ALEXANDRIACAPITAL

# Outlook Memorandum

January 2020 • S&P 500: 3230

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## STILL GAS IN THE TANK

Markets delivered in the closing quarter of 2019, capping off a rewarding year that marked a sharp reversal from the broad weakness that rattled investors in late 2018. For the full 2019, the S&P 500 Index rose 31% including dividends. Technology shares led the charge, with mega-caps Apple and Microsoft together accounting for almost a sixth of the S&P 500's 2019 gain. Bond markets also turned in a strong year with the Barclay's Aggregate Bond Index gaining 8.7% as the yield on the 10-Year Treasury declined from 2.67% to 1.80% and credit spreads tightened. Overseas markets were also strong, but once again trailed their U.S. peers as U.S. dollar-based returns for German and Japanese stocks came in at about 22%-23% while China was a bit stronger at almost 24%. Overall, the MSCI Emerging Markets Index gained 18.5% while the MSCI European Index advanced 24.4% (both in U.S. dollar terms).

Underlying the market's strength was the Fed's pivot from tightening liquidity during 2018 to adding liquidity as we closed 2019. Importantly, the Fed's shift coincided with interest rate cuts by major central banks around the world and the support of economic data that generally resisted getting tripped up by soft manufacturing activity. While policy actions have extended the current economic expansion (particularly relative to the pervasive fears of an impending recession a year ago), the path has not been without bumps as the Fed navigated weakening external economies, rising tariffs and trade threats, and sluggish business investment that mirrored progressively softer manufacturing activity. The Fed took seven months to deliver its first interest rate cut; even then, it conveyed a lack of conviction – a revelation that unnerved markets. Either due to the benefit of experience, political expediency, or just plain chance that the Fed's policy message steadied as we moved through late summer with a second and then a third interest rate cut and an end to its program of balance sheet reduction (draining reserves from the financial system). Soon after, markets embraced the Fed's subsequent recalibration of its balance sheet size in what can be characterized as a mild dose of quantitative easing. Amplifying the Fed's policy actions was a broad easing in uncertainties, as trade negotiators seemed to work with more professionalism and purpose and as the scope of potential Brexit outcomes narrowed.

Looking ahead, many of the clouds hanging over the markets and the economy have parted. Measures of liquidity and credit are rising at a robust pace, while low unemployment claims and wage growth points to a healthy jobs market and consumer economy. Corporate profitability has been more stagnate, but conditions for a return to growth are in place with the de-escalation in the trade war and expansive federal spending. The Index of Leading Economic Indicators is lagging the upturn in liquidity and credit conditions, but that may have more to do with tariffs and delayed business investment as opposed to a harbinger of what is to come. With favorable liquidity and a return to earnings growth, the conditions for further gains for stocks in 2020 are in place. Our primary concern: Improving conditions is exactly what the market is also seeing and pricing, and as we saw during 2019 the Fed's policy message may waiver, particularly given rising asset prices and the potential for inflation to move closer to its target.

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**Liquidity and credit conditions have improved following a prolonged period of slow deterioration (see charts below).** As we have previously noted, liquidity and credit are essential for the smooth function of the economy. A lack of liquidity or credit leads to higher interest rates and a more constrained ability to borrow – which then acts as a brake on the economy as households pull back from spending (home buying or remodels, vacations, and cars) and businesses cut back on purchases of equipment, expansion plans, and hiring.

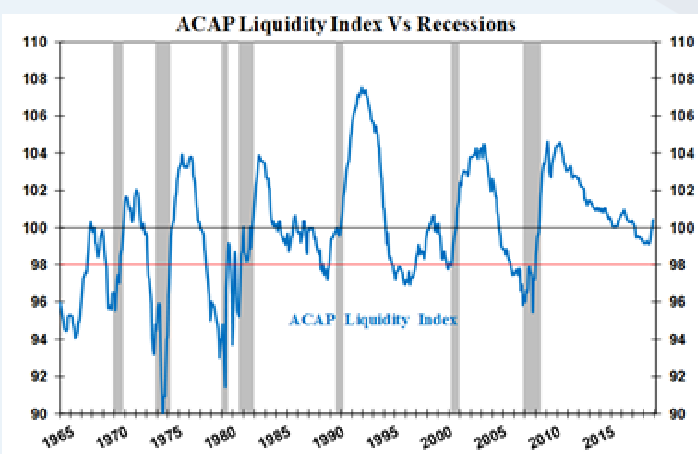
Following a tumultuous period for financial markets in late 2018 (driven by the Fed's efforts to constrain liquidity and credit), the Fed was determined to appease investors in early 2019 with a commitment to stop raising short-term interest rates. The path toward easing, however, actually took more than six months to unfold as policymakers wrestled with conflicting signals, including weaker yet resilient economic data, uncertainties in the global environment (including the trade war), persistent disinflation trends despite low unemployment, and buoyant federal spending when the economy was theoretically operating close to its non-inflationary potential.

Members of the Fed openly vacillated between a desire to support the economy proactively, adopt a framework that addressed the Fed's historical failure to achieve its 2% inflation target, and the more parochial view that monetary policy was supportive enough. As a result, for much of the first half of the year the Fed slow walked towards being more accommodative even as the yield curve flattened and briefly inverted. Investors were never quite sure the Fed was on track to respond to progressively weaker economic signals – a point punctuated by the Fed's measured approach to curtailing the shrinking of its balance sheet even while acknowledging broader economic issues (the Fed finally concluded its balance sheet reduction policies in September).

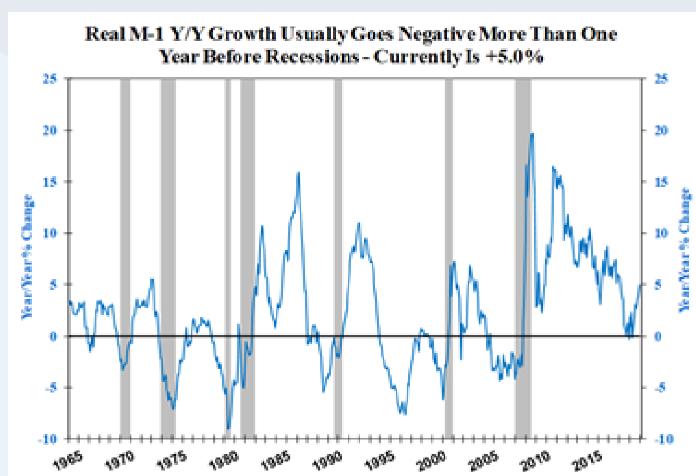
The first, heavily anticipated rate cut finally came in late July – but the Fed still obscured its policy signal, describing the cut as a mid-economic cycle adjustment (suggestive the Fed believed monetary policy was supportive enough). As the third quarter progressed, however, policymakers aligned behind a more coherent message and nurtured expectations for at least two additional interest rate cuts. For investors and markets, clarity and confidence on the direction of monetary policy arrived just in time – at a point where the slow deterioration in economic indicators was becoming a deeper concern – and sharply reversed what had been tightening liquidity conditions.

Less well known, soon after halting its policy of shrinking its balance sheet in September to $3.8 trillion in assets, the Fed immediately took a step to re-expand its balance sheet in mid-October with the purchase of $60 billion of short-term Treasury Bills to relieve stress that appeared in the repurchase agreement market (Repo for short, where financial institutions fund themselves with overnight money). Simply put, as the Fed shrunk its balance sheet over the last few years the excess liquidity that banks had and freely lent contracted to the point at which there were visible indications of curtailed lending activity. The Fed has been vague on details, but it has continued to expand its balance sheet by purchasing up to $60 billion of treasuries per month and is expected to continue to do so through March. While the stated purpose is to support short-term liquidity in the financial system, the equivalence to another round of quantitative easing is unmistakable.

The dynamics of 2019 turn the spotlight on liquidity and credit as essential for the health of markets and the economy. Stock




Recessions are preceded by an extended period of declining Liquidity, and rising Liquidity produces economic expansions.

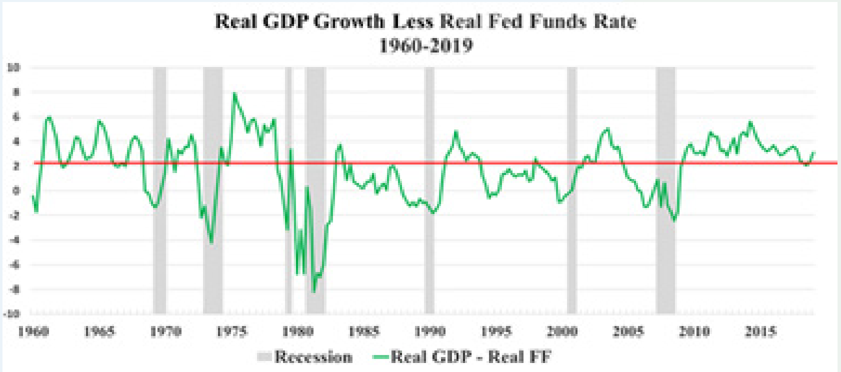


markets rallied to open the year on the relief that the Fed would not blindly keep tightening policy, but the momentum progressively stalled out as the Fed's policy actions continued to drain liquidity slowly from the financial system at a pace beyond that which the economy could sustainably shoulder, and as the lagged effects of the Fed's 2017-2018 tightening took hold. Toward the end of summer, however, real M-1 growth accelerated with the Fed's successive rate cuts and changes to its balance sheet policies (real M-1 provides an inflation adjusted measure of lendable cash throughout the economy). The acceleration that we observed in real M-1 was almost immediately followed by a resurgence in our ACAP Liquidity Index, which very clearly shows that the Fed's pivot to a dovish policy has quickly permeated into the financial system and is creating a backdrop for an easing in overall credit availability. Not surprisingly, the significant change in liquidity has been noted in markets which delivered a strong fourth quarter as investors anticipated not only diminishing recession risks for 2020, but a healthier economic backdrop for corporate earnings.

**Investors may not fully appreciate that short-term interest rates are poised to remain low by historical standards.** During 2019 the Fed debated whether it has been overly concerned about inflation – and thus implicitly recognized its historical failure over the past decade to achieve its 2% inflation target. The potential change in framework thinking is very significant and could portend a more symmetrical risk-benefit assessment as it relates to the Fed's key short-term interest rate. Simply put, the Fed is considering keeping rates lower for longer and being tolerant of a limited period of inflation above 2% that is nominally the mirror image of the below 2% inflation that markets and the Fed have been grappling with over the past decade – if enacted, this would be very bullish for asset markets in terms of slowing the pace of future rate hikes even as economic growth accelerates and inflation rises, and this would move markets further away from the deflation risks that periodically have handcuffed policy makers and depressed valuations.

At the same time, structural changes are dampening price pressures. Boomers entering the work force was a key force in the persistent inflation trends from 1970-1990 as employment and spending expanded irrespective of interest rates. Today, populations in the U.S., Europe, Japan, and China are aging, and the growth in prime working age adults is rapidly slowing – thus removing a persistent source of demand growth and leaving economies almost exclusively dependent on income growth (which tracks worker productivity), changes in the use of debt, and the spending impact from changes in wealth and new buying habits.

Meanwhile, rising debt levels (relative to incomes and/or tax revenues) across the world, including entitlement programs that are not adequately funded, suggests the economy is more sensitive to rising interest rates than it is to declining interest rates (and this aligns with more recent empirical data). In some sense, sluggish business investment and rising household savings rates (the domestic savings rate is hovering close to 10%) are likely influenced by rising debt levels – companies have production capacity to meet the demand owing to both disposable income and the annual change in debt. High pre-existing debt levels and aging populations means households are likely reluctant to borrow more money, leading to slower growth, greater price sensitivity, and less responsiveness to interest rate cuts.



**Relatively accommodative monetary policy may be the new equilibrium for investors.** Historically, real Fed Funds rates, when held for a prolonged period of time 200 basis points or more below real GDP growth spark both rising real GDP growth and eventually rising inflation pressure, which then prompts the Fed to raise its short-term rate sufficiently high to reduce the 200 basis point gap and slow economic growth (as the gap between the real cost of money and the real growth of the economy is narrowed, businesses pull back from borrowing since the growth rate becomes insufficient to cover the cost of borrowing).

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Interestingly, for the entire current economic expansion the Fed has held real Fed Funds more than 200 basis points below the rate of real GDP growth (this is visible in the above chart with the difference between real GDP growth and real Fed Funds remaining above the red 2% line) – and neither economic growth nor inflation has risen to levels that would have been expected based on historical precedent. The sluggishness in both real GDP growth and inflation over the past decade, and the last few years in particular, despite an empirically large and prolonged stimulus provided by the Fed seems to confirm the existence of structural changes in the economy that necessitates lower real rates to support real GDP growth.

**The current environment continues to favor stocks, though we see long odds of 2020 resembling anything like what we experienced in 2019.** Low unemployment claims and steady wage gains, together with a healthy household savings rates and expansive government spending appears to indicate that the Fed's interest rate hikes and balance sheet reduction during 2017 and 2018 did not tighten monetary conditions excessively to the point of applying a definitive choke on economic activity – and the result is that the Fed has been able to look relatively prescient with its 0.25% interest rate cuts in each of July, September, and October.

History shows that strong years are often followed up by a more normal year, to the tune of a 10% return – and this is consistent with our thinking given the backdrop of substantially improved liquidity and prospects for a resumption of corporate earnings growth given subsiding uncertainty around the trade war and the potential paths for Brexit.

Our enthusiasm, however, is tempered by the observation that most market participants also have noted the clouds are clearing – and this is evident in the market's strong gains since late September. Furthermore, we are mindful that just as was the case in 2019 the Fed could hesitate – this time in the face of rising asset prices and the fact that while its preferred inflation gauge remains below 2%, many other alternative measures are at 2% or slightly above. While the outcome of the election will be important, it is noteworthy that election cycles typically see a swell of additional spending and advertising activity for the economy.

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