Global Opportunistic Absolute Return

Quarterly Commentary

THE THIRD WAVE

The third quarter ended with investors swimming in pessimism on the global economy, commodity prices, and emerging markets—not to mention the plight of Middle Eastern refugees, Russian military intervention in Syria, and Volkswagen cheating on emission control tests. The quarter brought a lot of concerning news for investors. Much of the worry surrounded what seems to be a global manufacturing recession, which originated in China but now appears to be engulfing developed countries. Global nominal gross domestic product (GDP) growth has already slipped to a level that many would have considered recessionary in the past, while leading indicators suggest slowing may continue. And for all intents and purposes, inflation is nowhere to be seen in the developed economies.

All of this global uncertainty provoked the Federal Reserve (Fed) to back down from an expected rate hike in September. The U.S. economy is slowing with the health of the expansion in question given weak profit growth, declining profit margins (based on national income accounts pre-tax corporate profits), and September's soft employment report. Is this soft patch a mid-cycle correction or the beginning of full-blown recession, which tends to occur every seven or eight years?

We don't see either interpretation as correct. Instead, current developments more likely represent the third in a series of disinflationary/deflationary waves echoing from the Lehman crisis of September 2008. Prior to 2008 the global economy was anchored by the synergy between American consumption and Chinese production. America was the low-savings global spender of last resort, supported by a 30-year cycle of ever rising debt and leverage. Over that same time period, China emerged as the workshop for the world with a savings surplus to provide vendor finance. That relationship ultimately ended with the collapse of the U.S. super-cycle of private-sector debt in 2008.

The U.S. housing bust of 2007-2008 represented the first wave of deflation, which torpedoed American consumption. The impact on U.S. household spending blew a gaping hole in global demand. Faced with crippling excess capacity and a loss of consumption, the world was poised to sink into a deflationary depression. In response the G20 mounted the largest, most coordinated reflation policy in modern history. No initiative was greater than that from China. Chinese policymakers committed a four-trillion-renminbi stimulus package to shore up spending, in the process helping the globe fill a massive hole in demand created by the loss of American spending power. Ultimately, America emerged from this wave of deflation through a continuous process of monetary reflation that bought time more than anything else.

The second wave of deflation hit in 2011-2012 when the Europeans misread the G20-propelled bounce back in global activity as a return to normalcy. The European Central Bank (ECB) raised policy rates in 2011 and Europe's retched political apparatus commenced a witch hunt aimed at imposing austerity on its peripheral fiscal miscreants. European domestic demand fell sharply and its current account moved deeper into surplus. Stabilization arrived only after newly appointed ECB president Mario Draghi committed the full fire power of the central bank to buying peripheral debt. The compression in sovereign spreads amounted to financial stimulus and was the beginning of reflation.

China's economic slowdown is the third and possibly final wave. The world's factory has been adjusting to the loss of global spending power associated with American deleveraging and European austerity. This "adjustment" has been underway for some time. China's policymakers actually started to retreat from the massive fiscal reflation as early as 2010. But cutting investment and shrinking excess manufacturing capacity has become a policy priority ever since the new administration under President Xi Jinping and Premier Li Keqiang took the reins of power. Capital spending was expanding at an annual rate of nearly 25% at the end of 2013. The latest data show growth closer to 7%. The game plan was to reform other sectors of the economy to make up the slack. Consumption has risen as a share of GDP in recent years but the slide in manufacturing to this point has more than offset the improvement here and in services.

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Slumping economic growth in China together with a surging dollar has resulted in weaker commodity demand and plunging prices, hurting economic growth in commodity-producing emerging markets (EMs) across the world. Dollar strength and slowing global demand have created a stagflationary environment for commodity-producing EMs, which in turn has further weighed on the global economic growth outlook. EM currency weakness has created increased inflation pass-through risks in commodity-producing EM countries, which has propelled higher EM policy rates at the worst possible time—Russia and Brazil are the most extreme examples of this phenomenon. The GDP-weighted average of short-term rates in EMs—while lower in 2015—rose sharply after former Fed chairman Ben Bernanke's quantitative easing tapering message in early 2013 and is still slightly higher than levels that prevailed at the time. As a result of these forces, growth in the developing world is lower today than at any time in almost 20 years, a fact that weighs heavily on the global economy given these countries comprise almost 60% of global GDP.

So, the crucial question going forward is what stage are we at in this third deflationary wave? And how is policy reacting? We think it is fairly advanced and policymakers are reacting. A more positive growth/risk environment, however, requires improved sentiment on China/EM growth and a softer U.S. dollar.

CHINA: NO GROWTH WITHOUT CORRUPTION?

The solution to the first two waves of deflation was intense reflation, mainly in the form of unorthodox monetary policy. We thought that this was starting to take place in China earlier this year which was the basis for our view that global growth would improve. Initially, policy authorities moved reluctantly, not wanting to repeat the kind of "bazooka-style" fiscal stimulus of 2009 and relying instead on supply-side reform to re-invigorate growth. The momentum of stimulus has been building all year while the economy continues to slacken. Policymakers have introduced interest rate and reserve requirement cuts, new infrastructure spending, lending directives, and new funding models for provincial governments—not to mention proposals for a bad bank to host non-performing loans of the state-owned banks. Despite these measures, however, growth slowed during the second and third quarters. The spectacular failure of China's regulators in managing the collapse of the equity bubble has not helped.

The Chinese economy's lack of response to these stimulus measures could simply be due to a lagged reaction function, or the Chinese economy's transmission channels for fiscal and monetary policy may be dysfunctional. Financial system dysfunction was a big part of the first two deflationary waves, so this development would not be a complete surprise. America's financial system imploded when U.S. banks ceased interbank lending because of uncertainty around securitized/structured mortgage exposure. Ultimately, the Fed intervened and bought trillions of dollars of mortgage-backed securities. Likewise, European banks would not lend to each other at the height of the European sovereign debt crisis because they did not know who owned who's peripheral debt. Ultimately the ECB intervened in the peripheral markets with a slew of powerful support programs. Similarly, China's state-owned banks today are reluctant about lending because of fear of increasing exposure to the consolidating manufacturing complex. Ultimately, the government needs to provide explicit or implicit guarantees to avoid a severe credit contraction.

More problematic is that President Xi's anti-corruption drive might have created a serious policy dysfunction as well. Arguably, China has the tools to boost economic growth. But provincial and municipal officials are afraid to implement the central government's directives for fiscal stimulus because any significant investment activity involving large amounts of money invites investigation and the threat of career-ending reprisal, including prison. Lately, the President seems to have dialed up the hunt for corruption—with a by-product being the purge of opposing political forces—leading to bureaucratic confusion and a swift cessation of government intervention which is very atypical of China. Increasingly, we see growing signs that the Chinese government will falter in executing a coherent, pro-growth agenda.

In the meantime, prime lending rates are still 5%-6%, implying a real cost of borrowing greater than 10% based on producer prices or GDP-based deflators. Consequently, these companies are forced to finance growth internally, which partly works to sustain China's high savings rate and deflationary pressures.

THE DOLLAR UPTREND OVER FOR NOW?

If one global central bank created monetary policy for the entire world, it would be easing policy conditions. Yet the supply of U.S. dollars—for all intents and purposes the world's monetary standard—has become more scarce since the Fed ended quantitative easing. The apparent discordance relates to the Fed's policy targets and the dollar's role in the global financial system.

The Fed wants to renormalize policy because the real economy has slowly but steadily improved since 2008; correspondingly, the unemployment rate has sunk to levels associated with full employment. The uncertainty relates to inflation. Most of the board members of the Federal Open Market Committee cut their career teeth on fighting inflation—their instinctive worry is tight labor markets leading to higher wages and higher inflation. They prefer to tighten policy before realized inflation moves higher. If this policy blueprint were to play out, the strong dollar environment would certainly intensify in 2016.

However, nominal GDP growth of 3.7% in the U.S. is still only at levels that defined low points of most post-war business cycles, seven years after the Lehman crisis. This low nominal growth is mainly attributable to inflation running well below expectations. The Fed does not understand why inflation is so low and held an entire conference on the topic at this year's August Jackson Hole meeting. But the fact remains that the annual rate of inflation in the core personal consumption expenditure deflator has been below the Fed's 2% target in 80 out of the 84 months since the Lehman bankruptcy. If inflation and nominal GDP growth are low because of deflationary pressures, acting prematurely to tighten monetary policy would be a mistake. Profits could easily contract in a low nominal-GDP-growth world, turning a positive employment picture to a bad one.

U.S. dollar strength also creates significant deflationary pressure for the global economy. The dollar's role in the global economy far exceeds America's share of global GDP. Almost any global dollar-based measure of liquidity is contracting. Shrinking foreign exchange reserves in EMs more than offset the expansion in balance sheets of the big developed country central banks like the Bank of Japan and ECB, while foreign money growth measured in dollars is negative. Even GDP-weighted money growth in the emerging world measured in local currencies—while positive—has fallen to a level last seen during the EM crisis of the late 1990s.

In our view, dollar strength is already acting to depress nominal GDP growth in the U.S. and is slowing the developing world. But conditions in the U.S. have reached the stage where another 10% advance in the real trade-weighted dollar likely would push a big part of the world economy into price declines and the U.S. and world economy into recession. Dollar strength would provoke more stagflation abroad and deteriorate U.S. profit margins, which were already under pressure due in part to the erosion in corporate pricing power caused by the combination of external deflationary pressures and currency strength. For those EMs tied to the dollar, like China, the impact would be deflationary.

China's short-lived devaluation in August may have been more than a bungled exercise in managing the float. The devaluation may have been a pre-emptive strike by Chinese authorities, warning the Fed to take account of external factors as well as internal factors when making its rate decisions. The real effective exchange rate for China has risen almost 40% since late 2009. China will become more competitive over the next several years either through internal deflation via falling prices or devaluation. August currency volatility may have been a not-so veiled threat to unleash a wave of external-deflationary pressure into the U.S. if the Fed chooses to retain an overly myopic focus on domestic employment trends.

INFLECTION POINT

We think asset markets are quite advanced in discounting the third wave of deflationary pressures. With many asset prices washed out relative to longer-term measures, information risk is beginning to build surrounding policymakers' potential reaction to this third wave—setting the stage for a very positive mean-reversion opportunity. Early October's trend reversal in EM asset prices could mark the beginning of a mean-reversion process, although the timing is still too soon to be conclusive.

1. Our valuation work suggests that numerous EM currencies are washed out and that a lot of the macro trend of an EM slowdown is priced into the market; correspondingly, the dollar is expensive. Similarly, the bust in commodities may be over. The extent of the decline in commodity prices is around the same order of magnitude as other objects of speculation that have fallen during the bust phase of previous speculative cycles. For example, iron ore prices are down as much from their all-time high as tech stocks fell after the peak in 2000. The recent roiling in Glencore's stock price may be as contrarily indicative of a bottom in this complex as its initial public offering was at the top in 2010.
2. Perhaps, most importantly, policymakers are reacting. The Fed has already postponed one potential rate hike. This delay is positive at the margin. Economic sentiment is likely to stop deteriorating in China as well. In addition to the lagged influence of previous policy decisions, the Chinese leadership is refocusing on growth and trying to deal with the policy dysfunction. An important plenum session of the ruling Communist Party central committee takes place this month, which will be followed by new policy guidelines and an economic blueprint for 2016. We are looking for more clarity on policy implementation and measures taken to reduce policy dysfunction.
3. Falling commodity prices are self-correcting because of their impact on real incomes for global consumers. Similarly, the drop in the price of energy recorded a year ago amounts to a massive tax break for energy consumers. The scale of the relief is on the order of $2 trillion globally. Historically, the full effect of this stimulus tends to lift global economic conditions with a one- to one-and-a-half-year lag. This window of maximum benefit starts in the final quarter of 2015 and ends in the second quarter of 2016.
4. The global GDP-weighted level of short-term interest rates has fallen almost 100 basis points (bps), due mainly to a nearly 250-bps slide in the GDP-weighted level of EM interest rates. The lagged effect from this rate decline should be more evident over the next six months.
5. The dollar has probably peaked or is close to a top. Our expectation is that nominal GDP growth in the U.S. is going to remain low, a by-product of external deflationary pressures. If we are correct that another material advance in the currency would provoke a recession, then it should not lift off. Instead, we think that soft nominal GDP growth will weigh on Fed policy expectations, the trajectory of future rate hikes, and the value of the dollar. Correspondingly, headline inflation in EM economies will stabilize and fall if their currencies flatten out or rally on the back of dollar stabilization. This environment, in turn, will allow EM central banks to cut rates, particularly in countries suffering deep recessions like Brazil and Russia.

PERFORMANCE

Performance was affected significantly by the failure of China's policy initiatives to bolster growth during the second and third quarters of this year, combined with the effects of ongoing dollar strength. Instead of an improvement, nominal global GDP growth deteriorated and our performance was poor in both absolute and relative terms. The majority of the poor absolute performance was tied to currencies, primarily in EM currencies. A positive contribution to performance from bond holdings helped offset the negative contribution from currencies, with most bond valuations increasing during the quarter as a result of disinflation and a flight from riskier assets. During the third quarter of 2015, the Global Opportunistic Absolute Return strategy composite returned -4.75% (net -4.93%), underperforming the Citigroup 3-month T-Bill Index return of 0.01%.

POSITIONING AND OUTLOOK

Notably, since inception over 25 years ago, our Global Fixed Income strategies' performance histories are marked with infrequent but occasional drawdowns comparable to the most recent experience. We are not market-timers nor base our investments solely on a particular economic forecast. Instead, we look for extremes in asset prices to generate economic/policy reactions that ultimately lead to mean reversion. We have had valuation anomalies building across a range of global bond markets all year, and we are now getting the expected policy reaction. The Chinese boosted policy stimulus, but so far there is not much to show for it as discussed above. We think that is about to change. Similarly, the Fed has backed off its renormalization rhetoric, but so far it has positioned policy trajectory as delayed more so than being affected by a material shift in the outlook. Consequently, price extremes became more extreme in the third quarter, setting up what ultimately should be a bigger case of mean reversion.

Currently, the strategy's top fixed income holdings are U.S Treasurys and Mexican Mbonos. Mexican bond yields are higher than comparable Treasurys by the widest margin in over three years but the bulk of the valuation opportunity in the Mbonos really lies with the Mexican peso. The currency has been washed out dramatically relative to any objective measure of valuation. Domestic inflation has remained low, the economy has outperformed most of its Latin American neighbors, it has reduced its sensitivity to oil, and Mexico's exports are tied to the U.S. car industry which has been strong. As a highly flexible and liquid currency, the peso tends to be used by investors as a vehicle for hedging other EM exposure, hence it has been caught up in the general EM/commodity bear market, but should recover when the rest do.

As for Treasurys, they function in the strategy partly as a beneficiary of the generally deflationary global environment and partly to balance the risks that something goes very wrong and global growth keeps slipping lower.

Elsewhere, the strategy remains skewed toward many global bond markets in the emerging world, each with their own idiosyncratic profile. But in general, many of these markets exhibit high real yields, a by-product of the stagflationary conditions described earlier. Inflation should decline once EM currencies experience a fairly brief period of stability, which would permit central banks to begin easing. The recent rate cuts by the Reserve Bank of India are a good example of how a vicious, negative-feedback cycle has evolved into a virtuous one. The low inflation and boost to growth from cutting policy rates has supported the rupee.

In cases of more extreme uncertainty—like the Brazilian bonds in the strategy—we believe investors are being well-compensated to take risk. Long-term bonds yielded over 16% as late as the last week of September. Assuming no change in bond prices, the Brazilian real to dollar exchange rate would have to weaken to 6.24 to lose money based on a three-year holding period. The economy is deep in recession and, encouragingly, an anti-corruption drive appears to be in full-swing, which could potentially culminate with the impeachment of President Rousseff. We believe any respite in currency weakness will bring about lower headline inflation and the beginning of policy stimulus.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	C3MTB	USL3M
QTD	- 4.75	- 4.93	0.01	0.08
YTD	- 4.62	- 5.15	0.02	0.21
1 Year	- 3.59	- 4.31	0.02	0.27
3 Year	2.22	1.46	0.04	0.26
5 Year	3.41	2.44	0.06	0.31
7 Year	4.94	3.87	0.11	0.46
Since Inception	4.61	3.53	0.18	0.58

Inception Date: 6/1/2008

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

	Gross	Net	C3MTB	USL3M	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	C3MTB Rolling 3Y SD	USL3M Rolling 3Y SD
2015	- 4.62	- 5.15	0.02	0.21	9	4,765	65,624	0.18	4.47	0.01	0.01
2014	5.87	5.08	0.03	0.23	7	3,681	63,375	-	4.26	0.01	0.03
2013	2.32	1.56	0.05	0.27	6	2,996	50,050	-	3.86	0.01	0.03
2012	13.36	12.11	0.07	0.44	3	300	42,894	-	3.76	0.01	0.03
2011	1.20	- 0.05	0.08	0.34	2	58	33,122	-	4.53	0.02	0.09
2010	5.06	3.77	0.13	0.35	2	278	31,996	-	-	-	-
2009	15.22	13.82	0.16	0.71	1	172	29,199	-	-	-	-
2008	- 3.02	- 3.73	0.81	1.69	1	134	32,755	-	-	-	-

C3MTB = Citigroup 3 Month T-Bill Index USL3M = US 3M LIBOR

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Composite Description: The Global Opportunistic Absolute Return Composite (the "Composite") Inception date: June 1, 2008. Creation date: June 1, 2012. The Composite includes all fully discretionary, fee-paying, actively managed Global Opportunistic Absolute Return accounts with limited client mandated restrictions. Portfolios are constructed by synthetically reproducing the alpha (independent of the beta) generated by the Firm's Global Opportunistic Fixed Income Strategy. The use of derivatives will increase risk in the strategy. Alpha can be synthetically reproduced based on securities held in the portfolio, or as an overlay on securities held by clients outside of the portfolio (Unfunded Notional Value). The Unfunded Notional Value (in millions) was $210.4 at Dec 31, 2010; $229.5 at Dec 31, 2009; and $350.9 at Dec 31, 2008. This Unfunded Notional value is used in the asset-weighted composite return, but is not included in the Composite Market Value. No Commercial Paper will be employed to implement the Composite's strategy. The Composite utilizes over-the-counter forward exchange rate contracts to manage its currency exposure, these contracts are valued daily using closing forward exchange rates. Brandywine uses WM/Reuters daily FX rates taken at 4 p.m. London time. Benchmark indices' exchange rates may vary from Brandywine's exchange rates periodically. Benchmark: The Citigroup 3-Month U.S. Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. Each month the index is rebalanced and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond 3 months from the rebalancing date.London-Interbank Offered Rate (LIBOR) - British Bankers Association Fixing for US Dollar. The rate is an average derived from the quotations provided by the banks determined by the British Bankers' Association. The top and bottom quartile is eliminated and an average of the remaining quotations calculated to arrive at fixing. BBA USD LIBOR is calculated on an ACT/360 basis and for value for two business days after the fixing. Performance Calculation: Preliminary data, if so noted, reflects unreconciled data for the most recent reporting period. Portfolios are valued daily on a trade date basis and include dividends and interest as well as all realized and unrealized capital gains and losses. Return calculations at the portfolio level are time-weighted to account for periodic contributions and withdrawals. Performance results are calculated on a before tax, total return basis. The Composite returns consist of size-weighted portfolio returns using beginning of period values to weight the portfolio returns. Monthly linking of interim performance results is used to calculate quarterly and annual returns. Composite's valuations and returns are computed in U.S. Dollars ("USD"). The results are presented in USD or in other currencies (to accommodate overseas investors), the latter by converting monthly USD returns into other currency returns using the appropriate currency exchange rate returns. Gross returns reflect the deduction of trading expenses. The net of fee return does not include a performance incentive fee; it's comprised solely of the base management fee. 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. 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