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Economic & Market Observations: **Powell the Padawan**

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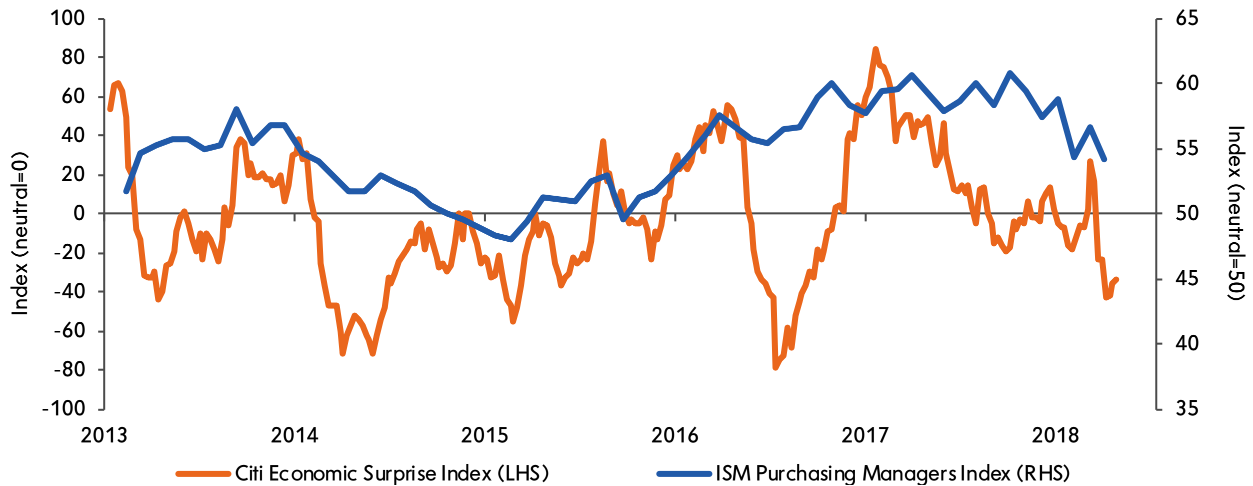
One wonders if Jerome Powell had a premonition of a bad feeling when he was offered the job as Chair of the Federal Reserve (Fed). His first year involved a lot of on-the-job training, including an equity market correction, outbursts of presidential wrath and, of late, a global growth scare. Over 2018, economic data releases in the US ran south of expectations and the spending intentions of purchasing managers sagged. Outcomes abroad, especially in Europe, looked ominous, with Italy technically in recession and Germany barely squeaking by one. At the start of 2019, good news out of China was few and far between.

Economic Surprises & Purchasing Manager Sentiment

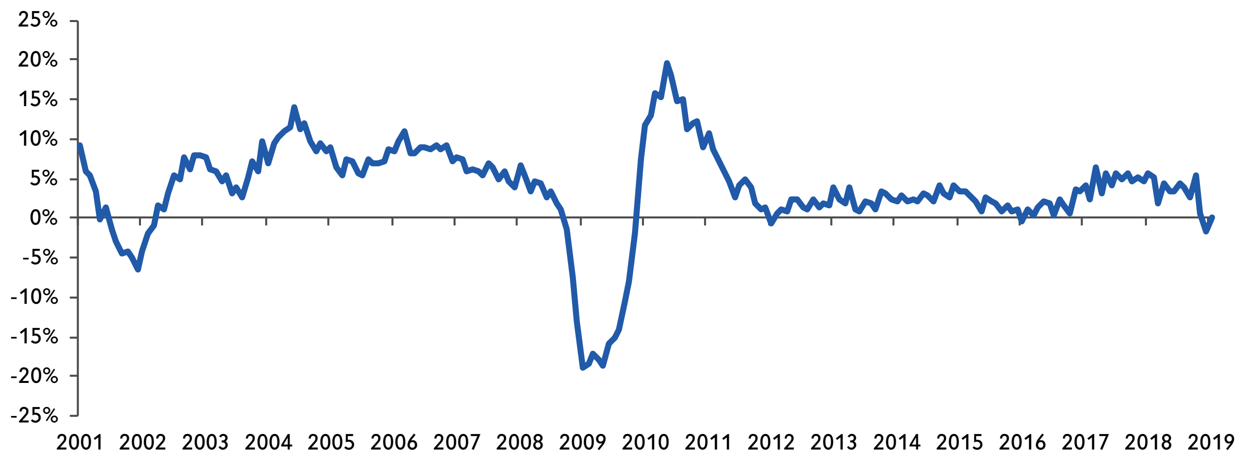


Source: Citigroup Markets and Institute for Supply Management, accessed via Bloomberg, April 5, 2019.

In retrospect, the world learned the consequences of global trade coming to a grinding halt. Trade volumes in December were below that of twelve months earlier, a sudden stop if ever there was one. During this fraught window, one government, the US, shut down partially and temporarily, while another, the UK, hyperactively polled itself about withdrawal from the European Union (EU) only to find disagreement and distraction. Meanwhile, Germany struggled with the uncertain transition of its auto industry (which accounts for more than 7 percent of national output) in the face of an electric future.

World Trade Volumes

12-Month Change



Source: CPB World Trade Monitor. As of March 25, 2019.

As these clouds massed on the economic horizon, investors recoiled at Fed Chair Powell's plan to continue tightening financial conditions. His unforced error at the December meeting of the Federal Open Market Committee (FOMC) was to sound tone-deaf about these worries. He compensated subsequently. Actually, he overcompensated. Not since a long, long time ago in a galaxy far, far away has patience been elevated to such a lofty status. Fed Chair Powell evidently heard the echo across the space-time continuum of Yoda's advice to Luke ("Patience you must have, my young Padawan") and extolled the virtue often and in consort with his colleagues.

By the time of the March FOMC meeting, all but five participants reported that it would be appropriate to keep the federal funds rate unchanged in 2019, a head-snapping change by nine of them (shown by the solid dots for March and the open ones for December in the chart below). The accompanying talk of data dependence and the potential for a reinterpretation of the Fed's price stability objective ratified the market view that recession was around the corner. The next move, the prevailing wisdom ran, would be to ease this year. A cycle was set in motion in which:

- Investors reacted poorly to economic news
- Risk markets sold off
- The Fed reacted to financial markets
- Expectations about future US monetary policy shifted sharply lower
- Central banks abroad swayed with the new direction of the Fed wind

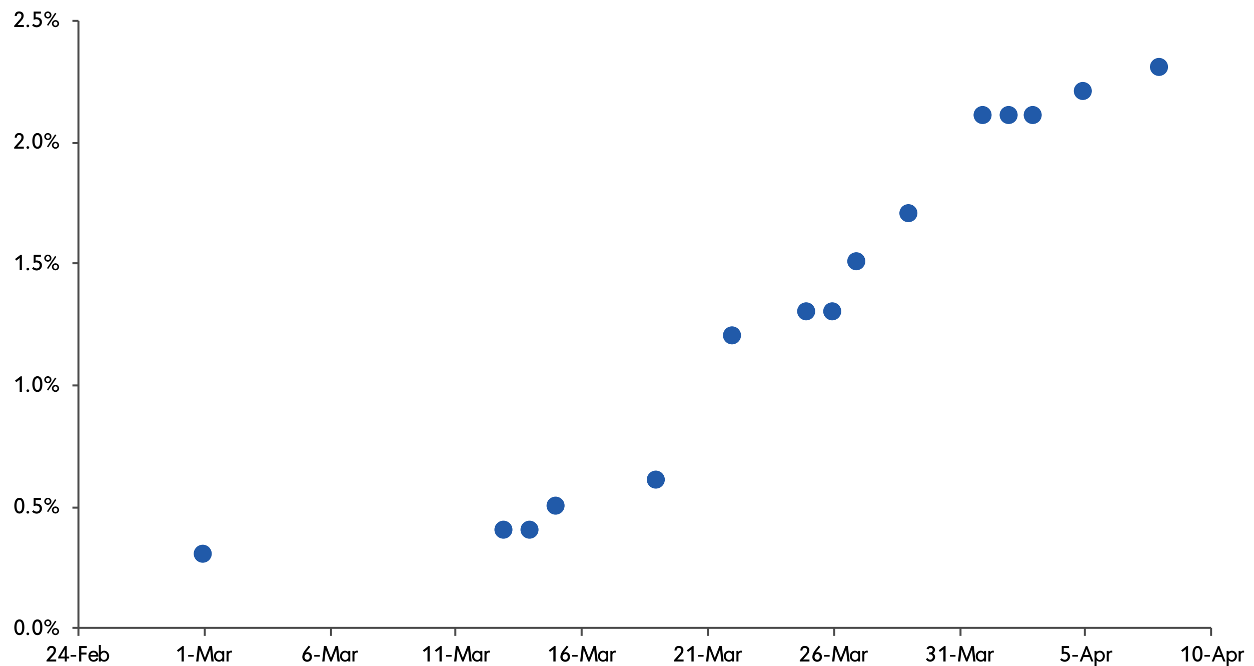
Summary of Economic Projections

4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
2018
2019
2020
2021
Long-Run
● March 2019 ○ December 2018

Source: Federal Reserve. Accessed March 27, 2019 at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20180321.htm. Note: Each data point represents one FOMC participant.

Fed Chair Powell might have been better served advising investors to be patient before darkening his own view of global economic prospects. After all, Yoda also prophesied that "Fear is the path to the dark side." In our view, the global economy, to quote Fed Chair Powell at another time, is in a "good place." Net employment gains averaging 200,000 on a 12-month basis evinces ongoing momentum in activity. An unemployment rate of 3¾ percent predicts pressure on resources. This pressure is already showing a little—admittedly not a lot—in costs and prices. At the same time, first-quarter real GDP appears to have grown around 2¼ percent according to most tracking estimates. This is not too shabby considering that unresolved residual seasonality in national income statistics leaves a trail over the past 30 years when the first-quarter outturn averages ¾ percentage points below the other three quarters of the year. If that pattern recurs, economic growth has not yet slowed materially from its 2018 pace.

Nowcast of First-Quarter 2019 Real GDP Growth



Source: Federal Reserve Bank of Atlanta.

The US retains cyclical momentum, in part, because President Trump is correct that trade matters less to us than to our trading partners. As a result, there is less ongoing drag on activity from the tensions he is fomenting. At the same time, China, the second-largest economy in the world, is providing significant, high-quality fiscal stimulus even as it reverses its efforts to deleverage the private sector and fight corruption.

The momentum will extend because financial conditions remain accommodative. A widely followed proxy for aggregate financial conditions only briefly veered into restrictive territory in December and the easing since is sufficient to add almost ¾ percentage points to real GDP by the end of 2020. Even the newly dovish FOMC (back to the dots) sees the current nominal federal funds rate as below estimates of its long-run level. That is, they envision tightening at some point, however imprecise they may be about when. Additionally, some of the run up in oil prices owes to supply machinations, but West Texas Intermediate crude trading above $60 per barrel gives no evidence of weakness in global demand.

Financial Conditions

Source: Goldman Sachs, accessed via Bloomberg. April 7, 2019.

Yes, the world is a risky place. Even an abbreviated list of the things that can go bump in the night is bracing. The US political system appears dysfunctional and will get a real-time stress test in the fall, with the pressing need to fund ongoing operations of the government as the new fiscal year begins and to raise the debt ceiling once Treasury Secretary Mnuchin has run out of tricks to work within the current limit. The two largest economies are locked in a trade dispute that tests competing visions of economic management. The UK is lumbering toward a decision on exiting the EU (or not), pushing the hard stop further and further into the future. Reform in France has sparked protests and produced the most extended "listening tour" of citizens' grievances since the French Revolution. The governing coalition in Italy and the new leaders of Brazil and Mexico sample from populist extremes, and multiple elections dot the calendar.

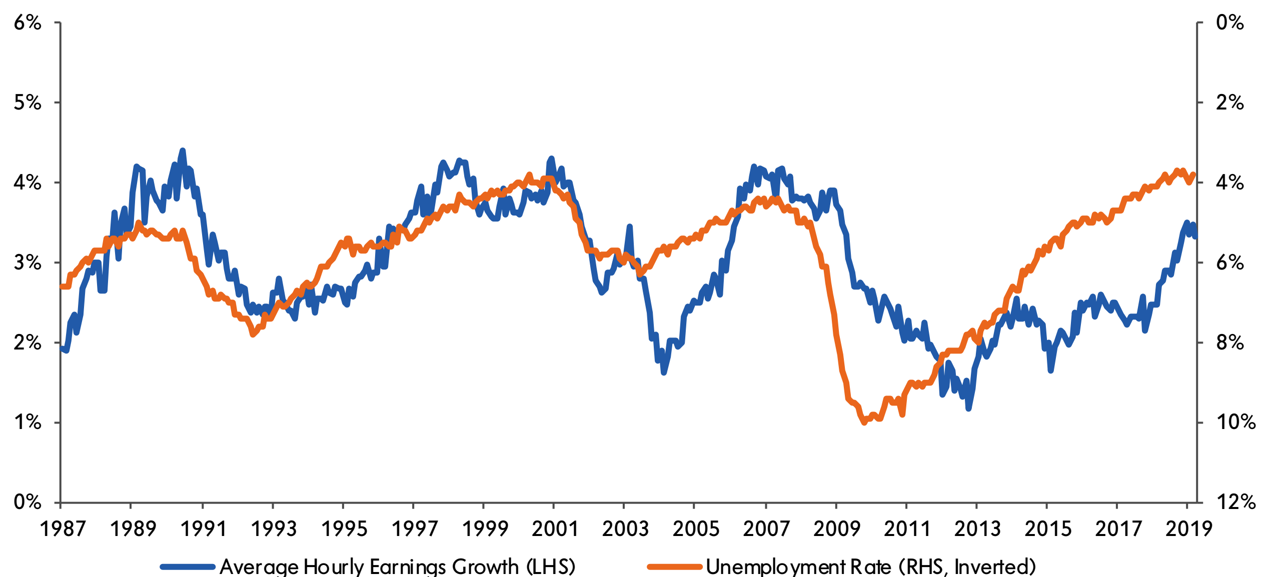
These are not areas where anyone should reasonably claim an edge in forecasting, but we still need a working assumption to move forward. Our assumption is that politicians will impair, not derail, economic expansion. True, the bilateral China-US trade dispute may generate a few more negative headlines, but there is light at the end of the tunnel and it is not a high-speed train. The two sides will be driven to reach agreement as the threat of not doing so becomes increasing evident in economic activity and financial market prices. We not only think that a deal gets done but that the outcome might also be a net improvement in trading relationships, with better protection of intellectual property rights and increased openness of Chinese markets. That said, global trade growth will be slower than its heyday before the Great Recession. Once the China-US trade dispute is pushed off stage, we assume the White House will not pivot to challenging the EU and Japan on auto trade. There is a confidential report about the national security implications of auto imports on the president's desk, so invocation of Section 232 restrictions cannot be ruled out. However, the tonnage of explosive powder on world activity that would be set off by an auto imbroglio probably makes even President Trump cautious. For the other working representative democracies, we assume checks and balances limit, to some extent, the ability of populists to damage their economies.

As for that non-working representative democracy consuming more of our attention than it produces of world GDP, the UK will most likely exit the EU in an orderly fashion in the fullness of time. However, the risks of a second referendum or new election have risen. A series of stories, probably apocryphal, sum up the situation. On the eve of St. Crisipin's Day, King Harry was advised to hold indicative votes on the best strategy at Agincourt, Queen Elizabeth heard similar advice when news hit that the Armada had set sail, and Prime Minister Churchill was told the same when it became clear that the Luftwaffe could reach London. All three demurred from repeated polling of the political elite and acted decisively, which is why the official language of England is not, respectively, French, Spanish or German. As of this writing, the official language of the UK government is remanded for Parliamentary debate.

This represents a benign enough global backdrop to permit the US to work through its cyclical dynamics in an orderly manner. That process is one of slowing. The 2018 pace of real GDP expansion at about 3 percent cannot be repeated without sending the unemployment lower than its already low level of 3¾ percent. Pressures on resources will mount, albeit slowly, as in the gradual growth of average hourly earnings as the unemployment rate goes down, shown in the chart below.

Average Hourly Earnings & the Unemployment Rate

12-Month Change



Source: Bureau of Labor Statistics and Federal Reserve Board, accessed via FRED.

Additionally, we think concerns about the US fiscal and current account deficits will weigh on the foreign exchange value of the US dollar. The yawning difference in monetary policy among the major central banks, with the Fed already through the exit door while the European Central Bank and Bank of Japan seemed unsure if there was one, dominated currency movements for a time. But that time is over, as the Fed is close to (but we do not think at) home and the others are thinking about the next steps. US dollar depreciation supports commodity prices and emerging market economies generally, spurs domestic inflation, and will be hard to stop once it starts in earnest.

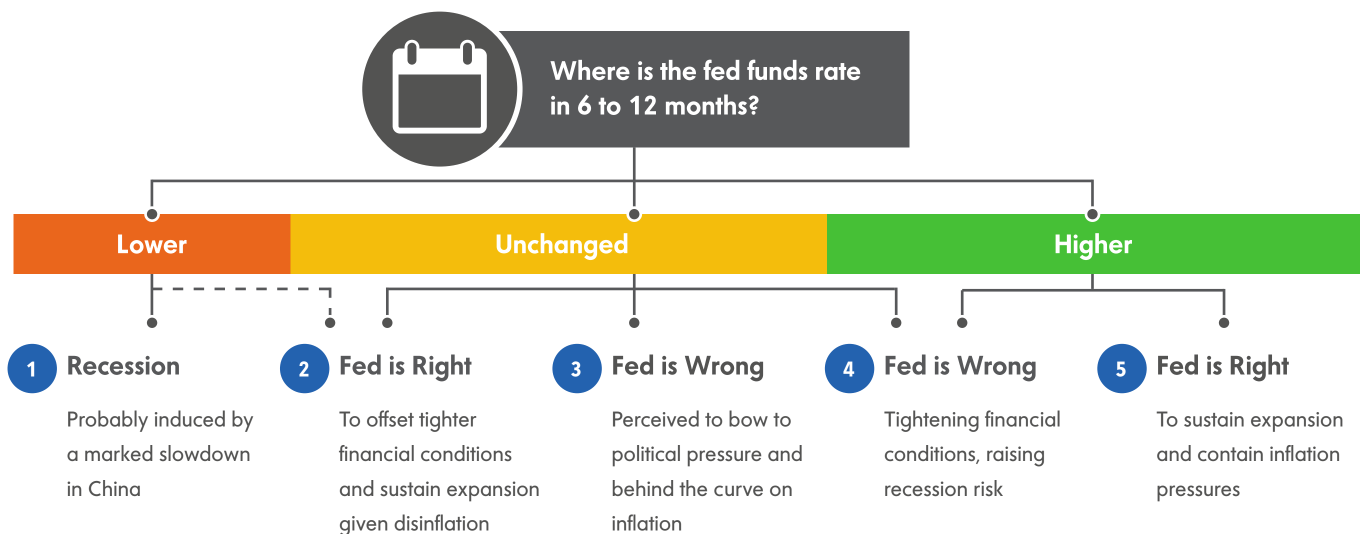
The Fed puts two speed bumps of additional firming, this year and next, in front of these exchange rate dynamics. Most of the disorienting pivot by Fed officials was about the communication, not design, of their monetary policy.

Fed Chair Powell learned that leading from the front of the pack makes you a target for investors and politicians. He dialed back guidance and coordinated a message of patience across the senior leadership of the institution. If patience is the watchword, the reasoning runs, the Fed will less likely be seen as prone to recession-inducing error. For the prior two years, the Fed tightened on the theory that inflation would rise given taut labor markets. Now, they will await evidence that the theory works.

We think the theory still works. Later this year, we expect cost and price inflation will tick higher, enough to turn investor sentiment away from recession and toward inflation risk. If this turn seems unlikely, explain the sea change in the prevailing view of the US economy in early versus late December. Pretty much the same people decrying quantitative tightening in December will be despairing at the behind-the-curve Fed in September.

Our discussion of risk management almost never lingers on point forecasts because risks are in the areas outside the central tendency. The decision tree below, which we have shown before, still helps to work though that process. Consider two questions that exhaust the logical possibilities. Where will the fed funds rate be in 12 months—lower, unchanged, or higher? Is the Fed right or wrong in that placement?

Potential Outcomes

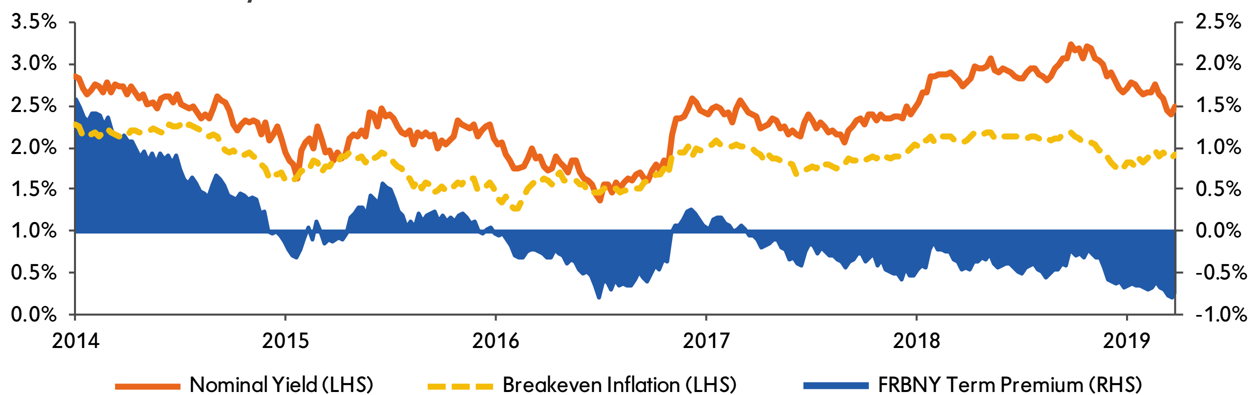


As of today, investors seem inclined to believe the Fed is correct to keep the funds rate unchanged for now and will lower it later in the year to sustain economic expansion given the evident lack of inflation (they are at 2). In our view, this honeymoon will linger until inflation materializes, and all the credit given to Fed Chair Powell for reticence will turn to doubt about subservience once there is a couple of upticks in costs and prices. Did the Fed push patience because it was “small-p” political and thought it advantageous to recede to the sidelines? Or was it “big-P” political with some senior officials jockeying to the pole position of presidential preference? We credit them for the former and believe they will wind up in the rightmost box of policy firming to sustain economic expansion. We suspect, however, that in the transition rightward along the lower boxes, markets will focus on the other, interim box that posits lack of resolution about inflation, before they get to the rightmost one of policy firming (this is the nasty trip across 3 and 4).

As for the transition and what can make it more abrupt, Yoda comes to mind once again. He advised that "Always two there are, no more, no less." In that regard, the President indicated his desire to have Stephen Moore and Herman Cain join the Board of Governors. Were that to happen, the communication of policy would become more haphazard and more weight would adjust to the "big-P" outcomes. We do not think both appointments go through, but the desire to do so is instructive about the pressure from the administration and doubts introduced in market expectations.

In our baseline, investors are currently underpricing the extent of Fed action and the pickup in inflation. The latter renders inflation breakevens attractive, and we counsel being short duration. As a note of caution, the Bureau of Labor Statistics is being innovative with its measurement of consumer prices, including "big data" and relying on single firms for scanner data. "Innovation" and "bureaucracy" are not good combinations, so we think that more idiosyncratic risk should be priced in than the norm.

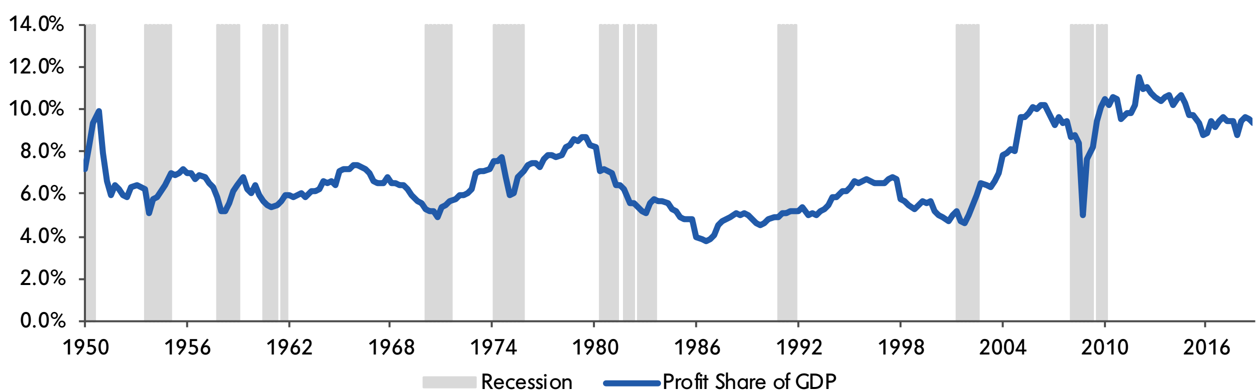
Ten-Year US Treasury Yields



Source: Bloomberg, accessed March 25, 2019.

The slowing of real GDP growth in the US might help sustain the economic expansion, but it casts a darker shadow on the corporate sector. Corporate profits track a much higher amplitude than GDP, seen in the distinct variations in the ratio of profits to GDP below. Our forecast has cost pressures showing only modestly through to prices, implying a squeezing of margins. This also suggests that the fundamentals for the corporate sector, although good now, will deteriorate, as will the earnings important for equity valuations.

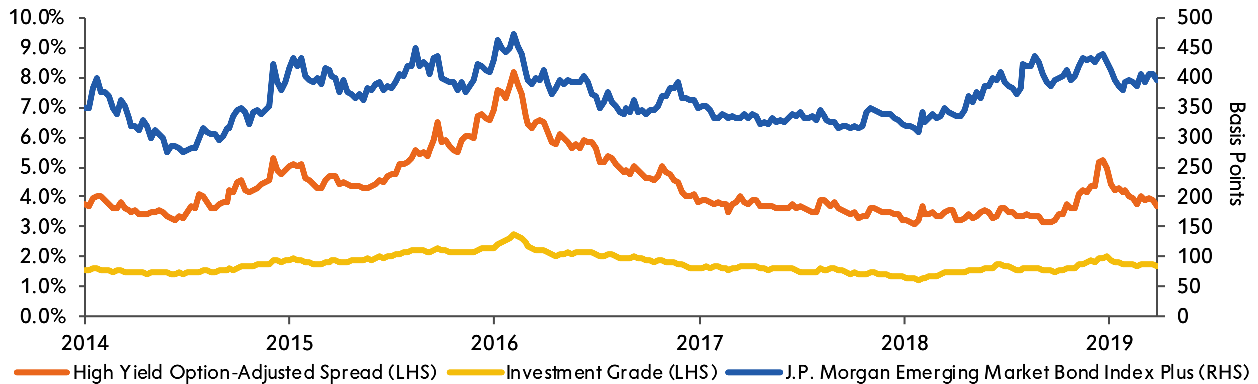
Corporate Profits as a Share of Nominal GDP



Source: Federal Reserve and National Bureau of Economic Research, via FRED. As of October 1, 2018.

If commodity prices hold, the US dollar depreciates, and global growth stabilizes, emerging market economies should look especially attractive. As for valuation, some space has opened up between their returns with domestic risk instruments, which we think will close to their benefit.

Selected Yield Spreads



Source: Bloomberg, accessed March 25, 2019.

Our advice is packed into a consistent investment landscape, as below. We summarize our views, which informs our valuation outlooks and the opportunities in the current environment. We end with another bit of wisdom from Yoda, who must have seen a lot in 900 years. His advice about planning ahead was, “Difficult to see. Always in motion is the future.”

Investment Landscape: March 2019

Economic Landscape

- Global economic growth, which unexpectedly slowed sharply at the beginning of the year, should rebound.
- Tailwinds to economic expansion include an ebbing of trade tensions, a more accommodative Fed and forceful Chinese stimulus.
- The level of DM activity will likely move further above its potential, adding to pressure on resources and corporate margins, and producing a modest pickup in inflation.
- In contrast to prevailing sentiment, we expect the Fed to tighten policy, albeit more gradually than we previously anticipated.
- Other DM central banks will remain dovish as long as the Fed is on hold.

Fixed-Income Valuation

- Sovereign DM yields are expensive, especially outside the US.

  Breakevens offer value and may provide inexpensive protection to upside inflation surprises.

  The US dollar appears expensive against other developed and emerging market currencies.
- Investment grade corporates are more fairly valued, especially at shorter durations, but fundamentals are likely to soften.

  With earnings growth expected to slow, high yield spreads are somewhat expensive.

  There is value in emerging market local currency and US dollar debt.

  While municipal securities have become rich, institutional investors are likely to find barbell strategies attractive.
- Interest rate volatility is low but will likely rise.

  Higher short-term Treasury yields provide attractive carry at the short end that will somewhat offset capital losses as rates rise.

  Securitized products, other than mortgage backed, are attractive.

Investment Themes

- Keep duration short to neutral in core developed market sovereign securities.
- Maintain short US dollar exposure, where appropriate, through option strategies given increased probability of tail risks.
- Maintain modest exposure to breakevens.
- Remain overweight in EM, both hard and local currency.
- Maintain current credit exposure and look for opportunities to emphasize quality and shorten duration.
- Maintain a modestly net long duration in municipal securities.
- Retain the modest underweight in MBS in favor of ABS and CMBS.
- Use option strategies with minimal cost to keep portfolios sufficiently convex.

Maintain a modest risk budget.

Vincent Reinhart

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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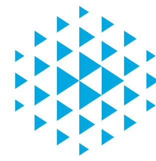

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