The Big Picture
by Geoffrey Barker

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CQS Asian Macro Fund

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How long is a piece of string?

The traditional view of monetary policy is that it works with so-called “long and variable lags”. Of course, this is inconvenient. How can policymakers judge whether they have done enough to stimulate growth or to cool things down? They may either be “pushing on a string” or be pulling furiously, not knowing when the slack will suddenly be taken up, the string tauten and the whole economic edifice tip over!

Academics have tried in vain to calculate “r-star” – the natural rate of interest that is consistent with trend GDP growth and stable inflation. However, there are too many unknowns in estimating potential growth and the output gap. And economic shocks can throw out the old rulebook.

Real interest rates are generally problematic both because it is hard to know which inflation rate to use (historic or expected... and expected by whom?) and because they just don’t work as a leading indicator. It turns out that interest rates are generally highest in real terms when demand for capital is strong, and low when weak. They are more of a signal of health than a useful tool of policy.

If central banks seek to distort the signal – for example by suppressing the yield curve – then there are liable to be unintended consequences. Without an accurate market price, capital tends to be misallocated, leverage increases, and efficiency declines. The upshot is that artificially low real rates end up reducing long-run GDP, not stimulating it.

Amid this uncertainty over calibrating monetary policy, it has therefore become fashionable to monitor “financial conditions” as an intermediate gauge of whether policy is starting to bite. This makes some sense in principle. Financial markets normally move ahead of the real economy, and they are sensitive to changes in liquidity.

Definitions vary but most financial conditions indices are a composite of four factors: interest rates (long and short), the exchange rate, the stock market and credit spreads. If market interest rates are dropping, the exchange rate is depreciating, stocks are rising and credit spreads tightening, then financial conditions are supposedly getting easier.

It is just this market combination that has had the US Federal Reserve on the backfoot so far in 2023. Having kept policy too easy for too long – and allowed inflation to surge way above target – Fed Chief Powell has been scrambling to raise interest rate expectations and “lean against” an apparent easing of financial conditions in the last few months, as he tries to slow the economy to contain prices.

But is he measuring the right variable or is he doomed to overtighten in a mirror image of the errors made in 2020 and 2021?

Financial conditions can be fickle, driven not only by liquidity but by the greed and fear of market participants. Measurement is also a problem. In particular, the direction of short- and long-term interest rates may be less important than the yield curve itself. A peak in long rates could be a sign of trouble rather than an easing.

The track record of financial conditions as a leading indicator of GDP is patchy. Specifically, there was virtually no warning of the global financial crisis in 2008 and there have equally been “false positives” in 1994 and 2015.

What is clearly missing from central bank analysis of monetary policy – and the major reasons why the inflation genie has been allowed out of the bottle – is the role of money itself. One does not have to be an ardent monetarist to recognize that the fiscal transfers made in the aftermath of the Covid crisis boosted private money balances and were the fuel for a surge in demand.

Yet, US money supply growth is now negative and overall credit growth is decelerating rapidly. Moreover, the Fed’s own “senior loan officers survey” indicates that banks have already tightened their lending standards to a point that has historically heralded recession.

The apparent easiness of US financial conditions in recent months may just reflect the difference between stock and flow. Savings buffers built up during the pandemic – both in the US and in other developed economies – have not yet been fully drawn down. And Quantitative Easing (QE) policies in Europe and Japan have not yet been reversed. But the trend of tightening is clear. Policy lags are simply longer than usual.

As well as downplaying the role of money and credit in their analysis, the other blind spot for many economists is corporate profits. The tightness or otherwise of monetary policy is best considered, not by comparing policy rates with inflation, but by looking at the aggregate cost of funds relative to the rate of return on investment (profitability). This is the "Wicksell spread", after the late nineteenth century Swedish economist.

The beauty of this measure is that it recognises the central importance of profits to the economic cycle. Conditions are restrictive if the cost of funds (proxied by corporate bond yields) exceeds profit growth by a given margin. This implies that there are several important factors outside of the control of central banks, notably cost pressures sapping earnings, that will determine the tipping point for policy.

Stubborn cost pressures are a threat to US profits in 2023, even as Europe enjoys some relief from last year's energy shock. Labour markets are tight, "onshoring" is raising the costs of production, interest costs are higher and any uptick in Chinese demand is liable to put a floor under oil and commodity prices.

So long as monetary conditions were easy, these cost pressures could be passed on to consumers but, as money supply drops and nominal GDP growth falls, so the sales curve will cut down through the cost curve.

In summary, while the Federal Reserve is busy raising rates to contain "financial conditions", corporate margin pressures are intensifying, and the jaws of the Wicksell spread are closing.

In its determination to quell inflation, at the risk of driving short-term interest rates into overshoot territory, the Fed is no doubt drawing some comfort from the notion that "balance sheets are strong". Thanks to the post-pandemic rebound in nominal GDP, US private sector debt/GDP ratios have dropped. Also, over the last decade, banks have rebuilt capital and are more thoroughly "stress tested".

Of course, lower private sector debt ratios are offset to some degree by higher public sector debts, but the real issue is the step change in financing costs.

For US households, 90% of mortgages are fixed term so the hit would only come if they needed to move. This is a major deterrent to relocation and explains some of the recent collapse in labour mobility – a cost factor for businesses. More broadly, the aggregate interest burden for households will rise to about 3.5% of GDP this year from a trough closer to 2.5% in 2021. So, interest costs are a headwind to discretionary spending but not likely to cause distress unless people start to lose their jobs.

The US corporate sector is a more complex problem. Non-financial corporate debt is just under 50% of GDP, slightly up from 45% in 2015, with only about a quarter of bond issuance "speculative grade" (according to S&P). Most larger borrowers took the opportunity to "term out" their debt maturities in 2021-22 and will not face serious refinancing pressures for another couple of years.

This is not the whole story, however, as there is another large category of non-financial, unincorporated debt (sole proprietors and limited partnerships) whose debt amounts to some 33% of GDP. This is mainly floating rate debt, some of it sourced outside of the formal banking sector, and subject to significant repricing.

In short, the Achilles heel in the US is going to be small business that will face margin pressure from higher unit labour costs and from rising interest charges. Given that some 40% of Americans work in companies with fewer than 100 employees, this is the likely trigger for higher unemployment, as the buffer of surplus savings is eroded.

As far as the financial sector is concerned, there is also no room for complacency even though bank leverage in the developed markets has been reduced since the Global Financial Crisis. According to the Financial Stability Board, in the US, the assets of shadow banks ("narrowly defined non-bank financial institutions" involved in credit intermediation activity) still account for some 85% of GDP, and they are vulnerable to sharp changes in funding costs and to mark-to-market losses on fixed income portfolios.

Indeed, there are similar vulnerabilities even outside the shadow banks, including in the pension system and among institutions exposed to private markets and leveraged loans.

The focus of this discussion has been on the US economy and the likelihood that the Fed will overtighten and trigger a hard landing with attendant financial risks. But many other central banks face the same dilemma, having allowed inflationary pressures to build and belatedly being forced to drain liquidity. Europe is probably only six months behind the US and Japan will also face a reckoning this year.

We are at the end of an era where cheap money and fiscal largesse could be relied upon to forestall difficult economic adjustments and come to the rescue of financial markets. We need genuine productivity gains and technological breakthroughs to reduce costs, spur profits and revive the Wicksell spread. In the interim, investors should brace for a period of creative destruction.

Geoffrey Barker

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