BREXIT, FED & TRADE – THE LIST TO WATCH IN Q1 2019

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SYNOPSIS

- Brexit, U.S./China trade and the Federal Reserve's (Fed's) monetary policy decision are some of the key events shaping markets so far in the first quarter of 2019.
- This week, a "patient" Fed left interest rates unchanged and struck a softer note than seen in the past, thus improving the mood of equity markets and easing fears of a Fed-induced recession.
- Markets have struck a positive tone in anticipation of progress toward both Brexit and a trade deal with China. While stocks have staged a nice rally to start the year, that doesn't mean we are fully out of the woods yet. Volatility will likely persist until we have a clearer path for Brexit and a tangible deal on U.S./China trade negotiations.

THE FEDERAL RESERVE

In 2018, markets were acutely focused on the path of interest rate hikes. Today, with the "patient" Fed set to leave interest rates unchanged, attention has shifted to the Fed's balance sheet. During the Great Recession of 2007/2008, global economies were threatened with excess debt after being propped up by years of easy credit that was rapidly becoming illiquid. Central banks across the globe embarked on a program of huge interest rate cuts and historically unique purchases of deteriorating assets known as "quantitative easing." Following the post-2008 recessionary period, the Fed's balance sheet expanded to roughly $4.5 trillion over the next several years, becoming larger than at any time in history, both in total dollars and as a percentage of the U.S. economy.

The Fed purchased large amounts of U.S. Treasury and mortgage-backed securities primarily to boost liquidity in the financial system during the crisis and to encourage recovery from the Great Recession. The Fed's action allowed for the injection of cheap money into the global financial system, resulting in a lengthy bull market in stocks and historically low interest rates. However, over the last year, the Fed has methodically trimmed its balance sheet from nearly $4.5 trillion to about $4.1 trillion because the economy no longer needs that support and continues to gain steam. The Fed had previously stated that it would be on "autopilot" as it looks to trim its balance sheet further to an unspecified level, though not as low as the $900 billion it held before the 2008 Great Recession.

The "autopilot" stance and the unwinding of the Fed's balance sheet – paired with the interest rate hikes – created much debate as to whether the Fed would send the economy into a recession, causing a sharp sell-off in the markets during the fourth quarter of 2018. This week, however, the Fed struck a more cautious tone and made it clear that it was willing to reconsider the plans to unwind its balance sheet should market and economic conditions warrant. The Fed even stated that the program is no longer on autopilot. While the specific effects of balance sheet reduction aren't yet known, it's reasonable to assume that the impact will be smaller than quantitative easing itself, given how slowly the Fed plans to shrink its holdings as interest rates gradually increase.

U.S./CHINA TRADE NEGOTIATIONS

March 1 marks the potential end of the 90-day trade war truce between the U.S. and China. Currently, there are few tangible details on the progress of the negotiations to date, which highlights the fragility of the truce. Here's what we do know so far: China's GDP growth slowed to 6.6% in 2018, which marks a 28-year low. The Chinese government is ramping up stimulus plans to keep the economy moving along amid mounting pressure, planning tax cuts and infrastructure spending, while also encouraging banks to extend more credit. In other words, the government is doing all it can to keep economic growth from cooling further. This effort may also be driving recent steps taken by China to increase

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its purchases of U.S. goods, protect intellectual property and further open its economy – all indications we hope could lead to an extension of the truce. The negotiations will continue this week as the two sides discuss a path toward U.S. demands for structural changes to China's economy and China's pledge to buy more American goods.

BREXIT

March 29 is the deadline for the UK's scheduled exit from the European Union (E.U.), otherwise known as Brexit. Prime Minister Theresa May now seeks to re-negotiate a deal with the EU after her last attempt failed to pass Parliament. With less than 60 days to the deadline, the options are: 1) exit the E.U. without a deal, 2) request an extension of the deadline, or 3) come to an agreement on a deal with the E.U. that will pass Parliament. So far this year, both the British pound and the U.K. stock market have posted modest gains – a sign of encouragement that the worst case of a messy exit could still be avoided.

CONCLUSION

A "patient" Fed has eased market concerns that rising interest rates would lead to a recession. While U.S. stocks have staged a nice rally to start the year, that doesn't mean we are fully out of the woods yet. Volatility will likely persist as we near the deadline for Brexit and U.S./China trade negotiations. Investors should maintain investment discipline, especially when it comes to diversification and rebalancing.*

*Diversification does not ensure a profit or guarantee against loss.

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