Ten Seconds Into The Future. Investment Outlook for the US Under 2 Rate Scenarios. Economic Slowdown in US.

The Real Economy:

2000-2005:

Low borrowing costs lead consumers to spend whether it was on houses, cars or stuff. The savings rate fell from 6% to 2% and households incurred increasing levels of debt particularly in mortgages, fueling a housing boom. House prices grew at between 10-15% per annum. Retail sales accelerated from an annual growth rate of 1.5-2% to 9% per annum in 2005. Auto sales ranged between 16-18 million cars annualized, from 14-16m in the late 1990s. Supply of credit surged as the securitization markets churned out bonds which required the creation of more collateral in the form of consumer loans and mortgages. The consumer binged on consumption financed by securitizations on which investors binged keeping borrowing costs low.

2005-2009:

Interest rates began to rise increasing debt service burdens and squeezing disposable income. Retail sales began to slip from 9% per annum growth to zero growth in early 2008 before the financial crisis led to a yearlong contraction in retail sales with rates of as much as -11.3%. In reaction, consumers retrench and savings rates surge to 8%. Unemployment surged from 4.4% to 10%. Assets from stocks to bonds to real estate selloff sharply as investors panic. Financial conditions are tight and funding markets are shut. Central banks the world over cooperate to maintain the global payments system despite a near failure of the credit system. There is a sharp retrenchment in GDP growth from 2.3% p.a. in 2007 to -4% in 2009.

2009 – present:

Despite fast and powerful recoveries in equity and credit markets, the real economy was slow to recover, taking till 2010 to recover to 3.1% and then averaging a meagre 2% till 2015. The current reading is 2.7% for Q2 2015. Employment and wages have been slow to recover, so too manufacturing.

In the aftermath of the financial crisis, banks have been tightly regulated, sometimes stifling so. Banks were blamed for the scale of the financial crisis as well as for being greedy in a time of plenty and abandoning main street in a time of need. The shadow banking industry, a close accomplice has similarly had its wings clipped. Only the corporate bond market has been conspicuously open and raising capital from investors. Unfortunately, most of the new credit has been to refinance old debt or to finance dividends, share buybacks and M&A. Weak corporate investment is a sign of weak business outlook.

Consumers on the other hand have been less willing to borrow or to consume. The memories of 2008 are fresh in the minds of the people. The sluggishness of the labour market to recover even as financial markets recovered their peaks have also dampened sentiment. The recent oil dividend, from a sharply falling oil price, was saved rather than spent.

Outlook:

There are reasons to expect a cyclical slowdown in economic growth. US trend growth is estimated to be circa 2%. This number is not observable but if true, it means that realized growth has run above trend for two years now. Core PPI has been rising for 2 years as well and may be peaking. While the ISM manufacturing PMI peaked in late 2014, the non-manufacturing ISM has been robust, peaking at 60.3 in August before retreating to 56.9. August may have been a cyclical peak.

The Fed has halted QE. While the USD curve has yet to steepen, and may more likely flatten, liquidity conditions are no longer as accommodative. Credit spreads have widened and effective borrowing costs have risen. Baa yields are at 5.33%, which are mid 2013 levels. The gains from reshoring have taken hold and are in fact fading as the rest of the world adjusts to a less trade conducive environment. Exports are falling faster than imports.

The risk of a US recession is still remote but a mid-cycle slowdown much like the mid 1990s is certainly possible and in the context of a rising rate environment, probable. The victims of a rate hike will, if 1994 was a guide, lie elsewhere. This begs the question of whether or when there will be a rate hike.

Financial Markets

2000-2005:

The Fed’s efforts to support sagging markets was accelerated by the need to maintain liquidity and open markets in the aftermath of 9/11 and saw the Fed Funds Target Rate fall from 6.5% to 1%. The thirst for yield accelerated innovation in financial products, in particular, fixed income and credit products including mortgage securities. The popularity of such securitizations led to excess demand translating into excess supply of end user credit. Low rates and weak credit standards led to securities which were not robust against economic downturns.

2005-2009:

As inflation breached 4% the Fed began to raise interest rates. The pace of rate hikes was aggressive, more so than the rate hikes of 1994 which had precipitated an emerging market crisis. Debt service costs rise, leveraged asset prices fall, real estate being topical, equities and bonds begin to fall. Collective investment vehicles like CLOs, CDOs and hedge funds begin selling assets as structured credit covenants are triggered and investors make redemptions. Bank proprietary desks and prime brokerage departments sell assets in unison. The S&P500 index falls my more than half and the iBoxx HY index falls by a third. Less liquid and more opaque markets like ABS and CDS markets seize up. Counterparties begin to fail. Bear Stearns requires a bailout by JP Morgan and by October,
Lehman Brothers is no more and AIG is under government control. The Fed and Treasury draw up large scale bail out plans to buy assets and to finance the purchase of assets.

2009 – present:

Since the crisis the Fed has been the central driver of financial markets, engaging in multiple rounds of quantitative easing through the direct purchase or funding of the purchase, of US treasuries and agency mortgage backed securities among other securities. Interest rates are cut quickly to 0.25% in 2008 and there they have remained. Financial markets have reacted positively to these measures, with S&P500 rising 17.5% p.a. from the lows in 2009 to date (Oct 2015), high yield 12.5% p.a. By comparison the Case Shiller Composite 20 has risen a mere 4.3% p.a. in the same period. Nevertheless, asset prices evidently have received the policies well. The impact on the real economy has been less remarkable.

The Fed and Treasury have been simultaneously doing the following:

- Buy distressed assets from private balance sheets, mostly private commercial and investment banks. Recapitalize the banks to allow them to continue to hold troubled assets.
- Issue treasuries in a very targeted way to finance these purchases.
- Suppress and control the entire yield curve through rate policy and buying treasuries.
- Engage in austerity (the budget deficit fell from -10% to -2.4% in the period), while mitigating its painful effects with epic liquidity provision and low interest rates.

The results have been encouraging compared to the conditions in China, Japan or Europe. However, government debt has surged. Corporate debt issuance has also surged as businesses take advantage of low interest rates. Corporate balance sheet leverage has increased and credit quality fallen as a result.

The main investors in corporate debt have been institutions with mutual funds and structured credit vehicles also significant. Retail participation has certainly increased relative to the pre-crisis era when investors were mostly institutional, hedge funds or structured credit vehicles. ***In the past, instability came from leveraged prop desks, hedge funds, prime brokers and levered and rules based structured credit vehicles. Currently, potential instability can come from panicky retail investors but leveraged holders of corporate debt are few and far between.*** Structures are now designed with a lot less implied leverage, banks have already been sellers or hold significantly more capital against existing positions, and institutions tend to be unlevered and long term holders.

The main investors in treasuries, to the extent of 13 trillion USD, are foreign investors

including their central banks (47%), the Fed (19%), state and local government (6.4%), private pensions (4.0%), banks (3.2%), insurance companies (2.1%), and mutual funds (8%). There is another pot of some 5 trillion USD of
government debt which is held by government agencies, the main agencies being Social Security (55%), government retirement fund (18%), military pension fund (9%), Medicare (5%) and the federal operating account (9%). The potential weak holders who might impact the treasury market include foreign central banks who may have to spend dollars to defend their currencies or lack current account surpluses to invest, or simply seek to diversify reserves away from dollars. A stronger USD may trigger a defense of local currencies leading to a sell off of treasuries or it may encourage more investment in USD assets, the response is difficult to forecast. Banks may be weak holders if their balance sheets are shrunk, say by an outflow of deposits, but what could cause an outflow of deposits? A competing avenue for savings would have to present itself, perhaps in the form of higher returns in money market funds, or a healthy and trending stock or bond market. Mutual funds could face redemptions, but again, what could trigger redemptions? The types of funds holding treasuries are conservative, low risk funds designed to balance against riskier investments. Some mutual funds hold treasuries as collateral for total return swaps referencing risky underlying assets. If these funds perform poorly, they may face redemptions which could trigger a selloff in treasuries. These funds almost exclusively hold short dated treasuries of maturities less than a year. The fact is that of the US government holds about 50% of the total national debt, between intergovernmental holdings and debt held by the public.

Outlook:

While the world’s central banks continue to be accommodative, the US Fed has signaled its intentions to raise rates, by some accounts, notably the Fed Chair herself, in 2015. Time is running out and the economy is beginning to show signs of weakness which may make a rate hike impractical.

The market has tightened financial conditions to the extent of a de facto rate hike of 25 – 50 bps. A strong USD is contributing to tightening as are credit spreads; IG spreads have widened over 50 basis points in the last 6 months. 3 month LIBOR is up from 25 basis points in 2014 to 33 basis points in September.

If the Fed raises rates it will most probably flatten the curve as the long end responds to the counterbalance of weaker inflation. The pace of rate hikes will likely be glacial, unlike the monthly hikes of 2004-2006.

The Fed has signaled that it would seek to normalize its balance sheet a year after the first rate hike. This may also be impractical. Debt levels are high. Total debt to GDP stands at close to 300% including government, financial, corporate and household debt. Since 2008, household and financial debt has moderated but government debt has nearly doubled. To maintain manageable debt service levels, the US treasury would not appreciate the term structure any much higher than it is today, particularly at longer maturities. Aggressive rate hikes would lift the yield curve from short to intermediate maturities. If the Fed was to sell assets, or simply not reinvest runoffs, the risk of a steeper yield curve is significant.

If there is no rate hike till say March 2016, it is likely that market rates would fall back with LIBOR tracking back towards 25 bps. A softer economy would see a flatter curve as well so a rally in the long end should be expected.

The path of spreads is another matter. Slower growth will weaken credit quality and deter investors resulting in wider spreads. However, a benign interest rate environment will mitigate the deterioration in credit quality to a certain extent.

If the Fed
hikes rates, the curve is likely to flatten with short rates rising faster than the long end. The 2-5 year sector will be particularly vulnerable whereas the 30 year will likely outperform. As for spreads, higher funding costs would exacerbate the credit quality deterioration leading to wider spreads. To a significant extent this has already happened in anticipation and if anything has overshot fair value.

As for equity markets, a slowing economy will impact corporate earnings which are already stagnating. If the Fed hikes rates it is unlikely to make a single move and will in any case put a temporary end to potential reratings and could in fact lead to a mean reversion in multiples. The risk is to the downside. If the Fed doesn’t move, then de-rating risk is lower but then reliance on earnings growth will not drive equities far either. If 1994 was a guide where the US economy slowed from 4.4% to 2.4%, avoiding a recession, the S&P500 traded in a tight range from 450 – 480.

For more volatility and potential returns, investors will have to look elsewhere.