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Could central banks boost stocks in the second half?

Weekly Market Compass: Trade wars remain a concern for the economy, but central banks appear poised to help

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The Fed is leaning toward loosening monetary policy, and several other central banks are exploring a more accommodative path. This is a critical factor in my second-half outlook, which I explore in more depth this week.

- The Fed is leaning toward loosening monetary policy, with a possible rate cut on the table for July.
- The Fed is not alone, as several other central banks are exploring a more accommodative path.
- Central banks' dovish turn is shaping my outlook for the back half of 2019.

The Federal Reserve (Fed) met last week and clearly telegraphed that it will no longer be "patient" and that it is leaning toward loosening monetary policy. Why? Fed Chair Jay Powell said trade developments and global growth concerns are on the mind of the central bank. As I look into the second half of the year, those two items are key to my outlook as well — and I believe the willingness of central banks to become more accommodative could be a positive development for stocks.

Is the Fed heading for a rate cut in July?

Last week's meeting deepened the abrupt "about face" we first saw from the Fed in January. Recall that just last October, Powell suggested that rates were "a long way" from neutral. Then just last December, he insisted that balance sheet normalization would continue on "auto pilot." But in January, the Fed abruptly changed its stance. It announced its plans to end balance sheet normalization by September 2019 and suggested it would be patient about its next rate decision — and that it could be a hike or a cut.

However, as the months passed, the market increasingly came to expect monetary loosening. And so last week's meeting represented a significant deepening in the Fed's dovish stance.

"... the case for somewhat more accommodative policy has strengthened," Powell said at his press conference on June 19.¹

Fed Vice Chair Richard Clarida explained in an interview, "There was, I think, broad agreement around the table that the case for providing more accommodation has increased since our May meeting."²

Minneapolis Fed President Neel Kashkari, a non-voting member of the Federal Open Market Committee (FOMC) this year, wrote in a June 21 essay that the Fed should cut interest rates



by half a percentage point, adding "I believe an aggressive policy action...is required to re-anchor inflation expectations at our target."³

It seems clear that a rate cut is on the table for the July FOMC meeting. But why? What is causing this continued march to more dovishness? In the past, members of the FOMC have suggested that they need to raise the inflation target, which justifies a rate cut without any deterioration in economic conditions – that is certainly what Kashkari suggested in his comments last week.

However, what we gleaned from the FOMC statement is that the Fed is concerned that the economy is slowing. The US economy is growing at a "moderate" pace, according to the Fed in its official statement, which is a downgrade from the previous meeting, when the central bank characterized the economy as "solid" in its official statement. And so the FOMC "will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion," the Fed's statement said. Powell provided more color during his press conference, explaining that, "It's really trade developments and concerns about global growth that are on our minds. . . . Risks seem to have grown."⁴

The risk of trade wars is what we have been warning about for several years now. Powell pointed to the fact that uncertainty has increased, and business investment is slowing. As I have warned, economic policy uncertainty has historically depressed business investment, and it seems that history may be repeating itself.

Global central banks may loosen policy as well

The Fed is not alone. Last week the European Central Bank (ECB) signaled its interest in loosening monetary policy. Ditto for the Bank of Japan, which is looking for more tools that could help it become accommodative. And while the Bank of England has been talking tough, it cut its growth forecast for Britain's economy to zero in the second quarter, highlighting risks from global trade tensions and growing fears of a no-deal Brexit.

And so the result has been that the universe of negative-yielding sovereign bonds grew last week to approximately \$13 trillion, according to Bloomberg.⁵ However, this phenomenon is not limited to government debt. Bloomberg also reported that nearly a quarter of investment grade credit is now negative yielding as well. ⁵

My outlook for the second half of 2019

Central banks' dovish turn is shaping my outlook for the back half of 2019. I expect slower growth, as I don't see an end to the trade wars. While stocks rose last week on news that US President Donald Trump and Chinese President Xi Jinping will meet at this week's G-20 meeting to discuss trade, I caution against any optimism. Nothing has changed that would suggest that China and the US will reach a common ground; if anything, both sides are digging their heels in. One or both parties to negotiations might try to put a positive spin on the talks, but I believe it is highly unlikely that a trade deal will be reached any time soon – if ever during the Trump presidency. However, I believe that significant central bank accommodation should not only keep the US and other major economies from going into recession, but should cause, in general, risk assets globally to outperform non-risk assets.



We also recognize the continued need to find diversified sources of income, as relying solely on traditional sources, such as government bonds, may not provide adequate retirement income in a low-yield world.

Below, I highlight the key points of my second-half outlook, developed with my colleagues in the Global Market Strategy Office:

Global:

- Risks are increasing around the world given the worsening trade situation and a general slowdown in economic growth. However, we expect more monetary policy accommodation by major central banks such as the Fed and the People's Bank of China, which would be a powerful force to help support markets and economic growth.
- Therefore, we expect global growth to decelerate only modestly in the back half of the year.
- In this environment, we expect risk assets to outperform in general. We also recognize the continued need to find diversified sources of income.

US:

- We expect the US economy to decelerate modestly in the back half of this year.
- We expect the Fed to provide adequate accommodation, which would help to continue to elongate this business cycle.
- Financial conditions have been easing since Powell's June 4 speech on the risks from the trade wars. In addition, inflation expectations are declining. This makes it increasingly likely that the Fed may cut rates. We expect this monetary policy backdrop to support risk assets — especially equities. However, we expect more volatility given that geopolitical risk is rising, and is not entirely priced into US equities.
- Also, given that rates are expected to be lower for longer, investors may consider a wider variety of income sources including investment grade credit, municipals and other higher yield fixed income asset classes, as well as dividend-paying stocks.
- We are following recession indicators closely. We believe investors should be ready to tactically shift their portfolios if compelling signs of a recession appear.

UK:

- The odds of a "no-deal" Brexit have ratcheted up. We believe such a deal would be better for the gilt market than for the equity market — with the caveat that any weakening in sterling should provide support to larger-cap equities (specifically UK multinational companies).
- We are not confident about the economic backdrop for the UK over the next year, but we expect it to improve over the longer term.
- Key question we are watching: When will the Bank of England cut rates to shore things up a bit?

Eurozone:

- We expect a continued, modest deceleration in the eurozone economy in the next few months.
- There are concerns that the next ECB president — who will begin his or her term in November — may be more hawkish and accelerate a slowdown in the eurozone.



- Because the ECB may not be accommodative enough, we are cautious about eurozone equities in the next six months.
- Exposure to eurozone investment grade and high yield credit makes sense, in our view.
- We believe eurozone real estate also looks attractive.

Asia Pacific:

- Japan is experiencing an improvement. We believe the yen is likely to stay around the same level.
- Valuations are attractive for Japanese equities, in our view.

Emerging markets (EM):

- In general, EM stands to potentially benefit from more Fed accommodation.
- However, EM could be hurt if the trade war worsens and the economic slowdown accelerates.
- We believe investors need to be selective with EM equities — we expect there to be both winners and losers.
- We expect China to maintain growth at the 6% to 6.5% level. The government is doing a good job in terms of providing stimulus to China, in our view. We recognize that Chinese monetary growth has been lackluster despite the level of stimulus, but looking at metrics such as loan growth and rail freight suggests growth is solid, in our view.
- We are also seeing more flows into Chinese equities because of greater inclusion in some MSCI indexes.

Conclusion

Looking ahead, we will be vigilant in terms of watching for signs that the slowdown may be turning into a recession. However, at this juncture, we expect the economic expansion to continue — albeit more slowly.

1 Source: Bloomberg, L.P., "Fed scraps patient approach and opens door to potential rate cut," June 19, 2019

2 Source: Bloomberg TV interview, cited in The Wall Street Journal, "Fed's Richard Clarida: 'We'll act as appropriate to sustain expansion,'" June 21, 2019

3 Source: Federal Reserve Bank of Minneapolis, "A strategy to re-anchor inflation expectations," Neel Kashkari, June 21, 2019

4 Source: Washington Post, "US markets mixed amid Iran tensions, G-20 anticipation," June 21, 2019

5 Source: Bloomberg, L.P., "The world now has \$13 trillion of debt with below-zero yields," June 20, 2019

Important information

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