INFLATION, MONETARY POLICY, AND LONG-TERM INTEREST RATES

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> *Market ambiguity regarding the future direction of US monetary policy is unjustified. There seems little doubt that the Federal Reserve is far more concerned over further economic weakness rather than rising inflation and is therefore very likely to remain in an easing mode for an extended period. The Fed appears highly motivated to achieve two specific objectives: Faster economic growth and higher inflation. This combination of economic trends would be bullish for common stocks and bearish for government bonds.*

Summary and Major Conclusions:

- The investment landscape continues to be dominated by pervasive fears of a global recession. These fears continue to intensify as incoming economic data continue to soften.
- This threatening environment has resulted in widespread weakness in business and investor confidence, which has triggered a stampede into ultra-safe government bonds, pushing yields to all-time lows. It has also led to massive monetary easing in central bank policy worldwide.
- The outlook for inflation is favorable, which implies continued monetary accommodation and depressed long-term interest rates. Core consumer inflation is likely to remain near the Fed's policy target of 2% throughout 2020.
- Market ambiguity regarding the future direction of US monetary policy is unjustified. The Federal Reserve is far more concerned over further economic weakness rather than rising inflation and is therefore very likely to remain in an easing mode for an extended period.
- The Federal Reserve is targeting faster economic growth and higher inflation. This combination of economic trends would be bullish for common stocks and bearish for government bonds.
- My forecast assumes that the Fed will reduce its policy rate twice within the next several months, from its current level of 2% to 1.5%. Fed officials continue to be concerned over deflationary pressures within the global economy, which have been compounded by the super-strong US dollar.
- The Federal Reserve will soon resume expansion of its balance sheet — through purchases of government bonds — as a means of increasing the amount of reserves within the banking system. The economic effect will be a further easing in global liquidity conditions and improved prospects for economic growth.
- World bond markets have become divorced from economic reality, with current valuations discounting a bleak economic outlook. Record low bond yields are consistent with a prolonged period of economic stagnation, intense deflationary pressures, and an indefinite period of extreme monetary accommodation, each of which appears unlikely.
- Currently at 1.5%, the yield on ten-year US Treasury bonds could fluctuate within a range of 1.5% to 2% in coming months. However, interest rates are likely to drift higher over the course of 2020 and into 2021.

- A sustained rebound in world economic growth will be the catalyst for a reversal in long-term interest rates. I expect bond yields to rise to 2.5% by the end of 2020 and to 3.25% during 2021.
- My forecast also assumes a pronounced steepening of the Treasury yield curve over the next 12 to 18 months. An upward sloping yield curve would be the signal that economic conditions are in an improving trend.
- Asset allocators will continue to prefer government bonds and defensive stocks until the world economy shifts direction. Evidence of a world economic rebound will spark a rotation out of bonds and safe stocks into economically sensitive stock groups.

The investment landscape continues to be dominated by pervasive fears of a global recession and deflation. These fears have intensified in recent months as incoming economic data continue to soften. However, unlike all other previous recessions since 1960 – which were triggered by classic business cycle-related imbalances and excesses – current recession risks stem from threats associated with trade policy, geopolitical instability, and domestic political dysfunction.

This threatening environment has resulted in widespread weakness in business and investor confidence, prompting a stampede into ultra-safe government bonds and pushing yields to all-time lows. It has also led to massive easing in central bank policy worldwide. This week's *Economic Perspective* provides an update on inflation and Federal Reserve policy, along with an analysis of implications for long-term interest rates.

OUTLOOK FOR INFLATION

In principle, an assessment of future inflation trends should be predicated upon several basic fundamental factors:

- Inflation is a quintessential *lagging indicator*, trailing changes in economic growth by a year or more.
- Inflation also lags trends related to money and banking – specifically the rate of growth in the *money supply and bank loans*.
- Domestic inflation is highly sensitive to *international* forces, because of the large percentage of imported goods purchased by US consumers.
- Inflation responds to changes in *capacity utilization* within the US manufacturing sector.
- Domestic inflation is significantly affected by changes in the value of the *US dollar*, with a time lag of 12 to 18 months.

In combination, these five factors suggest that core consumer inflation is likely to remain under good control over the next 12 months, at a minimum. The rate of economic growth slowed precipitously during 2019 and will allow inflationary pressures to ease with a time lag. The growth rate in bank loans and the quantity of money has been subdued, while manufacturing capacity utilization has been in a declining trend and is well below 80%.

Importing Deflation: Powerful factors outside the US also point to domestic price stability, as deflationary pressures spill over into the US. Import prices are declining and the US dollar has appreciated by 15% over the past 18 months. These fundamental factors will help to mitigate inflationary pressures throughout 2020.

Monthly Inflation Data: Current data on inflation support the outlook for only moderate inflation over the coming year. ***Virtually all measures of inflation peaked within the past year and are trending lower***. Core producer price inflation peaked at 3% earlier in the year and has slowed to a 2% pace. The GDP implicit price deflator has declined from a recent peak of 2.7% to only 2%. Labor compensation is also in a decelerating trend. Average hourly earnings have slowed from a peak of 3.5% earlier in the year to only 2.9%, while the Employment Cost Index is increasing at a modest 2.7% annual rate.

- **Inflationary Expectations**: The two most closely watched inflation indicators by Federal Reserve officials are the core Personal Consumption (PC) Price Deflator and market-based measures of inflationary expectations. The PC deflator is increasing at a 1.8% annual rate and comfortably below the FOMC target of 2%, while inflationary expectations have plummeted. Using the market for inflation-indexed bonds, inflationary expectations have declined from 2% earlier this year to only 1.5%.

<u>The key point is that both qualitative and quantitative factors point to continued moderate inflation in 2020, giving the Federal Reserve considerable latitude in the conduct of monetary policy</u>.

FEDERAL RESERVE POLICY

Market ambiguity regarding the future direction of US monetary policy is unjustified. There seems little doubt that the Federal Reserve is far more concerned over economic growth rather than inflation and is therefore very likely to remain in an easing mode for an extended period. <u>The Fed appears highly motivated to achieve two specific objectives</u>: (1) Faster economic growth; and (2) Higher inflation. <u>*This combination of economic trends would be bullish for common stocks and bearish for government bonds*</u>.

Two More Rate Cuts: My forecast assumes that the Federal Open Market Committee (FOMC) will reduce its policy rate twice within the next several months, from its current level of 2% to 1.5%. Federal Reserve officials continue to be concerned about deflationary pressures within the global economy, which have been compounded by the super-strong US dollar.

- **Data Dependent**: The Fed is also concerned about profound weakness in the global economy, which means that future policy actions will continue to be data dependent. Continued weakness in incoming economic data in coming months assures a dovish bias for all of 2020.

Shortage of Bank Reserves: In addition to further policy rate cuts, the Federal Reserve will once again begin to expand its balance sheet. For largely technical reasons, the Fed will be compelled to increase the amount of commercial bank reserves in the interbank market. A combination of a growing ***shortage*** of bank reserves and an ***abundance*** of Treasury debt issuance has triggered extreme intra-day volatility in market rates on overnight money market rates, which cannot be allowed to persist.

- **Increase in Bank Reserves**: The long-term solution to this imbalance is for the Fed to permanently increase the supply of bank reserves, which can be best accomplished by an increase in purchases of government bonds. Fed Chairman Jerome Powell has recently emphasized that a resumption of Fed purchases of US Treasury securities should ***not*** be viewed as a return to quantitative easing.

- **Balance Sheet Expansion**: However, the Fed chairman is splitting hairs: ***The need for additional bank reserves means that the Federal Reserve will be increasing its purchases of Treasury bonds by a large amount***. *The result will be an expansion of the Federal Reserve's balance sheet. The macroeconomic effect of an increased level of bank reserves via Fed purchases of bonds will be a further easing in global liquidity conditions* and an increase in monetary stimulus.

GOVERNMENT BOND YIELDS

Market yields on government bond have plunged to near all-time record lows. A combination of falling inflationary expectations and ongoing monetary stimulus will keep a lid on long-term interest rates in the foreseeable future. *World bond markets have become divorced from economic reality, with current valuations discounting a bleak economic outlook*. Record low bond yields are consistent with a prolonged period of economic stagnation, intense deflationary pressures, and an indefinite period of extreme monetary accommodation.

Extremely bearish market sentiment implies that bond yields are likely to remain depressed over the next three to six months, at a minimum. Currently at 1.5%, the yield on ten-year US Treasury bonds could fluctuate within a range of 1.5% to 2%. However, these unprecedented lows in bond yields are unsustainable, unless the world economy slips into recession within the next year. More likely, interest rates are likely to drift higher over the course of 2020, following a stabilization and rebound in global economic growth. I expect bond yields to rise to 2.5% by the end of 2020 and to 3.25% during 2021.

My forecast also assumes a pronounced steepening of the Treasury yield curve over the next 12 to 18 months. *An upward sloping yield curve will be the signal and economic conditions are in an improving trend*. Specific catalysts for a steepening yield curve include an end to the trade war, a rebound in manufacturing, and a concrete strengthening in Chinese domestic demand, and therefore imports from Europe and Asia.

ECONOMIC IMPLICATIONS

The expected direction of inflation, monetary policy, and market interest rates has favorable implications for economic growth in 2020. Ongoing stability in consumer prices should enhance consumer purchasing power; continued easing in monetary policy would improve global liquidity conditions; and depressed bond yields should fuel an increase in aggregate spending by lowering borrowing costs for housing, consumer durables, nonresidential construction, and business equipment.

Following another two quarters of 2% growth, US real GDP could expand at a 3% annual rate between the middle of 2020 and mid-2021. Accelerating growth in company earnings would be consistent with a strengthening of US and global GDP. Following another two quarters of weakness, corporate profitability should improve sequentially as 2020 unfolds. Earnings per share (EPS) for the companies in the S&P 500 could rise to $175, up from $162 this year and $160 in 2018.

INVESTMENT CONCLUSIONS

Spreading weakness in business and investor confidence has resulted in a collapse in government bond yields and massive rotation into defensive stock groups, including utilities, consumer staples, and real estate. These market trends appear likely to persist until there is compelling evidence of a sustained rebound in world economic growth. Other catalysts for a market shift from risk-off to risk-on include a reversal in trade policy, a rebound in the global manufacturing economy, and evidence of a bottoming in the Chinese economy.

The overall investment conclusion is that global investors will continue to prefer government bonds and defensive stock groups in coming months, exerting downward pressure on global equities and sovereign debt yields. Financial markets should reverse course during the next 12 months, with economically sensitive stock groups generating the best returns.

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CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

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Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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