Asset Management

STILL PLAYING THE "END OF CYCLE" THEME

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In wake of the Federal Reserve's recent changes to its economic forecasts and rate projections, we thought it prudent to share an update on how this reconciles with our macro views.

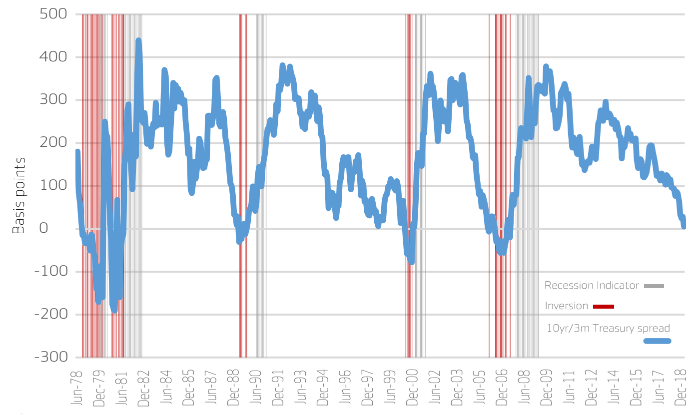
We have long been a proponent of a lower real neutral rate (R*) given the fundamental changes in the macro economy. This had been a key underpinning of our Rates Strategy call, which is for the terminal funds rate to be in the 2.50-2.75% range. With its latest move, the Fed is acknowledging the manifestation of this scenario.

Furthermore, our "end of cycle" theme continues to play out. In the wake of the Fed's latest moves, the difference between the 10-year US Treasury and the 3-month T-bill (cash proxy) collapsed to only 4 basis points (it was 48 basis points when we published our Outlook in late December and over 100 a year ago). This is critical because inversion of this ratio has been quite reliable in predating a recession within 9 to 24 months (we discuss why in our August 2018 report, Implications of an Inverted Yield Curve). It also has implications for asset allocation—once inverted, riskier assets such as equities and high yield bonds tend to generate lower risk-adjusted returns than investment grade bonds or government bonds.

Keep turning the asset allocation dial

We have long cautioned about an "all or nothing" attitude toward risk assets. Instead, we analogize a risk dial that can fluidly adjust with meaningful movements in the curve. To that point, we believe that the curve continues to call for portfolio de-risking and targeting alpha exposure consistent with positioning for late in the economic cycle.

Exhibit 1: A much followed indicator of a pending recession
10-year US Treasury / 3-month T-bill spreads



Source: Aegon Asset Management US, Bloomberg.