

Aggressive Fed Tightening and a Bank-Induced Credit Crunch Could Turn a “Slowcession” Into a Deep Economic Downturn

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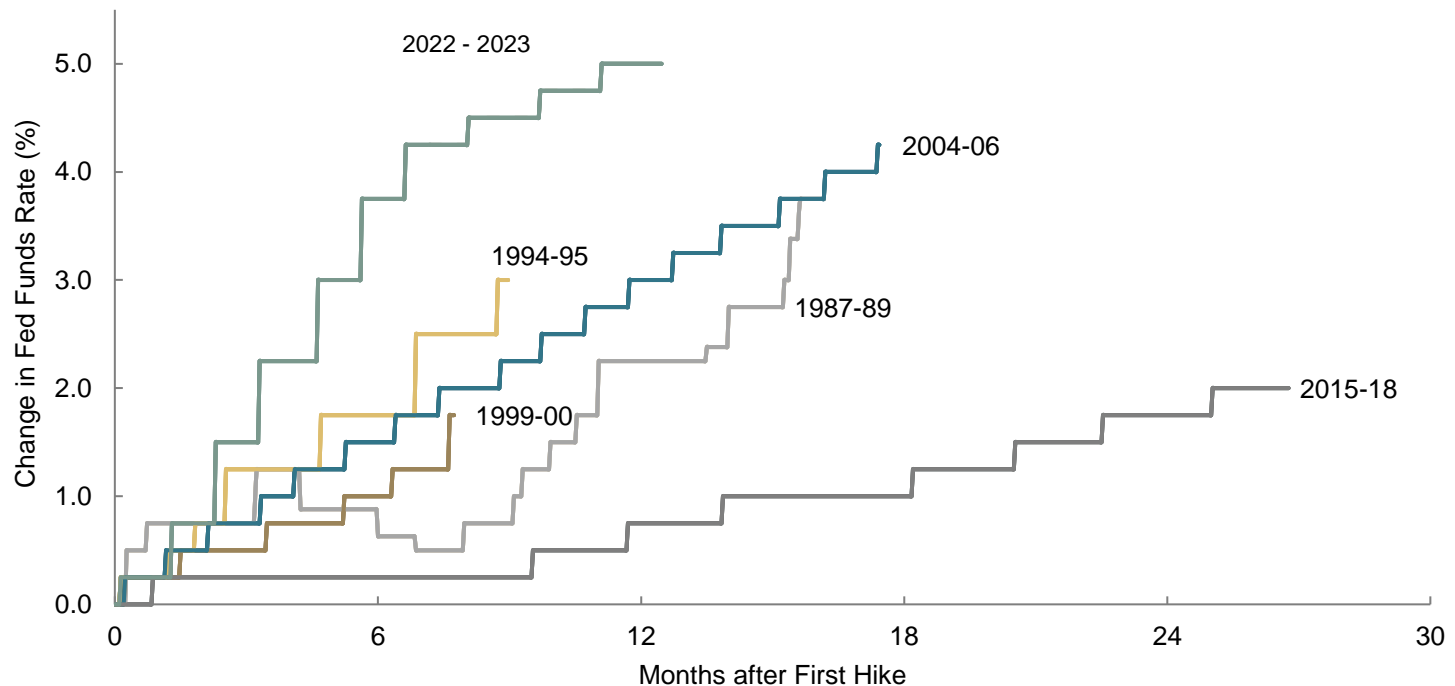
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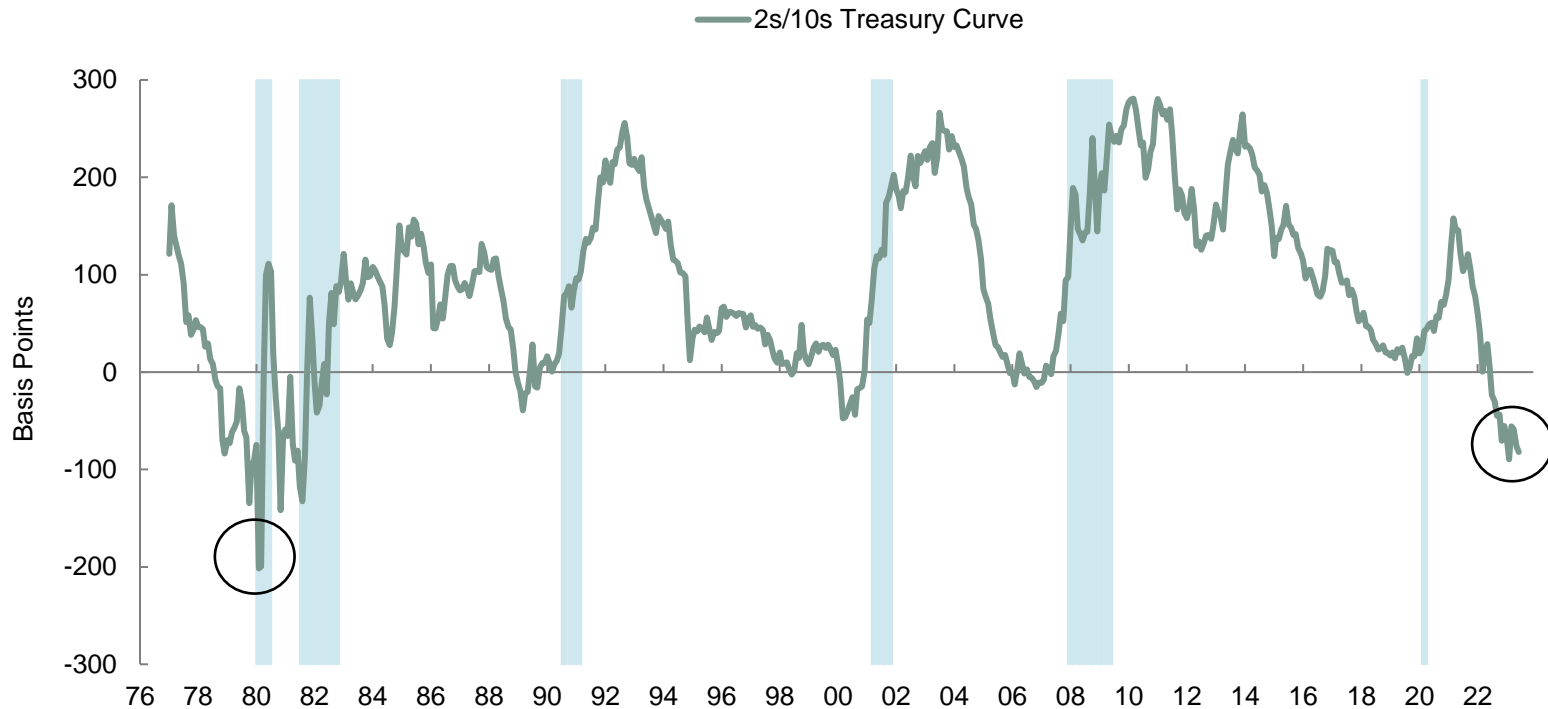
A Record Rise in Fed Funds

The Fed has raised rates at the fastest pace in more than four decades. The funds rate is in highly restrictive territory, evident from an inverted yield curve and high real interest rates.



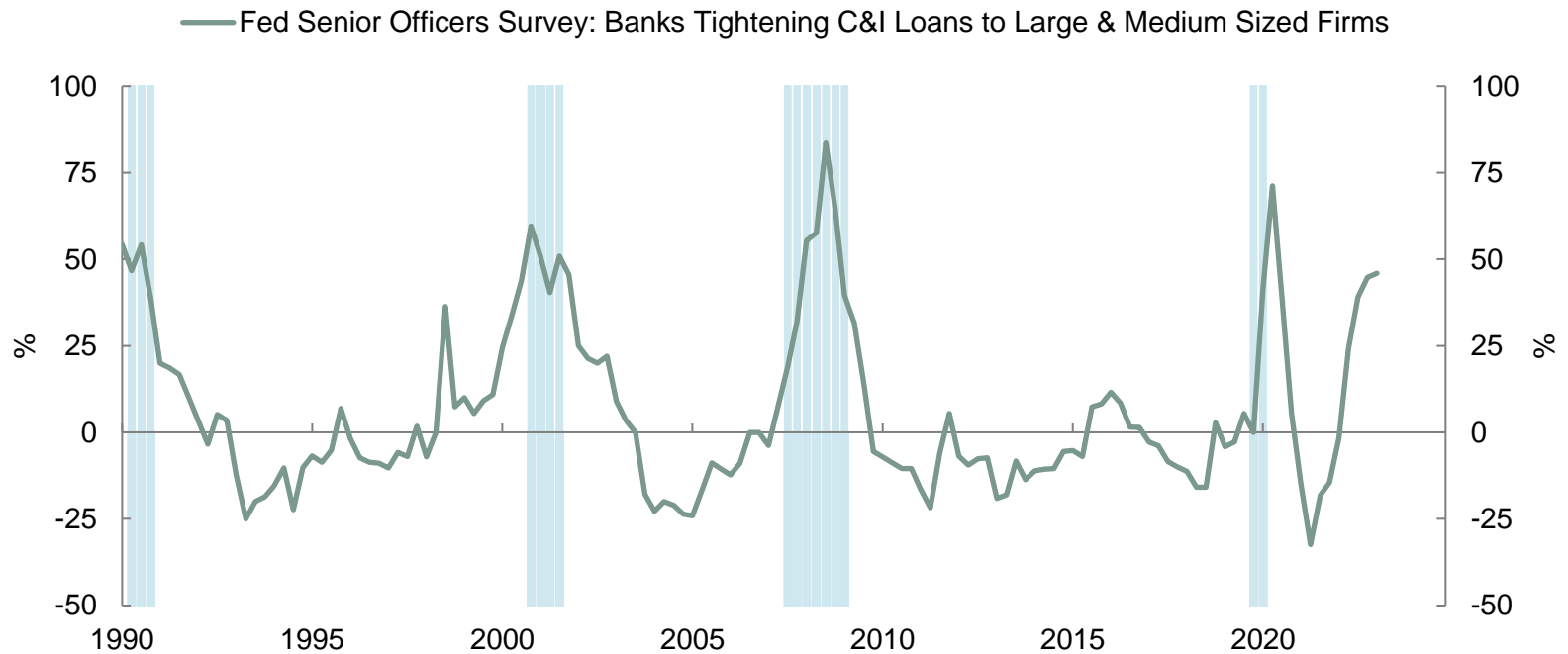
Historic Curve Inversion

The yield curve has been deeply inverted, which has led to a significant tightening in lending standards and bank deposit flight. The curve normalizes only when the Fed cuts rates.



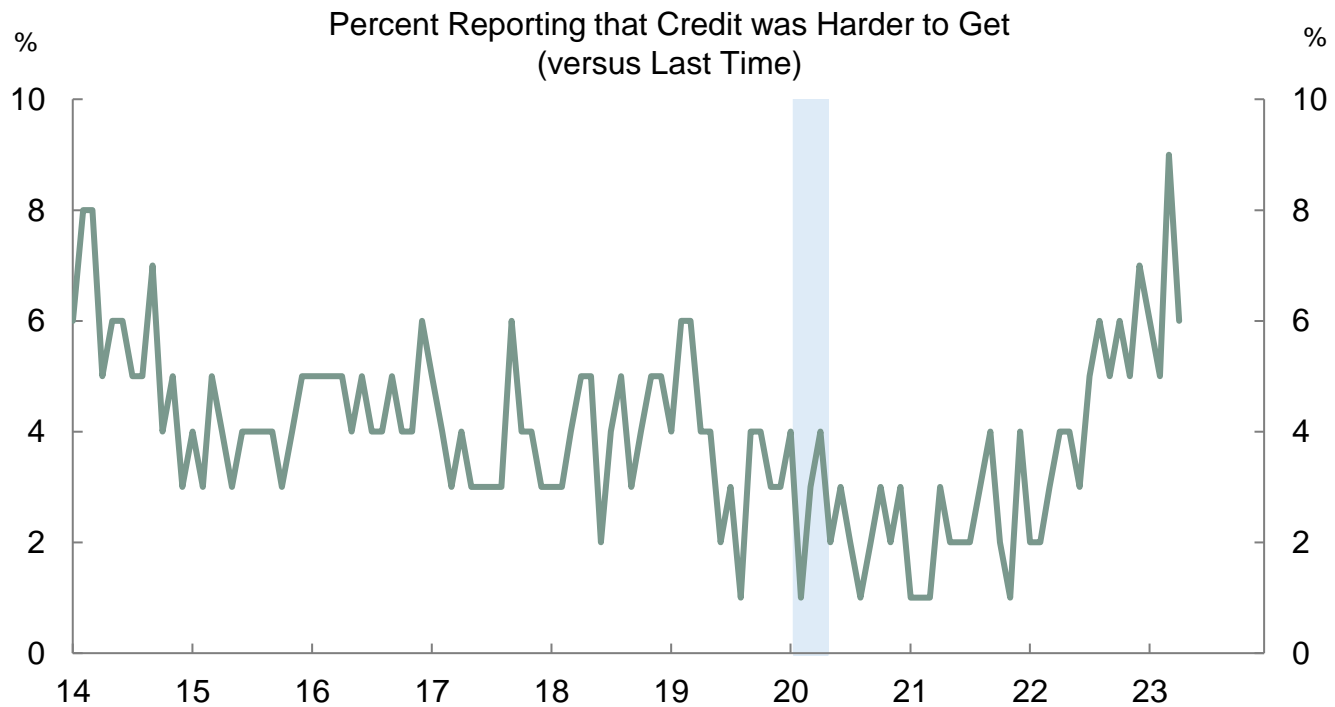
Tightening Credit Conditions

Banks are tightening lending standards at a recessionary rate. The effects of the regional bank credit crunch are expected to intensify in the months ahead.



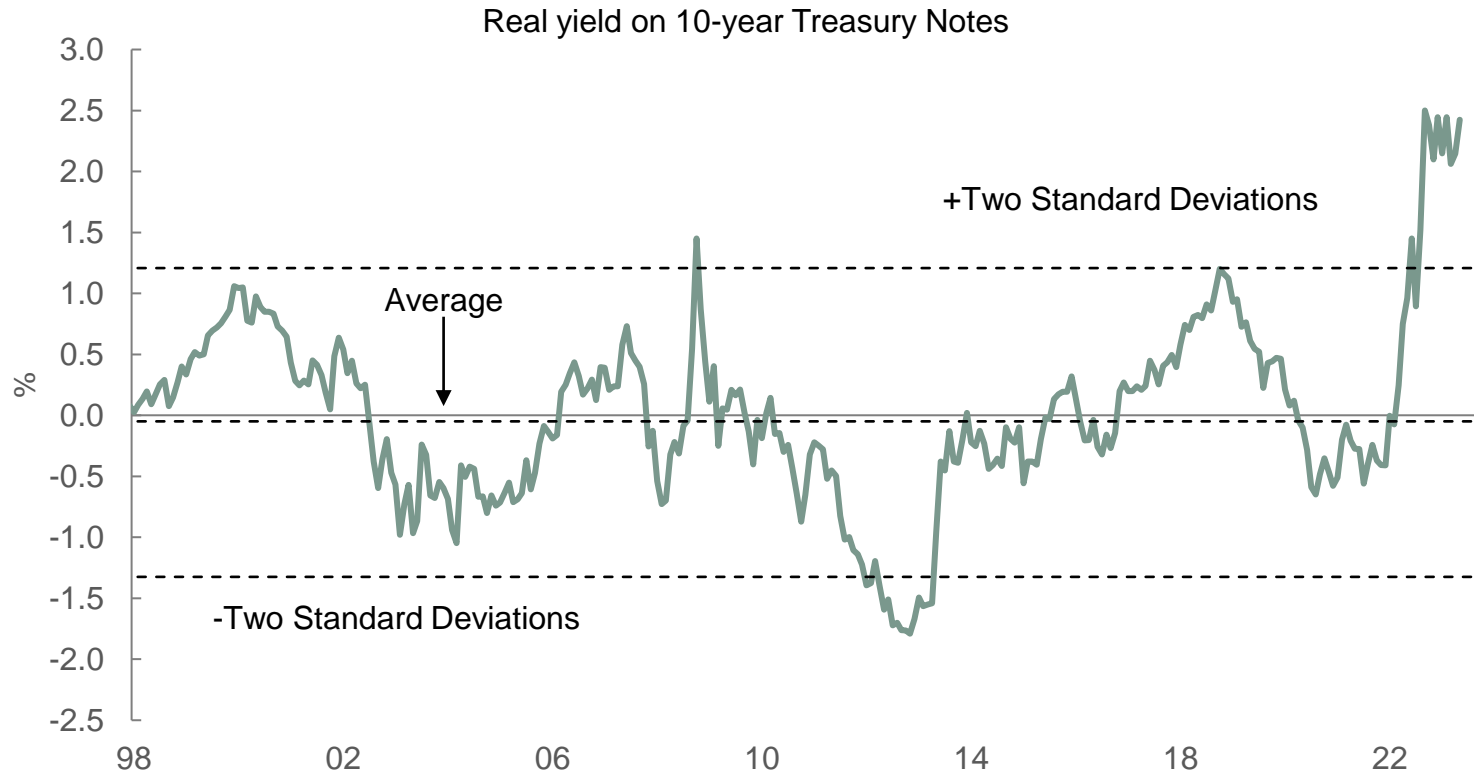
Credit Crunch Ahead

Small businesses are having some difficulty obtaining credit, a headwind to economic activity.



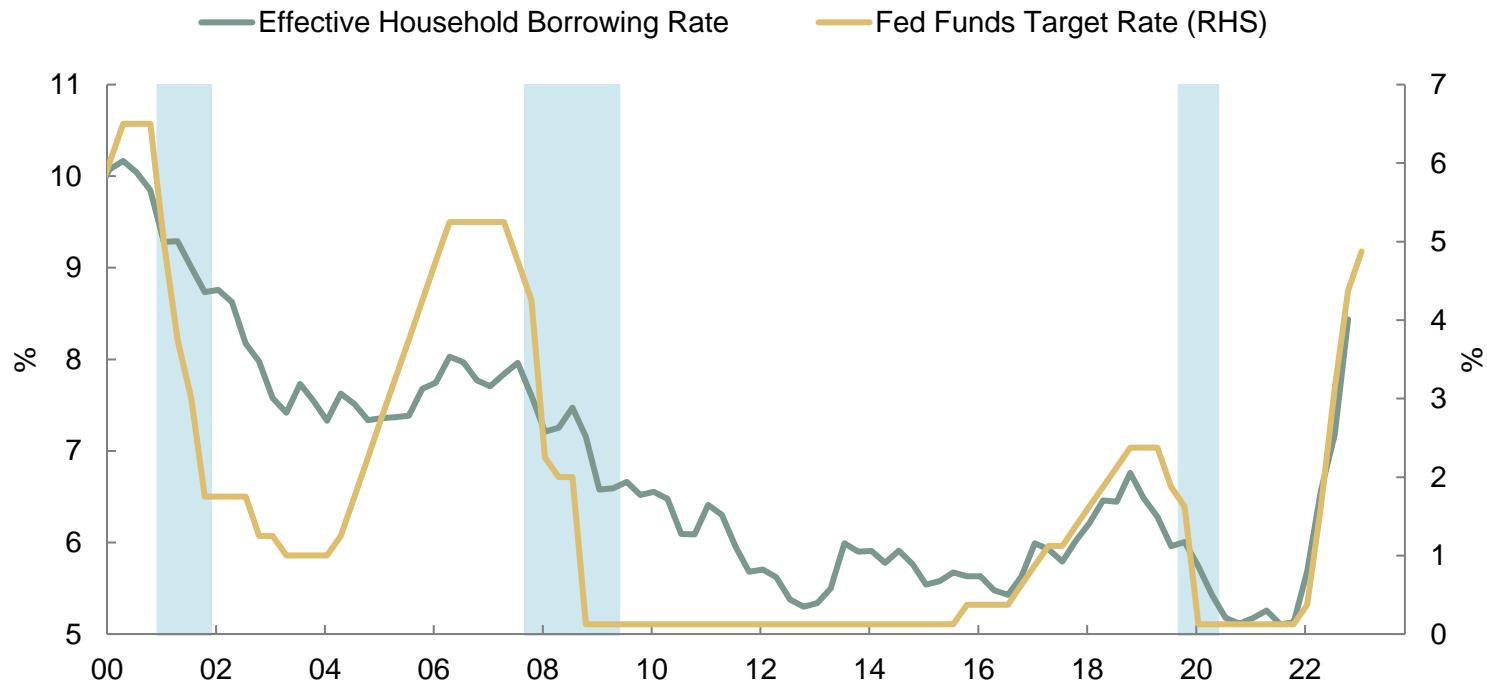
A Surging Real Rate

According to our estimates, the real long-term interest rate is well above its equilibrium level.



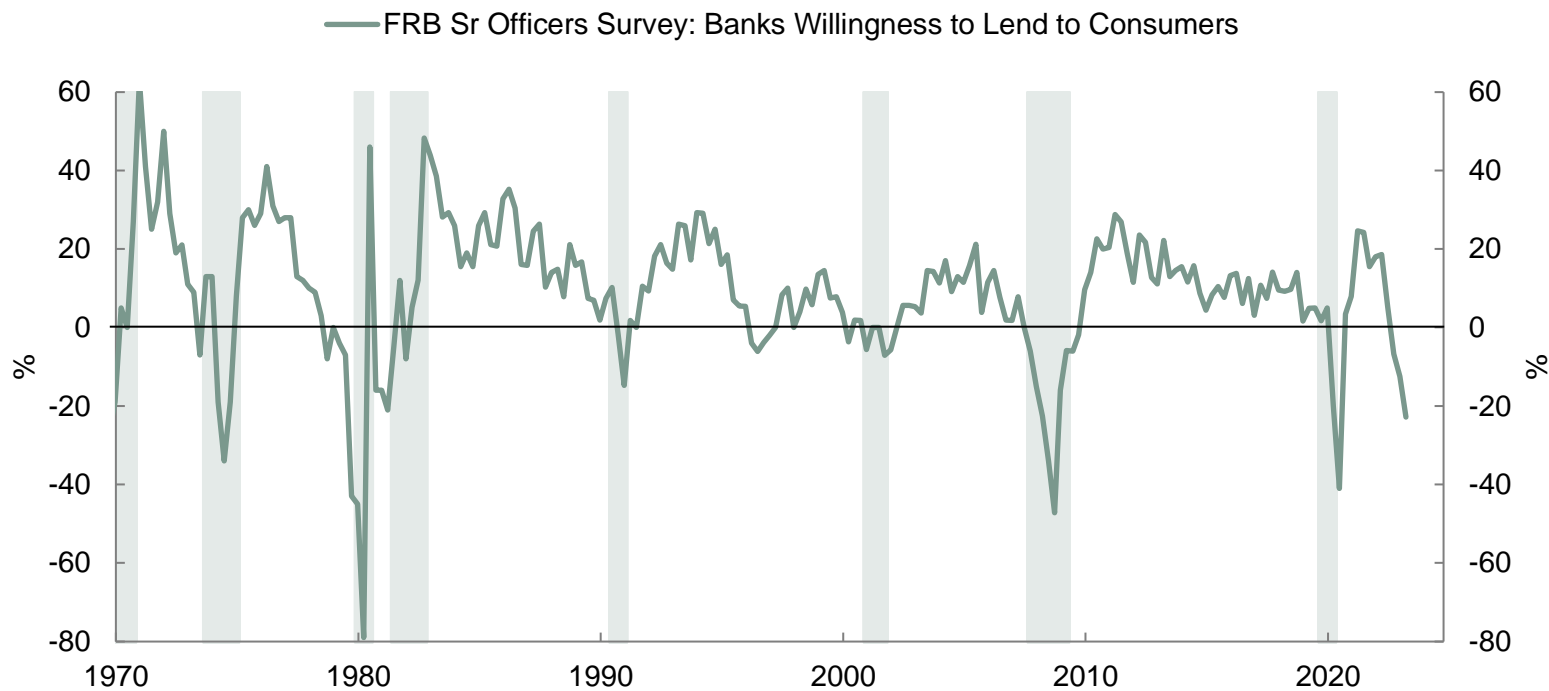
Soaring Household Borrowing Costs

Weighted average borrowing costs are at their highest level in 20 years.



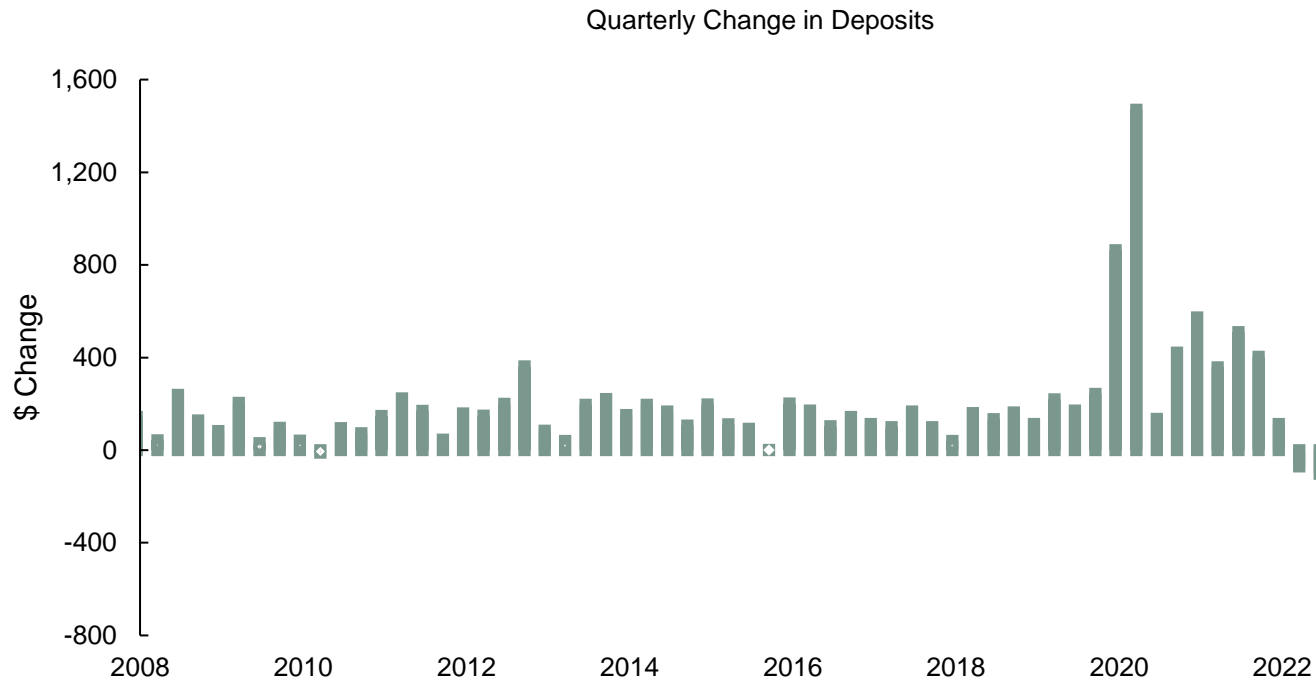
Reining in Consumer Lending

Banks' willingness to extend consumer credit has declined to levels normally seen during recession. This points to a sharp pullback in consumer spending.



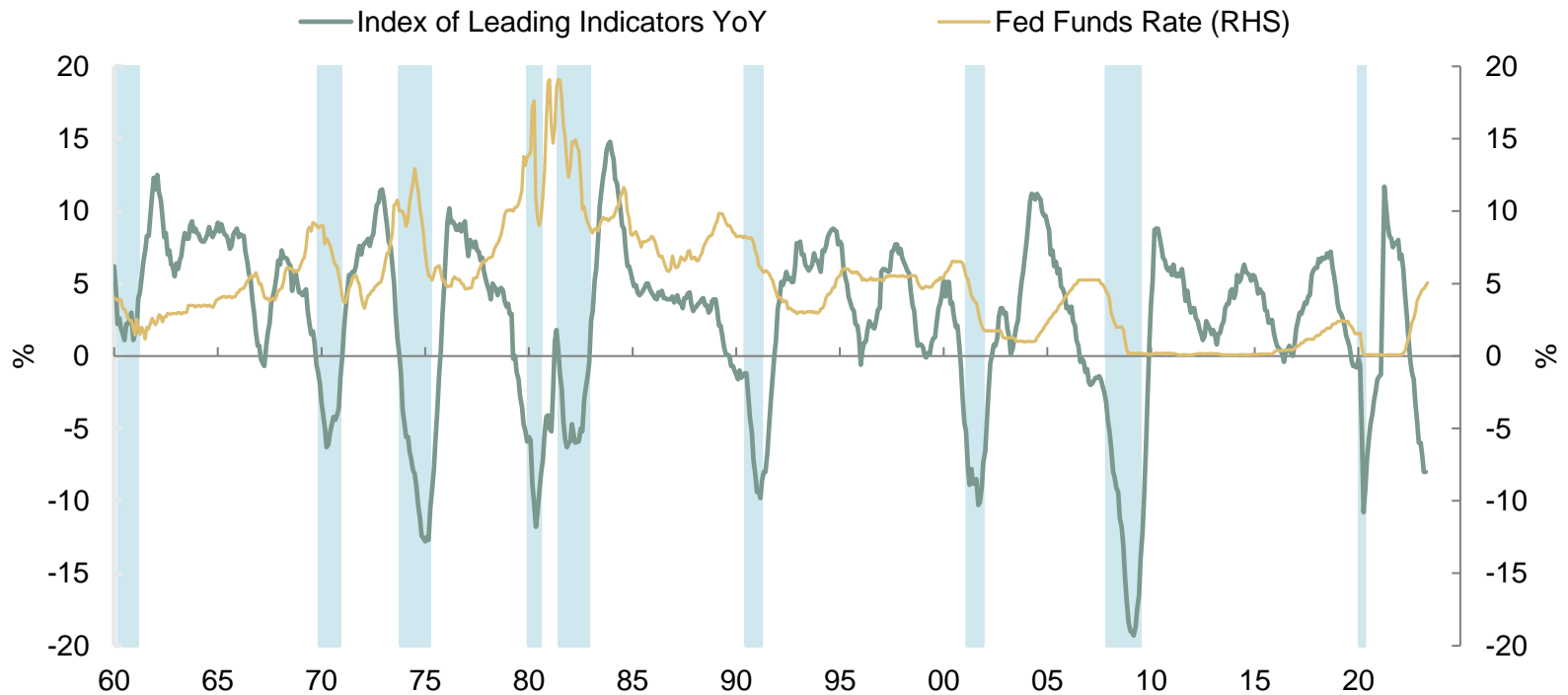
Massive Outflow of Deposits

Commercial banks are experiencing record deposit flight as money chases higher yields elsewhere.



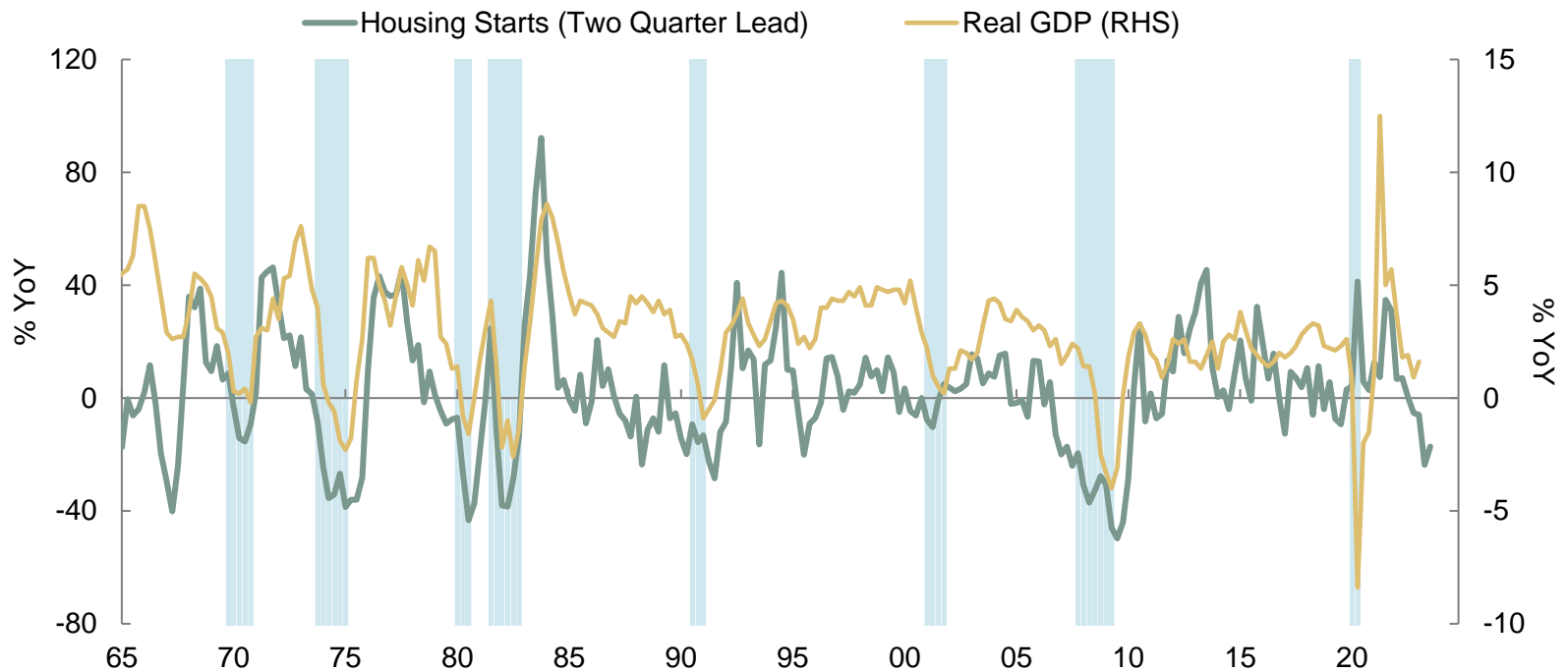
Tightening Into a Downturn

When the Index of Leading Economic Indicators enters deeply negative territory, a recession always ensues.



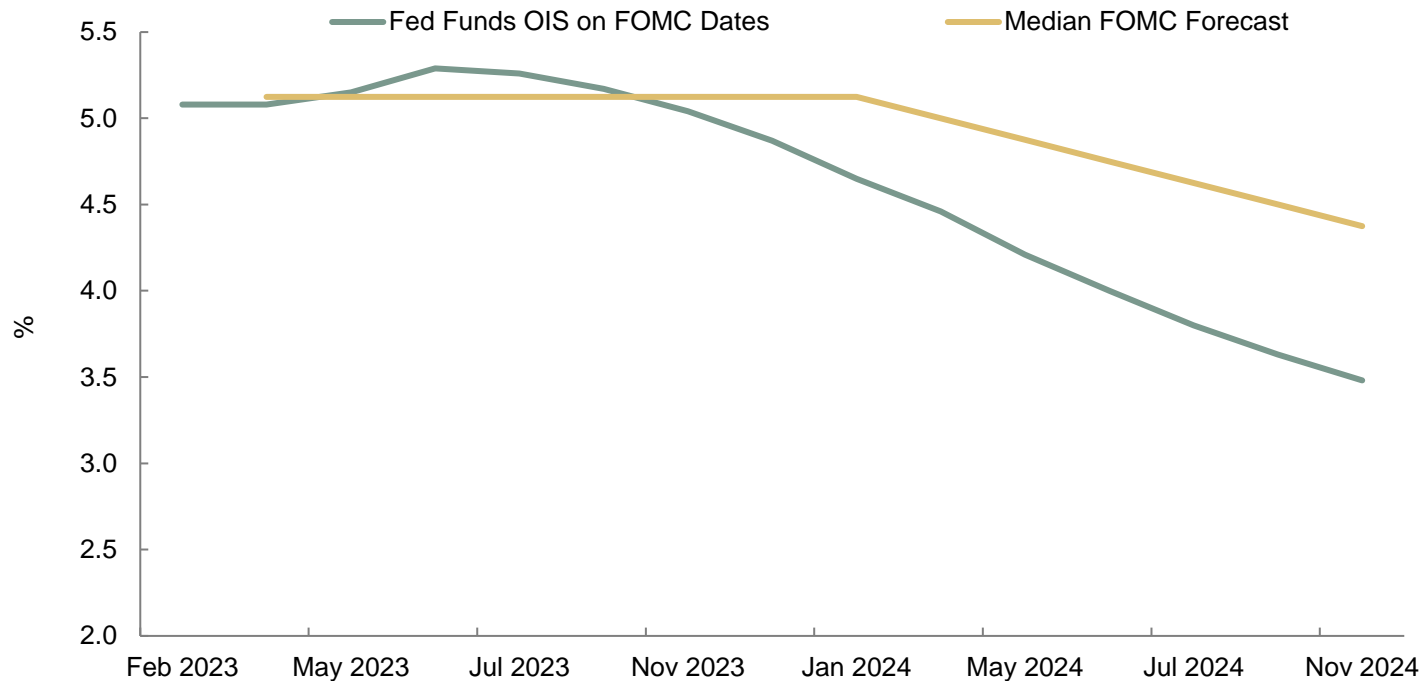
Housing Always Leading the Economy

Housing starts point to a recession in the quarters immediately ahead.



The Bond Market vs. The Fed

The bond market expects the Fed to begin cutting rates in December. However, the Fed is projecting “higher for longer” with rate cuts not occurring until sometime next year.



Timing The Pivot

Historically, the amount of time from the last Fed rate hike to the first Fed rate cut has been short. Given how much the Fed has raised rates, the past may be prologue.



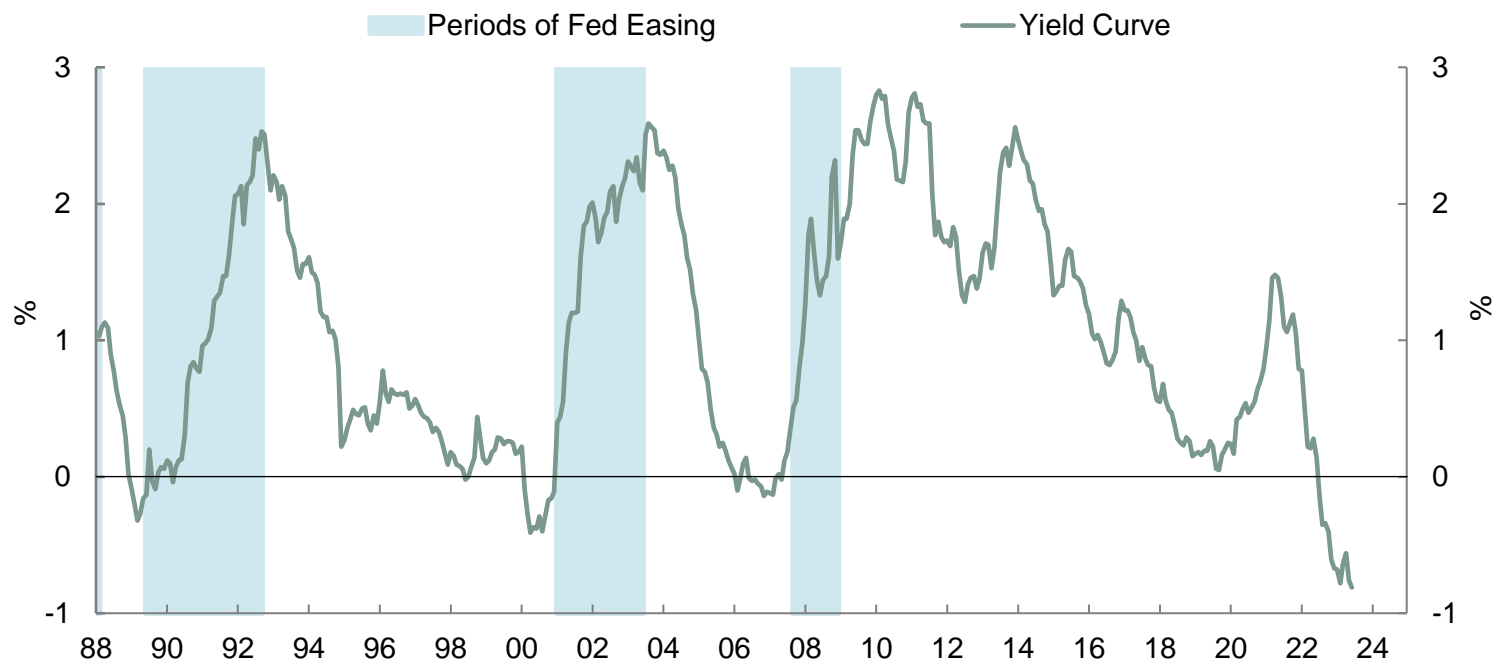
How Low Can They Go?

When the Fed eases policy, official interest rates generally fall a lot. The average decline in the fed funds rate is over 400 basis points.

How Much does the Fed Cut in Cutting Cycles?		
First Fed Rate Cut (Month)	Total Cuts (Bps)	Occurring over... (Months)
March 1960	280	17
December 1966	197	8
September 1969	547	18
October 1973	556	20
January 1980	479	7
February 1981	438	2
July 1981	1059	20
September 1984	563	24
November 1987	81	4
June 1989	681	40
July 1995	75	7
September 1998	75	3
January 2001	550	30
September 2007	513	16
July 2019	75	3
Average ->	411	15

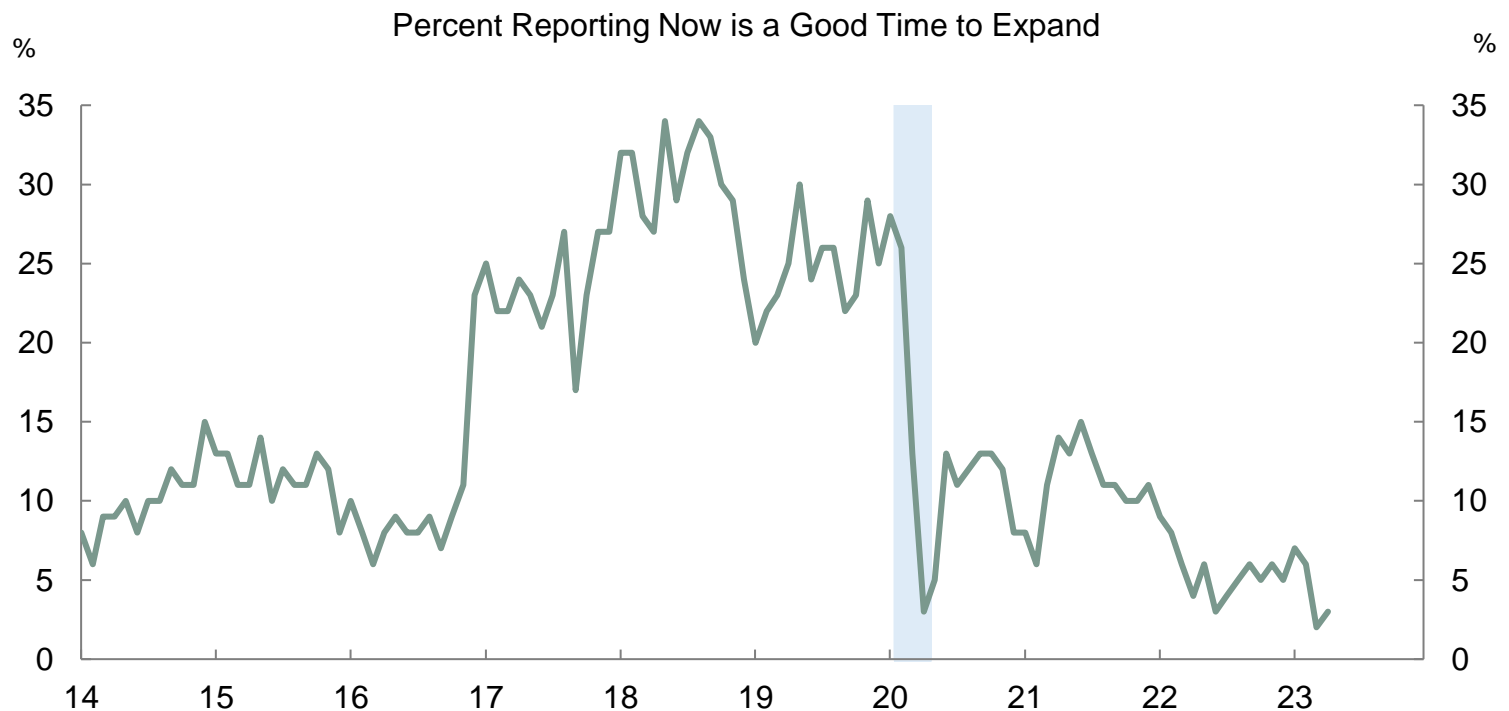
Deep Yield Curve Inversion

The 2s/10s Treasury curve normalizes only when the Fed is cutting the funds rate. Will this time be different?



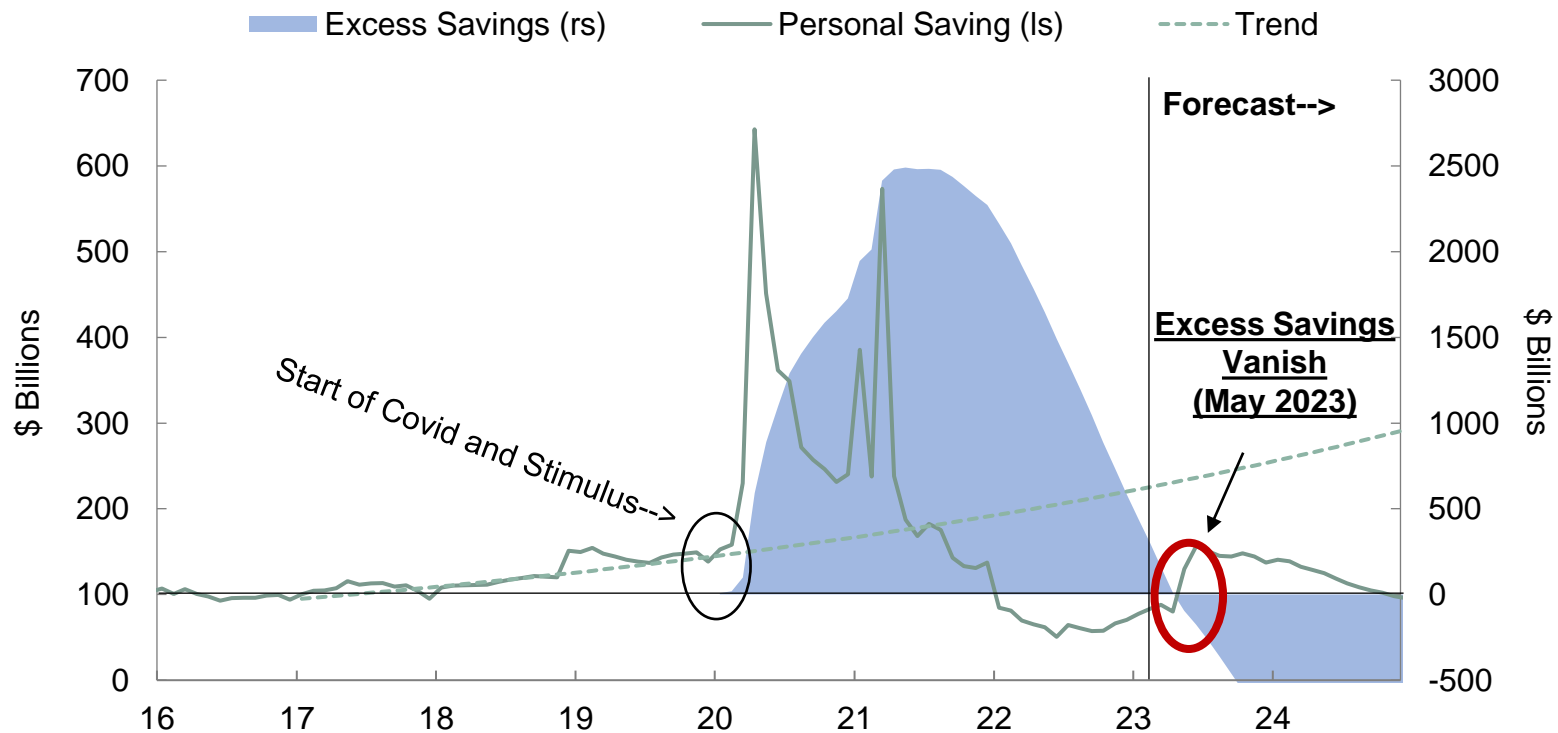
Negativity Abounds

The percent of small businesses reporting that “now is a good time to expand” is hovering near a record low.



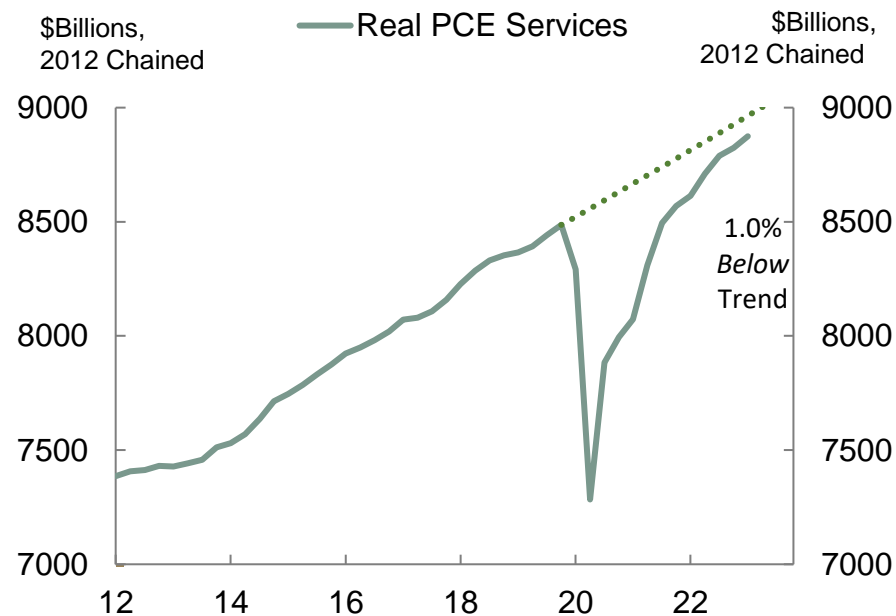
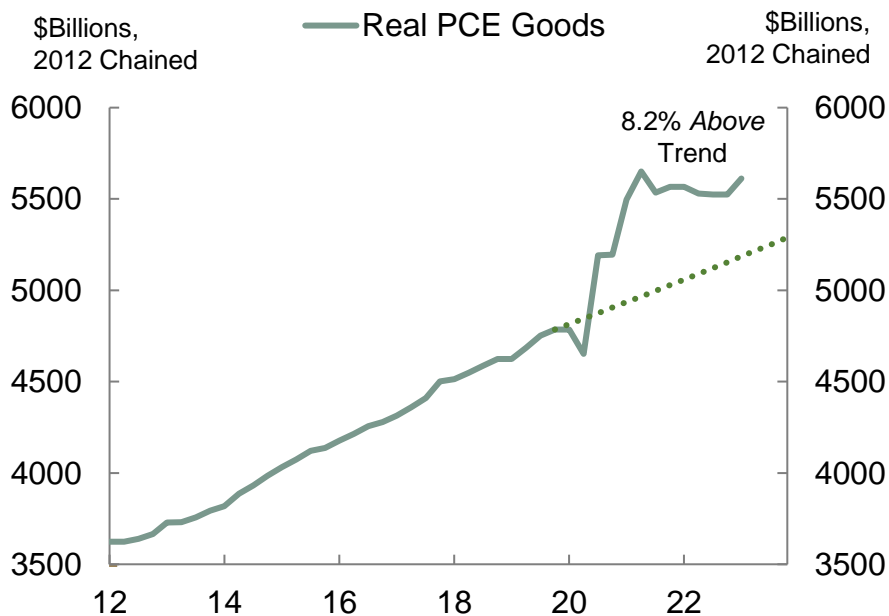
Almost Depleted

Households' "excess savings" are about to run out, which will negatively impact consumption.



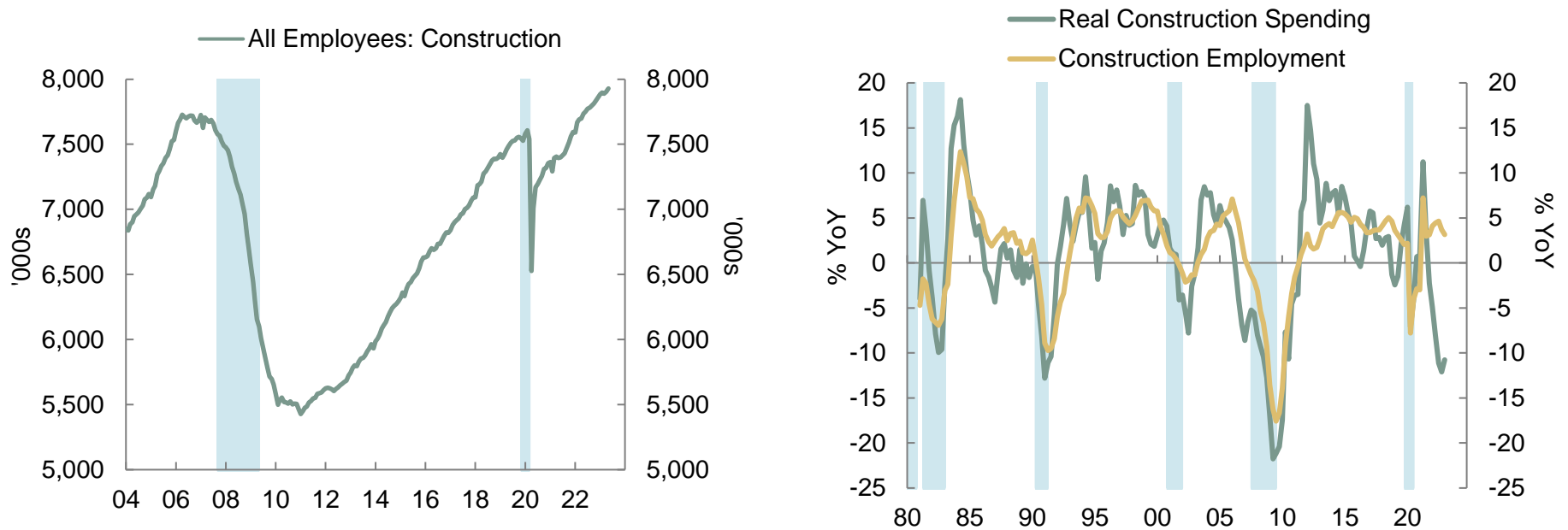
Lingering Pandemic Effects

Goods spending is well above trend while services spending is nearly back to trend.



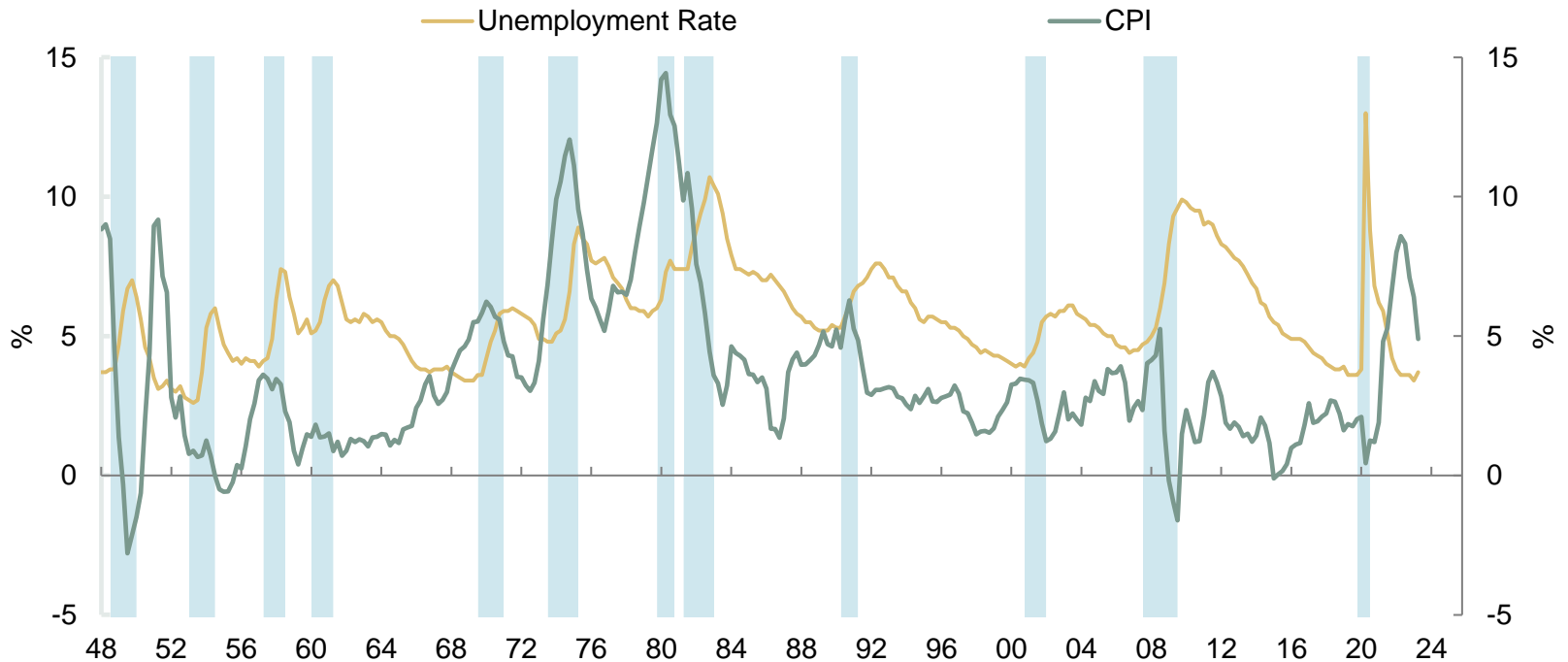
On the Cusp of Major Weakening

Construction employment remains elevated despite a collapse in spending. In the past, this has presaged a sharp decline in hiring.



Leading And Lagging Indicators

Unemployment rises shortly before recession while inflation bottoms well afterward. The Fed will not wait until inflation is back near 2% before lowering interest rates.



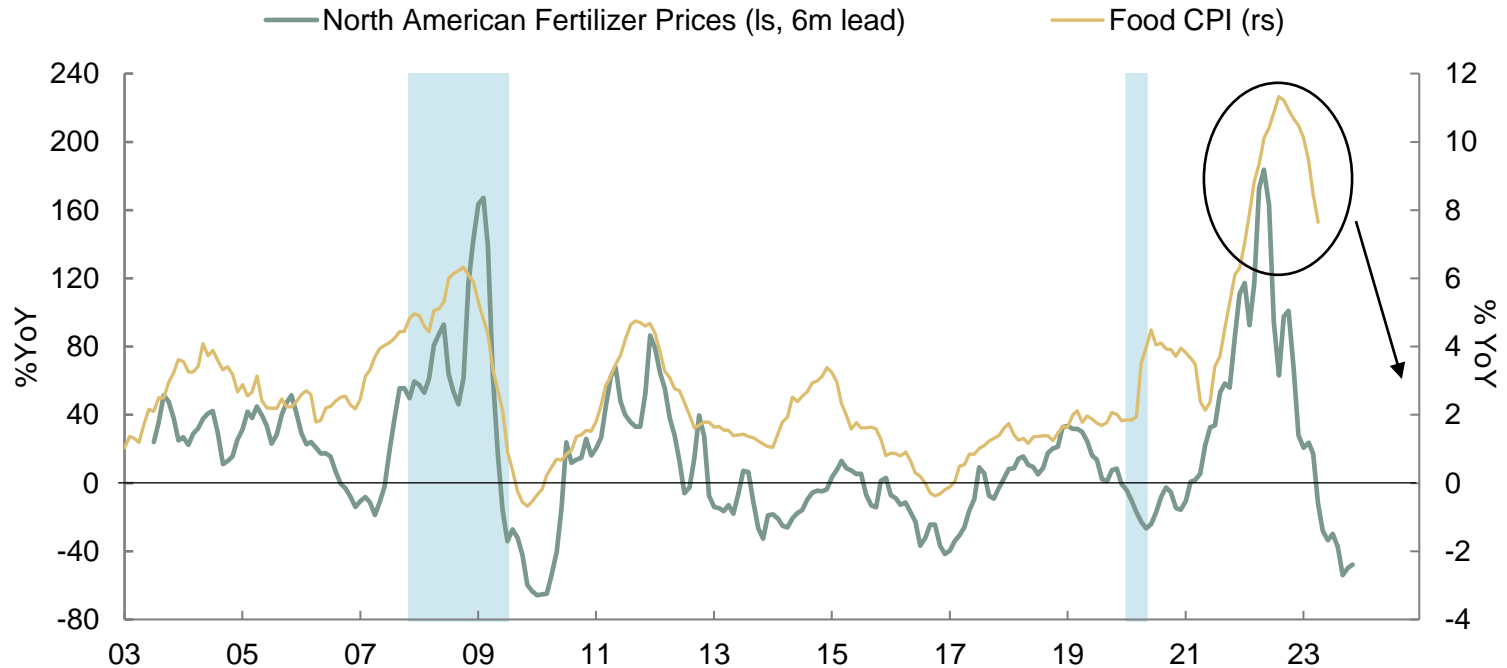
Watch the Unemployment Rate

The unemployment rate is an excellent leading indicator of the economy. In the past, it bottomed six months before the onset of recession, rising an average of 40 basis points from its cyclical low.

Trough in Unemployment	Peak in Economic Activity	Lead Time (Months)
October 1948	November 1948	1
June 1953	July 1953	1
March 1957	August 1957	5
February 1960	April 1960	2
May 1969	December 1969	7
October 1973	November 1973	1
May 1979	January 1980	8
July 1981	July 1981	0
March 1989	July 1990	17
April 2000	March 2001	11
May 2007	December 2007	7
	Average ->	5
	Median ->	5

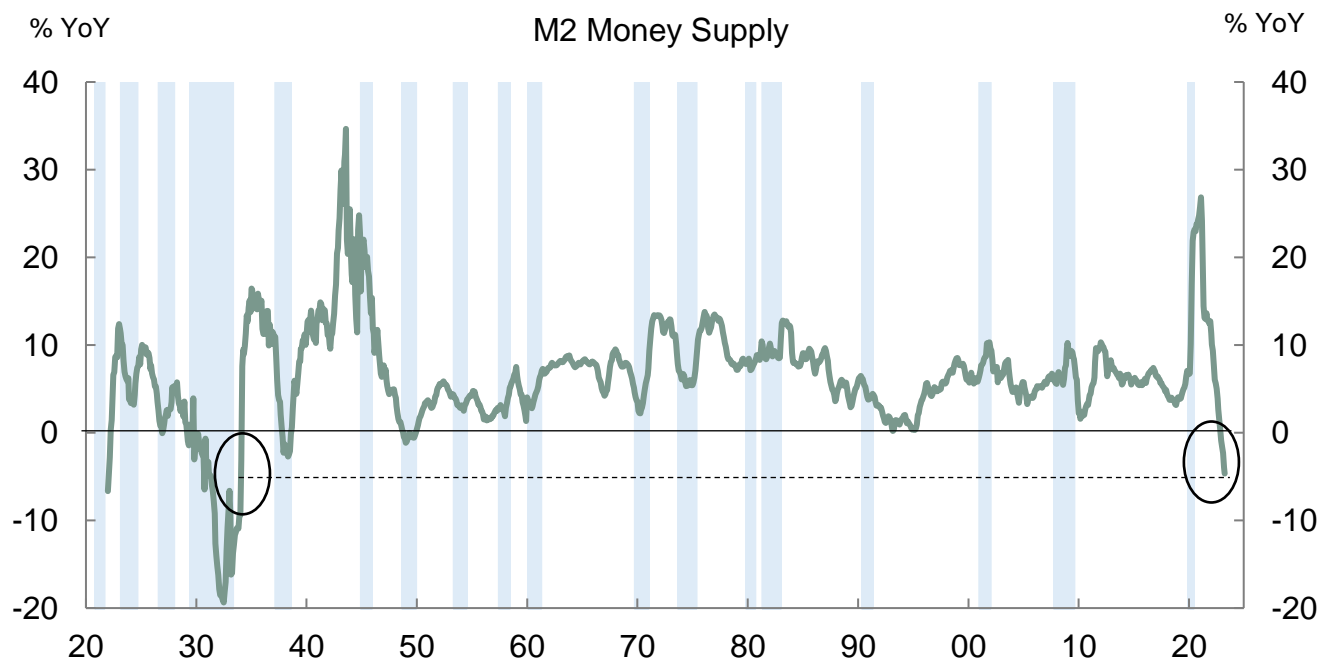
Inflation Peaked

Food accounts for nearly 14% of the consumer price index. Falling fertilizer prices will weigh on headline inflation.



Record Surge Followed by Record Decline

An epic surge in money growth has given way to an epic slowdown in money growth. Inflation pressures will continue to moderate.



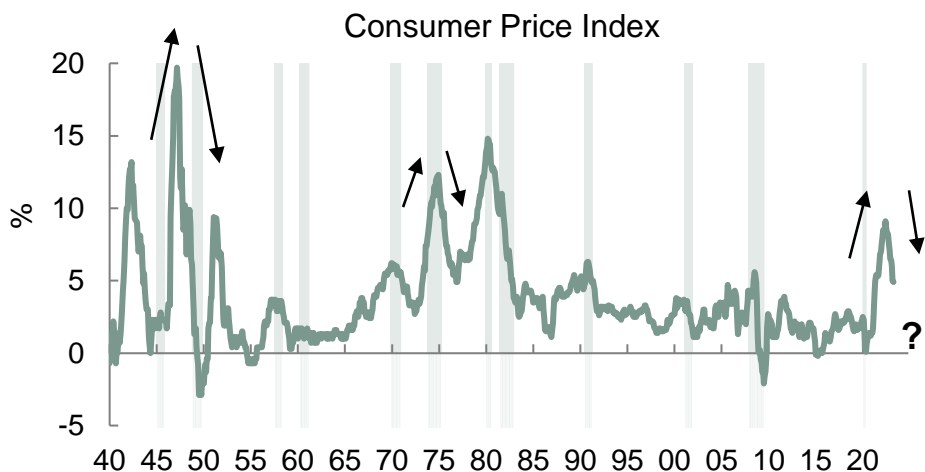
Weakening Pricing Power

The percent of small businesses planning to raise average selling prices has fallen dramatically and is close to its pre-covid readings.



What Goes Up Quickly, Comes Down Quickly

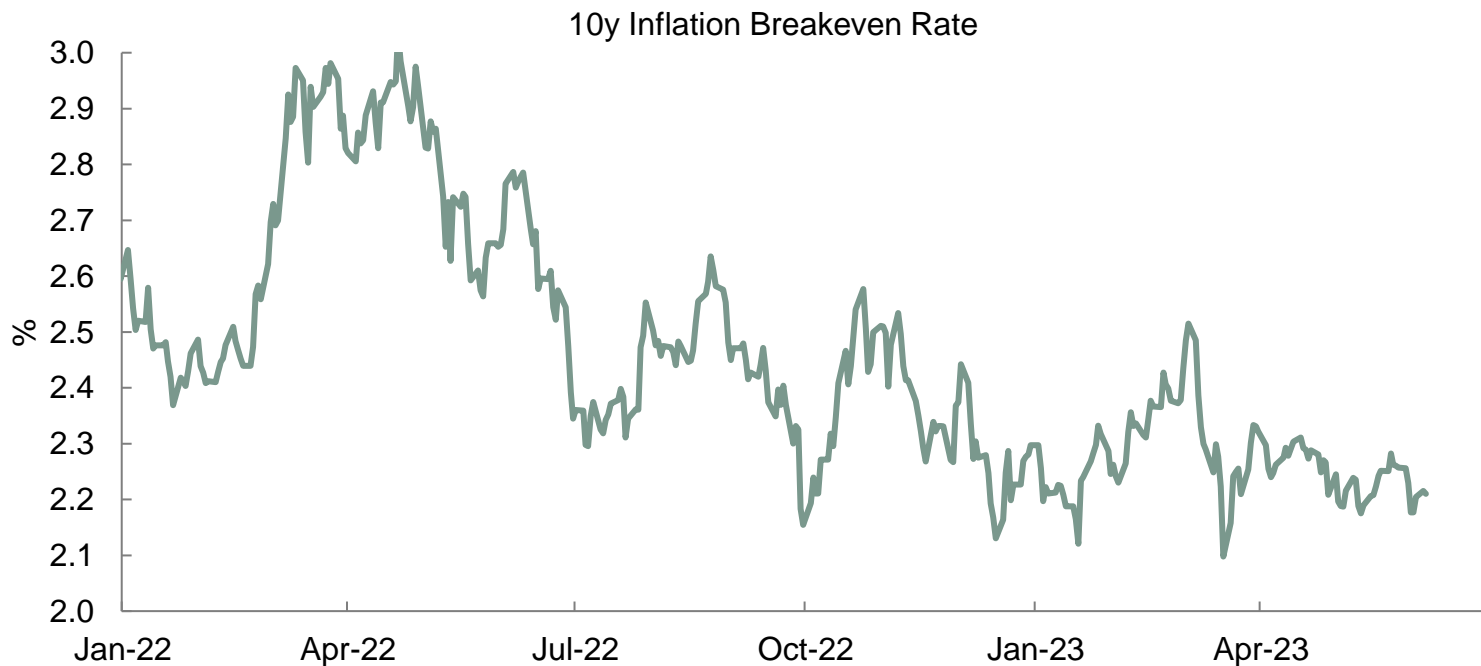
Inflation never plateaus. Big increases are followed by big declines. History repeats.



Inflation Upwing	Slope	Inflation Downwing	Slope
Sep 1940 to May 1942	0.35	May 1942 to May 1944	-0.47
Feb 1946 - Mar 1947	1.61	Mar 1947 to Apr 1949	-0.66
Jul 1949 - Feb 1951	0.58	Feb 1951 to Oct 1954	-0.21
May 1967 - Dec 1969	0.12	Dec 1969 - Jun 1972	-0.12
Jun 1972 to Dec 1974	0.37	Dec 1974 to Nov 1976	-0.31
Nov 1976 to Mar 1980	0.22	Mar 1980 to Jun 1983	-0.31
Jun 1986 to Sep 1990	0.07	Sep 1990 to Jan 1992	-0.25
Aug 2007 to Jul 2008	0.22	July 2008 to Dec 2008	-1.19
Jul 2021 to Jun 2022	0.37	Jun 2022 to May 2023	-0.44
Average 1940-2008	0.44	Average 1940-2008	-0.44

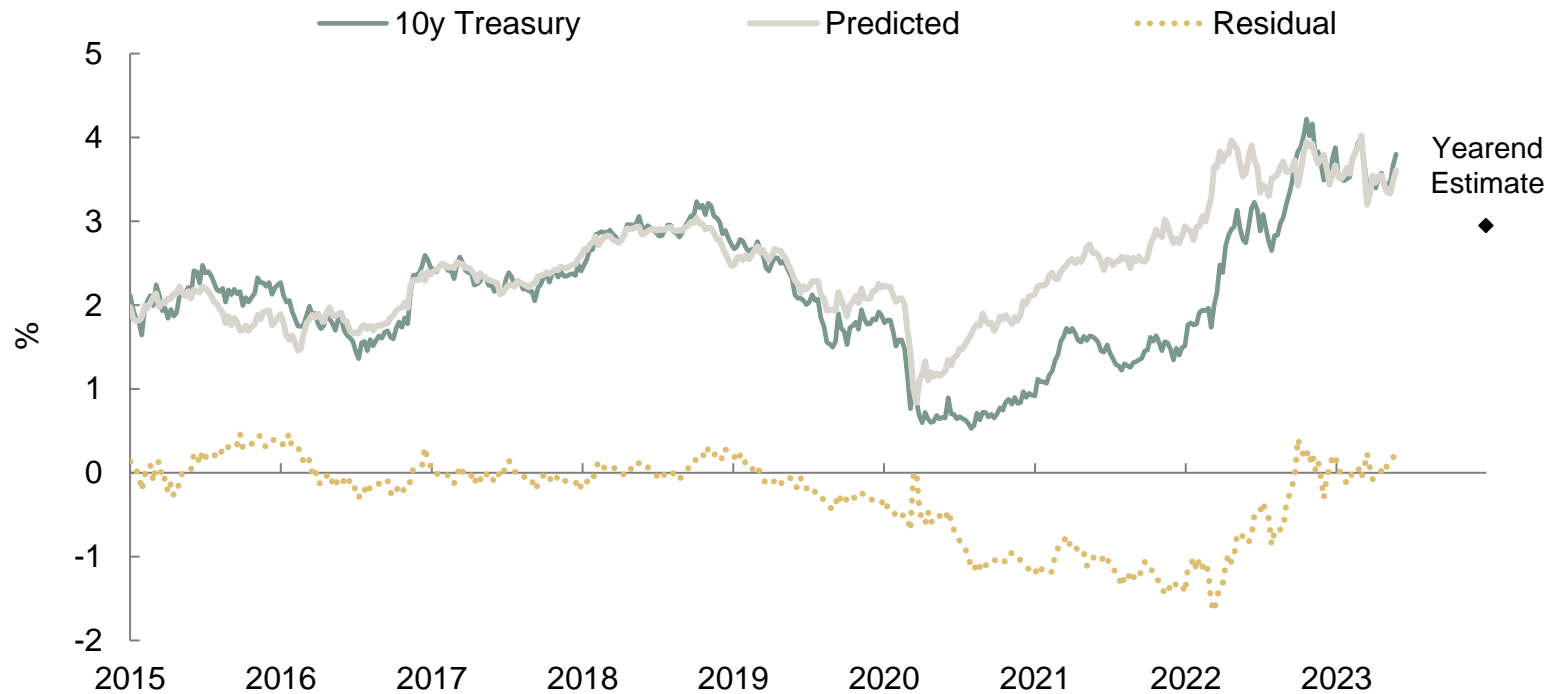
Stable Inflation Expectations

Despite elevated inflation, the bond market remains sanguine on the inflation outlook. Breakeven inflation has been low and stable.



Whither Long-Term Interest Rates?

Breakeven inflation and the one-year forward fed funds contract explains 90% of the yield on the 10-year treasury note. Fundamentally, yields are expected to fall.



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