



FIGHT THE FED

KEY TAKEAWAYS

- Over the past three months, both growth and inflation expectations have declined, potentially challenging the idea that the U.S. Federal Reserve will increase short-term interest rates.
- Currently, the Fed Futures market implies only two 0.25% rate hikes, while the Federal Open Market Committee projections suggest seven 0.25% rate hikes, by 2019.
- We view the monetary policy missteps combined with abrupt short-term interest rate hikes - without supporting macroeconomic data - as the most significant macroeconomic risk today.

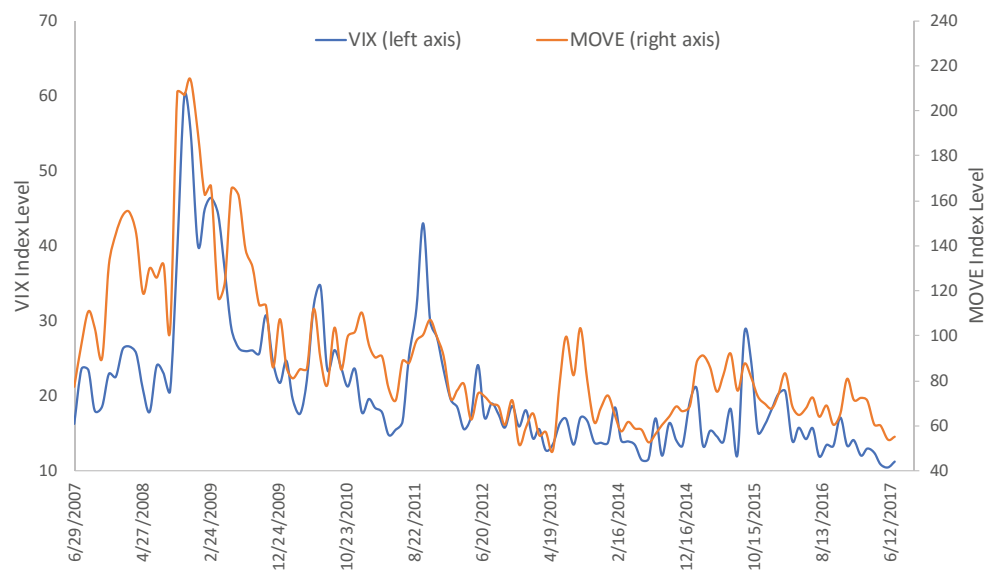
INTRODUCTION

The major stories within U.S. markets during the month of June were the low level of equity market volatility and the continued divergence between U.S. Federal Reserve (“FED”) projections and expectations implied by the fixed income markets. Typically, the month of June is a slow month for new macroeconomic and corporate fundamental data, and this past month was no different. During June, Washington politics and oil prices increased return dispersion with U.S. equity sectors. Interesting this increased in return dispersion was offsetting; thus the overall U.S. equity market exhibited low volatility. The equity market implied volatility, as measured by the CBOE Volatility Index (“VIX”); closed the month at 11.18, close to 10 year lows.

Figure 1

EQUITY AND FIXED INCOME MARKET VOLATILITY

Source: Innealta Capital using Bloomberg data. Time frame 06/30/2007 to 06/30/2017 from Bloomberg. “VIX” represents the CBOE VIX Index. “MOVE” represents the Bank of America MOVE Index.



DECREASING VOLATILITY

Figure 1 shows the VIX and the Bank of America MOVE index, a proxy for fixed income implied volatility. In each market, implied volatility, which is a proxy for the demand for insurance, has reached historic lows. The decline in fixed income volatility resulted from the market sentiment that the Federal Open Market committee (“FOMC”) will not raise short-term interest rates as quickly as projections suggest. Given the interdependence between markets, the observed large divergence between market-implied expectations and FOMC projections of short-term interest rates, in our opinion, should be top of mind for any investor.

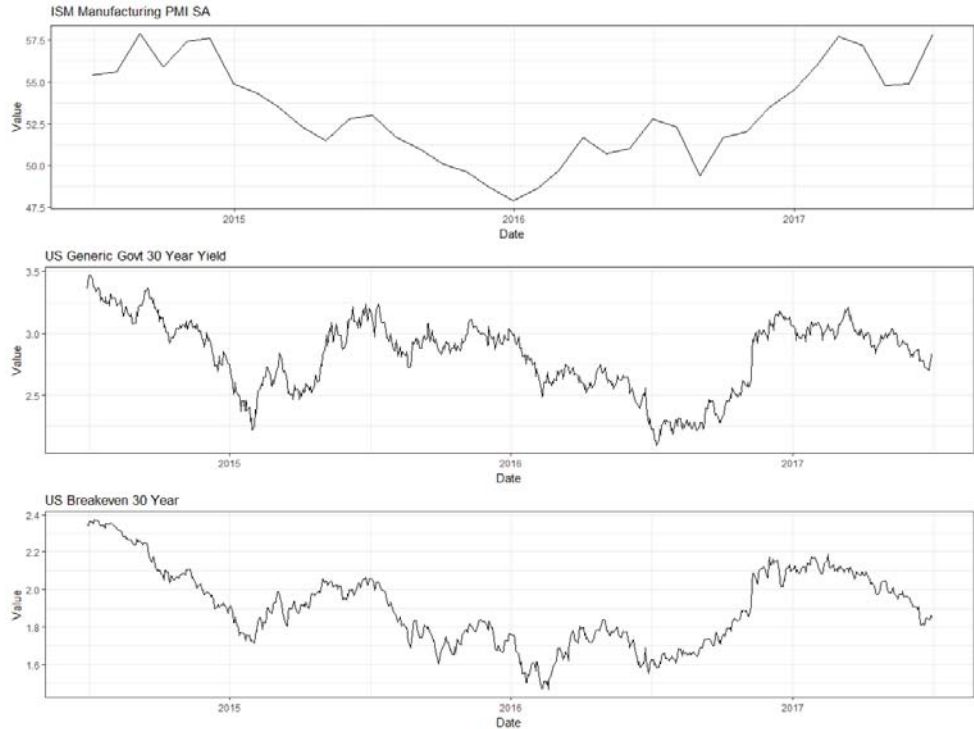
DECLINING EXPECTATIONS

Over the past three months, growth and inflation expectations have declined. Macroeconomic theory would suggest that longer-dated fixed income markets are directly related to growth and inflation expectations. Higher inflation and higher growth should theoretically lead to higher yields. Note that these are not the only drivers of the fixed income market; however, they are relevant to our analysis. We use the Institute for Supply Management’s Purchasing Manager Index as a proxy for growth expectations and the U.S. 30-year Breakeven Index as a proxy for inflation expectations. Figure 2 shows our growth and inflation proxies along with the yield on the 30-year U.S. Treasury. The figure shows that the recent decline in 30-year U.S. yields has coincided with declines in both growth and inflation expectations.

Figure 2

GROWTH AND INFLATION EXPECTATIONS, AND 30-YEAR U.S. TREASURY YIELDS.

Source: Innealta Capital using monthly data from 06/30/2014 to 06/30/2017 from Bloomberg. “Growth expectations” refer to the Institute for Supply Management’s Purchasing Manager Index. A value above 50 implies growth. “Inflation expectations” refer to the Bloomberg U.S. Breakeven 30-year index.



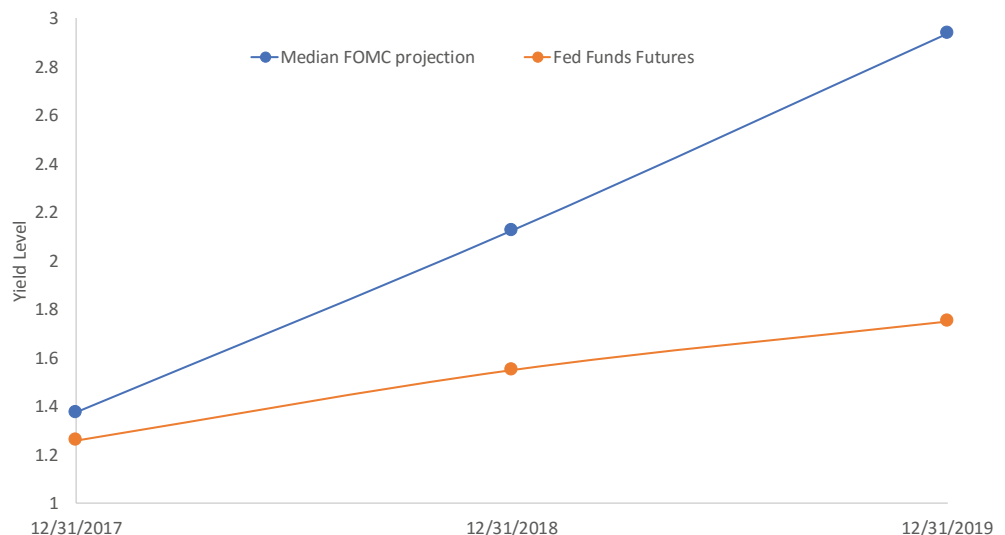
FIGHT THE FED

Currently, interest rates expectations - implied from the fixed income market - differ significantly from the expectations of the U.S. Federal Reserve. At the conclusion of each FED meeting, the FED publishes the “dot plot,” which shows the Federal Funds rates projections for each of the 16 members of the FOMC. Each dot represents a member’s expectation of federal fund rates at the end of the various calendar years. Practitioners use the median value for a given year as the FED expectations. Within fixed income markets, we can use a variety of short-term instruments to also estimate the value of Fed Funds rates at the end of each calendar year. Figure 3 below shows the dot plot and the Fed Funds Futures. The immediate takeaway is that, in the future, the FED expects higher interest rates than the rate implied by the fixed income market via Fed Funds futures. The median FOMC projection for the year end 2019, as of the last FED meeting on 06/30/2017, is 2.938%, while the Fed Funds futures, as of 06/30/2017, implying 1.750%. Assuming the FED hikes at 0.25% increments, then the market differs from the FED by almost five rate hikes.

Figure 3

DOT PLOT AND FED FUNDS FUTURES

Source: Innealta Capital using Bloomberg data as of 06/30/2017. Median FOMC projection calculated based on 06/14/2017 FED Meeting.



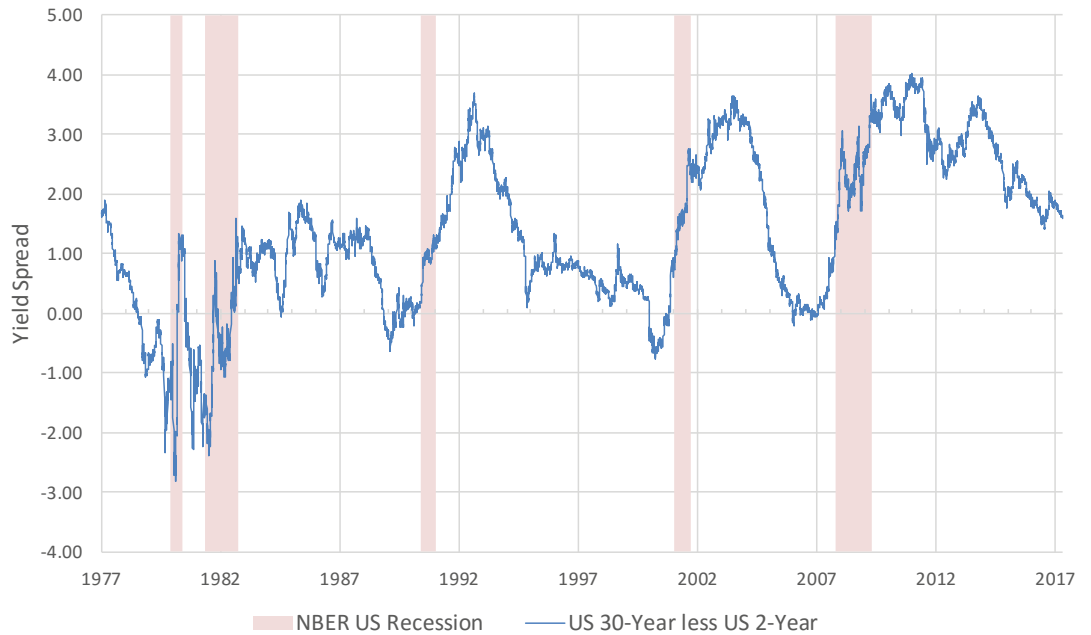
WHAT COULD HAPPEN?

Of the potential causes for a U.S. recession, we view a U.S. monetary policy misstep to be the most probable. We would define a policy misstep as a rapid increase in the Federal Funds rate that would lead to either a decline in U.S. economic growth, a decline in asset prices, or both. Since the last recession, which concluded in 2009, year-over-year U.S. GDP growth has only averaged 2.1%. Other potential causes of a U.S. recession such as a bank crisis, oil price spike, credit deleveraging, or a contagion from another economy, at this point, appear unlikely. Theoretically, if a policy misstep were to occur, this would likely cause the U.S. Treasury curve to flatten as short-dated fixed income markets would potentially underperform longer-dated fixed income markets on a duration basis. We can measure the yield differential between any two points on the U.S. Treasury curve to track the flattening or steepening of the yield curve. The line in Figure 4 shows the yield differential between the U.S. 2-year Treasury and the U.S. 30-year Treasury (“2s30s”) while the shaded regions represents periods defined by the National Bureau of Economic Research as U.S. recessions. Since the start of 2014, there has been a decreasing trend in this spread differential. If the FED projection of 2019 Fed Funds rates is correct, then the yield in the two-year fixed income market would need to rise by approximately 1.3%. In this same scenario, if U.S. 30-year Treasury yields remain constant, the yield differential would be close to zero. As shown in Figure 4, a yield curve differential less than zero precedes every U.S. economic recession since 1980.

Figure 4

TREASURY CURVE SPREAD AND U.S. RECESSIONS

Source: Innealta Capital using Bloomberg data. Time frame 01/01/1980 to 06/30/2017



RECAP

Unless economic growth dramatically improves, a rapid yield increase in short-term fixed income markets due to tightening FED policy could flatten, and possibly invert, the U.S. Treasury curve. Empirically, a flat yield curve has preceded U.S economic recessions. Currently, we see that growth and inflation expectations over the past three months have declined and do not support the FED’s conviction of increasing short-term interest rates. Ultimately, short-dated interest rates will match FED projections, as is currently the case in 2017. The main concern, which we view as the most important macroeconomic risk in markets today, is how those expectations converge.

IMPORTANT INFORMATION

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Chart Definitions

VIX represents the CBOE Volatility Index® (VIX® Index®), which is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. **MOVE** represents the Merrill Option Volatility Estimate. This is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. **ISM PMI** represents the Purchasing Managers' Index (PMI), which is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

It is not possible to invest directly in an index.

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