



# Economic Outlook: A Perspective from the Markets and Prices

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February 27, 2020

# On the Road to the Holy Grail of Monetary Policy

## Today's Complacency

- Full Employment, Price and Financial Stability
- Walter Donovan
  - “We are on the verge of completing a quest that began almost two thousand years ago. We’re just one step away.”
- Indiana Jones
  - “That’s usually when the ground falls out from underneath your feet.”

# The Outlook in a World of Disequilibrium

Not Starting from Square—Four Markets all in disequilibrium

The market can remain irrational longer than you can remain solvent

PCE Core Deflator Persistently Below Target

Wrong Target? Phillips Curve Model ---Autocorrelated Errors

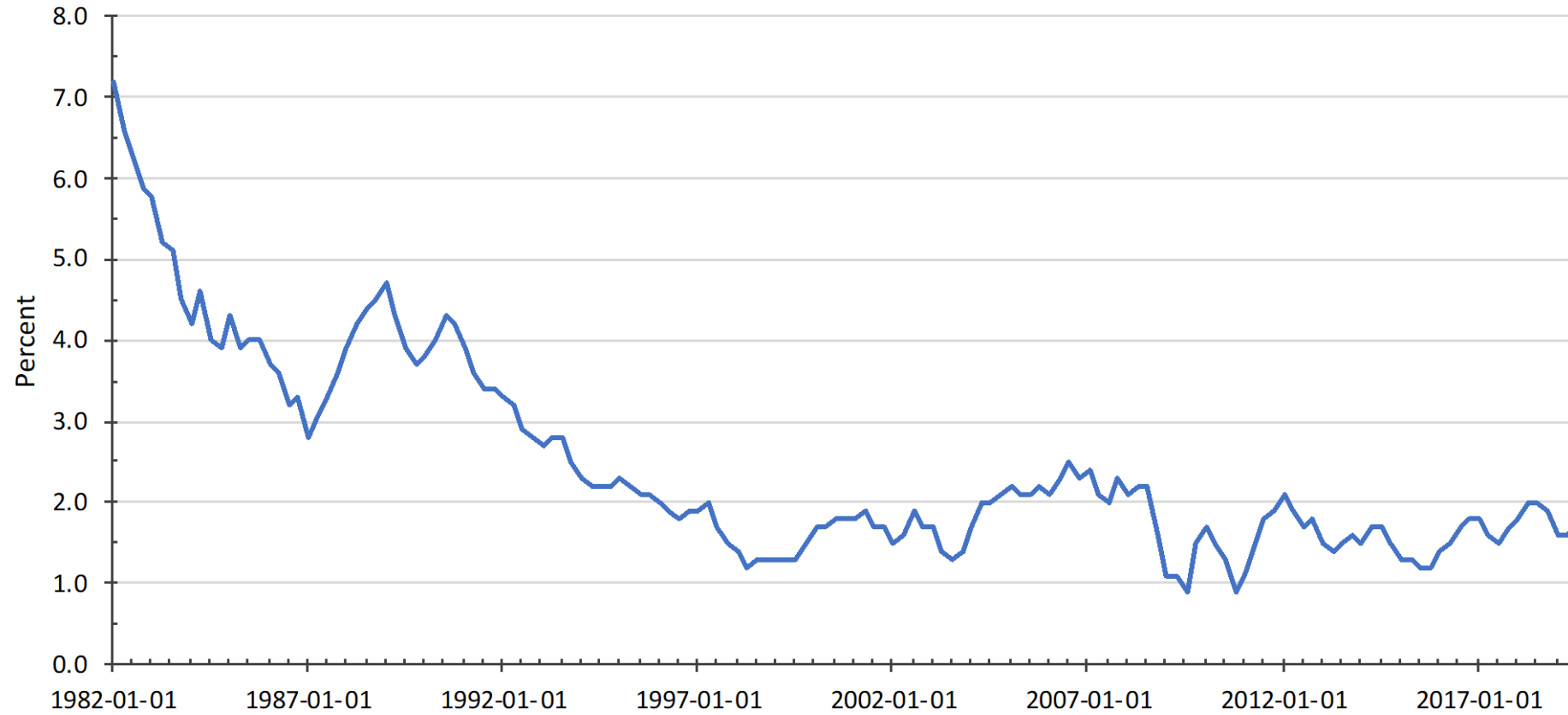
Normalizing Interest Rates—Normal to what?

Too High for Inflation Target, Too Low to Avoid Speculation

Managed Currencies—Persistent Trade Deficits-No BP equilibrium



## Personal Consumption Expenditures Deflator Change From Quarter One Year Ago



# Sticky Price Index

## Percent Change From One Year Ago



# Forces Unleashed

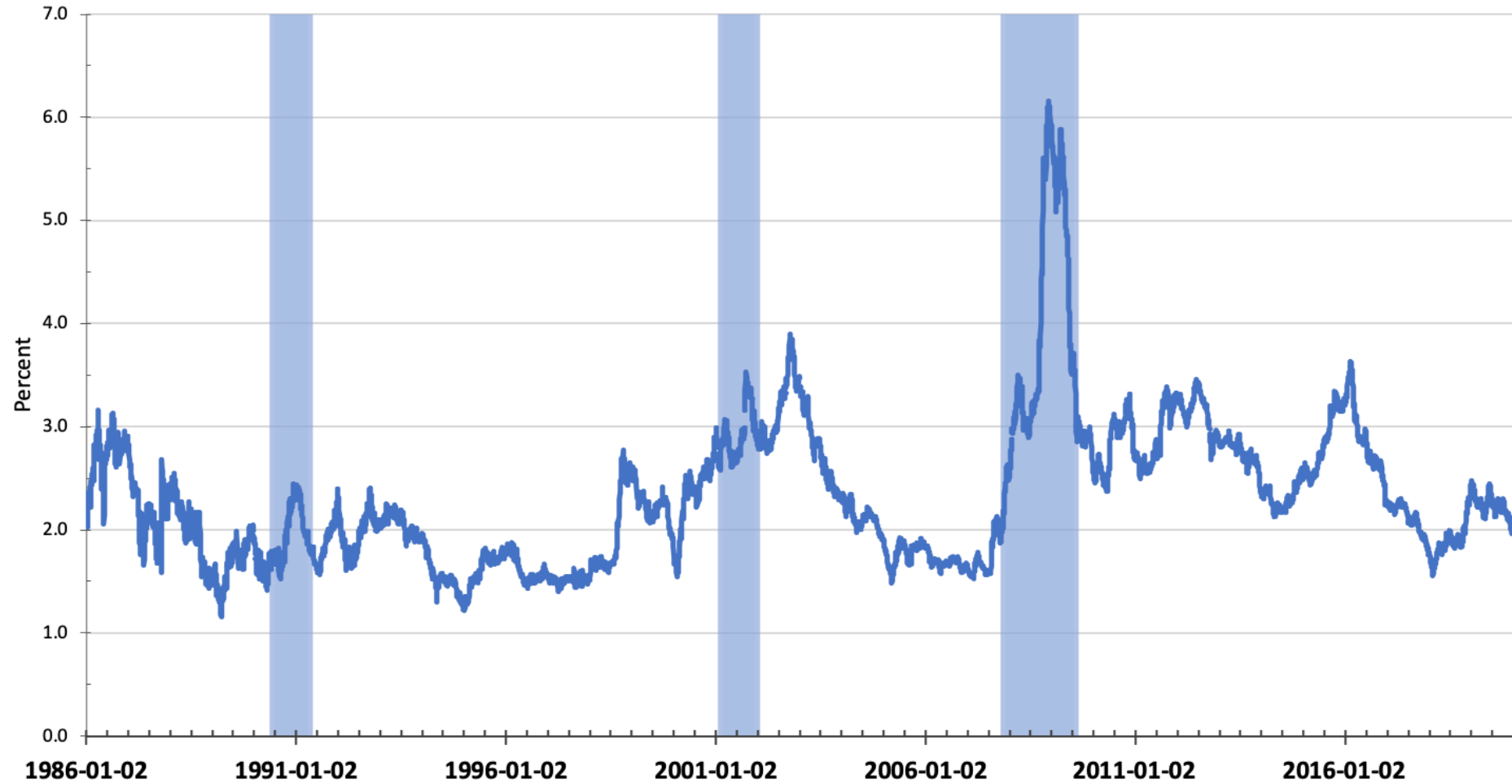
- Equity Market ---Value in Profitless IPOs?
  - Low Cost to Finance Speculation—Low opportunity cost with low interest rates
- Inflation “low” Therefore-Real Personal Income, Real Wealth Too High?
- Normalized Rates? Equities Overvalued, Credit Risk Underpriced
  - “Moody’s warns on frothy US junk bond market” 12 20 2019 FT
  - “US banks look vulnerable to a leveraged loans” 12 19 2019 FT
- Exchange Rates: “Why the Fed Changed Direction But the Dollar did Not” 05 01 2019 FT
  - “Asian Corporates gorge on debt—hard currency bonds” 0910 2018 WSJ



# President Bostic on CNBC: “Excessive Risk”

- Signs?
  - Equity and the Economy
    - Wilshire Index 170% of GDP
    - Second to 183% 2000-2001
    - 60% average over the past century
    - 81% in 1929
    - Excessive—more than 3 standard deviations away from the mean
  - Russell 2000 and Profits
    - 36% of Russell 2000 companies generated a net loss over the past 12 months
    - Yet, the Russell 2000 trades at 38.6 times trailing earnings

**Corporate Bond Yield Relative to Yield on 10-Year Treasury Constant Maturity**  
Percent, Daily, Not Seasonally Adjusted

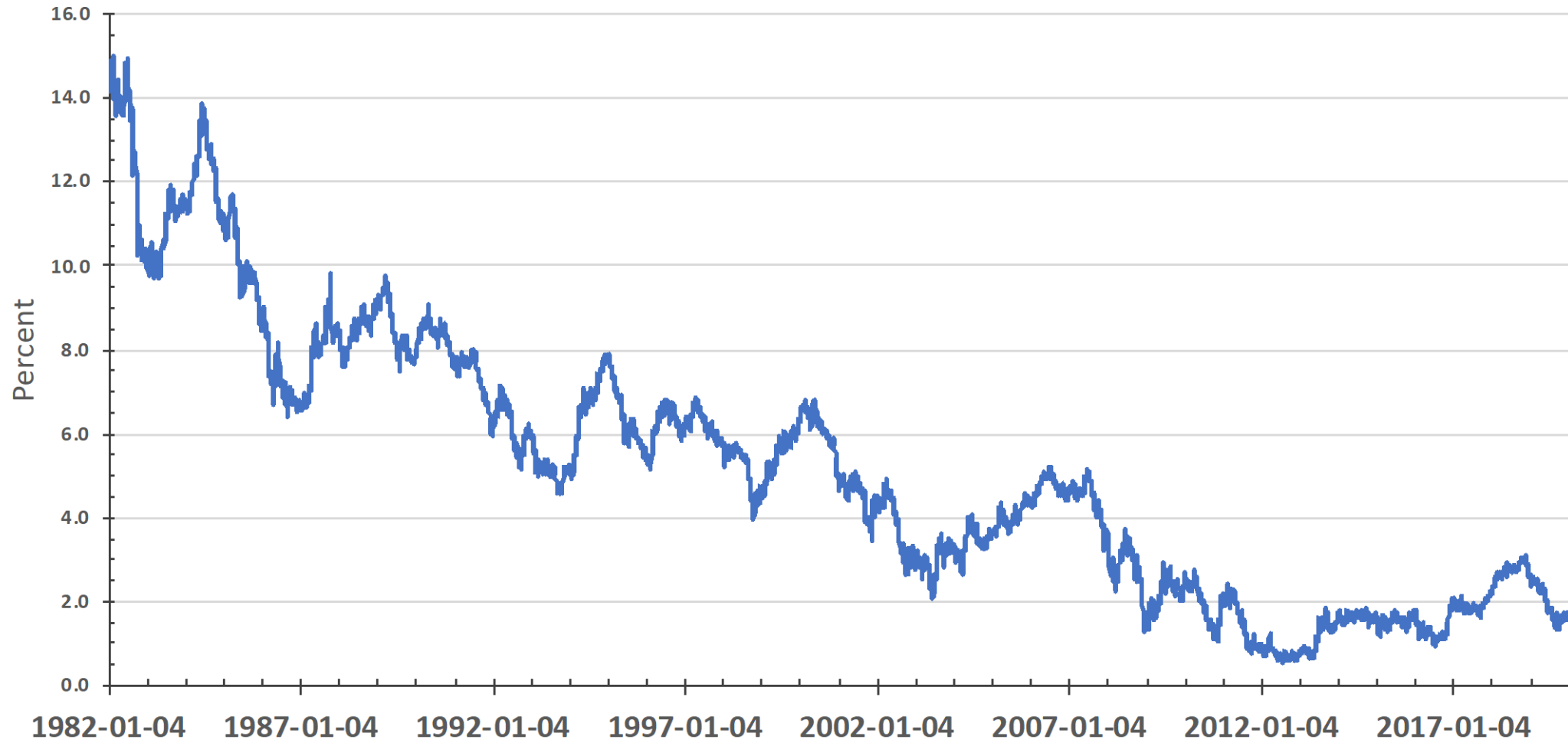


# So What Happens?

- Equity Market Forces—Correction(?) in Profitless IPOs--Restructure
- Inflation: Lessons from The Post WWI Gold Standard
  - Wrong target
  - Drift Upward in Alternative Inflation Benchmarks
  - Fed –ATL—not so sticky prices 2.8/2.5/2.1% last three years
  - Decline in Real Incomes, Wealth
- Normalized rates? Fixed Nominal Rates in a world of rising Inflation
  - Aggravates the low opportunity costs of speculative finance
- Exchange Rates: “Euro drops to weakest level since 2017 (against the dollar)”  
011320 FT



## 5 Year Treasury Constant Maturity Rate Percent, Not Seasonally Adjusted



# Short-Run Cycle Signals: Real Side






- Jobless Claims
  - 212 (4wk ma), below the average since December, 300 still bright line?
- ISM-Manufacturing
  - 50.9 (Jan.), above 4Q but below YA, production and orders above breakeven, jobs below breakeven, export orders up (global)—Pre Virus headlines?
- Factory Orders
  - Non-defense capital goods orders (ex-aircraft) down in Dec., up 1.0%CHYA
- Building Permits
  - Dec. @ 1.42M, above 3M and 12M averages, Pending Home Sales down in Dec. but above YA
- Confidence (Conf Bd) up in Jan. both present situation and expectations up



# Excessive Risk on the Credit Side?

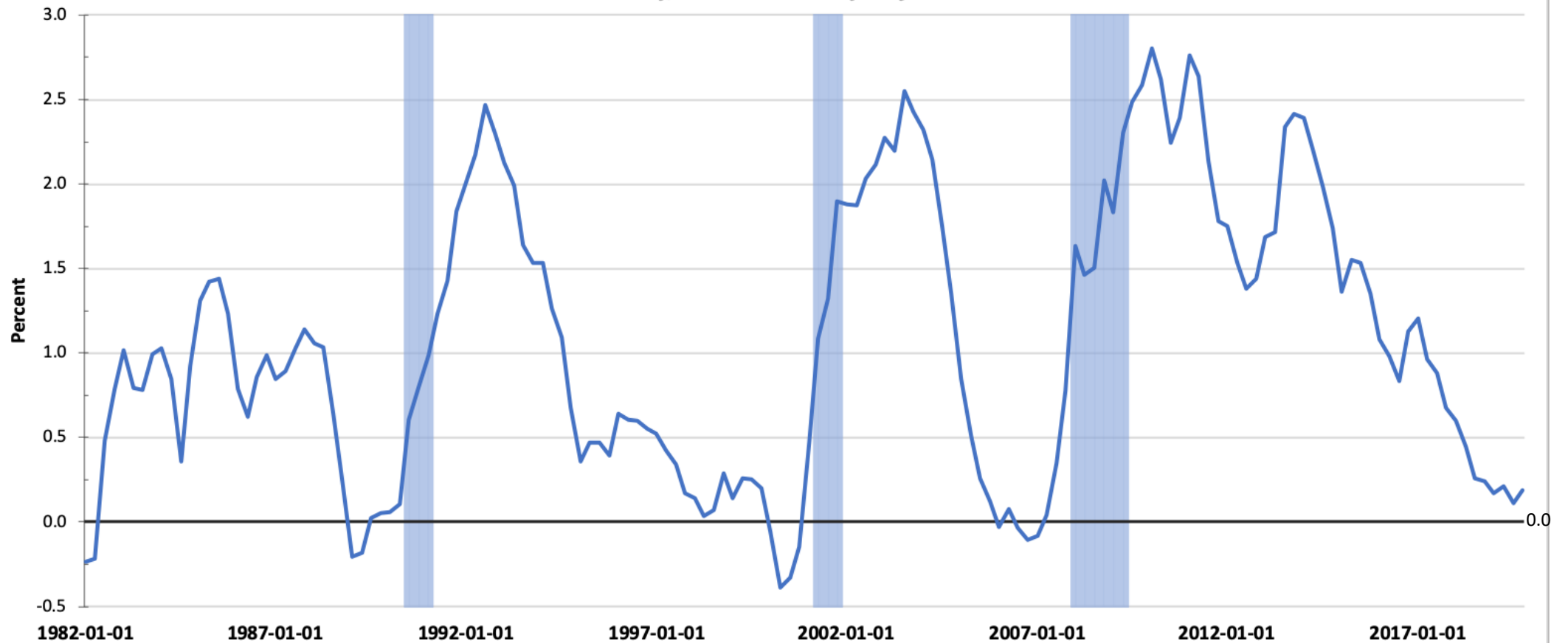
- S&P Ratings 65.1% of U.S. leveraged loans were single-B or lower versus 37.4% at the end of 2007
- First-lien debt to Ebitda for leveraged loans were 5.2 times in 2019 (matched all-time high in 2018), and a steady increase over the years from 3.8 times in 2008. For comparison, the ratio was 4.9 times in 2007 (S&P)
- Proportion of leveraged loans rates single-B-or-lower by S&P was above 65% in 2019---a steady rise from 53% in 2015 and compared to less than 40% in 2007.

# Short-Run Cycle Signals: The Financial Side

-  Equity Market: S&P 500, up 9.07% L3M, +22.88% Year ago
-  Quality Spreads (4Q 2019) : HY, BAA below YA
-  Leading Index: down in Dec. and flat versus a year ago
-  Corporate Profits ,adjusted after-tax: (3Q prelim) up 0.4% YA
-  Dollar Index: 99.07 up 2.2% YOY



**10 Year Treasury Constant Maturity Minus 2 Year Treasury Constant Maturity Percent,  
Quarterly, Not Seasonally Adjusted**



# Lessons in Credit

Progress is Cumulative in Science and Engineering,  
but Cyclical in Finance

Jim Grant



# Aggregate Demand

- Consumer Fundamentals
  - Real Income, Confidence, Credit Availability, Wealth
- Business Fixed Investment
  - Expected Final Sales, Credit/Profits/Interest Rates
- Federal/State Spending
- Residential Investment
- Inventory/Sales Ratio
- Japan: Easier FP, MP, slower Japanese export growth, 4Q GDP negative
- China easier reserve ratios, Canada slower job growth and metals exports?



# Economy: Full Speed Ahead, A Little Overheating

- Satipo “Let us hurry. There is nothing to fear here.”
- Indiana Jones “That’s what scares me.”
- So far so good: Half Time Score--- Falcons 21 Patriots 3

# Country Issues: A Sense of Balance?

- Fiscal deficit/GDP: >3% U.S., >2% Japan, France, Italy, Spain
- Negative Nominal 10Y rates: Germany, France, flat Japan
- Negative real rates: Japan, Germany, U.K., Switzerland, flat Canada, U.S.
- Inflation: Mexico 3+%, U.K., U.S. below 2%, Canada ~2%, Euro 1.2%, Japan < 1%
  - China 4.5+%
- Exchange Rates: Canada, UK, flat versus U.S. dollar, Euro Yen Mexican peso down, Chinese Yuan Appreciation versus year ago.



# Global Outlook: Major Trading Partners

- China: GDP slowdown, Yuan appreciation since 2013
  - Foreign exchange reserves steady, aggregate financing up
  - Dec 15---trade deal Phase I, drop currency manipulator tag
  - Easier reserve requirements
- Canada: flat GDP, inflation steady, BOC—unchanged, USMCA?
- Mexico, BOM cut growth forecast, expect lower rates 2020, USMCA?
- U.K.: Brexit Jan. 31, MPC dovish/shift Bailey March 16, composite PMI < 50
- Germany: PMI > 50 at EOY but autos weak
- Japan: slower Japanese export growth L12M, PMI < 50, Tankan down



# Inflation and Interest Rates

- Interaction of Product Prices, Wages, Productivity
- Tariffs—a one-time change in prices—not inflation
- Goods versus Services
- Short-term Rates: Anchored to the Fed
- Long-term UST rates: Deficit Finance and Central Bank Demand



# Excessive Risk: Money and Banking

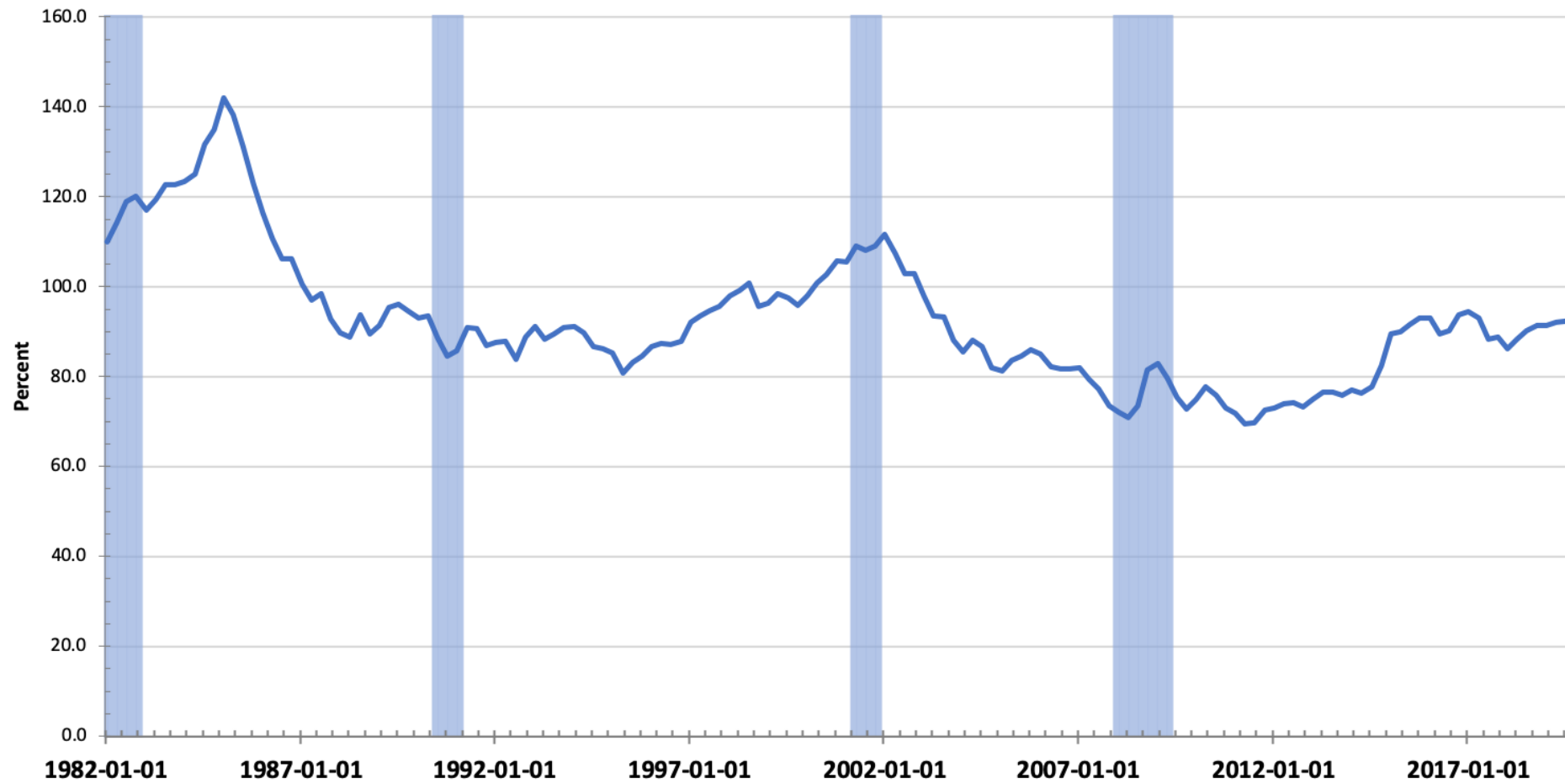
- Federal Reserve Bank Credit Growth
  - 21.2% L3M, 19.8% L6M, 2.8% L12M
- Fed “Shared National Credit Review, Jan. 31
  - Loans Deemed Classified up at 6.9% in January, up from 6.7% last January
- Fed SLOOS January 2020
  - “Significant net shares of banks expect performance to deteriorate for both credit card and auto loans to nonprime borrowers”

# Profits and Exchange Rates

- Profits: Slower Growth Year over Year yet Rising P/E ratio?
  - Top Line Sales
  - Bottom Line—Unit Labor Costs
  - Problem Internal Finance
- Exchange Rates; Stronger Dollar
  - Private Capital Flows—Corporate, Agency, UST
  - Relative Expected Short-term Interest Rates
  - Managed Exchange Rates

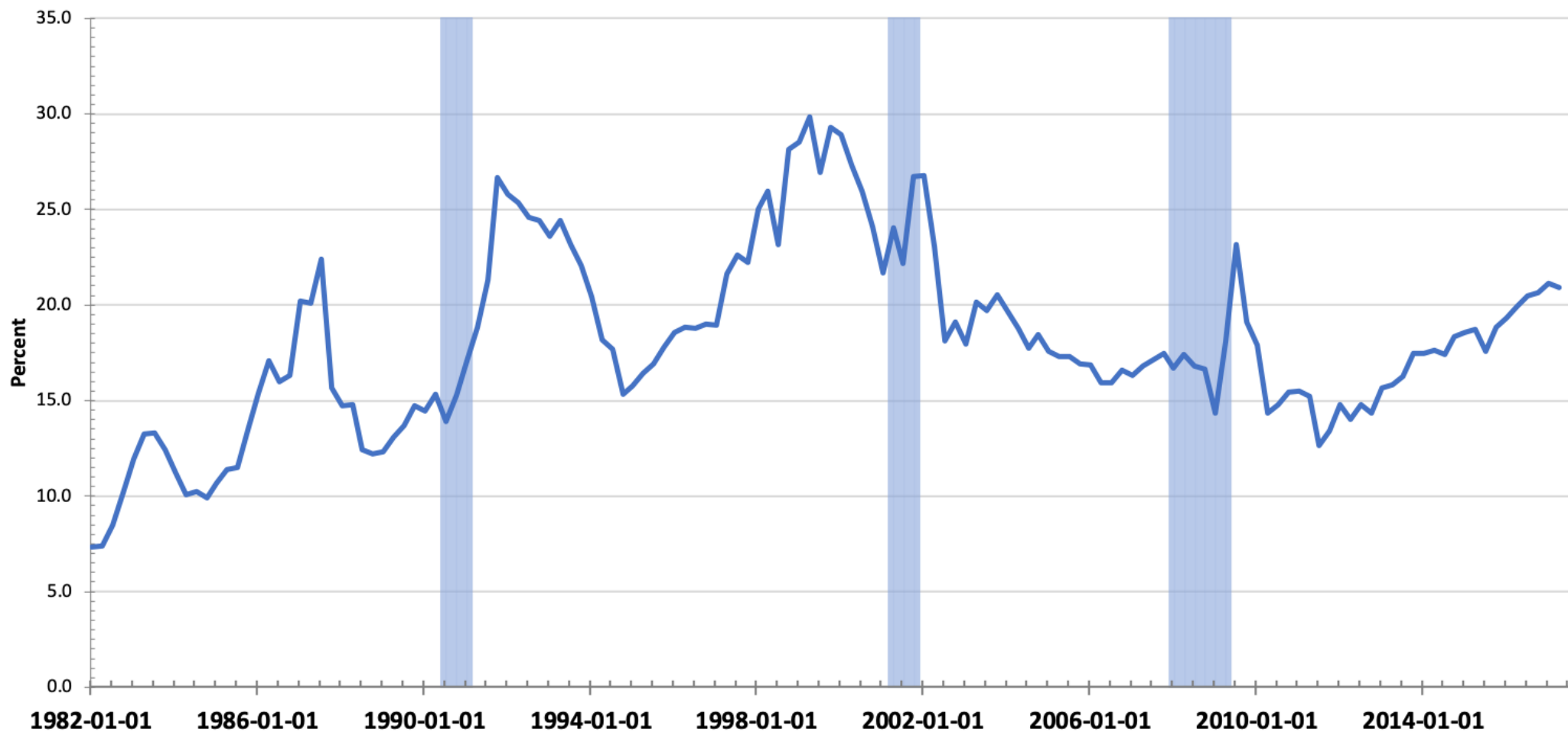


**Trade Weighted U.S. Dollar Index**  
**Quarterly, Not Seasonally Adjusted**



# P/E Ratio

## Quarterly, based on the S&P 500





# Baseline Outlook: Consensus on Disequilibrium

- The Indiana Jones Approach to Forecasting:
  - “I don’t know, I’m making this up as I go.”




		2020	2021
• Growth:	GDP	2.0%	2.2%
• Inflation:	CPI	2.1	2.2
	CORE PCE	2.0	2.0
• Interest Rates:	10Y	1.9	2.1
• Exchange Rates:	managed exchange rates +/- 5%		
• Profits:		up 2-3 %	



# The Big Issues

-  **Yield Curve: neither necessary nor sufficient for a recession**
-  **Case for slower, positive growth**

**Capital Goods orders, Profit Growth, ISM-manufacturing**

-  **Trade: a 100-year issue- supply chains/reliability/ redundancy**
-  **European area-continued weakness, low interest rates, capital outflows**
-  **China secular slowdown: slower global growth/exports/ low inflation**



# There is Nothing Permanent But Change

- Heraclitus

