Welling on Wall St.

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RESEARCH DISCLOSURES SEE PAGE 15

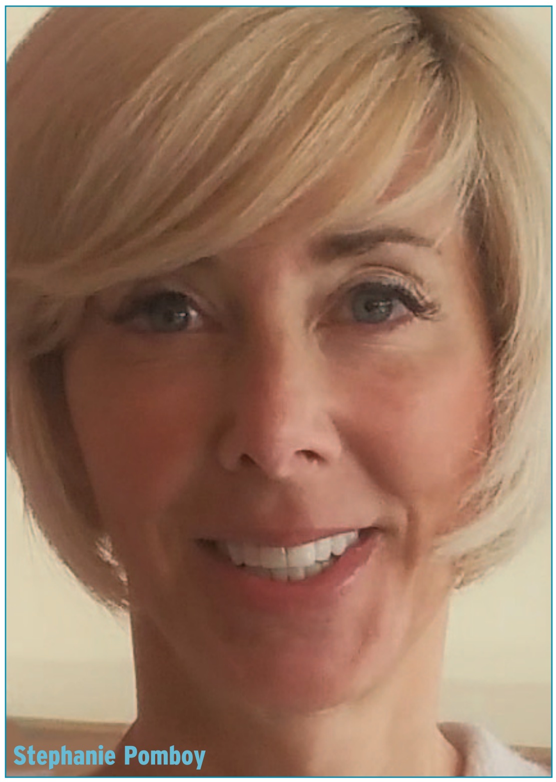
listeningin

Uncomfortable? Good!

MacroMaven's Conceptual Strategist Sees Vigilantes In Your Future

Stephanie Pomboy, the founder and economist at MacroMavens, has been confounding, challenging, unsettling, jousting with and just generally intriguing the clients of her iconoclastic institutional research service ever since she struck out on her own, way way back in 2002.

Not your typical Wall Street approach to clients, to be sure. But it works for Stephanie. Perhaps because of the nearly dozen years of battlefield experience she had dealing with Ed Hyman and Nancy Lazar's clients before hanging out her own shingle.



Stephanie Pomboy

Or perhaps because Stephanie's contrary streak is not some marketing confection, but as intrinsic to her approach as is her incessantly probing disposition, piercing intelligence and quick wit. Not to mention that she possesses a wicked pen, and the propensity to use it.

Stephanie picked up her economics degree at Dartmouth, and macro explorations that tend to skewer received wisdom are even more her thing today than they were when she was back on campus. As is calling things as she sees them. At this juncture, Stephany sees the Fed trapped in a box of its own making — and handcuffed from tightening again. That, Steph says, is what the vigilantes will be doing from here on out. Listen in, because she says you'll have to hold onto your hats.
KMW

Welcome, Stephanie. It's been way too long since we last did an interview — in 2011! But we're both still pounding out financial newsletters. How are you pitching MacroMavens these days?
STEPHANIE POMBOY: That's probably a good place to start. Otherwise, your readers will start wondering, "Why is she so negative?"

When I started Macro- Mavens, I really was trying to figure out what was an unexploited niche out there. To me, it became fairly obvious that the niche I was looking for was someone who looked all across the landscape and identified risks that weren't being appreciated — yet — in the marketplace.

You *did* know how the messengers tend to be treated, didn't you?
STEPHANIE: Yes, though in retrospect, I probably didn't take "Shoot the messenger!" nearly seriously

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enough. Anyway, my starting point *is* essentially very antagonistic. "Here's what the consensus thinks," I say. Then I urge, "Okay, now let's figure out what could *possibly* go wrong with that."

Which is where all the economic data you so assiduously collect come in —

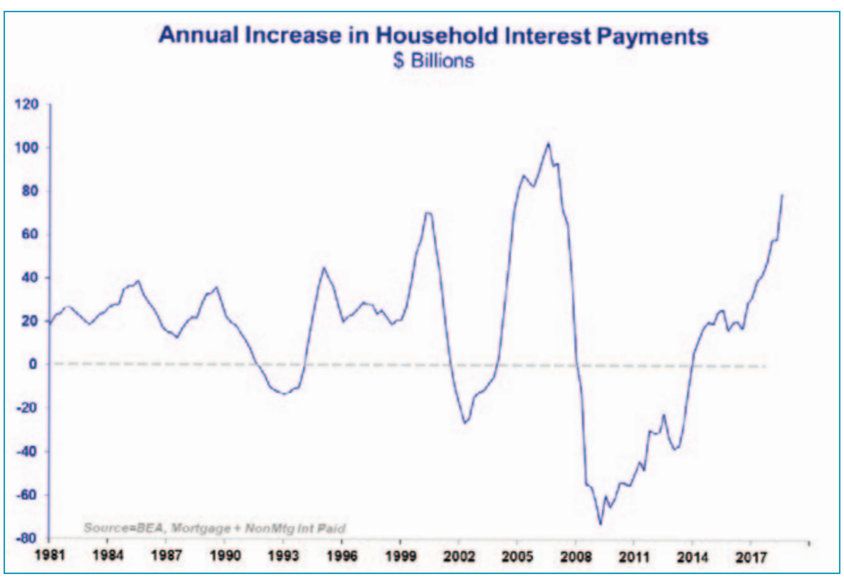
STEPHANIE: Right. I look at the economic data to come up with things that I see unfolding. Everything is based on the data.

For instance?

STEPHANIE: For example, I could see in the data that U.S. households were struggling with increasing debt service, going all the way back to when the Fed started raising rates in 2015. The data [chart below] quickly started showing that the higher rates were clearly acting as a stressor on consumer spending — even though that wasn't being widely appreciated.

The upshot is that I've been on that story ever since then. Of course, declining earnings haven't much mattered to equity investors [chart, page 3], because if a company can buy back shares — and its stock rises — who cares whether it is selling any merchandise at the end of the day?

"What I am trying to do is to identify risks and opportunities around the economic trends I see unfolding — ones that aren't being priced into the markets accurately."



That *has* seemed to be the case, although the buybacks can't go on forever — or there won't be any free float.

STEPHANIE: Right. *For a while*, the fundamentals will be sublimated to this liquidity. Nonetheless, that is basically my starting point. What I am trying to do is to identify risks and opportunities around the economic trends I see unfolding — ones that aren't being priced into the markets accurately.

The idea is your clients can take advantage of what the consensus is missing?

STEPHANIE: Right. Which really involves identifying big macro trends ahead of the curve —

Not always the easiest thing to do —

STEPHANIE: Well, the real struggle with that is you will go through periods when you're talking about things that you see coming down the pipeline — that no one even wants to hear about, so they'll tend to tune you out.

That makes you ever so popular at cocktail parties, I'll bet.

STEPHANIE: There's a real dearth of cocktail party invitations in my inbox, for sure. But it seems to me like this is a valuable service. MacroMavens' early warnings are a valuable tool for managers to have. Basically, if I'm not making people uncomfortable I'm just not doing my job, as far as I'm concerned.

Even if they are not positioning these risks immediately, at least there's an awareness of, "Okay, I should keep my eye on, for instance, the corporate credit problems, because those will eventually become a major issue." My clients don't necessarily have to react immediately to the risks and opportunities that I identify. But they can keep their eyes on the areas where the dangers are brewing. And they can navigate the mine field a little better that way.

Still, you'd be amazed at how limited the appetite for hearing any non-consensus views is right now.

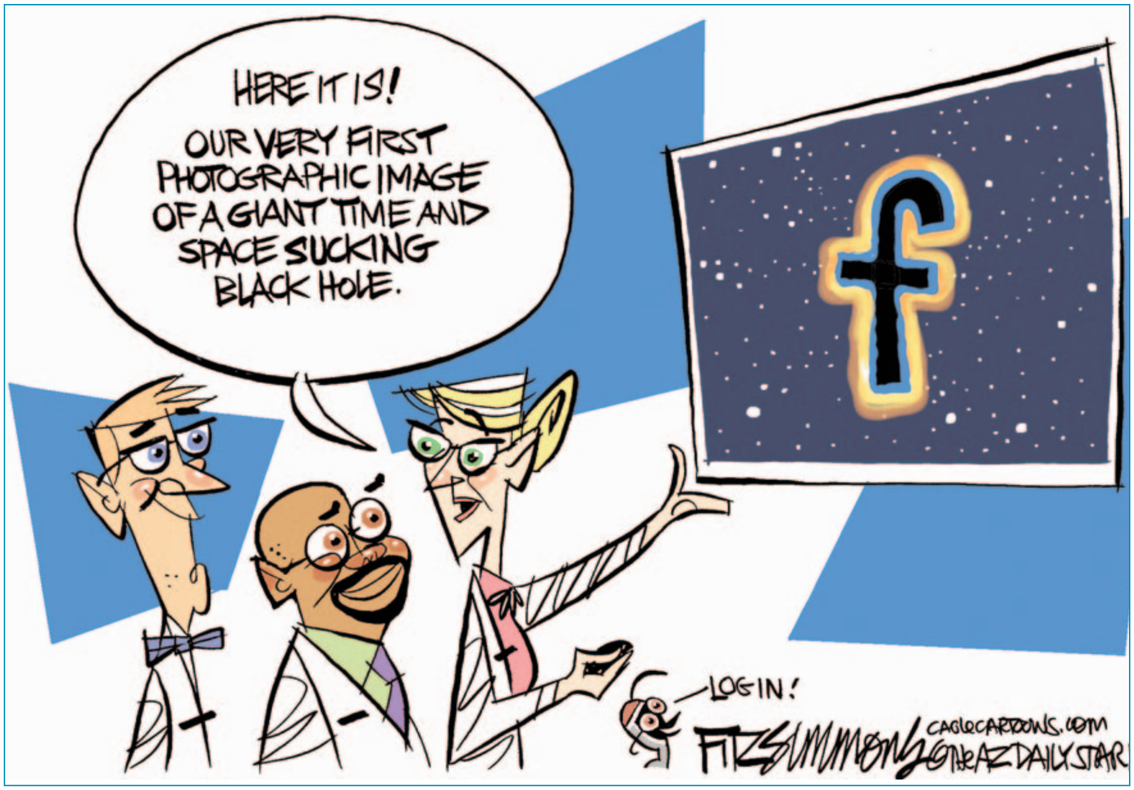
Oh no, I wouldn't!
STEPHANIE: I knew we'd have some kind of immediate connection here. Fellow cynics.

Oh gosh, yes. But everyone is a genius – and the consensus is always right – in a bull market.
STEPHANIE: Until they are not. But I don't get hate mail. Most people are polite enough to just not respond.

Hate mail is okay, as long as they renew their subscriptions!
STEPHANIE: That's what makes it important, as well as interesting, for me to get out constantly and meet with clients. I do make a point to spend a lot of time going out and sitting around tables, so I am actually able to read the facial expressions and the body language. That way, I can also hear the questions and the pushback. I find that it's quite interesting and informative to see how people try to deflect or push back against some of the dangerous economic trends that we have been highlighting.

Of course, very often it's the case these days that portfolio managers don't have the luxury to position against the consensus. The career risk would just be too great. So I always wonder, when I go in and I have these meetings — I mean, I love my clients. I feel like they're engaged, they're willing to have the discussion and talk about these ideas. But then I wonder if they go back to their offices and say, "Oh look, Amazon is up a tenth. I'd better go buy more." You know, I *know* they listen. But I don't know what they *do* with my advice.

Maybe they go home and apply it in their unconstrained personal accounts –

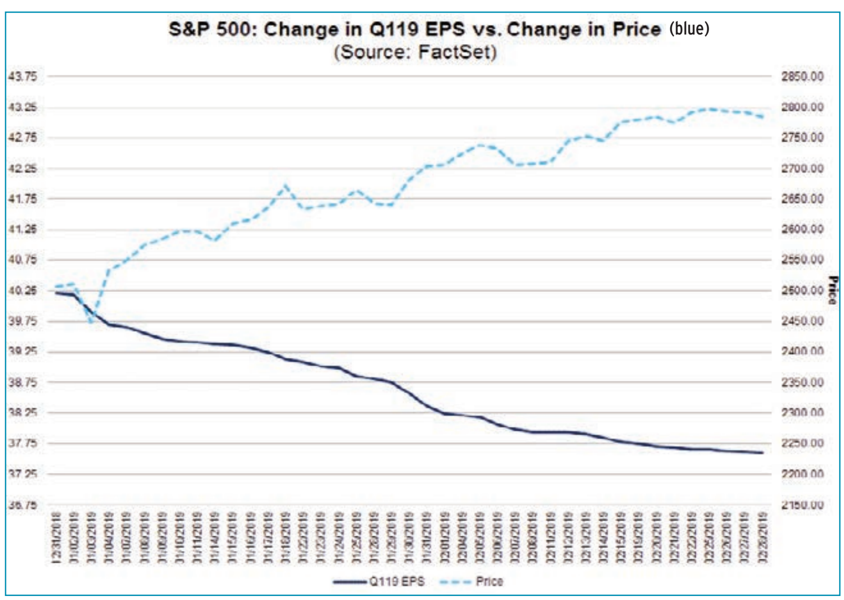


Spaced Out, David Fitzsimmons, *The Arizona Star,* Tucson, AZ

STEPHANIE: Right. Where they can short, or just unload whatever. Hey, you've got to hedge somewhere, I would guess. Oh, man, it's dangerous — you and I together. We could just really scare the bejeezus out of people with this stuff, but it's not Halloween yet.

No, and the trick is to provoke people enough to make them think, without turning them off. It's a fine line.
STEPHANIE: Well, I'm going to let you figure out how to craft this into something that walks that fine line.

All Charts Courtesy: MacroMavens



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No promises! What are you telling clients that's getting the most pushback now?

STEPHANIE: Well, if the fourth quarter did one constructive thing, it was to soften up people's willingness to hear about some of these concerns. There's now a little bit more of an awareness —

You think the fourth quarter downturn actually made that much of an impression? The bulls hardly skipped a beat after the market swooned in 2018's first quarter. And the major averages are back challenging their peaks as we speak.

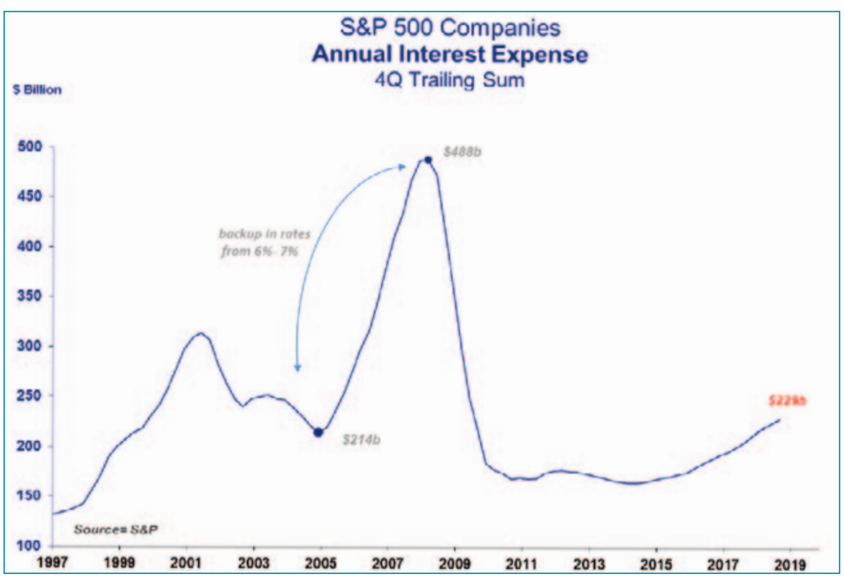
STEPHANIE: You're right that the early 2018 correction, investors just brushed right off their shoulders. That was no big deal at all. In fact, it was a buying opportunity obviously, right?

So it proved, in hindsight. Which only tended to cement bullish sentiment.

STEPHANIE: But I do think the fourth quarter downturn rattled people a little bit more. This whole conversation around the end of Fed rate hikes and of the Fed's balance sheet unwind — tightening which heretofore was viewed as some kind of innocuous event that was unfolding in the background — largely because that's how the Fed billed it: "This is just going to be like watching paint dry," and "There's nothing to see here" — has finally gotten some traction. Now, I think there's more of an appreciation for how dependent we are on continued monetary accommodation and liquidity.

Or at least it's more out in the open. During the first quarter, the proverbial man from Mars looking at this chart (page 3) might easily have concluded that weakening earnings were bullish for the stock market. And he wouldn't have been totally wrong. What investors secretly understood was that the market was rising *because* of the weakening fundamental backdrop, *not* despite it. Because everybody *knew* the Fed would have to become more accommodative — as it has! Indeed, the implicit assumption has been that the end of Fed tightening will eliminate any threat to growth — or, more importantly, liquidity.

Source: All Charts, MacroMavens, LLC



Dare I say you sound a mite skeptical?

STEPHANIE: I can't help it. Such universally-held beliefs just beg me to pick them apart. What I'm suggesting is that it's quite possible that the end of Fed tightening — in both rates and its balance sheet — will *not* return us to Nirvana and breathe new life into the credit cycle. As I wrote in March, the soundtrack to this year is likely to be Johnny Mathis singing, "Too Much Too Little Too Late."

Even though the President tweeted and the Fed eased? Surely, people aren't taking Trump's flirtations with Herman Cain and Stephen Moore seriously —

STEPHANIE: I guess people are generally discounting at least Cain as having any chance to get on the FRB. Even the Senate Republicans are asking, "Why didn't the White House run this one by us, because there's zero chance he's going to get approved." But we'll see.

Seeking consensus — much less advice and consent — is not the way this White House rolls.

STEPHANIE: Exactly. It's like, "Have you met Donald Trump?" That's not his protocol.

But that's theater. The Fed flipping monetary policy from, "We're going to have multiple further rate increases this year," to "Here, have some liquidity. You look thirsty," isn't mere Kabuki. Yet you're saying it won't be *enough* to recharge the economy and markets?

STEPHANIE: Well, this is the amazing thing to me. First, when they started raising rates and eventually segued to unwinding the balance sheet, I started to pull my hair out.

A little extreme, don't you think?

STEPHANIE: No. I *knew* it was just a matter of time until the negative impacts of that tightening would be plainly evident in the economy and the markets.

Now, obviously, for a while, those impacts seemed to be unfolding silently in the background. After the first rate hike in December of 2015, for the better part of the next two years, *only* the household sector data [interest rate expense chart, page 2] was even showing signs that it was aware that the Fed was raising rates. Corporate borrowing costs continued to go down [chart nearby] and liquidity was flowing because the appetite for risk was so rabid.

So the bulls romped.

Stephanie: Right. Unless you had a credit card balance that you were struggling to make payments on, and that was going up every month or every quarter, you wouldn't have known. I thought the markets were completely ignoring this silent tax being imposed on households. Okay, we didn't have the housing bubble that we had back before the financial crisis, but that didn't mean there weren't low-end consumers who were struggling with the increasing debt service costs.

Lots of them, actually.

Stephanie: Then of course when we got to the point where the Fed started to unwind its balance sheet and actually was starting to withdraw liquidity from the system, that's when it finally became pretty clear things were going to unravel fast.

But what I find most remarkable about that whole episode was that as recently as the end of October of last year, the Fed was debating whether they were going to raise rates two times or three times in 2019 — that was that talk around the table at the FOMC — ust how many rate hikes are we going to have to do? And of course the balance sheet reduction was on autopilot — rolling off $50 billion a month like forever — and the rationale for all this was that the economy was *so strong* that the reduction in monetary accommodation couldn't slow it, or the markets, down. "We are so great. Earnings are so fantastic." You'd see these guys coming on the financial networks and almost egging the Fed on. "The fact that they're raising rates is an endorsement of just how fabulous things are. Go for it."

Hit me again.

Stephanie: Right. It was a swaggering bravado. "We are so tough we can handle these rate increases." Meanwhile I was sitting there watching my long-term chart of the 10-year bond yield [above] — it goes back to Volcker days and the chart line just goes from the upper left to the bottom right in an almost-straight line fashion. We've had successively lower and lower rates.

Yes, a long secular bull market in bonds.

Stephanie: But we've also had financial crises happening at lower and lower rates. That speaks to just how vulnerable we are, as a levered economy, to

even tiny little rate increases. So while everyone was talking about how strong the economy was, and saying the Fed should be emboldened to raise rates, I was looking at the ten-year yield starting to go up over 3% back at the end of January. And my immediate thought was that 3.3% was basically the rate that burst the energy bubble back in 2014. We were at 3.2% then — getting up there — and of course within the span of a couple weeks, the entire narrative shifted.

The thing that was shocking to me wasn't that the market started to come unglued in December and there was a recognition that Fed policy was too tight for the moment. What was shocking to me was that the Fed's complete about face was *also* viewed as a bullish phenomenon in the market. So the economy was so strong at the end of October that the Fed couldn't possibly derail it. Then, in the span of barely more than one month, we went to complete hysteria that the Fed *had* to pause the roll-off of their balance sheet and they *couldn't* raise rates. Yet there was no extension of concern to the outlook for profits and economic growth in general. I mean there was a lot of lip service paid to the potential for a recession, blah, blah, blah. But ultimately, the Fed's reversal was just further reason to buy financial assets.

All news is good news when the bulls are in control.

Stephanie: Right, And yet, to me, the whole fourth quarter meltdown was a shining example of how incredibly vulnerable we are to *any* increase in rates. The obvious dynamic encapsulated in the chart above is that each new layer of debt applied to numb the pain of debt-induced economic and financial accidents has *lowered* the threshold of pain on rates — yet that dynamic continues to elude the Monetary Mensas at the Fed. The fourth quarter basically put in sharp focus for me just how narrow the box really is — the one that the Fed has found itself in. The reality is that trying to reduce this unprecedented accommodation by even the smallest amount was enough to really derail the economy and the markets in pretty swift fashion.

You're suggesting that the Fed's standard operating procedures, cumulatively, have been counter-productive?

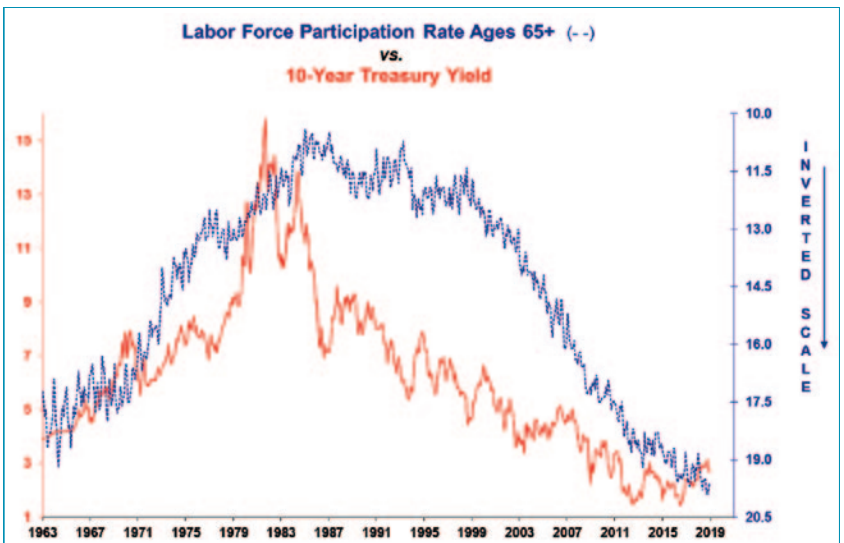
Stephanie: I am saying that the [page 5] chart shows that myriad crises over three decades attest to the fact that the standard monetary prescription for any economic/financial ailment — lowering rates to promote debt-fueled growth — not only erodes the Fed's future capacity to act, it directly contravenes the Fed's stated goals for growth and inflation. It is the opposite of everything it is intended to be.

You're saying that lowering rates to boost near-term spending — priming the pump — doesn't work?

Stephanie: It may boost short-term spending, as a bridge to wage growth. But over time, it does the opposite. Each layer of debt piled onto the economy depresses long-term demand.

How?

Stephanie: First, it obviously requires that more of each incremental dollar be directed to debt service, leaving less available for spending. Second, it erodes the miracle of compounding. Fed rate cuts push those inclined to save — like people approaching retirement — to redouble their efforts. That dynamic is especially powerful in an economy with an aging population. It's not for nothing that our labor force participation rate for those 65 and older has climbed [it's inverted in the nearby chart] as interest rates have shrunk. The upshot is that while generating each additional dollar of GDP required $1.28 in debt in the 1960s, in the 2000s, by 2017 it required $3.75 in added debt to increase GDP by a dollar.



So borrowing begets borrowing —

Stephanie: Yet no one's thinking about the big issues like, "Okay, can the Fed *ever* raise rates again?" And what is the wisdom of implementing a policy that greets every credit induced bubble bursting with further credit to numb the wounds? It seems so obvious to me that what we've been doing for the last 30 years is *not* a solution to the problem. We're just doing the same thing over and over, but expecting different results.

Moreover, there's another economic perversion created by rate repression. By herding savers into high-yielding, risky assets, it sustains non-economic enterprises — zombies — long beyond their sell-by dates. And thereby boosts supply. That's a recipe for *disinflation*, not inflation — even though that contradicts every economic textbook and monetary dogma — as the chart on the top of page 7 illustrates.

It sure does. What have all the economists screaming that ballooning debt would produce runaway inflation missed?

Stephanie: It's not that the Fed has failed to create inflation, really. It's a question of where. They've gotten plenty of inflation — in financial assets — instead of in the economy, in consumer prices. But to the extent that Wall Street gets this, they are happy about it, so they're not complaining.

Isn't the Street's love affair with indexing also rather actively making matters worse in the credit markets?

Stephanie: You saw that in one of my reports, didn't you? Here's the deal: The zombie side-effect of artificially-depressed interest rates is being compounded by the *structure* of the debt markets — as manifested in index funds.

How so?

Stephanie: Basically, the indices blindly weight members based on the market caps of their total debt. The more you borrow, the higher your index weight — and the *more* of your debt institutional managers need to buy. So, far from being punished, degrading one's balance sheet by borrowing more is actually *rewarded*.

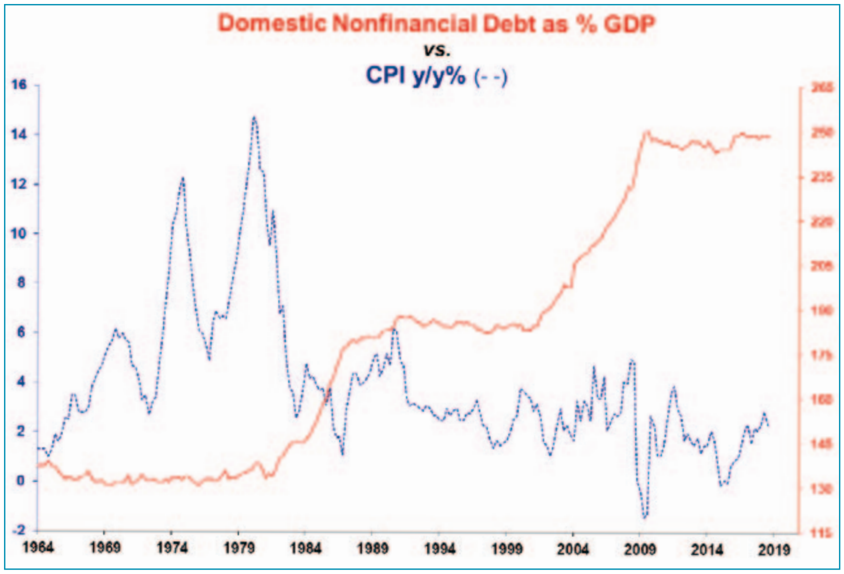
The free-market harness on recklessness has been broken, with the structure of debt indices the exact opposite of what it should be. This structural defect has the effect of taking the Fed's mal-investment tinder and lighting it ablaze. Whatever disinflationary forces would have accompanied a credit-fueled increase in capacity in the past are all the more powerful today.

But why haven't consumer prices budged?
STEPHANIE: At the risk of oversimplifying, by goosing demand and supporting zombies, the Fed has been putting pressure on corporate profits. And those profits determine the path of wages — which are what broad-based inflation depends on. You can see [in the chart, bottom of (this) page 7] the degree to which debt-fueled capacity growth depresses margins and wages by looking at the sharp decline in employee compensation as a share of corporate sector value added [on inverted scale] over the same stretch that debt loads have swelled.

Maybe. Worker comp has undeniably been squeezed. But corporate margins, globally — not just in the U.S. — were being lifted to peaks by globalization, until recently.
STEPHANIE: That's the problem with simplifying. But we don't have *consumer* inflation because people are being forced to allocate more spending to debt service and savings, at the same time that their wage growth is being constrained — so they simply don't have the capacity to absorb increased prices. And that inflation flows into financial assets instead. So the longer and harder the Fed has tried to create 2% inflation, the more it has fueled supply and taxed demand —forces that restrain the inflation it's tried to conjure.

Why is all this not obvious to the Fed?
STEPHANIE: I wrote about that not long ago, making the comparison with Japan. It is just ironic that we had someone, in Ben Bernanke — who built his reputation as an academic expert on deflation by studying Japan — running the Fed. Japanese deflation was his pet topic and he did a lot of work on it — yet Bernanke basically implemented here all the same policies that have failed miserably there. There's a total lack of introspection at the Fed.

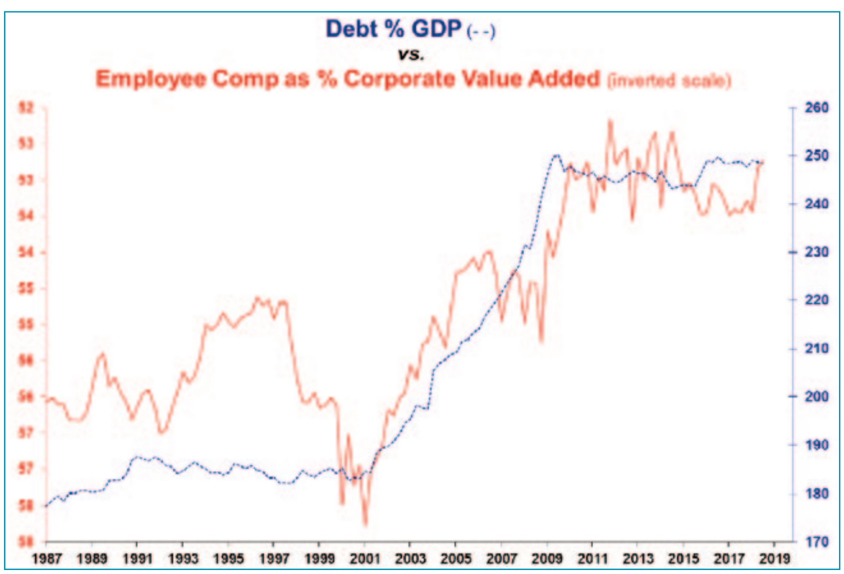
I don't know if it's just hubris — they believed they are smarter than the other guys, so they'd figure out how to make the same tools work. But what shocks me even more is that the markets continue to grant all of these Fed officials an aura of greater insight or better data access that will enable them to produce better outcomes than all history has done.



To reiterate, at some point, the fundamentals *will* matter and then this age of the machines and passive investing will begin to be scrutinized. But it's hard to overstate the role that this shift by investors to — it's not just passive investing — even "active managers" are really closet indexers — has played. Why would you stick your neck out and make some heroic bet? That's a career decision. If you get it wrong, you're out. Who has that luxury?

So obviously the days when you could actually hold some cash in your fund are completely gone. The heroic thing today is to shade your holdings of Amazon one-tenth of a percentage point above or below the market weight.

Sure. That's how you capture "alpha."
STEPHANIE: Exactly. In the world in which we live,



essentially we've discharged the fund manager of any fiduciary responsibility. It's basically, "I am investing in your fund that is long, say, technology, and your job is to buy all those stocks and don't ask questions. So shut up and do your job."

It does seem obvious this is a bull market phenomenon. It's all great as long as asset prices are going up and a monkey could make money But if and when the fundamentals do assert a role, it's going to be pretty ugly.

One of the things markets are really good at is taking things to unsustainable extremes, time and again.

STEPHANIE: Right, if you don't own the FAANG stocks these days, I don't know how you survive as a fund manager. That's on the equity side. On the bond side, the perversion of having bond indices weighted by the largest debtors basically rewards the most levered companies. We talk about ETFs in particular having the *illusion of liquidity*. But there's also an *illusion of quality* in indexed bond funds. You're rewarding the most profligate borrowers out there. How could that possibly end badly? With the Fed perhaps raising rates? "Get me some more of that, please."

The chart you gave me at the beginning of our chat (page 2), indicates that at least the S&P corporate sector is in pretty good shape in terms of interest expenses. Yet I saw recently that an enormous chunk of investment-grade debt is a scant one-downgrade away from becoming junk —

STEPHANIE: That's right. We really are dangling on the precipice. There's some $3 trillion of corporate debt on the lowest rung of investment grade. And there's around $1.5 trillion of corporate debt we know already is junk. Plus about $1.3 trillion in levered loans outstanding.

That's not a good thing. That's a total of $5.5 trillion in a corporate debt market that's not even $10 trillion — I think we're $9.5 trillion — that's extremely vulnerable to any increase in rates. So far we haven't seen a lot of bodies float to the surface. The back-up in rates in the fourth quarter was brief enough that people were able to hold it together. But it just seems to me that at some point this insatiable appetite for credit risk is going to start to diminish. And I keep thinking, "Well, one of the catalysts for that will be a wake up call on the profits front." Because I sit here and I look at all the macro economic data — and like we talked about at the top of this chat, the household sector has obviously been showing signs of strain ever since 2015. Sooner or later —

There's a weird disconnect between this economy's traditional reliance on consumer spending as its engine of growth and the reality that the overwhelming majority of income growth since the financial crisis has accrued to "the top 1%."

STEPHANIE: That's right. A Fed survey recently showed that 40% of Americans didn't even have the savings to cover a $400 emergency expense. So why should we be surprised that maybe people are struggling?

Especially if they use credit cards with 27%-28% APRs to bridge the gap. Low interest rates? Where?

STEPHANIE: It's crazy. What I think is noteworthy is that the difference between the haves and the have-nots that we are all so focused on in the household sector — that's become a major policy issue — is really nothing compared to what we're seeing on the corporate sector side. And I think that has bearing on the question of what's going to get investors to re-price risk.

Go on —

STEPHANIE: I keep coming back to this whole profit thing — but there's a huge other market — the rest of the market — that's not doing nearly as well as the indexes indicate. And not just in terms of market performance, but in terms of profit growth. The economy is widely skewed.

You've got the top 20% of companies that are doing great. But things look a whole lot different when you start to slice through to the other layers. I look at the BEA data for the National Income and Product Accounts — the government's tally of all-economy corporate profits. Granted, only a wonky nerd would bother to dig into these details —

Or someone who wants to look at the entire corporate sector, not just the biggest public companies — who only present their earnings after scrubbing them of all the bad stuff.

STEPHANIE: Exactly.

And yes, I've heard all the complaints. The NIPA numbers unfairly depress profits. They are figured way too conservatively. I'd suggest the opposite, though. I remember GAAP.

STEPHANIE: Yes, I know. I'll put it this way. There are three things that I view as attributes of the way NIPA tallies profits, but that proponents of the S&P's approach, I guess, would call "detriments." The first and most important is that the NIPA data doesn't cover just the top 500 companies. They look at the entire economy. You'll be shocked to learn that maybe the top 500 aren't exactly emblematic of what is happening on average. The second thing that the NIPA numbers have going for themselves is that they hew more closely to GAAP standards.

But maybe the best thing about NIPA data is that it's reported on a total dollar, rather than per share, basis. So in this era of rampant share buybacks, NIPA numbers give you a truer picture of what's really happening.

The gap between the two sets of earnings statistics is "yuge" today.

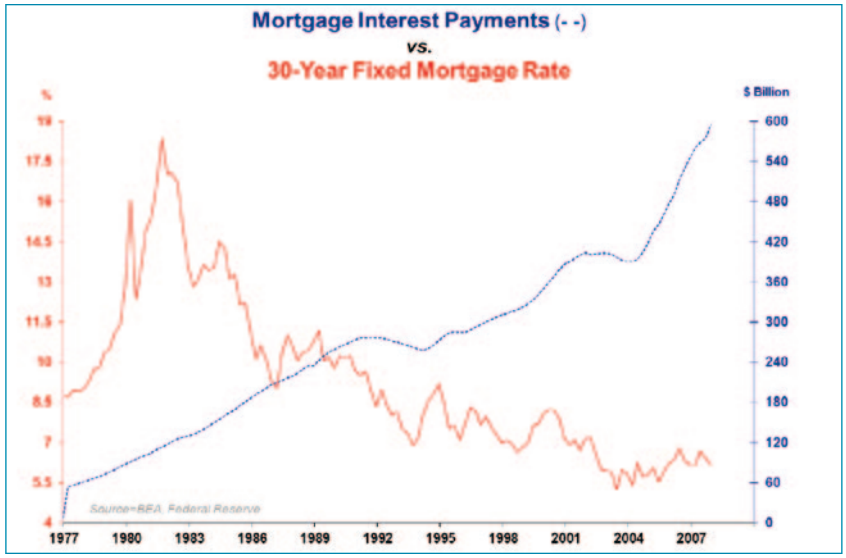
Stephanie: I've been watching this over the last year and while S&P profits are reported as up 24% for 2018 — and they literally have the pom-poms out on business TV every time some company reports — the NIPA number is up 7%. I mean, there's an ocean between these two numbers. Even if you want to argue that the NIPA numbers overstate the downside, so true profits growth is somewhere in the middle — that's a big ocean.

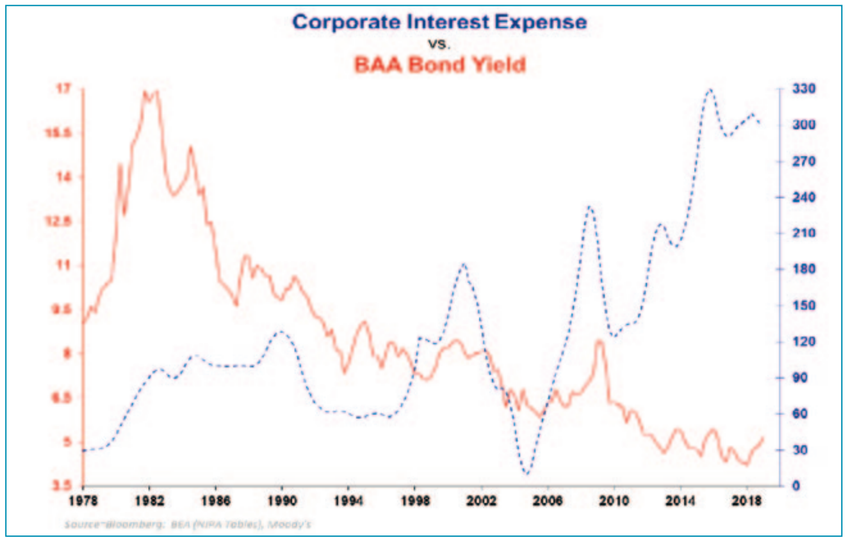
No kidding.

Stephanie: The scarier thing is that the NIPA data puts 2018 earnings *before tax*, which you *would think* would be a window into what we could see here in 2019, as the tax cut boost starts to roll off, at *down* 1.9% last year. Anyway, most estimates of full year S&P earnings gains have come down to around 4% for this year, which is a pretty herculean reduction from the 12% most comparable estimates were at for almost all of last year. No one's talking about negative earnings growth for 2019, anyway.

I wouldn't discount the possibility, just on the basis of how much 2018 numbers were flattered by the tax cut.

Stephanie: Right. By the tax cuts *and* by the share buybacks. And if one presumes — well, I shouldn't presume that we're going to see a tightening of credit conditions because obviously the Fed is working hard to make sure that doesn't happen anymore. But higher rates would not encourage further growth in buybacks. Buybacks are pretty much only as good as the access to cheap capital with which to finance them. So if that does start to go away, a fundamental support under the stock market disappears.





Plus, let's not kid ourselves. The biggest buyer of shares in this bull market has been the corporate sector — the issuers of those very shares.

Stephanie: Exactly. I get these weekly updates on the inflows into domestic equities and the number has a minus sign in front of it every week.

And that includes the ETFs, does it not?

Stephanie: Yes. It's stunning.

Lots of the companies doing buybacks have been going into hock to pay for them. Essentially, buying back their shares on margin.

Stephanie: That's the thing. It kind of gets back to the whole overarching topic of the reliance on credit in general and the lesson learned in the fourth quarter about how just little a dent in credit availability can have massive reverberations across the economy and the financial markets. And the way that the Fed's decision to "pause" interest rate hikes likely will contribute to the bubble in corporate debt.

Didn't you find Powell's assurances in February that ballooning corporate debt isn't a problem ringing about as hollow as Bernanke's 2007 claim that subprime problems were "contained"?

STEPHANIE: You bet. Not only are the "non-existent" issues about the same size — subprime mortgages amounted to about $1 trillion in 2007, or about 10% of the residential mortgage market, while leveraged loans today in the non-bank financial sector stand at about $1.3 trillion, or slightly more than 10% of non-financial corporate debt — but in both cases the catalyst for the explosion in borrowing in general, and at the lowest rung of the credit spectrum in particular, was excessive Fed accommodation. Ease that was instituted in response to the deflation of yet another bubble of the Fed's own creation. I'll go out on a limb here and say that in *both cases* — past and present — the catalyst for the bubble's demise will prove to be a seemingly "modest" rise in interest rates.

The difference is that while the Fed is busy patting itself on the back for shadowing Jamie Dimon, it's been virtually ignoring the non-bank financial sector, where explicit and implicit leverage is mushrooming, just as it was in 3-letter synthetic mortgage structures before the financial crisis.

"Non-bank financial sector" sounds so bland. Who or what is that?

STEPHANIE: Nothing more significant than ETFs and pension funds. Beyond the ultra long/short funds that offer two or three times the move in the underlying securities, many individual investors invest in HYG (the BlackRock/iShares High Yield ETF), JNK (the SPDR Barclays Capital High Yield Bond ETF), and other high-yield ETFs — *on margin*. Hedge funds do the same — times 10. But, at the risk of getting metaphysical here, the real leverage in these structures is in the gap between perception and reality.

What do you mean?

STEPHANIE: The perception today is that there is abundant and immediate liquidity — a perception that has emboldened investors to stake out far larger positions than they otherwise would (just as they bought more toxic CDOs on the misperception of quality). Meanwhile, thanks in large part to the very post-crisis regulations that are Powell's pride and joy, the reality is that institutions that once held lots of inventory of the underlying corporate bonds no longer do. With no ready supply with which to meet a surge in demand, Authorized Participants managing the ETFs have precious little ability — or desire — to step into the void when the selling begins.
The upshot is that these vehicles are only liquid in one direction. When selling pressure mounts, they gap down like hitting an air-pocket. In the extreme, they shutter. We've had plenty of examples, most notably around the flash crashes of 2010 and 2015. And neither of those instances were associated with the type of broad deterioration in credit quality that we are likely to see today.

In 2007, the lie was that you could take a cornucopia of crap, throw it in a package and poof, it was AAA. This time, the lie is that you can take a bunch of bonds that trade by appointment, lump them together in an ETF — and magically make them liquid.

Only if calls on that "liquidity" are very few and far between.

STEPHANIE: Yes, right. You can't be too cynical with this stuff. As the illusion is inexorably shattered, the corporate credit market will be shuttered (much the way the mortgage market closed to would-be homebuyers in 2007-8). Deprived of cheap funding, companies will slow or halt their buybacks. Meanwhile, investors who can't unload their credit exposure will be forced to dump stocks and other high-quality assets to meet redemptions or margin calls.

Sounds drearily familiar.

STEPHANIE: Because it is. The blowback to the economy will be swift and immediate. And Powell will finally figure out how conspicuously out of sync he's been. How could he have imagined that any issues in the corporate credit market would remain isolated and contained?

And then, somewhere along the line, massive unfunded pension liabilities, the other shoe waiting to drop in the non-bank financial sector, will finally drop, too.

Pension issues? It seems they're always looming. But except in isolated incidents, they don't wreak a lot of havoc.

STEPHANIE: Here we go again. It seems pretty obvious to me that with something like $7 trillion of unfunded obligations, the public pension sector has pretty meaningful problems. Yet every time I mention it, that's an area where the response I get

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tends to be something like, "Ah, pensions." I mean, people's eyes glaze over. Whether they say it out loud or not, they're thinking, "This isn't a problem we have to deal with today."

Well, it's actuarially boring — which is redundant, I know. And you *can* put it off until tomorrow.

STEPHANIE: Right. My clients have the luxury of procrastinating because they're still employed — and not trying to retire today on pensions that they're not going to ever receive. Oh, man.

The one place where time can't heal the wounds — though that's been tried, time and again — is in the pension mess. I really think this is where the whole corporate credit mess is going to be so painfully manifested. It's really going to be the flashpoint.

Aren't you being a mite dramatic?

STEPHANIE: I think not, because this time around, as I said, time isn't going to heal the wounds in the pension system, like it was more or less expected to, coming out of 2007-2008. But didn't then, either. The pension sector essentially couldn't recover along with the economy and the markets because the Fed was holding rates at artificially low levels, which actually swelled pension liabilities and prevented pension assets from keeping pace. It's stunning to me that after a decade of financial asset inflation, the pension funding deficit has not only not improved, it has expanded dramatically.

How did they manage that?

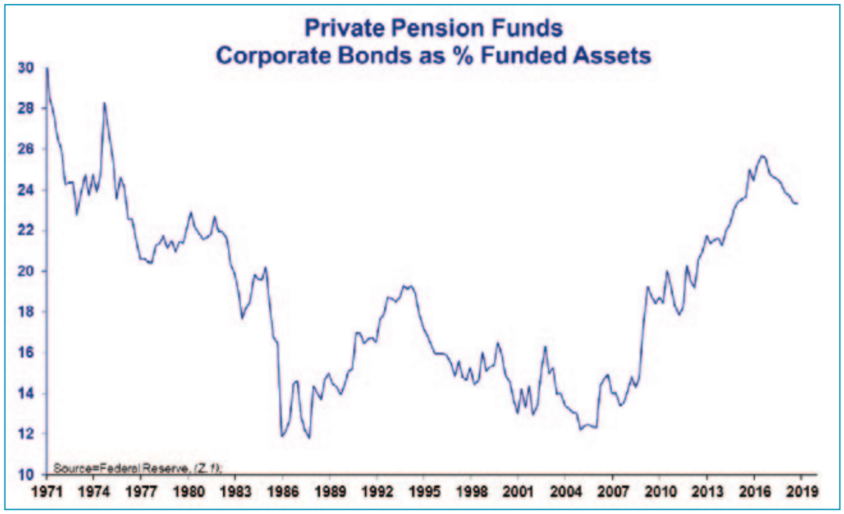
STEPHANIE: With two master strokes. No. 1, they allocated to exactly the wrong stuff at the bottom of the cycle.

Junk credit and alternatives?

STEPHANIE: Of course. Exactly. And No. 2, their demographics are terrible.

Don't forget too, that politicians went crazy promising retirees all sorts of stuff they couldn't really afford during the 1980s and 1990s when pension assets were soaring with the bull market.

STEPHANIE: Yes, so obviously, if pension managers had to make an 8% return assumption in a world of a 1% risk-free rate, they were out there buying the junkiest junk they could find — and probably levering it up as much as they could. So those guys — not surprisingly — now all have tremendous exposure to the corporate bond market [chart nearby] — and mostly to the riskiest, high-yield parts of it. When high yield credit craters, public and private pensions will see their funding shortfalls mushroom. So, as they did amid the Great Financial Crisis, corporations and state and local governments will move swiftly to shore things up. Companies will divert cash from buybacks and dividends. Local governments, constrained by balanced budget mandates, will cut spending and raise taxes.

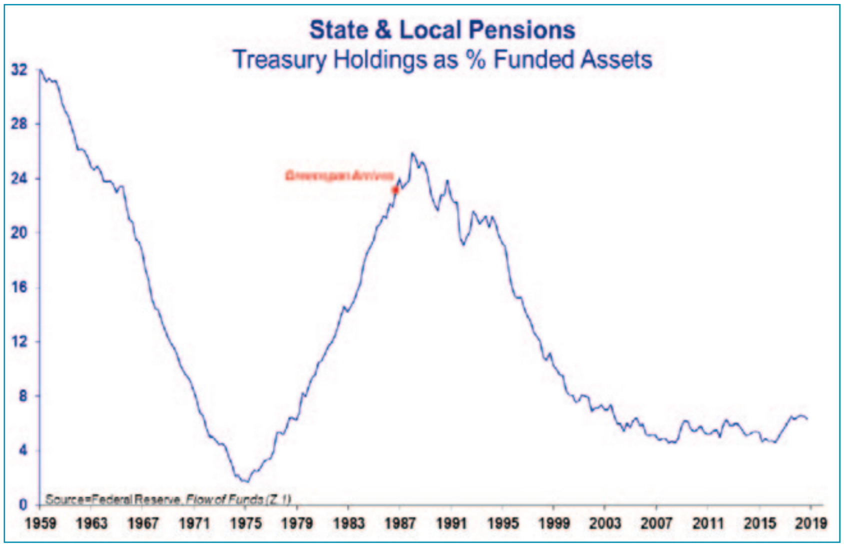


That would be pro-cyclical amid a crisis, when it'd be better to be counter-cyclical.

STEPHANIE: Right again. All in all, those steps will be exactly the opposite of what the economy will need in that moment. With a starting point of a $6.2 trillion deficit, the counter-cyclical effects of those frenzied funding efforts will be material. And the echoes of 2007-'08 will quickly grow too loud for even the Fed to miss. It's going to be interesting as it plays out because, as I said, time is an enemy of the public and private pensions with aging populations. Every day, more people come to collect these retirement benefits that aren't funded. The money has to come from somewhere.

If you want to see baby boomers get back into the streets like it's 1968 —

STEPHANIE: Right. Start cutting their pensions. It could get ugly really fast. There are two options: Either they reset these pension obligations — and what you're talking about happens. Or, you find a way for the federal government to step in and backstop the pension systems. But it is $7 trillion underfunded right now with the stock market almost back to its all-time record. What's it going to look like if we have a re-pricing of risk and, heaven forbid, stocks actually sustain a decline of 20%, while the corporate credit market also starts to crack? The underfunded balance could easily go to 10, 12, 14 billion dollars. It doubled in the last crisis, so why couldn't it do that again?



Good question. How can it get fixed?

STEPHANIE: Well, we can segue right into all sorts of creative monetary responses because the only way for the federal government to backstop these pensions is with a substantial assist from the Fed. You've dragged us very far back into my bear cave. And what scares me about it is that we're having this conversation now, with Wall Street celebrating a record bull run in the stock market, a 30-plus-year bull market in bonds, and a 10-year economic expansion. We should be having this conversation when we're in a recession not when we're skipping around at all-time highs.

But didn't you say the point of your work is to be forward-looking? Besides, you've been telling me these nosebleed asset price levels are an illusion —

STEPHANIE: Absolutely. They can flip on a dime. That's why, to me, this whole conversation is about the Fed — and the politicization of the Fed and the future of monetary policy — a conversation that's just getting started now. It will be interesting to see to what extent it factors into all of the Democrat's platforms as they start to vie for 2020.

If that crowd can focus on anything! Tell me, though, what do you think the Fed should do when faced with the next crisis?

STEPHANIE: You can bet the policy response to the inevitable bust will be as familiar as the excesses and illusions that bring us to that juncture. Whoever is at the Fed will bust out their same old, white guy moves, like they did following the subprime meltdown. They will try to get the credit market moving again with more QE and lower rates.

But its efforts, as they were in the immediate aftermath of the Great Financial Crisis, will be thwarted by regulators who are belatedly hog-tying the institutions on the front lines. So ETF authorized participants will find themselves subject to new regulations and layers of compliance. The whole passive management movement will be scrutinized. And at least for a little while, that will deprive the Fed of its magic repressive bullet — the institutional obligation to buy without regard for risk.

Then, frustrated and bedeviled by its inability to get the markets moving again, the Fed will bang its drum even harder (as it did with QE2, Operation Twist and QE3) and our global trading partners will engage us in the race to the bottom. Same old, same old.

Is that was passes for "good" news, just because it eventually "worked," last time around?

STEPHANIE: Well, pretty much. There is one thing that's likely to be "different this time" — which is that the fallout from this bubble will be tougher for policymakers to contain.

The middle class folks who ended up as collateral damage the last time around would probably argue that the fallout was not "contained" in the GFC.

STEPHANIE: Point taken. But after another spectacular monetary policy miss, even in elite circles, the Fed will be taken about as seriously as a guy in a polyester leisure suit with a gag arrow through his head. Making matters worse, the need to bail out corporations who "by no fault of their own" borrowed gobs of money to shovel at shareholders isn't likely to have the same political resonance that bailing-out innocent homeowners duped by evil bankers did.

No, but even that was controversial, if you remember.

STEPHANIE: True, so certainly don't count on more corporate tax cuts or a TALF for corporate credits. Instead, the policy response will likely focus on mitigating the fallout to consumers from corporate sector layoffs. Also, preempting the belt-tightening by state and local governments working to shore up their pensions.

How do you see that improbable feat getting pulled off?

STEPHANIE: I can see circumstances coming together so that the financing for this fiscal stimulus (beyond that provided by risk-fleeing investors and QE purchases from the Fed) might end up being provided by the very states on the receiving end. I mean, wouldn't it stand to reason that the federal government would mandate that all public pensions hold a certain share of their assets in "high quality" government debt — ostensibly to avoid a repeat of their corporate debt debacle? If public pension funds were required to hold, say, a quarter of their assets in govvies — which is the same level they held before Greenspan arrived on the scene and ushered in the era of monetary-induced speculation — they'd have to increase their Treasury holdings by $800 billion. Not exactly chump change. But I'm jumping way — way ahead!

We have been doing that here for a while now, worrying over vulnerability to higher rates, when the Fed has pretty much sworn off hiking rates ever again!

STEPHANIE: That's what it looks like now, with all the FRB members back-peddling frantically, and Moore and Cain waiting in the wings. And whether the impetus for the Fed's about-face was the dismal fourth quarter response, in the economic data, to the third quarter tightening — or the volley of poison Tweets from the White House — doesn't seem to matter to the markets. They're celebrating. But I can't help myself. I have to point out that with the Fed abandoning any pretense of tightening, it's just a matter of time before they're faced with a conundrum: What if the data take an unmistakable turn *for the better*?

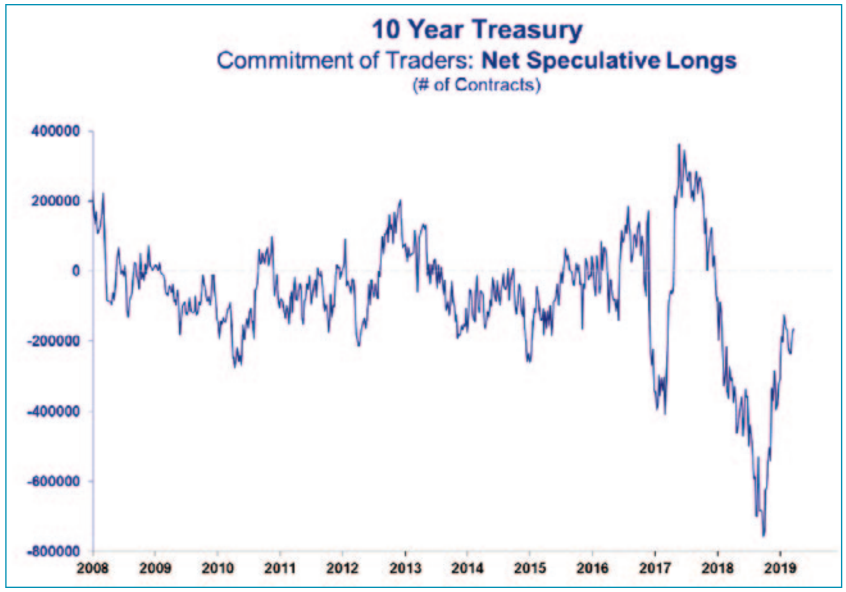
That sounds like a quality problem —

STEPHANIE: Not really, when the economic data turns better, the Fed will be in a dilly of a pickle. Chastened by the markets, the economy and the Tweeter in Chief, one presumes the Fed will tolerate a higher level of inflation and lower level of unemployment than they have before — and that leaves the markets to worry about overheating.

It's unlike you to worry about economic news being too good.

STEPHANIE: I know, when I wrote about this recently, I cracked that my clients might think it was an April Fool's joke. But I can see it happening if, for instance, the bond bears continue to capitulate like they have been of late — that would really test the Fed's uber-dovish stance. Wall Street strategists have lately been putting their Soul Cycle skills to work, back-peddling more frantically than the Fed, and cutting their yearend targets for the 10-year. But the specs are way ahead of them, according to the Commitment of Traders data [chart above].

Indeed, it's kind of amazing. Amid all the erudite theories being floated about why the yield curve inverted — and why "this time" it doesn't matter — the role that short-covering played in driving



long rates lower has been largely ignored. MacroMavens masochists (as I sometimes call my readers), of course, know better. I wrote last fall, while yields were climbing toward 3.3%, that the specs were boldly pressing their bets. With every basis point move the 10-year made toward levels that had proved unsustainable in the past, they upped their wagers that rates would go higher still. Until, ultimately, they were sitting on short exposure nearly double the prior record [again, chart above].

Then, as it became increasingly clear that the economy could not, in fact, handle a yield much over 3%, they rushed to cover those outsized (and offsides) bets. The role this played in driving yields lower cannot be overstated. In the 16 weeks from October 1 to the end of January, specs slashed their short positions by 630,000 contracts — a whopper by any standards. And leaving little doubt why the yield curve has flattened. (That leaves some risk for yields to pop up in the short-term. But I don't see the economic wherewithal for any meaningful increase in govvie yields.)

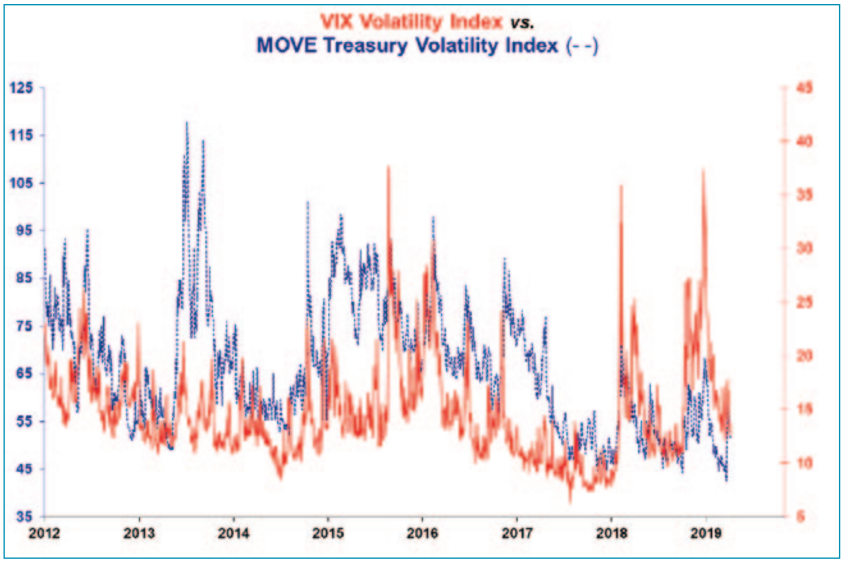
As the chart shows, the specs still aren't quite back to neutral. But I trust that they will get there precisely when the data take a temporary turn for the better. And when we find ourselves squarely in that pickle I mentioned.

Because?

STEPHANIE: If the Fed isn't allowed/inclined to tighten — and short rates are therefore stuck below where they "should" be — signs of accelerating economic activity will beckon forth the vigilantes.

I thought they were extinct —

STEPHANIE: No, just hibernating. Young 'uns will



have no idea what I'm talking about. But they'll find out soon enough. If the Fed is going to be forever behind the curve, it will fall to bond vigilantes to rein in economic excesses — both on the upside and the downside.

Now, since I've maintained that interest rates cannot possibly rise in any meaningful fashion, I obviously believe there is a forceful limit on how high rates can go. I also believe that the reliance on debt that is silently enforcing that ceiling is equally powerful in setting the floor. As borrowing becomes cheap, activity accelerates anew. But that doesn't preclude us from testing the bounds — in both directions — in increasingly manic fashion.

You're saying volatility will get wicked?

Stephanie: You've got it. As rates drop toward 1.5% and the economy gains momentum, bond vigilantes will work to douse activity by pushing rates higher. As rates close in on 3%, and the economy begins to shudder, the vigilantes will press rates sharply lower. So round and round we will go, whipsawing manically between these narrow extremes.

In essence, rates will continue to churn in the same channel, but in increasingly violent fashion. Or, in simpler terms, volatility will increase ***a lot***. And that increase in Treasury volatility will, as it always does, spill over to other markets. So stocks and other risk assets will get whipsawed in equally wild fashion. And that vol, I should stress, will also spill over into the economy, as credit-dependent consumers and businesses try to game a punchbowl t being heavily spiked one minute and yanked away the next.

Not much of a party! But there must be *something* you think will do well despite that wild ride —

Stephanie: One market that should see *less* volatility is the dollar. Like the Fed policy from which it derives its value, the dollar should be increasingly mono-directional. More specifically, that direction is lower. Indeed, the mystery during the market reset on our new monetary order these last few weeks is that the dollar has held up as well as it has. You'd think the Dollar Index [chart below] would have been working toward a return to the 100 level that obtained pre-QT, on its way back to the 88 level that obtained pre-rate increases. But it will soon enough.

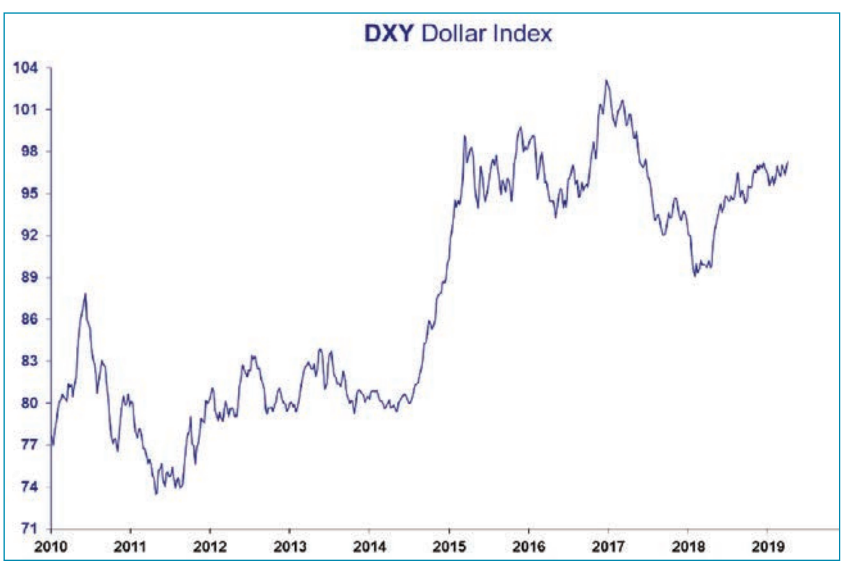
What makes you so sure?

Stephanie: Its strength is simply a function of the "cleanest dirty shirt" dynamic, with U.S. economic growth outpacing its developed-world peers and the EM looking dicey as well — *until just recently*. Fact is, the dollar has been losing steadily versus gold. Since Fed tightening expectations started to unravel in November, gold has climbed 8%.

So our new normal, with our non-reactive central bank lolling in its hammock, is that the task of smoothing-out the economic edges now falls to Wall Street. When the economy seems to be getting too hot, the bond market will douse it with higher rates. When things are getting too cool it will rush to lower rates to get things going again. In other words, with monetary policy effectively handed off to the markets, investors will be treated to nausea-inducing, super-sized swings.

That doesn't sound wonderful —

Stephanie: But it's as it *should* be. Free market reflexivity — not a room full of Ph.D.s — should



be the shock absorber for the economy.

But the adjustment won't be easy. Investors have gotten used to a steady diet of artificial rate regimes and suppressed volatility. That kitchen is now closed, and the Fed has tossed raw meat to the vigilantes.

Oooh, that's an unsettling image. But thanks, Stephanie. It's always enlightening to delve into your macro musings.

Welling on Wall St. Interviewee disclosure: Stephany Pomboy is the president and economist at MacroMavens, a economics-oriented investment research service she founded in February 2002, after spending 11 years working at ISI Group with Ed Hyman and Nancy Lazar. Armed with a Bachelors Degree in economics from Dartmouth College, Stephanie initially joined the economic research group at Cyrus J. Lawrence, which was then headed by Ed Hyman. But very soon thereafter, In 1991, the team left to establish ISI Group, an independent economic research firm – and Stephanie quickly found herself working closely with the largest and most sophisticated investment institutions, providing ISI's timely economic insights and analysis.

Stephanie started MacroMavens to build on that experience of providing timely macroeconomic research and commentary to the institutional investment community by striving n striving to identify important economic trends early while also distinguishing itself by avoiding Wall Street's typical overemphasis on short-term swings. The work is frequently cited in industry publications from *Barron's to The Wall Street Journal.* And Stephanie has been the subject of many interviews on Bloomberg, Fox Business and CNBC.

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