Redstone Advisors



Economic and Market Review

First Quarter 2019

"Even though in Chairman Powell's words, the Fed doesn't think they changed anything, they changed a lot, and it has just exploded through the bond market. They basically have said a fed funds rate of around 2.5% is normal, and a $3.8 trillion balance sheet is normal."
Ward McCarthy, Jefferies Group

The first quarter of 2019 in financial markets was defined by a significant dovish shift by the Federal Reserve, which indicated that interest rate increases could be on hold for the foreseeable future. In February, Fed Chairman Jerome Powell hinted at this pivot, saying in testimony to Congress that weaker global economic data and less supportive financial conditions, together with muted inflation pressures, warranted taking a patient approach with regard to future policy changes. Later on in March, after the Fed's policy meeting which kept the target range of the federal funds rate unchanged at 2.25 percent to 2.50 percent, Powell signaled a prolonged Fed pause. He said at his press conference that, *"we don't see data coming in that suggest that we should move in either direction. They suggest that we should remain patient and let the situation clarify itself over time. It may be some time before the outlook for jobs and inflation calls clearly for a change in policy."* Powell also expressed concern about persistently low inflation, calling weak global price pressures, *"one of the major challenges of our time".* Powell lamented, *"I don't feel that we have kind of convincingly achieved our 2 percent mandate in a symmetrical way. That gives us the ability to be patient, and not move until we see that our target goals are being achieved."*

Some Fed watchers were surprised by the dovish tilt. Stephen Stanley, an economist, remarked, *"It was very dovish. It suggests that the Fed has jumped to the conclusion that the weakening we have seen since the start of the year will be more fundamental and more persistent, rather than being temporary crosscurrents."* Scott Minerd of Guggenheim Partners added that the Fed has *"returned the punch bowl".* Bond prices and stock prices both finished higher for the month and quarter.

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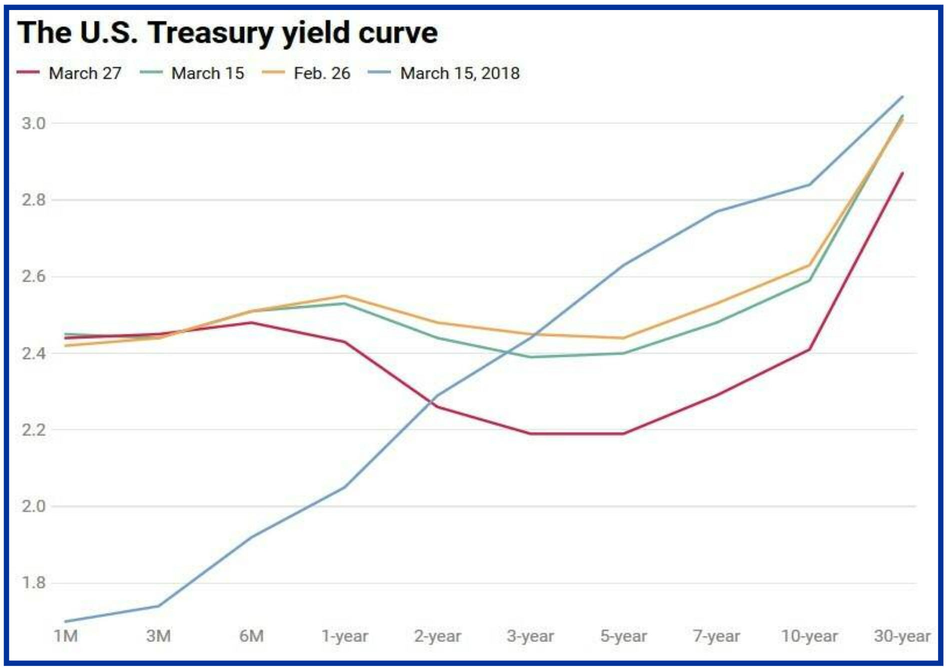
Additionally, the Fed said it would begin slowing the pace of reduction of its portfolio in May, lowering the cap on monthly redemptions of Treasury securities from the current $30 billion to $15 billion, and stop the drawdown altogether at the end of September. Beginning in October, the Fed said it will roll its maturing holdings of mortgage-backed securities (MBS) into Treasuries, with a cap of $20 billion per month. The Fed is still discussing the long-term composition of its portfolio and said limited sales of agency MBS might be warranted in the longer run. The Fed has been very gradually shrinking its massive $4 trillion portfolio of holdings since October 2017.

Last quarter we discussed how the normalization of monetary policy was a dominant theme for 2018, as the shift from quantitative easing to quantitative tightening was in full swing. Since 2015, the Fed has been attempting to normalize monetary policy by increasing rates and reducing its bond holdings from levels meant for a sluggish, post-crisis economy. Significantly, in March, the Fed essentially declared this normalization process to be finished. Lower than expected growth forecasts have persuaded central banks in the U.S. and Europe to step back from their intentions to reintroduce more normal monetary policy. Global bond yields dropped in March as central banks indicated they are willing to keep interest rates lower for quite longer than many had assumed just a year ago.

There is a debate in the market about whether to take comfort from the Fed's pivot to a more growth-friendly position or be worried of the potentially troubling reasons that prompted the central bank's change of heart. Tracie McMillion of Wells Fargo argued that, *"the prospect of central banks tightening has diminished to the point where markets aren't expecting any further tightening for the cycle. Even if we see economic data turn, we're still looking at very low inflation and very low yields."* What is concerning to some observers is that maintaining low unemployment and relatively stable inflation seems to require such expansive and extraordinary monetary policy. It suggests that powerful underlying forces like slow-growing demographics continue to damper economic growth and inflation across the world.

Treasury yields declined across the curve in the first quarter, and a portion of the curve ended the quarter inverted. The 1-year Treasury was at 2.41%, which was more yield than the 2-yr, 3-yr, 4-yr, 5-yr, and 7-yr maturities. The benchmark 10-year Treasury finished the quarter at 2.41% as well. The Treasury curve at quarter end, mid-March, end of February and one year ago can be seen in **Figure 1**. It is clear how much the curve has flattened from one year ago. The closely watched spread between the 2-year and 10-year Treasury slightly narrowed again to just 13 basis points, the ninth consecutive quarter that the 10-year/2-year spread has shrunk. In late March, after the Fed's decision to go on hold, the 10-year/3-month yield curve inverted for the first time since 2007. The inversion was temporary, lasting about a week, and minimal at only a few basis points. Its significance was debated. For some, an inversion is only meaningful if it lasts for at least four consecutive weeks or if it is at least 25 basis points. For context, during the last cycle, the 10-year/3-month spread first inverted in January 2006, almost two full years before the official start of the Great Recession. Notably, the Fed raised its benchmark rate an additional four times in 2006 after the initial 10-year/3-month inversion. The yield curve is often touted as an important forecasting tool, since before each of the past six recessions, the curve has inverted. While the inverted and abnormal shape of the Treasury curve should get attention, years of extremely accommodative monetary policy has distorted the curve and created a

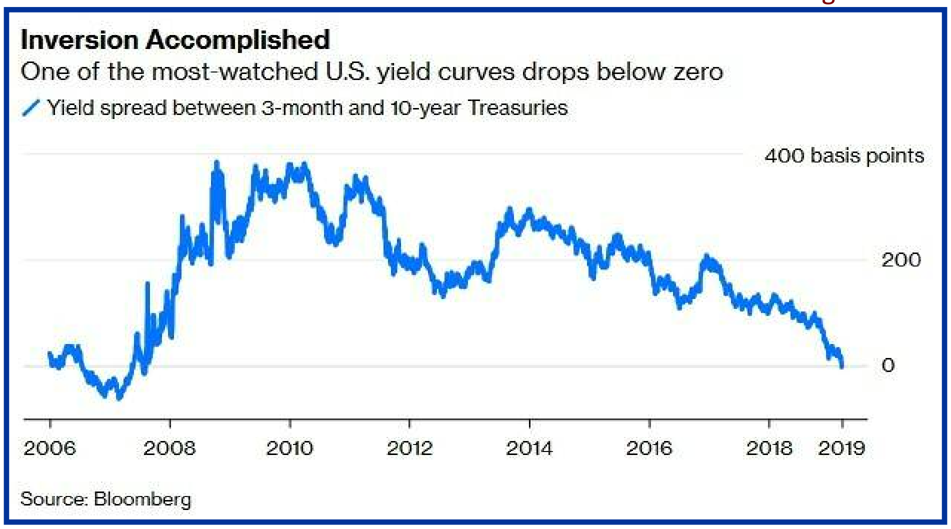
Figure 1



unique situation, making it difficult to determine with any certainty that an inversion definitively means a recession is looming. A history of the 10-year/3-month spread can be seen in **Figure 2**.

In early April, the 3-month T-bill is yielding 2.42% and the 6-month T-bill is yielding 2.45%, which is more than the yields on Treasury notes from two to seven years. Many investors with a pessimistic view of the economy are buying the 2-yr to 7-yr part of the curve, predicting that the Fed will be forced to cut rates in the near-term future. While segments of the Treasury curve have flattened, others have steepened this past quarter, notably the 30-yr/5-yr spread. Hot demand for 5-yr Treasuries explains the divergence, as investors are buying 5-year notes in a wager that the Fed sometime in the short-term future will lower rates in response to weakening US economic conditions. The tricky part, and impossible to predict of course, is knowing exactly when a downturn would happen.

Figure 2



The general takeaway for many investors from the combination of the Fed's pause, the yield curve inversion, and weak data coming out of Europe and elsewhere is that the current economic cycle is in its late stages and that we are approaching an inflection point. In early April the Brookings Institution and the Financial Times released the latest report of their tracking index which showed that the global economy has entered a "synchronized slowdown" which could be difficult to reverse in 2019. The report stated that, *"high levels of public debt are likely to limit the ability of major advanced economies to counteract a slowdown with fiscal stimulus. Conventional monetary policy remains constrained in many advanced economies where policy rates are close to or below zero, while any further unconventional monetary policy actions present significant risks and uncertain payoffs."*