Aegon Asset Management

MACRO OUTLOOK 2019: THE "END OF CYCLE" GAME

By Francis P. Rybinski, CFA, Chief Macro Strategist &
D. Harris Kere, CFA, Investment Strategist

As the calendar gets ready to flip, we believe the 'end of cycle' game is alive and well. The 'end of cycle' is the point in time during the economic cycle when market participants constantly debate how near or far is the cycle's end. For those keeping score at home, our base case calls for a constant slowing in the rate of growth, but no outright recession through 2020. That said, we see the distributions of risk heavily skewed to the downside of our below consensus forecasts, as illustrated in Exhibit 1.

While peak growth is most likely behind us, we believe the proper question for this debate should focus more on how the deceleration unfolds. The US economy has been growing well above potential and as a result, output gaps are now completely closed. The classic balancing act at this stage would typically consist of a central bank tightening monetary policy on one side and the strong economic drivers on the other. This time around has been made more complicated by (1) the removal of unconventional central bank policies (quantitative tightening, or QT) on one side and, (2) late-cycle tax cuts on the other with (3) substantial trade frictions sprinkled on top of the whole equation. This heightened complication created by these extra factors creates uncertainty which, in turn, gets translated into the markets as inherent risk which manifests itself via volatility as alternative end-game scenarios get priced.

"Therein lies the rub"

This misquotation of the famous quote from Shakespeare's 'Hamlet' captures the essence of the issue: we believe the economy is going to slow from current levels, the only question is, what will be the leading agent of change – central banks or geopolitics? If the trade picture were to immediately resolve itself and go back to circa-2016 policies, a substantial economic headwind would be removed, and the Federal Reserve (Fed) would be more apt to continue hiking towards 3.25% as implied by their projections— colloquially known as the 'dot plot'. However, if trade spats continue to escalate then the Fed will likely have to alter its projected course by either slowing or stopping the pace of rate hikes and, possibly, the pace of balance sheet withdrawal. This current dynamic simply cannot hold, and we believe something will have to give. In light of our somewhat jaundiced views regarding the trade situation, we tend to favor the latter scenario, and only see the FOMC hiking once in 2019 which would peak the funds rate at 2.75% for this cycle.

Can't we all just get along?

The current evolving state of international trade turns many of the core tenets of Adam Smith and David Ricardo (the early pioneers of trade theory) on its head. As is commonly understood, the erecting of trade restrictions (tariffs, et al) distorts established economics and creates inefficiencies and deadweight losses that must be absorbed by market participants. However, the true impact goes well beyond these immediate costs in that it also alters the hurdle rates for business, a critical factor in determining the 'if/when/and how' of capital expenditures and foreign direct investment. While not as immediate as a tariff, these 'costs' can be much more substantial in the long run and thus massively complicate the out-year forecasts of economic growth.

Our base case is that the US will likely continue on a relatively more restrictionist trade agenda that reverses the multi-decade trend of trade liberalization a direct result of President Trump's key advisors in this area—US Trade Representative Robert Lighthizer and Special Assistant to the President Peter Navarro—both of whom are two of the most draconian trade hawks the US has seen in many decades. Should there be a cabinet reshuffle that sees the exit of either or both of these men, it could be the sign of a meaningful positive turning point in the tone of the US towards trade. Until then, it will be quite challenging to achieve net liberalization on substantive trade issues. Thus, like our macro forecasts, the key question here is centered on how the restrictive trade policy unfolds—does the pendulum swing back far and rapidly? Or is it more subtle? We think it is the latter, but the former is what drives the negative skew around our base case.

Exhibit 1: Aegon AM US' Macro Forecasts

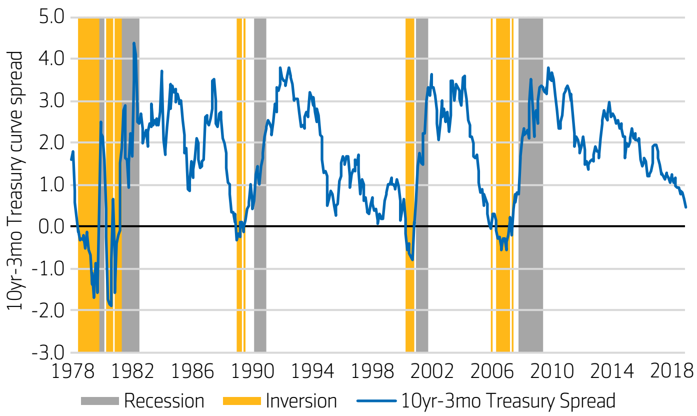
	2016	2017	1Q18	2Q18	3Q18	4Q18*	2018*	2019*	2020*
GDP (Real %, YoY)	1.60	2.30	2.60	2.90	3.00	3.00	2.90	2.25	1.80
Unemployment (%)	4.90	4.40	4.10	3.90	3.80	3.70	3.80	3.60	3.90
Core PCE	1.70	1.50	1.80	1.90	1.90	1.90	1.90	2.00	1.90
Fed Funds (Upper Bound, %)	0.75	1.50	1.75	2.00	2.25	2.50‡	2.50	2.75	1.75
Tsy10 (%)	2.45	2.41	2.74	2.86	3.06	2.69‡	3.10	3.00	2.50

Sources: Aegon AM US as of 12/31/18. Includes historical data sources from Bureau of Economic Analysis, Congressional Budget Office, Haver Analytics.
‡ The Fed Funds and 10-year Treasury rates for 4Q 2018 include actual numbers as of 12/31/18, not forecasts. *Estimated.

Asset Allocation Implications

If our base forecasts are correct, then a purely defensive portfolio would not be optimal yet, but is getting closer. As Exhibit 2 demonstrates, the 10 year-3 month yield curve flattened substantially in 2018, and is now in striking distance of inverting—48 basis points as of December 12, 2018.

Exhibit 2: The 10 Year-3 Month Treasury Yield Curve

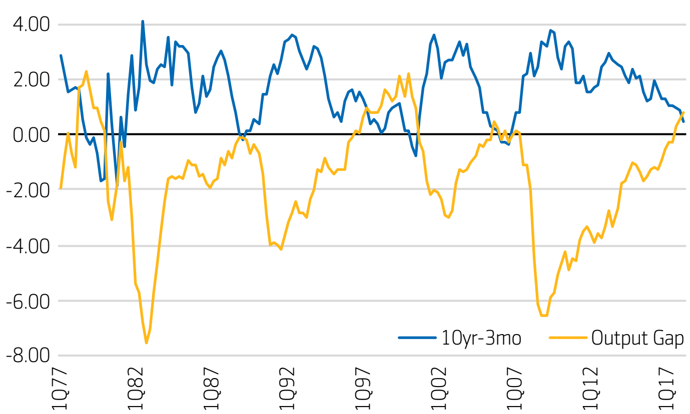


Sources: Bloomberg, Aegon AM Macro Strategy. As of 12/18/2018.

This has real economic consequences as the closer the yield curve gets to inversion, the more it removes a key incentive for lending to longer term projects that boost growth prospects. It is important to note that a yield curve inversion does not typically lead to a recession overnight. Once a curve inverts, there is usually a lag before a recession occurs given how many economic actors are involved, but a recession has historically occurred within approximately 24 months, with 9 months being the quickest.

As we wrote in our piece, "Implications of an Inverted Yield Curve," published in August of this year, an inverted yield curve typically signals the later stages of an economic cycle and is not ideal for the productive flow of investment capital and continued above-trend growth, it does not necessarily imply serious trouble for financial markets, at least within the context of continued economic growth. However, it is important to note that riskier assets, such as high yield bonds and equities, tend to generate lower risk-adjusted returns than investment grade credit or government bonds following a curve inversion.

Exhibit 3: Curve v. Output Gap



Source: Bloomberg, Aegon AM Macro Strategy. As of 12/18/2018.

Unless an investor needs duration for structural purposes, why would they take on long-term risk when they can get the same or higher yield with better risk-adjusted returns, in cash and cash-like assets? When overlaying this dynamic in the world of asset allocation, we caution against an 'all or nothing' attitude towards risk. Instead, we analogize a risk dial that can fluidly be turned down to match the reduction in the yield curve. Said another way, early in the expansion when curves are very steep and output gaps are large, it is much more palatable to aggressively position a portfolio to ride the beta wave, as demonstrated in Exhibit 3. When it is late in the cycle, a more balanced approach is consistent with the negatively skewed distribution of risks.

The year ahead

As the New Year approaches, the name of the game is how will all of this unfold: how will the deceleration unfold? How will the restrictive trade policy unfold? How near is the cycle's end? Our base case is that there will likely be a constant slowing in the rate of growth with no outright recession through 2020. But, the distribution of risks around that base case is skewed to the downside.

See also our Aegon Real Assets Macro Outlook for the year ahead.

Disclosures

Past performance is not indicative of future results. This material is to be uses for institutional investors and not for any other purpose. This communication is being provided for informational purposes in connection with the marketing and advertising of products and services. This material contains current opinions of the manager and such opinions are subject to change without notice. Aegon AM US is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as such. If there is any conflict between the enclosed information and Aegon AM US' ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you. The value of any investment may fluctuate. Investors should consult their investment professional prior to making an investment decision. Aegon AM is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity for purposes of any applicable federal or state law or regulation. By receiving this communication, you agree with the intended purpose described above.

The information presented is for illustrative purposes only. Individual accounts may vary based on restrictions, substitutions, cash flows and other factors.

Results for certain charts and graphs are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions.

Aegon AM US may trade for its own proprietary accounts or other client accounts in a manner inconsistent with this report, depending upon the short-term trading strategy, guidelines for a particular client, and other variables.

There is no guarantee these investment or portfolio strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest over the long-term, especially during periods of increased market volatility.

This document contains "forward-looking statements" which are based on change to the firm's beliefs, as well as on a number of assumptions concerning future events based on information currently available. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance and actual outcomes and returns may differ materially from statements set forth herein. In addition, this material contains information regarding market outlook, rates of return, market indicators and other statistical information that is not intended and should not be considered an indication of the results of any Aegon AM US-managed portfolio.

Aegon USA Investment Management, LLC (AUIM) is a US-based SEC registered investment adviser and is also registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA).

Recipient shall not distribute, publish, sell, license or otherwise create derivative works using any of the content of this report without the prior written consent of Aegon Asset Management US, 6300 C Street SW, Cedar Rapids, IA 52499.