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Weekly Bond Commentary:

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2019 Outlook for bonds

The economy and markets head into 2019 with more uncertainty than they did in 2018, but that doesn't necessarily mean the outlook must be negative. The Federal Reserve certainly doesn't think so. It believes the economy will grow enough to require two more hikes in 2019, which would take the target range to 2.75%-3.00%. But the financial markets seem to fear that further monetary tightening amid decelerating global growth and smoldering trade frictions raises near-term recession risk. The Fed must consider how deteriorating financial conditions affect its maximum employment and stable inflation objectives.

But can the U.S. economy expand while much of the world slows (especially China, Europe and Japan)? We think yes! The U.S. economy is fueled by a strong consumer, favorable job creation and fiscal expansion. Higher rates, tighter financial conditions and trade policy constrain, but do not overwhelm, domestic economic momentum. We may have seen a near-term top for the U.S. 10-year Treasury yield, but should our economic optimism prove correct, expect yields to rise back above 3% as 2019 unfolds.

Even if U.S. growth persists, the magnitude of Fed moves and the degree to which the 10-year rises above 3% rests on inflation. Tight labor markets should boost wage growth and inflation, but some portion may be absorbed by narrowing corporate profits. Tariffs should boost inflation, but trade conflict also restrains global growth and erodes market sentiment. Recent sharp oil price declines have weakened near-term inflation indicators. The net impact of these crosscurrents leaves high uncertainty for the inflation outlook for 2019.

The 2-year Treasury yield ended last week at 2.53%, the 3-year yield at 2.50% and the 5-year yield at 2.56%.