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WHEN THE INMATES START RUNNING THE ASYLUM

Last fall, the market sold off sharply as Federal Reserve Chairman Powell suggested that the Central Bank was intent on raising interest rates further. Bad views for the economy and the stock market.

At the end of July, President Trump tweeted that he was going to introduce tariffs on another $300 billion of Chinese goods. The 10-year Treasury yield promptly dropped to 1.70%. Lower rates, good news, right? Nope. The market dropped over 6% in a week.

So, what gives, and who is setting interest rates? Federal Chairman Powell has historically held that role as head of the Federal Reserve Open Market Committee which meets monthly to establish interest rate policy. But, maybe its Donald Trump, tweeting his displeasure of Fed Policy and browbeating Powell about rates being too high to compete globally. Or is it Wall Street, who has its own self-serving reasons for lower interest rates which in theory should push stocks and bond prices higher. But, it's also possible that U.S domestic monetary policy has been hijacked by Mario Dragi, head of the European Central Bank, ECB, who has driven the entire interest rate curve in Europe into negative numbers, making anything with a positive yield in North America look like a bargain.

One way or another the volatile swings we've seen in interest rates are fodder for columnists and commentators to make projections on the economy and by extension, the stock market.

Before we try to make sense of all of this, we'll stand by our earlier comment that we don't see a Bear Market until we get either monetary policy that is too tight (Trump's position) or we get the threat of a recession, for which the odds are increasing. But let me come back to Fed policy and the economy momentarily.

Instead I'd like to start with my perspective on interest rates. In my opinion, negative interest rates and the run we've seen in the bond market ranks right up there with some of the world's greatest valuation bubbles: the Japanese stocks and real estate markets of the 1980s, the Dot.Com bubble in the 1990's and the U.S real estate market in the 2000s as examples.

Today, there are $15 trillions of bonds that have negative yields. That means that an investor will actually get back less then he puts up, the borrower gets paid instead of the lender. In Germany, there are negative rates along the entire curve out to 30 years, while in Switzerland yields are negative through 50 years. So who buys this stuff? Index funds, those who are forced to by regulatory imperatives, sovereign wealth funds and Central banks are the suspects. It's also an interesting correlation that since December 2007, the Federal Reserve, ECB, Bank of Japan and the People Bank of China have tripled their balance sheet holdings of financials to $19.6 trillion from $6.4 trillion. That rise of $13.2 trillion almost matches the amount of bonds with negative yields.

But bond yields don't have to be negative for investors or speculators to participate in this fantasy. In fact, there are a number of investors who are frightened by the stock market's volatility are shifting to bond funds as they are showing reasonable rates of return and are presumed to be safer. What isn't recognized is that a lot of the quoted returns are coming from bond appreciation as interest rates go lower. It reminds me a lot of the tech boom when investors bought ridiculously overvalued stocks on the belief that they could sell them at even greater overvaluation. Valuations were driven higher by crowd mentality chasing momentum where higher highs confirmed smart money knowing something. In the trade, we refer to this as the "greater fool theory" and I believe it is at work in the bond market as investors buy ridiculously low yielding bonds believing that their yield will go even lower as US and Canadian bond yields are destined to go negative.

Let me give you a real example. On Sept. 20, 2017 the Austrian government issued a bond with a 2.1% coupon maturing in 2117. One hundred years.

At the time, we questioned who would lend money at that rate for a century. Well, they just re-opened that issue in July of this year and sold additional bonds at 154 to yield 1.2%. In other words, the bond appreciated by 54% in less than two years.

Today, after the recent spike down in rates the bond trades at 194 and yields .74% for the next 98 years. That's 26% appreciation in less than a month. So much for bonds being for widows and orphans.

And if 74 bps for a maturity you will never see is too rich, how about a 10-year U.S treasury at 2.00% that could go to zero if the Europeans keep buying? Unfortunately, that was last month trades as the yield quickly collapsed to 1.50% on August 19th. That is as dramatic a change in yields as I have witnessed in my 50 years in the business and worthy of both positive and negative interpretation for both the stock market and the economy. Never without an opinion, I'll provide mine shortly.

But before we get there, it's worth understanding why the Central Banks are doing what they're doing and how it's supposed to work. If you understand the fundamentals, my opinion might seem, well, less opinionated.

Central Bankers have been taught, most recently by Milton Freedman, that inflation is a function of monetary policy, i.e., more money chasing fewer goods causes the price to go up. However, Central Banks don't create money. The commercial banking system does. Central Banks create free reserves for the commercial banks which those banks can lend. When you get a loan at a bank, they simply create a bookkeeping entry in your account for an amount of money and by magic, new money has been created. Today, the US banks hold $12.9 trillion in deposits while required reserves amount to $158.5 billion. However, total reserves amount to $1.5 trillion, meaning that the banks have excess reserves of over $1.3 trillion. Before the financial crisis, excess reserves averaged around $10.00 billion. This explosion in free reserves was created by the Federal Reserve as it bought bonds from the banks in a process called Quantitative Easing (QE.)

Now each $1.00 of excess reserve can support $10.00 in new loans. So, the $1.3 trillion in excess reserve could support $13 trillion in new loans compared to the total U.S GDP of about $21 trillion.

So, as you can see, if the banks do decide to crank up their lending it could have an explosive impact on the economy and inflation. President Trump feels that lower interest rates will stimulate this demand for loans.

But so far, and especially in Europe, banks haven't been lending as much as they could for a couple of reasons. First, the Fed may be accommodating, but the regulators have passed numerous restrictions on capital, loan requirements and capital stress tests that discourage banking. In fact, in 2008, Congress authorized the Fed, to pay interest on excess reserves, further discouraging them from lending. Second, rate spreads are narrowing. So, if a bank can't make money on a loan, they won't make it.

However, in Europe the ECB, requires an institution to pay to leave excess reserve on deposits. The origin of negative interest rates. The ECB initially cut their deposit rate to -0.1% in June 2014. In September 2014, they cut the rate to -0.2% with a further cut in December 2015 and a final cut to -0.4% in March of 2016. The theory is, that if you penalize the banks, they will make loans instead. It might explain why foreign banks account for 36% of the total reserves parked at the Federal Reserve where they can earn a return.

The Bank of Japan follows a similar policy of charging -0.1% on a portion of the bank's deposits.

Furthermore, negative interest rates also put downward pressure on a country's currency which helps exports.

However, the downside to negative rates is that they put pressure on the entire curve and narrow the spread margin financial institution can make on a loan.

Between increased regulatory requirements and narrow lending spreads these policies haven't worked. Consequently, doing more of the same, lowering interest rates and QE isn't likely to improve the outcome on either inflation or the economy. In fact, Japan has been the mother of quantitative easing since 1990 without results.

It would appear that the Central Banks have run out of new ideas and just keep trying the same old ones over and over.

Although the economy hasn't responded as it historically does, other asset classes have. Traditionally, the initial dose of monetary policy has been absorbed by the financial market as stocks and bonds rally followed by an improvement in the economy. This time the stocks and bond markets have absorbed the financial stimulations with less trickling down to the real world. The most anomalous result, in my opinion, is seen in the bond market where the Central Banks have participated directly, such as in Europe and Japan.

Bottom line, this is not traditional monetary policy. This is monetary manipulation policy from which historical correlations can be dismissed. Nobody invests to lose money, which is what you get with negative interest rates. Borrowers may benefit, if they have access to the market. But it's mostly government issuers supporting government deficits that are participants. In the meantime, pension plans, savers and insurance companies are all suffering for the benefit of whom? Today, most government funded pension plans are severely underfunded. If they can't earn enough to cover their obligations it would seem that the obligations will either fall to the public through higher taxes or result in a cut in benefits.

Ultimately, the risk to the bond market is people's loss of confidence in money in which bonds are denominated. The rate of interest should reflect the perception of the risk associated with the paper. Is it possible that gold is the canary in the coal mine as governments run the money machine overtime?

This is a long prelude into why interest rates are acting as they are. I don't think negative interest rates are rational, but there is an old stock market adage that says, "markets can stay irrational longer than you can stay solvent".

I think that this long bond trade will end badly. But, could we get flat or negative rates in North America? Who knows. What I do know is that I'm not buying long dated bonds based on the greater fool theory. I'll leave that to the Central Banks.

So, what about the stock market? It can have corrections but is unlikely to enter a bear phase until you get a monetary policy tightening or the threat of a recession.

Right now, investors are worried that the former is signaling one and the latter is being caused by trade disruption.

Inverted yield curves, where the longer dated maturities yield less than shorter dated ones, have historically correlated with recession. On August 16th the 10- year treasury yield dropped below the two-year yield, and the stock market dropped 800 points on the sure sign that we're entering a recession. It's a sign worth paying attention to, but this time I don't buy it. As I've just said, I think this bond market is manipulated and fraught with speculation. Inverted yields, in my opinion, is an unreliable indicator. Furthermore, one has to understand that the price of credit, the interest rate, is less impactful than liquidity. I've seen interest rates in the high teens and the economy could function, although less profitably. Low rates and the inability to borrow will shut you down. That's what is happening in Europe.

Alternatively, I am watching the spreads between government and corporate bond yields. This has also been an equally reliable indicator of recession as investors will abandon corporates in favour of governments, due to their higher quality at the threat of an economic downturn. It's not happening. Consequently, I think the inverted yield curve is a false signal.

Furthermore, it appears that the Fed is leaning towards loosening monetary policy. Chairman Powell stated that the neutral rate for interest rates and unemployment was lower than previously estimated. So monetary policy has not been as accommodating as they thought.

Today the future Fed Funds rate is at 1.25% which suggests that the Fed will cut the Fed Funds rate three more times in the next twelve months.

So it would appear that the threat of monetary policy tightening if off the table. However, resolving the constipation in the system to get the money moving still remains an issue.

What about the economy? Globally, things are slowing but there are signs of stabilization. In the US we're also seeing a slowing as the stimulative tax cuts from last year have worked their way through the system. However, recent data points look pretty good. In July employment improved by 164K, consumer spending advanced 4.3% in Q2 while August retail sales continued this trend by improving .7% versus the .3% estimate. Productivity also improved last quarter to 2.3% against a 1.4% estimate. The dichotomy that we're seeing is between the manufacturing sector, which might be headed towards a recession and the consumer economy which is strong, as employment is high and confident. Overall, 70% of GDP is consumption.

Furthermore, there is hope for the manufacturing sector, although it might be tied to trade negotiations. Some of the slowdown that we are currently witnessing is due to the surge in orders for goods to beat the imposition of tariffs. Inventories swelled in the first quarter causing the spike in GDP. Now these inventories are being worked off as retail sales are strong. Once these inventories are realigned, manufacturing could get a second wind as we get later into this year.

The one thing I would watch is the employment statistics. As long as you get more workers working more hours at higher wages, there is more consumption power. However, the initial unemployment statistics release is notoriously flaky. It is subject to sizeable revisions. Consequently, when the economy is strong the revisions are generally higher and conversely, revisions are lower in a weak economy. Right now, the last couple of revisions have been negative. That trend is worth paying attention to. Second, I watch the hours worked. When an employer becomes concerned, the first thing he will do is cut back on capital spending. If things remain uncertain or actually slow down, he'll cut back on work shifts. You'll see it in the hours worked. Those have also stalled. Only as a last resort will employers lay workers off, especially today when the job market is tight. So the trends we're seeing confirm the slowdown in manufacturing.

Nonetheless, the economic elephant in the room is trade. Trump's recent threat to impose tariffs on an additional $300 billion of imports sent both bond yields and commodity prices lower, yet it only amounts to 0.14% of GDP. Quantitatively, even further tariffs shouldn't push the US into recession. The US GDP is about $21 trillion while exports to China amount to $108 billion and imports from China are $509 billion. In June imports from China dropped 12.6% or $5.6 billion while exports to China contracted 16.8% or $1.8 billion. However, imports from South Korea, Taiwan and Vietnam increased 9.2% - substitution at work.

As I see it, there are four possible outcomes to the trade war.

1. Everything gets settled favorably for the US. I'd put low odds on this happening.
2. You get a settlement that deals with the trade gap but does not deal with intellectual property rights and some form of enforcement mechanism. This wouldn't be good for the stock market or Trump's chances of re-election. He might give in, but it's unlikely.
3. You get an outright escalation in the trade war. Not a good outcome and ultimately not in anyone's best interest. It would also hurt Trump's re-election chances if the economy does go into recession. Although this approach doesn't seem logical, it is in fact the direction we're creeping. This war started April 3, 2018 with 25% tariffs on $50 billion of Chinese goods. Sept 5th, 2018 a 10% tariff was imposed on an additional $200 billion of goods. On May 5, 2019 the 10% tariffs were raised to 25%. And, on August 1st Trump threatened a 10% tariff on an additional $300 billion in goods starting September 1st and further threatened to raise the tariff to 25%. Looks like a trade war to me.
4. The fourth option is, I think, the most likely. Both sides stall while China plays the November 2020 presidential election. Trump has now acknowledged this strategy which probably motivated his recent tariff threat. However, there is danger in this strategy for China. First, there is no assurance that a Democrat in the White House would be easier to negotiate with. Some of the Democratic presidential candidates could be more extreme than Trump. Second, if Trump does get elected, he could go rogue on the trade dispute having nothing to lose as he wouldn't be running again. Third, Trump wins in a stall. No one is going to build a plant in China with the current uncertainty. In fact, companies are moving their manufacturing out of China. The trade war is re-mapping global supply chains where already 50% of global companies have announced plans to move production. This is also causing Chinese manufacturers to consider moving and is showing up in rising US imports from South Korea, Taiwan and Vietnam. If this is the most likely option, then we're not likely to see much relief from this issue and the market is likely to become less sensitive to the rhetoric unless things escalate further.

Can China play the currency card to aggravate the situation? Certainly, that would affect the US stock market and possibly Trump's chances at re-election more than any tariff or economic threat. However, there is a deterrent to that strategy. In 2015, China dropped the Yuan's value by 6% over six months and caused some significant damage to their financial markets. Today, a lot of Chinese property developers have borrowed in US dollars. China also needs US dollars to buy oil, food and basic materials. Although they may be 15% of the global economy the Yuan is less than 1% of global transactions. Besides, devaluing the currency won't resolve their slowing economy, too much debt, large capital outflows nor protests in Hong Kong. Currency devaluation is a threat but not without consequences.

China also has a problem in Hong Kong that could aggravate the trade negotiations. Protests over a bill allowing extraditions of Hong Kong residents to the mainland has been suspended but not withdrawn. This started about eleven weeks ago.

If China intervenes, then US Congress could impose sanctions as it did in 1989 after Tiananmen Square.

China has to be careful using force as it could be seen as an infringement on the rule of law and autonomy which underpins Hong Kong's status as a world financial centre. China pledged in the 1997 takeover of Hong Kong from the British to maintain "one country, two systems". Any loss of autonomy would threaten Hong Kong's most favoured nation trade status. If things go sideways here, property values will drop, the stock market will sell off and Hong Kong's role as a financial centre for Chinese and other Asian companies to raise capital could collapse.

However, if China can't resolve the Hong Kong protests, it's an encouragement for the Taiwan pro-independence forces to gain strength.

So, the trade war issue remains out there and we'll assume unresolved for the intermediate future with negative rhetoric influencing the market.

However, the biggest economic consequence from all of this is not the tariffs but the threat to business confidence. It will be a headwind for the economy and is an additive to the consequence of the tariffs.

Ultimately, uncertainty and the loss of confidence aren't good for the market's valuation. Nor are dwindling earnings estimates. Earnings forecasts are being slashed at the fastest rate in four years. Although, Q2 earnings posted a positive gain of .4% after being forecast to decline 2%. Q3 earnings projections have turned a bit more negative with an anticipated decline of 1.1% while Q4 is expected to see a solid 5.7% gain. Yet, that is down from 11.7% projected at the beginning of the year. Overall, analysts expect earnings to grow 2% this year and 10.8% next.

Right now, the S&P500 is projected to earn $165.52 this year and $184.40 next. That would leave this market valued at a 5.7% earnings yield that funds a divided yield of 2% and compares to a ten-year treasury yield of 1.55%. Not cheap, but not expensive and a bargain when compared to the euphoria in the bond market.

Conclusion

After Trump's tweet of new tariffs, the Dow Jones dropped 800 points and is back below its January 2018 peak. In fact, the market has now gone nowhere for almost two years. However, corporate earnings, as measured by the S&P500 have grown 24% while bond yields have declined, which should translate into higher not lower valuations. What has changed is the level of investor confidence.

There is uncertainty over trade policy, taxes, elections and Federal Reserve policy. Not to mention that investors are fed up with the stock market's volatility.

Last Fall the market was threatened by the Federal Reserve raising interest rates and the impact it would have on the economy. If that was causal, the recent decline in treasury yields is perceived to be predictive.

I won't dismiss the possibility that the gravitational pull of negative foreign interest rates won't pull US and Canadian yields lower. However, I would dismiss the predictive value in what is obviously a manipulated market. But even if one believes there is predictive value, inversions lead recessions by up to 22 months. The better gauge of recession will be the spreads between corporate and government yields which has remained positive. If I'm right, at some point, lower interest rates will be helpful to both the economy and stock markets as investors get pushed out the risk curve.

And what if longer rates start to rise? The predictive warning is then eliminated. Higher rates will be symptomatic of a healthier economy and as long as liquidity is available, marginally higher rates won't make any difference. One quarter of one percent isn't enough to affect the profitability of a project. Besides, higher rates would probably represent a normalization of the yield curve, not a tighter Fed. I would contend that this could set off a fairly sharp rally in the stock market and I can imagine a number of plausible causes for a steepening yield curve.

1. The economy could start to show signs of improvement. The inventory cycle I mentioned could play out. Furthermore, you could get some help from an easing in trade tensions.
2. The government could start borrowing further out on the yield curve. Why not lock in some of these ridiculously low rates for 50 or 100 years?
3. Any reversal in bond yields would result in losses that could cause a reversal of fund flows to fixed income funds and set off a self-feeding rise in rates.
4. The stock market might improve, reversing the risk-off trades that saw money getting parked in fixed income. A move to risk-on would see selling of bonds and cause higher interest rates.
5. European countries may move away from austerity budgets and embrace more fiscal spending to stimulate their economies. This is especially true for Germany which is on the borderline of recession while having run a budget surplus of 1.7% in 2018.

6. Finally, this latest move to lower rates could be a retest of the 2016 bottom at 1.37% on the 10- year treasury which has now dropped from over 3% to an intraday low of 1.48%. The bull market in bonds was declared dead two years ago but now is being questioned. The same thing happened in the early 80's. The bond bear market from 1946 to 1981 ended in the Fall of that year at 15%. Although the bond bear was declared dead, yields shot back up in 1983-84 causing many to believe that the bear market was back. The recent spike lower in yields could be a similar re-test.

For sure that market could experience a further sell-off and signals from the bond market could continue to aggravate the programed trading algorithms. However, I don't buy the inversion sell signal on the economy. The economy is slowing and there are things to watch that could change my mind. But right now, I don't see the economic issues as being binary – either growth or recession. It could just continue to grow slowly. Failing a recession, I don't see a bear market and if so, lower interest rates should help valuation rather than signal a sale.

Restrictive monetary policy is now off the table. Although I've never seen an easing cycle start with unemployment and real interest rates this low. A mid-term adjustment, as they refer to it, seems to be expected. Although the upside for the market averages may be limited by valuation, there are several pockets of mispriced sectors which could show substantial gains if market conditions normalize.
So, like the Federal Reserve, any changes in our opinion will be data dependent, but right now I think the stock market offers the best investment alternative.

Gerald Connor

Credits:
Grant's Interest Rate Observer
Wall Street Journal
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