Policy Evolution in 2019: The Ability to Invest Again

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by Rick Rieder
of BlackRock

Rick Rieder and Russ Brownback argue that an evolving policy stance at the Fed is altering the risk/reward calculus for investors this year, although left-tail risks remain.

Over recent weeks, the Federal Reserve has made a virtuous policy pivot in response to slowing global growth, decelerating U.S. inflation, and acute financial market volatility. Specifically, Chair Powell, Vice Chair Clarida, and several other Fed governors have all come out to highlight the need for patience and flexibility in adjusting monetary policy in 2019, a policy approach that has dramatically altered the way we're approaching portfolio construction. With the Fed now pursuing a more balanced approach that acknowledges divergent macro influences, we are emboldened to be more proactively positioned in select risky assets that now offer demonstrable intrinsic value on the heels of 2018's broad-based bear market for risk. Of critical importance to this approach is that owning risk-free U.S. Treasuries now provides both an attractive real yield, as well as a reliable hedge to risk today. In essence, in 2018 few assets worked for investors, other than cash, but as we enter 2019 both the policy and market landscape now allow for building balanced portfolios again, with attainable return targets.

Policy evolution alters the investment landscape

Considering that the effects of policy tightening are manifested with a lag and that global growth is decelerating, U.S. fiscal stimulus is set to wane, and U.S. inflation remains stubbornly below the Fed's desired target, our comfort in owning U.S. Treasuries in a balanced portfolio is bolstered today. Understanding this mix of influences, we expect the Fed will eventually slow and ultimately cease the runoff of its balance sheet in addition to halting further rate hikes. We think this balance sheet reduction is the primary catalyst in driving global liquidity growth to its slowest post-crisis level, which in our mind represents the greatest left-tail risk to an otherwise moderate and manageable descent toward economic soft landing.

Between the lines of the Fed's mandate is the need to keep borrowing costs for consumers and enterprises in-line with potential growth. If rates are too low, credit bubbles can form, but if rates are too high constrained credit can weigh on activity (see graph). Today, we see market-based borrowing rates as appropriately priced to balance this mandate, meaning we like being a lender to high-quality investment-grade (IG) corporates and emerging market (EM) debt today on an all-in yield basis, with some exposure to high yield debt as well. While growth is undoubtedly decelerating, we judge many IG and EM balance sheets to be quite strong through the lens of leverage, liquidity, and cash flow.

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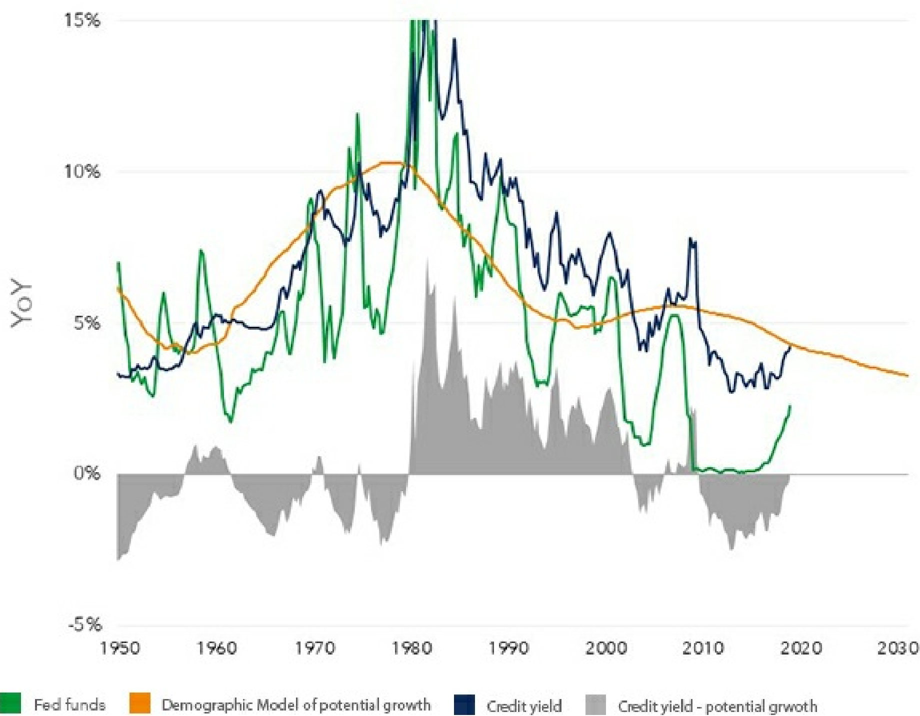

Higher wages weigh on margins, don’t lead to inflation

As we have argued elsewhere, many market prognosticators have pointed to accelerating wage growth as sufficient motivation for policy makers to place the brakes on the economy with more hikes in 2019; we disagree. There is no positive statistical correlation between wage growth and inflation and in fact the opposite is true. Wages follow inflation, not the other way around, and inflation today is irrefutably decelerating. Instead, policy makers should embrace the fact that wages are growing fastest for the lowest income households for the first time in a generation, a phenomenon that should be fostered and encouraged, not curtailed.

Ultimately, these rising wages may weigh on corporate profit margins, dampening business sentiment and eventually slowing new hires and investment. In other words, rising wages can slow growth organically, without any additional “help” from policy makers. Indeed, the body language of Corporate America today is a stark contrast to that of just one year ago, with widespread reductions in forward guidance for revenues, profits, and capital expenditures. Indeed, we find it interesting that changes in the Fed Funds rate track closely with capex growth, so higher funding costs clearly can hamper investment, as we have been concerned about (see second graph).

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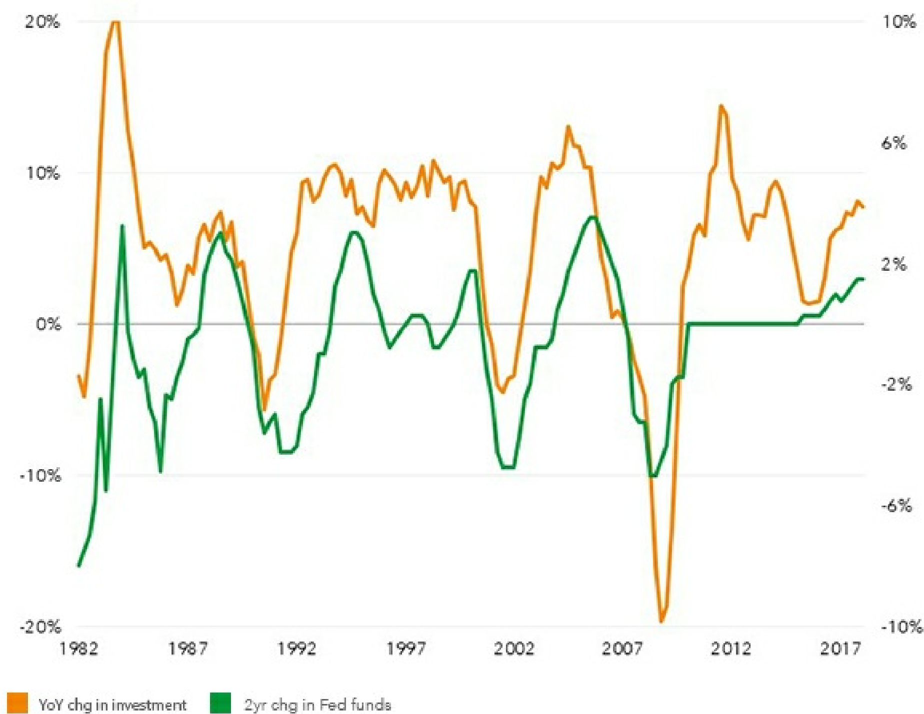

Investment implications

The ebbing of global liquidity, slowing global growth and waning fiscal stimulus, together are combined with building U.S. debt as a set of potentially fatter left-tail risks. This latter factor (large Treasury issuance) creates a potential crowding-out dynamic that may manifest itself in terms of higher volatility at the very bottom of the capital stack. For much of the past two decades, foreign central banks and Fed QE absorbed most of the deficit-financing Treasury supply, but these former buyers are now net sellers. This leaves U.S. investors as the main source of Treasury debt funding going forward, and suggests that a larger allocation to Treasury debt must come at the expense of previous allocations to risky assets, or from discretionary spending or cash reserves. With cash-like Treasury allocations offering attractive real returns, the inevitable crowding out will likely be felt through lower valuations and higher volatility at the bottom of the capital stack, where investors will need greater incentives in order to allocate capital.

All things considered, investors can now construct portfolios with a built-in hedge, sinceduration is now working again as a buffer to risk exposures. That allows investors to take much less risk than was required at the start of 2018 to attempt to achieve return targets. Accordingly, we still like front-end rates, which offer an attractive real yield and pay us to wait for tactical opportunities to increase weightings to riskier assets as inevitable volatility spikes will afford. Fascinatingly, roughly a year ago investors either had to move down-in-quality, or out the yield curve, to come close to generating a 5% total yield in a well-diversified fixed income portfolio. Today, however, with the backup in U.S. Treasury rates, and with the significant downward re-pricing of most risky assets in December, we find that hitting a meaningful yield can be accomplished with much less risk, since now the greater Treasury positions can serve as good ballast for the portfolio overall. In fact, with now higher risk-free rates and wider spreads in credit sectors, the total yield targeted can even be potentially higher than a year ago.

Simultaneously, we like owning spread assets in U.S. IG and EM that offer generous yields when paired with long duration expressions that also provide a powerful risk-off hedge. While there are downside scenarios to both the risky and risk-free components of this portfolio, we find it difficult to envision portfolio-wide losses under most plausible forward scenarios, and that these potential expected positive returns look especially compelling on a risk-adjusted basis.

Further, we are no longer relying on the dollar as a hedge to risk, as the more flexible and symmetric approach toward policy rates by the Fed has likely facilitated an evolution toward a more normal paradigm of dollar weakness that reflects perpetual U.S. trade and current account deficits. The turn of the calendar this year presents a very different set of themes for investors to contend with than was the case a year ago, but interestingly, it should also offer a more robust set of

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market opportunities to take advantage of.

Rick Rieder, Managing Director, is BlackRock's Chief Investment Officer of Global Fixed Income and is a regular contributor to The Blog. Russell Brownback, Managing Director, is Head of Global Macro positioning for Fixed Income, and he contributed to this post.

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