Centre Funds Insight – Fall/Winter 2015 Market Review & Outlook – U.S Treasuries

Interest rate changes are driven by real growth--the demand for loans--and inflation concerns or expectations--investors expect yields to provide some defense against higher future prices. Real GDP[1] growth over the period was consistent with, although slightly in excess of, the economy's potential and the unemployment rate moved to its currently estimated "full-employment" level of roughly 5%. However, weak growth in the U.S.'s major trading partners, a strong U.S. dollar and continued global political turmoil kept actual inflation below target and kept policy makers in check. As a result, the inflation premium in nominal yields reflected inflation expectations that remained well anchored but rates continued their volatile behavior of the previous six months--moving in a roughly 0.5% band between 2% and 2.5%--as investors tried to sort out the likely future path of monetary policy. Historically, there has been a positive and statistically significant correlation between the Federal Funds and the 10-year U.S. Treasury note yield, though it is not clear whether this correlation reflects a market reaction to Fed tightening or Fed validation of existing rate levels or causality running in both directions.

While our discipline for the Fund, the Interest Rate Scorecard, was generally cautious, it indicated a duration target in line with that of the market after rates moved back to roughly 2.5% in late June. After the Federal Reserve removed the "patience" language from its policy statement, the generally improving labor marker caused investors to place an increasing expectation on the Federal Reserve initiating the long anticipated "return to normalcy" or "liftoff" of its target for the Federal Funds Rate. Second quarter GDP estimates released during the period offset the residual seasonality bias in the growth estimate for the first quarter and resulted in growth over the year at or above current estimates for the economy's potential. And, spending for residential construction pointed to a seemingly sound housing market, robust auto sales continued at an annual pace of 17 million units (a level last achieved in the early 2000s), and wage and salary gains increased--later in the period. However, as the minutes from successive Federal Open Market Committee (FOMC) meetings suggested that policy makers were focusing on the below target run rate for inflation, the negative impact on U.S. manufacturing activity from a strong, and getting stronger dollar, and from weak growth in trading partners, investors became less certain in their outlook for both monetary policy and the economy.

While acknowledging Milton Friedman's assertion that the lags between changes in monetary policy and their impact on economic conditions are "long and variable," various FOMC members described themselves as being "data dependent" and suggested that they would at least like to see an acceleration in wage and salary growth to give assurance that the inflation rate would begin to move toward the Fed's 2% target. Wage and salary growth was a focal point both as a sign that the labor market was indeed sound--the short run Phillips curve relationship between increasing employment and higher wages did not seem to be holding--and to provide a signal for future inflation as the current pace was constrained by decreasing prices for imported goods due to a stronger dollar and lower oil prices.

Additionally, during Congressional testimony Fed Chair Janet Yellen indicated that she did not want to be constrained by a Taylor type rule[2] in the conduct of monetary policy. She argued that such a rule, which focuses on "gaps", actual versus potential GDP growth or actual unemployment versus the full employment unemployment rate and actual inflation versus the Fed's target, would preclude the Fed's consideration of potentially significant concerns for the U.S. economy. She referred specifically to the strength of the dollar

[1] Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.
[2] In economics, a Taylor rule is a monetary policy rule or formula that stipulates how much a central bank should change the nominal short term interest rate in response to changes in inflation, output, or other economic conditions.

and weak growth in the U.S.'s major trading partners and the negative impact that both could have for domestic manufacturing activity growth and employment.

The Fed failed to act at its September meeting voicing the concerns mentioned above as justification. Without specific guidance as to what would quell such concerns--and also the trade-off between increasing employment and below target inflation--and not knowing what the Fed might know that they don't, investors held or bought Treasuries. Some of the downward move in rates during the latter part of the period was also due to continued geopolitical turmoil--the dollar remains the global safe haven and the liquidity of the Treasury market most readily accommodates capital inflows--and to continued uncertainty over the impact--on growth and inflation--of lower oil prices. While lower energy costs led to increased disposable income and helped boost consumer spending for the economy as a whole, there were clearly negative employment and investment effects in the energy related sectors of the economy.

While the investment decisions in the Fund are, of course, based on our monthly portfolio research review process, it seems likely that the economic recovery will remain on track near term--though periods of slowing can always occur especially given that the recovery has been ongoing since mid-2009--and that the general trend will be to higher yield levels. We do not accept that the U.S. economy's growth potential has deteriorated to the point where current rate levels are consistent with long term equilibrium. Continued growth and the fact that at some point inflationary pressure will begin to build will force the Fed to tighten its policy stance. Additionally, yields on longer maturity securities, which are less dependent upon, though correlated with, Fed policy, will likely increase to bring risk premia to more normal levels.

Real consumer spending--the backbone of the economy--is up over 3% in the past year and household balance sheets look good in terms of wealth to income ratio and debt burden. The unemployment rate is now roughly in line NAIRU[3], the "non-accelerating inflation rate of unemployment", the economy is on pace to add 2.5 million jobs this year and job vacancies are the highest since the Department of Labor began collecting the data in 2000. Also, the U6 unemployment rate[4], which tracks those marginally attached to the labor force as well as those able to find part time work only, now stands at 10%. While above its pre-crisis unemployment level of about 8%, it has declined steadily from its recession peak level of over 17%. A trade-off between the official unemployment rate and the U6 could actually be a positive for growth if it occurred as a result of "discouraged workers" again having the confidence to become "job seekers." Unemployment claims have now moved back to pre-crisis levels and remain below 300,000. Claims continuing below 300,000 points to a sound labor market.

Our view continues to be that the strength of the dollar and/or weak growth in our trading partners not will pull the U.S. economy back into negative growth territory. However our glasses are not "rose colored" and there are certainly areas of concern. A global recession--including the U.S.--can't be dismissed although we think the likelihood is relatively small. Domestically both the current pace of investment spending and the seeming slowing of productivity growth--either labor or total factor—are troubling. The pace of investment spending may have been hindered to date by legislation, the current tax environment and uncertainty associated with it and regulation. Much research has been devoted to the negative impact on investment that such factors can have.

[3] The specific level of unemployment that exists in an economy that does not cause inflation to increase. The non-accelerating rate of unemployment (NAIRU) often represents an equilibrium between the state of the economy and the labor market.
[4] This number reflects the government's "U-6" report, which accounts for the full unemployment picture including those "marginally attached to the labor force," plus those "employed part time for economic reasons."

Economist Robert Solow[5] has commented "you can see the computer age everywhere but the productivity statistics". Some research has concluded that what we have is a measurement problem because of the difficulty in assessing the "price" of advancement in the technology related sectors and that current living standards are higher than the typical measurements of well-being suggest. So, there seems to be a productivity paradox. The solution--better measurement or confirmation of an actual slowing--is important as the real wage growth needed to sustain consumer outlays depends on labor productivity growth. Finally, while the magnitude of the impact is an issue, there is a view, popularized most recently by the academic authors Reinhart and Rogoff and outlined earlier by Fisher and Minsky, that recessions exacerbated by a debt overhang have sluggish recoveries that require both fiscal and monetary policy support. Nevertheless, the current recovery doesn't appear quite so slow since the potential growth is in fact 2%.

Work based on the options pricing theory of Fisher Black and embodied in the concept of a "Shadow Federal Funds Rate"[6] suggests that the Fed's ending of QE3[7] has already resulted in a somewhat a "tighter" monetary policy. However, comparing the level of the Shadow Rate to that implied by the Taylor Rule indicates that the Fed is "behind the Curve". Further delay in tightening would be based on the view that the economy is not yet "out of the woods" due to the strong dollar and weak European and Asian growth. The most likely economic scenario is that maintaining the Fund's Rate target at its "zero lower bound" would lead to a more dramatic acceleration in longer-term inflation than would otherwise be the case. This outcome is consistent with the business cycle experience of the U.S.--economic cycle exacerbated by the policy cycle.

An alternative outcome that is currently being discussed in policy debates is that the Fed guides, by extending the time period for the near zero target Fund's rate, the economy into a sustained period of low rates, subpar growth and/or deflation as a zero target rate is not consistent with a continued recovery and a positive inflation goal, i.e. the U.S. becomes Japan. We believe the appropriate policy to prevent this outcome would be an increase in the policy rate--again a Fed tightening--accompanied by more quantitative easing or QE. A tightening would indicate confidence on the part of policy makers in the ongoing strength of the recovery. A third scenario would be that productivity growth is in fact very weak, that investment spending stays low and combined with a trade deficit and inventory accumulation causes a pause in growth. Tightening by the Fed in this environment policy would exacerbate the cycle to the downside.

Given our most likely scenario--continued growth with a Fed "liftoff"-- a reasonable expectation based on history would be that the 10-year yield reaches at least 4% under such scenario; it simply accepts the 2% assumption for the economy's growth potential and the Fed's ability to hit its inflation target, also 2%. It may be higher with the typical cyclical overshooting and potentially much higher if the Fed's inflation policy loses credibility and/or is too long delayed. Additionally, if history is a guide, the upward trajectory will not be a smooth one. Rather, it could be somewhat violent with significant increases followed by periods of decline. In the period from January 1973 to September 1981 the 10-year yield increased by about 10% from just over 5% to almost 16%. But, rates increased in only about 60% of the 105 months. If anticipated, downward deviations provide an opportunity for return enhancement by lengthening duration.

Our investment discipline utilizes measures of real growth, inflation expectations, market based measures of current valuation and of the likely course of Fed policy changes (including factors on which the Shadow Rate concept is based) in assessing the likely near term course of interest rates. It is intended to preserve

[5] Robert Merton Solow is an American economist particularly known for his work on the theory of economic growth that culminated in the exogenous growth model named after him.

[6] Unlike the observed short-term interest rate, the shadow rate—first introduced by Fischer Black (1995)—is not bounded below by 0 percent.

[7] "Quantitative easing" refers to steps that the U.S. Federal Reserve takes in attempting to boost the country's lagging economy. Historically, the Fed's main tool for spurring growth has been lowering short-term rates. However, QE employs expansionary monetary policy, which involves the purchasing of bonds when the interest rate can no longer be lowered. In September of 2012, the Fed announced its third round of quantitative easing, often abbreviated to "QE3."

capital in periods of significant rate increases by decreasing duration but with the flexibility to extend duration or re-enter the market when our discipline suggests lower rates are likely. As this recovery matures, uncertainty increases as to how much longer it can go on. Periods of economic weakness as indicated in the data will likely occur, providing the opportunity to add value by lengthening exposure. What is relevant to the potential success of our discipline for our Fund is that interest rates continue to exhibit cyclical volatility--that the business cycle is not dead. Continued cyclical behavior will provide a basis for success even if the longer term equilibrium level of the economy's real rate-- due to a reduced real growth potential--is lower. While panic buying can move rates dramatically for short time periods, rate behavior over time is driven by the business cycle.

The Centre Active U.S. Treasury Fund is intended to serve as a core fixed income investment. Over time, it is intended to provide the same yield as the Treasury market with attractive diversification benefits. In addition to its wealth accumulation and diversification objectives, the strategy readily accommodates both systematic and unforeseen cash needs, given the liquidity of the Treasury market. Furthermore, the utilization of Treasury securities within asset allocation provides attractive diversification properties, as the correlation[8] between Treasury market returns and those of the U.S. equity market is, historically, negative during declining equity markets.

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Disclosures

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Diversification does not eliminate the risk of experiencing investment losses.

[8] In the world of finance, a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

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