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James Bianco

Economic Update

South Florida Bond Traders Association
2019 Annual Conference
February 8, 2019

- The market interpreted the Fed's December 19 Summary of Economic Projections for two more rate hikes, along with Powell's statement on continued balance sheet reductions, to be the equivalent of 4 or 5 rate hikes. This did not sit well with risk markets. The plunge in stocks reversed when Powell offered a more dovish tone on January 4 and again on January 30.

- Clearly there is a difference of opinion regarding the effect balance sheet reductions have on the markets. The Fed thinks these reductions are a rounding error in monetary policy, equaling less than 1 rate hike. The market thinks projected reductions equate to 2, or maybe 3, rate hikes via a loss of liquidity.

- All markets are moving in tandem as the "Powell Put" exists and has been exercised.

- By inserting the word "patience" into the FOMC statement, the Fed has signal it has paused. By adding the phrase "to determine," it is more likely signaling the rate hikes are over.

- The fear is the market selloff has damaged the economy. Sentiment is poor and earnings are on the verge of a recession. Q1 2019 y-o-y forecasts are now negative.

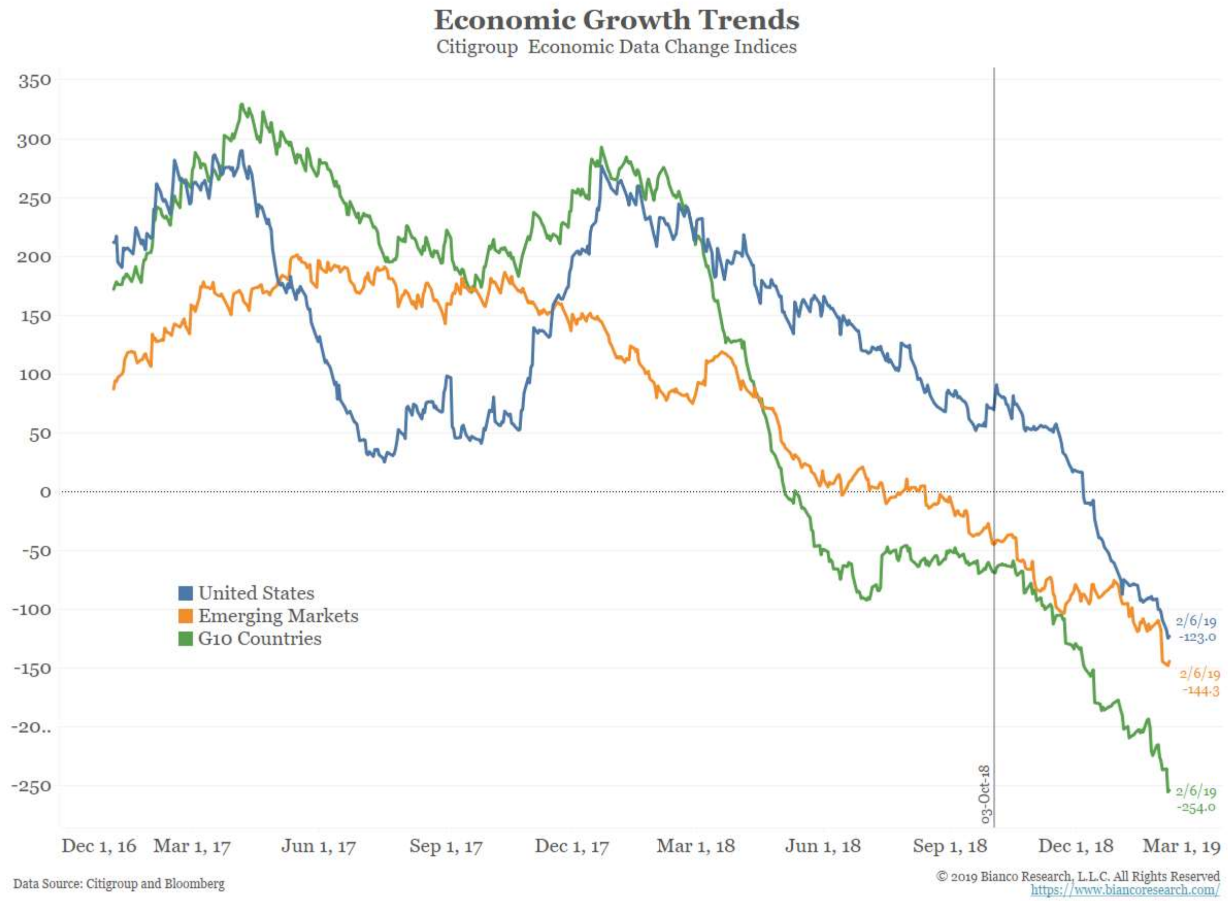
- As Bernanke himself stated, recessions occur because the economy is murdered. So look for the murderer (i.e., the Fed) and not the victim (economic data) to determine if a recession is coming. Economists never see one coming.

- The pain trade is lower yields.

- The yield curve matters and an inversion is a sign the economy is going into recession.

- It would be surprising if we do NOT see a restest of the late December lows. Later this spring, look for 10-year yields back near 2.55%, crude under $45 and the S&P back near 2500.

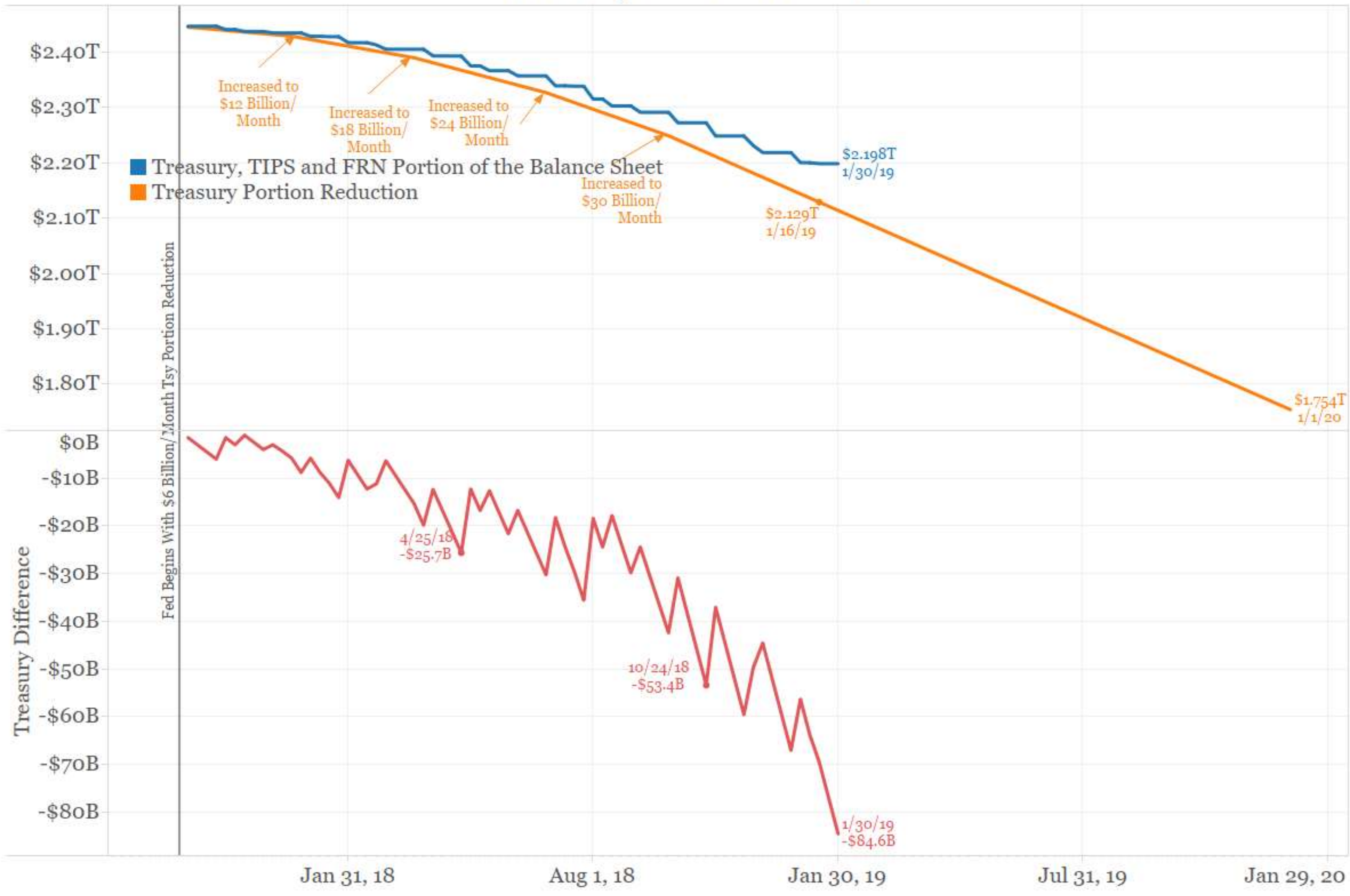
"There's really no reason to think that this cycle can't continue for quite some time, effectively indefinitely," Powell said Wednesday at an event in Washington hosted by The Atlantic magazine and the Aspen Institute.
– Bloomberg, October 4, 2018



So we thought carefully about this, on how to normalize policy and came to the view that we would effectively have the balance sheet runoff on automatic pilot and use monetary policy, rate policy to adjust to incoming data.

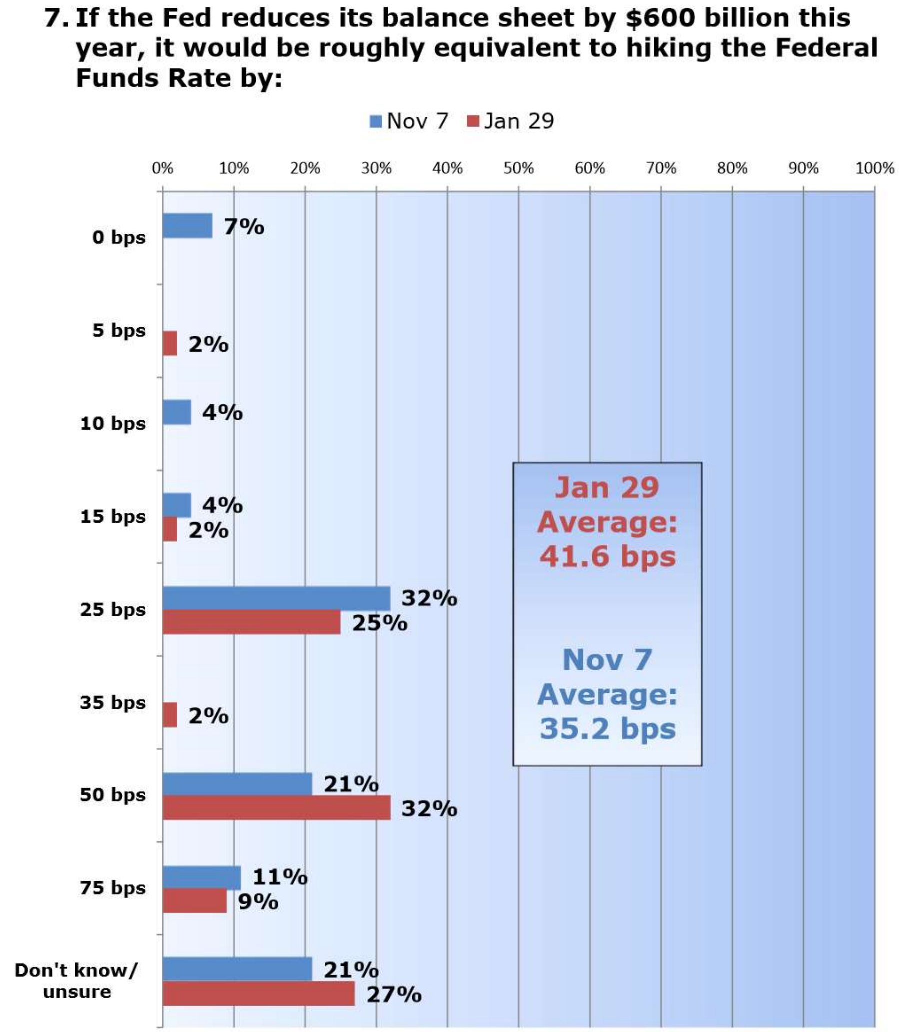
– Jay Powell, December 19, 2019

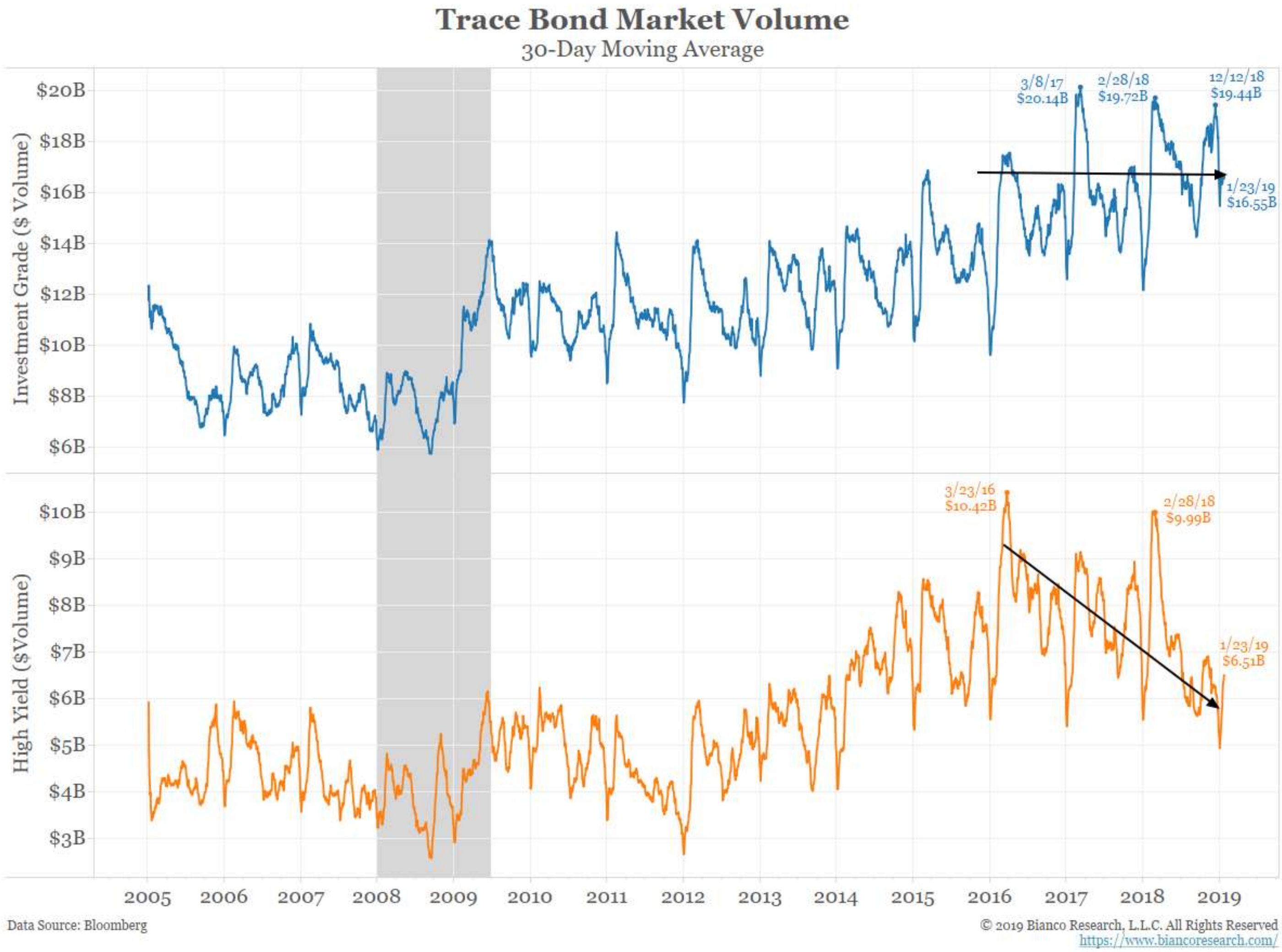
The Treasury Portion Of The Federal Reserve's Balance Sheet And Targeted Reduction



Data Source: Bloomberg

Kansas City Federal Reserve
May 10, 2017
[Forecasting the Stance of Monetary Policy under Balance Sheet Adjustments]
The Federal Reserve's balance sheet holdings can affect broad financial conditions, including interest rates. In this way, monetary policy accommodation provided through the balance sheet may, to a modest extent, substitute for changes in the target federal funds rate. Specifically, we find a $675 billion reduction in the Fed's balance sheet over a two-year horizon is about equivalent to a 25 basis point hike in the funds rate.




Trace Bond Market Volume
30-Day Moving Average
$20B
$18B
$16B
$14B
$12B
$10B
$8B
$6B
Investment Grade ($ Volume)
3/8/17
$20.14B
2/28/18
$19.72B
12/12/18
$19.44B
1/23/19
$16.55B
$10B
$9B
$8B
$7B
$6B
$5B
$4B
$3B
High Yield ($Volume)
3/23/16
$10.42B
2/28/18
$9.99B
1/23/19
$6.51B
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
Data Source: Bloomberg
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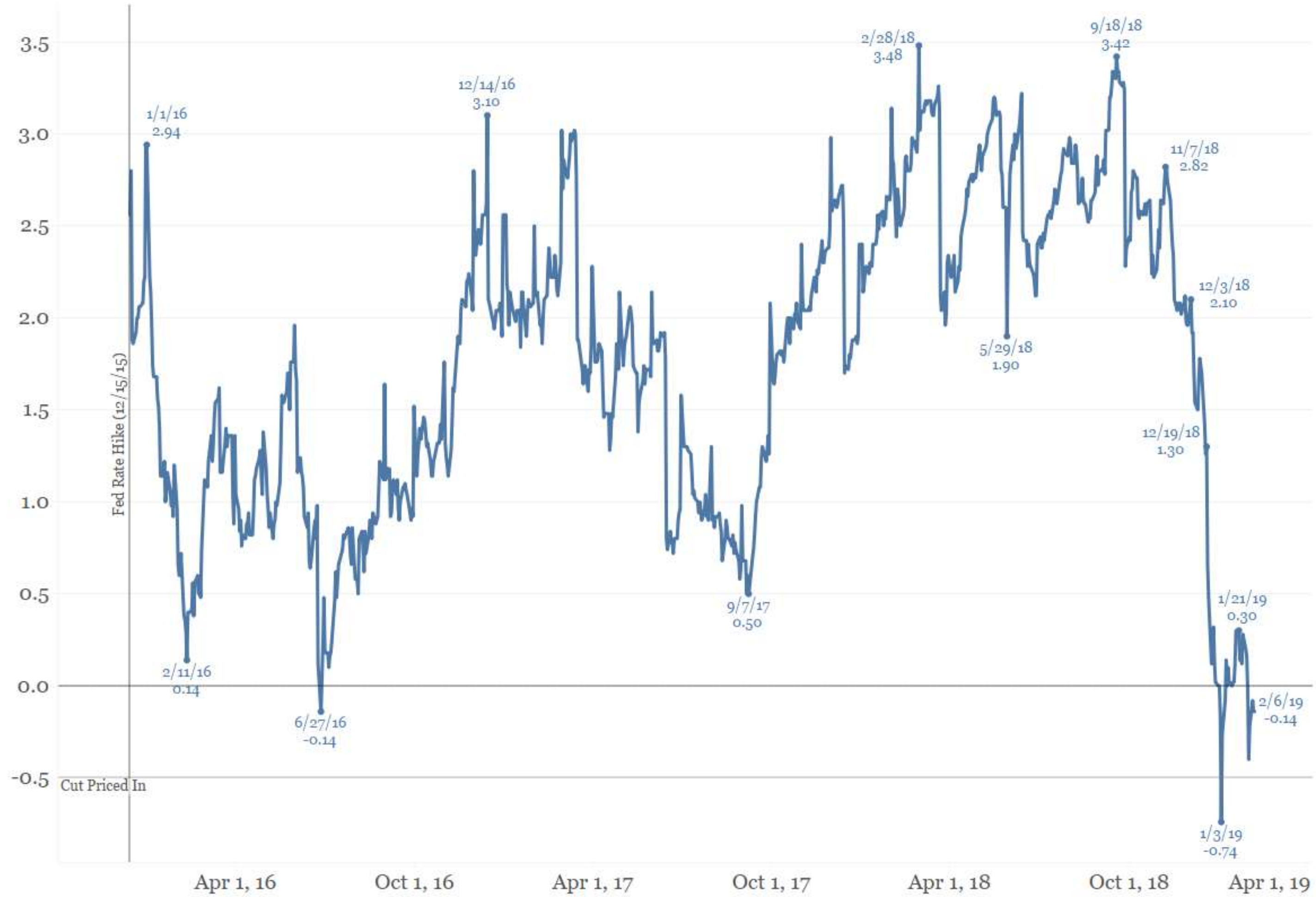
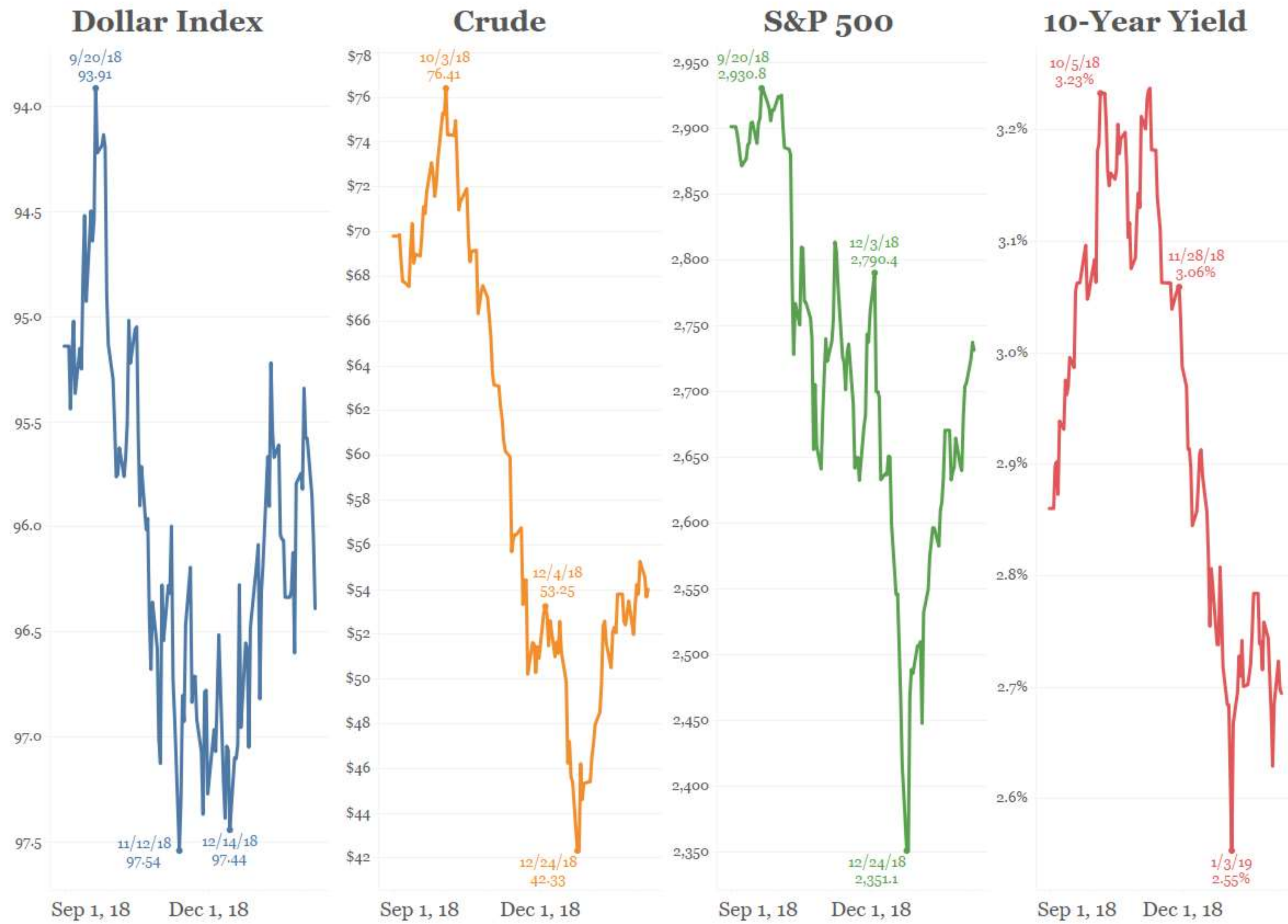
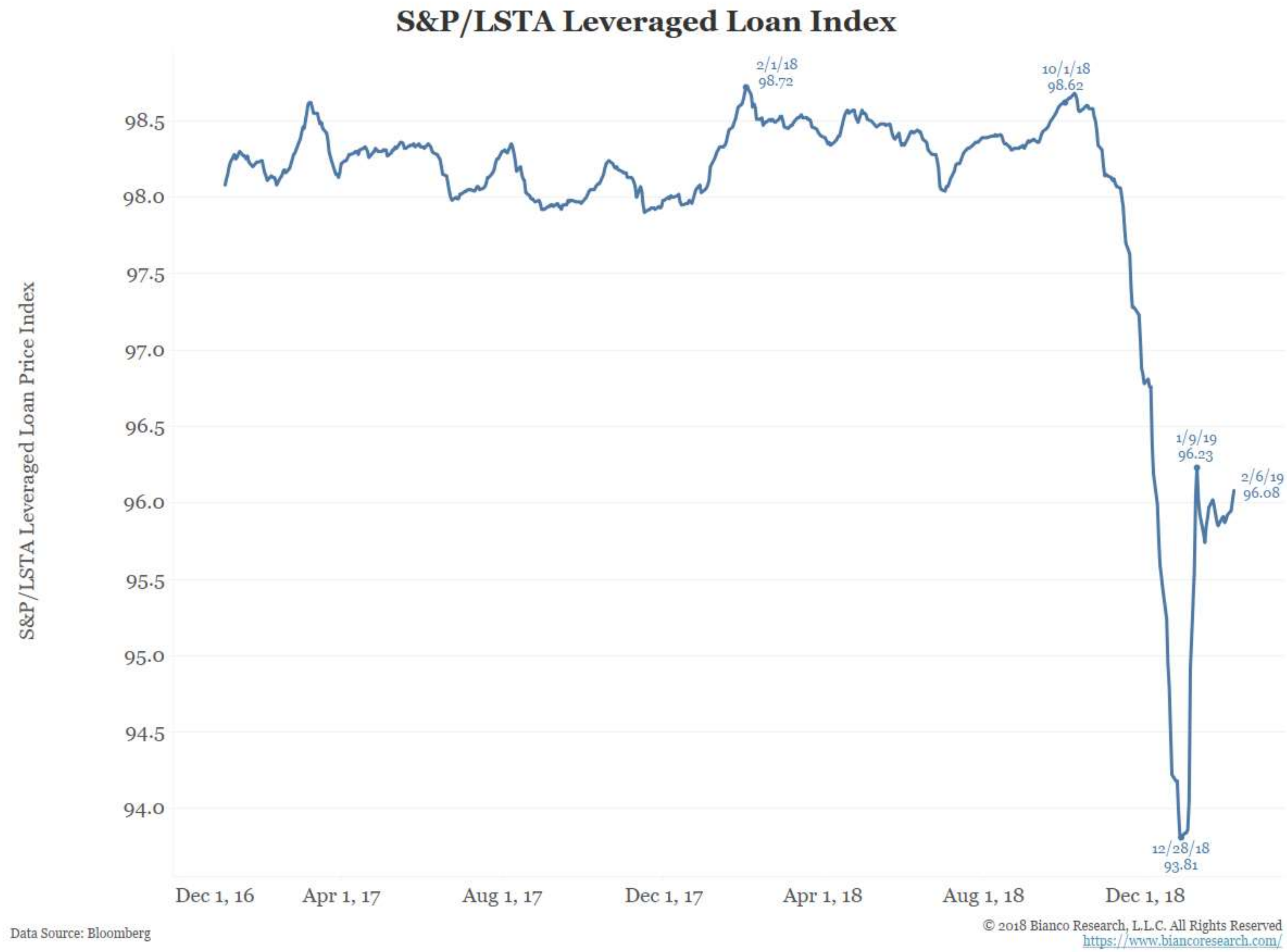
Number of Hikes Over The Next 12 Months



Source: Bloomberg WIRP Function



Source: Bloomberg


S&P/LSTA Leveraged Loan Index
S&P/LSTA Leveraged Loan Price Index
98.5
98.0
97.5
97.0
96.5
96.0
95.5
95.0
94.5
94.0
2/1/18
98.72
10/1/18
98.62
1/9/19
96.23
2/6/19
96.08
12/28/18
93.81
Dec 1, 16
Apr 1, 17
Aug 1, 17
Dec 1, 17
Apr 1, 18
Aug 1, 18
Dec 1, 18
Data Source: Bloomberg
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And particularly with the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves. But we're always prepared to shift the stance of policy and to shift it significantly if necessary in order to promote our statutory goals of the maximum implement and stable prices. – **Jay Powell, January 4, 2019**

But what I do know is that we will be prepared to adjust policy quickly and flexibly, and to use all of our tools to support the economy, should that be appropriate, to keep the expansion on track, to keep the labor markets strong and to keep — to keep inflation near 2 percent. – **Jay Powell, January 4, 2019**

And so we also said at the very beginning, I think in our original — certainly, the first policy normalization plans that I was involved in 2014, we said that we would be prepared to adjust our normalization plans as appropriate to achieve our goal. So if we ever came to the conclusion that any aspect of our normalization plans was — was somehow interfering with our achievement of our statutory goals, we wouldn't hesitate to change it, and that would include the balance sheet, certainly. – **Jay Powell, January 4, 2019**

The following passage was in January 30, 2019 FOMC statement:

> *In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.*

Historically the word "patience" in the FOMC statement means no move at the next meeting. As the chart above shows, many market participants believe the rate hike cycle is over.

The Fed will continue to reduce the balance sheet, which is a form of tightening. But the market believes the next rate move will be a cut due to economic weakness, most likely next year.

Do not celebrate a coming rate cut as a good thing. When things get bad enough for the Fed to cut rates, risk assets like stocks are usually suffering.

***Bloomberg* – (*December 3, 2018*) [Fed's Clarida Says 'Powell Put' Not a Useful Concept for Policy]**

Federal Reserve Vice Chairman Richard Clarida said the U.S. central bank will defend both sides of its inflation target and **cautioned investors against thinking the Fed would act to halt a sharp market decline. "I don't really think of it as a useful way to describe what the current Federal Reserve is doing**," he said Monday when asked about the concept of a "Powell Put" in an interview with Tom Keene on Bloomberg Television. Clarida, who took his post in September, said the Fed would tolerate inflation rising slightly above its stated 2 percent target for inflation. "We have a symmetric objective around 2 percent," he said. "Two percent is not meant to be a ceiling. We've operated below 2 percent, we could operate somewhat above 2 percent, depending on the shocks.

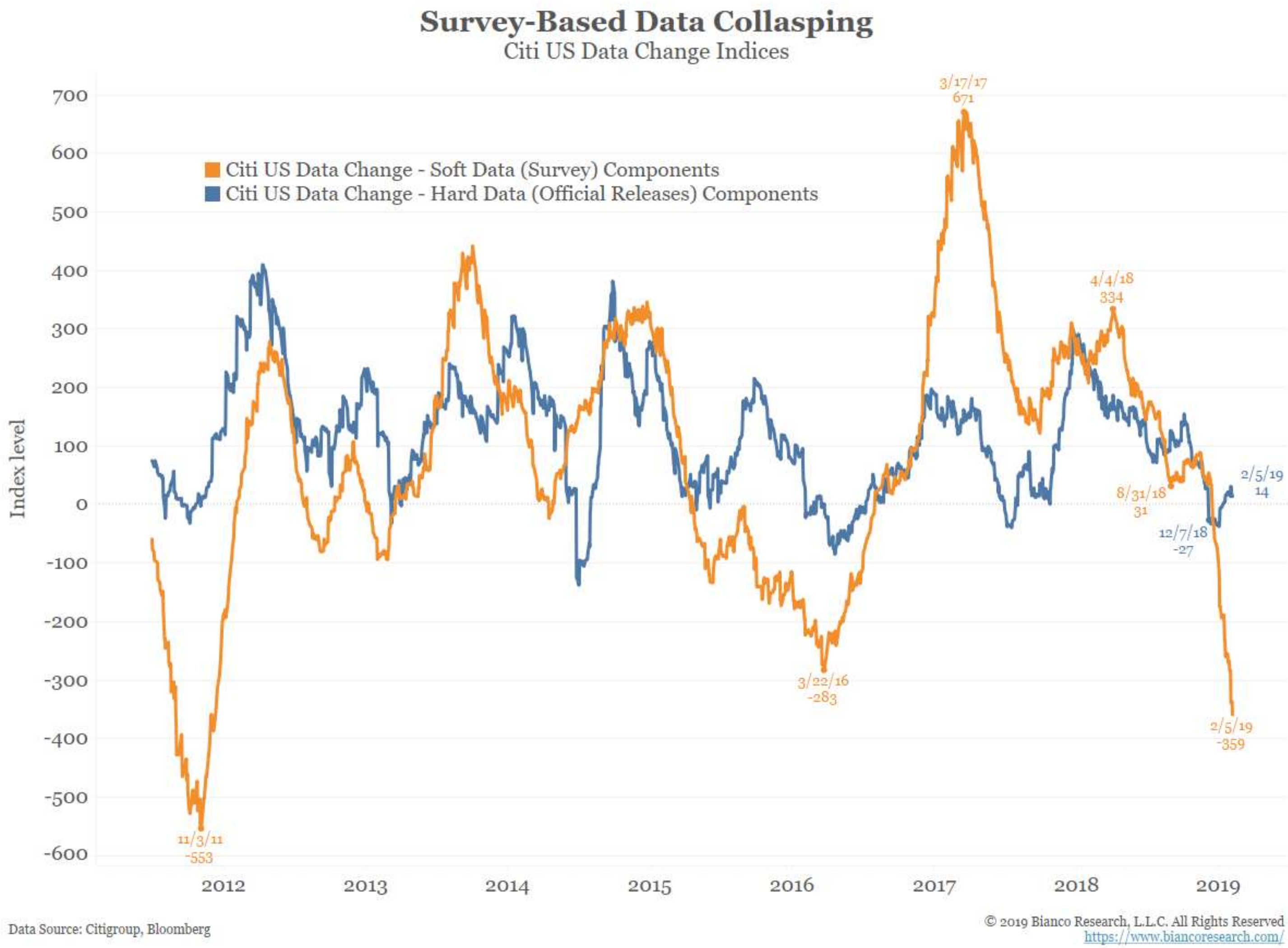
[Transcript of Fed Press Conference]
- January 30, 2019

MICHAEL MCKEE. Michael McKee from Bloomberg Television and Radio. ... And I'm wondering about your reaction to the criticism you got on your December 19th news conference, your later statements -- do you feel you've put a "Powell put" into the markets?

CHAIRMAN POWELL. ... So we don't react to, you know, to most things that happen in the financial markets. But when we see a sustained change in financial conditions, then that's something that has to play into our thinking. In fact, our policy works through changing financial conditions so it's sort of the essence of what we do.

GREG ROBB. Chairman Powell, Greg Robb from MarketWatch. Financial markets have reacted strongly to the decision and the press conference. The Dow Jones Industrial Average is up more than like 500 points. There's a sense in the market that there's, you know, what people call the "Powell put" on the markets. Are financial markets wrong in that assessment?

CHAIRMAN POWELL. You know, I would point to all the continuity here. You know, the thing we did on the balance sheet is something we've been working on for, frankly, years -- the thing we announced today. And so we're providing clarity there. I think that's a constructive thing to do. My honestly only motivation is to do the right thing for the economy and for the American people -- that's it. And this situation, I think, calls for patience -- I think it does. And it's just the stance of policy we think is appropriate. We see these uncertainties and we see a time when we can afford to -- we have the luxury of being able to wait and watch and that's what we're planning to do. And I think it's the right thing -- I feel strongly that it is.


Survey-Based Data Collasping
Citi US Data Change Indices
Citi US Data Change - Soft Data (Survey) Components
Citi US Data Change - Hard Data (Official Releases) Components
Index level
700
600
500
400
300
200
100
0
-100
-200
-300
-400
-500
-600
2012
2013
2014
2015
2016
2017
2018
2019
3/17/17
671
4/4/18
334
8/31/18
31
12/7/18
-27
2/5/19
14
2/5/19
-359
3/22/16
-283
11/3/11
-553
Data Source: Citigroup, Bloomberg
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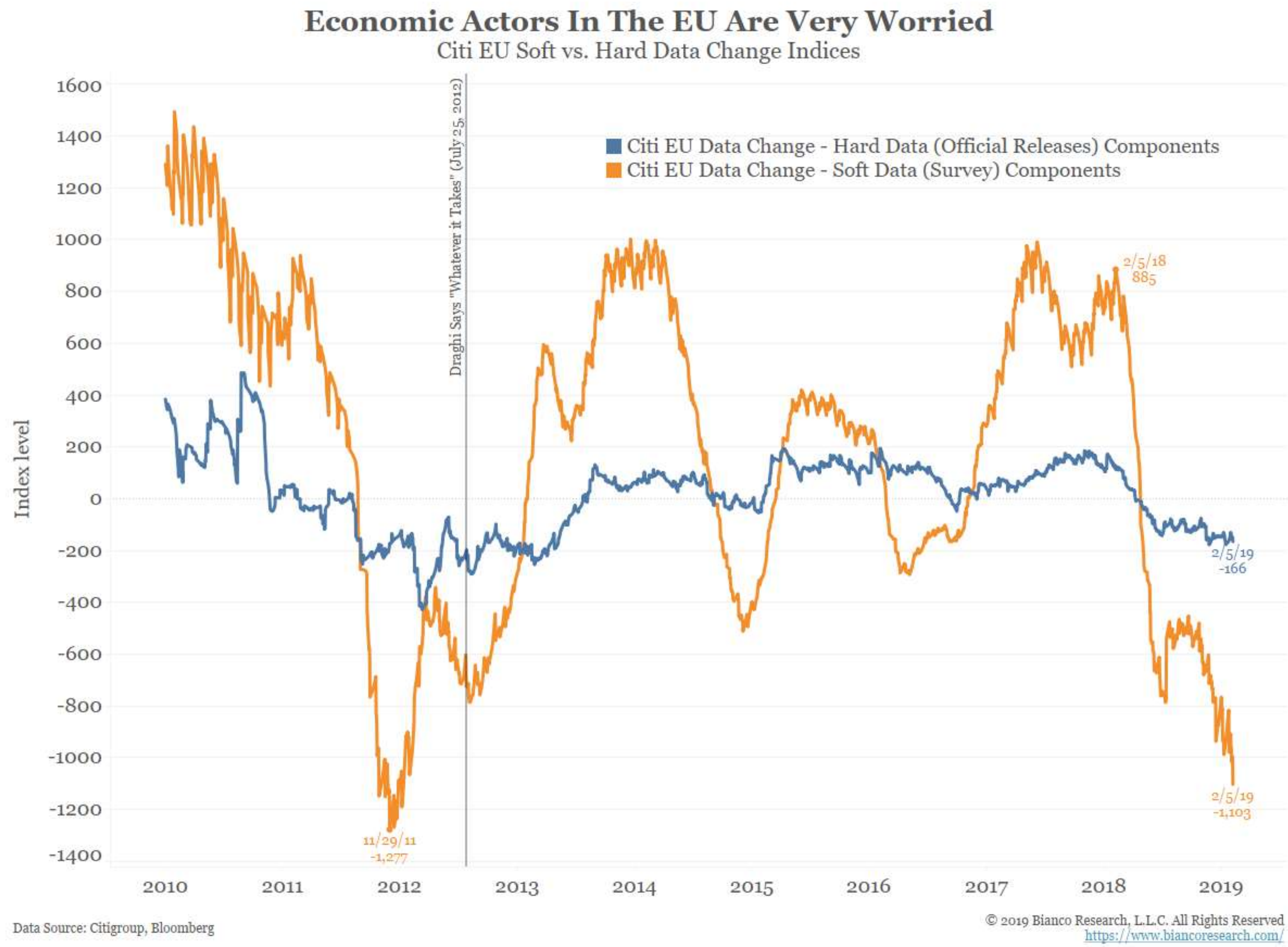

Economic Actors In The EU Are Very Worried
Citi EU Soft vs. Hard Data Change Indices
Citi EU Data Change - Hard Data (Official Releases) Components
Citi EU Data Change - Soft Data (Survey) Components
Draghi Says "Whatever it Takes" (July 25, 2012)
Index level
1600
1400
1200
1000
800
600
400
200
0
-200
-400
-600
-800
-1000
-1200
-1400
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
11/29/11
-1,277
2/5/18
885
2/5/19
-166
2/5/19
-1,103
Data Source: Citigroup, Bloomberg
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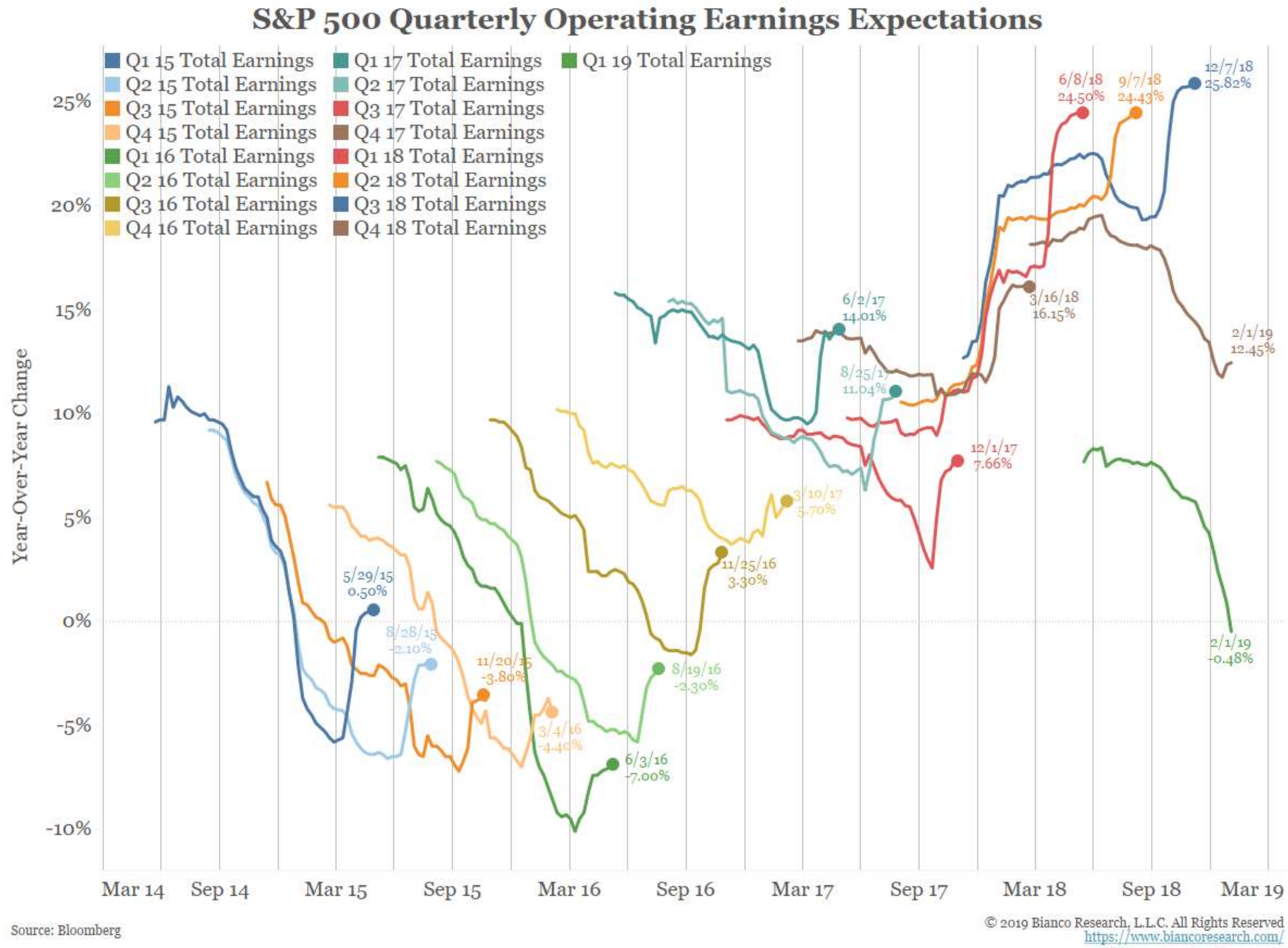
S&P 500 Quarterly Operating Earnings Expectations
Q1 15 Total Earnings
Q2 15 Total Earnings
Q3 15 Total Earnings
Q4 15 Total Earnings
Q1 16 Total Earnings
Q2 16 Total Earnings
Q3 16 Total Earnings
Q4 16 Total Earnings
Q1 17 Total Earnings
Q2 17 Total Earnings
Q3 17 Total Earnings
Q4 17 Total Earnings
Q1 18 Total Earnings
Q2 18 Total Earnings
Q3 18 Total Earnings
Q4 18 Total Earnings
Q1 19 Total Earnings
Year-Over-Year Change
25%
20%
15%
10%
5%
0%
-5%
-10%
5/29/15 0.50%
8/28/15 -2.10%
11/20/15 -3.80%
3/4/16 -4.40%
6/3/16 -7.00%
8/19/16 -2.30%
11/25/16 3.30%
3/10/17 5.70%
6/2/17 14.01%
8/25/17 11.04%
12/1/17 7.66%
3/16/18 16.15%
6/8/18 24.50%
9/7/18 24.43%
12/7/18 25.82%
2/1/19 12.45%
2/1/19 -0.48%
Mar 14
Sep 14
Mar 15
Sep 15
Mar 16
Sep 16
Mar 17
Sep 17
Mar 18
Sep 18
Mar 19
Source: Bloomberg
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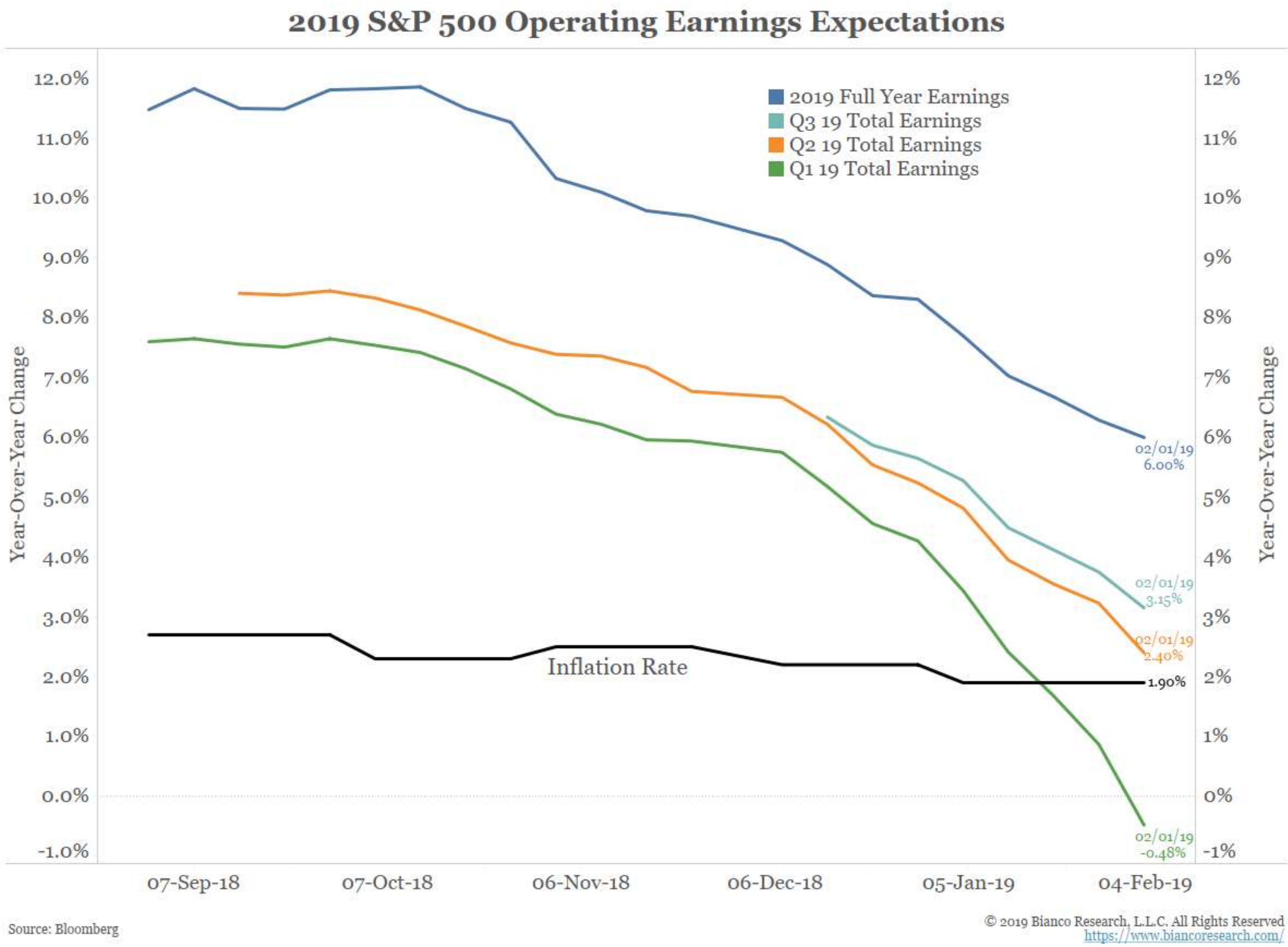
2019 S&P 500 Operating Earnings Expectations
2019 Full Year Earnings
Q3 19 Total Earnings
Q2 19 Total Earnings
Q1 19 Total Earnings
Inflation Rate
02/01/19 6.00%
02/01/19 3.15%
02/01/19 2.40%
1.90%
02/01/19 -0.48%
Year-Over-Year Change
12.0%
11.0%
10.0%
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
07-Sep-18
07-Oct-18
06-Nov-18
06-Dec-18
05-Jan-19
04-Feb-19
Source: Bloomberg
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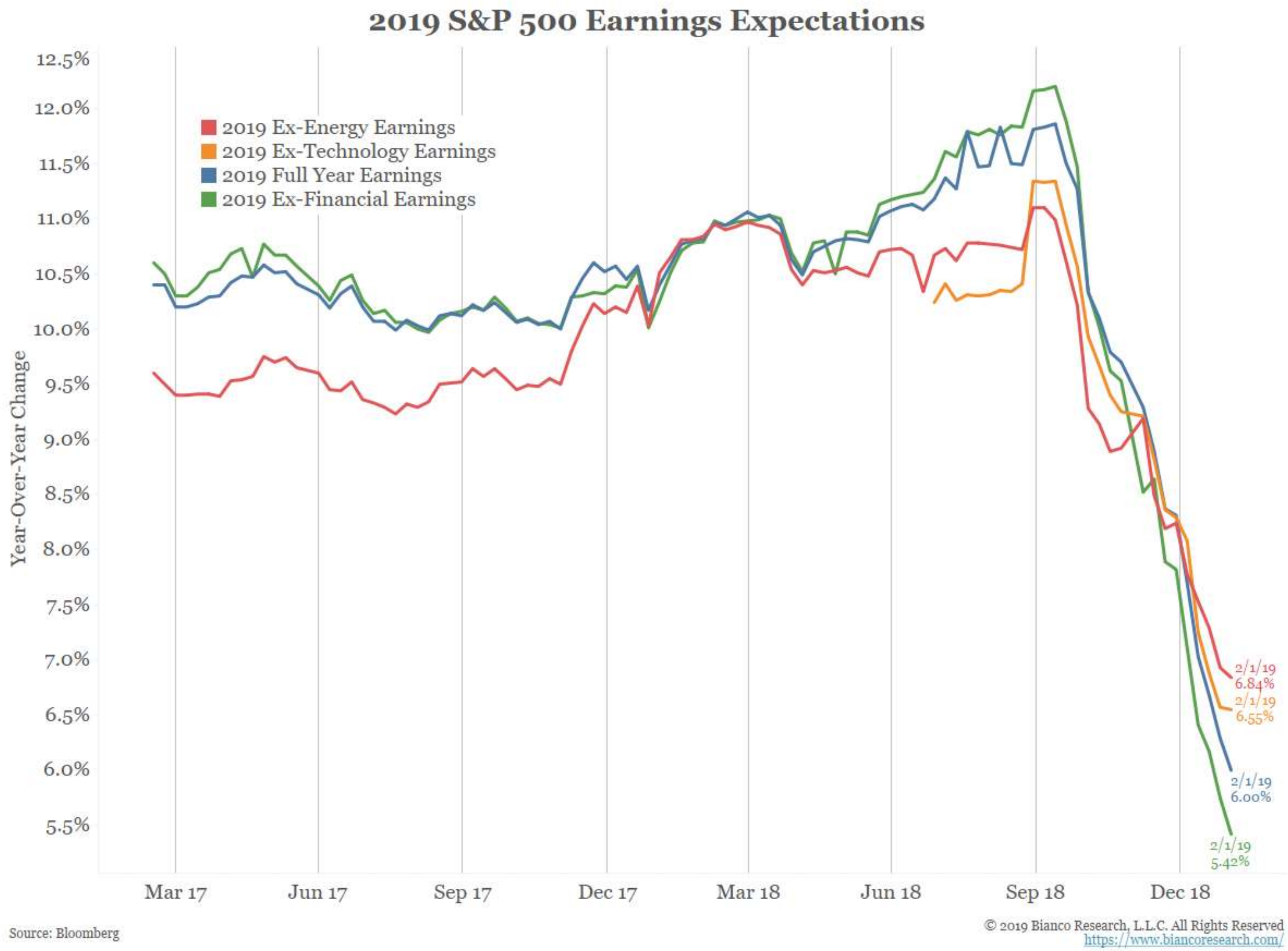

2019 S&P 500 Earnings Expectations
12.5%
12.0%
11.5%
11.0%
10.5%
10.0%
9.5%
9.0%
8.5%
8.0%
7.5%
7.0%
6.5%
6.0%
5.5%
Year-Over-Year Change
2019 Ex-Energy Earnings
2019 Ex-Technology Earnings
2019 Full Year Earnings
2019 Ex-Financial Earnings
2/1/19
6.84%
2/1/19
6.55%
2/1/19
6.00%
2/1/19
5.42%
Mar 17
Jun 17
Sep 17
Dec 17
Mar 18
Jun 18
Sep 18
Dec 18
Source: Bloomberg
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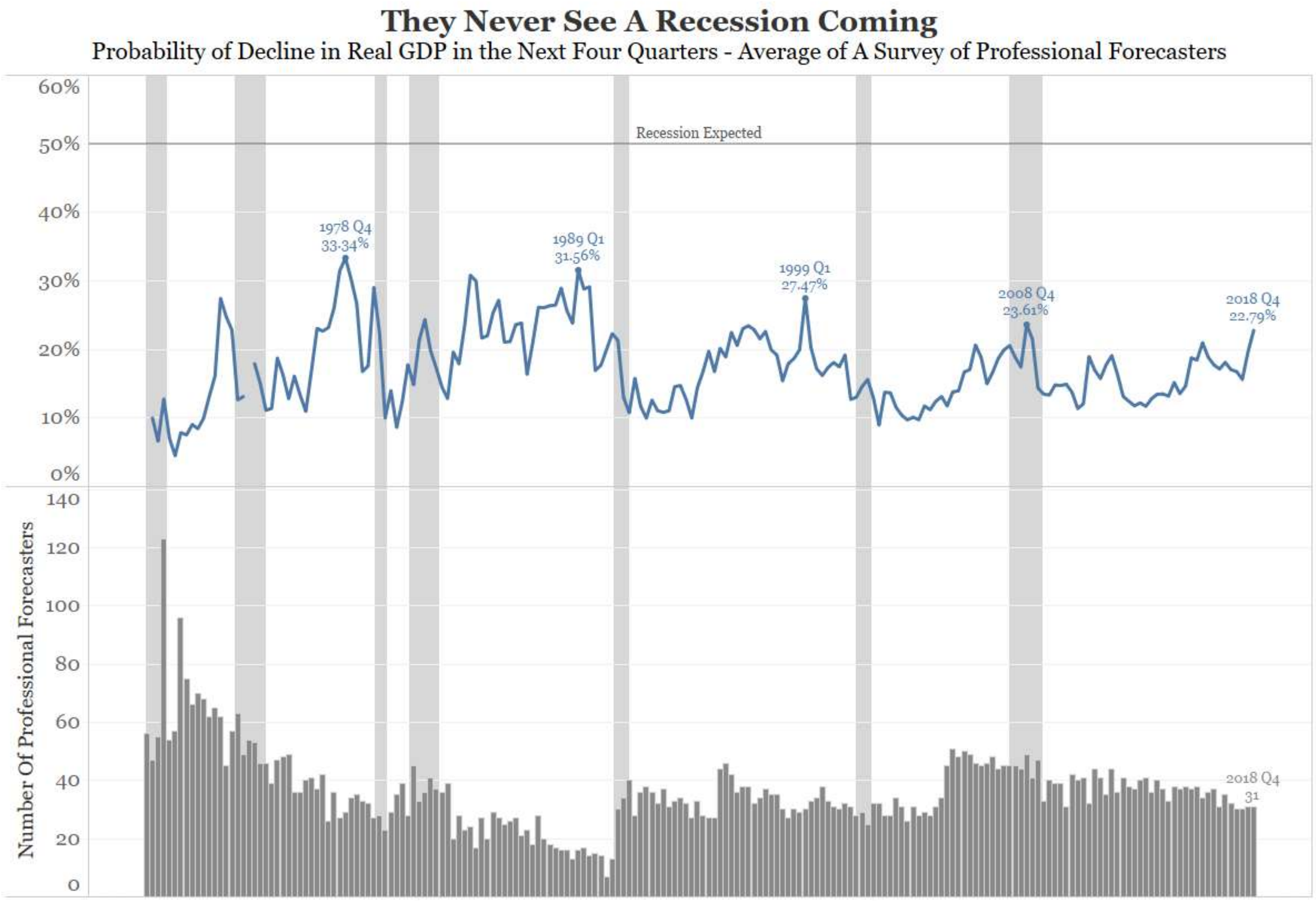
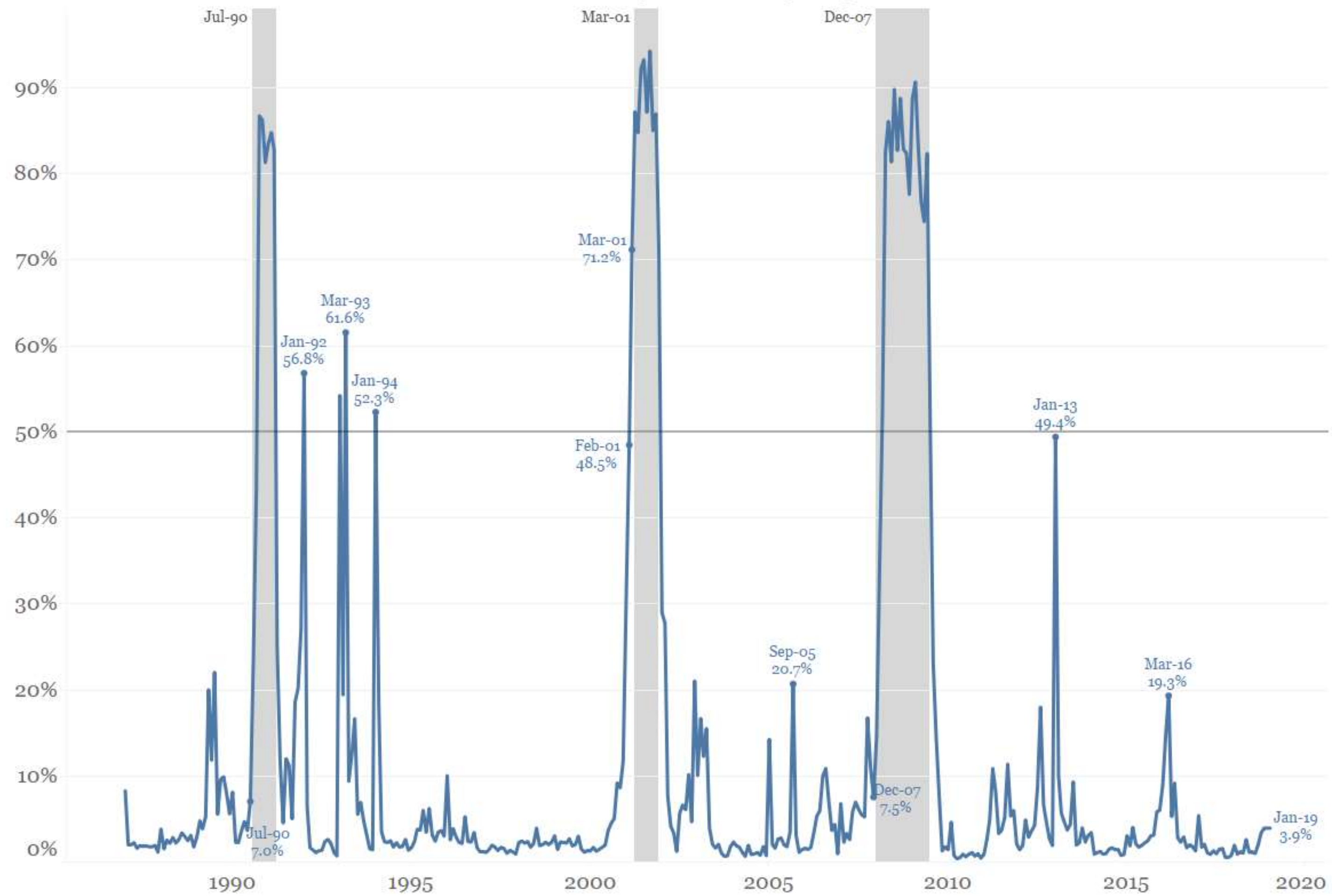
I don't think that expansions just die of old age. Two things usually end them. One is financial imbalances and the other is the Fed, and usually when the Fed ends a recession — ends an expansion, it's because inflation has gotten out of control and the Fed needs to tighten to bring it down. – **Janet Yellen, January 4, 2019**

But as Janet says, expansions don't die of old age. I'd like to say they get murdered, instead. – **Ben Bernanke, January 4, 2019**



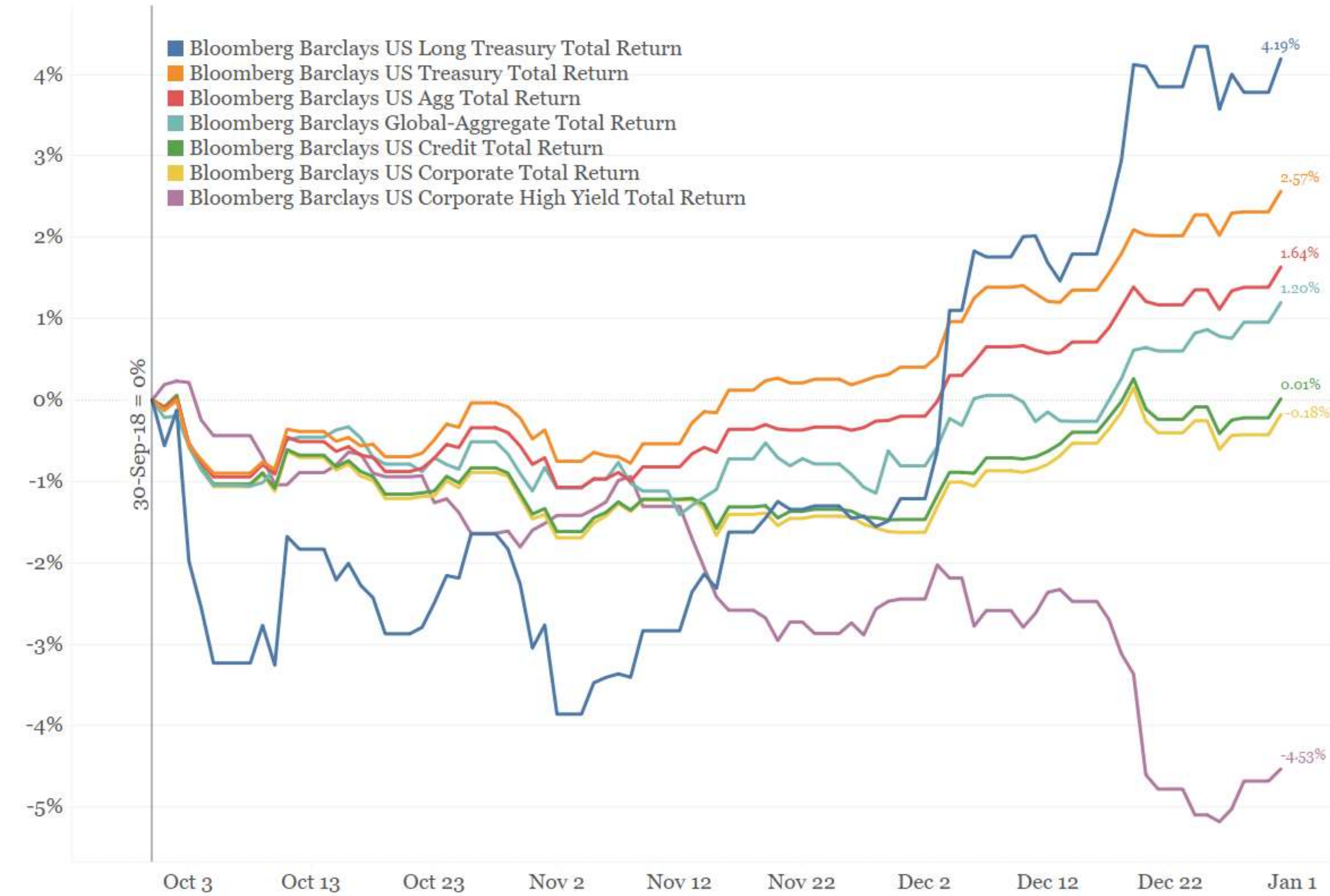
Data Source: Philadelphia Federal Reserve
https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters

Recession Probability - Jeremy Piger Model



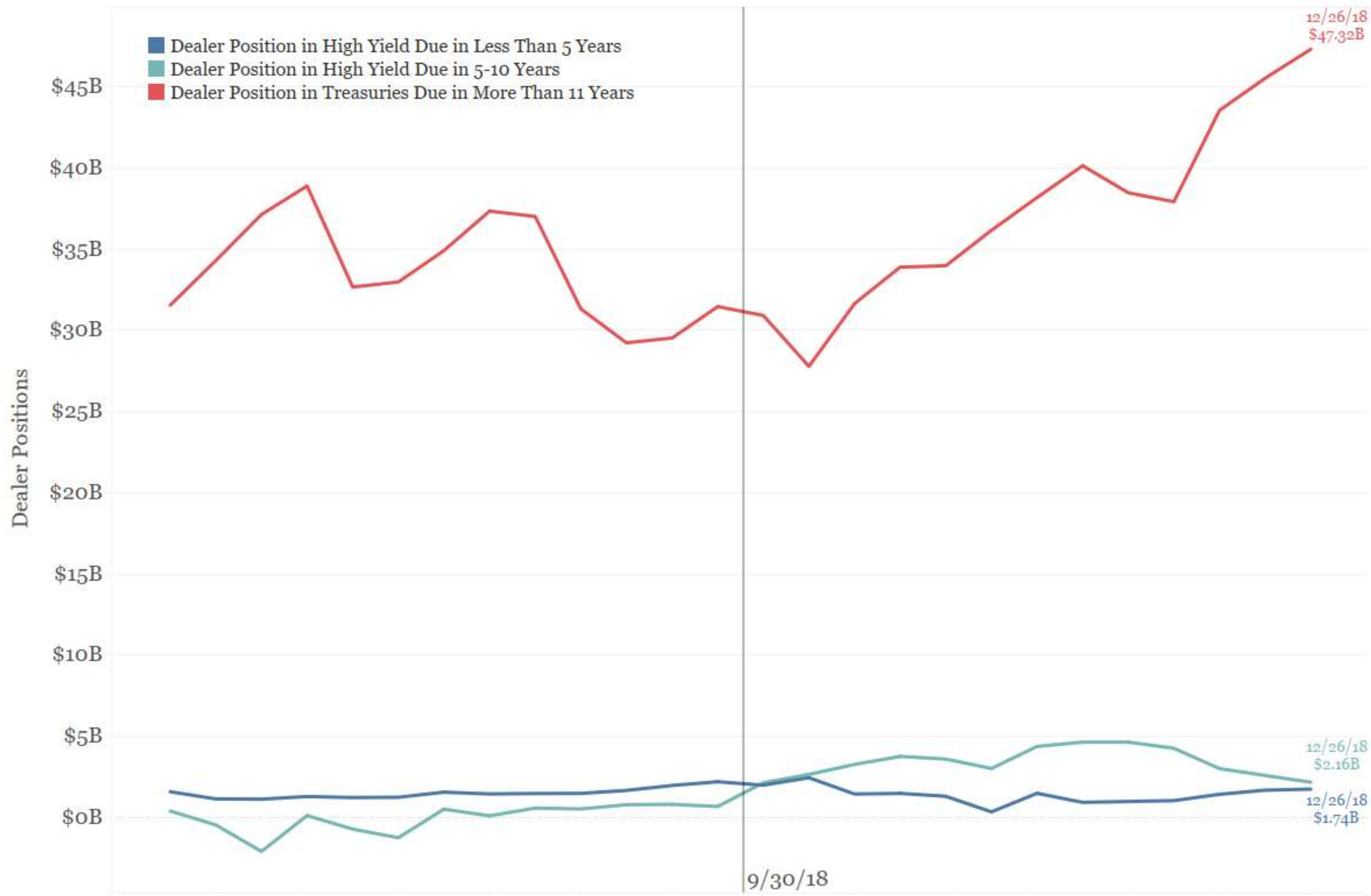
Data Source: Bloomberg, University of Oregon
https://pages.uoregon.edu/jpiger/us_recession_probs.htm/

Q4 2018 Fixed Income Total Returns

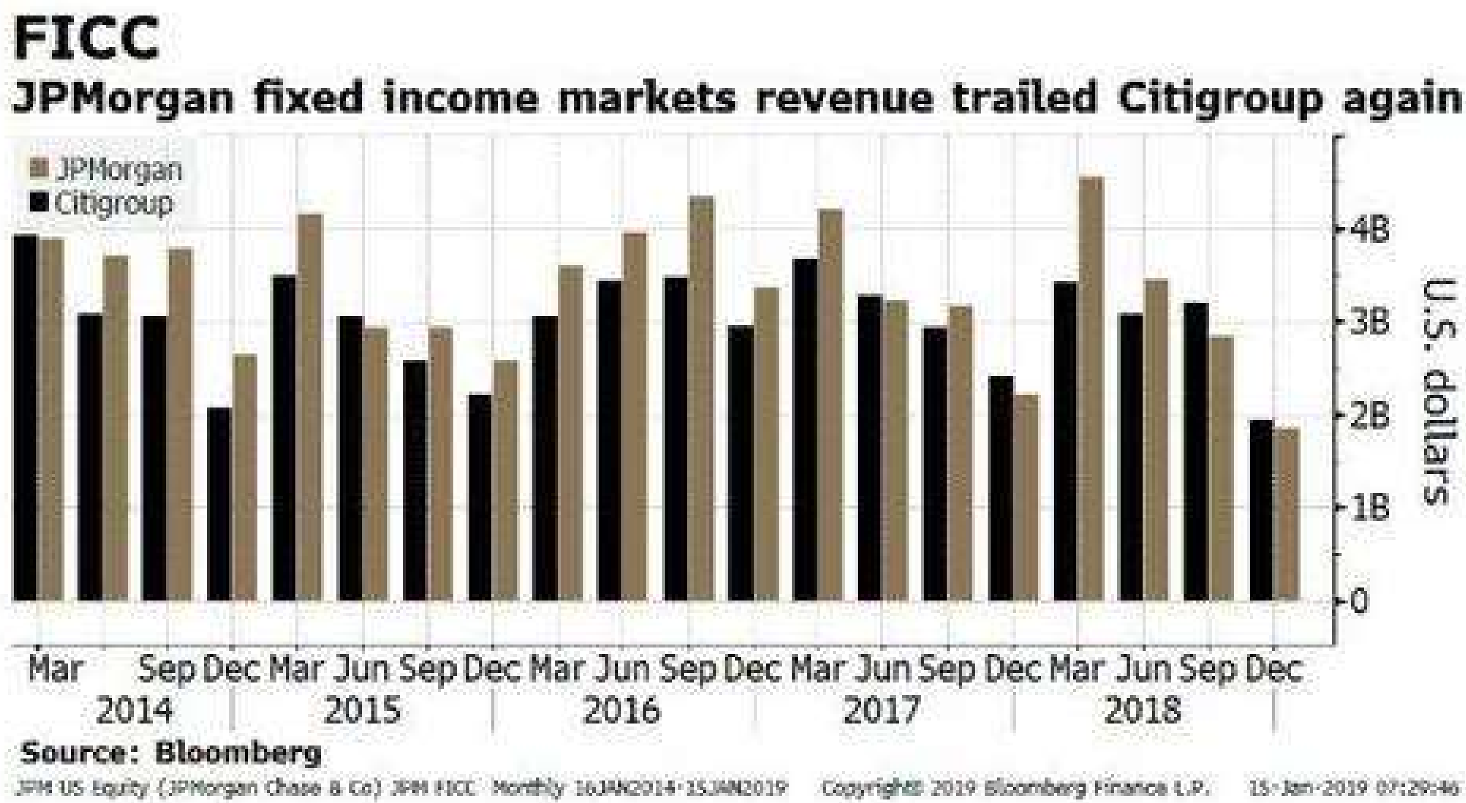


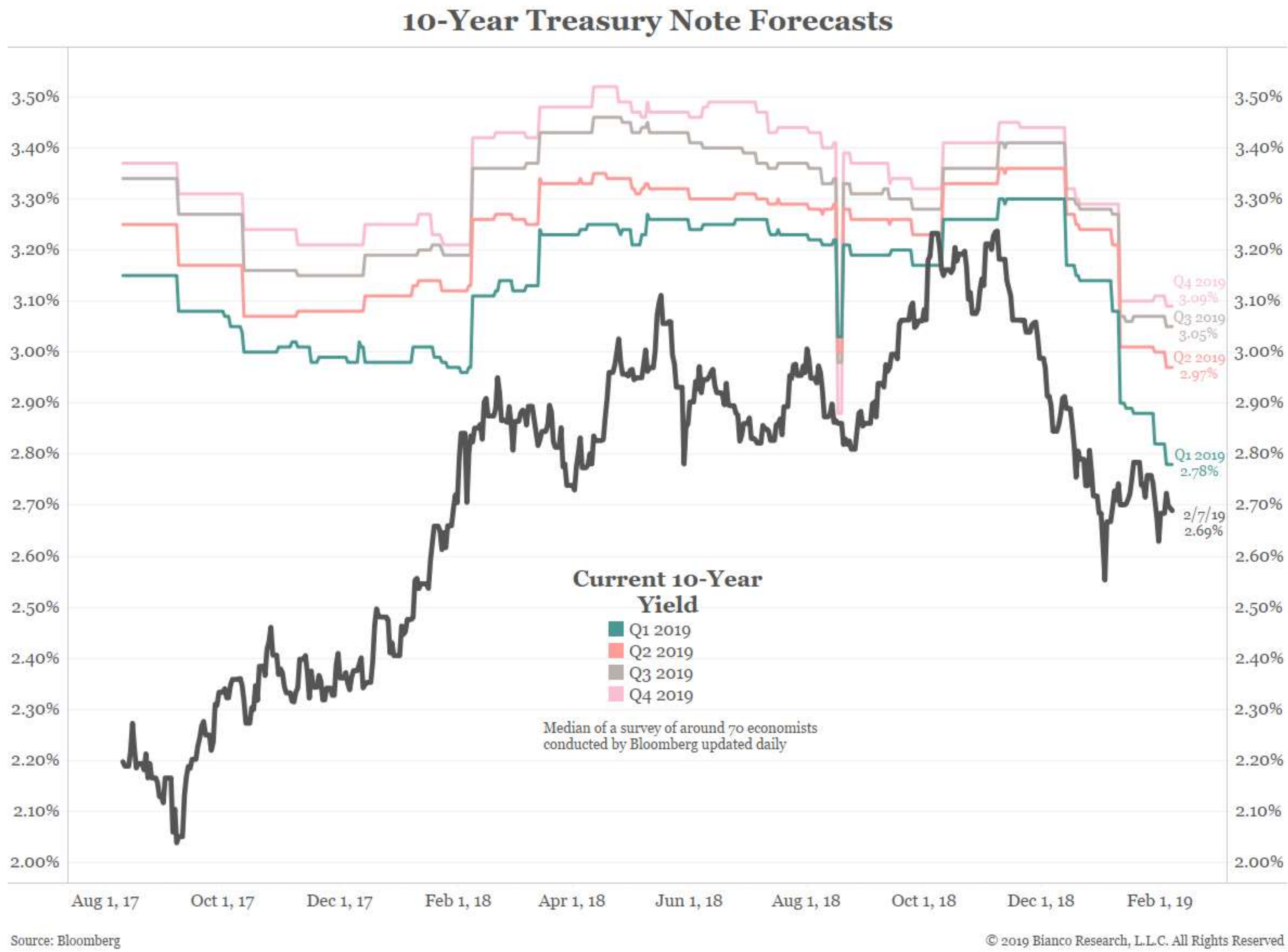
Data Source: Bloomberg

Dealer Positions



Data Source: The New York Federal Reserve


FICC
JPMorgan fixed income markets revenue trailed Citigroup again
JPMorgan
Citigroup
4B
3B
2B
1B
0
U.S. dollars
Mar Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec Mar Jun Sep Dec
2014 2015 2016 2017 2018
Source: Bloomberg
JPM US Equity (JPMorgan Chase & Co) JPM FICC Monthly 16JAN2014-15JAN2019 Copyright© 2019 Bloomberg Finance L.P. 15-Jan-2019 07:29:46


10-Year Treasury Note Forecasts
3.50%
3.40%
3.30%
3.20%
3.10%
3.00%
2.90%
2.80%
2.70%
2.60%
2.50%
2.40%
2.30%
2.20%
2.10%
2.00%
Aug 1, 17
Oct 1, 17
Dec 1, 17
Feb 1, 18
Apr 1, 18
Jun 1, 18
Aug 1, 18
Oct 1, 18
Dec 1, 18
Feb 1, 19
Q4 2019
3.09%
Q3 2019
3.05%
Q2 2019
2.97%
Q1 2019
2.78%
2/7/19
2.69%
Current 10-Year Yield
Q1 2019
Q2 2019
Q3 2019
Q4 2019
Median of a survey of around 70 economists conducted by Bloomberg updated daily
Source: Bloomberg
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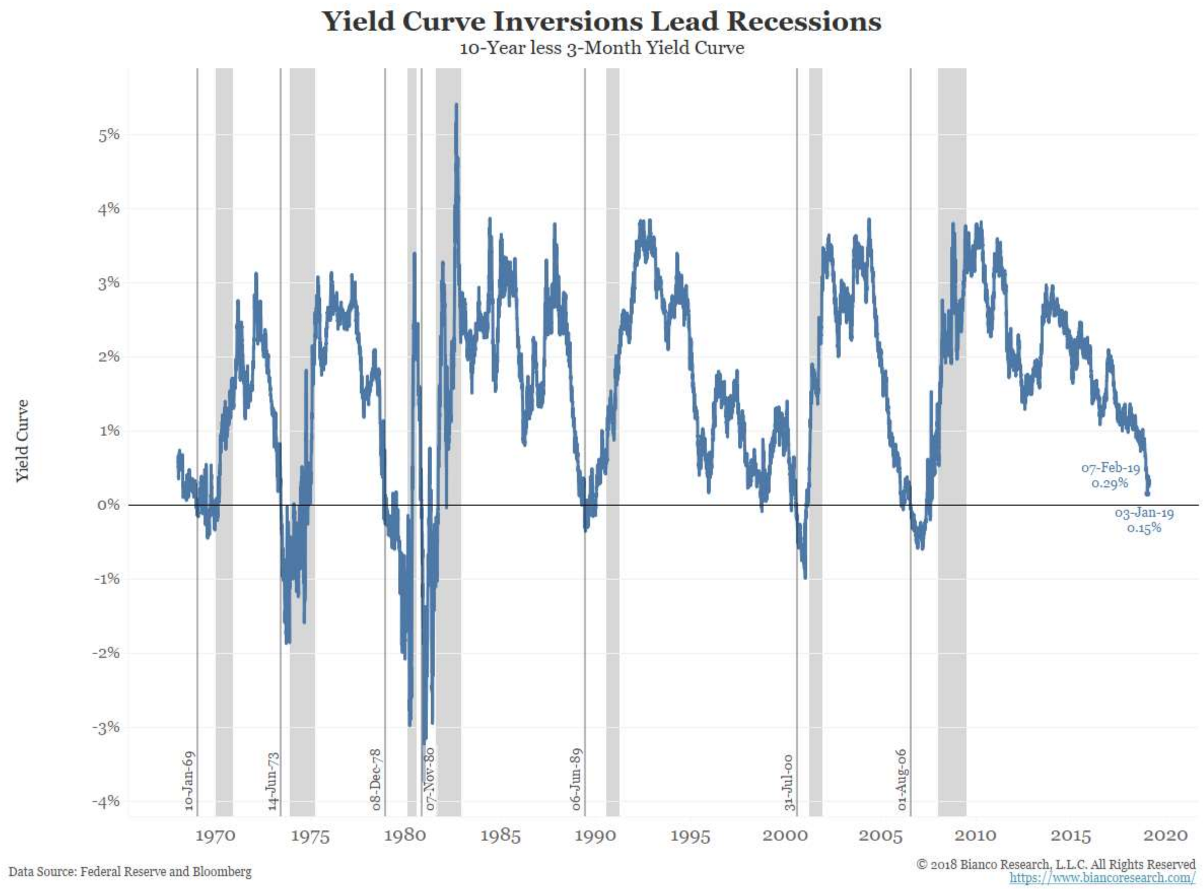
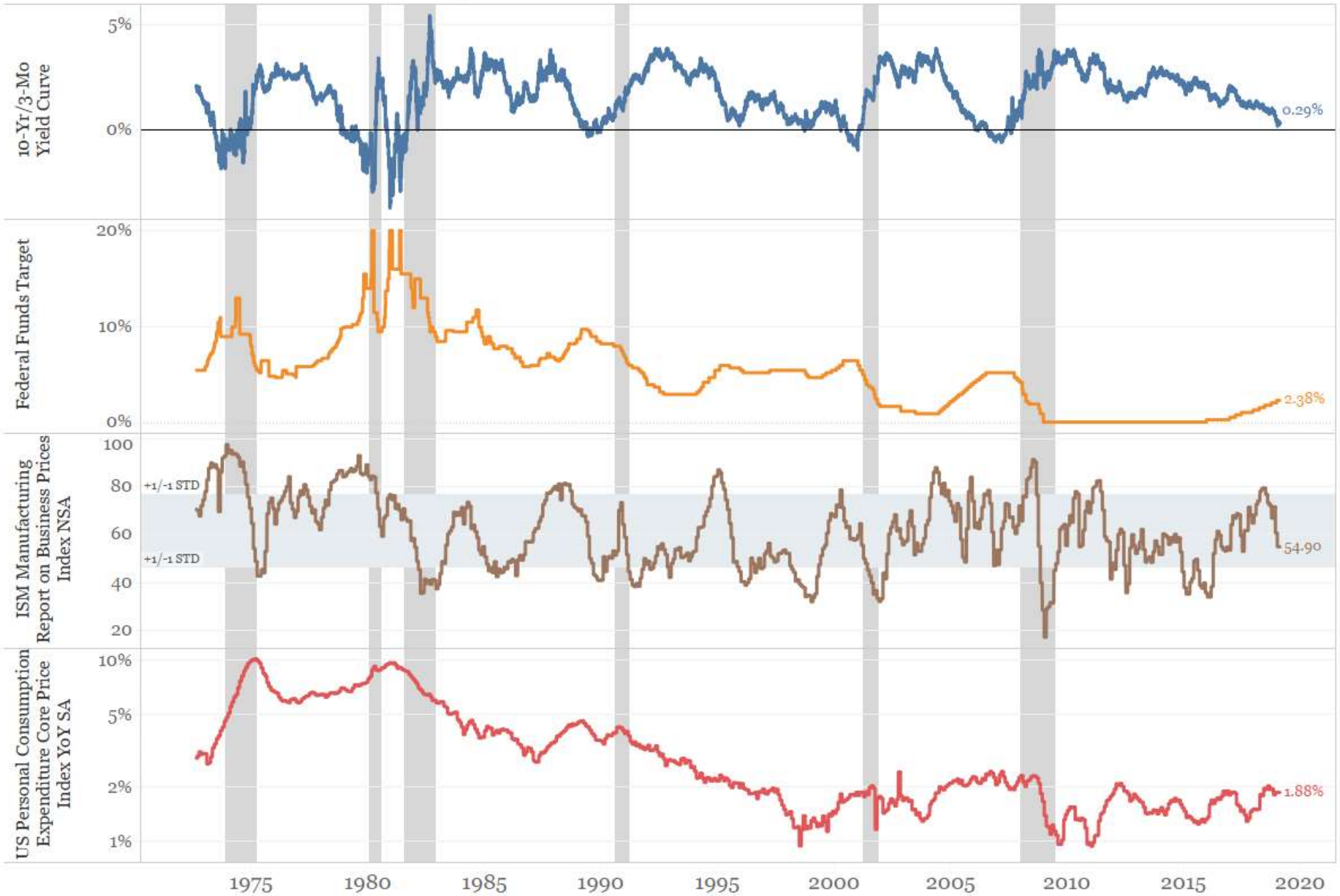
How Long Until The Recession?		
When the 3M/10Yr Curve Inverts For 10 Straight Days		
Date of Inversion	**Date of Next Recession**	**Days to Next Recession**
1/10/1969	Dec-69	325
6/14/1973	Nov-73	140
12/8/1978	Jan-80	389
11/7/1980	Jul-81	236
6/6/1989	Jul-90	390
7/31/2000	Mar-01	213
8/1/2006	Dec-07	487
Average		**311**



Why Does The Yield Curve Invert?



Data Source: Federal Reserve and Bloomberg

Bianco Research L.L.C.

550 W Washington Blvd
Suite 201
Chicago, Il 60661

Phone: (847) 304-1511
Fax: (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Analysts (847) 304-1511
Greg Blaha gblaha@biancoresearch.com
Ben Breitholtz ben.Breitholtz@biancoresearch.com
Peter Forbes peter.forbes@biancoresearch.com
Ryan Malo rmalo@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 606-1872
Max Konzelman Max.Konzelman@arborresearch.com

Arbor Research & Trading, L.L.C

1000 Hart Road, Suite 260
Barrington IL 60010

Phone: (847) 304-1550 Fax: (847) 304-1595
e-mail: inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

New York Sales Office
10 East 4oth Street 13th Floor
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office
Room 303
New Broad Street House
35 New Broad Street
London
EC2M 1NH
Phone 44-207-100-1051
Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com

Chicago Sales Office
James L. Perry james.perry@arborresearch.com
Phone (847) 304-1560 Fax (847) 304-1595

Geneva Sales Office
Rich Kleinbauer rich.kleinbauer@arborresearch.com
Phone (41) 22 565-2480