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The Fed 'put'

The Fed is supporting the market. Might China be next?

Published 02-15-2019

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Why does the Federal Reserve see the need to pause when employment is going strong (*more below*) and real wages are accelerating—they are now at their highest level since the early 1970s? The Institutional Strategist believes it's because policymakers have come to view the stock market as crucial to maintaining economic momentum. With the fed funds target rate serving as the mathematical basis for all interest rates and higher rates in turn acting as catalyst for slower growth, SIS Research posits that it only makes sense that "patient" found its way into Fed policy language after December's steep sell-off and that balance-sheet contraction slowed notably, with policymakers signaling it's nearing an end. The market's reaction to this dovish turnaround is telling. Normally, such actions would suggest a more-worried Fed, leading to lower stock prices and wider credit spreads. It's been just the opposite, with the S&P 500 having its best January in 32 years and high yield off to its best start in seven years. With global growth worries continuing to weigh on markets (*more below*), the question is will the Fed be driven purely by U.S. data (though softer, it's still strong, *more below*) or will it incorporate the ongoing slowdown in Europe and China.

Continued progress in U.S.-China trade talks and early evidence of a soft landing in China could help sustain the up-trend that began when volatility pulled back on the Fed's dovish turn (the VIX is at early October lows). Headway on the first front is helping drive the rally, but China's economic fate remains uncertain. One concern is

Beijing's deleveraging campaign after its massive post-crisis debt run-up could more than offset all the new China stimuli—at least 63 various measures by Cornerstone Macro's count. Indeed, China's commercial banks continue to drag their feet on lending. There have been hints of stabilization, with China this week saying January exports jumped 9.1%, smashing expectations for a 3.3% decline. But history suggests exports tend to be strong just prior to the Lunar Chinese New Year (Feb. 5 this year), only to tail off afterward. Longer-term, there's concern China will keep trying to do to high-value manufacturing what it did to low-value manufacturing the past 30+ years. This threatens a messy and protracted non-tariff trade war as the U.S.-China relationship has shifted from cooperative and commercial to, under President Trump, combative and competitive. Non-tariff barriers are difficult to quantify, much less enforce. But the underlying issue behind this battle is hard to ignore—who will lead this century's technology transformation? The Huawei-5G components controversy is one example. Cowen & Co. equates the importance of 5G in the 21st century to railroads in the 19th century.

Concerns about debt keep coming up in my travels. Global debt ratios have surpassed pre-crisis peaks, leading many to worry that excessive leverage could trigger the next financial crisis. But there are significant differences between then and now. Credit growth has been concentrated in the corporate sector rather than household sector, where debt service ratios look healthier. This is reassuring since financial crises tend to be preceded by excessive household leverage. Similarly, U.S. companies that have driven the increase in leverage actually have stronger interest coverage ratios and free cash flow, with tech a big part of the mix. That said, too much debt seems to be everyone's problem. Rising interest rates due to overwhelming supplies of new debt, in part used to cover maturing debt, could be a death knell for equity valuations. That day of reckoning may be coming, just not yet. For now, the Fed has backed off—one less thing to worry about here in the U.S. My biggest fundamental concern continues to be a China hard landing. China is stimulating like crazy. A China "put?"

POSITIVES

- **Soft landing watch** Consumer sentiment rebounded more than expected in February, as the end to the government shutdown and a friendlier Fed soothed nerves. Elsewhere, S&P capital expenditures (capex) experienced their fourth-largest increase on record in 2018, following only the peaks of the tech and housing bubbles and a one-time 100% expensing provision in 2011, which pulled forward investment. What's notable is this latest capex increase occurred despite a slowdown as trade tensions heated up, suggesting any resolution to trade uncertainty could spark a capex reacceleration.
- **This supports Fed 'patience'** January consumer prices were flat mainly because of lower energy; core CPI (ex-energy and food) held at 2.2% year-over-year (y/y). Producer prices followed a similar pattern, with the headline actually negative and the core up modestly. The Atlanta Fed's survey of business inflation expectations has slipped to 1.9% y/y.
- **It's a tight labor market** Job openings continue to accelerate faster than new hires, putting the gap between the two at a record high, with the number of openings in December exceeding the number of people looking for work for a 10th straight month. There's still a little runway left. Despite rising the past three years, the labor force participation rate remains below the peak reached in the last cycle.

NEGATIVES

- **Soft landing watch** December retail sales fell at their fastest pace since September 2009, stuffing coal in the stockings of what many thought would end up being a strong holiday sales season. Ex-autos, sales fell even faster, indicating Q4 2018 growth likely slowed more than expected and that the economy entered the new year with little momentum. Some believe the data is noisy, citing a big drop-off in online sales that didn't at all match what e-retailers reported. Elsewhere, January industrial production slumped for the first time in eight months, led by a big drop-off at auto facilities.
- **Soft landing watch** NFIB small business optimism plunged in January by the most in 3.5 years to its lowest level since just before the 2016 presidential election, bringing it in line with recent declines in other measures of business confidence.

Seven of the index's 10 components fell, with the outlook for economic conditions hitting a 27-month low.

- **Global soft landing watch** The global OECD composite leading indicator fell for the 15th straight month in December to a level representing the slowest below-trend growth since August 2009. The downturn remains broad-based, with the share of individual country indicators that are growing at 16.7%, the smallest percentage since July 2009. In Europe, Germany's economy has essentially stalled and U.K.'s went negative in December.

WHAT ELSE

Housing tailwinds Two key drags on housing—higher mortgage rates and rising prices—have moderated, and the recent pickup in homebuilder sentiment suggests worries over the new tax law's impact on housing may be fading. Combined with an easing of lending standards for residential mortgages, these developments are bolstering hopes for a housing rebound this year—a view reinforced by the strong 2019 start in homebuilding stocks.

This isn't helping consumer moods In a quirk of how the tax code was adjusted last year, the IRS and employers failed to get the withholding tables and execution right, so taxpayer refunds are down 8.7% on a y/y basis. If that is not enough, some taxpayers who think they will be getting refunds, won't. Contrast that with Amazon's second straight year of paying no tax on hundreds of billions of dollars in revenue, or Google paying more in fines than it paid in taxes last year. No wonder Sen. Rubio is circulating a proposed rule which would change the taxation of stock buybacks, the Institutional Strategist observes. It thinks corporate America may be on the cusp of paying far more in taxes in order to give relief to the middle class.

What do the central banks know that we don't? Since 2008, central bank buying of gold has amounted to nearly 3,700 tons, a sharp reversal of declining gold stocks since the mid-1960s. Both private and public "monetary" holding of gold have overtaken jewelry demand as the primary source of demand growth for gold in recent years. Central banks

and investors typically hoard gold as a hedge against inflation and geopolitical risks. Hmm.

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Consumer Price Index (CPI): A measure of inflation at the retail level.

High-yield, lower-rated securities generally entail greater market, credit, and liquidity risk than investment-grade securities and may include higher volatility and higher risk of default.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation and their plans.

The OECD composite leading indicator is designed to provide early signals of turning points between expansions and slowdowns of economic activity in member countries.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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