US Watch

POWELL FLIPS THE SCRIPT

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Economics: Balance sheet in play

- **Powell stops tightening, a "soft ease", negative impact of asset prices on growth will lead to a direct ease – tapering QT first?**
- **Most relevant part of December employment report is wages not jobs**

Markets: The Fed's balance sheet in 2019

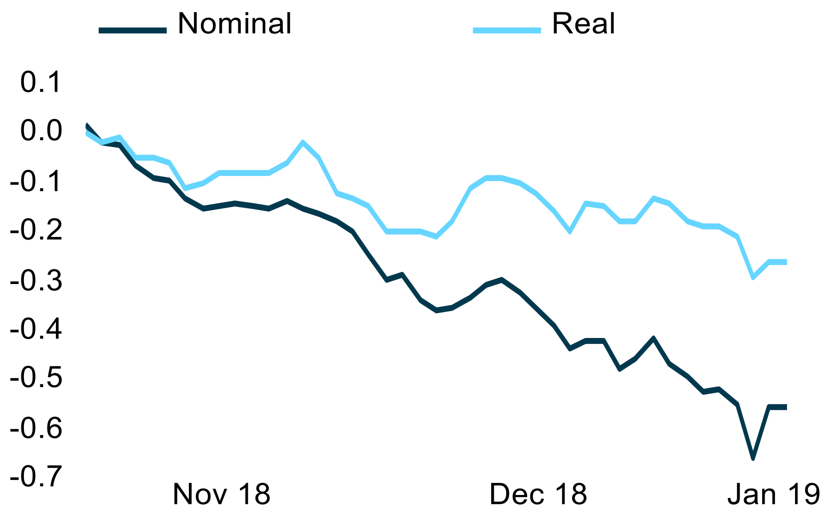
- **This year's contraction set to be $270bn**
- **Fed flexibility on QT makes it the marginal provider of global liquidity**

Politics: US-China trade talks resume

- **Beijing will offer concessions**
- **China's prime concern is to park the trade war, focus on their economy**

US 10 Yr Tsy Yield -- Nominal vs Real

Cumulative change from Nov 8 Peak Yield



Source: Thomson Reuters Datastream, TS Lombard

Economics: Balance sheet in play

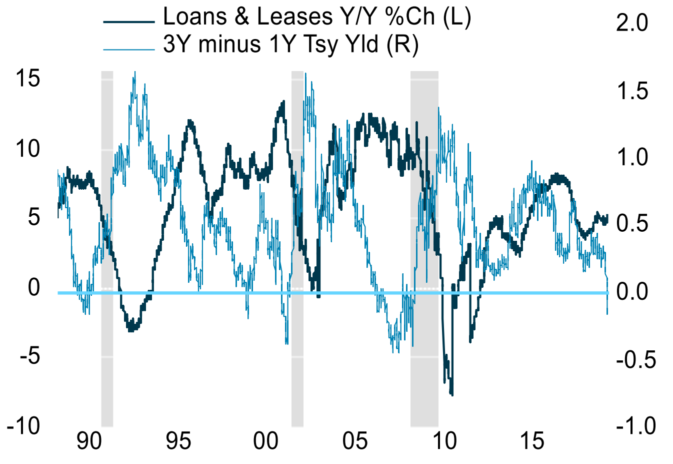
- **Powell hears the market and puts in a "soft ease"- step three in the process to an actual ease**
- **Fed still underestimating negative impact of asset prices on growth**
- **First move may be paring pace of QT to placate Fed staff and markets**
- **Relevant part of December employment report was wages not jobs**

The Fed moves from tightening to ease like an alcoholic going through the recommended 12 steps to end dependency. No quick jump to the end point is possible if the journey is to succeed. It 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 occasions when the Fed managed to avoid recession. By our count, Fed Chairman Powell's comments at the AEA meeting on Friday was step three.

Step one starts with some global financial dislocations, likely set off by Fed policy. The Fed's reaction is that they are the central bank for the US, not the world. Step two is when the dislocations start impacting domestic asset prices. The Fed's reaction is to downplay market volatility and remind everyone why the word "risk" is in the term "risk markets". Step three comes when the Fed realises something might be amiss but, since the domestic data remain fairly strong, they figure it is enough to let everyone know that they have finished tightening for now, a "soft ease" by simply no longer tightening. This was the message from the December FOMC meeting, but Powell botched it. Realising his blunder, he reiterated the message more directly on Friday and, more significantly, added on the possibility of tapering the pace of balance sheet reduction (QT).

Step four is the first ease, but it is only a little one at first, designed to mollify the markets and satisfy the Fed staff, who still sees no recession on the horizon. Our guess is that step four will come as early as the end-January FOMC, but more likely at the mid-March meeting. What this step looks like took a mysterious twist when Powell, on Friday, tossed in tweaking the pace of QT as a possible policy adjustment. This flips the longstanding script that QT is a background operation - as exciting as paint drying – and assigns the role of policy adjustment solely to the tool the Fed knows best: shifting the target rate for federal funds. It will be

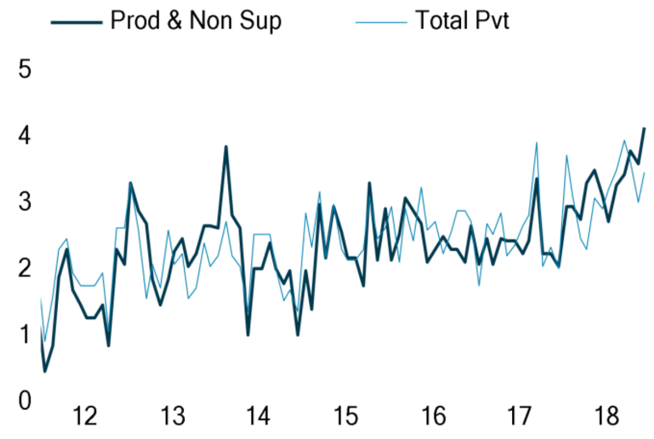
Bank Lending vs 3Y/1Y Yield Sprd



Source: Thomson Reuters Datastream, TS Lombard

Average Hourly Earnings

Annualized Three-Month %Ch



Source: Thomson Reuters Datastream, TS Lombard interesting to see how the market prices in the probability of a QT taper versus a cut in the funds rate.

Announcing a change in the pace of QT has become our best guess for how step four will be executed. Unlike so many, the Fed doesn't see QT as the source of myriad market maladies. This leaves tapering QT as the perfect step four. It would be likely to elicit some positive market reaction, meaning a steeper yield curve because the Fed would be giving back to the Treasury part of the yield subsidy QT takes away. As a result, some inflation premium should return to term yields. Whereas the UST 10-year yield dropped as much as 66bp from its high at the start of November, the TIPS yield fell only 29bp (page one chart). The Fed staff could accept altering the pace of balance sheet reduction because it plays well to the markets while they see QT as having no impact. Moreover, in the staff's model world nominal short yields are still too low because the rate of hiring remains too high - an inflationary stew they still want to cool.

For all those clamouring for QT to stop or slow, it useful to understand that QT isn't destroying liquidity, it is shifting it to the banks. This means debt offerings, public and private, have to compete for funding absent a large important buyer, the Fed. We can now add the ECB to the list of large buyers of debt now absent. QT would still have been like watching paint drying if the budget deficit hadn't doubled. But it has, and the Treasury's financing needs have skyrocketed just as the Fed has stopped monetising a portion of new issuance. Terminating zero yields at the short end and the term yield subsidy for maturities over 10 years was never going to be quick and easy adjustment for the markets. And just like risk markets are now repricing to adjust to the pull of capital back to safe harbour - the call of a flat to now slightly inverted curve - debt issuers, including the Treasury, have to deal with financing at market rates.

Step five is finally lowering the funds rate in earnest and usually in a bit of a panic. The Fed eventually reaches that stage because the process begins with the FOMC strangely disconnecting asset prices from their impact on growth. We say "strangely" because the Fed engineers a recovery through its impact on asset prices – this is how monetary policy works. It took nearly 10 years of zero short-term interest rates and monetising a goodly portion of the federal deficit to get the economy to this point. Yet what we hear from the Fed today, including Powell on Friday, is that the negative yield curve from one year out to five years is just the market voicing greater concern than the Fed about future growth. Powell said he hears these market concerns, is sensitive to them, and so there will be no more hikes for now. What he says is true. But no one, at least publicly, is connecting the now negative curve to the credit contraction of some degree that will follow (see chart above). Powell could recognise how the negative curve will redirect credit flows and skip right to step five - cutting rates to keep the expansion on track. But he won't.

By disconnecting the impact of asset prices on the economy, the Fed is focusing only on the economy's current run of data. The December employment report is a case in point. The headline 301,000 increase in private sector hiring was much greater than expected and supported the notion 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 - and it isn't once hiring turns to firing. Then jobs become coincident with the cycle. The Fed will typically ease after three months of declining employment, what pushes the FOMC from step four to step five.

Looking at the December report more closely, there is reason to believe that a good portion of the job gains will be reversed this month. Some 50% of the total increase came from hiring for retail, restaurants, admin and support services (includes temp help) and health care. In addition, there was a 38,000 increase in construction employment after a zero increase in November, for a 19,000 average over the two months. The average monthly change in the prior six months is 22,000. In other words, construction job gains in January will drop back to the average if not to a lower level considering the recent data on overall construction spending. When we look at the non-seasonally adjusted data we saw more seasonal hiring in restaurants and retail than the BLS data accounts for. The payback in the seasonally adjust data comes in January when there are more seasonal layoffs than the BLS adjustments are designed to offset. In sum, December's total employment gains overstate the economy's pace (2.6% QoQ real GDP growth in Q4 according to the Atlanta Fed model, down from the reported 3.4% gain in Q3 and 4.2% in Q2), but not the direction. It is still positive, even though momentum is slowing.

Accelerating wage growth in the December data is not misleading. Here is the inherent conflict between acting on the developing credit crunch from the negative curve and the inflation potential the Fed staff sees. As illustrated in the chart above, the three-month rate-of-change for average hourly earnings for production and non-supervisory workers is now over 4% on an annualised basis. This plus the drop in gasoline prices will contribute to steadying retail sales; the fall in equity values will be the only drag. We fully expect wage acceleration to continue throughout 2019 because pay typically lags the economy by about a year. It is why wages were disappointing in 2017 despite a strong year for GDP: they were mirroring the weaker level of activity in 2016.

Even the market understands wage growth lags – they dropped the inflation premium in term yields despite accelerating pay raises. The market is telling the Fed that rates are too high. This Fed was only ever going to keep raising rates as long as the yield curve gave them the runway to do so; inverting the curve was never its intention. Bernanke noted during Friday's panel discussion with Powell and Yellen that cycles don't die of old age but are murdered by the Fed. Powell has no desire to kill off this expansion and believes the link between wages and inflation is broken for whatever reason. Interestingly, no one talked about the global relationships impacting wages and prices, but that is a topic for another time. What then to do with a slightly negative curve, slowing growth and accelerating wages? The Fed, stubbornly clinging to its multi-step programme to get to an ease, will hold on for now to strength in lagging indicators such as wages to justify its belief that it can wait to act, even though asset prices have set a slowdown in motion.

We will now see who Powell really is as a Fed chairman. He won't kow-tow to the White House, his aspirations for his legacy are, we presume, higher than Arthur Burns or G. William Miller. We think his own confidence in his credit market experience will let him push back against the Fed staff much like Greenspan and Volcker did during their reigns. Powell, to us at least, sounded more like himself on Friday, more confident in his own reading of the markets based on his own experience. Still, he has yet to understand, at least publicly, that using Yellen's actions in 2016 today as the policy framework is wrong: lowering forward guidance when money markets offer a competitive return only accelerates the reversal in credit flows; it doesn't boost interest rate-sensitive sectors. Once he does, he will shift his policy rationale to Greenspan's in1995 – which he touted in his speech in Jackson Hole last August – "Greenspan argued that the FOMC should hold off on rate increases. Over the next two years, thanks to his considerable fortitude, Greenspan prevailed, and the FOMC raised the federal funds rate only once from mid-1996 through late 1998." We do not believe this is the 1990s redux, more on that at another time.

Knowing the markets as he does and assuming markets continue to signal stress through the noise of price volatility, Fed policy reversals are consequently going to come sooner than the markets are betting. Remember too that markets severely and consistently underestimated the Fed during the tightening cycle. This first act of easing looks now to be a cut in the pace of QT, i.e. step four.

Markets: The Fed's balance sheet in 2019

- **This year's contraction set to be $270bn**
- **But with ECB stepping away, any QT flexibility from the Fed could turn it into the global marginal liquidity provider**

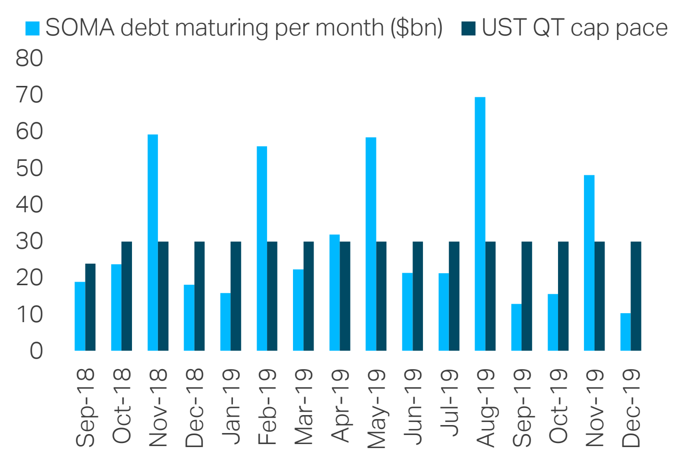
Last year, the Fed allowed $226bn of Treasuries and $111bn of MBS to run off its balance sheet by not reinvesting cash from coupon flows or maturities. We rang alarm bells in January when the first signs of a disorderly reduction in Treasury holdings were showing up – sharp bond price swings at the end of the month, and again in February, suggested the market was unprepared for the absence of a buyer which had been consistently price insensitive for most of the decade. But over time the process smoothed out, and by the end of the year, when the pace for Treasuries running off the balance sheet reached the Fed's top target of $30bn a month, the programme was having little impact around maturity dates.

This year, the pre-set maximum reduction in Treasuries remains at $360bn with another $240bn of MBS. MBS sales are largely driven by pre-payments (and are therefore both relatively unpredictable and relatively unimportant to market liquidity), but the maturity profile of Treasuries on the balance sheet means that only $270bn – at most – will be withdrawn.

This is still a swifter overall contraction in the Fed's balance sheet than last year and, once the end of ECB QE and the pace of BoJ QE are factored in, it means that global central bank liquidity provision will drop this year for the first time since 2015 (when it shrank for a single month). Market angst about central bank liquidity withdrawal is perfectly reasonable given that some market participants will have known nothing but these vol-suppression and risk premium contraction policies since the GFC. But the underlying reason for the angst may not be the Fed after all – the liquidity QE created is not disappearing, it is now owned by the banks.

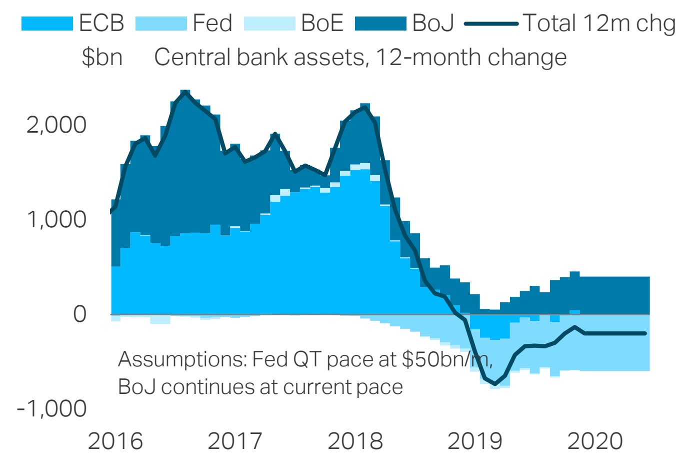
Our PCA on fixed income markets showed that a single factor was responsible for more than half the variability in global fixed income returns since 2013, and this factor's explanatory power fell below 50% only in September last year. In turn, as we wrote regularly last year, this factor was closely related to the New York Fed's ACM term premium and the pace of ECB QE. The end of ECB QE is likely more responsible for the tightening in market liquidity over the last month than

Fed QT this year throttled by maturity profile



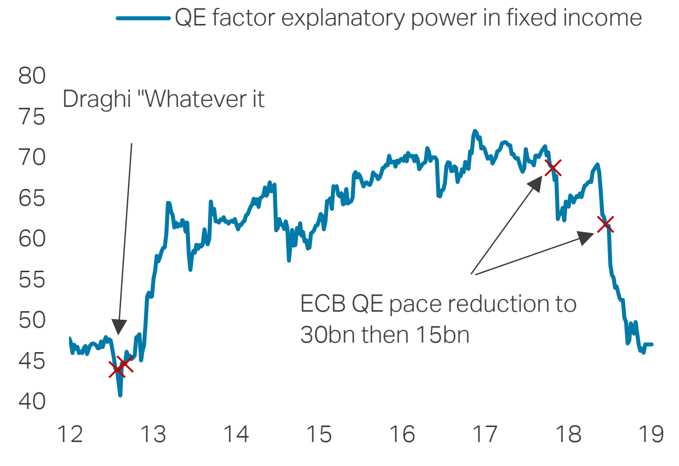
Source: NY Fed, TS Lombard

Global central bank liquidity contraction



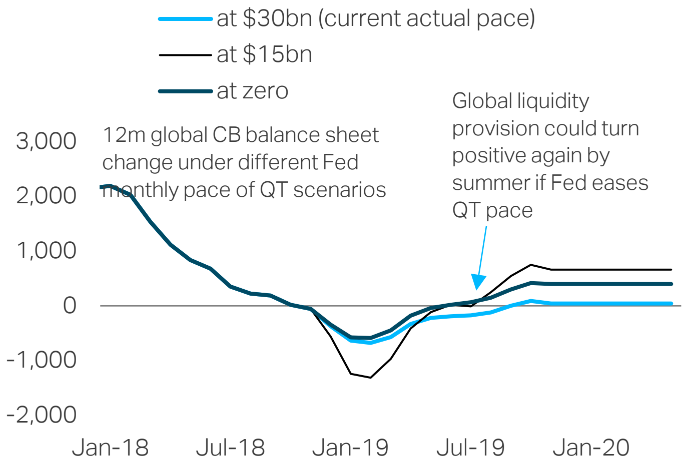
Source: Central banks, TS Lombard

End of ECB QE = end of driver behind FI returns



Source: Bloomberg, TS Lombard

By easing QT Fed could ease global liquidity



Source: Central banks, TS Lombard

the continuation of Fed QT, which, owing to maturity constraints, is only proceeding at a pace of around $20bn per month.

Still, if more liquidity is a cure for these symptoms it is not necessarily incumbent on the ECB to provide it. Besides, it probably can't: ECB QE is maxed out, according to the bank's own capital key and issue rules. And while we expect another round of ECB TLTROs this quarter, to counter the risk of liquidity drying up for Italian and Spanish banks, this is to offset the expiry of previous TLTROs over the coming 12 months.

To that end, Powell's comment on Friday that the Fed "if needed, would change balance-sheet runoff policy" was a marked shift from his previous statements that the programme was on auto-pilot and was the panacea that the market needed. The Fed has already shown some flexibility in recent months by treating the cap as a limit rather than a target. If the Fed chooses to officially reduce the cap or change the reinvestment profile, which currently proceeds along the lines of current average maturities, then global central bank balance sheet contraction could flip to expansion.

The blip in the central balance sheet chart in 2019Q1 is pretty much baked in, thanks to currency effects this time last year. But the chart above right shows how future policy could change if the Fed gave itself more leeway, notwithstanding any ECB effects. Buying flexibility for the Fed, as Powell did in his speech on Friday, is an important move. Just as significant is that the ECB has no such flexibility. A tweak in the Fed's balance sheet normalisation schedule could thus become a powerful tool.

Politics: US-China trade talks resume

- **Beijing will offer concessions, the long game continues**
- **China's prime concern is to park the trade war and focus on their economy**

China goes into the resumed trade talks in Beijing this week with the aim of offering the US sufficient conditions for President Trump to be able to claim a market-boosting victory and defer further tariff moves on 1 March, but without affecting the economic model on which the Communist Party and XI Jinping base their power. Trump's tweets that he expects a deal complement the desire for agreement that has underlain Chinese strategy since last summer and was reinforced by the ceasefire agreed at the Xi-Trump summit dinner in Buenos Aires a month ago. Each side has reason to reach a short-term settlement, but without abandoning the longer-run trial of strength set off in 2018.

For the leadership in Beijing, the prime concern is to park the trade war so it can focus on deleveraging and rebalancing the economy to provide a stronger, more self-sufficient base on which to build state–directed modernisation. It hopes that moves such as the reduction in auto tariffs, increased purchases of farm products and draft legislation to strength IP protection will be enough for Trump to be able to hold off on the next round of threatened tariffs. The focus would then be on US efforts to constrain Chinese technological progress. This, increasingly, looks like the real battleground, spurring Xi and his colleagues to stress the need to build up "self-reliance" (see "Xi Charts Course in 2019").

Coinciding with the growth slowdown, this policy imperative, combined with heightened nationalism, will provide a challenge to US companies which have become used to strong sales in mainland China, as highlighted by the downbeat sales report from Apple. It will spur Beijing to seek to strengthen regional trading arrangements, including the re-launched TPP without US involvement, as part of a rivalry that reaches well beyond the immediate trade issues and forms part of Xi Jinping's longer-term ambition of regional influence. The probability as the trade negotiators meet is, therefore, for agreement to defer the tariff implementation, giving Trump and the market a boost, but for a continuing confrontation on the strategic and tech fronts as the four decades of "positive engagement" between the US and China fade into history.

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