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New Year's Resolutions

Perhaps 10 years from now, we will be able to look back at 2018 with clearer perspective. Trying to assess the long-term impact of the last 12 months is a challenging endeavor, especially when significant events are evolving as we speak. But it seems that 2018 will be characterized by the many transitions it hosted in monetary, fiscal and foreign policy. In 2028, will we view 2018 as an incubation period that laid the groundwork for sustainable global trade relations or rather one that deepened the fissures between ourselves and our allies? Will 2018 mark the year that the U.S. Federal Reserve equipped the U.S. to better withstand the next downturn or did the central bank unwittingly trigger it instead? Only in the future do definitive answers exist. But the transitions are happening today. Below we discuss the major changes that occurred in 2018 and suggest a few resolutions to prepare for the new year.

The Rise of Protectionism – The reasons behind the ongoing trade dispute between the U.S. and China are numerous and messy. The short version: the U.S. believes China is manipulating the system to gain access to and steal U.S. intellectual property (i.e., copyrighted/patented technologies). The U.S. also accuses China of constructing legal barriers that create an uneven playing field for foreign companies to compete. China denies the accusations. The threat and imposition of tariffs is being used as leverage by the U.S. to force China into negotiations. Chinese officials have responded in kind thus far; however, more tariffs are on hold bilaterally until March. This is creating a 90-day grace period that allows for substantive negotiations to take place without fear of tariff escalations. The fallout from an all-out trade war would be painful. The stalemate cast a long, dark shadow of uncertainty in 2018. It disrupted financial markets, lessened the positive impact of the GOP's tax cuts and lowered new capital investment among American businesses. The negative impact on Chinese growth is already apparent in recent data. The same may be coming for U.S. activity.

Resolution 1 – The U.S. and China must come to terms. Trade uncertainty has down-shifted the engines of the global economy into neutral. President Trump and President Xi also have strong political incentives to hammer out a truce. An agreement that addresses intellectual property theft and reopens the U.S. and China borders to each other would likely reduce the losses global risk markets endured in 2018. It could also help raise longer U.S. yields which have fallen dramatically along with growth and inflation expectations. A steeper curve would signal a healthier global outlook and potentially extend the current expansion's life cycle. We believe some form of trade agreement will be reached. Failure to deliver one during the 90-day grace period (without a deadline extension) would create fear. That would probably spell more volatility and equity weakness in 2019. However, our base-case expectation for U.S. and China to reach a new trade agreement in 2019 provides us with reason to remain optimistic about the new year's prospects.

The Fed Grows Talons – Since December 2015, the Federal Open Market Committee (FOMC) has raised interest rates nine times, from a range of 0-0.25% to 2.25-2.50%. Four of those 25 basis point increases came in 2018. At the start of 2018, the Fed predicted only three. However, a slight uptick in inflation and a tax reform boost that was difficult to quantify gave the Fed anxiety it was falling behind the curve which resulted in an additional move. The Fed telegraphed four hikes fairly early in 2018 in an effort to provide transparency. The decision backfired. U.S. data slowed and global headwinds (i.e., trade disputes, Brexit, Italy budget crisis) made the Fed's stance look overly aggressive. Equity markets increasingly viewed the Fed as a threat to growth. President Trump's highly public criticism of the Fed exacerbated the concerns. The market priced in a rising probability of a 2020 recession, U.S. yields fell and equity markets tumbled. The Fed followed through with all four signaled hikes but reduced its number of anticipated 2019 hikes from three to two at the FOMC's December meeting. However, when discussing its decision-making, Fed Chair Powell projected insufficient willingness to ease future policy should U.S. data continue to weaken. Equity markets protested again.

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Resolution 2 – The Fed must stay independent, but also patient and nimble. The Fed deserves a lot of credit for blocking out the political noise in formulating its policy in 2018. Monetary policy must remain insulated from White House pressure to ensure policy decisions are made for purely economic reasons. That said, the Fed needs to renew its vow to stay data-dependent. The urgency it felt in 2018 to tighten – via rate increases and its balance sheet unwind – was overdone. It wants to restock its quiver with more arrows to fight the next recession – an understandable goal. But doing so too quickly will bring about the downturn it dreads before it can properly arm itself. Removing unprecedented accommodation is a tough, high-stakes task. It requires cautious, meticulous action. It is highly probable that the drag of 2018's tighter policy will emerge more deliberately in 2019 data. U.S. data is already suggesting the Fed must pause and monitor this impact. We believe moving forward with its current guidance could invert the yield curve between 2- and 10-Year U.S. Treasury yields. That equates to a historically bearish economic indicator. With more patience, the Fed could reclaim a supportive role – a shift that would benefit risk markets as well as business and consumer activity.

Hello, Volatility – In 2018, U.S. equity and bond markets endured some of the most volatile trading in years. Highly uncertain policy outlooks and the reduction of Fed liquidity fueled the fire. The incredible calm of 2017 made 2018 feel all the more tumultuous. It is important to note that, while jarring, 2018's volatility is far from unprecedented. In fact, it brought the Chicago Board Options Exchange Volatility Index (VIX) closer to historical norms (Bloomberg). 2019 will house major economic and geopolitical developments from trade talks to Brexit negotiations to the start of the 2020 election cycle. While every year hosts big events and surprises, 2019's ride will likely appear more akin to 2018 than the prior years of atypical complacency.

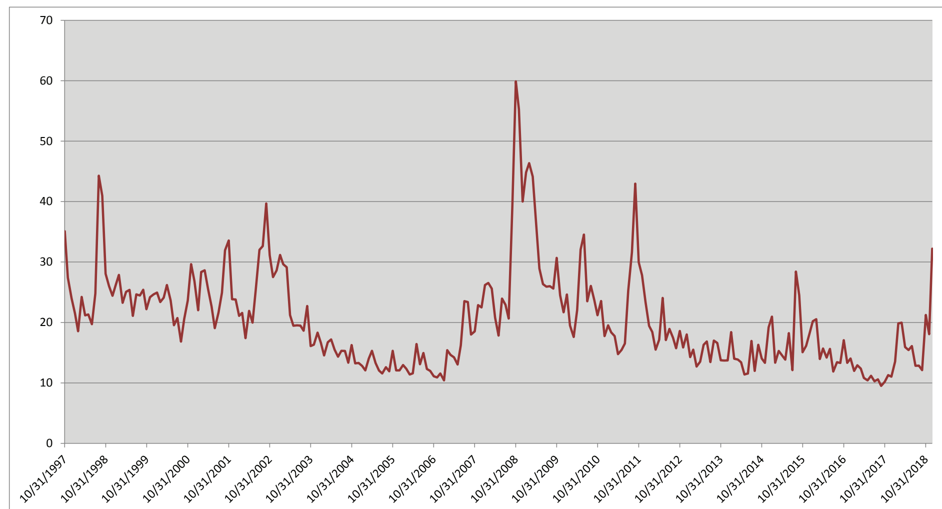

Figure 1: The CBOE S&P 500 Volatility Index (VIX) over the past 20 years measured on a monthly basis Source: Bloomberg

Resolution 3 – Stay diversified. The Fed's enormous stimulus efforts in the wake of the financial crisis created a tide that lifted all boats. The annual correlation between stocks and bonds has risen dramatically over the past decade. That trend appears to be reversing, meaning that bond performance is now better positioned to offset stock weakness, and vice versa. The power of diversification – and its ability to reduce risk – is regathering strength. This is a trend we expect to continue. Some investors have become overly concentrated in stocks as a result of seeking income during the ultra-low interest rate environment. Now is an opportune time to recalibrate allocations to benefit from a more defined inverse relationship between the two major asset classes and some of the highest U.S. yields in years.

The transitions that emerged in 2018 will shape the 2019 landscape – and beyond. We are invigorated by the countless opportunities that lay ahead and the privilege of helping you navigate them. Even for a world in constant flux, some things never change.

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