Economic Update
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First Quarter 2019 Review

The Juke. The best athletes have applied this tactic across a broad range of sports. The offensive player indicates he is going one way; then, with ankle-breaking speed, reverses direction and speeds past the defender, leaving the opponent with a quizzical look and broken ego. Devin Hester, a former NFL punt and kick returner, was one of the best at juiking defenders. (See link to his highlight reel here.) His ability to change direction without notice was second to none.

But the award for “best juke” in Q1 goes to the Federal Reserve. After months of communicating to investors that “we are a long way from neutral” interest rates, that the economic expansion can continue “for quite some time, effectively indefinitely” and that the balance sheet normalization is on “auto-pilot,” the Fed executed an about face even Devin Hester would envy! The Fed announced a pause to its rate-hiking campaign and a plan to wind down its balance sheet runoff in the coming months. (Figure 1) The Fed went from signaling three 25 basis points (bps) hikes in 2019 at the September 2018 Federal Open Market Committee (FOMC) meeting to signaling no hikes at the March 2019 FOMC meeting. (Figure 2) The Fed cited slowing household spending and declining inflation for reasons to be patient with monetary policy.

Other central banks followed suit, pivoting to a more dovish stance. The European Central Bank (ECB) signaled rate hikes would not occur until at least the end of 2019, downgraded growth and inflation expectations and announced another targeted longer-term financing operation (TLTRO) coming later this year. The Peoples Bank of China (PBOC) continued to ease monetary policy, in coordination with fiscal stimulus measures, in an effort to boost the country’s slowing economy.

The shift to a more dovish monetary policy offset fears of decelerating global growth. As a result, global equities and credit performed well in the first quarter. Government bonds also rallied as global growth expectations declined with the 10-year Bund yield trading negative for the first time since October 2016. The 10-year U.S. Treasury yield dropped to the lowest level since December 2017 during the quarter. Commodities generally rallied in Q1, with West Texas Intermediate (WTI) up 32.4%. (Figure 3)
Outlook

As we highlighted in “Where Are We in this Economic Cycle?” on April 8, 2019, the U.S. is in the later stages of the business cycle. Growth has persisted for nearly 10 years, notching the second-longest expansion in the post-war period. However, cumulative economic growth has been the shallowest of all the U.S. post-war expansions, with an annualized real growth rate of just 2.0%. (Figure 4 and Table 4) Since the middle of last year, global economic momentum has decelerated across both developed and emerging economies, as measured by the Citi Economic Data Change Index, although signs of bottoming may be appearing in China. (Figure 5) In the U.S., the closely watched 3-month to 10-year Treasury spread briefly inverted, an early warning sign that recession could be on the horizon. The Conference Board Leading Economic Indicator, which tends to dip below zero on a year-over-year (YoY) basis in the six to 12-months prior to recession, is still signaling expansion at 3.0% YoY. (Figure 6)

Monetary tightening by the central banks had formed a key headwind for global growth in the second half of 2018. This no longer appears to be an issue as the Fed has put rate hikes on hold and will end its balance sheet runoff policy this year.

Will the dovish central bank pivot be enough to extend the economic expansion?

As long as inflation remains muted, central banks can err on the side of caution. This appeared to be the case at the end of the first quarter, given muted price pressures as measured by core Consumer Price Index (CPI) and core Personal Consumption Expenditures (PCE) price index. Low unemployment and late-stage cyclical factors, such as higher wage growth, are not yet translating into higher realized inflation and inflation expectations.

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1 The Citi Economic Data Change Indices measure economic data relative to 1 year averages. A positive reading means that economic data have been better than before and a negative reading means that economic data have been worse than before.

2 The Conference Board Leading Economic Index (LEI) - The composite economic indexes are the key elements in an analytical system designed to signal peaks and troughs in the business cycle. The leading, coincident, and lagging economic indexes are essentially composite averages of several individual leading, coincident, or lagging indicators.
Outlook (cont’d)

Government Bonds
In previous notes we have expressed concern over government bonds and the poor supply/demand dynamic. While cyclical factors may continue to drive Treasury yields over the near term with yields moving in line with economic data, structural factors may push yields higher over the medium or long term as budget deficits grow and external demand potentially wains. (Figure 7) We remain neutral on government bonds over the near term with a less constructive outlook over the long term.

Corporate Credit
The Fed pause is supportive of so-called carry trades, including credit. That said, the growing size of the corporate credit market coupled with tight credit spreads leads us to prefer securitized credit over corporate credit. Along with investment-grade corporate credit, the leveraged loans market has increased substantially and is now the same size as the U.S. corporate high yield market at $1.2 trillion. (Figure 8) A deterioration in credit quality could lead to elevated ratings downgrades come the next recession.

Figure 6
Source: Bloomberg, DoubleLine

The Conference Board Leading Economic Indicator
Leading Up to Recessions
Year-over-Year

Months Leading up to Recession

Figure 7
Source: Bloomberg, DoubleLine. Red shading indicates periods when the economic data is coming in lower than the 12-month rolling average, as measured by the Citi Economic Data Change Index.

Figure 8
Outlook (cont’d)

U.S. Dollar
We continue to believe the dollar will likely decline over the medium term if growth stabilizes abroad. The growing budget deficit coupled with the persistent current account deficit should weigh on the dollar. So far the dollar has been quite stable. Despite the Fed’s dovish pivot from the Fed, the data out of Europe and Asia have continued to undershoot the U.S. (Figure 9) In general, the data in Europe and China have been weak, though recent purchasing manager index surveys of business sentiment in China and German business sentiment signal stabilization. In addition, the dollar has benefitted from U.S. investors repatriating funds from abroad back into U.S. assets. This was largely driven by one-off corporate tax reform in 2018. (Figure 10) If international growth improves and international equities begin to outperform U.S. equities, these investment flows could reverse.

Global Equities
The backdrop for global equities remains supportive given the ongoing economic expansion and the recent shift by central banks to more accommodative policies. We prefer to allocate to equities outside of the U.S., particularly emerging markets. Economic momentum in emerging markets has started to outperform that of the U.S., which could lead to emerging markets equity outperformance. (Figure 11) Our negative outlook on the dollar is also supportive of emerging markets, which historically exhibit negative correlation to the dollar.

In summary, the global economic backdrop is less vibrant than it was last year. That said most of the indicators we monitor, barring a few early warning signals (e.g., curve inversions), suggests the economic expansion remains intact. A major headwind to growth, central bank tightening, has dissipated with the broad-based dovish pivots by the major central banks. With the Fed in particular on hold, risk assets could continue to perform well as long as the economic data hold up. Structural factors such as growing budget deficits and reduced foreign demand make us less constructive on Treasuries over the medium and long term. However, we remain neutral on government bonds in the near term as they could receive support from cyclical forces. Credit may perform well in the current environment, but a cyclical downturn over the medium term could cause significant re-ratings in the sector. The incoming economic data will continue to be our ballast, helping us to avoid getting juked by market surprises. Good luck.
Definitions of Select Terms

**Basis Point** - A basis point (bps) equals 0.01%.

**Bloomberg Commodity Index (BCOM)** - An index calculated on an excess return basis that reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

**Consumer Price Index (CPI)** - A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living; the CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

**EM Sovereign Debt** is represented by Bloomberg Barclays EM Sovereign TR Index—The Bloomberg Barclays Emerging Markets USD Sovereign Bond Index tracks fixed and floating-rate US dollar-denominated debt issued by EM governments. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications.

**Eurostoxx 50 Index** - A stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Borse Group and SIX group, with the goal of providing a blue-chip representation of Supersector leaders in the Eurozone.

**Eur/USD** - The currency pair EUR/USD is the shortened term for the euro and U.S. dollar pair or cross for the currencies of the European Union (EU) and the United States (USD). The currency pair indicates how many U.S. dollars (the quote currency) are needed to purchase one euro (the base currency).

**ICE BAML U.S. High Yield Index** - Tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

**Institute for Supply Management (ISM) Purchasing Managers Index (PMI)** - An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

**Investment Grade** - Refers to the quality of a company’s credit. In order to be considered an investment grade issue, the company must be rated at ‘BBB’ or higher by Standard and Poor’s or Moody’s. Anything below this ‘BBB’ rating is considered non-investment grade.

**JP Morgan Emerging Market Currency Index (EMCI)** - A tradable benchmark for emerging markets currencies vs. USD.

**Morgan Stanley Capital International All Country World Index (MSCI ACWI)** - A market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, including both developed and emerging markets.

**Morgan Stanley Capital International All Country World ex-U.S. Index (MSCI ACWI ex-U.S.)** - A market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, including both developed and emerging markets but excluding the United States.

**Morgan Stanley Capital International Emerging Markets (MSCI EM)** - An index that covers 23 Emerging Market countries and is designed to capture the large and mid-cap representation across those countries.

**MSCI Emerging Markets (MSCI EM)** - An index that covers 24 Emerging Market countries and is designed to capture the large and mid-cap representation across those countries.

**Nikkei 225 Index** - A price-weighted index comprised of Japan’s top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.

**Personal Consumption Expenditures (PCE) Index** - Measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

**Russell 2000 Index** - A subset of the Russell 3000 Index representing approximately 10% of the total market capitalization and measuring the performance of the small-cap segment of the U.S. equity universe.

**S&P 500 Index** - A market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. The index is widely regarded as the best single gauge of large-cap U.S. equities.

**S&P/LSTA Leveraged Loan Index** - An index designed to track the market-weighted performance of the largest institutional leveraged loans based on the market weightings, spreads and interest payments.

**Spread** - The difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

**U.S. Corp IG** - The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

An investment cannot be made directly in an index.

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