December 14, 2016

Centre Funds Insight – Winter 2016/17 Market Review & Outlook – Fixed Income Market

As we enter another year in the midst of a cyclical downturn, it is increasingly more crucial to heed broader-picture indicators than relying on mercurial short-term data fluctuations. Void of a cyclical viewpoint, secular forces may be inadequate to address the challenges we face, namely low growth across rubrics: gross domestic product (GDP), productivity, employment, etc. Without a meaningful improvement in demographics and productivity growth, real growth will remain sluggish relative to the 20th Century experience of the U.S. economy. Meanwhile, although the election of Trump surprised many, it did not alter the dynamics of the fixed income markets in a fundamentally meaningful way. Going forward, uncertainty will remain high across the board and it is thus imperative to manage our portfolios with timely and tactical measures to ride out the cycle, something we will continue to execute.

Observations on the U.S. fixed income markets – recent rate increases and the likely future direction for interest rates

First we present the basics in order to provide context for both current rate behavior and its potential future moves.

- Over time the primary determinant of fixed income market performance – changes in bond values – is the change in the level of interest rates. The key measure of rate change stems from an upward or downward movement in the Treasury yield curve, which serves as the "riskless" measure of interest rates at each point of its maturity along the curve from very short maturities, e.g. Treasury bills, out to 30-year U.S. Treasury bonds. The curve is generally positively sloped because longer maturities are at greater risk and investors demand a term premium as compensation.
- Changes in Treasury yields along the curve reflect changes the economy's real growth and the resulting demand for credit to fund consumer spending and business investment. They're also affected by inflationary concerns and the resulting premium that investors demand to compensate them for the loss of purchasing power over the life of the bond – future dollars buy fewer goods and services. This relationship is captured by the famous "Fisher Equation": observed interest rates = an underlying real rate (a return on invested capital) + the anticipated rate of inflation (the rate at which the purchasing power of a dollar declines over time).
- Other fixed income market sectors such as municipal bonds trade at a spread relative to the riskless asset – a Treasury security of comparable maturity. Over short periods of time these other sectors may perform better (spreads narrow) or worse (spreads widen) than the Treasury market itself.

The Current Environment

- Since the election, Treasury yields have risen significantly with the 10-year benchmark rate moving from 1.88% to around 2.5% While this type of move is consistent with the type of "violent" breakout that rates have historically experienced and also with the longer term volatility of longer dated bond yields, it is somewhat puzzling in the absence of either real economic growth that is significantly above

The Interest Rate Scorecard℠ is a monthly publication of Centre Asset Management featuring an assessment and analysis of the macroeconomic environment and policy implications for the bond market based on Centre's proprietary investment discipline.

trend (potential) or of a significant change in inflationary expectations. Real growth in the first half of 2016 was at an annual rate of less than 2%, and while third quarter growth was strong it reflected primarily a surge in agricultural exports and inventory behavior. Absent another surge in demand in the global demand for soybeans, trade will likely be a drag on real growth in the last quarter of 2016. Most forecasts put fourth quarter growth in the 2.5% range, indicating a year over year growth in real terms at less than 2%. Consistent above-trend growth or above-target inflation is typically necessary to establish a firmly upward trajectory in rates.

- Both actual inflation and inflationary expectations have yet to reach the Fed's target of 2%. In the most recent release, the Fed's preferred measure of inflation, the deflator for personal consumption expenditures less outlays for food and energy, is up 1.7% over the same month a year earlier. At the same time, market based inflation expectations, computed by the Federal Reserve Bank of Cleveland remain anchored below 2% at 1.75%. Additionally, precious metals price behavior does not suggest investor concern about hedging against rising prices. Finally, recent work at the Federal Reserve Bank of Cleveland indicates a probability of less than 50% in five of the six models it tested that inflation will exceed 2% in the next three years.
- The Federal Reserve has repeatedly described itself as data dependent and "offered forward guidance" to investors that it is likely to move gingerly in raising its rate target. While the current unemployment rate, 4.6%, is below estimates of NAIRU, questions remain as to whether or not the extent of the labor force participation rate decline since the "Great Recession" reflects an ongoing trend or a cyclical effect of discouraged workers (the unemployment rate could increase temporarily if they reenter the workforce in search of jobs). Wage growth is also running below the pace consistent with the Fed's inflation target. Finally, new job postings have fluctuated month to month and generally below last year's levels. While the Fed will likely adjust the target rate range higher by another 25 basis points in December, the Treasury curve seems to have more than discounted a move of this magnitude.
- Reflecting many of the above arguments, our active duration management discipline, the Interest Rate Scorecard℠, recently positioned our fixed income portfolios at their market neutral duration settings given the uncertainty surrounding the course of monetary policy and labor force activity that is not consistently robust. Obviously, this recent move in rates could be the start of something big, but our fact-based discipline which does attempt to take investor sentiment into account, is not yet convinced. Rather, rates seem to be anticipating that president-elect Donald Trump's fiscal policy – lower personal income and corporate tax rates, potentially less regulation in all sectors of the economy and higher infrastructure spending will have a positive impact on growth in the relatively near term.
- Besides their effect on the level of the Treasury yield curve, anticipations about future fiscal policy in a Trump presidency have also impacted the spreads at which municipal securities trade relative to comparable maturity Treasury notes and bonds. The incoming Treasury secretary says that the president-elect plans the "largest tax change" since Ronald Regan. Since the election municipal spreads have widened significantly with the 10-year GO, now over one standard deviation above the long run ratio of yields. However, this band has been breached several times in the recent past and the new tax structure has yet to be passed. In this light, municipals may be oversold at this point. Furthermore, high quality municipals that make up our core portfolio in the Tax-Exempt Fund remain attractive from a risk perspective relative to the rest of the tax-exempt market. Many states continue to face pension and healthcare funding problems that may not be solved by an increase in growth at the national level. In fact, an improvement in growth at the national level may serve to highlight the growth-restrictive policies of several states and municipalities.

Where rates are likely headed

- Looking forward, a floor of 4% for the 10-year Treasury yield would seem consistent with the economic fundamentals. Historically there has been a very significant and positive correlation between growth in nominal GDP and the 10-year Treasury note yield. This is not surprising as the Fisher equation indicates that rates are made up of a real growth-related rate and an inflation-related component. If the economy's potential for real growth is consistent with the current and anemic 2% assessment and inflation reaches the 2% target, this would imply a nominal growth of 4% – the level toward which we believe the 10-year Treasury rate should move.
- Furthermore, work at the Federal Reserve Bank of San Francisco and elsewhere indicates that the economy's natural rate of interest could be in the 1-1½ range by the third quarter of 2017. With 2% inflation this would imply a Federal funds rate target of 3-3½% and, with a normal maturity risk premium, a 10-year yield of 4%.
- If under president-elect Donald Trump's tax policies, regulatory reform, educational program and infrastructure spending, the natural rate is raised back to its historical level of 2%, the range for the 10-year would move into the 4½-5% range. The timing of the impact on the natural rate is difficult to determine because the shape of the Laffer curve is not well defined from a time perspective – its third dimension – and it takes time to improve human capital through education and to encourage business creation and investment through regulatory reform and tax reduction. Additionally, if entitlement programs are not addressed, near-term tax cuts could cause the federal deficit to increase before revenue growth leads to its reduction. The impact of an increasing deficit on rates is uncertain. But, if printing money to fund spending takes place instead of or along with an increased deficit, the economy could experience accelerating inflation well beyond the 2% target, leading to higher rates.
- Even without fiscal programs proposed by the newly elected president, some Fed-based researchers have suggested that optimal monetary policy, given the various uncertainties about where the economy is in light of resource utilization – particularly the low rate of capacity utilization – would be to target inflation above the longer term target. So, it would seem that we are headed for at least a 4% level on the 10-year Treasury note. Current experience, though not yet grounded in materialization of strong growth or inflation fears, highlights that such moves can be violent.
- Even if the current rate increase does take place and becomes significant, further and bigger increases are likely next year and provide the need for a disciplined approach to rate risk management. However, rates don't move continuously in the same direction. During the period between January 1973 and September 1981, the 10-year Treasury yield increased from about 5% to almost 16% but rates increased in only 60 of the 105 months that made up the period. There were thus opportunities to add value through market neutral or even long duration (relative to the market) calls. Our discipline assesses the rate outlook and reviews our fixed income portfolios' duration positions on a monthly basis to attempt to take advantage of the opportunities that deviations away from the general trend provide in addition to taking advantage of the trend itself.

Conclusion

The election did not change the fundamentals of interest rate dynamics, and the its consequences on future rate moves remain uncertain. As noted, even if all promised policy changes do take place, the natural rate may be pushed upward, but its timeline and the impact on the 10-year Treasury are far from certain. If impactful, the execution of Trump's touted policies may further raise the deficit, potentially leading to rising inflation and target rate, but when and by how much will be persistent questions that may be impossible to answer now.

At a high level, the debate continues as to whether we need a cyclical or secular change to exit the current downturn. As the Economic Cycle Research Institute (ECRI) has noted, year-over-year payroll growth is still in a decline and remains near its low in recent years. GDP growth has similarly been hovering near its low, and the ECRI's coincident index, used as a broad measure of economic activity, has recorded a less than optimistic picture for the general economy. The researchers at the institute believe a lack of a forward-looking cyclical framework has contributed to the bad timing of a possible Fed rate hike, in collision with an "unwavering downward cyclical vector."

Only policies that improve demographics or productivity growth can be successful in bucking the structural decline trend in place since last year, but it would still be difficult to fully recover from the slowdown we've been experiencing. Short of a growth rate cycle upturn, it may not be feasible to get out of the rut, or the "low-flation" environment we currently find ourselves in, despite nominal month-to-month gyrations. Weak demographics and weak productivity growth spell trouble for real GDP growth, and Fed policies can only be short-term fixes at best. Along these lines, it seems cyclical, not secular, remedies are what's needed, and structural fixes without regard to a cyclical framework wouldn't prove effective. Overemphasizing short-term monthly or quarterly data without taking into account the whole picture of where we stand in the longer-term cycle risks losing sight of what truly drives growth.

As long as we remain in the cyclical downturn that commenced last year, it is only prudent to view any potential effects from the new administration's policies with a grain of salt, as consequences on inflation and rates will be uncertain. Through this lens, our disciplined risk management tactics prove even more relevant in today's environment.

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Definitions

1. Fed: The Federal Reserve
2. NAIRU: Non-accelerating inflation rate of unemployment, a level of unemployment that doesn't cause inflation to rise
3. Standard deviation: A statistic that measures the extent of central dispersion for a group of variables
4. Treasury yield curve: A line that plots the interest rates of Treasury securities with differing maturing dates
5. Basis point: One hundredth of a percent
6. GO: Government obligations
7. "Low-flation": An environment where economic growth and inflation are slow
8. Laffer curve: A supposed relationship between tax rates and tax revenues developed by economist Arthur Laffer
9. Fisher Equation: An equation that estimates the relationship between nominal and real interest rates under inflation

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

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