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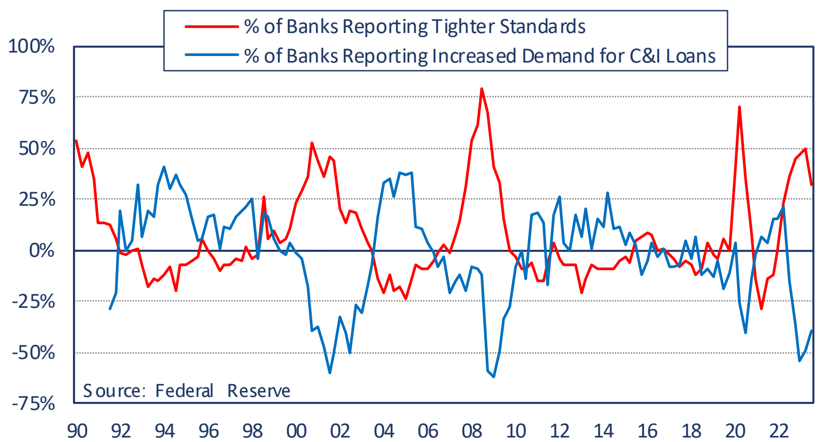
Agincourt Capital Management, LLC

INVESTMENT UPDATE

The Federal Reserve, while mostly known for the work it does in setting monetary policy for the US, has a number of other functions. One of those is data collection of several important economic statistics, including quarterly surveys of loan officers at US banks and US branches of foreign banks. This Senior Loan Officer Opinion Survey (SLOOS) asks bankers about changes in their lending standards, changes in the terms of the loans they're making, and any changes they're seeing in the demand for loans. The results of the most recent survey were just released, and as the chart on this page shows, banks are getting much more selective about who is and isn't credit worthy.

The third quarter survey (conducted in late September/early October) showed that credit conditions have continued to tighten over recent months, with more than 30% of the banks surveyed indicating that credit standards either "tightened significantly" or "tightened somewhat" compared to the previous period, for commercial and industrial (C&I) loans. You'll notice that the proportion of "tighter" responses dropped a bit from the previous survey; don't mistake that for an easing in conditions. If conditions are already near their tightest levels, respondents will answer "no change," as they can't get any tighter. Based on the commentary that accompanied the data, it appears that essentially every bank surveyed has raised credit standards over recent months. None are easing up.



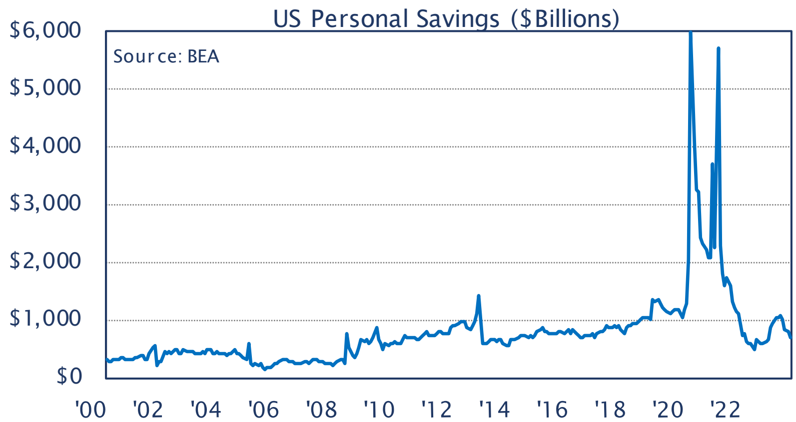
We've also plotted a separate data series from the same survey—the percentage of banks who reported an increase in demand for C&I loans. The survey results showed that most banks are experiencing a significant drop in demand for borrowed funds. This is hardly surprising, as the move up in rates over recent months is discouraging businesses (and households, for that matter) from increasing their debt levels.

Taken together, these series point to an impending recession. Like other leading indicators of the economy's direction, spikes in credit tightening and collapses in demand for loans have been highly correlated with economic downturns. A quick look at the chart shows that we are well within the ranges recorded for these two indicators in 2001, 2008-09, and 2020—all periods of recession (the data only goes back to 1990 for "tighter standards" and late 1991 for "demand for loans," but the former also was at a level above 50% in 1990, at the end of another recession). In fact, Deutsche Bank's US economic team's research estimates that there's a greater than 90% possibility of recession when tightening standards rise above the 40% level.

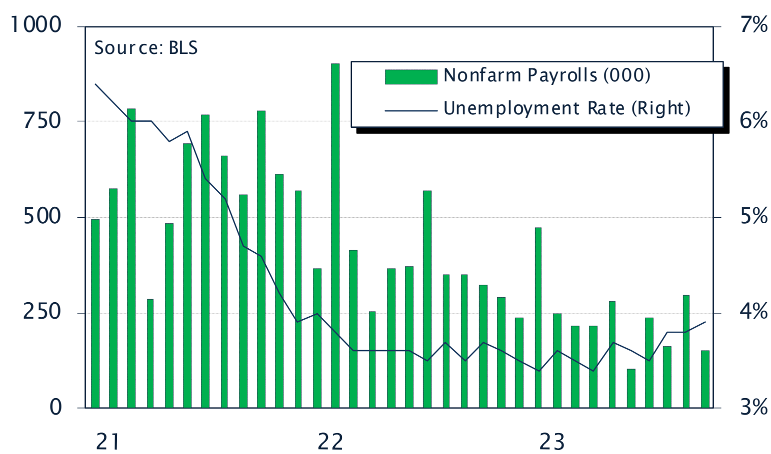
These levels are exactly what the Fed wants to see at this point in the cycle. It's well documented that the Fed has no direct way to slow or accelerate US economic activity. The main tools it has in its toolbox—raising or lowering the Fed funds rate, and (when that doesn't work well enough) buying or running off its holdings of government securities—work indirectly by increasing or decreasing borrowing costs for businesses and households. Changing the Fed funds rate impacts short-term and floating-rate borrowers, while large-scale bond purchases impact rates further out the maturity ladder, including home mortgage rates and longer-term industrial loans.

The Fed's current inflation battle, which has been going on now for the better part of two years, has seen the US central bank go "all guns a-blazing" by jacking up the Fed funds rate by more than 500 basis points over this period while shrinking its gigantic government bond portfolio by more than one trillion dollars. And while the Fed's Open Market Committee has only hiked rates once in its last three meetings, its members have threatened to keep pushing the funds rate higher if the economy doesn't slow enough to get inflation back towards its target of 2%.

And yet, consumers are still spending. Even when removing the inflated price of goods from the equation, personal consumption expenditures have been growing at an accelerating pace in 2023, to the exasperation of the Fed. The combination of higher borrowing rates and tougher lending standards has buried both the demand for, and the supply of loans, which is supposed to snuff out spending. If consumers are spending but not borrowing, the money must be coming from disposable income and savings.



The top chart shows the dollar amount of personal savings among US households over the past couple of decades. The first thing you'll notice is just how much money was pumped into the economy during the pandemic—at two different points, households had approximately $5 trillion more in savings compared to pre-Covid levels. That excess savings was quickly spent down, and today is back to, if not slightly below, "normal" trend levels. Further analysis across the wealth spectrum shows that excess savings have all but evaporated for most Americans, with only those in the top 20% of households having a savings cushion.



That implies that today's strong level of spending is coming almost entirely from current household earnings. With jobs still plentiful, consumers are feeling confident about their employment prospects, and that encourages consumption, which in turn continues to keep upward pressure on inflation. Increases in wages in the post-Covid period have further bolstered consumers, as has the ongoing shortage of workers in many industries. The stock market and the US housing market, despite recent jitters, have been surprisingly strong over the past couple of years, supporting consumer confidence even more.

If stable household employment—and the belief that work will continue to be available in the future—is what's driving consumer confidence and consumption at this point in the economic cycle, can the Fed achieve its 2% inflation target without doing some damage to the labor markets? Even after acknowledging the inherent lags in policy that make the employment data the quintessential lagging economic indicator, the Fed cannot back down yet. Failure to extinguish this cycle's inflation spike now means having to resume even tougher policies later, and that is, in the Fed's vernacular, suboptimal.

Fortunately, we're finally beginning to see early signs of cooling in the US jobs market. As the bottom chart shows, payroll growth has slowed in the second half of this year, to the point where the US is now averaging roughly 200,000 new jobs each month, a significant decline compared to what we were seeing a few months ago. Meanwhile, the unemployment rate has ticked up from a historic low of 3.4% in April to 3.9% in October.

Like the inflation numbers, these figures are moving in the right direction, but we're not there yet. Historically, the Fed has never cut the Fed funds rate when core CPI was above 2.7% (it's 4.0% now), except when the unemployment rate was also above 5%.

Nevertheless, the bond market in the last couple of weeks has begun to price in a shift in Fed policy, despite the Fed's warnings that inflation is not yet under control. Using imputed data, investors currently expect no further hikes in the funds rate, but do see a 50-50 probability of a rate cut in the first half of 2024.

If "a rate cut is just around the corner" sounds familiar, it's because investors have been overly optimistic for much of the past year about how quickly Fed policy would pivot, and each time, the market (and the Fed) has kept tightening. Is the current optimism just another head fake, or are we finally beginning to see the last of this tightening cycle? Unfortunately, even the Fed doesn't know the answer to that important question. But a weakening jobs market will certainly get us closer.