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Market Commentary

SEPTEMBER 2014

Two Out of Three Ain't Bad ~*Meat Loaf (1977)*

Executive Summary

- The global recovery is headed in the right direction but the pace of growth is sluggish and the outlook is clouded by uncertainties.
- Despite signs indicating that the Fed may raise rates sooner than initially expected, US bond rates have not responded much, largely because of the subdued global growth outlook.
- Fears of a potential European recession have been stoked by the recent downturn in core European economic data. The imposition of sanctions on Russia and the heightening tension surrounding Ukraine also threaten to dampen growth.
- Although slow growth in Europe is a chief concern, we believe proactive monetary policy from the ECB and sustained growth from other major economies will help maintain global economic expansion of 3%.
- We continue to believe the fundamental case for yield spreads is favorable. The combination of moderate-but-steady growth, further global monetary accommodation and high relative US yields support the case for tight credit spreads.

The global picture remains one of a forward-moving but uninspiring recovery. While the US economic recovery has improved, Europe's has faltered meaningfully, raising uncertainty in global financial markets. The overhang of geopolitical tensions in Ukraine and the Middle East also clouds the outlook. Fears of a hard landing in China have dissipated as growth has held up, but Asia and Latin America have seen less pick-up than had been anticipated. In this environment, global sovereign bond markets have rallied strongly. US yields have declined much less than most, leaving them among the highest of developed market nations (Exhibit 1).

Exhibit 1
10-Year Yields

Country	10-Year Yields (%)
US	2.36
Germany	0.91
Japan	0.49
Canada	2.00
UK	2.37
France	1.27
Italy	2.39
Sweden	1.42
Switzerland	0.43

Source: Bloomberg. As of 27 Aug 14

As we navigate investment strategies, it is hard for most of us to wrap our minds around the low levels of yields and the many years that they have prevailed. However, as low as US rates are, they pale in comparison to Germany's current sub-1% 10-year yield. This challenges a prevailing premise that US yields simply must go up, and therefore, portfolios must be short. This seems particularly compelling as the economy is in a multi-year recovery. Our view conforms to the rising rate thesis, but we expect the rise to be very gradual.

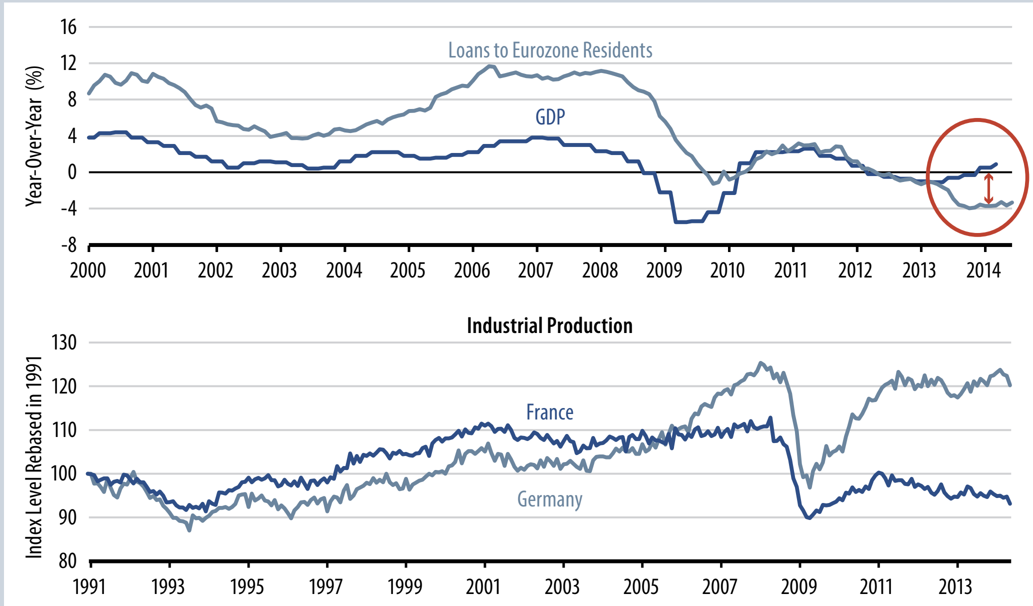
The recent announcement of 2Q14 GDP over 4% and the positive revisions to both 1Q14 and 2013, combined with the Federal Reserve's (Fed) forecast of sustained GDP growth above 3%, reintroduce the prospects for the long-awaited self-sustaining recovery. Additionally, the July Federal Open Market Committee minutes suggested that the Fed might raise rates sooner than previously expected. Yet US bond rates have been little changed, and the subdued global growth outlook (exacerbated by geopolitical considerations) is a major reason.

While we continue to believe the global economy is moving forward, our area of greatest concern is slow growth in Europe. The most recent challenges for the European Central Bank (ECB) are the slowdown in core European growth and the ongoing contraction of bank lending. Over the past several years, economic weakness in the European periphery has been offset by much better growth in the core. Now, the fear is that the core may also show economic weakness (Exhibit 2).

German growth expectations have dimmed, and the French growth rate also looks to be slowing noticeably. European banks have not de-leveraged anywhere nearly as meaningfully as US banks since the crisis, and the ongoing challenges of the periphery have exacerbated the strains on European banks' balance sheets. The ECB's move to negative interest rates combined with incentives is a carrot-and-stick approach to reinvigorate bank lending. We believe more accommodation will be forthcoming.

Fears of a potential European recession have been stoked by the recent downturn in core European economic data, particularly the negative 2Q14 GDP reading for Germany. The recent imposition of sanctions on Russia

Exhibit 2
European Growth is Slowing



Source: Bloomberg. As of 30 Jun 14

and the heightening tension surrounding Ukraine also threaten to dampen growth. We have maintained a very cautious view on European growth, but we expect a recession to be avoided. However, European integration and policy challenges have kept European growth under siege, and these issues will remain. ECB monetary policy must be very proactive if positive growth is to be maintained. We expect such policy action is on the horizon. In our view, the ECB may need to expand its current quantitative easing (QE) plans and find a method of directly purchasing government debt.

Fortunately, global growth is only partially dependent on Europe. The relatively low 3% global growth rate of recent years can be sustained with minimal growth in Europe, given moderate growth in the US, Asia and emerging markets. Recent data, while lackluster, are still supportive of this trend. Our view continues to be positive on global growth, albeit at this very subdued 3% rate. While global growth should be able to sustain the trend of recent years, such a backdrop is not suggestive of surging demand and rising inflation, or even sharply rising interest rates. Consequently, there has been an enormous rally in many global markets, intensifying the challenge for investors who need yield. The global rally underpins US rates, even in the face of a potential Fed tightening.

This backdrop also supports spread sectors. Many fear that credit spreads will come under pressure from Fed rate hikes as US growth strengthens. The argument that Fed liquidity helped drive spreads tighter implies that the removal of such liquidity would reverse the trend. This is especially concerning given the chances of a downshift in global growth. Indeed, as these fears mounted in recent weeks, yield spreads came under the most intense pressure of the year. Nonetheless, we continue to believe the fundamental case for yield spreads is favorable. Most importantly, current spread levels still imply a breakeven default rate high enough to provide an ample cushion against a slower-growth scenario that would avoid outright recession. The combination of steady if unspectacular growth, further global monetary accommodation, and high relative US yields also support the case for tight credit spreads. We added modestly to risk positions during the recent credit market weakness.

We are currently witnessing an extraordinary juncture in monetary policy: the Fed is potentially embarking on raising rates while the ECB institutes QE. The potential for a global growth shortfall is not lost on policymakers.

Our view is that the US economy will continue to grow at a moderate (2% to 2.5%) pace. Any pick-up in US growth to the Fed's more optimistic 3%+ forecast will have to be sustained for several quarters before the Fed would move rates up at a faster pace than is currently implied by the forward yield curve. The greatest risk to spread sectors is a diminution in growth, leading to reduced cash flows and higher probabilities of default. We think moderate US growth is conducive to improved spread sector performance. The risk to this fundamental backdrop—that would cause us to reevaluate—would be a substantial weakening in global conditions. However, we think policymakers on both sides of the Atlantic are very attentive to this risk.

The journey to interest rate normalization has been long and slow, and this will continue to be the case. The US and global recoveries are healing, but this process can continue to be characterized as two steps forward, one step back. Unfortunately for investors, this means watching both the forward and backward steps at the same time. The challenge for investors seeking yield is acute. We believe moderate overweights to the spread sectors, combined with opportunistic duration strategies that anticipate central bank course shifts present the best chance for success.