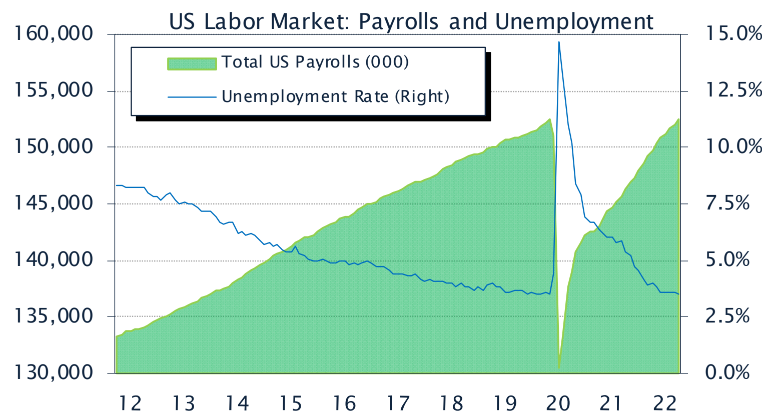
# INVESTMENT UPDATE

Earlier this month we got our first look at second quarter GDP, which showed that US economic output, for the second quarter in a row, showed negative real growth from the previous quarter. In "the old days," two consecutive quarters of negative GDP growth would satisfy the conditions necessary for declaring a recession. Things have changed over recent years (more on that later!), and the simple rules no longer apply; today the task of declaring a recession is the responsibility of the National Bureau of Economic Research, which uses a multi-factor approach, examining more than just aggregate US economic output.

Since economic data is compiled, reported, and analyzed with significant lags, the official pronouncement from the NBER typically comes months after the start of the typical recession. That's not very helpful for those of us trying to make decisions in real time, which is why we've seen plenty of debate about just where the US economy sits in the current cycle.




Arguably, the strongest case against the "recession is upon us" crowd is the data measuring the US labor market (one of the biggest inputs in the NBER's calculations), which remains remarkably strong. While it's true that employment and payroll figures are lagging economic indicators (i.e., employers don't typically let employees go until they are forced to do so to remain profitable), the labor market today appears to be going full steam ahead.

The chart on this page paints the picture. The US unemployment rate has fallen back down to 3.5%, its pre-pandemic low and the lowest level since 1969. Job growth has been consistently strong for months on-end; July's payrolls topped 152.5 million, now fully recovered from the losses suffered during COVID, one of the fastest job recoveries in US economic history. Not shown, but equally important, is that there are, at last count, more than 10 million job openings in the US, more than two open positions for every unemployed person in the country.

The labor market isn't the only factor that's continuing to show strength in the US economy—the energy sector, despite the recent softening of crude oil prices, is humming along, while the auto companies are still scrambling to try to produce enough vehicles to meet the pent-up demand from buyers, some of whom have been waiting for more than six months to have their cars delivered.

It is against this backdrop that the Fed must operate, and quite frankly, the relative strength of the labor market gives the Fed considerable latitude—at least for now—as it can continue to implement monetary policies more aggressively than it could in a weaker economic environment. This is sure to change, as political pressures will inevitably build as the Fed's policies begin to bite in the months ahead. But with millions of unfilled job openings, the Fed's path appears wide open for the next few months.

But that doesn't mean that the Fed's job is straightforward. As we well know, the Fed's two main tools—adjusting the overnight Fed funds lending rate and large-scale asset purchases—are limited in scope, heavy-handed in practice, and operate with significant delays. The first of these tools directly impacts the level of short-term interest rates, while asset purchases (also known as quantitative easing, or "QE") effectively removes some of the available supply of bonds in order to bring down yields on longer maturities. Neither one directly addresses the current issue at hand, namely inflation in the prices of consumer goods and services; instead these policies work indirectly, by making it more expensive to borrow money, which in turn slows demand and hopefully brings inflation down.

A wise man once said, "Conducting monetary policy is like driving down the highway backwards at high speed, while looking through a cracked rear-view mirror." While the Fed has been pretty clear about its plans to increase short rates, having already hiked the funds rate by more than 225 basis points in the last six months, less clear is its plans for reversing its QE program by reducing its nearly $8.5 trillion portfolio of Treasury and mortgage-backed securities (MBS). These bonds were purchased over the past 14 years, first ramping up after the financial crisis, and restarting when the COVID outbreak effec-

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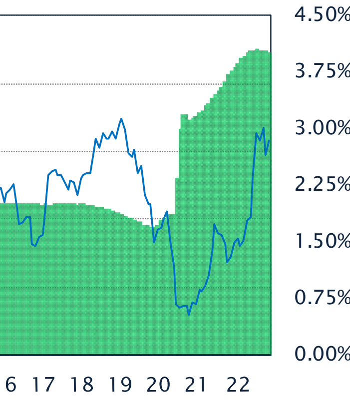
tively shut down economic activity in early 2020. The COVID-era purchases continued until late last year, and this summer the Fed began allowing some of its holdings to mature, without reinvesting the proceeds.

As the chart on this page shows, the Fed's QE program, while huge, has shown mixed results over the years in bringing down longer rates. Yes, in the early days of QE (2009-2011), yields on 10-year Treasury bonds fell measurably, as the Fed's purchases encouraged investors that the global financial system would survive; likewise, the reintroduction of large asset purchases in March and April 2020 brought some order to a fear-ridden bond market. But other than those two panic-driven periods, the relationship between QE and yield seems tenuous, at best.

But that "non-relationship" could be tested in the coming months. The Fed's balance sheet has grown so large that it's difficult to see how it can be pared back in any meaningful way without causing bond prices to fall (and yields to rise). The Fed currently holds $5.7 trillion in US Treasury securities of various maturities, and $2.7 trillion in agency-issued MBS (i.e., FNMA, FHLMC, and GNMA pass-through bonds). That represents approximately $1/4^{th}$ of marketable Treasuries outstanding and a whopping 38% of outstanding MBS. The current plan is to allow $95 billion to mature (or in the case of MBS, to pay down) each month in the coming months. For comparison, the maximum run off allowed in the 2018-2019 balance sheet reduction phase was just $50 billion per month, which led to liquidity issues in the banking system. This time, the Fed wants to reintroduce $1.5 trillion of government bonds into the market annually, for the next three years.




Keep in mind that, no matter what the Fed does, the US Treasury will be running deficits for the foreseeable future, which will require billions of additional new bonds to be auctioned in the coming years; if we are headed into a recession, those deficits will only increase further, and the Fed will not be there to help sop up the additional supply. Also, the Fed has flexibility in what bonds it chooses to purchase during the quantitative easing phase, and can target a particular maturity range to affect the shape of the yield curve. It has no such control over which maturities the Treasury will choose to issue; this additional supply of bonds could, depending on investor preferences, impact the yield curve in a way that's detrimental to the monetary policy that the Fed is trying to conduct.

There's also the thorny issue of how this "quantitative tightening" (QT) removes liquidity from the system, and from where those funds come. In the previous QT period, the Fed was forced to pare back the run off of bonds because reserves that member banks kept with the Fed were being drained too quickly, which put unwanted pressure on short rates. We'll defer a lengthy discussion about how the mechanics of QT impact the banking system, but note that since the Fed itself can't control who the marginal buyers of these bonds will be, it doesn't know exactly where the liquidity will come from as it's drained from the system. It's a huge negative from a monetary policy standpoint, and as a consequence the driving reason why the Fed would love to do away with the business of expanding and contracting its balance sheet to stabilize the economy.

The combination of a potentially sloppy unwinding of QE alongside a series of aggressive rate hikes means that the chances of a policy error are very high over the next few months. This hasn't been a typical economic cycle, and there are still huge imbalances between the supply and demand of various "things" (labor, housing, and autos, to name just three). The capital markets (in particular, the US stock market) may believe that the past two 75 basis point fund hikes and two more 50 basis point rate increases will do the trick, but we remain skeptical, if not that the terminal Fed funds rate is assumed to be too low, then that the Fed's work will be finished in a few short months.

As we've mentioned in past *Investment Updates*, there are global shifts happening in world trade and manufacturing, employer-employee work preferences, geo-political realignments, and the phasing out of carbon-based energy sources—nearly all of which are inflationary and will play out over years, not months. The Fed (and other major central banks—these are global issues) has the tools to slow economic growth, and will continue to use them aggressively. But we're unconvinced that, with inflation still running nearly at a double-digit rate, the Fed's 3.5% terminal funds forecast will be sufficient to bring inflation down anywhere close to its 2% target. And, as mentioned, tougher policy measures will become increasingly unpopular if they play out over an extended period.

The past year has been a rough period for bond investors, who are hungry for better returns. But we may have to wait a while longer for those to materialize. The Fed has plenty of work to do yet.