Monetary Policy in 2019, the Pause That Refreshes

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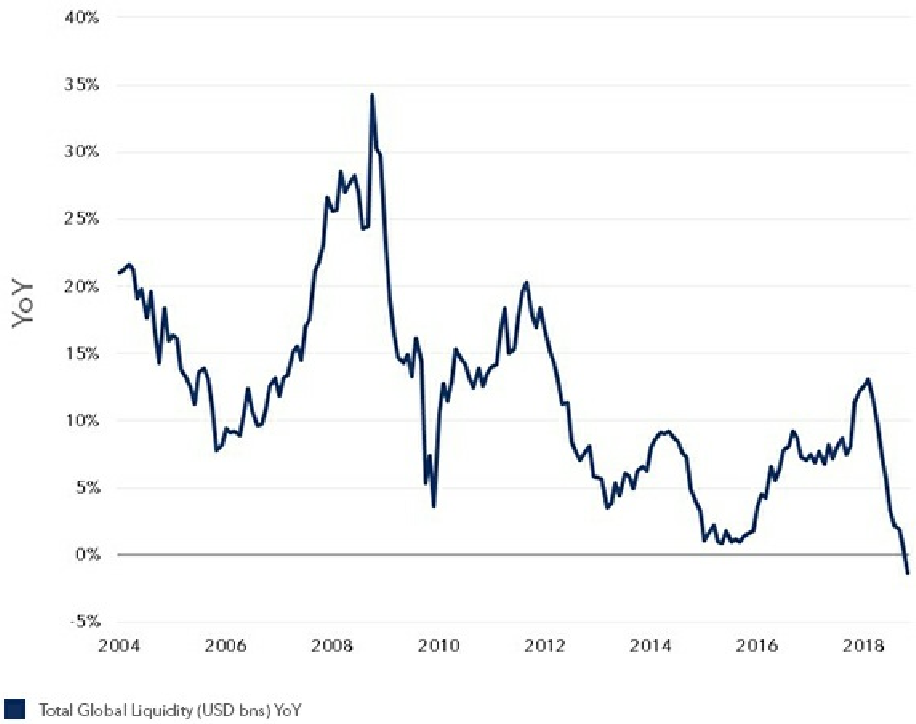
Rick Rieder and Russ Brownback argue that slowing growth, peaking inflation and tightening financial conditions combine to make a strong case for a Fed policy rate hiking pause in early 2019.

If you've ever endeavored to furnish a new dwelling, chances are you've faced the daunting task of installing a large wall fixture, perhaps a mirror or painting. The dreaded process entails extensive choreography with multidimensional measurements, access to the requisite tools, and a willingness to embrace the reality of numerous unsuccessful attempts and unsightly holes in your living room wall. Eventually, after wrestling your fixture onto its hook, you need to step back from the wall for a better perspective–a pause in your process to ensure that your laborious undertaking has achieved an optimal outcome. To us, the Federal Reserve's ongoing efforts to seek policy neutrality are a similarly painstaking and imprecise exercise, and that recent market tumult, alongside a deceleration in growth and inflation, provides sufficient reasons for the Fed to step back and ponder their efforts to date before acting further.

The evolution in global liquidity

Conventional wisdom says that 2018's market contagion is unjustified relative to the*de minimis* absolute level of cyclical policy tightening relative to history. To us, it's not the absolute level of tightening that's causing consternation, but the stark contrast of today's aggregate policy posture versus this time last year. In the fourth quarter of 2017, global liquidity was growing at its fastest pace ever: developed market real policy rates were negative, China was enjoying the tail-end of a multi-year credit explosion, and the U.S. was set to unleash powerful fiscal stimulus, a global policy cocktail that was perhaps amongst the most supportive postures of recent years for risk assets (see graph).



Sources: Bloomberg, JP Morgan, BlackRock; data as of December 10, 2018

Today, global liquidity is in steady decline, U.S. real policy rates are the highest levels in almost a decade, China is endeavoring to deleverage, and U.S. fiscal stimulus is set to abate. Moreover, U.S. Treasury supply has doubled from last year. This sudden policy U-turn is creating a two-fold systemic shock to the financial economy: the newfound availability of positive real-yielding risk-free securities, along with the significantly higher discount rates that need to be applied to risky cash flows, are crowding investors out of risky assets.

Many financial prognosticators stubbornly adhere to a forecast of significant additional policy tightening, even though markets are increasingly loath to price in that hawkish path. At this point, at least, we agree steadfastly with the markets and hold the view that we're at the doorstep of policy neutrality and a Fed pivot toward a more symmetric, and data-dependent, forward policy path is at hand.

Decelerating global growth is already apparent in both high frequency macro data and messaging from globally exposed corporations, as evidenced by sharply decelerating revenue, contracting margins and slower cash flow growth. More importantly, U.S. inflation has struggled to achieve the Fed's desired target, as secular inflationary headwinds remain firmly entrenched. For instance, ubiquitous technological innovation is enabling profound production efficiencies across every sector of the economy, from energy to retail. Further, the continuing evolution of cloud computing and data storage is driving a shift out of traditional corporate capital expenditure and into research and development, as companies race to build out machine learning and artificial-intelligence capabilities, or risk being left behind by more effective and lower cost competitors. We are still in the early stages of these generational deflationary trends.

Are rising wages a spur to higher prices?

Meanwhile, considerable ongoing debate exists about the degree to which accelerating wage growth will catalyze inflation as it sometimes has historically – a relationship we think has broken down. Counter to historical precedent, rising wages are in fact paradoxically dis-inflationary today. The relentless assault on corporate pricing power by information symmetry (think Amazon and user reviews) is forcing corporations to absorb rising wages through narrower profit margins, instead of pursing higher prices. As cash flows are squeezed, animal spirits are dampened and economy-wide activity slows. Further, today's wage earners have a demonstrable proclivity to save their rising wage windfall rather than divert it to incremental consumption. In total, rising wages are a virtuous societal phenomenon rather than a harbinger of inflation; a source of stabilization for a real economy that is flirting with systemic capacity constraints. Therefore, wage gains should be embraced by policy makers today rather than extinguished.

Further, the relationship between risky assets and inflation (orreal rates) is neither linear nor exponential, but parabolic. Risky asset valuations get hurt when inflation and real rates are *either too low or too high.* At the apex of that parabola is an optimal scenario where risk valuations flourish – and our demographic models of potential growth and inflation suggest that that apex is shifting to the left (in other words, risk assets flourish now at a lower level of inflation and real rates than in decades past). Most likely, the optimal risk-free rate has already been achieved, as evidenced by risk assets' struggles during 2018's "year of adjustment," and incremental increases from here are unwarranted. Thus, with the cyclical increase in rates now completed, portfolio balance can be restored anew and duration can once again be employed as an effective hedge for risk, making "risk less risky."

Investment implications

This new equilibrium rate plateau is far higher than anything experienced during the post-crisis era. As a result, one of our favorite regime identification tools is now flashing a more cautious signal. For several years the persistence of ultra-low rates meant that discounting corporations' free cash flow using their cost of financing revealed inherent cheapness down the capital stack. Today's higher rates and spreads have caused much of that "value" down the capital stack to evaporate, and we're duly adjusting our portfolios.

In 2018, long Treasuries posted a negative return, causing balanced portfolios of stocks and bonds to experience their only year of under-performance versus cash in at least half a century, outside of outright recessionary periods. The regime shift in risky versus risk-free correlation that we expect in 2019 cannot be understated: it means a portfolio of high-quality European and Japanese assets swapped back to U.S. dollars, Agency mortgage-backed securities and modest allocations to select EM and credit, could work well in the year ahead, if generously hedged with U.S. duration.

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