Making Sense of the Current Macro Environment

Recessions are non-linear events. Before they begin, the economy is growing (linearly) and suddenly there is a shock (non-linear) which throws GDP growth off its positive trajectory. For a time, output declines and a recession begins. What triggers this shock is random, which is why downturns are so hard to predict. Sometimes it can be a corporate event (i.e., Lehman Brothers) and sometimes it can be a breaking point for businesses and consumers who can no longer afford to borrow money (i.e., the cyclical downturn of the early 1980s).

The economy dodged a recession earlier this year. In March, the spread between 2- and 10-year Treasury notes went to -110 basis points which is twice the depth of the record inversion seen in 1981-1982 after adjusting for the level of interest rates. In turn, regional bank stress mounted. Silicon Valley Bank and several other large commercial regional lenders went bankrupt. Global financial markets teetered. Swiss authorities quickly arranged a shotgun marriage between Credit Suisse and UBS. In just two weeks, the Fed added $340 billion in liquidity through its discount window. Had these extraordinary actions not occurred, the economy may have entered recession.

Fortunately, the financial market conflagration did not spread to Main Street. The labor market continued to grow, equities continued to rally, and fears of recession began to fade. Fast forward seven months later, and the consensus of forecasters now thinks a downturn has been averted. A “soft landing” is now the dominant narrative, the opposite of where we started the year. But are we out of the woods? The answer is no, at least not with interest rates where they are and with Fed quantitative tightening on autopilot.

As the year has progressed, private sector borrowing rates have increased further, while the treasury curve remains inverted. Household auto, credit card, mortgage, and personal loan rates are near record highs. Commercial bank lending standards are tight. If something else breaks in the financial markets, the Fed’s kneejerk response will be to provide additional liquidity. This would likely help stabilize sentiment, and a crisis lasting more than a few days or weeks may yet again be avoided. But can periodic liquidity injections be enough to offset prohibitively high borrowing costs? History suggests otherwise, and eventually the Fed will need to cut interest rates if not restart quantitative easing.

The current macro environment is fraught with many risks, arguably more so than in the recent past. Consequently, investors should be attuned to the possibility that the consensus narrative changes yet again. Stay tuned.
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 of 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.

© 2023 SMBC Group. All rights reserved.