

The Fed Can't Juice This Economy, It Can Only Inflate Asset Bubbles—and Everybody Knows It

By Michael Eisenband

A couple of months ago we wrote about periods of time when financial markets became disconnected from the real economy and how we were likely experiencing such a period now. We also expressed concern about the way in which the stock market increasingly is regarded as a proxy for the U.S. economy and its performance. This is even truer today than it was when we first wrote about it in April: U.S. financial markets have soared to record highs (the S&P 500 just had its best first half since 1997), even though our economy has weakened a bit, business anxieties have ratcheted higher, the yield curve inverted and earnings growth is slowing.

How can this paradox be explained? Well, we all know the answer to that question: the Fed will come to the rescue! Markets have placed an enormous amount of faith (and speculation) in the belief that rate cuts will be forthcoming in the second half of the year, which will be an impetus to spur growth. However, the near certainty around that assumption merits closer scrutiny.

Foremost, there are some debatable arguments that underpin the case that rate cuts are needed for our economy at this particular time, such as the following:

- **Weaker U.S. economic growth justifies rate cuts:** This argument asserts that the U.S. economy is beginning to weaken, and so preemptive rate cuts are needed. Other than recent slack in some manufacturing activity and slowing job-creation numbers in an economy long regarded as approaching full employment, weakness sufficient to justify a series of rate cuts isn't plainly evident. Corporate profit growth has slowed slightly, but we've yet to see a baseline forecast for any major market index anticipating an earnings slump either this year or next. Consumer confidence, though backing off from a near two-decade high, still remains elevated, and most Americans believe the economy is in good shape and their spending is reasonably healthy. Chairman Powell's frequent references to global economic "crosscurrents" and "uncertainties" sound vague and remote. Indeed,

the greatest uncertainty facing corporate America's executives today concerns the impact of a self-inflicted economic wound by way of imposed tariffs and mounting trade tensions. This trade showdown has dragged on for more than a year, and lingering uncertainty regarding its ultimate resolution continues to impact corporate decision-making in tariff-sensitive industries. But a trade impasse could be resolved swiftly, at which point such uncertainty would be mitigated and business confidence restored. While trade talks are ongoing, rate cuts by the Fed run the risk of becoming a premature stimulus conflated with or complicit in the politics of trade policy.

The announced resumption of trade talks with China, the suspension of additional tariffs and a strong job report for June should reduce the apparent urgency for a July rate cut, but markets are nonetheless expecting one. Trade resolution combined with rate cuts is the scenario that investors really are hoping for. Markets are betting big that going into an election year the White House won't let stalled trade negotiations jeopardize our domestic economy and that some resolution, however substantive, will be reached, with victory declared just in time for the campaign season. And as financial markets become the proverbial tail wagging the Fed dog, hasty rate cuts will reinforce the impression that the Fed has been tamed.

- **Rate hikes by the Fed in 2018 were a mistake:** This is a protracted refrain from the White House, though some market watchers say that last December's hike may have been one too many. It attributes recent economic weakness to these 2018 rates increases when in fact senior executives widely cite the uncertainty created by escalating trade tensions initiated by the White House as the primary cause of concern and anxiety in the corporate sector. Criticizing the 2018 Fed rate hikes, White House trade advisor Peter Navarro recently blamed the Fed yet again, claiming, "What we're feeling now is that residual mistake." He further insisted that tariffs were not hurting U.S. economic growth. Not many CEOs and economists would agree with his assessment, nor were the majority corporate folks grumbling about high interest rates.

Moving toward a normalizing monetary policy was appropriate in late 2017 and 2018 when economic growth and consumer spending had accelerated, job creation was robust and large corporations were rolling in cash flow and buying back stock to an unprecedented degree. To argue otherwise is tantamount to the belief that monetary policy should never be normalized following years of extraordinary stimulus that was never meant to be permanently embedded in the financial system.

- **Low inflation justifies rate cuts:** This reasoning has been offered by many market bulls who say that inflation continues to run below the Fed's target of 2.0%, which is true, so nominal rates are too high. Inflation, as tracked by the Fed, is currently around 1.5%. However, the real (i.e., inflation-adjusted) rate of return on 10-year Treasuries was recently a meager 0.4%—the lowest rate since quantitative easing (QE) policies were being implemented. Treasury rates have plunged since early May in anticipation of Fed rate cuts, but even before the rally, real Treasury yields were near 0.7% compared to 2.1% from 2003–2008, the last period in which the economy was humming, before the financial crisis. Even if today's inflation rate was negligible, Treasury rates would still be considered low compared with most any era of economic expansion up to 2008. Those advocating for Fed rate cuts are essentially arguing that real rates of return on riskless and near-riskless debt should be nudged toward zero amid a period of unprecedented corporate prosperity and decent economic growth. This low inflation argument for rate cuts sounds more like an intended policy change seeking rationale.

As for the impact of lower rates on economic growth in 2019, there's plenty of evidence to suggest that its effect on the real economy has so far been negligible. In fact, interest rates have declined notably since the Fed's pivot in January without any appreciable boost to the "real side" of our economy: corporate investment and capital

spending, the housing market, auto sales or any other kind of big ticket items. Are there really many factories just waiting to be built if only borrowing rates were 25 bps lower? It may even be possible that a Fed-articulated pivot to lower rates will have the unintended effect of discouraging spending and investment by convincing decision makers that the economy is nearing contraction when in fact it has only backslid just a bit. In Europe the ECB remains aggressively committed to QE stimulus, and while it has failed to stimulate much economic growth on the continent, most of its major stock market indexes have moved considerably higher. That sounds familiar.

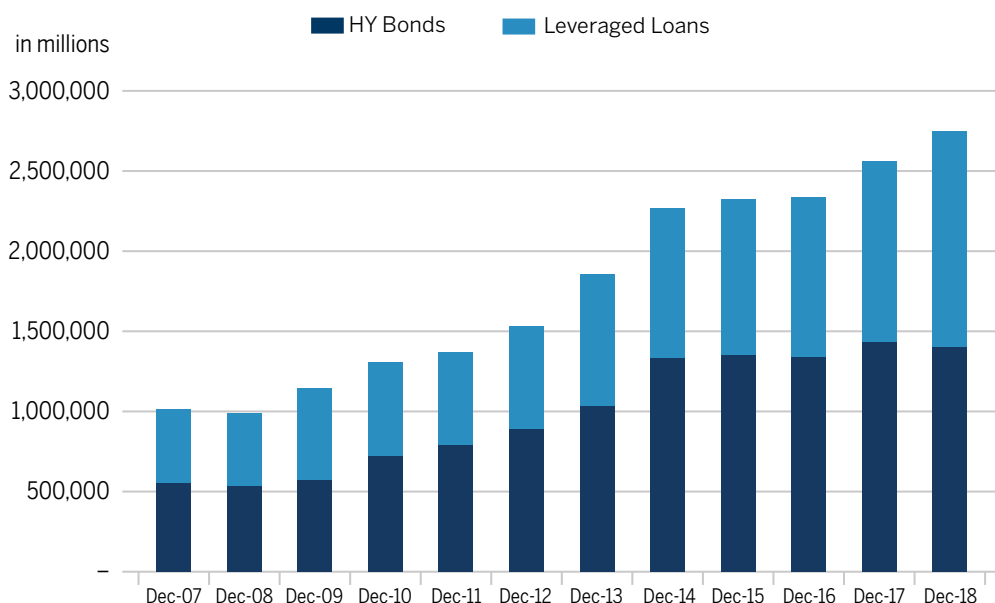
So why are markets so hopeful that the Fed can buttress our economy against a downturn? Because lower rates and the cessation of the Fed's balance sheet runoff will help ensure that financial markets and institutions remain awash in liquidity, which will encourage more risk taking and money flows into equity and corporate credit markets, and other asset classes. In other words, a dovish Fed policy would encourage the very behaviors that are often being cited as reckless by prominent market watchers and regulators, namely, undisciplined lending and excessive borrowing and speculation, and inflated valuations.

The signature achievements of three rounds of unprecedented monetary stimulus by the Fed have been a decade of modest and spotty economic recovery for most Americans, coupled with an explosion of corporate debt—particularly speculative-grade debt (**Exhibit 1**)—and surging private wealth for shareholders. This isn't quite the outcome that QE architects expected; nor did they envision a scenario where some \$3.5 trillion of monetary stimulus couldn't be slowly withdrawn a decade later for fear of disrupting financial markets, or one where leveraged corporate debt outstanding had increased by 180%, a CAGR of nearly 11% per annum, without any indication of abating.

Financial markets are saying loud and clear they are not ready to stop partying amid a softening economic backdrop, and soon enough we'll know whether the Fed will refill the punch bowl. For those waiting for corporate credit markets to get religion, more patience may be required. That's okay. There are more than enough floundering and distressed companies out there to keep us busy until that time arrives.

EXHIBIT 1

U.S. HY Bonds + Leveraged Loans Outstanding



Source: Deutsche Bank



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