Quarterly Commentary

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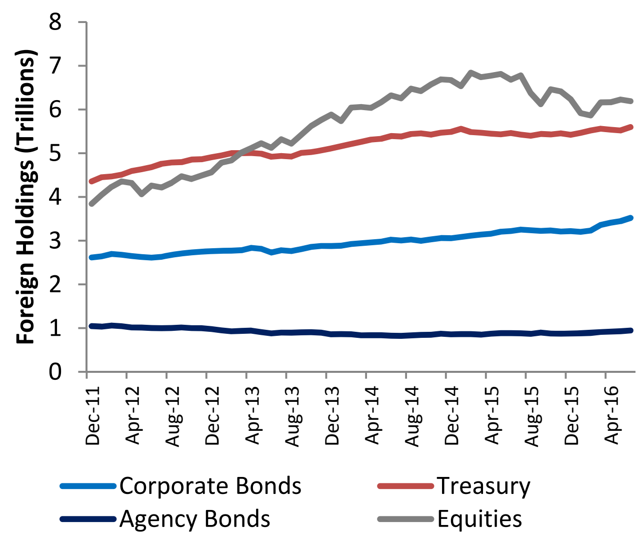
What was expected to be a tumultuous quarter following the "Brexit" vote turned out to be rather mundane as additional central bank policy further fueled the demand for yield, driving risk premiums lower in the fixed income markets. Treasury rates are between 10 and 15 basis points higher over the quarter, retracing much of the initial post-Brexit decline. Even U.K. bank spreads are trading at pre-referendum levels. Welcomed stability in commodity markets also provided strength to the markets, and the recent OPEC agreement should provide a floor on the price of oil.

Spotlight on monetary policy

Following the vote to leave the European Union, the Bank of England took proactive measures to brace the economy from the repercussions of the decision. Measures included reducing short-term rates, reinstating government bond purchases, and for the first time, buying corporate bonds. The Bank of Japan, faced with a fragile economy and a strengthening yen, announced it would use asset purchases to target a 0% yield on its 10-year bond. For those keeping score, the Bank of Japan was already utilizing negative short-term rates and quantitative easing. After announcing a corporate bond purchase program earlier this year, the European Central Bank commenced the program during the quarter, and according to Wells Fargo and Dealogic, is already the second largest manager of Euro investment grade credit! Turning closer to home, the Federal Reserve refrained from raising rates in September even though they believed the case for an increase had strengthened. Expectations for a rate hike in December are currently hovering around 60%. Interestingly, or maybe ominously, the Fed yet again lowered domestic growth and inflation expectations as well as the path of future rate hikes.

How have these actions impacted the capital markets? Higher asset valuations and lower yields globally. Combined, the Bank of England, Bank of Japan, and European Central Bank are buying about $200B worth of assets every single month, crowding out the traditional buyer base and driving yields even lower. This dynamic has dramatically increased foreign demand for U.S. fixed income, and in turn, has kept a ceiling on rates even as the Fed slowly normalizes monetary policy. Rate and equity volatility have remained muted and correlations between different asset classes have been rising. In other words, central bank policy has a stranglehold on the capital markets.

Exhibit 1: Foreign ownership of U.S. securities has been increasing due to the relative strength of the US economy and the hunt for yield



Source: U.S. Department of the Treasury

But is it working? By many standards, the levels of interest rates seen globally are extremely accommodative, yet growth has been modest at best. In July, the International Monetary Fund lowered their global growth outlook to 3.1% from 3.4% and has been warning that more fiscal action is needed to stimulate growth. In early October, they again marginally reduced their expectations for the advanced economies. The efficacy of additional monetary policy is at best questionable, but what could be more troubling is an unanticipated change of action by the central banks.

Politics taking center stage

Another emerging risk the International Monetary Fund identified was the increasing or rising popularity of nationalist policy in the developed economies. An obvious example of this was the U.K. vote to leave the European Union, but the sentiment exists in other European nations as well. Fringe parties have gained ground in Germany, France, and Italy by winning local elections, and with national elections next year in Germany and France, threaten the stability of Europe. The next test could be the Italian constitutional referendum in early December where the prime minister has stated he would resign if not approved. Commonalities amongst these parties include anti-immigration, protectionism, and Euro-skepticism. In the U.S., where we have the most polarizing candidates in recent history, the momentum of Mr. Trump (even Mr. Sanders) exemplifies the same dissatisfaction that is seen in Europe.

With monetary policy at its limits and a fragile global economy that is interconnected, political outcomes could threaten to break the trading ranges established these last few months. Regardless of the results in these elections, there is a growing population that is unhappy with the status-quo and will influence elections for years to come.

A few last words

It is unusual to not discuss the economy, but not much has changed since our last writing. GDP growth is expected to be around 2% for 2016, the labor market continues to be strong, and consumer spending has remained at a healthy clip. However, business investment continues to lag as corporations would rather buy back shares or increase dividends than invest for the future. With valuations propped up by monetary policy that is approaching the end of its usefulness, one cannot help but feel uneasy.