

Bond Market Observations

July/August 2014, Part II*, Global Investment Outlook

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Part I*, our Global Economic Outlook, was released in June 2014.

“When one admits that nothing is certain one must, I think, also add that some things are more nearly certain than others.”

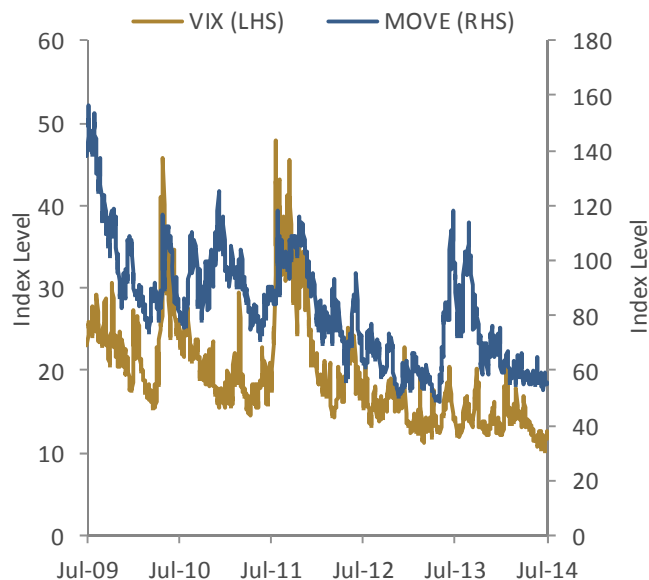
– Bertrand Russell

Executive Summary

- ▶ Risk assets got off to a strong start in 2014 and market volatility dropped near record lows by the end of the second quarter.
- ▶ However, heightened geopolitical risks and changing expectations for Fed policy increased volatility and reversed some of the gains at the beginning of the third quarter.
- ▶ Valuations in high yield and emerging markets have gotten cheaper, but the lack of a clear end game in Ukraine and Iraq poses the risk of further volatility.
- ▶ We believe these sectors will present opportunities to investors later this year as global economic growth prospects improve and key global hot spots settle into an unstable equilibrium.
- ▶ Investor focus will then likely shift back toward the Fed's exit and the timing of interest rate hikes.
- ▶ Historically, such policy shocks have tended to lead to temporary market dislocations that sometime present good buying opportunities.

Financial markets got off to a strong start in 2014. Indeed, both stock and bond market performance was positive during the first half of the year. The Barclay's Aggregate Bond Index returned 3.9% through the end of June, while the Standard & Poor's (S&P) 500 Stock Index had a total return of 7.1%. At the same time, measures of market volatility had fallen to cyclical lows. The Merrill Lynch Option Volatility Estimate (MOVE), a measure of Treasury market volatility, stood at around half its historical average. Likewise, the Chicago Board of Options Exchange S&P Volatility Index (VIX) dropped to its lowest levels ever.

MOVE and VIX Indices



Source: Merrill Lynch and the Chicago Board Options Exchange (CBOE) as of July 8, 2014

However, things began to change in late July and early August. Specifically, mixed U.S. economic data began to alter investors' expectations about the timing of the first interest rate hike by the Fed and geopolitical risks started to increase in Iraq and Russia/Ukraine. Consequently, volatility began to rise and risk assets began to sell-off. Indeed, the option adjusted spread for the Merrill Lynch U.S. High Yield Index rose from 3.4% in late June to 4.2% by early August before rallying back.

In our June Bond Market Observations, we cautioned that market valuations had become less attractive and that a correction in asset prices remained a risk. Consequently, we began trimming our exposure to investment grade credit, high yield and emerging market debt hoping that an increase in market volatility might create value in some of these sectors. We highlighted two potential triggers for an increase in volatility: heightened geopolitical risk or a policy shock. For now, with key global hot spots heating up and disappointing economic data, the focus is on the former. Yet, we expect this to change later this year as global economic growth prospects improve and we settle into an unstable equilibrium in Russia/Ukraine and Iraq. Investor focus will then likely shift back toward the Fed's exit and the timing of interest rate hike. Historically, such policy shocks have tended to lead to temporary market dislocations that sometimes present good buying opportunities.

Failing to Live Up to Expectations

For the fifth year running, the global economic expansion has failed to live up to investor expectations. In a recent speech, Fed Vice Chair Stanley Fisher noted, "Year after year we have had to explain from mid-year on why the global growth rate has been lower than predicted as little as two quarters back."ⁱ The recoveries in the developed economies, particularly Europe, have been below average. In the emerging markets, the early stages of the recovery were more in line with historical experience, but more recently growth has been disappointing in these economies as well.

At the same time, rising geopolitical risks in Russia/Ukraine and Iraq have increased concerns about future growth. In late July, the U.S. and Europe stepped up sanctions on Russia after the downing of a Malaysian Airlines flight by Russian supported rebels in Ukraine. This escalation heightened fears of a disruption in natural gas supplies to Western Europe during the upcoming winter months. Meanwhile, militant group ISIS (the Islamic State in Iraq and Syria) seized control of large sections of Northern Iraq raising concerns about oil production in the region.

However, these risks may be overstated in terms of their short-term economic impact. For example, Russia only represents about 3% of world GDP and the sanctions that have been imposed thus far are targeted at specific individuals and companies. Of course, there is always the possibility that Russia imposes an oil embargo against Western Europe, which could have more significant economic consequences, but this seems unlikely in the short-term since it would hasten Europe's diversification away from Russian natural gas exports. Furthermore, Ukraine and Russia seem to be making incremental progress toward a truce in recent peace talks in Germany.

Iraq probably poses even less of a risk to global growth in the short-term as U.S. involvement suggests ISIS is unlikely to make inroads into the major oil producing areas in the south of the country. Longer-term oil production may be affected by underinvestment in the sector, yet this should not result in sharply higher oil prices today. Therefore, our base case is that the Iraqi and Russian/Ukrainian situations will settle into an unstable equilibrium in the second half of this year. Both will have the potential to fuel bouts of volatility in financial markets, but neither is likely to derail the global economic expansion in the second half of this year.

Shifting the Focus Back to the Fed

Looking ahead, we expect to see a resynchronization of global growth in the second half with the United States and China leading the way. The Chinese government implemented target stimulus measures earlier in the year that are starting to filter through to the broader economy. These include a loosening of fiscal policies as well as a modest relaxation of monetary policy through cuts in the reserve requirements at some banks. In response, real GDP growth exceeded expectations by increasing 7.5% year-over-year in the second quarter of 2014. While the Chinese government is unlikely to lose sight of its longer term

structural reform goals, it seems they want to establish a floor under growth in the short-term.

Even more importantly, the U.S. economy rebounded sharply in the second quarter with real GDP increasing at an annualized rate of around 4% following a contraction of 2.1% in the first quarter. Although this growth figure was inflated by a build-up of inventories, a simultaneous bounce in capital equipment spending bodes well second half of 2014. In addition, nonfarm payroll employment has been averaging in excess of 240,000 jobs per month over the past six months, which is the best performance since 2006.

As a result, we expect the unemployment rate to reach the upper end of the Fed's longer-run forecast range between 5.2% and 5.5% by early 2015. The improving labor market should begin to translate into faster wage growth in the coming months, which is likely to help the Fed achieve its other goal of 2% inflation. Despite our economic view, we do not expect Fed Chair Janet Yellen to deviate from her message that there is ample slack in the labor market and that interest rates need to remain low for longer. However, we believe Ms. Yellen's dovish stance will contribute to expectations of higher future inflation, shifting investor focus back toward the timing of the first interest rate hike once the central bank ends its quantitative easing program (QE) later this year.

Shocks and Opportunities

Historically, periods of heightened geopolitical risks and/or policy shocks have coincided with bouts of financial market volatility. For example, both the Asian Financial Crisis in 1996/97 and the Fed tightening cycle between 2004 and 2006 led to spikes in market volatility and this weighed on market performance. While it is common for investors to get nervous and sell in the face of these shocks, in retrospect, our analysis suggests they can sometimes present good buying opportunities¹. Indeed, over the past two decades, we found that investors who bought the JP Morgan EMBI Global or the Barclays High Yield Bond Index during spikes in volatility on average ended up with a positive total return six months later. However, the results were not uniform with investors in both asset classes suffering negative total returns for more than six months after the surprise Fed tightening in 1994.

In assessing whether recent events will present buying opportunities, it is important to determine how persistent the shock will be and whether asset valuations are at attractive enough levels to compensate investors for the risk. Despite the recent modest increase in risk premiums, most spread sectors including U.S. and European investment grade remain somewhat overvalued. We believe that there is still too much uncertainty in our near-term outlook to justify aggressively allocating to credit risk exposure in multi-sector fixed income strategies. However, parts of the high yield market have cheapened up sufficiently such that we are selectively looking at companies that fit our long term view. Earnings for high yield issuers were up approximately 10% in the first quarter and

¹ We define shocks as +2 standard deviation moves from long term average in the monthly percentage change time series of S&P VIX Volatility Index.

second quarter results are comfortably tracking ahead of last year. In addition, balance sheet leverage has stabilized slightly below its long term average and defaults remain at 1.9% according to Moody's Investor Service.

Valuations in emerging market debt are more compelling, particularly in Latin America and Asia. Emerging market dollar debt is trading at a spread of around 315 basis points to U.S. Treasuries and local currency debt has a yield of roughly 6.6% as of mid-August. However, we worry about the vulnerability of the sector to the eventual tightening of Fed policy despite the improvement in market technicals following the sell-off that occurred in the spring of 2013 when talk of tapering QE first arose.

U.S. Treasuries continue to be one of the most overvalued sectors of the bond market based on economic fundamentals. Nevertheless, we are conscious of the fact that geopolitical risks remain high and the Fed remains a very large player in the market. Therefore, we have looked for other ways to express our short duration bias including through Treasury Inflation Protected Securities (TIPS), which are less likely to benefit from the flight to safety bid and should do well in an environment of rising inflation expectations.

We believe that the low volatility environment is unlikely to persist as the Fed continues to reduce accommodation and this has important implications for portfolio strategy. First, we have concerns about the agency mortgage backed security (MBS) market. MBS spreads remain tighter than historical levels and any rise in volatility will likely hurt MBS performance. Fed purchases are expected to slow from 80% of gross supply in the first quarter to 25% of gross supply later this year. Moreover, demand for MBS remains tepid as banks have not added as much this year and investors have little interest in the sector. Second, low volatility means that the cost of adding convexity to portfolios through contingent strategies in interest rate option markets is extremely low. This allows us to hedge the negative impact of potential changes in interest rates very cheaply.

The commercial mortgage backed security (CMBS) market has gotten cheaper recently due to the mixed U.S. economic data and weaker underwriting. Yet, we believe improving job growth and a lack of new construction should be supportive of the sector. CMBS also appears attractive relative to corporates and other asset backed securities. Therefore, we are looking through the current volatility and expect spreads to tighten over the medium term.

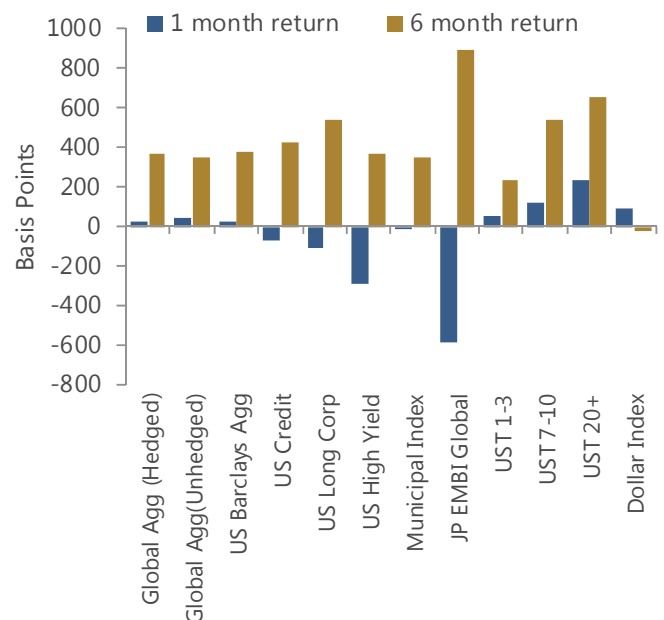
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Overall, we are keeping some powder dry to take advantage of new opportunities that may emerge in the fixed income markets as we work through periods of volatility associated with geopolitical risks and changing expectations for monetary policy. Although some of the spread sectors mentioned above have cheapened up during the recent bout of volatility, we remain cautious about allocating too much of our risk budget to these sectors at the current time given the lack of clarity about how long some of the shocks may persist. Nevertheless, we believe the improving global growth outlook should benefit the performance of some of these sectors during the second half of the year.

**Total Return Following a Shock
(2 Standard Deviation Move in the S&P VIX Volatility Index)**



Source : Barclays Point as of July 2014

ⁱ Stanley Fisher. "The Great Recession--Moving Ahead," a Conference Sponsored by the Swedish Ministry of Finance, Stockholm, Sweden. August 11, 2014.