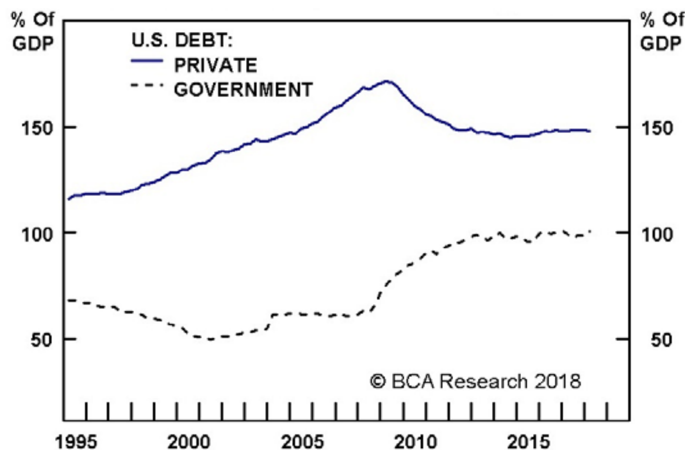
NOTES FROM THE NORTH: MARKET OUTLOOK

September, 2018

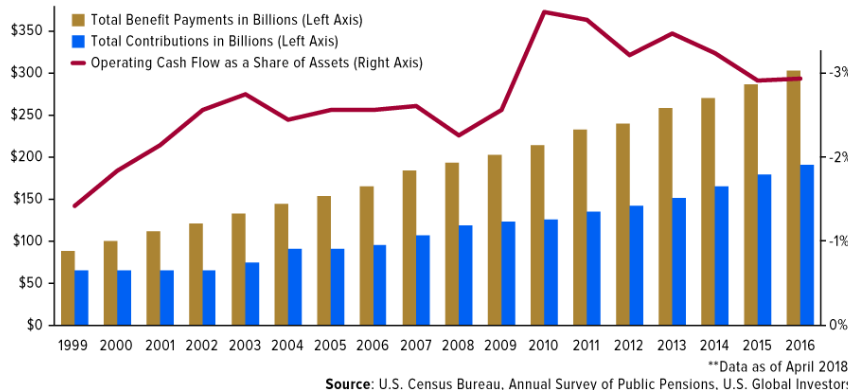
Sometime in 2008 or 2009, we remember having a conversation about how interesting it will be to learn about the Great Financial Crisis (GFC) from a history book. It's not exactly history yet, but it did officially pass its tenth anniversary recently, spurring a flood of articles reviewing the causes and the policies and actions used to mitigate the impact and set the stage for recovery.

In a nutshell, central banks lowered interest rates dramatically, in some cases to zero, while printing vast sums of money (a process known as "quantitative easing" or "QE") and pushing liquidity into the economic system. Now ten years past the crisis, the United States is clearly in recovery, allowing the Federal Reserve to start raising interest rates last October. Europe and Japan have been unsure as to the sustainability of their economic recovery and only now are thinking of beginning to normalize interest rates. In the U.S., asset prices have revived, banks are much better capitalized and have more restrictions on their operations, and despite surging student loan debt, the overall financial health of U.S. consumers has improved. For example, the household debt-to-income ratio is 30% lower than its 2007 peak, and consumers are not as exposed to changes in interest rates now that only 15% of the outstanding mortgage market is at an adjustable rate.



However, our annual fiscal deficit is ironically projected to reach 5.4% of GDP by the end of 2019. The divergent trends between private and government debt in the United States is highlighted in the chart at left. Around the world, global sovereign (government) debt has ballooned by 26 percentage points of GDP. The annual deficit of all governments remains elevated, at 2.9% of global GDP. At a minimum, high debt is viewed as an inhibitor of future growth. At its worst, it can cause havoc such as we are now seeing in Argentina, Turkey and South Africa. Italy could be next.

Like governments, U.S. corporations have used this period of low interest rates to borrow. It appears that most of the borrowing can be supported by future cash flows, but some companies with marginal investment-grade bond ratings could be downgraded to non-investment grade should rates rise sharply.



Source: U.S. Census Bureau, Annual Survey of Public Pensions, U.S. Global Investors

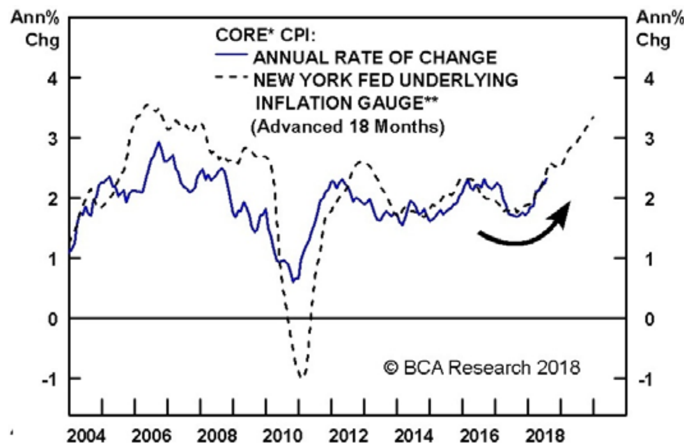
Pension plans might be negatively impacted by a raft of downgrades, and public pensions are already creaking under a surprising leap in unfunded liabilities at a time of rising stock and bond prices. Stephanie Pomboy notes that the $4 trillion in public pension liabilities *dwarfs* the $500 billion in underwater housing that helped trigger the GFC. She worries that a sharp, lasting market decline would deepen the pension hole, and could necessitate a bailout that could make QE "look like a rounding error."

The QE response to the GFC is not yet in the

history books. Other than in the US, central banks have not yet begun to raise rates or unwind their balance sheets. When Europe and Japan join the US on that path, net central bank purchases are likely to move from the equivalent of $100 billion a month in the fourth quarter of 2017 to zero starting in the fourth quarter of this year. Felix Zulauf, a Switzerland-based strategist and a long-time *Barron's Roundtable* participant, notes that a crisis usually begins when money gets tight. He writes that "while the Fed's balance sheet inflation since 2009 has inflated all sorts of asset prices, the serious reduction of its balance sheet should have just the opposite effect, namely to deflate asset prices." If Zulauf is right, when will the trouble start and what will it look like?

The conventional wisdom is that everything will be fine until rising inflation causes the Fed to raise interest rates too far. (The chart below illustrates recent trends in inflation.) BCA continues to think that the economy will continue to grow through next year and the equity bull market could stretch into the second half of 2019. However, rising rates could penalize bond prices over the next 12 months. J.P. Morgan strategists agree that prices on the 10-year Treasury will be pressured by a rise in rates from the current 3.0% level to 3.5%. From there, however, they believe the rate could be cut in half during the next slowdown. (That would make 10-year Treasuries a great investment in a weak economy when equity prices could be tumbling.)

Marko Kolanovic of JP Morgan agrees with BCA that equity investors are probably safe through the first half of 2019 and it is too early to cut equity holdings or move from cyclical to defensive stocks. However, Kolanovic raises a concern about a lack of liquidity in both bond and stock markets. He attributes this to a combination of new banking regulations that have caused the banks to gut their market making operations and the flow of funds from traditional money managers, who tend to buy when stock prices fall, to index funds and algorithmic traders, both of which tend to sell more stock when prices fall. The current bull market has been characterized by extended periods of calm punctuated with flash crashes. Recent examples include the 1,600 point intra-day drop in February of this year and a 1,100 drop in August of 2015. Note that both of these incidents occurred during an economic *expansion*. Kolanovic is worried that future flash crashes may be more violent and in fact could *cause* a recession (as opposed to a recession causing a market decline). This sounds daunting, indeed, but note that Kolanovic emphasizes his comments should be taken as a warning, *not* as a prediction.



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