January 10, 2019

2019 Outlook: Will the Fed Bring on Recession?

Executive Summary: We believe the Fed will continue to raise rates this year and economic conditions in the US will continue to soften. Risk aversion (with the Baa-Aaa now at 115 basis points) should continue to climb on the Fed's hawkish path. We expect the UST 10-year yield will move to 2.5% by the end of 2019. Our base case is for the S&P 500 to reach 2400 by year end. This is predicated on Powell raising rates at least once this year, causing a ~10% selloff before recovering. We expect the gold price to rise to $1350/oz. But so long as US GDP remains positive, a reflationary impulse should prove welcome relief for commodities, commodity-linked emerging markets and dollar-denominated debtors. If GDP falls below 2% and unemployment moves above 4.6%, it should furnish the case for a Fed pause. We expect oil to rise by at least 30%, ending the year around $60/bbl. We predict the euro will end the year at $1.20/€, the yen at Y103/$ and the yuan at CNY7.2/$. If the Fed pushes the funds rate to 3% or higher this year, we believe recession will follow. This would likely send the gold price above $1400/oz, the UST 10-year yield below 2% and the S&P 500 below 2000.

2018 Review: 2018 began promisingly with the Tax Cuts & Jobs Act in tow. But it was to be defined by three main risk variables: 1) Fed policy, 2) trade tensions (especially with China) and 3) political uncertainty (the midterm elections and the continuation of the Mueller probe).

Capital markets remained confident for most of the year that they could shoulder on despite such headwinds. On September 26, Powell suggested a "put" to markets, saying that a replay of tightening financial conditions like late 2015/early 2016 might produce a Fed pause. By October 3, 2018, the S&P 500 was up 8.5% on the year. But in an after-hours interview that day, Powell told Judy Woodruff the Fed was a "long way from neutral, probably"

The comment -- which suggested the current rate hiking campaign may extend well beyond 2018 -- touched off punishing market volatility that continued up to Christmas Eve.

On November 28, Powell offered a "walk back" of October 3, but risk aversion continued as the Fed appeared dead set on raising rates a fourth time. Meanwhile, other Fed hawks made clear that even reaching the "neutral rate" (estimated around 3.25%) would not mean a pause on rate increases.

Following a December 19 rate hike, despite emerging pockets of weakness in the US economy and abroad, Powell added that the process of reducing the balance sheet $50bn/month would stay on "autopilot." This comment, in addition to hawkish jawboning by other Fed hawks, reinforced market anxieties that the Fed would continue to pursue contractionary rate policy all through 2019 and beyond.

As we made the point to clients in October, it was far better to be in bonds than in equities. The S&P closed 14.3% lower on the year at 2506.81, in contrast to our January 2018 expectation for a 14% increase. Meanwhile, the UST 10Yr yield would end the year at 2.68%, close to our predicted 2.75%.

Among other important developments of Trump's Year II were: 1) the appointment of Justice Kavanaugh to the Supreme Court, through a contentious hearings process, 2) the nomination failure of hawk Marvin Goodfriend to the FOMC, 3) the announcement of a "trade truce" between the US & China at the G20 summit in late November, and 4) the troop withdrawal announcements on Syria and Afghanistan, along with the departures of "perpetual war" advocates Defense Secretary Jim Mattis, Chief of Staff John Kelly and UN Ambassador Nikki Haley.

2018 Midterms: Going into midterm elections, Democrats, led by Nancy Pelosi, unified around a platform pledge of protecting the social safety net; including healthcare, e.g. preserving Obamacare, expanding it, or campaigning on Medicare for All. In contrast to a confusing message on healthcare offered by the GOP, the Democratic position proved decisive.

On November 6, a "blue wave" swept over the House of Representatives, with Democrats winning about 40 seats, giving them a 15+ seat majority in the next Congress and control of tax legislation via the House Ways & Means Committee. The GOP increased its Senate majority by two seats.

All talk of additional tax cuts from House Ways & Means Chair Kevin Brady and the "lame duck" Republican Congress quickly evaporated. Similarly, talk of indexing capital gains for inflation fizzled out with only meager lip service from Treasury Secretary Steve Mnuchin.

2019 Outlook: Hawkish Fed Remains Clear & Present Danger

Could 2019 be a repeat of 2018?

Recall how 2018 began with the Fed forecasting four rate hikes, while futures markets were pricing in only one. The rest is arguably history.

A similar expectations gap exists today between the FOMC and markets.

If a hoped-for summit between Powell and President Trump materializes (as Kudlow has hinted recently), it may encourage Fed dovishness this year and reduce the expectations gap between markets and the FOMC. As with hawkish jawboning, the gap is a set up for more volatility.

One rate hike in 2019 may be enough to send equities crashing. Two would likely assure recession.

Without a "dead body" floating to the surface in distressed financial markets, there is a greater likelihood of a Fed rate increase than pause during the first six months of 2019.

Even more, Powell could implement two rate hikes in 2019 and still claim the Fed is exercising "patience" relative to the four-rate-hike schedule of 2018.

True patience, in our opinion, would equal a 12-month hiatus coincident with a recovery in capital markets, the economy, and a decline in risk aversion.

We see slim possibility of that.

While it may look as if the Fed is moving closer in line with market sentiment given its recent rate rhetoric, directionally, it remains headed in the wrong direction. Voting FOMC members, apart from Jim Bullard, support the notion that the neutral rate is 3-3.25%. (This is especially true for voter Charles Evans, who suggested a 6-month pause today).

More likely, the Fed will raise rates at least once and then announce a wait-and-see posture.

It's possible uber dove St. Louis Fed Jim Bullard argues for a rate reduction soon after the next rate increase. But typically rate reductions come amid a recessionary environment, as the economy's job generators have already sputtered out and unemployment is rising.

During the past quarter century, rate reductions not coincident with recessions include major dislocations. For example, a February 1, 1995 rate reduction came one month after the US coordinated a $50bn bailout for Mexico and a September 29, 1998 rate reduction followed the LTCM bailout just days earlier and the August 2018 Russian devaluation. The precedence for a 12-month pause was late 2015/early 2016, when the Fed backed off its forecasted four-rate-hike schedule to implement just one in December 2016. **Bottom line: The Fed's voting majority appears wedded to a hawkish agenda and remains the biggest risk to financial markets.**

Trade Policy: China-US Dispute to Continue:

The agreement of a December to March 1 trade war truce seemed to inject a sense of optimism that discussions between DC and Beijing would produce some agreement to reduce trade tensions. For the American side, China would deliver tangible results on IP theft protection, the end of forced technology transfers in joint ventures and the elimination of non-tariff barriers to US products. This would lead to tariff relief on the Chinese side.

If no progress is made by March 1, Trump has promised to raise the tariff rate on some $200bn in Chinese exports to 25%.

Unfortunately, we do not see Beijing offering such tangibles. **The threat of more tariffs on the horizon for China is very high.**

President Xi may be willing to accept higher tariffs as the cost of doing business with the US, until he is ready to transform China's trading model. Soy purchases may continue despite higher tariffs.

Chinese policymakers may permit a de facto slow-drip devaluation policy to mitigate the pain of higher tariffs. Last year, despite the introduction of 10% & 25% tariffs by the US, the yuan devalued about 10% against the dollar, helping to mitigate some of the tariff news. Therefore, a blanket 25% tariff on all Chinese goods, which Trump has threatened before, may witness of replay of yuan weakness.

While higher tariffs will create stronger headwinds for a Chinese economy decelerating well before any Trump tariff emerged, we see it mostly as a mainland equity negative. US markets may see a 2-3% impact from the China variable.

But to the extent Europe's economy remains largely dependent on Chinese trade and investment, we expect additional headwinds for Euroland coming out of this. Of course, core policymakers in the EU are mostly bereft of pro-growth fiscal ideas and remain tied to the fiscal austerity, so such a scenario would likely kill hopes for an end to the ECB's dovish posture. It could also furnish an additional reason for the Powell Fed to abandon hawkishness.

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Equities: S&P to End Year Lower. We believe Powell starts the year as a "hawk," but ends it as a "dove." In a positive scenario, if Powell agrees to an extended pause for most of the year, like 2016, we could see the S&P 500 appreciate 8% on the year, to reach 2800. Any shift to dovishness by the Fed should allow small cap stocks to outperform large caps.

But our base case is for Powell to commit the error of a 2019 rate increase. We believe this will cause a ~10%s correction in equities and force Powell to abandon hawkishness later in the year. **Accordingly, we see the S&P 500 ending the year 4-5% lower than it began, at ~2400 by year-end.**

Treasuries: Growth Threats to Drag Yield Lower. We continue to respect the oil/gold signal as a spot indicator of economic contraction/expansion. Generally, when the oil/gold ratio zooms above its long-term moving average of 15 barrels per gold ounce, it suggests economic deceleration at the margin and vice versa when it sinks below 15:1. Although it had reached extremes of more than 29:1 in late December, it has since moved back to a quite elevated 26:1.

This ratio works very well in suggesting the direction of the UST 10Yr yield, enjoying a strong correlation during the past twenty-four months.

If the Powell Fed stops signaling a multi-year rate increase campaign, we could see a welcome decline in the oil/gold ratio to ~18:1, which could send yield rates above 3.2% again.

But should any threats to economic growth arise, such as implementing the two rate hikes forecasted last December, we should expect the oil/gold ratio to rise past 28:1 and the 10Yr yield to collapse below 2%. **Bottom line: We expect the UST 10Yr to end the year at 2.5%.**

Gold, FX, Oil & Attractive Commodity Opportunities with Pause in Play

Gold to Rise. The melt up in the gold price since October (~8%) suggests declining demand for dollars due to slowing economic growth. A higher funds rate under a slowing growth scenario could push the gold price to $1375. Two rates hikes with recession to follow would likely encourage gold to $1400/oz. Assuming Powell raises rates at least once this year, we expect gold to rise above $1350.

So long as US GDP does not go negative, a reflationary impulse should prove welcome relief for commodities, commodity-linked emerging markets and dollar-denominated debtors. **Bottom line: We expect gold to end the year at $1350.**

FX: Yen Strength Likely. Given the inverse correlation between the Japanese yen and the dollar-gold price, our forecast for a year end gold price of $1350/oz suggests yen strength ahead. **We expect to end the year at Y103/$.**

Yuan Weakness Likely. We believe the steepening inversion between the US2M and CH2M will lead to further weakness in the Chinese yuan in 2019. **We expect the yuan to end the year at CNY7.2/$.**

Euro Strength Likely. Given the correlations between the oil price and the euro, our expectation for higher oil price leads us to expect euro strength in 2019. **We expect the euro to end the year at $1.20/€.**

Oil to Rise, Despite Volatility. We viewed $35/bbl as a potential bottom in late Q4 2018. But the 20% rally that's transpired since the December 24 low of $42.86/bbl appears built on the assumption that the FOMC has resolved to pause.

It hasn't.

Given our baseline expectation of at least one rate increase from the Fed before a pause, we expect more volatility for oil.

Still, we believe the commodity could move toward $60/bbl following a Fed shift to dovishness later in the year. **Bottom line: We expect oil to reach $60/bbl by year-end.**

Attractive Commodities Assuming Fed Pause. In the following chart, one can see that the decline in the Thomson/Reuters CRB Index (in orange) has been inversely correlated to rising risk aversion as expressed by Moody's Baa-Aaa spread (in blue).

We see this related both to the China slowdown and contractionary Fed policy.

Risk aversion can stabilize or decline if the Fed embraces dovishness in 2019. Under such a scenario, there will be attractive opportunities for appreciation in several commodities.

The **best long opportunities in commodities** based on BWR's tracking of the historic ratios between gold and 29 commodities reside in three groups: **energy** (oil and natural gas), **metals** (platinum and nickel) and **softs** (sugar and coffee). Palladium stands out as one potential short.

Bretton Woods Research's Commodity Matrix Assuming $1300 Gold Price

Category	Commodity	Recent Price (Spot/Index)	BWR'S Long-range Price Target	Pct Change Past 12-Months	Potential Upside/Downside
Energy	Oil (West Texas Intermediate)	47.96	70.63	-23.82%	47.26%
Energy	Natural Gas (Henry Hub)	2.80	4.12	-4.44%	47.08%
Energy	Unleaded Gasoline (US Retail)	2.24	2.96	-17.06%	32.18%
Energy	Coal (Penn Rail Car Coal)	63.75	58.71	41.20%	-7.91%
Grains	Rough Rice (1st mo future)	10.23	13.13	-12.68%	28.38%
Grains	Soy (S&P GSCI)	365.86	451.74	-4.38%	23.47%
Grains	Corn (S&P GSCI)	316.20	377.62	9.74%	19.42%
Grains	Wheat (S&P GSCI)	350.81	396.78	19.61%	13.10%
Meats	Lean Hogs (S&P GSCI)	90.85	121.02	-16.97%	33.21%
Meats	Live Cattle (S&P GSCI)	416.13	447.12	2.97%	7.45%
Meats	Lamb (frozen carcass)*	139.28	147.08	-0.87%	5.60%
Metal	Uranium 308 (Evolution Mkts)	24.63	39.91	-90.96%	62.03%
Metal	Platinum	798.51	1,248.49	-17.32%	56.35%
Metal	Nickel (LME)	11,042.50	15,740.03	-12.65%	42.54%
Metal	Silver	15.70	19.68	-8.26%	25.31%
Metal	Aluminum (LME)	1,869.75	2,192.64	-12.40%	17.27%
Metal	Copper (LME)	5,897.25	6,730.66	-16.46%	14.13%
Metal	Lead (LME)	1,938.00	2,187.81	-24.13%	12.89%
Metal	Tin (LME)	19,578.50	20,235.02	-1.99%	3.35%
Metal	Iron Ore (China 62% Ferrous)*	70.58	71.78	-3.35%	1.69%
Metal	Zinc (LME)	2,510.00	2,541.27	-25.09%	1.25%
Metal	Palladium	1,268.60	907.02	15.44%	-28.50%
Softs	Sugar (S&P GSCI)	125.58	189.41	-19.01%	50.83%
Softs	Coffee (Arabica 1st mo future)	101.60	147.26	-18.82%	44.94%
Softs	Lumber (1st mo future)	329.90	471.60	-30.03%	42.95%
Softs	Orange Juice (1st mo future)	121.30	161.24	-10.41%	32.92%
Softs	Cotton (S&P GSCI)	103.19	120.82	-7.44%	17.09%
Softs	Bananas (US)*	0.57	0.66	2.72%	15.76%
Softs	Cocoa (S&P GSCI)	92.73	107.13	24.33%	15.53%

*Sources: IMF, BLS, Bloomberg includes S&P Indices, Futrres and Dominant Spot Prices (*Most recent value from IMF/BLS Series)*

Bottom line: We see significant upside opportunities in commodities with a Fed pause.

Sectoral Outlook for a Metamorphic Fed: Be Ready to Flip Leaders & Laggards

Investors must be nimble given that market sentiment can turn on a few words from the Fed. The ongoing recovery in risk-on sectors such as technology, industrials and energy make sense given the market's optimism of a Fed pause for 2019. It also makes sense that risk-off sectors such as healthcare, utilities and consumer staples are lagging the broad market.

Assuming Powell raises rates, we would expect the relative performance of sectors to flip and would adjust accordingly.

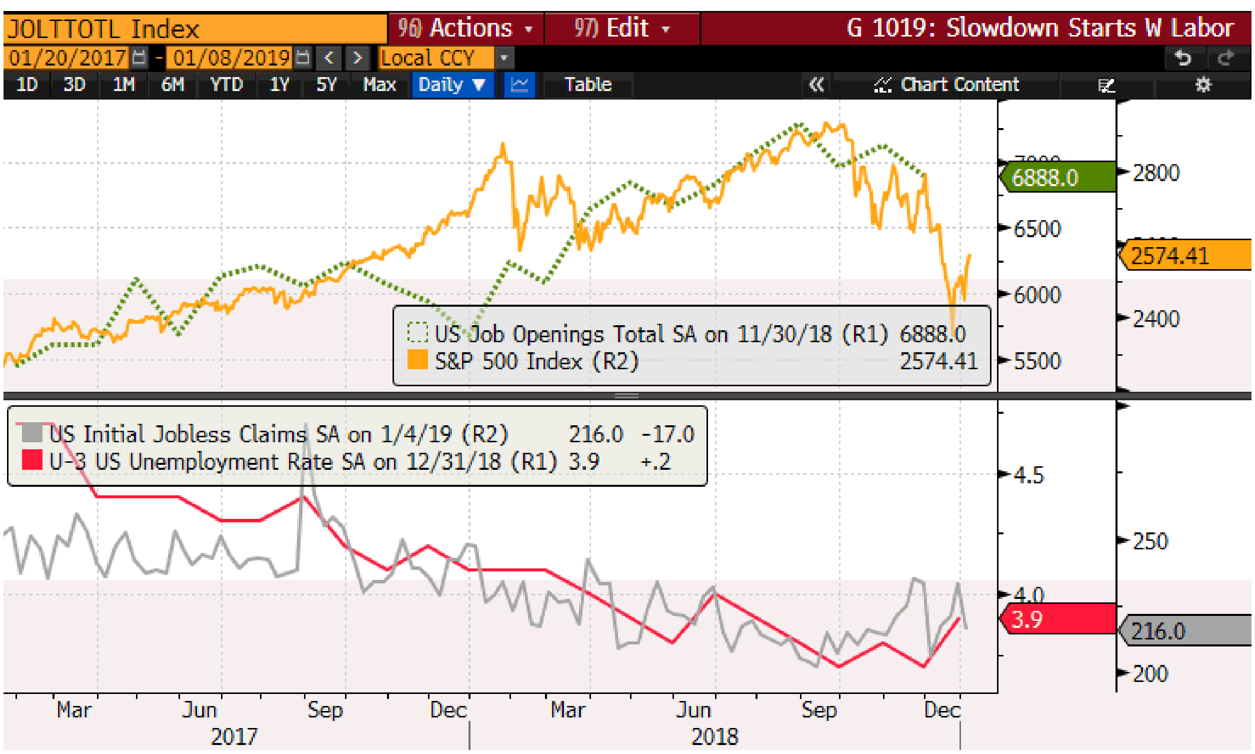
Economic Statistics to Worsen: Unemployment, GDP, CPI

We believe unemployment will trend higher (above 3.7%), GDP lower (below 3%) and CPI will remain flat-to-lower (2.0% and lower) in 2019.

Unemployment Rising. Phillips Curve-minded Fed officials view unemployment at 3.9% as below the non-accelerating inflation rate of unemployment (NAIRU), which is today estimated at 4.55%. This is a majority view.

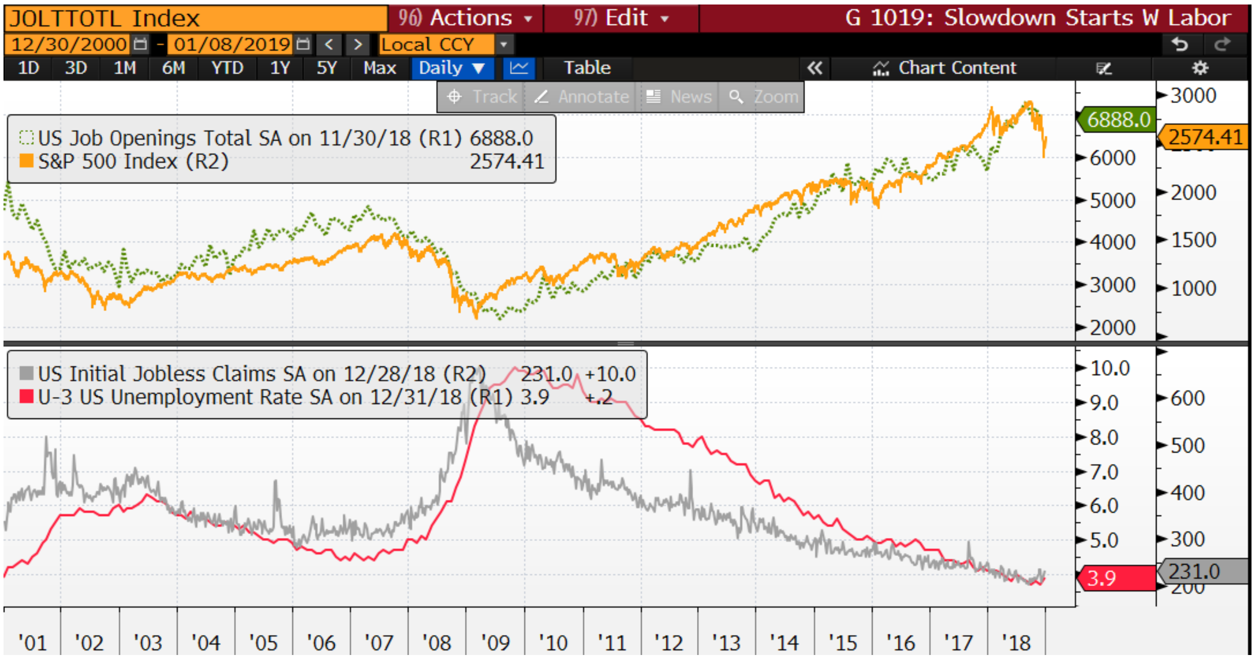
Of course, this is a Phillips Curve concept, which is invalid. Inflation/deflation are not caused by changes to the labor market, but changes in the value of the dollar.

The case that Fed rate hikes have already softened the economy, including the labor market, are clear enough in the rear-view mirror. As one can see in the following chart of the S&P 500 (in gold), total job openings (green dash), initial jobless claims (in grey) and U3 unemployment (in red), there is a strengthening case that job openings peaked in August, initial jobless claims bottomed in September and unemployment bottomed in November of last year.



With the funds rate in restrictive territory, unemployment increases from an historically low level of 3.7% are likely to be acceptable trade-offs for the Powell Fed. For 2019, we expect unemployment to climb in saw-tooth manner to about 4.2% under a Fed pause; 4.5% or higher if the Fed continues to increase rates. **This should weaken equities.**

Here is how the pattern has played out between labor weakness and the S&P 500 since 2001.



Bottom line: Unemployment rising above 4% is unlikely to produce a Fed pause, but 4.6% probably will.

Slowing GDP. In the same basket of flawed Phillips Curve thinking at the Fed is the idea of the “longer run potential growth rate.” In practical terms, the longer run potential growth rate simply becomes an approximation of what US GDP might be if unemployment is at NAIRU and inflation is under control (PCE deflator is below a 2% at 1.8%).

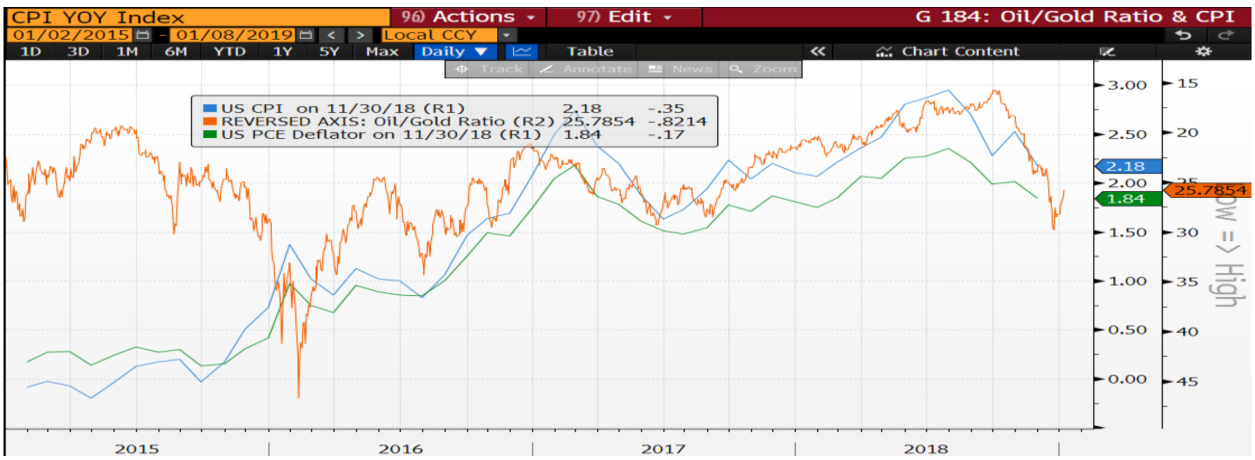
We view the FOMC’s estimates of the longer run potential as indisputable baselines of where one might see the Fed’s hawks go into repose. Of course, a GDP growth rate of 1.9% and official unemployment rate of 4.6-4.5% are nearly identical to the macro conditions prevalent during the last four months of the Obama Administration.

Thus, the Fed’s institutionalized preference for sub-3% GDP growth greased the skids for its counterproductive rate increases last year. It also puts it on a course of direct confrontation with President Trump, who championed GDP growth rates of 3% or better during the 2016 election.

The FOMC estimates GDP will slow to 2.3% by year end. We believe that's optimistic. Given the blowout in equities, growing pockets of weakness in the economy (housing, autos, financials, etc.), a weakening labor market, along with the cumulative drag of previous rate increases, we believe GDP will likely fall to 1.9%. **Bottom line: Under a Fed pause, we believe it's likely 2019 GDP will hit 1.9%. If the Fed continues to signal rate increases into 2020, GDP may slow to 1.5% or less.**

More Lowflation in 2019. In general, we see slowing growth likely to keep downward pressure on prices. In terms of CPI or the Fed's favored inflation figure, the PCE deflator, we expect continued undershoot of the Fed's 2% inflation target. CPI will likely come in at 1.9% or below in the coming months, with PCE coming in about 1.6%.

We believe this is likely given the extremes in the oil/gold ratio late last year and how that tends to lead statistical inflation measures. This can be seen in the following chart of CPI (blue), the Oil/Gold ratio (reversed axis in orange) and the PCE deflator (in green).



Bottom line: If rate hikes continue, we would expect the chronic undershoot of the Fed's inflation target to persist in 2019.

One caveat is if the Fed communicates a pause for more than 6 months sometime during the next two quarters. Like 2016, this would create conditions for a recovery in the oil/gold ratio back toward 15 barrels per gold ounce. In such a scenario, the CPI and PCE could make a saw-tooth climb higher, with PCE moving back to 1.9%, even slightly over 2% by year end so long as economic conditions recover.

Washington Politics, Mueller & the Fed

DC Politics & 2020. Under House Speaker Nancy Pelosi, we don't expect much promising legislation in terms of tax policy, infrastructure policy or immigration reform. With the House Ways & Means committee going to Democrats, we don't see much positive likely to come into tax legislation. But we will be on the lookout for any Roth IRA type of innovations from new House Ways & Means Chair Richard Neal.

As with 2018, Democrats likely see positions that protect/enhance the social safety net as the most attractive platform vis-à-vis generic Republicans. Therefore, we expect Pelosi to position herself and caucus as a protector of the social safety net. **Any deals made with Pelosi will likely require some claw back of the Trump Tax Cuts.**

Therefore, we don't expect healthcare reform to go anywhere. At most, Pelosi may attempt to introduce measures to shore up Obamacare, but they may not go anywhere in the GOP-controlled Senate. Recycling the victorious focus on the social safety net they used in 2018, Democratic leadership may see a "healthcare fix" platform for 2020 as a unifying theme to promote all rank-and-file Dems and their presidential candidate to power.

Mueller Threat Low. We see little threat of President Trump's removal from office with the ongoing Mueller probe. Impeachment may be taken up by the Pelosi House, but only if Democrats were sure such a move were likely to gain traction in the Senate: unlikely in a GOP-controlled Senate where a 2/3 supermajority is necessary to convict. Additionally, removal would bring on the prospect of President Mike Pence. Pence's social positions would likely be far to the right of Trump's. Certainly, his neoconservative brand of foreign policy is. **Bottom line: We believe Trump's removal from office is a very low probability risk.**

Political Dimensions of Fed Hawkishness. In terms of the political arena, we believe Trump has staked out the high ground on the critical debate over interest rates. Therefore, if a "stubborn" Powell raises rates and subsequently causes a recession, Trump will have "won" the blame game. To the extent Fed apologists have argued the president lacks removal power of the Fed Chairman (we disagree), the more Powell hawkishness will undermine public trust in an institution that lacks direct oversight or accountability. **Bottom line: Fed hawkishness is a limited political negative for Trump. It is arguably a greater political liability for the Washington Establishment and Democrats, so long as they support or keep silent on higher rates.**

Geopolitical Risks Broadly on the Decline: President Trump has begun to make good on promises to avoid foreign conflicts and return US troops home. In December, Trump announced he would be withdrawing troops from Syria and 7,000 of the 14,000-troop presence in Afghanistan.

Although there has been some walk back on logistical terms, ISIS has been broken in Syria. Meanwhile, Damascus has been in talks with Syria's Kurds, who fear Turkey may now move to crush Kurdish nationalists who no longer enjoy the direct support of troops and material.

The departures of "permanent war" school of advisers including National Security Adviser H.R. McMaster, Mattis, Kelly, et al., strongly suggest Trump intends to make his anti-interventionist brand of foreign policy stick.

Despite rhetoric by Secretary of State Mike Pompeo, the possibility of direct conflict with Iran is declining. Additionally, relations with North Korea are not deteriorating. A formal truce to the 1950-53 Korean War would be a dramatic triumph for President Trump. A summit with Russia's Vladimir Putin may even be possible. Prioritizing diplomacy over war benefits the US dollar and should prove popular.

Tail Risks:

- Fed becomes more hawkish;
- Failure of a TBTF financial institution;
- EM Default/Devaluation;
- Fall of Saudi Arabia/Venezuela/Iran;
- War: Russia vs Ukraine, Syria vs Turkey;
- Violence in the South China Sea;
- Brexit Postponed;
- European Banking Crisis erupts;
- Mueller Bombshell;
- House Impeachment Proceedings.

Bretton Woods Research