Third Quarter 2018

Economic and Market Observations: Trump, Trade, Twisters, and Trailer Parks

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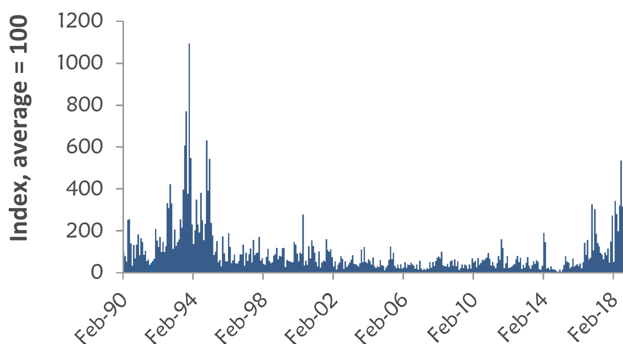
An urban legend holds that trailer parks in the Midwest attract tornados (allegedly because of their high metal content). This is scientific nonsense, of course, and gets the causation wrong about why there are relatively more newspaper headlines about damage at trailer parks. Twisters hitting relatively more densely packed, flimsily built mobile homes inflict a higher toll than those touching down in the open country or established settlements.

Figuring out the investment landscape is problematic right now because President Trump is the political equivalent of a tornado, striking unpredictably in places that are more or less able to withstand the force. The wind velocity on international trade disputes has picked up, as seen in a news count of articles about the topic touching a quarter-century high (although not achieving the commanding heights reached during the debate on ratifying the North American Free Trade Act, NAFTA).

Uncertainty about US Trade Policy



Source: Baker, Bloom, and Davis, accessed via Bloomberg, October 5, 2018.

Shelter from the storm is not equally available across countries for two of the reasons that President Trump presumably believes trade wars are "winnable."

First, the US economy is relatively closed, so trade is more important to most of our trading partners than it is to us. Trade penetration (the sum of exports and imports relative to nominal GDP) puts the US in the welterweight class along with Argentina, Brazil and Colombia, not in the league of bruisers such as Canada, Mexico and the Euro area. If uncertainty about trade policy saps confidence and investment intentions, the blow presumably is felt harder on trading-dependent nations. In retrospect, this helps to explain the unexpected slowing in Europe and Japan during the first part of the year and the backtracking on domestic reforms in China more recently.

Second, the US is cyclically stronger than most of our important trading partners, with financial accommodation still in place and fiscal impetus supporting growth this year and into next. An unemployment rate below 4 percent evidences excess demand, which is among the reasons inflation in our forecast is headed higher, albeit gradually. (More detail on our global forecast is provided in the box at the back.)

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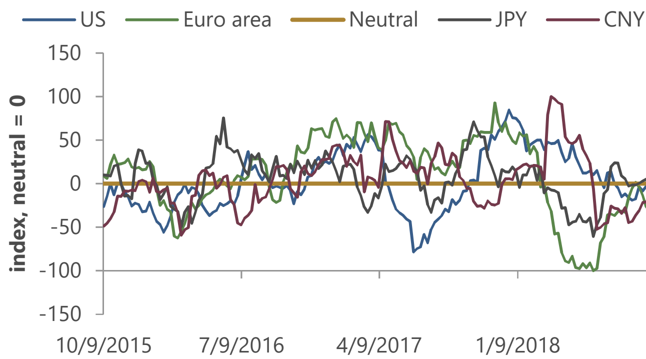
Economic Surprises



Source: Citigroup Markets, accessed via Bloomberg September 30, 2018.

However, we think the middle of the year was as good as it gets for the US, with real GDP growth slowing sequentially from the 4 percent average pace likely posted in the second and third quarters. The policy design of the Federal Reserve (Fed) is to eliminate accommodation and the fiscal boost to the level where spending rolls out of growth rates next year. Moreover, the uncertainty associated with ongoing trade disputes will impede investment. True, one twister broke up and blue skies emerged over the North American continent just as the quarter ended with an agreement in principal for a revised NAFTA. While the US-Mexico-Canada Agreement (USMCA) does not represent a material opening of trade among the three nations, it does prevent the deterioration from the status quo that clouded investment decisions.

Unfortunately, a storm alert is still in effect for other parts of the globe, probably for some time to come. The bilateral China-US trade dispute is likely to get worse before it gets better given the stakes involved. China depends on export-led growth to advance its high tech sector, and the US is suspicious of its growing global influence. We think the two sides will ultimately be driven to reach agreement as the threat of not doing so becomes evident in economic performance. But the threat has to become evident, reflected in slowing real GDP growth in both countries in 2019 and 2020.

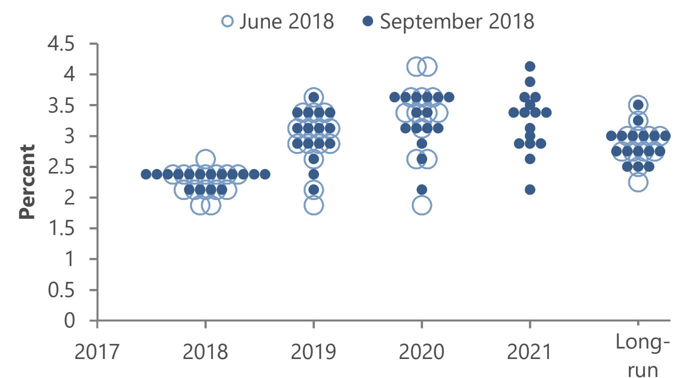
In addition to our forecast of a bumpy but relatively benign trade outcome is the assumption that other political developments will not derail expansion. This may seem heroic in light of idiosyncratic risks in important places, including the midterm elections in the US, a presidential vote in Brazil, and shambolic negotiations on the UK's withdrawal from the European Union (EU) even as Italian politicians challenge other EU officials. In our base case, politicians meet in the middle or delay, and economies muddle through. Growth in most advanced economies moves a tick or two lower, but economic expansion proceeds somewhat above the trend rate of potential output. This puts inflation on a modest upward trajectory, with the rise limited by well-anchored inflation expectations. With this backdrop and as long as commodity prices remain relatively well maintained, emerging market economies are expected to grow in the neighborhood of 5 percent through 2020, holding global real GDP growth around 3 percent.

	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
World							
Real GDP	3.3%	3.4%	–	3.1%	–	2.9%	–
Inflation	2.4%	2.9%	–	2.6%	–	2.5%	–

Source: Firm analysis as of September 10, 2018.

Our forecast for the Fed next year plows through the middle of the "dots" in its most recent Summary of Economic Projections. We think they will tighten four more times over the next four quarters, 25 basis points each time, to reach 3¼ percent one year from now. Chair Powell, among whose favorite phrases are "Let's stay in our lane" and "Let's not overthink this, people," is scaling back interest rate guidance and opting for simpler descriptions of policy design. We think, if our forecast of slowing economic growth and only a modest overshoot of inflation eventuates, the strategy that will appeal to him next fall is putting the fed funds rate on a plateau to await further developments in the economy. This is not a planned pause but a plausible resting point for policy makers, who from then on will explain themselves as data dependent and making decisions meeting by meeting in actuality as opposed to rhetorically as in the prior few years.

Summary of Economic Projections



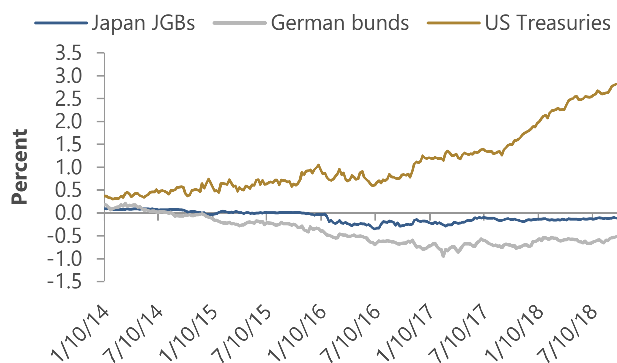
Source: Federal Reserve, accessed September 26, 2018, at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20180926.htm.

The Fed will go to the sidelines just as the European Central Bank (ECB) gets into the game and talk of lifting the yield cap begins to consume the attention of the Bank of Japan (BOJ). This is a tough, but important, inflection point on policy to call, but there are six obvious market consequences of what central banks are doing, why they are doing it, and when they would alter their plans.

First, as for the what, we expect modestly more firming by the Fed and a somewhat less inert ECB and BOJ than currently built into futures rates. As a result, sovereign yields look somewhat rich and it is best to be a bit short of the duration benchmark.

However, the US market comes closest to pricing the correct path for policy. So, second, the front end of the Treasury yield curve offers attractive yield pickup and only limited scope for capital loss as the Fed carries on with its plan.

Two-year Sovereign Yields



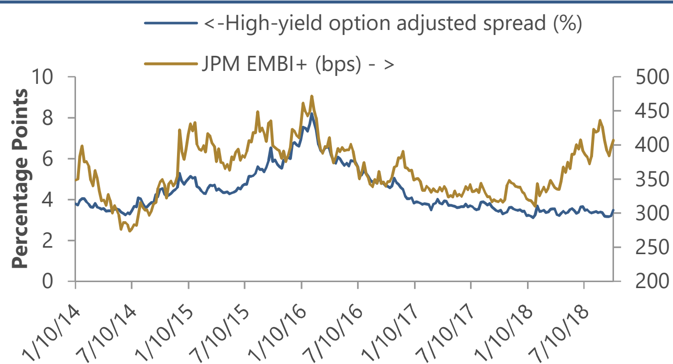
Source: Bloomberg, accessed September 30, 2018.

Third, the Fed will increasingly appear less of an outlier in the community of central banks. Recognition of this realignment eliminates the near-term support of divergent monetary policies on the foreign exchange value of the US dollar (seen in the wide spreads among the front end of sovereign yield curves). In that case, the medium-term problem of large current account and government budget deficits in the US will be seen in starker relief, tending to depreciate the currency. This is why we think that the US dollar appears expensive against other developed and emerging market currencies over the medium term. However, uncertainty about when sentiment may turn counsels executing a short US dollar position and using options strategies to limit tail risk, where possible.

The fourth opportunity relates to why central banks will be removing accommodation. Inflation is on the rise in advanced economies so that breakevens offer value along our baseline and provide inexpensive protection to any upside surprises relative to that path.

Fifth, risk assets should perform favorably if the Fed continues its measured rate increases, supports above-trend economic growth for a time, and looks the other way during a modest inflation overshoot. With fundamentals remaining strong, investment grade corporate spreads appear fair. That said, we remember that, while these are likely good times, bad loans are made in good times. Credit exposure should be limited and opportunities taken to step up the quality of holdings.

Selected Yield Spreads



Source: Bloomberg, September 30, 2018.

Pricing also matters, and the opening up of the spread between emerging market debt and US high yield corporate debt raises a perspective problem worthy of *Rashomon*. Does this wedge reveal that emerging market debt is cheap or high yield debt expensive? We shaded our view of valuation from both sides, putting relatively more weight on a mispricing on the emerging market side given that idiosyncratic political events were part of the international story. That is, high yield spreads are somewhat expensive, and market and political uncertainties create opportunities in emerging market local currency and US dollar-denominated debt.

Sixth, as for when central bankers might make a midcourse correction, staying-in-his-lane and not-overthinking Chair Powell has a higher tolerance of market upset than his immediate predecessors. Yes, if a significant, systemic selloff in US equity markets occurred, then the Fed would change its plans and scale back anticipated tightening. The hurdle of upset is somewhat higher and the reaction time a little slower. Low levels of interest volatility now counsel continuing to use option strategies to protect against a market correction and an increase in volatility in the future; it also makes securitized products unattractive currently.

As we do each month, we offer the scaffold of our thinking on market opportunities, starting from our view of the economic landscape and fixed income valuations, on which to build investment ideas.

Global Macro Views

United States	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	2.3%	3.0%	–	2.3%	–	1.6%	–
Inflation	2.1%	2.3%	–	2.2%	–	2.1%	–

Source: Firm analysis as of September 10, 2018.

While the US economy is unlikely to post growth rates as rapid as the 4 percent performance of the second and third quarters, the forces that propelled its momentum remain in place through the remainder of 2018 and most of 2019. Fiscal stimulus and regulatory relief are supporting investment and asset values. Strong employment gains and an updrift in wages give households the wherewithal to spend. The Fed is tightening monetary policy, but slowly and starting from an unprecedented level of accommodation, so that its stance is not yet tight. And credit markets and well-capitalized intermediaries remain receptive lenders. Disruptions to trading relationships have had no meaningful imprint on aggregate activity or prices, but the risk of worse to come may be impeding business planning and would jeopardize the ongoing expansion if they eventuate. Above-trend economic growth puts pressure on resources, evident in the unemployment rate near fifty-year lows and the modest tilt up in the path of consumer price inflation.

The policy rate is in motion because excess demand and inflation are piercing the Fed's goal of 2 percent. We expect the Fed to tighten four more times, bringing the policy rate to 3¼ percent by next fall. At that point, they will most likely wait. If forecasted inflation holds steady near goal, the wait may be a long one.

Fed officials provide a model of transparency and civil behavior compared with most other policy makers in Washington, DC. Our working hypothesis is that gridlock ties up Capitol Hill after the mid-term elections. If so, the headline-making events owe to executive action, which tends to be mostly about trade. The White House is picking off one trading partner at a time, from Mexico to Canada and next on to the European Union. Having brought the band back together, President Trump will extend his confrontation with China. Two preoccupations of the people in charge narrow the long, winding road to compromise. First, trade, especially the high tech sort, is central to President Xi's development plans. Second, a long-running China-US dispute may work to President Trump's political interest by firing up his base of support. Thus, the dialogue will likely continue to heat up, but we do not think it will ignite.

The only moving policy cog, aside from monetary and trade policies, owes to the calendar. As it rolls forward, the fiscal boost from legislated tax cuts and spending increases to the level of real GDP eases out of the growth rate. With monetary and fiscal policies gearing stimulus down, real GDP growth slows sequentially after 2018. We by no means have joined the camp of productivity optimists, but recent data led us to add ¼ percentage point to our assessment of real GDP growth, now at 1¾ percent.[1] If so, the Fed will manage to nudge the economy back to balance and mostly correct its inflation overshoot by 2020.

That this would be quite an accomplishment also implies considerable attendant risks, especially considering policymakers' uncertainty about their destination—the natural real short-term interest rate (r*). On this concern, along with the multiple irons in the trade-dispute fire and an almost surely contentious presidential election, we put the probability of recession in 2020 at one-in-three.

Euro Area	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	2.4%	1.9%	–	1.6%	–	1.5%	↓
Inflation	1.5%	1.8%	–	1.6%	↓	1.6%	↓

Source: Firm analysis as of September 10, 2018.

Our forecast for the Euro area economy remains below consensus forecast for this year and at consensus for next year. The risk to growth and inflation is not for this year, per se, since the hard data have cemented the forecast to within a tight range, but rather for 2019 and beyond. While the recent data indicate ongoing growth momentum, they highlight downside risk to growth and inflation, as capacity constraints are becoming more evident and large economies (Germany) are more sensitive to emerging market volatility and trade "wars." Trade skirmishes and capacity constraints are unlikely to diminish soon, so the cyclical momentum should be hindered into next year.

Monetary policy is set to remain quite loose at this time despite the tapering of the balance sheet coming in December. Moving into next year, the reinvestment flow picks up, and the ECB can shift duration somewhat to mimic a so-called European Twist. In short, we expect the ECB to move basically in line with current market expectations, with a small 10-basis-point hike at the end of 2019. Looking forward, a slow inflation trajectory will support further rate hikes, but that is a 2020 story. However, next year is a big year for the ECB, as three of the decision makers are seeing their terms on the Governing Council end: Draghi (October), Praet (May), and Coeuré (December). This means that the board will be quite different by year-end and thus the risk of a policy mistake rises.

Japan	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	1.7%	1.3%	–	1.1%	↓	1.0%	–
Inflation	0.7%	1.2%	–	1.5%	↓	1.5%	↓

Source: Firm analysis as of September 10, 2018.

Japan's economy rebounded in the second quarter from a soft patch in the prior one, with a larger-than-expected pickup in private capex. Japanese corporate profits have remained buoyant, construction remains robust, and bank lending is growing at a steady clip. These drivers of private demand have remained resilient to the mid-cycle slowdown and the maturing global trade cycle. As such, we continue to expect the economy will eke out a 1.3 percent annual growth rate in the entirety of this year. This is a touch lower than our earlier forecast—mainly due to the depth of the first-quarter slowdown and the likely disruptions to activity from recent earthquakes in Hokkaido and flooding in Osaka that have hit the tourism sector particularly hard. We think the growth rate will ease further in 2019, mainly on the worsening Sino-US trade conflict to which Japanese export-related supply chains are heavily exposed. But it should remain above potential amid accommodative policy settings and firming household consumption. Firmer real wages and greater full-time hiring should lower the country's vulnerability to exogenous shocks.

The ongoing labor market tightness, coupled with prolonged negative output gaps, should continue to raise inflation gradually. But there is also growing evidence of firms' capex in labor-saving processes. These trends may delay but should ultimately be unable to avert a further pickup in labor wages and inflation. Moreover, elevated oil prices will also boost Japan-style core (ex-fresh food) inflation. Additionally, as Prime Minister Abe has regained popularity and seems on course to getting reappointed at the lead of the LDP party, the odds of political instability have also abated. As such, we continue to see the pickup in Japanese inflation as a high-conviction, medium-term trend.

However, the upward trajectory will be more gradual than we had previously believed. We think Japanese inflation will reach 1½ percent (year over year) by 2019, but struggle to reach the BOJ's 2 percent goal. But accommodative policies should persist. Following the tweak to the yield curve control framework, and barring further stealth tapering (reduction of asset purchases), we do not think the BOJ will shuffle any closer to what could be perceived as an outright normalization of policy until the consumption tax is implemented. Doing otherwise carries a larger risk of adversely impacting the overall reflation effort.

United Kingdom	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	1.6%	1.6%	–	1.8%	–	2.0%	–
Inflation	3.0%	2.5%	–	2.4%	–	2.3%	–

Source: Firm analysis as of September 10, 2018.

[1] More about that can be found here.

In August, the Bank of England (BoE) hiked as expected—increasing the base rate 25 basis points, to 75 basis points. However, with no dissents to the decision, the hike was a tad more hawkish than expected. The BoE continues to see three hikes over the next three years in their commentary, although with inflation above 2 percent (at 2.15 percent) at the end of the forecast period and no output gap, the market may need to price in more hikes. Brexit uncertainty will stay the BoE's hand, but once a deal is done, monetary policy action is likely to occur quickly thereafter. The BoE also released their first estimate of r*, placing it in the neighborhood of 2 to 3 percent, but admitted that the near-term equilibrium may be lower. Crucially, this is higher than the market is pricing in. The focus for the remaining part of 2018 is likely to be the Brexit negotiations, which should concluded by mid-November.

Australia	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	2.3%	2.6%	–	2.8%	↓	2.7%	↓
Inflation	2.0%	2.0%	–	2.1%	–	2.0%	↓

New Zealand	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	2.9%	2.6%	–	2.4%	↓	2.5%	–
Inflation	1.9%	1.9%	–	2.2%	↑	2.3%	–

Source: Firm analysis as of September 10, 2018.

In Australia, the current environment of low wage growth and high household debt creates challenges for the Reserve Bank of Australia (RBA) to move monetary policy in either direction. We expect the next move in the RBA cash rate to be up, not down; however, do not expect a hike anytime soon.

Despite robust jobs growth in 2017, wage growth is not signaling a pickup. Even in territories with tight labor markets, such as New South Wales, which has had an unemployment rate below the estimate of its natural rate for a year, wage growth remains benign. Meanwhile, lower retail sales and savings rates may indicate downside risks to consumption. The RBA is reliant on public infrastructure spending and business investment to deliver on its growth expectations in 2019.

In New Zealand, the Reserve Bank (RBNZ) took a dovish turn this summer on the back of downbeat business confidence and downside risks surrounding growth. Our base case is for the RBNZ to keep rates on hold, but if poor business confidence is manifested in weak growth outcomes, we would expect monetary easing to occur.

China	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	6.9%	6.6%	–	6.2%	↓	6.0%	–
Inflation	1.6%	2.6%	–	2.0%	↑	1.9%	–

Source: Firm analysis as of September 10, 2018.

In China, hard data beginning late in the second quarter deteriorated more than expected, onshore stock markets have weakened, and manufacturing purchasing manager indexes (PMIs) have also begun easing. In response, authorities have placed a policy floor beneath emerging growth risks brought on by the lagged impacts of its financial deleveraging effort and the worsening trade dispute with the US. Among the measures, they have eased the pace of de-risking of wealth and asset management products, brought forward fiscal spending in infrastructure, begun issuing special bonds to ensure adequate financing, and lowered tax rates for households and corporates. Moreover, the required reserves of the banks (RRR) have also been cut for generating more on-balance-sheet lending space, even as off-balance-sheet (shadow banking) curbs remain in place.

Additionally, amid strict resident capital controls, authorities appear to be using the backdrop of trade tensions to introduce greater two-way volatility in the currency. So far at least, it has cheapened the renminbi (CNY) without hardening implied yields. Even the trade-weighted value of the currency has eased considerably without setting off turmoil in regional or global currency markets. China's overall balance of payments have held up reasonably well, even with a worsening current account position, due to large, index-inclusion-related foreign portfolio inflows into the bond market.

However, policy support is not going to be as far-reaching as in 2016, and certainly not as aggressive as in 2009. What is more, as China's economy shifts increasingly toward services and 'cleaner' industry, the nature and, especially, intensity of raw material demand is also expected to ebb. These underlying shifts also accord with heightened consumption and, as China gets richer, further outbound tourism, which will likely shift the current account into a full-year deficit by 2019.

As evidence of policy support has mounted, we have mildly raised our growth forecast for 2018, by one-tenth of a percentage point, to 6.6 percent with a balanced set of upside and downside risks. However, as the risk of a sustained, worsening trade conflict has risen, we continue to think Chinese growth will ease to a low 6-percent handle in 2019 and face further downside risk. Where we could go wrong is if the Xi and Trump somehow manage to find a face-saving way to extricate the bilateral relationship from escalating trade and geopolitical conflict.

South Korea	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP Growth	3.1%	2.9%	–	2.8%	↓	2.8%	–
Inflation	1.9%	1.9%	↓	1.7%	↓	1.6%	↓

Source: Firm analysis as of September 10, 2018.

South Korean GDP growth is on course to ease this year, in line with our expectations, but more than the market consensus. Despite a decent run of electronics exports, sluggish construction activity and lackluster consumption have become the main drags. Macro-prudential measures to curb mortgage-led household leverage and limit housing market bubbles have hurt the construction sector. Moreover, the recent minimum wage hike appears to have resulted in labor shedding, and the tech-led export cycle has been largely capital, and not labor, intensive. Additionally, the recovery of Chinese tourism flows has also been slow. All of these developments have kept output gaps from closing, with headline and core inflation trending well below the Bank of Korea's 2 percent inflation target.

We retain our longstanding view of a 'one or none' rate hike call from the Bank of Korea (BOK), and swap market pricing of higher front-end rates have eased in line with this view. A small bump in inflation, from adjustments to administered prices, may provide the excuse to the BOK to raise policy rates once, by 25 basis points,

before the year is out. This will claw back some ex-ante policy space for the central bank, ahead of a future slowdown, but it will not accomplish much else.

India	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP Growth	6.6%	7.5%	–	7.5%	↑	7.8%	–
Inflation	3.8%	4.6%	↑	4.5%	↓	4.4%	↑

Source: Firm analysis as of September 10, 2018.

Stronger-than-expected second-quarter activity underscores the recovery from the twin shocks of de-monetization and Goods and Services Tax (GST) implementation, leading us to raise the growth forecast for 2018 a touch, to 7.5 percent. We are also raising the inflation forecast by 2/10 of a percentage point on a firmer rebound, as well as a weaker rupee (INR) and higher oil prices. Consumption and investment continue to power ahead and should sustain GDP growth in a mid-7-percent handle, underpinned by favorable demographics, low debt and an improving domestic business environment. The resolution of bad loans in the banking system and recovery of credit activity, however, remains painfully slow. That will continue to impinge on actual and potential growth for a few more quarters. Core inflation will take more time to come down and elicit one or two more hikes from the Reserve Bank later this year and in 2019. Meanwhile, the current account deficit has widened to around 2.4 percent GDP, from less than 2 percent a year ago, and the contagion from other emerging markets has added to the pressure on the rupee. However, rupee depreciation has been orderly and is slowly restoring competitiveness to the economy. We do not expect any further path-breaking reforms ahead of the April-May 2019 nationwide elections.

Russia	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	1.8%	2.0%	↑	2.0%	↑	2.0%	↑
Inflation	2.8%	3.5%	–	4.0%	–	4.0%	–

Turkey	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	7.0%	3.0%	↓	2.0%	↓	3.0%	↓
Inflation	11.0%	17.0%	↑	15.0%	↑	12.0%	↑

South Africa	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	2.6%	1.0%	↓	1.5%	–	1.5%	–
Inflation	5.0%	5.0%	–	5.0%	–	4.5%	–

Poland	2017	2018	Balance of Risks	2019	Balance of Risks	2020	Balance of Risks
Real GDP	4.3%	4.5%	–	4.0%	–	3.5%	–
Inflation	1.8%	1.8%	↑	2.2%	↑	2.2%	–

Source: Firm analysis as of September 10, 2018.

The US-imposed sanction on Turkey on August 1 related to the continued detention of the American Pastor Brunson by the Turkish authorities. President Trump upped the ante by raising tariffs on Turkish steel and aluminum on August 10 and issuing hostile tweets. With President Erdogan remaining defiant against the US and Turkish authorities failing to meaningfully respond to the currency pressures through monetary policy, the Turkish lira has lost more than 45 percent via-a-vis the US dollar. Currently, we are waiting for the government and central bank's reaction to these events through the updated fiscal and monetary policy projections, which are set to be released later in September. As ever, there remains a risk of under-delivery by the authorities. At this juncture, orthodox crisis control management would suggest three actions to stop currency depreciation and ensure that Turkish entities are able to continue accessing external financing. However, we note the Turkish authorities have historically underperformed relative to markets expectations for orthodox policy. These three actions are:

1. Release of Pastor Brunson by the Turkish authorities, which has occurred, and a significant improvement in relations with the US
2. Significant monetary policy tightening and restatement of independent central bank authority
3. Adoption of a new economic policy framework

In South Africa, we have downgraded growth in 2018 but still expect higher growth in 2019 due to the positive impact from the leadership change, which leads to better sentiment among consumers and businesses and investment in the mining sector. If rand (ZAR) depreciation remains, inflation will likely trend toward the top end of the inflation band, but we not expect the South African Reserve Bank (SARB) to increase interest rates given the weak state of demand in the domestic economy. Land reform is likely to remain a contentious issue in 2018—and while the constitution is likely to be amended to allow symbolic transfers of land without compensation—we do not expect this to actually take place under the existing administration. Instead, the focus is likely to remain on the transfer of state land for agricultural purposes.

Russia will continue its process of economic recovery, aided by the significant recovery in oil prices. Inflation will remain just below the 4 percent central bank inflation target during 2018, despite the recent ruble (RUB) depreciation. We expect the central bank to cut rates more than is currently priced in during 2019. However, we continue to monitor the increased risk of meaningful sanctions being placed on Russia by both the US and EU, which could impact the economy, banking sector and debt markets.

The Investment Map Third Quarter 2018

Economic outlook	Valuations	Positioning
The trade dispute will probably get worse before it gets better, but the hit to economic activity is likely to be modest. In the US, accommodative financial conditions and fiscal impetus supports above-trend economic growth, exacerbating excess demand and putting upward pressure on costs. Despite multiple challenges, Chinese officials are likely to meet their goal for economic growth. Most other economies should grow at or above trend, as long as neither internal nor external politics derail the process. Commodity prices are likely to be range-bound. As inflation overshoots goal, the Federal Reserve (Fed) will tighten modestly more and be more willing to tolerate volatility than currently thought by most investors. With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy.	Above-trend economic growth makes developed market sovereign yields expensive. Breakevens offer value and provide inexpensive protection to upside surprises to inflation. The US dollar appears expensive against other developed and emerging market currencies. For institutional investors, municipal assets are fairly valued, with the long end looking the most attractive. With fundamentals remaining strong, investment grade corporate spreads are fair. High yield spreads are somewhat expensive. Market and political uncertainties create opportunities in emerging markets local currency and US dollar-denominated. Interest rate volatility remains low. Higher short-term Treasury yields provide attractive carry at the short end that will offset capital losses some as rates rise. Valuations of securitized products generally appear fair to rich.	Be biased toward short duration positions in core developed market sovereign securities. Maintain short US dollar exposure, where appropriate through option strategies given increased probability of tail risks. Maintain modest exposure to breakevens. Remain overweight EM assets. Maintain modest credit exposure but look to gradually step up the quality of the holdings. Rotate from short-duration municipal securities to longer duration ones or taxable bonds, where appropriate. Maintain modest underweight in MBS and emphasize ABS versus CMBS. Continue option strategies with minimal cost to keep portfolios sufficiently convex.

Take idiosyncratic opportunities to reduce risk.

Source: Firm analysis as of October 17, 2018

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