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Quarterly Macro Commentary

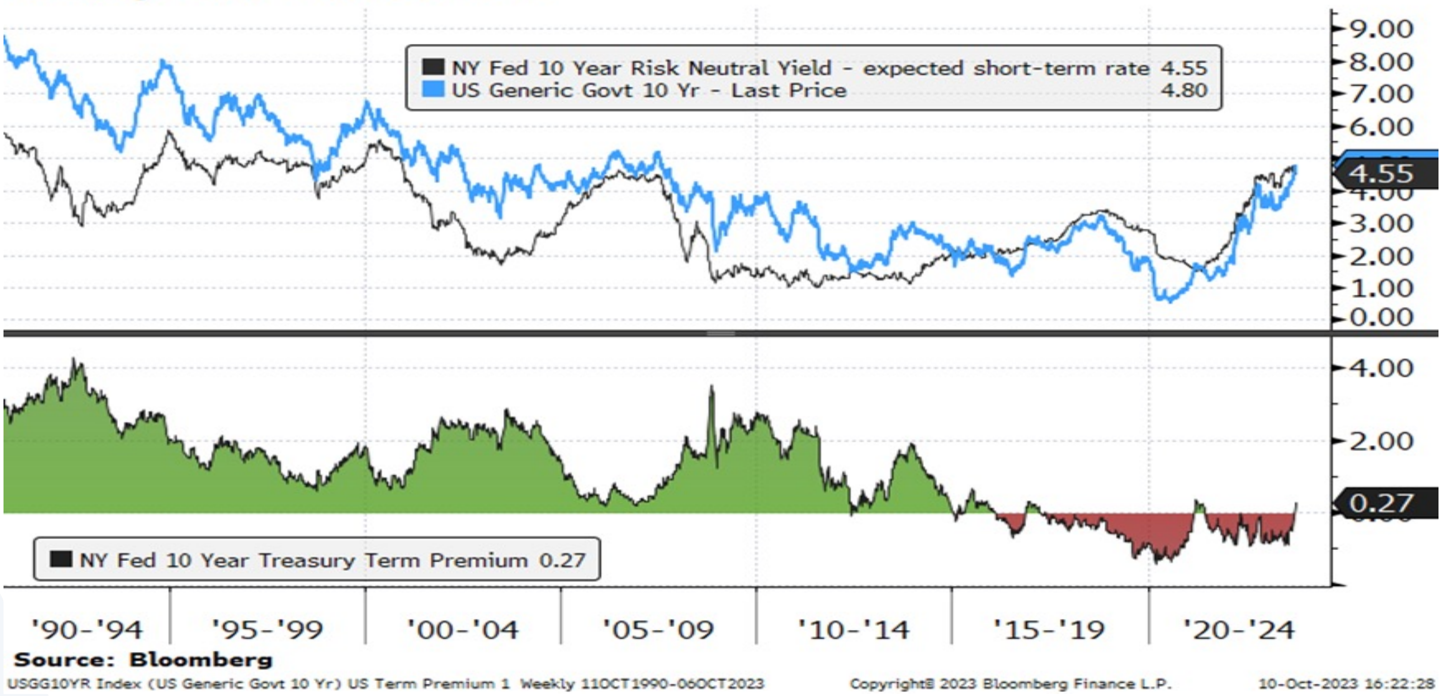
THIRD QUARTER 2023

In Q3, the US economy continued to demonstrate remarkable resilience in the face of higher interest rates. Meanwhile, Europe and China have been showing distinct signs of slowdown, if not outright recession. As US short-term rates have been ratcheted higher by the Fed, the expectations have also gradually shifted to the "higher for longer" scenario, which has become the latest market mantra. We have long remarked on the notion that central banks were prepared to hike "until something breaks". We think we are starting to see things break. Indeed, with the dramatic sell-off in long-dated sovereign bonds as long-term interests have risen, this is a potentially dangerous environment, not least because the infamous reflexivity of financial markets feeds back into the real economy.

Of note in recent weeks has been the apparent return of positive US term-premia after a decade of declines into negative territory. Term premia are (model based) estimates of the yield premium demanded on long-dated securities as opposed to the (expected) average value of overnight rates over the same time horizon. As imperfect as the various estimates maybe, several models are now indicating a sharp rise in term premia in US T-Notes. This appears to be driven by the sharpening political divide and intransigence in fiscal-policy debates as the US experiences faster growing debt loads at the same time as rising interest rates: a potentially destabilizing feedback loop (aka, reflexivity).

Questions are increasingly about the sustainability of US debt and federal spending. Without some significant political shift, the numbers start to look very troubling. While an MMT (Modern Monetary Theory) approach of more yield curve control is theoretically possible, there is zero evidence of this becoming a political reality any time soon. This recent surge in Treasury yields is indeed concerning, and the concern is that we are reaching the point where serious action is needed, but it is the kind of which often is only triggered after a crisis.

US 10-yr Note Term Premium



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