ALEXANDRIA CAPITAL

Outlook Memorandum

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POWELL & CO FLEX THEIR MUSCLES

The Fed upended markets in the fourth-quarter with a steadfast commitment for gradual monetary tightening despite progressively turbulent markets. In short, Fed Chair Jerome Powell's plan for a steady cadence of interest rate hikes and monthly balance sheet reduction collided with investors' assessment of decelerating economic activity, waning profit growth momentum, and rising global economic risks. Overall, the S&P 500 lost 13.5% during the fourth quarter and at its low was down nearly 20% from its high. For the full year, the S&P 500 declined 4.3% -- well within the range of historical variation, but remarkable for the pace at which it unfolded: The Christmas Eve stock swoon was the worst ever; the market's day-after-Christmas surge was the best ever; and this past December was the worst December since 1931. Most international markets fared worse in 2018, declining as much as 25% -- but for the most part those losses occurred earlier in the year with foreign markets sidestepping the steep U.S. declines during December.

Markets have been clawing back losses since their December low, beckoned on by historically reasonable valuations and a notably dovish pivot by the Fed – Powell & Co's prior guidance for as many as three hikes in 2019 (in total, 0.75%) has been supplanted with a prescription for patience and the suggestion that short-term rates may already be in the neutral range. The Fed is also seeding expectations that its process of draining $50 billion per month from the financial system may be brought to an early conclusion.

For investors, the late 2018 turmoil suggests the underlying market equilibrium is more fragile than previously thought. In contrast to a year ago, there are a plethora of issues hindering global growth – most prominently brewing global trade conflicts and the fading impact of the tax stimulus, but

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also an expanding list of stumbling overseas economies. As a result, the cumulative monetary tightening thus far, including actions by foreign central banks, may already be sufficient to ease incipient inflation pressure – especially considering that expanding global debt has been the engine of economic growth over the past decade.

Looking ahead, the strong jobs market and vastly improved household finances provides an important ballast for the U.S. economy (consumer spending accounts for ~70% of GDP) even as many overseas economies sputter. Uncertainty from external issues, such as Brexit and the trade conflict, is weighing on growth and constraining business investment, but that uncertainty will eventually resolve and restore some momentum to the global economic story. The big question, however, is whether monetary policy is correctly calibrated. Adjusted for inflation, short-term rates are effectively zero and thus should be stimulative, but the cumulative impact of prior tightening is still unfolding. Longer-term, the challenges of demographics, sluggish labor productivity, and a world overly reliant on debt points to accommodative monetary policy as the new equilibrium.

The recent market turmoil has the Fed's fingerprints all over it as global monetary policy, of which the Fed is the key policymaker, flipped from mildly expansionary to mildly restrictive. For the Fed, rate hikes that began as single 0.25% increases in each of 2015 and 2016 grew to three such hikes in 2017 and four in 2018. Additionally, the Fed's pace of balance sheet contraction accelerated to as much as $50bn per month this past fall – and, importantly, the Fed's forward guidance was calling for as many as three additional rate hikes and $600bn of quantitative tightening in 2019.

Contemporaneous with the Fed's actions, the European Central Bank concluded its quantitative easing in December, while the Japanese Central Bank's program of monetary expansion sputtered for most of the past year reflecting practical constraints and Governor Kuroda's growing concern about the risk-benefit tradeoff (the BOJ owns ~50% of Japanese government bonds and ~75% of exchange traded funds).

The flip in monetary policy reflects an effort to normalize policy – the process by which central banks look to return short-term interest rates and their bloated balance sheets back into a range that is historically familiar. In the U.S., transitioning to a mildly restrictive monetary policy had a logical basis – after years of subpar growth following the financial crisis, the economy was finally growing with more momentum, unemployment was measurably below the Fed's target and declining, wage growth was showing signs of life, and the pervasive disinflation that had come to characterize the post-crisis recovery was transforming into healthier price trends.

For the Fed, normalization has been loosely defined to suggest short-term rates around 3% and a balance sheet roughly half of the size it reached at peak. While what constitutes normalization has been influenced by post-crisis economic / regulatory dynamics, the concept of normalization itself is heavily guided by historical context – namely, that rates this low and central bank balance sheets this large must eventually presage inflation (which would be consistent with historical experience). An important assumption underlying this view is the innate expansion in credit – that is, the private sector is profit seeking and thus pursues loans (as lender and borrower) to capture additional profit opportunities. The Fed can influence the pace of credit growth through interest rates, prompting higher levels of loan demand when rates are low and lower levels when rates are high.

As central banks moved toward more restrictive monetary policy, the key variable has been the degree to which credit growth would maintain its positive momentum. Rising interest rates do not always constrain loan demand, particularly if economic growth is accelerating and inflation is moving higher – in other words, the business case for seeking additional loans can become more convincing even as the Fed raises rates.

Adjusted for inflation, the increase in interest rates has been much more modest over the past several years. When the Fed started raising rates in late 2015, short-term rates adjusted for inflation were approximately negative 1%. The Fed has subsequently raised interest rates an additional 2%, but inflation has also risen and thus rates adjusted for inflation have increased at a slower pace and now sit at about 0%. Not surprisingly, with the real cost of money still extraordinarily low, aggregate bank data indicates that U.S. credit growth has been steady (3%-5%) despite higher nominal rates – which is reassuring given the late 2018 turmoil.

Nevertheless, it is also noteworthy that the riskier corner of the corporate debt market, including high yield bonds and leveraged loans, were clearly strained during December. Although this segment of the credit market only accounts for a small percentage of overall credit, it still represents an ~$2.5 trillion exposure. Riskier corporate debt is mostly funded outside traditional banking channels, relying on financial engineering reminiscent of the collateralized mortgage obligations and credit default swaps that played a prominent role in the financial crisis. In the current iteration, post-crisis banking regulations and repressively low interest rates pushed investors and borrowers to seek alternative sources of yield/funds – thus effectively creating the current non-bank corporate lending structure. Setting aside the inherent features that may or may not dampen overall risks – what December demonstrates is that the provision of credit through this mechanism can evaporate overnight. Simply put, a key portion of the credit growth engine is extremely sensitive to interest rates and investor confidence.

Transient factors contributed to the late 2018 turmoil. Whereas a year ago U.S. tax policy, global monetary policies, and the overall business climate were all pulling in the same direction and stimulating growth, as 2018 progressed the effect of each of these dynamics began to wane or turn restrictive and worked to effectively amplify monetary policy. Certainly, part of the deceleration in economic activity that has been observed across the U.K., Germany, France, and Italy can be attributed to uncertainty over Brexit – a dynamic that not only is delaying spending (by both consumers and businesses) but also stokes demand for dollars (which has the effect of tightening dollar based monetary policy). At the same time, the U.S.-China trade conflict is provoking a similar effect across Asia (with effects also felt in the U.S., Europe, and Australia).

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While each of the economies of Europe, China, and Japan are confronting domestic issues that are undermining growth, resolution of Brexit and the U.S.-China trade conflict should at least reverse a portion of the tightness that has contributed to the broader economic slowdown and fears that a recession is near. The question is how weak are underlying economic trends?

Central banks are already taking a step back, thereby lowering the risk of policy mistakes and increasing the probability that the economic expansion can continue. Interestingly, shortly after ending quantitative easing, the ECB's Draghi noted softening economic conditions. As has been historically the case, the ECB seems destined to act at a measured pace, indicating that while it stands ready to support markets and the economy, it will reassess when it receives updated forecasts in March. The Fed, on the other hand, has gone to great lengths to roll back its guidance for 2019 and is now espousing a policy of patience that is being interpreted by markets to mean a pause and reevaluation of strategy/guidance.

Debt dynamics and fiscal deficits may keep a lid on interest rates and inflation. What is puzzling for many investors is that a policy of 2%-2.25%, rising progressively to 3%, would be viewed so worryingly or cause the type of turmoil and backlash experienced in December. Rates, adjusted for inflation, are effectively zero – so the hurdle for businesses to borrow money and invest profitably is exceptionally low, especially for the most credit worthy borrowers. Yet, markets rejected the prospect that rates would continue higher in 2019.

The revolt may simply be a function that an extra 0.75% hike in interest rates was set to occur in the face of broad evidence that a global slowdown was underway – a slowdown that may naturally reverse – but it may also reflect a general financialization of the economy in which ongoing growth requires a higher degree of monetary support compared to historical experience. This potential issue is not easily estimated but is a natural consequence to the extent debt levels are rising relative to income or GDP (such as in China, Europe, and Japan).

U.S. corporate debt levels have risen by $5 trillion since the financial crisis, versus a $1 trillion increase in corporate profitability. One-third of the increase has funded share buybacks rather than investment. Buybacks do not create a higher future set of profits with which to repay the debt, and thus are necessarily sensitive to aggregate borrowing levels and interest costs. On the consumer side, government guaranteed student loans have mushroomed from $100 billion to $1.2 trillion – education has a payback, but this may stretch the math.

The Fed seems better positioned. Hope springs eternal and we note that the current environment is somewhat "déjà vu, all over again." Preceding recessions, the Fed typically enacted a prolonged tightening cycle that ostensibly ends as the Fed detects signs of stress – much like we witnessed recently. Markets typically express relief, latching on to threads of optimism that the Fed may have engineered the coveted soft landing: an economy that slows sufficiently to relieve inflationary pressure, but nevertheless continues to expand.

Despite the Fed's best efforts to pursue monetary policy that minimizes large swings in the economy, going into 2008/2009, it was excess risk taking (both lending and borrowing) in the residential mortgage market – and all of the entities so involved – that created the crisis. Then, like now, low interest rates (coming out of 2002-2004) and monetary policies that were exceptionally accommodating encouraged imprudent risk taking. This time, it is not the mortgage market but perhaps the corporate debt market. Ironically, institutions (insurance companies / pension funds) have piled into corporate debt and related structured products in order to avoid mortgage related investments that created write-downs for their portfolios a decade ago.

Could this time be different? Rather uniquely, real short-term rates remain essentially zero – which is an unprecedently low level at the end of a tightening cycle. Historically, real rates typically must exceed 1% in order to apply enough restrictive pressure to pull an economy into recession. At the same time, high global debt and wide fiscal deficits may mean that rates can be restrictive at levels that are lower than that which has historically been associated with recessions. But, with unemployment near record lows and consumer balance sheets in decent shape we can see a scenario where leverage in the corporate sector creates headwinds for certain risky assets but leaves the economy overall unaffected since most of this debt is held outside of the banking system.

Looking ahead, prudence should govern investors. Easing market stress is likely to entice the Fed to raise rates – which may seem like a benign circumstance, but nonetheless tempting fate given the interrelation of poor demographics, the preexistence of excessively high debt levels, and federal debts growing at the pace of $1.5 trillion per year (on budget plus off budget items). It is no coincidence, in our opinion, that Powell appeared steadfast throughout the fourth-quarter until cracks appeared in the riskier corporate bond market. Powell is intimately familiar with the leveraged loan / private equity universe, and thus is well informed of the degree to which a bubble (and financial risks) have formed. In other words, Powell is apt to find ways to prevent greater risks from emerging in credit markets, and the most powerful tool is demonstrating to investors that there is "risk" in risky investments.

Unlike earlier in the decade, the Fed is now looking for opportunities to tighten policy, so good economic news should be followed up with more restrictive monetary policy, and while weaker economic news may not trigger tighter policy… it foreshadows slower growth. This suggest the risk / reward of monetary policy is skewed negatively for the foreseeable future and we would submit this means asset allocations should be positioned more towards cash and high-quality short-term fixed income securities and away from risky assets that have benefited from historically accommodative monetary policy.

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