PCM
Peak Capital Management

Spiking the Punch Bowl

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Brian Lockhart, CFP®

An epic Tug-O-War ensued in mid-April between the Fed and the bond market that shows no signs of going away, even if the Fed is hinting at their ultimate defeat. While the Fed was still sounding hawkish about rates and their projections showed more tightening ahead, the bond market began to move in the exact opposite direction. The 10-year Bond has now dropped from a yield of 2.6% two months ago to under 2% today. While the Fed has been saying the economy and labor market remain on track for growth, the bond market was screaming recession with an inverted yield curve.

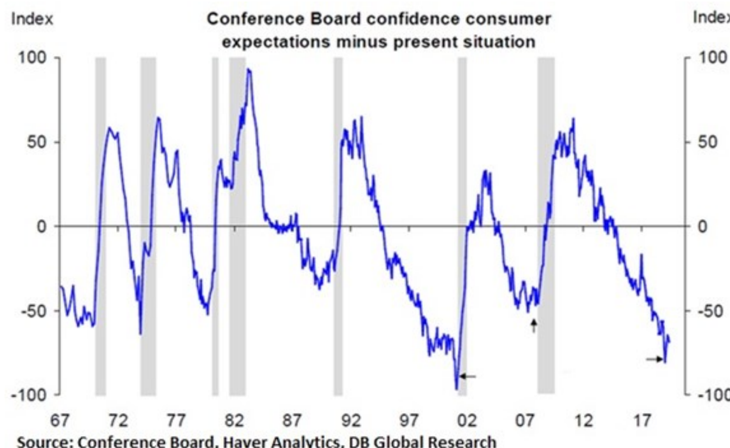
There was some capitulation by the Fed in their June meeting. While they did not cut rates, they all but announced there would be a rate cut at the July meeting. Each Fed governor, whether a voting member or not, provides their personal estimate of where rates are headed. As of today, 8 of 17 believe a rate cut will happen this year with 7 of those 8 expecting a cut of 50 basis points by year end. That leaves a thin majority forecasting rates will remain unchanged.

The data over the last month certainly seems to be supporting the bond market's view of growth. Capex spending has fallen sharply as the benefits of the corporate tax cuts have diminished, the ISM Purchasing Managers Index continues to fall and is at 2016 levels, and employment growth has fallen off a cliff. Add to poor corporate data that shows rising delinquencies at the consumer level and you can understand why the bond market is acting like the Fed may be too late in spiking the punch bowl.

If a rate cut is imminent, and I believe it is, the question becomes whether it will achieve higher growth or simply drive risk asset prices higher. There is equally a plausible case to be made that the current weakness in the data is transitory and primarily the result of the "trade war" with China. The disruption in globally linked supply chains results in the dispute being felt in every corner. Some economists suggest that when Trump and Xi decide to play nice again these headwinds will reverse and the economy resumes above-trend growth.

That seems optimistic to me even though I do not doubt the recent downturn in CEO confidence is negatively impacting growth. GDP growth is still largely driven by what consumers are doing and that is where the concern lies. The Conference Board tracks consumer sentiment and one of the most interesting data points is how consumers view the future versus their present situation. If you expect your discretionary income or wealth to be higher in the future it facilitates a higher level of spending. When you think present conditions are more favorable than the future, spending slows and recessions often follow. The chart shows consumers are now more bearish about the future than at any point in the last 50 years except for 2001. Each time the data spiked down as it is today there was a recession that followed quickly.

A mere hint of the Fed being behind the curve on inflation could send yields skyward and really do harm to the economy.



Source: Conference Board, Haver Analytics, DB Global Research

I am a believer that the direction data is moving is more important than the relative level. There are other data points you can rely on that suggest the U.S. economy is doing just fine and is poised for accelerating growth. It is possible the Fed lacks transparency not because they are withholding information about their plans, but because they simply do not know which way the economy is moving. A sense of urgency, spurred by the action in the bond market, may force the Fed to act and cut rates even sooner than they would prefer.

Chairman Powell has added a new description when discussing inflation or the Personal Consumption Expenditures (PCE). He states that the Fed sees the inflation target as "symmetric," suggesting that if years are spent with sub-2% inflation it would not be a problem to have years of above 2% inflation. While it might make sense to a novice follower of the economy, it is actually dangerous to consider. The last few months have demonstrated the ability of the bond market to flex its muscle and dictate policy direction. If the yield curve was not inverted it is unlikely we would be discussing the Fed spiking the punch bowl, but would be talking about when the Fed was going to take away the punch bowl. A mere hint of the Fed being behind the curve on inflation could send yields skyward and really do harm to the economy.

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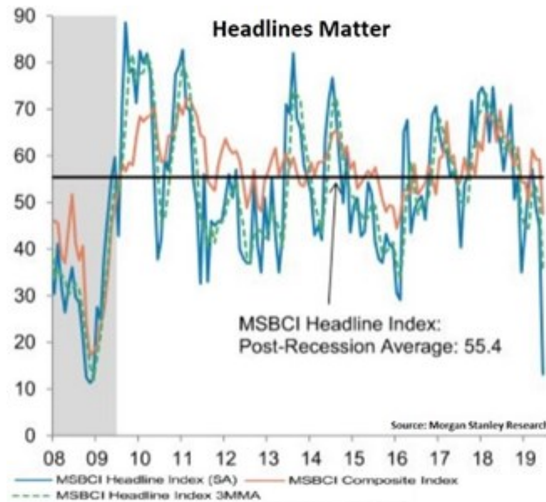
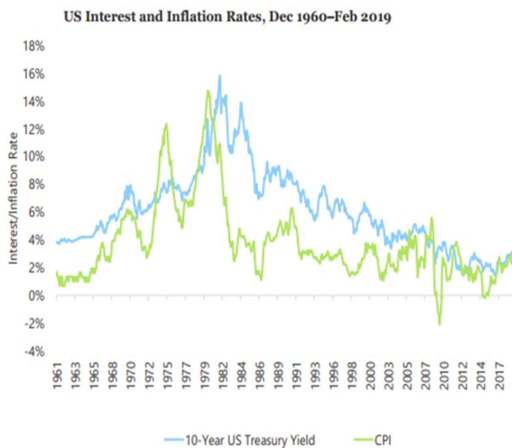
Headlines Matter



A typically reliable gauge of business conditions in the U.S. is published by Morgan Stanley and tracks headlines in financial media. As the chart indicates, the recent drop in the Headlines Index is severe and is now approaching the level last seen in early 2009. The latest reading of 13 is well below the 33 level considered necessary to forecast continued growth in the economy and just a fraction of the post-recession average of 55. The last time the index dropped this dramatically was in 2008 just before the Great Recession began. Trade tension with China may be fueling part of the collapse, but conditions are signaling that consumers are likely to retrench spending that will ultimately lead to lower profits and slower growth.

- The sub-component for Manufacturing fell all the way to 0 in the latest reading, suggesting a contraction in manufacturing orders and new employment could be imminent.
- The data is consistent with the latest release of the NY Fed's Empire State business conditions that plunged a record-breaking 26 points into negative territory, well below expectations.
- Equity investors seem impervious to the weak economic data and rising risk of recession, bidding the S&P 500 to a new high as they trust the Fed will again be the white knight to save the day.

Modern Monetary Theory



There has been significant discussion recently to define or redefine the role of central banks and the objective of monetary policy. This post great recession definition is being labeled as Modern Monetary Theory (MMT). MMT makes the case that central banks should respond to growing government programs and economic demands by aggressively printing money, unconstrained by tax receipts and borrowing. If MMT succeeds in adoption, the impact to markets is meaningful. Investors may anticipate growing, high, and/or volatile inflation. This scenario hinders savers and investors alike because real returns in stocks and bonds become muted. The chart to the left from Research Affiliates shows the relationship between the 10 year treasury interest rate and inflation (CPI) dating back to 1961. Historically, the money supply has served to reign in inflation. The future may show the opposite to be true, also.

- Far left leaning politicians gravitate towards MMT because it allows increased spending on social programs with less emphasis on raising taxes to fund the programs.
- MMT makes the case to its advocates that the theory has the ability to decrease wealth inequality by bringing the lower and middle class more in line with the upper class through government programs.
- Stagflation may also occur, historically providing less than favorable market returns.

Interest Rates and Housing

We've discussed at length the impact interest rates have on housing. We're mentioning the topic again this month because interest rates have taken a significant move lower as the 10-year yield is currently hovering just above 2%, which is far lower than most forecasts from just a year ago. Likewise, the Fed is expected to lower its target rate at its next meeting in July. So, what does this backdrop potentially mean for the housing market? As the chart below indicates, the 30-year fixed mortgage has dropped below 4% after trading near 5% just last November. This suggests that, in theory, housing has become more affordable and demand should strengthen going forward.

- While lower interest rates certainly help, it doesn't necessarily translate into a stronger housing market. At this point, potential buyers might simply wait under the assumption that rates will continue to drop. In other words, there may be no immediate impact on housing overall.
- In addition, there are still inventory issues to consider. A limited supply of homes tends to push prices higher, which could more or less offset the affordability gains resulting from lower interest rates. So in popular markets, particularly on the coasts, affordability might remain out of reach for many buyers.

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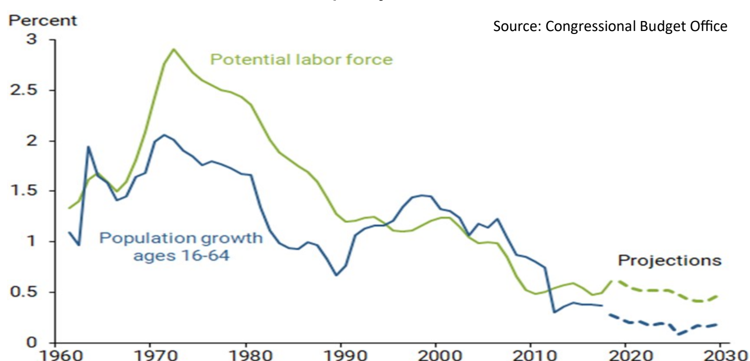
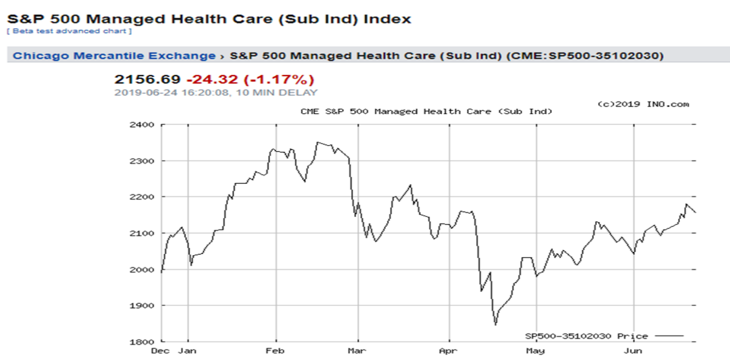
Macro View – GDP Growth Trends

Jerome Powell has communicated that he is focused on GDP growth rates, bringing analysts to wonder what is normal GDP growth historically and moving forward. GDP growth from 1987 to 2007 averaged 3% in the U.S. The growth since the great recession from 2009 through 2018 has been 2.3% per year (San Francisco Federal Reserve Bank). Attribution to the slowing growth often points toward productivity and demographics. The Congressional Budget Office chart below shows labor supply growth dating back to 1960. An aging population and a decreasing potential labor force may indicate less productivity. Above trend growth in GDP may be the short term result of occurrences such as the Trump tax cuts. In an economic paper published June 24, 2019, the San Francisco Federal Reserve Bank concluded, "…our best guess is that productivity growth over the next five to six years will be in line with previous slow regimes. During those regimes, GDP per hour rose around 1-1.25% per year."



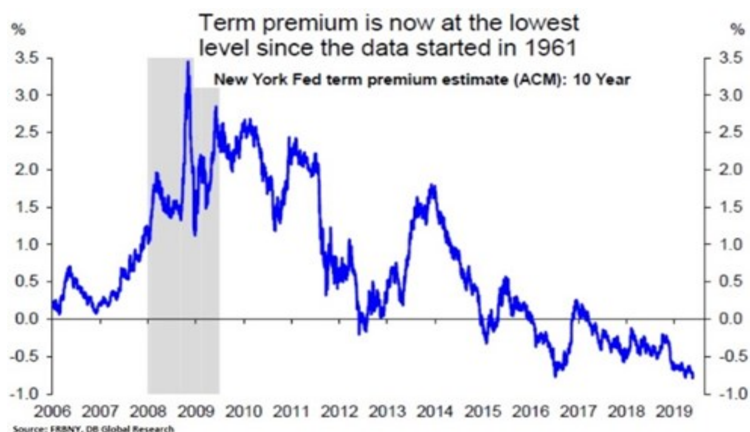
Taking Stock – Medicare for All Winners and Losers

Heading in to the presidential election, there will be no shortage of discussion on healthcare and the most effective approach to healthcare. Medicare for all (MFA) will be one solution discussed. MFA would likely eliminate private health insurance. Investment managers are watching closely and contemplating what companies will suffer or thrive under MFA. The Kaiser Family Foundation estimates that in 2017, roughly 156 million Americans, half of the total, received health care benefits through private employer-sponsored plans (CFRA Research). The S&P 500 Managed Health Care Index is up about 2% YTD, as of June 24, underperforming the S&P 500 by about 15%. MFA bills discussed in the Senate and House initiated a decline in the index by 10% or more in the following weeks (CFRA Research). It appears that MFA may have been baked in to the price of the index and constituents of the index. If investors feel that MFA is not likely to pass, a bounce in price of the managed healthcare index may follow.



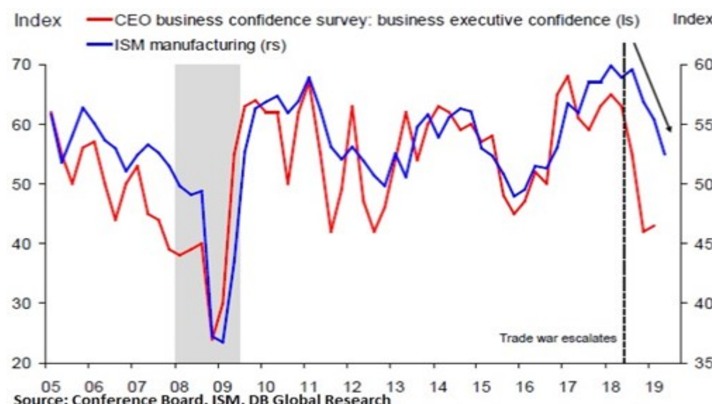
Fixed Income - Vanishing Term Premium

In June the term premium, the amount of excess interest investors demand to own long-term bonds rather than shorter durations, slipped to the lowest level since the data was made available starting in 1961. When relationships as basic to the understanding of macroeconomics like interest rates and duration break 50-year records it is worth taking note. Inflation is generally regarded as the benchmark for the term premium. Higher future expectations for inflation results in a higher term premium. If accurate, the chart would be forecasting a long period of deflation, the Fed's worst nightmare. Today's negative term premium is more likely the result of an imbalance between supply and demand in the Treasury market. Future uncertainty is high, raising demand for longer duration Treasuries to hedge the risk of economic contraction. This illustrates the strange times we are in.



Technical - Charting Confidence

Technical indicators like trend following are typically applied to asset prices, but can be just as valuable at predicting the future of the economic growth or corporate spending if the indicators are reliable. The ISM manufacturing data is considered a valuable "leading indicator" as it has historically identified inflection points in the economy. The correlation over the past 15 years shows that CEO confidence has a correlation above 85% to ISM data. CEO confidence could be considered a leading indicator to a leading indicator. Since the escalation of the trade dispute with China in mid-2018, CEO confidence has plummeted even if the latest reading showed a slight bounce. If historical correlations remain intact, the ISM data will move into contraction territory below 50 over the next couple of months. Exports to China are less important to CEOs than their supply chain, creating consternation.



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An Overview on Tariffs

Clint Pekrul, CFA

With all the talk and headlines about tariffs, we thought it would be worthwhile to provide a high-level overview of what a tariff is and how it can be viewed as a negotiating tool with respect to economic policy. Essentially, a tariff is a tax on imports that is established by a sovereign entity such as the United States. The basic premise is that by taxing imports into the country, and thus making imported goods more expensive, consumers will adjust their spending habits and buy locally produced goods and services instead. A tariff seems like a simple fix to a very complex problem. But most economists tend to agree that tariffs are not beneficial to the economy as a whole over the long-term, and in fact the imposition of tariffs can have unintended consequences.

Some people might be casually familiar with tariffs from the Smoot Hawley Tariff Act of the 1930s. Enacted during the Great Depression, the goal of the tariff was to ease the economic burden on domestic industry by imposing a duty on imported goods. But most economists argue that the Smoot Hawley tariff ultimately did more harm than good. After the U.S. imposed taxes on primarily agricultural imports, our trading partners responded in kind and imposed tariffs on U.S. exports. The result was higher food prices at the worst possible time, and global trade continued to deteriorate. If the Smoot Hawley Tariff Act is the primary case study on trade wars, it's no wonder that president Trump's tariffs are coming under such scrutiny.

The U.S. Constitution gives Congress the authority to implement tariffs and regulate commerce. But in 1934, after the disastrous effects of the Smoot Hawley tariffs were better understood, Congress passed the Reciprocal Tariff Act, which gave the executive branch (i.e. the President) authority to negotiate trade agreements with U.S. trading partners. The Act served to reverse the protectionist policies of Smoot Hawley and allow the president to renegotiate existing tariffs and liberalize global trade. Later on, Congress passed the Trade Expansion Act of 1962, which gave the president wide latitude to impose tariffs in the name of national security.

It's somewhat ironic that the measures designed to liberalize foreign trade – for example, the Reciprocal Tariff Act and Trade Expansion Act mentioned previously – are now being used by president Trump to more-or-less single handedly impose protectionist trade policies. If today's trade war escalates further, it wouldn't be surprising for Congress, at some point, to attempt to interject itself into making tariff policy. In fact, two Senators – Pat Toomey from Pennsylvania and Mark Warner from Virginia – have introduced legislation to curtail the President's authority to negotiate tariffs.

There are numerous theories about the relationship between tariffs and inflation. On the surface, it would seem that tariffs would be inflationary, given that the price of imports become more expensive. But the relationship between tariffs and overall price levels isn't so clear. For starters, according to the Organization for Economic Cooperation and Development, only 12% of American consumption on goods and services is satisfied by foreign producers. In addition, the mix of American consumption is largely tilted towards services, such as healthcare and entertainment. Conversely, most of what is imported into the U.S. is in the form of physical goods. The bottom line is that recent tariffs won't likely move the needle all that much when it comes to overall price levels (at least that's what the current data is telling us).

Ultimately, the question that we need to ask is whether the Trump administration's trade war with China (along with potentially many other countries) will deliver any meaningful and lasting results to the U.S. Or, stated differently, do trade wars actually work? While the Trump administration has made claims about the success of the tariffs, the underlying data doesn't necessarily support it. China has responded in kind with their own tariffs on imported goods from the U.S., and they show no signs of backing down. In the short-run, the tariffs will increase prices of imported goods. But in the long-run, the result could be higher prices for all goods and services (both foreign and domestic). The decline in foreign competition could make domestic firms less efficient.

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Q: Is Facebook's Libra a game changer for cryptocurrencies?

I doubt that it is a coincidence that the same week Facebook announced its foray into the world of blockchain and cryptocurrencies, the world's largest crypto jumped 20% and is above $11,000 for the first time in 15 months. In case you doubt that Facebook's Libra is a significant event, consider who their named partners are for the venture: Visa, Mastercard, Stripe, Uber, Spotify, and Paypal all have a stake in Libra.

Libra will bring a much-needed dose of credibility to blockchain-based currencies, but I do not think Facebook's ambition is to take on Bitcoin as the 800-pound gorilla in cryptocurrency. Instead, I think Facebook is positioning itself to become a global leader in payment processing, leapfrogging over established players in this space like Venmo, Apple Pay, Google Wallet, and Snapcash.

Because Libra is going to be backed by actual currency, like U.S. dollars, it will resemble more of a blockchain version of Paypal. Because of Facebook's near universal reach globally, the fees for making transactions will be lower than any other offering benefitting retailers, and ultimately consumers. The greatest beneficiaries, however, will be the 1.7 billion that currently have no ability to have a bank account according to the World Bank Findex.

It is difficult to predict the impact on Bitcoin or Ethereum, but I do believe that Facebook is poised to become the largest payment processing company in the world.

As I have mentioned in previous PCM reports, I'm not a qualified expect on the nuances of cryptocurrencies. But when Facebook announced it would launch its own version through Libra, I think it took the market by surprise. Technically, Libra is separate from Facebook as a unique entity, and as I understand it, will be controlled by the Libra Association. This association is made up of corporate representatives, such as Visa, MasterCard and PayPal, as well as several other venture firms that forked over the $10m entrance fee. So essentially, a group of corporate bigwigs would control this new global currency by providing financial backing to support a relatively stable value (unlike Bitcoin, which is quite volatile).

I guess the biggest question at this point is, will people actually trust Facebook with their money? Given their recent troubles with privacy protection, where is the evidence that Facebook, with its 2.2 billion users, will be able to safeguard this new currency from cyber hackers? In addition, Libra is controlled, or backed, by a group of private corporations, which is much different than having currencies controlled by governments and central banks. So, Facebook's launch of Libra is certainly ambitious, and expect there to be much opposition to it, at least initially.

Q: How will the conflict with Iran impact the markets?

The fact that Iran is taking such aggressive action in the Gulf Region is a sign that sanctions against the country are working as intended. It was well-documented that an escalation nearly occurred with a strike by the U.S. before being called off at the last minute over concerns for civilian casualties. If the markets believed that an all-out war with Iran was remotely possible, I think risk assets would have reversed the recent gains. So far, that has not been the case.

The greatest risk to the economy, and the markets, would be a sharp rise in oil prices that resulted in lower consumer spending. The impact so far has been minimal because very few countries purchase oil from Iran for fear of losing access to the U.S. markets for their exports. If Iran is able to de-stabilize the Strait of Hormuz that connects the Persian Gulf with the Gulf of Oman, the impact on oil would be much greater.

We live in a very different world with the current Administration. No President, at least in my recollection, has attempted to leverage the power of the U.S. consumer as a geopolitical tool. This is clearly Trump's strategy in negotiations with China over intellectual property and fair trade. Trump has threatened Europe that if they refuse to follow the sanctions against Iran they may lose access to U.S. consumers as well, a strategy that appears to be working for now.

The worst, almost unthinkable scenario is that Iran is able to launch a nuclear attack and instigate a full-blown global conflict. If that were to happen, yields on U.S. Treasuries would almost certainly collapse as investors around the world would flock to safe haven assets. Yields on other government debt would likely go even more negative than they are today. As for equities, we'd likely experience volatility around the world similar to what we experienced during the depths of the Great Recession of 2008. The scenario described above is why the current situation with Iran is so tenuous. One false move or knee-jerk reaction from Trump against Iran could also have long -term adverse effects, albeit not the doomsday scenario of a nuclear conflict.

Ultimately, I don't think tensions in Iran will escalate into something that could derail the global economy. Secretary of State Pompeo is working to create a Mid-East coalition against Iran, and president Trump has said he's willing to negotiate with Teheran in an effort to stave off further development of a nuclear arsenal. What will likely happen is some sort of stalemate through sanctions and a unified mid-east coalition. Any potential conflict with the Middle East is especially troublesome. We've been in Afghanistan for almost 20 years to the tune of several trillions of dollars. So, the recent developments in Iran are noteworthy.

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Model Weights

All weights as of July 1, 2019

Income

Income	
Mortgage Backed Bond	42.57%
Investment Grade Credit	15.20%
High Yield Bonds	9.25%
Preferred Stock	22.80%
US Dividend Equities	3.48%
US REITs	6.70%

Balanced Income

Balanced Income	
US Dividend Equities	17.02%
International Dividend Equities	18.79%
US REITs	10.28%
High Yield Bonds	27.34%
Long Term Treasuries	26.57%

US Growth

US Growth	
Low Volatility Factor	16.06%
High Quality Factor	12.86%
Small Cap Factor	10.65%
Value Factor	13.51%
Momentum Factor	12.91%
Long Term Treasuries	34.01%

Global Growth

Global Growth	
Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	5.11%
Value Factor	6.13%
Momentum Factor	6.41%
Developed Market Equity	19.56%
Emerging Market Equity	13.18%
Long Term Treasuries	34.86%

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