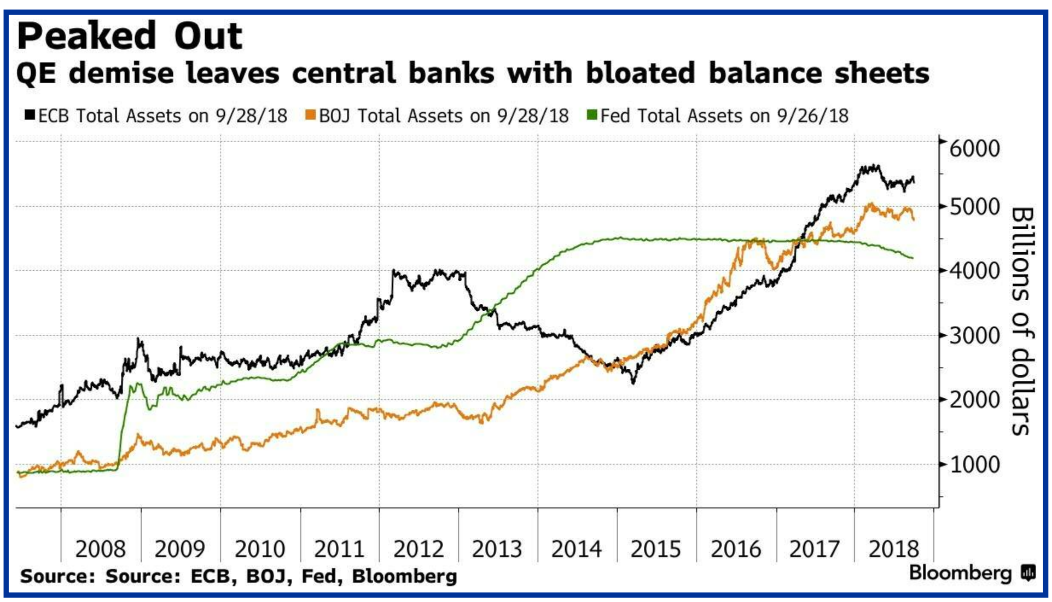
Redstone Advisors

Economic and Market Review

Third Quarter 2018

The third quarter of 2018 was a continuation of the gradual shift towards normalization of monetary policy. The slow transition from quantitative easing (QE) to quantitative tightening (QT) has been a topic of discussion in the financial markets. Quantitative tightening, or the reduction of central banks' massive stimulus efforts, has been slowly moving along in 2018. Over the past few years, extraordinarily accommodative monetary policy has led to the collective balance sheet assets of the Federal Reserve, European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England adding up to a remarkable 37 percent of their countries' total GDP. That is a significant increase from less than 10 percent in 2007, data from Bloomberg shows. Meanwhile, a recent report by JPMorgan Chase showed that the average interest rate in developed economies surpassed 1 percent for the first time since 2009. One analyst described it as a "glacial trend of monetary policy normalization." The growth of the ECB, BOJ and Fed balance sheets in the decade since the financial crisis of 2008 can be seen in **Figure 1**.

Figure 1



In mid-September, ECB President Mario Draghi reiterated a timeline for the conclusion of the central bank's bond buying program. The ECB's program is set to wind down at the end of this year. It is important to add that while the ECB's bond-buying program is wrapping up, the ECB and BOJ are still

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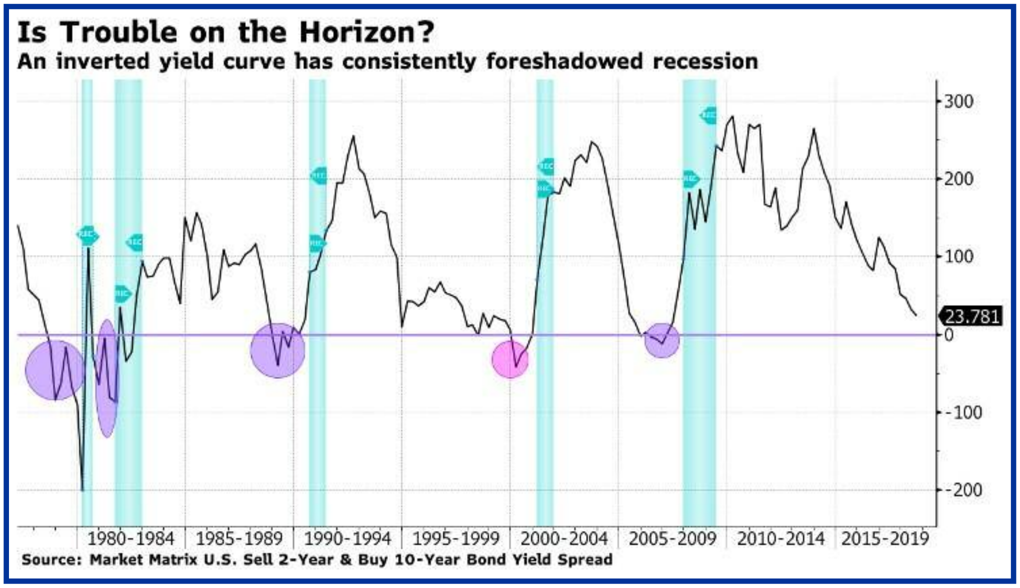
many months away from any change in interest rate policy. Many economists believe that the BOJ will need to maintain its extraordinary stimulus for an extended period, given persistently weak inflation and rising risks to growth from US protectionism and China's slowdown. The ECB's current deposit rate is negative 0.4 percent and the BOJ's current short-term policy rate is negative 0.1 percent. Those are quite a divergence from the current fed funds rate, which was just increased to a new target range of 2%-2.25% by the Fed. Michael Schumacher of Wells Fargo noted, *"The central banks for years have been big tailwinds for the markets. They've been super helpful for equities and they're becoming a little bit of a headwind. The Fed is getting company from the ECB and maybe the Bank of England…central banks are switching from being super-stimulative to stimulative."* Some analysts are cautioning investors not to be overly worried about tighter monetary policy. They point to a Bank of America report showing that the balance sheets of the four main central banks (Fed, ECB, BOJ, BOE) will shrink by just 4 percent by the end of 2020. Bank of America economists wrote in the report, *"We are worried about a lot of things—trade wars and oil sanctions come to mind—but we are not worried about quantitative tightening."* When analyzing the market, it's important to have perspective of how accommodative central banks still are, and are set to be for many more months to come.

It is not just monetary policy that is undergoing a transition. These past several months, all four major government policy levers in the US economy –monetary, fiscal, regulatory and trade policy—have changed directions under President Trump. Bob Miller of BlackRock said, *"In the last year and a half the policy mix has changed dramatically. Each policy lever has a different lag in its effects, and it's very hard to fathom the net impact of all the changes."* As we mentioned last quarter, with respect to the current economic cycle, we believe that we are in a transition period from late mid-cycle to early late-cycle. Ray Dalio, founder of investment firm Bridgewater Associates, one of the largest hedge funds, has predicted the current economic cycle would end in 2020. The reasoning is that higher interest rates, a slowing housing market and the fading effect of the fiscal stimulus increase the odds of a recession in the coming years.

Treasury yields at the short end of the curve continued their steady ascent higher throughout the third quarter as the yield curve slightly 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. The one-year Treasury finished the quarter yielding 2.59%, the highest level going back more than a decade. The spread between the

2-year and 10-year Treasury narrowed to just 22 basis points at quarter end, the seventh consecutive quarter that the 2/10yr spread has shrunk. An inverted yield curve, where short-term rates rise above long-term ones, has historically preceded economic downturns. This is illustrated in **Figure 2**. In early September, New York Fed President John Williams said, *"In thinking about the historical experience of the yield curve, we do have to be cautious about applying it to this current situation. We and other central banks around the world have taken aggressive actions to buy lots of long-term assets, which has arguably pushed down the term premium, or the yield, on 10-year Treasuries."* Williams added his own upbeat view of economic conditions, declaring *"this is about as good as it gets"* in terms of achieving the Fed's dual mandate of maximum employment and low, stable inflation. Another regional Fed President, Robert Kaplan of Dallas, said this month that the message of the flattening yield curve is that, "*prospects for future growth are somewhat sluggish or uncertain*". He added, "*The longer end is saying boy there's a lot of money looking for safe assets*". In early October, longer-term Treasury yields broke out from their narrow trading range and reached multi-year highs. Specifically, the 10-year Treasury note climbed to 3.23 percent, the highest since 2011. The 30-year Treasury hit 3.39 percent, the highest since 2014. Some analysts noted that improved growth prospects, rather than an acceleration in inflation, explained the move higher in yields. Only time will tell if these higher longer-term yields can hold.

Figure 2



In September, in a widely-expected move, the Federal Reserve increased their benchmark fed funds rate by a quarter point to a new target range of 2.00% to 2.25%. Most Fed officials expect to raise rates one more time this year, and three more times in 2019. This marks the first time that the Fed has lifted its fed funds rate above 2% since 2008. The

Federal Open Market Committee (FOMC) dropped its long-running description of monetary policy as “accommodative”, an acknowledgment that rates have moved closer to the neutral level which neither stimulates nor cools off the economy. The Fed is trying to pull off a tricky feat, engineering a soft landing of the economy by increasing rates just enough to prevent overheating, but not so much that they set off a recession. Fed Chairman Jerome Powell, in a press conference after the Fed decision, said, *“These rates remain low. This gradual return to normal is helping to sustain this strong economy for the longer-run benefit of all Americans.”* Powell added that the removal of the sentence about policy accommodation doesn’t mean a change in the Fed’s path for gradual tightening guided by incoming economic data. Even with today’s hike, policy remains accommodative, he explained to reporters. Powell, while calling the economy strong and financial vulnerabilities moderate, conceded that the Fed is hearing a “rising chorus” of concern about tariffs and the Trump administration’s shift toward protectionist trade policies. In addition to raising rates over the past year, the Fed has also very gradually reduced its massive $4 trillion portfolio of bonds and other securities.

One area of financial vulnerability to keep an eye on is the investment-grade corporate bond market. According to a recent report by Bloomberg, there is about $2.47 trillion of US corporate debt rated in the BBB tier, more than three times the level at the end of 2008. BBB is the lowest notch of the ratings ladder for investment grade bonds, above more speculative junk or high-yield bonds. BBB debt now comprises a record 49 percent of the investment-grade bond market. The concern is that with so many of these BBB ratings dependent on the ability of these highly leveraged corporations to deliver on their debt reduction promises, any speedbump in the economy or withdrawal of investor money could lead to a surge of downgrades to junk status. The rise in BBB debt over the past several years can be seen in **Figure 3**.

Figure 3