



October 2019

Economic & Market Observations: **The Right Stuff?**

Vincent Reinhart | Chief Economist & Macro Strategist



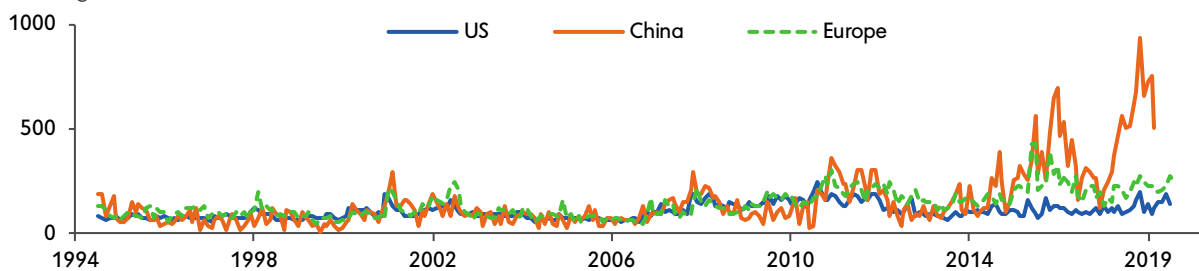
The 1983 movie *The Right Stuff* interwove the story of the Mercury 7 astronauts with highlights of Chuck Yeager’s career as a test pilot. The latter provides the dramatic depth and an apt metaphor for the economic policy of President Trump. (This, perhaps, may be the only time the President is put on par with the Air Force general). Midway through the movie, Yeager pushes his plane past Mach 2 for a new speed record and temporarily blacks out. The plane spins out of control and tumbles to earth as Yeager breaks the canopy with his helmet. With the ground close in sight, he regains consciousness, steadies the ship, and pulls out of the dive with seconds to spare.

President Trump has similarly managed to put an expensive piece of machinery in a corkscrew crash dive. It is called the global economy, which is being buffeted by his moves to restrict international trade and threats of more to come. Central to our economic forecast and assessment of financial valuations is the assumption that he is willing and able to pull up in time to avoid a flaming wreck by cooling his trade war jets.

We are sure about the way down. Measures of economic policy uncertainty culled from press clippings are at record high altitudes (yes, an altitude test is another scene in the movie). The Baker, Bloom and Davis measures plotted below are indexed to average 100 from 1985 to 2009. Their last three monthly observations average 160, 250, and 660, respectively, for the US, Europe, and China¹.

Economic Policy Uncertainty

Average 1985–2009 = 100

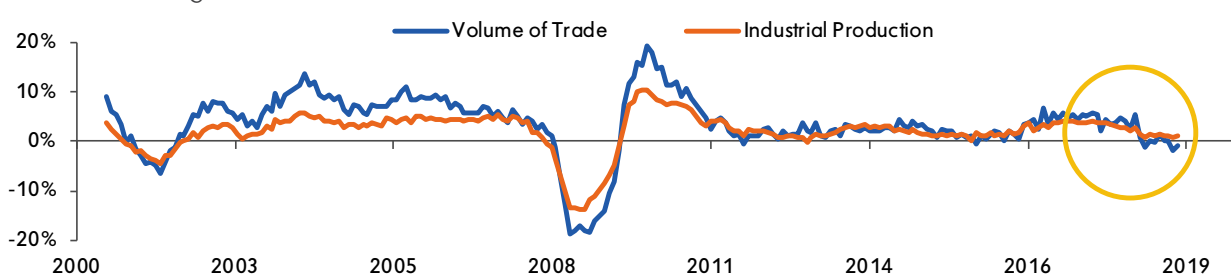


Source: Baker, Bloom, and Davis, accessed 10/1/19 via FRED.

Those elevated levels evidence concerns, in part, about the disruption of supply chains from the prior imposition of tariffs and, in part, the possibility of future trade levies. The former reduces output in the transition of rejiggering efficient production paths, adding to costs. The latter freezes business people in their tracks by increasing the value of deferring spending until the trade landscape clears. Through June, the volume of trade was 1.4 percent below its year-ago level (as depicted below).

Global Trade and Industrial Production

12-Month Change

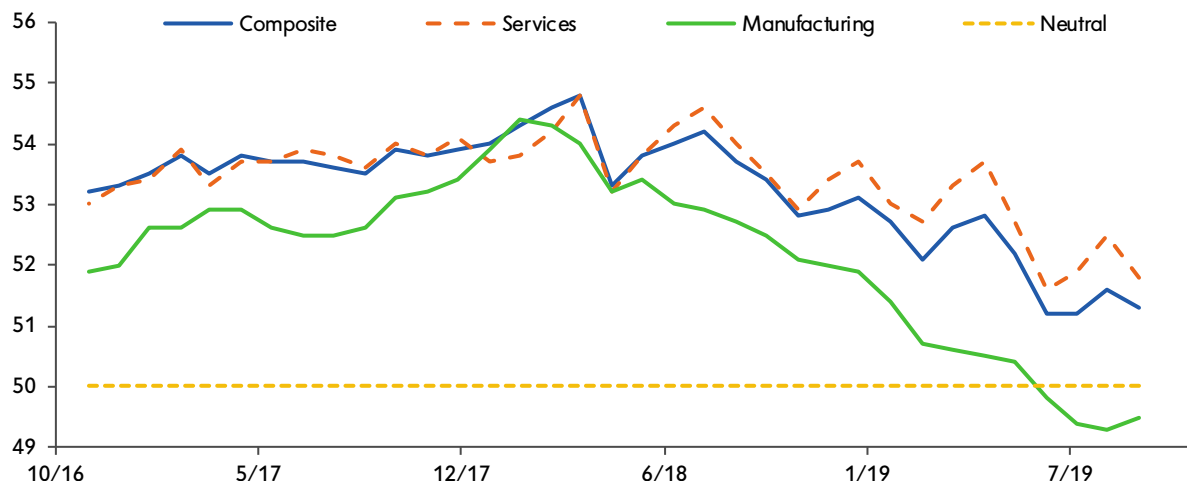


Source: CPB.nl, accessed on 10/1/19.

This shrinkage in volume is matched by price declines, implying a good-sized fall in nominal trade receipts. Not surprisingly, purchasing managers are a gloomy group. The order book of manufacturers worldwide is in contraction territory (below 50 in the following chart) and the composite index is held up only by expanding services.

MARKIT World PMIs (Seasonally Adjusted)

Neutral = 50



Source: MARKIT, accessed 10/1/19 via Bloomberg.

We have not, as yet, hit the eject button to our forecast that the US economic expansion will be sustained. Importantly, the trade dispute is more about goods than services and, therefore, is more consequential for our goods-centric trading partners than for us. This was already foreshadowed in the first figure: The perceived policy uncertainty in an economy maps well into its relative share of manufacturing (about 30% of value added in GDP in China, 20% in Europe and 12% in the US). We believe our relatively closed, service-producing economy can weather a few-quarters-long downdraft in global spending. However, the downdraft has to be limited in force and duration. Continuing weakness in the economies of our trading partners and in domestic manufacturing would eat into incomes, wealth and confidence over time. While the president is willing to fight on many fronts including Canada, Japan, Mexico and South Korea, with many weapons like tariffs justified on economic or national security grounds, quotas, and outright bans, the key dispute is between the first and second largest economies in the world—the US and China, which together control 40 percent of global GDP.

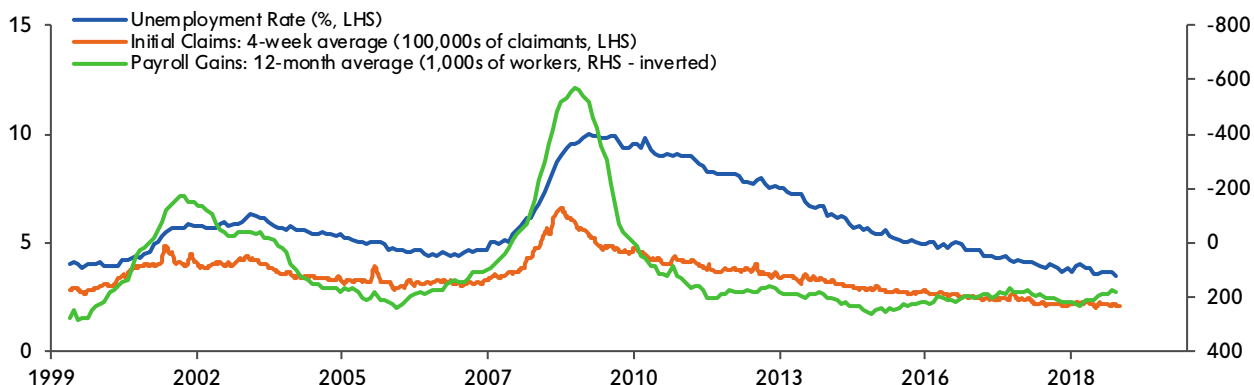
Here’s where Test Pilot Trump is critical to the plotline, which is easiest read backward. The president presumably wants to be reelected in November 2020. Those prospects are brightest if the US economy performs well in the first half of 2020. Extending the trade dispute for much longer in late 2019 jeopardizes that project. Self-interest, therefore, should counsel the president to seek a partial resolution to the US-China trade dispute sometime soon, lessening the drag on the level of activity so as to boost its growth rate in the most opportune time window. As an added bonus, an achievement on trade now would divert attention, for a time, from the impeachment row.

President Trump’s co-pilot, President Xi of China, must work with him, not against him. We believe such cooperation is in the Chinese president’s self-interest as well. Tariff and policy uncertainty weigh heavily on his manufacturing-dependent economy, and domestic policy options to offset the drag are somewhat constrained. The national balance sheet is already highly leveraged, the recently enacted tax cuts seem to have been mostly saved by cautious households, and currency depreciation would invite international criticism and may worsen capital flight.

In our view, a practicable deal would be limited in scope compared to the one mooted in May, as things have been said since that cannot be unsaid. Chinese negotiators have to put aside longer-term geopolitical issues (such as access to US technology for the tech-giant Huawei) and the US negotiators must accept that opening markets and better protection of intellectual property rights in China will be specified in administrative rules rather than legislation. A rolling back of some old tariffs (or at least not implementing new ones) as well as agricultural purchases by China would likely round out the deal. The outcome has two-sided risks of more closed or open economies than we have currently. However, the two nations will almost certainly remain wary of each other in future dealings.

The deal, trumpeted as tremendous, should help global markets, household and business confidence, and avoid self-inflicted wounds from two more rounds of US tariffs. Removing a negative to the outlook adds to the other forces supporting US economic momentum. Financial conditions remain accommodative, wealth is higher on net this year, and job gains bring with them income generation. Indeed, the labor market is in the “good place” that Federal Reserve (Fed) Chair Powell keeps citing. Monthly employment gains currently average about twice the pace that keeps the unemployment rate unchanged, the unemployment rate has drifted down to near an all-time low, and initial claims on unemployment insurance are inconsistent with a clear-and-present threat to the expansion.

Labor Market Utilization

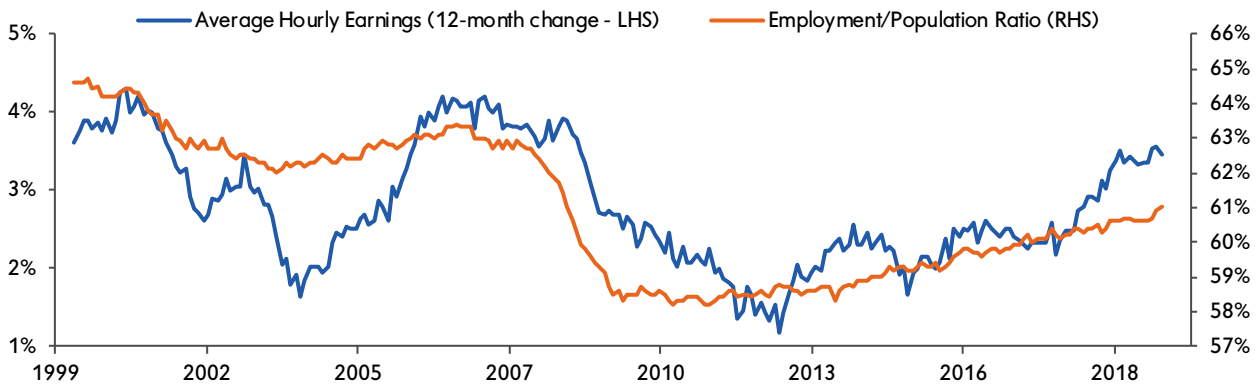


Source: BLS and Commerce Department, accessed 10/1/19 via FRED.

That said, the world is a risky place, and recessions tend to creep up suddenly and in a surprising manner. We could be wrong about politics—Presidents Trump and Xi may see their self-interest differently than we do. Or, the downward force of gravity on global manufacturing is already too powerful to avoid a crash landing. And, there are other hot spots around the globe that could get hotter. While this is not our base case, we put about one-third chance of recession next year.

Along the narrow path of our baseline, US real GDP expands at a 2 percent clip for the remainder of this year and next. True, this is slow by historical standards and represents a deceleration from 2018. However, last year’s pace was above that of potential real GDP. Should it repeat for an extended period, an already taut labor market would tighten in a manner that would invite an abrupt swing in monetary policy and threaten expansion. A cooling in real growth, instead, limits the extent of upward pressure on costs and inflation. In our forecast, as more of the population enters the workforce, the growth of average hourly earnings only creeps up. Those faster costs translate into faster consumer price inflation. As the past few years demonstrate, however, the relationship is loose, and depends on productivity growth, the extent of margin absorption, the prices of traded goods, and the anchoring of inflation expectations. We have penciled in a modest pickup in inflation that will put an end to the Fed’s easing cycle after one more quarter-point move.

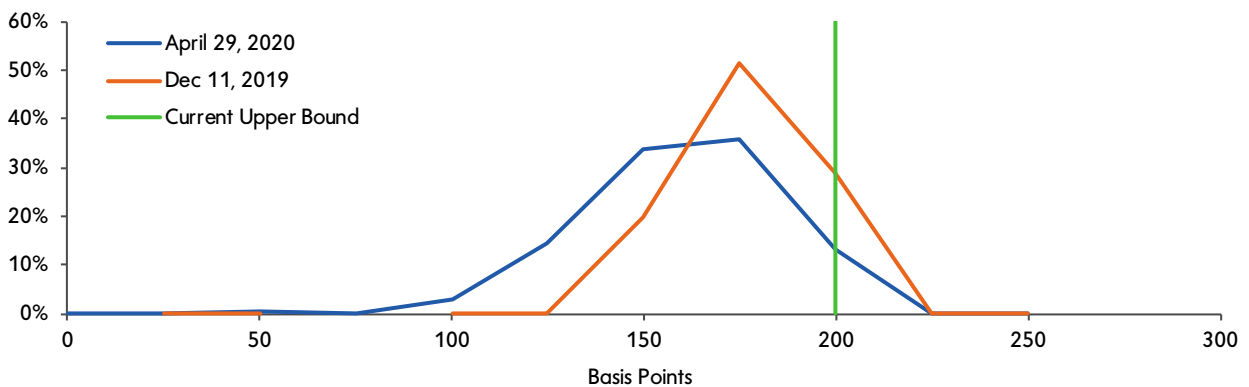
Labor Market Utilization and Average Hourly Earnings



Source: BLS, accessed 10/1/19 via FRED.

Our outlook does not actually give Federal Open Market Committee (FOMC) officials much reason to ease more. The global economy gets less gloomy after a key risk dissipates, labor markets tighten further, and costs and prices accelerate. In point of fact, the first assumption in that list undercuts the FOMC’s justification in its statements that insurance cuts were warranted as a consequence of the “...implications of global developments for the economic outlook.” However, a partial resolution of the trade dispute will probably not play out quickly enough in advance of the FOMC meeting at the end of October, and the Fed’s momentum in easing at its prior two meetings carries it forward. After all, monetary policy mostly follows Newton’s first law that a body in motion stays in motion and a body at rest stays at rest. That is why the Fed lingered so long at the effective lower bound to interest rates, why it tends to be slow on the uptake for a change in the direction of policy, and why its last action in a cycle tends to be looked upon with regret. Thus, we are a little more confident than most that the Fed moves imminently, but less so that they move more than that.

Implied Probabilities of Fed Action

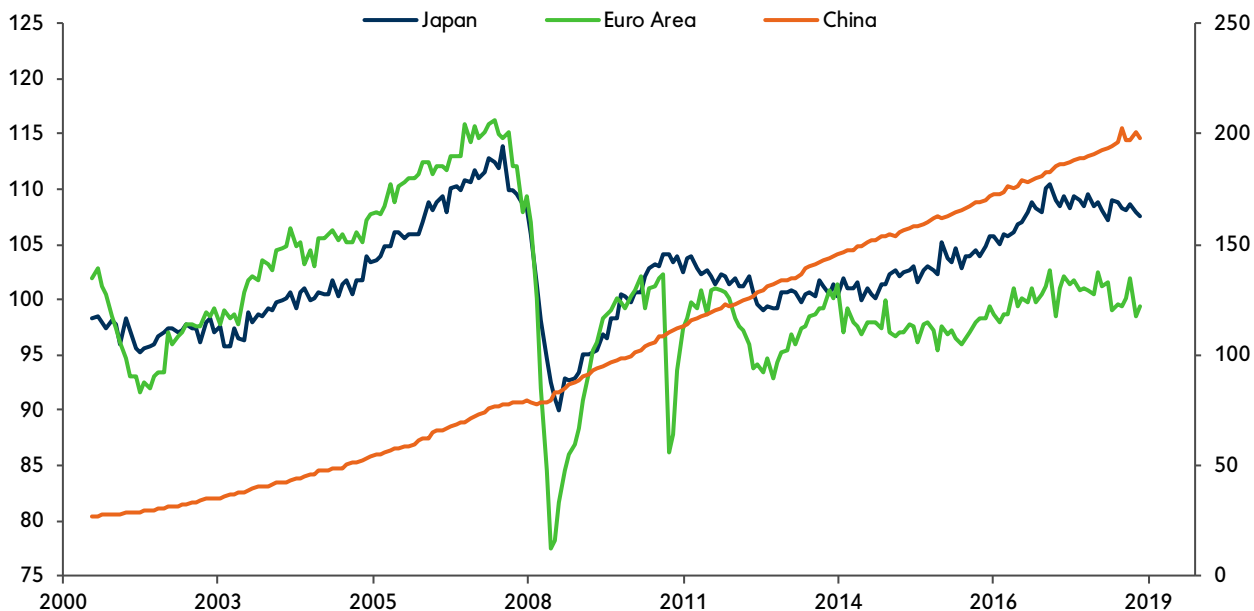


Source: CME Fedwatch tool. Accessed 9/23/19.

The turn in trade sentiment and the stimulus in the pipeline steadies Chinese real GDP growth at a touch under 6 percent next year. Such an outcome, after all, is what President Xi presumably hopes to gain by returning to the negotiating table, and it would extend the remarkable expansion of its economic base. Size matters, and an extended forecast would include incremental slowing in China’s rate of growth as coordination issues and leverage concerns accumulate, and as the rest of the world becomes somewhat less accommodating to Chinese ambitions.

Industrial Production

Index, 2010 = 100



Source: CPB.nl, accessed 10/1/19.

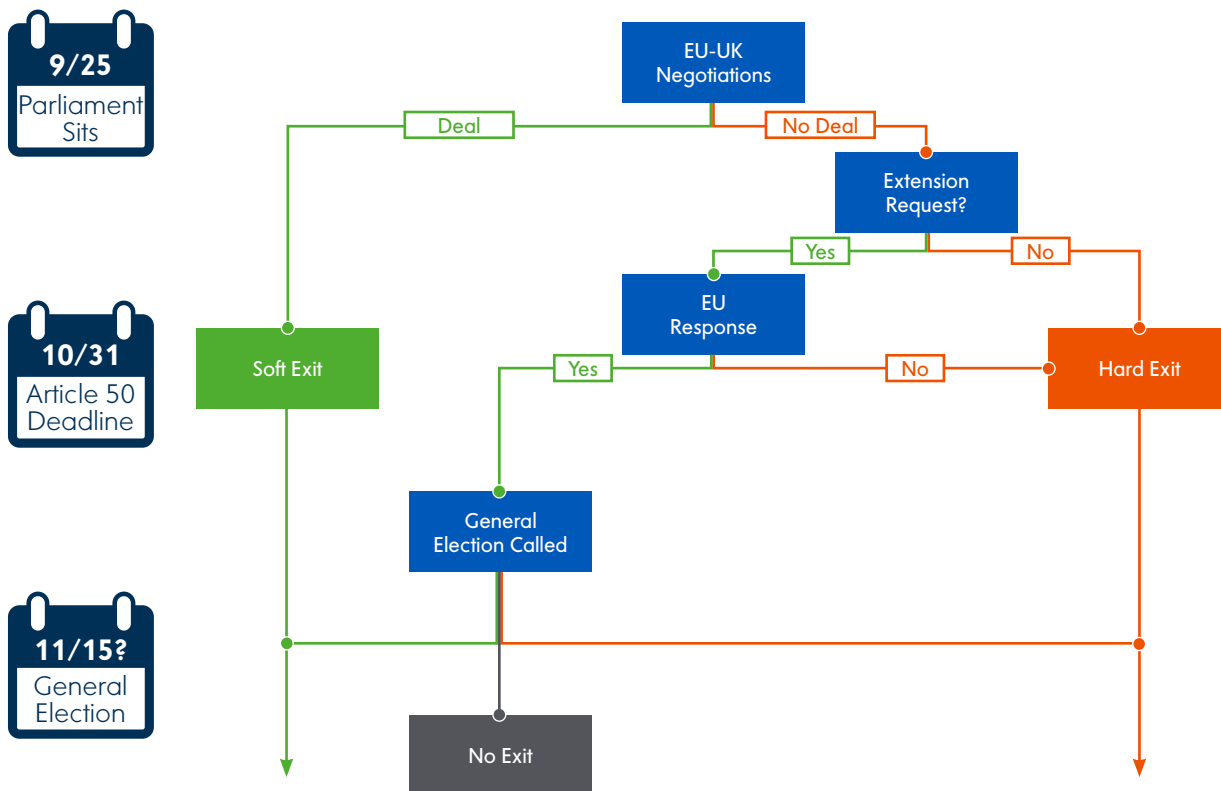
Manufacturing is crucial to many of the key economies on the European continent, making it difficult to be optimistic about the Euro area were the global economy to fall off the narrow path of our baseline outlook. The Euro area economy rebounds along the baseline though, because trade matters more there than in the US and modest incremental internal stimulus is in train. President Draghi leaves the European Central Bank in a position to deliver more monetary easing, albeit at the cost of committee comity. Fraying political coalitions also raises the odds of fiscal impetus in Germany and Italy that would allow France to tag along.

Japan is another trade-centric economy that would potentially benefit from a lessening of US-China tensions (although it is in a dispute of its own with Korea). Consumption trends and non-manufacturing firms' capital spending intentions (as in the Tankan survey) have held firm despite weakening external demand. There is no central bank where Newton's first law holds firmer than the Bank of Japan, and we expect it to keep its stance as accommodative as it can through multiple outlets of unconventional policy.

An irritant in *The Right Stuff* is that, interspersed in the gripping narrative of astronauts and test pilots are attempts at comic relief. Jeff Goldblum and Harry Shearer, normally no slouches at comedy, play bumbling bureaucrats at the fledgling National Aeronautics and Space Administration who intrude to no good effect. This brings us naturally to Boris Johnson, the Prime Minister of the United Kingdom, trying to extricate his nation from the European Union (EU) while leading a minority government that has been defeated at every turn.

The UK has already marginalized itself on the world stage, representing about 5 percent of global nominal GDP. Nonetheless, we have to work through the implications of Brexit because how it happens, if it does, matters for perceptions of risk and attitudes toward risk taking. The decision tree works out the plausible paths that politicians might meander along in the next few weeks.

Potential Outcomes of UK Deliberations on Exit from the European Union



Three dates are fixed. The EU leaders meet October 17 and 18, providing Johnson the last opportunity to cut a deal. Many times the Prime Minister has asserted significant progress during negotiations, and his EU counterparts shrugged in disbelief. There may be room to be flexible at the last minute about the “Irish backstop,” or how to police trade on an island when one part is in the EU (the Republic of Ireland) and the other is in the UK (Northern Ireland). An at-the-wire deal gets the UK out of the EU by the Halloween deadline.

Without delivering a deal from the EU summit, Prime Minister Johnson is required by law to request an extension of “Article 50,” which governs the exit, by October 19. The EU leaders must approve this unanimously. There is no apparent way to wriggle out of that responsibility short of breaking the law, and the EU is likely to grant an extension so as not to be blamed for a disorderly exit. Neither scenario should be ruled out, of course, as Johnson may be so fixated on exit to flout the law or so irritate with his EU counterparts that they just say no. The most likely case, though, is an extension, which will almost surely trigger an immediate call for a general election that will effectively be a referendum on exit.

The risk of it ending badly on Halloween is about as frightening as another extension followed by national dithering. For now, the UK enjoys financial accommodation pricing in high odds, but not certainty, of a messy divorce. If the divorce papers are served, either before or after an election, the Bank of England will likely view exit as an adverse supply shock. The EU, for all its tough talk, will not likely shut its borders to the UK in order to cushion its own economy from the shock. As a result, we expect a fast market reaction followed by a slow moving train wreck associated with the unraveling of supply chains and the transfer of the financial industry. At this point, however, we are not sure if it involves heavy rolling stock or model gauge “O.”

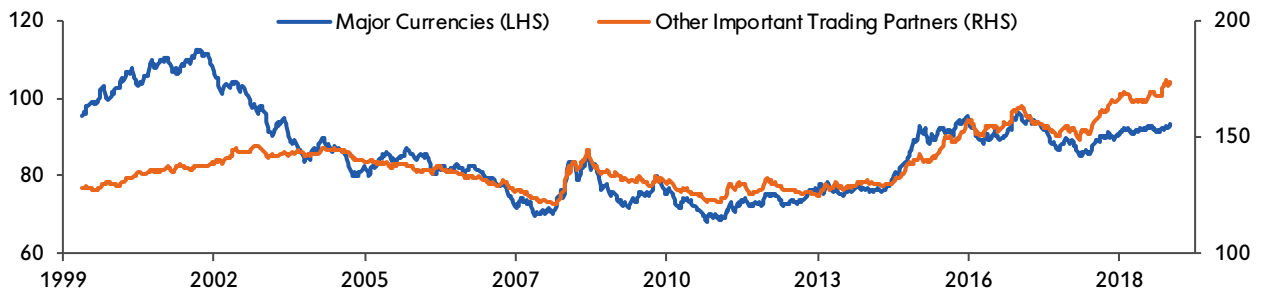
The central banks of the other Western offshoots, Australia, Canada and New Zealand, can only deviate from their larger counterparts for so long. Without inflation pressures and in the face of global uncertainty, they will focus on maintaining competitive currencies, although they will be watchful of their highly leveraged household sectors.

We expect mild economic expansion in Brazil this year. In 2020, privatization, tax reform and the removal of pension reform uncertainty should aid a recovery. Inflation remains low and expectations are well anchored below the central bank’s target. Mexico faces multiple headwinds, part external and part internal. Still, household consumption is growing and growth could get better footing if uncertainty about the US–Mexico–Canada Agreement were resolved.

There are many moving parts in this outlook, creating risks and financial market opportunities. We are relatively confident about a medium-term feature of the outlook. Concerns about the US budget and current accounts and a waning of safe-haven demands (if trade uncertainties abate) will weigh on the foreign-exchange value of the dollar. At some point, twin deficits matter. However, given the multiple risk events dotting the horizon, safe-haven demand may dominate for a time to come.

Foreign Exchange Value of the US Dollar

Index, 1997 = 100



Source: Federal Reserve, accessed 10/1/19 via FRED.

Sustained economic expansion and a weaker US dollar would support commodity prices generally, consistent with WTI oil prices varying in a range of \$50-\$70 per barrel. The upper band is enforced by the productivity of US shale oil producers. The lower level is more about the revenue needs of Russia and Saudi Arabia. The latter will be especially focused on keeping prices firm in the run-up to the initial public offering of a portion of the state oil company, hardening the bottom of the band.

WTI Crude Oil

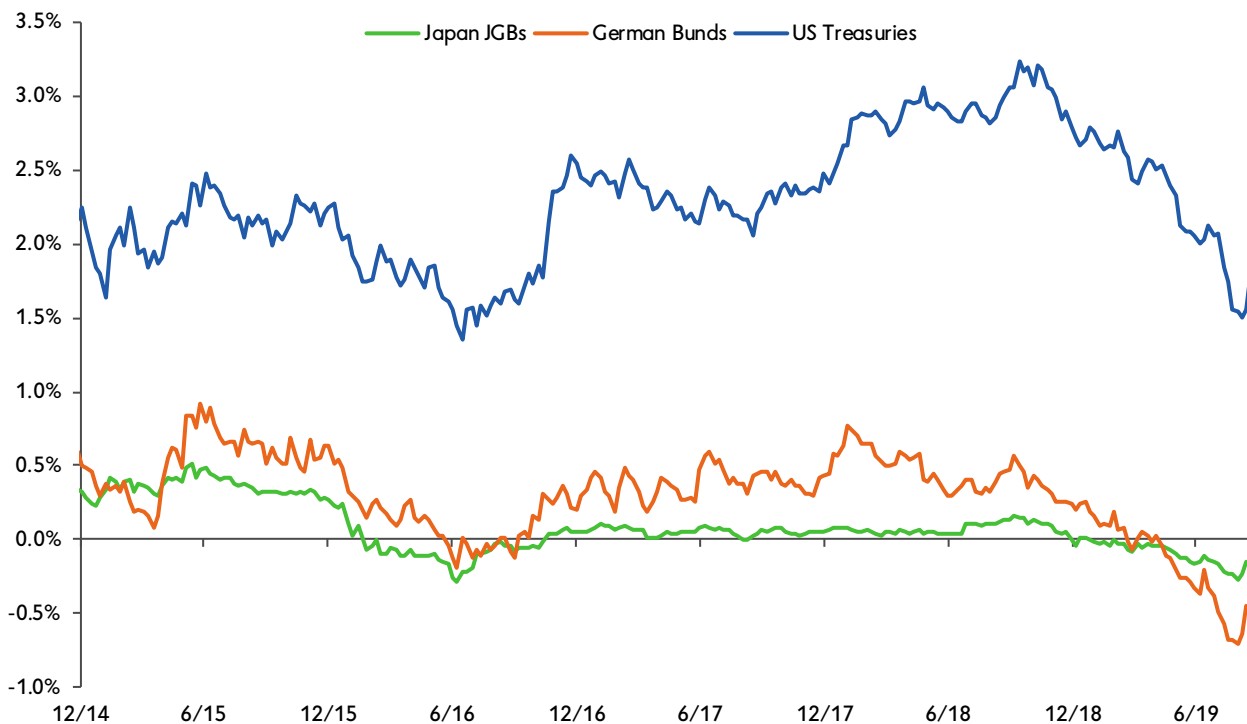
US Dollars per Barrel



Source: US EIA, accessed 10/1/19 via FRED.

If we are correct in our assessment that investors are overpricing the extent of Fed easing and underpricing the pick-up in inflation, Treasury yields are likely to rise somewhat. However, Treasuries are lonely in the pack of sovereign securities, given how many of that set “offer” a negative rate. This acts as a sea-anchor that should slow a rise in Treasury yields. As a result, a more straightforward way to express our view is to appreciate that breakeven inflation appears very attractive.

Ten-Year Sovereign Yields



Source: Bloomberg, accessed 10/8/19.

Slowing US real GDP growth will be associated with a more pronounced slowing in earnings growth. While investment grade corporate spreads are fairly valued now, fundamentals will likely soften. With earnings growth expected to slow, high yield spreads are somewhat expensive. There is value in emerging markets local currency and US dollar debt. All the while, recognize that the volatility of financial prices will rise.

Also recognize that, because risks to the outlook abound, we could fall off either side of our central tendency of surgical Fed easing and a political recovery in trade talk. One more quarter point of easing would prove insufficient if trade craters, pulling business and consumer confidence with it. However, it cannot be disregarded that we may be more than right about our political forecast. If President Trump finds friends among Xi and Kim, confidence might rebound more significantly. That is why there are risks to both sides of our forecast. It is also why, while we may start a conversation about portfolio choice based on the central tendency of our forecast, attention mostly focuses on the range of possible outcomes. Those conversations are summarized on the following page in our quarterly investment landscape. This maps our views on the economy (the left column) into a sense of asset price valuations (the middle column). Our investment themes (the right column) are ways to make those views actionable. For now, those opportunities are somewhat constrained by our conviction that it is best to maintain a modest risk budget.

The Investment Map: September 2019

Economic Landscape

The scale and scope of President Trump's disputes on trade pose a significant headwind to global economic growth.

While this creates a distinct negative risk to the economic outlook, our operating assumption is that political necessity will lead to compromise.

If so, the lessening of trade tensions supports aggregate demand, adding to pressure on resources and corporate margins and producing a modest pickup in inflation.

We expect the Federal Reserve (Fed) to ease policy less than the prevailing sentiment as long as politics does not derail economic expansion.

We believe the economies of major US trading partners will generally benefit more than the US from a diminution of trade uncertainty and their central banks will remain dovish.

Fixed Income Valuation

Sovereign developed market yields are expensive. Breakevens offer value and provide inexpensive protection to upside surprises to inflation.

The US dollar appears expensive against other developed and emerging market currencies over the medium term.

Investment grade corporates are fairly valued, but fundamentals are likely to soften.

High yield spreads are currently somewhat expensive and should similarly face a deterioration in fundamentals as earnings growth slows.

There is value in emerging markets local currency and US dollar-denominated debt.

Municipal securities are rich across the yield curve.

Valuations of mortgage-backed securities cheapened.

Other securitized products are attractive for their high-quality carry.

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.

Retain a slight overweight in emerging markets, both hard and local currency.

Maintain current credit exposure and look for opportunities to emphasize quality and shorten duration.

Multisector portfolios should be underweight municipal securities in light of valuations.

Be overweight quality securitized products.

Maintain a modest risk budget.

**Vincent Reinhart**

Managing Director, Chief Economist & Macro Strategist

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.

Endnotes

¹ This raises a finer point in interpreting these indicators of economic policy uncertainty. The policy shock is mostly the same across countries. The sensitivity of citizens in different economies, as reflected in news readership demand, is decidedly skewed.

Disclosure

Mellon Investments Corporation (“Mellon”) is a registered investment advisor and subsidiary of The Bank of New York Mellon Corporation (“BNY Mellon”). Any statements of opinion constitute only current opinions of Mellon, which are subject to change and which Mellon does not undertake to update. This publication or any portion thereof may not be copied or distributed without prior written approval from the firm. Statements are correct as of the date of the material only. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or not authorized. The information in this publication is for general information only and is not intended to provide specific investment advice or recommendations for any purchase or sale of any specific security. Some information contained herein has been obtained from third party sources that are believed to be reliable, but the information has not been independently verified by Mellon. Mellon makes no representations as to the accuracy or the completeness of such information. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment and past performance is no indication of future performance. The indices referred to herein are used for comparative and informational purposes only and have been selected because they are generally considered to be representative of certain markets. Comparisons to indices as benchmarks have limitations because indices have volatility and other material characteristics that may differ from the portfolio, investment or hedge to which they are compared. The providers of the indices referred to herein are not affiliated with Mellon, do not endorse, sponsor, sell or promote the investment strategies or products mentioned herein and they make no representation regarding the advisability of investing in the products and strategies described herein. Please see mellon.com for important index licensing information.

For more market perspectives and insights from our teams, please visit www.mellon.com.



MELLON

www.mellon.com

