NEWPERSPECTIVES

Commentary from New Century Advisors
July 2017

Global Inflation: Fronts Collide

- **Three weak CPI prints, rising oil volatility, a Fed bent on removing monetary accommodation, and diminished hopes for fiscal and regulatory salvation combined in a perfect storm for TIPS breakevens in Q2**
- **TIPS have bounced back in the last couple of weeks, led by oil and yet another strong TIPS auction**
- **The global economic backdrop has been more supportive, with strong PMI prints pointing to continued manufacturing strength and reduced downside risks**
- **But there too, falling energy prices and global central bank hawkishness have weighed on developed market linkers**
- **EM continues to perform well and we'd argue that the sector provides a global disinflationary hedge in addition to the more commonly attributed benefits of diversification and commodity exposure**
- **We conclude with an expanded section of charts looking at some of the trends and developments in the inflation data and market positioning**

Slowly It Turns…

In the last two weeks, TIPS breakevens saw their largest gain in any two week period since December, when they were still enjoying the promise of a new administration. As hopeful as that sounds, the recent gains come off of lows not seen since October, before the presidential election.

In addition to waning optimism over fiscal stimulus and tax and regulatory reform, TIPS responded to three less-than-anticipated CPI prints in a row. The Fed has dismissed the recent downturn in inflation prints, blaming them on one-offs, most notably in the downward adjustment to cell phone plans. While we are less sure, we nonetheless have a fairly sanguine outlook going forward. In addition to our expectation that core inflation will stabilize near current levels before rebounding back towards 2%, we see upside risk from food prices, along with a near term tailwind from the bounce in energy prices.

Ultimately, as with any asset class, TIPS performance is in part driven by flows. We continue to keep a watchful eye on ETF flows and other indicators for any signs of distress. We note that the past three TIPS auctions all brought record demand.

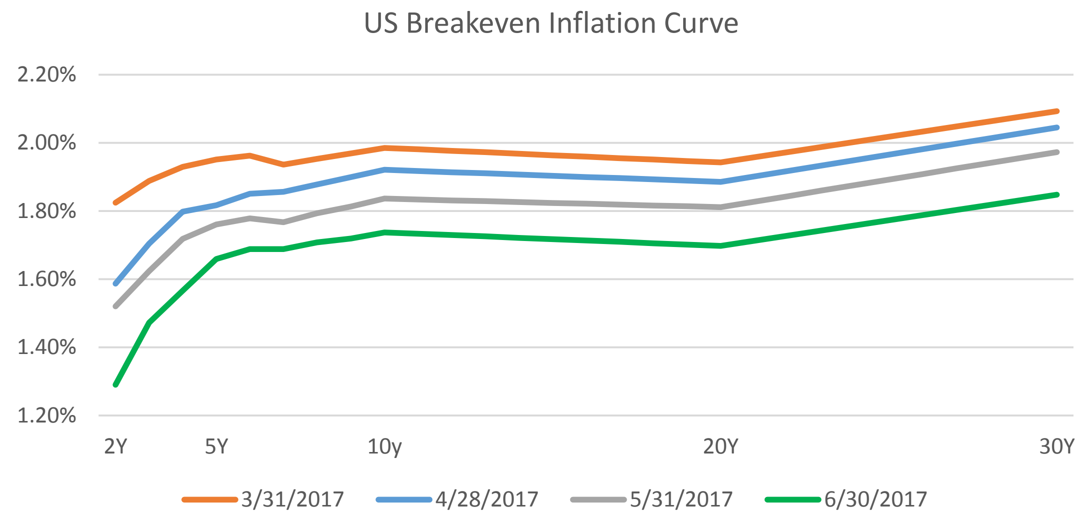
We expand our focus globally this month, where we note that breakevens also broadly declined in Q2. We also point to expansionary PMIs, led by strength in Europe, which should in turn provide some support to

www.newcenturyadvisors.com
research@ncallc.com

inflation going forward. Moreover, we make the case that inflation is itself global, as inflation prints and breakevens are highly correlated across countries. In particular, we look at EM, where we see inflation-hedging and diversification opportunities, even in disinflationary periods as we've seen in Q2.

Q2's Perfect Storm

The following chart is a pretty clear picture of the trend in TIPS breakevens during the second quarter. From about the 5yr sector on out, the downward shift has been more or less parallel across the curve, while the front end has been more heavily impacted by the selloff in energy.



Source: Bloomberg and New Century Advisors

Consider all that TIPS endured since the end of March:

- CPI fell from 2.7% YoY in February (released in March) to 1.9% in May (released in June). Core CPI fell from 2.2% YoY to 1.7%
- After wobbling in March, oil prices fell sharply in Q2, from a high >$54/bbl in early April to a low of just above $42/bbl in late June
- The Fed hiked for the 3rd time in six months in June and reiterated their expectation for at least one more hike this year. In addition, the Fed advanced their balance sheet reduction plans, with many expecting a reduction in reinvestments as early as September
- Tax and regulatory reform and an infrastructure spending package, all of which were expected to boost growth and drove assets into TIPS, have met with further delays as Congress failed to first pass a healthcare bill to replace the ACA and thus the follow on tax legislation, also expected to be a growth booster, has stalled.

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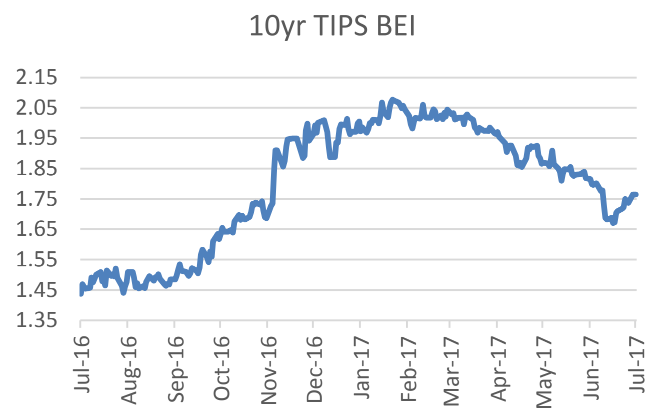
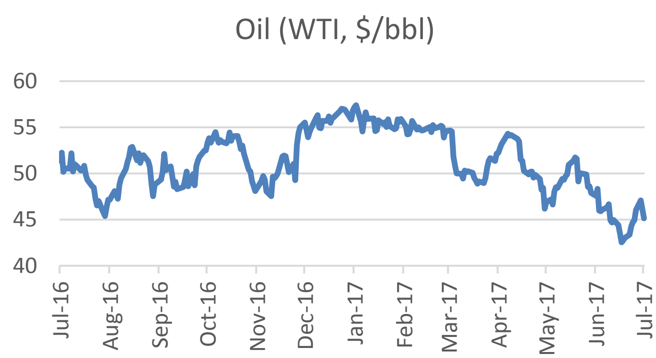
Looking at a one year chart of 10yr breakevens (right), we see that TIPS started to outperform last fall, even ahead of the U.S. presidential election. Following Trump's win BEI immediately gapped wider and then continued to outperform throughout most of Q1. But for all the factors listed above, it was a much different story in Q2. After touching a high of 2.08% in Q1, 10yr BEI ground steadily lower through Q2, eventually reaching a low of 1.67% in June, completely erasing their gains since the election.



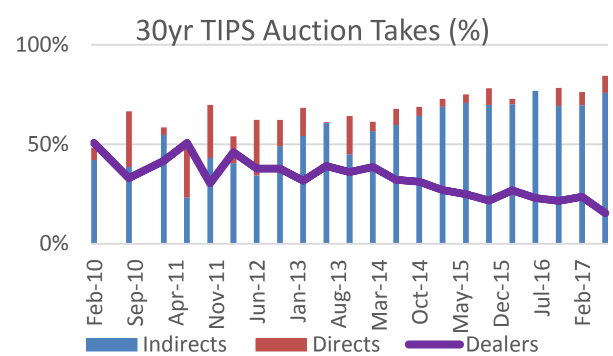
Source: NCA and Bloomberg



Source: NCA and Bloomberg

There has been a recent bounce in breakevens since their lows on June 20th. That rise has corresponded with a bounce in oil (left), also off of YTD lows. While political uncertainty is likely to remain elevated for some time and the Federal Reserve's gradual removal of policy accommodation will play out over several years, TIPS will take their cues in the near term from daily moves in the energy markets and from the monthly inflation data (next CPI release date Friday, July 14th).

Not all of the data for TIPS from the 2nd quarter were disappointing. TIPS enjoyed record-setting end-user (investor) demand for all three TIPS auctions in Q2. TIPS are auctioned once per month, typically on the 3rd Thursday, alternating between 10yr TIPS auctions every other month, with 5yr and 30yr TIPS auctions each coming every 4th month. As the chart to the right clearly shows, as measured by their 'take' (the share of the auction awarded to them), investors have been steadily accumulating TIPS in the primary market. In each of the last three auctions, end-users have set records



Source: U.S. Treasury and NCA

(Direct and Indirect bidders combined), in turn leaving record low allocations of TIPS for the dealer community to redistribute in the secondary market. The corresponding charts for 5 and 10yr TIPS auctions are included in the charts section at the end.

What does this mean? Clearly recent TIPS performance on a relative basis versus nominal bonds should temper any conclusions we draw with respect to overall demand for the asset class. However, it clearly isn't dead, either. Rather, we think a number of factors contribute to this clear trend, including:

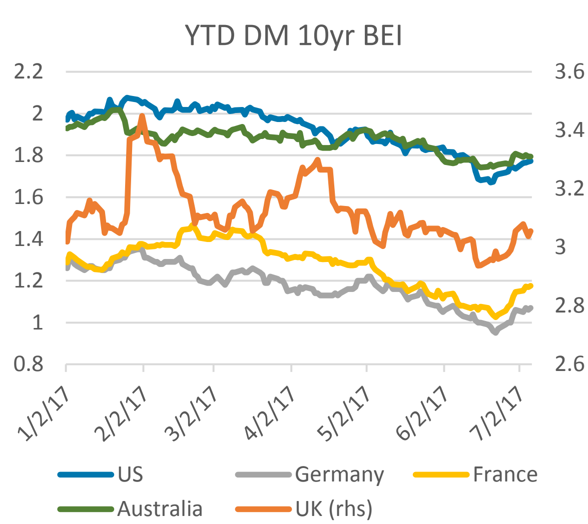
- Relative value of TIPS within global rates (vs. the UK, Germany, and Japan in particular) attracting international investors
- Limitations to secondary market liquidity that drive demand to auctions
- Declining ability for the dealer community to warehouse risk

A Global Perspective

TIPS were not alone in underperforming their nominal comparators in Q2 as global breakevens generally declined. In addition to declining oil prices, inflation markets also responded to increased hawkishness by global central banks, with the ECB, BoE, BoJ, and even more recently the BoC all moving closer to unwinding policy accommodation.

	Local Currency Return		Local BEI Return	
	Q2	YTD	Q2	YTD
Australia	0.65%	1.82%	-0.44%	-0.56%
Italy	1.48%	-1.52%	0.28%	-0.57%
Canada	1.15%	-0.17%	-0.55%	-2.80%
Spain	1.74%	0.87%	0.66%	0.27%
France	1.57%	-1.63%	0.05%	-0.98%
Denmark	-0.64%	-0.68%	-0.15%	-0.19%
Germany	-1.38%	-3.01%	-0.17%	-1.18%
Japan	-0.34%	-1.37%	-0.19%	-1.20%
New Zealand	3.14%	3.90%	1.54%	0.59%
Sweden	-0.42%	-0.73%	-0.11%	-0.08%
UK	-2.26%	-0.56%	-0.43%	-0.83%
US	-0.41%	0.95%	-1.89%	-1.39%
WGILB	-0.62%	-0.06%	-0.97%	-1.13%

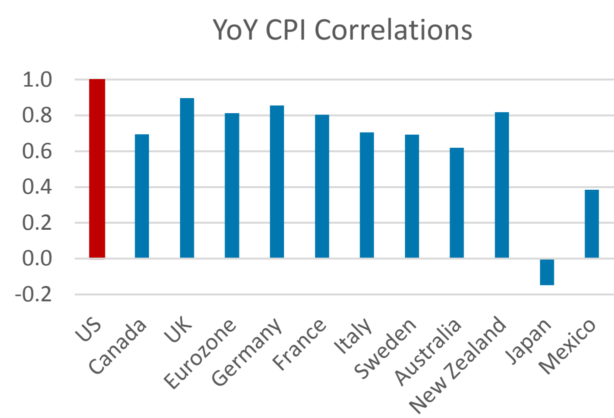
Source: Barclays and NCA



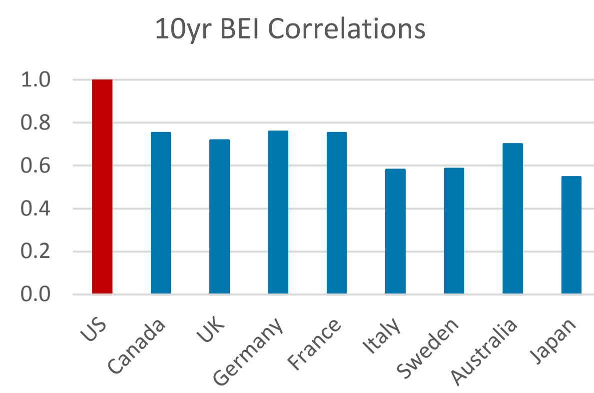
Source: Bloomberg and NCA

As a recent paper by the Economic Cycle Research Institute (ECRI) attests, due to, "the growing global interdependence among countries through expanding trade and financial linkages," international inflation cycles are increasingly synchronized (https://www.businesscycle.com/ecri-news-events/news-details/economic-cycle-research-ecri-lakshman-achuthan-international-inflation-cycles-sync-up).

Indeed, note the high level of inflation correlation across developed countries and their inflation markets, over the past decade.

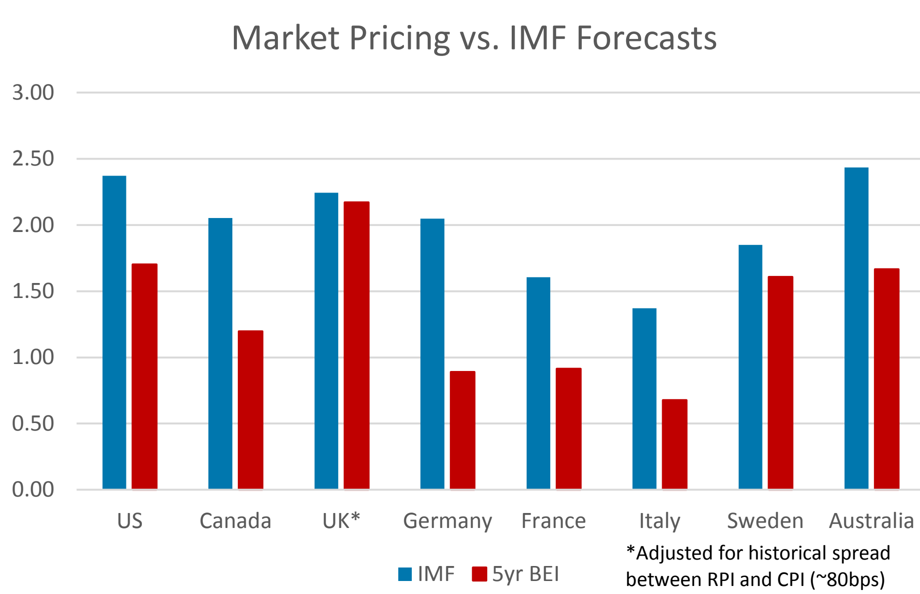


Source: Bloomberg and NCA



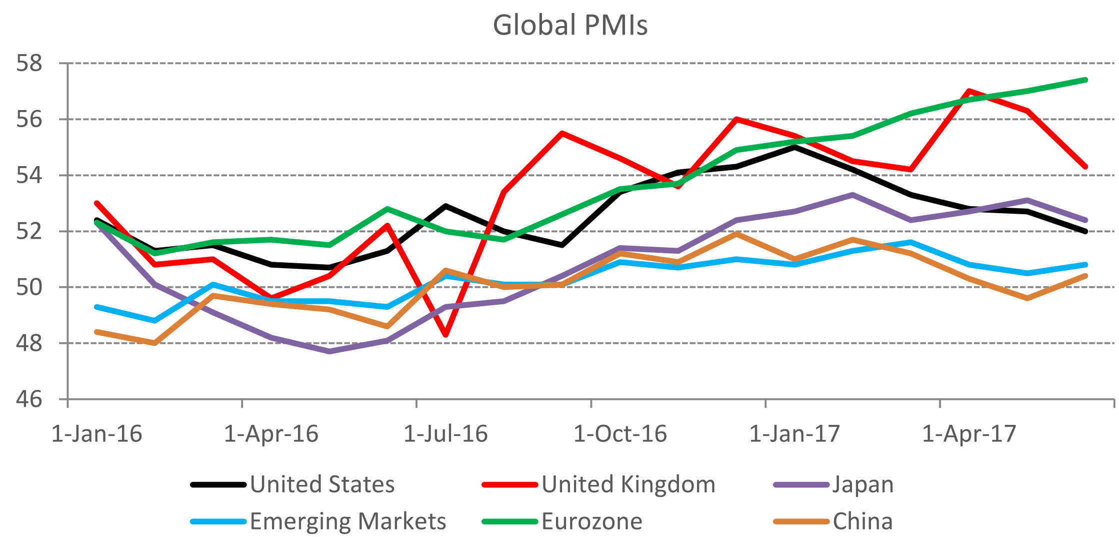
Source: Bloomberg and NCA

This correlation creates opportunities between markets. With the exception of the UK linker market, which is artificially rich relative to inflation forecasts due to forced de-risking by pensions, all breakeven markets trade cheap to inflation expectations, though in varying degrees.



Source: IMF, Bloomberg, and NCA

While markets have responded to swings in energy markets and changes in central bank communications, in the longer term they are driven by broader economic trends. Global manufacturing, as represented by PMI prints, remains robust, led by particular strength in Europe, providing some reason for the rationale that the recent spate of weaker inflation prints may not last.

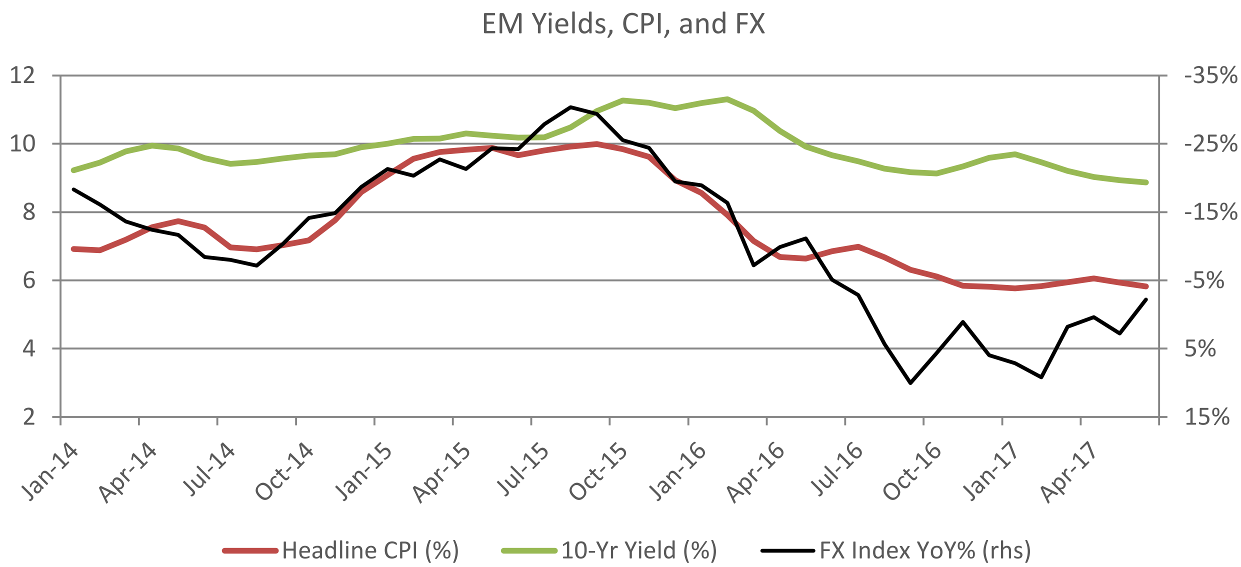


Source: Bloomberg and NCA

A Case for EM

NCA has a successful track record of tactical allocations into EM in our global inflation portfolios. In addition to a source of alpha, we believe emerging markets are a natural fit with the investment objectives of the underlying portfolios, namely diversification and a hedge against inflation. Heavily resource-dependent economies in particular can provide additional exposure to commodities.

But the outperformance of EM in Q2 points to another advantage that such an allocation brings to an inflation portfolio, namely its tendency to outperform in a *disinflationary* environment. In the chart below we've combined the 10yr local currency bond yields, domestic YoY CPI rates, and YoY change in FX rates for Brazil, Turkey, Russia, and Indonesia (inverting FX). The relationship between the three is quite evident: as local inflation rates fall, so too do bond yields, while their currencies appreciate. While this same relationship generally holds true in DM as well, the effect is more muted in a low rate environment, particularly one driven by QE.



Source: Bloomberg and NCA

In Closing

The fundamental backdrop remains positive for the TIPS asset class and for global linkers more generally, but challenges remain. Domestic fiscal policy delays and a string of disappointing inflation prints unwound the overly-optimistic post-election trade, sending the asset class to YTD breakeven lows in June. But the market once again found support, climbing off the breakeven lows in recent weeks, aided by a turnaround in energy. We continue to see opportunities overseas, particularly in EM, which have further room to outperform as global rates come under pressure from more hawkish central banks. We remain ever vigilant on flows and market positioning, keeping a close eye on various measures of investor demand.

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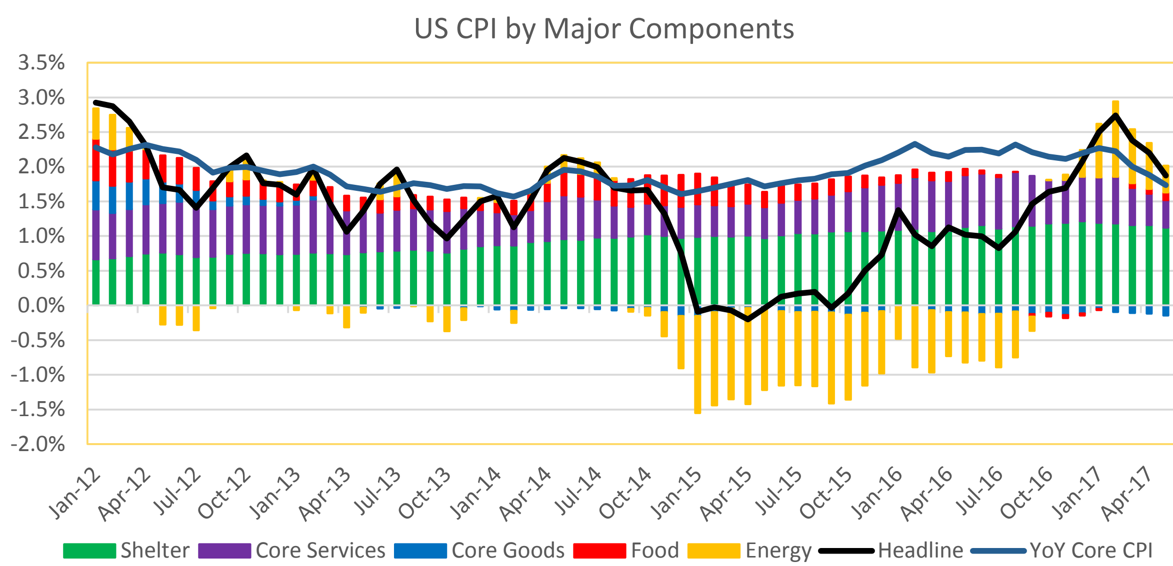
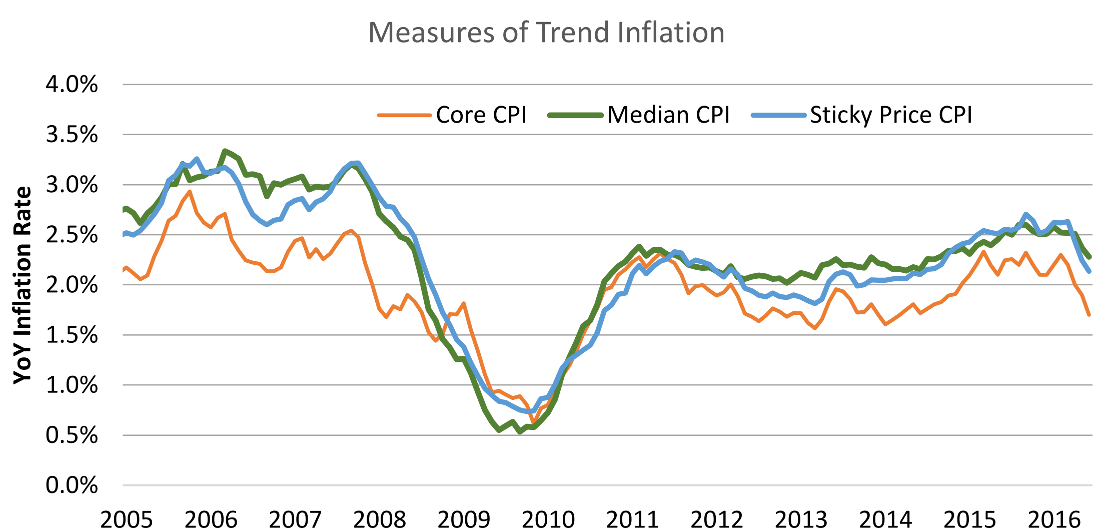
Charts

In this section we update many of the charts we follow to study trends in the inflation data as well as market positioning.

Inflation Charts



Source: BLS and NCA



Source: BLS, Cleveland Fed, and Atlanta Fed

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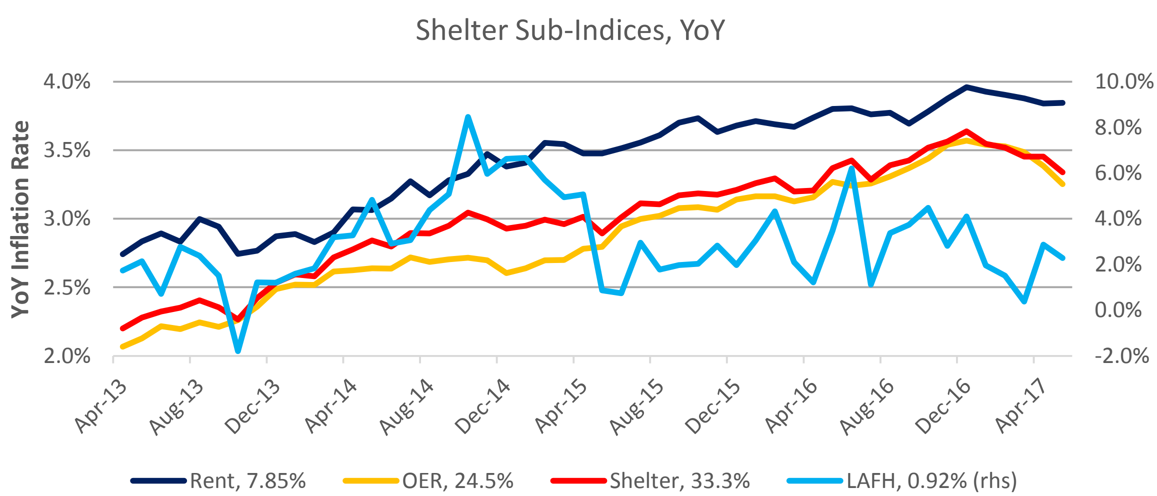
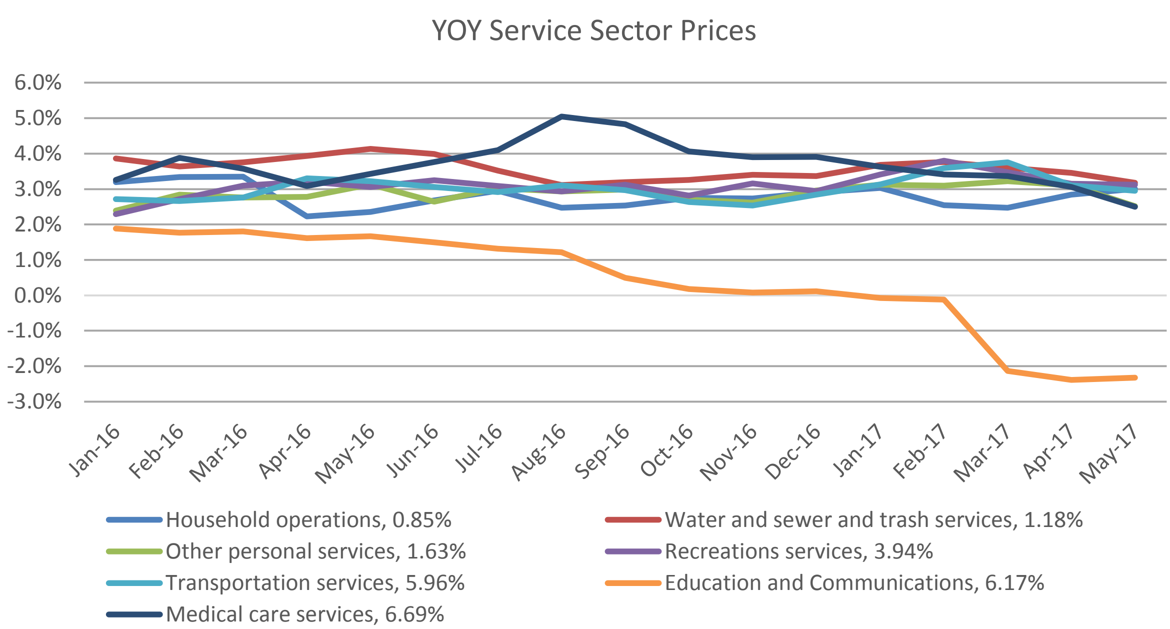
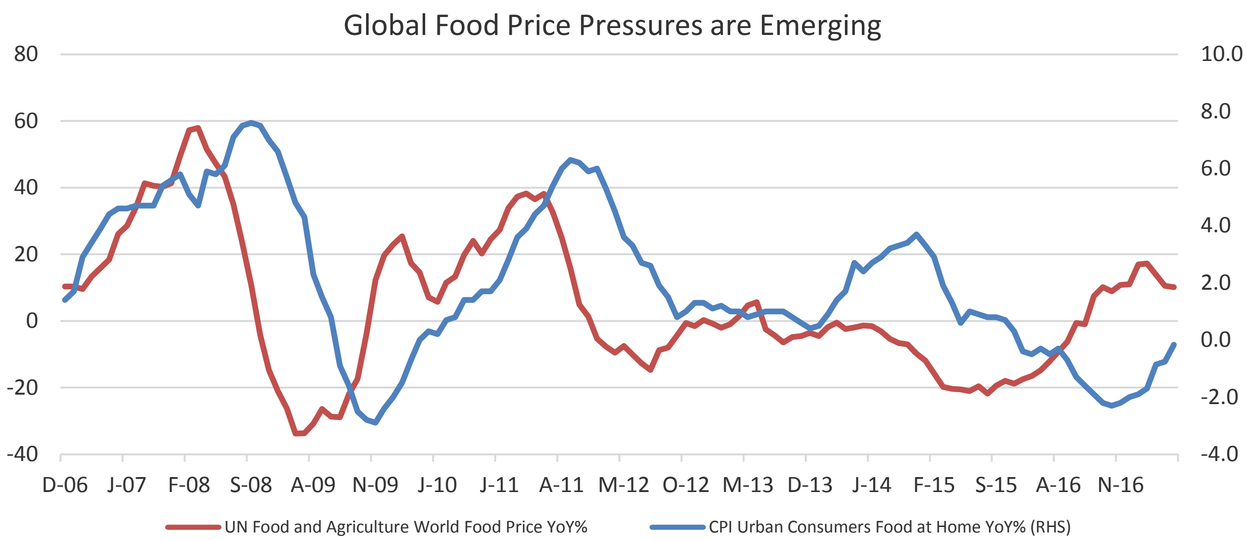


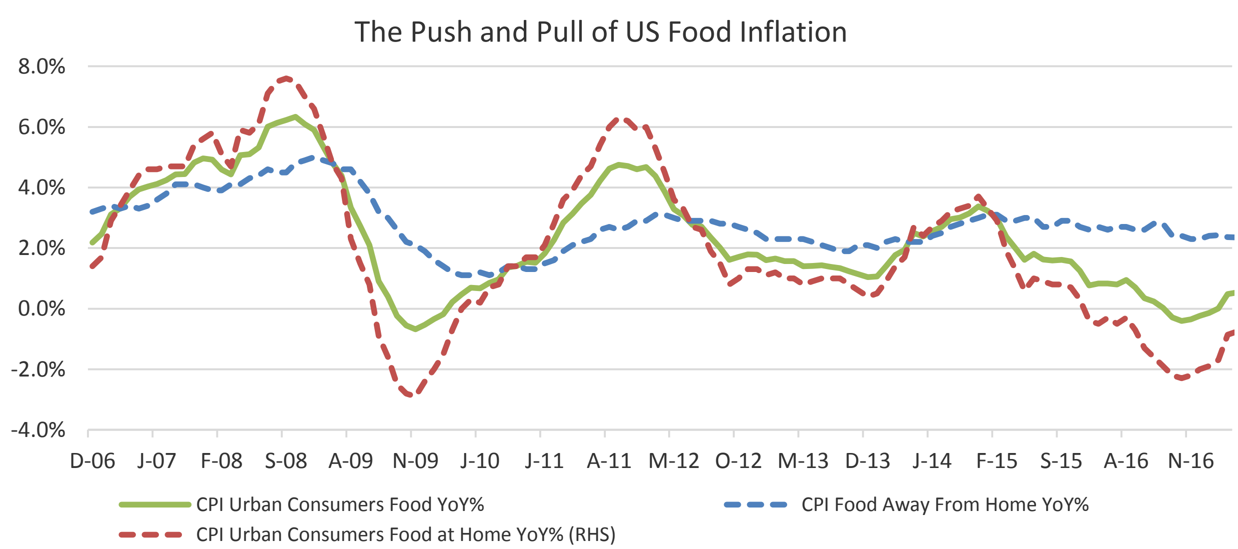
Source: BLS and NCA



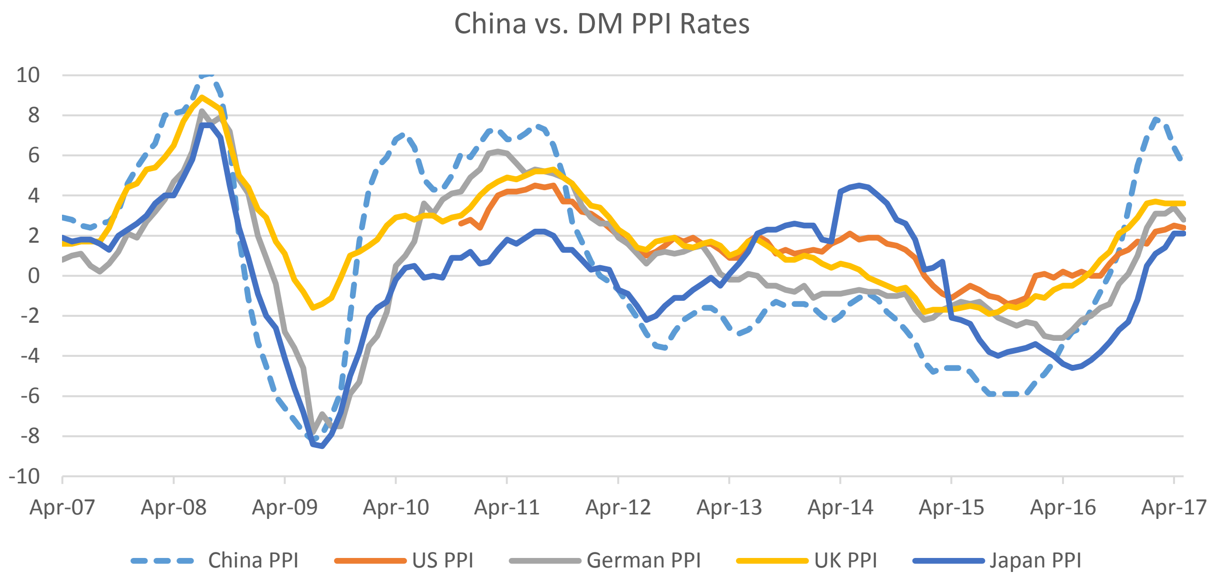
Source: BLS and NCA



Source: BLS, FAO, and NCA

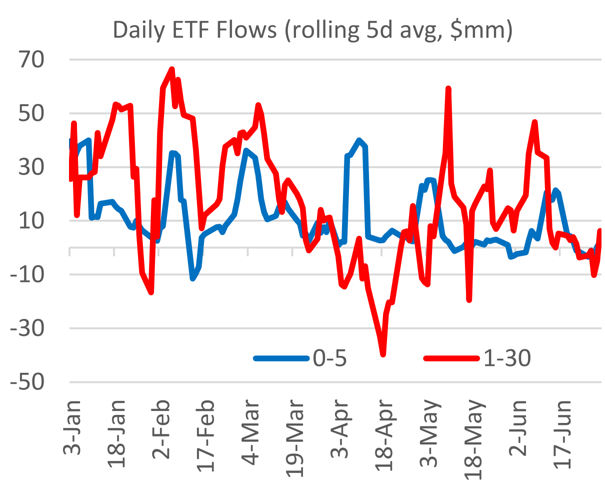


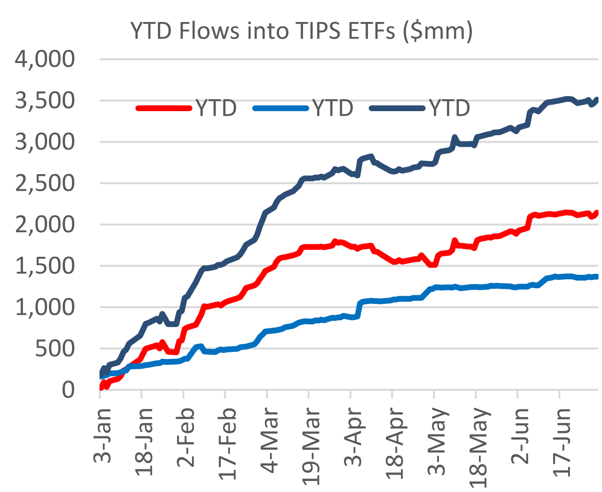
Source: BLS, FAO, and NCA



Source: Bloomberg and NCA

Flow and Positioning Charts





Source: Bloomberg and NCA

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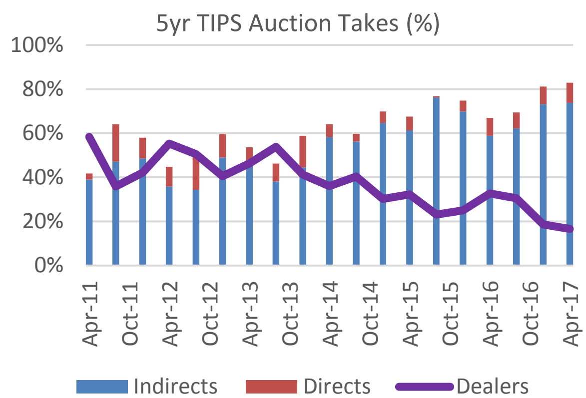
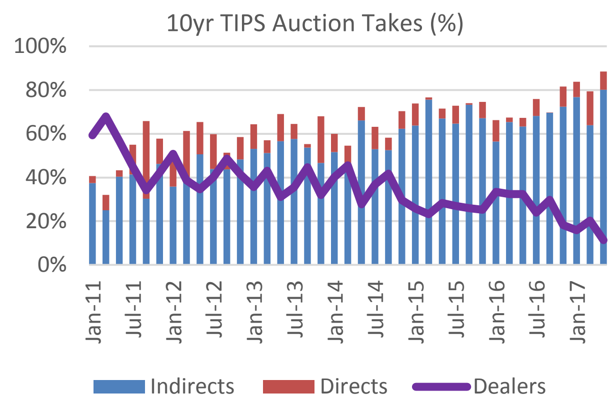
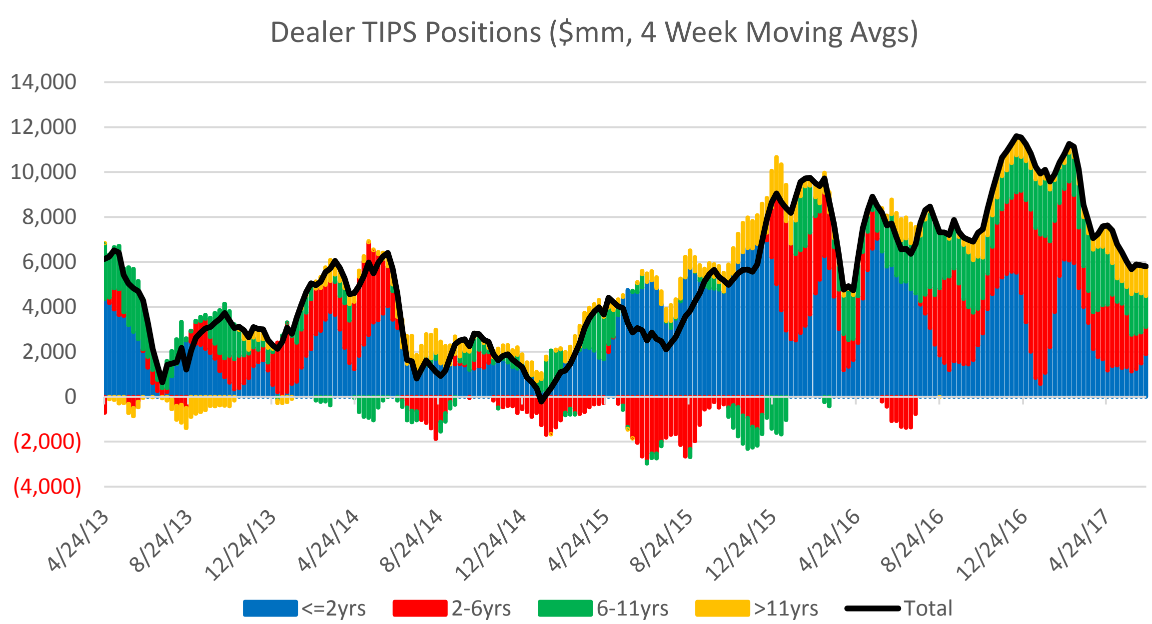




Source: U.S.Treasury and NCA



Source: NY Federal Reserve and NCA

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For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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