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Market Commentary

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The more you explain it, the more I don't understand it. ~Mark Twain

The US economy continues to exhibit the modest growth and low inflation that we have anticipated for some time. In such an environment, spread sectors should continue to outperform Treasuries and interest rates should largely be range-bound. In the aftermath of the global financial crisis, the enormous amount of economic slack has necessitated extraordinary worldwide monetary accommodation—and thus low yields—to underpin the global economy's healing process.

Across the globe, the potential for the reemergence of systemic risk forces us to consider a broad range of scenarios that might support or derail our strategy. Monetary policy regime changes are central in such considerations. That is why the potential for policy changes at the Federal Reserve (Fed) has unsettled US and global markets so greatly. This has forced investors to critically reevaluate positioning in the wake of sharp price declines across the broad scope of fixed-income sectors.

In our view, the severity of the sell-off in both risk assets and the US Treasury market in reaction to the Fed's warning of probable tapering of quantitative easing (QE) represented an overreaction to the underlying fundamentals. As fundamental value investors, we perceived an opportunity not only to add modestly to our sector overweights, but also to move from an underweight to slightly overweight duration position.

May and June saw very adverse performance for both Treasuries and spread assets. The proximate cause was the announcement by Fed Chairman Ben Bernanke in May that the Fed might start to taper its QE program as early as September of this year. This was based on the Fed's optimism that economic growth would improve meaningfully in the second half of 2013 and throughout 2014. Sensing that the strong safety net of Fed accommodation would dissipate, investors reduced holdings across the fixed-income space.

In June, Bernanke reaffirmed this guidance, going further in stating that should the Fed's economic forecast come to fruition, its bond buying program would end in mid-2014. This accelerated the widespread selling, including substantial retail redemptions across fixed-income products. With global economic growth very subdued, the rise in bond yields and the associated strengthening of the US dollar brought emerging market (EM) bonds and currencies under substantial downward pressure as well. This raised the rather unusual market circumstance wherein risk markets sold off as the Fed was raising the US growth forecast. The correlations between "risk-on assets" and "risk-off assets" which had been so strongly negative (as highlighted in our April note) switched to almost perfectly positive.

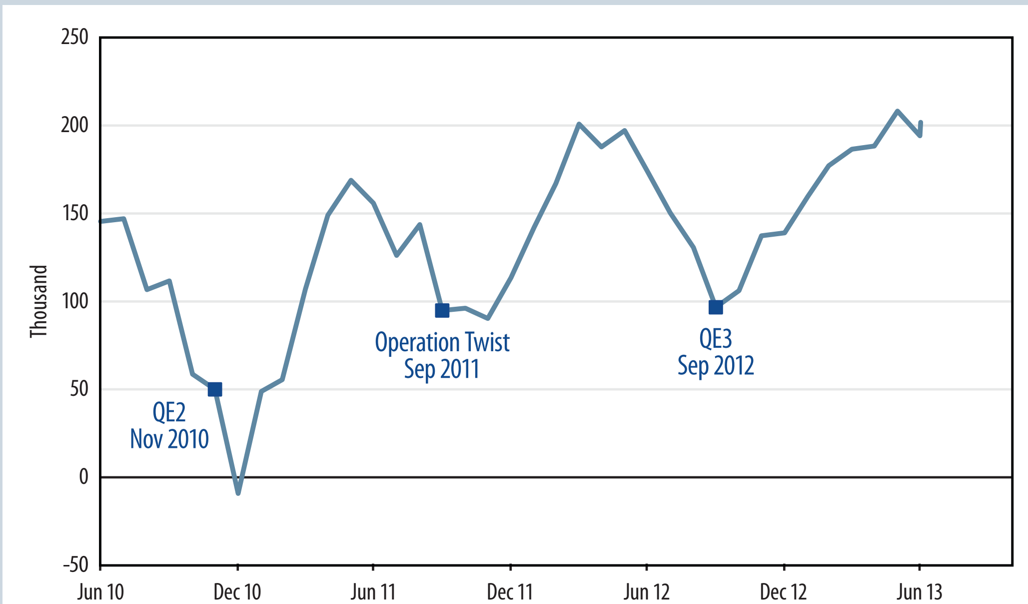
We all understand that market moves can not only be violent, but also somewhat self-sustaining in the short run. Over time, however, the fundamentals will win out and historical correlations will recur. This suggests the usefulness of employing the diversified strategic approach of overweighting both spread sectors and duration positions at this juncture. Either growth is going to significantly improve as per the Fed's forecast, in which case risk assets will ultimately benefit, or else growth will be more subdued than expected, in which case the rise in Treasury rates will abate.

A Tale of Two Indicators

Over long periods of time, the story of interest rates is just the story of inflation. So often, you hear the comment that interest rates are just, "too low—therefore they must go higher." What's really being said is that inflation is just too low and must go higher. Ultimately this should prove true, but we continue to focus on just how long and difficult this process may be. While a common refrain for the last three years, the chorus that rates must and will go higher has not proven to be the basis for a successful investment strategy over that period. A world of high underemployment or unemployment and of enormous unused capacity, where US and global growth continue at only a very moderate pace, suggests that monetary policy must continue to be extremely accommodative for an extended period of time.

This is the message that Chairman Bernanke has recently begun to articulate in the aftermath of the recent market turbulence. To put it simply, he is trying to walk a very fine line. On the one hand, he wants to provide a path for the Fed to exit from QE should the economy improve, but on the other hand, he does not want rates to rise so sharply as to threaten the expansion.

Exhibit 1
Nonfarm Payroll Growth (6-Month Average)*



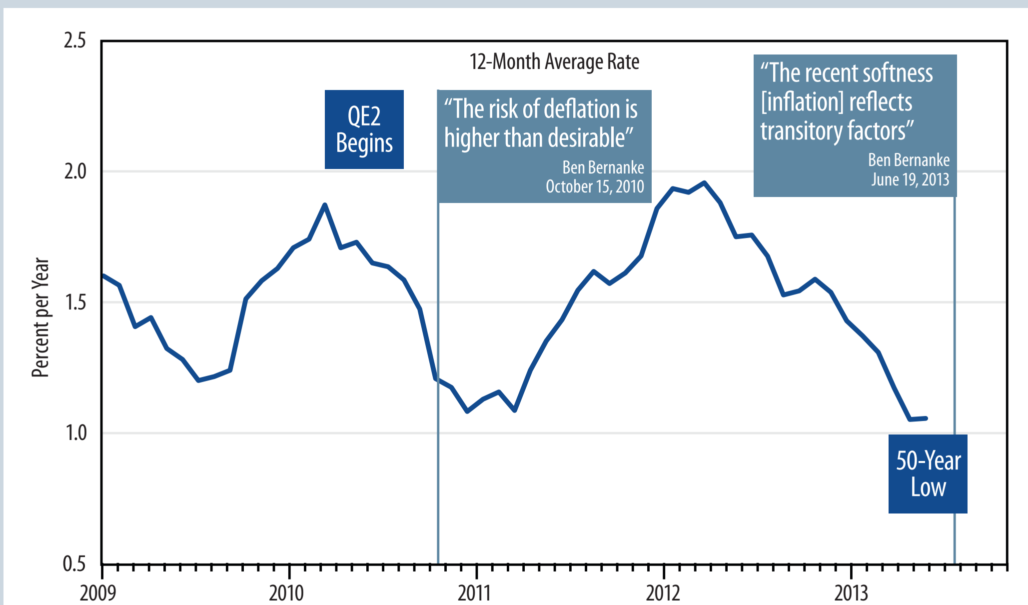
**Data is based on what was available at the time, which may be different than the revised data.*
Source: Bureau of Labor Statistics, St. Louis Federal Reserve. As of 05 Jul 13

Why has he chosen this particular moment to enunciate a prospective end to QE? Perhaps he has been influenced by rising concerns among a larger and previously more supportive segment of the Federal Reserve Board that has started to question the net benefits of continuing QE given current conditions. Or, it may be his desire to undertake the heavy lifting of unwinding this program so as not to burden his successor. The inclination to slow or reverse stock and bond market enthusiasm and leveraging may have played a part, but the most compelling evidence is the improvement in the labor market. (Exhibit 1)

The Fed launched QE3 last year with a focus on the need to reduce the unemployment rate. Their contention in advancing the program was that the stubbornly high unemployment rate was cyclical as opposed to structural, and that the Fed needed to be more aggressive to keep that condition from changing. Since the inception of QE3, the unemployment rate has dropped from 8.1% to 7.6%. The growth rate in payroll jobs has also improved over this time and should that continue, unwinding this particular form of stimulus would be warranted.

On the other hand, the rate of inflation has not merely remained subdued. The Fed's preferred measure of inflation, the core PCE deflator (Exhibit 2), has fallen to a fifty-year low! It's easy to see how so many market participants were not only surprised, but even stunned by the timing of the Fed's decision to taper. The Fed stressed not only the uncomfortably low level of the inflation rate but also the attendant deflationary risks as crucial elements behind QE2 and their official interest rate guidance. So with inflation at a new low, the Fed's reference to "transitory factors" holding it down caught the market by surprise.

Exhibit 2
Inflation as per Core PCE Deflator



Source: Bureau of Economic Analysis. As of 31 May 13

This is where Bernanke has had to backtrack. In recent statements, he has reiterated the importance of monitoring the inflation rate and has again pointed to deflationary risks. We believe the Chairman has always been sincere in his concern about the risks of deflation. It is not that this is his forecast, but that the risk of a downside break would be very difficult for the economy to weather. Bernanke's reiteration of this theme is important. The Fed will keep policy extraordinarily accommodative under these circumstances. This has calmed markets, reaffirming a commitment to near-zero interest rates for an extended period of time.

Whether the inflation rate or the US economy will improve swiftly or sufficiently to confirm the Fed's targets is open to question. An additional challenge is the sluggishness of global growth. Europe remains in recession, and we remain very cautious on its growth prospects. While we continue to believe that China will engineer a soft landing, the recent tightening of monetary conditions engineered to wring out financial excesses suggests the strong possibility of sluggishness in the next two quarters. EM growth has also been marked down sharply. In combination, this global backdrop represents a meaningful headwind to significantly higher inflation.

In this context, it's easy to understand the dismay of the European Central Bank, the Bank of England, and many EM central banks as their interest rates rose in conjunction with the US. Even if the US economy is sufficiently strong to withstand higher rates, much of the rest of the world is not. We continue to believe that US and global growth are moving forward, but still at a subdued pace. Global labor markets, commodity markets and industrial capacity will improve from their fragile conditions slowly.

Over the last few years, market pricing has often suggested that we were too optimistic on the prospects for economic recovery. Occasionally, pricing has viewed us as not optimistic enough. We have stuck to our strategic guns with overweights to spread sectors and a cautious yet opportunistic view on duration, understanding the current economic environment's unusual need for accommodative monetary policy. Against this backdrop, we believe the market's fear of the Fed is overdone.