May 2018

Bond Market Observations:

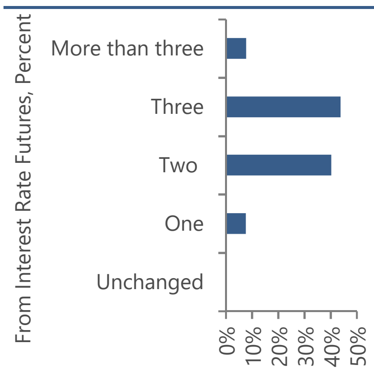
Conviction and the Courage that Comes with Coupon

By: Active Fixed Income Investment Committee

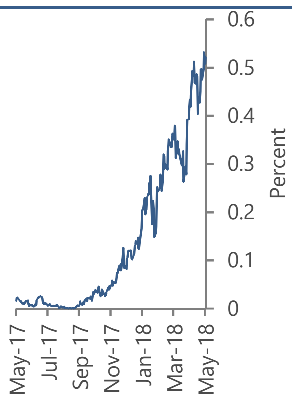
Maintaining the courage of your convictions seems easier to read about in poetry (think of those mainstays of the Victorian era, "If" and "Invictus") than to live with as an asset manager. We believe a simple narrative plays out within our investment horizon. We position accordingly, but we protect ourselves from being too wrong.

The global economy continues to expand in 2018, with the growth of advanced economies mostly in sync and faster than that of their potential to produce. This puts pressure on costs and sends inflation higher, toward the inflation goals of two of the Big Three—the Bank of Japan and the European Central Bank (ECB)—and over that of the biggest—the Federal Reserve (Fed). We think an overachieving Fed tightens three more times this year and may talk into markets plans for higher rates. Even now, the median Fed official thinks that the policy rate will outstrip its long-run level—as do we, even more so.

Implied Probabilities of Additional 1/4 Point Fed Hikes in 2018



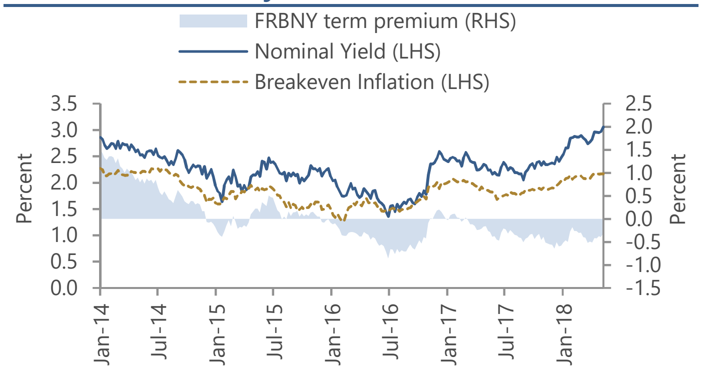
Implied Probabilities of Three or More 1/4 Point Fed Hikes in 2018



Source: CME Fedwatch Tool, accessed May 21, 2018

We were at four hikes during 2018 for some time. Other financial market colleagues are moving to that view, as the chart shows, but are not there yet. This is not Gertrude Stein's Oakland, there is a there there. Their journey to there gives Treasury yields room to rise, counseling a duration target short of benchmark, especially when considering that Treasury term premiums should rise as volatility increases when the Fed's policy path is more contested and its security holdings shrink. Such an environment also put chips on what elicits the official response—rising breakeven inflation.

Ten-Year US Treasury Yields



Source: Bloomberg, accessed May 21, 2018

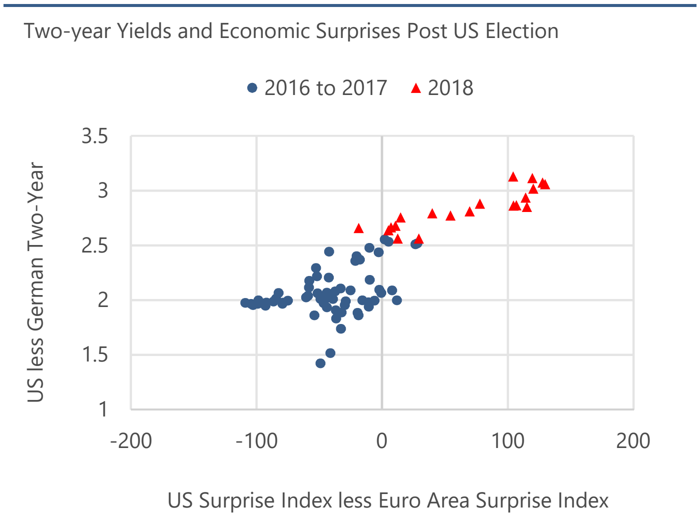
The correction of the market view of the Fed blows a modest tailwind on the foreign exchange value of the US dollar, but this force for appreciation only survives the realignment of expectations. In our view, the more dominant medium-term driver for the dollar, to depreciate, is necessary to fund burgeoning fiscal and current account deficits.

Another looming reassessment nudges this process along. Fundamentals support solid, synchronous growth among the advanced economies. Our current thinking is that the first-quarter perceived pothole in Europe partly owes to bad weather (actually lowering outcomes) and partly to the over-zealous effort of economists to mark up their forecasts in 2018 to compensate for being late in factoring in rapid European growth last year (making economic surprise indexes gloomy). Smoothing through those special factors, the slowing of late effectively takes the sharp edge off the well above-trend growth in 2017, part of the process of getting to a sustainable outcome. When data settle out and the synchronous expansion narrative is confirmed, the ECB will be seen as back in motion, and interest rate differentials will narrow.

Strong economic fundamentals, including oil and other commodity prices holding their recent gains, support credit valuations, both domestically in terms of investment-grade and high-yield securities and their municipal counterparts, and internationally, in terms of dollar and local-currency obligations. That said, rising rates, along with the higher volatility usually accompanying such outcomes, is more problematic for securitized products. However, the Fed's substantial remaining holdings of mortgage-backed securities (MBS) which is unhedged to its lengthening duration, contain the downside risk.

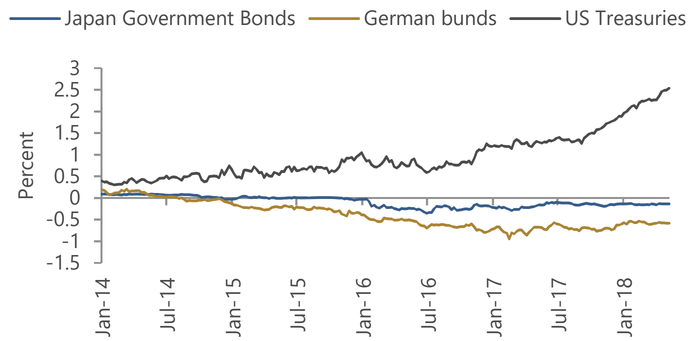
Everyone appreciates a good story, including us, so it is inconvenient when reality intrudes. Those European economic data surprise indexes are uncomfortably dark, especially relative to the brighter US outcomes fueled by fiscal stimulus. It has left its mark on markets, in that the wedge between US and euro-denominated sovereign yields opened further. As the chart below shows, the swing from the euro area generating good news (the blue circles from post-election 2016 and all of 2017 when the euro economic surprise index was above that of the US) to becoming a fountain of despair in 2018 (the red triangles) corresponds to a widening of the spread of the yields on two-year Treasuries relative to German bunds. Presumably, investors brought forward action by the Fed and pushed out expectations about the ECB. News about the formation of an opportunistic Italian coalition from the left and right wings of the political spectrum raised concerns about the cohesion of the European project in light of an untenable fiscal program in an economy with a large debt and deficit.

US Relative to the Euro Area



Source: Bloomberg, accessed May 21, 2018

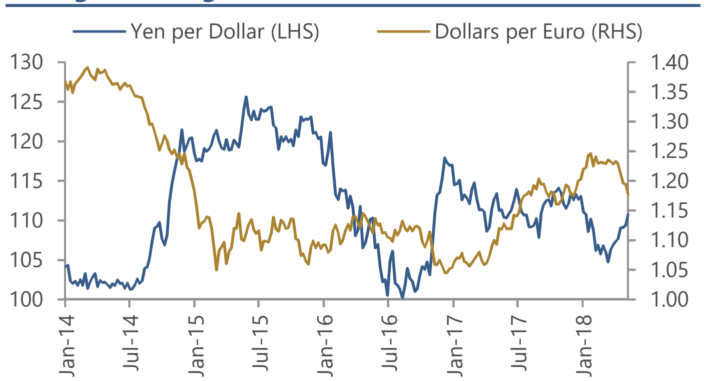
Two-year Sovereign Yields



Source: Bloomberg, accessed May 21, 2018

The widened spread matters for the incentive it creates to park funds in dollars. The associated appreciation of the dollar strains a few important emerging market (EM) economies dependent on continuing foreign capital inflows, notably Argentina and Turkey. As the upcoming World Cup reminds, these are nations with histories of unforced errors, magnifying the risk. All this brought to the fore memories of the twin concerns of late 2015 and early 2016 about Fed overtightening and China slowing. Investment decisions should focus on the second act of that play, as the Fed right-sized its tightening plans and better economic fundamentals reasserted themselves. We expect no need for the former and a bit of the latter.

Foreign Exchange Value of the Dollar

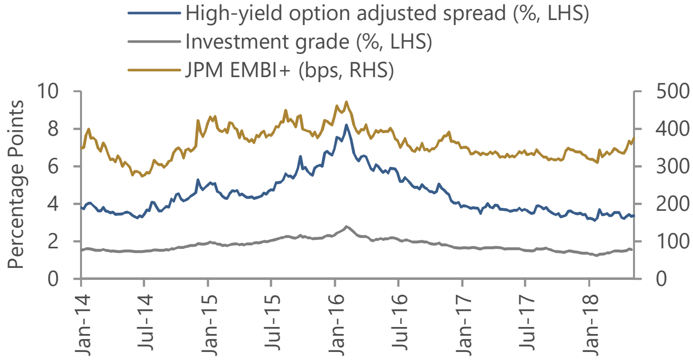


Source: Bloomberg, accessed May 21, 2018

If it becomes evident that economic fundamentals support solid economic growth, central banks, much as grade school children called to recess, will likely get into line, however haphazard the process. Here is when courage needs to accompany conviction. Markets are not there yet.

Spreads of investment-grade and emerging-market sovereign securities have widened. An outsized sensitivity to oil, and the growing attraction of the loan market, might explain the better performance of high-yield spreads. Nevertheless, our outlook does not explain investment-grade and emerging-market yields. Our conviction about the story explains why it appropriate to remain modestly overweight EM securities, understanding that higher coupons absorb potential adverse price changes. Where such margins are thinner, it makes sense to rotate from high-yield to investment-grade securities, reflecting both the differential valuation and the accompanying reduction in overall risk.

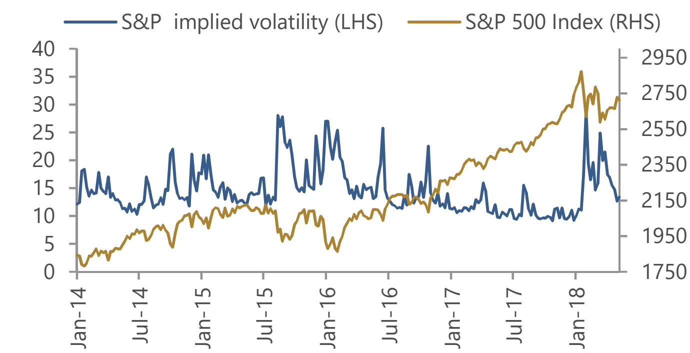
Selected Yield Spreads



Source: Bloomberg, accessed May 21, 2018

Two more technical issues are of note. The steadying of equity prices was associated with a deep dip in the implied volatility of prices—near the bends-worthy depths of last year. As has been true for some time, rate volatility dances to a different drummer. It did not decline, but it still seems low. As a result, hedges with options can keep portfolios relatively convex at an attractive cost.

S&P 500 Equity Price Index and Implied Volatility



Source: Bloomberg, accessed May 21, 2018

The short end of the yield curve warrants attention. Reading the newspapers (thereby demonstrating we are in a shrinking minority of the population), it seems that considerable foreboding surrounds the moment when the front end of the Treasury yield curve looks down on the long end. We are not sure why in current circumstances (but we dutifully did due diligence and found no mention in the Book of Revelations). Rather than fret, consider it an early opportunity associated with Fed tightening and outsized Treasury issuance. LIBOR spreads have narrowed, to be sure, but to a level that remains attractive to many alternatives. Take a parking spot in prime territory when it opens.

Three-month LIBOR OIS Spread

Source: Bloomberg, accessed May 21, 2018

What about the cross currents to the medium-term outlook? The Victorians knew how to face doubt with a stiff upper lip. Rudyard Kipling asked the world an important question about conviction and doubt (in “If” mentioned earlier):

> “If you can trust yourself when all men doubt you,
> But make allowance for their doubting too;”

In current circumstances, we think the next line should be “Position for excess return, but clip high coupons, too.” We are not always this poetic. As proof, we attach our updated investment themes, reflecting our pedestrian belief that process wins out in the long run.

The Investing Landscape

Economic Landscape

The cooling of growth in the first quarter in many advanced economies should prove temporary.

In the US, accommodative financial conditions and fiscal impetus supports economic growth, exacerbating excess demand and putting upward pressure on costs.

Other advanced economies are expanding synchronously and robust growth in China supports emerging market economies and commodity prices.

With inflation poised to overshoot the Fed's goal, more tightening is in store than currently built into markets.

With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy;

They thus far remain willing to lean against market instability.

Fixed-Income Valuation

Synchronized economic expansion makes developed market sovereign yields expensive.

Break-evens offer value and provide inexpensive protection to upside surprises to inflation.

The dollar appears expensive against other developed and emerging market currencies.

For institutional investors, municipal assets have cheapened, especially at the five-year maturity.

With fundamentals remaining strong, investment-grade corporate spreads are fair, although high-yield spreads are somewhat expensive.

Market and political uncertainties create opportunities in emerging markets local currency and dollar debt.

Interest rate volatility remains low.

Still-wide LIBOR spreads provide attractive carry at the short end.

Valuations of securitized products generally appear fair to rich.

Investment Themes

Maintain short duration bias in core developed market sovereign securities.

Be biased toward increasing short dollar exposure.

Maintain modest exposure to break-evens.

Remain overweight EM risk.

Maintain modest credit exposure but take opportunities to rotate from high-yield to investment-grade corporate debt.

Maintain a neutral position in tax-exempt municipal securities.

Maintain modest underweight on MBS and emphasize ABS versus CMBS.

Continue option strategies with minimal cost to keep portfolios sufficiently convex.

Look for opportunities to add to risk selectively.

Source: BNY Mellon Assset Management North America as of May 22, 2018

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