Why Inflation Isn’t What You Think

The Federal Reserve has long wrestled with stubbornly low inflation. A decade ago few would have expected this to be a problem, but Personal Consumer Expenditure (PCE) inflation, the Fed’s preferred measure, is coming in at 1.8% this year. Federal Open Market Committee (FOMC) members have been considering allowing inflation to overshoot their target of “around 2%”. As Eric Rosengren, president of the Federal Reserve Bank of Boston, noted, if you’re trying to average 2%, “you can’t have only observations that are below 2 per cent.”

One consequence is that, when inflation does eventually move above 2%, the FOMC may delay efforts to lower it so as to allow for some catch up.

Outside of the FOMC’s technical concern with achieving its desired 2% average, inflation generates few worries. Keeping up with the cost of living is a crucial objective of saving for retirement, yet few appreciate a shortcoming in traditional measures of inflation.

Inflation indices measure the cost of a representative basket of goods and services of constant utility. The basket rarely fits individuals, but it reflects society’s pattern of purchases and so is right on average. The catch is in the last phrase, of constant utility. Products and services generally improve, and because those improvements increase utility, statisticians typically adjust for the improvement, lowering inflation.
Consumer electronics is a good example. iPhones get better and more expensive with every new release. But the inflation data place a value on those improvements and adjust down to calculate the price of an iPhone with the same features. My niece took clear, well-lit photos on the weekend with her iPhone 11. The phone costs more, but the photo quality means you’re getting more phone than before. Better photos mean more utility, although beyond the enjoyment of being flattered by the imagery, there’s little else to do with that extra utility.

The Bureau of Labor Statistics (BLS) publishes the Consumer Price Index (CPI). The Fed prefers the PCE because it dynamically adjusts for shifting consumption patterns, and is more representative of actual consumer behavior. But for decades we followed the CPI, and the point that follows applies to inflation indices generally.

The BLS publishes a list of items in their CPI subject to “hedonic quality adjustment”. It’s mostly clothing and consumer electronics. Mens’ suits are apparently improving in quality as well – or perhaps it’s now harder to buy a cheap suit. In any event, suits are apparently better value for
money than in the past, which in inflation math is deflationary.

I wrote about this topic in *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors*. In a subsequent blog I highlighted one of the most absurd hedonic quality adjustments – airline tickets (see *Why Flying is Getting More Expensive*). Even though economy flyers everywhere would agree that cramped seats and lousy food make commercial air travel an endurance, the BLS found that quality (which they defined simply as ease of cancellation) had improved, boosting value for money and thereby lowering the cost of airfares within the index.

What it means is that keeping up with inflation doesn’t mean keeping up with your neighbors. The statisticians are measuring prices, and their approach has some logic. But they’re just not measuring what most of us think they’re measuring. If inflation seems lower than the rate you experience personally, it’s probably because you accept quality improvements but don’t think of them as price reductions. iPhones cost more, even if hedonic quality adjustments provide an offset. You’re still having to pay more cash, leaving less for something else. Inflation statistics reflect this less than you think.

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**Pension Funds Keep Interest Rates Low**

The Equity Risk Premium reveals that stocks are cheap relative to bonds (see *Stocks Offer Bond Investors an Opening*). A corollary of this insight that bonds are expensive is that you can replicate the return on $100 in ten year treasury notes
with a combination of stocks and cash. It relies on a few assumptions, such as an unchanged dividend yield, known dividend growth rate and unchanged tax policy. Because it shows that as little as 13% in equities, with the rest in cash (i.e. a 13/87 barbell) can match the ten year note, it starkly highlights the expense of bonds.

Pension funds are large investors, including in fixed income. The OECD estimates that they hold over $8TN in bonds, equal to approximately 10% of the global investment grade bond market. About half is U.S. pension funds.
An interesting blog post by Colin Lloyd (see The Pension Fund Apocalypse) estimates that the real return on this $8TN in debt is negative.

A consequence is that U.S. pension funds earned a negative real return last year of -3.9%. The S&P500 was -4.4% (nominal), but fixed income didn’t help.
This unsurprising result has worsened with this year’s further drop in bond yields. Although the math of divesting from long term debt is compelling, pension funds face complex restrictions on their asset allocation. For example, U.S. pension funds maintain a 28.1% allocation fixed income, in the certain knowledge of a negative real return. They inexplicably raised their allocation, from 24.9% the prior year.

What should have happened by now is that discerning pension funds shift away from bonds, but so far there’s little evidence of this.

The demand for fixed income from investors such as pension funds is fairly inelastic. Colin Lloyd calculates that the nominal return on bonds over the past century is 4.3%. The regulatory framework assumes that negative real returns can’t persist indefinitely, and that mean reversion will bring higher yields. But the inability or unwillingness of pension funds to lower their exposure makes such a correction less likely.

More flexible investors, such as endowments and foundations, can be more discriminating. But the persistence of
low/negative yields, with almost $17TN of sovereign debt now yielding less than zero, shows that demand remains strong.

Bond yields may rise from their recent new lows. But a return to the long run average real return of 2% would require ten year notes to yield 3.5-4%, double their current level. Continued negative real returns and unchanged fixed income allocations will make it harder for pension funds to be fully funded.

It doesn’t have to lead to a crisis, but it’s one reason to expect long term rates will remain low for the foreseeable future. Perversely, for funds that seek to match the cashflows of assets and liabilities, lower interest income can lead to greater bond investments to achieve a required level of cashflow. What’s needed is a relaxation of regulations to allow a more objective rejection of bonds when returns are inadequate.

Pension funds are one reason rates have stayed low.

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**Bond Buyers Should Buy Pipeline Stocks**

Yields on McDonalds’ Euro-denominated bonds recently joined European sovereign debt in negative territory. It’s a headline writers dream (juicy burgers, not yields…customers and
investors pay to do business, etc).

$17TN in publicly traded debt now yields less than zero – 30% of the entire investment grade market. Debates rage about what this means. Bond investors are not accused of being analytically weak – something bad must be over the horizon. As mentioned before, we’re contemplating the idea that such a stubborn retention of fixed income investments reflects a degree of risk aversion towards stocks, for fear of a sharp fall. The searing memories of the financial crisis are within the careers of most market participants. Stocks are always vulnerable to a big sell off. But the preponderance of caution reflected in the scramble for low-risk yet yield-less bonds suggests speculative fever is not rampant. In this view, stocks are cheap.

The energy sector has provided unattractive risk/return of late. It’s why it’s so cheap. One of the reasons for poor sentiment could be climate change. 82% of the world’s energy comes from fossil fuels, and the average of serious 20-year forecasts sees this at around 80% in 2040. Reading articles on renewables can consume much of a day, every day, while those expecting the 82% share to stay roughly the same are a rare breed.

If equity valuations on midstream energy infrastructure stocks reflect a widespread belief that oil and gas pipelines will soon be as useful as a VHS recorder, bonds issued by these same companies should offer commensurately high yields.

But they don’t. A review of yields on the investment grade bonds of U.S. issuers in the American Energy Independence Index averages 3.7% (using the weights of the index). Although yields of any kind are hard to obtain nowadays, the 3.9% yield on 2054 bonds issued by Enterprise Products Partners (EPD) suggests a high expectation of being repaid in full. This in turn requires pipelines and related infrastructure to maintain their critical role in America’s energy supply for at least
another four decades. EPD’s stock yields over 6%. Its distribution is growing and buybacks are likely. Try and conceive a scenario in which the holder of the 2054 bonds will, over any plausible investment horizon, do better than the equity investor.

Kinder Morgan (KMI) has bonds maturing in 2098, in effect perpetual debt, yielding 5.1%. Although this is modestly higher than the stock’s 4.9% dividend yield, next year’s expected 25% hike will fix that. Although the 2098 bond issue is a tiny $26MM, they have $33BN outstanding, much falling due after 2040. The holders of KMI 2098 bonds no doubt congratulate themselves for doing better than investing in French energy giant Total (TOT), who recently issued perpetual Euro debt at 1.75% (see Blinded by the Bonds). But if they like KMI’s 80 year bonds, they’d have to prefer the equity.

The investment grade issuers in the table represent half of the American Energy Independence Index. Their long dated bonds yield 4.3% – profligate by today’s standards, but nonetheless too low to reflect anything other than confidence of full repayment over the decades ahead. The holders of these bonds

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Description</th>
<th>% of Index</th>
<th>TTM Dividend Yield</th>
<th>Maturity</th>
<th>S&amp;P Rating</th>
<th>YTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>OKE</td>
<td>ONEOK INC NEW</td>
<td>8.04%</td>
<td>4.89</td>
<td>2049</td>
<td>BBB</td>
<td>4.36</td>
</tr>
<tr>
<td>EPD</td>
<td>ENTERPRISE PRODS PARTNERS L P COM</td>
<td>7.70%</td>
<td>6.08</td>
<td>2054</td>
<td>BBB+</td>
<td>3.88</td>
</tr>
<tr>
<td>TRP</td>
<td>TC ENERGY CORP</td>
<td>7.48%</td>
<td>4.63</td>
<td>2049</td>
<td>BBB+</td>
<td>3.93</td>
</tr>
<tr>
<td>KMI</td>
<td>KINDER MORGAN INC DEL</td>
<td>7.44%</td>
<td>4.90</td>
<td>2098</td>
<td>BBB</td>
<td>5.10</td>
</tr>
<tr>
<td>ENB</td>
<td>ENBRIDGE INC</td>
<td>7.32%</td>
<td>6.56</td>
<td>2046</td>
<td>BBB+</td>
<td>3.73</td>
</tr>
<tr>
<td>WMB</td>
<td>WILLIAMS COS INC DEL</td>
<td>6.63%</td>
<td>6.45</td>
<td>2044</td>
<td>BBB</td>
<td>4.38</td>
</tr>
<tr>
<td>ET</td>
<td>ENERGY TRANSFER LP</td>
<td>4.34%</td>
<td>8.88</td>
<td>2049</td>
<td>BBB-</td>
<td>4.78</td>
</tr>
</tbody>
</table>

48.95% 5.85 4.28
must regard equity buyers as having abandoned all reason in allowing dividend yields to drift so high.

If fixed income buyers like midstream energy infrastructure, eventually equity buyers will find reason to follow.

We are invested in EPD and KMI.

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Stocks Offer Bond Investors an Opening

The Federal Open Market Committee probably feels pretty good about last week’s decision to cut rates. We noted the multiple macro issues confronting decision makers (see Fed Ponders Multiple Uncertainties). With Chinese trade negotiations moving away from a deal, diversification isn’t helping as all risk assets are lower.

Government bonds provide a useful counterweight at such times – U.S. ten year yields briefly dipped below 1.7%. Knowing when to sell is key to extracting value from the flight to safety.

We regularly note the Equity Risk Premium (ERP), the difference between the earnings yields on the S&P500 and ten year treasury yields. It’s been showing stocks are cheap – on days like Monday, when global stocks were routed on trade war fears, it’s easy to overlook the ERP.
Interest rates remain ruinously low. Last month, in Real Returns on Bonds Are Gone, we showed that profit growth would provide an even more powerful ERP-case for stocks.

Current fears are for a growth slowdown, although bottom-up earnings forecasts on Factset continue to project 11% higher earnings next year. The chart below reflects the impact of a 20% drop in earnings – a substantial decline. Even an outcome as dire as this would leave stocks substantially cheaper than ten years ago. During the financial crisis, earnings fell by 29% over three years, from 2006-09.

Getting the ERP back to its 50+ year average of 0.6 would require a 60% drop in earnings.

Over $12TN of sovereign debt has negative yields (see Still Fearing Another Financial Crisis). The continued inflexible allocation to fixed income of vast pools of capital reflects widespread fear of another financial crisis. In effect, a 60% drop in stocks with its consequent mean reversion of the ERP is regarded as plausible by a great many large institutional investors.
Over the near term the ERP has little to say on valuations. Trading dominates as much as ever. But over any realistic investment horizon – say a year or more – the math is striking. P/E ratios are historically high, as adherents of Cyclically Adjusted Price Earnings (CAPE) maintain. But bond yields are historically low, and there’s little point in considering either in isolation.

The pricing of financial assets reflects a healthy degree of caution, something easily overlooked when a downturn in trade negotiations hurts risk assets. Trillions of dollars is avoiding stocks in favor of the tyranny of low and negative interest rates. U.S. state and local defined benefit public pension funds hold $4.4TN in assets, $4.2TN less than projections show they need. This 48% funding shortfall isn’t going to be solved by bonds.

We think equities provide a substantial margin of safety compared with bonds for long term investors.

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Fed Ponders Multiple Uncertainties

If not today, then within a few weeks the Federal Reserve is likely to acquiesce to President Trump’s call for lower rates. Ten year U.S. treasury yields are low by most measures at 2.05%, but they’re the highest in the G7, and even higher than
Greece’s. The President has criticized Fed policy as creating unnecessary headwinds to the economic boom his policies have created.

Trump is obviously talking his book. With the unemployment rate below 4% for a year and hourly earnings growing at 3.1%, the economy is not obviously in need of stimulus. Inflation continues to remain below the Fed’s 2% target. The Phillips Curve, which posits that you can have low unemployment, or low inflation, but not both, long ago ceased to explain the world.

There are an unusual number of macro uncertainties that the Fed must consider.

The ongoing trade dispute with China is hindering growth, and not just in China. Germany recently halved its forecast 2019 GDP growth forecast, to 0.5%. We think it’s likely the U.S. will close a deal with China in time for the economy to show a benefit heading into next year’s Presidential election.

Tensions with Iran seem to have eased recently, and crude oil has slipped by $5 as the possibility of a closing of the Straits of Hormuz has receded. Iran is likely to avoid direct
confrontation with the U.S., and election calculations similarly suggest that Trump will avoid anything that could become a lengthy military engagement. The possibility of accidental confrontation remains, but this issue is for now lurking in the background.

Brexit continues to be an absorbing spectacle of self-destruction by a country enduring serial poor leadership. Although Conservative PM Boris Johnson claims that the UK is leaving the EU on October 31 with or without a deal, this seems unlikely. Parliament has voted against a hard Brexit, and as many as 30 Conservative party MPs, including former Chancellor of the Exchequer Philip Hammond, have vowed to ensure the country doesn’t leave the EU without a deal. Moreover, the PM doesn’t have a mandate for a hard Brexit, since the referendum offered a simple choice and none of the senior Brexit campaigners advocated it.

PM Johnson endured booing crowds on a recent visit to Scotland, where voters chose Remain three years ago. A rocky visit to Northern Ireland looms, whose population is also facing the prospect of being dragged unwillingly out of the EU by the English majority. Brexit is now the defining political issue in Britain. Ask where someone lives (i.e. urban vs rural) for a good guess at where they stand.

Assessing the precise economic impact of a hard Brexit is tricky. There’s plenty of historical data on countries joining trading blocs; far less of countries leaving, because as The Economist dryly notes, “…this rarely happens.” But the downside risk to the UK is substantial, and the impact might ripple across the world. Fed chair Jay Powell has cited Brexit as another potential threat to economic growth.

It’s quite possible that the October 31 deadline could pass with the UK still in the EU. Parliament is likely to prevent a hard Brexit, and the EU won’t simply eject the UK, much as many may wish to. A general election might resolve the issue,
and if parties opposed to a hard Brexit (Labor and Lib-Dem) are victorious, a second referendum could reverse the first. Britain isn’t yet out of the EU, and there are several more scenes to play out.

Finally, one more risk that’s coming over the horizon is the 2020 election. It looks like Trump’s to lose, but with over fifteen months to go a lot can happen. At some point, it’s likely Trump’s re-election will look in doubt – either because the Democrats abandon their idealism and pragmatically opt for an electable candidate, or because a new presidential scandal erupts that sticks. Stocks are likely to react poorly, and a nasty presidential election that reflects badly on all concerned is probably in store.

With all these risks to consider, who can blame the Fed for taking out a little bit of insurance by lowering rates.

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**Still Fearing Another Financial Crisis**

“Concerns about trade and Gulf tensions spur rush towards sovereign debt.” warned the Financial Times last week. Almost $12 trillion in bonds trades at a negative yield. According to Tim Winstone, fixed income portfolio manager at Janus Henderson, “Investment grade is nuts. About 24% of my benchmark yields less than zero.” Even a dozen European junk
bond issues trade with negative yields.

The comments by Tim Winstone reveal much about investor risk appetites today. As a fixed income manager, his job is to pick bonds and stay invested. His clients have already made their asset allocation choice. While he might rationally choose to shun junk bonds in favor of equities, which at least have the potential of a positive return, his mandate doesn’t offer such flexibility.

Colin Purdy, Chief Investment Officer at Aviva Investors, explained, “For some investors, there is an acceptance that it’s not about absolute returns, but relative returns.” This is true to a point, but most investors would add that positive nominal returns are a priority.

Firms that invest in bonds for clients are grappling with an excess of demand versus supply. Rigid fixed income allocations that are insensitive to return reflect extreme risk aversion.

Market participants are drawing different conclusions from this. A common misconception is that bonds reflect looming trouble for stocks. Someone once explained to me that bond
buyers are naturally a dour bunch because we just want our money back, while equity buyers can dream of unlimited upside. But just because fixed income investors look more closely at balance sheets doesn’t mean that they’re always right.

If yields reflect extreme risk aversion, so do P/Es. While there’s no shortage of observers warning that stocks are overpriced, a lot of money that could buy equities is scared, preferring to own negative-yielding bonds instead. The conclusion must be that fear of another financial crisis runs wide and deep.

Infrastructure offers the stability of bonds with the upside of equities. This is especially true of midstream energy infrastructure (see The Coming Pipeline Cash Gusher). Valuations reflect the expectation of equity volatility with bond-like returns, but every quarter balance sheets strengthen, cash flows increase. Current holders are benefiting.

Last week, in Real Returns On Bonds Are Gone, we showed how much equities could appreciate before becoming historically expensive versus bonds. The quotes above from fixed income managers reflect widespread institutional risk aversion. At some level you might think firms would turn money away rather than invest it for negative returns. But they don’t, and it therefore falls to clients to impose more discriminating criteria.

What seems clear is that if stocks fall 25%, many investors will be comfortably positioned in fixed income. Their equity exposure was already set for that possibility.

But if none of the bad things people fear happen, and bonds fall, poor returns will be exacerbated by negative starting yields. The stock market continues to climb the wall of worry. Surprises will cause a drop, but the plausible negative events are priced in.
Real Returns On Bonds Are Gone

A recent short term strategy outlook from a large buyside firm walked through market expectations for Fed policy, S&P earnings, the election and drew conclusions about the likely direction of stocks over the next six months. Such analysis is endlessly fascinating even if trading profits are unreliable.

The essay touched on, but didn’t examine, what must be the biggest force driving markets – persistently low interest rates.

The real return on ten year treasury notes going back almost a century is 2%. Given 2% inflation, a neutral Fed should cause long term yields to drift up towards 4%. The Fed has been manipulating rates lower for most of the past decade since the 2008-9 financial crisis, but last year the bond buying ended and short term rates began moving higher. Yet ten year note yields peaked at 3.3% in November before descending to 2% recently.

Clearly, the historic relationship has changed. The balance between demand for and supply of safe, long term assets has shifted. Bond investors collectively have accepted lower future returns. There is plenty of interesting academic research to explain why. Real interest rates have been in
decline for thirty years, as shown in this chart from the Federal Reserve Bank of Minneapolis. They now appear to be negative, as defined by the average short term rate over the past decade.

![Secular Decline in Real Rates](chart.png)

Although many commentators fret over what they perceive as unsustainably high stock prices, the plausible explanations for low interest rates largely reflect reduced risk tolerance by investors. While the decline in real rates has been steady, gross fixed investment fell sharply in the U.S. during the financial crisis and has barely recovered. This implies companies have remained cautious, dampening the issuance of long term corporate debt.
Another factor, highlighted in *The Safe Asset Shortage* (Caballero et al), notes that the financial crisis and subsequent Eurozone crisis led to a reassessment of which assets really were safe. Debt issued by FNMA and FHMC was assumed to be more risky following their conservatorship by the U.S. Unsatisfied demand for AAA debt instruments led Wall Street to produce Collateralized Debt Obligations (CDOs), which sought to pool riskier debt and repackage it into tranches of varying risk. But it turned out that the AAA tranche of a CDO retained some tail risk that sovereign debt did not. This perspective blames the 2008 crisis on unmet demand for safe assets.
Oddly, Caballero concludes that German and French sovereign debt similarly lost their allure. However, their yields are more than 2% lower than U.S. equivalents and solidly negative, which suggests ample holders willing to pay for what they perceive as highly safe investments.

Although memories of the financial crisis are receding, it seems to have permanently lowered risk tolerance. This, combined with a reduced supply of safe assets and perhaps the demographics of aging populations in wealthy countries have moved equilibrium long term rates lower. In recognition of this, the Fed has been adjusting their own long term equilibrium rate down in recent years.

A compelling solution is for a substantial increase in government funded infrastructure investment. This would take advantage of demand for long term debt and, assuming better infrastructure raised productivity, would not increase debt:GDP.

The shortage of safe assets is also reflected in the Equity Risk Premium (ERP), the difference between the earnings yield on the S&P500 and ten year treasury yields. It shows that
stocks are cheap relative to bonds.

Since any investment is worth the net present value of its future cashflows, discounted at an appropriate interest rate, this has profound implications for stocks. Bond yields that are permanently lower suggest that stocks need to adjust substantially higher before fixed income can offer a competitive return.

The historically wide ERP underpins an investor’s choice to overweight equities. A return to its 50-year average of 0.6 (versus 3.6 today) isn’t imminent. But if next year it narrows halfway, to 2.1, and earnings grow by the 11% Factset bottom-up forecast, the S&P500 will be at around 4,400, nearly 50% higher than today.

U.S. energy infrastructure is an even better bet than the broader equity market. The shortage of high quality long term assets makes this sector especially attractive, as private equity funds seem to appreciate more readily than public markets.

Whatever the causes of permanently low interest rates, they
Can Trump Manage the Economic Cycle?

The current economic recovery, launched out of the cauldron of the 2008-09 financial crisis, continues to percolate. Directly following the 2016 presidential election, many stunned observers forecast numerous types of disaster. So far, those dire predictions have been wrong, although the future always provides lots to worry about.

The cancellation of tariffs with Mexico fits the Trumpian pattern of seizing what’s on offer and declaring victory – not difficult when no lines had been publicly drawn in the sand. The president’s 2020 re-election campaign remains an important element in U.S. economic policy (see The Trump Put).

Tariffs on Mexican imports would have been disruptive to sectors such as autos, given the integrated supply chains made possible by NAFTA. Republicans in Congress were considering blocking them. The protracted dispute with China has dampened growth somewhat, but the consequent political pressure has,
oddly, fallen more on the Fed than the White House.

Six months ago, Fed chair Jerome Powell carelessly allowed that multiple rate hikes might be coming: “Maybe we’ll be raising our estimate of the neutral rate and we’ll just go to that, or maybe we’ll keep our neutral rate here and then go one or two rate increases beyond it.” (see Bond Market Looks Past Fed).

Those hawkish comments were quickly walked back, while Trump has continued to call for lower rates. Some view this as challenging the Fed’s independence. Ironically, much of the justification for lower rates lies with the constraints being placed on trade with China, policies implemented by the White House. Last week Powell said, “We do not know how or when these issues will be resolved.” He continued, “We are closely monitoring the implications of these developments for the US economic outlook.”

Once again, the Federal Open Market Committee’s (FOMC) “blue dots” are exposing how far behind the market they are. The FOMC’s long run equilibrium rate for the Fed Funds rate remains at 2.8%. Ten year treasury yields, a decent proxy for the average expected short term rate over the next decade, are much lower, at 2.17%.
For years the Fed has been lowering their policy guidance, lagging a process well anticipated by bond investors. Futures markets are predicting almost three rate cuts over the next year, while FOMC projections are for unchanged policy.

On current form, it’s likely the Fed will “independently” grant Trump’s desired rate cuts. Don’t be surprised if Chinese trade tensions are then resolved in time for the election. It seems to be how things work nowadays.

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**Stocks Will Trump Tariffs**

A couple of months ago we noted in *Blinded By The Bonds* the
paltry yields available on long term debt. Since the 2008 financial crisis, the main driver of returns has been capital appreciation, since current income has been so low. Sure enough, over the last couple of months ten year treasuries have dipped another 0.3%, to around 2.1%. German ten year bunds now “yield” -0.20%. For an institution, the alternative is to hold currency in a vault. The cost of physical safekeeping of cash explains why investors are paying the German government to look after their assets.

The fall in long term yields reflects growing expectations that the Fed will cut short term rates. JPMorgan is forecasting two reductions in the Fed Funds rate by year-end. Yield curve historians fret that the inverted curve warns of a pending recession. It depends on the Fed. The bond market is telling them they have the wrong short term rate. The Federal Open Market Committee’s (FOMC) transparent process has removed all mystique. Who remembers William Greider’s 1989 Secrets of the Temple: How the Federal Reserve Runs the Country? Or Bob Woodward’s 2000 volume Maestro: Greenspan’s Fed And The American Boom. The transition from deity to technocrat in FOMC leadership is complete.

We now see a bunch of government economists with no more information than the better private sector economists trying to figure it out. The mental dexterity to switch from raising rates (the FOMC’s posture through 4Q18) to cutting may take a year. The odds of a recession depend on the FOMC’s humble acceptance that they have little unique insight. Crowdsourcing monetary policy, relying on the signal from bond yields is the logical evolution. The FOMC faces a Behavioral Finance problem – over confidence, combined with anchoring to their previously held beliefs. The economy’s growth path will turn on how well they adapt their behavior.

Trade friction is a growing cause of concern. On this, we’d simply note that when President Trump moves into re-election mode, China’s then-current proposal will be seized and another
victory for America claimed. Trump can’t control the market, but a president who Tweets the Dow’s milestones (even when they’re a return to old highs) is unlikely to let policy get in the way of boosting stocks (see *The Trump Put*). Tariffs are only an issue for 2019. The way bonds are moving, Trump may claim further credit for persuading the Fed to lower rates.

Falling bond yields and stock market weakness once again highlight the Equity Risk Premium (ERP), which is the difference between the earnings yield on the S&P500 and ten year treasuries. This starkly reveals the superior choice stocks offer versus bonds. At just over 4.0, the ERP is at a level reached only three times since 1962 (in 1979, 2011 and 2012). In each case, subsequent equity returns were quite satisfactory. Moreover, Factset is forecasting 11% S&P500 earnings growth, so the 2020 ERP looks even more compelling.

There will always be surprises. The biggest potential problem we see is Iran, where U.S. policy seems to have an undefined objective while steadily denying Iran access to sell its oil. It resembles U.S. policy towards Japan prior to World War II, when we denied them access to oil imports. As tensions rise in
the Gulf, a military miscalculation is possible. Iran’s options are unclear. Although there are many more compelling reasons to be invested in midstream energy infrastructure, holding U.S. energy assets during a Middle East war would be a better bet than many.

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A Reactive Federal Reserve

The other morning a CNBC guest was able to share an insight not normally found on TV. The need for ten-second ideas greatly limits the ability of otherwise intelligent people to share much wisdom. R.J. Gallo, whose Christian names are apparently only initials, trades municipal bonds for Federated Investors. He suggested that rates can rise slowly because people expect no worse.

More precisely, Gallo said that because inflation expectations are so well anchored at around 2%, the Fed can wait until actual inflation rises. Gallo noted that, “The Fed has been unable to structurally hit their inflation target for many years.” He went on, “The Fed is not totally sure how the inflation process works”
This makes a lot of sense. The reason the Fed has maintained a Fed Funds forecast that’s too high is because they’ve incorrectly expected rising inflation. They’ve struggled at times to even get the Personal Consumption Expenditure price index (their preferred measure) to reach their 2% target.

The high inflation of the 1980s, which afflicted most developed economies, is more history than a memory for most market participants. “Almost a generation of people... have seen very low inflation for (a) very long (time).”

Gallo therefore argues that we’re, “moving to an era where the Fed is allowed to be reactive.”

That would represent a substantial shift in thinking. Fed chair from 1951-70 William McChesney Martin famously said, “The job of central bankers is to take away the punch bowl just as the party gets going.”

Successive Fed chairs have ever since operated with the expectation that they were party poopers, although it’s probably a couple of decades since one acted that way.

Ten year treasury yields at 2.5% show there is little fear of
rising inflation. This, combined with the Fed’s inability to identify the circumstances that will cause inflation, lead to the insight that the Fed is moving from proactive to reactive. They understand less than they used to. Or, given their more transparent decision making process, we now know that they always understood less than we thought (see Bond Market Looks Past Fed).

The conclusion for bond investors is that Fed policy on short term rates will follow bond yields, which is probably as it should be. Fed policy has been more accurately forecast by expectations embedded in the yield curve. Collective expectations of inflation are as good as the Fed’s best analysis, and perhaps better.

It’s a natural progression for short term rate policy to be increasingly set by bond investors. An inverted curve (as was briefly the case earlier this year) caused some fears that the Fed would cause a recession. The correct conclusion was that the path of policy rates was wrong. Fed chair Powell duly put this right (see Bond Market Corrects Fed).

Rising bond yields will be a necessary requirement for the Fed to push short term rates higher. Until that happens, investors can remain comfortable that the Fed is still on hold, which continues to favor stocks.

SL Advisors is the sub-advisor to the Catalyst MLP & Infrastructure Fund. To learn more about the Fund, please click here.

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