Fixed Income Macro Outlook

American Century Investments®

Our Global Macro Strategy Team's Perspective

THIRD QUARTER 2015

U.S. Economy

Moderate growth with increased possible upside

- **Moderate Growth with Increased Possible Upside:** Our most likely (54% probability) scenario continues to call for moderate growth, producing near-term annualized economic growth rates of 2.0% to 3.0%. However, we also see a significant possibility (36%) of an upside breakout of over 3.0% growth.
- **Improving U.S. Fundamentals Despite Soft First Quarter:** The U.S. economy seems to have achieved sustainable growth, despite global economic weakness and a soft first quarter. Corporations are generating profits, unemployment is grinding lower, consumer debt levels are falling, tax revenues are growing, and inflation, interest rates, and corporate default rates remain relatively low.

U.S. Inflation

Muted in near term but still long-term concerns

- **Muted in Near Term:** A 1.5% to 3.0% increase over 12 months in the overall CPI appears most likely to us (66% probability). (CPI is a government index derived from detailed consumer spending information.)
- **Long-Term Concerns as Economic Conditions Improve:** We think that the longer-term trend from here is upward, assuming the U.S. economy continues to strengthen. We believe higher inflation (a 12-month CPI change over 3.0%) could occur in the coming three to five years because of monetary and fiscal policies enacted since 2008 and improving U.S. economic growth.
- **Don't Be Complacent:** We believe strongly that some level of inflation protection be incorporated into investor portfolios.

U.S. Monetary Policy

Interest rate normalization depends on data, particularly inflation and wage growth

- **QE3 Completed but Other Stimulus Continues:** The Federal Reserve's (the Fed's) third bond-purchase program (quantitative easing, QE) since 2008 ended in October 2014. But the Fed still owns a large portfolio of bonds it purchased through QE, and will continue to reinvest its coupon income. And short-term interest rates remain very low, even if the Fed starts raising them.
- **Policy Change Indicators Switched from Forward Guidance to Data Dependency:** In March, the Fed switched from forward guidance (language triggers) to data dependence (data triggers) to indicate when it might begin interest rate normalization. This could result in more financial market volatility as markets try to anticipate the Fed's response to economic news.
- **Rate Normalization Expected; Timing and Magnitude Are Data Dependent:** The Fed is expected to begin raising short-term interest rates from their near-zero level some time in the next 12 months. But we think global economic weakness and low inflation will allow the Fed to temper the timing and magnitude of possible rate increases.

U.S. Interest Rates

Range-bound with upward bias toward normalization, but constrained by non-U.S. factors

- **Range-Bound With Upward Bias:** Given our expectations for moderate, sustained, and possibly higher U.S. economic growth, we expect the 10-year U.S. Treasury yield to rise to between 2.25% and 2.65% in the next 12 months. We think this longer-term trend is fundamentally supported, assuming the economy strengthens. We expect an eventual normalization of long-term interest rates after years of artificially low levels caused in part by the Fed's QE programs.
- **Near-Term Non-U.S. Headwinds for Higher Interest Rates:** Weaker global economic fundamentals, aggressive non-U.S. monetary policies, low inflation, a strong dollar, uncertain global geopolitical factors, and demand due to the wide yield disparity between U.S. bonds and those of other developed countries are working together to keep interest rates low in the near term, despite improving U.S. economic fundamentals.

Global Economy

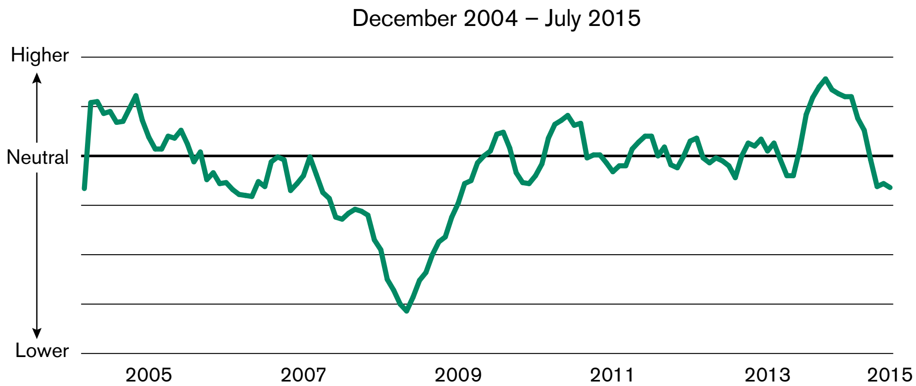
Divergence from the U.S. in terms of weaker economic growth and more aggressive monetary policies

- **Global Divergence in Economic Growth:** Outside of the U.S., the global economy is mostly struggling. Europe has required monetary stimulus to fight deflation, Japan is easing out of recession, and Russia, China, and Brazil are slowing.
- **Global Divergence in Monetary Policies:** While the Fed is contemplating tighter monetary policy, most of the world's other central banks in developed economies are still considering or implementing additional monetary easing.
- **Low Inflation:** As in the U.S., inflation is unlikely to be a near-term threat. However, the amount of monetary and fiscal stimulation that has been prescribed could create longer-term inflationary pressures.

Fundamental U.S. Economic Trends

Quantitative Inputs From Our U.S. Interest Rate Outlook Model

Figure 1 — U.S. Interest Rate Outlook: Aggregates all other outlooks. Identifies potential interest rate trends.



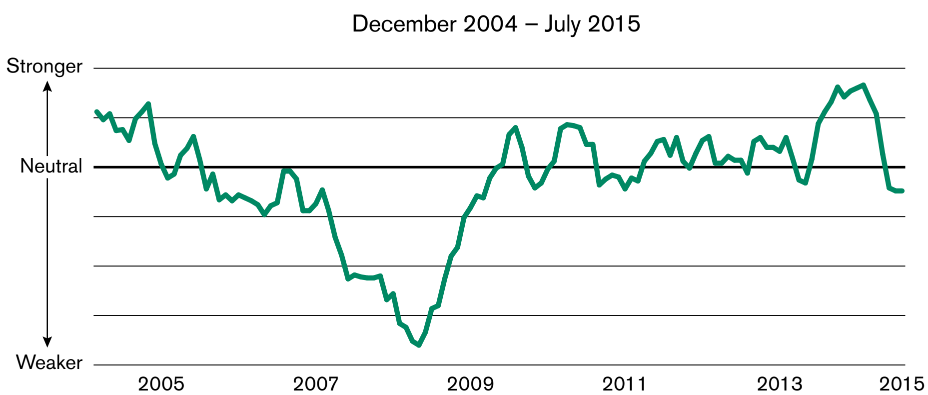
Our anticipated ranges for the 10-year U.S. Treasury note yield:
Next 3-6 months: 1.80% to 2.40%
Next 12 months: 2.25% to 2.65%

Trend:

Key Points:

- Our U.S. Interest Rate Outlook has been mostly range-bound near neutral since 2010. Like U.S. economic growth, it peaked during the third quarter of 2014, reaching its highest level since 2005, but since then it has slid back toward neutral.
- Improved U.S. economic fundamentals and expectations for future Fed rate hikes continue to support higher rates in the longer term.
- But near term, non-U.S. factors have dominated the U.S. factors, keeping rates low.

Figure 2 — U.S. Economic Outlook: Aggregates our consumer and business outlooks. Suggests economic growth trends.

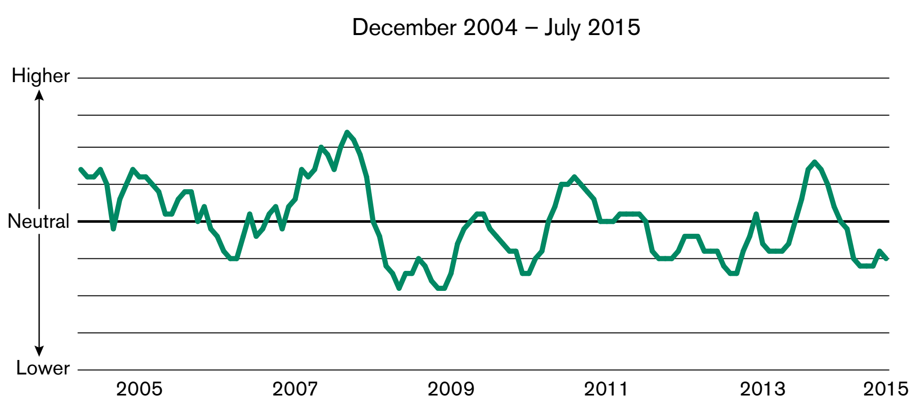


Trend:

Key Points:

- This continues to illustrate the U.S. economy's subpar "square root sign" growth pattern since the Great Recession—a big dip followed by a mostly sideways pattern. (Past post-recession recoveries have shown more of an upswing after the big initial dips.)
- In January 2015, the model reached its highest level since 2004, but has slid sharply back toward neutral since then.

Figure 3 — U.S. Inflation Outlook: Aggregates data from our quarterly Inflation Monitor. Suggests inflation trends.



Trend:

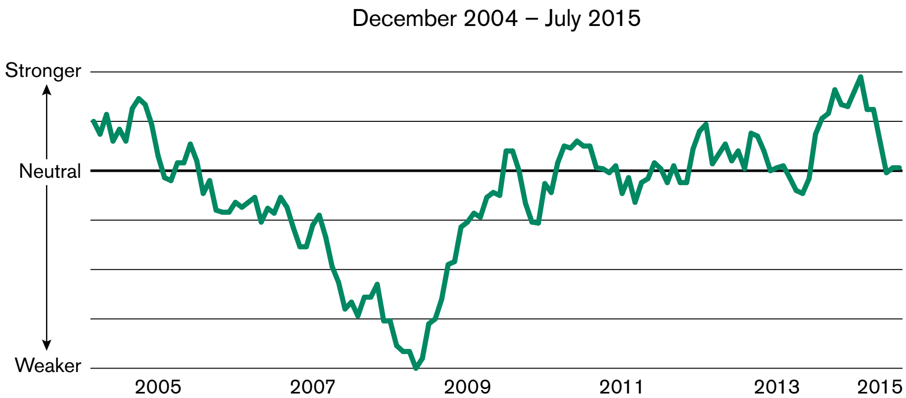
Key Points:

- There's little indication of inflation in the near term. We expect inflation to remain largely contained for the next 12 months, mostly because of subdued global growth, depressed commodity prices, and a stronger U.S. dollar.
- For more information on the components of our Inflation Outlook, please see our quarterly *Inflation Monitor*.

Fundamental U.S. Economic Trends (continued)

Quantitative Inputs From Our U.S. Interest Rate Outlook Model

Figure 4 — U.S. Consumer Outlook: Includes employment, retail sales, housing, and consumer confidence.

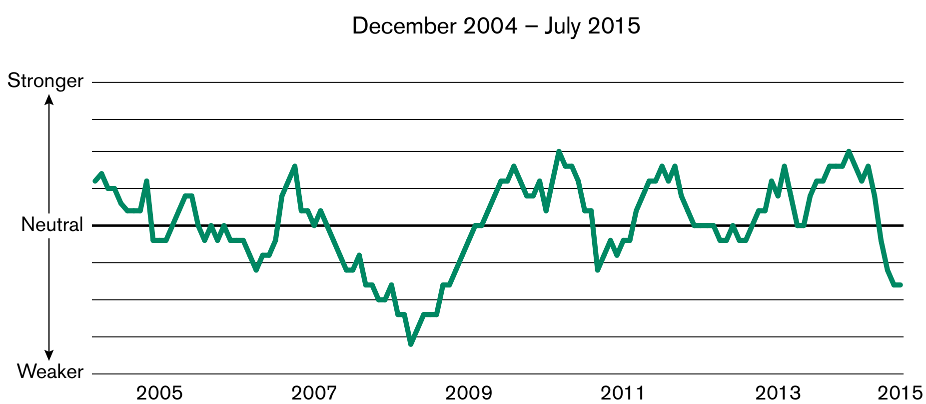


Trend:

Key Points:

- January 2015 marked the highest level for this model since 2004. Since then, it has retreated as consumer confidence and spending have eroded.
- The consumer sector has struggled to recover since 2008. Unemployment, the housing market, high debt levels, and low wage growth have weighed on consumers.
- Labor market improvement is critical to this sector. U.S. employment is improving, but wage growth is still lagging.

Figure 5 — U.S. Business Outlook: Includes suppliers, production, capacity utilization, and corporate profits.



Trend:

Key Points:

- November 2014 marked the highest level for this model since 2004. But it has reverted sharply downward since QE3 ended.
- Businesses fared better than consumers for much of the post-2008 recovery period, helped by monetary and fiscal stimulus.
- The business outlook has grown cloudier, with weakened global economic growth, a strong dollar (which affects exports and earnings), and the possibility of higher interest rates in the U.S.
- We believe short-term volatility in the directional trend component of our model is making the outlook look worse in this graph than we think it actually is.

Background: How the Global Macro Strategy Team uses this data.

Figures 1-5 represent output from our proprietary Interest Rate Outlook Model, which provides a systematic, disciplined way to review fundamental economic indicators and policy trends in a purely quantitative manner.

Our model measures and quantifies long-term trends in economic activity, then processes that data to suggest long-term fundamentally based trends for interest rates.

The model examines selected U.S. economic indicators over an extended time frame, typically since the early 1980s, and evaluates them on two metrics:

1. Relative levels compared with historic averages, and

2. Directional trend.

The model establishes a neutral level for each indicator, then measures whether it is high or low compared with historic averages and whether it is trending higher or lower. Then, the model weighs and aggregates these multiple indicator levels and trends into Figures 2-5. The levels and trends in Figures 2-5 are weighted and aggregated to create Figure 1.

(Important Note: This model represents just one set of inputs used by the Global Macro Strategy Team in its overall outlook-creating and strategy-setting processes. The model is not the final determinant of our macro strategy—it is carefully weighed and vetted with other inputs, both qualitative and quantitative. But we believe the graphs are useful to show and share, as part of our fundamental and proprietary view of the bigger macroeconomic picture. Also note that Figures 1-5 do not display the full time frame of the model, just 2004 to 2015. This helps show recent trends more clearly.)

Source (for all graphs): American Century Investment Management. Outlooks and interest rate ranges are based on proprietary evaluations of information. This information is not intended to serve as investment advice.

Macro Observations — Changes Since Last Quarter

- ***Trend Reversals—Dollar Down, Oil Prices Up, Bond Yields Higher:*** Market trends that had been in place since last summer reversed in the second quarter, due, in part, to signs of stronger economic growth, particularly in Europe. Indications that the European Central Bank's aggressive stimulative policies were working caused the euro to rebound against the U.S. dollar and European sovereign bond yields to soar from their negative levels. This helped trigger a broader bond sell-off that resulted in longer-maturity U.S. Treasury yields finishing higher during a calendar quarter for the first time since December 2013. Meanwhile, oil prices stabilized as the U.S. dollar lost some of its upward momentum as investors pondered when and by how much the Fed might raise interest rates (see below).

G. David MacEwen & Victor Zhang* — We Think the Fed Should Raise Interest Rates

- With short-term interest rates still extraordinarily low, Fed rate hike expectations are building. But the path to more normal rates remains uncertain, and is triggering market volatility as investors anticipate these moves. This volatility is particularly notable because we're coming out of a period when the Fed's policies and programs helped suppress volatility.
- When will/should the Fed raise rates, and by how much? "Hawks" think the Fed should start soon, while "Doves" believe more patience is prudent. On one hand, a decision to hike rates seems clear-cut. Rates have been historically low since 2008 and the U.S. economy is growing, with inflation pressures building in the services sector. However, global factors are constraining economic growth and keeping inflation in the goods sector low. And the capital markets are sensitive to change. The Fed doesn't want a repeat of 2013's "Taper Tantrum."
- We side with the Hawks, but are carefully considering both sides. We believe higher rates give the Fed more future policy flexibility, help limit financial risks from asset bubbles and inflation, and can reward fixed income investors in the long run (income is a big component of bond total returns over extended time frames).
- Increased volatility is likely. But that's part of normal market behavior. Volatility favors active portfolio management, and it can be addressed with diversified, risk-adjusted investment approaches and long-term holding strategies.

G. David MacEwen — Prepare for Periods of Bond Price Volatility as Markets Normalize

- After reaching for higher yields in recent years, we believe some bond investors are unprepared for more volatile market conditions as the Fed moves toward raising short-term interest rates.
- Since 2008, the Fed has suppressed bond market volatility and encouraged risk taking with low interest rates and massive bond-buying programs. Bond investors reached for yield by moving into higher-risk asset classes like high-yield corporate bonds.
- Investors took on multiple risks, particularly credit (default) risk. Liquidity and price risks are other concerns, particularly if investors put themselves in the position of having to become sellers in short-term stress periods. These risks number among several important market risks across all asset classes that investors should prepare for as markets re-normalize after years of volatility suppression.
- Investor preparedness for more-normal market conditions is a growing issue as we anticipate Fed interest rate hikes in an environment in which: 1) individual portfolios hold more bonds, 2) banks and other dealers hold fewer bonds because of post-Financial Crisis regulations, and 3) defaults could increase as interest rates rise.
- Can these factors result in bond market volatility and illiquidity in stress periods, similar to what happened in 2008? We believe economic fundamentals are better than in 2008, and that the markets will most likely adjust in price terms that would facilitate trading, not complete illiquidity. We saw this in the corporate high-yield market in 2008.
- Prepared investors don't have to become sellers in stress periods. By holding short- to intermediate-maturity bond positions diversified by sector and credit quality, and realistically assessing risk exposure ahead of time, investors can put themselves in a better position to hold, not sell during short-term periods of market volatility.

**MacEwen and Zhang are Co-Chief Investment Officers at American Century Investments.*

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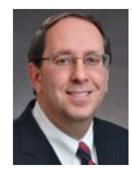

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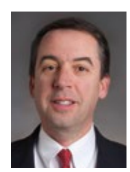

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Generally, as interest rates rise, bond prices fall. The opposite is true when interest rates decline.

Diversification does not ensure a profit nor does it protect against loss.

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Non-FDIC Insured • May Lose Value • No Bank Guarantee