MONTHLY MACRO OUTLOOK

08 JAN 2019

ThirdRock

KEY MACROECONOMIC DEVELOPMENTS

- Oil is unlikely to prolong its slide, although any macro stimulus from low oil prices is not expected to be dramatic
- Tail risks in Europe abound, from excessive ECB tightening to persistent financial fragility in Italy to Brexit spill overs
- While the dollar strengthened dramatically in 2018, downside risks dominate, suggesting a weaker greenback in 2019

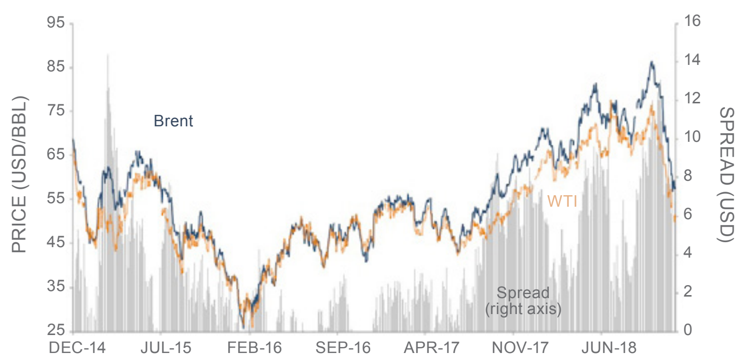
Markets renewed their downward pounding in December, albeit with a slight reprieve in the final days of 2018. The heightened volatility leads us to explore tail risks in greater detail. We argue that the slide in oil prices is unlikely to provide much stimulus to overall economic activity in the year ahead, and may even turn out to be a contractionary shock for the United States (which has traditionally enjoyed a bonus from cheaper oil). Tail risks are also present in Europe, principally from ECB policy tightening in the face of an already-decelerating Euro Area economy. And finally, we speculate that the dollar's strengthening run may end in the year ahead.

IN SEARCH FOR THE NEW GLOBAL OIL BREAKEVEN

Part of the reason why oil inspires such strong reactions from observers is because of the sheer intrigue behind what goes into determining its price. While oil has a clear use value and production chain—meaning its price dynamics respond to fundamental demand and supply dynamics—even these fundamentals are subject to unusual uncertainty, stemming from the how major sources are located in geopolitically-sensitive nations in Africa, Latin America, and the Middle East. Further amplifying any given price movement is the fact that oil is also often subject to intense speculative trading. Put it all together, and it is clear that projections and analyses surrounding black gold should be viewed with a healthy dose of caution.

With that mealy-mouthed opening, we're now ready to discuss some recent developments in oil markets. After soaring to new heights—briefly peaking in early October at prices not seen since prior to the dramatic collapse of oil in 2014—oil is again back down (and up and down again), clocking in at about $54 a barrel (averaging Brent and WTI) in early December (Fig. A). Beyond the evident volatility, one important feature of the recent evolution in the Brent-WTI series is that the spread differential between them—which first emerged in the second half of 2017 and has persisted almost without relief for most of 2018—is now among the largest it has been for the past half-decade. In fact, the last time spreads between the two were as large—around the beginning of 2015—U.S. producers promptly remediated the pipeline constraints that gave rise to the large spread in the first place, and that alleviation of logistical bottlenecks in shale led to a short-term price collapse.

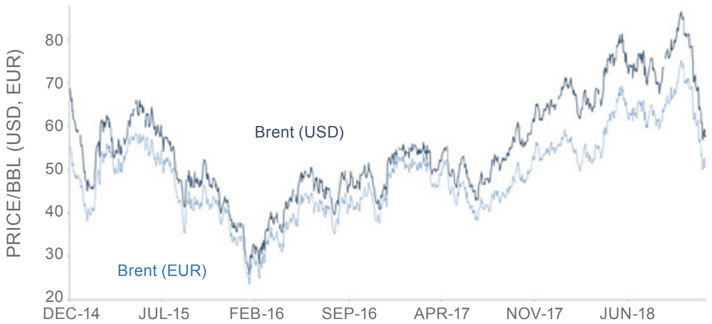
FIG. A: THE RECENT COLLAPSE IN OIL PRICES HAS NOT BEEN ACCOMPANIED BY ANY NARROWING OF THE WTI-BRENT SPREAD



Source: Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Spread is the difference of Brent and WTI prices per barrel.

Unlike the oil price shock of 2011, where a significant part of the persistently high oil price was attributable to the relative weakness of the U.S. dollar (oil contracts are generally written in dollars; while the euro-equivalent barrel price at the time undoubtedly increased, it rose by far less), the drop has not been due to currency movements. The dollar-euro rate has remained within a stable trading range over the past month, and redenominating Brent prices in euros reveals a dive of comparable magnitude (Fig. B). Moreover, the dollar-euro barrel spread—which began to widen around the middle of 2017, concomitant with that for Brent and WTI—has remained even after the recent fall (although narrowing somewhat).

FIG. B: THE RECENT BRENT-PRICE COLLAPSE HAS OCCURRED REGARDLESS OF CURRENCY OF DENOMINATION



Source: Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Brent prices measured in USD and EUR.

“ By and large, geopolitical tensions have historically been associated with hikes, rather than easing, in oil prices. ”

One possible justification that has been offered for the recent decline is that supply from Saudi Arabia and United States shale increased substantially, leading to a temporary oversupply. While we generally agree with the relative importance of supply-side explanations (more on that later), we find this claim quite implausible. For starters, oil prices have steadily ramped up since the second half of 2017 until the most recent sharp slide, and that strengthening has occurred on the back of an accumulation in U.S. horizontal rig count over about the same window (more than doubling to the December count of 887). Given the speed with which shale is typically able to deliver to market from the time of new rig sinking, it is difficult to see why any lagged effects would take that long to pass through.

Nor is the argument that Saudi Arabia had increased production all that convincing. While the Saudis undeniably announced increased output in August, October and November (and reportedly stealthily supplemented the market in September), part of this was in order to offset anticipated supply tightness associated with the reimposition of Iranian sanctions. Yet these supply increases had barely made a dent in prices through most of the period, which leaves one wondering why the effects of oversupply did not seem to matter earlier.

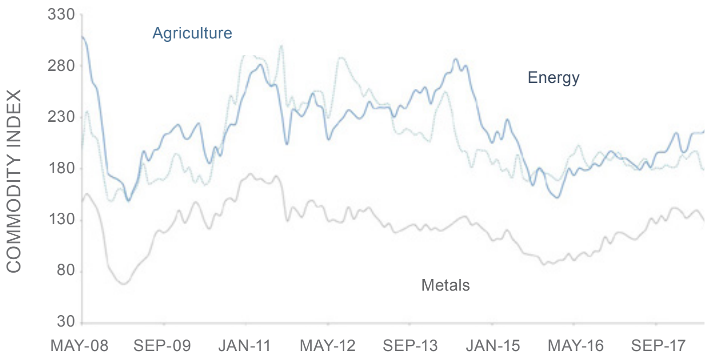
Admittedly, it is possible that the mechanics behind how Iranian sanctions have been reintroduced may have led to a temporary glut. In particular, the significant number of key oil-importing nations were offered waivers to the embargo—a list that includes China, India, and Japan, all major customers of Tehran—and this would likely have removed much of the bite, as opposed to blanket sanctions. With Iranian oil still available at the margin, the unabated supply increase by the Saudis may well have been the final straw for markets looking for a signal to trade the oil price down.

But it’s also useful to recall that October and November were also accompanied by unprecedented political tension (in recent times, anyway) in the Kingdom, due to the fallout surrounding the Khashoggi case. Although counterfactual inferences are, by definition, unverifiable, it is not difficult to imagine how such an event could well have precipitated a nervous trading traction in the opposite direction. By and large, geopolitical tensions have historically been associated with hikes, rather than easing, in oil prices.

The other usual suspect in these instances is that commodities—of which oil is obviously a part—are retreating in sympathy, suggesting that the price movement is a more general one afflicting the entire asset class. A simple comparison reveals that this is not an open-and-shut case. While changes in the prices of agricultural products, industrial metals, and energy tend to move in unison (more or less) over extended period of time, the shorter-term deviations are instructive, and in this case, food prices—which did not enjoy the upswing that energy and metals did since the start of 2016—have nevertheless mostly held up in the face of the recent softness (Fig. C). If anything, the most recent two months registered upticks in the index (although, as one might expect, we tend to heavily discount such short-term blips).

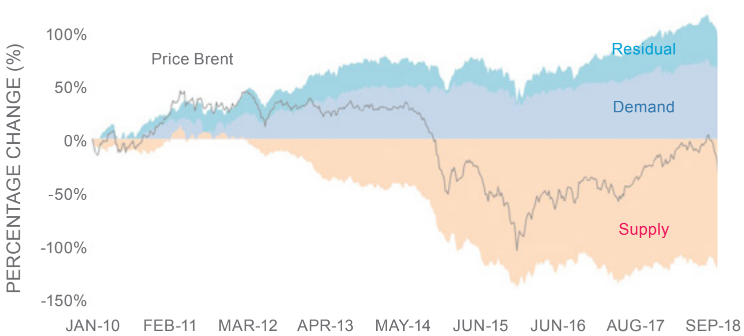
A more systematic decomposition of the demand-versus-supply contributors to oil prices—courtesy of the New York Fed— corroborates this suspicion. Essentially, the approach relies on a large number of financial variables that have historically provided strong explanatory power for changes in the oil price to infer the extent to which contemporaneous changes in the oil price may be due to either supply, demand, or something else (labeled as the residual). On the basis of this model, the recent oil price collapse thus appears to be mostly due to demand-side factors (as well as the unexplained residual) (Fig. D). Of course, this does not preclude the fact that supply-side factors have, since the middle of 2012, been responsible for the bulk of oil price movements. But it has relatively less to do with the recent plunge.

FIG. C: WHILE THE PRICES OF ENERGY AND INDUSTRIAL METALS HAVE DIPPED, AGRICULTURAL GOODS PRICES HAVE REMAINED FAIRLY ROBUST



Source: Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Energy, metals, and food indexes correspond to the Dow Jones energy commodity index,the Dow Jones industrial metals index, and the Dow Jones agriculture/livestock index, respectively.

FIG. D: A BREAKDOWN OF CONTRIBUTORS TO CHANGES IN THE CRUDE OIL PRICE UNDERSCORES A RECENT SOFTENING OF DEMAND



Source: Thirdrock compilation, from FRBNY Oil Price Dynamics Report.
Notes: Residual reflects price movements otherwise unexplained by supply or demand factors. The sum of changes in supply, demand, and the residual is the Brent crude price.

Yet the divergence itself hints at where the source of downward pressure on oil prices truly lie. The decline in oil (and energy, more generally) has occurred alongside declines in industrial metals. As we mentioned in last month's outlook, copper—a key indicator of the strength of underlying global industrial activity—has been among the commodities exhibiting material price weakness. In recent years, such pullbacks have often signaled diminished demand from China, which in turn is reflective of a slowdown in demand for manufactured goods worldwide.

Where do we go from here? Well, as an investment shop, we are concerned about oil prices—beyond holding some commodities in one's portfolio for diversification purposes—mainly for what it tells us about underlying macro fundamentals, and in turn these fundamentals for other asset prices (predicting the level of oil prices really isn't in our wheelhouse, but if forced to take a position, the notion of a \$50–\$60 trading range strikes us as reasonable). Here, it is instructive to look back to 2016, when everyone (including us, to be quite honest) was forecasting that the collapse in oil would prove to be a positive spur for most economies, given how most were still net oil importers. As it turns out, any macro lift was fairly mild, and for the United States in particular, 2016 was quite a challenging year, owing to a spillover effects of the Chinese slowdown (for reasons unrelated to oil), as well as the fact that shale energy had become such a feature of U.S. growth from 2010 onward that the correction in oil prices led to an outsized drag from the sector.

Our impression is that this time round will be similar. The U.S. is already slowing, and a contraction in the oil sector will do it no favors. The jury is still out on whether shale can fulfill its promise of affording America energy independence and allowing it the opportunity to become the next swing producer. On one hand, shale technology has continued to improve and many industry insiders now suggest average cost breakeven as low as $40 a barrel; on the other, it is unclear how successful otherwise-nimble shale producers can be when financing is no longer as abundant in an era of higher interest rates (rig count has declined in recent weeks, and looks to continue doing so through till at least February). Our sense is that the latter explanation will likely dominate, and with global demand weakness matched by comparable supply cutbacks, oil prices are unlikely to slide indefinitely. That said, should oil prices keep falling regardless, the unexpected beneficiaries may turn out to be other oil-importing economies such as China, Europe, and Japan, all of which are struggling to manage their faster- than-expected economic decelerations, and which will certainly welcome any boost they can get from external stimulus, whether from cheaper oil, or otherwise.

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EUROPE: TAIL AND NOT-SO-TAIL RISKS IN EUROPEAN MACRO

By just about any stretch of the imagination, Western Europe remains a lovely part of the world: the food is great (the wine even better), and the overall quality of life and ease of living—supported by a generous welfare state and a rich historical legacy of public goods—is high. It is small wonder that migrants from across Eastern Europe and Africa flock to the shores of the world’s second-largest economic region, in search for brighter prospects. The Euro project is often regarded as the gold standard for modern, democratic, and liberal aspirations, and one emulated at least indirectly by other regions seeking a model for greater economic integration (such as those in Africa and ASEAN). It is perhaps ironic, then, that so many observers only point to the deep-seated problems of the European Union, and warn of an impending collapse of the Eurozone (mea culpa, we have on occasion also echoed such pessimism).

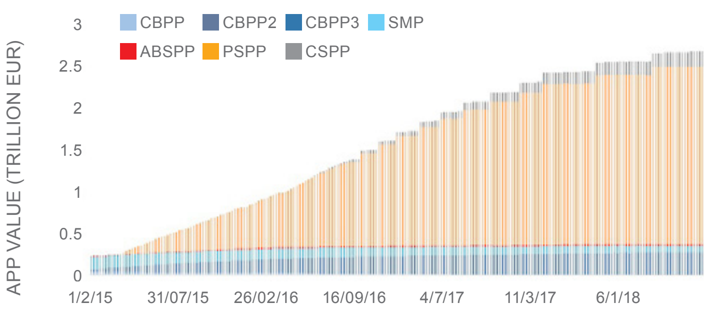
But it is the nature of economic analysts to worry, of course, and so it is worth thinking through some of the more unlikely— but still worrisome—tail risks that threaten the viability of the broader European economy. Before we launch into this discussion, however, it’s worthwhile documenting our baseline view of how we see the region evolving in both the shorter and longer run.

It’s easiest to start with long-run expectations. Our baseline model for Euro Area potential growth—which incorporates demographic changes in an aging European labor force, slowing human capital contributions owing to diminishing returns to an already highly-educated population, and a continued gradual but relatively limited buildup of physical capital—projects a long-run growth rate that averages a little less than one percent per annum for the region over the next decade. Given this relatively modest long-run trend rate, then, we regard the GDP growth prints over the past year or so (in the high 2s) as a clear outperformance, owing to a combination of an delayed return to potential (from the double-dip recessions of 2011 and 2013), some overshooting in export-oriented Eurozone economies due to a QE-induced competitive euro (particularly Germany), and a favorable external environment as the world was in the throes of a synchronized expansion. Yet we had argued repeatedly that this short-run outperformance was unlikely to last, given the region's long-run fundamentals as well as structural impediments associated with the slow pace of labor market reform.

It was with not a small amount of gratification (though not schadenfreude) to see the process of mean reversion in the European economy take hold, and macro performance in the region return to growth rates closer to our one-percent annual baseline. Which naturally brings us back to our original question: what might bring this state of affairs into a much more perilous situation?

For us, the major risk (by far) stems from unabashed tightening of monetary policy by the European Central Bank (ECB). ECB termination of asset purchases will take an average of EUR 15 billion monthly in demand for long-term securities off the table (from a monthly average of about EUR 60 billion in 2017, and highs in excess of 80 billion the year before). To be fair, this plan has been previously well-telegraphed, and the termination of purchasing flows does not (yet) entail a rolling off from the still-massive stock of assets on the central bank's balance sheet (see Fig. E), which would be even more contractionary in nature.

FIG. E: WHILE THE END OF ECB PURCHASES AMOUNTS TO REDUCTIONS IN LONG-TERM SECURITIES DEMAND, IT IS NOT A CONTRACTION YET



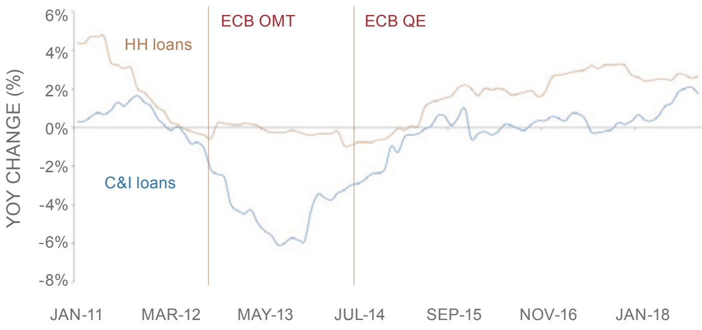
Source: Thirdrock compulation, from ECB
Notes: CBPP = Covered Bond Purchase Program; SMP = Securities Market Program; ABSPP = ABS Purchase Program; PSPP = Public Sector Purchase Program; CSPP = Corporate Sector Purchase Program. Data only record liquidity from expanded asset purchase programs, and not standard facilities.

> **" The end of the ECB QE program is occurring in a much weaker environment than that which prevailed during the tightening process for the Fed. "**

The concern here is that the end of the ECB quantitative easing (QE) program is occurring in a much weaker global environment than that which prevailed during the tightening process for the Fed; current conditions are more akin to those that prevailed during the Fed tapering episode in the summer of 2013, which resulted in substantial volatility in financial markets, especially among EMs. Without the ballast of strong external demand, therefore, a successful end to European QE will depend much more on the region's internal growth dynamics. But European growth at the moment is also much weaker than contemporaneous U.S. growth was at the start of its monetary contraction process, even setting aside the lower potential growth rate for the region as a whole. And forward-looking indicators offer little relief for what lies ahead: The Euro Area PMI collapsed to its lowest level since the start of 2018 in December and is just one point above contraction territory.

Moreover, while ECB unconventional monetary policies did help end the severe credit crunch that the Euro Area was undergoing at the time (Fig. F), the recovery in loan growth has been unimpressive, especially with regards to all-important lending to commercial and industrial (C&I) enterprises. Indeed, the growth in C&I loans—which until the middle of 2018 had hovered around zero—has only just caught up to growth in household lending. Perhaps more important, the expansion of both classes of lending—at rates of about 2 percent on a year-on-year basis—remains significantly below those during the pre-crisis period (2004–08), of 8 and 9 percent, respectively.

FIG. F: WHILE ECB QE OPERATIONS RESOLVED THE CREDIT CRUNCH, THE GROWTH OF COMMERCIAL LENDING HAS BEEN ANEMIC



Source: Thirdrock calculations, from ECB monetary and financial statistics
Notes: C&I (Household) loans sum MFI volumes to euro area non-financial corporations (households) for short-term lending durations.

FIG. G: THE GROWTH RATE OF THE MONEY SUPPLY HAS BEEN LOW, AND HAS FAILED TO MATCH RECENT HISTORY

Source: Thirdrock compilation, from ECB monetary and financial statistics
Notes: Broad money supply defined as euro-area M3.

With such slow rates of lending, it is unsurprising that recent growth rates for the broad money supply in the Euro Area has failed to match not just that in the pre-global financial crisis period, but even that during the recovery period from the European sovereign debt crisis (Fig. G). This slow rate of growth in money suggests that monetary policy—in spite of the ECB's best efforts—has not been very expansionary at all, and hence has been a very limited tailwind for economic growth. But tight money has consequences beyond the real economy, of course; with the money supply constrained, inflation has much less space to run. Small surprise, then, that as the growth of the money supply has come down from the recent peak in mid- 2015, Euro Area inflation has likewise ground lower, picking up only with the more recent bounce observed since early 2018. Taken together, the risk of renewed growth slowdown and disinflation, which would be further exacerbated by unrelenting ECB monetary policy tightening, represents our most significant concern for Europe in 2019.

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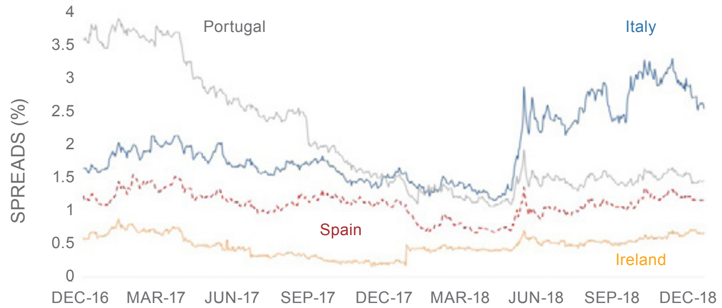
While the recent rapprochement between Italy and the EU seemed to have ended a tail risk that we had been concerned about since mid-2018: the fact that the fragile populist coalition between M5E and Liga in Italy would rupture over irreconcilable differences in their respective approaches toward the national budget, as well as between them and the European Commission. Eventually, the episode ended with a step-down by Italy—shaving their initial deficit target from 2.4 to a little more than 2 percent of GDP—but with the Commission ceding some credibility in their ability to deal with larger recalcitrant Euro Area economies. Markets have largely taken this news positively, with Italian sovereign spreads over comparable German bunds continuing to fall from the peak of 3.3 to 2.5 percent since late November.

FIG. H: ITALIAN SPREADS BEGAN COMPRESSING IN LATE NOVEMBER, AND CONTINUES TO CONVERGE WITH OTHER PERIPHERAL ECONOMIES



Source: Thirdrock calculations, from Datastream
Notes: Spreads calculated for 10-year government bonds relative to the German 10Y Bund.

In some ways, the fact that Italy would eventually need to give in more to resolve the impasse was always on the cards. As noted by Olivier Blanchard and Jeromin Zettlemeyer at the Peterson Institute for International Economics, the spread widening in bond markets over the past few months had meant that whatever economic boost that would have been forthcoming as a result of heightened fiscal expenditures would have been largely offset by the contractionary effects of higher interest rates. Consequently, the fact that Italy ultimately relented became mostly a political (rather than economic) calculation, of how best to convey this reality the voting populace. So, the immediate worse-case scenario of Italy violently exiting the monetary union has been avoided (for now), and both investors and EU officials can breathe a sigh of relief.

Lest investors think that they are out of the woods, however, it is worth noting that Italian troubles hardly end with this fiscal agreement. While the agreement allows the governing coalition to declare a certain modicum of victory in each party's fulfillment of electoral promises, the coalition itself remains, in our view, fragile. This means that future bones of contention could easily devolve into flashpoints that could easily split the governing structure and lead to fresh (early) elections, and all the attendant uncertainties that come along with a new government respecting the existing deal.

Italian banking fragility also remains an ongoing concern, with capital difficulties faced most recently by a midsized Genoese bank, Carige. But so long as the more fundamental problem—of chronically lagging productivity and growth—remains unresolved, and the budget deal has done little to address the economy's uncompetitive labor markets, capital misallocation, and ineffective public sector. So, while we'd share in the relief and downgrade our short-term concerns over Italy, we remain skeptical of its medium-long-term economic prospects and continue to urge investors to exercise caution in taking on Italian asset exposures.

More generally, Italian bank difficulties are symptomatic of the wider problem faced by all European banks, especially those based in the larger, core economies. Because banks have strong incentives to hold the sovereign debt of their sovereigns— which in turn means that any default by either the banking sector or the government automatically gives rise to problems for the other (the so-called "doom loop" of European banking)—only a full banking or fiscal union will be able to break this unhealthy codependency between the two, and until that occurs, the EU will inevitably face amplified shocks from what could otherwise be fairly routine defaults.

" Should Brexit go ahead, the effects on the EU will be nontrivial. "

The third tail risk for the region stems from the effects of Brexit for the greater European Union. Much ink/bytes have been spilled in making the case that the UK will be the greater loser in a divorce scenario (a point that we have made ourselves and continue to agree with). There have been some rumblings in recent weeks about how there could well be a second referendum on an exit from the EU (a notion strangely termed as the "people's vote," as if the first referendum did not somehow involve the people). Current odds, offered by the always-entrepreneurial British betting establishment, stand at around 7:5, or a little shy of 60 percent (lest one gets too carried away, it's worth recalling that betting odds favored the no-Brexit outcome the first time round). So, there is a material chance that Brexit, which had consumed British economic analysts and observers for the better part of the past two-and-a-half years, may not go ahead after all.

Should Brexit go ahead, however, the effects for the EU will be nontrivial. Of course, the extent of the fallout will depend on the contours of the eventual deal (for example, Theresa May's much-harangued deal, a Brexit-in-name-only Norway model, or a worse-case WTO-only outcome). Regardless, the effects of Brexit will be felt differentially across the varying European economies While trade exposures for the EU at large to the UK are significantly smaller than for the UK to the EU—about 5 versus 48 percent in goods, and 11 versus 51 percent in services—certain EU economies, such as Belgium, Germany, Ireland, and Spain—maintain either large export surpluses or import deficits vis-à-vis the UK, and stand to face economic dislocations that would result from more hard versions of Brexit. And with cross-border capital flows greatest between the UK and the largest European economies, any glee that Frankfurt, Paris, or Madrid may feel in capturing a share of the City of London's banking business should be tempered with the possibility that the adjustment process would, in the interim, be accompanied by financial disruptions.

Finally, geopolitical risks remain ever-present. The most recent reminder of this has been the gilet jaunes protests in France, which is symptomatic more generally of how populist politics remains ascendant across Europe, and even in countries where centrist parties have remained relevant—such as Germany or the Netherlands—the political mainstream remains on a back foot. And across EM Europe, rising authoritarianism has not been forcefully refuted (not least because the liberal West is busy dealing with political challenges at home).

On balance, our pessimism about short-run as well as medium-run European prospects leads us to recommend caution insofar as holding European assets are concerned. Certain well-run European firms, with a global footprint and solid corporate fundamentals, may still prosper in the years ahead. But overall, we find it difficult to be excited about European equities or fixed income at this stage.

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ON THE DOLLAR AND TARIFFS

2018 proved to be a banner year U.S. dollar. After languishing at lows of more than 1.2 per euro through most of the first quarter, the greenback staged a strong recovery over the course of the rest of the year, steadily appreciating in both nominal and real terms, before stabilizing over the last two months (Fig. I). Given this dramatic shift—where the dollar reversed almost of its perplexing losses over 2017—the question foremost of many minds is whether this renewed strength is here to stay, or whether the currency will again swing in the opposite direction, confounding currency strategists once again.

FIG. I: AFTER WEAKNESS IN THE FIRST QUARTER, THE DOLLAR STRENGTHENED IN REAL AND NOMINAL TERMS OVER THE REST OF 2018

Source: Thirdrock compulation, from JP Morgan/Datastream
Notes: Nominal rate given with USD as base and EUR as quote currency, so that an increase represents an appreciation. Real rate given as the trade-weighted real effective rate, calculated using the CPI, such that increases likewise represents an appreciation.

We've often stressed the difficulty of forecasting short-term movements in foreign exchange—a position grounded in oodles of academic research—but of course, that has never stopped us from venturing views that are premised on solid analysis of the data. We make such an attempt again here, with the usual caveats.

The case for continued strength in the greenback is straightforward. For the year ahead, the U.S. economy is expected to easily outperform other major G4 economies, where growth has already slowed even more dramatically over the course of the second half of 2018. Furthermore, a continuation of the trade war—in particular, the raising of new tariff barriers—would lead to dollar strengthening, as implied by basic theory (tariffs raise the relative price of foreign goods relative to the United States and induces substitution into cheaper American-made products; this increased demand for goods priced in dollars likewise increases demand for the currency). Chinese authorities have also been acquiescent to dollar strengthening, since economic theory tells us that every 1 percent depreciation of the renminbi has the potential to offset an increase in import tariffs of 1 percent (so long as exports also enjoy a 1 percent subsidy). And after the recent market downturns, some investors believe that U.S. assets are now fairly-valued, which is also supportive of dollar strength.

But the risks, in our view, are definitively skewed to the downside. The reasons are six-fold. First, even though a rising-rate environment does—all else equal—imply a stronger dollar, the presumed schedule of rate rises has been announced well in advance, and hence largely priced in. If anything, the only way to reconcile the continued interest rate differential between the U.S. and the rest of the world with the appreciation that has already occurred is for the market to expect depreciation ahead (the logic of this argument relies on an arbitrage condition called uncovered interest parity, but we won't go into the gory details here). Second, the rate hike cycle is more likely to pause or at least match market beliefs of only two more increases; if so, future rate movements will lend less support to the currency than presently. Third, the risk from slowing growth is skewed to the downside. Markets have priced in solid growth prospects into 2019, so if the economy underperforms relative to expectations—or even enters into an earlier recession than anticipated (as we have previously speculated)—then the dollar will weaken accordingly.

Fourth, to the extent that relatively overvalued U.S. asset markets re-converge with valuations elsewhere, capital flow reversals that will accompany such a move will mean additional downward forex pressure. Fifth, the tariff argument for dollar strength glosses over the fact that Chinese retaliation means that tariffs work in the opposite direction, too. When we pair that fact with how the pass-through of foreign exchange typically takes a year before it shows up in real activity, it is not difficult to see that theoretical tariff effects could well be overstated. Finally, with the dollar having strengthened as much as it has to date, it is difficult to imagine that the currency-sensitive administration will not exert renewed pressure for policy to constrain further appreciation, especially under an otherwise-pliant Treasury under Secretary Mnuchin.

Taken together, we believe that factors in favor of more dollar strength in 2019 appear to be well-priced into the prevailing exchange rate, whereas the risks that would lead to a swing toward dollar weakness abound. The end to dollar strength may well be nigh. As usual, we encourage any outright bets on directionality (as opposed to hedging) to do so vis-à-vis an especially undervalued counter currency; the yen comes to mind.

INVESTMENT TAKEAWAYS

Market volatility is high, and we do not see any immediate relief to this jittery environment. It is useful to recall, of course, that gyrating markets can occasionally throw up major bounces alongside sharp selloffs. We retain our tactic of selling into strength and rotating into defensive sectors. Given the tail risks discussed in this Outlook, we see little tactical reason for overexposure to Eurozone assets, at least in the short run. Our barbell suggestion of holding either short or long duration Treasuries paid off in December, and we continue to recommend this approach for now. A number of Asian EM assets have recently presented attractive valuations, and those with a strong stomach for risk may even consider distressed EM assets that were significantly oversold in 2018, such as (selected) Argentine or Turkish equities.

The author Jamus Lim is Economist at Thirdrock Capital. A former lead economist at Abu Dhabi Investment Authority and senior economist at the World Bank, Jamus is also currently an Associate Professor at ESSEC Business School in Singapore.

GENERAL

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