October 2019
S&P 500: 2977

OUTLOOK MEMORANDUM

Cutting Through The Noise

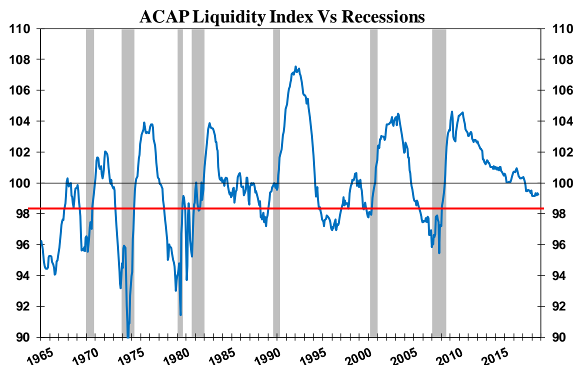
Markets eked out a small gain during the third quarter. U.S./China trade rhetoric at times cooled, until it heated back up; the inversion of the Treasury yield curve sparked fears of an impending recession, until it turned positive; the UK was careening toward a hard exit, until it wasn't; and the unprecedented attacks on Saudi oil infrastructure triggered an oil price spike, until damage assessments suggested production would be rapidly back on line. The potential disruptive issues are impactful, yet the market has seemed largely indifferent except for sporadic bouts of pessimism. Year to date, the large company indices are up a touch more than 20% while small caps lag with a more modest 14% gain. MSCI's emerging market index is up about 6% on the year; Europe is up about 13.5%. Domestic gains notwithstanding, market breadth offers a cautionary tone as fewer stocks are making new highs and once high-flying IPO/tech bell weathers languish; we note that stocks have returned only about 4% since levels reached in early 2018. As for bonds, the miserly yields at the start of the year have not been an impediment – progressively lower interest rates have lifted bonds from 7% for municipals to as much as 10% for Treasuries and 15% for corporates.

The plethora of issues, from tariffs to Brexit and the turmoil in Washington, is muddying the signals of traditional indicators. The New York Fed's barometer recently pegged the probability of recession in the next twelve months as high as 35% but the model is derived from the slope of the Treasury yield curve, which may be sending an exaggerated signal given that sputtering economies across Asia and Europe have pushed $15 trillion worth of bonds (outside the U.S.) into negative yield territory (discussed below). Manufacturing surveys have been weak, particularly overseas – but how much of that weakness reflects the ongoing U.S./China trade conflict and Brexit uncertainties (which could resolve), versus simply a consequence of a natural slowdown in China, perennial weakness in Europe, or the fallout from the Fed's prior pace of interest rate hikes and balance sheet reduction?

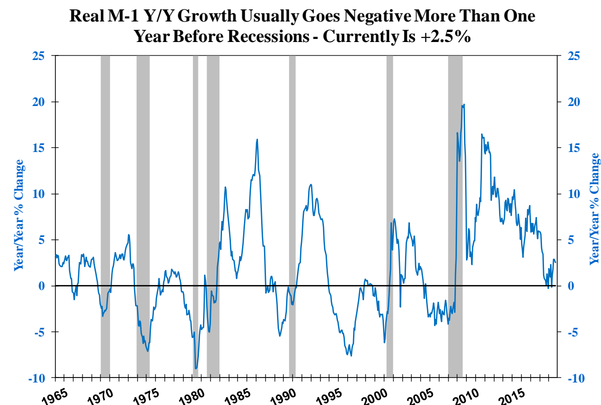
While the media is sounding the recession alarm, our indicators suggest system-wide liquidity remains sufficient to support continuing economic growth – but the margin of cushion is thin. The market's resilience in the face of successive challenges is one indication that there is ample liquidity for financial markets. At the same time, weak business investment, sagging confidence, and soft inflation trends mean there is room for yet more aggressive monetary policy. Foreign central banks have already joined the Fed in implementing new stimulus measures while the consumer and service sectors are still expanding. Real short-term rates are low and comfortably below real GDP growth, and poised to move lower in the coming months assuming additional Fed cuts. While ample liquidity and more monetary easing on the way suggests stocks will continue to outpace other assets, our optimism for the coming year is tempered by revisions to earnings estimates and the persistence of exogenous issues, each carrying potentially negative outcomes, that currently are dampening the stimulative impact of monetary and fiscal policies.

Liquidity and credit remain the lifeblood of economic systems and financial markets. When liquidity and credit are relatively scarce, businesses and households encounter higher interest rates and difficulty borrowing money to fund projects or consumption. They respond by reducing spending or selling assets in an alternative effort to create liquidity – ultimately leading to a broad slowdown in spending, investment, asset values, and growth that ends in a recession. On the other hand, when liquidity and credit are readily available, the cost of money (interest rates) is relatively cheap and attractive – and businesses and households are able to utilize liquidity to purchase homes, cars, vacations, etc.

Our indicators show that liquidity remains sufficient for domestic economic growth, though as we have previously highlighted, the margin of cushion is thin. Our ACAP Liquidity Index, for example, is holding around the 99 level and above the 98 level that historically signifies heightened recessionary risks about one to two years in advance. In this regard, the Fed's pivot from a hawkish policy at the end of 2018, to a neutral policy earlier this year, and interest rate cuts at its July and September meetings, have been timely in providing monetary support – especially since the policy change arrived while employment and wage growth has remained strong. Importantly, even assuming a deterioration in our index to below 98 over a relatively short timeframe, the knock-on effects to the economy generally take one to two years to become evident.



Central banks, globally, have shifted to an easing bias led by the Federal Reserve. The European and Japanese Central Banks have been moving in the same direction as the Fed, and in fact just about every major central bank is currently on an easing path. Together, these actions provide support for the global economy and financial markets; domestically, the Fed's recent policy stance gives us more confidence that real M-1 money growth will remain at a positive level (Real M-1 growth measures the extent to which the amount of money in the economy, adjusted for price inflation, is growing. Over the course of an economic cycle, real money growth enhances liquidity relative to economic activity, with the result being a stimulus to credit, asset values, and economic activity.)



Underscoring the ample level of liquidity, real short-term interest rates are at an economically stimulative level. The Fed controls the supply of money, but it can only loosely encourage the extension of credit throughout the private sector. This dynamic has colloquially been referred to as pushing on a string. Historically, real Fed Funds generally have been two percentage points lower than real GDP growth during sustained economic expansions (see chart below). Real GDP growth has faltered whenever the Fed raised real short-term interest rates (that is raised the Fed Funds rate, in response to an overheating economy, faster than inflation was increasing). At present, the Fed is not only cutting interest

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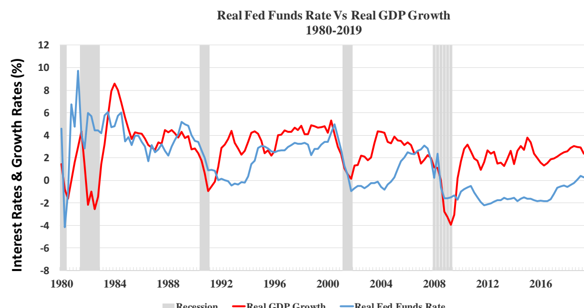
rates, but doing so at a time at which the real Fed Funds rate is already at a significant gap of more than 2% to the real GDP growth rate. This is an indication of the timeliness of the Fed's policy shift, together with the degree to which the Fed is currently stimulating. With the real short-term cost of money effectively below zero at a time when the real growth in the economy remains close to 2%, businesses can outgrow the cost of investment.



Global macro issues are seeping into the economic data and obscuring the positive trends in liquidity. The combination of tariffs, the protracted Brexit saga, slowing economic growth in China, high debt levels, and perennial weakness throughout Europe and Japan are having a multi-dimensional impact on the economy. Short-term, how can a business invest in global production when the rules and costs of trade may abruptly change? Manufacturing indices across Europe and Asia generally have been weak reflecting the U.S./China trade conflict and the uncertainty of Brexit. In the U.K. business investment has been falling almost every single quarter since 2017 – businesses have no confident way to estimate the future terms of trade between the U.K. and the rest of the world (or even to know whether cross-border trade will suddenly face major disruptions). Manufacturing in the U.S. has fared much better, but one index of manufacturing activity recently slipped to a level signaling a slight contraction. A broad German manufacturing index, in contrast, has been contracting for almost a year.

In Europe and Japan, economic growth was stubbornly slow even before Brexit and the trade war surfaced. Layering on the impacts of tariffs, uncertainty, and other "policy" shocks forced European and Japanese central banks to the extremes of monetary policy – negative short-term rates. To be clear, negative policy rates are unprecedented and only are justified by theoretical benefits. On the surface, negative policy rates are intended to increase the incentive for banks to lend money into the economy (holding cash incurs a penalty cost, whereas lending can generate a profit). The reality that seems to be taking shape, however, is that negative policy rates (and low interest rates in general) force a contraction on the banking industry through reduced profitability, as evidenced by the extremely poor performance and discounted valuations of banks across Europe and Japan (relative to their U.S. counterparts).

For much of this year, the financial media has obsessed over the slope of the yield curve. (The slope is typically computed as the difference in yield between 10-year and 2-year Treasuries, though some analyses look at the difference in yield between 10-year and 3-month Treasuries.) A positively sloped yield curve (yields on longer-term bonds are greater than yields on shorter-term bonds) is the norm in a healthy economic environment as investors require extra compensation for the higher cumulative risks during the life of a longer-term bond. A negatively sloped yield curve, in contrast, typically presages a recession given that it signals short-term illiquidity that boosts rates to a level that crimps lending (thus constraining economic activity), leading to expectations for lower interest rates and lower inflation in the future. While the slope was positive to start the year, the difference was only about 0.17% and the slope subsequently flattened and briefly turned negative before more recently moving back to a positive 0.15% after the Fed cut rates twice.

While yield curve inversions do not cause recessions (inversions do not directly impact

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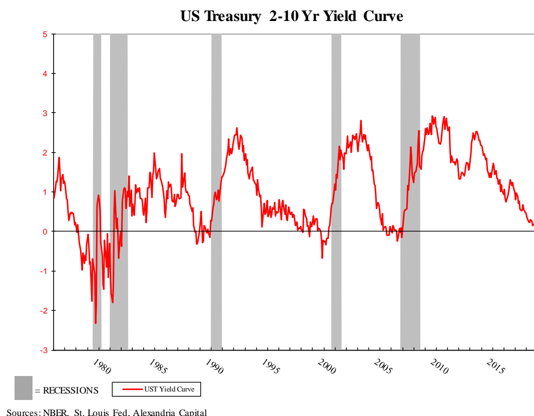
bank profits and lending ability since banks make loans at spreads above short-term rates), Fed surveys highlight that senior executives adopt more cautious lending standards in the presence of an inverted yield curve. Simply put, banks interpret inversions as harbingers of what is to come. Not surprisingly, the data shows that persistent inversions precede recessions. Intuitively, the depth of inversion and the pace in which the Fed responds are also important to the eventual path of the economy.

In the current environment it is possible that an inverted yield curve does not reflect domestic illiquidity – especially given tight credit spreads and resilient markets. Rather than domestic illiquidity, it might reflect the pervasive negative yields outside the U.S. that are leading global investors to invest heavily in U.S. bonds, inflating their prices and reducing U.S. long-term bond yields. This is a factor contributing to the flat slope of the U.S. yield curve. Overseas, the German 10-year bond yielded ~9% in the early 1990s and first dipped into negative yield territory in 2016. In Japan, yields have similarly been on a long downward trajectory, and like Germany, initially touched negative yield territory in 2016. Today, there are about $15 trillion worth of bonds (globally) that have negative yields – owners of the bonds are, if held to maturity, guaranteed to lose money. Investors are in effect paying to lend money as opposed to being paid to lend money. Norinchukin Bank, a Japanese cooperative serving farmers and fishermen, highlights the connection between low or negative yields overseas and the U.S. yield curve: Norinchukin has become the dominant source of funding in the market for U.S. collateralized loan obligations (investment vehicles that buy up loans to junk-rated companies).

Stocks should continue to outpace other assets. The global easing cycle that is underway is an important step toward assuring that adequate liquidity and credit continues to flow through the economy. Domestically, the Fed's recent interest rate cuts come on top of



Sources: NBER, St. Louis Fed, Alexandria Capital

tangible evidence that liquidity is already at a healthy level as evidenced by tight credit spreads, healthy bank loan growth, and the market's resilience in the face of multiple exogenous issues. Soft economic data overseas is an area of concern as it will weigh on export growth, but most of the weakness is confined to manufacturing indices that are far more sensitive to tariffs, trade uncertainty, and the post Brexit landscape. Among European countries, Germany appears to be hardest hit – as expected given that exports account for ~47% of GDP, compared to about 12% for the U.S. Nevertheless, the consumer and service sectors of global economies are continuing to expand. The consumer represents about 70% of the U.S. economy, and is buttressed by steady jobs growth, a record low unemployment rate, and increasing wage gains. Importantly, persistently weak inflation trends continue to provide policy makers with a lot of room to maneuver; whether the general disinflation is due to new technologies, aging demographics, or high debt levels the reality is central banks have consistently missed their inflation targets.

Looking ahead, the conditions are in place for more normal market returns over the next year (5%-10%), but our optimism is tempered by revisions to earnings estimates and the prospect that resolutions on tariffs and Brexit could prove elusive and/or be overshadowed by election politics. Nevertheless, in a world characterized by low and declining interest rates, and falling inflation, valuations for stocks continue to look compelling.

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