

## *Bond Market Observations:* **Cold Comfort**

**By: The Standish  
Investment Committee**

More of the same—when the same entails the muddling through of the global economy—offers neither many opportunities, nor much comfort to investors. World real GDP growth has settled into a 3% glide path, abetted by additional nudges from a few major central banks and several months of the absence of bad news. Led by cautious, downright change-averse US Federal Reserve (Fed) officials, US monetary policy will overstay its hand, putting inflation on a trajectory to overshoot the national goal of 2% next year. More tightening than is currently priced in will follow, but rate renormalization will remain glacial by historical standards.

The torrent of funds flowing through the sluice gates of investing opened by G3 central banks continues toward any positive-coupon instrument. This technical lift to fixed income prices should last until, well, it stops. And we have reasons to fret about its durability. We felt the fickleness of the process, and the consequences for bond yields, when doubts materialized about the willingness and ability of the European Central Bank (ECB) and the Bank of Japan (BOJ) to engineer incremental accommodation.

When so much rests on continuing confidence in central banks—and with important elections filling the calendars of major economies—the Standish advice is to:

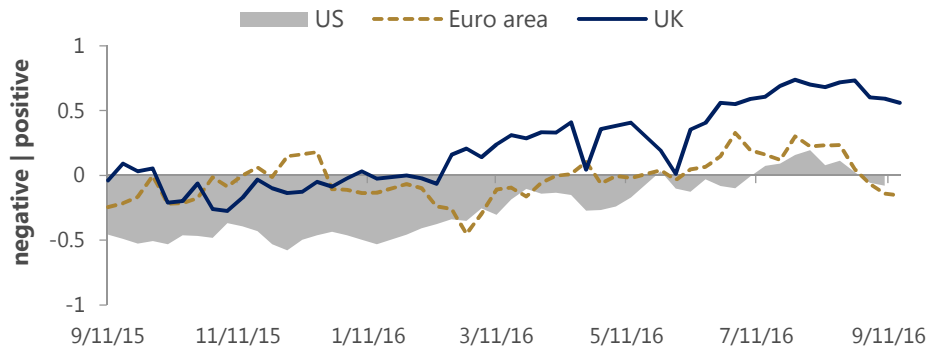
- **Keep risk budgets lean:**  
Valuations of fixed income instruments are mostly rich and fragile to disappointment. The cash will come in handy when prices pull back on bouts of wonderment about whether the central bankers behind the curtain have more levers to pull.
- **Remain overweight breakeven inflation:**  
The Fed, the central bank with policy traction, wants to and will engineer a modest pickup in inflation. Indeed, expectations about inflation may not be as well anchored if the Fed does not communicate calmly once it gets what was wished.
- **Keep durations at, or leaning short of, benchmarks:**  
Cash provides comfort, especially when yield curves in major advanced economies steepen. We would have more conviction about being short duration were it not for the overwhelming and persistent support of technical factors in pulling yields down. Central banks cannot crush volatility forever, but they have been able to do it for a very long time.
- **Push even harder on security selection:**  
Our sense is that firms with an investment-grade rating have taken too much advantage of the tailwinds of easy finance, positioning them later in the credit cycle compared to the high-yield sector and emerging-market sovereigns. Rotation toward the better end of those two assets classes picks up some carry and can help in shortening duration. Higher quality asset-backed securities also help on both scores, as long as volatility remains relatively muted.

Take a hopeful note when it comes, because the underlying theme is grim.

**THE ECONOMIC OUTLOOK BRIEFLY NOTED**

Even the most somber classical music requiems are interspersed with passages of uplift. The economic data over the past two months were not as inspiring as Bach, but they were not as grim as Mahler. Among the advanced economies, data ran brighter than has been the case for some time. As seen in the chart, a measure of the net difference between economists' expectations of major data news, and the reality of those releases, clawed back toward positive territory. The euro area flirted with positive numbers for a time before dipping back into negative territory, but we think that provides a spur to further easing action from the ECB. The biggest surprise among the surprises was in the United Kingdom, where no discerning dent was evident from the referendum result to leave the European Union.

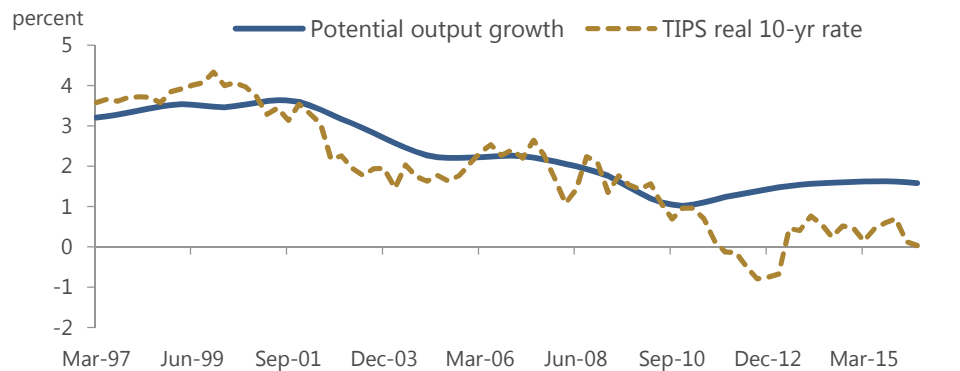
**Economic surprise indexes**



Source: Bloomberg, accessed 9/20/2016.

Take a hopeful note when it comes, because the underlying theme is grim. The aggregate supply of advanced economies is growing slowly, as aging populations eke out a small gain, on net, and do not increase their output per hour much. In the US, we, along with the Congressional Budget Office (CBO), think that potential real GDP is expanding 1.5% per annum. Worse still, it slowed some time ago, so the current margin of slack is slim. Lower potential output growth dims households' expectations of income and firms' hope of earnings. The former save more and the latter invest less, pulling down real interest rates. This mechanism is strikingly evident in the chart at the right, where the ten-year real yield on Treasury inflation-protected securities since 1997 follows the downward path of the CBO's estimate of potential output growth. Indeed, the relationship separates by approximately 1% in 2011, which may be a good estimate of the cumulative effect of quantitative easing by major central banks that has crushed volatility and lowered term premiums.

**Potential output growth and the real ten-year rate**

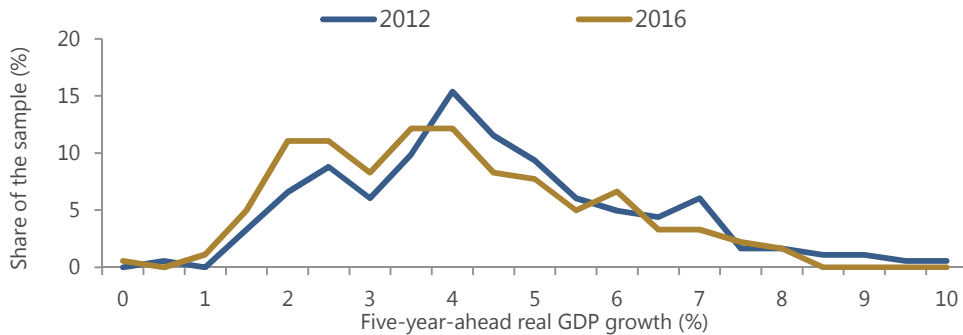


Source: Congressional Budget Office and Bloomberg, as accessed 9/20/2016.

Aside from having central banks with big balance sheets, the other advanced economies also share the US's longer-term problem of slower potential output growth. Over the past five years, the

International Monetary Fund (IMF) has marked its assessments of long-term growth lower in six of the seven G7 economies. Indeed, the problem is more widespread, still. As shown in the chart below which compares forecasts made in 2012 to those made this year, the IMF staff has trimmed five-year-ahead real GDP growth in 70% of the almost 190 economies covered.

**Distribution of five-year-ahead real GDP growth across countries\***



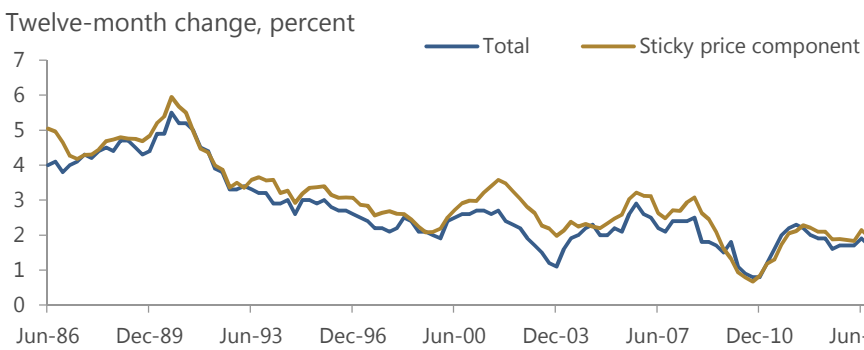
Source: International Monetary Fund, World Economic Outlook (various April issues) and Standish calculations as of September 21, 2016. \* Same country sample

The challenge for the Fed is that potential output growth started slowing even before the financial crisis.

Two other points are worth noting. First, the right tail to the distribution has pulled in, implying the expectation of fewer very rapidly growing economies. Second, a distinct right tail remains nonetheless, indicating that some emerging market economies—presumably in which population growth is rapid and there is scope for productivity catch-up—have room to run.

The challenge for the Fed is that potential output growth started slowing even before the financial crisis. As a result, growth around 2% since has eliminated virtually all resource slack. Core consumer price inflation, and its subcomponent that is especially inertial, already runs above the Fed’s 2% inflation goal. Earlier declines in the prices of oil and other imports kept headline inflation subdued, but those effects are rolling off. As a result, consumer price inflation will overshoot in 2017.

**US consumer prices excluding food and energy**



Source: BLS and FRB Atlanta accessed via Bloomberg (9/21/2016)

The November election, no doubt, adds to the usual fog surrounding the economic outlook. Regardless of electoral outcome, we expect more fiscal impetus and a backpedaling on trade relationships in 2017. The extent and composition of both depend on the vote count, of course; and we suspect that the changes will be more extreme if one party sweeps into control of both the White House and Capitol Hill.

While those forecasting election outcomes have not fared well this year, prediction markets suggest that an electoral sweep is a live possibility. The Iowa Electronic Market, a business school project, runs a winner-take-all contract on Congressional control in which it is possible to price distinct outcomes for the House of Representatives and the Senate. Presumably, the odds strongly favor

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that the same party sweeping Capitol Hill wins the White House, offering the possibility of moving the levers of policy quickly. When that last happened, with the 111<sup>th</sup> Congress whose term started in 2009, the majority-Democratic government passed the American Recovery and Reinvestment Act in the second month of President Obama's first term in office. According to current pricing, as depicted in the table, there is a 14% probability of all-Democratic control and a 40% chance of all-Republican control. The other cell—a divided government—sets the baseline for more of the same.

### Winner-take-all price on Congressional control

		House of Representatives	
		Democrat	Republican
Senate	Democrat	0.14	0.45
	Republican	0.00	0.40

Note: Adjusted to sum to 1.

Source: Iowa Electronic Markets as of September 21, 2016

As for monetary policy, another Federal Open Market Committee (FOMC) meeting has come and gone without action for the simple reason that, most times, a committee does not move when its chair does not want to move. We think the dynamic of the past two years will repeat itself. Fed Chair Janet Yellen expresses a general and timeless agreement on the importance of removing policy accommodation, but finds reasons to put it off for another day. Ultimately, tightening is extracted from her by her restive colleagues as she reluctantly agrees to hold the group together. This pairing of a general willingness to tighten in principle with an infrequent acquiescence in fact keeps her credibility mostly intact, her colleagues at bay, and the policy rate lower for longer.

As was the case last year, though, the clock is ticking down on 2016. The compromise at the most recent meeting combined keeping the funds rate unchanged with signaling the strong intention to raise it in December. In doing so, the Fed gets a free look at the November election, giving monetary policymakers a better sense of the likelihood of fiscal impetus in 2017. In addition, for a dovish leader, a tightening deferred may never come. Delay has consequences, and inflation overshoots the Fed's 2% goal next year. We think that the Fed will pick up the pace of tightening next year, hiking 25 basis points on two separate occasions, most likely in June and December.

While this ranks as phenomenally slow in historical context, the Fed is aggressive among its advanced economy peers. Sluggish expansion now in the euro area and Japan, and outright contraction impending in the UK, will induce more policy action from their central banks. Whether that action translates into meaningful accommodation poses a compelling question and, in part, depends on the assuredness of official communication. The recent lack of clarity from the ECB and the redefinition of policy design on the fly from the BOJ might betray flagging confidence in the project.

Where we remain a little more confident, as of now, is that emerging market economies will maintain their pace of moderate growth. China's leaders have the ability to deliver real GDP growth around their goal of 6.5%, even at the expense of going slower on reform and imperiling the national balance sheet. Their relative success supports commodity prices and economic expansion in other emerging market economies; but it also stores up troubles for another day.

Investors face an unpleasant trudge if the ridge line on the map defining our global outlook eventuates. Economic growth is slow, real rates are low, and spreads are compressed; but the alternatives on either side of that map pose a different set of challenges. If the US economy sputters, then we are in store for an even longer spell with less of the same performance than currently. The talk would quickly turn to how the Fed would ease policy, how the ECB and BOJ would be faced with more unwelcome disinflation, and how the political fabric of Europe would be stretched further—all while important elections loom, and emerging market economies experience a reduction in their export markets. This alternative scenario feels like an arid plateau of even more diminished opportunities than those that are available now.

The other side threatens a steeper change in financial prices. A single-party government in the US, for instance, can be a quick agent of change, reminding investors that rates can go up, as well as down, as budget deficits build—a sense that might be underscored as inflation moves above the Fed's goal.

#### FOUR KEY FEATURES OF THE ECONOMIC LANDSCAPE FOR INVESTORS

As we survey the landscape of the global economy at Standish, there are four key features relevant to investors over the next half year and beyond.

##### 1. Potential output growth has slowed across almost all advanced economies, but less so in emerging market ones.

A slower trend growth rate, through its encouragement of saving and discouragement of investment, suppresses real returns and makes cash cheap to hold on corporate balance sheets. The former lends itself to the search for higher coupons, despite the associated greater risk, while the latter facilitates financing transactions rather than acquiring physical assets. In other words, risks are sought after by demanders of funds and encouraged by suppliers.

Two aspects of slower potential output growth matter as well. First, the slowing is not shared by many emerging-market economies, so there are opportunities for higher real return elsewhere. Second, the slowing already happened in the US, so there are slim resource margins to absorb the Fed's policy accommodation.

##### 2. The Fed tightens faster than market participants currently anticipate but not quickly enough to keep inflation from overshooting 2%.

Fed Chair Janet Yellen may be a reluctant warrior, but she cares enough about her institution and her place in history to avoid intentionally letting inflation out of the box. That said, we strongly suspect that she does not view inflation as darkly as her immediate predecessors or her colleagues, so the box does open a crack. Long-term nominal yields move modestly higher and inflation rises. Of course, an inconvenient Greek myth advises not to open the box at all, warning that the sequence has risks surrounding it; especially concerning how well the chair manages the worsening social dynamics of a group whose members differ dramatically on all of the tradeoffs involved.

##### 3. The other major central banks trek deeper into the territory of unconventional policy, but some appear unconfident about the journey.

Fed officials might fight about quarter percentage points but ECB and BOJ policymakers are revealing significant doubts about their ongoing projects. The ECB has to tune its program by year end in order to extend asset purchases. Hemmed in by their own rules, they appear reluctant to do so. We think, though no one can be sure, that the intent of the BOJ's cap on the ten-year JGB yield was to put in place automatic accommodation should inflation rise. The problem here is that they have no direct mechanism to push inflation higher. The Bank of England shows more eagerness to pull the levers of policy and will probably do so soon.

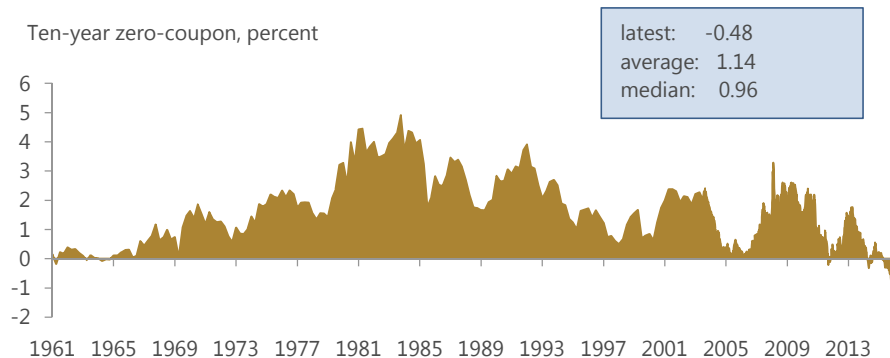
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A single-party government in the US, for instance, can be a quick agent of change, reminding investors that rates can go up, as well as down, as budget deficits build—a sense that might be underscored as inflation moves above the Fed's goal.

Market pricing reminds us that central bankers cannot eliminate all risks forever, and sometimes pose their own source of risk.

The extended stay of major central banks in the terrain of unconventional policy, along with their inability to generate inflation, has positioned about one-third of the universe of developed sovereign debt in negative territory.<sup>1</sup> This situation provides powerful support to any fixed income instruments with a positive coupon, which is reflected in the low level of the estimated term premium on a ten-year Treasury zero-coupon security (as calculated by researchers at the Federal Reserve Bank of New York). As seen in the chart, paying 0.5% for the privilege of hold a longer-term fixed income instrument is relatively unique in the past half century.

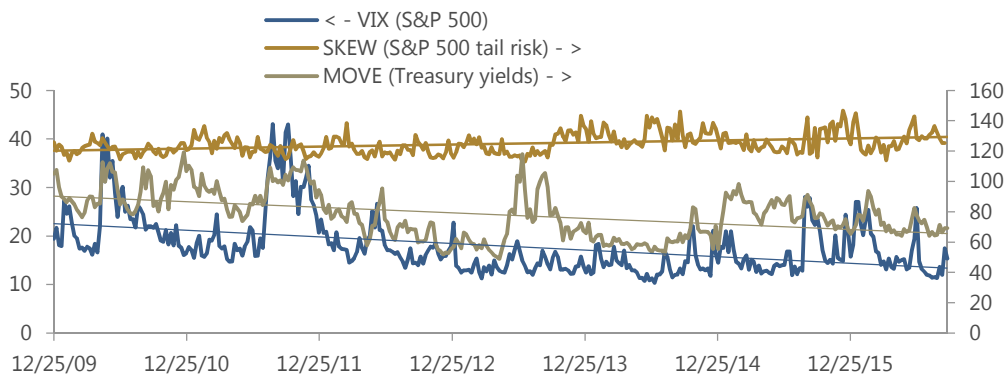
### Treasury term premium



Source: Adrian, Crump, and Moench at the FRBNY, accessed via Bloomberg (9/21/2016).

This official prod to risk-taking has crushed market volatility. As has been widely noted, forward-looking measures of volatility inferred from options on futures for both equity markets (the VIX for the S&P 500) and Treasury yields (the MOVE, which is a weighted average from one-month options sampled along the yield curve) have trended lower and are now at the bottom end of their historical range (as in the chart below).

### Implied volatilities



Source: CBOT and Merrill Lynch accessed via Bloomberg (9/20/2016)

Market pricing reminds us that central bankers cannot eliminate all risks forever, and sometimes pose their own source of risk. Notable spikes in these implied volatilities are associated with concerns about the Fed, including the “taper tantrum” in 2013, the actual announcement of tapering in 2014, and the start of the rate-firming cycle last year. Less widely noted is that, even as implied volatilities shrank, investors have become more concerned about tail risk, at least in the equity market. The upward-trending orange line plots SKEW, which trades on the CBOT and settles using a basket of out-of-the-money put options to price the implied probability of a negative return of two standard deviations or more, and shows more, not less, concern in markets. This sense of an elevated result of downside outcomes remains significantly higher than before the financial crisis.

<sup>1</sup>This is within the universe of developed market sovereign debt in the Bloomberg index, as accessed on 9/22/2016.

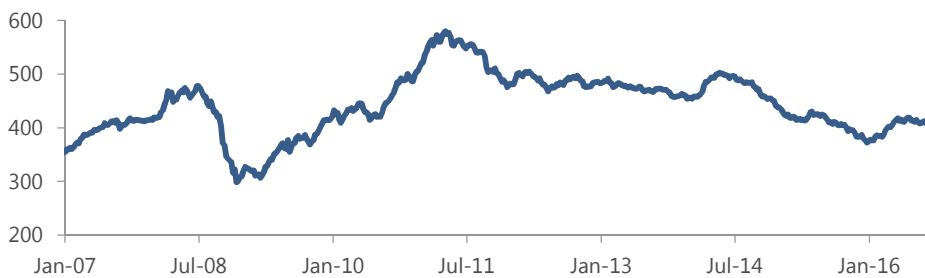
**4. Commodity prices remain supported by global economic growth, as well as relatively tame changes in the foreign exchange value of the dollar.**

While we may be taking too much stock in the recovery of commodity prices since the start of the year and their relative stability as of late, from top-down and bottom-up looks, they seem likely to be range-bound for the time being. Global economic growth is tepid, to be sure, but it also seems relatively steady. While the Fed is marching to a different drummer than other central banks, its shift away from the pack is expected to be limited, and so the foreign exchange value of the dollar should move sideways to only a little higher. Oil prices, importantly, seem bounded from above by the flexible supply of US shale oil producers and from below by Middle East swing producers with a longer-run view. As the earlier sharp decline in commodity prices recede in the rearview mirror, US inflation picks up, potentially reawakening inflation expectations.

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**Spot commodity prices**

index, 1967 = 100



Source: Commodity Research Bureau, accessed via Bloomberg (9/22/2016)

**PICKING A PATH AMID THE MAP OF RISKS**

Portfolio choice at Standish revolves around our allocation factors, or our group assessment for each important fixed income asset class of current valuations and the fundamental and technical support to those valuations. Those judgements begin with our sector experts, are supported by models, and fit into an overlay of our global macroeconomic view. As a result, the allocation factors are granular in nature but can be aggregated up to the high level view shown below.

**Standish Allocation Factors**

	Valuation	Fundamentals	Technicals
Nominal sovereigns	Red	Green	Green
TIPS	Green		
Investment grade	Red		Green
High yield	Green		Green
Emerging market		Green	Green
Asset-backed	Green		Green

Color code

Valuation	Fundamentals/Technicals
cheap	positive
somewhat cheap	somewhat positive
fair	neutral
somewhat rich	somewhat negative
rich	negative



As a result, we think fundamentals support the government debt of advanced and emerging market economies.

Central bank ongoing purchases of securities and apparent willingness to moderate any prior stance if financial conditions seem poised to tighten creates overwhelming technical support to all fixed income instruments with a positive coupon.

Our simple metaphor for this dominant process is that the seismic shock from central banks has set off a wave of investable funds that has already crested over the safest assets. As a result, valuations of advanced economy government and investment-grade securities are rich by all metrics. The leading edge of this process is not as far along in the sectors foreign investors have historically been more reluctant to enter—emerging-market sovereign, high-yield, and asset-backed securities—so valuations are not as stretched. Of course, we worry about signs of white foam in those markets, too, which are a little more evident in the narrow spreads of emerging market economy sovereigns; hence, our view is that this class is fairly priced.

Economic fundamentals are discouraging to us as citizens, but more reassuring as investors. Slow and steady real economic growth keeps real rates from rising much and commodity prices in a narrower band than witnessed over the past few years. As a result, we think fundamentals support the government debt of advanced and emerging market economies. Shrinking Fed policy accommodation adds to financial market volatility, which offsets the fundamental support of continued economic growth in other sectors. That Fed accommodation does not shrink quickly though, and as inflation tracks above the Fed's goal for a time, there is significant value to be had in TIPS.

#### PUTTING IT TOGETHER IN PORTFOLIOS

When there is little to pick through in a terrain flooded by the central bank tsunami and a foreboding that bad things yet may happen, the Standish advice is to:

- **Keep risk budgets lean** because valuations of fixed income instruments are mostly rich and fragile to disappointment. The cash will come in handy when prices pull back on bouts of wonderment about whether the central bankers behind the curtain have more levers to pull and news from the many elections on the calendar.
- **Remain overweight breakeven inflation** because the central bank with policy traction, the Fed, wants to and will engineer a modest pickup in inflation. How investors react to US inflation tracking above 2% is an interesting question that has not been posed for some time. If inflation expectations appear less firmly anchored, we are not convinced that the Fed will communicate calmly once it gets what was wished or that investors will react well.
- For the same reason, **keep durations at, or lean short of, benchmarks**. With economic growth slow, rates will not go up much, but they will go up. Cash provides comfort, especially when yield curves in major advanced economies steepen and talk of inflation grows. However, we lack conviction about being short of duration because of the overwhelming and persistent support of technicals in pulling down yields. We do not believe that central banks can crush volatility forever, but as we have seen, they have been able to do it for a very long time.
- Within the remainder of portfolios, **push even harder on security selection**. Our sense is that firms with an investment-grade rating have taken too much advantage of the tailwinds of easy finance, positioning them later in the credit cycle compared to the high-yield sector and emerging-market sovereigns. Rotation toward the better end of those two asset classes picks up some carry and can help in shortening duration. Higher quality asset-backed securities also help on both scores, as long as volatility remains subdued. From a domestic perspective, all of them have the advantage of being encircled by a higher barrier separating them from major foreign institutional investors.



The sequence from the economics to markets to portfolios fill in a coherent picture—a picture we end with on the last page. The first column repeats the four key features of the economic landscape, which map into six implications for financial markets. Where those implications tend to lower expected returns, we have shaded the box red, and where they raise them, we opted for green. If a box gradually lightens or darkens, we have signaled how our conviction about this changes with the horizon. And the rightmost box summarizes how this is actionable in portfolios.

### The Standish View On Portfolio Strategy

#### Four key features of the economic landscape

Potential output has slowed across advanced economies, but less so in emerging market

Fed tightens faster than expected, but not fast enough.

Other central banks continue to increase accommodation.

Commodity prices trade in a narrow range.

#### Six implications for markets

① Real rates are low and many asset classes are rich.

② EM is relatively more attractive.

③ Long rates rise, some.

④ Breakeven inflation looks cheap.

⑤ Technicals should continue to support most asset classes.

⑥ Some high yield and emerging market sovereign securities have value.

#### Four investing themes

① **Keep risk budgets lean** because of a lack of conviction, as ⑤ may or may not persist, ① is keeping rewards low, and ③ will bring back volatility.

② **Keep duration at benchmark or leaning short** because of ③ and the risk that ⑤ reverses.

③ **Remain overweight breakeven inflation** because of ④.

④ **Push even harder on security selection** because the effects of ⑤ are not uniform, which along with ⑥, implies that there is value selectively in high-yield, EMEs, and ABS.





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