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What We Think…

November 17, 2017: "*I strongly share that sense of mission and am committed to making decisions with objectivity and based on the best available evidence, in the longstanding tradition of monetary policy independence… He's strong. He's committed. He's smart.*"

December 24, 2018: "*The only problem our economy has is the Fed. They don't have a feel for the Market, they don't understand necessary Trade Wars or Strong Dollars or even Democrat Shutdowns over Borders. The Fed is like a powerful golfer who can't score because he has no touch - he can't putt!*"

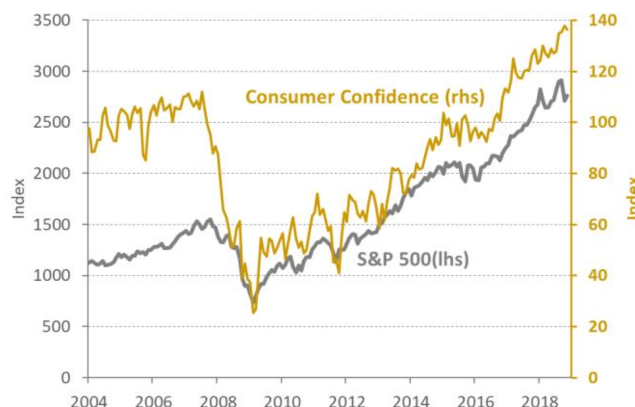
What a difference a year makes? Life under President Trump is a constant game of survivor for those in Washington, and Fed chief Powell was the latest senior White House official to experience firsthand what survival means. At one time there was a question of whether Janet Yellen would be reappointed Chair of the Fed – the job went to Powell in what most interpreted as Trump's intent to put his stamp on the Fed. However, last month's Fed tweets from the president would make one think that Trump has already disowned this version of the Fed and has no qualms making life more difficult for the its chairman and his leadership. This, despite the risk of negative consequences – in December we saw the stock market react negatively to Trump's tweets. Nevertheless, when Powell was asked at the American Economic Association meeting in the first week of January if he would step down if President Trump asked for his resignation, he bluntly replied: "No".

President Trump is not happy that the Fed is raising rates (which is not necessarily uncommon for a president) and this opinion is shared by many who think that the current path of monetary tightening has been too steep. Critics believe that the combination of balance sheet unwind (quantitative tightening – QT) and interest rate hikes is too aggressive for this late stage in the economic cycle, especially with so many additional risks. The current pace of balance sheet unwind is $50 Billion/month, which according to Wu & Xia[1] has translated to the equivalent of 300 bps of tightening since May 2014. Combine that with 225 bps of rate increases since December 2015 and that totals 525 bps of effective tightening since May 2014. Investors have dramatically reduced expectations of rate increases in 2019, having taken the probability in November of close to three hikes to less than one now.

Figure 1: US Retail (ex Auto) & Existing Home Sales

Source: Bloomberg & Lorica Investment Counsel Inc.; Dec 2018

Figure 2: US Conference Board Consumer Confidence versus S&P 500



Source: Bloomberg & Lorica Investment; Dec 2018

US Economic data has deteriorated, but in our view, not to the point of signaling a recession. The most interest sensitive parts of the economy have shown the effects of tighter monetary policy, most notably in housing which has trended downwards (see Figure 1). Consumer confidence has slipped, albeit from very high levels; and the deterioration and volatility of the stock market is

[1] Wu & Xia of the Federal Reserve Bank of Atlanta devised the Wu-Xia Shadow Federal Funds Rate which troughed in May of 2014 at -3%. Since that time, according to Shadow rate, tightening has been equivalent to approximately 5.25% (3% + hike since Dec. 15)

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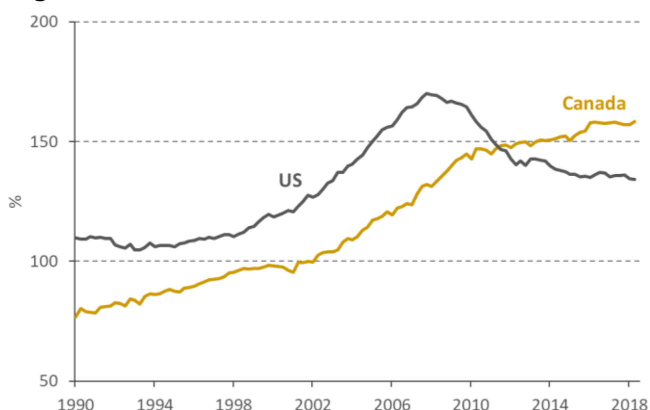
problematic for confidence (see Figure 2). The US consumer has continued to spend but appears less willing to take on more debt, thus resulting in falling household debt to income given generally positive wage growth and favourable tax savings (see Figure 3). However, the consumer still has room to slow without driving the economy into recession.

Figure 3: US & Canada Household Debt to Income[2]



Source: Federal Reserve Bank of St. Louis, Statistics Canada & Lorica Investment; Dec 2018

In Canada, retail and home sales have both slowed, but consumer balance sheets have nevertheless continued to deteriorate (see Figure 4). Despite higher interest rates and extremely leveraged households, Canadians are still consuming and have been surprisingly comfortable to take on more debt in contrast with American consumers. The housing strongholds of Vancouver and Toronto have predictably slowed in response to higher mortgage rates and macroprudential policies. However, as long as wage growth does not stall, we expect consumption growth to be positive (last year's retail sales growth likely averaged 0.3%, but was uneven throughout the year), and we will not be surprised to see home buyers re-engage after becoming more accustomed to higher rates. We think a Canadian recession is unlikely. But we expect to continue to see significant regional differences, particularly with weak Canadian energy prices posing challenges for oil producing economies. It will be interesting to see how effective the interim solution of adding rail cars will be in reversing some of Canada's oil distribution problem; supply cuts have resulted in some relative gains for the price of Western Canadian Select. (According to the BoC, the sharp fall of WCS will cost the Canadian economy 0.5% of GDP from summer/18 to the end of 2020.)

Figure 4: Canada Retail (ex Auto) & Existing Home Sales

Source: Bloomberg & Lorica Investment; Dec 2018

Outside of North America, the economic situation is more troubling. The Chinese economy is feeling the effects of US tariffs and slower growth elsewhere. The US government has enacted tariffs on $250 Billion of Chinese exports versus reciprocal tariffs of only $110 Billion, with the potential for more from both sides; though another round of US-China trade talks is currently under way. The IMF expects Chinese growth of 6.2% in 2019 after 6.6% in 2018. However, we are always skeptical of Chinese growth forecasts given: (a) the unreliability of Chinese economic data, and (b) the ability of the Chinese government to stimulate the economy. "Shovel ready" is more of a reality in China than in the US and Canada where there are a host of government and legal impediments. However, complicating plans for renewed infrastructure spending by the current government is the excessive amount of debt in the Chinese economy, where debt has increased from 171% to 300% of GDP over the last 10 years, according to the Institute of International Finance. Nevertheless, we don't expect to see a significant deterioration in Chinese

[2] Note: Credit market debt and disposable income for both countries are adjusted according to methodology outlined in Statistics Canada article "Reconciling Canadian-U.S. measures of household disposable income and household debt: Update"

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growth, with the outside chance of some form of a compromise on trade with the US.

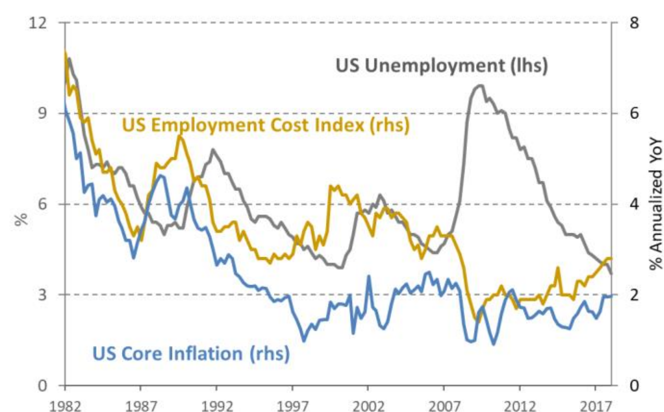
European growth, despite years of stimulus, is still precarious. France, Italy and Spain grew at 1.6%, 1% and 2.2% respectively, in 2018 according to the IMF, and will all likely slow in 2019. Political instability across the continent will only make matters worse. (Note the rise of the Yellow Vests in France, the Five Star Movement and League party in Italy, and the Vox party in Spain.) Germany too, is slowing – growth of 1.9% in 2018, after many years of stronger growth largely tied to exports. (Also note the rise of the Alternative for Germany party.) Finally, there's Brexit, which threatens to push the UK (expected growth of 1.5% in 2018) into recession, notwithstanding the uncertainty surrounding its ultimate resolution. The ECB, for what it's worth, is intent on tightening policy having indicated an end to additional QE in December (reinvestment will continue); although we don't expect to see interest rate hikes anytime soon.

The trajectory of the Japanese economy has not changed much and the economy remains overly reliant on extreme monetary policy. We don't anticipate much change in 2019 and expect the BoJ to continue QE. Finally, in emerging markets beyond China, 2018 was a challenging year as economies endured the dual burdens of weak commodity prices – most notably energy, and weak currencies. Unfortunately, slower growth in the developed world, increasing trade tensions and diverse energy supplies means more tough times ahead for EM.

Amidst signs of slowing economic growth globally, US employment remains a beacon of strength. December's household survey showed 333k job gains (including revisions) and an increase of 419k in the labour force – the strongest report since February. Wage growth was also encouraging at 3.2% YoY and the unemployment rate remains close to an historical low at 3.9%. However, tight labour markets, fiscal policy, indebtedness, trade, global weakness and higher rates will translate into volatile data and overreactive investors.

We have seen the dichotomy before, where a relatively strong US economy appears as an island against a sea of weaker economies globally, most recently in 2012. We remain confident the US can withstand global forces and do not think Fed policy will be the ultimate tipping point into recession. The Fed has used tightening labour markets with the potential for ensuing higher core inflation as the main rationale for normalizing the yield curve (and its balance sheet), through a combination of QT and rate hikes. However, we are yet to see historically low unemployment rates translate into consistent wage pressure nor credibly higher core inflation (see Figure 5).

Figure 5: US: Unemployment Rate versus Employment Cost Index & Core Inflation[3]



Source: Bloomberg, Bureau of Labour Statistics & Lorica Investment; Dec 2018

We don't believe that either the Fed or the Bank of Canada are dogmatic regarding tighter monetary policy, being more opportunistic than anything else. We think both are more motivated to bring yields to more neutral levels, giving them more room to maneuver policy, rather than fighting-off inflation. Halting policy will not cause either bank restless nights – recent comments from both the Fed and BoC support this view. It will be a challenge for the central banks to pursue further normalisation in 2019, but we expect capital markets to eventually reassert themselves and provide cover for sparing rate increases. The Fed should eventually raise

[3] Note: Wages are Employment Cost Index; prior to 2001 SIC System, OCSM, and 1990 employment weights (BLS); and after 2001, 2012 NAICS, 2000 and 2010 SOC codes, and 2012 employment weights (Bloomberg).

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rates twice in 2019 but be less aggressive with guidance. (It is worth noting that recent interference by President Trump will not make life easy for the Fed, as it will be careful to avoid the perception of pandering to the White House; thus, the recent reassertion of its "data dependency".) The Bank of Canada will struggle to increase rates once in 2019.

It is inappropriate to translate the recent near-bear-market fall of the stock market as foreboding of a recession, given our belief that the information in capital market prices has been distorted since the credit crisis. QE is being undone as we speak, and part of that undoing can reasonably be translated to the response of capital markets. Recall that a hesitation of the Yellen-Fed to raise interest rates appeared to be connected to the concern for capital market blowback – not unlike what we are currently experiencing. We had hoped the Fed would have begun the normalization process long ago but have been supportive, nonetheless. We are just content to see the Fed, and to a lesser degree, the Bank of Canada build up their policy arsenals for future use as opportunities present themselves.

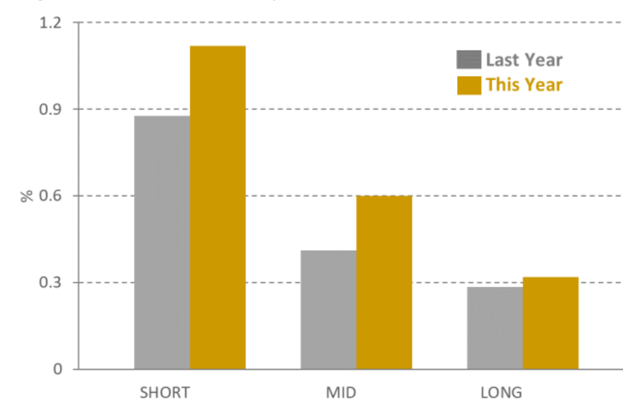
Yield curves in Canada and the US have been flattening steadily since the beginning of 2014 but have only flirted with inversion over the last six months. In both cases, expectations of further central bank rate increases combined with low expectations of slower growth embedded in low term premiums have resulted in excessively flat yield curves. The low-point of the US 2-10's yield curve this cycle was 11 bps on Dec. 19, while the low-point for the Canadian curve was even flatter at 4 bps on Dec. 11. We have also previously mentioned the supply/demand dynamics in Canada, which have resulted in relatively low long Canada yields and consequently, a very flat 10-30's Canada curve (having inverted in October, although steepening to 22 bps at year-end). Part of normalising yields requires an upward sloping yield curve – the 2-10 US and Canada curves are only 14 and 7 bps respectively, today. Should the Fed withhold further rate increases, we expect it to continue with its balance sheet unwind, which should help steepen the yield curve.

Credit generally did not fare well in 2018 as investors shied away from riskier assets. However, Canadian investment grade corporate bonds, particularly those with shorter maturities, were relatively unscathed, as the combination of underlying sovereign strength, relatively good liquidity, favourable supply/demand dynamics, and concentration of regulated domestic-centric issuers resulted in more limited spread widening. High yield, leveraged loans and EM were some of the poorer performing credit sectors, especially in Q4.

We expect riskier assets to be volatile in 2019 as investors contend with a variety of uncertainties, many of them political in nature. Canadian corporate credit, perhaps one of the more stable credit sectors, should again fair relatively well. Within the investment grade universe there will also be a variety of factors impacting specific industries including the flat yield curve – finance and utilities, weak commodity prices – energy, and consumer indebtedness – retail and telcos.

Canadian breakeven corporate yields in the front end of the yield curve, which, at the beginning of last year, offered reasonable protection against rising yields and widening yields spreads, offer even more protection now. Breakevens look attractive in both absolute terms – the result of higher overall short-term yields, and relative to breakevens further out the yield curve – the result of an exceedingly flat underlying Government of Canada yield curve (see Figure 6).

Figure 6: Canada Corporate Break-evens



Source: FTSE Canada Universe Bond Index & Lorica Investment Counsel Inc.; Dec, 2018

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