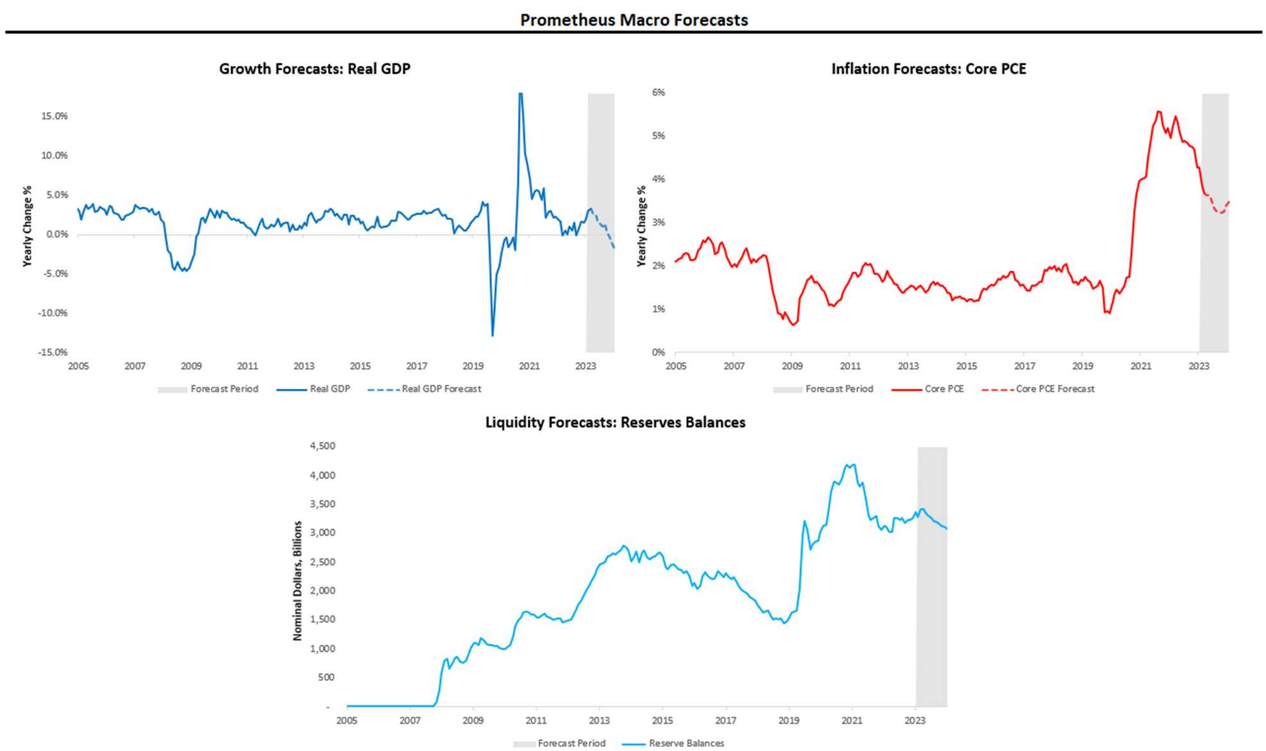
Month In Macro

This note aims to share our research team's internal checkpoint process in evaluating the current state of the economy as it pertains to markets. The pages that follow will have familiar content for those who follow our work, but with the added benefit of connecting the dots across all the economic and financial data our systems use to make portfolio decisions. Our primary takeaways are as follows:

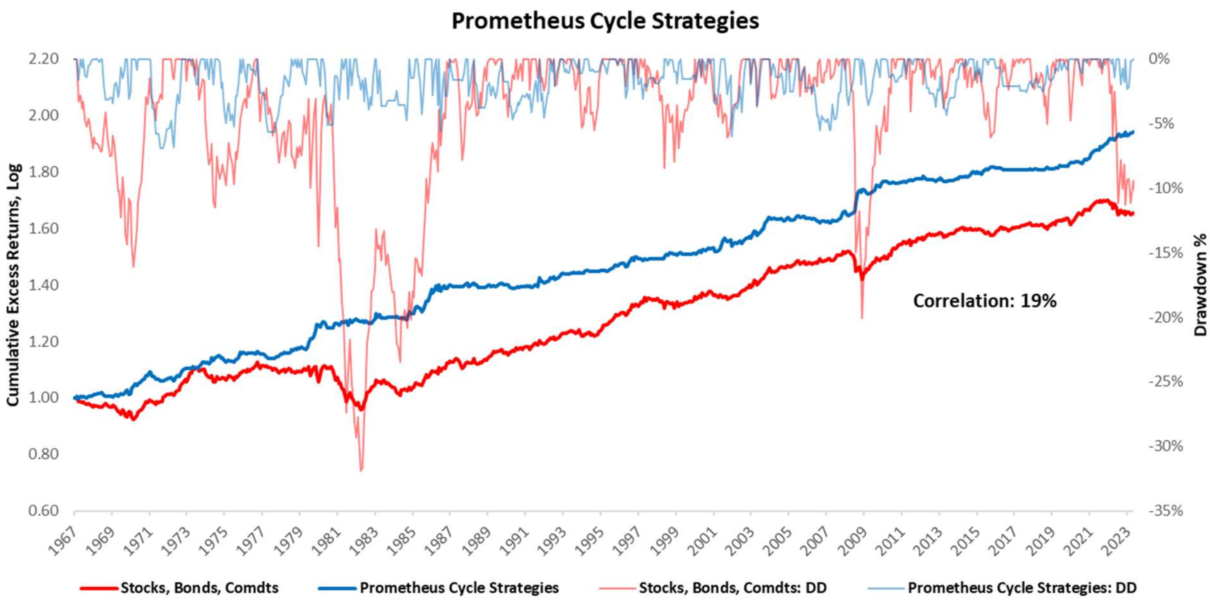
- ***Nominal GDP expanded by 0.66% in September, with real GDP increasing by 0.38% and inflation rising by 0.28%. Meanwhile, despite ongoing QT, reserve balances remained flat during the same period.***
- ***Most recent employment data shows signs of weakness driven by manufacturing weakness. We think this can continue, but not at the current pace. Until nominal activity declines meaningfully, we will remain in an inflationary regime.***
- ***Cross-currents from policy winds coming from the Fed and Treasury continue to blunt the tightening of financial and economic conditions. We expect these cross currents to keep liquidity at a high level.***
- ***After making all-time highs last month, our Cycle Strategies remain short stocks, short bonds, and long commodities.***

We begin with our high-level assessment. We expect growth to trend lower, inflation to remain resilient, and liquidity to contract modestly & slowly. We show our forecasts for each below:

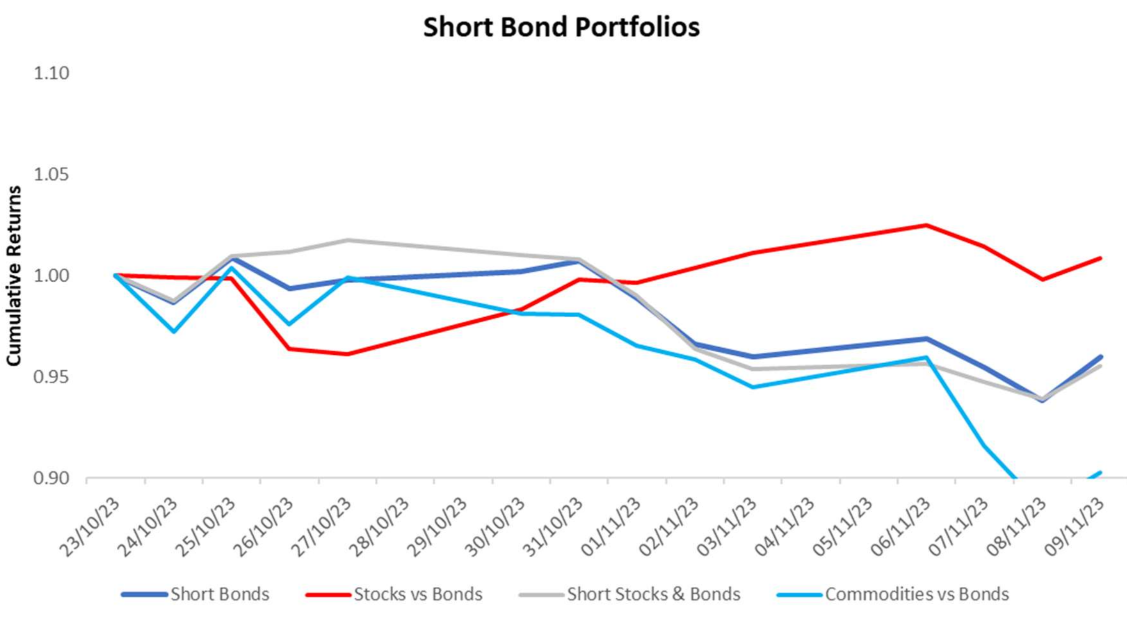


Our view remains consistent with those outlined in our previous Month In Macro, though our liquidity views have shifted to more neutral.

For reference, we show our Cycle Strategies below:



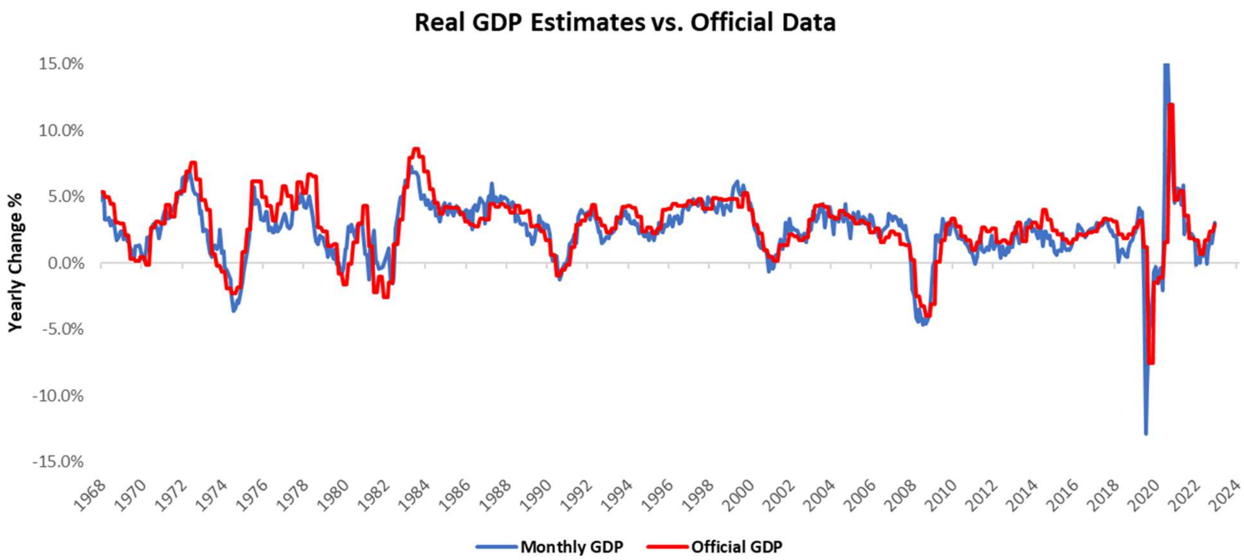
Above, we show the performance of our Cycle Strategies through October. November has thus far been less favorable to our exposures, with the short-bonds portfolio beginning to underperform over the last few weeks.



We consider this a significant development and think it is worth assessing the dynamics deeply. We largely attribute this change to recent declines in employment data, changes in Treasury issuance patterns, and the potential end of the hiking cycle. We evaluate these in great detail in the pages that follow.

GDP: Resilient Nominal Activity

Before we dive deep, we think setting the stage for where we are is essential. For the latest data through September, our systems place Real GDP growth at 3.04% versus one year prior. Below, we show our monthly estimates of Real GDP relative to the official data:



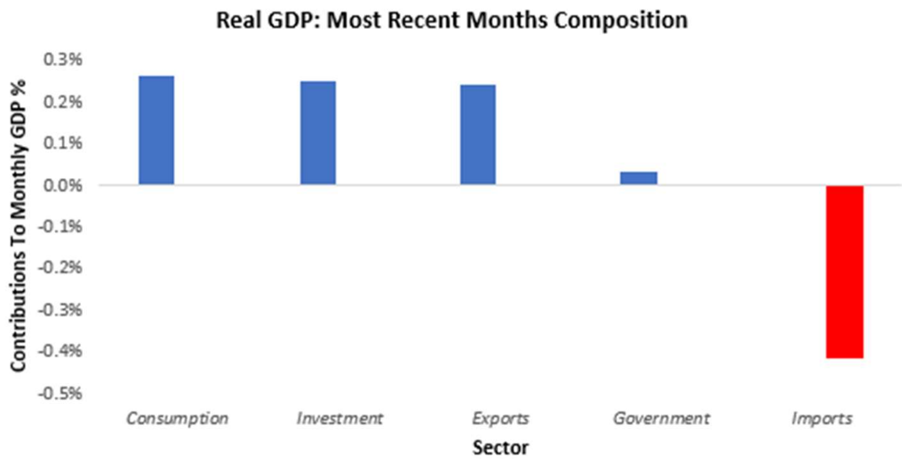
In September, GDP came in at 0.38% versus the prior month. We decompose the most recent months' data into its major divers to better understand this increase. Below, we offer the contribution by sector to monthly GDP in the table:

Contributions To Monthly GDP Changes

	GDP	*C*	*I*	*G*	*X*	*M*
Oct 22	-0.5%	0.1%	-0.2%	0.0%	-0.2%	-0.2%
Nov 22	0.4%	-0.2%	-0.1%	0.0%	-0.1%	0.8%
Dec 22	0.0%	0.1%	0.0%	0.0%	0.1%	-0.3%
Jan 23	0.8%	0.7%	0.1%	0.0%	0.5%	-0.5%
Feb 23	-0.1%	0.0%	0.0%	0.0%	-0.5%	0.3%
Mar 23	0.2%	-0.1%	-0.2%	0.0%	0.3%	0.2%
Apr 23	-0.5%	0.1%	0.2%	0.0%	-0.6%	-0.3%
May 23	0.8%	0.1%	0.1%	0.0%	0.2%	0.4%
Jun 23	0.5%	0.2%	0.1%	0.0%	0.1%	0.2%
Jul 23	0.4%	0.4%	0.1%	0.1%	0.1%	-0.3%
Aug 23	0.7%	0.0%	0.3%	0.0%	0.1%	0.3%
Sep 23	0.4%	0.3%	0.3%	0.0%	0.2%	-0.4%
Cumulative	3.0%	1.6%	0.7%	0.3%	0.3%	0.1%

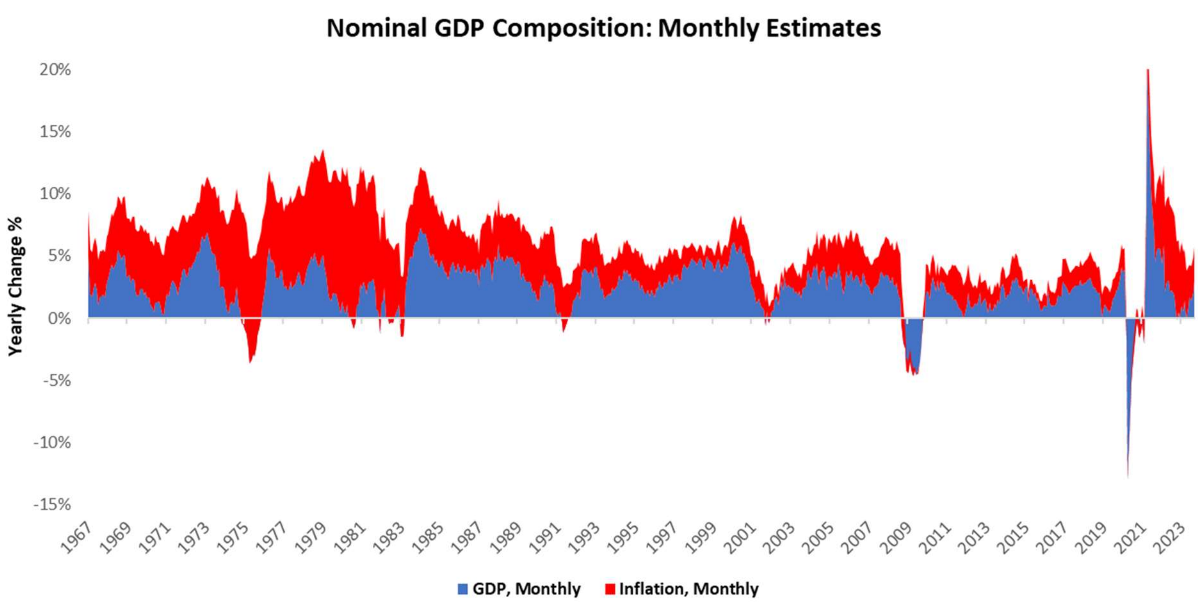
As we can see above, yearly GDP (cumulative, at the bottom of the table) has improved significantly, as investment has ramped up significantly after a difficult period during 2022. Additionally, consumption spending has remained resilient.

Below, we show the weighted contributions to the most recent one-month change in real GDP and the recent history of month-on-month GDP. Additionally, we offer the contribution by sector to monthly GDP in the table below:



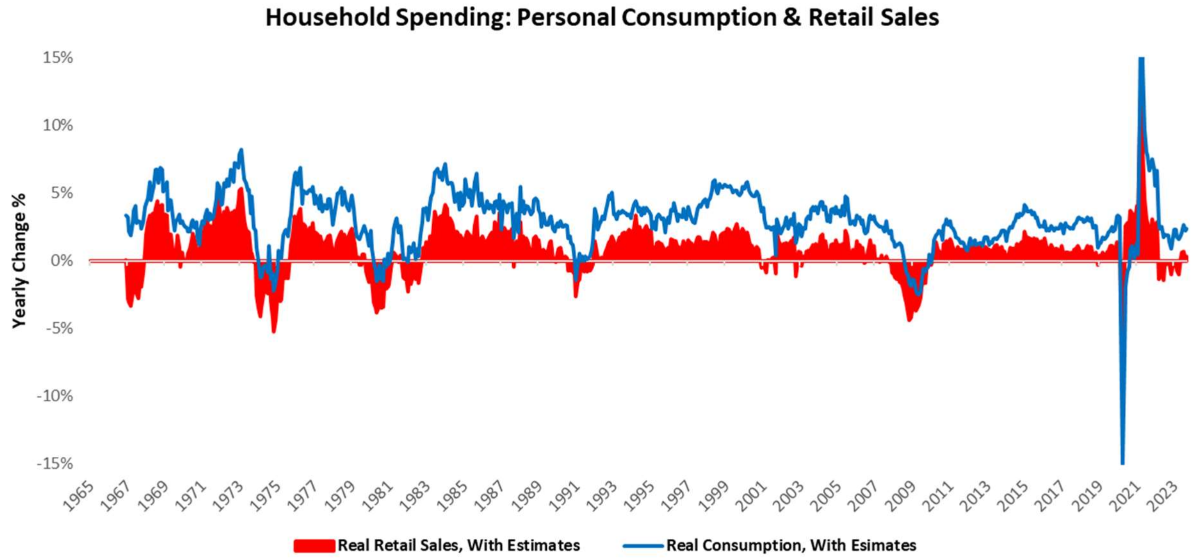
Real GDP MoM	
Oct 22	-0.5%
Nov 22	0.4%
Dec 22	0.0%
Jan 23	0.8%
Feb 23	-0.1%
Mar 23	0.2%
Apr 23	-0.5%
May 23	0.8%
Jun 23	0.5%
Jul 23	0.4%
Aug 23	0.7%
Sep 23	0.4%
Cumulative	3.0%

Our latest estimates place nominal GDP at 5.77% versus one year prior. Nominal activity continues to remain elevated relative to recent history:

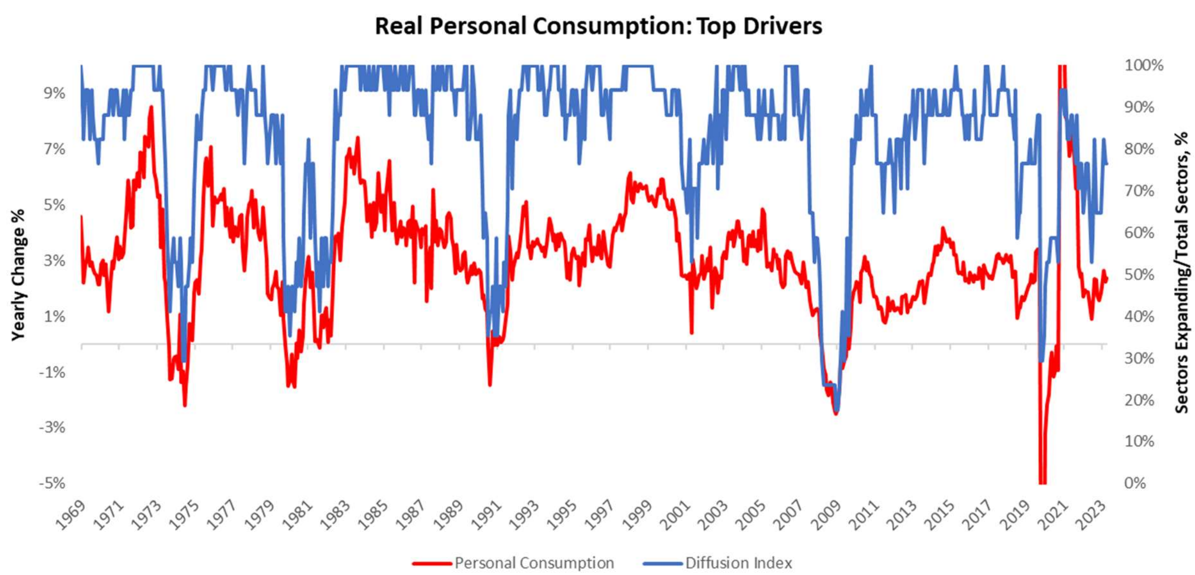


At a monthly print pace of 0.66% growth in September, nominal spending remains far away from conditions that are consistent with the Federal Reserve's 2% inflation target. Next, we turn back to real GDP to understand the composition of growth.

In September, real consumption spending increased by 0.27%. Over the last year, consumption has added 1.63% to GDP growth of 3.04%:

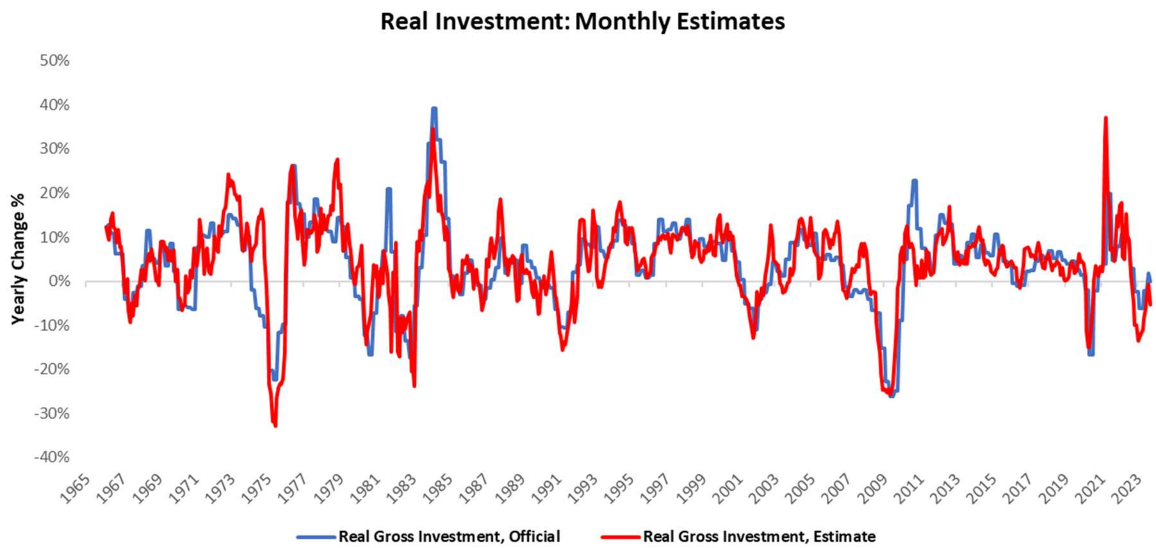


Personal consumption remains strong across the board, with 76% of industries showing increasing real spending over the last twelve months.

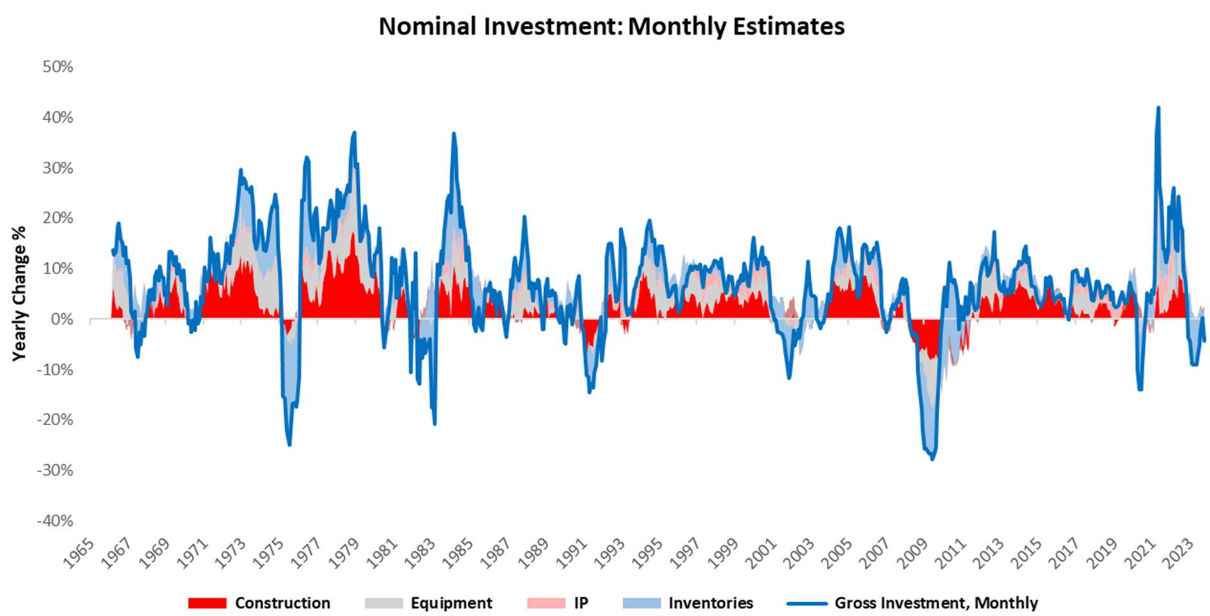


This strength in personal consumption reflects the strength of employment, which remains within secular highs relative to the labor force. It is important to note that consumption, while an important component of economic health, is not always very sensitive to recessionary conditions. On the other hand, real investment offers more insight into cyclical conditions.

In September, real gross investment increased by 0.25%. Over the last year, investment has added 0.65% to GDP growth of 3.04%.

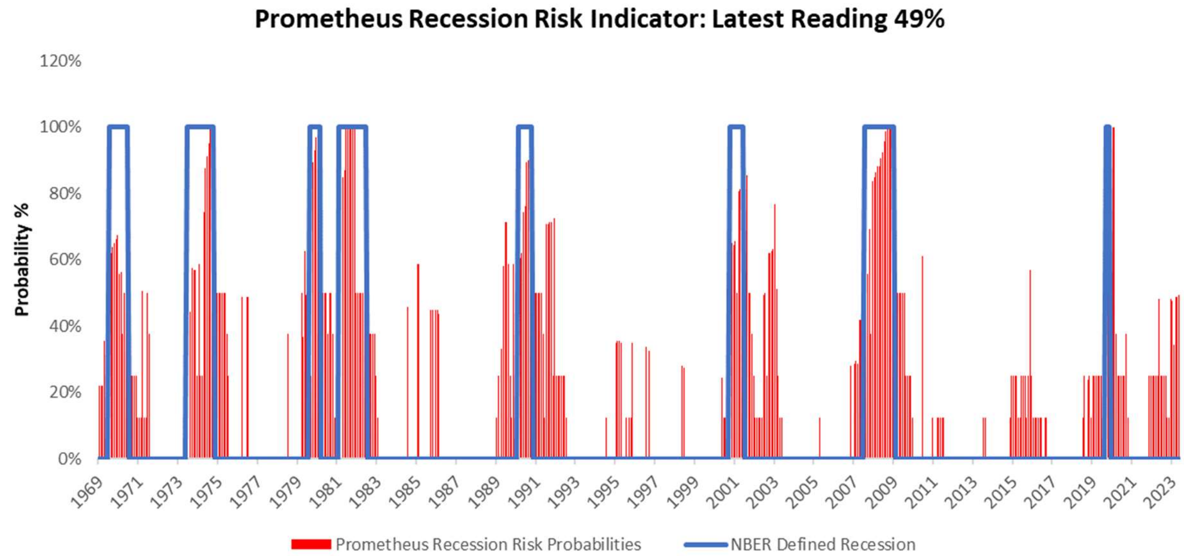


This move has largely come from an improvement in nominal spending on construction, along with a slowdown in the inventory drawdown that began late last year. Below, we show our nominal investment estimates by component:

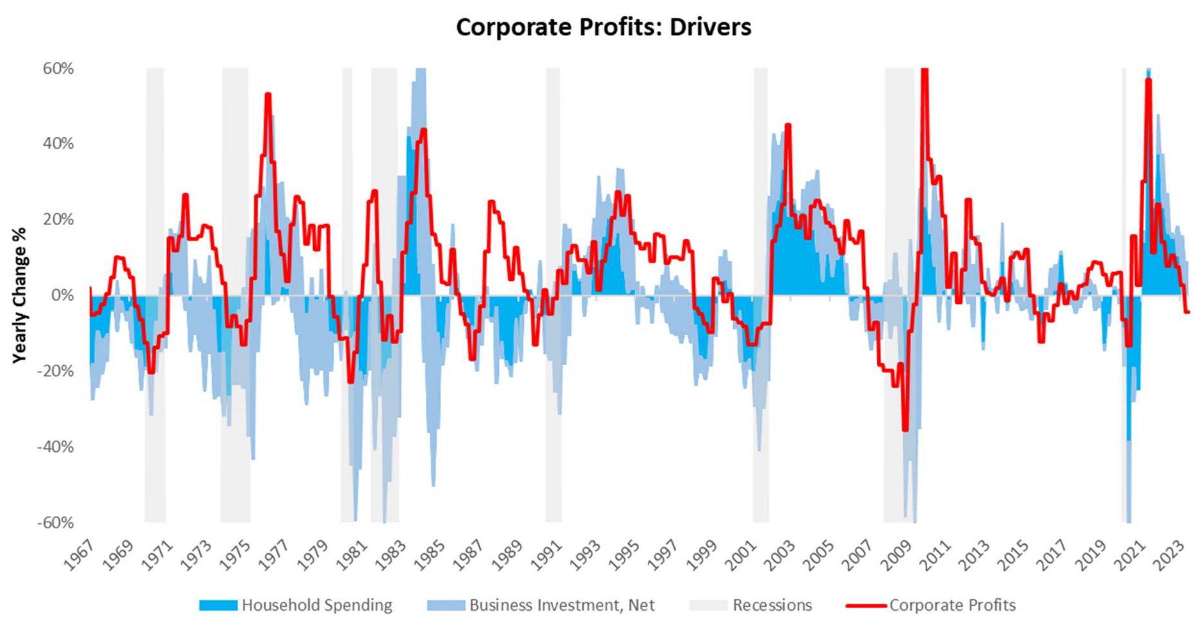


As we can see above, the upward shift in gross investment has significantly changed the environment, spurring a reacceleration of economic growth. The combination of resilient consumer spending and accelerating investment has kept recession odds compressed.

Below, we show our recession risk indicator, which has typically been a good contemporaneous barometer of recessionary economic conditions. Recession risk remains flat:



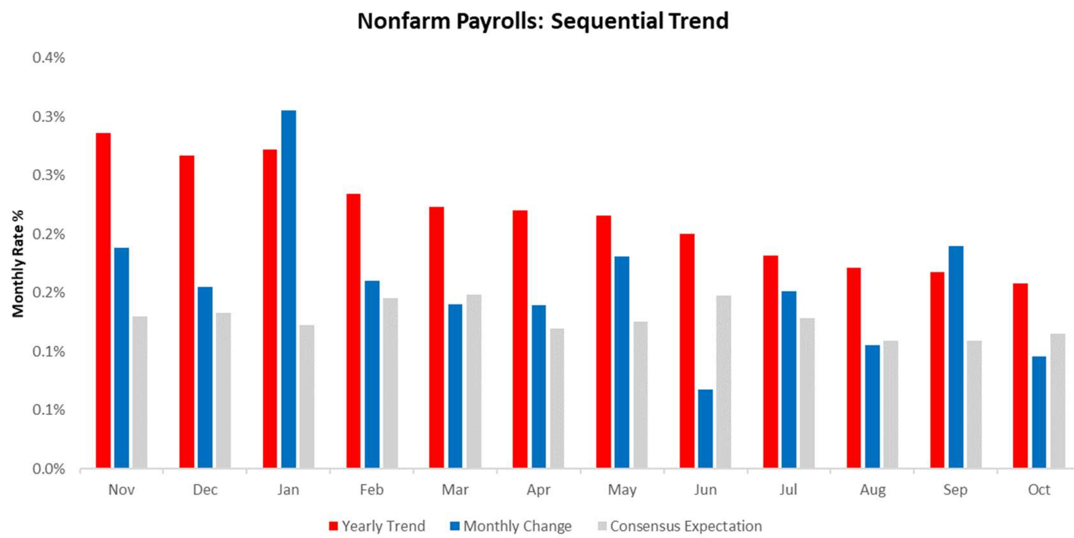
These contained recessionary pressures have allowed household spending and gross investment to continue to flow to corporate profits:



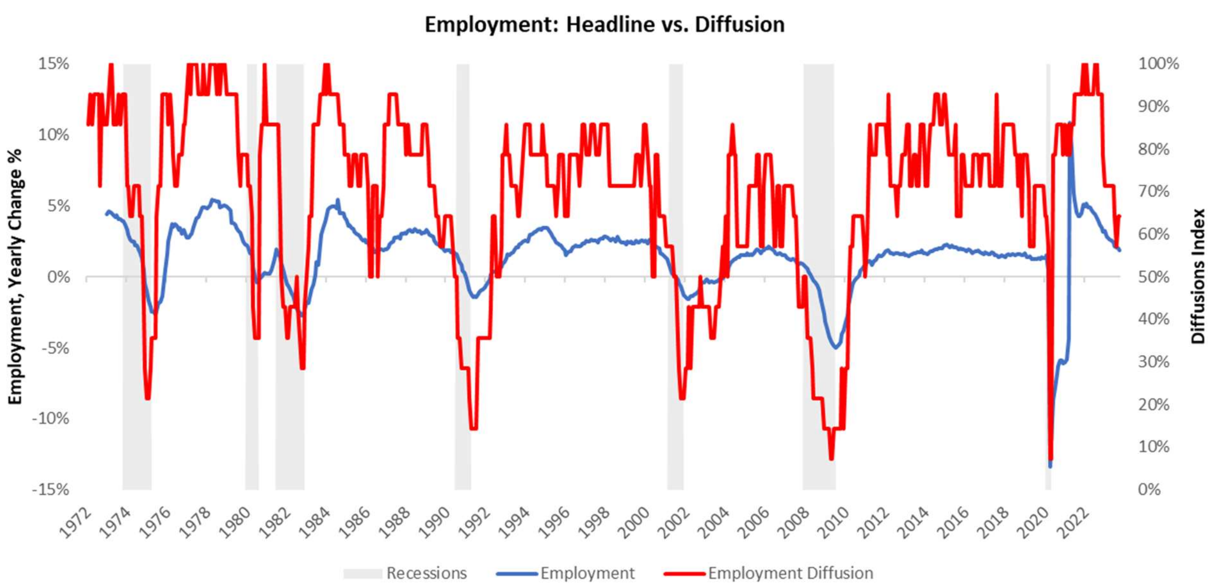
As we can see above, corporate profits have declined, with resilient nominal GDP preventing precipitous declines. However, there have been recent indications that we may have reached a crucial juncture in the economic cycle, i.e., employment has begun to show some modest weakness. We examine this in detail in the next section to assess these conditions.

Cyclical Spotlight: Is Employment Turning?

A development that has significantly impacted markets has been the recent weakness in employment data. Archetypically, short rates rise, nominal spending falls relative to interest burdens, profits get squeezed, and only then do significant lay-offs occur. We dissect the drivers to understand better if this downtrend is durable. To begin, we visualize the recent weakness in nonfarm payrolls below:



Nonfarm payrolls increased 0.1% in October, disappointing consensus expectations of 0.11%. This print contributed to a sequential deceleration in the quarterly trend relative to the yearly trend. While this print wasn't a contractionary one, breadth has begun to weaken meaningfully:



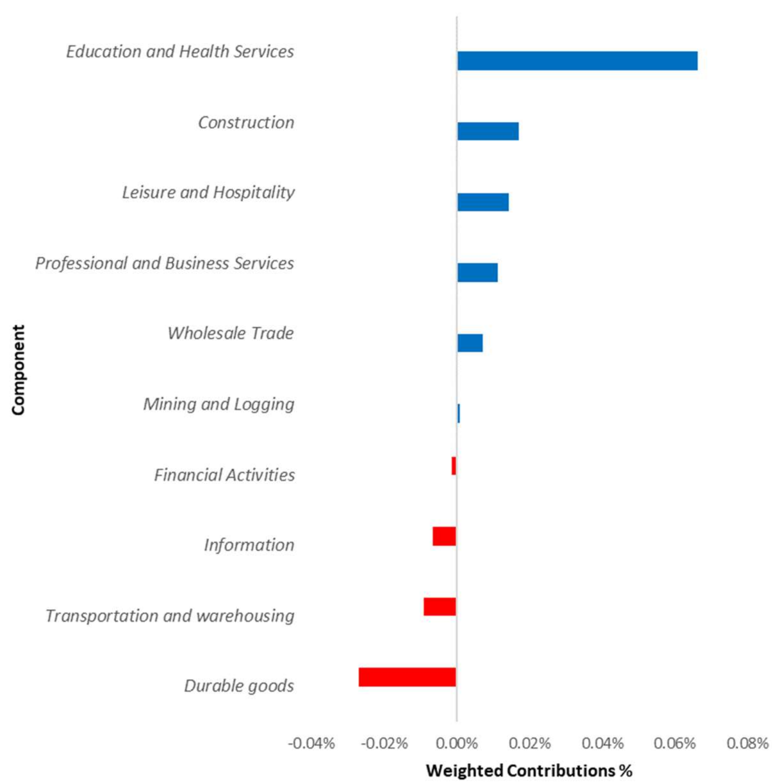
This weakness in employment has come alongside weakness in hours and nominal wages, resulting in weak nominal income data for October. We show the decomposition of our estimates below:

Nominal Employee Income: Composition, Most Recent Month

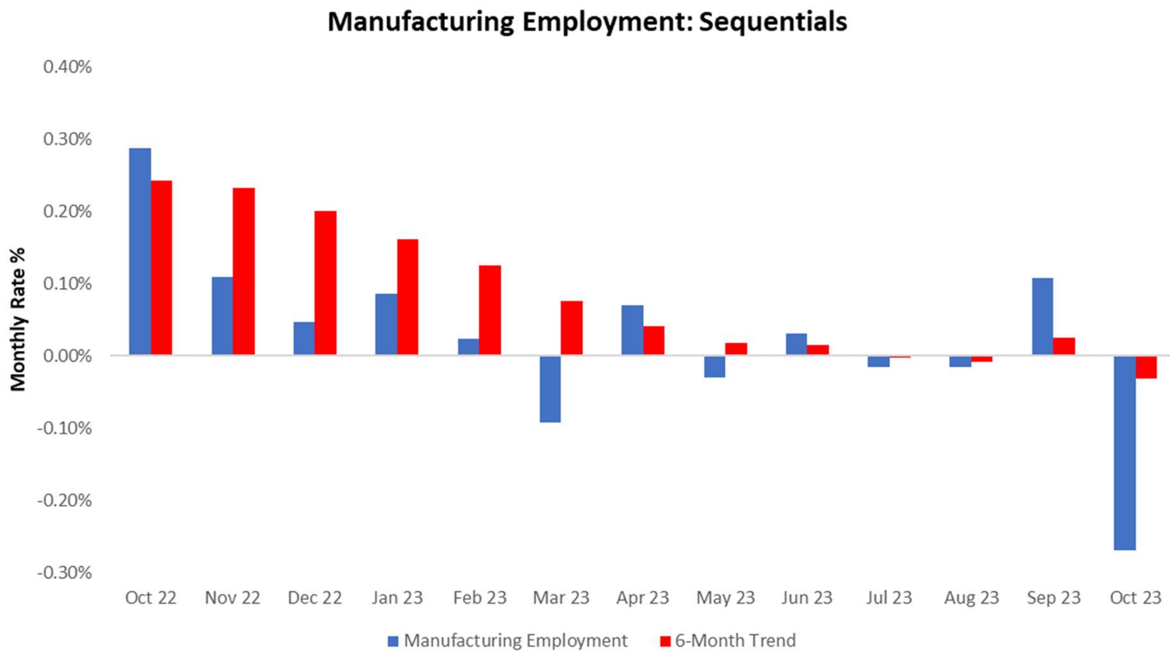
	Nominal Income	Employment	Real Wages	Hours	Wage Inflation
Durable goods	-0.05%	-0.03%	0.00%	-0.04%	0.02%
Wholesale Trade	-0.04%	0.01%	-0.01%	-0.03%	-0.01%
Professional and Business Services	-0.03%	0.01%	-0.01%	-0.12%	0.08%
Retail Trade	-0.03%	0.00%	-0.01%	-0.02%	0.01%
Financial Activities	-0.01%	0.00%	0.02%	-0.03%	-0.01%
Mining and Logging	-0.01%	0.00%	0.00%	0.00%	-0.01%
Transportation and warehousing	0.00%	-0.01%	0.00%	-0.01%	0.02%
Information	0.00%	-0.01%	-0.01%	0.01%	0.01%
Utilities	0.00%	0.00%	0.00%	0.00%	0.00%
Nondurable goods	0.01%	0.00%	0.00%	0.01%	0.00%
Other Services	0.01%	0.00%	0.00%	-0.01%	0.02%
Leisure and Hospitality	0.03%	0.01%	-0.02%	0.00%	0.04%
Education and Health Services	0.05%	0.06%	-0.02%	-0.05%	0.07%
Construction	0.06%	0.02%	0.00%	0.00%	0.03%
Total	**-0.01%**	**0.07%**	**-0.10%**	**-0.29%**	**0.31%**

As we can see above, over October, we have seen a broad-based contraction in employment. Zooming in, the primary drivers of this print were construction (0.02%), Durable goods (-0.03%), and education and health Services (0.07%). Below, we show the top 10 drivers of the monthly change:

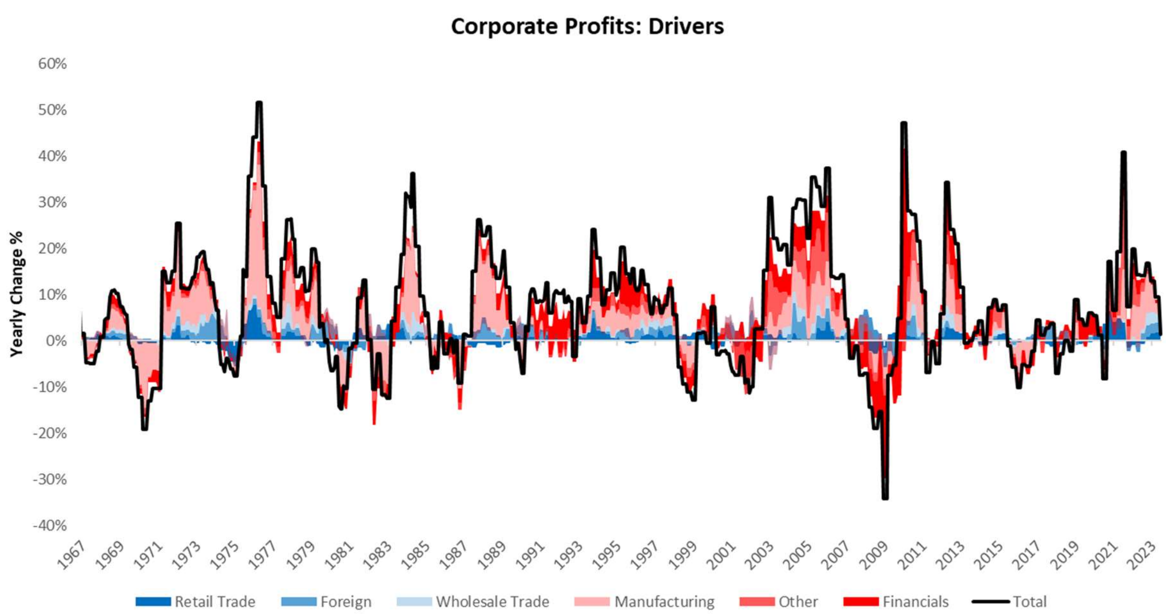
Nonfarm Payrolls: Top 10 Contributions To Monthly Change



As we can see above, this weakest area of employment was durable goods manufacturing, continuing a recent trend of weak manufacturing employment. We highlight weaknesses by showcasing the sequential data in manufacturing employment:

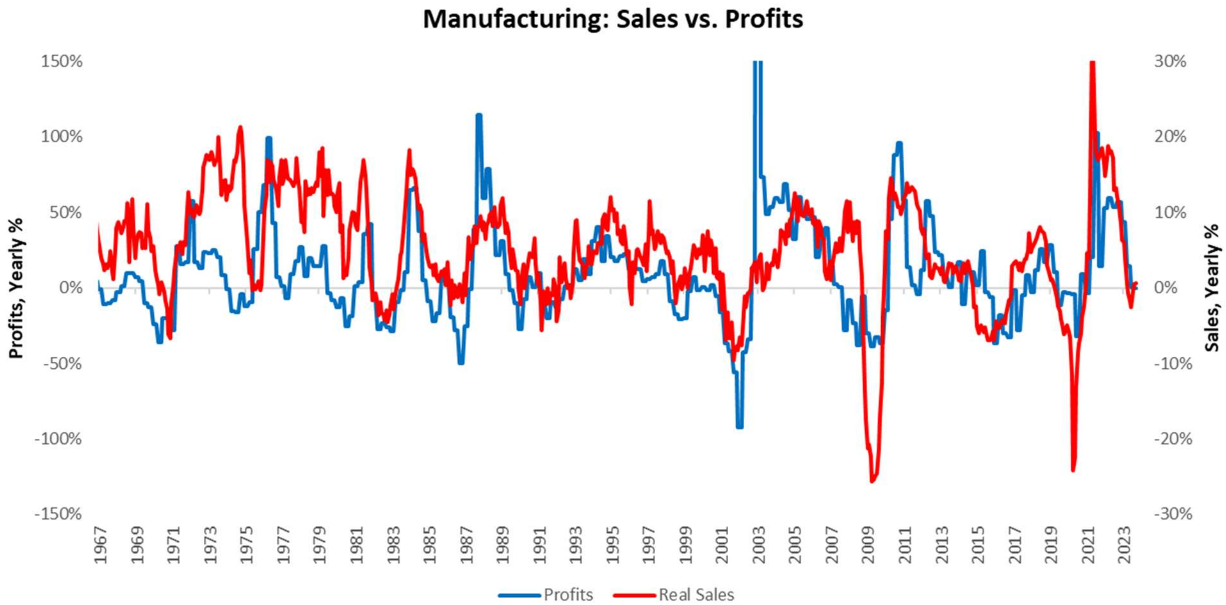


Manufacturing activity is of significant importance during this economic cycle and over time. This significance is because the manufacturing sector accounts for a large share of corporate profits. Most recently, manufacturing profits have declined:

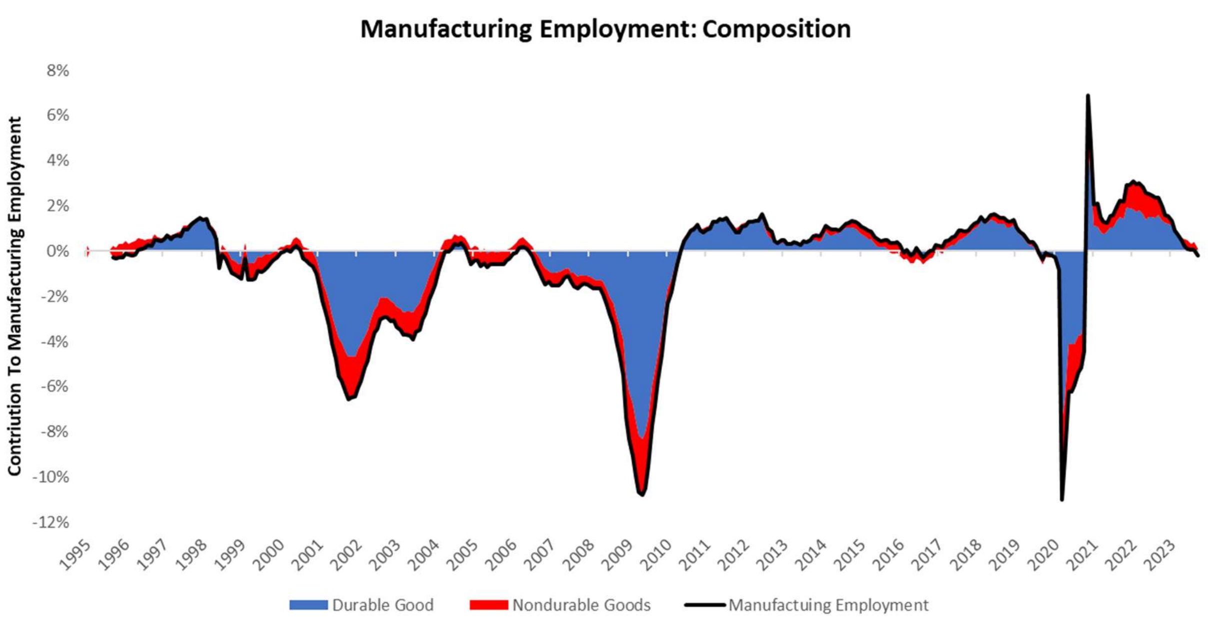


As we can see above, manufacturing has joined financials as a drag on corporate profits. This change is consistent with the pressures we have seen from nominal sales.

Below, we visualize the relationship between nominal sales and profits for the manufacturing industry. As we can see below, recent profit declines are consistent with contracting nominal sales:

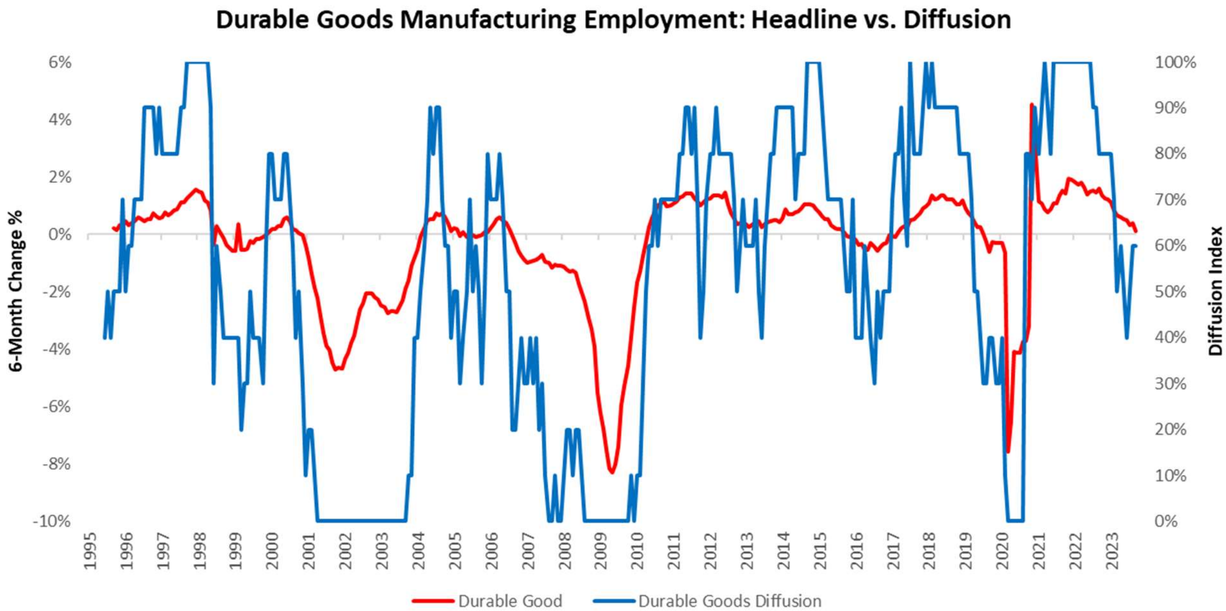


As such, barring a significant upturn in manufacturing activity, manufacturing employment will likely remain under pressure. To better understand the distribution of pressures, we zoom into manufacturing employment. There are largely two areas, durable and nondurable employment:

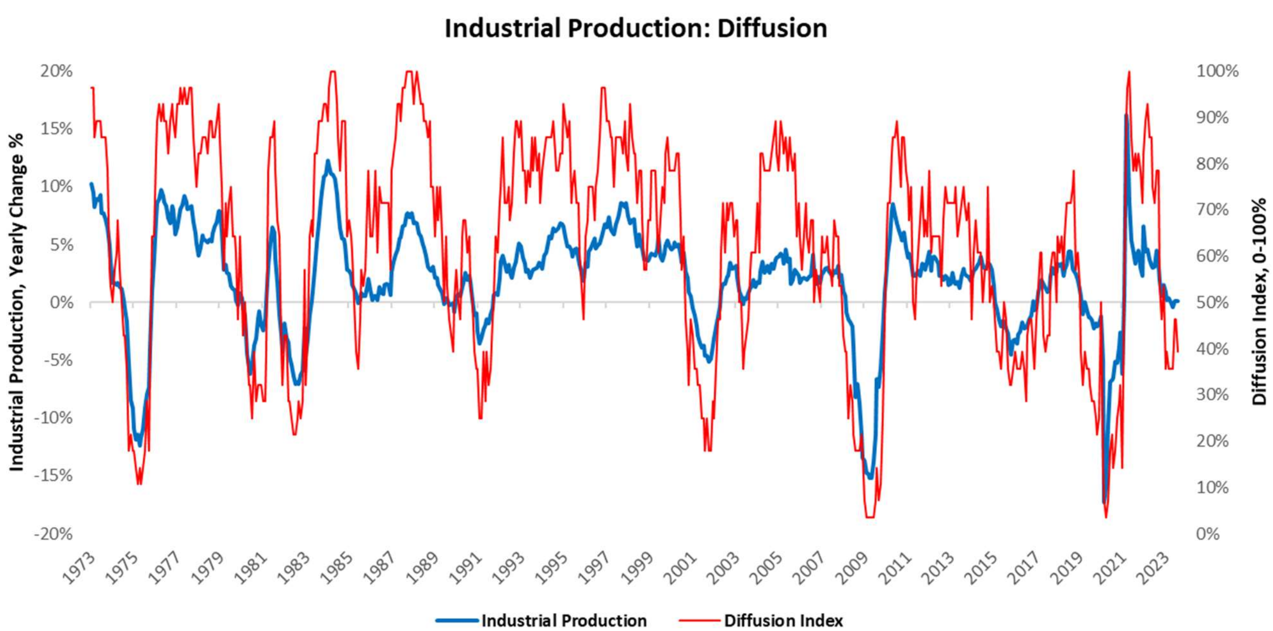


As we can see above, durable goods employment accounts for the majority of manufacturing employment. Furthermore, it has been the primary driver of recent weakness. We drill down deeper.

To assess the breadth of weakness in durable goods manufacturing, we look at the headline numbers relative to the diffusion of the subcomponents. We show this below:

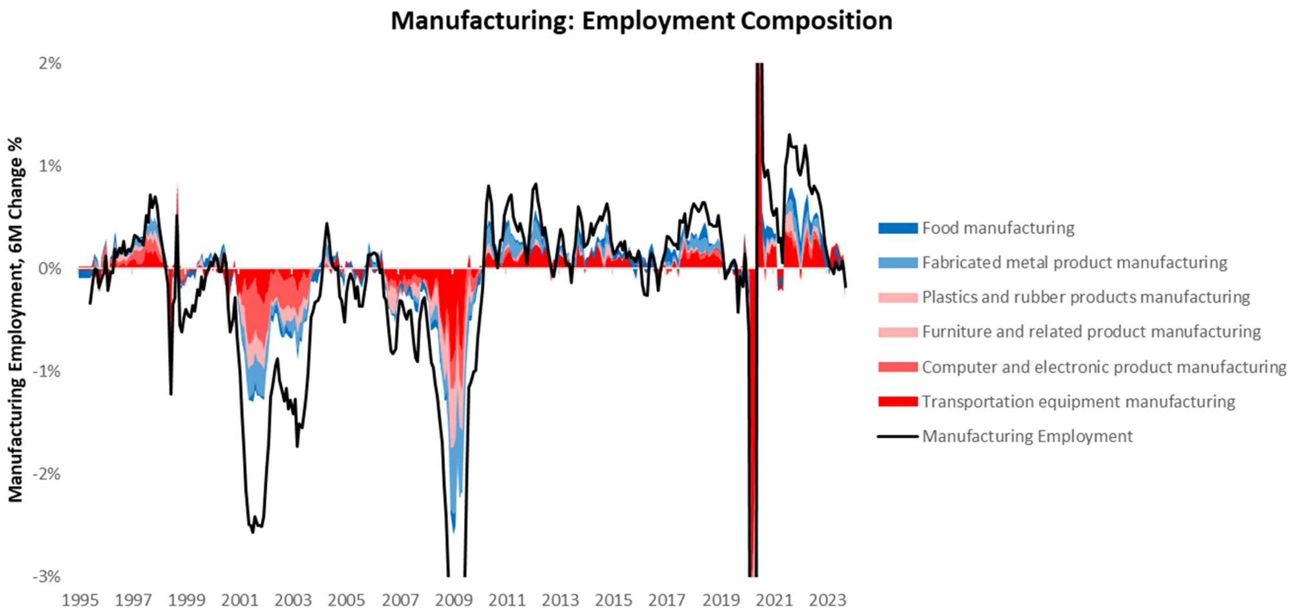


As shown above, approximately 40% of subindustries have laid off workers over the last six months. These conditions are consistent with what we see from industrial production data:

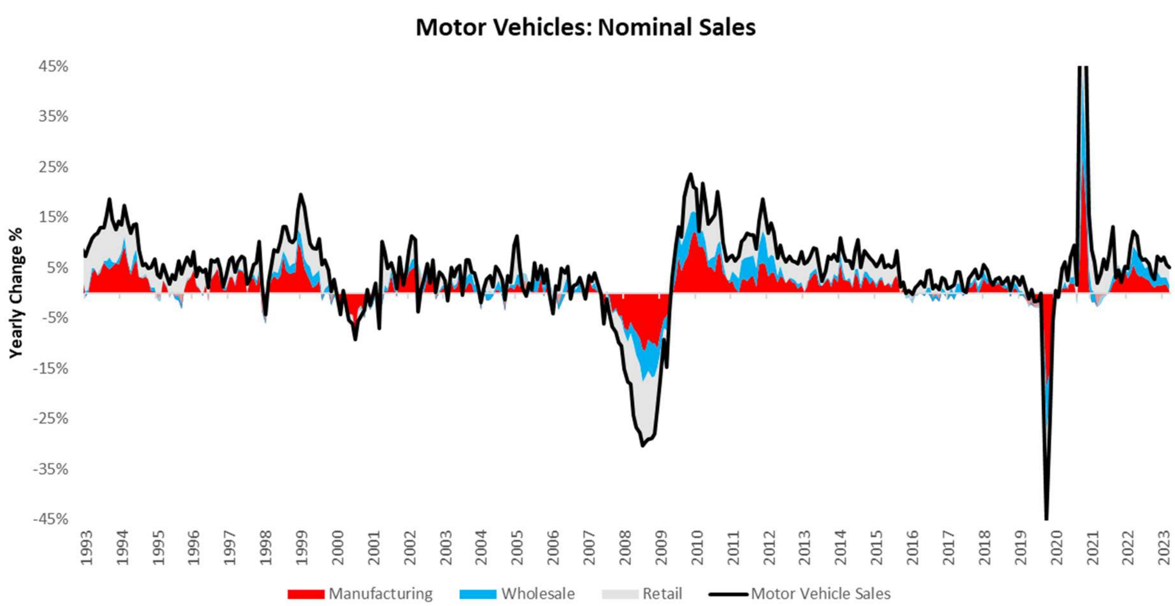


As we can see above, consistent with manufacturing sales and profits data, industrial production shows significant weaknesses in output, both in level and diffusion.

Thus, the weakness in manufacturing looks broad-based and expanding. However, while we think it makes sense for this weakness to continue to spread, we think it is important to highlight that it is unlikely to continue to spread at the current pace. This expectation comes from our understanding of transportation income dynamics, which remain robust relative to their employment. Transportation manufacturing was the largest contributor to the slowdown in durable odds employment last month and has contributed significantly to recent weakness:

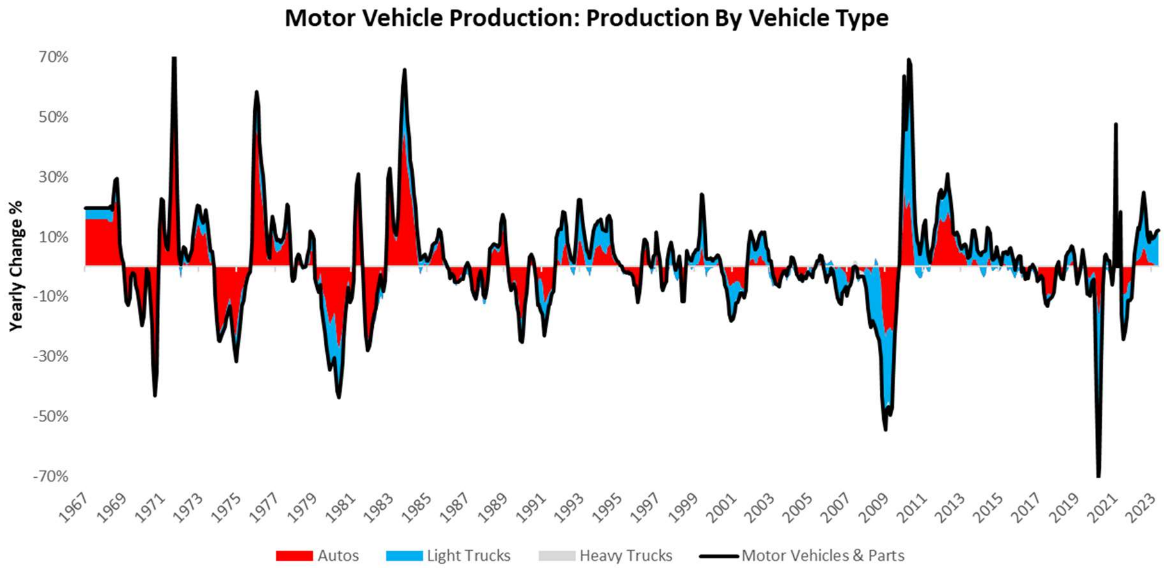


While this is consistent with broad manufacturing weakness, it is inconsistent with transportation dynamics. Below, we show nominal sales across the motor vehicle complex:

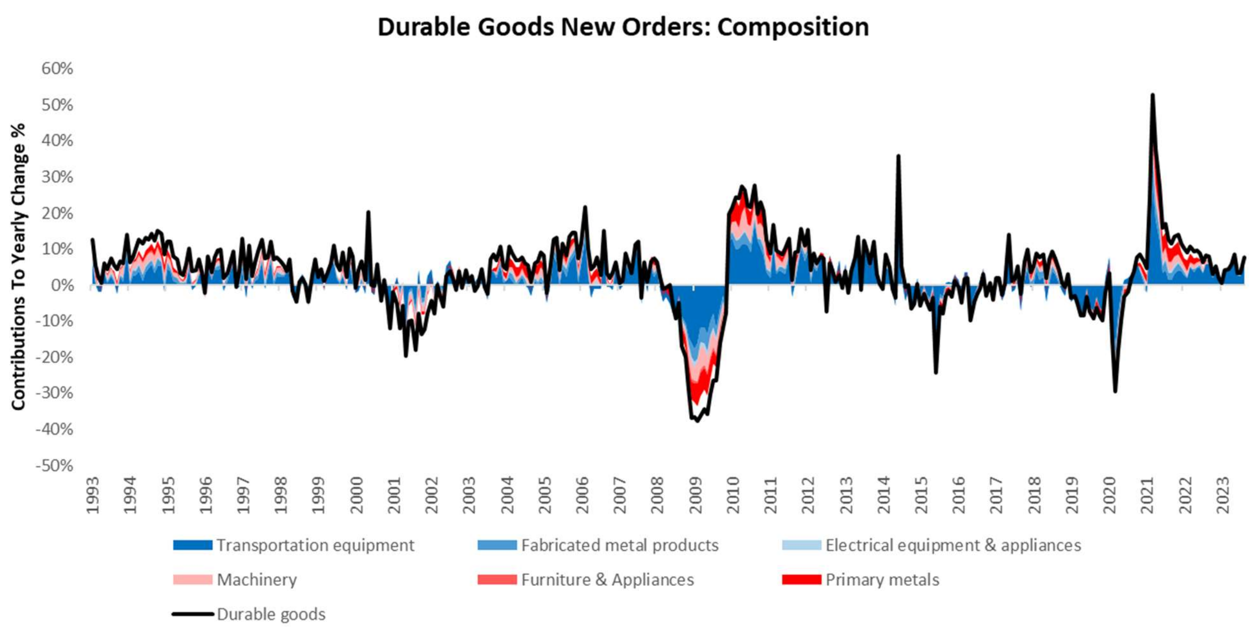


As we can see above, nominal sales remain strong for motor vehicles.

Furthermore, motor vehicle product remains strong as well. We show production by type:

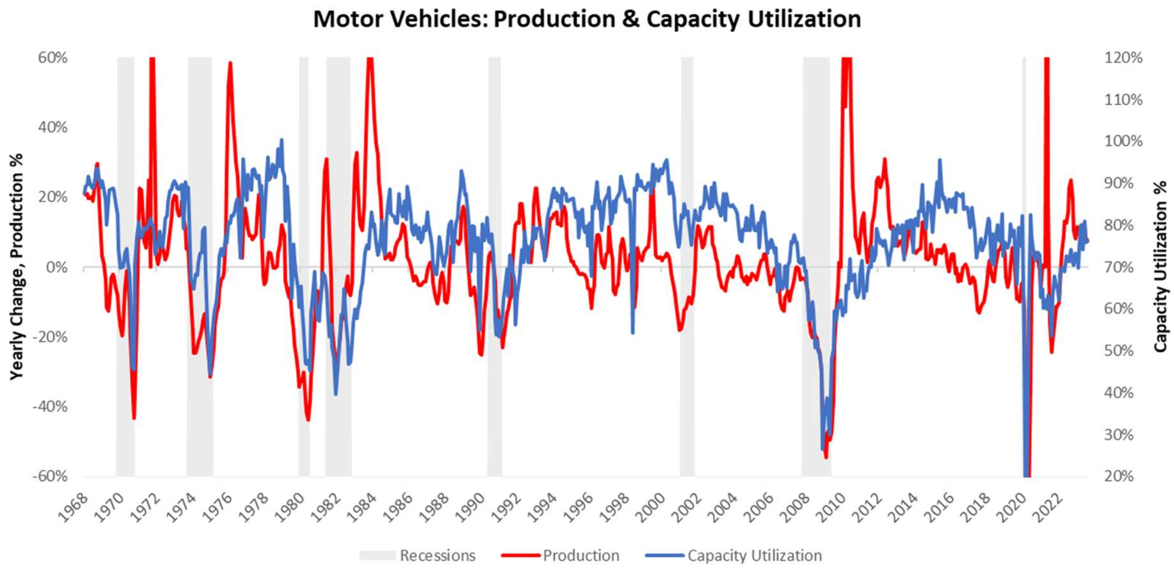


Additionally, orders for new transportation remain the strongest part of manufacturing durable new orders in the economy.



As we can see above, new transportation equipment orders have almost single-handedly kept orders for the manufacturing sector in expansionary territory. This strength is not just in nominal activity but also in real activity.

Motor vehicle production and capacity utilization have typically been good indicators of cyclical conditions. Currently, motor vehicle production relative to capacity is inconsistent with a recession. According to our estimates, readings between 65% and 43% are consistent with recessionary activity.



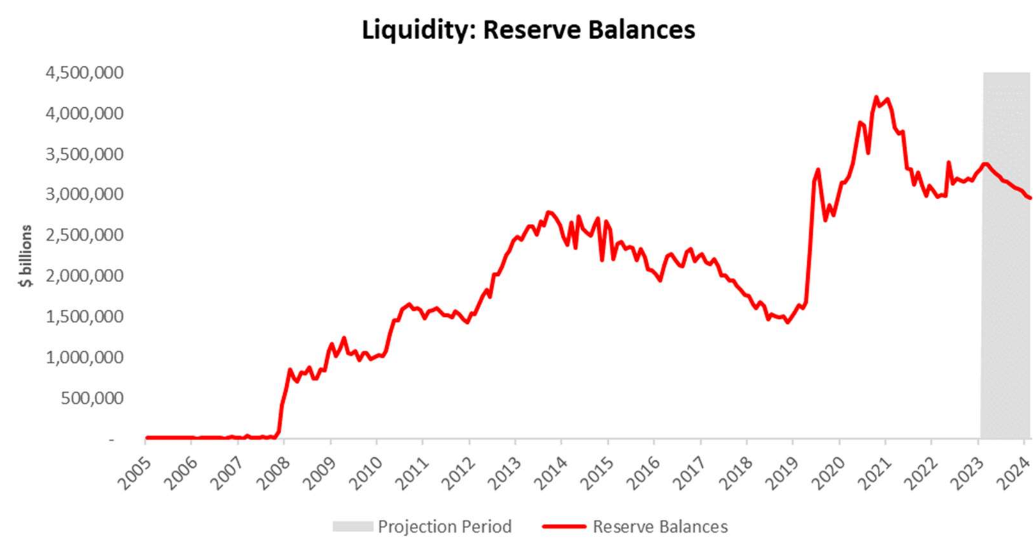
Therefore, through triangulation, our assessment of the weakness in transportation manufacturing employment stems from the UAW automobile workers' strike rather than from underlying weakness in the sector. As such, upon completing a deal between union workers and automobile companies, transportation employment will likely bounce. This bounce will likely temper the magnitude of ongoing manufacturing weakness's impact on employment. To be clear, our assessment is that manufacturing will weigh on employment; it just won't continue at the same pace, given transportation dynamics. The weakness in the manufacturing sector is another step forward in the archetypical cycle template, but significantly more softening is required for a broader impact.

Liquidity: High And Stable Under Policy Cross-Currents

Liquidity conditions are at a complex juncture, with significant cross-currents and varying market impacts. As such, we think providing a detailed dissection of liquidity dynamics is essential better to understand the path for asset markets and the economy. Our assessment of conditions is as follows:

- ***The fiscal impulse has fallen off markedly, slowing the flow of government spending to nominal GDP. This decline has occurred as the Treasury has moved to raise its cash balances, with revenues remaining weak and spending moderating significantly.***
- ***This decline in spending has created a deceleration in the rate of Treasury issuance, both in terms of gross issuance and the issuance of coupon securities. The decreasing pace of issuance has ameliorated some of the pressures in the bond market.***
- ***Slowing gross issuance is likely to have two impacts. First, it will likely marginally support treasury bond markets as the private sector has to absorb fewer coupon securities. Second, the slowdown in bill issuance will likely result in further money market funds invested at the reverse repo facility at the Federal Reserve.***
- ***Money from reverse repo will likely flow directly or indirectly into risk assets via the banking system and repo markets. Thus, any declines in the reverse repurchase facility in excess of the Quantitative Tightening clip will support reserve balances.***
- ***Finally, the tightness of monetary policy via interest rates has likely reached an interim peak. This pause will result in the moderation of tightening pressures in financial markets. Conversely, this will also cap the short-rate benefit that has flowed to many corporations and households relative to their slow-moving debt service costs. As such, the market-discounting impact of higher short rates is likely to be behind us, while the economic impact on income and spending will likely be ahead of us.***

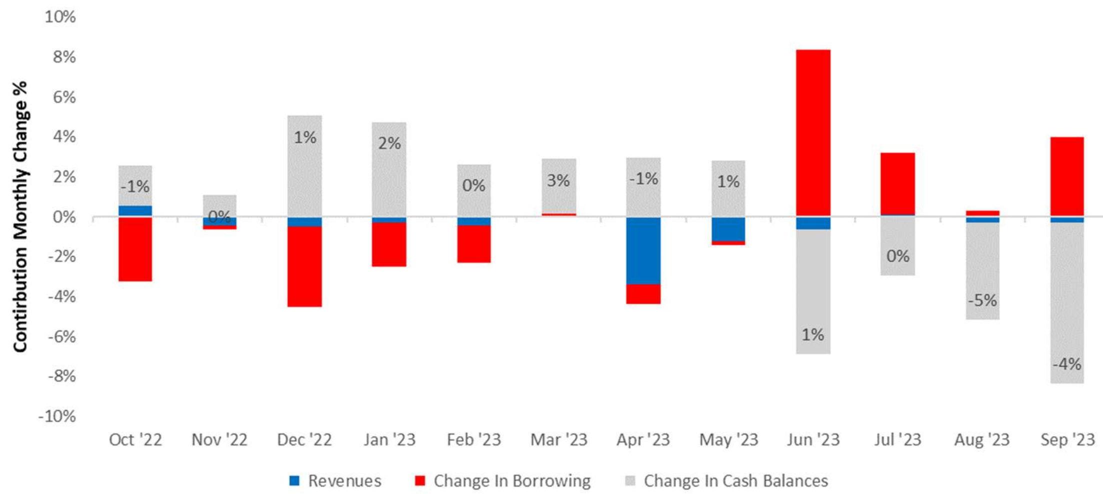
When we net these dynamics, we see conditions continuing to worsen but at a slower trend. While falling reserve balances will drag financial system liquidity, we expect that private sources can offset the pace of decline. As a high-level anchor, show this expected path for reserve balances below:



In the pages that follow, we work through the drivers of our assessment.

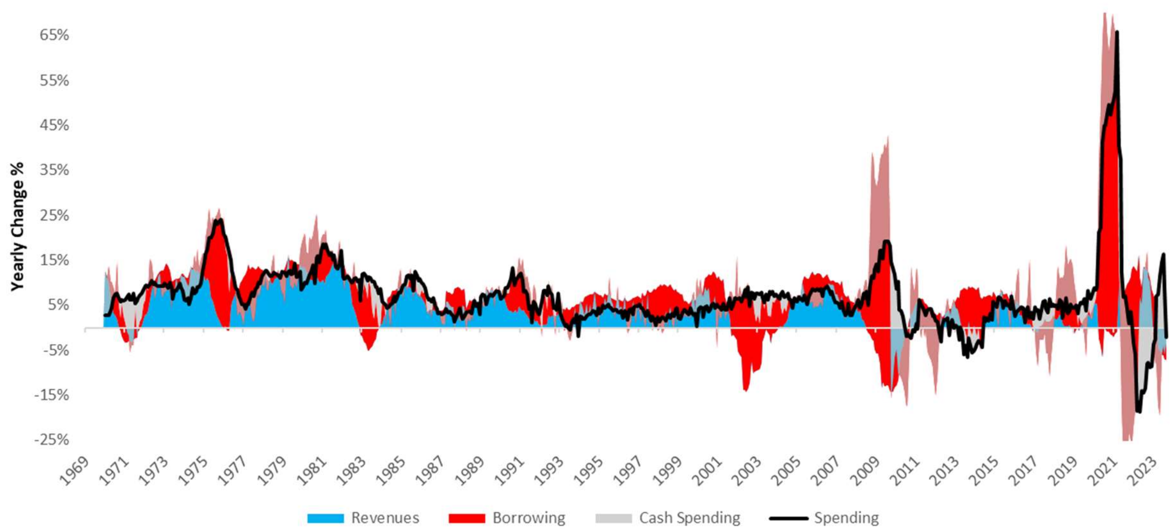
We begin with our tracking of the fiscal impulse. As outlined previously, the fiscal impulse has deteriorated materially. Below, we show our sequential tracking of fiscal spending and its composition:

Fiscal Spending: Sequentials & Composition



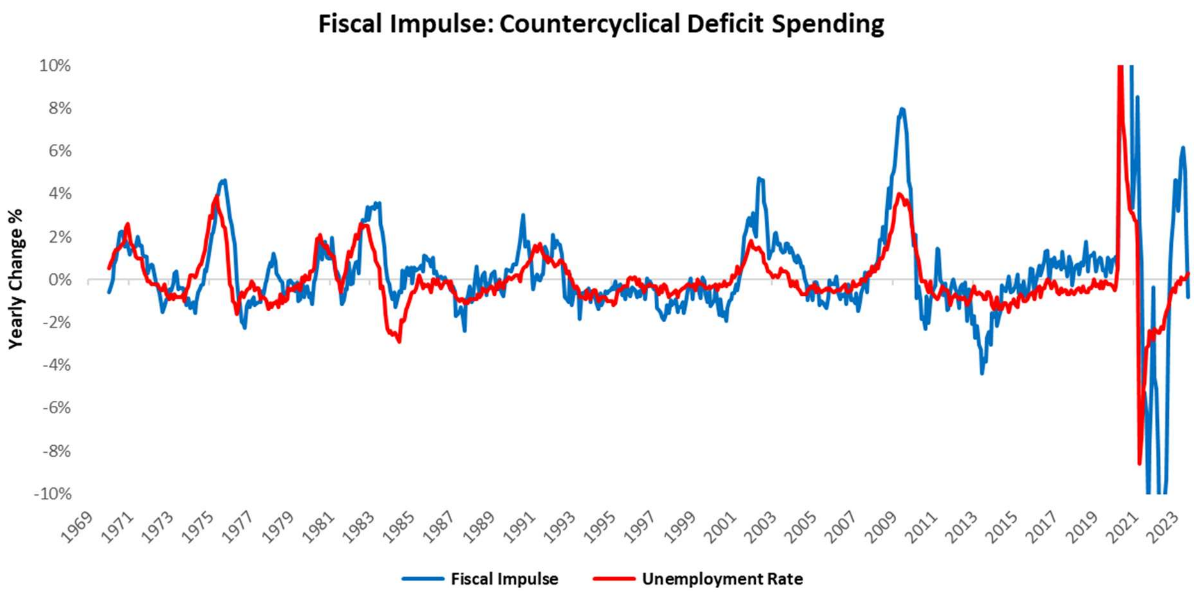
As we can see above, fiscal spending has slowed as the Treasury has moved to increase its cash balances in the form of the Treasury General account. We zoom out to offer a big-picture perspective on the yearly changes below:

Fiscal Impulse: Sources

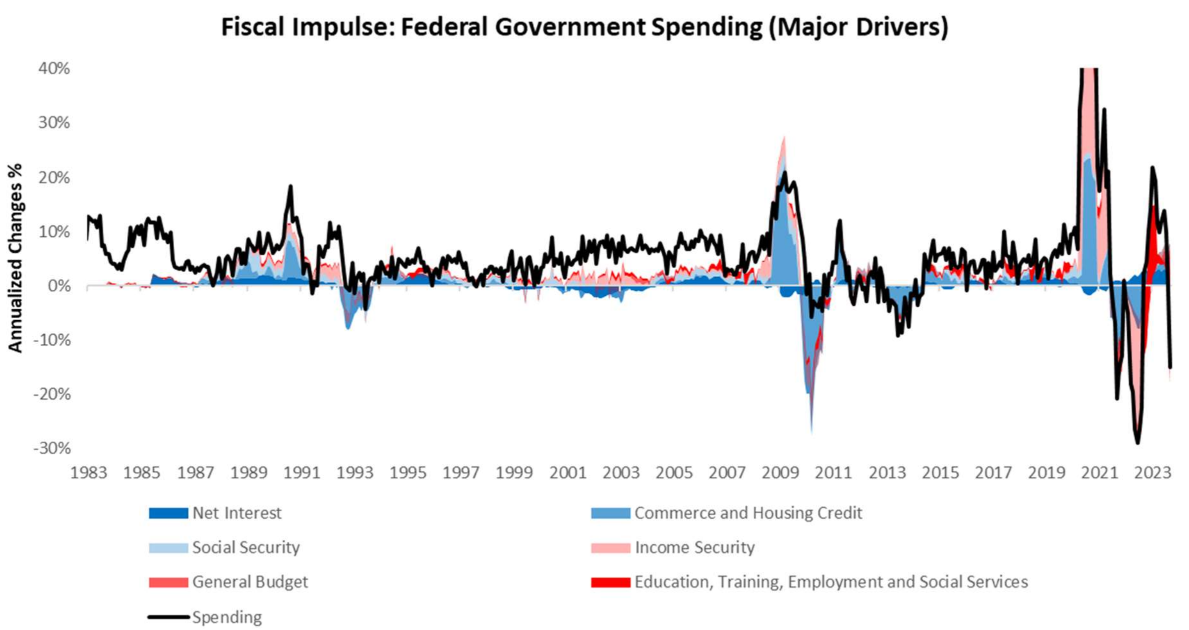


If sustained, this pullback in fiscal impulse will create conditions that are far more consistent with current economic conditions. Fiscal spending typically ramps up as economic activity slows, offering an automatic stabilizer to the economy.

Below, we show how this logic has borne out over history. As we can see below, the fiscal impulse is typically a countercyclical stabilizer to the economy, and the recent reversion reflects the lack of need for the stabilizers.

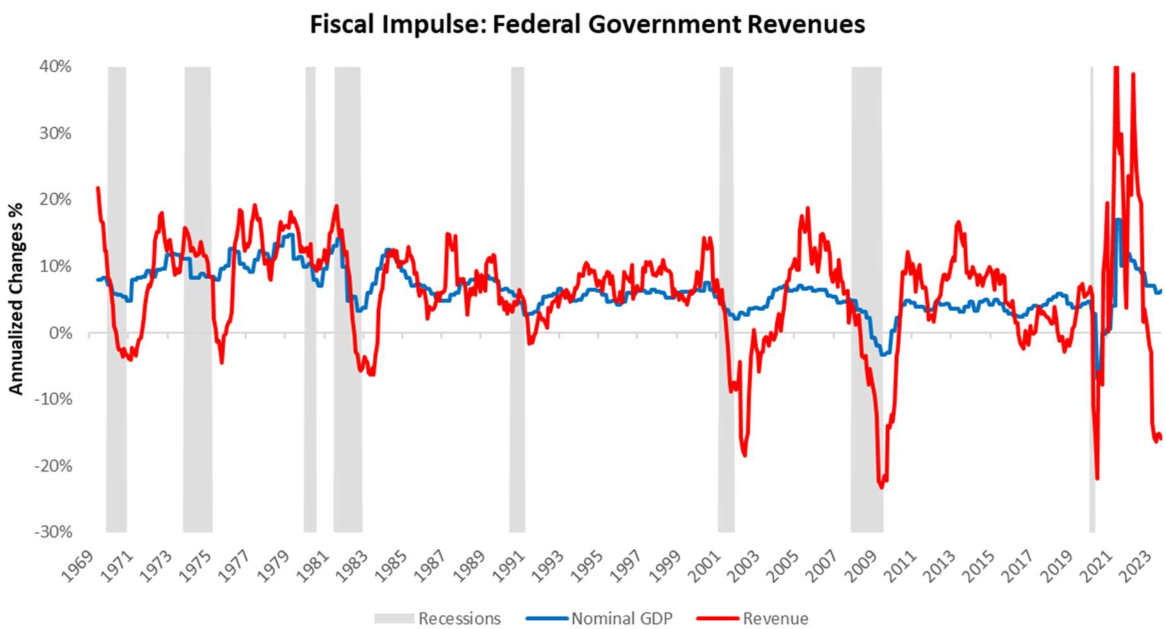


To better understand what is driving this sharp inflection in the fiscal impulse, we dig into the composition of fiscal spending:

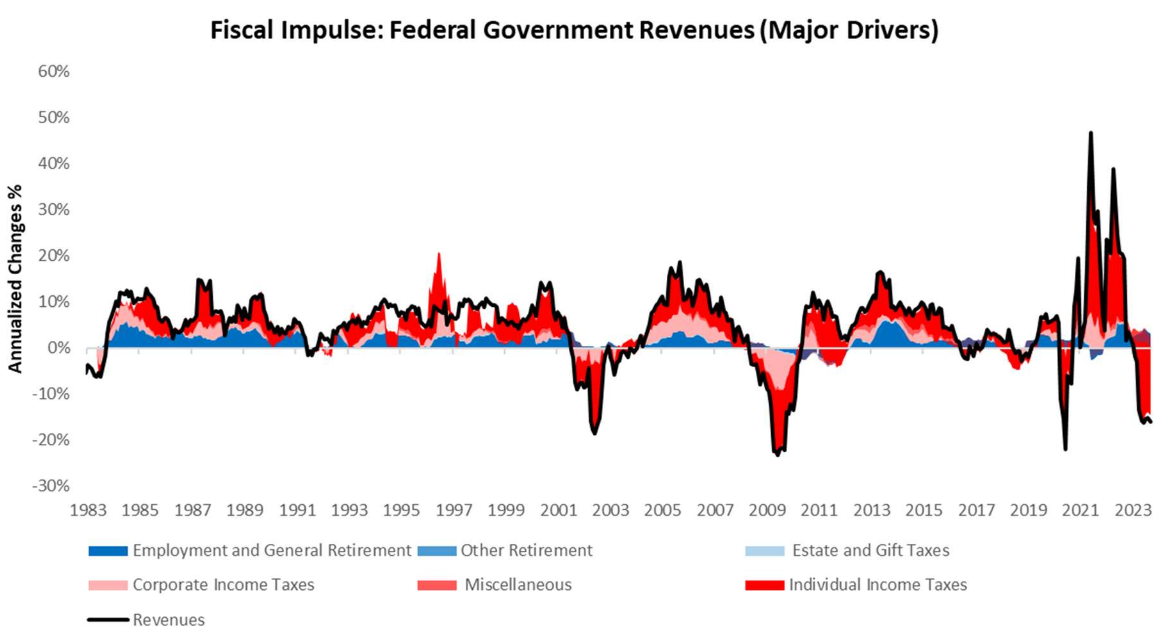


The primary driver of the decline in fiscal spending has been the sharp drop-off in education, training, employment, and social services spending. A drop-off in student loan forgiveness largely drove this decline, as the government records loan forgiveness as a budgetary outlay.

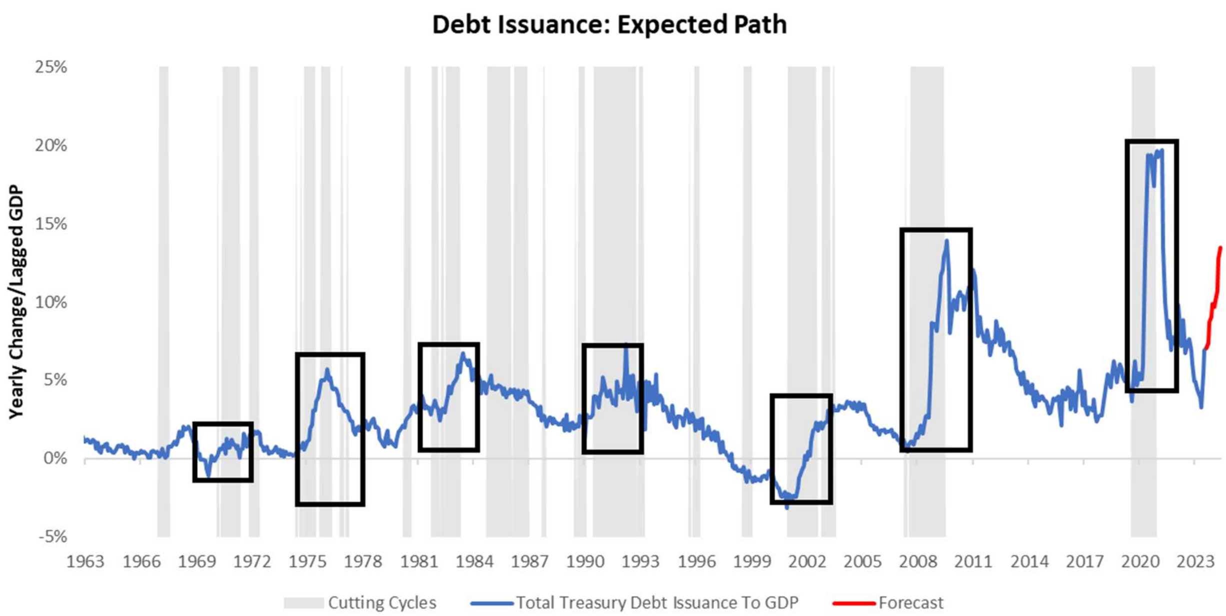
Thus, we expect education spending to remain a headwind to fiscal spending rather than the significant tailwind we have seen in recent years, barring a policy change. At the same time, government interest expense will likely remain a stable undercurrent to fiscal spending. On the other hand, government revenues continue to remain weak relative to nominal growth conditions:



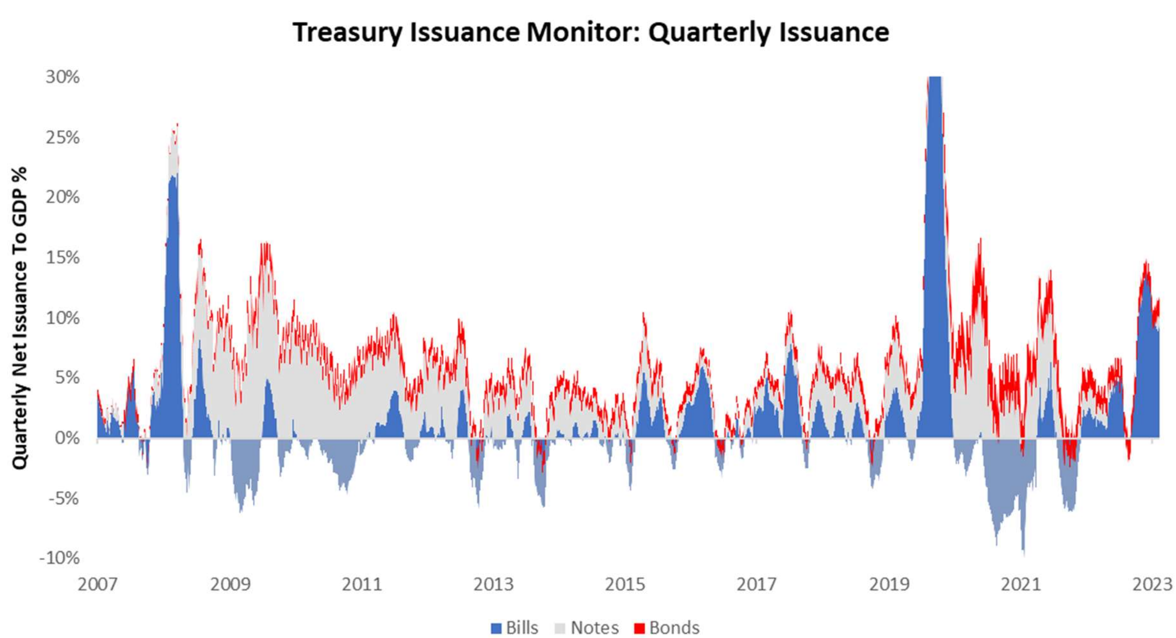
This weakness in government incomes almost entirely stems from weakness in individual income taxes, driven by changes in capital gains tax and tax-loss harvesting. When we look at tax sources contemporaneous with economic activity, i.e., employment taxes, we see much less weakness. We visualize these major drivers below:



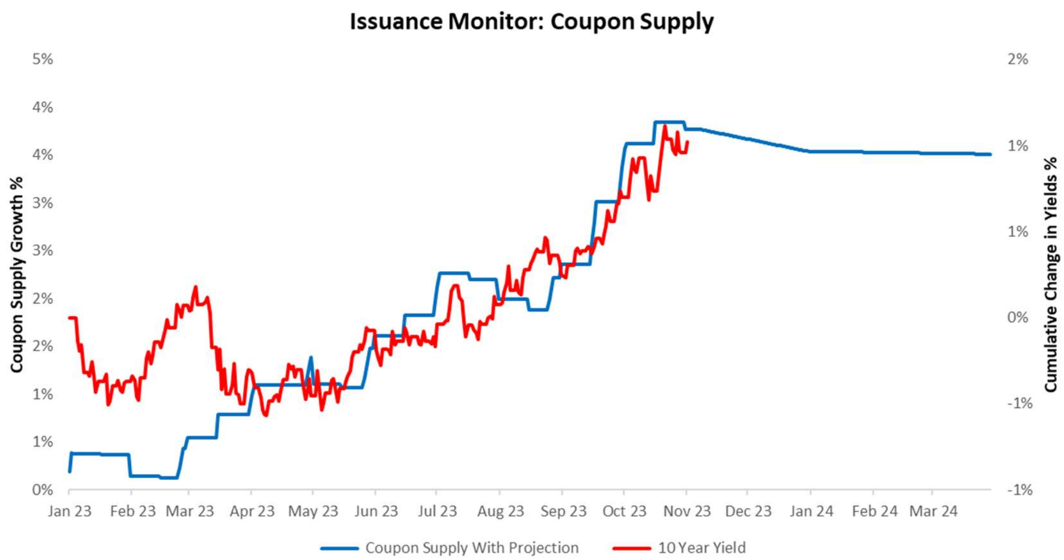
The combination of these factors creates a dynamic of a slowing fiscal impulse (spending) but a rising borrowing (debt outstanding). The size at which debt levels are increasing relative to nominal activity remains historically anomalous, particularly outside of cutting cycles. We visualize the path for the outstanding debt below:



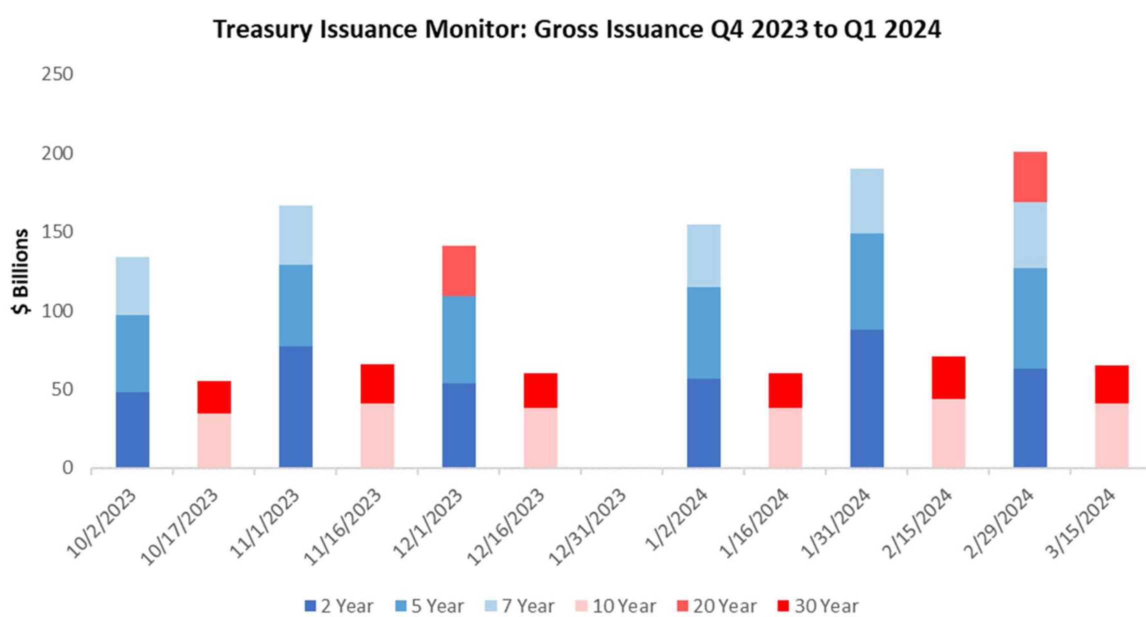
The above shows the change in total debt outstanding relative to nominal activity. As illustrated, the projected path remains steep, which has created significant pressures in the bond market as there has been limited capacity and appetite to absorb this issuance, particularly the issuance of longer-duration securities. We zoom in on the composition of quarterly issuance below:



As we can see above, Treasury bills have become a significantly larger part of total issuance and, in large part, occupying the space that was typically reserved for coupon issuance. However, in prior quarters, coupon issuance once again began to tick back up. Given the inflation dynamic and the Fed still having more interest rate hikes to complete at the time, this increased coupon issuance significantly negatively affected bond yields. We visualize this below, along with the projected path of the newly announced trajectory for Treasury bill supply:

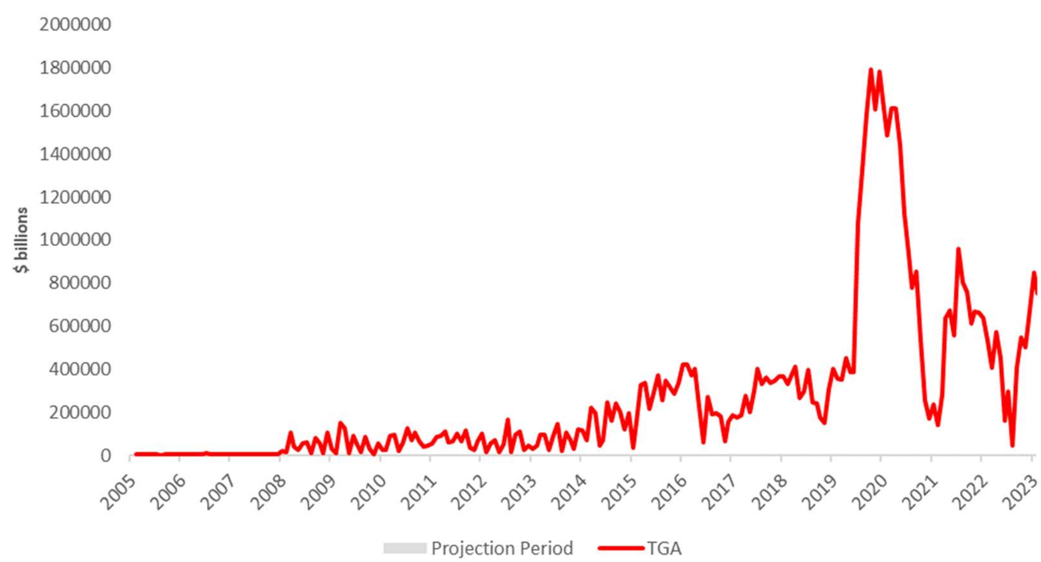


Over Q4 2023 and Q1 2024, the Treasury estimates to slow the pace of its gross issuance, allowing markets to absorb this high issuance marginally better. We show the expected gross issuance below:



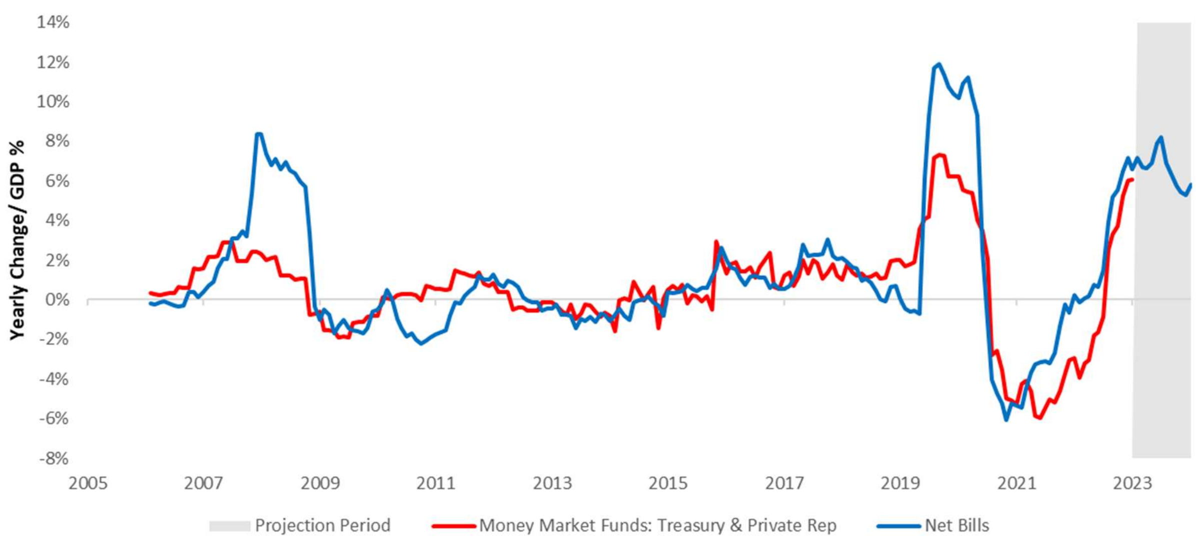
Nonetheless, the size of issuance remains challenging to absorb. Now, while coupon issuance declined, so did bill issuance. This slowing is consistent with the high level of cash balances maintained by the Treasury at the Fed.

Federal Reserve Liabilities: Treasury General Account

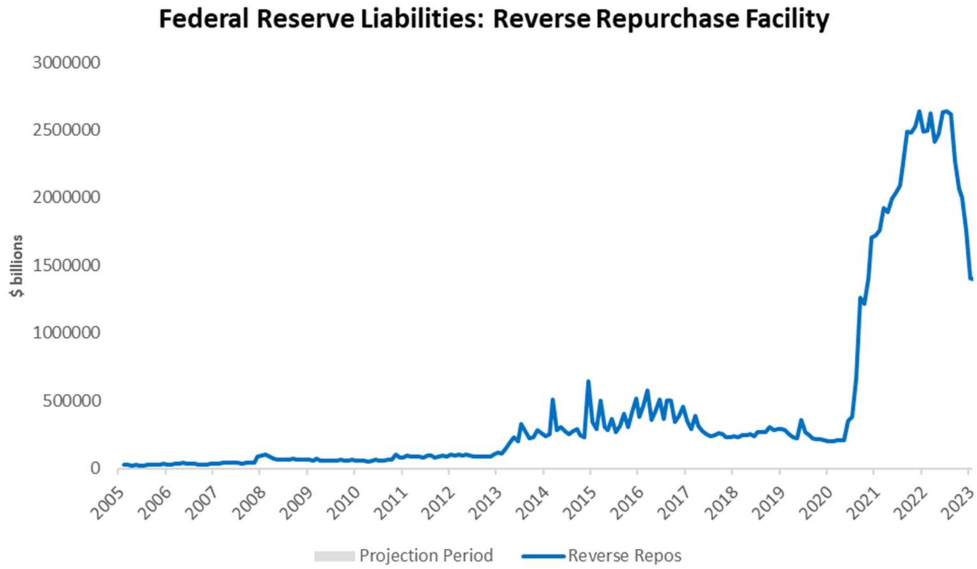


With a lower expected deficit and high cash balances, the need to issue at an accelerating need declined. This coupon slowdown offers respite to bills but also reduces liquid assets available to money market funds. Money market funds largely invest their proceeds into Treasury securities, either directly or indirectly via repo. We visualize this below:

Treasury Bill Supply: Money Market Allocation Impact

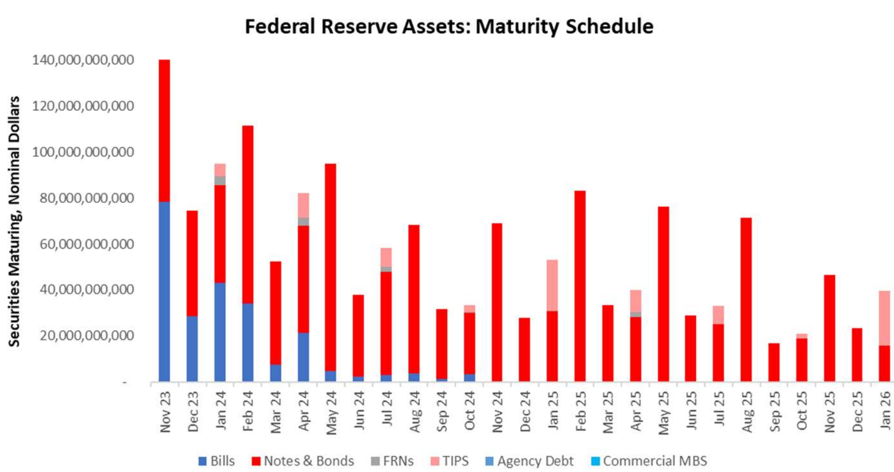


As we can see above, as the bill supply net of fed holdings increases, so do money market fund allocations. However, when bill issuance is declining relative to money market fund assets, this money is now allocated to the Fed's reverse repurchase facility.

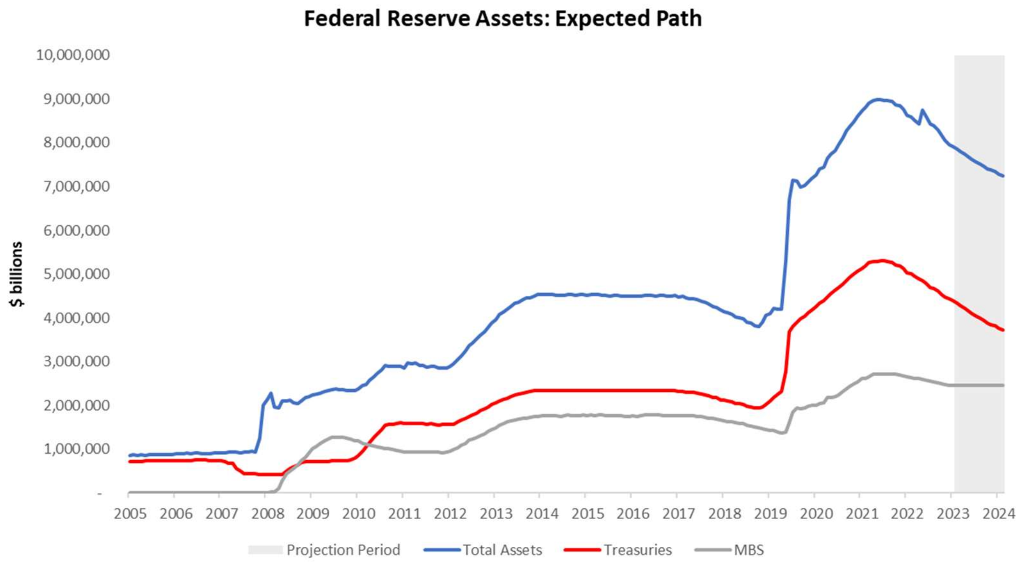


As such, the slowdown in Treasury bill issuance will also be a slowdown in the RRP drain, resulting in modestly fewer declines in reserve balances held at the Federal Reserve for a given pace of Quantitative Tightening. We discuss this next.

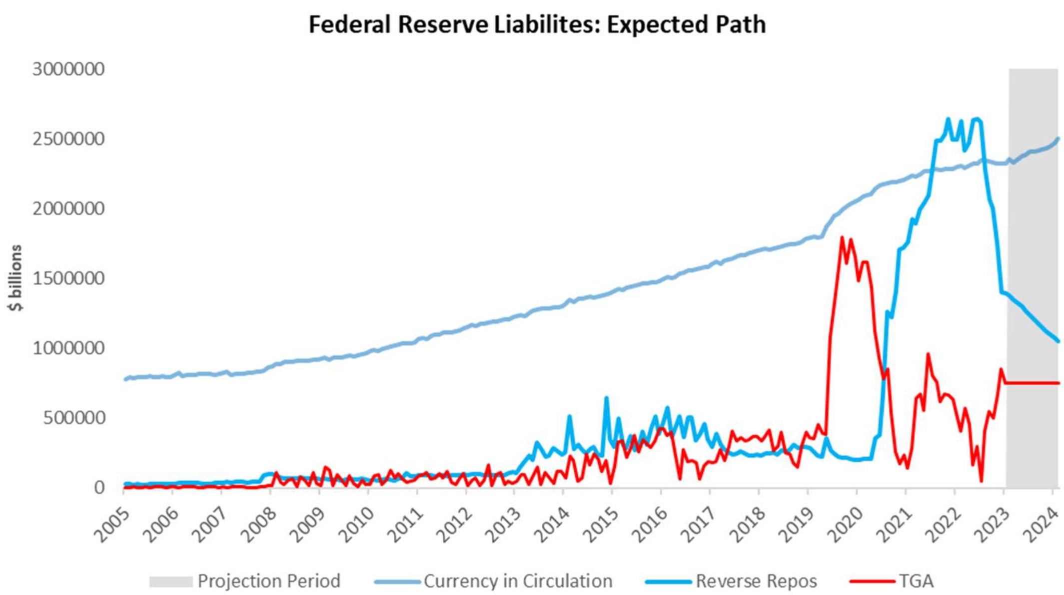
Reserve balances are the most highly liquid form of assets in the financial system as they are the liabilities of the Federal Reserve. Furthermore, in the post-2008 era, these balances have become so large that they have outsized effects on liquidity conditions. During Quantitative Tightening, the Fed aims to reduce reserve balances to tighten financial conditions. The pace of reserve tightening is a function of the factors supplying reserves to the financial system (Fed purchases or sales) relative to the factors draining reserves from the system (savings outside the financial system). Estimating the path for both is required to understand the path for reserve balances ahead. We begin with the asset side, which is relatively straightforward:



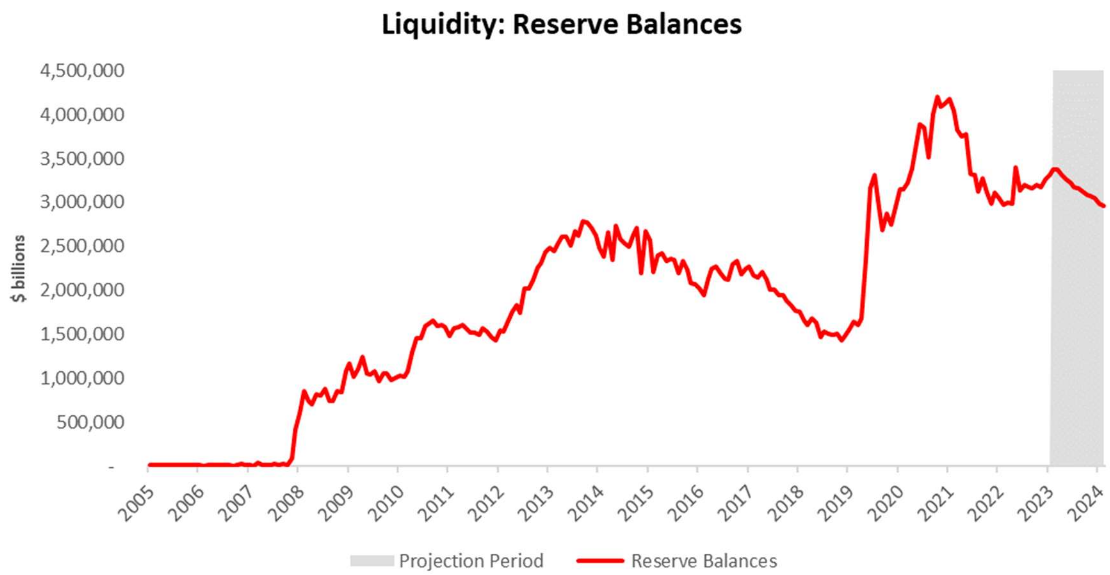
Above, we show the roll-off of assets from the Fed's balance sheet via maturity. This schedule is the primary driver of the decline in the Fed's assets. We visualize the path ahead of the Fed's asset and major components below:



Next, we turn to the liabilities side of the Fed's balance sheet. We expect the RRP drain to slow modestly, in line with slower issuance, the TGA to remain roughly constant, and the currency in circulation to expand per its seasonal trajectory. We visualize these expected paths below:

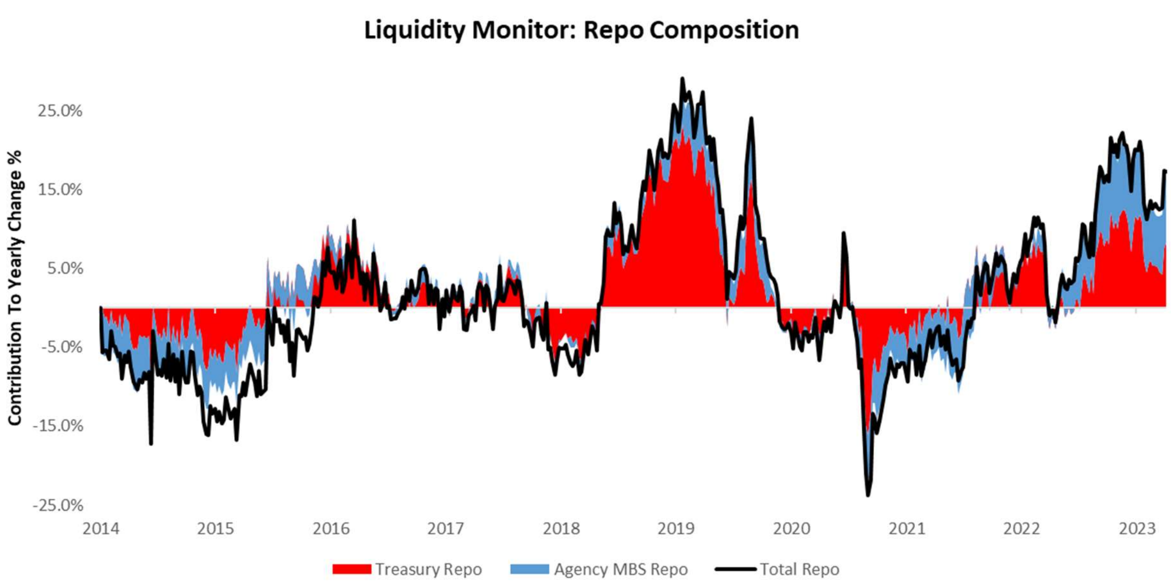


The net impact of these estimates leads to our estimated path for reserve balances, which we reiterate below:



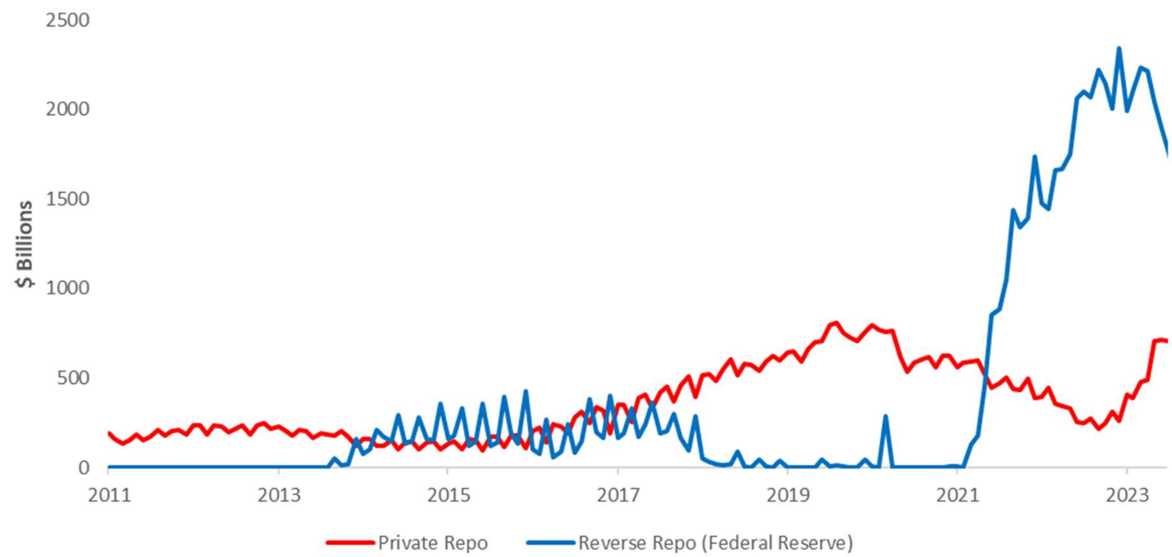
Now, while this path is indeed lower, it is modest relative to the roll-off of the Fed's balance sheet; as such, we see issuance dynamics as blunt the Fed's Quantitative Tightening.

Thus, while Quantitative Tightening will have some degree of negative impact until the RRP drain is complete or put on hold, it will be largely ineffective. We see this in recent repo market data, which shows reacceleration:



Recall that money market funds can invest in Treasury securities directly, in private repo (largely backed by Treasuries), in the RRP, or other short-term private securities. The most recent declines in RRP balances have resulted in a flow into private repo:

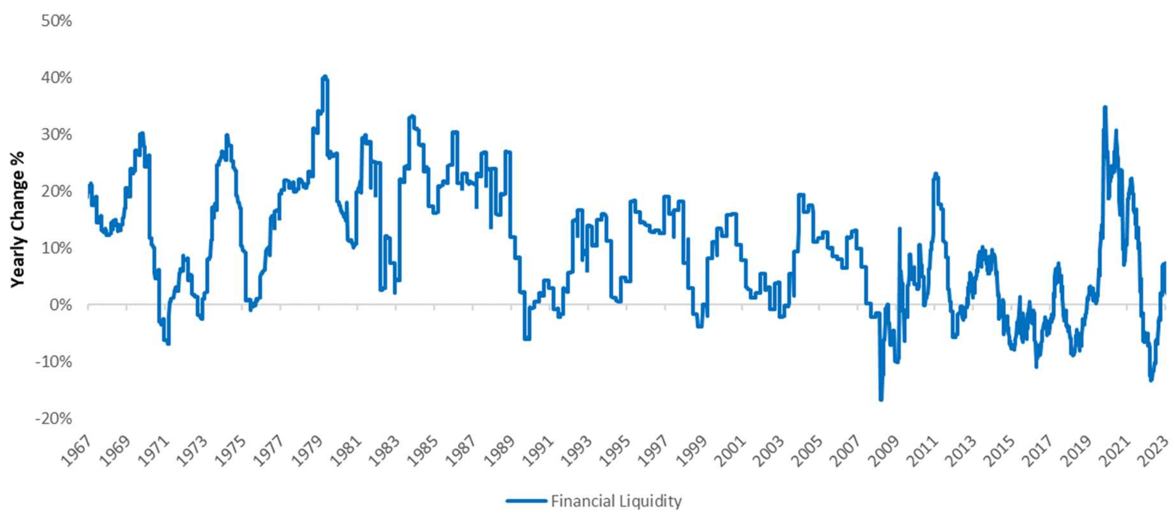
Money Market Fund Repo: Private vs. RRP



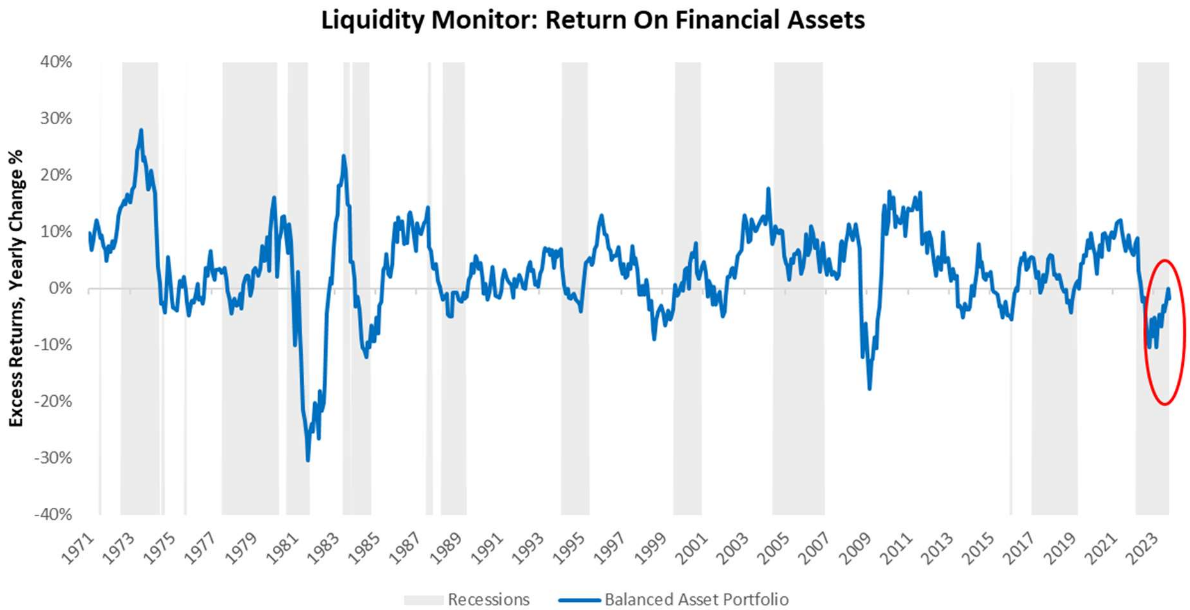
While reserve balances are the oiling in the machine of the banking system, repo is a crucial component of market liquidity. The rise in private repo activity and investment suggests a healthy appetite to take risk and cash that seeks to underwrite it.

The combination of these conditions has created an environment where the financial system has a significant amount of liquidity within the ecosystem:

Financial System Liquidity Gauge

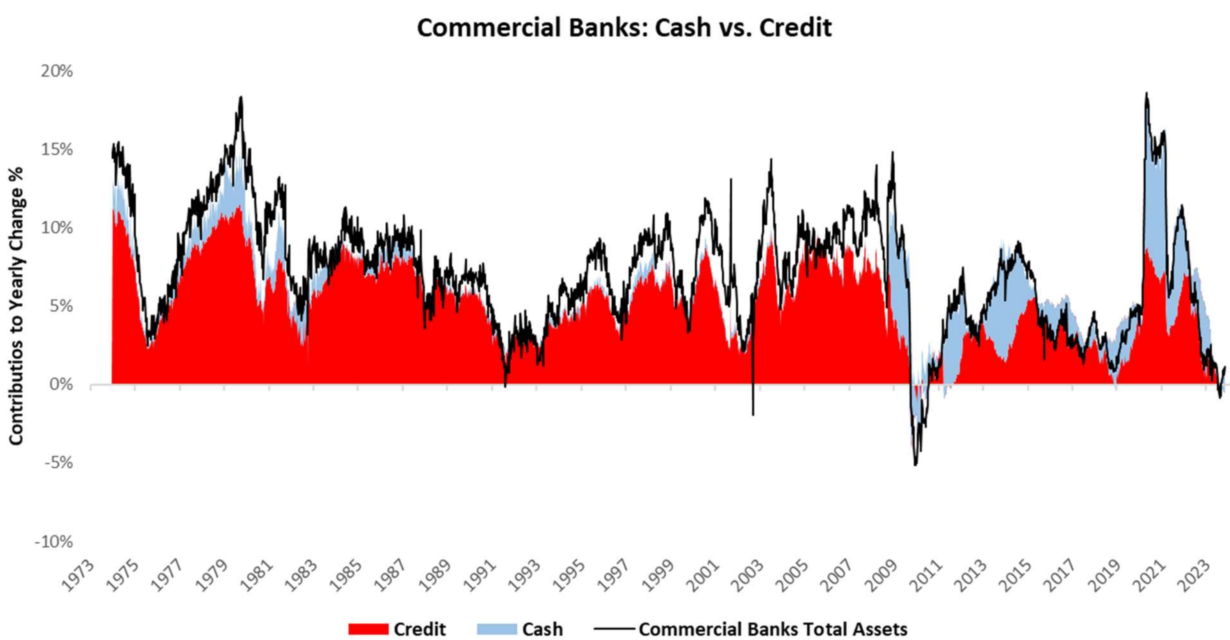


This liquidity facilitates ease of leverage and risk-taking in financial markets, allowing financial assets to recover from lows. Below, we visualize the rise in the form of the returns on a balanced portfolio of risk assets over time:

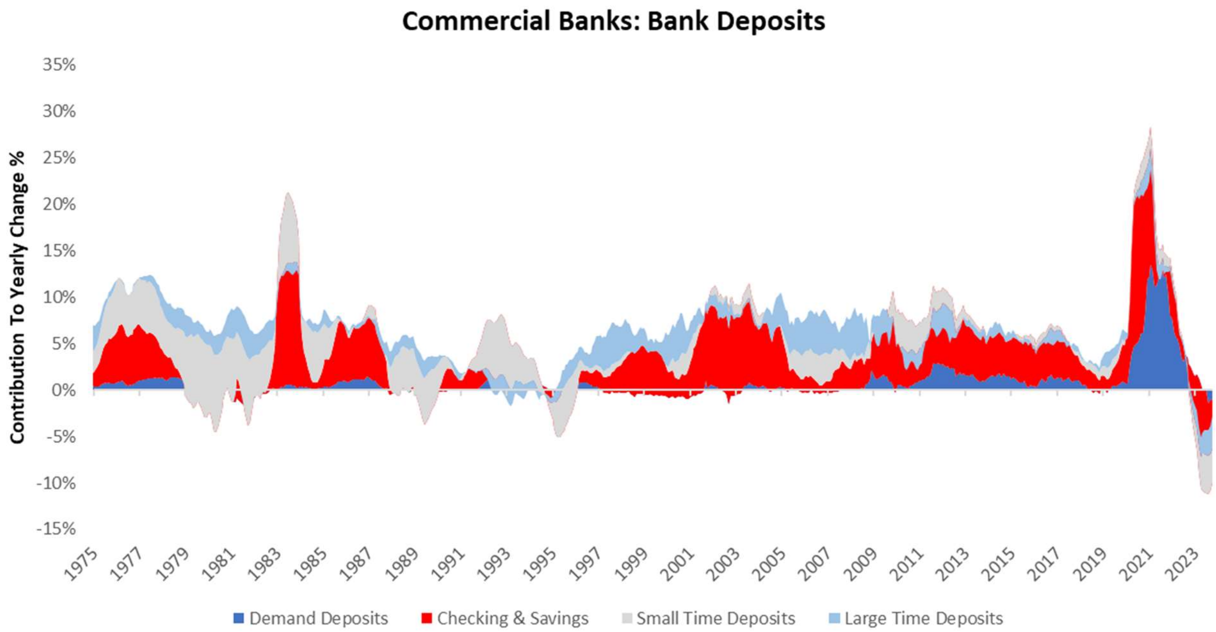


As we can see above, market conditions across a balanced mix of assets seeking to earn a risk premium in markets have improved, consistent with a positive liquidity impulse.

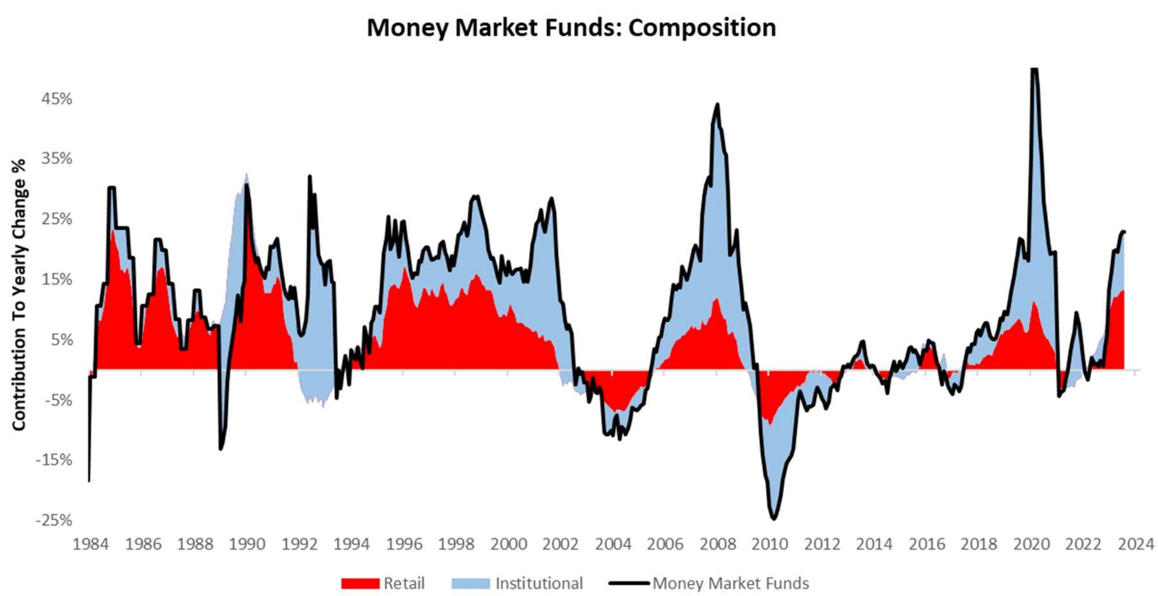
We see further evidence of these liquidity conditions in commercial banks, where bank cash assets have risen relative to their credit assets (i.e., lending), enough to create a modest stabilization in total assets:



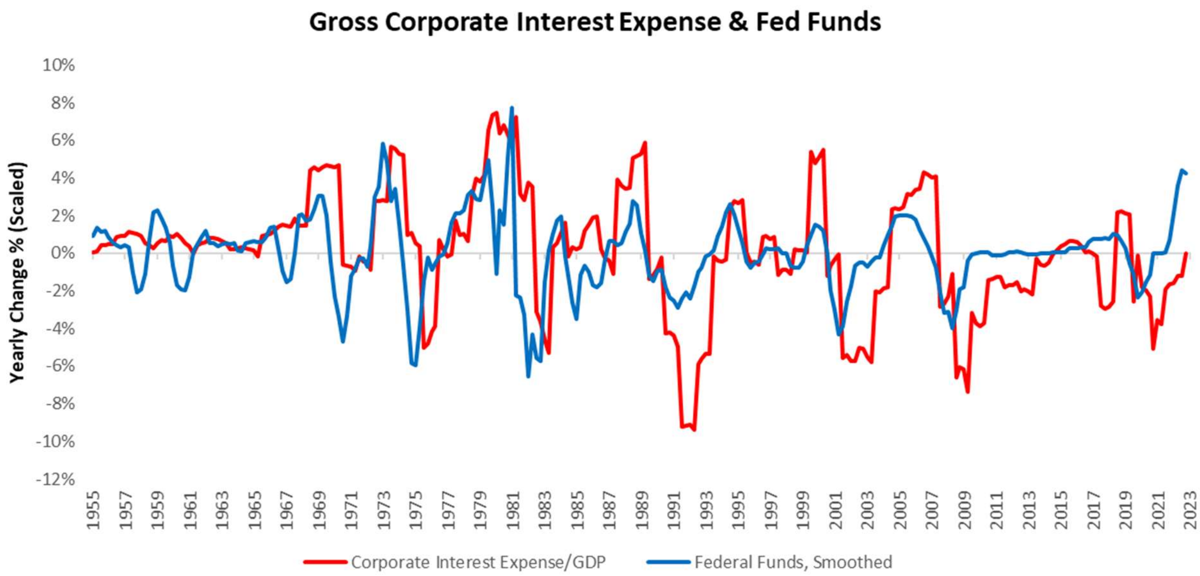
On the other side of this asset mix, deposits have also stabilized, though checking and savings deposits continue to decline. We visualize the deposit mix below:



As we can see above, checking and savings deposits have declined significantly; however, this has not been as much of a liquidity drain as it appears on the surface. A significant amount of checking account decline has been a rebalancing of investor portfolios from low-yielding instruments to high-yielding instruments in the form of money market funds. Below, we visualize the inflows into money market funds over time:

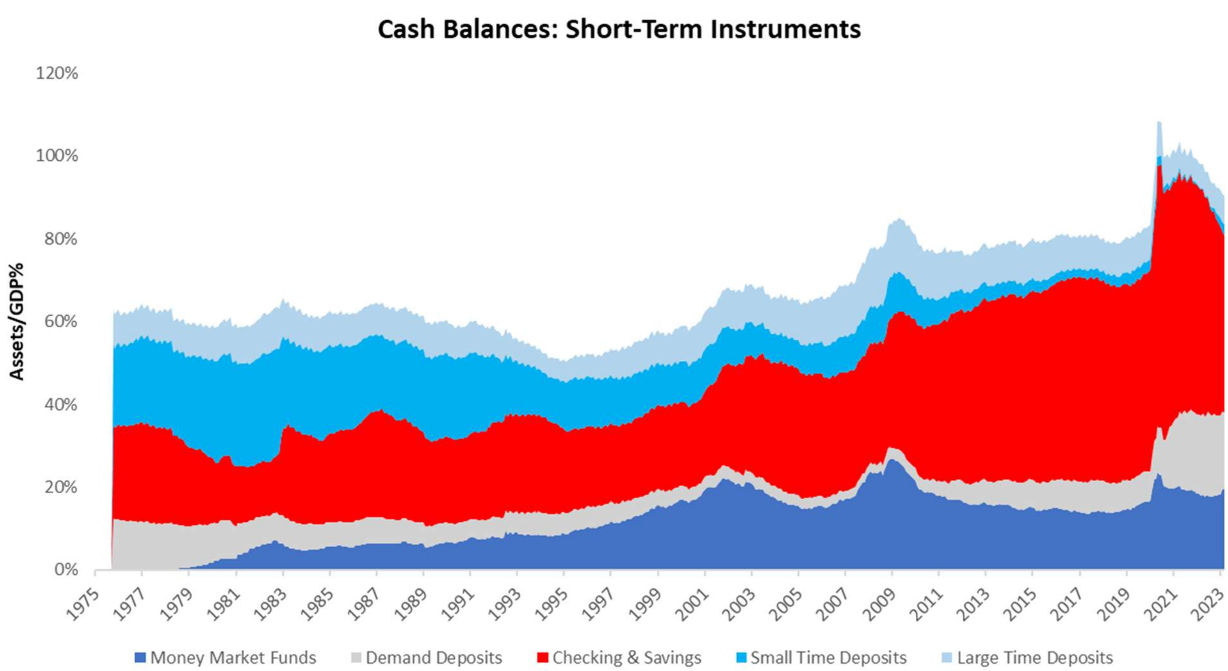


As we can see, these money market fund inflows have been significant during this hiking cycle, as money market funds have offered a yield premium to short-term deposits at commercial banks due to higher interest rates of Treasury bills. This dynamic brings us to the driver of the changes in interest rate policy.

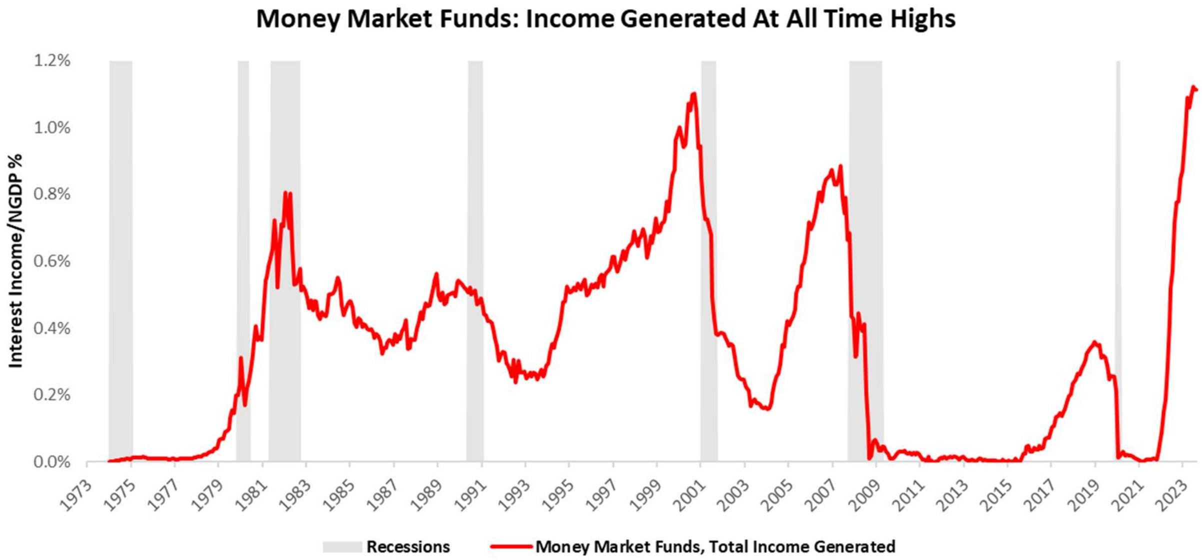


The purpose of hiking short rates is to increase the cost of capital to slow lending and borrowing, feeding into nominal spending, which fuels inflation. Above, visualize how rising short rates have typically raised gross corporate interest expense to achieve these goals. What has been different this cycle has been the recomposition of the economy to have significantly largely cash balances on the private sector balance sheet.

Below, we show short-term cash instruments have risen significantly relative to GDP:

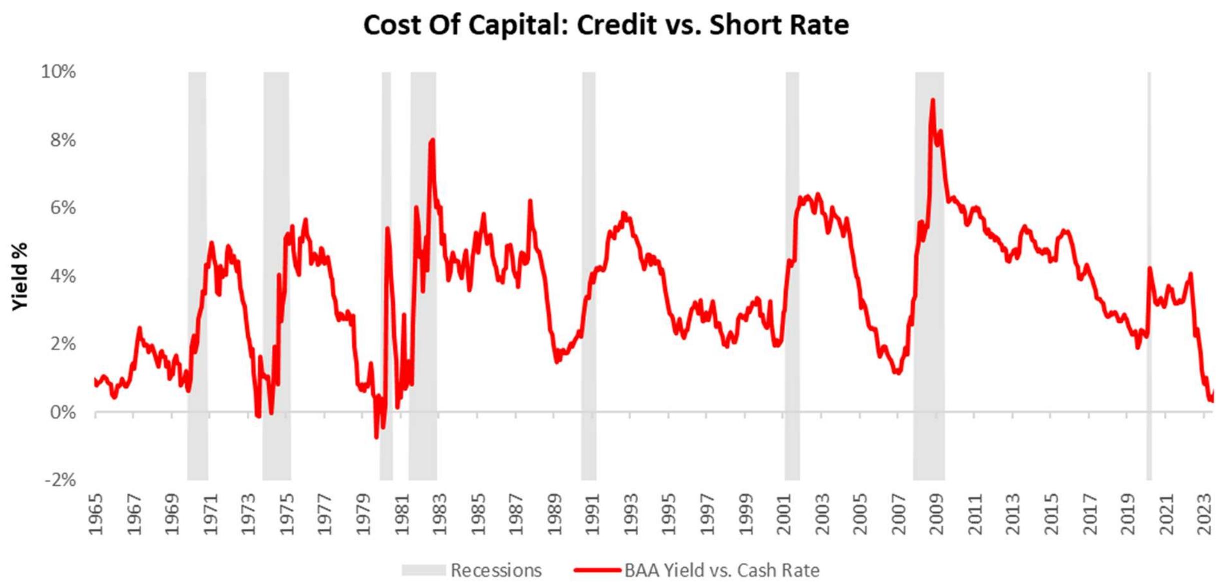


This increase in short-term cash instruments has created an environment where the private sector is insulated from rate hikes relative to history, as they earn short rates. Below, we show the estimated income benefit coming to businesses solely from money market fund incomes:

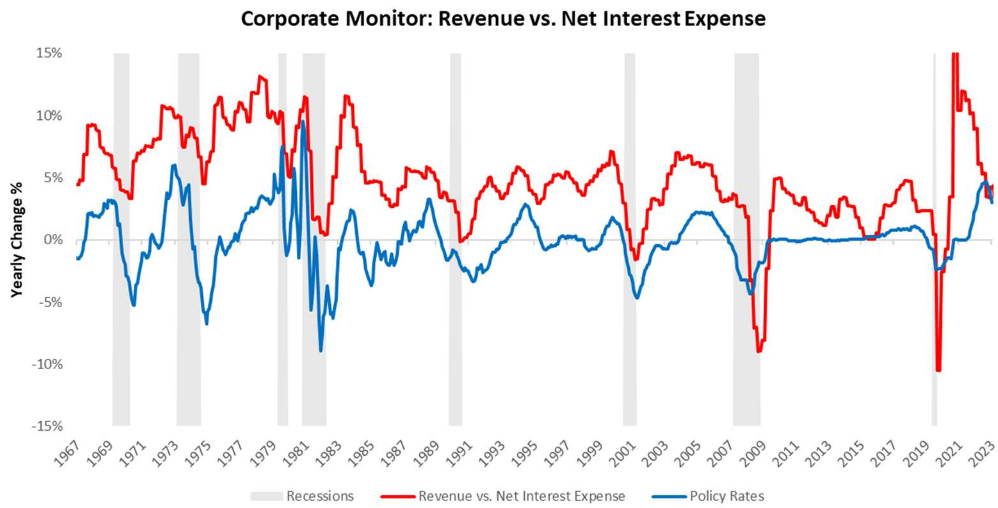


As we can see above, money market fund holders earn historically elevated interest relative to GDP. Furthermore, timely measures of credit costs remain compressed relative to short rates.

Below, we show how credit yields remain contained relative to short rates:

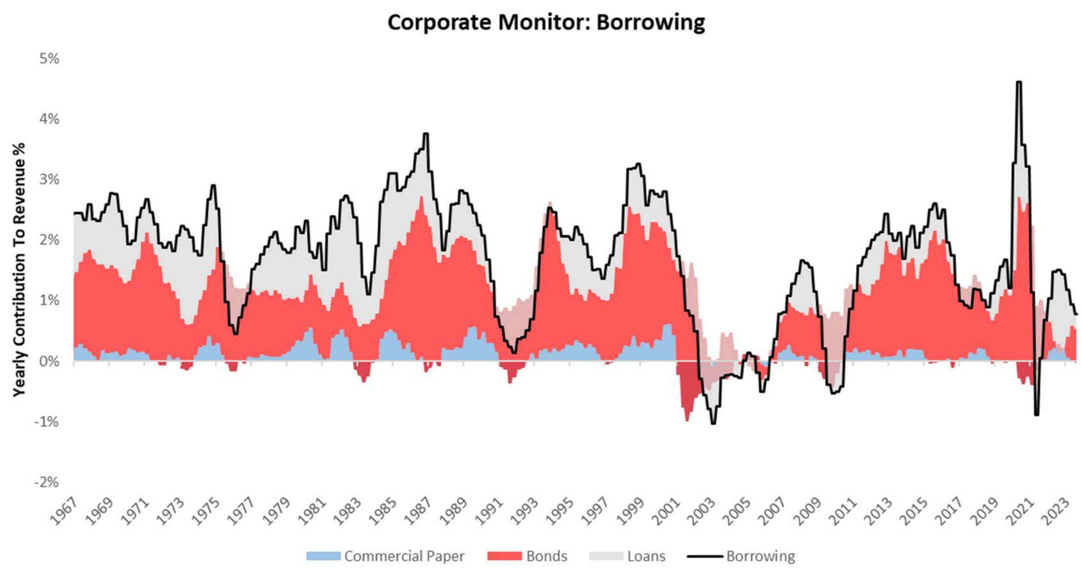


When we add to this dynamic that only persistent and prolonged yield spikes make their way into the reset of debt service costs, we see net interest costs remaining contained relative to corporate revenues despite the Fed hiking short rates:



Thus, while the Fed has engaged in a historic level of policy tightening, the impact on overall corporate borrowing activity has been modest.

Below, we show how corporate borrowing activity has remained modest, though it has decelerated somewhat.



Therefore, while policy rates have increased significantly, the pass-through of short rates through opposing channels has largely muted the tightening. Additionally, fiscal spending dynamics have resulted in significant short-term issuance, dulling the impact of Quantitative Tightening. The combination of these factors has created a liquidity backdrop beneficial for risk-taking. We think it is important to recognize that for this environment to continue, we require short rates to rise further, alongside further fiscal stimulus financed by short-term paper. While one of these things may be possible, the combination seems unlikely. We continue to monitor these conditions closely.

Conclusions

We reiterate our expectations and our views on macro and risk.

- ***Nominal GDP expanded by 0.66% in September, with real GDP increasing by 0.38% with inflation rising by 0.28%. Meanwhile, despite ongoing QT, reserve balances remained flat during the same period.***
- ***Most recent employment data shows signs of weakness driven by manufacturing weakness. We think this can continue, but not at the current pace. Until nominal activity declines meaningfully, we will remain in an inflationary regime.***
- ***Cross-currents from policy winds coming from the Fed and Treasury continue to blunt the tightening of financial and economic conditions. We expect these cross currents to keep liquidity at a high level.***
- ***After making all-time highs last month, our Cycle Strategies remain short stocks, short bonds, and long commodities.***

This environment remains a challenging asset, though stabilizing liquidity conditions will likely offer some respite. However, this will probably be only a modest respite without an accelerating liquidity backdrop. Stocks will likely outperform bonds, though we continue to prefer neither beta. If private sector liquidity re-accelerates, commodities will likely outperform. Until next time.

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