Goldilocks and Three Potential Bears: A Market Fairy Tale

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“Hold it. You know what I’d like to see? I’d like to see the three bears eat the three little pigs, and then the bears join up with the Big Bad Wolf and eat Goldilocks and Little Red Riding Hood! Tell me a story like that, OK?”

— Bill Watterson

I desperately wish that I could come up with a term other than “Goldilocks” to describe today’s US economic environment. Go on. I dare you. How would you describe a US economy chugging along at about 2 percent growth with incredibly low interest rates driven by still easy monetary policy and tame inflation? Is there any other way to label it? Don’t take my word for it. Some 36 percent of market professionals responding to July’s Bank of America Merrill Lynch Global Fund Manager Survey described the economy as fitting the “Goldilocks” standard of “high growth and low inflation.” That remains near the peak set in June and reflects the views of 207 panelists with $586 billion assets under management.1 So, if it looks like Goldilocks, smells like Goldilocks and acts like Goldilocks, I guess it’s Goldilocks!

Not Too Hot, Not Too Cold — The Economy is Just Right

Our Goldilocks economy has lasted for quite a few years. And recent economic data releases suggest that, unlike the fairy tale, Goldilocks doesn’t plan on fleeing the three bears’ cabin anytime soon. According to the advance estimate released by the Bureau of Economic Analysis on July 28, real gross domestic product (GDP) increased at an annual rate of 2.6 percent in the second quarter. That was a marked improvement from the paltry 1.2 percent first quarter growth, but the simple two-quarter average remains a modest 1.9 percent.2 On August 4, the US Bureau of Labor Statistics (BLS) reported total non-farm payrolls increased a higher than expected 209,000 in July, and the unemployment rate was little changed at an incredibly low 4.3 percent. Despite the strong jobs figures, wage growth as measured by the average hourly earnings data has been stuck at roughly 2.5 percent year-over-year since 2015.3 In addition, the BLS reported on August 11 that US consumer prices rose less than expected in July. The so-called core CPI rose 1.7 percent in the 12 months through July and has been stuck at this level for three straight months.4 Plainly, inflation remains well below the Fed’s 2 percent target. While the economy has likely defeated the too cold deflationary scenario, it remains a safe distance from the too hot inflationary scenario.

The complacency demonstrated by most measures of financial market volatility suggests that Goldilocks has made herself at home in today’s US economy. She doesn’t seem too concerned about bears. However, perhaps as in the fairy tale, just as Goldilocks settles down for a long peaceful nap, she could be frightened by the unexpected arrival of one or more of these three bears:

1. Mama Bear Yellen and the Potential for a Monetary Policy Mistake

Fed Chairwoman Janet Yellen is mixing up her latest batch of monetary policy porridge. She’s trying to avoid making it too sweet or too tart for investors’ taste buds. But after nearly a decade of experimental monetary policy will she be able to concoct a policy that’s just right for the economy and investors?
Market participants trust Yellen and her Fed colleagues implicitly not to make a monetary policy mistake by tightening conditions prematurely and choking off the long but modest economic recovery. In fact, financial market volatility remains at historic lows despite elevated policy uncertainty and geopolitical tensions because investors believe that when push comes to shove, the Fed will save their bacon, er I mean porridge. And, who could blame them? This behavioral bias has been acquired through thirty years of experience. The Greenspan put was used during the market crash of 1987 and then again during the Long Term Capital Management (LTCM) crisis. And Chairman Bernanke certainly flew his monetary policy helicopter proudly during the years that followed the global financial crisis.

Mama Bear Yellen has continued the tradition by nurturing the economy and markets for far too long during this recovery. She missed past opportunities to wean investors from emergency policy measures. Now, like petulant children, investors refuse to accept the possibility of tighter conditions. In fact, despite tough talk from Yellen and her Fed policymakers, market participants still expect monetary policy conditions to remain easy for some time. According to Bloomberg, just 26 percent of investors expect the Fed to raise rates at least once more in 2017, despite the Fed’s promises to do so.5 Investor experience leads to the conclusion that there is a Fed put. However, I’m fearful that it won’t get exercised until prices are materially lower from where they sit today.

Yellen has promised time and again to tighten monetary policy conditions gradually and only if the environment is perfect. But do the Fed’s actions speak louder than her words? As Lacy Hunt and Van Hoisington reported in their Q1 Review and Outlook, the Fed has started the fifteenth tightening cycle since 1945. In 80 percent of the previous 14 tightening cycles, recessions followed. Said differently, the economy was only able to avoid a recession in 3 of the previous 14 cycles. Regardless of whether there was a recession, the last 10 tightening cycles exposed over-leveraged parties and financial crises followed. Today, examples of over-leveraged actors are bountiful due to long-term easy money policies. In fact, total domestic non-financial debt, excluding off balance sheet liabilities such as leases and unfunded pension liabilities, reached a record 254.8 percent of GDP in 2016, 5.6 percent greater than when Lehman Brothers failed. Business debt surged to a record 72.6 percent of GDP in 2016, eclipsing the prior peak of 70.2 percent reached in 2009.6 With the business sector so levered, there isn’t much room for a monetary policy mistake. The risk is clearly present that the Fed’s current tightening cycle will chase out one or more heavily leveraged players, just as it did in all the previous tightening cycles since the 1960s.

Investors are overestimating the power of the Fed put. Should policymakers continue on their current path of tightening monetary policy conditions — as they have promised — history would suggest the probability of a recession and/or financial crisis is much higher than investors currently have priced in to risk assets.

2. Papa Bear Trump and the Potential Failure of the Republican Policy Agenda

Zero. That’s how many legislative victories have been achieved in the first eight months of the Trump presidency. For a president who boasted about winning bigly, this has got to be frustrating. So far, investors have shrugged off the political circus. They’re used to it, I guess. Synchronized global growth and improving earnings have empowered them to look past the silliness that has come to define US politics.

But how long can investor indifference to the potential failure of the Republican policy agenda last? Surely some of the post US election rally has been driven by investor expectations for lower taxes, less regulation, increased infrastructure spending and more affordable healthcare. Although not signaling contraction, most economic data peaked a couple months ago and the year-over-year earnings comparisons are going to get a lot tougher in the second half of 2017. An aggressive fiscal policy agenda was supposed to offset any challenges that may arise from tighter monetary policy. So far, we have the Fed raising rates and no fiscal policy offsets.

The Republican policy agenda was intended to give a shot in the arm to the sluggish US economy. However, as the policy agenda prospects have waned so, too, have the popular Trump trades that performed so well from Election Day to
Inauguration Day. This has got to be making an overly-sensitive Papa Bear Trump grumpy. And, with midterm elections on the horizon, Trump may be getting nervous that someone wants to try his Oval Office chair for comfort.

With no legislative victories to boast about and prospects for future wins dimming, concerns are growing that President Trump may pivot to the more controversial parts of his agenda where he doesn’t need Congressional approval, such as trade policy. At least in the short term, ill- advised trade policy won’t be good for the economy or markets.

3. Baby Bear Kim Jong Un and the Potential for Conflict

Tensions have been rising over North Korea’s nuclear ambitions and its rapidly developing missile program. According to the Financial Times, anxiety has increased following reports that North Korea has solved one of the final technological challenges in nuclear missile design by miniaturizing an atomic warhead. The breakthrough, if true, follows an unprecedented number of tests and increase in missile range over the past two years.7

President Trump has threatened to respond to “any more threats” from North Korea with “fire and fury like the world has never seen.”8 Not to be outdone, North Korea’s leader, Kim Jong Un threatened to strike the US Pacific territory of Guam. With North Korea and the US trading increasingly incendiary threats, Trump may have unintentionally backed himself into a corner. He may feel compelled to act should North Korea not heed his warnings.

Disagreements within the Trump administration on how to diffuse the North Korean situation pose additional risks. Some in the administration advocate launching a preemptive strike to end the North Korean nuclear threat; others prefer pursuing diplomatic discussions to end the standoff. Unfortunately, thus far, the diplomatic route has not deterred the North Koreans from developing their nuclear program.

Even as Secretary of State Rex Tillerson insists that “Americans should sleep well at night,”9 content like Goldilocks in Little Bear’s bed, fear is growing that Trump may elect the military option to end the North Korean threat. Particularly given the absence of legislative victories and waning support from Trump’s most ardent supporters, US military action seems more likely now than it did earlier this year. This could further complicate already cool relationships with both China and Russia. In the near term, US military action against North Korea could result in increased volatility, a flight to safe havens and, quite possibly, a market correction.
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When Fairy Tales and Reality Collide

I often struggle with the idea that maybe I’m too cautious in my approach to Uncommon Sense themes. As the market reaches new heights and volatility plummets new lows, identifying things that could go wrong becomes a much lonelier place. Is the sky really falling? Are there bears at the door? After all, good but not great growth, low rates and benign inflation have always been a constructive backdrop for risk assets. And, this time has proven to be no different. Just because this economic expansion and coinciding bull market are among the longest in history doesn’t mean they can’t be even longer still. Bull markets don’t die of old age. In fact, most of the economic and earnings data suggest that the path of least resistance is higher for the economy and risk assets. And most investors I meet with are invested for such a prolonged good environment. Should monetary policy remain loose and fiscal policy progress be made, that would further support the economy and markets.

However, just as I feel it is my Uncommon Sense responsibility when times are tough — and thankfully since 2009 there haven’t been many of those times — to talk investors off the ledge, convince them to stay disciplined, well diversified and follow their long-term investment plan, I feel responsible for identifying what could go wrong when it seems like nothing could go wrong. When markets are climbing and investor complacency is high, investors should be thinking about what could derail the good times. In today’s feel-good environment, we have to remember that the three bears may come home and send Goldilocks running for her life.

4 CNBC, “US Consumer Price Index rise 0.1% in July, vs 0.2% increase expected.” August 11, 2017.
5 Bloomberg, August 11, 2017.
9 Katrina Manson, “North Korea escalates threat as Tillerson seeks to ease tensions.” Financial Times, August 10, 2017.

Glossary

Consumer Price Index (CPI) A measure of the average change over time in the prices paid by consumers for a market basket of consumer goods and services.

GDP or Gross Domestic Product The monetary value of all the finished goods and services produced within a country’s borders in a specific time period.

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