

The US Economy & Financial Markets in 10 Slides

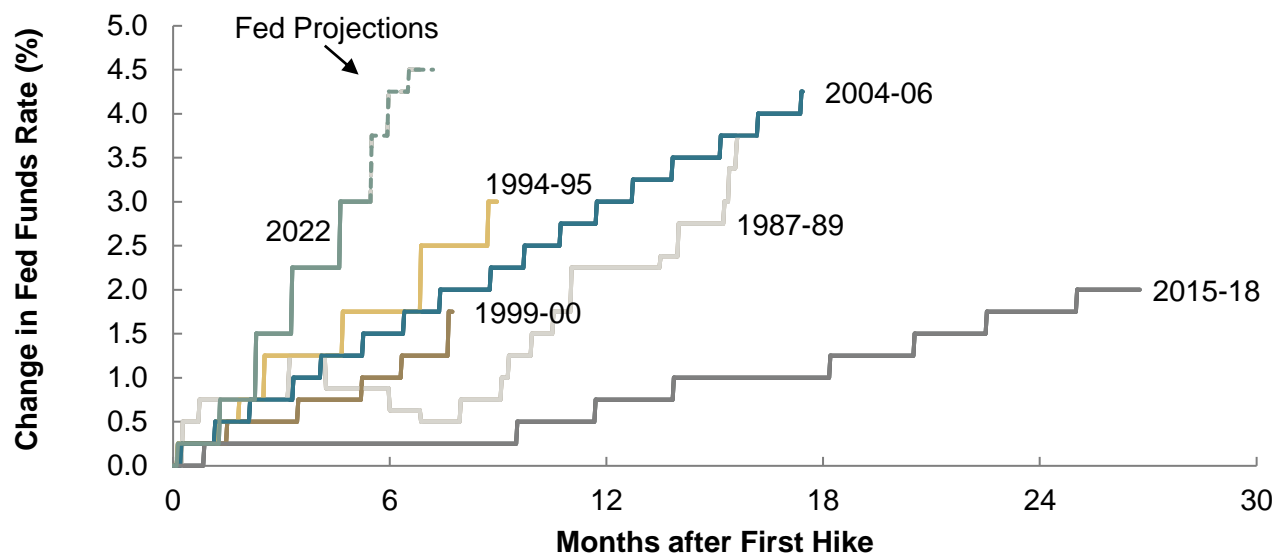
Joe Lavorgna
Chief US Economist
SMBC Nikko, Inc.

(212) 893-1528
joseph.lavorgna@smbcnikko-si.com
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Soft Landing Doubts

- The Fed has raised rates 300 basis points (bps) in just six months, twice as fast as the 1994-95 tightening cycle which saw a soft landing. In fact, there has been only one other instance when interest rates rose more quickly over such a short period of time—July 1980 to January 1981. What happened? The economy entered a deep recession that year which extended into 1982 with unemployment rising close to 11%.

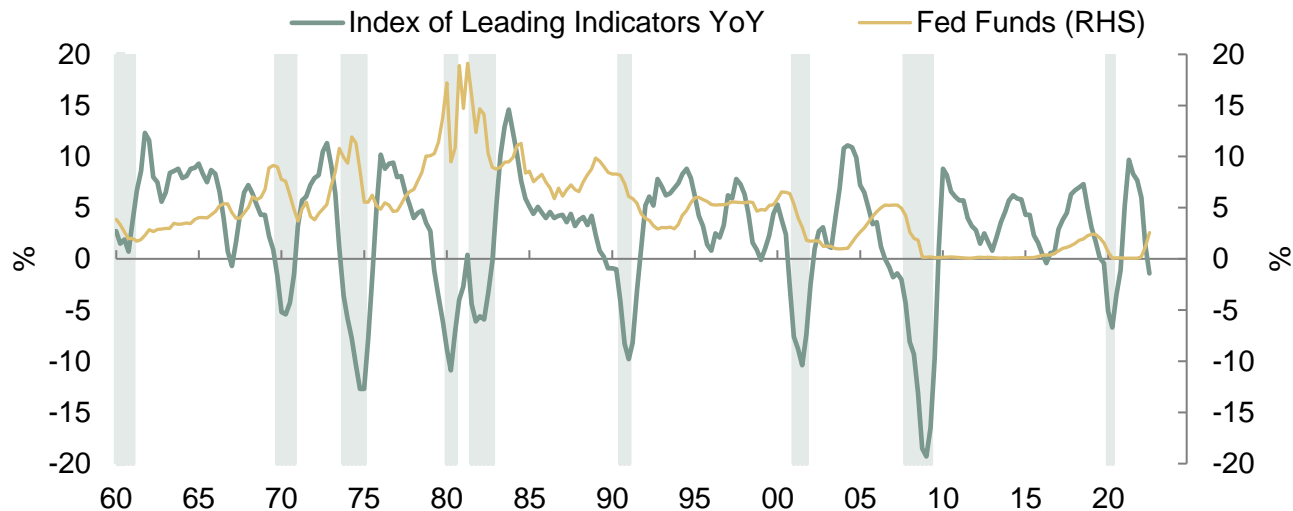
Change in Fed Funds Since the First Rate Hike



Leading Indicators Signal Recession

- The Index of Leading Economic Indicators is down 1.4% over the past 12 months. Why does this matter? Because the economy has always experienced a recession when this has occurred. Nevertheless, the Fed is on track to tighten further, taking interest rates into deeply restrictive territory.

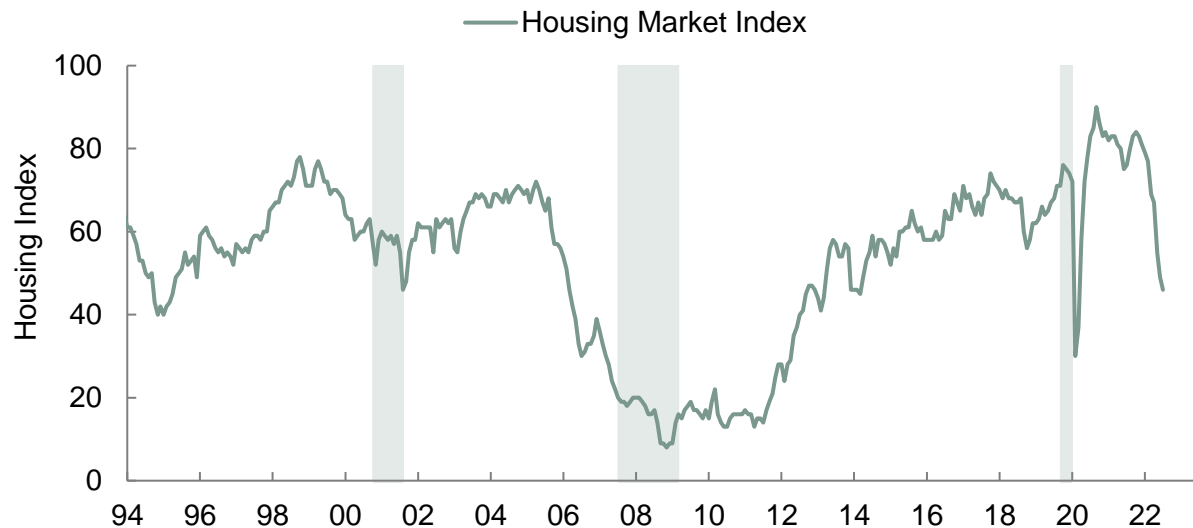
Index of Leading Indicators vs. Fed Funds



Trouble On Housing Horizon

- Housing is already in recession. The National Association of Homebuilder's housing market index fell to a 38 reading last month, its lowest level since the pandemic. More troubling is the fact that activity is down 42 points from where it was 12 months ago. This is the biggest year-over-year decline on record. Can a deep housing downturn be avoided? Doubtful

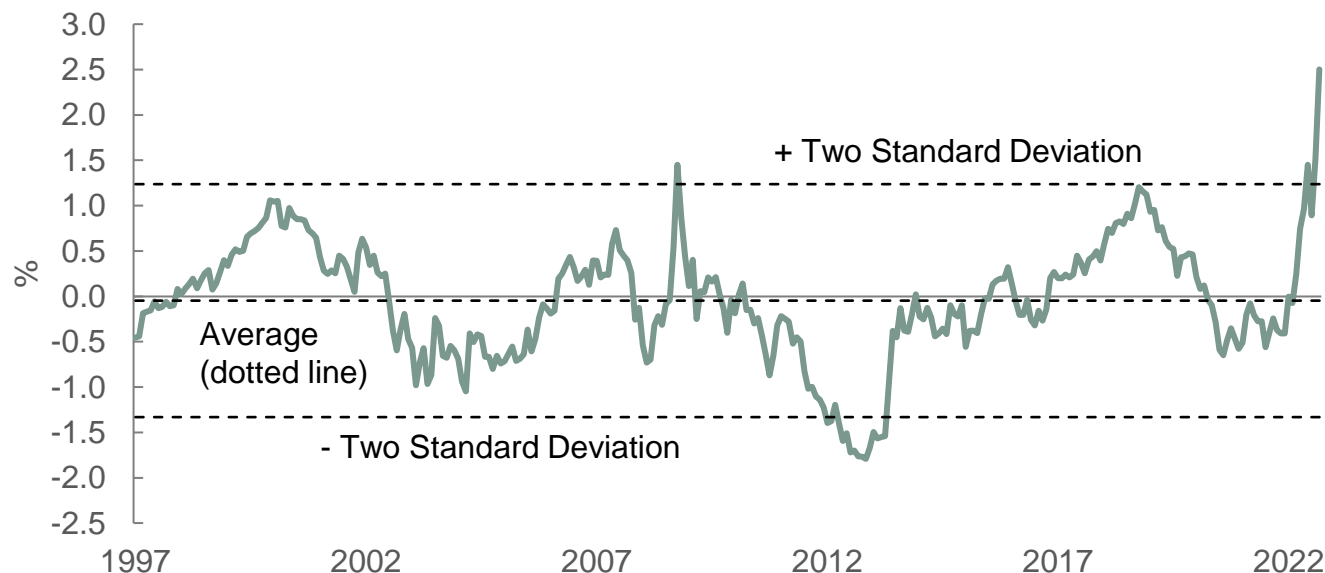
Plunging NAHB Housing Index



Record Rise In The Real Rate

- According to our calculations, R-star which is also known as the natural rate of interest, has risen to a record high reading. Its level is approximately four deviations from its long-term average. It is not surprising that residential investment, led by a historic spike in interest rates, fell at a 26% annualized rate last quarter.

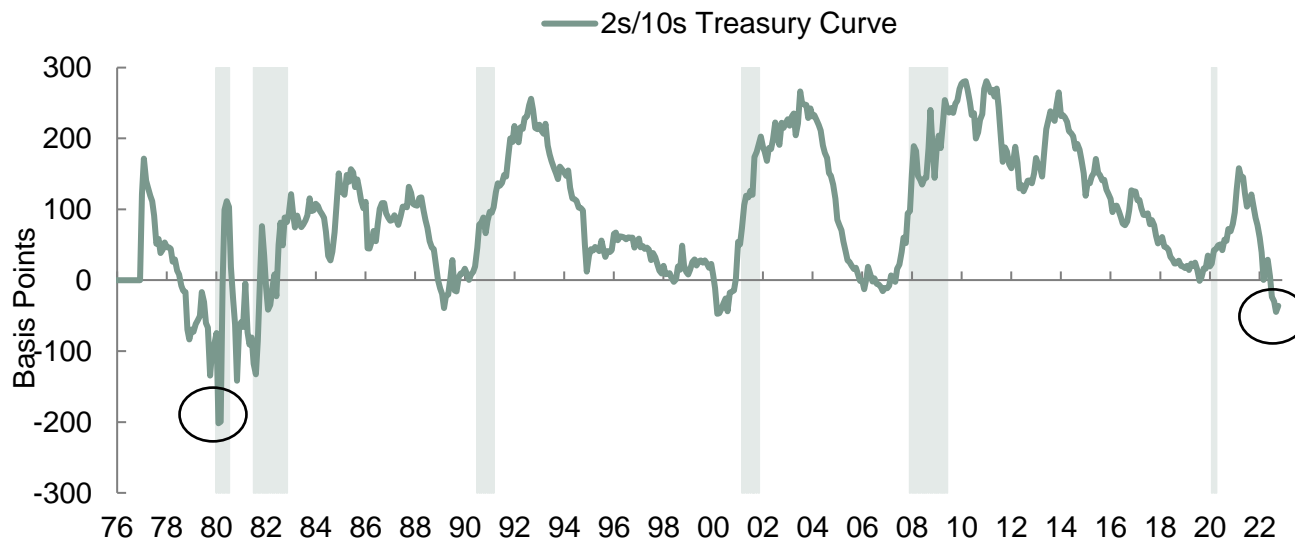
10y Real Rates Adjusted for Secular Downtrend



Historic Inversion Points To Potentially Deep Downturn

- The treasury yield curve is deeply inverted. The 2-year note is yielding roughly 40 bps more than the 10-year note at 4.37% versus 4.01%. However, when adjusted for the level of interest rates, the current inversion is the largest on record. The yield curve is both a predictor and cause of recession. Absent a Fed pivot, expect credit and liquidity to deteriorate further.

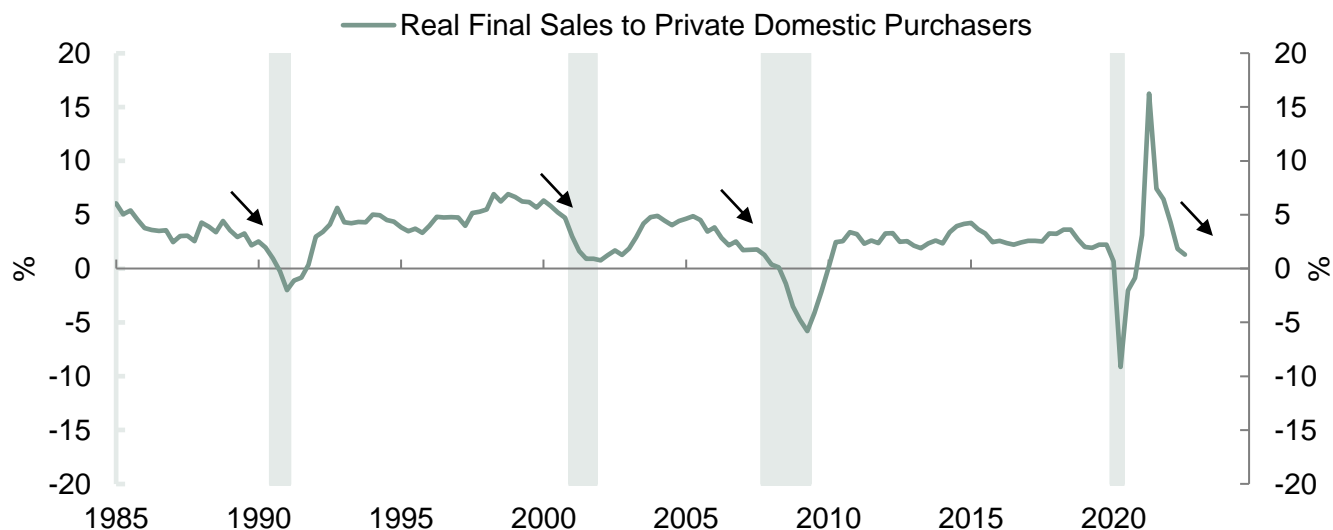
2s/10s Treasury Curve and Recessions



GDP Not What It Appears

- Against the current financial backdrop, the economy is rapidly losing momentum. Private final domestic demand, defined as GDP less inventories net exports and government spending, was up just 0.1% last and grew only 1.3% over the past year. Fixed business investment is already in a recession, declining 5.1% in Q2 and 4.9% in Q3. Remember that more than the entire increase in Q3 2022 GDP was due to net exports.

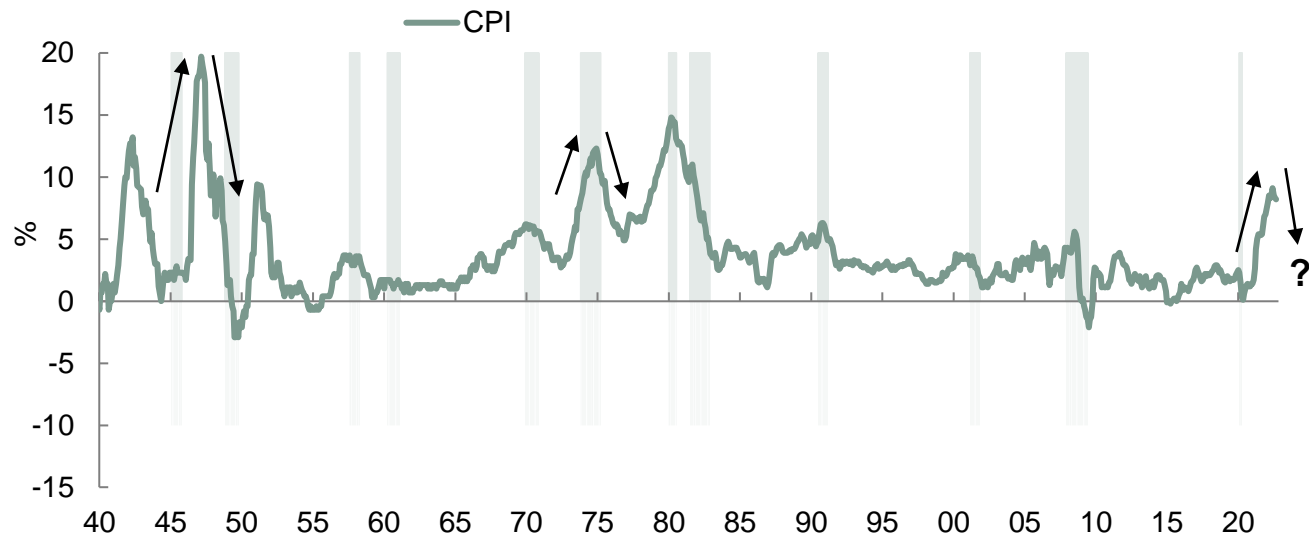
Domestic Demand Downshifting



Symmetry In Inflation Trends

- Inflation is a lagging economic indicator. It tends to peak during recessions and bottom during recoveries. Importantly, our analysis has found that the rise in inflation is proportional to the fall in inflation. In essence, what goes up fast comes down fast.

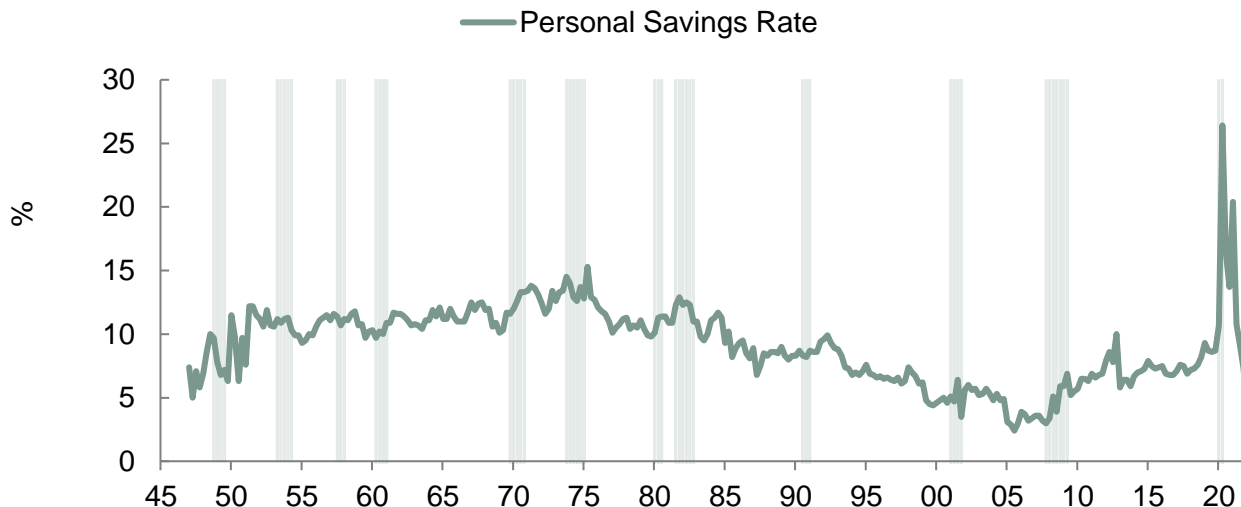
Inflation does not Plateau at an Elevated Reading



Depleted Savings

- Households are tapped out. The saving rate was just 3.3% last quarter, close to the record low readings registered between 2005 to 2007. But unlike that period when stocks and housing were rising, consumer net worth is collapsing in 2022. Fed Flow of Funds data show a \$6.2 trillion drop in household net worth through the first half of this year. Frightening.

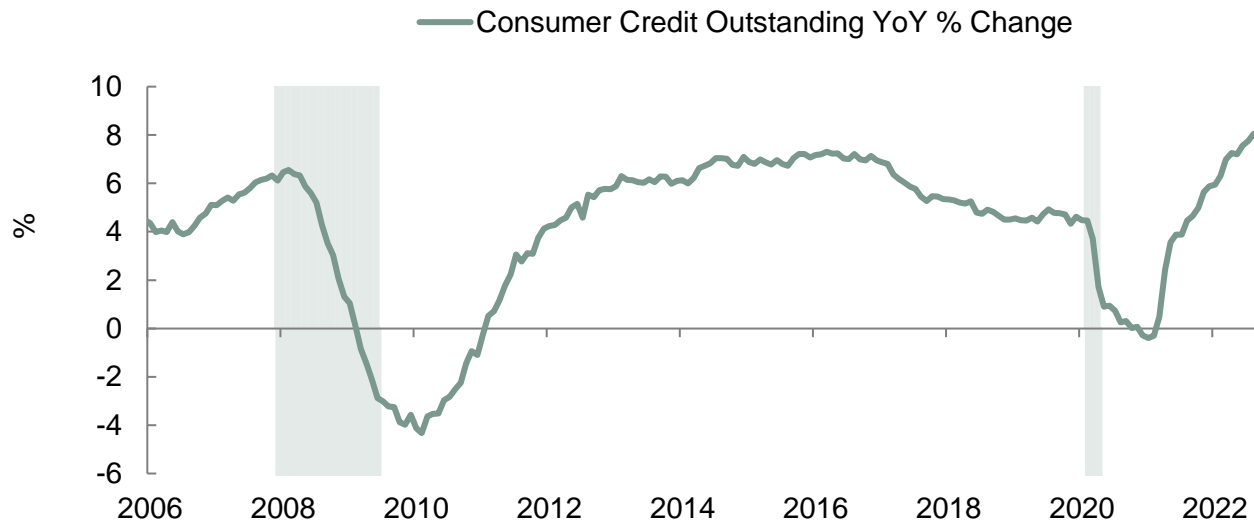
Consumption to Slow As Personal Savings Rate Rises



Running Up Credit Cards

- Household distress is evident from surging credit card usage. Over the past year, credit card balances are up 15%, which is the largest increase in over 40 years. This is particularly troubling considering the unemployment rate is still 3.5%.

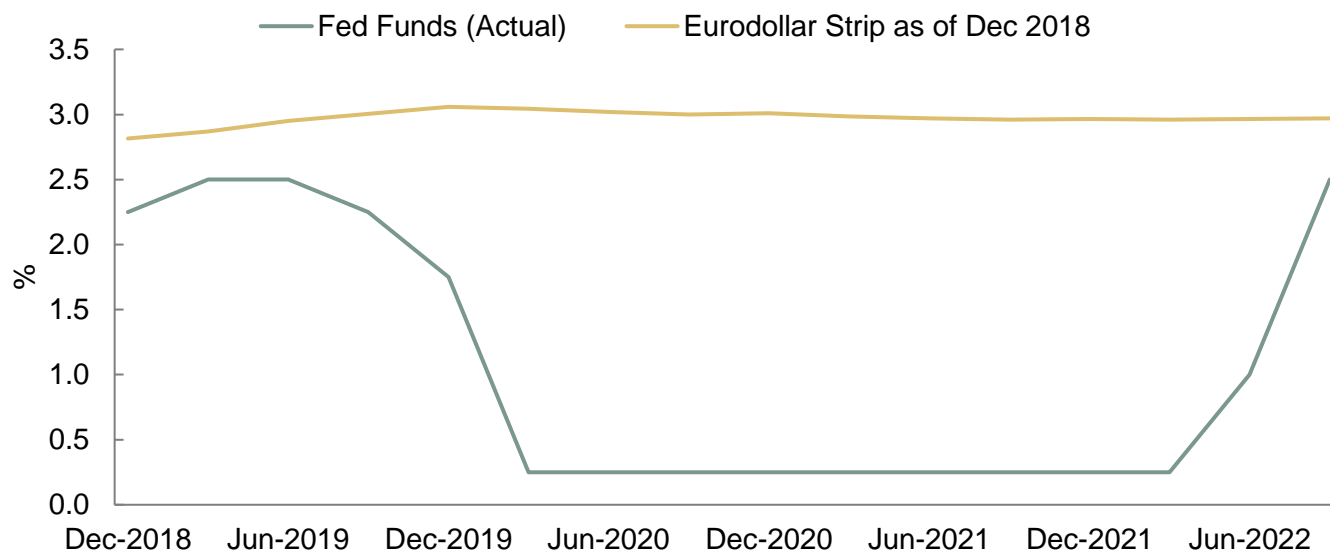
Soaring Credit Card Usage



Fed Turning Points

- The Fed is going to raise interest rates by 75 bps in November and likely again in December (but maybe only 25 bps) because inflation has yet to cool. We expect the Fed to begin cutting interest rates by the middle of next year. The bond market almost always misses these moves. Witness the Eurodollar curve on the last hike of the 2015 to 2018 interest rate cycle. Investors did not see the easing in policy.

End of 2018 Tightening Cycle – Actual Path of Fed Funds vs. Market Expectations



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