Red Cedar Investment Management

Outlook 2019

December 2018

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Twelve basis points. That's all that stands between us and a recession in 2019 if you consider that a yield curve inversion between the 2-year and 10-year U.S. Treasury is an indicator of impending economic disaster. For our part, we think the doom and gloom is being blown out of proportion and that this economic expansion has room to run. There will absolutely be twists and turns along the way, but we have confidence that the Federal Open Market Committee (FOMC) and global leaders will keep the global economy on the correct path throughout 2019.

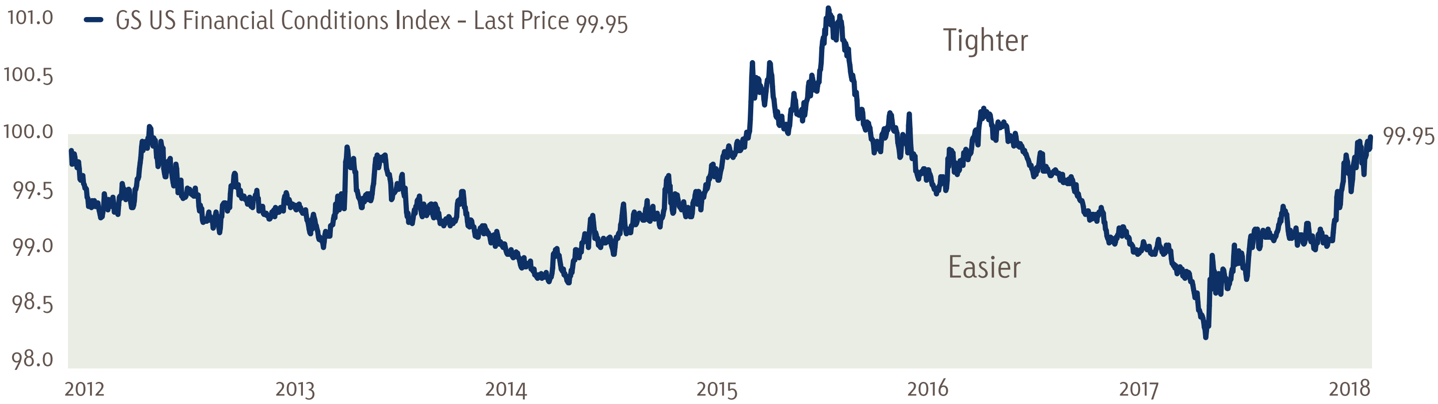
THE FED SLOWS THE PACE OF TIGHTENING

Markets have historically tested the new FOMC chairman. With the flattening yield curve, stocks down 10% off their highs, a trade spat, and falling oil prices, Jerome Powell is going to earn his keep. We say this chaos is normal. In fact, it is what a return to normalcy looks like and it doesn't necessarily have to end badly. At face value, eight rate hikes during this cycle might seem excessive, but the real fed funds rate is just barely positive. However, if we throw in a stronger USD (up about 8% YTD), wider credit spreads, and a shrinking Fed balance sheet, financial conditions are not as easy as they appear. When taking these other variables into account, the Goldman Sachs Financial Conditions Index shows that conditions are just about at neutral.

We think Vice-Chairman Richard Clarida summed it up perfectly when he said:

"As you move into the range of policy that, by some estimates is close to neutral…it is appropriate to sort of shift the emphasis towards being more data-dependent. I think Chair Powell the other day made the analogy … if you're in a dark room, especially without your shoes on, you want to go slow so you don't stub your toe. So I think data dependence makes sense right here."

In all likelihood, the Fed will have one more rate hike at the December meeting, but give forward guidance that is dovish and lower the market's expectation for rate hikes in 2019. Accordingly, we expect possibly one rate hike in 2019 and that will be pushed back further into the year. This guidance of a possible pause, along with fiscal policy and resolution to the trade spat should steepen out the long end of the yield curve, and for the time being, calm the frazzled nerves of the financial markets in 2019.



Source: Bloomberg, Goldman Sachs

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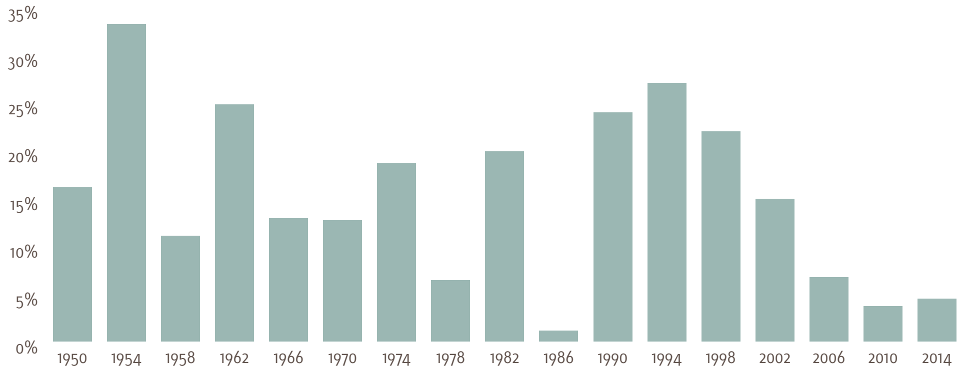
STOCKS RALLY IN 2019

The recent approximately 10% drawdown in the stock market along with the flattening of the yield curve seem to indicate the market is beginning to price in a recession for 2019. The decline in oil prices is also being interpreted as a sign of slowing global growth. The recent selloff in stocks has created a more palatable consensus with the next twelve-month earnings multiple for the S&P 500 of 15.5x vs. a 20-year average of 16.3x; not cheap, but not rich either. As our friends at Strategas have pointed out, stocks have rallied in the 12 months following a mid-term election since 1950.

S&P 500® price return 12-month period following mid-term election



Source: Strategas

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There are many theories as to why this phenomenon occurs. Perhaps there is something to the theory that gridlock is good or that sitting presidents pull every economic lever possible to ensure their party wins in another two years. In any event there is $122bn of fiscal stimulus still to come in 2019 courtesy of the Tax Cuts and Jobs Act. Certainly, a possible escalation of the trade war with China has both markets and CEOs fearing the worst. However, we do believe this gets resolved sometime early in 2019. In recent talks, China has agreed to reduce the import auto tariff from 40% to 15%. It has also been reported that they will begin purchasing 5M to 8M tons of US soybeans per month. These developments have also opened the door to further talks between President Xi and President Trump. For his part Xi Jinping is aware of the toll this trade spat has taken on his country. President Trump also knows the impact tariffs will have on the U.S. consumer, business confidence and the financial markets. Given Trump's proclivity to judge his own success on how well the stock market performs, we think the odds are pretty good that an agreement is reached soon, thereby lifting the cloud of economic uncertainty from the minds of investors. A trade deal which lowers or eliminates tariffs would also be another source of fiscal stimulus to the U.S. economy. While we don't expect a repeat of the approximately 22% earnings growth of 2018, we do think the U.S. economy can produce 5-10% earnings growth in 2019. Against this backdrop and the attractive earnings multiple, we think stocks have the scope to rally by 10-12% in 2019.

US DOLLAR AND OIL

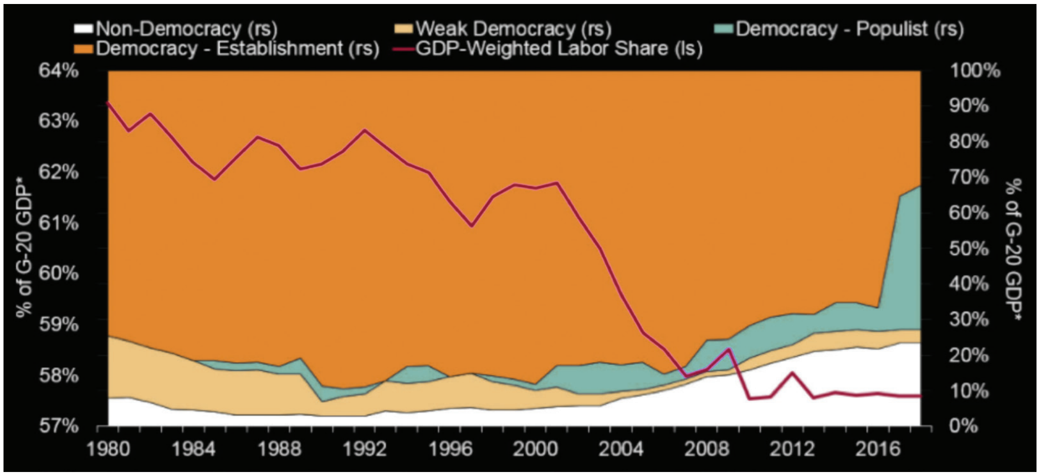
Much of the USD's roughly 8% rise for 2018 can be attributable to interest rate differential due to a Federal Reserve in the midst of a rate-hike cycle while most other central banks are on hold. Another reason for the strong dollar is the economic outlook for the US versus the rest of the world. Prior to 2018, there was a global synchronized economic recovery. Entering 2018, the US decoupled from the rest of the world with the benefit of the fiscal stimulus. Meanwhile, China and much of the emerging markets began to slow as export-driven economies were hurt by tariffs and structural headwinds. Europe has also rolled over as their economy is tied to emerging markets. As we enter 2019, we expect fiscal stimulus to come out of China as they continue their evolution into a consumer driven economy. We also expect an end to the trade disagreement that should help drive growth in China and other emerging markets. This is our long-winded way of saying that we think the dollar is at or near its peak. If the dollar weakens as expected, it will also serve to ease global financial conditions and provide a backdrop for global growth.

Of course, a weaker dollar should also help oil prices as well. We think too much of the fall in oil prices is being interpreted by investors to be demand-driven and a reflection of a drop in global demand. While global demand has softened somewhat, we believe there is a supply glut in oil right now. Between OPEC's inability to restrict supply, increased U.S. supply, and Trump's waivers allowing some countries to continue purchasing Iranian oil, there has been an unanticipated uptick in supply. As the market adjusts to this reality during 2019 we expect oil prices to retest the low to mid-60s.

POPULISM IS NOT DEAD YET

Following the 2016 U.S. election and the referendum on Brexit, many pundits believed populism would be a short-lived fad. That has turned out not to be the case as recent elections in Brazil and Mexico, as well as the Yellow Vest movement in France have shown. In fact, a large portion of the world's population is dissatisfied with their share of the economic pie and establishment political parties.

G-20 GDP share by governance, labor share of income



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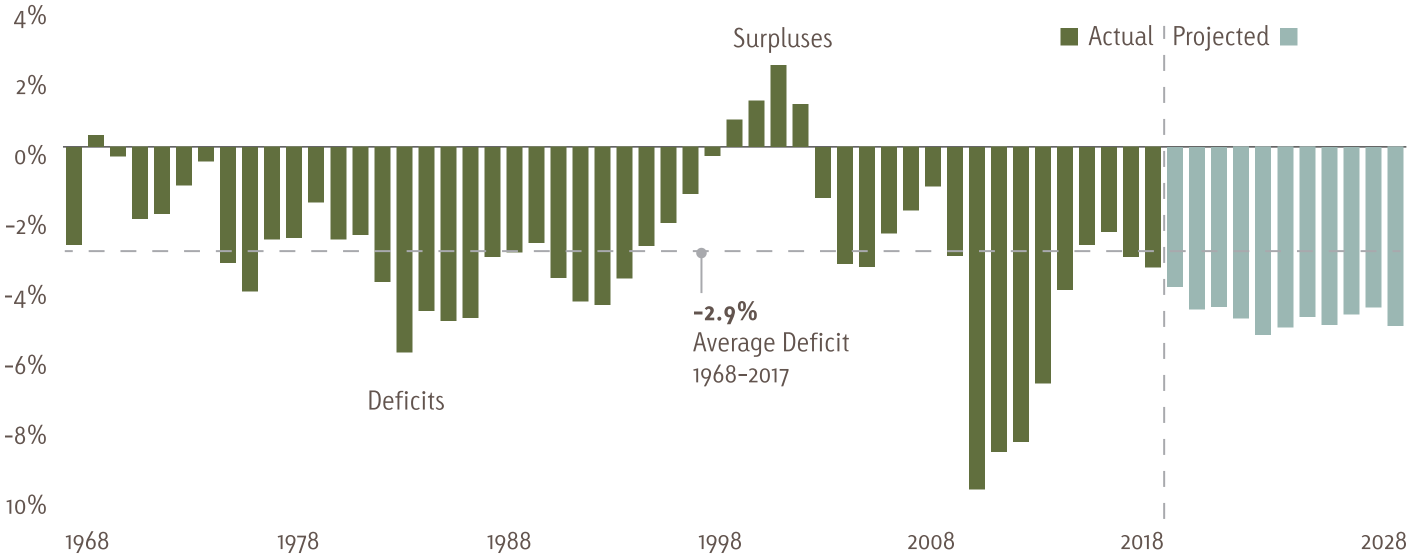
Source: Bloomberg Economics, Freedom House, International Monetary Fund, Penn World Table
*Data includes G-20 countries plus Spain; Russia data begins in 1992; U.S. Republican Party characterized as populist after 2016.

This populist movement still has room to run and will play out over the next several years. It also has enormous implications for investors. We have already seen fiscal stimulus in the United States as President Trump is eager to create economic growth at all costs. Even if it means unsustainable deficits as far as the eye can see.

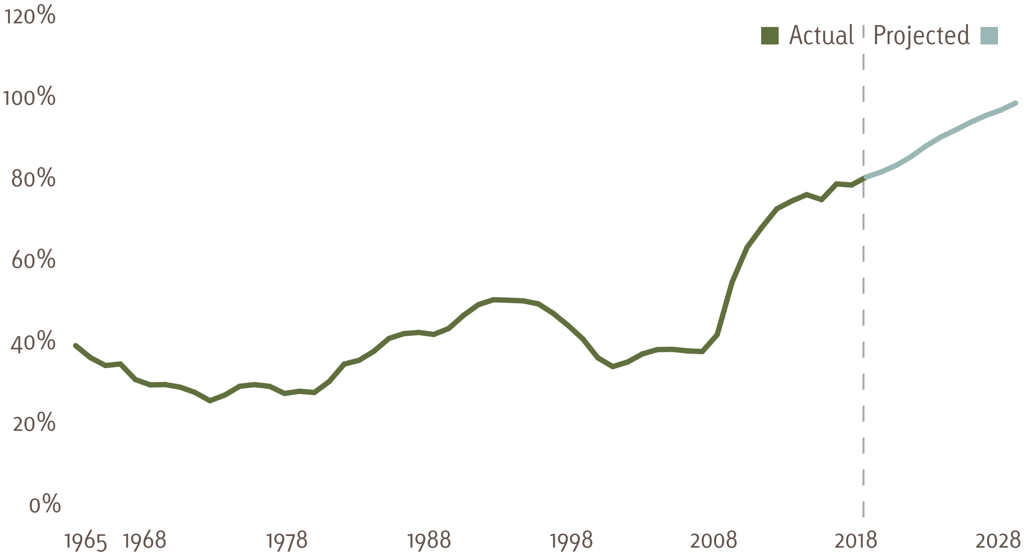
Total deficits or surpluses (percentage of GDP)



Source: Congressional Budget Office

To be fair, Trump isn't the only one. Italy now has the Five Star Movement and Northern League ignoring the EU's rules on budget deficits. The mainstream political parties in Germany are weakening (see Angela Merkel) while the populist Alternative for Germany (AfD) political party now enjoys double digit support. The Yellow Vest movement and riots in France have caused Emmanuel Macron to back off the fuel tax and the movement is now spreading to other European countries. The investment implications of this rise in populism will be greater fiscal stimulus creating inflationary growth and financed with debt that is unsustainable. The days of Quantitative Easing (QE), ZIRP (Zero Interest Rate Policy), and other programs are numbered. Graphs which show the percentage of negative-yielding sovereign debt will be replaced with charts of debt as a percent of GDP.

Federal debt held by the public (percentage of GDP)



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Source: Congressional Budget Office, CNBC

Debt issuance will be increasing and yields along with it. The golden age of passive investing will soon give way to active strategies where trading, stock picking, and nimbleness will matter in the pursuit of excess return. This is not the end of capitalism, rather it is populism providing a negative feedback loop to the populace and its political leaders to get their act together, serve the people and make good political decisions. And then the pendulum will begin swinging back the other way.

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