

Washer set to deep clean: Beware alternating rotations, drain could reopen



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IN A NUTSHELL

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Still washing out easy money in the real economy and exuberance in valuations

Investors will probably remember 2023 as a year of washing out excessive pandemic fiscal/ monetary policies and inflated asset values. The U.S. Federal Reserve (Fed) hiked rates near 500bp over the past 12-months and asset values are soaking in rising capital costs and weaker earnings ahead. While asset values and inflation are well below their 2022 highs, the rinse isn't finished. This washer now appears set to the deep clean cycle with long and alternating spinning. A cleanse for goods and services inflation as well as rich digital and real asset valuations. This setting is likely locked in and the door can't be opened until finished. In an emergency, the wash can be pulled out by cracking the glass door; but because the cleaning pros are exhausted by two years of messy blotches, with new tints emerging in the whites and darks, they will likely set-it and forget it. Will this wash finish with a brilliant shine or faded colors?

Disinflation now from brakes and scrapes: Terminal rate on hold until recession

Inflation fighting remains priority one for the Fed. As the biggest stain on this tainted expansion is 2+ years of inflation at 40-year highs. While the Fed clearly acknowledged funding challenges facing smaller banks, the Fed appears to expect and is willing to accept tightening credit conditions from these challenges. We take this as a willingness to accept some small accidents stance from the Fed in its fight against inflation. While we believe backstop institutions can effectively contain accidents, we think we've entered a new phase of more aggressive monetary policy tightening that is dangerous for risk assets. We do not believe the Fed will act to stop a recession. It's only likely to act to stop a deep recession.

Panic of '23: Deposit flight for some banks, higher cost of deposits for all

The issue of rapidly rising deposit base costs is a challenge as big as deposit flight. While the latter is acute for some banks, the former is the bigger challenge for most banks. Which is why we think the Fed should cut the Discount rate, especially if further Fed Funds hikes. We discuss this idea and point out that before 2003 the Discount rate was below the Fed Funds rate. The spread was quite large in 1980-81 when the Fed attacked inflation with efforts to cut credit availability, before it resorted to deep recession in 1982.

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Financial system regulators and supervisors are on edge, tough exams ahead

If the Fed accepts credit tightening and small banks losing share as a channel of its inflation fighting policies, it's unlikely to wince at a 20-30% downturn from peak in equities this summer with sympathetic signals of sooner cuts. Financial institutions are preparing for stricter supervision and regulation and high-risk asset investment or intermediation will be scrutinized. It will also be interesting to watch tensions between Treasury, Congress and Fed officials heat up this summer around debt ceiling fights given a backdrop of the Fed slipping from profitability. The Fed might see time (reserve carry) moving against them.

Investor concerns about the Fed "running out of bullets" might return

The Fed's ability to "fund" further rate hikes to fight inflation or set-up special facilities to relieve strains at some banks or elsewhere might be called into question as the Fed swings to full year operating losses. Losses from cost of liabilities (including interest paid on reserves) exceeding return on assets. While profitability should be considered, as Treasury and Congress will, we think the ultimate asset or liability, albeit off balance sheet, of a central bank is whether inflation is below or above its target. When inflation is below target, it can cut the Fed Funds rate, as paid on reserves, and/or increase non-interest bearing cash in circulation. When inflation is above target it must raise rates and/or reduce cash in circulation even if it leads to losses (financial asset shrinkage), otherwise it risks impairing its crown asset of inflation management credibility. We don't think the Fed is out of inflation fighting bullets and it still has ability to provide liquidity and borrowing cost relief.

Financials stumble badly; Tech laces up again, but a springtime rally is unlikely

The commodity/goods inflation plays are worn out. The reopening plays are stretch injured. Digital plays are too expensive to keep all on field. Defensives defeated by fixed income. And the moment Financials stepped on to the field they stumbled on basic non-forced error. At over 3950, the S&P 500 is broadly overvalued despite being nearly 20% below its record high. Sticky inflation is making the Fed turn to heavy detergents and rapidly rising bank deposit costs turns the odds against a springtime rally as it hobbles bank's ability to be the next leg. All of this raises the chances of a moderate recession this year to about 50%, in our view. We've taken shelter and position for next cycle leadership with Health Care, Communications, Aerospace & Defense, Rails, Electric Equip., Utilities and big Banks.

Glossary

A [balance sheet](#) summarizes a company's assets, liabilities and shareholder equity.

[Defensive stocks](#) are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

The [discount rate](#) is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

[Disinflation](#) describes a slowing of the pace of price inflation.

The [federal funds rate](#) is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. When a depository institution has surplus balances in its reserve account, it lends to other banks in need of larger balances. A bank with excess cash, which is often referred to as liquidity, will lend to another bank that needs to quickly raise liquidity.

[Fiscal policy](#) describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

[Inflation](#) is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

[Liquidity](#) refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

[Monetary policy](#) focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The [U.S. Federal Reserve](#), often referred to as "[the Fed](#)," is the central bank of the United States.

The [United States Congress](#) is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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