SHAKEN AND STIRRED

FFTW Quarterly Outlook - First Quarter 2017

FOR PROFESSIONAL INVESTORS - January 2017

Overview

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

- The market narrative for the year ahead as well as where we see opportunities in 2017.
- The single most important event of the last quarter - the election of Donald Trump - and what challenges and consequences we think this suggests for markets in the foreseeable future.
- The cyclical upswing in the US which has revived animal spirits and buoyed expectations in global growth.
- The process of fiscal reform and fiscal stimulus and why they could be messy and drawn out.
- The ECBs conditional retreat from quantitative easing and our expectations that the bank will further taper the pace of purchases at the start of 2018.

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Watch the video interview of Dominick discussing our fixed income outlook

INTRODUCTION

Looking back on 2016, I can't help but note that my commentary for the first quarter riffed on a French expression that loosely translates as, "The more things change, the more they stay the same". At that time, global growth remained sluggish, global fiscal policy remained constrained by high levels of debt or political paralysis, and monetary policy in much of the developed world was viewed as struggling to provide sufficient support to growth and inflation. The financial crisis was fading further into the rear view mirror, but a deep-rooted pessimism on global growth prospects in a heavily-indebted world prevailed.

The current mood among investors could hardly be more different. The election of Donald Trump as US president, coupled with a cyclical upswing in global growth, has revived animal spirits and buoyed expectations that at least in the United States, the low growth and low interest rate narrative of the post-crisis period may be drawing to an end. Much of this optimism stems from prospects for fiscal and regulatory easing. For the time being, investors appear to have put aside concerns about the incoming administration's protectionist leanings and an isolationism that could upend the international order. We remain concerned about these risks, and view them as an important part of the market narrative in the year ahead. We also see the process of fiscal reform – let alone fiscal stimulus – as messy and drawn out, the Republicans' filibuster-proof majority notwithstanding. Still, we recognize that perception of a more business-friendly operating environment and prospects for lower household and corporate taxes could underpin stronger spending and investment, leading to a pickup in growth in the year ahead. But the $100,000 question is whether the new administration's policies can meaningfully boost the economy's potential in the years ahead. Without this, stimulus could stoke inflation and lead the Federal Reserve (Fed) to bring forward interest rate increases and the day of reckoning for balance sheet runoff. A move away from gradual policy tightening may be a story for 2018, but markets won't wait until then to discount the risk. The European Central Bank's (ECB) conditional retreat from quantitative easing (QE) also bears close monitoring; should the Governing Council mark up the Eurozone's growth and inflation outlook, pressure could build later this year for another reduction in the pace of asset purchases.

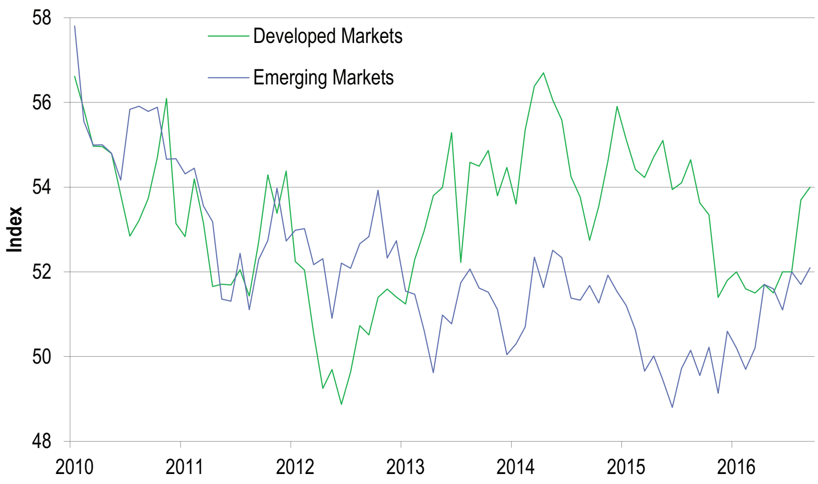
Finally, the populist tide that ushers Trump into the White House (and the UK eventually out of the European Union) has yet to ebb. Investors largely shrugged off stalled constitutional reform and Prime Minster Renzi's resignation in Italy. A similar complacency regarding upcoming elections in France and the Netherlands (and possibly in Italy as well) is unwarranted, as markets will view the results as referenda on remaining in the Eurozone.

FOURTH QUARTER REVIEW

Undoubtedly the single most important event of the last quarter – and the one to have the largest consequences for markets in the foreseeable future – was Donald Trump's election victory. We view the election outcome as heralding significant challenges to the broad US policy consensus of recent decades, which included a strong commitment to free trade, a willingness to extend a security umbrella to allies abroad, support (albeit, grudging at times) for immigration, and respect for central bank independence. While this paradigm shift suggests greater uncertainty going forward, most immediately the election resulted in a revival of optimism towards the US economy in light of the incoming president's vow to cut household and corporate taxes, increase spending on the military and infrastructure, and revitalize the manufacturing sector. Initial pronouncements from the incoming president as well as early cabinet appointments only furthered conviction that the new administration would prioritize pro-growth policies as well as efforts to redress perceived imbalances in foreign trade relations. Thus the remainder of the quarter generally saw an extension of reflation trades – higher interest rates, wider inflation breakevens, a stronger dollar and broad gains for equities.

The election came at a time when global growth optimism was already on the rebound. Activity surveys in developed and emerging economies were showing clear signs of bottoming, the nadir of the US corporate profit recession appeared to be behind us, and some of the worst fears regarding the UK economy in the aftermath of the Brexit vote were proving unwarranted. In addition Chinese growth, which had been a major market focus earlier in the year, proved less of a concern as the leadership revealed a preference to slow structural reform efforts in favor of near-term economic stability ahead of the key leadership transitions to take place in 2017. Higher oil prices, supported in part by a deal across many major oil producers to limit production, also played into the global reflation narrative.

GLOBAL PMI ACTIVITY SURVEYS



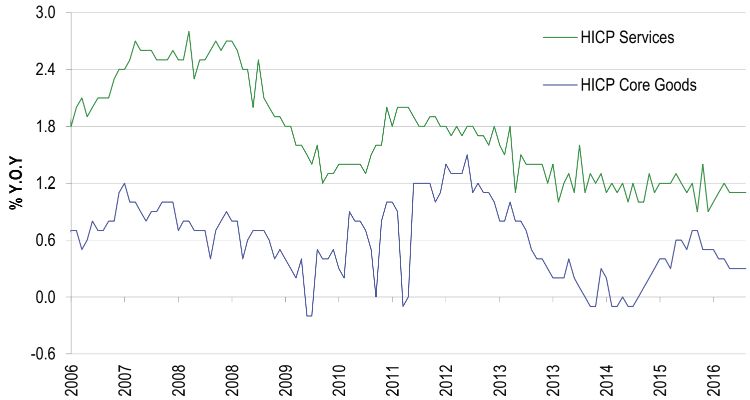
Source: Markit

With growth rebounding over the second half of the year and the labor market continuing to tighten, at its December meeting the Fed finally achieved an additional rate increase in its quest to gradually normalize the policy stance. Recent declines in the unemployment rate have served to increase the Committee's confidence that inflation will rise back to the two percent objective in the coming years, leading many Committee members to project a somewhat steeper path for the policy rate. The most important piece of information from the December meeting surfaced most prominently in the Chair's press briefing. While taking pains to avoid weighing in on appropriate fiscal policy, Chair Yellen made clear that fiscal policy that provides near-term stimulus but does little to boost trend growth would ultimately lead to a tighter monetary policy stance. This may be an obvious point but one that we believe many investors ignored in the immediate aftermath of the election. Fiscal stimulus may do little more than bring forward future growth absent a pickup in the productive capacity of the economy.

Most central bank meetings fail to match the pre-meeting hype: changes in the stance are usually telegraphed in advance and we learn little new in the press conference. The December Federal Reserve meeting certainly fell into this category; the ECB's final meeting of the year did not. The Governing Council announced that it plans to scale back its QE program, with the pace of asset purchases set to fall from €80 billion per month to €60 per month between April and December 2017. To be clear, the ECB will continue to buy bonds throughout this year, and most likely the majority of next year too, and even when purchases do come to a halt, the stock of purchases should still anchor yields. In other words, the stance will remain accommodative for some time to come. However, the fact that the central bank has begun the process of pulling back from QE is important.

What is really interesting about the ECB decision is the fact that the central bank has begun the process of withdrawal while acknowledging that there is no evidence yet of an upward trend in underlying inflation in the Eurozone and that the central bank's own forecasts do not suggest that the ECB will achieve its inflation mandate in 2019. In other words, this is definitely a case of mission not yet accomplished. We therefore regretfully conclude that the ECB is no longer in 'whatever it takes' mode when it comes to achieving its inflation target. The sense of urgency appears to have faded now that the risks of outright deflation have receded. The other interesting news to come out of the ECB meeting was the revelation that the legal constraints on the proportion of the market that it can purchase are likely closer than the market anticipated. In the words of one member of the Executive Board of the ECB, the Governing Council 'is very reluctant to change these limits.' The obvious takeaway is that certain countries – notably Portugal – are close to the point where they can no longer feel the direct benefit of ECB QE, and moreover even if the ECB does continue asset purchases for an extended period then it may be forced to start purchasing other assets.

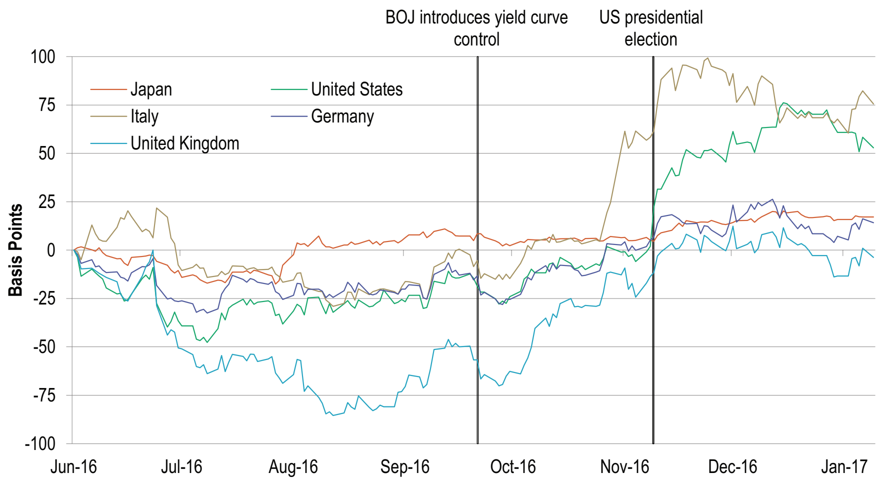
EUROPE: CORE GOODS AND SERVICES INFLATION



Source: Bloomberg

Ironically, one country that has benefited inordinately from the Trump-induced reflation trade is also one of the United States' largest trading partners, Japan. With the Bank of Japan having recently eschewed conventional QE in favor of yield curve control and committing to achieving an inflation overshoot, the JGB market has been largely immunized from the global rise in bond yields. This policy stance contributed to outsized yen depreciation against a wide range of currencies over the quarter, as well as strong performance by Japanese equities.

CHANGE IN SOVEREIGN 10-YEAR YIELDS SINCE JUNE 1, 2016



Source: Bloomberg

On the European political front, Prime Minister Renzi lost his bid for constitutional reform, and the margin of defeat in the referendum was somewhat larger than expected. Renzi resigned in the aftermath, as he signaled he would, so the job of making sense of Italy's electoral system will fall to his successor, Gentiloni. As things stand, one house will be elected under a winner takes all system whilst the other will be elected under a fully proportional system which is a recipe for parliamentary gridlock when both houses are equal partners. In the meantime, the referendum result doomed the plan to recapitalize the world's oldest bank, Monte dei Paschi di Siena, with private money, leaving the taxpayer to pick up the tab and in the brave new world that means bond-holders will have to be bailed-in.

Elections will likely come sooner in Italy than the notional timetable suggests (spring 2018) and with the insurgent Euro-sceptic Five Star Movement still riding high in the polls and the Italian establishment facing formidable challenges there is plenty for investors in Italian debt to consider even before factoring in the gradual withdrawal of the ECB QE comfort blanket.

FIRST QUARTER VIEWS

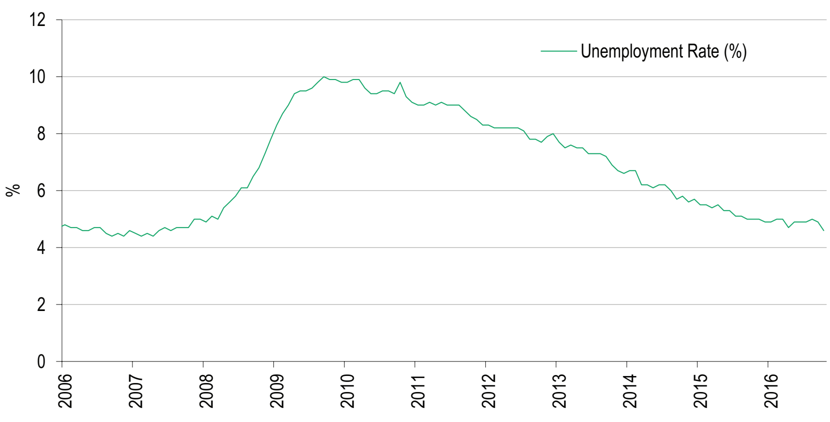
Any regime change comes with some level of uncertainty, but Trump's election brings two particular sources of uncertainty that will contribute to market volatility in the years ahead. First, his style of leadership is wholly unlike that of other modern presidents, characterized by a disdain for policy details, and a focus on attention-grabbing issues to energize his base and criticize opponents. Investors, along with Trump's cabinet and Congressional allies, will need to interpret this new style and divine the policy direction in his communications. The process promises to be messy, though the incoming president's lack of engagement on details could free his cabinet to assume more authority and drive policies forward.

Second, sweeping change to the policy mix itself will spur market volatility – and trading opportunities. Deregulation and fiscal easing can stimulate growth, with implications for fixed income, equities, currencies and commodities. Specific policy proposals, such as a roll-back of environmental regulations, a move to a border-adjusted tax, immigration restrictions and protectionist policies will also inform the outlook for asset classes, sectors and firms. And with market and policy rates still not far from historic lows, an increase in inflationary pressures could induce a fixed income correction similar to the 2013 Taper Tantrum.

Perhaps we are getting ahead of ourselves. In the near term, Congress may provide the clearest signal of the incoming administration's ability to deliver on its promises. If Republican senators can hold together their razor thin majority and repeal portions of the Affordable Care Act without specifying a successor health plan, they will increase investor confidence that the reconciliation process can also be used for sweeping tax reform. Even in that case however, tax reform will be difficult to achieve. The switch to a destination-based corporate tax system is critical to achieving deficit neutral tax cuts, but the border adjustment provision is controversial as it creates clear winners and losers across business sectors and could run afoul of WTO rules due to similarities with an import tariff. Even if Congressional Republicans are able to move past these issues, the process could still drag out well into the second half of the year.

One thing is clear, though. Trump's policies tend to the inflationary. The import tax embedded in the border adjustment provision may feed through to consumer prices. Increased deportations and restrictions on immigration will reduce labor supply at a time when the economy is already near full employment. In addition, even modest protectionist efforts, such as cajoling firms to halt or reverse off-shoring of manufacturing, could increase business costs. Most importantly, tax cuts will spur consumer and business spending and sustain growth, at least for a while, above the economy's productive capacity. Of course, deregulation and corporate tax reform could very well encourage business investment, which would provide a much-needed boost to productivity and potential growth that would in turn help keep inflation in check. However, higher potential growth will take time to achieve. In the meantime, immigration restrictions, which would reduce growth of the labor force, could have the opposite effect on the economy's productive capacity.

US UNEMPLOYMENT



Source: Bloomberg

Given these uncertainties, the Fed will take a cautious approach to further tightening for the time being. We currently anticipate two policy rate increases this year, but the risks around our base forecast are skewed towards more tightening. This is because fiscal stimulus will come on line at a time when the economy is already operating at potential. The fact that wages are rising suggests shortages in some portions of the labor market, which will increase the Committee's confidence that inflation will rise to the 2% objective. Fiscal stimulus may not arrive until the second half of the year, but broad expectations for stimulus – as well as deregulation – may boost consumer and business spending in the coming months. Clear signs of a pickup in final demand as well as additional wage pressures could set the stage for a March rate increase.

Finally on the US outlook, a note of caution is in order as a counterweight to current market optimism. From a market and economic perspective there is much about the incoming administration's policies that are concerning. First, if Republicans' fiscal discipline cracks and Trump gets much of what he wants on fiscal policy, the country's long-term debt sustainability will be significantly impaired. Second, Trump's very public attempts to influence individual firm's business decisions could ultimately weigh on business confidence and investment. We also remain concerned that Republican efforts to reform the Federal Reserve could impinge upon the central bank's operational and decision-making independence. And the new administration's anti-immigration and protectionist streaks make for poor economic policy. Finally, the potential retreat by the United States from its traditional international commitments may create a vacuum that other powers will look to fill, in both the economic and military spheres. In short, much could go right for the economy in the years ahead, but much could also go quite wrong.

Turning to Europe, the focus will be on the ECB. As we discussed above, the ECB has already announced the beginning of the end for QE in all but name. With higher oil prices lifting headline inflation far above the danger zone of deflation and the survey data pointing to a cyclical upturn in activity we anticipate a more hawkish tone from the ECB. We doubt that the ECB will be in a hurry to scale back the plan for purchases in 2017 that it announced in December, but we cannot rule that out. Certainly, we expect the improved economic outlook and the stronger case for winding down QE to dominate the debate and that should move markets. The ECB managed to taper in December without a tantrum, but we are not convinced that Draghi will be able to repeat that trick in 2017. We expect the ECB to announce this year that it will taper the pace of purchases further at the start of 2018.

There is plenty of political event risk to overcome in the coming months. We have elections in Netherlands and France before the summer, and there is a reasonable chance that we will have elections in Italy too. In each case the market will watch the results closely to see whether Eurosceptic candidates and parties are in fact gaining support at the European ballot box, and ultimately the probability of an existing Eurozone member putting the question of exit from the currency union to its electorate. In the meantime, the UK should formally announce its decision to exit the EU at the end of March. The final outcome of this process is unclear, but at this juncture we do not have great expectations that the discussions will be harmonious or that the final settlement will create minimal impediments to trade between the UK and the EU. Our base case is that the UK opts for a so-called Hard Brexit, with the UK outside the EU's common tariff wall. If it becomes clear that this scenario is playing out then we would expect sterling to come under renewed pressure and the likely economic uncertainty to weigh on activity in the UK.

CURRENCY MARKET OUTLOOK

US real growth has averaged about 2% per annum since the post-Lehman recovery started in 2009. Trump's recent election may boost real growth to about 2.5% in the medium-term as a result of fiscal stimulus (largely unfunded personal and corporate tax cuts, and an infrastructure spending program). In our base-case scenario, risks of a recession in the next few years have diminished, while longer term risks have likely increased due to threats of protectionism, and/or an overheating of the US economy that triggers inflation, Fed tightening, and substantially higher interest rates. In this sequence of events, the US dollar is likely to rise in early 2017, as US growth and rates rise. In the meantime, other major economies are likely to remain mired in a low-growth/low inflation mode beset by political issues and elections in Europe (Brexit, migration, and elections in the Netherlands, France and Germany), continued struggles with the politics of Abenomics in Japan, and subdued growth in China and EM generally, though global growth is picking up from low levels in most regions of the world. This base-case scenario is subject to a large degree of uncertainty in the coming year as Trump's agenda may not be fully implemented, protectionist pressures may arise much sooner, and/or financial markets (stocks, bonds, credit spreads) may react negatively and disrupt growth prospects before the actual fiscal stimulus comes into play.

We expect to remain long the US dollar versus major currencies in the next few months. We will reassess conditions after Trump's policies and the willingness of Congress to enact Trump's agenda become a bit clearer.

SPREAD SECTOR REVIEW AND OUTLOOK

Credit markets were able to navigate successfully through the fourth quarter. Looking ahead to the coming quarter, we anticipate bouts of volatility as cross-asset rotation continues to evolve. In the US, while much is unknown of the incoming administration's policies, the driving impetus is clearer. The market expects a fiscal package that many believe will drive personal consumption and inflation higher. This will likely lead to higher bond yields but credit risk can perform well if growth does indeed pick up. Our US cycle indicator continues to register late-cycle dynamics but recent positive data suggest this may be a false signal. Supporting this false signal theory, the third quarter marked the end of the US earnings recession. Should positive data continue we anticipate increasing our risk allocation to US High Yield corporate debt.

Across much of Europe we remain cautious, as valuations are unattractive given elevated political risk. With the experience of 2016, Sector Rotation will look to make use of options strategies ahead of potential stress events. Given the balance of risks we will maintain our underweight in EU markets. As previously stated, at some point in 2017 we expect the ECB to continue to wind down its bond buying program, even if only verbally. We expect markets to reprice to this new reality leading to overshoots and potential buying opportunities. Our EU cycle indicator currently reads mid-to-late cycle and because of this we have a preference for High Yield over Investment Grade credit.

Sector Rotation's current investment themes remain reflation, fiscal impulse and political risk, and reflexivity. Outside of a negative monetary policy surprise we believe risk assets have the potential to perform well through February and likely into March. For this reason it is our expectation to retain our core holdings of CMBS, US Investment Grade Corporates, and European High Yield. Our theme of reflation is expected to act as a tailwind to some of our core positions in floating rate products such as interest-only mortgages and CLOs. Lastly we look to continue using volatility products as a way of expressing directional views when valuations become extreme.

EMERGING MARKET FIXED INCOME OUTLOOK

We start 2017 on a cautiously optimistic note for the Emerging Market Fixed Income (EMFI) asset class. The positive momentum over 2016 was interrupted by the surprise US election outcome and its implications for global trade and Fed policy trajectories. Nevertheless both EMFI local-currency and hard-currency indices returned close to 10% over the year. We believe we are firmly in a carry regime, and investors will be ultimately drawn to the high yields and inflation protection of EM assets. We foresee high single digit returns for EM debt this year, with local currency performance outpacing that of hard currency bonds.

Our constructive view of EMFI is also founded on a number of observations. With EM growth bottoming and inflation under control or even declining in many markets, we currently see opportunities at the asset class level for both hard currency and local currency debt. Emerging markets still have room for fiscal and monetary stimuli, and we concentrate our exposures in the local high yielding countries where we expect rate cuts to materialize in the coming quarters. Although we expect the US dollar will rally against Japanese yen, Chinese renminbi and Euro, this does not necessarily translate into weaker EM currencies, especially if it's a reflationary growth environment in the US. EM can still outpace a rising US dollar – this has happened many times in the past. Although future Trump policy proposals will likely have direct negative effects on Mexico and China, his policies should stimulate higher economic growth in EM broadly that ultimately should be positive for the EMFI asset class, particularly away from these two countries.

There are obvious exogenous risks to our optimism and they are well-known: adverse US policy decisions toward global trade, a Fed that is more hawkish than expected, political tension in the EU perhaps triggered by difficult Brexit negotiations, or increased risk of global armed conflict with a belligerent US president. We continue to closely monitor such developments as well as potential policy changes at the Bank of Japan and ECB. A turn in rhetoric or in the balance sheet target of either institution could have a significant impact on appetite for fixed income broadly and the EM asset class in particular. Risks more endemic to EM such as rising corporate debt levels (although we see debt levels as sustainable in most markets) or accelerating capital outflows could proverbially spoil the party. In terms of systemic events we see debt restructuring for Venezuela as inevitable this year and a messy end game there may serve to remind investors than this asset class is not default free. Indeed, these risks are ever-present and have arguably increased recently but not to the extent that markets may have priced.

From the past cycle, investors have learned painfully well the differences between local currency and hard currency debt, between investment grade and high yield EM, and between sovereigns and corporates. We enter the first quarter of 2017 moderately more positive on local-currency than hard-currency debt, following the Fed's 25 basis point rate hike in December and likelihood of accelerated rate hikes going forward. We see higher US Treasury yields but not necessarily continued dollar strength against EM. Although Trump's policies may help the US capital account near term, ultimately the stimulative effects of tax cuts and recovery in commodities prices will damage the current account, exporting risk seeking capital to emerging regions. We continue to favor corporate bonds relative to sovereigns but are cautious of investment grade credits, as they are most closely correlated with US Treasuries. We see the sweet spot currently in lower duration, higher yielding EM issues.

TIPS MARKET OUTLOOK

As noted, we believe Trump's ascendancy to the Presidency increases inflation risks significantly. But in the near term, the pricing of inflation risk will be impacted by the Fed's policy reaction function. In December, Chair Yellen dismissed the notion that the Federal Open Market Committee (FOMC) would let the economy 'run hot'. We believe that the FOMC assesses the economy to be close to full employment, and wishes to forge ahead with normalization. Yellen explicitly noted that a fiscal boost is not warranted, suggesting the FOMC would lean against any inflationary impact.

In portfolios, we remain meaningfully overweight on breakeven inflation rates, anticipating a further widening in 10-year breakevens from 2% to at least 2.25%. 10-year breakevens have already widened from 1.40% over the summer. The trade is supported by the following: (i) inflationary aspects of Trump's policy agenda; (ii) Asset allocation flows into the asset class will remain strong in the first quarter of 2017; (iii) Background core CPI inflation is 2.10% year-over-year as of November 2016 and is anticipated to rise towards 2.25% - 2.50% in 2016; (iv) The Fed will maintain its gradualist approach to normalization, and will thus tolerate a modest overshoot of inflation - though it will resist the temptation to inflation 'run hot'. The risks to the trade are that the dollar moves sharply higher, the FOMC turn unduly hawkish, or the economy suffers an external shock.

We believe that the bulk of the Treasury sell-off is behind us, and that 10-year Treasury yields should top out somewhere between 2.50% and 3%. Tactically, risk assets look vulnerable to a pull-back, given the sharp rally after the election and the narrative that 'Trumponomics' will raise growth and lower taxes. Speculative duration positioning also looks extended.

Strategically, Treasury yields cannot rise too far. First, the neutral policy rate, r*, will remain low because of demographics and leverage. We do not subscribe to the thesis that a Trump administration will meaningfully raise trend growth via a productivity miracle. In fact, Trump's focus on protectionist measures and immigration controls is likely to damage the long-term economic potential of the US economy. Second, aging demographics implies a preference for fixed income assets. Pension funds remain underfunded and will be incentivized to use the improvement in their solvency ratios as a result of the equity market rally to reallocate to bonds. Third, the Republicans' radical proposal to end the deductibility of interest payments against corporate income taxes may reduce future corporate debt supply, aggravating shortages of fixed income. Finally, Treasury yields are already high by international standards. Additional widening of yield spreads could contribute to further dollar appreciation, which would both tighten financial conditions and lower inflation.

BIOGRAPHY

Dominick DeAlto
Chief Investment Officer - FFTW 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