

Macroeconomic Update

# The Economy Is Not Immune to the Effect of Tight Monetary Policy

Recency bias hits the market's economic outlook.

Faced with a series of strong economic data releases, the market has increasingly come to the conclusion that the economy is structurally better able to withstand higher interest rates. This dynamic can be seen by decomposing the move in Treasury yields, with the selloff almost entirely due to real yields rather than inflation expectations, and most pronounced at the back end of the yield curve. Digging further, we can see that a large portion of this shift is due to a rising term premium, indicating greater uncertainty about the outlook. We agree with the view that the neutral rate for the economy has moved higher, but we think the magnitude of the move in the market is overdone. It is a mistake to think strong economic data will continue and that the impact from monetary tightening is behind us.

Many forecasters are extrapolating this year's economic strength without recognizing growth has benefited from a number of factors this year that are unlikely to be repeated, namely a huge expansion of the fiscal deficit, a major slowdown in inflation, and a rebound in labor supply. As these factors fade, the headwinds from tight

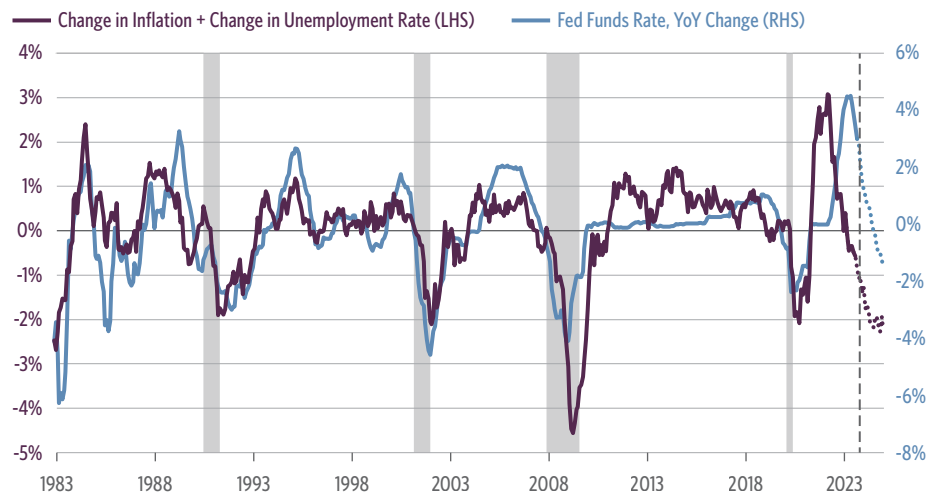
monetary policy will be more apparent—headwinds that will only grow in strength. And the longer monetary conditions stay tight, the greater the risk of something breaking (regional banks and commercial office real estate remain key risks). All this means that the recent economic trajectory cannot be assumed to continue, especially given the substantial restraint that will be imposed by the recent rise in long-term borrowing costs.

Uncertainty is elevated, and rightfully so given the diverging signals in the data and many traditional economic models not “working” as they should. This uncertainty extends to the Fed, which looks set to hold off on further rate hikes while waiting to see if the data start to align better with the softening conditions reflected in their Beige Book reporting. We continue to think the gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

*By Matt Bush and Maria Giraldo*

The gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

## Weaker 2024 Economy Should Pave the Way for Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Actual data as of 9.30.2023. Change in inflation measured as six-month change in YoY% core PCE price index, change in unemployment rate measured as YoY change. Shaded areas represent recession.

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