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ARTIVEST INVESTMENT OUTLOOK 2019

The Fed Blinked… Now What?

U.S. Fed Guidance, Market Reactions, and Other Investment Themes for 2019

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Introduction

As we close 2018 and kick off the New Year, many market commentators and investment managers have offered innumerable perspectives or even bold predictions for 2019. Artivest Research decided to dive into the fray as well. Below we offer some of our thoughts, beliefs, and tidbits of research on investment and economic themes that may develop in 2019.

Artivest Research Scenarios for 2019

The Economy

Let's start with the easier, softball points of view, and then we'll get into the nitty-gritty. First and foremost, we believe that the U.S. may **continue to see growth**, although more of a "late cycle" economic growth. Thus, GDP remains positive, but lower than in previous quarters. Equally important on the topic of growth is the U.S. Federal Reserve's recent responses to economic (and market) indicators and their anticipated reaction in 2019.

First, some context: in 2018 Jerome Powell, U.S. Fed chair, appeared to be on a very deliberate path to raise interest rates, in part, to prevent the U.S. economy from overheating, but also we suspect to add arrows to his quiver in the event of another recession (when rate decreases are an important tool in the belt of any monetary official). In December, right around when the markets' participants were ending their holiday shopping and starting to baste the turkey, Powell commented on the "autopilot" nature of quantitative tightening (does that mean no one was at the wheel?), and remarked that the

Fed's "models" showed the need for additional rate rises.[1] At about the same time, the President of the United States took to Twitter and urged the Fed to slow down the rate rises.[2]

All of the aforementioned events likely contributed to the worst December of S&P 500 Index performance since the Great Depression of the 1930s.[3] And so… the Fed blinked. It subsequently communicated that it is "being patient…and listening" to the market (both of which are generally always good practice to apply in life in our humble opinion).

So where does that leave us now? Is Powell an accommodative Fed chair who looks at equity market performance as an additional input into policy setting, or, is he an "independent thinker," who only responds to economic data regardless of market performance (or presidential tweets)?

We believe more of the former case than the latter: the U.S. Fed is **likely to keep the accommodative approach** and is unlikely to raise rates again, *unless* equity markets and inflation expectations recover to the highs reached in 2018. In other words, he is data-responsive *and* price-responsive, and similar to a predecessor, has offered the market a "Powell Put."

Two parting observations on this topic:

- One analysis by economists with the Atlanta Fed concludes that the quantitative easing program was equivalent to a rate cut of almost 3%.[4] As interest rates were 0% for several years after the 2008-2009 financial crisis, this implies that the actual "shadow" Fed funds rate reached a low of -3% during this time, and that rates have been rising from this low. This implies that markets have been reacting to this shadow-rate low and not just the real rate rises from 0%. This shows just how significant the QE program has actually been (and how relatively well the markets have reacted to a +5% rate increase).
- If Trump closely follows the market and puts additional pressure on the Fed to ease rate rises (or even lower them), does the Fed respond to the markets or respond to Trump? We wonder how this will be perceived in the future, in the next bout of volatility (and Trump tweets).

On the political front, two major topics stand out: U.S.-China tariffs and the partial government shutdown.

- On the U.S.-China tariffs, we believe that if the market uncertainty continues for some time, leaders in the **U.S. and China may be forced to reach a détente**, or a stopgap resolution, in the trade war (and underlying IP) disagreement. As of this writing, initial trade talks had already commenced (which strengthens the signal that both sides know that no one wins from a trade war).

- On the government shutdown, we will largely avoid this political landmine and only make the following observations: this shutdown is preceded by 21 other shutdowns (10 of which led to furloughed government employees), and all have been ultimately resolved.[5] This shutdown will likely end up as the longest shutdown given the extreme partisanship on both sides. Ultimately, however, we believe a **resolution will be found before profound economic repercussions occur**.

Equity Markets

Now we move on to the heart of the conversation: equities. We believe that **U.S. equity markets will ultimately end higher** than where they started on January 1st. The performance may not be without its **bouts of volatility**, which may increase in frequency. However, we believe that the volatility will ultimately have an upwards bias, and leave the S&P 500 Index **somewhere between the 2018 highs or lows**.

We expect that international developed and emerging equity markets (ex Europe) may outperform the U.S. on a relative basis, given strong fundamentals and lower valuations.

- If we look at the MSCI All Country World (ACWI) ex USA,[6] we see that the price to earnings (P/E) ratio is 20% cheaper than the P/E of the S&P 500.[7] International markets typically trade at a discount to U.S. markets, although the long-term average discount has been smaller, around 10%.

- Furthermore, the dividend yield on the ACWI is 65% higher than the S&P 500.

- Lastly, continued accommodative monetary policy (in the form of the reinvestment of balance sheet run-off and the absence of rate hikes by the European Central Bank[8] and reduced but ongoing QE at the Bank of Japan[9]) should offer a smaller, but non-trivial tailwind to these markets.

Fixed Income

Given the Fed's apparent accomodative approach on the path of interest rates, we expect a **continued flattish—but positive—yield curve** throughout 2019. Within the corporate bond market, **investment grade (IG) spreads may widen**, and lower-tier IG corporates may fall off the ladder and into high yield (HY). **High yield spreads may also widen substantially** as investors accelerate the unwinding of historical positions that were previously reaching for yield, and buy higher-quality bonds that may offer similar return. Lastly, any further deterioration in company fundamentals in this category may also reset spreads closer to a "fair," long-term risk premium (the long-term high-yield average is 5.6% and has been higher in late economic cycles or early recession stages; currently it is at 5.3%).[10]

Commodities

Overall, we believe that we may see a **softer commodities environment** for 2019. We would posit, however, that **energies might have room to fall** a bit more. In addition to its importance as a substantial exporter to the global liquefied natural gas market, the U.S. is a net oil exporter for the first time in its history. It may follow then that OPEC countries, again faced with a lower price or substantial production cut, may not be willing to cut production.

We expect that base metals, which historically exhibit positive correlation to economic growth, to **trade flat or down for the year**, outside of any tail events, as global economic growth decelerates. We expect a similar **downward move for precious metals**, as these metals have historically rallied during risk-off or tail-risk environments, but may struggle in slow-growth or low-inflation environments.

Foreign Exchange (FX)

In currencies, we anticipate **a firmer dollar**. Despite the projected slowdown in U.S. economic growth and the Trump administration's past references to their preference for a weaker dollar, on a relative basis, no other currency stands out as safe haven for 2019. Within the U.S. Dollar Index (the DXY), the euro, Japanese yen, and the British pound together make up 83% of the index, and each currency has its own headwinds. One could say we call the dollar the prettiest horse in the glue factory.

- The euro? It's basically a political basketcase. It continues to face political overhang on its long-term resiliency, given widely different deficit levels across the member countries, and a political unwillingness to share debt burdens. This is in addition to a less euro-friendly government in Italy, and upcoming legislative elections in Portugal and Greece in October.[11]

- The Japanese yen has historically appreciated during trading in risk-off environments, and we believe that there will not be a significant change to its status as a safe-haven currency outside of the Asia region. Absent an extended risk-off environment, we see continued weakening of the yen given the Bank of Japan's struggle to kick-start inflation (and support Japanese exporters).[12]

- The UK will continue to face significant challenges with Brexit, and the British pound will take the brunt of the hit as UK-domiciled companies and investors slowly trickle out.

While we think that the dollar will outperform these currencies specifically, we also think there is a strong likelihood that a **number of individual DM and EM currencies outperform** the USD.

Finally, we have the FX runt on the proverbial playground who's always picked last but wants to be first: the Chinese yuan is striving to become a worldwide reserve currency, but **we believe this is still several years away**. A current hurdle is the fact that the Chinese government leans more interventionist than free-market oriented with respect to its currency's value, and continues to have an offshore and parallel onshore (but tightly controlled) currency.[13]

2019 Risks

Here we state the risks that would derail not only our 2019 scenarios, but that could generally surprise markets and turn things south. First and foremost is the Fed: it has (indirectly) communicated an accommodative, patient stance towards the markets, but there is a risk that this was only a stopgap. If the Fed were to change their opinion on the path of raising interest rates to a market agnostic stance, then they run the **risk of roiling markets and slowing growth enough** to potentially tip the U.S. into a recession.

Within China, we believe that there is an increased risk of a **shadow banking surprise** or other off balance sheet instruments to surface and roil the local, and perhaps global, economy. Various estimates place the amount of shadow debt at a staggering 70%-78% of China's GDP. Although the Chinese government is trying to manage this as best they can, it's no small task. For years, the PBOC watched, and at times even encouraged, domestic companies to borrow large amounts of capital for local projects. This led to the proliferation of the China growth narrative and their "economic miracle." However, if domestic companies are forced to go from off balance sheet (think shadow) to on balance sheet funding (Chinese bank loans or corporate bonds), we'd expect that they would be faced with higher rates and/or lower liquidity. The PBOC has added some stopgap measures to try to prevent this from happening or at worst buy some time for themselves. Given the size of China's economy, an unexpected slowdown (or even a recession) could shake worldwide markets, including the U.S.

On the investment side, with the significant increase in corporate spreads, we believe that there is a risk that losses and defaults tied to leverage loans and high yield bonds **could impair a non-bank financial institution** (such as a private market or direct lender). Due to the flood of capital in recent years and proliferation of covenant-lite loans, the underwriting practices within the direct lending environment became more aggressive. While we suspect an event of this nature would be notable, we do not view this as a macro event or expect any significant knock-on effects to broader capital markets.

Strategies

Given our viewpoints, here are some investment areas and strategies that we believe may have potential to outperform in the incoming environment:

- **Select EM or frontier market portfolio managers** that either specialize in allocating between countries or markets poised for recoveries or upswings, or within countries that invest across the capital structure. Not all countries are progressing economically at the same pace, and country differentiation (and security selection within countries) is paramount.

- **Idiosyncratic developed market corporate credit strategies:** given the backdrop of widening spreads, this may offer an opportunity for outperformance for skilled managers within this space.

- **Commodities** have historically been effective for portfolio diversification in late stage cycles. Managed futures have historically offered a straightforward access point for participating in commodities, both on upsides and downsides.

- **Niche markets that are new or growing rapidly due to secular trends:**

  - **Cannabis** is expected to grow into an $80 billion legal market by 2030, which represents a ~16% annual growth rate for the next decade plus.[16] Although public market valuations remain high (on a price/sales basis), we believe private market investors hold the advantage in this capital-starved industry.

  - **Qualified Opportunity Zone** investing may become an important investment class given the undeniable tax benefits.

  - **Real Assets** such as income producing real estate as investors continue to seek yield.

- **On a longer timeline beyond 2019**, we believe that, at some point, in the medium-term future there exists the possibility of an existential crisis in a minor, but developed, economy where its debt burdens overwhelm its ability and willingness to repay them. This may shake the faith in fiat currencies and propel interest in cryptocurrencies into the mainstream as a store of wealth.
    - Importantly, however, cryptocurrencies remain a niche interest and are currently mostly used for speculative trading.

On that note, we will close our piece and thank you for your interest and attention.

Sources

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S&P 500 Total Return Index. The S&P 500 Total Return Index is the total return version of S&P 500 Index. The S&P 500 Index is unmanaged and is generally representative of certain portions of the U.S. equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed reinvested in the S&P 500 Index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.

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GLOSSARY

The definitions below are for informational purposes only.

P/E Ratio. The price-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

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