Recession Watch: longer debt maturities are no panacea

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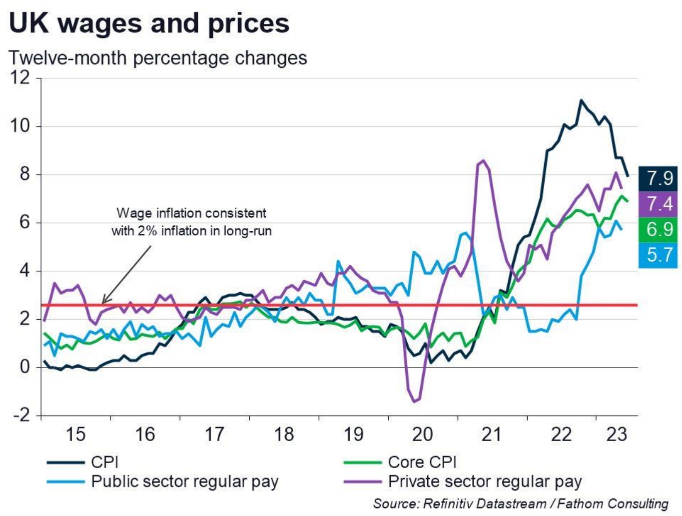
Headlines

- The rosier near-term outlook that we unveiled in our *Global Outlook, Summer 2023* continues to unfold, but we are not out of the woods yet
- We argue that longer debt maturities complicate and lengthen the transmission from tighter monetary policy to weaker aggregate demand, but they do not stop it
- Recession can still be avoided, but only if firms set prices and workers submit wage claims on the basis that inflation is going to be 2% — credibility is more or less everything
- This is a more likely prospect in the US than in Europe

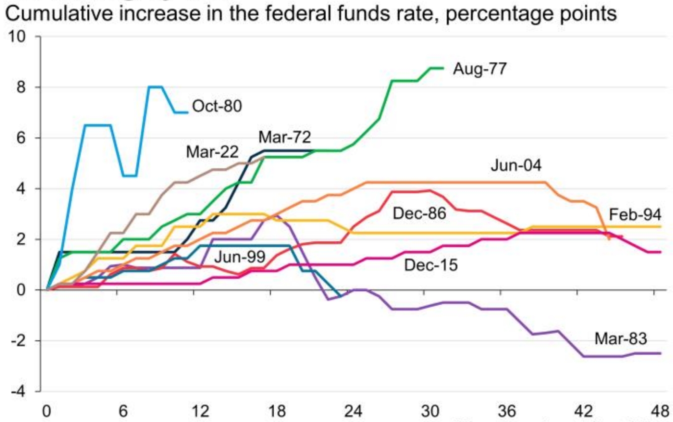
In Fathom's *Global Outlook, Summer 2023*, finalised in early June, we changed one of our key calls. Our central scenario no longer included a global recession this year. In the US, real wages had already started to rise on a twelve-month basis. Our judgement was that this pattern would soon be repeated in the euro area and in the UK. Most major economies had got through the worst of the cost-of-living crisis without entering a period of economic contraction. There were one or two exceptions — at the time of writing, the euro area had just suffered two consecutive quarters of falling output, driven by weakness in Germany. However, we felt the region was likely to return to growth before the year was out. Against this backdrop, investor sentiment had switched firmly back to 'risk-on', and we anticipated further gains in broad equity indices through the second half of the year. Scroll forward a couple of months, and we find that the S&P 500 has continued to drift higher, the euro area looks to have expanded by 0.3% in Q2 (with the initial estimate of a contraction in Q1 revised away), while the UK press only this week has declared an end to the cost-of-living crisis, with wage inflation finally expected to outstrip CPI inflation. So far, so good.



But there was a caveat to our apparent optimism back in early June. The message of our previous forecast was very much 'one bullet dodged': there were still two in the chamber. We named the two remaining bullets (or risk scenarios) 'It's out for delivery' and 'Sticky inflation'. In the first of these, the full effect of the monetary tightening that was already in place had yet to hit home. Recession was already baked in the cake and it was just a matter of time. We attached a uniform 60% weight to this scenario across countries. Since finalising our previous forecast, we have detected among other forecasters a growing sense of optimism that recession can be avoided, full stop, despite a more rapid tightening of monetary policy across the major economies than we have seen in decades. This time, in other words, will be different, with many seeming to pin their hopes on the protection offered by rising debt maturities, in part for corporates but particularly for households. In the remainder of this *Recession Watch*, we explain why, from the perspective of avoiding recession, longer debt maturities are something of a red herring. We also discuss the circumstances in which recession can be avoided – because undoubtedly it can.[1]

US hiking cycles*

Cumulative increase in the federal funds rate, percentage points



*For each historic hiking cycle we stop the line when a recession began or at 48 months

Source: Refinitiv Datastream / Fathom Consulting

In the US, 30-year fixed-rate mortgages are the norm, and have been for some time, with the share of adjustable-rate mortgages (ARMs) in total loan applications averaging less than 10% since the GFC. This means most US mortgagors are insulated not just from the month-to-month decisions of the FOMC, but in many cases from whole hiking cycles. In the UK, by contrast, the proportion of fixed versus variable-rate mortgages has tended to fluctuate, with households often choosing the lowest rate on offer – so preferring variable rates when the yield curve is upward-sloping, and vice versa. More recently, their behaviour has changed, arguably for the better. Data recently made available by the Bank of England show that the proportion of variable-rate mortgages in the stock has fallen from around 70% ten years ago to just over 10% today. Moreover, the growing importance of fixed-rate mortgages has been driven by mortgages with a rate that is fixed for more than two years – typically either three years, or five years. The consequence is that, to date, the effective rate of interest paid by UK households has risen far, far less than the policy rate. During the tightening cycle of the late 1980s, the two moved almost in lockstep. From the perspective of avoiding recession, the longer maturity of debt, and household debt in particular, must surely be a good thing? We are not convinced.

1. In 'Sticky inflation', higher inflation had become embedded, and more tightening was to come. We felt that this scenario was much more likely to apply to the UK than to other major economies.

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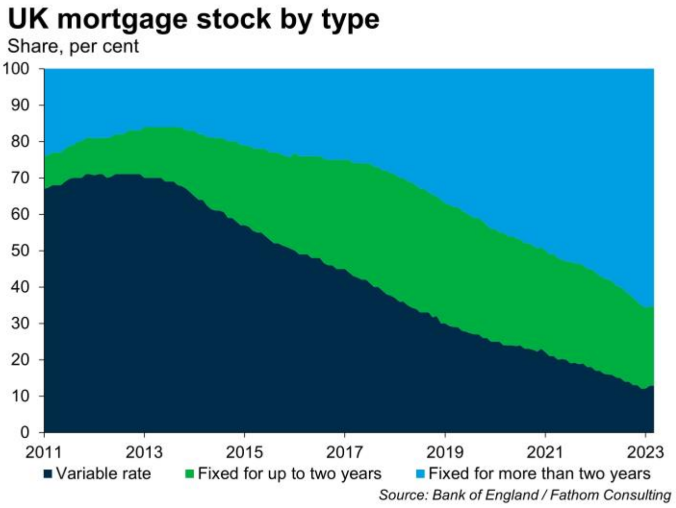

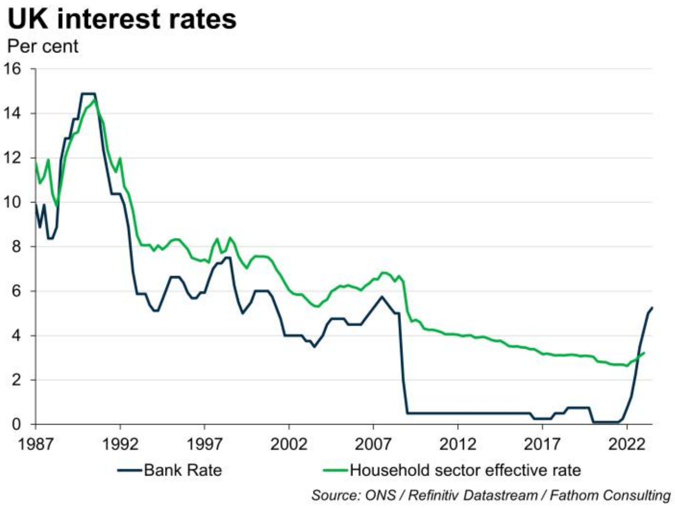

When central banks tighten monetary policy by raising the policy rate of interest the aim is to reduce nominal demand, and with that upward pressure on prices, given potential supply. It works through a variety of channels, but there are two particularly important ones:

It changes the incentives facing the marginal borrower / saver

The real rate of interest — the nominal rate of interest minus expected inflation — is the return to postponing expenditure today. It is, equally, the reward to saving. As the real rate of interest rises, firms and households are more likely to choose to save at the margin than to spend. This channel unambiguously reduces nominal demand.

It changes the cashflows accruing to past borrowers and to past savers

Indebted firms and households that have borrowed at variable rates will have to use more of their current incomes to finance their debt when interest rates rise. Their disposable incomes will fall. Equally, those with net financial assets (who tend to be households rather than firms) will earn more on their savings. Their disposable incomes will rise. Although the impact of this channel on nominal demand is not unambiguous, it is typically assumed that the cashflow effect of tighter monetary policy on nominal demand will be negative, as those with net financial assets tend to have a lower marginal propensity to consume than those with net financial liabilities. It is also often the case that banks pass on increases in the policy rate to their lending rates more rapidly than they pass them on to their savings rates.

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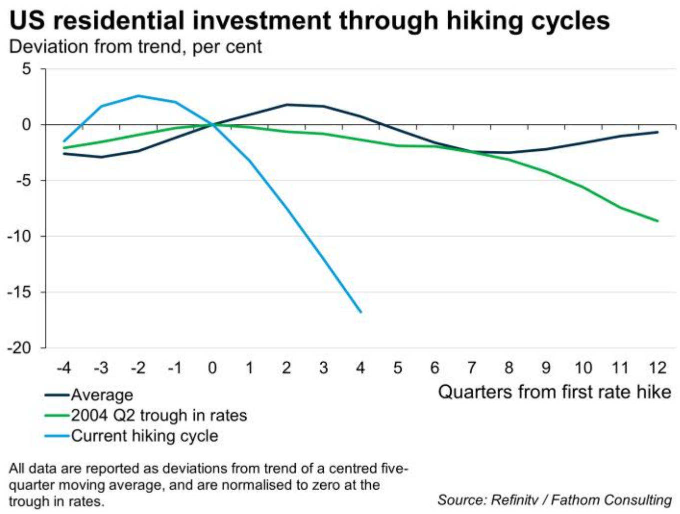

There seems to be an emerging view that longer debt maturities mean that the second channel is less powerful and, consequently, many major economies can avoid recession. This seems wrong to us, not least because the first channel is still operating. In the chart above we show how US residential investment has tended to behave through hiking cycles. It is one of the most rate-sensitive components of aggregate demand. It typically begins to fall, relative to trend, between two and three quarters after the first increase in the federal funds rate. In the previous hiking cycle, which began in 2004, the response was more rapid. And in the current hiking cycle, US residential investment looks to have peaked, relative to trend, even before the first interest rate rise.[2] More importantly, to the extent that longer debt maturities mean that monetary policy is less effective than before, the quid pro quo is simply that interest rates will need to rise further. This will strengthen the first channel. Moreover, when firms and households do refinance, the impact will be larger than it would have been otherwise.

Longer debt maturities protect the borrower from interest rate risk, but at the same time they expose the lender. There is no free lunch here. When rates rise unexpectedly, the firm or household that chose to borrow long term will experience relief. But the lender sitting on the other side will experience regret to just the same degree. Banks will typically hedge their exposure to interest rate risk – though not always (witness the experience of Silicon Valley Bank). Nevertheless, some counterparty somewhere will be sitting on the wrong side of that deal. The risk that we set out in our previous forecast was that the unexpectedly sharp upward movement in interest rates across the major economies would lead to a reduction in credit supply – there were already signs of this in the US Senior Loan Officers Opinion Survey, for example. And that by itself could have material, adverse real effects.

At best, longer debt maturities may lengthen the lags between changes in monetary policy, and changes in the real economy, but they do not protect one from the other entirely. That is not to say recession is inevitable, in any of the major economies. It is not. The way to avoid recession is for expectations of inflation to adjust. Workers need to accept wage increases on the basis that inflation is going to be 2%, and firms on average need to set their prices on the basis that their non-wage costs are also going to rise by 2%. Historically, it has almost always required a recession to force workers and firms to change their behaviour in this way. It might not do this time, though we continue to see a so-called soft landing as more achievable in the US, where the cost-of-living crisis was less severe, than in the euro area or the UK, where the hit to real wages was substantial, and there is much more for workers to attempt to claw back.

2. As we have argued elsewhere, the Fed had got itself 'behind the curve', continuing through for much of 2021 and 2022 to make forecasts for the federal funds rate that appeared inconsistent with its own forecasts for growth and inflation. It seems likely that the construction industry, along with other rate-sensitive sectors, saw the current tightening coming for longer than would normally be the case.

Continued

We shall dig more deeply into these issues, and update the weights we attach to our scenarios, as we work on our *Global Outlook, Autumn 2023* over the next few weeks.

Further reading

[Recession Watch: is the Fed tightening going to plan?]

[Which came first — credit crunch or recession?]

[Global Outlook, Spring 2023: the Good, the Bad and the Ugly]

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