US Macroeconomics

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Making Sense of the Current Macro Environment

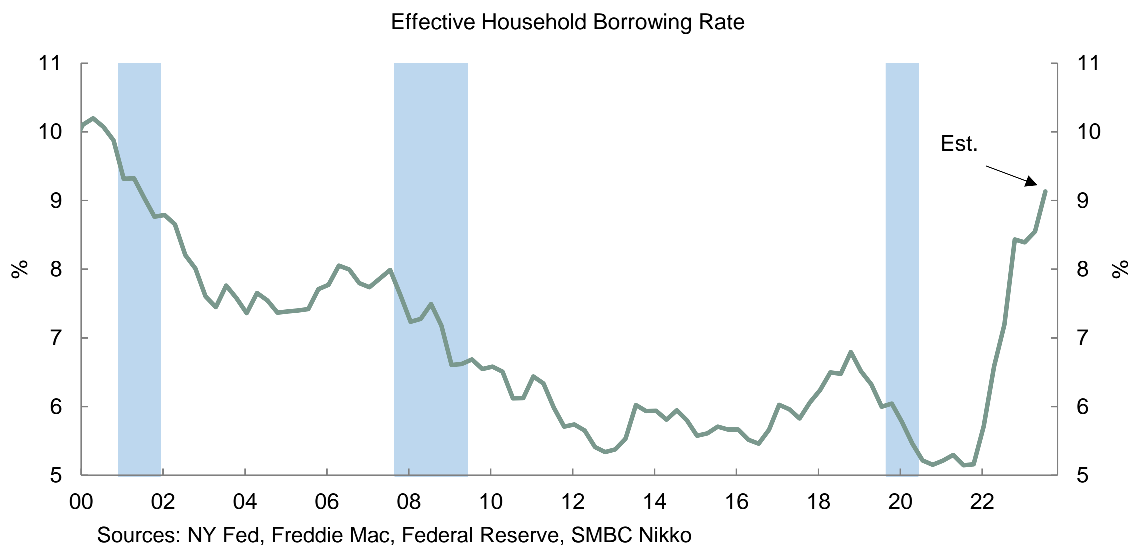
Recessions are non-linear events. Before they begin, the economy is growing (linearly) and suddenly there is a shock (non-linear) which throws GDP growth off its positive trajectory. For a time, output declines and a recession begins. What triggers this shock is random, which is why downturns are so hard to predict. Sometimes it can be a corporate event (i.e., Lehman Brothers) and sometimes it can be a breaking point for businesses and consumers who can no longer afford to borrow money (i.e., the cyclical downturn of the early 1980s).

The economy dodged a recession earlier this year. In March, the spread between 2- and 10-year Treasury notes went to -110 basis points which is twice the depth of the record inversion seen in 1981-1982 after adjusting for the *level* of interest rates. In turn, regional bank stress mounted. Silicon Valley Bank and several other large commercial regional lenders went bankrupt. Global financial markets teetered. Swiss authorities quickly arranged a shotgun marriage between Credit Suisse and UBS. In just two weeks, **the Fed added $340 billion in liquidity through its discount window**. Had these extraordinary actions not occurred, the economy may have entered recession.

Fortunately, the financial market conflagration did not spread to Main Street. The labor market continued to grow, equities continued to rally, and fears of recession began to fade. Fast forward seven months later, and **the consensus of forecasters now thinks a downturn has been averted**. A "soft landing" is now the dominant narrative, the opposite of where we started the year. But are we out of the woods? The answer is no, at least not with interest rates where they are and with Fed quantitative tightening on autopilot.

As the year has progressed, private sector borrowing rates have increased further, while the treasury curve remains inverted. Household auto, credit card, mortgage, and personal loan rates are near record highs. Commercial bank lending standards are tight. **If something else breaks in the financial markets, the Fed's kneejerk response will be to provide additional liquidity**. This would likely help stabilize sentiment, and a crisis lasting more than a few days or weeks may yet again be avoided. But can periodic liquidity injections be enough to offset prohibitively high borrowing costs? History suggests otherwise, and eventually the Fed will need to cut interest rates if not restart quantitative easing.

The current macro environment is fraught with many risks, arguably more so than in the recent past. Consequently, investors should be attuned to the possibility that the consensus narrative changes yet again. Stay tuned.



Sources: NY Fed, Freddie Mac, Federal Reserve, SMBC Nikko

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