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Fed's Dovish Churn & Kudlow, Market Outlook, US-China, Mnuchin

Fed's Dovish Churn & Kudlow. On Monday, Chicago Fed Chief Charles Evans (2019 and 2020 FOMC voter) said he didn't see a need to move on rates until fall 2020. He added rates could move either way, up or down. We believe they are more likely to move lower, if anything. But Evans' words were consistent with the pronouncement from St. Louis Fed Chief Jim Bullard last week that normalization is now over. For the uber-dovish Bullard, his concern is in a sustained inversion of the curve.

Although the Fed would tout its independence in the face of President Trump's opposition to further rate increases, the hawkish camp is in retreat at the FOMC. The latest dovish rhetoric comes on the heels of a much more assertive Larry Kudlow, who now argues the funds rate should be reduced by 50 basis points and the Fed should look to avoid an inverted yield curve. On both points, this message aligns with Bullard's admonitions in December 2018.

Meanwhile, with the White House adopting a "personnel is policy" approach, Kudlow has been instrumental in promoting the potential nominations of supply-side growthers Steve Moore and Herman Cain. Both have made statements in the past supporting a return to a gold standard. (e.g., Cain's 2012 op-ed in the WSJ). More recently, Moore has begun to champion the idea of fixing the dollar's value to a CRB-peg and using commodities as a guide for monetary policy. Most important, both have criticized Fed Chairman Powell's hawkishness in H2 2018.

Trump, in our opinion, wants a buzzsaw at the Fed. Whether one champions the gold signal or the Thomson\Reuters CRB signal (CRY:IND on Bloomberg); the argument for further rate increases is likely to be fiercely resisted by Cain and Moore at the Fed. We are dismissing reports the Administration is already looking for replacements, given the pushback on the nominees. While Moore has been visible and outspoken in defending his views, Cain has yet to write a new op-ed. Once he begins clearing his throat, we think the odds on his candidacy will improve.

Near-Term Market Outlook – Sideways. With the Fed on defense, we remain very confident equity markets will appreciate and the growth outlook will improve. Specifically, we believe equities will rally beyond September 2018 highs (2930 for the S&P 500). An S&P of 3,200-3,300 now looks possible by December, so long as rate hawks remain in retreat.

But in the near-term, falling probabilities for rate cuts coincident with a rally in the UST 10-Year yield suggest equities may move sideways in the face of this current adjustment. But to the extent this allows for a steepening of the yield curve, it should fuel gains later in the year.

Most important, the dynamic of falling rate cut probabilities and a rising 10-year yield is taking place without *any* increase in rate hike probabilities being reflected in futures markets. This is a strong backdrop for the equity and growth outlook. Some of this is likely reflected in declining risk aversion, such as the Baa-Aaa spread moving to 100 basis points from 129 in early January and the decline in the oil/gold ratio to 20 barrels per gold ounce from a peak of near 29:1 on December 24.

US-China: More "Progress" Near Final Stage. A Reuters exclusive reports that according to two sources the US side is willing to back down on longstanding demands that China reduce or eliminate subsidies to state-owned enterprises and strategic industries -- support the White House's China hawks say puts competitors at an unfair disadvantage.

What exactly has the US conceded?

In BWR's view, this reflects two key realities: 1) the belief was bound to fail that China would alter fundamental aspects of its economic model in the short-term, and 2) the Trump administration's rhetoric has left it under pressure to deliver a "deal" of some kind even if this means effectively failing to achieve one of its stated objectives.

But the seeming retreat on this front likely means the Administration's China hawks, led by USTR Robert Lighthizer, will redouble efforts to make the case against China's designation as a "market economy" by virtue of allowing it to keep its government subsidies entrenched.

Last week's flurry of reports claiming "progress" on US-China trade talks included 1) the announcement that bilateral "trade monitoring offices" in the US and China would be setup to help monitor future trade agreements, 2) the ability of both sides to implement unilateral sanctions despite the monitoring offices, and 3) an agreement on the yuan-dollar policy. We look at all this news as a net positive.

Notably missing in the trade progress announcements and photo ops between US-China was Robert Lighthizer; it was mostly a Steve Mnuchin and Liu He affair. And while Mnuchin may be credibly pushing back against Lighthizer's hawkishness, Lighthizer effectively holds deep influence on such proceedings, i.e., there will be no real "deal" without Lighthizer's approval. To that end, Lighthizer has been neck deep working on "enforcement" mechanisms, which remains part of the final details of any deal.

So far, the outlines of this final deal suggest a form of "managed hostility" may be the best-case scenario going forward. US tariffs may go up on Chinese goods, and China may raise tariffs on US goods. But with bilateral offices and continuing relations, there will be ongoing dialogue on important trade issues. **Bottom line: US-China trade will continue to take place and for the USA Inc. the concentration of supply-lines out of China will continue to diversify.** As Reuters noted this week, because of the 10% and 25% tariffs applied on $250bn in Chinese goods to date, a diversification of supply-chains has already begun, with Vietnam, South Korea, Taiwan, and Mexico benefitting.

Finally, to underscore how the "TradeWar" threat to China and world trade has been overblown, if all of China's $540bn in US-bound exports were to fall under a 25% tariff, that would equate to a straight line threat of $140bn in revenues, less than 1.5% of

China's ~$13tn economy. As Fed Chairman Powell made clear recently, tariffs are not the primary driver of China's economic difficulties.

The End of Mnuchin? Treasury Secretary Steve Mnuchin may be sensing the end of his usefulness at Treasury. As a loyal foot soldier in 2017, Mnuchin was exemplary in withholding comment when he disagreed with the President and delivering support wherever needed on important initiatives of the Administration, such as the Tax Cuts and Jobs Act – his signature accomplishment. But later in 2017 and for much of 2018, he has allowed additional fiscal stimulus to whither on the vine, such as the proposed move to retroactively index capital gains for inflation, by reinterpreting Treasury regulation (which Grover Norquist has pushed, along with Kudlow). Meanwhile, the move to make permanent or reduce personal income tax rates has received little to no lip service. It may not even be on his radar, given the late stages of China talks.

To be sure, the failure to reach a China deal will likely continue to vex Mnuchin. He has reportedly been pushing back against the China hawks such as Peter Navarro and seems to represent a softer side (Good Cop), to Lighthizer's tougher side (Bad Cop). But Lighthizer is the country's top trade lawyer. We don't see Mnuchin having much to show for any deal concluded within the next few weeks.

Meanwhile, Mnuchin has been on the receiving end of criticism, however indirect, from President Trump, who reportedly now views his selection of Jerome Powell as Fed chair, on Treasury's recommendation, as the worst decision of his presidency to date. This week, Mnuchin stood by his recommendation of Powell saying, "I don't feel I picked the wrong person."

Of course, when stocks were collapsing in Q4 2018, Mnuchin offered little pushback on Fed hawkishness, even as Trump reportedly worried aloud that Powell was trying to "turn me into Hoover." Mnuchin's televised tiff with Maxine Waters over wanting to be dismissed from hearings because he was late for a "very important meeting" (later revealed to be with a Bahraini official) suggested he may be simply losing patience with the job.

Given his signature accomplishment of the Tax Cuts and Jobs Act and his private sector experience, where he could make billions, we would not be surprised to see him depart before 2020.

Who would come after Mnuchin remains an open question. The official would need to push back against Democratic House efforts to obtain Trump's tax returns. And he/she would still go through a confirmation process where a Republican "Never Trump" core of Senators Mitt Romney, Cory Gardner, et al, likely would prove nettlesome. Mick Mulvaney's name rises to the top of our list.

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