The market is expecting monetary policy will bolster stagnant growth and extend the cycle; this is creating cheap financing for businesses, some of which are poor investment opportunities.

In early October 2018, after US Federal Reserve Chairman Jerome Powell made an infamous reference to “policy being a long way from neutral,” the yield on 10-year US Treasury bonds jumped to 3.25% and federal funds futures proceeded to price in multiple interest rate hikes over the following year.

Much has changed in the ensuing months. Economic conditions in the United States have slowed in response to the compounded effect of multiple Fed hikes in 2017 and 2018. Fiscal accommodation and tax reform provided a temporary sugar high, but could not mask softening economic conditions for long. Global manufacturing responded poorly to a variety of economic and geopolitical concerns. Disinflation reared its ugly head again while tariff and hostile trade rhetoric rounded out a challenging first half of 2019.

In eight short months, the futures market moved from predicting significant tightening to anticipating aggressive accommodation. As of this writing, the market expects two or three rate cuts this year and at least five cuts in aggregate into 2020 in this Fed cycle. Ten-year US Treasury rates have not seen a 3% handle since November and are dancing on a 2% precipice today. Pre-Trump administration lows of 1.35% are often mentioned in the daily market rhetoric. Negative interest rates around the world are commonplace again, and global central bankers are competing in the dovishness stakes.

Some argue that global interest rate markets are telling us something:
Are we listening?

Stock indices in the US stand near all-time highs while various measures of volatility remain at historically subdued levels. The credit risk markets have only yawned. US investment-grade and high-yield spreads, for instance, are only slightly wider than 2019’s tightest levels, and this performance comes against the steady drumbeat of rallying interest rates. From a historical perspective, the credit risk markets are far from flashing fear or recession risk relative to the rates markets. Even US dollar emerging market debt, buffeted by daily headlines about trade tensions, sits near 2019 tight spreads.

In fact, the markets are telling us something: Global central banks reign supreme!

The market is once again saying central banks can revive stagnant growth in an economic slowdown, and maybe even in the depths of a recession. Rates and risk markets might be flashing mixed messages, but they are clearly saying that central bankers can successfully extend the business cycle. In effect, this means central bankers can prop up asset values and financial assets, often at the expense of the real economy. Is that a good thing? Does an extended business cycle actually improve conditions for all, or simply delay the inevitable slowdown?
A recent report from the McKinsey Global Institute shows that the bottom 10% of companies studied destroyed as much economic profit as the top 10% generated. In this case, the bottom 10% recently lost 1.5 times more economic profit, on average, than the same cohort did two decades earlier. The McKinsey study included 5,750 public companies and focused on economic profit as a way of reflecting economic value created by companies’ operating activities and investments. The companies in the study made up 65% of global corporate pretax earnings over a twenty-two year period. Clearly, the economic cycle has successfully been extended relative to past cycles, but is markedly less efficient in certain respects.

We observe similar dynamics in the US high-yield market. Many celebrate the subdued default characteristics of the post–financial crisis environment. Default statistics are often used as a proxy for credit quality and market health, and viewed as a reason (or excuse) to chase yield in the riskiest parts of the market. Defaults, however, may be low simply because of abundant liquidity, not necessarily operating efficiency. Many commentators refer to this cohort of credit with a far more affectionate moniker: zombies. These are high-yield entities burning more cash and economic profits than they earn, subsisting solely on the less-discerning nature of central bank liquidity and fund flows chasing unsustainable yield.

Is it really any wonder central banks globally are struggling to meet inflation targets? Perhaps unprecedented accommodative monetary policy in the interest of generating a historically long business cycle is starting to work against itself.

In our view, central banks today are creating cheap financing for capital-seeking entities, some of which are poor investment opportunities. Others remain afloat for extended periods as financial markets support unprofitable business models. Admittedly, many entities are not in such dire circumstances, but continue to enjoy cheap debt financing that enables extensive financial engineering in the form of share repurchases, dividends or sizable merger and acquisition activity.

This is all taking place against an economic backdrop that is increasingly less sensitive to interest rates, especially as it relates to employment conditions, a view held by the Kansas City Federal Reserve Bank, among others. Said another way, the efficacy of monetary policy is again in question. While asset markets clearly benefit, the flow through to employees and the real economy is often limited.

To conclude, I would like to address the reference to forest fires in the title of this note, and what this analogy might imply for economic cycles. Forest fires are dangerous, ugly and destructive. However, if contained and properly managed, they also serve an important function for the overall health of the forest. Dead and decaying trees and undergrowth burn to ash and the nutrients return to the soil. Thick underbrush and debris burns away, permitting more sunshine to reach healthy plants. Most importantly, robust and established trees in the forest no longer need to compete with weaker trees and plants for resources. In other words, there is no crowding out.

Recessions are similarly dangerous and unpleasant, but may play an analogous role in the economy. Some economic destruction can prove to be healthy, especially if weaker investments are no longer crowding out limited resources and debt balances are able to find healthy, more sustainable levels. In this context, active investment managers are able to play a valuable role: proactively managing risk and allocating capital efficiently.
Endnotes

1 McKinsey Global Institute, “What every CEO needs to know about ‘superstar’ companies,” April 2019.