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Featured G

Variant Perception

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At any point in time the price of a security reflects the perception that Mr. Market has on the economic and financial outlook. On the other hand, making money is about anticipating how the outlook is likely to unfold differently. Call it information risk—which way the outcome is likely to swing relative to the view Mr. Market has embedded in prices at each moment in time. Occasionally, extreme investor optimism or pessimism will drive asset prices to a similar extreme and create a valuation anomaly—at least with respect to longer-term factors driving intrinsic return. In theory those anomalies can provide exceptional mean reverting investment opportunities. In practice, exploiting fear and greed systematically is extremely difficult mainly because of the same emotions.
So it is important to know what Mr. Market has priced into securities and what the information risk is with respect to that view. Where is the variance from what is perceived today likely to be the greatest risk a year from now?

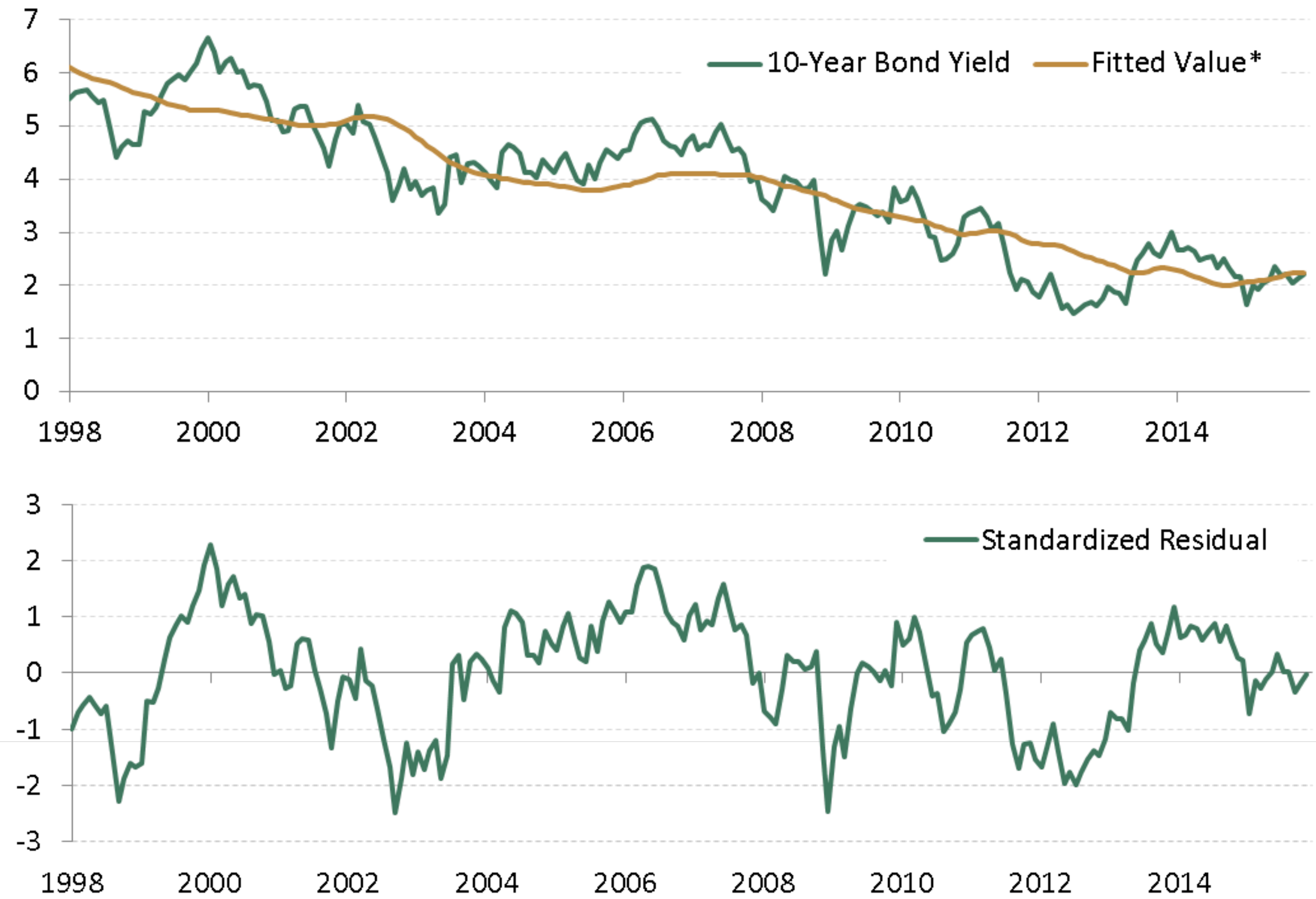
For most of this year investors have been confronted with slower global economic growth and weak commodity prices, which were mainly caused by the interplay between slower growth in the developing world—led by China—and dollar strength fostered by divergent trends in the U.S. monetary policy versus just about everywhere else. The short-covering risk rally since late September was really triggered by the Federal Reserve's (Fed's) waffle on the September rate decision, as well as some new policy measures announced by Beijing. Secular stagnationists like Larry Summers believe that the world will keep slowing all the way through 2016; surveys continue to show that the two main drivers of negative tail risk worries are premature tightening in U.S. monetary policy and an economic bust in China.

Just how worried is Mr. Market about these risks?

The U.S. bond market is less convinced. Current prices reflect a more balanced view between negative tail risks and factors which could present positive tail risk—or positive growth surprises. This conclusion stems from the fact that current yields are very close to the levels predicted by our bond model. There is no anomaly. Bond investors are neither overly pessimistic nor optimistic, which may say more about the model than the real world but the drivers in our model are a group of simple economic variables that have more or less captured the trend in bond yields for the last 30-40 years in real time, irrespective of the prevailing policy regime or unique economic circumstances at any given time.

Chart 1 shows the level predicted by the model for 10-Year Treasury yields along with the actual level of yields. The difference between these two lines is shown in the lower panel of the chart and is expressed in terms of standard deviation units. Over long periods of time, bond yields have oscillated above and below this line. Since 2007, yields have fallen sharply below the model level during periods of financial crisis: the first decline followed the Lehman bankruptcy and the second occurred later during the European sovereign debt crisis. Subsequent reversion back to the predicted level of the model—or above—always coincided with policy reflation: first the G20 package of stimulus in 2009 and again, later during Europe's reflationary drive to lower peripheral sovereign yields.

Chart 1: U.S. Bond Model *Percent; As of 11/3/15*



**Estimation interval: Jan 1998 – Sep 2015*
Source: Thomson Datastream

So if investors were really worried about these negative tail risks, current yields would already be lower. The fact that yields are not and the market has a more balanced view probably explains why yields did not fall more during the middle of the equity market weakness during late summer.

The conclusion that there is no anomaly in the U.S. bond market flies in the face of prevailing wisdom that low bond yields are a by-product of financial repression, unorthodox monetary policy, and central bank manipulation. Even the Fed has statistical models of its own that conclude the basis point impact of every $100 billion in quantitative asset purchases. This finding seems to challenge the fact that every quantitative easing program coincided with at least an initial rise in Treasury yields.

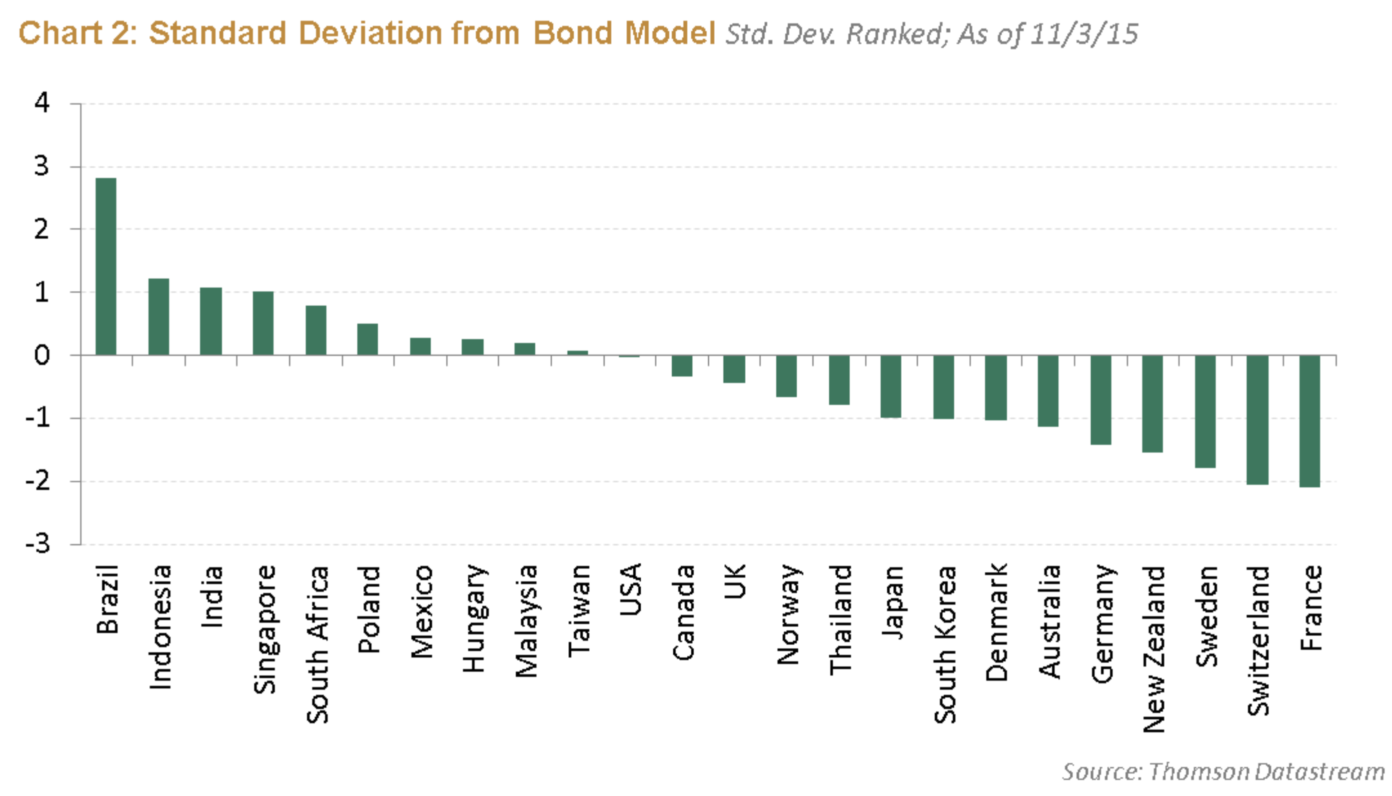
Nonetheless, it worth considering the possibility that Treasury yields are where they are simply because there is not much inflation, economic growth has been steady but very slow, and real short-term interest rates are negative. According to this framework, a decline in 10-year yields to the old lows of 1.4% in 2012 would only take place in an extreme risk-off environment such as a financial crisis, recession, or intense deflationary wave. Conversely, a rise in 10-year Treasurys towards 3% or more would flag late-cycle business conditions of an overheating economy.

The macro story embedded in the current valuation of the U.S. Treasury market, which is the global "risk-free" benchmark, is that the global economy is expanding slowly but steadily, there is not much inflation, and that fears of a global recession are exaggerated—provided the Fed does not move too quickly and China does not collapse—which the market does not seem too worried about based on prices. Conversely, the boost to growth due to lower energy prices, more stimulus from China, and reflationary policy across the emerging-market world provide positive risk to the global growth outlook. Overall it seems like a fairly balanced perspective

without a lot of information risk. So at the moment we believe there is not much value in Treasurys.

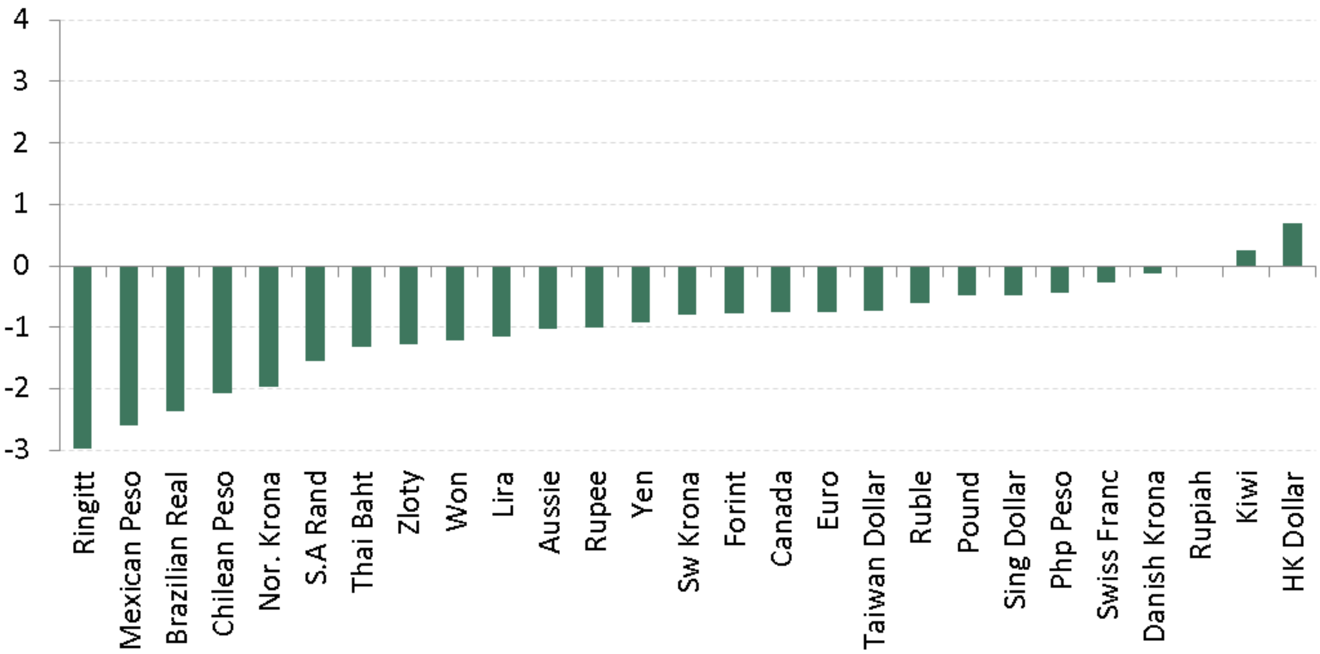
However, applying the same lens to other markets and assets gives a different perspective.

Chart 2 shows a snapshot of bond valuations across a spectrum of countries. What *is* notable is the range of anomalous pricing on either side of the fairly neutral risk free benchmark, namely Treasurys. With Brazil and Switzerland as the outliers, investors seem to have run from emerging-market debt and piled into Japanese Government Bonds, German Bunds, and French OATs. Emerging-market debt seems to have an equity-like risk premium built into it while investors in Europe and Japan clearly have a more deflationary tilt to their outlook than the view expressed in Treasurys.



The same impression is created by looking at currency valuations. Again using proprietary Brandywine Global models, Chart 3 shows a snap shot of currency valuation measures across a range of countries. The first observation from this chart is that most currencies are trading below their intrinsic value, meaning the U.S. dollar is overbought.

Chart 3: Standard Deviation from Currency Model *Std. Dev. Ranked; As of 11/3/15*



Source: Thomson Datastream

The currency baskets that are the most washed out relative to our models are in the commodity- and energy-linked cases. It is fairly clear that the market has priced in an extremely bearish outlook for the global commodity complex, an extension of momentum in the latter for longer.

The degree to which various markets have sold off also reflects idiosyncratic risk; however, there are clear signs that investors have become indiscriminate and are throwing the baby out with the bath water. The Mexican peso is one of the most washed out currencies in Chart 3, up there with its Latin American counterparts. Yet, Mexico has not needed to raise rates to fight stagflation like Brazil. Inflation has remained low and Mexico has reduced the sensitivity of its economy to an oil-induced terms-of-trade shock by developing its manufacturing sector and trade link with the U.S.

As for oil prices, if the world economic outlook is more balanced, oil prices may be closer to stabilization than some strategists believe. Similarly, the collapse in iron ore prices has fallen to a level that matches the bust phase of other previous objects of speculation like tech stocks in the early 2000s, the Nikkei in the early 1990s, and gold in the early 1990s. The case for a further shakeout is getting a lot smaller and instead, history suggests we should be making a bottom.

It may be the case that the opportunity set for next year could be emerging-market debt. Investors have become somewhat indiscriminate in their pessimism towards this asset class as evidenced by the anomalous pricing in local currencies and debt. Moreover, information risk could be skewed to a better outcome than the extreme one currently embedded in prices, if the perception of the world economy reflected in U.S. Treasury prices is a more realistic assessment of the future.

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