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A Good Place

Q1 2020 COMMENTARY

For now, investors should celebrate the "good place" we're in. As we know, things can change quickly, but for the first quarter of 2020 markets—despite bouts of profit-taking—are poised for growth and better things ahead.

Highlights

- U.S. housing could play a key role in GDP growth
- Global economy should stage a modest recovery
- Details matter in the "Phase One" China agreement

Throughout most of 2019, Federal Reserve Chairman Jerome Powell characterized the U.S. economy and monetary policy as being in "a good place," despite an onslaught of criticism from the president. That followed the last rate hike in December 2018, which came with indications that there would be more to come in 2019, perhaps two hikes. Surely, year-end 2018 market performance didn't point to a good place despite the Federal Open Market Committee (FOMC) December 19 statement that "the labor market has continued to strengthen, and that economic activity has been rising at a strong rate." By December 24, the market was decisive in declaring that the Fed had made a mistake, and from a sector perspective, the market was bracing for an economic downturn.

On January 4, Powell changed direction, and the Fed pivot increasingly brought us closer to a good place. Instead of rate hikes, 2019 was the year of rate cuts with a "patient" Federal Reserve. And instead of keeping the unwinding of the Fed's balance sheet on "auto-pilot," which many astute observers claimed added to a tightening of financial conditions when combined with rising interest rates, Powell said the Fed "wouldn't hesitate" to adjust balance sheet management if necessary. In less than two weeks the Federal Reserve set markets, and the underlying economy, on the path toward a 2020 "good place."

An almost daily barrage of headline-grabbing worries faced investors and traders alike as the market climbed the proverbial "wall of worry": trade and tariff tensions, inverted yield curve concerns with their implications for an economic recession, $17 trillion of negative yielding global debt, global economic slowdown, earnings recession fears, Brexit, global unrest, and impeachment proceedings. Yet global markets, underpinned by global central bank stimulus and the continuation of trade negotiations and agreements, can begin 2020 with the hope that economic conditions are set to rebound, albeit slowly but steadily.

LOWER FOR LONGER

This past summer, global central banks in both developed and emerging markets began a vigorous campaign to lower interest rates as global growth prospects dimmed. In the U.S., while there have been three "insurance" rate cuts in 2019, the Fed's assertion that it is prepared to keep rates low for longer by allowing inflation to climb above its stated 2% target in order to ensure that inflation expectations become well anchored has helped markets. For nearly 11 years the 2% target has been elusive against a background of low inflation globally.

At the FOMC press conference in December Chairman Powell said, “In order to move rates up, I would want to see inflation that’s persistent and that’s significant. A significant move up in inflation that’s also persistent before raising rates to address inflation concerns: That’s my view.” When asked by a reporter if this view is a “codified” view within the FOMC, Powell explained, “We haven’t tried to turn it into some sort of official forward guidance. It happens to be my view that that’s what it would take to want to move interest rates up in order to deal with inflation.”

As the Fed has lowered rates during 2019, concerns over the effects of the trade war with China, particularly the uncertainty surrounding corporate confidence and capital expenditures, have been given as a primary reason for these “insurance” cuts. Also, the global slowdown coupled with stubbornly low inflation have been an integral part of the Fed’s rationale for easing monetary conditions. As trade frictions ease, and growth prospects display signs of picking up, many analysts feared the Fed would be quick to move interest rates higher again.

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Powell’s comments at the last Fed press conference underscored what he said at the previous meeting, that rates are on hold until inflation makes a clear and persistent move higher. This would include pricing pressures moving to the upside, as well as rising consumer inflation expectations. When asked why he was confident the Fed would meet its 2% inflation target by keeping rates low, Powell replied, “I would say there’s more humility than there is confidence at this point. It’s been very challenging to get inflation to target. If you look at the world, the United States of all major economies has come closest, but it still hasn’t quite been able to achieve it.” These comments are reflected by the Fed funds futures market which, at the end of 2019, projects a rate cut in 2020 if inflationary pressures and growth do not meet expectations.

In the eurozone, the stage was set in September as the central bank outlined a second round of quantitative easing that involves €20 billion a month of asset purchases for as long as the economy requires it. In addition, the European Central Bank (ECB) main deposit rate was lowered to -0.5%, a record low. Former ECB President Mario Draghi, who has been succeeded by Christine Lagarde, said at the September meeting, “In view of the weakening economic outlook and the continued prominence of downside risk, governments with fiscal space should act in an effective and timely manner.” At the December ECB meeting, Lagarde, who spent eight years as head of the International Monetary Fund (IMF), and who kept the ultra-loose monetary stimulus intact, delivered a more upbeat assessment of the 19-member eurozone economy. “These downside risks on the horizon are less pronounced. That’s encouraging.” In addition, “incoming data point to continued muted inflation pressures and weak growth dynamics, although there are some initial signs of stabilization in the growth slowdown,” she said.

Low inflation, however, continues to stymie policymakers. With regard to the seemingly set-in-stone 2% inflation target, Lagarde said she is “neither a dove nor a hawk. My ambition is to be this owl, which is often associated with a little bit of wisdom.” That said, she expressed concerns about the effects of attempting to push up inflation rates. “We are very aware of the side effects. We would not be doing our job if we were not monitoring and being extremely attentive to that balance of cost-benefit.” Previously, before taking over the ECB presidency, she has stated that monetary policy cannot be the only remedy for sluggish growth. Like Draghi, she called on governments to introduce fiscal stimulus to augment monetary stimulus. At the December meeting Lagarde asked for “growth-friendly” policies from governments, saying, “It takes many to dance the economic ballet that delivers price stability and economic growth.”

In Japan, Haruhiko Kuroda, the head of the Bank of Japan (BOJ), recently reiterated his position that “our monetary easing efforts are aimed at achieving our price target, not at helping fund government spending. There needs to be a clear line drawn on this point.” After decades of policymakers trying to induce inflation into the economy, Kuroda stressed that for monetary and fiscal policies to be effective, structural reforms are necessary. Like his Western counterparts, he made clear that the BOJ stands prepared to cut rates if necessary, in order to reach its 2% inflation target. Japan’s cabinet has given approval for a $122 billion fiscal stimulus package to help revive growth and to limit downside risks.

At the December meeting of the BOJ, rates were left unchanged and the massive quantitative easing program was left in place; however, the Policy Board will guide the short-term interest rate, currently at -0.1% towards 0%. Although the quarterly BOJ Tankan survey showed that sentiment among Japan’s manufacturers fell to a seven-year low due primarily to the slowdown in global growth, Kuroda said at the press conference following the BOJ meeting, “Japan’s economy has been on a moderate expansion trend.”

While China is not attempting to lift inflation—inflation for food prices has risen sharply because pork prices climbed as an African swine fever decimated China’s hog herds—it is trying to stimulate growth without causing a material spike in inflation. China’s manufacturing sector has suffered from the trade war with the U.S., leading to increased stimulus from policymakers. According to a November 2019 United Nations report, the trade war has cost China $35 billion in export trade for the first six months of 2019. The report terms the trade war spat a “lose-lose” situation for both the U.S. and China, and the wider world. According to data derived from United States Customs and Border Protection, companies in the U.S. have paid approximately $40 billion in extra taxes for imports of parts and finished products from China since the onset of increased tariffs.

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To help alleviate the effects of the downturn in trade, Beijing has introduced approximately 100 stimulus measures since 2018. Taxes were lowered, rates have been cut, and banks have been allowed to lend more. For the first time since 2016, in November there was an interest rate cut in its one-year medium lending facility (MLF) loans. The small cut, just 5 basis points, was indicative of the overall restraint authorities have shown in trying to stabilize the economy with a series of moves that are more measured than what was implemented during the global slowdown that began in 2008. It is clear authorities are seeking a more stable and sustainable recovery with targeted measures, including infrastructure spending, designed to boost demand. Moreover, with China’s debt-to-GDP ratio high (particularly corporate debt), due to cheap debt being used to fuel its earlier dramatic double-digit growth rates, Beijing has sought to unwind excesses rather than continue to increase the spiral.

PHASE ONE TRADE DEAL

The long-awaited Phase One trade agreement is a net positive for global trade and global growth, not just trade exclusive to the U.S. and China. Global manufacturing should begin to see a boost as the Chinese economy inches higher. As domestic demand continued to weaken in China in 2019, imports fell approximately 4.5%. The German IFO business climate index rose in December more than expected, offering hope that the eurozone’s largest economy, and a major exporter, sees global conditions easing as trade war headlines diminish. The *Wall Street Journal* editorial that followed the deal’s announcement welcomed the economic news, saying it’s “essentially a détente that eliminates the damage from pending U.S. tariffs and even makes some progress on long-standing problems like China’s intellectual property theft.” Terming the president’s trade policy as “willy-nilly,” the editorial states the tariffs and consequent retaliation “have catalyzed a manufacturing recession and caused CEOs to reduce capital spending.”

Along with the Phase One agreement, the threat of auto tariffs against Europe appears to have receded for now, and the revised NAFTA agreement enjoys bipartisan support. While the Phase One détente has been dubbed a “skinny” deal, as it is fairly light on specifics but full of promises, it was designed, according to officials in Beijing, to “boost confidence in global markets and pave the way for more U.S. services and products to enter China.”

At the very least, the nearly 20-month trade war may be over, even if only temporarily. In an interview on FOX Business, U.S. Trade Representative Robert Lighthizer said that the U.S. and China have reached a point where “we have a very good phase one agreement and we’re going to find out whether or not it works … This is not just about purchasing. This is about structural change. This is about taking the first big step to determine whether or not two different systems can work together in the future to their mutual benefit.” He added, “Hopefully, we’ll find a way that we can both get rich.”

At the end of 2019 Beijing announced the lowering of tariffs on imports from all of its global trading partners, including pork products, semiconductor products and medicines, continuing a practice of end-of-year tariff cuts introduced in 2017. As far as the Phase One progress was concerned, China’s state media at the end of December reported President Xi saying that the U.S. and China had agreed to the Phase One deal, and while details have not yet been finalized, there are market expectations that the agreement could be signed as early as January 2020.

THE GLOBAL ECONOMY SHOWING SIGNS OF RECOVERY

Recent economic and trade data releases indicate that the global economy may be showing signs of improving, albeit slowly. Business activity in the U.S. climbed to a five-month high toward the end of 2019, while industrial output and consumer spending in China also increased. Analysts are upgrading their projections for 2020 economic growth in both countries as downside risks abate. Consensus estimates now project China’s growth to reach 6%, revised up from 5.7%, while U.S. GDP should reach 2.2%, slightly higher than the Federal Reserve's estimate of 2%. The International Monetary Fund (IMF) expects global growth to improve in 2020, with a forecast of 3.4%. In an interview with *The Wall Street Journal*, the head of the IMF, Kristalina Georgieva, said that while the IMF expects a rebound in growth, "there are quite significant downside risks" to the forecast, including trade tensions.

Global stock markets are indicating that with central bank support, trade tensions easing, and an uptick in data and confidence, the global economy should stage a recovery. According to a Bank of America Global Research survey, 50% of global fund managers project stronger global economic growth, with 22% expecting weaker growth.

A GOOD PLACE CONTINUES INTO Q1 2020

It stands to reason that because U.S. markets have been pricing in continued central bank liquidity, an easing of trade tensions, and optimism over economic and business conditions, markets in the U.S. can become "over bought" and need a spate of consolidation before resuming the uptrend. With small- and mid-cap stocks—as well as micro-cap stocks—joining the rally, it suggests that institutional money managers see the U.S. economy on solid, if not stellar, footing.

The National Federation of Independent Business (NFIB) small business optimism index released on December 10, showed that in November small business owners' optimism climbed to the highest month-over-month gain since May 2016. The NFIB's chief economist said, "Owners are aggressively moving forward with their business plans, proving that when they're given relief from the government, they put their money where their mouth is, and they invest, hire, and increase wages."

The Business Roundtable CEO Economic Outlook, a survey based on the projections from the largest U.S. corporations, was less optimistic, particularly with regard to trade policy, although the estimate for 2020 U.S. GDP was 2.1%. The Phase One agreement, reached after most of these industry surveys, coupled with the United States-Mexico-Canada Agreement (USMCA), should help ease concerns that trade tensions will continue to thwart capital spending and hiring plans. The widely followed Duke University/CFO Global Business Outlook, released in early December, was also decidedly less optimistic in its outlook: "Half of U.S. CFOs Expect Recession in 2020 as Election Looms," with 59% of respondents indicating they will be strengthening their balance sheets, which includes reducing costs. And 54% of U.S. firms "indicate they are unlikely to spend their cash holdings during 2020 to preserve liquidity and spending power should a recession take hold and tighten lending markets." Fannie Mae's Economic and Strategic Research Group chief economist projects that "housing appears poised to take a leading role in real GDP growth over the forecast horizon for the first time in years, further bolstering our modest-but-solid growth forecasts through 2021." Consensus estimates say housing, along with associated spending on such things as furniture, appliances and construction materials, could contribute a little over a half percent to 2020 economic growth.

Despite continued strength in the employment landscape, an optimistic consumer, the solid underpinning of the housing market, and the easing of trade tensions, the tug-of-war regarding a 2020 recession continues. President Trump's approval rating in his handling of the economy has moved up to approximately 50%, from a low of 40% earlier in 2019, based on the CNBC All-America Economic Survey released on December 18. And his beloved barometer of his economic performance, the markets, finished 2019 near new highs.

Risks have abated, to be sure, but have not been eliminated. Geopolitical risks remain, and trade concerns, while easing, could pick up again as the administration turns its attention back toward the European Union, particularly regarding the taxes imposed on U.S. technology companies doing business in Europe. In addition, it's worth watching the Phase One deal as specifics emerge and are clarified. And then there are risks associated with the 2020 election. But for now, investors should celebrate the "good place" we're in. As we know, things can change quickly, but for the first quarter of 2020 markets—despite bouts of profit-taking—are poised for growth and better things ahead.

References include the following: Associated Press, *Barron's*, Bespoke Investment Group, Bloomberg.com, CNBC.com, Cornerstone Macro Research, Evercore ISI Research, *The Financial Times*, Goldman Sachs, International Monetary Fund (IMF), *The Japan Times*, Morgan Stanley, Natixis, *The New York Times*, Oxford Economics, Renaissance Macro Research, TheStreet Real Money, Thomson Reuters, UBS, United Nations Conference on Trade and Development (UNCTAD), *The Wall Street Journal*, *The Washington Post*.

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