

What To Expect In Markets And The Economy in 2019. Q&A With Burnham Banks.

We began 2018 with expectations of synchronized expansion and then things slowed down almost everywhere. How do you see the economy progressing?

Trade is an interesting area since the American President decided to turn a Cold War into a shooting one. Global trade, as a percentage of GDP, had peaked in 2008 and has steadily declined until 2016, when it stabilized and rebounded. Unfortunately that rebound had run out of steam by early 2018, well before trade protectionist rhetoric was translated into tariffs and quotas. The slowdown has affected Europe the most but is apparent in the US and China as well. The openness of the European economy is a factor, trade is over 80% of GDP. This deterioration in trade is an important and long term phenomenon. The economic crisis was a turning point as it made countries pursue a less collaborative and more rivalrous policy. China's reduction on trade dependency was less reactive and more an effort to create a more balanced economy less reliant on any one engine of growth. The US, had a pragmatic issue of growing an economy where the banking system was damaged, government debt levels had climbed to fund bail outs, and household demand and balance sheets had been dented by the mortgage crisis. Trade was an avenue of growth, but it had to reverse a large and chronic deficit with China and the rest of the world. The rebound in trade in 2017 was not a fundamental reversal of this trend but a respite, and the reversion to trend is now being exacerbated by a belligerent US President. I don't think the primary trajectory has changed. Specialisation and trade is good and we've reaped the

benefit for decades, but recently the incremental benefits had come with some adverse side effects, such as inequality, unemployment, less robust albeit more efficient supply chains. The US reshoring phenomenon began in 2010, and I don't see it stopping. As automation and robotics become more ubiquitous, the tendency is for production to be located closer to end markets. As US or Western companies are the most global, there will be some net retrenchment in globalization of supply chains. One implication is potential inflation from loss of efficiency, but this will probably be compensated for by more efficient localized production. Involuntary reshoring, the type driven by policy shocks, is another matter and tends to be a lot more inflationary with efficiency losses not compensated by robustness gains. Generally, trade will be a drag on global growth in the coming years. Given that global trade represents a third or more of global GDP, this drag will be substantial. And given the nature of trade, the drag will be synchronized.

Technology is an important factor. Cold Wars are good for technology. They are when the public purses are made available to private enterprise to further innovation and technology. The US leads in many areas in technology, although the tech sector is possibly one of the most globalized of sectors with a single chip being designed in Europe, arranged in the Netherlands, and fabricated and completed in China by a Taiwanese company, before finding its way into an American device. The Cold Trade War will disrupt this ecosystem, resulting in more expensive devices, but will encourage domestic innovation. The near term effects are most likely to be negative as global supply chains are disengaged and reorganized domestically. Capex will rise but it will be wasteful resulting in more robust but less efficient production. Greater automation will have impact on employment. I don't think AI will live up to its promise in the short or medium term, but simple automation can already have significant impact. Given tight labour markets and a rise in

xenophobia and anti-immigration, technology will be a more important aspect of localized supply chains.

There are some risks to the tech industry from regulation. In the past decade, technology has run ahead of regulation as the regulatory spotlight was turned to banks. This needs to change and I think it will. It has already begun in Europe and could spread to the US. Regulation is another step in shifting the balance from efficiency to robustness but which will also slow the meteoric growth of the tech industry.

Policy has been a driver of markets and the economy. A decade on from the financial crisis it is only right that we come off monetary accommodation. The Fed is well on its way, the ECB will stop net purchases of assets, the PBOC has been regulating the nature and quantum of credit growth for a couple of years now. Even the BoJ may ease off the accelerator if not tap the brakes.

In the short term, the **Fed needs to reset interest rates** to a level from which it can cut them to deal with a slowdown. The problem here is that time and time again, it never fully normalizes before the next crisis or slowdown. The analogy here is anti-biotic resistance. The Fed has to be careful also how far it goes, given that government and corporate debt levels have surged in the last decade. Household leverage, thankfully, has not risen as quickly. The short term, slightly myopic view is that the Fed will continue to raise rates as far as it can without triggering a recession. If as I expect the economy slows over 2019, the Fed may lengthen the intervals between hikes, but generally, the Fed will keep going, past neutral, perhaps well past neutral, to get to a level from which it can credibly cut rates. The question here is whether the economy gives the Fed this latitude, or if it falters before the Fed is done. Prior to the tax cuts in the US, I would have said that the answer was yes, that a slowdown would occur, but that it would be sufficiently shallow that the Fed could maintain course even through the slowdown.

However, the tax cuts have now increased inflation, and the national debt, placing the Fed in a difficult position; deal with the inflation or the national debt service. Either way, fiscal policy has lengthened and deepened the economic cycle. My revised expectations are that the Fed will cave not to Donald Trump, but to the stock of debt that needs to be financed and refinanced. Even so, with a neutral rate of 3% Fed Funds, say, an overshoot to 3.5% or 4% is still manageable. Unless the curve steepens too much. The management of balance sheet normalization will be of great importance. On top of this, market funding costs, basically the yields in the corporate bond market, will be important. With companies buying back shares in the last few years, basically depleting their capital, and often times funding this with debt, corporate leverage has risen significantly. Higher rates and wider spreads would place corporate balance sheets under some stress. For households, higher rates would mean a slower housing market and retail sales, both acting as brakes on the economy. In the longer term, the accumulation of debt makes higher rates simply impractical for the US. That QE has been demonstrated to work also means that it will be deployed in future to deal with less serious crises as well. The long term trajectory of rates is therefore one of short periods of rising rates, perhaps rising more quickly, and long periods of falling rates, perhaps falling more gradually.

The ECB's problems are more complicated both in the short and long term. As it is Eurozone growth is slowing and inflationary pressures are ebbing before the ECB has had a chance to raise rates, or normalize its balance sheet. We know that net purchases under its Asset Purchase Program cease in Dec 2018. What we don't know is how it will reinvest cash flows. I expect them to lengthen the duration of their portfolio and to supplement this de facto accommodation with LTROs at the back end of 2019. With time, a shallow slowdown will be turned around into growth once more. That's the short term view. The longer term view is complicated. Politics could

lead to the loss of a member of the Eurozone, and size matters. If an economy the size of Italy quits the Euro, it might actually break it. It is difficult to envisage Euro rates significantly above zero for any length of time. The most likely scenario is that the ECB emulates the BoJ's policy in the last 20 years and maintains zero rates to accommodate the weakest members of the Eurozone. At some point the threat to the Euro will come from societal and political pressures and not commercial or economic ones.

Japan is in the midst of economic reform which might lift rates out of negative territory at some stage but not far from zero. This already would be regime change and have implications for the economy and the savings industry. The economy would likely transform itself gradually to a more balanced, in terms of gender and foreigner participation, economy and would regain some vitality from doing so.

As for India which is also of interest, the real change has been the political one and the country is on the reform track. The risk is that the Prime Minister loses his majority or mandate and the reform agenda is stalled or rolled back. The hard work of demonetization and tax alignment (GST) has been done, the recapitalization of the financial system is underway with the regulator wielding a newly inked bankruptcy code, and it seems that India will be one of the more vibrant economies in the short to medium term, and extend this into the long term. The main threat to growth is energy prices, and it is a real threat as supply is likely to become more of an issue. Another threat is the independence of the RBI, already compromised this year. If, oil doesn't rise too quickly, inflation should not be acute

The PBOC has the most policy tools at its disposal, but also has a complex economy whose financial system, shadow and formal, has grown more quickly than regulators' ability to monitor, measure and regulate. The PBOC is still in risk management mode 10 years after a massive fiscal and monetary

expansion that it has only begun to moderate and manage since 2015. Since then, efforts to reduce leverage have precipitated slowdowns and capital markets volatility. The recent slowdown in the Chinese economy can mostly be attributed to tighter monetary policy than the trade war as the PBOC seeks to deleverage and regulate the shadow banking sector while channelling credit through the regulated banks. That the PBOC has only reacted moderately to recent market volatility is a positive sign that it will tolerate free markets even if unruly ones and signals confidence that China can tolerate slower growth in the 6.0% – 6.5% region. Growth is unlikely to rebound given the size and heft of the Chinese economy but a slower decay to 4.0% – 4.5% over a longer time frame would not be a disaster. There is a more important lesson to be learnt in China. **China operated QE in 2008, then started to normalize policy in 2015.** The Chinese experience of normalization may be extrapolated to the US. When the effects of normalization became too acute, China paused. When markets improved, they resumed. The US will likely go through the same phases as they manage their system leverage down to more reasonable levels.

These are very long term considerations. What about 2019? What are your expectations for 2019?

The world ex US has likely reached the crest of the economic cycle. Europe and China are slowing, in part due to a slowdown in trade which they do a lot of with one another. The US cycle has been prolonged, I don't know for how long, possibly into late 2019. The US will eventually slow, probably in early 2020, and given the tax cuts and the leverage in corporates due to the increased leverage, might be deeper than I initially envisaged before the tax cuts but it will still likely be a shallow recession.

Europe is a worry. 2019 will see new management in Brussels which will distract from policy. If the ECB actually tapers QE

without compensation, expect the European economy to slow down markedly. Any compensation will help financial markets but likely have less impact on the real economy. Politics are a recurring issue in Europe and with EU elections in late 2019, the risk of disruption is high. The far left and right have not gone away and a slowdown in Europe will certainly ignite their cause.

China will continue to slow. The GDP prints are quite clearly 'massaged' and a 6.2% print somewhere in 2019 would be expected, if nothing else to test the market. The restructuring of manufacturing is mostly complete and the impact of trade wars, if they haven't been somewhat settled, will have less of an impact. Policy will remain tight on balance but the marginal impact of policy will have been blunted. China is closer to completing normalization of policy than either the US, Europe or Japan.

What ailed the markets in 2018 and how do you see markets in 2019?

Strong economies, slowing moderately. I don't think we have weak economies. Growth has been robust, relative to new normal equilibria. The problem we had in 2018 was that markets had priced in continued synchronized economic acceleration in growth at the peak of that growth. The slightest disappointment would have triggered a sell off.

US stocks are expensive relative to rest of the world. China stocks are cheap. Even with the weakness in 2018, equities are still expensive. The skew is therefore to the downside. Given the significant valuation premium in US equities relative to the rest of the world, I expect convergence and US underperformance. **China, India and Japan hold considerable value** relative to the US and I expect them to outperform. That said, it is still possible that they all give a negative

absolute return.

USD duration is still a short. As long as the economy remains stable, even if there is a shallow deceleration, I expect the Fed will continue hiking rates. The pace may slow, but it will be not only dependent on macroeconomic data, the Fed will also watch market credit spreads, lest they widen too much. I expect **3 to 4 hikes in 2019** and possibly 2 more in 2020, as long as the economy and market can digest it. There is less certainty around the balance sheet normalization. Here, the Fed has latitude to manage the duration of its portfolio. However, given that as a percentage of total outstanding bonds, the Fed was a third of shorter maturities and three fifths of the long bond, I expect the **curve to steepen along the 2 to 30**. Now, it may be that the curve flattens to the belly but the 30 year has lost a significant buyer. Another theme is that sharp declines in risk assets create demand for shorter maturity treasuries.

There is **value in Asian credit** but the soft links to USD import Fed policy when more accommodative policy may be more appropriate. As a result, **Asian high yield is preferred to investment grade**. Spreads are sufficiently wide to dominate duration. **In Europe 5 year credit duration is valuable as is 15+ year rate duration**. The ECB will have to advertise hawkishness while practising dovishness, quite the opposite of the Fed. Expect an LTRO at the back end of 2019 to roll over a wall of maturities. There is even an outside chance of an early LTRO program to sterilize the QE taper. A more likely scenario is a dovish **operation twist** even as net purchases under the asset purchase programs are terminated. Either way, euro duration is probably the only duration to own.

Corporate IG is a difficult trade. Current spreads offer near fair value but the risk reward is not attractive. Corporates are over leveraged, the economy is rolling over, and rates are rising. High yield is an even more difficult trade. While HY spreads have risen lately (from 290 in Jan to 420 in November)

and are possibly at fair value, the risk of overshoot is high. Momentum in HY could see spreads over 650. IG spreads (155 in Jan and currently 234) could see 320. Similarly, loan spreads which went from 250 in March to 315 in November could easily head to 550. Certainly 420 is an easy target.

Opportunities lie in CLOs but even here, spreads have only just begun to widen. The default characteristics and the dynamics between tranches offer some positioning opportunities. At some stage in 2019, equity is likely to look attractive. In the meantime, the IG bonds are likely trade down in price but probably still give a small positive total return. Compared with cash, it will be a hard call.

One area which has sold off well past fair value is **European bank subordinated capital**. Returns in the low to mid teens is not impossible. This asset class has been profitable before but is somewhat correlated to equities. For those who believe the story, given how much bank equities have sold off, it may be more sensible to just buy the stock. In any case, European banks look like good value. And on the subject of banks, US banks are also good value having lagged the market in the last legs of the bull market.

Finally, there is energy. The oil market is a minefield of technicality, fundamentals and politics. That said, oil tends to be supply driven and future capacity is seriously constrained. US shale can only grow so much and is dependent on cheap credit. With the HY market in a bit of trouble, OPEC has turned on the taps. I think the disagreement over quotas is a bit of a show and that the Saudis are intentionally oversupplying the market to depress the price. Not for long but certainly while the credit markets are stressed, in an effort to sweat the US producers. These are short term strategems. In the longer term, failure to invest in long cycle oil will create the supply imbalance. **Buy oil and/or oil companies.**

How would you invest for 2019? And how about the longer term?

If you want to invest in 2019 to make money in 2019 you'll be in a hurry and make a lot of mistakes. If you haven't de-risked your portfolios by now, especially in credit, you should. Volatility is quite stationary and high vol begets high vol. There are fragilities in the market, more than there are in the economy, and there will be opportunities to deploy cash in 2019. To deploy cash, you need to have cash. To find bargains, you have to be patient. 2.5% for 3 month cash means you can be very patient. This is not to be underestimated. With short rates rising, the price for waiting is low, and this will apply to all USD based investors. If everyone faces this, you will have to be more patient than most.

You can be less patient to deploy in Chinese equities. Valuations are cheap and China is further along QE normalization than any other country.

You can be less patient to buy banks. US banks are good value, European banks even more so, although the subordinated capital securities are probably better risk reward in Europe.

Energy is a tricky one. OPEC will sweat US shale but at some point the realities of capacity constraints will bite and OPEC will not be able to hike production any further. Everybody knows how energy markets turn on a dime.

You should be patient in credit. It is sufficiently low vol that you can try to time it. Lets talk about leveraged loans. This is a very attractive asset class given its structural seniority and floating rate coupon. However, it suffers from fickle liquidity. It can be as liquid as the IG bond market one day and liquidity can evaporate the next. To get a jump on the loan market, monitor the discounts in the closed end loan funds. You can afford to be a bit early if you can buy at discount to NAV.

The HY market will be impacted by the oil market. The HY market is slower moving than the oil market so you might want to time the HY entry when you have some confirmation in the oil market. Be patient with HY. It is very late in the day and you will be investing before the downturn. Give it a miss and wait for the next cycle if you have to.

The IG market will be driven by duration, unless you can lever your portfolio or hedge the duration. Be very patient with IG. The budget deficit, QE normalization, rising inflation, are not ideal for duration. As for spreads, there is still further potential widening even from current levels.

Economic growth is slowing in 2019. Even if it mild, only buy assets which are pricing in a slowdown. Be less patient with assets pricing in a sharp slowdown. Be patient with assets pricing in a shallow slowdown. Avoid assets pricing in business as usual.

What are the risks that we get a recession and even beaten down sectors fall further?

This is the most important question of all.

The rivalry between China and the US is a very significant risk. Today we see it manifesting in trade and technology. The US President has been very aggressive and sometimes counterproductive, dispensing friendly fire. Hopefully, private commercial interests prevail and deter politicians from populist antagonisms. If the trade war escalates and supply chains have to be duplicated locally, embargoes and quotas are established, tariffs and taxes are raised, output would fall while prices were rising. Fiscal and monetary policy would be severely constrained. In this scenario, gold becomes a good substitute for short term treasuries as a reserve asset.

Another risk is our understanding of the economy particular as it relates to how inflation and interest rates interact. If higher rates somehow stoke inflation, say for example by causing substitution away from fixed capital to labour, or because real rates are more stationary than nominal rates, then the central bank's reaction function would exacerbate any inflationary situation. This also would lead to a stagflationary scenario.

Societal currents are a significant risk and difficult to quantify financially. Inequality is rising to acute levels leading to people rejecting the current social contract. Capitalism has been perverted, since the fall of Communism, a hypothesis validated by the solutions to the financial crisis of 2008. So far it has led to unexpected results which should be classified simplistically as the rejection of the status quo, and thus may not be rationally explained. Brexit, the election of Donald Trump, the composition of the Italian government, the democratic representation of the Alternative fur Deutschland in the Bundestag, and the gilet jaunes in France and Belgium.