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June 11th, 2019

Cake

What's next for U.S. equity markets, and what historical analogs might provide some insight? There are plenty of bullish pundits citing renewed monetary policy easing as a catalyst for higher equities – some even suggesting a melt-up could yet occur. While a surprise (at least to us) cut this week could propel equities higher for one last gasp, I'd not chase. Since my 2019 *Outlook*, I've been suggesting a 'tale of two halves' narrative for risk assets.[1] In it, my team and I described a first half characterized by a correlated risk-on resulting from improved central bank communication, more reasonable valuation, and more favorable optics around China trade. This has largely occurred. In particular, our mid-year target for the S&P 500 was and remains 2,800, while our year-end target remains well below street consensus at 2,500.

The recent rally in U.S. equities is largely a result of market participants believing they can have their rate-cut-cake and eat it too. Market participants' Pavlovian response to a cut of any kind – regardless of context – has been well reinforced over the past ten years. As my team and I have pointed out, and as **Figure 1** illustrates, a cut now would bode ill (as a signal rather than a cause) for the U.S. economy over at least the next year. Will the Fed cut in June? While in play, we don't think the Fed will cut, as it would amount to

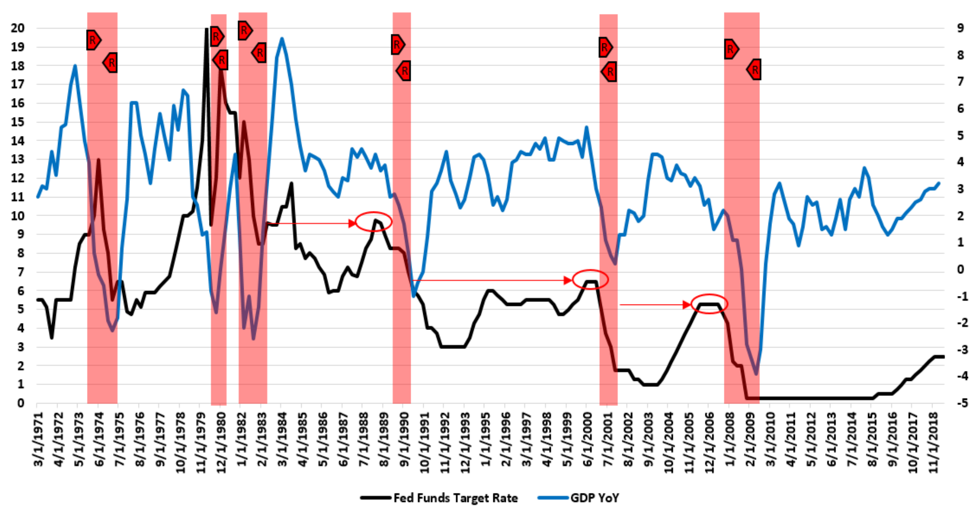

Figure 1: Late Cycle Fed Cuts (black, LH) Most Often Precede Recession (red shading), GDP YoY (blue, RH) Source: Cantor and Bloomberg

[1] The 2019 Outlook was published on January 4th, 2019.

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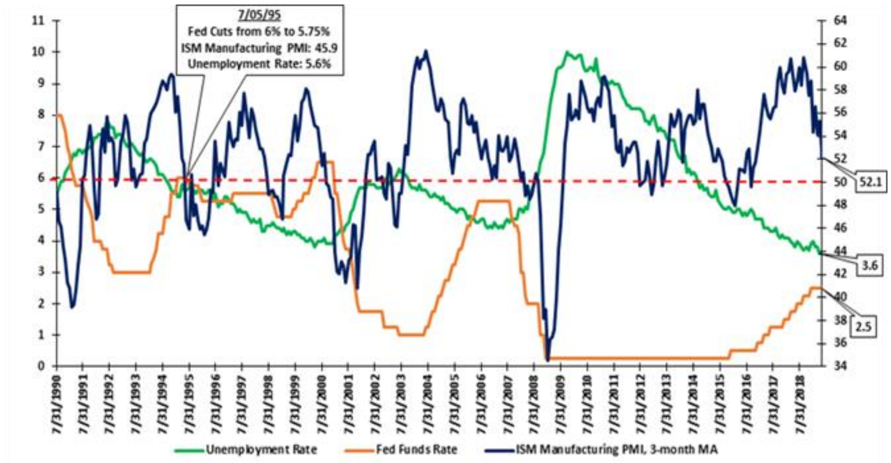

Figure 2: Unemployment Rate, Fed Funds Rate (LH) vs. ISM Manufacturing PMI (RH); Source: Cantor and Bloomberg

preemptive action.[2] There are three relevant precedents upon which market participants have relied to justify such preemptive Fed action.

Some argue that market conditions are analogous to 1995, when the Fed cut preemptively. I disagree. In our *BIG Picture* piece entitled *Fed Reaction Function* (dated April 20, 2019), my team and I presented our view that current conditions did not resemble 1995, and we continue to hold that view. As **Figure 2** shows, when the Fed decided to cut in 1995, economic conditions were significantly worse than they are today. ISM manufacturing was deep in contraction, and at 5.6%, the unemployment rate was significantly higher than it is today. That said, the view has consistently been that the Fed will cut if equity markets risk-off by more than 15% or if there is a hard turn in the economic data, neither of which have occurred *quite* yet. Such conditions will likely manifest later in the year, especially if rates markets are as predictive as we think they are. It's a matter of when - not if.

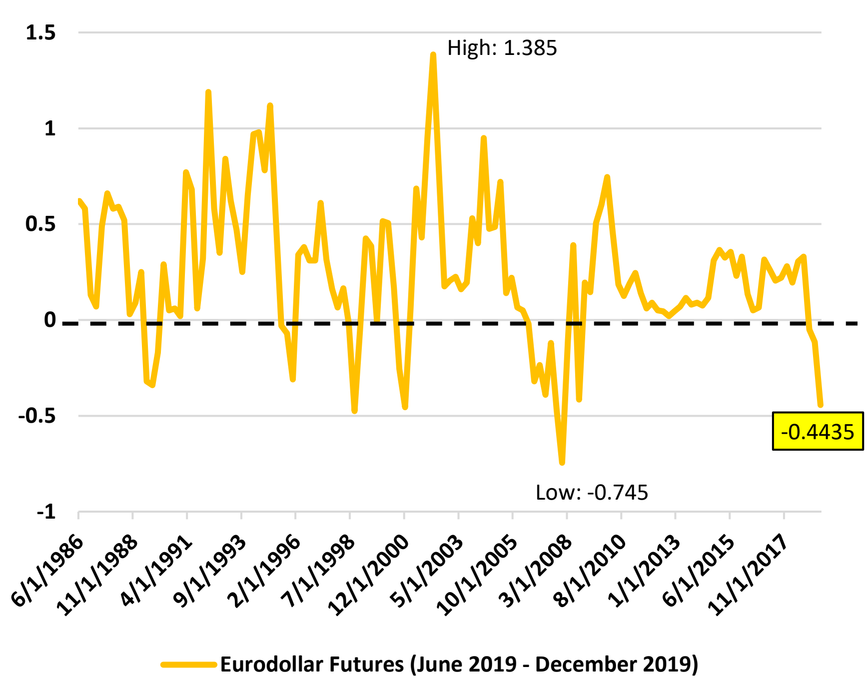

Figure 3: ED1 (June 2019) - ED3 (December 2019)

Eurodollar futures markets (ED1 – ED3 = 40bps) are implying an 80% chance of two cuts between June and December. This

[2] To be clear: I do think U.S. economic conditions will warrant a Fed cut in late summer and another in fall. My team and I have been arguing strenuously since mid-year 2019 that global economic conditions were beginning to deteriorate and the U.S. economy would follow late this year.

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suggests the Fed is too tight relative to economic conditions (**Figure 3**). The correlation between 10-year rates and ISM manufacturing show that ISM will move into contraction in the near future (**Figure 4**). Nonetheless, we don't believe that the Fed will move before that happens – nor should it. The equity markets and rates markets are severely disconnected, and that disconnect is the result of expectations for market intervention from the Fed, upon which markets have become far too reliant. My expectation is that equity market volatility will precede the Fed's next move. Certainly, with the S&P 500 at ~2,900 amidst a global slowdown and flat U.S. earnings, the risk-reward appears poor to owning U.S. equities.

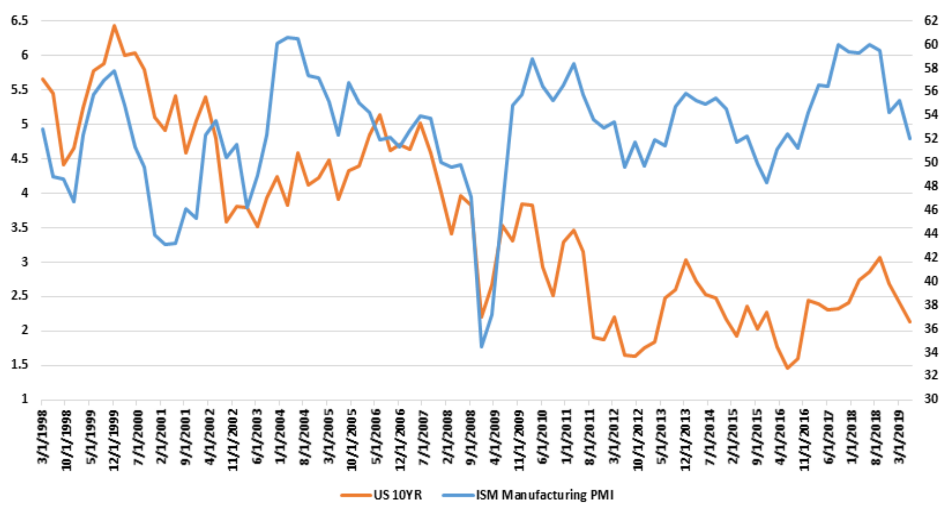

Figure 4: ISM Manufacturing PMI (RH) vs. U.S 10-Year Rate (LH), 1998-Present; Source: Cantor and Bloomberg

Looking at another potential historical precedent, I also do not believe that the current situation is analogous to the early 1970s when President Nixon appointed Arthur Burns as the Chairman of the Federal Reserve. While we will leave the reader to his or her own conclusions about the similarities between Donald Trump and Richard Nixon, it would appear that Chairman Powell is far less naïve than the academic, Burns. On February 1, 1970, Burns, known as a Republican loyalist, took office. Preceding the 1972 election, Nixon is alleged to have instructed Burns to cut rates. Burns lowered funds starting in mid-1971 from 5.75% to 3.5% into March of 1972; GDP growth picked up to 5.6 % in 1972 from 3.3% the year prior. Inflation rates rose to 5.3% from 3.6%. This may have helped exacerbate the impact of the oil shock, which occurred as a result of an OAPEC oil embargo, which was retaliation for U.S. aid to Israel during the Yom Kippur War. While clearly there was a complex brew of potential causes, this policy period was followed by a considerable amount of asset volatility.

Lastly, the kind of central bank coordination that occurred in February 2016 at G20 is unlikely. Recall the backdrop from 2015 into 2016. A burgeoning China slowdown and fears of an aggressive devaluation of the

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yuan catalyzed two selloffs – one in late summer of 2015 and the other in early 2016. Complicating the U.S. backdrop was a U.S. earnings recession and a rise in default rates amongst energy companies that risked sparking a broader U.S. default cycle. The G20 meeting that year was in February in Shanghai. At the time, my team and I failed to appreciate just how aggressive and coordinated the global central bank policy response would be. After a largely correct markets call for 2015, we failed to pivot bullishly enough on this stimulus. Could we be making the same mistake here? We don't think so.

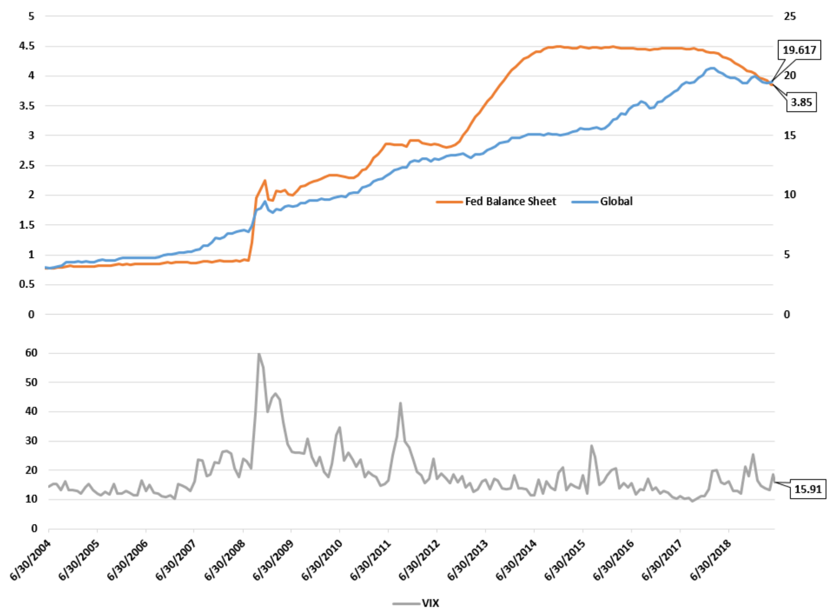

Figure 5: Fed (orange) and cumulative (blue) central bank balance sheets; Source: Bloomberg and Cantor

For one thing, global central bank balance sheets are no longer expanding in aggregate. **Figure 5** shows that 2015 equity market volatility (green lower panel) was quickly suppressed by an expansion of global central bank balance sheets (on a stable Fed balance sheet). Now conditions are quite different with the ECB no longer buying new bonds and the Fed selling its holdings. While rates volatility caused by higher rates has abated this year, rates are considerably higher here in the U.S. than in the rest-of-the-world and most developed market central banks remain on hold after only recently being in normalization mode.[3] Lastly, there is no longer a post-crisis chorus of Kumbayah coming from world leaders. Instead, the world's largest economies are embroiled in what appears to be a prolonged trade war. This makes coordination more difficult especially because many central banks are not independent of the governments engaged in the trade dispute. Lastly, we do not think the Fed wants to hand President Trump a rate cut into the G20 meeting simply because he asked for it. There must be an objective basis for Fed action.

[3] While true, the lean is clearly much more dovish than just a month ago, and emerging market central banks have already started to move with Russia, for example, cutting for the first time in 2-years.

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Conclusion

Will we see a change in Fed's *modus operandi* in June that results in a cut? We believe a cut in June would require a philosophical change in approach, as we would take it to be a preemptive move influenced by the executive branch. This is why June is such an important meeting. Were it to cut, policy would begin the slide down a slippery slope – a slide back to ZIRP and back to QE (quantitative easing). While we hold the unfortunate belief that all central banks will be at zero interest rates and aggressive QE (including the Fed) in the not-so-distant future, we also think the Fed wants to resist moving in that direction too quickly. Why? For one, the Fed understands the inadvertent redistributive effects of its policy decisions.

Wages compensate labor. Interest compensates owners of capital - credit investors, in particular. As a result, rate cuts, which set the cost of capital, implicitly make a wealth redistribution decision from credit investors to labor (in the form of lower unemployment). Moreover, not only do central bank decisions lead to wealth redistribution from creditors to labor, but low rates typically also discriminate against credit investors in favor of equity capital providers (as the 'Fed model' implicitly acknowledges). Moreover, a central bank decision to maintain low rates effectively discriminates against retirees in need of income; thus, there is an additional, unintended demographic consequence. Overall, current workers and equity investors tend to be favored over retirees and credit investors.

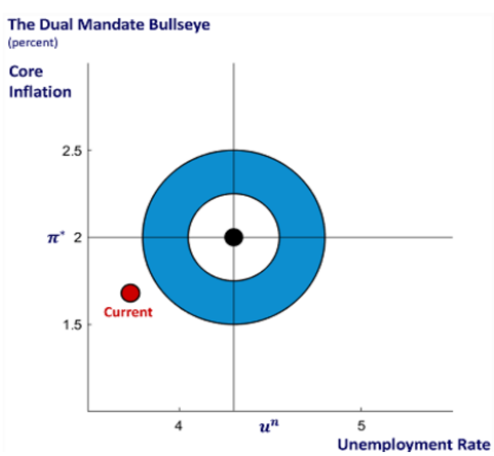

Figure 6: Federal Reserve Bank of Chicago on the Dual Mandate - Current Policy Stance

The unintended redistributive impact of Fed (and all central bank rate policy) comes largely without explicit legislative authority outside the Federal Reserve Act. Thus, in our view, the Fed still recognizes that the bar for central bank action in a capitalist economy should be relatively high. Historically, the Fed has generally viewed it as such through its data dependent approach and through its mandate to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest

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rates."[4] We would also note that "moderate long-term rates" seems to exclude both extremely high rates *as well as* extremely low rates. With the current condition of policy (as shown by **Figure 6),** the Fed would appear not to have cause to act just yet. Indeed, it's our view that the Fed will eventually be compelled to move back to ZIRP (zero interest rate policy) over the course of the next couple of years as yet lower rates are required to maintain even the most meager of growth rates. Because we believe the Fed wishes to maintain precedent as well as its independence, it will remain reactive to the data – at least for June – but the data continues to evolve as we foresaw it in the beginning of the year.

[4] Statement on Longer-Run Goals and Monetary Policy Strategy, adopted effective January 24, 2012; as amended effective January 29, 2019.

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