Market Commentary

February 2019

The Return of the Bond Vigilantes or at Least Something Close

In days past, bond vigilantes would protest monetary and fiscal policies deemed unconstructive by selling bonds, raising interest rates and generally intimidating markets and policymakers. At the onset of the Clinton Administration, advisor James Carville famously quipped he would like to be reincarnated as the bond market, given the influence it wielded over the new President's policies. Of course, back then, bond markets tended to gripe about fiscal deficits and spending profligacy, which all seems so very quaint. Complaints over deficit spending now fall on deaf ears in Washington – and any attempts to learn sign language would be futile.

To be fair, financial markets are complicit in the general complacency over federal debt and deficits, focusing instead on stimulus and growth. Equity investors have bullied their way into the vigilante posse and seem to enjoy flexing their muscles by elevating financial market volatility and tightening financial conditions. When the vigilantes perceived the Federal Reserve (Fed) was oblivious to the growing clouds on the economic horizon, they howled – loudly. The Fed and its humbled Chairman read the vigilantes ransom note and met each demand unconditionally, promising flexibility and patience in all matters. Not that I am complaining. Coming into 2019, we considered overly-aggressive Fed tightening to be the greatest risk to market stability and continued economic expansion. That risk has been decisively reduced.

So why did the Fed pivot so dramatically from the December 19th rate hike to the January 30th capitulation? I mean really, how much changed in those six weeks? As you might have guessed I have some theories.

First, financial conditions did tighten and economic data did weaken in the fourth quarter. Unfortunately, the Fed and Chairman Powell failed to adequately acknowledge these rather obvious points in a timely fashion. Going into the January meeting, Fed officials probably realized previous rhetoric was too strident at a point when investors were asking them to pay attention to slumping data. December's ugly markets were simply the vigilantes screaming "WATCH THE ROAD!!!" from the backseat.

Second, I think the Fed failed to recognize the stifling impact the protracted government shutdown had on consumer, business and investor confidence. It's on them to acknowledge *This Is Not Your Father's* Administration and Congress, and that common sense and compromise may not prevail.

Third, and most importantly, signaling an extended pause in tightening was the right policy decision. Inflation and inflation expectations levels have eased. Wage growth has not accelerated and shows little sign of sparking cost-push inflation. U.S. economic growth will likely fall from 2018's tax-cut stimulated pace. All of which persuasively argues for a less rigid approach to monetary policy. But I must admit, there was just something insincere about the Fed's retreat. It felt like the statement and press conference were designed to give the Fed some breathing room and get the markets off its back.

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Overall, our view on the Fed's turnabout remains somewhat unchanged from what we shared in our January 31st Quick Insights post:

> In USBAM's opinion, Fed officials – Chairman Powell in particular – likely believe monetary policy rates are still below neutral and are biased to continue tightening. Chairman Powell's previous comments about rates being "a long way" from neutral and how balance sheet downsizing should be on "autopilot" were unfortunate and unnecessary verbal gaffes, but likely reflected the Chairman's true opinions. Within this context – not to mention the December Dot Plot's call for two 2019 rate hikes – it seems likely the Fed would prefer to lift rates when market conditions permit. Those conditions would include continued job growth, an extended period of relative financial market stability, a resolution to federal government budget and debt ceiling issues, and a steeper yield curve, as the Fed is – or at least should be – reluctant to invert the yield curve via a policy move. We believe such an environment will be met over time, which has us calling for a H2/2019 rate hike.

Given this outlook, there should be a general drift upward in the yield curve, with the risk of a severe jump in rates being low. But to be sure, I won't fall out of my chair if the Fed doesn't raise rates this year. Europe is slipping toward recession and China is slowing – although our base case for a credible Chinese trade deal would be a positive catalyst for growth and markets. Fed funds implied probabilities actually skew toward a rate cut rather than a rate hike (12.6% vs. 2.7%) by year end. But I would argue current investor sentiment is too deeply influenced by December's swoon and fear of the vigilantes' wrath. Outlooks change quickly these days. After all, it was only a few short months ago these same voices were howling the Fed was behind the inflation curve and needed to decisively raise rates.

Sources:

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[See next page for important disclosure information.]

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