

I believe the regimes of forever quantitative easing and negative interest rates are nearing an end. On July 6, 2016 we moved our bond market rating to "maximum negative". Since then yields have been gently rising and I think the bond market is sniffing out the narrative that the regime is about to change to bond unfriendly. This is a longer-term secular shift away from bond buying and maybe toward inflation. It's a big moment to get defensive on interest rates, maintain a defensive duration and reduce risk. That's what I meant when I said "sell everything" at the end of July.

Interest rates bottomed in July. The two-year is up 16 basis points (bps), the five year is up 23 bps. The 10-year is the real reason I've turned negative on bonds. On July 6, the 1.38% yields we saw in July 2012 was breached and it went down to 1.32% on an intra-day basis. It didn't hold below 1.38% and now it's significantly above that by 25 bps. That was definitely the market rejecting the new low. Between now and year-end I believe the 10-year yield will be higher, likely low 2's which means they could rise 40 bps. The long bond did exactly the same thing, hitting 2.22% in January 2015, making an intra-day of 2.09% and rejected that low. It now sits above 2.22%.

Overall, I think the economy is too weak for the Federal Reserve (Fed) to be talking about raising rates. Gross Domestic Product (GDP) is falling with nominal GDP at a level associated with past recessions. 2016's real GDP is unbelievably lower than any year in the last decade.

The ISM Manufacturing Index is now at the lowest level since 2009 and looks to be on recession watch. But the Fed has hit their goal of unemployment of 5% where it's been for over a year. However, the unemployment number is about to cross over its 12-month moving average which is at least a necessary condition for a recession. It's not as important as the 36-month moving average which is not close to being crossed over but would almost guarantee a recession, so the Fed seems to have some room. Core CPI is slightly above their 2% target but the two main contributors are shelter and healthcare, not exactly a broad inflationary sign. The Future Inflation Gauge (FIG) had been quiescent for the past seven years and all the sudden it's showing some signs of life in the last several months. So the Fed must feel like they are supposed to raise rates, however, they have lost confidence in themselves as demonstrated by the significant downgrading in their dot forecasts. They did raise rates once back in December and it caused a disaster in global markets in the ensuing six to eight weeks. The dollar fell 7%, that's inconsistent with what most people think. The dollar does not rise when the Fed starts to raise rates.

But it seems the Fed wants to prove their independence from the markets and from the World Interest Rate Probability (WIRP). Historically, the WIRP has been above 70 when they raised rates. Why not make that the parameter and not have a Fed? My guess is the next time the Fed tightens it will be when the WIRP is below 50, maybe 40 or 45 and the

S&P 500 is not at the high, the other mechanistic indicator they are accused of following. I don't believe there will be rate hike in September.

If the Fed raises rates, it would add to the deficit which now sits at \$500 billion. One thing we do know is this political election shares a similar "stimulate the economy" theme with Hillary promising to add \$275 billion and Donald promising to double that with fiscal stimulus programs to try and get the economy growing. Again, not bond friendly.

**Markets – U.S. Dollar** – Has been moving sideways for some time now. We're in the middle of a range but I believe weirdly, it may break to the downside. Not high conviction though.

**Mortgages** – The shorter duration hurt the sector the first half of the year, only to become an advantage for the remainder of the year.

**Corporate Bonds** – Overvalued in two ways: 1) spreads have tightened even when rates fell which is unusual. 2) they have a long duration. I don't think corporate credit is a great bet.

**Junk Bonds** – Up 14.7% YTD which is incredible. It has recession risk and default risk. I continue to favor EM over junk bonds.

**Emerging Markets** – We've been using the sector in lieu of corporate bonds this year which has been the right thing to do. It's been a top performer.

**Commodities** – Gold seems to sense some inflation but you don't want to trade in and out of it. I'm seasonally bullish on gold.



# Definitions & Disclaimer

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## Definitions

**Core Consumer Price Index (CPI)** = CPI is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. Core CPI excludes food and energy.

**Future Inflation Gauge (FIG)** = The FIG utilizes relevant economic data to attempt to predict the cyclical swings of inflation. In general, the FIG goes up before acceleration in inflation and vice versa.

**Gross Domestic Product (GDP)** = Gross Domestic Product is the amount of goods and services produced within a given country/territory.

**ISM Manufacturing Index** = This index from the Institute of Supply Management (ISM) monitors employment, production, inventories, new orders and supplier deliveries.

**Thompson/Reuters CRB Index** = An arithmetic average of commodity futures process with monthly rebalancing.

**World Interest Rate Probability (WIRP)** = WIRP is Bloomberg's world interest rate probability calculation which displays the probabilities of rate increases by central bank meeting date.

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