A sea-change or a highly anticipated first step towards “normalization”

As the Fed moves ever closer to the end of its third (and most likely final) round of quantitative easing, investors brace for the next move, i.e. the first rate hike in more than eight years and, as a result, the end of what we all have grown accustomed to since the end of 2008 - ZIRP or Zero Interest Rate Policy.

Over the past few years, the Federal Reserve’s highly accommodative monetary policy has been the topic of much debate among investors. For some, the Fed’s actions have played a significant role in lifting the US economy out of the hole created by the financial crisis and the ensuing Great Recession. For others, the Fed has planted the seeds of potentially extremely destabilizing asset bubbles, a form of inflation that inevitably materializes when central banks implement and maintain for too long extremely loose policy settings.

A similar debate is now taking shape as to whether the expected shift in US monetary policy should be seen as a major threat to the economy and the markets or merely a gradual adjustment justified by improved economic fundamentals. In order to analyze the impact of the upcoming tightening cycle, we will first take a closer look at where the market consensus currently stands when it comes to the timing and path of future rate hikes. Next, we will provide a broad overview of recent economic trends and discuss whether the US economy has reached a stage where a gradual removal of monetary policy is not only justified but also unlikely to derail the recovery. Beyond the cyclical recovery, the growing consensus around the theme of structurally weaker potential growth in coming years will be addressed as this has important implications for financial markets. Finally, we will analyze how the current cycle is likely to play out and provide recommendations as to how investors should be positioned going forward.

Our view: The aggressive policy measures implemented by the Federal Reserve were necessary given the damage inflicted upon the global economy, financial system and governments’ balance

Key Takeaways

- The current recovery has been very weak by historical standards. The financial crisis left deep wounds and traditional medicine was not as efficient as in previous cycles. However, the US economy has been healing for quite a while and we believe that the improvement seen over the past five years is significant enough to warrant a gradual removal of the extraordinary monetary stimulus implemented since 2008.

- The upcoming tightening cycle is a topic so highly debated that we doubt it will be too disruptive for the markets. However, despite frequent and transparent communication by Fed officials, the next few months leading up to the first rate hike are likely to be associated with a pick-up in market volatility and potentially some profit-taking in both equity and bond markets, as investors have not fully embraced the Fed’s guidance in terms of the pace at which monetary policy will be tightened.

- Tighter but still easy: Monetary conditions will still remain very accommodative once the Fed starts to hike rates. We believe that the US economy is still in the recovery phase of the cycle and the persistence of a relatively large output gap means that the next recession is still several years away.

- Beyond the cyclical recovery, it appears likely that the US economy will settle into an environment of structurally weaker potential growth in coming years. This means that the fed funds rate will probably peak at a much lower rate in this cycle. This will likely limit the upward pressure on bond yields, particularly in an environment where bond yields are depressed internationally due to ongoing monetary easing in some major foreign economies.
sheets during the financial crisis. A deeper credit crunch, government and corporate defaults, as well as deflation had become clear and present dangers. The Fed’s actions were instrumental in lessening the likelihood of these threats and contributed to a gradual economic recovery. We believe that the US economic expansion is now approaching the point where it can be self-reinforcing and is strong enough to warrant a gradual normalization of interest rates. Despite improving growth dynamics, persistent low inflation and limited signs of wage growth will provide the Fed with the necessary flexibility to fine-tune this normalization process if the economy relapses and/or markets adjust too fast and lead to a more pronounced and premature tightening of credit conditions.

Market Expectations

Successful investing is anticipating the anticipations of others - John Maynard Keynes

In 1994, the US economy was emerging from a big recession, and Treasury yields began to rise slightly from their 1993 lows as the growth outlook improved. Taking their cue from rising yields (interpreted as a sign that bond investors had started to discount a rate hike), the Fed began to tighten monetary policy, despite limited signs of inflation risk. From February 1994 to February 1995, the Fed doubled its benchmark rate to 6% from 3%. Investors used to low interest rates were shocked when borrowing costs rose so sharply, leading to large selloffs in both the bond and equity markets.

Although it’s always dangerous to use these words, it does very much seem that “this time, it’s different”, in large part because of Janet Yellen’s (and Ben Bernanke previously) clearer and more frequent statements on what would cause central bank policy to change. Investors have also been gearing up for this shift in monetary policy since last summer’s so-called “taper tantrum”. To some extent, one could argue that the experience of 1994
helps explain the violent move higher in bond yields as soon as the Fed announced their plans to gradually taper their bond purchases. Going into 2014, an overwhelming majority of investors were positioned for a further rise in bond yields. However, when investors are intensely focused on a specific risk, chances are that this risk does not materialize.

To gauge whether a repeat of a 1994 scenario is likely (i.e. a sharp bond market selloff driven by a surprise policy move), one needs to look at what type of tightening is already discounted by investors.

Based on financial futures (both fed funds futures and Eurodollar futures adjusted for the basis spread between LIBOR and the overnight fed funds rate), the consensus view is that the first rate hike will come around the middle of next year, with the fed funds target rate reaching 0.75% by the end of 2015, 1.75%-2.00% by the end of 2016 and 2.75% by the end of 2017.

Fed officials have provided constant insight into their thinking over the last few months and the Federal Reserve not only provides a regular update on economic projections but has also, since 2012, added a projection of where each FOMC participant expects the Fed funds rate to be at the end of the next several years (the so-called “blue dots”). Although there is a wide dispersion among the 17 participants, the average forecast currently stands at 1.25% for the end of 2015 (range of forecasts from 0.25% to 3.0%), 2.5% for the end of 2016 (range from 0.5% to 4.0%) and 3.75% for the end of 2017 (range from 2.0% to 4.5%).

Although it is important to note that these projections by no means offer a perfect picture of what the Fed’s intentions are going forward, it is nevertheless quite striking that investors seem to be collectively at odds with these forecasts. While the market consensus has gradually moved higher this year (by roughly 50bps), it remains well below the views expressed by Fed officials, indicating that the market does not believe the Fed will tighten as much as they claim they will.

**Our view:** The upcoming tightening cycle is a topic so highly debated that we doubt it will be too disruptive for the markets. However, the short end of the curve does not factor in an imminent, nor a significant tightening of monetary conditions while the Federal Reserve Board’s own projections seem to point to a slightly more aggressive Fed. These projections also seem somewhat contradictory with the “considerable period of time” language kept in the FOMC’s most recent statement. As such, and despite frequent and transparent communication by Fed officials, the next few months leading up to the first rate hike are likely to be associated with a pick-up in market volatility and potentially some profit-taking in both equity and bond markets, particularly if good economic data and/or additional Fed guidance lead investors to adjust their expectations closer to the Fed projections.

**Escape Velocity**

As indicated in last quarter’s PB Insights, the current US economic recovery is already getting ‘old’ by historical standards (62 months compared to an
average of 40 months for post-war expansions) but, more importantly, it has been the weakest recovery on record since WWII. Since bottoming out in the second quarter of 2009, US GDP is up a cumulative 11% in real terms, or only 2.2% on an annualized basis, roughly half the average during previous economic expansions.

This paltry recovery coming on the heels of the most severe recession since the Great Depression (a 4.2% peak to trough decline in GDP) raises some important questions about the current business cycle and the likely path of monetary policy going forward.

As shown in the chart to the right, the US economy still remains well below the level it would have reached if it had been able to expand at a rate in line with its growth potential (or trend growth). The gap between these two lines is referred to as the output gap. While measuring trend growth is notoriously complicated and is more an art than a science (more on this later), estimates by the IMF and the CBO are broadly consistent and suggest that the output gap is still around 3%-4% of trend GDP in the US. What does this all mean?

- First, it means that the economy is still not operating at full capacity. By extension, it means that there is enough spare capacity (unemployed labor force and excess manufacturing capacity) to allow the economy to expand without creating inflationary pressures. Even without estimating potential GDP growth, this seems to be consistent with the observed levels of manufacturing utilization rates and measures of unemployment and underemployment. It is also corroborated by the absence of underlying inflationary pressures in the US economy.

- Second, it does indicate that the next recession is still some years off. Absent a negative exogenous shock, economic expansions usually end due to tight monetary policy, driven by the Fed’s mandate to prevent inflation from rising too far above its target. Above-target inflation would be a sign that the output gap has been closed.

Looking at the past 11 post-war recessions, the output gap had been closed ahead of each recession with the exception of the early 80’s (recession caused by the oil crisis). Over the next five years, the CBO estimates that the potential annual growth rate of the US economy stands at 2.2%. As a result, for the output gap to be closed, the US economy would need to grow at a rate faster than 2.2% on a sustainable basis. Assuming a 3% output gap, it would require a 3% annualized GDP growth over the next four years to close the output gap. The existence of a large output gap therefore means that the US economy would be able
to deliver above-trend growth for several years without triggering out-of-control inflationary pressures. In such an environment, the Fed will have plenty of time before it will have to hike rates into restrictive territory in order to engineer an economic slowdown.

Does it make sense for the Fed to initiate a tightening cycle in an environment where growth has barely kept pace with trend and has been too weak to materially close the large output gap? In other words, has the US economy finally reached what economists call the “escape velocity”?

In physics, escape velocity refers to the speed necessary to break free of the gravitational field without further propulsion. In economics, it refers to the moment when the US economy will finally be able to break free from the gravitational pull of the Great Recession and grow at a robust rate without the need for aggressive policy support. When an economy reaches escape velocity, a virtuous cycle emerges where rising demand leads to a sustainable pick-up in investment and hiring, which in turns creates a positive feedback loop of improving confidence, risk taking, and additional spending.

Five years into the recovery, we believe that the missing links for the economy to achieve escape velocity are gradually falling into place:

1. While economists and the Fed are still concerned with the low level of labor participation rate and anemic wage growth (barely keeping up with inflation), payroll gains have been strong for several months in a row and both measures of unemployment (traditional and expanded to take into account discouraged workers and part-time workers looking for a full-time job) have steadily come down to levels very close to full employment. In previous cycles, the Fed would already have tightened with the unemployment rate so close to the so-called NAIRU (Non-Accelerating Inflation Rate of Unemployment).

If, as we will discuss later, some of the remaining slack in labor markets is structural rather than cyclical, there is little that monetary policy can do in this context and further delaying the first rate hike will not solve this issue.

2. Despite the flurry of bad headline news (terrorism, war, low growth, etc.), consumer confidence has actually recovered strongly to reach its highest level since 2007. Consumer spending has so far been restrained by limited income growth and generalized risk aversion, while wealth gains (rising equity, bond and house prices) have a disproportionate impact on only a limited segment of the population. However, leading indicators such as confidence, credit growth and improving job prospects point to a more pronounced and sustainable recovery in consumer spending going forward.

3. The usual transmission mechanism by which monetary policy leads to a stronger economy is through bank lending. This mechanism was largely impaired earlier in this recovery and both the supply of credit and demand for credit remained weak despite the Fed’s aggressive actions. Credit growth is now relatively robust and lending
standards are supportive of a further recovery in money supply. A gradual improvement in the money multiplier should help sustain enough momentum in the economy in coming quarters.

4. Fiscal policy turned restrictive at a time when growth prospects were still very fragile. However, the public sector is gradually becoming a tailwind instead of a headwind for growth, particularly at the local and municipal levels.

5. The rebound in capital spending has been lackluster in this cycle but recent trends have been more encouraging. The necessary conditions for a pickup in corporate investment have been present for quite a while already (low funding costs, strong balance sheets, improving ROE) but uncertainties over the underlying strength of final demand kept companies overly cautious in the current cycle. Ongoing economic recovery, gradually rising capacity utilization rates and tighter labor markets should act as triggers for a more robust recovery in capital spending going forward.

Our view: The current recovery has been very weak by historical standards. The financial crisis left deep wounds and traditional medicine was not as efficient as in previous cycles as deleveraging forces, risk aversion on the part of consumers and businesses, as well as weakness on a global basis acted as significant headwinds. However, the US economy has been healing for quite a while now and we believe that the improvement seen over the past five years is significant enough to warrant a gradual removal of the extraordinary monetary stimulus implemented since 2008.

Potential Growth and Neutral Fed Funds Rate

As mentioned previously, the concept of potential or trend GDP is particularly tricky and prone to various interpretations. It is nevertheless extremely relevant when it comes to forecasting the future path of official interest rates. The potential growth rate of an economy is basically the rate of growth which can be achieved at full employment without creating inflationary pressures. It is primarily a function of two factors: growth in the labor force and productivity gains.

It is commonly accepted that in the long run, the neutral real (adjusted for inflation) fed funds rate should be roughly equal to the potential growth rate of an economy. If the economy is already operating above potential, monetary policy should be restrictive and the fed funds rate should move above the neutral level. Conversely, when the economy is operating below its potential, monetary policy should be accommodative and the fed funds rate should be set below the neutral level.
Coming out of nearly six years of ZIRP, it goes without saying that any rate hike would represent a tightening of monetary conditions but several rate hikes would be required before monetary policy becomes outright restrictive. This helps explain why the economy and equity markets usually continue to move higher in the initial phase of a tightening cycle.

Historically, a federal funds rate of 5% was viewed as the point where monetary policy was turning restrictive and would lead to a slowdown in economic activity and, as a result, become a significant headwind for equity markets. The 5% level was consistent with 3% potential growth rate and 2% inflation.

There is a growing debate as to what the potential growth of the US economy is and what the “new neutral” policy rate should therefore be. As already alluded to, the CBO forecasts point to a potential growth rate of 2 to 2.25% over the next 5-10 years. Recent trends in labor force growth (downward pressures due to aging population and a potentially structural decline in labor force participation rate) as well as slower productivity gains seem to be consistent with a reduced potential growth rate going forward. Assuming 2% inflation, this would translate into a 4% neutral fed funds rate. Historically though, the fed funds rate has rarely been above nominal GDP growth and since the 80’s (and the subsequent disinflationary trends), there has been a consistent pattern of lower peaks in each tightening cycle. In an environment of elevated debt levels (not only in the US) and global excess savings, it seems reasonable to expect interest rates to be lower in order to stimulate spending and investment as well as discourage savings and provide relief to borrowers (debt to income ratios would otherwise have a tendency to continue to climb, everything else being equal, if debt servicing costs –i.e. interest rates – are higher than income growth).

The growing consensus that the fed funds rate will most likely peak around 3% in the current cycle is one of the main factors explaining why bond markets have performed so well this year, despite the rise in expectations when it comes to rate hikes in 2015. This is also where the disconnect is the most pronounced with the Fed as the “blue dots” of the 17 FOMC members seem to indicate that the collective Fed view is for the neutral rate to be around 3.75%. However, it is worth highlighting that this average has steadily come down over the past 2 years and stood at 4.5% in 2012.

Market expectations of where the neutral fed funds rate should be can be assessed by analyzing longer-dated Eurodollar futures (investors’ collective view of where the 3-month LIBOR rate will be in coming years) as well as forward treasury yield curves. The message from both seems to be consistent with the view that the fed funds rate will peak at a much lower level in this cycle:

- Eurodollar futures: the implied 3-month LIBOR rate stands at 3% by the end of 2017 and 3.5% by September 2019, five years from now. Assuming a 0.25% basis spread between 3-month LIBOR and the Fed funds rate, this would be consistent with a 3.25% policy rate by 2019.
- The 5-year forward 5-year treasury yield (a measure of investors’ forecast for where the 5-year Treasury yield will be 5 years from now) stands at 3.5% (it stood at 4.6% at the start of the year). Assuming that the yield curve will be relatively flat by that time and taking into account a small term premium to compensate investors for the uncertainty of holding longer-dated bonds, this seems to also be consistent with a fed funds rate at 3 to 3.25% by 2019. Directionally, the drop in 5Y forward rates is consistent with the lower potential growth thesis and resulting lower neutral fed funds rate. The magnitude of the move however (together with the gently upward trend in the 5-year spot rate) reflects a sharp drop in the term premium, consistent with the Fed’s guidance and willingness to limit upward pressure on long-dated bond yields.

Our view: Estimating the long-term potential growth rate of an economy is more an art than a science and extrapolating recent trends well into the future is always a dangerous proposition. Yet, we do sympathize with the view that the US economy is likely to settle into an environment of weaker structural growth once the current cyclical rebound has run its course. In such a scenario, the upward pressure on long-dated bond yields is likely to be much less pronounced than during past tightening cycles. Betting against the US economy has been a losing game for some time already and we do not share the pessimistic view of the doomsayers advancing a scenario along the lines of Japan and Europe (“secular stagnation”). While an aging population, lower labor participation rate and lower productivity gains (a consequence of weak capital spending) appear to be, at least partially, structural trends, this could all rapidly change through the implementation of bold reforms (corporate tax, immigration) or another round of American ingenuity in terms of technological innovation. We should also not forget the extent of the damage that was inflicted upon the economy during the financial crisis and the impact this had on confidence levels for both companies and households. There will continue to be an intense debate about the extent to which the current slow growth environment is mostly structural or mostly cyclical. As investors’ views of this topic evolve, so will long-dated bond yields.

Still Easy, But Tighter

If history is any guide, investors should not be excessively worried in the early stages of a rate-hike cycle. Despite the very well-known Wall Street saying “don’t fight the Fed.”, it is important to put the Fed’s actions in perspective. In other words, there is an important distinction to be made between tight and tighter, as well as easy and easier.

On numerous occasions, we have discussed what a typical business cycle looks like, with an economy generally going through four major phases based on the level as well as the trend in GDP growth:

I. Reflation: GDP is below potential and growth is decelerating
II. Recovery: GDP is below potential but growth starts to re-accelerate
III. Expansion: GDP is above potential and growth momentum is still strong
IV. Slowdown: GDP is above potential but growth starts to decelerate

The business cycle has important implications for asset allocation decisions as summarized in the following table.

<table>
<thead>
<tr>
<th>Phase</th>
<th>Growth</th>
<th>Output Gap</th>
<th>Inflation</th>
<th>Best Asset Class</th>
<th>Best Equity Sector</th>
<th>Best Equity Market</th>
<th>BY</th>
<th>Yield Curve</th>
<th>FI Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reflation</td>
<td>Below Trend</td>
<td>Increasingly Neg</td>
<td>Bonds</td>
<td>Defensive Growth</td>
<td>US</td>
<td>Bull Steepening</td>
<td>Bull</td>
<td>Sovereign / IG / Nominal</td>
<td></td>
</tr>
<tr>
<td>Recovery</td>
<td>Below Trend</td>
<td>Getting Less Neg</td>
<td>Stocks</td>
<td>Cyclical Growth</td>
<td>EU / Asia</td>
<td>Bear Steepening</td>
<td>Bear</td>
<td>HY / EM Debt / Nominal</td>
<td></td>
</tr>
<tr>
<td>Expansion</td>
<td>Above Trend</td>
<td>Increasingly Pos</td>
<td>Commodities</td>
<td>Cyclical Value</td>
<td>Latam / Australia</td>
<td>Bear Flattening</td>
<td>Bear</td>
<td>HY / EM Debt / TIPS</td>
<td></td>
</tr>
<tr>
<td>Slowdown</td>
<td>Above Trend</td>
<td>Getting Less Pos</td>
<td>Cash</td>
<td>Defensive Value</td>
<td>UK / Switzerland</td>
<td>Bull Flattening</td>
<td>Bull</td>
<td>Sovereign / IG / TIPS</td>
<td></td>
</tr>
</tbody>
</table>

Monetary policy plays a significant role in shaping these cycles. In a perfect world, Central Banks would like to see the economy growing at its long-term potential growth rate and they use monetary policy tools to steer the economy in that direction in order to make the cycle as smooth as possible. Broadly speaking, Central Banks are likely to tighten monetary policy in phases 3 and 4 and ease monetary policy in phases 1 and 2. However, similar to the phases of the business cycle where both the level and the direction of growth matters, a monetary policy cycle can also be divided into various phases based on both the level and the trend in official interest rates as highlighted in the following table:

<table>
<thead>
<tr>
<th>Monetary Conditions</th>
<th>Fed Funds Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate Cuts</td>
</tr>
<tr>
<td>Easy</td>
<td>Phase I</td>
</tr>
<tr>
<td>Tight</td>
<td>Phase VI</td>
</tr>
</tbody>
</table>

The Fed has been on hold since 2009 and has maintained an unusually accommodative policy since then (Phase II). Once the Fed implements the first rate hike, we will move into Phase III - monetary conditions will still remain accommodative until a succession of rate hikes brings the fed funds rate back to its neutral level (Phase IV). From a business cycle perspective, this would be consistent with an economy exiting the recovery phase and entering the expansion phase. In this phase, growth tends to be strong and even accelerate and, as highlighted before,
the economy is able to reach ‘escape velocity’, meaning that it can sustain higher rates. The first rate hike usually happens late in the recovery phase or early in the expansion phase.

Equity markets usually struggle either ahead or right after the initial rate hike. This can be explained by a change in market dynamics and the resulting rotation in market leadership.

**Market Leadership**

While liquidity and valuation expansion played a major role in the previous phase, higher rates and a gradual tightening of liquidity conditions translate into a bigger focus on earnings growth. Coming out of an economic slowdown or recession, easy monetary conditions help investors to gradually price out the tail risks associated with an economy operating below its potential. In the current cycle, risk aversion had reached unprecedented levels given the extent of the potential threats facing the global economy.

Over the past few years, policy makers have implemented the necessary measures to tackle these threats and, as a result, investor confidence improved and valuations have normalized across the various markets (higher P/E multiples, tighter credit spreads and lower volatility).

Following a typical initial decline, equity markets usually recover and the bull market can continue, but earnings growth becomes the main driver supporting higher stock prices. As a result, the sectors most sensitive to improving growth prospects tend to take over market leadership.

Another factor explaining this change in leadership is related to developments in the bond markets. The typical trend observed in the early stage of a tightening cycle is a “bear flattening”. This means that bond yields move higher across the entire yield curve but the upward pressure is more pronounced at the short end of the curve (i.e. short dated bonds - a lot more sensitive to higher fed funds rate) than at the long end of the curve. The current recovery has been extremely long and weak by historical standards and interest rates have been kept at extremely low levels. As a result, we expect any yield curve steepening (in anticipation of the first rate hike) to be short-lived and a bear flattening to rapidly take place even before moving into the expansion phase of the cycle.

Long dated bonds are obviously impacted by higher short-term rates (as a 10-year yield should reflect where investors expect short-term rates to be over the next 10 years) but they are also impacted by expectations of when and at which level the Fed will end the tightening cycle. Long bonds are also impacted by other factors beyond the control of central banks, such as supply/demand dynamics.

As mentioned before, the Fed (and other central banks for that matter) has increasingly tried to gain a more pronounced control on the entire yield curve in order to improve the efficacy of its policies. The impact of monetary policies on the business cycle comes mainly from the availability and the price of credit. Since households and businesses do not borrow only at the short end, losing control of how long-dated bonds perform could significantly impair the transmission mechanism of monetary policy decisions. Verbal easing or tightening has therefore become an integral part of central banks’ toolkit in recent years (such as Mario Draghi’s “whatever it takes” comments or the Fed’s “considerable period of time” statement).

A typical bear flattening in the bond market reinforces the rotation into cyclical sectors and markets as higher bond yields will act as a headwind for interest rate sensitive sectors. As bond yields have been depressed for several years in the current cycle, investors have searched and reached for yield across various asset classes, as highlighted by the stellar performance seen in REITs, MLPs or utilities. As a result, these sectors could suffer disproportionately from the rotation away from yield towards growth.
How the current cycle will likely play out and what it means for investments

While recent growth indicators suggest that the Fed could tighten at any moment, we still expect the first rate hike to be postponed until the second half of 2015:

- From a practical perspective, the Fed will first need to engineer a reduction in banks’ excess reserves and/or raise the rate on these reserves, otherwise the effective fed funds rate will remain depressed and will not follow the path of the target fed funds rate. This is the result of the significant amount of excess reserves banks hold following the Fed’s large bond purchases.

- Inflation trends give the Fed a lot of flexibility to delay the first rate hike and wait until they feel very comfortable that the economy is strong enough to stand on its own.

- The current cycle is also atypical in the sense that other major central banks are maintaining and even expanding their aggressive monetary policies. This has already resulted in a sharp appreciation of the USD, which represents a de-facto tightening of monetary conditions in the US and which could negatively impact growth prospects and further depress inflation going forward. The Fed might therefore want to wait and assess how these trends play out in coming months.

- Being the most important central bank globally, the Fed’s actions will have an impact on global liquidity conditions and global flows, as we have seen during last year’s taper tantrum. As a result, we expect the Fed to err on the side of caution and be sensitive to how higher rates in the US could impact developments in other places, in particular in those areas where growth remains fragile and continues to require depressed interest rates.

Given the Fed’s willingness to lag the economic improvement and the starting point of zero interest rates, we expect Phase II of the tightening cycle to last longer than usual. It will likely take years before interest rates will be raised back to a neutral level, which we estimate to be 3% in this cycle.

As a result, we maintain our very constructive stance on equities and believe that the bull market has several more years to run. Trends in the bond markets will be even more important as higher bond yields could hurt equity valuations going forward. The most likely scenario though is that the 10-year treasury yield will not move up dramatically in coming years. We believe that the fair value for the 10-year is probably around 3.5% but that the move towards fair value will also be a very long process, for the following reasons:

- Policy de-synchronization: with zero interest rates in Japan and negative short term rates in Europe, the gravitational pull from depressed bond yields internationally will limit the upside pressure on treasury yields as global investors will continue to be attracted by the relative large carry offered by the US market.

- We expect continued guidance from the Fed throughout the cycle in order to prevent a more pronounced rise in bond yields. The Fed has already provided this type of guidance through lowering their forecasts for the long run neutral fed funds rate.
In an environment of “lower-for-longer” bond yields, equity markets could benefit from a further valuation expansion, to complement the bulk of the gains which we expect to come from earnings growth.

As evidenced by the chart, the earnings yield for equity markets remains substantially higher than bond yields. This is highly unusual.

Earlier in this cycle, this could be justified by the potential for highly disruptive tail risks to impact the global economy (EU debt crisis, debt deflationary spiral to name only a few). More recently, the broad consensus among investors was that this unusual and abnormal gap would be closed by rising bond yields, back to what most market participants considered normal levels, around 5%. However, if bond yields remain structurally lower around 3.5%, the gap will have to be closed by a reduction in the earnings yield (i.e. rising P/E ratios).

The most common force which has been cited as a driver for this trend to occur is the so-called “great migration”, with investors migrating from low yielding bonds into equities. While there have been a lot of bumps along the road, fund flows have been broadly consistent with this thesis in recent months. But the corporate sector will play - and is already playing - a significant role in ‘arbitraging’ this anomaly away. Indeed, companies have and will continue to have a significant incentive to issue more debt at depressed yield levels and use these proceeds to either buy back their own shares or buy the shares of other companies (M&A deals). The pickup in share buy-backs and M&A activity is expected to continue and intensify going forward as long as financing costs (corporate bond yields) remain below free cash flow yields. Over time, this should lead to higher P/E multiples if treasury bond yields remain at these low levels, assuming that credit spreads do not widen (this will eventually happen once debt/equity ratios expand too far and/or when lending and credit conditions become too tight - a trend we don’t expect to develop until a few more years).

**Our view:** We maintain our constructive stance on equities as well as credit, and our portfolios are invested in order to benefit from a further recovery in global growth and a normalization of monetary policy in the US. As previously indicated, monetary policies will be further eased in Europe and Japan and there is also the potential for some level of easing in several emerging economies. This divergence in monetary policy is one of the reasons why we continue to recommend an overweight in international equity markets. We have summarized our investment strategy in the table on the following page entitled “Asset Allocation Views”.

In a nutshell, don’t be afraid of the Fed!

If you have any questions or would like more information, please contact your Webster Private Bank portfolio manager, or email us at pbinfo@websterbank.com.

Source for charts: FactSet 09/25/2014

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