

US Macroeconomics

August 10, 2023

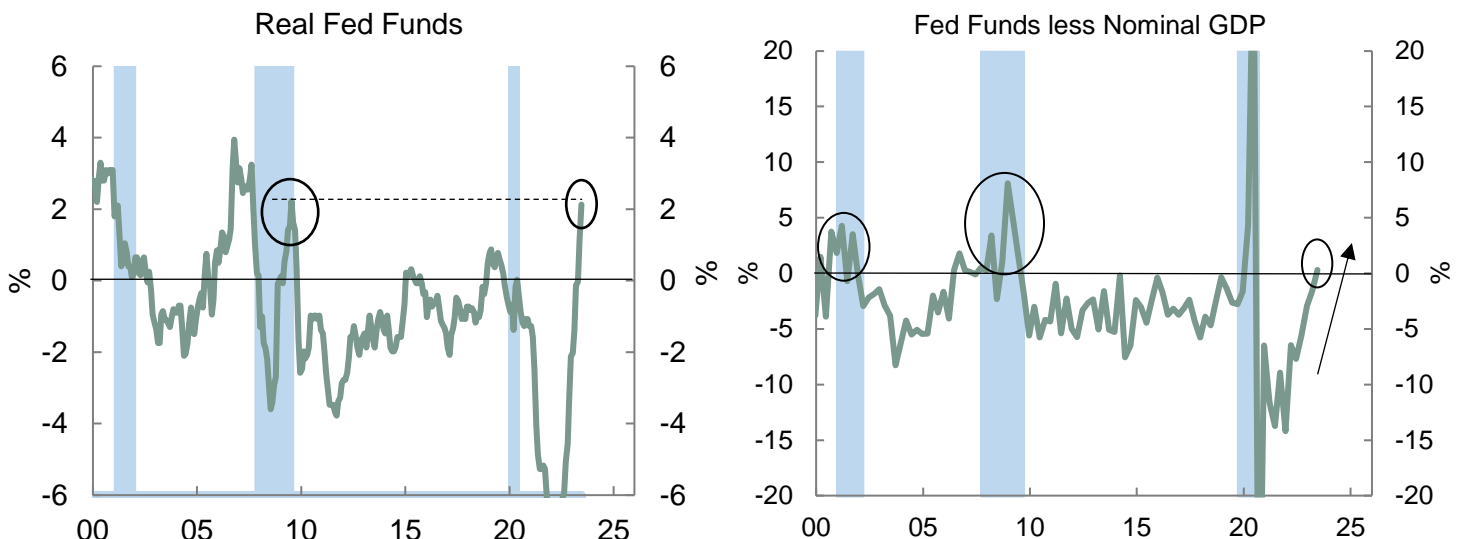
Troy Ludtka, Senior US Economist | 212.224.5483 | troy.ludtka@smbcnikko-si.com

Beware Rising Real Rates

Today's July CPI report is another dataset affirming the broader disinflationary trend that has taken place over the last year, and this has been right in line with our view. What is of particular interest going forward, however, is how **inflation's comedown has effectively led to a rapid tightening of financial conditions** even though the Fed is *stepping away* from hikes.

What started as a drop in food and energy inflation, has given way to the stickier components of inflation softening too. Shelter, which accounts for 34% of the overall CPI index, has softened quickly. This alone moves the index lower. Over the last three months, shelter costs have risen 5.6%, annualized. Compare this with June's 5.5% rate, May's 6.3% rate, April's 7.2%, March's 8.5% and February's peak of 9.5%. Meanwhile, Fed Chair Powell's preferred 'super-core' measure is falling even faster. Annualized over the last three months, super-core is up just 1.7%! Again, compare this with 1.4% in June, 3.1% in May, 4.2% in April, 5.2% in March. **Inflationary forces, across the board and especially in critical areas, are in retreat.** Not only is this likely to dominate the recent rise in energy prices that has occurred since July 21, but this has profound, far-reaching consequences.

There are two big picture takeaways. First, the decline in inflation has led to a sharp tightening in financial conditions as illustrated in the left chart below which shows the highest real rates (2.18%) since July 2009 (2.23%). This means that **price increases are insufficient in covering interest costs (in other words: debt is no longer being inflated away)**. Second, softening inflation also means that nominal growth — by definition — is slowing. For the first time since Q2 2009, interest rates are greater than nominal *growth* (see right chart), meaning that **the economy is also not outgrowing its interest obligation either.** In sum, neither increased productivity nor inflation is sufficient in covering interest expenses. No wonder loans are running increasingly delinquent (see our August 8th piece)! This dynamic (interest rates relative to growth) is one of the most profound in economics and now implies that economy-wide debt is going to become a lot harder to payback as the flow of funds on net are pulled out of the private sector and into the financial sector. This requires households to cut spending, thus exacerbating the disinflation.



Sources: Federal Reserve, BLS, BEA, NBER, Haver, SMBC Nikko

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.