



# Mind the Gap

With upward revisions to the natural rate, it looks like the Fed may still have plenty more wood to chop.

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## Key takeaways

- One measure of the natural rate of interest—R-Star—recently was revised higher by 0.9 percentage points, implying U.S. Federal Reserve policy remains quite accommodative.
- This change suggests to me the potential for more upside risk to interest rates.
- My conclusion that the Fed is still well below neutral further supports my view that a sell signal from an inverted yield curve over the next 12 to 18 months likely will prove premature.

## Is Fed policy easier than we thought?

A big part of my market-cycle work is based on the thesis that monetary policy should be judged not against some arbitrary rate of interest (like zero) but rather on where the policy rate is set relative to the natural (or neutral) interest rate, otherwise known as R-Star. R-Star is the theoretical rate of interest (meaning it cannot be observed directly) at which the economy is in equilibrium, i.e., growing at its full potential amid stable inflation.

This context in turn has implications for what effect an inverted yield curve (which could appear by 2020) might have on the business cycle. My thesis has been that, this time around, an inverted curve could pack less of a punch were it to occur when the Federal Reserve's target rate is only at or modestly above the neutral rate. So, to me, the level and direction of R-Star is very important.

Conventional wisdom in recent years has been that R-Star has been flat-lining just above 0% real and 2% nominal, which implies Fed policy has now approached the neutral

zone (with a federal funds target rate of 1.75%–2.0%). This in turn suggests that, after seven rate hikes, the Fed may not be all that far from the end of its tightening campaign, assuming the Fed’s goal is to go from a very accommodative to a somewhat restrictive monetary environment. Indeed, the federal funds forward curve has been signaling just that, pricing in just three more hikes by mid-2020 to a terminal funds rate of about 2.7%. This is well shy of the Fed’s dot plot,<sup>1</sup> which suggests six more hikes through 2020.

So, it was a meaningful development for me when I noticed a few weeks ago that one particular measure of R-Star, the Federal Reserve’s Laubach-Williams two-sided estimate<sup>2</sup> (there are others), was revised meaningfully higher, from 0.05% to 0.86%. Now, instead of peaking at around 2.0% in 2007 and falling to around zero in 2015

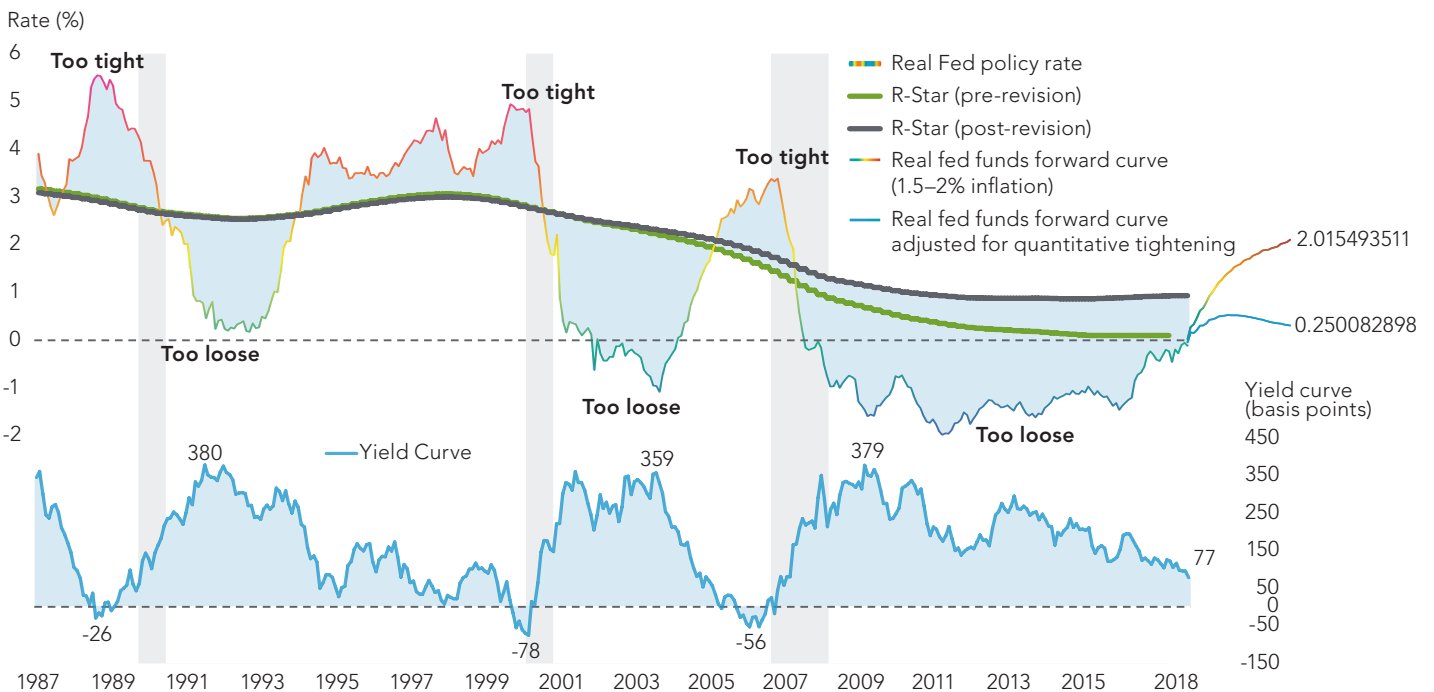
(and essentially flat-lining ever since), R-Star is shown as having fallen to 0.86% by 2015 and slowly climbing since (Exhibit 1).

Why should we care about a revision to a theoretical and backward-looking construct? Well, if R-Star is at zero (real) and core PCE<sup>3</sup> is 2%, then nominal R-Star is at 2%. That would mean the fed funds target rate has effectively already reached neutral, implying that if the Fed intends to get to a moderately restrictive state, the forward curve has it basically right in pricing in just three more hikes over the next two years.

But if nominal R-Star is not at 2% but rather at 3% and rising, as one of the revised Laubach-Williams series now suggests, then that says to me the Fed has a lot more wood to chop just to get to neutral, let alone moderately restrictive.

**EXHIBIT 1: Compared with the natural rate (R\*), real U.S. monetary policy might still be “easy”**

Fed Interest Rate Cycles (1987–2018)



Sources: San Francisco Federal Reserve, Haver Analytics, Fidelity Investments; monthly data as of August 31, 2018.

I don't want to make too, too much of this, since after all R-Star is a theoretical construct that cannot be observed in real time. How much the Fed bases its monetary policy decisions on the level and direction of R-Star is something about which we can only speculate. My guess is that it's just one of many inputs.

Still, the difference between 0.05% and 0.86% amounts to about three rate hikes, which is not insignificant. What this suggests to me is that instead of being at neutral, the Fed may actually still be quite accommodative vis-à-vis the natural rate. That in turn could mean the fed funds forward curve may be too complacent with the market's assumption of three hikes to 2.67% by mid-2020, and by extension that the Fed's dot plot has it more right than the forward curve. Indeed, since Labor Day weekend the 10-year Treasury yield curve already has jumped by more than 20 basis points. Who knows? There might be some upside risk to the dot plot come September or December if some members of the Federal Open Market Committee conclude that the economy is stronger than they had previously anticipated.

The above also suggests that financial conditions could tighten further and the dollar, strengthen further. I think of it this way: For months now the market has been waiting for the proverbial light at the end of the tunnel in terms of the divergence in monetary policy between the U.S. Federal Reserve and the rest of the world—especially the European Central Bank (ECB). The longer we wait, the closer the Fed will get to the end of its tightening campaign and the closer the ECB will get to the start of its. Now, that light at the end of the tunnel may be getting dimmer instead of brighter.

If financial conditions tighten and the dollar strengthens, that in turn suggests it may be too soon to bottom-fish in emerging-market waters. EM relies heavily on a falling dollar and easy liquidity conditions. I think investors may

be overreacting here—EM is showing a year-to-date through September 15 performance gap of roughly 20 percentage points versus the United States—but, without a catalyst in the form of easier liquidity conditions, it's hard for me to see a bottom.

It also suggests to me that valuation headwinds for equities in general could persist for some time, given that P/E (price-earnings) ratios generally move lower during periods when financial conditions are tightening, as they are now. With U.S. year-over-year earnings growth peaking, U.S. equities may see little upside from here.

My "glass-half-full" interpretation is that because the Fed may be a lot more accommodative than thought, even a fed funds rate north of 3% would not be problematic for the U.S. economy, whether or not Fed action results in an inverted 3m10y curve (where 3m10y is the difference between 3-month and 10-year Treasury yields). So, it adds to my conviction that a sell signal from an inverted curve in 2019 or 2020 would be premature. In my view it likewise follows that even if 10-year Treasuries go well into a three-handle [3%], it likely won't kill the expansion.

The bottom line is that the Fed probably is further below neutral than even I thought it was.

### Mind the other gap as well

The performance gap between the U.S. and ex-U.S. (especially EM) equities is unprecedented; by my count the U.S.–EM differential is, as of September 15, at least 20 percentage points since the January peak in the global stock market. Relative performance is highly correlated to relative earnings growth of course, so it should come as no surprise that the year-over-year earnings gap between U.S. and emerging markets also is huge, shifting from +11% to -13% (Exhibit 2).

Earnings and performance gaps between the U.S. and EM economies are far from uncommon, but what is

unusual (indeed, unprecedented) is the fact that this earnings gap is happening with U.S. earnings growth (and economic activity in general) accelerating higher while the rest of the world is slowing down. From what I can see in the MSCI series, this is a first. Usually it's just a matter of all series moving directionally in tandem but EM moving more so than the United States.

So, is EM a buy? That's a tough one. The earnings and return gap usually resolves itself by EM recovering and, in the process, converging to U.S. levels, so my guess is that this should happen in the coming months or quarters. My sense that China is probably at the nadir of its two-year boom-bust cycle and now actively trying to reflate its

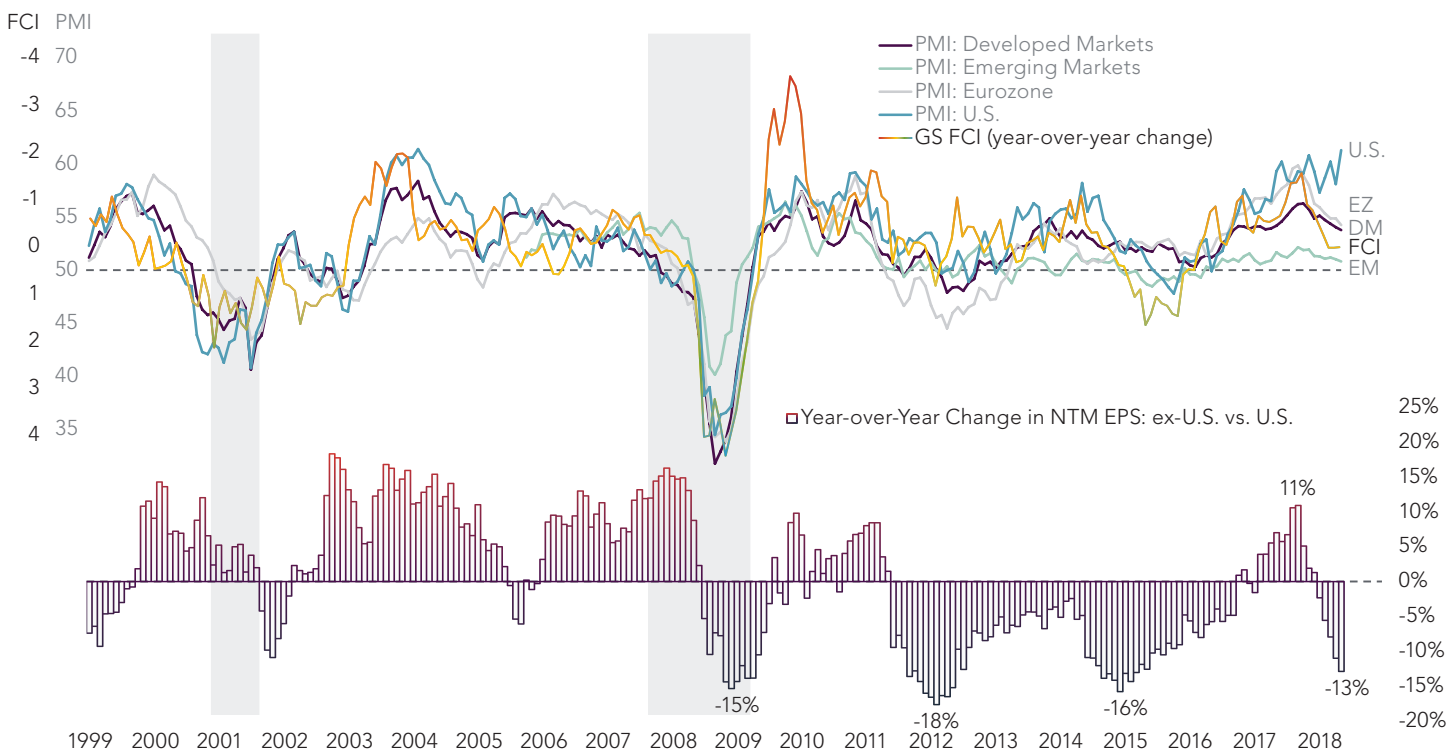
economy corroborates this thinking. So, perhaps we are close to an inflection point.

But as I pointed out earlier, if financial conditions continue to tighten from here as the Federal Reserve continues to raise rates—perhaps longer than the consensus currently expects—then it's hard to see a bullish catalyst developing over the short term. Back in 2016 when EM had a similar downturn, it was the Fed that came to the rescue by slowing down its tightening trajectory. Such an outcome seems much less likely this time around.

But even if EM does not recover in absolute terms, the relative performance gap could start to narrow in the coming months. In addition to the possibility of a

**EXHIBIT 2: Divergence between the U.S. and the rest of the world**

Comparing Various Purchasing Managers' Indexes (PMIs), Financial Conditions, and Year-over-Year Relative Earnings Growth (1999–2018)



PMIs shown for developed markets, emerging markets, the eurozone, and the United States. The Goldman Sachs Financial Conditions Index (GS FCI) indicates whether financial (liquidity) conditions are easing or tightening. Lower chart depicts year-over-year changes to estimated (next twelve months, or NTM) earnings per share for U.S. versus non-U.S. equities. Sources: Haver Analytics, Bloomberg Finance L.P., Fidelity Investments; monthly data as of August 31, 2018.

recovery in China's growth, it's also plausible that some of the performance gap will narrow from the U.S. side. As the top panel in Exhibit 2 shows, PMIs generally move in the opposite direction of the FCI. Thus it is somewhat unusual for the U.S. PMI to be making new cyclical highs while financial conditions are tightening. Clearly the U.S. tax cuts have played an important role in that divergence. In a way, the country's tax cuts have rendered the U.S. temporarily immune to the late cycle.

But signs have pointed to the growth rate for U.S. earnings peaking at around 24% (year-over-year) and that next year's growth could be back down to trend (around 7%). This suggests that the U.S. economic and profit cycles may soon see a deceleration (but not a contraction), much like EM and the rest of the world is already experiencing.

Perhaps it will be a combination of China reflatting at just the time the U.S. slows, as positive effects of the tax cuts peter out. My hunch is that this could be a 2019 story. We'll be watching.

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## Endnotes

<sup>1</sup> The "dot plot" is a graph showing where each of the 16 members of the Federal Open Market Committee (FOMC), the Federal Reserve's rate-setting body, expects the policy rate to be at the end of various calendar years and in the long run; the dot plot is published after each meeting of the FOMC.

<sup>2</sup> The Laubach-Williams (2003) model—developed by economists John C. Williams, currently president and CEO of the Federal Reserve Bank of New York, and Thomas Laubach, Director of Monetary Affairs at the Federal Reserve Board—is a multivariate model that uses data on real GDP (gross domestic product), inflation, and the federal funds rate to extract trends in U.S. economic growth and other factors influencing the natural rate of interest. The one-sided ("filtered") estimate considers only data available at the moment of calculation ("real time"), whereas the two-sided ("smoothed") estimate incorporates retrospective or "hindsight" information as it becomes available. Other measures of R-Star exist as well.

<sup>3</sup> The "core" PCE price index, calculated by the U.S. Bureau of Economic Analysis, is defined as personal consumption expenditure (PCE) prices excluding the more volatile food and energy prices.

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## Index definitions

**Goldman Sachs Financial Conditions Index** tracks changes in interest rates, credit spreads, equity prices, and the value of the U.S. dollar; a decrease in the index indicates an easing of financial conditions, while an increase indicates tightening.

A **Purchasing Managers' Index** (PMI) is a survey of a country's purchasing managers in a certain economic sector. A PMI over 50 represents expansion of the sector compared with the previous month, while a reading under 50 represents a contraction, and a reading of 50 indicates no change. The Institute for Supply Management® reports the U.S. manufacturing PMI®; Markit compiles non-U.S. PMIs.

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