Q2 2018

CIO Newsletter

Q2 2018 Monetary Tightening, Fiscal Easing

Current Environment

The second quarter of 2018 saw the continuation of several trends described in this newsletter in prior quarters. Fundamentals remain solid in US GDP growth and corporate earnings, while employment and inflation are warmer but not yet overheating. The Federal Open Market Committee (FOMC) continues to tighten monetary policy with a seventh rate hike in June, while the yield curve flattens ever closer to an inversion that historically has predicted a recession.

Capital markets are skittish and variable, especially with the escalating trade war, but strong buybacks have helped to protect US stock prices so far. Europe's economic activity has slowed after the synchronous global growth of 2017, and China's stock market decline extended to bear market proportions (a 20% decline) as trade anxieties were added to the mix. Investment-grade US corporate bonds continue to see their value decline relative to US Treasury bonds (spread widening), while corporate debt issuance has increased to fund some large acquisitions.

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We also saw a new dynamic materialize in the second quarter as emerging market currencies came under pressure. The most dramatic losses were in situations like Argentina, Turkey and Indonesia, where there are already significant fiscal problems and high inflation, but there is also a wider anxiety that the combination of monetary tightening and fiscal easing by the US will drain capital and liquidity from emerging markets toward the US. The governor of the Reserve Bank of India issued a plea for the FOMC to moderate policy to ease the impact on emerging market economies (Financial Times, June 3rd), but the FOMC does not appear to prioritize this concern.

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Developed market currencies are also interesting. With the US dollar strengthening so far in 2018, there are some unusual forces at play which link back to prior discussions of yields, inflation, fiscal and monetary policy and economic growth. As shown in the following chart, implied forward pricing in currency markets suggests that the US dollar is expected to decline significantly relative to other large currencies over the next several years. However, implied forward prices have poor predictive power for the future currency spot rate, typically referred to as the "forward premium puzzle".

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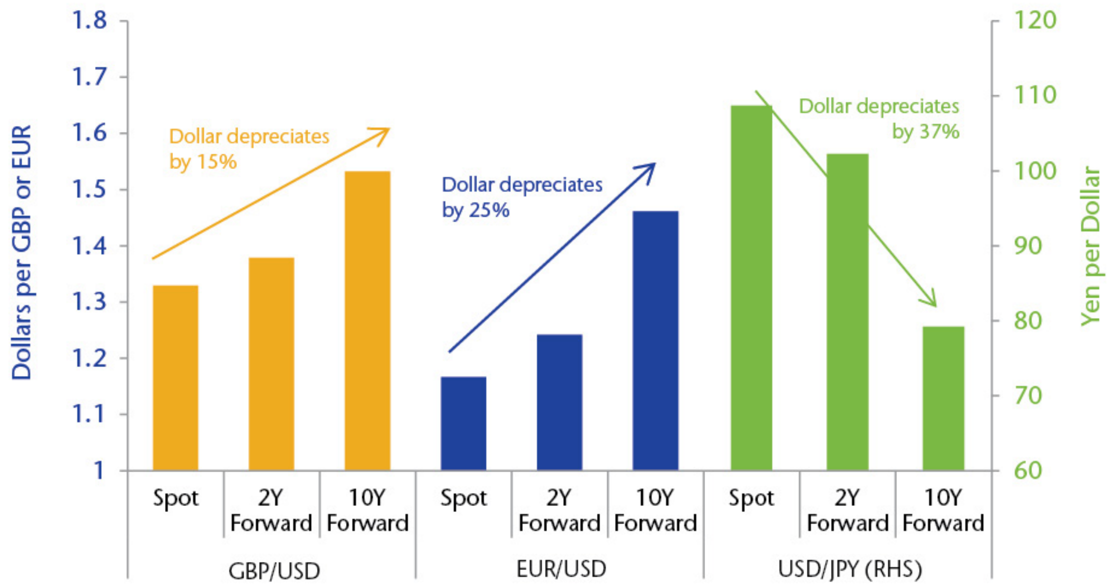
Current Environment (cont'd.)

Implied Forward Rates for US Dollar



Source: Bloomberg, measured at 5/31/2018

In the short term, the dollar has actually appreciated recently as rising US yields increased demand for US bonds (draining capital from other bond markets), and fears of a trade war drove some capital to the relative safety of the US.

Another more general impact is that the cost of hedging is reducing demand from European and Japanese investors for US bonds.

So why are we talking about expectations for dollar depreciation? We can look at currency expectations through three broad theories: (1) purchasing power parity expects a currency with higher inflation to depreciate so that purchasing power remains neutral, (2) covered interest rate parity (CIRP) expects a currency with higher yields to depreciate to avoid arbitrage opportunities and (3) supply/demand would expect an expanding supply of a currency to cause it to depreciate. The forward premium puzzle stands counter to all three. Compared to the Eurozone and Japan, the US currently has higher inflation, higher bond yields and is expected to issue a lot more government bonds net of central bank purchases in the coming years (expanding the supply of dollar-denominated assets), which suggests expected dollar depreciation under all three theories. However, the magnitude of implied depreciation looks excessive for the global reserve currency and one of the healthiest economies.

Be wary of mark-to-market losses on that hedge if US yields continue to rise faster than the other regions.

One specific impact for investors of these implied forward rates is that US investors holding foreign assets, e.g. in Europe or Japan, can consider adding a currency hedge on those assets and lock in a 2-3% annual appreciation from the currency effect, especially if you doubt that the dollar will actually depreciate by that much over a sustained period. But be wary of mark-to-market losses on that hedge if US yields continue to rise faster than the other regions. Another more general impact is that the cost of hedging is reducing demand from European and Japanese investors for US bonds, which is part of the reason we see spreads widening (mentioned above) on US investment-grade credit bonds. US yields did not rise quickly a few years ago as quantitative easing (QE) was tapered because European and Japanese investors had a large demand for US bonds while their own QE was still proceeding at full steam. But if hedged US bonds are less appealing now to foreign investors, we could see US bond yields drift higher than expected.

Longer-Term Outlook

Investors closely watch inflation to anticipate the pace of monetary tightening by the FOMC. With that in mind, it is worth reviewing the long term drivers of US inflation. In the following charts we can see that for the PCE index – the FOMC's preferred measurement for inflation – during the Great Moderation since 1985, 87% of inflation has come just from housing, education, health care and pharmaceuticals.

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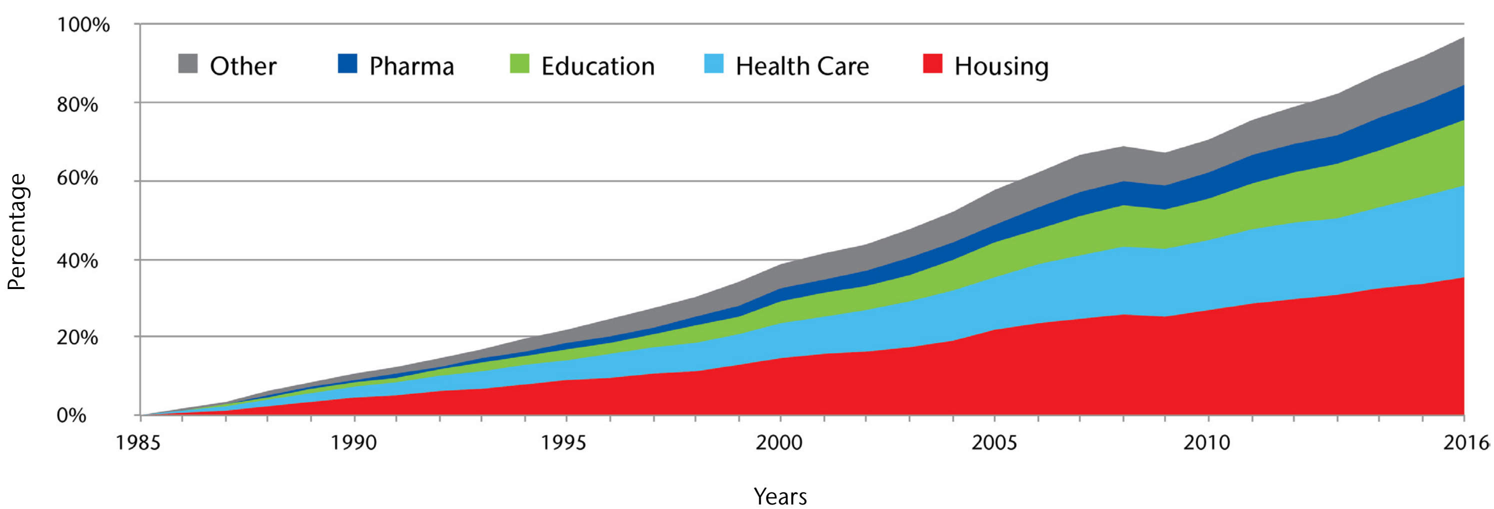
All other facets of consumer expenditure have been responsible for just 13% of accumulated inflation over three decades, which represents disinflation or outright deflation for most.

There are no real consumer alternatives to housing, education or health, so pricing power has been concentrated in "needs" rather than "wants." It also means that policy has an outsize effect on inflation as government-backed debt and low interest rates, tax deductions, mandated use, regulated supply and shifts in government subsidy have all contributed to price increases over the long-term.

Cyclical inflation, i.e. conditions in which demand is growing faster than economic capacity leading to a generalized rise in prices, has been low for many years. Structural, demographic and policy-driven inflation has been much more important. Even with oil prices rising strongly in the past two years and some rebound in wage inflation, it is unlikely that cyclical inflation will come to dominate. This will contain how much monetary tightening is needed to maintain the FOMC inflation target, especially if student and mortgage debt cannot continue to expand at the rate of recent years.

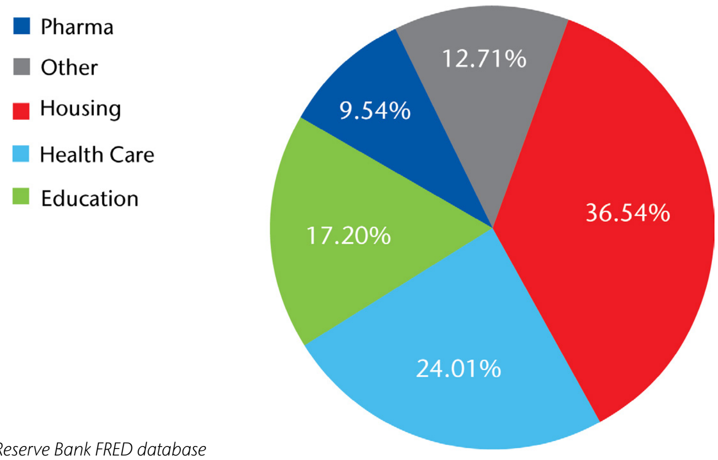
PCE Price Growth Index



Source: St. Louis Federal Reserve Bank FRED database

Longer-Term Outlook (cont'd.)

Relative Share of Each Factor (1985-2016)



Source: St. Louis Federal Reserve Bank FRED database

Current Positioning

We continue to be concerned about this late stage of the credit cycle. Credit spreads on long corporate bonds have widened further than expected in recent months, to the point where they are becoming attractive again. However, we continue to trim what had been a long-standing overweight to credit relative to government bonds because a short-term rebound in credit could still be followed by deeper losses as the credit cycle approaches a downturn. US nonfinancial corporate debt is at an all-time high of 45% of GDP[1] even if interest coverage still looks relatively healthy, e.g. 7.0x for the S&P 500.

The first rule late in an economic cycle is to look where too much debt has accumulated: last time was mortgages and banks, this time is corporations and students. Investment-grade credit may see a slight rebound in the second half of 2018, but we will still be trending toward a more conservative stance on credit until the larger cycle plays out.

Within the term structure of the yield curve, we have been overweight at the long end of the curve for several years, benefiting from curve flattening. We are preparing to move bond portfolios to curve-neutral positions, effectively shifting some duration exposure earlier in the term structure. The yield curve looks set to continue to flatten further and possibly even invert, but a curve steepening likely waits somewhere ahead whenever the FOMC has to respond to the next recession.

For the equity markets, our medium-term views have shifted from positive to neutral on non-US-developed stocks, with just a very slight positive to emerging markets.

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This is well aligned with our shorter-horizon market-aware views, which had shifted to slightly bearish on non-US stocks relative to US. Although growth and momentum have out-performed so far, shifting toward quality should help as indebtedness and

sustainability of earnings receive more scrutiny.

Outside of stocks and investment-grade bonds, we highly value the role of diversifiers in portfolios but need to be careful how they will fare in a rising-yield environment. Opportunistic and uncorrelated rather than "beta" allocations are preferred, but there are fewer outlets at attractive prices.

[1] *Source: Ned Davis Research as of June 2018*

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