Financial Market Weekly

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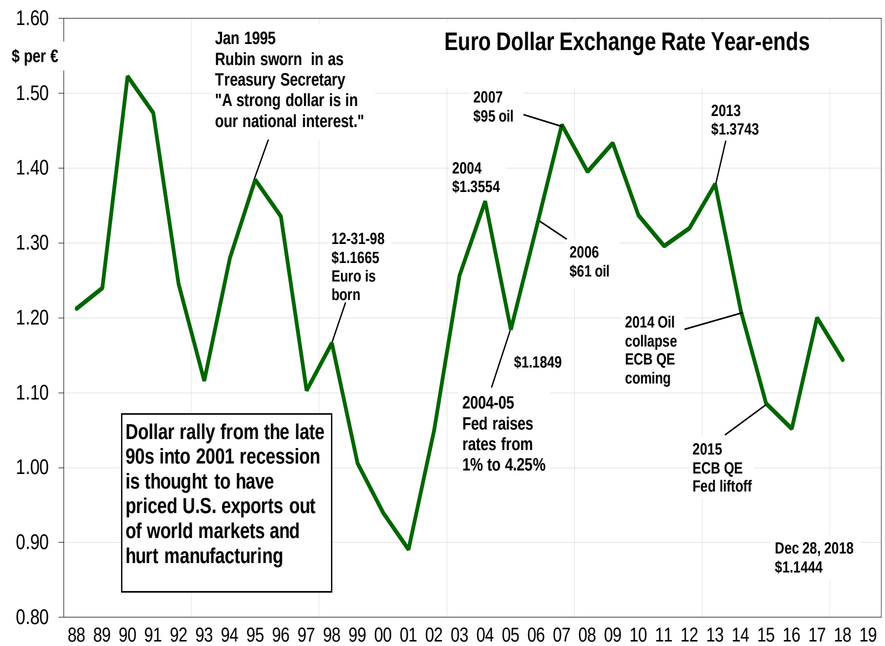
THE EURO TURNS 20



The Euro turns twenty years old this year. After watching the stock market closely for a couple of weeks, we thought we would look at something that is easier to understand like foreign exchange rates. It can't be that difficult. While Dow industrials stocks ranged over two thousand points high-to-low the last two weeks, the Euro traded from $1.13 to $1.15. Nothing. A couple of cents. What could be easier?

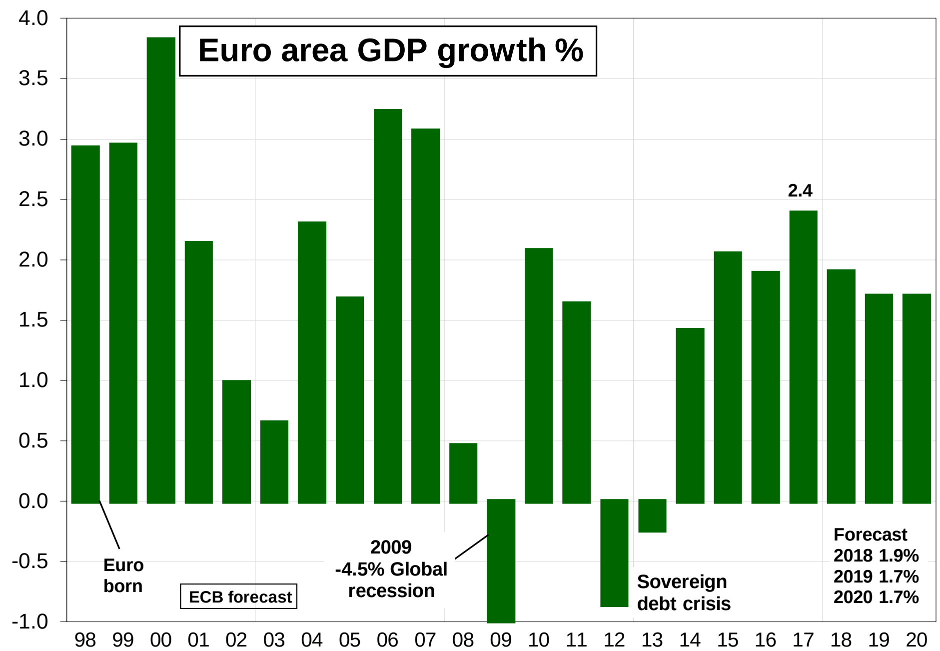
From the U.S. perspective, both academics and famous hedge fund traders never thought the Euro would last. That one or two weak countries would crash out of the eurozone and break the region apart, splintering its currency. But people and companies in the eurozone seem to like the currency even if they don't always like the politics. It has been a good store of value. It was $1.1665 at its birth in 1998, and closed $1.1444 tonight twenty years later. Steady as a rock.

The Euro area economy is moving ahead. The market didn't like the negative GDP in Germany in the third quarter, but Draghi was optimistic. Not an optimist by nature, and doesn't seem in any hurry to raise interest rates from zero before he leaves office next year. In a recent speech, Draghi defended the euro as a natural extension of the "single market" concept which requires a single currency and the move to this common market is not the same as "globalization," a word that is used often in a pejorative sense where some countries and their workers are left behind.

Draghi: "continuing confidence with increasing caution"

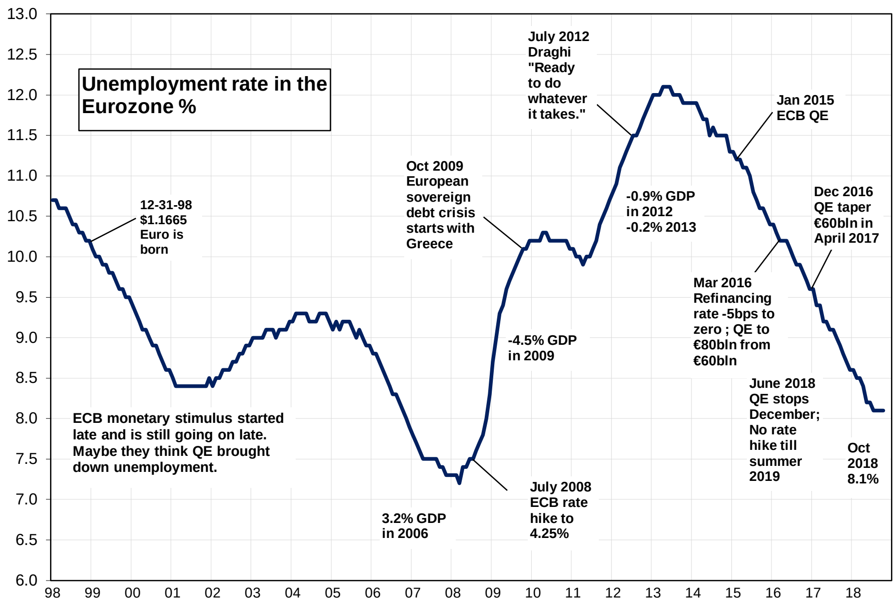
Anyway, euro area growth is moving ahead, he said at this month's ECB meeting press conference, despite the recent decline ("softer external demand [China exports]… sector-specific factors [autos]").

For those of you who like risks to the outlook, like a good central banker, he added some for the coming year: "uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent." Nevertheless, the ECB looks for 1.7% growth in 2019 and 2020.



Looking at the continued decline in unemployment, it is a surprise that monetary policy isn't further along in its return to neutral following the original crisis a decade ago. Even if growth fell in 2012-13 during the European sovereign debt crisis.

There was a lot of concern at least in the rest of the world that Italy might exit the Euro earlier this year. Italian bond yields have come back down however. Italy is 13.6% of the Euro area economy and was expected to grow 1.0% in 2019 in the IMF October 2018 World Economic Outlook with an update due in January 2019.



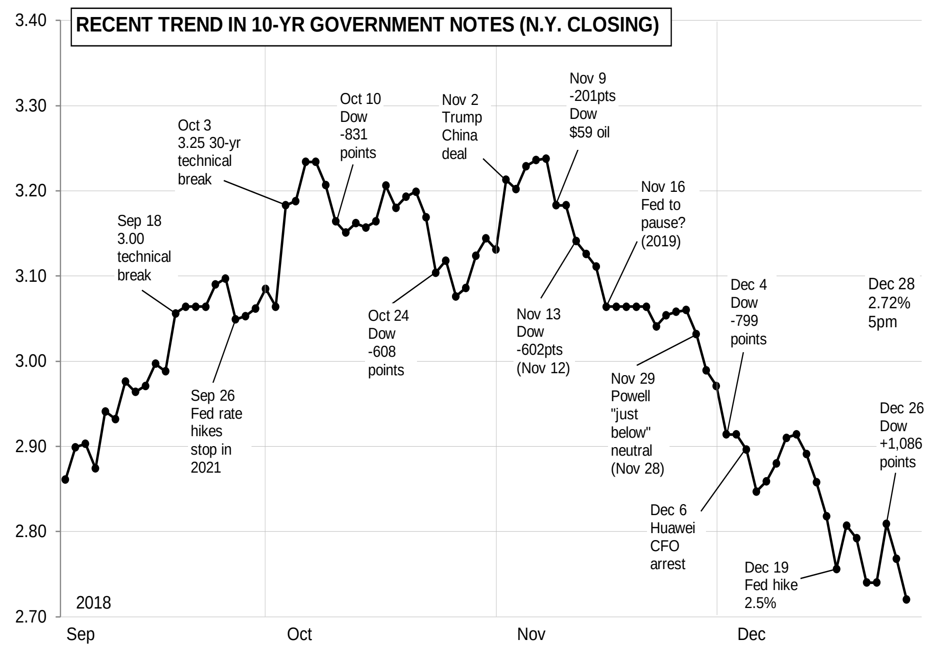
Even with some wide swings, the Euro has been stable over the last twenty years on a year-end basis. The dollar's appreciation during the Rubin Era at US Treasury sent the Euro down to $0.89 in 2001, a major dollar rally which helped convince American factories to pack their bags and move overseas. The Euro was "finished" several times the last several years, yet never made it back down there. The lowest intra-day was $1.034 on January 3, 2017 during the Trump dollar rally. The Euro was almost $1.40 before the oil crash in 2014-15. It's not unreasonable to project the Euro will head to $1.40 within the next few years when the commodity cycle normalizes. Assuming there is a commodity cycle with an upswing in prices, seeing as the most prominent commodity, crude oil, keeps getting knocked down with fracking supply shocks and new discoveries.

Euro area expected to see real growth in 2019

Real GDP %			GDP nominal dollars			Population		
2020	2019	2018	trillions	2017	Percent	millions	2017	Percent
1.6	1.9	1.9	Germany	3.277	25.9%	Germany	82.7	24.4%
1.6	1.6	1.6	France	2.291	18.1%	France	64.8	19.1%
0.9	1.0	1.2	Italy	1.716	13.6%	Italy	60.6	17.9%
1.9	2.2	2.7	Spain	1.163	9.2%	Spain	46.3	13.7%
			sub-total	8.447	66.9%	sub-total	254.4	75.1%
1.7	1.9	2.0	Grand Total	12.633	100.0%	Grand Total	338.6	100.0%
			*** Year/Year Growth IMF Oct 2018 forecasts					

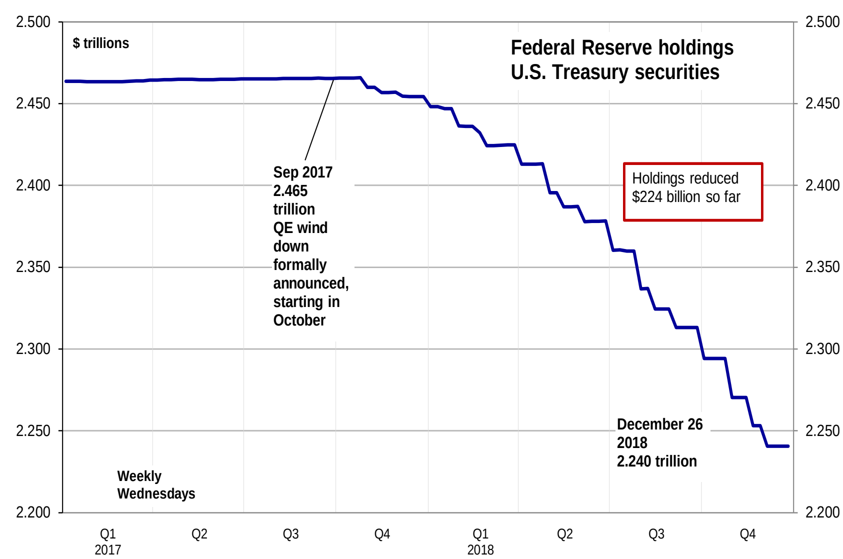
MARKETS OUTLOOK

	28-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.02	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.72	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.56	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.52	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.80	2.70	2.95	2.95	3.20	3.20	3.45	3.45	3.70
Fed Funds Rate	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
2s/10s spread	20	20	10	10	10	10	5	5	0



Another wild week for stocks and not as fun for bonds. Unless you are long bonds. The rally did not stop at 2.80% 3-month Libor and doesn't care a fig whether the Fed says they will "tighten" two more times in 2019. (There's that word "tightening" again, where the Fed has lost the battle to explain how rate hikes to neutral don't slow the economy.) Blame the president who won't give up the fight against rate hikes saying he is handicapped by higher rates versus Obama who had zero interest rates. Treasuries closed 2.72% on Friday versus 2.79% last week. Happy New Year. 2019 can't be worse for the stock market, can it?

FEDERAL RESERVE POLICY



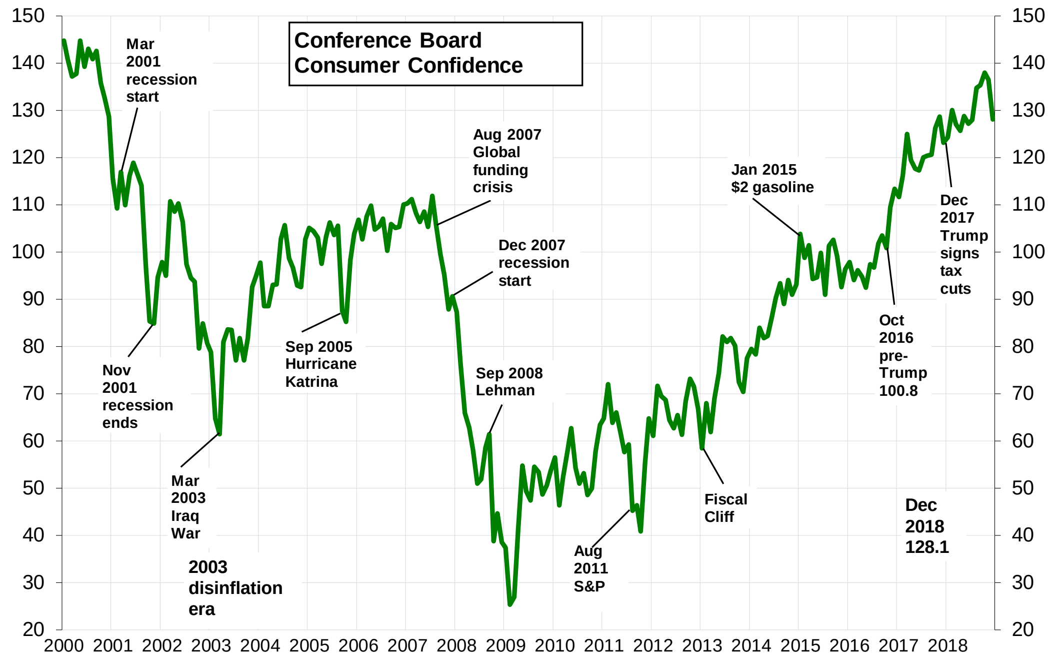
The Fed meets January 29-30 to consider its monetary policy. It is supposed to be a live meeting with a Powell press conference. But the odds of a rate hike to 2.75% are only 6% at the Fed's next quarterly meeting on March 19-20, 2019; no one is thinking a gradual rate hike is coming in January. No one is thinking. The Fed median forecasts have penciled in two rate hikes in 2019. The market focuses a little on the Fed's balance sheet from time to time when it isn't doing anything important. QE purchases were made to "improve financial conditions" as Bernanke said. Now the Fed is selling back $360 billion per year of Treasuries to the market which "adds" to the $1.1 trillion Federal budget deficit this year (ending September 2019). Trump's tweets don't seem to like the Fed withdrawing liquidity, but they probably will wind the balance sheet down at least through the end of 2021. Shouldn't mean much. The QE purchases sit as dead money excess reserves in the banking system is the economic theory.

OTHER ECONOMIC NEWS THIS WEEK

Consumers giving up as year draws to an uncertain close (Thursday)

Breaking economy news. The consumer confidence index tumbles 8.3 points to 128.1 in December. The December decline is the sharpest monthly pullback this year, and you have to go back to July 2015 to see a more sudden loss in the public's economic optimism.

It doesn't seem to be the labor market which by most measures is the best since the 1960s. Those saying jobs are hard to get fell to a new low since the recession ended at 11.6 percent in December. Whatever the reason, the sudden loss of consumer confidence is likely to make Fed officials think twice before raising interest rates again any time soon. Markets don't even venture to guess at when the Fed might next raise interest rates given the losses in the stock market this year and the critical presidential tweets which both argue for the Fed to stand down after raising rates at the last five consecutive quarterly Fed press conference meetings.



Net, net, the consumer seems to be trembling a little as the year draws to a close with a cascade of negative news headlines that may portend a more uncertain economic outlook ahead for 2019. Government shutdown, stocks cratering, Washington politicians unable to find common ground, China trade negotiations without a sign the trade war is over, wages not keeping up with the unaffordable rise in home prices. There aren't many reasons to think that 2019 will be much better for the economy than it is right now as the year draws to a close.

Consumers have been the driving force behind the solid economic growth recently with business investment cooling, and if the consumer gets cold feet, then one of the economy's major engines may fail to keep the economy flying high towards the Trump economics team's goal of making this economic expansion the longest and greatest in modern economic history. The economy finishes its tenth year of forward progress in June 2019, but it's not going to make it next year if the consumer doesn't keep spending it. The consumer is giving up in December and this puts a question mark over how much economic growth is going to slow down in 2019 after 2018's banner year fueled by the Tax Cuts and Jobs Act. Stay tuned. Story developing.

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