

Volatility May Rise as Asset Prices Decipher the Fed

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The economic data that are close by, i.e. coming out in the next several weeks, are not likely to reveal any dramatic weakness such that the U.S. Federal Reserve (Fed) would be compelled to cut rates. However, if one extrapolates the risks for potential economic weakness due to U.S.-China trade policies over the next several months and quarters, defined as the near-term from the Fed's perspective, then cutting rates sooner to insure against anticipated future weakness may be an appropriate response.

This presents a conflict between the market and the Fed, where the market is counting on sooner and quicker rate cuts, while the Fed may be inclined to cut later and more slowly. As such, volatility may rise as asset prices reconcile the timing and degree of policy support from the Fed.

Our Highest Conviction Views: We believe rates will remain low, U.S. consumer strength will continue, and there is low recession risk and thus low default risk.

1. Non-Agency Mortgage-Backed Securities (MBS): Credit fundamentals remain strong.
 - a. The unemployment rate has stayed low, while incomes are rising.
 - b. Default rates and delinquencies have remained low.
 - c. Housing is still affordable based on affordability indices.
 - d. Housing supply remains low.
2. Corporate Credit: We have a domestic real economy bias, and favor higher quality.
 - a. Investment grade
 - i) Financials: good fundamentals, yield per unit of credit risk, and cash flows.
 - ii) Communications: mainly deleveraging stories.
 - iii) Basic industries: metals and mining.
 - b. High yield: We like building products, gaming (stable), and transports. We favor higher quality, with a BB bias.

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Under the Radar Opportunities

- Emerging markets, specifically Central Eastern Europe: Czech Republic, Hungary and Poland.
 - These economies have been robust with rising inflation and seem disconnected from the risk of global slowing.
 - These are attractive high quality bonds to own (all investment grade rated) because they may re-connect to the global cycle if it weakens further.

Biggest Risk: A slowdown in China below a 6% threshold.

- China needs GDP growth above 6% to keep job growth stable at 13 million in 2019.
- Sub-6% GDP growth likely leads to a labor force contraction—and the government will need to respond.
- A portion of the Chinese government stimulus may be consumed internally (social policies to meet basic needs), which means the rest of the world receives fewer external benefits from China's stimulus.
- This could weigh on global growth, and tighten global financial conditions more than currently expected.

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