TOP of MIND

INTERVIEW WITH CHARLIE HIMMELBERG

Charlie Himmelberg is Co-Chief Markets Economist at Goldman Sachs. Below, he argues that global economic growth is likely to endure despite the lingering risk of a market correction.

Allison Nathan: Where are we in the US business cycle today?

Charlie Himmelberg: There are many ways to date an economic expansion. Chronologically, the US economy is clearly late in the cycle. But when it comes to identifying the types of imbalances that could signal the end of the expansion, we seem to be coming up short. The labor market has arguably tightened beyond the level of full employment, but imbalances there still seem mild. And it's hard to pinpoint any areas of excessive or unsustainable credit growth like what we saw in the last cycle. The household sector has actually been deleveraging in this expansion. Given that we're in such a low-rate environment, this means that the debt burden on households is remarkably low today. In the corporate sector, while there has been significant re-leveraging, companies have been able to finance themselves at extremely low rates, and lock in those rates at long maturities. So even though we should be mindful of today's high corporate leverage ratios, it's hard to see how a slowdown in corporate credit creation would bring an end to this expansion, either. Finally, any fiscal headwinds that we might expect from deleveraging in the public sector are probably more behind us than they are ahead of us, especially if tax reform provides some tailwinds. This lack of imbalances suggests to me that the expansion has more room to run.

That said, what may be even more important to the longevity of the current cycle—and may not be as appreciated by investors—is the extent to which inflation expectations are anchored. This significantly reduces the risk that Fed actions pose to the expansion. More often than not, at least in post-war history, recessions were preceded by monetary tightening. That's arguably because central banks did not always have the luxury of well-anchored inflation expectations. If you think back to the Volcker era, for example, central banks weren't just fighting cyclical inflation; they were fighting the movement of inflation expectations. And once those inflation expectations get built up, it typically takes a tremendous amount of economic pain to bring them back down. As a result, policymakers have historically been inclined to hike out of the mere fear of inflation, which raises the risk of stopping an expansion prematurely.

But today, well-anchored inflation expectations allow the Fed to move gradually and test whether we are actually at an inflationary point of capacity utilization. We may be forecasting more Fed hikes than the market is pricing, but we expect them to happen at roughly half the pace of past hiking cycles. It therefore seems much less likely this time around that the Fed will precipitate a recession.

Allison Nathan: Does that imply that the bull market can continue? Should we think about the business cycle and the market cycle as one and the same?

Charlie Himmelberg: Not quite. There has been a pretty close correlation over the last 50-60 years between the stock market and the real economy. The stock market tends to lead the business cycle by about eight months on average. But at the same time, asset markets experience a lot of volatility that doesn't always signal an impending economic slowdown. As the economist Paul Samuelson liked to say, the stock market has forecasted "nine of the last five recessions." My view is that the conditions today are actually pretty ripe for a market correction, but not a recession. Again, it's very hard to tell a story where the real economy rolls over. It's easier to tell a story where the market cracks on some other catalyst.

Allison Nathan: Where do you see vulnerabilities today?

Charlie Himmelberg: Equity and bond market valuations look extreme by any metric. While there are some good fundamental reasons for that, it's hard not to worry that the risk premium in risky assets has fallen to unsustainable levels.

Allison Nathan: But on the equity side, aren't valuations justified by low interest rates?

Charlie Himmelberg: That is a common refrain, but the devil is in the details. Much of the decline in long-term rates is due to factors that have nothing to do with how one should value future dividends for equities. I would argue that the single biggest reason for the decline in 10-year bond yields over the last 30 years is the decline in inflation. Since the early 1980s, estimates of the term premium have declined roughly five percentage points, which is tied not only to the lower levels of inflation, but also to the lower risk of inflation. In theory, these factors should play no role in the discounting of dividends for equities. Adjusted for these factors, rates have not declined by nearly as much as 10-year bond yields. That means that the equity risk premium has not fallen nearly as much as the

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decline in 10-year yields would seem to imply. So in my view, the equity market can't use the decline in bond yields as justification for current valuations; valuations are just high.

Allison Nathan: Do stretched valuations necessarily imply that we are heading towards a market correction?

Charlie Himmelberg: No. That's the tricky part—the pain trade, so to speak. If you look historically at the effects of high valuations on tactical returns, say, one or two years ahead, it's surprisingly difficult to get bearish readings off of valuations. Now, over a longer horizon, the current level of equity valuations does imply very low expected returns. In fact, by my estimates, they imply expected returns on the order of zero over the next five years. That is obviously far below historical averages, suggesting that at some point in the next five years, we are indeed going to see some kind of correction. But how much edge do valuations give you in predicting the timing of that correction? Statistically, the answer is disappointingly little.

Allison Nathan: So what do you see as the biggest risks to the market today?

Charlie Himmelberg: I would focus on two. One is the withdrawal of quantitative easing (QE). In principle, it should be a non-issue. But I see good reasons to be worried, which are rooted in the psychology of markets. From my recent discussions with investor clients in both Europe and the US, it's clear that most market participants give QE a lot of credit for the current level of bond and equity valuations. Unless that QE narrative can be replaced with something else, I see a risk that withdrawing QE will significantly reduce investors' willingness to own the market. So far, the Fed has deftly managed the unwinding of QE, with no major market impact. But other QE programs around the world have to unwind at some point. So I do think there is quite a bit of risk—not in the year ahead but over the next several years—that markets will struggle to reconcile stretched valuations with reduced support from central banks.

The other risk I worry about is the possibility of a downturn in corporate profitability despite the continued economic expansion. That's actually a fairly typical late-cycle pattern. Profit margins tend to fall much sooner than GDP growth, partly because the labor market puts pressure on wages at a time when companies don't have as much pricing power, and have already exhausted the productivity gains from redeploying spare capacity. Given that we expect the unemployment rate to fall to 3.8%—with risks skewed to the downside—I think the pace of wage growth only picks up speed from here.[1] And it isn't obvious to me that companies can offset that. In addition to the usual competitive considerations, price inflation has been weak, and—again—stable inflation expectations have likely weighed on pricing power. So I have much higher conviction in wage inflation gaining traction in a tight labor market than in price inflation picking up in a world with such well-anchored expectations. So unless you're quite optimistic about productivity gains to offset that wage growth, it's hard to feel optimistic about the risks to profit margins over the next year.

Allison Nathan: These both look like longer-run risks to watch. What are you worried about nearer-term?

Charlie Himmelberg: If you told me six months from now that the market had sold off by 15%, I would say it was probably due to a shift in market psychology (like an over-reaction to the failure of tax reform or the end of QE) or some sort of market-glitch (like the 1987 crash). Market structure is very different today given the changes to broker-dealer balance sheet capacity since the financial crisis. We've also seen a growing allocation of retail and institutional money into "premium chasing" quant strategies, including, for example, ETFs that sell equity vol. I think many of these developments are positive, but the associated market structure remains largely untested. So I would not rule out the risk of a glitch that triggers, say, a 5-10% correction.

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Allison Nathan: Do you think a major correction would play out differently in this cycle than in the last one?

Charlie Himmelberg: Yes, because the search for yield in the current cycle has evolved differently. In the run-up to the last crisis, the search for yield went off the tracks by applying high leverage to structures that featured some pretty dramatic mismatches between maturity and liquidity. When that came apart, it resulted in forced liquidations and a downward spiral in prices. In the current expansion, the search for yield has probably been at least as intense, but I think the lessons learned in the crisis have discouraged a repeat of these mistakes. Instead, I think illiquidity is the new leverage. With so much competition for assets at increasingly high prices, many investors—especially long-duration investors like insurers and pensions—seem to be putting as much of their portfolio as possible into illiquid assets. That includes private equity, private debt, direct lending, and commercial real estate (CRE), among others. You can see this shift in the differential between the rate of return on CRE and real yields on Treasuries, which is closing in on 30-year lows. So the premium required to sacrifice liquidity has compressed.

The silver lining is that not only have investors deployed far less leverage than in the last cycle; in many cases, they're also sitting on a lot more cash. So if a market dip reaches fairly sizeable levels—say, 10% or 15%—there is money on the sidelines that could step in to seize those opportunities. So there is limited leverage to fuel a fire, and maybe even a little water to help douse the flames.

Allison Nathan: Given everything we have discussed, what should investors own today?

Charlie Himmelberg: Investors will have to strike a difficult balance. On the one hand, this recovery can probably power through 2018 and even a couple of years beyond that. Even if investors knew with perfect foresight that a recession would start in two years' time, history suggests they would want to stay fully invested; the year prior to a recession has historically been the best year to own equities, and it has not made sense to rotate out of them until the recession was practically upon us. That said, it's hard not to want to be defensive, given where current valuations are.

I would describe my own view as "reluctantly bullish," which in practice means I'm bullish on economic growth, but cautious on valuations. So, for example, if you want to own equities today, I think you want to own "growth betas," like global industrials. I think it also means you want to own emerging market equities, many of which are further behind in the cycle, and companies in developed markets that can keep up rapid sales growth.

I also think that 10-year Treasury yields in the mid-2% range are not as over-valued as many assume, since growth risks skew toward recession beyond the next one to two years. If we do find ourselves in a recession, markets will know that policy rates are going back to zero, in which case duration should provide a valuable hedge to risk portfolios.

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[1] On November 17, 2017, the forecast for the US unemployment rate was changed to 3.5%.

Disclosure Appendix

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