

STRATEGY NOTE

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2018 WAS A YEAR TO FORGET...

WILL BEARS & POLITICIANS TAKE OVER MARKETS IN 2019?

HIGHLIGHTS

- The market rout intensified into the year-end sending major US Indices into correction territory. From their peak, the S&P 500 and the Dow Industrial Average are down 17.5% and 16.3%, while the tech heavy Nasdaq Composite is 22% in the red.
- Oil is still in free fall and is now down more than 37% from a high of \$86/bbl in October. This is despite the OPEC+ agreement to cut output yet again after a few months of expanding production. Main culprits are a weakening global demand outlook and an expanding US production.
- Treasury yields seem to be starting to trend back down while the US yield curve is flattening which is intensifying concerns about an upcoming US slowdown and perhaps an outright recession.
- Financial conditions in the US are tightening. Corporate spreads in both the HY and IG space are trending up, market volatility is back and this time it seems that it's back to stay.
- Despite a rate increase in December, the fourth this year, the Federal Reserve has toned down its language significantly along with its economic outlook. Markets are becoming increasingly convinced that there are only 2-3 hikes remaining in the current tightening cycle.
- Growth in the global economy is projected to continue to grow albeit at a slower rate. Trade tensions, however, if not resolved, will have a taxing effect on the global economy. Export based economies such as China and Japan will be especially vulnerable, but the ripple effects would be spreading to a much wider circle.

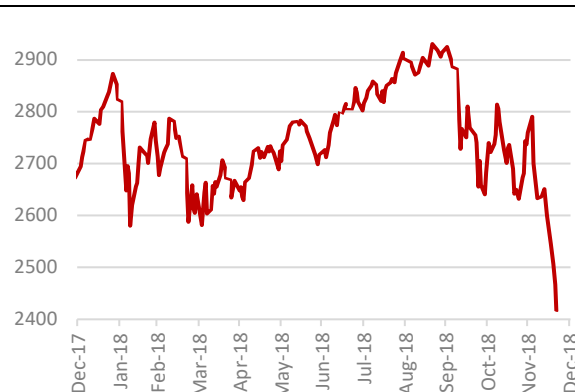
A YEAR TO FORGET

The year 2018 would probably prove to be the year where politicians and geopolitics played a bigger role in determining market conditions than any other economic or fundamental variable in recent history.

The Brexit saga took its toll on the UK market and it seems to be still far from ending, while Italy's budget dilemma and the most widely spread and violent protests in France in years, in addition to the post-Merkel transition in Germany, are adding to the uncertainty of the investment environment in Europe. The factor which seems to have had the most impact on the markets this year, however, remains by far the presidency of Mr. Trump. He renegotiated NAFTA with Mexico and Canada and managed to replace it with the USMCA. He pushed for the implementation of protectionist trade policies and imposed tariffs on allies and non-allies alike which is leading to trade tensions among the largest global economies and hurting global growth. He also withdrew from the Iran nuclear agreement which contributed to the volatility in oil markets. He has also been publicly criticizing the Fed Chair J. Powell over the rising interest rates. These are just some of the factors that contributed directly and indirectly to the market sell-off that started around the beginning of October.

Global markets are poised to end 2018 deep in the red. The MSCI World All Country Index is down 12% year-to-date with one week left till year-end, while the MSCI Emerging Markets Index and the Euro Stoxx 600 down 16.8% and 13.5% respectively. Major US Indices, although they appear to be doing comparatively better on a year-to-date basis, they are all in correction territory when measured from their October peaks. The S&P is now down 17.5% from the peak, the Dow Industrial Average is down 16.3%, while the tech heavy Nasdaq Comp is 22% in the red.

Chart 1. S&P 500 Performance



Source: Bloomberg, NBKC

Chart 2. BRENT Performance



Source: International Energy Agency (IEA), NBKC

The market selloff and the return of volatility have been triggered by a host of economic and political factors. Early in October comments by Fed chair J. Powell in which he suggested rates

are a “long way” from neutral were blamed for the initial sell off. Shortly after, the IMF downgraded global growth for 2018 and 2019 citing trade wars and geopolitical tensions. It specifically warned about a slowdown in emerging markets which are the main source of growth in oil demand. Oil prices tumbled by more than 37% from their October highs and didn’t recover despite the OPEC+ agreement to cut production...again. The deal seems to have merely provided a rather fragile and temporary floor for prices until further clarity on demand development and US production materializes over the coming months.

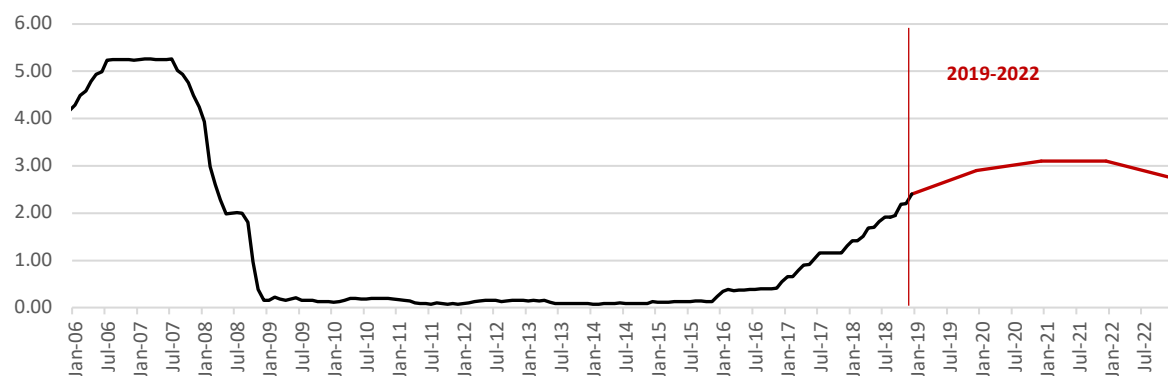
Investors’ fears were exacerbated by concerns of a looming global economic slowdown and even a possible recession. The global economy is facing headwinds from a strong dollar, intensifying trade wars, and a flat yield curve, while the US economy is showing signs of weakness and is expected to witness a deceleration in growth over the coming quarters.

US ECONOMY

The Fed

Around the beginning of October expectations were for another three to four hikes in 2019, but things started to change quickly after the market selloff started in early October. Suddenly, markets seemed to be facing a host of challenges that all became the focus of analysts at the beginning of the fourth quarter and market confidence in the Fed path during 2019 seemed much more uncertain. The December FOMC meeting was highly anticipated for cues on the way forward.

Chart 3. Effective Federal Funds Rate – Historical and Projections



Source: FRED Federal Reserve Bank of St. Louis, Federal Open Market Committee (FOMC), NBKC

As was widely expected, the Federal Reserve raised its target rate for the fourth time this year to a range of 2.25-2.50% in December. This makes it the 9th rate hike in the current cycle which started in December 2015. Even though the December hike was largely discounted by investors, the accompanying statement and economic projections did little to appease markets. There seems to be much less certainty about the future direction of the Fed path going into 2019 and beyond even within the FOMC itself. The Fed Chairman have given two conflicting statements about the neutral rate in the span of less than two months. In early October he suggested that rates are a “long way” from neutral, then in late November, he

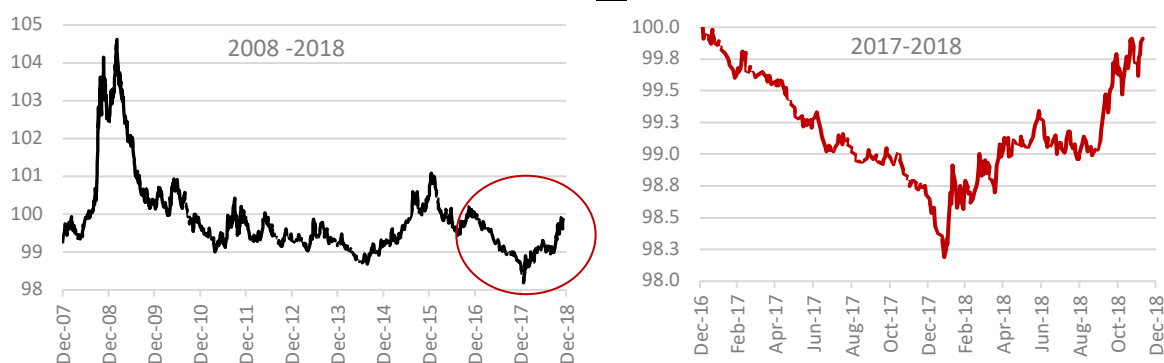
said that interest rates “remain just below the broad range of estimates of the level that would be neutral for the economy”.

The summary of economic projections accompanying the December statement showed some changes in the expected path of rate hikes and a more dovish stance overall. Now only two hikes are projected next year down from three back in September. The median rate for 2019 as per the December Dot Plot is now 2.90% down from 3.10% 3 months ago, while that of 2020 and 2021 is 3.10% down from 3.40%. The long-term neutral rate is 2.75% compared to 3.0% previously. In terms of major economic indicators, the Fed now sees US GDP growing at 3.0% in 2018 and 2.3% in 2019 down from 3.1% and 2.5% in September. Projections for 2020 and 2021 remained stable at 2.0% and 1.8% respectively. Inflation projections, on the other hand, have moderated from 2.10% to 1.90% in 2018 and from 2.0% to 1.9% in 2019 compared to September. These dovish projections and downward projections were seen as a confirmation of fears of an upcoming slowdown and helped tightened the bear hug on the markets.

A few days prior to the FOMC meeting, a survey by the Wall Street Journal (WSJ) pointed that all but one of the 60 economists polled expected only two hikes in 2019 down from the three they expected the previous month. Around half expected a rate hike in March, while 28% expected the Fed to stay put until June. Others pointed to low inflation and trade tensions as possible reasons for policy makers to adopt a wait-and-see stance during the first half of next year. Beyond 2019, economists surveyed by the WSJ expect the FOMC to finish raising rates by 2020 and actually start an accommodating cycle by late 2021. Their median forecast called for the federal funds rate to increase to 2.89% by the end of next year, then to 2.93% by mid 2020 before slipping back 2.90% by the end of the same year then declining to 2.82% by the end of 2021. An earlier forecast in November had expected rates to peak at 3.15% in 2020.

Tightening Financial Conditions

Chart 4. Goldman Sachs US Financial Conditions Index



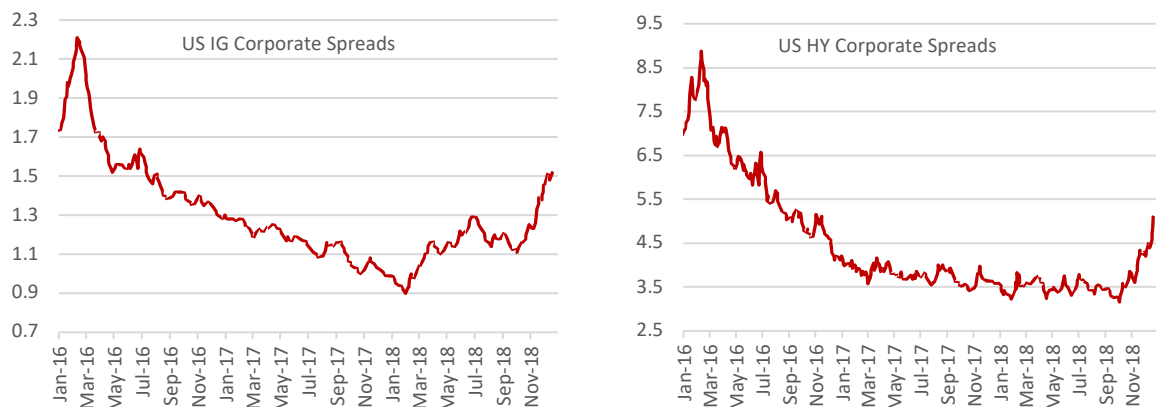
Source: Bloomberg, NBKC

Financial conditions indices measure the health of financial markets using a combination of indicators including short-term and long-term treasury rates, credit spreads, dollar value, and equity prices. One of the most watched of such indices is the Goldman Sachs US Financial Conditions Index (GS USFCI) depicted above. The higher the index the tighter are the financial

conditions. The GS USFCI, while still below the highs of early 2016, has been trending higher since January 2018 and the move higher has been accelerating since the beginning of October. In fact, the index has risen by around 85 basis points since the beginning of October coinciding with the start of the decline in the equity markets and the spike in volatility.

Another indicator of financial markets stress is the reversal that seem to be happening in credit spreads. The expansion in the US investment grade corporate spreads started back in February after reaching a low of 0.90%. They moved to a high of 1.30% on the 2nd of July then eased up to 1.11% in the beginning of October before expanding by 40 bps to 1.52% currently.

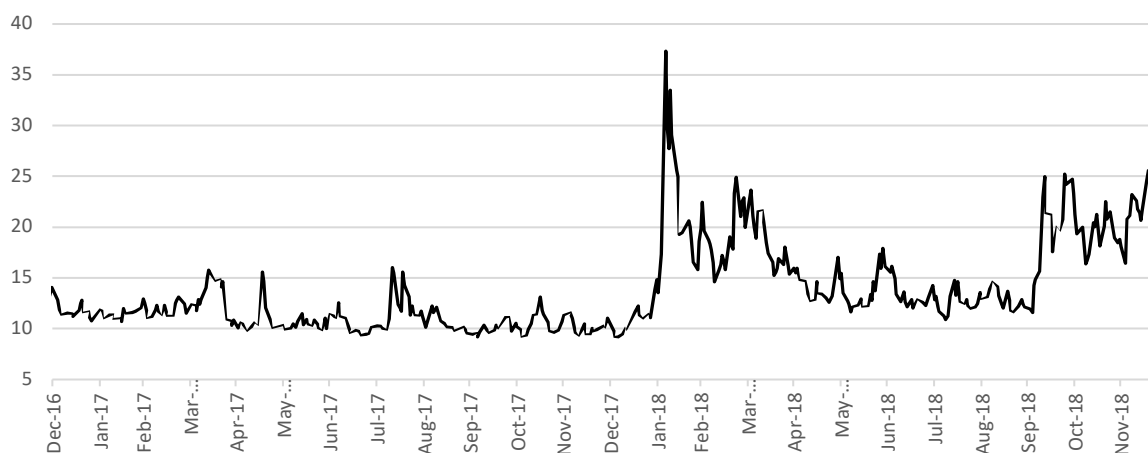
Chart 5. US Investment Grade and US High Yield Corporate Spreads



Source: FRED-Federal Reserve Bank of St. Louis, NBKC

The move in the High Yield space, on the other hand, was concentrated in the fourth quarter of this year and was much more pronounced. After having trended down for the longer part of the last two years, US high Yield Corporate spreads jumped by 195 bps to 5.11% since October. Whether this trend will continue and for how long will be highly dependent on the interest rate environment and development in the overall economy.

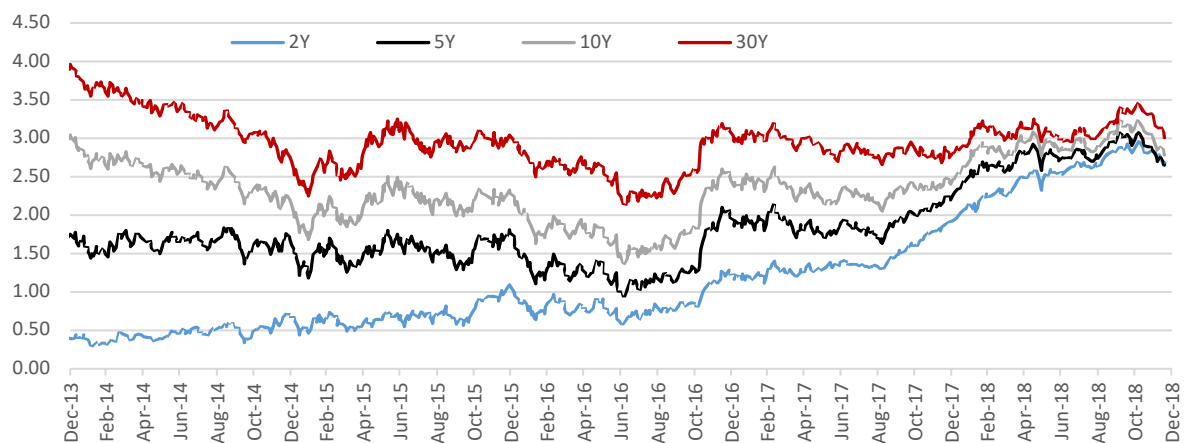
Chart 6. CBOE Volatility Index



Source: FRED-Federal Reserve Bank of St. Louis, NBKC

Volatility is also back to the markets especially in the past couple of months. The CBOE Volatility Index (VIX) receded after a spike in February and has since been generally trending lower with occasional spikes that quickly dissipated. It did, however, jump in early October with the start of the market rout and, excluding the February spike, has reached a new high for the year. Volatility had, in fact, spiked on several occasions throughout the year but the ensuing market dips were short-lived. The buy-the-dip behavior, which prevailed throughout most of the year, turned into sell-into-strength post-October and began to feed a downward spiral that is still acting in full force.

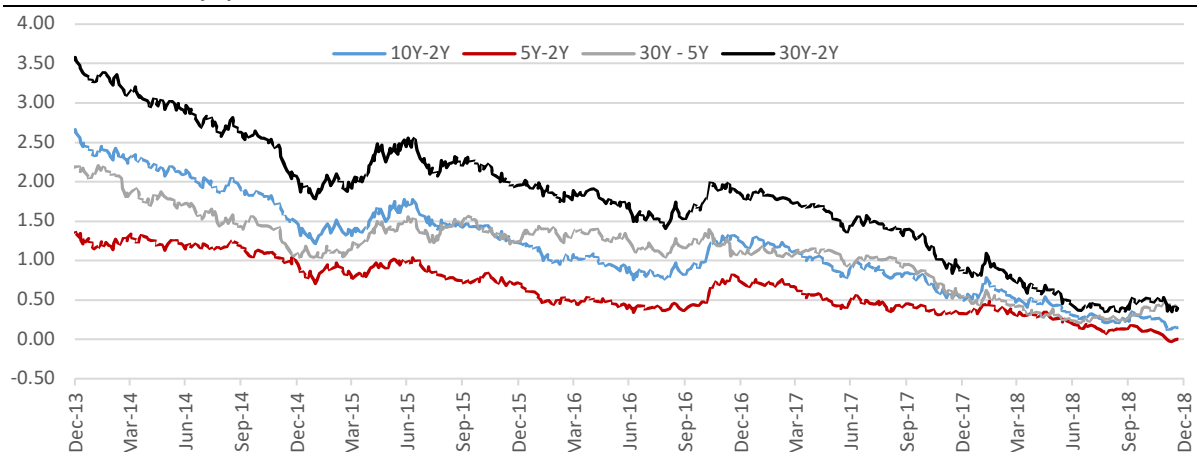
Chart 7. US Treasury Yields Across Maturities (2014-2018)



Source: US Department of Treasury, NBKC

Tightening US financial conditions are also manifesting in the behavior of US treasuries and the yield curve. Spreads across maturities have been steadily declining as the shorter-term rates have been rising much faster than the longer-term rates since the Fed started the current tightening cycle.

Chart 8. US Treasury Spreads Across Maturities

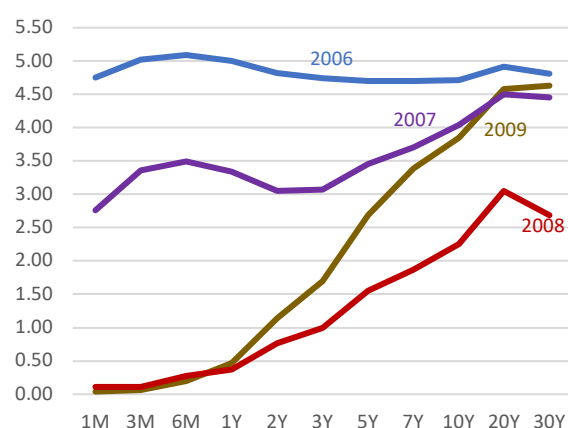


Source: US Department of Treasury, NBKC

The spread between the 5-year and the 2-year treasury has actually turned marginally negative in December, while the spread between the 10-year and 2-year treasuries has been fluctuating between 10 and 15 bps in the past few weeks.

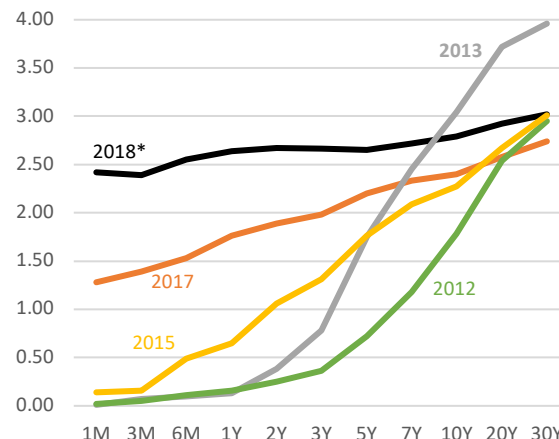
This has resulted in a practically flat yield curve that is even slightly inverted across medium term maturities. This could potentially have serious consequences on the availability of credit in the economy as it would affect the willingness of banks to lend. This would in turn bite into the profitability of the banking sector, degrade the financial wellbeing of households, and hurt the profitability of businesses, and investors.

Chart 9. US Treasury Yield Curve Leading Up To 2008



Source: US Department of Treasury, NBKC

Chart 10. US Treasury Yield Curve 2012-2018



Source: US Department of Treasury, NBKC

Note: * 2018 yield curve as of 20 December 2018

A flattened yield curve is seen by many economists as a precursor or an early indicator of an upcoming recession with a lag of around two years. This has been the subject of a multitude of discussions recently which is compounding the worries of investors and adding to the downward pressure on markets.

THE GLOBAL PICTURE

Table 1. World Economic Growth Forecast

Gross domestic product, constant prices	2016	2017	2018	2019	2020	2021	2022	2023
World	3.27	3.74	3.73	3.65	3.66	3.64	3.58	3.59
Advanced Economies	1.71	2.34	2.36	2.13	1.72	1.68	1.54	1.48
Euro Area	1.89	2.39	2.03	1.88	1.65	1.55	1.45	1.41
Major Advanced Economies (G7)	1.48	2.14	2.19	2.00	1.49	1.49	1.31	1.24
European Union	2.04	2.66	2.20	2.03	1.81	1.73	1.67	1.63
Emerging Market and developing economies	4.39	4.72	4.68	4.68	4.93	4.88	4.82	4.84
Emerging and developing Asia	6.46	6.54	6.52	6.31	6.42	6.31	6.18	6.11
Emerging and developing Europe	3.27	5.98	3.77	1.98	2.83	2.55	2.56	2.75
Middle East and North Africa	5.19	1.79	2.00	2.55	2.92	2.97	3.03	3.02
China	6.72	6.86	6.60	6.18	6.22	6.00	5.75	5.60

Source: International Monetary Fund, World Economic Outlook Database, October 2018

In its World Economic Outlook published in October, the IMF downgraded the performance of the global economy and warned of the particular vulnerability of emerging markets. The IMF cited increasing trade tension and geopolitical instability as main drivers for the slowdown.

Another challenge that would be faced by the global economy is the rising interest rate environment in the United States and the lack of synchronization among major global policy makers. While the US Federal Reserve is in the middle of a tightening cycle, most of the rest of the world is still easing. This has been feeding an already strong dollar and making new and existing debt for emerging market economies even more expensive.

Chart 11. Trade Weighted USD Index



Source: FRED-Federal Reserve Bank of St. Louis, NBKC

The lack of synchronization among global central banks doesn't seem to be ending any time soon. The Bank of Japan remains in easing mode with economists seeing inflation heading back to zero in the coming year especially with energy prices tumbling. The Japanese economy is export driven and a slowing growth in China added to trade tensions and Brexit chaos will not be of any help in reversing the current trend.

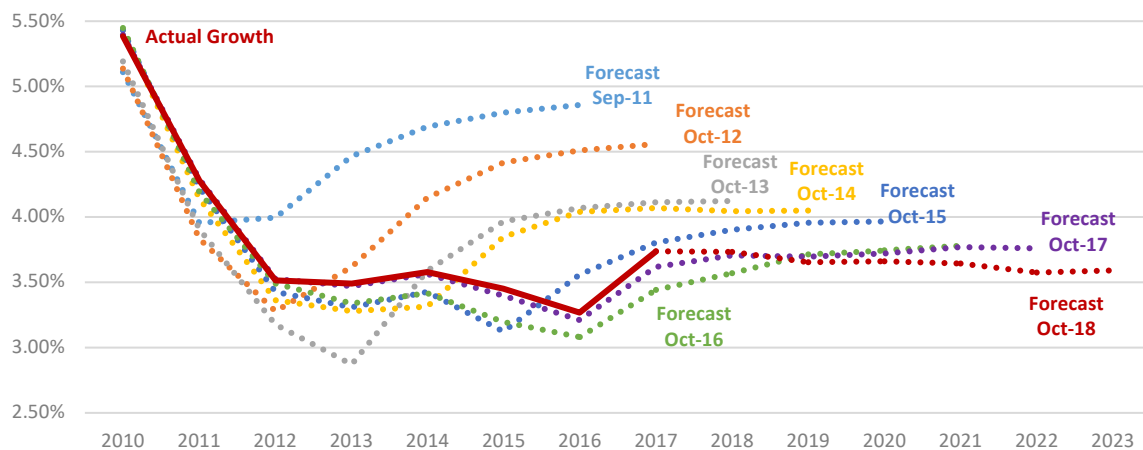
At least in terms of expectations given currently available data, the ECB will not be starting its interest rate hiking cycle until the Fed is almost finished. The European Central Bank (ECB) just announced it is stopping its massive 2.6 trillion-euro bond-buying program ending around four years (since March 2015) of quantitative easing. The Governing Council said maturing debt will still be replaced for an "extended period of time past the date when it starts raising the key ECB interest rates", and that rates will remain at record lows "at least through the summer of 2019". This is now likely going to be pushed back until end of 2019 after the FOIMC statement and the global markets reaction.

In the UK, on the other hand, the question marks around Brexit keeps getting bigger and until a resolution is reached it will be extremely challenging to add to the stress in the markets by raising rates.

The chart below adds confirmation to the concerns surrounding global growth in the coming few years. It depicts the IMF projections for the global GDP growth for the past 8 years since September 2011. Notwithstanding the fact that the IMF projections for the past seven years have practically failed to materialize, this year marks the first time over this period that the IMF's projections for the next five years show a downward slope. Global growth is projected to decline from 3.73% in 2017 to 3.59% by 2023. It sees growth for Advanced Economies decelerating to 1.48% from 2.34% in 2017, while that of the Euro Area down to 1.41% from 2.39%. Notably, the Chinese economy is seen growing below 6% for the first time in decades.

Growth in the Middle East and North Africa, however, is projected to grow from around 2.0% currently to a little over 3.0% in the next five years. It is worth noting though that these projections were issued just before the crash in the US markets and the 37% slide in oil prices, the latter being a major determinant of growth in many of the middle eastern oil exporting countries.

Chart 12. IMF World GDP Growth Historical Forecast



Source: International Monetary Fund, World Economic Outlook Database- (October 2018), NBKC

FINAL THOUGHTS

The path of the monetary policy in the US will be a major determinant of market stability. Despite a rate increase in December, the Federal Reserve has toned down its language significantly along with its economic outlook. Markets are becoming increasingly convinced that there are only 2-3 hikes remaining in the current tightening cycle and that the US economy will continue to grow during the coming 2-3 years albeit at a significantly lower rates than before and under a benign inflationary environment.

The year ahead seems to be a pivotal year in determining whether the growth in the global economy post the financial crisis will continue and at what rate. Much will be contingent on the development of the geopolitical scene and the manner in which trade disputes will evolve. A lack of resolution or an intensification in trade wars will surely have taxing effects on the global economy. The effects would be most pronounced in export-based economies such as China and Japan, but the ripple effects would spread to a much wider circle.

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