Global Sovereign Credit

Quarterly Commentary

NORMALIZATION IS NOT A DIRTY WORD

A year ago the prevailing macro view of the world was one of financial repression and secular stagnation. It was a compelling explanation for the tepid deflationary global growth that has prevailed for much of the time since the global financial crisis (GFC).

We followed a different storyline last year. We made the case that there were "stirrings" of an end to this story of financial repression and positioned the strategy accordingly. Those signs of "stirrings" have since morphed into the strongest and most synchronized phase of global economic growth since 2008. Correspondingly, performance results this quarter and over the last year have been very positive.

The rhetorical questions now are: What is next? Has growth peaked? Is the world economy about to slow again?

We have seen other periods in the last nine years when economic growth picked up for a while but then languished, encouraging global policymakers to double down on unorthodox stimulus and sending Treasury yields to track even lower. Like previous instances of global strength since the GFC, the latest episode has been preceded by a mélange of reflationary forces, including Chinese policy stimulus, a weaker dollar, and a more dovish Federal Reserve (Fed)—the impulse effects from which have generally petered out. With hindsight, we all know that earlier calls for policy normalization have been premature and perennial year-end predictions of higher bond yields from Wall Street analysts have been wrong year after year. But central bankers are relentless, if nothing else, and are beginning to sing from the song sheet of normalization again, notwithstanding the collapse in their credibility. More bad judgement? Or is something about this latest pickup in global growth different?

Our views have not changed. Global growth may be peaking but we doubt it will fall off much, if at all. For starters, it is important to look at just the character of the economic data and take note of how different this uptrend is compared with previous rebounds in activity since the GFC. With all Organisation for Economic Cooperation and Development (OECD) member countries expanding together for the first time, the breadth of this recovery alone is unprecedented since 2008. In addition:

- Global trade finally appears to be breaking out of its post-2008 torpor, due in part to the stabilization in global commodity prices. Chinese trade growth, a bellwether indicator, reversed higher in 2016 after a nearly five-year slump. Similarly, South Korean export price inflation, another sensitive global trade indicator, popped higher after years of stagnation.
- U.S. capital spending has accelerated, firms have shown greater willingness to commit to capital spending longer in advance, and investors have begun to favor the shares of companies spending on capital over companies accumulating cash, a major reversal from previous years. Consumer comfort surveys have reached levels not seen since the early part of the century, and the U.S. employment-to-population ratio is back to levels that prevailed during the good times. For example, 6.3 million job openings with 7 million unemployed are striking numbers. Even more telling is the slowdown in the growth rate of commercial bank savings deposits, which in combination with the latest signs of a pickup in lending, could be a powerful indication that households are becoming more confident about the future and willing to put some cash back to work in the economy or markets. Most recently, wage growth has plateaued at a still-low level, but any reasonable leading indicator of future wage gains points to significant gains looking out a year from now.
- The Chinese economy remains propped up by a mixture of policy support and underlying strength in domestic demand. The falloff from last year's surge in credit growth has created a negative credit impulse and slower real estate inflation. Nonetheless, the government has targeted steady growth and more selective credit control over lending to the wealth management industry. Recently, policymakers cut reserve requirements for banks' lending to small businesses. Overall monetary conditions remain positive.
- In Europe, leading economic indicators, like money supply, suggest growth has probably peaked but is un-

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likely to retreat to any significant degree. Skills shortages across Europe have spiked to levels not seen in 16 years while labor market tightness in Germany is unprecedented. Meanwhile, private sector credit growth has stabilized. The fiscal austerity of a few years ago has given way to incremental expansionism as the French lead the way with tax and labor reforms, the British contemplate a corporate tax cut to stay competitive with Europe, and various countries within the European Union consider the case for tax relief.

- Japanese economic growth continues to boil as well with nominal industrial production growth exceeding 10%. This growth is remarkable for an economy with a shrinking population and one that is usually a flywheel for the world economy. Nonetheless, second quarter gross domestic product (GDP), even after being revised lower, was very balanced in its composition.
- Commodity prices and Emerging Market-related currencies have made a meaningful recovery from the epic bust that ran from 2011 until 2015. The vicious cycle of currency weakness, rising inflation, higher rates, and weaker growth has completely flipped, replaced by one of currency strength, falling inflation, lower rates, and better growth. Central banks in many of these countries are behind the curve; with interest rates well above inflation, they still have more latitude to cut rates. Hence, global GDP-weighted short-term rates could still inch lower.

Behind these improving global business-cycle developments are some key structural factors.

The epicenter of the post-crisis malaise has been the collapse in the U.S. household debt supercycle and the destruction/closure of China's enormous excess productive capacity. However, for a year now, household deleveraging in the U.S. has been on hold while China's economic trajectory has stabilized.

Secondly, policy conditions remain very expansionary, notwithstanding how strong the global recovery has become. Part of the reason may be that central bankers fully expect the world economy to languish in the period ahead much as it has in the past. Or, they may have become believers in the secular stagnation view of the world. The European Central Bank (ECB) and Bank of Japan (BOJ) continue to make major asset purchases despite tight labor markets and robust growth. The People's Bank of China is trying to encourage banks to lend to small businesses. None of these considerations take into account fiscal policy, which for the most part is getting more expansionary around the world.

Lastly, the significance of the collapse in the price of oil is easy to forget. The oil bust has given the global oil consumer a multi-trillion dollar lift in savings compared with the oil bill they received at the peak of the cycle. We mentioned this powerful catalyst for growth several times in 2015 and 2016. It looks like the 18-month average lead time has played out with textbook predictability.

All these factors suggest to us that the world is in the very early phases of "normalizing" away from the near decade-long lingering after-effects of the GFC to a new normal steady state, the character of which is yet to be determined. We doubt that the new normal will look anything like before 2008, but it should be better than what has transpired since that time.

In some ways the global expansion is beginning to rhyme with the old business cycles of the past, only a very stretched out version. In this case, the global cycle may only be at the mid-way point with America in the lead and the emerging world lagging. The initial phase of this normalization period should tend to read like past history—but again stretched out—where some elimination of stimulus is a necessary condition for economic prosperity and not an impediment. What remains to be determined is where the neutral line is.

WHAT IS NORMAL?

There is no way of knowing in advance what the new steady state of the world economy looks like if we are indeed emerging from a 10-year post-crisis adjustment phase. High corporate debt levels in America, U.S. dollar-denominated corporate debt in the emerging world, and household debt in many developed countries of the world, like Canada, Australia, New Zealand, and many countries in Europe, all point to a low equilibrium in interest rates. But these are structural stock effects that are independent of where business cycle flow factors may want to take the world economy.

Central banks in particular are especially nervous and rightly so. Historically, central banks and the Fed, in particular, have ended most post-war business cycles by raising rates too far when confronted with late-stage business cycle pressures, like excess credit and/or inflation. Fed Chair Yellen's detailed analytical presentations on the uncertainty surrounding her inflation forecasts are refreshing in their candor but disturbing given the significance of inflation to the investment outlook and the long lead time between policy action and economic reaction. On the one hand, if policy is too expansionary the central bank risks fostering the need for more aggressive tightening later when inflation surfaces. These are the classic ingredients for a financial crisis and recession. On the other hand, a prematurely tight monetary policy could short-circuit business cycle normalization and provoke another deflationary relapse. Adding to the uncertainty, a potential regime change will unfold at the Federal Reserve over the course of the next several months. Four out of the seven sitting members of the Federal Open Market Committee (FOMC), including the chair and vice-chair, are due for appointment. The late financial historian Charles Kindleberger famously warned that transitions in leadership were dangerous times for investors.

Given all these uncertainties, the stance of the Fed and other central banks around the world is "go slow." We are skeptical about central banks' ability to recognize inflationary pressures or other market disequilibrium in advance. Therefore, our view is that this bias in policy will lead to erring on the side of overdoing the stimulus. Unemployment in numerous countries in the developed world is at quarter-century low. If our view is correct and the world economy is normalizing along a very stretched-out cycle, then attendant wage and inflation risks are gradually building. Yet, more and more market participants and policymakers are throwing the Phillips Curve theory of inflation out the window because this cycle has yet to manifest these kinds of pressures. In the U.S., corporate sector revenues are up, profits are strong, and demand for labor is firm. Why would wages and prices not be bid higher?

RISKS TO GROWTH

Geopolitical risks abound, any number of which could hurt the global growth outlook. It is hard not to see how war on the Korean Peninsula would have any other effect then harming global growth, but rational self-interest continues to argue against this outcome, a view that the market seems to have adopted as well.

Just when the French elections took some of the uncertainty out of European politics, developments in Germany and Spain have created new ones. Chancellor Merkel's diminished support, the rise of the German right wing, and the emergence of a weaker coalition government speak to erosion in the stability at the core of the European Economic and Monetary Union. Similarly, the violence surrounding the Catalonian vote for separation from Spain could inflame forces of separatism there and across the rest of Europe. There are many other small population groups across Europe looking for the same independence that Catalonia wants. How these developments manifest over time is unpredictable. The risks are obvious, but they could also provoke more constructive measures aimed at bolstering the kind of growth and prosperity for which populists clamor.

Protectionism is another threat, but so far the U.S. administration appears to be executing its "America First" priorities without resorting to an all-out trade war. It is hard to know how much is theater or posturing. President Trump threatens protectionism; his lieutenants seem to approach issues more measuredly.

However, we believe the biggest threat to growth is quantitative tightening, as we discussed last quarter. It represents enormous information risk. Some members of the FOMC have referred to its effects as akin to watching paint dry. This view may be more hope than forecast. We strongly doubt it will be smooth. Initially, the Fed's balance sheet drawdown will be fairly small and offset to some extent by continued expansion of other central bank balance sheets in the world. Whatever impact it may have will be a creeping one. But by mid-2018, we expect it will become more intense. If confidence continues to build in the economy and the velocity of money begins to surge, even then it will not be restrictive. But, there is no way of knowing any of this in advance.

ANOMALIES CREATE OPPORTUNITIES AND RISKS

Our relatively optimistic macroeconomic storyline flies in the face of the current profile of fixed income prices in many parts of the world, particularly the developed countries. Across Europe, the vast majority of sovereign fixed income securities still trade with a negative nominal yield. It is doubtful that any person or entity owns these securities who does not have to. European insurance companies and pension funds looking to immunize long-duration liabilities have been forced to chase bond yields ever lower. German bunds are at historically low spreads relative to Treasuries, and European high yield corporate debt trades at the same level of yield as U.S. sovereign debt. European capital flow data captures the flood of fixed income capital leaving the continent as investors bail on ECB asset purchases in search of yield, much of it coming into U.S. fixed income securities, particularly corporate bonds.

We do not know what the catalyst for unwinding this anomaly in European bond prices will be, but the attendant investment risks are plain to see. At some point, the forces acting to suppress bond yields will unwind, and could do so rather abruptly. ECB President Draghi is bending over backwards to avoid another "taper tantrum." It remains to be seen how this can be accomplished.

The recent Canadian experience offers some insights. The spread between Canadian and U.S. 10-year sovereign bonds reached a historic extreme during the most recent quarter. The Canadian central bank did a complete about-face on monetary policy, shifting abruptly from arguing in favor of extremely accommodative policy to making the case for normalization. In a matter of a few weeks, this historic spread disappeared to zero, the yield curve in Canada steepened, and the Canadian dollar rallied. We expect to see more of this over the next year.

Conversely, our theme of normalization calls for stable, low-inflation, self-sustaining growth, which is ideal for many fixed income markets in the developing world.

PERFORMANCE

The Global Sovereign Credit strategy composite returned 3.20% on a gross-of-fees basis (3.02% net) for the third quarter, outperforming the Bloomberg Barclays 60/40 (emerging/developed) Sovereign Credit Index return of 2.09%. Returns were strong during the third quarter in terms of both contribution and attribution. The biggest contributor to attribution came from the currency weightings. Roughly two-thirds of the quarter's gains came from currency markets. One of the major alpha drivers this year and in the third quarter has been the across-the-board weakness in the U.S. dollar. The strategy was well positioned for this trend, which is why currencies added so much to returns. The euro clearly had a strong rally this year and into the third quarter. As we have noted before, we expressed our constructive views on Europe by being long a basket of currencies that included peripheral European and Scandinavian currencies, the British pound, and a small position in the euro, which was sold on the move to 120 EUR versus the dollar during the quarter. As a result, performance attribution for the euro is negative. However, adding in the rest of the European currency basket makes the overall result a clear positive. Within this basket, the Norwegian krone was particularly responsive to gains in oil prices during the quarter while the Swedish krona advanced after the Riksbank confirmed inflation drew closer to target. British pound sterling exposure also was a strong contributor, as the currency surged after the Bank of England surprised markets with talk of a near-term rate increase. Other developed market currencies also contributed favorably to returns, including the Canadian dollar, which hit a two-year high against the USD, and the Australian dollar, as both gained against an improved economic backdrop and strong commodity prices.

Overweight exposures to medium- and long-duration bonds in higher-yielding, commodity-producing emerging markets, particularly Brazil and Indonesia, were top contributors to relative performance. In both countries, bonds rallied during the period against a backdrop of synchronized global growth, a weaker U.S. dollar, stabilizing commodity prices, and robust export demand. Brazil has further benefited from economic reforms, with its central bank indicating the pace of interest rate cuts could soon slow and the real appreciating against the USD during the quarter. Other Latin American countries, like Peru, also saw inflows during the quarter due to high real yields and improving fundamentals, further supported by solid macroeconomics and a stable political backdrop. Overweight exposure to shorter-duration Portuguese government bonds added to returns as well, benefiting from stronger domestic growth and employment, as well as a shrinking budget deficit. Southern Europe continued to be a major contributor to growth, and Portuguese bonds received an added boost after the country's credit rating was upgraded during the quarter.

POSITIONING

Overall positioning did not change that much during the quarter. However, a tactical decision was reached during the quarter to add some U.S. dollars back to the strategy given the extent of the greenback's slide this year. The beginning of balance sheet shrinkage in the U.S. as well as heightened expectations of tax reforms/cuts in Congress could also act to support the currency. Despite this tactical shift, we remain fundamentally negative on the dollar and remain underweight the greenback, just not as underweight as we once were. We remain underweight European duration and short euro exposure but continue to own peripheral, non-eurozone currencies like the Norwegian krone, Swedish krona, and Polish zloty. We also remain overweight pound sterling exposure and have no exposure to Japanese government bonds or the yen.

More generally, we reduced duration further during the last quarter by selling residual holdings of U.S. Treasuries. This action is clearly in line with our macroeconomic outlook. Duration remains concentrated in the emerging world, which in our view remains a strong value proposition. In emerging markets, real yields are high and inflation is falling, which is in contrast to the negative real yields in the developed market. As mentioned earlier, if normalization goes mainstream and global growth sustains itself in the 3.5% range, our story of interest rate convergence and dollar weakness will continue to add value relative to the index.

Supplemental information to the attached Global Sovereign Credit GIPS compliant composite.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	B6040
QTD	3.20	3.02	2.09
YTD	14.62	14.02	10.16
1 Year	5.58	4.85	1.18
3 Year	1.83	1.12	- 0.28
5 Year	3.39	2.67	- 0.49
Since Inception	4.42	3.69	0.04

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	14.62	14.02	10.16	3	3,308	73,890	-	9.06	7.52
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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