Dr. Quincy Krosby Chief Market Strategist, Prudential Financial

Regime Change

Q2 2018 COMMENTARY

The second quarter—which statistically is not the most hospitable in terms of returns—should enjoy solid growth here and abroad; solid, if not stellar, earnings; the fiscal stimulus beginning to filter into the real economy; and a Federal Reserve that wants to maintain the "middle ground" to ensure a smooth transition that avoids jeopardizing the economic recovery.

Highlights

- Federal Reserve chairman Jerome Powell takes the helm
- A brief history of recent regime changes at the Federal Reserve
- The market enters a period of crosscurrents

Q2 OPENING BELL

The term "regime change" is currently trending in the headlines, from "More expect Venezuela will collapse and have regime change within 12 months" to "Pushing back against Iran: Is it time for regime change?" As we enter the second quarter of 2018, however, the term is increasingly used to describe a subtle but equally important shift in economic policy. Monetary policy stands out as a significant economic catalyst, and with the departure of Federal Reserve Chair Janet Yellen, we've seen headlines blare: "How to survive the regime change in markets."

Referring to February's market correction, triggered by fears that inflation was beginning to assert itself, the *Financial Times* succinctly stated: "Whether correction turns into regime change is down to the Fed." But do members of the Federal Open Market Committee (FOMC) of the Federal Reserve view their job as protectors of stock market performance, the way they seemingly did coming out of the financial crisis?

Newly installed Fed Chairman Jerome Powell, greeted on his first official day with a 4 percent market sell-off, appeared upbeat about prospects for the economy. "We don't manage the stock market, but it enters into our thinking," he testified on Capitol Hill at the end of February. "The stock market is not the economy, but it is very much a factor in the economy's overall performance."

As a Federal Reserve governor, Powell spoke at a 2017 meeting of the American Finance Association and observed that low interest rates can lead to "excessive leverage and broadly unsustainable asset prices." He added that if risk taking doesn't result in financial instability, it is not the "Fed's job to stop people from losing, or making, money."

Now that Fed Governor Powell is Chairman Powell, he is taking monetary policy towards normalization, while markets hope it's not toward premature tightening.

Prudential
Bring Your Challenges®

SIGNIFICANT REGIME CHANGES AT THE FED

G. William Miller: Feeds Inflation

It wasn't that long ago when inflation surged under the Fed chairmanship of G. William Miller (1978 – 1979), appointed by President Carter. A lawyer by training, he took office when the economy was already showing signs of rising inflationary pressures, but Miller was hesitant to raise rates.

The U.S. dollar lost 42 percent against the Japanese yen and over 30 percent against the German mark, and stagflation took hold. Stagflation is the unfortunate combination of a stagnating economy—high unemployment, low demand—engulfed by rising inflation, which had reached 14 percent by early 1980.

Last year, following the appointment of Jerome Powell—also a lawyer rather than a Ph.D. economist—critics pointed to Miller's tenure, which the *Financial Times* termed a "disaster."

Paul Volcker: Slays Inflation

Miller was followed by Paul Volcker (1979 – 1987), who is credited with bringing inflation under control. According to a 2015 interview, President Jimmy Carter was advised that Volcker, the president of the New York Federal Reserve, would be a mistake. "They knew that if I appointed him, he would institute the tough medicine of tight monetary policy, which would be difficult for the economy in the short run," Carter said.

Volcker indeed sent a powerful message of policy regime change in his first press conference. "If we are going to progress and prosper, we need a sense of confidence that we are moving toward price stability at home," he said. Rate hikes brought inflation down to 3 percent in 1983, but the "tough medicine" would put the U.S. into a recession, with the unemployment rate rising from 6 percent in the summer of 1979 to nearly 11 percent in 1982.

President Carter lost the election in 1980, but President Ronald Reagan kept Volcker as Fed chairman. In August 1982, with the unemployment rate at 10.8 percent, Volcker lowered rates and the economy began to gain strength while the secular bull market was launched.

Alan Greenspan: The "Great Moderation"

Alan Greenspan's tenure as Federal Reserve Chairman (1987 – 2006), made him the second-longest serving Fed chairman. The period was labeled the "Great Moderation"—even though the 1987 Black Monday crash occurred two months after he began, a series of rate hikes in 1994 led to losses in fixed income portfolios, and the tech bubble crash led to a low interest rate environment with easy access to subprime mortgages that ultimately led to the financial meltdown in 2008.

Interest rate cuts helped soften the shock of the 1987 crash as Greenspan asserted that the Fed "affirmed today its readiness to serve as a source of liquidity to support the economy and the financial system."

In 1994, a strong economy, along with a strong stock market, was followed by a series of rate hikes. Critics worried that Greenspan was seeing "imaginary inflationary pressures." On February 4, 1994, the FOMC decided to raise rates slightly for the first time in many years. The statement following the meeting said, "The decision was taken to move toward a less accommodative stance in monetary policy in order to sustain and enhance the economic expansion." The public statement was unusual in that the Fed didn't historically announce changes in the federal funds rate. It explained that Greenspan sought to "avoid any misunderstanding of the committee's purposes, given the fact that this is the first firming of reserve market conditions by the committee since early 1989."

The Dow sold off. Analysts agreed that markets were facing a more difficult reality. Rates were raised again in between meetings. Following the series of rate hikes, Orange County, California, the richest county in the U.S., came under pressure as the county's funds, which had bet on the direction of interest rates, suffered major losses leading to bankruptcy. Fixed income portfolios lost money in 1994 although the stock market managed a positive return.

In 1996, Greenspan delivered his famous "irrational exuberance" speech, although the stock market paid little attention to his warning. Greenspan was adamant that it wasn't the Federal Reserve's job to puncture bubbles; rather, the Fed could help after the bubble burst. Criticism aimed at Greenspan focused on his use of monetary policy to create a boom-and-bust cycle that included the 2008 financial collapse.

Ben Bernanke: To the Rescue … With $4.5 Trillion

As the Great Recession unfolded, Fed Chairman Ben Bernanke (2006 – 2014), suggested that the subprime mortgage crisis was contained. Without realizing that subprime mortgages were the basis for highly leveraged derivatives that spread their toxicity across portfolios and balance sheets globally, Bernanke would preside over the collapse of major financial institutions, including Bear Stearns and Lehman Brothers. The ensuing fallout led to an absence of confidence, a withdrawal of market liquidity and a deep recession.

Bernanke lowered rates to nearly zero, which was called zero-interest-rate policy. In addition, Quantitative Easing, or the Fed's buying of bonds, was implemented. Mortgage-backed securities were also purchased by the Fed.

On October 4, 2010, Bernanke wrote an op-ed piece published in the *Washington Post* that explained the Fed's plan and defended spending an additional $600 billion for purchasing long-term Treasury securities. Bernanke outlined a "virtuous circle" in which easier financial conditions promote economic growth. This in turn leads to lower mortgage rates, more affordable housing, and refinancing. Lower corporate bond rates should encourage increased investment, while higher stock prices bolster consumer wealth and confidence. Spending results, and as spending increases, so will incomes and profits move higher.

This was followed by a December 5, 2010, appearance on *60 Minutes.* Chairman Bernanke defended the Federal Reserve's controversial bond-buying program as necessary to help the economy and, by extension, help lift employment. Moreover, he explained the importance of trying to foster inflation, because "we're getting awfully close to the range where prices would actually start falling."

At the time, much of the criticism focused on the potential of quantitative easing leading to strong inflation. In fact, gold sales were rising as popular commentary suggested that gold would serve as a sound hedge to inflation. Bernanke countered on the show that the fear of inflation was overstated. "We've analyzed it every which way," he said. "One myth that's out there is that what we're doing is printing money. We're not printing money." He added that the Fed could raise rates "in 15 minutes if we have to."

In 2012, under Bernanke's guidance, the Fed approved 2 percent as an inflation target, a target it has yet to achieve as the FOMC met in March 2018. While credit is given to Bernanke for keeping the economy out of the kind of downturn that ravaged the U.S. during the Great Depression, he's been criticized for keeping rates too low, for too long. The policy forced pension funds, insurance companies and individual investors to take on undue risk in order to meet obligations. Moreover, worries persist on how the Fed will ultimately unwind its $4.5 trillion balance sheet and normalize interest rates.

Janet Yellen – The Path Towards Normalization

Chair Janet Yellen (2014 – 2018), the vice chair under Ben Bernanke, paved the way for a more transparent Federal Reserve. Labeled a "dove" by analysts, Yellen had outlined a plan to raise rates four times in 2015, yet because of a litany of concerns, there was only one rate hike in December, the first hike since 2006. The "too low, for too long" criticism intensified as a result.

A labor economist by training, Yellen maintained that the low-rate policy was necessary because "slow progress in moving the economy back toward full employment will not only impose immense costs on American families and the economy at large, but may also do permanent damage to the labor market." As the labor market added more jobs and the economy gained traction, she surprised analysts as she laid the path towards normalization with a steady pace of rate hikes. Her signature "patient and gradual" approach towards a higher interest rate environment helped assure stock market investors that the rate-hike cycle would be well telegraphed before each move by the FOMC. Yellen's style was to keep markets informed and to make certain there weren't any surprises.

Janet Yellen left the Federal Reserve with the unemployment rate falling to a healthy 4.1 percent during her tenure, and low-wage workers are beginning to see higher wages. This was accomplished before the promise of fiscal help from the tax cut plan.

Ironically, Chair Yellen was applauded by many Republicans for doing a difficult job under difficult conditions, and many wanted her to stay on. *Politico* quoted Scott Sumner of the conservative Mercatus Center as saying, "Yellen is on a glide path to near perfection, as she will probably end her term achieving the Fed's dual mandate better than any other chair in history."

Jerome Powell – Pragmatist at the Helm

Chairman Powell enters the second quarter with two important market "tests" behind him. The first, in February, was the Semiannual Monetary Policy Report to the Congress, and the second, the FOMC meeting in late March, in which the committee raised rates as it continues the path toward rate normalization.

A lawyer by training but with enough tenure immersed in monetary philosophy, Chairman Powell will make decisions based on the broad swath of evidence. Powell emerged as a pragmatist, willing to examine the data without embracing the loftier language of an academic economist's theoretical models and somewhat esoteric explanations. He is to the point, confident in tone and comfortable in his delivery.

His message was clear: with inflation moving closer to the Fed's 2 percent target and employment gaining strength, the path towards normalization may need a faster pace. "The economic outlook has strengthened," Powell said. "Headwinds have turned into tailwinds." Accordingly, as the economy gains traction a higher-rate path is appropriate, but Powell reiterated that the path will be "gradual," the word most closely associated with Yellen.

Powell underscored that rate increases must be underpinned by a stronger economy, and was firm that a fourth rate hike would be appropriate if conditions warrant it. Important for market participants was his comment that the committee hasn't seen signs that the U.S. is on "the cusp" of accelerating inflation, although inflation is expected to recover during the second quarter.

He stressed the need to balance two risks: one, raising rates too quickly and pushing inflation below the Fed's 2 percent target, and two, raising rates too slowly and having the economy overheat, thus forcing the Fed to raise rates quickly and causing a recession. "We're trying to take the middle ground … gradual increases in the federal funds rate." The rate hike at the March meeting was "another step in gradually scaling back monetary accommodation."

The *Wall Street Journal* in its editorial following Powell's first FOMC meeting said, "The bottom line is that the Powell Fed is continuing on the path set by predecessor Janet Yellen, as widely expected. Mr. Powell isn't showing much leg regarding his own monetary philosophy, as he hasn't throughout his tenure as a governor since 2012. He will be tested, but not yet."

Q2 LOOK AHEAD: THE MARKET ENTERS A PERIOD OF CROSSCURRENTS

To say that volatility has made a comeback in this new regime is an understatement. Nearly dormant in 2017, 2018 ushered in a spate of market selling with the proverbial "buying on the dip" that we became so accustomed to, requiring deeper dips and more selective buying. Indeed, calls for the return of "active" management seems increasingly realistic.

With interest rates being one of the major pillars, if not the major pillar, behind the rationale of buying equities, the transition from zero-interest policy to a more normal rate environment will put the market more at risk for bouts of volatility.

The market will be as data dependent as the new Fed chairman. The 10-year Treasury yield has been flirting with 2.9 percent much of the first quarter, and it, along with the 2-year Treasury yield, will be a guide to the path of the economy and, of course, the Fed. Crossing 3 percent and managing to stay above that level could trigger volatility as markets adjust for more hawkish statements from Fed officials.

Not only are higher rates a concern, but the Fed has also been unwinding its balance sheet, and the pace of the "QE Unwind" moves up from $20 billion a month in the first quarter of 2018 to $30 billion in the second quarter, followed by $40 billion a month in the third quarter and $50 billion a month in the last quarter of the year. The unwinding began in the third quarter of 2017 with $10 billion a month. While accommodation and liquidity remain healthy for markets, any difficulties resulting in the "unwind" could also spur bouts of volatility.

The cost of capital is increasing and discussion has begun regarding the LIBOR-OIS spread, with concerns over the widening spread sparking comments that this is indicative of potential problems within the banking system. Many seasoned analysts, however, have observed that the widening spread has more to do with mechanical supply/demand issues. Still, there's an ongoing tug-of-war as to whether or not the economy can handle this year's series of rate rises as the Powell Fed ushers in the next phase of the regime change.

Earnings expectations continue to be revised upwards on both the top and bottom lines. Given the strength of earnings reports over the last year, it's hard to remember that the earnings recession didn't end until the third quarter of 2016, when we finally saw year-over-year growth following five quarters of contracting earnings. As the global economy improved and demand picked up markedly, top-line revenue growth returned in earnest. Expectations are that earnings should remain supportive for markets, and with the U.S. dollar still competitive against the currencies of our trading partners, market conditions are constructive.

Market watchers will be focused on which sectors lead the market higher—will they be the cyclical-related sectors or the more defensive ones? This sector leadership exemplifies the tone of investor thinking as to whether we are in a slowdown or expansionary environment.

Trade war concerns continue to cause intense market jitters. President Trump issued an executive order at the end of March that could impose tariffs on up to $60 billion of imports from China. This is in addition to the steel and aluminum tariffs introduced, but with important exceptions. The president did stress that there will be negotiations between the U.S. and our trading partners, but the overall effect must be a level playing field.

Following the March FOMC meeting, Chairman Powell was asked about the effect on the economy from tariffs and a possible trade war. He replied that conversations with FOMC members and business leaders suggested that trade policy has become a concern for growth going forward. The market continues to sort through the headlines and comments from the administration to determine which sectors and specific companies are best positioned for different scenarios.

The new regime is a return, in many ways, to a normal market. Normal markets require catalysts to climb higher. The second quarter—which statistically is not the most hospitable in terms of returns—should enjoy solid growth here and abroad; solid, if not stellar, earnings; the fiscal stimulus beginning to filter into the real economy; and a Federal Reserve that wants to maintain the "middle ground" to ensure a smooth transition that avoids jeopardizing the economic recovery.

References include the following: *Barron's, Bloomberg,* CBS News, CNBC.com, CNN, Cornerstone Macro, *The Economist,* Evercore ISI, Federal Reserve, *Financial Times, Forbes, Fortune,* Goldman Sachs, Macro Risk Advisors, MarketWatch, Morgan Stanley, *Newsweek, The New York Times,* NextBigFuture.com, Oxford Economics, Politico, Renaissance Macro, *Time, The Wall Street Journal* and Wikipedia.

0316322-00001-00