Sterling Advisors

THE MARKET MATTERS

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When Trump and Powell Collide

We are destined for a historic showdown in 2020. No, not President Trump versus the eventual Democratic Party nominee; though next year's U.S. presidential race will certainly be a gloves-off battle for the White House. If either Senator Elizabeth Warren (D-Mass.) or Senator Bernie Sanders (D-Vt.) earn the Democratic nod, the election will be charged by two diametrically opposed visions for America – socially, economically and politically. The stark contrast between the GOP's current agenda and many of the Democratic Party's viable contenders will foster a great deal of policy uncertainty as Election Day approaches – particularly if it's a tight race. We'll closely analyze the proposed economic platforms and their potential impact once we have our nominees in hand. In the meantime, however, 2020 already has two titans ready to square off against one another. The events of 2019 have made a public conflict between Trump and U.S. Federal Reserve Chairman Jerome Powell all but inevitable.

Let's take a quick look back before discussing the future. President Trump's trade war mixed with the Fed's 2018 rate hikes put the U.S. economy under significant strain as that year drew to a close. Then, in early 2019, the attitudes within the White House and the Eccles Building changed dramatically. On the trade side, the stresses in global manufacturing, GDP and each country's stock market became too painful for Trump and Chinese President Xi to ignore. That forced Trump and Xi to hit the pause button on their escalating tensions to create a safe space for more productive talks. On the Fed side, these factors coupled with disinflation and poor business capital spending trends forced the Fed to acknowledge what we already knew – it had tightened too far, too fast in 2018. Enter the infamous "Fed pivot" that ultimately gave way to three rate cuts in 2019. Those three cuts removed 75% of 2018's policy tightening. Plus, the Fed not only ended its balance sheet reductions, but it ultimately added holdings through U.S. Treasury bill purchases in support of the repo market. The Fed balance sheet is growing yet again, re-topping $4 trillion in October (Federal Reserve).

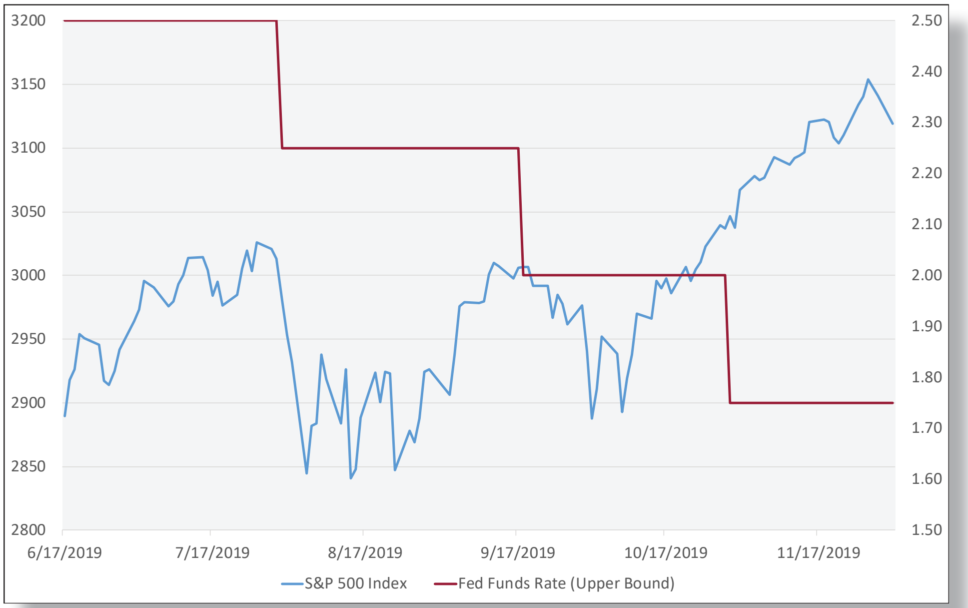

Chart 1. The S&P 500 has rallied almost 10% since the Fed began lowering its benchmark rate earlier this year
Source: Bloomberg

As the Fed shifted from hawk to uber-dove, Trump broke from typical presidential protocol and hammered the central bank's officials – calling them everything from "misguided" to "boneheads." It was an unartful and unhelpful contribution to independent monetary policymaking. Powell & Co. rightfully refused to respond to the attacks, maintained an arms-length buffer between its dual mandate and the Oval Office, and formulated policy the way it thought it should (right or wrong). But here's the catch. Although I don't think Trump's criticisms had any impact on the Fed's decision to turn dovish, it still must be noted that Fed policy ultimately evolved into a stance much more aligned with the president's wishes. The Fed reinstated an easier monetary policy environment Trump could live with. Even though Trump still believes rates should be slashed to zero (i.e., in-line with our European peers) or even into negative territory, his Fed-bashing has slowed considerably following the Fed's recent stimulus.

That's about to change.

President Trump faces a vitriolic, passionate re-election campaign. And as unpredictable as the past three years have been from an agenda and policy perspective, we know Trump views the U.S. economy as the ultimate litmus test of his presidency. Actually, to put a finer point on it, he views the U.S. stock market as such. His exuberant tweets after each of the Dow's new all-time highs are Pavlovian. But the correlation between a presidential re-election and favorable economic sentiment is extremely powerful. Trump is well aware. But here's where things get tricky for 2020. No market force has provided more support for the U.S. equity market than the Federal Reserve. The Fed's reassertion over the past year that it has this economic expansion's "back" has been critical to U.S. equities setting 20+ all-time records in 2019 (Bloomberg). One interesting aside: the Fed's rate cuts and dovishness came with a complicating side effect. The return of monetary accommodation allowed President Trump to take a more aggressive trade line against China, which inhibited progress towards an agreement. It continues to damage business investment and pull global manufacturing into a deepening contraction. The Fed is enabling Trump's trade tactics, whether it likes it or not. But now, the Fed is changing its tune. After taking the Fed funds rate down to 1.50-1.75%, it now wants to pause for several reasons: 1) to protect what policy cushion it has left; 2) to allow the impact of its 2018-2019 rate maneuvers to settle in; 3) to monitor U.S. data, which remains slow-but-stable; and 4) in my opinion, to remove its influence on trade, forcing the White House to negotiate without the inadvertent benefits of an ever-easier Fed.

None of this will sit well with the president.

Now that the Fed is signaling a desire to be patient, any further deterioration in U.S. and/or global activity will likely make market participants extra uncomfortable. They've lost – at least temporarily – their primary safety net. With no deal yet signed (and the mini-deal for Phase I not addressing many of the key issues like intellectual property theft), we expect the data to continue its drift lower. Leading indicators in manufacturing, capital spending, and the flat yield curve suggest growth challenges exist as we move forward. And from a less scientific standpoint, this march to new all-time highs on a seemingly daily basis cannot continue ad infinitum. Extremely positive trade outcomes are currently being priced in. In other words, the risk for equity weakness and volatility is increasing just as Trump will desperately want the opposite. However, the Fed has shown no signs it will capitulate to White House demands or threats. It's possible the data could sour enough to compel the Fed to continue to soften its stance, which would in turn satisfy President Trump. But the Fed is running out of policy flexibility. It may want to assuage bearish equity traders with lower rates and more stimulus – and arguably did just that in 2019 – but it doesn't have that luxury anymore. It doesn't have the flexibility to execute any more "insurance" cuts. As of today, it's more likely the Fed's next rate move is lower, not higher. But it will have to be in response to concrete data disappointments. The Fed knows it can re-establish its data-dependency right now – and I certainly hope it will. Just like 2018 didn't call for relentless rate hikes, the near-term isn't calling for more cuts either. Patience is appropriate. It's time to start weening the world off monetary stimulus – despite the risk of negative outcomes – because we must have a Fed with logs stored for the next economic winter.

That does not sync well with Trump's motivations as the election cycle heats up. This period of Fed patience leaves markets at their most vulnerable state since January. The Fed and the White House have played nicely in recent months. That was a result of the Fed's actions better aligning with Trump's expectations of the Fed throughout 2019. The reasons behind each (global economic stability and re-election, respectively) mattered not. The means were the same, so the ends didn't matter as much. Now the ends don't mesh – at all. We already have a trade war that will not be resolved this year and a particularly contentious battle for the White House is looming as well.

In 2020, a Trump-Powell fireworks show may upstage them both.