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CAN TRUMP MAKE BONDS GREAT AGAIN?

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ABOUT THE BOUTIQUE
SEIX INVESTMENT ADVISORS LLC

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Seix Investment Advisors LLC (Seix) is a fundamental, credit-driven fixed income boutique specializing in both investment grade bond and high yield bond/leveraged loan management. Seix has applied its bottom-up, research-oriented approach to fixed income management for more than 20 years. The firm's success can be attributed to a deep and talented group of veteran investment professionals, a clearly defined investment approach and a performance-oriented culture that is focused on delivering superior, risk-adjusted investment performance for our clients.

REVIEW OF THIRD QUARTER 2016

Mind-numbing may be a bit dramatic, but the third quarter proved to be less chaotic in the capital markets, lacking the volatility and angst that marked the first quarter and the latter part of the second quarter. The VIX Index (volatility on the S&P 500 Index) averaged just over 18 during the first half of 2016, with spikes into the upper 20s around the middle of February amidst the commodity price spiral/risk-off environment and following the surprise Brexit vote at the end of June. The average for the VIX during the third quarter was just over 13 with a high that just breached 18 in September, coinciding with the mid-month Federal Open Market Committee (FOMC) meeting. Central bank meetings are prone to elicit brief spikes in volatility, certainly around those that include a press conference. It's an occurrence limited to only four times a year, but the capital markets view those particular meetings as "live," given the central bank's penchant for wanting to fully explain its actions, or lack thereof, in the spirit of full transparency. The irony of those brief volatility spikes is that it is the actions of global central banks in the post-financial crisis era that has contributed mightily to the suppression of volatility. Central bank "puts" under asset markets has been the norm for several decades, with many arguing that the Greenspan action following the 1987 stock market crash was the beginning of this unholy union whereby "moral hazard" has grown unfettered ever since. Most market participants have adopted the belief that asset market declines will always be supported by central banks and the limitless liquidity they offer to stem any downturn. Even Stanley Fischer, current vice-chair of the Federal Reserve Board (Fed), recently opined in a speech in early November that there's an obligation to intervene in "disorderly" markets. What exactly qualifies as "disorderly" is a mystery, but as careful observers of central bank behavior, the metric for "disorderly" has seemingly been reduced dramatically over the years.

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The third quarter witnessed a moderate rise in interest rates, with the front end of the yield curve underperforming. Two- and three-year rates rose about 18 basis points (bps) while five-year and 10-year rates rose 15 and 12 bps, respectively. The long end was the real outperformer as the yield on the 30-year bond only rose three bps for the quarter. The quarter saw the 10-year close at 1.60%, after having made a new all-time closing low on July 8th at 1.36%. Given the trading conditions in this post-election environment, this summer's low in rates feels like a lifetime ago, but as we will discuss shortly, the macroeconomic and capital market landscape is in a heightened state of flux, debating both monetary and fiscal cross currents amidst the market's surprise reaction to the Trump presidential election victory.

Spread sectors in the third quarter delivered positive excess returns across the board with credit outperforming the securitized sectors. Investment grade corporate bonds registered 173 bps of excess, with all of that occurring in July and August. Industrials were the best sector at 191 bps of excess return, followed by Financials at 149 bps and Utilities at 122 bps. Within the securitized sector, commercial mortgage-backed securities (CMBS) performed the best with 91 bps of excess return while residential mortgage-backed securities (RMBS) delivered 64 bps of excess. Asset-backed securities (ABS) rounded out the securitized sleeve with only 26 bps of excess. The plus sectors (high yield and emerging markets) offered significant outperformance during the quarter. High yield credit recorded 576 bps of excess return while emerging market debt offered 354 bps of excess.

The kindness of central bankers, primarily the Bank of England (BoE) but also the European Central Bank as well as the G7, following the Brexit vote in late June, provided the strongest tailwind to risk markets in the third quarter after a bumpy first half of July. That Brexit is an incredible opportunity for the United Kingdom (UK) to unshackle itself from the bureaucracy of the European Union (EU) remains our contention, and the economic calamity the "Remain" camp spent months propagating remains a fallacy. So much so, in fact, that the BoE has already taken several victory laps, claiming its post-Brexit actions are responsible for saving the UK economy from impending doom. Particularly funny from our vantage point on this side of the Atlantic, but perhaps less so to those in the UK who are ready to move forward with the process. The multi-year process that will become Brexit has only just begun and pending court challenges stand to make it even longer. Hell-bent on derailing this binding resolution, some factions within the UK still operate as if Article 50 (formal notification of withdrawal from the EU) will never be triggered. But Prime Minister May, a supporter of Remain, is smart enough to understand that the people have spoken and leaving the EU is irreversible at this point.

Given the moderate rise in rates, only Treasuries produced a negative total return in the third quarter and all other returns in both total and excess terms were uniformly positive. Exhibit 1 below offers the detailed return data for the third quarter:

EXHIBIT 1: LOWER QUALITY PRODUCES BETTER EXCESS RETURNS IN Q3 (%)

	Q3 TOTAL RETURN	Q3 EXCESS RETURN	1-YEAR TOTAL RETURN	1-YEAR EXCESS RETURN*
Aggregate	0.46	0.68	5.19	1.32
Treasury	-0.28	n/a	4.09	n/a
Agency	0.25	0.44	3.68	1.00
RMBS	0.60	0.64	3.61	0.94
ABS	0.20	0.26	2.16	0.85
CMBS	0.59	0.91	5.22	1.62
Corporate	1.41	1.73	8.56	3.51
High Yield	5.55	5.76	12.73	9.84
HY – Ba/B	4.98	5.20	11.70	8.72
HY – Ba	4.36	4.60	12.13	8.98
HY – B	5.70	5.89	11.26	8.47
HY – Caa	8.20	8.37	16.12	13.72
HY – Ca-D	17.11	17.25	27.16	25.44
HY – Loans	3.30	n/a	5.96	n/a
S&P 500 Index	3.85	n/a	15.42	n/a

**As of 9/30/16*
Sources: Barclays, Bloomberg, data pulled 10/1/16

Past performance is not indicative of future results.

PRESIDENT-ELECT TRUMP

Once again the pollsters and the bookmakers were on the wrong side of a historic vote as Donald Trump defied the odds to be elected the 45th President of the United States. Trump's election on the heels of the UK referendum (Brexit) to leave the EU may be the beginning of a populist economic movement that is rejecting a globalist economic agenda that has left behind the average person resulting in vast inequality, both from an income and wealth perspective. Another potential watershed event already lurking is the constitutional referendum in Italy, scheduled to be held on December 4th. This offers another opportunity for the broader population to repudiate a sitting government, necessitating new elections where another populist agenda (a Euro-skeptic party called the Five Star Movement) can rise to power and seek an outright referendum on EU membership. On the heels of Brexit, the EU is not prepared for a similar outcome in Italy, which could potentially spell the effective end of the union for all intents and purposes.

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It was with intent that this Perspective was held back to await the election results, as the outcome would potentially have a dramatic influence on the macroeconomic backdrop driving capital markets over the following quarter and years. Practically speaking, the idea that anyone can accurately predict with any degree of certainty what a Trump presidency will mean to the country, economy and capital markets at this stage of the game is pure fantasy. In short, the devil is always in the details, and we have little detail as it relates to the pending policies of our incoming commander-in-chief. Like every election cycle before it, there were plenty of broad and grand statements made by Candidate Trump over the past 18 months of campaigning, with a particular emphasis on "grand" as it relates to this non-traditional politician. Rather than guess at what may or may not transpire, we have decided to distill some of the more consistent messaging that came out of the Trump camp during the campaign and juxtaposing it with the realities of governing versus campaigning. Drawing lasting firm conclusions is difficult at this stage, although the surprising risk rally that ensued almost immediately upon the Trump victory implies that it's all smooth sailing from here.

Trump ran on a campaign of tax cuts, infrastructure spending, renegotiating multilateral trade deals, border security/immigration reform, deregulation and repealing and/or replacing the Affordable Care Act. The financial markets had an interesting schizophrenic reaction to Trump's victory as they shifted from a Smoot-Hawley protectionist limit down selloff to a pro-growth Reaganomics-like risk rally all in a matter of a few hours. In fact, this amazing shift in market psychology actually occurred before the U.S. financial markets formally opened following Election Day and has for the most part continued ever since. It is a remarkable interpretation of a campaign that was so prone to mixed messaging and an inconsistent tone, where trial balloons arrived directly from the candidate (via Twitter) in the middle of the night with only random follow through by the campaign thereafter. Deciphering the Trump candidacy was challenging to say the least, but handicapping the legislative agenda that will be forthcoming is fraught with more uncertainty than the markets seem to be discounting.

The consensus based on preliminary financial market movements seems to be assuming that President Trump will get his way, particularly as it relates to tax cuts, rolling back regulations as well as a repudiation of the Affordable Care Act given that Trump had some "coattails" that helped the Republicans maintain control of both the Senate and the House. Small cap stocks (proxies for domestic growth) and financials (proxies for less regulation and higher interest rates) have led the risk rally, while fixed income assets led by U.S. Treasuries have suffered losses since the election as the market perceives that the tax cuts will be unfunded and the infrastructure spending will be largely debt financed. As such, the combination of unfunded tax cuts and debt-financed infrastructure spending will result in more U.S. Treasury supply, higher inflation and potentially more aggressive tightening by the Fed. This knee-jerk emotional market reaction appears to be driven more by fast money, as the devil is in the details that we do not have yet, as the Trump transition team has only just begun the process of vetting and naming members of President-elect Trump's cabinet. Some have gone so far as to say that the Trump election marks the end of the 35-year bond bull market. It would seem premature to draw such conclusions at this point. While we agree that President-elect Trump has a pro-growth agenda, it is far from certain that the Republican-led Congress will sign a blank check of deficit busting, debt ballooning legislation given the nearly $20 trillion in federal debt already outstanding.

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Immigration and trade reform were hallmarks of this campaign since the beginning, with no shortage of ink spilled about the wall soon to be built on our southern border with Mexico. These issues resonated with many in several swing states that produced Trump's Electoral College advantage, but will also prove to be somewhat contentious with Congress, even within the Republican caucus. That being said, trade policy changes can be enacted relatively easily as this is an area where the Executive Branch has broad powers that can be employed without the consent of Congress. As a business person who is fairly well versed in the art of negotiation, Trump will likely take advantage of both the Executive Branch authority, as it relates to trade, as well as the leverage he can use being the "negotiator-in-chief" for the largest economy in the world. It is important to make the distinction that Trump is not anti-trade, but rather for fair trade, a concept many would say was lacking in many multi-lateral free trade agreements (North American Free Trade Agreement, etc.). Signatories on many of these agreements would be wise to prepare for a more vigorous negotiation than took place historically. The transition team, through a video summarizing some of the future Trump administration's objectives for the first 100 days in office, has already confirmed withdrawal from the Trans-Pacific Partnership on the first day of the Trump administration. Negotiating trade deals on a bilateral basis where a country like the U.S. uses its leverage as the largest export market in the world and therefore negotiates from this position of strength, strikes us as a common sense approach to trade, not a protectionist anti-trade policy. Immigration will be more complex for Trump to navigate and early indications from the transition team already intimate that a mass deportation of all illegals is not where the new administration is headed. Both these issues (trade and immigration) really resonate with the core base of support that swept Trump into office, so effecting some changes here should be expected.

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The rolling back of regulation should provide a boost to the economy and the entrepreneurial spirit lacking in this recovery, leading to the rebirth of small businesses across the country. Small business has always been the job creating backbone of the U.S. economy, and this is the first recovery in the post-war period where more small businesses died than were created. Many regulations can be rolled back relatively quickly, while others like Dodd-Frank will take time and may be blocked by Democrats in the Senate. Similarly, as it relates to the Affordable Care Act, Democrats will fight aggressively against any repeal efforts, but either through repeal or massive amendment, this universal health care legislation is going to be changed, one way or another.

Infrastructure spending was another prominent feature of Trump's campaign promises. This issue appeals to a fairly broad and bi-partisan element of the electorate. Given his background as a real estate developer, Trump naturally gravitates to this topic and is never bashful in showering accolades on any property that bears his name. Despite the broad appeal, infrastructure spending will entail a large discretionary spending commitment that Washington has recently had difficulty finding consensus as it relates to paying for such initiatives. Given the sizeable deficits experienced since the financial crisis, the overall debt of our country has returned to near historic proportions relative to the size of our economy (in nominal dollar terms, the debt makes a new high with each passing day). Paying for a significant fiscal stimulus will prove challenging, as there exists a sizable contingent of fiscal conservatives in the Republican caucus who will resist a program that is wholly debt financed and further damages our country's already precarious debt situation. The Trump team's plan is looking for a public-private partnership that will utilize tax credits to attract private capital, an innovative but certainly untested method to finance such a large infrastructure spending program. Similar fiscal constraints are going to impact the prospects for Trump's promise of lower taxes and/or tax reform. Prior proposals from the Republican caucus have looked to tie tax reform to the repatriation of corporate cash held overseas, but again, the ultimate question of how to pay for such reform and/or relief remains the complicated and unanswered question. These are prominent features Candidate Trump put forth over the past 18 months, but again the devil is in the details, and the path to compromise will require considerable public debate that will be on full display to all, including the financial markets.

While these legislative initiatives will be critical to the early stages of a Trump presidency, we must also point out that the President-elect is going to have the opportunity to potentially reshape the composition of the Fed over the first 18 months of his term. There are currently two vacancies on the Board of Governors of the Fed, with only five of the seven board seats filled. Immediately upon taking office, Trump will be able to fill these vacancies and have an immediate impact on the debate at the FOMC. Candidate Trump and his economic advisers were critical of the Fed keeping rates too low for too long, and as such, any nominees he puts forth will likely offer philosophical as well as practical diversity to the FOMC with the hope for some "harder money" proponents pushing back against the "soft money" neoclassical group-think that has dominated the FOMC for too long. The natural voting rotation of the FOMC in 2017 becomes more dovish by virtue of the rotation of more hawkish regional Fed bank presidents of the FOMC that will see more dovish ones take their place. The appointments to fill the vacancies can serve to counteract this dovish shift in 2017.

Early in 2018, Chair Yellen's four-year tenure leading the central bank ends and Candidate Trump has already said a reappointment will not be forthcoming. Similarly, in June of 2018, the four-year tenure of Vice-Chair Fischer also ends. This combination of expiring chair terms will offer President Trump the opportunity to appoint two additional new members to the Board of Governors, meaning that four of the seven members of the Fed's Board will be Trump appointees within the first two years of his presidency, a dynamic that is likely to change the FOMC fairly dramatically in relatively short order. For full disclosure, both the chair and vice-chair terms that are ending are not full term completions for Yellen or Fischer, but the historical precedent that has been followed is that Fed leadership typically resigns the balance of their Board of Governor term upon completion of a four-year leadership role. Over the full history of the Fed, only one sitting chair returned to finish their term as a regular member of the Board. Hence, the expectation is for both Yellen and Fischer to resign from the Board at the completion of their leadership terms.

The evolution of President Trump's views on the Fed and the policies it pursues may differ from Candidate Trump's views. Once at his desk in the Oval Office, President Trump may want the Fed to keep rates low to finance tax cuts and infrastructure spending given the already burdensome debt load he discussed on the campaign trail.

The defining element of the policies will really come down to whether President Trump remains wholly populist once in office, or does he shift to a more pragmatic approach that offers changes to the status quo, but perhaps not to the degree the campaign rhetoric implied. The leaks on immigration reform already hint at a pragmatic President Trump. So does some of the softer posturing as it relates to that wall, as an early 60 Minutes interview with the President-elect made references to areas where the wall may not actually be a wall after all. There will be much to learn about the incoming 45th commander-in-chief over the next few months, which leaves us even more skeptical of the rather interesting and wholly one way capital market reaction thus far since Election Day.

The focus of the Trump administration policies should be on rebuilding a vibrant middle class with increased opportunities for everyone, as an expanding middle class is a prerequisite to a strong, healthy and sustainable economy.

MAKE BONDS GREAT AGAIN

As bond investors, there is nothing that we want more than much higher interest rates, thereby making the asset class great again from an income perspective in the eyes of institutional investors. The election of Trump has also led many to conclude that the 35-year secular bond bull market is over and significantly higher interest rates are imminent. The election outcome and a potential platform of tax cuts and fiscal stimulus prompted us to widen our trading range for the 10-year U.S. Treasury from 1.5% to 2.5% from the 1.5% to 2% range we had in place all year. While it is possible that rates could break out to the upside (risk parity volatility induced selloff), the structural issues of excessive debt, excess global capacity, aging demographics and low productivity growth will continue to exert deflationary pressures that will likely keep interest rates low for a long time. Long-term interest rates are driven by economic growth and inflation/inflation expectations, while the potential growth of an economy is a function of the growth in the labor force and the productivity of that labor force. The pro-growth agenda of President-elect Trump will take time to implement and will likely have a larger cyclical impact in 2018 than in 2017.

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To the extent that these pro-growth policies encourage small business formation and increased business capital investment focused on productivity enhancing technologies that create high paying job opportunities, the potential to improve potential growth via improved productivity increases. However, the structural issues will continue to serve as headwinds to growth as they have for the duration of this recovery and lower for longer remains our base case as these deflationary forces remain firmly entrenched and secular in nature. More time and very difficult decisions are required to remedy these issues and politicians have been unwilling to tackle them thus far. As history has instructed, the political class typically fails to act absent a real crisis. Perhaps this is another political tendency the President-elect can approach from the non-traditional perspective of an outsider elected by Main Street. Hope springs eternal…

OUTLOOK & PORTFOLIO POSITIONING

Approaching year end, our portfolio sector weightings to the primary spread sectors (RMBS and corporate bonds) remain near the index weighting. Valuations (fair-to-rich across most spread products) in tandem with the age of the spread cycle, guide us to not aggressively reach for yield at the macro level, as many investors are prone to do at the end of the cycle. Having dry powder to deploy at more attractive spreads in the future seems a more prudent core bond strategy. In a similarly defensive approach, our core plus mandates remain void of any strategic non-investment grade exposure.

The country eagerly waits for the details around what the President-elect's cabinet will look like and exactly what legislative priorities will be the focus of the first year or two under President Trump. As we have become accustomed to, presidential campaigns are full of promise; however campaigning and governing ultimately prove to be very different things. The behavior in the capital markets since Election Day has been curious to say the least, as the potential for debt financed fiscal pump priming, deregulation and a more business-friendly administration is priced in as if it's all a done deal and will cure the structural issues Trump inherits coming into office. While we are cautiously optimistic that the macroeconomic backdrop might enjoy a cyclical improvement with the implementation of some of Trump's pro-growth agenda, the path from here to there will be long and challenging, with plenty of drama and volatility offering tactical opportunities along the way.

Asset-Backed Security (ABS) is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt.

A Basis Point is equal to 0.01%.

The CBOE Volatility Index (VIX Index) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

Commercial Mortgage-Backed Securities (CMBS) are a type of mortgage-backed security that is secured by the loan on a commercial property. A CMBS can provide liquidity to real estate investors and to commercial lenders.

Credit spreads are the difference between the yields of sector types and/or maturity ranges.

Federal Open Market Committee (FOMC) is the Federal Reserve Board that determines the direction of monetary policy.

Residential Mortgage-Backed Security (RMBS) is a type of security whose cash flows come from residential debt such as mortgages, home-equity loans and subprime mortgages. This is a type of mortgage-backed security that focuses on residential instead of commercial debt.

Standard & Poor's 500 Index is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market.

Yield Curve is a curve that shows the relationship between yields and maturity dates for a set of similar bonds, usually Treasuries, at any given point in time.

Investors cannot invest directly in an index.

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