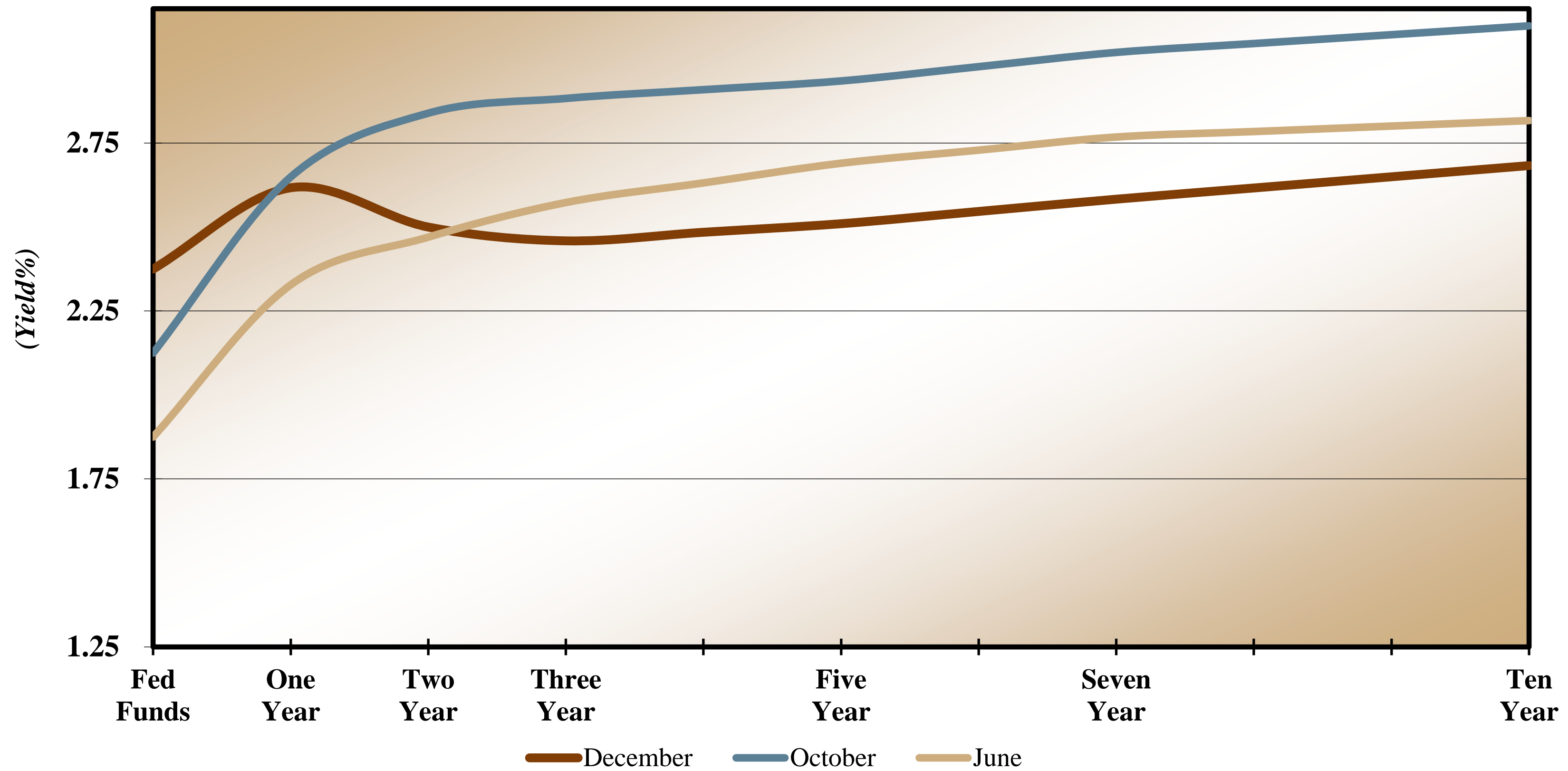
General Economic Outlook

2019 & 2020

Executive Advisory



Yield Curve Dynamics

	Fed Funds	One Year	Two Year	Three Year	Five Year	Seven Year	Ten Year
June	1.875	2.328	2.470	2.573	2.690	2.768	2.817
October	2.125	2.649	2.839	2.883	2.935	3.020	3.099
November	2.125	2.701	2.831	2.858	2.887	2.975	3.060
December	**2.375**	**2.617**	**2.500**	**2.459**	**2.510**	**2.583**	**2.683**
Incremental Change		0.242	(0.117)	(0.041)	0.051	0.073	0.100
Incremental Change by Year		0.242	(0.117)	(0.041)	0.025	0.037	0.033
Cumulative Change		0.242	0.125	0.084	0.135	0.208	0.308

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Double, double, toil and trouble; Fire burn and cauldron bubble.
...By the pricking of my thumbs, Something wicked this way comes.

William Shakespeare
Macbeth, Act IV, Scene 1, 1606

Something happened at the end of 2018. We moved from a country confident in its outlook, to one with profound questions about the future.

As indicated by the comparative Yield Curves on the prior page, we made a tangible shift in the fourth quarter of 2018. We finally entered the era of the dreaded *"Negative Yield Curve."* For some this is only a mild curiosity, but for those who manage money, this has potentially profound implications. In late December, the 2-3, 2-5 yield relationships went negative. In fact, as you can see in the Curve on the previous page, everything from the One Year through the Seven Year went negative. Although the 2-10 (the *classic* Curve) continued to maintain 15 bp's of spread, a reversal in this area seems all but certain, most likely occurring within the next 6 to 9 months.

This is significant because a negative Yield Curve has preceded every post-war recession, and this history goes back much further. The implication going forward is that this signal conflicts with the Fed's official outlook. The Fed sees a reduced, but comfortable in their eyes, growth rate of 2.25 - 2.50% GDP in 2019 and 2.00 - 2.25% in 2020.

They see this slowdown as being a healthy development which should lead to a slight increase in the Unemployment Rate, which they see as being the result of an increased participation rate. All of which will contribute to dampening inflationary pressures, which they seem to see as their greatest obstacle to economic stability. This, of course, is diametrically opposed to the Market's outlook for reduced inflationary expectations, fully realizing that the Fed has failed to meet their inflationary targets for at least the last six of seven years.

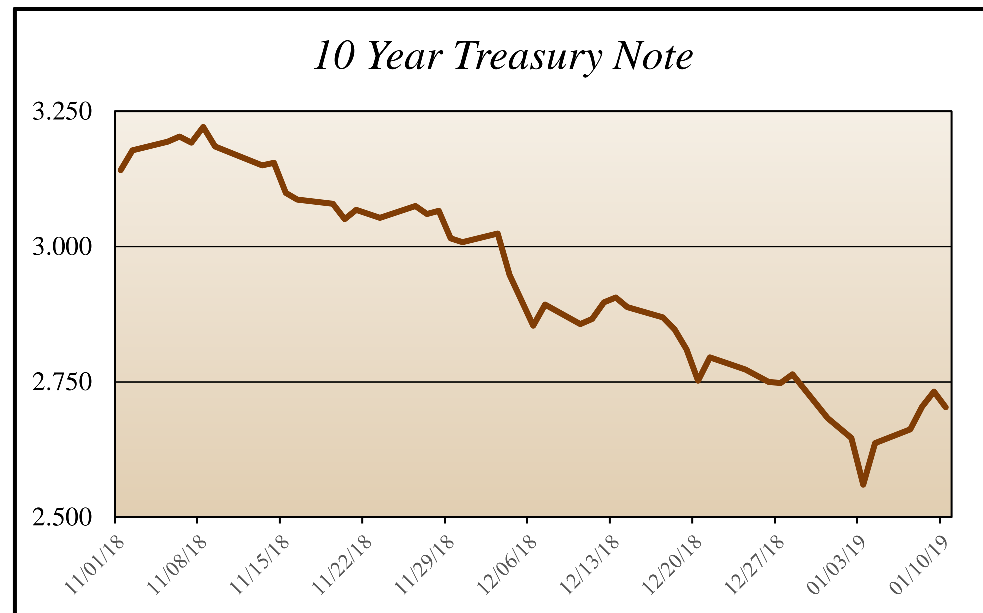
This sets the stage for a tumultuous 2019, which promises to be reach Shakespearian proportions. At the end of 2018, we had an extremely difficult time with valuing the Portfolios, which I will address in more detail below. We have also had an extremely difficult time establishing a Forecast of the 2019 Budgeting process. I literally changed, back and forth, at least six times about whether or not to show a Rate increase in 2019.

This dilemma boils down to the fact that the Fed indicated as recently as October, that they would be increasing rates at least three times in 2019 and would not be finished. In December, even in the face of incredible market volatility, they still indicated that they intended to move at least twice in 2019. This is in the face of the *"Market"* seeming to believe that the Fed should be signaling a *"pause"* at the very least, if not at least a nominal easing to avoid a recession.

This is more than just an academic issue. While the Fed is moving full steam again, as they always have during this stage in a recovery, the Market recognizes the impact that Quantitative Tightening is having on the markets and the economy. The Fed seems oblivious to this very harmful process, which removes enormous amounts of Liquidity each and every month.

The graph of the 10 Year Treasury Note activity from November through early January on the right shows the market sentiment during this period.

The 75 bp decline in the yield on the 10 Year Treasury Note indicates that the Market believes that the Fed made a tremendous "Policy Error" and they were willing to put their money where their mouth was.



Based upon the above events and anticipated issues in 2019 and 2020. The Market is expecting a "Pause" in Fed activity in 2019. In our Budget Forecast, we have assumed that there will be a single rate increase in 2019. This is not because we think that it represents good policy, rather it is because the Fed seems to stubbornly rely upon their internal forecasts (which have been notoriously in error) in the face of what appears to be reality to everyone else. The following represents what we see as economic headwinds (perhaps turning to a gale) in 2019.

We see the following events and issues as dominating economic considerations in 2019:

- Economic Slowdown in the United States
- Continued Economic Slowdown in China
- Continued Economic Slowdown in Europe with the risk of recession in 2019
- Tremendous uncertainty surrounding Brexit
- Dis-inflationary pressures in the US and especially in China and the EU
- Political instability in the US
- A continuing flattening of the Yield Curve (2-10 yr.), possibly inverting in 2019
- Continued volatility in commodity prices
- Continued stress in the housing markets for both new and existing homes
- Continued pressure on Retail Sales, including automobiles

We continue to experience great difficulty in executing Securities Transactions. We continue to see dramatic variance between market makers. For example, whereas we would expect variance on single issues to be in the 1 to 2/32 range (312 - 625 Dollars per Mil), we have been experiencing 4/32's (1,250 per Dollars per Mil) to the cover and 18 to 20/32's (5,625 - 6,250 Dollars per Mil) from high to low. This is symptomatic of a very unhealthy market, as we have also seen in the stock market with 500 to 1,000 point daily swings becoming routine.

There is nothing healthy, or normal, about this. I don't want to be an alarmist, but these are the kinds of conditions leading up to 2008 & 2009.