Market Comment for the Week of December 31, 2017

Risky Business

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A bundle of potential late-cycle surprises in 2018

Challenges to the assets markets this year, coming off a remarkably strong and placid 2017, ironically are being elevated less by an aging economic cycle than by the return of broad-based, respectable growth. Economic strength increases the chances for a turn from last year's disinflation and lower interest rates—2017's big surprise for stocks, supporting rich valuations and reinforced by unexpectedly strong earnings growth plus the resurrection of growth-friendly tax reform late last year. A key outlook uncertainty this year is the interplay of policy, inflation, and interest rates, all central to asset performance. At issue for fiscal policy is the inflation threat from tax-related stimulus in an economy already operating near full capacity. For monetary policy, the issue is its re-coupling with bond yields, likely dependent, in part, on the timing and trajectory of inflation's turn higher.

Surprises come in all shapes and sizes. One distinction is between known and unknown unknowns—the former a visible threat, the latter wholly unanticipated and, therefore, potentially more disruptive. Other risk categories are more obvious distinctions between domestic versus international, and political versus economic shocks. Endogenous shocks are tied to the internal workings of the economic cycle—like interest rates pulled lower by disinflation—while exogenous threats originate outside an economic cycle's internal workings.

Systemic threats tend to be among the more imposing surprises, pervasive by nature and often tied to inflation, interest rates, the dollar, oil prices, and other performance levers. Event risk has its most enduring impact when linked to supply chains, labor mobility, foreign investment, and other economic fall-out (like the 1973 Arab oil embargo, Thai flooding, and the Japanese earthquake in 2011 or, among the known unknowns, disruptions associated with Brexit). What's clear is that the economy and asset markets are vulnerable even during a seemingly benign environment. That was apparent from the role of the great moderation—reduced economic, price and interest-rate volatility between the 1980s and the early part of last decade—in setting the stage for the asset-driven financial upheaval and great recession of 2008–2009.

Against this backdrop, what follows is a brief checklist of potential surprises capable of altering the slow turn from a Goldilocks environment to a more typical combination of late-cycle growth, rising inflation, and heightened market volatility.

I. Domestic systemic

1) Another asset-driven economic cycle is triggered by inflation's slow turn higher, re-coupling bond yields to unexpectedly aggressive rate increases by a more hawkish, Trump-nominated Federal Reserve Board. Bond prices decline with the rise in yields, hitting investors particularly hard at these historically low yield levels elevating price sensitivity to rate changes. The rotation from risk to increasingly attractive safe-haven assets touches off an unwinding of asset-price inflation, aggravated by the growing popularity of complex and opaque securities supercharging performance. Similarities to a decade ago, more by nature than degree because of less aggressive increases in leverage, nonetheless make the Fed's interest-rate normalization a potential catalyst for heightened market volatility and consolidation in conjunction with structural changes discussed below.

2) Inflation remains stuck at a below-target rate, keeping the Fed at bay or uncoupling for another year inflation-sensitive **bond yields** from rate increases by a more hawkish, Trump-nominated Federal Reserve Board. Subdued interest rates stoke risk-asset prices in a replay of 2017, leaving increasingly rich valuations vulnerable to a correction when rates finally do turn higher.

3) Profit margins and earnings growth are pressured by subdued inflation undercutting business pricing power, encouraging more aggressive cost cutting weighing on wage increases, hiring, and on spending growth in the dominant consumer sector.

4) A continuing resolution funding the government beyond January 19 fails to pass, forcing a government shutdown and bolstering the Treasury market via a prospective cut in debt supply. Treasury securities gain added support from an ironic safe-haven trade in the run-up to an 11th–hour agreement to raise the debt limit against a hard deadline in March, much as they did under similar circumstances in August 2011.

II. Domestic event-driven

1) A Democratic sweep in the mid-term elections, regaining control of the House and Senate, puts the president's legislative program on ice.

2) Federal interest payments (the government's most uncontrollable expense item) as a share of revenues rise noticeably with the Fed's rate hikes and associated increases in market rates, moving the rising budget deficit, and associated financing costs, back on the market's radar screen in much the same way that they did in the late 1980s and early 1990s. Fresh questions about rising budget deficits and debt add to uncertainties over future tax and spending changes as the balance of power in Washington inevitably shifts.

3) A technical glitch at a major exchange disrupts final stock auctions, affecting asset prices of trading-portfolios, retirement, and other mutual-fund accounts. Untested backups fail to provide sufficient cover, rippling through to associated options and derivatives markets.

4) Problems at Bank of New York Mellon Corp., the sole remaining clearinghouse for repos, risks disrupting settlements in this key corner of the money market, potentially rippling through stock, bond, currency, and other trading.

5) One or more weak links during a market unwind, exposing regulatory, structural, or other flaws capable of aggravating a seemingly mild disturbance. Among the potential flashpoints: a) a liquidity mismatch between liabilities of exchange traded funds (ETFs) and less tradeable assets, resulting in disruptive fire-sale prices to meet redemption demand and/or b) the lack of a liquidity cushion producing much the same disruption in the corporate bond market, due to a reduced middleman role by banks reacting to the increased capital cost of carrying such assets on their books.

III. International systemic

1) Oil prices suffer a relapse on a breakdown of output discipline by major producers and on another production ramp-up by U.S. shale producers responding to earlier price increases.

2) Commodity prices decline under the combined pressure of rising global interest rates, a strengthening dollar, and a tilt in China's economic growth from investment- to slower, consumer-led economic growth. Dollar strength and weakening commodity prices potentially have a three-fold effect on emerging-market credit quality, blunting export revenues, squeezing local-market liquidity by drawing funds to overseas markets, and adding to the local-currency cost of servicing dollar debt in more heavily indebted countries.

3) International banks' dollar funding pressure persists, aggravated by tougher U.S. bank-capital rules, fall-out from the Fed's interest-rate normalization, and tax reform's success in encouraging a repatriation of corporate overseas cash. International banks' dollar shortage forces a pullback in local, cross-border, and trade-related lending, undermining global growth.

4) An enduring bitcoin price collapse ripples through the financial market, triggered by problems with crypto-ETFs, options, and other derivatives leaving clearing houses exposed. A liquidity squeeze initiated by a wind down of aggressive central-bank stimulus triggers margin calls on crypto-investments and pressure in a still-nascent market for bitcoin-backed dollar loans, raising the specter of a systemic credit squeeze encouraging a risk-off rotation into safe-haven investments from stocks and other highly charged assets.

IV. International event-driven

1) China's financial strains resurface, on problems in its shadow-banking system created by central-bank credit tightening spilling over to the traditional banking system. Government funding for large, state-owned financial institutions fails to reverse completely the fall-out on domestic credit availability and risk-off trading by investors rotating out of emerging markets with close trade ties to the country. An alternative scenario: worsening trade ties and/or geo-political strains with the U.S. blunt foreign sales growth enough to aggravate credit-quality issues of large, state-controlled banks exposed to China's export sector, with the same effect on credit availability and risk-off trading.

2) Stepped-up sanctions on North Korea add to worsening tensions with China already aggravated by restrictions on China's U.S. foreign investment and by a U.S. refusal to declare the country a market-based economy. China's tit-for-tat response squeezes U.S. high-tech, auto, and other major industries operating in China while adding to tensions in the South China Sea, a major international trade route. Potential trade disruptions leave emerging markets with close economic ties to China most exposed.

3) A Saudi-Iranian military conflict disrupts the flow of Middle East oil, sending energy prices soaring. Fragile domestic institutions in Saudi Arabia are an added venue for oil-supply disruptions vulnerable to pushback by conservatives against domestic social reforms. Aggravating the threat to regional stability are worsening internal protests in Iran, risking the replacement of moderate President Hassan Rouhani with a hardliner contributing, with the U.S. administration, to the breakup of the 2015 nuclear accord and to more aggressive pushback against more activist Saudi foreign initiatives.

4) An abrupt NAFTA exit by the U.S. triggers a tailspin by the Mexican peso (and a more moderate decline in the Canadian dollar), adding to local-currency financing costs of local firms' dollar debt while undermining sovereign and corporate credit quality. The more enduring threat from economic and financial disruptions comes from a victory by left-wing populist Lopez Obrador, ushering in a period of heavy-handed government regulation, economic and financial strains reminiscent of the early 1980s, and trade disruptions affecting the U.S. auto industry and agri-business most noticeably.

5) Italy's parliamentary elections in early March result in a populist coalition favoring withdrawal of the country from the euro, raising fresh questions about the future of a highly centralized European Union (E.U.) and of regional tensions already surfacing with the Catalonia independence movement. Fresh regional economic and financial uncertainties touch off a run against the euro and a pullback in consumer and investment spending out-weighing a boost to exports from improved competitiveness.

6) A hard Brexit by the U.K., with few safeguards in place, leaves trade relations between the U.K. and the E.U. in limbo. Resulting economic uncertainties trigger capital flight from the U.K. and more exposed E.U. countries into dollars, Swiss francs, Japanese yen, and gold risking added financial strains from resulting liquidity pressures.

7) Passive investing's inherent bias of channeling funds to high-flying stocks, based on cap-weighted allocations, exposes a peaking market to heightened volatility as investments are unwound to track a correction in underlying indexes.

8) A breach of cyber-security freezes the global payments and clearing network enough to send asset markets tumbling by investors fleeing to haven investments.