

Global Fixed Income Investment-Grade

Quarterly Commentary

THE DOLLAR, CHINA, AND OSTRICHES

For most of 2015, the strategy was positioned in anticipation of reflationary economic policy reviving the global economy. A lot of policy stimulus was put in place during the course of the year as we had predicted. But a revival in the global economy never happened. China's downturn continued, manufacturing went into recession around the world, and global weakness showed signs of leaking into the U.S. economy.

Is the dollar and its many attendant variables all one big trade? The dollar goes up, commodities decline, emerging markets currencies lose value, and this negative feedback cycle leads to lower global growth. The interplay of the strong dollar has created a lot of anxiety surrounding the data points related to global growth. We cannot remember being in an environment when the difference between real and nominal growth numbers has been this wide. Last month, for example, the statistics on retail sales were released and sales at the pump were down 19.6% year-over-year. Yet volumes were up approximately 3.5%. Is the economy expanding or contracting? Are we better or worse off? In our opinion, global growth is better than the statistics. However, the impact is having a dramatic effect on corporate profitability and tax collections in emerging markets. There is no question that global gross domestic product (GDP) has weakened, but the decline in nominal terms is much greater.

World GDP is estimated by the International Monetary Fund (IMF) to have declined last year by \$3.8 trillion in nominal dollar terms, or -4.9%. There has not been a contraction that large in 35 years except during the Great Recession. Yet at the same time, *real* global GDP growth in local-currency terms was running close to 3%. The difference in the perception of economic performance based on the two GDP measurements—nominal dollars versus volume—is an important part of last year's story as well as the story for the year ahead. Deflationary forces and a strong dollar have been at the center of that split personality, with commodity prices in a persistent bear market. If commodity prices stay flat until 2018, their 10-year rolling annualized return will reach the lows seen in 1933, during the depths of the Great Depression.

We have been more constructive on the global outlook than the actual out turn for three reasons:

First, the collapse in the commodity complex and the energy market is enormously stimulative and equivalent to a \$2 trillion tax cut. The time lag between the price decline and a stronger economic growth play out is long, at 12-18 months. We have been in the sweet spot since the fall and expect this important variable to stimulate growth.

Secondly, global GDP-weighted short-term interest rates have been falling all year. Falling interest rates eventually open a window to foster growth, a point in time that arrived late last year.

Lastly, many economies in the world have enjoyed substantial currency devaluations relative to the U.S. and China. The currency declines effectively redistributed growth away from the U.S. toward the global community. So why has the world economy disappointed with these tailwinds? What are prospects like for 2016 given these factors? And what are the implications for the strategy?

There are two main culprits behind last year's dismal growth story. The first is the nature of China's economic slowdown. The second is dollar strength. The attitude of policymakers is related to both. Markets are concerned that the policy stance in both economies increases the chances of a global recession. Authorities in the two countries disagree and at the moment, are acting like ostriches with their heads stuck in the sand. Ultimately we think that policy will shift in a more growth friendly direction, but it may take a catalyst to make policymakers move.

CHINA: TRANSFORMATION OR BUST

In our last letter, we described what was happening to China as the third in a series of deflationary waves that has followed the collapse of the U.S. debt super cycle in 2008. The Chinese economy has been slowing ever

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since its policymakers began to unwind the countermeasures put in place to neutralize the initial shock waves from the 2008 crisis. The policy goal has been to muzzle credit growth—which for an economy with a 50% savings rate—is akin to strangling it. Capital spending was expanding at a rate of 35% as recently as 2012, fell to 14% at the end of 2014, and 10% by the end of 2015. Producer prices have fallen for 46 straight months and nominal GDP growth has dropped below 6%, lower than in 2008, and the lowest since the Asian financial crisis in the late 1990s.

China's strong man President Xi has been extremely successful in battling corruption and implementing major reform projects like reorganizing the country's defense forces. More recently, he has waded into economic affairs, confident that he can deliver supply-side reform which includes: reducing industrial capacity, shuttering zombie state-owned corporations, forcing companies to go green, and tax cuts. This is all great for the long run, if implemented. What is worrisome is that supply-side reform is extremely painful and highly deflationary in the short term, but capacity/supply reductions will have a salutary effect on commodity prices as the disequilibrium is reduced. This is why the government has warned Chinese citizens of the short-term pain and sacrifice for long-term social stability. The government has announced hundreds of initiatives to counter the fallout from the industrial restructuring with fiscal stimulus, but it is on a scale far smaller than what was deployed in 2008. The initiatives have been so widespread that the Chinese authorities' handling of the economy and financial markets has been clumsy at times, but the goal for stabilization remains in place.

- The government has taken a kind of successive approximation approach to fiscal support for the economy, unleashing fresh government spending on infrastructure, a little at a time. So far we estimate fiscal thrust to be about 2-3% of GDP, well short of the nearly 10% fiscal bazooka applied in 2008, although the economy has slowed to levels not far from the lows seen during the Global Financial Crisis. The authorities say they don't want to spend more because that is what got them in trouble in the first place.
- What would boost confidence in the growth outlook is if there was a clear plan to close zombie companies and recapitalize the banking system. For example, the combination of a U.S.-style Troubled Asset Relief Program (TARP) program combined with large government debt issuance to finance the recapitalization would help foster a sense that credit was no longer an albatross hanging over the economy. However, there has been no sign that this is coming. Instead, lending from financial institutions continues to grow well in excess of nominal GDP growth, hinting that state-owned banks are still papering over the losses of state-owned companies with more bad debt.
- Perhaps what has been most problematic for China's growth is the activity of the People's Bank of China (PBoC). The natural tendency for the renminbi is to decline if the government is going to encourage consolidation in the manufacturing sector without sufficient fiscal offsets. However, the PBoC has been intervening for over a year to support the currency in the face of private capital outflows. This is tantamount to a tightening in monetary policy. As a result, the central bank's balance sheet is contracting despite cuts to interest rates and reserve requirements. Chinese monetary policy has actually become more restrictive.

There are signs that the pace of the slump is slowing and growth might be starting to stabilize. However, even if this were to be the case, we doubt that growth is faster than China's underlying potential growth rate. So it is no coincidence that risk-off periods over the last 6-9 months have coincided with days of weakness in the renminbi. Without domestic reflationary action to support the Chinese economy, weakness in the Chinese currency boils down to a beggar-thy-neighbor export of its deflationary pressures, which is deflationary for the rest of the world.

DOLLAR DEFLATION

Market indicators suggest that investors are worried about external economic weakness leaking into the U.S. economy via a strong dollar, not to mention the impact of dollar strength on emerging economies. The Federal Reserve (Fed) is less concerned, which is the reason for the disconnect between the slope of the money market curve and the Fed's "dot plot."

There has been little profit growth for U.S. non-financial companies since the dollar started its big rally in 2014—monetary base growth has slumped, many of the Fed's own liquidity indicators are eroding, and the manufacturing sector is in recession. Manufacturing is only a fraction of the economy these days but its cycle is highly correlated with the overall economic cycle. The U.S. economy went into recession in 11 out of the last 13 times that the Institute of Supply Management (ISM) manufacturing index dropped below 45. The index is still not there but has been heading in that direction. Correspondingly, the yield curve has flattened, corporate credit spreads have widened, and commodity prices are falling. These are not the normal signs associated with the preconditions for tighter domestic monetary policy. Our view has been that in a zero-bound world, currency fluctuations take on a more significant monetary role. The dollar's surge since July 2014 is worth 100 basis points of tightening by the Fed by some estimates.

The Fed is focused instead on employment and wage gains, and expects that gains in real incomes from falling energy prices will offset any negative forces on profits from the dollar and external weakness. So far that has been true, at least based on the behavior of the U.S. bond market. The 30-year Treasury has hovered near 3% since mid-2015, suggesting that lower energy prices and the boost to real incomes have compensated for the hit to profitability associated with strength in the broad dollar index.

But employment is a lagging indicator and it is dangerous for the Fed to be making policy based on what has already happened in the past. If profitability remains weak, companies will soon begin to taper hiring plans. The Fed argues that rising wage inflation is the first step toward achieving its medium-term inflation target of 2% for the core personal consumption deflator.

EUROPE AND JAPAN: GLOBAL STRONGMEN?

It is ironic that Europe would be considered one of the strongest areas of economic growth in the world today—that says a lot about the state of the world economy. German bond yields are negative on the front part of the curve although some of this could be linked to the European Central Bank's (ECB's) purchase of government debt. Similarly, the Japanese economy in real terms is growing at a 1.6% annualized rate. Nominal GDP growth has risen to its highest level in decades, yet 10-year Japanese Government Bonds (JGBs) are trading at 0.2%.

The significance of these factors on the global outlook is that the world remains very deflationary, demand is scarce, and supply is overly abundant. Undue currency strength penalizes an economy—the effects of which we are seeing in both the U.S. and China.

SOMETHING HAS TO GIVE

The path forward will be determined largely by the policy response from the Chinese and American authorities, as well as by the trend in the U.S. dollar. We believe there is a good chance that by the end of 2016 we will see something that we have not witnessed since before the Great Recession, which is a synchronized global expansion, albeit at a slow pace. As hopeful as this may sound, getting there is going to be a challenge. Policymakers in both countries are very rational, but at the moment, neither looks too willing to react to market concerns about the risk of recession.

The PBoC is resisting currency weakness at the risk of further central bank balance sheet contraction, weaker domestic economic growth, and continued deflation. Intervention by itself is fruitless and counterproductive.

The Federal Open Market Committee's (FOMC's) median expectation that rates rise 3-4 times this year may be born more out of frustration than the economic data. As 2015 wound down, high-frequency estimates of GDP growth signaled a significant slowdown. So far, the Fed's rhetoric on the prospect of higher policy interest rates has ratcheted higher. It is possible Fed officials feel they are already behind the inflationary curve in view of reports of upward pressure on wage inflation, and may be irritated that they have not raised rates sooner due to their caution following the 2013 Taper Tantrum and last September's drop in risk assets.

Something has to give or the world could be pushed into a global recession. Many emerging economies are already at the breaking point with dollar strength weighing heavily on the trillions in dollar debt accumulated since 2009 by their non-financial corporate sectors. The collapse of commodity prices has broken the economic models for many large emerging economies and dollar strength is pushing them toward a debt crisis.

While a significant U.S. dollar rally could pull the global economy into recession, we can point to three possible developments—one or more of which we believe could come to fruition and spur growth—and potentially reverse the downward trend in global growth:

1. The Fed could retreat from its "dot plots," motivated by weaker economic data, lower stock prices, or a receding picture on core inflation.
2. Similarly, China's leaders might accelerate remedial fiscal support for the economy if they begin to worry more about downside risks in the system.
3. It is possible that the dollar could begin an autonomous retreat which would bring enormous relief to developing economies and risk assets in general. The dollar has already topped out against the major currencies in 2015, with the yen and euro putting in lows during the first half of 2015. We think the driver for this has been the softening trend in U.S. economic growth relative to trends in Japan and Europe. However, the broad dollar index has moved up all year. It is very unusual for the broad dollar index and the trend in the dollar against the majors to diverge for very long.

PERFORMANCE AND POSITIONING

During the fourth quarter of 2015, the Global Fixed Income strategy composite returned -1.07% (net -1.18%), outperforming the Citigroup World Government Bond Index return of -1.23%. The main reason for the relative outperformance was the sharp drop in the euro during the course of the quarter as ECB President Draghi promised to expand quantitative easing operations if inflation did not pick up sooner. The biggest positive sources of attribution came from avoiding U.K. Gilts and the pound sterling, and exposure to the Australian dollar which rallied during the quarter. The biggest relative detractor came from the bond market, and was due mainly to South African bonds weakening, although the weakening rand also detracted from relative performance. In addition, an underweight in Japan resulted in missing out on some positive performance in JGBs.

Capital markets are very forward thinking and much of the macro story outlined earlier is already deeply discounted in global currencies and bond markets. Our various currency and bond metrics signal stretched valuations, particularly in Latin American bond and currency markets, Eastern European bond and currency markets, and select Asian markets such as India and Indonesia. Valuation only identifies the opportunity or risk; we are waiting for the catalyst to ignite the mean reversion process that we believe will lead to the capture of total return.

Earlier in our discussion we suggested that "something has to give" to alter the stance of policymakers in China and the U.S., or trigger an autonomous drop in the broad dollar index. That "something" is likely the catalyst for the total return opportunities the strategy is positioned for. Pending that catalyst, there is the chance of further short-term disappointment.

Three months ago, we wrote that we felt the fourth quarter was an inflection point in the economic and investment outlook—that has turned out to be the case in a number of ways. The Chinese, for example, have officially abandoned the peg to the U.S. dollar after 10 years and are now targeting a basket of currencies. They did this in order to avoid the possibility that the currency would be dragged higher by a stronger dollar. The dollar bull market also became more discriminating in

the final quarter of the year with the yen looking like it had put in a bottom, and the euro unable to make new lows despite intense rhetoric from ECB President Draghi. Three months ago we felt that a much stronger dollar was counterproductive to the global economy. We continue to believe that and it is reflected in the strategy's positioning.

The consensus view on the currency outlook is that policy divergence is the main driver. However, our view is that capital is attracted to economic growth. Dollar strength surged in mid-2014 at a time when the U.S. economy was having a bounce and the rest of the world was very weak. Economic surprise indices completely flipped in 2015, with the U.S. growing much slower than expected and Europe surprising on the upside. In other words, the redistributive influence of the dollar surge supported European and Japanese economic growth at the expense of U.S. economic growth. Nominal GDP growth among the three economies has probably converged. Correspondingly, the dollar has topped out against these currencies and we began to reduce our dollar overweights against the majors during the year by purchasing the yen, Swedish krona, Norwegian krone, as well as the Polish zloty and Hungarian forint.

However, the dollar has continued to rally against many emerging market currencies held in the strategy because economic growth conditions in several of these economies have yet to stabilize. At the margin, however, there are signs of improvement—even in the worst cases. What is apparent is that balance of payments conditions are stabilizing in favor of the emerging world. Across many currencies, foreign direct investment inflows exceed shrinking current account deficits. A positive basic balance is very constructive in the long haul.

Brazil has been one of the hardest hit of all the emerging economies due to a combination of chronically sticky levels of inflation, a terms of trade tied to energy and commodity prices, and a nightmare for macro-economic governance. However, even in Brazil, there are signs that the extremes in bond and currency prices are beginning to affect the economic outlook. Foreign direct investment exceeds the current account deficit, implying that there is no longer any fundamental balance-of-payments pressure on the currency. Moreover, the current account is shrinking due to the intense domestic recession along with more competitive exports. Lastly, there are signs that service sector inflation is rolling over, a development which could signal a significant cooling in headline inflation once the currency stops weakening. The only real negative in Brazil relates to the political uncertainty surrounding the possible impeachment of President Rousseff, but even that development could be a long-term plus. Holding public officials accountable is always a positive step in the direction of better governance.

The strategy continues to hold a significant level of duration in the form of unhedged, local currency Mexican Bonos. The value opportunity is in the currency, where our metrics signal that the peso is trading 2.5 standard deviations away from long-term sustainable measures of the currency. The peso has been dragged lower as a proxy hedge against the prospect of emerging market currency weakness against the dollar. Unlike some of its Latin American peers, inflation remains well contained and the economy is doing much better as well. However, pending a shift in the policy stance of both the U.S. and China, there is a chance that the peso could still experience additional weakness. Unfortunately, it is the character of financial markets that the final leg in a trend is often the most volatile, and is often part of the process for a catalyst to kick start the mean reversion process. At the start of 2016, the peso broke below the range that had contained the currency since last July, signaling the start of what should be the final chapter of its decline.

The biggest risk in the outlook is that the U.S. dollar continues to strengthen and reinforce a negative feedback cycle for global growth, along with the possibility that the Chinese central bank unilaterally devalues its currency by 15%. Both outcomes are highly deflationary and counterproductive for a global reflation story to regain its footing.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	CWGBI	BGA
QTD	- 1.04	- 1.15	- 1.23	- 0.92
YTD	- 7.38	- 7.80	- 3.57	- 3.15
1 Year	- 7.38	- 7.80	- 3.57	- 3.15
3 Year	- 1.89	- 2.40	- 2.70	- 1.74
5 Year	2.80	2.26	- 0.08	0.90
7 Year	6.24	5.67	1.03	2.40
10 Year	5.65	5.08	3.44	3.74
Since Inception	8.56	7.97	5.10	5.23

Inception Date: 7/1/1992

GIPS INFORMATION (% , Unless Otherwise Noted) (Results shown in USD)

	Gross	Net	CWGBI	BGA	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	CWGBI Rolling 3Y SD	BGA Rolling 3Y SD
2015	- 7.38	- 7.80	- 3.57	- 3.15	14	1,876	68,819	0.31	5.25	4.39	3.90
2014	5.58	5.00	- 0.48	0.58	15	2,046	63,375	0.42	5.77	4.28	3.93
2013	- 3.43	- 3.96	- 4.00	- 2.60	16	1,871	50,050	0.26	6.08	4.60	4.36
2012	12.98	12.37	1.65	4.32	18	2,195	42,894	0.50	5.84	5.52	4.90
2011	7.61	7.02	6.35	5.64	16	1,783	33,122	0.29	7.88	7.57	6.53
2010	12.90	12.29	5.17	5.55	17	1,588	31,996	0.78	10.08	9.26	7.96
2009	17.85	17.22	2.55	6.94	19	1,925	29,199	1.59	9.78	8.83	7.53
2008	- 2.60	- 3.13	10.89	4.79	28	3,484	32,755	1.56	7.86	7.39	6.38
2007	10.32	9.73	10.95	9.48	37	8,869	49,208	0.62	4.57	5.48	4.40
2006	5.55	4.97	6.12	6.64	40	7,347	39,241	0.67	4.67	5.86	4.78
2005	- 2.83	- 3.36	- 6.87	- 4.48	36	4,876	26,332	0.14	6.24	7.24	5.99

CWGBI = Citigroup World Government Bond Index (Unhedged) BGA = Barclays Global Aggregate Bond Index

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Composite dispersion is calculated using the asset-weighted standard deviation method for all portfolios that were in the Composite for the entire year. Composite dispersion is not presented for periods with five or fewer portfolios. The number of accounts and market values are as of the end of the period. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. Past performance is no guarantee of future results. A complete list describing the Firm's composites as well as any additional information regarding the Firm's policies for calculating and reporting performance results is available upon request. Fee Schedule: Institutional Client Separate Account Management Fee Schedule (minimum initial investment: \$50 million): 0.450% on the first \$50 million; 0.400% on the next \$50 million, and 0.350% on any portion of assets in excess of \$100 million. Institutional Client Commingled Account Management Group Trust Fee Schedule (minimum initial investment: \$1 million): 0.550% flat fee on all assets. Institutional Client Commingled Account Management Global Investment Trust Fee Schedule (minimum initial investment: \$1 million): 0.450% on the first \$50 million; 0.400% on the next \$50 million, and 0.350% on any portion of the assets in excess of \$100 million. Additional information on the Firm's fee schedule can be found in Form ADV Part 2A which is available upon request.

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