EMSTONE ADVISERS, LLC

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Numbers in the News

Indicator	12/31 Value	Versus 9/30
2-yr T-note yield	2.49%	-33bps
10-yr T-note yield	2.68%	-37bps
Yield Curve (2-10yr)	19bps	-4bps
ICE BofAML High Yield (YTW)	7.95%	+167bps
S&P 500	2,506.9	-14.0%
Dow Jones Index	23,327.5	-11.8%
NFIB Optimism Index	104.4	-3.2%
Industrial Production Last 12 months (Nov)	+3.9%	-1.7pp
Payroll Employment (000)	150,263	+762
CPI last 12 months	+1.9%	-0.4pp
Core CPI last 12 months	+2.2%	NC
Personal Consumption Deflator (PCD) last 12 months (Nov)	+1.8%	-0.2pp
Core PCD Last 12 months (Nov)	+1.9%	-0.1pp

Bloomberg Barclays Bond Index Returns

	Fourth Quarter	12 Months
Aggregate	+1.64%	+0.01%
Government/Credit	+1.46%	-0.42%
Intermediate G/C	+1.65%	+0.88%
Intermediate A+ G/C	+1.96%	+1.19%
1-3 Year Govt	+1.31%	+1.58%
Municipal Bond	+1.69%	+1.28%

bps = basis points (0.01%)
pp = percentage points
AR = annual rate
NC = no change

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The global economy experienced "synchronized recovery" in 2017. As the good times rolled into 2018, the story became divergent. Aided by fiscal stimulus, the US economy accelerated during the year while other major economies were losing steam.

Fiscal Stimulus and its Impact ❖ Fiscal stimulus worked through the channels of personal consumption and government spending. The tax cuts helped juice up real personal consumption. In addition, ramped-up defense spending provided a boost to the manufacturing sector. Consequently, the US Gross Domestic Product (GDP) posted an impressive 4.2% annualized growth rate in the second quarter, before cooling to 3.4% in the third quarter.

As we entered the fourth quarter, personal spending remained strong and manufacturing activity expanded. Factories managed to work down their order backlogs, while grappling with labor shortages and transportation constraints. Confidence among small business owners remained near an all-time high. Though business investment strengthened a bit in the first half of the year, the corporate tax cuts did little to spur business investments. According to surveys and trends in corporate actions, the primary uses of the windfall from the corporate tax cuts were share buybacks and acquisitions. Then in the second half of the year, non-residential fixed investment, which includes spending on equipment and software, softened.

As business investment cooled, the pace of economic activity likely decelerated a bit in the fourth quarter, maintaining an average growth rate of about 3% for the year. This represents a temporary boost, from last year's 2.5% growth, but it has come at considerable expense. Even as economic growth strengthened and the unemployment rate reached a 49-year low, the federal budget deficit reverted to a widening trajectory in 2018. The non-partisan Congressional Budget Office estimates the federal government's net interest costs are projected to quadruple as a percentage of GDP over the next three decades as US Treasury debt accumulates at a faster pace.

Where Stimulus was Ineffective ❖ Though personal consumption enjoyed a boost, the tax cut for consumers was modest and was not enough to spur interest-rate sensitive sectors like housing and auto sales. Despite the strong economy and a solid job market, auto sales slowed as borrowing costs crept higher. Also, new and existing home sales declined sharply during 2018 as mortgage rates rose. Meanwhile, home prices continued to inflate, driven by supply shortages. As a result, housing became less affordable, especially for first-time home buyers. The National Association of Realtors' Housing Affordability Index has fallen to the lowest level in a decade. Worsening affordability is a headwind for housing. This is pitted against the tailwind of favorable demographics – the swelling ranks of millennial households. The headwind is overwhelming the tailwind.

"Anti-Stimulus" Trade Policies ❖ If one foot of the US was on the "fiscal gas pedal", the other foot was tapping on the brakes. While the tax cuts were meant to encourage investments and growth, trade and immigration policies were counter-acting as disincentives. The initial wave of tariffs in the US-China trade war was focused on capital goods. This extracted a toll on businesses. During the third quarter earnings season, many industrial firms reported that import tariffs were biting into profits. Moreover, US exporters were impacted by retaliatory levies. According to the American Farm Bureau Federation, after pre-tariff surge, US soybean exports to China fell 97%, through the first seven weeks of the 2019 marketing year due to the 28% retaliatory tariffs on US-sourced soybeans. The trade war only intensified as the year progressed. Additional tariffs on $200 billion of Chinese imports, including consumer goods, went into effect in September. Retailers, such as Walmart, have warned that prices will rise for consumers as a result of this policy. During the talks held on the side lines of the G-20 summit in December, the US and China agreed to a temporary cease-fire on imposing additional tariffs, and China has temporarily resumed buying US soybeans. The biggest risk factor for global growth in 2019 is worsening trade conflicts.

Economic Outlook for 2019 ❖ Personal consumption, supported by a healthy labor market, is the sole engine of growth that appears intact, as we enter 2019. While lower gasoline prices are helpful, personal income growth, has been relatively modest in this expansion cycle. Hence, we don't expect as much pulling power from this engine. Meanwhile, as the impact of trade conflicts begins to hurt, manufacturing has started cooling in tandem with a slowing global economy. In addition, we cannot expect much help from business investment. As financial conditions tighten, the higher cost of capital is a hurdle to private investment spending. Corporate balance sheets are already levered up, financing share buybacks and acquisitions. Any additional boost in demand from government spending is also likely to fade unless an infrastructure spending bill gets passed. Hence, we expect the pace of economic activity to moderate significantly in 2019. The global growth story is now developing into a "synchronized slowdown."

Fixed Income Commentary ❖ During the fourth quarter, interest rates declined, and the yield curve flattened. Investment grade corporate credit was weak with a total return of just 0.01% leaving the full year return with a decline of 2.11%. Excess return numbers were even more dramatic (see table). The real story here is the strong rally in US Treasuries. The combination of a 14% decline in the equity market and significantly wider credit spreads created a "flight to quality." Ten-year Treasuries declined 37 basis points (0.37%) over the quarter to close at 2.68%. Shorter two-year notes fell 33 basis points ending the year at 2.49% and flattening the yield curve four basis points.

Bloomberg Barclays Index Fourth Quarter, 2018	Total Return	Excess Return[1]
Treasury	+2.57%	NA
Agency	+1.90%	-0.16%
Credit	+0.01%	-2.85%
BBB-rated	-0.90%	-3.88%
Securitized (MBS, ABS, CMBS)	+2.04%	-0.56%

Corporate credit performance reflected growing concerns in the equity markets as international trade discussions deteriorated and retaliatory tariffs were imposed. Tension with China coincided with signs of a downturn in their economy, a concern given China has been a significant engine of global growth and oil consumption. Consequently, oil prices took a significant leg down on a supply glut to experience its first annual decline since 2015.

The reality of a complex, interconnected, and interdependent global economy weighed heavily on markets as President Trump pushed his America First agenda. Discord in international trade left few corporate sectors unscathed and muddied the business outlook. An interesting recent development has been China's unwillingness to accept poor quality recyclable materials. Apparently, that country has been the recipient of most of the world's recycling. China's announcement has retailers scrambling to redesign packaging. Manufacturers are anticipating a margin squeeze in an environment of limited pricing power. As mentioned above, the auto sector is also on a down trend and tariffs will add unnecessary pressure. All these factors caused corporate spreads to widen as the year ended.

Diving into the sectors, excess returns were negative and widespread. The curve-adjusted excess return over Treasuries for the energy sector was -4.86% with oil field services and independent energy being hit particularly hard. Even life insurance which had been a strong performer for many quarters was not spared, underperforming Treasuries by 4.25%. Diversified manufacturing was down -4.56%, food and beverage -4.10%. Financial institutions and pharmaceuticals fared a tad better underperforming 2.33% and 3.42%, respectively, while home construction was -1.67%. There has been much written about lower rated credit (BBB) comprising an increasingly large percentage of the investment grade market and what this might mean in a recession. As a result, investors have begun the process of rotating into higher rated credits. We expect this to continue.

Although the Fed raised the overnight federal funds rate 25 bps in December, that move was largely discounted by the market. However, fears of rate hikes in 2019 led to further deterioration in the equity and credit markets and benefitted Treasuries. While several members of the FOMC are expecting two or three more rate hikes in 2019, the outlook for the economy and inflation, and volatility in risk assets will determine the future path of Fed policy. We believe the ten-year Treasury will trade in a range of 2.50% to 3.00% in the first half of this year and the Fed could slow their rate hike process for fear of further equity and credit market weakness.

[1] Curve-adjusted excess return over US Treasuries