How Fast Can the Fed Ease? The Private Sector Response to Easier Conditions Will Be a Key Factor

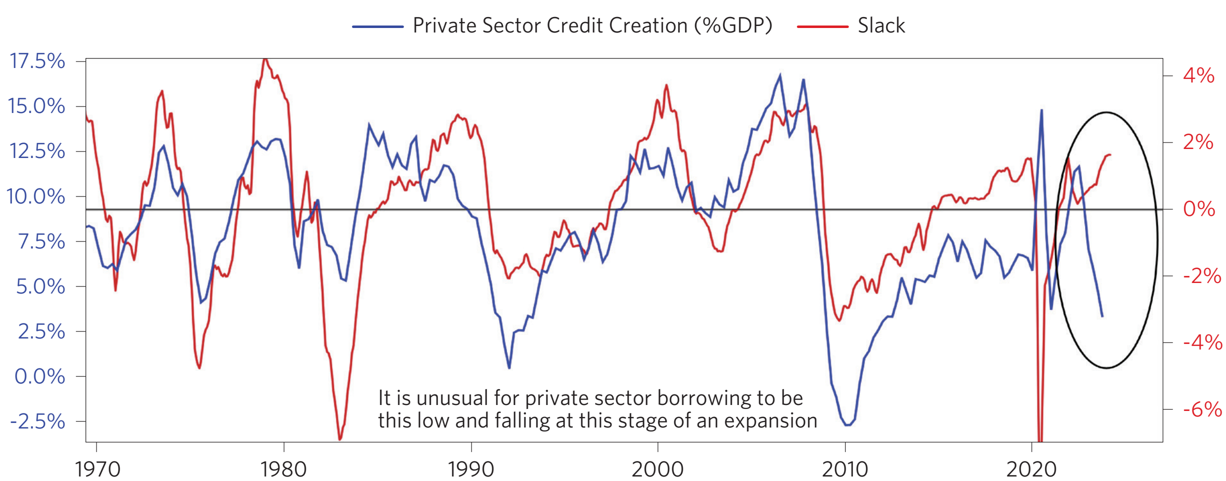
In a tight economy with high levels of fiscal spending and a very healthy private sector, there is limited room for a pickup in private sector borrowing without reigniting inflationary pressures.

FEBRUARY 12, 2024

KAREN KARNIOL-TAMBOUR
LARRY COFSKY
YUSUF JAILANI

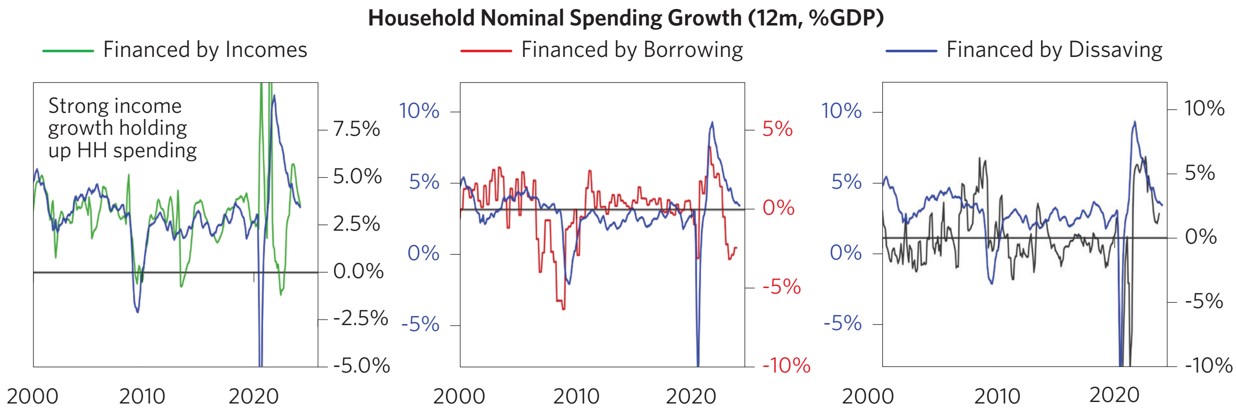
BRIDGEWATER

This has been an unusual expansion. Typically, a few years in, expansions are fueled by growth in private sector credit creation as households and businesses borrow to spend in excess of income growth, reinforcing the positive momentum in the economy. Eventually, conditions make it such that the Fed needs to tighten policy, which makes borrowing more expensive, leading to a contraction in credit creation and an economic slowdown. Today, however, growth is still humming despite a meaningful slowdown in private sector borrowing, as higher interest rates reduced the incentives for corporations and households to lever up. Instead, the economy has been held up by large and ongoing fiscal stimulus (which will likely continue at least until the November elections) along with strong private sector income growth. As financial conditions ease with the Fed's pivot toward a more dovish stance, we see the private sector in a strong position to respond to lower rates and easier financial conditions. Balance sheets are unusually unencumbered at this stage of the expansion and are coming out of a sustained period of deleveraging, while wages are still rising at a healthy clip. This means that Fed easing is likely to be stimulative, which in turn will limit how much easing makes sense given the strong starting point of the economy.



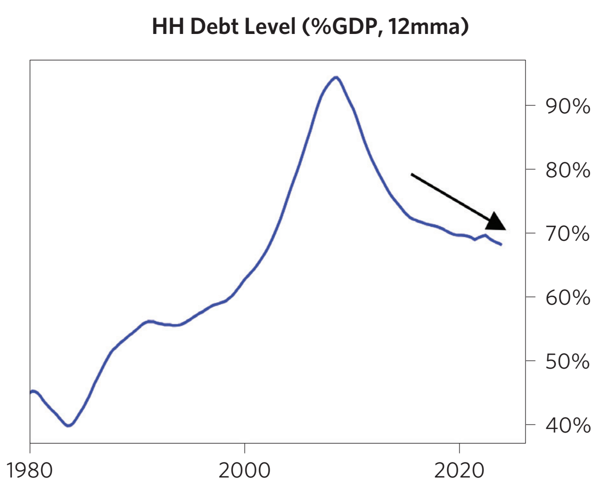
Strong Income Growth Held Up Household Demand Despite a Sharp Fall in Borrowing

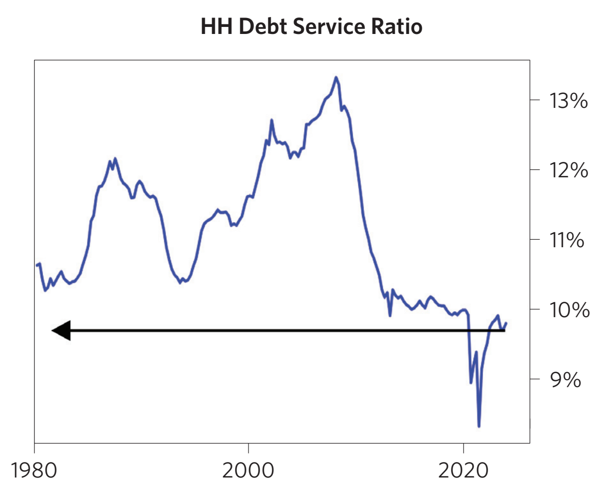
Household spending, which represents roughly three quarters of the economy, has remained robust despite a massive contraction in borrowing. Spending has been held up by strong income growth, which was kick-started by massive pandemic era stimulus and sustained by ongoing high levels of fiscal spending. This kept employment and wages growing at a healthy rate and meant that the massive decline in credit creation did not lead to an economic contraction.



Strong Balance Sheets Provide Room for Households to Increase Borrowing

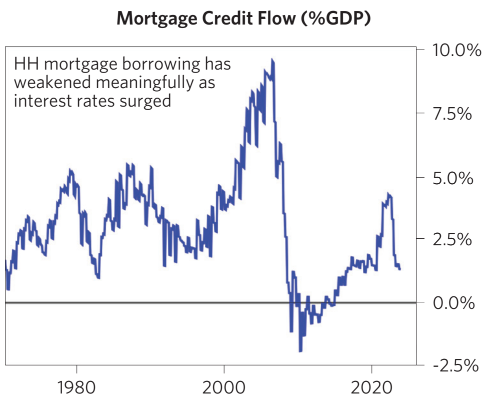
Households have deleveraged meaningfully over the last 20 years, including during the current cycle. Their balance sheets aren't stretched as they usually are when economic cycles are near their end. So, there is plenty of room for households to leverage up in response to more favorable incentives.

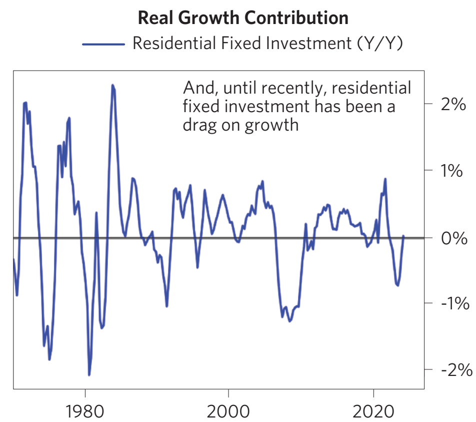




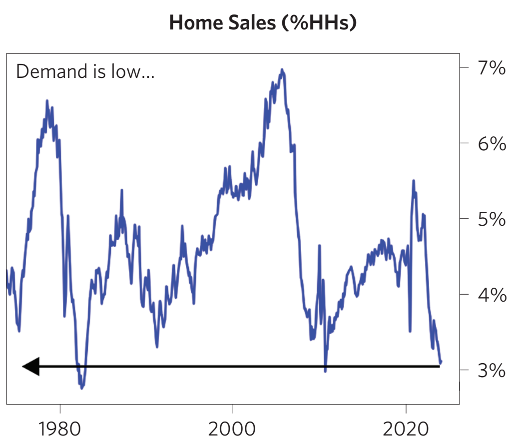
One of the main channels for household borrowing is the housing market. And while housing is a relatively small direct input to US economic growth, it punches above its weight because it is the largest asset on household balance sheets, the collateral for most household borrowing, and roughly 30% of consumer price inflation. Despite the unprecedented rise in rates, when we look at housing today, we see prices as likely to remain strong, demand as unlikely to fall much further, and mortgage rates that will need to remain elevated to prevent an increase in demand and keep the market in balance.

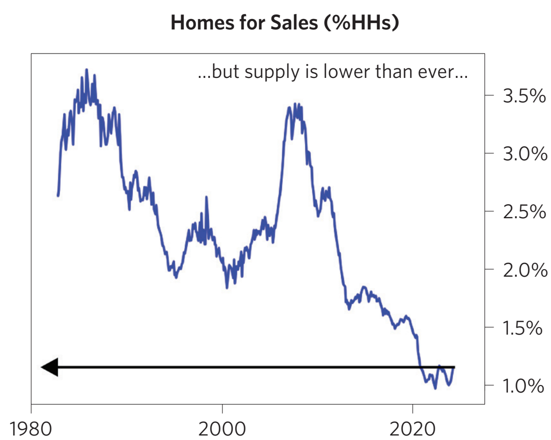
The sharp increase in interest rates over the last few years led to a meaningful decline in household mortgage borrowing and a fall in residential fixed investment, though the latter has stabilized recently.

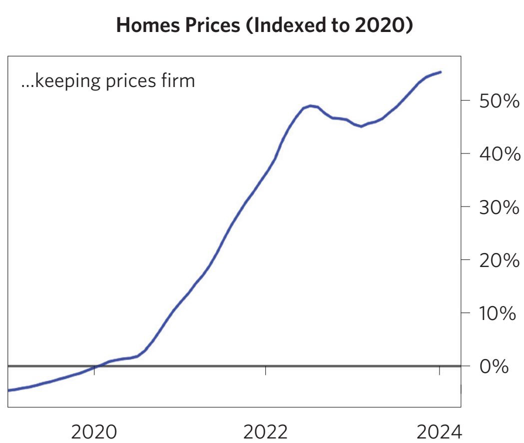




The huge rise in mortgage rates has resulted in significant deterioration of affordability and crushed the demand for housing. At the same time, however, the supply of homes is the lowest on record. This reduction in demand has not been enough to cool price increases as tight supply has continued to exert upward pressure.

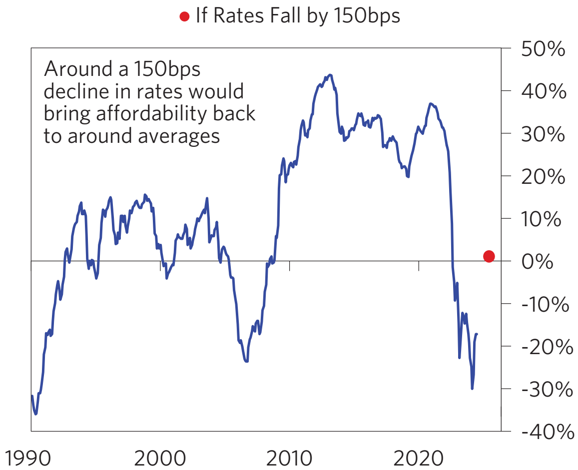




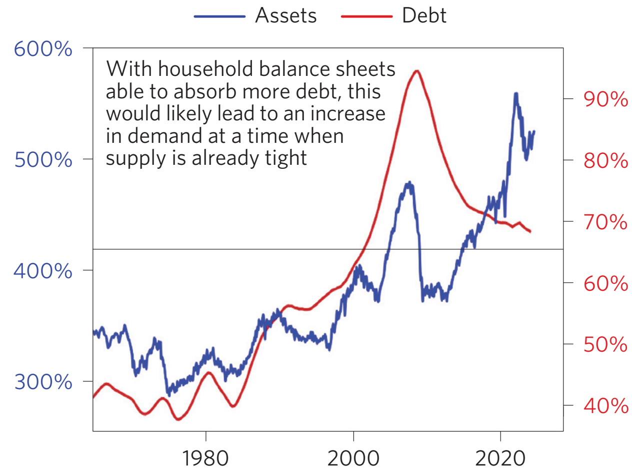


Going forward, any appreciable rate decline is likely to quickly lead to more demand and higher prices and activity at a time when there is little slack in the economy to absorb this boost. As the chart below on the left shows, given the strength in household incomes, even a 150bps decline in mortgage rates—not large compared to typical easing cycles—would bring affordability back to around average, boosting demand at a time when supply is extremely tight.

USA Housing Affordability Index

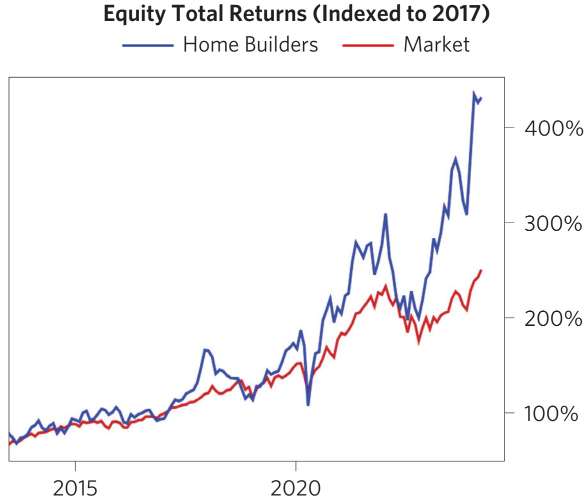


HH Balance Sheets (%GDP)

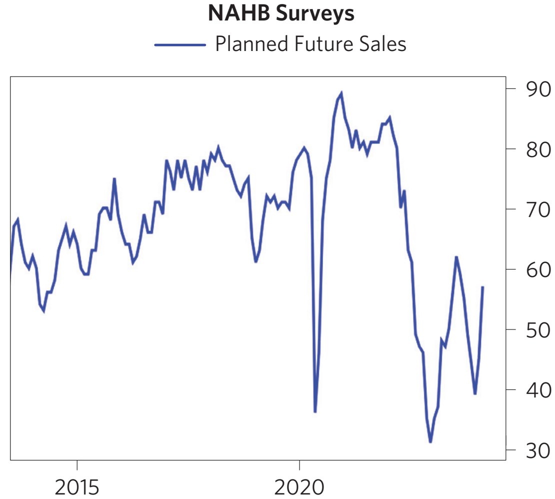


This dynamic creates a positive outlook for builders, and we see that reflected through a marked improvement in sentiment and a large rally in their stock prices. This positive response is occurring with mortgage rates still about 400bps higher than two years ago. We think rates another 100bps lower would result in a material increase in borrowing and building.

Equity Total Returns (Indexed to 2017)

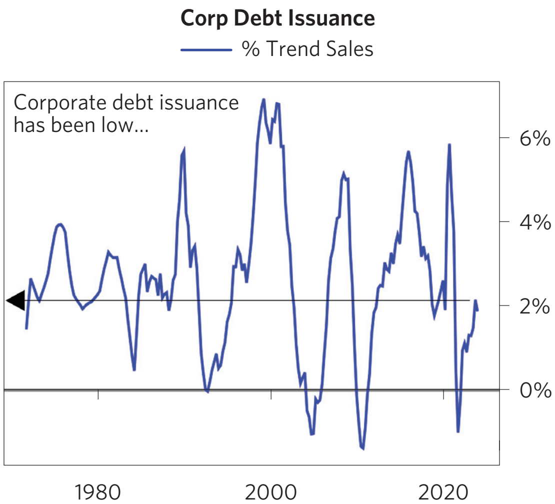


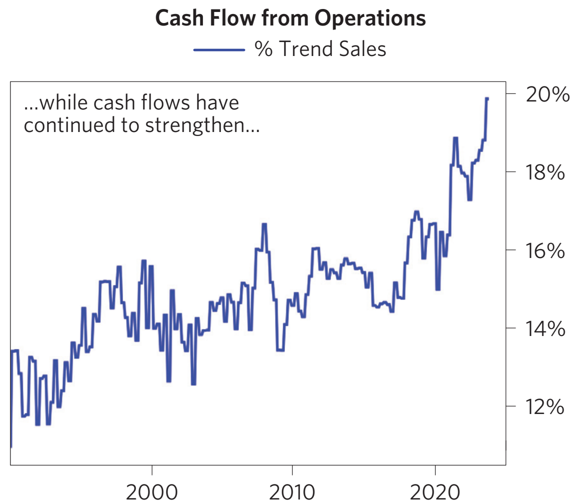
NAHB Surveys



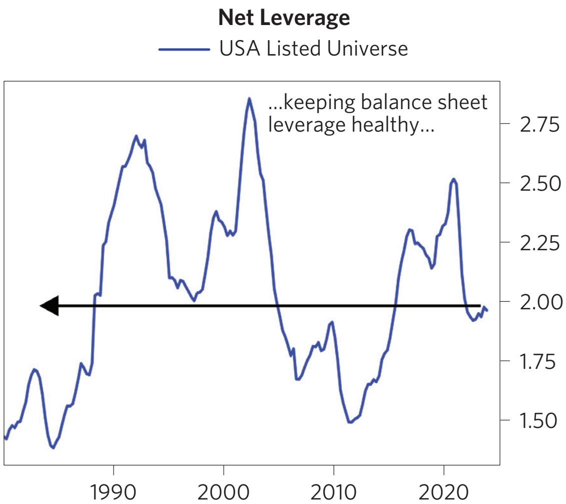
Strong Corporate Fundamentals Support an Increase in Borrowing and Investment

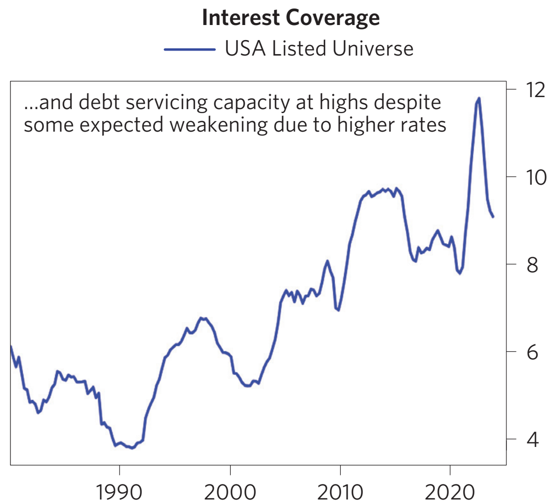
In the direct aftermath of the COVID pandemic, companies took advantage of historically low rates by issuing a lot of debt, allowing them to build up an unprecedentedly large amount of liquidity. That, along with continued strength in corporate cash flows as economic activity remained strong, allowed companies to reduce debt issuance when yields rose and capital market volatility was elevated.



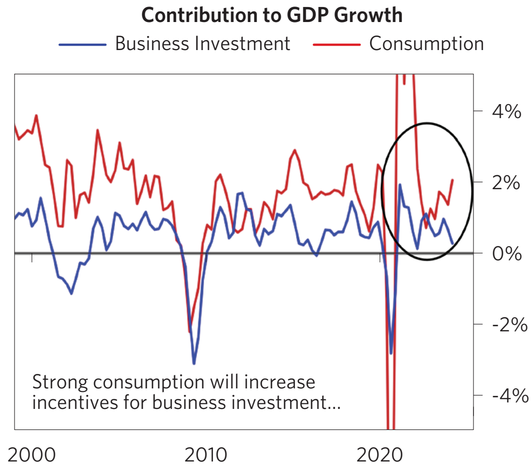


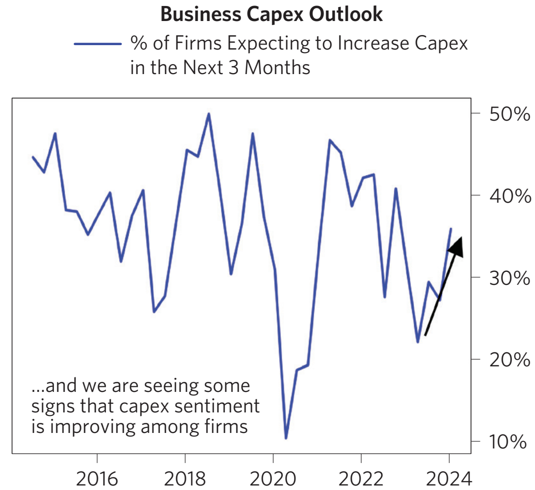
The lack of new debt issuance, coupled with strong earnings, has kept corporate fundamentals in a very healthy position. Balance sheet leverage has barely ticked up, while interest coverage remains at highs despite the inevitable deterioration due to higher interest rates.





With balance sheets in a healthy position, businesses have the capacity to respond to the continued strength in household spending by increasing investment. Business surveys we track indicate that capex sentiment is already improving.



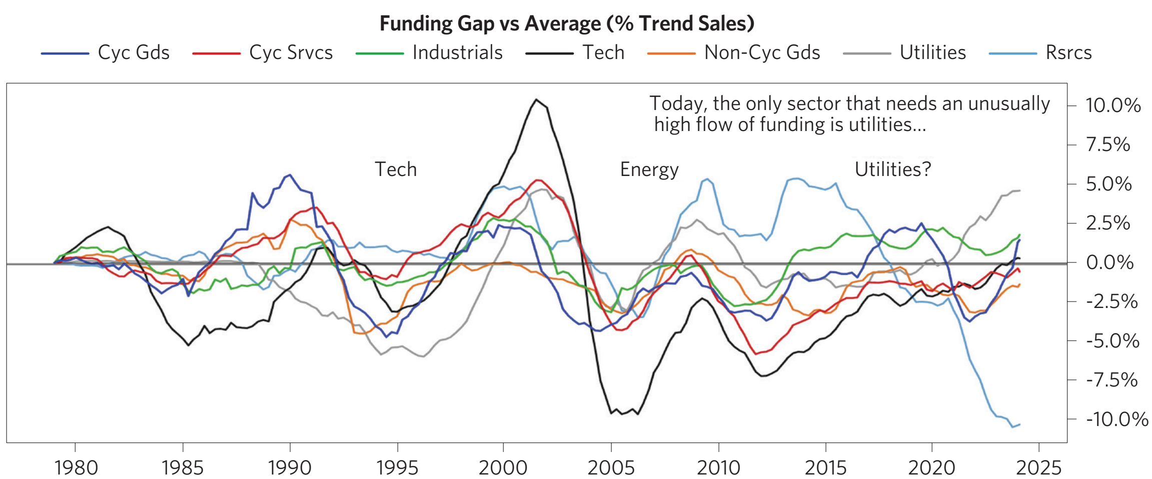


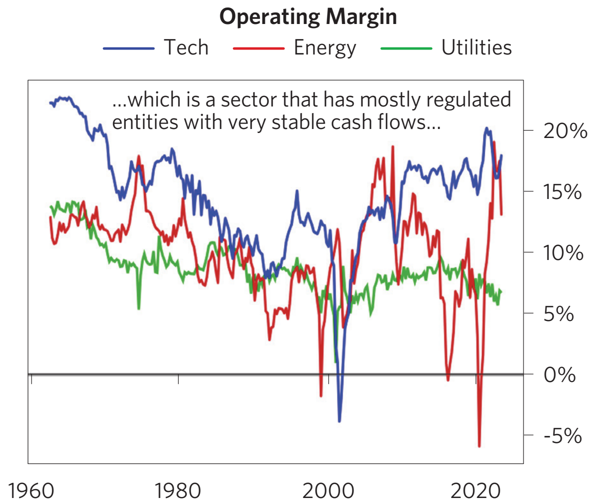
Source: National Association for Business Economics

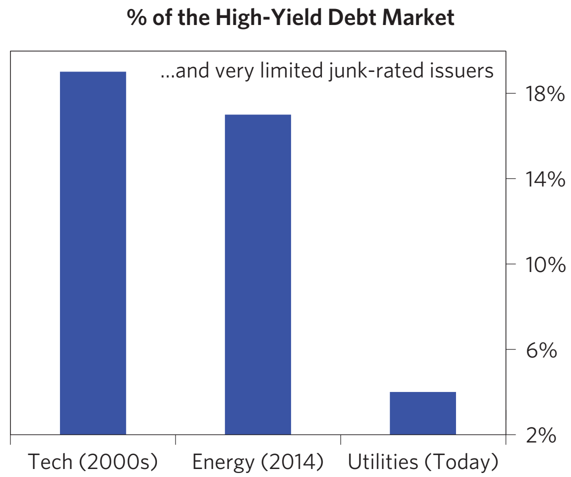
There Are Limited Signs of Corporate Excesses That Could Tighten Credit Availability

While the aggregate picture for corporate credit markets looks benign and supportive of an increase in borrowing, we are always wary of excesses underneath the hood that could cause a tightening in conditions, especially as we approach the end of a tightening cycle. Such risks look limited to us today.

Historically, several extreme credit sell-offs have coincided with the buildup and subsequent unwinding of risk in specific sectors. In the 2000s, the high-yield market had a roughly 20% exposure to the tech sector, which faced a sharp default cycle after the breakdown of aggressively leveraged capital structures. In 2014-16, the high-yield market had around 17% exposure to the energy sector, whose capital structures were predicated on the continuation of a high-energy-price environment. The subsequent crash in energy prices naturally led to a meaningful credit downturn. One way we screen for such risks is by looking at any sectors that have an unusually large need to attract capital. Today, the only sector that meets that criterion is utilities, a sector with largely investment-grade, regulated entities with very stable margins. This is a meaningfully healthier setup than that presented by the tech and energy sectors in prior credit breakdowns.

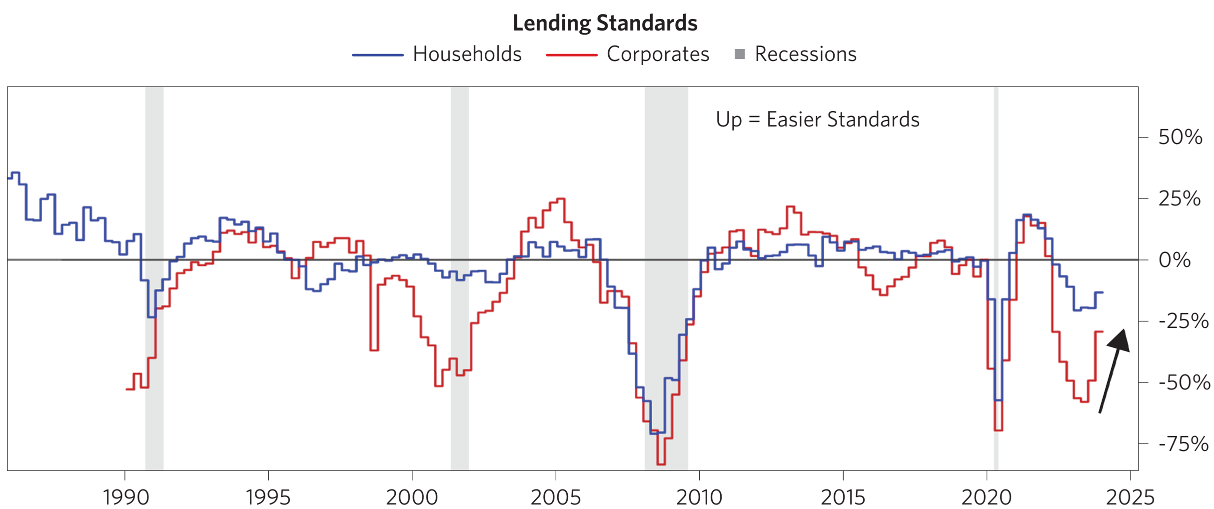






The Supply for Capital Will Likely Turn More Supportive

Banks tightened lending standards rapidly and preemptively in this cycle, anticipating a decline in economic activity that has not materialized. Standards have become less restrictive recently but remain tight; with borrower fundamentals on a strong footing and policy turning less restrictive, we would expect further easing from here, which should support an expansion in credit creation.



Important Disclosures and Other Information

This research paper is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives, or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This material is for informational and educational purposes only and is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned. Any such offering will be made pursuant to a definitive offering memorandum. This material does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors which are necessary considerations before making any investment decision. Investors should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, where appropriate, seek professional advice, including legal, tax, accounting, investment, or other advice.

The information provided herein is not intended to provide a sufficient basis on which to make an investment decision and investment decisions should not be based on simulated, hypothetical, or illustrative information that have inherent limitations. Unlike an actual performance record simulated or hypothetical results do not represent actual trading or the actual costs of management and may have under or overcompensated for the impact of certain market risk factors. Bridgewater makes no representation that any account will or is likely to achieve returns similar to those shown. The price and value of the investments referred to in this research and the income therefrom may fluctuate. Every investment involves risk and in volatile or uncertain market conditions, significant variations in the value or return on that investment may occur. Investments in hedge funds are complex, speculative and carry a high degree of risk, including the risk of a complete loss of an investor's entire investment. Past performance is not a guide to future performance, future returns are not guaranteed, and a complete loss of original capital may occur. Certain transactions, including those involving leverage, futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Fluctuations in exchange rates could have material adverse effects on the value or price of, or income derived from, certain investments.

Bridgewater research utilizes data and information from public, private, and internal sources, including data from actual Bridgewater trades. Sources include BCA, Bloomberg Finance L.P., Bond Radar, Candeal, Calderwood, CBRE, Inc., CEIC Data Company Ltd., Clarus Financial Technology, Conference Board of Canada, Consensus Economics Inc., Corelogic, Inc., Cornerstone Macro, Dealogic, DTCC Data Repository, Ecoanalitica, Empirical Research Partners, Entis (Axioma Qontigo), EPFR Global, ESG Book, Eurasia Group, Evercore ISI, FactSet Research Systems, The Financial Times Limited, FINRA, GaveKal Research Ltd., Global Financial Data, Inc., Harvard Business Review, Haver Analytics, Inc., Institutional Shareholder Services (ISS), The Investment Funds Institute of Canada, ICE Data, ICE Derived Data (UK), Investment Company Institute, International Institute of Finance, JP Morgan, JSTA Advisors, MarketAxess, Medley Global Advisors, Metals Focus Ltd, Moody's ESG Solutions, MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, Refinitiv, Rhodium Group, RP Data, Rubinson Research, Rystad Energy, S&P Global Market Intelligence, Sentix Gmbh, Shanghai Wind Information, Sustainalytics, Swaps Monitor, Totem Macro, Tradeweb, United Nations, US Department of Commerce, Verisk Maplecroft, Visible Alpha, Wells Bay, Wind Financial Information LLC, Wood Mackenzie Limited, World Bureau of Metal Statistics, World Economic Forum, YieldBook. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

This information is not directed at or intended for distribution to or use by any person or entity located in any jurisdiction where such distribution, publication, availability, or use would be contrary to applicable law or regulation, or which would subject Bridgewater to any registration or licensing requirements within such jurisdiction. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without the prior written consent of Bridgewater® Associates, LP.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.

