September 2017

Bond Market Observations:

Lean Forward, But Not Over Your Skis

By: The Standish Investment Committee

Over the past few months, we had been looking for opportunities to add to our lean risk budget. Our problem was not with fundamentals but with prices. The global economy seemed on track to deliver modestly above trend real GDP growth that would push up inflation modestly in the fullness of time. Data mostly supported our view that a more synchronous global expansion would lead the Federal Reserve to continue to normalize its monetary policy and eventually draw in a few colleague central banks to join the party.

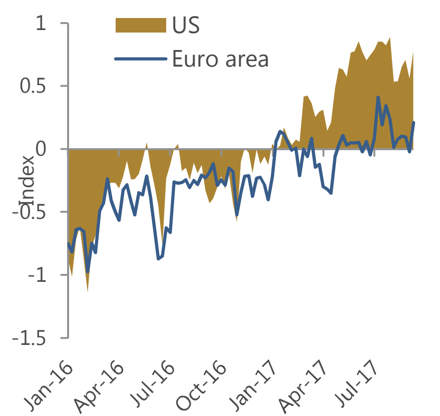
A few missiles over the horizon and a flurry of tweets concentrated the attention of investors that the bad things that can happen are really bad and more probable than previously contemplated (although still, we hope, remote). The dip in Treasury yields and widening of credit spreads sparked by those concerns afforded an opportunity to add to the risk budget, which we took.

So, where are we now?

As always, our process is to triangulate our core investment theses from an understanding of the forces shaping the global economy and an assessment of fixed-income valuations.

The forces shaping the global economy are mostly favorable. Financial conditions remain in the accommodative zone for both the US and the Euro area. Abstracting

Financial Conditions



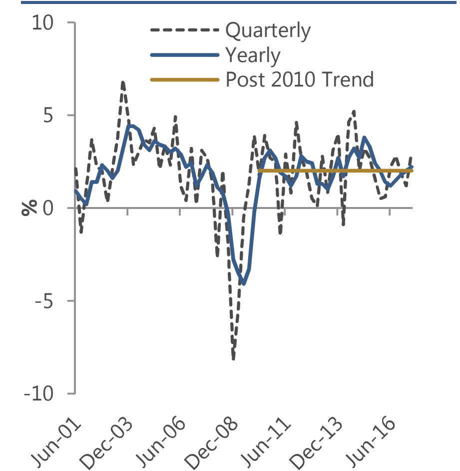
Source: Bloomberg as of 9/22/17

from storm-related distortions, US real GDP is expanding around 2 percent, along the same track it followed since 2010. More recently, economic expansion in other advanced economies is moving more in sync with that pace, if not better in some important cases.

Among advanced economies, this seems likely to work down resource slack because we think the aggregate-supply growth bar is relatively low. Their aging populations are increasing slowly, at best, participating less in organized work, and adding less incremental output for additional hours of work than had been the recent norm. That is why real interest rates are low, as a slow trend in income encourages saving and discourages investment. Of course, our working hypothesis is also that all advanced economy sovereign yields are distorted by central bank action, but that some are more distorted than others. The net consequence is that real benchmark rates are low, which tend to compress risk spreads around that bottom.

Reduced slack should also add impetus to inflation. In the US, the five-month string of downside inflation surprises recently snapped. We suspect this relates to swings in the foreign exchange value of the dollar. Dollar appreciation last year pulled US import prices lower for longer than history predicts. The dollar has long since turned around to net depreciation on foreign

Real GDP Growth



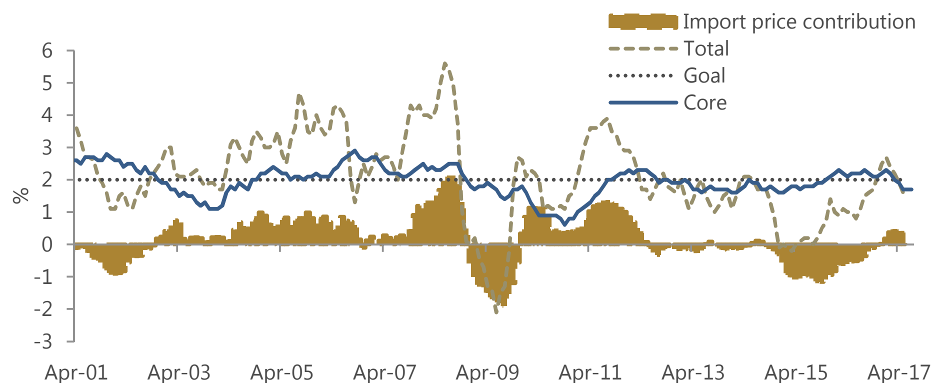
Source: Bureau of Economic Analysis as of 9/22/2017.

exchange markets, and import prices are now adding to domestic inflation—and will increasingly do so going forward. The net rise may be modest, but it still implies that inflation breakevens are cheap.

Fed chair Yellen is patiently tidying up the central bank house for her successor when her term ends next February. This is why, at the just-completed FOMC meeting, officials set in motion their plan to scale back repurchases of maturing and prepaying securities and signaled one more quarter-point funds rate increase this year. If our forecast eventuates, economic data between now and December foam the runway for Fed action. In that forecast, inflation continues to move higher, which justifies a couple more policy moves in 2018, even as economic growth remains tethered around 2 percent for another year. If so, the Fed is not so much tightening monetary policy but normalizing its stance given a solidification of fundamentals. This improvement in fundamentals, by the way, led us to the view that developed market corporate yields are fair to modestly expensive.

In its execution, the Fed gives at the short end—it will tighten one more time this year—but takes at the long end by trimming its estimate of the terminal federal funds rate. The swarming "dots" are another gift from Chair Yellen to her successor. By talking down the long end, the Fed is institutionalizing "lower for longer" that will be hard for the next Fed chair to wriggle out of. We think this strategy will work, and a monetary body in motion stays in motion in 2018 (i.e., the Yellen precedent binds). President Trump, however, already has four Fed governor slots opening up and has yet to designate both the chair and vice chair. A more dramatic change may materialize. In that case, we will find out what happens when an unstoppable force meets an immovable object. Our suspicion, our fear, is that this event releases a lot of energy were it to happen.

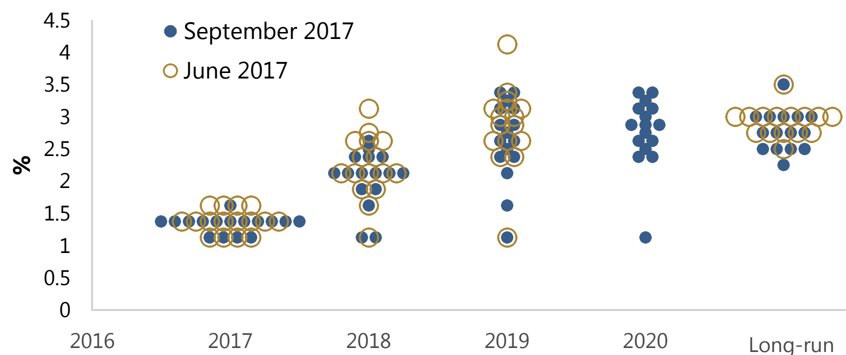
Consumer and Import Prices, 12-Month Change



Source: Bureau of Labor Statistics and Standish calculations as of 9/22/2017.

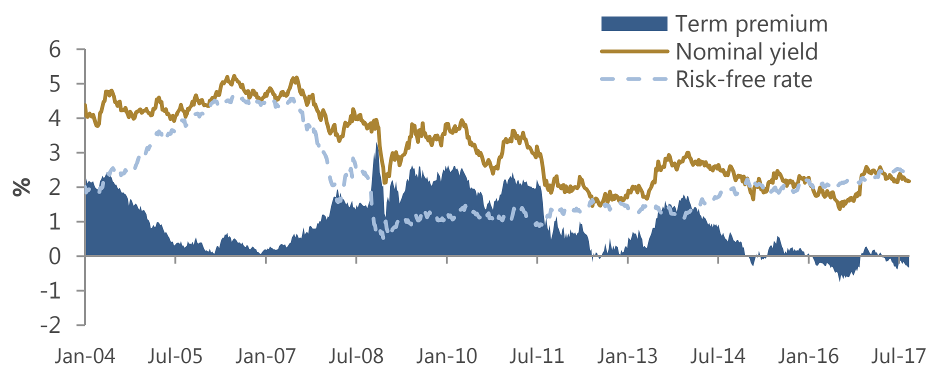
Note: Import price changes are multiplied by one-tenth to capture pass through to consumer prices.

Summary of Economic Projections



Source: Federal Reserve as of 9/22/2017

Ten Year Treasury Yields



Source: Federal Reserve Bank of New York and Bloomberg as of 9/22/17.

In the baseline, the Fed tightens more than currently priced into markets, supporting our view that Treasury yields are currently rich, which is also reflected in estimates of term premiums that still reside in negative territory. Looking at the broader canvas of fixed-income assets, sovereign rates in the Euro area and Japan are richer still because of the heavier weight of distortionary central bank policies. We think that balance-sheet arithmetic leads the European Central Bank to slow asset purchases, which alongside a relatively well-performing European economy, opens up the chance of a significant correction in those yields. As a result, dollar-bloc rates appear relatively more attractive than European and Japanese ones.

With this alignment of the stars, the dollar may depreciate even as the Fed surprises

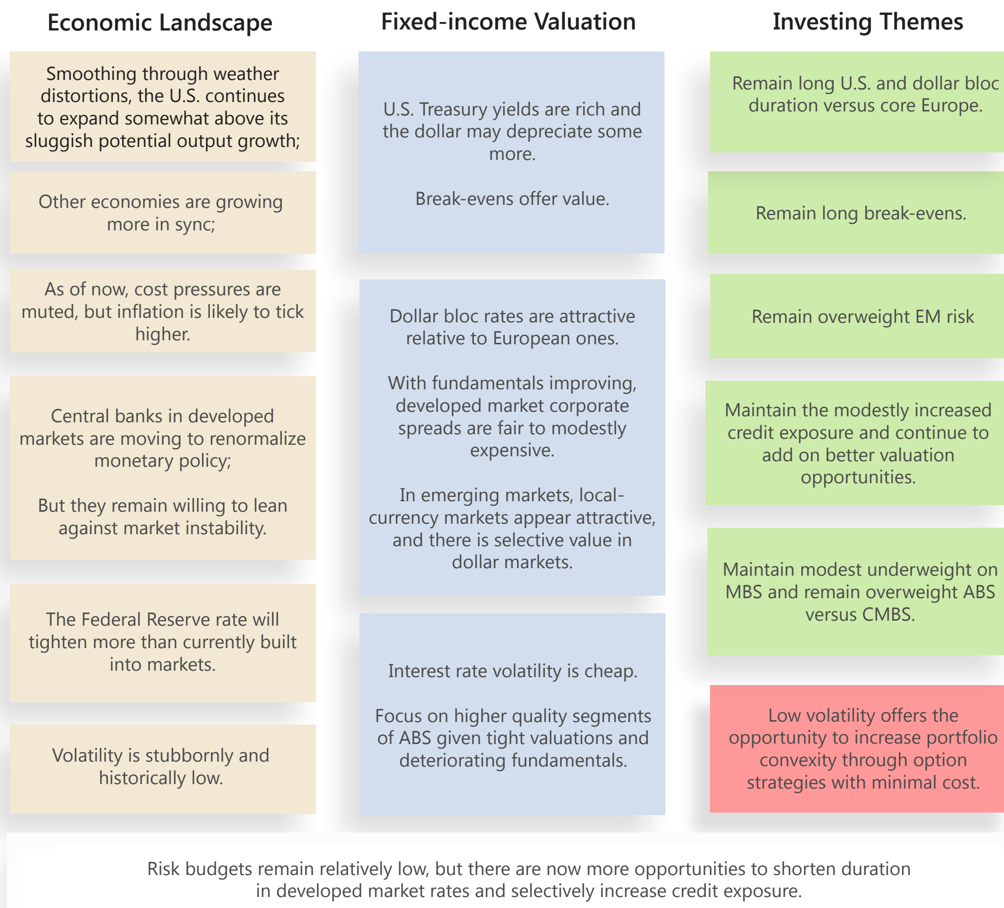
modestly to the upside. Note that when the US dollar depreciates against the euro, it tends to depreciate relatively more against emerging market currencies. That is why we see value in local currency markets. Without the contribution of expected currency revaluation, however, dollar emerging market debt requires greater scrutiny.

Recognize that, given precedent, any departure from the central track will lead Fed officials, as well as their colleague central bankers in other advanced economies, to lean against even modest market strains. They might not do so as much as complacent investors have come to believe, but market opinion is what matters for market pricing. As a result, forward-looking measures of price volatility will remain low and protecting against adverse interest-rate movements will remain relatively cheap. Take the invitation and buy some. Other positions sensitive to volatility are more complicated. In particular, security selection is especially important in the securitized market, given tight valuations and deteriorating fundamentals as the Fed slims its balance sheet. For now, it seems best to focus on the higher-quality segment of the ABS market.

As is evident in the fully articulated investment landscape below, our views about the global economy and valuation of fixed-income instruments do not materially differ from last month. We merely walked our forecast forward in time and became a little more confident about valuations.

Going forward, we believe that the global economic expansion will amble along and central banks, with the Fed in the vanguard, will revisit unusual policy accommodation. As a result, developed market sovereign yields are more likely to rise than fall and credit risk spreads are more likely to narrow than widen. This presents opportunities to keep duration in developed market yields short and selectively increase credit exposure. As a cautionary note, consider that the likely outcomes are decidedly asymmetric. Inflation has been slow to materialize in advanced economies so that the central bank shift is incremental, not monumental. Moreover, with valuations already mostly rich, the prospect for them to get significantly richer if the more likely good case develops is limited. While less likely, should events turns darker, the scope for a freefall in yields and widening in spreads is more considerable. As a result, this is not an environment to lean forward toward risk. Rather, pick up carry selectively and protect by being short duration and buying interest-rate protection. However, be prepared to take advantage of openings when they present themselves.

The Investing Landscape



Source: Standish as of September 2017

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