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"Batten down the hatches..."

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The phrase "batten down the hatches" has nautical roots. English sailors, on the command of the ship's captain, would prepare the deck for foul weather. The battens were wooden strips used to cover the ship's ventilation grates. The captain had complete control of the timing of readying the ship for the storm. Captain Donald Trump would like the same discretion over the timing and actions of the Fed, although he is unlikely to get it. The President correctly sees the risks of a US recession rising in line with his reelection bid. He would like to instruct the Fed Chairman Jay Powell to lower interest rates further and faster. The Fed in an effort to maintain its independence may be forced to move less aggressively and slower.

The forecast of a late-cycle implies that at some point the cycle will end. Chairman Powell at his latest press conference chose to call it mid-cycle. We choose to disagree. The Fed is behind the curve and will continue to chase the market to low or negative rates. The inverted curve between Fed funds and 30-year bonds implies such. The U.S. is on a course to make the mistakes of both the Japanese twenty years ago and the Europeans ten years ago. In theory, market manipulation appears easy. Whenever economic conditions slow, it is necessary for governments to spend money and central banks to ease monetary conditions by lowering interest rates. This countercyclical exercise would seem to balance out the weakness and allow perpetual prosperity. In the short run, such measures can be quite effective. In the long run, however, these incentives can encourage the wrong behaviors. A fiscally expansive policy can lead to over-indebtedness by governments. Monetary largess expands private credit at a time when available opportunities are least attractive. The Trump tax cuts may prove to be mistimed both politically and economically.

At some point, the short-run becomes the long run. The Great Financial Crisis was the result of decades of failed policies to manage capitalism. Desperate attempts to keep the game alive by kicking the can down the road are failing. Unconventional measures that were supposed to be temporary have been made permanent. Global public and private debt levels are at staggering levels. Bonds bearing negative interest rates exceed $15 trillion and make up over 25% of some global bond market indices. Investors have been chased out of the risk curve in order to receive the prospect of an acceptable real return. Savers are penalized for their prudence. Consumers have been rewarded for their decadence. Speculators profit from frontrunning government policy while investors are left holding the bag. It is the creditor that bears the most risk as the system gradually is unable to prop up the debtor.

The challenge, as global growth slows, is to produce enough income to service debt. Traditional fixed-income investors like insurance companies and pension funds are finding it difficult to invest at yield levels sufficient to match their liabilities. As they stretch for yield at narrow yield premiums the incremental risks that they are taking are unlikely to be rewarded. There has been a significant deterioration in credit quality in traditional sources of credit since the financial crisis. There has been a steady negative migration in the credit ratings of investment-grade credit within the corporate credit market. To a lesser extent, the same has been true for governmental debt, particularly within emerging debt markets.

Fixed-income investors today must differentiate among issuers with the ability to meet their obligations through the next cycle. There is an increasing probability of a global recession. The dynamics of trade, technology and politics ensure that the criteria for success will be different than in the past. Economies across the globe are adjusting to massive technological change at a time of heavy indebtedness. There will be big losers as well as big winners as GE, Kraft and P&G bondholders have experienced recently. Diversification is perhaps the best an investor can do. Adding emerging market debt introduces a different set of risks somewhat uncorrelated with the short-term economic cycle.

Over time countries have established more flexibility in their ability to meet obligations. Sovereign obligors have been more adept at managing reserves. They have developed local markets to dampen hard currency volatility. Global institutions like the IMF have become better informed at managing debt crises. Politics may play a more prominent role in a sovereign restructuring than it would in a corporate default, but at least the factors contributing to the credit problem as well as its resolution are vastly different.

With the prospect of further slowing in economic growth globally and the risk of a US recession increasing, it is prudent to upgrade credit quality and diversify portfolio holdings. While it is difficult to find value in traditional fixed-income sectors given the absolute level of interest rates and contraction in spreads, there still may be opportunities in high-quality emerging market debt to diversify risk. Recent issuance by high-quality issuers from middle eastern countries represent an attractive sector within credit markets. Kuwait, Abu Dhabi and Saudi Arabia are examples of high-quality bonds that trade at a yield premium to similarly rated bonds. Certainly, the short- term correlation to oil is high and will negatively affect these credits in a global economic slowdown. However, these countries have substantial resources to maintain their credit quality through a downturn and will continue to reduce their long-term risks through a deliberate strategy to diversify their economies away from fossil fuel dependence.

It is quite possible the we are at the beginning of the end of this prolonged global economic expansion. There have been a few imbalances. Growth has been tepid, but so has inflation. Interest rates have been well behaved. Investors are forced to accept higher risk for moderate returns. They have also willingly accepted far less liquidity. Equities have done extremely well. The end of the economic cycle should prove far more challenging. Discovery of several risks or imbalances that were not anticipate or identify is probable. The trend in rates is likely to be more negative. Inflation may give way to deflation. Lower returns are anticipated with higher levels of risk. Volatility should rise making equities less attractive. Liquidity will be at a premium. It is time to “batten down the hatches” and prepare for the approaching storm.

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