



LSR View

# TRADE WAR DAMAGE TO TRIGGER FED RATE CUT

Charles Dumas / Steven Blitz

- 2018's rising dollar and falling yuan caused an EM-led global slowdown
- Triggers were Fed QT with a doubled US federal deficit, and trade war
- EMs incl. China, 40% of world GDP, could be very slow in early 2019
- Export dependent DMs, Europe and Pacific rim, also hit
- The high dollar hurts US exports, and S&P earnings, while capex slows
- Latest Fed hike hurt after stock prices slumped, also gov't. shutdown
- Fed will taper QT soon, and then cut rates a notch in Q3
- With Chinese stimulus also coming through, recovery into 2020

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## Summary

The world economy is in a strange state, with unusual EM locomotive power – to the downside – arising from synchronised weakness (including China) and yet triggered by a succession of US actions that in combination have caused and/or worsened that weakness. The importance of EMs is that China accounts for 15% of world GDP (at current prices) and non-Chinese EMs for 25% (which is also the US ratio) for an EM total of 40%. But in normal circumstances, EM cycles are not synchronised, as EMs are dispersed geographically and very varied in character.

The four successive US actions that precipitated this slowdown (whatever their merits in other respects) were the end-2017 tax reform and fiscal stimulus in a mature phase of the cycle, doubling the federal deficit at a time when the Fed's quantitative tightening (QT) was already potentially draining liquidity from financial markets; the threat from May 2018, of all-out trade war, mostly against China; the dubious decision to add another rate hike in December 2018, despite slumping stock prices; and the current federal government shut-down. The latter pair of US actions are largely relevant only to the US slowdown, but the first two created major problems for most of the world economy, now spilling over to the US.

The US dollar had an orderly retreat from near-20% overvaluation in spring 2017, falling nearly 10% until spring 2018, amid a global boom (by post-GFC standards). No doubt the boom, had it continued, would have led to problems in various countries and sectors, but it was cut short, as was the dollar's decline. The nascent upswing of the yen and euro was first checked by a very sharp rise in eurodollar rates, outweighing the continued dollar-negative effects of major trade imbalances. Eurodollar rates and differentials with the euro and yen were boosted by the funding policies of the US Treasury, with its doubled deficit; by the Fed's QT proceeding throughout 2018 at more than 2% of GDP; by delayed effects of earlier regulation changes for money-market mutual funds; by the ECB's decision to keep short-term euro rates at minus 0.4% for 18 months from spring 2018; and by repatriation of offshore dollars from tax havens by US corporations benefiting from the tax reform. This triggered dollar appreciation in March-April.

In May, the rejection by President Trump of Treasury Secretary Mnuchin's negotiated deal with the Chinese authorities over US grievances led to broad-based trade war, though specifically focused on China. The real, trade-weighted yuan plummeted 7-8% by September, and safe-haven flows into the dollar ensured an equal real gain by that date from its March level. Dearer dollars raised import costs (as did higher oil prices until September) and the cheaper yuan undercut countries' exports. Trade-war pain was 'exported'. Japan, Germany and Italy saw falling real GDP in Q3, with continued weakness in Q4 spilling over into the first half of 2019.

For non-oil EMs it was a bloodbath, as their massive deficits over 12 years meant rising dollar debt values and interest costs added to their vulnerability from major deficits. While the recent cut in trade war fears has stopped the financial rout, the accompanying austerity programmes mean their domestic demand and import growth is curtailed well into 2019. And in China, the epicentre of the trade war, slowing domestic demand, though temporarily offset by US import stockpiling until last autumn, signals serious weakness in early 2019 as exports fall back.

Where does this all leave the US? Traditionally regarded as a semi-closed economy, its export and import ratios to GDP of about 15% are similar to those of Japan and the euro area (EA, excluding intra-EA trade) – ie, not so very closed. US stock market earnings, and therefore market values with all their importance in the US economy, are heavily affected by the real level of the dollar, reinforcing the deflationary impact of its 2018 rebound and current overvaluation.

The shift to apparently all-out trade war last May set back a boom in US business capex, which grew at a 4% annual rate in Q1 and Q2, a typical late-cycle surge helped by lower corporate tax rates. In Q3 it was minimally up as US firms expressed their doubts. Real exports were down, if less affected than in Japan and Germany, and that seems to have continued in Q4. Housing has been flat to down for several quarters. The recent fall in oil prices is unlikely to stimulate consumption, as it simply restores real income losses that caused a temporary drop in household saving in Q3. And inventories, heavily run up in Q3 and Q4, will be used to satisfy demand in Q1 and Q2, curtailing output in the US as well as China.

We are forecasting a two-phase Fed response to all this. In phase one, probably by the March FOMC meeting, the Fed will implement QT tapering, ideally spending the money it gets from Treasury redemptions on short-term paper, to try to restore a positive yield curve. In phase two, perhaps in Q3 when the downs and ups from the government shutdown have worked their way through the economy and the underlying slowdown is fully evident, the Fed could cut the funds rate by a notch, especially if by then the troubles of China, EMs and export-dependent savings gluttons (possibly even Brexit gremlins) have led to another downward lurch in stock prices, as seems possible given China's recent effect on the Apple share price.

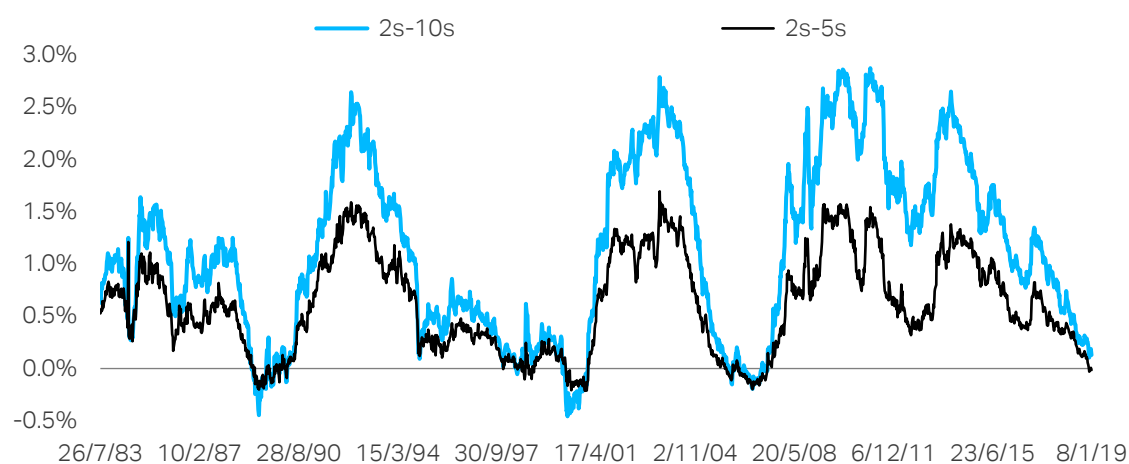
So we do not share the widespread view that the US economy will grow at 2-2½% through 2019, with further Fed hikes that precipitate a slowdown or even recession in 2020. The slowdown is already happening, and it is globally synchronised, though led by EMs. Most likely, Fed easing will kick-start US recovery late in 2019, while strong Chinese domestic stimulus will help get the rest of the world going. Two of the last ten US election years have been disasters (1980 and 2008) but that means 80% have not been! What actually happens in 2020 and 2021 – at least in the US – is the subject of a speculative section at the end of this View.

## Is Fed tightening done for now?

Fed tightening may be done for now, reflecting several factors:

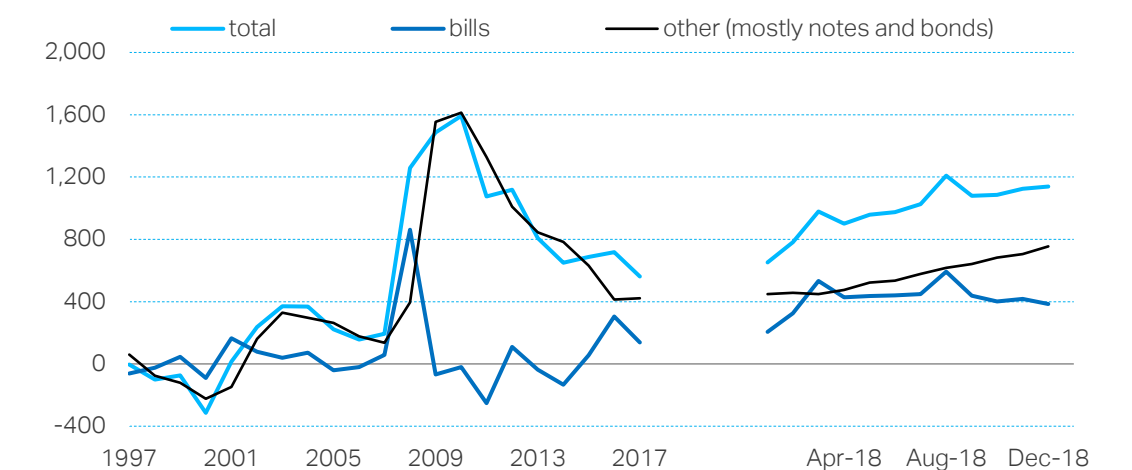
1. We are forecasting growth during 2019 (Q4/Q4) at or below potential, ie 1½-2%, with a non-trivial chance of further slowing or even a recession
2. The case for higher nominal and real interest rates has partly depended on the doubling of the Federal budget deficit resulting from the tax cuts put in place at the end of 2017
3. The threat of trade war has frustrated the hope corporate tax cuts would lead to a surge of business capex, such as is normal in the late stages of an economic up-cycle
4. The combination of higher interest rates and a strong dollar have, in this context, slowed the economy – and the Federal government shut-down does not help
5. One effect of these points is embodied in the flattening of the yield curve, a traditional signal heralding a contraction in credit extensions that lead to an economic downswing
6. Fed Chairman Powell looks as if he could prove more market-sensitive than some of his predecessors – in any case, he has a less arduous end-of-upcycle task, as the economy, though arguably overheated in 2018, did not lurch into an inflationary spiral

**Chart 1: US T-note yield differentials, %**



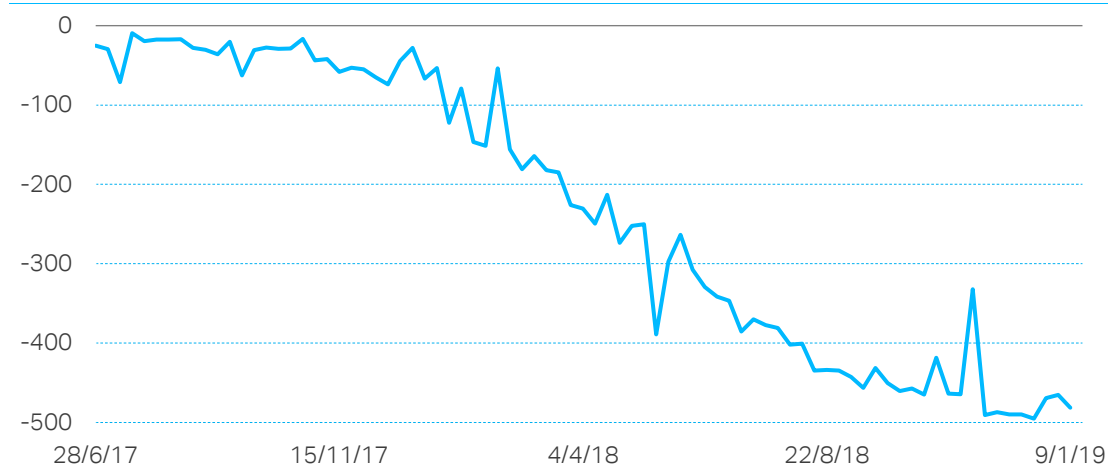
Source: Datastream, TS Lombard

The yield curve itself, though a reliable indicator of forthcoming recessions in the past, certainly does not suggest recession in 2019. First, the 10-year minus 2-year yield differential is not yet negative, as it became before each of the recession of 1990-91, 2001 and 2008-09, though the 5-year differential with the 2-year became zero to minimally negative recently. Second, the 5s-2s differential went negative a full year and a half before the recessions of 1990-91 and 2008-09, and a year before the 'recession' of 2001 (in fact, four quarters of stagnation, two slightly down, two slightly up). On past form, even if the 5s-2s differential stays below zero and is joined by the 10s-2s, it suggests recession as early as late 2019 more likely 2020 when a topping-out of the cycle would be more typical – more or less in line with our forecast of growth at or just below potential. It is, however, too soon to be forecasting possible recession, even if the Treasury yields point that way. We have enough faith in Fed Chairman Powell to predict that the 2018 monetary tightening will now pause – and may even give way to some easing later this year – recession remains low-probability.

**Chart 2: New change in US federal debt outstanding, \$bn YoY**


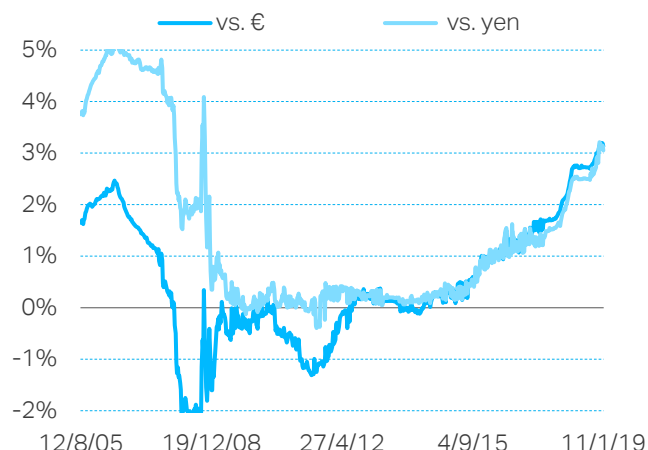
Source: US Treasury, TS Lombard

Both the upswing of interest rates and the (resulting) strength of the dollar are a function of late-cycle fiscal stimulus combined with implementation last spring of US-China trade war. The shape of the yield curve has been affected by those factors as well as the pattern of US Treasury funding of its budget deficit, by the run-off by the Fed of its balance sheet – ‘quantitative tightening’ or QT – and by a variety of other goings-on in US and global money markets. As the chart above shows, the increase of Treasury debt outstanding – one measure of the federal deficit – about doubled from \$560bn in 2017 to \$1,139bn in 2018. Of that \$1,139bn, \$384bn was funded with T-bills and \$755bn with other securities, mostly notes and bonds.

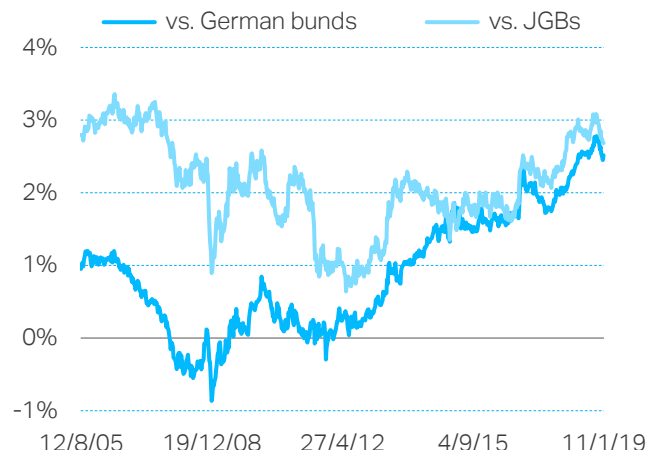
**Chart 3: Change in Fed's b/s assets, 3-month MA, \$bn annual rate**


Source: US Federal Reserve, TS Lombard

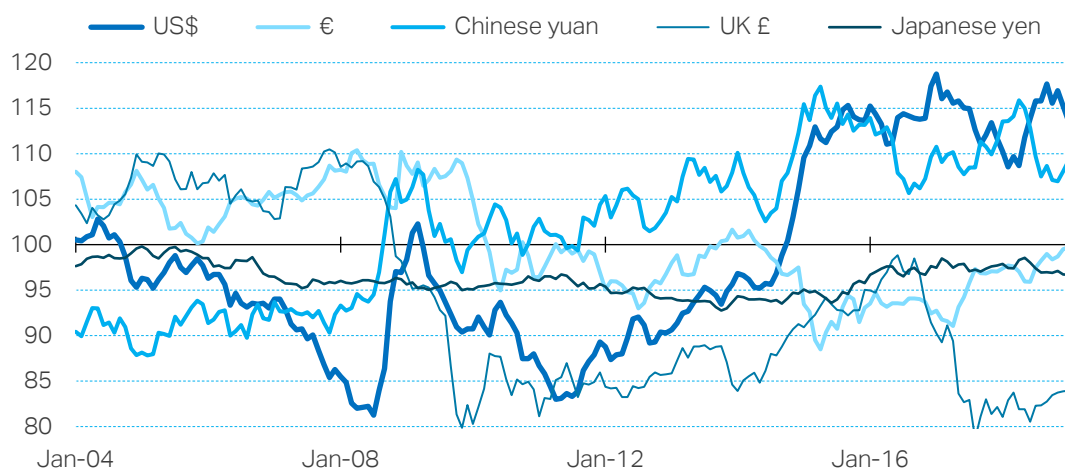
However, while the Fed's balance sheet was roughly unchanged during 2017, it shrank by \$373bn during 2018. The banking system in effect substituted the loss of reserves with acquisition of the \$384bn of T-bills. But the timing was a bit skewed. The issuance of bills was most intense earlier in the year, as the earlier chart shows, but the rate of QT rose steadily through the year, reaching a little under a \$½ trillion annual rate by September, and staying there. At the short end of the yield curve, the pressure of supply from these two factors was at its most intense in the spring, just about the time when the dollar started to soar.

**Chart 4: US\$ 3-mth Libor differentials**


Source: Datastream, TS Lombard

**Chart 5: US 10-yr gov't. yield differentials**


Source: Datastream, TS Lombard

**Chart 6: Real FX rates, PPI-based, long-run average = 100**


Source: Datastream, TS Lombard

In the year to spring, 2018, the real, trade-weighted dollar index fell back from its cyclical peak, but then it soared until September, when it again approached 120% of its long-run average value – a level that looks like some kind of boundary. The dollar had fallen back in the year to last spring as the yen and euro were buoyed by large current-account surpluses, both at 4% of GDP. But the sharp upswing of interest rate differentials in early 2018 revived the impact of these differentials on FX rates. Two factors were the repatriation of US companies' overseas retained funds, motivated by tax incentives and penalties on offshore earnings included in the end-2017 tax cut – this cut into the funding of offshore dollar loans, raising dollar Libor – and the ECB's announcement that its minus 40 b.p. interest rates would be kept unchanged until late-summer 2019.

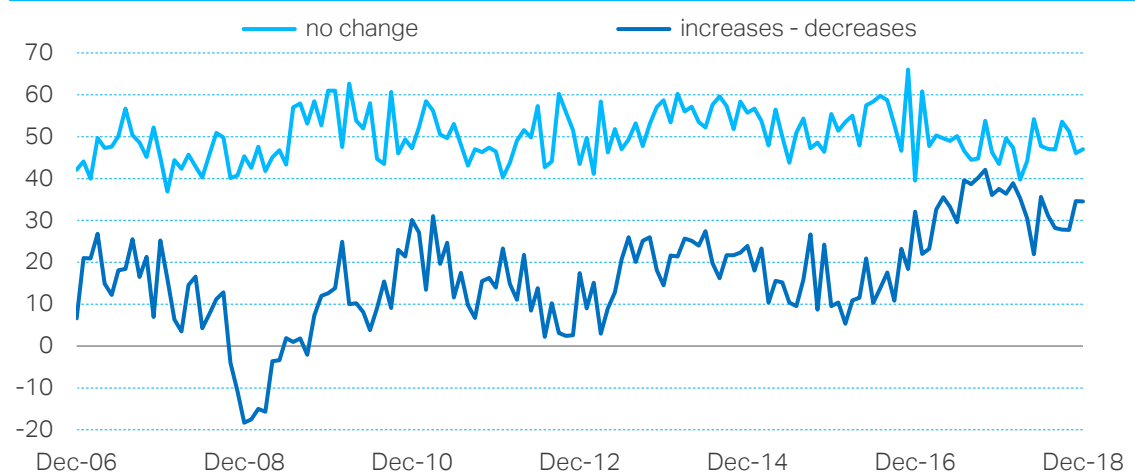
The interest-rate differentials were further expanded by the Fed's steady tightening, the rapid upswing of US real growth, the swelling of short-term US rates by European and Japanese investors hedging Treasury purchases back into euros and yen, and some residual effects of earlier US changes in the regulation of money market mutual funds. These effects kick-started the dollar's April upswing, reversing the previous 12 months' decline, and also added to the flattening of the yield curve as so much of the upswing of rates was concentrated in short

maturities (including the peak of bill issuance). The shift in the curve from flat towards inversion accelerated sharply late in 2018 – notably after the mid-term elections.

## Trade war, rising dollar, growth slowdown, stock market slump

The second stage rocket powering the soaring dollar was the late-May adoption of trade war – tariffs on metal imports, and ditching by President Trump of agreements negotiated by Treasury Secretary Mnuchin with the Chinese authorities. Disruption of supply-chain economics meant this action strongly discouraged business capex. This was accentuated by a safe-haven flight of investors into the dollar, curtailing export prospects and business profitability. The simultaneous slump of the yuan ‘spread the pain’ from the trade-war combatants (US and China) to the rest of the world, with imports (typically priced in dollars) becoming more expensive and exports facing much tougher Chinese price competition – China is not only growing more slowly, already curbing world trade growth, but also ‘exporting’ deflation.

**Chart 7: Future capex intentions - Philadelphia Fed survey**



Source: Philadelphia Fed, Datastream, TS Lombard

Between summer of 2017 and last winter, the balance of capex intentions monitored by the Philly Fed was more positive than at any time since the boom before the first oil crisis in 1973-74. But mid-2018 saw significant slippage in the balance expecting an increase, and a minor increase in those intending no change. One result of all this was that the Q3 GDP data showed an actual decline in the volume of exports – and October’s number was right on the Q3 average in real terms – and only a slight gain in real business capex, which had been growing at a 10% annual rate in the first half of the year. The capex outlook perked up a little in November and December, but the simultaneous slippage in both ISM surveys – manufacturing and non-manufacturing – suggests that hopes for a serious capex boom will be disappointed, though some growth should occur.

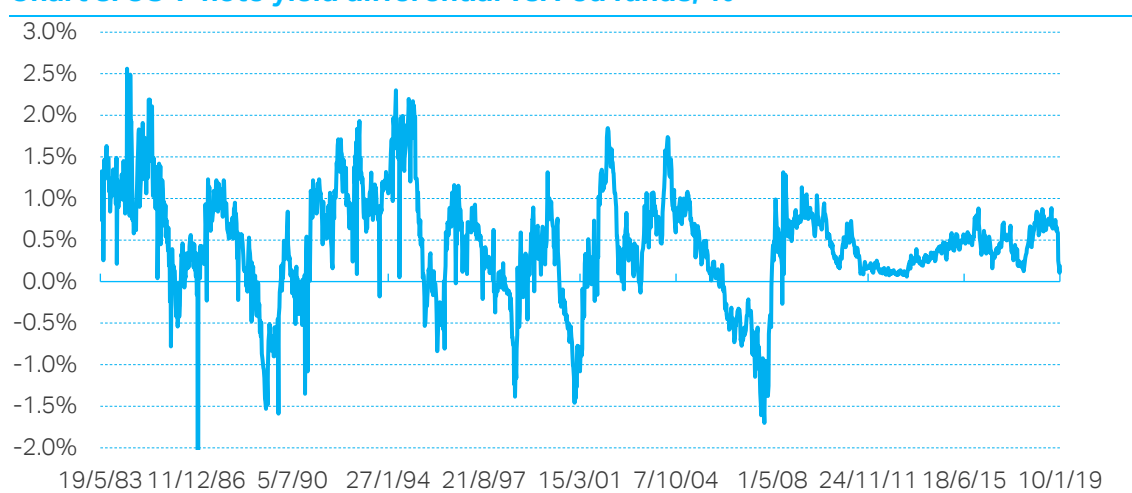
With housing also far from buoyant, US growth during 2019 now depends largely on consumers responding favourably to jobs growth and modestly positive real wage growth, helped by cheaper gasoline. This prospect is further inhibited by the likely impact of the Federal shut-down and the sharp stock market correction. My colleague, Steve Blitz, has pointed out that recent flows of household cash into stocks has caused their value to exceed housing for only the third time since WW2. And this time it is actual flows that are a major reason for this (as opposed



simply to very high market valuations in the late 1960s and late 1990s) – many households confronted with zero interest rates on deposits have put money into stocks simply to get a 2% yield rather than nothing at all. With the Christmas Eve S&P down only a whisker less than 20% from its September peak, consumer confidence may come down a few notches (as the Conference Board's measure already has).

## Bond market rally helps flatten the curve

**Chart 8: US T-note yield differential vs. Fed funds, %**



Source: Datastream, TS Lombard

The potential damage from the stock market correction is broader than this, as it has been the major reason for the rally in Treasuries. The 10-year yield's decline from its November peak of 3.24% to 2.77% now (and a low of 2.56% on January 3rd) is a major reason why the differential versus the 2-year note has disappeared; against the 47 b.p. fall in the 10-year yield, the 2-year is only down by 38 b.p. to 2.58%. The 2-year yield is heavily affected by expectations of future Fed moves, and this is illustrated by the sudden collapse at the end of 2018 in the differential with the actual Fed funds rate, which had formerly remained a healthy  $\frac{3}{4}\%$  or so for most of last year.

On the plus side, slippage of US yields has taken some of the sting out of the dollar's overvaluation; from a mid-October peak at 117% of its long-run average real, trade-weighted value, the dollar is now 3% less overvalued. The yuan has recovered from the mid-6.90s to the dollar to 6.79.

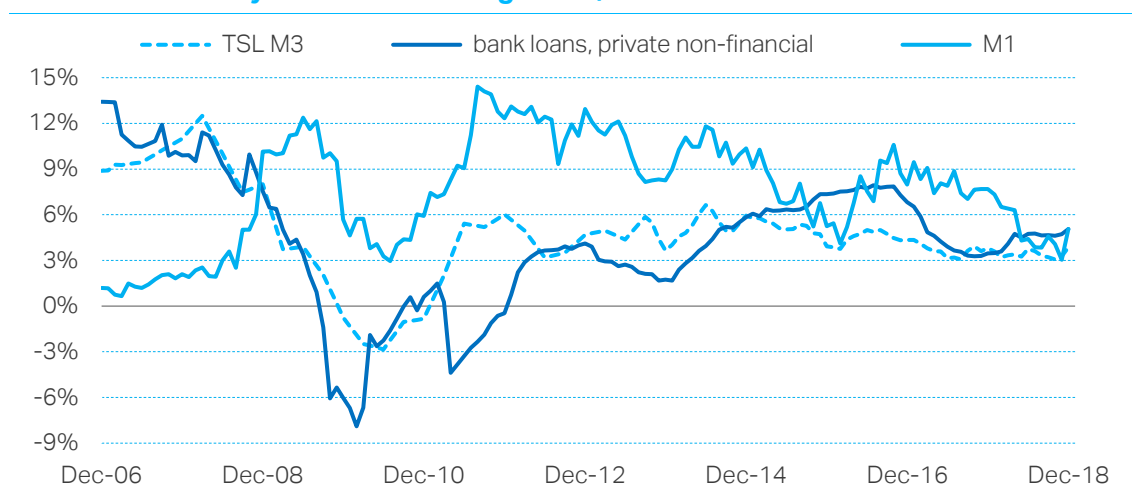
## What will banks do?

Banks start to have a problem when the funds rate is close to the rate they can get on short-dated Treasuries (typically the 2-year note). Not only are they discouraged from holding Treasuries, but also the competition between bank lending and the commercial paper market becomes stiffer. Fortunately for the banks, the stock market's relapse spilled over into junk bonds, and the junk-bond yield spread has widened by more than 1% since October. This awareness of risk – defaults in junk bonds are closely connected to the economic cycle – has spilled over in turn to the commercial paper market. The A2/P2 one-month c.p. spread over the Fed funds rate widened from the 30-40 b.p. range for much of the summer, and below 30 b.p. in

the early autumn, to more than 70 b.p. in mid-December, when the stock market rout was at its worst. It has now fallen back, but the wider credit spreads banks need are still there, if only marginally wider.

Alongside this analysis, we have the basic point that short-maturity dollar paper now has a positive real yield, even in 'risk-free' Treasury paper. Investors generally now have a serious cash alternative for the first time since the financial crisis, ten years ago. Much of what is going on in the financial markets springs from this, including the stock sell-off, as my colleague Steve Blitz has demonstrated in our publications. So it is not just banking intermediaries that will now want a more appropriate return to risk.

**Chart 9: US money and bank credit growth, % YoY**



Source: Datastream, TS Lombard

The Q3 swing into major inventory accumulation probably continued into Q4, and that may be part of the reason for the acceleration of commercial and industrial loans. These grew at more than a 10% annual rate between Q3 and Q4, after only a 6% rate in Q3, and December's C&I bank loans were up 9.7% YoY. Other bank loans to the real economy (real estate and consumer) saw slowing growth late last year, though for consumers this largely represents an unhealthy shift towards credit-card and other non-bank borrowing.

Banks describe C&I loan standards as getting easier, but this may simply recognise their need to satisfy clients with borrowing needs, either to fund inventory or for other purposes. The consumer drift away from bank loans could indicate banks' reluctance to lend at low margins, with consumers following the path of least resistance into more costly forms of debt such as credit cards – a 'back-door widening' of credit spreads. Either way, the growth of money and credit has settled into the 4-5% range, and could fall back gradually.

## Doubled Federal budget deficit => problems under any scenario

The underlying issue is not Federal Reserve policy, it's the budget deficit and 2018's fiscal stimulus at a mature stage of the up-cycle. Federal financing last year doubled from \$561bn to \$1,139bn, and that is the root issue. Alternatives to fund it were basically bills or bonds, ie, short or long term, with respective drawbacks:

- If too many bills (as actually happened) inevitable rate increases are concentrated at the short end, tending to flatten the curve, postponing pain as the initial date of inversion has generally been followed by recession some 18 months later (as seen above)
- If too many notes and bonds (the alternative funding policy) long rates go up, there is no curve inversion, but a general increase of rates along the curve to whatever level is needed to stymie the growth artificially produced by mistimed Keynesianism

Why were so many bills issued? Partly because of well-orchestrated talk about QT-driven dollar/bank-reserves shortages – but mostly to hold back the financial market consequences of fiscal stimulus. Why commentators should expect money to be kept spectacularly easy in the face of mistimed fiscal stimulus is a mystery. As discussed above, the focus on bill issuance is a reason short rates are so high vis-à-vis longer-dated paper – arguably, monetary policy should have been neutralising/sterilising the fiscal stimulus at this stage of the cycle by non-bank financing, ie, maturities greater than 2, probably 5, years. Obviously, the proximate cause of the inverted curve is the collapse of the 10-year yield, but with the fragile level of stock prices achieved under QE, some sort of accident was always likely to produce that result – the accident in the event being the trade-war effects on the dollar and the non-US global economy.

What about the non-appearance of inflation? First, we think it probably will go up a bit, and to the extent it doesn't that's because of the strong dollar, cutting import prices and slowing the economy. Wages in particular are accelerating a bit. Second, it already is high – the natural inflation rate in the US is close to zero, so the 2% rate now firmly in place represents overheating (and the folly of inflation targeting).

## What will the Fed do now?

The Fed moves from tightening to ease like an alcoholic going through the recommended 12-steps to end dependency. If the journey is going to be a success, no quick jump to the end point is possible. This is a process the Fed follows with alarming regularity. This was true when the Great Financial Crisis began to unfold and it was true in 2016 and 1995, two times when the Fed managed to avoid recession. By our count, Fed Chairman Powell's comments at the AEA meeting on January 3 was step three.

Step one is typically kicked off by some global financial dislocation, most likely instigated by a shift in Fed policy. The step one Fed reaction is to repeat their mantra that they are the central bank for the US not the world. Step two comes when these dislocations begin to negatively impact domestic asset prices. The Fed "playbook" is to then downplay market volatility and remind all why the word "risk" is in the term "risk markets". Step three comes when the Fed realizes the downshift in asset prices suggests something could be amiss or create slower growth. Because the current flow of domestic data remains strong enough, step three is to communicate that the ratcheting-up of the funds rates is done for now -- data dependency is ascendant. This was the message from the December FOMC meeting, but Powell botched it. Realizing that, Powell reiterated the message more directly on Friday 4 of January and added on the possibility of tapering the pace of balance sheet reduction (QT).

Step four is the first ease, but usually only a little one at first, designed to mollify markets (get some steepness back into the yield curve) and satisfy the Fed staff, who still see no recession on the horizon. Our guess is that step four come as early as the end-January meeting, more likely the mid-March get together. This step now looks to be an adjustment in the pace of QT. This flips the long standing script that QT is a background operation, as exciting as paint drying,

with the role policy adjustment assigned to what they know best -- shifting the target rate for Federal funds. It will be interesting to see how the market prices in the probability of a QT-taper versus a cut in the funds rate.

A change in the pace of QT has become our best guess for how step four will be executed and since Powell's announcement it has been taken as gospel by the market. The reduction in the Fed's balance sheet pushes full responsibility for financing the rollover and expansion of Treasury debt back onto the private sector. Adjusting the pace of QT should not be that big of a deal. The rate of QT was always arbitrary - designed to deliver a balance sheet of a theoretical size by some chosen date. The timetable for transferring responsibility for financing Treasury debt to the private sector was thought to have no material impact on yields. This would have likely been the case if the deficit had remained on its pre-tax cut trajectory. It didn't. Real yields shot up, interest-sensitive sectors of the economy slowed and the equity market repriced. Put another way, had the budget moved into sharp surplus, the clamour would have been for the Fed to quicken the tempo of QT because of a shortage of collateral.

The pace of reduction of the Fed's balance sheet in the second half of 2018 was about \$40bn a month. A 'tapering' of this QT could involve a specific monthly target, presumably less than \$40bn, or could be expressed more vaguely, given the variability of the cash inflow to the Fed from maturity of its current holdings.

Step 5 is finally lowering the funds rate in earnest and usually in a bit of a panic. The Fed eventually gets to a panic because this step-wise process begins with the FOMC strangely disconnecting asset prices from its impact on growth. Asset prices matter. They determine the economy's trajectory – it is how monetary policy operates – and prices have shifted enough to lower the global economic outlook although not yet signal a recession. Yet, as per usual, what we hear from the Fed today is that markets are pricing a world different from the current run of economic data.

The economy's current run of data is a case in point. December industrial production was, for example, strong but it is usually rising right into the end of the expansion. What the December production data told us is that the recession has not already begun – something we all know. The headline 301,000 increase in private sector hiring for December was much greater than expected and supported some notions that the economy is still running "hot" – contrary to other data, including regional Fed surveys. Employment is, however, a lagging indicator until it isn't. When hiring turns to firing employment become coincident to the cycle. The Fed typically eases after three-months of declining employment and production, which is right in line with what's usually gotten the FOMC from step four to step five.

The slowdown in the US economy will become more evident in the coming months, the knock-on effect from declining real exports, lesser growth of business capex, a slowdown in credit creation, and consumers discouraged, despite the gasoline price windfall, by losses on their until-now-burgeoning stock portfolios. Because the impact of QT tapering probably proves to be fleeting, Powell will eventually channel Greenspan's 1995 policy operation and cut the funds rate at least once. The timing is hard to call. Between the government shutdown and a correction to the Q4 inventory build-up in advance of the proposed hike in tariffs on Chinese imports, Q1 will look weak. Because both these events are self-correcting (we assume the government will reopen at some point), growth in Q2 gets a subsequent boost. This leaves Q3 as the quarter of decision for where the economy is and, by our account, the likely time when the Fed realises that a 2.5% fed funds rate of 2.5% is above neutral, no longer "just below".

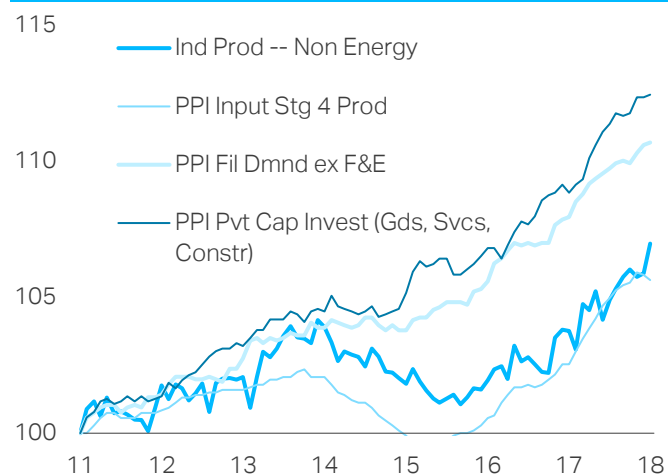
## What does 2019 say about 2020 and 2021?

Quite a lot, as it turns out. Market pricing heading into 2019 and its consequent impact on this year's growth removes recession risk from 2020. Recession is either going to occur in 2019 or the economy is going to skirt by because of the actions we expect -- the Fed tapers, the PBoC injects liquidity, and enough of a resolution of the China-US trade dispute. If there is recession instead, the impact likely lingers into 2020. Staying with our base case, 2020 will consequently be a year with re-accelerating activity with still faster wage growth with prices following.

The backdrop to this coming year will be higher costs, regardless of the pace of growth, because wages and prices work with about a 12 month lag. Further, unlike 2016 and 2017, when the Fed last manipulated asset prices to keep the expansion going, this time around utilization of capital and labour is quite a bit higher and beginning to pull up prices. Production growth today comes with more rapid acceleration in input prices (see chart) and the upturn in wages is set to pull up core CPI (see chart). The mild slowdown we envision for 2019 will not introduce very much slack into the economy, leaving the price pressures heading into 2020 at least where it is today.

**Chart 10: Increased production increases prices**

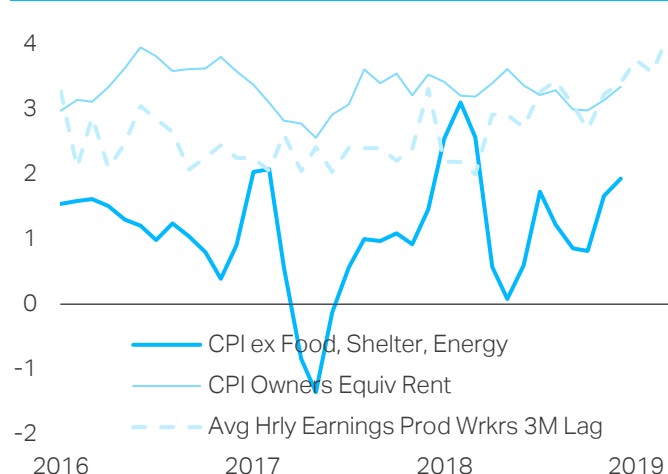
Rebased to Jan 2012=100, log scale



Source: Datastream, TS Lombard

**Chart 11: Wages begin to pull inflation higher**

3M annualised %chg



Source: Datastream, TS Lombard

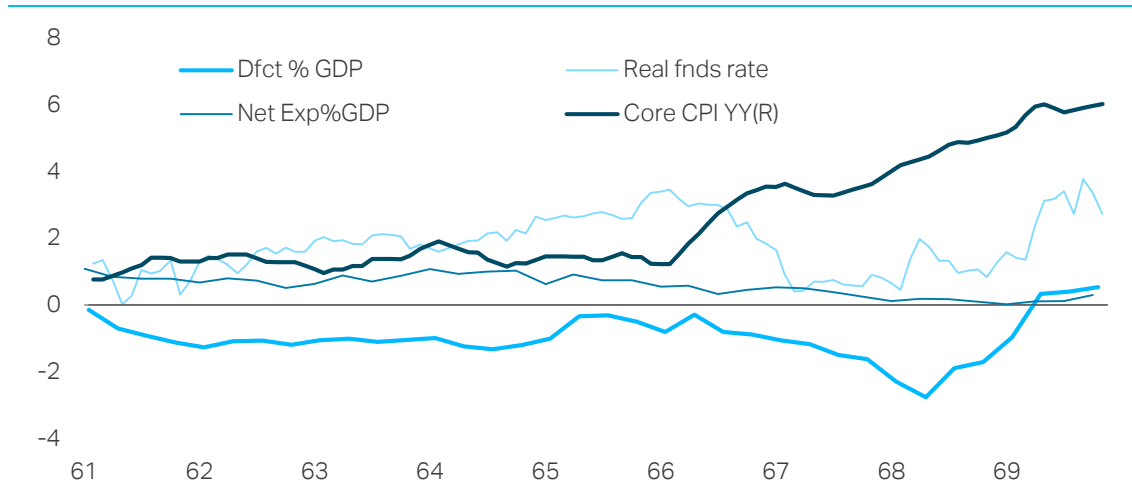
What 2020 then looks like is a more typical moment of the late stage cycle, accelerating prices. This year we felt the Fed would look past the nascent upturn in wages and prices to keep the expansion growing, and everything continues to point in that direction. By 2020, however, the story will be different and there will likely be an itching among FOMC members to slow growth and chase down inflation. We are not, to be clear, talking about "INFLATION", but about core price growth getting up to 3%. While it is difficult to tell exactly what the Fed will do, so much depends on how they look back on 2019, but we suspect they will not hold back, meaning the setup is there for a more traditional downturn in 2021. From a political standpoint, this works out just fine. Whether there is a new President or not, by the time recovery comes around in full force it will be in time for the next election cycle.

There is some possibility that Powell will push to go slow in 2020, citing Greenspan pushing back against Fed staff calls for higher inflation based on domestic utilization. Greenspan was right to hold off on changing the funds rate, as inflation never materialized. Goods prices, in fact, have been flat since the mid-1990s, offsetting the upturn in services prices (rent mostly). Here,

however, is where Powell could be making a mistake. While we are sympathetic to the view of rapid growth in capital spending in the US, tied to advances in production without labour that, in turn, on-shores activity, this is a very different world from the 1990s. The supply shock from China and Russia joining the world's market economies and the expansion of globalisation are not coming around again. If anything, a reversal of globalisation looks more likely and the implications are decidedly more inflationary than disinflationary.

While this is not the 1960s and we do not see a 1970s-like inflationary surge in the offing for too many reasons to list here, it is nevertheless informative to remember that the Fed worked in 1966 to reverse a developing credit crunch from turning into recession (see chart below). By failing to allow a recession to develop, the stage was set for the inflationary upturn that ensued. There are the tell tale signs that the Fed working hard today to keep a mild recession from developing will buy them more of an inflation headache in 2020. Lessons learned from the past, however, suggest to us that the Fed will get aggressive at some point in 2020 and thus raise the likelihood of a downturn in 2021.

**Chart 12: Fed policy (1960s expansion)**



Source: Datastream, TS Lombard

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