Bond Market Observations: Navigating Sharp Corners

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As investors, we detest sharp-cornered outcomes associated with political decisions. Binary choices include yes or no to a referendum, Republican or Democrat as U.S. president, or principal payment versus default on a bond.

By: The Standish Investment Committee

While the event happens after the fact with the probability of zero or one, before the fact markets assign a probability between zero and one (unless the result was painted on the wall by surprise-averse officials such as those populating the Federal Reserve). When politics are in play, it is hard to have a forecasting edge, a point call may turn out to be completely wrong, and financial prices are sure to adjust on the resolution of the event as the probabilities embedded in valuations move to zero or one.

A particular irony is from the other perspective—sitting as a policymaker in front of a discrete event—the discipline of a sharp corner sometimes elicits calming behavior in the official community, mostly in a manner similar to adventurers sneaking around the sleeping jungle cat in the movies. In the current environment, we think that there are four sharp edges in the future that increase our confidence about the near-term outlook, even though this may be understood, in retrospect, as living in the calm before the storm. And besides, we believe that, now the Fed has a cushion for its policy rate above the zero lower bound, central bank officials would step into the fray to diffuse market strains if political outcomes are somewhat more ragged than expected.

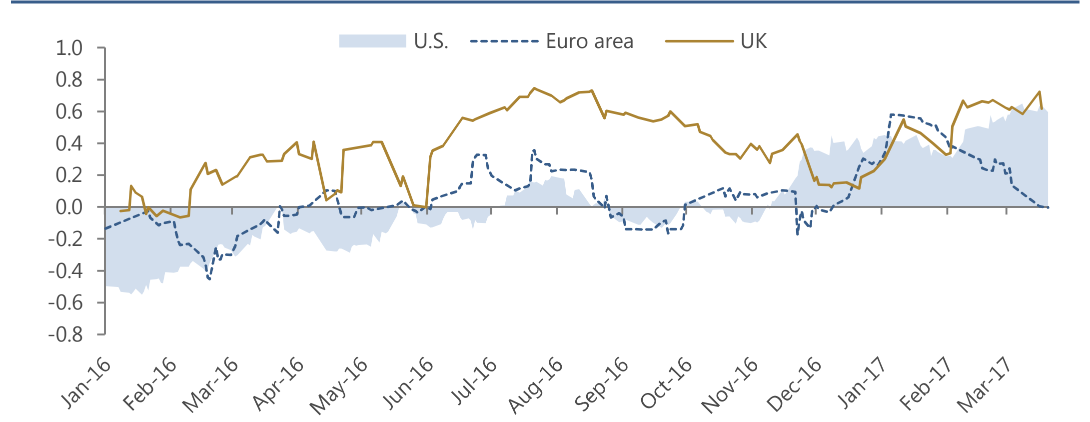
The corners in our future include:

1. The threat of catastrophe in the U.S. midterm elections will make Republicans in the Congress cooperate with a president that some view, to put it delicately, with mixed feelings. The drama played out between Capitol Hill and the White House over the past few days over the American Health Care Act, notwithstanding, we think that the Administration gets to yes on a few issues because nothing but no is untenable.
2. The French and German elections lurk in the nightmares of European Central Bank (ECB) president Mario Draghi. His strategy will be to keep the stance of policy unchanged so as not to attract attention. Because that stance is very accommodative, ECB easing continues almost full-throttled as the European economy revives.
3. President Xi of China intends to consolidate power at the November Communist Party conference. Delivering steady economic growth and brooking no foreign slight are top priorities before then. Officials have enough levers of power to get what they want, at least for now.
4. The attempt by a new generation of leaders in Saudi Arabia to reduce the oil dependence of that economy faces a significant market hurdle—the planned public sale of a portion of the state oil company. Read the enforcement and potential extension of quota cutbacks as an official attempt to provide a stable market backdrop to yield the best possible price for that initial public offering.

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

This assessment of the political scene lends confidence to the judgment that global economic momentum will be sustained in 2017. It helps, too, that incoming data across advanced economies have mostly run on the strong side of expectations (as in the chart). The area in the north of the chart speaks to a global manufacturing upswing, more evident, to be sure, in equity values, risk spreads, and data on confidence and business intentions than the national income and product accounts. Evidently, business people (those who build things) and those who fund those builders see opportunities arising from regime change in Washington, D.C. As noted, we do, too, but worry that the political process will range from clumsy to downright chaotic, causing volatility to spike at times.

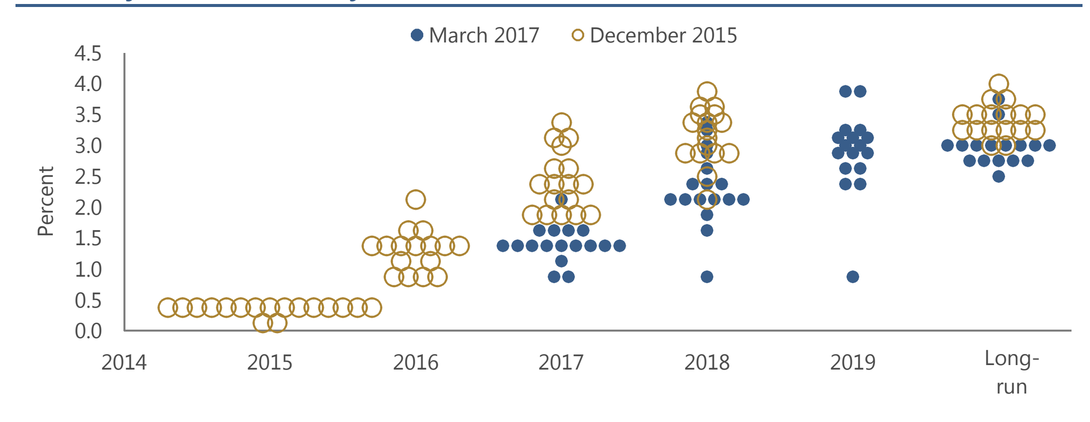
Economic Surprise Indexes



Source: Bloomberg, accessed as of March 27, 2017

The cyclical upsurge in aggregate demand occurs along a path of still-subdued aggregate supply growth, as in advanced economies demographics are mostly destiny and productivity enhancements are scarce. This is why inflation continues to rise and Federal Reserve (Fed) officials are promulgating guidance of two more quarter-point hikes this year. As opposed to this time last year, we take them at their word given our mostly similar assessment of economic fundamentals. Last year, Fed officials sequentially marked their guidance about the path of policy rates lower toward that of market participants over the course of 2016. This discounting stopped by the March 2017 meeting, leaving the Fed now looking to do in 2017 what it had earlier planned to do in 2016 (the outlook revision from December 2015 to March 2017 is plotted below). The net effect is to narrow the white space between the Fed and the financial world.

Summary of Economic Projections



Source: Federal Reserve at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm as of March 27, 2017

As a consequence, nominal Treasury yields seem to embed reasonable expectations for the path of U.S. monetary policy, telling us that it is appropriate for the overall duration of a portfolio to hug its benchmark. With ECB unconventional monetary policy locked in place by politics, for now, the evident scarcity premium in bunds should continue. Thus, leaning away from German sovereign securities and toward those of the U.S. and the dollar bloc is a more cost-effective means of hitting a duration bogey.

The best way to express our view on monetary policy is to position in instruments directly priced to the reason the Fed tightens and other central banks of advanced economies stop ratcheting accommodation higher. Inflation is poised to rise some more and breakeven inflation still looks relatively cheap—although not as much as six months ago.

This is an environment in which to remain flexible and emphasize security selection. Investor expectations about policy achievement from the Trump administration are swinging in a wide arc. If our core thesis that a few modest successes will be racked up is correct, times when the talk is of crushing defeat or giddy accomplishments present opportunities to tune positions to those appropriate for the medium-term outlook.

In our assessment, spreads on U.S. corporate debt are about fairly valued but non-U.S. credit obligations offer more opportunity to pick up carry. Essentially, policy distortions in European and Japanese markets have sent investors offshore in the pursuit of yield, squeezing returns here but not as significantly as in their local markets. U.S. credit can generate extra return through security selection—that is, looking to pick up alpha rather than increase beta.

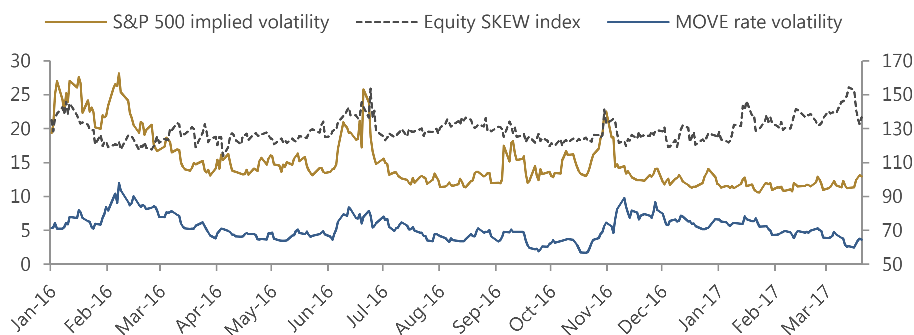
Some investors have been talking up a political tail risk that would benefit U.S. corporate yields. Comprehensive tax reform of the sort pushed by Speaker Ryan and Ways and Means Chairman Brady would include the removal of the interest-rate deductibility of corporate debt, both to discourage leverage and find revenue to offset lower marginal tax rates. The passage of such legislation would create a strong disincentive to new corporate issuance, so holders of legacy securities would increasingly enjoy a scarcity premium. But this legislation has other consequences to consider in a diversified portfolio. In particular, as already noted, nondollar credit, both emerging of emerging market sovereigns and selected corporates, offer a yield pick-up. In principle, our economic forecast offers a reason to leave that unhedged. After all, we think that expected U.S. fiscal, regulatory, and monetary policies support an appreciated foreign currency value of the dollar, not further appreciation from here. If so, the rally in the dollar is behind us and foreign-currency denominated securities have an upside from currency revaluation.

Except, before dipping a toe into that water, remember that Messrs. Ryan and Brady are desperate to do a belly flop into the same pool. The key and controversial element of their plan is a border-adjustment tax, the enactment of which would be a major dislocating force in the foreign exchange, associated with sizable (and unknowable before the fact) appreciation of the dollar broadly against many currencies. So, if Ryan-Brady is in our future, U.S. credit looks a little more attractive and nondollar credit should be hedged. If not, U.S. credit does not get that policy fillip and unhedged foreign exposure does.

Our political judgment is that the first year of the Trump presidency will produce neither unmitigated disaster nor unprecedented triumph. The passage of a reform as sweeping and uncertain as put forward by House leadership is remote in 2017, in part because the item above it on the list, reforming and replacing the Affordable Care Act, exhausted everyone's patience.

This is a reminder that the risks surrounding the volatility of financial prices is asymmetric—it is easier to imagine how implied volatilities rise from their subdued levels than fall even further. True, the event study offered by the implosion of health care reform shows how hard it is to shake market complacency, but the possibility remains. This asymmetry, along with the plodding renormalization of Federal Reserve policy, explains why we still cast a wary eye toward Mortgage Backed Securities (MBS) and Commercial Mortgage Backed Securities (CMBS). More value is to be had in Asset Backed Securities (ABS), given their current pricing and short duration.

Implied Volatilities



Source: Chicago Mercantile Exchange (CME), accessed via Bloomberg, as of March 27, 2017

Every month we summarize the latest views as succinctly as possible with a schematic mapping of our understanding of the economic landscape and fixed-income valuations into specific portfolio recommendations. Not to disappoint:

Features of the Economic Landscape	Fixed-income Valuation	Investing Themes
Economic expansion seems assured.	Treasury yields embed reasonable expectations for the path of monetary policy.	Keep overall duration at benchmark.
Around a flat path of potential output;	Dollar rates are attractive relative to Bunds.	Long U.S. and dollar bloc rates versus core Europe.
So, inflation ticks higher.	Break-evens are still attractive but closer to fair value.	Remain long break-evens.
Public policy will likely buoy confidence. However, the legislative process may be rocky, causing volatility to rise at times.	U.S. corporate bonds are fair value. Tax reform would improve fundamentals and fair value assessment. Non-U.S. credit markets offer more value than U.S. credit markets.	Be opportunistic toward EM sovereign risk.
	There is value in local emerging markets.	Maintain selective exposure to high yield and long corporates. Favor alpha over beta positions. Retain a preference for ABS relative to MBS and CMBS.
The Federal Reserve would react to financial market instability. Market expectations and Federal Reserve rate guidelines are well aligned.	We expect dollar weakness from current levels. Low volatility environment is exposed to disappointment around policy implementation.	Be opportunistic toward EM sovereign risk.

In this note, we have already checked all the boxes in this schematic but one. As at the bottom right, now is not the time to change the risk budget, which remains relatively lean. The path ahead has too many sharp corners to rush headlong. A slower journey allows paying more attention to security selection and taking advantage of excessive fears or hopes about political events. If, as we think, politicians continue to talk big but plod along in practice, swings in market perceptions will present opportunities.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

The **CBOE SKEW Index ("SKEW")** is an index derived from the price of S&P 500 tail risk. Similar to VIX®, the price of S&P 500 tail risk is calculated from the prices of S&P 500 out-of-the-money options. The Merrill Lynch Option Volatility Estimate (MOVE) is a yield curve-weighted index of the normalized implied volatility on 1-month Treasury options. An investor cannot invest directly in any index.

All investments involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing.

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