CAPITAL GROUP®

Long Duration
For the Month of November 2016

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LDI Update

General Market Update

The market response to the U.S. election was pronounced. U.S. GDP growth and inflation are expected to accelerate and the Federal Reserve raising rates in December is considered a near certainty. Equities and oil prices moved higher.

Treasury yields moved decidedly higher in the weakest month in years, retracing the entire years' worth (and then some) of rate declines. The 10-year Treasury yield rose 56 basis points to 2.39% while 30-year Treasuries backed up 46 basis points, ending the month at 3.04%. Investment-grade credit spreads tightened slightly, with energy-related names and financials doing well.

New issuance at $74 billion fell short of expectations as the rapidity of the rate rise stemmed issuance. This trend is expected to continue with muted expectations for December of $20-25 billion. Year to date volume is up 6%.

Sector Focus – Chemicals

The U.S. chemicals sector includes a diverse set of companies spanning petrochemicals, agricultural chemicals, industrial gases and paints/coatings. Overall industry margins and earnings peaked in 2014 and have slowed over the last 2 years. Slowing growth coupled with low rates has resulted in record M&A activity, with several large deals awaiting regulatory approval (Dow/DuPont, ChemChina/ Syngenta, Bayer/Monsanto).

Broadly speaking, the decline in earnings resulted from lower crude oil prices (which reduced a U.S. cost advantage in petrochemicals), a weak agriculture market, and pockets of commodity chemical overcapacity. Bond spreads, however, have rallied along with the broader basic materials sector, and are at their narrowest levels in 18 months.

The outlook for U.S. chemicals differs by subsector and, as a result, security selection is the driving force of returns. Debt financing to fund record M&A activity will be a significant driver of spreads as the sector's bond market footprint grows in 2017. Our outlook on the sector remains cautious in the near term as valuations are skewed to the downside, given the substantial risks and headwinds in the industry.

Structural Issues

Since the U.S. elections, equity, bond and currency markets have all priced in substantial policy changes: looser fiscal policy, a different corporate tax regime, and easing of regulations.

An exception is monetary policy. Inflation expectations have risen by about 30 bps at the 30-year maturity point. But the market is not expecting the Fed to behave differently, and is pricing in just one to two rate hikes per year for the next three years.

Fed policy has been far from traditional in recent years. The effective Fed funds rate is currently around 0.4%. If the Fed were following a traditional Taylor rule right now, its 2% inflation target would imply a Fed funds target of over 2% today. Of course, it's much more reasonable to expect the Fed to maintain its dovish orientation. However, it is important to consider the implications of other, less likely scenarios.

Many conservative economists believe that Fed policy has been counterproductive, reducing returns to savers while encouraging firms to engage in debt-funded financial engineering rather than making investments in physical and human capital. It is possible that this school of thought may gain ground.

If so, the opportunity exists to substantially reshape the Federal Reserve Board in coming years. There are already two vacancies on the board, and it is possible that Fed governors Lael Brainard and Daniel Tarullo may decide to depart as soon as 2017. Chair Janet Yellen's term expires in February 2018, and Vice Chair Stanley Fischer's term expires in June of that year. So there could be up to five newcomers (out of seven total) by mid-2018.

What would this mean for long-term bond yields? A hawkish Fed would imply a drastic rise in short/intermediate term yields, but if it meant fewer concerns about inflation risk, Treasury yields at the long end might be stable or even lower. A new Fed regime would certainty make yields more volatile – which, in turn, would drive higher funded status volatility.

(Portfolio managers Andy Barth and David Lee, along with analyst Mandeep Saini, contributed to this report.)

Wesley Phoa is one of the portfolio managers responsible for managing Capital's long duration strategies.

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