December 3rd, 2018

Trade policy and Fed policy…what's driving the shift?

My how quickly things can change in terms of market pricing and investor sentiment. On the back of a 90-day truce on the U.S. / China trade front, risk assets are picking up right where they left off last week with a strong rally to kick off December, and last week was the best week of the year for the Dow (+5.2%) and the S&P 500 (+4.8%). Who would have thought a negotiation that resulted in a decision to restart future negotiations could elicit such a reaction? It was only seven trading days ago when the S&P 500 was in the midst of registering the second 10% correction of this calendar year. Even more troubling were the stats put out by Deutsche Bank two weeks ago showing that nearly 90% of global assets had generated a negative return through early-November in U.S. dollar terms – the first such occurrence in over a century.

For sure, some of last week's rally was driven by Fed Chair Jerome Powell's dovish speech at the NY Economics Club, but what does it say about markets where price action in either direction is so desperately tied to such subtle policy shifts? This is a rather important characteristic for all investors to consider and serves as a reminder that the manic market behavior that started at the end of January is still at play as we close in on the end of 2018. After all, what did we really learn from the two key events over the last week (Powell's speech and the Trump/Xi dinner)?

Starting with the U.S. / China trade war – what we know this morning is that there is a 90-day détente on future tariffs starting on Jan. 1, where the terms of the truce appear to be vague and the bar remains extremely high for the deep differences between these two countries to be resolved in such a short window of time. Bloomberg put out the best summary I've seen, comparing side by side the respective statements from the two nations:

U.S. STATEMENT (LINK)	CHINESE STATEMENT (LINK)
Tariffs on $200 billion of Chinese goods won't be raised on Jan. 1.	Wang Yi's statement says there will be no higher tariffs. Deputy Commerce Minister Wang Shouwen said separately tariffs on $200 billion of Chinese goods won't be raised on Jan. 1.
Those tariffs will be raised to 25 percent if a deal is not reached in the next 90 days.	90-day deadline not mentioned.
Not mentioned.	Both leaders asked their teams to speed up talks, work toward scrapping all tariffs and reach a mutually beneficial, win-win agreement.
U.S., China will negotiate immediately on forced technology transfer, intellectual property protection, non-tariff barriers and cyber theft.	U.S., China will work together to reach a consensus on trade issues.
China will purchase "very substantial" farm, energy, industrial and other products.	China will import more U.S. goods.
China will immediately restart buying agricultural products.	Not mentioned.
Xi will reconsider Qualcomm-NXP deal.	Not mentioned.
Bilateral visits not mentioned.	Trump, Xi will visit each other's countries at an appropriate time.
China will designate Fentanyl a Controlled Substance.	China will tighten supervision of Fentanyl, revise rules on the drug.
U.S., China and North Korea will work toward a nuclear-free Korean Peninsula.	China supports another meeting of U.S. and North Korea's leaders.
One-China policy not mentioned.	U.S. agrees to continue respecting One-China policy.
Market access not mentioned.	U.S. and China agree to boost market access.
Chinese students in U.S. not mentioned.	Xinhua story forwarded on Foreign Ministry WeChat account says U.S. welcomes Chinese students to live and study.

Perhaps the most objective view investors could take would be to just let this saga run its course and not pay too much attention to it over the next couple of months, as with most of these negotiations, not much seems to get done until the end of the negotiating window draws near. This isn't to say the powers that be won't be working towards their respective goals, but my view at the current time is that this is likely a false dawn and reality is likely to bite at some point after the turn of the year. One of the few concrete examples any of us can go off of as it relates to this administration's agenda on China is the "currency manipulator" file which was a campaign promise and was used as a threat early on in Trump's presidency, but it never gets invoked. I'm not taking a side on whether I think it's right or wrong to label China as a "currency manipulator", but rather am pointing out that it is a very complicated and nuanced process with wide reaching implications. The same framework should be considered by investors on the trade file.

The other market moving event last week (and a subject area that I feel much more comfortable opining upon than I do global trade policy) was Fed Chair Powell's speech in New York. After having some time to parse over the speech a couple of times, I'm of the view that there really wasn't that much of a significant change in tone. One market data point ratifying this view is the front-end of the Treasury yield curve, where one would expect that if the Fed was making an about face then the 2-year T-bill yield wouldn't be higher today than it was the morning of the speech. After all, this is the market instrument that is most sensitive to Fed policy actions. But perhaps it's signaling nothing more than that the Fed is nearing the end point of its rate hiking cycle, but the Fed remains some ways away from actually cutting interest rates.

It's important to go back to comments Powell made on October 3rd in order to gain a greater understanding as to why markets had the euphoric reaction they did to his comments last week.

> *"The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore."*
>
> *"Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral…We may go past neutral, but we're a long way from neutral at this point, probably."*

Some argue that this hawkish language was what sparked the October sell-off as markets didn't take kindly to the idea that the Fed was "a long way from neutral" and that they "may go past neutral". The thought was that such an aggressive posture would usher in even more restrictive monetary policy, when already the highly interest rate sensitive parts of the economy, like autos and housing, have been experiencing material weakness.

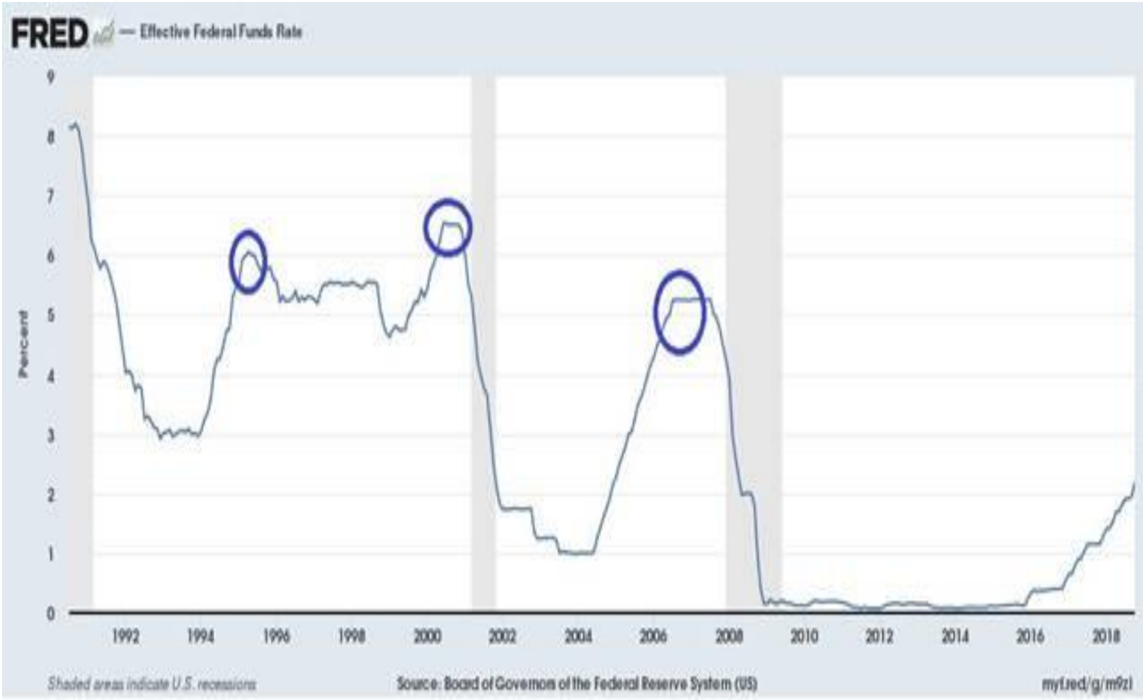
Fast forward to last week's comments from Powell, where the key verbiage that the market liked was as follows:

> *"Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy – that is, neither speeding up nor slowing down growth".*

So, he went from "well below neutral" to "just below the broad range of estimates of neutral" – to grasp this distinction it requires the knowledge of what the FOMC committee estimates the neutral range to be, which is 2.5% – 3.5%. Those less inclined to just take the Fed's word on what the neutral range could be could use history, math, and a bit of analysis to come up with an estimate. Since the 1980's and on through the present, the 10-year Treasury bond has yielded about 2% to 2.5% above the rate of real GDP growth, and has been roughly equal to nominal GDP Growth. Treasury bill yields have typically stood at 0.5% to 1% above real GDP growth, but slightly below nominal GDP growth. Even if one assumes that real GDP growth will push towards 2% annually, those figures suggest that a neutral Treasury bill yield would reasonably fall in the area of 2.5% – 3.0%.

So, with the fed funds rate in a 2% to 2.25% band right now, rates are between 25 – 50 basis points below the low end, and rates are still about 75 – 100 basis points shy of the midpoint. I fail to see how this updated view is so much different than the comments made on October 3rd, but it sure resonated with the equity markets, and that matters a whole lot more than what I think.

However, I do think it is wise for investors to exercise a bit of caution in getting too far out over their skis in terms of pricing the Fed out of any additional hiking beyond the December FOMC meeting. History shows that the Fed has never (not even once) completed a tightening cycle without taking the funds rate above neutral. Another item to consider for all the stock market cheerleaders is the history of Fed pauses and how in hindsight they haven't exactly turned out to be a good thing for equities or the economy. Circled on the chart below are the last three times the Fed paused or outright finished its interest rate hiking cycle, with the pause in the mid 1990's being the only occurrence that wasn't followed by a bear market and economic recession within 12 – 18 months.

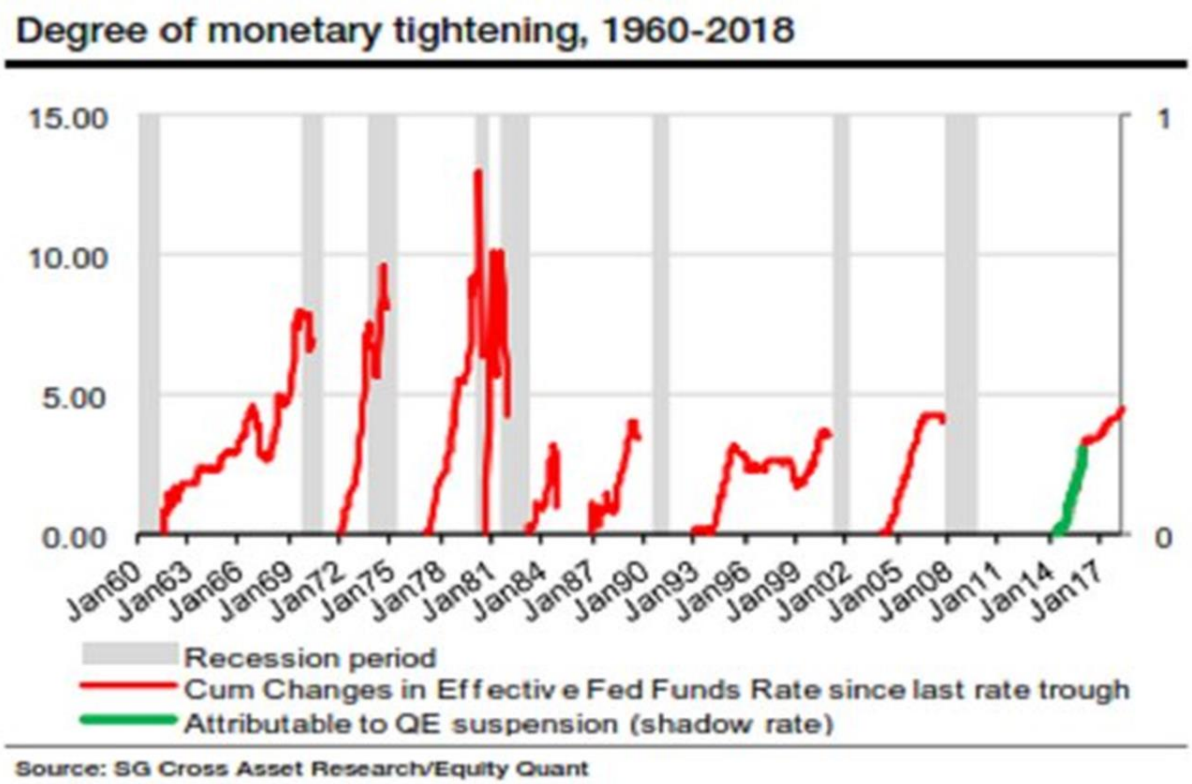


Something else to consider is how the stock market reacted to what amounted to being a marginal spin of the dial by Powell last week. I took a look back at the last cycle (and yes, no two cycles are exactly alike) to see how markets reacted to Fed action deep into an economic cycle – like the late-cycle set up we find ourselves in today.

- August 17, 2007 – Fed announces a 50-basis point cut to the discount rate to 5.75%. The Dow rallied +233 points, or 1.8%
- September 18, 2007 – Fed cut the fed funds rate by 50 basis points to 4.75%. The Dow was up +336 points, or 2.5%. The equity market peak was only a few weeks away.
- December 21, 2007 – the Fed initiates bi-weekly Term Auction Facility auctions (TAF) to bolster market liquidity. The Dow gained +205 points, or 1.6%.
- January 23, 2008 – The Fed cut both the discount rate and fed funds rate by 75bps. The Dow ripped by +299 points, or 2.5%.
- January 31, 2008 – The Fed cuts both the discount rate and fed funds rate again, by 50 basis points this time. The Dow jumped by +207 points, or 1.7%.
- March 11, 2008 – The Fed created the Term Securities Lending Facility (TSLF). The Dow surged by +416 points, or 3.6%.
- March 18, 2008 – Fed cuts rates by 75 bps, cuts the discount rate by 75bps to 2.5%. The Dow rallied by +420 points, or 3.5%

You get the point – it's the market's disposition to celebrate the handholding of the authority that controls the price of money. For those of you less familiar with economic and market history, in the last cycle, the market peaked in early October and an economic recession commenced in January 2008. So all of the relief ushered in by the Fed taking accommodative action wasn't enough to stop the contractionary forces that were already set in motion. We could go through the same exercise for the 2001 – 2002 period, but I'll save you the time. The moral of the story is that when you get late into an economic expansion and the Fed pivots from tightening policy to pausing or easing policy, it's not a healthy development and should make anyone paying attention ask the question of…"Why?" What are they seeing that the masses may be missing?

It's still early days in assessing the full impact of the Fed's current tightening cycle, and this is a point Powell made sure to mention in his speech last week: *"We also know that the economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized."* This is yet another key concept for investors to keep at the forefront of their thinking. Even though this tightening cycle seems muted with eight hikes thus far (which has only taken the fed funds rate to a range of 2% – 2.25%) and a hiking cycle that has been drawn out over the course of 3 years, but the Fed has also been contracting its balance sheet which some economic models estimate is equivalent to an additional 300 basis points in tightening.



Let's consider a hypothetical where the Fed may in fact hike for the last time this cycle in December, but leave its balance sheet contraction schedule in place. At a $600 billion annualized pace (according to Bernanke's own math that he laid out when implementing QE 2, which amounted to $600 billion in asset purchases) this is equivalent to a 75 bps to 100 bps hike in interest rates. None of the economic expansions going back over the last four decades have survived this level of tightening without succumbing to an economic recession. This isn't something to fear, but more so something that should be proactively prepared for, in that recessions are inevitable facts of life and this is yet another cycle where monetary policy stayed too loose for too long only to be upended eventually by over-tightening. Forewarned is forearmed.

It makes sense for investors to be asking themselves how it is that in a matter of six weeks, the narrative coming out of the majority of Fed speakers who have been hitting the speaking circuits has shifted in such a manner, from an economy that is extremely strong and required additional tightening to one where any additional hikes are data dependent. Perhaps the yield curve is sending the right message with the 10/2s melting down to 18 basis points today with parts of the short-end flirting with inversion. Or maybe it's the slate of housing data from starts, to permits, to sales all turning down at a double-digit annualized pace over the last three months. What does it tell you to see General Motors and Ford both announcing significant layoffs over the last several weeks – the individuals running these companies are making these decisions based off some knowledge of their future demand prospects, right?

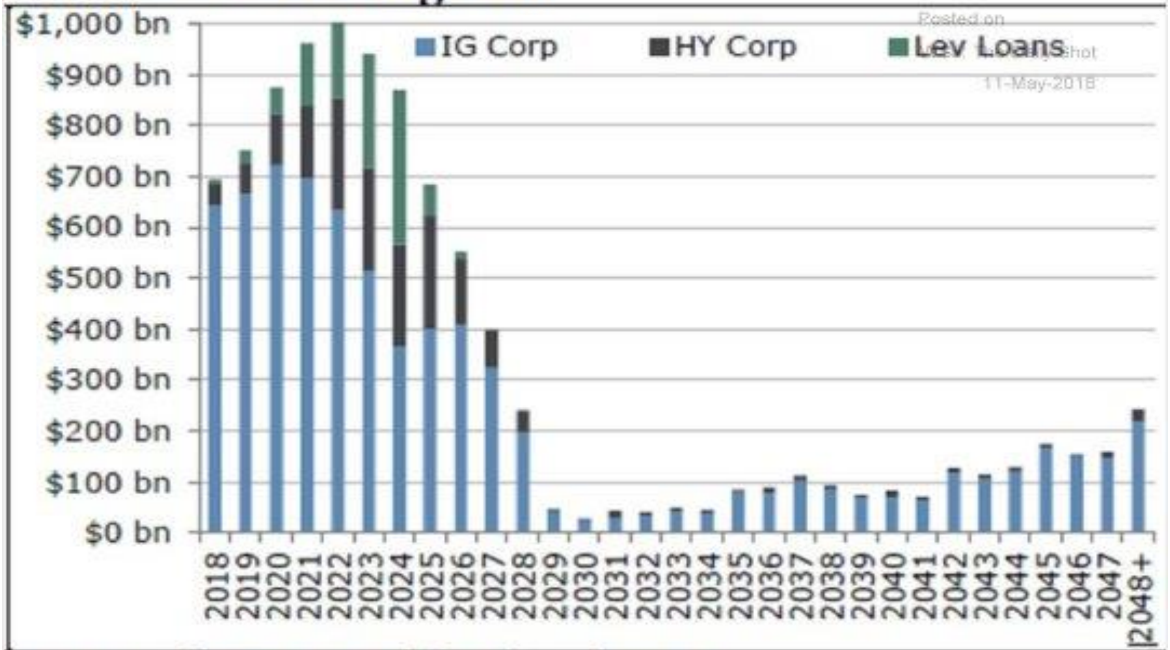
Alright, I don't want to get too far down the rabbit hole of negative data as I expect there is going to be plenty to scribble about on this subject in 2019. It's still too early and inconclusive to have a high degree of confidence or conviction that an economic recession transpires in 2019, but what is less open for debate at the current time is that growth is set to slow in a meaningful way. As of today, the St. Louis Fed Nowcast model is calling for 2.3% real GDP growth in Q4 and this is below both the New York Fed's 2.5% estimate and the Atlanta Fed's 2.8% forecast. These aren't concerning levels of economic activity, but they do indicate a meaningful slowing from the 4.2% level in Q2 and 3.5% level in Q3.

This growth slowdown is something the stock market has been pricing in for almost two quarters now and in a more intense way since Q4 began. So far this quarter, only four of the eleven sectors that make up the S&P 500 are positive (Utilities +6.65%, Consumer Staples +4.41%, Real Estate +4.3%, and Healthcare +0.27%) – all considered defensive, low beta, stable sectors. On the flip side of this strength is weakness in Energy (-10.77%), Technology (-7.8%), Industrials (-6.4%), and Consumer Discretionary (-6.15%) – the cyclical, momentum, high growth areas that led the market early in the year when the consensus view was all about globally synchronized growth are all lagging as global economic growth weakens.

So yes, I'm happy to see the equity markets more than unwind the Thanksgiving Week Massacre and set the stage for an early Santa Rally, but I continue to view these rips as nothing more than an opportunity to cleanse portfolios and reposition into what is looking likely to be a challenging 2019. I continue to view 2018 as nothing more than a prolonged topping process in the U.S. equity markets where the S&P 500 (even after this massive rally) still trades below levels it reached in late January. The strong rally over the last several weeks has done nothing to sway this opinion, especially with the array of non-confirmations from other economic and market variables: credit markets have drastically lagged the appreciation in the stock market, the U.S. dollar continues to hover near its 2018 highs, long-term Treasury yields have declined for four consecutive weeks, and global economic data continues to slide.

One last point on the credit markets as it relates to stocks, and that is the record $1.2 trillion that is estimated to be returned to shareholders this year in the form of dividends and buybacks. Let's just say it is highly probable that this will set the high-water mark for this cycle and these cash flows will have to compete with increased input costs, wage growth, and rising interest expenses in 2019. Keep in mind the growth that has taken shape in the corporate credit space this cycle, where 50% of the investment grade credit market carries a BBB rating (one notch above junk bond status) and it's estimated that 30% of this $3 trillion in BBB credit has debt/EBITDA ratios consistent with junk status. These companies will pull out all the stops to keep themselves from being downgraded to junk status which would meaningfully increase their cost of capital, and if that means halting stock buyback programs and slashing dividends, that's what they will do. The graph below details the refinancing wave that will see nearly $4 trillion in corporate debt have to be rolled over or retired over the next four years.

Exhibit 6: Maturing Debt



Source: Wells Fargo Securities, Bloomberg L.P.

This also calls into question the extent to which S&P 500 profit estimates are trimmed in 2019 with consensus estimates for S&P 500 earnings already having come down 2.6% for Q4 (the largest cut in two years), and just think when we get into Q1, multinational companies will be looking at comping a U.S. dollar that is up 8-10% year-over-year. That's a tough task in aggregate for the S&P 500 that still derives approximately 45% of its earnings from overseas.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

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