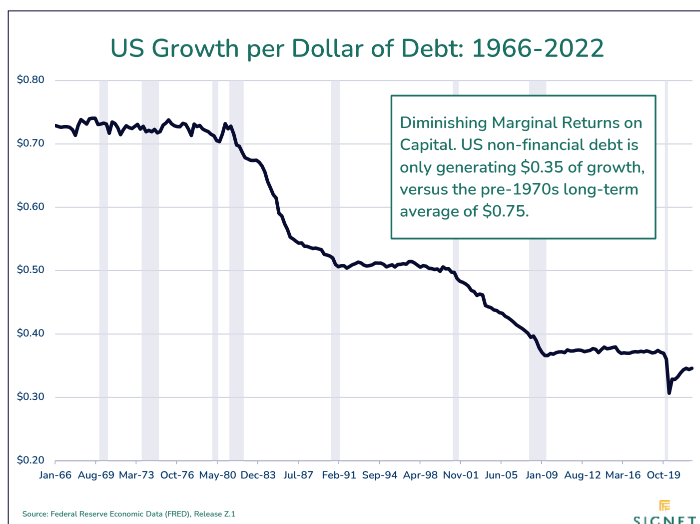
Beneath the Surface

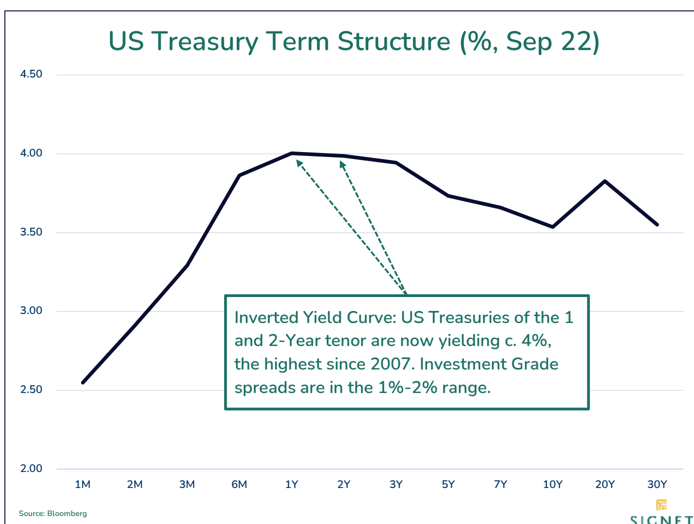
Snap Comment – 20 September 2022

SIGNET

Growth and the Debt Trap

- As suggested in the August edition of 'Beneath the Surface', asset prices are under further pressure given the draining of liquidity and tightening monetary conditions. You cannot see this tightening in the Fed's balance sheet (QT), which has risen by 1% YTD. Instead, it is happening through the Reserve Balances, which have declined by more than 21% this year.
- The problem with *overusing* capital – specifically debt capital – as a dominant factor of production for an economy is that it results in diminishing marginal returns because of sub-optimal investment. We can see the impact via the chart on the left, where a dollar of US non-financial debt is currently generating only $0.35 of US growth. We contrast this with the 1945-1980 period, which had a rate closer to $0.75. The questionable debt dynamics of the last few decades have been exacerbated by the fiscal exuberance of the last two years, where US Total Debt has risen by 20% ($15tr), as the authorities battled the economic impact of the Covid pandemic.
- Credit isn't created to meet private sector economic demand; it is created to fuel the capital markets and asset prices. Like any stimulant, the inefficient allocation of capital has non-linear repercussions: at first GDP growth rises, but it then slows before finally rolling over. For the growth cycle to continue the stock of debt must grow exponentially. Debt is not repaid – it is refinanced – and that means interest rates are forced lower and lower. This process has been disinflationary since 1980 and, beyond the recent and ongoing exogenous shock, there is every reason to believe it will continue to be disinflationary (unless there are significant amendments to central bank powers).
- While the world equity markets have only retraced 50% of their pre-to-post pandemic levels, the bond markets are having one of the worst years on record. The bond markets are focused on the current inflation data, and the implied Fed policy rates of 4.5% in 2023 and 4% in 2024. This is all 'priced in' to the markets. What is not 'priced in' are the growing indicators suggesting that inflation will normalise, perhaps because of a recession. For example, the Cleveland Fed's 2-year Expected Inflation metric is at 3.17% and it's 10-year metric is at 2.35%. In inflation adjusted terms, the US Treasury Term Structure – the chart on the right – compares favorably for the first time in years.
- This aggressive sell-off in the bond markets, notably at the quality end, may now present us with a compelling opportunity, especially as the structure of the yield curve – heavily inverted – suggests that we are being confronted by a potentially serious global recession. The Flight to Quality is a powerful phenomenon.





Therefore:

- Remain defensively positioned. Broad equity weakness may tempt investors – but observe for better entry points.
- Elements of the Fixed Income markets are beginning to look attractive here: begin re-building allocations.
- Investments: prioritise liquidity and quality. For corporate securities, target resilient growth and profit margins.

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