

The Possible Trinity for 2019

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With 2018 behind us, we think it's also time to bid farewell to the peak in U.S. growth for this cycle. A central part of our outlook hinges on the idea that the U.S. could ["trade places"](#) with the global economy in 2019. In order for this switch to happen, the U.S. economy needs to slow down while the rest of the world either stabilizes or produces a slight increase in growth. If we're right about this view, the U.S. dollar should undergo a year of weakness similar to 2017. Emerging market assets stand to be a primary beneficiary from the idea of trading places, particularly as they are undervalued and under-owned coming into 2019. We will be looking for three constructive factors to facilitate the flow of capital back into emerging market assets in 2019—all three factors are necessary: Federal Reserve (Fed) policy, fiscal and monetary policy in China, and U.S.-China trade relations.

The U.S. economy can no longer remain immune to tightening financial conditions. In 2019, we expect that a convergence of factors will dampen growth: peak fiscal stimulus—there isn't any more in the pipeline—the lagged effect of higher rates, accelerated balance sheet reduction, the effects of 2018's strong dollar environment, and trade tariffs. Even the Fed has suggested that U.S. growth should drift lower in 2019 to around 2.3% and will follow a modestly lower trajectory for fed funds rate increases. We are in the camp of 1-2 Fed rate hikes in 2019; if we're wrong, it'll be because the Fed didn't need to hike rates at all in 2019, and will continue to tighten through balance sheet reduction. At its December meeting, the Fed pledged to monitor global conditions after acknowledging that global growth moderated in 2018. We found this development encouraging, though we think the Fed really needs to listen to the message embedded in the yield curve. The Fed also needs to realize that balance sheet normalization is a form of tightening, and that quantitative tightening shouldn't necessarily remain on "autopilot." There is a lag when it comes to the effects of monetary policy, and three years of rate hikes—nine in total—and over one year of balance sheet contraction will have an impact on the U.S. economy. The biggest risk here is if the Fed continues to fight cyclical inflation while ignoring secular disinflationary forces and powers ahead with tightening, and thus prolonging the countertrend rally in the dollar.

Conversely, we need to see more stimulus out of China in 2019, both in terms of fiscal and monetary policy. China's policy response last year was underwhelming, and policymakers did not implement enough stimulus to counteract U.S. tariffs or the strong dollar environment. In order for global growth to remain stable or modestly improve, the Chinese economy needs to do the same. The unresolved trade dispute between the U.S. and China remains the biggest threat to economic growth in China, and our trading places theory. We will continue to monitor whether this trade skirmish develops into a full-blown economic cold war.

This year, we'll be looking for policymakers to set the tone for the global financial markets, whether it's Fed officials, the People's Bank of China, or the U.S. or Chinese governments and trade officials looking to make progress. In 2019, we simply need these macro factors to remain stable. The best case and most probable scenario is for the U.S. economy to slow but not fall into recession, China's economy to stabilize, the U.S. dollar to weaken, and the Fed to pause. Collectively, these events would provide strong positive catalysts for emerging markets out performance this year.

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