MONTHLY MARKET REVIEW

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ROCKEFELLER CAPITAL MANAGEMENT

The Liquidity Trap

Eurosclerosis deepens; the hunt for 2% inflation

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Buoyed by the optimism for a new round of Fed easing, U.S. equities hit new highs in July despite growing weakness in global manufacturing activity. However, stocks receded shortly after the Fed served up the widely expected 25 basis points (bps) Fed funds rate cut. Some market participants were disappointed that Chairman Powell characterized the rate cut as a "mid-cycle adjustment" rather than the "beginning of a long series of rate cuts." The big mover for July was the U.S. Dollar Index which surged 2.5% to close at a 26-month high, much to the chagrin of President Trump the interventionist-in-chief. Sterling was pounded to its lowest levels against the greenback in 30 months on the rising odds of a no-deal Brexit. The euro lost ground as the European Central Bank (ECB) signaled additional easing to combat the slowing economy. In the Treasury market, U.S. long bond yields were essentially unchanged, but German bund yields collapsed to all-time-lows.

The advance estimate of the second quarter U.S. GDP came in at a better-than-expected 2.1% growth. However, it was quite a bifurcated economy – consumer and government spending grew at unsustainably high rates of 4.3% and 5%, respectively, but private investment and exports shrank by 5.5% and 5.2%. It was clear that trade issues had impacted business investment. The export-heavy German economy saw its manufacturing PMI fall to 43.2, the lowest in 9 years. Various earnings reports also confirmed the softness in global manufacturing activity, with auto and related sectors feeling the most pain. Not surprisingly, the commodity complex from copper to crude oil traded down in unison. Precious metals, however, managed to stay in the black for the month despite the strength in the U.S. Dollar.

With the Fed having downplayed the prospect of further rate cuts, markets will likely revert to trading on fundamentals, which are mixed at best. It did not help that President Trump just tweeted that he intends to impose 10% tariffs on the last $300 billion of Chinese exports to the U.S. starting in September. Similar to the last round of trade tension escalation in May, it could cause market drawdowns. However, as we have seen in the past, President Trump has the flexibility to diffuse the tension as needed. It is in his best interest to avoid disrupting the economy and markets ahead of the 2020 election.

EQUITY MARKETS INDICES[1]	6/28/19 Price	7/31/19 Price	MTD Change	YTD Change
MSCI All Country World	523	524	0.2%	15.1%
S&P 500	2942	2980	1.3%	18.9%
MSCI EAFE	1922	1897	-1.3%	10.3%
Russell 2000®[2]	1567	1575	0.5%	16.8%
NASDAQ	8006	8175	2.1%	23.2%
TOPIX	1551	1565	0.9%	4.8%
KOSPI	2131	2025	-5.0%	-0.8%
Emerging Markets	1055	1037	-1.7%	7.4%
FIXED INCOME				
2-Year US Treasury Note	1.76%	1.87%	12	-62
10-Year US Treasury Note	2.01%	2.02%	1	-67
BarCap US Agg Corp Sprd	1.15%	1.08%	-7	-45
BarCap US Corp HY Sprd	3.77%	3.71%	-6	-155
USD Performance				
Chinese Renminbi (CNY/$)	6.87	6.88	0.2%	0.0%
Brazil Real (Real/$)	3.85	3.81	-1.0%	-1.8%
British Pound ($/GBP)	1.27	1.22	4.4%	4.9%
Euro ($/EUR)	1.14	1.11	2.7%	3.5%
Japanese Yen (Yen/$)	107.85	108.78	0.9%	-0.8%
Korean Won (KRW/$)	1154.80	1183.01	2.4%	6.5%
US Dollar Index (DXY)	96.13	98.52	2.5%	2.4%
COMMODITIES				
Gold	1409	1414	0.3%	10.2%
Oil	58.5	58.6	0.2%	29.0%
Natural Gas, Henry Hub	2.31	2.23	-3.2%	-24.0%
Copper (cents/lb)	271	267	-1.5%	1.3%
CRB Index	181	179	-1.4%	5.1%
Baltic Dry Index	1354	1868	38.0%	47.0%

Source: Bloomberg.

The upside-down world of negative interest rates has created a once-in-a-five-thousand-year opportunity to make money on debt issuance. It is fiscal malpractice to not take advantage of negative interest rates to finance fiscal stimulus in the face of economic weakness.

KEYNES REDUX

On New Year's Day, 1935, in the midst of the Great Depression, British economist John Maynard Keynes wrote George Bernard Shaw that he was authoring a book that would revolutionize the way the world thinks about economic problems. Indeed, his magnum opus, *The General Theory of Employment, Interest and Money*, published in February 1936, provided the theoretical underpinning for modern macroeconomics with the central tenet that government intervention can moderate the booms and busts in business cycles. Keynesian economics, also called demand-side economics because of its focus on aggregate demand for goods and services, became the standard economic model in much of the world from the 1940s through the 1960s. During the 1970's, however, it started to lose influence to monetarism as a result of the emergence of stagflation.

Monetarism, notably championed by Milton Friedman, is built on the belief that management of the money supply is the primary determinant of growth and price stability. The ascendancy of Thatcher and Reagan also gave rise to supply-side economics, which theorizes that economic growth is most effectively created by spurring investments via de-regulation and tax cuts. The so-called Chicago School of economics – sound monetary policy coupled with the free market economy – gained so much prominence that Robert Lucas, Jr., a brilliant University of Chicago economist who later won the Nobel Prize, proclaimed in 1980 that, *"Keynesian economics is dead."*

The success of the U.S. economy from the mid-1980s to the mid-2000s, a phenomenon dubbed, "The Great Moderation," invariably gave rise to over-confidence among supply-side economists. Lucas, who seemed to have a flair for grand pronouncements, wrote in 2003 that the, *"central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades."* Just five years later, however, the global financial crisis pushed the world economy to the edge of the abyss and led to a resurgence of Keynesian economic policies. Central banks also went wild with quantitative easing and negative interest rate policies.

The fact of the matter is that the modern economy has become so complex that it's unrealistic to expect one set of policy tools, either Keynesian or supply-side, to be the panacea indefinitely. Policymakers should take a multidisciplinary approach that incorporates factors such as innovation, cross-border issues, currencies, psychology, etc. Importantly, they should also acknowledge that some things are simply beyond their control.

As a side note, Lucas was awarded the Nobel Prize for his work on rational expectations. Yet the person with the most rational expectation and the best timing turned out to be his ex-wife Rita, who inserted a clause in their 1989 divorce agreement that entitled her to 50% of any Nobel Prize awarded before October 31, 1995. Lucas won the prize 21 days before the expiration of the clause, and Rita walked away with a cool $500,000 windfall.

A DASH FOR TRASH

On May 5th, many investors' lazy Sunday morning were interrupted by President Trump's tweets on the sudden breakdown in the Sino-U.S. trade negotiation. Their immediate thoughts were probably focused on the likely economic and market fallouts. Unbeknownst to most at the time, the rising fear and uncertainty were about to unleash a mad stampede for the perceived safety of sovereign bonds, including the already negative-yielding securities, and ultimately force central bankers into a reluctant easing cycle.

Prior to those tweets, the 10-year U.S. Treasury yield was 2.53% and the German 10-year bund yield was still in positive territory. The ECB was expected to keep its negative 0.4% benchmark rate through year end, and the odds of a 25 bps Fed funds rate cut by the end of 2019 were about 50%. By the end of July, the 10-year sovereign bond yields in the U.S. and Germany had dipped to 2.01% and a record negative 0.44%, respectively. The aggregate value of the world's negative yielding bonds has soared from $10 trillion to $13.8 trillion during the same period. It's simply amazing that investors were rushing to buy bonds guaranteed to lose money if held to maturity. That said, many buyers were probably confident that they would be able to unload these bonds to the greater fools at even higher prices.

The growing pool of negative yielding bonds also drove money into bonds issued by less creditworthy entities. The three most indebted European nations, Greece, Italy and Portugal, saw their 10-year government bond yields collapsing to as low as 1.98%, 1.49%, and 0.28%, respectively. To put things into perspective, these countries have bloated debt-to-GDP ratios of 182%, 134%, and 123%, respectively, yet they can borrow at lower rates than Uncle Sam. More stunning was the fact that fourteen non-investment grade issuers had their euro-denominated junk bonds bid up so high that their yields fell below zero. Now, that is a dash for trash.

LIQUIDITY TRAP

With the Eurozone's loans to businesses and consumers growing at a decade high of 3.3% and the benchmark rate sitting at an already astounding negative 0.4%, further rate cuts are unlikely to do much to help the economy. In fact, much of Europe's economic slump may be beyond the control of European central bankers. Germany, the locomotive of Europe, has been experiencing a sharp slow-down in manufacturing activity due to external factors such as China's weaker consumption, Brexit uncertainty, and trade frictions. With exports accounting for 47% of its GDP, Germany would benefit more from rate cuts in China than further easing by the ECB. Further rate cuts would also hurt Germany's ageing population that has pushed the country's household savings rate to a multi-decade high of 10.9%. Lower yields could drive German savers to curtail consumption in order to squirrel away more money for retirement. In short, Europe may be in a liquidity trap where further rate cuts will do little to lift the real economy.

What Europe needs is good old Keynesian economic stimulus to spur domestic consumption and infrastructure investments. It's time to challenge the Germanic fixation with budget austerity and debt aversion. The upside-down world of negative interest rates has created a once-in-a-five-thousand-year opportunity to make money on debt issuance. It is fiscal malpractice to not take advantage of negative interest rates to finance fiscal stimulus in the face of economic weakness. At his July press conference, ECB President Draghi emphasized that "fiscal policy will become of the essence" if the economic outlook continues to deteriorate. Many hoped that his anointed successor, Christine Lagarde, would be able to leverage her political skill and stature to convince Northern Europeans to loosen the purse strings.

The most bullish outcome for Europe would be a royal flush of fiscal stimulus out of Germany, another round of QE from the ECB, an orderly Brexit, recovery in China's imports, and continued ceasefire in the trade war with the U.S. It would put eurosclerosis into remission and turbocharge European equities. This is, of course, just a mid-summer night's dream. However, given the low market expectation, getting a few of these catalysts to work could still spark a period of outperformance for European equities.

MUTED INFLATION?

One of the justifications for the current round of monetary easing is that inflation has consistently languished below the 2% target, a holy grail created by modern central bankers and their army of Ph.D. economists. Paul Volcker, the ex-Fed Chairman who broke the back of inflation in the 1980s, begged to differ. *"A 2 percent target, or limit, was not in my textbook years ago,"* wrote the greatest living central banker in his 2018 memoir. *"I know of no theoretical justification."*

Inflation as we know it today is quite different from Volcker's days at the helm of the Fed. In 1983, the Bureau of Labor Statistics (BLS) changed the way it estimated the cost of shelter services for owner-occupied dwellings. Hedonic pricing was introduced in 1998 to adjust prices based on changes in quality and characteristics. On its website, the BLS shows how the replacement of a $250 CRT television with a $1,250 plasma TV is measured as a price change of *negative* 7.1% due to quality and size improvements. In 1999, substitution, which assumes changes in consumer purchases in response to price fluctuation, was incorporated. As an example, if the price of beef rises but the price of pork stays the same, the inflation measurement could assume that consumers would switch from beef to pork. These changes have materially understated inflation – both the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) Index – compared to the methods used in the early 1980s.

The biggest component in the Consumer Price Index is shelter services, accounting for 33% and 42% of CPI and CPI-less food and energy (the core-CPI), respectively. For owner occupied dwellings, rather than measuring the change in housing prices, which was the practice until 1983, the BLS calculates an imputed "owners' equivalent rent." It has probably understated inflation in recent years as house price appreciation has outstripped the increase in rents since 2012. The CPI data pegged the inflation in owners' equivalent rent of residences at 2.9% per year from 2012 through 2018, yet the S&P/Case-Shiller for U.S. National Home Price Index and Zillow had home value appreciating at over 6% per annum during that period. On the other hand, inflation in the U.S. was likely overstated from mid-2007 to early 2012 as the housing market's multi-year price decline was not reflected in the inflation calculation.

A 2018 academic paper titled, *Housing Rents and Inflation Rates* also challenged the accuracy of BLS's rental surveys. It argued that the surveys have under-represented new tenants who would provide a more accurate view on the rental market. The paper concluded that U.S. inflation may have been overstated by 1.7% to 4.2% annually during the Great Recession but understated by 0.3% to 0.9% annually during the current expansion. Interestingly, this 0.3% to 0.9% adjustment would bring the latest core-PCE inflation, the Fed's preferred price barometer, from 1.6% to a range of 1.9% to 2.5%, thus fulfilling the Fed's self-imposed 2% inflation mandate. Problem solved!

While most seniors would agree that the Social Security cost-of-living-adjustment, which is tied to the increase in CPI, does not come close to the real-life inflation, some analysts claim that the BLS has persistently *overstated* inflation by being too conservative in its use of hedonic pricing and substitution. This argument is built on the exponential improvement and new products and services created by technological advances. It would conveniently justify central banks' ultra-loose monetary policies in search of the "elusive" 2% inflation. On the other hand, it would also imply that gains in real income, real output, and standards of living have been chronically understated. In short, the one thing that reasonable people can agree on is that inflation measurement is flawed. However, any attempt to change it and the subsequent policy implications will be fraught with controversy. It will pit statistician's theoretical assessment of quality improvement against people's real-life experience and pocketbook issues.

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