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THE LONG-TERM EFFECTS OF THE TIGHTENING CYCLE

The global economic landscape has been experiencing a tightening cycle for roughly a year, and it is becoming apparent that its effects are both spreading and deepening as disequilibrium becomes more apparent. Recently, we have also experienced that the banking system is likely to be a contributor to the damage being done. The flow of liquidity from cash and credit to assets and spending is critical to the success of economies, and the combination of central banks raising interest rates and draining reserves, coupled with banks experiencing more constrained deposit and capital conditions and tightening credit standards, is likely to constrain the flow of money and credit to markets and economies. This, in turn, is likely to have a detrimental impact on spending and income.

Three major equilibriums and two major policy levers interact to drive markets and economies. The first equilibrium in the rich world is spending and output in line with capacity, which roughly translates into approximately 2% real growth with 2% inflation, a nominal spending growth rate of 4% to 5%, and an average unemployment rate. The second equilibrium is that debt growth must be in line with income growth, meaning credit growth that is not too high or too low, with interest rates that act as neither a major incentive nor disincentive to borrow. The third equilibrium is a normal level of risk premiums in assets relative to cash, meaning that bonds provide an expected return above cash, and equities an expected return above bonds, commensurate with these assets' risks. The two policy levers are monetary policy and fiscal policy. The economic and market swings that we see reflect the never-ending struggles of the marketplace and of policymakers to achieve equilibrium. In the West, we are far from equilibrium, while in the East, we are closer to it. The closer an economy is to equilibrium, the easier it is to fix problems and the lower market volatility.

In developed economies, high nominal spending, when compared with the ability of an economy to produce more, remains the greatest disruption to equilibrium today. This leads to inflation that is significantly above target, leading to big policy shifts and high market volatility. Despite aggressive policy action, the United States (US), Europe, and the United Kingdom (UK) have not moved much closer to equilibrium. On the margin, the nature of the disequilibrium has shifted from too much inflation to not enough growth, with the risk premiums on assets decreasing relative to cash.

The path from disequilibrium to equilibrium allows for big market swings. When looking at why the economy is in bearish disequilibrium, we see that inflation is too high. Nominal spending, in turn, is too high to bring inflation down and unemployment is too low to bring wages down, and despite nominal growth being too high, the real growth rate is lower than desired. In the end, a weaker real growth rate, that is, an earnings recession of sorts, is required to resolve the other imbalances.

In conclusion, the effects of the recent tightening cycle are spreading and deepening, and the damage to the banking system is a manifestation of this tightening. Markets are in disequilibrium and the high level of nominal spending remains the greatest disruption to equilibrium today. Despite aggressive policy action, the US, Europe, and the UK have not moved much closer to equilibrium. The path from disequilibrium to equilibrium allows for big market swings, which is a frame of reference for longer-term positioning. It is thus crucial for policymakers and market participants to remain vigilant and proactive when managing these risks and when taking steps towards a more stable and sustainable economic environment.