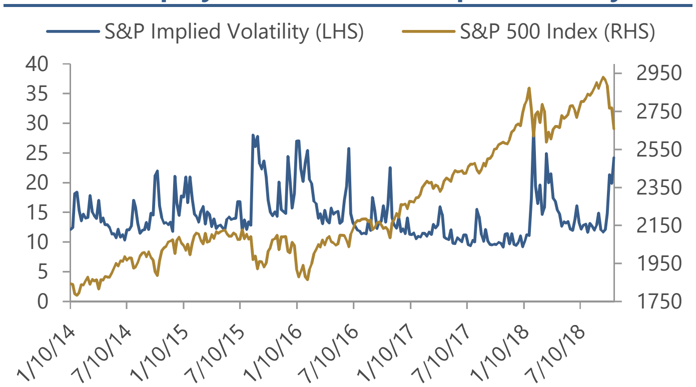
October 2018

Economic and Market Observations Update: October Fright Fest

by Vincent Reinhart
Chief Economist & Macro Strategist

Jamie Lee Curtis is back on the big screen, but relatively more bloody mayhem has occurred in equity markets this month. The mask is on and risk is off. We thought for some time that volatility in most financial markets was preternaturally low, but like going to see one of those movies with eyes wide open, it is stomach churning nonetheless to witness the anticipated event. Equity markets sold off most days this month, and forward-looking measures of price volatility reverted to near their February highs.

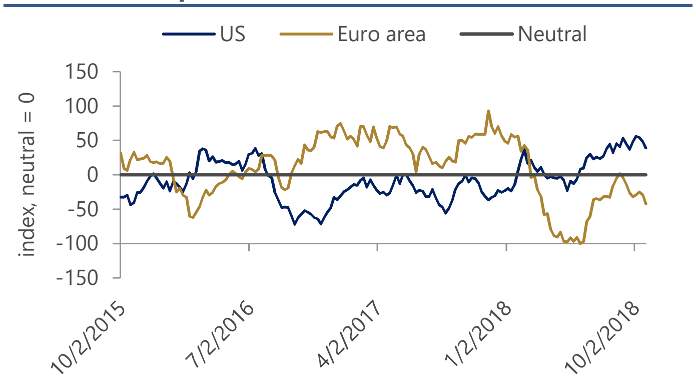
S&P 500® Equity Price Index and Implied Volatity



Source: Bloomberg, 10/28/2018.

US economic data provided no obvious trigger for the selloff. Indicators mostly point to activity clocking in above trend, and data surprises moved back into positive territory. Businesses report that their spending intentions remain in expansion mode, but this has not shown up in capital spending, which has been soft.

Economic Surprises



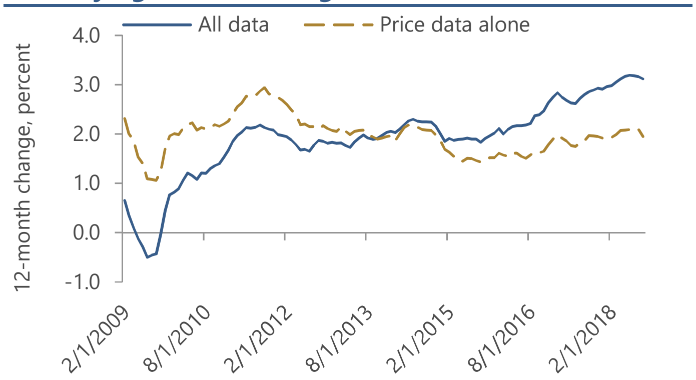
Source: Citigroup Markets, accessed via Bloomberg 10/28/18.

No progress was made in settling the trade dispute with China, consistent with our view that the relationship will get worse before it gets better and creating a headwind for business investment. In that regard, trade and tariffs got multiple mentions on quarterly corporate earnings calls. There is also circumstantial evidence Chinese officials are struggling to find sufficient domestic levers to pull to offset the external drag from trade. We think they will succeed because of ample precedent, but this may be closer run, adding to fundamental risk. The European economy retains its ability to disappoint, with data on the cool side of expectations and the discussion of Italian fiscal policy heated.

STANDISH

With US activity expanding above trend and resource use already pressed, cost pressures are rising. If this sounds familiar, it should because the assertion has been the linchpin of our forecast for some time as wages and consumer price gains inch up. Inches accumulate and inflation is at or above the Federal Reserve's (Fed's) goal of 2 percent. More seems to be in store, at least judging by the Federal Reserve Bank of New York's (FRBNY's) underlying inflation gauge, which ran over 3 percent for the past seven months. However, that workstream shares the problem we have: The overall gauge runs hot because of capacity pressure, and using prices and costs alone to predict future inflation is less worrisome, albeit with a prediction still above goal.

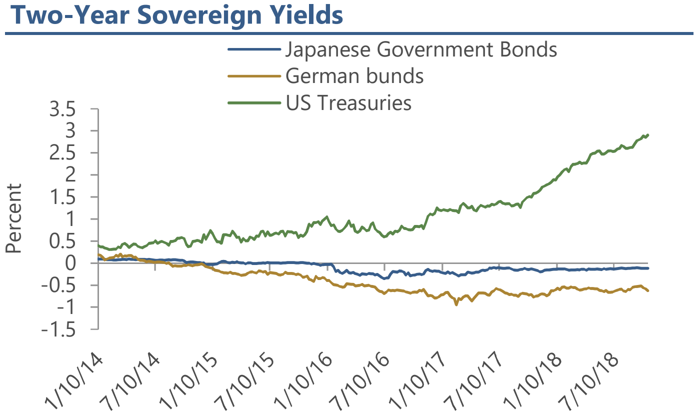
Underlying Inflation Gauge



Source: FRBNY, via Bloomberg, accessed 10/28/18.

Our forecast for inflation is not as lofty at that of the FRBNY, but it is enough to see value in inflation breakevens and be wary about holding duration in developed market sovereigns. To be sure, the sovereign selloff this month was a bumpier journey along our expected path and makes them a little less expensive now. Investors got the message that, despite (or maybe even because of) complaints from the White House about raising interest rates, the Fed will continue to firm policy. The script in financial markets is as predictable as that of a slasher film, except in current casting. Fed chair Jay Powell is as relentless in his pursuit of excess demand as Michael Myers is in chasing cheerleaders.

Two-Year Sovereign Yields

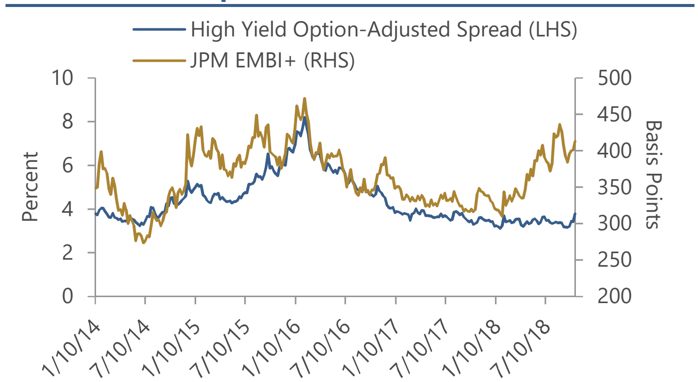


Source: Bloomberg, accessed 10/28/2018.

Powell will stop (on his own, not be stopped), but when nobody knows, including him. The hope is the neutral rate of interest will seem a little more obvious when the Fed is closer to it (which is a lot like the identity of the assailant in the last ten minutes of many slasher movies). The irony is the attendant tightening in financial conditions substitutes some Fed action. We have penciled in four more quarter-point hikes, one each quarter. That is why we see value at the short end, as higher yields provide attractive carry to offset some capital losses as rates continue to rise. The US offers that opportunity here, as the onset of policy renormalization is about a year off for the European Central Bank (ECB) and further removed for the Bank of Japan.

We think the Fed gets it about right (but the path of success, to be sure, is narrow), and real GDP growth slows sequentially to its potential by 2020. The unemployment rate lingers below its natural rate for some time, painting a favorable backdrop for corporate debt. We think investment grade spreads are fair, and high yield ones are not going to regain their prior tights of this cycle. This latter point is especially relevant in comparison with emerging market debt. We think there is value in emerging market local-currency and US-dollar debt, which has been cuffed about by political uncertainties and US-dollar appreciation.

Selected Yields Spreads



Source: Bloomberg, accessed 10/28/2018.

Dollar strength is owed mostly to the marked divergence in central bank policies, but that story is getting old. Expectations about the ECB will start shifting well in advance of action (especially as gossip about the next ECB president grows in 2019). Over time, the weight of US twin deficits in the current account and budget balance will cause the dollar to sag, which is why we hold with some conviction that it is expensive against other developed and emerging market currencies.

Conviction can be hard to come by in a scary October. A movie theater offers the consolation that the lights will come on after about two hours of mayhem. We are not sure how long the financial market fright lasts, which is why we prefer option strategies to implement our views where possible in light of the fatter tails on potential outcomes. Take any chance a volatile market provides to step up the quality of holdings and reduce risk further. Also, do not go into the barn alone at night.

The Investment Map October 2018

Economic Landscape	Fixed Income Valuation	Investment Themes
The trade dispute will probably get worse before it gets better, but the hit to economic activity is likely to be modest.	Above-trend economic growth makes developed market sovereign yields expensive, although less so after the recent back-up.	Be short to neutral duration in core developed market sovereign securities.
In the US, accommodative financial conditions and fiscal impetus supports above-trend economic growth, exacerbating excess demand and putting upward pressure on costs.	Break-evens offer value and provide inexpensive protection to upside surprises to inflation.	Maintain short dollar exposure, where appropriate through option strategies given increased probability of tail risks.
Despite multiple challenges, Chinese officials are likely to meet their goal for economic growth.	The dollar appears expensive against other developed and emerging market currencies.	Maintain modest exposure to break-evens.
Most other economies should grow at or above trend, as long as neither internal nor external politics derail the process.	For institutional investors, municipal assets are fairly valued, with the long end looking the most attractive.	Remain overweight EM assets.
Commodity prices are likely to be range-bound.	With fundamentals remaining strong, investment-grade corporate spreads are fair.	Maintain modest credit exposure but continue to step up quality of the holdings.
As inflation overshoots goal, the Federal Reserve (Fed) will tighten modestly more and be more willing to tolerate volatility than currently thought by most investors.	High-yield spreads are somewhat expensive.	Maintain bias to longer-duration municipal securities or, where appropriate, taxable bonds.
With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy.	Market and political uncertainties create opportunities in emerging markets local currency and dollar debt.	Maintain modest underweight in MBS and emphasize ABS versus CMBS.
	Interest rate volatility remains low.	Continue option strategies with minimal cost to keep portfolios sufficiently convex.
	Higher short-term Treasury yields provide attractive carry at the short end that will offset capital losses some as rates rise.	
	Valuations of securitized products generally appear fair to rich.	

Take idiosyncratic opportunities to reduce risk further.

Source: BNY Mellon Asset Management North America as of October 17, 2018

STANDISH

www.standish.com ● info@standish.com