US Watch

POWELL'S PATIENCE BEING PUSHED

Steve Blitz / Andrea Cicione / Grace Fan

Economics: Fed's summer vacation is cut short

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- Trump's tariff war with China lowers inflation expectations
- Fed to cut rates in June?

Markets: Powell polishes his put

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- Equities have rallied, perhaps a sign of investors' trust in the Powell put
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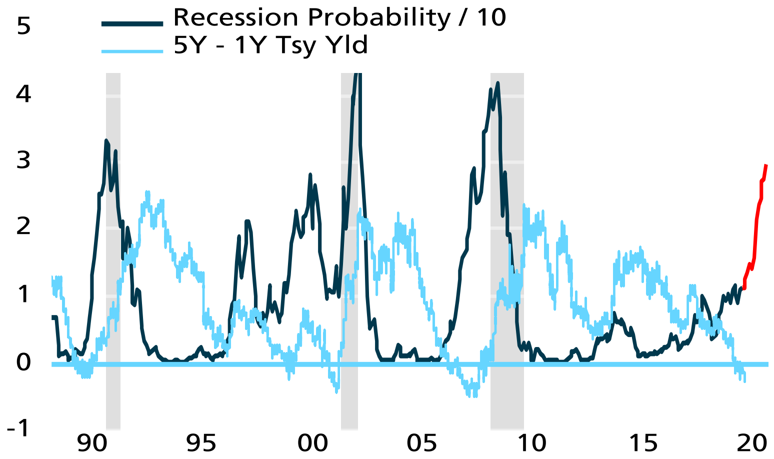
Politics: Bullying Mexico

- Trump advances on key political goals as he steps back from the brink
- Senate Republican rift sets outside limits to presidential overreach
- Looking ahead, watch legal challenges to "Remain in Mexico"

NY Fed Recession Probability

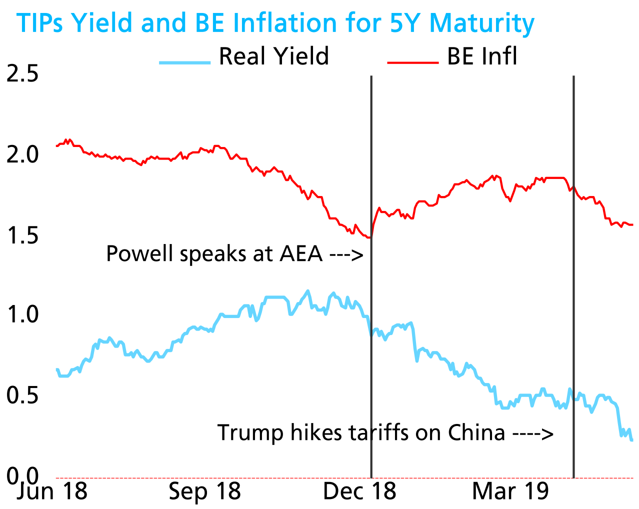


Source: Thomson Reuters Datastream, TS Lombard

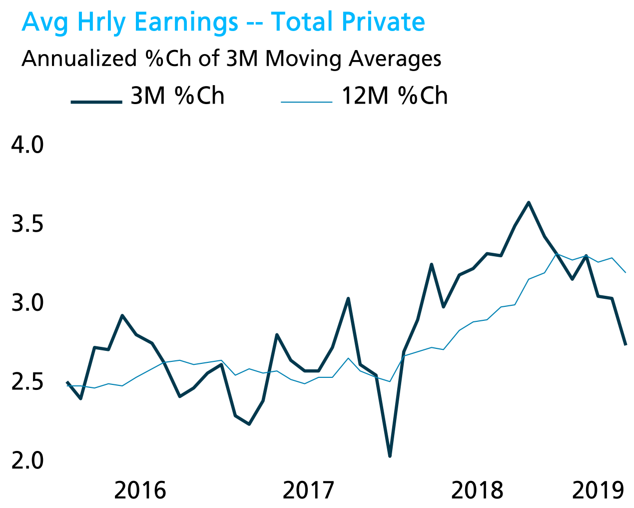
Economics: Fed's summer vacation is cut short

- **Employment data reflect weakening activity**
- **Trump's tariff war with China lowers inflation expectations**
- **Fed to cut rates in June?**

It looks like Powell's self-imposed vacation from policymaking isn't going to last very long. The rising probability of recession from the inverted yield curve and downturn in some economic data (see front page chart) plays a role in cutting short Powell's planned beach time, but he can also thank Trump's recent surprise move to impose additional tariffs on imports from China. As we illustrate in the chart below, Powell's early-January words at the American Economics Association, which included the hint that QT was ending, had the desired market effect of lowering real yields and reviving forward inflation expectations. This positive mix ended a few weeks back with Trump raising the stakes in the trade dispute with China – real yields dropped and then so did inflation expectations.



Source: Thomson Reuters Datastream, TS Lombard



Source: Thomson Reuters Datastream, TS Lombard

Keeping inflation expectations pumped up is critical for the Fed. With the air again leaking out of this balloon, the patience to ease has likely come to an end. The Fed will focus on the economy to divine the timing for the first rate cut. Until then, promises alone are helping to buoy markets - a dubious result (see this week's Market section). Given the slowdown in hiring to a 150,000 monthly pace for the past three months, the FOMC must soon decide whether the economy has reached at the targeted neutral destination - the purpose of their last two rate hikes - or whether it is passing through neutral on its way to an even weaker pace of growth. A cut or perhaps two could help ensure the economy isn't passing through.

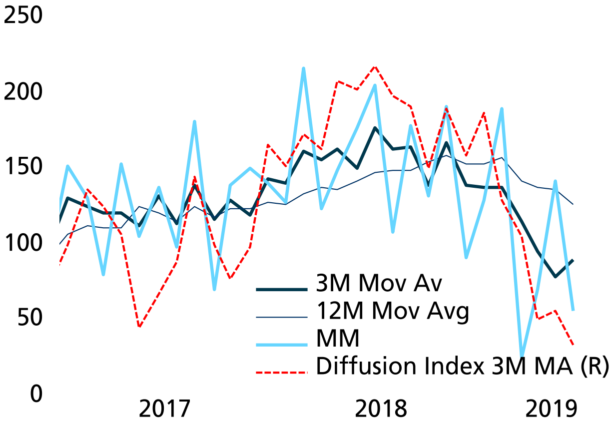
Powell, like Greenspan, understands that markets send relevant signals about the economy's trend direction long before the actual data. It is the reason why early this year the FOMC reacted to December's swoon in the capital markets by lowering forward guidance to zero and announcing the end of QT. Now pushed to ease, why not go in June? Nominal wage growth is slowing (see chart above), there is no upward pressure on inflation, higher tariffs are on the way (a tax on consumption) and the negatives of a strong dollar are already here.

The biggest barrier to a June rate cut is that it comes prior to the G20 summit. The political optics are poor and there is the possibility - however small – of a Trump-Xi trade deal that could sharply improve market sentiment and mitigate the need for an immediate rate cut. Therefore, in order for the Fed to cut this month they need a little more evidence that the May employment data aren't a fluke (they aren't, but the Fed is the Fed). If they get confirmation - and it is there if they know where to look - they will cut this month regardless of the political optics. If they don't, they will wait for the June jobs report and cut in July. Data dependency at its worst.

We write about the economy being in "neutral" because that is how the Fed likely sees the 150,000 average monthly jobs gain for the past three months - a result of the 75,000 increase in employment in May and downward revisions to March and April. This new low average is, in fact, the upper end of the range considered to be neutral (100,000 to 150,000) because it effectively matches labour force growth and thereby puts no pressure on the unemployment rate in either direction. The pace of job creation away from health, restaurants and retail has, however, been fading since the middle of last year along with the hiring diffusion index for all firms (see chart below). The slowing rate of overall wage gains stems, in part, from this mix-shift in new jobs towards lower-wage positions. The last two rate hikes essentially cemented the economy's downturn towards neutral, which, by definition, means the Fed drove rates a bit too high to get this result. And when we see the flattening employment/population ratio for 25- to 34-year-olds, our expectations for discretionary consumer spending flattens as well (see chart below).

Emp in Non Low Wage Industries* (M/M Ch)

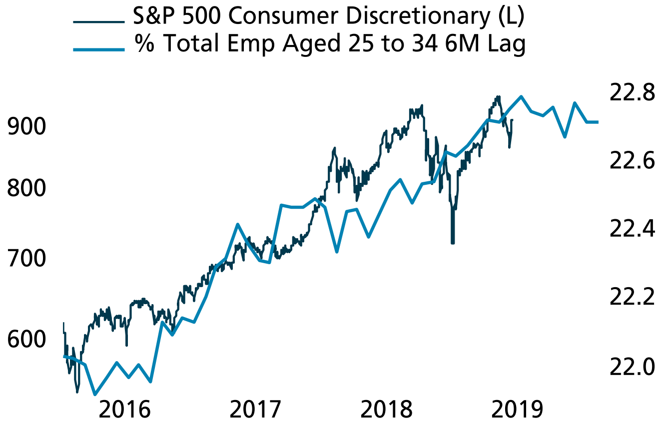
*excludes Retail, Health, Restaurants



Source: Thomson Reuters Datastream, TS Lombard

Consumer Discretionary & Millennials at Work

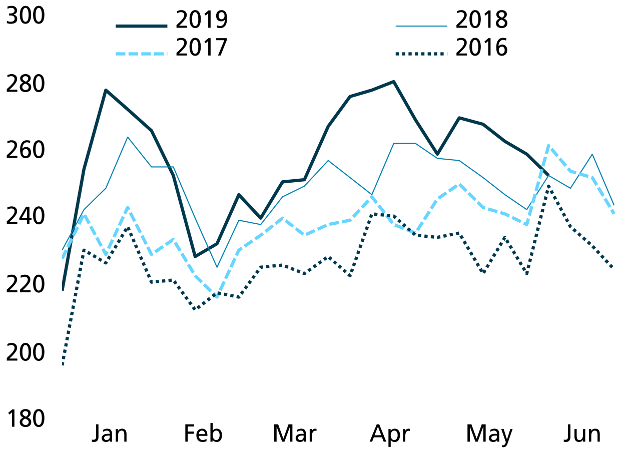
Log Scales



Source: Thomson Reuters Datastream, TS Lombard

Our view that the economy will continue to slow down is borne out by the drop in mortgage applications for purchase (see chart below). There was a bit of surge earlier this year as sales delayed by the run-up in real mortgage rates late last year were unleashed by the subsequent decline in rates. Pent-up demand now spent, the continued fall in yields has yet to stimulate housing demand. It might yet do so if the equity market - the best indicator of consumer sentiment - stabilises, but that will mean realising the Fed's promise to cut rates. Railcar loadings of cyclical cargo also indicate a slowing economy, as the pace is below the levels of the past two years (see chart below).

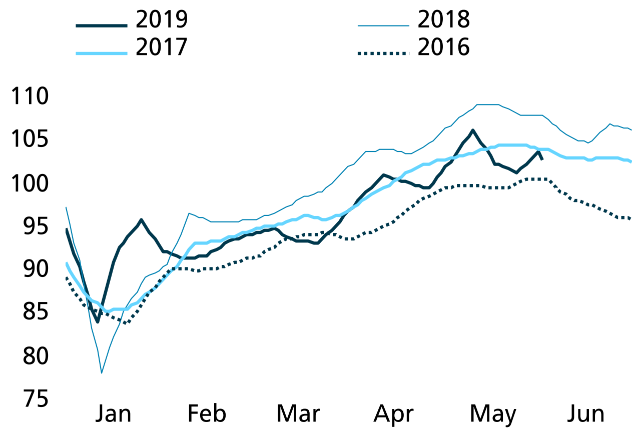
MBA Mtg Applications Index for Purchase



Source: Thomson Reuters Datastream, TS Lombard

Railcar Loadings Cyclical Cargo (000s)

Chemicals, Metal, Nonmetallic & Forest Prod -- 4Wk Mov Avg

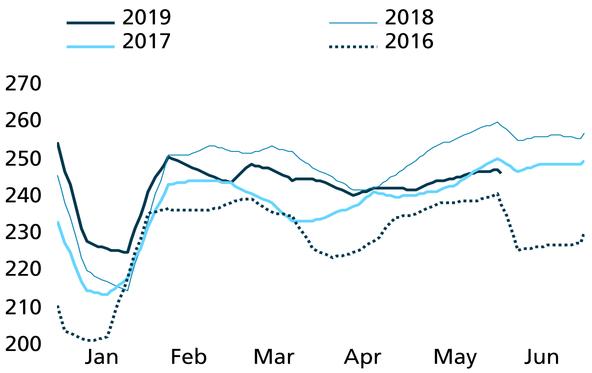


Source: Thomson Reuters Datastream, TS Lombard

One of the reasons cited for expecting weaker top-line GDP (GDI has already slowed to around 1.5% real growth) is an adjustment to inventory levels built up the past three quarters in anticipation of higher tariffs. We see the beginnings of this slowdown in the volume of railcar loadings of containers dropping below year-ago and 2017 levels (see chart below). This indicates less inventory crossing the country, notably consumer products imported by sea. The April wholesale sales and inventory data also tell the tale of an economy weakening: growth rates for both have slowed while the I/S ratio continues to climb. Inventory is not yet declining but destocking looks set to begin in the coming months. Our working estimate is for real GDP to expand about 0.8% QoQ SAAR in Q2 with a rebound to only 1.2% in Q3 – the quarter when we have long expected growth to slow as the lagged impact of last year's tightening of financial conditions combines with fading fiscal stimulus.

Railcar Loadings of Containers

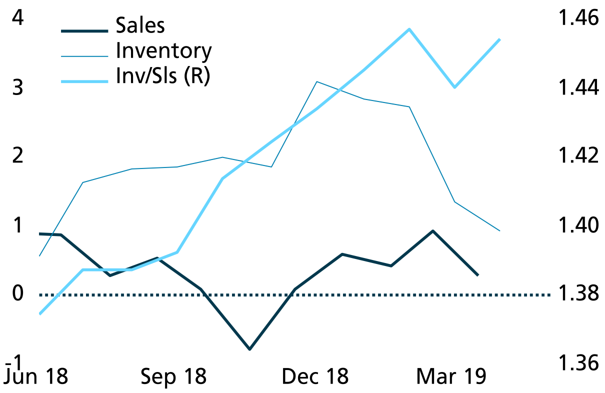
(4W Mov Avg, 000s of Carloads)



Source: Thomson Reuters Datastream, TS Lombard

Wholesale Sales and Inventory ex autos & oil

3M %Ch for Sales and Inventory



Source: Thomson Reuters Datastream, TS Lombard

How much patience does the Fed have before easing? Or is the wait now about scaring some leverage out of corporate balance sheets? This is a real quandary for the Fed – balancing the right interest rate against the potential for too much unproductive leverage. To resolve the quandary, the Fed seems to be leaning towards using regulatory restraints more aggressively to control leverage rather than keeping interest rates too high. If the Fed does ease as expected, it would not be a surprise if they also told the banks to raise their levels of precautionary capital.

Markets: Powell polishes his put

- **After Powell's remarks, rate markets now discount multiple Fed cuts**
- **Equities have rallied, perhaps a sign of investors' trust in the Powell put**
- **But the reaction in the two markets is not entirely consistent**

The content of this note was first published in Macro Strategy on 6 June 2019.

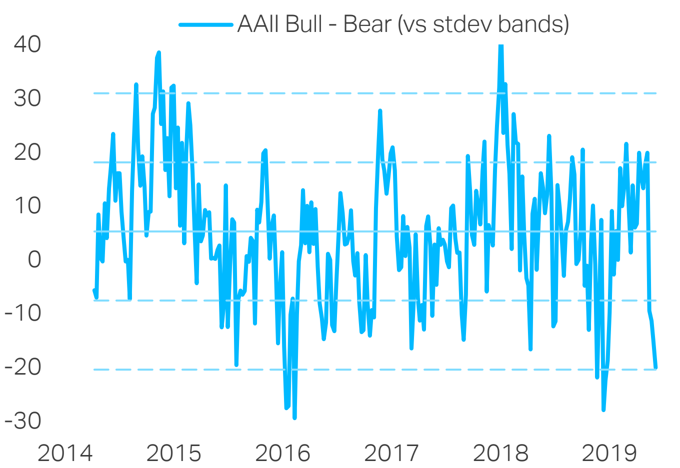
Markets overreact to Powell comments. On Tuesday Jerome Powell unleashed the strongest rally in the S&P 500 since 4th January by saying the Fed stands ready to ease monetary policy if the latest trade war escalation damages the economy. Arguably, the Fed chairman was stating the obvious. Still, his comments were a departure from the hitherto official line that the Fed would be 'patient' – code for 'on hold for the foreseeable future'.

US stocks bounce boosted by oversold conditions. Just like in May, when Trump triggered a sharp sell-off by threatening fresh tariffs on Chinese imports, the market reaction to Powell's remarks was amplified by the extremity of prevailing sentiment – bullish in May, bearish in June. As the charts below show, investors were deeply bearish last week: the number of bulls vs bears was about two standard deviations below average. The RSI for the S&P 500 was also in oversold territory, the benchmark having been overbought back in May. For this reason we wouldn't read too much into the extent of the equity market's rise on Tuesday.

Rate markets too excited about Fed cuts? The (over)reaction was even more exaggerated in interest rate markets. The chances of one policy rate cut by December have been gradually rising since April. Now, however, not only are two 25bp cuts almost fully priced in, but as many as three (or more) are considered more likely than not (top-left chart on the next page).

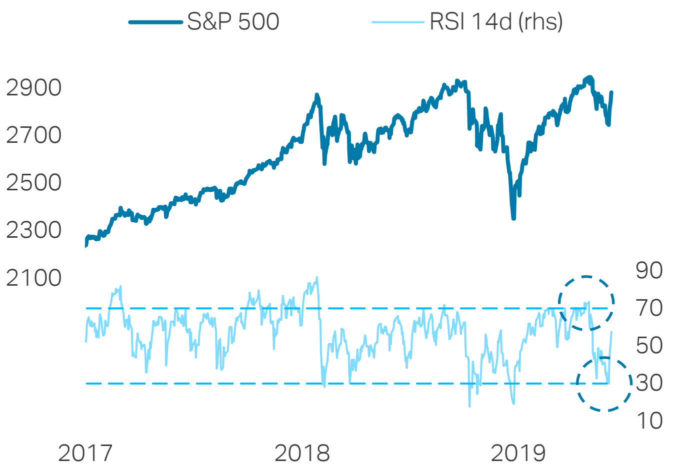
Recession pricing. We have held the view for some time that the Fed would likely make an 'insurance cut' by Q3. In the meantime, the threat of higher tariffs and ever more trade uncertainty have increased the probability of further easing, so a second rate reduction before year-end no longer seems out of the question. But three or more cuts would require a deterioration in the economy that goes beyond the slowdown to 1% real GDP growth we now expect in Q2 and Q3 – virtually a recession. If this is what the rate markets are pricing in, it seems inconsistent with the positive reaction in equities.

Equity investors were very bearish last week…



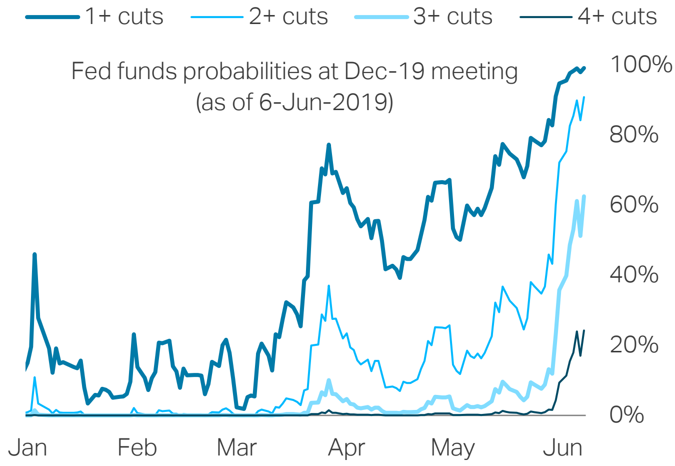
Source: Bloomberg, TS Lombard

…And equities were oversold



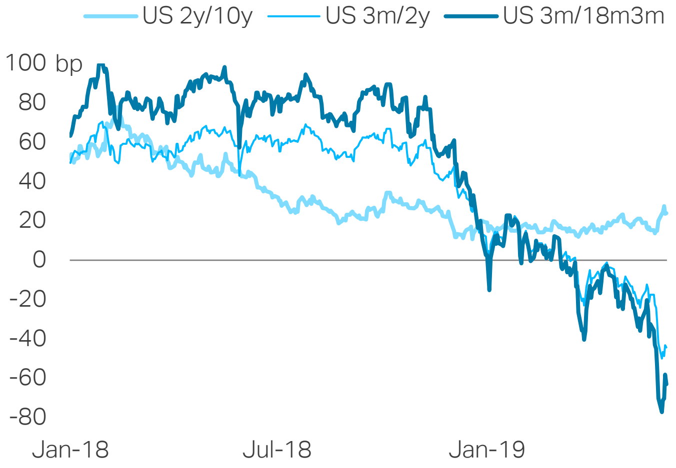
Source: Bloomberg, TS Lombard

Greater than 50% chance of three cuts in 2019



Source: Bloomberg, TS Lombard

US 2/10y steeper, but short-end more inverted



Source: Bloomberg, TS Lombard

Yield curve still inverted. While the 2y/10y section of the yield curve has steepened in response to Powell's comments, both the 3m/2y and 3m/18m3m spreads have become more negative. Fed research shows that these near-term spreads have greater power in predicting a recession than the 2y/10y. They are also more likely to cause (as opposed to signal) an impending economic contraction, because an inverted curve tends to choke off credit creation.

Real rates lower. Not only has the yield curve inverted further at the front end, real rates have fallen too – another signal of expectations of slower real growth. We bought TIPS last week in anticipation of such a move and keep the position open this week. But why aren't equity markets paying attention to rate market moves?

All else equal, lower rates are good for equities. But if rates fall in response to expectations of a weakening economy, all else is not equal. What the stock market is not yet factoring in is that profit forecasts will have to be revised down if growth does indeed slow more than consensus anticipates. Additionally, recessions tend to happen years after the yield curve inverts. And although equities price in falls in GDP before they occur, there is likely a window during which stocks can pretend not to know what's likely to happen and continue rallying.

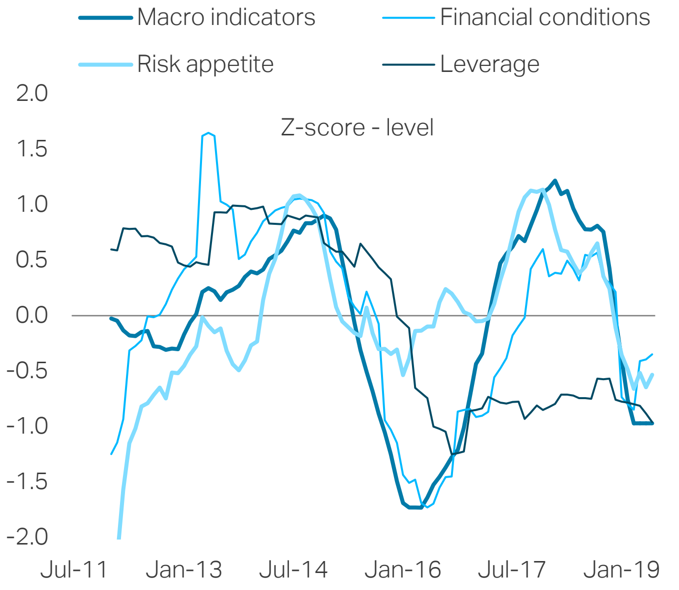
US credit cycle in the 'slowdown' stage. To be clear, we are not forecasting a recession, but we take the inverted curve signal very seriously. Besides, the curve is not the only worrying sign we see at the moment. Our **CyclQEST** framework indicates that the credit cycle remains firmly in the 'slowdown' stage, which means tighter-than-average and deteriorating credit conditions. The breakdown of our credit conditions index is informative. Macro indicators have continued to worsen, while risk appetite and financial conditions have fluctuated over the past few months, mirroring similar moves in risk asset prices. Leverage, after two years of relative stability, has started climbing again. (See charts on the next page.)

Vol trending higher. Another indication that the rebound in shares may soon lose momentum is the overall upward trend in equity volatility. The VIX bottomed in 2017, with the average for the year at a record low of 11. The average for the first nine months of 2018 was a much higher 14.7. Since October 2018 the average for the VIX has climbed further, to 17.5. Importantly, over the same period credit spreads have repriced, lagging equity prices substantially – perhaps an indication that higher asset volatility has transferred value from bonds to stocks (see Multi Asset section in June's Chartbook).

CyclQEST: US credit cycle in 'slowdown' stage

Source: Bloomberg, TS Lombard

Macro and leverage still getting worse



Source: Bloomberg, TS Lombard

Have US equities already peaked? The trend in volatility matters because our analysis of the 13 major market cycles of the past 90 years shows that equities move from a low- to a high-vol regime only after the market has peaked. The recent rising trend in the VIX could be a sign that we are indeed transitioning into a higher-volatility world. If the shift is confirmed, it would be a strong indication that the peak in equity prices may be behind us.

All of this can obviously change, and it's not hard to imagine a scenario that would transform this gloomy outlook. A US-China deal would put trade tensions on hold for a time, even if a war of attrition between the two is likely to continue. The Fed could deliver a precautionary cut, to keep inflation expectations from falling further. A Fed easing on concerns over inflation rather than growth would likely spur an equity market rally. Financial conditions and risk appetite would recover, and macro data may also turn around as confidence returns. **CyclQEST** would move into the 'recovery' stage and likely go full circle before another growth scare comes along. But that would be something for investors to worry about another time.

How likely is this scenario? In the near term, not very. We think that the US and China will agree to extend trade negotiations for another three to six months, meaning that uncertainty looks set to linger, even if full escalation is avoided for now. The Fed will probably cut in the summer, or by September at the latest. What happens next is path-dependent but, for the time being, we remain cautious. Expectations of aggressive Fed cuts this year will likely be priced away in coming weeks, weighing on equities. And if they aren't, earnings estimates will probably have to adjust lower to reflect a dimmer economic outlook.

Politics: Bullying Mexico

- **Trump makes progress on key political goals as he steps back from the brink**
- **Senate Republican rift sets outside limits to presidential overreach**

Ahead of the official launch of his re-election campaign later this month, Trump fired up his base before calling off his latest tariff threat. Two days before the planned imposition of 5% duties on all Mexican imports, the president abruptly pulled back from the brink on Friday evening (7 June) following bipartisan pushback, with the announcement of a migration deal with Mexico which would "indefinitely" suspend tariff implementation. Still, in a clear sign that the threat has not been definitively defused, the agreement sets a 90-day timeline to re-evaluate the situation if the US government is not satisfied. Underlining this point, Treasury Secretary Steven Mnuchin on Saturday affirmed that Trump retains the authority to impose the tariffs if he decides that Mexico has failed to abide by its commitments.

To avert the tariffs, Mexico has agreed to significantly expand its "Remain in Mexico" programme – a move that could seriously overtax its northern border cities. The main concession it made was to agree to accept the return of "all" illegal migrants who cross the US southern border. So far this year, Mexico has accepted more than 10,000 such migrants. With the resources of key border cities already strained, there are worries over how the fiscally strapped government of President Andrés Manuel López Obrador (AMLO) will fund this new plan – especially if the number of migrants sent back escalates exponentially. To add to its problems, under the vague terms of the deal released thus far, Mexico will now offer "jobs, health care and education" to the migrants – a promise that it is already struggling to meet for its own citizens.

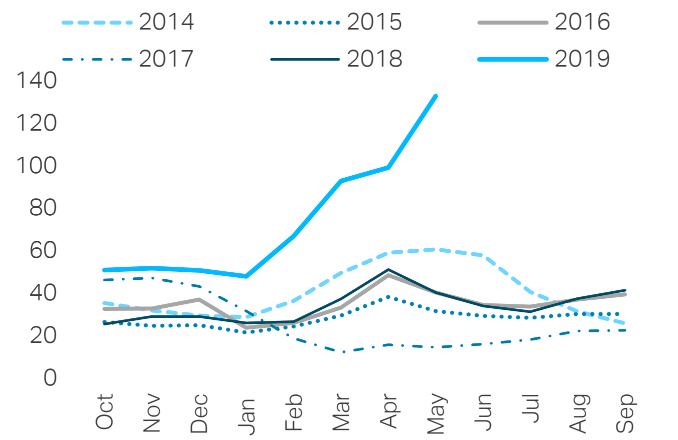
Mexico will also militarise its southern border – a move that could have positive short-term results for migration inflows yet fails to address structural problems. The second component to the deal was Mexico's agreement to deploy 6,000 troops to 11 municipalities on its southern border with Guatemala to stop immigration at the source. The government also announced the establishment of 10 new border control posts and suspended more than two dozen bank accounts tied to people who have helped to organise Central American migrant caravans. The steps could temporarily aid a dip in US border apprehensions – a common trend in the summer months anyway, as migrants prefer to avoid making the crossing in brutal heat (see Chart 1 below) – but they are clearly provisional measures designed to placate Trump after border arrests spiked in recent months.

Longer-term reasons for concern include: 1) The Mexico-Guatemala border spans more than 850km and has limited fencing, casting doubt on whether a mere 6,000 troops can control migration; and if it becomes harder to cross from Guatemala, as time goes on migrants are likely to try from other points on Mexico's southern border, including neighbouring Belize; 2) Strapped for cash, the Mexican government slashed funding for its immigration agencies in its 2019 budget, leaving it with little bureaucratic capacity to process sizeable numbers of new migrants without compromising its 2019 primary surplus target of 1%; and 3) From a structural point of view, AMLO's plan to reinvigorate Central America via a new 'Marshall Plan' involving investment of $10bn a year is a far better way of tackling the root causes of the region's migration crisis; yet the US has shown little interest in committing resources.

Economically, because Mexico has little capacity to absorb a deluge of Central American migrants, Trump's deal could boomerang back on the US longer term. This is particularly true after the Mexican economy in Q1/19 spluttered to its worst GDP performance in annual seasonally adjusted terms since 2009, as Chart 2 below illustrates. The flip side of the coin is that, despite its concessions, Mexico did manage to evade an even worse threat for now – a stern US demand that it sign a "safe third-country" deal that could allow the US to deport all of its illegal migrants to Mexico if they had first set foot there before reaching the US. Yet should Mexico's economy falter further, illegal emigration to its northern neighbour is likely to swell, thus potentially backfiring on the US.

Chart 1: US southwest border apprehensions*

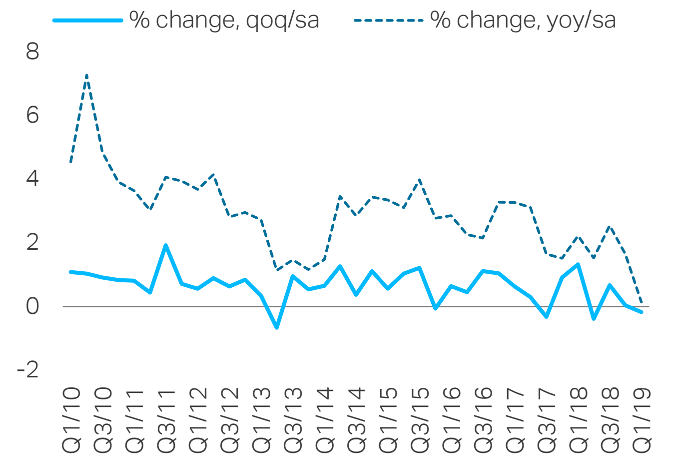
Thousand people



*Does not include those ruled inadmissible at ports of entry.

Source: US Customs and Border Protection.

Chart 2: Mexico's GDP



Source: INEGI.

Looking ahead, legal challenges to "Remain in Mexico" are key to watch. A US appeals court could still overturn the deal given that civil rights groups previously challenged the programme as illegal under international law. That, in turn, could prompt Trump to set a new deadline for tariff implementation as he seeks to extract other concessions from Mexico. The upshot would be continued uncertainty about tariffs, unnerving investors, while bolstering Trump's objective of winning re-election in 2020.

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