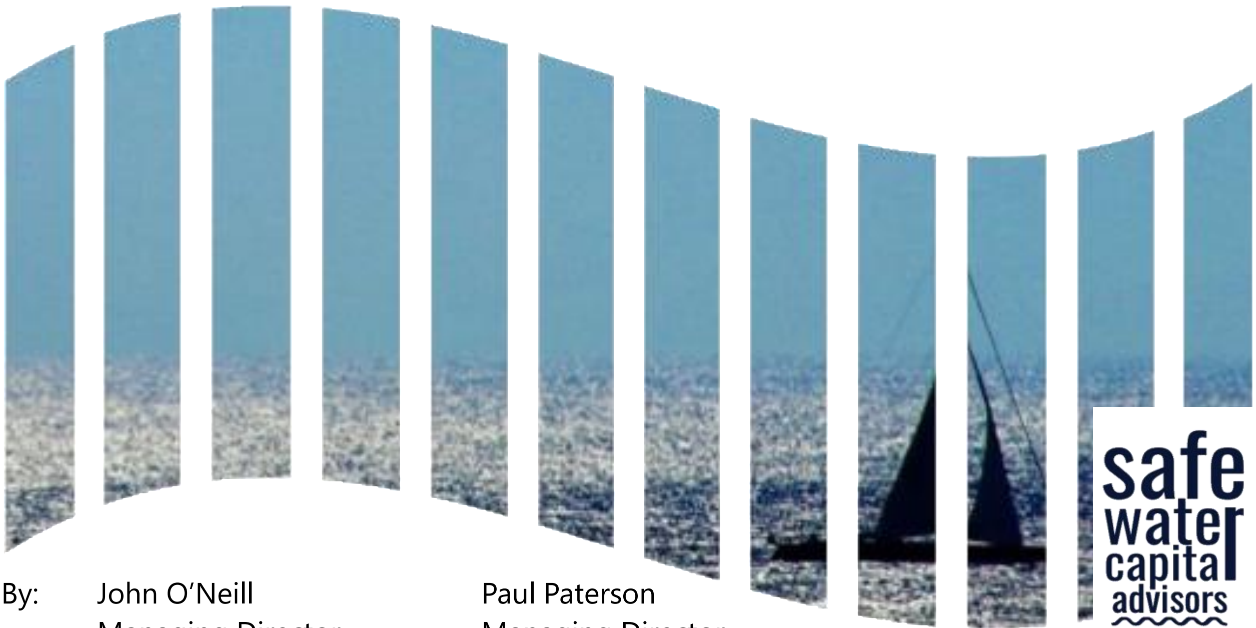
The Economy Grows While Interest Rates Peak



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The traditional thinking has always been that the Federal Reserve has significant power to influence the economy by raising or lowering rates and they use it to avoid extremes within the economic cycles.

However, after a 525 basis point rise in rates this year, it appears the Fed's influence is waning, as GDP growth is strong at 4.9% in the fiscal 3rd quarter, and unemployment is still near historical lows.

This may be due, in part, to the fact that in previous economic cycles, the changes in rates went hand-in-hand with changes in credit availability. The thought process was that people would be less inclined to borrow, if rates were higher. However, it appears that this notion was wrong at today's rates, as entrepreneurial business people can rationalize relatively higher risk with higher reward. Furthermore, rates today are relatively average compare with rates over the last 50 years.

Perhaps, higher rates signal to banks (and their regulators) that previous aggressive lending will lead to greater future credit losses, and they should focus on the improved returns from non-credit investments. This would have the same effect as businesses not borrowing, while also explaining why it is different this time.

The term "Shadow Bank" was coined by PIMCO economist and money manager, Paul McCulley, in a 2007 speech at the annual Fed-sponsored, financial symposium in Jackson Hole, Wyoming. This was right at the beginning of the Financial Crisis of 2008-09 (two Bear Sterns hedge funds collapsed and Lehman Brothers stock fell sharply).

McCulley defined shadow banking as "the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures," and traced its origins back to the birth of the Money Market Mutual Funds in the 1970's.

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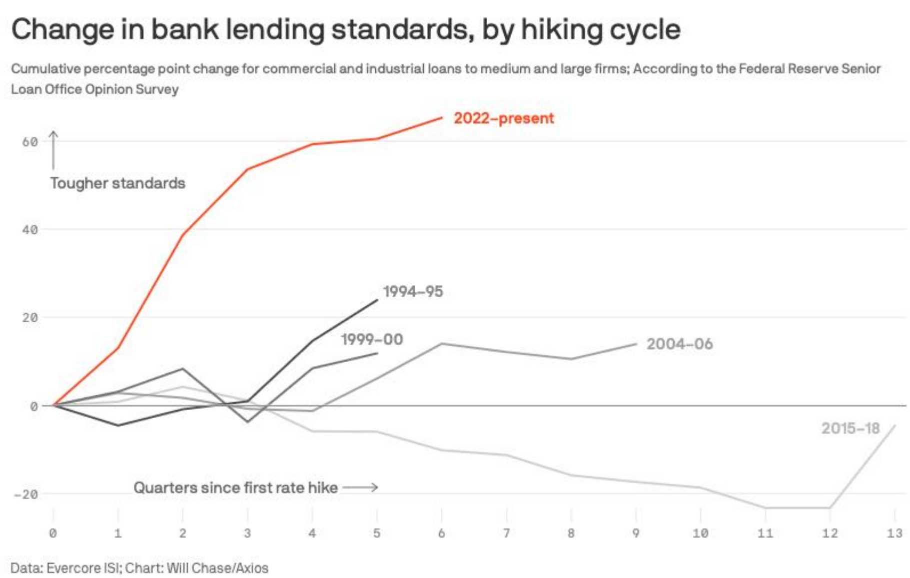
For roughly 20 years, economists and academics have been warning about the danger of a growing pool of unregulated credit. Meanwhile, the size of the estimated shadow banking system has grown from about $15 trillion in 2007 to well over $60 trillion today.

A key advantage of the shadow banking system is that it reduces the dependency on traditional banks as the primary source of commercial credit. Again, this may be a part of the connection that has made the Fed's rate increases less effective than previous cycles.

Banks, in fact, have tightened credit this year, as shown in the Senior Loan Officer Opinion Survey (SLOOS). The July 2023 Senior Loan Officer Opinion Survey shows the largest share of banks (a net 51%) reporting tighter lending standards for larger and medium-sized firms since the period following the onset of the pandemic and, before that, the 2008 financial crisis.

This looks more ominous in a graph:



In previous cycles, this reduction in credit would have dramatically slowed the U.S. economy. However, this time it did not.

As the warnings about shadow banking have subsided, they have been replaced with strong praise for the "Private Credit" market, which is a relatively-small subset of the shadow bank market at $1.5 trillion with nearly $400 billion of dry powder available as of year-end 2022.

Six of the largest alternative asset managers Standard & Poors rate (Apollo Asset Management Inc., Ares Management Corp., Blackstone Inc., Brookfield Asset Management Inc., The Carlyle Group and KKR & Co.) have roughly doubled assets under management devoted to credit since the end of 2019, reaching approximately $1.4 trillion.

This new unregulated capital may be what has diluted the Fed's ability to influence the economy via interest rates by encouraging additional borrowing under standard underwriting. So we are entering unchartered territory relative to where the economy goes from here. It may also signal that future distress borrowers may be focussed at non-reguated lenders versus banks.

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