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The Carlyle Compass

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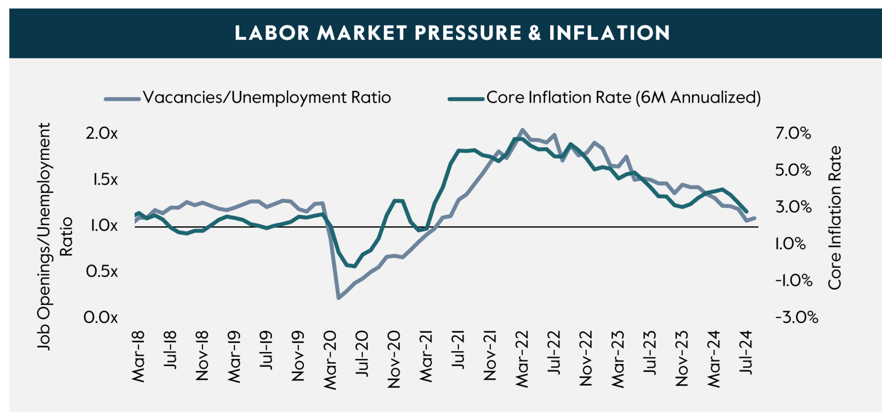
The time for rate cuts has arrived. This is not just the assessment of Chair Powell and the Federal Open Markets Committee (FOMC), but virtually all analysts.

Elevated interest rates have depressed residential investment and housing transactions, increased the effective cost of inventories, durable goods, and other items that need to be financed, and stressed households with high consumer credit balances. Cumulatively, this has resulted in a dramatic fall in job openings relative to the pool of job seekers. For the first time since the onset of the pandemic, there is now rough alignment between the number of people seeking work and open positions in the U.S. (Figure 1).

Figure 1: Labor Market Back in Balance

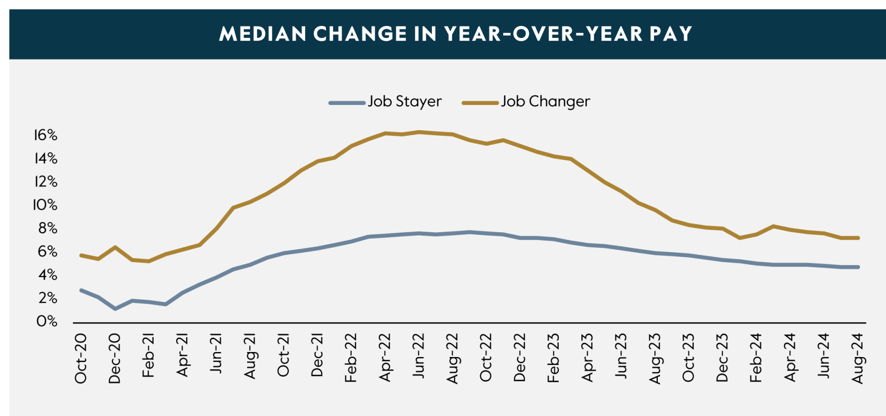


Source: Carlyle Analysis; Federal Reserve Board of Governors, September 2024. There is no guarantee any trends will continue.

When core inflation was running at nearly 7%, there were two open jobs for every unemployed person. Management teams complained incessantly about difficulties attracting and retaining talent during this time. According to ADP data, people who stayed at their jobs enjoyed typical wage gains of 7.7%, but those leaving to work elsewhere saw gains of 16.4%—a record disparity.

Now that the labor market has returned to balance, the gap between the experience of “job changers” and “job stayers” has narrowed (Figure 2). In August, the typical wage premium to leaving was 250bps, less than one-third of the 870bps spread in early 2022. With less greener grass available on the other side, workers have been more content to stay with their current employer, leading to a deceleration in overall wage growth.

Figure 2: Less Greener Grass on the Other Side



Source: Carlyle Analysis; ADP Research, September 2024. There is no guarantee any trends will continue.

The post-pandemic inflation shock has ended; monetary tightening has done its job. And, thankfully for all involved, it simply required a sharp decline in open, but unfilled positions, rather than a wave of layoffs, as some had feared.

With what Powell described as a temporary “collision” between pandemic-distorted labor and product markets now in the rearview mirror, base rates should decline to more *normal* levels. But before assuming this means cash and bond yields that prevailed in 2019-20, it may prove useful to ponder some questions:

- Who today believes in a globalized economic future, where the free and frictionless flow of capital and goods across borders allows costs to decline geometrically as every component, part, and stage of the production process becomes its own contestable market, open to all competitors irrespective of geography?
- What share of societal resources will be consumed by combatting climate change now that nearly everyone recognizes the problem cannot be solved without developing the green industries and employment opportunities for economies to remain competitive (viable?) during and after the energy transition?
- How has the capital, computational, and energy intensity of Artificial Intelligence (AI) transformed the net cash flow profile of the digital businesses that previously accounted for most of the disinflationary rise in corporate savings?
- Will past underinvestment in housing and defense procurement sharply reverse in light of shortages and heightened geopolitical risk?
- To what extent will massive fiscal deficits constrain monetary policy in the years to come?

Clarifying Effect of Rate Cuts

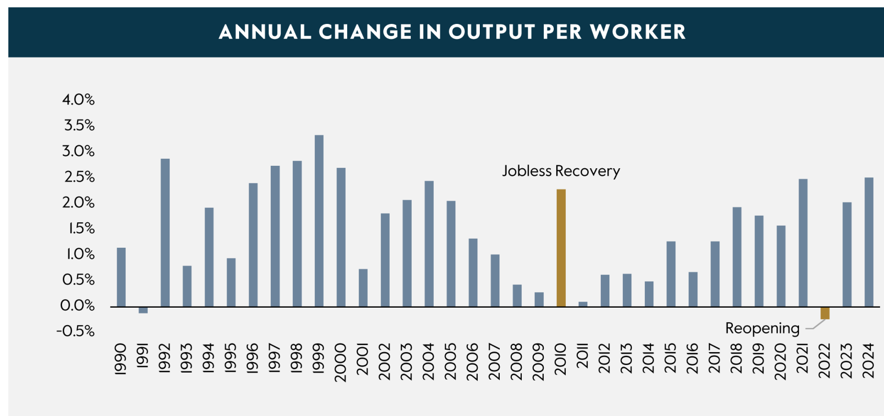
Talk of interest rate “normalization” often elides questions about what level of rates is “normal” in the context of current fiscal deficits, an industrial capex boom, and rising trade frictions.

There’s a costly tendency to evaluate interest rates relative to their past levels rather than economic fundamentals. This was evident in the years following the Global Financial Crisis (GFC).

As long as the Fed was “printing money,” these analysts could ignore anemic productivity growth (Figure 3) and below-target inflation and assume that low rates were just a ruse pulled by central banks to inflate asset prices artificially. With each new asset purchase program—“QE2” in 2010, “Operation Twist” in 2011, “QE3” in 2012—warnings about a bond

market "bubble" grew louder.

Figure 3: Anemic Post-GFC Productivity Growth

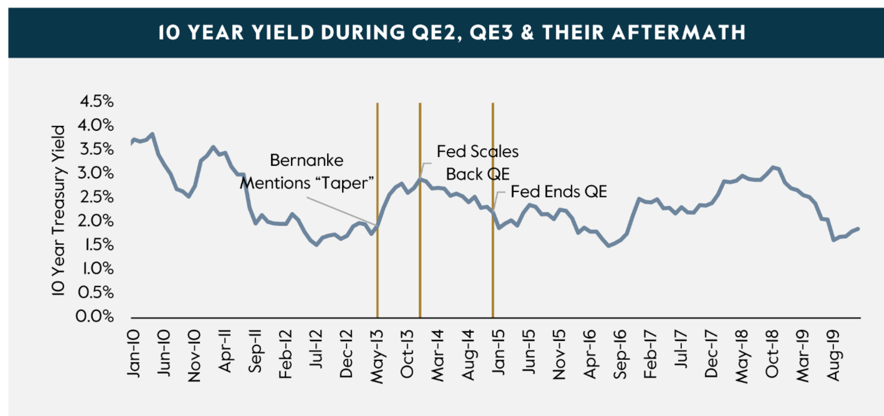


Source: Carlyle Analysis; Congressional Budget Office, August 2024. There is no guarantee any trends will continue.

It was only when Bernanke first raised the possibility that the Fed would "taper" asset purchases in May 2013 Congressional testimony that these theories could be put to the test. With the Fed stepping back, some analysts analogized the looming adjustment in bond yields to the release of a compressed coil spring and positioned portfolios accordingly.

The immediate market reaction was as expected: bond yields spiked and equity markets sold off. Yet, a surprising thing happened: bond yields were lower when the Fed stopped buying bonds in January 2015 than when Bernanke first surprised markets with the idea of scaling back purchases (Figure 4). Real yields remained 200bps below past averages for the rest of the decade.

Figure 4: A Look Back at the "Taper Tantrum"



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

After this experience, monetary chicanery proved a less satisfying explanation for low rates. Academics explored how demographics, globalization, and digitalization could alter savings and investment propensities in ways that cause "equilibrium" or "neutral" interest rates to evolve over time. This, in turn, propelled "r-star" from obscure monetary economics notation to a favorite discussion topic among finance media.

Don't be surprised to see something similar play out over the next year. A series of cuts will help to clarify the extent to which the post-2021 adjustment in rates reflects fundamentally changed economic circumstances rather than a short-lived monetary response to pandemic distortions.

Rather than return interest rates to what some consider to be "normal" levels, the looming series of rate cuts may instead reset perceptions of what's normal in the current environment.

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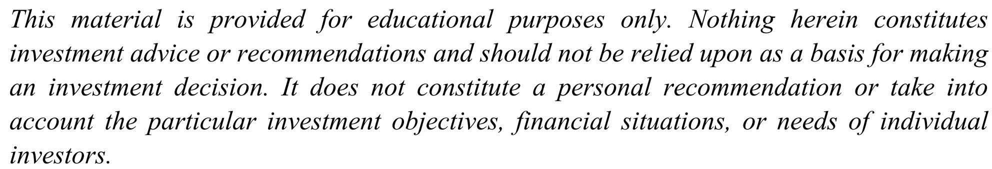

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