NIS Update: May 19, 2016

Topic: Fed Minutes Release and its Implications

To Our Clients and Consultants:

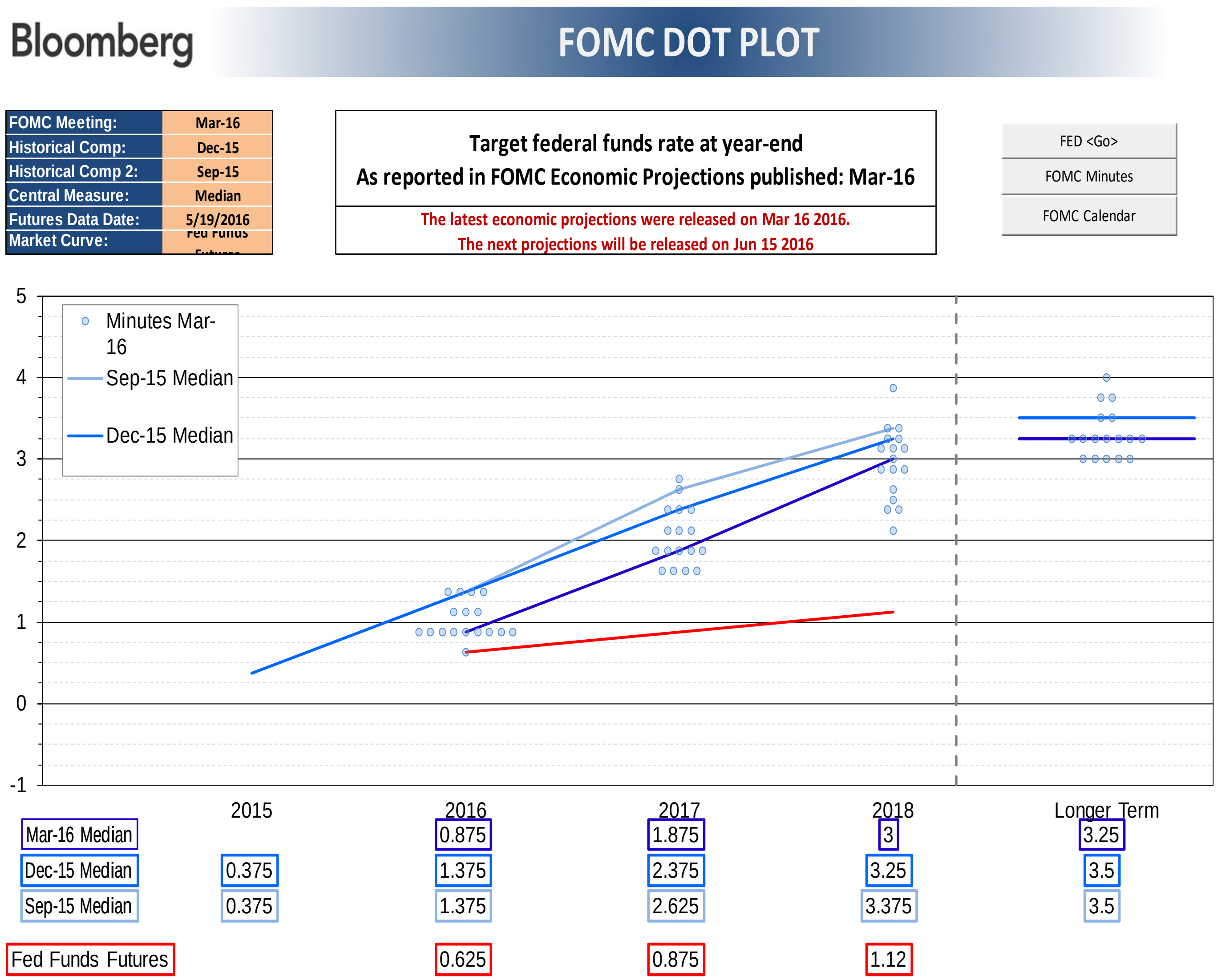
Yesterday the bond market traded off on details released from the most recent FOMC (Federal Open Market Committee) meeting. The bond market most likely reacted to two sections in the report. The first detailed the Federal Reserve's communications and subsequent market reactions. Basically, the market previously interpreted little chance of a rate move in June and a low trajectory of further moves. Fed members felt that given the improvement in financial conditions over the previous months market projections had become a bit complacent. The second section detailed the possibility of a hike in June pending positive data with varied opinions around whether the information would provide a "clear" signal. The committee was really looking to add flexibility in our opinion.

Meanwhile, much of the content remained status quo, such as improving labor market conditions, still low inflation, tepid industrial and manufacturing activity, soft business spending, and a fairly resilient financial system. Concerns surrounding foreign growth eased as better than expected data in Canada and Europe, coupled with more upbeat readings in China, seemed to put a floor in risk markets including those in the U.S. Much ink was spilled summarizing the rebound in equity markets and bonds spreads with a concurrent lowering in volatility, but overall the committee wanted further evidence of a sustained rebound before raising the target rate.

Our Observations:

This awakening was as much about perception (who is in charge, markets or Fed?) as about the fundamentals. Maybe that is too harsh. I guess it is about trying to improve the communication disconnect between the markets and the Fed. For more insight to future rate direction, we look at what has been going on with market expectations and interest rates both abroad and here in the U.S.

Fed Fund Futures (red line) are much lower than Federal Reserve projections. Bond market participants have a more bearish outlook than Fed officials. We believe the Fed would like these plots to come closer to one another. Putting June back in play and the possibility of a summer hike should at a minimum give the market some concern that its stance is too pessimistic.



Source: Bloomberg

The 10-year U.S. Treasury yield currently stands at 1.85%, while yields across the globe (not so much in Asia) are up about 20bps from their spring lows. It looks to us that rates may have put in a bottom.

LLP

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Regional | 97) Settings | World Bond Markets

91) Bonds | 92) Spreads | 93) Curves

Maturity 10 Year | Trading Mode | Data Range YTD

Country	CMI	Security	Bid / Ask	Yield	Yld Chg	Yield	Low	Range	High	YTD Chg
1) Americas								Avg Now		
10) United States		T 1 5/8 05/26	97-30+ / 97-31	1.849	-0.5		1.659		2.269	-42.1
11) Canada		CAN1 1/2 06/26	101.440 / 101.480	1.342	-2.2		.996		1.546	-4.7
12) Brazil (USD)		BRAZIL6 04/26	101.815 / 102.265	5.695	+17.9		5.317		7.238	-142.6
13) Colombia (USD)		COLOM 4 1/2 26	100.795 / 101.230	4.339	+14.3		3.985		5.634	-59.6
14) Mexico (USD)		MEX4 1/8 01/26	103.285 / 103.630	3.675	+11.3		3.345		4.221	-20.7
2) EMEA										
20) United Kingdom		UKT2 09/07/25	104.865 / 104.885 c	1.437			1.301		1.957	-52.0
21) France		FRTR 0 1/2 26	99.950 / 99.965 c	0.504	-0.7		.432		.984	-48.0
22) Germany		DBR0 1/2 02/26	103.185 / 103.195 c	0.169	+0.2		.088		.626	-45.8
23) Italy		BTPS 2 12/25	104.525 / 104.555 c	1.491			1.211		1.709	-9.8
24) Spain		SPGB 1.95 26	103.260 / 103.325 c	1.586	-0.8		1.420		1.825	-17.6
25) Portugal		PGB2 7/8 07/26	98.135 / 98.410 c	3.060	+0.2		2.493		4.061	+56.7
26) Sweden		SGB2 1/2 05/25	117.193 / 117.404 c	0.510	+0.7		.387		.977	-46.7
27) Netherlands		NETHER0 1/2 26	101.125 / 101.150 c	0.384	-0.2		.246		.790	-40.6
28) Switzerland		SWISS 1 1/4 26	115.670 / 116.135 c	-0.332	+0.8		-.484		-.100	-21.2
29) Greece		GGB3 02/24/26	73.880 / 74.840 c	7.318	+5.2		7.192		11.118	-53.3
3) Asia/Pacific										
30) Japan		JGB 0.1 03/26	101.631 / 101.832 c	-0.085	+1.8		-.146		.255	-34.0
31) Australia		ACGB 4 1/4 26	116.683 / 116.765 c	2.344	+5.9		2.225		2.875	-53.2
32) New Zealand		NZGB 4 1/2 27	116.580 / 116.989 c	2.690	+7.0		2.570		3.561	-86.6
33) South Korea		NDFB 2 1/4 25	104.664 / 104.798 c	1.815	+2.9		1.757		2.061	-25.5

Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
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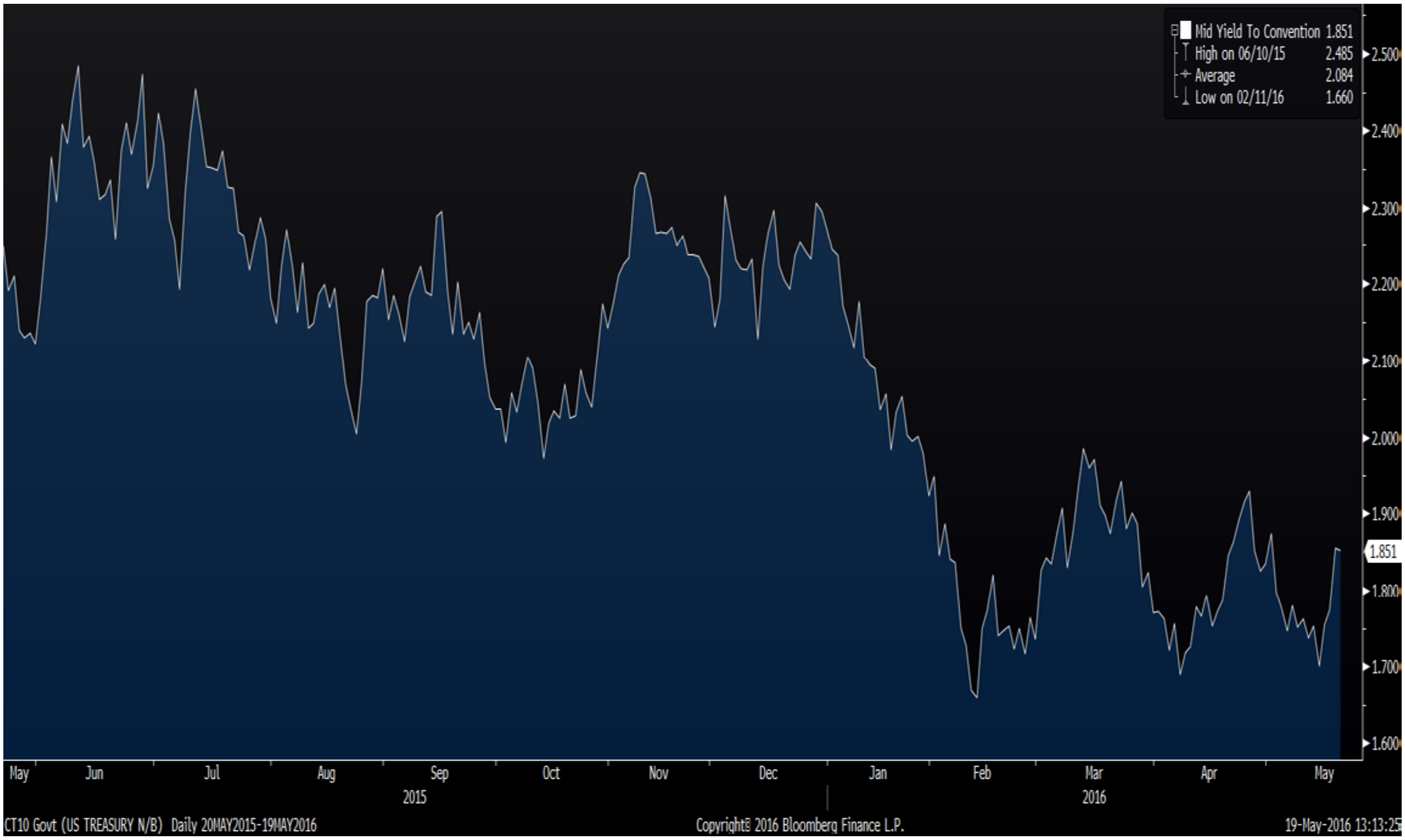
Source: Bloomberg

Taking things a step further, we highlight the U.S. 10-year yield on a twelve month chart. One could argue that economically speaking, the world is not much different than when we started the year (ECB, Japan, China policy aside), so even a partial retracement of the January rally (lower yields) gets the 10-year note above 2% in short order. Additionally, a triple bottom formation around 1.65% looks like a technical floor (this actually goes back to 2012) and barring much more technical buying. To me, the trade that causes the most pain right now would be an upside move in yields.



Source: Bloomberg

We remain slightly underweight duration across portfolios and have used the most recent rally in corporate spreads to trade up in quality. Our general stance on duration is approximately 97% of index, with durations in DFI accounts being lower due to an overweight in the Absolute Return Fund. Additionally, we are underweight the short end of the rate curve in portfolios.

Please feel free to contact us with any questions regarding your portfolio or the markets. We enjoy hearing from you.

Sincerely,

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