Bridgewater®
Daily Observations
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Tracking How and Why the Tightening Isn't Biting

Tightenings typically continue until something breaks, setting off a self-reinforcing contraction—but that hasn't happened yet this cycle. In this Observations*, we walk through the potential breaks we are tracking and whether they are becoming more significant threats to the economy.*

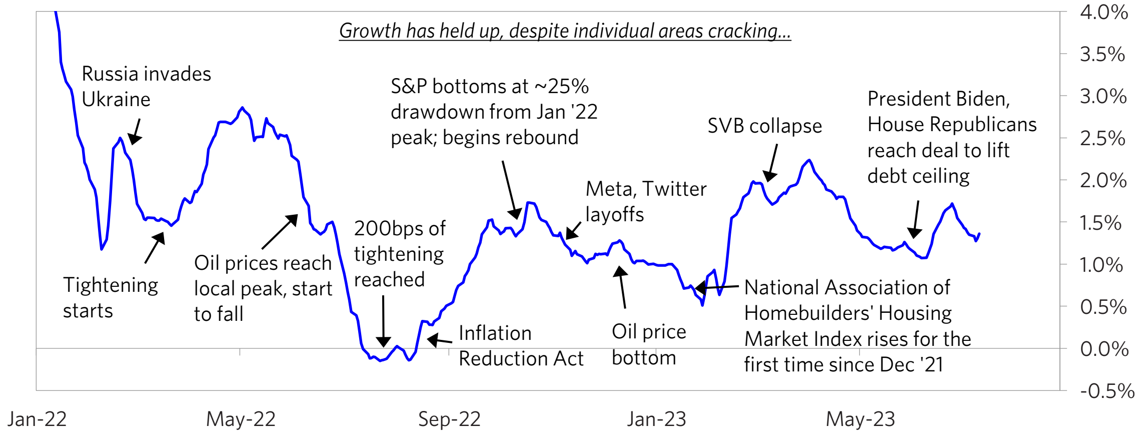
In Wednesday's *Daily Observations*, we put the current tightening cycle in historical context. Today, we focus on what is happening in this cycle at a more granular level, exploring how the tightening is creating strains in different pockets of the economy. **What ultimately cracks in each cycle varies depending on the excesses of the prior expansion. Once something big breaks, a self-reinforcing contraction in spending and incomes can be set in motion, which then typically requires an easing to reverse. This hasn't happened yet.** Our measures of real growth have been range-bound between 1-2% for most of the last year, and none of the areas that have cracked so far look big enough in isolation or in aggregate to push the economy into a recession.

In large part, this is because there were few excesses in borrowing and investment to pop this cycle. The areas experiencing strains today are also being cushioned by higher asset prices and the stabilization of some of the earlier sectors to crack, like housing. Without more tightening or weaker asset prices, the most likely outcome we see is a gradual slowdown in which both households and businesses wind down their spending relative to their incomes. If a sharper contraction is needed to get inflation to fall to and stay at target, the Fed will probably need more tightening, which could take multiple forms. It would most likely come through a pullback in liquidity as the Treasury shifts back toward financing the deficit through bond issuance rather than T-bills, but it could also happen through some of the easing discounted in the next couple years coming off, or even through more short rate tightening.

Below, we show the stability of real growth rates in the context of the developments of the last year and a half. Fiscal policy (particularly in light of a lack of bond issuance) and lower commodity prices have been supports, the drags from housing are behind us, and the other areas that have been impacted by the tightening (CRE, certain banks, the tech sector) were not big enough to curb sustained nominal income and hiring growth.

In the rest of this *Observations*, we go through in more detail: 1) the rebound in asset prices (the real big thing that has not cracked), 2) the stabilization of housing, 3) the modest hit to other forms of consumer credit, 4) continued healthy business capex, 5) the hit to commercial real estate, 6) the stabilization of bank deposits and the recent bounce in strained bank equities, and 7) the hit to tech incomes and venture capital. **The goal is to share what we are seeing and how we are tracking whether any of these things are likely to become more significant imminent threats to the economy.**

Coincident Growth (3m, Ann)



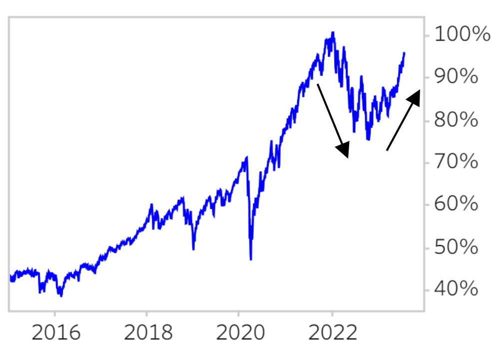
Assets Rebounded Quickly This Cycle, Minimizing the Hit to Household Wealth

One of the main mechanisms through which tightening cycles can work is by hitting asset prices and wealth. This erosion of wealth prompts households to pull back their spending, contributing to declining spending and incomes. This effect is magnified when the prior increase in wealth is debt-fueled, which gives rise to a self-reinforcing dynamic as wealth falls. Consistent with this pattern, equities and home prices both fell in the wake of the tightening. However, the impact of this initial decline was muted by the fact that the run-up in private wealth in this cycle came about primarily through government rather than private-sector borrowing, limiting the ripple effects of falling wealth on private-sector balance sheets. The initial decline in household wealth also reversed only a small part of the run-up that immediately preceded it, further curbing its effect on the behavior of households, whose wealth remained high relative to just a couple years ago. And assets then bounced back quickly as markets priced in increasingly rosy earnings expectations and both easier policy and a pullback in home selling propped up home prices.

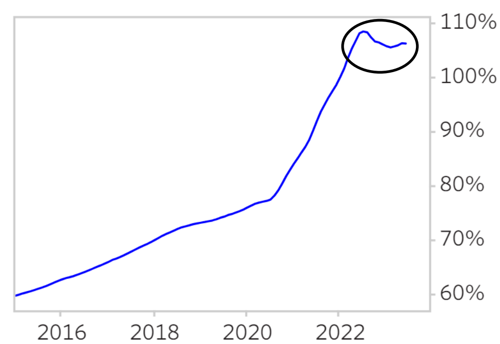
Assets (Indexed to EoY 2021)

S&P 500

The S&P has rebounded after its initial decline

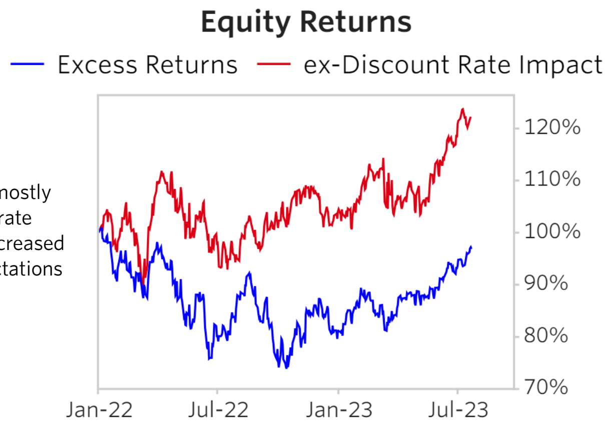


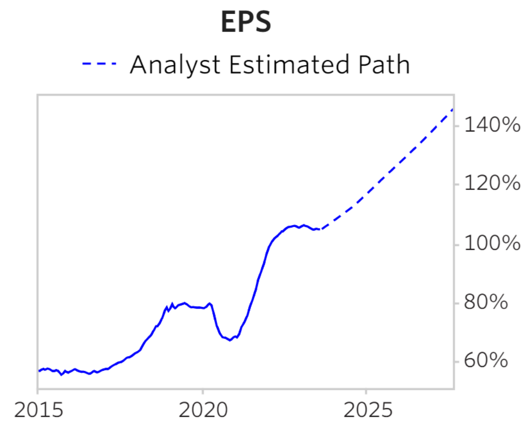
Home Prices



Home prices haven't come down much, particularly relative to the COVID run-up; supported by undersupply of housing along with lower yields in recent months

Initial decline mostly from discount rate impact, not decreased earnings expectations



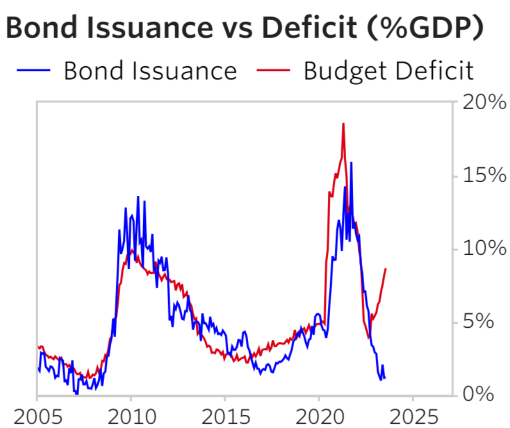


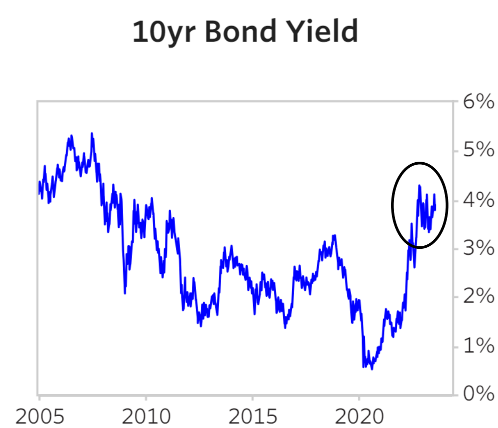
Markets continuing to price in rosy outcomes for earnings from here

The Liquidity Reprieve Is Mostly Behind Us

As we've discussed in prior *Observations*, the rebound in asset prices in recent months was driven in part by an unusually low level of bond issuance relative to the fiscal deficit, which has kept interest rates lower by reducing demand for long-duration capital in financial markets. This support to assets was compounded by the Fed's lending to banks in the wake of Silicon Valley Bank's collapse, which temporarily offset some of the impacts of quantitative tightening on liquidity. This dynamic is likely to reverse ahead as bond issuance eventually rises to fund the deficit—particularly since banks and the Fed, the two biggest buyers of duration in recent years, are no longer buying. But up to this point, this "liquidity reprieve" has kept asset values up, minimizing the impact of the tightening on the real economy.

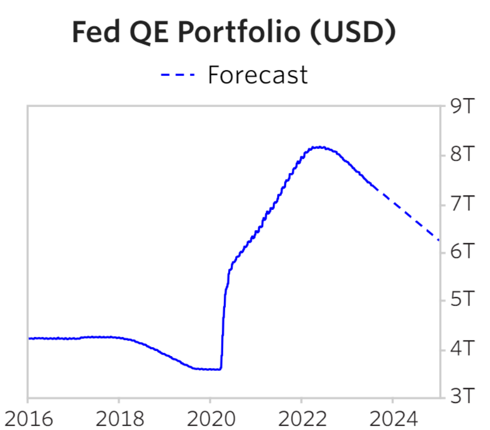
Bond issuance has been very low relative to the deficit...

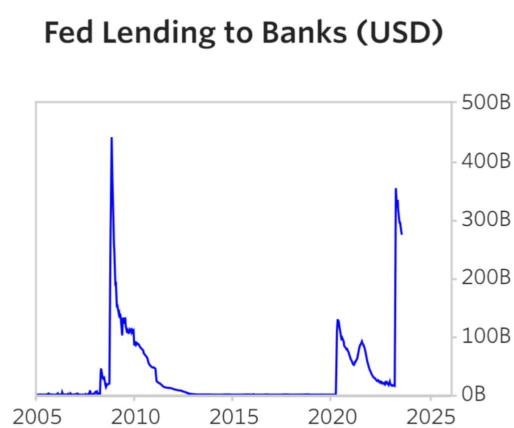




...helping to prevent a more meaningful rise in bond yields

The Fed continues to reduce its bond holdings...



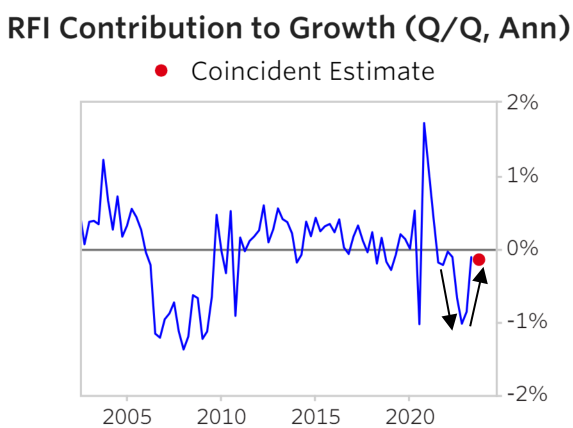


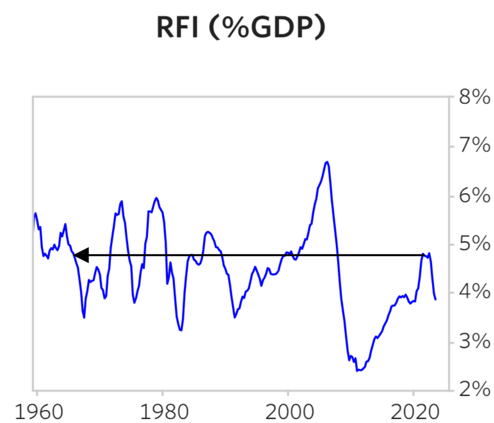
...but in recent months, this QT was partly offset by the injection of liquidity to at-risk banks

Housing Contracted Fast, but Was Too Small to Cause a Recession and Has Since Stabilized

Mortgage borrowing and construction activity were impacted by the tightening early on, as one would expect. But the size and broader implications of a housing contraction vary across cycles depending on the nature of the prior expansion. In this cycle, excesses like construction booms, bad loans, high debt levels, and banks leveraged to a hit in credit were not in place, limiting the impact on the economy. If anything, a shortage of housing, a growing population, and lingering supports from the pandemic are supporting activity and boosting prices and wealth today. The real strains could come about when or if unemployment rises, causing more forced sales. But in the short term, construction will likely be neutral to positive due to a shortage of housing, while sales are likely to be stable or rise off of today's extremely low levels due to natural turnover and household formation.

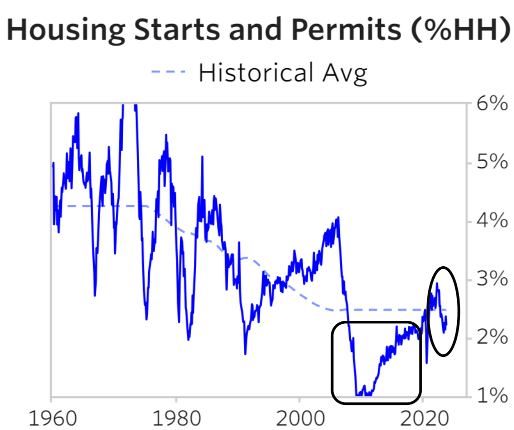
The tightening brought about a large contraction in construction activity that seems to have been short-lived

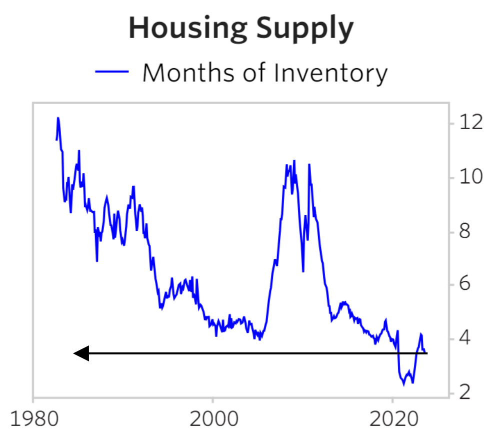




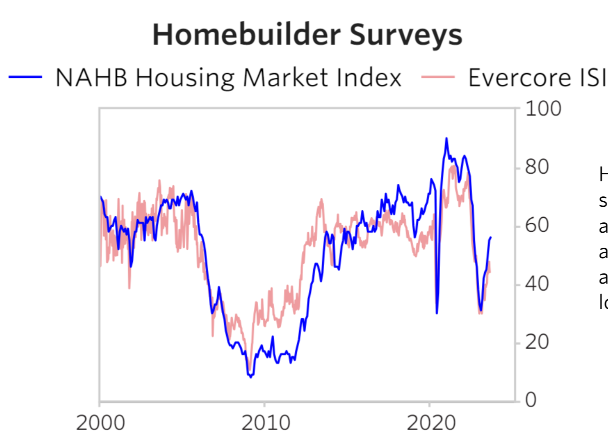
Housing activity peak was low relative to prior cycles

Construction activity is stabilizing after a much smaller decline than in prior cycles; the decade of underinvestment following the GFC is supporting activity today





Housing supply is close to secular lows

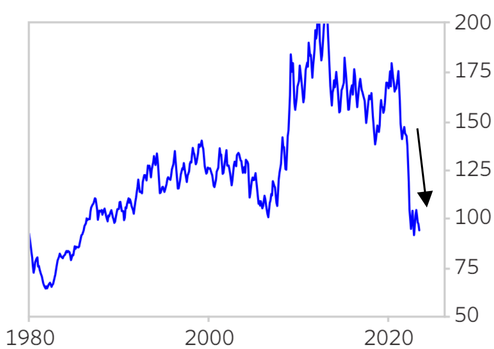


Homebuilder surveys corroborate a bounce in activity and more optimism about the forward-looking picture

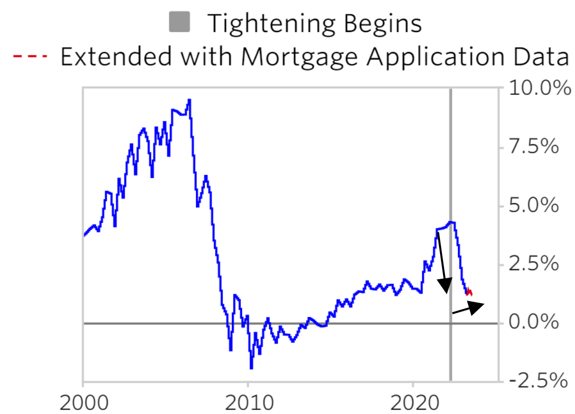
Home sales have stabilized in recent months after the initial contraction. The primary driver of this stabilization was moderating mortgage rates, as we show below. But even if rates rise somewhat from here, we would not expect another big leg down in sales. They are already around secular lows relative to the size of the population, and these numbers likely have a natural bottom, as some people will always need to move. Crucially, strong incomes and better lending standards have limited forced sales so far this cycle. That has meant that the volume of houses put on the market has come down along with demand, limiting the effect of a weak housing market on home prices and wealth.

NAR Housing Affordability Index

Very unaffordable relative to history (100 = family with median income would need to spend 25% of their income on the monthly mortgage payment for the median house)



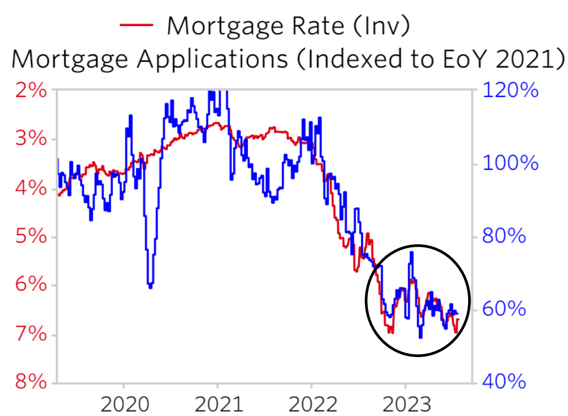
Mortgage Credit Creation (%GDP)



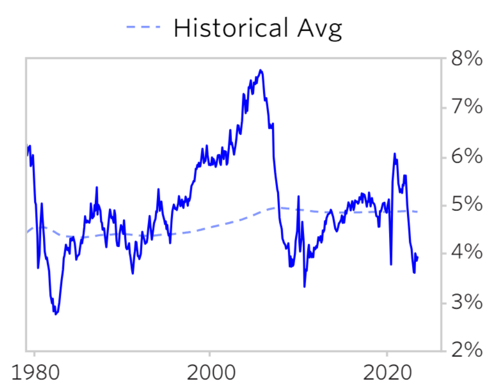
Big hit to mortgage credit creation, which has flattened out recently

Mortgage Rate vs Applications

Weekly mortgage application data suggests uptick in recent months is a function of mortgage rate moves



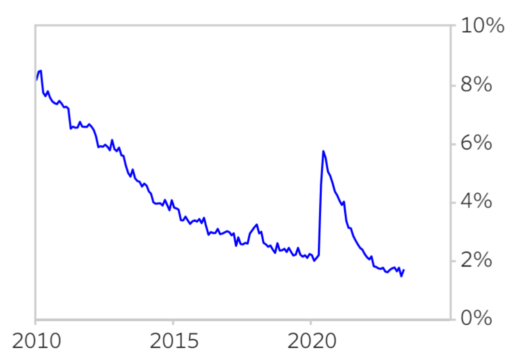
Home Sales (%HH)



Sales fell to around the historical lows reached during the GFC—a further big fall looks unlikely

FHFA, Delinquent Mortgages (%Total)

Payment problems on mortgages remain low due to strong employment, limiting forced selling

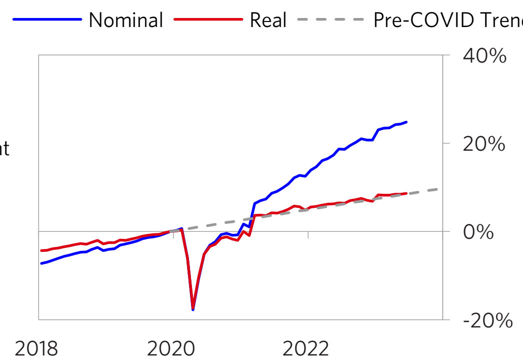


Consumer Demand Has Been Mostly Unaffected, as Elevated Cash Balances and a Tight Labor Market Have Caused Households to Keep Spending

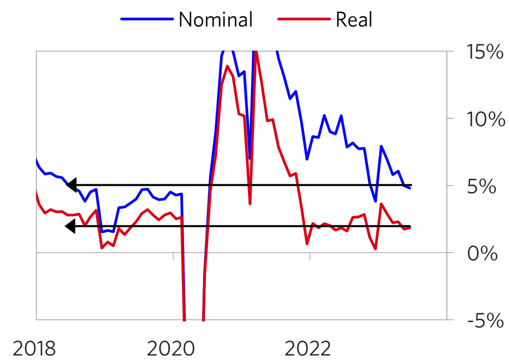
Higher rates typically weigh on household consumption in a few ways. Consumer credit becomes more expensive; higher returns on cash increase the incentive to save rather than spend; debt service costs claim a larger share of incomes; and falling household wealth, worsening labor markets, or fears of a broader slowdown cause households to save more. In this cycle, however, consumer demand has been remarkably strong, as households drew on the savings that they accumulated during the pandemic to supplement their incomes, and some of the tightest labor markets in history further encouraged spending. As we've discussed in prior *Observations*, this strong household demand has been one of the major drivers of the broad resilience of growth this year. We are now seeing some normalization in nominal demand, but it continues to grow at a pace that is far from consistent with a contraction, which would likely require a large decline in asset prices or an increase in unemployment to come about.

Consumption has remained consistent with the cyclically hot pre-COVID economy

PCE Level (Indexed to EoY 2019)



PCE Change (6m, Ann)

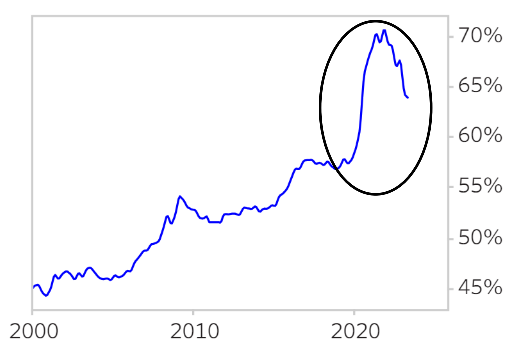


Spending growth is slowing to normal levels, but remains solid

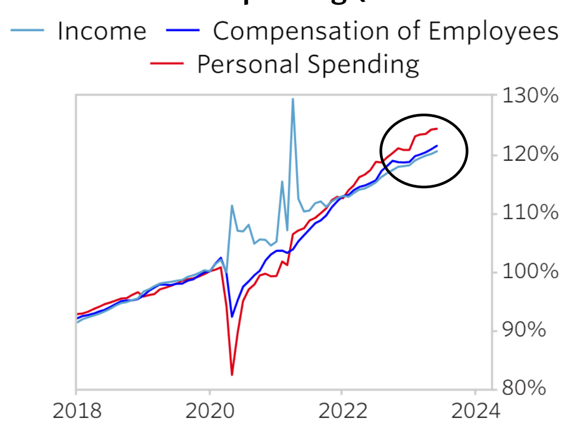
Note: PCE data through May, extended to June using retail sales data and other indicators

Consumption was supported by the cash that households accumulated from fiscal transfers and declines in spending during the pandemic

Household Cash Savings (%GDP)



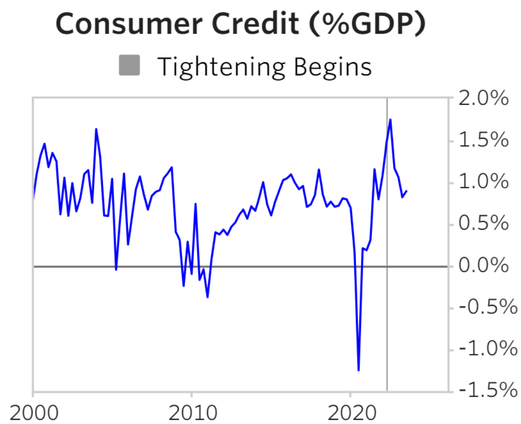
Nominal Income and Spending (Indexed to EoY 2019)

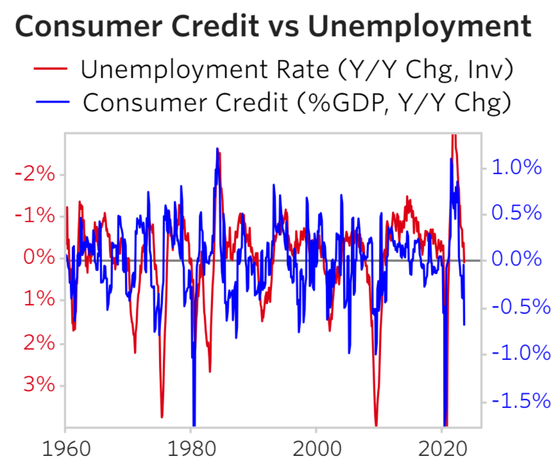


These excess savings enabled household spending to remain high relative to incomes over the past year

Consumer credit is only a small piece of the economy, and while higher rates have caused it to recede somewhat, the decline in this one source of household spending has been offset by robust cash savings and strong nominal incomes. Moreover, the durable goods that are frequently purchased on credit—especially autos—were supply-constrained entering the tightening, which both created pent-up demand that is counteracting the effects of higher rates today and reduced their share of the economy entering this tightening cycle, minimizing the impact of weakness in these sectors.

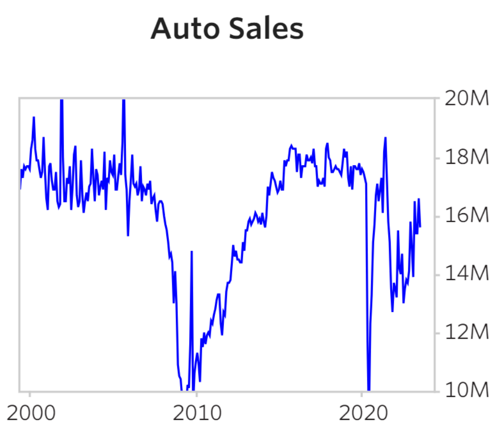
Relatively small decline in consumer credit following the rate hikes

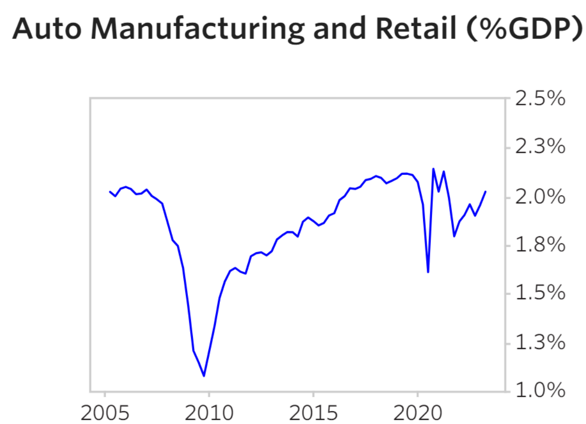




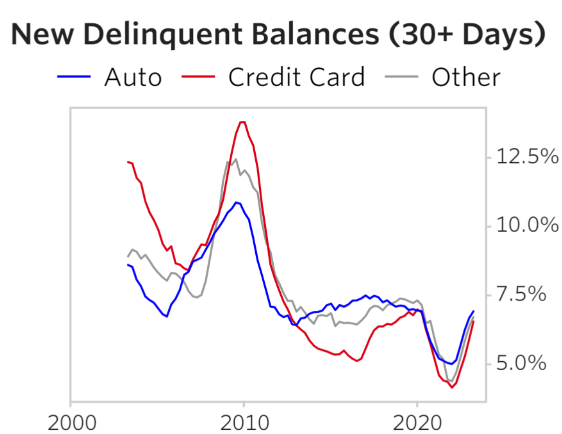
Consumer credit is quite sensitive to incomes and employment, and is unlikely to collapse while those remain solid; historically, big declines in consumer credit before UE rises are rare

Auto supply mostly recovered; consumption suppressed by supply going into rate hikes, limiting their impact





Small as a share of the economy, particularly in this cycle

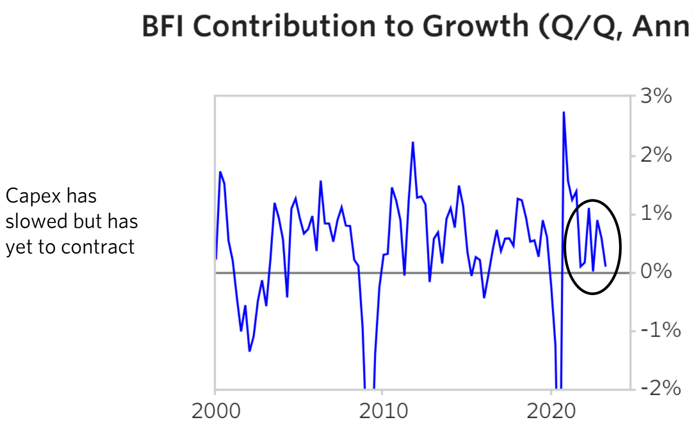


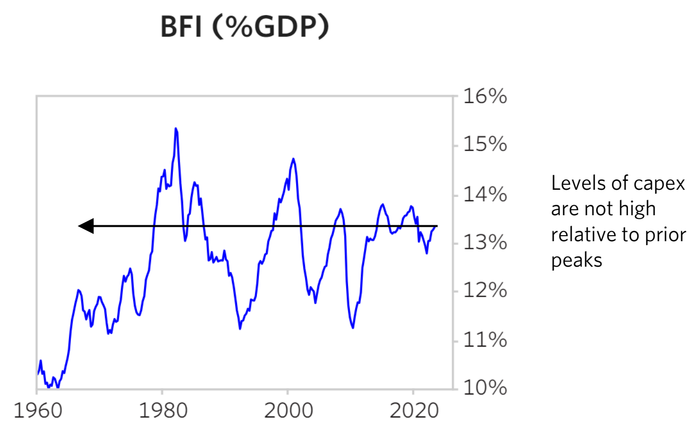
Uptick in HHs experiencing payment issues, but so far this looks mostly like a normalization from unusually low levels during the pandemic, when HHs had a buffer from stimulus payments; no evidence of big loss/default cycle

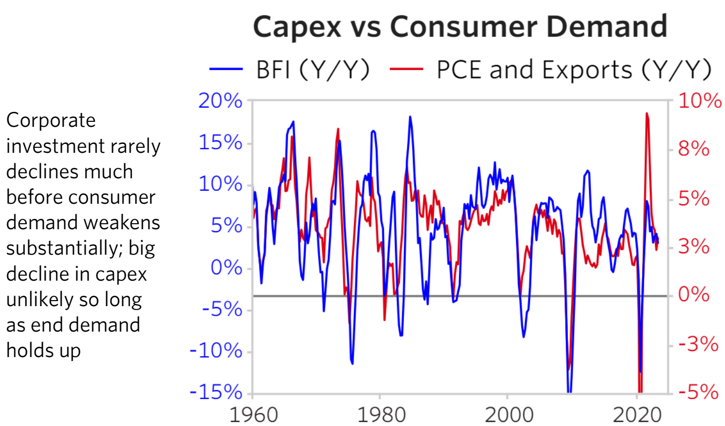
Capex Has Slowed, but It Is Unlikely to Contract Before Consumer Demand

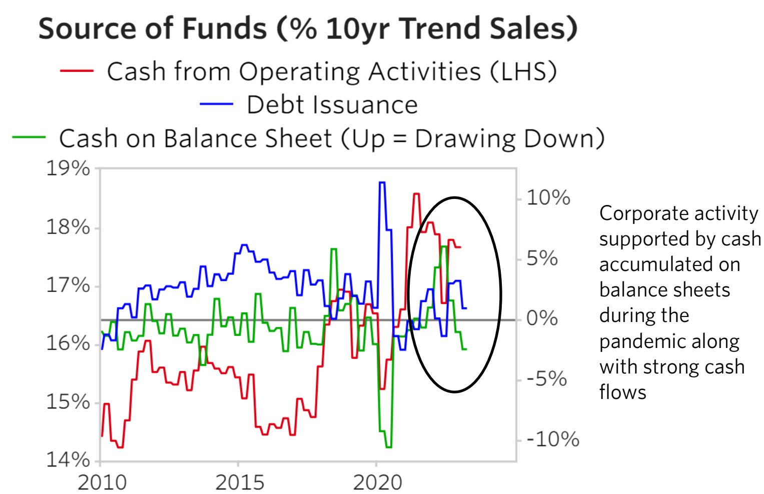
While the tightening increased the cost of borrowing for businesses, business investment is ultimately motivated by the end demand that companies experience and anticipate. We have yet to see a contraction in capex despite higher rates, as strong household demand has both financed and incentivized continued business investment, and levels of capex were reasonable entering this cycle.

Furthermore, as we've analyzed in prior *Observations*, businesses—like households—entered this period with strong cash balances, which they increasingly drew on to finance spending as borrowing became more expensive. These higher cash levels muted the impact of the tightening on corporates by giving them the flexibility to borrow opportunistically, waiting to borrow when rates look most favorable. While some of these buffers now look to be spent down, corporates are unlikely to pull back in a major way so long as end demand holds up.





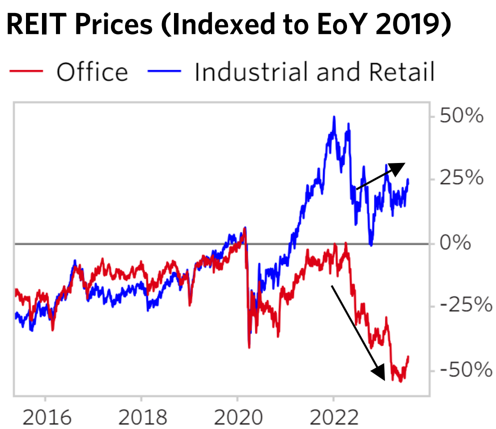


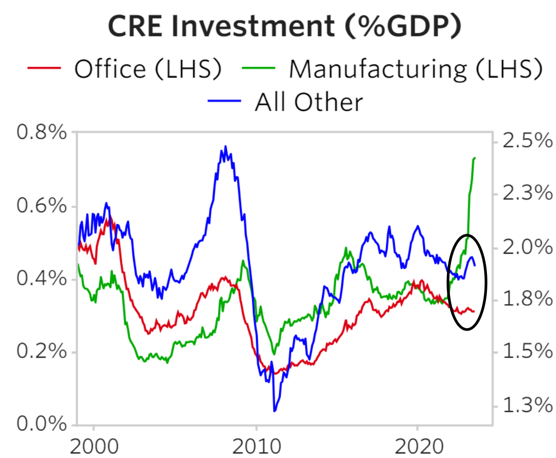


The Cracks in Commercial Real Estate Look Manageable

Commercial real estate is a highly cyclical, rate-sensitive area of the economy, and it has shown some weakness since the tightening. However, the risks in this sector are concentrated in the office subsector, where the impacts of higher rates are coinciding with a sharp decline in demand for office space following the pandemic. This subsector is quite small—office investment is around 30bps of GDP—and unlikely to have major ripple effects as it weakens. Meanwhile, good lending standards in the decade before the pandemic are limiting the likelihood of second-order impacts to the financial system from weakness in CRE. Sustained high rates will create a drag in commercial real estate over time, but this will play out gradually, and CRE is just not all that big a component of the economy. We discussed commercial real estate in more detail here.

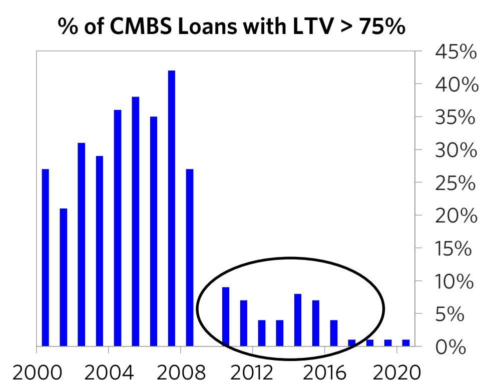
Within CRE, big difference between office and non-office; non-office looking OK





Problematic office sector is ***small***: investment is ~30bps of GDP in total; manufacturing investment surging due to industrial policy incentives; other CRE investment, which covers a very diverse set of sectors, looks OK

Minimal risk of financial contagion; only a minor loss cycle is priced in...

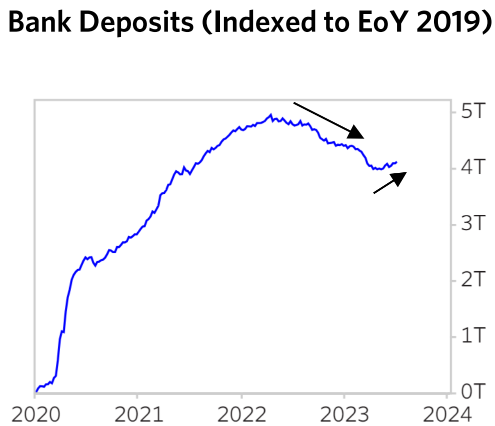


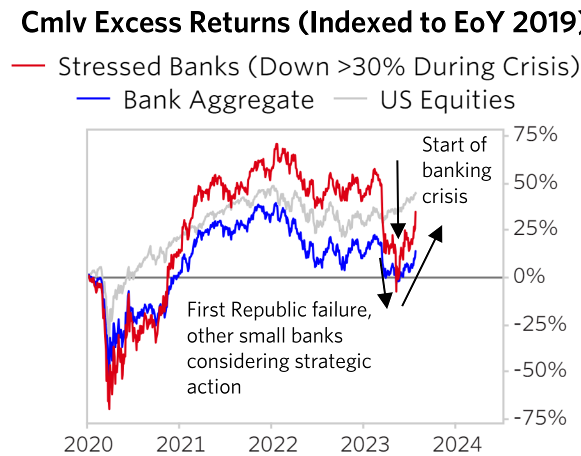
...partly due to improved lending standards post-GFC

Strains in the Banking Sector Appear to Be Relatively Contained

SVB's collapse in March drew attention to duration mismatches at some banks, raising the risk of a broad pullback in lending as bank earnings deteriorated. While these banking strains initially looked like they could be the big break that would set off a self-reinforcing contraction, that scenario seems increasingly unlikely to us today. We are actively working through Q2 bank earnings as they come out and will share more detailed takeaways on the banking strains in a coming *Daily Observations*. But at a high level, our view today is that these strains look likely to impact the real economy primarily through a moderate pullback in lending in some individual pockets where stressed banks were the predominant lenders.

Deposit flight has stabilized recently, but the rise in deposit costs that it prompted will weigh on bank earnings ahead, likely representing a marginal drag on lending



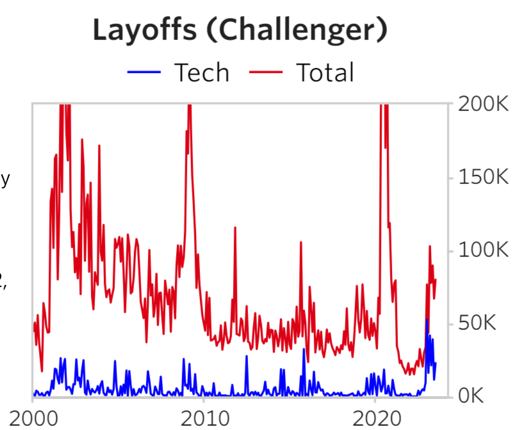


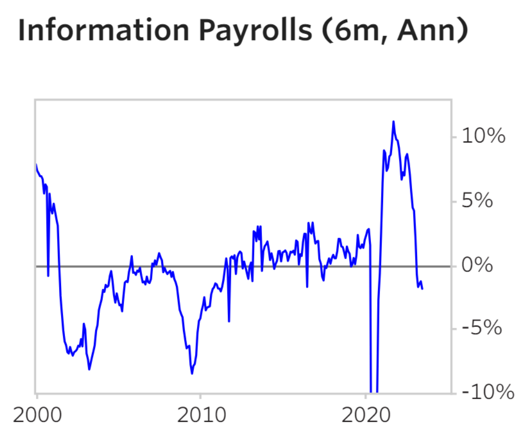
Fears receding; rebound ~40% off of lows, at a time when the 2yr rose by over 100bps

Other Cracks Had Only a Limited Impact on the Real Economy

The tightening had a rapid impact on tech companies, especially startups, as cheap funding dried up and investors became less interested in financing projects with earnings far out in the future. This came on the heels of a surge in valuations and hiring during the pandemic. But the deflation of those excesses had only a small effect on the national economy, in large part because the tech industry is only a small segment of total employment. And more recently, we have seen a slowing in tech layoffs along with a rebound in valuations, with the latter inspired in part by enthusiasm about AI and machine learning.

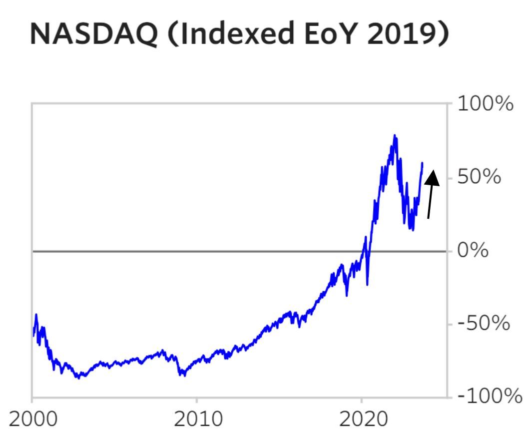
Small employment impact (the tech industry employs ~3-4% of total workforce); Challenger report reflects ~230K tech jobs cut since 2022, which is ~10bps of total employment

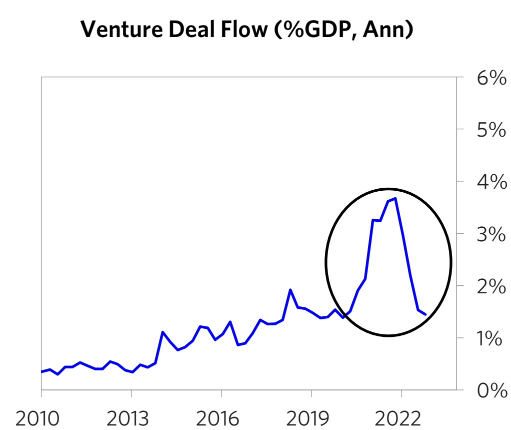




IT is experiencing only a modest reduction in payrolls, and off levels that rose tremendously during the pandemic

Tech stocks recovering





Froth of COVID period eliminated; likely to bounce from here on AI/ML enthusiasm

The tightening also hit the frothiest, most speculative assets, like retail stocks and cryptocurrencies. While this erasure of wealth was likely a drag on household spending on the margin, the wealth effect here was muted, in part because the speed of the prior run-up limited its impact on household spending. Although these assets fell, they did not totally collapse, and they have rebounded some in recent months. A more significant downturn could be partly driven by—and contribute to—a broader sell-off in risky assets, but there is nothing here yet that points to an imminent contraction.

Asset Prices (Indexed to Jan 2022)

Substantial loss of paper wealth in very frothy financial assets early in the tightening (e.g., retail stocks, crypto); these highly speculative assets have rallied in recent months