

STRATEGAS Insight

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One Policy Error Waiting on Another

The market has long been (rightly) accused of testing each new Federal Reserve (the Fed) chair. Jay Powell's first 18 months on the job have been no different. Out of the gate, the Powell Fed effectively continued the course of quantitative tightening and federal funds rate hikes that had begun under his predecessor, Janet Yellen. But by September of last year, after just seven months on the job, Chairman Powell's suggestion that Fed policy was "a long ways from neutral," combined with advertising an additional hike in 2018 (which occurred in December), proposing as many as three hikes in 2019 and the potential for more in 2020, and increasingly hostile rhetoric on the trade front from the Administration—proved too much. Investors rushed to sell the S&P 500 Index, taking 20% off its late September all-time high to a closing low of 2,351 in the abbreviated Christmas Eve session. Chairman Powell, Vice Chairman Richard Clarida, and their FOMC

contemporaries were quick to pivot. Early in January, the Fed effectively put monetary policy on hold for the foreseeable future and began discussing how to curtail its program of balance sheet run-off (now slated to end in September 2019). In the midst of the 35-day government shutdown and less-than-robust Q418 corporate profit reports—with trade negotiations slipping off the front page—the market had what it needed. Investors bid the market to its strongest four-month start

(17.4%) since 1987 (19.1%) and in the process made a new all-time closing high (2,945 on April 30). The Fed certainly knows how to talk itself out of a jam. But—and most importantly—the bar is higher for the Fed to do more than just talk.

Enter President Trump. The breakdown in trade negotiations with China (as we discussed in *Insight* last month) and the Administration's increasingly frequent engagement of tariffs (or the threat of them) to extract both economic and noneconomic

S&P 500 Index



Source: Strategas

concessions (e.g., increased border security from Mexico) from international trading partners has increased markedly the level of *uncertainty* among the business and investor communities. Although the heft of US trade is a powerful weapon and likely to bow *most* onto whom it is trained, the negative implications—even if the *long-term results of the extracted concession are in the US's national interest*—appear threefold. Longer term, we risk irreparable damage in our international relationships: Do not underestimate the lasting implications and latent resentment from our bullying sovereign nations to our will. Intermediate term, economic and market headwinds persist. The Administration appears emboldened by its (apparently successful) run at Mexico over border security. The President intimated during both his press conference with British Prime Minister Theresa May (June 4) and an impromptu call-in interview with CNBC's Squawk Box (June 10) that tariffs could be used during other, noneconomic disagreements (i.e., to compel our NATO allies to adhere to the Treaty's provision for defense spending, etc.). Tariffs could pop up anywhere we do not get our way... It is tough to operate a business in that environment. More near term, the prospect of a trade war, particularly one with several theaters of conflict (China, North America, Europe, Japan, etc.)—even with the *apparent resolution of the recent border flare-up with Mexico, the USMCA trade agreement has yet to be ratified by the US Congress*—will continue to be a headwind to business sentiment which, in turn, will dull the economic expansion and, ultimately, will negatively affect corporate profits.

The President has suggested this expanded course of tariffs is reasonable because the economy is strong, unemployment is low, and the stock market is up. The reality may be less robust. As our chief economist Don Rissmiller noted over the weekend, the economic outlook is softening. The manufacturing sector is slowing. It is likely only a matter of time until the service economy also comes under downward pressure. US GDP is likely to be weaker after Q1's inventory build, and coupled with the recent slowdown in momentum, it might even come in with a 1% handle. Employment data has softened. US payroll employment rose just 75,000 month over month in May, with downward revisions of 75,000 in prior months. Average hourly earnings were up 0.2% month over month and slowed to 3.1% year over year from a high of 3.4% in February. The work week was flat, the labor force participation rate was flat, the unemployment rate was flat at a low, and this jobs report likely reflects conditions before the full impact of recent trade uncertainty

worked through the economy. From its highs in late April, the S&P 500 Index sold off more than 6.5% through the first week of June. Regardless of whether the President is right or current conditions prevail, the balance is delicate. At a certain point, the impact of *uncertainty* will be too difficult to overcome.

The equity market has managed to recapture some of the recent sell-off, given the Fed's acknowledgement that present conditions warrant attention and its insistence on remaining "flexible." The bond market, however, has gone a step further, leveling a 97.5% probability that the Fed will cut rates before year end. That seems aggressive to us.

The Fed will likely disappoint investors (and the President, who has been merciless in calling for the FOMC to ease) in the near term. The Administration has indicated that the next chance for substantive progress on trade negotiations with China will be at the G20 meeting in Japan at the end of June. The Fed will want to see

Market Based Probability of Rate Cut in 2019 (%)



Source: Strategas

what comes from that meeting and to what extent the data have softened further in June and July before taking action. With no meeting planned for August, September is the first meeting at which the market could reasonably expect a policy change based on economic data. Further, while rate policy is on hold, the Fed is technically undertaking a course of quantitative tightening by allowing balance sheet proceeds to run off, as opposed to reinvesting them. This program is scheduled to end in September. Before then, any moves to ease monetary policy (short of further curtailing the run-off program itself) would be in conflict with the program. The bond market, however, now places a 75% probability that the Fed will cut rates at its July meeting! Hold on tight.

As we wrote in *Insight* last July, “Assessing the Four Horsemen of the Economy,” policymakers are vested with control of four distinct policy levers (fiscal, monetary, regulatory, and trade). In the 1930s, the US tightened monetary, fiscal, and regulatory policy while engaging in a global trade war. It is not difficult to see how a recession turned into a 13-year depression. Today, fiscal and regulatory policy are easy. Unfortunately, monetary policy is likely too tight for an extended trade war, but the implications of the Administration’s escalating trade tensions with China have yet to be fully addressed in the economy, leaving the market to handicap the impact of one policy error (trade) while increasing the risk of another (monetary).

Although we have increased our own odds of a downside shock to 30% and reduced our odds of an upside surprise to 15%, as our chief investment strategist Jason Trennert recently wrote, the greatest source of solace we could imagine is that the rebound in cyclicals is likely to be as violent as the sell-off we are seeing now—perhaps more so—if trade tensions dissipate. It is not hard to imagine the trade war ending after the Fed has had to ease twice. In such a scenario, positive developments in global trade could lead to an almost instantaneous steepening of the yield curve and a rally in risk. The Fed will eventually help, but it seems unlikely until headline economic data get bad enough to give them cover to be “preemptive.” Stay tuned.

Advisor Takeaway:

The Fed has proven quick to pivot following the December market sell-off, putting monetary policy on hold as the stock market plummeted 20% from its all-time high. Investors may hope the Fed will do so again in the wake of escalating trade tensions that threaten business sentiment, economic expansion, and corporate profits. Although the strong economy emboldened President Trump to use tariffs, we are witnessing definite signs of softening. Manufacturing is slowing, payrolls rose a mere 75,000 in May, hourly earnings declined slightly year over year, and the S&P 500 Index fell 6.5% from its April high. And using trade to force sovereign nations to accede to our will may have lasting, negative implications, and it increases uncertainty for businesses and investors in the near term. Before making a policy change, the Fed seems poised to assess the results of the trade talks between the US and China at the upcoming G20 meeting and to further examine unfolding economic data. As it stands, monetary policy may be too tight to withstand an extended trade war, raising odds of a downside market shock. But, if the Fed cuts rates, global trade tensions could dissipate, boding well for a rebound in cyclicals, a steepening yield curve, and a risk-on investment landscape.

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Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **Gross Domestic Product (GDP)** rate is a measurement of the output of goods and services produced by labor and property located in the United States. **Real Gross Domestic Product (GDP)** is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. **Nominal Gross Domestic Product** is gross domestic product (GDP) evaluated at current market prices. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **PCE (Personal Consumption Expenditure) Index** of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. **FAANG** is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The **North American Free Trade Agreement (NAFTA)** is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The **Seasonally Adjusted Annual Rate (SAAR)** is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The **Atlanta Fed GDPNow** forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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