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CAPITAL MANAGEMENT

"It is a Riddle, Wrapped in a Mystery, Inside an Enigma: but Perhaps There is a Key"
Fixed Income Outlook
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While Winston Churchill's quote above referred to Russia on the eve of World War II, it can also explain investors' current thoughts about the markets. There seems to be little conviction about the future growth of the economy, the direction of interest rates, the shape of the yield curve and where asset prices will go in the coming months and years. Additionally, the economic data at times seem to be quite contradictory as to what would switch markets into a "risk on" or "risk off" mode. Past correlations, whether real or imagined, seem to be less of a guidepost today. Whether you are a passive allocator, relative value swapper, fundamental stock picker, macro focused or anything in between, recent market moves have made investing difficult, especially when benchmarked against the economic backdrop. It may be instructional to take a step back and try to create a mosaic from what we know versus what we think we know or may accept as fact. What do we know for certain? The past is usually a safe place to begin and although it is not prologue to the future, it can be helpful in gathering one's thoughts.

It has become a pretty standard meme that "risk on" and "risk off" assets should not have synchronous performance, but rather should counterbalance each other. What we mean by that is that if equities are rising in price, this typically means that demand for "safe" assets such as Treasuries or gold should diminish. In times of stress, we have indeed seen investors head for the exits and seek out the perceived safety of these haven assets. That said, so far this year, the behavior of "safe" haven versus "risk on" assets is not dissimilar, causing some head scratching. What does this mean for the future? If we examine them one by one, maybe we can gain some insight.

First, the equity market, as measured by the S&P 500 Index (the "S&P 500"), returned 9.3% this year through June 30. For the past 15 years, this level of performance for the first half of a year has only been bested three times (in 2003, 2012 and 2013). That's not too shabby given we are in a low growth, low inflation world where economic expectations have been muted by our government's inability to pass any meaningful fiscal stimulus measures. If we compare the first half performance of the S&P 500 in each of the past 30 years to its corresponding full year's performance, we find that the second half performance was negative only eight times. In four of those, the first half was also negative and was followed by additional losses. We're sure the statisticians among you can put a finer point on it, but by our simple reckoning, if historical norms hold, there is about a 1 in 10 chance of experiencing negative second half performance in the S&P 500 this year. In fact, there have only been five negative return years in the past 30 for the S&P 500 and all of them were clearly accompanied by unequivocal economic turbulence or asset bubble deflations: 1990, 2000, 2001, 2002 and 2008. While the past is not necessarily prologue (our apologies to Shakespeare), it does seem to favor continued positive equity performance.

Next, high yield performance year-to-date has also been positive. In our January 2017 Outlook we examined the return probabilities for the high yield market and observed that for the past 30 years, each time the market had a negative return year, the following year's return was greater than 10% in all but one instance (2000). Additionally, in four of the five instances when that happened, the subsequent year's return was also greater than 10%. With that in mind, we did not think it was a stretch for 2017 to be another good year. So far this year, the BofA Merrill Lynch U.S. High Yield Index has returned 4.9% while the BofA Merrill Lynch 1-3 Year U.S. Cash Pay High Yield Index has returned 4.1%. Not a bad start to the year.

Let's move on to interest rates and Treasuries. So far this year, despite the Federal Reserve's (the "Fed's") two hikes in the target federal funds rate totaling 0.50% (50 basis points), the underlying rates on the 5-, 10- and 30-year Treasury bonds have only moved 4, 14 and 23 basis points, respectively. The return on each of those bonds for the first half of 2017 was 1.2%, 2.1% and 5.5%, respectively. Without dwelling on the philosophical implications of the term premium and what the flatting of the curve portends for the future economy, one can see that the Treasury markets are behaving rationally; the more risk you took, the higher the return.

Gold, seen as a "safe haven" asset by some, is also participating in the rally and has increased in price by 7.8% year-to-date in U.S. dollar terms. The confusion lies in the question: If "risk on" assets are performing well, then why are "safe haven" assets also performing well? Enigmatic indeed.

Markets are up and the economy is still expanding, albeit slowly, so why are we non-plussed? Perhaps we should look beyond our borders for the answer; and we're not referring to divine intervention here. What do all of these assets have in common? They are all U.S. dollar denominated. Perhaps we should examine the supply-demand dynamic for dollars to solve this enigma. There are currently some large demand streams that we know about for dollars and likely many more that are not as evident. One is asset flows out of Asia and other countries to the U.S. We've all heard the stories about the exodus of Chinese wealth to our shores; that is only part of the story. Since the Chinese economy has somewhat stabilized following the People's Bank of China's stimulus last year, trade surpluses have begun growing again. Reserves peaked in 2014 at $4 trillion and are now slightly above $3 trillion and growing again, which means they are once again buying Treasuries. We'll keep an eye on this as it is an important incremental demand factor for U.S. Treasuries and a slight headwind to curve-steepening. The Swiss National Bank (SNB) is another curious case of dollar asset demand. In a recent missive, John Mauldin points out that because Switzerland is a well-run country with little debt, increased demand for holding Swiss francs has wreaked havoc on their exchange rate, thereby hurting exports. Since 2000, the Swiss franc has doubled in value versus the U.S. dollar. To combat this, the SNB has printed money to buy U.S. dollars and euros, even going so far as to have a negative 0.75% deposit rate. They are also printing money to buy U.S. equities. Yes, that is correct; printing money to buy stocks. According to Mauldin, they currently own about $80 billion dollars of U.S. equities and he guesses they also hold about $20 billion of European stocks. That would make them the eighth largest public holder of U.S. equities. These are not the only examples of non-traditional buyers of U.S. dollar based assets, but are indicative of the impact that currency and trade can have on U.S. asset prices. While each of these alone does not fully explain the concomitant rise in U.S. asset prices, taken as a whole they could perhaps be a causal factor. This bears close monitoring.

Inflation is also at the forefront of people's thinking when it comes to the Fed's normalization and economic policy. While we have seen a gradual increase in the core inflation rate globally, the pace of change has been glacial and has most recently ebbed. There seem to be differing opinions on whether we really want higher inflation or not. Those who wish to see faster interest rate normalization by the Fed lament the recent loss of momentum in core Consumer Price Index (CPI). This is a narrow view. Charles Dumas of Lombard Street Research recently opined that inflation targeting is folly and that to want inflation is to disregard one of the main functions of money, namely as a store of value. He points out that true growth means falling prices relative to income growth, and gives as examples the late 19th century U.S. and British economies (which we wrote about) and the post Korean war period in the U.S. He posits that inflation targeting may be misguided and has resulted in a massive misallocation of resources both here, in Japan and in Europe. We tend to agree with him. After over 20 years and countless trillion of yen, the Bank of Japan has barely moved the needle on inflation or growth, yet they are now calling it a success. Could this be their way of elegantly allowing themselves to stop the madness? Measuring inflation is a less-than-scientific endeavor. The Bureau of Labor Statistics tries to measure a basket of goods and services that make up the CPI but it is far from a perfect proxy for consumers' actual experience, which is what actually drives spending behavior. Traditional economic thinking believes that when we reach full employment, then wages rise and inflation soon follows. To date, we have seen employment levels that should be driving wage growth, but so far it has been anemic at best. Without expounding on the productivity conundrum here, let us agree that perhaps we are using the wrong measure of full employment. As is typical with economic cycles, we usually know retrospectively when inflection points have been reached and we believe it will be the same here.

Tactically, where does that leave us today when approaching this market? It is not as much a riddle as initially thought. Ellen Zentner at Morgan Stanley best captured the essence of this expansion when she described it as "aging gracefully." Obviously there have been ebbs and flows but generally speaking we have a stronger global backdrop, have slain the deflationary dragon and monetary policy in the U.S. is beginning its slow but steady path to normalization. In Europe we are beginning to shift the discussion from accommodation to normalization but would not expect that to happen overtly any time soon. In sum: steady as she goes.

In this slow growth, low inflation environment, we prefer economic sensitivity to interest rate sensitivity. We favor shorter duration and continue to add convertible exposure when we find compelling value, either in busted, bond-like issues or in converts underlying attractive companies where we are getting paid a fair interest rate and have an option to participate in that company's future growth. We still like the absolute yields in the shorter end of the high yield market and given that it has been 15 months since the end of the last correction, we are maintaining an above normal cash position to allow for buying during the next one.

As always, we thank you for your continued trust and welcome any questions and comments you may have.

Sincerely,

Carl Kaufman | Bradley Kane | Craig Manchuck

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It is not possible to invest directly in an index.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The BofA Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The BofA Merrill Lynch 1-3 Year U.S. Cash Pay High Yield Index is a subset of the BofA ML U.S. Cash Pay High Yield Index including all securities with a remaining term to final maturity less than 3 years. The Bank of America Merrill Lynch U.S. Cash Pay High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly issued in the U.S. domestic market.

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

A basis point is a unit that is equal to 1/100th of 1%.

Core Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services excluding food and energy.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.
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