Global Bond Markets: Back to Basics

Canterbury Consulting Manager Call with Dr. Sonal Desai of Templeton Global Macro

On March 29, 2016, Dr. Sonal Desai, Director of Research at Templeton Global Macro and Co-Portfolio Manager of the Templeton Global Bond Fund ("Fund"), recently shared her thoughts on the global macroeconomic environment and on the potential opportunities in the United States and abroad. Below are the key takeaways from the conference call. The summary does not necessarily represent the views of Canterbury Consulting.

MACROECONOMIC ENVIRONMENT

- The decline in oil prices, the fear of a U.S. recession, and the uncertainty surrounding growth in China are the three primary factors that have recently affected markets. In general, Dr. Desai believes that these fears are overblown and transitory in nature.
- Commodity Complex and Oil Prices
    - The decline in oil prices as a result of increasing supply is generally good for the global economy on a net basis. Recent data shows that the global economy had record-high demand for oil last year. However, record-high supply created a negative sentiment.
    - The largest developed and emerging market nations have benefitted from lower oil prices. Lower oil prices have result in a $700-$800 annual tax cut for consumers.
    - While markets have rebounded somewhat since the February lows, the decline in the energy sector has weighed on levels of capital expenditures for U.S. companies as well as the spread of U.S. corporate bond issues. That said, the commodity downturn will not lead to a broad economic downturn in the United States. Additionally, there is far less leverage in the system at this time relative to pre-2008.
- General Fear of a U.S. Recession
    - Media headlines have overestimated the probability of a U.S. recession; economic indicators and the underlying data points simply don't support these probabilities.
    - The U.S. labor market has continued to gain strength and is the most accurate indicator of inflation. Since the financial crisis, the unemployment rate has fallen more rapidly than the participation rate. While U-6 unemployment (includes part-time & temporary work) is meaningfully higher than U-3 unemployment (the official rate), the U-6 rate is only 1% higher when compared to its pre-crisis level. Traditionally unemployment rates bottomed out at 4.2% before 2008 (currently at 4.9%).
    - Wage inflation will not automatically lead to price inflation, however, consumers will begin to consume more and create a higher level of aggregate demand. Price inflation should increase once aggregate demand accelerates.
    - Inflation is largely underappreciated by the market. The headline impact from lower energy prices will fall out by this time next year.
    - The Fed will most likely raise rates two to three times this year. They do not have perfect foresight, however, and will err on the side of caution. Moreover, global turbulence seems to have paralyzed the group into not acting quickly. Additionally, once inflation takes hold, raising rates will have little immediate impact on curbing further inflation.
    - If U.S. GDP growth projections are at 2.0-2.5% and inflation projections are at 2.0%, 10-Year Treasuries should hypothetically yield 4-5%. Therefore, longer-dated Treasuries are in bubble territory and rates appear to be dangerously suppressed.

- China Economy and Growth Characteristics
  - The market has persistent concern with both fundamental growth in China and currency stabilization. Current market values are pricing in a disorderly devaluation of the yuan. However, this scenario is unlikely to occur due to the government's tight control over monetary policy.
  - The IMF Special Drawing Rights ("SDR") basket inclusion does not have immediate implications for China, however, the country wants the yuan to be a staple currency on a global scale. This gives further evidence to an orderly handling by the Chinese government.
  - In 2015 China incurred $600 billion in reserve outflows, which while large, is more than manageable given its significant foreign reserves of $4 trillion. Additionally, it is expected that China will continue to tighten its capital controls.
  - A significant portion (40%) of the most recent outflows can be explained by Chinese corporations' repayment of debt raised in foreign markets (Chinese companies chose to issue debt in international markets to take advantage of lower interest rates present in those markets).

CURRENT OPPORTUNITIES

- Currency
  - In aggregate, emerging market currencies are trading 25% below their 2009 levels, presenting opportunities on a select basis (i.e. a number of currencies have been unfairly sold off).
  - Select opportunities include the Mexican peso and Malaysian ringgit; both are significantly undervalued relative to the underlying fundamentals (large foreign reserves and stable to improving economies). The Templeton Global Fund is positioned to take advantage of these opportunities.
  - The U.S. dollar is expected to react differently to non-U.S. developed and emerging market currencies because of the differences in monetary policies being pursued in these two different groups of countries.
  - The Fund has a short position in the yen and euro relative to the dollar on the basis of the divergence of monetary policy in these countries relative to the United States.
  - Given current valuations of bonds and of currencies, currencies offer the best chance for outperformance.
- Duration
  - The Fund has a negative duration positioning in the United States because the team believes that rates are in bubble territory and are likely to move up.
  - Inflation is underappreciated and there is no possibility rates do not go up in the future. This is the greatest risk to fixed income portfolios.
  - The Fund as a whole is duration neutral.

Sonal Desai, Ph.D

Templeton Global Macro

Sonal Desai, Ph.D., is a senior vice president and director of research for Templeton Global Macro. Templeton Global Macro offers global, unconstrained investment strategies through a variety of investment vehicles ranging from retail mutual funds to unregistered, privately offered hedge funds.

Dr. Desai is a portfolio manager on a number of funds, including Templeton Global Bond Fund and Templeton Global Total Return Fund. She is responsible for shaping the team's research agenda of in-depth global macroeconomic analysis covering thematic topics, regional and country analysis, and interest rate, currency, and sovereign credit market outlooks. Dr. Desai holds a Ph.D. in economics from Northwestern University and a B.A. in economics from Delhi University. She is part of the Templeton Global Bond Fund portfolio management team named Morningstar's Fixed Income Manager of the Year in Canada in 2013.

Loren Asmus

Associate, Investment Research

Mr. Asmus is part of Canterbury's Research Group and is responsible for the sourcing, due diligence, and monitoring of public market investment managers. He joined Canterbury in 2013 as an analyst serving institutional and taxable clients. Prior to Canterbury, Mr. Asmus was an Institutional Fixed Income Representative for Mutual Securities, LLC, where he provided fixed income solutions for county and city municipalities. Mr. Asmus graduated from California State University, Fullerton, where he double majored in Business Administration, Finance, and Music Performance, Jazz Studies.

About Canterbury

Canterbury Consulting is a leading investment advisory firm, overseeing more than $16.4 billion for foundations, endowments, and families. Founded in 1988, the Company designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients.