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Market Commentary

NOVEMBER 2013

The dog that didn't bark. *~Literary allusion ascribed to Sir Arthur Conan Doyle*

Executive Summary

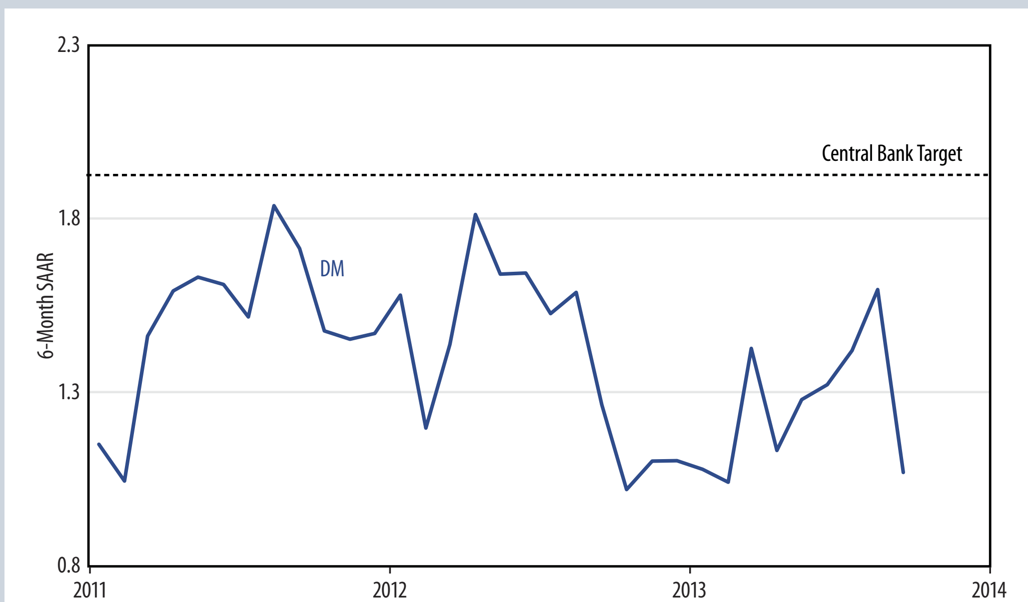
- Low and falling inflation is a worrisome global phenomenon. It is a potential warning sign for both corporate and top line revenues, and economic growth. We believe it will increase, but very slowly.
- Global central banks will need to stay exceptionally accommodative. This is a crucial component of the outlook for risk markets.
- We expect global growth to improve at a moderate pace in 2014. Even with the substantial compression in credit and sector spreads, we continue to maintain our overweight position.
- We think the continuation of spread compression toward long-term averages is very likely. This position, however, needs to be monitored closely.

Our position has generally emphasized overweights to credit and spread products, based on the view that a moderate US and global recovery combined with low inflation will lift these markets while keeping sovereign yields anchored. We expect growth to improve modestly next year, but we think the recent decline in inflation will keep monetary policy on a very accommodative footing. Even with the substantial compression in credit and sector spreads, we continue to maintain our overweight position.

After more than four years of recovery, arguably the most notable aspect of the expansion has been the absence of inflation. Monetary policy experimentation and accommodation have been attempted across the developed world on a scale never seen before. Pundits, policymakers and investors have predicted the seemingly inevitable inflationary fallout.

Still, despite ongoing recovery and more quantitative easing (QE) programs and their equivalents than anyone can remember, core global inflation in 2013 will record its lowest level since the crisis year of 2009, and headline inflation, while more volatile, is not really any higher. What's more, the softness in commodity prices and continued tepid wage growth suggest that this low-inflation trend will continue. Just as important, inflation remains below central bank targets across the developed market economies. (Exhibit 1)

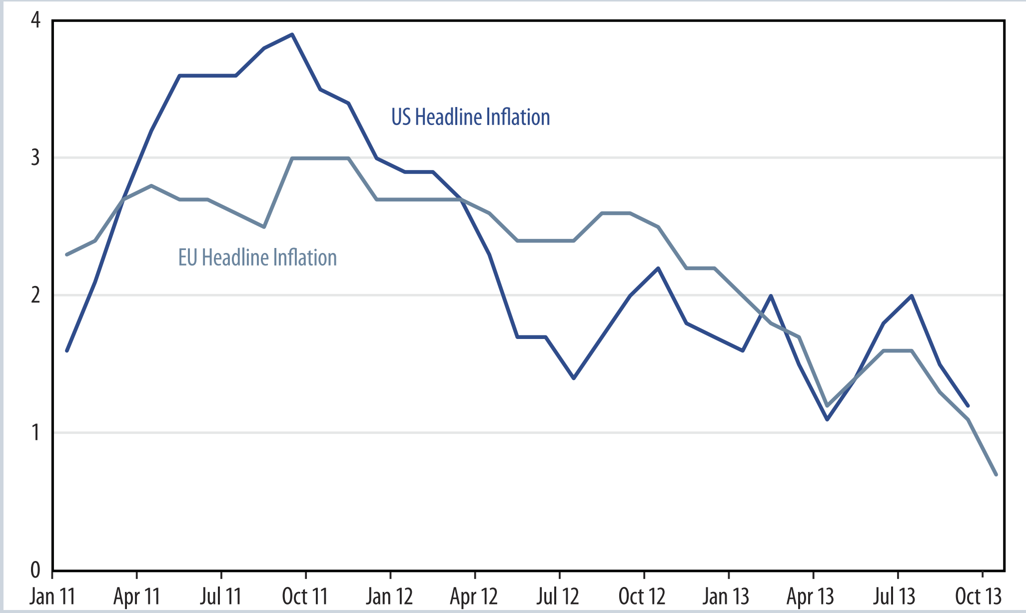
Exhibit 1



Source: JP Morgan. As of 30 Sep 13

Early this year there was concern that the Federal Reserve (Fed) might tolerate an inflation overshoot. Now the low level on headline and core inflation has led to discussion of the Fed adopting an inflation floor. In Europe the ECB has eased policy further as anxiety has risen over whether sharply falling inflation is masking evidence of declining demand. (Exhibit 2)

Exhibit 2



Source: BLS, EuroStat, Bloomberg. As of 31 Oct 13

Continued low inflation is a profoundly important fact for fixed-income investors. Fear of an imminent inflation breakout has kept many on the bond market sidelines in recent years, despite the brutal 0% alternatives available on short-term investments.

Fixed-income markets have rallied over the past two months, following summer fears of Fed "tapering." The Fed's pronouncement that it would be able to unwind its QE program as soon as the middle of 2014 was based on its expectation of GDP growth of just under 3% through the end of next year. Such a growth rate would bring the unemployment rate down, leading the unwinding of the asset purchase program implemented to achieve that goal. The markets' fear of such outcomes led to tightening projections in the forward markets, which we believed were unlikely to be realized.

In response to this market action, the Fed walked its projections of tapering back, to some extent, and it also emphasized its commitment to continued low rates even after its balance sheet expansion ends. Similarly, market and Fed expectations of growth have moderated on softer than expected economic data. These changes have brought yields somewhat lower and rewarded our extension of maturities. We would emphasize, however, that beneath the favorable recent swings in Fed talk and economic growth data, the continued softness in inflation has been an ongoing support for the bond markets.

One of the key questions is how and when the Fed might react with respect to the inflation rate. We have always believed in the sincerity of Fed Chairman Ben Bernanke's concern over the potential consequences of deflation and the necessity to truncate that risk. That is one of the reasons the markets were caught so off guard this spring when he argued that the low level of inflation was transitory. After rates rose substantially in response, Chairman Bernanke reversed himself and re-emphasized the twin objectives of the Fed: that even if growth becomes more satisfactory, inflation remain below target. This was meant to reassure markets that even after QE ends, monetary policy will stay very accommodative.

The Fed's forecast is for growth just under 3% for 2014 and for inflation to move back toward the 2% target. But what if the Fed misses its growth target? After all, it has consistently overestimated growth in recent years, with an average error of 1.5% over the last five years[1]. Similarly, what if inflation fails to move back up to target?

Former Fed Chairman Alan Greenspan confronted this problem in 2002. He was so startled by the inability of the Japanese to extricate themselves from deflation, he called for an "asymmetric" risk monetary policy: explicitly keeping the federal funds rate "too" low. His legacy may have been heavily tarnished by the housing boom which followed, but at the time, his concern was real and understandable. Chairman Bernanke has shared these types of concerns during his tenure, and the crisis has led him to extravagant monetary policy initiatives to forestall downside risks. Fed Vice Chair Janet Yellen has been the Fed's most successful forecaster during this period, and she more than anyone else at the Fed has been focused on downside risks to growth and inflation.

Low inflation is a global phenomenon. It is worrisome. We believe it will turn up, but very slowly. Global central banks' policies will need to stay exceptionally accommodative.

This is a crucial component of the outlook for risk markets. While growth has been modest and inflation low, the enormity of the policy accommodation has restored optimism that economic growth is on a more assured path to normalization. This combined with falling default rates across virtually all fixed-income spread sectors has lifted returns.

This landscape should continue to favor spread sectors. As value investors, we have tracked the rising prices for spread product and considered paring our positions, but we remain overweight. We think the continuation of spread compression toward long-term averages is very likely.

Our view is that the US and global recoveries will continue to improve, but at a moderate pace. This position, however, needs to be monitored closely. Low and falling inflation is a potential warning sign for both corporate top line revenues and economic growth. We intend to follow carefully both its path and that of policymakers' responses.

[1] *Federal Open Market Committee as of November 18, 2013.*