# Spiking the Punch Bowl

Market Viewpoint: July 26, 2019

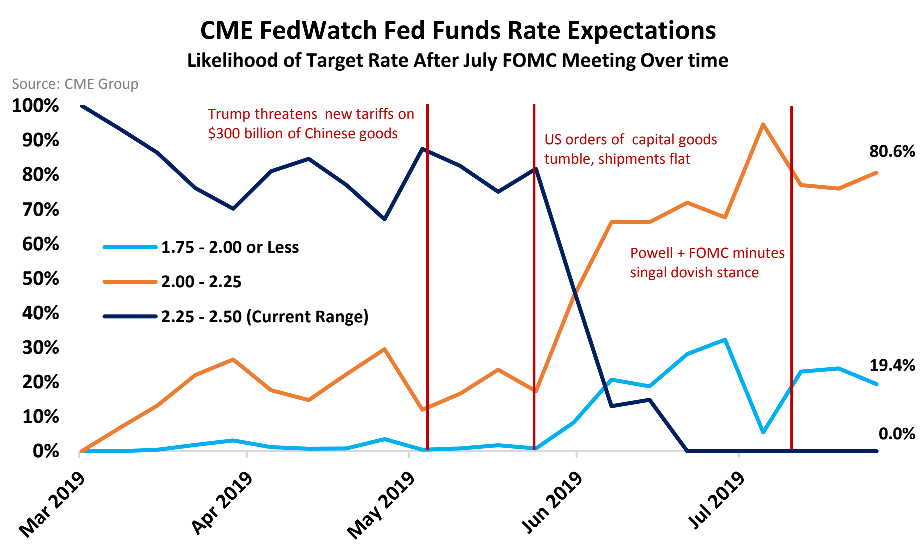
***Summary: Central banks around the world are becoming increasingly dovish in the face of a global growth slowdown. It seems almost certain that major and emerging economies alike are prepared to pull back interest rates – even central banks with bloated balance sheets that have yet to raise rates in over a decade. In effect, the proverbial punch bowl is being liquored up to try and keep the party going, making it that much harder to eventually sober up when it inevitably ends.***

On the heels of the move towards more dovish – commentary and a hiatus on further interest rate hikes, the Federal Reserve is now widely expected to cut rates within a few weeks. It remains to be seen whether they do or not or if the cut is a quarter point or 50 basis points as some are hoping. Indeed, the futures market continues to look for three cuts by the end of the year. Nonetheless, financial asset prices have received a big boost with US equities hitting all-time highs.

The Fed is not alone in its move towards further easing. The European Central Bank (ECB), Bank of Japan (BOJ), and a number of other central banks have signaled they are in a similar mood.

The tightening of monetary policy has been referred in the past as taking away the punch bowl. With interest rates historically low and central bank balance sheets bloated, the current rush to easier policy might be thought of as spiking the punch bowl.

Although June's nonfarm payrolls data, which saw the US add 224,000 jobs versus a consensus estimate of only 165,000, threw some cold water on the case for a whopping 50bps rate cut, it was not enough to shake most traders' certainty that a rate cut was indeed coming in July. While employment numbers are one side of the Fed's dual mandate, inflation lies on the other and has been stagnant thus far in 2019. June did see an uptick in the core CPI, but the core PCE remained around 1.5% through May, well below the Fed's target of 2%.




Appearing before Congress on July 10, Fed Chairman Jerome Powell addressed the speculation about the direction of current monetary policy with some of his most dovish statements to date, pointing to inflation that remains "muted" and wage gains that were only modest. Powell also said that "broad" global weakness is clouding the U.S. economic outlook amid uncertainty about the Trump administration's trade conflict with China and others. Later in the month, Powell went on to say "uncertainties" over the economic outlook are likely to increase.

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Minutes from June's FOMC meeting showed that the Fed's overall sentiment seems to agree with Powell. According to the minutes' text, "several participants noted that a near-term cut in the target range for the federal funds rate could help cushion the effects of possible future adverse shocks to the economy… Some participants also noted that the continued shortfall in inflation risked a softening of inflation expectations that could slow the sustained return of inflation to the Committee's 2% objective." So, while employment remains strong, Powell and others at the Fed have begun voicing pessimism about inflation pressures and growth, which bolsters the case for more immediate rate cuts.

Powell's testimony went even further in regard to international growth, stating that data for other major economies has "continued to disappoint", highlighting the growing likelihood of global easing setting in over the next few months.

Last month, ECB President Mario Draghi said more stimulus will be needed if the outlook doesn't improve. Prolonged uncertainty, largely driven by trade tensions, means the downside risks to growth and inflation have now materialized. According to a Bloomberg account of the ECB's June meeting, "There was broad agreement that, in the light of the heightened uncertainty… the Governing Council needed to be ready and prepared to ease the monetary policy stance further". In a press conference earlier this week, Draghi lamented that "this outlook is getting worse and worse," while the Governing Council's monthly statement showed willingness to prolong stimulus and maintain price levels.

The Eurozone PMI declined from 52.2 to 51.5 in July. Worse yet, the bloc's manufacturing sector PMI continued its contraction for the sixth month in a row, accelerating the decline from 47.6 to 46.4 (a PMI below 50 signals shrinking manufacturing activity); a nearly 7-year low.

Eighty percent of economists in a Reuters poll believe that the European Central Bank will either cut its deposit rate or ease its forward guidance further by pledging to keep interest rates lower for longer by the end of September. All but one of 45 economists who answered an extra question on the next policy measure expect the ECB to ease further in addition to extending already-announced long-term cheap loans to banks.

Japan is also likely to cut rates, which are already negative, even further before year end. While the BOJ has said that Japan's economy was moving in line with the central bank's projection, GDP growth reached an annualized 2.2% during the January-March quarter, an improvement from 1.6% growth in the final quarter of 2018, they remain concerned about uncertainty through the rest of the year. BOJ Governor Haruhiko Kuroda told a recent press conference that "If the economy loses momentum toward achieving our price target, we'll of course consider expanding stimulus without hesitation". Reuters reports that that the central bank Governor signaled the BOJ could combine interest rate cuts with bigger asset buying if needed to keep the economy on track to achieve its elusive 2% inflation target.

More accommodative monetary policy might also be required for more than just stimulus. Last month, Hiroshi Ugai, chief Japan economist at JPMorgan, told Bloomberg that the BOJ would have to move rates lower in response to any Fed easing, or else risk a sharp strengthening of the Yen. It would be a disastrous prospect for the export-reliant Japanese economy. JP Morgan now expects the BOJ to lower its short-term interest rate to -0.3% from -0.1% in September. Japan's exports declined for the sixth consecutive month in May after growth in major economies that consume a large amount of Japanese goods, the US and China in particular, was dented by trade tensions. Japanese manufacturing activity contracted in June to hit a three-month low.

The People's Bank of China (PBOC) may even be preparing for its first rate cut in four years. The Chinese economy has responded little to stimulus measures that have already been taken to counteract the negative impact of trade tensions with the US. The government has already injected large amounts of liquidity into the financial system over the last year, and they are prepared to continue stimulus by making more cuts to the reserve requirement ratio. However, Reuters reports that analysts believe China's GDP growth is still nearing the lower end of the government's 2019 target range of 6% - 6.5%. Now that the PBOC has begun guiding some short-term rates lower, a benchmark rate cut seems increasingly likely.

A number of other countries have already started cutting their benchmark rates.

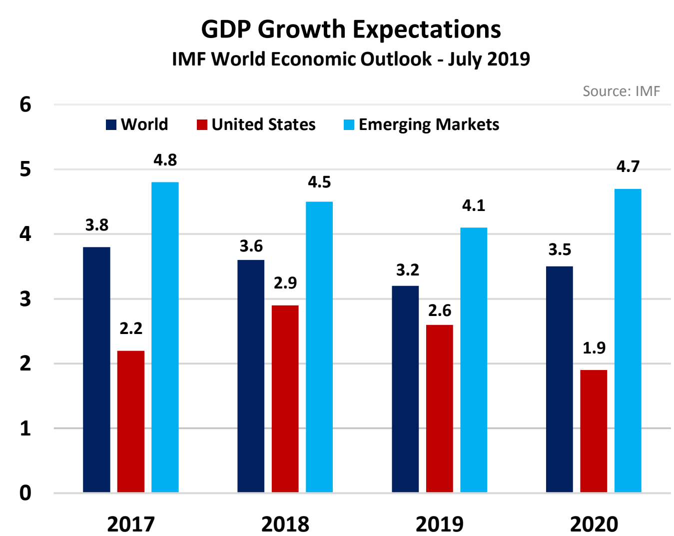
The Reserve Bank of India (RBI) was one of the first major central banks to begin easing this year. June marked the 3rd month in a row that the Reserve Bank of India cut their benchmark lending rate – the fastest pace of easing since 2013 – and changed its stance on liquidity from neutral to accommodative. Although growth has been very strong over the last decade, that trend slowed in 2018-2019 as the country lost its top spot among the fastest-growing major economies, slipping behind China. Accommodative monetary policy is seen as a bulwark against persistently high unemployment figures. Stimulus is seen as a means of stronger growth to generate jobs for the millions of young Indians that enter the labor market each month.

The Reserve Bank of Australia (RBA) cut interest rates by 0.25% again this month, following its first cut since August 2016 just last month. This brings the new cash rate to 1%, the lowest level ever. Reuters reports that RBA Governor Philip Lowe said the central bank is prepared to ease monetary policy again if needed to help boost job growth and stoke inflation. He also called for fiscal help in combined action with rate cuts to address employment concerns. According to the Finder RBA Cash Rate Survey, 73% of economists surveyed believe the RBA will cut even further, down to a rate of 0.75%. 32% see cuts continuing all the way down to 0.5%. The Australian economy grew only 0.4% in the first quarter of 2019, the slowest rate since 2009, largely due to stagnant wages and stubborn unemployment.

Nations in Southeast Asia are beginning to signal easing as well. Data from the Philippines showed the country's annual inflation slowing to a near two-year low in June. The Bangko Sentral ng Pilipinas (BSP) in May rolled back its benchmark rate from a decade-high, and announced a three-step reduction in bank reserves to 16% from 18%. According to ANZ Research, the BSP could slash rates again as soon as August.

Indonesia is also signaling their readiness to start cutting rates after six hikes last year. Bloomberg reports that the Indonesian central bank is proceeding more cautiously to avoid destabilizing its currency. Indonesia's Rupiah was one of the worst performing currencies last year amid an emerging-market rout.

One common theme among all of these easing regimes is that none of the countries mentioned have actually fallen into negative growth territory. In fact, according to the IMF's World Economic Outlook, they still see global growth at 3.2% in 2019, then rising to 3.5% in 2020. The forecast is even more optimistic for emerging markets, which are expected to grow at 4.4% and 4.8% over this year and the next.




Most of these actions are not bring taken to stave off recession, but rather, to make strategic improvements to certain aspects of economies. In regard to the punch bowl analogy, the party isn't really running out of punch, but the party has quieted down. Therefore, the hosts have decided it's time to make things more exciting by adding some liquor to the mix. As might be expected at such a party, it is likely to end badly.

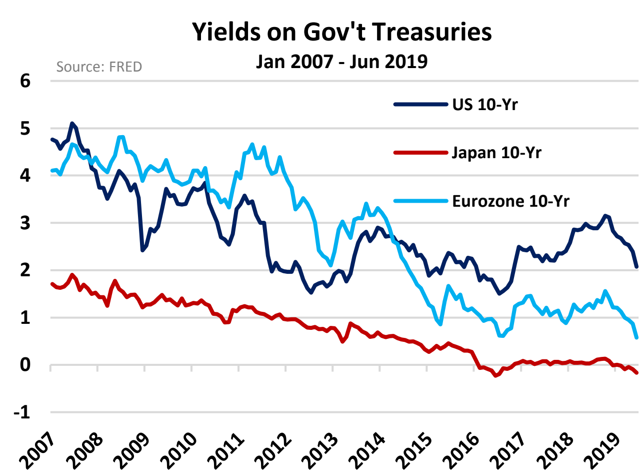
Already inflated stock and bond markets have rallied strongly on easing speculation. Following Fed Chair Powell's aforementioned dovish comments to congress, the S&P 500 rose above 3,000 for the first time ever. According to data provided by Robert Shiller, the index's total price to earnings has risen back to levels we saw in the fourth quarter of 2018 – just prior to the short-lived bear market that saw a fifth of the S&P 500's value wiped out before bouncing back.

These new all-time highs come as earnings growth for the second quarter is expected to slow into the single digits. While S&P Indices currently estimates operating profits for the S&P 500 to grow about 9.7%, others like FactSet, who measure earnings on a blended basis, expect earnings growth of -2.6%, with six of 11 sectors forecast to report declines. If earnings do indeed end up in negative territory, it will mark the first time the index has reported two straight quarters of year-over-year declines in earnings since the first and second quarter of 2016. Although it's still early in earnings season, preliminary results point toward broader weakness as Factset also reports that 77% of the 113 companies that have issued pre-announcements warned that their earnings numbers will be worse than what Wall Street analysts are estimating.


The currency translation effect has become a serious problem for earnings growth in the past few quarters, [as MRP predicted it would be last September](). Since the dollar had retained its relative strength versus the prior year through the second quarter, US companies that did significant business overseas took a hit to growth when other currencies were translated into dollars. Bank of America estimates that currency headwinds subtracted 1.7 percentage points from S&P 500 sales in the second quarter, a sharp reversal from last year, when exchange rates were a bigger headwind for stocks. Of the 22 S&P 500 companies that have conducted earnings calls through July 11, foreign exchange was cited on more than half as a factor that either hurt second-quarter results or is expected to moving forward, according to FactSet data. That was the highest proportion of factors, including trade policy and labor costs.

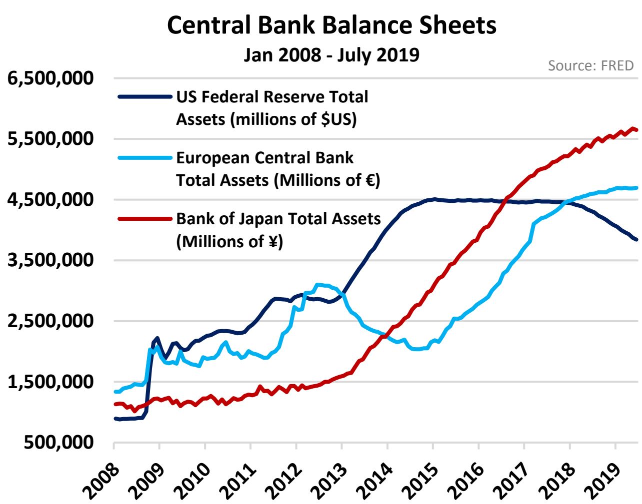
At the same time, bond prices continue to climb, sending yields plummeting. Treasury yields have fallen so far that the yield on short-term bills has been higher than on long-term notes for more than a month now, a sign that investors are concerned about the durability of the decadelong economic expansion. The 10-year even fell below 2% for the first time since 2016 in early July. Although stronger CPI number from June sent yields higher, they're still well below late 2018's high of over 3.2%. Foreign markets have seen even more drastic runaway pricing as, according to Barclays, almost $12 trillion of investment grade corporate and government bonds have negative yields, predominately in Europe and Japan.

There are a few dangers baked into any easing at the Fed. First, if a cut is ultimately what stokes inflation and growth toward the Fed's target, that could eventually lead to a resumption of tightening. The shift in attitude toward easing happened very quickly and a return to tightening could be just as sudden. If traders have euphorically priced several rate cuts into their outlook for the rest of the year, the prospect of pulling the punch bowl, or even just maintaining a more neutral policy, could hit equity prices hard. Additionally, a larger cut of 50bps could exhaust the Fed's most powerful tool to ward off weaker data if it is ineffective.




Global easing is even more concerning, considering many major central banks, including the BoJ and ECB, have never meaningfully pulled back on their stimulus programs since they were enacted in the recovery period after the Great Recession.

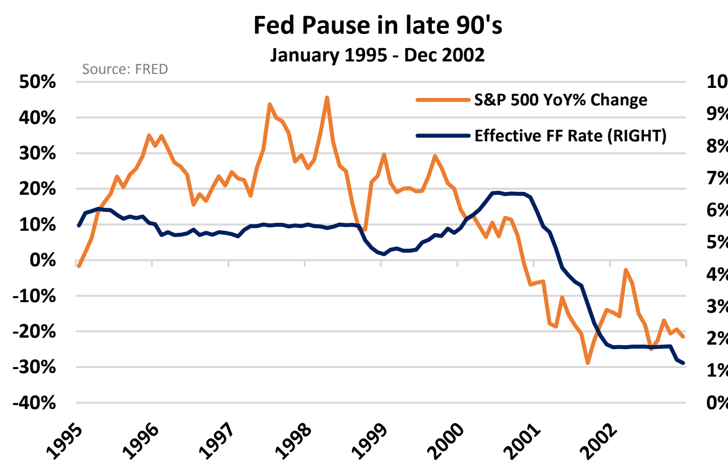
While quantitative easing (QE) concluded in the ECB in December 2018, the bank is likely to resume bond purchases in the fall, along with the aforementioned easing of already negative rates. The BoJ, which begun its "Qualitative and Quantitative Easing" (QQE) program in 2013, followed by "QQE2" in 2014, has yet to even attempt to take their foot off of the gas pedal. What's most worrying is that these stimulus efforts have been so ineffective thus far. One has to wonder when the punch bowl begins to overflow and returns on accommodative expansionary monetary policy diminish. Worse, if the economies of Japan and the Eurozone continue to be non-responsive to stimulus, what more can central banks do to ward off recession?




By contrast, the Fed did instate a temporary balance sheet shrinkage that's seen the central banks total assets decline by $650 billion, but that only put a moderate dent in the amount of debt they still hold. The Fed's balance sheet is still 300% larger than it was prior to the beginning of QE in 2008.

According to Forbes, in every case going back to 1971, when the Fed began a new easing cycle while the economy was expanding, stocks went up three months, six months, nine months and 12 months later. No exceptions. However, what remains to be seen is if we are truly entering a sustained easing – or just a pause in a continued tightening cycle.

The latter was much the case in the late 1990s when the Fed pulled back rates while stocks had begun to turn downward in response to financial crises in Asia and Russia, and the near-collapse of major hedge fund Long Term Capital Management. Three consecutive cuts of 25bps in September, October, and November 1998 sent stock prices higher, but a return to tightening less than a year later saw equities prices slam on the brakes. By the time 2001 rolled around, stocks were in free-fall, as the S&P dropped nearly 50% and the Nasdaq eventually plunged over 90% before bottoming out in 2002. Initially, payrolls and other employment data had been resilient and inflation well under control; even GDP figures were on the rise. While that would normally be good news for equities, the prospect of a return to less accommodative monetary policy actually reduced market sentiment and drove down stocks. In effect, good news was bad news.




We've begun to see symptoms of this same condition recently. Blowout jobs numbers for June sent stocks tumbling as traders began to doubt they'd get the 50bps cut they were hoping for – or worse – that they'd get no cut at all in July. While Fedspeak throughout the month has reassured investors that a rate is almost certainly coming, we could see a continuation of "good news is bad news" if inflation and other key data begins ticking back upward later in the year. So, while equity markets may continue to be buoyed, as previously mentioned, spiking the punch bowl usually doesn't end well.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