



# *Trampled under Thucydides*

*Global economic outlook in the shadow of US-China struggles*

**2024**

**GLOBAL MACRO PANORAMA – PART 3: USA**

Barra Kuku Mamia  
*Senior Economist*

- The chances of a Fed rate cut in 2024 are growing ever slimmer, as US inflation shows no sign of converging towards the Fed's 2% YoY target. Indeed, fundamental ("supercore") inflation is starting to rise again, underlining the difficulties of setting too-low of an inflation target against a backdrop of an energy/geopolitical crisis.
- The current US economic expansion has many peculiarities that skew the usual business cycle indicators—including classic recession signals like the yield curve. Above all, the high interest rates have been a net positive for the upper- and middle-classes, who benefit from higher financial incomes and one-off tax-loss harvesting. Their strong demand, especially for services, partly explains the resilience of US growth and labor market.
- But a high-rate environment is a net negative for borrowers, including low-income households and the federal government. Declining living standards among the former explains why Trump is now favored to win the 2024 Election, despite solid macro numbers.
- The US real rates will eventually have to turn negative, given the high level of federal debt and the need to finance its industrial policies. But there is less certainty over what would constitute the "pivot point", with several possible scenarios (those we deem more likely are **in yellow**):
  - **Trump's triumph:** As president, Trump would exert greater control over the Fed and direct it towards weak-USD/low-rate policy which he favors
  - **Gradual slowdown:** The US economy is cooling down as the tax-loss harvesting effect fades, but it may only warrant a rate cut in 2025
  - **Banking crisis:** While credit risk is rising (esp. from CRE), liquidity has improved since the regional bank crisis of 2023
  - **Sovereign bond crisis:** While US rivals (esp. China) are de-risking from US Treasuries, the situation is manageable for now due to robust demand from elsewhere and a shift towards short-term bills issuance
  - **"Passive pivot":** The Fed does not cut nominal rates meaningfully, but is simply overtaken by rising inflation

*This is part 3 of 4 in our Global Macro Panorama*

**Part 1 – Commodities**

**Part 2 – China**

**Part 3 – USA**

**Part 4 – Core and periphery**

*\* all data and forecasts are updated at least one week prior to the original publication date, on Jun 12<sup>th</sup> 2024*

## Apologies, updates, and reassessments

- When we released [Parts 1](#) and [2](#) of this **Global Macro Panorama** in February (on commodities and China, respectively), we expected to follow them up quickly with Part 3 on the US economy. Alas, other tasks and priorities made it impossible for us to finish it on time, and only now are we able to publish the report.
- Of course, the four-month delay does give us a chance to look back at the analyses and predictions that we made in the first two reports. So, in the interest of transparency, we shall run down some of the major points and see how they stack up to more recent data and developments—starting with our commodity price predictions for 2024.

- **Crude oil (Brent) – REI forecast: USD 80 – 90/bbl – Q2-24 avg.: 85.1**

We foresaw a slight price increase compared to 2023, as there is less scope to increase US shale output to counter production cuts by OPEC+, tempered by high global inventory levels (ex-US SPR). Thus far, both arguments have held, and—other than geopolitical escalation such as the Israel-Iran missile attacks—we expect prices to move sideways with some gradual “up-creep”.

- **Coal (CIF ARA) – REI: USD 85 – 105/MT – Q2-24 avg.: 112.0**

Our skepticism on coal was based on China’s high level of inventories and domestic production. The former remains true, but the latter does not, as mining accidents led to closedowns. This is a temporary disruption, but it is

also possible that Chinese output would stabilize at lower levels even after reopening, nudging prices slightly upwards.

- **CPO (Malaysia) – REI: USD 760 – 920/MT – Q2-24 avg.: 856.3**

We were mildly optimistic on CPO, given El Niño and full implementation of B35 program (mandatory 35% biodiesel blend) which could curtail exports from Indonesia. And the market has indeed tightened, although the really high prices around the time of Eid al-Fitr was only temporary.

- **Copper (LME) – REI: USD 8,300 – 8,900/MT – Q2-24 avg.: 9,832**  
**Nickel (LME) – REI: USD 15,700 – 18,000/MT – Q2-24 avg.: 18,892**

Industrial metals surprised on the upside, as we underestimated the extent of Chinese demand. There is still a good argument to be made that the rally is unsustainable, as Chinese inventories have remained high. Nevertheless, it is difficult to bet against China’s willingness to keep doubling down on its industrial prowess.

- **Gold – REI: USD 2,000 – 2,380/oz. – Q2-24 avg.: 2,343**

Our bullish call on gold has proven correct, as China’s buying spree (both central bank and retail) proved a more potent catalyst than any speculation about Fed rate cuts. But there may be less upside in the near-term, as the gold-to-oil ratio is now close to 30 (93<sup>th</sup> percentile since the Nixon shock). Further gains, then, probably hinges on further deterioration in the global economy and/or geopolitics.

- **Our call: Climate factors to push tropical crop prices higher vs. temperate crops (✓)**

When we made this call, cocoa prices were starting to climb upwards, and coffee soon followed. Rice prices, meanwhile, remained elevated in spite of recent harvests. La Niña is expected to bring relief, but the lagged warming effect from El Niño (on top of the global warming trend) remains to be reckoned with for the remainder of the year.

Note also that temperate crops face their own struggles, especially wheat. In recent weeks, news of extreme weather has raised concerns over winter wheat harvests in Russia and the US. Altogether, then, we see food inflation as a key long-term risk as global warming accelerates.

- **Our call: Oil price to increase relative to other commodities, as the “global misery index” rises (✗)**

As we wrote in [Part 1](#), “misery” (inflation plus unemployment rates) boils down to how costly energy is relative to the rest of the economy. What we argued here, then, was that energy cost would consume a larger share of the global economy, leaving less room for other industrial demand.

The reason why we were wrong was, once again, China. In addition to its robust industrial output, China is investing heavily into electrification and renewables, displacing fossil fuel demand with massive, up-front demand for metals. In the future, it might be appropriate to replace our oil-centric measure of energy cost with a basket of fossil fuels and critical minerals.

- **Our call: China to issue more bonds and loans, including via balance sheet expansion by the PBoC (✓)**

Our thesis on China boils down to this: China desperately needs to avoid debt-deflation cycle, and accordingly it has to massively expand credit for its utilities and manufacturing sectors—with the added benefit of outproducing the West in key strategic areas.

This thesis has proven more correct with each passing day. PBoC balance sheet has continued to expand, albeit somewhat more slowly, while the Chinese government has recently issued CNY 1 Trillion worth of ultra-long bonds. The latter seems to be an effort to counterbalance the continuing slowdown in private credit.

- **Our call: Recovery of Chinese housing market and consumption to remain sluggish, hampered by the authorities’ supply-side focus (✓)**

This hypothesis remains broadly correct, and while there are improvements in China’s household consumption, the situation remains a mixed bag. The supply-demand gap in the housing market has begun to narrow, and things are likely to bottom out by 2025.

On the other hand, household income growth remains subpar, while retail sales seem to be slowing down, especially relative to industrial production. This leads to our age-old problem of excess inventories.

- **Our call: Margin compression and excess inventories to continue plaguing Chinese industries (½)**

Excess inventories in China peaked late in 2022 amid zero-COVID policy, and significantly declined throughout 2023. Clearing up these excess, however, required price discounts, which led to a decline in industrial profits.

So far in 2024, a reverse dynamic seems to prevail. PPI is stabilizing (albeit still negative) and profits are recovering, but inventories are piling up again. Broadly speaking, then, there has been little change in the general dynamic of overproduction and underconsumption.

- **Our call: China's export-oriented strategy could trigger Western reaction, including tariff by a potential second Trump administration (✓)**

This has proven true even with Biden still in office, with recent tariffs on EVs and other (related and non-related) items. And it is not just the West either, with countries like Mexico, Brazil, and Chile also imposing tariffs on Chinese steel.

Whether or not these could stymie Chinese industries is debatable, given China's genuine cost and (in many cases) technological advantages. And as a last resort, China could still subsidize unprofitable industries and/or push for consolidation that could eventually create leaner and meaner companies.

### Our (temporary) scorecard:

**Hits (7/12) • Partial (4/12) • Misses (1/12)**

# Part 3

# USA

## The last mile is the hardest

- Since 2023, discussions about the US economy has largely revolved around Fed rate cuts—when it would start, and by how much. Market sentiments have fluctuated, but at the turn of the year there was general belief—since dashed—that aggressive cuts are coming in 2024.
- Key to this conviction was the cooling US inflation, which—as we discussed in [Parts 1](#) and [2](#)—was not primarily the Fed’s doing, but largely the result of SPR release and oversupply in China. Small wonder, then, that disinflation has been most conspicuous for energy and goods but less so for services.
- This apparently sufficed to bring inflation down towards the 3 – 4% range, but to get to 2% as the Fed envisions, more services disinflation would also be needed. One likely source is shelter, where the official figures lag sharply behind indicators from e-commerce sites, which had already shown cooling rental inflation since late 2022.
- Beyond shelter, however, the potential for disinflation may be more limited. Indeed, if we look at "supercore" measures of inflation—stripping out most of the volatile items—we can see that the disinflation process is stalling or even reversing.

- We should also note that supercore inflation, despite supposedly excluding energy, remains susceptible to energy shocks, which may yet recur due to OPEC+ production cuts or geopolitical tremors. This aligns with the energy-centric view of inflation we expounded in [Part 1](#), and against the common notion of energy as just another subset of inflation.

## No hail to the chief

- The other factor behind the stubborn inflation is robust demand from US consumers itself. Demand for goods have rebounded after a post-lockdown lull, while demand for services is growing faster than most of the 2010s.
- This is mirrored by the job market and GDP growth. While payroll growth has normalized relative to 2022, there remains notable “growth spots” such as logistics, services, and especially construction. The latter is partly driven by a boom in manufacturing-related construction, thanks to incentives from Pres. Biden’s industrial policies (CHIPS Act, IRA).
- It is striking, however, that voters have not given much credit to Biden for the economy. Much ink has been spilled in analyzing why Trump has been leading in the polls, from foreign policy to sheer partisanship. But there may also be a decisive economic factor—namely that the strong top-line macro figures belie an underlying decline in living standards, particularly for low-income households.

## Whose demand is it anyway?

- Nominal wage growth has been strong, but (until recently) it failed to catch up with inflation. The Fed’s battle against inflation has itself been a Pyrrhic victory, as it means higher interest burden for indebted households.
- Low-income households are disproportionately affected, as they rely mostly on wages and loans to finance their consumption. Indeed, the value of their savings have declined in real terms, and many now has to work extra jobs to maintain their living standards.
- For asset-rich upper- and middle-classes, however, things look much rosier. In 2023, they even managed to garner additional savings, thanks to higher earnings on their fixed-income portfolios as well as a large windfall from a temporary reduction in personal taxes.
- The latter was the result of a sharp drop in asset prices in 2022—following Fed rate hikes—which reduced taxable capital gains and allowed investors to benefit from tax-loss harvesting. The Fed’s tighter policies, as such, has inadvertently fueled demand from wealthier households. This demand is now reversing as tax payments recovers, which may be a key reason why US GDP growth is likely to slow in 2024, perhaps towards 1.5 – 2.0% YoY.
- Higher demand from wealthier households might have helped low-income workers find jobs, but it could also inflame populist sentiment, as the latter are practically stuck in an “inflation treadmill”. Indeed, there are signs that



the US political realignment is quickening, with poorer Hispanics and even Blacks starting to shift towards Trump. This leaves the Democrats as a party mainly of educated urbanites, making their electoral math much tougher.

## A time to borrow, a time to repress

- The widespread tax-loss harvesting was nonetheless a strong argument that it is tight monetary policy—not a reckless spending spree—that drives the sharp increase in US fiscal deficit. By our estimate, about 80% of the deficit increase in 2023 was attributable to Fed policy, either via higher interest payment or the fall in personal taxes.
- This is essentially a classic situation when, under high real rates, resources are transferred away from borrowers (low-income households, the federal government) towards savers (large corporations, wealthy households).
- But the US government can ill-afford this burden at its present debt levels. Historically, periods of high government debt is often followed by a period of negative real rates, which can help reduce the debt/GDP ratio.
- The period of negative real rates in 2021-22 might have been too short, or not drastic enough, and another round of this “financial repression” might well be necessary in the future. Doing so, however, may be politically tricky, especially if it involves an increase in inflation.

- One possible pivot point is if Trump is elected in November. Trump is known to favor low interest rates and a weaker USD, in order to reduce the current account deficit. He has also stated his intention to have a stronger say in the Fed’s policymaking.
- We need to emphasize, however, that future negative real rates are not just a matter of political contingency, but dictated by actual needs to lighten the debt burden (i.e. fiscal dominance) and to strengthen domestic industries in order to (fight the climate crisis/bolster military capabilities versus China/creating jobs and staving off populism\*).

\* pick whichever is an easier sell to your constituents

## Apocalypse not yet

- There are, of course, other possible pivot points for Fed policy. One of them is a favorite trope of the “Dollar-skeptic” crowd, whereby the USD might be deprived of its reserve currency status in the near future, as a result of its increasing weaponization of the Dollar’s pre-eminence in the global financial system. Recent large selloff of US Treasuries by China (USD 53.3 Bn in Q1) certainly looks like an acceleration of this trend.
- As foreign demand for USTs dries up, it is argued that the US would have to either (1) offer much higher yields; or (2) resort back to QE and Japan-style yield curve control—both rather drastic scenarios than what we have today.

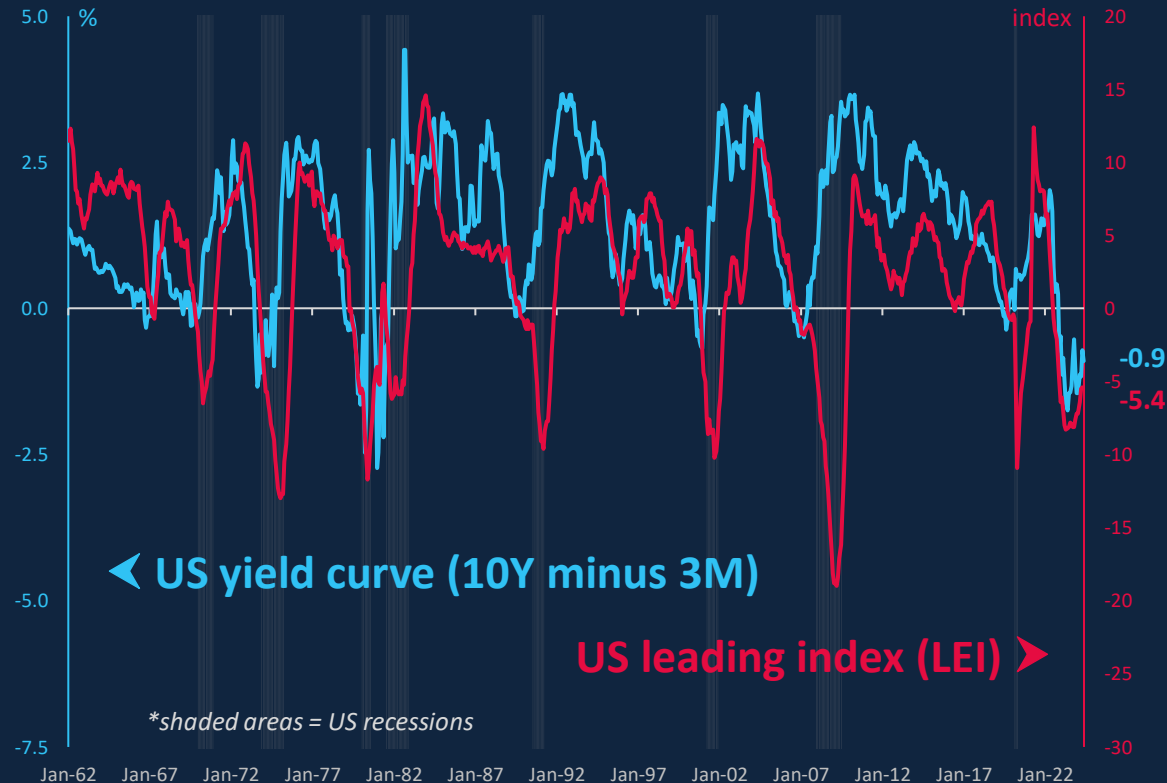
- [A closer look at the TIC data](#), however, reveals that foreign demand for US Treasuries has remained robust, and the recent selloff by China has made very little dent compared to Russia's selloff after its annexation of Crimea in 2014.
- It appears that the US can still rely on a large pool of liquidity to finance its debt, including “friendly” central banks, foreign private entities, and its own domestic investors. The weaker foreign demand since 2022 may not be the result of geopolitically-motivated dumps, but [mostly a by-product of higher real Fed rates](#)—as other central banks sell USTs to defend their currencies.
- This is not to say that the UST market is entirely out of the woods. Duration risk (due to uncertainty on rate outlook) has thinned out demand for longer bonds, to which the Treasury Dept. responds by [issuing more short-term bills](#). As it is, the Treasury would find it hard to lengthen its issuance without causing bear steepening and much tighter financial conditions.
- The expiry of BTFP earlier this year triggered fears of renewed liquidity risk, but this has not materialized. It helps that the [deposit flight that we saw last year has subsided](#), and that the wholesale funding market has not malfunctioned as in 2008. [Bank reserves have also stayed stable](#) despite the Fed's balance sheet reduction, limiting the risk of a sudden spike in rates.
- But if banks' liquidity has improved, other risks still lurk. Unrealized losses from bonds continues to sit on the balance sheet, while [credit risk is starting to rise](#) partly due to issues in the commercial real estate (CRE) market. All these limits banks' willingness to lend, which clearly points to slower growth in the future.
- Still, given stable liquidity and continued “transfer” to the private sector in the form of high-yielding bill issuance, the slowdown is likely to be a gradual one. This puts our timeline for macro-driven Fed rate cuts in the early- to mid-2025, coinciding with our Trump-driven rate cut scenario.
- Overall, US data do seem to show the necessity of low/negative real rates in the long-run, but the short-term [signals are ambiguous enough](#)—and the inflation concerns tricky enough—that the policy shift is likely to be delayed. This delay, coupled with China's lopsided growth, will continue to make life difficult for emerging economies—as we will examine in our final part.

## Slow road to stagflation

- The other possible pivot point, of course, is [if the US experiences a recession](#) and/or 2008-like shock to its banking system. The failure of SVB and several regional banks in early 2023 seemed to tease this possibility, but the Fed's response—providing liquidity through Bank Term Funding Program (BTFP)—managed to contain the crisis.

# False alarms

For the past two years, the yield curve and leading index has wrongly predicted the US economy to fall into recession



Note:

- The US yield curve and LEI has had a perfect 8/8 record at predicting recessions between 1969 – 2020.
- This time, YC inversion has been prolonged but without predicting recession (yet), partly due to “immaculate disinflation” via the release of oil stocks from the US SPR, and partly also due to the shift of UST issuance towards short-term bills.
- Meanwhile, the LEI’s “miss” is likely attributable to its heavy reliance on manufacturing indices, whereas the post-pandemic cycle in the US has mostly been driven by other sectors (services, construction).

# It ain't over till it's over

Since the late 80s, US recessions only begin *after* the yield curve has normalized

Cycle	Phase 1 – From peak inversion back to neutral YC					Phase 2 – From neutral YC to the end of recession			
	Start	End	Recession at end?	Change in 3M yield	Change in 10Y yield	Start	End	Change in 3M yield	Change in 10Y yield
#1	Jul-69	Feb-70	Yes	+0.19	+0.57	Feb-70	Dec-70	-2.35	-0.90
#2	Aug-73	Oct-74	Yes	-1.20	+0.50	Oct-74	Apr-75	-1.93	+0.35
#3	Dec-79	May-80	Yes	-3.55	-0.22	May-80	Aug-80	+0.66	+0.96
#4	Jan-81	Sep-81	Yes	-0.38	+2.74	Sep-81	Dec-82	-6.75	-4.80
#5	Jun-89	Jan-90	No	-0.50	-0.02	Jan-90	Apr-91	-2.08	-0.19
#6	Dec-00	Feb-01	No	-0.88	-0.11	Feb-01	Dec-01	-3.29	-0.03
#7	May-07	Jun-07	No	-0.33	+0.55	Jun-07	Jul-09	-4.54	-1.57
#8	Aug-19	Oct-19	No	-0.32	+0.12	Oct-19	May-20	-1.54	-1.05
#9	May-23	*	No*	+0.01	+1.00				

Source: Bloomberg, NBER, BCA Economist

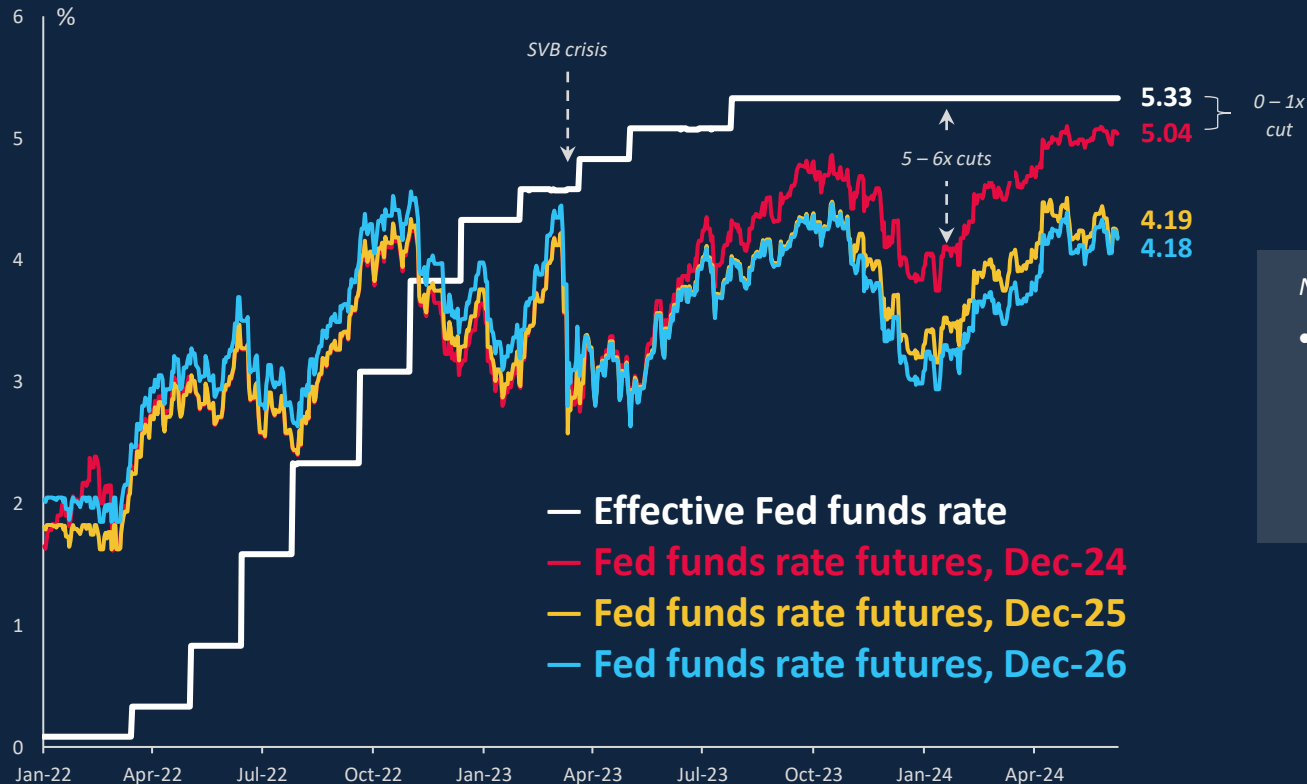
\* Per May-24, the US yield curve has not un-inverted nor has recession been declared by the NBER

## Note:

- The current inversion episode is quite atypical, since short-term yields have risen (albeit slightly), which last happened in cycle #1 (1969-70) prior to the prolonged inflationary shock of the 1970s. Meanwhile, the increase in long-term yields so far is second only to cycle #4, i.e. during the Volcker shock.

# Fool me twice

The market has twice made wrong collective bets that the Fed will rapidly pivot towards accommodative policies

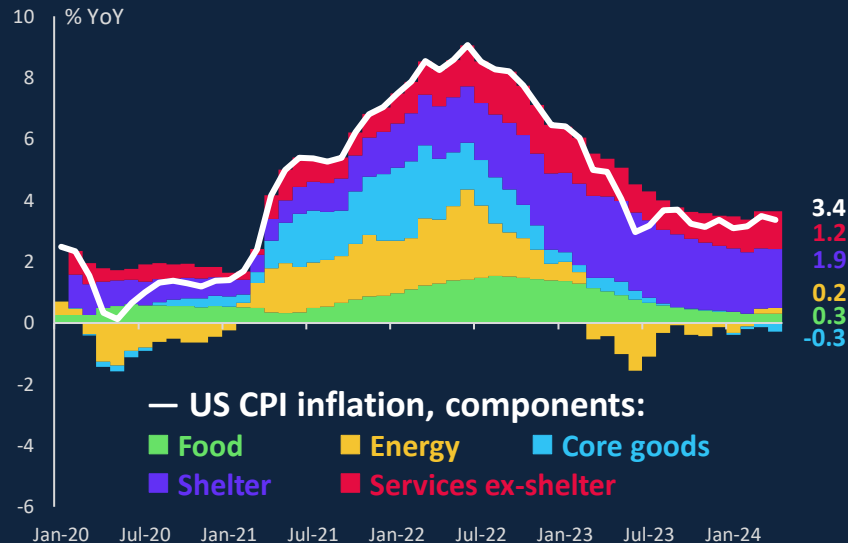


#### Note:

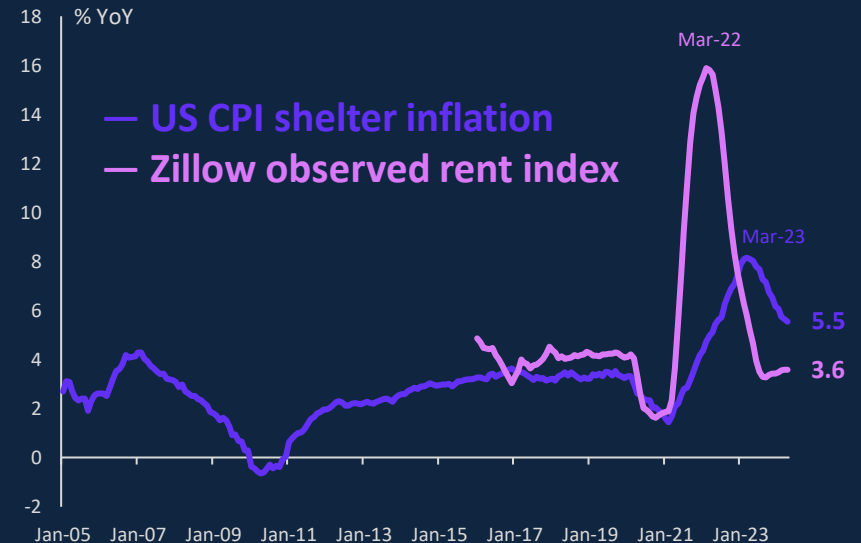
- The overly bullish expectation of 5-6x rate cuts at the turn of the year was generally predicated on (1) the Fed's communication at the Dec-23 FOMC; and also (2) the QRA in Nov-23, which caused the pressures on UST market to ease temporarily.

# Tough nut to crack

Getting US inflation back to 2% would require disinflation in services, but only shelter (due to a lag in measurement) could be relied upon



Source: BLS, BCA Economist



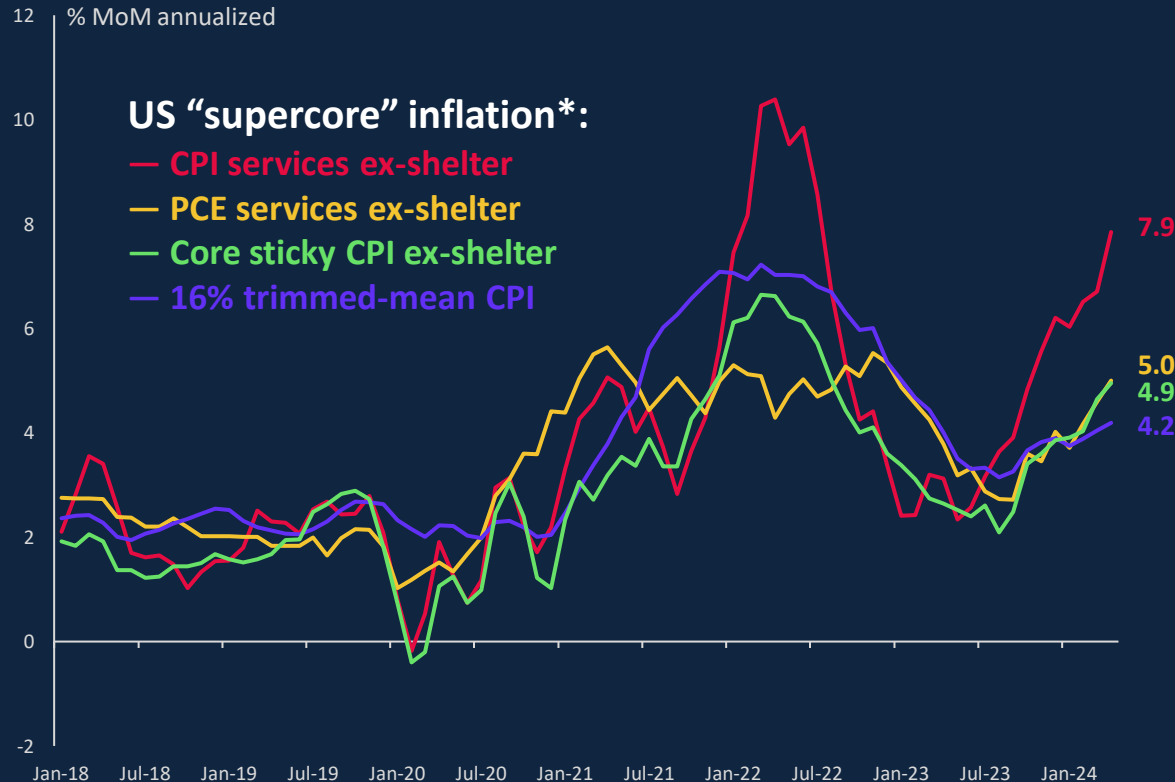
Source: St. Louis Fed, Zillow, BCA Economist

## Note:

- Of US inflation drivers, only core goods are still falling since mid-22, consistent with our hypothesis of global disinflation driven by China's excess output.
- The lag between official shelter inflation and e-commerce data might be related to the former's methodology, which relies on surveys including on the OER (owner-estimated rent), which—as befits its name—is not based on actual market prices.

# An offensive rebound

Fundamental, non-volatile measures of inflation seems to be rising again, threatening to derail the prospects of a Fed easing

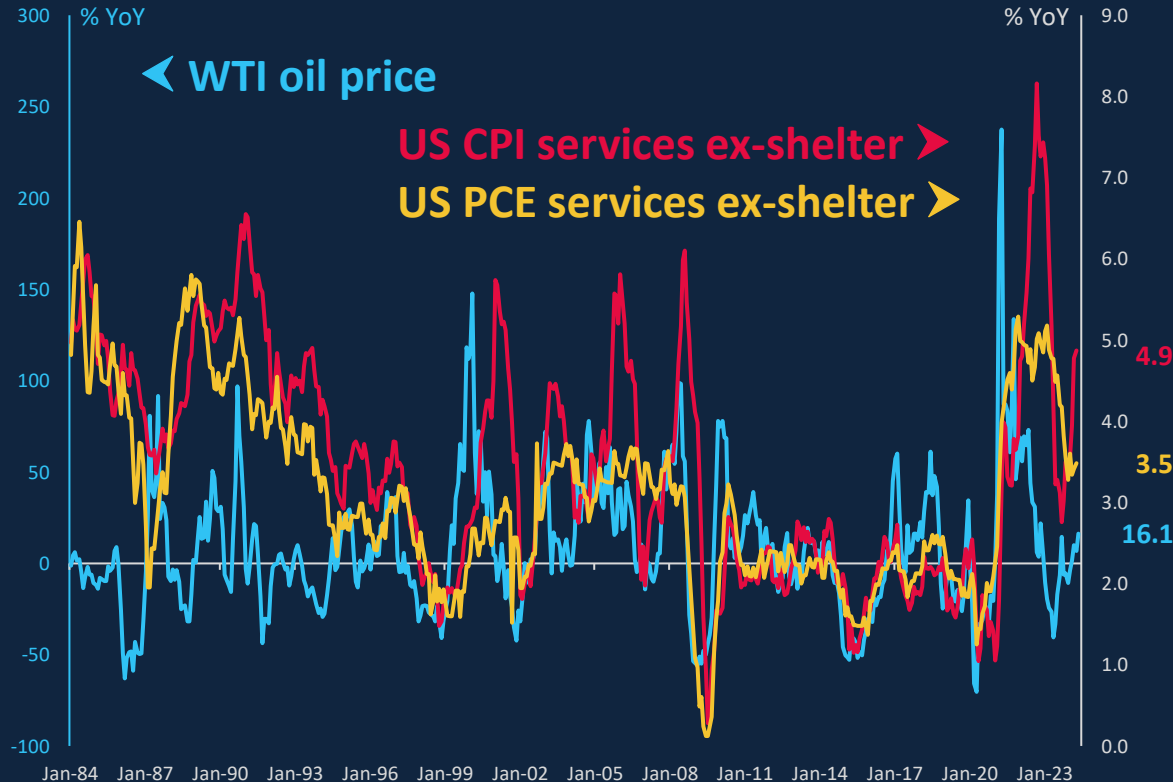


Note:

- There is no official measurement of “supercore” inflation; the four series shown here represent alternative estimates.
- Sticky-price CPI includes only items that change prices relatively slowly, while the 16%-trimmed mean CPI excludes the top 8% and bottom 8% items in terms of inflationary contribution.
- Supercore inflation generally leads the headline inflation (albeit inconsistently), and the increase in supercore numbers from Q4-23 onwards may presage another phase when US inflation accelerates.

# It's turtles all the way down

"Supercore" inflation measures are calculated so as to exclude energy, but are still susceptible to fluctuation in energy prices



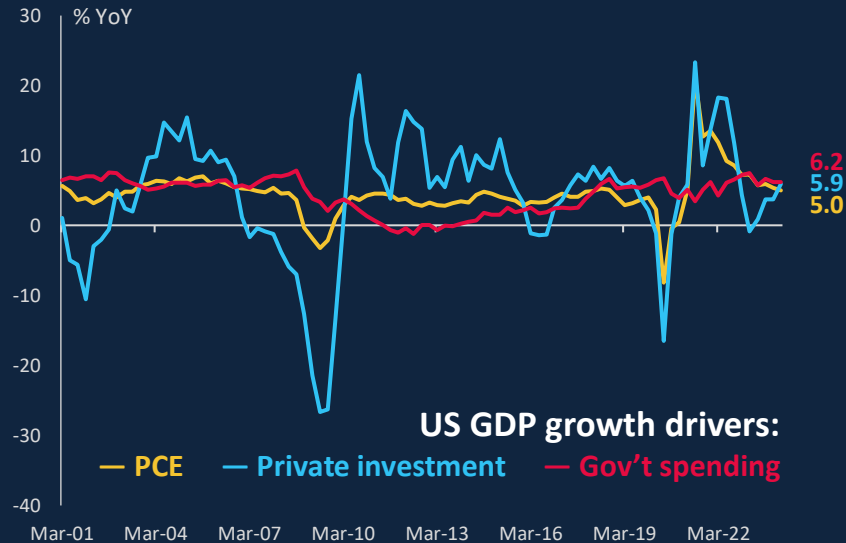
## Note:

- As energy need is pervasive across all economic activities, it is entirely understandable that oil price fluctuations will have some indirect cost-push effects on the production of all goods and services.
- These indirect effects (e.g. via cost of electricity, wage demand, or even monetary policy) means that there tends to be a substantial lag between oil price and supercore inflation.



# Appetite for construction

High housing prices and incentives from Biden's industrial policies have boosted the contribution from investment to US growth



Source: Bloomberg, BCA Economist



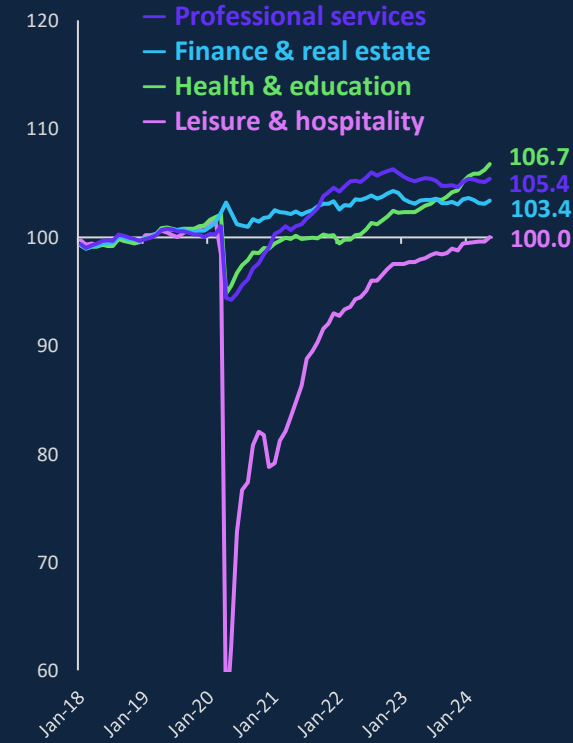
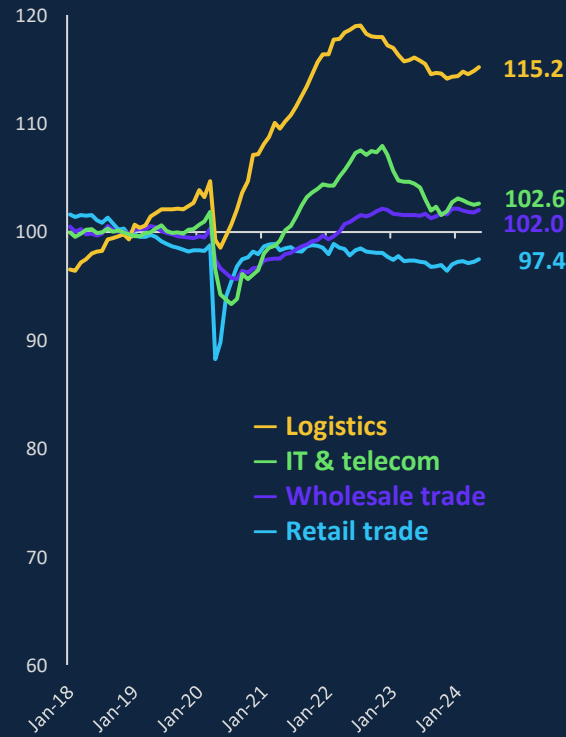
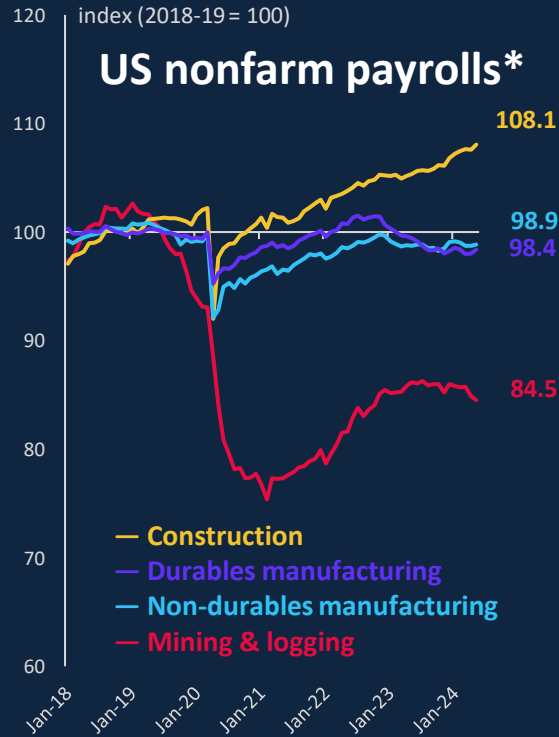
Source: Bloomberg, BCA Economist

## Note:

- Despite strong investment in manufacturing facilities, private investment still slowed in 2022-23 due to the preponderance of residential investment on overall growth. There has been recovery on this front in recent quarters—bolstered by high house prices—but it is likely to slow again in the near future as demand for housing remains sluggish, hampered by worsening affordability (due to prices as well as interest rates).

# Hot spots in a cooling market

The pace of recruitment has slowed compared to the red-hot 2021-22, but construction, logistics, and some services continue to add jobs

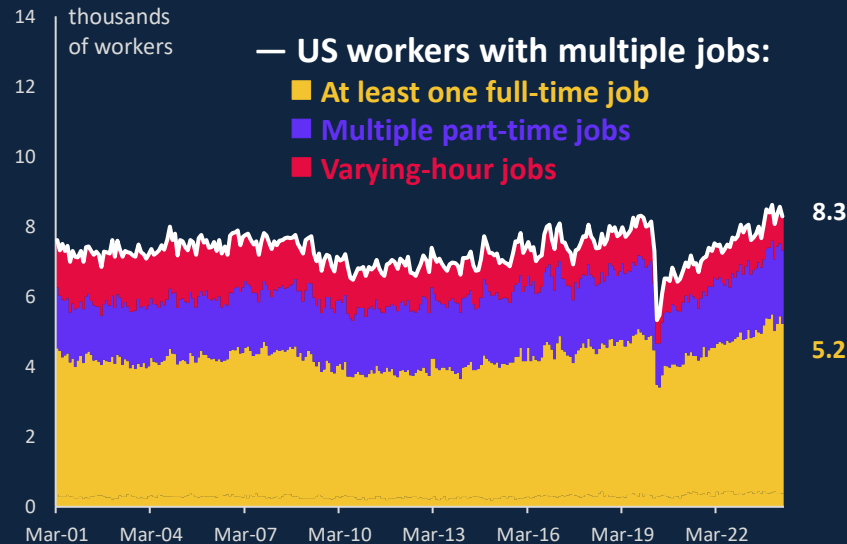


Source: St. Louis Fed, BCA Economist

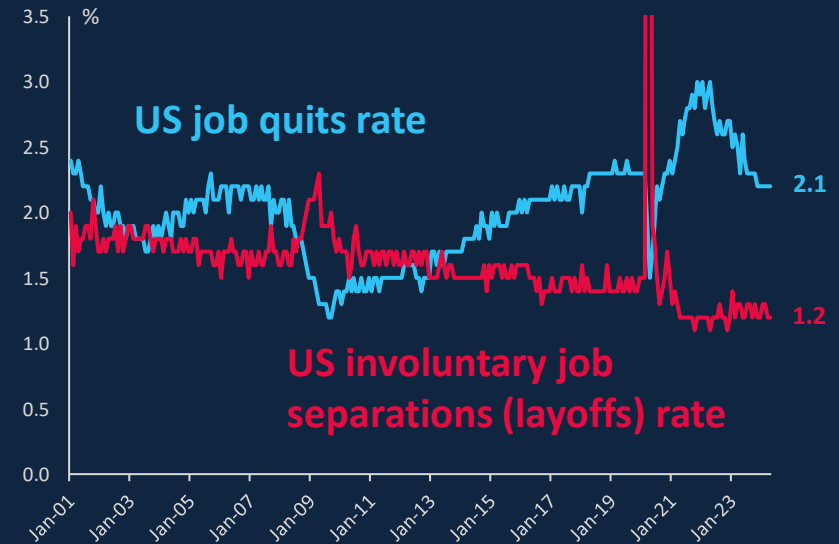
\* normalized to the size of US workforce

# Desperate for jobs

US workers are increasingly working multiple jobs, while the “Great Resignation” hype is firmly in the past



Source: Bloomberg, BCA Economist



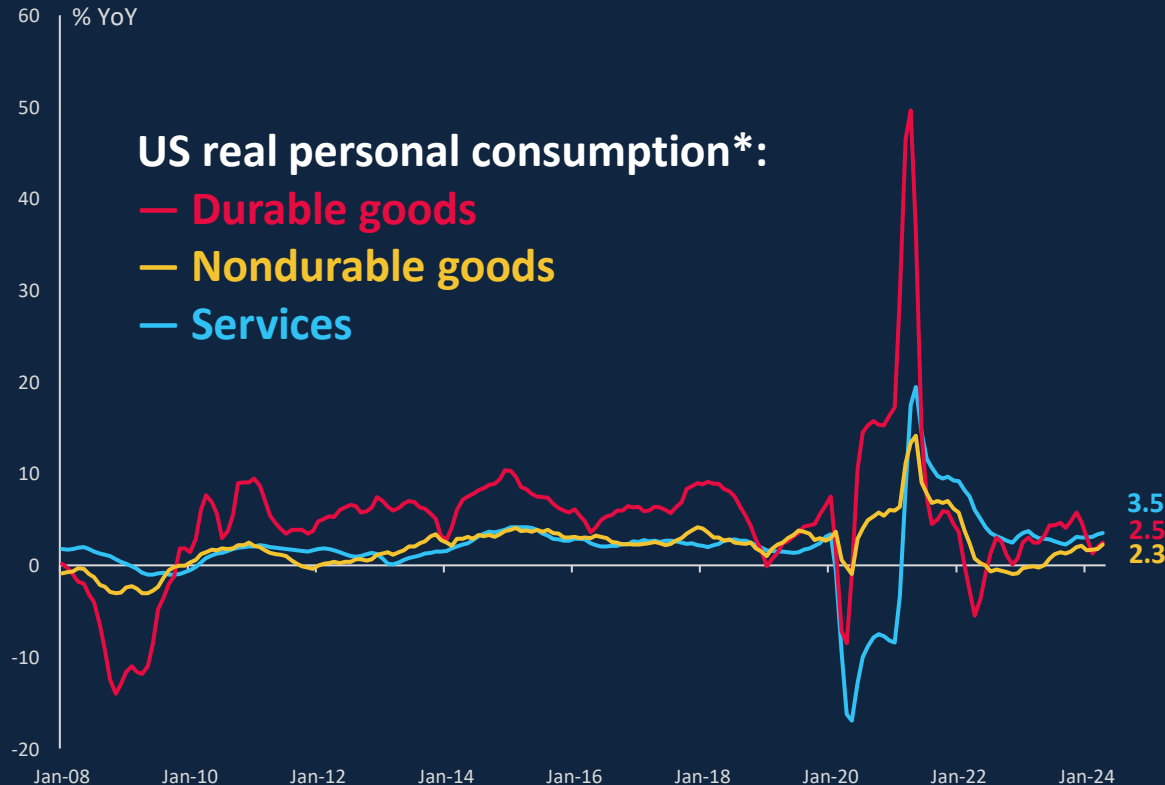
Source: Bloomberg, BCA Economist

## Note:

- The “Great Resignation” narrative seemed to have peaked in mid-2022 (based on Google Trends data), which coincided with peak quit rates.
- Despite slowing quits rate, layoffs remain near historic lows, showing a lack of recessionary momentum. Slowing recruitment but limited layoffs suggests limited job opportunities for young/new workers, similar to other countries (e.g. China, Indonesia) after the pandemic.

# Exuberant demand

Consumer demand, especially for services, explains why US growth has been resilient following the pandemic



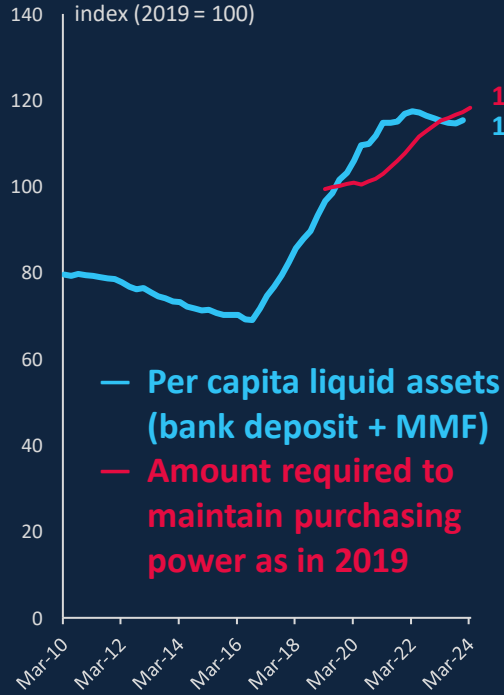
*Note:*

- The negative growth in goods demand in 2022 (affecting durables and nondurables at different times) seemed to be caused by a reorientation of the average US consumption basket towards services, after the relaxation of lockdowns.
- Recent growth in consumption of services (avg. 3.0% YoY since 2023) is faster than the average growth throughout the 2010s (2.1%).

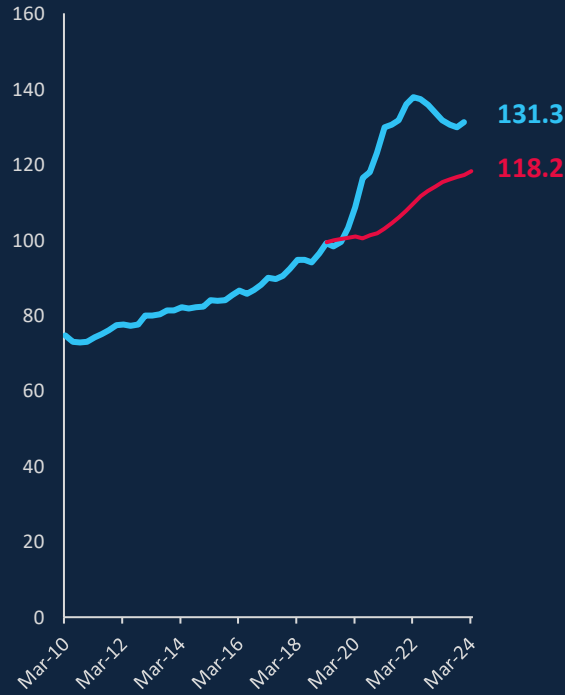
# Mind the gap

High-income US households have become very cash-rich, but conversely the purchasing power of poorer households have declined

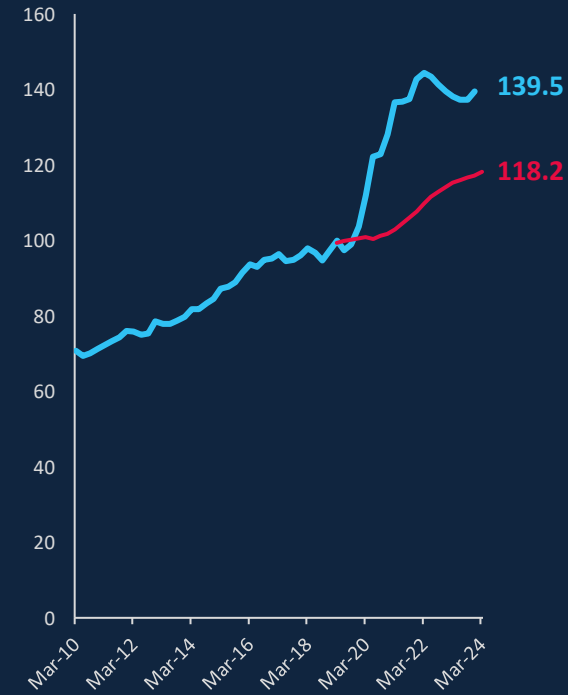
## 0<sup>th</sup> – 40<sup>th</sup> income percentile



## 40<sup>th</sup> – 80<sup>th</sup> income percentile



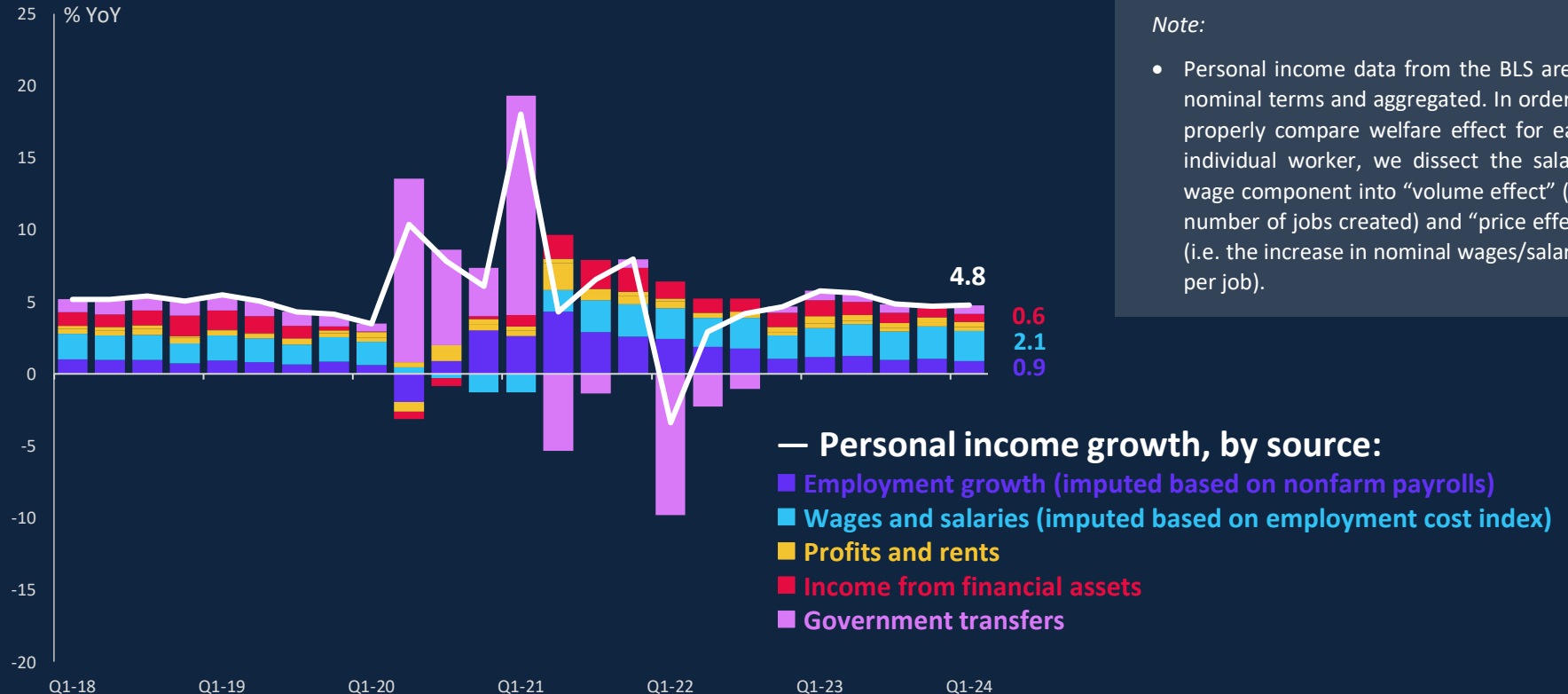
## 80<sup>th</sup> – 100<sup>th</sup> income percentile



Source: Federal Reserve, BCA Economist

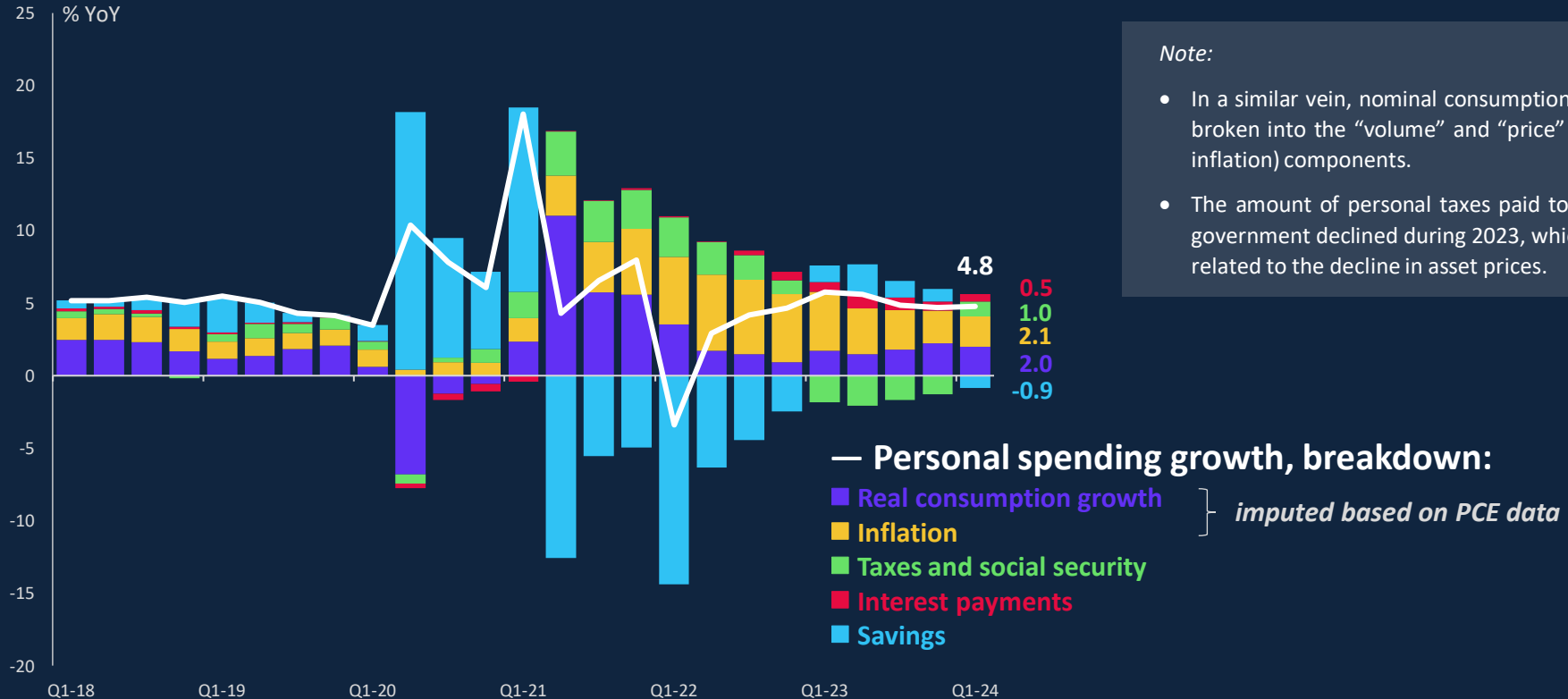
# One step forward ...

Nominal wage and employment has been growing much faster than before the pandemic



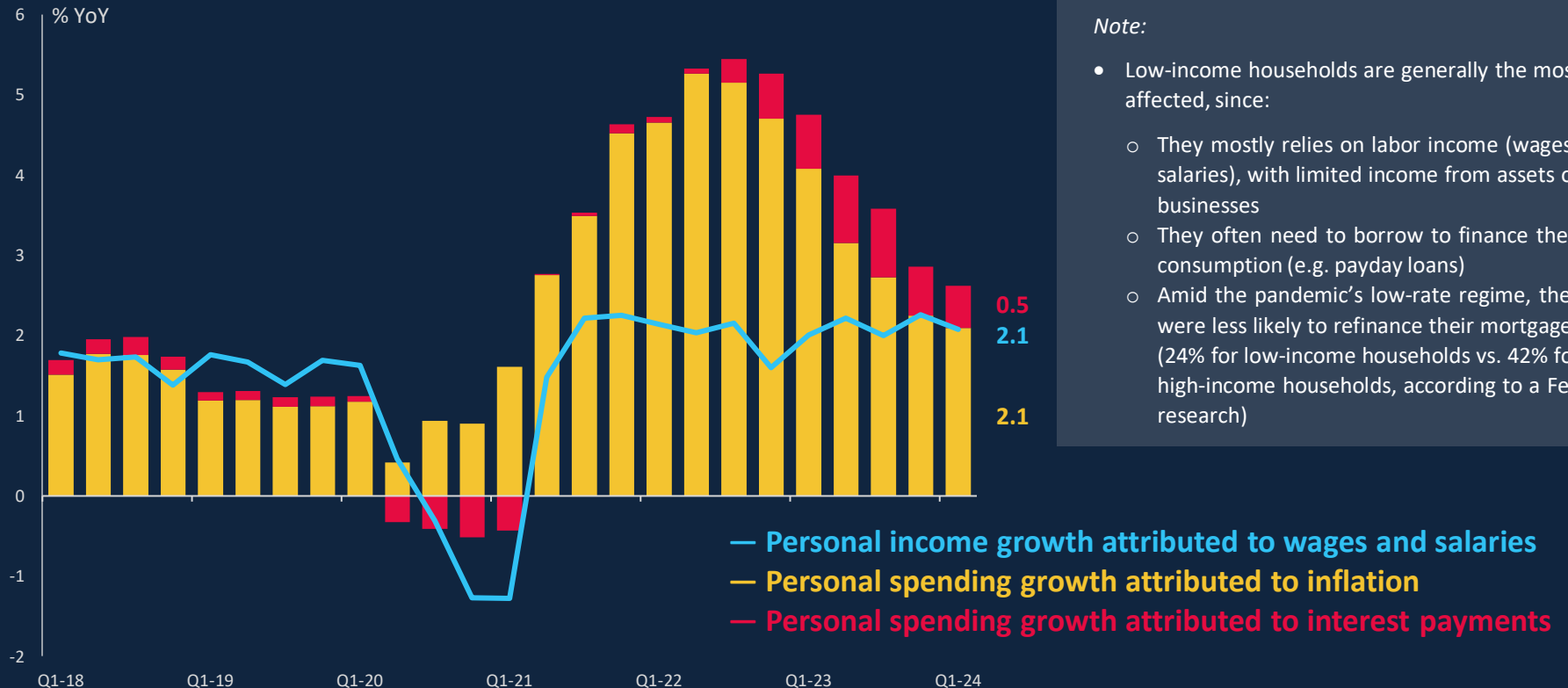
# ... two steps back ...

Inflation has eaten into savings and real consumption, except for asset-rich households benefiting from declining capital gains tax in 2023



# ... and we fall behind on the treadmill

Households that rely solely on wages have suffered from a double whammy of high inflation and rising interest rates



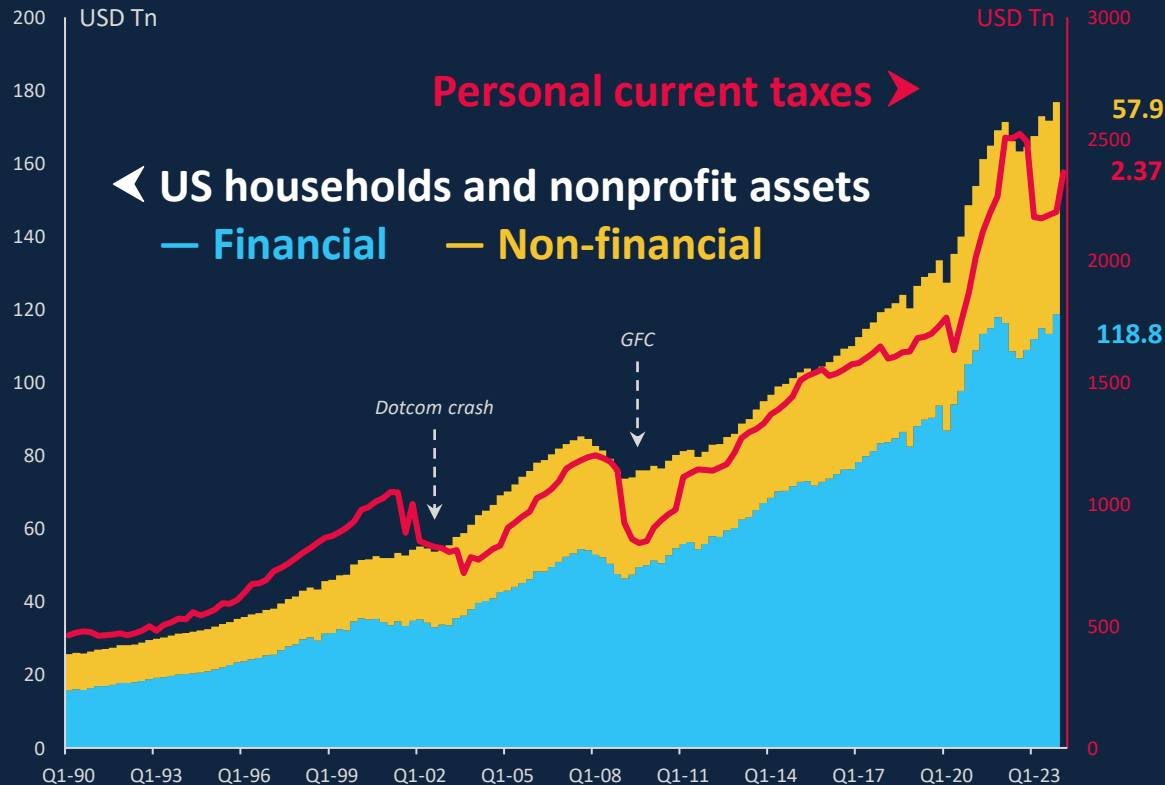
## Note:

- Low-income households are generally the most affected, since:
  - They mostly relies on labor income (wages/salaries), with limited income from assets or businesses
  - They often need to borrow to finance their consumption (e.g. payday loans)
  - Amid the pandemic's low-rate regime, they were less likely to refinance their mortgages (24% for low-income households vs. 42% for high-income households, according to a Fed research)



# From Wall Street to DC

Federal revenue from personal taxes is greatly impacted by periods of sharp market correction

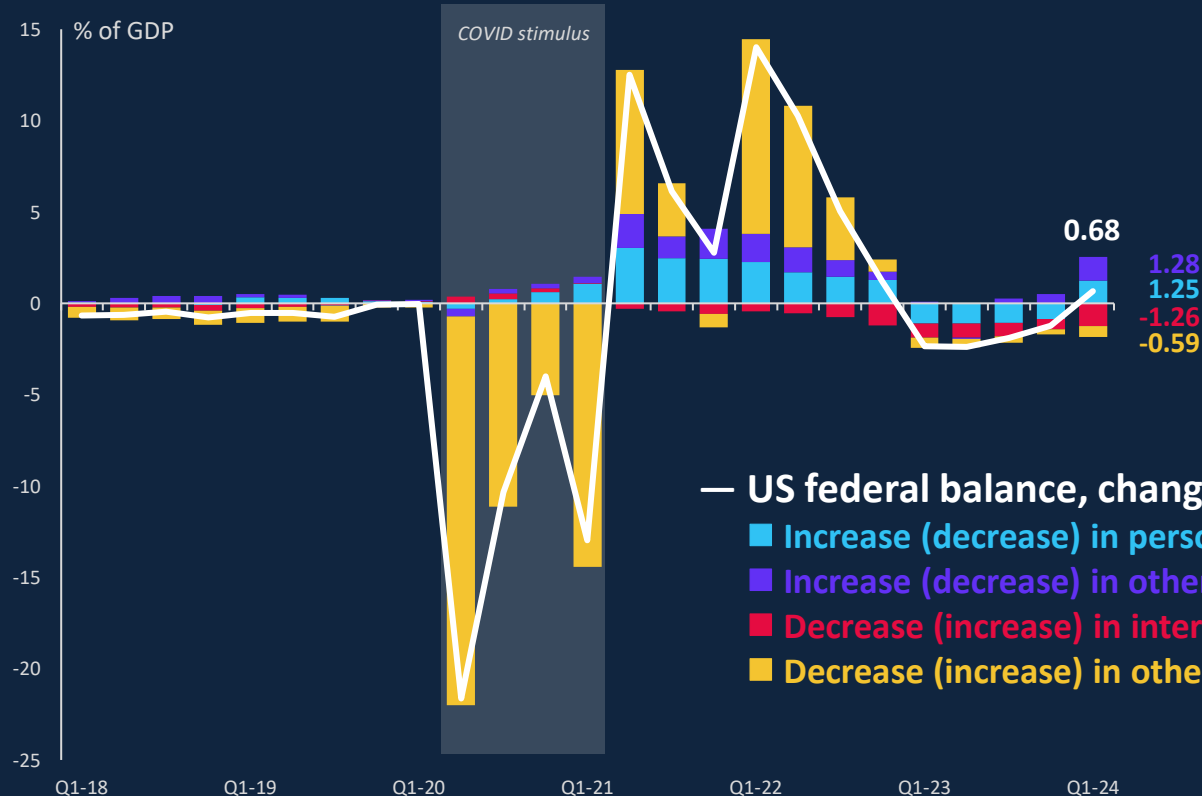


Note:

- The correlation between asset prices and US personal tax receipts can be explained by tax-loss harvesting, whereby investors sell off their assets at a loss to reduce capital gains tax on the rest of their portfolio.
- The Google search popularity of the term “tax-loss harvesting” peaked in late 2022, which may indicate the prevalence of such practice even among retail investors at the time.

# Fed versus Fed

The widening federal deficit is mostly due to higher interest rates and lower personal tax receipts, both a product of tight Fed policy

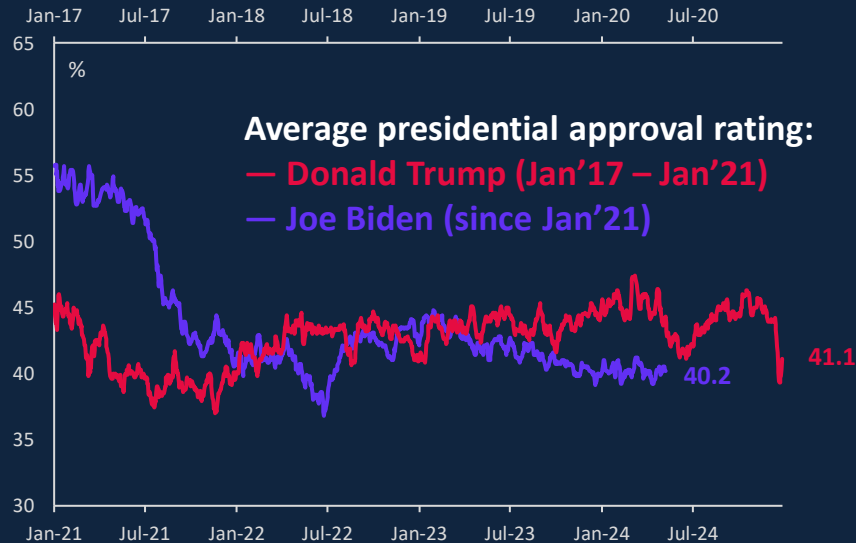


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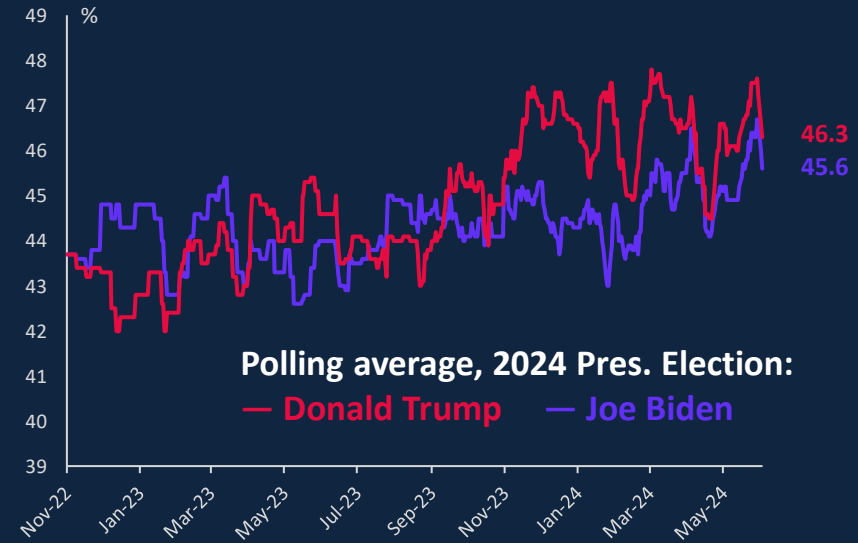
- Revenue from personal taxes swings by about 3% of GDP between bull and bear markets, while higher interest rates have added another ~0.9% of GDP to the annual fiscal deficit in recent year.
- Such a large effect makes it doubtful that the US could sustain high or rising interest rates for a long period.

# Moment of truth?

The disconnect between strong macro numbers and declining living standards may propel Trump back into the White House



Source: Real Clear Politics



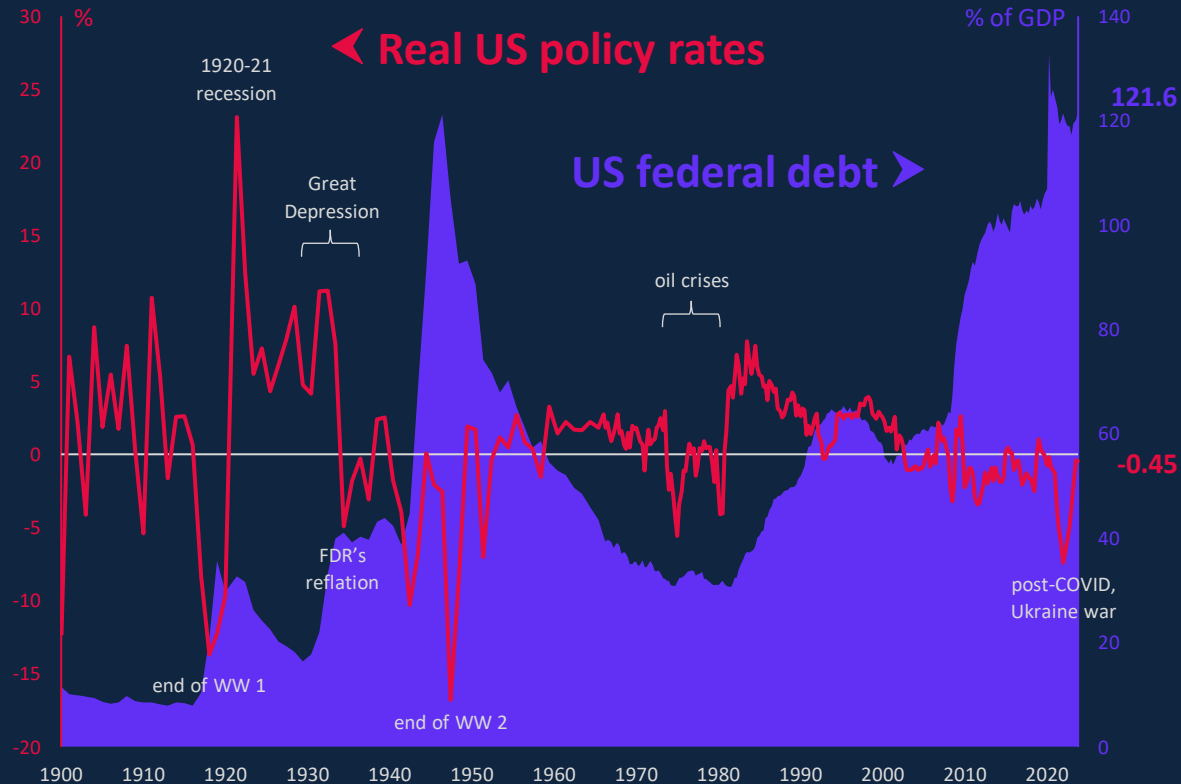
Source: Real Clear Politics

## Note:

- According to Pew Research (Jan-24), only 28% of voters have a positive view on the economy, albeit with a big partisan gap (44% for Democrats, 13% for Republicans). For those with negative view, inflation is overwhelmingly the top concern (61%) over a lack of jobs (15%), national debt (7%), high interest rates (6%), and wealth inequality (5%).

# Accentuate the negative

Historically, high federal debt levels necessitate negative real rates to an even more drastic extent than in 2022

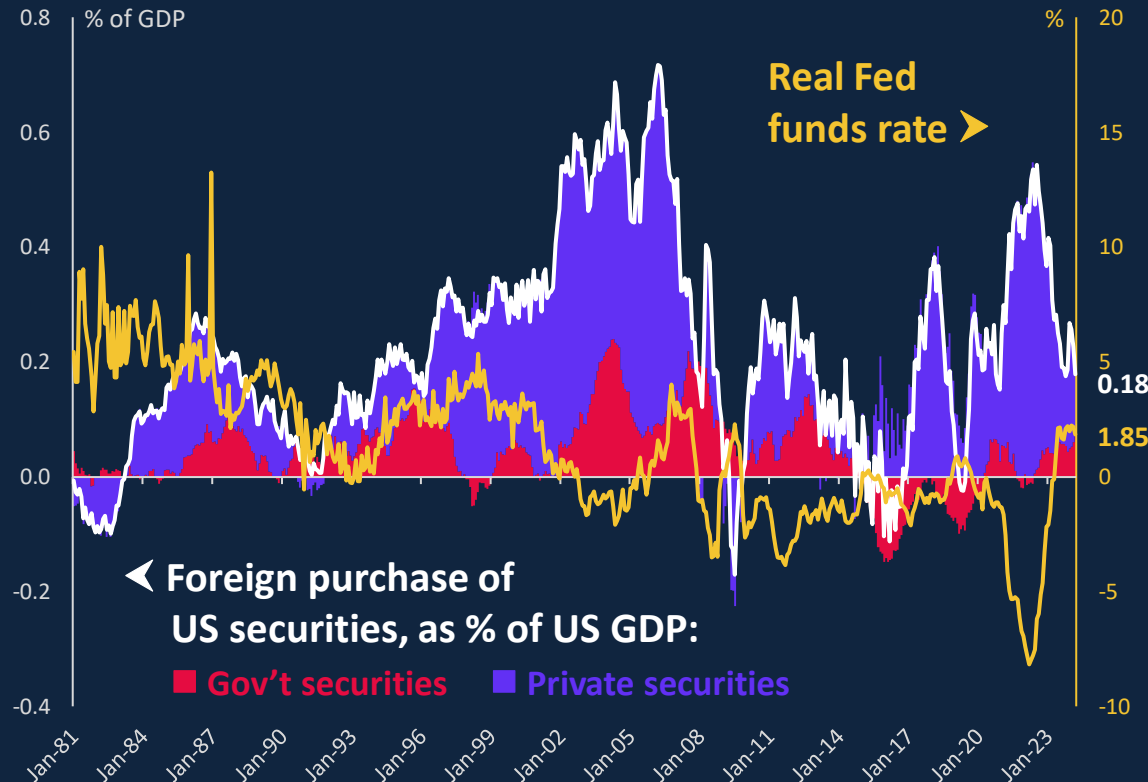


Note:

- In both the post-WW1 and post-WW2 periods, the negative real rates were driven mostly by a sharp burst of high inflation (18 – 22%) over a 2 – 3 years period, without much of an increase in the benchmark rates.
- It is worth noting that periods of positive real rate alongside large US debt buildup during the 80s and 90s coincided with a recurring bout of debt/currency crises in the peripheral markets (Asia, Latin America, the Eastern Bloc) as global capital flows were redirected towards the US.

# Inverted logic

High US real yields used to drive inflows to the US in the 80s and 90s, but since then it is associated with periods of selloff

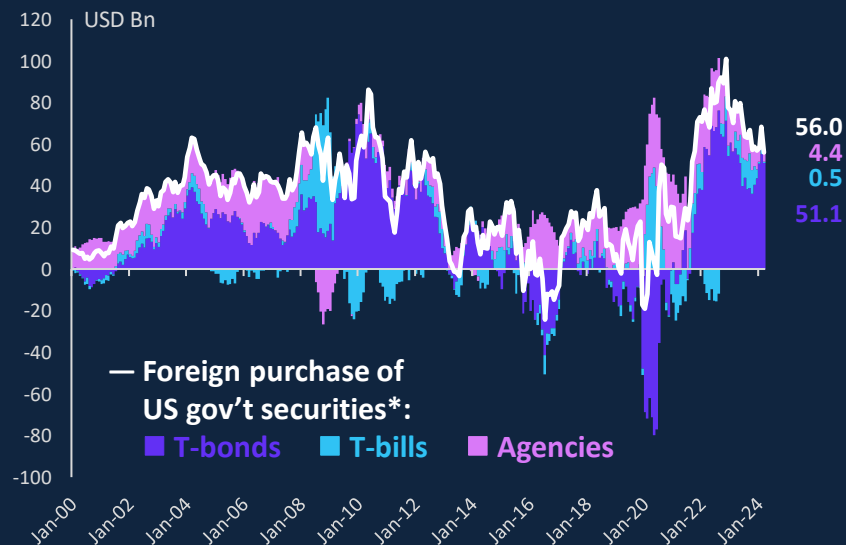


*Note:*

- As noted before, high real rates in the US used to siphon off capital from other countries to the US. After a series of crises, many EM learned to accumulate FX reserves (often UST), and a rising China would take this strategy to the extreme (prior to 2016).
- Since then, the dynamic flips. Negative US real rates is now associated with larger BoP surplus among EM (both current and capital accounts), which is then recycled to US assets. In contrast, positive US real rates forced countries to selloff their US holdings.
- As such, it is high Fed rates (not low) that would more likely drive de-Dollarization. High US rates deprive EM of access to USD and increase the chances of debt crises, prompting them to seek assistance from China.

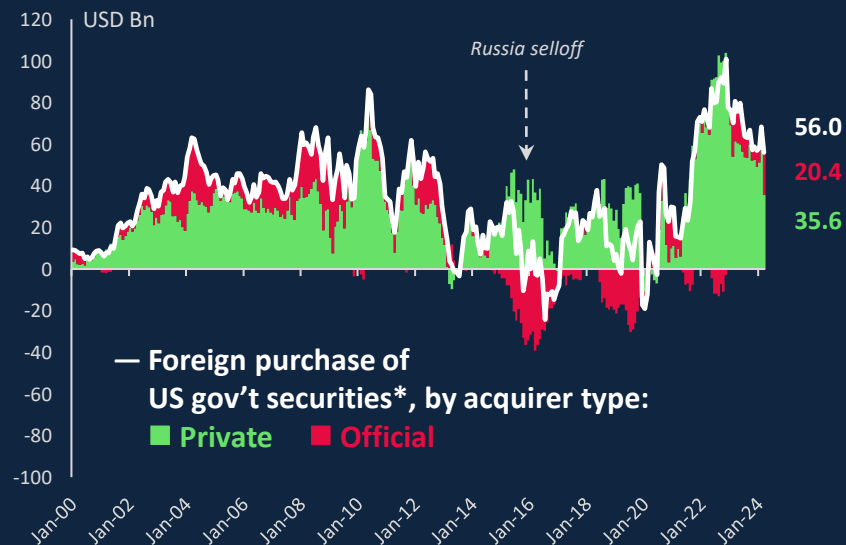
# Demise greatly exaggerated

Despite rising tensions since 2022, any attempt by rival countries to ditch US Treasuries has been outweighed by higher demand from elsewhere



Source: TIC, BCA Economist

\*7M centered moving average



Source: TIC, BCA Economist

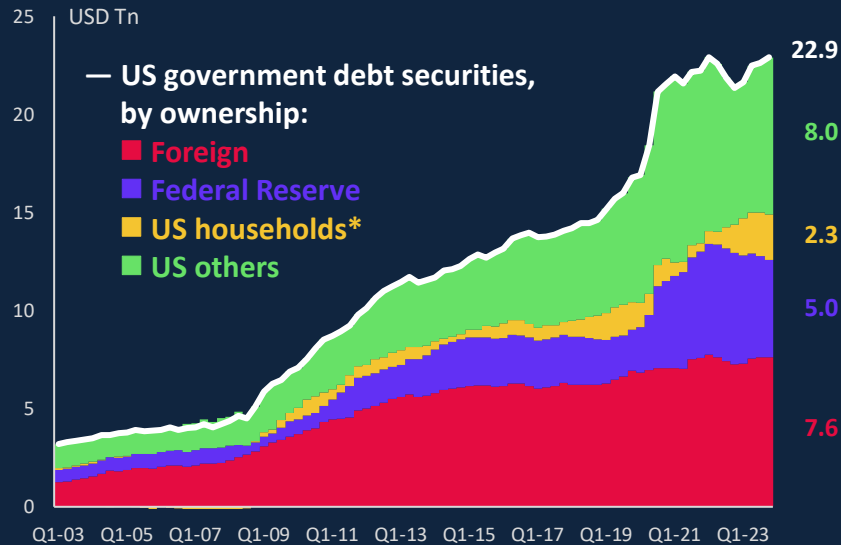
\*7M centered moving average

## Note:

- Some analysis (e.g. Council of Foreign Relations) has shown that Chinese holding of US assets have not declined by as much as officially reported, if we include offshore custodians (e.g. Belgium) and alternative asset classes (e.g. agency bonds). The very complementarity of China and US current account (huge deficit vs. huge surplus) necessarily means that at least some of China's savings will end up financing US borrowing, directly or indirectly.

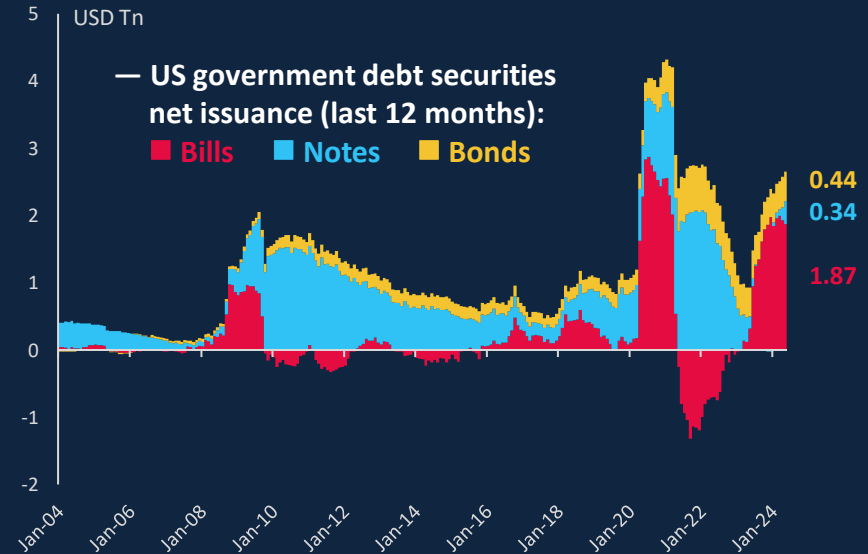
# Short-term solution

With the Fed shrinking its balance sheet and private investors reducing duration, US government has resorted to issuing mostly short-term bills



Source: Bloomberg, St. Louis Fed, BCA Economist

\* including nonprofits



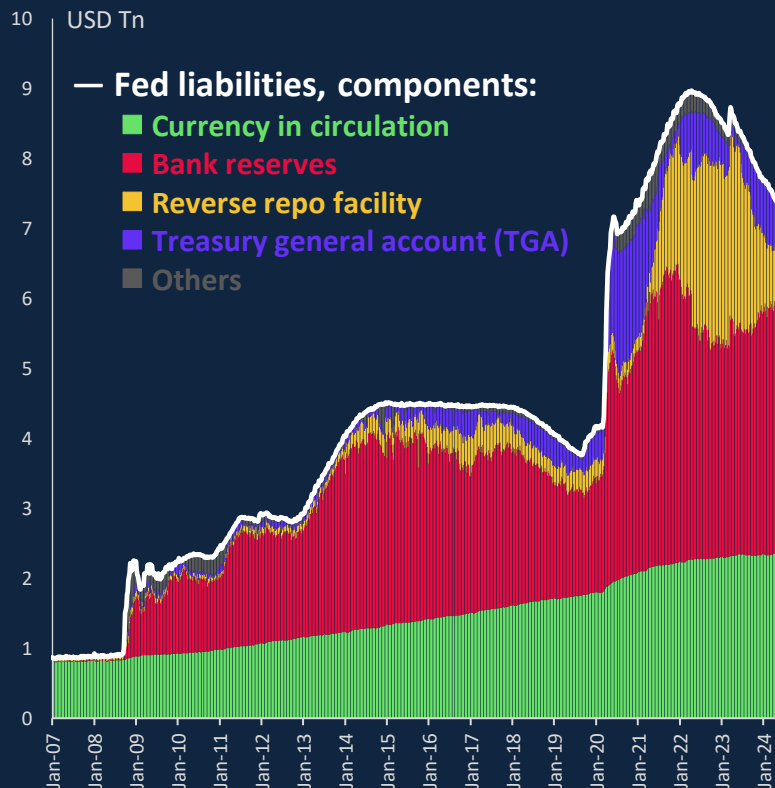
Source: Bloomberg, BCA Economist

## Note:

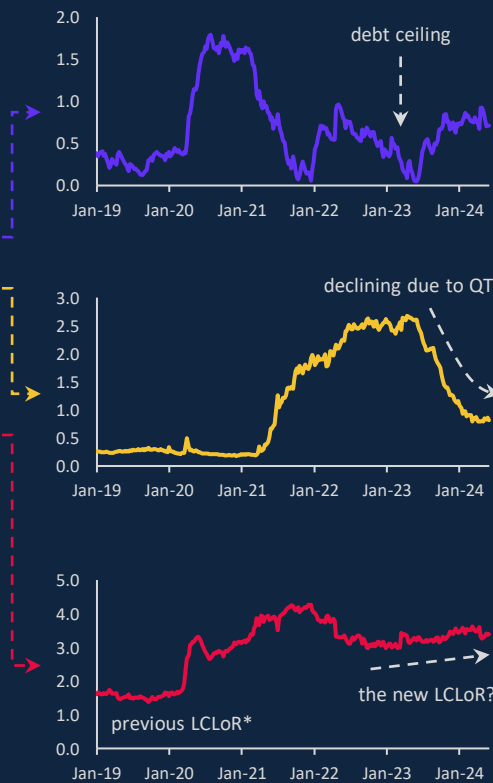
- Given its status as the main global risk-free asset, demand for US T-bills are immanently stretchable with respect to supply. Still, the US government cannot rely on T-bills indefinitely, as (1) issuing it effectively eases financial conditions and risks undermining the Fed's policy; and (2) it is partly funded by the sales of other short-term assets e.g. bank reserves and reverse repo at the Fed, which may destabilize the money market if stretched too low.

# Closing in on Goldilocks?

The Fed is slowing down quantitative tightening with sufficient liquidity all around, albeit still-outsized balance sheet



Source: St. Louis Fed, BCA Economist



\* lowest comfortable level of reserves

- TGA has been ample and stable since Q4-23, which may reduce the need for large net UST issuance that could eat into RRP and/or bank reserves.

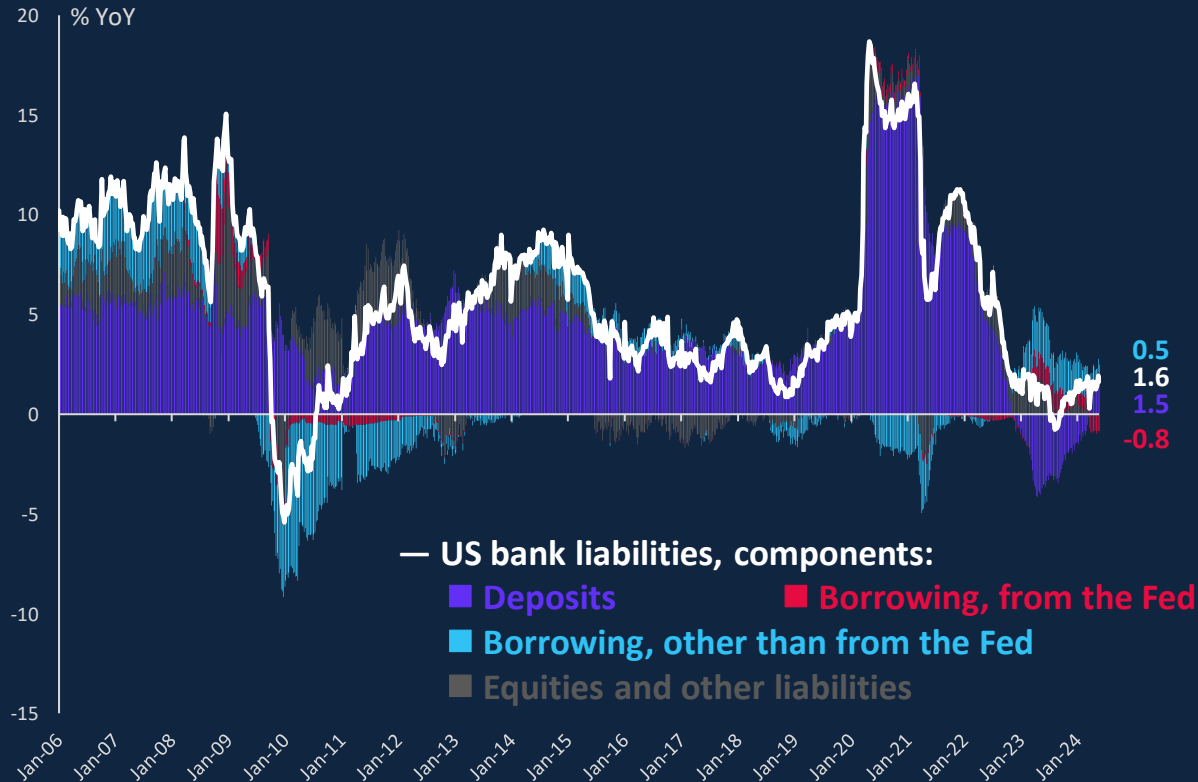
- RRP was the main casualty of QT combined with UST issuance in H2-23. Slowing pace of RRP decline might be a sign that liquidity is stabilizing.

- Stable bank reserves curb the risk of a rate spike as in 2019. This new stable level is however much-elevated relative to the previous.



# Crisis averted

Bank deposits are recovering after a period of flight, allowing the Fed to exit its extraordinary lending program

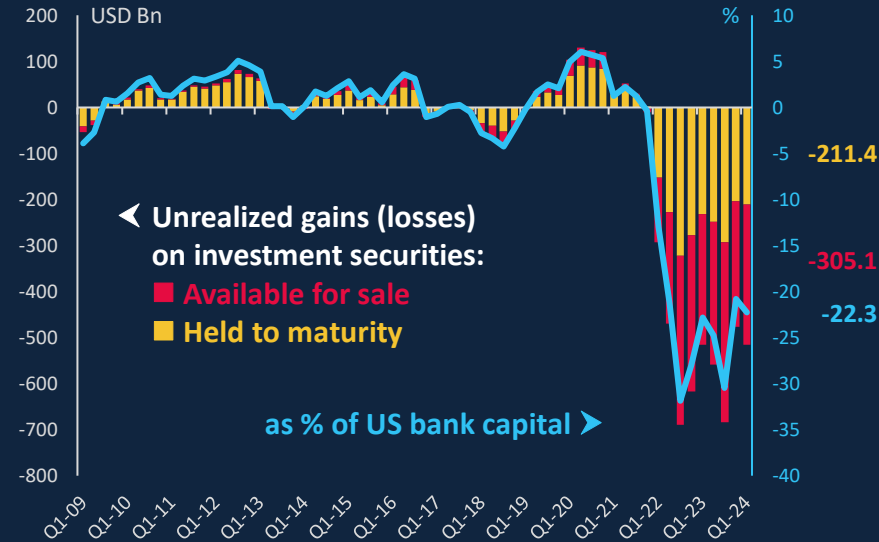


*Note:*

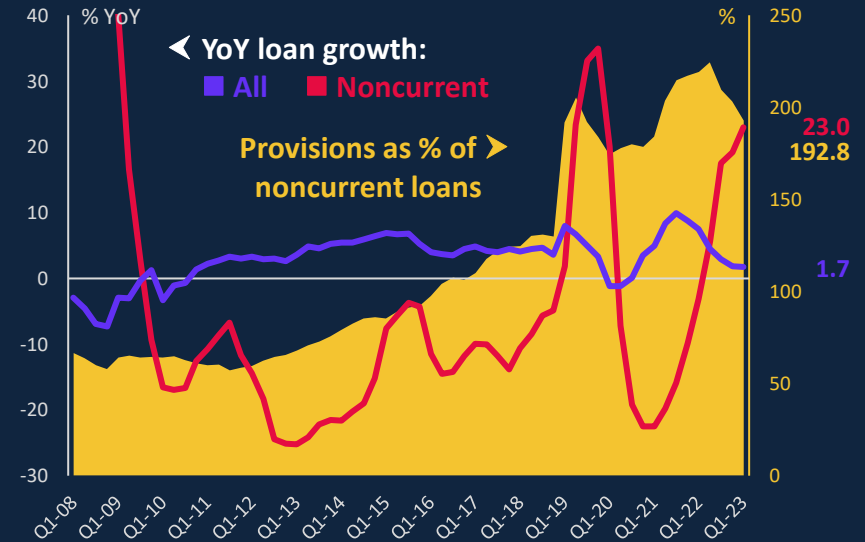
- With the expiry of BTFP, banks are expected to go back to the Fed's discount window to fulfill urgent liquidity needs.
- A clear positive sign for the US banking system relative to 2008 is the fact that the wholesale funding market (i.e. borrowing from other than the Fed) has not contracted amid the liquidity crunch in 2023.

# Dangers still lurking

Despite sufficient coverages, losses on loans and bond securities are likely to curtail future risk-taking



Source: FDIC, St. Louis Fed, BCA Economist



Source: FDIC, BCA Economist

## Note:

- While the liquidity crisis of 2023 crisis disproportionately affected regional banks, the recent increase in noncurrent loans happens mostly for banks with assets above USD 250 Bn.
- Banks' lending standard has tightened across the board, with loans to commercial real estate (CRE) showing the most drastic tightening.

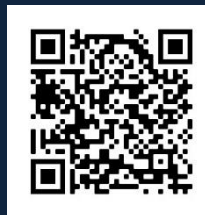
## Projections of macroeconomic indicators

	2019	2020	2021	2022	2023	2024E
<b>GDP growth (% YoY)</b>	5.02	-2.07	3.69	5.32	5.04	<b>4.97</b>
<b>GDP per capita (USD)</b>	4,175	3,912	4,350	4,784	4,982	<b>5,149</b>
<b>CPI inflation (% YoY)</b>	2.59	1.68	1.87	5.51	2.61	<b>3.21</b>
<b>BI 7-day Repo Rate (%)</b>	5.00	3.75	3.50	5.50	6.00	<b>6.50</b>
<b>10Y gov't debt yield (%)</b>	7.04	5.86	6.36	6.17	6.45	<b>6.92</b>
<b>USD/IDR exchange rate</b>	13,866	14,050	14,262	15,568	15,397	<b>16,304</b>
<b>Trade balance (USD Bn)</b>	-3.3	+21.7	+33.8	+54.6	+37.0	<b>+32.6</b>
<b>Current account balance (% of GDP)</b>	-2.71	-0.42	+0.30	+0.98	-0.14	<b>-0.50</b>

Source : BPS, BI, Bloomberg, BCA Economist estimates

Notes:

- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate all refers to end of year position
- 10Y yield and USD/IDR exchange rate projections refer to fundamental values; actual market values may vary depending on market sentiment and technical factors



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## BCA Economic & Industry Research

**David E.Sumual***Chief Economist*

david\_sumual@bca.co.id  
+6221 2358 8000 Ext:1051352

**Victor George Petrus Matindas***Senior Economist*

victor\_matindas@bca.co.id  
+6221 2358 8000 Ext: 1058408

**Keely Julia Hasim***Economist / Analyst*

keely\_hasim@bca.co.id  
+6221 2358 8000 Ext: 1071535

**Aldi Rizaldi***Research Assistant*

aldi\_yanto@bca.co.id  
+6221 2358 8000 Ext: 1020451

**Agus Salim Hardjodinoto***Head of Industry and Regional Research*

agus\_lim@bca.co.id  
+6221 2358 8000 Ext: 1005314

**Gabriella Yolivia***Industry Analyst*

gabriella\_yolivia@bca.co.id  
+6221 2358 8000 Ext: 1063933

**Elbert Timothy Lasiman***Economist / Analyst*

Elbert\_lasiman@bca.co.id  
+6221 2358 8000 Ext: 1007431

**Fikri Adam Zaqi***Research Assistant*

fikri\_zaqi@bca.co.id  
+6221 2358 8000 Ext: 20378

**Barra Kukuh Mamia***Senior Economist*

barra\_mamia@bca.co.id  
+6221 2358 8000 Ext: 1053819

**Lazuardin Thariq Hamzah***Economist / Analyst*

lazuardin\_hamzah@bca.co.id  
+6221 2358 8000 Ext: 1071724

**Thierris Nora Kusuma***Economist / Analyst*

thierris\_kusuma@bca.co.id  
+6221 2358 8000 Ext: 1071930

**Eri Tristanto***Economist / Analyst*

eri\_tristanto@bca.co.id  
+6221 2358 8000 Ext: -

**PT Bank Central Asia Tbk****Economic, Banking & Industry Research of BCA Group**20<sup>th</sup> Grand Indonesia, Menara BCA

Jl. M.H.Thamrin No. 1, Jakarta 10310, Indonesia

Ph : (62-21) 2358-8000 Fax : (62-21) 2358-8343

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