Fixed Income – Judging the Potential Headwinds

March, 2018

SUMMARY

- **Current conditions are generally unattractive, with low yields and spreads across both sovereign and corporate debt**
- **Central bank policy adjustments will influence supply/demand dynamics, with the potential for increased volatility**
- **We will share key insights regarding the bond market and how potential headwinds may affect portfolio positioning**

HISTORY & BACKGROUND

Utilizing ACG's network of investment professional contacts, we take the opportunity at the beginning of each year to compile outlooks and perspectives relevant to the global fixed income markets. By polling 20 closely-followed firms, our Year-End Manager Survey captures projections on key variables along with sector specific views. The 2018 Fixed Income Summit, held in mid-January, also offered our team live interaction with four respected market veterans.

INSIGHTS & PORTFOLIO IMPLICATIONS

Interest Rates

Following the credit crisis, Wall Street and investors have consistently predicted rising interest rates. The chart below shows that projections of 10-Year US Treasury yields have been off by an average of nearly 1% over the last eight years. With the exception of 2013, all have overshot. Bloomberg's monthly survey of 60 - 75 global economists calls for rates to slightly exceed 2.9% by year end.

Projecting Rates Has Been A Difficult Task

Source: Bloomberg, as of 12/31/17

Tax Reform & Fiscal Policy

As expected, there has been much conversation around the Tax Cuts & Jobs Act (TCJA), and the prospect for potential fiscal spending. Looking beyond the anticipated benefit to near-term growth, there is concern about the longer term effectiveness of increasing US deficits at a time when the economy is already accelerating. Also, the ultimate impact on taxpayer behavior, consumer and corporate spending, and any unintended consequences will take time to unfold.

Federal Reserve

Following a year in which the FOMC's actions finally met their own internal projections, our Survey and Summit participants seemed rather comfortable with the baseline scenario of three additional hikes in 2018. There is less agreement regarding the terminal level for the Fed Funds rate, with estimates ranging from 2.5% to 3.5%. Both the endpoint and the pacing of normalization relative to other central banks has implications for bond returns and the value of the US dollar relative to foreign currencies.

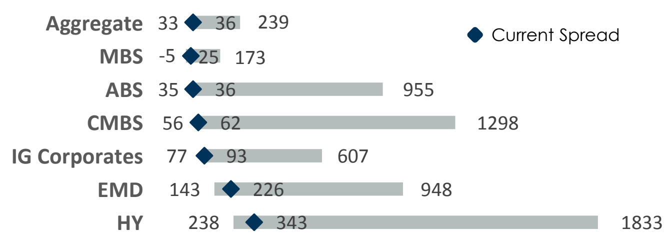
Inflation

The outlook for inflation is thought to be the determining factor in how the FOMC will act. Given recent strength in economic indicators, and the lagging nature of inflation, current expectations may be too low. Increasing inflation expectations may be an underappreciated risk. The FOMC's difficulty in achieving its targeted 2% level, however, may reflect structural changes that are overwhelming any cyclical uptick in prices.

Emerging Markets

The most universal view seems to be a preference for emerging market debt, particularly local currency issues. That said, there are risks that must be considered. The high beta nature of emerging markets means any disappointment in global growth would likely have an outsized impact on this category, and any dramatic rise in US rates would weigh on US dollar-based bonds that are trading at relatively tight spreads.

Spread Compensation Tight Across The Spectrum



Source: Bloomberg, Barclays indices, 15-year range as of 12/31/17

ACG'S POSITION

In 2017, global fixed income markets performed better than expected. With widespread global growth and building signs of inflation, central bank policy normalization will likely continue or even accelerate. Tight credit spreads leave almost no margin for error, and may lead to greater downside risk for fixed income strategies with limited coupon income to buffer losses. While high quality bonds should be retained for proper portfolio balance, we see merit in differentiated strategies that expand the implementation toolkit within fixed income. The ability to broadly diversify portfolio risk factors remains valuable, and should assist in the goal of downside protection even amid bouts of higher volatility. For investors able to handle illiquidity, private credit and credit hedge funds should potentially be considered.