DECEMBER 2018

INVESTMENT UPDATE

There's no question that 2018 has been a weird year. A quick Google search will point you to various stories about the Czech president burning a giant pair of red underwear, the NHL player who was banned two games for licking opponents, the news that North Korea's Kim Jong Un travels with his own personal toilet, and the existence of KFC's chicken-scented fireplace logs. But we've got bigger things to talk about, as 2019 is looking like a pivotal year for the capital markets. Here are eight things we think you might want to keep an eye on for 2019.

1. The Fed is likely to slow its roll in 2019—but only by a little bit. Over the past two years, the Federal Reserve has bumped its benchmark overnight lending rate (the "Fed funds" rate) seven times, each by 25 basis points (0.25%). This month, it will do it once more, raising the rate into the range of 2.25%-2.50%. These hikes, which have been on a once-every-quarter schedule, will probably slow during 2019. While we could argue that there are reasons why the Fed will keep on its current schedule, there are growing concerns that higher rates will soon begin to suppress US growth. After keeping the funds rate at near-zero for more than seven years, increased borrowing costs are already impacting overseas emerging markets, where cheap money has been used to fund massive spending projects. To paraphrase current Fed Chair Jay Powell, while we don't know exactly what the equilibrium rate is that keeps growth and inflation in balance, the Fed is a lot closer to a "neutral" policy today than at any time in the current economic cycle. Our guess is two more hikes in the first half, and one in the second half of 2019.

2. On the other hand, the Fed is not likely to slow down when it comes to shrinking its balance sheet in 2019. Not only did the Fed cut short-term rates to zero in the aftermath of the financial crisis, it also bought trillions in government bonds (Treasuries and agency-backed mortgages, aka "MBS") in order to bring longer rates down. The Fed's balance sheet ballooned fourfold, to more than $4.5 trillion by late 2014, and the Fed kept it at that level for three more years, re-investing maturities and mortgage paydowns every month. In January of this year, it started allowing some of those bonds to mature without replacing them. That roll-off schedule ramped up throughout 2018 and is expected to remain unchanged, with a combined $50 billion of Treasuries and MBS rolling off each month throughout 2019. By year-end 2019, the Fed's balance sheet will be approximately $900 billion smaller than it was this time last year.

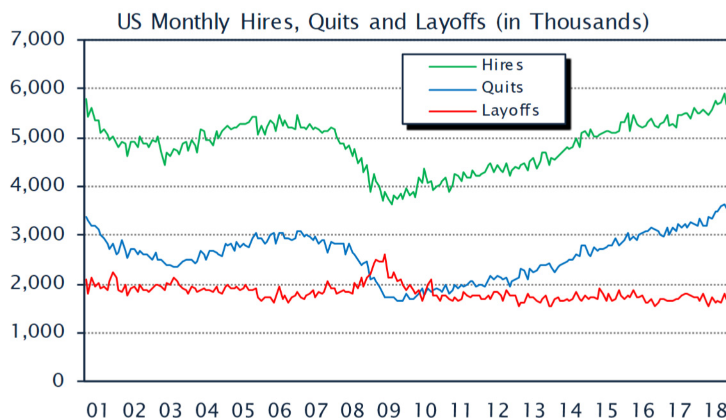
3. The Fed is way ahead of its international colleagues when it comes to "normalizing" monetary policy, but we expect some catch up in 2019. The European Central Bank (ECB) will finally end its balance sheet expansion this month, four years after the Fed did so. The ECB's multi-year quantitative easing (QE) program was expanded to include not just government bonds, but corporate credits and asset-backed securities. The Bank of Japan's QE program is far larger relative to its bond market and domestic economy than either the Fed's or the ECB's, but it doesn't publish or announce its schedule of purchases. Nevertheless, it's clear that the BOJ, too, is winding its QE program down, as net purchases are slowing to zero; not a minute too soon, as Japan's QE holdings now represent more than 200% of its GDP (the Fed's holdings, by comparison, are only about 20% of US GDP).

4. Don't look for clarity in US trade negotiations in 2019. "Confusion to the enemy!" seems to be the trade policy of the Trump administration, at least as it pertains to our dealings with China. The administration has made good on its promise to ratchet up tariffs on Chinese-made goods throughout 2018, and China has followed in-kind with tariff and trade barriers of its own. Fortunately, both sides appear to have called a truce on new tariffs for the time being, but our strong impression is that we will see a resumption of the tit-for-tat escalation shortly after the new year. While nobody claims that China plays fair—it has little respect for intellectual property rights, uses every sort of trade "cloaking" method to under-report its massive trade imbalances, and has monetary and regulatory trade barriers that slam the door on foreign manufacturers—we would prefer that US policy focus on forcing China to open its borders and reduce tariffs. The US is moving into a dangerous area; by tossing out existing international trade agreements and placing tariffs on imports from some of our most important trade partners, we run the risk of igniting an outright trade war. So far, the damage has been minimal, but if the situation escalates to include the auto industry, we run the risk of doing significant damage to the US economy.

5. Brexit will almost certainly, at least very likely, probably, may, or could happen in 2019. Or not. Like the US's mercurial trade policy, the decision to leave the European Union (EU) is a significant risk for England. After negotiating a 585-page exit agreement with the EU last month, British PM Teresa May now realizes she doesn't have the votes to pass it (as required) in Parliament. Without an affirmative vote, England will leave the EU without an agreement at the end of March. Under the terms of the agreement, England will have to pay an exit fee, and will continue to have free trade with the EU member countries until year-end 2020, but must also abide by the EU's rules and regulations, including the labor rules that are broadly unpopular in the UK.

Either way, once out of the EU, England will have to renegotiate all new trade agreements individually with the 27 countries in the Union (and everyone else), and stands to lose its status as the major financial center of a united Europe. A third—and even less likely—outcome is that the UK calls for another Brexit referendum, which could see the British people changing their minds about leaving the EU (if current polls are to be believed). Like the US, England might like the romantic idea of "going it alone," but it's not the prescription for political stability or for consistent economic growth. Economists at Deutsche Bank predict a two-year recession if the UK cannot negotiate an exit deal before the end of March.

6. There will be no recession in 2019. Yes, we're on record as being concerned about the Fed's aggressive "normalization" of monetary policy, including the risks associated with an inverted yield curve, but those risks operate with a considerable lag. If indeed the Fed does stick with its current median forecast of three fed fund hikes in 2019, we will (in the absence of a significant and unexpected pickup in inflation, and thus, long-term bond yields) have an inverted Treasury yield curve, with short rates higher than long rates. That is a sure sign that the Fed has exceeded the level of interest rates at which businesses and households are willing to lend and borrow; when this happens, the economy inevitably slows, optimism about the future recedes, and the cycle heads south. But, again, this happens over a period of months, and while it will be a topic of conversation throughout 2019, we won't see the defining "two consecutive quarters of negative GDP growth" happen prior to year-end 2019. However, 2020 may be a different story.



7. We expect investment returns to be much better in 2019. We say this knowing full well that forecasting rates and stock market returns are fool's errands, but we're basing this purely on fundamental analysis. While 2018 is shaping up to be the worst year for combined stock and bond returns since the financial crisis, we know that when the markets get beaten up, they tend to rebound. How can that be, given the rather dour economic picture? The simple answer is that there's already a lot of bad news priced into current asset prices. In the US stock market, despite record earnings in 2018 and forecasts calling for further earnings growth next year, equity prices have dropped by 10% since September and are now at the same level as a year ago. This is due to a significant drop in price to earnings ratios for US stocks, a measure that is now at its lowest level since 2012. Investors either don't believe the earnings growth story or they are simply pulling money out of the stock market for emotional reasons; either way, it appears that the sell-off is overdone. Likewise, the average high grade US bond yields 3.5%, the highest rate investors have been offered since late 2009. Of course, prices could continue to drop, but it's fair to say that we are very well advanced in this interest rate cycle.

8. We might just witness an all-time high for US workers quitting their jobs in 2019. This is an unusual statistic, in the sense that it sounds like a bad thing, but it's actually a positive. "Job quits" (as the Bureau of Labor Statistics calls it) is a sign of a healthy economy; when folks are confident in their ability to find employment (or once they've actually been offered a new job), they quit their existing job. As the chart shows, just like new hires, we see the quits number rise during periods of economic growth and decline during recessions when employment opportunities dry up. In October, we saw an all-time high in job quits, as more than 3.6 million people voluntarily left their jobs that month. At the lowest point in the last recession when layoffs were exceeding 2 million per month, only about 1.6 million people were quitting their jobs in an average month. Likewise, the ratio of folks who quit relative to all separations (e.g., layoffs, discharges, retirements, etc.) has been running at record levels—over 60%. The quits rate has been a good leading economic indicator in the past, so it's worth watching in 2019 to see if the numbers can remain at these very high levels.

We'll leave it at that. A year-end *Investment Update* that is short on controversy, short on comedy, and pretty short on content, too—a perfect end to 2018! But before we go, we'd like to catch you up on one story from last December's *Update*, regarding "Mad" Mike Hughes, the limo-driving amateur rocket builder who has been launching himself hundreds of feet into the sky in homebrewed rockets in order to prove that the world is flat. He did it again in March, earning another trip to the hospital, but surviving his blast over the Mojave desert. When asked if he still believed the world is shaped like a Frisbee, Mad Mike said, "Yes, I believe it is. Do I know for sure? No, that's why I want to go into space."

Here's hoping Mr. Hughes, and every one of us, gets a chance to live out our dreams in 2019.