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FIDUCIARY MATTERS

Where do we go from here? It's complicated.

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Growth is the cure for all ills. There is clear and undisputed evidence that the global economy is slowing from China to the U.S., but on a relative basis, the U.S. is still growing faster than most developed economies. The December 2015 FOMC liftoff decision has caused financial conditions to tighten and risk assets are being repriced accordingly along with a lower earnings reality and risen uncertainty. The lack of meaningful wage growth, productivity growth, greater economic activities and elevating core inflation are all courses of concern, but they do not necessarily point us to recession as the natural destination soon. There are many factors at play. The dollar strength, commodity prices, oil price and the global economy are all contributors to FOMC's decisions each meeting going forward. We are now again looking to the U.S. consumer as the pillar of strength to lift us out of the current malaise.

The excessive leverage in the private, corporate and public system globally prior to the Financial Crisis brought forward growth, production and capacity that have proven to take even more years to absorb. The Great Recession that ensued was so massive and painful that it elicited unprecedented policy responses. Regardless if austerity was the explicit fiscal mandate or implicit belt tightening, the go-go years were over. The only policy tool that remained to save the day was monetary. Reversion to the mean after a financial bubble and extraordinary policy response takes a long time.

Fast forward to 2016, the world remains in a recovering mode. In fact, the New Normal may even be too optimistic. The decoupling between the developed economies and the developing and emerging world turned out to be more a hope rather than a reality. Emerging and developing economies absent of the purchasing power and animal spirit of the developed counterpart cannot be the independent beacon of growth. We are as dependent on each other as we have ever been. The mutual dependency of exporter and importer and producers and consumers remains unyielding. However, after years of low growth, the capacity to withstand minor shocks, mistakes and errors has been significantly diminished. There is simply less room for errors with downside risk more exaggerated.

It is important to distinguish between rate normalization vis-à-vis a rate increase. Under either circumstance, the FMOC is raising rates, but historically when the FOMC raised rates, it was to dampen economic activities and leverage which, when endured, led to recessions. However, in the case of normalization, the FOMC is raising rates to return to a normal policy environment and not for the purpose of containing enthusiasm. The unconventional policies of Large Scale Asset Purchase (also known as Quantitative Easing) and zero interest rate policy (ZIRP) were used to prevent the U.S. from falling into a financial abyss. The U.S. economy has significantly recovered by any measure, and ZIRP is no longer necessary. Normalization (although late) is thus natural and appropriate (Chart 1). FOMC does not want an extended ZIRP which could lead to unintended negative consequences and fuel financial bubbles. However, there are signs of a slowing economy in the U.S. and globally. Inflation expectation is moving away from target (Chart 4) as the treasury yield curve continues to flatten and as the short end yields rise (away from ZIRP) and the longer end yields lower (Chart 2). The FOMC will remain extremely cautious

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to manage its interest rate policy during this "unusually uncertain" time, as so coined by Chairman Ben Bernanke in 2010. Under the distorted monetary environment, investors are not justly compensated for taking on maturity risk. On February 2, 2016, the spread between a 10-year and a 30-year treasury bond was a measly 81 bp (Graph 3).

Many Central banks have raised interest rates post crisis to end up lowering them subsequently[1] to prevent their economy from sputtering. Although the reasons for policy change were different, the about-face points to 1) the global dependence on super accommodative monetary policy and 2) the lack of other policy measures (such as fiscal) to ignite growth. Obviously, the central bank actions were premature with their domestic and global economy remaining in low gears (Chart 5). Now, it is almost fashionable to go negative. Japan's central bank just became the latest member of the negative interest club (Chart 6). After 20 years of mild deflation, the three arrows of Abenomics have been insufficient to spur sustainable growth and price stability. One of the unexpected consequences of negative rate is savers are saving even to make up for the negative yield instead of rushing into risk assets.

The Chicago Fed's National Financial Conditions Index (NFCI) measures the financial risks in the system. Its subcomponents measure the rate of change of systemic risk, credit conditions and leverage. When the FOMC raises rates, it tightens financial condition. Thus, when the condition tightens, it has the same effect as raising interest rates, so the FOMC can hold off. Since August last year and certainly so far this year, financial conditions have tightened which leads Fed watchers to suggest that the FOMC would hold off raising rates for the entire 2016 (Chart 7). We still maintain that there could be a 50bp increase in 2016.

The U.S. led the world into the Great Recession and is the first one to recover from it. Today, the U.S. economy continues to be "the cleanest shirt in the dirty laundry". This fact is transmitted in the form of a strong dollar. The strength of the dollar has been a mixed blessing for the U.S. This has pushed down prices which allows consumers to have greater spending power, but the strong dollar has had an overall negative impact on exports (corporate earnings) and especially so during a period of global economic slowdown (Chart 8). Dollar strength has compounded the woes for oil since 2014 (global oil is denominated in USD) and, to a lesser extent, all commodities (Chart 9). With market anticipating a reduced probability for rate hikes this year, the U.S. dollar has retreated recently. This is not good news for the ECB and BOJ. Both are using QE and negative interest rates to drive down their currencies in hopes of importing inflation and spurring growth and export. If the market expectation of a weakening dollar persists, ECB and BOJ would need to take more actions. Take a seat and let's witness what's next for central bankers to fulfill the slogan "*we will do whatever it takes*"!

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[1] http://www.wsj.com/articles/lesson-for-fed-higher-interest-rates-havent-been-sticking-1442167699

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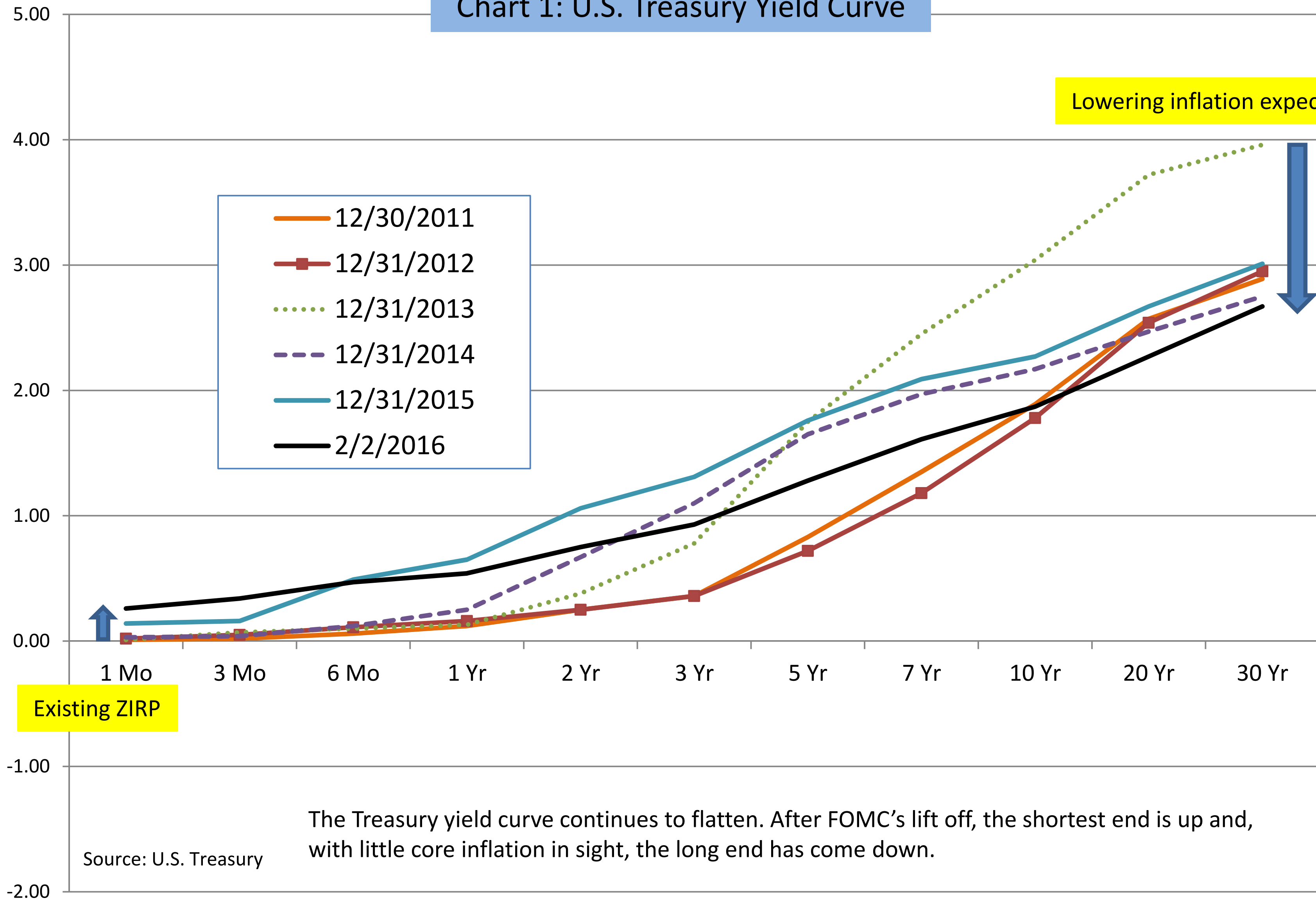

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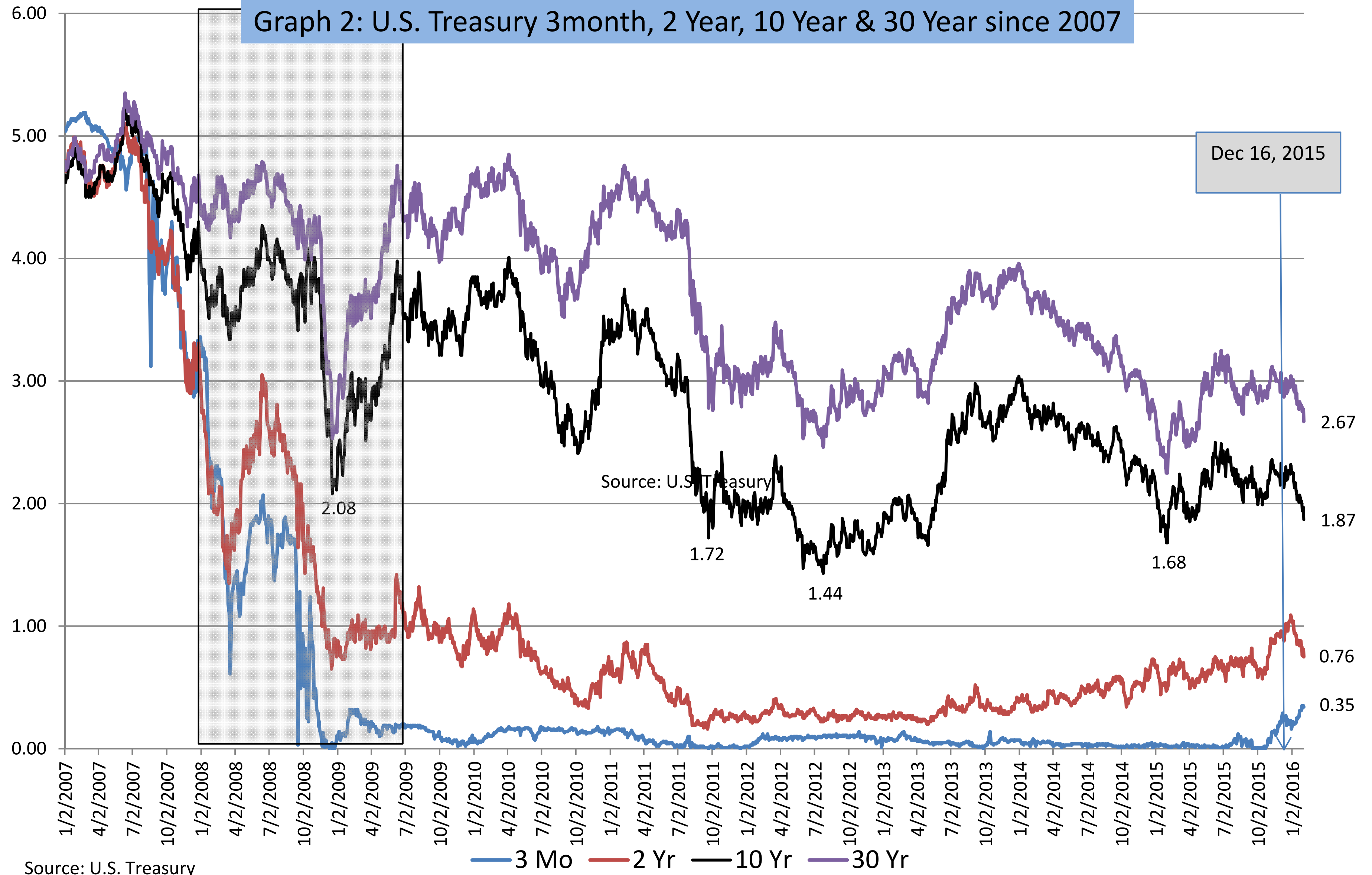

Source: U.S. Treasury

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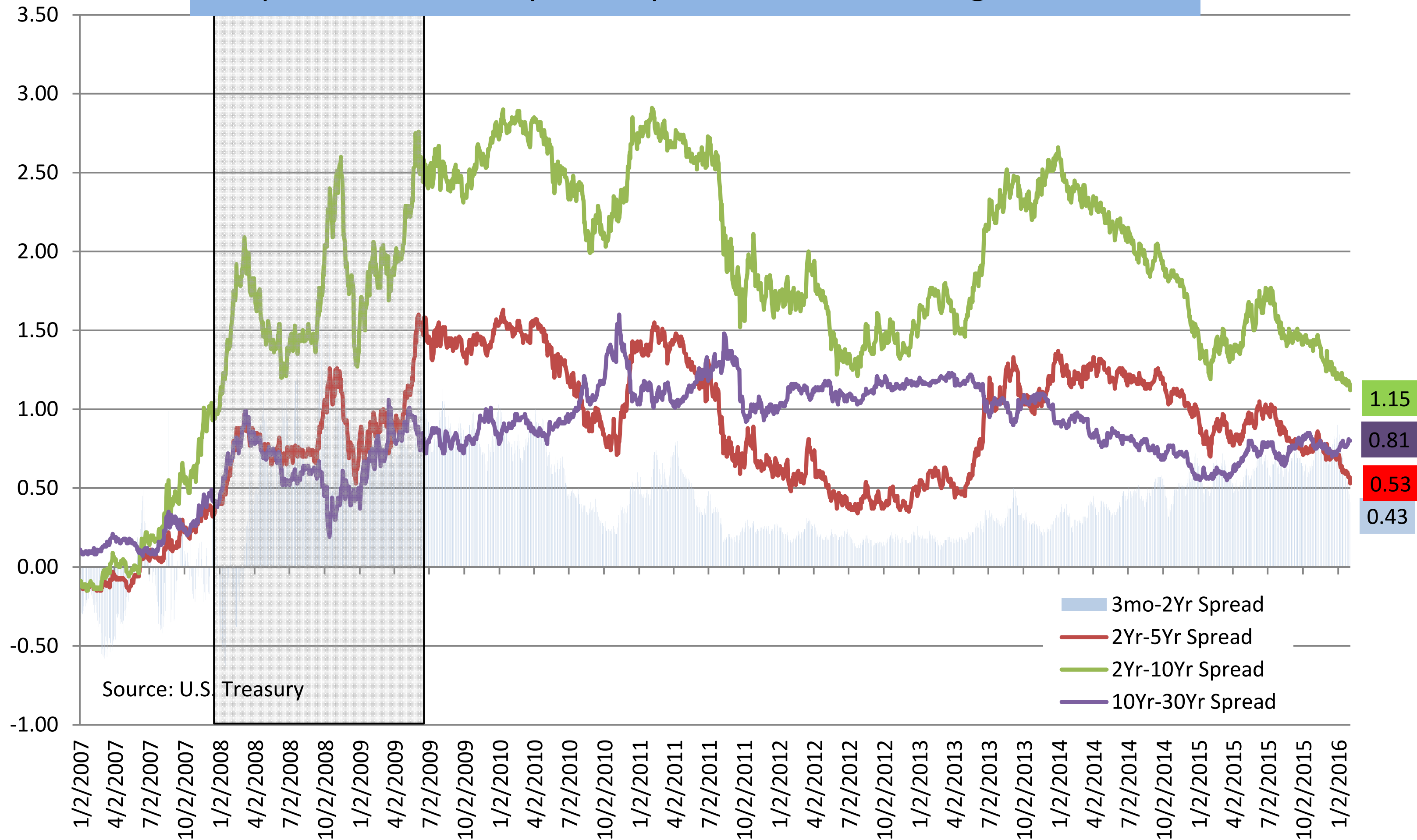

The yield differential between two points on the yield curve helps to inform us the reaction function to US (lesser extent global) economic forward view and where there may be value for investing. On a very basic level, increasing spreads suggests a positive yield curve which indicates stable economic conditions in the coming time. Contracting, or decreasing spreads, would suggest decelerating economic conditions resulting in a flattening yield curve. The unconventional monetary policy since 2008 has distorted the yield curve.

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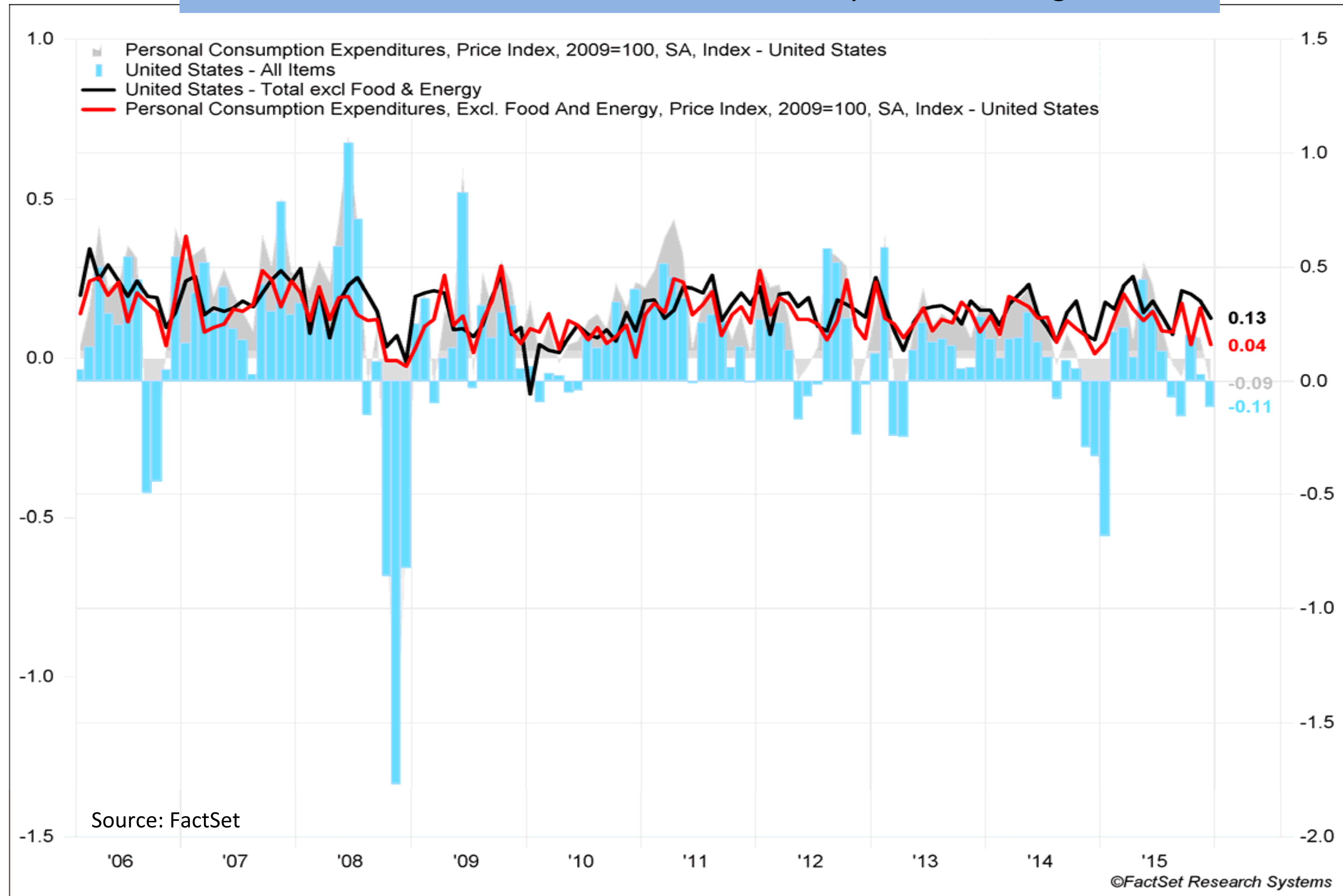
Chart 4: INFLATION
CPI & PCE Vs Core CPI & PCE – Monthly Rate of Change



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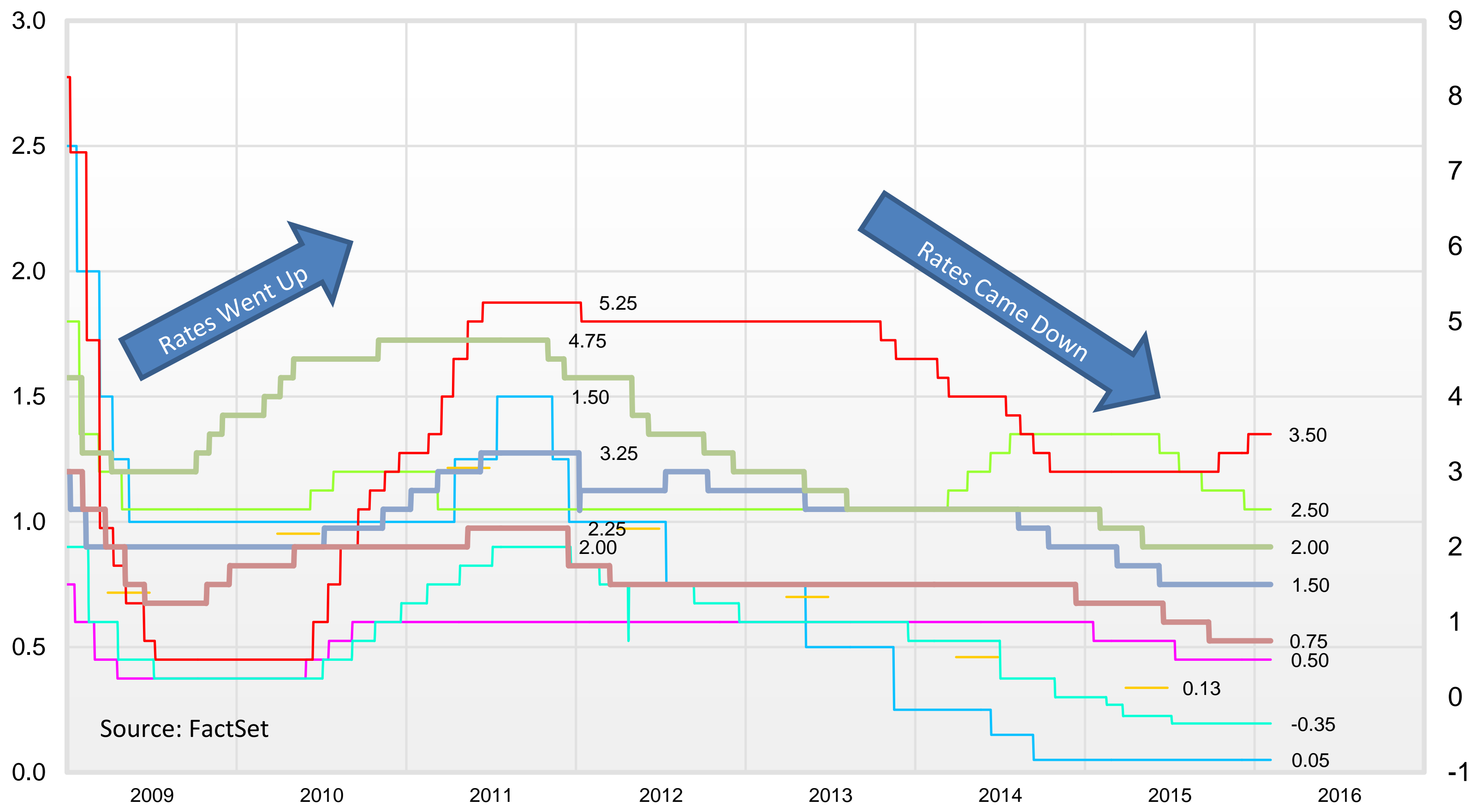

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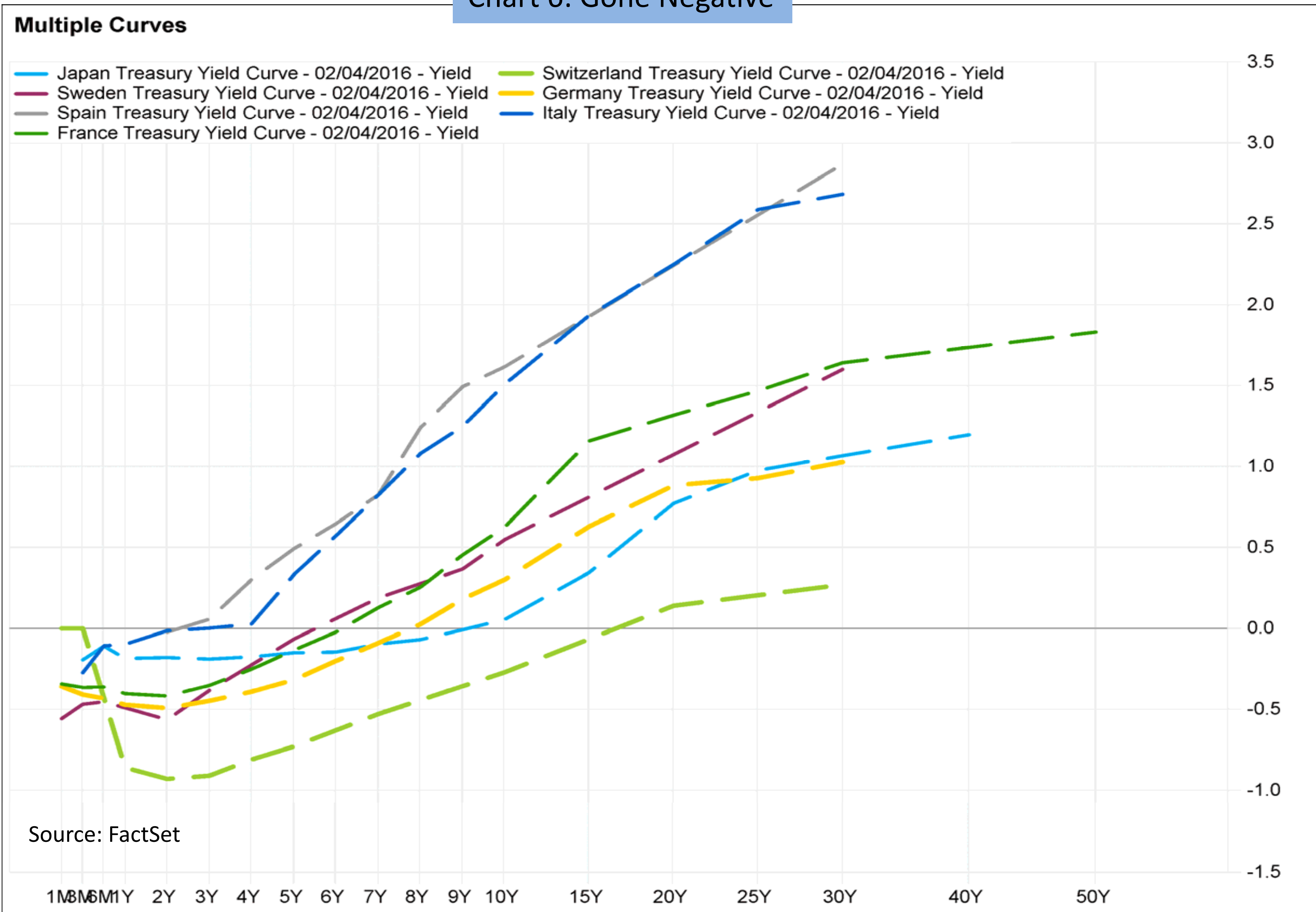

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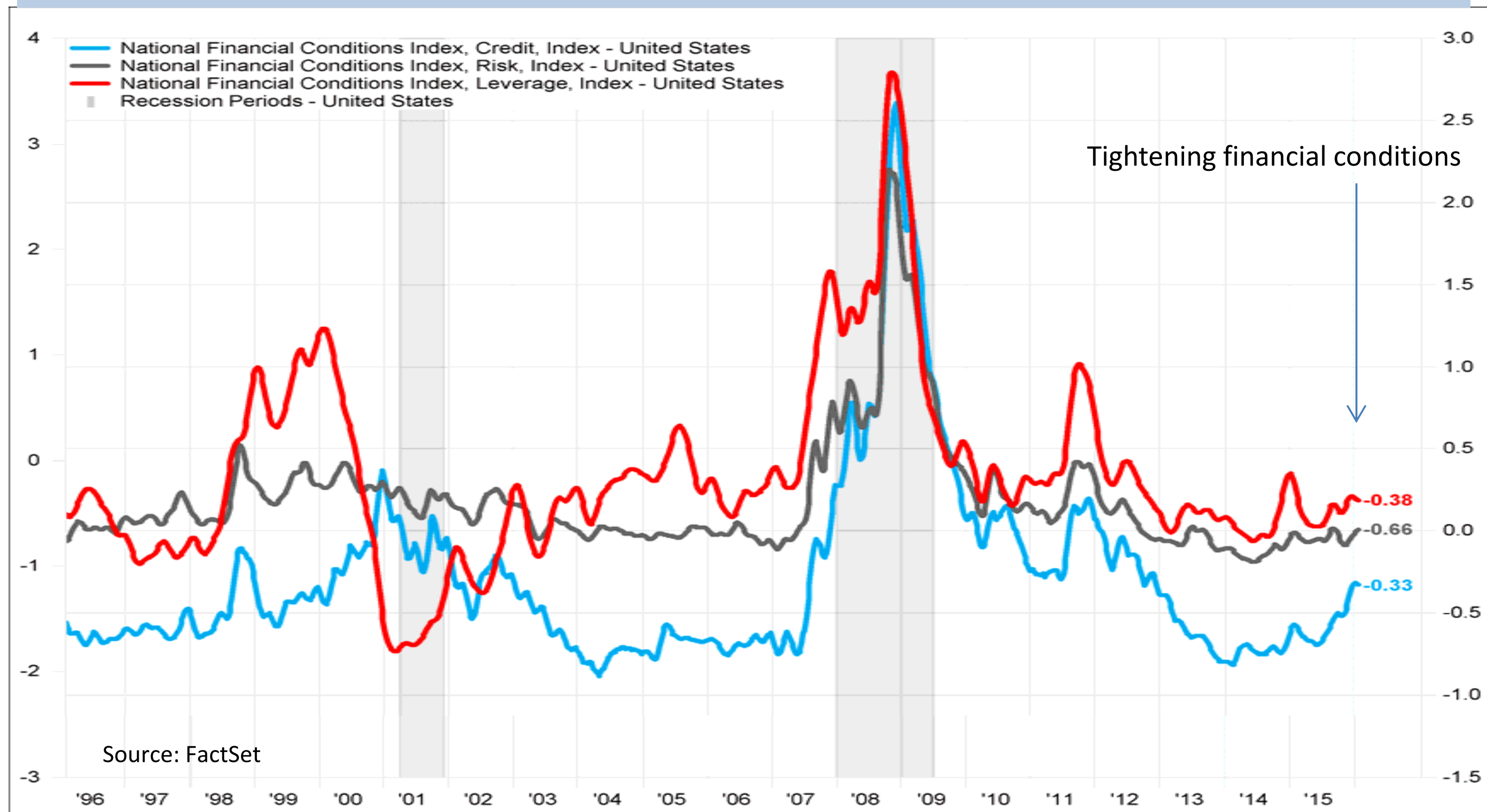
Chart 7 - Chicago Fed National Financial Conditions Indexes: Credit, Risk & Leverage



The National Financial Conditions Index (NFCI) is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1973. Positive values indicate financial conditions that are tighter than on average, while negative values indicate financial conditions that are looser than on average. The three subindexes allow for a more detailed examination. The risk subindex captures volatility and funding risk in the financial sector; the credit subindex is composed of measures of credit conditions; and the leverage subindex consists of debt and equity measures. Increasing risk, tighter credit conditions and declining leverage are consistent with tightening financial conditions. Thus, a positive value for an individual subindex indicates that the corresponding aspect of financial conditions is tighter than on average, while negative values indicate the opposite.

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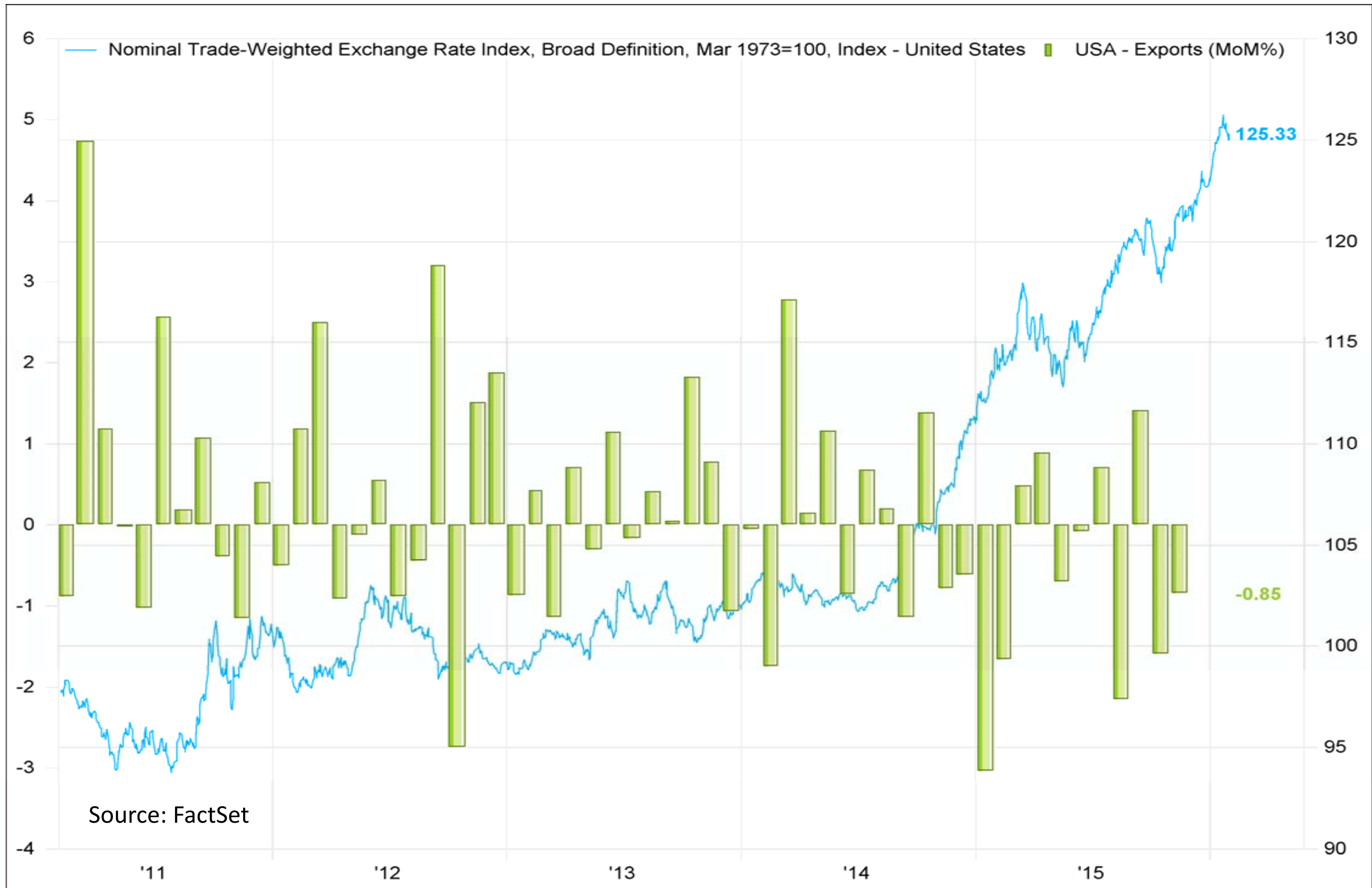
Chart 8 - U.S. Dollar & Exports



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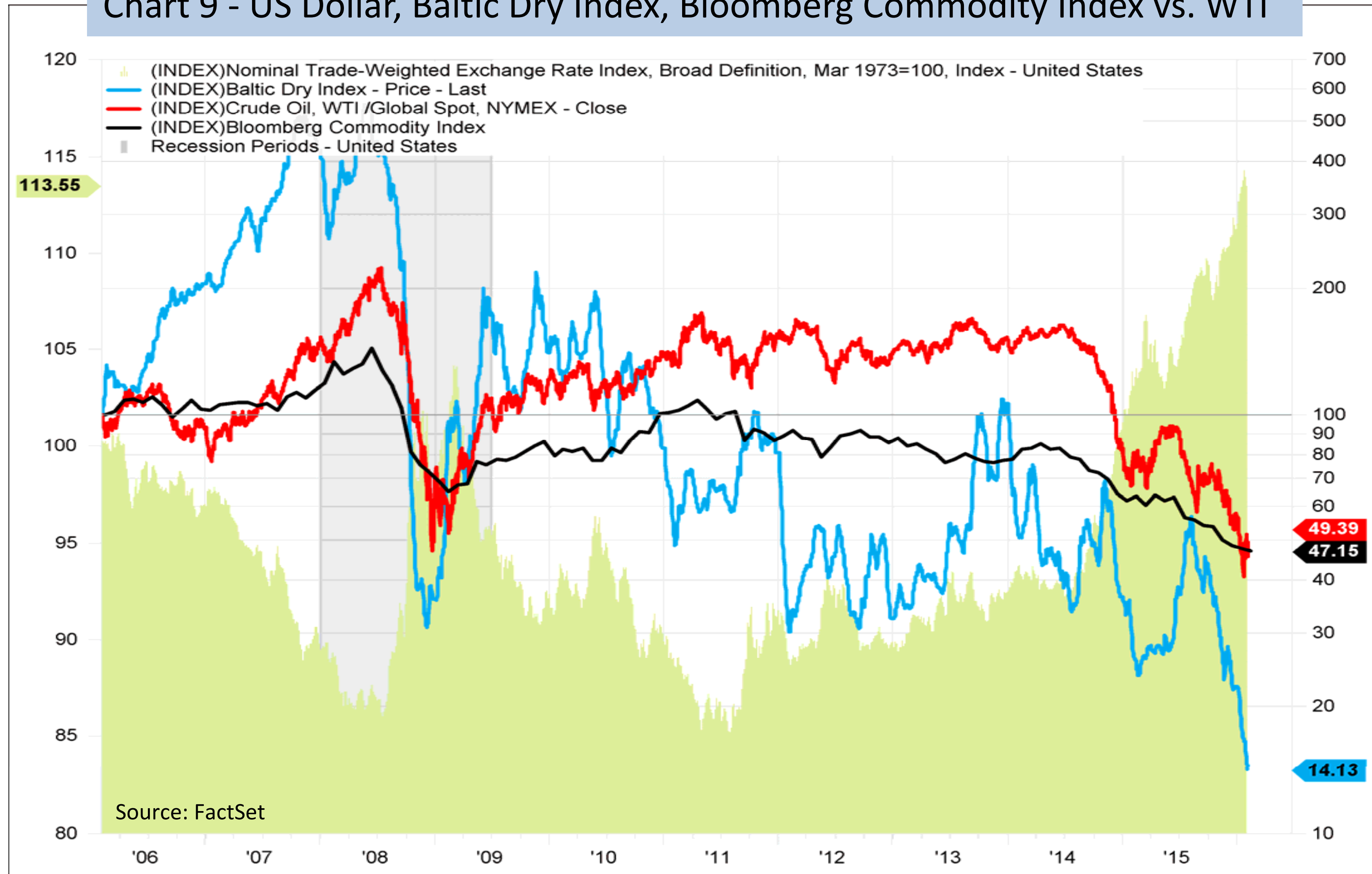

Oil is a component of the Bloomberg Commodity Index, and both prices have been falling. In the case of oil, it is exacerbated by a supply glut, the dysfunction of OPEC and the U.S. energy revolution. The rise of the US dollar has also pushed down oil prices in dollar terms. The Baltic Dry Index confirms the drop in price (activities) for global shipping of goods (commodities etc.) and is one indicator of weakening global economic activities.

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