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INVESTMENT PERSPECTIVES

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You can lead a horse to water…

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The new Bruce Springsteen autobiography, *Born to Run*, lists for $32.50 on the publisher's website. The local Barnes & Noble sells it for $19.50, confident that more people will purchase the book at the lower price. In a different section of the store, other rock biographies are marked down to $1.98, because management knows that the books are junk: no one wants to read poorly written hagiographies of two-bit, one-hit wonders.

There's a lesson here for the world's central bankers. They sell a product, too: money. When they wish to sell more of it, they mark down the price. When they think there's a glut, they raise the price to curtail demand. Most of the time, this system has worked well.

But today, after years of central banks keeping interest rates extremely low, our perception of the price of money has changed. No longer do we think that we are getting this product – money – for a bargain price; instead, we act as if money were as desirable as those $1.98 books. No one wants to buy a worthless product, no matter how low the price.

When the Bank of Japan and European Central Bank initiated negative interest rates early this year, they reinforced this notion: Their "product" was so undesirable that they would pay us to take it off their hands. It shouldn't have surprised anyone that the response was a gigantic collective yawn: You can give us free money all you want, but if we think it's worthless then we don't want it and we won't use it.

It may seem counterintuitive, but perhaps the better way to encourage people to purchase and use money is to persuade them that money actually has value. Perhaps by raising the price of money, central bankers might restore confidence and even encourage corporate leaders to invest in their businesses again.

It's worth a try. After all, if I think the Springsteen book will be cheaper in the future, I may delay purchasing it. But if I think the price of *Born to Run* (or money) will go up next week, I'd better purchase today.

>> PERSPECTIVES ON THE ECONOMY

Deal or no deal on oil?

By Christina Lakich
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The Organization of Petroleum Exporting Countries agreed in September to its first output cut in eight years, which we view as an about-face from its earlier effort to flood the global crude market. The deal is a gentle concession to the American shale producers, who have fared better in the price war of the last two years. OPEC desperately needs to improve market sentiment because member countries have been staggering under the revenue erosion that lower prices have inflicted on their economies. The production cut is minimal compared to the group's overall output.

We are skeptical that OPEC will be able to enforce the production cap. Historically, OPEC has been unable to hold members to their commitments, and some countries may be exempt from this particular agreement. Even if the cartel holds firm, it would take at least six months for OPEC's planned output cuts to have any effect on the oil market.

OPEC can no longer control oil prices unilaterally; resilient American producers are now the price-setters in the global market. The U.S. is expected to produce about 8.8 million barrels per day this year, just above its 2014 output. Further, if the price of oil improves as a result of the OPEC deal, we may see domestic activity accelerate again. We anticipate that potentially higher U.S. activity would offset lower OPEC production, keeping prices relatively stable in a $45 to $60 range.

TRIMMING OUTPUT

As oil prices have recovered from their February lows, OPEC has agreed to its first production cut in eight years.

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>> FOCUS ON EQUITIES

The search for yield in a yield-less market

By Tim Garvey
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As central banks in Europe and Japan have entered the uncharted realm of negative interest rates, investors worldwide have sought income wherever they could find it. Even U.S. Treasury debt is trading at all-time low yields. This begs the question: where do investors put their money when interest rates are at a historic bottom? The answer, based on what we have observed so far in 2016, is into the stock market – and especially into sectors that pay high dividends.

And why not? The S&P 500 dividend yield of about 2% this year has been consistently better than the 10-year Treasury yield, which has fluctuated between 1.35% and 1.75%. This is an extraordinary development: Other than in the current economic expansion, the last time that stocks yielded better than bonds was almost 60 years ago, in 1958.

Through the first half of this year, equity markets were driven almost entirely by the search for yield, as is evident from a glance at sector-by-sector performance. Through June, the two leading sectors were Telecoms and Utilities, with total returns of 26% and 24% respectively. Companies in these sectors typically offer high and stable dividends. Meanwhile, the more growth-oriented sectors, such as Technology and Health Care, posted meager 2% and 3% total returns respectively. It's hardly surprising that the combination of global economic uncertainty and exceptionally loose monetary policies worldwide led investors to pile into stocks that offer steady streams of income.

Since June's Brexit vote, however, investor sentiment has shifted markedly. By the end of September, the Telecom and Utilities sectors' year-to-date returns had dropped to 18% and 16% respectively, while Technology jumped to 13%. We think that investors have transitioned away from traditional dividend-rich sectors into growth areas for three main reasons: first, the valuations of high-dividend sectors became too stretched; second, earnings expectations are becoming more bullish for 2017; and third, the Fed seems increasingly likely to raise interest rates in the coming months. Rising interest rates would make high dividend yields seem less compelling. Growth stocks, meanwhile, would benefit if investors believe the Fed's action indicates a strengthening economy. It will be interesting to see if this trend continues to drive the markets into year end.

>> FOCUS ON FIXED INCOME

Yield curve illustrates gap between Fed and market expectations

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Federal Reserve Chair Janet Yellen and most members of the Fed's policy-setting committee expect to increase the federal funds rate before year-end as the labor and housing markets continue to improve. Longer term, officials are cautiously optimistic, forecasting two more increases in 2017.

Bond markets tell a very different story, however. Investors are not as upbeat about the outlook for the economy, as evidenced by long-dated Treasury yields that are near historic lows. The yield spread between 2-year and 30-year Treasury securities was only 1.55 percentage points in early October, compared with an average of 2.57 percentage points over the past five years. Investors seem to think that a rate hike in the near term will stunt economic growth, diminishing the chance that inflation will rise to the Fed's target of 2%. This has resulted in higher demand for Treasuries maturing more than 10 years from now.

As Treasury bond prices have risen, investors have been forced to look for yield elsewhere. Money (much of it from the $10 trillion of foreign sovereign debt that trades with negative yields) has been gushing into lower-quality credit this year; these high-yield bonds gained 13% through September, outpacing equities and other domestic bond categories. Yet despite the strong gains, we believe high-yield bonds still have some upside; the yields on these bonds are more than five percentage points above those of comparably dated Treasury debt; in the past, the difference has been as low as three percentage points. We think high-yield debt remains attractive.

THE SPREAD BETWEEN THE 2-YEAR AND 30-YEAR TREASURY YIELD

The difference in yield between 2-year and 30-year Treasury has been shrinking steadily for more than two years.

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