FOR SUCCESSFUL ASSET ALLOCATION TODAY, FOCUS ON THE FEW THINGS THAT REALLY MATTER

JULY / AUGUST 2013

Highlights

- In the US, we think four thematic pillars form the basis of economic recovery, of policy trajectory, and of prospective asset class return potential, they are: housing, energy, labor, and lending.
- The factors that we believe are vital to supporting economic growth, and that guide monetary policy, are regionally differentiated, so we look at what really matters for Europe, China, and Japan.
- Finally, we believe a variety of economic and market technical factors are likely to keep interest rates capped in the shorter-run, providing a set of investment opportunities, but rates could drift modestly higher as the year comes to a close.

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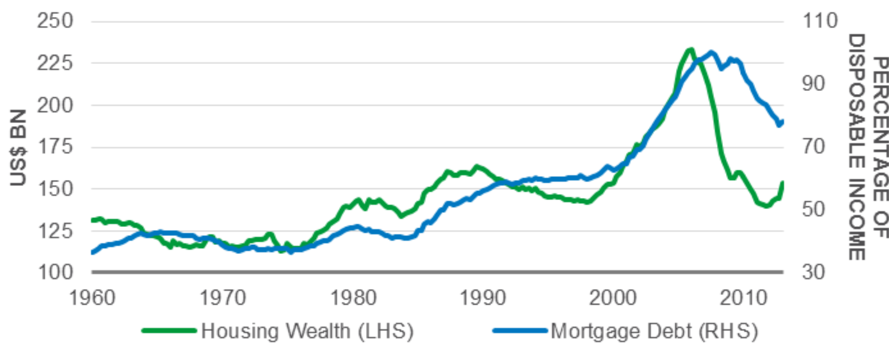
In the near three-decade-long period that we've closely followed financial market dynamics, one of the many lessons learned is the idea that markets, generally speaking, appear to focus on one thing at any given time (or perhaps a couple, at most). Thus, it is not entirely surprising when we see higher risk premia awarded to those market areas that hold greater degrees of uncertainty and complexity, and conversely, it makes sense that in the markets in which it is easier to discern the impact of relevant economic and financial trajectories, lower levels of risk premia tend to take hold. In today's environment, we think successfully investing across the globe, across asset classes, and across segments of the capital structure is partly a function of understanding these axioms. Today, these concepts also hold from the standpoint of investing across distinct geographic domiciles, and therefore we believe there are a few key factors in the United States, in Europe, in Japan, and in China that are vital to consider for understanding how each of those economies and markets is likely to perform, and for judging the distinct risks embedded in them. As a result, we will examine the primary economic drivers that matter most in each region, how they might impact monetary policy, and what implications they hold for capital allocation.

Figure 1: US HOUSING WEALTH INCREASES, WHILE MORTGAGE DEBT DECLINES



Source: Bank of America Merrill Lynch Global Research, Federal Reserve

The views expressed are those of Rick Rieder, Chief Investment Officer of Fixed Income, Fundamental Portfolios as of July 2013 and may change as subsequent conditions vary.

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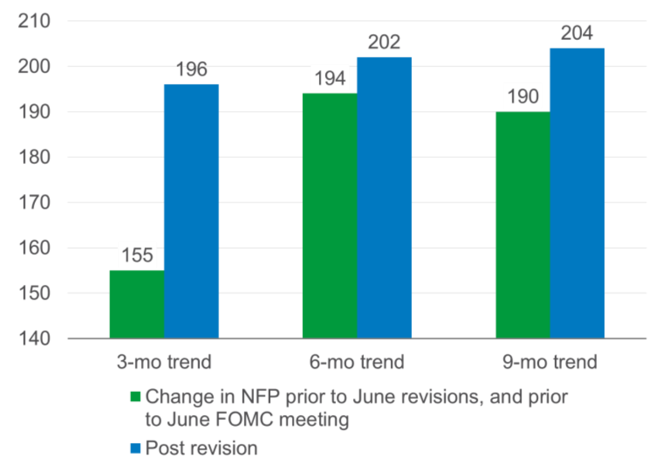
The Four Pillars of US Economic Recovery: Housing, Energy, Labor and Lending

We identify four pillars on which we believe the US economic recovery is relying, and they are: the rebound in housing, the energy revolution, cyclical improvement in labor markets, and supportive lending and financial market conditions. We shall look at each factor in turn. Much has been made of the fact that Fed quantitative easing has strongly supported financial asset prices over the past couple of years, primarily benefitting the owners of such assets, which tend to be high-income/wealth cohorts. Indeed, when looking at the drivers of changing net worth in the US from the first quarters of 2008 to 2013, the vast majority of net worth gains (near 90%) were made from increased equity markets, and other financial asset prices, and a modest portion from rebounding real estate prices. Of course, the Fed has been purposely engineering this “wealth effect” in order to support consumer spending, and therefore our highly consumer-driven economy. Yet with the value of residential real estate finally showing meaningful gains, and as mortgage debt is reduced, the vast amount of middle-income households may now begin participating in this advance in net worth (see Figure 1).

Thus, it is vital for the Fed to make sure higher mortgage rates do not hamper this rebound. Encouragingly, home price affordability remains high relative to its history, despite the recent spike in mortgage rates. Also, consumer home-price expectation and purchase survey data suggest that many potential buyers may move sooner rather than wait, as home prices are rising, yet are still expected to rise further. Therefore, it is not surprising to see that pending home sales spiked as mortgage rates rose, and as long as mortgage-lending standards continue to show signs of easing, this trend may continue. Of course, housing data has not been uniformly positive, as June witnessed weaker-than-consensus housing starts, but this may be an aberration due to idiosyncratic weather-related factors.

While a good deal of attention has been devoted to the second pillar of economic recovery that we identify, the revolution underway in the US energy sector, and particularly the development of new technologies for extracting natural gas and oil, the overarching economic impact of these changes remains underappreciated in our view. Indeed, annual imports of crude oil have fallen $400 billion since 2008, helping to improve the country’s trade deficit, and helping to create a dynamic in which the US dollar can remain strong while keeping inflation moderate and less volatile. So while the USD has already witnessed considerable gains since bottoming in 2011, we believe in this environment further gains in the trade-weighted dollar are possible (perhaps as much as 6%) should QE wind down in the next year. Near-term, however, relatively dovish language from the Fed, intended to reassure markets, is likely to elicit a pause in the dollar’s move higher. Moreover, despite some hand wringing over the near-term price volatility of oil, at the retail level the share of retail sales that gasoline represents has been trending down in recent years, and the seasonal run up in gas prices heading into the summer driving season was much more muted in 2013 than the average increase over the past decade. Moderating levels of inflation are not merely a US phenomenon, and in fact there has been a downtrend in inflation measures globally over the past two years, largely driven by food and fuel price declines. This fact should continue to allow central banks considerable freedom in maintaining monetary accommodation, as they can look past near-term inflation volatility in the effort to support economic recovery.

Figure 2: CHANGES TO NON-FARM PAYROLL DATA, PRE-/POST-REVISIONS (IN ‘000S OF JOBS)



Source: Bureau of Labor Statistics; monthly trends ended June 30, 2013, data as of July 5, 2013.

The US labor market recovery has been slow and uneven, to say the least, but there are some areas of improvement that the Fed can point to. For example, in recent months upward revisions in non-farm payroll numbers have meaningfully strengthened the average pace of jobs growth this year (see Figure 2). Moreover, outside those sectors that we have called ‘structurally-impaired’ in the past (such as construction, financial services, and government), the job gains have generally been on par with those of past cycles. This is partly why it is vital for the Fed to not allow rising mortgage rates, or financial market instability, to cut short the recovery in housing, since as construction improves, further job gains could be seen in that sector. As it stands today, the vast bulk of added jobs in recent months have instead come in the areas of professional and business services, leisure and hospitality, and retail trade, while sectors most impaired by the financial crisis and ensuing recession have remained weak.

Further, we suspect that as employment recovers the labor participation rate may stabilize, or even improve somewhat, which would have the effect of keeping the unemployment

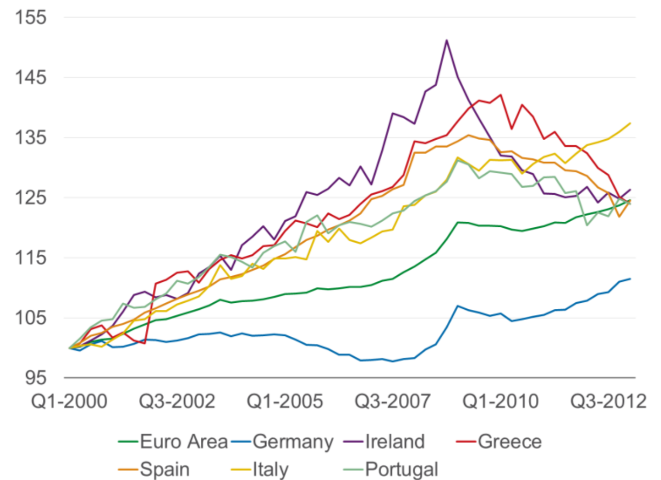
rate (7.6%) high for some time. Moreover, it is important to note that Chairman Bernanke has clearly indicated that the Fed's 6.5% unemployment target should be viewed as a "threshold" and not a simple trigger for judging the likelihood of future monetary policy actions. Ultimately, we believe that the Fed will increasingly come define slack in the labor force more broadly, rather than overly focusing on the unemployment rate, as the target they seek to influence. Still, this suggests to us that policy should remain highly accommodative for a considerable period of time yet, even as the Fed considers beginning the tapering of its QE program, perhaps as early as September. The maintenance of easy policy is particularly key, as our fourth economic pillar, lending growth, appears to have stagnated this year. For example, commercial and industrial loan growth has slowed to a near 6% rate in 2013, from last year's range of 10% to 14%. Also, we believe both recent and impending banking sector capital restrictions may curtail loan growth, alongside moderating economic growth, so low policy rates are likely to be appropriate for some time.

Economic Fortunes Diverge Across the Globe: A Look at Europe, China, and Japan

Given the backdrop for our four pillars of US economic recovery, minimal inflation, and the likelihood of Fed QE tapering later this year, we think the economic trajectory of the US is relatively clear versus other parts of the world. That is to say, we are likely to see real US GDP growth around the 2% mark, with a slow labor market recovery given the structural headwinds facing impaired sectors of the economy. As a result, policy should remain highly accommodative in the US, and ironically, we are likely to see the Fed taper of QE coincide with downward revisions in its real GDP growth forecasts. That is partly due to the fact that the Fed's central tendency economic projections have chronically overstated real growth potential, and often have had to be revised downward. Our rationale for believing that QE tapering can begin to take place has more to do with the fact that net issuance of US Treasuries is expected to decline meaningfully over the next year, so Fed purchases can decline alongside this trend without upending markets.

Much of the rest of the world has a more complex and uncertain set of realities to contend with (and for markets to attempt to anticipate) and Europe is clearly a hard case in this regard. The region's sovereign debt and banking crisis, alongside austerity measures and a burdensome regulatory framework have resulted in a significant deterioration in the Eurozone's economic competitiveness. For example, even with the recent surprise improvement in Spain's unemployment data (the first decline in two years), the unemployment rate there still resides at more than 26%. With Spain's labor force at roughly 23 million people, it is astounding that nearly 6 million individuals are without a job, and half of them have not worked in more than a year. One of the great challenges for the Spanish economy, and indeed for all the Eurozone's peripheral economies, is to navigate a reduction in nominal unit labor costs to the point where labor markets are more competitive and meaningful improvement in unemployment can take place (see Figure 3).

Figure 3: EUROZONE NOMINAL UNIT LABOR COSTS NEED TO BECOME COMPETITIVE
(2000-2013, Q1-2000 = 100)



Source: Citigroup Markets Research

Keeping in mind our broad theme that each geographic region has a few particular factors that matter most for the trajectory of economies/markets in that domicile, we believe that for Europe the vital elements are resolution of the fiscal growth versus austerity debates, as well as bank capital and lending improvement. One curious aspect of the Eurozone's current recession is the extent to which core consumer price levels have held up, but when one investigates some of the reasons, the fact becomes less encouraging. Specifically, a key contributor to relatively elevated core Consumer Price Index levels in Europe has been a rise in consumer taxes linked to austerity measures, not the abatement of deflationary pressures per se. For example, both Spain and Italy have increased their value added taxes to 21%, from 18% and 20%, respectively, and Germany's VAT rose by nearly a fifth to settle at 19%. Those tax increases all figure into core price inflation, and arguably they may end up reducing consumption and therefore hamper growth prospects as well. Moreover, Eurozone bank lending to households and non-financial corporations has been meager to declining for more than a year now, with peripheral countries witnessing more than a 10% decline in lending activity in aggregate since June 2010.

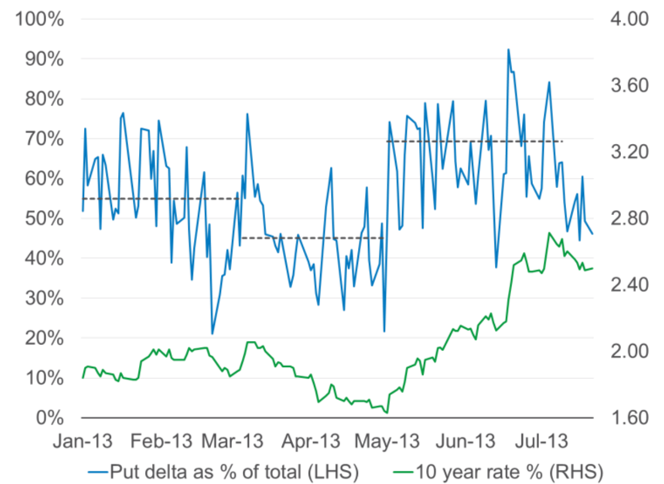
Despite the challenged economic prospects for the Eurozone, there are some tentative signs of improvement, and if the region can strike the right balance between growth policies and austerity measures, while simultaneously opening up the banking sector's credit creation channels, genuine gains might eventually be forthcoming. Still, from an investment perspective, it's important to note that Europe is one of those market regions where risk-premia remain wide and where problems may be adequately priced into markets, in our estimation. As a result, we believe that selectively chosen European high-yield bonds, certain parts of the regions' equity markets and short-end peripheral sovereigns hold value today. That is particularly the case if, as we suspect, the European Central Bank's relaxation of capital rules portends greater policy accommodation down the road, supporting the aforementioned markets.

Of course, to invest in Europe, much of the developing world, or even in the US manufacturing sector, a primary assumption that must be dealt with is the pace of slowing in China's economic growth (which could drop to 6.5%, but not appreciably lower in our view). Indeed, while the past decade has seen a doubling in China's share of global GDP to roughly 11.5%, and the country today accounts for nearly 60% of GDP (both in nominal USD terms) in the Asia ex-Japan region, it is also the most complex and difficult economy in the world to adequately analyze. Demand from China has clearly turned down, and vitally, credit growth (particularly outside the regulated banking system) is now being constrained. That is likely the result of a proactive attempt on behalf of China's leadership to moderate what is seen as excessive lending in certain segments of the economy, but clearly it is having an impact on growth. Added to this, we believe China's growth is particularly important to the European recovery. Finally, in the case of Japan, the principal driver of short- to intermediate-term economic gains and market returns is straightforward: investors need to focus on the progress of Prime Minister Abe's "Three Arrows" policy. The recent Liberal Democratic Party election victory appears to place Abe's policy on a path toward implementation, and since it was announced, Japanese business survey sentiment has spiked higher, private consumption has improved, and of course, Japanese equities have led the world in performance. While Japan's well-known long-term challenges remain firmly in place, shorter-term, the economy is more positively situated than it has been in decades.

The Path of Monetary Policy, Market Stability, and Investment Implications

In all the domiciles we have examined, the vital economic drivers identified all hold a common thread regarding their potential impact on monetary policy, which in turn holds profound implications for asset markets in those regions. Thus, in the US, when the Fed stepped up conversation about the possible reduction of QE asset purchases later in the year, the market response was dramatic. After performing strongly for the past decade, and serving as a bulwark to investor portfolios through the financial crisis, May and June saw damaging losses in the bond market as rates moved higher before stabilizing.

Figure 4: US TREASURY OPTION PUT DELTA INDICATES A RISE IN RATE RISK HEDGING



Source: Credit Suisse

A roughly 100 basis point rise in rates at the 10-year part of the yield curve sent rate volatility spiking higher and produced meaningful losses across fixed income sectors as well as other asset classes. It also illustrated perfectly, however, the risks embedded in generalized bond market exposures (such as those tethered to the Barclays US Aggregate Bond Index) that we have warned of for many months, and it underscored the value of a more flexible and opportunistic approach to fixed income. Indeed, the duration on the Barclays Index has approached 5.5 years, its highest level in decades, which continues to place investors at risk since rates may yet move higher in the medium-term as the Fed starts tapering QE. We could imagine the current yield on the 10-Year Treasury drifting closer to 3% over the coming several months, as the market further adjusts to the reality of QE tapering, comes to accept that tapering is distinct from the policy rate tool (which remains, in our view, pegged near zero for more than two years), and weighs the potential candidates for the next Fed Chairman. In this context, if we assume that bond markets (using the Barclays index as a proxy) return to long-run average volatility levels and that the index reverts to normal return distribution patterns, the probability of a yearly loss on bonds is still near 25% today (from a historic average level of less than 10%), even with higher starting yields.

Still, we believe that Chairman Bernanke's recent communication to markets, as well as our sense that asset flows out of fixed income may stabilize in the near-term, should hold down the extreme levels of rate volatility witnessed recently. Moreover, there are some market

technical factors that we believe should help keep a ceiling on Treasury rates near-term and help keep rates reasonably range-bound until later in the year, we think. The factors are ascribable to positioning that many institutions have taken recently in their portfolios, to hedge a degree of interest-rate risk, as put delta accounted for near 69% of total delta on US Treasury options since the sell-off began in May (see Figure 4). Additionally, rate volatility has already retraced more than half its recent move higher, and cross-market volatility gauges that rose in May and June have also moderated. In the current environment, we think these short- to intermediate-term technical dynamics, alongside our broader economic views, lend themselves to investing in assets that provide decent carry-trade opportunities (such as select US, European and Asia-region high yield), assets that have lagged other sectors this year (such as commercial mortgage-backed securities and Agency mortgage-backed issues), and assets that benefit from relatively more attractive valuations and lower degrees of left-tail risk (such as some equity-type exposures).

When assessing a probabilistic matrix of outcomes regarding both US growth prospects and monetary policy surrounding the timing of QE tapering, we can judge the potential for various asset classes' performance in the coming months. Thus, along one axis we consider the possible changes in monetary policy relating to the timing of QE tapering: either that the Fed begins to taper QE in late-2013, or it maintains its full $85 billion/month in asset purchases. Then, along the other axis, we hypothesize that economic growth in the US will either improve modestly from its current trajectory, or it could deteriorate from here (it is unusual for economic growth to merely remain at a flat trajectory for an extended period). Under this matrix of assumptions, our base case with the highest degree of probability (55% likely in our estimation), is that economic growth strengthens from here and the Fed begins its QE tapering later in 2013 (probably in September). We place very low odds (5%) on the outcome that would be most advantageous for risk assets, which is improving economic growth alongside no taper in QE, as the dynamics of policy opinion at the Fed would make that a very difficult path. The final two possible outcomes; that growth deteriorates from here, with Fed QE tapering later this year, and without such a change in policy, each receive a 20% chance of occurring. For the purposes of this exercise, we also place less emphasis on the extent of asset class movements and focus more on the direction of those moves.

Ultimately, the analysis suggests to us that over the next few months, equity markets have an 80% likelihood of being flat-to-higher, while nominal interest rates have a better-than-even chance of drifting modestly higher, with real rates remaining flat-to-lower.

This is precisely the kind of investment regime in which carry in higher-yielding debt will work for investors, and value can be found selectively in the equity slice of given capital structures. In this context, benefits accrue to those who are looking to generate income and match liabilities in fixed income, but it accrues even more powerfully to those that seek to take advantage of selective opportunities in risks at the lowest part of the capital structure. We think that the still powerful economic principles to be found in the models of Robert Merton, Fischer Black, and Myron Scholes hold lessons for investors today. As a result, we believe that many market participants overly focus on earnings and growth metrics when assessing firm valuation today, ignoring that fact that the value of the cash-flow that accrues to the equity-holder has historically, and will be, extraordinarily enhanced by the size of the debt claim being reduced, the cost of that claim being lower, and the value of the embedded option that is enhanced by the natural extension of the time value of the option (in other words, by the debt being pushed further out.) Over the past decade (ending in the first quarter of 2013), we have seen earnings per-share and book value per-share for corporations in the SPX grow substantially, while per-share net debt has plunged 58%, according to recent JP Morgan market research and Bloomberg data. Moreover, Bloomberg data reveals that the average US corporate credit maturity profile has extended from near 5.5 years at the start of 2009 to 7.75 years today, or by 40% over the period, illustrating a powerful dynamic that we think should redound to the benefit of equity investors.

In the end, as we have argued, monetary policy across the globe is likely to stay easy for some time, but it is evolving very differently across domiciles, with varying degrees of policy certainty regarding both commitment and implementation. It is therefore vitally important for investors to focus on those factors that truly matter for policy reaction functions, which we have tried to elaborate extensively upon. As policy trajectories evolve this year, and as open questions (such as the identity of the next Fed Chairman) are answered, we shall see whether this investment regime holds, and whether the factors we deemed to truly matter to markets were the ones that really mattered.

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