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April 2012

Is a Turning Point for Policy, and Markets, on the Horizon?

Fixed Income Market Outlook

Highlights

- We are likely to continue to see slow economic growth and data volatility in the US, and while the economy overall appears to be in decent shape, possible fiscal drag on the economy from the government sector and elevated oil prices remain key risks to watch.
- There are tremendously important market dynamics occurring that we think will shorten business cycles and keep real interest rates suppressed in the years ahead.
- Still, while we do think rates may back up modestly in the next several months, powerful supply/demand dynamics and other factors should continue keep yield increases limited.

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Whither the Economic Recovery?

We have previously argued that investing today has become less a matter of judging how central bank policy impacts the economy, but rather it is more about how economic conditions influence central bankers' policy decisions, which in turn have driven financial markets. To that end, in this month's market outlook we will examine the state of the economic recovery in the United States and what we think it augurs for the path of Federal Reserve monetary policy in the year ahead. Further, we shall look at new developments in business cycle dynamics and the much discussed phenomenon of financial repression before turning to how these many issues factor into investment opportunities today.

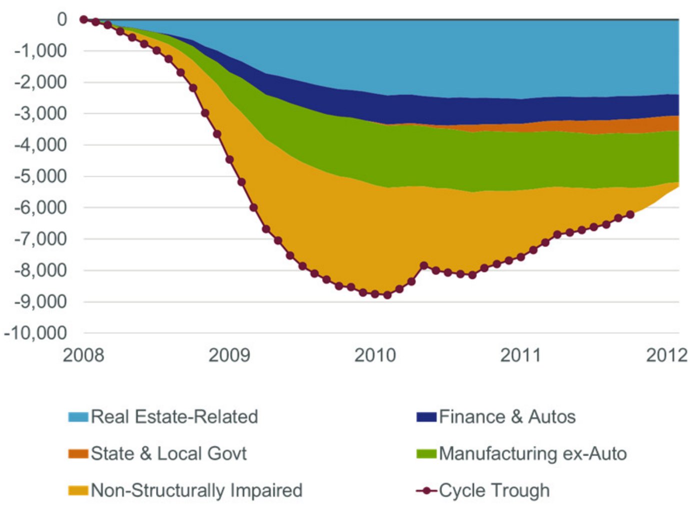
For well over a year now we have been resolute in our view that the US economy would see slow growth for an extended period of time, as we argued that it would both avoid a secondary recession and also not surprise excessively on the upside, due to a variety of structural headwinds. On this our opinion has not changed. We think the economy is going to "bat .200" (for those in the US), which is to say that we envision a considerably long period of subpar growth around 2%. As we argued last month, we think that while there is little doubt that the near-term data is better, we think some degree of that improvement is due to idiosyncratic factors that are unlikely to benefit data in the months to come. For instance, some evidence suggests that late-2011 data may have been positively impacted by seasonal statistical aberrations relating to the 2008 financial crisis, raising questions about the actual strength of selected data prints. Additionally, the atypical weather patterns witnessed across the U.S. in early 2012 have largely flattered first quarter economic data, and particularly labor market data, but are unlikely to continue to do so.

Perhaps we are already beginning to see signs of this tailwind waning as March payroll data, at 120,000 came in significantly below the 205,000 consensus estimate, and private payrolls missed estimates by an analogous amount. Of course, January and February saw quite strong jobs gains, but the previously mentioned weather factor may go some distance toward explaining that strength. More importantly, however, is the fact that much of the payroll gains witnessed since the start of the labor market recovery have come in

The views expressed are those of Rick Rieder, Chief Investment Officer of Fixed Income, Fundamental Portfolios as of April 2012 and may change as subsequent conditions vary.

the non-structurally impaired sectors of the job market (see Figure 1), which suggests that rapid progress in employment may remain elusive in the months to come. Indeed, Fed Chairman Bernanke has suggested as much and he has remained quite vocal in his concern about prospects for further labor market recovery. In fact, much of the improvements we have seen in the unemployment rate, which recently declined to 8.2%, result from a shrinking labor force participation rate rather than robust job creation. If we fixed the labor participation rate to its October 2009 level, for example, then the current unemployment rate would stand closer to 10%. Still, much of the recent data suggests that employment should continue to slowly improve, and that "hours worked" is now at a level that suggests further need for hiring. So, while the economy is in decent shape, it also presents a challenge for the Fed, as conditions are not strong enough to pull back accommodation yet, and we think we may see some further policy stimulus prior to the eventual exit of the Fed's accommodative stance.

Figure 1: Payroll Employment Since Peak (1,000s)



Source: BLS, Department of Labor, Credit Suisse

On the consumer-spending front, we also see some mixed signals, as clearly there is some improvement from pent-up demand (particularly in the form of auto purchases), which is being aided by increased credit extension. At the same time we question whether this is a road to tangible economic growth. The question becomes more pertinent considering the fact that wage growth remains mired at a very low 1.5% level, so additional spending would likely require further use of credit, but without commensurate additions to income. Also, while we have seen some improvement to housing markets of late, the "house as automatic teller" model of lending won't come back anytime soon, and we don't think any housing recovery will help spending much. Further, government support of lower-to-middle class household spending may decline precipitously in the near-term, which raises the issue of the risks to growth in our outlook.

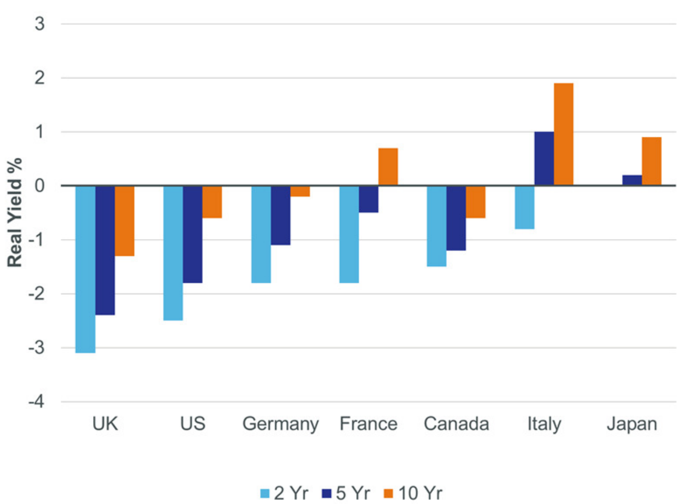
Thus, we find ourselves in a situation where the economy may grow at a modest 2% rate, while there is a significant chance of an ominous fiscal drag from the government sector in 2013. Indeed, under current law, and without the sort of legislative compromises (prior to an election) that have become rare in Washington in recent years, the federal fiscal contribution to real GDP growth could become a meaningful drag, as taxes increase and stimulus wanes. Additionally, other parts of the globe (such as China and other developing markets) appear to be experiencing a deceleration in growth and Eurozone Purchasing Manager Index levels have recently come in weaker than expected. All this is not to suggest renewed recession (although Europe could well be heading there), but it does highlight the relative fragility of the recovery and its susceptibility to market shocks. One concerning risk continues to be oil price levels and the possibility of a price shock due to unrest in the Middle East, so we carefully monitor oil prices changes and consider their possible impact on economic conditions.

Business Cycles, Financial Repression and the Path of Interest Rates

There is a major dynamic to consider within this growth story, which will be with us for a while, and that is that both business cycles, and related market cycles, are likely to be shorter and more volatile as the developed world is in the middle of a profound financial repression resulting from years of excess leverage accumulation. At some point in the future (likely different times for different regions), there will be an emergence from this financial repression, resulting in a healthier market recovery, but the path between here and there may be long and difficult to traverse. Regardless of whether we look at regional Fed surveys, ISM data, or simply the standard deviation of GDP growth (which has effectively doubled since 2007, when measured over 20 rolling quarters), it has become increasingly clear that the post-financial crisis environment has resulted in dramatic increases in data volatility related to business cycle patterns. Almost by definition, persistent lower growth should be more volatile, particularly with monetary policy helping to stimulate the economy. Interestingly, analysis from the National Bureau of Economic Research suggests that in recent decades monetary policy has helped create a business cycle pattern with shorter contractions and longer expansions, but we wonder if that dynamic may now be changing?

The phenomenon of financial repression (as examined by scholars such as Carmen Reinhart, Kenneth Rogoff, and others) involves the maintenance by policy makers of low nominal interest rates, even in the face of meaningful inflation, which keeps real interest rates lower than otherwise would prevail under more natural market circumstances. This combination can have the effect of reducing a country's debt-to-GDP ratio by essentially serving as a tax on savings. That is not merely theoretical speculation and history can be instructive for discerning where the economy and financial assets are headed over the coming months and years. For instance, in the period after WWII, the U.S.' s government debt was reduced through a combination of low real interest rates and higher inflation, a trend we appear to be revisiting. Reinhart' s research has also shown that during the period from 1945 to 1980 the average annual real yield on short-term government debt in developed countries was negative (-1.6%), but that from 1981 to 2009 it had turned to a healthily positive 2.8% annual real yield during the bond bull market (Reinhart and Sbrancia, 2011). Where do we stand today regarding financial repression? A recent snapshot of developed country bond yields reveals (see Figure 2) that most countries are already well into negative real rate territory on the shorter end of their yield curves, and many are nearing that point at the longer end as well. We may be in this state for a while as the Fed artificially suppresses real rates, but we think the U.S. may eventually emerge from the condition sooner than Europe.

Figure 2: G7 Real Government Bond Yields (02/12)



Source: Bloomberg

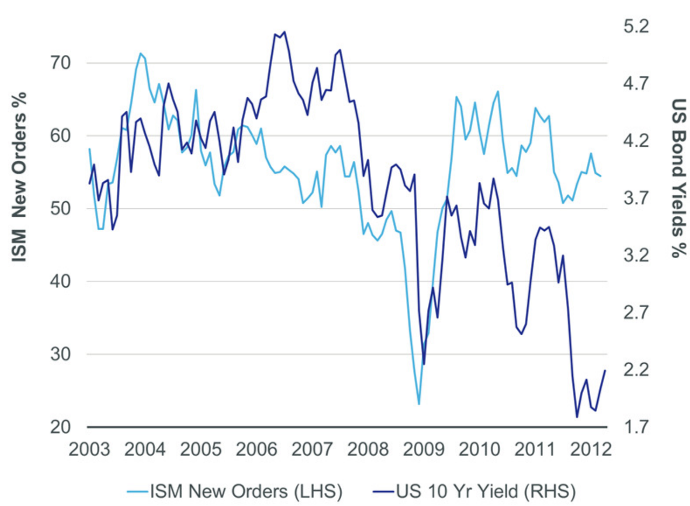
Still, as Fed policy makers look to the US financial system for direction on the recovery, there are some early signs of encouragement. Bank capital levels in the U.S. are growing and are looking as strong as they have for many years. Moreover, the shadow banking system appears to be stabilizing in the U.S. (although this may take awhile longer to occur in Europe), and the shrinking of bank lending that took place after the financial crisis and recession has been starting to reverse in the U.S. in a much more broad-based way than we saw last year. Indeed, commercial and industrial loans are recovering nicely, consumer lending seems to have stabilized, and even real estate lending has tentatively begun to turn positive. Ultimately, the Fed would be very keen to see an increased velocity of money develop from this activity, which would be one of the tangible catalysts for gradual exit from its highly accommodative stance.

We have long argued that supply/demand technicals within fixed income markets should hold rate levels down, as a tremendous need for yielding assets is met by a dwindling fixed income supply (particularly of high-quality issues) in the context of global deleveraging. Last month we also argued that growth in the US monetary base has dramatically outpaced growth in the supply of US fixed income assets over the past few years, and consequently that dynamic will also lead to structurally lower rates for some time. Still, we have also been of the opinion that rates should be modestly higher than they currently are, particularly as expectations adjust regarding the timing and type of further Fed action. There is little question that Fed interventions are greatly impacting rates markets, and we think that later in the year we could see Operation Twist shift into a sterilized form of quantitative easing. Also impacting rates moves is the fact that international purchases of Treasuries have slowed, and large official institutions that have historically been key buyers (such as China, fueled by foreign exchange reserve accumulation) may continue to reduce purchases as global growth slows and reserve build abates.

Investment Implications: Interest Rates and Sector Valuation

In our view, the transfer of Treasuries from foreign holders to the Fed, and the eventual move toward the exit of highly accommodative policy should force rates closer to fair value (with yields rising and prices falling). There are various metrics that indicate that Treasuries have disconnected from fair value price levels, and whether judging by economic momentum, by stage in the business cycle, or by manufacturing activity metrics (see Figure 3) the sector appears overvalued. As we have argued previously, we think the 10-Year Treasury yield should probably be 50 to 75 basis points higher than it is today and it may rise as the year progresses.

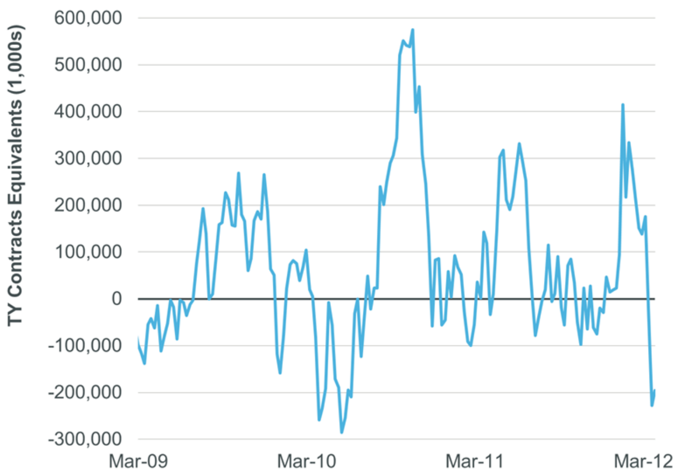
Figure 3: Treasury Yields vs. Manufacturing Activity



Source: Bloomberg

Are markets already anticipating a shift in monetary policy stance, or at least a move higher at the long end of the yield curve, as short rates are still likely to remain pinned for some time? It would appear so. Consensus opinion appears to be evenly divided between those that think 10-Year Treasury rates will remain in a tight band around 2%, and those that think the range will shift modestly higher, with very few taking the view for extreme moves in yield. Moreover, the traditional relationship between easy monetary policies leading to a weaker currency (leading to higher risk asset prices) seems to be waning. Is that fact a function of the expectation of a US monetary policy shift, is it due to even easier policies that are occurring in other regions, or is it that the relationship no longer holds in the present environment? Regardless of the cause, it has become increasingly clear that investors are preparing for higher rates by positioning for a shift in duration to higher levels. In fact, this can be see in the steep decline in US Treasury futures net positions (see Figure 4), and an analogous dynamic can be seen in the cash equivalents for Treasury futures.

Figure 4: US Treasury Futures Net Positions



Source: Commodity Futures Trading Commission

Some degree of these recent movements in US financial markets may reflect the possibility that we are closer to some form of policy exit, but if that is the case, what does it imply for investment opportunities today?

As we have stated before, and given the many dynamics described above, we do not think the Treasury sector offers much value at current price/yield levels, and with possible rates moves, the region could hold some meaningful volatility. We are also less sanguine about the Agency mortgage-backed securities markets, since a good deal of further Fed action has been priced into that market and the negative convexity in a rising rate environment could be dangerous. Hence, we like owning yielding assets five years and in on the yield curve in sectors such as commercial mortgage backed securities (CMBS), asset backed securities (ABS) and high yield/bank loans. We think that owning intermediate-term spread assets, while rates are generally held down allows for good yield capture in a low rate world.

We also think, however, that one must be quite cautious about the protection provided by absolute yield levels at this point, and about the potential for deteriorating underwriting standards. Improving commercial real estate markets, alongside more conservative leverage levels on newly originated loans than in the pre-crisis period, lead to opportunities in that space. And while high yield bonds still look like a decent bet, given the moves we have already seen in this market, we think the sector has become more of a carry story with the hope that equity markets continue to perform well, leading us to favor the bank loan sector. In the end, while we think some recent market movements may be beginning to foreshadow an eventual exit from the current monetary policy stance, we do not think that moment is upon us yet and we may well see more stimulus prior to the move toward an exit. Still, we do think reducing risk a bit now makes sense and that investors should also begin thinking about what longer-term market dynamics (such as abbreviated business cycles and financial repression) will mean for their portfolio returns in the years ahead.

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