LEGG MASON
GLOBAL ASSET MANAGEMENT

MARKET UPDATE September 2018

WESTERN ASSET: THOUGHTS ON THE US ECONOMY

John L. Bellows
Portfolio Manager /
Research Analyst

- *We think the US Federal Reserve (Fed) will pause hiking rates in early 2019, which is not what the market is expecting.*
- *What could cause the Fed to push on past neutral would be an obvious imbalance in the economy, either from the financial side or inflation side. This is not obvious at this stage.*
- *We think the fiscal stimulus is having a one-off impact on growth. We don't see a permanent change in US productivity or economic behaviour.*

We think the Fed will pause in early 2019

Our (non - consensus) scenario is: The Fed will hike in September, remove the characterisation in its Minutes that policy is accommodative. As long as growth remains well supported, we think they will hike again in December. In 2019, we think the Fed will pause, which is not what the market is expecting. The market is mispriced for what we see are the fundamentals.

Going into 2019, the Fed would be in a much more complicated situation. Interest rates would be at 2.5%, around neutral policy. In early 2019, we would expect to see some moderation in US growth, the fiscal boost to roll off, we would be another six months into the cycle without an obvious acceleration of inflation. That would be a very different environment to now. Policy at neutral, inflation not accelerating and growth slowing. In that environment it's not obvious why the Fed would want to push past neutral into tight policy. If the Fed were to pause in early 2019, that would be well below what the market is pricing in at the moment.

Reasons for expected Fed pause

We think the possibility that the Fed pauses its rate hiking cycle in 2019 is plausible based on our interpretation of Fed comments as well as of economic data. We come to this scenario based on three key observations: 1) the Fed's bias, which we believe is dovish. 2) Recent comments made by Powell suggest Fed policy is close to neutral. 3) There are no obvious imbalances in the economy, either from the financial side or inflation side, that would cause the Fed to push on past neutral into tight policy.

1) Fed has a dovish bias

To elaborate on these, we think the Fed has a constitutionally dovish bias. The Fed is inheriting an environment where its credibility is under pressure, as it hasn't met its inflation target for some time. Notably former Fed Chair Yellen, who had a dovish bias and wanted to see a healthier labour market and higher inflation, did not have inflation at target for even one month during her four years as Fed chair. Instead inflation consistently was under 2%, despite fairly signficant labour market gains. At her final press conference, she made the key observation that the one thing the Fed left undone during her tenure is the inflation mandate. This seemed to indicate that there is something in the underlying global and US inflation backdrop which is not understood sufficiently by the Fed and the market and will continue to put downward pressure on inflation. In addition to these comments from Yellen, President Trump has appointed a few Fed members who we believe also have a dovish bias.

2) Fed policy close to neutral

The Minutes of the August Fed meeting suggest to us that it is close to removing the characterisation that its policy is accommodative. The Fed has been raising interest rates and every time stated that policy is still accommodative and supportive of recovery. For September, we expect the Fed to say that policy is around neutral.

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In Fed Chair Powell's Jackson Hole speech, he talked about former Fed Chair Greenspan's legacy, focusing on the fact that the Fed paused the interest rate hiking cycle in 1995 and then stayed on hold for 1995 & 1996. This is the period that Greenspan gets credit for correctly having an economic call on monetary policy and for letting the economy run for another six years until the end of the business cycle in 2001. In the same speech, Powell characterised the current environment, as one where he does not see obvious signs of overheating in the economy and inflation is showing no signs of moving past 2%. That does not sound like a hawkish Fed.

3) No obvious inflation imbalances

Looking ahead at what the market has priced in to the forward curve, through the end of 2019, three hikes are fully priced (one in September (fully priced), one in December (half priced) and another 1 ½ hikes priced in 2019). We expect the Fed to pause in early 2019, which is not priced into the market. What could cause the Fed to push on past neutral, would be an obvious imbalance in the economy, either from the financial side or inflation side. This is not obvious at this stage. Stock markets are up, but not backed by credit growth that is concerning. So we don't see financial stability concerns. Inflation could move up, but we are not seeing signs of that (ie Yellen comments, we are a number of years into the business cycle and still accommodative monetary policy, wage growth remains below 3%, inflation remains muted).

In terms of balance sheet normalisation, we think interest rates remain the focus for the Fed and it will react there first. Balance sheet management is likely to remain in the background. Looking forward to end 2019, our view is that we don't think balance sheet reduction needs to go on much past the end of 2019. The Fed is already facing an environment where we are seeing some tightness in funding markets. It doesn't need to reduce the balance sheet by USD 1 trillion (trn) to tighten conditions.

More value in front end of US yield curve now

We still have a significant long exposure at the long end of the yield curve, but have increased exposure in the 2-5 year bucket over the year to date. We've had a focus on the long end of the yield curve for some time and our yield curve flattening positions have been very effective for us. We use duration as a risk diversifier, as a position with a negative correlation to risk assets, and the long end of the yield curve was more effective than the front end from a risk mitigation point of view over recent years. While the long end provided the potential for yields to fall and to work as a risk diversifier, there was very little room for two-year yields to fall. That has now changed. Two- and five-year yields have risen this year and we believe there is room for those yields to fall. A further reason for increasing our front end exposure is based on a value argument, i.e. what is priced into the market and what we believe is a feasible outcome for the Fed. We think a pause by the Fed in 2019 is very plausible, but not priced into the market.

Impact of fiscal stimulus on growth

We think the fiscal stimulus is having a one-off impact on growth. We don't see a permanent change in US productivity or economic behaviour. The fiscal stimulus is mainly government spending rather than tax cuts. Government spending is as much as 10% higher year over year and on our calculations would add around 50 basis points (bps) to Gross Domestic Product (GDP). However, this part of the fiscal stimulus rolls off early next year. The spending increases we are seeing are on the discretionary parts of the budget (non-mandatory), such as defence, infrastructure, health, education. Congress authorises that, takes some time on how to apportion it and then spends it in Q3 and Q4 of 2018. Then that stops. In order to sustain that, Congress would need to authorise another 10% increase in spending for the following year. That could happen, but is not our base case.

The tax cuts, meanwhile are smaller in magnitude this year and ramp up over time. The key question here is, are the tax cuts changing the nature of the US economy so it's not just a one-time boost, but a more permanent change? For that to happen you would need to see productivity enhancing capital expenditure or changing consumer behaviour. We are not seeing either of those.

More moderate outlook for growth in 2019

We are sceptical that the growth we have seen so far this year will be repeated next year. Aside from the fiscal boost, the rest of the economy is performing as expected. Consumer spending growth is in line with income growth. Capital expenditure growth is driven mainly by the energy sector and infrastructure. We are not seeing a behavioural change by corporates or consumers. The tax cuts cause a cut in US government revenue and increase corporate cash flows. Implicitly this means some debt is being shifted from corporates to the government. The government issues more debt, corporates less. That's a financial stability enhancing change. It's very unusual to see an improvement in corporate credit quality nine years into the business cycle. Usually it deteriorates into the end of the business cycle. We look at

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aggregate credit metrics (growth of private credit relative to GDP) to monitor whether there are signs of excess credit growth from a macro-economic perspective, but private credit growth has been moving in line with GDP growth so we haven't seen that.

Inflation expectations vs inflation data

Surveys are showing inflation expectations build, but inflation data are not showing it. The Fed can't act on survey data that may be showing inflationary pressures, if actual inflation data doesn't show it. As highlighted by Yellen in her final speech as Fed Chair, there are long term persistent forces that remain significant on the inflation front. A declining labour share of output, income growth is not going up in a sustainable way. Where could we be wrong? The labour market could get so tight that we see wage pressures building, but we are not there yet. Some people highlight that as monetary policy acts with a lag, the Fed could argue that even though it is not seeing inflation now, it needs to act preemptively. But we think that would be a tough case to argue.

Yield curve as a predictor of a growth slowdown or recession

The case for market participants who expect a US recession in late 2019/2020 hinges on some of that fiscal policy stimulus slowing, a lack of follow through on taxes through productivity or consumer behaviour and a Fed that continues to hike until you get to a business cycle change. We think the Fed will pause before that point. The Fed's goal is to avoid having a recession. With prudent Fed policy, recession is not something that has to happen. The business cycle could go on for a number of years. If the Fed shows some restraint, the yield curve could steepen a bit. For a sharper steepening you would have to get upward pressure on back end yields, which seems inconsistent with the low inflationary environment. Or you would have to get a big rally in front end yields, which would be a signal that the cycle has changed.

Impact of US trade policy and tariffs

Trade tariffs cause a one-time increase in the price level. What we care about when we think about inflation and bond yields is the expected inflation, so the inflation to be repeated on a year over year basis over the next 10 years. When you increase the price level today, that has no implication for what the price level is going to do next year. In fact, if you increase the price level today without a commensurate increase in income, that's going to weigh on demand and bring down inflation over following years. If you were to see a broadening of tariffs, we therefore think that would be negative for demand and US Treasuries do quite well in that environment.

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