GUGGENHEIM

July 30, 2019

Global CIO Outlook
The Fed's Sugar High

Scott Minerd
Global Chief Investment Officer
and Chairman of Investments

In the runup to the upcoming FOMC meeting, policymakers debate the value of what would normally be considered rather unorthodox policy actions. Even as the U.S. economy continues to grow beyond potential with labor markets operating at levels associated with full employment, an unusually loud public debate has ensued around appropriate policy action. The consequences of the Federal Reserve's actions in the next week could be with us for much longer than we think, ultimately culminating in the next recession and increasing the risks to financial stability. The Fed will be starting yet another monetary sugar high that doesn't address the underlying structural problems created by powerful demographic forces which are constraining output and depressing prices.

Given the Fed's long running polices of data dependence, by almost every measure policymakers should be considering another rate hike in anticipation of potential economic overheating as a result of looming limitations on output. Instead, debate has been focused on the need to take preemptive action to avoid a potential slowdown. The timing and magnitude of potentially large and rapid rate reductions has dominated public discussions by Fed officials over the past month. Many inside and outside the Fed acknowledge that the US economy is doing fine, yet simultaneously argue the preemptive action may be necessary to avoid recession.

A rather abrupt shift in thinking was set in motion last December when, after raising overnight rates by a quarter of a percent, Fed Chair Jerome Powell signaled more hikes were to come and that balance sheet reduction was on "autopilot." Alarmed by the market tantrum that ensued, Fed policymakers began a mop up campaign which included its now famous "pivot" to patience.

While the Fed has more than succeeded in stabilizing the markets, asset prices around the globe have taken off. Not only did the S&P 500 recover earlier losses but it now sits at a record high. The liquidity driven rally which ensued has driven up a panoply of asset prices including bonds, precious metals, energy, and even cryptocurrencies.

In Europe, fears of faltering inflation and disappointing economic data have focused attention on the European Central Bank (ECB). ECB President Mario Draghi has signaled that more easing is in the pipeline with growing expectations of the policy rate heading even deeper into negative territory and the likelihood of renewed quantitative easing (QE). Anticipation of more monetary accommodation has pushed 10-year German bund yields deep into negative territory along with French and Dutch sovereign yields.

Policymakers had long assumed that sustained negative interest rates in a major economy was a symptom of the unusual circumstances in Japan. Now, apparently, the Japan disease has spread to Europe with the prospects that negative interest rates may become a long-term fixture in the euro region.

In the U.S., concerns are mounting that the global slide toward negative yields could infect the market for Treasury securities should the U.S. slip into a recession while rates are so close to the zero bound. These concerns are well founded. In the post-war era, the Fed has reduced short-term rates by an average of 5-1/2 percent during easing cycles associated with recessions. The required stimulus in a recession today could necessitate large scale asset purchases of nearly $5 trillion to overcome the monetary limitations of the zero bound. Such a policy action could easily result in negative Treasury yields.

In an attempt to immunize against the global contagion of negative rates, the Fed is intentionally overheating the U.S. economy in hopes of raising inflation above its 2 percent target rate. Once inflation approaches some undefined rate, perhaps 2.5 percent, the Fed will then reverse course by increasing rates to higher levels than we are experiencing today. However, such a policy move is not without its own risks.

Additional accommodation this late in the business cycle is likely to push asset prices higher, similar to what occurred in 1998. Between September and November 1998, the Fed cut rates by 75 basis points during the Asian crisis, creating the backdrop that pushed technology stocks into bubble territory. The Fed was later forced to respond to signs of an overheating economy and reversed course only eight months after it had cut rates, and raised short-term rates to the cycle high. We know how that ended. After driving the Nasdaq into bubble territory, less than two years later the index began a sickening slide, with losses of approximately 80 percent from the March 2000 peak and 36 percent from when the Fed first began to cut rates.

Just as Fed accommodation led to the Internet bubble then, the Fed's current actions could result in an asset bubble similar to 1998. Stimulative policy at this point in the business cycle is likely to have a similar impact of funneling capital into select risk assets and crushing risk premiums in the months ahead, and we know the payback that follows. It will not end well.

If successful, the ultimate unwind of this policy will require higher short-term rates to hem in inflation, which will pressure the highly leveraged corporate bond market that is currently near record levels of debt relative to earnings. Higher rates in the future are likely to force high volumes of downgrades and defaults, which could cause markets for risk assets to seize up as credit spreads dramatically increase and equity prices plummet.

Chairman Powell has been extremely clear that the Fed will go for broke, and do whatever necessary to keep the expansion going while increasing inflation expectations. Most likely, a quarter point at next week's FOMC meeting will be followed by another half percent before year-end. Current market pricing indicates that even more is anticipated next year. As long as the Fed doesn't perceive that inflationary pressure is becoming too daunting a problem, policy makers are prepared to do everything they can to keep the economy going.

Eventually, the Fed will achieve its objective and price pressures will rise as unemployment continues to fall. As for the yield curve, long-term rates are likely to remain low even when short-term rates begin to rise again. Given the depressed neutral rate—the rate of interest that is neither expansionary nor contractionary—resulting from low growth potential and the Fed's continued commitment to an average inflation rate of 2 percent, in all likelihood the market will view future rate hikes as transient. This is likely to keep long term rates low while QE will reduce the supply of bonds, which will only depress yields further.

Slow growth associated with the depressed neutral rate cannot be solved by the Fed with monetary policy. The real problem is the product of structural changes within the economy which has reduced growth potential relative to the past 50 years.

Demographics play an extremely important role. Not only is an aging population creating an acute labor shortage, but the opioid crisis and failures in education and job training are limiting the supply of skilled labor. The truth is that more must be done to improve the quality and quantity of labor.

Without growth in supply side inputs and increased demand associated with a faster growing, younger demographic, the real neutral rate is likely to remain low and may even fall into negative territory. The depressed neutral rate is limiting the power of policy makers to stimulate demand without risking significantly higher inflation and greater financial instability.

The correct policy action should be to focus on supply side factors to quickly enhance potential growth. Education and job training are important longer-term to ultimately address the issue, as is addressing the blight of the opioid crisis, but these solutions take more time than we have if the U.S. is to avoid recession.

The simplest way to avoid recession and the associated negative rates would be a rapid increase in the supply of labor. A rational immigration initiative could quickly offset the risks of a slowing economy by providing more workers and entrepreneurs who can plug the yawning gap between available jobs and available workers. Two million new workers could raise output potential by 2% or more. This would push the neutral rate higher by stimulating economic growth while increasing tax revenue to the U.S. Treasury from the rapid growth in personal income.

Leaving the current problems associated with a depressed neutral rate in the hands of the Fed is likely to create greater risks in the future. The Fed's current policy of anticipatory and preemptive rate cuts will ultimately lead to unsustainably high asset prices and increased financial instability. This can only make the next down turn worse. If the U.S. continues down the current policy path we may very well find out that the Fed's cure for avoiding a near term recession and negative interest rates may ultimately make the disease worse.

Risk Considerations

Investing involves risk, including the possible loss of principal. This material is distributed or presented for informational or educational purposes only and should not be considered a recommendation of any particular security, strategy or investment product, or as investing advice of any kind. This material is not provided in a fiduciary capacity, may not be relied upon for or in connection with the making of investment decisions, and does not constitute a solicitation of an offer to buy or sell securities. The content contained herein is not intended to be and should not be construed as legal or tax advice and/or a legal opinion. Always consult a financial, tax and/or legal professional regarding your specific situation.

This material contains opinions of the author or speaker, but not necessarily those of Guggenheim Partners, LLC or its subsidiaries. The opinions contained herein are subject to change without notice. Forward looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable, but are not assured as to accuracy. Past performance is not indicative of future results. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. No part of this material may be reproduced or referred to in any form, without express written permission of Guggenheim Partners, LLC.

Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited and Guggenheim Partners India Management.
Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited and Guggenheim Partners India Management.
©2019, Guggenheim Partners, LLC. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Guggenheim Partners, LLC.