December 2017

Bond Market Observations:

Jingle, Jingle, Jingle

By: The Standish Investment Committee

Holly was already strewn about the breakroom by the time the Investment Committee met, but that was not the source of the relative good cheer. Across advanced economies, recent data on activity has been upbeat, consumers come across as confident, and meaningful fiscal impetus seems in motion in the US and, perhaps, elsewhere. Central bankers share the good feelings, in that Fed officials and ECB staff upgraded their outlooks for real growth (as had BOJ policymakers a few months ago). While the direct economic impetus of corporate-tilting tax cuts in the US is limited, it adds to the impetus from ongoing deregulation and lowers the chance that the White House resorts to activity-crimping executive actions with a legislative achievement in the bag.

Considerable uncertainties attend how President Xi will use the power he successfully consolidated at the recent Chinese Communist Party conference. Our guess is to expect more of the same, slow and measured reform and a tapering of the use of leverage that implies a modest easing of growth. Continued Chinese expansion puts a floor on commodity prices and fosters the growth of other emerging market economies.

Around the world, inflation seems hard to come by, and we think that the major economies will not hit their inflation goals by the end of next year. The Fed gets closest as measured by their preferred PCE price index and overshoots with CPI inflation. Still, policy renormalization is ongoing and, judging by the reaction to the FOMC's quarter-point hike on December 13th, is getting good press. The Fed may be in front, but the ECB will make news in 2018 with moves on its balance-sheet program. The BOJ, while hewing to its yield cap, will look for opportunities to slow the expansion of its balance sheet.

The Fed is guiding toward three moves next year, but we suspect that they will one-up that. As in 2017, there will be four policy actions at the four press-conference meetings in 2018. This year, one of the actions was an announcement of balance-sheet shrinkage. With this program in place, all four moves in 2018 will be about the policy rate. In our forecast, the unemployment rate goes down deeper into the "threes" and inflation rises more than in the Fed's Summary of Economic Projections. The former likely leads them to mark up their own projections sequentially and worry more significantly about harder-to-define excesses. The latter requires them to pick up the pace of firming to raise the federal funds rate in real terms. Even then, the actual real federal funds rate will be below its longer-run level of ¾ to 1 percent (according to FOMC participants) throughout 2018. That is, the Fed may be raising rates, but its policy remains accommodative, thereby supporting financial conditions and suppressing the volatility of asset prices.

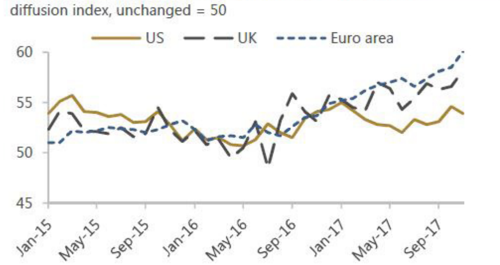
Stronger economic growth, a modestly upward-sloped path of inflation, and firmer (not firm) Fed policy shapes how we view fixed-income valuations. The short story is that stronger economic fundamentals push up sovereign yields as their central banks move to renormalize policy and supports narrow risk spreads to

Economic Surpise Indexes

Source: Bloomberg, accessed 12/11/17

Manufacturing Purchasing Manager Intentions

diffusion index, unchanged = 50



Source: Market, via Bloomberg, accessed 12/11/17.

those sovereign yields.

The former is mostly in or future as monetary policy makers in advanced economies are slow to move. The Fed is first out the gate but will do more than currently priced into markets. That is why we think longer-term sovereign yields will rise, more so ultimately abroad, and it is best to be short duration. The proximate trigger to their action is rising inflation, implying break-evens are cheap. Because other central banks will follow the Fed, the appreciation of the dollar is in the rearview mirror and it is time to begin in build a short dollar position.

The latter, narrow spreads, is mostly here and now in valuations across asset classes. We are more reassured that economic fundamentals support the narrow margins on corporate, emerging market sovereign, and securitized products, but also appreciate that this has exhausted most opportunities for capital gains going forward. Some alpha is available, selectively, mostly higher up the quality ladder. This adds up to a modest, incremental, and opportunistic tilt toward risk on those occasions it is cheaper. This is not a signal to be "risk on" because too many moving parts to the outlook could wipe out the modest incremental expected returns. Buy interest-rate protection for outsized events and pick up carry here and there.

We summarize this in our monthly description of the investment landscape.

The Investing Landscape

Economic Landscape

The pace of economic expansion has picked up in many advanced economies. Growth in China is expected to cool somewhat on structural reforms but still anchor solid expansion in emerging market economies.

As of now, cost pressures are muted, but inflation is likely to tick higher.

The Federal Reserve rate will tighten more than currently built into markets.

With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy;

But they remain willing to lean against market instability.

Volatility is stubbornly and historically low.

Fixed-Income Valuation

Synchronized economic expansion makes developed market sovereign yields expensive.

Break-evens offer value and provide inexpensive protection to upside surprises to inflation.

Dollar appreciation has mostly run its course.

Intermediate high quality tax-exempt municipal assets are fair value relative to Treasuries.

Corporate spreads are modestly expensive but strong fundamentals and supportive technicals are likely to keep spreads stable.

Uncertainty around political events open opportunities in emerging markets local currency.

High quality emerging markets dollar debt looks fairly valued, but some frontier markets look attractive.

Interest rate volatility is cheap.

Outside of higher quality segments of ABS, valuations of securitized products appear expensive.

Investment Themes

Maintain short duration bias in core developed market sovereign securities.

Build a short dollar exposure.

Maintain modest exposure to break-evens.

Selectively remain overweight EM risk.

Maintain modest credit exposure.

Move to neutral in intermediate high quality tax-exempt municipal securities.

Maintain modest underweight on MBS and remain overweight ABS versus CMBS.

Continue option strategies with minimal cost to keep portfolios sufficiently convex.

Bouts of volatility provide the opportunity to pick up carry. However, the overall risk budget should stay lean, emphasize quality, and be protected against outsized events.

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