July 2019
S&P 500: 3000

OUTLOOK MEMORANDUM

The Goldilocks Market

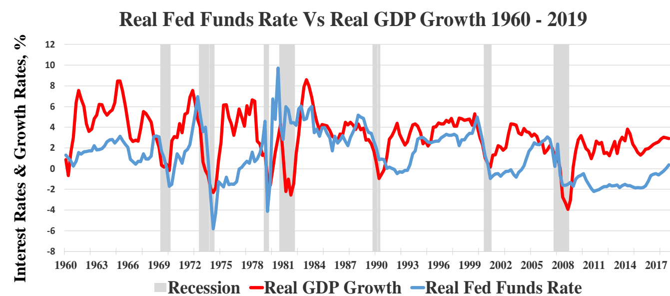
Markets delivered positive results in the second quarter, though the path was not entirely smooth. April extended the first quarter's advance but May delivered a pronounced pullback as negotiations between the U.S. and China broke down amid accusations that China backtracked from previously agreed terms. Technology stocks led the declines in May, as Trump threatened to raise tariffs and the administration targeted Chinese tech titan Huawei citing national security concerns. The broader market was also pressured by the Fed's characterization of weak inflation readings as "transient," thus exposing an innate hesitance to respond swiftly to the market's perceived deceleration in economic activity. June, in contrast, delivered a profitable reprieve as trade rhetoric cooled and both China and the U.S. laid the groundwork for a restart of negotiations with a Trump-Xi meeting at the G-20 summit. The Fed also changed course (once again) and steered expectations toward a rate cut at its July meeting. For the quarter, the S&P 500 gained 4.3% and the broader bond market (as measured by the Barclay's Aggregate) appreciated 3.1% as interest rates continued to fall. Overseas, markets were also buoyant despite a stronger dollar, with international equities advancing 3.3% and emerging markets delivering a 1.8% return. Commodities were the noteworthy loser in the quarter, with the Bloomberg Commodity Index falling 1.8%. Currency alternatives, however, enjoyed a resurgence with gold gaining 9.0% and breaking through $1,400 for the first time in five years. However, this pales in comparison to the speculation in Bitcoin which skyrocketed from ~$4,000 to over $12,000 for a 200% gain.

Markets are reaching new highs on the expectation that a looming Fed rate cut and the initiation of a global easing cycle will prove timely and prolong the economic expansion. Low unemployment rates and resilient consumer spending suggests investors' optimism may come to fruition – especially if a trade resolution lifts the cloud hanging over business investment. Nevertheless, we see a shrinking margin for error as investors walk the narrow path between anticipating accommodative monetary policy and an unremarkable global economy. In this regard the outcome of trade negotiations and monetary policy weigh heavily in our outlook, especially given that our indicators are at a level characteristic of a late cycle environment. The U.S. economy has been displaying signs of slower growth – just enough for the Fed to open the door to interest rate cuts, but not so much that it adopts a recession-like urgency. Sputtering growth across Europe and Asia is also dragging European and Asian central banks back toward monetary easing. The risk for investors is that a trade deal proves elusive and the economy continues weakening despite new monetary stimulus, or a trade deal is achieved and the economy strengthens enough for the Fed to delay rate cuts, or even consider raising rates – either of which would be expected to weigh on stock markets.

Our economic indicators are moving into late cycle territory… In our previous update, we pointed out that the Fed may have tightened sufficiently to reduce inflation concerns, noting that Fed tightening cycles of 300 basis points or more have been historically followed by recessions. In in the current cycle, the Fed has already implemented 300 basis points of tightening (including the estimated impact of balance sheet reduction). As is typical when the Fed tightens, the pace of business activity slows, and inflation pressures are reduced. In the U.S., broad economic indices measuring conditions within business supply chains, deliveries, new orders, and demand for services continue to hold at levels that indicate the economy is still expanding, but the intensity of activity is down from its year-ago highs. Overseas, manufacturing / industrial production are generally contracting, while the consumer and service sectors are still expanding. Not surprisingly, year-over-year inflation has downshifted from a 2.1% rate last summer to a 1.6% rate at the last reading (based on the Fed's preferred PCE price deflator).

BASF (the giant multi-national chemicals company), for example, recently struck a cautionary tone that exemplifies the current environment, noting soft conditions across the industrial sector, specifically autos in China. Similarly, freight volumes and pricing have been softer (stock prices for many trucking/freight companies are down 30% or more from their highs). On FedEx's June quarterly results call, management noted they "expect global economic growth to moderate as the developed world sees slower growth and both domestic and external factors weigh on emerging markets."

While the Fed has held short-term rates steady over the past six months, falling inflation has pressured the real short-term interest rate higher and into a range that is historically restrictive. During the past six decades, real short-term interest rates in periods of sustained economic growth have been at least 2% below the Real GDP growth rate, with the pace of growth slowing whenever the Fed raised real rates so that this gap narrowed to less than 2% (see chart below). Economists frame this by noting the neutral rate of real interest (the rate that neither promotes nor restrains growth) is about 2% less than real GDP growth. The gap today has narrowed to about 1%, with a real rate of interest today of about 1% (the Fed's target rate of 2.5% less 1.5% inflation) compared to expected real GDP growth of about 2%.



As highlighted by the media, the yield curve has become partially inverted with the difference in yield between 3-month and 10-year Treasuries turning negative, while the more conventional spread between yields on 2-year and 10-year Treasuries has remained positive. Inversions are an indication that markets perceive the Fed's short-term rate to be too high and an indication of the extent and timing to which markets believe the Fed needs to lower rates to support financial conditions. Inversions are also a potential signal (especially if the negative differential persists and spreads to the entire yield curve) to the banking industry that more difficult economic conditions may lie ahead (higher delinquencies and loan losses), which in turn prompts banks to tighten lending standards and reduce the flow of new loans. For now, however, the inversion is modest and banking data indicate that new loans continue to grow at a healthy 5% year-over-year rate. Furthermore, high-yield bond spreads (the amount of extra interest that riskier companies need to pay in order to borrow money) remain near historical lows – an indication that business as usual is continuing in the credit markets.

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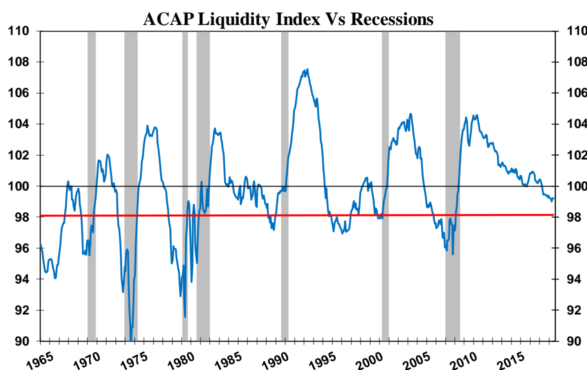
…with a thinner cushion to absorb any incrementally negative developments. To be clear, the contours of the economic softness (weak business investment and manufacturing, sluggish export markets) are consistent with the fallout we would expect from the ongoing trade conflict, not just between the U.S. and China but also with the EU, Canada, Mexico, and now between Japan and South Korea. Our ACAP Liquidity Index has held steady recently (see chart below), sitting above the 98 threshold that typically signifies elevated recession risks on the horizon. The Index is down from its highs earlier in this expansion, but liquidity is still currently adequate to support ongoing growth and financial markets. We note, however, that while liquidity is conducive for a continuing expansion (approximately 99) it is susceptible to a breakdown in trade negotiations (which can prompt a stronger dollar and tighter financial conditions), weaker economic trends, or a delay in the Fed's promised easing. (Our Index measures financial conditions across the economy, condensing easily observed inputs such as interest rates with more arcane data such as real rates, the growth in money supply, and the "dry powder" the financial industry has for making loans.)



The easing cycle is arriving while the economy is still expanding. The financial news media is fixated on weak manufacturing trends and associated industrial activity surveys, particularly across Europe and Asia, as pundits look for the proverbial canary in the coal mine. Consumer spending, however, accounts for ~70% of the domestic economy and is still growing (supported by low unemployment and rising wages). Service sector surveys are also indicative of an expansion. Overseas, a similar story is playing out even though consumer spending represents a smaller share of foreign economies. Measures of the German consumer/service economy show continued growth even as the industrial export machine slumps (likely reflecting the trade conflict). In China, consumer spending is growing at a better than 10% pace even as industrial output stalls (presumably also as a result of the ongoing trade conflict).

What is notable is the Fed is recognizing that easing inflation provides headroom for new monetary stimulus (paving the way for a rate cut in late July) even as broad swathes of the economy continue to exhibit strength. This timely action strikes us as consistent with a potential new, dovish paradigm taking hold among central bankers – in which a recognition of the historical failure to achieve inflation targets may, as initially circulated by Fed Vice Chairman Clarida, warrant less concern about temporarily overshooting inflation targets in pursuit of growth mandates. Overseas, Europe and China have also seen similar reductions in inflation, while Japan has been battling persistent deflation trends for years. In response, each of the major central banks, including the Fed, the European Central Bank, and the Japanese Central Bank are all switching gears with renewed plans to stimulate their respective economies. All told, central banks representing over 80% of the world economy are shifting toward monetary easing.

Importantly, when governments, companies, and consumers all have access to cheap and abundant credit – the mechanics of generating growth and positive investment returns are almost automatic. With pending interest rate cuts, a potential trade deal, and meek political resistance to fiscal stimulus, our late cycle indicators can easily move in a favorable direction for investors. The partial inversion in

the yield curve may be short-lived as more liquidity is pumped into the financial system, while a trade deal and inflation pickup can push real short-term rates back to a stimulative level.

Easing monetary policy may represent the new equilibrium for investors. As we write this Outlook, about $12.5 trillion worth of bonds, globally, have negative yields. That is, savers are PAYING borrowers to take their money! Money market rates in Europe are approximately -.40%. The Japanese 10-year government bond has a yield of -.25%. German bonds offer a guaranteed -3.5% absolute return over a 10-year holding period. Real yields are even lower assuming positive inflation rates (the Swiss 10-year bond, less inflation, offers a -20% real return).

It is unclear whether the extreme level of interest rates taking hold globally is a reflection of accumulating debt levels (which can be viewed as a harbinger of lower future demand if the debt was not used to fund productive investment), aging demographic trends (which would point to sluggish growth, and investment preferences that are shifting more conservative), underlying forecasts for weak growth, or lingering concerns over budget deficits, pension obligations, Brexit, etc. What is clear, however, is that exceptionally low rates and expansive monetary policies of the past ten years have not revived economic growth back to historical levels and inflation has consistently fallen below target. Simply put, the incremental benefit from progressive rate cuts and new debt issuance has been falling. At the same time, higher rates seem to have maintained their potency. The implication is that central banks need to adopt progressively easier monetary policies in order to achieve their desired level of inflation. In other words, the neutral rate of interest is lower than in years past (the neutral rate was an estimated 5.25% back in 2007, versus 1.75% today), and it may be drifting lower over time in response to rising debt levels, technology, and aging demographics.

We are more cautious near term, but the environment continues to favor stocks. For investors, the recent parallel gains for stocks and bonds is not entirely unprecedented, but nonetheless noteworthy given that conditions which typically support a rally in bond markets (caution and flight to safety) are not often associated with more risk-taking on the part of investors (strengthening economic outlook and rising profit expectations). Taken together, markets are positioning for the Goldilocks scenario of both lower interest rates (which has positive implications for valuing future cash flows, such as earnings and dividends) and stabilizing/improving economic fundamentals (which, in turn, provide support for corporate earnings growth). This positioning, however, leaves little room for either better economic growth that resurrects prospects for higher interest rates, or faltering growth that undermines corporate earnings.

Bull markets (and economic expansions) do not die of old age; rather, they die with monetary policy becoming too restrictive and triggering the collapse of a bubble or a recession. At present, none of these factors appears to be an issue and the Fed is moving to cut interest rates and ease policy in advance of a potential broader economic slowdown. Earnings estimates for the S&P 500 have declined 5% since the start of the year, but preliminary estimates for 2020 suggest a return to solid growth aided by many of the factors we highlight above. As a result, we continue to expect modest mid-single digit gains for the market through the balance of this year, though the path may be susceptible to updates on the trade negotiations. From a portfolio perspective, we are taking the recent market strength to trim overweight positions (particularly those that may be more sensitive to the trade outcome), but we continue to maintain a healthy exposure to stocks reflecting attractive relative valuations and our outlook that the most likely path forward is easier monetary policy and a resolution to the trade conflicts.

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