July 2017

Bond Market Observations:

Epitaph For A Trade

"Or is it that all experience is partial and incomplete, that what seems a short, straight line today is merely part of a rational circle?"
—Eric Ambler, *Epitaph for a Spy,* p.1.

By: The Standish Investment Committee

To cut to the chase, after looking into all the moving parts of our economic outlook and assessment of fixed-income valuations (and revising more than a few) this month, we retain our core advice to prudent investors. Maintain a relatively lean risk budget and emphasize more liquid risk factors. True, the volatility of financial markets is phenomenally low and there have been some blowout returns posted in a few asset classes this year. We have benefitted from this in our high-yield and emerging-market holdings, among other places. If the past were prologue, it might seem time to lean into risk.

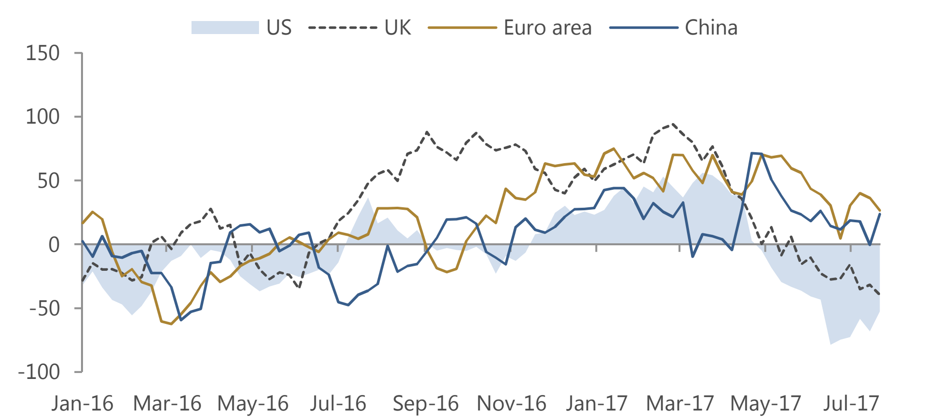
This is not the time. Capital gains this year have flattened the tradeoff between expected return and risk to an unattractive degree. The duration of the aggregate fixed-income portfolio has risen to the point that it does not take much of an adverse event to swamp skimpy carry. In six months' time, if the central tendency of our economic outlook eventuates, US inflation will have revived, investors will better appreciate that the Federal Reserve intends to hew to its plan to renormalize monetary policy, and worries will emerge about the signal regarding future economic activity sent by a flattening yield curve.

And that is the central tendency. To us, markets seem to be putting too little weight on the tails of potential macroeconomic outcomes, either US inflation rebounding in as inexplicable manner as it has fallen or the Fed fearing that possibility and tightening policy too abruptly.

These are volatility-fomenting events. Remember, too, that the next six months will likely produce regime change at the Federal Reserve. President Trump's choice, and how investors assess the choice, may reset the investing landscape.

Explaining the straight line of our outlook to the future requires Ambleresque circling back to current circumstances. The air continues to leak from the hope-filled balloon that the Trump administration would provide a material lift to activity. Our expectation about fiscal stimulus never had much of an altitude, consistent with a modest package stitched together by the end of this year to notch a legislative accomplishment to avoid disaster in 2018 midterm elections. We think that this will still happen, but we have more worries that the legislative process is so sclerotic that increasing the debt ceiling and keeping the government operating will pose more of a challenge than need be. Regulatory relief, requiring a slow slog through the Federal Register to execute, more meaningfully supports economic expansion a bit above a woefully slow trend rate.

Economic Surprise Indexes



Source: Citigroup Global Markets, via Bloomberg, accessed 7/25/2017.

Over the past few months, economic data mostly surprised to the downside, consistent with the steady sagging of tracking estimates of second-quarter real GDP growth. The latest labor market report revived spirits, in that an economy on the cusp of failure does not print employment gains in excess of 200,000. As a result, we stick to a forecast of real GDP growth above 2 percent going forward, above that of potential output and putting pressure on costs.

That said, cost pressure is not evident in consumer prices, the growth of which have slid in recent months. This puts core inflation, measured either by the growth of the market-favorite consumer price index or the Fed-friendly personal consumption expenditure index, below 2 percent. The US is not alone, in that inflation across advanced economies mostly ran soft. Data are data and sometimes disappoint. For now, we take this as noise obscuring a rising inflation theme, which is why the Fed tightens one more time (by 25 basis points) this year and a couple more times next year.

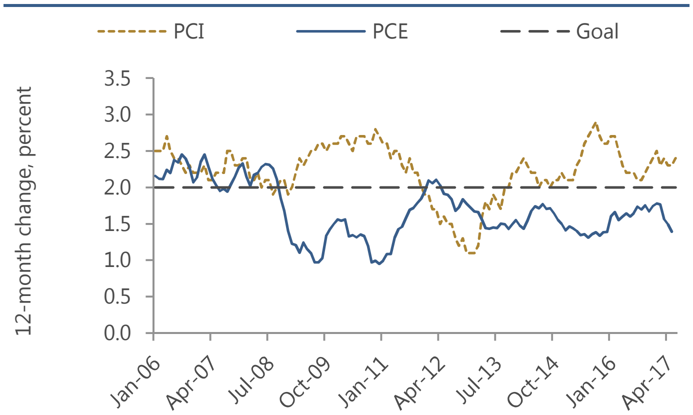
If so, the scaling back of market expectations about Fed action is overdone and inflation expectations too tame. This is one among the reasons to be long break-even inflation. With growth slow, though, and the Fed, while not dropping money from a helicopter but acting as a helicopter-parent that is phobic to any misstep in markets, volatility should remain subdued. As a result, buying protection on volatile rates is and will be cheap, which is attractive in a potentially riskier world.

However, it is not that riskier a world. Economic growth is above trend, corporations meet or exceed earnings expectations, firms have access to finance, and the VIX, if not in single digits, will move in the lower end of its historical range. In light of the rally in corporate markets thus far this year, developed market investment grade spreads are fairly valued, but high yield debt is more attractive.

Tightening Fed policy, both in terms of raising its funds rate target and slimming its balance sheet, and a backup in volatility bodes poorly for securitized assets. In that segment, focus on higher quality segments of ABS and CMBS given tight valuations and deteriorating fundamentals.

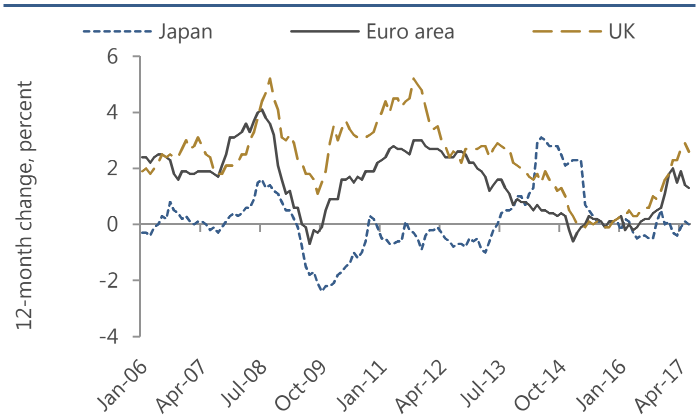
Central banks more broadly generally got good press for tightening, or at least signaling the intention to tighten. They apparently want to enter the renormalization phase of the policy cycle, induced to firming policy to catch up to increases in the neutral policy rates as headwinds to activity abate further.

US Core Consumer Price Inflation



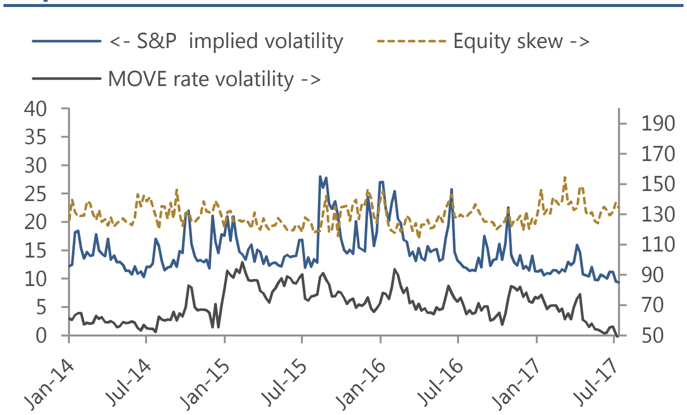
Source: Bloomberg, accessed 7/25/2017.

Other Advanced Economies Consumer Price Inflation



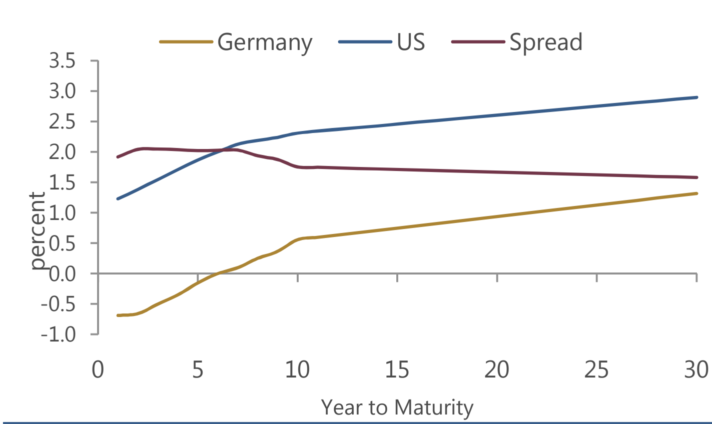
Source: Bloomberg, accessed 7/25/2017.

Implied Volatilities



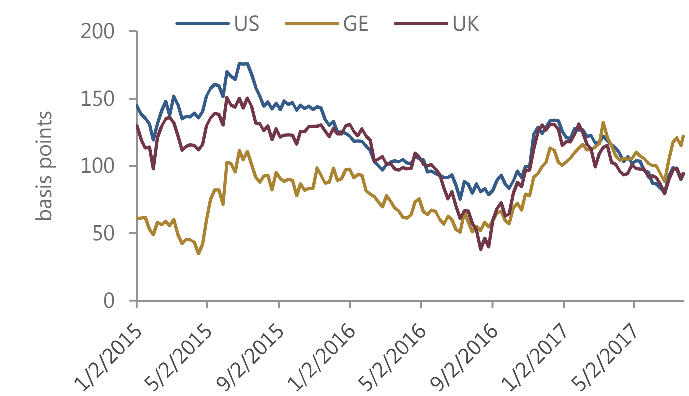
Source: Bloomberg, accessed 7/25/2017

Sovereign Yield Curves



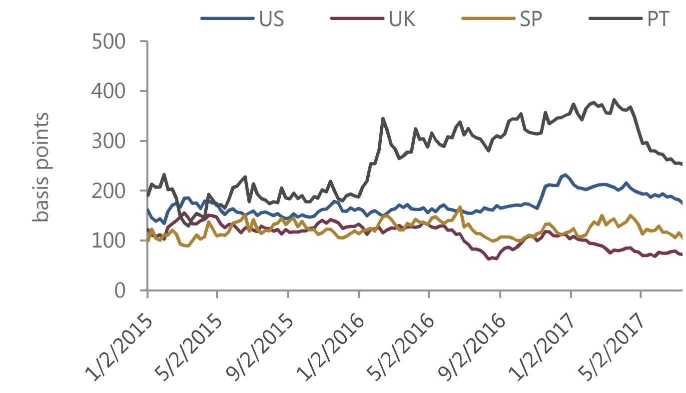
Source: Bloomberg as of 7/25/17

10-Year less-2-Year Note Yield



Source: Bloomberg as of 7/25/17

10-year Spread to German Bund Rate



Source: Bloomberg as of 7/25/17

Because it is mostly words, not action, for now, yield curves steepened in developed markets. The European Central Bank is the sluggard in the pack, which is why dollar interest rates are more attractive than bunds, but some of that spread has declined. Within Europe, spreads to bunds have narrowed as election and bank-risk events failed to materialize.

This marks still another market in which return opportunities narrowed. We think that there is still some value there, which is why a portfolio short of its duration benchmark can be long dollar-bloc and European periphery assets, as long as it is short bunds.

The prospect of firming policy in other developed markets makes the Fed less of an outlier in central banking circles. In the near term, it is still mostly intent, not act, outside the Americas, which makes us think that the US dollar moves sideways against its peers. There is more room for EM currencies to gain vis-à-vis the dollar, as they have more room to demonstrate economic improvement. As a result, local currency merging markets appear attractive. It is a tougher field trip for dollar EM, as we think that the best selective value is in frontier markets.

We opened with a passage from Eric Ambler's *Epitaph for a Spy,* which in 1938 helped to turn the direction of his genre of fiction. After Ambler, world-weariness pervades among spies. This is how we feel when looking at narrow spreads and subdued volatility. This landscape is blocked out below, which as always maps our views on the economic outlook and fixed-income valuation into investing themes.

It seems fitting to close with the last sentence of the same book we opened with because it captures how we view investment opportunities. A reluctant, often hapless, inductee into international espionage glimpses back on the train taking him away from the resort that was the dark center of an all-consuming puzzle. *"I was surprised to see how small it looked among the trees."*

Economic Landscape	Fixed-income Valuation	Investing Themes
Global economic expansion continues at a tepid pace.	Some developed market rates have re-priced to tighter expected monetary policy and offer value but others remain low relative to our expectations.	Maintain a relatively lean risk budget and emphasize more liquid
Potential output is expanding sluggishly.	Dollar rates are attractive relative to European ones.	Overall duration is biased to slightly below benchmark.
As of now, cost pressures are muted, but inflation is likely to tick higher.	Break-evens offer value.	Remain long U.S. and dollar bloc duration versus core Europe.
Central banks in developed markets are moving to renormalize monetary policy;	Developed market investment grade spreads are fairly valued, but high-yield debt is more attractive	Remain long break-evens.
But they remain willing to lean against market instability.	While dollar depreciation versus other developed market currencies has mostly run its course, there is room for more against many EM currencies	Remain overweight local currency EM risk but scale back dollar exposure.
The scaling back of expectations about Federal Reserve rate tightening is overdone.	Local-currencies emerging markets appear attractive, and there is selective value in dollar frontier markets	Maintain modest credit exposure but be prepared to add on better valuation opportunities.
The ECB will announce a tightening of its asset purchase program this year.	Interest rate volatility is cheap	Maintain modest underweight on MBS and remain overweight ABS versus CMBS.
Volatility is stubbornly and historically low.	Focus on higher quality segments of ABS and CMBS given tight valuations and deteriorating fundamentals	Low volatility offers the opportunity to increase portfolio convexity.

Source: Standish as of July 2017

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