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EYES ON EUROPE

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* **Finally the European Tipping Point?**
* **Fed Term Premium Puzzle**
* **Fed Pause … and Then What?**
* **Deferring Higher Interest Rate Expectations**

We continue to see economic momentum in the U.S. that should drive earnings in the financial sector, as summarized in our mid-December report, "Frantic Market / Enduring Economy." However, we are lowering interest rate expectations for this year, at least for the first half, pending further economic data and developments. While the factors we highlighted for a 4%+ 10-year Treasury rate and additional policy rate hikes remain in place, we expect the Fed to wrestle with what appears to be at least a "temporary normal" in inflation along with escalating tensions in Europe.

A change in either could affect both the direction and amplitude of interest rate movement.

European Union economic growth continues to weaken with Italy in recession and Germany near. Stark political divisions, minority governments, rising populism and an uncertain Brexit leave recovery unlikely. **Nearly a third of the World's imports go to Europe, roughly triple that of China.** While no single country dominates, the destination for U.S. exports to the European Union in aggregate matches or exceeds Canada, Mexico and, by a wide margin, China. Europe's deceleration is in sharp contrast relative to just six or nine months ago. This could prove to be exceptionally unfortunate timing. European Parliament elections, on a five year cycle, next occur this coming May. ECB President Mario Draghi retires in October. We continue to see Europe as the most worrisome risk, not China, and Euro unity may well be approaching a tipping point.

Many investors believe the Federal Reserve has paused after witnessing sharp market downturns in December. We highly doubt this was the primary motivation. The fed has its own doubts about monetary rules and theory. The Fed has struggled to find a clear explanation for the term premium or inflation linkages post Crisis. They have not tried to hide their uncertainties, nor are they likely to gamble in any direction until European prospects are clearer, our own economic trajectory appears firmer, and our trade dispute with China is closer to resolution.

Core consumer price inflation appears to have stabilized just under 2.2% for the past six months. Producer prices advances are slowing, although stabilization is not yet evident. Quantitative easing is thought to have removed about 100 basis points in the 10-year term premium, but neither its cessation nor gradual removal appears to have restored higher rates. Regarding further removal, the Fed has actually moved in the opposite direction, some signaling a $3.5 trillion bottom to balance sheet size, a full $2 trillion higher than originally targeted. This level could be reached by November and the $1 trillion cumulative reduction over the last two years may have only added 25 basis points to long rates.

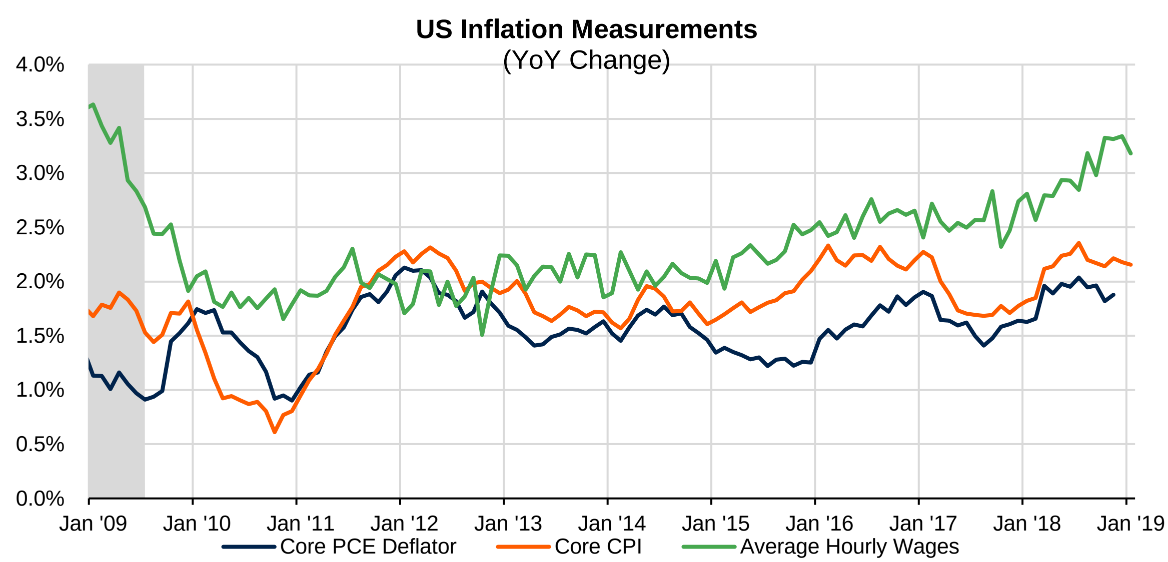
With the exception of business investment, most domestic U.S. macroeconomic variables still point toward ongoing, reasonably healthy economic strength. While we do not expect this strength to sustain a 3+% real growth trend, we believe a 2+% trend should still be achievable with no clear case yet for a predictable future downturn or recession. Pundits keep moving out their guess for when a recession could occur. Most have kicked this can into 2020 and a few have even gone beyond.

Adding more uncertainty than normal, business investment and other GDP components on a national level have not been released past the third calendar quarter of last year, due to the shutdown's impact on the Bureau of Economic Analysis (BEA). Fourth quarter GDP elements are to be first available at the end of February. This leaves the latest monthly Purchasing Manager's Index (PMI) as perhaps the best proxy, showing only a partial rebound from a surprise, December fall. Consumer spending data is largely intact, absent the sharp December retail sales drop that was considered anomalous by many. Even after final 2018 GDP data is revealed it is unlikely to be interpreted or projected with any definition or confidence until a longer pattern emerges over the next several months of data. While both U.S. business investment growth has slowed and confidence has declined, neither have gone negative.

In sum, three major economic issues are shrouded or uncertain at the same time the economic cycle is under suspicion of a recession. In our view, none of this is likely to resolve the crossroads challenging Fed policy until the second half of 2019. If Europe or its Union were truly near a tipping point, the Fed would undoubtedly exercise restraint and err on the side of caution. Unless inflation or economic momentum advance the 10-year Treasury is unlikely to pass the 3-1/4 peak of last November and no further short-term rate hikes are likely in the first half of this year.

The post-pause course of rates could still resume upwards if inflation begins to creep higher again. We have often noted this lengthy economic expansion is on an extended time scale. Therefore, most macro variables have simply taken longer to move.

Wage gains have been underway for six years albeit at a very slow pace and suggested a near-term pause at 3.2% in January. Price inflation has stubbornly vacillated for seven years. More recent as well as



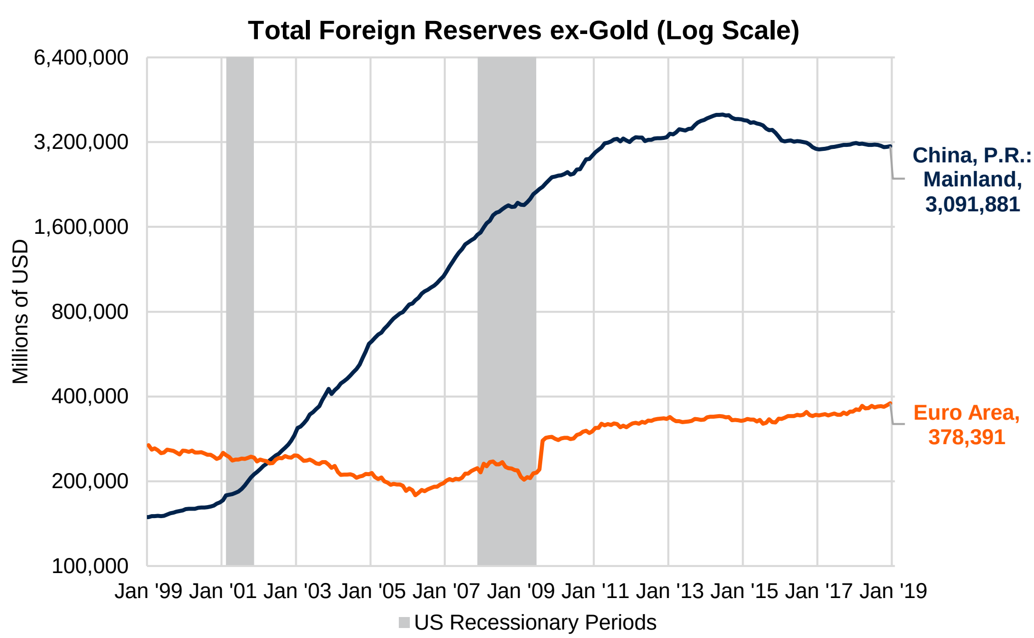
Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics ongoing monthly core CPI and PCE deflator data carry the greatest weight for monetary policy. We have to wait. As will the Fed.

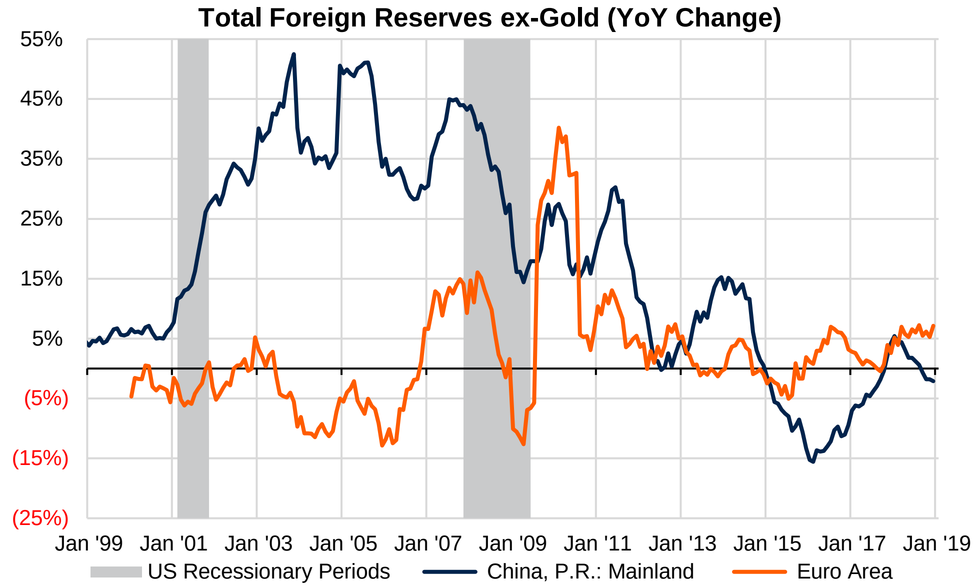
Consumer and business spending still have above trend potential from tax reform. How much and, importantly, for how long is unclear. The business investment cycle could yet recover and consumer confidence could further sustain growth. Too close to call, pending more timeline data.

The Fed has grown accustomed to this reduced term premium abnormality, but frequently casts it somewhat as a puzzle. If the Fed is puzzled then we should be as well. Real long-term rates have remained in a 75-100 basis point level in contrast to the 200-250 basis point post-War range. The simplest explanation for this low term premium is the slow expansion itself and gaining recession conviction. Whether it is a 2020 or 2022 recession there is little reason, for the moment, for markets with a three to ten year term horizon to expect higher rates, at least without more evidence of rising inflation.

We are about to learn much but probably not before late spring.

Finally, as we are highly concerned about EU turmoil, it is worth pointing out that past phases of Euro turmoil had the effect of depressing U.S. Treasury rates as they instigated a flight-to-quality demand hike. While this can occur again, and is probably already a factor, the supply of foreign held "hard" currencies – especially the U.S. Dollar – is also a factor. As seen below, total foreign reserves have nearly flat-lined and are barely above their levels of a decade ago. China's reserves have actually declined some but were already ten-fold the size of those in the EU by 2014. Overall lack of reserve growth correlates to declining world trade growth in general. Thought of differently, the flight-to-quality supply side has been cut in relative terms. Hence, any depressant effect on U.S. rates may prove more limited than in the past.





Source: International Monetary Fund International Financial Statistics

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