All Eyes On The Election

The focus of financial markets has largely shifted to next Tuesday's U.S. election. We highlighted in the September 29 **MRB *Global Fixed Income Report*** that a change in our recommended duration stance may be warranted following the election result. For now, we remain mildly long duration as a form of insurance: the U.K.'s vote to leave the European Union underscored the fact that surprising political developments can happen, and the odds are high that a Trump victory, were it to occur, would introduce a great deal of policy uncertainty into the marketplace (at least for a time).

It is important to reiterate that MRB's investment recommendations are ***politically neutral***, in that we do not favor one outcome over another. Our sole focus is to predict the likely direction of financial markets. But most investors would agree that sound and predictable government policy is an important factor influencing the economy. Regardless of one's political opinion, it is impossible to escape the conclusion that Trump's policy proposals are incomplete and in some cases at odds with the stated positions of the Republican party. This suggests that a Trump victory will, for a time, result in increased policy uncertainty.

We noted in the October 18 **MRB *Theme Report***[1] that the introduction of extreme policy uncertainty, combined with fiscal drag, materially impacted the pace of U.S. economic growth in late-2010 and 2011

[1] **MRB *Theme Report***, "***The Long-Term Rate Outlook (Part I): Secular Stagnation Versus MRB's "Aftershock" Theory***", October 18, 2016

MRB Global Fixed Income Recommendations*

	-		N		+
Duration				■	
Government Bonds		■			
Yield Curve**			■		
Inflation Protection				■	
Corporates: Investment-Grade				■	
High-Yield				■	
EM: USD-Denominated Debt				■	
Local Currency Debt		■			

DM Government Bonds (Currency Hedged)***

	-		N		+
Australia				■	
Canada				■	
Euro Area				■	
Euro Area Ex-Germany				■	
Germany			■		
Japan		■			
New Zealand			■		
Norway				■	
Sweden			■		
Switzerland		■			
U.K.			■		
U.S.			■		

* 6-12 month horizon
** + = steepener and – = flattener
*** Relative to hedged global fixed income benchmark

Note: + = maximum overweight, N = neutral, – = maximum underweight

- Global fixed-income investors should downgrade portfolio duration to neutral if Clinton wins next week's U.S. election with no credible basis for contestation.
- Relative value and the cycle argue for an overweight stance towards U.S. high-yield corporate bonds. p.5
- The commodity-driven selloff in Aussie bonds is no basis for a downgrade. Stay overweight. p.7
- Recent Swiss bond outperformance has been partially driven by the sharp decline in the pound, which is heavily oversold. p.8

Latest Fixed Income Clippings p.10

Summary Of MRB's Global Fixed Income Recommendations
(6-12 Month Horizon)

- **Duration (Overweight/Long) / Government Bonds (Underweight):** A mildly long duration stance acts as U.S. election insurance against a Trump victory. Downgrade portfolio duration to neutral if Clinton wins with no credible basis for contestation.
- **Yield Curve (Neutral):** A mildly long duration stance is consistent with a neutral yield curve stance. Position for a modest bear steepening in the event of a Clinton victory.
- **Inflation Protection (Overweight):** U.S. inflation expectations have room to rise further. Stay overweight global inflation protection, but strongly favor U.S. exposure.
- **Investment-Grade Corporates (Overweight) / High-Yield Corporates (Overweight):** Corporate bond spreads will rise in response to heightened policy uncertainty, but sluggish growth is not enough to cause a major corporate bond default cycle to occur.
- **EM USD-Denominated Debt (Overweight) / EM Local-Currency Debt (Underweight):** EM sovereign bonds are vulnerable in the near-term to a Trump win, but a downgrade is premature. Local-currency bonds remain a commodity play to avoid.

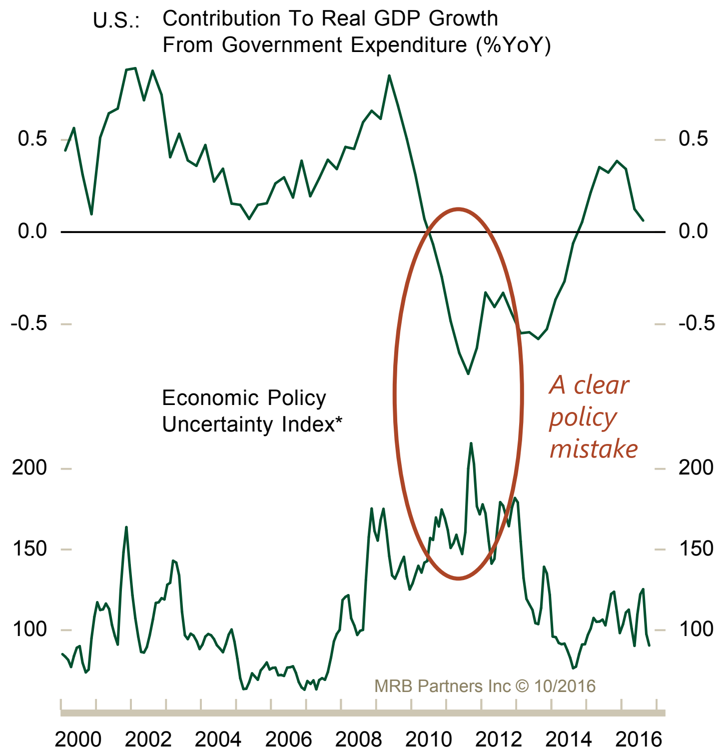
- **Australia (Overweight):** The recent commodity-driven selloff in Aussie bonds represents a poor basis for a downgrade given the risky structural outlook. Stay overweight.
- **Canada (Overweight):** The ongoing drag from oil prices and a very significant household debt burden suggests that optimism toward the Canadian economy is not warranted.
- **Euro Area (Overweight) / German Bunds (Neutral):** Easy ECB policy will support the relative performance of euro area bonds ex-Germany by capping periphery spreads. German Bunds remain very overvalued, warranting no more than a neutral allocation.
- **Japan (Underweight):** The BoJ's decision to freeze 10-year JGB yields at 0% means that the appropriate allocation to Japanese bonds is the mirror image of an investor's portfolio duration.
- **New Zealand (Neutral):** The RBNZ retains a bias towards further action, which no longer warrants an underweight stance.
- **Norway (Overweight):** Norwegian business sentiment remains weak despite the recent bounce in the price of oil, and our policy pressure gauge is deeply in "easier policy needed" territory.
- **Sweden (Neutral):** Swedish bonds are materially overvalued and potentially subject to large shifts in sentiment. For now, mistaken central bank policy will continue to support their relative performance.
- **Switzerland (Underweight):** Swiss government bonds have recently benefitted from the collapse in the pound, which is unlikely to continue in the near-term.
- **U.K. (Neutral):** While Brexit is likely to ultimately be deflationary, a sterling-driven rise in inflation expectations warrants a tactically neutral stance on U.K. Gilts.
- **U.S. (Neutral):** U.S. Treasury yields will fall back to lower levels in the event of a Trump victory. A sure-fire Clinton victory will likely warrant downgrading the U.S. to underweight.

(**chart 1**). Trump's stated policy proposals, if enacted as described, would significantly ***increase*** the Federal deficit and the debt (i.e. they would represent the ***opposite*** of fiscal drag). But as we concluded in the September 13 **MRB *U.S. Research Highlight***[2], there would inevitably be conflict between establishment Republicans and a Trump camp about expenditures. This would leave investors and economic agents with no clear signals on the likely direction of future policy decisions and would leave the window open to potentially extreme results.

A Trump presidency could ultimately lead to ***higher*** government bond yields, but in the near-term his election would likely contribute to elevated financial market volatility and at least a temporary paring of risky asset exposure (potentially benefitting bonds in the near-term). Such a risk-off event may also cause another delay in the Fed's plan to hike interest rates in December, depending on the scale of the reaction among investors and firms.

Should investors downgrade exposure to spread product or inflation-linked bonds in response to a Trump victory? The answer is no, at least not initially. First, the pro-growth stance that we have recommended since late-August has been mild in nature, which is reflected in the fact that our allocation towards fixed-income within an overall ***balanced*** portfolio has remained at neutral (**table 1**). Second, while the likelihood of a post-election selloff in pro-risk assets is high were Trump to win, part of these losses would be offset by a modestly long-duration stance. In short, the initial few weeks following a Trump victory are likely to provide important new information relevant to a 6-12 month investment time horizon, meaning that we would prefer to wait and determine whether the tone from Washington is one of unity or discord (as well as the resulting budgetary implications of any policy announcements that appear to have congressional support). That having been said, we would be inclined to ***lengthen*** portfolio duration and ***cut*** risky asset exposure on signs that policy uncertainty is negatively affecting consumer confidence or business sentiment.

Chart 1 **Fiscal Drag And Huge Policy Uncertainty Hurt Growth This Cycle**



* Smoothed; source: Economic Policy Uncertainty

Table 1 **Our Pro-Growth Stance Has Been Mild In Nature**

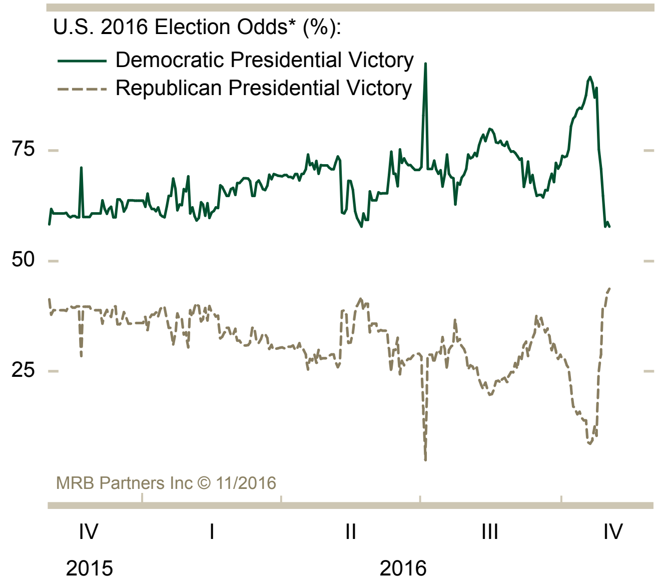
Overall Asset Allocation	-		N		+
Equities				■	
Fixed Income			■		
Cash		■			
Commodities		■			

Note: 6-12 month horizon MRB Partners Inc © 11/2016
– = maximum underweight, N = neutral and + = maximum overweight

[2] MRB *U.S. Research Highlight*, ***The U.S. Election: More Tweak Than Change Is Likely***, September 13, 2106

Chart 2 highlights that a Clinton win is still the most likely outcome of next Tuesday's contest, even though the odds have narrowed considerably (it is unclear whether the latest FBI investigation will durably affect the outcome). If Clinton wins the election with no credible basis for contestation, best represented by her gaining a Democratic majority in the Senate, we are very likely to recommend that investors ***downgrade portfolio duration to neutral***, with the potential for further reductions in the months ahead.

Chart 2 **A Clinton Win Is Still The Most Likely Outcome**



* Winner take all market; source: Iowa Electronic Markets
** Source: Iowa Electronic Markets

Within a global bond portfolio, our modestly long duration stance has been in recognition of the ongoing search for yield, which remains a very powerful driver of global fixed-income returns. But we have also noted that the occurrence of a major short duration event is certainly possible over the coming year, given the very rich pricing of global government bonds and gradually improving global growth backdrop. The odds of this outcome would increase under a Clinton victory, especially with a win in the Senate, for two reasons:

1) It would likely reduce perceived policy uncertainty, and would boost expectations of the passing of a credible infrastructure plan. We noted in the November 1 **MRB *U.S. Equity Sectors Research Highlight*** that Clinton's plan is comprehensive and broad in scope, and that she has stated that passing it would be among her top domestic priorities.

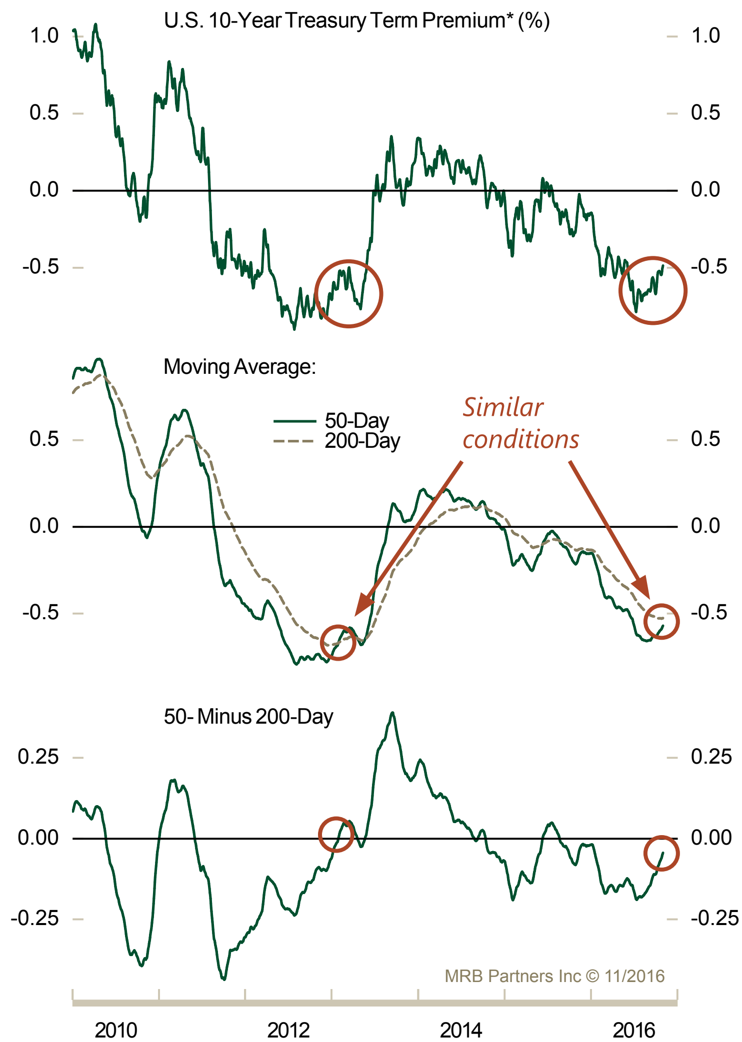
2) The reduction of policy uncertainty would likely be perceived by the market as providing a solid "green light" for the Fed to raise interest rates in December, given that the Fed's confidence in moving forward with further hikes increased greatly in the weeks following Brexit (when it became clear that there would be no immediate spike in financial stress following the vote).

A Clinton victory would reduce perceived policy uncertainty and would raise the odds of a December Fed rate hike

Chart 3 highlights that any additional steps towards tightening policy could push the term premium up even further, which is already exhibiting behavior similar to the run-up to the Taper Tantrum of 2013. The chart shows that the term premium has recently been deeply depressed, and the 50-day moving average is about to cross the 200-day moving average (as it did approximately three months prior to the onset of the Taper Tantrum). The appropriate positioning to respond to this threat is to ***underweight U.S. Treasurys*** and to be at most neutral portfolio duration, until there is clear evidence that risks to global economic growth are receding and that interest rate risk is the primary concern of fixed-income investors. The development of such circumstances would likely warrant a further downgrade of portfolio duration to below-average levels, as well as a reduction of our allocation to fixed-income within an overall (i.e. balanced) multi-asset portfolio.

Final Word: *Global fixed-income investors should downgrade portfolio duration to neutral if Clinton wins next week's U.S. election with no credible basis for contestation. A modestly pro-growth portfolio will suffer moderate losses following a Trump victory, but the tone from Washington in the weeks following the election will be a key determinant of the appropriate fixed-income asset allocation stance over a 6-12 month time horizon. Lengthening portfolio duration and cutting risky asset exposure may be warranted on concrete signs that policy uncertainty is weighing on consumer confidence or business sentiment.*

Chart 3 **The Term Premium Is At Risk Of A Sharp Rise**



* Smoothed; source: FEDS Working Paper 2005-33

U.S. High-Yield Corporate Bonds: Relative Value Still Compelling

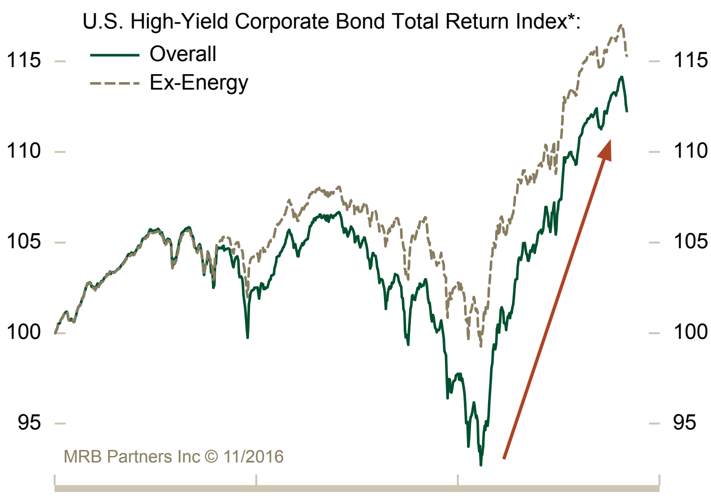
MRB has argued consistently for the past two years that the rise in U.S. speculative-grade defaults represents a sector-specific default wave and not a generalized turn in the credit cycle. We noted repeatedly over the past several months that U.S. high-yield corporate bonds are attractive[3], and have recommended an overweight stance within a hedged global fixed-income portfolio for most of the year.

In validation of our stance, **chart 4** clearly shows that 2016 has been a spectacular year for the performance of high-yield corporate bonds: overall high-yield has earned a return of 15% year-to-date, whereas ex-energy bonds have earned 12%. Given this material rise, many fixed-income investors have wondered whether corporate bond pricing has become expensive.

In absolute terms or from the perspective of a multi-asset portfolio, the answer is yes. Speculative-grade corporate bond yields are 375 bps below their long-term average, suggesting that long-term absolute returns are likely to be lower than what investors could otherwise have hoped for even under the assumption of a continued economic expansion.

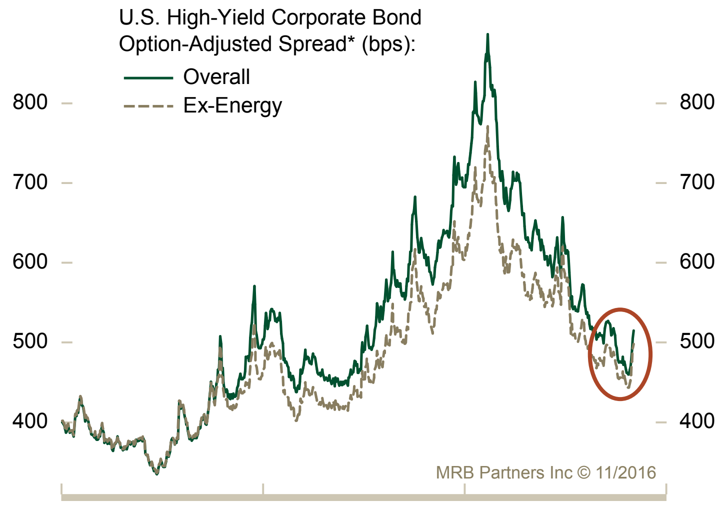
[3] **MRB *Fixed Income Research Highlight***, "***U.S. High-Yield Corporate Bonds: A Quick Update***", March 10, 2016
MRB *Global Fixed Income Reports* , ***March 31, 2016*** and ***September 1, 2016***
MRB *Weekly Macro Strategy Reports*, ***April 22, 2016***, ***June 17, 2016*** and ***July 8, 2016***

Chart 4 An Amazing Year For High-Yield Performance



* Rebased; source: BofA Merrill Lynch

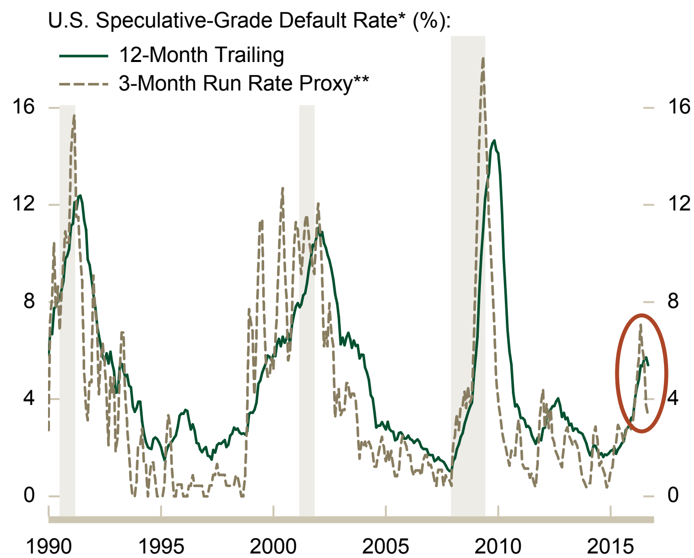
Chart 5 High-Yield Spreads Are Still Attractive



* Source: BofA Merrill Lynch

But investors who argue that corporate bonds are richly valued seem to be ignoring the fact that this is only true because the value of U.S. government bonds is even worse. **Chart 5** presents the option-adjusted spread of U.S. high-yield corporate bonds (both overall and excluding energy issuers), which clearly shows that spreads are not at unduly low levels. Since it is relative and not absolute valuation that matters when judging the appropriate allocation to high-yield bonds ***within a fixed-income portfolio***, **chart 5** highlights that an overweight stance is still compelling. This is still true in the event of a Trump victory next Tuesday (at least initially), as history suggests that even a non-recessionary slowdown is not enough to cause a generalized default cycle to occur[4].

Chart 6 The Default Rate Is Set To Decline



* Source: Moody's
** Sources: Moody's, BofA Merrill Lynch, and MRB calculations
Note: Shaded for NBER-designated U.S. recessions

Finally, **chart 6** presents an update of the 12-month trailing default rate, along with a forecast based on the default count of corporate issuers. Our proxy for the default rate implies that the latter has definitively peaked and is set to decline sharply absent a new, sizeable economic shock. This largely reflects the waning effect of energy-sector defaults on the overall default rate, and history would suggest that our default rate proxy has room to fall further if default activity in commodity-related sectors returns to normal.

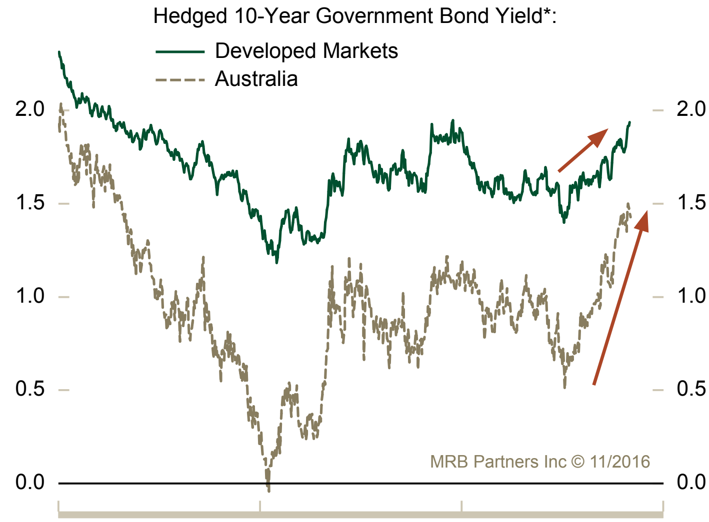
[4] **MRB *Fixed Income Research Highlight***, ***U.S. High-Yield Corporate Bonds: Six Key Questions***, October 6, 2015

Using the default rate implied by our short term proxy, the fair value for U.S. high-yield corporate bonds is 420 bps[5]. As shown in **chart 5** above, spreads are currently above this level, underscoring that ***relative*** value remains attractive.

Final Word: *Barring events that would warrant a broad-based reduction in risky asset exposure, relative value and the cyclical state of the U.S. economy suggest that an overweight stance towards U.S. high-yield corporate bonds continues to be warranted.*

Aussie Bonds: China Risks Warrant An Overweight Stance

Chart 7 **Australian Bond Underperformance Has Been Active, Not Passive**



* Hedged using 3-month forward currency contracts; market-capitalization weighted in the case of aggregates; source: MRB calculation

Australian bonds have underperformed our hedged DM benchmark since the beginning of September. This underperformance has been active, in the sense that both Australian and developed market (DM) government bond yields have risen, with the former rising more than the latter (**chart 7**).

Chart 8 highlights the following observations:

- The rise in Australian bond yields does not appear to have been driven by a surprising improvement in the macro data (**panel 1**). The economic surprise index for Australia has oscillated around the boom/bust line for the last three months, and currently sits in modestly negative territory.

- The underperformance of Australian bonds is not simply a function of the backup in global bond yields, as Aussie bonds have actually exhibited a below-market beta over the past year (and thus should have outperformed as global yields rose). **Panel 2** shows that a rolling 3-month alpha for Australian bonds has fallen sharply into negative territory, underscoring that the magnitude of the selloff is distinctive to the Aussie bond market.

- Rising commodity prices, particularly iron ore, may be magnifying the rise in Australian government bond yields even if the rout in global government bonds was the immediate ***trigger*** for the selloff. **Panel 3** highlights that iron ore prices have risen over 60% since their late-2015 low, and the trend in unhedged Australian bond yields has run counter to that of iron ore prices over the past year when the two series have usually been

Rising commodity prices may be magnifying the rise in Australian government bond yields

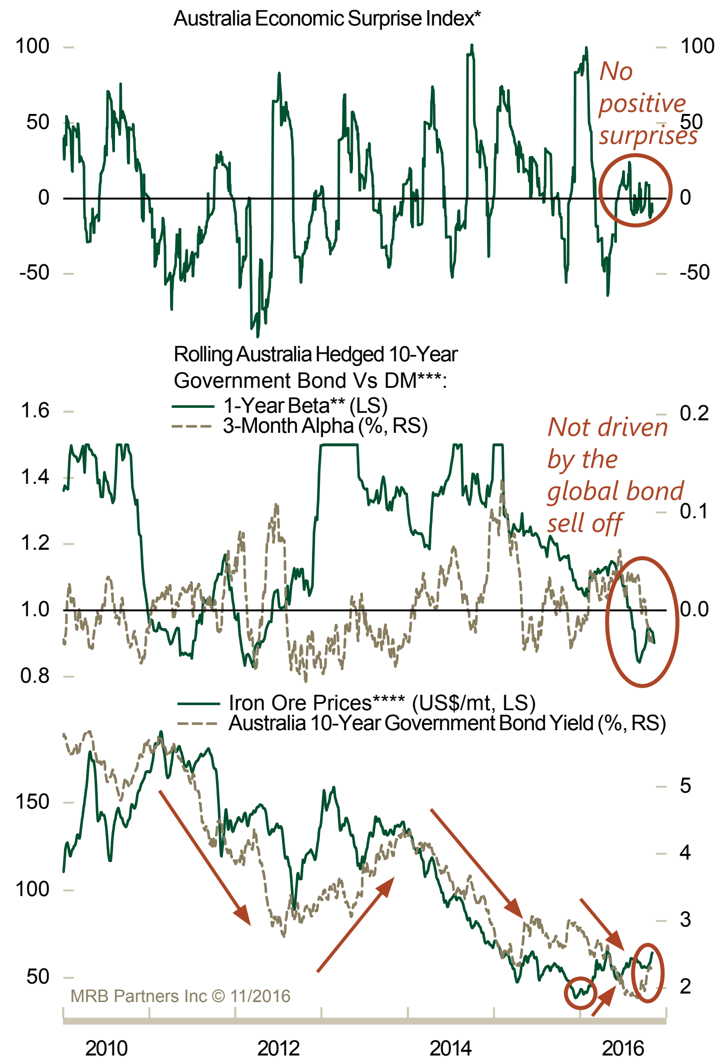
[5] Our calculation assumes a 200 bps risk premium relative to duration-matched U.S. government bonds and a recovery rate of 35%.

strongly (positively) correlated. This suggests that the rise in Aussie yields may have been partially "pent up" given the improvement in commodity prices.

Based on **chart 8**, we continue to recommend that fixed-income investors maintain a favorable stance towards Australian government bonds. From a cyclical perspective, we are unwilling to reduce our exposure to Australia based on a rally in commodity prices, as the rally will simply unwind once China fears re-emerge next year. While the timing of a hard landing scare is uncertain, the risk/return of an underweight position is poor given our negative long-term view on developed commodity market economies[6].

Final Word: *The commodity-driven selloff in Australian government bonds represents a poor basis for a downgrade. The prospect of China hard landing fears emerging in 2017, as well as an extremely poor structural outlook for developed commodity markets, continues to argue for an overweight stance within a hedged global fixed-income benchmark.*

Chart 8 **Rising Commodity Prices May Be Juicing The Rise In Aussie Yields**



* Source: Citigroup
** Truncated at 1.5
*** Hedged using 3-month forward currency contracts; market-capitalization weighted in the case of aggregates; MRB calculation
**** 62.5% FE deliveries to Quingdao, China; source: Bloomberg

Swiss Bonds: Benefitting From The Collapse In The Pound

Swiss bonds have rallied significantly relative to their DM counterparts since late-September, with 10-year hedged returns ranking highly over the period among the regional government bond markets included in our DM aggregate.

Switzerland is a reliably low-beta government bond market, and some of the outperformance over the past month has occurred because of the rise in global government bond yields. However, **chart 9** suggests that Swiss bonds have also benefitted from capital outflows from the U.K., in response to a collapse in the pound. The Swiss franc has long been regarded as a safe haven asset in Europe, and it appears that Switzerland is among the destinations of choice for investors who are selling their Sterling-denominated assets.

6 ***MRB Global Fixed Income Report***, September 29, 2016

Should fixed-income investors increase their exposure to Swiss bonds in response to this surge in relative performance? For now, our answer is no. On the one hand, we view the decline in the pound over the past few months as a rational response to the developments concerning the Brexit negotiations. Brexit is unequivocally negative for the U.K. economy, and its implementation (which is still likely even given today's court decision) could dampen investment and potentially send the U.K. economy into recession. It will also challenge London's status as a global financial center, which implies that the pound will have to be much weaker over an extended period in order to reduce the U.K.'s sizeable current account deficit.

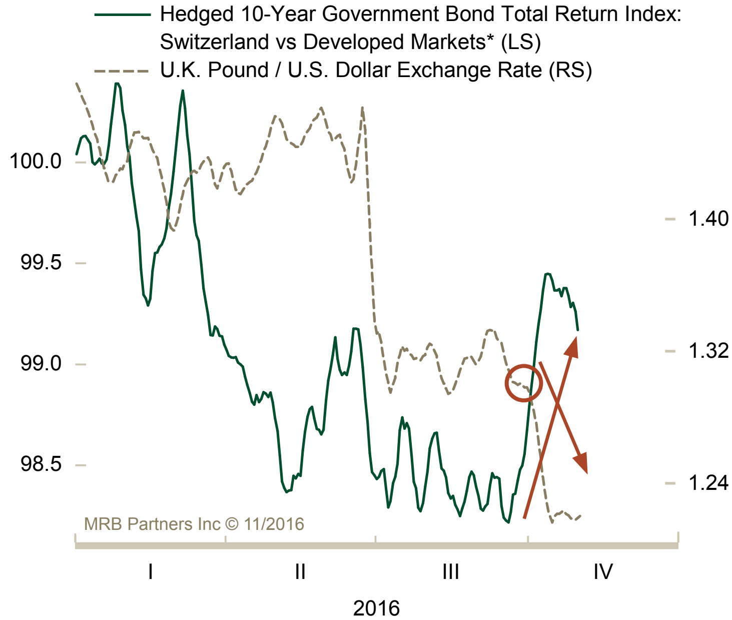
However, volatility in the pound has recently declined quite significantly, even though it is still high based on recent history (**chart 10**). In addition, our cyclical momentum indicator shows that the pound is extremely oversold (**panel 2**), suggesting that it is risky to chase short-term Sterling-driven Swiss bond outperformance.

Our overall duration stance remains the most important factor in determining the appropriate allocation to Swiss bonds, given Switzerland's low-beta relative to our hedged DM benchmark. For now, we continue to recommend a below-average allocation to Swiss bonds, but we noted above that a reduction of our overall duration stance is possible following next week's U.S. presidential election. Were this to occur, we would likely recommend that investors increase their Swiss bond exposure to at least a neutral stance. Stay tuned.

Final Word: *Recent Swiss bond outperformance has been at least partially driven by the sharp decline in the pound, which has been showing some signs of stabilization. An increase in Swiss bond exposure will likely be warranted following the election if the result is consistent with a reduction in portfolio duration.*

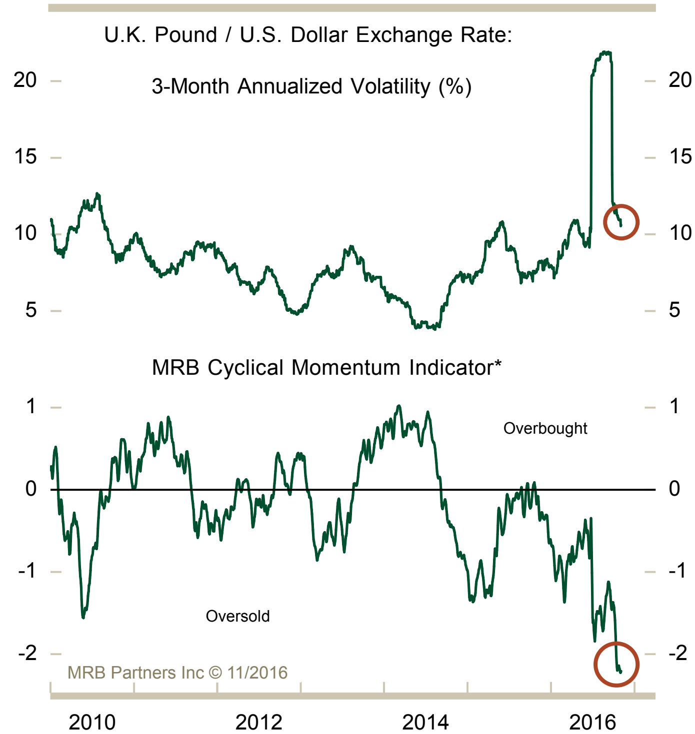
Jonathan LaBerge

Chart 9 **Swiss Bonds Have Benefitted From The Collapse In The Pound**



* Hedged using 3-month forward currency contracts; market-capitalization weighted in the case of aggregates; smoothed; MRB calculation

Chart 10 **Don't Chase Sterling-Driven Swiss Bond Outperformance**



* Standardized

Latest Fixed Income Clippings

The Long-Term Rate Outlook (Parts I, II, and III)

This three-part report outlined MRB's perspective on the secular outlook for policy rates, and whether rates in equilibrium will ultimately end up as low as the Fed currently projects. ***Part I*** *highlights that the MRB Aftershock Theory provides a much more credible explanation of subpar economic growth over the past seven years than is offered by the idea of secular stagnation.* ***Part II*** *notes that the Fed (wrongly) believes that the natural rate of interest has declined significantly; instead, household deleveraging reduced the beta of the economy to monetary policy, which is now slowly rising.* ***Part III*** *looks to the future, and underscores that we can identify additional potential Aftershocks over the coming few years. But several potential economic stabilizers also exist that may allow the Fed to raise interest rates more than investors (and even the FOMC) currently expect.*

Theme Reports ***PartI***, ***PartII*** and ***PartIII***
October 18, 20, 27, 2016

Global Inflation-Linked Bonds: Stay Overweight, But Favor The U.S.

There is a good case for U.S. inflation expectations to continue to rise, but the odds are lower in the euro area and Japan. In the U.K., the spike in long-term inflation expectations is occurring because of a strong correlation between the long- and short-ends of the curve, which has the potential to reverse sharply if Brexit-related uncertainty begins to adversely impact the economy. Investors should continue to maintain an overweight stance towards inflation-linked bonds within a hedged global fixed-income portfolio, but should concentrate regional positioning in favor of the U.S.

Fixed Income Research Highlight
October 25, 2016

U.K. Bonds: Tactically Downgrade To Neutral

The rise in nominal 10-year Gilt yields since late-September has been driven by a rise in long-term inflation expectations, rather than a spike in real yields. This suggests that investors are reacting to the likelihood of currency-driven inflation, both over the cyclical and secular investment horizons. Our view is that the surge in long-term U.K. inflation expectations is not sustainable, but the potential for a further currency-driven rise in inflation expectations in the near-term warrants a tactical downgrade of U.K. government bonds to neutral within a hedged global fixed-income portfolio.

MRB *Weekly Macro Strategy Report*
October 14, 2016

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Independent Investment Strategy

November 3, 2016

MRB – The Macro Research Board is a privately-owned independent research firm providing integrated, global, multi-asset investment strategy as well as actionable, absolute-return ideas. Our views incorporate a long-term outlook based on in-depth theme research, together with rigorous forecasting models and indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to ensure that investment strategy is developed and articulated in an integrated, coherent and client-friendly manner.

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