THE BIG PICTURE

FOURTH QUARTER 2018

Summary

Following an all-around strong year in 2017, the global economy took a noticeable step back in 2018. The fourth quarter saw trends in global economic activity moderate further, though conditions are not uniform across different regions. The U.S. possesses the strongest characteristics in terms of growth, inflation, and employment, while European and Japanese economies notably lag behind in these respects. The Chinese economy has seen less favorable trends as well. Fiscal policy provided little help to monetary authorities as disputes surrounding trade, budgeting, and domestic affairs soured sentiment and increased uncertainty for consumers and businesses alike. For better or worse, 2019 may very well prove to be the beginning of an inflection point for the global economy over the coming years.

Domestic Economy

The U.S. economy remains one of the strongest in the developed world, though the pace of growth may slow.

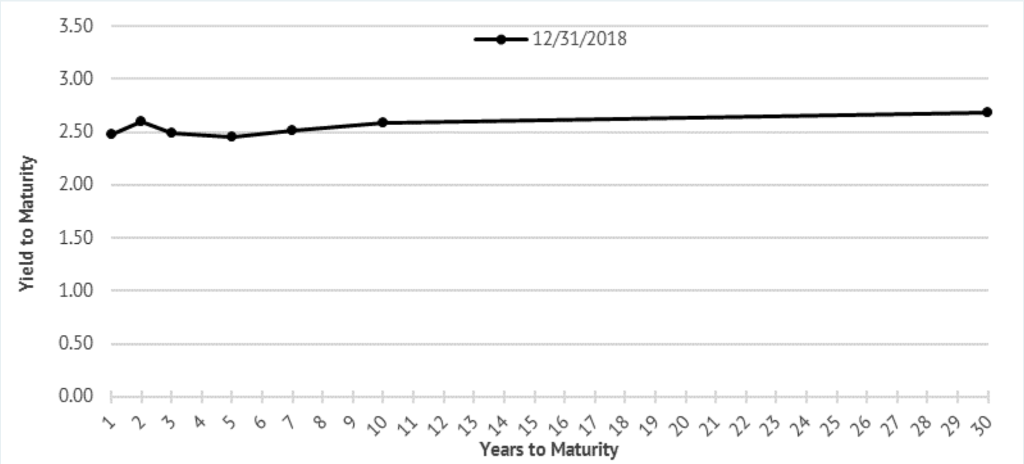
Despite concerns voiced by the equity market, economic fundamentals within the U.S. remain the strongest amongst developed nations. Unemployment remains near historical lows, corporations are growing revenues and earnings, and business investment has accelerated. The most recent December jobs report indicated over 300,000 jobs were created, which materially surprised markets to the upside.[1] The Conference Board's Index of Leading Economic Indicators is clearly in expansionary territory, reflecting that a recession in the near term is not likely.[2] All this being said, survey-based measures of future economic activity have taken a step backwards, suggesting the pace of expansion has slowed. The Markit PMI (purchasing manager index) survey, a leading indicator of GDP, has declined steadily since the beginning of the year, though it still firmly indicates expansion[3]. Additionally, the Federal Reserve Bank of Atlanta's "GDP Now" model indicates a drop off in the expected GDP growth rate as the year closed out. In summary, while the trend in growth has slowed, there is much to be pleased with when it comes to the U.S. economy.

Monetary Policy

The U.S. Federal Reserve is entering a challenging period in U.S. economic history. Interest rates have been moving towards levels more consistent with history, and the economy and markets must adapt. Fed Chairman Jerome Powell stated in November that rates were "just below" neutral, which many viewed as an indication of a looser future policy. However, that sentiment quickly dissipated when the Fed announced an additional 25 bps increase in the Federal Funds Rate in December. Given the recent softening in certain domestic economic indicators and deeper concerns abroad, many questioned whether this was the correct decision. The Fed, in a sense, is managing for the present as well as the future. On the one hand, it must remain data dependent in an effort to keep interest rates at a level consistent with supporting stable inflation and full employment. On the other hand, FOMC members recognize that the economy is in the latter stages of the economic cycle, and should conditions turn for the worse, the Committee needs as much headroom to cut rates as possible.

Another factor the Fed must deal with is the shape of the yield curve. As of December 31, the short-end of the yield curve has inverted (meaning it is downward sloping). Long-term rates (10 through 30 years) are still above short-term rates, however the curve is extremely flat. The Fed is handcuffed in a sense since they could invert the entire curve if they proceed to raise short-term rates without the market moving the long-end of the curve higher. In many cases, an inverted yield curve has pre-dated recessions, and therefore is a closely watched indicator of future economic conditions. As Chairman Powell recently stated, the Fed will be "sensitive" to the markets. If long-term rates remain subdued, the Fed will likely take a more cautious approach in setting policy rates.

U.S. Treasury Yield Curve



Source: Bloomberg

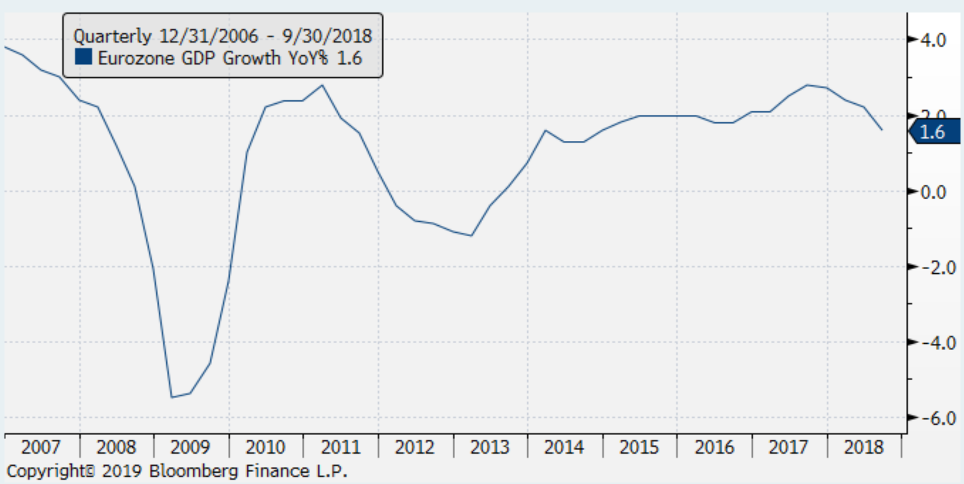
International Economy

Developed Europe

Political uncertainty is negatively impacting the economies of Europe.

Data indicate that Eurozone economic activity is decelerating. While GDP growth for the third quarter registered 1.6%, that figure was lower than the prior quarter's rate for the fourth consecutive reading. Germany, the Eurozone's strongest economy, surprised many by contracting during the third quarter. Forward-looking Purchasing Manager's Index (PMI) survey data has shown a clear shift from expansionary readings down to neutral readings.

Eurozone GDP Growth (Year over Year)



Source: Bloomberg

The change in trend partly reflects uncertainties surrounding EU policy amidst the emergence of populism in countries such as Italy and trade relationships with the United States and United Kingdom. The new Italian government was able to come to terms with the EU on a new budget, which was certainly a stabilizing development. However, in France, Emmanuel Macron's government faced loud and aggressive protests surrounding a tax increase on fuels designed to encourage more environmentally friendly modes of transportation. It has been difficult for the region to fire on all cylinders as it did in 2017 given the disparate obstacles faced by Eurozone members.

United Kingdom

The U.K. electorate declared its desire to detach from the European Union over two years ago and yet an exit deal remains out of reach. Prime Minister Theresa May has an agreement in place that the European Union will accept, but its passage through Parliament appears unlikely. As it stands, a "No Deal" scenario in which no agreement with the EU is reached has become more likely, and the government is taking measures to support the nation in such event. The impact of a freefall out of the EU would have a widespread impact on the economy as the free flow of goods and people would be halted. The Bank of England estimates that a No Deal outcome could reduce cumulative GDP growth by up to 8 percentage points through 2023 and increase unemployment to over 7% at its peak[4]. One possible alternative to a "No Deal" scenario is a second referendum which allows the public to revote on E.U. status. Current polling generally indicates a majority of voters would now favor a "remain" vote if asked. Theresa May has staunchly opposed such as measure on the grounds that it undermines a democratically-determined decision, and it remains to be seen if the government would actually facilitate such a vote.

Japan

Japanese GDP growth declined sharply in the third quarter down to 0% year-over-year, which at first glance is certainly concerning. However, a slew of natural disasters materially impacted that statistic, and growth is anticipated to rebound in the fourth quarter. From a monetary policy perspective, the Bank of Japan (BoJ) remains one of the last major central banks involved in quantitative easing. 10-year Japanese Government Bonds (JGB) yield about 0%, which is the BoJ's target. Economic growth is anticipated to remain positive, but lower than most other developed economies. Japan remains dependent on exports to fuel growth, and reduced global demand due to cyclical forces and trade uncertainty could present challenges for domestic companies.

Emerging Markets

China

Emerging markets, particularly in Asia, have operated under the shadow of U.S. protectionism, evidenced by declining equity markets and currencies. The ongoing negotiation between the U.S. and China on trade terms has seen its ebbs and flows, but an agreement has not been reached as of the end of 2018. While the U.S. economy has performed relatively well during the negotiating period, China's economy has seen a noticeable deterioration. Equity markets are down sharply, and measures of manufacturing activity have slipped to the lowest levels since 2016. The People's Bank of China has reduced required reserve ratios for banks in an effort to free up additional liquidity to the economy. While the percentage of Chinese GDP generated from exports has declined from a high of 36% in 2006 to 20% in 2017, it remains 8% higher than for the U.S. economy.[5] The Trump administration may believe it has the upper hand, but at some point, U.S. consumers will begin to feel the effects of higher prices on imported final goods or domestic goods made using imported inputs.

China remains immersed in trade disputes with the United States.

Brazil

Over the past five years, South America's largest economy has experienced a deep recession, high inflation, and political corruption. The nation has been in need of positive leadership capable of leading reforms to get the economy back on its feet. In October, Brazilian voters elected Jair Bolsonaro, a far-right candidate with hardened views who some have dubbed the "Trump of the Tropics." To help lead his administration, Bolsonaro named Paulo Guedes to head the nation's economic planning. Guedes is a classically trained economist who is reported to support market-centric reforms that would involve privatizing state-owned firms like Petrobras and cutting taxes. Given that the country has resumed positive economic growth, successfully combatted high inflation, and is seeing a spike in consumer confidence, the new administration may be inheriting a viable framework for reforms. Of course, campaign promises are always easy to make and hard to fulfill.

Brazil's new President is seeking economic and social reforms many hope will return the nation to more prosperous times.

[1] Bureau of Labor Statistics

[2] Bloomberg, Conference Board

[3] Bloomberg

[4] Bank of England -EU Withdrawal Scenarios and Monetary and Financial Stability.

[5] World Bank. Data As of 2017