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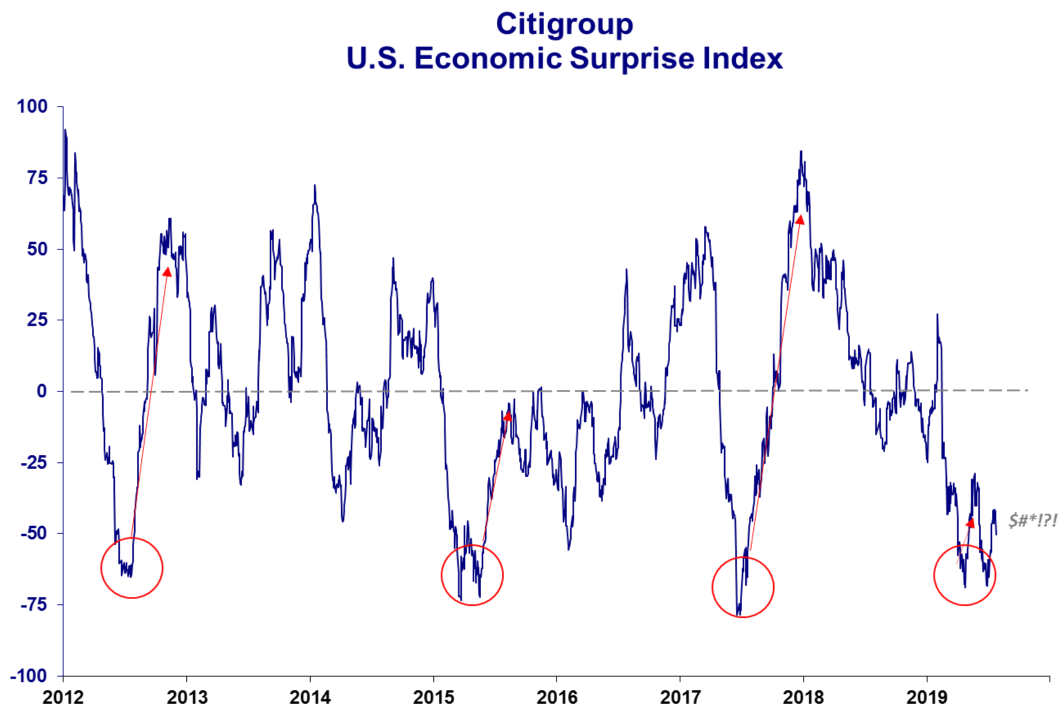

Still Thinking Waaaay Too Small...

Lest there were any doubt, **the degree to which the markets *still* don't 'get it' was powerfully evident in the action last Friday.** Having the debate over 25bp or 50bp this month definitively laid to rest by the Fed's WSJ plant midday – the last day members could make any communications ahead of their July 31st meeting-- was sufficient to convert stock market gains to losses and send gold down a snappy $22.

The implication that the extra 25bp could make the difference between sustaining our record-long expansion infinitely into the future and our slumping into recession, is so ridiculous I feel guilty giving it fresh life here! I mean, since when has Fed policy ever been so finely timed and tuned? In case you were wondering, 'never' is the answer to that question. Indeed, if the Fed has consistently demonstrated anything, it's a pitiful *lack of finesse*. It always tightens too late, eases too long and gets its economic forecasts totally wrong.

But **even more risible than the weight being placed on an extra 25bp now, is how little that will amount to when we look back on this whole affair after all is said and done.** In the stark light of hindsight, it will be seen as a drop in the bucket of monetary stimulus that followed. For, **contrary to popular perception, what we are embarking on here is not some short, shallow and shrewd 'insurance policy'. It's the renaissance of bazooka-style, guns a-blazin' stimulus** – here and around the globe— **that's going to make 2007-8 look like child's play**. That's right. I said it. And given my proclivity for repetition, you can bet I'll be saying it again…and again…and again!

Now that I've got your attention, let me settle back down and get to the "why" of it all. We can start with the fact that **the 110bp decline in 2-year yields and 120bp decline in 10-year yields, since the wheels came off in the 4th quarter, STILL hasn't undergirded economic activity…*eight months later*.** As I have fretted aloud countless times throughout the 1st and 2nd quarters, **the failure of reflexivity to set** up --and lower rates to sow the seeds of their own demise by fueling growth and inflation -- **is a stunning testament to the depth of late-cycle exhaustion and the economy's innate deflationary tendencies**. Rather than a deadcat bounce, the data have landed with a deadcat thud (see above).

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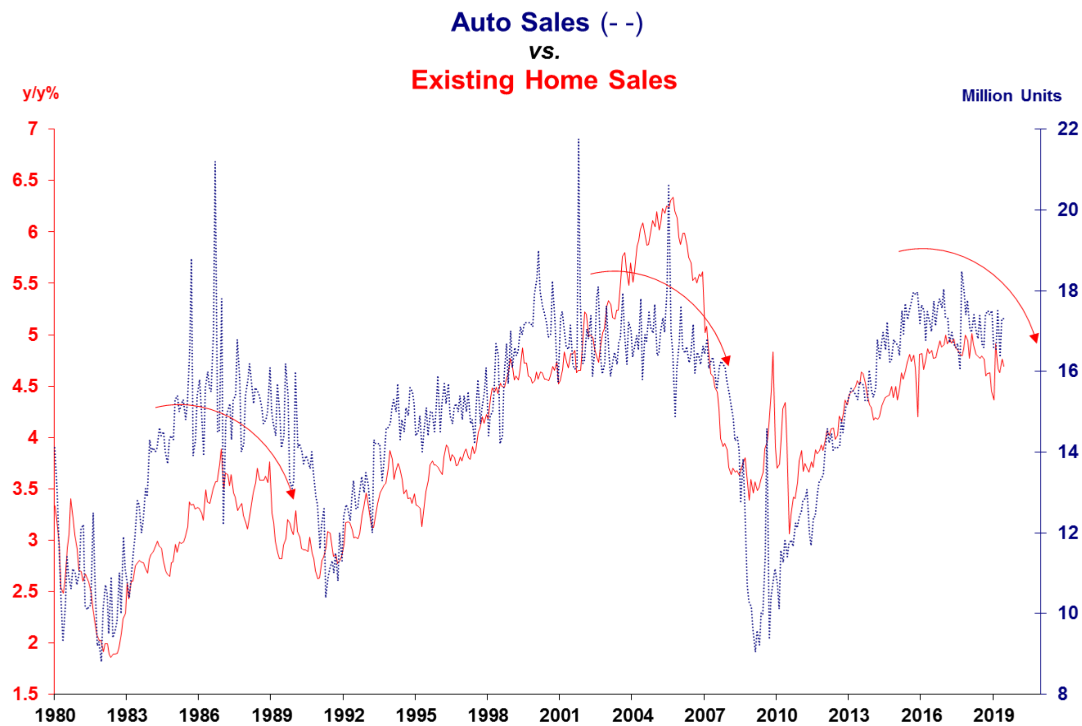

Nowhere is this dour dynamic more blaring than the interest-sensitive sectors that should be the strongest—*housing and autos*. Depending on which housing metric you look at, activity peaked between November 2017 and February 2018. In other words, at least a year and a half ago. For autos, the peak was even earlier, in Sep 17**. In both cases, as you can see above, the collapse in rates has failed to reverse the 18+ month downtrend.**

The notion that the next 25bp will accomplish what the 100-plus bp move over the last 8 months has not would be easier to swallow if the drop in rates had not <u>also</u> been accompanied by further strengthening of labor markets and an historic rebound in financial assets. Fact is, it would be hard to string together a more favorable collection of developments for consumer spending. Except maybe flattering seasonals, lower energy prices and a period of unusually depressed consumption beforehand. Oh wait. We did have those. *Sigh.*

All of which suggest a larger force at work. Something which (children: cover your ears) **will not be handily surmounted by a 25bp cut in overnight interest rates.**

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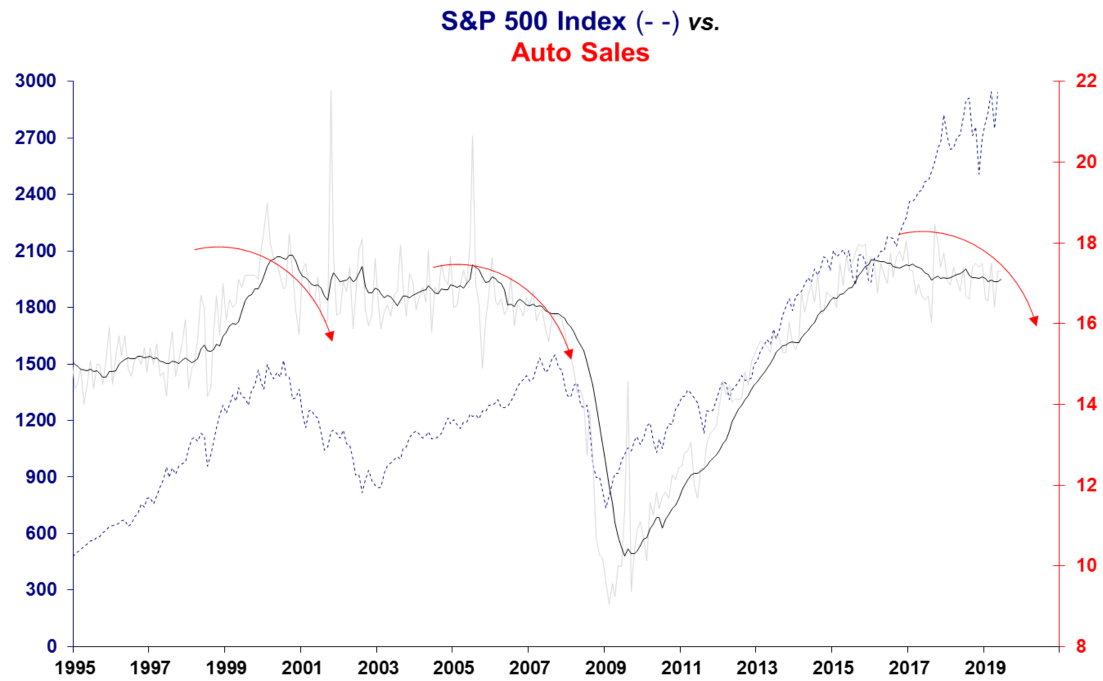

Then again, it's just **the same something larger that has been evident in the inability for companies to pass on the increase in input costs for nigh TWO YEARS now** (!!) and which the markets have cheerfully ignored. Even now, as the tax cut veil lifts and the earnings recession that has been churning behind the scenes since the middle of last year is revealed, they dismiss the hit as temporary.

As they do, **the wedge between asset prices and the fundamentals grows wider still.** And the makings of a dangerous come-uppance are put in place. **Which brings us to the REAL target of the Fed's new accommodative stance…**

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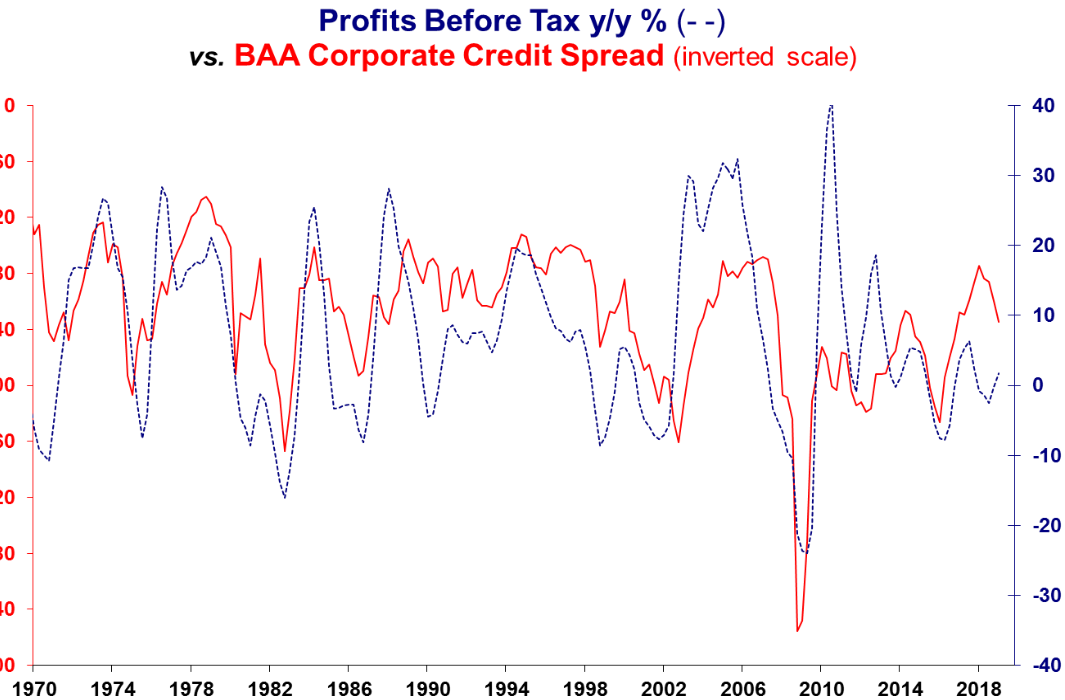

It's not the consumer. *Obvi!* The consumer's just fine. Hence the Fed's demonstrable lack of concern about the slowdown in housing and autos… and the relentless squeeze being exerted on corporate profit margins from the inability to pass along higher input costs to said strong consumer throughout all of last year. *Nope.* **What's *new* and has them borderline panicked is the tightening of credit conditions in the corporate sphere.**

Even as the stock market surges to new record highs, having long since recouped its 4q losses, the credit markets remain relatively tight. IG and HY spreads remain +45bp and 70bp above their Sep lows, respectively. **And THAT is something the Fed cannot abide**. For **the maintenance of uber-accommodative corporate credit conditions is the lynchpin upon which our financial and economic fortunes now rest.** *Access to cheap financing is key to stock buybacks, which is critical to sustaining the earnings illusion (or providing cheerful distraction from the grim reality) which, in turn, is key to sustaining extreme equity valuations, preserving the positive wealth effect and the illusion of corporate earnings strength…and around and around we go.*

While it has taken great care not to call corporate debt a 'bubble', lest it send folks scrambling for the life rafts, **the Fed has acknowledged the existence of froth in certain segments of the market. It would have to be remarkably obtuse not to see how devastating the deflation of –whatever they want to call it—would be for the economy and financial markets more broadly.** So they are now doing whatever they can to prevent the teetering corporate credit market from tottering into oblivion.

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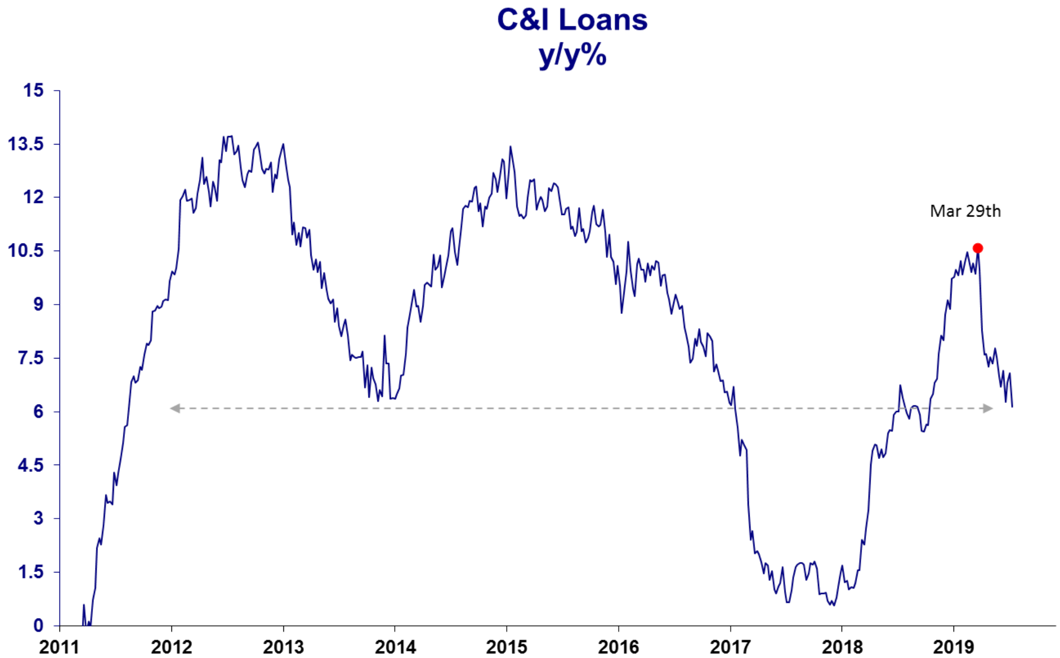

But here again, **if the move in rates *in anticipation* of the Fed's cut has failed to resuscitate the appetite for risk both inside and outside the banking system, why should we imagine its long-awaited delivery will make any difference?**

We shouldn't. **The Fed has already waited too long**. Witness the **collapse in C&I lending to its slowest y/y pace since 2011** (above) **and total corporate debt issuance since 2014 (below).**

Capital Markets Issuance			
	IG	HY	Lev loan
2012	$603b	$174b	$333b
2013	690	216	673
2014	749	242	579
2015	866	204	442
2016	821	145	445
2017	855	182	886
2018	789	132	874
2019	$714b	$174b	$459b

Creditors have started to nose something funky in the air. Something vaguely familiar. *Sniff sniff.* **Is that the classic late-cycle scent they detect?** Could it be that the profit recession isn't, in fact, a temporary function of Trump's tariff tiffs, but endemic to a lent-up and spent-up consumer (who refuses to pay higher prices)?? **As investors get increasingly hot on the scent, the Fed's belated efforts to Febreeze it away stand less and less of a chance.**

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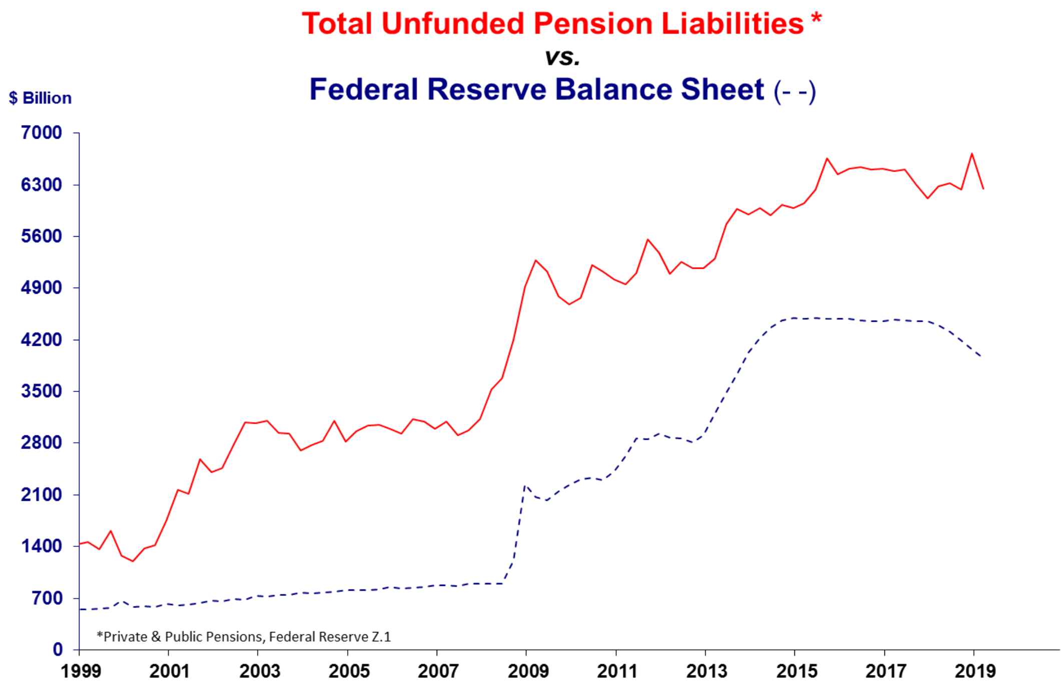

As lamented in recent missive**s, this tightening of credit conditions will begin to weigh on earnings, *which will tighten credit farther still.*** Before you know it, capex and hiring will go out the window. Consumer spending will get dragged out with it. **Profits will slump deeper into recession**, dragging down valuations. The positive wealth effect will turn negative… **and illiquid corporate debt will get re-priced in swift and dramatic fashion**.

THAT is when the magnitude of monetary stimulus we are about to witness will finally come into focus and the forecast made at the top of this rant will start to look less ridiculous. **The impact of the corporate bond bubble bursting on pensions ALONE will 'require' a monetary response that will make post-crisis QE 1, 2 and 3 look mild**.

That crazy suggestion is rendered starkly sane when you look at what happened back then. In June of 2008, the combined deficit of private and public pensions was $893b. By December of that year, the market meltdown had seen the shortfall mushroom 2.5x, to $2.24t. (!!)

Courtesy of the Fed's repressive rate regime (and its swelling effect on discounted future liabilities) in the decade that followed, **our starting point today is $6.24t.** If history repeats, we're in deep doo doo. **A two-and-a-half fold increase in the deficit from here would take unfunded pensions liabilities to $15.6t. <u>That's one trillion LARGER than the entire consumer sector</u> (!!) and more than 4 times the size of the Fed's balance sheet** (see above).

Of course, history isn't likely to repeat… *unfortunately*. Thanks to the aforementioned repression, pension managers were 'forced' to beef-up their exposure to the weakest credits in order to achieve anything close to their 8%-style return mandates. As a result, **public and private pensions are now sitting on their largest exposure to corporate bonds since 1980. So the destruction we see this time is sure to be worse…*far worse*… than it was in the quaint, old days of subprime mortgage debt and SIVs.**

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All of which begs the question—at least to this mind—of why gold isn't trading at $5,000/oz?!! Much less, why it got clocked for 22 bucks on Friday. **Clearly, investors are still thinking WAY too small.** ***Just like the Fed.*** Both imagine that 25bp will make a difference, where the 100-bp-plus drop in market rates has not. Both imagine the slowdown is temporary—driven by exogenous events soon to be resolved. And both believe, therefore, that the Fed has the situation well in hand.

Meanwhile, **the failure of reflexivity to set up even the deadest of deadcat bounces, the steadfast deceleration in housing and autos and the retreat in bank and nonbank lending all speak to our arrival across the rubicon to a place where lower rates are no longer stimulating growth**. They are just further inflating asset bubbles….and expanding the destructive consequences of their inevitable bust.

As it becomes clear that the Fed is *already* behind the curve and that its incrementalism doesn't stand a chance of catching a corporate credit market where post-crisis regulations have destroyed liquidity and left prices to air-pocket downward, **the magnitude of (belated) action the Fed will be required to take to catch up will come into sharp focus.** The question isn't whether there will be one, two or three rate cuts. It's how soon and how forcefully QE will be restarted.

It's not just me saying it. **Looking at the canary in the monetary debasement coalmine (gold) this is 2007-8 to a tee.** When markets started to price in a shift in Fed policy to easing in August of 2006 (see addenda), gold was trading at $625. In the 13 months that lapsed between the anticipation of the 1st rate cut and its ultimate delivery in Sep 2007, the yellow metal rallied 26%--or 2% a month. Flash forward to today, the markets first began pricing-in Fed rate cuts at the end of December, at which time gold was trading at $1245/oz. In the seven months since, gold is up 14.5%...*eg. 2% per month*.

In the 2007-8 easing cycle, gold went on to rally another 140% before the QE frenzy hit its apogee in 2011. A similar rise today would send the barbaric relic over $3,500/oz. Clearly… *not* a calculus that was undertaken by the folks who sold on the prospect of 25bp, rather than 50bp, last Friday!!

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Expected Fed Funds Change*
(12 months Forward)