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Economic & Market Observations: **A Churchillian Moment**

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The gears inside the global machinery of economics and finance turn in abrupt and unpredictable ways, raising the possibility investors' portfolios might get caught and grind down. This is why we have dialed down risk exposure, for now.

For some time, our economic forecast has been that US real GDP growth would slow sequentially from 3% over the past 1½ years, to 2%, so that the expansion may be sustained. Guided by Federal Reserve (Fed) Chair Powell in 2018, we thought Fed tightening in 2019 would provide the necessary headwinds to get that result. President Trump's willingness to fight aggressively on many trade fronts is an unexpected source of drag on demand, and risks a more adverse outcome. Into this breech, Fed officials now believe policy must remain even more accommodative than previously thought.

We do not think this is forever. By our reckoning of the presidential political calculus, the necessity of the electoral calendar will promote compromise later this year, lessening the drag and risk from trade. The removal of an activity drag should provide a boost to growth. Because trade matters more to our trading partners than to us, the rebound is likely to be more pronounced abroad.

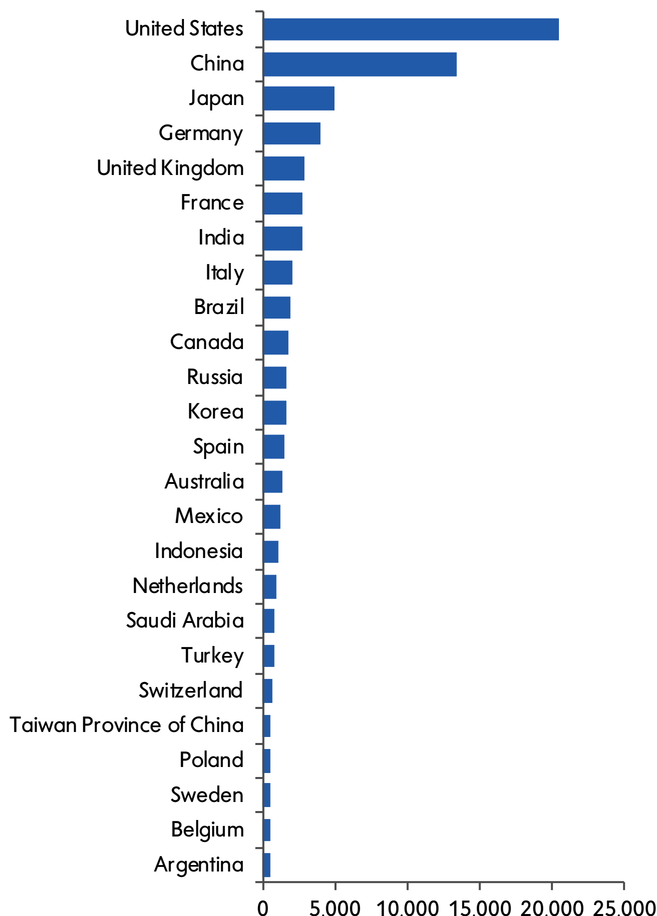
The key to our outlook is an assumption about the political economy. We believe politicians disrupt but do not derail economic expansion. This is an assumption, not a forecast, as no one can plausibly claim an edge in predicting President Trump's behavior.

No doubt, the world is a risky place. The US political system is dysfunctional so do not rule out a standoff on the budget or debt ceiling later this year. The two largest economies in the world are locked in a trade dispute. As can be seen in the league table of global nominal GDP (right), 40% of global income comes from the two places that are currently arguing.

More disconcerting, the scale, scope and goals of US tariff threats have broadened. Trade can be about immigration and terrorism as well as an exchange of goods and services. Meanwhile, and not unrelated, tensions are flaring in the Middle East, which is apparently less dislocating to the US economy given the ambitions of shale oil producers.

The UK is lumbering toward an exit from the European Union (EU). The table above provides reassurance that the UK represents only 5% of global GDP. For all its parliamentary tradition and royal pageantry, the UK has marginalized itself on the world stage. Partly as a consequence of the European parliamentary election, the ruling coalition in

Nominal GDP, 2018
USD, Billions



Source: IMF, *World Economic Outlook* (4/19).

Germany is fraying, the polarized makeup of Italy's governing coalition seems unbalanced, and elections in Greece and Spain will likely look for new leadership. Meanwhile, the heads of the two largest Latin American economies represent opposing populist extremes.

The good news from this morass is that risk presents new opportunities. Some of this could work out for the better. For instance, the US-China marriage may stay together and both sides respect each other more. Knitting together coalitions in Europe may entail fiscal stimulus, helping that flagging economy. Perhaps aggressive policy action is necessary to jumpstart growth in Latin America.

Once again, Winston Churchill was there first. His well-known and often-quoted view of forecasting Russian action "...is a riddle, wrapped in a mystery, inside an enigma."

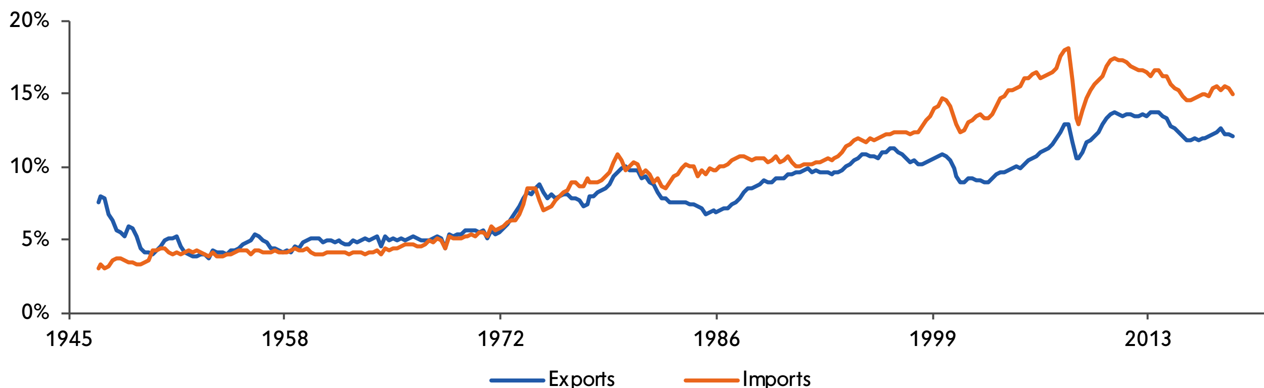
- Our **riddle** is the extent to which concerns about trade restrain aggregate demand in the US and abroad.
- The **mystery** is why, even as aggregate demand is above its potential, sluggish US inflation has caused GDP to be above its natural rate.
- The **enigma** is the response of the Fed to an environment where it is straining to fulfill its mandate of maximum employment and stable prices, with excess demand in labor markets and inflation below goal.

People, however, do not quote the rest of Winston Churchill's remarks about Russia in 1939. Churchill went on to say, "...perhaps there is a key. That key is Russian national interest." Right again. We think political interest will contain the US and its disruptive influences, and global expansion will remain on track.

The Riddle

Our outlook starts (and perhaps ends) with our understanding of President Trump's view on international trade. There are four pillars. First, trade matters more to our trading partners than to us. This is about the arithmetic of a trade deficit. Because we import more than we export, a greater volume of production goes into the United States than production leaves the United States.

Exports and Imports of Goods and Services
Relative to Nominal GDP

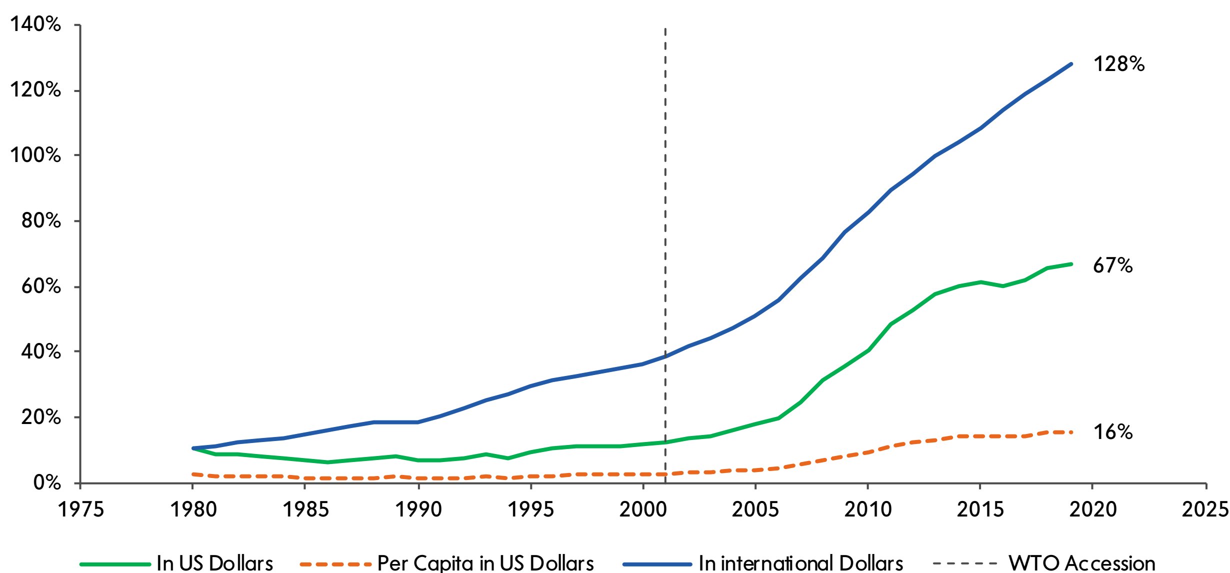


Source: BEA, accessed via FRED, 6/26/19.

Second, the US has relative cyclical momentum compared to most of its important trading partners. Third, according to the president, trade importantly involves large multinational firms with rents to bargain over and shareholders to please. Fourth, tariffs are a wedge to open a broader conversation. That is, they are a means not an end. Put together, this leads to President Trump's conclusion that the current environment provides a window to press trading partners on a redistribution of the rents from trade and to make progress on other issues.

Why the focus on China? The fraught US-China relationship can be explained with four numbers derived from three different calculations of Chinese nominal GDP relative to the US in the chart below. First, as is obvious across all three lines, China's 2001 accession to the World Trade Organization turbocharged export-led growth.

Nominal GDP of China Relative to the US



Source: IMF, *World Economic Outlook* (4/19).

Second, Chinese nominal GDP in US dollars is 67% of US GDP. From the US perspective, this implies that China is our largest competitor. From the Chinese perspective, nominal GDP in terms of international purchasing power is actually larger than that of the United States because Chinese services are so cheap. Indeed, the ratio stands at 128%. Chinese officials see this ratio as an ability to command resources to project power on the international stage. Because China is a populous country, relative per capita nominal GDP is only 16% of US output. China is a middle-income developing economy, which inclines its officials to believe that it deserves protection from competition and sharing technologies.

This poses problems for the long haul because the most important strategic competitor of the US wants to be treated differently than warranted by the size of its footprint in the global economy.

Our working assumption about the trade dispute is that the president's prospects for re-election require cutting some deals to show confidence, leaving open some disputes as wedge issues with voters, and delivering a well-performing economy in the first half of 2020. Consequently, the bilateral US-China trade dispute will get better, but only slowly and not to the point it once was. The two sides will be driven to reach agreement as the threat of not doing so becomes evident in economic and financial market performance. Notice that this presents the two-sided

risks of more closed or more open economies. The two nations, however, will almost certainly remain wary in future dealings as security issues become more and more pressing. Their challenge is to put the security issues in a box separate from their economic issues.

Flare-ups with other countries are likely and related to issues resonant with voters, including immigration and the auto trade. The short summary is that the president gets partial closure on China and rattles the cage on autos, all dictated by the electoral map.

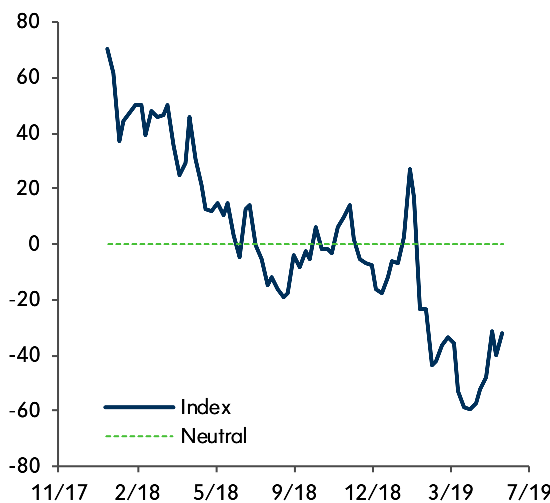
We believe the UK is likely to leave the European Union (EU). Boris Johnson, who campaigned on the promise to exit with or without a treaty, is the prohibitive favorite to become the next Conservative leader. EU leaders are unlikely to be receptive to renegotiating the treaty. If they are, however, Johnson has the appropriate credentials among staunch leave supporters to gain parliamentary approval. Brexit by the October 31 deadline is more likely to be without a treaty than with one. Nevertheless, it is hard to know what to believe given the posturing in advance of the election and negotiations with the EU.

The disruption in supply chains and government administration may be considerable, but a relative price, the exchange rate, will adjust. Until then, the Bank of England is frozen. A central bank cannot preemptively act on the presumption that politicians will fail epically.

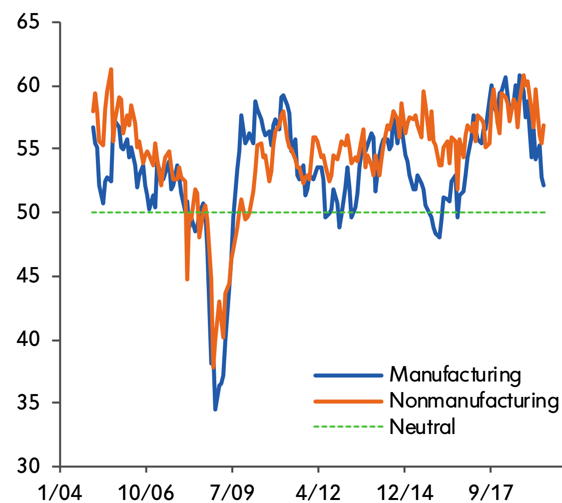
We do not have an epic fail as our base case in the US. Rather, economic growth is likely to slow sequentially to around trend and inflation should drift higher.

Yes, there is a lot of talk that economic data have disappointed and purchasing managers' expectations point downward. We read this as an inventory cycle related to trade uncertainty, which is considerable, but in our outlook dissipates.

Economic Surprise Index
Neutral = 0



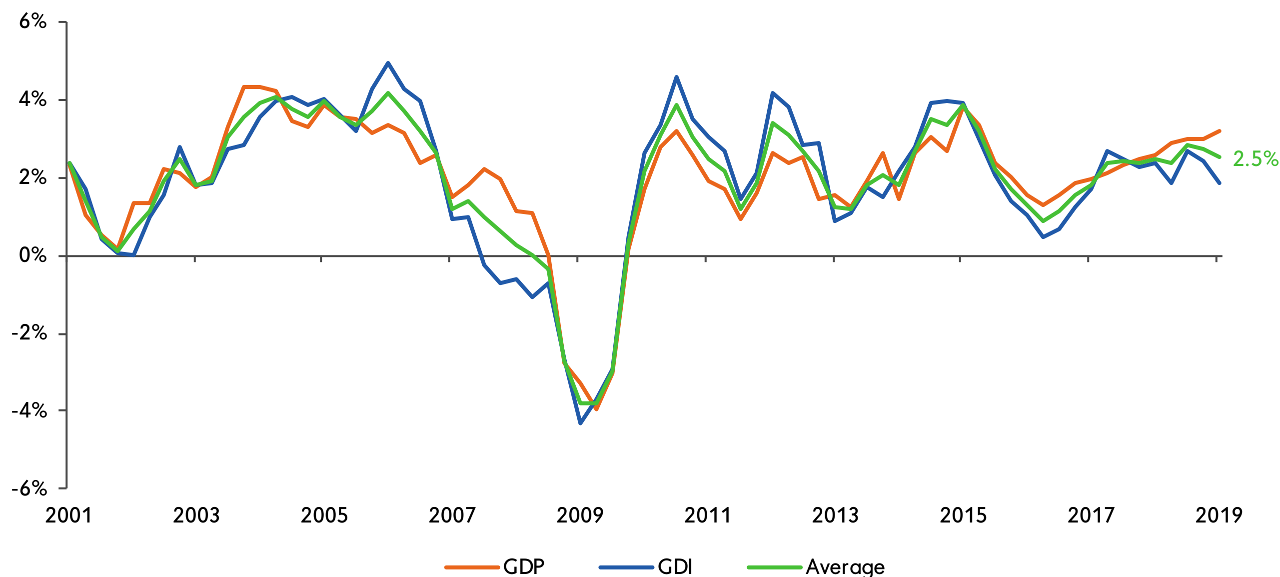
ISM Purchasing Managers' Index
Neutral = 50



Source: Citi Markets and the Institute for Supply Management, accessed via Bloomberg, 6/26/2019.

We also think the potential slowing is more dramatic in the headlines than in reality and, therefore, more easily achieved. National gross output can be measured by how much it produces or how much income is received. The former is gross domestic product (GDP) and the latter is gross domestic income (GDI). In a perfect world, they would be equal. We are not in that world in that they do not always equal, but the average of the two seems to be a better measure of underlying activity than either part. The average, shown as the solid line below, suggests that we have been growing at around 2½% and, as a consequence, only a modest slowing is necessary to get back to the 2% pace of potential output.

Growth of Economic Activity
Four-Quarter Change



Source: BEA, accessed via FRED, 6/26/19.

Aside from trade dispute effects, which we think will subside, financial conditions are accommodative. Most Fed officials see the current nominal federal funds rate as below the lowest estimate of its neutral rate. This is one definition of accommodation. By others, financial conditions are easy. This helps to offset the drag from uncertainty on investment.

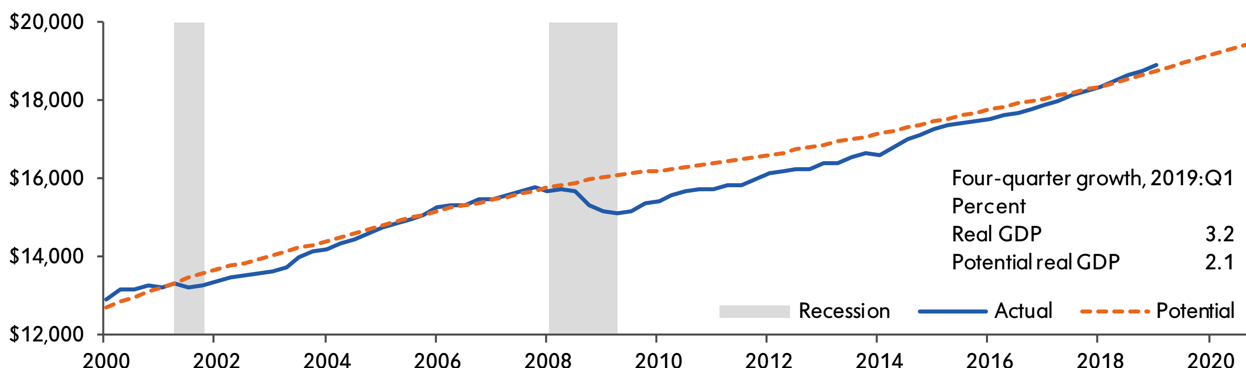
As for consumption, households are wealthy and income is growing. Jobs are being created, on net, with non-farm payroll gains running at twice the rate that would be associated with an unchanged unemployment rate given the slow decline in population growth. Higher frequency readings in the labor market are also suggestive of underlying pressures on jobs.

The Mystery

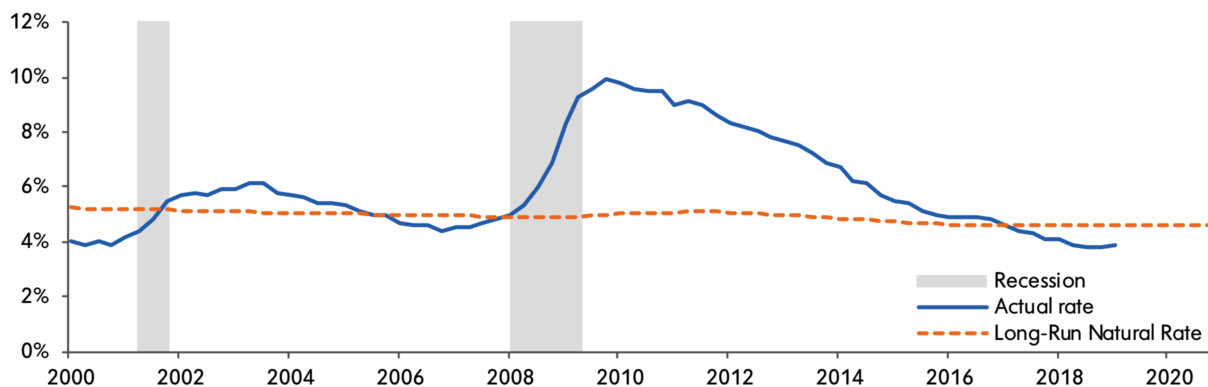
Regarding the sluggish inflation, remember that levels matter. True, US real GDP has been growing faster than its potential, putting the level of demand above that of supply. Meanwhile, the unemployment rate is below its neutral, or long-run rate. This follows the assessment of the Congressional Budget Office (CBO) as on the following page.

Real GDP and Potential GDP

Billions of Chained 2012 US Dollars



Unemployment Rate and Its Natural Rate



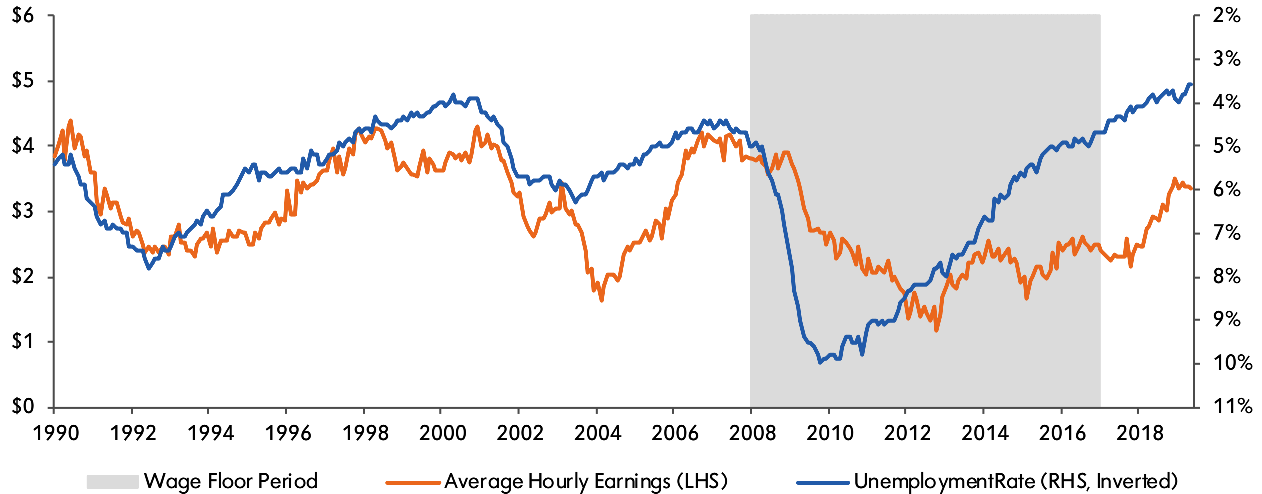
Source: Bureaus of Economic Analysis and Labor Statistics and the Congressional Budget Office, accessed via FRED, 6/13/2019.

However, the breech is only recent. GDP went above its potential during the first part of 2018. The unemployment rate dipped below its natural rate in the beginning of 2017. Moreover, the recession was deep and long, implying that a cumulative resource gap accrued.

We think everyone has been impatient to see inflation rise. If inflation changes with the resource gap—there is a Phillips curve—then the net change in inflation depends on the cumulative gap. Why are we surprised that inflation is below its level in 2007 when the output gap averaged 2¼% in the 12 years since?

The first place to look is wages. The unemployment rate fell below its natural rate a year earlier than in product markets. As shown in the chart below, there is a close association between average hourly earnings growth (the left axis) and the unemployment rate (the right axis, inverted). The shaded area, which includes the deep recession and recovery, is the exception. In that episode, the unemployment rate fell so fast that firms, in principle, should have cut wages in US dollar terms. In reality, bosses avoid an absolute cut in workers' wages because it creates morale problems. This notion is just as important as a lower bound than the other, more famous one about policy rates. The reluctance to cut wages implied that their level was higher than firms desired during the initial recovery stages. They made up that lost ground with slower wage gains than the labor market would subsequently dictate. We think we are done with the catch-up and the unemployment rate will drive wage growth in the manner as it did prior to 2008.

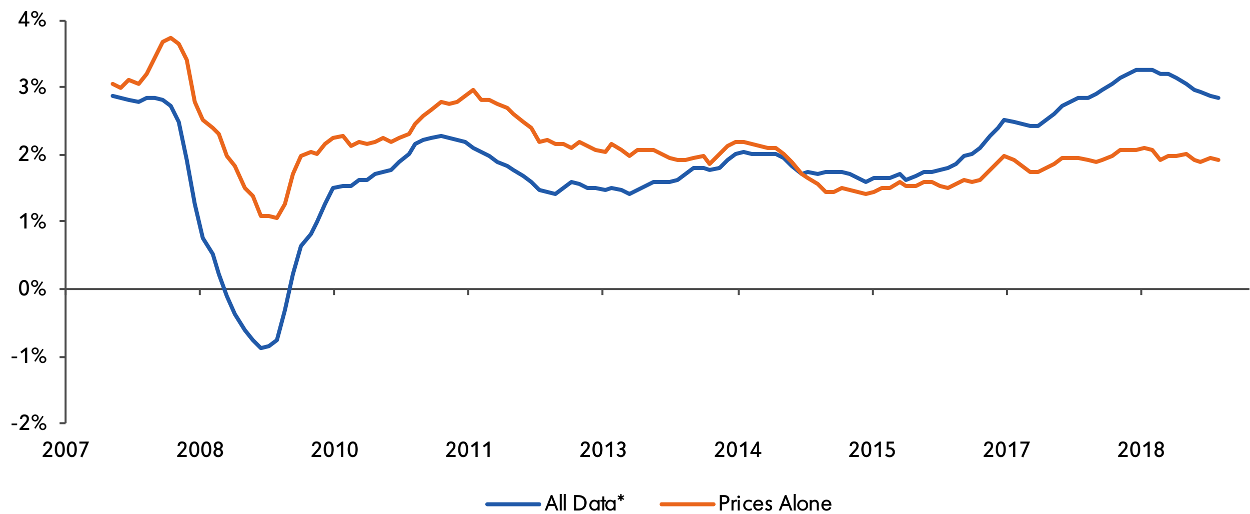
Average Hourly Earnings and the Unemployment Rate
Twelve-Month Change



Source: BLS, accessed via FRED, 6/25/2019.

Domestic cost pressures, however, are not yet evident in inflation, but we think they will be. The Federal Reserve Bank of New York runs two statistical exercises that attempt to predict consumer price inflation. In one, they use all available macro data, including activity and prices. In the other, they only use price data. The orange line shows how difficult it is for the price complex to find inflation. The assertiveness of activity measures in observing inflation emerging now matches their push to forecast deflation in 2009. The retrospective message is to fade the most recent turn.

Underlying Inflation Gauges



Source: FRBNY, accessed via Bloomberg, June 20, 2019. *All data is data on activity and prices.

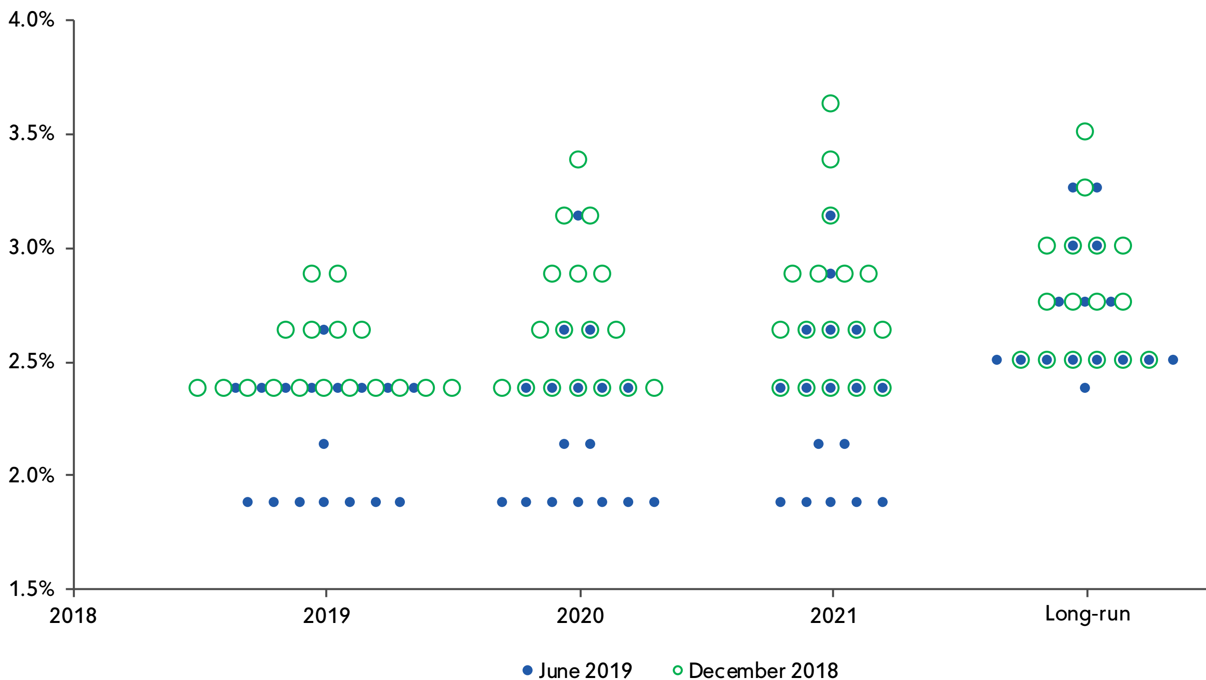
Be patient, inflation will turn up.

The Enigma

The Feds' view of policy has evolved in a manner unprecedented during such a short spell. In December 2018, the Federal Open Market Committee (FOMC) believed that further increases in the target fed funds rate would be necessary to sustain economic expansion. A few months later, members were talking about an unchanged policy stance. At its June meeting, the FOMC emphasized how it would be necessary to ease policy to protect growth. How often does a view of the economic outlook spin in such short order?

As we can see in the Summary of Economic Projections (SEP), seven FOMC members believe they will have to ease 50 basis points this year. Chair Powell reassured that even those who straight-lined the fed funds rate in their projections appreciate downside risks, meaning that the Committee has his back.

Summary of Economic Projections



Source: Federal Reserve, accessed 6/19/2019, at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20190619.htm. Each data point represents one FOMC member.

We think the Fed changed its communications strategy at the same time that the outlook shifted under its feet. Chair Powell came to appreciate that guiding markets to an outcome they do not want is unappreciated. When he was forecasting that rates would rise, he became the target of criticism by investors, pundits and politicians. Given that the place at the front of the pack proved costly, Fed Chair Powell moved to the back.

Meanwhile, President Trump's assertiveness on trade created enough doubt about aggregate demand for the Fed to rethink its policy stance.

Our advice is not complicated. Former Fed Chair Alan Greenspan did it once during the modern Fed's first obsession with the zero lower bound to nominal interest rates in 2003 to 2004. Greenspan set a "fire break" in which rates were lowered by a comfortable margin to support activity. That stance, along with the reassurance more would be

done in the unlikely event more was needed, was enough to stop the downward spiral in easing expectations. Our advice is that Fed Chair Powell gets a shovel and starts digging.

Advice is not a prediction. Consider what the Fed may have wanted to do, and what it is most likely to do.

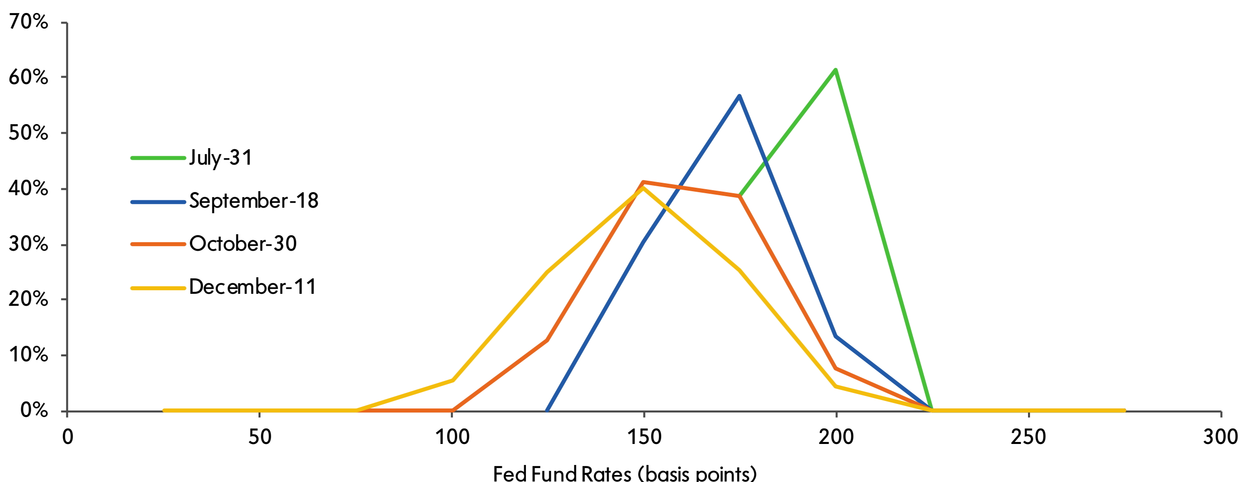
If Fed Chair Powell could get into Doc Brown's Delorean, he would return to the fall of 2018. The chastised Fed Chair would eschew rate guidance and emphasize data dependence. A rate rise in December would be described as an insurance hike, given the low level of inflation and despite the low unemployment rate. Meanwhile, we would hear that the Fed felt everyone's pain and would pivot on demand.

In the event, there is no going back as Fed Chair Powell drives a Tesla. What the Fed will do is less obvious. The swing in guidance can be charitably explained as the Fed moving as the bullseye of the economic outlook moved. Understandable, but not definitive. A 25 basis point cut is the easy, lazy policy choice that will feed expectations of much more to come but seems to feed the beast of market expectations while being tone-deaf to concerns about financial stability.

Whatever the Fed chooses, President Trump will intrude into the frame. It has gotten to the point where he cannot name the current Fed chair, only "the Fed guy." Our president expresses a preference for the president of the European Central Bank (ECB) and the governor of the People's Bank of China. We understand the conventional wisdom that criticism of the Fed chair leads everyone to circle the wagons around the criticized. Still, all this makes it painfully evident that Powell is a one-term chair. His colleagues can count, and they treated Bernanke and Yellen with less deference when the political arithmetic started the count down to their exit.

If 50 basis points of cuts is all that is in store from the Fed this year, market participants will be disappointed. Current futures pricing puts considerable odds on as much as a 100 basis point reduction this year. That is one of many of our problems with current market pricing. If history matters, one percentage point of Fed cuts in six months would be the panicked response to recession, which is inconsistent with the pricing of risk assets. Either the December federal funds rate futures contract is wrong or equity prices are wrong.

Implied Probabilities of Fed Action



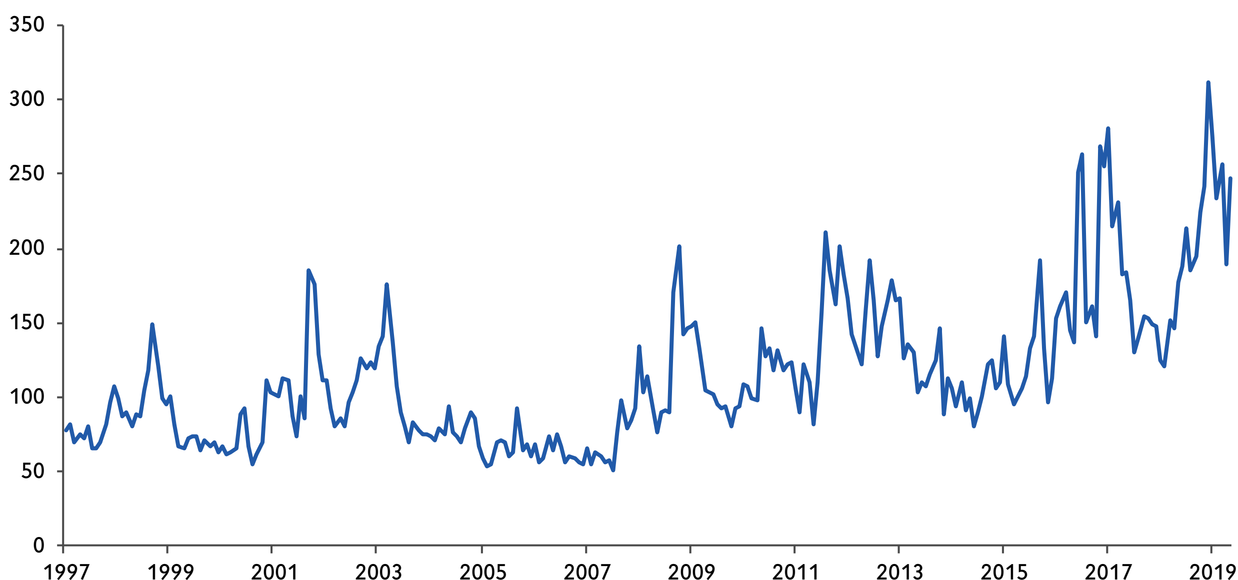
Source: CME Fedwatch tool, 6/17/2019.

Obviously, the Fed has a big footprint on the world economy. There are multiplier effects from its actions because, as noted above, trade matters more to many of our trading partners than to us.

The second-largest economy in the world had already slowed so far in 2019 because of policy-induced tightening in an attempt to rein in leverage and deal with corruption. The disruption of supply chains in the face of trade uncertainty is a significant new challenge. Officials are providing a drip feed of credit easing and fiscal stimulus. A partial resolution of the trade dispute will provide an additional lift that should send growth to the government's target.

Global Economic Policy Uncertainty

Average = 100



Source: Barker, Bloom, and Davis at http://www.policyuncertainty.com/global_monthly.html.

The European economy retains its ability to disappoint. As Mario Draghi, the president of the ECB recently explained, "the risk outlook remains tilted to the downside...The risks that have been prominent throughout the past year, in particular geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets have not dissipated." If our trade view eventuates, some of those risks will dissipate. Meanwhile, the ECB will continue to keep policy accommodative and increase accommodation if necessary. The pressure to keep governing coalitions together in Germany, Italy and Spain raises the prospect of modest fiscal stimulus. We expect only modest stimulus because those with fiscal space are the most reluctant to use it. The overarching problem in Europe is that a bank-centric continent never came to grips with its banking problem.

Japan has a longer history of disappointment. Economic data have fallen short of expectations over the past few months and real GDP growth has been below 1% over the past three quarters. Despite massive fiscal and monetary stimulus, officials have been unable to generate sustained inflation. As a trade-dependent economy connected to both China and the US, policy uncertainty must weigh heavily on spending now. If there is some resolution to that uncertainty, there is some hope for Japanese activity. That said, President Trump may threaten tariffs on autos, a resonant issue for his voter base and a significant industry in Japan.

Risks and Opportunities

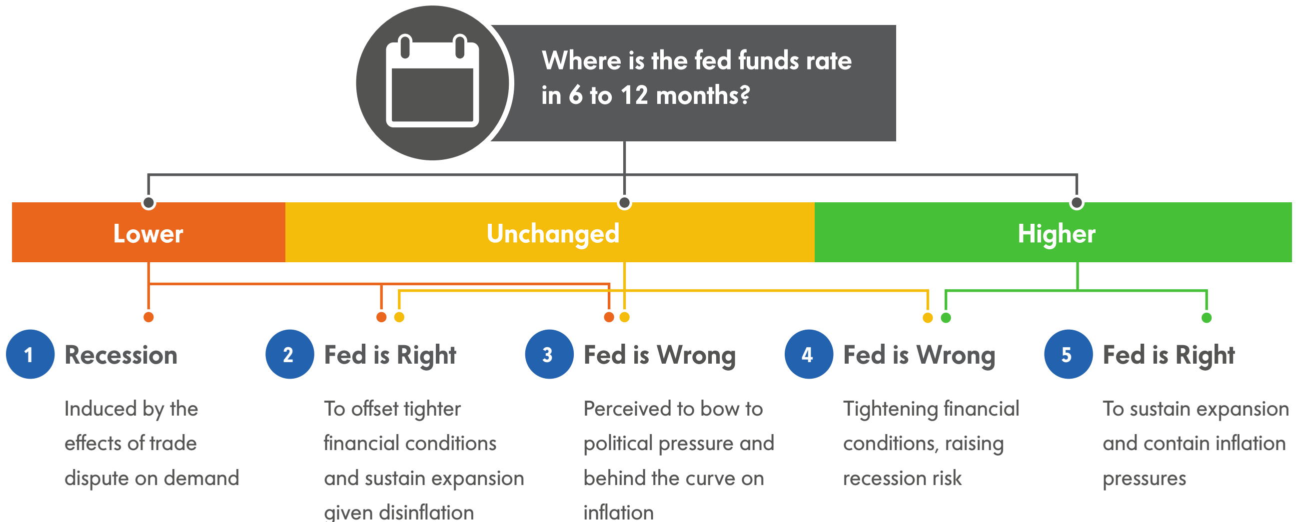
There are many moving parts in our outlook, creating risks and financial market opportunities. Concerns about the US budget and current accounts, and a waning of safe-haven demands (if trade uncertainties abate), will weigh on the value of the US dollar. At some point, twin deficits matter.

Sustained economic expansion and a weaker US dollar support commodity prices. We expect WTI oil prices to trade in a range of $50 to $70 per barrel. The upper band is enforced by the productivity of US shale oil producers. The lower level is more about the revenue needs of Russia and Saudi Arabia.

If we are right that investors are overpricing the extent of Fed easing and underpricing the pick-up in inflation, Treasury yields are likely to rise somewhat. However, Treasuries are lonely in the pack of sovereign securities, as about $13 trillion of that set "offer" a negative rate. This acts as a sea anchor that should slow a rise in Treasury yields. As a result, a more straightforward way to express our view is to appreciate that breakeven inflation appears very attractive.

We think slowing US real GDP growth will be associated with a more pronounced slowing in earnings growth. While investment grade corporate spreads are fairly valued now, fundamentals are likely to soften. With earnings growth expected to slow, high yield spreads are somewhat expensive. There is value in emerging markets local currency and US dollar debt. All the while, recognize that the volatility of financial prices will rise.

Risks to the Outlook Abound...



Understandably, we could fall off either side of our central tendency of surgical Fed easing and a political recovery in trade talk because risks to the outlook abound. The decision tree is drawn according to two possibilities. First, what will the federal funds rate be in 6 to 12 months? Logically, it could be either lower, unchanged or higher. Second, is the Fed right in putting the fed funds rate there?

The answer to that is either yes or no. Our central tendency is the narrow path from an insurance cut to a well-performing economy (step two in the diagram).

There are risks on either side to our outlook. Easing by 50 basis points would prove insufficient if trade craters and pulls business and consumer confidence with it. But we may be more than right about our political forecast. If President Trump finds friends among Xi and Kim, confidence might rebound more significantly. That is why we have boxes to the left and right of our central tendency.

In our quarterly investment landscape that summarizes our views on the economy, valuations and investment themes, the bottom line is to maintain a modest risk budget. About our central tendency, some might wonder why we channeled a bellicose UK prime minister to turn the dial on risk down. Read history. We are now more about the interwar Churchill of *The Gathering Storm*. Husband resources for the challenge to come.

The Investment Map: June 2019

Economic Landscape	Fixed Income Valuation	Investment Themes
The scale and scope of President Trump's disputes on trade pose a significant headwind to global economic growth.	Sovereign developed market yields are expensive. Breakevens offer value and provide inexpensive protection to upside surprises to inflation. The US dollar appears expensive against other developed and emerging market currencies.	Keep duration short to neutral in core developed market sovereign securities.
While this creates a distinct negative risk to the economic outlook, our operating assumption is that political necessity will lead to compromise.		Maintain short US dollar exposure, where appropriate through option strategies given increased probability of tail risks.
If so, the lessening of trade tensions supports aggregate demand, adding to pressure on resources and corporate margins and producing a modest pickup in inflation.	Investment grade corporates are mostly fairly valued, but fundamentals are likely to soften. High yield spreads are currently somewhat expensive and should similarly face a deterioration in fundamentals as earnings growth slows. There is value in emerging markets local currency and US dollar-denominated debt. While municipal securities have become rich, institutional investors are likely to find barbell strategies attractive.	Maintain modest exposure to breakevens.
		Retain a slight overweight in emerging markets, both hard and local currency.
		Maintain current credit exposure and look for opportunities to emphasize quality and shorten duration.
We expect the Federal Reserve (Fed) to ease policy less than the prevailing sentiment as long as politics does not derail economic expansion.		Multisector portfolios should be underweight municipal securities in light of valuations.
Other developed market central banks will remain dovish.	Interest rate volatility is off its low and will likely rise further. Securitized products are attractive for their high-quality carry.	Be overweight securitized products, with an emphasis on ABS and CMBS.
		Use option strategies with minimal cost to keep portfolios sufficiently convex.
Maintain a modest risk budget.		

Vincent Reinhart
Managing Director, Chief Economist & Macro Strategist

Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Disclosure

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