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# Economic & Market Observations: **Years of Living Dangerously**

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What a year 2019 was. There were enough risk events to fill a fretful decade, including multiple rounds of tariffs, a military stare-down in the Middle East, expressions of nuclear ambitions by states hostile to US interests, an impeachment of the US president, the threat of a government shutdown or debt-ceiling standoff, and the possibility of a disorderly UK exit from the European Union. Many were expressed in a rancorous tone if not outright incivility.

Framing an economic outlook based on assumptions about political events is always fraught in a year of living dangerously. At points in 2019, it seemed possible that our world view would fall as flat as the character played by Linda Hunt at the end of the 1982 movie of the same name.

The biggest surprise is that this collection of risks did not derail global economic expansion. Ironically, the third impeachment of a president in US history cleared the political chessboard. The House's motion was unconvincing to the uncommitted, and Donald Trump's approval rating hit an all-time high. House Democrats had to evidence cooperation in the form of approval of the US-Mexico-Canada Agreement (USMCA) to reset trade relationships, passage of budget resolutions that averted a federal government shutdown, and the suspension of the debt ceiling to rule out default. The first in that list freed some bandwidth of Trade Representative Robert Lighthizer to bring home the first phase of a US-China trade arrangement. In the event, the rational actor theory panned out as Presidents Trump and Xi agreed on a limited compromise, long on promises about opening markets and protecting intellectual property rights in addition to targeted Chinese purchases of US goods. Importantly, the US took intentional harm to the global economy off the table by cancelling a round of tariffs slated for December 15th and a partially rolling back the September 15th round of tariffs. The simple arithmetic of the outlook is that the removal of a negative is a positive.

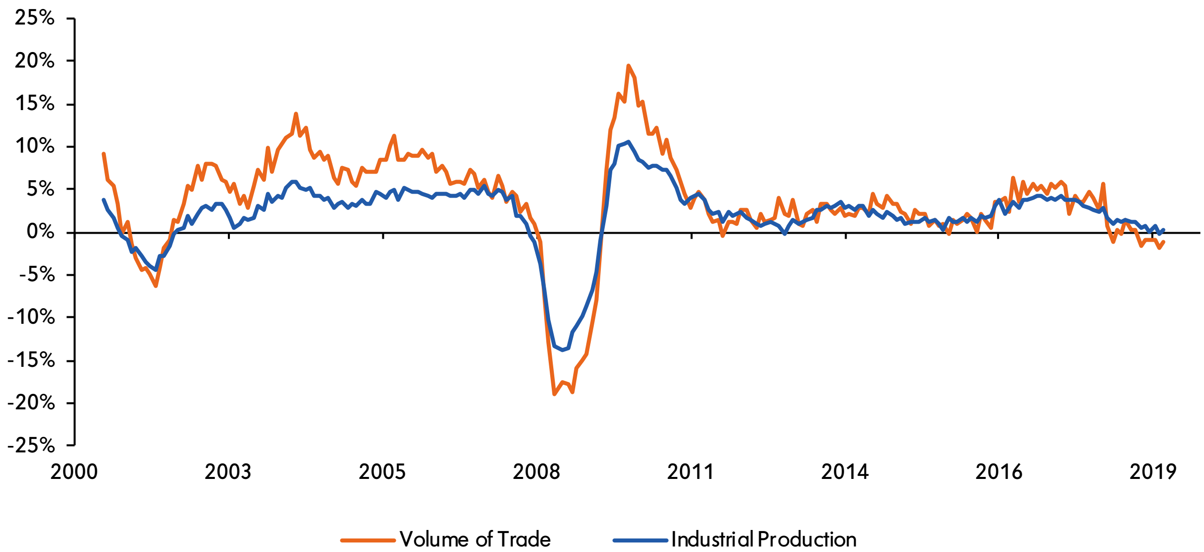
**President Trump's Approval Rating**
Average of Polls


Source: Real Clear Politics, accessed on 2/12/20 via Bloomberg.

Thus, 2020 opened on a hopeful note, with the contraction in global trade volumes receding in the rearview mirror and favorable prospects of a more synchronous, albeit slow, worldwide expansion. Hope, the thing with feathers according to Emily Dickinson, was quickly plucked away. For a time, the Middle East went back to a boil and now an epidemic clouds the outlook for China. Meanwhile, the four-year presidential cycle set in motion in 1788 presents the dispiriting reality that this year will be consumed by election politics. If 2019 felt bad, 2020 may prove worse.

**Global Trade and Industrial Production**

12-Month Change




Source: CPB.nl World Trade Monitor, accessed 2/7/20.

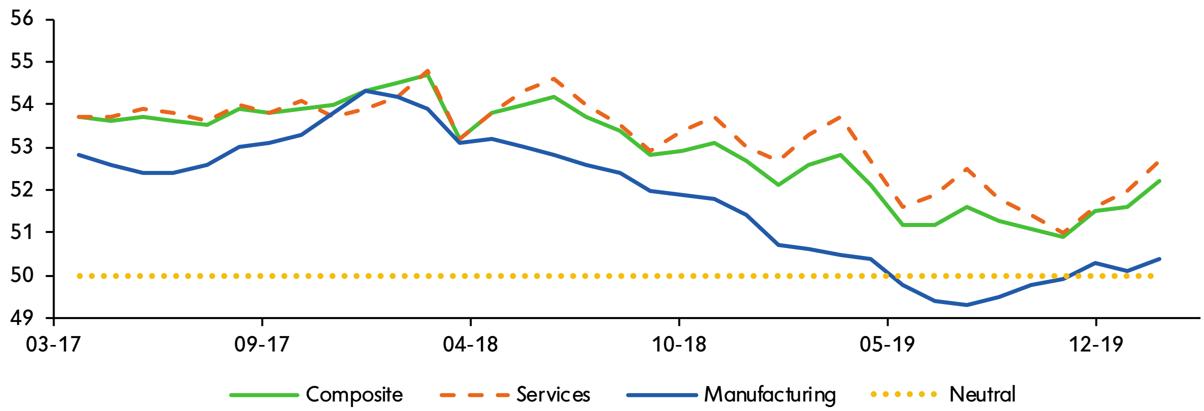
Once again, however, muddling through is usually the best bet. We have no edge in epidemiology and interpret events in China as showing the two sides of a command-and-control economy coin. Provincial control at the top allowed COVID-19 to spread initially in silence without a buildup of adequate health care infrastructure. But national leadership moved quickly to contain the epidemic when its threat became evident and will use policy impetus to cushion its toll on the economy. There will be a toll on the economy, of course. We expect real GDP growth to slow sharply in the first quarter, given the extent of shuttered businesses and absent employees, before rebounding in the second quarter. The expected rebound will not completely reverse the effect of the earlier slowing, as not all demand can be pent up to be released subsequently. We have pared a couple of tenths from expected annual real GDP growth for 2020.

Slower Chinese growth will ripple through the global economy, most felt among regional neighbors woven into its supply chains and emerging market economies dependent on the sale of its commodities. Oil is the commodity price now most important to the US given the prevalence of fracking. Its price has been protected on the downside as a few important suppliers have cut production in response to weak demand. Obviously, considerable downside risks in the world's second-largest economy attend this outlook, mostly associated with scale (how much will spending slow) and scope (how well will the infection be contained).

Trade uncertainty is, perhaps temporarily, a smaller share of global risks. A calming of trade tensions benefits export-centric economies, a club that does not include the US as a member. Indeed, construction of the baseline was influenced by global trade volumes, which have stopped contracting, and with it, industrial production. True, the Eurozone economy closed last year on a soft note, but forward-looking data have since improved. While a significant drag from events in China or assertiveness from President Trump on auto tariffs cannot be ruled out, we expect real GDP growth to improve as the year unfolds. The monetary policy of the European Central Bank should remain accommodative under the cover of its review of its policy strategy. We expect GDP growth in the UK to move sideways this year as Boris Johnson struggles to get a trade deal done.

**MARKIT World PMIs (Seasonally Adjusted)**

Neutral = 50

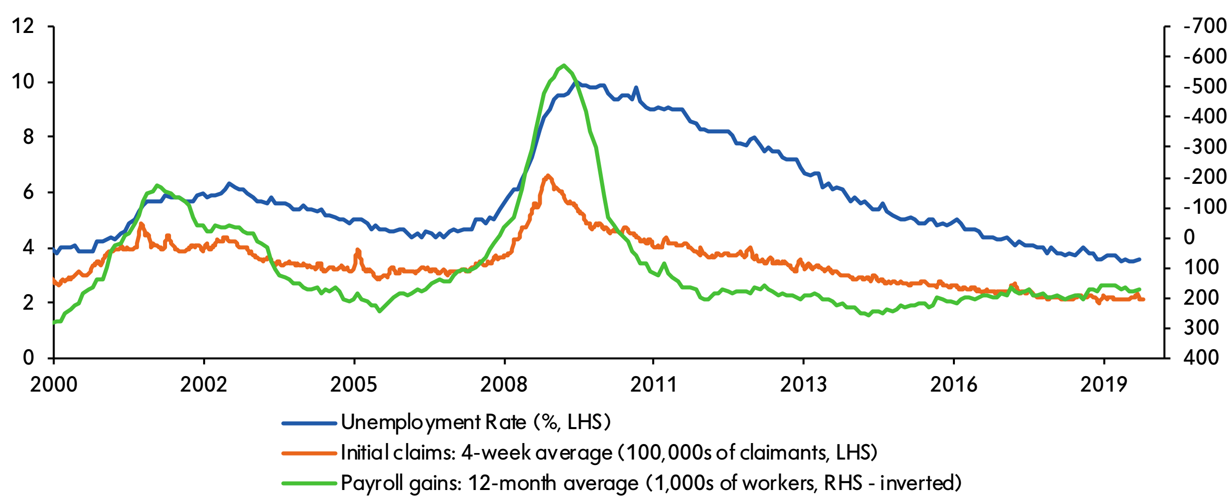



Source: MARKIT, accessed on 2/6/20 via Bloomberg.

Latin America has a high exposure to China growth through commodity prices, with Brazil and Chile among the most exposed. Brazil has been gradually recovering, supported by a more dynamic domestic market but trade in the first quarter will pose a setback. Elevated domestic political uncertainty in Chile will be the main driver of its performance. In our view, Mexico is less exposed to China and we expect a mild recovery in 2020 supported by consumption and manufacturing exports associated with the passage of the USMCA.

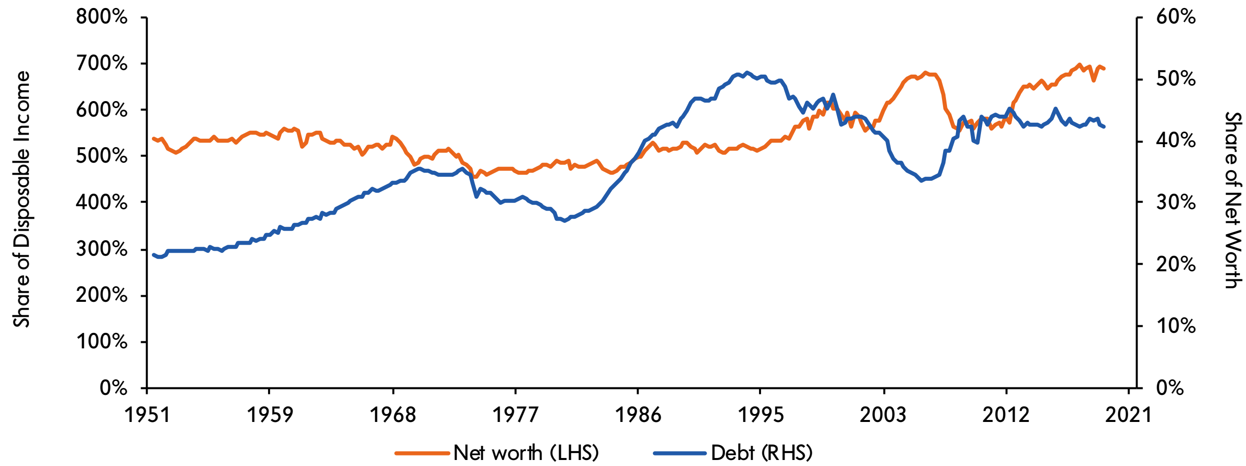
At home, our service-oriented economy hums along, creating an average of approximately 175,000 jobs per month and putting wage gains on a shallow incline. Households have additional income to spend and the confidence to do so. Financial conditions remain accommodative, and credit seems to be flowing smoothly. An important source of support to those prices and quantities has been the significant net gains in equity values, notwithstanding their bumpy ride. Household wealth relative to disposable income is well maintained. The debt of nonfinancial corporations has moved up faster than that of nominal spending, but with interest rates low, debt service remains contained. Moreover, the level of corporate debt has roughly moved in tandem with equity values. That is, the balance sheets of households and firms appear relatively well aligned in the aggregate given current stock prices.

**Labor Market Utilization**




Source: BLS and Commerce Department, accessed 2/6/20 via FRED.

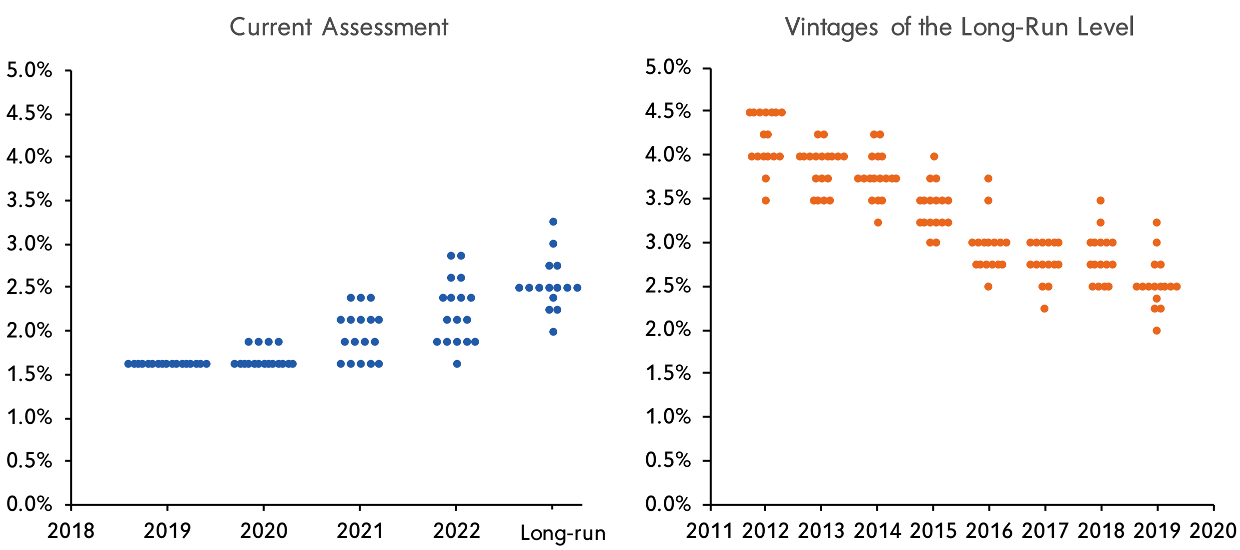
**Balance Sheets of Households and Nonfinancial Firms**




Source: Federal Reserve, Financial Accounts of the US, accessed 2/13/20.

With earnings growth slowing—probably faster than that of nominal GDP growth—these lofty valuations owe to the low discount rate applied to future income. A critical agent is the Federal Reserve (Fed), which measures its policy stimulus in teaspoons three-quarter-points full. As Fed Chair Jerome Powell repeatedly explains, his policy committee bought insurance by easing three-quarters of a percentage point in 2019, thereby placing the level of the funds rate three-quarters of a percentage point below its equilibrium. All of the Fed's reports, remarks, and body language indicate they want to keep it there throughout 2020. In our view, the current white space between the actual fed funds rate and its estimate of its long-run (or equilibrium) value in the left panel (below) really represents an insurance rider on the Fed's six-year policy of lowering its notion of the equilibrium funds rate, the right panel (below), to recalibrate policy setting so is not inadvertently restrictive.

**Assessments of the Appropriate Nominal Fed Funds Rate from the Summary of Economic Projections**

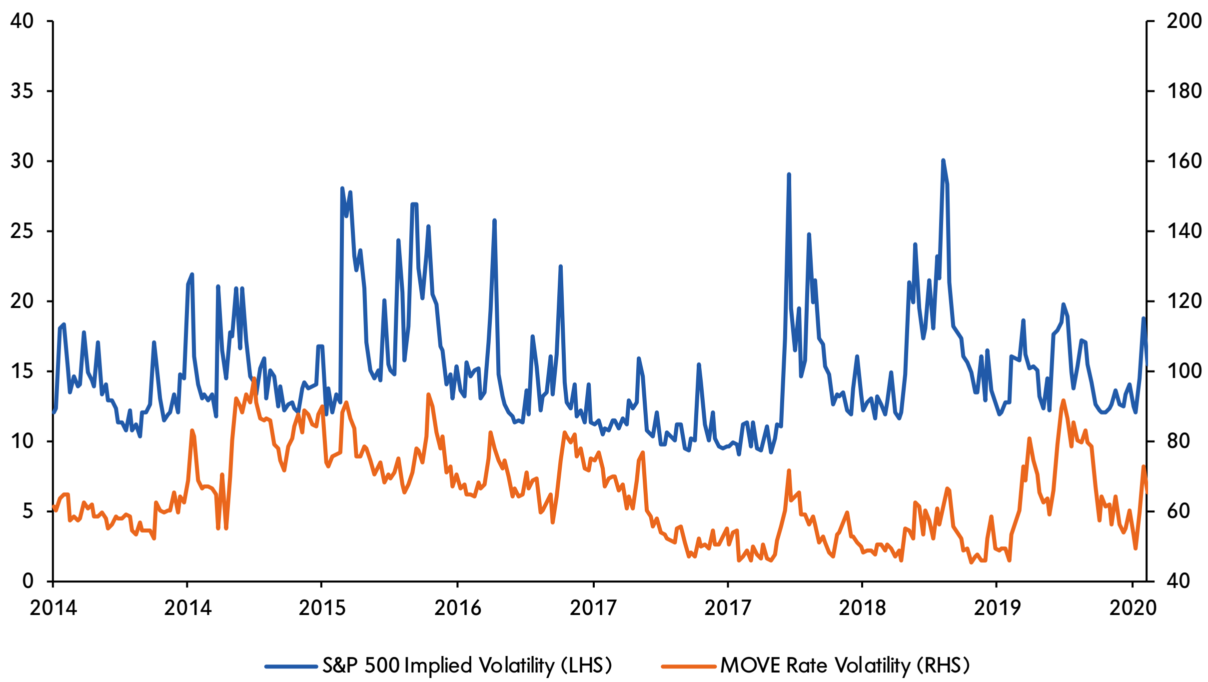



Source: Federal Reserve at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm, accessed 1/8/20. Note: In the right panel, readings are for year-end meetings with the exception of 2012, which is from the April meeting.

We think that the wedge between the actual and its equilibrium rate is, to sing from the same page of the hymnal as Fed officials, in the right place (if maintained this year) to keep the economy in a good place. The Fed spent 2016-2018 tightening on the theory that an unemployment rate below all conventional renderings of its natural rate would send inflation higher. It did, but not by much. Now, they will need hard evidence in the form of inflation moving significantly above their goal of 2 percent before ratcheting the policy rate higher. They would be quicker on the draw to lower rates if domestic job creation faltered or inflation expectations sagged. Neither are our base case. Rather, we think sustained economic expansion puts enough pressure on resources to provide evidence supporting the Fed's theory of inflation determination. We expect that inflation rises gradually this year and next, but a pace at first gratifying, not alarming, to Fed Chair Powell. A risk over the longer haul is that investors will become alarmed before Fed officials, but that is probably a story for next year.

There are many moving parts in this outlook, creating risks and financial market opportunities. Concerns about the US budget, current accounts, and a waning of safe-haven demands (when China rights its currently rocking economy) would weigh on the value of the US dollar. At some point, twin deficits matter, especially in a presidential election year when neither major-party candidates expresses concern about the federal budget deficit or debt and both compete to show their hostility to international trade. Indeed, an unfolding market mystery is why investors appear sanguine about November 3rd in that implied volatilities of the S&P 500® Index and Treasury notes are not especially elevated and move more on overseas than domestic developments. One possibility is that market participants are tuning out the political cacophony until the top of each ticket becomes clear. Another is that we may have a touching faith in checks and balances—that the most likely outcome will be a divided and ineffective government. Perhaps, as Election Day draws nearer, this may change.

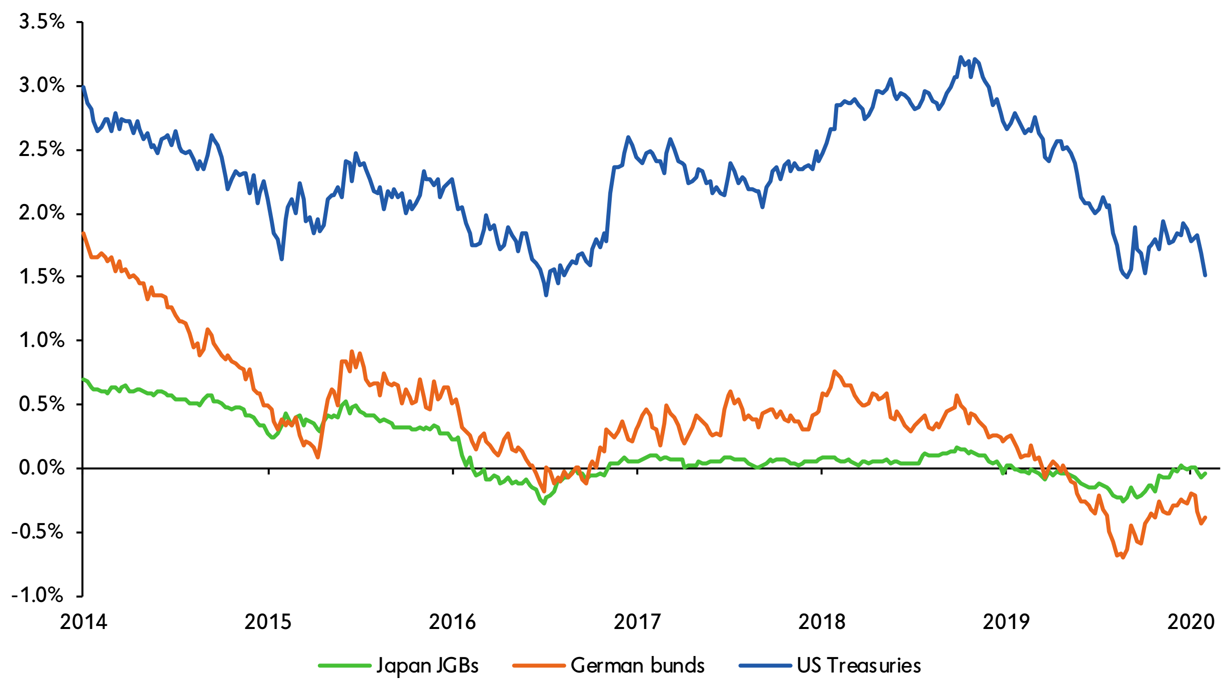
**Implied Volatilities**




Source: Bloomberg, accessed 2/13/20

If we are right that investors are overpricing the extent of Fed easing and underpricing the pick-up in inflation, Treasury yields are likely to rise somewhat. The emphasis should be on "somewhat" as not much easing is currently priced in and the rise in inflation in 2020 will be subdued. Moreover, US Treasuries are lonely in the pack of sovereign securities, as about $17 trillion of that asset class provides the privilege of offering a negative rate. This acts as a sea anchor that should slow any rise in Treasury yields. As a result, a more straightforward way to express our view is to appreciate that breakeven inflation appears very attractive.

**Ten-Year Sovereign Yields**




Source: Bloomberg, accessed 2/13/20

While macroeconomic fundamentals are otherwise solid, slowing real US GDP growth will likely be associated with a more pronounced slowing in earnings growth. Corporate executives, who have benefitted mightily over the long run of the equity bull market, may try to offset that valuation drag with debt-funded buybacks. This will be especially tempting given the high valuation multiple in a low interest rate environment. This is one of the reasons we expect corporate fundamentals to deteriorate over time, albeit from a base made better by stabilization of macroeconomic fundamentals. Technicals in the corporate debt market remain favorable, but stretched valuations and rising leverage leave this asset class vulnerable. We do not see this as a reason to change overall exposure yet but rather to look more for relative-value opportunities.

There is value in emerging markets local currency and US dollar debt, meriting an overweight in these two asset classes. Valuations of agency mortgage-backed securities richened but are still attractive, as are the high-quality tranches of other securitized products. That is why we believe it appropriate to be overweight high-quality securitized products.

As shown below, in our quarterly investment landscape that summarizes our views on the economy, valuations, and investment themes, the bottom line is to maintain a modest risk budget.

### The Investment Map: February 2020

#### Economic Landscape

Some of the macro risks clouding the outlook lifted. The impeachment process fostered cooperation on the budget, passage of the USMCA trade treaty, and the Phase I trade deal with China.

This lessened uncertainty and removed a looming impediment to the global outlook, another round of US-China tariffs.

Manufacturing activity and trade seems to have bottomed out. The US is growing near that its potential rate. Pressures on resources will likely produce a modest pickup in inflation.

We expect the Federal Reserve (Fed) to keep the policy rate at its prevailing accommodative level as long as economic expansion is not derailed.

The economies of our major trading partners will generally benefit more than the US from a diminution of trade uncertainty and their central banks will remain dovish.

#### Fixed Income Valuation

Sovereign developed market yields are expensive.

Break-even inflation offers value and provides inexpensive protection to upside surprises to inflation.

The US dollar appears expensive against other developed and emerging market currencies over the medium term.

The stabilization of macro fundamentals support corporate debt, and market technicals remain favorable, but stretched valuations and elevated leverage leaves this asset class vulnerable.

There is value in emerging markets local currency and US dollar-denominated debt.

Municipal securities are rich across the yield curve.

Valuations of agency mortgage-backed securities richened but are still attractive, as are the high-quality tranches of other securitized products.

#### Investment Themes

Keep duration short to neutral in core developed market sovereign securities.

Maintain short US dollar exposure, mainly versus emerging markets were relative carry is more attractive.

Maintain modest exposure to break-even inflation.

Retain overweight in emerging markets debt, both hard and local currency.

Maintain current corporate credit exposure and look for relative value opportunities.

Multisector portfolios should be underweight municipal securities in light of valuations.

Be overweight high-quality securitized products.

Maintain a modest risk budget.

## Vincent Reinhart

Managing Director, Chief Economist & Macro Strategist

Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

## Disclosure



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