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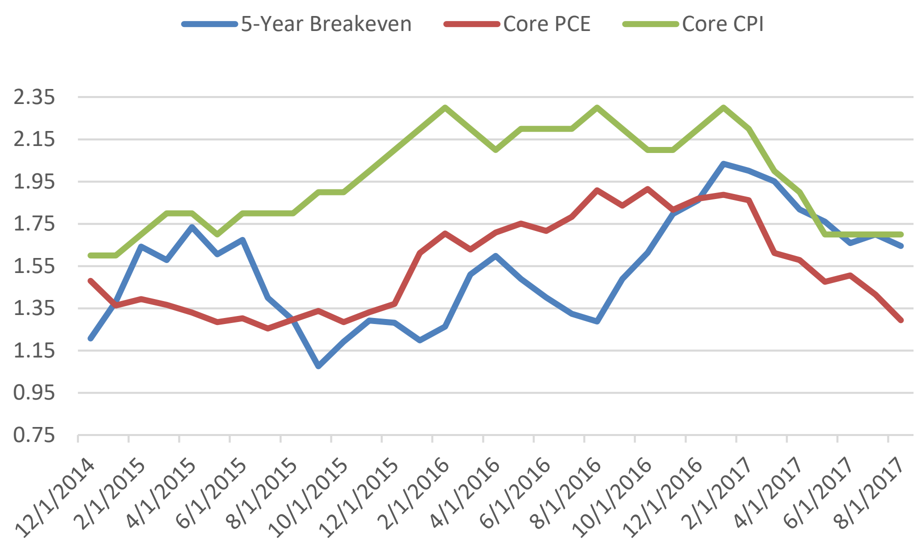
MARKET Commentary

Conventional Policy for Unconventional Times

Fall 2017

Market sentiment shifted markedly during the quarter. Evolving monetary policy expectations coupled with possible fiscal policy stimulus spurred risk asset prices higher. Yields bounced off of year-to-date lows and futures rose from just a 25% probability of a December hike to around 80%. Weaker inflation data (see Figure 1) had convinced investors that the Federal Reserve (Fed) would pause their gradual pace of rate increases until 2018. However, Fed officials opined that lower inflation was transitory and did not warrant deviations from policy forecasts jolting market expectations.

Figure 1: U.S. Inflation



Source: Bloomberg

The sharp move higher in yields caused all investment grade sectors to post negative returns for September eroding third quarter performance which still remained modestly positive. Portfolios benefited from exposure to corporate issuers which topped all investment grade sectors for the third straight quarter. The yield curve flattened with short rates jumping to price in a December hike while longer maturities rose more modestly.

The economic backdrop is constructive for less accommodative policy globally, but there will be additional volatility as markets determine appropriate valuation levels absent the distorting impacts of central bank policy.

More Normal

The Fed followed a June rate hike with an official balance sheet reduction announcement at their September meeting. Starting in October, Fed officials will

US Treasuries

As of 29-Sept

Benchmark	Yield
3 Month	1.04%
6 Month	1.19%
1 Year	1.29%
2 Year	1.48%
5 Year	1.94%
10 Year	2.33%
30 Year	2.86%

Bank of America/Merrill Lynch Index Returns

Q3, 30-June to 29-Sept

Index	Return
1-3 Yr Gov/Corp ≥ A	0.30%
1-3 Yr Municipals	0.42%
1-3 Yr Agencies	0.28%
0-3 Month UST	0.25%
S&P 500	4.48%

Source: US Treasury, Bloomberg, BofA/ML, and S&P

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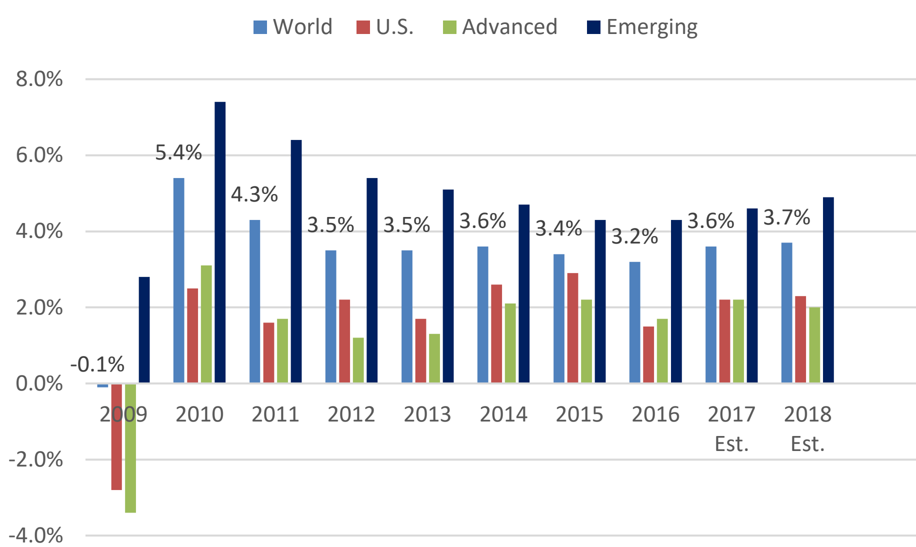
passively reduce asset holdings by $10B per month ($6B Treasury and $4B MBS) by not reinvesting. The run-off will increase by $10B every three months until it reaches a maximum of $50B per month while maintaining the proportional 60/40 security-type split (max $30B Treasury and $20B MBS). Further, the Fed still expects to hike three times in 2018 while the market has priced in just over one. Alongside less accommodative domestic policy, the Bank of England is expected to hike rates shortly and the European Central Bank (ECB) will likely taper their quantitative easing program that currently purchases €60B of sovereign and corporate bonds a month. The ECB's program expires in December, but is expected to be extended into 2018 at a slower pace reducing a strong technical bid in U.S. markets over the coming year.

Synchronized global growth, as reported by the International Monetary Fund (see Figure 2), that is forecast to accelerate, has opened the door for central banks to begin exiting unconventional monetary policy a decade after the onset of the financial crisis. We haven't experienced such broad-based economic growth for some time and policymakers hope that it is mutually reinforcing. Additionally, if fiscal stimulus is enacted growth is expected to accelerate further.

Figure 2: Global Economic Growth



Source: International Monetary Fund (10/17)

However, low wage and consumer price inflation has central bankers wary of removing stimulus too quickly. Fed Chair Yellen recently noted that the "biggest surprise in the U.S. economy this year has been inflation". Given tight labor markets and accelerating growth, central bankers are willing to slowly remove accommodative policy with the expectation that inflation will start to trend higher. Further, the Fed has stressed that it wants to get back to utilizing fed funds as the primary monetary policy tool. Given the enormous impact central bank support has had we see any exit acceleration as having a material impact on markets. Stable economic growth, low inflation, declining political uncertainty and broadly supportive monetary policy have contributed to a low-volatility market environment. Evolving monetary policy and political uncertainty represent the two biggest risks to markets near-term. Risks that will provide investment opportunities for patient investors.

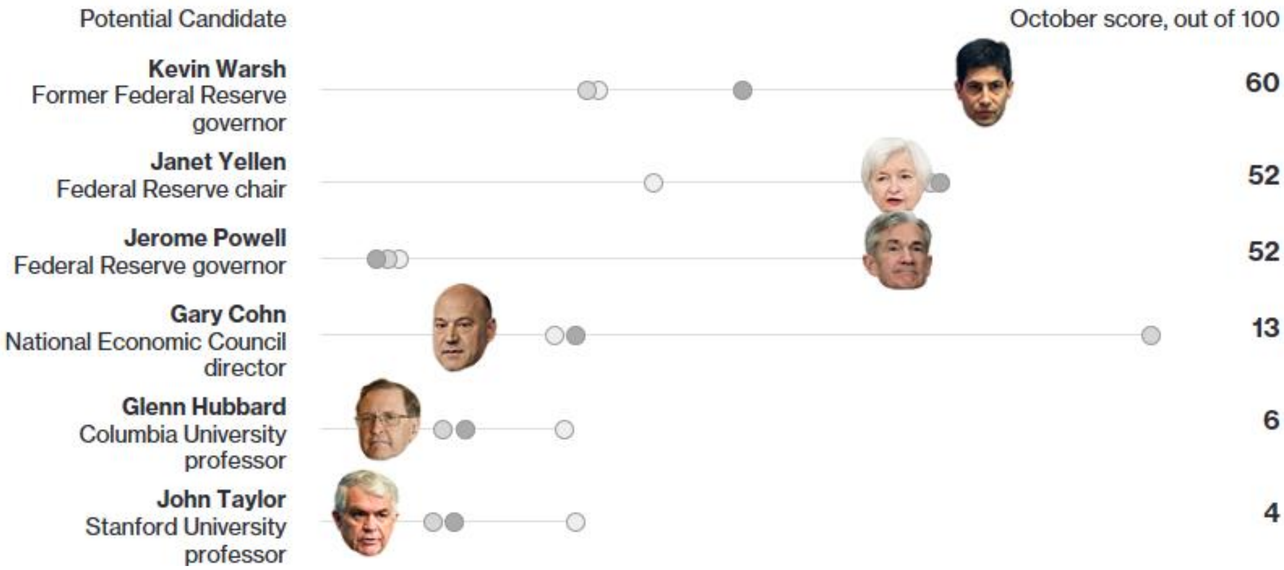
Bernanke, Yellen and?

Fed Chairwoman Yellen's term ends in February 2018. President Trump has announced he will select his nomination for her replacement before his scheduled November 3rd departure on a five-nation Asian tour.

Trump is working with a shortlist of five names: former Fed Governor Kevin Warsh, Stanford University economist John Taylor, current Fed Governor Jerome Powell, National Economic Council Director Gary Cohn and current chair Janet Yellen. In addition to the top position, three of seven board chairs, including the vice chairman, are vacant awaiting nominees allowing Trump to further impact monetary policy well after he is out of office.

Warsh is the odds-on favorite by economists at the moment (see Figure 3) while Powell and Taylor have been mentioned by the press as favored by Trump. However, with the Trump Administration, front-runner status can change quickly - just ask Gary Cohn. The status-quo candidates are Yellen and Powell. Powell may have a leg-up on Yellen as he has opined that financial regulation has gone too far and Trump was critical of Yellen during the election, although he has tempered his criticism since taking office.

Figure 3: Race for Fed Chair



Source: Bloomberg Economist Survey

Warsh, Hubbard and Taylor represent disruptions to the status–quo. Each has been critical of Yellen's tenure and the ultra-easy policy she has overseen. Further, Taylor and Warsh believe current policy is a cause of sluggish growth rather than a consequence of it. Expect higher interest rates if one of them is nominated.

The End of LIBOR

The scandal-ridden London Interbank Offered Rate (LIBOR) is targeted to expire by the end of 2021. The benchmark gained importance as a determinant of the floating leg of derivative contracts and rose to more mainstream usage in the past decade within mortgage and student loans. The rate is based on a survey of bank-to-bank daily lending rates submitted by member banks which traders eventually manipulated to suit their trading positions. The stated timeframe provides a window to adopt alternative interest rate benchmarks as well as transition existing contracts and securities to the new benchmark. An estimated $350T in notional of outstanding securities reference LIBOR currently, according to Bloomberg. Therefore, the adoption of a new benchmark represents a significant challenge for legacy agreements and systems.

The transition plan includes a shift to a market based rate such as the Broad Treasury Financing Rate (BTFR) in the U.S. and/or Sterling Overnight Index Average (SONIA) in the U.K. Markets will have to become familiar with the new benchmark and develop futures and options based on the index once the daily data are available. With the growth of related markets, new securities and contracts can adopt it and then legacy LIBOR securities can be tackled. Further, there is talk of requiring banks to hold more capital or increase the risk weighting for LIBOR-based contracts to incentivize a timely transition. Much more is to come, but we will continue to monitor the situation as it evolves.

Looking Forward

Accelerating global growth has investors seeking risk assets pushing equity prices higher and spreads lower. However, growth and inflation have not reached levels that bond investors are overly concerned with resulting in a flat yield curve. Congress has made the first step, of many, towards tax reform, which could provide a tailwind to growth in 2018. Meanwhile, the Federal Reserve will likely have new leadership as well as an overall composition that is more hawkish than what markets have experienced in the recent two decades. Further, central banks overseas will begin to slowly remove accommodative policy. Stronger growth and a gradual exit from accommodative policy should not be disruptive to current market conditions. However, given the size of balance sheets liquidity could be challenged. U.S. politicians could stumble and geopolitical risks could resurface resulting in volatility we would welcome and take advantage of in the form of higher spreads.

Please contact the desk with questions or to discuss investment opportunities as we head into an eventful close to 2017.