US Macroeconomics

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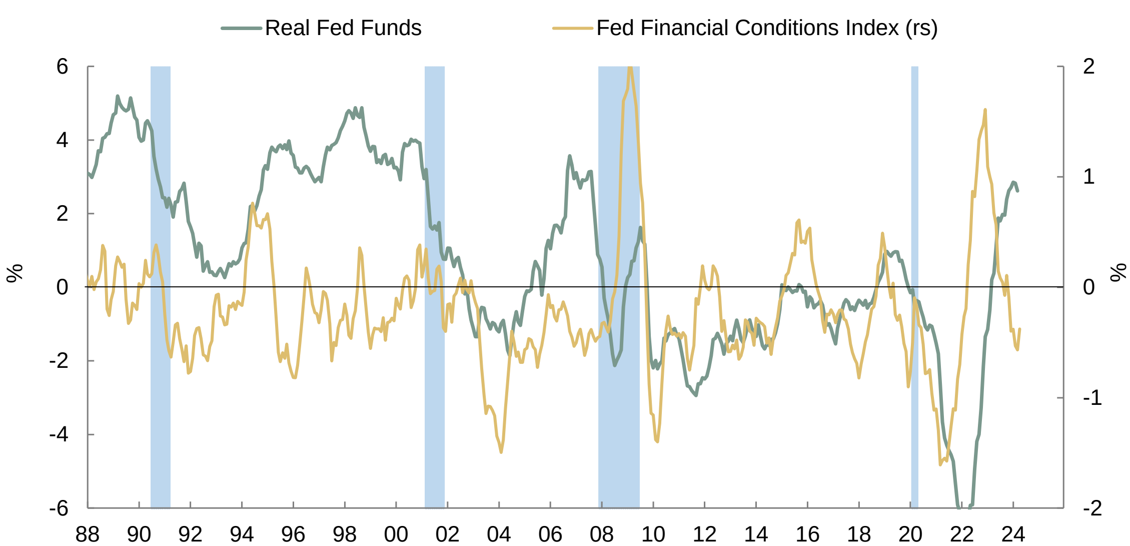
The Tight Money Offset

The Fed has raised rates 525 basis points (bps) over the March 2022 to July 2023 timespan, which is the fastest and most aggressive tightening cycle since the early 1980s. In turn, household borrowing rates have soared to a two-decade high while the deeply inverted treasury yield curve has caused commercial banks to meaningfully tighten lending standards. The real funds rate (fed funds less year-over-year PCE inflation) is near 3%, a level which historically has helped to trigger recession. Yet, **the economy has continued to grow**, and the consensus of economists has both lowered the probability of and pushed out the timing of the next downturn. What gives?

A common answer among investors is rapid government spending. **The US has never run a 6%-plus budget deficit outside of recession alongside a sub-4% unemployment rate**, as was the case last fiscal year. Surely government largesse is artificially boosting aggregate demand, which in turn is complicating the Fed's job of slowing inflation. After all, it is difficult to slow price appreciation when the government's demand for goods and services is so strong as the public and private sectors compete for limited resources. But there is another factor that has kept the economy strong. Loose *financial* conditions have largely offset tighter *monetary* policy.

The Fed Board's financial conditions index (FCI) consists of seven variables: federal funds rate, the 10-year Treasury yield, the 30-year fixed mortgage rate, the triple-B corporate bond yield, the Dow Jones total stock market index, the Zillow house price index, and the nominal broad dollar index. Positive (negative) values represent headwinds (tailwinds) to GDP growth over the next year. A reading of positive 1 percent means that financial conditions are subtracting 100 bps worth of real GDP growth over the following year. **Financial conditions are currently a *tailwind* to growth with the FCI registering a reading of -0.38**. Stocks (-0.36), home prices (-0.13), 10yr UST (-0.01) are tailwinds to growth while fed funds (0.03), mortgages (0.02), BBB (0.01), broad dollar index (0.06) are slight financial headwinds to growth.

Meanwhile, **the real fed funds rate is positive and hovering around 2.6% as of March 2024, down from a cyclical peak of 2.8% previously**. But if inflation continues to grind lower over time, real fed funds will continue to edge higher. Recent readings are already consistent with levels that shortly proceeded the 2001 and 2008 downturns. By this metric Fed policy is tight. But as long as stocks continue to boom, no doubt aided by AI enthusiasm, the two series will continue to diverge. Presently, they are at their widest gap since August 2007 which was five months before the economy tipped into recession. Consequently, the current situation is unlikely to persist. Something will likely break. The obvious question is in what direction. Stay tuned.



Source: Federal Reserve, BEA, Haver, SMBC Nikko

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