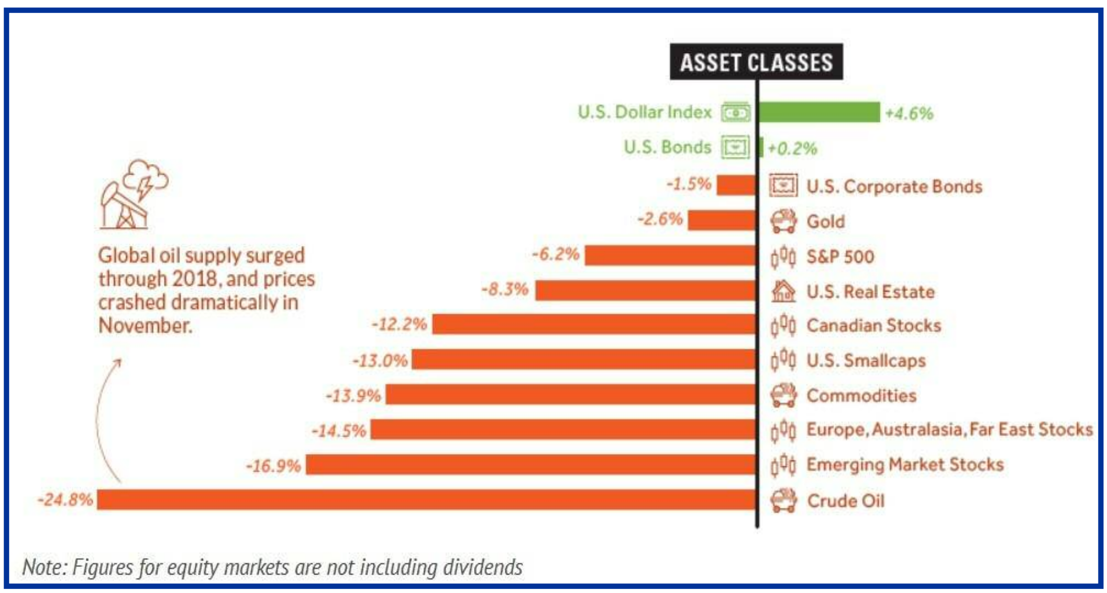
Redstone Advisors

Economic and Market Review

Fourth Quarter 2018

The final quarter and particularly the final month of 2018 was a volatile period in financial markets, as huge swings in the stock market rattled investors. Stock volatility spiked amid worries about the pace of global growth and the possibility of Fed policy tightening more than expected. A theme for much of 2018 has been the gradual shift towards normalization of monetary policy, the slow transition from quantitative easing (QE) to quantitative tightening (QT). Quantitative tightening, or the reduction of central banks' massive stimulus efforts, continued its slow progress throughout 2018. *"All assets have underperformed in 2018 simply because the Fed accelerated the process of tightening monetary policy with a two-pronged approach of both hiking rates and reducing the balance sheet. So it follows intuitively that it would be difficult to find pockets of outperformance when the Fed is actively trying to deflate asset bubbles,"* noted the head of U.S. rate strategy at BMO. A summary of how various asset classes performed in 2018 can be seen in **Figure 1.**

Figure 1



Treasury yields at the short end of yield curve declined in the 4th quarter, a noteworthy reversal from their steady ascent higher that had been occurring since September 2017. For the quarter, the 2-year Treasury fell by 33 basis points (bps) from 2.84% to

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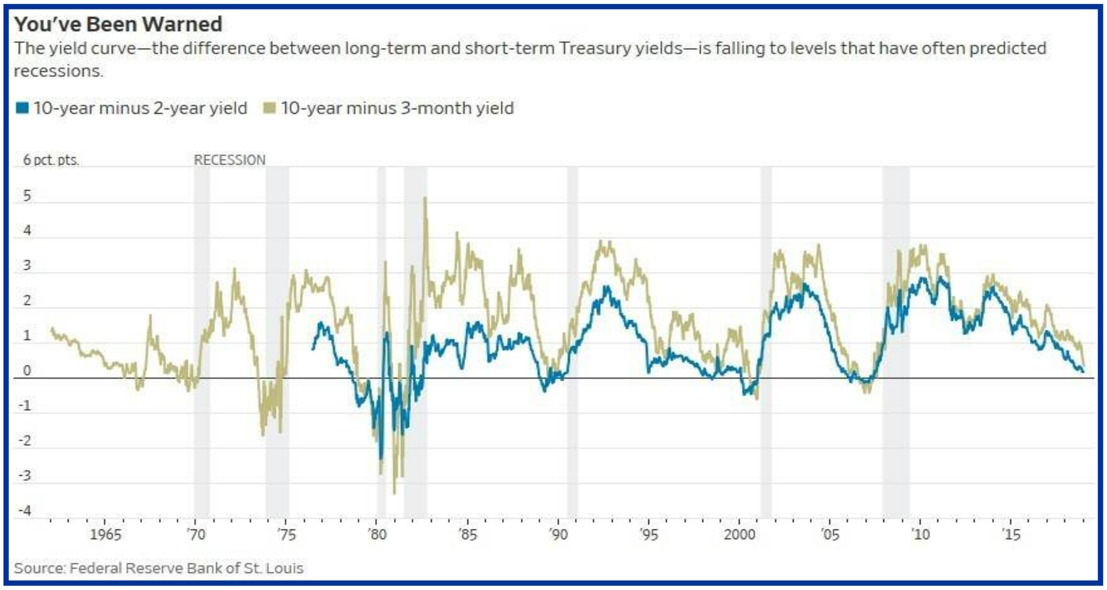
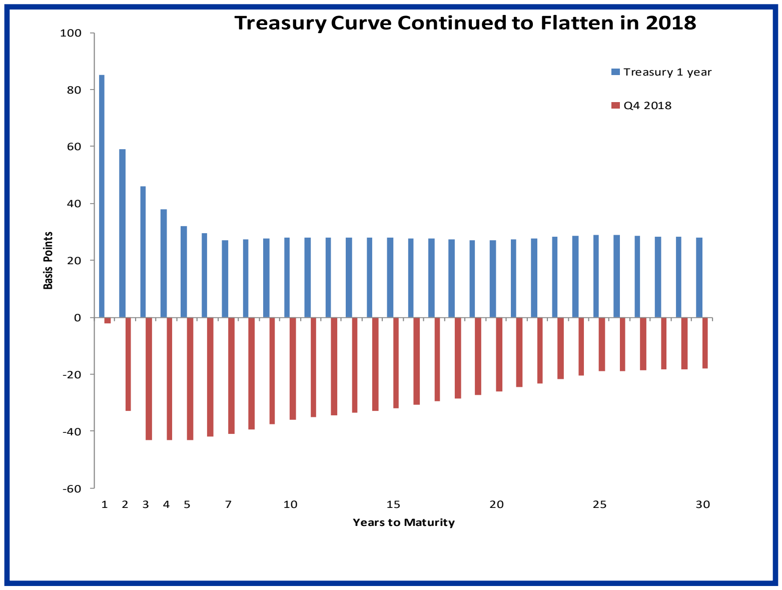
2.51% while the 3-year Treasury fell by 43 bps. The declining yield of the 2-year Treasury can be explained as investors increasingly believing that the Fed will hold off on raising rates in the first half of 2019, opting for a pause. The largest movement for the quarter came at the 3-year to 5-year segment, where yields declined on average by 43 bps. The spread between the 2-year and 10-year Treasury slightly narrowed to just 19 bps at year end, the eighth consecutive quarter that the 10-year/2-year spread has shrunk. A history of the 10-year/2-year spread and the 10-year/3-month spread can be seen in **Figure 2**.

Figure 2



Interestingly, there was an inversion at the short end of the Treasury yield curve during the fourth quarter. In early December, the 3-year to 5-year segment of the curve inverted for the first time since 2007. Analysts interpreted the move as the first signal that the bond market is putting the Fed on notice that the end of its tightening cycle is approaching. One strategist noted that the inversion could be reflective of the market pricing in some rate cuts starting in 2020, when many predict the end of the current economic cycle. Currently, the fed-funds futures market is pricing in a 50% probability of a rate cut by January 2020. At year end, the 1-year Treasury at 2.57% yielded more than the 2-year, 3-year, 4-year, and 5-year Treasury. In fact, the 1-year yielded almost as much as the 7-year Treasury, which finished the year at 2.60%. The 2/10-year spread has historically been the measure to use when talking about a textbook yield curve inversion. The flattening of the yield curve has been the trend for 2018, as one can see in **Figure 3**, which shows the change in Treasury yields for the fourth quarter and year to date 2018. A flattening yield curve suggests that the bond market is skeptical of any reflation forecasts, seeing little risk of accelerating growth and inflation in the future. *"There are significant headwinds to growth, with incremental benefits of fiscal policy diminishing after this quarter,"* argued John Herrmann of MUFG Securities Americas. The largest move of the year came at the short end, where the 1-year shot up 85 bps and the 2-year jumped 59 bps. The closely watched benchmark 10-year Treasury, after hitting a multiyear high of 3.23% in early October, tumbled back down during the 4th quarter to finish the year at 2.70%. Our view is that the flattening yield curve at this point isn't signaling a recession is imminent, however it does suggest that the economy is likely to remain bogged down in a low rate environment for quite some time. "Lower for longer" is a popular mantra for the bond bulls.

Figure 3



In December, the Federal Reserve increased their benchmark fed funds rate by a quarter point to a new target range of 2.25% to 2.50%. This was the fourth rate hike of 2018 and the ninth such increase since December 2015. In reducing the number of rate hikes they forecast in 2019 down to two from three, Fed officials signaled they may soon pause their tightening campaign. The bond market has a slightly more pessimistic view than the Fed, as fed funds futures prices are currently indicating one increase at most for 2019. In recent history, the Fed predicted four rate increases in December 2015 and then ended up raising rates just once for all of 2016. Of note, the median estimate among Fed officials for the so-called neutral rate in the long run fell to 2.75% from 3%. Fed Chairman Jerome Powell has reiterated that Fed policy isn't on a fixed course and that it reacts to changes in the economy. Last month, he said, *"Unforeseen events as the year unfolds may buffet the economy and call for more than a slight change from the policy projections released today."* 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. An ideal "soft landing" for the Fed would be a slowing in growth that keeps both unemployment and inflation low and stable. In a press conference after the FOMC decision, Mr. Powell said relatively benign inflation gives the Fed room to be patient in setting policy. The 10-year U.S. breakeven rate, which measures the market's inflation expectations over the next decade, fell in mid-December to 1.83%, the lowest level since September 2017.

In early January, Mr. Powell said Fed officials were monitoring jittery financial markets and would modify their plans if recent volatility caused the economy to slow down more than anticipated. *"We will be prepared to adjust policy quickly and flexibly and use all of our tools to support the economy should that be appropriate,"* Mr. Powell assured. He cited certain risks to the economic outlook as including slower global growth, China weakness, trade tensions related to tariffs, and general policy uncertainty coming out of Washington. As it raises short-term interest rates, the Fed is also gradually shrinking its crisis-era balance sheet holdings of Treasury and mortgage bonds. Even with the reductions so far, the Fed's mammoth portfolio still is roughly $4 trillion in size. It is set to shed another $500 billion in 2019. *"There's no textbook on unwinding a balance sheet like this,"* noted Federal Reserve Bank of Dallas President Robert Kaplan. Mr. Powell, for his part, said he doesn't think the portfolio reduction is an important part of the story of the recent market volatility. He noted that the amount of bonds that the Fed is effectively putting back into the market has been dwarfed by new debt issuance to fund government deficits by the U.S. Treasury. Mr. Powell framed the key question for the Fed at this moment as whether the economy performs in line with many forecasters' relatively optimistic expectations that growth will slow to a still respectable level, or whether recent market fears of a more severe slowdown prove correct. Mr. Powell stated that the US economy is solid, and that the principal worry he would have is global growth, which is slowing. The question to him is how much that affects the US, given that global economies are more interconnected today than in the past.