UPDATE ON THE CURRENT MACRO BACKDROP

June 10, 2019

New Fronts in the Trade War?

Market stress levels have risen considerably over the past month or so since Presidential tweets first began to make clear that investor expectations for a resolution to the ongoing U.S.-China trade tensions had run well ahead of the facts. As the consensus view on the likelihood of a deal between the two countries progressively flipped from "just around the corner" to "nowhere in sight", equity markets pulled back, economists began ratcheting back their growth outlooks, and expectations for an even further dovish shift in U.S. monetary policy have continued to swell.

Such trends have seen greater traction recently, as the administration has begun to initiate trade policy actions on additional fronts, raising the specter of a potentially larger and more protracted trade war. Although a last-minute deal has spared us (for now) from the potentially material damage of the threatened tariffs on the import of goods from Mexico, the apparent broadening of the theater of hostilities seems, nonetheless, to have raised the stakes for investors.

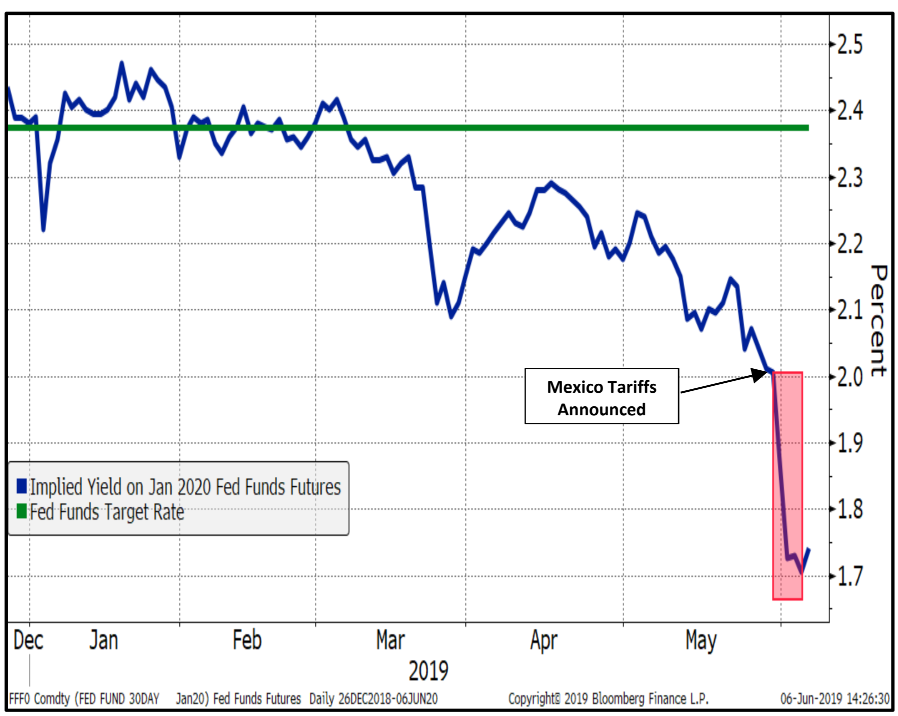
Save for the deal struck over the weekend between the U.S. and Mexico – one of our largest trading partners – these tariffs were set to go into effect this morning, June 10th, at a rate of 5% and then escalate by an additional 5% each month to a maximum of 25% by October. Such threats by the administration were significant for a number of reasons. On the one hand, they recast onto a global stage what had previously seemed a fairly geographically-limited conflict (i.e., China); more noteworthy still, however, is the fact that this represented a use of the tools of trade policy to pursue policy objectives in other, unrelated areas: specifically, while the dispute with China can be seen as seeking to gain greater protection of intellectual property rights and to stop the forcible transfer of technology, in the case of Mexico, the explicit goal of the tariffs has been to pressure the Mexican government to stop the flow of illegal immigrants coming across the U.S.'s southern border.

Obviously, as such measures prove effective, they risk fueling a temptation to use what has started to be referred to as "weaponized" trade policy in the pursuit of a whole host of U.S. policy initiatives, even at the cost of inflicting what could be substantial economic harm here at home. U.S. trade measures taken and proposed to date against China (ignoring the impact of any retaliatory actions) – if sustained – are expected to trim nearly 0.60% off of the rate of growth of the U.S. economy, while those proposed against Mexico likely would have reduced it by a further 0.40%. Meanwhile, the economy would also likely experience higher prices as a result of such tariffs, potentially eating into corporate profit margins or consumer confidence (or both), while heightened uncertainty from a wider theater of hostilities would make life more challenging for businesses attempting to plan out production and supply chains.

Tipping the Scales of the Bond Market

Despite the Fed's repeated assurances that it intends to wait patiently for a clearer view of the economy's trajectory, markets had already begun to price in the possibility of a rate cut even prior to the announcement of tariffs on Mexican goods, investors speculating that – in spite of a tight labor market and decent growth backdrop – the Fed would ease in an effort to boost inflation. Given, however, that – in the history of the Fed – there has never been such a "benign" rate cut, this was more wishful thinking than anything else. It helps explain, however, why the market's consensus outlook shifted so dramatically following word of the Mexico tariffs: to the extent that escalating trade tensions looked to pose a credible threat to economic growth, the case for a Fed rate cut would no longer seem quite so far-fetched. Investors quickly seized on this scenario, sending their outlook for short-term interest rates (via the Fed Funds futures market) straight off a cliff (Chart 1, above), reflecting a deep conviction that the Fed will be forced to cut interest rates multiple times over coming quarters.

Chart 1: Tariffs Send Market's Short-term Rate Expectations Off a Cliff



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Such lofty expectations aside, however, how likely is it that the Federal Reserve will actually deliver the rate cut(s) that markets are now looking for? In the short run, we believe the answer is "Not very." Given a tight labor market and inflation the Fed has characterized as only "transitorily" low, we think the Fed will require tangible evidence of a deterioration in growth to justify a policy reversal back into easing mode. With the next FOMC meeting taking place in mid-June, there will be little if any hard data for the Fed to point to showing damage to the economy from current trade policy measures. From there, however, investor expectations jump considerably: market-based probabilities of a rate cut go from 23% at the June meeting to nearly 68% by July (they continue to rise the further out we go, reaching nearly 100% probability of multiple cuts by year-end). The current economic data, however, implies a much lower probability: looking at a key gauge of U.S. manufacturing activity (the National Association of Purchasing Managers' PMI index) as well as the strength of the labor market, the implied probability of a rate cut within the next six months is 35%, higher than it was last year but still fairly low for the time being (Chart 2, above).

Chart 2: Current Level of Activity Not Pointing to Near-term Rate Cut

We also believe the Federal Reserve will want to be mindful not to act too quickly to avoid sending the wrong message – that is, that they stand ready to cut interest rates left and right to bail out the economy and that, therefore, additional trade restrictions can be put in place without worrying about their impact on growth. Having said that, it's clear that pressure on the Fed has been growing and – if U.S. trade policy takes a more ambitious turn – it becomes increasingly likely that, over time, we will begin to see interest rate cuts out of the Fed in response to the ongoing trade dispute(s)'s drag on growth, fueling of uncertainty, and adverse impact on the business and consumer outlook.

Lots of Market Bark, But How Much Actual Economic Bite?

The bond market's recent message really has been two-fold: aside from a dramatic increase in rate cut expectations, the bond market has also raised a red flag regarding U.S. economic growth, bringing the yield on the U.S. 10-Year Treasury ominously lower to signal that it now considers the U.S. expansion at risk. Although we certainly are expecting the current array of tariffs to begin weighing on economic growth, our Investment Committee believes the result will be slower but still positive growth for the time being, a view supported by both the economic- (based on hard data) and market-based (based on changes in stock and bond prices) probabilities of recession (Chart 3, right) which have both risen slightly but generally remain relatively low by historical standards. As a result, we currently maintain our view that a U.S. recession remains unlikely in the near-term.

Chart 3: Slower Growth: Yes. Recession: Not Yet