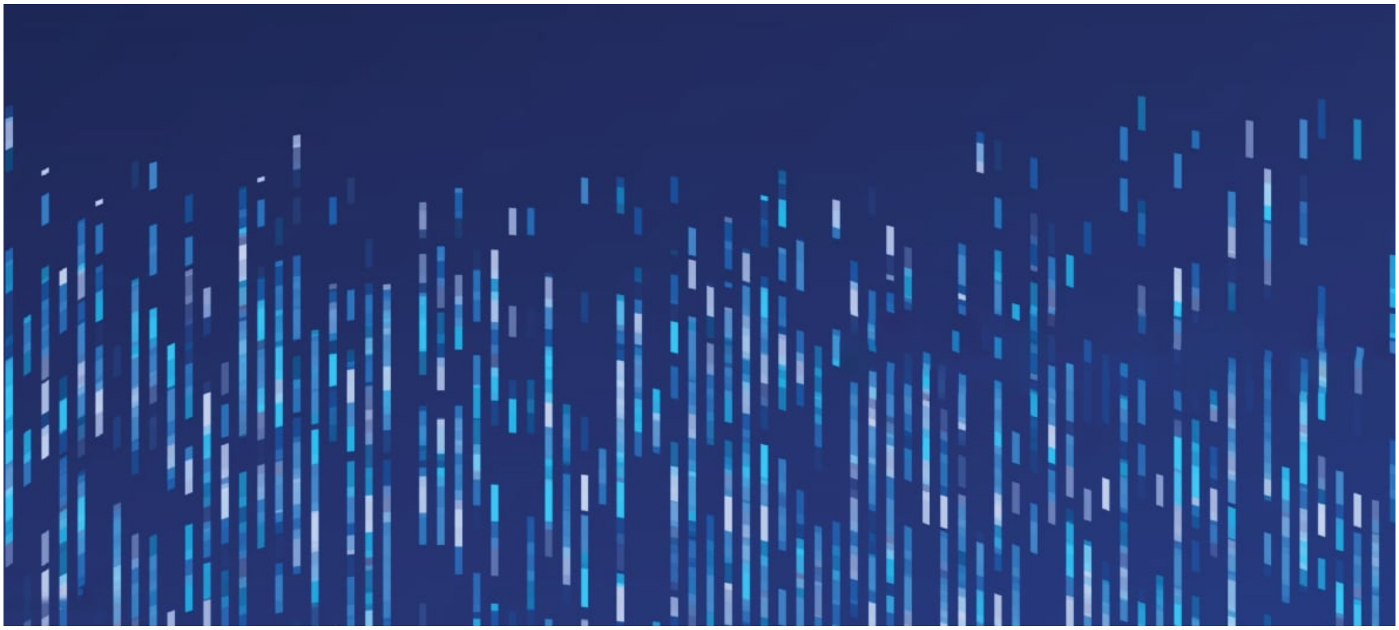

Capital Bytes – November 3, 2022

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Capital Bytes: Why It Might Be Nearly Impossible to Predict America's Economic Trajectory

Just about every money manager and investor alike is struggling to plot both an economic path, as well as the Federal Reserve's (Fed) rate trajectory. But 2022 is truly unlike any other time in history, and that may be a big problem for forecasts. Following the second-greatest worldwide economic crisis, most markets, both domestically and abroad, have enjoyed the longest expansion in recorded history. This recent record run was supported by central banks' willingness to keep money cheap, changes in social trends (think the rise of the gig economy), along with globalization, and by unprecedented, dramatic monetary and fiscal actions taken by world leaders in response to a pandemic not seen since the Spanish Flu.

And as the world's leaders now diverge to address the inflationary aftermath, the future of the greatest economy of all comes into question. According to the Wall Street Journal, cash-rich consumers could be the reason interest rates stay higher for longer. After all, a more than decade-long bull market in housing, stocks, bonds and commodities has dramatically increased Americans' average wealth, home equity and excess savings. When you compound that wealth with rounds of "helicopter money" dropped into our coffers during the pandemic, most consumers are entering this period of “pre-recession” in a much better economic state than ever before. We certainly believe that a cash-rich consumer who’s still feeling FOMO (fear of missing out) is going to make the Fed’s job much harder, but there’s more to that reasoning.

Let’s not forget that the pandemic also drove interest rates to abnormally low levels at a time when modest increases in rates were likely more appropriate as the economy was still humming along by the end of 2019 (+2.1% GDP). According to Fed economists, U.S. households have amassed and retained roughly $1.7 trillion in excess savings through mid-2021, as they tucked away money and withheld spending. During the pandemic, most individuals and businesses were also able to lock in ultra-low interest rates on all sorts of debt. This not only reduces carrying costs, but also deters home sales at the consumer level. The three main reasons the housing market is not responding the way it should is that prices are not only up markedly since before the pandemic, but interest rates are also nearly triple where they were at the trough — and Americans have record levels of equity. According to CoreLogic, consumers gained $3.6 trillion in home equity between Q2 2021 and Q2 2022, a near 28% jump.

By many estimates, America is in the best pre-recession shape in recorded history, which unfortunately dulls the effects of the Fed’s ultra-aggressive rate hikes. And while cracks are forming in the housing and labor market, they remain relatively resilient. This seems to be frustrating the Fed, but that’s simply because they have no real past comparison. Put simply, historical repercussive rate precedents are going to be hard to cite and a cash and equity flushed consumer base is likely to trigger an extended period of high rates as their response lags. These factors create a very real impetus for the Fed to get increasingly aggressive as it’s not getting the same response from the marketplace that history suggests (which could hurt far more than intended). The Federal Open Market Committee (FOMC) is fully prepared to tilt the economy into recession, but it may be prudent for them to let the effects of damaging rates play out. Regrettably, an over-correction of the FOMC is increasingly likely as they are driven by hard data that can severely lag real-world experiences.

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