Equities Higher, Yields Lower, Unusual Times

July 2019

Through June 30, 2019, the NASDAQ Composite was up 20.7% and the S&P 500 was up 17.3% for the year. The S&P 500 index hit a record high on June 20, and other U.S. equity indexes were near records during the final days of June. On November 8, 2018 the ten-year U.S. treasury yielded 3.24% and on June 30, 2019 the ten-year yielded 2.01%. Historically, strong equity markets have not been accompanied by declining yields, but 2019 is proving to be most unusual.

Equity markets have tended to be arbiters of economic activity. Strong markets generally preface robust or improving activity, and a good economy tends to be accompanied by higher, not lower, interest rates. Commencing in the fourth quarter of 2018, economists began to downgrade their growth expectations for both the U.S. and global economies. Supporting their bearish shift, economic data, especially in manufacturing, began to deteriorate. Observers attributed the underperformance to the trade disputes the Trump Administration initiated with China, Europe and Mexico. However, despite the friction, U.S. unemployment data hit fifty year lows, job openings exceed job seekers by nearly one million, services continued to be strong globally and GDP growth surpassed 3.0% on an annual basis during the first quarter of 2019. Despite this and record high equity indexes, the Fed is expected to cut rates at the end of July. Perhaps the Fed feels duty bound to react to economic weakness abroad or maybe they are taking anticipatory measures because of the trade friction. Either way, doubters may be pardoned for questioning the wisdom of rate cuts on the heels of record equity prices.

The U.S. has not faced a period like this in some time, and we think the incongruity between equity prices and zero to negative real rates should be a source of concern. The table below shows historical levels of equity markets (represented by the S&P 500) and yields of the ten-year treasury six months before and six months after the Fed changed the direction of monetary policy. It is unusual to see equity markets rising ahead of Fed easing, whereas it is common to see yields falling. If one adheres to the notion that markets provide information, bond yields and Fed action would suggest the economy is faltering, which begs the question, what message are equity markets delivering?

Markets Behavior and Fed Policy

		S&P 500			UST 10yr Yield (%)		
Date	**Fed Action**	**6 mo. Prior**	**Action Date**	**6 mo. Later**	**6 mo. Prior**	**Action Date**	**6 mo. Later**
9/9/1998	Easing	1095.44	1049.02	1310.17	5.66	4.92	5.26
6/30/1999	Tightening	1231.93	1372.71	1464.47	4.65	5.78	6.37
1/3/2001	Easing	1469.54	1347.56	1234.45	5.99	5.16	5.38
11/6/2002	Add'l Easing	1052.67	923.76	929.62	5.07	4.04	3.79
6/30/2004	Tightening	1109.64	1140.84	1213.55	4.26	4.58	4.26
9/18/2007	Easing	1402.06	1519.78	1330.74	4.57	4.47	3.48
12/16/2015	Tightening	1937.78	1972.74	2100.44	2.31	2.30	1.58
7/31/2019	Easing ?	2704.10	2992.02	?	2.63	2.05	?

Clearly, equity markets are applauding the Fed's support, and, away from U.S. treasury yields, narrowing credit spreads suggest the central bank's action will postpone a deterioration in creditworthiness. The global search for yield is alive and well with the full blessing of monetary authorities. But should markets be so enthusiastic? After the 2008-2009 recession,

monetary authorities pursued extraordinary measures to support their economies. Housed in terms of "necessity," measures like negative interest rates, limitless purchases of government bonds and the abolition of a "real" rate of interest, became acceptable experiments as long as inflation remained at bay.

It seems the flaw in central bank thinking may now be reappearing. Like a patient addicted to pain killers, monetary authorities were not able to restore markets to their proper independent and unsubsidized functioning before being called back to action. It appears the Fed, the ECB, the BOJ and the Bank of England are now saddled with moral hazard, leading economic actors to rely on their support at the first signs of stress. The behavior of markets has been perversely altered by the authorities to encourage relentless borrowing by governments and corporations. To exit the vicious cycle, the global economy needs real growth, something government borrowing does not accomplish.

For now, we expect the Fed to cut rates on July 31 and higher risk markets to endorse the move. Longer term, we continue to worry that zero real rates (and negative rates in Europe and Japan) will promote improper incentives and risk-taking in the market. When those risks become excessive, the Fed (and others) may not have the tools to combat the fallout.

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