HILLTOPBANK
Wealth Management

QUARTERLY MARKET INSIGHTS – THIRD QUARTER 2023

To the Clients and Partners of Hilltop Bank Wealth Management:

As readers of this letter are well aware, the Federal Reserve's goal in increasing interest rates is to slow the economy and bring down inflation. This remains the single most important theme in the economy, and while great progress has been made on this front since inflation topped out above 9% last summer, more work remains to be done.

The Arguments for and Against Further Fed Action

Currently, headline inflation is at 3.7% year-over-year, a slight increase over the last few months. If we take out some of the more volatile prices (specifically food and energy), we arrive at core inflation, which is 4.1% year-over-year. The Fed's stated goal is for inflation to be 2%, so the obvious point to note is that we are still twice that figure. This presents a difficult question for Jerome Powell and the rest of the Board. Should they continue raising rates, or wait to see what impact the long and variable lag of monetary policy has already wrought?

On the one hand, the economy continues to grow with surprising resilience. US GDP is currently estimated to be growing at 5.1% on an annualized basis. Most economists believe the natural rate of growth is closer to 2%, and that growth faster than that figure produces further inflationary pressure. Let's put that in the column arguing for the Fed to further tighten monetary conditions.

For another argument in favor of tighter financial conditions, the unemployment rate remains historically low. It increased from 3.5% to 3.7% over the last quarter. While that may look like a negative at first glance, what the unemployment rate is actually measuring is how many people *currently looking for work* cannot find it. The increase, rather than resulting from folks losing their jobs, is the result of more Americans joining the labor force - 736k more. We added jobs, but not 736k of them.

So, on the one hand, the Fed sees a strong economy, a strong labor market, and inflation that remains above their stated goal. Why might they still decide not to raise rates again this year?

First, the current pace of interest rate increases has been the fastest in Fed history, and the current 5.25-5.50% range for Fed Funds is the highest since just before the Great Financial Crises. Our economy has changed a great deal in the fifteen years since then, and because economics is not an exact science, no one knows exactly how these higher rates will play out. That being said, we ought to expect the impact to be two-fold.

First, sticker shock will deter some spending. Take, for example, a person who was willing to pay $300,000 for a house with 20% down, and a 2% interest rate on their mortgage. Their monthly payment would have been about $887. Fast forward to 2023, and instead, they are offered an 8% mortgage. That same house will cost them a monthly payment of $1,761. Given that steep difference, they may choose to forgo the purchase altogether. In fact, sales of previously owned homes are on track for their slowest year since 2011. That same calculus applies to other transactions such as autos or business fixed investment.

The second-order impact of those higher interest rates will occur when debt previously taken out must be refinanced. Companies that were able to raise funds by offering bonds paying 2% will, over the next few years, have to issue new bonds at whatever rate is then prevailing in the market. Similarly, some homeowners from our previous example will eventually be forced to move, whether for new jobs, or more space, and have to give up their current, low mortgage rates for something higher. Indeed, not just companies and individuals will be subject to those new higher rates, but so will the government.

Ten-year US Treasury yields, which underlie much of the pricing of other financial assets, recently reached a 15-year high of 4.89%. That is the price that the government must pay to borrow and fund its spending, and there is currently a lot of spending going on. One recent estimate from the Congressional Budget Office puts our government's spending at $2,058 billion in the upcoming fiscal year. That's an increase from $933 billion in the fiscal year just ending. Now, while those are both unfathomable amounts of money to any of us mortals, it is well within our government's ability to pay (assuming, perhaps naively, that politicians do not get in the way). As a percentage of our entire GDP, it is actually a smaller amount than what it was just three years ago.

While the US can certainly afford to pay that amount, it is a lot of borrowing to finance. Just like any other market, the market for Treasuries is impacted by supply and demand. Running deficits of the size we currently are results in a lot of supply. At the same time, the big buyers of Treasuries over the last decade (the Fed, banks, and China, in that order), are scaling back. In any market, more supply and less demand should lead to lower prices. In the case of bonds, prices and yields move in opposite directions, which is part of the reason we are now seeing the rate on 10-year Treasuries increase.

Back to the Fed's current conundrum, even if it believes tighter monetary conditions are in order, it can look to the bond market and reasonably conclude that the market is tightening conditions well enough without further intervention. Markets are doing the Fed's job for it. The question in front of them is whether this tightening will be the correct amount to continue to bring down inflation without going too far, and there is no way for them to know that except in hindsight.

What I have just described is a complicated problem but a simple choice. The Fed can either raise rates, do nothing, or cut them. On the peripheral, other levers may be deployed, but the interest rate decision will have by far the greatest impact.

In contrast, what if the Fed had more control of the entire economy? If they also set fiscal policy, directed investment flows, and could even arrest CEOs who underperformed, would that greater control lead to better results? I'm not so sure.

It is Tough to Build the World's Largest Economy

If you had unlimited power and were setting out to build the largest economy in the world you would hope for a few preconditions to be in place. You would want a large and able workforce, the desire and ability to make great strides in technological advancement, and the best-laid plans. China in the 1990s met at least the first two of these preconditions.

In 1998, with the goal of eventually overtaking the US as the world's largest economy, the Chinese Communist Party legalized the private ownership of real estate. Starting in Beijing and Shanghai, and then in other "tier-1 cities" (followed by tier-2, -3, etc.), there was a great boom in development. The system they designed worked like this: The local governments would borrow money to buy cheap land, developers would construct sprawling complexes (also debt-financed), and the Chinese people would buy the units. Developers worked with provincial governments to build millions of housing units every year, and the sales proceeds would be used to finance the construction of the next development - often before the previous development had even been completed. Families would move into their new apartments, and even purchase further future units for investment.

Over time, developers would build more units than the demand could support, with the result being "ghost cities" – vast complexes where the units were sold but unoccupied, often held for investment rather than a productive stock of housing.

If this sounds similar to the subprime mess of 2008, it's because it is - the bubble in the Chinese housing market has been a source of concern for some time. Both In 2008 and again in 2014, the bubble began deflating. Both times the developers and local governments were bailed out by stimulus from Beijing. They kept the treadmill running.

The result has been local Chinese governments have borrowed heavily to finance these developments. The IMF estimates that their debt has risen to 32% of China's GDP, while "potential liabilities" have grown to 53% (together, that's 85% of China's total GDP). Local governments have been servicing that debt through further borrowing, and remittances from Beijing (which collects the income taxes in their system), but primarily from land sales. Until 2021 land sales contributed about the same as transfers and tax receipts, but in 2022, land sales fell by about 2 trillion yuan ($275 billion). This year they are expected to have fallen even further as the two largest buyers were the developers Evergrande and Country Garden, both of which are now in serious financial trouble, with more than one executive arrested on unnamed charges. This time around, the CCP seems much less inclined to save a market that's grown to an estimated $62 trillion in size.

As it turns out, even with unlimited power to direct your economy, the demographic advantages that come with a billion-person population, and a successful campaign of appropriating others' technological advances, building a successful economy from scratch is still very difficult. It may turn out that the final precondition, well-laid plans, is missing.

While the US Federal Reserve Board has a hard decision to make, if you gave them more levers, I doubt they would be any more successful. To reformulate the famous Churchill quote, capitalism is the worst economic system we have, except for all the others.

Best,

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