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"The Old Normal"

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There are many things about the "new normal" that investors believe they can profit from if and when things return to the "old normal." Within fixed-income markets, several distortions remain from the market dislocations which occurred during the financial crisis. The adjustment of these rate sectors within the fixed-income markets to rapid change from regulation, unconventional monetary policy and market adjustment is extraordinary. However, returning to "normal" may prove illusory. President Trump may turn back regulation but he is less likely to promote a banking system as highly levered as the one that existed in the period leading up to the financial crisis. The Fed may "normalize" interest rates but from a lower level and without a substantial decrease in its balance sheet. Finally, the market adjustment that has concentrated capital in the hands of the investor client at the expense of Wall Street brokers will not be reversed. Perhaps the "old normal" may not have been "normal" after all.

Interest rates movements are thought to be mean reverting and should move higher over the next several years. However, powerful headwinds from technology and demographics suggest otherwise. The consensus that is positioned to benefit from higher-interest rates may be sorely disappointed, consistent with the pattern of the last several years. Slow growth and moderate inflation are byproducts of a heavily indebted system and supportive of low-interest rates, but savers and investors demand sources of reliable high-quality income. The strong demand will continue to support the scarcity of a reliable source of income. Resultantly, the reach for yield will continue.

The strength of the U.S. dollar will continue to attract capital to the United States until it doesn't. It is very unusual for foreign investors to receive premiums at current levels from investing in U.S. stocks and bonds. Interest rate differentials strongly favor allocating capital from Europe and Asia to the States. So far, U.S. equity returns have been supportive, in that they continue to outperform. A reversal of the dollar's fortune most likely will coincide with the next recession which may be closer in time than is commonly held. The dollar is a very crowded trade.

Distortions due to money market reform have made the acquisition of offshore dollars very expensive. Prior to the reforms that were implemented last October, foreign banks and corporations could source U.S. dollars through the issuance of CD's

and commercial paper. Over $1 trillion of assets in institutional money market funds were transferred to government funds from credit funds as a result of the regulatory change. Domestic banks would normally capitalize on the opportunity to supply dollars to foreigners, but they have been capital constrained by Dodd-Frank. This has produced an opportunity to profit from currency hedging which is contradictory to the theory of covered interest arbitrage. This distortion while unlikely to persist, will magnify the impact of any attempt by the Federal Reserve to "normalize" interest rates. The terminal interest rate for this economic cycle may be less than 3%, far below previous cycles.

Another anomaly appears to be swap spreads. Swap spreads historically traded at a positive yield spread to similar maturity Treasury collateral. Swaps spreads were viewed as a bank funding rate, subject to the credit risk of the counterparty. Treasury bonds were deemed risk-free. Since the financial crisis, swap spreads have consistently traded a spread through Treasury collateral or at a negative spread. As a result, swap spreads appear to offer investors wanting to hedge rising rates a better alternative to Treasury bonds.

However, during the "new normal," changes to the regulatory environment might have permanently impacted the way in which we look at swaps. Bank balance sheets have been restricted under the regulatory framework of Dodd-Frank and Basel III. Pension funds and insurance companies are struggling to meet liabilities given the low-interest rate environment. Hedge funds and other speculators are less able to acquire funding through the repo markets.

In an era of exchange clearing, collateral posting and netting, the credit risk associated with swaps may be limited to finding another counterparty to replace the swap if a counterparty fails. Meanwhile, investors in Treasury securities have more capital at risk due to the principal payment due at maturity. There is no terminal principal payment due on swaps, just an exchange of a series of cash flows periodically when the contract is in force. Swaps may represent the most efficient means by which counterparties can exchange duration risk.

Of late, the demand side for swaps has been explosive. Pension funds find using swap spreads an attractive way to increase duration as lower rates force their liabilities to extend. They are willing to "pay," that is earn less, to acquire the duration using swaps because they can employ leverage. The initial and maintenance margin associated with swaps uses less capital than investing in Treasury securities. The traditional arbitrage in which the banks and dealer community would take the other side of the trade is now constrained by capital requirements. The repo market in which the leverage could have traditionally been offset is not as deep as it once was.

On the supply side, there has been consistent selling pressure on Treasury securities by global central banks, in particular, China. There is also some concern that the Federal Reserve is considering altering its balance sheet reinvestment policy. Banks and dealers, hence, must use swaps to hedge the interest rate risk of holding inventory. Historically, a deeper repo market provided an efficient hedge. Today, swaps become one of the better hedging vehicles.

At first blush, it would appear that there are some interesting opportunities within the fixed-income market for "low risk" trades betting on higher rates, a higher dollar, a return to interest coverage equilibrium and a positive spread between swaps

and Treasury bonds. However, the concept of "normal" has shifted. It may not be mean reverting in all cases.

A return to the "old normal" will be anything but smooth, or sure. A higher-quality banking system with greater capital efficiency is certainly a plus. Yet, aggregate debt levels against a backdrop of slow growth and moderate inflation will be a significant impediment. Expect more volatility before any attempt to return to historical relationship. The financial crisis was not the end of the world, just the end of the world as we knew it.

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