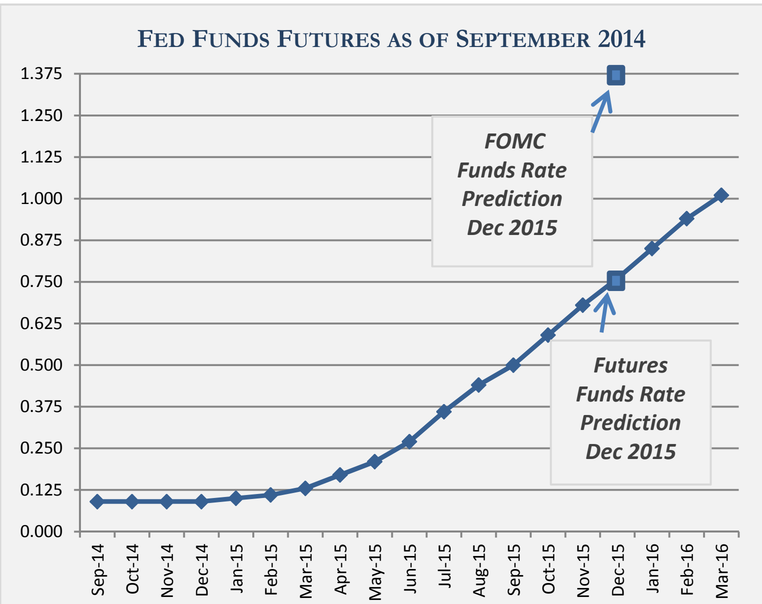
Economic Progress in the US and Stagnation in the ECB and Asia: Central Bank Policies That Impact the Markets

The global economy is weak, geopolitical risk is heightening, and the combination of economic sanctions and Ebola fears are paralyzing already weak economies. As the US jumps ahead in the recovery race, the dollar is strengthening against the Euro and the Yen.

Can the "magic" of central bank policies continue to fuel growth and price stability?

Since the Great Recession, the markets have become overly reliant on the power of the central banks to do whatever it takes to "bail out" or "pump up" flagging economies or overly leveraged balance sheets. The central bank tools have been covering a much broader swath than in the past: lowering rates to zero (or lower in the case of the ECB), layering on asset purchases in the form of quantitative easing, and unleashing the power of the podium to tactically deliver comforting messages to the markets. As we approach year-end, our Fed may be backing away while other central banks likely have more work to do. As of September 2014, the markets are predicting that the funds rate will hit .75% by the end of 2015. The Fed, on the other hand, projects that the funds rate will hit 1.375% at the end of 2015, a broad divergence of opinion on the pace of the rate hikes which further reflects the disconnect between the futures market and Fed opinion. The markets may prove to be too complacent.



Source: Bloomberg

This period of central bank transition should not have a dramatic impact on rates in the near-term, and in fact longer-term rates should remain low and range-bound well into year-end for several reasons:

- While the US recovery is on track, Europe and Asia are struggling and deflationary pressures continue to take center stage. While our Fed is contemplating a rate increase beginning in late 2015 as part of their exit strategy, the weaker regional economy in the Eurozone will require policy accommodation in QIV 2014 and well into 2015 and 2016. The strengthening dollar is a direct result of this dichotomy.
- Global rates, particularly in developed countries, will likely continue to remain low well into 2015, indirectly creating a ceiling on longer term US Rates. At quarter-end, the UST 10Yr is not only trading significantly higher than Germany and France, but is also trading higher than Spain and Italy, based on the assumption that the ECB will need to be aggressive in its easing policy.
- Geopolitical risks in the Ukraine, Iraq and Syria, and Africa have impacted Emerging Markets and High Yield, and should generate some pressure on lower quality securities. These hotspots of unrest should fuel demand for higher quality assets, but could also slow the growth momentum in Europe and the Middle East.
- While the US economy is healthier than most of our peers (QII GDP was revised from +4.2% to +4.6%) and the Labor market is showing signs of strength, Housing remains tentative. Inflation is on the decline in both Europe and the US, with commodity prices falling, and all central banks are focused on averting a deflationary disaster.

The Curve Flattens Further in QIII

The Fed's Treasury Asset purchases will end in October 2014, as expected, with QEIII having focused on purchasing in the intermediate to longer end of the yield curve. However, as the purchases have been winding down all year, there has been little or no impact on the market and the curve has continued to flatten. In the past year, the 2Yr has migrated from 30 basis points (bps) to almost 60 bps, the 10Yr has traded between 2.35% and 3.00%, closing QIII at 2.48%. This curve bias has flattened the 2Yr to 10Yr area of the yield curve year-to-date by 73 basis points. It is highly unlikely that 2Yr Treasuries will trade much higher in yield until we get closer to a Fed Funds rate hike. It is equally unlikely that the 10Yr Treasury will break out of this range (2.35%-3.00%) without a major shock to the system. The market consensus has 10Yrs hitting 2.74**%** at year-end.

Fund Flows, Supply … and Demand

Demand for taxable fixed income has continued to be very strong this year, and actually accelerated in the third quarter. According to Lipper data, net inflows into taxable mutual funds and ETFs were approximately $37.5 billion, a step up from $33 billion in the previous quarter. Inflows have steadily accelerated throughout 2014, with sequential growth in QII and QIII of 5.5% and 13%, respectively. The breadth of demand is particularly impressive given that high-yield taxable funds and ETFs totaled seen about $6.25 billion of outflows in 2014, including outflows in four out of the last five weeks of the third quarter.

While flows have been positive, investment grade supply is on target to surpass 2013's record issuance. Total investment grade issuance for the first three quarters of 2014 stands at $1.09 trillion, with $290.5 billion issued in the third quarter from 254 issuers. The majority of that issuance came in September where issuers brought a total of $165 billion to market, making it the largest month of issuance in 2014. Issuance by Financials was by far the largest in the quarter at $130.5 Billion. Maturity ranges were tightly concentrated between three and ten years with 78% of all issuance falling in the seven year range. "BBB" rated credits continued to dominate the quality spectrum with $122 billion (or 42% of the quarter's total) issued with a "BBB" rating. Moody's aggressive stance on credit has pushed several "A" rated issuers into the "BBB" category, and it remains a place to add value with issuers who have strong balance sheets.

Strong supply and demand, coupled with geopolitical concerns, put pressure on spreads in QIII. Investment grade corporate spreads widened somewhat with most of that movement occurring in the month of September. Geopolitical concerns continued to force Treasury rates lower, supporting the widening trend. Investment grade corporate option adjusted spreads (OAS) ended the quarter at +112, up from +99 at the end of June. The higher quality bonds outperformed lower rated bonds, with "AA" rated bonds achieving the best performance.

Sector Focus

The lowest agricultural commodity prices seen in seven years have helped put a lid on inflation, but are also presenting increasing risks for agriculture and related industries. On a positive note, the downward pressures on crop prices will significantly lower input costs for issuers like Archer Daniels Midland (ADM). ADM processes oilseeds, corn, wheat and other commodities into value-add products like vegetable oil, protein meal and biofuels. While commodity processors should flourish in the near term, we are also keeping a close watch on companies which may indirectly suffer from lower farmer income, including capital equipment manufacturers. With farmers facing lower revenues and the U.S. fleet of tractors and combines at the youngest age it's been in nearly a decade, it is very possible that farmers will look to cut costs out of their capital investment plans. The Financials continue to benefit from healthy balance sheets and the constant oversight of regulatory scrutiny. The Energy sector, the worst performing sector, was driven by the price pressures on oil, and Technology was the best performing sector over the quarter.

We look for the bond markets to remain range-bound for the foreseeable future, with credit spreads on higher quality assets remaining narrow. As the change in Fed policy approaches in 2015 and volatility returns, these assets should outperform their higher risk counterparts. By aligning our portfolio management initiatives with our research process, our performance has largely been driven by security selection and execution. We intend to continue to uncover value in this way from a credit perspective, and to target value with yield curve positioning.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives.

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