GUGGENHEIM

December 27, 2018

Global CIO Outlook
Sometimes Meteors Strike the Earth

Scott Minerd
Global Chief Investment Officer
and Chairman of Investments

On Feb. 15, 2013 the Chelyabinsk Meteor, weighing approximately 13,000 tons, exploded over Russia, creating a blast about 30 times more powerful than the bomb dropped on Hiroshima. More than 1,500 people were injured and many were hospitalized as a result. There was no forewarning of the meteor's arrival. Fortunately, the explosion did not occur above a major city or the damage could have been catastrophic.

While we are told that thousands of meteors strike the Earth each year, most are much smaller and fall in sparsely populated regions. Yet the message is clear: A major meteor strike can happen at any time with little or no warning.

For the past year, I have been asked what could possibly affect our projections for the economy and the Fed's rate path. I have consistently pointed to the high risk of exogenous shocks, especially given the seemingly endless policy risks around trade and foreign policy. Each presidential tweet offered another meteor, with the risk that a large one could eventually strike.

The past month has provided not just a meteor or two but a virtual storm. It is difficult to list all the bad news, or which meteor was the source of the recent market explosion. Was it collapsing oil prices, in part the result of White House pressure for OPEC production increases while at the same time U.S. output continued its unabated rise? Perhaps it was the sudden crack in credit markets when investment grade bonds issued by the likes of GE and PG&E unexpectedly collapsed in price? Perhaps the world suddenly awoke to the risks of a global trade war? Maybe the Cassandra chorus of famous investors highlighting dangers associated with QE-induced overleveraging of corporate balance sheets suddenly exposed the 800-pound gorilla that I had thought we all knew was already sitting in the room.

By the time the Federal Reserve met last week it was clear the market was holding on to the hope that a reassuring voice of reason would let us all know that the policymakers were ready to step in if the storm got too bad. After a tepid promise that only "some" rate increases were in the tightening pipeline led to an initial selloff, market participants seemed prepared to give the Fed the benefit of the doubt and stocks began to rise again.

Then BANG! Another meteor out of the blue! The balance sheet was on "autopilot." What happened to "data dependence"? Fed policymakers had been clear in the past, assuring investors that the balance sheet was a tool that could be used to adjust policy, but that option now seemed to disappear. This was just too much!

I am highly sympathetic to Chairman Powell's circumstances. Last Wednesday's meeting was perhaps the trickiest I can recall in my career. In the wake of the turmoil of the preceding weeks the situation was delicate. With an economy expanding above potential and well past full employment, clearly rates need to be increased further to get closer to neutral. To deliver the necessary medicine, the Fed would certainly know that the patient would be sensitive given recent volatility. The language in the policy statement and related press conference would require the Fed to thread a fine needle. Clearly, it failed.

New York Fed President Williams did a commendable job last Friday after the FOMC meeting making it clear that "autopilot" may have been a poor choice of words. Certainly, the Fed would act responsibly and would use all tools as necessary and appropriate. But, let's face it, the damage had been done.

Any hope of restoring order was gone, especially as the meteor shower kept coming. Say goodbye to Secretary of Defense Mattis, who many say was the "last adult in the room." And then another big explosion! The threat that Chairman Powell may be gone! An attack on the sanctity of central bank independence was probably worse than the risk that Powell would actually be removed as chairman.

No doubt there is more volatility to come and with holiday-dampened liquidity. I don't see many investors willing to step in to buy especially given that so many were caught offside. I am quick to remind people that the recent events are exactly what we had expected—but we had expected it late next year, not now. Those investors who got underweight risk early were punished with subpar performance relative to their peers while other investors chose to linger a while longer at the punch bowl as the party went on. Now the punch bowl crowd is caught with too much risk which they are desperately trying to offload.

The exogenous event is upon us. What should be done? Don't panic! While risk assets may be vulnerable to more downside, liquidity is returning to the markets. What would have been a normal seasonal correction has turned into the worst December sell-off in equities since the Great Depression. Now is the time to be adding risk to portfolios.

Is this the bear market? I doubt it. This looks a lot like a late expansion correction similar to the Asian Crisis in 1998. Then stocks fell by 15 percent. The Fed will be quick to rescue markets if stocks continue to fall from their highs. Policymakers haven't the stomach to watch this dislocation turn into a systemic crisis. When will they step in? A continued slide in risk assets that pushes stocks down by close to 20 percent from recent highs should be enough.

Will this lead to a recession in 2019? No. We do not have a single recession signal from our proprietary indicators. If we see three successive declines in monthly leading economic indicators, that would be a warning that recession is possibly imminent. Four months would probably seal the deal.

What about Treasurys? The current flight to safety is likely to reverse soon. It is probably too late to buy now. T-bills would be a safe haven offering a reasonable return.

When all is said and done, the current risk-off volatility should probably be welcomed. And just as there is usually a seasonal cold snap preceding winter, it is usually followed by a period of Indian summer. If I'm right about a return in confidence, which would likely be aided by a pause in Fed rate hikes or even an unexpected temporary rate reduction, then there could be another selling opportunity once prices stabilize.

Of course, there is still a lot of chaos in the world, both here at home and overseas in China and Europe. Another meteor could strike at any moment. I trust that the Fed stands ready to do what it takes to avoid calamity.