Strategy
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Contacts

Lance Pan, CFA®
Director of Investment Research and Strategy
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

Three Themes in 2015

Abstract

The three new trends we watch out for in 2015 include the start of an interest rate tightening cycle, consequences of worsening supply shortage, and resurging geopolitical uncertainties. We recommend moderate portfolio duration and a laddered portfolio structure. Other suitable tools may include callable securities, floating rate notes and bonds with putable and callable features. Remain steady and cautious through the transitional year, especially with credits exposed to geopolitical uncertainties and the oil economy. Consider alternative credit investments including supra and sovereign agency names and senior tranche asset backed securities.

Introduction

'Tis the season for gifts, resolutions and market outlooks. At the beginning of each year, we are obliged to join the crowd and provide our best outlook on prevailing market trends that could affect the corporate cash investment landscape.

If December gives a hint for the New Year, "volatility" is the first word that comes to mind. Going into the last month of the year, few market participants had expected the spectacular declines in crude oil prices and the Russian Ruble. The Fed performed another wordsmith trick, replacing "considerable period" with "patience" in describing the continuum between the end of quantitative easing and the first interest rate hike. As a result, stock, bond, and commodity markets were treated to a big year-end rollercoaster ride.

For 2014, our picks for the three trends impacting cash investors were the aftermath of financial regulations, anticipation of a steeper yield curve, and proliferation of innovative products. By now, the formulation of new regulations is mostly in the rear view mirror, while implementation tasks continue. The yield curve has steepened significantly and may continue on the front end, although long-term bond yields may be more stable. As for new financial products, the trend should remain in place as regulations continue to drive innovation.

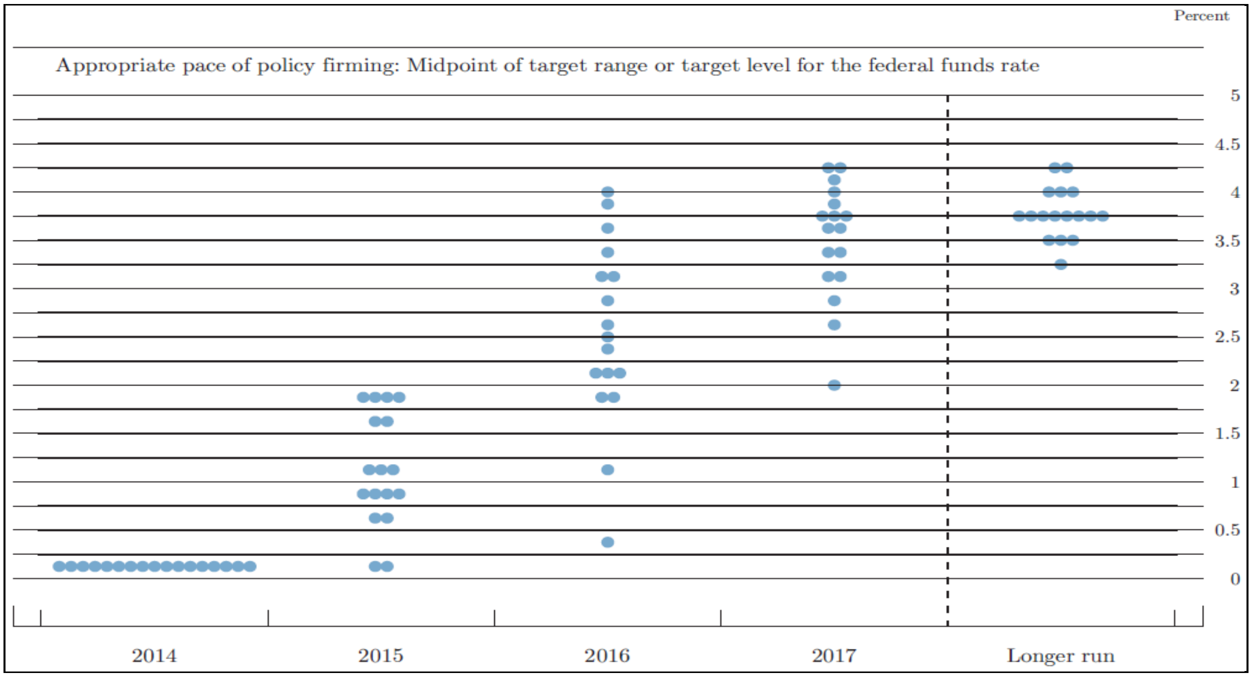
Here are the three new trends we will watch out for in 2015: the start of an interest rate tightening cycle, consequences of worsening supply shortage, and resurging geopolitical uncertainties.

Start of a Tightening Cycle

Without much suspense, both the interest rate market and the Fed expect higher short-term rates sometime in 2015. U.S. economic growth continues to be resilient, supported by robust payroll gains, moderate hourly earnings growth, and a stable core inflation outlook. Recent strong retail sales and declining oil prices should further stimulate consumer demand, which anchors healthy GDP growth. These positive developments should allow

Fed to stay the course towards interest rate normalization that should begin in the second half of the year.

Figure 1: The Fed Dot Plot



Source: Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents. Figure 2. Overall of FOMC participants' assessments of appropriate monetary policy. December 17, 2014.

At the conclusion of the Fed's two-day policy meeting on December 17, Chair Janet Yellen commented at the press conference that the central bank probably will have a lead time of two FOMC meetings before the start of higher rates. The mean projection by Fed officials places the fed funds rate at 1.125% at the end of 2015 and 2.537% at the end of 2016 (Figure 1). Likewise, the fed funds futures market puts July 29, 2015 as the first FOMC meeting towards higher rates.

From these projections, we can deduce that the first rate hike may happen in the third quarter of 2015 with a margin of error of one or two FOMC meetings. Fed officials were quick to point out that the pace to interest rate normalization is not on a set schedule. Other macro events, including growth disappointments in Europe, Japan, and China as well as volatile oil prices and geopolitical uncertainties may accelerate or delay the Fed's moves. The increasingly interconnected economies around the world likely will force the Fed's rate increases to be at a measured pace to offset recessionary forces in Europe and Asia.

Coping Strategies: Consider shortening portfolio duration, maintaining a laddered structure for reinvestment, focusing on income opportunities and horizon returns, and upgrading portfolio quality to lessen the impact from spread widening. Refer to our newsletter from last month on how separately managed accounts may help manage higher interest rates.

Consequences of Worsening Supply Shortage

The lack of high quality liquid investments is a big concern for corporate treasury portfolios. It is not a new problem, but, unfortunately, there is no relief in sight, and the consequences are shaping up to be worse in 2015. As widely recognized, a multitude of factors contribute to this problem with lasting impact.

For example, the liquidity coverage ratio (LCR) and supplemental leverage ratio (SLR) requirements of the Basel III Accord severely limit banks' ability to fund through deposits, repurchase agreements and asset backed commercial paper. The net stable funding ratio (NSFR) requirement, introduced in 2014, and an additional wholesale funding capital charge on large global banks, not yet formulated, may further limit banks' access to wholesale markets for funding. Meanwhile, bail-in requirements and reduced government support continue to put a negative credit ratings bias on most banking systems.

On the other hand, growth slowdowns outside the U.S., the end of a commodities boom, mergers and acquisitions, and geopolitical uncertainties all place negative credit pressure on the remaining strong banking systems in the world, namely the Nordic region, Australia, Canada and Asia. In 2015, we may see fewer issuers in the short-term market that satisfy both credit and liquidity requirements of the corporate treasury community.

Also contributing to the worsening supply shortage are government issuers. Declines in the Treasury's fiscal deficit could continue in 2015, resulting in lower Treasury issuance. Funding needs at the government sponsored enterprises (GSEs) also are unlikely to expand, especially given the prospect of higher interest rates that slow down mortgage applications.

Supply shortage may cause complicating inconveniences in 2015, because Moody's has warned that some money market funds may lose the AAA fund ratings[1]. One cause for the negative industry outlook is the gradual deterioration of average portfolio credit quality from mostly double-A to mostly single-A ratings. At some point, the rationale for assigning AAA ratings to a portfolio of mostly single-A names becomes difficult to justify regardless of other criteria. When the AAA ratings are at risk, we think that a conceivable outcome would be for funds to request their ratings be withdrawn instead of getting the downgrades.

Another consequence of supply shortage may be higher risk taking by portfolio managers. Traditionally, short duration portfolios employ a credit barbell strategy that seeks to balance shorter maturity, lower quality names with longer maturity, higher quality ones. When higher quality names are in short supply, portfolio managers may be more inclined to use lower quality names in all maturities, leading to a riskier portfolio.

Coping Strategies: Consider high quality supra, sovereign, and agency credits, government repurchase agreements with non-primary broker-dealers, senior tranche AAA-rated asset-backed securities, all of which can be purchased through separately management accounts. Extend beyond the usual money market curve but remain vigilant on credit selection.

Resurging Geopolitical Uncertainties

For a number of years, markets were fixated on the risks within the financial realm and were blessed with a relatively benign geopolitical landscape. 2014 gave us a taste of high geopolitical uncertainties. The Ebola outbreak, though relatively contained in several West African countries today, remains a significant threat to public health and world commerce. The extremist Islamic State in Iraq and Syria stepped onto the world stage last year and severely disrupted regional economic order and caused horrific human tragedies.

The 2014 Ukrainian revolution escalated to Russia's annexation of the Crimean Peninsula, its support for the separatist movement in Eastern Ukraine, and the ensuing economic sanctions by the U.S. and the E.U. China, while attempting to engineer a soft landing from recent economic excesses and combat high level corruption, threatens a regional balance of power by making escalating territory claims against Japan, Vietnam, and the Philippines. Coincidentally, the $100 billion New Development Bank supported by the emerging economies of

[1] Vanessa Robert et. Al., 2015 Outlook – Money Market Funds: Market challenges underpin negative outlook, December 12, 2014.

Brazil, Russia, India, China and South Africa (BRICS) was born on July 15, 2014. Also in 2014, Russia and China, old comrades in arms, renewed their strategic alliances in a tacit show of force against the economic supremacy of the G-7 countries.

Even the recent precipitous fall in oil prices was woven into a web of increasing geopolitical uncertainties. Saudi Arabia's decision not to impose restrictions on crude production suggests a loosening grip of the Organization on the Petroleum Exporting Countries (OPEC) on the crude market. Major non-OPEC countries, namely Russia, Venezuela, Iran and Iraq are shouldering much of the economic burden. Russia's currency crisis and the impending economic recession probably will not end quietly, contributing to more economic uncertainty.

While predicting geopolitical outcomes may seem a futile exercise, uncertainty will cause capital market participants to flee to safe haven assets, causing their value to rise. It is unlikely that all of the aforementioned geopolitical uncertainties, especially the crisis situation in Russia, will come to satisfactory conclusions in 2015. One possible outcome may be delayed interest rate normalization by the Federal Reserve if financial markets go into a tailspin. Another likely outcome may be continued popularity of U.S. government securities and lower bond yields.

Coping Strategies: Stay overweight in high quality and highly liquid instruments. Discern and avoid investments that could be impacted by increasing geopolitical uncertainties, such as economies dependent on oil production and/or Central and Eastern Europe.

Conclusions: Steady and Cautious Through the Transition

For portfolio construction, we recommend considering moderate duration based on the assumption of a measured Fed interest rate trajectory. Longer term bond yields likely will be less volatile than short-term rates. Laddered portfolio structures may be less risky than barbelled strategies, especially since credit deterioration is often associated with higher rates. Other suitable tools may include callable securities, floating rate notes and bonds with putable and callable features.

On the subject of credit selection, spreads probably will continue their recent upward move with lower quality names experiencing the most spread widening. Eurozone names may benefit from further quantitative easing policies of the European Central Bank, although such relief may not compensate for the lack of growth needed to improve profitability. Credits in commodities sensitive countries as well as regions and industries exposed to Russia and the oil economy may have more difficulty adjusting to recent surprises. Consider alternative credit investments including supra and sovereign agency names and senior tranche asset backed securities.

About Us

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Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com