THE National Investor

Sept. 4, 2018 *You can get information anywhere. Here, you get KNOWLEDGE.* Vol. No. 23 -- 17

A FED-FOCUSED FALL

As I alluded to in the immediate aftermath of his closely-watched speech to the assembled banking intelligentsia at the Kansas City Fed's picnic in Wyoming, Fed Chairman Jay Powell made very clear that the central bank's "normalization" mode is pretty much on auto pilot. As I expressed right afterward, the notion that crept into the markets of his being a *dovish* speech is certainly not what Yours truly heard.

Indeed, as you already know, I am of a mind that the Fed will be front-and-center in the markets' mind as we move into Fall. While, at the end of the day, all the issues involving trade and what not do matter somewhat, at the CORE of what *should be* the factors watched by markets is a central bank **about to ratchet up the tightening**. This month it will go to a net $50 billion/month reduction in its balance sheet; and quite likely signal at the next F.O.M.C. get-together on September 25 - 26 that a fourth hike in December is still in play.

First, on the federal funds rate: as I discussed in some detail after his speech, **most everyone else overlooked the ongoing key reason why Powell wants to keep this game of Monetary Jenga going: THE MARKETS.** Said Powell, in part, "In the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation. Thus, risk management suggests looking beyond inflation for signs of excesses."

Echoed Cleveland Fed C.E.O. and President Loretta Mester in an interview from Jackson, *even with Fed "normalization" thus to date*, there were some concerns especially as to corporate and other debt and the overall valuation of the stock market generally.

That markets still don't (or don't want to) get this isn't a total shock. Everyone got so used to the so-called "Fed put" for pretty much a decade that maybe no one is capable of entertaining any idea other than that the Fed's job is to keep markets elevated. That the central bank, led by Powell (and supported by the great majority of Fed governors and voting F.O.M.C. members) has been fairly clear about not wanting markets to get any frothier seems an aberration *rather than a core motivation*.

A RENEWED RISE IN THE DOLLAR IS LIKELY

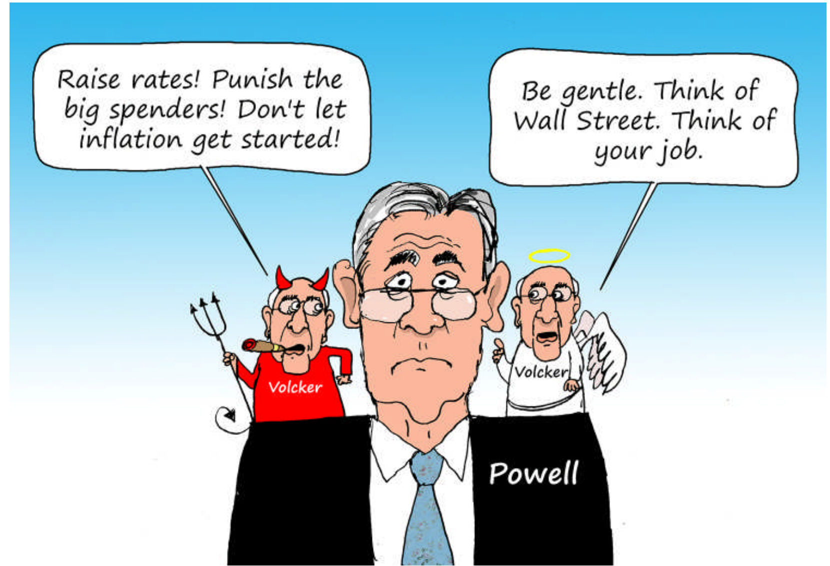
As I alluded to earlier, I'm kicking myself after the fact for advising that you sell EDZ. Already, as we are getting September underway, the U.S. Dollar Index is storming higher, back to well above 95. Even at its weakest recently of what is turning out to have been a very brief consolidation, the greenback merely went back down to "paint" that right shoulder (left) I discussed before with this same chart. The odds are high *if not overwhelming* that we will shortly see another attempt to leave that reverse H&S formation behind and push anew toward the 100 level.

That higher move in the U.S. Dollar Index will be caused by *several* factors:

-- **The Fed's rate hikes** -- Gradual rate hikes for the foreseeable future "remain appropriate," says Powell. While the one ostensibly "dovish" thing he did say at Jackson was that the Fed won't be too quick to accelerate its pace if inflation were to push higher than its target for a spell so, too, did he imply that he and others *still* believe that a small version of the 70's-style "cost-push inflation" is in the cards. And he doesn't want to see the Fed fall too far behind if its correct; that would lead to a "destabilizing overheating."

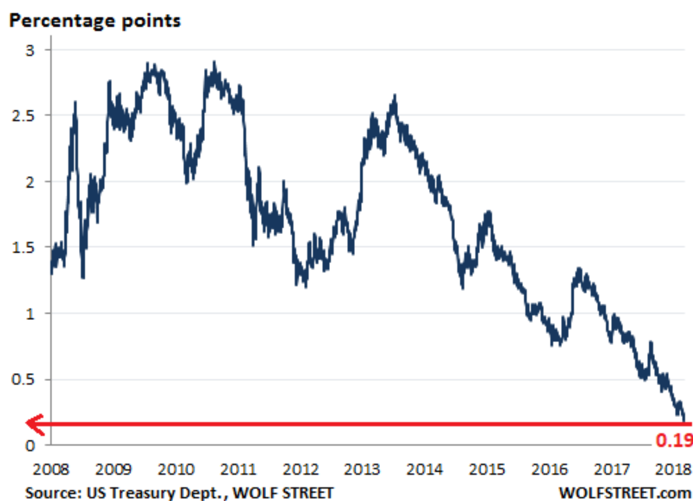
-- **The "Return (or Revenge?) of the Monetarists"** -- If anything, Powell has softened for public and market consumption--so far--what some suggest is a re-embracing of old school monetarism. By this, I mean that there could well be more of a retreat from the central bank's recent bouts of monetary activism than has met *even my eye*. My friend Wolf Richter -- at https://wolfstreet.com/2018/08/26/fed-staff-lays-intellectual-foundation-for-hawkish-approach-to-inflation/ -- recently reported on (among other related things) a research report authored by five economists on the Fed's staff, suggesting that the central bank might be inclined to go "early Volcker." *If this ends up being the case it will be that much more likely we'll see the Fed pull out that one proverbial stick too many at some point.*

-- **The markets are a bit "offsides"** -- This may sound strange given the recent reports of the dollar longs being a bit aggressive BUT--as I said earlier where gold is concerned (on those record short positions) long dollar positions likewise don't in and of themselves mean an end to the run. And that's all the more true if the underlying narrative supporting that stronger dollar remains compelling *if not becomes more so*.



Few in the markets right now expect an (early) Volcker-type attitude at the Fed. Near term, Fed watchers see a two in three chance at best of a fourth 2018 hike in the federal funds rate even though the Fed has virtually guaranteed one in its "dot plot." Longer-term whereas the Fed says the rate at the end of 2019 will be North of 3%, market expectations are for 2.6%. That latter would mean pretty much one or NO rate hikes in 2019. If I am correct and this month's F.O.M.C. meeting and resulting presser by Powell get the market to understand there WILL be a December hike...and likely more where that came from...*both* the dollar and rates will have to respond more.

-- **The E.C.B. remains stuck** -- As I have commented for a while now, Europe's dynamics are a MUCH different kettle of fish than the U.S. right now. Especially with Italy and (increasingly *again*) Spain banking issues, E.C.B. head Mario Draghi can *talk* all he wants about ending Q.E., unwinding his own balance sheet and maybe raising rates before the Second Coming. The FACT is the "Japanification" of Europe is continuing to gather steam. But unlike as with Japan's set of dynamics, the euro will NOT survive its own open-ended expansion. As currency traders get ever more whiffs that the only way the euro survives is to become a Venezuela-like currency, the dollar will benefit.



INVERTING THE YIELD CURVE

Perhaps as early as its upcoming hike the end of this month, the Fed will have inverted the yield curve for the first time in over a decade. The fact that it will have done so 1. consciously and 2. while dismissing the relevance of that occurrence today is telling; *and underscores that the central bank really is that "hawkish."*

For a brief time a couple weeks or so back, that 2 - 10 spread on Treasuries shrank to an 11-year low of a mere 19 basis points. As I write this it's opening back up a bit; mostly as the long end (back

to the 2.9% area on the bellwether 10-year Note, about the mid-point of its recent range) as at least some traders react to the continued strength for stocks, still-strong economic numbers for the U.S. economy, and the like. **But make no mistake: we are virtually guaranteed to see a full-on inversion (short term rates higher than long term ones) before year end.**

Besides *some* rotation of money from Treasuries to stocks as economic news remains good and the markets in the U.S. stay aloft **those changing Fed expectations should also lead to more *outright selling* at the long end.** That would be a belated admission that the market has underestimated the Fed's resolve. That will likewise lead to a little resurgence of the old *bond market vigilantism* as well; the combination of a hawkish Fed, modestly rising inflation and more Treasury debt issuance likely leading to another try to get the 10-year's yield North of 3% *sustainably*.

Thus, the impending inversion of the curve will be a matter of timing. The fed funds hike coming at month's end will *at least* come close. The question is whether traders are spooked enough by the Fed's hawkishness to stick to *their* guns (for some of them) and be bullish on the long end of the market, as they would think a recession is increasingly likely. Time will tell (and Yours truly will, too, as the various moving parts come into focus!)

The factor of foreign demand will continue to keep a lid on yields. With growth, currencies and entire national banking systems (read, Italy) creaky elsewhere, I don't care how much more net issuance the Treasury floats of its I.O.U.s (for the time being, anyway.) Demand from overseas investors will remain strong and may well get even stronger. So the odds remain against a *sustained* move higher for long-term yields. We probably *will* get a re-test of the high around 3.12% on the 10-year Note. *More than that, though, I doubt.*

DEFINING "NEUTRAL"

It won't be until *at least* December (assuming that is when we get a fourth rate hike for the year) when we get any suggestion from the Fed that it has reached what it will consider a "neutral" stance on monetary policy. That would be the first time we've been told such a thing is operational since before the 2008 Financial Crisis. Ever since it's been "accommodative," etc.

Leaving aside for a moment any rationale for why the central bank would afterward even be *restrictive*, by December it will have to figure out what equilibrium really is. In these times of rate structures necessarily being compressed well below historical levels, we won't see the federal funds rate 3 - 4 % points higher than the nominal rate of inflation like in the old days. But today? Maybe 1%. Which means that with this hawkish Fed "neutral" may still be closer to 4% than 3% funds rate.

We'll see. For present purposes it will be interesting to see whether this month's rate hike (and, importantly, what Powell telegraphs afterward) are enough of a jolt to markets to make a big difference. For already-weak emerging markets it could get ugly, especially if the dollar and interest rates rise strongly together. Already-bloodied commodities will lose more. And it all may just be enough to undermine world-leading U.S. stocks as well.

(The above is excerpted from the first regular issue for September)

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