CUTWATER
ASSET MANAGEMENT

CIO Economic Commentary

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If the World is Flat, Why is the Yield Curve So Steep?

One of the biggest conundrums in the U.S. bond market this year has been a decrease in interest rates in the face of a widespread expectation that rates would rise. While we still believe the forward path of rates is higher, this seeming enigma is explicable when we take a step back and look at some of the shorter-term drivers of interest rates, such as our snowbound GDP. As the American economy continues to broaden and improve, entering what we call the self-sustaining "sweet spot" of this prolonged cycle, we continue to forecast that rates will be moderately higher in twelve months. We do not, however, expect an ultimate rate blowout.

Falling rates this year have perhaps been the result of the market starting to realize that interest rates will not approach levels anywhere near those seen in the days of big hair and Members Only jackets. While a volatile stock market and geopolitical risks and bond market capitulation may be behind the roughly 50 basis point fall in the 10-year note, I believe there remains a major unanswered question: why is the U.S. yield curve so steep?

In pondering this question, Thomas Friedman's *The World is Flat* comes to mind.[1] Friedman's groundbreaking book makes the case that, thanks to new technologies, the world of rigid information silos and impermeable national borders is now history. Constrained information flow is fast becoming as outdated as the belief that explorers would meet their doom by sailing off the edge of the earth. Friedman argues that with instantaneous global communication and ever-more efficient supply chains, international trade has made people of all nations inextricably connected. According to Friedman, national borders will continue to fade into near-irrelevance as time goes on. Indeed, shouldn't this message be one of the vital lessons of the global financial crisis of 2008-2009? During the crisis, as markets all over the world plummeted in tandem and global correlations turned to one, investors everywhere belatedly discovered how leveraged asset-backed mortgages in the U.S. could expose a daisy chain of interconnectedness and pain. If we previously believed the world was round, well, investment portfolios proved otherwise as they were most certainly flattened!

But if the financial world is now flat, why is the U.S. yield curve still so steep?

Although the world of investment flows may now be "flat," when we compare developed world yield curves, even after accounting for differing growth and risk levels, we think, to paraphrase Jimmy McMillan[2], "the U.S. yield curve is too damn steep!" At 300 basis points spread between the 2-year T-bill and 30-year bond, the current slope of the U.S. yield curve correlates more closely with recessions than with the recovery we are now experiencing. If investment flows now move in a (relatively) frictionless and flat world, we believe the spreads between the yield curve of the U.S. and those of other developed countries are currently too wide. Over the long-term, we expect that "flat world" investment drivers will eventually catch up and have an equalizing effect on developed world sovereign curves. We believe there is value to be wrung from this observation, particularly in an environment of moderately rising rates—which is where we believe we are heading. We defend this view further on, but first let's update our economic view and year-to-date scorecard.

1 Thomas L. Friedman, The World Is Flat: A Brief History of the Twenty-first Century (New York: Farrar, Straus and Giroux, 2005).
2 Former New York Gubernatorial candidate from "The Rent is Too Damn High" party.

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2014 CUTWATER SCORECARD

Regular readers of my quarterly letters will forgive me if I remind them that we take a "long view" as we attempt to look through a *full economic cycle* when determining how best to construct a portfolio. After all, without a sense of where we are in a business cycle, how can we determine if we are getting fair compensation for accepting the risks embedded in our portfolios? This risk centric discipline is Cutwater's "true north." Several years back we called for a multi-year "checkmark-like" GDP recovery pattern with a low slope of about 2% GDP growth that would ultimately steepen to 3%. We are pleased to see that this prediction has been fairly accurate as we passed through the first four phases of the seven phases we identified. Midway through last year I posited that we would be solidly into our fifth phase, the "self-sustaining" part of this recovery in the back-end of 2013 with a further pick up into 2014.

In my 2014 outlook "Approaching Cruising Altitude: You are Now Free to Move About the Economy," we asked readers to think of our economy as a jumbo jet ascending toward an ultimate cruising altitude of 3% annual GDP growth. The title referred to our view that the need to remain strapped in during the bumpy rides of 2011 and 2012 would give way to smoother economic air and allow Americans the confidence to invest and spend—in essence, more freedom to "move about the economy." Our jet would be carried higher as all four of its engines (consumer, investment, government, and net exports) add thrust simultaneously for the first time in this recovery.

For 2014 we expected GDP to pick up altitude toward our target goal by growing from roughly 2% to between 2.5% and 3% for the full year. As stated, our view is that we are entering into the economic "sweet spot" of this cycle. The growth slope is picking up but not so much that we risk overheating with inflation or generating systemic asset bubbles. (Not yet, anyway; although later we hazard an early guess on what might bring this cycle to its inevitable end.) As discussed below, we believe we are now in roughly the seventh inning of this nine inning game. Perhaps the first quarter stock market pullback and lower rates is more of a "seventh inning stretch."

With the tenth-worst winter in a generation freezing over much of the Nation, U.S. GDP was snowbound in the first quarter of 2014. Weather certainly clouded the picture for the economy, portending implications for a dovish Fed to continue on its market-friendly path. A dovish Fed is still considered supportive of the search for yield, and therefore tighter credit spreads. And, while GDP growth was negligible in the first quarter, we are of the belief that the freezing weather was the main cause of that poor showing.

While the stock market has stalled thus far this year, we don't believe we have seen the top, rather, we believe the large run-up of valuations in 2013 borrowed from 2014's returns. We also believe this breather in stocks is healthy for the market. The flushing out of momentum players likely prolongs the bull market by delaying the inevitable excess and overconfidence. We remain constructive on equities and believe a growing economy will support corporate earnings while improving confidence and moderately higher rates will support price-to-earnings multiple expansion. With that said, equity volatility also seems to have slowed withdrawals from retail bond funds, which we believe helped keep a lid on interest rates. Despite the volatility in equities and the rally in Treasuries, the spread market in bonds did not indicate trouble ahead as spreads stayed firm—the correct outcome, in our view. Although there was some noise in the geopolitical and economic growth stories, our macroeconomic outlook is still supportive of a "risk on" environment in the credit markets.

Our call on stronger GDP and increasing consumer, business, and investor confidence continues to drive our expectation of moderately rising rates and tighter spreads. Here is our scorecard year-to-date:

Forecast: We forecasted diminishing need for Fed support, and a continuation of QE tapering, leading to moderately higher rates. It should be noted that rates are pushed up *not as a result of inflation*, but rather as part of a continuation toward higher *real yields* which are still too low, given the age of this cycle. (We still expect 10-year Treasury yields end somewhere between of 3% to 3.5% over the next 12 months).

Score: We were off. Rates rallied in longer maturities due to a flight-to-quality trend as geopolitical concerns in Ukraine and a weather-induced slowdown in the U.S. caused traders to seek safety. We would point out that rates actually *increased* a bit in the shortest maturities, however, which is a core expectation of ours. One of the challenges to maturities inside of five years is that real yields are still in negative. For example, investors buying 5-year TIPS are *guaranteed* to experience a negative real return over the next five years. This doesn't make much sense to us. Given that there are prudent ways to achieve positive real yields over the next five years in equities and spread assets such as ABS and floating rate bonds, we think our "risk free" pricing benchmark is "too damn low."

Forecast: We expected moderately tighter credit spreads (10 or so basis points for investment grade credit and 50 or so basis points for high yield). Although we would argue there is not much "beta" left to be wrung out of current spread levels, slightly tighter spreads are supported by a market still searching for yield. (Note: we at Cutwater have already begun our journey of "rotation" away from beta-seeking toward more idiosyncratic bottom-up selection in credit and ABS.)

Score: After a slight stall in the early winter, spreads generally continued to rally across most sectors, as we expected, which helped drive much of our outperformance, given our overweight in credit and structured securities.

We forecast outperformance for long-dated municipals, high yield, and bank and finance paper, and "yieldy," less liquid ABS and CDO products.

Score: We scored high here as most of our sector calls played out, particularly in municipals and the issue specific ABS we selected such as EETC aircraft bonds. Municipals and high yield, both of which are out-of-index sectors, outperformed all Barclays Aggregate sectors in terms of excess return over Treasuries. Bank and finance lagged a bit but, given the improving economy and positive credit quality dynamics, we view this as an opportunity to add to our holdings.

We believed, and still do believe, that the yield curve is too steep and we expected the yield curve to flatten, particularly in the long-end as institutional players continue buying long bonds to de-risk and the market continues to sharpen its focus on when the Fed will tighten policy.

Score: We earned satisfaction on this call as the yield difference between 10-year and 30-Treasuries flattened from nearly 100 basis points to 80 basis points. This flattening, when combined with our sector and issue selection, added significantly to our outperformance. We believe this flattening trend has further to go and will last until the end of this cycle: possibly two or three years down the road. While we expect rates to increase, we believe the odds of a flatter curve are more predictable. Therefore we chose to stay close to home on duration but position portfolios in more of a credit and curve oriented “barbell,” which should outperform a bulleted portfolio, given our outlook.

In sum, we are reasonably pleased that three out of four central predictions played out and contributed to our solid performance. So, as we sail this flat earth, with maps in hand and sextant at the ready, what do we see from here?

UPDATING OUR 2014 OUTLOOK

We believe our multi-year “check-mark like” GDP forecast remains on track. The course we set at the end of 2013 still looks promising to us. With first quarter GDP snowbound at virtually zero percent, our full-year outlook of 2.5% to 3% GDP growth now seems a mathematical stretch. We still think 2.5% is possible, though, as 2nd quarter GDP rebounds with a “broken window pane” impact and the second half approaches 3%. The key point, however, is not whether GDP is, say, 2.5% or 2.7%, but that growth is accelerating and confidence is building. This environment points to higher rates ahead and, perhaps more predictably, toward a flatter yield curve. This is also a supportive environment for risk taking; although, with credit spreads where they are, the “margin of safety” is thin and shrinking. This dynamic has caused us to focus our portfolios more intently on idiosyncratic bottom-up bond selection. This focus is evidenced by our increased allocations to the “hard collateral” obligations of the ABS market. We continue to favor structured credit over corporate credit.

We also see support for ABS and structured bonds coming from continued flows into unconstrained bond funds as asset owners hunt for lower correlation return opportunities. While many of the benchmark consumer ABS (autos and cards) have performed well, we find that there are many pockets of value remaining in the less trafficked subsectors of ABS. And while some of these bonds may be less liquid, we believe that with careful underwriting, shorter-dated and amortizing structures are worth adding to the front-end of our barbell portfolio structure.

SECTORS

ABS is not a Four-letter Word

Why has ABS lagged? We have found that there are fewer investors in this sector due to the investment infrastructure required to understand and underwrite complex securities. Also, we find that ABS still suffers a lingering stigma born in the Great Recession. We don’t believe ABS should remain a “four letter word” for much longer, however.

When thinking back on the financial panics that have occurred in my lifetime, it’s striking how many three-letter words were to blame. When I began my career in the 1980s, junk bond buyers provided vast sums to raiders and private equity pioneers who, in turn, introduced America to the leveraged buyout or LBO. When high yield defaults spiked around 1990 and many of the largest deals soured, LBO became a dirty word for many.

In the 1990s investors of all sizes fell in love with another three letters as the suffix “.com” captured America’s imagination. Attaching the magic suffix to mere business plans somehow generated multibillion dollar valuations. The bubble eventually burst, of course, as the year 2000 saw the shares of tech darlings fall by 90% or more, searing deep psychological scars on millions of investors. Before long, however, investors blew another bubble, this time in credit markets. Asset owners around the world flocked to various types of asset-backed securities: CDO, CLO, MBS, etc., in search of yield. We all remember how that episode ended.

Each time investors suffer widespread losses, the three-letter word perceived as being responsible becomes the equivalent of a four-letter word as investors spurn the culpable asset class for years thereafter. In the recession of late 2001, the levered corporate sector caused the most pain for bond investors, while high quality ABS performed relatively well. Small wonder, then, that ABS was the relative darling of the next five years. As happens in cycles, market participants often flip between sectors because of the “once burned twice shy” psychological, regulatory, and career risk aftershocks are typically long lasting. In 2008, it was over-leveraged ABS that burned investors. And while we are not quite there yet, in this cycle our money is currently on over-leveraged corporates burning investors. As we watch covenant quality slip, leverage creep up, and spreads continue to compress, it is becoming increasingly clear that many corporate bonds are headed toward the land of unattractive risk/reward profiles.

Conversely, even though we are now five years into a recovery aggravated by the “four letter” ABS market, Cutwater still finds quite a few “babies” in the ABS markets, who have been unfairly thrown out with the crisis-era bathwater.

RATES AND CURVE

What we spy on the horizon for the next six to twelve months is moderately higher rates with a particular trouble spot being the 2 to 5-year area of maturities which everyone seems to have "piled into" over the past two years to hide from duration risk. The intermediate maturity "belly" is no longer the safe haven it once was as the economy continues to improve and we move away from monetary accommodation. Perversely, it may now be the case that long duration returns might outperform intermediate duration even as rates rise, but why? Because the curve is so steep and carry is still high at the longest maturities while the flattening curve softens the blow of declining bond prices as we trend toward moderately higher rates. We believe a "barbell" portfolio structure is the superior way to harness this view.

Although it now may seem far away, we expect a 10-year Treasury yield of 3% to 3.25%, by year-end. With that said, we do not think the rate rise will be a blowout because the forces keeping a lid on rate levels are strong. Here is why:

First, compared to most other developed countries, the U.S. Treasury curve is high and very steep. Especially relative to European sovereigns, the long-end of the U.S. curve seems comparatively attractive. Compare the 10-year U.S. note at 2.5% to the German 10-year at 1.3%. Thanks to the accommodative Draghi, even the PIIGS are catching a break. Spain and Italy can now both borrow 10-year money at yields around 3%. The U.K. offers a comparable yield but is a little further along its tightening path, while Japan's 10-year offers a sizzling 60 basis points. With developed world sovereigns trading so tight relative to Treasuries, we believe Treasuries look attractive on a *relative* basis. This dynamic might even support a rotation of a "carry trade" to the U.S.

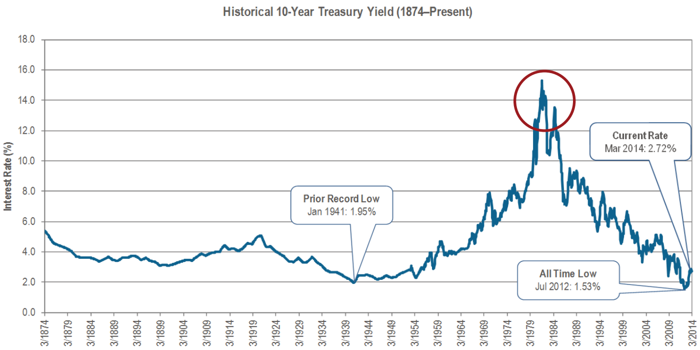
Second, the Treasury market is arguably the world's number one flight-to-quality asset class. The first quarter impact of "unknown unknowns" such as Russia's actions in Ukraine and fears over the economic impact of winter weather drove capital into the safety of Treasuries (this capital flight also put pressure on Treasury bears who added to the rally by covering their short positions). Indeed, while safety seekers could also get some protection by just buying short-end Treasury bills yielding nothing, these are virtually a zero correlation asset, which is arguably not as compelling a hedging vehicle as the long-end of the Treasury curve, which typically exhibits a negative correlation to risk assets. Readers may remember that old Porsche advertisement, except for hedging portfolios we can modify it to: *"The long bond.... there is no substitute."* That is partially why many managers in the growing "unconstrained" space, who are balancing the search for return while capping "draw-down risk," typically have some exposure to long Treasuries.

Third, as I mentioned above, the slope of the yield curve is "too damn high." If we look at the historical slope over the past several decades, the spread between 30-year and 2-year Treasuries averages 150 basis points. The current spread is double that. Further parsing shows that the long-term average spread between 2-year and 10-year Treasuries has been 100 basis points (versus 200 today) and the long-term average spread between the 10-year and 30-year is 50 basis points (versus 80 today). Given the stage of this recovery, combined with low inflation, the curve seems inappropriately steep. There is a spirited debate going on in the bond market now about how to position for what comes next. One camp is hanging out in the short-end (2-5 years) because they expect the Fed won't raise rates as soon as the market believes. A lot of institutional and retail money has piled into this trade. Unfortunately, the herd has made the intermediate part of the curve very expensive and, therefore, the cost of being wrong will be high. Indeed, if we look once again at the TIPS market, 5-year TIPS now sport a real yield of *negative* 40 basis points—which we see as a warning sign, especially since longer TIPS have positive real yields. Flattening in the long-end has begun and it is likely to have a long run ahead. Despite an environment of rising rates, the long-end will not bear the brunt of the duration risk, counterintuitive as that may be. We believe the intermediate maturities are the ones to avoid in this cycle. And, as we know from studying economic, credit, and rate cycles, the curve often becomes inverted at the end of a tightening cycle. So, now that we are 5 years into the recovery, a flattener looks like a pretty good bet.

The *fourth* reason to expect flattening is something I call "the other great rotation." The demographics of our aging population will be a continual driver of demand for long-dated fixed income. Demographics are going to drive historic amounts of capital into the long-end of U.S. interest rate markets. In the U.S., public and private pension assets are estimated to be approximately $7 trillion in size and roughly split 60/40 between stocks and bonds. Faced with volatile markets and aging beneficiaries, plan sponsors now have a challenging mismatch between their assets and liabilities. By their very nature, pensions have long-duration liabilities. By adding long-duration fixed income to better match these liabilities, plan sponsors can effectively mute the asset liability mismatch. De-risking in this manner has already begun and is likely to accelerate. There is a catch, though. There is simply not enough high quality, long-dated bonds to satisfy this growing wave of demand. Even a 10% asset allocation shift from stocks to bonds could create an incremental $600 billion in demand for long bonds, which is equivalent to 100% of the outstanding supply of Treasuries with maturities longer than 10 years. While that shift certainly will not occur overnight, the supply/demand imbalance is not going away any time soon.

Finally, the market may be at the beginning stages of internalizing where rates might top out in this cycle. This is not just a matter of economics and mathematical forecasting; this is also a psychological exercise. How many times have we heard that the 25-year bull market in bonds is over? *Haven't you heard? The quarter-century secular bull market is over.* Quick...what's the opposite of a 25-year secular bull market? ...Well, not so fast. Of course we have come down from the very lofty peak near 16% interest rates during the early 1980s. However, might that have been the long-term anomaly? Leaving that period out, the average rate on the 10-year Treasury over the past 100 years has been roughly 4%. While we are still a little away from that today, I am not sure the market has yet focused on the end game and recognized that we are not likely headed to the runaway yields of the days of platform shoes, bell bottoms, and powder blue prom tuxedos (mine came with a ruffled shirt).

"Spot the Anomaly"

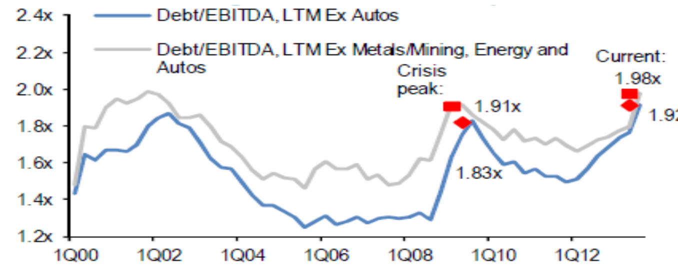


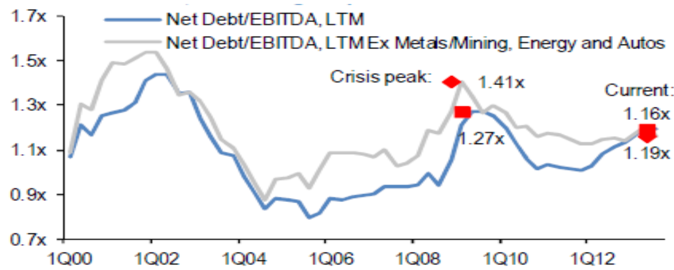
As for the math of where rates might head, we note that over the long run, real yields correlate to real GDP. If we plot our expectations for real GDP, we see it reaching 3.0 or 3.5% at the top of the cycle. If we add in inflation of around 2%, we could craft a case for nominal 10-year Treasury yields reaching 5%, give or take. While breaking 5% is possible, and maybe even likely, we think that the drag of high leverage and scarring from the great recession could keep 10-year rates closer to 4.5% in the later innings of this cycle. If this occurs over the next two to three years, returns will be suppressed but still positive, particularly in select spread sectors. The key to decent returns will be active management and curve positioning (e.g. the barbell vs. bullet decision), sector and issue selections. In this regard, we continue to favor long-dated municipals (although we have reduced a bit into strength), bank and finance, a sector which continues to de-lever, and shorter-dated ABS and structured products such as EETCs and CLOs. If we are correct, and spreads continue to tighten, we expect to continue our counter-cyclical rotation even more toward more idiosyncratic bottom-up selection and ultimately, less risk. So, how do we think about where we are in the cycle?

The Long View—the Seventh Inning Stretch

While we are constructive in our outlook, we are ever mindful of where we may be in this economic cycle. As stated in our previous piece, we believe we are close to the 7th inning of a 9 inning game. We are certainly not in the first innings and we don't believe we are in the ninth, but with spreads in credit indices breaking 100 basis points versus the previous "cycle tight" of roughly 75 basis points for investment grade and 400 for high yield, we think the world of beta is slim and fair-to-rich values abound. Additionally, we are paying close attention to who owns what and in what areas of the curve. The explosive growth of retail money in the bond market via ETF channels has added risk, in our view. As retail volume grows and Wall Street's ability to provide liquidity shrinks, we are closely watching retail-oriented sectors such as high yield and shorter-dated municipals. As rates rise and intermediate maturity bond prices drop, however, we believe this crowded trade will unwind. We also note that credit is actually deteriorating at this point and likely will continue worsening until we reach the bottom of the 9th.

"Leverage is growing but…interest coverage is ok"





Sources: JP Morgan, Markit, September 17, 2013

As you can see, the credit metrics imply that gross leverage is already quite high but interest coverage is acceptable. Also, net leverage (net of cash on balance sheet) is much lower. Add a maturity wall that is two to three years away and we believe the game is not quite over. So, what can we expect for the next inning or two?

We ask what happens to net leverage as corporations continue to spend their cash to buy companies, return money to shareholders, and accelerate capital investments? Well, net leverage will likely grow to higher levels. I was struck by the response to the Fed's guidance that private equity financing deals not exceed 6 times EBITDA. Here's how I would write this headline: "Fed warns companies not to go above 6 times EBITDA, companies respond by going above 6 times EBITDA" as over 40% of recent deals exceeded that guidance. Finally, if we consider that the Fed will likely be in the throes of its rate increase campaign right when leverage is growing and the maturity wall comes due… we think the next "four letter" three-letter word could be spelled F-E-D.