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Global CIO Outlook
Looking Past the Liquidity-Driven Rally

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Federal Reserve (Fed) Chairman Jerome Powell's message was loud and clear this quarter: Sustaining the expansion is of utmost importance. Unsurprisingly, the Fed's "pivot" to accommodation pushed stocks to new highs, drove yields and spreads lower, and supported prices for real estate, commodities, and cryptocurrencies.

On July 31, the Federal Open Market Committee (FOMC) followed through on Powell's commitment with a 25 basis-point cut to the federal funds target rate. Painted as just a mid-cycle policy adjustment, the market perceived the cut to be hawkish. Less than 24 hours later the preemptive ease, which was intended to immunize the U.S. economy against weak global growth, was put to the test with the announcement of 10 percent tariffs on Chinese goods beginning Sept. 1. This pushed the S&P 500 lower and credit spreads wider, an early sign that the rate cut failed its objective.

Given the market's vulnerability to such exogenous factors, to keep the expansion going the Fed has boxed itself in to deliver more rate cuts this year. This may drive a rally in risk assets based on the market's perception that liquidity will be plentiful during this period of Fed easing. Plentiful liquidity means that sellers have confidence they will always find buyers at reasonable and relatively predictable prices. The Indian Summer for risk assets that I have been writing about continues as complacency around liquidity fuels speculative behavior.

Long-term investors need to listen for the rhyme of history. When the Fed similarly pivoted from tightening to easing in 1998 in response to the Asian financial crisis, the easy money inflated risk assets, most notably tech stocks. The tech boom drove the U.S. economy into overdrive, putting the Fed back in hiking mode less than a year later. The bubble burst: The Nasdaq collapsed about 80 percent peak to trough, and high-yield credit spreads widened by over 600 basis points as the tech bubble burst.

While our intermediate-term outlook is that the Fed will succeed in reflating the economy, and rates on the 10-year Treasury will move towards 2.5 percent, ultimately when the next recession arrives the implications are ominous. Clients and readers know that we are prudent risk managers. We will take investing risks when we believe we are being adequately compensated for them, but now is not one of those times. We dialed up our appetite for risk in 2008 and 2009, when the financial crisis hammered prices for risk assets, and in 2016, when the credit market's over-reaction to the oil market collapse offered up tremendous value. Now we are dialing it down. As the Fed begins its easing campaign to try to extend an already long-in-the-tooth expansion, credit spreads are already tight across the fixed-income spectrum. Credit spreads could get tighter in this liquidity-driven rally, but history has shown that the potential for widening from here is much greater.

This time around the bubble is not in tech stocks or even equities more broadly. While commercial real estate may be somewhat overpriced, residential real estate remains reasonably priced relative to incomes and mortgage rates.

So where is the bubble today? I hate to admit the ugly truth, but it may well be in bonds, and in particular the sovereign debt of governments around the world. The category of supposed "risk-free" assets has risen to prices which guarantee a loss to investors in many countries around the world. Like all bubbles, the end is not easily discerned and will often reach extremes as investors choose ludicrous prices in the hope that tomorrow's price will be more ludicrous.

I doubt the end is near. To quote Winston Churchill, "This is not the end, it is not even the beginning of the end. But it is perhaps the end of the beginning." The curse of negative rates will be with us for a while, and eventually may reach the shores of the United States.

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