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The Carlyle Compass

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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.*

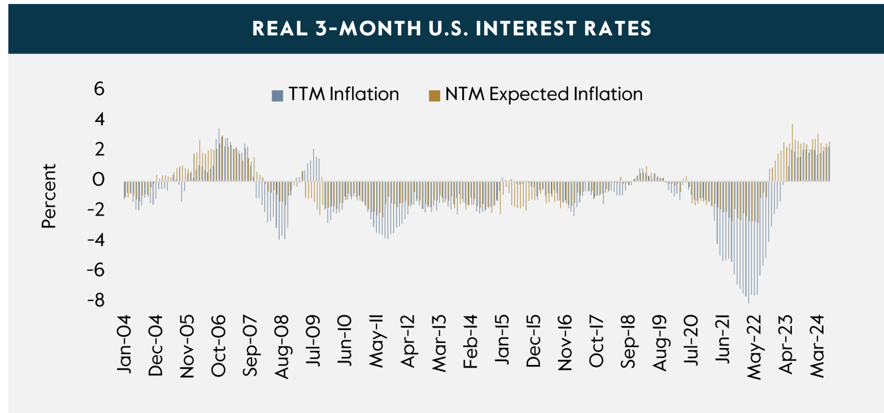
The U.S. stock market just had its best week of 2024. New data contextualized the July employment report, placing the long-rumored "soft landing" back on the menu. Attention now turns to the Federal Reserve Bank of Kansas City's annual Jackson Hole symposium, where Powell is expected to make the case for a September rate cut and offer additional perspective on how far rates may fall from there.

Before looking ahead, investors should take a moment to consider the implications of the recent market reaction to the jobs data. Not just the price action, amplified as it was by a negative liquidity shock originating in Japan, but the commentary it aroused.

The plane, it seemed, had crashed into the mountain. An obscure recession "rule," lacking theoretical foundation and disavowed by its author, had been triggered. Rates had to fall, and fast. Some called for an emergency, inter-meeting cut of 75bp. Futures priced nearly six 25bps cuts over the final three Fed meetings of 2024. We seemed on the cusp of calls for zero rates and QE.

None of this should be dismissed as hysteria, hysterical as it may seem. It stems from a rational presupposition: real interest rates are much too high (Figure I) and bad things are bound to happen as a result. Analysts ascribe more value to an assumed "natural rate" of interest—an *unobservable* state variable—than months of data indicating that the economy has weathered high rates far better than expected, with spending gradually decelerating to rates consistent with the Fed's inflation target. One soft number is semiotically transformed into the Hindenburg.

Figure 1: Rates Again in Unfamiliar Territory

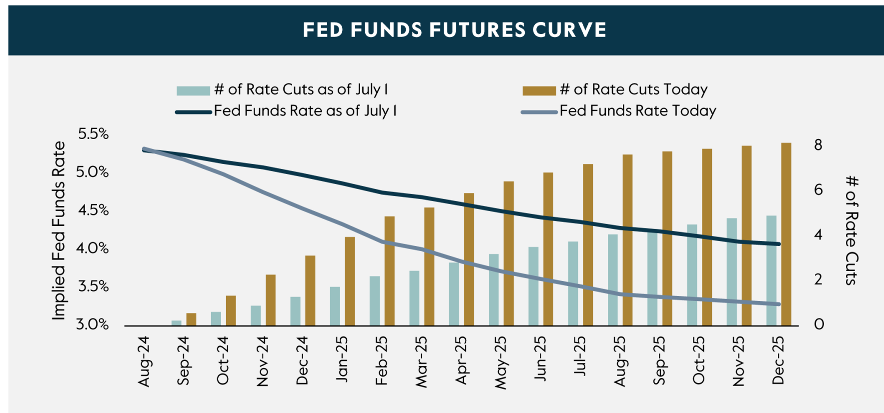


Source: Carlyle Analysis; Federal Reserve Board of Governors, August 2024. There is no guarantee any trends will continue.

Recent commentary looks like the mirror image of that from a decade ago. Esteemed investors then were as convinced rates were "unnaturally" low as people today are convinced they're unnaturally high. Each upward gyration in yields was taken as a foretaste of the bloodbath in bonds that was certain to come. No matter how sluggish the economy or quiescent inflation between 2009 and 2014, analysts still assumed rates would revert towards prior levels. Central banks embraced successive rounds of forward guidance and QE, in part, to disabuse market participants of this presumption and signal that rates would remain low far longer than priced into the forward curve. Agree or disagree with their unconventional methods, one must appreciate the disconnect central banks faced.

How similar is the situation today? The case for rate cuts has been made; this is a question of calibration. A market that interprets modest disappointment as a falling sky has already delivered a significant amount of easing, with mortgage rates down 150bp from their peak and three-year swap rates at a 165bp discount to SOFR. Aggressive cuts at the outset of the easing campaign could invite market participants to price even more cuts into 2025, pulling down forward rates and bond yields to levels that perturb inflation's glidepath to target (Figure 2).

Figure 2: Whole Lot of Easing Goin' On



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

Rate cuts are coming. But don't be surprised if they arrive on a schedule that forces rates market participants to reconsider some of the assumptions embedded in recent price action.

"Chicago, that Toddling Town"

One can forgive political analysts for expressing "shock" that the Harris and Trump campaigns have aped each other's proposals on the tax treatment of gratuities and minor dependents. But an economic policy analyst voicing similar sentiments hasn't been paying attention. Deepening "polarization" between electoral coalitions on social policies and aesthetics cloak an emerging consensus on a host of core economic policy questions (see *Compass, July 23*).

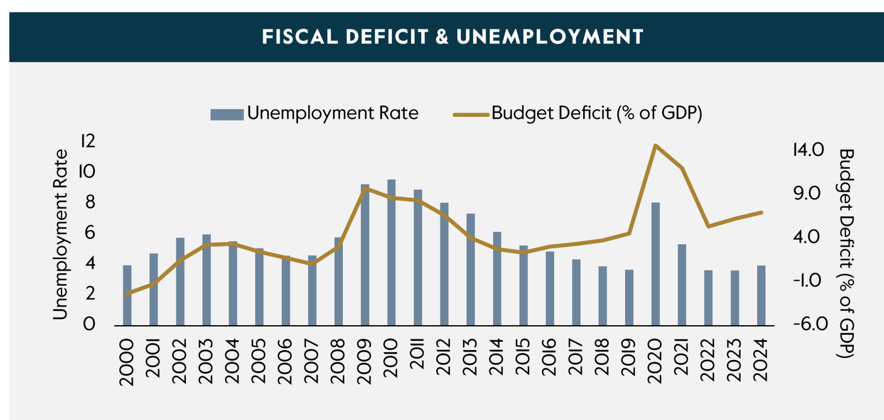
For the past 40 years, economic policy has been oriented around the subject of the

"consumer." Questions of trade, regulation, and industry competition were evaluated based on their consumer welfare implications, with the goal of driving prices down. Exceptions to this rule were derided as "rent-seeking" by interests using policy to raise input or product costs artificially relative to what would obtain in an unfettered market. A larger share of real income and purchasing power growth came from falling inflation and interest rates rather than nominal wage increases.

Today, both parties embrace wage and production subsidies, protectionism, and vigorous enforcement of competition policy. National security concerns accentuate the shift towards domestic rather than externally-sourced output.

Perhaps this is precisely the response one would expect in a vibrant democracy, but it's not clear why the levels of inflation and interest rates that prevailed in 2016 would be a natural outgrowth of this new policy configuration. And this is before considering the implications of the parties' shared fiscal insouciance, epitomized by the aforementioned convergence on tax policies. Federal borrowing this year is about 6% of GDP ($1.6 trillion) greater than would be expected at this point of the business cycle (Figure 3). Taking campaign promises at face value suggests this may be the low-water mark for the next four years.

Figure 3: Record Borrowing Needs on Cyclically-Adjusted Basis



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

Markets can and will adapt to new circumstances so long as policymakers do not couple these changes with administrative controls that impede the necessary adjustments.

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