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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Final Monetary Solution for the Euro Zone: “Whatever It Takes” and “As Long as It takes”

Submitted September 15, 2019

Mario Draghi’s penultimate meeting at the European Central Bank (ECB) was contentious and combative. He somehow pulled it off with a cut in the ECB deposit rate from minus 0.4% to minus 0.5% and with a new round of quantitative easing that will pump 20 billion euros directly into the market every month. These actions were less than either economists expected, or the market would have liked. Nevertheless, he gained the support of the hawkish banks--Germany, Netherlands and France--by acknowledging the stress that the policy of negative rates inflicts on the profitability of banks operating in the euro-zone and by insisting that it was high time for fiscal policy to take charge.

Firstly, the ECB introduced a system known as tiering which the Swiss National Bank and the Bank of Japan already practice, exempting the private banks’ holding excess liquidity from the charge brought about by the negative rate policy. A tiering system is absolutely necessary to soften the detrimental consequences of a negative deposit facility rate. The exemption will benefit banking institutions in Germany, Netherlands and France, which hold a significant portion of excess liquidity and make most use of the ECB’s deposit facility. For example, it represents 200 million Euros in reduced costs for the Deutsche Bank. It’s clearly a concession to get approval from the hawkish central banks in Germany, France and the Netherlands. It won’t help bank lenders in the 16 other countries like Spain, Italy and Greece for they make little use of the facility.

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Secondly, Mr. Draghi admitted that the ECB had very little ammunition left to fight a downturn, let alone a recession, suggesting that the real elephant in the room is fiscal policy. It's what is needed to get growth and inflation back on track, according to all members of the Governing Council. By refraining from further monetary largesse, politicians may have to take fiscal action to reinvigorate inflation and engineer growth. The rationale behind this admittance by Draghi is to prepare the ground for Christine Lagarde's new role as head of the ECB in November. She needs to know that the monetary authorities will support her in her effort to convince countries with budgetary and current account surpluses like Germany, Austria, Holland and Denmark along with non-surplus members like Sweden, Russia, Norway and Switzerland to introduce expansionary economic measures. Lagarde is a seasoned political operator and consensus builder. Mr. Draghi has been quite open in advancing that she may prove especially useful going forward, in moving the whole European economy toward fiscal stimulus. As a matter of fact, she can do more than just move the needle on fiscal stimulus across the bloc. She has demonstrated at the helm of the IMF, that she is capable of fostering trust among skeptics, to internally amend dissent and engineer political outcomes. In this connection, she obtained the unanimous support of the ECB's 25-member Governing Council for last week's plea she issued to the European parliament for fiscal help.

The aforementioned background allowed Draghi to overcome his critics by bringing off a dovish monetary miracle with a bang. The new QE program is to "run for as long as necessary" and "only end shortly before the ECB starts raising rates." Moreover, the ECB promised not to raise interest rates "until it has been seen the inflation outlook robustly converge with its target of just 2%."

Given the current political context, the ECB is forcing governments not to cling to economic orthodoxy and do more of the heavy lifting. The bold finale was symptomatic of the upside-down world of modern finance where a lower policy rate brought higher long-term rates. We are now about to have an upwardly sloping yield curve in Europe and the U.S.. By making a whole swath of excess reserves exempt from negative rates and persuading governments to spend, banks logically cash out of bonds and park their bond trading gains at the ECB for profits. By the same token, QE at infinity is transforming sovereign debt-to-N-GDP ratios by moving bonds from risk-averse investors towards more risk-tolerant central banks. A sizable QE can be meaningful because it is an important risk transfer, easing the transition from monetary policy to fiscal policy. Barnaby Martin of Bank of America explained in a note to investors that fixed-income markets are

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less likely to be subject to tantrums as debt levels rise, if the long-term buyers of sovereign debt are risk tolerant central banks. It makes some sense, for central banks are indeed mostly "buy-and-hold" institutions. He points out the experience of Japan. Japan has one of the highest government debt-GDP ratios across the globe, and yet the volatility of Japanese bonds has been conspicuously low for ten years. The ECB has, in fact, sent a message that it will support all fiscal measures by being an active buyer of debt issuance.

As one would have expected, President Trump reacted in his usual way, emphasizing that the boneheads at the Fed sit, and sit, and sit while the ECB is acting quickly, cutting rates which hurt U.S. exports. He is urging the Fed to cut rates to zero and beyond to finance government spending. Although this is not surprising coming from a real estate developer, it is a bad idea.

It is evident that the moves by the ECB and the oil supply shock are ramping up pressure on the Fed and raising the expectation that a second 25bps rate cut is in the cards for Wednesday. The reversal in bond prices, better than expected prints for retailers and higher consumer prices may be causes for the Fed to pause, yet, the fed-funds future market still puts an 88.8% chance of a 25 basis points cut. While I believe that the Fed may hesitate to fully manifest its intentions while the trade negotiations are on, the Fed will probably cut rates until the yield curve is no longer inverted, and the policy rate equals the neutral rate. We are almost there.

However, I'm certain that we are not going to see negative or zero-bound interest rates in North America in this cycle. There are big differences between the Eurozone and U.S. economies.

1. Overall economic growth is much stronger in the U.S. (2.1%) than in the Eurozone (1.0%).
2. Overall inflation is much higher in the U.S. (2.3%) than in the Eurozone (1.0%).
3. Overall the U.S. has a Current-Account Deficit (2.2% of N-GDP) versus a 2.9% surplus for the Eurozone.
4. Overall the U.S. has a Budget deficit that is 4.7% of N-GDP compared to smaller deficit of 1.1% for the Eurozone.

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Based on the above data and relying on the thesis that the percentage change in N-GDP is what in the fullness of time, determines the interest rate level, on average it should be about 1.5% higher than in the Eurozone. This is particularly important as the U.S. can ill afford to have interest rates equal to those in the Eurozone because foreign capital is essential for the funding of its twin deficits which represent almost 7.0% of N-GDP.

The Fed has been lukewarm at best about the possibility of negative rates for it could cause an outrage among borrowers who rely on liquidity to fund their investments or spending. It would definitely drag the Fed into a political maelstrom. In fact, the big U.S. banks are more money market banks than deposit banks and therefore subjected to market disruption. Unlike their peers in the U.S. Euro-banks and the Canadian ones, are significantly less sensitive to money market conditions.

In the final analysis negative rates could be deemed illegal and, therefore, are way down the list of things that the Fed would do.

P.S.1 Productivity gains have been good of late---a noticeable upward swing started at the end of 2016. James W. Paulsen of Leuthold Group wrote an interesting perspective in the Barron's on welcoming productivity back. Note that rising productivity negates the need to lower interest rates.

"We have an unemployment rate of only 3.7%, fairly strong wage inflation despite an economic slowdown, job openings exceeding the number of unemployed workers, and we're in the midst of the longest-ever recovery in U.S. history. Is there a more opportune moment for productivity to finally make an appearance in this expansion?

At a time when many worry that a recession lingers nearby, it is comforting to remember that productivity is inherently a recovery extender. It allows a fully employed economy to continue to grow without aggravating the forces that often bring its demise (higher inflation, higher yields, policy tightening, profit

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margin pressures and real income erosion). Without productivity gains, once full employment is reached, the economy often becomes a zero-sum game--either business takes most of the economic fruits in profit, or scarce labor wins by demanding a larger and larger share of the overall budget. However, with rising productivity...profits and labor incomes can both rise together."

P.S.2 Surges in oil prices have on several past occasions created recession triggers, with such episodes occurring in 1990, 2000 and 2008. In the judgment of Data Trek, a 90% price spike is needed to bring about the necessary imbalance to cause a recession. In other words, oil would have to rally to $90 a barrel to affect a tipping point.

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By Hubert Marleau

The September FOMC Delivered a Hawkish Decision: New Motto "Never Explain, Never Apologize"

Submitted September 18, 2019

The Federal Reserve cut its benchmark interest rate by a quarter-percentage point for the second time in two months as it tries to guard the economy against trade-related uncertainty and slowing economic growth around the world. According to the OECD, intensifying trade conflicts are sending global growth to a mere 2.9% this year compared to a previous forecast of 3.2%.

The policy rate is now set in a range of 1.75 to 2.00 percent. While Chairman Jerome Powell left the door open for further cuts if the domestic economic conditions were to deteriorate, pledging that the Fed is data-dependent, not a single official sees the fed fund rate falling lower than 1.5 to 1.75 percent through the end of 2022. The so-called dot plot showed that the fed funds rate will remain unchanged through the rest of 2019 and 2020.

The markets have noticeably reduced the odds of another rate cut in October to 55% compared to 100% before the meeting because the message set the bar higher for further easing. In Greg Ip of the WSJ wrote that Chairman Powell refused to elaborate on what the Fed will do next, leaving less room for misinterpretation and forcing the market to think for itself. In the final analysis, Mr. Powell said: "We made one decision at the meeting." What else could he say. There is a slip within the FOMC. The disagreement is unusual, making it difficult to predict which way the monetary stance is heading. In my view, what can be realistically and safely deduce is only one more rate cut of 25bps. Based on what we know about the economy today, we will then soon have a policy rate that will be lower than the neutral rate and an upward sloping curve. That can only be good.

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