INSIGHT & PERSPECTIVE

"Bad" News Is "Good" News

June 28, 2019

Based on recent commentary from ECB President Mario Draghi and Fed Chair Jerome Powell, central bankers again appear ready to backstop this economy and market.

Central Bank Safety Net

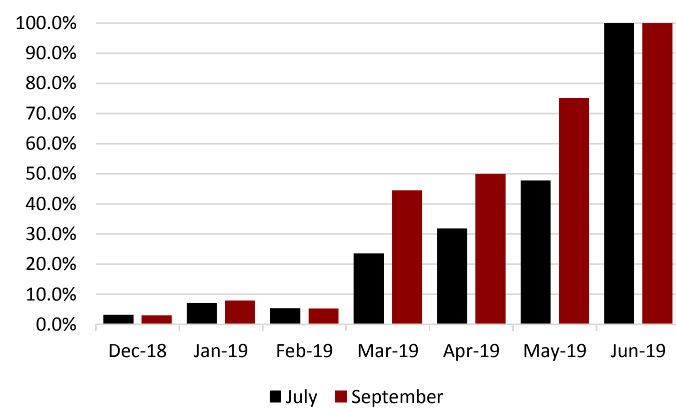
The world economy is slowing, inflation is below target, earnings growth is ebbing, Iran tensions are rising, trade visibility is limited, and Purchasing Managers' Survey data is closing in on "contraction" territory… Did we mention that global equity markets are near all-time highs? Given all the "bad" news, investors are apparently feeling pretty good. Mario Draghi and Jerome Powell are seeing to that. Both are leading the European Central Bank (ECB) and the Federal Reserve, respectively, toward the potential for further monetary easing; targeted at sopping up much of the worry that macro-economics and geopolitics currently have to offer. Indeed, monetary policymakers seem ready with a safety net when the economy or market starts to wobble. As a result, investors apparently have no fear, and "bad" news is not "bad" news any more. The unsteady economic data we have received in some instances is no longer "bad"...it has been digested as "good" because participants feel it may foster monetary action sooner rather than later.

The old market adage "Don't fight the Fed" (or the ECB), appears alive and well. And its hard to bet against the tide of monetary policy. History tells you it is not a good idea. So, we have a market that indeed has some issues at its doorstep, but investors have grown keenly aware that policymakers seemingly stand ready to tactically manage against a slowdown. In our

Probabilities for July and September Federal Reserve rate cut based on Fed funds futures market rates.

Figure 1: Implied Probability of Fed Rate Cut in July and September

Source: Bloomberg



view, policymakers' interest in more closely managing decision-maker (business or investment) behavior has in part prompted the bullish environment. Despite the risks, we believe it may stay that way.

Setting The Tone

Recent comments from the Fed Chair Powell, and ECB President Draghi, we believe, are directly responsible for the latest bout of equity price buoyancy. Powell, in his latest post-Fed-meeting presser appeared to signal lower rates are just around the corner. Fed fund futures are currently implying a 100% chance of a rate cut in July. Powell's monetary counterpart, Draghi, delivered a June 18 speech announcing that more stimulus could be on the way if European economic conditions continue to suffer. Draghi's position may be compromised by the fact that his term ends this fall, but markets immediately reacted to his message.

Thus Powell and Draghi seem steadfast in potentially backstopping bouts of economic or market weakness, and investors have certainly picked up on this. We believe it has set the tone for the bullish market we are witnessing. With the strength of the ECB and Fed balance sheet, and policy levers at the ready, investors are putting money behind the two policy heavyweights. We find it hard to argue. In our view, sustained monetary accommodation, and the likelihood of more easing could make the global equity rally last longer than previously anticipated. We were initially skeptical after the fast start to the year, however the affirmation of resolute policy by Powell and Draghi has changed that view.

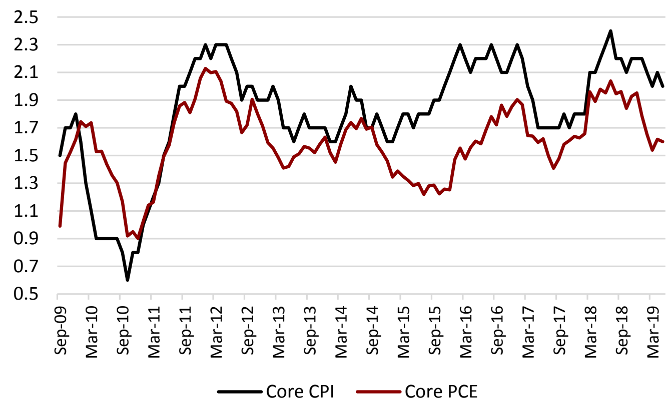
Inflation Giving Fed Room

Fed policymakers have clearly taken notice of the definitive turn lower in inflation since early 2018. The stubbornly low inflation seems to be confounding Fed members, but inflation levels are giving policymakers room to ease policy in order to target a 2% inflation run-rate. The Fed uses Core PCE (Personal Consumption Expenditure) as its key inflation barometer. We believe inflation is being held down by structural factors in the economy, globalization, and more intense price competition fostered by the internet. These issues, in our view, should help keep market interest rates, including the Fed funds rate, lower for an extended period.

Figure 2: Core CPI and Core PCE
Source: Bureau of Labor Statistics, Bureau of Economic Analysis

Both inflation series have been range-bound for several years now.

Core = excludes food and energy prices.



A Measured Approach

While central bankers' apparent willingness to tactically support the economy and the market has made us just a bit more bullish, we would not digest this commentary as an equity risk green light. We believe equities may be further supported by monetary policy, however, we remain concerned about the issues we mentioned at the outset of this report. As such, investors may want to maintain a tactical equity overweight but we would take only guarded risk. On a bullish scale of 1-10, we would be about a 5.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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