The US Cash Cushion

The US economy is on course to undergo two major transitions this year. First, interest rates will go up as the Federal Reserve tightens monetary policy. Second, economic conditions will get more volatile, as the government and the Fed cut back their stabilizing interventions and the private sector resumes prime responsibility for capital allocation. Together, these imply that economic players will be hit by higher borrowing costs even as their cash flows become less predictable. This is not a great combination. The good news is that households, businesses and banks all have large cash cushions.

- **Households and businesses.** When Covid struck, the US government launched a munificent fiscal support effort, throwing lifelines to businesses via initiatives including the Paycheck Protection Program and mailing out stimulus checks to households. A lot of this money is still sitting on household and business balance sheets. As the chart below shows, cash-to-liabilities ratios for US households and businesses rose steeply through Covid and remain elevated today. With no more stimulus payments on the way, households and businesses are likely to run down their cash balances as confidence improves. Nevertheless, both are well placed to ride out higher borrowing costs and increased economic volatility.
- **Commercial banks.** Commercial banks are also cashed-up. By launching aggressive quantitative easing, the Fed not only boosted bank reserves, it also indirectly displaced the commercial banking system as a provider of capital to the economy. With fewer profitable lending opportunities, banks saw their cash-to-liabilities ratio grow strongly, as the bottom pane in the chart below shows. This hurt bank profitability but led to greater balance sheet stability. With Fed tapering, and at some point quantitative tightening, the cash sitting on commercial bank balance sheets is likely to fall. But given the high starting point, US banks are also well placed to withstand heightened economic volatility

Image not found or type unknown

- **The US government.** After Congress raised the US government's debt ceiling on December 16, the US Treasury has rebuilt its cash balance to US$703bn, or roughly one week of outlays. The probability that the Treasury might have had problems meeting its near-term obligations was always small; now it is infinitesimal.

So, although the Fed is going to tighten, and although the US can expect heightened volatility, there is little chance that a liquidity squeeze could tip the economy into recession. The US has three layers of protection:

- Borrowing costs are rising from very low levels relative to US corporate returns on invested capital. This means US businesses will still be able to borrow and invest profitably as borrowing costs rise.
- The private sector has plenty of internal funds to finance capital spending, which means investment plans are less sensitive to higher yields than in previous cycles.
- Should heightened economic volatility make cash flows less predictable. US economic players have sizable cash cushions they can draw down to meet their obligations.

This adds up to a relatively positive picture for equity investors. The near-term probability of a recession is low, and outside recessions, equity market selloffs tend to be short-lived. This suggests cashed-up investors could benefit by buying the equity market dip when realized volatility abates. Large-cap value stocks, especially banks, are the preferred play to minimize any drag from higher yields.

compiled from sources believed to be reliable, but accuracy cannot be guaranteed and Evergreen makes no representation as to its accuracy or completeness. Securities highlighted or discussed in this communication are mentioned for illustrative purposes only and are not a recommendation for these securities. Evergreen actively manages client portfolios and securities discussed in this communication may or may not be held in such portfolios at any given time.