



# STANDISH



## Bond Market Observations

June 2011

*"If you can find a path with no obstacles, it probably doesn't lead anywhere."*

– Frank A. Clark

### Executive Summary

- Investors are shedding risk as they worry the soft patch may morph into another recession.
- We continue to believe the slowdown in the global economy is temporary and the global economic expansion is sustainable.
- We believe a point will be met where expectations are low enough such that positive economic surprises may turn the tide in favor of risk assets.

### Lowering the Bar for 2011

Consensus expectations for US economic growth in 2011 have been revised significantly lower since the beginning of this year. According to Bloomberg, the median projection for 2011 real GDP growth has fallen from 3.2% in February to 2.6% in June. The forecast downgrades are not surprising given the disappointing nature of the recent economic data. For example, the ISM Manufacturing Index dropped from 60.4 in April to 53.5 in May and the US economy generated just 58,000 jobs in May after averaging 220,000 per month during the prior three months.<sup>1</sup>

The combination of high commodity prices and temporary production cutbacks associated with the Japanese earthquake/tsunami are behind some of the weakness. However, the global outlook is further clouded by the end of quantitative easing in the United States, the battle over the debt-ceiling in the US Congress, Europe's sovereign debt woes, and the risk of over tightening by central banks in emerging market countries. These concerns have caused investors to shed risk as they worry the temporary soft patch may morph into another recession. As a result, US 10-year Treasury yields have fallen from 3.6% in early April to under 3% in early June with 10-year German Bunds following a similar pattern.<sup>2</sup>

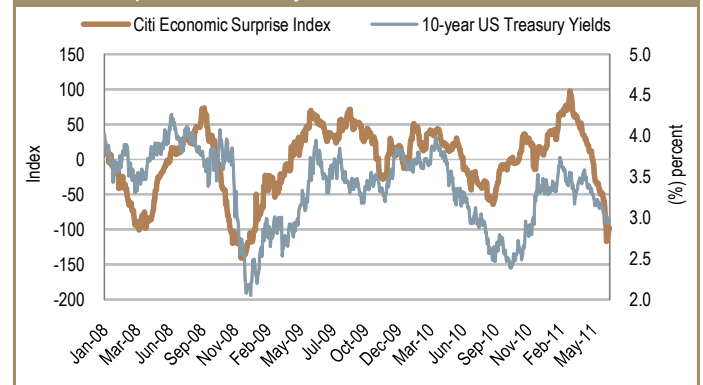
We continue to believe the economic expansion is sustainable given that private demand in the form of consumer spending and business investment has been behind much of the rise in economic activity. Healthy corporate profits, a gradually improving labor market, and the accommodative stance of monetary policy are just a few of the factors supporting our view. The question is whether expectations have been beaten down enough such that economic or political developments can result in positive surprises that will turn the tide back in favor of risk assets.

### When Will the Tide Turn?

The Citigroup Economic Surprise Index (CESI), which measures deviations between consensus estimates and actual economic data, suggests that expectations have not yet caught up with reality. In fact, the CESI is near its lowest levels since the 2008 global financial crisis, which indicates that the consensus has been too optimistic about the recent economic data. Yet, with each downward revision to the consensus forecast, we believe we are getting closer to the point where the data will begin surprising on the upside.

Historically, the CESI has tended to be a poor predictor of overall economic activity. However, the series has a better track record as a contrary indicator of 10-year US Treasury yields at extremes. In other words, the CESI has tended to trough just before Treasuries sell-off and it has tended to peak just as Treasuries are about to rally. The fact that the CESI appears to be near an extreme at the present time would imply that the bulk of the recent Treasury rally is probably behind us.

Economic Surprise Index Contrary Indicator At Extremes



Source: Citigroup Global Markets and the Federal Reserve as of June 10, 2011

The key economic variables that we are watching for signs of a shift in momentum are the initial claims for unemployment insurance, the ISM manufacturing activity index, and core new orders for capital goods. These leading indicators were among the most adversely affected by the transitory supply-chain disruption associated with the Japanese tragedy in March and therefore should be amongst the first to rebound as the Japanese automakers and parts suppliers get production back up and running.

The high frequency of the weekly jobless claims data makes it an attractive indicator to watch for changes in cyclical momentum. The series typically leads fluctuations in the overall economy by one to three months. This time was no exception with the uptick in claims in early March leading the deterioration in the rest of the economic data by about two months due in part to the time

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lag with which most other economic data is released (e.g., April's manufacturing production figures were released the third week of May). Therefore, we are closely monitoring the claims data for signs that the soft patch is ending.

We tend to focus on the four-week moving average of jobless claims to gauge the underlying trend rather than look at the volatile weekly figure. Although we have begun to see some stabilization in the number of new claims filed over the past few weeks, we believe it is premature to say that the data are pointing to an imminent improvement in the economy. Once there are signs of a definitive trend lower in claims, which we would expect to occur later this summer, one can look to the ISM Manufacturing Index and the core new order for capital goods figures for confirmation of the rebound in activity. By that point, we would expect Treasury yields to start rising as investors begin to feel more comfortable that recession risks have receded.

## Too soon to Sound the All Clear

Despite our belief the slowdown in the US economy is temporary and there is little value in Treasuries at current yield levels, we are not of the view that interest rates are headed sharply higher in the near future. According to the Standish Treasury model, two of the primary determinants of 10-year rates are inflation and monetary policy, neither of which points to an abrupt rise in interest rates at this juncture given limited corporate pricing power and a Federal Reserve that is likely to be on hold for much of the next year. Furthermore, even after the transitory effects of the Japanese tragedy fade, there are other risks lurking on the horizon that may heighten market volatility and potentially boost demand for US Treasuries.

The most pressing is the battle in the US Congress over extending the \$14.3 trillion debt-ceiling. If no action is taken by August 2, the US government could run out of money to meet its obligations. In response, Standard & Poor's, Moody's and Fitch have threatened to put the US government's AAA-rating on watch for a possible downgrade should this type of technical default occur. Although it is difficult to know exactly what will happen to Treasuries in such a situation, a convincing case could be made that Treasuries may rally in the short-term as concerns about fiscal retrenchment undermine prospects for economic growth.

Outside of the US, the lack of resolution to the European

sovereign debt crisis has placed government bonds in peripheral Europe under pressure which has benefited both German Bunds and US Treasuries. Initially, investors reacted by selling the debt of Greece, Portugal and Ireland. But, more recently, Spain and Italy have also come under some pressure as European officials publicly debated the efficacy of a near term restructuring of Greek debt. Standard and Poor's decision to change its outlook on Italy from "stable" to "negative" in late May has not helped matters. Our expectation is that Europe will postpone a restructuring in Greece until it can be certain that such an event will not lead to a contagion that will drag down all of peripheral Europe and potentially result in a pan-European banking crisis given cross-holdings of government debt. Nevertheless, Bunds and Treasuries could see a safe haven bid during the periodic bouts of volatility we expect to see in peripheral European spreads.

The final risk relates to emerging markets (EM) and the idea that budding inflationary pressures may result in an over tightening of monetary policy and sharply slower economic growth. This is probably lowest on our list of concerns particularly since a growing number of EM central banks appear to be approaching the end of recent tightening cycles. Most investor worries relate to China where industrial production and retail sales have disappointed as money and credit growth has decelerated. Yet, the data seem to point to some moderation rather than a collapse in growth. Thus, the impact on demand for US Treasuries is likely to be negligible. In fact, over the longer term we would not be surprised to see some reduction in demand for US Treasuries from emerging markets as these economies reach higher stages of development and rely less on export oriented growth which implies a lower level of reserve accumulation.

Overall, we expect Treasury yields to rise to around 3.75% in the second half of the year as the US economy rebounds, inflation begins to accelerate, and the Fed prepares to exit its ultra-easy monetary policy. Further out, a failure to address entitlement reform in the United States has the potential to put significant upward pressure on US Treasury yields. The Government Accountability Office has estimated the rising spending on Medicare and Medicaid will cause the structural US deficit to steadily increase beyond 2020 all other things being equal.<sup>3</sup> According to our long-term bond model, Treasury yields may rise 20-30 basis points for each percentage point increase in the structural budget deficit.

<sup>1</sup> Institute of Supply Management <sup>2</sup> Bloomberg <sup>3</sup> Government Accountability Office Long Term Federal Budget Simulations

The ISM Manufacturing Index is a monthly index released by the Institute of Supply Management which tracks the amount of manufacturing activity that occurred in the previous month.

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