Global Unconstrained Fixed Income

Quarterly Commentary

STIRRINGS OF AN END TO FINANCIAL REPRESSION?

The third quarter ended with investors nervously anticipating what may arguably be the most important geopolitical event of the year: the U.S. Presidential election. Donald Trump and Hillary Clinton offer radically different visions for American domestic and foreign policy. As a result, the uncertainty makes it extremely difficult for businesses and investors to plan in advance of November 8. What will stay ambiguous even after the election is the size of the gap between what the new administration wants to do and constitutional constraints.

Clearly, the tone and character of the U.S. political contest has rattled investor nerves at a time when uncertainty was already high going into the quarter. The British vote to exit the European Union at the end of the second quarter left investors in shock and the governing elite scratching their heads about the real concerns of citizens of continental Europe. Much has been written about this development in the last three months, most of it negative. The thread of angst has run from worries about a British recession, to the risk of isolationist political contagion in Europe and America, to populist bashing of globalization. The problems of the 1970s brought us Reagan and Thatcher and an economic revolution. The current risk is that frustrated voters may opt for a populist revolution. Protectionism is already on the rise. The risk to global growth will grow worse in our view if politicians succumb to the populist approach as the means to resolving our social/economic ills and to stay in power.

There is a good case that all this political uncertainty hijacked economic growth during the third quarter, at least in the developed world. The irony is that growth began to stir in the emerging and developing world. Nonetheless, there was no recovery in the level of 30-year U.S. Treasury yields, the global risk-free bond benchmark. The close on June 30 was 2.29%; the close on September 30 was 2.31%.

The Treasury market's persistent anxiety in the third quarter reflected the general character of the global fixed income and interest rate landscape these days, an environment that is surreal! There is nearly USD 12 trillion in negative yielding corporate and sovereign debt in the Bloomberg Barclays Global Aggregate Index, divided roughly equally between Europe and Japan. Over 70% of the Citigroup World Government Bond Index is trading below a 1% yield. The European Central Bank (ECB) participates in private corporate bond placements; the yield on short-term corporate AA or better credit in Europe is less than zero. Savers need to pay a bank interest to hold their deposits in several European countries. Germany's largest commercial bank has only $15 billion in market cap after raising $31 billion in equity and is at risk of bankruptcy 8 years after the Global Financial Crisis. The U.S. has had near zero interest rates over this time, and the cash on the balance sheet of the 10 largest central banks in the world exceeds USD $20 trillion. Central banks' ability to reflate price levels, at least in the developed world, appears exhausted, yet they continue to engineer new forms of unorthodoxy. For the Bank of Japan (BOJ), it is "Quantitative and Qualitative Monetary Easing with Yield Curve Control." In the U.S., Federal Reserve (Fed) Chair Yellen has openly discussed the possibility of buying other assets besides government bonds.

Beyond fear, the prevailing fundamental factors which connect many of the dots in today's fixed income markets are low nominal gross domestic product (GDP) growth, deleveraging in American households, fiscal austerity, excess productive capacity in China, too much debt almost everywhere, and growing conviction that central banks cannot create inflation. Increasingly, investors and policymakers are buying into the story of "secular stagnation," the theory championed by Harvard heavyweight Larry Summers. The world is characterized by a dearth of investment opportunity, an absence of demand, and an excess of savings, or so goes his theory. Extrapolating into a future of dwindling or contracting labor supply along with persistently underwhelming productivity trends argues lower for longer—interest rates, bond yields, and nominal GDP growth.

The strategy is invested for a somewhat different story. We believe that sovereign bonds in the developed countries offer no value and in some instances are severely overvalued and extremely risky. As such, we are short bonds in the U.K., France, and Germany, and the strategy is skewed to the emerging world, unhedged.

Explicit in our strategy construction is our macro call for a slow but gradual improvement in the world economy, an outcome at odds with developed country bond markets that seem priced for something far worse. Less

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explicit but embedded in positioning is a growing sense that we are transitioning to a secular change in the trend of global interest rates from a steady downward trajectory to a flatter trading range—at least initially—with yields currently at the low end of that range.

Here is a mixture of cyclical and secular views that support these thoughts and positioning.

ON THE SECULAR FRONT

1. The main propellants behind the post-2008 "new normal" seem to be losing momentum. The U.S. household debt-to-personal income ratio has stopped declining, and debt-servicing ratios remain very low. It looks to us like deleveraging has ended for the time being in U.S. households.

   At the same time, the growth of Chinese nominal GDP growth and emerging market private sector consumption has bottomed out.

   These are important developments *if sustained*. In our view, the post-2008 environment has been dominated mainly by the collapse in the U.S. household debt supercycle and the corresponding consolidation in Chinese corporate spending. The synchronicity of credit-financed American consumption and Chinese production defined the pre-2008 global economy. It all came to an end with the U.S. real estate bust which drove U.S. household savings higher and punched a hole in global demand. The Chinese authorities responded initially by propping up domestic spending through massive fiscal stimulus but ultimately reversed course which sent domestic nominal GDP growth from 25% in 2007 to less than 6% last year. The realignment/stabilization of these two trends would remove a big factor behind the subnormal new normal of the last eight years.
2. Fiscal policy is shifting globally. The operative word for fiscal policy the last five years has been austerity, which has made the global savings glut worse! There is a growing sense among the policy elites of the world that monetary policy has been exhausted and now it is fiscal policy's turn. Larry Summers has been relentless in calling for infrastructure and government spending as the policy prescription for secular stagnation. The International Monetary Fund (IMF) is calling for the same. Ultimately, a shift from the recent stance even to neutral would be significant.
3. Policymakers are beginning to realize that negative interest rates are potentially an academic exercise gone bad. Negative interest rates may have propped up asset prices, but they have crushed interest savings, undermined banking profitability and credit flows, and forced individuals to save more. Worries about their economic future under these conditions mean that retiring baby boomers dampen their spending and boost savings. Bank of England Governor Mark Carney is categorical in his objection to using negative rates, and both the ECB and the BOJ seem to be retreating from this policy.
4. Deutsche Bank may be the final act in an eight-year drama of recapitalization and reregulation of the Western banking system. And, let's not forget the Italian and Portuguese banks. Nothing like kicking a man when he is down—or in this case an entire sector. The world's regulators chose to follow the U.S. real estate bust and European sovereign debt crisis with a punishing legislative program aimed at increasing capital provisions, imposing more severe lending restrictions, and curtailing banks' profit-making activities. Besides curbing bank lending, these measures have helped put a bid into safe-haven government debt by raising the bar on what constitutes liquid capital on banks' balance sheets required to meet new and more stringent stress tests.
5. Lastly, productivity may not be the force weighing on interest rates that the secular "stagnationists" believe. What is really happening to productivity may not be best reflected the way it is currently measured. Economists measure productivity growth simply as the growth rate of real GDP per capita. Economic growth has slowed in the last 10 years, so it is no surprise that this measure would slow too. But one sign that productivity may be about to pick up is the growth in U.S. wages. The Atlanta Fed's wage tracker shows growth already of about 3.5%, indicating real wages are rising.

ON THE CYCLICAL FRONT

The post-2008 deflationary contraction in U.S. household leverage and the compression in Chinese economic growth have unfolded in waves over the last eight years. The first wave was the U.S. real estate bust. The second wave was the European sovereign credit crisis. The third and most recent has been the slump in global growth from early 2014 to date. Each wave has been followed by a reflationary initiative which has boosted growth, albeit temporarily. In 2009, it was the G20 package of coordinated policy stimulus. In 2012, it was a combination of the "do whatever it takes" mandate from ECB President Draghi, Abenomics, and open-ended quantitative easing by the Fed.

The third concerted reflationary response came earlier this year. The difference this time is that reflationary initiatives could stick for longer, if secular influences are losing momentum.

- The Chinese ramped up fiscal spending this year in order to stabilize the decline in nominal GDP growth.
- The Fed has been ratcheting lower its dot-plot trajectory all year. Increasingly, senior Fed spokespersons like Chair Yellen and Vice Chair Fischer talk about a low and long-lasting equilibrium policy rate.
- Lastly, the U.S. dollar has stabilized, which permitted policymakers in the emerging world to provide domestic monetary stimulus. This trend has turned a vicious cycle of weakening emerging market (EM) currencies, rising inflation and interest rates, and slower growing economies into a virtuous cycle of strengthening EM currencies, falling inflation and interest rates, and faster growth.
- Global short-term interest rates have been falling since early 2015 largely on the back of EM countries gradually being able to ease domestic monetary policy.

- Finally, part of the stabilization could be a long-lagged reaction to the most recent rounds of monetary stimulus in some of the developed parts of the world, although this view runs counter to current conventional thinking. However, there has been massive stimulus added to the global economy via the ECB's asset purchase program which started in early 2015, Japan's expanded asset purchase program which began in late 2014, and the most recent step up by the Bank of England. Not to be forgotten are the stimulative effects from this year's compression in corporate bond spreads.

Our expectation all year has been that the world economy would do better than expected and that the marginal source of improvement would be the developing and emerging world. So far this expectation is playing out.

- The Organisation for Economic Cooperation and Development's (OECD) global leading indicator of economic activity remains fairly flat but turns up when the six largest non-member countries are added.
- The global composite Purchasing Managers' Index (PMI) published by JP Morgan also appears to have stabilized well above 50.
- China is clearly the focus of the turnaround in the emerging and developing basket of countries which currently account for over 60% of the level of global GDP. What is noteworthy in China is the improvement in nominal GDP growth, a corresponding turnaround in business conditions, and stabilization in China's producer price index—after falling for over four years. Not surprisingly, export data from neighboring economies is beginning to pick up. The PMI for Singapore, regional trade *entrepôt*, has recovered off the lows of the first quarter and reported a new high in September. There are similar signs of stability in other parts of the EM economic universe.
- Commodity prices have stabilized notwithstanding the recent hit to gold. The U.S. dollar and global liquidity measures which take account of foreign exchange reserves in the emerging countries are closely connected with commodity prices. But, capital is attracted to growth, and the marginal improvements in global growth are coming from the emerging world. Therefore EM currency stability and strength should remain a feature of the global investment outlook.
- Growth appears slow and steady in the U.S., with the September Institute for Supply Management reports downgrading the risk of recession. But, there does not seem to be much of a growth impulse. Similarly, European growth remains reasonable if not slowing slightly. The rise in oil prices relative to gold has historically telegraphed a shift from liquidity dominated asset markets to trends dominated more by economic growth. The recent bottoming in the number of oil rigs in the U.S. is another sign that the economic fallout from the plunge in oil prices is over, in our view.

By conventional measures, risk is rising as the central theme for the macroeconomic story slowly swings from an investment regime built on liquidity and unorthodox stimulus to one based on growth from the emerging world. The growing hint of regime change means those assets with value derived mainly from the capitalization effects of low interest rates stand to be most at risk.

PERFORMANCE AND POSITIONING

The Global Unconstrained Fixed Income strategy composite gained 0.80% gross of fees (0.61% net), outperforming the 0.07% return of the Citigroup 3-Month U.S. Treasury Bill Index for the third quarter. More importantly, we believe that risk-adjusted performance is significantly better considering that global fixed income returns have been driven by the collapse in developed country yields where "0%" is the new equilibrium level. If Larry Summers' financial repression plays out, they may be a store of value—if one believes the return of one's asset is a value proposition. We have another perspective; we believe the risk of permanent capital loss is very high. Is a 50 basis points move in long rates that outrageous? As mentioned earlier in our letter, we are short these bond markets. Meanwhile unhedged exposures to South African, Indonesian, and Hungarian government bonds were the largest contributors to returns.

We continue to believe that overall positioning is in line with where we see value and what the likely macro outcome will be. In general terms, strategy duration is skewed away from the developed world and toward emerging market sovereign bonds. We strongly believe the "safe haven" bonds are the riskiest bonds in the global bond universe. In this respect, the recent sell-off in the German bond market might be the beginning of what could be significant mean reversion in this market as the European outlook stabilizes and the central bank contemplates tapering its asset purchases.

Going forward, the outcome of the U.S. election could pose asymmetric risk for the Treasury market. A victory by Donald Trump could be quite bearish, at least initially, in anticipation of his pledge to cut taxes and boost spending. A victory by Hillary Clinton might be seen more as a continuation of the status quo, however, the diminution in uncertainty might be enough to destabilize the market as we wrote earlier. Political risk is at record levels of uncertainty, and asset prices are priced to the uncertainty. The rhetorical question: What happens to prices if this uncertainty dissipates? With reversion to the mean a key underlying tenant of our investment process, this anomaly of extreme "political uncertainty" seems exploitable to us.

The largest detractor from quarterly results and one of the most disappointing components of the strategy this year has been the Mexican peso. Mexican bonos are a significant portion of the strategy and are held unhedged. The weakness in the peso has been notable when ranked against other EM currencies. The weakness this year in the face of generalized EM currency stability and strength elsewhere is especially noteworthy.

There are two main problems for the peso. The first is the balance of payments. The energy crisis and impact on oil exports caused Mexico's current account to nearly double despite large gains in the exports of automobiles and auto parts into the U.S. Until recently, Mexico's central bank did not raise rates and squeeze domestic absorption, unlike other EM central banks. However, the price of the currency would appear to have more than discounted this factor. Mexico's real effective exchange rate at the end of July dropped to the lowest level since early 1996, according to the IMF. The weakness since that time implies that the currency is cheaper than any time since 1995, or since the Tequila crisis, which saw Mexico default on its sovereign debt. Current conditions in the country are far better now than at that time—in fact, there is no comparison. In addition, oil has stabilized, which should help prop up the balance of payments.

It is hard not to conclude that a substantial part of the weakness in the peso can be correlated with the probability the market has given to a Trump victory in November. The Republican candidate has made a number of statements likely to disaffect relations with Mexico and has repeatedly promised to tear up the North American Free Trade Agreement (NAFTA). Again, it seems that a lot may be reflected in the price of the currency, judging from his visit with Mexican President Enrique Pena-Nieto, which seemed to show a more pragmatic approach. In addition, Trump has since retreated from a position of scrapping NAFTA to renegotiating the treaty. As implied in our opening paragraph, a Trump administration would be constrained by the other two branches of the government.

OUTLOOK

Summing up our view, we believe that risk is rising. Asset prices capitalized by interest rates benefit from the current surreal interest rate landscape and will continue to do so as long as the current regime persists. Last year at this time, our story was very simple and tied to the unsustainability of further dollar strength. The simple version of our view: the dollar falls, commodity prices rise, EM currencies rise, EM rates fall, and we end a vicious cycle and begin a virtuous cycle of lower rates and better growth. This strategy has worked well and has tested our mettle with the recent extreme rise in political uncertainty. We took advantage of this uncertainty to fade or even short bonds in the developed world. Our strategy has shifted around the theme of “Something Stirring” in the global economy. If this theme plays out as we expect, our current positioning should do much better than the benchmark.

Supplemental Information to the attached Global Unconstrained Fixed Income GIPS compliant composite.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	C3MTB	USL3M
QTD	0.80	0.61	0.07	0.20
YTD	4.50	3.92	0.19	0.51
1 Year	4.55	3.77	0.20	0.62
3 Year	2.29	1.53	0.09	0.37
5 Year	4.23	3.36	0.08	0.38
7 Year	4.18	3.19	0.09	0.36
Since Inception	4.60	3.56	0.19	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
2016	4.50	3.92	0.19	0.51	8	4,111	69,540	0.11	4.50	0.03	0.06
2015	- 4.57	- 5.29	0.03	0.31	9	4,635	68,819	0.21	4.53	0.01	0.02
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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Creation date: June 1, 2012. The Composite includes all fully discretionary, fee-paying, actively managed Global Unconstrained Fixed Income 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. Effective March 31, 2016, the composite was changed from "Global Opportunistic Absolute Return" to more accurately reflect the strategy's investable universe. 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. 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: The Institutional Client Separate Account Management Fee Schedule (minimum initial investment: $50 million): 0.750% on the first $50 million; 0.650% on any portion of assets in excess of $50 million or a base fee of 0.15% plus 15.00% of performance in excess of the 3 month Treasury Bill (Citigroup Index). Institutional Client Commingled Account Management Fee Schedule (minimum initial investment: $1 million): 0.650% Flat fee on all assets or a base fee of 0.15% plus 15.00% of performance in excess of the 3 month Treasury Bill (Citigroup Index) 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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