THE BIG PICTURE

THIRD QUARTER 2018

Summary

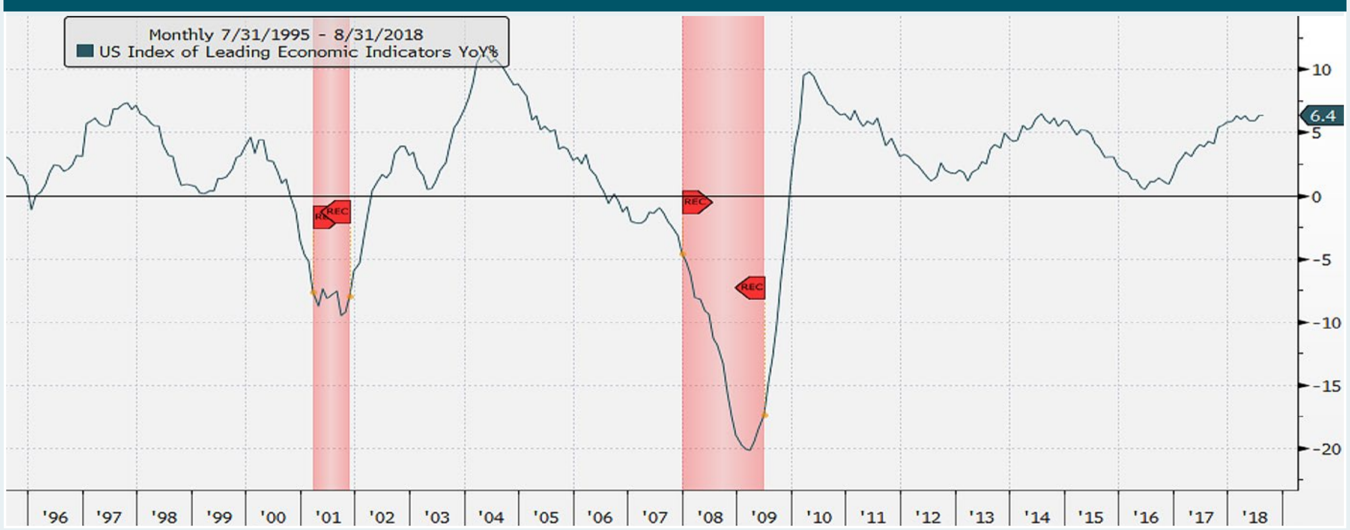
Economic trends from the first half of the year generally persisted into the third quarter. Despite heightened political and trade rhetoric, the U.S. economy continued to accelerate, posting strong growth and employment metrics. The Federal Reserve maintained its tightening bias accordingly. Activity within foreign economies moderated, though developed markets fared better than emerging markets. International trade gained stability within North America, yet matters between the U.S. and China, as well as the U.K. and the E.U., remain uncertain.

Domestic Economy

Small business and consumer confidence remain at or near peak levels.

Momentum in the U.S. economy was sustained during the third quarter on a variety of fronts. GDP growth for the second quarter printed at an annualized rate of 4.2%, the highest figure since 2014. Unemployment fell to below 4%, and the number of involuntary part time workers has fallen to near pre-2008 crisis levels.[1] Small business and consumer confidence remain at or near peak levels.[2] Additionally, leading economic indicators are trending upward, indicating that momentum is picking up. Wage growth has picked up this year, running at nearly 3.0% year-over-year most recently, although with the pickup in inflation, real wage growth remains subdued. Given the strengthening economic picture, the Federal Reserve raised interest rates at the September FOMC meeting. The federal funds rate has now been increased eight times since 2015, with the overnight rate sitting at the 2-2.25% range.

U.S. ISM Non-Manufacturing and Manufacturing



Source: Bloomberg.

[1] Bureau of Labor Statistics, Bloomberg
[2] National Federation of Independent Business, Bloomberg

Trade

The Trump administration's ongoing fight for more favorable terms with major trading partners pressed on during the quarter. Negotiations with NAFTA partners Mexico and Canada produced results late in September as the U.S. agreed to resolutions with each nation. The new bill, now called USCMA (U.S.-Canada-Mexico-Agreement), includes notable differences surrounding the automotive production chain and in certain agricultural product markets. Of course, target number one for Trump has been China, and developments on that front have not yielded results thus far. Tensions appear to be escalating further, as the U.S. applied new tariffs in September, followed by a retaliatory tariff by the Chinese. However, given that Trump's brash style with Canada and Mexico resulted in a deal, there may yet be hope for a similar outcome with China, however unlikely it currently seems.

Midterms

The U.S. midterm elections coming in November could prove to be an important inflection point in U.S. policy. Currently, Republicans control both the House and Senate, however the Democrats have an opportunity to retake one or both houses. From a policy perspective, this would represent a shift from a straight runway for Republican-driven initiatives towards a potential return to the gridlock seen during the Obama administration. Tax reform helped send markets skyward in 2018, although there may be higher volatility should power shift in Washington.

International Economy

Developed Economy

Eurozone

While the economic environment is not quite as bullish as in the U.S., Eurozone economic activity still expanded at a moderate pace, and unemployment marched lower during the third quarter. Despite positive headline trends, indicators such as retail sales and consumer/business sentiment have softened some, and the overall rate of GDP growth has slowed. 2017 appears to have been a year of "above-potential" growth, meaning that the economy fared better than its long-term trend. That being said, the European Central Bank (ECB) feels comfortable enough to eliminate supportive asset purchases by the end of the year. Still, the ECB will be keen to maintain relatively accommodative conditions, and absent unexpected inflationary pressures, will continue to keep a very soft touch with regards to forward guidance and talk of tightening liquidity.

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United Kingdom

The U.K.'s negotiation with the E.U. on Brexit terms is growing ever more critical as the deadline for a deal approaches. For Theresa May, coming to terms with the European delegation hasn't been the only obstacle as the U.K. has experienced a great degree of internal dissention surrounding its trade proposals. These challenges were highlighted in July by the departure of the original leaders of the Brexit movement in Foreign Secretary Boris Johnson and Brexit Secretary David Davis. The U.K. and Europeans have until January of 2019 to ratify the withdrawal treaty.

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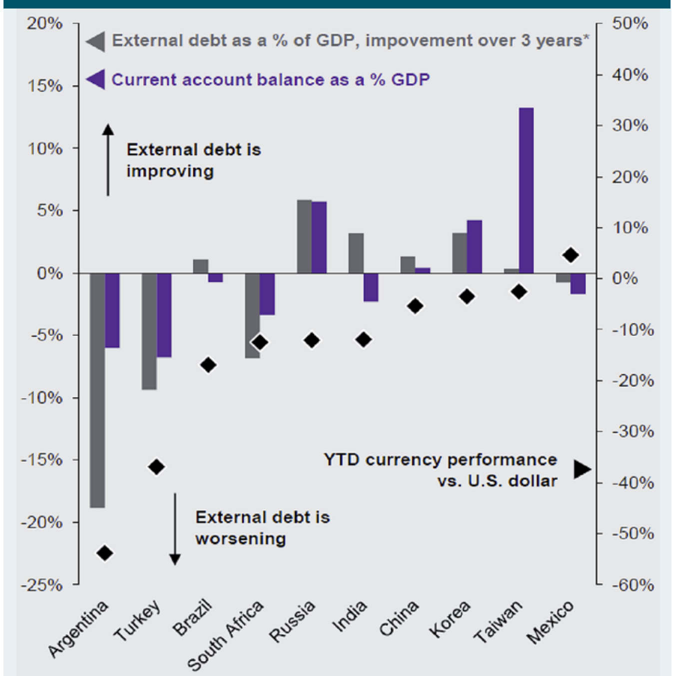
From an economic perspective, many have been surprised by how well the U.K. economy has fared this far into the proceedings. While unemployment remains low and the economy has shaken off temporary inflation, equity markets have lagged, GDP growth has slowed, and leading economic indicators have turned negative. While a recession is not necessarily imminent, the risk of one has increased, and the possibilities of a disappointing new trade agreement or even a "no deal" scenario stand out as clear downside catalysts.

Emerging Markets

Emerging market volatility subsided during the quarter, though challenges remain in certain nations. Argentina, which saw its currency depreciate rapidly earlier in the year, received confirmation from the IMF on a larger aid package worth an estimated $57 billion that will be used to shore up domestic funding needs as the country tries to tackle persistently high inflation and budget deficits. Terms of the bailout include a commitment to a floating exchange rate and monetary base targets.[3]

While Argentina and Turkey have experienced their share of issue, the tumult within EM has shown limited spillover effects thus far. EM nations with more manageable debt burdens and more balanced current accounts have fared much better and seen relatively modest currency movements relative to the U.S. dollar.

EM Currency Drivers



Source: JP Morgan.

In the shadow of ongoing trade disputes with the U.S., Chinese authorities are dealing with an internal balancing act of their own. Leaders are striving to manage the country's slowing growth trajectory while reigning in ballooning credit growth within the economy. In an ideal world, authorities would be able to manage each in unison; however, the slowdown in the global economy and the threat of tariffs are forcing leaders to prioritize. China's preference for maintaining growth was made abundantly clear in August, when China's banking and insurance regulator called for increased long-term lending to institutions experiencing "temporary" issues. Required reserve ratios have been cut twice this year, freeing up additional liquidity in the banking sector. With the potential for a large reduction in trade with the U.S., authorities are preemptively seeking to ensure there is enough credit to fill any holes left by trade gaps.

[3] IMF Press Release No. 18/362 – September 26, 2018