CLOUGH CAPITAL
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Beyond the Fed: Structural Forces Driving Long-Term Market Strength

We believe fundamental pressures will force short-term interest rates down, even if the Federal Reserve (the "Fed") is slow to reduce the overnight rate it controls. Given the level of free cash flow businesses are generating, this helps sustain the outlook for equities in coming years.

Investors spend a lot of effort guessing when and by how much the Fed will reduce interest rates. But what is more important is that financial market conditions are still positive, even in the face of the fastest Fed tightening in history. Under normal circumstances, the monetary backdrop would be negative for securities prices. Quantitative tightening[1] has reduced the size of the Fed's balance sheet from over $9 trillion in 2022 to $6.6 trillion today. Expectations are modest as to how rapidly the Fed will ease and private credit, bank credit and money supply growth remain on the weak side. These all argue for a weak economy and disappointing profits.

But the securities markets are telling us something different, that financial conditions are easy, despite the Fed. Crypto is booming. Bond managers have raised hundreds of billions of dollars expecting a flood of distressed bonds for sale, but high yield spreads are near the lowest ever, distressed bonds are sparse, and the CBOE Volatility Index (the "VIX") [1], a measure which uses S&P 500 Index[1] option premia to identify stress in equities, is at a low point that tells us securities market conditions are good. We believe all of this is because the private sector is now throwing off excess cash and the economy is less dependent on what the Fed is doing. Liquidity is building up despite tight monetary conditions, and outside of recession, that is unique in the post-war period.

We think the rise in private sector savings is long-term, and this suggests U.S. bond and equity markets have a secular liquidity tailwind and the economy can grow faster without creating sustained inflation problems. It also suggests the underlying deflationary forces which affect the global economy will remain in place and the trend to lower interest rates will resume. We have put forth three interconnected reasons for this.

First, apart from the Federal Reserve, demographics play the strongest role in determining the secular trend of interest rates. Other things being equal, people tend to save more as they age. And that is becoming even more likely as lifespans become longer. Japan is probably the most vibrant example. As its population aged, the Japanese economy has generated excess savings for decades and real interest rates have rarely been positive. A widespread concern in the U.S. is that as baby boomers retire, labor force shortages will bring on higher inflation. But that leaves out part of the equation. Retirees spend less. They buy fewer homes and cars. They might spend more on leisure, but travel and leisure represent only 3% of the economy. The fact that the baby boomers are about to turn over 50% of the housing stock will only intensify deflationary forces.

Second, private sector balance sheets are far too levered to allow interest rates to remain at current levels. Having reached ~150% of gross domestic product ("GDP"), private debt is increasingly difficult to service as interest rates rise, and they remain a secular deflationary force. Consumers appear to be impervious to this, but the aggressive use of installment credit taken down at 20% plus interest rates to sustain current spending should soon roll over.

Third, technology is a major force for improving productivity, particularly labor productivity. While difficult to measure, the U.S. economy has been generating higher levels of real GDP with fewer workers; since 2019, hours worked have actually declined 2% while real GDP rose 11%. This has been a major source of profits for businesses. And the advent of artificial intelligence ("AI") promises further productivity gains.

So how is this all working out? While intensive fiscal stimulus, the consumer's use of COVID savings and expensive installment credit have sustained consumption, these consumption supports are faltering. Credit balance delinquencies among the 30-39 age group, those with the highest propensity to spend, have risen from 4% in 2021 to over 8% today and they are moving up rapidly. And wage growth and job openings as a percentage of the labor force are declining. As far as businesses are concerned, $1.8 trillion in business debt must be rolled over in 2025-2026, according to Fed research, at double or triple the interest rate cost.

We hold a contrary view here, but once the Fed does ease, there are strong reasons to expect bank deposit rates to decline sharply. What is new in this cycle is that bank credit and M2[1] have been sluggish, signaling the banking system is allowing deposits to run off. This implies that at current interest rates there are not enough legitimate assets to allow banks to leverage the $18.5 trillion in deposits they hold. In other words, to grow, banks must add bad loans to their balance sheets. Even today, simple checking account deposits earn 5-10 basis points, and that level suggests deposit rates would be far lower were the Fed not so aggressive.

There is a secular dynamic here. We think the developed world is gradually entering a savings to investment imbalance, where the desire to save exceeds the ability to spend and invest. That began in Japan thirty years ago, migrated to Europe around the time of the Greek debt credit crisis, and could describe the U.S. economy in coming years, particularly if immigration is constrained. All of this tends to force the natural rate of interest lower.

Clients still question our beliefs that the secular decline in inflation and interest rates will resume and the fears of a dollar collapse are overblown. Concerns over excessive federal government deficits have been a reality, on and off, since 1789. Even before the constitution was written, Alexander Hamilton argued in the Federalist Papers that government debt is an asset, not a liability, since it establishes a public credit that can be used instead of taxes, and it creates liquidity and an asset which can be used as a store of value. Concerns over default by the U.S. Treasury is specious, in our view. For one, default by the U.S. Treasury is an impossibility, unless done intentionally, because the U.S. federal government creates its liabilities in its own currency. Secondly, the Federal Reserve has unlimited capacity to buy U.S. debt. The issue, of course, is whether the supply of new securities creates an inflationary event which would cause the dollar to collapse, and an uncontrollable compounding of debt liabilities. Here are our thoughts.

Despite the new supplies of U.S. Government securities, the total sum of U.S. dollar liabilities outstanding will rise far more slowly, if at all. The total sum of U.S. dollar credits includes not only those of the federal government, but the private sector as well. Federal debt outstanding today totals roughly $36 trillion, including agency debt, while total outstanding private debt (households and businesses combined) is far larger, currently totaling almost $50 trillion. As a percentage of GDP, which we think is the correct way to look at it, private debt is actually declining as baby boomers retire, borrow less and generate more savings than the economy can invest. Government debt, though expanding, is leveling off relative to GDP, and could decline if interest rates fall. In the meantime, over the past eighteen months, the Fed has reduced its holdings of government and mortgage securities by roughly $1 trillion, which suggests monetary policy has been tighter than thought. And the U.S. population is close to peaking absent another surge of immigration.

Japan is an extreme example of what is likely to happen to the U.S. Beginning in the 1990s, Japan's population began to age and save. But because Japan has been running much larger fiscal deficits to deal with its aging population, deficits have been large, and Japan cannot depend on large demand for its debt from other countries. Today the Bank of Japan holds government securities equal to more than 115% of GDP (five times that of the Fed's holdings of U.S. debt). So, government spending is making up for the decline in private spending. One could make the case that had the government failed to make up the decline in private spending, Japan would have been in serious recession for the past 25 years. This sounds speculative, but it does answer some perplexities of today's securities markets. It explains why bank deposit rates for simple demand deposits range in the 0-15 basis point range.

We suspect any weakness in economic data, especially on the labor front, will rally bonds. The dollar's foreign exchange value, at 99, is in the middle of its trading range over the past 10 years.

If our thinking is correct, short-term rates will eventually decline because the financial sector will have little incentive to pay up for its liabilities. Even private equity is facing difficulties in finding investments for the enormous funds they have raised, and most private borrowing is used for asset purchases. The economy is generating is liquidity and depending on far less on the Fed to do so.

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[1]Definitions:
Quantitative tightening: contractionary monetary policy used by a central bank to reduce assets on its balance sheet, shrinking the overall money supply and liquidity in the economy. It is used to control inflation by allowing bonds to mature without reinvestment or by selling them, which increases interest rates and slows economic activity.
CBOE Volatility Index: a real-time market index used as an estimate of the expected volatility of the S&P 500 Index by calculating the midpoint of real-time S&P 500 Index option bid/ask quotes. The index is used by investors to evaluate market sentiment and perceived risk.
S&P 500 Index: a free-float capitalization-weighted index that measures the performance of 500 of the largest U.S. equities representing all major indices. Indexes are unmanaged and one cannot invest directly in an index.
M2: the U.S. Federal Reserve’s estimate of liquid assets is a broad measure of money that includes M1 (currency in circulation and checking account deposits) plus savings accounts, money market accounts, and small-denomination time deposits. It represents a significant portion of a country’s total money supply, including assets that are highly liquid and can be readily converted into cash, providing a broader view of money circulating within the economy.

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