MARKET STRATEGY VIEWPOINT

Mid-Cycle Slowdown...or Economic Stall?

September 27, 2019

Although it's still premature to be more definitive, we believe current U.S. economic weakness is temporary and conditions could rebound in the coming quarters.

Upward turns in economic activity across several countries may foretell the same in the U.S.

In aggregate, U.S. economic data, relative to expectations, has already begun to recover.

An economic rebound scenario may be a modest benefit for stocks, although return expectations are still subdued.

U.S. Economy Poised for a Rebound?

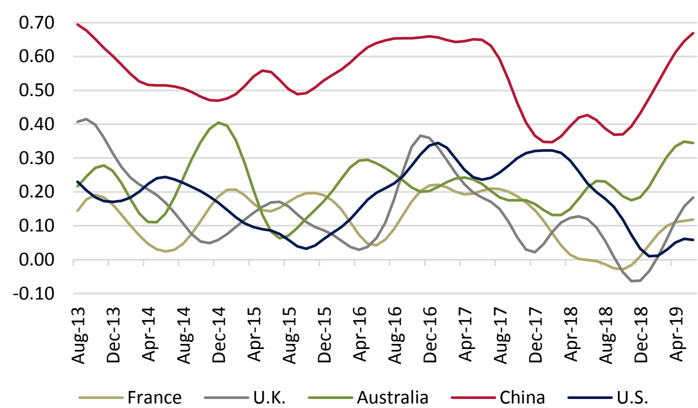
Domestic economic activity has indeed slowed in a similar fashion to what we witnessed in 2012 and 2015-2016. The question now on the minds of many markets participants is: what's next? Is this slowdown the beginning of the end for the long-standing, bullish business cycle; or is it simply a pause that refreshes? In our view, the U.S. economy may still have some fuel left in the tank. That is, a resurgence could be in the offing, although the bounce may be less definitive versus that witnessed in 2017 and 2018. To us, the bullish business cycle is more likely to live on, at least for a bit longer.

The primary reasons for this view are that economic data points outside the U.S. have begun to show early signs of a turn, and U.S. economic data points have again begun to come in better than expected. We believe this early international economic activity could eventually pass to U.S. shores in the form of better manufacturing and services activity. So far, the U.S.,

The early LEI rebound in the U.S. has been slight to-date (Figure 1). Partially because the U.S. economic dip has been more recent and China's monetary stimulus has had a greater impact on other regions of the world.

Figure 1: Leading Economic Indicators (LEI): 3-Month Moving Average

Source: Organization for Economic Cooperation and Development



Germany, and Japan have not yet seen the early signs of a mid-cycle upturn when compared to other countries. However, economic data in these countries and in the rest of the world has indeed improved (relative to expectations) from trough levels witnessed earlier this year. Citigroup Economic Surprise indices have been on a definitive rebound (Figure 2).

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This type of activity is often a precursor to an eventual improvement in overall economic conditions. These indices rebounded well ahead of the mid-cycle economic recoveries witnessed in 2013 and 2016.

To be clear, we believe any U.S. mid-cycle recovery scenario may not be a vigorous one this time around. There will likely be no tax policy reform to juice a recovery and monetary policy adjustments, in our view, are at risk of having diminishing effects.

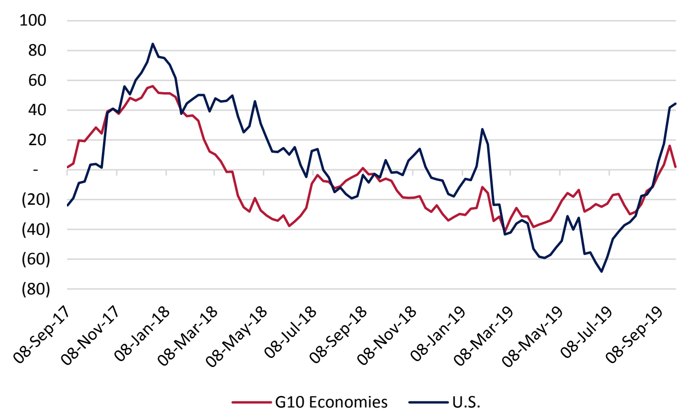
The key risks to our "recovery" outlook are the waves of political uncertainty currently emanating across the U.S. (which could cloud the visibility of business leaders) and the seemingly ever-present U.S./China trade albatross.

Citigroup Economic Surprise Indices measure aggregate economic data results relative to consensus forecasts.

Recent activity in these indices, we believe, may foretell better economic things to come.

Figure 2: Citigroup Economic Surprise Indices

Source: Citigroup



Treasury Bond Profit-Taking May Have to Wait

Being overweight long-duration Treasury bond exposure has been one of the most lucrative trades of the year so far; driven in part by negative interest rates, the change in Fed policy, and economic weakness. While the trade looks a bit overdone in the near-term and prone to potential profit-taking, interest rate futures traders may want to wait for more material signs of a rebound in economic activity. Figure 3 illustrates what has been a long-term lock-step relationship between the 10-year Treasury yield and the ISM U.S. Manufacturing Index. When manufacturing activity has weakened, Treasury yields have fallen in tandem.

With U.S. manufacturing activity still in a nosedive, Treasury yields are unlikely to move sustainably higher, in our view. We do believe an eventual rebound in manufacturing activity could spell a near-term end to the recent Treasury rally. Over the intermediate-term however, we anticipate we could see new record lows in Treasury yields as U.S.

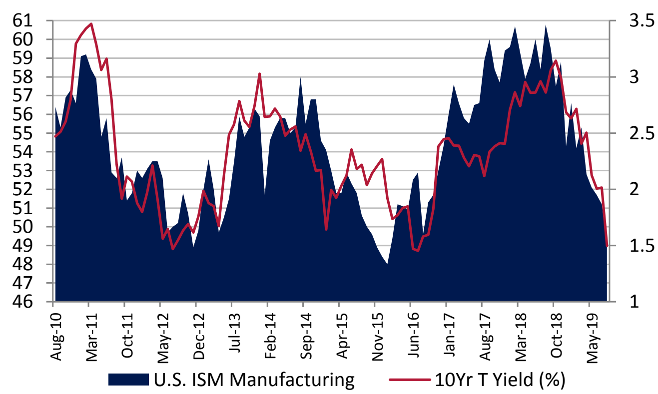
monetary policy slowly follows that of both the Bank of Japan and the European Central Bank. The bottom line here is that a potential near-term Treasury sell-off, in our view, may present a good buying opportunity for those looking to shore-up their core bond exposure. We believe the risk of sustainably higher rates has been firmly diminished.

A near-term move higher in Treasury yields may only follow more definitive signs of U.S. economic recovery.

Currently, U.S. manufacturing activity is still in free-fall.

Figure 3: U.S. ISM Manufacturing Index vs. 10-Yr Treasury Yield

Source: Institute of Supply Managers, Bloomberg



Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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Stock investing involves risk including loss of principle.

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Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

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