Super Bull LIII

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"In my view, while market volatility will continue to ebb and flow, these fluctuations are not likely to have important implications for policy." Jerome Powell, November 14, 2014

"And if risk taking does not threaten financial stability, it is not the Fed's job to stop people from losing (or making) money". Jerome Powell, January 7, 2017

"Everyone has a plan until they've been hit." Joe Louis

In a mere six weeks, **the FOMC pulled the equivalent of a full 90 degree turn**—from tightening on auto-pilot in December, to an extended pause by January. While Chair Powell, and others, had certainly hinted that patience was the new policy virtue since the start of the year, the full extent of that newfound patience only came entirely into view with this week's statement and press conference. Besides openly suggesting that the case for further rate hikes had weakened, and that there was flexibility on the balance sheet unwind, the Fed also dispensed with any official bias to tighten. This new, milder 2019 version of the FOMC, with the deep-freeze on rates, further fired up the spirited recovery in almost all markets. To wit, after suffering through its worst December since the 1930s (down 9.2%), the S&P 500 roared back with a 7.9% surge in the opening month, its best January since 1987. (It would be impolite to mention what also happened to stocks later in 1987…)

The reasons for the sudden about-face in the Fed's tone can be put in four main baskets:

1. Slower global growth
2. Policy uncertainty
3. Lower inflation expectations
4. Tighter financial conditions

Now, before assuming that the pause is about to become permanent—and perhaps even give way to rate cuts—**let's consider those four baskets, in reverse order**. The big rebound in markets, lower yields and a softer dollar have already begun to wash away some of the tightening in financial conditions. The deep slide in inflation expectations late last year was almost entirely due to the plunge in oil prices—prices that have since popped $10/barrel and are, again, close to long-run norms. Policy uncertainty will linger, but at least we may have a few questions answered soon on each of the shutdown (restart on Feb 16?), trade with China (tariffs cranked on March 2?), and Brexit (hard exit on March 29?).

That leaves probably the **most important** item on the list—**slower global growth**—and the one change that Powell allowed had "important implications for us". A veritable wave of disappointing overseas data has washed ashore this year, including a broad cooling in China, weak PMIs in Europe, a technical recession in Italy, and even some serious slippage in Canada's domestic demand. But, in most cases, we are seeing some special factors weighing on top of a moderate cyclical cooldown, with the U.S./China trade battle providing extra aggravation. And while there is still plenty

of event risk on that latter front, the tone from negotiators remains positive, and the markets continue to take the worst case off the table.

Meantime, there is **the underlying resilience of the U.S. economy quietly churning away in the background**. It's even further in the background than normal, due to the paucity of reliable economic releases, courtesy of the 35-day shutdown. But the indicators on hand remain mostly solid. At the top of the list is employment, with January adding 304,000 new jobs and wages rising 3.2% y/y. While the figures were slightly polluted by the shutdown (including the further rise in the jobless rate to 4.0%), the big picture is that the critical job market is showing precisely zero signs of fading. As just one example, the economy has added almost 1 million jobs in the past four months alone—that takes us back to the start of October, precisely when markets began to fret about a weaker economic outlook. As well, the manufacturing ISM partially rebounded in January to a sturdy 56.6 after a deep dive in December, led by a snap-back in new orders.

On balance, we would assert that **the market**, and perhaps even the Fed, **is getting ahead of itself in fully removing odds of further rate hikes**. Looking at past cycles, there have been many episodes of lengthy pauses (and even some small mid-cycle rate trims) that were then followed by another series of rate hikes. **Tightening cycles are rarely neat and tidy**—the one exception was the 2004-06 cycle (a 25 bp hike every meeting for 17 meetings), and it ended in near-disaster. But we are in the business of projecting what the Fed will do, not what it should do, and there is simply no denying the Fed's newfound caution. **We have accordingly taken out one Fed rate hike from our 2019 outlook, now looking for just one more rate hike in December**. The key point, though, is that **we continue to believe that the Fed is much more likely to hike further than to cut rates**, especially in light of a drum tight job market, better prospects for U.S./China trade, and the firmness in oil prices.

We **took a similar scalpel to our Canadian rate forecast this week**. The reasoning rhymes with the Fed call, but doesn't repeat it verbatim. As we outlined in last week's Focus, we are of the view that neutral rates in Canada could be as low as 2%, so the current overnight rate of 1.75% is almost there. Add on disappointing domestic spending trends, the BoC's ongoing concern about a weak housing market (which we don't fully share), persistent questions about the fate of NAFTA 2.0, as well as a less aggressive Fed, and you are left with little reason for the Bank to step down hard on the brakes. Similar to the U.S., though, we continue to believe that **the underlying bias is to lift rates somewhat higher from here, and there truly is as much upside risk to our "one rate hike in 2019" call than there is downside**.

To conclude, we would note that the TSX just had its best month in a decade (popping 8.5%), 10-year GoC yields are below inflation at under 2%, the Canadian dollar is highly competitive at 76.4 cents, and credit conditions remain robust—in other words, overall financial conditions are supportive. And, with a federal election bearing down on us this October, fiscal policy is likely to be mildly supportive as well this year. At a time when the domestic job market is also at its tightest in decades, this augurs for an eventual return to further snugging from the Bank of Canada.

At the profound risk of alienating the entire state of Louisiana, as well as the anti-Patriots brigade, some of us are actually pretty pleased with this year's Super Bowl

matchup. Full confession, I have been a Rams fan for many a year—think Roman Gabriel…no?...John Hadl…no?...Pat Haden…not yet?…Vince Ferragamo…nothing? It's been a long slog. And, one has to at least admire the amazing consistency of the Brady/Belichick efforts of the past two decades. Whatever the circumstances of how they got here, it should be a good game. Heart over head, Rams 23 Pats 21.

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