March 31, 2019

March / First Quarter 2018 Summary Report

Macroeconomic Risks and Geopolitical Dynamics

March 31, 2019

OVERVIEW

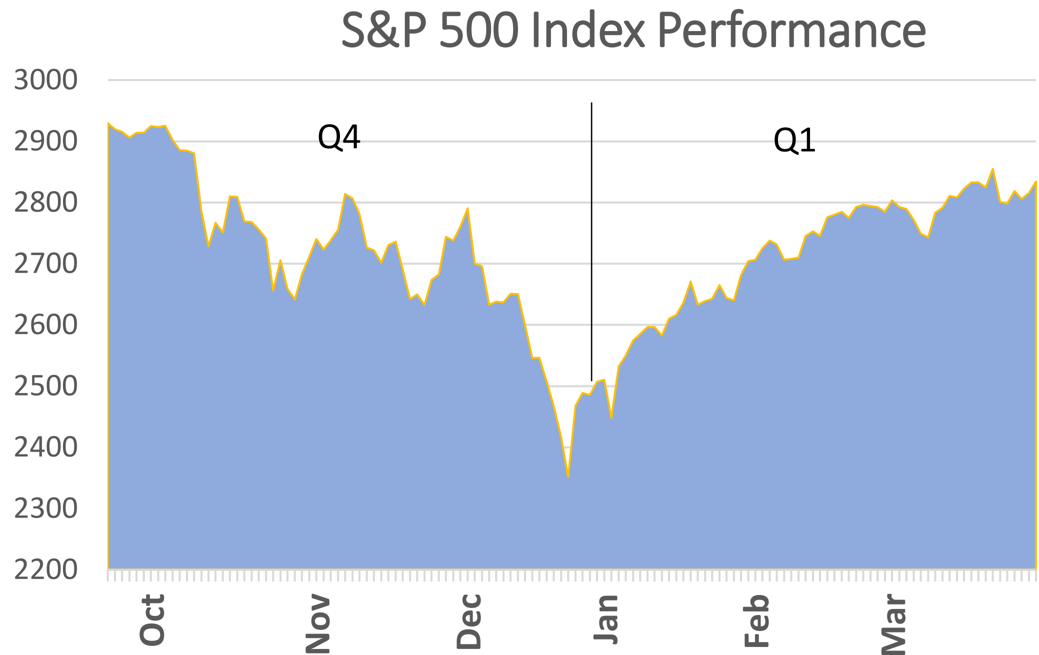
In keeping with the Grey G Capital Research framework, this report focuses on short-term macroeconomic dynamics in terms of how they relate to deeper capital market trends. As part of our analysis, these capital market trends are closely correlated with emerging trends in international relations.

Our focus is on how short-term trends fit within a longer-term process of capital market expansion and international integration. We identify major cyclical challenges currently facing this process of capital market expansion and international integration, assessing policymakers' ability to counter these challenges effectively. Following a macroeconomic and capital market overview, this report concludes with analysis of how geopolitical dynamics have shifted in March and Q1 2019.

In terms both of capital market and geopolitical momentum, the first quarter of 2019 – and March 2019 in particular - represent likely short-term and long-term inflection points. The shifts these inflection points represent have potentially far-reaching implications which investors would be well served to incorporate into their forecasting models and decision-making processes. Clients should reach out to their Grey G point of contact for further clarification on any point of interest here as well as full access to probability projections and data for incorporation into internal risk models.

SUMMARY

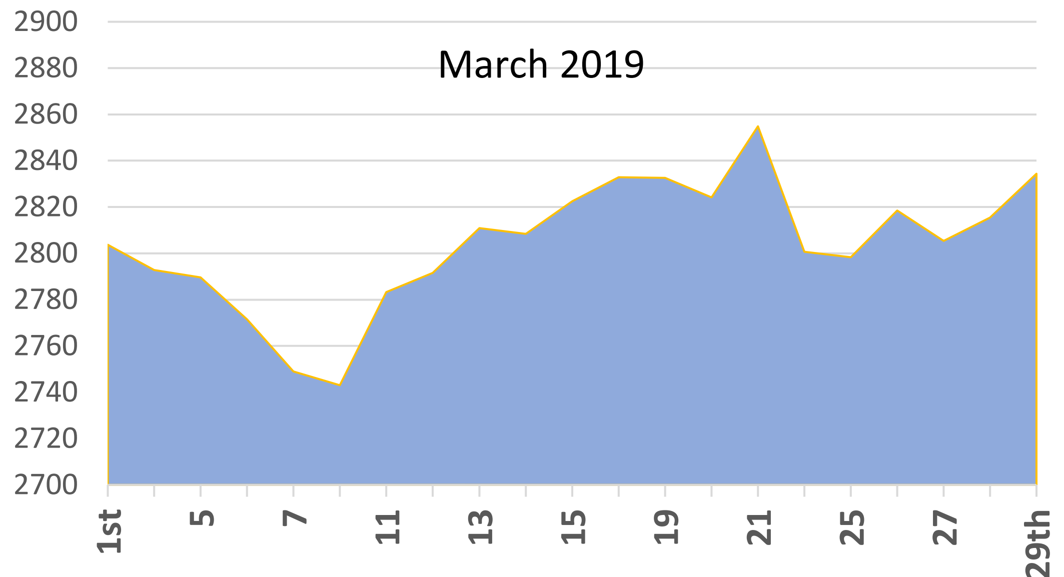
After suffering a bear-market-equivalent drop of 20+% in the final quarter of 2018, equity markets have staged a dramatic recovery in the first quarter of 2019. Indices closed March and the first quarter of 2019 back near September 2018 all-time highs, with this equity market recovery appearing initially to be driven by confidence in sustained economic strength in the US despite a prolonged tightening of monetary policy. A shift in the world's second largest economy – China – away from contractionary policies towards expansionary stimulus further boosted market confidence, as did continued expectations of an imminent US-China trade deal.



A growing sense that the 20% market selloff of Q4 2018 was overdone in light of underlying US economic fundamentals led to a rapid recovery in US equity markets in January and February 2019. By early March, this recovery was faltering amidst indications of weakness in multiple US macroeconomic growth components. These macroeconomic weaknesses were compounded by worries of a shift in geopolitical momentum following the unsuccessful Trump-Kim summit in Vietnam at the end of February, as well as the failure of US-China trade negotiators to meet a supposed early-March negotiation deadline.

After a short-term drop in early March, equity markets quickly stabilized as no acute geopolitical crisis emerged and signals grew that a shift in Fed policy away from a tightening bias was imminent. This expected Fed shift evolved rapidly beyond an expectation that the pattern of quarterly rate-increases which began in December 2016 (pausing only in 3Q 2017) would merely pause again. Fed officials indicated strongly in March that not only would they hold off on increasing interest rates and cease the unwinding of Quantitative-Easing-related assets from the Fed balance sheet; Fed policy guidance went further to indicate a strong willingness to aggressively respond with monetary stimulus should there be any further deterioration in the macroeconomic environment.

This represents a fairly dramatic policy shift, yet confidence in the ability and willingness of policymakers to continue to support capital market and economic expansion appears to have eclipsed any concerns relating to the underlying drivers of recent macroeconomic weakness. As this Fed policy shift and an inversion of parts of the yield curve were digested, volatility within a relatively narrow range characterized capital markets in March. Overall, however, US markets ended March and the first quarter of 2019 resuming their upward trend.



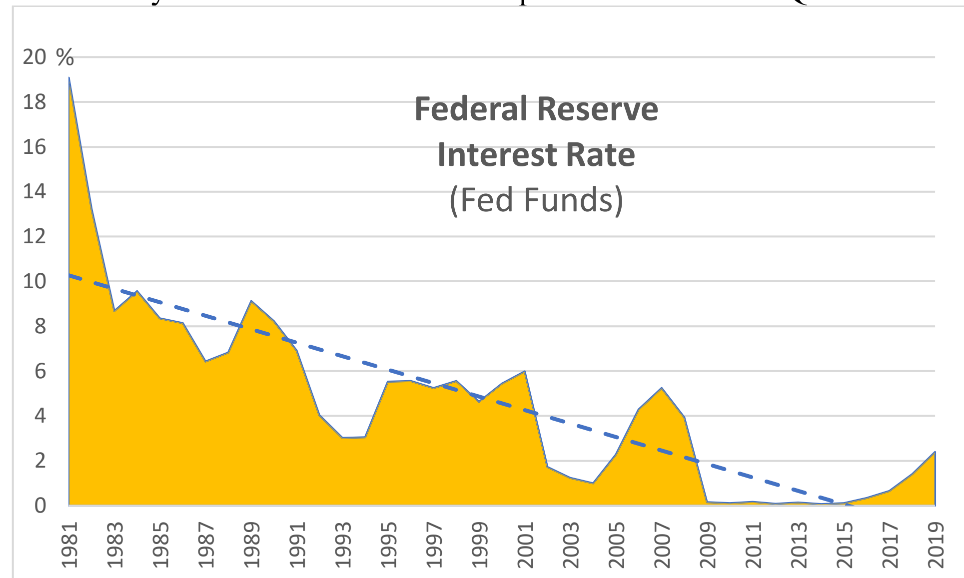
Assessing Current Market Expectations

The rebound in markets may represent an appreciation that earnings expectations currently remain strong despite some economic headwinds. To the extent that this upward trend represents a discounting of negative macroeconomic news in favor of an appreciation of looser monetary policy, the mantra of "don't fight the Fed" is worth considering. This mantra has long served market participants well, and an environment of low returns on debt securities and abundant capital has proven very effective in propping up asset values. There are, however, multiple potential weaknesses in market valuations in terms of expectations of expansionary monetary and fiscal policy.

First, the scale of the policy challenge the Fed faces may be significantly underestimated. **Grey G Capital Research analysis indicates that underlying sources of macroeconomic weakness likely extend beyond what is associated with short-term policy cycles.** Long-term cyclical aspects of capital expansion are a critical dynamic driving current market valuations yet tend to be overlooked. As covered in more detail in this report, Fed policy and the capital markets may best be understood within the context of a decades-long trend of interest rate declines and capital stock expansion. Beyond policy challenges associated with this long-term underlying dynamic, Fed policy may face significant challenges even in the context of short-term macroeconomic dynamics.

The Fed Funds rate now stands near 2.5%. This means monetary stimulus available

to policymakers in terms of the amount rates might be cut is less than what has been required to address past short-term cyclical challenges. Rapid interest rate reductions as documented in the below chart represent Fed cuts in response to previous recessionary pressures. Not only are rate cuts currently available less than has previously been necessary to stimulate the economy; the Fed's balance sheet is also already burdened with assets from post-2008 rounds of Quantitative Easing.



The Emergence of New Policy Expectations

In this context of limited Fed "powder," March represented a likely inflection point in terms of economic thinking. A clear trend emerged in economic policy papers citing the potential not only for US monetary policy to push to and even beyond the zero-interest-rate barrier – as other major economies have been doing.

Opportunities for fiscal and monetary stimulus to be used creatively together, and thereby support far greater levels of monetary and fiscal stimulus than has been previously considered feasible per traditional economic theory, emerged as a prevalent theme in March, too.

March may thus represent a point where expectations regarding both the scale of macroeconomic challenges as well as the resources available for policymakers to respond to these challenges diverged from underlying economic fundamentals.

A willingness to experiment within a new economic environment could represent policy innovation and be considered a positive that affirms market confidence. However, this may also reflect a classic market denial of long-established economic realities in favor of reinforcing existing bubbles. At a minimum, there seems a high element of risk associated with these ambitious stimulus theories, as discussed in more detail later in this report.

In terms of market sentiment and fundamentals, any significant deterioration in short term macroeconomic indicators can be expected to put confidence regarding remaining stimulus options to a serious test.

Deterioration in the Geopolitical Environment

In addition to these macroeconomic and capital market trends, geopolitical dynamics which emerged in March also appear to have been discounted by markets in a way that does not match Grey G Capital Research views of fundamentals and technical trends.

In particular, a focus on short-term trends related to US-China trade negotiations appears to be missing a deeper shift in geopolitical dynamics. This deeper dynamic is perhaps best assessed as a trend of the US more actively engaging threats that its national security policymakers see emerging from Asia. Current US-China trade tension is but one aspect of this trend, which is likely to extend beyond any pending US-China trade deal. March freedom of navigation exercises in the South China Sea and Straits of Taiwan by the US Navy are another indicator. The Q1 breakdown of US-North Korea negotiations might also be considered within this context.

These are not isolated events but part of a geopolitical pattern. Growing underlying tensions between the global system's two largest economies are unlikely to dissipate long-term despite any short-term conciliatory developments. Positive short-term developments may have significant short-term market impacts, but longer-term dynamics are of primary focus within the Grey G risk analysis framework.

In addition to this existing geopolitical tension, the end of March saw the emergence of another potential major geopolitical inflection point: the active entrance of Russian military assets into the Americas.

The scale of Russian efforts to intervene and stem a collapse of the Maduro regime in Venezuela is currently minor. Within the global economy, both Russia and Venezuela are also relatively insignificant players. However, the emergence of direct Russian intervention in the Americas in March represents a very serious challenge to US national security priorities beyond the specifics of the Venezuelan situation.

Concepts of the Americas as the United States' exclusive sphere of influence extend back two centuries to the Monroe Doctrine. The centrality of this belief to American national security thinking implies a strong probability of an American response to Russian incursions beyond what would be considered proportionate to the actual immediate threat. Such an escalation has potential consequences across the global geopolitical spectrum.

OUTLOOK AND PROJECTIONS

Detailed analysis of debt and asset markets per the above and other points, as well as market projections, are reserved for Grey G Capital Research clients. Public release of research beyond the above summary is delayed to maximize client value.

For further information on Grey G Capital Research client and retainer options or bespoke research possibilities, please contact: client.relations@greygcapital.com

Further discussion or comments on points covered in this research summary are welcomed by the report's editor and principal author, Mark Reedy. Contact at: reedy@greygcapital.com

This report builds on previous Grey G Capital Research monthly and special reports, including:

"Geopolitical Shifts and Secular Bull-Bear Market Dynamics"
(Grey G Capital Research, October 2018)

"Implications of Global Economic Imbalances and the US-China Dynamic"
(Grey G Capital Research, November 2016)

"Mini-Market Cycles vs. Bull Market Momentum: a 'New Monetary Reality' and Possible Lessons from Japan"
(Grey G Capital Research, September 2016)