CIO LETTER

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Beware of "New Normal": The Economic Cycle is Not Dead

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"As long as there are games to play, it is not over."
Sir Alex Ferguson, Scottish Football Manager

The big surprise for global investors so far in 2014 has been the performance of core government bonds, starting with US Treasuries, with the 10-year bond total return being more than 5%.[1] With most investors bullish on risky assets at the beginning of the year, virtually no one expected to see 10-year US Treasury yields reach levels close to those last seen when the recession was at its most acute. For the most part, neither long-only investors nor hedge vehicles were able to predict the rally in longer-term benchmark sovereign bonds, and this is confirmed by the disappointing results of many global macro hedge strategies year to date.

In theory, we could claim that we have not been completely unprepared for this evolution in financial markets. In our outlook for the year, *Be Long, Be Careful*, we called for a more balanced and diversified investment approach, due to less compelling valuations for some risky assets (especially US equities and some areas of the credit market). But the truth is that we have been surprised, as have many other investors, by long-term core government bond yields continuously scoring new lows.

So, what's the real consensus trade today in the market for Treasuries and about duration? At the beginning of the year, as we said, most investors were bearish on US Treasuries and, to a lesser extent, on German Bunds. Today, there are many attempts to explain why the current low yields are fair. These range from the *Secular Stagnation* expression dusted off by Larry Summers, to the *low for long* theme played recently by Ben Bernanke (referring especially to short-term rates), up to the theories that advocate permanent low growth due to lack of innovation. In short, on this front, we see more and more signs that another *"this time is different"* story is taking shape in the market.

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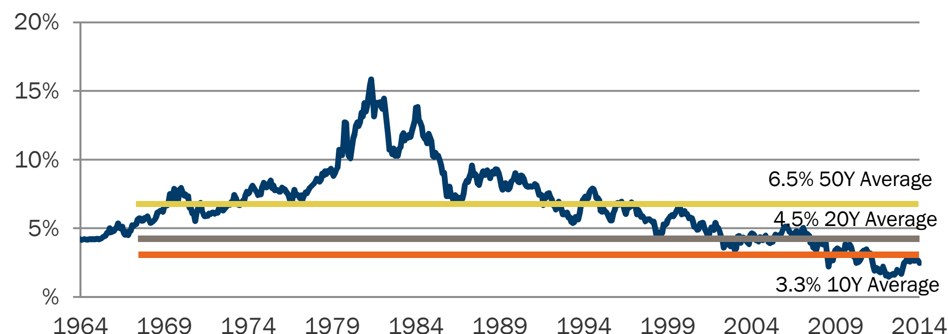
10-Year US Government Bond Yields: Are They Fair?



Source: Bloomberg, data as of June 4, 2014.

[1] Source: Bloomberg, data from December 31, 2013 to June 4, 2014.

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Other tentative explanations for low yields are based on flow-related arguments that are at least in part tautological. Investors feverishly searching for yield have become cautious on Emerging Markets and, as a result, are seeking "safer" yields in developed markets' bonds. With the 10-year German Bund yield close to 1.5%, they may find 10-year Treasury yields of about 3% interesting[2]. In short, however justified, it seems to us that today there is a strong consensus in the market that short- and long-term interest rates are going to stay low for a long time, as a result of permanent low growth. The *Japanization* of the developed world economy (persistent low growth and deflationary forces) is the concept behind this conviction that seems to be applying first of all to Europe, but also to some extent to the US.

On the other side of the debate, the main bearish argument for government bonds is the inevitability of "mean reversion" for interest rates and, strictly connected to it, the belief that the concept of economic cycles is not dead.

Why we believe that the economic cycle is not dead

We are fully aware that it is not easy to make short-term macroeconomic forecasts, especially after a financial crisis with the potential to bring such long-term headwinds to the economy. The deleveraging phase that usually follows credit/real estate bubbles, the dislocations in the job market and in the investment cycle, the distortions created by the excess of regulation (for example Basel III and Solvency II[3], which are keeping the demand for safe assets extremely strong) are just some examples of the legacies of the Great Financial Crisis. **As long-term investors, rather than engaging in short-term macro forecasting, we are more interested in the big picture and in understanding the long-term macro environment ("secular") in which we are going to invest in the next 3-5 years. At the same time, we believe in the existence of short-term economic cycles and in the reversion to mean of financial markets.**

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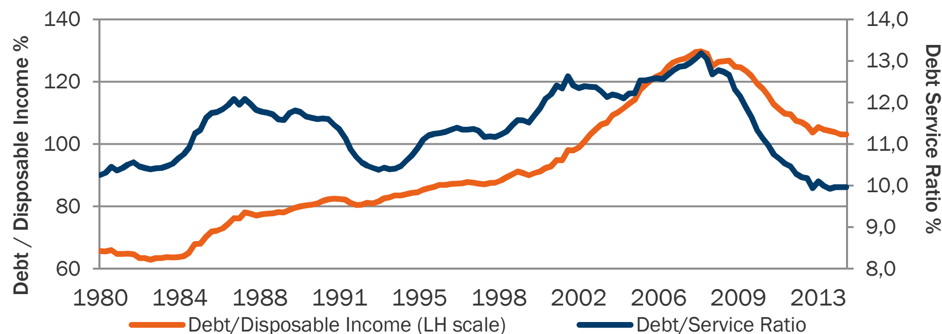
Regarding the long-term macro picture, the total level of government debt, worldwide, has increased, not decreased since the financial crisis and is now up more 30% since 2007[4]. We believe this will probably prevent central banks from managing an aggressive tightening, but will not change, in our opinion, the link between growth and rates that underpins any economic cycle. Were central banks to lose that link, (starting with the Fed), it could be disruptive for their credibility.

Looking at short-term economic indicators, in our opinion the situation looks pretty clear. In the US, the deleveraging phase of the private sector is at the point of maturity. The household debt service ratio (that measures debt payments as a percentage of disposable income) and the debt/disposable ratio are both far below the pre-crisis level, and we are seeing evidence of credit growth in the banking sector.

US Households: Deleveraging Is Near Completion



Source: Bloomberg, data available as of June 4, 2014.

[2] Source: Bloomberg, data as of June 4, 2014.
[3] Basel III is the name of regulatory standards on banks, Solvency II a set of EU regulatory rules on insurance sector.
[4] Elaboration Pioneer Investments, on BIS Quarterly Review of March 2014 for Total General Government Debt in advanced economies.

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We tend to believe that the next step in US monetary policy will set the stage for a normalization of interest rates and that long-term government yields are directionally headed up.

One could argue that the recovery of the labor market is abnormally low, but we believe that this trend can only partially be attributed to the recent crisis. If we look at long-term trends, we can see that the transformation of US labor market was already in place well before the crisis. Wages, although slowly, are starting to grow again in the private sector. And signs of normalization are coming also from the housing market, with business activity and prices slowly recovering.

For this reason, we tend to believe **that the next step in US monetary policy will set the stage for a normalization of interest rates and that long-term government yields are directionally headed up.**

In Europe, the growth trajectory remains very muted, although we are finally seeing positive signals from cyclical indicators. These signals are not coming only from the business side but also from consumer indicators, thanks in part to the easing of fiscal austerity that was mostly responsible for the extended recession. Here, the legacy of the crisis is more profound, especially in terms of unemployment. The outcome of recent European elections, with some anti-euro forces gaining ground, could be a trigger for finally implementing more convincing pro-growth fiscal measures. For its part, the ECB (European Central Bank) is reacting by acting more forcefully to revive the bank loans' market, in an effort to fight deflation fears and to indirectly weaken a strong euro.

In addition, the robustness of credit markets both in the US and Europe (in some cases even too strong and bordering on overheating) seems to point to a sound corporate sector and suggests that an impending recession is not in the cards.

We believe that the most appropriate investment strategy going ahead is a balanced and diversified approach, which calls for retaining a preference for risky assets, but on an increasingly more cautious and selective basis.

In conclusion, we believe that **the most likely trend for long-term government bond yields is up**, in the wake of normalizing economic conditions. Nonetheless, the normalization of long term yields may be slow to unfold. Inflation, the biggest enemy of bonds, is still the "great absent" of this post-crisis recovery, regulations support the demand for safe assets and we are far away from an overheating of the economy on a global basis. In addition, the other main asset classes, notably equities and even more so credit markets, are not showing particularly compelling valuations. The result on balance is that we confirm only a moderate negative view on core government bonds in our asset allocation.

I cannot help but reiterate that the most appropriate investment strategy going ahead is a balanced and diversified approach, which calls for retaining a preference for risky assets, but on an increasingly more cautious and selective basis. In addition, volatility priced at reasonable levels may provide the opportunity to buy protection on any equity downside.

Approaching the World Cup, I would like to close with an expression which is quite popular in Italy: He does not win who scores one more goal, but who concedes one less. Sometimes, it is better to play defense.

Important Information

Unless otherwise stated, all information contained in this document is from Pioneer Investments and is as of June 4, 2014.

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