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The Carlyle Compass

By **Jason Thomas**
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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

Please note we will not issue a Carlyle Compass newsletter July 2, 2024 due to the US Independence Day holiday.

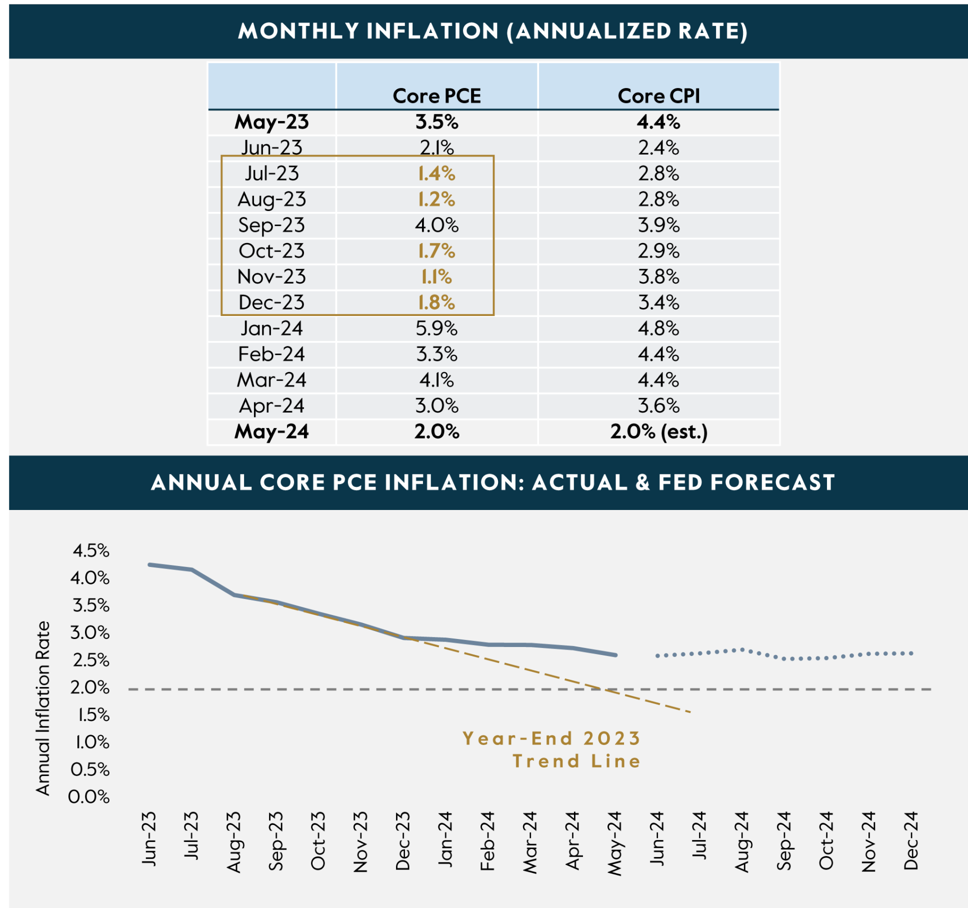
July marks the unofficial start of tournament season at the golf clubs that ring the Tri-state area around Manhattan. Naturally, finance professionals' attention has turned to signs of "sandbagging," where the lucre of pro shop credit motivates some competitors to set an advantageously low bar for their performance in the upcoming event.

This year, their prime suspect is not a tournament entrant but the Federal Open Market Committee (FOMC). As reported in the June Summary of Economic Projections, the median FOMC member expects core inflation to finish the year at 2.8%, meriting a single rate cut, to 5.15%. With the Fed's preferred inflation measure already below this level, interest-sensitive expenditure categories, like housing starts, weaker than at any point since the depths of the pandemic, and policy rates dropping elsewhere in the world, many bankers see the Fed positioned for the central bank equivalent of a net 61 en route to the C Flight championship.

But is the Fed's forecast for inflation and interest rates upwardly biased?

This Friday's release from the Bureau of Economic Analysis may reveal that core prices finished May up just 2.6% from year-ago levels. But the "comps" get tougher from here. The annual inflation rate the Fed targets is the product of 12 monthly inflation rates. Over the next several months, very low year-ago readings will roll outside of this window, requiring annualized inflation to fall below 1.9% for the rest of the year just to keep the annual rate of inflation from rising. Benign recent data provide no assurance this will be achieved, as the Fed discovered last year when sharp disinflation in summer and fall was followed by the winter's disappointment (Figure 1).

Figure 1: 2.8% Year-End Inflation A Reasonable Bet



MONTHLY INFLATION (ANNUALIZED RATE)

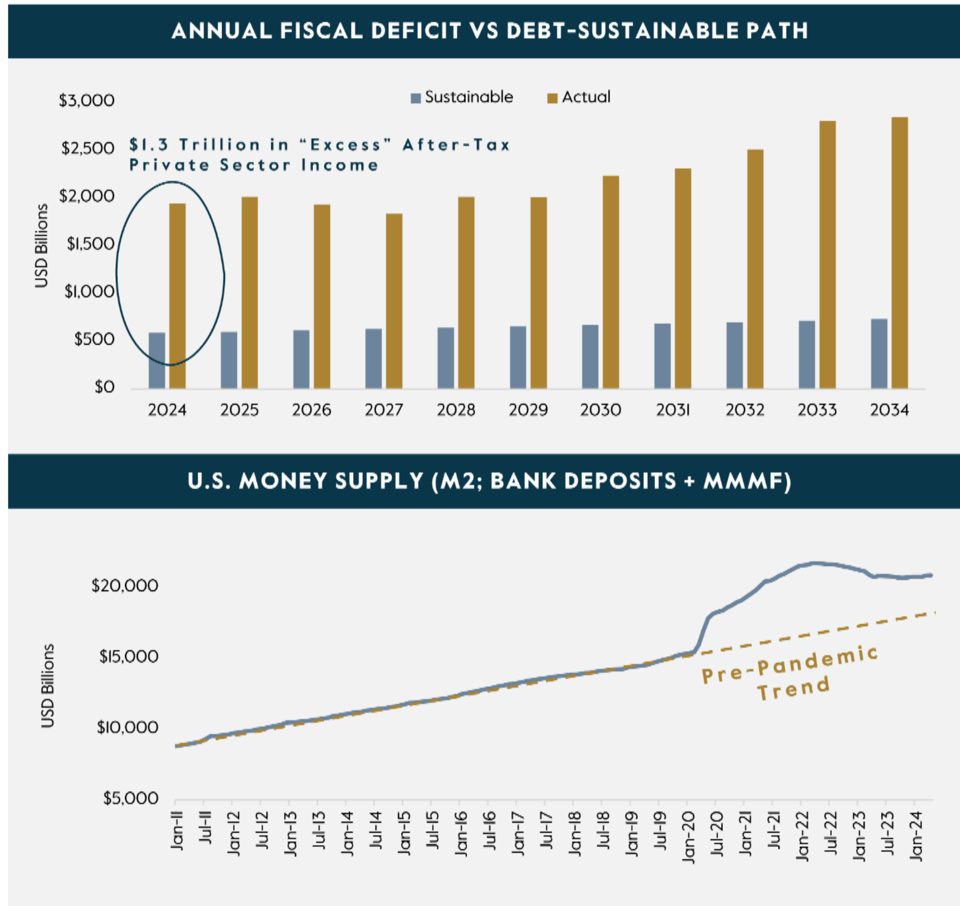
	Core PCE	Core CPI
May-23	**3.5%**	**4.4%**
Jun-23	2.1%	2.4%
Jul-23	1.4%	2.8%
Aug-23	1.2%	2.8%
Sep-23	4.0%	3.9%
Oct-23	1.7%	2.9%
Nov-23	1.1%	3.8%
Dec-23	1.8%	3.4%
Jan-24	5.9%	4.8%
Feb-24	3.3%	4.4%
Mar-24	4.1%	4.4%
Apr-24	3.0%	3.6%
May-24	**2.0%**	**2.0% (est.)**

Source: Carlyle Analysis; Federal Reserve, June 2024. There is no guarantee any trends will continue.

Fiscal policy also complicates the picture. Often discussed with the tedious moralism of "borrowing from our children and grandchildren," or employed as a plot point in an exotic tale of de-dollarization and financial doom, the deficit's basic mechanics are quite simple: the government credits private bank account balances more than it debits them.

Last week, the Congressional Budget Office (CBO) revised up its estimate for the fiscal 2024 budget deficit to $2 trillion, or 7% of U.S. GDP. This means the annual after-tax incomes of households and businesses are now $1.3 trillion higher than they would be if the federal debt were on a sustainable path (Figure 2). That's a lot of excess liquidity, especially if lower rates cause more of it to be spent rather than saved.

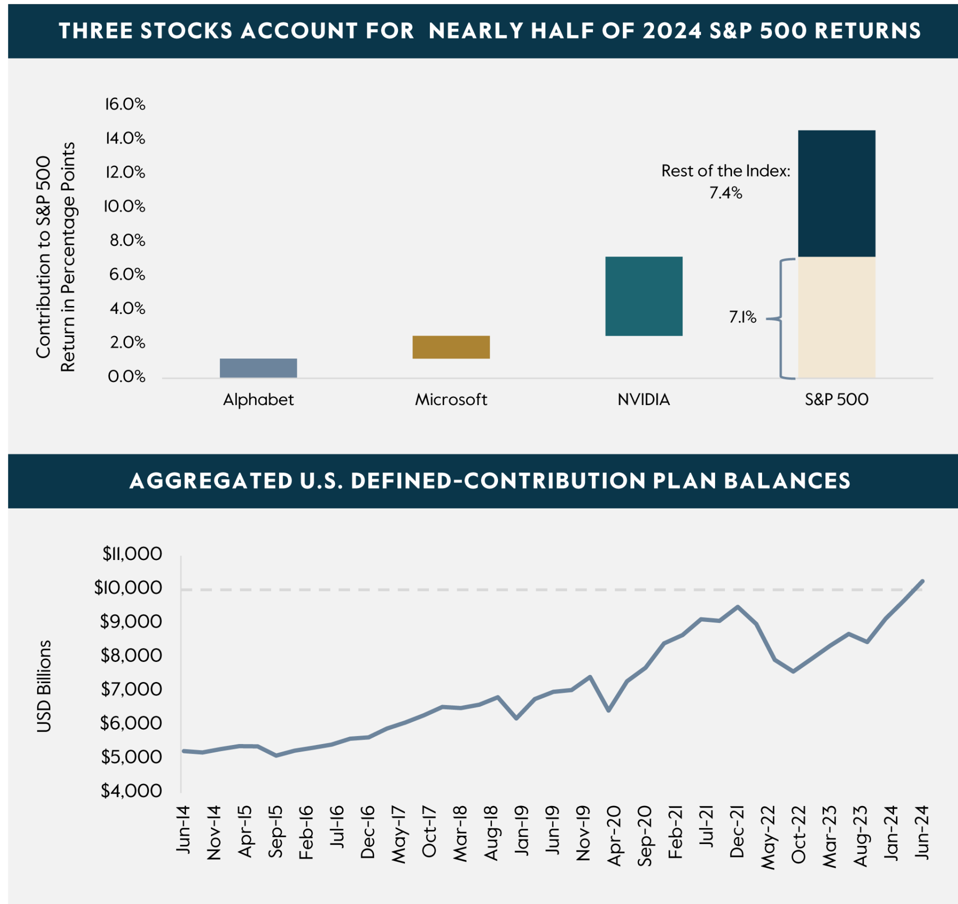
Figure 2: What of the Fiscal Impact on Price Stability?



Source: Carlyle Analysis; Congressional Budget Office, Federal Reserve, June 2024. There is no guarantee any trends will continue.

And though one can question the health of the stock market rally given that just *three* stocks have combined to account for nearly half of the S&P 500's year-to-date gains, those gains will be reflected in households' Q2-2024 401(K) statements, with aggregated balances likely to exceed $10 trillion for the first time in history (Figure 3). When coupled with low mortgage interest rates, mostly fixed for 30 years prior to 2022, the U.S. household sector looks to be in rare financial health.

Figure 3: Concentrated Gains, But Gains Nonetheless



Source: Carlyle Analysis; Bloomberg, Federal Reserve, June 2024. There is no guarantee any trends will continue.

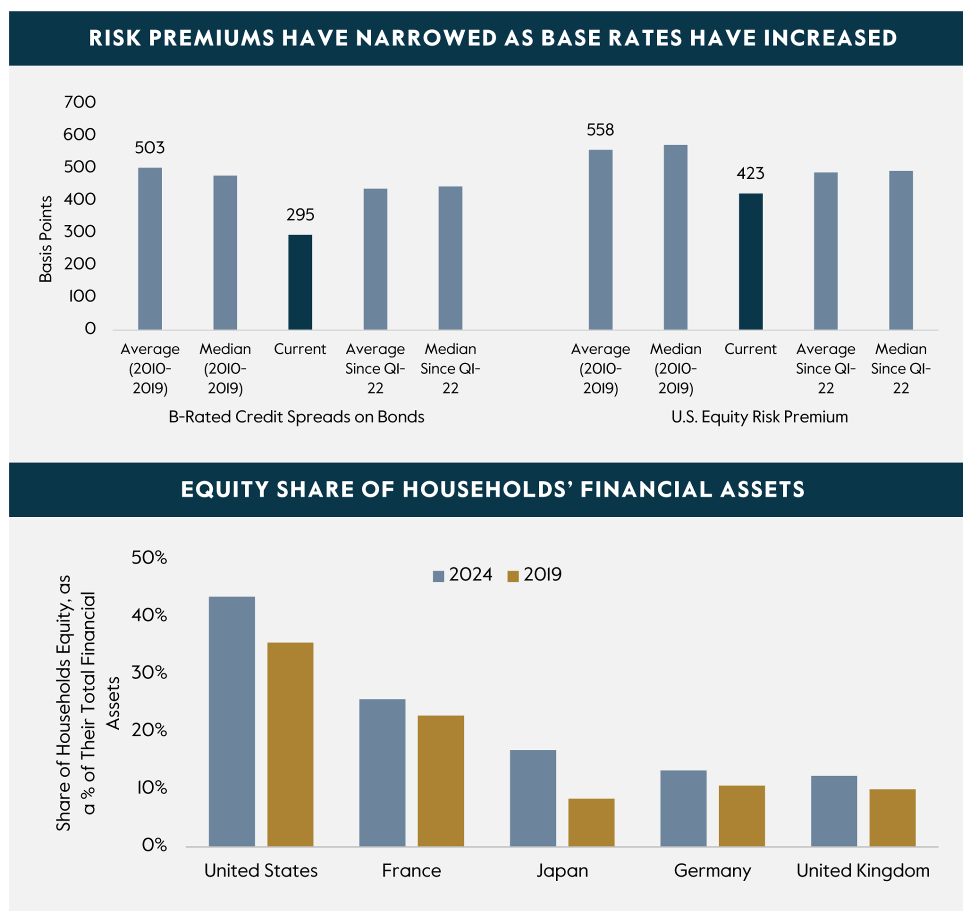
In other words, inflation closer to 3% than 2% and one or two rate cuts seems like a forecast that reasonably bisects the range of possible outcomes, not something confected to introduce obvious asymmetry.

Reconsidering the "Reach for Yield"

Higher (real) rates are expected to deter borrowing and make it more attractive to save rather than spend. But they are also expected to increase the allure of low-risk investments. This is just the inverse of the "reach for yield" critique one heard so frequently during the period of zero interest rates, when paltry bond yields supposedly pushed investors into more aggressive allocations. One would think the 500bps adjustment in risk-free rates would cause investors to shun risk.

That isn't happening. Risk premiums that can be measured directly, such as credit spreads, have narrowed substantially since 2019, when the dollar value of negative-yielding bonds exceeded $16 trillion. Risk premia that can be estimated using "consensus" dividend or earnings growth estimates, as for stocks, have likewise compressed. The same trends are evident in household portfolio construction, with equity allocations now at-or-near records across advanced economies despite very different levels of risk tolerance and growth expectations (Figure 4).

Figure 4: Not What the "Reach for Yield" Crowd Had in Mind



Source: Carlyle Analysis; Federal Reserve, Aswath Damodaran, OECD, June 2024. There is no guarantee any trends will continue.

Maybe the jump in allocations is just a sign of an overbought stock market, at least in the U.S. But the decline in the price of risk should prove confounding to those whose worldview had been shaped by the "reach for yield" narrative. Low rates don't make people indifferent to risk; they lead them (rationally) to pay more for assets—like money-losing tech companies—whose expected free cash flow arrives further in the future. And higher rates have had the anticipated impact on those stocks, which remain down 43% since the Fed's pivot.

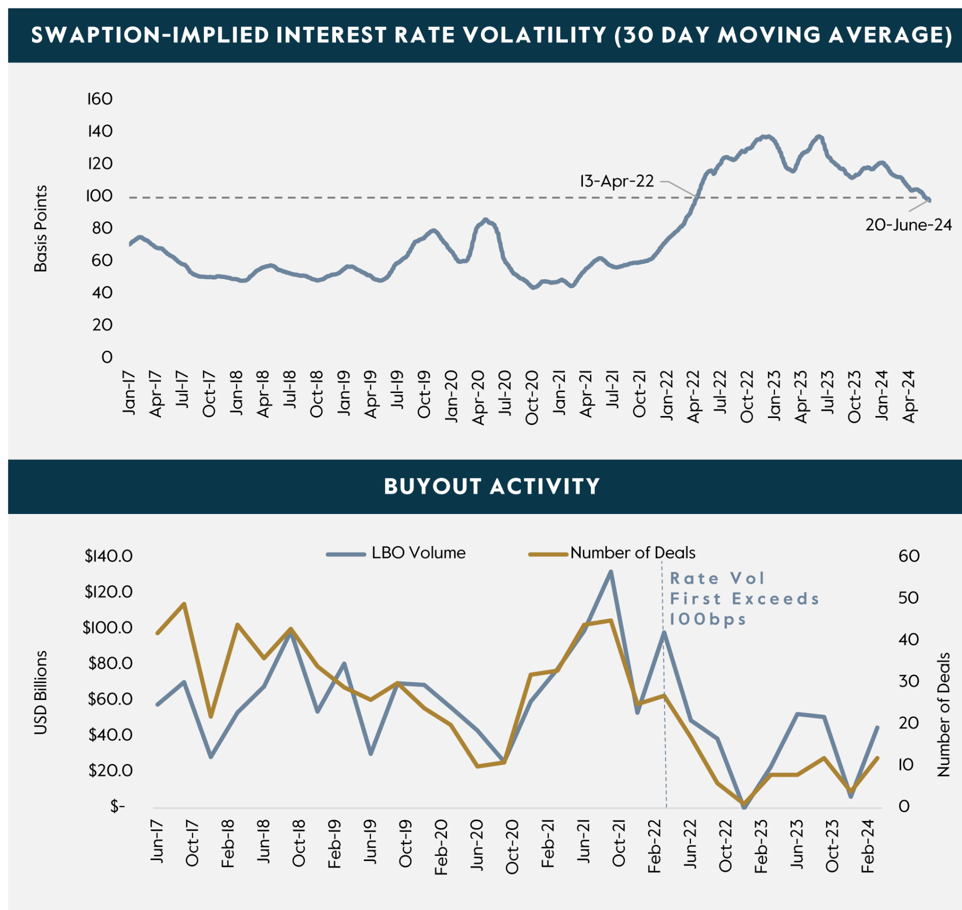
Minding the Gap in Price Expectations

The *level* of interest rates takes a lot of blame for the decline in M&A volumes since 2021, but perhaps the main culprit has been the sharp rise in their conditional volatility. There's nothing about the level of rates that should dent deal volumes; it's uncertainty about their evolution that should slow sales processes.

If deal finance costs decline, a would-be seller could expect to find a buyer willing to pay more for that asset in the future. Hence, the value of the "real option" to postpone a sale should be a function of the likelihood and magnitude of the potential fall in rates (holding all else constant). This is best proxied by the interest rate volatility implied by the prices of swaptions or options on futures.

As implied interest rate volatility rose, sellers became more reluctant to transact at prices they might soon regret. Now that expectations for base rates have become anchored at higher levels, implied volatility has declined and with it the probability of a regret-inducing upward jump in future sales prices (Figure 5).

Figure 5: Swaption Premiums as a Proxy for Bid-Ask Spreads?



Source: Carlyle Analysis; Bloomberg, S&P Cap IQ, June 2024. There is no guarantee any trends will continue.

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