

Flickering Light at the End of the Tunnel

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Key Points:

- 1 U.S. recession does not seem likely for 2016 and U.S. economic outlook appears to remain solid**
- 2 Global policy experiments (negative rates), low growth and inflation remain major themes of investor sentiment**
- 3 The light at the end of the tunnel is at best intermittent and the risk appetite could remain volatile**

The Age of Negative Interest Rate Policy (NIRP)

After a rocky 2015, 2016 started with elevated volatility. Investor sentiment took a hit from negative data on economic activity out of China; a renewed economic recession and lack of reflation in Japan; and persistent disinflation and banking sector fragility in the Eurozone. However, the biggest concern for global investors in January and early February was the possibility that the U.S. economy could fall into recession before any monetary policy normalization had occurred. In other words, markets were worried that the U.S. Federal Reserve (Fed) would have to resort back to quantitative easing, or even NIRP, after raising interest rates off the zero bound in December.

In the January issue of our Quarterly Quadrant (Turbulence) we argued against the U.S. recession concerns. Our research and modeling efforts were indicating that the risk of recession was low and that a consistently-solid U.S. labor market could generate some healthy wage and price inflation. Since then, as we expected, U.S. economic activity has accelerated in some key areas, including manufacturing, while inflation expectations have improved.



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Fig 1: A healthy improvement in U.S. inflation expectations

Source: Bloomberg as of 3/31/2016

**Fig 2: &w signs of recession**

Source: Bloomberg as of 3/31/2016



While negative interest rates in the United States for now remain just an assumption to stress-test bank balance sheets, they are a reality across much of Europe and in Japan. This is yet another monetary policy experiment in an attempt to create some credit growth and inflation across a large part of the developed world that is still mired in stagnation and disinflation. NIRP is a testament of central banks and governments' commitment to economic reflation, however it also constitutes uncharted territory and could potentially turn into a challenge to central banks' credibility.

Additionally, the effects of NIRP on the banking sector and economic activity are unknown or at best ambiguous. Therefore, the result of the distortions created by these policies could be more market volatility.

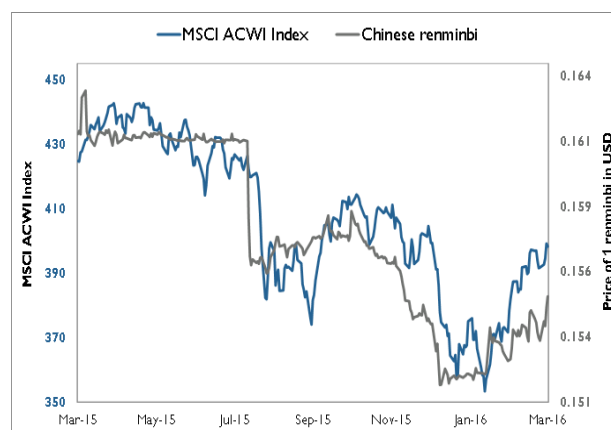
Looking ahead

While a U.S. recession seems to be off the table for 2016 and the U.S. economic outlook appears to remain solid, there is no lack of global issues that could derail investor sentiment.

The slowdown in the Chinese economy and its impact on the global economy will most likely continue to be a concern for investors. Investor sentiment around the Chinese economy tends to be reflected in the Chinese currency, the renminbi, which has shown a strong relationship with global equities—therefore being a driver of global risk appetite.

Fig 3: Renminbi (RMB) & MSCI ACWI go hand in hand

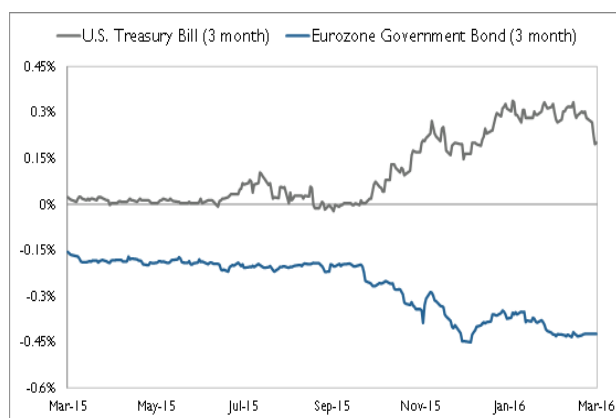
Source: Bloomberg as of 3/31/16



As noted, the distortionary effects of NIRP are another question mark. Importantly, its introduction, as well as other monetary policy easing measures in Europe and Japan, has increased the monetary policy divergence with the United States. This divergence, well captured by interest rate differentials, could drive further strength in the U.S. dollar. This is assuming the Fed progresses in its normalization effort by raising interest rates further in 2016, something that appears likely given the positive performance of the U.S. economy.

Fig 4: Widening interest rate differential between U.S. & Europe could lead to a stronger dollar

Source: Bloomberg as of 3/31/16



Windhaven positioning

The light at the end of the volatility tunnel is at best intermittent and it is likely that risk appetites will continue to be volatile as the world juggles a slowdown in China, the stagnation of much of the developed world (Europe and Japan), and the distortions introduced by central banks. This is on top of the delicate balancing act of the Fed that is gradually normalizing monetary policy after an unprecedented period of unorthodox easing.

In the wake of the heightened volatility in the past ten months, the Windhaven Global Strategies Model has lead us to gradually reduce our international and U.S. equity exposure, and increase our U.S. fixed income exposure across different maturities and assets (corporate, sovereign and inflation-protected securities). This gradual shift has mitigated losses during recent down markets while still benefiting from intermittent periods of positive investor sentiment. While some segments of U.S. fixed income remain among the asset classes favored by our model, we remain ready to add equity and equity-like positions back to the mix as positive investor sentiment solidifies, always paying special attention to downside risk management.

Important Disclosures:

The information provided herein is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

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Past performance is no guarantee of future results.

International investments may involve additional risks, which could include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

Chinese renminbi is measured by CNYUSD spot exchange rate – Price of 1 CNY in USD.

Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median).

Market inflation expectations are calculated by subtracting the real yield of the inflation linked maturity curve from yield of closest nominal Treasury maturity (USGGBE05 Index).

MSCI All Country World Index (ACWI) – A free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

Windhaven's risk management process includes an effort to monitor and manage risk, but should not be confused with and does not imply low risk or the ability to control risk.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

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Please refer to Windhaven's ADV Part 2 for additional information.

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