

October 2016

Oh, Say Can You See

Look to the horizon

When you read the title and close your eyes, you will most likely see the Star-Spangled Banner waving over Fort McHenry, but the question for investors right now is whether there is something else that we can see on the horizon, something we have been warned would inevitably happen for so many years already: higher bond yields.

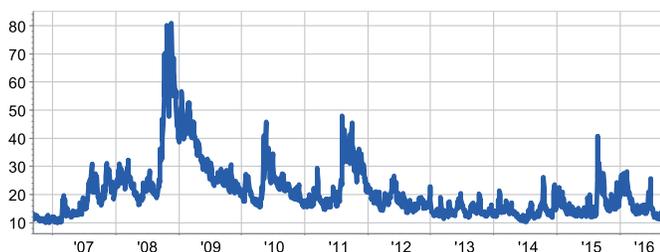
The calm before the storm

One has to agree that the summer was relatively boring. Only two days into the summer, some thought the Brexit vote would spice things up a little bit, but the excitement didn't last for too long. To help us go through the dog days of summer, we were fortunate enough to be entertained with the Olympic Games and the great performance of Team USA.

In recent history, the month of August has become the spoiler-in-chief, delivering some nasty surprises for investors, from the Greek Drama and US rating downgrade in 2011 to the Chinese devaluation last year, as well as the tail end of the Taper Tantrum in 2013.

Equity Implied Volatility

Volatility is volatile and will mean-revert



But just as we all know that it's wise to sell in May and go away (until November), according to the Weather Channel, the Atlantic Hurricane season runs from June through November. We might just have witnessed the calm before the storm. And there seems to be plenty of potential strong (head) winds for the markets in the next

two months. Let's leave aside the Presidential Election and focus instead on Central Banks, bond yields and the economy.

There is one thing we know about market volatility—it has a strong tendency to mean-revert. Volatility has been depressed across most asset classes in recent weeks and you don't need a PhD in physics to understand that, at some point, it will start moving higher. Once again, we expect that Central Banks will be the main culprits for a return of market turmoil.

Can bond yields climb during the fall?

We often hear market commentators highlighting new highs for equity indices as if this should be seen as an extraordinary development. The reality is that stock prices should move higher in the long run and today's new high will usually end up as a little dot on an upward trend. The same cannot be said about bond yields reaching new lows, which has been the hallmark of the current business cycle. In the wake of the Brexit referendum, the 10-year Treasury yield reached another new low on July 8 at 1.3579%. While you may think this is insane, some stranger things happened on the very same day, with the yield on Switzerland's 50-year government bond dipping below 0%.

Switzerland's 50-year government bond

Negative 30- and 50-year Swiss yields



Maybe, just maybe, this 1.3579% was the endpoint for the 35-year bull market in Treasury bonds. Over the past few

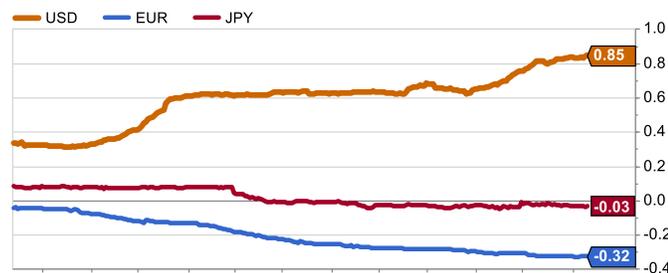
weeks, the 10-year yield has very gradually inched higher and is currently sitting around 1.6%.

If bond yields continue to climb, this will have major consequences for most markets as the “search for yield” has been a dominant theme for many years.

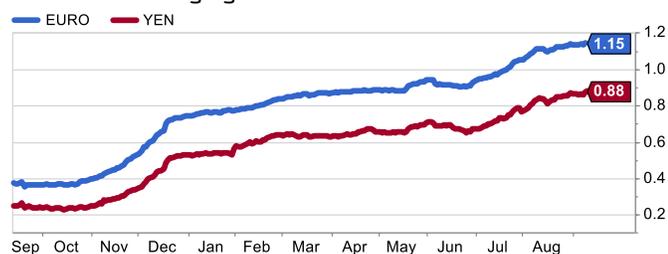
Several factors are behind the recent reversal in bond yields. First and foremost is the realization that Brexit is not the end of the world and that the initial knee jerk reaction of forecasting doom for the global economy was, to put it mildly, a slight exaggeration. Second, several FOMC (Federal Open Market Committee) members have made it clear that they are still in a tightening cycle (as a reminder, since it seems so long ago, the Federal funds rate was raised last December). Third, foreign demand for U.S. Treasury notes and bonds might be fading as an unforeseen consequence of the money market reform which resulted in a relatively sharp increase for USD LIBOR rates. As a result, the cost of hedging U.S. dollars for foreign investors went up quite significantly (the difference between USD and foreign deposit rates), largely eating into the apparent yield pickup offered by U.S. bonds. And finally, although growth is still disappointing, inflation seems to be rebounding due to rising wages, poor productivity gains, bottoming commodity prices and a stable to slightly weaker dollar in recent months.

USD LIBOR rates and cost of hedging

Recent trends in 3M LIBOR rates



Cost of USD-hedging for overseas investors



However, these factors alone are unlikely to keep pressuring bond markets enough to offset several ongoing trends which have acted as tailwinds for bond prices. As already mentioned, economic data—in particular in the U.S.—has been relatively disappointing in recent weeks. Most notably, the ISM indices (surveys of purchasing managers) for both the manufacturing and the services parts of the economy seem to be rolling over.

ISM indices

Institute for Supply Management



While job creation is on a record 76-month streak, the most recent payrolls data was also disappointing. Capital spending and durable goods orders are still weak and some earlier bright spots (such as auto sales) appear to be peaking. Global demand for government bonds remains very strong as QE in Japan, the U.K. and the Euro-area is currently running at a rate higher than net new bond issuance in these markets. Regulatory pressures also remain a factor driving commercial banks' demand for government bonds. While dollar-hedging costs have moved higher, many global investors are very much willing to purchase Treasury bonds unhedged on the expectation that the dollar will soon resume its uptrend (given diverging monetary policies on a global basis). While we are on the topic of hedging, government bonds have repeatedly shown their value in times of market turbulence as a good hedging tool for balanced portfolios. This should provide additional support for bond markets in a very uncertain world. While yields are very low, the yield curve is still relatively steep (although significantly less so than a few months ago) and taking some duration risk still makes sense for yield-hungry investors. But perhaps the main factor that will limit the extent to which bond yields can move higher is the ongoing debate around the neutral Fed

funds rate or its terminal value in the current tightening cycle. If the neutral rate is somewhere below 3%, this will cap the 10-year yield well below this level. This is because the U.S. business cycle is already well advanced and a recession is very likely in the next 2-3 years. This means that the Fed will have to cut rates at some point and the yield curve usually inverts ahead of a recession.

Another tantrum?

As you can imagine, we are not too worried about bond yields in the medium term. Still, there is a growing risk that yields could overshoot in the near term. We don't believe this will be triggered by a significant improvement in economic data (although the U.S. economy is likely to rebound after several quarters of inventory liquidation), but more likely due to actions from Central Banks, in particular outside the U.S. Indeed, we don't believe that the Fed will be the main factor behind a bond selloff, whether they hike in October, December or early next year. We already know that the Fed is not easing anymore and its balance sheet is already shrinking as a share of the GDP. The main threat will come from policy actions outside the US that would be seen as a sign that aggressive easing policies could soon be over.

Over the past few years, there have been three episodes where bond yields have spiked significantly higher, and each time it was seen as an indication that aggressive easing was coming to an end: the announcement of the second round of QE in the U.S. in late 2010 (at that time, the consensus view was that this should be enough to kick-start the U.S. economy), the Taper Tantrum in May 2013 and, more recently in 2015, the start of QE in the Euro-area. The following table provides some information about what happened to bond markets and other asset classes during these "bond tantrums".

Fixed Income Sectors	Start of QE2 (10/11/10 - 2/10/11)			Taper Tantrum (5/2/13 - 9/5/13)			ECB QE Announcement (1/30/15-8/10/15)		
	Starting YTM	Ending YTM	Total Return	Starting YTM	Ending YTM	Total Return	Starting YTM	Ending YTM	Total Return
US Aggregate	2.40%	3.29%	-3.1%	1.73%	2.68%	-4.9%	1.93%	2.49%	-2.8%
US Treasury	1.32%	2.23%	-4.8%	0.80%	1.55%	-4.5%	1.09%	1.62%	-3.3%
US Treasury 10-20Y	2.95%	4.11%	-10.2%	2.06%	3.36%	-11.0%	1.89%	2.63%	-6.2%
TIPs	2.20%	3.12%	-5.0%	1.42%	2.46%	-10.1%	1.56%	2.17%	-3.9%
MBS	2.97%	4.06%	-1.7%	2.32%	3.50%	-4.0%	2.28%	2.85%	-1.1%
Munis	3.01%	4.01%	-5.4%	2.04%	3.43%	-8.8%	1.79%	2.40%	-2.2%
Invest. Grade Corporate	3.49%	4.22%	-3.3%	2.61%	3.59%	-6.4%	2.79%	3.41%	-4.3%
High Yield	7.99%	7.43%	5.0%	6.13%	6.01%	-2.2%	6.78%	6.64%	2.4%
Preferred Securities	6.91%	7.05%	0.8%	6.22%	6.67%	-8.2%	5.88%	5.93%	0.1%
Intermediate Govt/Credit	1.52%	2.34%	-2.9%	0.98%	1.82%	-3.3%	1.36%	1.85%	-1.4%
EM \$ Debt	5.36%	6.22%	-3.9%	4.48%	6.27%	-10.4%	5.59%	5.84%	0.2%
EM Local Debt	6.16%	7.09%	-3.7%	5.24%	6.96%	-14.8%	5.89%	6.81%	-6.0%

Today, every major Central Bank currently pursuing aggressive monetary policies could potentially trigger another bond market selloff, by either ending QE purchases earlier than anticipated (this could be the case for the Bank of England if the consequences of Brexit are not as dire as expected), announcing a "Taper" similar to the Fed in 2013 (the ECB could surprise the markets by sticking to the current deadline of March 2017 to end its QE operations) or announcing another set of policy measures that are aggressive enough to convince investors that the Central Bank has done what is needed in order to achieve its objectives in terms of growth and inflation (that could be the case for the Bank of Japan after finalizing its assessment of the effectiveness of previous policies).

What does it mean for investors?

DON'T BE COMPLACENT



While we have long argued that interest rates and bond yields are unlikely to climb towards levels seen before the financial crisis, we also believe that the 10-year Treasury yield is more likely to move up than down from current levels. Investors appear too complacent when it comes to the Fed tightening cycle in the medium term and with regards to future inflation trends. Bond yields will move higher in a more meaningful way once investors start pricing in a more sustainable rebound in growth and inflation overseas. As mentioned, one potential trigger for this to happen could be a shift in expectations when it comes to aggressive monetary policies in Europe and/or Japan.

CONSIDER STRATEGIC PORTFOLIO CHANGES TO ACCOUNT FOR RISK



We have made a few changes to our portfolios in order to take this risk into account that investors may want to consider. First, we have slightly reduced the duration of our bond portfolio. Second, within equities, we continue to hold a decent exposure to minimum volatility strategies, but we have also started to scale back our allocation to areas which have strongly benefited from the low interest rate environment, such as utilities, telecommunications and consumer staples. At the same time, we have increased our exposure to financials and other areas that tend to perform better in a rising rate environment, such as cyclical.

PROCEED WITH CAUTION



The above changes may likely prove to be a tactical trade though as we believe that the odds of a U.S. recession in the coming 18-24 months are increasing and portfolios will need to be skewed towards defensive sectors/markets while duration will also have to be lengthened once again in coming months. This could even happen earlier if the Fed decides to hike in December while the economy shows some signs of losing momentum, as indicated by recent PMI readings. For now, we remain of the view that one month doesn't represent a new trend but we will keep a close eye on incoming data to gauge the actual strength of the expected growth pickup later this year.

TO VIEW A MORE DETAILED DESCRIPTION AND ANALYSIS OF THESE INSIGHTS, VISIT WWW.WEBSTERBANK.COM/PB.

Source for charts: FactSet as of 09/03/16

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