January 2018

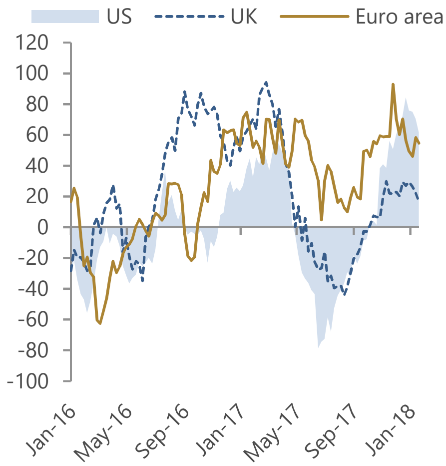
Bond Market Observations:

Déjà vu, All Over Again

By: The Standish Investment Committee

The late, great Yogi Berra was right, and we have been here before. Global economic growth is running above its longer-term trend, inflation in advanced economies is poised to rise, and the Federal Reserve will travel further up the firming path than commonly understood (with some other major central banks trailing behind). That has been our story for some time and, if anything, events over the past month give us more reason to stick to it.

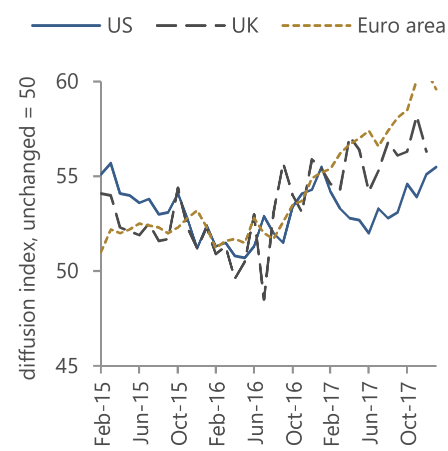
Economic Surprise Indexes



Source: Citigroup Markets accessed via Bloomberg January 25, 2018

Part of this is data. In advanced economies, economic releases mostly ran better than expected, purchasing managers see their order books bulging, and now-casts of global GDP growth are firming. Partly this is about politics. President Trump scored a legislated victory with the passage of tax reform and the warring parties in Congress managed to keep the government running after only a short shutdown. The former imparts a modest boost to growth, reinforcing the impetus associated with ongoing deregulation, and both lessen the chance that the White House will resort to major counter-productive executive actions on trade.

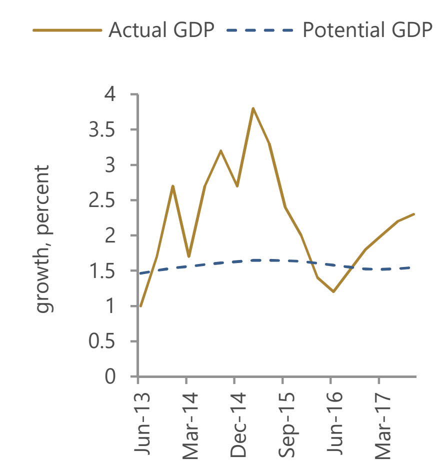
Markit Manufacturing Purchasing Manager Intentions



Source: Markit accessed via Bloomberg January 28, 2018

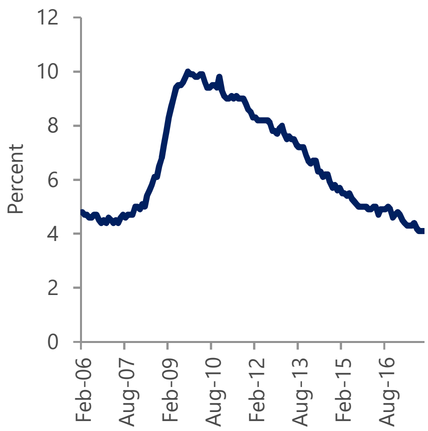
Administration officials, however, were by no means operating on radio silence. In particular, when someone whose name appears on a currency admits he does not mind a weaker value of that currency, listen. Treasury Secretary Mnuchin's remarks about the dollar, as well as the tenor of other comments and moves on tariffs, mark a more combative posture and add to downward pressure on the foreign exchange value of the dollar. At 4.1 percent, the US unemployment rate is almost surely below its natural rate, and above-trend growth will further open the gap. Domestic pressure on costs are picking up as dollar depreciation adds impetus from abroad.

US Real GDP



Source: BEA and CBO, accessed via Bloomberg as of January 25, 2018

US Civilian Unemployment Rate

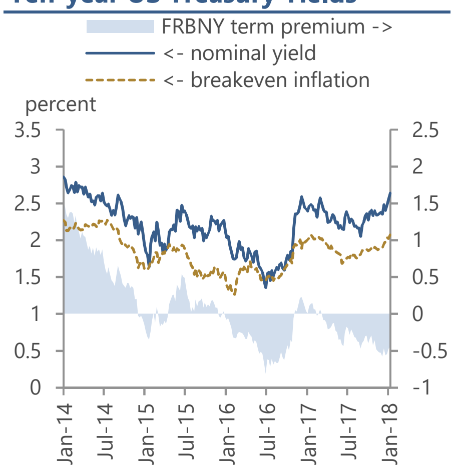


Source: BLS, accessed via Bloomberg as of January 25, 2018

Inflation is in play, and so too will be the Fed. We suspect that Chairman Powell will emphasize continuity in the process of policy renormalization. Last year, the Fed acted at its four press-conference meetings, with the policy rate hiked at three and a plan to shrink its balance sheet announced at the fourth. We think that the Fed will follow the same script this year, raising its target 25 basis points four times and following through with its plan to trim its balance sheet gradually.

This lower-for-longer path of the funds rate should prevent inflation from seriously breaching the central bank's 2 percent goal. True, market participants are not there yet, with about 80 percent of the probability weight resting on a year-end outcome below a target range of 2-1/4 to 2-1/2 percent. But market participants will come around as long as data play out as in our forecast. As expectations are revised

Ten-year US Treasury Yields



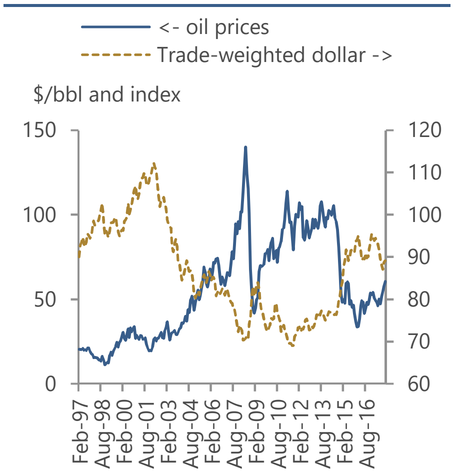
Source: Bloomberg, accessed January 25, 2018

up and the Fed's balance sheet goes down, longer-term Treasury yields should extend their recent rise, implying that portfolios should be shy of their duration benchmark. A more direct approach is to be long the trigger to Fed action, inflation. That is, break-even inflation looks cheap to us.

Our view has been that fiscal laxity at home and central bank renormalization abroad would weigh on the exchange value of the dollar in the medium term, but the gradual realization that the Fed would tighten more than currently priced into markets might delay the adjustment. With US officials talking the dollar down, the difference in timing of monetary policy action is likely to be no more of a speed bump to the dollar's descent.

A weaker dollar is the wind under the wings of commodity prices. Firm commodity prices and well-maintained growth in advanced economies and China keep emerging market economies humming. This provides fundamental support to pockets of the high-yield sector and emerging-market sovereigns. As always, that is a terrain to tread carefully.

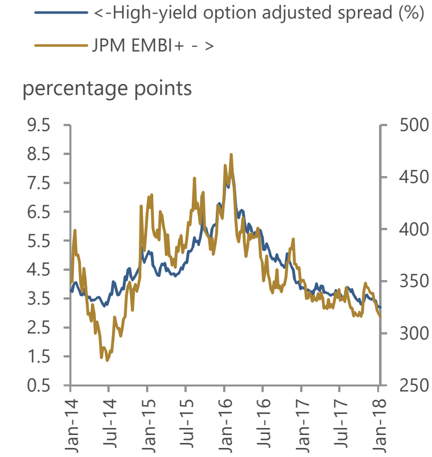
WTI Oil Price and Trade-weighted Dollar



Source: Bloomberg, accessed January 25, 2018

The paradox of portfolio selection is that we are more confident about the outlook and more worried about asset choice. Yogi captured the reason when he explained about a popular restaurant that "No one goes there nowadays, it's too crowded." Improved economic prospects have captured investor attention, crowding many markets. This both tightens most risk spreads and raises the risk of disorderly markets as the many who flocked in try to leave together should events turn dark.

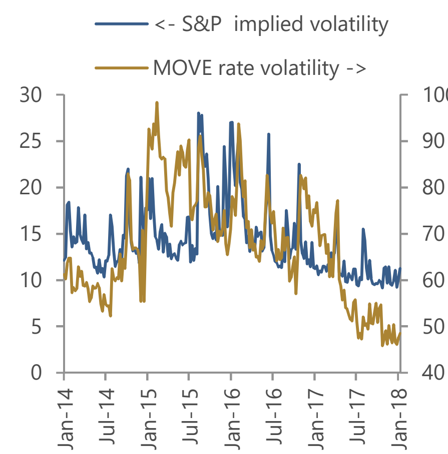
Selected Yield Spreads



Source: Bloomberg, accessed January 25, 2018

This problem can be approached from opposite directions. Keep risk budgets lean to limit exposure to tail events or search out less crowded (and by definition thinner) markets to pick up carry at the cost of more risk. We suggest doing some of both, but judiciously and selectively regarding the latter. The environment amps up the reward to nimbleness. If bouts of uncertainty drive the prices of some assets into the fair-to-cheap zone, exercise that buying opportunity. Symmetrically, however, view investors getting especially exuberant in some market segments as opening the door to harvest profit. The net result should be a relatively lean risk budget that drifts higher in terms of quality.

Implied Volatilities



Source: Bloomberg, accessed January 25, 2018

There is one asset class that seems inexplicably cheap to us, implied volatilities. Despite DC dysfunction, Mideast hotspots, and squabbling among the family of nations, the volatility of equity prices and interest rates has trended lower. Take advantage of cheap protection from outsized events through options strategies at a minimal cost.

Let's finish with an admission. We may have subconsciously focused on baseball metaphors because everyone in our hometown is obsessed with another game in another sport coming soon. But also, baseball is the right description of much of investing. A major-league season is a long slog of 162 games feeding into a multi-tiered playoff. Each games works without a clock. As a result, a strategy that is in its seventh inning might lead to a quick denouement or a lot of extra innings. Also, baseball provided its fair share of philosophers. Add Buck O'Neill, Satchell Paige, and Casey Stengel to the alphabetic list starting with Yogi Berra.

So, it is appropriate to end with two more quotes from number 8. Yogi once explained: "You've got to be very careful if you don't know where you are going, because you might not get there." That is why we provide a monthly roadmap of the Standish view on the global economy, fixed income valuations, and investment themes, as below.

It is good to know where you think you are going. That way, as Yogi advised, "When you come to a fork in the road, take it."

The Investing Landscape

Economic Landscape

Advanced economies are growing faster than their potential, reducing slack in some, creating excess demand in others, and limiting the risk of a near-term downturn.

Robust growth in China supports the expansion of

As of now, cost pressures are muted, but inflation is likely to tick higher.

The Federal Reserve rate will tighten more than currently built into markets.

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

But they remain willing to lean against market instability.

Volatility is stubbornly and historically low.

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.

Tax-exempt municipal assets are somewhat rich.

Corporate spreads are modestly expensive but strong fundamentals and supportive technicals are likely to keep spreads stable.

Uncertainty around political events open opportunities in emerging markets local currency.

High quality emerging markets dollar debt looks fairly valued but some frontier markets look attractive.

Interest rate volatility is cheap.

Valuations of securitized products generally appear fair to rich.

Investment Themes

Maintain short duration bias in core developed market sovereign securities.

Maintain a short dollar exposure.

Maintain modest exposure to break-evens.

Selectively remain overweight EM risk.

Maintain modest credit exposure.

Maintain a neutral position in intermediate high quality 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.

The overall risk budget should stay lean, emphasize quality, and be protected against outsized events.

Source: Standish as of January 19, 2018

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