CENTRAL BANKS PLAYING CHUTES AND LADDER

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As Senior Portfolio Manager, Jamie developed and manages the Navigator Global Opportunity portfolio and manages the Premier Fixed Income Strategies. In addition, Jamie manages covered call options deployed on individual stocks and exchange traded funds in the Premier Portfolio Group and implements collar strategies on individual blocks of stocks. He is a member of the Clark Capital Investment Committee. Jamie has over 25 years of experience with fixed income securities. He began in municipal credit research and worked in public finance before moving to a position in trading where his experience included trading municipal bonds and employing fixed income futures and futures options. He has extensive experience in dealing with mutual funds, and trust departments and money managers. He received his degree from St. Joseph's University.

A Game for Ages 4 to 7

Chutes and Ladders is a child's board game, based on a 10 by 10 grid numbered 1 to 100. Children are rewarded for good deeds by advancing up the ladder and drawing closer to the winning #100 square. Bad deeds cause you to go backwards, sliding down the chutes toward the beginning of the game at square #1.

In the game, there are 9 ladders and 10 chutes. Let's examine the issues facing the Fed within this simplistic construct.

Ladders: Taking You to the Land of Normalized Rates

- The Leading Economic Indicators (LEI) jump 0.6% in April, suggesting stronger growth ahead.
- Retail Sales rise 0.5% in May, the second straight monthly gain.
- Business inventories rebound 0.4% in March, signaling the inventory correction may be nearing an end.
- The producer price index (PPI) rises 0.2% in April.
- The May headline unemployment rate is at 4.7%.
- Wages rise 1.3% year to date

Chutes: Taking You to the Land of Negative Rates

- The U.S. economy grows 0.5 in the first quarter, the slowest quarterly expansion in two years.
- The Japan Manufacturing PMI contracts to 48.2, its lowest reading since January 2013.
- The China economy expands only 1.1% in the first quarter.
- U.S. industrial production falls 4% in May.
- U.S. durable goods orders decrease 2.2% in May.
- U.S. manufacturing PMI slips to 50.5, the lowest level since October 2009.
- The U.S. economy grows 0.5% in the first quarter, the slowest quarterly expansion in two years.
- The U.S. June employment report showed private sector jobs increased by only 38,000. The lowest number in five years.
- The U.S. unemployment rate declines to 4.7% from 5.0% because almost a half a million people gave up searching for jobs.
- The World Bank shrinks 2016 forecasts for economic growth from 2.9% to 2.4%.
- On June 16th, the German 10-year interest rates turn negative. Now eight countries have negative two year interest rates at the end of the quarter.
- And then finally BREXIT; gold rose and equities plunged.

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In the child's game, your odds of beating your opponent are pretty close to 50/50. In the Fed's game, more chutes seem appear everyday instead of ladders to climb to normalized rates.

Chutes Outnumber Ladders: What's a Fed to Do?

In our view, the May jobs report really surprised the Fed. The Fed was trying to signal a possible rate increase at the July interest rate meeting. In fact, as recently as the end of May, Fed Chair Yellen had indicated interest increases could happen "in the coming months."

However, the 38,000 private sector job growth in May changed everything. Yellen's press conference after the number was announced was uninspiring and lacked confidence. She mentioned the word "uncertain" numerous times.

On June 17th, a surprise came from St. Louis Fed President James Bullard, when he announced a white paper on a new forecasting model. This model saw maybe one interest rate increase through 2018 as an appropriate course. This is just another signal that "lower for longer" is the rule.

Ladders to Where?

A bond is a way to provide a series of cash flows over a set number of years. As bonds mature you re-invest at the longer end of the ladder and supposedly get a higher interest rate. On June 17th, if you were a German bond investor, you were faced with buying a bond ladder providing negative interest rate returns for 10 years. No coupon payments for 10 years. Your return is based solely on price appreciation which actually does happen if rates keep going further and further into negative territory.

I would suspect a buy and hold approach in a negative rate environment won't do so well when rates return to positive territory.

Brexit Was a Big Chute. Draghi's Response: "Let Them Eat credit"

Britain voting to leave the EU created market turmoil. There was a swift devaluation of the British pound. The equity markets sold off and gold soared. This was the short term reaction and it would be premature to make a macro call on the long term implications of Brexit.

A short-term assumption is that this will be another obstacle in global growth and spark yet another round of accommodative monetary policy from the world's central banks. Our Fed is really in a difficult position with the dollar soaring after Brexit. The Fed's response will probably be cautious and hold off interest rate hikes for the next few quarters.

The interesting response will be from the European Central Bank. The second quarter is ending with negative two-year rates in France, Germany, Italy, Spain, Sweden, Netherland, Switzerland and Japan. Of that group, only Italy and Spain have five-year interest rates above zero. The Mario Draghi zero interest rate policy has gone beyond free money into negative interest rates. It's almost Marie Antoinette-ish as he shouts from the rooftops, "Let them eat credit!!"

Negative Rates: A Chute the Fed Cannot Place into the Game

Negative rates are not a path that the Fed can go down. Negative rates are a threat to capitalism in my opinion. To make it simple, there are two parts to a transaction in a capitalistic society. The purchase or sale of a good and the financing of that transaction. It is assumed this transaction is for some profit which adds to growth. The financing of the transaction is the second component of the growth. If the transaction is financed at a zero interest rate, there is no growth of cash flow. There is a return from the borrowing of the money but not a return on the borrowing itself.

Can the Fed Land on Square #100?

To end a game of Chutes and Ladders, the child must land exactly on square #100. It appears the Fed was trying to have everything land perfectly on square #100 and missed their chance to raise rates earlier in this economic cycle.

Now we have the new chutes of the May jobs report, Brexit, and negative interest rates, and a Fed with one interest rate cut available to them (or maybe a QE4?). Lower for longer seems the way it is for now.

Did I mention the original name of the game was Snakes and Ladders. Now that sounds a bit scarier.

Brexit Starts a Muni Rally

The quarter was dominated by the May jobs report and Brexit. The quarter began with munis firm in price but priced fairly richly, in our opinion, compared to Treasury bonds. A punk May payroll number of 38,000 started a rally in Treasury bonds and munis followed suit.

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The July reinvestment which consists of interest payments and matured bonds in munis has traditionally created strong demand. The Brexit vote on June 23 caused Treasury 10-year bonds to spike to a 1.40% yield at one point in overnight trading. That morning the first trades in munis were 12-18 points lower in yield. My experience, after having traded in munis on summer Fridays, has been that when the market gaps open, volume tends to come to a grinding halt as participants try to digest the new lower levels. That was not the case this time. With negative rates in sovereign debt worldwide and munis having investment grade ratings, there was a consistent bid to find value in the market all day.

Treasury bonds closing the quarter at 1.47% and the 10 year AAA muni right around that range really is unprecedented. The July reinvestment flows will determine if there is follow through to new yield lows.

Credit Was Calm . . . and Then It Wasn't

High yield continued to rally off its lows set in February when oil bottomed and kept grinding higher as there were very few sellers in the market. New issues came into the market and refinanced higher coupons with ease. Some lower credit commodity companies opportunistically bought back their debt at discounts to par.

Investment grade credits kept pace with rallying Treasury bonds and in many cases traded at spreads that continued to tighten. The hold music for a bond dealer I call was "Summer Wind" by Sinatra – it was all so calming. Who knew the Brits and their "stiff upper lip" pride would cause an EU exit vote to win and the markets to be roiled.

The 1.70% yield on 10-year Treasury bonds was a technical area that we thought could cause a further move lower in yields if it was breached. This happened on June 9th. Bonds successfully re-tested that area and then rallied back to the lows.

Then it happened. Britain voted for independence to leave the EU and go on their own. Equities sold off, gold soared, high yield bonds were hit and Treasury bonds traded to an overnight low of 1.40% on the 10-year bond. The high yield sell-off was limited to certain issues. It did not seem like the start of a huge sell-off but appeared as if buyers used the opportunity to add to positions. Sure enough after a sell-off of a day, high yield rallied on June 28th.

Brexit created a several day volatility event, a chute that took away the probability of a July rate hike. As to where it goes from here, we will keep monitoring and actively managing. One thing that seems likely from the outcome of Brexit is that central banks will continue to be accommodative until more ladders appear.

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Navigator® Fixed Income

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Second Quarter 2016 — Portfolio Commentary

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