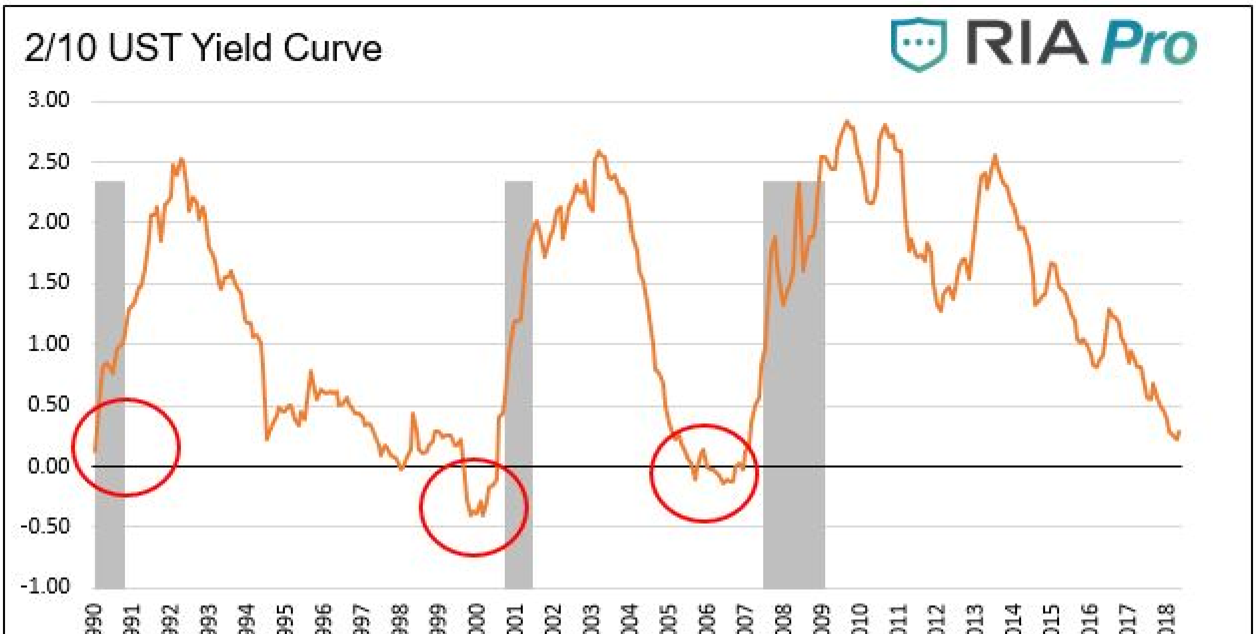
With the mid-term elections now behind us, we can begin to better assess market dynamics using a known outcome. The Democratic party has regained control of the House of Representatives while at the same time Republicans extended their majority in the Senate. Nevertheless, the power shift in the House will certainly change the political dynamics and increase the level of acrimony on Capitol Hill. The pent-up frustrations of Democrats and their disdain for everything ?Trump? seems certain to apply brakes to the agenda of the current administration. Over the past two years, that agenda has demonstrated itself to be decidedly pro-growth by any means necessary. Of chief concern to us is that growth and prosperity are two very different things. Temporary growth by means of further expanding the country?s debt obligations, as has been the case since the financial crisis, will do nothing for long-term prosperity. Indeed, as the populist movement here and abroad demonstrates, we are already well down the path of sacrificing prosperity for growth. This matters more so today than in prior years because of the problems we are beginning to see in capital markets as interest rates rise. ***The advancement of pro-growth strategies fueled by debt and non-productive expenditures by policy-makers has assured a widening of wealth inequality and the populist revolt (if there were another way for us to emphasize that statement, we would).*** Just to ensure readers do not think us partisan, this is the same strategy advanced to varying degrees by every President and Fed since Franklin Roosevelt in 1933. It certainly does not hold any promise of advancing prosperity to her citizens. Like the socialization of losses in the financial crisis, only a few benefit while the vast majority of the population bears the ultimate and eventual burden. With Republicans now forced to share power and having less influence in pursuing the Trump plan, it raises an important question: What difference will the congressional split and resulting gridlock make for the economy?

The Signals

Even before the results of this election were known, the bond market was sending confounding signals about the direction of the economy. It can best be described by looking at short-term interest rates (Fed Funds, Eurodollars and 2-Year note Treasuries) on the one hand and longer-term interest rates (10-year notes and 30-year Treasury bonds) on the other. Traditionally, when economic growth picks up steam as an expansion advances, interest rates begin to rise to anticipate that growth may cause rising inflation. Investors?, concerned about the rate of inflation, demand a higher return. Historically, the Federal Reserve (Fed) would follow the markets lead by



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the Fed

Courtesy St. Louis Federal Reserve What we see today, in a time when markets have become accustomed to the Fed leading the markets as opposed to following them, is an unusual contrast between the short-end and the long-end of the yield curve. Using the Eurodollar and Fed Funds futures complex as market-based indicators of short-term interest rates, investors imply that the Fed will hike interest rates two times (0.25% each) in 2019 and stop. Meanwhile, the Federal Reserve is telling us through their projection of rate hikes (the dot plot) that they intend to hike rates at least three times in 2019 and possibly more in 2020. The long end of the yield curve, which is less responsive to Fed Funds expectations and more sensitive to fundamental economic activity like growth and inflation, has recently been steepening. That is to say, although short rates have continued to move higher, the longer end of the yield curve is also moving higher and by a greater magnitude. The 10-year and 30-year Treasury yields are either telling us that economic activity is durably robust and therefore threatens a rise in inflation and/or the longer maturity Treasuries are worried about the amount of issuance required to fund the coming trillion dollar deficits. But if that were the case, it seems the short end would also be mutually expressing those concerns.

Graph courtesy Bloomberg The conflicting message is that while on the one hand, the market in short rates is *under*estimating what the Fed is telegraphing regarding rate hikes (2 versus 3), the long end is expressing a concern that the Fed is going to need to be more aggressive.

Summary

Like the tax cuts and budget deal passed a few months ago, incremental federal spending going forward can only be funded by expanding the deficit even further. The optics of more fiscal stimulus (i.e., infrastructure spending and tax cuts) will boost near-term estimates of economic growth and likely impose on the Fed to extend plans for rate hikes further. At the same time, larger deficits mean even more Treasury supply at a time when foreign interest is declining which also implies higher interest rates. For an economy so sodden with debt, higher interest rates are problematic which appears to be the outcome no matter what. Democrats? control of the House likely puts an end to any such plans as they seem determined to railroad any further stimulus efforts put forth by Trump. That may relieve bond markets from worrying about the risk of even more deficit spending, but it does not atone for past sins and the anvil of debt burdens now hanging around the country?s neck. For anyone who is unclear about the idea that growth does not equal prosperity, we would argue that you are about to get a first-hand lesson in that difference. If you think Donald Trump and Bernie Sanders were outsiders in the 2016 campaign, the tone in Washington here forward is likely to fuel populist momentum. The only thing we are willing to predict is that of even bigger surprises heading into 2020.