Points to Ponder

March 22, 2019

The First Tee...

The Price is Right?...Fed officials are baffled by on-going low-level of inflation growth:

- The Central Bank established its 2% explicit inflation growth target in 2012 *(Bernanke's brainchild)*:
  - Since that time, the Fed's preferred inflation indicator (the Personal Consumption Expenditure price index…PCE) has averaged just 1.4%, while the Core PCE reading (which excludes food & energy costs due to their volatile nature) is 1.6%:
    - Inflation growth has lagged below the 2% level long before it became the Fed's target, averaging 1.8% since 1993.
- The Fed's inflation consternation is grounded in several key data points *(historical inflation stimuli)*:
  - GDP has expanded for 10-years, unemployment at 50 year low and a 0% Fed Funds target for 7 years
    - Economists characterize their theories for low inflation growth under three classifications *(justifying the unjustifiable?)*:
      - **Slack**…which postulates the labor market has not been as tight as believed…unaccounted workers (resulting in slow wage growth):
        - Fed officials established the threshold of a 4.4% unemployment rate (or lower) would induce inflation growth (an over-shoot):
          - Unemployment data only counts people actively looking for work, companies have hired people off the sidelines (hidden labor slack).
          - Expanding trade with developing nations has added at least 1 billion workers to the global labor supply (international labor slack).
          - The inverse relationship between the level of unemployment and the rate of inflation (the Phillips Curve) has been dormant.
      - **Secular Disinflation**…a number of structural and demographic changes could be placing downward pressure on inflation:
        - The large size of the retiring Baby-Boomer population is driving-down average compensation (older people tend to spend less).
        - The contraction of organized labor, a growing concentration of workers among fewer employers, technology/robotics advancements and the expansion of international trade have reduced pricing leverage on wages and goods.
      - **Anchored Expectations**…inflation outcomes are heavily influenced by what the public expects inflation to be:
        - An extended period of below capacity economic growth can lead to weak inflation…this can eventually lower business and consumer expectations of future price increases, restricting inflation growth to below the Fed's 2% target even as the economy expands.
        - The persistent undershoot of the Fed's target is eroding expectations, undermining the 2% inflation anchor.
        - "Inflation expectations are now the most important driver of actual inflation"…Jerome Powell's Congressional testimony.
  - Reaction to inflation expectations typically follows two channels: consumption and price setting:
    - If a large percentage of consumers and businesses expect inflation to rise substantially in the near future, they will accelerate purchases and investment decisions…at the same time, workers will seek higher wages and firms raise prices:
      - Accelerating demand, combined with rising wage and price pressures, help to generate inflation growth that was anticipated.
  - The aging population and declining risk tendencies have contributed to a lower neutral rate level:
    - The neutral rate is the interest rate that neither restricts or stimulates the economy or the level of inflation:
      - The reduced level of the neutral rate increases the probability the Fed will have to reduce its benchmark target rate to zero percent during future economic downturns to sufficiently stimulate growth and prevent inflation from falling below 2%.
- Fed re-boot…the Central Bank is re-thinking how it administers monetary policy to influence inflation:
  - Federal Open Market Committee (FOMC) currently utilizes a "bygones" approach to inflation tracking:
    - This strategy is based on the FOMC not caring how much the inflation growth rate has previously missed their 2% inflation goal (under or over shooting the number), but that the current price appreciation pace is at the desired objective:
      - Tepid inflation implies the Federal Funds rate has less room to increase before it restricts economic growth, leaving the Central Bank with less alternatives to combat the next economic contraction…launched the creation of QE stimulus during the last crisis.
  - The Fed is considering implementing a monetary policy strategy called **Average Inflation Targeting**:
    - Also known as Temporary Price-Level Targeting, this plan involves allowing for inflation to exceed the 2% target to compensate for periods when price growth trends are below the desired growth goal *(allowing economy to run hot)*:
      - A period of too low prices would require an offsetting period of too high prices…leaving the target rate lower or higher for a longer period.
    - Past Federal Reserve Chairman Ben Bernanke has suggested only using the new policy methodology when rates are at zero (temporary)…this would allow the Fed not to have to tighten policy during good economic periods to reverse elevated inflation caused by transitory factors such as an extended spike in gasoline prices *(value volatility vacuum)*.
  - The Fed has worked vigilantly at establishing inflation fighting credibility since the 1970's and 80's:
    - Public trust in the Fed's commitment has resulted in inflation not responding to significant market shocks.

At the turn...

The Back Nine…

Kissing Cousins…collateralized loan obligations (CLOs) are being scrutinized as rising risks are starting to resemble similar issues seen in collateralized debt obligations (CDOs):

- CDOs, funding toxic subprime mortgages, were the catalyst for the 2008 economic crisis:
  - The structure of CLOs are similar to CDOs, by pooling multiple loans to create a synthetic investment:
    - Investors purchase pieces (tranches) of the underlying interest and principal cashflows of the CLO portfolio:
      - Risk is allocated differentially by the order investors get paid first and which tranches absorb the most losses *(the CLO pecking order)*:
        - Low-risk senior tranches typically carry credit ratings of A or better, ranking first for payments and only have losses if equity pieces default.
        - Less risky subordinate or mezzanine pieces are typically rated between BBB and B, and rank ahead of equity *(hovering in junk status land)*.
        - High risk CLO equity tranches, which are unrated, are the first to absorb losses and the last for repayment *(and the first to go into default)*.
          - Investors in high quality tranches, are more insulted from actual losses, but could face mark-to-market write-downs if the current value of the security falls.
  - CLO's are primarily repackaged leveraged corporate loans and subprime consumer credit (auto loans):
    - The credit quality of the leveraged loans that underlie a large portion of CLOs are typically not investment grade:
      - Leveraged loans are very sensitive to economic conditions…problems in the loans could occur simultaneously during economic downturns.
      - The loans have minimal investor protection, with over 70% of outstanding CLOs lacking covenants allowing for monitoring of financial conditions and early intervention to manage borrowers with problems *(what you don't know won't hurt you?)*.
      - The corporate loans, typically collateralizing CLO portfolios, are normally fewer and larger size loans, adding concentration risk.
- Currently, CLOs outstanding globally stand at $700 billion…with annual new-issuance at $100 billion:
  - The current size and issuance of CLOs are comparable to the amount of subprime CDO volume in 2008
    - CLO portfolio's currently purchase 50% to 60% of all leveraged loans…the strong demand for loans by CLOs has resulted in a lower price of credit and relaxed lending terms (firms wishing to break into CLO market typically have to take credits others do not want):
      - Japanese banks own about a third to all CLOs outstanding…purchasing almost 75% of the outstanding AAA tranches.
  - CLOs have gained popularity with investors who are searching for higher returns *(rose colored risk glasses)*:
    - The riskiest CLO tranches can yield as high as 20%...unfortunately, some of these buyers are unsophisticated investors *(just like 2008!)*
- Issuance of U.S. auto asset-backed securities hit a record $107.3 billion in 2018:
  - Over 7 million Americans were at least 3 months behind on their car payment at the end of 2018:
    - On a percentage basis, this 5.5% delinquency rate was the highest since 2012 (the share considered sub-prime were the most since 2010).
    - The past 3 -years, the companies offering loans to the riskiest borrowers are the ones using CLO securitization the most

19th Hole...

Put not your trust in money, but put your money in trust.

Oliver Wendell Holmes

Ross Elford, First Vice President

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