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Market Commentary

The 2019 U.S. Growth Checklist: Conning Cites Reasons for Optimism – With Caveats

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The downturn that ended a volatile 2018 carried into 2019, with many market observers suggesting that future U.S. growth may be in jeopardy. Conning thinks that view may be overwrought, and while we understand the concerns, we also see data supporting continued U.S. growth, albeit at a lower rate than the previous two years.

Driving much of the speculation is an indicator that historically has shed light on what's next: the yield curve. When the curve inverts - i.e., when short-term yields become greater than longer-term yields – the U.S. economy has often subsequently fallen into recession. The U.S. 2 Year Treasury Note yield has recently been higher than that of the 5 Year Note yield, thus sparking this concern.

This flattening bears watching, but we note that other market demands also appear to be weighing on the 5 Year Note yield. There are also other yield curves that may be better predictors.[1]

Meanwhile, investors seem more focused on lower inflation expectations: the yield advantage of buying Treasury Inflation-Protected Securities, or TIPS, versus same-maturity Treasuries, narrowed steadily in 2018's fourth quarter. Real TIPS rates (which account for inflation) have been more stable, indicating that the market appears more concerned about lower inflation than a growth slowdown. This is consistent with our expectation of reasonable but slowing growth over the course of 2019.

Conning reminds investors that developing a thoughtful strategy for the long term and staying disciplined is often a better approach than reacting to short-term events, especially given the wealth of market opinions. There is still much that is positive about the U.S. economy, but we are monitoring other news for impact on our long-term views.

The positives:

- <u>The pro-growth economic and fiscal policies that are in place are not easily undone.</u> Many Trump administration policies have spurred employment and lifted GDP. While the virtuous effects of tax cuts are now well absorbed, there are enough second-order effects from banking regulatory relief, repatriation, and capex to keep the expansion going into 2020.

- <u>U.S. data remains strong as global growth appears to desynchronize.</u> Slower global growth and lower yields may dampen sentiment and export growth, but our nation's strong fundamental and domestic policy environment remains intact.

- Divided government historically has generally been a positive. The 2018 mid-term elections put the U.S. House of Representative back in Democratic control, but the counterbalance of a Republican-controlled Senate in our opinion means we will see a limited amount of new legislation.

The concerns:

- Issues remain over trade with our North American neighbors and China. President Trump's new trade deal with Mexico and Canada requires House approval, and his Democratic rivals could extract some anti-growth concessions. The China relationship is not only about tariffs, but also technology transfers and intellectual property protections, and they will be a lot harder to solve. Trade is a key growth factor and these negotiations will likely have a significant impact.

- Political battles could weaken the president's negotiating positions. House Democrats say they have significant investigations planned for President Trump. These could be a major distraction and the U.S.'s negotiating counterparties may be able to use them to their advantage, diminishing potential results for the U.S.

- The U.S. Federal Reserve's interest rate increases are pressing some perceived limits. While the Fed clearly signaled its recent rate increases, the prospect of two more increases in 2019 scared many investors in December. Minutes from the December meeting, however, showed a much more cautious attitude among the governors than came through in the press conference.

Your Conning team will be keeping an eye on the markets and focused on your investment goals. Please let us know if you have questions.

1. "Information in the Yield Curve About Future Recessions," Michael. D. Bauer and Thomas M. Mertens, Aug. 27, 2018, FRBSF Economic Letter, Federal Reserve Bank of San Francisco, https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/information-in-yield-curve-about-future-recessions/