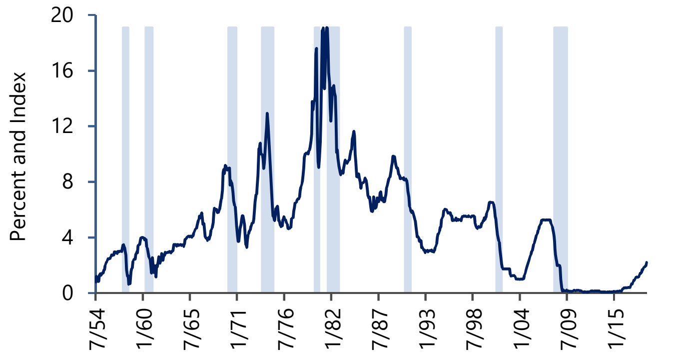
November 2018

Economics and Markets Update: Into Thin Air

by Vincent Reinhart
Chief Economist & Macro Strategist

The top of Mount Chimborazo in Ecuador is the point furthest away from the center of the earth. The German naturalist Alexander von Humboldt came just short of that peak in 1802, setting an altitude record that stood for thirty years, all the more remarkable without reliable charts in an era well before bottled oxygen. Federal Reserve (Fed) Chair Jay Powell is similarly leading the global economy into thin air. Is it possible to raise the targeted federal funds rate in the US so as to tighten financial conditions, slow real GDP growth back to trend (but not below), and limit the overshoot of inflation? Powell also lacks a reliable map of his destination, the neutral nominal federal funds rate, but seems committed to climb at the steady pace of one-quarter percentage point up every calendar quarter.

Federal Funds Rate and Recession



Source: Federal Reserve and the NBER, accessed via FRED, 11/17/2018
as of 10/1/2018

His fellow travelers, us included, are already skittish about what can go wrong because the economic landscape is littered with the carcasses of expansions that ended badly in prior Fed attempts to scale the heights. Indeed, only one succeeded in the modern era of Fed communication, the Greenspan firming of 1994 to 1995. And even then, while the economy ploughed ahead, financial markets were extremely volatile.

At the time, US politics seemed especially divisive, marked by a then-record rejection of the incumbent president's party in the midterm elections that gave "Contract with America" Republicans control of the House of Representatives. Debt-ceiling showdowns and government shutdowns ensued. The general feeling was that the political climate could not get worse.

How naive.

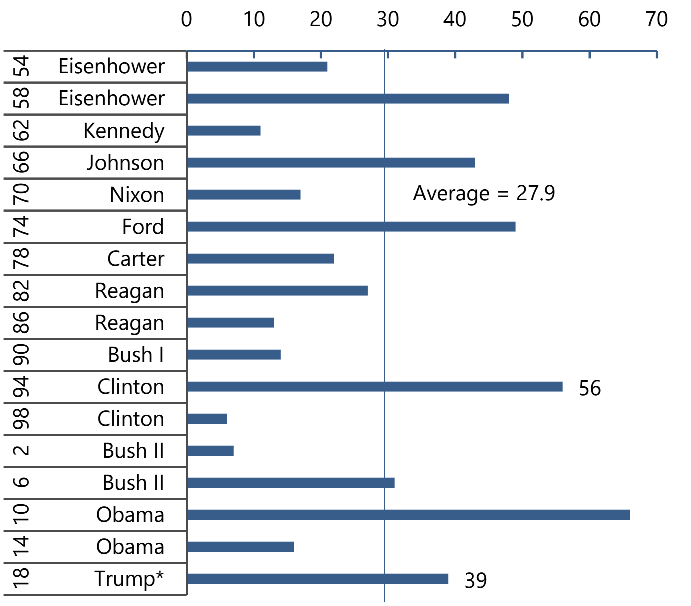
Recently, US voters once again opted to divide the government, although the House seat turnover did not quite amount to a "Blue Wave" and Republicans gained in the Senate. The dispiriting conclusion is that the 2020 presidential contest has officially begun and political discord will only get worse. The Democratic leadership in the House will direct various committees to launch investigations of the president's performance, re-litigate appointments, and pressure agency heads to walk back their deregulation efforts. Included in that will be the release of the president's tax returns, which will be sure to generate both unfavorable headlines and White House antipathy. Showy legislation from the House will build the Democratic platform for 2020 plank by plank. But there is no chance

STANDISH

Standish is a brand of BNY Mellon Asset Management North America Corporation.

that any bill will be signed into law because neither Hill leadership nor the White House will want to give the other side a victory. The wider margin in the Senate will embolden the White House to be more aggressive in nominations, especially judicial ones.

House Seat Loss in Midterm Elections for the Party of the Incumbent President, Number



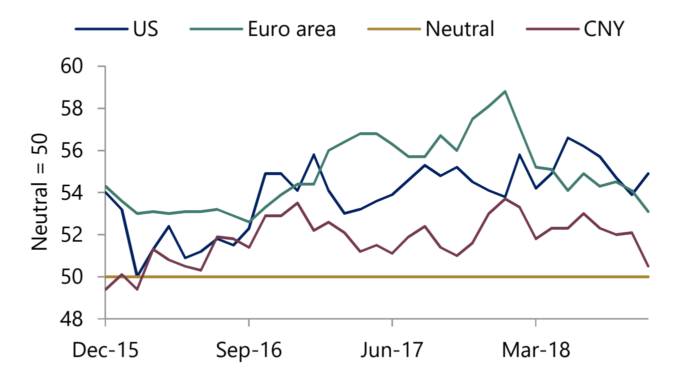
Source: Vital Statistics on Congress, Table 2-5, Brookings Institution.

* Forecast from fivethirtyeight.com, accessed 11/18/18.

For his part, President Trump will rely more on the levers of executive power, particularly on international trade, to demonstrate he remains in charge. Thus, trade disputes with China and about autos with Europe will escalate until whichever comes first—the presidential election campaign or a material dislocation in the US economy or its financial markets.

Thus far, the implicit White House bet that trade means more to our trading partners than to us remains in the money. Spending intentions by purchasing managers in the US have held up better than in China and the Euro area. Similarly in equity markets, the net of roughly zero gain from the S&P 500® Index compares favorably to the view from abroad.

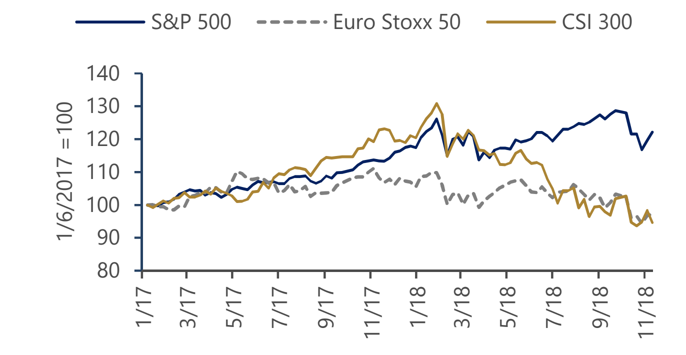
Manufacturing Purchasing Managers' Composite Index



Source: Markit, accessed via Bloomberg 11/13/2018 as of October 2018.

The foreign political vista remains bleak. British Prime Minister May limps to the Brexit finish line. The odd political coupling at the helm in Italy continues to dare the European Commission. Meanwhile, Brazil and Mexico are about to install leaders from opposite ends of the political spectrum, both of whom relish defying convention. The challenge to Chinese leadership is economic in that they need to toggle the levers of policy to find substitutes for export growth that will be impaired by the ongoing trade dispute. This requires slowing reforms, weakening the national balance sheet, and tolerating depreciation of the yuan. These are all sources of support to the foreign exchange value of the safe-haven currency, the US dollar, and threats to the successful completion of Jay Powell's journey.

Equity Indexes



Source: Bloomberg, accessed 11/19/2018.

In our baseline outlook, political drama is a drag on, but does not disrupt, global economic expansion. Real GDP growth slows modestly, starting from a pace that is above its longer-term trend. In the US, resource use is taut, as evidenced by an unemployment rate headed to 3-1/2 percent. Inflation is already around the goal of 2 percent, leading the Fed to tighten modestly more and be more willing to tolerate financial market volatility than currently thought by most investors.

Much more will be done by the other major central banks. We expect the volume on that conversation to increase early next year as market participants speculate about Mario Draghi's replacement at the helm of the European Central Bank (ECB). Later on, Haruhiko Kuroda will begin to ponder a slow unwind of unconventional policy to cement his legacy at the Bank of Japan (BOJ).

Four investment themes are implied by major central banks moving from out-of-sync to a closer alignment over time. First, the rise in inflation anticipated in advanced economies makes inflation break-evens attractive. Second, it also makes us wary about holding sovereign duration, although the net backup in longer-term yields over the past few months makes them somewhat less expensive. Third, the wide gap between yields at home and abroad makes it more cost effective to express a short bias with foreign sovereigns. Fourth, the systematic firming of US monetary policy usually breaks some financial market pottery. Price volatility has been low for a very long time—testimony to the Fed's ability to crush risk. As they get out of that game, fluctuations in asset prices have risen, although mostly concentrated in the equity market. We think that the Fed's agenda has risks in a world that is a risky place. Plan on fixed income volatility rising and take advantage now of relatively cheap hedges.

PAST PERFORMANCE IS NOT NECESSARILY INDICITAVE OF FUTURE RESULTS.

If the Fed gets it right, as in our baseline forecast, corporate credit seems fairly priced and there are opportunities in the emerging markets (EM) asset class, especially considering the miserly carry elsewhere. But, there is enough chance that the Fed stumbles or politics intrude to advise reducing risk further now by stepping up the quality of corporate holdings and positioning a reduced overweight in EM more defensively.

We end with a note of frustration, which is reflected in the rightmost column of our Investment Landscape. A favorable economic outlook is not favorable for investment opportunities when current spreads are already squeezed to that outcome. And if the baseline trail is marked by potential obstacles ahead and the downhill slope to the sides steep and therefore punishing to a mistake, the good times are times to reduce risk. Having cash available provides opportunities to rebalance at missteps in markets and the macro economy and will be consoling in the event of a more serious slide downhill.

Economic Landscape

- Global economic growth is expected to slow modestly as the Fed removes financial accommodation, but multiple political risks cloud the economic landscape.
- Among others, a divided US government eliminates any chance of legislation and will likely worsen the trade dispute, there are distinct threats to European cohesion, and extremes are about to take power in Brazil and Mexico.
- Still, the current level of DM economic activity is above potential and cost pressures are building.
- Chinese officials are likely to meet their goal for economic growth (at the cost of slowing reforms and worsening the national balance sheet), supporting commodity prices and other EM economies.
- As inflation overshoots goal, the Fed will tighten modestly more and be more willing to tolerate volatility than currently thought by most investors.
- Other DM central banks will move, albeit slowly, to renormalize monetary policy.

Fixed Income Valuation

- Pressures on resources in DM economies make their sovereign yields expensive, although less so after the recent back-up.
- Break-evens offer value and provide inexpensive protection to upside surprises to inflation.
- The dollar appears expensive against other developed and emerging market currencies.
- Investment-grade corporate spreads are fair, but fundamentals are likely to soften.
- High-yield spreads are somewhat expensive.
- Emerging markets local currency and dollar debt offer attractive carry, but market and political uncertainties are elevated.
- For institutional investors, municipal assets are attractive, especially those at the long end.
- Interest rate volatility is low but will likely rise.
- 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.

Investment Themes

- Be short to neutral duration in core developed market sovereign securities.
- Maintain short dollar exposure, where appropriate through option strategies given increased probability of tail risks.
- Maintain modest exposure to break-evens.
- Continue with the recently reduced overweight in EM assets but position more defensively over time.
- Maintain modest credit exposure but continue to step up the quality of the holdings.
- Maintain bias to intermediate- and longer-duration municipal securities.
- Retain the modest underweight in MBS and emphasize ABS versus CMBS.
- Use option strategies with minimal cost to keep portfolios sufficiently convex.

Take idiosyncratic opportunities to reduce risk further.

Source: Firm analysis as of November 2018

www.standish.com ● info@standish.com