"I'M STILL STANDING"
FFTW Quarterly Commentary - Third Quarter 2016

FOR PROFESSIONAL INVESTORS - October 21, 2016

Overview

In this paper, we take a look at following topics:

- Brexit wasn't the only bump in the road that global markets were forced to navigate; in fact, political uncertainty was the dominant theme of the third quarter.
- One of the most important developments has been in the world of central banking when the Bank of Japan (BoJ) unveiled a radical re-write of its monetary strategy.
- The list of potential market moving events is long for the fourth quarter - but headlining the list is the US election which has the potential to underwhelm and overexcite even the most seasoned investment professional.
- As we move toward year-end we see fiscal policy becoming a prominent theme in the market's thinking and believe concerns around building financial imbalances within China could weigh on market sentiment.

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Watch a video of Dominick discussing FFTW's outlook

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Introduction

Elton John's hit from the early 1980s "I'm Still Standing" is a fitting anthem for the quarter that has just passed. The UK economy did not grind to a halt after the vote to leave the European Union, although the currency is sinking like a stone. Appropriately enough the song was taken from the album Too Low for Zero which will no doubt strike a chord with fixed income investors that are becoming increasingly resigned to the idea that negative yields are the new norm.

Brexit is not the only bump in the road that global markets have been forced to navigate over the past three months. Political uncertainty has been a constant theme, oil prices have continued to yo-yo on the back of supply disruptions and talk of yet another production freeze and concerns around the health of the European banks have flared up on a couple of occasions. But despite all that, risk sentiment is still standing, although perhaps not dancing on European beaches 'looking like a true survivor, feeling like a little kid'. Stocks moved sideways. Implied volatility has remained low by historical standards but has moved up more recently.

We think that confidence in the capacity of central banks to stabilize the system has been an important factor in driving the price action over the prior quarter, helping to insulate the market from shocks. It is interesting to note that the RMB has depreciated against the dollar through much of the year but without triggering the angst that we saw in January. However, central banks are being forced to consider ever more radical steps to continue supporting demand in a world in which there is a global glut of savings looking to find a home and too few companies looking to put capital to work. Structural forces are suppressing real interest rates and boosting asset prices.

Old hands in markets will recoil at the idea of a central bank setting the price of long-term bond – isn't that what capital markets are for? However, that is the world we now trade in: the BoJ has established a target for 10-year Japanese government debt and it is willing to lend at a fixed rate over 10 years and buy away from market prices to deliver it. In truth the BoJ was already the dominant player in the JGB. The reason the BoJ has taken this step is because the market had become concerned that it would soon own all the bonds. What has changed is that the BoJ now has a more effective strategy for implementing monetary policy and a more ambitious goal: to over-shoot its target. All that remains is for Governor Kuroda or Prime Minister Abe to act and generate escape velocity in inflation. If and when they do that, the implications for yen assets could be profound.

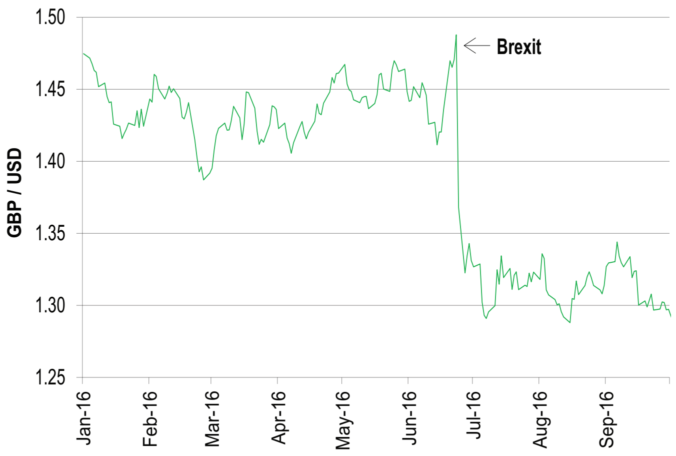
We should be careful extrapolating from the serenity of the past quarter. Markets may not always dance to Elton's tune. The market reaction to recent headlines that a consensus was building within the ECB to taper its quantitative easing (QE) program highlights just how sensitive current valuations are to the strategy pursued by central banks. After all, investors are not buying risk assets in expectation of solid growth in earnings; they are buying on the basis of a rock bottom discount rate applied to modest income streams as well as the promise of a central bank "put option". The clear and present danger to risk assets remains a significant and sustained increase in inflation that would force the world's central banks to retreat from their current accommodative stance.

Third Quarter Review

The dominant theme of the third quarter has been political uncertainty. In the United States, the presidential election raises the risk of a sharp reversal in the multi-decade trend of globalization and a destructive bout of protectionism. In Continental Europe, politicians continue to struggle with the pressures of the economic malaise and mass migrant flows, and an upcoming constitutional referendum in Italy threatens to topple Prime Minister Renzi. In emerging markets we have had ample evidence of instability: a failed coup in Turkey, the ongoing saga in Brazil and simmering tensions in South Africa. Last but not least, we have UK politicians and investors struggling to come to terms with the outcome of the Brexit vote. But despite that manifest political uncertainty the sky did not fall. Markets kept their nerve, comforted perhaps by the expectation that the world's central banks would not be pulling away the punch bowl anytime soon.

The UK shocked global markets by voting on 23 June to leave the European Union. What happened next was just as surprising. Economists had expected the UK economy to slow sharply, as the increased uncertainty weighed on domestic demand. However, the data have confounded the consensus: the economy appears to be holding up just fine. It's not entirely clear why the Brits kept calm and carried on spending. But the speed with which a new Prime Minister was appointed and the fact that his successor has not triggered the formal exit process probably had something to do with it. For companies and households in the United Kingdom it may have seemed that nothing much had changed, except that the currency plunged in value, paving the way for some imported inflation and a recovery in net trade. The UK may have dodged a bullet in the short run but the terms of Britain's exit from the EU remain to be resolved. Initial optimism that the UK may find some way to nullify the outcome of the vote (by holding a second referendum or a general election) or would be able to agree a deal which protected key industries such as financial sector has started to fade. UK officials remain insistent that they will regain control over migrant flows and European officials remain insistent that there can be no free movement of goods and services without free movement of labor. As reality started to dawn, the pound started to slide and bonds sold off too – a market move that is more familiar in emerging markets.

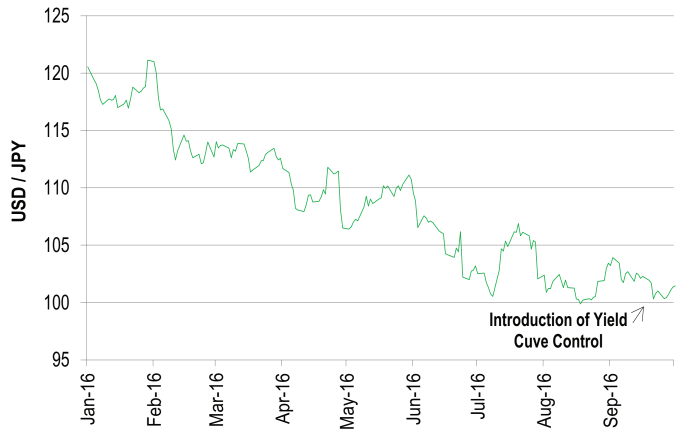
Chart 1: GBP / USD (Jan. 1 – Sep. 30, 2016)



Source: Bloomberg, as of September 30, 2016

For all the focus on politics, the most important development this quarter was in the world of central banking. The BoJ unveiled a radical re-write of its monetary strategy at the September policy meeting. Up to this point the BoJ has followed the central bank orthodoxy on implementing QE: expanding its balance sheet at a given pace in an effort to influence yields. However, the market had started to become concerned that the BoJ would soon run out of bonds to buy and would therefore hit an effective upper bound on QE. The BoJ has sidestepped this problem by announcing a target for long-term yields and by innovating the tools to deliver it: fixed rate bond purchases and 10-year refinancing operations. Moreover, the BoJ has committed to over-shoot its inflation target as a necessary step in re-anchoring inflation expectations. The announcement that a central bank intends to control the yield curve and overshoot its inflation target ought to have made the market sit up and pay attention. However, the market reaction was lukewarm at best: in fact, the yen appreciated against the dollar on the day. The price action – or lack of it – probably had a lot to do with the fact that the BoJ did not back up its courageous new policy framework with action: the Bank did not cut the policy rate or place its new yield target below the prevailing level of market yields. We expect the market to gradually come round to the BoJ's new strategy, but it may take easing the monetary stance (cutting the policy rate or the long-term yield target) or Prime Minister Abe easing the fiscal stance (to take advantage of the yield cap) in order to make the market believers of an inflation overshoot. In the medium-term we believe that a cheaper yen is a necessary condition for success of the strategy.

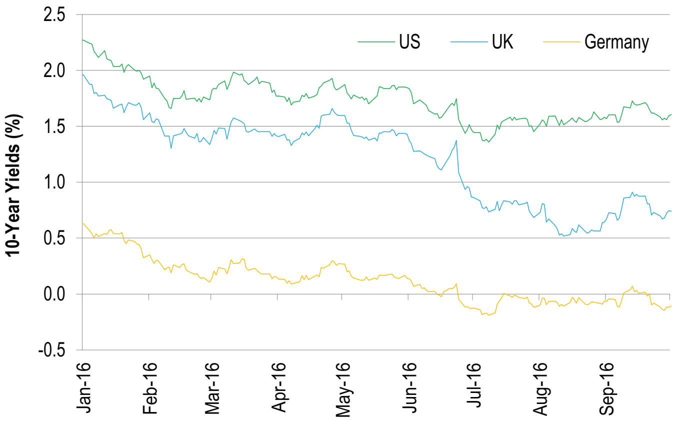
Chart 2: USD / JPY (Jan. 1 – Sep. 30, 2016)



Source: Bloomberg, as of September 30, 2016

Elsewhere central banks have done their bit to keep the show on the road. The ECB confounded some exuberant market expectations that it would announce additional stimulus in the third quarter and instead remained in implementation mode, delivering the package that was announced at the end of the first quarter. However, President Draghi did deliver a clear message that the ECB understands that it will have to preserve a loose monetary stance if it wants to drive inflation back up to the target, and therefore asset purchases will have to continue beyond the current milestone of March 2017. At one point investors attached a significant possibility to the Federal Reserve (Fed) raising rates in the third quarter, but in the end the Federal Open Market Committee (FOMC) decided to leave rates on hold. Perhaps more importantly, the mood music from the more influential members of the Committee suggests a greater willingness to wait for confirmation that the Fed is on track to achieve its mandate before taking action. In contrast to the turmoil at the start of the year, when investors started to question whether central banks were still willing or able to achieve their mandates, for much of the quarter there seemed to be greater confidence in the capacity of central banks to stabilize markets in the face of the these potential shocks.

Chart 3: 10-Year Government Yields (Jan. 1 – Sep. 30, 2016)



Source: Bloomberg, as of September 30, 2016

Finally, concerns over the health of the European banking sector have been a frequent refrain in recent months. To begin with the focus was on the Italian banks and their capacity to manage the twin headwinds of large portfolios of non-performing loans and low net interest margin in a world of rock bottom interest rates. The market spotlight fell on the world's oldest bank (Monte dei Paschi di Siena, MPS) in particular, which had the dubious honor of recording a negative capital ratio in the ECB's stress tests that were released over the summer. A rescue package was duly announced for MPS but a lot of the details are yet to be ironed out and the recapitalization is scheduled for immediately after Renzi's referendum. Attention then shifted from the world's oldest bank to Germany's biggest bank: Deutsche Bank (DB). News that DB's fine relating to dealings in RMBS could reach $14 billion led some commentators to question whether Deutsche could survive the blow, particularly given the German government's reluctance to bend the new bail in rules (BRRD). However, with substantial buffers of liquid assets and the ECB in fixed rate full allotment mode the prospects of a funding strike bringing down Deutsche seem remote. Likewise, there may be little realistic prospect of significant capital raising via a rights issue but Deutsche still has assets which it could sell if needs be – in particular, DWS, the asset management business. But just because we do not expect Deutsche to topple it doesn't follow that we are not concerned about the capacity of the European banking system's capacity to finance the recovery.

Fourth Quarter Views

As always seems to be the case, we have an important quarter ahead of us in terms of central bank meetings. The ECB will almost certainly have to come off the fence and announce what it plans to do next year at the December meeting – not only how many assets it will buy, but which assets. The outlook for wages and prices remains too anaemic to seriously consider tapering, unless the ECB is prepared to effectively concede defeat in the fight to restore price stability. We expect the ECB to continue buying bonds throughout 2017 and that will require changes in the technical details of the program. In the short-run, the ECB will likely relax self-imposed "issue" and "issuer" constraints on how many bonds it can buy, which will benefit the long end of the German curve and Portugal respectively and eventually we expect ECB QE to drift off key, providing a capital benefit to the Italian market. The Fed will probably raise rates in December, although the impact on the market should be cushioned by dove-ish communication about the future path of rates. On the other hand, stronger than expected data on activity and a weaker pound mean that the Bank of England (BoE) will probably not ease policy further in the fourth quarter as it had earlier signaled it was likely to do. Finally, the wild card on the central banking front remains the BoJ: will the central bank cut the policy rate and the yield target at the November or December meetings to cement the credibility of its commitment to overshoot? We expect the BoJ to take action at some point, but at the current juncture the central bank is giving mixed messages.

The US presidential election in November is undeniably a market event. To be fair there is something approaching a consensus around the need for increased spending on infrastructure and perhaps the military, although there remain important differences on the how much, and more importantly, how financed. In any case, the Congress will play a major role in shaping any shift in the fiscal stance whoever is elected. The real divide between the candidates lies in policy issues where the President has much more discretion – in particular, around trade and immigration. In the short-run, a Trump victory will likely trigger a classic risk off move, with stock prices and bond yields moving lower. Further out, we believe the Treasury curve would steepen, given higher inflation and greater issuance.

At the time of writing, Clinton holds a commanding lead but any shift in the polls will likely trigger volatility, with the peso seemingly the market's favorite Trump trade. The outcome of Prime Minister Renzi's referendum on constitutional reforms looks a much closer call. Renzi has given a pretty clear signal that he will step down if he loses the vote. That would not necessarily lead directly to fresh elections, but it would likely force investors to attach a greater probability to Renzi's chief opponent – the €–sceptic Five Star Movement – winning that election when it does come. Moreover, Renzi's defeat and eventual demise might force a more broad-based re-pricing of political risk in the European periphery.

One theme which is likely to become more prominent in the market's thinking as we move towards year-end is fiscal policy. There is an emerging consensus within the policy community that finance ministers need to play a more active role in both supporting the economy, whether it is investments in infrastructure or more traditional forms of stimulus. Investors increasingly expect that consensus to be implemented, whether that is the incoming US President calling on Congress to increase spending, the UK government calling time out on the previous administration's fiscal consolidation plans, Prime Minister Abe taking advantage of the BoJ's new regime to announce fresh spending measures or European governments pushing back against the constraints imposed by Europe's fiscal rules. Any material shift in the monetary/fiscal mix clearly has implications for asset prices – most obviously long-term bond yields, but then into all asset prices via the discount rate.

Finally, we could end the year as we began, with markets turning their attention back to China. Uncertainty about the health of the Chinese economy and the direction of Chinese policy was the catalyst for a month and a half of risk off at the start of 2016. We do not expect a repeat performance in markets but concerns around building financial imbalances within China could weigh on market sentiment. Property prices and mortgage lending are booming in China and perhaps more worrying, land is being sold in auctions at prices above those for residential property in the neighborhood. In the short-run, the housing bubble is good news, filling the government coffers with revenue and (artificially) raising net worth in the real economy, but when the housing market turns down, there will be losses and perhaps of more concern, renewed questions about the domestic demand for RMB assets.

Currency Market Outlook

US growth, though lackluster since about a year ago, is likely to pick up for the balance of 2016 and US inflation has firmed lately; core PCE inflation is currently running at 1.9% quarter-over-quarter. These developments should allow the Fed to nudge up the funds rate, most likely once by year-end. The longer run outlook for the US economy has been downgraded by both the Fed and private forecasters, who now expect a shallow tightening path, with a much lower terminal funds rate than earlier predicted, due to low productivity and a lowered potential GDP growth estimate. In Europe and Japan, the economic and inflation outlook remain dim, with no signs that inflation targets can be realized any time within the next year, and even within a visible horizon.

There is currently only one tightening by the Fed priced in for all of 2017, and markets ascribe only a 65% probability to a tightening in the fourth quarter of 2016. In the near-term, US GDP may move well over 2% in the third quarter and in the fourth quarter after elections, which could lead the expected 2017 policy path to reprice higher. This could set the stage for the USD to rally by 5-10% against the euro and the yen, depending on whether further monetary stimulus by the BoJ and ECB set the stage for a stronger narrative of divergent monetary policy to return to the fore. The British pound, on the other hand, is likely to weaken further against most major currencies, as Brexit negotiations lead to more significant economic difficulties over time.

Spread Sector Review and Outlook

Global credit spread markets tightened over the quarter as the market grew more comfortable with the UK Brexit outcome and more generally the continued realization that central bank liquidity would remain accommodative for the foreseeable future. The BoE announced its own version of a corporate bond buying program which drove credit spreads tighter in sterling corporate bonds. Our positioning in UK sterling and US corporate credit experienced some degree of tightening during the summer.

OPEC's decision to freeze output will provide oil prices with a short-term floor, which will be supportive to inflation and US high yield. However, we do not have a constructive view on long-term oil prices, as a recent pickup in the Baker Hughes rig count among other variables signals limited upside for oil prices. More succinctly we continue to hold the view that oil will trade in the $35-55 handle for the coming year.

Over the last couple of months our growth cycle indicator had been stalling and recently shifted its signal from expansionary to late cycle. Typically credit spreads do not perform well in this environment but we are intently aware that central bank stimulus can skew and distort our indicator. Even if this turns out to be a false signal we will continue to respect both the central bank liquidity programs and what the model is suggesting as a potential path.

The giant price insensitive sail being powered by central banks' accommodative policies is likely to continue the global grab for yield and yet corporate credit fundamentals are steadily deteriorating. We remain mildly bullish on global investment grade corporate credit largely on the strong reach for yield technicals. As for high yield corporates, while spreads may well tighten from current levels, we believe this asset class's risk reward relationship is becoming progressively skewed as valuations continue to rise while fundamentals deteriorate.

A persistent weight on our cycle model has been corporate EPS, which judging by expectations for the third quarter of 2016 US earnings does not look encouraging. Currently the market expectation is for a 2% decline in earnings which would mark the sixth consecutive quarter of year-over-year declines.

However even with this backdrop we continue to expect elevated corporate issuance out of the US and EU as companies continue to make use of historically low debt financing costs. We would caution that there could be a slowing in demand from investors outside of the US as foreign exchange hedging costs have increased, resulting in a less attractive calculus for investing in US debt.

We continue to favor an allocation to floating rate spread product and have a preference for higher rated CLOs and CRTs. While we concede US economic growth has been uninspiring, the consumer has thus far remained resilient and recent data has confirmed that CMBS is well positioned as a defensive carry investment.

Lastly, we caution investors not to be lulled by the low volatility experienced in credit spread sensitive markets over the last quarter. If our credit cycle indicator turns out to be correct it suggests that now may be a prudent time to lighten risk positions and potentially miss the last few months of the rally while liquidity is available.

Emerging Market Fixed Income Outlook

We remain optimistic on the Emerging Market Fixed Income (EMFI) asset class heading into 2017. The positive momentum in EMFI continued through September and, year-to-date, it holds its position as the generator of some of the strongest returns amongst all asset classes available. We see tell-tale signs that the prolonged slump in the asset class for the three years since the beginning of 2013 has given way to new green shoots and prospects for strong returns for the foreseeable future. Three of the key driving forces are beginning to turn in favor of positive momentum for emerging markets: we see Fed policy as being largely priced in, commodity prices as having bounced definitively and EM fundamentals showing increasing signs of improvement.

We do not think that hard currency spreads have become expensive. Country risk as a stand-alone asset class remains cheap to historical mean (c.60th percentile at end September) and has room for further compression, particularly in an environment of low volatility.

EM currencies broadly look attractive to us now, and year-to-date have lagged the rally in other EM assets. Currencies offer among the highest carry available in liquid instruments, and valuation recovery is supported by rising commodity prices and incipient signs of growth among EM countries.

The technical picture is also very healthy with strong inflows into EMFI that are well diversified both in terms of investor base as well as in terms of geography. It is our expectation that this trend of inflows to the asset class is set to continue as, despite the fact that we have recently had higher allocation to EM, we still think it is relatively low (at around 12% of a total global bond portfolio when at its peak it reached 18%). The level of flows further augments our positive expectations for positive performance from EMFX and interest rates.

TIPS Market Outlook

At the end of the first quarter, we were extremely constructive on TIPS as an asset class, given dove-ish rhetoric from the FOMC, reduced concerns about a yuan realignment, recovery in risk assets, a softening dollar, rising commodities prices and upside surprises on core inflation. More recently, our enthusiasm for the asset class has diminished given the FOMC's evident preference to raise rates before year-end, and ongoing concerns over global growth. Still, we believe there is upside, both on real yield and break-even inflation rates, given the global backdrop of financial repression, the current level of actual inflation (which exceeds the current level of break-even inflation rates) and the Fed's determination to return inflation towards target.

Biography

Dominick DeAlto
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Head of Fixed Income - BNP Paribas Investment Partners

Dominick is Head of Fixed Income for BNP Paribas Investment Partners' Institutional business and CIO and Head of Fixed Income for FFTW. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He oversees and guides investment processes across teams, ensuring consistency and branding of processes. Dominick is responsible for challenging the strategies and processes of the various investment teams. He also works with the head of each product team to define strategy for fixed income activities, focusing on meeting client needs. In addition, Dominick heads the alpha team responsible for determining sector allocation trades for the firm's portfolios. Dominick joined FFTW in 2013 and is based in New York.

Prior to joining FFTW, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management. Dominick began his career as a credit analyst at Chase Securities Inc. after graduating from their industry leading credit training program.

Dominick has over 28 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.

Disclosure