

KEY SHIFTS IN THE LANDSCAPE

- The Federal Reserve is now dovish and interest rates have fallen significantly.
- U.S. – China trade deal and Brexit delayed but are not problems.
- Global growth remains in flux but may have stabilized.

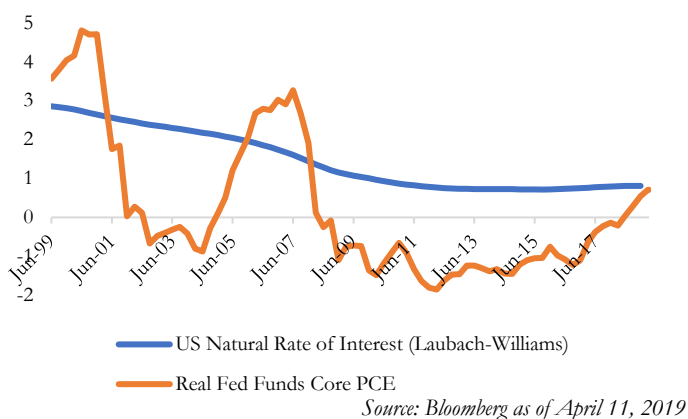
Late 2018 seems like a lifetime ago. The Federal Reserve raised rates for the fourth time in 2018 at its December meeting which drew ire and caused angst. The European Central Bank ceased adding to its stockpile of assets and continued to steer markets toward a potential interest rate hike in 2019. The U.S. – China trade negotiations caused volatility in global manufacturing as companies raced to beat potential tariffs. Always a source of comedic entertainment, European politics were dominated by the debate surrounding Brexit. As it turns out, the whole thing will likely be replayed in late September with the new October deadline. Global growth rates waned to varying degrees. Europe saw its growth slow to a crawl, China slowed but stimulated, and fears about the trajectory of the U.S. economy became palatable. In 2019, much has changed as many of the headwinds that came storming to the forefront of investors' and policymakers' minds in late 2018 have abated - for better or worse.

THE MONETARY POLICY PIVOTS

When the Fed tightens monetary policy too quickly, it commits a “policy mistake”, and policy mistakes are associated with recessions. Markets were fearful the Fed was heading for a mistake in the fourth quarter of 2018. And this was a legitimate concern. The Fed was approaching the “natural rate of interest” when further interest rate increases become restrictive to growth. Not to mention, members of the Fed’s policy-setting Federal Open Market Committee saw further hikes in 2018. The Fed’s lack of recognition that policy was approaching or potentially at restrictive levels caused some panic.

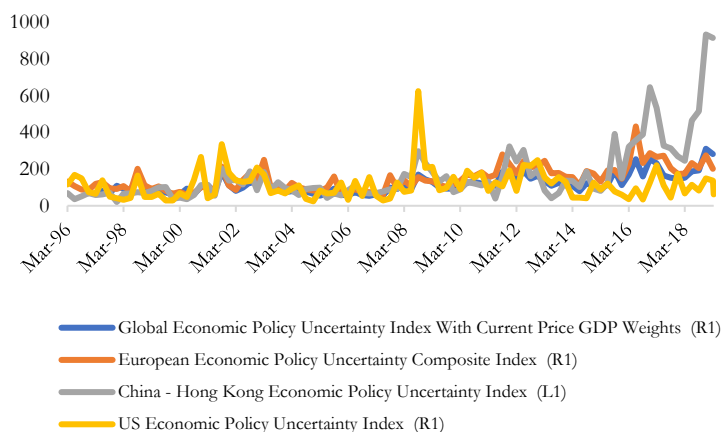
But, suddenly, the Fed backed away from its tightening stance to a prolonged pause stance. Not only on interest rates but the balance sheet normalization as well. Ostensibly, the Fed can take a pause because there is little inflation pressure. Given the current outlook, inflation is unlikely to force the Fed to raise rates anytime soon, prolonging the sustainability of the pause.

The Fed’s dovish pivot, combined with a similar stance from the European Central Bank, helped to moved global interest rates lower. The U.S. 10-year Treasury yield is currently hovering around the 2.5% mark, well below the 3.25% level of late 2018. This fall in rates has contributed to stabilization in growth. While there is some likelihood that rates will drift slightly higher, it is unlikely that U.S. rates will return to 2018 levels in the near-term.



ECONOMIC POLICY UNCERTAINTY

Throughout 2018, policy uncertainty crept higher. Critically, this was not an isolated occurrence. The U.S., China, and Europe saw uncertainty rise to varying degrees. There is Brexit to provide uncertainty to Europe (among numerous other things) and the U.S. - China trade deal to increase the degree of volatility in trade elsewhere. Some of these headwinds have abated. For example, a “hard Brexit” is less of a threat, and the U.S. and China appear to have made progress toward a deal. But the two delays have not completely assuaged the uncertainty. Given that Brexit and the trade deal remain outstanding, this makes a great deal of sense. But the risks are not as potent as they once were in the U.S. and Europe.

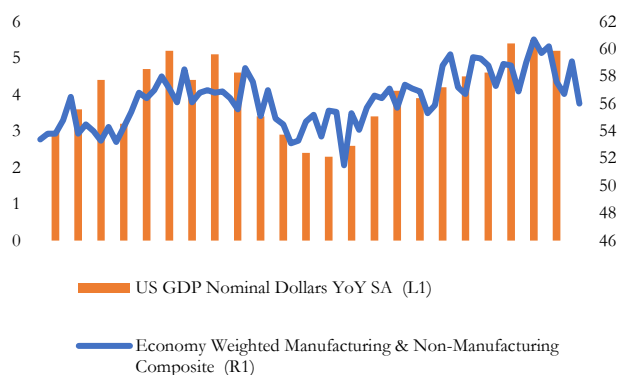


However, China remains well above comforting levels. While there were improvements made in uncertainty through the first quarter, there remains the potential for a significant tailwind as risks abate further in 2019.

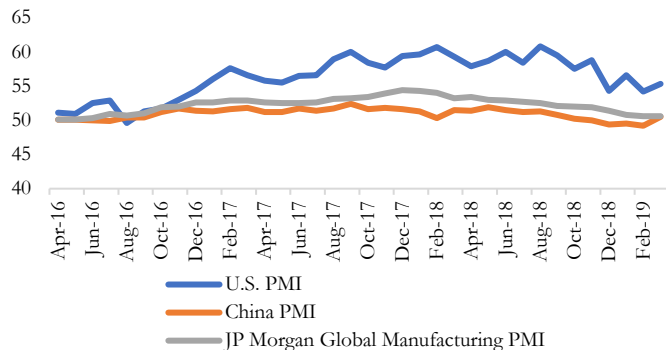
GLOBAL GROWTH WITH U.S. CHARACTERISTICS

The U.S. economy is slowing down, but it is slowing down from one of the fastest post-financial crisis periods of growth. That is understandable given that in 2018 the U.S. witnessed the quickest post-recession pace of growth.

Of more concern, the pace of growth in China began to slow. Coupled with the above-noted uncertainty regarding the outcome of trade talks with the U.S., fear mounted quickly that the U.S. and China's growth rate could be



Source: Bloomberg as of April 11, 2019



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However, the reaction to the slowing pace of growth was profound in China and the U.S. The Fed ceased its hawkish hiking cycle, and the Chinese authorities instituted significant easing policies. These reactions are part of the reason that the two economies appear to have stabilized on the manufacturing front.

While the U. S. and Chinese manufacturing gauges rebounded, the global gauge merely held flat. The primary point here is that the U.S. and China caused the most fear, but quickly became the primary sources of relief. That is the power of stimulus.

IT'S NOT THAT BAD

Despite the reprieve from trepidation in the first quarter, there are reasons to remain vigilant. These include the yield curve inverting (3-month to 10-year), slowing jobs growth, and potentially negative near-term earnings growth. None of these should cause fear, yet.

The U.S. yield curve did invert, but it did not invert long enough or deep enough to trigger the alarms for an impending recession. Slowing jobs growth is a misnomer of sorts. At current unemployment levels, the U.S. should only be expected to generate between 100,000 to 150,000 jobs per month. The government shutdown has been a distortion to the data, but the U.S. economy is creating plenty of jobs. On the earnings front, the first quarter of 2019 is expected to be negative, but earnings are expected to be positive in subsequent quarters. Corporate earnings weakness spilling over into the second quarter and beyond would be more disconcerting.

U.S. GDP trackers point to a growth pick-up in the second quarter, and unemployment claims are at multi-decade lows (and keep making new lows). In the end, the fear and angst surrounding the global economy are reasonable. But the U.S. has stabilized at a lower growth rate, and there are few signs a recession is on the horizon.

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