Concerted Monetary Easing Increases Global Economy's Resilience to Shocks

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EXECUTIVE SUMMARY

– We believe the pricing out of systemic risk due to coordinated central bank easing largely explains the rally in global capital markets since the beginning of 2013.
– Further down the road, easy money increases the risk of asset bubbles and inflation, but we see little evidence of either today.
– We expect Treasury yields to trend sideways to lower during the second and third quarters before rising toward year end.
– We remain bullish on the U.S. dollar, given political uncertainty in Europe and the Bank of Japan's aggressive policy stance.

"That which does not destroy, strengthens." — *Frederic Nietzsche*

The global economy has been resilient in the face of a series of shocks since the beginning of 2013. The year started with a rancorous debate over the fiscal cliff in the United States, which ended with a larger- than-expected fiscal drag. This was followed by the lack of a clear winner in the Italian parliamentary elections, which has thus far prevented the formation of a new government for Europe's third largest economy. More recently, the Cypriot banking system was brought to the verge of collapse, forcing the government to request a bailout from international lenders.

Over the past two years, shocks of this magnitude had sent capital markets reeling, sparking a flight to safety into U.S. Treasuries or German Bunds. Yet thus far in 2013, the reaction from investors has been more muted, raising questions about what has changed. Several factors contributed to the increasing resilience of the global economy to shocks, but we believe the most important has been the concerted monetary easing by the major central banks, which is finally beginning to gain traction.

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Central bank intervention is largely responsible for the pricing out of systemic risk that has driven the rally in global capital markets in 2013. In the short term, idiosyncratic risks related to country, sector and currency allocations may be more important to portfolio performance. In the discussion that follows, we explore the idiosyncratic risks related to a mid-year U.S. slowdown, political uncertainty in Europe, and the Bank of Japan's (BoJ) adoption of a more aggressive policy stance. Further down the road, easy money increases the risk of asset bubbles and inflation, but we see little evidence of either today.

RISK OF A MID-YEAR U.S. SLOWDOWN

The U.S. economy got off to a strong start at the beginning of 2013, with real GDP growth likely north of 2% in the first quarter. However, more recent data on employment, retail sales and manufacturing activity suggests the economy may be rolling over a bit as we head into the second quarter. We continue to be concerned about the risk of a mid-year slowdown resulting from the tax hikes and spending cuts amounting to 2.2% of GDP, which went into effect over the past few months.

Although we believe this growth slowdown will be temporary, we worry that the markets may begin to fear the worst, especially if the situation in Europe begins to flare up again. Consequently, we expect the Federal Reserve to stay the course with its $85 billion per month quantitative easing (QE) program until late this year when we are projecting a pickup in economic activity. Given this backdrop, we expect Treasury yields to trend sideways to lower during the second and third quarters before rising toward year end.

Our expectation is that even when Treasury yields begin to rise, the increase is likely to be gradual as seen during the Fed tightening cycle in 2004 rather than the sudden increase that occurred in 1994. Part of the reason for the abrupt rise in rates in the early 1990s was that the Treasury market was caught off guard when the Fed announced an increase in borrowing costs with its first-ever policy statement in February 1994. Prior to this, the Fed had given little hint that it was about to embark on its first interest rate hike in five years.

By contrast, today the Fed is much more transparent and will seek to telegraph its message to investors well in advance of any change in policy. The Fed provides detailed policy statements after each meeting containing its interest rate decision, policy bias, and voting breakdown. It also publishes the minutes of each meeting with a three-week lag where policymakers' views are expressed in greater detail. Most recently, the Fed has begun providing quarterly forecasts for key economic variables along with thresholds for the unemployment rate and inflation.

Taken together, this would suggest that there is a lower risk of large divergences between market expectations and Fed actions. Other factors limiting the risk of a sharp sell-off in U.S. Treasuries include the shortage of high-quality assets globally; increased financial regulation that is encouraging banks to hold a higher proportion of high-quality assets on their balance sheets; and the aging demographic pattern in the U.S. and other developed markets, which favors fixed income over equities.

We believe investment grade corporate bonds can hold up relatively well given this backdrop. However, the absolute low levels of Treasury yields combined with the large amounts of cash on corporate balance sheets suggests conditions are ripe for leveraged buyouts and mergers and acquisitions, which pose downside risks to bond investors. Thus far, apart from a few high profile deals, activity has actually declined. The reason is two-fold: average enterprise value in the investment grade market is high at $13 billion and valuations are not cheap. Nevertheless, we believe that avoiding companies and/or sectors susceptible to corporate event risk will be important in 2013.

When a secular rise in interest rates does begin, which we do not expect before the end of 2013, high yield corporate bonds may provide protection for fixed income investors. Our analysis shows that high yield bonds have posted positive total returns in rising interest rate environments. Indeed, the Barclays High Yield Index has posted an average total return of 86 basis points in rising interest rate environments since 1987.[1]

POLICY RISKS IN EUROPE AND JAPAN

Despite our concerns about the U.S. growth outlook for the next couple of quarters, we are bullish on the U.S. dollar given the political uncertainty in Europe and the aggressive policy easing being pursued by the Bank of Japan (BOJ). The Italian parliament is highly fragmented following the February 24-25th elections, and new elections are likely at some point in the next six to nine months. In the meantime, the Italian economy continues to languish in recession.

Although we do not expect Italy to deviate from its current fiscal reform path, this might change if the anti-austerity Five Star Party led by Beppe Grillo ended up with a majority in a new election later this year. While this is not our base case, it would clearly be a negative for Italian government bonds. For the time being, investors have been willing to look past the Italian political landscape. In fact, apart from Italy, peripheral government bonds have held up relatively well. This might change were Italy to backtrack on reform and elevate concerns about a breakup of the euro. In general, these developments are not supportive of the euro, and we expect the common currency to weaken in the coming months.

1 As of April 18, 2013.

The Japanese yen faces challenges of its own. New BoJ Governor Haruhiko Kuroda formally introduced a program of quantitative and qualitative monetary easing with the stated goal of achieving a 2% inflation target on a sustainable basis within two years. To this end, the BoJ will expand the monetary base by roughly 115% from ¥126 trillion to ¥270 trillion between now and the end of 2014. The majority of this increase will be achieved by raising the central bank's monthly purchases of Japanese Government Bonds (JGBs) across the entire yield curve. The Japanese yen has already tumbled 15% against the U.S. dollar this year, and it is down closer to 30% from its highs in September 2012.[2]

Ironically, after rallying in anticipation of the BoJ's announcement, long-end JGBs have risen back to pre-meeting levels. Indeed, the 30-year JGB yield tumbled from 1.54% before the meeting to 1.22% immediately afterward only to rise back to 1.55% as of mid-April. A similar pattern has been followed in the U.S. Treasury market after each successive round of quantitative easing by the Fed. Therefore, we would not be surprised if JGBs continue to underperform U.S. Treasuries in the near term.

NO SIGNS OF INFLATION OR AN ASSET BUBBLE…YET

While central bank intervention has driven the rally in risk assets, easy money also poses risks. Critics argue that quantitative easing will lead to inflation and asset bubbles in the future. For now, inflation as measured by the consumer price index (CPI) does not appear to be a problem in any of the major developed markets. Indeed, with the exception of the United Kingdom, CPI inflation is running at 2% or less in most developed countries.

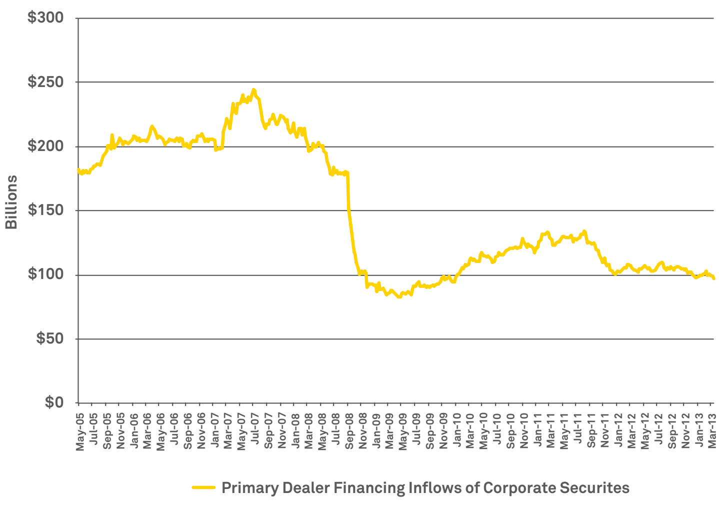
As for the formation of asset bubbles, though certain trends bear watching, there are few signs of imminent overheating. For example, the U.S. housing market is nowhere near the inflated valuations of earlier this decade. House prices as measured by the Case-Shiller 20-city composite are up about 9% from their lows, but they are still 29% below their 2007 peak.[3] Moreover, record low mortgage rates suggest buying is more attractive than renting in many markets. One could argue that the Chinese housing market is closer to bubble territory, but higher down-payment requirements and the adoption of measures to restrict the number of units one can own appear to have quelled speculation. Indeed, Chinese homebuyers are required to make down payments of 30% on first homes and 60% on second homes, which puts the no-down-payment loans of the bubble years in the U.S. into perspective.

In global financial markets, the discussion of bubbles also seems premature. Fed Governor Jeremy Stein – the central bank's bubble expert – has said that even though credit spreads have tightened in recent months, they remain moderate by historical standards. Nevertheless, several developments bear watching, including the increase in covenant-lite loan issuance and the use of loan proceeds for dividend recapitalization, which benefit stockholders to the detriment of bondholders.[4]

According to our models, the U.S. Treasury market is the furthest away from fundamental value of any of the major fixed income sectors due to the impact of Fed asset purchases. Yet traditionally, when asset bubbles burst, investors lose all or at least part of their principal. This seems a very low risk in the Treasury market unless you believe the U.S. government will default. Therefore, while we would agree that Treasuries are overvalued, we believe it would be incorrect to describe them as a bubble.

At some point, the combination of the reach for yield and easy money could lead to the reemergence of systemic risk, especially if investors are able to use short-term financing to leverage up. This was what created the high degree of correlation between risk assets during the 2008 global financial crisis. However, there is little evidence of such behavior today. Indeed, primary dealer financing of corporate debt securities remains well below its pre-crisis peak.

Exhibit 1 – There Are Few Signs of Releveraging by Primary Dealers



Source: Federal Reserve as of April 2013.

2 As of April 18, 2013.
3 As of April 18, 2013.

4 Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement, and Policy Responses," a research symposium sponsored by the Federal Reserve Bank of St. Louis, February 7, 2013.

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