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INVESTMENT MANAGEMENT

There Is No Alternative

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There is evidence that the massive bond buying by the U.S. Federal Reserve and other central banks in the aftermath of the 2008 credit crisis helped reduce global economic risk. It may well be that the central bankers believed that there was no alternative to quantitative easing (QE) in the post-crisis years.

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An IMF Staff Position Note in 2009 concluded that, following the bankruptcy of Lehman Brothers, tail risks were reduced by "unconventional monetary policy."[1] The weakness of the overall global economic recovery pushed central banks to maintain bond buying longer than anticipated. Though the U.S. and the UK have ended QE, the eurozone and Japan are still buying bonds—eight years after the 2008 crisis. The end result is that interest rates in the developed world are unusually low *(Display 1)*.

QE was intended to reduce interest rates and spur investment. From that perspective, it has been a notable failure. Low bond yields succeeded in encouraging firms to borrow, but they used the proceeds to buy back stocks rather than to invest in the economy in a productive sense.

Investors may find themselves recalling the song, "Tina," performed by the punk rock group, The Mekons: "It looks like an accident / Caused by the government / Good people with good intent." The song's title, "Tina," is an acronym for one of its lyrics: "There is no alternative."

[1] Source: Bloomberg.

DISPLAY 1
Yields remain extraordinarily low

Past performance is no guarantee of future results. Source: Bloomberg.

Much of the upside in equity markets this year is probably explained by investors' own version of "there is no alternative," another reference to the Mekons' song. With an improving economy and low or negative real bond yields, equities appear to be the only reasonable alternative. The problem is that, if interest rates in fact go up, relative valuations can change drastically.

End of an era?

Across the globe, there are signs that the era of declining interest rates may be coming to an end—or at least at an inflection point. The U.S. is clearly moving towards normalization of interest rate policy; the Fed is not likely to be buying bonds at a higher price. Two consecutive strong payroll numbers—both close to 300,000 additional jobs—combined with other evidence suggest the US economy is heating up and inflation could be on the horizon.

That's not good for bonds. Bond yields tend to rise in a stronger economy, but what really hurts is inflation. The big gap we've seen between headline inflation and core inflation—with headline inflation almost 1 percent lower—have been strongly correlated with energy prices. When energy prices stop declining, it's very likely that gap will close. History has shown that it's most likely to converge toward the higher core inflation rate. The result could be a very sharp correction in yields within a relatively short period of time.

In Europe, the ECB is having trouble with QE implementation issues. And even the Bank of England, which wants to stimulate the U.K. economy after the damaging Brexit vote, is finding that it's not able to buy as many long-dated bonds as it wants simply because pension funds need those bonds and aren't willing to sell them. In Japan, it looks like the Bank of Japan is having second thoughts about its monetary policy, with the potential conclusion being to do less.

U.S.: Why are real yields negative?

The "accident caused by the government," in the Mekons' song, could very well be pushing real bond yields into negative territory. After years of QE, the 10-year Treasury is now priced for a negative real return. As of mid-August, it was yielding near 1.6%, while so-called "core inflation" (excluding food and energy) was 2.2% in the 12 months ending July *(Display 2)*. With three-month rates hovering around 0.3%, the level of negative real yields appears extreme.

There are two possible explanations for negative real yields. One is that the economy is very weak or contracting. The other is that bonds are in a bubble caused by years of extensive QE. Let's explore both possibilities.

- *It's not the economy…*

  In our view, the global economy and the U.S. economy are in good shape, despite weakness in capital investment. The cessation of investment by the entire energy sector—a result of the collapse in oil prices—has taken a toll. The same oil price decline, however, has helped consumption.

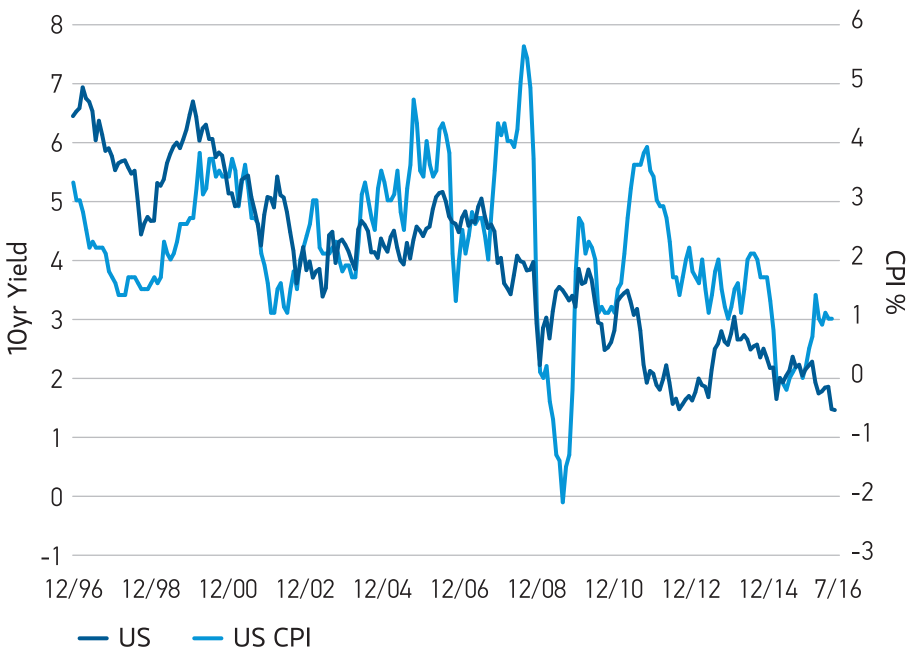
  Besides leaving money in consumers' pocket at the pump, oil goes into almost everything manufactured. When oil prices fall, other prices eventually follow. This dynamic is slow to work its way through the system: Consumers initially don't trust the windfall. But gradually, they start to spend more—making millions of small consumption decisions that raise aggregate demand.

  There has been criticism that the recovery has been primarily in low-paying service sector jobs, but these are the sectors that fuel a consumer-driven recovery: restaurants hire additional staff, or stores add an extra sales clerk. Eventually, the spending translates into an investment in a new restaurant or store. And so on.

  Beyond the energy sector, companies worldwide have been pressured into cost-cutting as a means of boosting profits. Chronic underinvestment since 2008 may soon force companies to replace obsolescent equipment that has dampened productivity growth. As the

DISPLAY 2

Real yield on US 10-year Treasury appears negative



Past performance is no guarantee of future results. Source: Bloomberg.

pressure to boost productivity builds, we expect investment to grow. The potential re-building of inventories, which have also fallen sharply, is another source of growth. Meaningful investment in inventories could add another 1% to GDP growth.

We're not worried about the U.S. election. We believe both Clinton and Trump are stimulative—either via infrastructure spending or tax cuts—and the government's checks and balances would constrain any excesses in domestic policy. The election could have consequences for foreign policy, but there is a lot of space between foreign policy and the domestic economy.

- *…but it could be a bond bubble*

  An alternate explanation for negative real yields is that persistent large-scale central bank purchases of bonds have forced prices up so high that bonds are in a "bubble." No rational long-term investor would choose to buy them because yields are below the forward-looking inflation rate.

The only rational buyers left would be those who must buy them for regulatory reasons, such as insurance companies, pension funds, or similar institutions that are required to match assets and liabilities. Aside from rational buyers, there are short-term investors who think they can flip the bonds later for a higher price. These investors tend to drop away when the music stops—when yields stop falling.

Unfortunately, predicting when a bubble will burst is difficult. Some have been expecting it for the last few years, and they've been wrong. But eventually, we believe it will happen: The short-term investors will drop out of the market because the trend of persistently low rates will start to reverse. And when that does happen, the long-term investors are not going to be there, simply because the prices are too unattractive from a buy-and-hold perspective.

If bond yields do rise, a momentum-driven sell-off could unfold as investors who, in search of yield, went out on the yield curve beyond where they would normally feel comfortable. This self-perpetuating situation could lead to significant losses. For these reasons, most of our concern in the US is on the potential for rising rates.

The dynamics of an improving economy and potentially rising bond yields apply broadly to the developed markets everywhere—in North America, Japan and Europe.

Europe: Manageable issues

Europe is working through political difficulties, but the major risk, namely Brexit, has passed. Other issues, such as the banking system, are related to credit or profitability, and not issues of solvency. Since banks tend to prosper in a higher interest rate environment, rising rates could be a tailwind for them. Generally, however, the TINA risks apply.

Japan: Reasonable stimulus

Japan has a meaningful fiscal stimulus of about $40 billion this year and $130 billion longer term,[1] which seems a reasonable number when combined with the loose monetary policy and benefits from cheap energy. And although the market reacts very negatively to a rising yen, its rise cheapens imports, which are a very significant component of its manufacturing. A rising yen is not necessarily a negative.

Emerging markets: Many points of interest

- *China: Aware of their problems*

  Any dramatic slowdown in China would undermine the "global economy is healthy" thesis. Fortunately, the Chinese government is well aware of all of the problems they have, and they have the tools to deal with them. They seem willing to pursue fiscal stimulus for short-term measure, even if their long-term resource allocation might not be optimal.

  The important metric in China is inflation—particularly food inflation, since about 30% percent of income goes to food. As long as food prices are under control, the government can spend to maintain economic growth. At some point, though, there will be the inevitable trade-off between spending and controlling inflation.

- *Asian emerging markets*

  Many Asian emerging markets tie their currencies to the U.S. dollar and are thus vulnerable to the risk that U.S. interest rates rise. Because of the potential for transmission of this risk, we're neutral (as opposed to positive) in the region.

- *Latin America*

  We are generally optimistic about prospects in Latin America, which we see as being a beneficiary of economic strength in the U.S. Their free-floating currencies largely insulate them from higher interest rates in the U.S. And, with the exception of Venezuela, we have seen pronounced political shifts toward more business-friendly policies. Cheap energy also helps. We're somewhat more cautious on Brazil, though the Olympics often provide a lift.

- *India: Significant improvements*

  An aggressive government in India appears to be stimulating the economy, including through the promotion of solar energy. Significant tax reform measures—an effort that has been decades in the making—were just recently instituted to enable businesses to more efficiently move goods and services across regions without the complication of differential tax rates. We see this as a huge positive in terms of infrastructure and are thus hold a favourable view of the country's prospects.

- *Eastern Europe, Middle East and Africa*

  We remain cautious in Eastern Europe, Middle East and Africa, primarily due to the unpredictability of Russia. Although the Russians want to end the sanctions, they still have clear geopolitical ambitions in the Ukraine and possibly in Estonia, Latvia and Lithuania.

Fixed Income: Selectivity is key

- *Developed markets*

  We view the high yield sector as still attractive on a relative basis. In the investment grade arena, the potential for rising bond yields in the U.S. is concerning. With regard to euro and Japanese yen, we are neutral. Overall, we suggest that developed market bond investors should be positioned in the low end of their typical duration range.

- *Emerging markets*

  We are neutral in emerging market hard currency because of the potential for higher rates. In local currencies, however, there is reason for a slightly more positive view: These bonds are generally below purchasing power parity and their economies are improving.

Commodities: Could benefit from inflation

Without OPEC's influence on the oil market, price fluctuations make it difficult to uncover the actual "fair price". We are therefore neutral on oil. But we have a favourable view on gold, which may transition from its role as a geopolitical risk hedge to an inflation hedge. Copper and other industrial metals may also benefit from an economic upturn.

Conclusion: We stand prepared

The reconciliation between a fairly healthy global economy and negative real bond yields could cause the bond bubble to burst. The timing of such events is always difficult to predict; however, recent rises in Japanese and global bond yields suggest it may happen sooner rather than later.

Regardless of what the Mekons say, we have many alternatives at our disposal and are prepared to use them in the current environment. We have sought to reduce overall portfolio risk and duration substantially in anticipation of higher volatility from rising bond yields. Global equities appear reasonable as long as there is not a sharp increase in interest rates. But if rates rise fast and quick, we are ready to reduce our exposure to help ride out short-term volatility. We say "short-term volatility" because we would expect rising interest rates to be the result of a strengthening economy, which could drive the market higher over the long term.

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