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MAR
2019

MONTHLY MACRO OUTLOOK

ThirdRock

KEY MACROECONOMIC DEVELOPMENTS

- Inflation worldwide has fallen as commodity prices have weakened; this is the case for both headline and core prices.
- For the United States, recession risks in 2019 are minimal, although leading signals make it hard to rule out one in 2020
- Our review of calls over the past half year reveals one major missed call regarding Latin American risk assets

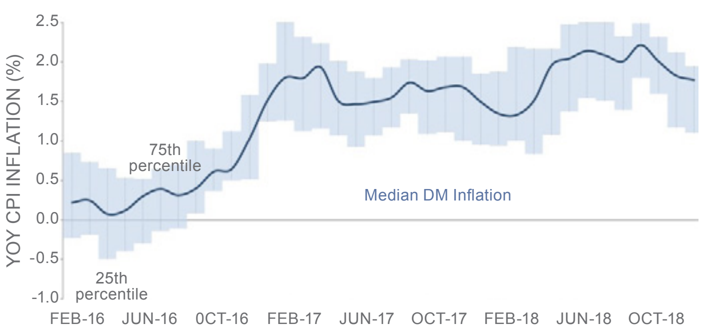
Although we discussed global inflation patterns fairly recently, the incoming data have moved materially enough to warrant another look; we conclude that price pressures in both developed (DM) and emerging (EM) markets have been relieved sufficiently that a takeoff this year is no longer in the offing. In light of recent market fears about a recession, we return to the theme by exploring leading indicators; our conclusion here is that there has been an undeniable softening in the fundamentals, but a recession in 2019 is pretty much off the cards. Finally, we conduct our semiannual exercise of comparing the accuracy of our calls to the actual (or emerging) data.

A QUICK REPRISE ON THE GLOBAL INFLATION THEME

We had only very recently—three months ago, in fact—reviewed the inflation picture, but the incoming data has moved appreciably enough (in favor of our view, thankfully) that it seemed worthwhile reprising the topic briefly one more time. Our December Outlook raised the possibility that inflation "would likely reverse," premised on how the drivers of inflation—especially the commodity contribution to the story—was exhibiting weakness. So our thinking is that this time round, we would take a slightly different tack. We will look at several decompositions that make up the overall inflation picture and perform a small compare-and-contrast exercise between patterns in Europe relative to the United States. We think this is important, since the latter has only just recently started to emerge from its deflationary cocoon, and the risk of falling back into the web of falling prices there is actually quite real.

Before we launch into the analysis proper, let's look again at the requisite inflation distribution chart, which we routinely share (not least because we return to this ourselves rather often). Compared to just a few months back, where we noted that "inflation appears to have settled down," median inflation among developed markets (DMs) has fallen even more than our sanguine view—along with those of financial markets—would have expected (Fig. A). The January data suggests that prices in the median DM are growing at only 1.4 percent; this is well below the standard two percent target for most advancedeconomy central banks, and also marks a steady weakening from the most recent high (of 2.2 percent last October).

FIG. A: COMPARED TO THE FOURTH QUARTER OF 2018, MEDIAN DM INFLATION IS SET TO RETURN TO THE LOWS OF EARLY 2018



Source:Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Bars correspond to 25th and 75th percentile of YoY CPI inflation among DMs.

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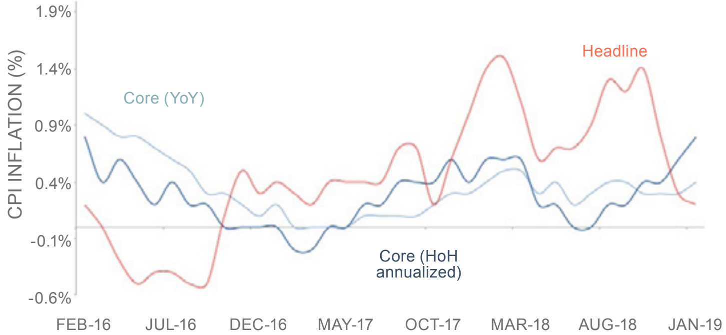
Remarkable, this softening is not only due to the economies of the Euro Area, which has been struggling with disinflationary and deflationary forces since the end of the acute phase of its sovereign debt crisis (around 2012). In fact, while both headline and core inflation in Europe have moderated—and undoubtedly, remain substantially below the European Central Bank's (ECB) stated aim of "below, but close to, 2 percent"—core price dynamics in the monetary union really haven't changed all that much over the past year or so. In other words, the ECB continues to hold the unenviable crown of perennial under shooter vis-à-vis its inflation target, but it hasn't underperformed much of late.

Instead, the drag comes from two sources, one a familiar friend, and the other a bit of a surprise visitor. The familiar friend, of course, is Japan; headline inflation there slid from 1.4 percent in October to 0.2 percent in January. This dip stands in sharp contrast, however, to what is happening to inflation in core prices, which is either stable or even trending upward, depending on the specific calculation one applies (Fig. B).

FIG. B: THE DROP IN HEADLINE INFLATION IN JAPAN IS THE CAUSE OF DISINFLATION, COMPARED TO TRENDS IN CORE THAT HAVE FALLEN LESS

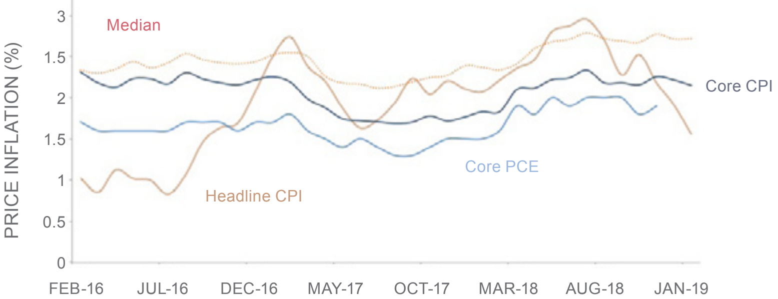


Source: Thirdrock calculations, from Datastream.
Notes: Rolling YoY and annualized HoH inflation of the monthly consumer price index, excluding food and energy (core) and including (headline).

This distinction is important, especially because core inflation had been weak in Japan for the past two years. Hence, even if the most recent strengthening does not persist, the underlying price dynamics look to be reasonably strong. And ultimately, it is the movement in core inflation that will determine how inflation evolves in the medium to longer term. Suffice it to say that we believe that the headline dip we currently observe is more than likely to be transitory than not, a function of falling energy prices, and one that will likely stabilize as the oil price slide worldwide appears to have found a bottom.

The slight surprise is the United States. To be sure, the retreat in headline inflation there echoes the falls across all DMs (Fig. C). But what we expected less was the absence of more upward pressure in core prices, whether measured by the standard consumer price index (CPI) or the indicators that the Federal Reserve tends to stress more, Personal Consumption Expenditures (PCE) (for those who care, the difference in these two flavors stems from the weights, composition, and adjustments applied to the respective price baskets; by and large, both indexes tend to hug each other closely, although divergences do occasionally emerge).

FIG. C: THE DIP IN U.S. HEADLINE INFLATION ECHOES OTHER DMS, BUT CORE INFLATION HAS CHANGED LESS THAN ELSEWHERE



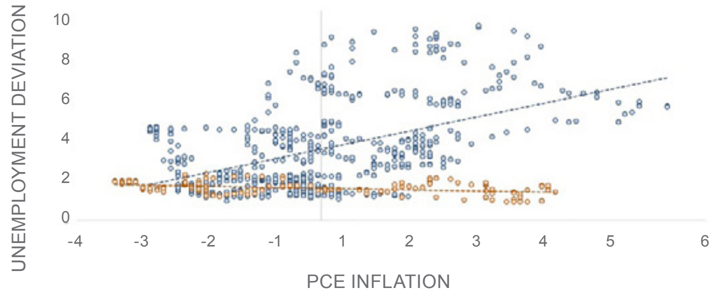
Source: Thirdrock calculations, from Datastream.
Notes: YoY inflation of the monthly headline, core (excluding food and energy) for either the consumer price or personal consumption indexes, and median (of all CPI components) consumer price indexes.

There are two ways to interpret this fact, one a more glass-half-full point of view, and the other a more pessimistic one. The negative take is that, in spite of very solid progress in wage inflation over the course of 2018, there has been very little transmission through to actual prices. This means producers have not been compelled to raise final prices much, perhaps because they fear that doing so would erode their market positions. The reason why this is a little unfortunate is that it means that workers (and, by extension, consumers) will not capture much of the economic recovery, were the cycle to end soon (peak wage growth, according to the Federal Reserve of Atlanta's median wage tracker, topped out at close to 5.5 and 4.5 percent in the previous two end-cycles, respectively, while it remains below 4 percent currently).

The upbeat view is that this is good news for financial markets, on at least two fronts. First, it ensures that profits (and hence equity prices) would be higher than otherwise; if indeed we enter into an earnings recession sometime this year, more severe earnings misses would almost certainly tip the fragile economy into outright recession. Second, it also allows the Fed to take a longer breather in its pause—perhaps even not hiking any more this year (as markets are already pricing in, in contravention to the FOMC's telegraphed dots, which still suggest that a hike or two later in the year may be in the works).

Regardless of one's take on the matter, it is still difficult to see how core inflation might pick up, even if unemployment stays low. This is the famous (or infamous) "flattening Phillips Curve" argument, a claim that since the crisis, the traditional tradeoff between inflation and unemployment no longer seems to help. We have our own reservations on the strength of the precrisis relationship—if anything, the pre-2007 inflation-unemployment tradeoff appears to be upward rather than downward sloping, as might be predicted by theory (see Fig. D)—but it is undeniable that any post-2007 relationship is pretty much absent (although, ironically, slightly downward sloping). Consequently, we hold fast to the view that any wage pass-through to prices are like to be, at best, rather modest.

FIG. D: SINCE THE GLOBAL CRISIS, THE RELATIONSHIP BETWEEN INFLATION AND UNEMPLOYMENT HAS BEEN LARGELY ABSENT



Source: Thirdrock calculations, from FRED
Notes: Blue (orange) dots correspond to the precrisis (postcrisis) period, defined around 2007M9.Unemployment deviation calculated as difference between contemporaneous unemployment rate and period average. PCE inflation calculated as the YoY change in the PCE index. Dashed lines denote best linear fit to each corresponding period's data.

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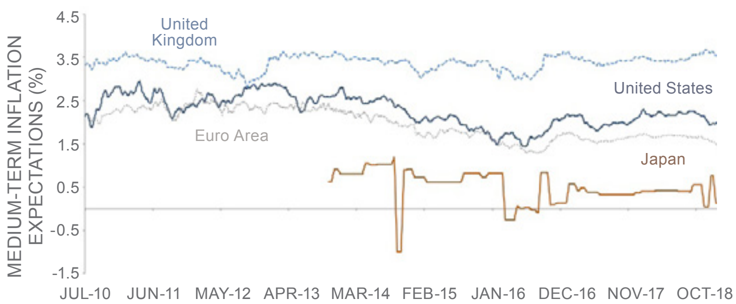
Markets appear to agree, especially when one looks beyond the immediate horizon to the medium run. Inflation expectations for the five years to come, five years from today—the so-called 5Y/5Y forward—have displayed, since 2016, remarkable stability across all major developed markets (Fig. E). This contrasts with the chart for shorter-run expectations that we had shared back in December (which was based on 5Y inflation swaps alone). This stability is comforting and is a sign that market beliefs surrounding medium-to-long term inflation remain pretty solidly anchored. But (and you knew there was a but), the bad news is—at least from the perspective of the BoE, ECB, and BoJ—these expectations are significantly different from the official central bank targets (all of 2 percent).

FIG. E: FINANCIAL MARKET PRICING OF INFLATION EXPECTATIONS IN G4 ECONOMIES HAVE BEEN VERY STABLE SINCE AROUND 2016

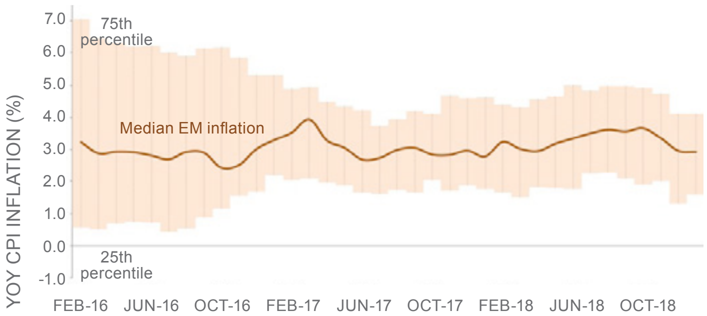


Source: Thirdrock calculations, from Thomson Reuters Datastream. Notes: Medium-term inflation expectations correspond to the 5Y5Y forward inflation swap (forward implied TIPS breakeven for US) rate, smoothed using a 10-period moving average.Japan data begin in 2009M6.

As discussed previously, the fact that UK inflation is elevated into the indefinite future stems from Brexit, and the fact that the weak pound, coupled with Britain's trade dependency on Europe, means a bunch of imported inflation (as is the case for the U.S., the inflation-unemployment relationship in the UK has been pretty much flat in recent years). Japan appears to still struggle to beat its deflation demon, with expectations hovering closer to about 40 basis points (bps), well below even by the more conservative insider view that the BoJ should be targeting the unofficial target of 1 percent.

Before moving on, a quick look at EM inflation is in order. As was the case for DMs, inflation in the median developing country has likewise ticked down over the final quarter (Fig. F). The median is now 2.7 percent, appreciably below the targets of just about every EM central bank out there (save the Czech Republic, Israel, Poland, Peru, and the West African States; one could even bucket the former three as advanced economies, given their high-income status). Just as incredibly, the spread between the lower and upper quartiles remain markedly narrow, suggesting that the factor driving the inflation slowdown is almost certainly global in nature.

FIG. F: MEDIAN EM INFLATION HAS ALSO COME OFF THE BOIL, WHILE REMAINING NARROWLY DISTRIBUTED



Source: Thirdrock calculations, from Thomson Reuters Eikon. Notes: Bars correspond to 25th and 75th percentile of YoY CPI inflation among EMs.

In the final analysis, our review of global inflation dynamics makes it clear—at least to us—that the probability that inflation will take off this year remains very low. Like many analysts, we were certainly heartened by the possibility that the synchronized expansion and heady energy prices would become more permanent fixtures in underlying trend inflation, but this seems to not be the case. Couple this low inflation premium with a fairly compressed term premium—the premium for the 10-year Treasury, as estimated by New York Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench, currently rests at around 2.7 percent, not much higher than the most recent minimum in mid-2016—it seems hard to see how long-term yields could escalate quickly in the months ahead.

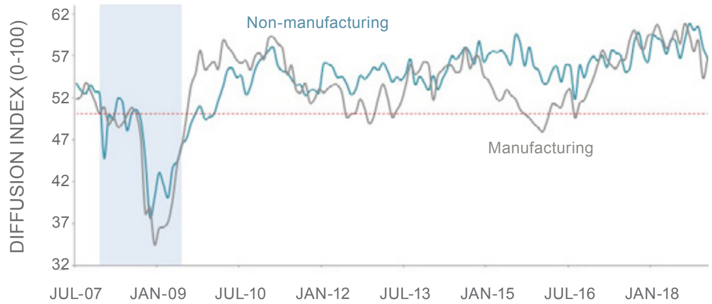
UNITED STATES: LEADING INDICATORS PAINT A GRIM PICTURE, BUT THERE'S PROBABLY ENOUGH GAS TILL YEAR-END

Since the middle of last year—when the United States posted its strongest quarter-on-quarter growth rate in the past four years (although contrary to the claims of Trump that it was the best historically)—we have cautioned against excess optimism about the likelihood that growth was in new, uncharted, future-so-bright-you'd-need-sunglasses territory. Indeed, there was ample reason, even as far back as mid-2018, to poke holes in the overall U.S. macro data. We called it the "Swiss cheese" quality of the American economic story.

In December, markets appeared to come round to—and alas, exceed—our view. But with equities galloping unabashedly forward in January—the S&P 500, for instance, retraced virtually all of its losses of December—it seems like markets are once again overshooting on the upside. So it is perhaps useful to take another sober look at what has transpired in the data since. We focus our analysis, this time round, on a suite of forward-looking indicators, although we'll also provide an update of recession probabilities based on our in-house quantitative model.

In our last Outlook, we discussed how, on a global basis, signals on the production front were materially weaker than those on the consumer side. It is therefore probably worth starting on the same foot, with the widely-followed purchasing managers' indices (PMIs). For the U.S., in particular, it's important to examine not only the manufacturing PMIs, but also the nonmanufacturing index for services (NMI), especially given the diminishing importance of manufacturing for the U.S. economy (even though, as we'll argue, changes in manufacturing activity tend to be a little underappreciated in terms of its contribution to turns of the business cycle). Since 2017, however, both series have tracked each other very closely (Fig. G).

FIG. G: PRODUCER CONFIDENCE AMONG MANUFACTURERS AND NONMANUFACTURERS HAVE BOTH TURNED DOWN RECENTLY



Source: Thirdrock compilation, from ISM/Datastream.
Notes: ISM manufacturers and nonmanufacturers composite indexes. Nonmanufacturing ISM not seasonally adjusted. Red dashed line is indicative recession threshold for both series, and shaded areas capture NBER-dated recessions.

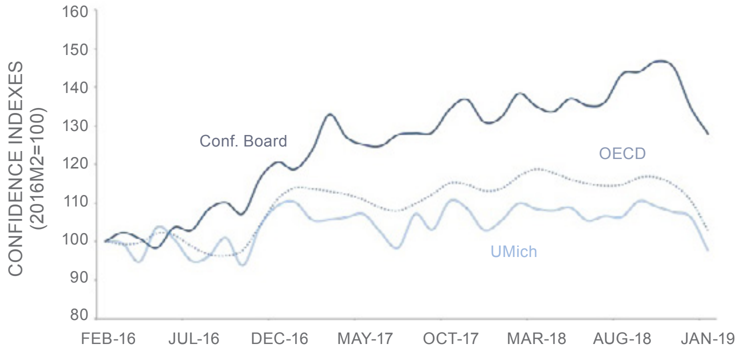
Which is why the flattening and subsequent drop in producer confidence strikes us as somewhat worrisome. Unlike the so-called "manufacturing recession" in early 2016—where industrial manufacturing activity underwent an almost year-long slump (corroborated here by an extended dip below 50 for the PMI in early 2016), but services remained resilient through the drop (giving rise to an appreciable divergence of the NMI from the PMI)—the flattening and slide in both series over the past quarter has been highly coincidental. To us, this is indicative of a more systematic weakness in the U.S. economy, relative to the 2016 episode.

Of course, it's important to recognize that on an absolute basis, either series remains relatively elevated; the manufacturing index stands at 56.6 (as of January), and its services counterpart a shade higher (at 56.7). In level terms, therefore, there appears to be little cause of immediate concern, given that the typical contractionary threshold for the index is 50. But the topping out of the economy back around August or September of last year is quite undeniable, and sharp collapses just prior to recessions can play out remarkably quickly (in as little as about a half-year). So we remain vigilant in monitoring the short-term evolution of this indicator, as an important canary in the recession coal mine. After all, weak production prospects will eventually translate into slower hiring and reduced incomes for workers and consumers, both key indicators of the state of the business cycle.

This naturally allows us to segue to the consumption front. While many observers have correctly trumpeted the (still) very strong job market, we are a little more circumspect. Principally, this is because we have always stressed that labor markets are lagging, rather than leading, indicators—a point we've made before—and even at virtually unprecedented unemployment rates (the last time the U.S. hit the 3.7 percent attained in November last year was in 1968), the employment rate for the working-age population has actually not even recovered the peaks attained prior to the past three recessions. We have also previously discussed the fact that unemployment has bobbled around what seems like a floor of around 4 percent—whatever post hoc reasons one can muster to justify a positive spin on the increase—and how this flattening in the change of the unemployment rate is a classic end-cycle feature.

But to gain additional insight via forward-looking indicators of the cycle, we examine measures that proxy the confidence of the mighty American consumer. According to three distinct measures, confidence has clearly retreated over the past few months, and in one instance—the well-known University of Michigan Survey of Consumer Sentiment, the index has actually dipped below the level observed at the start of 2016, at the time of the manufacturing recession (Fig. H). Alert readers would unabashedly point out the fact that that didn't result in a recession. True enough, but it's also worth noting that, with a divided Congress, the U.S. is unlikely to enjoy another unexpected tailwind from fiscal stimulus before 2020 (unlikely, but not impossible; there is a slim possibility that the House Democrats would be willing to work with Senate Republicans and perhaps even the White House to deliver an infrastructure bill, so long as it includes significant concessions on other fronts, such as immigration and security for Obamacare).

FIG. H: CONSUMER CONFIDENCE WEAKENED HAS STEADILY RETREATED OVER THE PAST FEW MONTHS, IN ONE INSTANCE FALLING BELOW 2016



Source: Thirdrock calculations, from Conference Board, OECD, UMich/Datastream.
Notes: Consumer confidence index normalized to 100 at 2016M2. OECD index magnified by multiplicative transform to better accentuate changes relative to base year.

We wrap up our tour of individual leading indicators by returning to financial markets, in particular, the by-now-infamous yield spread. The spread has received a disproportionate amount of attention from market commentators over the past quarter, especially as segments of the curve (such as the 3 year-5 year spread) began to invert. But as grizzled bond traders will undoubtedly note, inversions at intermediate frequencies do occur will little persistence or consequence, and hence we echo their caution in this regard. Nevertheless, we would be remiss if we failed to mention recession-implied pricing based on the yield curve.

Among the entire suite of spreads, the most reliable—from a recession-predictive perspective—is the 3-month/10-year spread (3M/10Y, as opposed to the one studied by financial market observers, the 2Y/10Y spread). And since January, the slide in this 3M/10Y spread has actually stabilized above zero (Fig. I). This pause is nontrivial insofar as calling any recession for 2019 is concerned, since the duration between curve inversion and actual recession tends to range from as little as 6 months to as long as two years. To some extent, bond markets may be taking the cue from the Fed: were the rate hike cycle to experience an extended pause, then pricing on bonds would reflect that new policy stance, and in turn, there would be a breather on any recession. In this sense, then, markets are now relaxing their forward pricing on the probability

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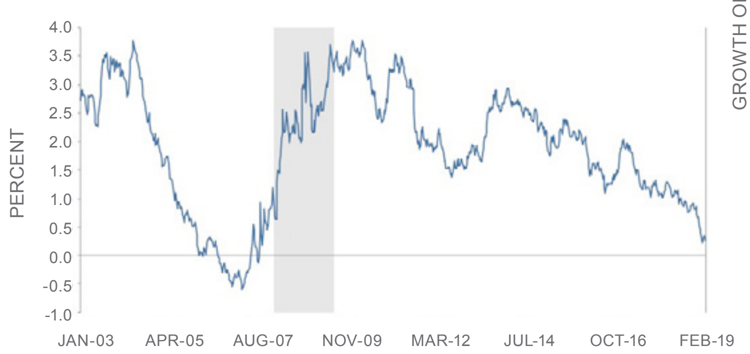
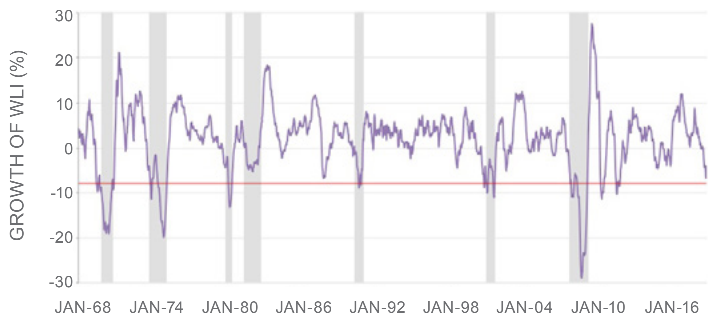
FIG. I: THE MOST RELIABLE FORECASTING SPREAD FOR TREASURIES HAS YET TO INVERT, AND HAS RECENTLY STABILIZED



Source: Board of Governors of the Federal Reserve System (US)/FRED
Notes: 3M-10Y spread calculated as difference between the respective constant-maturity rate Treasuries. NBER-identified recession periods shaded in gray.

Setting aside individual measures, aggregate leading indexes likewise paint a picture of a decisive slowdown, if not quite a recessionary scenario as yet. Perhaps the most concerning among these comes from the weekly leading index (WLI) of the Economic Cycle Research Institute (ECRI). Although ECRI famously got its most recent recession call incorrect—and has been more guarded ever since—the WLI has been a historically reliable signal, especially when conditioned on a sufficiently strong contraction (Fig. J). There is admittedly some overfitting of the relevant threshold here, but such strong dips have coincided with all but one subsequent recession since 1968 (incidentally, you can see the justification for ECRI's bold recession call in 2011). And the most recent available data offer little comfort for an analyst hoping to avoid making a recession call based on this signal alone. ECRI, on its part, has been warning that the substantial economic weakness—even if it doesn't translate into a recession outright—would very likely be accompanied by pullbacks in the equity market. And in that, they have been proven correct by December's drawdown.

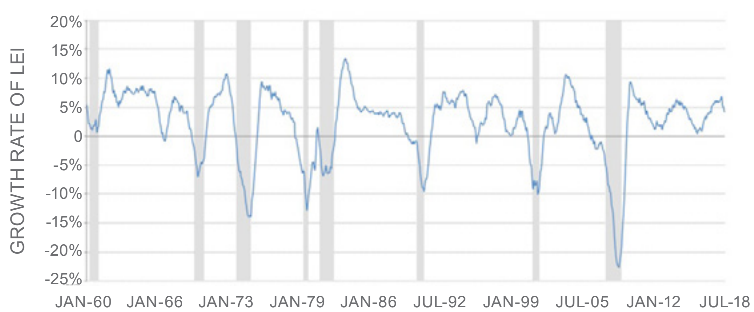
FIG. J: THE GROWTH RATE OF THE WEEKLY LEADING INDEX IS DRAWING DANGEROUSLY CLOSE TO HISTORICAL THRESHOLDS FOR DOWNTURNS



Source: Thirdrock calculations, from ECRI.
Notes: NBER-identified recession periods shaded in gray. Maroon line indicates the WLI growth threshold for which, if breached, has typically coincided with the onset of an NBER recession.

This dismal picture isn't universal, of course. But even among the aggregate indicators that remain relatively elevated, the turn of the direction of economic expansion, and a concomitant slowing of momentum is palpable. One example of this is the Conference's Board's leading economic index (LEI), which has swung down for a sufficiently long time that we can feel comfortable calling the September 2019 a local peak (rather than simply statistical noise) (Fig. K). Now, while the index continues to grow at a rate far above contraction—and has also traditionally offered false positives with contractions occurring intra-cycle—the LEI is also liable to deteriorate suddenly. So chalk this down as yet another measure that we are keeping our eyes peeled to.

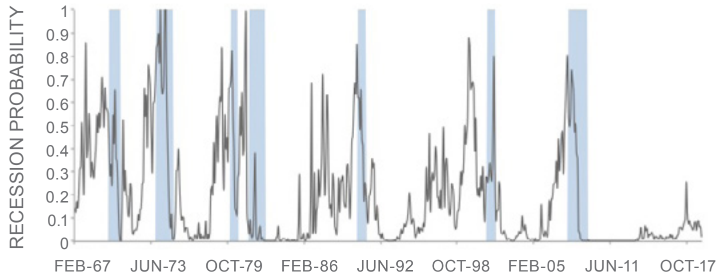
FIG. K: EVEN AMONG THE MORE OPTIMISTIC AGGREGATE LEADING INDEXES, THE INFLECTION IN GROWTH MOMENTUM IS EVIDENT



Source: Thirdrock compilation, from Conference Board/Datastream.
Notes: Leading economic index (2010=100) comprses 10 differentially-weighted leading indicators drawn from labor, manufacturing, housing, financial, and consumer confidence measures.

“ We are on recession watch but hold to the view that one would show up in 2019 is very low. ”

FIG. L: EVEN TAKING INTO ACCOUNT THE LATEST DATA, THE LIKELIHOOD OF A RECESSION IN 2019 REMAINS MINISCULE



Source: Thirdrock calculations, using ISM/Datastream.
Notes: Recession probability based on a multivariate probit model, with constant. Coefficient for independent variables computed with Huber-White robust standard errors, and are all significant at standard levels. Independent variables include ISM PMI, consumer confidence, auto sales, housing starts, initial claims, and the unemployment rate. Probabilities calibrated to better match full probability distribution.

On balance, what the suite of leading indicators suggest is a material deterioration in the macro outlook, accompanied by the possibility of a rocky ride in the months ahead. This heightened likelihood of a recession in the future is perhaps best evaluated with the aid of our recession probability model, taking the latest data into account (due to availability issues, the farthest out we are able to go is December 2018). As longer-time readers may recall, our model takes a host of higher frequency macro and financial market indicators, plugs them into a probabilistic model of recession likelihood (calibrated to historical NBER-dated recessions), and yields various probability predictions for recession. While the model doesn’t offer much lead time before it swings from low to high recession probabilities—and its performance in terms of utilizing real-time data are also somewhat suspect—it nevertheless offers us a decent gauge of how such probabilities are evolving with the contemporaneous data.

It is here that we find a mild surprise. Not only are current probabilities of a recession virtually nil (a point with which most economists would concur), one-year-ahead probabilities are also very low, having risen steadily in recent quarters but collapsing again in the latest period (Fig. L). Indeed, the highest risk of a recession, according to the model, was back in September of last year, when durable goods spending was declining, and housing markets were falling even more sharply. But as these measures have stabilized (housing, in particular, has been so weak over the course of the recovery that its relative downturn is now also paradoxically less consequential)—and with December’s equity gyrations offset but a calmer bond market—recession risks are now again close to zero for the year ahead.

While initially surprising, it is not entirely inconsistent with our own recession call, which is for a small (10 or 15 percent maximum) unconditional probability of a recession in 2019 (unconditional because we do not explicitly build in anticipated Federal Reserve action), with a much greater likelihood of one in the year thereafter. Our recession model doesn’t go that far out, but for the much shorter-run future, it appears to agree with our more subjective take, based on the quantitative signals we just discussed. Bottom line: we are on recession watch, but hold to the view that the likelihood that one would show up in 2019 is very low, while a 2020 recession seems to be close to a toss-up.

A (LUNAR) NEW YEAR STOCKTAKING

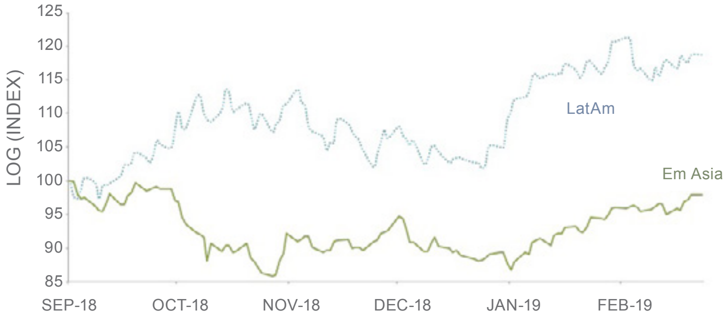
With the turn of a new year (at least for those who follow the East Asian lunar calendar), it’s again time for us to review our macro calls and benchmark them against what actually happened. As usual, we do so with not just the objective of keeping us honest, but also to learn from where we may need to adjust our views, if necessary. Our takeaway the last round was that we were reasonably sound in a number of calls, although we would remain open to the evolving data flow.

First, one quick validation: the U.S. yield curve continued to flatten but went through all of 2018 without inversion, as we predicted. That said, certain segments of the curve (notably the 3Y/5Y spread) did invert in

December, to the consternation of markets when it occurred. But this was not followed by the more important inversion of short-to-long-dated yields (whether you consider the market's preferred 2Y/10Y spread, or the 3-month/10-year differential, as we do). Of course, calendar years are just artificial constructs to keep track of time, and so we don't place too much stock on a time-based bet such as this, but the general point that recession risks were not quite so binding back then. On our part, we would not be as confident betting on an inversion at some stage this year, following on from our discussion on recession risks earlier in this Outlook. We believe it comes down to less the front end—after all, most in markets expected a pause for the rest of the year—but more the back end.

Our September Outlook made a major call on EM assets, in which we pretty much fell flat on our faces. We had claimed then, on the basis of current account balances and real exchange rate gaps, that ASEAN economies were better positioned than other EMs (including those in Latin America) to weather the gathering EM store, and hence outperform. Well, it did turn out that EM Asia fared admirably over the period, both in terms of economic resilience as well as risk asset performance. But Latin American assets, led by Brazil, completely outperformed EM Asia (Fig. M). Moreover, this turned out to be, in large part, a currency story; the lira, for example, strengthened by 10 percent (with a lot of volatility along the way), compared to 5 and 1 percent appreciations by the rupiah and ringgit, respectively, over the same period. We've since revised our expectations of Latin American performance—especially on Brazil (see last month's Outlook)—but we're hesitant to expand this take to the rest of LatAm; this is especially the case for Mexico, which (still) faces trade-related risks with its largest trading partner, so long as the Trump administration remains in charge.

FIG. M: MEASURED IN DOLLAR TERMS, LATIN AMERICAN ASSETS STRONGLY OUTPERFORMED EM ASIA SINCE SEPTEMBER 2018



Source: Thirdrock calculations, from Datastream
Notes: Asia and LatAm equities represented by the MSCI AC Asia and MSCI EM LatAM, S&P 500, and MSCI World indexes, respectively. Indexes are represented in logarithms, so that comparable increases or decreases imply equivalent percentage changes.

That same Outlook, we also suggested that Turkey would impose some form of capital controls, but no generalized contagion was in the offing. We also suggested, if anything, that a DM like Italy was of greater sovereign risk. Here, we were closer to being right: a limited set of currency controls were announced in October, and no contagion erupted. Indeed, EMs—including hard-hit Turkey—have bounced back handsomely.

What about Italy? We were partially right there: yield spreads relative to the bund rose till it peaked in December at the height of the market madness. But just as quickly, spreads have since collapsed, and the last we checked, spreads were down to 270 bps, which was around the levels in September. Seen from the bigger picture, Italy remains a risk, though: the equivalent spread in the first quarter of last year was less than half of what we see today (128 bps).

In our October Outlook, we looked at global trading conditions and reiterated our concerns about the global trade war not going away any time soon. As recent developments have shown, such concerns haven't gone away. A nontrivial reason for the S&P's dive in December last year was due to fears over trade, and even with the recovery in the index, other sectors have been more permanently hit. Soybeans took the bulk of the blows in the war, as have commercial aircraft manufacturers (Boeing, in particular). And while there isn't much substitute in the aerospace sector, new value chains established with Brazil and Canada are not going to be easily broken.

Furthermore, even if China and the U.S. were to come to some amicable resolution (a near-certainty), our guess is that much of that resolution would involve an equal dose of major handwaving and minor concessions, with more tweetable "wins" than genuine structural shifts. We do not think, for example, that China will acquiesce to any permanent peg against the dollar, and even if it buys more American soybeans, the bilateral trade deficit—already diminished—will make little difference to the overall multilateral deficit for the United States. On the flip side, we expect to see some agreement to police intellectual property with greater zeal, but no concrete promises to give up on Made in China 2025.

Just as important, there has been much less movement with the ongoing spat vis-à-vis the EU and Japan. The reality is that Trump was not kidding when he indicated that he was a "Tariff Man," and given this predisposition, we do not see any easy end to the trade tensions in the year ahead.

That same outlook, we discussed how Brexit might play out. We suggested that the final deal would turn out to be quite unfavorable to the UK—due to its greater exposure to EU trade than vice versa, and by its hasty decision to activate Article 50 early—and that there'd be some kicking-the-can down the road before a relatively soft resolution. And, indeed, the deal has been slammed by British politicians for being too favorable to Europe, which has since reopened the possibility of a new referendum (dubbed the "People's Vote," although it is unclear whether the "people" would necessarily choose to remain even after a second attempt). In the meantime, the likelihood that Brexit would be delayed has risen appreciably, till 2020 or 2021 at least. Whether we will end up with a soft Brexit remains to be seen, but we are optimistic that some not-greatfor-Britain-and-better-if-they'd-stayed deal will eventually be agreed on, unless a second referendum overturns the original result altogether (and even so, things need not be all peaches-and-roses; expect a lot of resistance from Brexiteers to such an outcome, were it to occur).

Our November Outlook took a stand on the business cycle in the world's two largest economies: the United States—where we warned of weakness without recession—and China, where we discussed a gradual slowing (without collapse), which would nevertheless entail negative spillovers for the rest of the world. We've already taken on the issue of the U.S. in this edition of the Outlook: the slowing has become evident in leading indexes as well as real-side data (the GDP growth rate for the last 3 quarters reads 4.2 to 3.4 to 2.6 percent). And as we know, markets belatedly responded to the U.S. fundamental deterioration in December.

China has similarly slowed, and estimates of its true underlying rate are much closer to our trend estimate of 5.5 percent than a year ago. And as we shared in last month's Outlook, the Chinese production pullback is now palpable in global industrial production figures, and especially so in commodity exporters. The latest annual work report delivered by Premier Li Keqiang to the National People's Congress shows that even the Chinese themselves agree: the growth target for 2019 has been lowered to a range of 6 to 6.5 percent this year (from "about 6.5 percent" for 2018). So chalk that down for another correct call.

December's Outlook predicted slowing inflation which, as we've discussed earlier, has since come to pass.

Finally, our January Outlook speculated that the oil price slide would not last (to be completely honest, we were a little mealy-mouthed and hedged that call with a discussion of what would happen if oil prices were to have kept falling). And voila, oil prices have since stabilized: the average Brent-WTI price currently stands at $62 per barrel, well up from the trough of $48 at the end of December. Regular readers will be aware that we regard a range of $50–60 as an entirely reasonably trading range for the medium term, based on our impression of the extraction costs of the marginal U.S. shale producer, adjusted by financing costs.

ThirdRock

INVESTMENT TAKEAWAYS

Markets have really gotten ahead of themselves since the December slump, and have done better than almost anyone (including us) would have expected during the dark (literally and figuratively) pre-Christmas winter. An increasing number of observers credit this recovery to a renewed “Fed put,” and while we are sympathetic to this case, we remain—for fundamental reasons expounded in this Outlook—cautious over the longer-than-one-year prospects for U.S. assets, and have continued to take advantage of the rebound to reduce equities exposure and rotate more into defensive sectors and REITs. Allocations to hedge funds with low or negative correlations are also attractive, although the recent performance of the historically solid CTA sector leaves more to be desired. With inflation less of a risk in the year ahead, our inflation-protected securities function more as tail risk hedges, and we use gold more as a portfolio hedge. We have maintained selective purchases of high-quality firms in EM space, expanding the coverage beyond EM Asia.

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.

“ We remain cautious over the longer-than-one-year prospects for U.S. assets. ”

GENERAL

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