

Interdependence Day

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

Has the Fed ever started an easing cycle with the equity market at, or near, an all-time high? We pose this question in almost a rhetorical fashion, because it certainly appears likely that this is exactly what is going to unfold in the coming weeks. While all major U.S. averages reached for the stars on Wednesday, market pricing on the Fed barely blinked this week—a 25 bp cut on July 31 is still almost fully baked in, even in the face of a solid June jobs report. True, 10-year bond yields snapped higher on the 224,000 payroll gain, bouncing more than 10 bps to 2.05% from the two-year lows reached mid-week. But all this really did was to fully brush aside prospects of a 50 bp slice (which always looked like a very long shot), and quash recession chatter. Stocks receded from all-time highs on Friday, seemingly disappointed that the economy is still healthy enough to warrant only modest rate relief.

Now a reasonable person could well ask—and many have—precisely **why is the market so dead certain the Fed will cut rates at this stage?** After all, financial conditions are strong, led by the record level for equities. Even with a small backup last month, the jobless rate of 3.7% is still basically at a 50-year low, and wages are grinding higher (still up 3.1% y/y, versus an average gain of 3.0% last year). While GDP will cool to a mild 1.3% pace in Q2, it's still up 2.5% y/y, which is most certainly above potential. Commodity prices are rising broadly this year, not falling, so deflation talk is wildly overdone. And even the much ballyhooed cooldown in core inflation has still left many measures close to the 2% target.

The answer can be pretty much boiled down to one word—**trade**. It has become readily apparent that the ongoing global trade frictions, and the never-ending threat of more, have clipped the world economy more than initially thought. With each passing week, the evidence of rising pain from trade tussles pours in. Markets had a short-lived celebration over the U.S./China trade truce following the G20 meetings, but we're really only back to where we were six months ago—more talks ahead, but the threat of higher tariffs loom large. Meantime, measures of factory activity continue to spill lower, whether sentiment, orders, or exports. One measure of the global PMI for manufacturing has tumbled four points from robust levels in little more than a year to below 49.5 as of June. Similarly, world export volumes have dropped in the past 12 months, compared with hearty gains in the prior two years.

The widespread pain in exports and manufacturing has cut global growth to below potential and tamed core inflation pressures broadly. While services and consumer spending have generally held up well (the Euro Area services PMI has actually been rising of late), the concern is that the weakness in factory activity will eventually bleed into broader growth trends. In turn, long-term yields are tumbling almost everywhere against the backdrop of a subdued outlook for global growth and inflation. It's well-known that 10-year government bond yields in havens such as Japan, Switzerland and Germany are locked in negative terrain, but they've recently been joined by France

ECONOMIC RESEARCH

1-800-613-0205

economics.bmocapitalmarkets.com

Douglas Porter, CFA, Chief Economist

+1 (416) 359-4887

douglas.porter@bmo.com

(not exactly a bastion of fiscal strength). Even Italian yields have tumbled on better budget behaviour, falling below 1.8%, or 30 bps clear of like-dated U.S. yields. But maybe the most staggering factoid, and one that best shows just how eager investors are for yield: 10-year yields in Greece have drooped to just below 2.1%, within a few meagre bps of Treasury yields. So, yes, Greece can now basically borrow your money at about the same cost as Uncle Sam.

While the U.S. employment report did its level best to break the going-lower-always-and-forever mantra in the bond market, there's not much market-moving data in the coming week aside from Thursday's U.S. CPI. Instead, all eyes will be trained on the central banks, especially on Wednesday. Fed Chair Powell will speak before the House on that day on the just-released Monetary Policy Report, and then to the Senate on Thursday. The Bank of Canada's rate decision is also at mid-week, and Governor Poloz will face the media and discuss the MPR (see **Focus** for colour). With politics rudely intruding into the Fed's realm in the past year, Powell may spend much of his testimony fielding questions about his job, rather than about the job he needs to do... unfortunately. We seriously doubt that the overall message from either policymaker will deviate from the overriding view that the Fed is poised to trim rates by 25 at the end of the month, or that the Bank will continue to stay on the sidelines until further notice.

The answer to the question at the start of the piece is, technically, no. However, **an amazing number of recent easing cycles have surrounded periods of strength for equities;** and, sometimes come within days of all-time highs. To cite just a few recent samples:

Perhaps most notably, the first rate cut of the **2007/08 cycle** came on September 18, 2007. Stocks were down a bit at that point, but rallied to a record high in the next few weeks after the move—a somewhat ominous comparison!

In **July 1995**, stocks were *just* off a record high, when the Fed first trimmed during the peso crisis. It was a similar story in the next two trims in that short cycle in **Dec/95** and **Jan/96**. Technically the Fed wasn't cutting at a record high, but equities were bullish through this whole period (rising and above the 50-day ma).

The Fed was also easing in the **summer of 1990**, when stocks were hitting a series of highs. However, when the first Gulf War began shortly thereafter, stocks and rates fell heavily in the following months.

April 21, 1986. Stocks were at a record high two days before, basically counting as cutting at a record high, but the easing cycle had begun earlier, in a choppy easing/tightening pattern in the mid-1980s. Earlier in that cycle, on **December 18, 1985** (i.e., first cut after a few rate hikes), stocks were a day or two off a record high.

So, as odd as it may seem, the overall conclusion is that **record highs for stocks and an easing Fed can indeed go hand-in-hand.**

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