An Update from Our CIOs: Entering the Second Stage of Tightening

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Higher rates for longer will drag bond yields higher and produce a grinding pressure on growth. A rise in yields and low growth will further compress equity yields relative to bonds.

We see two big forces that will continue to exert upward pressure on long rates and downward pressure on the economy: 1) the need to sustain a restrictive monetary policy until key economic conditions have settled into their desired levels and 2) an emerging liquidity hole in the bond market.

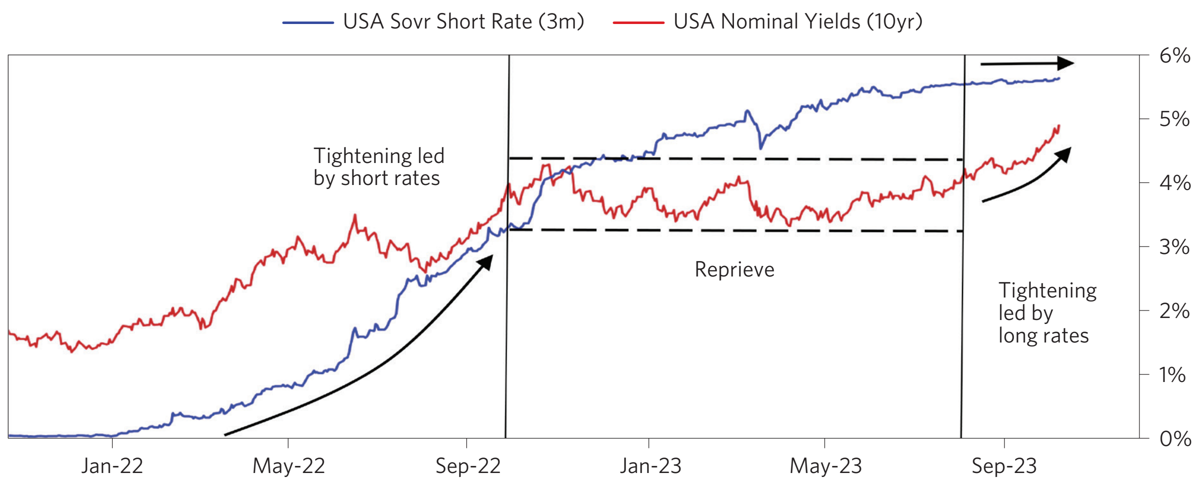
With respect to the monetary policy influence, the level of economic growth is not weak enough to justify a cut in interest rates at the same time as the level of inflation remains too high. The right response to this set of conditions is to hold short-term interest rates about where they are or to raise them a bit further.

This is a unique configuration of market forces. Typically, changes in economic conditions are the biggest drivers of changes in yields and asset prices. And in the first two waves of this tightening cycle—the rise and then fall in spending, growth, and inflation—that was the case. At this stage of the tightening cycle, what matters most will be whether the desired levels of conditions have been met; so far, they have not.

The impact of this imbalance between the level of conditions versus what is desired by policy makers began to be felt in the third quarter. Given a) a level of inflation that was still moderately too high, b) a level of wage growth that was too high to allow inflation to settle into the target range, c) labor market conditions that were too strong to exert a downward pressure on wages, and d) real growth that was not so weak as to justify an easing, it became clear to the markets that the proper monetary response was to sustain or raise short-term interest rates from their current levels. Given a level of bond yields that was well below this, an upward adjustment in bond yields was required, which we see as the beginning of the next stage of the tightening cycle. Looking ahead, if the T-bill rate stays at 5% or higher, to get a risk premium in bonds you need a bond yield of 5.5% or higher. And given the coming supply of bonds and the withdrawal of central banks from buying them, demand will need to come from private sector investors, who will require a risk premium relative to cash.

With respect to the emerging liquidity hole in the bond market, US government borrowing on the long end of the yield curve is about to rise to very high levels, well in excess of the existing demand to buy bonds. The impact of this liquidity hole has been delayed by the Treasury funding its substantial fiscal deficit via T-bills, with the demand for those T-bills coming from a residual excess of liquidity left over from prior MP3 policies. Going forward, government borrowing will shift to the long end, and the store of excess liquidity will gradually decline until it is gone. This will force supply to clear at a market price determined much more heavily by private sector investors, whose demand for bonds has been far less than the future required demand. The sell-off in bonds in the third quarter began when it became clear that issuance was on the rise.

The second stage of the tightening cycle can be clearly seen in the market action. Earlier in the tightening cycle, short-term interest rates rose and dragged long-term interest rates higher. Then, beginning in October 2022 and lasting almost a year, there was a reprieve. Hikes in short-term interest rates continued, but bond yields traded sideways, reflecting market expectations for future easing, combined with the Treasury circumventing the pressure on long rates by issuing T-bills funded by excess central bank reserves. In the third quarter, both conditions shifted as described above, initiating the next stage of the tightening cycle, led by long rates.



Implications of the Next Stage of the Tightening Cycle

While it is happening through the bond market, the implications of the second tightening cycle go far beyond bonds.

For the economy, we should see higher short-term and long-term rates for longer produce a grinding pressure on growth. As future easing is pushed back, the level of real interest rates has vastly diminished the incentives to borrow and leverage up relative to the stimulative real rates of the past 15 years. The credit system is healthy enough that an acute contraction in credit is not the most likely outcome, but a higher level of rates that persists for longer will close the arbitrage between the level of interest rates and the level of growth (changing the economics of leveraging up private assets) and, on the margin, will redirect income from spending to debt service, as existing debts are refinanced at higher interest rates.

For equities, as bond yields rise to compete with cash, the equity market becomes more uncompetitive relative to bonds, propagating the impact of higher cash rates out the risk curve. It's important to realize that the primary support to equities this year has been contracting risk premiums, enabled in large part by the past liquidity reprieve and expectations that cash rates would soon fall. But lower cash rates cannot be relied on to restore risk premiums relative to cash because conditions do not justify a cut in rates. And given grinding pressures on growth and restrictive policy that discourages an acceleration in credit, it is not likely that an acceleration in earnings will restore the competitiveness of equities relative to bonds, as earnings are more likely to be a contributing drag. Instead, restoring risk premiums in equities relative to bonds and bonds relative to cash likely requires higher yields and lower prices. The shift in liquidity dynamics that is now happening is an impetus for this process to begin.

For the US dollar, the continued need for tight policy for now has been a support as the economy has stayed strong, though much of this strength is already in the price of the dollar, limiting upside. Going forward, there is more ambiguity. If tightening breaks through to growth and assets, its net effect can turn to a headwind; meanwhile, the secular backdrop for the dollar is not attractive given a multidecade high in the real exchange rate, a relatively wide current account balance, and the potential for massive US Treasury issuance to spill over to a balance of payments imbalance that could pressure the dollar and bond yields.

Around the world, as the tightening cycle has progressed, the divergences have grown. There are now many differences in the nature of tightening pressures across the US, Europe, the UK, Australia, and Canada; the secular and cyclical picture in China and Asia more broadly; between EMs that tightened aggressively and those that didn't; and in the pricing across currencies, equities, and bonds in each economy. As a result, some of the biggest opportunities in this environment are in relative value trades and non-USD currency cross-rates. We elaborate more on these divergences below.

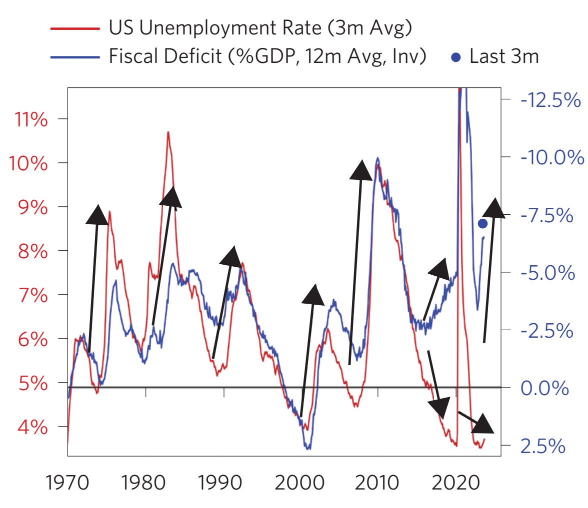
The biggest unknown relates to the potential productivity impact of the technology breakthrough in AI and large language models. The pricing can make more sense if we are on the verge of a substantial and sustained rise in productivity. The level of wages would imply a lower inflation rate. The discounted growth in earnings would make more sense. And a higher level of real interest rates could be sustained with less impact on the economy. Bond yields would still need to rise to provide a risk premium to the new equilibrium level of real short-term interest rates, but the economy and equities could more easily withstand those interest rate effects. Our latest research on these effects can be found here.

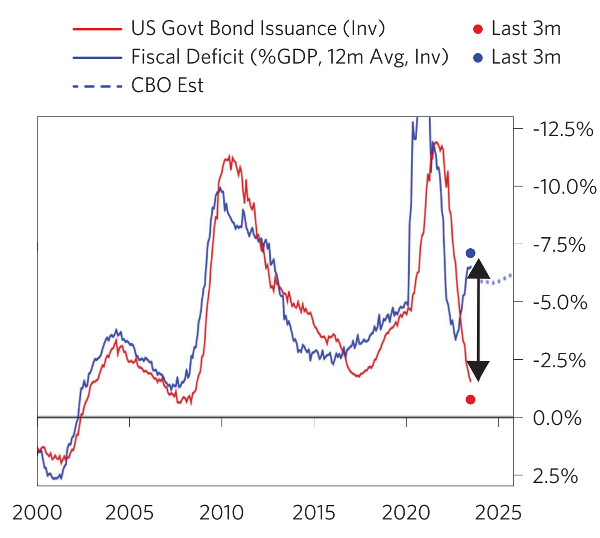
How Did We End Up in a Second Tightening Cycle?

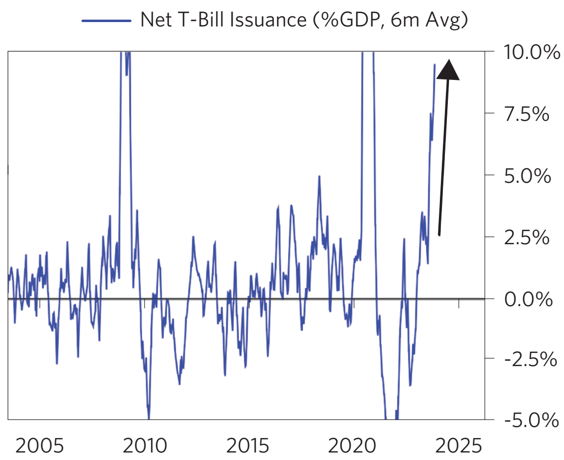
For much of the past year, many of the usual impacts of tightening were offset, producing a lull that may as well have been a pause in tightening. As a result, although we are now 18 months into one of the fastest and biggest tightening cycles in history, when you look at unemployment rates, activity levels, or stock prices, you see few signs of its effects. Why has the impact of this tightening been so muted? There were three big, interrelated drivers that produced resilience, which are now reversing.

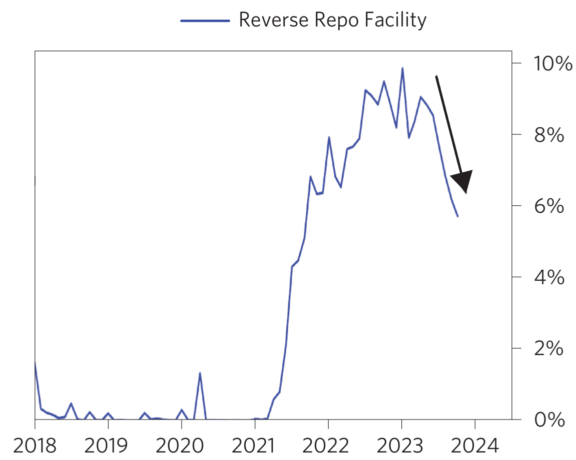
1. **A big deficit expansion that was funded "for free" produced a liquidity reprieve that allowed money to flow into both cash and assets.**

   This year saw a big expansion in the US fiscal deficit despite a strong economy. This was funded at the short end with almost no net bond issuance, so the economy experienced the benefit of a fiscal deficit expansion putting money in household pockets but without upward pressure on yields. And, unusually, the money to fund the deficit largely didn't have to come from sources that could be used for spending or purchases of other risky assets. The money to purchase the T-bills that were used to fund the deficit largely came from essentially inert cash that had been parked at the Fed's reverse repo facility. As T-bill rates rose and were in line with or slightly higher than the repo facility, money shifted from that facility into T-bills, allowing the deficit to be funded without absorbing capital that was in productive use. The result was a greater amount of money available to purchase long-duration and risky financial assets than there would have been otherwise.

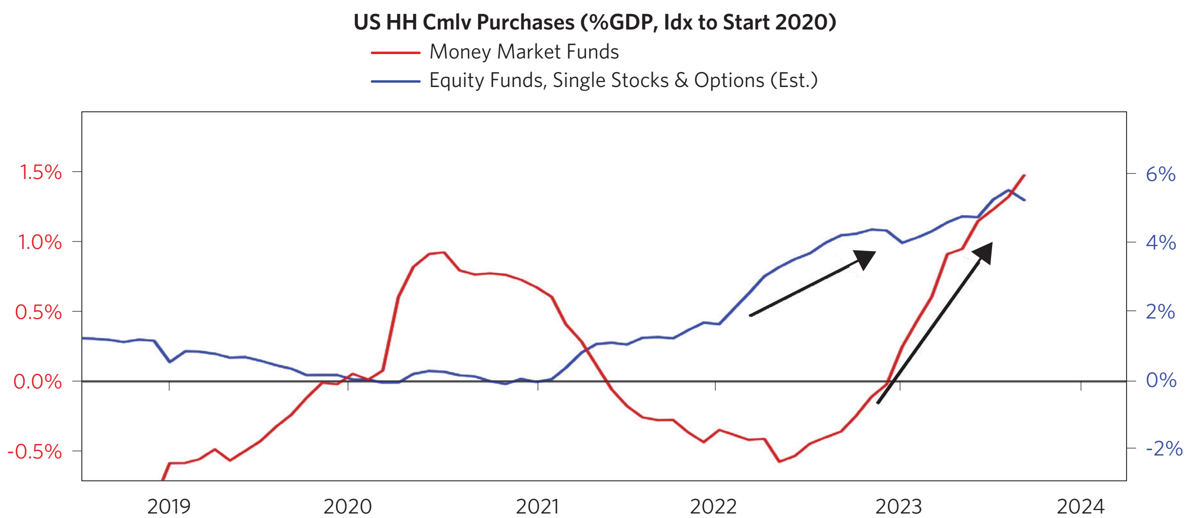






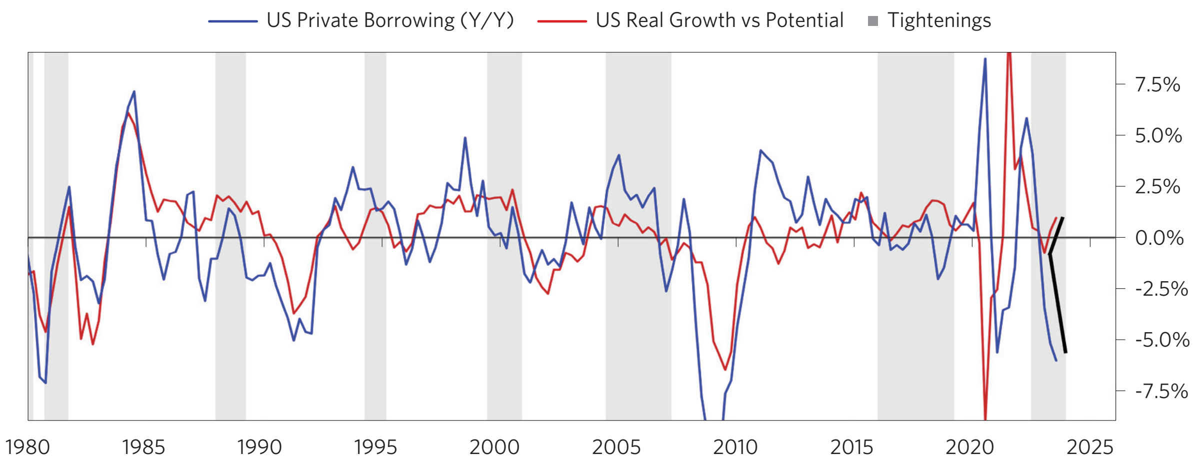


The liquidity that was released from this process offset the impact of quantitative tightening. Money was able to flow into both cash and assets simultaneously. The positive inflows that occurred into both money market funds and equity funds were a sign of this liquidity environment.

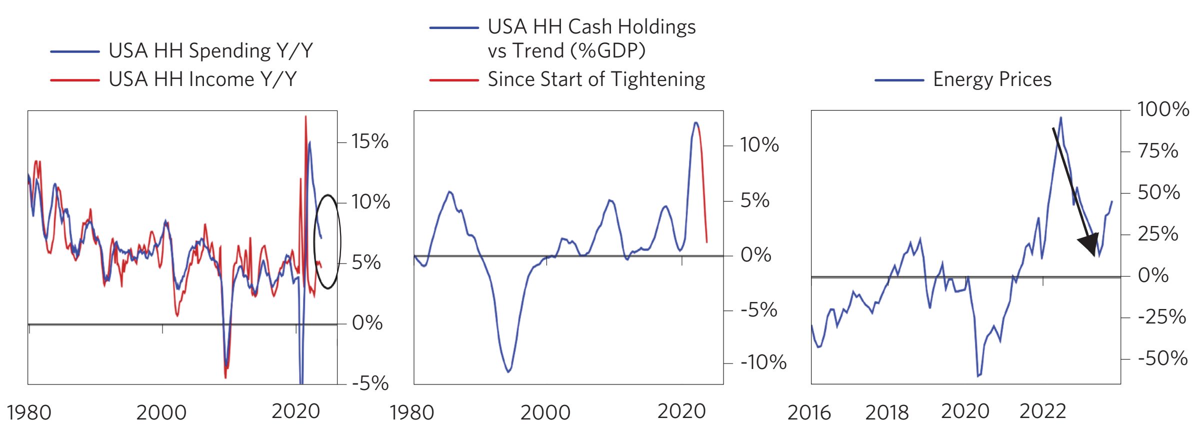


2. **Strong balance sheets and dissaving let households keep expanding their spending despite the contraction in credit.**

Although the tightening had the usual impact of curtailing borrowing, growth remained resilient.

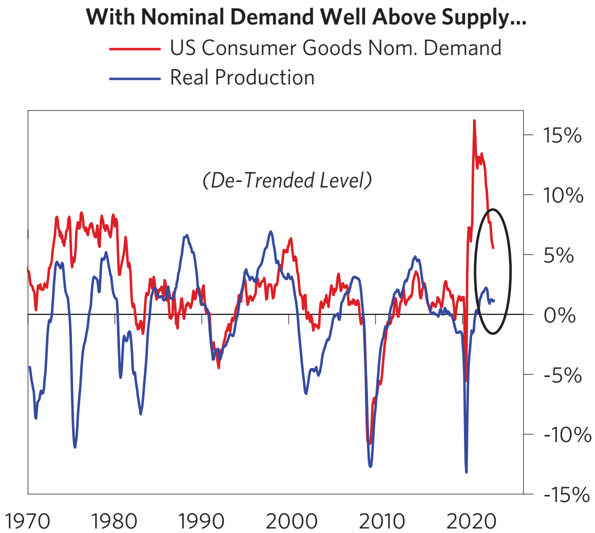


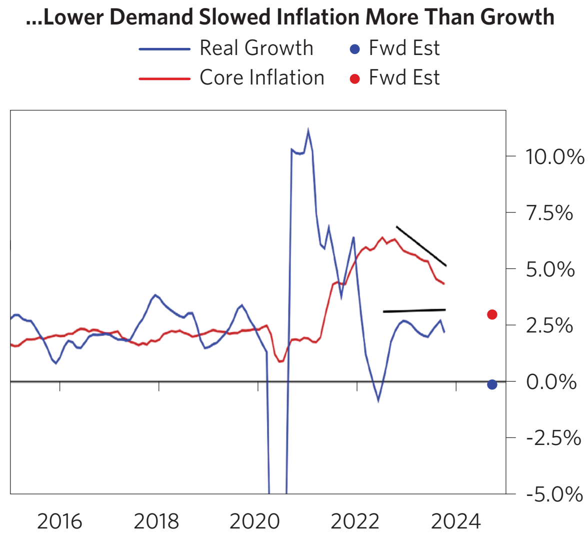
While the liquidity environment discussed above helped support growth, another important factor was the unique strength of balance sheets due to prior MP3 policies. COVID-era stimulus had allowed households and corporates to build up strong balance sheets and cash buffers. This allowed them to keep spending well in excess of their incomes, though as they did so, their balance sheets normalized to a substantial degree. At the same time, falling energy prices provided relief to households, especially in Europe.



3. **While spending did decline, it produced a fall in inflation without a contraction in growth, due to the extreme imbalance between high spending and supply.**

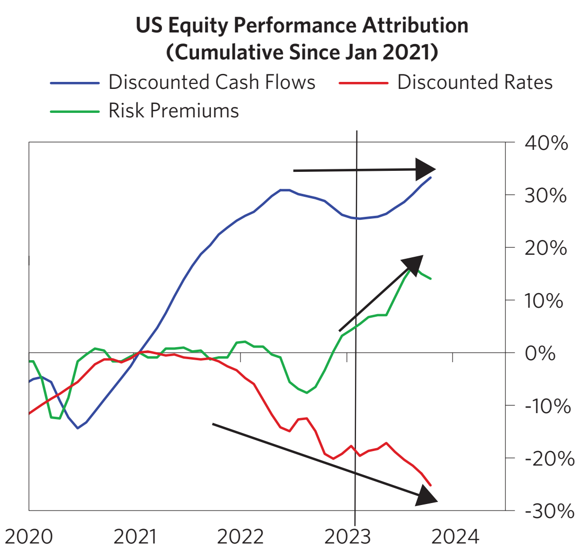
Earlier in the cycle, MP3 policies had driven nominal spending well above supply. As the tightening began to slow spending from highs, supply was still trying to expand to catch up to the level of spending. As a result, the fall in spending had a disproportionately large impact on inflation versus growth. In response to falling inflation, markets discounted a quick end to the tightening and a pivot to easing, supporting assets.

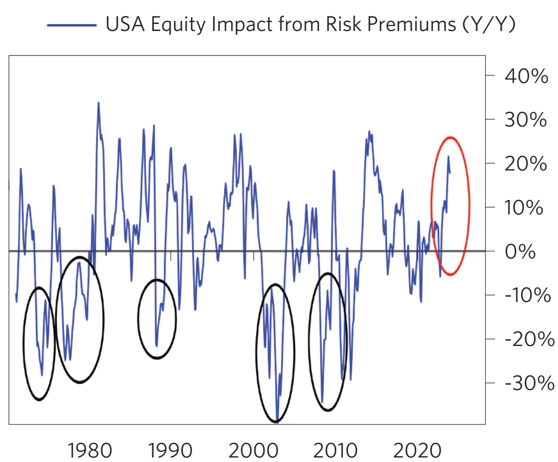




The net of these impacts was to allow spending to keep growing, growth to stabilize, unemployment to stay low, and money to keep flowing into asset markets.

You can see how these dynamics affected the US equity market by decomposing the drivers of equity performance into the impacts of risk premiums, discount rates, and discounted cash flows. As spending was able to continue, cash flows were resilient to the tightening, while the liquidity reprieve supported a contraction in risk premiums and limited the headwind from rising discount rates over the past 12 months. The fall in risk premiums more than offset the headwind from rising discount rates. These dynamics have led to a net unchanged equity market since the rise in interest rates began, rather than a deeper and more extended decline.





Across Economies, We See Increasingly Divergent Conditions and Pricing

In the US, real growth has remained particularly resilient as the significant fiscal easing allowed households to keep spending even as they pulled back from borrowing. Inflation has fallen to be closer to the Fed's target but remains too high. The continued resilience in growth, coupled with the tightness of the labor market, risks reaccelerating inflation from here. At the same time, the growing supply/demand imbalance for bonds as QT continues and issuance picks up means that the liquidity-hole dynamic is likely to be felt most acutely in the US.

The UK and Europe face more difficult and more stagflationary conditions. Inflation is further above target and growth is weak, near zero. In both economies, inflation is far too high, and wages are rising at a rapid clip, supported by tight labor markets and union actions to secure pay increases. Policy makers are trying to thread the needle between keeping policy tight while avoiding a meaningful contraction. The longer that inflation remains higher than desired and the farther from target that it is, the more acute the choices will become and the more likely that a downturn will be necessary. Market pricing in Europe is very different than in the US. The ECB has fallen behind this tightening cycle, offering significantly lower yields. The equity market is already discounting much weaker growth, and the euro is competitive.

Japan is in a completely different part of the cycle. Slower reopenings following the pandemic and a smaller fiscal easing meant that the imbalances in Japan were not as severe as elsewhere. This allowed the BoJ to maintain an easy policy for longer. More recently, with inflation now holding at-to-above their target, we are seeing policy makers respond by gradually removing extraordinary accommodation. The pace of adjustment has been slow, so we are seeing market action that classically indicates an unsustainably easy policy, characterized by a rate rise led by long rates with a weakening currency. This calls for a faster policy shift that would accelerate the rise in bond yields and could potentially generate a sharp bounce in the currency (and the yen is prone to this, historically). Equity valuations remain attractive, though less so than earlier in the year.

China is in the midst of a secular deleveraging that will likely take many years to work through at the same time as domestic and international political risk have risen markedly. After the initial bounce in growth earlier this year from the pivot away from zero-COVID, growth has slowed. Policy makers are transitioning the economy toward a consumption-driven model of growth. Overall, growth remains weaker than desired, as the debt overhang in the property sector remains a significant drag, employment growth has been modest, and savings rates have risen. Low inflation rates imply that policy can remain accommodative, but the prioritization of deleveraging some sectors and avoiding excessive leveraging up in others has limited the aggressiveness of the stimulus so far. Looking forward, we expect policy to remain easy but restrained. That said, the increase in risk and likelihood of slower growth are well discounted across the equity, bond, and currency markets.

Across other emerging markets, the peak impact of tightening dollar liquidity has likely passed. At the same time, there are big divergences between emerging markets. Latin American economies tightened a lot and are poised to benefit from a reconfiguration of global supply chains. Emerging Asian economies are heavily impacted by China and generally weaker, with much less of an inflation problem. Emerging Europe is dealing with extremely high inflation via tight policy.

Building a Resilient Portfolio to Navigate the World as It Swings from Disequilibrium to Equilibrium and Back Again

With respect to the positioning of portfolios, it is important to recognize that the vast majority of global economies and their market pricing remain in a state of disequilibrium. In a state of disequilibrium, economic and market volatility is higher, assets tend to underperform cash, and the path back to equilibrium is iterative, requiring, as a function of the size of the disequilibrium, a number of years to resolve.

For perspective, economies and markets were roughly in equilibrium in 2019. Then there was a big down caused by the pandemic, which triggered a lot of stimulation, which produced a big up, which triggered an aggressive tightening, which caused a big down, then a pause, and now, four years since the last equilibrium, another tightening led by the long end. Such iterations will continue until desired conditions are met, at which point we will probably be in a fine-tuning-type environment until excesses once again occur, at which point we will go through another version of the cycle. No economy has remained in equilibrium indefinitely, and generally not for long. Recognizing the reality that economies and markets will continue to go through periods of equilibrium and disequilibrium, with each having its own characteristics, it seems logical that building a portfolio of assets and alphas that is as resilient as possible across these shifts should be a high priority. For us, high returns with low environmental bias have always been our overarching goal.

Thank you to Jason Rogers for his contributions to this piece.

Important Disclosures and Other Information