

Notes from the Jury Box

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If you haven't heard much from me lately, it's because I've been spending much of this month in federal court, slowly sifting through competing narratives and developing an understanding of what actually happened in a particular case; I'm hopeful that the prosecution and defense will wrap up their cases in the next week or so, at which point we the jury will sit in judgment of the accused. As a first-time juror, I've been letting Jimi Hendrix's words guide me:

*If you can just get your mind together, then come on across ...
But first, are you experienced? Have you ever been experienced?
Are you trying to prove that you're made out of gold and can't be sold?
So, are you experienced? Have you ever been experienced?*

Well, I have. It's been a sobering responsibility, knowing that my judgment and my persuasive skills will have a life-changing impact on the defendant's life, one way or the other. Although I've never before sat on a jury, my day job requires me to evaluate evidence and reach a conclusion – *buy or sell*, if not *guilty or not guilty* – on many investment opportunities for our clients. After a lifetime of judging “cases” and arguing politely with my colleagues, I hope I can apply the same open-minded approach to the current task at hand.

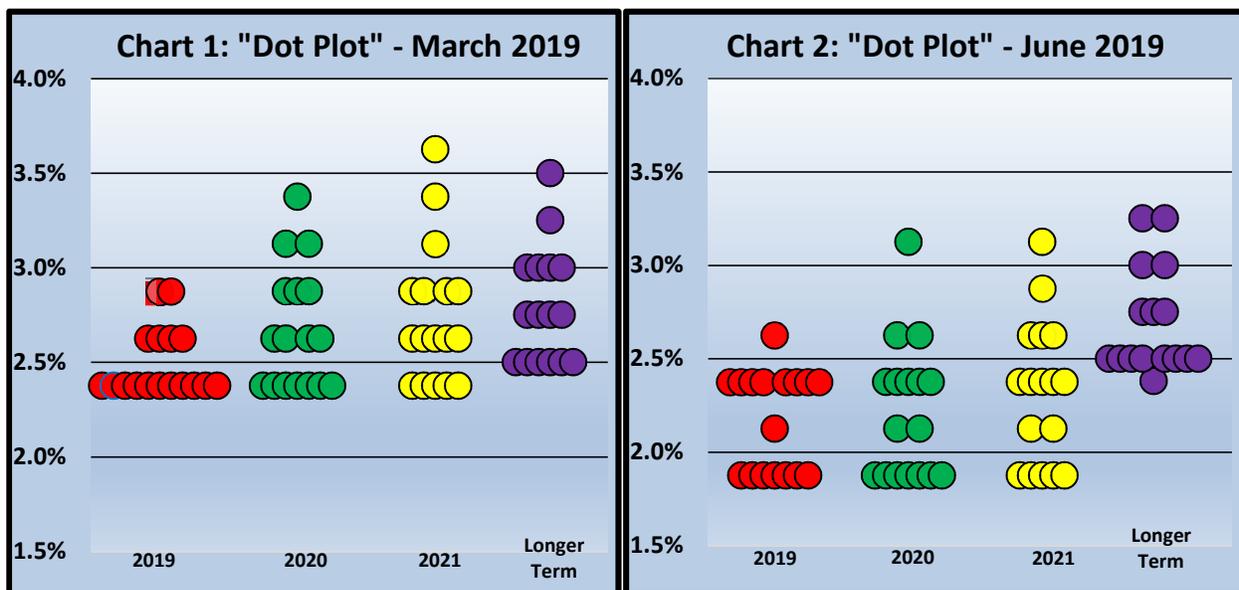
During the many brief breaks in the trial, I've been thinking about another person who bears an enormous burden of judgment and persuasion: Federal Reserve Chair Jerome Powell. As he weighs the economic evidence presented to him and his fellow jurors (that is, the other voting members of the Fed's policy-setting Open Market Committee), I imagine that he is getting his mind together, using his experience to inform his judgment, and maintaining his probity.

Based on the outcome of yesterday's Fed meeting, it appears that Mr. Powell has held his ground even as some of his fellow jurors have changed their minds based on new evidence. Since the Fed's last meeting in late March, many investors have been clamoring for lower interest rates. They – the prosecution, if you will – build their case for lower rates on the expected fallout from higher tariffs on Chinese imports (slower demand as consumers and businesses delay purchases until the tariff environment stabilizes, combined with higher costs related to shifting supply chains); on concerns that a reversal of the big inventory buildup earlier this year would weigh on future GDP growth; and on persistently low inflation.

Against these arguments, other investors – call them advocates for the defense of current interest rate levels – point to a tight labor market with 1.6 million more job openings than unemployed workers; to improving estimates of second-quarter GDP growth; to 3% “final sales” growth; and to elevated stock and bond prices. The gallery of investors had been waiting for weeks before the Fed's verdict yesterday.

Unlike my criminal trial, the Fed’s Open Market Committee doesn’t need a unanimous verdict. The decision – to keep rates steady – was largely expected; the suspense revolved instead around the language of the Fed’s supporting statement and how the committee expects future decisions to unfold. The statement was also unsurprising: Compared with the same statement three months ago, words such as “patient” and “transitory” disappeared, and “solid” growth was transformed into “uncertainties about this outlook.” In every paragraph, the Fed’s language was considerably more dovish than it had been after the March meeting.

The individual votes of the 17 voting members also tell a story of evolving judgment, as shown in Charts 1 and 2. These widely touted “dot plots” show the Fed’s “voting” in the form of a single dot for each individual Fed governor’s expectation of the level of overnight interest rates over the next several years. Since the March Fed meeting, economic data has steadily weakened, although the overall numbers remain comfortably in positive (expansion) territory.



Source: Federal Reserve

Even without the prospect of imminent recession, the data – slower housing starts, sluggish consumer spending, soft manufacturing output, and persistently low inflation – have clearly spooked several Fed governors. Challenging trade negotiations worldwide undoubtedly also influenced the vote. Three months ago, not a single governor expected to see any rate cuts through year-end 2021, and the vast majority expected the fed funds rate to remain flat at about 2.375% before rising in the future. Today, as seen in Chart 2, eight governors have switched sides: One sees a single quarter-point cut, and seven expect *two* quarter-point cuts this year. These governors also think that rates will remain lower for the following two years.¹ These governors believe that the economy needs some help to maintain its upward trajectory.

¹ James Bullard, President of the St. Louis Fed, may have played the Henry Fonda role in this version of *Twelve Angry Men* (retitled herein *Seventeen Politely Disputatious People*), since he was the only Governor to vote in favor of an immediate rate cut yesterday. He appears to have gained seven allies for the next meeting, in late July.

Equity and fixed income investors are clearly expecting lower interest rates. In fact, futures contracts on Treasury bonds indicate that government bond investors are even more bullish than the Fed's doves, as bond prices imply *three* quarter-point cuts by year-end. Credit spreads (the difference in yield between corporate bonds and Treasury debt of the same maturity) are thin, suggesting that the bond markets aren't worried that falling rates are harbingers of recession. Likewise, stock prices are touching their all-time highs, as the equity community has bet heavily on the old "don't fight the Fed" maxim over slowing earnings growth as the dominant theme.

Chair Powell apparently still sides with the defense: If he had voted to cut rates, he may have been able to swing a majority or even unanimous decision in that direction, so it is likely that his vote was to keep the fed funds rate flat at 2.375%. In my view, this was the right conclusion, despite substantial crosstown traffic pressuring him to vote for a quarter-point cut. Seeing through the purple haze of politics and punditry, Chair Powell recognizes that the economic data still show the U.S. economy to be in good shape, resilient and likely to withstand the current tempest. In support of this thesis, it's instructive to note that all 17 voters still think that rates will likely be flat or higher in the longer term, as shown on the right side of Chart 2.

Just as my fellow jurors and I are attempting to construct our own theory of what happened in a particular criminal case now before the federal district court, so too the "jurors" on the Federal Open Market Committee evaluated the data to test possible theories of what has been happening in the economy before they rendered their verdict yesterday. Pushing the analogy a bit further, my Eastern Bank Wealth Management colleagues and I are always working to develop and modify our views of the investment landscape, and to render our verdict in the form of portfolio management recommendations. Without rigorous analysis of the relevant data in each case, all of these theories and resulting conclusions would be nothing more than castles made of sand.

Since January, our primary thesis has been that the U.S. economy would decelerate but not tip into recession; based on this view, we established a view that the Fed's three-year campaign to raise interest rates had come to an end with last December's final hike, and that the central bank's turnabout might take the wind out of the dollar's sails after a big rally. We also outlined our hypothesis that the U.S. economy is built on a stronger foundation than other developed markets, but that emerging markets could rally as the dollar softened.²

We have held to these views even as the markets have swung wildly from despair (in December) to enthusiasm (January through April) to pessimism (in May) and back to cautious optimism today. Our steady outlook stems from our view of the data, which remains in Goldilocks land – not too hot, not too cold.³ When stock prices jumped, we took some profits to rebalance accounts back to our preferred neutral allocation; we are still comfortable with this stance.

² Please refer to "Take a Look Ahead," January 17, 2019.

³ Our biggest mistake so far has been that emerging markets have been somewhat weak, as investors apparently doubt that they can thrive even as China's economy slows and U.S. tariffs adversely affect global trade volumes. We think that concern will prove short-sighted, as American companies increasingly shift production out of China and into nearby countries. Even so, tariffs have hurt the Chinese yuan, and Brexit has hurt both the British pound and the euro; with other major currencies under pressure, the dollar has fared better than we had anticipated six months ago.

All the same, we need to recognize that the outlook *is* a bit darker than it was earlier this year. The cumulative strain from tariff uncertainty has weighed on corporate capital spending; housing growth has slowed despite lower mortgage rates; manufacturing and services indices have softened. Wall Street still expects decent earnings growth this year and an acceleration next year, an outlook that seems too rosy to us.

In particular, we need to be thoughtful about the emerging trend away from globalization and toward “slowbalization.”⁴ As a natural response to higher tariffs and export controls (among other trade barriers), companies are rethinking their global supply chains and concentrating their operations in fewer locations; global networks are becoming more regional, with North America, Europe, and southeast Asia emerging as the largest supra-regional trading blocs. As geopolitical considerations force companies to slowbalize, trans-regional trade (e.g. between North America and Europe) has slowed, while intra-regional trade (e.g. within North America) is likely to accelerate modestly. The overall impact of this trend is likely to be negative.

And yet prices remain elevated: Investors are bullish despite the slowing outlook, putting their trust in the Fed to cut rates before any recession is likely to arrive. Falling forecasts and rising prices make for a risky environment, and we have responded throughout this year by keeping our overall stock exposure close to neutral. We have also shifted some of our equity holdings to more defensive (and regional) industries and companies. In this way, we are still participating in the stock market’s assault on new records, but we have given our clients some cushion when the inevitable downturn finally arrives.

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⁴ Dutch author and futurist Adjiedj Bakas coined this term four years ago to describe the shift from a multinational global view to a more regional approach to corporate strategy and national economic policy. For a detailed view of how specific industries may be affected by slowbalization trends, please refer to *The Slowbalization Playbook* by Michael Zezas et al., published by Morgan Stanley May 30, 2019.