Fed Policy Observations

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Firm Overview
Aetos Alternatives Management, LP ("Aetos") is an independent firm that, since its inception, has been a leader in providing investment advisory services and constructing fully customized hedge fund solutions for a broad range of institutional clients.

Founded
2001

Firm AUM[1]
$11.7 billion

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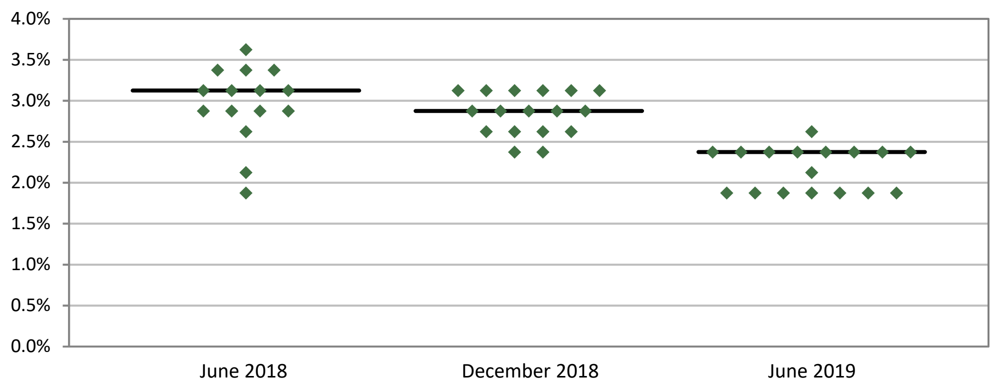
EXECUTIVE SUMMARY

On July 31, 2019, the Federal Reserve ("Fed") announced that it was cutting the Fed Funds Rate 25bps to a range between 2% and 2.25% and suspending its balance sheet tapering program. However, in the hours following Fed Chair Jerome Powell's news conference, the S&P 500 traded down -1.8% and the US dollar appreciated +0.6% as markets reacted negatively to his comment that the Fed did not see its actions as "the beginning of a long series of rate cuts." In other words, markets were looking for a more sustained commitment to easing than the Fed was prepared to telegraph at the time.

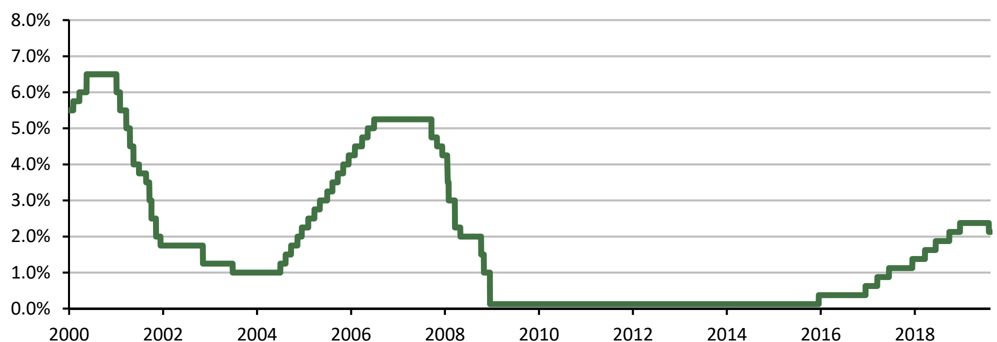
The interplay of monetary policy, fiscal policy, and markets has been of great interest to us of late. In the following discussion, we focus on developments that might have led the Fed to go from projecting 2019 rate hikes *(Figure 1)* to cutting rates for the first time since 2008 *(Figure 2)* and how they impact investment opportunities going forward.

Figure 1: FOMC Projections for 2019 Fed Funds Rate (As of FOMC Meeting Date)



Source: FOMC

Figure 2: Historical Fed Funds Rate



Source: FOMC

[1] As of June 30, 2019

Most discussions on monetary policy start with the Fed's dual mandate of "maximum employment and price stability," with price stability targeting inflation near the Fed's symmetric 2% objective. On the surface, current data remain positive. The unemployment rate is at its lowest levels since the 1960s, and job creation remains on pace to top two million for a ninth consecutive year. Although the Fed's preferred inflation measure (core personal consumption expenditures) has fallen short of 2%, it has consistently ranged from +1.5% to +2%, and longer-term, market-based expectations have hovered around +2%. Wage growth has disappointed, however, despite what appear to be tight labor market conditions.

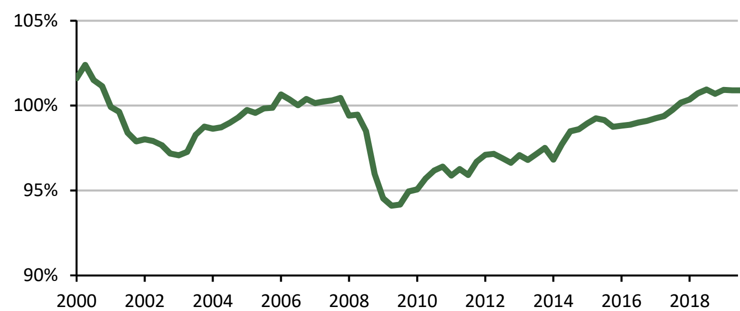
Given these predominantly positive observations, the question remains why the Fed was compelled to ease. One answer would be to suggest that the Fed's decision was motivated not just by current data but also by future expectations, which were informed by several intertwined factors spanning the economy, fiscal policy, and markets. We highlight these factors in a broader discussion of US trade policies, their impact on economic growth, and recent moves in both equity and fixed income markets in the following paragraphs.

THE ECONOMY

Following the 2008 Financial Crisis, the Fed implemented quantitative easing ("QE") programs to support the economy. These monetary measures kept consumer borrowing rates low, stimulating both the housing and automotive sectors, and enabled stressed businesses to refinance their balance sheets and avoid defaults.

QE remained in place for most of the past decade as GDP remained well below potential GDP, which is a function of population growth, labor force participation, and productivity *(Figure 3)*. It was not until the economy had closed the gap between actual and potential GDP that the Fed began scaling back accommodations at the end of 2015. Even in a tighter monetary environment, GDP continued to grow above potential, which likely informed the Fed's previous forecasts for rate hikes in 2019.

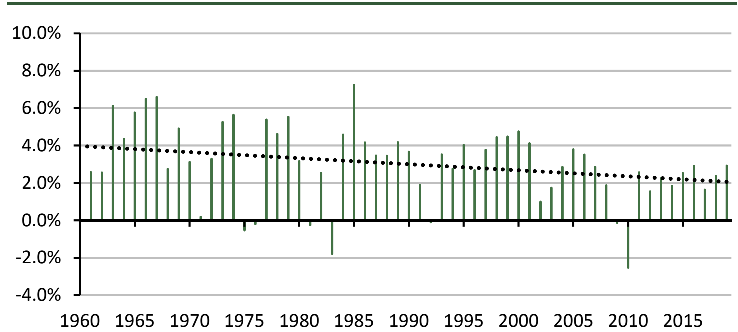
Figure 3: GDP / Potential GDP



Source: BEA, CBO

GDP growth has slowed relative to past cycles *(Figure 4)*, a fact that is often cited as justification for expansionary rather than contractionary policies. However, this view fails to account for a similar slowdown in potential GDP growth, which has been less than two percent since the Financial Crisis. We believe that the slowdown in potential GDP is consistent with a large portion of the labor force entering retirement (i.e., baby boomers), declining birth rates, and reduced immigration. Absent a jump in productivity, we are likely looking at a new "normal" where previous levels of three percent growth are unlikely to be achieved.

Figure 4: Annual Real GDP Growth (YR/YR)



Source: BEA

In our view, the latest print for GDP growth was solid (+2.1%), but there are troubling trends in the underlying data. Private investments have been lackluster for several quarters, and gross exports contracted at an annualized rate of -5.2% (-0.6% drag on Q2 2019 growth). Slowing business investment in the US appears to be part of a global phenomenon, with trade uncertainties delaying spending and leading to a slowdown in manufacturing activity *(Figure 5)*. As trade negotiations drag on—particularly between the US and China—we expect these trends to persist and potentially worsen.

Figure 5: Global Manufacturing PMI

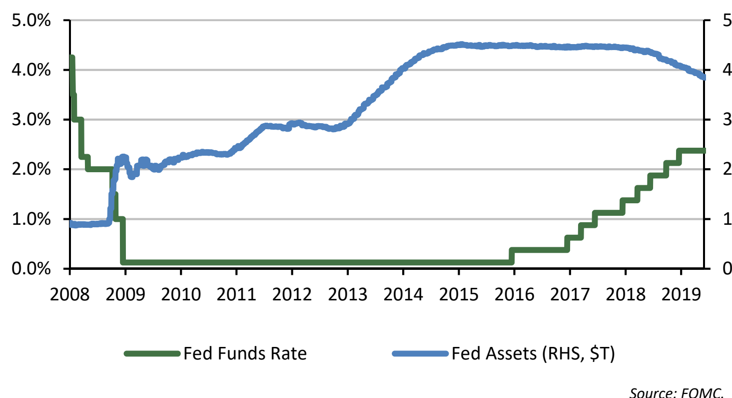
	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19
Global	54.3	54.0	53.2	53.4	53.0	52.9	52.7	52.5	52.1	52.0	51.9	51.4	50.8	50.6	50.5	50.4	49.8	49.4	49.3
United States	55.5	55.3	55.6	56.5	56.4	55.4	55.3	54.7	55.6	55.7	55.3	53.8	54.9	53.0	52.4	52.6	50.5	50.6	50.4
Eurozone	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52.0	51.8	51.4	50.5	49.3	47.5	47.9	47.7	47.6	46.5
China	51.3	50.3	51.5	51.4	51.9	51.5	51.2	51.3	50.8	50.2	50.0	49.4	49.5	49.2	50.5	50.1	49.4	49.4	49.7
Japan	54.8	54.1	53.1	53.8	52.8	53.0	52.3	52.5	52.5	52.9	52.2	52.6	50.3	48.9	49.2	50.2	49.8	49.3	49.4
Germany	61.1	60.6	58.2	58.1	56.9	55.9	56.9	55.9	53.7	52.2	51.8	51.5	49.7	47.6	44.1	44.4	44.3	45.0	43.2
United Kingdom	55.2	55.3	54.8	53.8	54.3	54.0	53.9	52.9	53.7	51.1	53.3	54.3	52.8	52.1	55.1	53.1	49.4	48.0	48.0
France	58.4	55.9	53.7	53.8	54.4	52.5	53.3	53.5	52.5	51.2	50.8	49.7	51.2	51.5	49.7	50.0	50.6	51.9	49.7
India	52.4	52.1	51.0	51.6	51.2	53.1	52.3	51.7	52.2	53.1	54.0	53.2	53.9	54.3	52.6	51.8	52.7	52.1	52.5
Italy	59.0	56.8	55.1	53.5	52.7	53.3	51.5	50.1	50.0	49.2	48.6	49.2	47.8	47.7	47.4	49.1	49.7	48.4	48.5
Brazil	54.3	54.0	53.2	53.4	53.0	52.9	52.7	52.5	52.1	52.0	51.9	51.4	50.8	50.6	50.5	50.4	49.8	49.4	49.3
Canada	55.9	55.6	55.7	55.5	56.2	57.1	56.9	56.8	54.8	53.9	54.9	53.6	53.0	52.6	50.5	49.7	49.1	49.2	50.2
Median	55.4	55.3	54.3	53.8	53.7	53.2	53.0	52.7	52.5	52.0	51.9	51.5	50.8	50.6	50.5	50.2	49.8	49.4	49.4
Average	56.0	55.2	54.3	54.3	54.0	53.9	53.7	53.3	52.8	52.1	52.2	51.8	51.3	50.6	50.0	50.0	49.4	49.2	48.9

Source: Bloomberg, HSBC/Markit

FISCAL POLICY

Although the Fed operates independently—recent public pressure from President Trump to cut rates notwithstanding—coordination between monetary and fiscal policies remain important to maximize their impacts. For example, following the 2008 Financial Crisis, both monetary and fiscal policies were initially expansionary, with the Fed cutting rates and Congress passing fiscal stimulus in the form of legislation targeting infrastructure spending. When fiscal stimulus waned, the Fed stepped in with extraordinary measures (i.e., QE) to further support the recovery *(Figure 6)*.

Figure 6: Monetary Policy Since 2008



Source: FOMC.

With a number of economic indicators trending negatively and signaling a slowdown, and the effects of the 2017 tax cuts waning, more targeted fiscal stimulus might be expected. However, it has been politically difficult for Congress to set fiscal policy over the last decade, with a debt-ceiling crisis in 2011 followed by partial federal government shutdowns in 2013, 2018 and 2018-2019, and it is particularly difficult to see a divided Congress setting aside differences to pass stimulus this close to the 2020 Presidential election. With fiscal policy thus paralyzed and trade uncertainty weighing on the economy, the Fed has likely concluded that only monetary tools would be available to combat a near-term downturn and decided on preventative action.

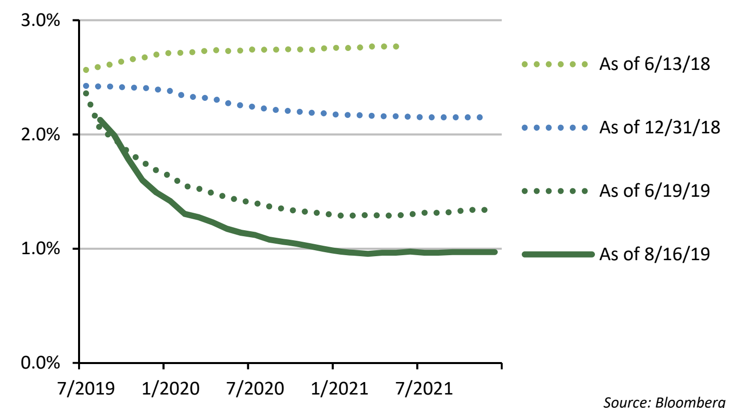
MARKET SENTIMENT

Although we believe the Fed focuses on fundamental factors, it is informative to look at market indicators to gauge where investors think monetary policy might be going and their confidence in its effectiveness. Among the many indicators that we track, there are two that we highlight below: (1) yield curve shape and (2) equity market responses to changes in interest rate expectations.

Yield Curve Shape: While the Fed sets benchmark short-term interest rates, the yield curve shape is ultimately determined by a combination of market forces including shorter-term interest rate expectations and structural supply and demand. In a healthy environment, we would expect the yield curve to slope "up and to the right," representing the premium one normally receives for taking on the risk of owning longer-duration assets. More recently, the yield curve has become extremely flat (at least compared to US norms) and has inverted at various times and points along the curve.

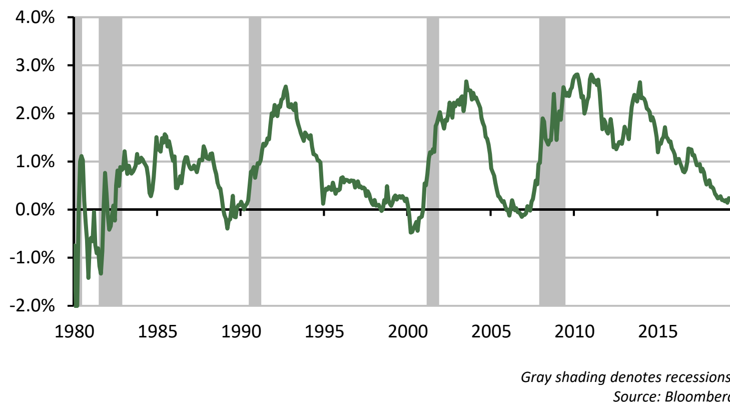
We believe that the flatter yield curve can be largely explained by market expectations, which are pricing in three total cuts in 2019 and additional cuts in 2020 (*Figure 7*), rather than structural issues with supply and demand. While history suggests that the yield curve inverting is a strong indicator of future recessions *(Figure 8)*, we caution against overreacting to small sample sizes.

Figure 7: Market Implied Fed Funds Rate



Source: Bloomberg

Figure 8: 10YR - 2YR Treasuries Spread



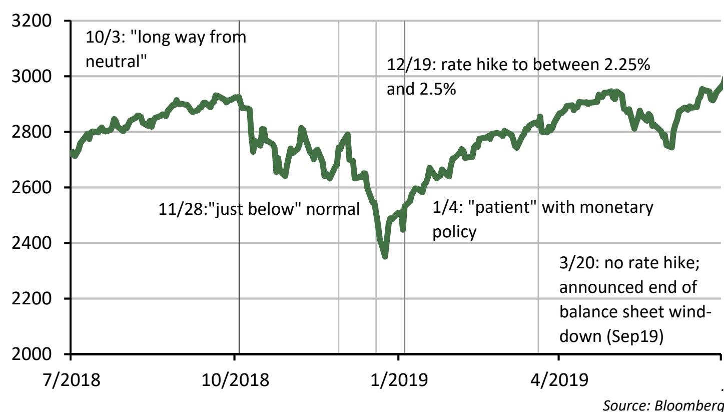
Gray shading denotes recessions.
Source: Bloomberg

Equity Markets: Since former Fed Chair Bernanke's comments about the possibility of ending quantitative easing set off the first "taper tantrum" in 2013, there have been several instances of dramatic market responses to changes in policy expectations.

For instance, in early October 2018, markets reacted very negatively to current Fed Chair Powell's observation that interest rates were "a long way from neutral." At the time, the Fed Funds rate ranged between 2.0% and 2.25% and the Fed's forecast for longer-run rates was 3.0%. Starting October 3rd through its December low, which included a December rate hike, the S&P 500 declined -19.0%.

Markets started to turn on Christmas Eve, picked up steam during Powell's January 4th speech where he sought to reassure markets that the Fed would be "patient" with monetary policy, and eventually rallied to new all-time highs *(Figure 9)*.

Figure 9: S&P 500 Price History



Source: Bloomberg

It has been interesting to think about why markets have remained so dependent on Fed policy. Over a decade after the Financial Crisis, we would have expected both businesses and the economy to be more resilient. However, consider the table below *(Figure 10)*, which shows the implied value of a dividend stream derived using a dividend discount model.

Figure 10: Dividend Discount Model

	Rf Rate	Discount Rate	Expected Growth Rate 3.5%	4.0%	4.5%	5.0%	5.5%
Discount Rate	1.00%	6.50%	67	80	100	133	200
	1.25%	6.75%	62	73	89	114	160
	1.50%	7.00%	57	67	80	100	133
	1.75%	7.25%	53	62	73	89	114
	2.00%	7.50%	50	57	67	80	100
	2.25%	7.75%	47	53	62	73	89
	2.50%	8.00%	44	50	57	67	80
	2.75%	8.25%	42	47	53	62	73
	3.00%	8.50%	40	44	50	57	67

Analysis assumes initial dividend of $2/share and equity premium of 5.5% over the risk-free rate

All else equal, an increase of 0.75% to our base-case risk-free rate (i.e., three rate hikes) results in a -20.0% decline in value (from $67 to $53), which nearly matches the S&P 500's decline at the end of 2018.[2] Although we are not suggesting that this completely explains equity market moves (we remain believers in long-term, fundamental value), we do think it is partly responsible for the equity volatility around announced changes to Fed policy. To make matters more complicated, at these historically low levels of interest rates, the mathematical sensitivity of valuations to changes in rates is higher than when rates were closer to 5% than 2%.[3]

CONCLUDING THOUGHTS

Our observations have led us to conclude that while the shift in Fed policy away from tightening was more rapid than expected, it was likely warranted. Uncertainty around trade has had a chilling effect on global growth, particularly in terms of business spending. Moreover, it appears that fiscal support for the economy—especially in the immediate future—has become uncertain. This is particularly important to the Fed's decision-making process as monetary stimulus traditionally has not been as effective as fiscal stimulus in buoying the economy due to the former's indirect transmission mechanism of supporting lending markets and lifting asset prices rather than directly impacting consumer spending.

On the bright side, the past few years of Fed tightening has created some room for future rate cuts to support the economy, and current Fed Governors appear open to creative, i.e., extraordinary, measures. However, we caution against assuming, absent new data, that the Fed is now pursuing a stimulative policy. While we believe that the Fed's next move is more likely to be easing rather than tightening, we also think that the Fed is sensitive to perceptions that their actions are dictated by anything other than economic conditions.

Concerns about encouraging moral hazard notwithstanding, we have probably returned to a regime of coordinated central bank easing. From a markets perspective, this likely means a return to increased correlation across asset classes, with fewer "big ideas," and a particularly difficult environment for expressing broadly bearish views. We do not have a crystal ball to predict how long US trade negotiations, whether with China, the EU or elsewhere, might be a drag on global growth, or how long it will take to re-create disrupted supply chains. However, this should still be a good opportunity for stock pickers to differentiate themselves through idiosyncratic idea generation (particularly ones who are able to generate alpha from shorting).

In closing, we would like to offer a cautionary warning. We are several years into an extended period of supportive policies, which spawned the mantras of "buy the dip" and "TINA" (i.e., there is no alternative to owning equities). We can see why there might be a temptation to continue with the same playbook. However, the combinations of political and economic uncertainties in addition to dependency on accommodative monetary policy are likely to result in periods of higher market volatility than has prevailed over the last decade. During these episodes, correlations across asset classes tend to increase as well, so portfolios will need to be durable with low leverage to weather these storms.

[2] Analysis assumes initial dividend of $2/share. Base case assumes 4.5% growth rate roughly equal to GDP (2.5% real GDP growth plus 2% inflation) and 7.5% discount rate roughly equal to the risk-free rate (2%) plus an equity risk premium (5.5%).

[3] A 0.75% increase in the risk-free rate starting at 5% results in an -11% decline in value (from $33 to $30).

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