Global Sovereign Credit
Quarterly Commentary

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NORMALIZATION

What a difference a quarter can make.

At the end of March, the global Citigroup Economic Surprise Index had risen to its 97th percentile! Surprised by the relatively strong global synchronized expansion, the investment world embraced reflation as the macro investment theme du jour and appeared—at least briefly—to dismiss the theory of secular stagnation. The reflationary drivers behind this global upturn included China's 2016 fiscal boost, dollar stabilization, and last year's retreat from normalization by the Federal Reserve (Fed).

But by the end of the second quarter, only three months later, the economic surprise index was in full retreat, oil prices were falling, Treasury bond prices were rising, and the U.S. yield curve was flattening—a challenge to the reflation and sustainable growth thesis. Some of the reflationary drivers behind this year's pick up had also gone into reverse: China pulled back on its fiscal levers and the domestic credit impulse was in retreat; the Fed reenergized its normalization plans while other major central banks collectively signaled that the multi-year period of unorthodox policy stimulus may be drawing to an end. In the U.S., hope turned to doubt regarding prospects for tax cuts and reform.

In our March quarterly commentary we wrote to you saying that the sustainability of the synchronized global expansion would turn out to be the main issue going forward. That has clearly become the case as we enter the third quarter of the year.

Our view has not changed from March.

By our lights, we still believe that the reflationary expansion in the global economy is real and sustainable. Economic growth could moderate slightly in the second half of the year, but we believe there is lots of evidence that the world economy is on a trajectory of sustainable growth. Given this backdrop, Treasury yields should move higher.

Taking a glance at the main economic regions of the world supports the case for a continuation of sustainable economic growth in the world economy, without the need for continued monetary policy support.

In China, there are still plenty of positive factors supporting growth, notwithstanding the recent retreat in credit growth or property price inflation.

- Indicators like the monetary conditions index and M1 growth have retreated, but not on the scale that took place from 2012-14. Correspondingly, corporate profit growth should remain positive. In addition, the growth rate in the money supply also correlates with the Li Keqiang index of economic activity—bank lending, rail freight, and electricity consumption—which serves as a reasonable proxy for real gross domestic product (GDP) growth. All of these factors suggest Chinese growth will stay supported over the next year or so.
- The Chinese authorities' recent efforts to control credit growth have been selective and aimed at reducing shadow bank activity, which contrasts with less discriminate efforts taken to muzzle credit growth in 2014 and 2015.
- Finally, there is the Silk Road Project. The scale of this project is dramatic with estimates ranging from $4-$8 trillion, and a development timeframe of around 10 years. China's interest in this project is clear. The country can use up its spare industrial capacity and excess savings by partnering up with countries through vendor-financed infrastructure development. The project opens the door for greater regional trade and development, and provides a welcome mechanism for China to fill the vacuum in global leadership created by the Trump Administration's "America First" policy stance.

In Europe, growth is above trend with no trace of a slowdown evident in any early leading indicators. European households are borrowing at a rate of roughly 6% a year; non-financial corporate credit growth is lackluster but

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positive. The French elections have reduced political tail risk, while German Chancellor Merkel's blind eye to the Italian bank bailouts may be a hint of a refreshingly more practical approach to making Europe work. Tax cuts are part of the German Chancellor's election campaign agenda and over 80% of the French assembly is composed of reformers.

Japan's economic performance profile is reasonable to us, considering the headwind of a dwindling population. The build-up to the summer Olympics in 2020 is in full view in downtown Tokyo. Industrial production growth—a narrow, but probably the single best coincident indicator of Japanese economic activity—is expanding at a rate of almost 7%.

American economic growth has been the biggest disappointment over the last three months—the U.S. economic surprise index falling the most of all the regions. Nonetheless, we continue to see signs of moderate and sustainable economic growth:

- Real personal spending growth is running roughly 3%
- Initial public offering activity during the first six months of 2017 has eclipsed all of 2016
- Home ownership may be bottoming after a 12-year decline
- Bank lending growth has been soft but lags lending surveys and corporate spreads by a year, which are all upbeat
- And, forward-earnings estimates correlate with capital spending, which is already in a rebound based on the growth rate in manufacturers' new orders

International trade data corroborate the positive regional economic trends. Container traffic is on the rebound and is a leading indicator of global trade flows. Countries are mobilizing to accelerate plans for greater free trade as a defense mechanism against policy threats from the America First "fair" trade initiatives. Japan and Europe are the latest to announce a free-trade agreement. Industrial commodity prices—a bellwether of the global economy—are down only 2% from their peak, after rising nearly 30% since December 2015.

If anything, the world seems to have entered a phase of macroeconomic nirvana, characterized by moderate and sustainable low-inflation growth. Equity market valuations, narrow corporate bond spreads, and low volatility reflect a growing market consensus that this macro nirvana could last for some time. The important questions are: what will end it and when?

THE NEW TAIL RISK

There are numerous tail risks to the outlook, some of them familiar: geopolitics, excessive debt levels in China and corporate America, as well as uncertainty over the Trump fiscal agenda.

But the newest and possibly biggest economic tail risk in the outlook is the Fed's intention to shrink its balance sheet.

"Quantitative Tightening" (QT) represents enormous information risk. The U.S. has no history of balance sheet reduction which it can rely on as a guide. Nor should investors believe that the Fed knows what the intended or unintended consequences might be. Quantitative easing was controversial from the start, and there remains tremendous disagreement over what and how it was supposed to work. The risk is that QT turns out to be a particularly harsh form of policy tightening, a concern that Fed Chair Yellen seems concerned about. What's missing from the Fed's discussions is any way of gauging the effects of QT short of market and/or economic turbulence.

All the non-U.S. examples of QT have been deflationary. The Bank of Japan shrank its balance sheet in 2006, triggering a reversal of the carry trade and disrupted markets ahead of the Great Financial Crisis. The People's Bank of China had to shrink its balance sheet in 2015 in order to prop up the Chinese currency in the face of capital outflows. The result was the sharpest slowdown in the world economy since 2008 and a riot point in global markets toward the end of 2015 and early 2016.

It is not clear why the Fed has chosen QT before returning interest rates back to "normal," but we think it is a mistake. Implicitly, the Fed is saying that the size of its balance sheet represents a potent source of expansionary monetary policy which is no longer appropriate in view of what the central bank perceives to be growing inflation risks. This could turn out to be a very dangerous assumption given the extraordinary increase in bank deposits relative to loan creation, the rise in the savings rate, and the sharp drop in the U.S. money multiplier.

Monetary policy restraint is what usually kills the U.S. business cycle. There have been 19 official recessions in the U.S. since 1914; all preceded by monetary restraint but one. Fear of inflation typically provokes the monetary tightening, which appears to be the case again currently. At the moment, price inflation is dormant and wage inflation low. There have been numerous explanations for the underwhelming levels in both: technology, globalization, and changing consumer preferences. But competition is at the core of these theories, and lately the news headlines have provided a front row seat on how that works to keep prices in check. Amazon's purchase of Whole Foods, Walmart's competition with Amazon in the e-commerce space, and more recently the arrival of German supermarket chain Lidl attest to the power of competition in keeping prices down.

The Fed frames its thinking about inflation risks in terms of the "Phillips Curve," the theory which suggests that inflation is related to the size of the gap between the economy's actual output and its unobservable potential. The Fed's estimates of potential output and this gap warn that the U.S. economy is already operating at full capacity. In addition, low energy prices and once-off items like mobile phone services explain much of the recent dip in inflation rates. Low energy prices dragged breakeven inflation rates and bond yields lower during the second quarter. But the latest weakness in oil looks more like a positive supply shock than a

negative demand shock given the narrowing in corporate spreads and strong stock market. Whatever the case may be, the Fed is not waiting and wants to start slowly tapering its balance sheet later this year.

The QT screws will be slow to turn at first. So the timing of a material impact on global liquidity conditions is more likely to be next year. Other central banks around the world have sounded more hawkish of late as well, but in most instances, the rhetoric is aimed more at preventing another Bernanke taper tantrum by giving the market lots of notice. Markets may react in advance to the less accommodative stance of monetary policymakers, but any meaningful tightening is probably part of next year's story.

PERFORMANCE

The Global Sovereign Credit strategy returned 4.13% on a gross-of-fees basis (3.95% net) for the second quarter, outperforming the Bloomberg Barclays 60/40 (emerging/developed) Sovereign Credit Index return of 3.24%. Performance was strong in both absolute and relative terms, and the source of attribution primarily came from yield curve and duration decisions, although currency selection also positively contributed to returns. On the fixed-income side, unhedged exposure to peso-denominated Mexican Bonos significantly contributed to relative outperformance. A favorable outcome of regional elections, plus a surprise rate hike in May from the Bank of Mexico, helped sustain the rally in Mexican assets during the quarter.

Exposure to U.S. Treasuries contributed to relative outperformance. The U.S. Treasury yield curve flattened throughout the period, as investors sold short-dated bonds in favor of the longer end of the curve, making our Treasury positions accretive to quarterly performance. However, we are dollar bearish—this forecast positively impacted relative returns for the period.

In Europe, both core and peripheral countries generated economic momentum in light of the broad regional growth story. Italian BTPs and French OATs also rallied even though economic reform and sustainable growth had yet to gain traction in their respective economies. The strategy's lack of exposure to Italian and French sovereign bonds—as well as ultra-high quality Bunds that benefitted from demonstrable German growth—detracted from quarterly performance; however, exposure to Portuguese bonds contributed to relative performance as the entire yield curve rallied upon the release of better-than-expected data. This position was the greatest contributor to relative performance for the period. Incidentally, the strategy's significant underweight to the euro—a position that we closed late in the second quarter—significantly detracted from absolute and relative performance. The euro rallied on positive economic data, European Central Bank (ECB) rhetoric, and optimism created by signs of a new alliance between French President Macron and German Chancellor Merkel.

We remained constructive on European currency prospects other than the euro, and maintained exposure to a basket of European currencies, all of which benefitted from the favorable regional conditions and synchronized global growth. Currency positions in the Swedish krona and Norwegian krone contributed to performance, as did unhedged exposure to zloty-denominated bonds in Poland. Other Eastern European currencies rallied alongside the zloty, including the Hungarian forint and Czech koruna; the strategy's lack of exposure to the forint and koruna detracted from relative performance. The Czech koruna removed its peg to the euro during the quarter, which helped the currency appreciate. The favorable European growth environment—along with synchronized global growth—generally helped export-heavy countries like Poland, Hungary, and the Czech Republic.

Exposure to the British pound sterling also contributed to outperformance, even as the currency's valuation fluctuated from the time the snap election was announced to its June results. A weaker Japanese yen benefitted the country's trade position, and a significant underweight to the currency helped performance—we concomitantly closed this position along with the euro. On the other end of the quality spectrum, avoiding currencies like the Russian ruble positively contributed to performance.

Positions in a mix of other developing market currencies and local-currency bonds also contributed to performance, including the Malaysian ringgit, South African rand, Indian rupee, and unhedged exposure to Indonesian sovereign bonds. Brazilian assets were hit hard mid-quarter when current President Temer was implicated in the pervasive car wash scandal. Short- and intermediate-term Brazilian yields ended the quarter lower and the real did not entirely recover its losses. Unhedged exposure to Brazilian government bonds detracted from quarterly performance. Valuations on peso-denominated Colombian bonds served as a proxy for the volatility in Brazil; the strategy's position in these bonds detracted from performance. The search for yield drove up asset prices in countries the strategy did not maintain exposure to, such as local-currency Thai bonds, and the lack of exposure also detracted from performance. A new position in lira-denominated Turkish bonds contributed to performance.

POSITIONING

There have been few overall changes. Broadly speaking, our Global Fixed Income strategies are underweight benchmark duration in the developed world. Late in 2016, we responded to the selloff in the Treasury bond market by adding back Treasury duration, though we pared that position at the end of the first quarter.

We don't believe there is a major price anomaly in the U.S. government bond market. Consequently, there is no valuation tailwind likely to drive returns going forward. Instead, the macro environment will be the chief driver of the trend in the global risk- free bond market for the duration of the year. Yields are more likely to be higher than lower, and the yield curve steeper by year end based on our positive view of the global economic outlook. The modest holdings of Treasuries may seem contrary to that point of view. However, our U.S. Treasury position is a key component of risk management; they are an anchor to the windward in the event that our more constructive global macro view turns out to be overly optimistic, or that U.S. balance sheet reduction quickly proves to be deflationary.

The level of yields in core Europe seems anomalous in relation to above-trend GDP growth. ECB President Mario Draghi's upbeat recent comments on the outlook for

the European economy imply that central bank support for this market will soon diminish. Therefore, we avoided German Bunds and French OATs.

Duration elsewhere in the strategy is concentrated in many emerging-market sovereign bonds. Yield spreads in these markets are high relative to inflation. If our optimistic outlook on world growth proves accurate we expect the risk premium to diminish. The soothing effects from firmer commodity prices should feed back into corporate profitability—improved tax revenues are all intertwined in a positive feedback cycle. This positive feedback cycle intersects with our thesis for renormalization of the global business cycle and the reason we are overweight emerging markets and currency bonds.

Across the emerging countries, idiosyncratic factors continue to hold sway. Mexican Bonos seem inexpensive. Brazilian sovereign bonds have had a good run, but more gains seem likely with the economy showing signs of weakness. South African bonds offer good yield but our concern grows over governance; the negatives include Zuma's propensity for kleptocracy, his dismissal of a highly credible finance minister, the unwillingness of the African National Congress to remove him, and his interest in undermining the independence of the central bank. During the quarter, we added a very small position in Turkish government bonds, another emerging country with a questionable governance profile. In Turkey's case, Prime Minister Erdogan seems to have discovered that the path to political rehabilitation among the urban Turkish voters could be domestic economic stability—at least for a while. We are not sure how long this will last. Consequently we look to take advantage of an investment offering high yields in an inexpensive currency.

The British pound is washed out relative to standard valuation metrics, a by-product of Brexit-induced uncertainty, as well as weakness in real incomes following the currency-induced spike in headline inflation. However, monetary data looks very expansionary, building society lending growth is about to turn positive, industrial order books are soaring, and the Organization for Economic Cooperation and Development leading indicator is rising. The ruling Conservative party's loss of Parliamentary seats in the June general snap election will likely reduce the probability of the U.K. pursuit of a "hard" Brexit—this always struck us as a low probability outcome in any event. The ideal outcome from an economic viewpoint was always going to be one close to the arrangement that existed prior to the Brexit vote. All these factors suggest a better out turn than the view embedded in the price of sterling.

SUMMARY

In summary, we feel the strategy will do well if the business cycle normalizes. We believe the early lift off is beginning to rhyme with the old business cycles of the past. The 1.6% recessionary global growth during a 5-month stretch in late 2015 is fading from the rearview mirror, along with the theory of secular stagnation. We have viewed the story line differently, beginning with our call for stirrings of an end to financial repression in late 2016, synchronized global recovery at year end, and now normalization. We believe normalization will be the playbook used by the central banks, with the U.S. writing the first chapter, and the subsequent chapters to be written by Europe and Japan. The book will read a little like past history, where initially rates rising in tandem with economic prosperity are not an impediment but a necessary condition for the business cycle.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	B6040
QTD	4.13	3.95	3.24
YTD	11.07	10.69	7.91
1 Year	4.00	3.28	0.65
3 Year	0.45	- 0.25	- 2.44
5 Year	4.01	3.29	- 0.07
Since Inception	4.00	3.28	- 0.36

Inception Date: 5/1/2012

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

	Gross	Net	B6040	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	B6040 Rolling 3Y SD
2017	11.07	10.69	7.91	4	3,160	71,546	-	9.30	7.82
2016	4.49	3.77	2.28	7	3,435	65,498	-	9.66	7.87
2015	- 11.98	- 12.61	- 9.07	5	2,835	68,819	-	8.63	6.77
2014	10.93	10.17	- 1.64	3	2,661	63,375	-	-	-
2013	- 4.30	- 4.97	- 5.03	3	1,453	50,050	-	-	-
2012	12.96	12.44	4.69	3	945	42,894	-	-	-

B6040 = Bloomberg Barclays 60/40 Sovereign Credit Index

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