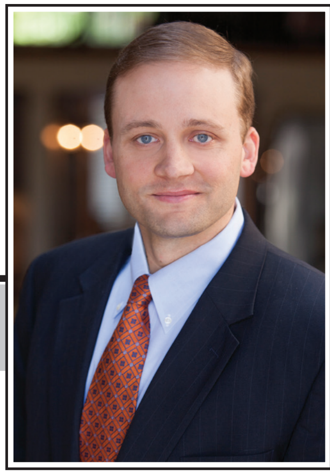
Sterling Advisors

THE MARKET MATTERS

August 2019



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In the Cut

With the arrival of August, the U.S. economic expansion turns 122 months old. Its origins date back to June 2009 (National Bureau of Economic Research). That means we're officially living within the longest period of uninterrupted GDP growth in the history of the United States. That's a notable milestone. But this period of prosperity comes with a few caveats. For one, the pace of growth has been lackluster. As we ascended from the depths of the financial crisis, one would have expected a more V-shaped rebound. Instead, that graph looks more like an "L" with a slight lean backwards. Unemployment has simultaneously approached all-time lows, but the robust hiring trends have failed to generate the commensurate wage gains one would expect. That has contributed to the low inflation environment and the declining labor force participation rate (i.e., individuals either working or actively seeking employment). Additionally, these tepid trends have emerged despite the backdrop of unprecedented monetary stimulus and steep tax cuts.

The mixed signals sent during this expansion make it feel more fragile than previous ones. It has fostered trepidation among businesses and consumers not typically associated with a decade-plus of positive GDP and all-time highs in U.S. equity indices. Perhaps the hesitancy comes as a result of the scar tissue left behind by the Great Recession. If the events of the financial crisis permanently instilled more caution and care among investors and borrowers, that would be a healthy benefit of going through the late-2000's many challenges. But that's probably being overly optimistic about our collective memories. What's more likely is we've become excessively dependent upon the U.S. Federal Reserve to sustain bullish equity outlooks and keep the U.S. expansion on track – and the Fed knows it. The Fed's impact now spreads far beyond U.S. interest rates and a fixed income-specific narrative. The Fed is perceived as the tide that raises and lowers all boats.

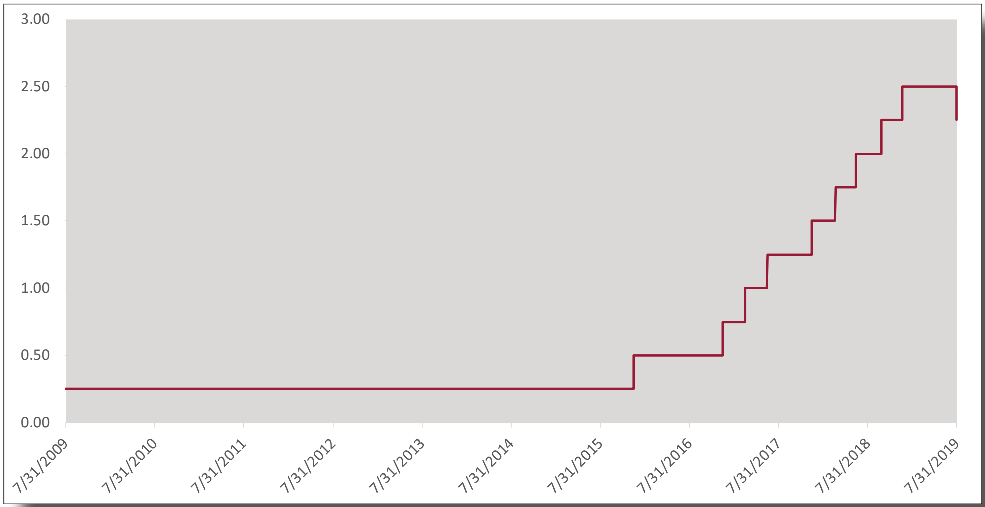

Chart 1. The Fed funds rate (upper bound, %) over the past 10 years Source: Bloomberg

These factors contributed to the pressure on Fed officials at the July 31st Federal Open Market Committee (FOMC) rate decision where it reduced the Federal funds rate for the first time since 2008. We believed a rate cut in the context of strong jobs data and low-but-stable inflation was an unnecessary precaution. The narrow distance between where the Fed funds rate is today and the zero-bound means the Fed must view each basis point as invaluable. Policymakers must also remain fully dependent upon incoming data for its decision-making. In our opinion, recent data is asking for patience, not uber-accommodative action. Overly dovish policy increases the risk of asset bubbles and feeds into investors' addictions to monetary stimulus. So what forced the Fed to stare down these risks and ease policy anyway? Our suggested reasons:

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Market Pressure – At the end of last year, the Fed not only raised the Fed funds rate, but also signaled more tightening to come in 2019. It did so despite slowing growth, stagnant inflation, and escalating U.S.-China trade tensions. With the 16% pullback in the S&P 500 Index (Bloomberg), investors made it clear they believed the Fed was making a big mistake. Fed Chair Powell, trained in the Bernanke and Yellen eras, doesn't want to fuel tantrums in U.S. markets. With their revolt at the end of 2018, U.S. equity investors placed a great deal of pressure upon the Fed and its policy guidance. The central bank was going out on a limb to deliver rate hikes that virtually everyone believed were unnecessary. By March 2019, the Fed had completely capitulated to the market consensus and walked back its previous plans to tighten. Many Fed officials have all but said they had made a mistake in December. By June 19, market participants had priced in a 100% probability the Fed would cut rates at the July 31 meeting (Bloomberg). The Fed delivered on these expectations to avoid the tantrum in U.S. markets that would have ensued had the Fed not given investors the rate cut they demanded. The market will always want lower rates and more accommodation. At some point, the Fed will have to say 'no' to the clamoring herd. However, the July 31 FOMC rate decision and Powell's press conference made it clear that's not happening anytime soon.

Globalization – The world's most prominent economies have reached an unprecedented level of globalization. Our fates have become inextricably intertwined. To an increasingly high degree, the U.S. feels the impact of flagging growth and confidence in places like the European Union. As Eurozone manufacturing contracts as a result of rising tensions with the U.S. and its other trading partners, it creates a ripple effect worldwide. Ditto for the U.S.-China trade standoff. Japan's three-decades of stagnation remove potential growth from the global system. Although the Federal Reserve is tasked with U.S.-centric objectives, economic globalization makes it virtually impossible to ignore international developments when striving to meet those mandates. It's an extremely difficult balancing act. The rise of nationalism and protectionism reduce the coordination between the world's policymakers, thereby hampering their ability to respond potently to deteriorating growth outlooks. Central banks are acting in a vacuum at a time when their reliance upon each other has never been greater. In the Fed's mind, the threats to global growth required a response from the world's most powerful central bank.

Deflation – Deflation is a vicious beast, one with which the Fed does not want to tangle. Although the idea of falling prices sounds nice, it can begin a cycle that is very difficult to reverse. In short, consumers begin to expect prices to be lower in the future so they postpone purchases. That leads to lower current demand, which can lead to layoffs and rising unemployment. That further lowers spending and leads to an increase in defaults and financial difficulties for families and businesses. This is a scenario monetary policy alone can't solve. Being in such a low inflationary environment – and therefore in close proximity to deflation – is enough to keep the Fed up at night. Especially given the slowing growth and demand around the world. We need some inflation because it encourages spending today with the expectation prices may be higher tomorrow. It keeps the growth engine running. The fallout from previous deflationary periods is playing into the Fed's staunch dovishness in 2019. But the Fed better be careful. It reduces its ability to respond to future developments with each rate reduction.

Trade Uncertainty – We have addressed the futile nature of trade wars. Bottom line: everyone loses. Heightened trade tensions are clouding economic outlooks, decelerating manufacturing activity worldwide, and severely damaging new business investment. None are more damaging than the ongoing stalemate between the U.S. and China. President Trump is hammering the Fed to lower rates to support the expansion. But nothing is weighing on U.S. growth more than the prolonged trade battle with China. It's forcing potential activity to the sidelines until some clarity on the trade front is provided.

The Fed focused on these factors at the July 31 FOMC decision and lowered rates despite conditions not fully calling for it. In doing so, it limited its ability to react should U.S. and global data continue to deteriorate. It also further enabled a market that feels it can have its monetary stimulus on demand. At some point, the Fed is going to have to be the bad parent and say 'no.'

Some tantrums are unavoidable.