UNCOMMON SENSE

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Stall Tactics: Will Borrowed Time Eventually Bring Down the Bull Market?

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"How did it get so late so soon?"

— Dr. Seuss

Regular readers of Uncommon Sense have likely noticed that each month it shows up a little later. Some of my more curious readers may even be wondering why this has been happening. Sadly, it's because I'm the master procrastinator! I can find almost anything to do except sit down and write this article. From the important — meeting with clients, speaking at conferences, giving media interviews and following the markets — to the mundane — making a grocery list, folding the laundry and watching TV. Not to worry, though. I give myself 1,000 mental lashes for each digression and I have a plan to get back on schedule. That is, if I can stop procrastinating long enough to execute the plan.

Anyway, this month, like all the months before it, I explained to my awesome editor that I needed more time to deliver a draft to meet our deadline. And, as always, she granted me an extension. Mission accomplished. What a pushover! Will she ever learn? Oddly, buying myself time makes me happy — like I'm getting something valuable for free. I feel like I'm living on the edge, carefully toeing the line while trying to avoid falling off the cliff. What a rush!

But wait. Aren't there negative consequences to my stolen time — stress, unhappy bosses, disappointed readers and missed deadlines? And, while I'm deeply satisfied living on borrowed time, aren't I playing with fire? Ironically, however, rather than ratchet up the stress, something positive has emerged from all my procrastination. I got an idea for this month's article. Like me, the market is operating on borrowed time thanks to a decade of accommodative monetary policy, the Trump administration's massive fiscal package and unresolved trade negotiations between the US and China. Investors fear volatility, illiquidity and many other risks. However, perhaps they should worry about the sustainability of a market chugging along on borrowed time, even as its 10-year milestone is in sight.

Rocky Mountain High?

To be fair, I have a few clients to thank for this month's borrowed time theme. When both the Dow Jones Industrial Average and the S&P 500 Index reached all-time highs during the third week of September, I was meeting with financial advisor clients in the great state of Colorado. As I reflected on those conversations once back in Boston (yes, you guessed it, to avoid writing), some of our clients' more skeptical questions and observations began to gnaw at me.

I thought back to a tasty lunch in downtown Denver where I had a wonderfully engaging and wide ranging conversation with a dynamic duo. Their wealth management practice has a small number of incredibly successful ultra-high net worth families. The team's leader explained to me that they were still confidently investing in US stocks. He kept pressing me to find flaws in their current investing logic. That's what great investors do. Admittedly, it's difficult to find reasons not to like US stocks right now.

As we said our goodbyes, the team leader casually mentioned how we had both experienced several market catastrophes during our investing lifetimes, he a few more than I. He predicted that there would be more in the future and lamented our collective inability to identify these painful events in advance for our clients.

It had been evident throughout our lunch conversation that this experienced investor was conflicted. On the one hand, he is confidently investing in US stocks. On the other hand,

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he intuitively knows that something about the current market environment doesn't feel quite right. I shared his uneasiness about this market environment, but I couldn't quite put my finger on a specific problem.

At another meeting in Colorado Springs, I spoke to a group of top financial advisors from the Rocky Mountain region. They politely listened to my prepared comments regarding the current state of the markets. But their questions also unearthed doubts about the perceived strength of today's market. Hadn't a decade of emergency global monetary policies artificially inflated asset prices? Sure, the massive US fiscal package has accelerated domestic economic growth, but aren't the stimulative effects only temporary? And, finally, on the surface it may appear that the US is winning all of these trade skirmishes, but over the long-term, doesn't rising protectionism lower overall global trade and thwart global growth?

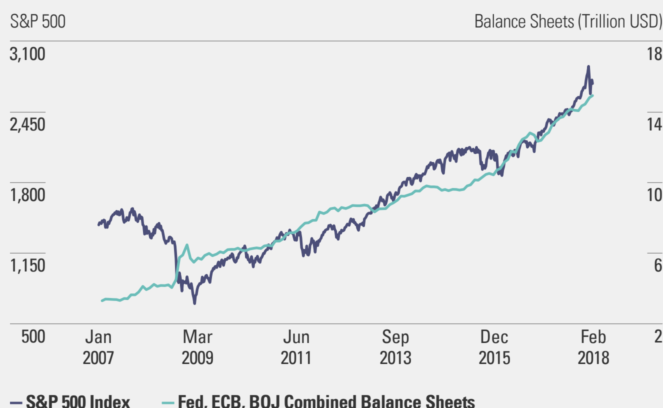
Boom! That's when I finally understood that aching uncertainty that something just didn't feel right about this bull market. Relief. Thank you, Colorado! Now let's explore how monetary and fiscal policy and trade talks have affected the market, walking that fine line between living on borrowed time and facing some sobering long-term consequences.

Slowly but Surely Moving Off Easy Street?

The US Federal Reserve (Fed) raised interest rates for the eighth time in the last three years on September 26. Despite these persistent rate increases, monetary conditions in the US remain wildly accommodative. In fact, today's targeted fed funds rate roughly equals the Fed's preferred measure of inflation. As a result, real interest rates in the US are essentially zero. The Fed's balance sheet may have peaked in early April 2016 at $4.5 trillion, but it weighs in at a still hefty $4.2 trillion as of September 19, 2018. That's a great deal more than the $870 billion in Fed balance sheet assets in early August 2007 just prior to the global financial crisis.[1] In addition, in his Jackson Hole speech in late August, Fed chair Jerome Powell further underscored his gradualist approach to monetary policy. The Fed may be simultaneously raising rates and reducing its balance sheet, but it cannot yet be described as tightening monetary conditions.

Not to be outdone, the Bank of Japan (BOJ) concluded a two-day meeting on September 19 by keeping its aggressive monetary policy unchanged, opting instead to monitor the effectiveness of recent tweaks amid chronically weak inflation. At a news conference, BOJ governor Haruhiko Kuroda told reporters that "the current powerful monetary easing measures are still necessary to achieve our 2 percent price stability target." The central bank's decision-making board voted to maintain ultra-low interest rates while pledging to keep rates down "for an extended period of time." It also kept unchanged its sizable purchases of risky assets.[2]

Figure 1: With the Fed Rolling off Its Balance Sheet and the ECB Set to Begin Tapering in December, the Impacts of Asset Purchases which Have Kept Borrowing Costs Low and Supported Equities Will be Lessened



Source: Bloomberg Finance L.P., State Street Global Advisors, 09/24/2018.

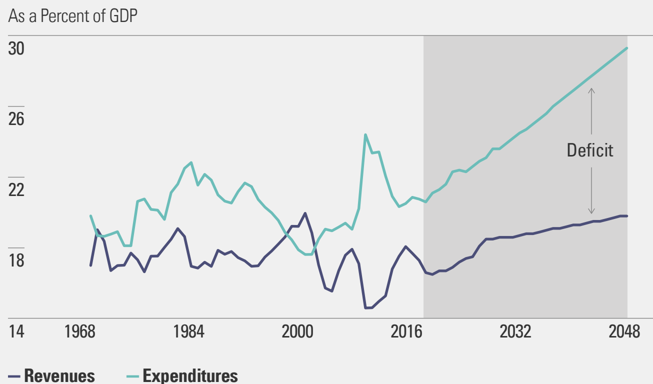
Finally, the European Central Bank (ECB) left benchmark interest rates unchanged on September 13. In a subtle change to the bank's guidance, the ECB announced plans to end bond purchases at year-end and keep interest rates at record low levels at least through next summer.[3]

So many central banks from around the world are keeping monetary conditions easy. But, if the global economy is on such firm footing, why is it necessary for the world's central banks to keep interest rates at historically low levels and balance sheets fat? Ten years on from the worst of the financial crisis, central banks are using what was supposed to be a temporary solution as a permanent crutch. Obviously central banks remain fearful about removing easy monetary policies too quickly from the fragile economy and markets. It may very well be the prudent course of action, but it sure feels like living dangerously on borrowed time to me.

The Money Pit?

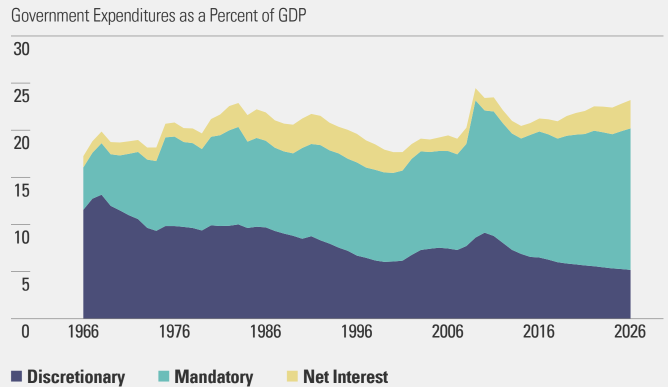
Monetary policy helped restore confidence in the financial markets and repair a challenging credit environment. It literally bought time for businesses and consumers to repair balance sheets and encouraged financial institutions to lend again. It supported and lengthened the shallow economic recovery and bull market. However, monetary policy was never able to return economic growth to the good old days.

Figure 2: The Budget Deficit is Set to Balloon from 3.5% of GDP Last Year to an Unprecedented 9.5% of GDP by 2048



Source: Congressional Budget Office, State Street Global Advisors, 09/24/2018.

Figure 3: Mandatory Spending and Interest Payments Will Rise to 18% of GDP by 2026



Source: Congressional Budget Office, State Street Global Advisors, 09/24/2018.

With the rise of populist candidates and in the aftermath of a wild 2016 presidential election, fiscal policy quickly became the silver bullet solution to boost our long but shallow economic malaise. With Republicans firmly in control, a massive fiscal stimulus package was passed with the expectation that it would permanently alter the trend growth rate to a much higher level. Classic supply side economics.

According to Strategas Research Partners, this year we will see $700 billion in repatriated corporate profits, 122 billion in individual tax savings, $80 billion in corporate tax cuts and $100 billion in increased government spending.[4] In addition, accelerated depreciation that was incorporated as part of the new tax plan has spurred businesses to increase capital spending by 13 percent year-over-year.[5] All told, more than a trillion dollars in fiscal policy will run through the US economy in the coming quarters. And, its positive effects are easily observed. The US economy will likely have back-to-back quarters of 4+ percent GDP growth. Productivity measures are climbing. On September 20, the number of Americans filing for unemployment benefits fell to the lowest level since November 1969.[6]

All this good cheer comes with some painful long-term consequences. The US federal deficit is fast approaching a trillion dollars. The US federal government debt burden has surpassed $21.5 trillion. Nearly 80 percent of every tax dollar the US government collects goes to pay for entitlement programs (i.e. Social Security, Medicare and Medicaid) and interest expense on that giant debt load.[7] And, the problem is only getting worse as the American population ages and the debt burden rises. As a result, the US Treasury is on track to issue over $1 trillion in marketable debt this fiscal year.[8] It is unusual for the government to be borrowing so much when the economy is doing so well.

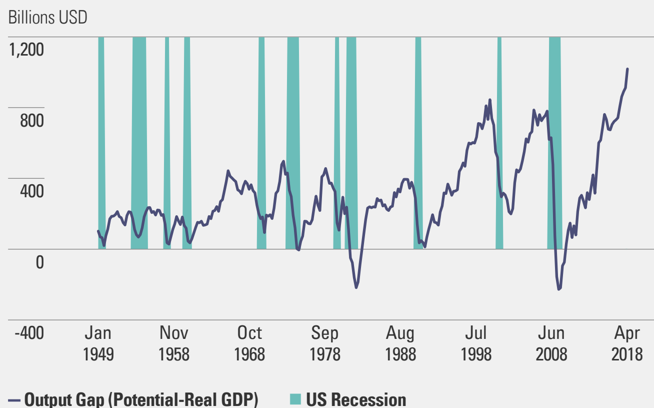
Admittedly, policy wonks and market watchers have been warning about these risks for decades. So far, it hasn't mattered too much. However, longer-term massive deficits brought on by profligate government spending will likely result in slower growth, higher interest rates or both. Until then elected officials will continue to borrow time to enhance their chances of being re-elected. Let someone else deal with the long-term consequences of their actions. Politicians happily living off the borrowed time of our children.

Clash of the Trade Titans?

I may be pressing my borrowed time theme a tad too far here, but give me a minute to address the trade dispute between the US and China. Secretary of the Treasury Steven Mnuchin kindly provided China one more chance to avoid tariffs on Chinese imports to the US when he extended an invitation to Beijing for more trade negotiations on September 12. Just a few short days later, on September 17, the Trump administration announced tariffs on $200 billion of Chinese goods. But a funny thing happened. The proposed tariffs were just 10 percent, not the 25 percent many had anticipated, plus they excluded more than 300 products. It seems as though the administration wanted to avoid going nuclear in the trade dispute. Or, perhaps they were buying some time for a big trade win before the US midterm elections in November. The markets applauded their effort.

Interestingly, China is also attempting to buy some time. Their response to the $200 billion in tariffs showed restraint. In addition, Chinese officials committed not to purposefully devalue the yuan as a weapon in the trade conflict. This signaled to the US some willingness to negotiate. However, China refused to accept the administration's most recent invitation for more trade talks, saying it would not be bullied by tough trade tactics.

Figure 4: The Economy Can Only Run Above Potential for So Long, and Spikes in the Output Gap, Like We are Seeing Currently, Historically Precede Recessions



Source: St. Louis Federal Reserve, Bloomberg Finance L.P., State Street Global Advisors, 09/24/2018.

What's going on here? Both the US and China are delicately trying to avoid some of the more serious consequences of a trade war by buying some additional time. The Trump administration wants a trade win in the worst way before midterms. And, the Chinese want to wait until after the elections to determine if Trump trade policy has been strengthened by the electorate or weakened. It's a game of cat and mouse. Markets have responded positively when it appears the trade dispute may be thawing and they have suffered when it flares up. Buying time may be a thoughtful negotiating tactic, but the markets crave resolution.

Time Is On Our Side?

Putting off important tasks stems from the present bias where we tend to overweight today's joy and discount tomorrow's potential pain. Instead of writing, I'll enjoy a day at the beach, or even clean up the kitchen, believing that it will be easy to catch up tomorrow. Trouble is, tomorrow always holds another big batch of distractions, so it's tough to resist the allure of the present. That's why procrastination, whether it's mine, the central banks' or the government's results in this unsettling concept of living on borrowed time.

Investors, especially those working with a financial advisor, aren't accustomed to viewing time in a negative light. They rightfully interpret a long time horizon positively, and the market's long-term performance has rewarded them for their patience and discipline. But borrowed time presents risks. Even as investors gobble up US stocks and continue to be rewarded for their investments, there's an eerie feeling that time may be running out.

If we have borrowed time from the future, have we borrowed returns, too? What if this time around the temporary positive effects of easy monetary policy and massive fiscal stimulus stole investors' future returns? What if delaying the pain from more normal monetary policy conditions results in an increase in market risks? What future challenges will we have to deal with in the aftermath of the current generous fiscal policy package? As the stimulative effects of monetary and fiscal policy wane, investors should make the time to prepare their portfolios now for more normal bouts of market volatility in the future.

1 Board of Governors of the Federal Reserve System, September 19, 2018.

2 "BOJ stands pat on stimulus policy, says it will monitor impact of recent tweaks," The Japan Times, September 19, 2018.

3 "European Central Bank holds interest rates steady as economy ticks over," CNBC, September 13, 2018.

4 "It's Raining Money in the United States," Strategas Research Partners, LLC, August 30, 2018.

5 "It's Raining Money in the United States," Strategas Research Partners, LLC, August 30, 2018.

6 "US weekly jobless claims fall as labor market strength continues," Reuters, September 20, 2018.

7 Congressional Budget Office, September 2018.

8 "Treasury sets $78 billion auction as it's on track for topping $1 trillion in issuance" Marketwatch, August 1, 2018.

Glossary

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

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