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2018

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Around THE Curve

It’s Not Just One Thing

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After having taken a breather in July, volatility re-entered developing markets in August—and despite the headlines—the weakness wasn’t about one thing. The emerging market selloff was brought about by a more hawkish Federal Reserve (Fed), at a time when the pace of global growth has slowed. Trade tensions only added another level of uncertainty, which markets then had to price. The fact that market liquidity typically seizes up in August only exacerbated the price impact of these factors. It was the magnitude of the recent move in emerging market currencies that surprised many market participants. Though the events of early August were a short-term market contagion, emerging markets aren’t near an economic contagion—at least, yet. We outline what signals the Fed, and to a lesser extent, the White House, would need to listen to in order to deviate from their current policy objectives.

The Fed

Some markets were recently unsettled by an increasingly hawkish Fed amidst the widening relative growth differentials between the U.S. and the rest of the world, and the resultant strong dollar environment. Take a look at this Federal Open Market Committee (FOMC) statement from August 1:

> *Information received since the Federal Open Market Committee met in June indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators of longer-term inflation expectations are little changed, on balance.*

Some variation of the word “strong” appears four times in the opening paragraph alone! New Fed leadership usually creates uncertainty, and Chair Jay Powell inherently sounded more hawkish right out of the gate, particularly when compared to his predecessor, Janet Yellen. The Powell Fed is resolutely focused on domestic conditions. So unless something breaks in the U.S., the Fed isn’t going to change the course of tightening. Yet, the Fed has been tightening since December 2015. What could actually give the Fed reason to turn more dovish?

We expect the Fed will ultimately listen to the message embedded in the Treasury yield curve—we find it constructive that Chair Jay Powell referenced it in his recent Congressional testimony. Relative Treasury supply issuance has pushed the shorter end of the Treasury curve higher while the long end of the Treasury curve remains anchored by the relative spread differential to German Bunds. However, the real message embedded in the curve is a cautionary flag saying the Fed isn’t behind the inflation curve, a big reason why we think the Fed will eventually pay attention to this signal.

We will get more clarity on the thinking from Fed leadership at the Economic Policy Symposium later this week in Jackson Hole, but the markets aren’t expecting Powell to back off that fourth rate hike just yet. The return of U.S. dollar strength likely won’t be enough to convince the Fed to soften its hawkish tone at this juncture, but we believe the effects of a strong currency and the impact of tariffs on U.S. economic indicators should convince the Fed and White House to reconsider their policies.

The U.S. Corporate Sector

We've seen a significant uptick in capital expenditures (capex) this year but that appears to be waning—at least at the margins—as U.S. businesses postpone this type of investment spending until we get better clarity on the trade outcome. American corporations have to be extremely confident about their economic prospects in order to commit to capex; the current uncertainty on whether the U.S. is moving to a full blown trade war will have a negative impact on this source of economic growth.

It might take one or two quarters for the impact of tariffs to show up in U.S. corporate earnings—there's usually a lag impact of approximately 4-6 months. But when the impact does happen, we expect U.S. equities to sell off. Both the Fed and White House are interested in preserving U.S. equity market strength, though the two are increasingly at odds. The Fed wants to preserve household wealth, and Trump uses the stock market as one way to gauge the success for his presidency. A slowdown in capital expenditures, hiring, and wage growth will also be areas of concern related to corporate profitability.

However, the most immediate mechanism to change Fed policy and get the presidential administration to back off would be weakness in the U.S. equity market; dollar strength has really impacted the economy yet but somehow doesn't appear to be working its way into Fed discussions as of yet. Going forward, it will be a waiting game to see what will break in the U.S. economy that will be enough to convince the Fed, or even the White House, to back off.

Final Thoughts

We hold the view that a strong dollar is counterproductive to the Fed's and White House's objectives, and they could finally be convinced to change course once a strong dollar erodes corporate profits and the trade balance. Remember, we find that a 10% move in the dollar is approximately equal to 100 basis points of tightening. The best case would be an implicit or explicit agreement amongst the G7 along the lines of the *Plaza Accord* to devalue the dollar to improve the U.S.'s current account deficit.

At this point, it's still too messy and too early to assess the true impact of protectionist trade policy. As more and more countries find themselves within the crosshairs of the Trump Administration's tariffs, it's hard to imagine how many allies are ready to help the U.S. improve its trade and current account deficits. A big risk is moving into an economic Cold War that pits the U.S. against China, and watching how current allies align themselves. The NAFTA or bilateral negotiations with Mexico and the European Union will offer some insight on whether the Trump Administration wants to work with traditional partners and allies. China, though, is a strategic competitor, and hitting China with more and more tariffs could have very broad global consequences. We've read many recent headlines about the fear of an emerging market contagion sparked by Turkey, but the real risk to emerging markets—aside from the Fed making a policy mistake—is a more sustained slowdown in the Chinese economy.

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