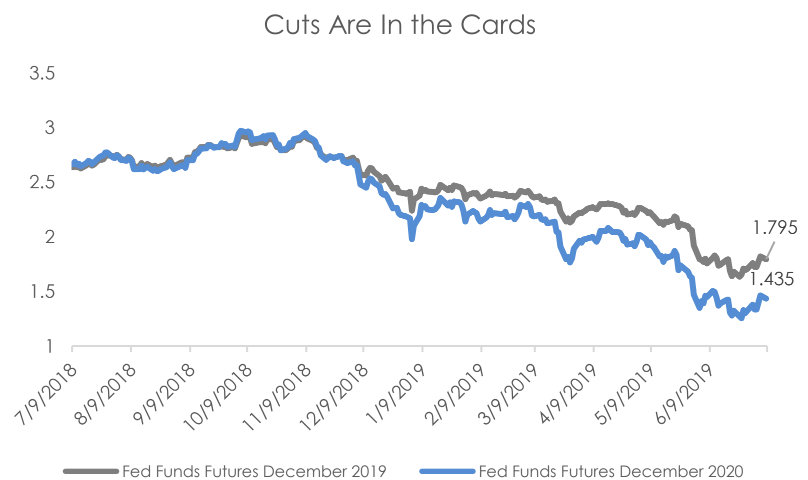
If "surprisingly strong" is a good descriptor of the U.S. economy in the first half of 2019, the second half may be defined by "lower to prolong" as central bank policy again comes to dominate. The U.S. economy remained resilient to trade uncertainty and a sharp slowdown in global growth in the second quarter. Trade and the U.S. Federal Reserve ("Fed") were in focus with China and Mexico the focus of tariffs and monetary policy evolving from "patient" to "lower to prolong." U.S. employment and wage gains were impressive, but business investment was markedly weak. Global growth disappointed with Europe leading the way. Those disappointments led major central banks to lean toward cutting interest rates or have already done so. With numerous cross-currents, the second half of 2019 will be eventful.

When framing the outlook for the U.S. and the rest of the world, there are three things that become immediately apparent: monetary policy, trade and tariffs, as well as the U.S. consumer. Global central banks, including the Fed, have swung from removing monetary accommodation to pointing toward at least a mild easing cycle. Trade uncertainty has been a headwind for business investment and contributed to a slowing in the manufacturing data. Benefitting from an insulated economy, the U.S. consumer has been robust.

Most importantly, there is little that will alter the current trajectory of central banks pivoting toward a global monetary easing cycle. Even better data from the U.S. or Europe would only alter the extent, not the direction, of monetary policy. This should help extend the economic recovery, but monetary policy works with lags. And these lags can be long. This is likely to cause a gap between the expectations and the realization of better growth, and inflation, for the U.S. and elsewhere. These "air pockets" are likely to cause volatility across numerous asset classes but eventually support growth. Though central banks and their tools are not cure-alls, the actions can have a forceful effect and bear watching for 2020 and beyond.

EASING BACK BY THE CENTRAL BANKS

The doves are flying everywhere. The U.S., Europe and Asia all have central banks leaning dovish now with some already cutting rates and others indicating that looser policy is imminent. While the rate cuts will not be "deep" by traditional cut cycle standards, or in Europe's case the monthly asset purchases too high, there is a mild global easing cycle underway.



Source: Bloomberg Professional as of 6/9/19

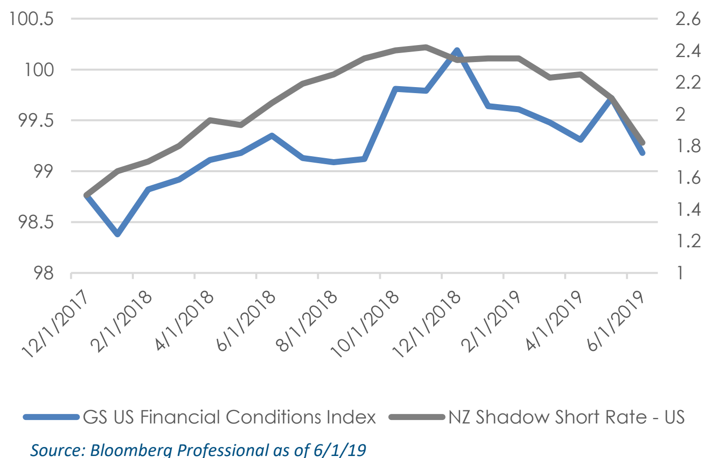
Following a dovish June FOMC meeting, the market began to aggressively price in a combination of insurance cuts (cuts to prolong the expansion) and recession cuts (cuts to avoid an imminent recession). Currently, the market has settled on insurance cuts in July and September of 0.25% each month. Not to be left out, the European Central Bank ("ECB") and Bank of Japan have followed suit, or never stopped, or both.

The ECB tilted to a dovish stance, and its likely course of action is possibly cutting rates *further* into negative territory and additional quantitative easing. Unlike the U.S., Europe was not able to raise rates over the past couple of years. The Bank of Japan has also signaled its willingness to engage in further easing. So, while the U.S. has some easy firepower with rate cuts in positive territory, the rest of the world is not so lucky.

How central banks navigate this "lower to prolong" cycle matters. The U.S. only requires a bit of easing, but the rest of the world appears to be in much more tenuous shape. The Fed is the one with the easy to use ammunition. Therefore, the Fed may be relied upon to carry more of the explicit global easing burden.

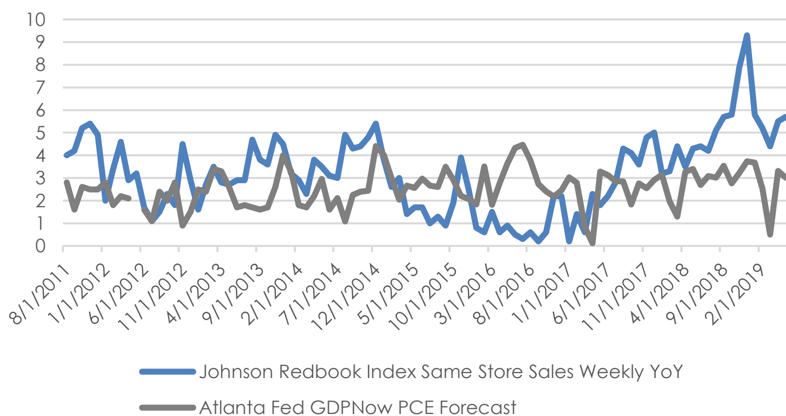
TRADE AND TARIFFS (AND THE CONSUMER)

As supply chains become disrupted, confused or threatened, businesses become increasingly unlikely to undertake significant investment. This has played through in the data as U.S. manufacturing surveys have retreated and capital goods orders have decelerated. This is the sensical outcome of tariffs and trade altercations. Uncertainty is the enemy of investment, and the ebb and flow of trade is the current overhang.



Source: Bloomberg Professional as of 6/1/19

Granted, the U.S. and Mexico have reached a detente. But China and the European Union ("E.U.") are still in the trade and tariff mix. And while China has continued to stimulate its economy, the stimulus, thus far, does not appear to have been enough to overcome the downward pressure on exports. China has turned on the credit taps, but the flow through has been difficult to pinpoint in reliable data. Europe has garnered few headlines in 2019. But this is unlikely to remain the case. If one thing is certain about attempting to solidify a trade deal with the E.U., the numerous competing interests make a deal onerous to complete in a timely or efficient manner.



Source: Bloomberg Professional as of 2/1/19

But thus far the consequences of the trade and tariff battles have been relatively contained. The U.S. consumer has held up well, hiring – though more volatile of late – remains robust and wage gains are in the 3% range. The all-important U.S. consumer is still strong and there are few signs of this changing.

For the U.S. economy to continue to thrive, the consumer will need to carry the U.S. through the second half of the year. Lower interest rates should help alongside reasonable wage growth. For the most part, oil and gasoline prices have remained subdued allowing wage gains to be spent on other consumption items. The consumer is reasonably well positioned to continue supporting the expansion, allowing the U.S. economy to muddle through the weak levels of business investment.

ON THE SHOULDERS OF THE FED

Early in 2019, the Fed periodically cited inflation and global headwinds in its assessment that a pause in the rate cycle was necessary. This made sense. The Fed was the only major central bank raising interest rates with any sort of cadence and regularity. With inflation moving slowly and global headwinds yet to abate, the Fed has cover to maneuver rates lower. Fed officials have emphasized that a variety of data is analyzed in the decision-making process.

But the incoming data is only likely to increase the number of cuts, not lower it. In truth, the data does not matter much. With Europe readying its next salvo of monetary easing, the Fed will be reluctant to allow its monetary policy to deviate any further than it already is from the rest of the world. This is the emergent "global" rhetoric from Fed officials. "Global slowdown" and "global weakness" are the easy out to "insurance" interest rate cuts as these risks build against the Fed hitting its inflation target. This makes U.S. data *less* relevant, and the persistent data weakness abroad *more* relevant.

In a gift to the Fed, the market has already largely done the Fed's job for it. An alternative measure of monetary policy, the shadow rate, shows that lower rates have already contributed the equivalent of a couple of rate cuts without the Fed doing anything. Importantly, this makes it far more critical for the Fed to follow through with some easing. Because, if it does not, the benefits of the free easing will evaporate, and likely cause future easing to be deeper and quicker.

THE SECOND HALF: LOWER TO PROLONG

Global easing should assist in extending the cycle. It is less clear, however, when the stimulus will begin to affect the real economic variables. There is likely to be a gap between the expectations for a longer cycle, and the realization that the economic cycle has been extended. How the market deals with the "air pocket" between expectations and realized economic outcomes is difficult to assess, but it bears watching.

As noted, markets have already done the easing for the central banks, and therefore some of the benefits of easing could show up relatively quickly. But it will not be instantaneous. Instead, there will be gaps in the data and plenty of opportunities to question whether central banks have done enough or waited too long. That is unavoidable. This choppiness should not be confused with failure.

The longest U.S. expansion should live on, but the second half of 2019 is unlikely to resemble the beginning of the year. Growth will be slower and less inspiring with easing that does not necessarily inspire confidence immediately. The global economy should continue to muddle through as the monetary stimulus works through the system.

DISCLOSURES

This report is furnished for the use of Avalon Investment & Advisory and its clients and does not constitute the provision of investment or economic advice to any person, nor the recommendation of any security. Persons reading this report should consult with their investment advisor regarding the appropriateness of investing in any securities or adopting any investment strategies discussed or recommended in this report. Statements regarding future prospects may not be realized. The information contained in this report was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy, timeliness, or completeness by Avalon Investment & Advisory. The information contained in this report and the opinions expressed herein are subject to change without notice. Past performance is no guarantee of future results. Neither the information in this report nor any opinion expressed herein constitutes an offer to buy or sell, nor a recommendation to buy or sell, any security or financial instrument. Avalon Investment & Advisory does not provide legal, tax, or accounting advice. ©2019 Avalon Investment & Advisory. All rights reserved.