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INVESTMENT MANAGEMENT

What’s Going on in the Markets: A Bond’s Eye View

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | 11 October 2018

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On October 3 U.S. Federal Reserve (Fed) Chairman Jerome Powell’s comments indicated for the first time that they may <u>tighten</u> their monetary policy. Equity markets have traded lower every day since that statement. It is important to note that U.S. Treasury yields moved first, followed by equity/risky assets. I’ll explain why this is important, but first let’s discuss what is going on in the markets.

<u>An important distinction</u>

The Fed has been raising rates since December 2015 to remove excess accommodation. The goal has been to “normalize” policy rate levels to neutral. Moving to ***neutral*** **IS NOT the same as** ***tightening***. Powell on October 3 announced he may tighten the Fed’s monetary policy, and this set in motion the events of higher rates and falling risky asset prices.

Based on Fed models, a 3.00% fed funds rate is widely viewed as the neutral rate (real fed funds rate (r*) of approximately 1% + 2% inflation target = 3%). This is approximately what the market is pricing for the terminal fed funds rate.

<u>What changed?</u>

Powell’s comments indicated that the Fed may increase rates toward 3.50%, reinforcing the Fed’s “dot plot” prescription, which is 50 basis points higher than the 3.00% market consensus policy rate—meaning a tightening of 50 basis points for which asset prices need to reconcile.

<u>Assessing the risks</u>

Much of the adjustment in asset prices has come not from U.S. Treasuries but from riskier assets, namely equities that are adjusting to a higher discount rate (interest rate) for cashflows (earnings).

Mathematically, this has mechanical consequences, some of which are:

1. It lowers the present value (PV) of prices (equity prices fall).

2. Bond spreads widen in response to an upward change in the risk-free rate. This happens because spread product is typically short the credit default option, a component of the spread, which increases in value (rho, in option terms). In other words, you become short a more expensive option, thus the spread widens to reflect this option price change.

A rise in risk-free rate sets in motion this *mechanical* repricing of risky asset valuations.

Bottom line

Market price action today can be explained *mathematically* through the *mechanics* set in motion by a rise in risk-free rate expectations. Of course, this could trigger knock-on effects and an overshoot under the mechanical fair value—perhaps this is what we are seeing today. We are not diminishing this risk, but we see it as a temporary correction. Why? Because economic fundamentals remain strong, which to us are more important for medium- and long-term investment horizons.

An important observation to make is that U.S. Treasury yields barely moved as risky asset prices fell. It is the classic case of the U.S. Treasury market adjusting first, to be followed several days later by riskier assets. This is the cornerstone of our thesis behind this move in risky asset prices, which is that it is a rational and *mechanical* adjustment to higher risk free rate expectations.

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DEFINITIONS

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

Rho is the measure of the change in an option's price due to a change in the risk free interest rate.

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