



May 2017

Bond Market Observations:

Coping with Climate Change

**By: The Standish
Investment Committee**



A few more pieces have fit into place of the economic and financial market puzzle that we have been staring at for so long. It is not that US economic data have been especially encouraging. The first-quarter pothole was a little deeper and more bone jarring than expected, and household and business surveys on the outlook have continued mostly to run ahead of official statistics. The Washington political scene still does not make sense. The atmosphere of antagonism may be short of its all-time worst—after all, no one has been caned on the Senate floor and the president has not yet fired a pistol off the back porch of the White House. Nonetheless, the prospect for cooperation between the two parties seems remote; a lot of oxygen under the Capitol dome is sucked up by pursuing scandals at the cost of framing economic policies and spasms of concern about the viability of the Trump administration trigger bouts of financial market volatility. While the French presidential-election result was reassuring, President Emmanuel Macron will need to pivot from campaigning to governing which, judging by recent US experience, could pose a challenge. In addition, other major risk events dot the European calendar.

Nevertheless, we take some comfort in the observation that investors now seem more resigned that slow economic growth, low real interest rates and compressed risk spreads reflect the climate to come, not the weather of the moment. The lining is silver in this dark economic cloud because this climate allows central banks to renormalize the stances of their policies slowly and to a previously unthinkable low cruising altitude for nominal policy rates. With growth slow, large firms can muscle into a bigger market share in order to raise profit margins. They can do so without stretching their balance sheets, while supporting their share values and while justifying narrow credit risk spreads. In these circumstances, financial-market volatility will mostly remain low in a world that delivers neither economic growth nor drama. This implies that there are selective investable opportunities in corporate credit.

Given this economic backdrop, only small changes were necessary in our depiction of the investment landscape this month. We still advise being leery of risk-taking, favoring portfolios with durations shy of the benchmark in advance of the nominal Treasury backing up as investors get fully on board with the US Federal Reserve (Fed) firming train. The appropriate place to position for this Fed firming is to focus on policy makers' concern—breakeven inflation rates should rise as the weight of resource use pushes up costs and shows through to headline inflation. Even so, nominal dollar-bloc rates remain the best houses on a bad block as long as the European Central Bank (ECB) pins German bund yields at uneconomic levels.

Features of the Economic Landscape	Fixed-income Valuation	Investing Themes
Economic expansion seems assured as corporate earnings continue to improve and oil prices remain range-bound.	Treasury yields are slightly rich given our expectations about monetary policy.	Overall duration should be slightly below benchmark.
Potential output continues to expand sluggishly;	Even so, dollar rates are attractive relative to European ones.	Remain long U.S. and dollar bloc rates versus core Europe.
So, inflation ticks higher.	Break-evens are modestly attractive.	Remain long break-evens.
Public policy will likely buoy confidence, and central banks would lean against bouts of financial market instability.	Corporate fundamentals are improving, but valuations seem a bit rich.	Remain overweight EM risk, both in dollars and local currency.
Still, the political process may be rocky at times, causing volatility to spike.	We expect dollar weakness from current levels.	Maintain exposure to corporate credit and high-quality ABS, emphasizing security selection.
The scaling back of expectations about Federal Reserve rate tightening is overdone, especially regarding the longer term.	Value remains selectively in dollar and local-currency emerging markets.	Remain underweight MBS and CMBS.
The ECB will signal a tightening of its asset purchase program this year.	Volatility is stubbornly and historically low.	Maintain the risk budget at current levels for now.
	MBS and CMBS will continue to be under pressure.	

Source: Standish as of May 2017

The overshoot of US inflation is modest and contained by the gradual renormalization of the Fed's monetary stance, both in terms of the level of the policy rate and the size of its balance sheet, now unfolding. Slow and telegraphed Fed firming that locks in its dual objectives of maximum employment and 2% inflation is partly made possible by the relatively steady expansion of the global economy. The near-term success of Chinese officials in delivering growth according to their five-year plan sustains a cyclical upswing in manufacturing worldwide; and, Saudi vigor in enforcing oil production cutbacks, even as US shale oil producers ramp up output, keeps energy prices range bound. In these circumstances, US economic performance is not much of an outlier, which caps the foreign-exchange value of the dollar. This provides a favorable backdrop for emerging-market credit, especially when denominated in local currencies. Nothing in this assessment makes MBS and CMBS look any better, especially relative to more attractively priced, shorter duration ABS.



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