Bernhard Eschweiler, PhD
Senior Economic Advisor

Bernhard advises ZAIS on macroeconomic risks and prospects related to credit markets and is a regular contributor to "ZAIS Insights"

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Strategists like to look for historic parallels when analyzing current and future economic and market conditions. A popular comparison at the moment is early 2016.

Back then, both the global and the U.S. economy were slowing, China was especially a concern, and oil prices had dropped sharply. The market was worried about recession and yet the Fed had just made its first rate hike after finishing QE tapering and projected 100 bps of further tightening in 2016. Equity and high yield markets sold off sharply in response, similar to the market turmoil seen at the end of last year. Economic uncertainty and market volatility coupled with low inflation, however, quickly persuaded the Fed to take a pause.

In the end, the Fed only resumed tightening in December 2016. Financial markets responded with relief and by mid-February 2016 started a rally that lasted two years.

Not yet all green

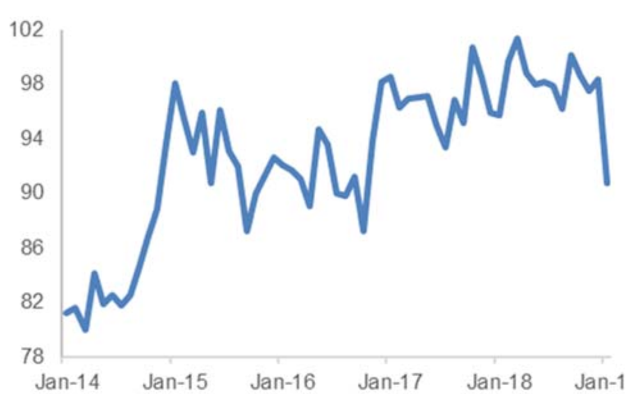
Expecting a repeat of the 2016 pattern is not unreasonable. Indeed, inflation has moderated and the Fed has already signaled that it will probably take a pause. The market has responded favorably to the prospect of a more patient Fed. So, what could go wrong?

To be sure, we are not expecting a recession in 2016, but the market may have to digest more bad news. There is currently little hard data to go by thanks to the government shut-down, but the survey data suggests that the economy probably took a hit at the start of the year.

- The University of Michigan consumer sentiment index tumbled in the preliminary January report (chart 1).
- Regional Fed surveys from New York also suggests that the ISM manufacturing survey will make another sizeable drop in January (chart 2).
- Finally, we believe the government shut-down may take a bigger toll on growth than is generally thought.

Chart 1: U.S. consumer confidence

Index 1966: Q1=100



Source: University of Michigan[i]

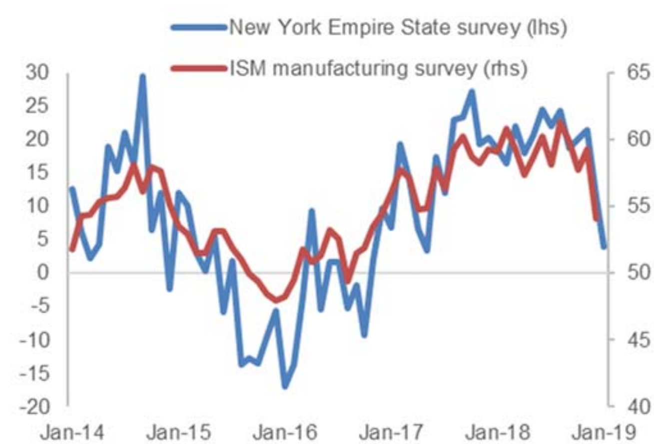
Not all is the same as in 2016

Moreover, not all is the same as three years ago. First, the expansion is three years older. That is a lot in a business cycle life time.

- Already, this business cycle is the second longest post-WW2.
- Labor resources are getting tight as the unemployment rate is close to historic lows.
- Wages are accelerating, which in turn is squeezing corporate profits.
- Last year's corporate tax cuts were a relief, but that effect may not last much longer.
- The corporate sector is not in distress, but the willingness to invest appears to us to be fading.

Chart 2: U.S. business surveys

Balance of responses, both scales (%)



Sources: Federal Reserve Bank of New York: Empire State Manufacturing Survey and ISM [ii] [iii]

Second, while monetary conditions are not outright restrictive, they are no longer as easy as they were three years ago. The Fed has hiked interest rates 200 bps and is closer to the neutral rate than three years ago.

Furthermore, the Fed has already shrunk its Treasury and mortgage holdings by 10%; we expect it is likely to continue even though Fed Chairman Powell has signaled a more flexible approach to the balance sheet adjustment.

Less positive catalysts and more risks

Against that background it will probably require a strong catalyst to reaccelerate economic activity.

Fiscal policy is unlikely to come to the rescue, given the split powers in Congress. In fact, fiscal policy could become a drag if the conflict between the President and Democrats is prolonged.

And there are other risks. Europe has slowed significantly and the risk of a hard BREXIT, the fiscal calamities in Italy and France, plus the general inability to agree on reforms and more integrated policy initiatives dim the prospect of a rebound as in 2017.

The other uncertainty is China. We are convinced China has the means to prevent a hard landing. But the latest round of Chinese data[iv] [v], importantly the December trade report, shows clearly that China is slowing. A U.S.-China trade deal could be a real game changer, but that is currently just a possibility and not, to our thinking, the most likely outcome.

Between recession and rebound

Bottom line, we see neither a recession nor a convincing rebound as the most likely scenarios for 2019. To us, slowing economic activity with risks to either side is the most likely outcome for 2019. The current market rebound may be justified on the expectation that the Fed will be patient and recession is not likely in 2019. However, a lasting economic rebound as in 2016 and the following two years seems to us to be similarly unlikely. Instead, with the economy expected to slow, we believe markets will probably move in a volatile sideways range this year.

More information

As always, we are available to discuss our views with you. Please contact your client relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com.

[i] University of Michigan, University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UMCSENT, January 29, 2019.

[ii] Federal Reserve Bank of New York, Current General Business Conditions; Diffusion Index for New York [GACDISA066MSFRBNY]: Release Empire State Manufacturing Survey, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GACDISA066 MSFRBNY, January 29, 2019.

[iii] Federal Reserve Bank of Philadelphia, Leading Index for the United States [USSLIND], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/USSLIND, January 29, 2019.

[iv] China GDP 2018 https://tradingeconomics.com/china/gdp

[v] China Import/Exports December 2018 https://tradingeconomics.com/china/exports

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