by Russell Redenbaugh & James Juliano
Monday, June 3, 2019

FED DEFLATION RISK...AGAIN

The Federal Reserve is on the margin. The biggest risk to U.S. growth assets is a deflationary monetary policy error. U.S. equity investors must proceed with caution.

On December 24, 2018 U.S. stocks bottomed and began a significant advance after the Federal Reserve reversed course on its monetary policy language. From October 4, 2018 through December 2018 Chairman Powell repeatedly made the mistake of telegraphing excessive interest rate hikes at a time when equity, bond and gold markets were signaling a more patient approach to rate hikes was warranted. Powell ignored these market signals and maintained his position that the Federal Reserve would be increasing rates to or above "neutral." This policy arrogance in the face of contradictory market signals caused investors to sell risk assets in favor of safe haven assets in a fashion that became panicky by mid December. On Christmas Eve Powell began reversing course and in the first week of January he pivoted the Fed's monetary policy stance to a more measured, wait and see approach regarding rate hikes. U.S. stock markets surged higher. Small cap stocks led the way rallying 25% through May 8th.

The Fed is now on the verge of making another deflationary policy mistake, and Powell needs to telegraph willingness to lower interest rates in order to prevent a December type panic. Stock and bonds markets are decisively announcing that real growth is at risk, and lower interest rates are needed. Powell should not make the 2018 mistake of arrogance. Instead, he should listen to markets and adjust the Fed's stance on monetary policy towards lower interest rates.

Here's the data he should be using as grounding to shift monetary policy.

Small and mid cap U.S. stocks have been underperforming the S&P 500. This pattern of returns is counterintuitive given rising trade war uncertainty. Larger cap companies more exposed to global trade and revenue should be underperforming as trade war threats increase. Remember, trade policy uncertainty has been on the margin for over a year. China and Mexico trade negotiations are not new news. But as trade uncertainty drags on, the threat to economic growth is becoming more and more apparent. If the Federal Reserve does not react by addressing these concerns with a potential path to lower interest rates, then a deflationary policy mistake will occur. Small and mid cap domestic companies are most at risk to such a monetary policy error, hence their underperformance over recent months. As shown in the chart below, small cap stocks nicely outperformed the S&P500 from December 24, 2018 through March after Powell moved the Fed away from a deflationary mismatch toward a more wait and see approach. Small cap stocks have recently been underperforming, because in the face of rising trade uncertainty there is an increasing risk the Fed will not adjust monetary policy toward lowering interest rates..

The bond market confirms this concern. Real growth rate expectations embedded in the 10-Year Treasury bond market are collapsing, dropping 29% in just the past week. Now at just 40 basis points of real growth, the bond market is signaling a severe threat to economic prosperity. We think this is being driven not only by trade policy uncertainty, but more acutely by the risk of the Fed missing the signal to adjust interest rates lower in the face of such trade policy uncertainty.

Just like in December, only the Federal Reserve can correct monetary policy and adjust its language. Going from definitive rate hikes to a more wait and see approach was a sufficient policy shift to stop the deflationary panic in December. But a wait and see approach is no longer sufficient in the face or escalating trade policy uncertainty. Powell now needs to adjust policy, or at least policy language, toward rate cuts. His first chance to do so is tomorrow at a speech he’s giving in Chicago. Today James Bullard, the St. Louis Federal Reserve president, said in a statement that lower rates “may be warranted soon.” Powell needs to reiterate and expand that sentiment in order halt the past month sell-off in growth assets.

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ALLOCATOR

Fixed Income

Bonds are an asset class that does well in a deflationary policy environment (Low Growth & Strong Currency)

We have long said the Treasury bond bubble will pop again as it did from May2013-Jan2014 when long term Treasury bonds fell 18%. With voters choosing Trump's pro-growth agenda to ignite growth, we believe the this is even more likely. Treasury bond prices are at risk to fall 30-50%, and we expect any moves higher in bond prices (lower in yields) to be short-lived. Since most other bonds price off of Treasury yields, fixed income in general is a risky asset class.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Investment Grade	LQD	9/9/2016	$119.00	$120.83	1.5%	
Aggregate Bond	AGG	9/9/2016	$109.00	$110.40	1.3%	2017 rise in Treasury bond prices (decline in yields) due to inflation expectation falling while growth expectation flat. This is a positive combination for future economic growth. Bonds remain a risky asset class that could decline 30-50% as real growth normalizes higher.
Municipal	MUB	9/9/2016	$111.00	$112.87	1.7%	
TIPS	TIP	9/9/2016	$114.00	$115.27	1.1%	
Extended Duration	EDV	9/9/2016	$128.00	$126.86	-0.9%	
US Treasury 3-7 yr	IEI	9/9/2016	$124.00	$124.90	0.7%	
US Treasury 7-10 yr	IEF	9/9/2016	$109.00	$108.91	-0.1%	
US Treasury 20+ yr	TLT	9/9/2016	$133.00	$131.83	-0.9%	
International Total Bond	BNDX	9/9/2016	$54.40	$56.47	3.8%	
High Yield	HYG	4/12/2016	$77.00	$84.90	10.3%	Act more like equities than bonds, benefit from improving growth

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Commodities

A change in the price of gold is a change in the value of the currency. When gold rises, the currency's value falls and vice versa. Commodities are an asset class that does well when the currency is weak.

If growth is slowing while the currency weakens, there is stagflation. Own precious metals.

If growth is accelerating while the currency weakens, there is an inflationary expansion. Own agriculture, industrial and energy commodities.

Commodities suffered heavy losses in the strong US Dollar environment 2012-2015. In 2016 Dollar weakness was caused by election uncertainty and commodities rallied. That weak Dollar trend was reversed by Election2016. The demand for transactional and asset based Dollars will rise if Trump's pro-growth policies are implemented and fall if his policy agenda fails. Gold's recent decline back below $1,300/oz is a confirmation of better policy and rising growth rates. Capital is beginning to leave safe haven asset classes as policy uncertainty diminishes.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Gold	GLD	10/2/2017	$120.77	$123.33	2.1%	
Silver	SLV	10/2/2017	$15.67	$13.65	-12.9%	
Energy	DBE	8/13/2014	$28.97	$13.46	-53.5%	
Oil	USO	7/30/2014	$37.00	$11.10	-70.0%	
Agriculture	DBA	9/13/2011	$32.50	$16.62	-48.9%	
Broad Comm. Index	GSG	8/5/2011	$33.00	$15.01	-54.5%	
Base Metals	DBB	6/17/2011	$23.00	$15.29	-33.5%	

ALLOCATOR

Real Estate

Real Estate is an asset class that performs well when growth is accelerating. When rising growth is coupled with a strong currency, own real estate tied to business activity (like commercial REITS). When rising growth is coupled with a weak currency, own real estate tied to commodities (farmland).

Commercial RE will be helped by improving real economic growth. RE properties leveraged to businesses & economic growth are preferred under pro-growth US policies.

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/ Loss	Policy Notes
Residential	REZ	12/21/2016	$61.00	$72.60	19.0%	Real estate assets have declined as higher interest rates expectations lower the perceived attractiveness of housing demand and real estate's dividend yield.
Building/Construction	ITB	12/21/2016	$28.00	$36.42	30.1%	
Mortgage REIT	REM	4/1/2016	$35.00	$41.23	17.8%	
REIT	VNQ	3/7/2016	$75.50	$86.89	15.1%	

ALLOCATOR

US Equity

We have been waiting for a 1980s/90s type of policy driven equity bull market for sixteen years. The 2014 midterm House/Senate/gubernatorial election shifts put us on the path as pro-growth candidates propelled the GOP to majorities. It was a repudiation of anti-growth economic policies and a big step toward a Reagan/Clinton type of equity bull market. Despite the voters' growth signal, Obama doubled down on his tax/spend/regulatory (EPA) agendas in 2015 causing stocks to be range bound and volatile. As 2016 began, policy uncertainty ahead of November's elections became the biggest threat to equities. The ebb and flow of the presidential political season moved markets in both directions as investors waited to learn which policy theme would prevail in November – growth vs. redistribution. Voters decisively made their choice in Election2016, and growth won. Trump's pro-growth policy agenda beat Hillary's anti-growth policy agenda in landslide fashion. Republicans retained control of the Senate, House and increased their control of governorships by three. The policy stage is now set for Trump and Congress to keep delivering pro-growth tax, regulatory and monetary policies. As they do, a bull market in U.S. equities will ignite to rival the 1980s/90s

US Equity - Cap Size

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Micro	IWC	7/11/2016	$72.00	$88.17	22.5%	Most tied to domestic policy / growth
Total Market	IWV	5/19/2016	$117.00	$162.14	38.6%	
Large	IWB	5/19/2016	$111.00	$153.15	38.0%	Large caps should underperform smaller caps as domestic economic growth accelerates
Small Cap	IJR	5/19/2016	$54.00	$73.17	35.5%	Most tied to domestic policy / growth
Mid Cap	IWR	4/6/2016	$38.57	$52.53	36.2%	More tied to domestic policy / growth

POLICY BASED INVESTING

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US Equity - Style

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Large Growth	IWF	7/11/2016	$101.00	$148.20	46.7%	Growth outperformed value in 2017 across all cap sizes. Trend will continue as tax cuts get implemented.
Small Growth	IWO	7/11/2016	$140.00	$187.57	34.0%	
Small Value	IWN	5/19/2016	$92.00	$114.14	24.1%	
Mid Growth	IWP	5/9/2016	$90.00	$133.48	48.3%	
Large Value	IWD	4/6/2016	$95.00	$119.57	25.9%	
Mid Value	IWS	4/6/2016	$68.00	$83.93	23.4%	

US Equity - Sector

Asset	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Staples	XLP	6/5/2017	$57.00	$55.61	-2.4%	Defensive sector hurt by rising growth
Utilities	XLU	6/5/2017	$54.00	$58.25	7.9%	Defensive sector hurt by rising growth
Metals/Mining	XME	5/8/2017	$29.00	$24.40	-15.9%	Tied to commodity prices, hurt by strong Dollar
Energy	XLE	3/13/2017	$69.00	$58.77	-14.8%	Tied to commodity prices, hurt by strong Dollar
Healthcare	XLV	2/8/2017	$71.00	$87.28	22.9%	
Discretionary	XLY	11/14/2016	$79.00	$110.94	40.4%	Consumer strong w/ rising growth expectations
Financial	XLF	7/18/2016	$19.00	$26.01	36.9%	Helped by Trump deregulation (Dodd Frank) & rising interest rates
Materials	XLB	4/6/2016	$44.00	$52.75	19.9%	Global growth
Industrial	XLI	3/14/2016	$52.00	$72.05	38.6%	Global growth
Technology	XLK	3/7/2016	$41.00	$71.89	75.3%	Repatriation tax reform huge plus for tech companies

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Foreign Equity

Country	ETF	Action Date Red Sell/Green Buy		Current Price	% Gain/Loss	Policy Notes
Mexico	EWW	10/1/2018	$51.23	$42.92	-16.22%	Freer and fairer trade agreements are pro-growth for all parties involved
Canada	EWC	10/1/2018	$28.78	$27.33	-5.04%	
Denmark	EDEN	7/2/2018	$63.89	$61.17	-4.26%	European polices not improvng despite anti-austerity movements across the Euro Zone. Capital is fleeing. A zero trariff trade deal with the U.S. would reverse course and be very pro-growth for European economies.
Switzerland	EWL	7/2/2018	$32.58	$35.96	10.37%	
Netherlands	EWN	7/2/2018	$30.51	$29.65	-2.82%	
Sweden	EWD	7/2/2018	$30.51	$29.18	-4.36%	
Eurozone	EZU	7/2/2018	$41.01	$37.92	-7.53%	
Spain	EWP	7/2/2018	$30.35	$28.14	-7.28%	
Poland	EPOL	7/2/2018	$21.78	$22.33	2.53%	
France	EWQ	7/2/2018	$30.52	$29.00	-4.98%	
Germany	EWG	7/2/2018	$29.98	$26.92	-10.21%	
Italy	EWI	7/2/2018	$28.89	$25.94	-10.21%	
Austria	EWO	7/2/2018	$22.65	$19.50	-13.91%	
Israel	EIS	2/26/2018	$52.41	$52.11	-0.57%	
Vietnam	VNM	10/9/2017	$14.99	$16.19	8.01%	Demographic leverage to US economic growth policies
Indonesia	EIDO	7/24/2017	$26.78	$25.31	-5.49%	Demographic leverage to US economic growth policies
Ireland	EIRL	1/26/2017	$39.00	$41.24	5.74%	
Singapore	EWS	1/11/2017	$21.00	$22.84	8.76%	
China	FXI	1/6/2017	$35.50	$40.37	13.72%	Strong Dollar emerging market, tied to US growth
World Ex US	VEU	11/15/2016	$43.50	$48.72	12.00%	Global growth reset higher after US Election2016
Norway	ENOR	8/20/2016	$20.00	$24.18	20.90%	
UK	EWU	8/4/2016	$30.50	$31.69	3.90%	Brexit was a vote for growth
Finland	EFNL	7/26/2016	$33.00	$36.68	11.15%	

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Japan	EWJ	7/15/2016	$47.00	$52.72	12.17%	
South Korea	EWY	7/13/2016	$52.00	$55.57	6.87%	
Hong Kong	EWH	7/6/2016	$19.00	$24.66	29.79%	
Frontier Mkts	FRN	7/5/2016	$10.50	$13.85	31.90%	Highly levered to Eurozone growth movement
Peru	EPU	6/29/2016	$30.50	$35.01	14.79%	
South Africa	EZA	6/29/2016	$51.00	$52.86	3.65%	
India	EPI	6/27/2016	$19.00	$26.43	39.11%	Strong Dollar emerging market, tied to US growth
Taiwan	EWT	6/21/2016	$27.00	$33.08	22.52%	
Thailand	THD	5/20/2016	$64.00	$89.58	39.97%	
Belgium	EWK	3/16/2016	$16.50	$17.87	8.30%	
New Zealand	ENZL	3/5/2016	$36.00	$51.10	41.94%	
Philippines	EPHE	8/5/2015	$37.00	$35.19	-4.89%	
Qatar	QAT	12/1/2014	$24.00	$18.30	-23.75%	
Malysia	EWM	10/3/2014	$41.00	$29.62	-27.76%	
Australia	EWA	9/16/2014	$22.50	$21.80	-3.11%	
Greece	GREK	7/14/2014	$20.00	$9.10	-54.50%	
Portugal	PGAL	6/4/2014	$15.00	$10.50	-30.00%	
Columbia	ICOL	6/27/2013	$21.00	$12.12	-42.29%	
Turkey	TUR	6/1/2013	$58.00	$22.82	-60.66%	
UAE	UAE	5/20/2013	$23.00	$14.11	-38.65%	
Russia	RSX	8/7/2011	$30.00	$19.97	-33.43%	Weak Dollar emerging market
Brazil	EWZ	7/14/2011	$60.00	$41.65	-30.58%	Weak Dollar emerging market
Chile	ECH	3/1/2011	$61.00	$38.52	-36.85%	
Egypt	EGPT	2/23/2004	$64.00	$29.76	-53.50%	

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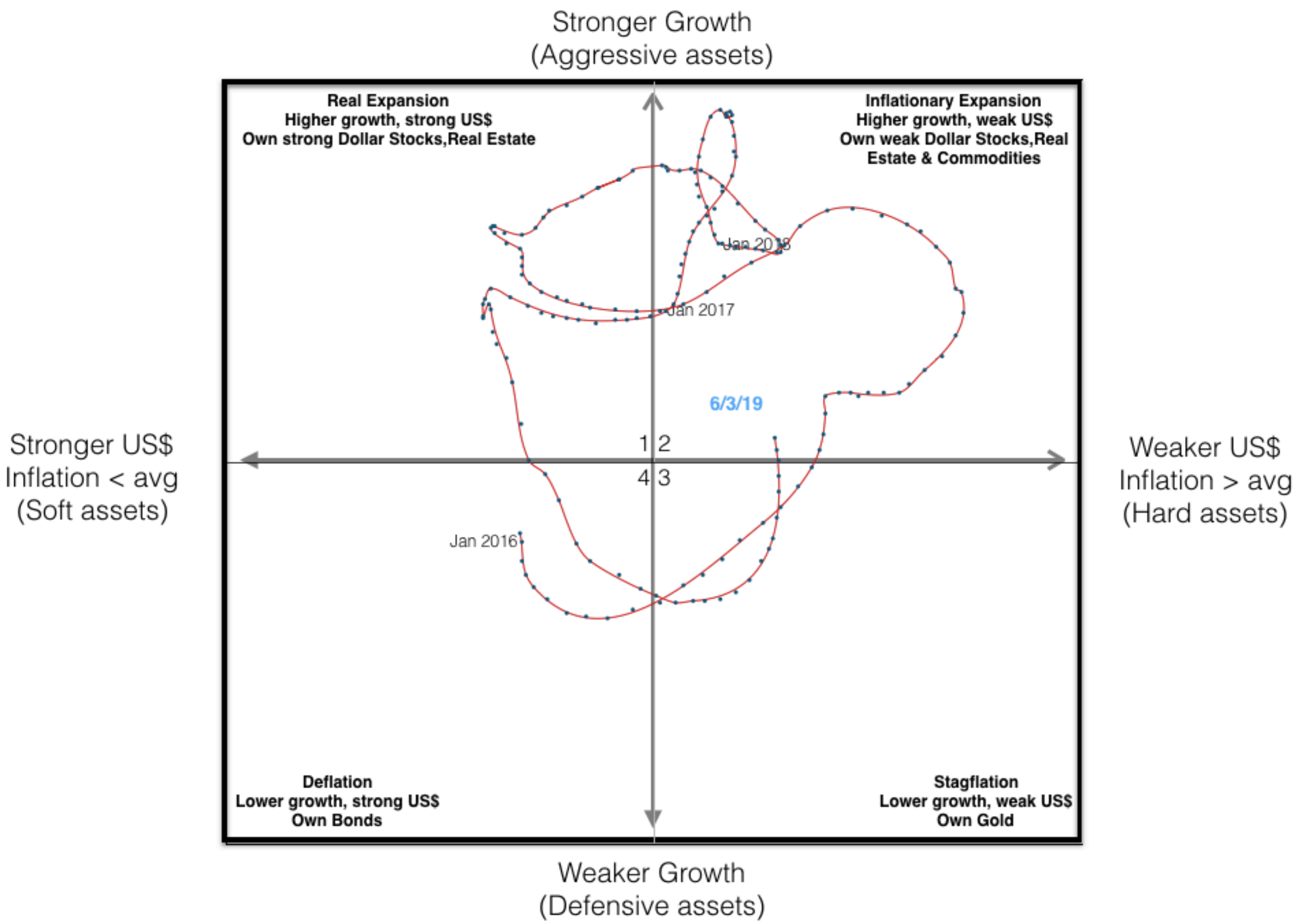
POLICY MAP

Growth increased versus last week (.07 to .14): Despite pro-growth tax and regulatory policy improvements since 2016, growth has tipped into negative territory over fears of a 2008-style, deflationary monetary policy mistake.

Value of US$ was increased versus last week (0.64 to 0.63): Dollar had been stable between gold $1,300-$1,375/oz, and recently strengthened to $1,230/oz. This strong Dollar signal gave the Fed room to pause rate hikes until economic and market data calm down.



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BOND YIELD COMPONENT ANALYSIS

Nominal Yield: 2.14% (-8%) **Inflation Expectation Component: 1.74% (-2%)** **Real Growth Component: 0.40% (-29%)**

Real growth exited the range of .30-.70 to the upside after 2017 tax cuts. In recent weeks growth expectations embedded in bond market have dislocated from equity markets. The collapse in real growth so far seems caused caused by global bond market dynamics, not a significant deterioration in U.S. policy outlook. But with trade policy uncertainty high, the Fed should address the need for lower interest rates soon than later to prevent a Q42018 deflationary policy mistake.