July 2019 Outlook

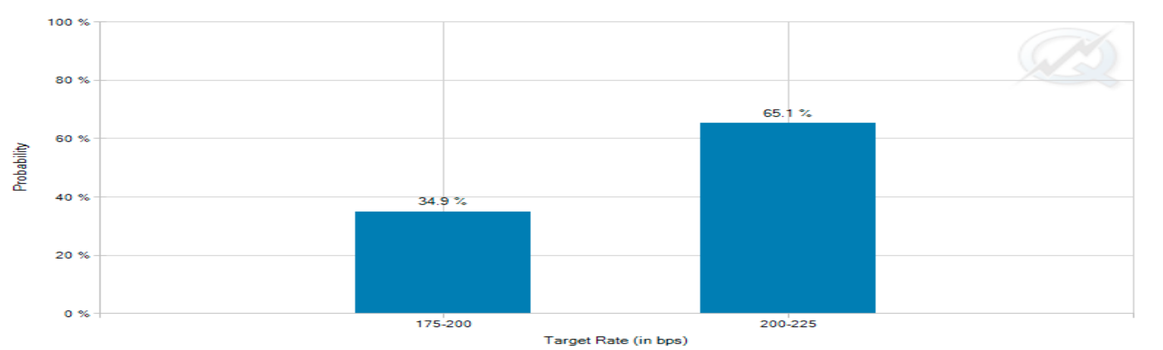
The Moral Hazard of the "Fed Put"

We seem to be significantly in the minority in our views that an interest rate cut at the end of this month is not justified and is potentially detrimental.

We can illustrate how out-of-the-consensus we are in two ways. The first way is a simple, unscientific observation of "the conversation" that has been occurring in the media for the last couple of months. Not only does the preponderance of news stories, interviews and "guest host" opinions declare the likelihood of rate-cuts in July, but we have heard actual journalists on financial news channels declare that rate-cuts are a foregone conclusion based on this data point or that, or this market move or that.

31 Jul19 | 18 Sep19 | 30 Oct19 | 11 Dec19 | 29 Jan20 | 18 Mar20 | 29 Apr20

MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
31 Jul 2019	ZQN9	31 Jul 2019	97.6013	13,628	311,062	100.0 %	0.0 %	0.0 %



TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 16 JUL 2019	1 WEEK 10 JUL 2019	1 MONTH 17 JUN 2019
175-200	34.9%	27.1%	29.2%	16.1%
200-225	65.1%	72.9%	70.8%	68.4%
225-250 (Current)	0.0%	0.0%	0.0%	15.5%

* Data as of 17 Jul 2019 07:53:30 CT

As Source: https://www.cmegroup.com

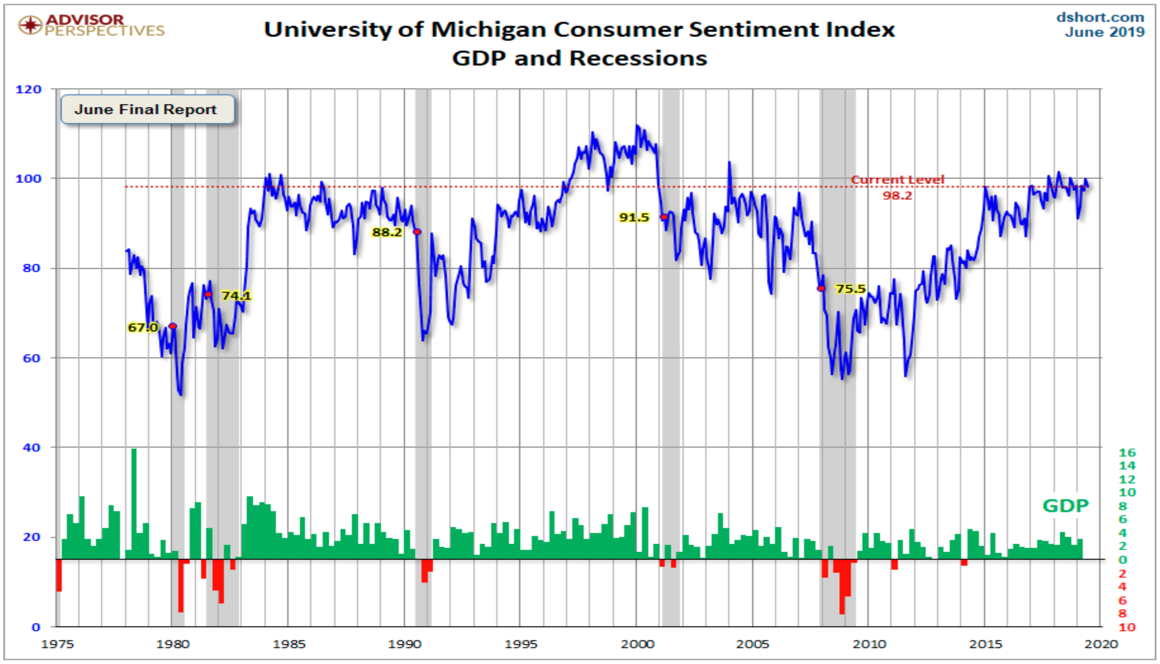
The second piece of evidence, the Fed Funds Futures market, better *quantifies* our minority status. seen below, the CME (Chicago Mercantile Exchange), which trades futures contracts on the likelihood of a change in the Federal Reserve changing monetary policy in upcoming FOMC meetings, shows that **100% of participants in this market expect a rate cut**, with 65% betting on a quarter-point cut, and 35% betting on a half-point rate cut.

Monetary policy is generally one of two levers of influence governments have in spurring, or trying to cool economic activity, with an aim to prolonging market cycles, or the prevention of sharp drop-offs of economic activity which could result in recessions. The primary lever of monetary policy has traditionally been the level-setting of short-term interest rates which, in turn, affects the rest of the yield curve, the amount of currency in circulation, and ultimately regulates the “velocity of money” in the economy. Monetary policy is controlled by a country’s Central Banking Authority (Federal Reserve in the US, European Central Bank for the EU, Bank of Japan for Japan). The other tool, of course, is **fiscal policy**. Fiscal policy is ultimately controlled through political channels. Generally thought of as being independent of monetary policy, fiscal policy affects economic activity through taxation and regulatory rules.

Consider, for a moment, these four recent economic releases:

- Retail Sales for the month of June rose by 0.40%. Economists polled by Reuters had a consensus estimate of a rise of 0.10% for June. Strip out retail gasoline sales (which is affected by the price-drop in gasoline, not the amount of consumption) and sales rose a robust 0.70%. This “core” measure was also revised upward for previous months.

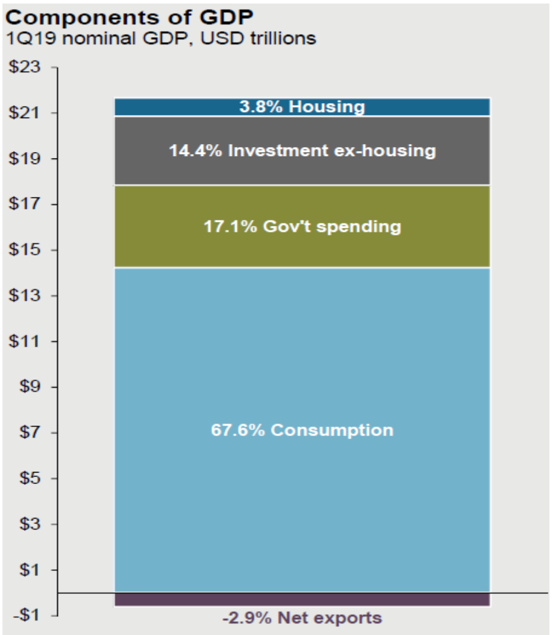
- The University of Michigan Consumer Sentiment Index for June came in at 98.2, down slightly from May (by 1.8). We will let the following chart from Advisorperspectives.com illustrate this measure, relative to history:



- Non-farm payrolls (the number of non-agriculture jobs created) in June rose by 224,000. Consensus expectations were for a rise of 160,000—an upside surprise of 65,000 jobs for the month. We note that all monthly economic data releases tend to be "noisy" for a variety of reasons, including seasonal and weather-related anomalies. Looking at a four-month average, we see average non-farm payroll jobs created at 189,500 per month, while the average of the consensus estimates is 177,500 per month.

- Consumer prices for June, stripped of volatile food and energy items (i.e. "core") came in at a 0.3% month-over month (consensus was for unchanged), and annual core inflation pushed up to 2.10%, up from 2.0%. The annual core CPI number has been 2.0% or higher since March of 2018.

Let us pause here and say there are a myriad of other economic data metrics released monthly, and we can't review all of them (was that a sigh of relief?). But we can say with some confidence that none of them are flashing red, in our opinion. We highlight these four items with an eye on 1) reminding ourselves, and you, our reader, what the primary driver of our economy is, and 2) the Federal Reserve's **dual mandate**.



Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009.
Guide to the Markets – U.S. Data are as of June 30, 2019.

First, as we have pointed out before in these pages, the Gross Domestic Product of most developed countries is roughly 2/3 driven by the consumer. Both Retail Sales and the University of Michigan Consumer Sentiment survey are direct measures of the health of this important economic constituent. One looks backward at the data, one looks forward with surveys. Keep in mind, these measurements are taken in an environment replete with news of tariffs, trade disputes and US-China relations.

Second, as stated on the website of the Federal Reserve Bank of Chicago (www.chicagofed.org); "***The monetary policies of the Federal Reserve are to foster economic conditions that achieve both stable prices and maximum sustained employment***" (emphasis added).

The PUT:

Consumers of financial news may have heard the term "Fed Put". A Put option is a derivative contract which essentially provides protection against a certain downside move in the underlying security, usually a stock. Buying a Put is much like buying insurance. One can feel more confident, perhaps even *care-free*, knowing that you are insured should something unexpected, negative, or both transpire that causes your investment to lose value.

It is the Federal Reserve's role to support the economy and the specific mandates to which Congress has charged it using the tools of interest rate adjustment. As we have seen, the fundamentals of the US economy are sound. Both the backward measurement (Retail Sales) and the forward measure (Consumer survey) indicate the consumer is on solid footing. The current unemployment rate of 3.7% remains at historically low levels. And yet, not only does the narrative hold that rates must be cut, the stock market has, in recent weeks, *counted on this cut* by making new all-time highs in all major US equity indices. Folks, this is the definition of the Fed Put.

Investors feel confident that Jerome Powel and the rest of the FOMC "has their back"—so they go ahead, they keep buying stocks, keep moving the market higher.

Recall the fourth quarter 2018 stock market tumble. In our January Outlook we asked these questions: "*Is the stock market predicting the economy? Does the economy justify the stock market moves?*" We asked these questions in a "Wag the Dog" context, as we saw no economic justification for the market's slide (especially to that degree). The genesis of the plummet was a speech in early October when Chairman Powel intimated that there would be no pause in interest rate hikes.

Pardon our sarcasm, but the quarter-point rate hike that *did* occur in December of last year did so much economic damage that it resulted in the retail sales, consumer sentiment, and employment metrics outlined above! Not only that—the impact of this rate hike in December was so severe that the S&P 500 is up 21.15% since then! Much of the "narrative" since the December rate hike has concluded that the Fed made a mistake with this decision.

<u>The Moral Hazard</u>:

"Moral Hazard" is a term often used in the financial industry—and especially the insurance sector. According to Investopedia.com, "*moral hazard is the idea that a party protected in some way from risk will act differently than if they didn't have that protection*".

As stated, major stock indexes in the US have been making new all-time highs for much of the last month. We should also point out that bond prices, as expressed by the Bloomberg Barclays Aggregate Bond Index, are trading at 3-year highs. US ten-year Treasury yields have fallen from 2.66% at the start of the year to 2.06% as we write--a 23% decline (bond prices and yields move in opposite directions). Let us state these facts differently: The stock market is seemingly forecasting a very bright economic future, while the bond market is forecasting something akin to a recession.

Obviously, they can't both be right. Perhaps less obviously, the Fed must choose a side.

We were struck with the rapidity of the Fed's about-face in the fourth quarter. The statements "*we're nowhere near the neutral rate*" and "*we're going to be patient going forward*" are separated by only three months. Oh, and a nearly 20% slide in the price of the S&P 500.

In January Chairman Powell also added that in addition to the exercise of patience, the Fed would be "listening very carefully" to signals the market is sending.

Nowhere in the mandate of the Federal Reserve is there a clause to "support asset prices" or "support stock market indices". Equity markets should, and historically have served as discount mechanisms, where prices reflect the probabilities of both potential economic growth and potential perils of economic decline. Today, however, it seems equity prices can only be justified by slashing interest rates.

We recently commented in a video segment that it is imperative for Central Banks around the world to maintain their credibility when regulating monetary policy. We think not only should a mandate be strictly adhered to, but that doing so provides all the clarity needed by markets to anticipate potential interest rate moves and to adjust prices according to that data, as well as other risks which may be present. **We are concerned, however, with the prospect of central banks financially engineering market outcomes**. Doing so, in our opinion, is a moral hazard which threatens the credibility of the institution(s).

Last quarter we outlined reasons why CCR Wealth Management had aggressively reduced our non-US equity exposure. Principal among these was the prospect that interest rates from Europe to Japan are already in negative territory. Clearly such aggressively loose policy, coupled with massive asset purchasing programs (i.e. "quantitative easing") have done little to spark reflation or an economic boom. And now? The proverbial guns have no bullets. And these economies are slowing.

Yes—economies around the world are slowing—growing, but at slower paces. July marks the 121st month of the current economic expansion in the US, making this the longest economic expansion in history. We think that is extraordinary. We also think it will last a bit longer, even without rate cuts. But as we wrote 18 months ago, fiscal stimulus like that enacted in the US in 2018 is a temporary measure and the effects are wearing off. Growth rates were always expected to slow relative to 2018. Probability of a recession here in the US in the near term is low in our opinion, and in most of the opinions which we survey.

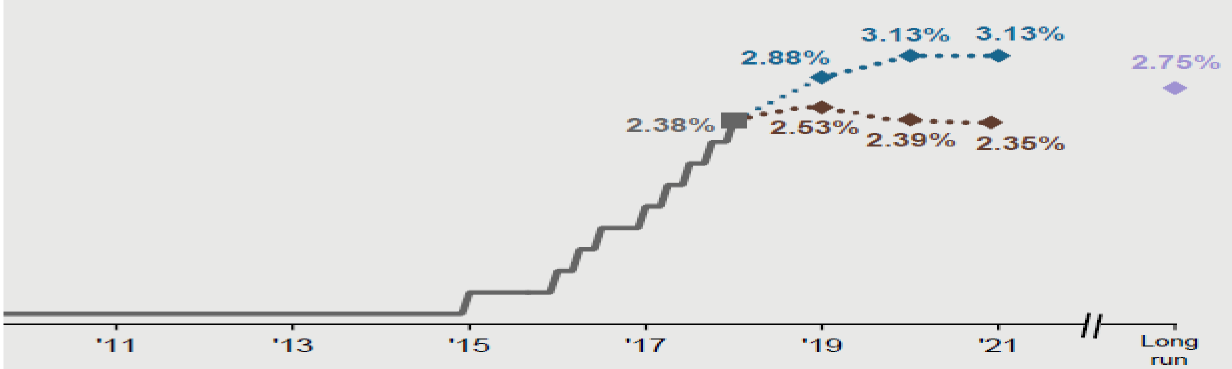
In summary, the FOMC meeting is July 30-31st—likely only a handful of days from the delivery of this piece into your mailbox. Stocks in the US fully expect an interest rate reduction to be announced on July 31st by virtue of their proximity to all-time highs. We see a very low probability that the Fed will see things the way we do, but if we're wrong (and rates are not cut), we expect a sharp equity sell-off in the US.

Even if rates are cut a quarter-percent on the 31st, we still see the likelihood of a sell-off in equities because a good chunk of the market expects a half-point rate reduction. Reiterating the views expressed in our April Outlook video, we see the current pace of market advancement as unsustainable outside the framework of interest rate cuts and we expect corrections ahead. With a sound underlying economic foundation here in the US, our longer-term outlook for equities remains constructive. For most, this means adjusting your expectations rather than your portfolios.

FED/MARKET INTEREST RATE EXPECTIONS AT THE END OF 2018

FOMC December 2018 forecasts
Percent

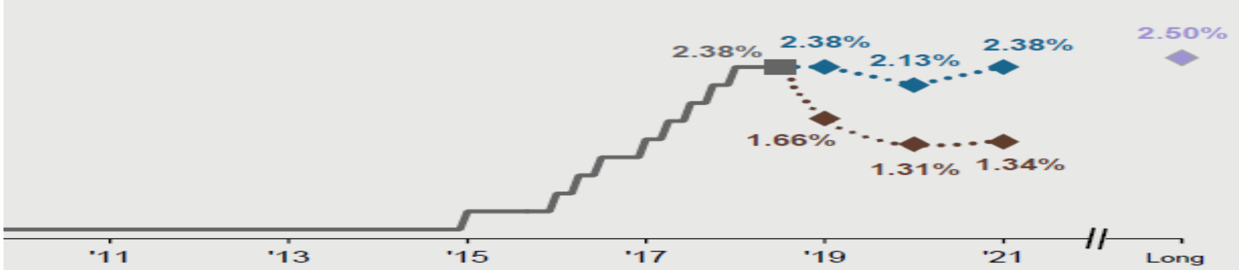
	2018	2019	2020	2021	Long run*
Change in real GDP, 4Q to 4Q	3.0	2.3	2.0	1.8	1.9
Unemployment rate, 4Q	3.7	3.5	3.6	3.8	4.4
PCE inflation, 4Q to 4Q	1.9	1.9	2.1	2.1	2.0



FED/MARKET INTEREST RATE EXPECTATIONS AT THE END OF JUNE, 2019

FOMC June 2019 forecasts
Percent

	2019	2020	2021	Long run*
Change in real GDP, 4Q to 4Q	2.1	2.0	1.8	1.9
Unemployment rate, 4Q	3.6	3.7	3.8	4.2
PCE inflation, 4Q to 4Q	1.5	1.9	2.0	2.0



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the June 2019 FOMC meeting and are through December 2021. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy.
Guide to the Markets – U.S. Data are as of June 30, 2019.