Economic and Market Review

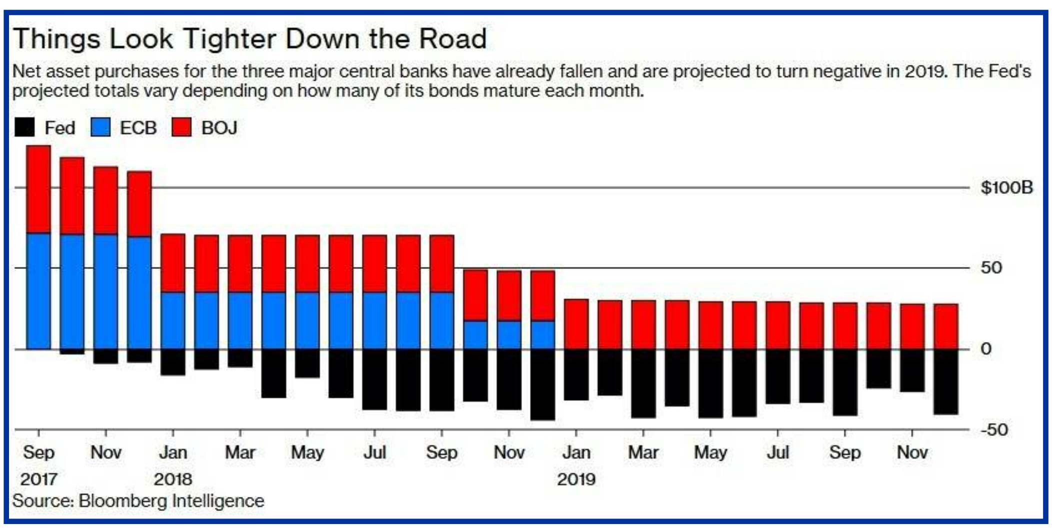
Second Quarter 2018

"We're late in the cycle. We've got a Fed in play. Trade uncertainty. You have the political uncertainty that's real and is in front of us."

Dan Ivascyn PIMCO

The second quarter of 2018 can be characterized as a transition period in the financial markets. For one, there is the gradual transition from quantitative easing (QE) to quantitative tightening (QT). Quantitative tightening, or the reduction of central banks' massive stimulus efforts, has been a driver of asset performance so far in 2018. This year has marked a change in the wave of global liquidity that helped support certain asset values. Since 2008, financial markets have seen roughly $12 trillion in QE as central banks' balance sheets ballooned in size. The Federal Reserve, European Central Bank (ECB) and Bank of Japan (BOJ) have added just $125 billion to their holdings year-to-date, well beneath the $1.5 trillion level of 2017, Merrill Lynch estimates. While the Fed is currently shrinking its balance sheet as part of a normalization of its policy stance, the BOJ and ECB are still adding to their balance sheets, although they have been reducing the size of their purchases. Even with the tapering of purchases, the value of assets held by the BOJ is set to surpass the nation's annual economic output over the coming months. The ECB's balance sheet is on track to expand through the end of this year as well. It's important to keep in mind that the BOJ and ECB are both still holding short-term interest rates in negative territory. Looking forward into late 2019, projected monthly net asset purchases by the Fed, ECB and BOJ can be seen in **Figure 1**.

Figure 1



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With respect to the current economic cycle as reflected by the BofA Merrill Lynch Global Fund Manager Survey, we believe that we are in a transition period from late mid-cycle to early late-cycle. Economic growth in Europe is now in a visible downtrend as reflected by the Citi Eurozone Economic Surprises Index and there is growing evidence that global growth has peaked. There will be no runaway synchronized global growth. This is in part what the flattening Treasury yield curve is telling us. Speaking of the global economy, the International Monetary Fund (IMF) recently put out a report projecting that debt as a share of GDP will decline over the next five years for all advanced economies except for one, the United States. In addition, this past quarter there was concern that the global economy could be transitioning into a trade war, as tariff threats were exchanged between the Trump administration and other countries, notably China. The markets are concerned that the tough talk and saber rattling could possibly escalate into a full-blown trade war with wide-ranging consequences. Tariffs increase uncertainty for global markets, as supply chains are disrupted and costs increase for consumers and producers.

Treasury yields at the short end of the curve continued their slow and steady march higher throughout the second quarter as the yield curve flattened once again. Short-term Treasury yields have been steadily rising since September 2017 as traders have taken cues from the Fed which has been committed to increasing rates as it tightens monetary policy. Very short-term (One-month & Three-month) Treasury bill yields have recently moved higher as the Treasury has ramped up T-bill issuance to fund tax cuts and government spending. Meanwhile, longer term Treasury yields have largely held steady, consolidating in a narrow trading range as concerns remain regarding long-term growth and inflation. One reason given for the curve flattening is that long-term yields have been subdued because capital spending hasn't quite ramped up the way some forecasters predicted after the 2017 tax bill was passed. The 10-year Treasury note yield peaked at 3.10% in mid-May and then declined, finishing the quarter at 2.86%.

Another factor keeping long term Treasury yields in check is the demand from global investors who are drawn to the yield that Treasuries offer compared to most other developed government bond markets. For example, at the end of June, the 10-year UK bond offered 1.24%, the 10-year German bund offered 0.32%, and the 10-year Japan Government Bond offered just 0.02%. In May, the spread between the 10-year Treasury and the 10-year German bund reached its widest levels in almost three decades. Meanwhile, at the shorter end, 2-year German and Japanese bond yields are still negative, while the 2-year US Treasury offers a relatively attractive 2.53%. The spread

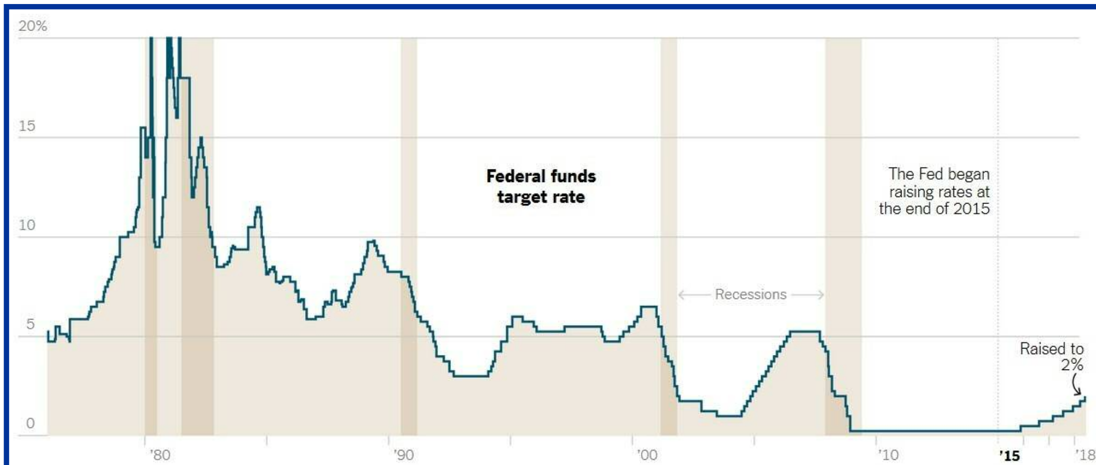
Figure 2

between the 2-year and 10-year Treasury narrowed to just 30 basis points (bps) by quarter end, the flattest it has been since 2007. The flattening trend can be seen in **Figure 2**. Meanwhile, the 5/30-year spread narrowed from 42 bps to 25 bps over the course of the 2nd quarter. A flattening yield curve suggests that the bond market sees little risk of accelerating growth and inflation in the future. James Bullard, president of the St. Louis Fed, said in a recent interview, *"I'm getting concerned about the flattening yield curve."*

This past quarter the Trump administration raised concerns of a global trade war by enacting tariffs on imports from some of the closest U.S. trading partners and allies, who quickly promised to counter with tariffs of their own. The U.S. announced unilateral global steel and aluminum tariffs in March. However, Canada, Mexico and the European Union (EU) had been offered temporary exemptions to the tariffs. Commerce Secretary Wilbur Ross announced in late May that the exemptions would not be renewed, thus subjecting those countries' metals exports to the tariffs. The EU said it is planning to strike back with its own tariffs on U.S. exports worth about $7.5 billion, including steel, motorcycles and agricultural goods. Senator Orrin Hatch, Republican chairman of the Senate Finance Committee, said: *"Tariffs on steel and aluminum imports are a tax hike on Americans and will have damaging consequences for consumers, manufacturers and workers. I will continue to push the administration to change course."* Many analysts have expressed concerns about the potential for tariffs to dampen economic growth and slow the pace of employment gains. In late June, heads of the world's top central banks warned that intensifying trade conflicts could ricochet through financial markets and weaken the world economy, potentially prolonging the era of historically low interest rates. Increasing tensions over trade come at an inopportune time for central banks, which have started gradually moving away from the very accommodative and easy-money policies introduced since the global financial crisis. Agustin Carstens, general manager of the Bank for International Settlements (BIS), warned that one possible trigger for an economic slowdown or downturn could be a proliferation of protectionist measures.

In mid-June, in a widely-expected move, the Federal Reserve raised their benchmark fed funds rate by a quarter point to a new target range of 1.75% to 2.00%. Fed officials projected a total of four rate hikes for 2018 (two more this year), which was up from a projection of three hikes at their March meeting. We remain of the opinion that the Fed is engaging in an opportunistic reload ahead of the next market reset. With fiscal policy very accommodative, the Fed is taking the opportunity to reset the fed funds rate ahead of the next economic downturn. A history of the fed funds target rate going back over four decades can be seen in **Figure 3**.

Figure 3



Note: Rate is the federal funds rate until Sept. 27, 1982, the federal funds target rate until Dec. 15, 2008, and thereafter it is the upper limit of the federal funds target rate range. | Source: Federal Reserve

Fed Chair Jerome Powell alluded to the balancing act the Fed is attempting, saying, *"Raising rates too slowly would make it necessary for monetary policy to tighten abruptly down the road, which could jeopardize the economic expansion. But raising rates too quickly would increase the risk that inflation would remain persistently below our 2% objective."* Mr. Powell said the economy was approaching a "normal" level that could allow the Fed to soon step back and play less of a hands-on role in encouraging economic activity. The Fed is keeping a close eye on wage growth, which has been disappointingly meager despite the unemployment rate falling to around 4%. Weak wage growth has been enough to keep the Fed on its gradual rate-hike course. Yet it is unimpressive overall, slightly above its three-year average. Many economists point to three main factors they say are holding down wage growth: low productivity growth, demographic changes, and foreign competition and globalization.