

High Drama in Washington: Policy Heroines or Unfolding Greek Tragedy?

Outside of a cottage industry of Fed watchers, people do not wait with bated breath for Fed speeches and Policy Minutes releases. Accepting this reality, today's policy drama may best be envisioned as a plot summary to a gritty film noir drama.

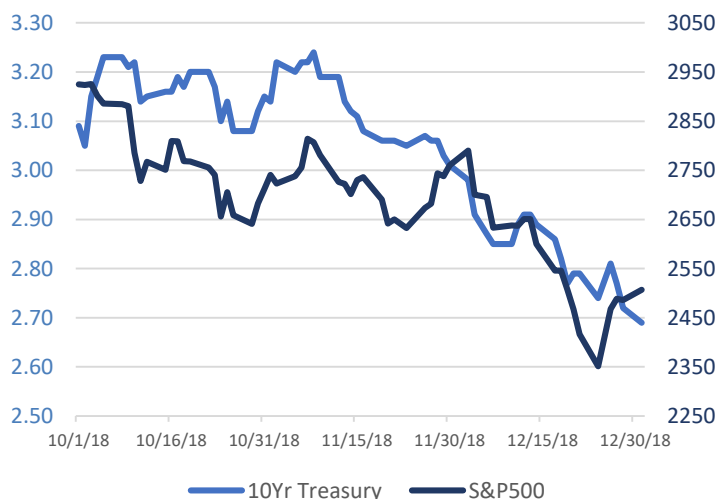
FIRST ACT: MID-DECEMBER 2018

From an ornate conference room in Washington D.C., Jerome Powell, our protagonist and Chairman of the Federal Reserve, assesses the economy through a fog of murky and conflicting data. He and his team discuss raising rates for the fourth time in 2018 citing high employment, strong consumer spending, and a need for monetary policy normalization. However, slowing inflation, weakening global growth, and a flattening yield curve trouble them. Across town he faces an unexpected adversary in the form of President Trump, the man who appointed him. Having linked the success of his presidency early on to stock market performance, Trump lays the blame for the current sell-off on the shoulders of Powell and the Fed.

Does Powell raise rates at the risk of aggravating markets, or will he pause, possibly setting the stage for an overheated economy?

Complicating Powell's conundrum, equities are on pace for their worst quarter since 2009. Demand for Treasuries pushes yields down as investors flee to "risk off" assets. Political uncertainty is growing, with the US Government approaching yet another shutdown as President Trump demands funding for his politically sensitive border wall.

Q4 – Market Drama Unfolds



Source: Federal Reserve Bank of St. Louis

SECOND ACT: DECEMBER 19-20 FOMC MEETING

Against this backdrop, and with Federal Funds Futures implying the probability of a hike at only 68% (notable in that the morning before every previous Fed Funds hike in the post-Financial Crisis era the odds were nearly 100%), Powell and his colleagues ultimately decide that economic conditions warrant a higher Federal Funds Rate. Although they signaled a more dovish forward tone by reducing their 2019 "dot plot" forecast from three hikes to two, the market, which had expected no hikes in 2019, trades off.

THIRD ACT: DECIPHERING MARKETS & FED RESPONSE

While it is easy to write this off as a mistake, and we believe the Fed is overly optimistic if it thinks the economic fundamentals warrant two hikes in the coming year, let's put ourselves in Powell's shoes.

Although the 2019 script is yet unwritten, we agree with the Fed's assessment that US economic growth, while slowing, remains solid, but this only explains part of the market's recent story. Powell's October comments that the Fed Funds Rate was "nowhere close to neutral" contributed to that month's equity selloff, as did an unexpected spike in Treasury yields, implementation of \$200 billion of additional Chinese tariffs, and expiration of a tax break for companies buying corporate bonds for their pension plans.

The housing market has also slowed considerably, although this can just as credibly be explained by the Tax Cut and Jobs Act's changes to state and local income tax deductibility as underlying US economic health. And, while the stock market slid after the Fed meeting on December 19th, the Fed was hardly the only newsworthy event, as a government shutdown grew from an unlikely risk to near certainty by the Fed meeting's close on the 20th. The market's negative reaction to post-meeting press comments reinforced the pain of self-inflicted wounds.

FINAL ACT: INTO THE NEW YEAR

The Fed's decision to only slightly slow the pace of rate increases is one we find concerning, and indeed, Powell subsequently walked back his comments somewhat in a round table at the start of January. Higher rates will strengthen the dollar, making US exports less competitive at the same time global demand is weakening. Continuing to raise rates during a period of decelerating inflation (the Fed's preferred gauge dipped below their 2% target in the quarter and on a trailing three-month basis is now a worryingly

low 1.1%) risks slowing growth and potentially pushing the US economy into recession. Powell may have been influenced by a desire to demonstrate independence by hiking when President Trump was pressuring him not to. Perhaps, but bowing to non-economic considerations is problematic.

We close by noting that, as in a Greek tragedy where a character's downfall is often prompted by a flaw in their personality driving them to self-defeating actions, 2018's market volatility has been heavily influenced by unforced errors on the part of the Federal Reserve and White House (with an assist from the UK and EU). The trade war President Trump initiated at the start of the year has led to repeated sell-offs, yet has thus far not born fruit other than a few changes to NAFTA. Even the Chinese year end "truce" merely represented a 90-day cessation in hostilities rather than an actual

breakthrough. Given sustained US growth in the face of a slowing global economy, Fed watchers may recall that former Chairman Greenspan's speculation concerning whether the US could be an "oasis of prosperity" in the late 1990s was followed by a series of rate cuts. The disconnect in that rate policy relative to this past December's decision and 2019's "dot plot" is noteworthy.

We do not believe this is a story destined to end in tragedy, and with a President highly motivated to see sustained strong stock markets, there is growing speculation that a "Trump put" has replaced the former "Yellen put" (see the President's "great buying opportunity" comments). But, we likely have not seen the last of these tragic flaws, or the volatility that often follows in their wake. We believe the economy still looks good; the question in 2019 will be whether the actions of key decision makers allow it to remain that way.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- AAA muni yields dropped across the curve towards the end of 2018, largely due to dwindling inflation concerns, weakening global economic prospects, and an expectation of slowing or stalled rate increases. Fed Funds Futures were pricing in a 10-20% chance of a rate increase at any of the 2019 meetings in early January trading.
- The entire yield curve was lower over Q4, although the 5 to 12-years saw the largest decline. The 10-year Bloomberg Barclays index was the top performing segment at +2.09%.
- A larger move lower in UST yields led short to intermediate munis to underperform, while longer muni/taxable relationships were unchanged. 30Yr munis remained at 100% of 30Yr UST, while 2, 5 and 10Yr ratios all moved higher over Q4 at 71.77% (+1.66%), 77.29% (+2.46%) and 84.76% (+0.17%), respectively. We continue to see relative value in intermediate maturities.
- 2018 issuance came in at \$338.9 billion, down 24%. Refunding issuance declined 61% due to 2017 tax reform. Muni issuance expectations for 2019 range from \$355-390 billion, as New Money Issuance is expected to increase and Q1 should be higher than the same period of 2018.
- Despite Q4 outflows, muni technicals remain favorable mainly due to a decline in outstanding supply. Expectations are for net negative issuance in 2019 to hit \$70 billion vs. \$121 billion in 2018 according to JP Morgan.
- With a lid on rates, we will be maintaining duration for our Intermediate portfolios at 4.60-4.70 years.

Investment Grade Corporates & Treasuries

- The 10Yr UST remains in a trading range at 2.60-3.15%, and the Fed seems unlikely to raise rates twice in 2019. As the market gets comfortable with a Fed on hold, we could see short rates decline and some yield curve steepening.
- Corporate risk premiums spiked towards year end along with political headlines, trade fears, and slowing economic conditions. The cost of issuing a 5 year single A corporate bond rose from 2.68% (2.21% UST + 47 bps of credit spread) at the beginning of 2018 to 3.42% by year end (5Yr UST plus 30 bps and spreads widened by 44 bps).
- Corporate issuance for 2018 was down 12%. This trend is expected to continue during 2020.

Equities

- Despite gaining more than 6.5% over the final four trading days, the S&P 500 experienced its worst quarter since 2011 with a loss of 13.5%. A total return of -4.4% broke a nine-year winning streak that had produced 15% annual returns and represented the first negative year since 2008. The markets remained highly volatile as 2019 trading began.
- A combination of headwinds impacted Q4, led by global growth concerns, potential for a Fed policy mistake, and trade tensions with China. DC drama was largely ignored for much of 2018 with investors focusing on tax cuts and deregulation. That abruptly changed late in the year as legal developments (Cohen, Mueller), presidential tweets ("Tariff Man," Powell criticism), resignations (Kelly, Mattis), and a government shutdown shook confidence.
- While these concerns are real, we feel Q4's equity declines were too severe. In our opinion, the US economy should grow 2-2.5% in 2019, with the IMF forecasting global growth of 3.7%. While down from recent levels, these estimates remain positive. Investors have been pricing in recession and slowing growth is not the same as contraction.
- Corporate earnings are also projected to increase by 12.4% when 4Q18 data is released and, although +7.6% expectations for 2019 are likely to be tempered, recent sentiment seems too bearish.
- Nonetheless, volatility could persist. We are looking to Q4 '18 earnings season to provide some relief. Progress on trade talks with China is welcome, although we'd like to see a firm deal before getting too excited.

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