HOLBROOK HOLDINGS

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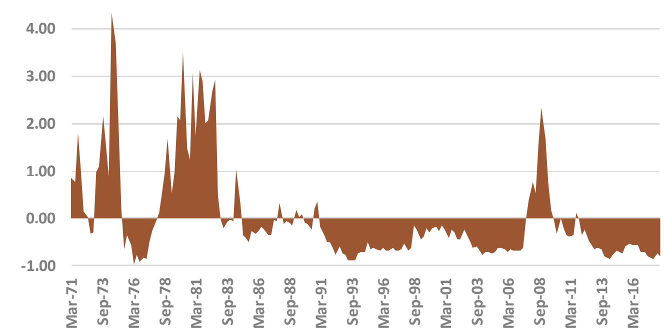
THE UNITED STATES IS BECOMING MORE NORMAL

FED "HAWKISH" POLICY IS REALLY JUST NORMAL

Forward projections issued by Federal Reserve members after the June meeting sparked broad criticism for its "hawkish" guidance. The "dot-plot" was revised from an expected three rate hikes in 2018 to four. Lost in all of the post-announcement commentary was the fact that only one voting member adjusted their baseline forecast, which was enough to push the median projection higher. Headlines focused on the "looming dollar crisis," the "vulnerability of Emerging Markets to a rising dollar", and of course, potential for "imminent yield curve inversion" in the United States. The headlines, as usual, are just noise, and do more to hurt the average investor than help. The bipolarity of economic commentary is corroborated by the fact that only six months ago, the major concern was dollar weakness. Do NOT fixate on a media narrative, because it is driven by sentiment, and sentiment is not only fickle, it is an investor's worst enemy.

I do not want to snub the importance of monetary policy on both economic growth and the markets. They certainly have an effect, but context is warranted. The U.S. economy currently has an unemployment rate of 3.8%, below many estimates for what constitutes full employment. And, core-PCE, the Fed's preferred measure of inflation, is close to their 2% "symmetrical" target. What follows is very simple, normalization. Until these two lagging metrics deviate from Fed objectives, there will be no change to policy. Monetary policy is still very accommodative and monetary conditions are extremely loose as demonstrated in the subsequent chart. The last two recessions were preceded by financial condition readings much closer to (or above) zero. Although we are in the late stages of this expansion, financial conditions are not yet flashing red, and the Fed certainly has room to tighten.

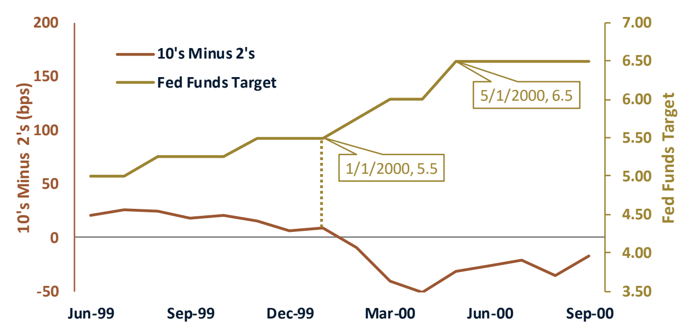
Financial Conditions Index



Source Bloomberg, CFNFC Index, 6.20.2018

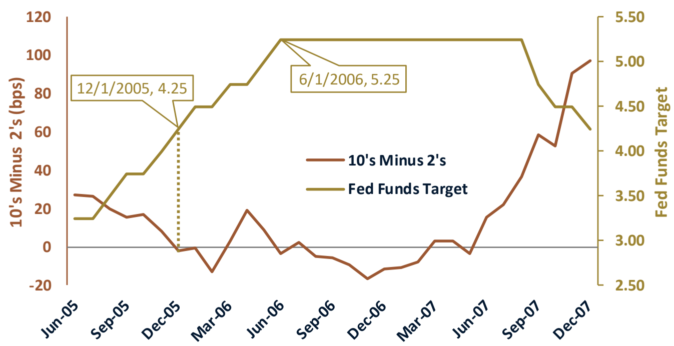
For those that think the Federal Reserve will stop hiking rates for fear of an inverted yield curve, history will take the other side of that argument. In both the last two rate-hiking cycles the Fed raised short-term rates an additional 100 bps after the yield curve inverted.

2000 Fed Response to Inversion



Source: Bloomberg 6.20.2018

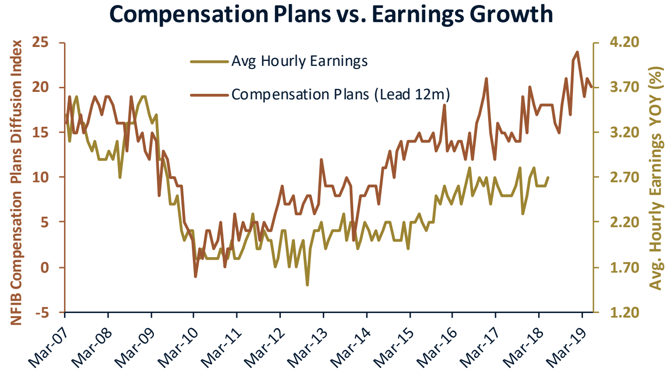
2005 Fed Response to Inversion



Source: Bloomberg 6.20.2018

Federal Reserve members note that wage growth has yet to spike, and as such, gradual normalization is appropriate. One indicator that I follow is the NFIB Small Business Survey. The Small Business Compensation Plans Diffusion Index generally leads wage growth by twelve months. In the following chart you can see that it is likely wage growth will continue to accelerate. If so, there is a risk that the Fed might hasten their tightening program.

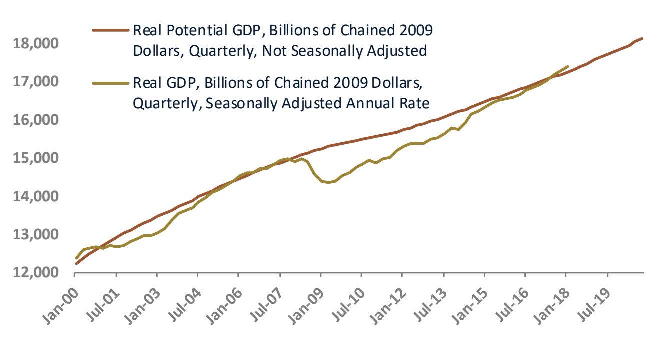
Compensation Plans vs. Earnings Growth



Source: Bloomberg 6.20.2018

Recently, the output gap has closed and Real GDP in the U.S. is overshooting it's potential. Historically, this has been an inflection point for accelerating inflation.

Real GDP vs. Potential Real GDP



Source: Federal Reserve Bank of St. Louis, 6.20.2018

So, while market pundits debate whether the Fed raises three or four times in 2018, I'll handicap it at four or five.

ECONOMISTS HAVE THE DEMOGRAPHIC ARGUMENT ALL WRONG

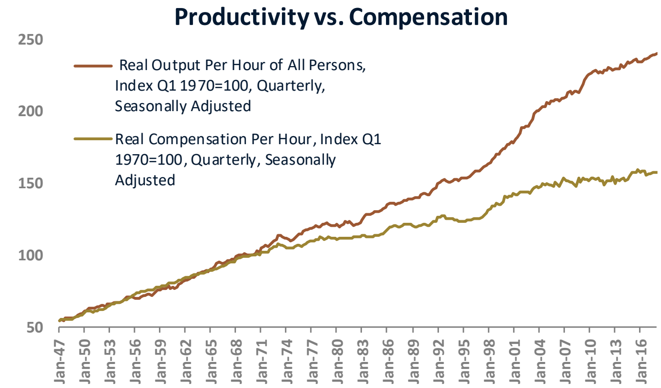
Many economists view aging demographics as a deflationary force for developed economies. They cite Japan as their case study. Indeed, Japan has an aging population and has suffered from deflation for much of the past thirty years, but correlation is not causal. Few empirical studies have actually been conducted on the matter, and it is far more likely that persistent deflation (or disinflation in the U.S.) is the result of stagnant wages resulting from a labor supply glut.

In the U.S., aging baby-boomers expanded the labor-force population after 1970. Rising female participation rates exacerbated labor oversupply. And finally, globalization gave U.S. companies access to a massive pool of cheap labor overseas. However, all of these demographic forces are reversing. The female participation rate topped out in 2000, and the overall working-age population in the United States has been falling since 2007. Outsourcing is less profitable as the cost of labor in emerging economies catches up to that of the U.S. As the labor glut transitions to a shortage, wages will likely breakout of their multi-generational doldrums, and disinflation (and falling yields) will be a relic of the past.

The more recent risk of global trade wars will serve to accelerate an inflationary process that is already taking place. Not only do tariffs directly raise consumer prices, but they inflate production prices at every level of the supply chain.

In terms of aging demographics -- On the surface it might seem that older cohorts consume less. However, from a money flow perspective, this is not the case, especially in what I forecast to be the political environment moving forward. Older cohorts have a higher marginal propensity to consume. That is, they spend a higher percentage of their income. And while a growing percentage of their income will be sourced from transfer payments (Social Security, Medicare etc.) all of that is spent and recycled into the economy. Whether it is financed by savers via taxes (the working-age cohort) or with more sovereign debt, it doesn't matter, both are inflationary.

I titled this newsletter, "The United States is Becoming More Normal," and while it directly refers monetary policy, its application may be far more prescient and universal. I include the below chart because it is my favorite. It incapsulates a multitude of economic trends over the last 50 years. The chart plots productivity growth (output per hour worked) and compensation growth.



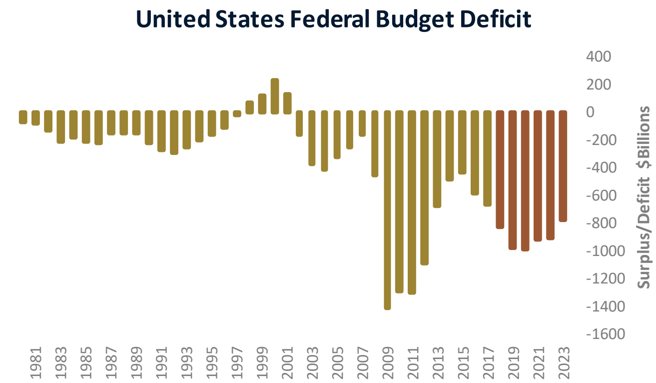
Source: Federal Reserve Bank of St. Louis, 6.20.2018

Until 1970, both time-series grew in lock-step as workers directly benefitted from increased productivity. Since then, the gap between the two has expanded. Why have these diverged? Simple, the aforementioned labor supply glut. The implications of this divergence have been colossal. Corporate profits have ballooned as margins expanded. Income inequality followed. Companies invested more to access cheap labor than they did to grow capex. Investment and productivity naturally slowed. Many of the current economic problems can be attributed to the demographic changes and labor oversupply that surfaced in the 1970's.

As this glut shifts to a shortage, everything we have come to know over the last fifty years will reverse. Companies will experience margin deterioration. Income inequality will begin to reverse. Firms that have spent the last few decades investing in labor will start shifting their inputs and capex will spike. Investment and productivity will ultimately be the result. Wage growth and inflation will re-emerge. And interest rates? They will go higher. In short, monetary policy is not the only thing that will normalize.

MONEY SUPPLY IS DICTATED BY FISCAL DEFICITS – LIQUIDITY IS DICTATED BY THE FED

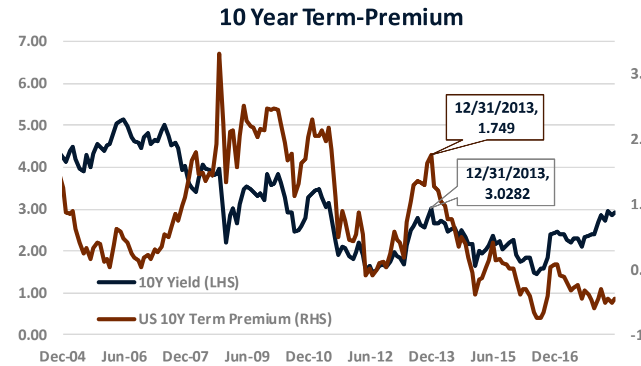
Again, I do not want to minimize the effect that the Federal Reserve has on the economy and the markets, but I do want to make a few distinctions. First, the true monetary base is grown through the issuance of sovereign debt. As the Federal government spends, it injects money into the economy. It can then recapture that money through the implementation of taxes, or, as it recently has done, it can finance any over-spending by accessing the debt markets. Now turning to the Federal Reserve and the Banking system: Both have tangible effects on the money supply in the short-run. The Federal Reserve, through its open-market operations can alter the money supply by purchasing or selling sovereign debt. Their actions are then magnified through the lens of a fractional reserve system. The point is that while the Federal Reserve and bank lending affect money supply at the margin, true money growth is a function of the Federal deficit. The Congressional Budget Office, expects high fiscal deficits over the next decade, and that ignores the potential for a Recession. Money supply growth, regardless of Fed intervention, is likely to accelerate.



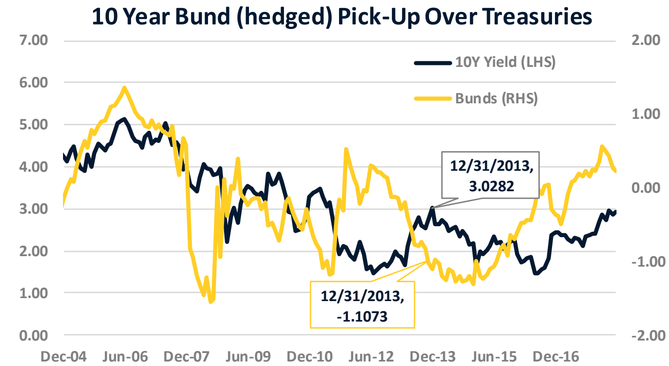
Source: Congressional Budget Office, 6.20.2018

THERE IS NO RELATIVE VALUE IN TREASURIES

The last time we tested 3% on the ten-year treasury was the fourth quarter of 2013. The market had spent much of the latter part of the year reacting to Bernanke's indication that QE would be tapered (the Taper Tantrum). Furthermore, on a relative basis, long-term treasuries offered decent risk/reward prospects. The ten-year term-premium (the premium investors demand to hold longer-term treasuries instead of continually reinvesting three-month T-Bills) was 1.75%. This compares favorably to the term-premium today which is -45 bps. That effectively means that long-term treasury investors are actually paying to take on duration risk. Negative term-premiums have persisted over the last couple of years, but prior to 2012 the last time they were negative was the early 1960's. Treasury bulls should be asking themselves if the current environment is an anomaly or are we about to experience some sort of mean reversion. I am in the latter camp. In any case, investors in the ten-year treasury bond in late 2013 were being compensated for their duration risk. Today? Not so much.

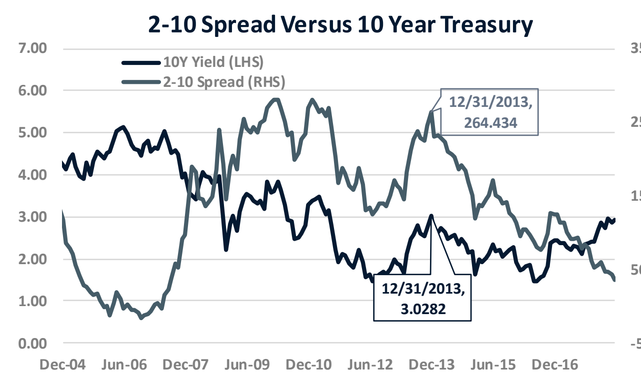


Source: Bloomberg 6.20.2018



Source: Bloomberg 6.20.2018

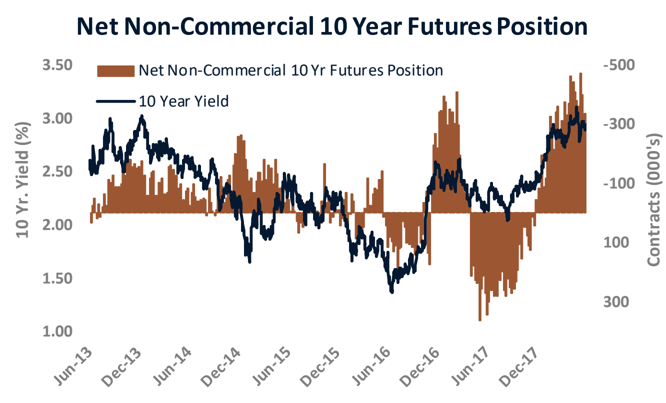
Similarly, and somewhat related to the previous point, the yield curve is offering little value on the long-end. Below is a chart of the ten-year yield and yield curve steepness. The last time we tested 3%, a ten-year bond offered 264 bps of yield pick-up over a 2-year treasury. Investors were incentivized to extend duration so as to pick-up yield. Today, due to aggressive Fed policy on the short-end of the curve, that yield pick-up is only 36 bps. As more and more rate hikes get priced in to the market, the risk becomes that the Fed will NOT be as aggressive or that they will shift their QT program from short-term reinvestments, to outright selling of longer-term bonds. Both would result in significant steepening.



Source: Bloomberg 6.20.2018

Recent trends at treasury auctions have been characterized by weakness in the indirect bid (foreign Central Banks). This makes sense given that treasuries, although providing significant nominal yield pick-ups, are actually relatively expensive when currency risk is hedged. The chart below shows that in 2013, the last time we flirted with 3%, a German investor could get an additional 111 bps of yield on a hedged basis by investing in treasuries over bunds. Today, that same investor is 23 bps better off by staying in Bunds. I expect continued weak indirect bids at auctions since treasuries are offering little value to foreign investors.

Given the lack of relative value in treasuries, especially on the long-end of the curve, I expect yields to move higher over the next twelve months -- potentially much higher. However, the short treasury trade is currently a crowded one. Net speculative short positions in the ten-year futures contract are hovering at all-time highs. This does not guarantee that yields will move lower in the near-term, but it certainly increases the likelihood. It is not until this imbalance is remedied that I believe longer-term rates can spike meaningfully.



Source: Bloomberg 6.20.2018

CONCLUSION

The "hawkish" Fed is really quite normal when viewed in the context of their dual mandate, current monetary conditions, and the economy. Inflation expectations post-Fed have remained stable, and an inverted yield curve, although inevitable, will not prevent the Fed from reacting to macro-economic data. In terms of treasury rates, the long-end of the curve offers very little relative value and we expect rates to continue on their upward trajectory after sentiment becomes less bearish and the short treasury trade becomes less crowded.