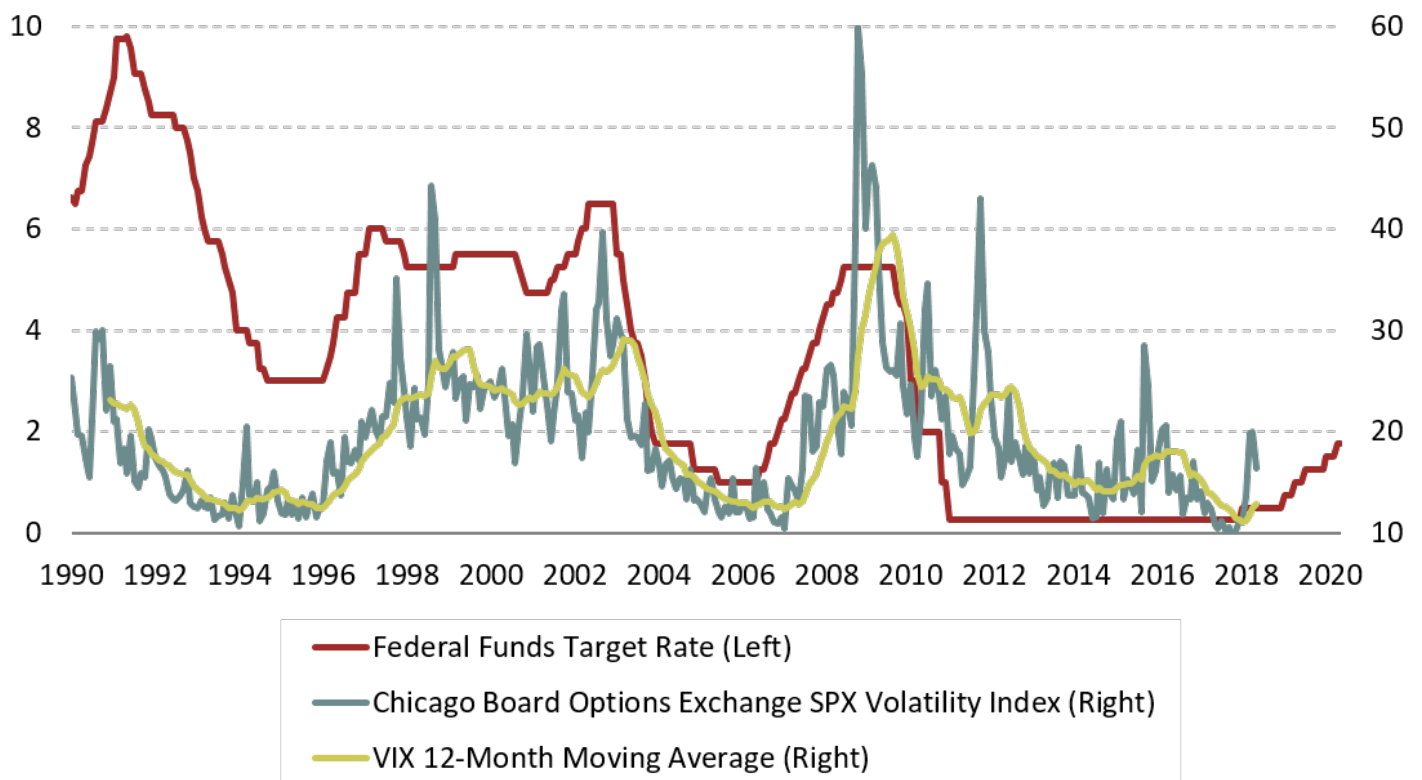


Normalizing in an Abnormal World

Volatility has returned to the stock market, two years after the Federal Reserve (Fed) first raised interest rates—pretty much on cue based on past cycles of normalization (see [Chart 1](#)). It is a normal feature in the evolution of the business cycle and it is likely here to stay for the duration of this cycle, or until there is a crisis.

Chart 1: Volatility and Normalization on Cue

As of 3/3/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

But, volatility should be regarded as a yellow flag for the investment cycle. It is a sign that the Fed has grown confident with the progress of the economic expansion and that normalization has entered a familiar phase—and that’s the problem.

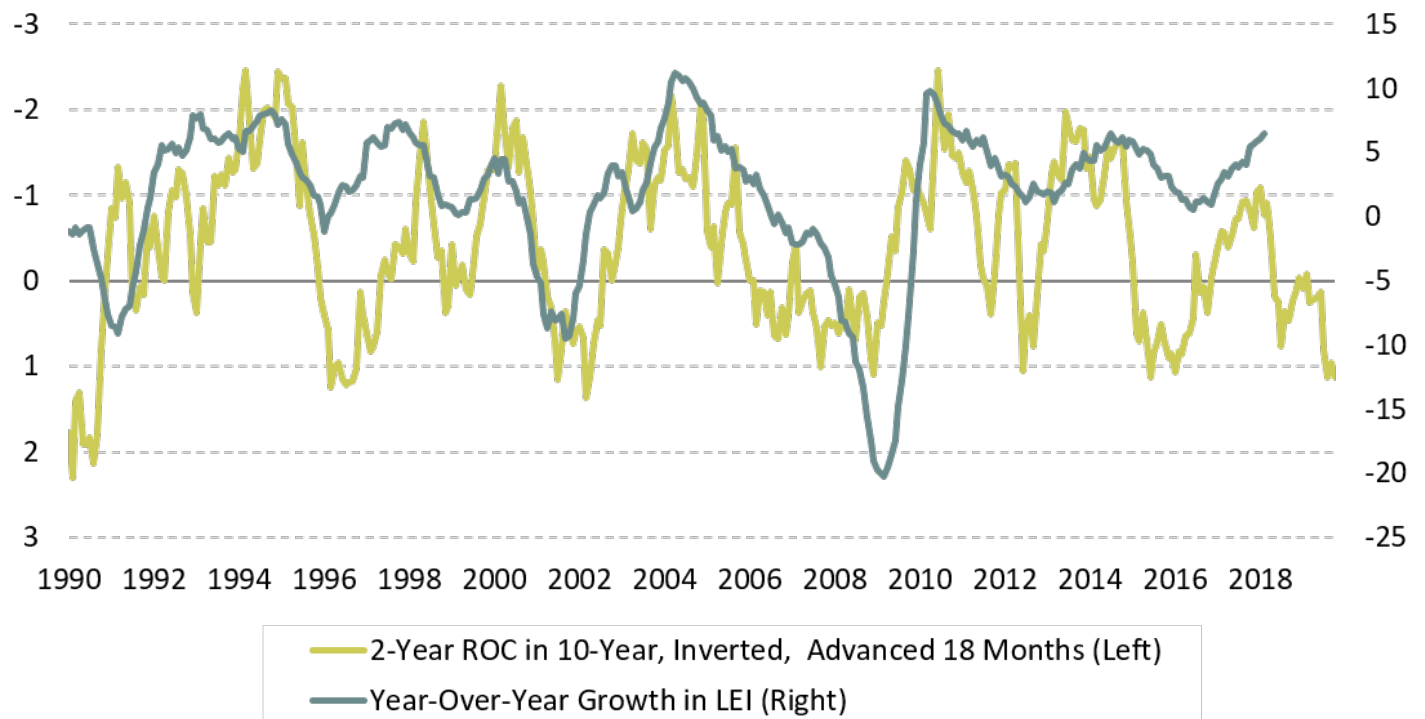
The Fed is sounding hawkish again, yet capital markets—which are the natural regulators of noninflationary, sustainable economic growth—have already adjusted. The long end of the Treasury yield curve, for example, has already normalized into the global mini-boom that has unfolded since early 2016. The global business cycle bottomed in late 2015-early 2016. Since then, the cycle has unfolded into the strongest economic upturn since 2010, with more countries participating in the global expansion in 2017 than at any time in years.

Correspondingly, the yield on the 10-year Treasury note has risen nearly 170 basis points (bps) from its post-Brexit low in July of 2016, to its recent high of slightly more than 3%. Yields have risen almost 100 bps alone in the last nine months.

Historically, this kind of increase in long-term interest rates tends to correlate with a meaningful downturn in the future growth rate of the U.S. Leading Economic Indicator (LEI)—see [Chart 2](#)—which, in turn, is closely related to the trend in the growth of nominal gross domestic product (GDP). There is no sign in any of the coincident or near-term economic data of an imminent retreat in the U.S. economy. But, a subsequent downturn in the growth rate of the LEI and nominal GDP beyond this year may already be in the pipeline, becoming more entrenched sometime in the second half of 2019. Rising energy costs are another factor that could contribute to a slower pace of activity later in 2019. This may be the message of the yield curve which is one of the 10 components that make up the LEI.

Chart 2: Absent Tax Cuts, Higher Bond Yields Slow The Economy

%, As of 3/27/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

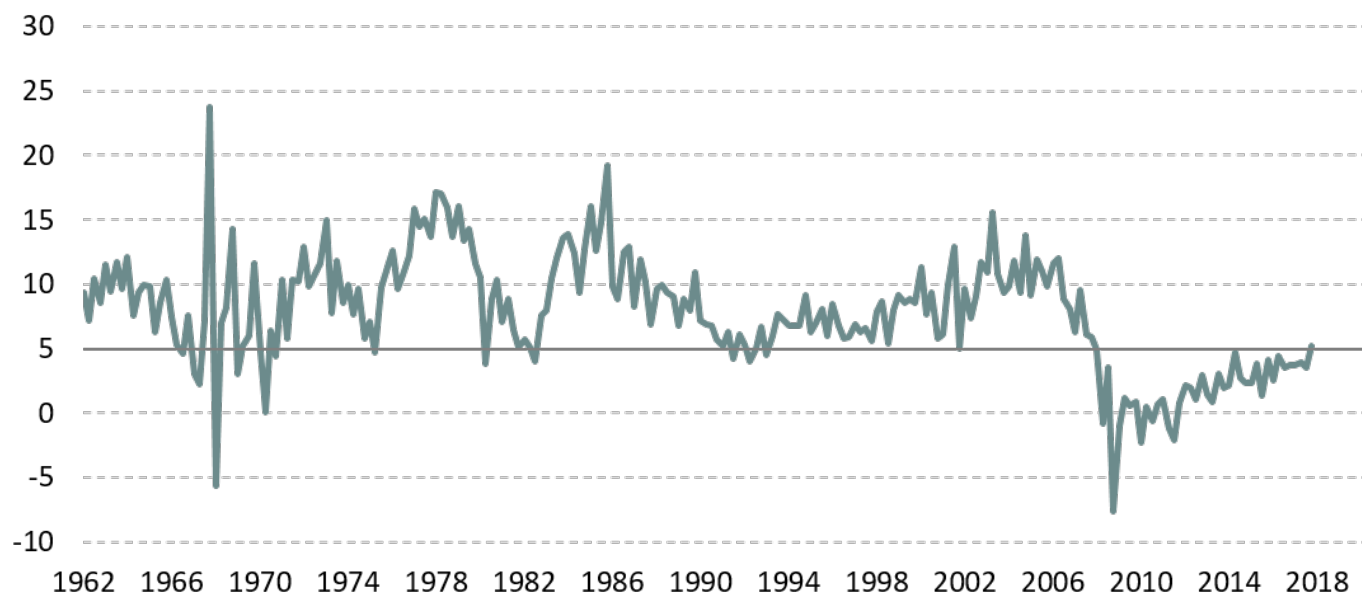
Despite the flattening in the yield curve, various Fed spokespersons seem to be suggesting that 3-4 rate increases this year seems reasonable. Stick to a more gradualist course is the message from the bond and money markets. Investors are still discounting a much slower pace of rate hikes than the Fed in the out-years—and after only one or two hikes for this year—the market is discounting almost no rate hikes over the following two years.

Fundamentally, there is lots of support for the more gradualist course of action.

First, there is household credit growth, see [Chart 3](#). It collapsed during the real estate bust to an historic low of nearly -8%, a development which brought an end to seven decades of household leveraging. Prior to 2008, household credit growth never fell much below 5%, even during recessions. It has taken 10 years for household credit growth to grind its way back again to this level, roughly the same level as nominal income growth. Consumers are spending in proportion to their incomes and are not re-leveraging. It speaks to a more stretched business cycle with reduced extremes, up and down.

Chart 3: U.S. Household Debt Growth

Annual % Change, As of 12/31/2017



Source: Bloomberg (© 2018, Bloomberg Finance LP)

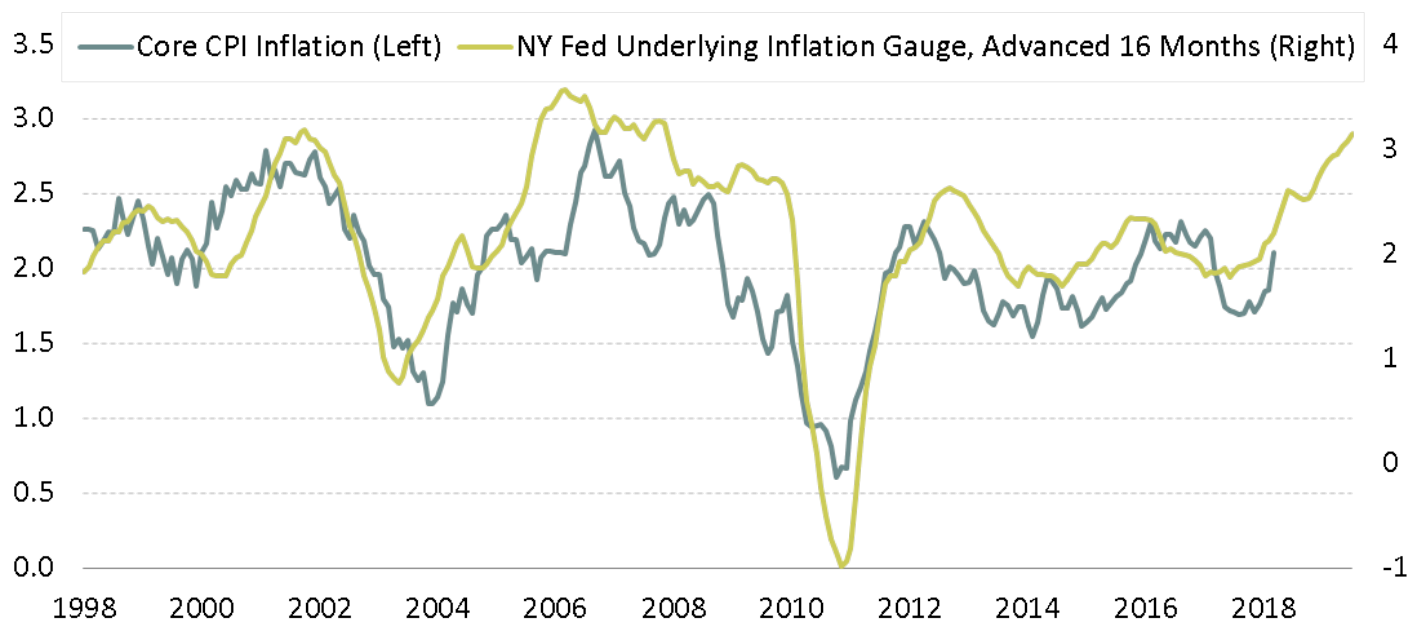
Second, the post-crisis collapse in global real yields has not recovered because China has not found a new use for its excess savings given the retreat in U.S. household credit demand. Absent a strong global growth surge in the next 18 months, Treasury issuance from the U.S. may not be the problem feared by investors because of this persistent savings surplus. It may disappear eventually as China's labor force contracts and its savings surplus shrinks, or if the "One Belt One Road" project gains traction. But that seems a longer-term risk than a business cycle threat.

Lastly, there is the Fed's balance sheet. Chair Jerome Powell is planning to shrink the balance sheet at an annual rate of \$600 billion by the end of the year. The official line from the Fed is that its members expect the tapering to be a market non-event. This could turn out to be a case of the triumph of imagination over intelligence, a phrase originally coined by Oscar Wilde to describe a first marriage. If unorthodox monetary stimulus was as potent a source of reflation as suggested by former Fed Chair Ben Bernanke, how can the significance of its retreat be dismissed so easily?

The Fed's playbook looks pretty much like the old one despite the strong message from the market to keep moving slowly. Some members of the Federal Open Market Committee (FOMC) do seem concerned about the yield curve. On the other hand, Fed Chair Powell himself has been more dismissive and has suggested paying less attention to the yield curve, that it might be distorted by a depressed term premium. In the meantime, the FOMC's confidence in the need to tighten has been reinforced by the coincident economic data. Most business cycle indicators also are flagging an uptrend in inflation for the next year or so, both in prices and wages (see [Chart 4](#)). The Fed has been worried about capacity constraints, especially in the labor market, and viewed last year's dip as technical in nature and likely to reverse. The message from these indicators and this year's uptrend in inflation will validate the Fed's view and encourage more, rather than less, tightening.

Chart 4: Business Cycle Indicators Point to Higher U.S. Inflation

Annual % Change, As of 02/28/2018



Source: Macrobond, Haver Analytics

It is the first normalization cycle since the Great Financial Crisis, yet no one knows what normal looks like. Complicating the outlook is the simultaneous and accelerating contraction in the central bank's balance sheet, something it has never done before. History shows that the central bank usually keeps tightening until there is a crisis and/or a recession. If the market is right, something will come along that convinces the Fed to stop or change course. It's impossible to know in advance what that might be, although there are a range of suspects. But all incoming Fed Chairs are inevitably tested, earlier usually rather than later. In the interim, more churning and volatility in capital markets is likely to be the norm.

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