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The Road to Normal

Q3 2018 COMMENTARY

> We're in a new environment that could shift even more if markets sense the Fed is making a policy mistake. This new backdrop calls for caution and selectivity, as companies now must earn investor approval as markets adjust. This could create more risk and volatility, as the road to normal proves to be anything but.

Highlights

- Central banks proceed with caution on policy changes
- World watches and waits amid trade tariff threats
- Fed determined to normalize interest rates

There is an old saying that "all roads lead to Rome," which literally means that during the time of the Roman Empire every road led to the imperial capital city. Transformed by history, the expression has been generalized to mean that all roads, all paths and activities, radiate from the center of things.

In the world of global markets, the last nine years have been governed, for the most part, by central banks, and by central bank financial largesse, commonly called liquidity or accommodation. Trillions of dollars have been injected into sovereign debt, corporate debt, mortgage-backed assets and even ETFs, to jump-start global growth. With interest rates near zero and lower, the global economy has been lifted out of stagnation, and with fiscal stimulus introduced in the United States, estimates for U.S. growth continue to be upgraded. Although the "synchronized global recovery" that characterized the world's economy last year has been modified, the European Central Bank (ECB) and the Federal Reserve have begun the difficult task of moving monetary policy toward a path commensurate with healthy economies.

The goal is to adjust policy without thwarting the recovery that was so stubborn in developing, and to bring rates to a neutral or equilibrium level that neither stimulates the economy nor hinders it. And while the Fed has assured markets that the path toward rate normalization will continue to be gradual, the ECB has issued a clear timeline of slowing and ending bond purchases, followed by a pause, and rate increases not beginning until the summer of 2019. Meanwhile, the Bank of Japan (BOJ) will continue its quantitative easing, or bond-buying program, as it strives for inflation to reach the seemingly elusive 2 percent level, a level associated with "healthy" inflation.

Although the Federal Reserve appears determined to raise rates again in September, and perhaps in December, there are obstacles that may deter a more hawkish approach. Clearly, the Fed would like to take advantage of still-favorable global financial conditions, but as Federal Reserve Chairman Jerome Powell noted at the press conference following the June FOMC (Federal Open Market Committee) meeting, the Fed can move in either direction depending on the situation. Still, the ability to add more basis points to the Fed's tool kit will

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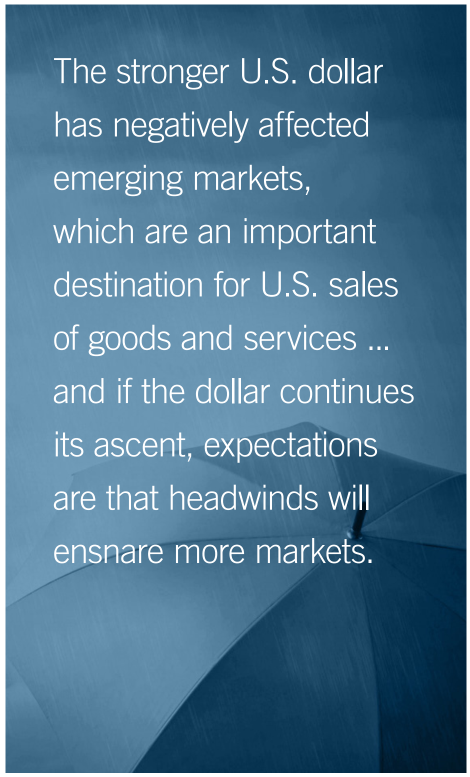
allow the FOMC to use conventional monetary policy rather than relying on the unconventional policies introduced during the downturn. The prevailing question for markets is whether the economy can withstand the tightening, albeit gradual, following nine years of ultra-low rates and a market coddled by central bankers who refused to let markets slide and adjust on their own in what used to be considered normal market behavior.

William McChesney Martin Jr., who served as Fed Chairman for 19 years (April 2, 1951 – January 31, 1970), once said the primary role of the Fed was to “take away the punch bowl just when the party gets going.” The tug-of-war in both the equity and Treasury markets centers on a crucial question regarding the very strength of the party.



THE ECONOMIC BACKDROP

2017 was the year hailed as the beginning of a synchronized global recovery, with economic growth and ultra-loose monetary conditions underpinning global markets. This year, however, is beginning to show signs of moderating—although still solid—growth, along with determined central banks beginning the long road toward normalizing monetary policy.

In the eurozone, where exporters are responsible for nearly half of the economy, a stronger euro against major trading partners impeded sales, and business confidence surveys reflected concerns over export growth. Conversely, U.S. exporter-focused companies are concerned about weaker sales, as the U.S. dollar has strengthened as a result of stronger economic data and a Federal Reserve seemingly intent on moving ahead with at least another rate hike this year, and possibly a fourth hike in December. According to S&P Dow Jones Indices, almost half of the sales of S&P 500 companies comes from outside the U.S., and during the 2018 first-quarter earnings season, large exporters cited the weaker U.S. dollar as lending significant support to sales.

The stronger U.S. dollar has negatively affected emerging markets, which are an important destination for U.S. sales of goods and services. Moreover, investors are pulling out funds as the weight of the strengthening dollar exacerbates problems for countries with sizable trade deficits and dollar-denominated debt. Turkey, Argentina and Brazil have come under pressure, and if the dollar continues its ascent, expectations are that headwinds will ensnare more markets.

In China, meanwhile, the economy appears to be losing momentum according to many broad-based indicators. Exports, industrial output, corporate investment and retail spending all showed signs of slowing in May compared with similar data a year ago, and if the U.S. imposes tariffs, it could hasten the downturn. Interestingly, the People’s Bank of China (PBoC), which typically raises its reverse repo rate (RRR) following a Federal Reserve rate hike, did not move rates following the Fed’s June rate hike, calling into question China’s 6.5 percent 2018 growth target. All of this suggests that financial conditions in China are tightening, and it isn’t surprising that the PBoC is recommending that the RRR should be cut to “ease burdens on financial institutions and smooth the interest rate transmission mechanism. While financial market risks have been effectively released, banks’ capital adequacy and reserves face obvious constraints.” To be sure, if the economy shows signs of increasing strain, the Chinese authorities will introduce both monetary and fiscal stimulus, but the current trade dispute with the U.S. comes at a time when China hopes to deleverage the economy from an albatross of bad loans that engulfs much of its financial infrastructure.

The World Bank warned, “A worldwide escalation of tariffs could lead to cumulative trade losses equivalent to those experienced during the global financial crisis.” Christine Lagarde, head of the International Monetary Fund, issued her own warning that the clouds are “getting darker by the day.”

In the U.S., growth prospects continue to be strong, but the torrent of tariff and counter-tariff headlines have placed a pause on many plans for corporate expansion and hiring. The U.S. Business Roundtable’s most recent CEO Economic Outlook Survey Q2 2018 indicates a “modest decline in the overall economic outlook amid increased uncertainty surrounding government policies, particularly the direction of U.S. trade policy.”

Estimates for corporate capital spending—muted during the recovery—are being revised upward because of stronger profits, competitive tax rates and reduced government regulation, allowing companies to expense 100 percent of capital expenditures (full capex expensing), and overall capacity constraints. Accordingly, GDP could be given a substantial boost as corporate spending increases, which could also extend the economic expansion. In the short term, manufacturing activity remains strong and the pickup in retail spending reflects a strong job market. Core inflation remains tame but firming.

CENTRAL BANKS REACT

At the recent annual ECB Forum on Central Banking in Sintra, Portugal, Fed Chairman Powell reiterated previous comments on the “strong” economy and “balanced” risks as primary reasons to continue gradual increases in the federal funds rate, although he warned changes in trade policy “could cause us to have to question the outlook.” Businesses, he added, increasingly worry about how tariffs would affect plans for investment and hiring. With regard to the ability of central banks to help stimulate demand in the event of a recession, Powell was fairly direct in his remarks, saying that with rates still close to zero, there’s less capacity to help and less opportunity to increase spending in terms of fiscal policy.

ECB President Mario Draghi raised concerns that the trade disputes have led to “considerable uncertainty” within the 19-nation eurozone. He said that the ECB could delay plans to finalize its 2.5 trillion ($2.9 trillion) bond-buying program, and that the first interest rate increase could be postponed. At one of the most important ECB meetings of the year, Draghi announced in June that bond purchases would be finalized at the end of 2018, and the first rate hike could come in the summer of 2019.

Haruhiko Kuroda, governor of the Bank of Japan, has kept its loose monetary policy as Japan continues to fight a softening economy, but worries that the indirect impact of trade tensions could “be quite significant if the escalation between the U.S. and China continues.”

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THE FED MARCHES ON

Despite concerns over trade, Chairman Powell has made his case for normalizing rates: “Earlier in the expansion, as the economy recovered, the need for highly accommodative monetary policy was clear. But with unemployment low and expected to decline further, inflation close to our objective, and the risks to the outlook roughly balanced, the case for continued gradual increases in the federal funds rate is strong.”

That statement echoes Powell’s previous comments at the June press conference following the FOMC meeting. At the ECB conference, he underscored what he has said over the last few years, that accommodative policy should not remain in place for too long a time. He noted that while the last two recessions were triggered by financial imbalances rather than inflation, he doesn’t currently see problems with asset prices. Powell, who has capital market experience, added that although “some asset prices are high by historical standards, I do not see broad signs of excessive borrowing or leverage. In addition, banks have far greater levels of capital and liquidity than before the crisis.” He noted there remains uncertainty around monetary policy, but that FOMC members broadly support the gradual approach of interest rate hikes.

As the determined Fed chairman signals a steady path toward policy normalization, investors question whether market gauges are seeing something other than strong growth. For example, the series of PMIs (Purchasing Managers’ Indexes), compiled from private sector companies and offer a reading on the health of the economy, questions whether economic growth has peaked. Globally, PMIs are slowing as 83 percent of countries have lower PMIs. In 2017, however, 83 percent of country PMIs were higher on the year. In the U.S., PMI reports are moderating.

And then there’s the yield curve, a key indicator of sentiment about the trajectory of the economy. With long-term rates (the 10-year Treasury) continuing to narrow the differential with short-term rates (the two-year Treasury), the enduring question is why this is happening, even though investors agree with the Fed that the economy will continue to expand. When the yield curve flattens, as it has recently by the narrowest gap since 2007, analysts are left scratching their heads as to decipher the message from the bond market. Historically, it predicts an economic slowdown. Steepening yield curves suggest a robust economy with a healthy dose of inflation. When the yield curve inverts, with the longer end dipping below the shorter end, it means recession ahead in about nine to 12 months. At least this has historically been the case.

Chairman Powell has been asked about his views on the yield curve, and his answers have ranged from the “risk on/risk off” in markets, as the safety trade steers investors into Treasuries and thus pushes yields down, to investors assessing what the neutral rate is. He has stressed that members of the FOMC discuss it, but they are more focused on ultimately navigating toward the neutral rate.

John Williams, the president of the Federal Reserve Bank of San Francisco who will take over as head of the influential New York Fed this summer, explained at a conference in April that while an inverted yield curve is a “very clear symbol that the economy’s about to go into a recession,” flattening is typical as the Fed raises rates. He doesn’t see a recession on the horizon and expects longer-term rates to rise as the Fed continues to raise rates and unwind its balance sheet. Many economists who have studied the yield curve see the relationship between the 10-year Treasury and the three-month Treasury bill as more predictive of where the economy is headed. And here there's better news, at least for now. The gap between the two is considerably wider than that of the two-year Treasury and the 10-year Treasury. Still, we would be well warned to keep our collective eyes open for any signs of severe flattening, for that will be the signal that a slowdown is upon us.

With the Fed having a press conference at every FOMC meeting beginning next year, reporters will have a chance to ask Chairman Powell about the yield curve, the neutral rate and the Fed's plans for its balance sheet at each meeting. When asked about concerns over the Fed rate cycle and its effect on global markets, Powell has said "risk sentiment will bear close watching as normalization proceeds around the world. The Federal Reserve will communicate our policy strategy as clearly and transparently as possible to help align expectations and avoid market disruptions."

THE MARKETS AND RATE NORMALIZATION

Markets are typically concerned with earnings, and earnings over the coming quarter should continue to deliver solid results. But circumstances have changed, and could change dramatically if market participants sense the Fed is in the process of making a policy mistake. To be sure, there is still an abundance of liquidity left in the proverbial punch bowl, and central banks are being particularly careful, gradual and patient. But central bankers understand the "too low for too long" environment has its own share of dangers and risks. This new situation calls for caution and selectivity, rather than the years of markets moving higher and higher via central bank accommodation. Now companies must earn investor approval as markets adjust to the new framework. This will involve more risk and more volatility, as the road to normal proves to be anything but normal.

References include the following: Bespoke Investment Group, Bloomberg, Business Insider-Australia, CNBC, Cornerstone Macro Research, The Economist, Evercore ISI, The Financial Times, Goldman Sachs, JP Morgan, Morgan Stanley, The New York Times, Oxford Economics, Renaissance Macro Research, Reuters, S&P Dow Jones Indices, The Wall Street Journal

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