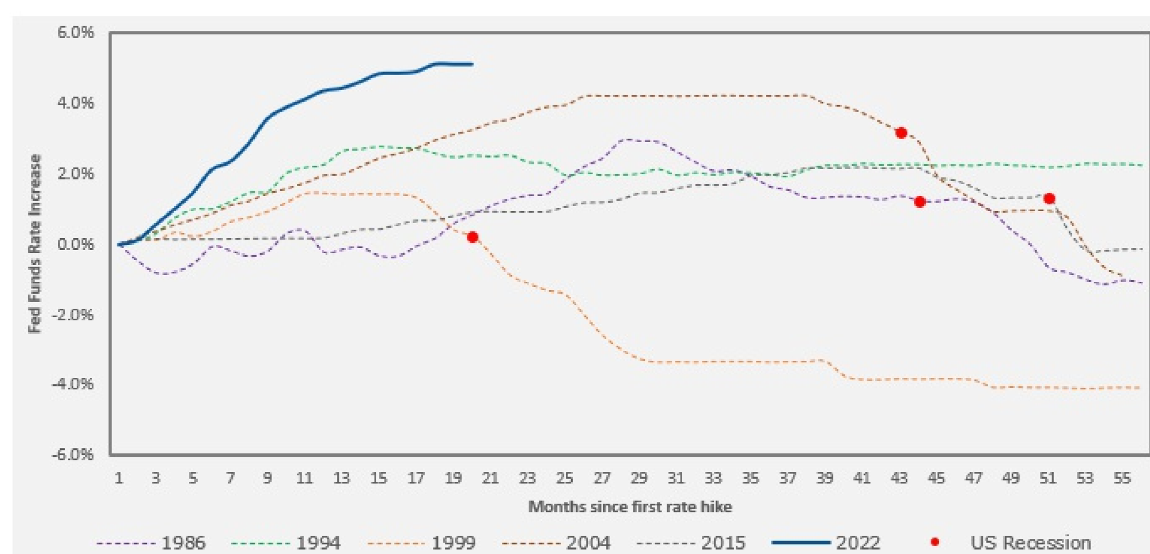
Long and Variable Lags

One of the key macroeconomic themes over the last two and a half years has been the level of US inflation. Initially thought to be 'transitory' following the COVID pandemic, inflation continued to rise for much longer than many investors expected. The chart below illustrates the level of US inflation over the last 20 years, including the unprecedented spike up to 8.9% in June 2022, as well as the US Federal Reserve's inflation target rate of 2.0%

The US Federal reserve has the mandate to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates". These objectives are often referred to as a 'dual mandate' – encouraging economic growth but also keeping inflation in check. Its most important tool in the battle against high inflation is in setting US interest rate policy via the level of the Fed Funds Rate. A higher rate, also called tight monetary policy, aims to slow down a rapidly growing economy or inflation rising too high above the inflation target.

The major challenge the Fed has always faced is that there are 'long and variable lags' - a term originally coined by Milton Friedman, before any change in interest rates filters through to the real-world economy. In response to the sharp increase in inflation during 2021 and 2022, the Fed has embarked on a very aggressive interest rate hiking cycle, raising rates by 5.25% in only 16 months. Only 2 interest rate hiking cycles in the last 50 years have not resulted in recessions, and in both those cases the rate has only risen by 3.0%. The current levels of tightening have always led to a US recession in the past – with no exception.



The chart above compares the latest hiking cycle to the previous five, and note that the sharpest rate of increase has been since March 2022. The red dots indicate the onset of a US recession, all at various lags after the Fed's final decision to hike. A few observations:

- Rates have often stayed 'higher for longer' in the past, e.g. not brought down immediately after a pause.
- We have seen recessions in four out of the last five completed cycles, but with lags varying between 20 and 51 months after the first decision to hike.
- Significant increases, such as the 2004 and 1986 cycles, do not necessarily result in earlier recessions.
- Recessions often start only after rates have been stable for a while or even decreased.
- The lag has generally been longer than most investors would expect.

While the four cycles charted above have an average lag of 40 months, the average over the last 10 hiking cycles since 1972 sits at 31 months. The latest commentary from the Fed indicate that the committee is not yet convinced that inflation has been tamed, while other research shows that signs of stress are starting to appear in company cashflows, capex intentions and loan delinquencies.

At Seed we do not know exactly what the future holds, but we trust our underlying managers to remain flexible and position for a wide range of outcomes as this latest cycle plays out.

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For any questions or assistance please feel welcome to reach out to our Investment team on investmentteam@seedinvestments.co.za

Chart Source/s : Seed Investments (31 October 2023)

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