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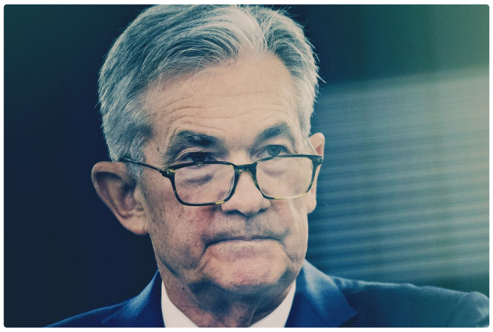
Are Central Banks Losing Their Economic Clout?

By Randall W. Forsyth Sept. 13, 2019 8:09 pm ET



Photograph by Andrew Harrer/Bloomberg

The Federal Reserve will hold its most important policy meeting this week since, well, its last one in July and until its next one in October.

That's the pitch whenever the Federal Open Market Committee gets together, which happens every six weeks or so. And the line is just as true as ever. But a significant shift may be at hand for the Fed and the world's other major central banks.

Monetary policy, as practiced for the past four decades, might be changing. With interest rates at historic lows, and below zero percent in much of the world, its ability to continue to guide and sustain the world's advanced economies could be nearing an end. Fiscal policy—that is, government spending and taxing decisions—could take on greater importance.

That's the message from Mario Draghi following his penultimate meeting presiding over the European Central Bank this past week. Japan could also be ready to expand its fiscal stimulus after nearly three decades with the world's lowest interest rates, which have failed to end that nation's near economic stagnation and deflation.

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As for the U.S., its fiscal policy already is easy. The federal government just announced that its deficit for the 11 months of fiscal 2019 was more than $1 trillion. To be sure, that excludes September, the final month of the fiscal year, in which Uncle Sam typically runs a surplus. But the shortfall still equals more than 4% of gross domestic product, a deficit normal during recessions, but not in the 11th year of an expansion.

Across the pond, the European Central Bank's official monetary moves this past week consisted of a 10-basis-point (0.1 of a percentage point) cut in its policy rate to minus 0.50%, with "tiering" to exempt some banks from the consequent charge on their deposits at the ECB; a new round of refinancing operations; and a resumption of the ECB's asset purchases of up to 20 billion euros ($22.15 billion) a month.

But that wasn't the real point, writes Bill Blain, strategist at Shard Capital in London, in his ever-witty Morning Porridge missive.

"Europe is heading down a new road—the fiscal super-highway. Draghi confirmed it when he called it 'Time for Fiscal Policy to take Charge,' challenging governments with 'fiscal space to act in an effective and timely manner.' It was a perfect setup for his successor, Christine Lagarde, who has but one role: to ensure that the politics of Europe fall in with fiscal stimulus."

And rather than worrying that more euro-zone borrowing portends a debt crisis, ECB purchasing should hoover up the bonds sold to cover deficits, he adds. "Strip it to the core and you could argue all that's really happening is the ECB is printing lots of money for European states to juice their economies."

That's preferable to negative interest rates, which act as a tax on banks, contend John Ryding and Conrad DeQuadros of RDQ Economics.

And it's also preferable in the minds of most German savers. A recent story on the European Central Bank in the German daily newspaper Bild was headlined, "Count Draghila is sucking our accounts dry." It pictured the ECB chief as the infamous vampire.

The RDQ team notes that Germany is considering establishing an agency to finance infrastructure and climate-change spending without violating deficit rules, which Chancellor Angela Merkel said would be money "well invested." That shows an important change in thinking after five years of Berlin budget surpluses.

Japan also might be moving to fiscal stimulus, according to Steven Ricchiuto, U.S. chief economist at Mizuho Securities. While Prime Minister Shinzo Abe had been considering a second round of consumption taxes, Ricchiuto had eye-opening conversations with clients on a recent Tokyo trip about modern monetary theory, a hot topic in economics and financial circles.

Basically, MMT would allow fiscal deficits to be financed by the central bank, with the constraint being when this debt monetization boosts inflation near an unacceptable level. With the main alleged economic problem now being that inflation is too low, that constraint is absent.

The federal-funds futures market on Friday placed an 89.6% probability on a 25-basis-point cut in the Fed's key interest rate this past week. President Donald Trump would like the Fed to go to zero, or below, to get the economy running hot while his tariff wars cool global trade and worsen uncertainty.

The Fed already has stopped shrinking its balance sheet and will be buying more Treasury securities with reinvested interest and maturing issues. A resumption of active buying, aka quantitative easing, would seem likely in the next recession. All of which sounds as close to modern monetary theory as "damn" is to swearing.

Is that what gold is anticipating?

Behind the stock market's climb to within a hair of its record high lay dramatic shifts beneath the surface of the major indexes. Moreover, this reversal of fortune coincided with a dramatic backup in the bond market. The two appear related.

Early this past week saw a sudden, violent shift, on which Barrons.com reported extensively, out of the biggest previous winners, momentum stocks, and into the biggest laggards, value stocks. The high-momentum erstwhile winners were not only technology companies but also less-sexy utilities and consumer stocks. The low-momentum issues were heavily tilted toward financials and energy, two groups that heavily populate the value sector.

Before this past week's moves, the stock market had been extremely polarized, as a result of collapsing bond yields, according to Andrew Lapthorne, Société Générale's head of quantitative research. "What created this problem was fear of an impending slowdown and a search for perceived safety," he writes in a research note. So, investors eschewed assets with volatility and a risk of a loss.

That led them to more "bondlike" stocks, such as consumer staples and utilities, with dividend yields well in excess of Treasuries. Secular-growth themes, such as tech, also were thought to be less vulnerable to a slowdown. Value stocks, ironically, were viewed as risky, being volatile, subject to more cyclical downside, and having underperformed for years.

That fear of slower growth had sent bond yields tumbling during the sultry days of August, with the Treasury's 30-year maturity falling below 2% for the first time last month. The benchmark 10-year note plunged to a low of 1.47%

in the week ahead of Labor Day, amid widespread predictions that it would break the low of 1.36% set in 2016.

The decline appeared inexorable as the total of negative-yielding global bonds burgeoned to $17 trillion and with the Fed expected to cut short-term interest rates at least two more times this year. But that sentiment apparently had gone too far, with overwhelming bullishness among bond managers meeting a torrent of new paper from corporations more than willing to take advantage of record-low borrowing costs. By week's end, the 10-year Treasury note's yield was 1.88%, more than 0.4 of a percentage point above its recent low.

The snapback in yields resulted in the bond-proxy "quality" stocks surrendering five months of relative outperformance versus value stocks in just two days, Lapthorne continues. Many investors are stressing out because the former "safe" favorites they own have lost quite a bit of money, while the value stocks they don't own have rallied.

Bianco Research points to another popular gauge, the Bloomberg U.S. Pure Momentum Portfolio, which buys the stocks with highest returns over the past year and shorts those with the worst. Through Wednesday, that momentum index had suffered its worst 10 days in the past decade.

But not everybody is stressing out. Bianco observes that the resurgence in value stocks probably is helping active value portfolio managers, whose traditional notions of emphasizing cheap stocks have swamped indexers and other passive strategies that emphasize factors such as momentum.

All of which points to the overlooked bond risk in the equity markets. The betting had been too heavily weighted in favor of bonds and their proxies, based on expectations of a weaker economy.

Indeed, the rebound in yields suggests that the "third mini-recession" of the long economic expansion that started in 2009 is ending, according to Evercore ISI.

The backup in yields, plus the all-but-certain one-quarter-percentage point cut in short-term rates expected on Wednesday at the conclusion of the Fed's policy meeting, should eliminate concerns about an inverted yield curve.

The new expected federal-funds target range of 1.75% to 2% would put its midpoint even with the 10-year note's yield. Moreover, global short-term rates are down, while money supply growth has accelerated and corporate credit spreads have remained flat. All of this points to positive growth, the firm concludes.

After betting against growth, Lapthorne argues, investors should be buying “cyclical upside.” That would include bank stocks, automobile shares, and Japanese and value stocks—“which, by definition, is a portfolio of the world’s problems.”

Bonds play a valuable role in investment portfolios by providing a hedge against things going wrong. Value stocks are showing their worth as a hedge against things going right. Leaning too far in either direction can be dangerous, as the past week shows.

Write to Randall W. Forsyth at randall.forsyth@barrons.com
