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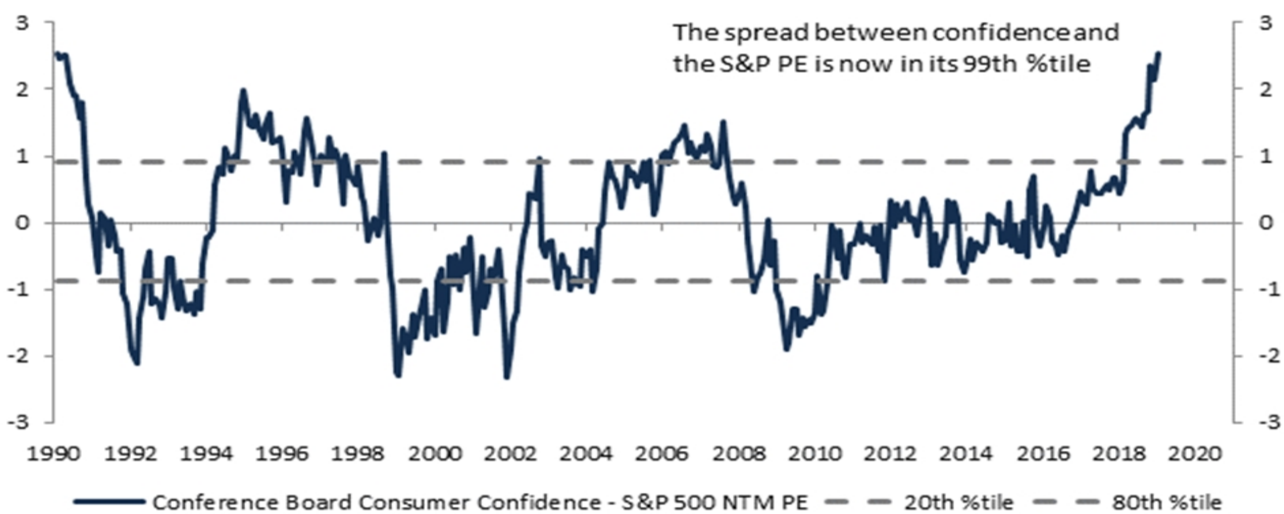
Monetary Policy & Confidence

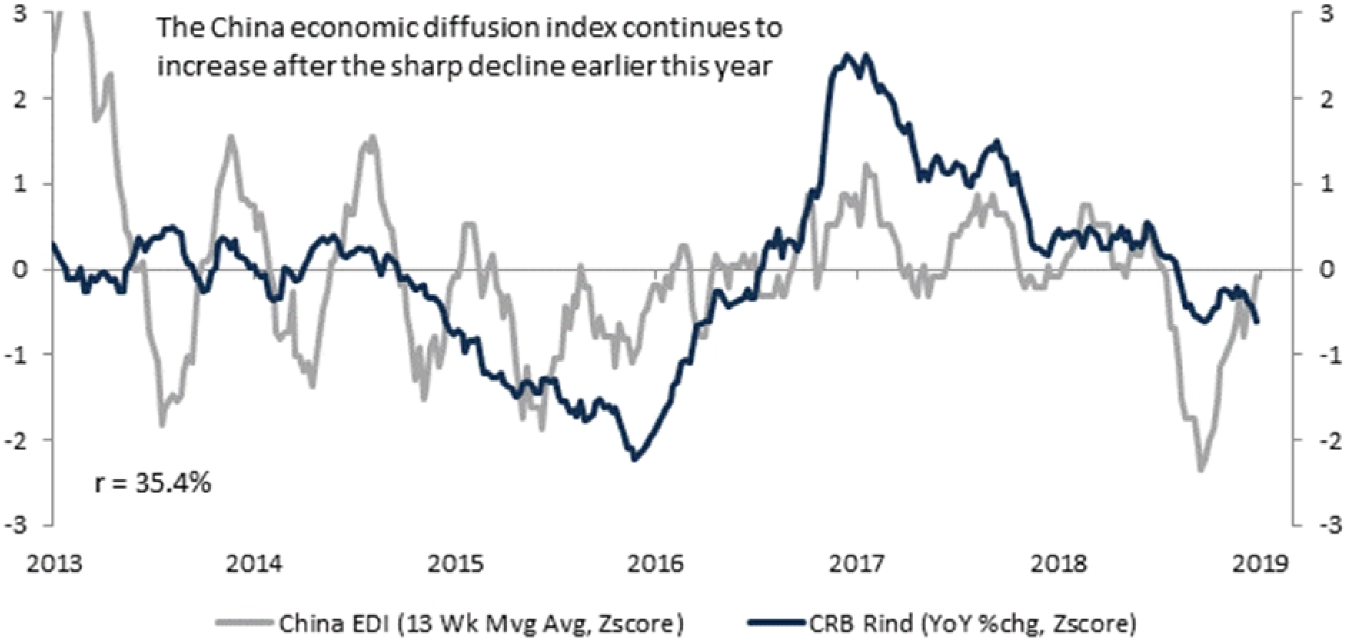
SUMMARY: S&P futures are higher this morning putting the index on track to rise 7.7% over the past three days as extreme oversold conditions unwind. Press reports in China continue to highlight new stimulus measures and the EISI China economic diffusion index has recovered, suggesting a stabilization of economic growth.

As the Fed laid out, stocks are part of financial conditions and declining equity markets generally coincide with lower consumer confidence, which fell in December. The transition from tighter monetary policy to lower confidence can be messy. Today, the spread between consumer confidence and the S&P PE is extreme. If that spreads normalized with the S&P PE staying flat and confidence collapsing, the risk of a much more sever slowdown in economic growth would increase. The elevated VIX and sharp deterioration in investor sentiment suggests a sharp decline in confidence as well.

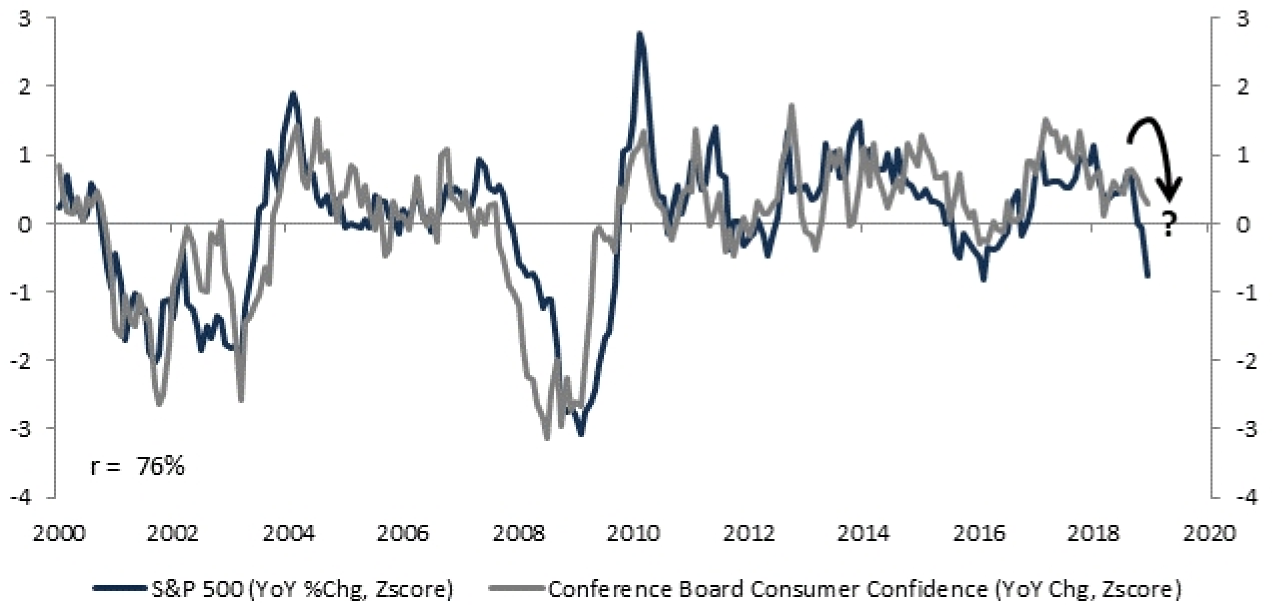
Investors now assume the Fed will need to ease policy eventually to avoid a collapse in confidence. That assumption is a support for risk assets and Dollar negative. As we outlined in our 2019 Outlook, assuming the trade war eases, risk assets should grind higher as confidence deteriorates some and economic growth slows.



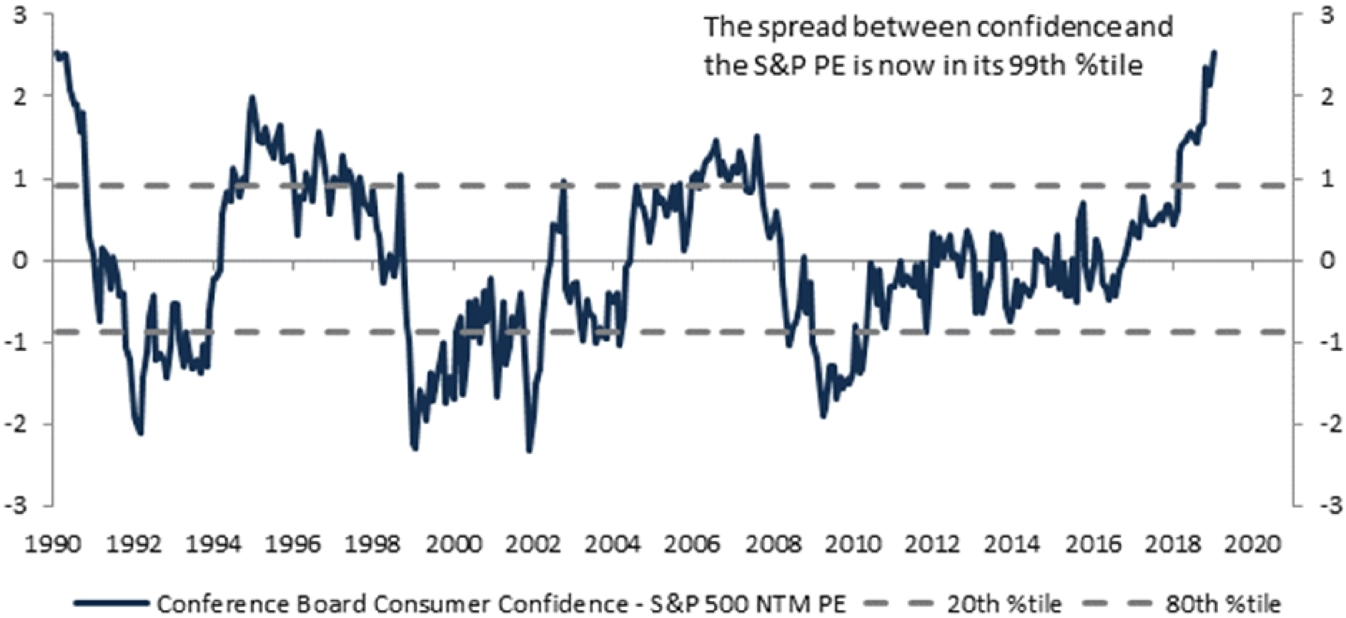
MARKET VIEWS: Risk assets are higher again this morning and S&P futures put the index on track to rise +7.7% over the past three days. Press reports in China continue to highlight new stimulus measures with the Economic Information Daily noting that tax cuts could exceed CNY 1T and that the deficit should increase to more than 3% of GDP next year. The EISI China economic diffusion index (EDI), has recovered. Assuming the trade war does not escalate, global growth outlook will firm as China growth stabilizes.



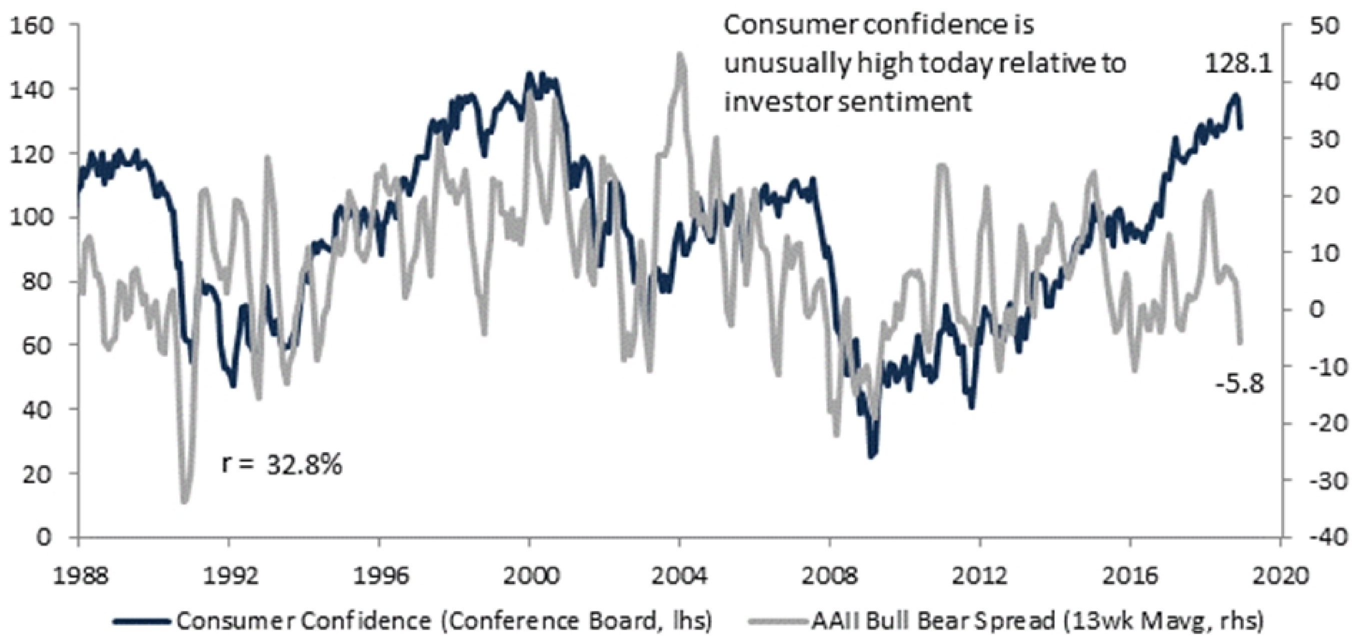
Consumer confidence declined in December and as the Fed has laid out monetary policy works through expectations. “Expected future short-term rates change Treasury bond rates, which in turn affect the lending rates faced by households and businesses… These changes then influence expenditure decisions, and thus current and expected future resource utilization.” Equity prices are part of financial conditions and lower prices generally results in lower confidence, which hopefully will result in stable inflation.



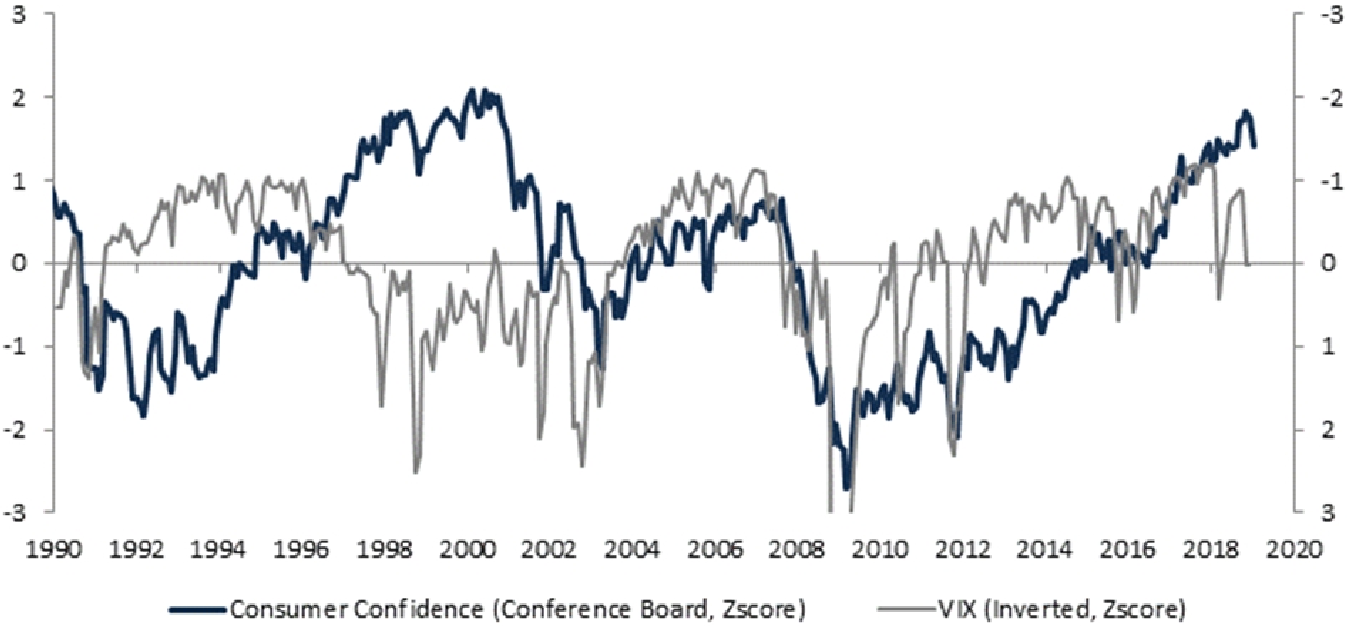
The issue investors have to deal with is that the path from rate hikes to lower confidence is imperfect. The spread between consumer confidence and the S&P PE is now extreme. If that spreads normalized with the S&P PE staying at these levels and confidence collapsing, the risk of a much more sever slowdown in economic growth would increase.



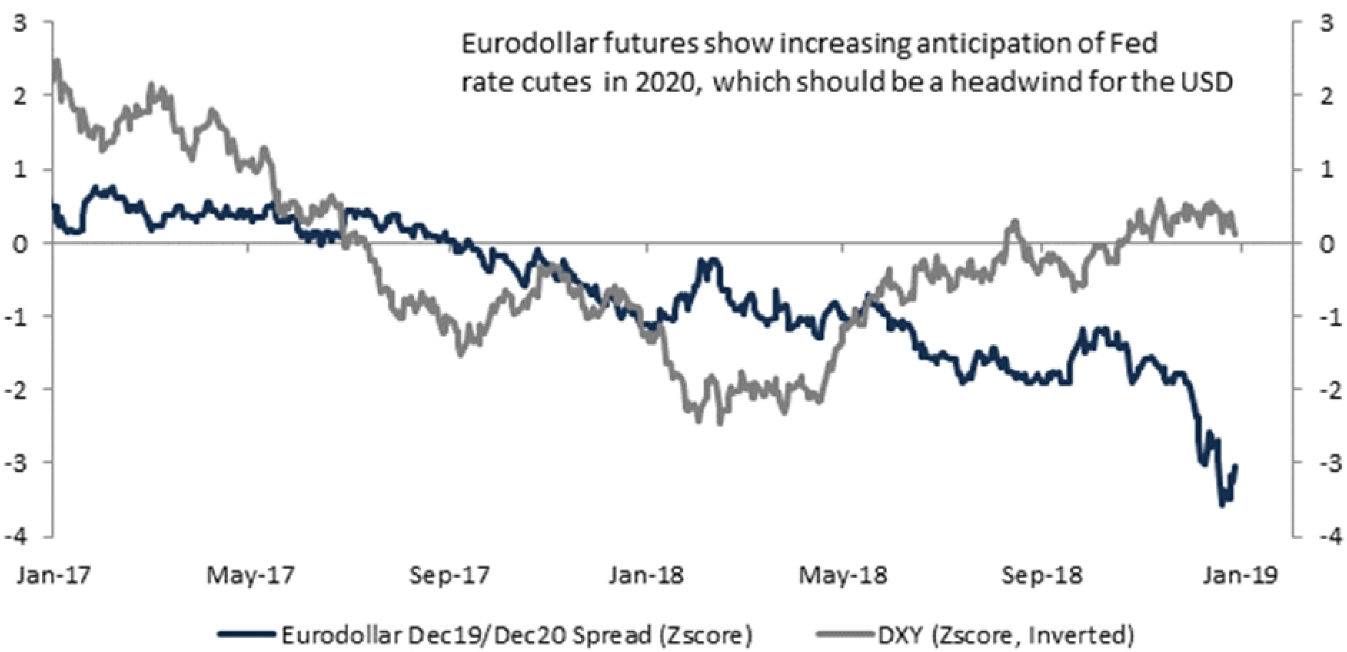
Investor sentiment readings are suggesting a much more severe decline in confidence as well.



Consistent with the decrease in investor sentiment, persistently higher volatility is pointing to a sharp deterioration in confidence.



If the stock market doesn't bounce, investor sentiment improve and the VIX decline, the risk of a sharp deterioration in confidence would increase. That is likely why the Fed has signaled a more neutral policy stance recently and Eurodollar futures are pointing to a potential cut in Fed funds (after maybe one hike next year) in 2020. Investors are assuming the Fed will need to support risk assets and ease financial conditions eventually. The scary scenario is if the trade war escalates and risk assets decline despite neutral policy from the Fed. In the scenario we outlined in our 2019 Outlook, risk assets would grind higher as confidence deteriorates some and economic growth slows toward 2% next year.



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