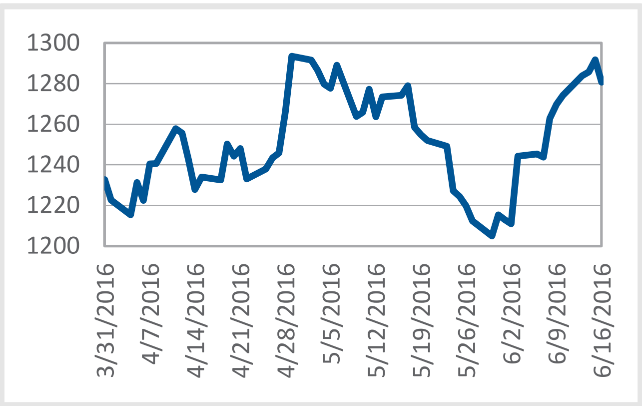
Bulletin: Crisis or Opportunity?
June 2016

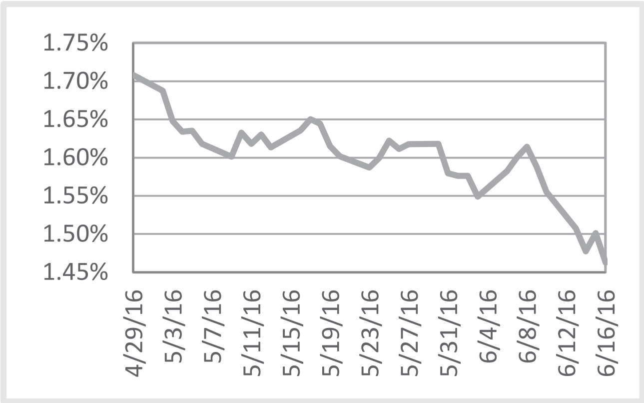
Since the lackluster release of the US jobs report, the tempo of fear has begun to accelerate as we draw closer to the Brexit vote. The Fed has tried to inoculate the world by communicating an accommodative policy with a slower path for future rate raises. However, market indicators until recently have shown an increased level of fear:

- Gold appears to be trying to break out of its recent trading range of about 1,200 to 1,300. This event alone does not mean a crisis is guaranteed, but it reflects growing fear – if not of Brexit, of monetary debasement due to greater Fed accommodation. At best, the Gold break-out so far reflects tenuous uncertainty in the market.
- Treasury-inflation protected securities (TIPS) have been helping to clarify the character of the gold rally. If gold was up due to inflation fears, TIPS would be performing well in recent days – they are not. TIPS have been meaningfully underperforming nominal Treasuries, and TIPS break-evens have been breaking down. The recent trading range for inflation expectations in the 10-year part of the curve was from around 1.5% to 1.75% - but it is now falling below 1.5%. We believe this indicates a deflation fear in the TIPS market. Consequently, gold is rallying on pure risk-off.

Gold Spot Price ($)



10 Year TIPS Break-evens



Source: Bloomberg

- Nominal Treasuries confirmed these trends: The Treasury curve had been experiencing a bull flattener, where long-term rates are converging on the short-term.
- While there is still concern over Brexit, polls have suggested the “remain” campaign is now leading after the murder of British MP Jo Cox. In reaction to this shift in polls, markets have tilted again to a risk-on posture, but there may be more substance to this stance than simply polls.

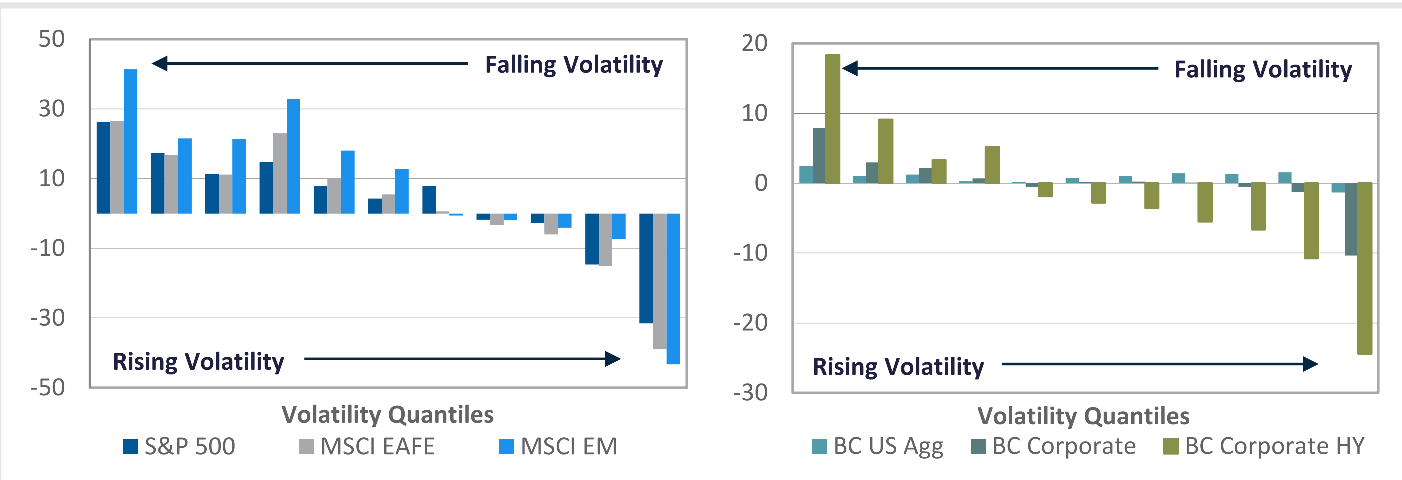
Global economic data released in recent weeks was neither notably weak nor notably strong. Recent trading, until the shift in Brexit polls, was influenced by these risk-off cross currents. These patterns are reminiscent of the August 2015 crisis over China’s currency revaluation and the instability in the first weeks of 2016. We have believed that this fear may be setting us up for another risk-on opportunity. Jo Cox’s assassination is a contributing factor in reassessing the Brexit outcome. But ultimately U.S. central bank policy, which has been accommodative, and economic fundamentals, which have been positive, should be the key drivers of a viewpoint, despite all the noise.

Volatility indicators confirm this has been a contained scare thus far. Benchmarks that reflect directly on fear are elevated, but not at crisis levels. The VIX, MOVE, and JP Morgan Emerging Markets Currency Volatility benchmarks have all risen in the past few weeks, but the responses to market events remain well below levels seen in August 2015 and the start of this year.

A detailed analysis of the 3 volatility benchmarks noted above gives us useful perspective on how to position for the future.

1. The charts below analyze emerging market (EM) FX volatility, as measured by the JP Morgan EM Currency Volatility Index, from 2001 through 2016. We separate equity index returns into quantiles associated with changes in the volatility of EM currencies. As you can see in the chart on the left, historical periods of lower volatility in EM currencies have correlated with higher equity market returns. We care about EM currencies and trends in their volatility, as we believe they are the weakest link in the capital markets chain. Crisis frequently develops in financial systems under stress, or markets that are less developed, which is typically associated with emerging markets. Thus, if calm is returning to these currencies because they do not forecast a Fed tightening in the near future, we believe it is a positive harbinger of returns in equities. As the chart on the right shows, falling volatility in EM currencies is also associated with the outperformance of high yield and corporate bonds.

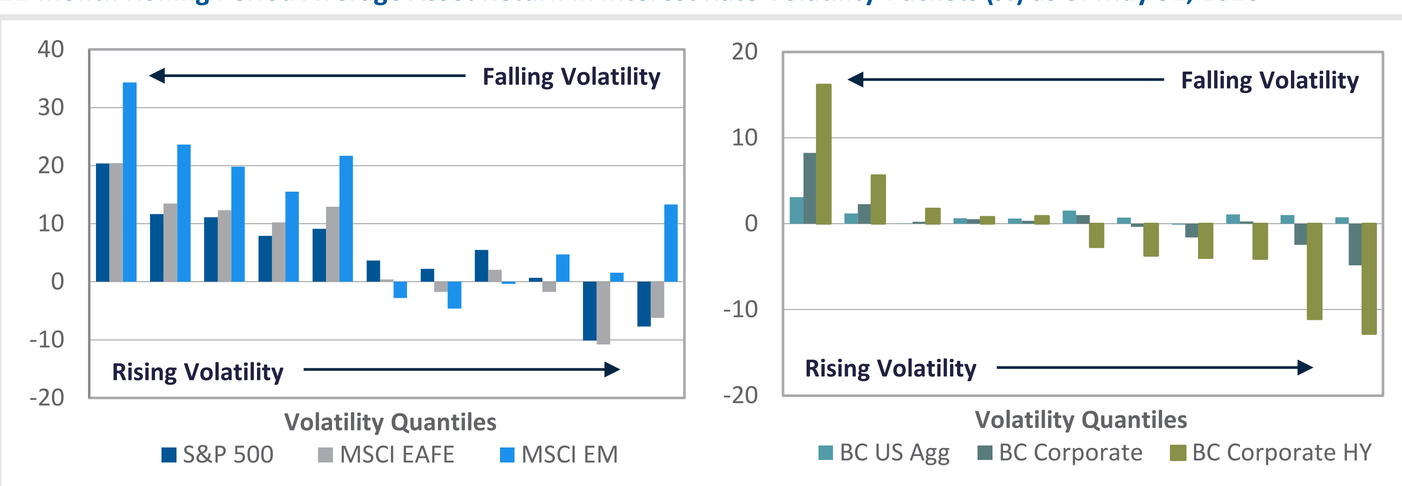
12-month Rolling Period Average Asset Return in EM Volatility Buckets (%) as of May 31, 2016



Source: Bloomberg

2. We measure volatility in the US Treasury market through the Merrill Lynch Options Volatility MOVE Index. Like the prior FX volatility study, we break down the past fifteen years of the MOVE Index into buckets of rising and falling volatility. The results are directionally similar to the FX study; where we can note that falling volatility is supportive of risk-on, while rising volatility is generally not.

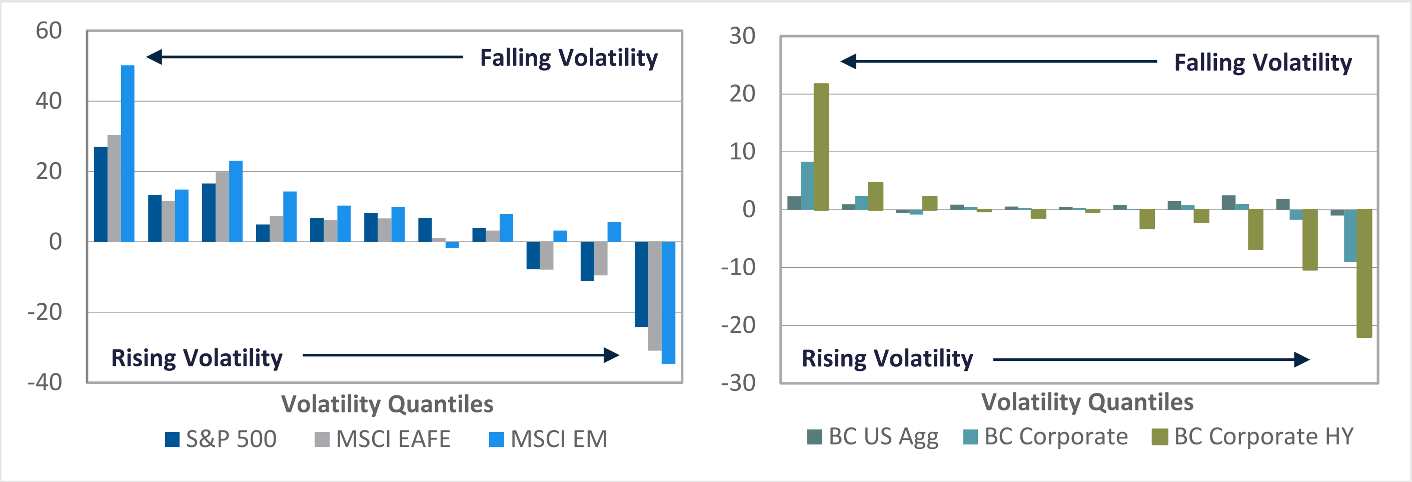
12-month Rolling Period Average Asset Return in Interest Rate Volatility Buckets (%) as of May 31, 2016



Source: Bloomberg

3. Not surprisingly, our study of equity market volatility, captured by the VIX Index, which measures the volatility of the S&P 500, shows the same pattern.

12-month Rolling Period Average Asset Return in Stock Market Volatility Buckets (%) as of May 31, 2016



Source: Bloomberg

Likewise, we believe that the current geopolitical and global contexts support Fed inaction and a weaker US dollar. Fed tightening leads to a stronger dollar, which in turn contributes to global financial instability, forcing EM borrowers to repay dollar-denominated debt more expensively. It also increases the probability of a devaluation of China's currency, which would be a highly destabilizing force. A stronger dollar would also strengthen the forces of deflation and further undermine what remains of the manufacturing sector. We believe that the Fed, which would do well to avoid all of these outcomes, thus looks even less likely to raise rates.

The most recent jobs report and impending Brexit vote has given the Fed cause to delay. If the analysis above is informative, it would be reasonable to expect a trading range environment for fixed income, with a tightening spread bias. As for equity investors, there is an old saying, "sell in May and go away." We believe that was good advice in 2015, but may prove misguided this summer.

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IMPORTANT DEFINITIONS

- Brexit is the possibility of Britain leaving the European Union.
- JPM EM Currency Volatility Index follows implied volatility on emerging market currencies versus the U.S. dollar.
- The Chicago Board Options Exchange Volatility Index (VIX) is an expectation of 30-day future price volatility implied by options contract prices.
- MOVE index is the yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
- Morgan Stanley Capital International (MSCI) EAFE Index serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia.
- Morgan Stanley Capital International (MSCI) Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 835 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
- The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.
- Barclays U.S. Corporate Investment Grade Index is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued.
- Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

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