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FED SHADOW

Bull Market, Meet Your New Fed

Monday, January 29, 2018

Donald Luskin

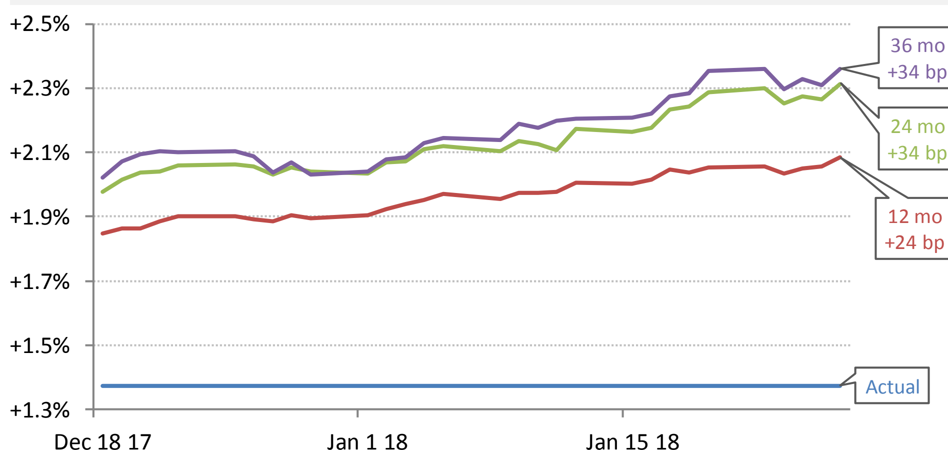
Since TCJA, one new 2018 hike is expected. Stocks and yields agree it's not a tightening.

We come into Wednesday's FOMC meeting, Janet Yellen's last, with the funds rate at 1.375%, seemingly at the Fed's definition of "neutral." That's *almost precisely* in line with the Q3-2017 reading of the Laubach-Williams model for estimating the real natural rate of interest (at negative 0.08%) plus core PCE inflation (at 1.5% year-over-year).

- The Fed has signaled, and markets have understood, that there are more rate hikes to come, gradually, as the economy continues to improve and the real natural rate rises along with it (see, among many, "Yellen's March to Neutrality" March 6, 2017). Since the Tax Cuts and Jobs Act was enacted on December 19, 2017, without any particular signals from the Fed – it seems everyone is staying quiet, out of courtesy for incoming chair Jerome Powell – *the money-market curve has upgraded its forward funds rate expectations by one rate hike 12 months forward – from two hikes, to three – and one-and-a-half hikes 24 months and 36 months forward – from two-and-a-half hikes, to four* (please see the chart below). *We don't think this implies a tighter Fed, only a faster-growing economy to which the Fed will index the funds rate, thus maintaining approximately today's neutral policy stance.*

Is the economy really accelerating? Friday's below-consensus 2.6% Q4-

Curve-implied forward funds rate versus actual From enactment of TCJA



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US FED, US BONDS, US STOCKS: The Fed comes into Yellen's last FOMC perfectly neutral according to its model. Markets have built in one more rate hike for 2018 since TCJA was enacted, which means a growth acceleration is expected, to which the Fed will index rates – but not tighten. The GDP miss does not indicate economic weakness, but a surge in demand mirrored in rising debt service ratios. Equity valuations have moderated since TCJA, earnings growing faster than stock prices, and will not be a factor for the Fed. Powell will continue the Fed's policy of gradual hikes in turn with the natural rate of interest. He may talk tough in his early months as chair to establish the impression of independence, but he is Mnuchin's puppet. The back-up in bond yields, mostly explained by growth in inflation compensation, confirms that the Fed is not expected to tighten policy as the economy accelerates, even as it hikes rate in synchrony with it. A gradual back-up should continue.

[Strategy dashboard]

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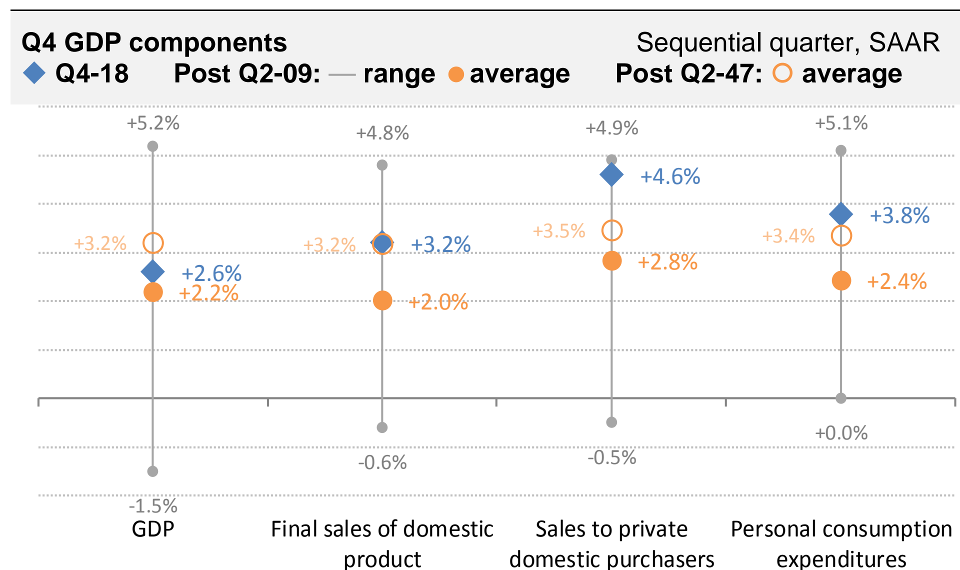
2017 Gross Domestic Product report might give one pause. The Fed may read it that way, too. But we don't put all that much stock in GDP – especially the "advance" release which will be subject to multiple revisions. *And a careful look at the internals, which the Fed is perfectly capable of doing, ought to restore any lost confidence* (see "Data Insights: GDP" January 26, 2018).

- The big "miss" component was net exports, which took 1.13% off quarter GDP growth. But this aggregation conceals the happy fact that, within it, exports grew 6.9% in the quarter, contributing 0.82% to growth. The problem – if indeed it even is a problem – is that imports grew faster, at 13.9%, taking 1.96% off growth.
- *Filtering all this out – that is, filtering out the implicit prejudice against imports in the headline GDP calculation – we see final sales of domestic product, sales to domestic purchasers, and personal consumption expenditures coming in well above average for this expansion* (please see the chart below).



Source: BEA, TrendMacro calculations

- *This upswing in consumption – without regard to the nation of origin of that which is consumed – is consistent with a healthy economy.* For those who have explained so-called "secular stagnation" as a "shortfall of aggregate demand," this ought to be particularly good news.
- This is happening, as we would expect, against a backdrop of household debt service and financial obligation ratios just beginning to recover from their post mortgage crisis lows (please see the chart on the following page).
- We don't regard debt as an inherently bad thing (it depends what you borrow for). So while we welcomed the retrenchment of these ratios from their pathologically high levels seen at the peak of the mortgage speculation boom in 2007, now we are just as happy to see them expand from their equally pathologically low levels in the Not So Great Expansion following the Great Recession.

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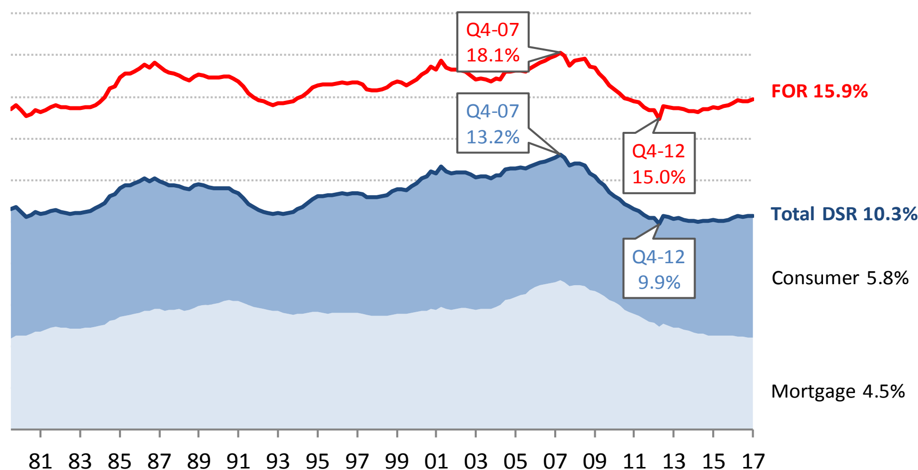
US household financial obligation and debt service ratios



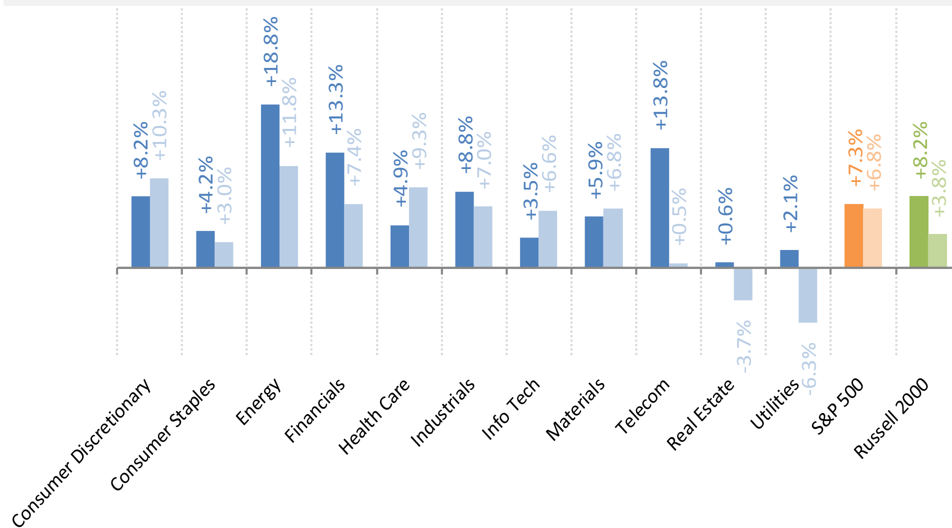
Source: FRB, TrendMacro calculations

- *This is all perfectly consistent with our 2016 call that we are entering a new generational "turning" from risk-aversion toward risk-tolerance – and an emergence from "secular stagnation"* (see "2017: It's Bigger than The Donald" December 30, 2016).

Let us interject a comment about stock prices. Just because US stocks have delivered a total return of 7.5% year-to-date, we don't see them as being in any kind of bubble. A number of our clients are, quite prudently, worried about this.

- Everyone is entitled to his own view of appropriate valuation. But when a long-time very frustrated bear like Jeremy Grantham calls this move a speculative "melt-up" driven by "price acceleration," but not yet a "bubble" – that's just a narrative trick that allows him to get on board, but still be bearish. Okay, that's how he wants to handle his business risk. But it speaks to a widespread cognitive dissonance that prevents seeing the fairly simple underlying fundamentals which explain why stocks are doing what they're doing – which is exactly what we said many investors would have to struggle with (see "2018 Outlook: From Denial to Acceptance" December 29, 2017).
- The simple reality is that, with the enactment of the Tax Cuts and Jobs Act, after-tax corporate earnings automagically go up about 11%, on average (see "Tax Cuts: Smells Like Victory (For Some more than Others)" December 18, 2017). *We don't see why a value investor should be concerned, or even surprised, that stock prices are going up at the same time that earnings are going up.*
- As of Friday, S&P 500 consensus estimates had risen by 7.3% since TCJA was enacted on December 19, 2017. Stock prices are up 6.8% – so while there is significant variation among sectors, *overall, the market P/E ratio has contracted. Stocks have actually become less richly valued this year even as they have zoomed to all-time highs* (please see the chart on the following page). This is

Change from Dec 19, 2017 enactment of TCJA
■ Forward earnings ■ Stock prices



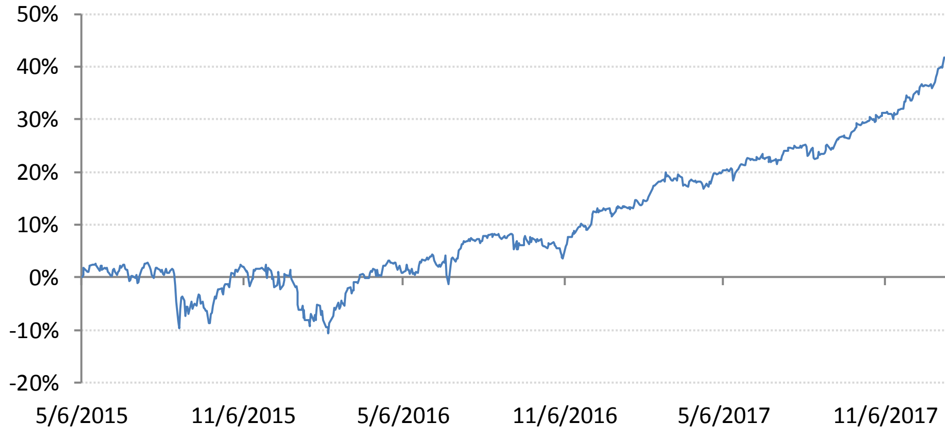
Source: Bloomberg, TrendMacro calculations

even more true in smaller-capitalization stocks, with the Russell 2000 up 3.8% while forward earnings are up 8.2%.

- As an aside on market timing, we note that even with a back-up in long-term Treasury yields since TCJA was enacted, the fact that the growth in forward earnings has outstripped the rally in stock prices means that the US equity risk premium has not yet narrowed beyond its cycle tight of March 2017. We're not wedded to any single indicator to help us anticipate the inevitable correction, but that one's our first-among-equals (see "A Year of Upgrades in 16 Days" January 16, 2018). *The ERP hasn't given its signal quite yet – but it's close.*
- And the earnings upgrades that have already flowed into the consensus are getting close to our rough-and-ready forecast of 11% (again, see "Tax Cuts: Smells Like Victory (For Some more than Others)"). That forecast is only for the short-term first-order effects of TCJA. *But those initial effects are the low-hanging fruit, and as we get closer to picking it from the trees, it will get harder for stock prices to maintain momentum.*
- Bringing this back around to the Fed, the minutes of the December FOMC meeting give scant mention to valuations as a policy concern (see "Data Insights: FOMC Minutes" January 3, 2018).
- *It wouldn't shock us if valuations are mentioned more prominently in the minutes of the January 2018 meeting, when they are published three weeks later.* It's on everybody's mind. And it wouldn't shock us if stocks reacted with a brief correction.
- It *would* shock is if valuations were mentioned in the FOMC statement, which would elevate them to an inappropriately great level of prominence, one that implies that the Fed actually intends to do something about it. That's not going to happen at Yellen's last meeting – or at one without a press conference at which it could be

explained and contextualized.

- And then there's the "once burned twice shy" factor. The last time Yellen went there – saying in *ad hoc* remarks following a May 6, 2015 speech that "equity market valuations at this point generally are quite high… There are potential dangers there…" – it didn't work out so well. Stock prices are 46% higher today than they were when Yellen said that (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- At least she got a little correction out of it three months later – thanks to China's surprise devaluation (see "On the RMB Devaluation" August 11, 2015) – and again four months after that, thanks to Yellen's own mistake of "lifting off" (see "On the December FOMC" December 16, 2015) in the face of an incipient recession driven by crashing oil prices (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- That's nothing compared to former chair Alan Greenspan's "irrational exuberance" speech on December 5, 1996, after which the stock market never traded lower, even in two major bear markets – and is now 474% higher (please see the chart below).

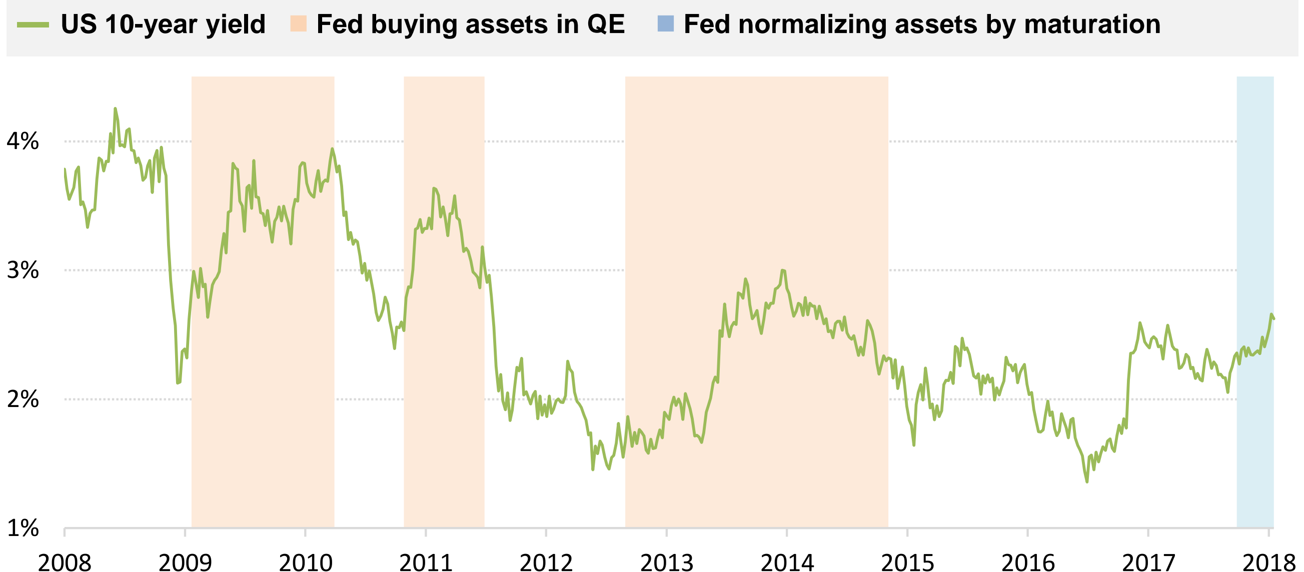
Source: Bloomberg, TrendMacro calculations

There is every reason to think that incoming chair Jerome Powell will do what all incoming chairs do – basically, nothing but promise what amounts to policy continuity. Don't for one minute believe over-excited media commentaries such as Bloomberg's howler this morning, claiming Powell's arrival means "Gradual Pace Ripe for Rethink." This incoming chair, as far as we know, has never expressed an original opinion about policy or economics in his life, and was likely chosen because he will be an obedient puppet of Treasury Secretary Steven Mnuchin (see "Warsh the Reformer, Powell the Plodder" October 3, 2017, and "On Powell for Fed Chair" November 2, 2017).

- To be sure, the very fact that Powell will be an obedient puppet is a good reason to expect, in the usual Washington manner, that he will pretend to be otherwise. We expect at some point early in his chairmancy Powell will seem to say some surprisingly tough thing, and markets will dutifully react. That will be a head-fake and, all else equal, a buyable dip.
- *The core of Powell's policy thrust will be the same as that which evolved once Yellen learned from her premature lift-off mistake* (see "Yellen Adds 'Uncertainty'" March 30, 2016) – *to estimate the natural rate of interest, and index policy to it as it gradually rises when the economy emerges from secular stagnation* (see "Yellen Gives Conservatives Something to Cheer" February 17, 2017).
- *This expectation of ours would be locked into an absolute certainty if, as rumors have it, San Francisco Fed President John Williams (Yellen's successor there) is slated to nominated to be the next Fed vice-chair. He is a leading scholar on the concept of the natural rate of interest, and is one of the creators of the Laubach-Williams and Holston-Laubach-Williams models, which are the Fed's favorites for estimating it.*
- The nomination of Marvin Goodfriend to the Federal Reserve Board cuts the other direction. He is an unreconstructed hard-money perma-hawk, who we have said is the kind of dogmatist favored by the *End the Fed* Ron Paul wing of the GOP (see "Trump's New Faces on the Fed" June 5, 2017).
- We were delighted to see him squirm in his nomination hearing last week under merciless grilling by Democratic members of the Senate Finance Committee Sherrod Brown (D-OH) and Elizabeth Warren (D-MA). They pummeled him for numerous warnings that the Fed must not implement quantitative easing in order to ease unemployment, for fear of sparking runaway inflation – warnings which turned out to be unfounded.
- Brown asked him, "Why were you so wrong so many times? …Would this economy be in this good a shape if they – if they had listened to Marvin Goodfriend…?" Goodfriend stammered out a response that his views were only "academic."
- The *New York Times* exaggerated when it claimed that Goodfriend "declined to explain his thinking." *Times* columnist Paul Krugman outright lied when he spun that same story into a claim that Goodfriend was "simply refusing to answer questions."
- Truth or lie, fair or unfair, this hazing probably scared Goodfriend straight. And it's parallel to the through-line of the best central bank

thinking everywhere in the world now – that when the natural rate of interest is naturally low or negative, inflation will be low no matter what central banks do (see, among many, [“Yellen’s March to Neutrality”] March 6, 2017). *That re-frames the inflation debate from primarily worrying about too much of it, to worrying about too little of it.*

- Clients have asked us whether we are worried that the 10-year Treasury yield has backed up 23 bp since TCJA was enacted – about the same move as the increase in market-implied rate hike expectations over the same period. Does that not imply that the Fed is, in fact, expected to not just be hiking rates, but actually tightening by doing so?
- No, we don’t think so. We note that over the same period, the 16 bp widening of the inflation-compensation component of the 10-year yield explains most of the total back-up. That’s the opposite of what we’d see if the market were discounting a tightening – we’d see inflation expectations narrowing and yields falling.
- Separately, we utterly dismiss the idea that yields have risen because the Fed is gradually normalizing its asset portfolio (by having allowed maturities no greater than $10 billion per month last quarter, and $20 billion per month this quarter). We have learned (whether or not Goodfriend really has), over the decade of QE, that whenever the Fed starts *buying* assets, yields *rise*, even though the stated intent is to engineer them lower. Then when the programs *end*, yields *fall*, even though the ensuing tantrum is driven by the fear they will rise (see the chart below and, among many, "I Shall Fear No Taper" January 27, 2014).



Source: Bloomberg, TrendMacro calculations

- So it is encouraging to us that “this time it’s different” – that yields have backed up since normalization began (history would have suggested they would fall). *This tells us that the economy has outgrown the need for the Fed to de-risk the market by acting as a warehouse for duration (which is all that QE ever did)* (see, among

many, “Time for Taper Tantrum Two?” April 6, 2017).

- *We expect yields to drift higher driven by more of the same – gradually improving growth and inflation expectations, and a Fed that will gradually hike rates in synchrony with them – and not tighten.*

Bottom line

The Fed comes into Yellen’s last FOMC perfectly neutral according to its model. Markets have built in one more rate hike for 2018 since TCJA was enacted, which means a growth acceleration is expected, to which the Fed will index rates – but not tighten. The GDP miss does not indicate economic weakness, but a surge in demand mirrored in rising debt service ratios. Equity valuations have moderated since TCJA, earnings growing faster than stock prices, and will not be a factor for the Fed. Powell will continue the Fed’s policy of gradual hikes in turn with the natural rate of interest. He may talk tough in his early months as chair to establish the impression of independence, but he is Mnuchin’s puppet. The back-up in bond yields, mostly explained by growth in inflation compensation, confirms that the Fed is not expected to tighten policy as the economy accelerates, even as it hikes rate in synchrony with it. A gradual back-up should continue.