What is ELB?

As global market rates move closer to zero, policymakers confront what "effective lower bound" is for the Fed's benchmark rate.

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I headed northeast this week with advisor meetings in Massachusetts, New Hampshire and Maine. In Worcester, Mass., an advisor took issue with my insistence that most Americans aren't debating the trade war but are busy shopping. "Tell anyone you're a financial advisor and their No. 1 question is about Trump, the trade war and tweets." He reminded us of the 25% chicken tariff, which was part of a trade war in the 1960s and is still in effect today. It was imposed on light trucks (and originally on potato starch, dextrin and brandy) in 1964 by the U.S. under President Johnson in response to tariffs placed by France and West Germany on importation of U.S. chicken. But I digress. What is ELB?? Google says ELB stands for "elastic load balancing," a service that routes requests to Amazon Web Services and automatically distributes resources to meet incoming traffic demands. Huh? That is not what the July Fed meeting minutes were referring to when ELB was mentioned 15 times. ELB in Fed-speak stands for "effective lower bound" and presumably refers to "zero" rates or conceivably even less. The presumption is the fed funds target rate can't fall below zero, yet the minutes hinted Fed policymakers are worried it's a slippery slope from zero to negative. Chair Powell was even more obsessed with ELB in a June 4 speech, mentioning it *26 times* and calling the proximity of interest rates to the ELB "*the preeminent monetary policy challenge of our time*." In July's Fed minutes, several participants warned that many foreign central

banks "had only limited policy space to support aggregate demand" if downside risks to the global economy are realized. Despite the massive spike in negative-yielding sovereign debt—$17 trillion and counting—does this suggest global monetary policy might be exhausted as a stimulus?

In the U.S., not a single Treasury bond has a higher yield than the current fed funds target rate—not even the 30-year bond. A cut of 75 basis points (futures are pricing in three quarter-point cuts over the next four Fed meetings) could reverse this yield-curve inversion. But even with an inverted yield curve, the question is what's driving it, and the answer seems to be lower and negative yields elsewhere, rather than outright concerns about an imminent recession here in the U.S. FundStrat is watching high yield as the canary. It notes that, in 2000 and 2007, the yield spread between high yield and comparable-maturity Treasury bonds widened continuously even as stocks managed new highs, confirming the business cycle was turning. Today, high yield is rallying as stocks make new highs, a sign the cycle remains very much intact. Investment-grade credit also continues to act well, with a strong correlation to the S&P 500. Considering the extraordinary moves in recent weeks, the main stock indexes look surprisingly benign. The S&P, Dow and Nasdaq are trading above their 200-day moving averages, favorable and normal for a bull-market cycle. However, the Russell 2000 and the Dow transports have been trading below their moving averages, denoting a dichotomy in the marketplace. Leadership continues to skew defensive, as high-beta stocks vs. low beta traded to fresh relative lows early this week and the Dow utility average hit a record high. Since global leading economic indicators peaked in January 2018, the S&P is flat, with high beta down 14%, low beta up 14% and the S&P dividend yield higher than the 30-year Treasury bond for the *first time since 2009*.

The silver lining missing in all this talk of negative global yields and yield-curve inversion is demographics. We had this global baby boom that sent productivity soaring when this generation hit its most productive years (around age 40). It also provided supply-demand inflation. Productivity then tailed off as boomers began aging into retirement. Now, a new, larger generation, the millennials, is on the cusp of entering its most productive years, suggesting productivity is about to break out again. With the lack of a quick resolution on the U.S.-China trade front, there are enough crosscurrents

in the global financial world to contain the market in a neutral trading range for the intermediate term, with the indexes yo-yoing between all-time highs and recent lows. Defensive stocks and high growth companies should continue to outperform in this environment. At an advisor dinner in Salem, N.H., the discussion centered on the search for income and the tried-and-true dividend strategy. And, if inflation is not likely to bring on a recession, could it come from a credit event? Where will that event arise? Europe, all agreed. As Boris Johnson asks the Queen to suspend Parliament, perhaps to "ease" the path to a hard Brexit, Third Seven doesn't even think this is Europe's biggest worry. Longer term, it would be atypical for an uptrend to not eventually resume as long as there is no recession (our base case). Looking at the last 10 major market tops, the average 12-month performance leading up to the final S&P top was approximately +20% (vs. relatively flat at the moment). So let's not overreact. Now, can anyone enlighten me on "elastic load balancing?"

POSITIVES

- **Consumers are confident** August Conference Board consumer confidence came in well above consensus, just off a 20-year high, and the 52-week average of Bloomberg's separate consumer comfort gauge improved to its highest level since May 2001. And although Michigan sentiment fell to a 3-year low on a big drop in the expectations component on tariff worries, the current conditions component remained at historically robust levels.
- **Confident consumers like to spend** Underpinned by the strong labor market, Q2 consumer spending was stronger than previously estimated, rising at an annual 4.7% pace, its strongest pace in 4.5 years. Spending rose even faster in July, topping consensus.
- **Earnings are holding up** Q2 corporate profits—net income with inventory replacement and differences in income tax and income statement depreciation taken into consideration, aka operating profits—rebounded the most in five years. On a year-over-year basis, profits increased almost 3%, reversing Q1's decline and lessening the risk of a technical earnings recession. Despite increased risks brought on by negative trade shocks, 1-year forward S&P earnings growth estimates have remained stable at about $175.

NEGATIVES

- **Strong headline masks muted capex** July durable goods orders jumped the most in nearly a year but shipments of non-defense, non-aircraft capital goods fell. This proxy for actual capital expenditures (capex) was revised down for June as well. Core business orders (cap goods ex-defense and aircraft) are now rising at their slowest annual pace since January 2017.
- **Falling mortgage rates aren't helping much** After a June spurt, pending home sales fell again in July, slowing housing's recent uptrend. The National Association of Realtors says a lack of inventory is partly to blame as the shortages are causing prices to climb, albeit at a more moderate pace lately. A downward revision to residential investment helped trim the second estimate of Q2 GDP growth to 2% from the previous 2.1%.
- **Nonresidential construction doesn't look so hot, either** The American Institute of Architects architecture billings index, which tends to lead non-residential commercial construction by roughly nine months, is rolling over on a trend basis. Design contracts have fallen to their lowest level in nearly seven years.

WHAT ELSE

Election watch Republicans have the edge to keep the Senate, but the fortunes of GOP senators up for re-election in competitive states in 2020 is likely to be largely driven by how well Trump does. Recently announced retirements have Republicans defending eight seats in competitive states compared to only four for Democrats. A repeat of the 2018 election would very likely produce a Democratic sweep, giving Democrats the opportunity to pass a bold progressive agenda and have important implications for investors.

Who doesn't like lobster? The weather during my travels this week was perfect. But the lobster roll was unreal. Maine is known for its lobster, and that little roll was expensive! My local colleague shared that lobster will only get more expensive as next year, the state will limit the amount of Atlantic herring, a critical source of bait for the East Coast lobster fishery, to half the amount currently.

I'm team U.S.A. The nature of America's GDP makes it difficult for weaker global growth to portend a recession in the U.S. America led global recessions in 1975, 1982, 1991 and 2009, when the U.S. consumer was pulling back. That's not the case today (*more above*), as low unemployment, a relatively high savings rate and near-record consumer net worth are making for a resilient consumer.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio, in comparison to the market as a whole.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Investments cannot be made directly in an index.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The American Institute of Architects' monthly Architecture Billings Index is a based on a survey of work underway at architecture firms.

The Bloomberg Consumer Comfort Index is based on weekly telephone survey of consumers seeking their views on the economy, personal finances and buying climate.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

There are no guarantees that dividend-paying stocks will continue to pay dividends.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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