Macro Analysis - 'The Volcker Moment'

01/01/2023
Krzysztof Strzelec

The US economy is currently confronted with a multitude of challenges, including an intensive interest rate hiking cycle and the implementation of monetary QT. These factors are likely to exert a significant influence on the economy in the forthcoming quarters, and it is essential to comprehend how they may affect various sectors and stakeholders. We will delve deeper into each of these factors and consider their impact on the economy.

Beginning with the interest rate hiking cycle, it is worth noting that the Federal Reserve has been incrementally raising rates over the past year in an effort to curb inflation and stabilize prices. Higher interest rates can be advantageous in that they can assist in preventing prices from rising too quickly, which can be beneficial for consumers and businesses. However, higher interest rates can also make borrowing more expensive, which can have negative effects on economic growth.

The current interest rate hiking cycle has been one of the quickest on record, with the Federal Reserve raising rates at a faster pace than in previous cycles. This has sparked concerns about the potential impact on the economy, as some analysts posit that the rapid pace of rate hikes could lead to a slowdown in economic growth. Businesses and individuals may be less willing to borrow due to the higher cost of credit, which could result in a decline in investment and consumption.

In addition to the interest rate hiking cycle, the US is also experiencing monetary QT, or the process of reducing the size of the central bank's balance sheet. This is being achieved through the sale of assets or the allowance of maturity without replacement. Monetary QT can have a tightening effect on the money supply and can lead to higher interest rates. While monetary QT can help to stabilize prices, it can also make it more difficult for businesses to access credit, which can slow economic growth.

There are divergent opinions on the impact of monetary QT on the economy. Some argue that it is necessary to reduce the size of the central bank's balance sheet in order to prevent future inflation and stabilize prices. Others believe that the tightening effect on the money supply could lead to a slowdown in economic growth, as businesses may struggle to access the credit they need to invest and grow.

It is evident that the interest rate hiking cycle and monetary QT are complex issues that will have significant impacts on the economy. It will be important for businesses and investors to keep a close watch on these developments and adjust their strategies accordingly.

A potential boom and bust cycle in inventories is a challenge currently confronting the US economy. If companies amass expensive inventories but then experience a drop in consumer demand, their earnings may suffer as they strive to sell those products. This can lead to a slowdown in economic activity and could potentially result in layoffs and other cost-cutting measures.

One factor that could contribute to a boom and bust cycle in inventories is the high cost of stockpiling goods. If companies are paying a premium for their inventories, they may be less inclined to reduce prices in order to sell those goods if demand falls. This could lead to excess inventory and lower earnings for the company.

Furthermore, we have experienced the bullwhip effect in the supply chain. 2020 and 2021 monetary surplus and stimulus packages to support the economy recovering from lockdowns gave a false impulse. As a result, demand has been artificially increased from consumers and retailers reverberating the supply chain, causing wholesalers to overstock and manufacturers to overproduce in preparation for a flurry of orders. The excessive supply results in lots of surplus inventory, forcing retailers to slash their prices or be left with heaps of unsold goods. On the top of that, we had supply chain shortages further fuelling this phenomenon. Many businesses stockpiled more than needed in order to prepare for additional supply chain crisis issues. Moreover, expecting prices to keep increasing, they further overloaded inventories, ending up with expensive storage, stockpiled at the price peak.

In addition to the high cost of stockpiling goods, a drop in consumer demand could also contribute to a boom and bust cycle in inventories. If consumers are less willing to spend due to economic uncertainty, rising interest rates, or other factors, companies may struggle to sell their products. This could lead to excess inventory and lower earnings. Squeeze on people's savings created by a current monetary tightening and interest rates hikes is going to have a significant impact on the demand side. This will prevent companies from passing costs on to consumers leading to lower earnings in the effect. The strength of the dollar and the European cost of living crisis caused by elevated energy prices following the Russia-Ukraine conflict is an additional strongly negative factor affecting our economy. It's worth reminding us, a massive part of the revenue of many US large companies comes from outside the US, and Europe is one of the major regions contributing to the profits of these businesses.

Poor liquidity in financial markets is a serious issue affecting the activity in the markets. Liquidity refers to the ease with which assets can be procured or sold in the market, and it is a crucial factor in the stability and functioning of financial markets. When liquidity is low, it can be more difficult for buyers and sellers to find counterparties, which can lead to higher transaction costs and reduced market activity.

There are several factors that can contribute to poor liquidity in financial markets. One is an increase in the supply of assets, which can make it more difficult for buyers to find sellers, and vice versa. Another is a decline in market demand, which can result in a reduction in trading activity and lower liquidity.

Poor liquidity can have negative impacts on the economy, as it can make it more difficult for businesses to access the capital they need to invest and grow. It can also lead to higher borrowing costs, which can be a burden for individuals and businesses.

In addition to poor liquidity in financial markets, the US economy is also facing the challenge of overloaded pension and equity funds. These funds invest in a variety of assets, including stocks, bonds, and other securities. When they become overloaded, it can be a sign that they are taking on excessive risk and may be vulnerable to market downturns.

Overloaded pension and equity funds can have negative impacts on the economy, as they can lead to a decline in investment and a reduction in economic activity. They can also increase the risk of financial instability, as they may be more prone to large losses if market conditions deteriorate.

Banks are currently facing the challenge of hiding losses on bond positions. Rather than acknowledging these losses on their balance sheets, they are removing them in order to wait until the bond maturity date. This can further reduce their liquidity and make it more difficult for them to meet their financial obligations.

There are a number of risks associated with banks hiding losses on bond positions. One is that it can erode investor confidence, as investors may be concerned about the stability and transparency of the bank. This can lead to a decline in the bank's stock price and make it more difficult for the bank to access capital.

Another risk is that it can increase the risk of a financial crisis. If the losses are significant and the bank is unable to meet its financial obligations, it could lead to a crisis of confidence and a potential bank failure.

The overvaluation of defensive large-cap stocks, which are being priced like growth equities in the bull market, could potentially lead to a market sell-off. This sell-off could be significant, considering the extant challenges facing the market, including poor liquidity in financial markets, overloaded pension and equity funds, and banks obfuscating losses on bond positions.

One factor that could contribute to a market sell-off of defensive large-cap stocks is poor liquidity. If it becomes more onerous for buyers and sellers to find counterparties, it can lead to a reduction in trading activity and lower liquidity. This can make it more difficult for investors to dispose of their positions, which could lead to a sell-off of defensive large-cap stocks and the whole market as the ultimate effect.

Another factor is the possibility that pension and equity funds will be forced to divest their positions in the event of a black swan or credit event. If these funds are overloaded and become vulnerable to market downturns, they may also need to sell off in order to meet client withdrawals and redemptions. The current deposits may not be sufficient to cover these withdrawals, and the funds may be compelled to sell their positions in order to meet their obligations. This could lead to a sell-off of defensive large-cap stocks as these large investors divest their positions (where many are currently hiding, remaining fully invested – believing it's not going to be affected).

The US economy is presently facing a number of challenges that could potentially lead to a market crash in the second quarter of 2023. Despite this, there is currently a high level of market sentiment and optimism, with many investors ignoring the risks and exhibiting greed in their attempts to time the market and buy the bottom. These risks include a highly intensive interest rate hiking cycle, monetary tightening (also known as quantitative tightening or QT), and a potential boom and bust cycle in inventories. In addition, there are concerns about poor liquidity in financial markets, banks obscuring losses on bond positions, overloaded pension and equity funds, and overvalued defensive large-cap stocks.

One factor that could contribute to a market crash is the risk of significantly lower earnings for Q1 2023. Earnings for Q4 2022 may be still elevated due to increased Christmas spending on credit, but this could lead to a decline in earnings in Q1 2023 as consumers pay down their credit card debt and consumer savings remain at all-time lows. Additionally, as more and more parties become aware of the risks involved, a sell-off may commence in Q1.

All of these factors could increase the risk of a market crash, particularly if a black swan or credit event were to occur. It is imperative for investors to be cognizant of these risks and to carefully manage their portfolios in order to mitigate the potential impact of a market crash. It is important for investors to be aware of the high level of market sentiment and optimism, and to exercise caution rather than succumb to greed and ignore the risks at hand.

Taking into consideration mentioned above deflationary forces and coming to a conclusion, it does not mean that inflation will be slayed right away. The inflationary power can prevail as it's not caused by just a monetary surplus. Unwinding this effect by slaying the demand side is one of the Fed's tools, but what's beside it? We can see a clear disconnection between monetary and fiscal policy, therefore the Fed's impact is not formidable enough. On the top of that, people's bad spending habits are not easily reversed, especially when fuelled by fiscal spending. The pain must be felt to accomplish the task, the negative wealth effect. Supply chain issues are not resolved, nor controlled by Fed, and so is the energy crisis. The very 'Volcker Moment', Fed enforcing put on the US economy and call to fight inflation might not be over just yet, and it can take more than what is currently understood by 'higher for longer' to succeed.