NBAD

From West to East

Weekly Investment View

28th August, 2016

What the lady really said at Jackson Hole

The markets moved nervously in ranges last week, second-guessing what Fed Chair Janet Yellen might say in her speech at the Jackson Hole symposium in relation to the possible timing of a further increase in US interest rates. In this report we have attempted to boil down the content of what was actually said, removing the worst of the monetary jargon, to reach some basic conclusions regarding the parameters within which the US Federal Reserve operates. In the markets, the S&P500 closed down 0.7%, Eurozone stocks were 1.4% to the good (the euro was weaker), Japanese stocks were 1.1% lower (reflecting weak domestic inflation data), Chinese stocks were 1.7% weaker (following good gains in previous weeks), and the dollar was 1.2% stronger on its index over the week. Oil prices continued to be helped by talk of output restriction discussions in Algeria next month, and also by a static US rig count from the previous week.

'Janet Yellen gave the impression of preparing the market'

The Jackson Hole gathering is generally an academic, non-market moving event, but this time there was trepidation regarding the Fed Chair's remarks, causing market participants to be on the edge of their seats. She stated, "In light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months". She went on to say this was data-dependent but seemed to raise the prospect of a US rate rise sooner rather than later, and that rallied the US dollar. Also last Friday, the Bank of Japan's Governor Haruhiko Kuroda said they would act to achieve price stability, suggesting further monetary easing may follow in the coming months. Benoit Coeure, an ECB executive board member, commented at the weekend that if other central banks didn't act to stabilize prices, they would look to provide more monetary easing.

So what else did Ms Yellen actually say? The US economy had approached the Federal Reserve's statutory goals of maximum employment and price stability (but with no mention of the unadjusted version of the unemployment rate, just below 10%, and with price stability being inflation of 2%). The labour market is expected to make further progress, with US inflation picking up as a result.

'Yellen ignored the volatility in US retail sales, and still-low labour participation'

She said, "US economic activity continues to expand, led by solid growth in household spending, …but business investment remains soft, and subdued foreign demand and the appreciation of the dollar since mid-2014 continue to restrain exports" (so (a) they are ignoring the volatile, inconsistent nature of retail sales and increase in the savings rate, (b) they really are worried about corporate investment, and (c) let's not forget how dollar strength hurt the economy…). Then: "While economic growth has not been rapid, it has been sufficient to generate further improvement in the labor market…Although the unemployment rate has remained fairly steady this year, close to 5%, broader measures of labor utilization have improved" (but the latter is only fractionally off a multi-year low).

Continuing: "Inflation has continued to run below the FOMC's objective of 2%, reflecting in part the transitory effects of earlier declines in energy and import prices" (beyond their control, sure, but as oil prices have bounced this impact will reverse). "Looking ahead, the FOMC expects moderate growth in real GDP, further strengthening in the labor market, and inflation rising to 2% over the next few years" (further strengthening in the labour market could be more +180-190,000 gains, needed for unemployment to kept static – and if it might take another few years for inflation to rise to

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2%, that isn't a very optimistic view). So it does seem appropriate that, "…the FOMC continues to anticipate that gradual increases in the federal funds rate will be appropriate over time to achieve and sustain employment and inflation near our statutory objectives" (the emphasis is on 'gradual' i.e. not hugely bearish for markets, provided growth doesn't take off). From a different paragraph, the FOMC acknowledges that, "the economy is frequently buffeted by shocks and thus rarely evolves as predicted".

'There are good reasons for rates to stay low, vs. history'

Yellen's speech mentioned that forecasts show the Fed funds rate settling at about 3% in the longer run, vs. a historical average of above 7% between 1965 and 2000. So the Fed is expected to have far less scope for interest rate cuts than in the past. Ms Yellen referred to the marked decline over the past decade, and globally, in the '*long-run neutral real rate of interest*' - i.e. the inflation-adjusted short-term interest rate consistent with keeping output at its potential on average over time'. She noted several

reasons for this: the slower growth in the working-age populations of many countries, smaller productivity gains in advanced economies, a reduced propensity to spend (after the various financial crises around the world since the late 1990s) – and lastly the possibility that there is a shortage of attractive capital projects. She linked all this to the existence of very low bond yields, before admitting that "…our understanding of the forces driving long-run trends in interest rates is nevertheless limited, and thus all predictions in this area are highly uncertain" (so if we think we are in the dark, they admit they are as well).

So given an average fed funds rate of about 3% in the long-run, how can the Fed fight recessions? Ms Yellen noted that during the past nine recessions, the FOMC cut the fed funds rate by between about 300 to 1000 basis points, with the average being about 550 basis points – so the Fed could face a shortfall of about 250 basis points in the scope it might need to deal with the average recession. "The fed funds rate at the start of the past seven recessions was appreciably above the level consistent with the economy operating at potential in the longer run… and reflected some combination of initially higher-than-normal labor utilization and elevated inflation pressures", she said. Continuing, if these circumstances occurred again in the future, "the federal funds rate at the onset of the recession would be well above its normal level, and the FOMC would be able to cut short-term interest rates by substantially more than 3 percentage points". However, Yellen referred to a study which concluded that, "even if the average level of the federal funds rate in the future is only 3%, (new policy tools) should be sufficient unless the recession was unusually severe…". She then observed that, "this analysis could be too optimistic…".

'Yellen hinted at no use of negative rates on her watch'

Yellen said that, "By some calculations, the real neutral rate (i.e. where fed funds *should* be) is currently close to zero, and it could remain at this low level if we were to continue to see slow productivity growth and high global saving". Under such conditions, "the average level of the nominal federal funds rate down the road might turn out to be only 2%" (i.e. at least more accommodative than 3%). The simulation analysis referred to in her speech, "certainly overstates the FOMC's *current* (her italics) ability to respond to a recession, given that there is little scope to cut the federal funds rate at the moment". However, she goes on to say, "In addition to taking the federal funds rate back down to nearly zero, the FOMC could resume asset purchases and announce its intention to keep the federal funds rate at this level until conditions had improved markedly" (so they would not hesitate to bring back QE if they had to).

She added, "…future policymakers might choose to consider some additional tools that have been employed by other central banks… for example, they may wish to explore the possibility of purchasing a broader range of assets. Beyond that, some observers have suggested raising the FOMC's 2% inflation objective, or using nominal GDP targeting…I should stress, however, that the FOMC is not actively considering these additional tools and policy frameworks, although they are important subjects for research" (so she stamped on much that had been speculated upon before the meeting: they will not buy stock EFTs (like Japan); they will not raise the inflation target (i.e. allowing it to get out of control before they act), or target a GDP number (too difficult to control).

'Fiscal policy toolkit needs to be improved'

Interestingly, Ms Yellen said, "Beyond monetary policy, fiscal policy has traditionally played an important role in dealing with severe economic downturns. A wide range of possible fiscal policy tools and approaches could enhance the cyclical stability of the economy" (so she underlined the use of fiscal policy in conjunction with monetary policy, at the same time hinting that the fiscal toolkit needs to be expanded). Also, the lack of productivity growth is underlined as a worry: "Finally, and most ambitiously, as a society we should explore ways to raise productivity growth… (which) would tend to raise interest rates and therefore would provide greater scope to ease monetary policy in the event of a recession" (but she regards raising productivity growth as 'ambitious', hence difficult to achieve, keeping rates low).

Investment Strategy Summary:

Our Asset Allocation Committee met last Thursday (prior to Jackson Hole), with the main conclusions that overweight positions in High Yield Corporate and Emerging Market Debt should be reduced to neutral, boosting cash levels, pending analysis of market outcomes from the symposium. As evidenced by funds flows, these sectors have been bought aggressively, and now look very over-bought, with some valuations at extremes. The Bloomberg US Dollar High Yield Corporate Bond Index is up 14.7% for the year-to-date, with its yield down to 6.39%. The JP Morgan Emerging Market Bond Index is up, also by 14.7% over the same period. The average yield on EM Investment Grade bonds has fallen to 3.60%, from a high of just under 5% in January. If the Fed does move next month, that could prick a short-term bubble in these asset classes. Next Friday's August Non-Farm Payrolls (forecast to come in at +180,000) will be very important in determining the near-term course of US rates. The case for being fully diversified across portfolios looks especially strong at the moment. We expect to see good opportunities for alpha generation later in the fourth quarter and going into 2017. Positions in gold as a 'safe haven' continue to be recommended, especially given current uncertainties. Investment flows into gold-related assets have looked solid.

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