

# Higher rates, tighter credit, and less liquidity matter

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**Fixed Income Strategic Forum 2023 | Issue 03**

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## Executive summary

*In Issue 02 of the Fixed Income Strategic Forum 2023, “Recession: Everything and all at once?” – a play on the phrase “gradually and then suddenly” as is commonly the case with recessions – we pondered if and when a recession would commence. Since then, financial markets have continued to perform well, dismissing the likelihood of recession and seemingly embracing the soft-landing or even no-landing scenario.*

*Whether encouraged by the semblance of resilience in the US economy or the strong performance in financial markets, or perhaps troubled by the possibility that inflation may be stickier than desired, the US Federal Reserve has added to the soft-landing narrative, increasingly citing the likelihood that interest rates will be required to remain higher for longer. Although, perhaps, this is incongruent, and financial markets are only listening to what they want to hear.*

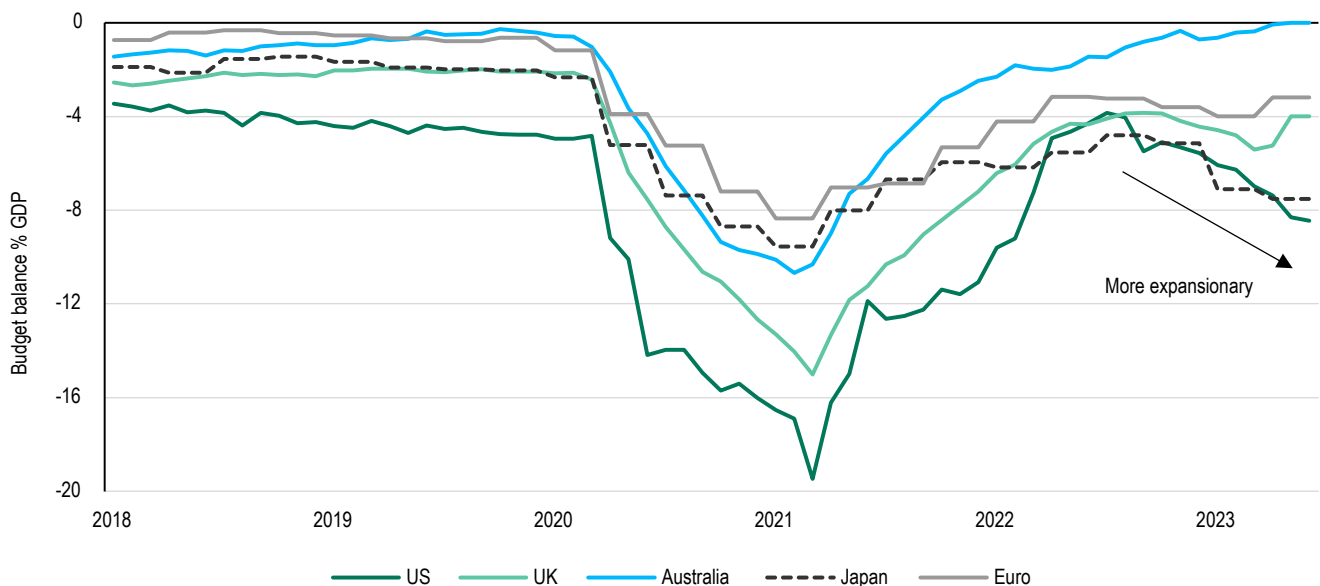
*Nonetheless, as we gathered for Issue 03 of our Strategic Forum in September 2023, the backdrop was one in which investors appeared to be more and more influenced – romanced, perhaps – by the market’s recent performance and have increasingly embraced the possibility of a soft landing or no landing for the US and the global economy. Meanwhile, the evidence supporting the likelihood of a recession has continued to build, albeit more slowly than many impatient market commentators, including ourselves, have (so far incorrectly) anticipated. In hindsight, asking the question, “Recession: Everything and all at once?” in Issue 02 appears to have been too early; however, upon examination of the evidence for Issue 03, we remain of the view that the question is not if a recession will occur but rather when it will occur and how hard it will be.*

## Maybe it's different this time?

Despite many compelling patterns and indicators supporting the adage “it’s never different this time,” the reality is that financial markets have been increasingly drawn to the potential of a soft or no landing. While this is not unusual in and of itself, markets do tend to embrace hope, and often when facing the prospect of an economic downturn, they embrace the possibility that “maybe it’s different this time.” Since Issue 02, we can identify several influences contributing to the better-than-expected sentiment and performance of financial markets as well as the resilience of the US economy.

First, the stronger-than-expected support provided by fiscal policy was a key influence that we underestimated from May to September (Figure 1). It is well understood that fiscal policy had been playing a significant offsetting role to the (aggressive) monetary tightening, and the remnants from many of the COVID-19 pandemic-response policies were still working their way through the economy. Although our anticipation was that the US debt ceiling debate in May would likely bring that to an end and the fiscal policy stimulus pulse would wane, leaving the weight of the monetary tightening to exert greater influence, quite clearly that has not happened – well, at least not yet. Indeed, the debt ceiling debate concluded without any major immediate demands for fiscal cuts, and hence the fiscal pulse remained at a stronger-than-expected level through mid-2023.

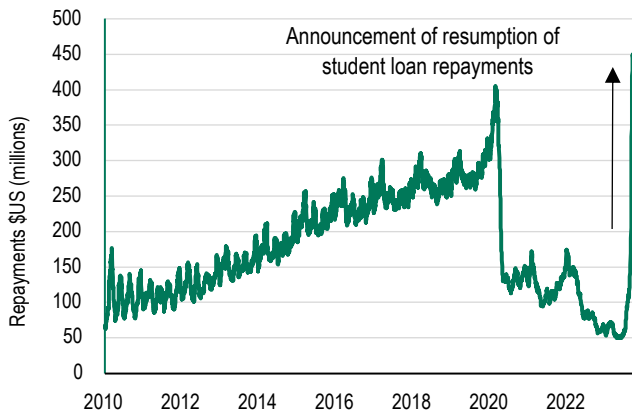
**Figure 1:**  
**Stronger-than-expected fiscal policy**



Source: Macrobond, 2023.

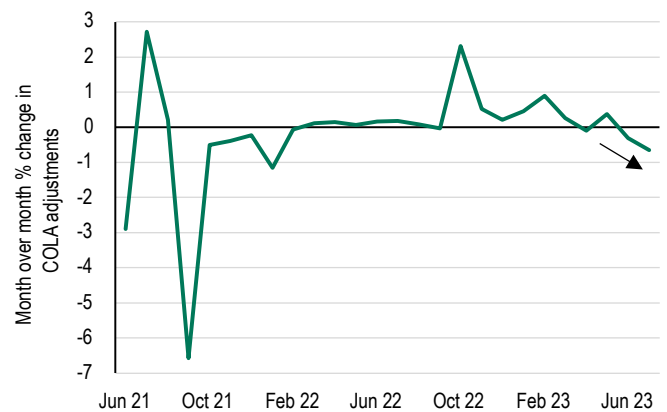
While in hindsight this stronger fiscal pulse has become apparent, there are key aspects of US fiscal policy that are now ending. Both the student loan repayment forbearance and the cost-of-living adjustment (COLA) benefits, which were significant COVID-19 pandemic-assistance programs, are rolling off. The expiry of these benefits is absorbing a considerable amount of discretionary spending, and as such, the fiscal pulse appears particularly challenged going forward (Figure 2 and Figure 3). Having said similar things about US fiscal policy back in May, we are a little pensive to be saying them again. Fiscal policy is a key area to watch for the period ahead, although it does look like there is firmer evidence that the fiscal pulse may weaken notably as we head toward the end of the year and into next year. In addition, 2024 is an election year, so the potential for additional supportive fiscal policies is less likely.

**Figure 2:**  
**Student loan repayment resumption**



Source: Macrobond, 2023.

**Figure 3:**  
**Government social benefits COLA**



Second, financial markets have benefited from the performance of the so-called “Magnificent Seven”: the seven mega technology firms and their association with the excitement around generative artificial intelligence (AI). A closer examination of this year’s equity market performance reveals it is largely these seven companies that have performed strongly. Given that they constitute 30% of the S&P 500® Index’s market capitalisation, their influence has fostered a perception of widespread success across equity markets. Indeed, without these seven stocks, the remainder of the S&P 500 Index (and notably many other global indices) is up only marginally (or down in some cases) year to date, and this is likely due in part to the influence of the strong performance “halo” the Magnificent Seven has afforded. If not for this influence, we wonder if market participants would form the same view of market resilience that so strongly permeates the prevailing narrative. While the equity market appears to be resisting the headwinds of much tighter monetary policy, it can only do so for so long. More recently, there have been rising concerns around whether this performance can be sustained, particularly given the overvalued nature and price-to-earnings (P/E) ratios of companies such as NVIDIA Corp. Indeed, there are signs that the initial euphoria may now be faltering. Markets, particularly those with very narrow leadership, often play catch-up eventually, and when they do, they do so abruptly. Will it be the not-so-Magnificent Seven in the months ahead?

Finally, and perhaps most importantly, the lack of quantitative tightening (QT) was influential. In 2022 many global central banks, including the Fed, initiated balance sheet reduction. This is often referred to as QT and results in a reduction or draining of liquidity from financial markets, and this was expected to continue throughout 2023. This is the opposite of the once-unthinkable expansion of balance sheets during year after year of quantitative easing (QE). A closer examination reveals that due to various emergency actions required by central banks (including the liquidity provision surrounding the US regional bank incident in March 2023), liquidity has not been drained this year. Instead, there has been net liquidity application. This tends to have a supporting influence on financial markets as the excess liquidity needs to find a home. As such, this significant, surprising, and little discussed influence has also likely played a key role in the resilient performance of financial markets so far this year. Nonetheless, as our team came together in September to discuss our views for Issue 03, this net application of liquidity was in the process of shifting back to a stance of QT and therefore a reduction or draining of liquidity in financial markets (unless something else breaks...as it may well).

To summarise, upon evaluating the primary contributors to this year’s market resilience – namely, stronger-than-expected fiscal policy, the pronounced influence of the so-called Magnificent Seven on equity markets, and the absence of QT – it became apparent that these factors are poised to diminish. Consequently, the prevailing narratives of “a more resilient economy,” “higher for longer,” and “maybe it’s different this time” also seem poised to fade, particularly as the influence of aggressive monetary policy levers are now converging to exert their full force on the economy as we head toward year end. While there is a sense that patience is wearing thin, we know that monetary policy and higher rates matter. Aggressive tightening creates significant headwinds for the economy via monetary and credit tightening and this time even more so for financial markets with the additional liquidity tightening associated with QT.

## Brace for impact – as the forces of monetary, credit, and liquidity tightening converge

We had highlighted the following points in recent issues of the Strategic Forum, and in typing them out again, the gravity reminds us that to ignore this reality is to ignore it at one's peril.

1. We have been, and still are, experiencing the most aggressive monetary policy tightening cycle since Fed Chair Paul Volcker's hiking cycle in 1979-1980. It is the fastest, broadest, and steepest hiking cycle in 40 years (Figure 4).
2. Whenever this was experienced in the past at this pace, a recession has always followed.
3. Similarly aggressive tightening cycles of the past occurred under very different economic conditions, relative to today's indebted modern economy. Past similar cycles featured little indebtedness; this cycle is occurring in one of the most indebted global environments of all time. High debt and higher yields do not mix well.
4. We also know that the monetary policy reaction function occurs with long and variable lags and typically takes approximately 12-18 months to show the full effects. Therefore, it would seem rational to anticipate that one of the most aggressive and rapidly implemented tightening cycles (a succession of 75-basis-point hikes per meeting without pause) will reveal significant impacts on the economy in the coming months.
5. We are also experiencing a significant shift toward liquidity (money) contraction and/or QT, following more than 10 years of constant positive liquidity support via QE.
6. We highlight that many of the hallmarks, indicators, and even narratives (including "it's different this time") leading up to economic growth slowdowns and recessions are already here, such as significant yield curve inversion, with both the 2-year/10-year and, quite extremely now, the near-term forward spread. As the saying goes, "it's never different this time."
7. Aggressive monetary policy causes familiar patterns and eventually leads to credit tightening. Given the prevailing environment, banks and other financial institutions, including the shadow banking system, have tightened lending standards and risk positioning considerably since March, aiming to sure up their defences and do what they can to not be the next weakest link to fall. Similar to monetary policy's long and variable lags, the US Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) now shows the level of tightening that has always led to recessions, with the onset lagging by approximately six to nine months (Figure 5 and Figure 6).
8. Central banks' rhetoric quite often includes references to a return to normal or leaving interest rate settings at certain higher points for long periods of time. This time around, it is called "higher for longer." If that does indeed occur this time, it would be unusual. In other words, history suggests that "higher for longer" is more an aspiration than a reality.

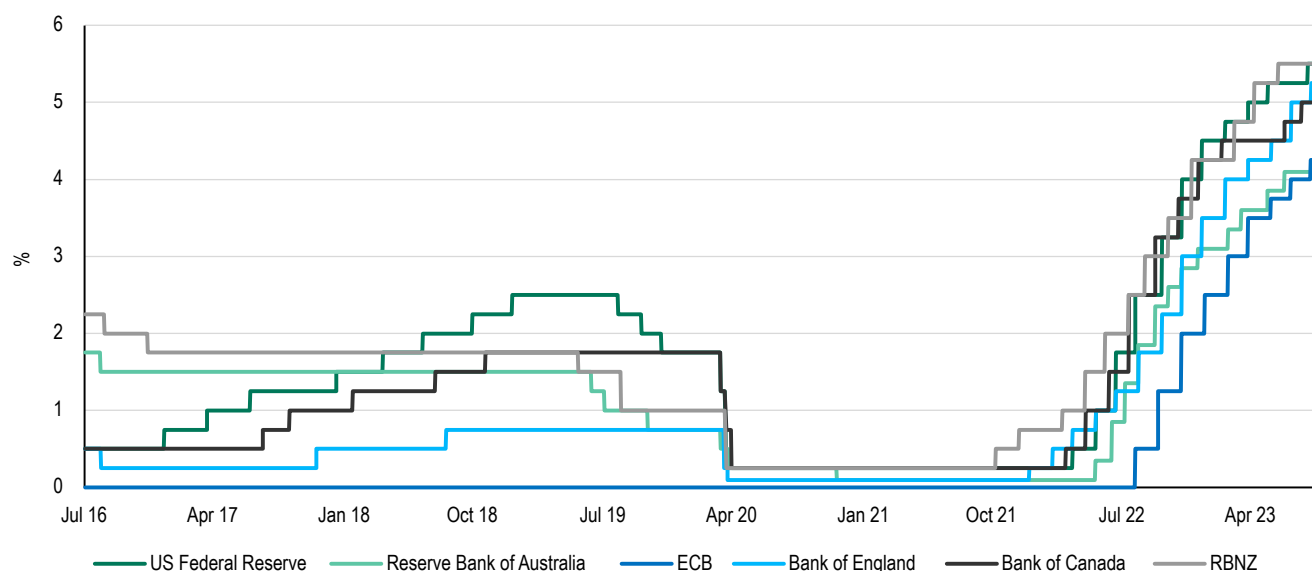


Higher rates matter.  
Tightening of credit  
conditions matters.  
QT matters."

In summary, higher rates matter. Tightening of credit conditions matters. QT matters. The long and variable lags have these three significant forces converging in 4Q23 and into 1Q24. We can observe current market prices are for a no/soft landing scenario, ignoring this evidence and these well-known linkages and patterns. Just because the long and variable lags have not revealed themselves yet does not mean they are not going to happen.

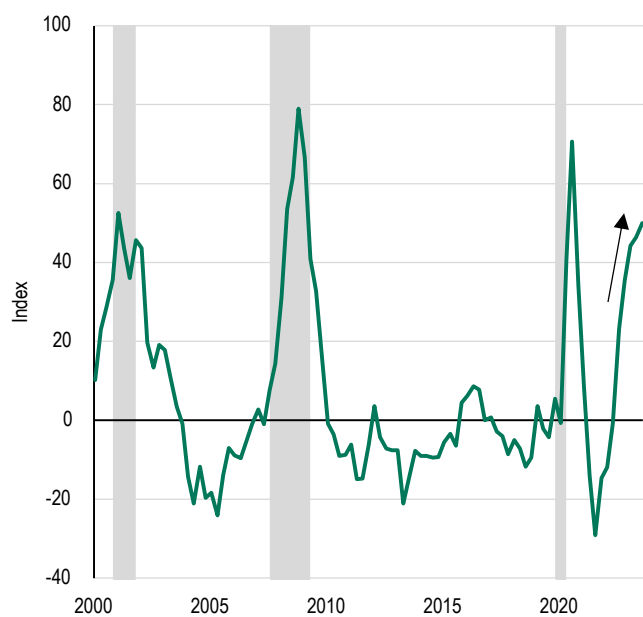
Since we started Issue 03 of the Strategic Forum 2023, we can already observe many market segments experiencing difficult trading conditions, perhaps most notably the US bond market.

**Figure 4:**  
**Co-ordinated and aggressive rate hikes**



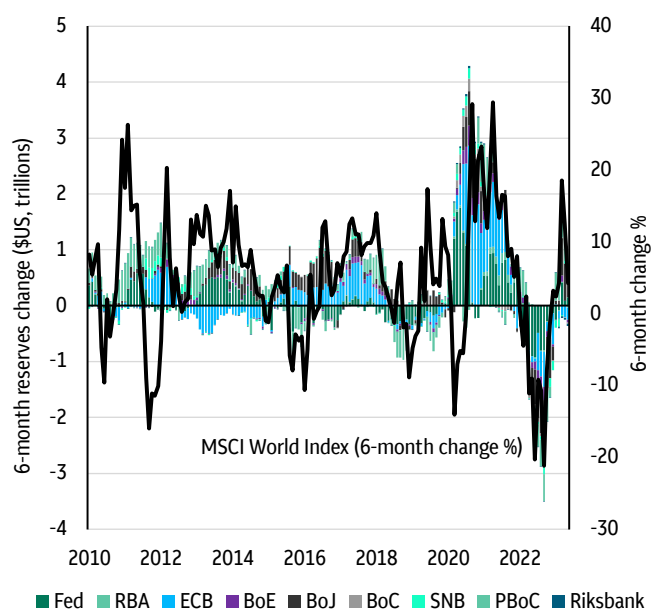
Source: Macrobond, 2023.

**Figure 5:**  
**SLOOS proportion of banks tightening lending standards**



Source: Macrobond, 2023.

**Figure 6:**  
**Global central bank reserve change**



## Will QT be the straw that broke the (bond) market's back?

While “higher for longer” has increasingly found its way into the market narrative, there is another narrative building within the bond market. The resolution of the US debt ceiling debate has led to a significant increase in the amount of borrowing the US government requires (bond issuance). This is while the Fed is attempting to implement QT again. Meaning, the previously largest buyer of US Treasuries, the Fed itself, is not a buyer anymore. Indeed, it is letting its balance sheet roll down and no longer recycling its maturities into new holdings, which means it is in effect adding to the amount of US Treasuries that need to be bought by other parties. Bond markets are increasingly concerned about who will buy all the new issuance.

Further, this supply imbalance is occurring at a time when other previous large buyers, such as China and Russia, are no longer buying US Treasuries. Moreover, the Bank of Japan is adjusting its monetary policy settings that in effect are making investing in Japan government bonds far more attractive for local and foreign investors. In essence, we are facing a situation in which many of the once significant buyers are now increasingly absent, while the issuance of US Treasuries has meaningfully increased, ultimately causing angst of a significant imbalance.

While some market participants are keen to interpret the resultant shift higher in yields as confirming the resilient economy and “higher for longer” narrative, the prevailing economic and inflation data do not support this. Indeed, the bond market appears to be disconnecting from the softening economic cycle, and if this drift higher continues to occur, it will place even further pressure on the economy, financial markets, and, in particular, the banking and shadow finance sectors.

## Higher for longer? Well, until something breaks

Many market commentaries seem to centre on closely monitoring the economy for signs of a potential recession. The prevailing “higher for longer” narrative suggests if the economy manages to achieve a soft landing or no landing, then financial markets can withstand the slowdown and the recent strong performance may continue.

Our own review of company fundamentals does suggest most high-quality companies are well equipped to navigate a slowdown. This offers some encouragement around the likelihood of a softer or more cyclical recession and gives us pause in terms of not being too bearish about the outlook for the economy. However, financial markets are not the economy. In the “lower for longer” environment, financial markets disconnected from the broader business cycle. During this period, it was financial markets, rather than the economy, that reaped significant benefits from years of near-zero interest rates and the trillions of dollars in QE measures. However, these favourable conditions have now reversed, presenting a stark contrast. We highlight by example the 2001 recession as one that was a fairly mild downturn for the economy, yet the 2001 recession did burst the Nasdaq bubble, and financial markets had a particularly difficult time. So maybe it is a soft landing or cyclical recession, although we still must ask the question, does this necessarily translate to a soft landing for financial markets too?

Our view is for a cyclical recession commencing in late 2023, with a risk that it evolves into a hard landing. We would caution that “higher for longer” is not something to celebrate. In the past “higher for longer” has always been more of an aspiration than a reality, and therefore a period of “higher for longer” this time would be unusual. Further, it does not mean a soft landing. Indeed, “higher for longer,” particularly in such an indebted system, is not conducive to a soft landing at all. If it is “higher for longer,” the more time that goes past, the more likely more things will break in the financial system and the more likely a hard landing occurs.

It is often said that central banks hike until something breaks, and during 2022 the early signposts of things breaking began to appear and gather pace, culminating in the failure of three US regional banks in March 2023. We want to point out that the prevailing conditions when things broke in March are still in place. In fact, they have worsened. And if QT is permitted and proceeds with full force, conditions will likely worsen further.

While the Fed was inventive around the problems posed by the banking system, this has created a feeling of confidence that perhaps these issues can be ring-fenced, thereby allowing “higher for longer” to persist. The reality is that we don't know what breaks next. Is it an insurer? Is it something in the commercial property space? Is it a large fund in the shadow finance system? What we do know is that higher yields, for a longer period, will trigger more (and more) defaults. Interest-rate-sensitive sectors will remain under pressure, and leveraged companies will pay higher borrowing costs. In other words, higher yields and QT mean the liquidity tide continues to recede and therefore the risk of more things breaking is heightened.



We do not believe central banks will realise their aspirations of “higher for longer.” Instead, they will eventually pivot, perhaps only once the converging and considerable influences of monetary, credit, and liquidity tightening inevitably trigger further financial market dislocation – breaking more things – and perhaps causing a hard landing for the economy. Things breaking would require more (emergency) QE, and so all this could change on a dime. Hence, we recommend being watchful of sudden shifts in liquidity. For the moment, though, we are on heightened alert for the increased likelihood of challenging market conditions with an increasing possibility of financial market dislocation.

## Fixed income investment implications

Our base case is for a cyclical recession, such as that experienced in 2001. Taking heed of the 2001 “tech crash,” which resulted in a more dramatic impact on asset markets than would have been expected given a mild recession for the economy, we note a similar (albeit delayed) risk environment for financial markets this cycle. This risk stems from an environment of prolonged overtightening of monetary policy and tight credit conditions. As tightening monetary policy, liquidity, and credit standards ripple their way through the economy, we remain positive on bond markets, as history guides us that bond yields decline once a rate hike cycle has clearly peaked. We are more cautious on the outlook for credit markets but remain opportunistic for circumstances across global markets in which a flexible and dynamic approach is required.

- **Rates:** Central banks are near the end of their tightening cycles, but visibility regarding the magnitude of further rate hikes is low as they remain truly “data dependent.” We remain constructive on duration as a protective lever within portfolios, retaining a bias to increase duration as yields rise. We favour the front end of curves, where yields are relatively insulated from bond supply-and-demand-related concerns, as we approach the end of the cycle.
- **Credit:** Credit spreads have proved resilient even though earnings have entered a recession due to slowing revenue growth. While most companies entered this slowdown well prepared, current valuations are pricing in almost entirely optimistic macroeconomic conditions. We believe the lagged effect of significant tightening will impact the broader economy, leading to earnings and ratings pressure. Our outlook for credit remains defensive; however, nuances across markets are providing some opportunities to add value, and we expect to continue capitalising on these as they arise.
- **Emerging markets debt:** The global backdrop continues to be the main driver for the asset class, with spreads on hard currency debt remaining stable compared with same-rated global credit. Corporates with proactive balance sheet management and reform-minded sovereigns with buffers are favoured, although valuations here remain tight. We will look to increase exposure to emerging markets when valuations compensate us for the risks.
- **Structured securities:** Fundamentals bottomed in the wake of the historic tightening of monetary policy; however, we believe a sustainable recovery is underway in US housing. As such, we have increased our exposure to mortgage-backed securities (MBS), especially US agency-backed MBS, which are offering attractive spreads backed by robust structures and strong credit fundamentals. Commercial MBS spreads remain at historical wides though face challenged fundamentals.
- **Currency:** Previous drivers of currency price action in 2022 such as risk sentiment and financial conditions have given way to rate differentials. Strong price action in US yields (nominal and real) have underpinned US dollar strength. Extended moves are increasingly attracting the attention of central banks and government officials, with Japanese Ministry of Finance and People’s Bank of China officials making statements and taking policy actions to arrest weakness in their currencies. Despite the risks to markets, we expect the US dollar to remain range-bound, unless the Fed’s outlook changes due to deteriorating market conditions.

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Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

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Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

A cost-of-living adjustment (COLA) is an increase in Social Security benefits to counteract inflation.

Gross domestic product (GDP) is a measure of all goods and services produced by a nation in a year. It is a measure of economic activity.

The price-to-earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its earnings per share. Generally, a high P/E ratio means that investors are anticipating higher growth in the future.

Quantitative easing (QE) is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increased the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Quantitative tightening (QT) refers to when central banks raise interest rates. In a tightening monetary policy environment, a reduction in the money supply is a factor that can significantly help to slow or keep the domestic currency from inflation.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters.

The Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices is a survey conducted by the US Federal Reserve Board to gain insight into bank lending practices and conditions.

Student loan forbearance allows someone to temporarily stop making payments against student loans.

The **MSCI World Index** represents large- and mid-cap stocks across 23 developed market countries worldwide. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **S&P 500 Index** measures the performance of 500 mostly large-cap stocks weighted by market value, and is often used to represent performance of the US stock market.

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