ALEXANDRIACAPITAL

Outlook Memorandum

April 2019 • S&P 500: 2834

QUICK U-TURN; CHARTING A NEW PATH

After precipitating the market's late 2018 collapse with a tone-deaf commitment to hike interest rates three additional times in 2019 and keep its balance sheet reduction on autopilot, the Fed sparked a broad asset price recovery with an abrupt shift toward a dovish monetary posture in early January. Powell's U-turn started with a reassurance that the Fed would be patient and the suggestion that rates may already be in the neutral range (intentionally targeted to dispel the notion that the Fed was ineptly careening toward ***causing*** the next recession or crisis). The Fed has since burnished its dovish credentials, acknowledging that evolving economic dynamics may be dampening the impact of stimulative policies and suggesting that the Fed may be more concerned about having undershot its inflation target during recent years. Also aiding the rebound: Trump's postponement of new tariffs, Brexit delays, and better than feared Chinese economic data.

The dovish message has been well received. The S&P 500 returned 13.6% in the first quarter, recovering nearly all its losses from the fourth quarter. International equities, as measured by the MSCI All World x-US Index, gained a little more than 10% paced by the almost 18.6% gain in Chinese stocks. Bonds also performed well, with the Barclays Aggregate Bond Index returning 3.0% while credit spreads tightened to lift high yield bonds 7.6%. Liquidity also returned to the collateralized loan market after lending ground to a halt in December.

Looking ahead, the Fed's reversal looks timely. Global economic momentum has decelerated and reached the point where the yield curve is flirting with inversion while growth in real U.S. money supply is close to turning negative – both of which suggest policy may already be nearing a point that is too restrictive. At the same time, other data indicates the dovish pivot may be arriving just in time to support stalling growth and delay the onset of the next recession. The deceleration in economic growth may partly reflect transient comparison of strong tax stimulus infused growth last year and the impact of trade conflicts. The ACAP Liquidity Index, while edging lower, remains at a neutral level (consistent with the healthy pace of bank lending) and the Index of Leading Economic Indicators is still making new highs. Unemployment and jobless claims are at lows, and real wages are rising – both supportive of consumer spending (~70% of our economy). And on the horizon the trade conflict is inching toward resolution, which should reverse some of the negative sentiment that has weighed on business investment and contributed to tighter monetary conditions.

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The late 2018 turmoil prompted the Fed reversal. Throughout the fourth quarter the Fed seemed determined to avoid kowtowing to investors even as stock market losses accumulated. Following two interest rate hikes in 2017 and four in 2018, Powell & Co were decisively posturing for three additional hikes in 2019 and an up to $50 billion per month pace of quantitative tightening that would continue on "autopilot." By late December, however, the near uniform cooling of global economic conditions (China, Japan, Australia, and Europe, with some spillover to the U.S.) was coming into sharper focus. More acutely, the market for U.S.leveraged loans ground to a halt in December and was threatening to become self-reinforcing if companies lost access to capital (which would cause credit metrics to deteriorate). The Fed may have also harbored some concern that weakness in the leveraged loan market (~$1.2 trillion) could also spill over into the equally sized high yield bond market.

The Fed's dovish pivot lowers the risk of a policy mistake. Incoming economic data has been weaker following last summers' 3% economic growth rate. Restrictive impacts from the Fed's interest rate hikes may be having some effect (with the late 2018 actions still seeping into the economy for another year), but at least part of the deceleration can be attributed to the protracted trade conflicts (principally China, but Mexico and Europe have been sporadically involved) and the waning effect of tax stimulus on year-to-year comparisons.

U.S. jobs growth, while still strong, may also be cooling and feeling the effects of both the government shutdown and tariffs: for the first three months of the year, the Establishment survey reported 533,000 new jobs – a barometer for the underlying resilience of the economy; while the Household survey, which is far more sensitive to short-term swings in hours worked, reported 197,000 jobs lost in the first quarter. Still, recent weekly unemployment claims set a new record low.

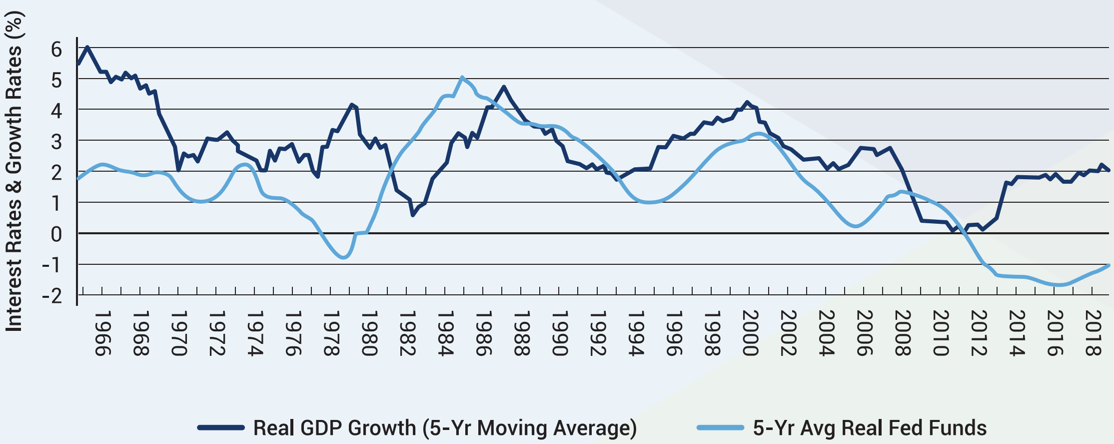
The Fed may have already tightened sufficiently to reduce inflation concerns… Fed tightening cycles of 300 basis points or more have been historically followed by recessions – and in the current tightening cycle, which began in 2015, we have already seen 300 basis points of tightening when including the estimated effects of the Fed's balance sheet reduction (which is continuing for now, but at a tapering rate). This does not mean a recession is inevitable, however. Tightening measures have only lifted rates to 2.5%, while real shortterm interest rates (adjusted for inflation) are still only 0.50%. Overseas, real short-term interest rates are even lower at negative 2% in Europe and negative 1% in Japan.

Underscoring this phenomenon, approximately $9 trillion in bonds (globally) carry negative yields before adjusting for inflation – the debtors (mostly sovereign) are being paid to borrow money. When the real cost of money is so cheap for such a large segment of the global economy the mechanics of generating growth should be automatic – simply put, governments and private sector companies have an extraordinarily low hurdle to profitably borrow money and invest to generate growth.

…and may now be recognizing that low real rates could be a prerequisite for growth. During the past 60 years, real short-term interest rates in periods of sustained economic growth have been about 2% below the Real GDP growth rate, with the pace of growth having slowed when the Fed raised real rates so that this gap narrowed to less than 2%. Economists frame this by saying that the "neutral" rate of real interest for the Fed is about 2% below the Real GDP growth rate.

If we assume that U.S. economic growth will slow to about 2.5% this year, this suggests that the neutral rate of real Fed Funds would be about 0.5%. With the Fed having set the Fed Funds rate at 2.50%, and with core inflation running at a 2.04% rate, real Fed Funds are already a theoretically neutral level of 0.46% (2.50% - 2.04% = 0.46%). This means that if the Fed raises its Fed Funds rate any higher (or if inflation moves lower), it is likely to further slow the growth of the economy and would increase the likelihood of a recession. As such, the Fed is hyper focused on overall future inflation expectations, which have dipped even though current inflation is running close to 2%.

Real Fed Funds Rate vs. Real GDP Growth (5-Yr Averages)
1965-2019



A rethinking of monetary policy may be on the horizon. While the negative impact of tariffs and the waning boost from tax stimulus has contributed to recently slower growth, the economy's observed sensitivity since the financial crisis to modestly restrictive monetary policy is also a natural consequence of a global economy increasingly reliant on debt and deficits amidst less than favorable demographic trends. In 2017 and 2018, the growthgenerating effect of incremental debt was almost 20% lower than prior to the financial crisis, with more pronounced effects among more indebted countries.

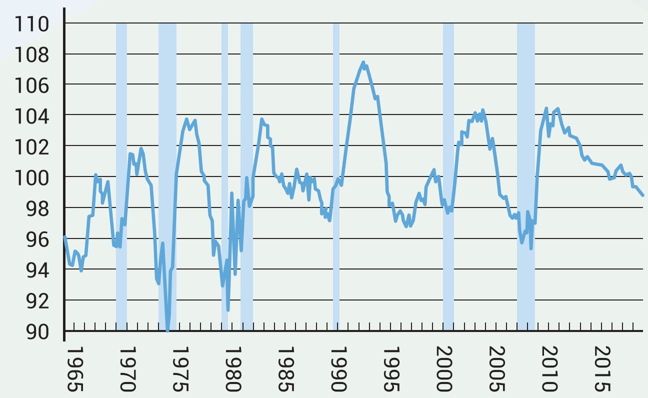
If higher real rates are formidable at constraining the economy, the implication is that the "neutral" level of real interest rates may drift lower over time to offset increasing levels of debt (and will continue to do so in the presence of diminishing economic returns from the creation of new debt). Hence, economies like Japan (Europe looks to be heading down this path as well) become trapped in a deflationary spiral of increasing levels of debt producing lower growth, lower inflation, and lower interest rates which leads to even higher debt levels to combat slower growth.

One of the more subtle developments that may be emerging is the prospect that monetary policy can be less concerned about overshooting its inflation target. This evolution in thinking is long overdue and reflects a persistent inability of central banks to achieve their targeted level of 2% inflation (most notably the U.S., EU, and Japan). Zero interest rates and massive Quantitative Easing have not produced the desired increase in inflation…yet as discussed earlier, modest policy tightening has been seemingly quick to weigh on economic activity and lower inflation expectations. Setting aside the negative impact of tariffs or waning tax stimulus, the asymmetry of potent interest rate hikes versus impotent rate cuts may effectively provide the Fed far more room to err on the side of accommodation – an important departure from central bankers' predisposition to worry about uncontrolled inflation, and suggestive that accommodative monetary policy may become the new equilibrium. The prospect of more forceful policy easing as the Fed tilts its dual mandate more toward generating economic growth and away from concern over inflation, while controversial and bound to stir political angst, stands to provide an important tailwind for asset prices and investors in the short-term and potentially delay or soften the next trough in the business cycle.

Looking ahead, pockets of economic strength, resolutions to trade conflicts, stimulus measures, and relief over the global dovish pivot may bridge the current softness. Manufacturing Purchasing Manager Index (PMI) readings in the U.S. have softened from their highs toward the middle of last year, but continue to signal expansion, while the service PMI continues to hold at a healthy level – both largely shrugging off the negative weight of the government shutdown in January and the ongoing trade conflict with China. In addition, the Index of Leading Economic Indicators is still making new highs while the unemployment rate, low weekly jobless claims, and wage growth are all supporting the consumer side of the economy (~70% of GDP, which is also supported by positive savings rates and healthier household balance sheets).

Overall credit growth also remains firm and our ACAP Liquidity Index, as a result, is above levels that historically have preceded recessions by one to two years into the future. Meanwhile, China's manufacturing PMI has crept ever so slightly back into positive territory on the heels of a new ~$300 billion fiscal stimulus (in addition to monetary easing) – that should begin filtering into the economy and lift manufacturing activity and consumer spending in the months ahead. In Europe, the manufacturing PMIs may be weak (not surprising given the trade conflicts), but readings for the more important service sectors (particularly Germany) are pointing toward resilient growth. Interestingly, oil and copper prices (both very sensitive to global economic conditions) are in upward trends and strongly off their recent lows on the back of better than expected demand (oil prices have also been supported by OPEC cuts and disruptions in Libya and Venezuela).

ACAP Liquidity Index vs. Recessions



The risk of exogenous shocks is receding. Historically, most significant recessions or crises are preceded by some sort of macro disruption – as highlighted by both the dot-com and housing busts. In other words, the economic and market outlook does not darken simply because of the advanced age of the expansion or bull market. Investors are keenly aware of the role monetary policy played in creating initial conditions preceding the last two recessions, especially given the punitively low interest rate environment over the past ten years which pushed investors to chase returns while assuming higher levels of risk. In fact, a likely unspoken policy objective of the Fed's effort to normalize interest rates is to avoid presiding over another asset bubble. As a result, there is an inordinate amount of energy directed to identifying the next bubble – even though bubbles are probably only recognized in hindsight. The primary candidates for that "next" risk seem to be the riskier corner of the corporate debt market, China, or even Brexit.

> "A rethinking of monetary policy may be on the horizon"

While corporate credit protections have declined, the Fed's pause is occurring while liquidity in the leveraged loan and high yield markets remains ample – thus while these markets are focal points for investors, the risk that they become the trigger for a crisis is receding. Meanwhile, Brexit seems to be limping toward a more rational outcome; the trade conflict is inching toward some sort of settlement; and China's economy is stabilizing with renewed stimulus.

We have a modest outlook for 2019 following the strong start. Markets have rebounded from the dismal fourth quarter, largely reflecting relief over altered central bank policy guidance amid signs the global service economy was holding up, stimulus was on its way, and evidence of some progress (or at least rational decision making) on trade conflicts, Brexit, and other politically charged issues. At the same time, expectations for earnings growth moved lower with the recently soft economic data. This suggests a more muted opportunity lies ahead barring a reacceleration in economic activity and earnings.

While the lagged effect of monetary policy represents a headwind, we note that extraordinarily low real rates offer an indisputable tailwind for both economic and earnings growth. Short-term volatility due to politics or slowdowns notwithstanding, the emerging era of accommodative policy as the new equilibrium, if we are correct, demands investors remain invested and capitalize on dips that reflect short-term thinking, until such time the Fed and other central banks prove they can ignite inflation. Stock valuations sit at approximately 17x forward earnings for the S&P 500 – entirely reasonable in the context of current rates, growth, and profitability. While we think there is room for valuations to move higher, particularly with a dovish Fed, we are grounded in our expectations for a substantial rerating.