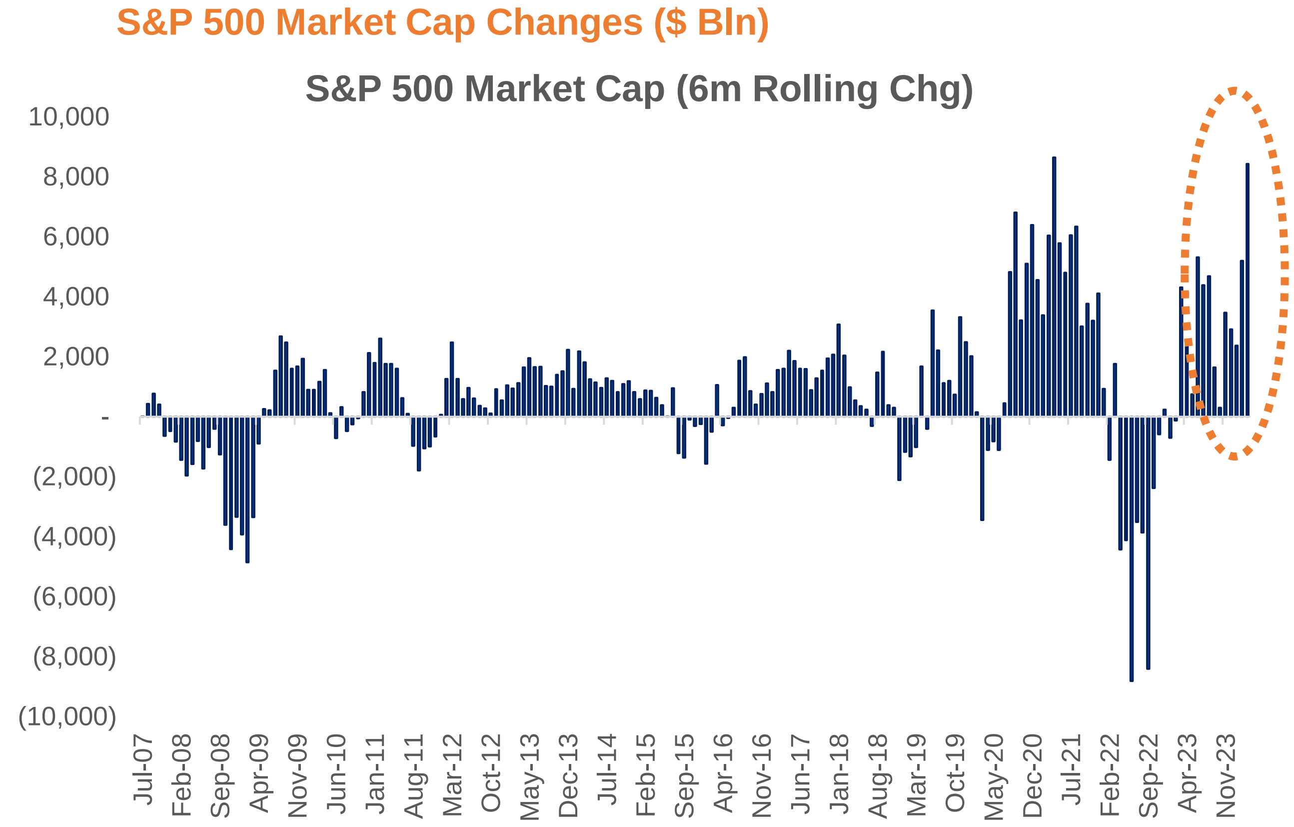


Source: Bloomberg as at 12/04/24

Once the US Treasury went all-in on fiscal stimulus in 2023 there was no need for the Fed double down with a dovish pivot. In a re-run of 2021, Fed policy amplified the Treasury stimulus helping to drive financial conditions to even more extreme levels. One could be forgiven for thinking that higher inflation was in fact the ultimate goal. While the shifting trajectory of inflation is unquestionably concerning, we can take comfort in the fact that many of its driving factors may begin to dissipate in the next few quarters. The totality of the stimulus supporting the economy over the last 15 months has been nothing short of staggering. On the fiscal side we have seen a deficit of over $2 trillion dollars, allied to monetary support of over $1 trillion (through the RRP linked liquidity) in addition to the continued wind down of excess savings from the COVID handouts (>$2 trln).

Stock market stimulus – market capitalisation of the S&P 500 has risen in excess of $8 trln in the past 6 months

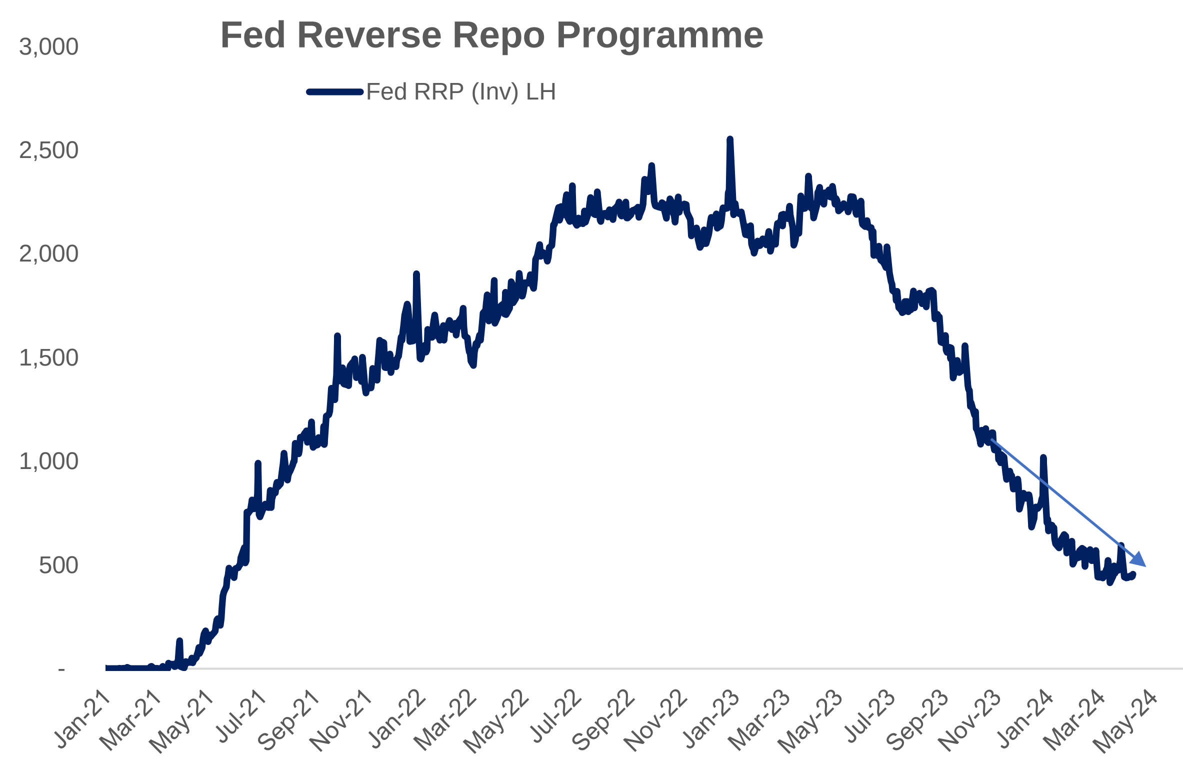
S&P 500 Market Cap Changes ($ Bln)



Source: Bloomberg as at 12/04/24

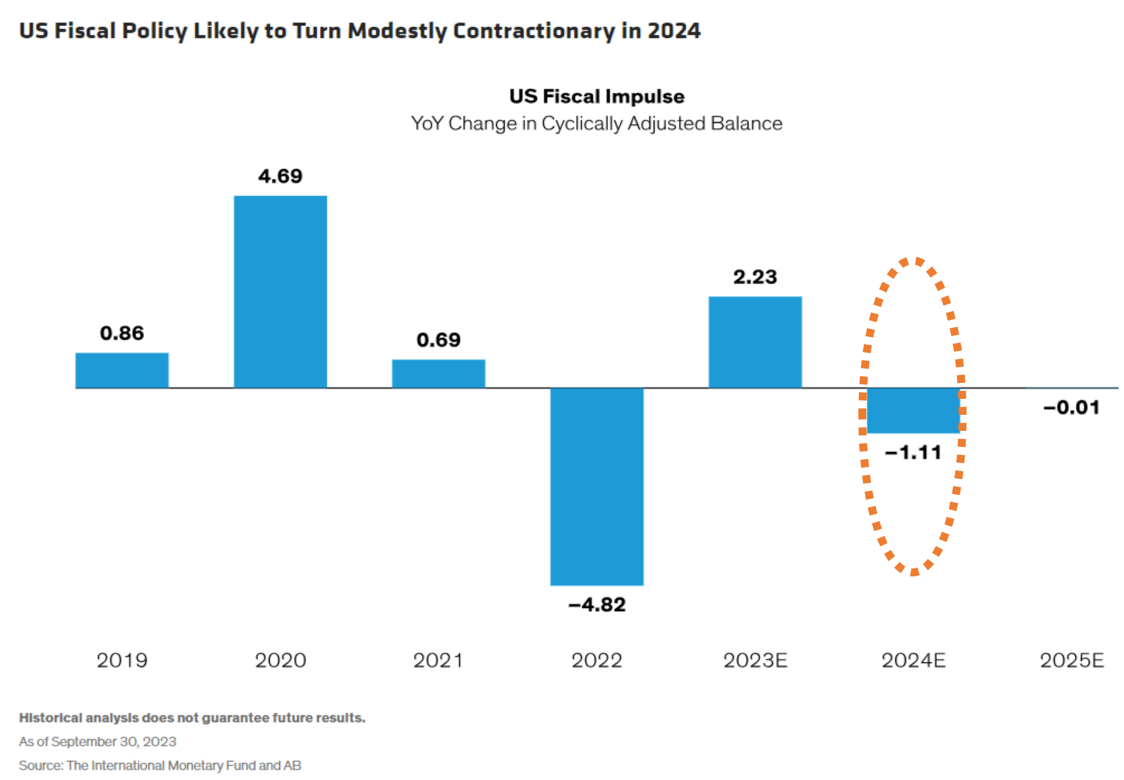
The monetary impact of verbal intervention might have been even greater. Thanks to Powell's dovish pivot away from 'higher for longer', financial conditions loosened to a record extent creating a wealth effect in excess of $8 trillion dollars (increase in market cap of the S&P 500 from October 2023). To put this in context the destruction in stock market wealth during the whole of the GFC was roughly $8 trillion. This irresistible combination of record fiscal and monetary support has undoubtedly underpinned a reversal in the inflationary trend.

Fed Reverse Repo Dwindling



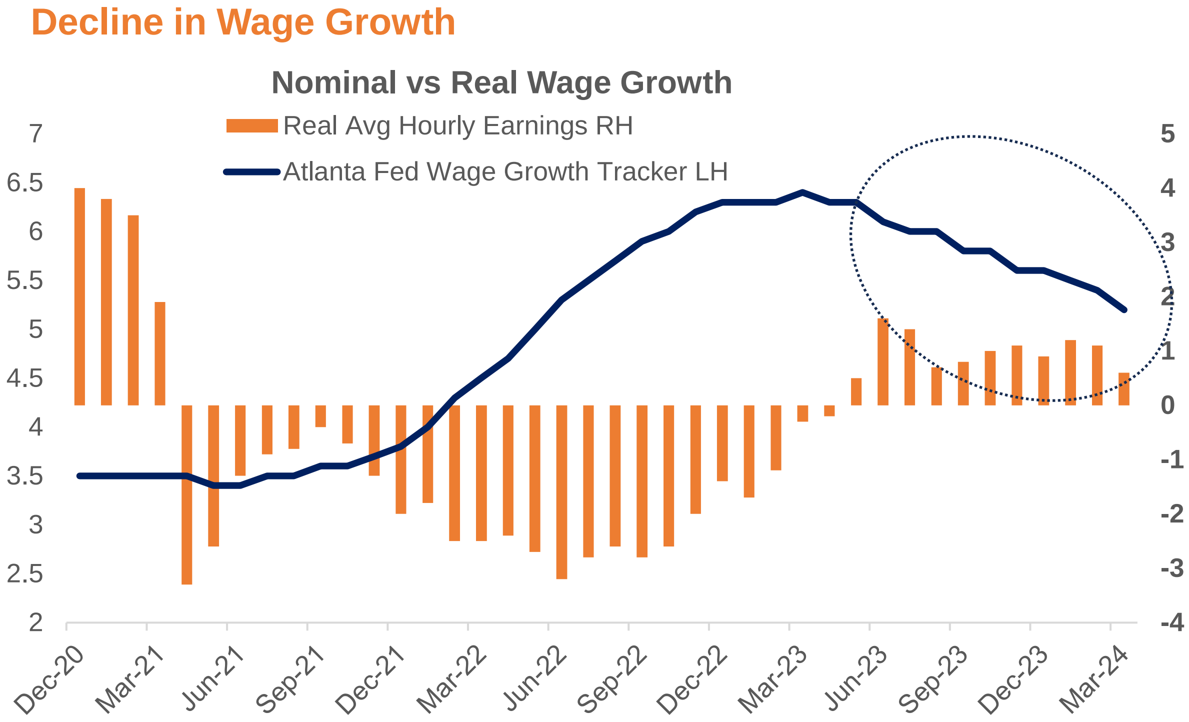
Source: Bloomberg as at 12/04/24

US Fiscal Impulse to Turn Negative in 2024



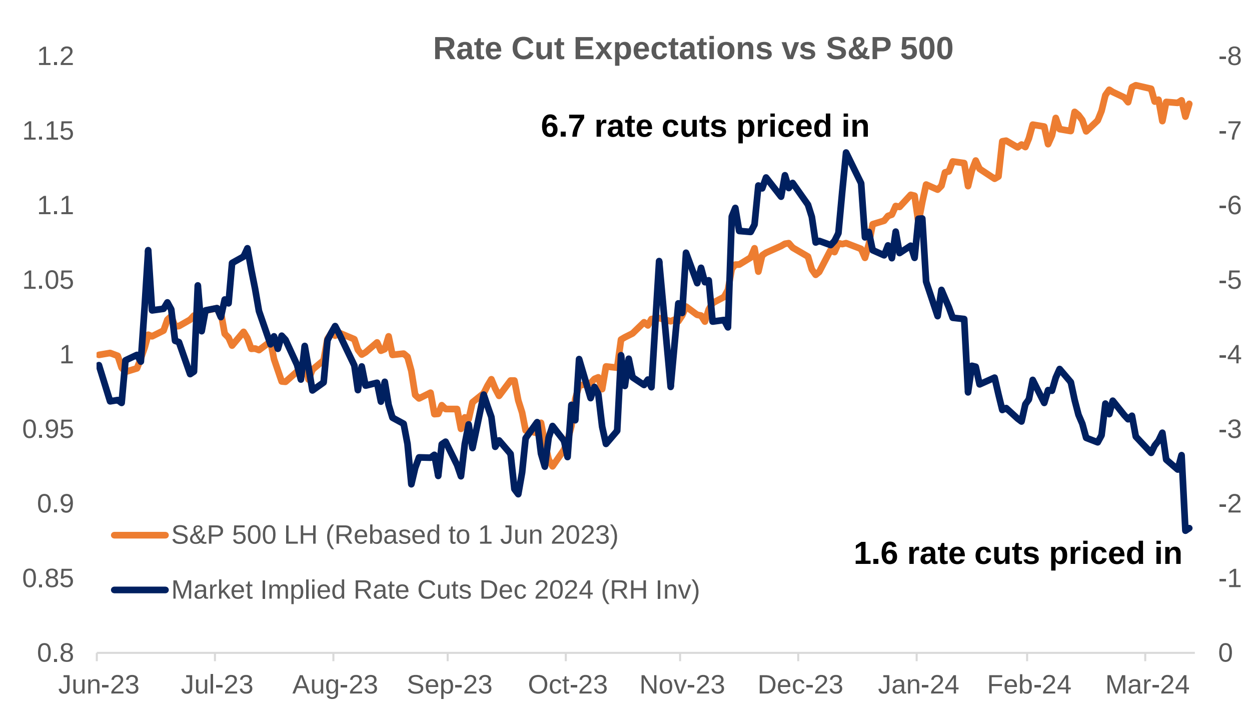
However, the marginal trend in these key supports might be set to decline. The Fiscal Impulse is set to turn negative according to various analysts[1], the net liquidity from the Fed supporting the large deficits (via the RRP) is running low while the excess savings from Covid are already used up according to the San Francisco Fed[2]. Expanding wage growth, which has been supporting the consumer, is also cooling in both real and nominal terms while the ~ 7 rate cuts that had been priced in post Powell pivot have been largely undone. Multiple expansion on equity pricing will have to be justified in the form of higher earnings - no easy feat. Last but by no means least, we are getting closer to the point where the lagged impact of higher rates will be felt. The growing stresses in the credit markets are real, if not yet readily observable in the indices, however a continued tightening in financial conditions might change that.

Decline in Wage Growth



Source: Bloomberg as at 12/04/24

Equity Markets Decoupled from Rate Expectations (For Now)

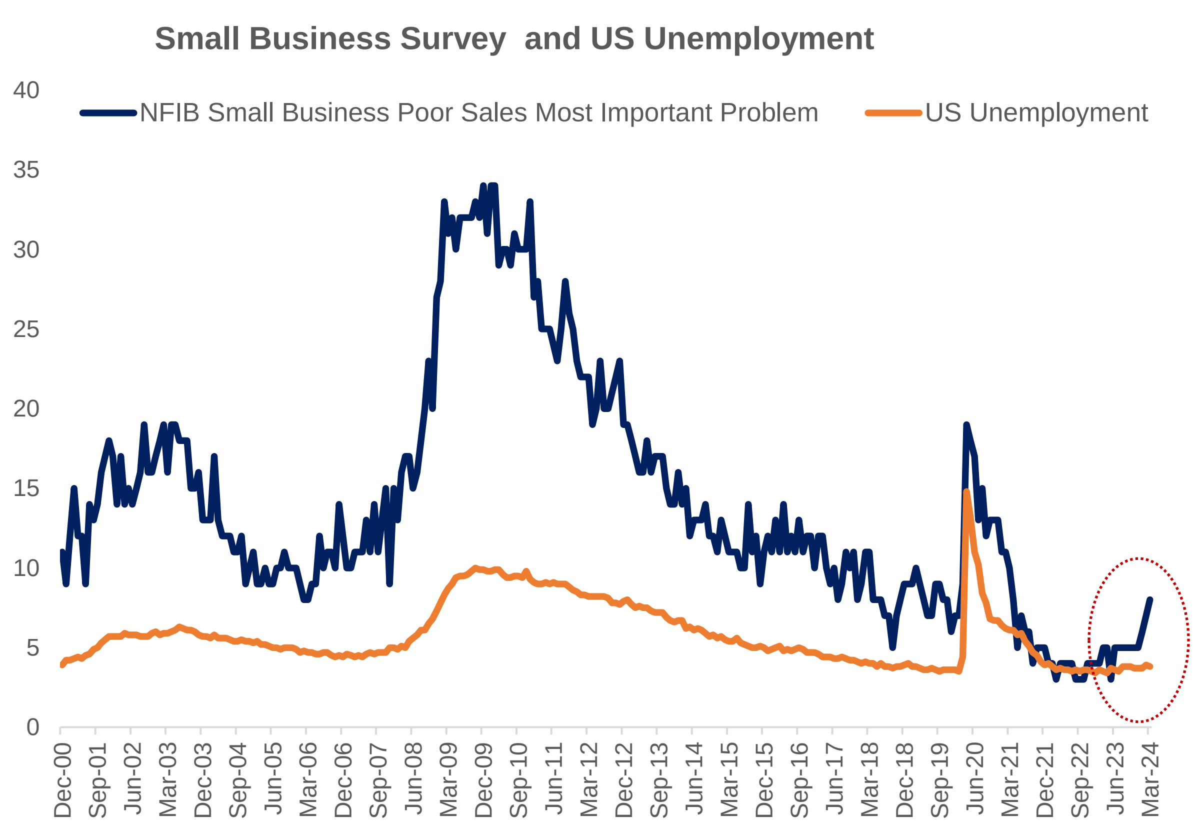


Source: Bloomberg as at 12/04/24

1. [Multi-Asset Investing: Tracing the Growth Impact of US Fiscal Policies | AB (alliancebernstein.com)](alliancebernstein.com)
2. [Pandemic-Era Excess Savings - San Francisco Fed (frbsf.org)](frbsf.org)

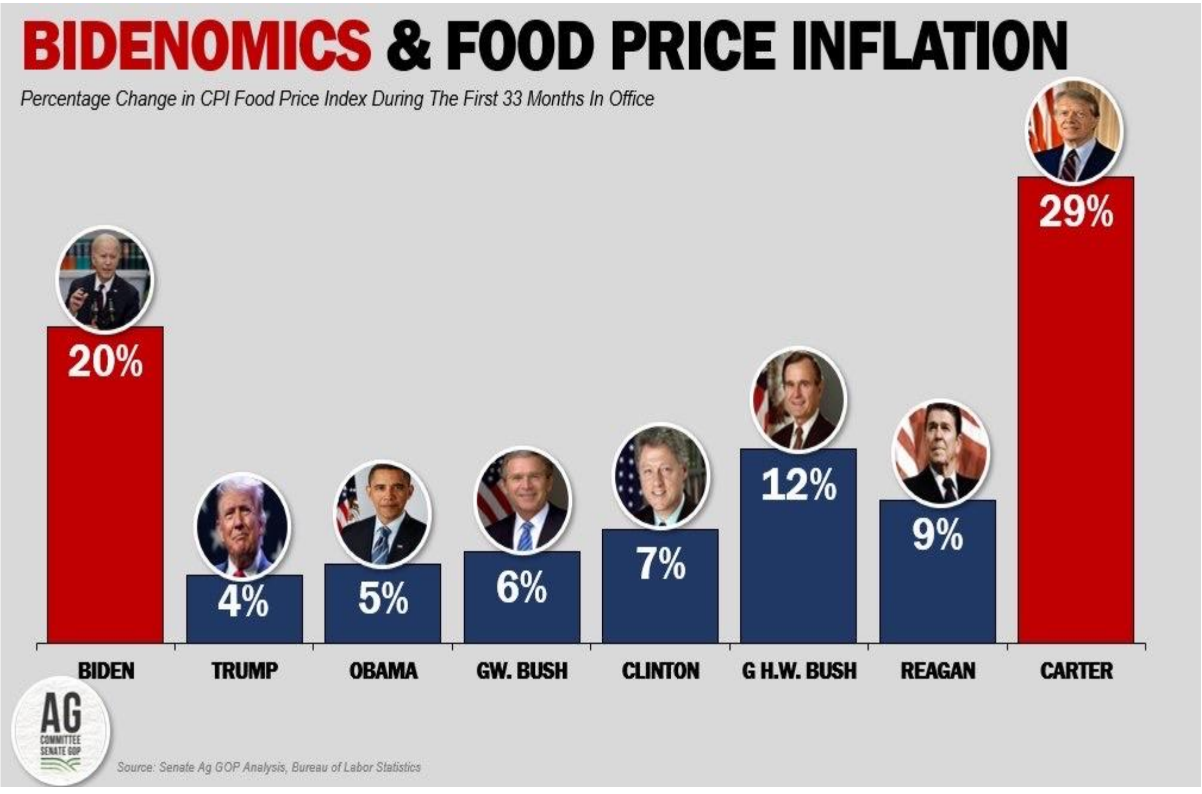
Biden has also a considerable problem. At present his election campaign was going to rest on two key issues; Bidenomics and Abortion. The first one is under the microscope due to the failure to get inflation under control in the eyes of many Americans. It was an incredibly risky choice to keep the economy red hot for as long as they have. As the US faces more headwinds in the summer a shift in fiscal policy to a more expansionary one is highly unlikely, and more importantly would be highly unpopular. As mentioned the outlook for inflation isn't as scary as it was in 2022 or even last summer. That didn't stop the government bond market reacting badly to the CPI results; backed up by stronger than expected Jobs data last Friday. While there is much confusion around where the economy is heading at the moment, we feel the direction of travel for underlying stimulus packages is downward. Financial assets, which have for the most part been insulated from the stress of higher rates, might face even more headwinds over the coming months as they compete increasingly with issuance from the government bond market.

Small Businesses Starting to Feel the Pinch



Source: Bloomberg as at 12/04/24

Inflation Not Good for Re-Election



The market's recent focus has centred on rates rather than growth. Once the narrative shifts to growth related concerns, risk assets will come under real stress - something the Fed have tried so desperately to avoid. However, a critical miscalculation of the impact of fiscal policy and the evolving dynamics of inflation have exposed a cold reality - the economy needs to correct if inflation is to recede. Inflation data has unequivocally shown that the Fed has been fighting the wrong battle in striving for a soft landing. They must now shift their focus and let the higher rates to do their job. This is what the economy really needs and ultimately will allow rates to move back to more sustainable levels.

IMPORTANT INFORMATION

12th April 2024

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