FORSTRONG GLOBAL

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ASK TYLER

THE VIEW FROM BOND LAND

WITH FISCAL POLICY MAKING A COMEBACK, WHAT IS YOUR VIEW ON BONDS?

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Replying to criticism during the Great Depression for changing his position on monetary policy, John Maynard Keynes famously quipped "When the facts change, I change my mind. What do you do, sir?" Our Investment Committee may use the same words regarding our interest rate outlook. Having been vocal proponents of a "lower for longer" view since 2009 (with a fair share of rotten tomatoes thrown our way), we adjusted our positioning in the summer of 2016: the 35-year bond bull may be over.

Note that our core scenario is not for a bond market crash. However, yields have very likely seen their lows. Several reasons support this view. For one, bond values are stretched. Secondarily, there is a growing awareness (both in policy and public circles) that low rates are actually impeding economic growth, increasingly seen as (1) hindering the process of what Joseph Schumpeter gleefully called "creative destruction" (i.e. witness Japan's stagnation since the mid-1990s), (2) creating uncertainty causing companies to delay investing, (3) promoting social discontent, as the wealthy have been prime beneficiaries of the era of easy money, and (4) fueling asset price inflation without similar benefits bestowed upon the real economy.

Given the above it is not surprising that fiscal stimulus is making a comeback. In many ways, the election of Trump and Trudeau — who were elected in large part on platforms of anti-austerity — are merely symptomatic of this regime shift. We are indeed moving away from loose monetary, tight fiscal policies to tight monetary, loose fiscal settings (at least in the US, which has become a leading indicator of what other global policymakers will do in the post-crisis period).

Consider the Fed's latest moves. As expected, they went ahead and raised the benchmark interest rate by 25 basis points in December. Less widely expected was the positive tone of the Fed's comments on the economic outlook, and its slightly more hawkish view on the trajectory of rates, with policymakers now projecting three rate increases in 2017 rather than two. Fed chair Janet Yellen described the changes as "tiny". But the unnerved market reaction underscored how investors recognize this profound monetary to fiscal shift.

INVESTMENT IMPLICATIONS

Bond rallies will still present themselves. However, for Western bond market exposures, keep duration strategically short and tactically take on floating exposures when bonds become overbought.