A capital markets expert offers insight based on TAC ECONOMICS research.

The Market Insight

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Writer and commentator David Wigan offers his thoughts on the key trends revealed by TAC ECONOMICS quantitative models and insight.

Love Changes Everything?

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Take-away

Fed policy change boosts markets… but for how long?

The Fed changes everything

In the words of the well-known song, Love Changes Everything. However, as every economist will tell you, it's not love that changes everything. It's the Fed. Emboldened by the Fed, equity markets in the first quarter staged a rally from the first week of January until April. Bond yields, meanwhile, fell sharply until the end of April (and have retraced somewhat since). The cause of this sharp turnaround from a weak fourth quarter of 2018 was a Fed 'pivot' which saw it move from predicting two rate hikes in 2019 to a prediction that its key rate would remain in its current 2.25-2.5% range at least through this year. Rates are now seen peaking at 2.6 percent sometime in 2020, roughly a percentage point lower than the historic average. Of course, this does not take into account the impact of balance sheet easing, which TAC economists estimate was equivalent to 75 bps of hikes in the year to January, but it is still a sure sign that the U.S. economy has entered a more subdued phase.

Of course, this does not come as a huge surprise. TAC scenarios for more than year have predicted a cyclical reversal in the U.S. from around mid-2019. With that in mind the Fed's change of direction is entirely justified, albeit that it comes slightly earlier than expected.

TAC's central projection for the U.S. economy is a gradual progression to a cyclical trough in 2020, with the slowdown gathering pace and spreading worldwide in the first half of next year. TAC recursive partitioning models suggest a mild U.S. recession or no growth in the first two quarters of 2020. For the full year, TAC expects 1.6% growth, compared with 2.4% in 2019.

The impact of the "Powell put" on asset prices is a welcome relief for investors that were hit hard in 2018, and for asset managers. However, whether those gains are sustainable is another question. If the cycle is turning, there can be very little fundamental reason for valuations to continue rising. In fact, the more likely scenario is a return to bouts of volatility and a sharply negative reversal once the realities of the slowdown come home to roost on the corporate bottom line. Further, any reversal is likely itself to trigger a further slowdown in the U.S. and other mature economies.

Coda: The ECB runs out of ammo

One indirect impact of the Fed's policy reversal has been a parallel easing switch by other large central banks, including the ECB, Bank of Japan and Bank of England. All of which have gone into dove mode. The ECB significantly changed its forward guidance, with rates now seen on hold at least through the end of 2019 (the previous guidance was "at least through the summer of 2019"). As a result, German 10-year Bund yields, fell from 24 basis points at the beginning of the year to as low as minus 8 basis points at the end of March, the first time they had gone negative since the height of the QE binge in 2016. The difference of course is that economic and cyclical conditions are not the same as they are in the U.S. Certainly, the eurozone economy is in no great shape (Germany narrowly avoided a recession in the fourth quarter of 2018) but the end of the tightening cycle in Europe before it even started leaves the central bank with very little ammunition if conditions take a turn for the worse.

The death of the economic cycle?

Strange things afoot in the global economy, which have been subject to much speculation in economic circles. First, as the U.S. and other economies approach, or surpass, full employment, there is little sign of accelerating inflation. The U.S. unemployment rate is a mere 3.8%, which represents nothing more than friction in the normal course of people changing jobs. Yet, inflation has averaged just 1.5% since 2014. From an economic perspective that's illogical. In conventional theory there must be a trade-off between unemployment and inflation. One explanation for the anomaly is found in the Philips curve, which describes the relationship between rates of unemployment and corresponding rates of wage increases. The curve is resolutely flat, with companies seemingly able to hold down wages despite rising demand for labour. TAC analysis suggests reasons for the breakdown between employment and wages include demographic factors (entry and exit from the labor force creating a down-pressure on average wages) and socio-economic dimensions such as the reduced role of trade unions and collective bargaining. The knock-on effect on inflation is exacerbated, it suggests, by structural changes in distribution and retail networks.

All of this matters for companies because without inflation it is very difficult to increase profit margins. This view is supported by a TAC econometric model that points to a swing from +20% y/y in 2018 earnings per share growth to -12% in the third quarter of 2020.

The implication of a margin squeeze is that companies are forced to borrow more to increase earnings, and that is exactly what has been happening. Total US corporate debt, as a percentage of GDP, has risen fast since 2015 and has overtaken the previous peak seen in 2007. For the first time in modern U.S. history, corporate debt will soon be higher than household debt. The increase in leverage is particularly worrisome for risky firms. Among high-yield borrowers, the proportion of companies with a debt-to-ebitda ratio below 4 declined from 60% in 2010 to 30% in 2014-15 and less than 20% in the third quarter of

2018. Corporates with leverage above 6 increased from a negligible 5% in 2010 to 35% in the third quarter 2018.

The implication may be that the trigger for market reversals is no longer Fed action and the economic cycle. Rather it is levels of corporate leverage and performance. Fixed income investors beware!

Emerging markets – out of the woods?

As in their developed market cousins, money poured back into EM in the first quarter, as the short-term economic outlook improved. However, investors should not get too comfortable in their seats. TAC models predict a reversal and slowdown in the second half of this year and the first half of next year, with variations depending on country size, commodity dependence and sensitivity to international trade.

The key driver of improving sentiment is of course the Fed, which in backing away from rate rises has relieved pressure on local currencies and delivered a positive reversal in terms of dollar liquidity. The reason is that international investors in EM tend to be more adventurous when U.S. rates stay lower for longer. Valuations were also more attractive after EM underperformed in 2018 while concerns over China have receded.

Of course, some countries are more sensitive to U.S. monetary policy than others and the historical correlation is non-linear, with the highest levels of sensitivity evidenced at lower rates. Based on traditional Taylor rules for Key EM, estimated coefficients for inflation (or gap with official target) and for output gap show that Brazil and to a lesser extent Turkey are the most “sensitive” to U.S. rates, while South Korea, Poland, India and Indonesia are less so. In terms of the direct impact on monetary policy of changes in U.S. rates, India and Russia are most impervious. In short, the central banks of those countries do not look to the Fed for direction.

Still, EMs economies remain sluggish, amid the continuing impacts of higher U.S. rates, trade tensions, structural rebalancing and uncertainty around the Chinese economy. Monetary policy has also tightened in some EMs and politics in countries including India, Indonesia, and South Africa continue to weigh. TAC sees the negative dynamic will persist for the rest of the year, though perhaps less than previously though as a more accommodative Fed feeds through into more positive sentiment.

TAC has revised upwards (marginally) it’s predicted average growth rate across 10 key EM for the coming quarters. China and Brazil are at the vanguard. However, the picture is variable, with a slowdown in some EMs being driven by local factors. India, Indonesia and Turkey are most affected. South Korea also faces challenges, amid vulnerability to a shock to the business cycle.

From an exchange rate perspective, Brazil is on TAC’s watchlist, highlighting the country’s sensitivity to risk aversion and domestic politics, and the currency was notably unmoved by capital inflows following the election of President J. Bolsonaro. Elsewhere, China’s currency is overvalued and remains on at Watchlist, reflecting huge domestic leverage and continuing trade-related risks vis-à-vis the U.S.

Kicking the policy can down the road

An interesting trend over recent months is the willingness of governments to delay addressing difficult questions. The prime example is Brexit, the crunch date for which has not been put back until after the northern hemisphere summer. Trump, meanwhile, has delated implementation of further tariffs on China. Chinese authorities in turn are delaying decisive action on deleveraging, and long-awaited infrastructure investment through public-private partnership. Indeed ‘ostrich bias’ seems to be thriving in political circles. For investors, that’s no bad thing. It may mean the good times will stay for a few months yet.

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