# Bond Market Observations Update: Marking Our Views To Market

OCTOBER 2016

The analysis of investment opportunities at Standish is an ongoing process, the results of which we formally document with our bimonthly Bond Market Observations (BMO). We are about midstream between last month's and next month's BMOs, so it seems appropriate to provide a mostly tactical update on our investing themes.

By way of recap, we offered four investing themes:

- **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.
- **Remain overweight breakeven inflation** because the central bank with policy traction, the Federal Reserve (Fed), 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.
- For the same reason, **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 of 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.
- 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 relatively muted.

These observations still seem right to us, but since writing in late September, sovereign yields have edged higher and market participants have become more confident that the Fed officials will tighten one-quarter percentage point at their December meeting (as in the chart). The sense that the Fed will let inflation overshoot next year also seems to have sunk deeper into market sentiment, as reflected in a widening of break-even-inflation spreads. Tactically, we are in less of a rush to shorten duration and add to break-even positions as some of the direct benefits have already happened. Part of this was to take

profits on some break-even positions and part to have cash for coming opportunities. By December, as the Fed tightens, headline consumer price inflation moves above the Fed's 2-percent target, and the talk turns to sizing the expected worsening in the federal budget deficit next year, volatility will move higher, providing the chance to deploy cash along the lines of our core investing themes.

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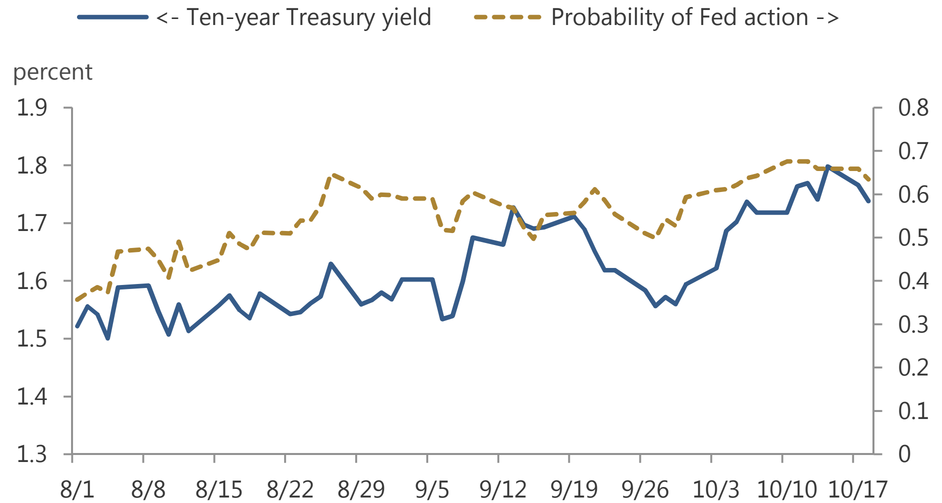
### Selected Financial Market Quotes




Source: Bloomberg as of October 18, 2016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