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Demand deceleration intensifying

Macquarie Fixed Income Strategic Forum 2023 | Issue 02

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Executive summary

At the beginning of the year, our analysis from Issue 01 of the Macquarie Fixed Income Strategic Forum 2023 series included the prediction that demand deceleration would overtake supply recovery as the dominant factor affecting the macroeconomic environment. As we enter the second half of 2023, we conclude in Issue 02 of the Strategic Forum series that we have seen that narrative largely play out. An array of economic data, including household spending and supply chain stress indicators, has reinforced our views and our resulting economic outlook of lower inflation and lower growth. Looking ahead, we use a critical lens on our outlook and identify the main factors that have the potential to change it: fiscal policy, monetary policy overtightening, and the deterioration of credit lending conditions. Lastly, we note that the implications of these could be profound for investors, as the likelihood of a dislocation in financial markets slowly creeps upwards.

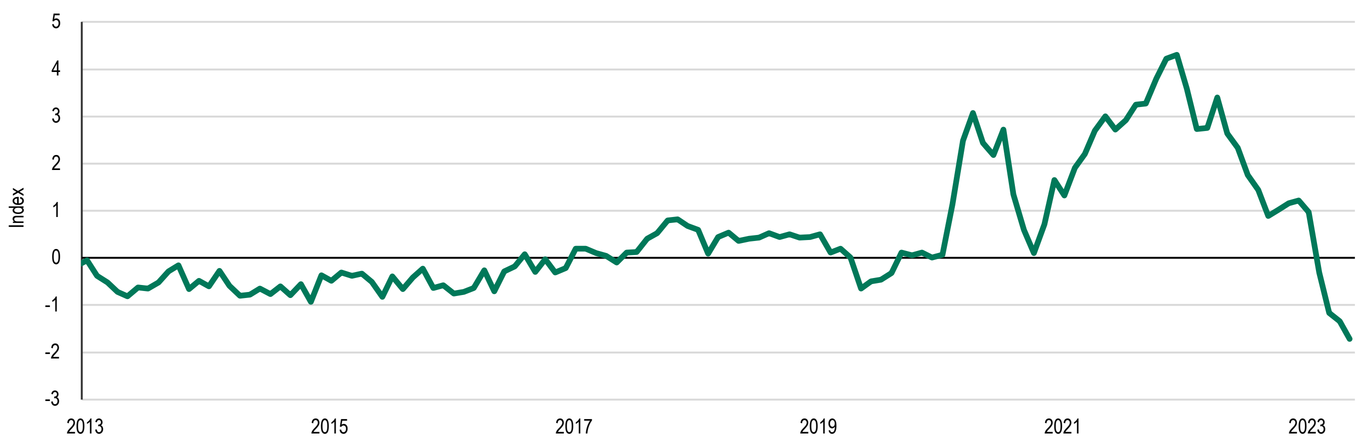
Introduction

As global economies began a transition away from “stagflationary” conditions at the start of 2023, we highlighted what we considered an important shift in the key forces affecting the big macro picture. We believed demand would overtake supply as the main driver of macroeconomic outcomes. In other words, the direction and magnitude of the broader economy through 2023, and the resulting investment landscape, will likely be determined by slowing demand rather than the rate of supply recovery. Investors should therefore emphasise demand-related developments, in our view. Our key conclusions in Issue 01 of the Strategic Forum 2023 series were for inflation to fall and for a cyclical recession to unfold in the second half of the year. With the second half of 2023 now in view, we believe it would be helpful to reassess our analysis and to identify the risk factors that could change this trajectory.

What has happened since the start of 2023?

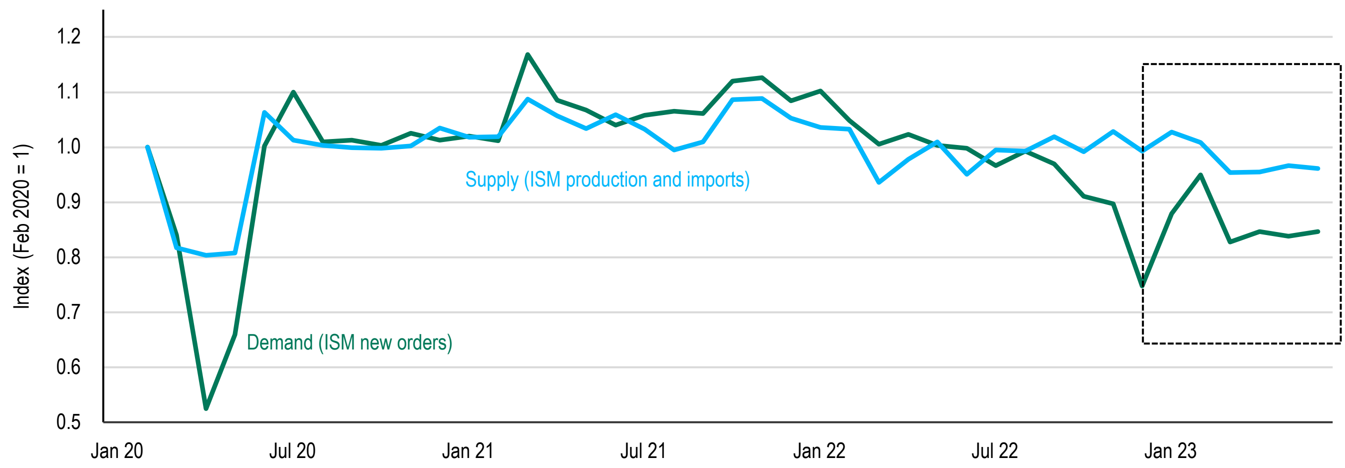
The supply recovery that had been our core theme since 2H21 has broadened and deepened while remaining on a slow, sustainable, positive trend (see Figure 1). Demand has weakened as we anticipated, with movements becoming more pronounced, but not enough to give rise to outright demand destruction (see Figure 2). The other development worth noting, in our view, was the unexpected banking crisis, centred in US regional banks – a sign of underlying economic fragility implying that when rapid and significant monetary policy tightening is engaged, “things tend to break.”

Figure 1:
Global Supply Chain Pressure Index



Source: Federal Reserve Bank of New York, July 2023.

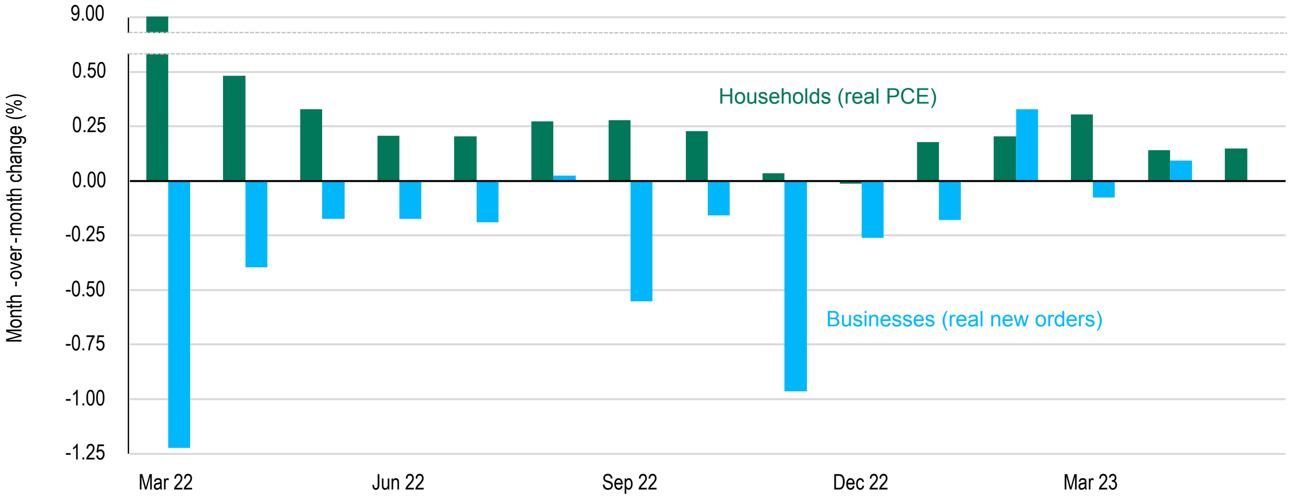
Figure 2:
Demand and supply since the COVID-19 shock



Source: Institute for Supply Management, July 2023.

Household spending growth in the US has moved to the downside since the year began, while business spending levels remain muted, implying a lack of incentive to significantly expand operations (see Figure 3).

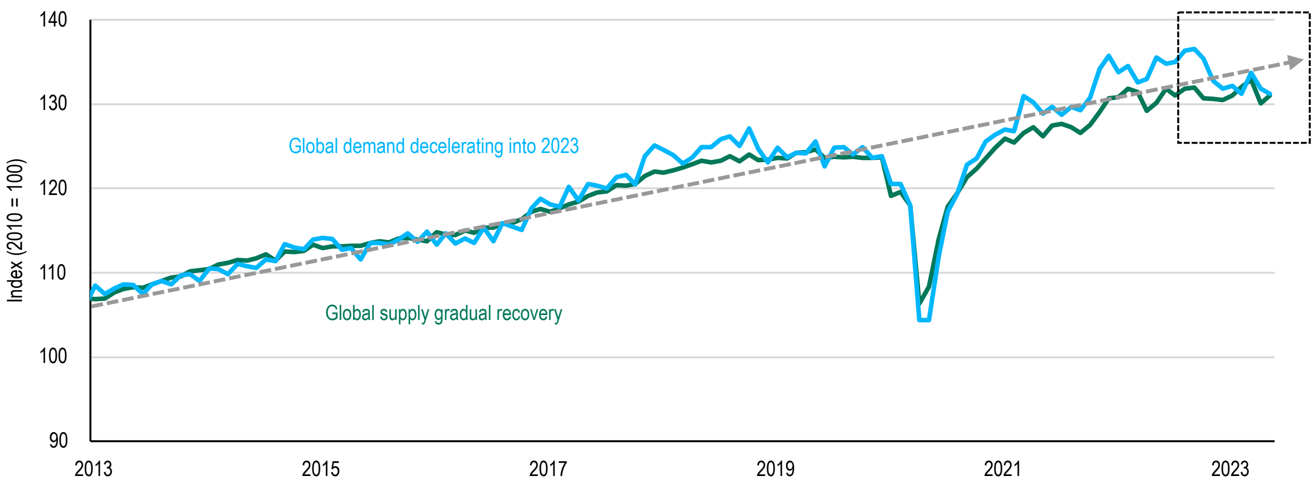
Figure 3:
US household and business spending



Sources: US Bureau of Economic Analysis, Institute for Supply Management, July 2023. Personal Consumption Expenditures Price Index (PCE).

This trend can also be observed globally: Growth in world trade (a proxy for global demand) decelerated into 2023 after peaking in 3Q22, while global production (a proxy for global supply) remains on a steady but moderate growth trajectory (see Figure 4). In short, the trend of intensifying demand deceleration is very much intact, and as we noted in Issue 01 of the Strategic Forum 2023 series, should remain the main determinant of macro outcomes, while supply recovery becomes less significant.

Figure 4:
Global demand and supply indicators

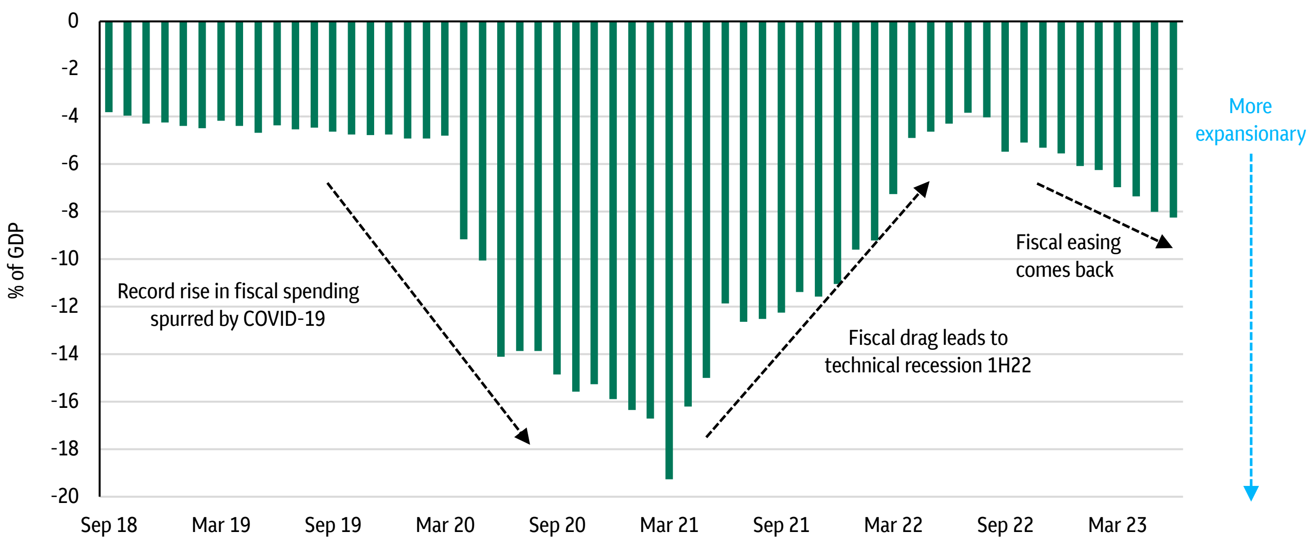


Source: Refinitiv, July 2023.

So why hasn't demand *deceleration* turned into outright *destruction*?

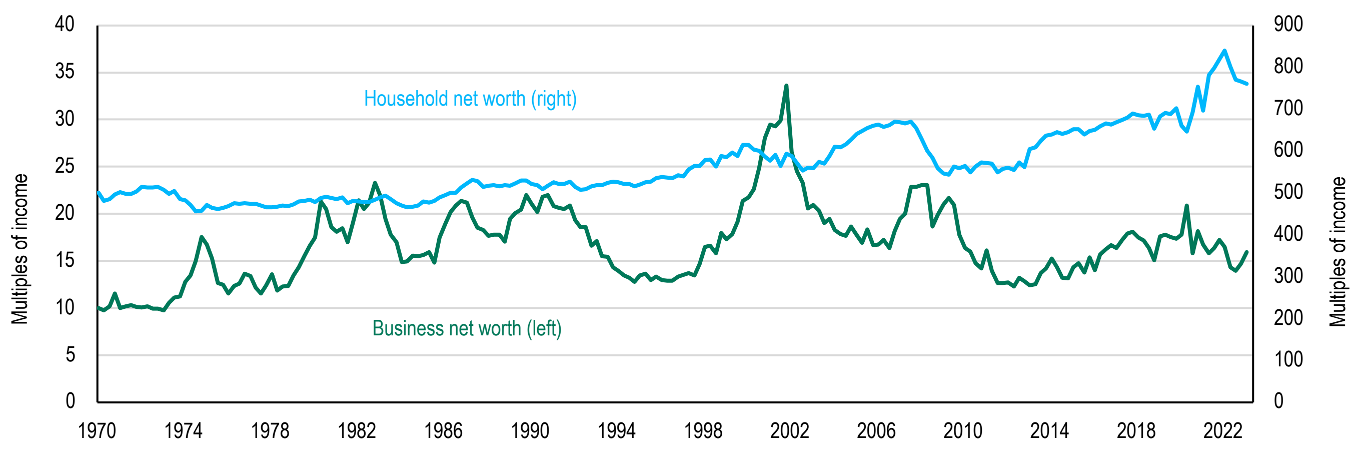
While better-than-expected winter weather in the Northern Hemisphere was helpful, we believe the most important factor in preventing outright demand destruction was the continued easing of fiscal drag (see Figure 5). This was mainly due to a rise in government spending, as well as increased fiscal transfers from the highest cost-of-living adjustments for government support recipients in about 40 years. This (less obvious) hand of fiscal policy has worked to offset the (more publicised and hence more obvious) action of tighter monetary policy. In addition, households and businesses benefited from starting the year with relatively more resilient financial balance sheets (see Figure 6).

Figure 5:
US federal government budget deficits



Sources: US Treasury, US Bureau of Economic Analysis, Macquarie, July 2023.

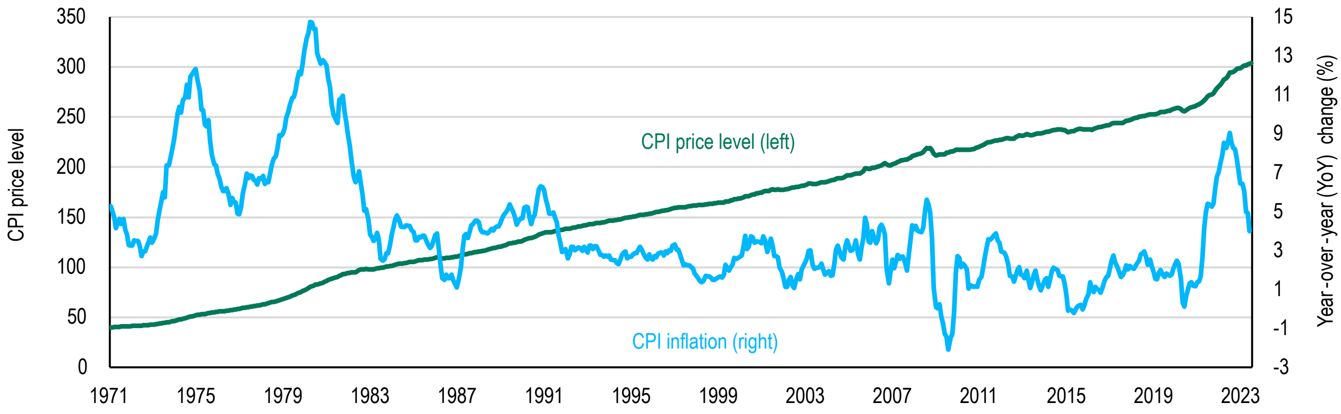
Figure 6:
Household and business net worth



Source: US Federal Reserve, July 2023.

While the demand trend has not turned into outright destruction, the risks are skewed to the downside. Why is this the case? Perhaps the biggest legacy from the combined supply shocks of the pandemic and then the Russia-Ukraine war has been the "inflation scar" imposed on all economies. Price levels have launched higher and historically do not generally retrace, so we all are left with "having to pay more, much more, for everything" (see Figure 7). This is not to be confused with inflation, which is price growth, now on a downward trend.

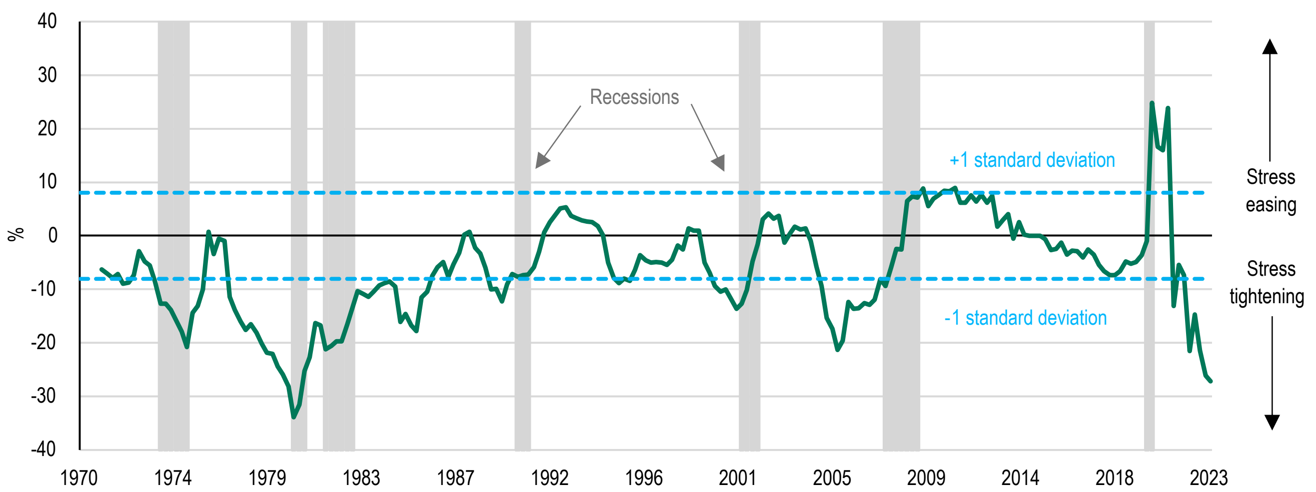
Figure 7:
US Consumer Price Index (CPI) price levels and CPI price growth (inflation)



Source: US Bureau of Labor Statistics, July 2023.

This scarring comes at a time when permanent income was attempting to buck the long-term structural downward trend on the back of massive government transfers that began during the pandemic. Negative income effects accompanied by elevated cost-of-living pressures (especially in the things we all need such as food, energy, shelter, and medicine), and exacerbated by rapid interest rate rises, have resulted in a significant worsening of household stress in a fairly short period (see Figure 8). In short, the worsening economic fragility of both households and businesses set the scene where exogenous headwinds could tip demand deceleration into outright destruction.

Figure 8:
Macquarie US household stress indicator



Sources: US Federal Reserve, US Bureau of Labor Statistics, Macquarie, July 2023.

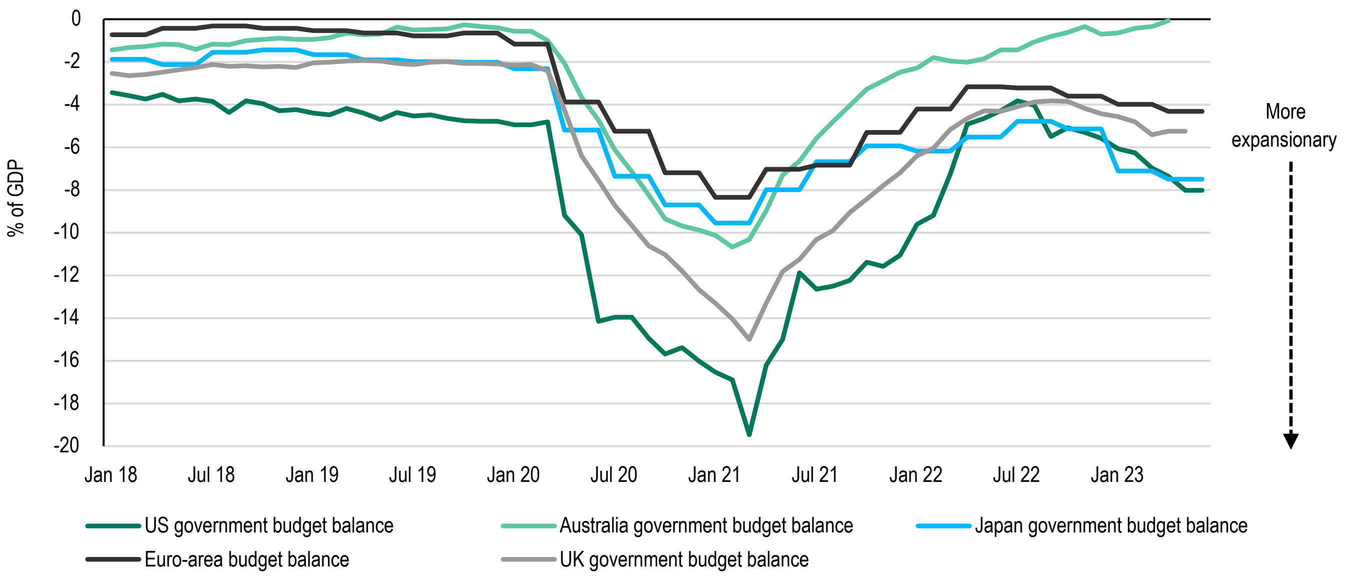
What could change the current trajectory of the current demand-supply environment?

Fiscal policy

At the time of Issue 02 of the Strategic Forum 2023 series, the uncertainty of the US debt ceiling outcome and risks for a repeat of the fiscal tightening that followed the 2011 debt ceiling resolution loomed large on our radar. The fact that the debt ceiling agreement had not imposed serious spending cuts for the rest of fiscal 2023, followed by fairly moderate spending caps in 2024, has been correctly viewed with relief by financial markets, in our view.

Figure 9 illustrates the contrasting approach to fiscal policy across countries, with Australia the most fiscally conservative and the US and Japan taking a more liberal approach. Given the significant positive effect of easing fiscal economic policy in the second half of 2022 and into 2023, we believe a reversal would certainly darken the outlook. Therefore, we remain alert to any shift towards tighter fiscal policy, but for now investors should expect a neutral to modestly expansive fiscal policy in the US through 2023, in our view.

Figure 9:
Fiscal policy levels across key global economies

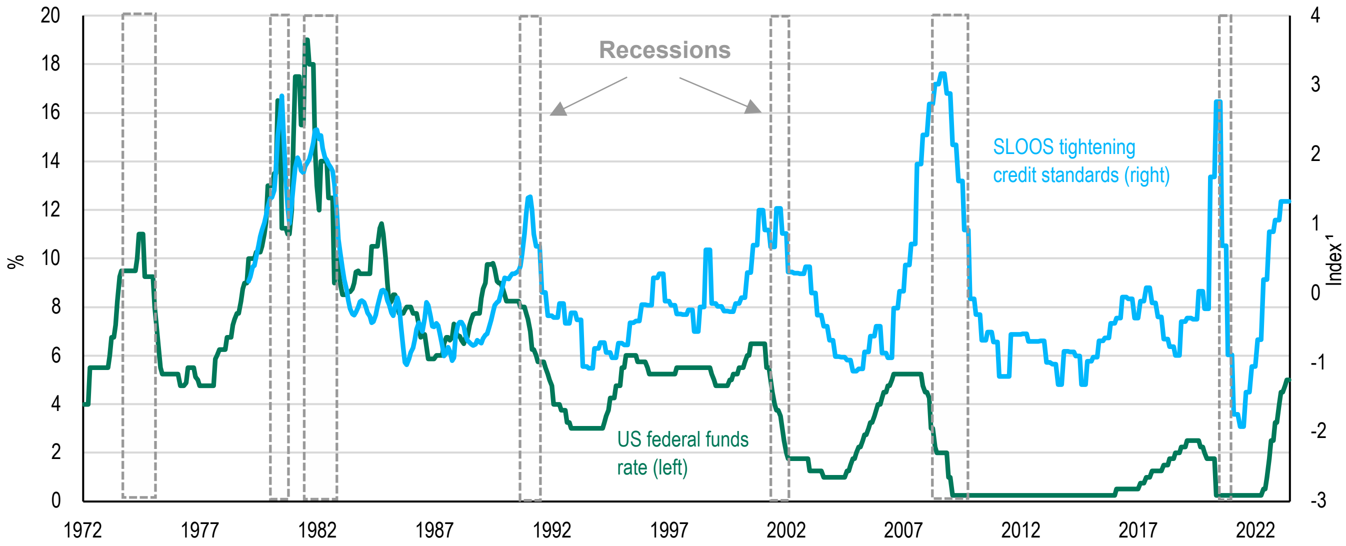


Sources: Refinitiv, Macquarie, July 2023.

Monetary policy

This has been the fastest and the largest rate hike cycle since the 1980s and, for many countries, it is not finished yet. History shows that rate hikes alone do not necessarily bring about a recession because rate hikes create winners (savers and lenders) and losers (borrowers). However, if credit quantity restrictions are being imposed on even credit-worthy borrowers, everyone is a loser. Historically, when significantly tightened credit conditions have occurred at the same time as rate hikes, a recession has unfolded each time (see Figure 10).

Figure 10:
Historical US rate hikes, credit restrictions, and recessions



Sources: US Federal Reserve, Macquarie, July 2023. SLOOS refers to the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices.
1. Index shows the number of standard deviations from the long-term average.

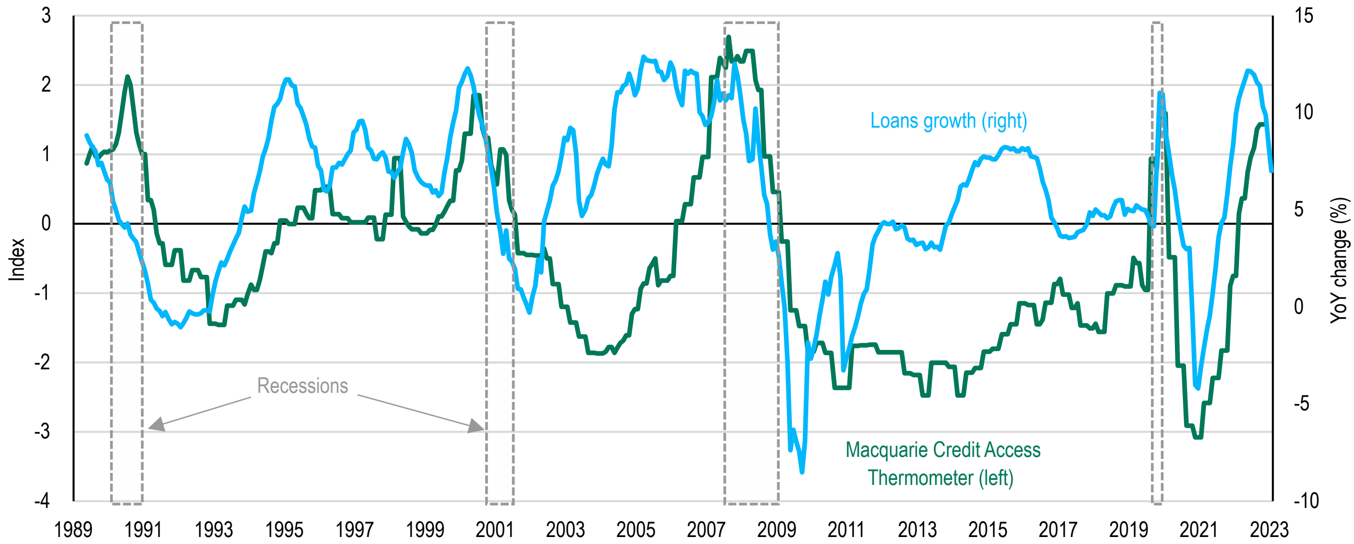
We should point out that even if sustained rate hiking cycles do not cause a recession, they almost always trigger or create conditions that give rise to financial market dislocation. Depending on the severity, these could turn into a systemic financial crisis. For example, even though the sustained rate hiking cycles of 1983-1984 and 1994-1995 are considered benign episodes, resulting in "soft landing" economic outcomes, financial dislocations did emerge that adversely impacted markets.

At this stage, while tighter credit restrictions have started to emerge, conditions are not yet tightened sufficiently or prolonged enough to adversely impact economic activity. This can be seen by the fact that loans growth is still positive, although clearly on a declining trend. However, rate hikes are now at magnitudes that would impact spending – our rule of thumb on US interest rate overtightening[2] has breached traditional thresholds, implying that US policy is in overtightening mode.

The risk of something "breaking" in financial markets is probably higher now than at any time since the global financial crisis (GFC), even if economic activity has not slipped into demand destruction or recession yet. We would recommend investors stay vigilant not just on interest rate policy but also on where credit conditions are headed for the rest of the year. In this regard, we use one of our proprietary signals – the Credit Access Thermometer – to help guide the discussion (see Figure 11). The signal's current message is that credit access is tightening, although not as acutely as recent episodes where a recession transpired.

2. Rule of thumb: overtightening is attained when policy interest rates exceed a three-month moving average of household spending by more than 2.5%.

Figure 11:
Loan growth and our Credit Access Thermometer



Sources: Macquarie, US Federal Reserve, July 2023.

Implications for inflation and growth in 2H23

Our analysis also shows that the balance of risks for any change leans more towards outright demand destruction rather than for an about-turn into buoyant demand. Moreover, the rate of supply improvement has now reached a fairly steady state that is unlikely to be reversible, in our view. However, we believe it is also unlikely to surpass the intensity of demand deceleration and therefore unlikely to act as a meaningful counterweight.

This analysis reinforces our high conviction call of a significant disinflation trend. The only unknown is how low inflation will go, with the outlooks varying by country. For example, in the US, prolonged demand deceleration with the rising probability of demand destruction raises the risk of disinflation turning into deflation. This is a key difference from our previous analysis in Issue 01 of the Strategic Forum 2023 series, where we emphasised falling inflation without touching on the possibility of deflation. On the other end of the spectrum, a unique emergence of record population growth in Australia will likely keep inflation higher than central bank comfort levels.

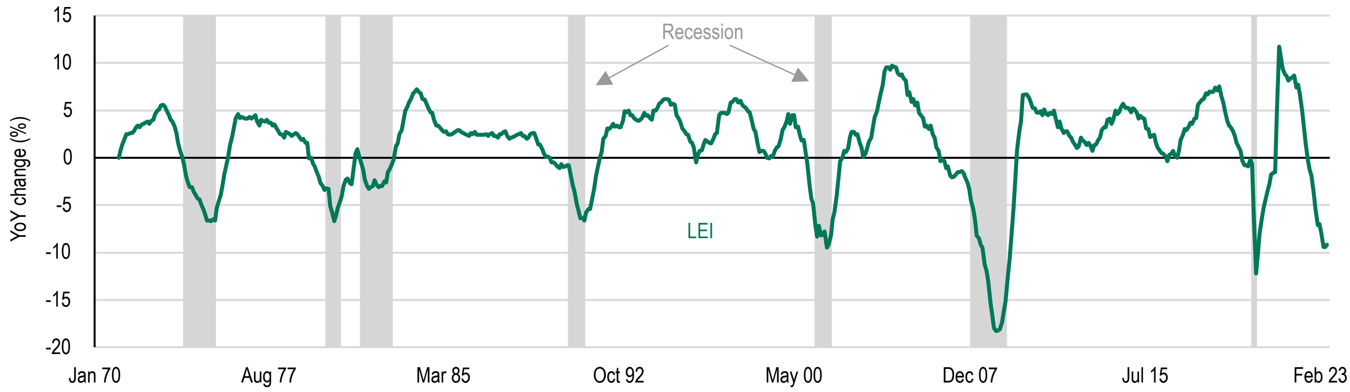
The impact on economic growth is less definitive. A significant slowing of growth is certainly the likeliest outcome but since demand deceleration has not turned into outright destruction, a recession is not guaranteed. This is further supported by the relatively less-aggressive fiscal stance generally implemented by governments globally. In the US, for example, the resolution of the debt ceiling has significantly reduced the risk of a fiscal policy headwind to growth, at least for the rest of 2023. However, as mentioned above, the prolonging of demand deceleration tends to lead to rising fragility, which raises the risks of adverse effects from other exogenous headwinds.

A clear and present headwind is the on-going central bank tightening, with monetary policy close to or in overtightening mode in many developed markets. In fact, the easing path of fiscal policy has actually increased the burden on monetary policy to deliver the goal of bringing inflation back to target. The lack of evidence of outright demand destruction means that the threshold for an interest rate pause or a cut is even further off, in our view. This implies a higher probability of doing too much and "breaking something." But what "breaks" may not be the traditional contraction in real economic activity. It could very well be in financial markets where a systemic crisis erupts and spills over into the real economy because of the increased fragility of the broader economy.

Therefore, our sense is that a **financial market dislocation should, in our view, no longer be a low-probability event.** As the probability rises, the longer rate hikes continue, and credit restrictions should increase. We might not be able to identify where the dislocation will likely manifest and which asset sectors it would involve, but if it is sufficiently serious and systemic, a recession will emerge.

While a **recession in 2023 is not inevitable, it remains our base case** call as we head to 2024. For now, key leading indicators of demand, such as the Conference Board Leading Economic Index® (LEI), continue to point in the direction of a recession (see Figure 12). But they also do not signal that the potential recession will be serious – more a post-tech crash recession of 2001 than a post-GFC recession of 2007-2009.

Figure 12:
LEI and recessions



Sources: Macquarie, The Conference Board, July 2023.

Conclusion

Issue 02 of the Strategic Forum 2023 series revisited our key conclusions at the start of 2023, which were for inflation to fall and a cyclical recession to unfold in the second half of the year, with demand deceleration overtaking supply recovery as the main driver of macroeconomic outcomes. As we go further into 2023, it is increasingly evident to us that demand deceleration is dictating the direction of the broader economy even as aggregate supply rises slowly but steadily. Financial markets are seeing evidence that inflation has peaked and a clear disinflation trend has begun. However, the "widely expected" economic recession has not yet manifested.

Our analysis had previously highlighted that prevailing conditions, namely more resilient balance sheet positions of households and businesses along with easier-than-anticipated fiscal policy, were working against the forces driving demand destruction.

However, the prospect of overreliance on monetary policy suggests to us that the probability of financial risk is higher than previously expected. Historically, sustained rate hike cycles always deliver a financial dislocation, if not always a recession. This view is further enhanced by the fact that credit conditions have now tightened, with the prospect of further restrictions in coming quarters. The combination of overtightening monetary policy and rising restrictions on credit access has delivered a recession every time in the past. This implies a greater probability that the root cause of a recession this time will stem from financial markets. Unless serious fiscal and monetary loosening emerges – and the threshold for that is high, in our view – all it takes is for distress to emerge in financial assets and a systemic spillover into a recession could occur, given fragile households and an increasingly downbeat business sector.

History also suggests that risk markets never really adequately "price" a recession, and financial crisis-led recessions are even more unpredictable. As a result, our updated base-case outlook is for the disinflationary trend to continue, with the possibility of deflation by the end of 2023 to early 2024, together with a cyclical recession that's no worse than the recession of 2001 that followed the tech crash.

Investor implications: A Regimes Framework update

Our Regimes Framework, a recent addition to our macro strategy toolbox, aims to provide a big picture guide to how a typical portfolio may react in the expected upcoming economic environment. We recognise that macroeconomic outcomes are, by nature, uncertain and hence the model utilises alternative economic scenarios with assigned weights that represent our view on the likelihood of each.

After being refreshed with our updated views, our Regimes Framework model still recommends that investors stay vigilant on risk and maintain a bias to overweight duration. If a recession manifests in coming quarters, we believe bond yields will likely fall and yield curves steepen as market expectations move to anticipate central bank rate cuts – a positive result for bond markets. The outlook for credit is more reserved with spreads forecasted to widen, particularly for below-investment-grade credit. However, for investment grade credit, the current high levels of absolute yield should help offset some of the capital loss. If continued central bank tightening delivers a harder landing for the economy, portfolio returns should be positive, with significant returns for bond markets, as we believe even larger falls in bond yields and more aggressive central bank easing are likely to follow eventually.

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High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds. The high yield secondary market is particularly susceptible to liquidity problems when institutional investors, such as mutual funds and certain other financial institutions, temporarily stop buying bonds for regulatory, financial, or other reasons. In addition, a less liquid secondary market makes it more difficult to obtain precise valuations of the high yield securities.

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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Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavourable positions in such markets, thus subjecting the investment to substantial losses. 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.

Demand destruction is a permanent downward shift on the demand curve in the direction of lower demand of a commodity, such as energy products, induced by a prolonged period of high prices or constrained supply.

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.

Monetary policy tightening occurs when central banks raise interest rates, and easing occurs when central banks lower interest rates. In a tightening monetary policy environment, a reduction in the money supply can help slow inflation.

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

Stagflation occurs when persistent high inflation is combined with high unemployment and stagnant demand in a country's economy.

The **Conference Board Leading Economic Index (LEI)** is constructed using 10 component indicators to summarize and reveal common turning points in the economy in a clearer and more convincing manner than any individual component. The LEI is a predictive variable that anticipates (or "leads") turning points in the business cycle by around seven months.

The **Global Supply Chain Pressure Index (GSCPI)**, created by the Federal Reserve Bank of New York, tracks the state of global supply chains using data from the transportation and manufacturing sectors.

The **Institute for Supply Management (ISM) New Orders Index, ISM Production Index,** and **ISM Imports Index** monitor the volume of new orders, production, and imports, respectively, based on the ISM's surveys of manufacturing and services firms.

The **Personal Consumption Expenditures Price Index (PCE)** is a measure of inflation that is calculated by the Bureau of Economic Analysis, representing changes in consumer spending on goods and services. "Core" PCE excludes food and energy prices.

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.

The **US Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Index performance returns do not reflect any management fees, transaction costs or expenses.

Indices are unmanaged and one cannot invest directly in an index.

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