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Re-Calculating

Q1 2019 COMMENTARY

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Highlights

- Fed's seemingly steadfast commitment to raising rates and unwinding of its balance sheet fuels market concerns
- China may find path toward policy changes to end tariff war
- Troubles brewing in corporate debt markets

As we enter 2019, it may be difficult to remember the exuberance that greeted 2018. After all, the synchronized global economic recovery, which had been a predominant theme for most of 2017, helped spur consumer and business confidence, while the new $1.5 trillion Tax Cuts and Jobs Act signed into law December 22, 2017, helped ensure a strong and optimistic foundation for 2018. By early April, however, signs of slowing global growth began to emerge, even though the U.S. economic expansion was gaining momentum and corporate earnings on the top and bottom lines were delivering stellar returns.

Fast forward, and markets now are discounting an economic slowdown in the U.S. as well. But there is an abiding question: Are we transitioning to a slower but still solid economy, as the Federal Reserve suggests, or a deeper downturn that could result in a recession? The global synchronized recovery itself has been rebranded as the global synchronized downturn. The debate as to what brought an unraveling to a market that has only rewarded the most defensive sectors and Treasuries focuses primarily on the Federal Reserve's path toward interest rate normalization and unwinding of its balance sheet. That's coupled with—or exacerbated by—uncertainty surrounding the tariff war with China. Add to the list the allegedly waning "sugar high" of the tax cuts, Brexit uncertainty and market volatility triggered by high-frequency trading gone hyperbolic.

THE FEDERAL RESERVE SEES "CROSS CURRENTS"

In what has become a heated attack on Fed policy, and specifically on Federal Reserve Chairman Jerome Powell by President Donald Trump, market participants have become increasingly vocal that the Fed is inching closer to committing a policy error, one that could lead to a significant downturn. Following the Federal Open Market Committee (FOMC) meeting in late December, The Wall Street Journal's editorial page led with "Powell to Markets: Take That." The editorial admonishes the Fed for its decision to raise rates for the fourth time this year despite "some cross currents" that are emerging, slowing global growth, and U.S. growth projected by the Fed to shift to a 2 percent to 2.5 percent range in 2019 from 3 percent in 2018.

The WSJ editorial was blunt: The Fed told financial markets "they don't matter all that much to the real American economy. The markets barked right back that the Fed doesn't appreciate the current signs of financial stress that could become economic trouble in 2019."

During the FOMC press conference Mr. Powell, while underscoring that the Fed will become increasingly data dependent, supported Fed projections for two rate hikes in 2019 by stressing that the economy should be strong enough to absorb higher rates. "We have seen developments that may signal some softening, relative to what we were expecting a few months ago," he said, alluding to the softening global economy and periods of increased market volatility. However, "in our view, these developments have not fundamentally altered the outlook."

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>
> Janet Yellen,
> Former Federal Reserve Chair

President Trump, who has called the Fed "loco" and who tried to persuade the Fed to "feel the market, don't just go by meaningless numbers," could soon join the vigil over the yield curve as it flattens in response to weaker economic and inflation data and Fed policy. When the yield curve inverts—when shorter-term Treasuries (the 3-month Treasury or the 2-year Treasury) yield more than longer-term Treasuries (the 10-year Treasury)—that can signal weaker economic activity. This causes markets to expect a recession within 12 to 16 months. But in and of itself, an inverted yield curve does not cause a recession. A flattening curve is more of a warning sign that growth trends are moderating, and unless there is a spate of unequivocally stronger data, the flattening will continue with its message. But with an already hypersensitive market, the yield curve vigil is sure to highlight each and every basis point move.

THE TARIFF WAR

The so-called "tariff war" between the U.S. and China is a far more profound disagreement between the two countries, and regardless of how many soybeans and planes China buys from the U.S., the core issues cannot be solved within a 90-day "truce" period. Certainly, negotiations can continue, but the U.S. is demanding China to radically change its ingrained trade practices, which, according to the U.S. Trade Representative's (USTR) report, centers on a policy of supporting cyber-enabled theft of U.S. intellectual property and continuing to use "foreign investment restrictions to require or pressure the transfer of technology from U.S. companies to Chinese entities." In a recent speech, Vice President Mike Pence said, "The United States will not change course until China changes its ways." He urged China to halt and pull back its South China Sea military expansion and stop the theft of U.S. intellectual property in its move toward its "Made in China 2025" mandate.

With China's economy continuing to slow and a heavy infusion of fiscal and monetary stimulus measures, Beijing kept "Made in China 2025" language out of its most recent State Council document. But as an attempt to appease the White House hardliners, it is not enough, as the Trump administration seeks concrete language of changes in trade practices—and changes that can be monitored.

China's Central Economic Work Conference (CEWC) that ended just before the new year placed a heavy emphasis on stabilizing and nurturing growth, including tax and fee cuts, more powerful monetary easing, accelerating economic reform and promoting "all-around opening up" of the economy. In addition, and borrowing from the "Made in China 2025" language, the conference stressed "high quality development in manufacturing." It is clear from the CEWC that China is now in "whatever it takes" mode.

As the world's second-largest economy, stabilization of the Chinese economy is crucial for the global economy, and perhaps continued weakness serves as a catalyst at the negotiating table. In November, retail spending grew at the slowest pace in 15 years, industrial production was considerably weaker, and construction has slowed. President Trump was quick to tweet that "China just announced that their economy is growing much slower than anticipated because of our Trade War with them. U.S. is doing very well. China wants to make a big and very comprehensive deal. It could happen, and rather soon!"

The clock is ticking on the 90-day tariff truce, and the U.S. and China may find that a constructive move toward policy changes are in the best interests of both countries and the global economy at large.

CORPORATE DEBT TROUBLES BREWING

As the stock market tumbled in late 2018, concerns mounted that with rates rising and a slowing economy, corporate debt could be the asset class most vulnerable to a more material downturn. Former Federal Reserve Chair Janet Yellen warned in a recent speech, "Corporate indebtedness is now quite high, and I think it's a danger that if there's something else that causes a downturn, that high levels of corporate leverage could prolong the downturn and lead to lots of bankruptcies in the non-financial corporate sector." She added the debt is being packaged in instruments similar to those used to wrap subprime mortgages before the financial crisis.

The corporate debt market grew as a result of inexpensive credit and investors hungry for yield in an environment of zero interest rate policy. According to Securities Industry and Financial Markets Association data, total corporate debt in the U.S. has reached $9.1 trillion. BBB-rated bonds, the lowest rung of investment grade bonds, have become an increasingly larger portion of investment grade as the economy has expanded, and as investors have sought the yield they provide. Concerns are mounting; however, that should economic conditions deteriorate, these bonds could be downgraded below investment grade. According to UBS, the investment bank, there is $4.3 trillion in lower-quality bonds and high-yield bonds. As long as economic growth remains stable, Moody's Investor Service forecasts that default levels on corporate debt will decline in 2019. However, Mark Zandi, chief economist of Moody's Analytics, sees rising default rates if the economy faces a deeper slowdown: "I view this as the most severe threat to the economy and financial system."

Along with the relentless selling in the equity markets, loan funds are suffering from record outflows as investors show indications of worries over deteriorating credit quality. The de-risking across global equity markets has carried over to credit markets as the Fed has continued to raise rates and project more rate hikes into 2019, along with the unwinding of its balance sheet. The concern and warning from the equity markets have migrated to the credit market as the Fed seemingly appears steadfast in its move toward interest rate normalization.

A "MOOD OF ANGST"

Chairman Powell commented that he sees a "mood of angst" about concerns of U.S. growth going forward. And that's exactly what the markets have been telegraphing from the significant deterioration in housing and building, auto companies and auto parts, and financials, and now joined by nearly all cyclical companies. Small and mid-cap names are under pressure, a group which should do well if the economy is expanding. The late Paul Samuelson, who was hailed as the "Father of Modern Economics," famously commented that the stock market has predicted nine of the past five recessions. The popular retort is that the Federal Reserve has predicted none and caused nearly all of them.

To be sure, the economic data in the U.S. remain solid, slowing somewhat but not stalling. And maybe the "mood of angst" is an overreaction to a market conveying that something important has changed. But like the GPS we've become accustomed to, the market is also constantly digesting data, fundamentals and headlines to calculate and re-calculate the price commensurate with growth and earnings. Should underlying conditions change for the better, the "mood of angst" will also be lifted. But should conditions weaken, re-pricing will continue until the correct equilibrium is found.

At some point the market will either discover it made a mistake by being too bearish, or the Fed will discover it made a mistake by not being dovish enough, making for a particularly interesting first quarter. For those who are patient and selective, this discovery will provide attractive opportunities in the cyclical areas of the market that have been under pressure and suffering from a "mood of angst."

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References include the following: *Barron's*, Bespoke Investment Group, Bloomberg, CNBC, Cornerstone Macro Economics, *The Economist*, Evercore ISI, Evercore ISI China Research, The Federal Reserve, *The Financial Times*, *The New York Times*, Renaissance Macro, Reuters, UBS, *The Wall Street Journal*.

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