The Great Unwind (Second of a Series)

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News reached us last week of the demise of the Choco Taco. Or not. Cousin to the Klondike Bar, this chocolate-nut-waffle-taco-vanilla-fudge-ice-cream novelty seemed to be yet another victim of supply-chain issues when its manufacturer announced it was being discontinued.

Choco-Taco's creator chalked it up to the times. "I believe if there had never been Covid and never been the war in Ukraine," Alan Drazen told the WSJ, "the Choco Taco would be rolling along." Fans of the triple treat flooded social media demanding its reinstatement. The clamor prompted a "Stay tuned!" tweet from Klondike. Is it gone forever, or coming back?

Clarifying the status of a delicacy was much on our minds as market wags argued whether 2Q's negative 0.9% – on top of 1Q's negative 1.6% – constituted a recession. Notables (such as the current and past Fed chairs) were surprised if we were in such a downturn, given (among other things) the strength of the job market. What to call two straight modestly bad quarters?

As our *Chart of the Week* shows, the low levels of negative output should not be much cause for alarm, as items like inventory adjustments accentuated the numbers. Not since 1969 have we seen two such small slumps in a row. But could things get worse?

Welcome to the Precession! While it doesn't feel like a recession, with the strength of the labor market, consumer spending, and corporate earnings, the drag of higher rates is being felt in capital markets. The bond market is essentially shut down, though $4 billion of cash in-flows last week should give it a boost.

To understand the inertia the Fed is fighting, consider how long "race to zero" was in place before the new "race off zero" (as one friend called it) kicked in. It will take time to unwind excess liquidity from the system, impacting market prices and volatility. Having grown accustomed to the oxygen tank of low rates, the patient is gasping for breath without them.

Perspective is helpful here. The average Fed Funds rate since 1971 is 5.43%. That's more than double the current 2.25-2.50%, a level that has precipitated much worry about recessions and market slowdowns. And no wonder, since borrowers will likely see their interest expense increase over the next year or so, at least.

This also highlights the importance of modeling the appropriate forward curve into debt repayment projections. How will that impact the prevalence of 7x unitranches? It already seems to have had a chilling effect.

As another friend told us, this "hammers home the importance of security and industry selection more than ever within the broader portfolio construction dialogue."

Next week: We look at expected credit risk for the Great Unwind.