macro scan

Wednesday, June 26th, 2019

- ***Fixed Income weakness driven mainly by the "walk back" of aggressive cuts by various Fed officials***
- ***Energy markets providing an additional tail wind for higher rates***
- ***US economic data deterioration continues – could push the Fed back to aggressive cuts rhetoric***
- ***Quick hits: G20 consensus, more on global CB dovish pivot, high level macro thoughts***

The three day weakness in equities (recall the buyback blackout is now in full effect) is pausing as Tsy Sec. Mnuchin says a trade deal with China is "90% done." That, along with better Durable Goods data (the first decent data in a while) is also helping to send fixed income lower. However, really the weakness in fixed income is stemming from a "walk back" of the idea of immediate, aggressive cuts by Bullard, Powell, and Barkin.

- Bullard (dove/dissenter): *"it seems like a good time for an insurance cut; 50bps in July would be overdone"*
- Powell (moderate, dot most likely drifting lower): *"shouldn't overreact to short-term swings in sentiment"*
- Barkin (hawk, non-voter until 2021): *"doesn't know whether rates should be cut this year"*

So the two voting members of the FOMC that spoke yesterday provided a clear signal that AS OF NOW, there is unlikely to be a 50bps cut in July. Since the Bullard comments, the ED strip has sold off ~8bps and the odds of a 50bps cut in July has gone down 10%. The reaction seems very fair given only those comments.

Additionally, the selloff in fixed income gained another tailwind with the recent rise in the energy complex. This first stems from the massive fire at the Philadelphia Energy Solution refinery which is now expected to close. This is the largest refinery on the east coast so its closing is significant. That has sent gas futures 13% higher in the last week.

Gas futures are testing its downtrend resistance and as of now forming a "shooting star" candlestick which is usually indicative of a "blow off top"…

Furthermore, WTI saw its second consecutive surprise API inventory draw and this week's was massive (-7.6m vs. -0.8m exp.). That, along with the gas rally, is aiding in lifting WTI prices which should work to lift inflation expectations which then normally lead to higher nominal yields.

WTI has rallied sharply in the past week up to its 200-day MA in what appears to be a normal 4th wave corrective rally inside a larger 5-wave sell off…

As you can see from the above two energy charts, they both appear to be showing tactical rallies inside larger downtrends. Any further rally would change that narrative so let's monitor these charts over the next week to help us ascertain inflation expectations and therefore nominal yield direction.

Above I emphasized the phrase "AS OF NOW" with regards to Fed speak. Why? It is always important to monitor Fed speak for (a) policy pivots and (b) near-term signaling. The policy pivot has been made apparent here all year first from a neutral "wait and see" to now full easing bias.

In terms of near term signaling, the Chairman has made it clear that the FOMC is "closely monitoring" the incoming data and will "act as appropriate." Therefore, the size, pace, and velocity of the easing is completely dependent on the incoming economic data.

Long time readers will know the whole point of The Macro Scan is to be forward looking and not take things at face value. That's how one generates alpha. This is why all year we have looked at forward looking economic indicators not the headline Unemployment Rate which is <u>THE</u> most lagging indicator.

And if you take Fed officials for the word, you would have not caught this epic fixed income rally.

THEN -> Bullard (March 29th): "it is premature to contemplate a rate cut"
NOW -> Bullard (June 25th): "two rate cuts would ensure a soft landing"

It is therefore important to keep our eye on the prize which has been, and continues to be, the trajectory of the economic data. As we spoke about on June 18th, the data has gone from simply a rate of change weakness to overtly weak. Since then; the data continues to deteriorate.

- **Leading Index** – revised lower and missed expectations
- **Markit Manufacturing and Non-Manufacturing PMI's** - missed expectations
- **Regional PMI's** – so far 3/3 have moved lower than the previous months with 2/3 showing big misses to expectations – would indicate a weak NAPM PMI that will be precariously close to slipping into contraction

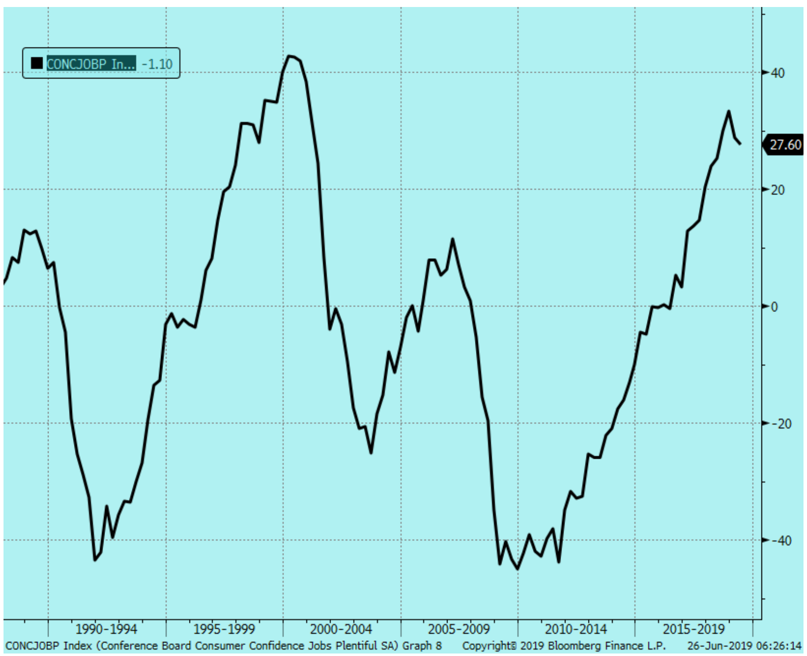
- **Consumer Confidence** – very weak
- **Retail Sales** - slightly strong but tends to be noisy and likely weaker given consumer confidence data
- **Housing data** – too mixed to draw any conclusion whether weak or strong at this point

The regional surveys are important because they have been the "tell" since last October that the best of times are behind us in the US and that there is now risk that a contraction is near.

The consumer confidence data yesterday was most troubling. Powell himself was on TV yesterday saying the "consumer is strong" and that has really been the bull narrative for the US's service based economy. What if the consumer is starting to suck wind? Yesterday's data is therefore disconcerting because that takes Bullard from saying "insurance cut" to talking a rate cut cycle.

The labor market data will also be vital. That has been the reason behind the strength of the consumer and as we have discussed many times now, there are signs the labor market is topping/UER bottoming ranging from: NFP/ADP weakness, rate of change on JOLTS softening, number of help wanted postings online declining.

Notable in yesterday's Consumer Confidence data was the softness in their labor indicators. The decline in the spread of "jobs plentiful" less "jobs hard to get" is declining at a rate that tends to lead into recession.



Also notable in the consumer confidence data was the drop in "expectations" from 106.6 to 94.1 (high was 135.70 in Sept. '18). That follows the decline seen in the UMich survey for "expectations" from 93.5 to 88.6. Suddenly folks are feeling not so hot about their future.

This loss of confidence and potential pivot in the labor market is the reason I highlighted "AS OF NOW." It could completely change the Fed's narrative to more aggressive cuts. After all, the consensus opinion is a soft landing as the labor market is still strong. That thought is now open to debate which means the next few weeks of data will be pivotal. Thus, just because Bullard walked back the 50bp cut yesterday; doesn't mean you can rule it out yet. The economic trajectory suggest further weakness at a time most expect growth and inflation to come in around a convenient 2%.

Indicator	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Economic Activity										
Real GDP (YoY%)	2.2	1.8	2.5	2.9	1.6	2.2	2.9	2.5	1.8	1.9
Industrial Production (Yo…	3.0	2.0	3.1	-1.0	-2.0	2.3	4.0	1.4	1.6	1.5
Price Indices										
CPI (YoY%)	2.1	1.5	1.6	0.1	1.3	2.1	2.5	1.8	2.1	2.0
PCE Price Index (YoY%)							2.0	1.6	2.0	2.0

The risk continues to be that the cycle has ended, the Fed has not pivoted dovish enough, and that all those that believe the US will comfortably glide into a 2% growth/2% inflation regime will be proven wrong. A lot of this will depend on the G20 outcome this weekend.

With regards to the G20, just want to highlight the consensus opinion heading into it is firmly that there will be a deal not to impose any additional tariffs and to keep negotiating. So any deal that is more developed is bullish the economy/risk assets and bearish fixed income. Conversely, certainly if there is new tariffs imposed; risk assets will melt, the economic trajectory will worsen, and there is not enough cuts priced in.

In terms of the global central bank trajectory, the dovish pivot continues all over the world.

- **RBNZ**: a lower OCR might be needed over time due to downside risks
- **Bank of Korea**: stated that it would respond appropriately to drastic worsening in economic conditions. It now saw 2019 inflation below the prior April view of 1.1%
- **ECB**: source reports that they are legal loopholes for the ECB to buy more govt debt
- Even someplace esoteric like **Iceland**: contraction in the domestic economy was still anticipated and was expected to show more clearly in coming months

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Putting all of this together in a big picture macro thought, lower interest rates continues to be the macro trade that has the clearest path because of the softening data, central bank rhetoric, and long-term macro-economic trends (demographics, technology, etc).

Equities are more difficult. At some point, they will need to re-price to the lower growth trajectory which analyst have not accounted for yet. However, there is so much central bank accommodation around the world that it is unlikely the "world will end." Central banks are doing a decent job getting ahead of this one and that should stave off a disaster for now.

The Dollar is also a tough call. In theory it should be weakening because the Fed can cut the most compared to its G3 counterparts, but it is also the best of the worse. So USD inflows can continue as the US remains the worlds "safest" place to park your investments. There is also some credence to the idea that there is a Dollar shortage.

Therefore, as long as G20 does not break any new ground, the various long expressions of fixed income continue to be the best macro expressions at the moment (please see the note on June 20th for the full list). Additionally, long Gold is making a lot of sense as it wraps in the lower rates, potential for risk off as equities re-price to a slower growth world, and a Dollar that could weaken as the Fed cuts. Buy any Gold dips.

Kind Regards,

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