1167 CAPITAL

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The View from 1167 | The Hour of Active

According to most mainstream forecasters, the global economy is through the worst of its recent slowdown. In its April forecasts, for example, the IMF projects global growth to pick up from +3.3% this year to +3.6% next – driven by an acceleration in emerging market (EM) growth (+4.4% in 2019 and +4.8% in 2020) more than making up for stagnant developed market (DM) prospects (+1.8% this year, +1.7% next).

By itself, this benign outlook would suggest that everything is well set for EM LC government bonds over the next 18 months. The income yields currently available (around 7% per annum) after the 2018 late summer sell-off deliver very attractive levels of steady income – and there is the added potential for falling global bond yields and strengthening EM currencies to turbo-charge total returns with a dose of capital gains as well; the usual trinity of factors that drive total returns.

Most investors are not convinced that things are quite so simple, however – and rightly so, in our view. They see several disruptive threats looming over the baseline scenario above:

- What if the current DM slowdown is more extreme than expected – with the boom times in the US especially turning to bust?
- What if the ongoing US-China trade dispute is not resolved amicably?
- What if the US dollar continues to strengthen, squeezing the global financial system where it hurts the most?

The net result of this tension between a positive fundamental base case and extensive downside risks has been an increase in uncertainty and a step change in market volatility.

It is at times like this that active management has an opportunity to prove the value it can add. After two years of exceptionally correlated returns in EM bond markets – a paradise for passive investment styles – it seems that the Hour of Active could just be at hand.

In this *View from 1167*, we'd therefore like to address each of the potential threats above in turn – answering three questions for each:

- What is our assessment of the threat?
- How are we positioning the Funds to protect against – and potentially profit from – it?
- How do we think it will evolve from here?

Threat 1: Global slowdown ahead?

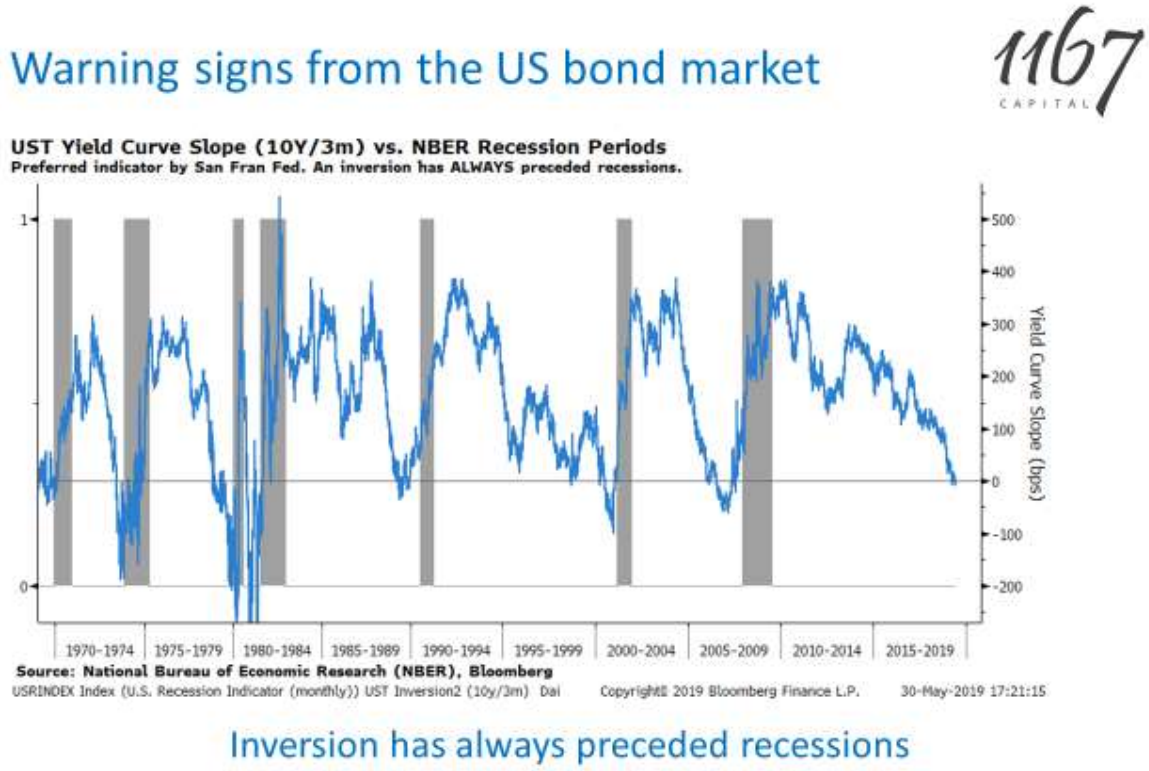
Assessment: Our views on this theme will already be familiar to most of you. In January, we set out three arguments:

- The Fed may already have gone too far in tightening US monetary policy;
- Any subsequent slowdown will be exaggerated by the very high level of private and public sector debt; and
- US Treasury yields may therefore have peaked.

We positioned for this scenario by adding significantly to the Funds' duration in Q4 2018 – taking it from around 4 at the end of September to around 8 at the end of January, 2019, with approximately half the increase coming from a direct increase in exposure to the long end of the US Treasury yield curve (via call options), and the rest from extending the duration of the Funds' EM bond portfolio in a concentrated range of markets.

With the strong rally in US Treasuries over the period given a second wind by the Fed's pivot on interest rates in January, this positioning played out well in Q1 2019. Where do we stand now, mid-way through Q2 2019?

In a sense, not a lot has changed – as the old saw goes, monetary policy works with "long and variable lags", and the consequences of the Fed's policy error in raising rates too far too fast will take some time to play out. Indeed, one of the most reliable historical predictors of a US recession – the inversion of the yield curve, measured between the 10-year and 3-month Treasury yields – has now been triggered three times over the past two months (once in March and twice in May, with the latest inversion being more aggressive than the first two):



Does this mean a US recession is definitely bearing down on us sooner than expected? We are no wiser than anyone else on that question. But we do believe that on the basis of data like this it is sensible to insure the portfolio against such risks.

Positioning: We have taken three steps – the first tactical, two more strategic:

- Tactical: full hedging of EM currencies most sensitive to global risk-aversion
    - We have fully hedged the Funds' exposure to the Mexican peso and the South African rand, thereby reducing overall EM currency exposure meaningfully.
    - This tactical re-positioning is aimed at damping down the Funds' overall sensitivity to global risk-aversion: as two of the most liquid EM currencies, the peso and the rand are deployed heavily as proxies for EM risk generally.

- Strategic: long 20-year US Treasury bonds, via options.
    - If the US economic outlook does turn out materially worse, US Treasuries are likely to rally hard – with the longer end of the curve generating the most bang for the buck.
    - The Funds have invested c. 0.2% of NAV in call options to buy 20-year US Treasury futures with underlying notional exposure of c. 36% of NAV. The factsheets show (delta-adjusted) exposure of around half of that as the options are now at-the-money with a delta of 0.5.
    - The options have already served the Funds well but if US 20-year yields (currently yielding 2.5%) were to revisit their 2016 lows of c. 2.0% at the time of the options' expiry, this position would increase in value to c. 2.7% of NAV – for a total profit of c. 2.5% of NAV to the Funds.
    - If the gloom over US prospects turns out to be a red herring, meanwhile, the downside is strictly limited to the option premium (c. 0.2% of NAV).

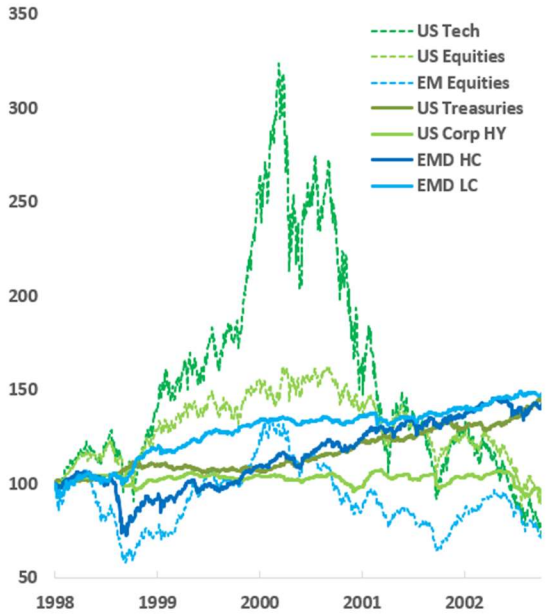
- Strategic: long the Japanese yen, via options.
    - In the various episodes of market turbulence over the past few months, the Japanese yen has yet again shown its colours as the ultimate risk-off, safe-haven asset. We believe it would rally strongly in the event a more pronounced global slowdown becomes the market's base case.
    - The Funds have invested c. 0.1% of NAV in options to buy the Japanese yen against the US dollar. These options are quite long-dated (expiring in early 2020) and struck at an exchange rate of 105 yen to the dollar (c. 4% stronger than today): the low implied volatility making long-dated, out-the-money options of this sort a cheap way to get insurance against a tail-risk scenario, without the need to assume more risky naked long exposure.

Outlook: It would be a mistake, in our view, to become too bearish on emerging market debt (EMD) as an asset class on the basis of a global slowdown narrative. We have put in place the hedges described above to cushion the short-term volatility which we would expect to manifest in a more severe slowdown scenario. But they are also designed in order to allow the Funds to maintain their underlying, strategic long exposure to attractively valued EM LC government bonds.

This is important – because as we also explained in January, history shows that EMD is one of the few asset classes that can deliver significant positive performance even in severe global risk-off environments. We used the chart below, which shows the performance of a range of asset classes over the 1998-2002 boom-bust market cycle, to demonstrate this point.

Can EMD perform when DM equities don't?

Asset Class	Total Return		
	Dec 31 1997 - Mar 9 2000	Mar 9 2000 - Oct 4 2002	Dec 31 1997 - Oct 4 2002
US Tech	223.7%	-77.2%	-26.3%
US Equities	48.8%	-45.3%	-12.1%
EM Equities	31.8%	-45.3%	-27.9%
US Corp HY	4.2%	-8.7%	-4.9%
US Treasuries	9.3%	32.4%	44.7%
EMD HC	15.9%	23.0%	42.5%
EMD LC	34.8%	9.6%	47.7%



Source: Bloomberg. Indices used: US Tech = Nasdaq Composite; US Equities = S&P 500; EM Equities = MSCI Emerging Market Equities; US Corp HY = Bloomberg Barclays US Corporate High Yield; US Treasuries = JPMorgan US Treasuries Index; EM Hard Currency = EMBI Global Diversified; EM Local Currency = JPMorgan ELMI+. All returns calculated using total return indices provided by Bloomberg.

In our assessment, the lesson from this period is that everything depends on starting valuations. EMD started the 1998-2002 with cheap valuations, as a result of EM's mid-90s Balance of Payments crises.

Following the historic 2013-15 bear market, and the abrupt sell-off of H2 2018, our view is that fundamental valuations in many EM LC bond and currency markets remain favourable. A couple of summary charts, showing (i) the spread between the weighted average 10-yr yield of the EM LC index and the 10-year US Treasury yield, and (ii) the Real Effective Exchange Rates of two baskets of EM currencies, are included in Annex 1 to this note to illustrate the point.

The net result is that we have taken advantage of what we see as favourable pricing to implement the hedges described above; but we are reluctant to de-risk too much given the cheap fundamental valuations on offer.

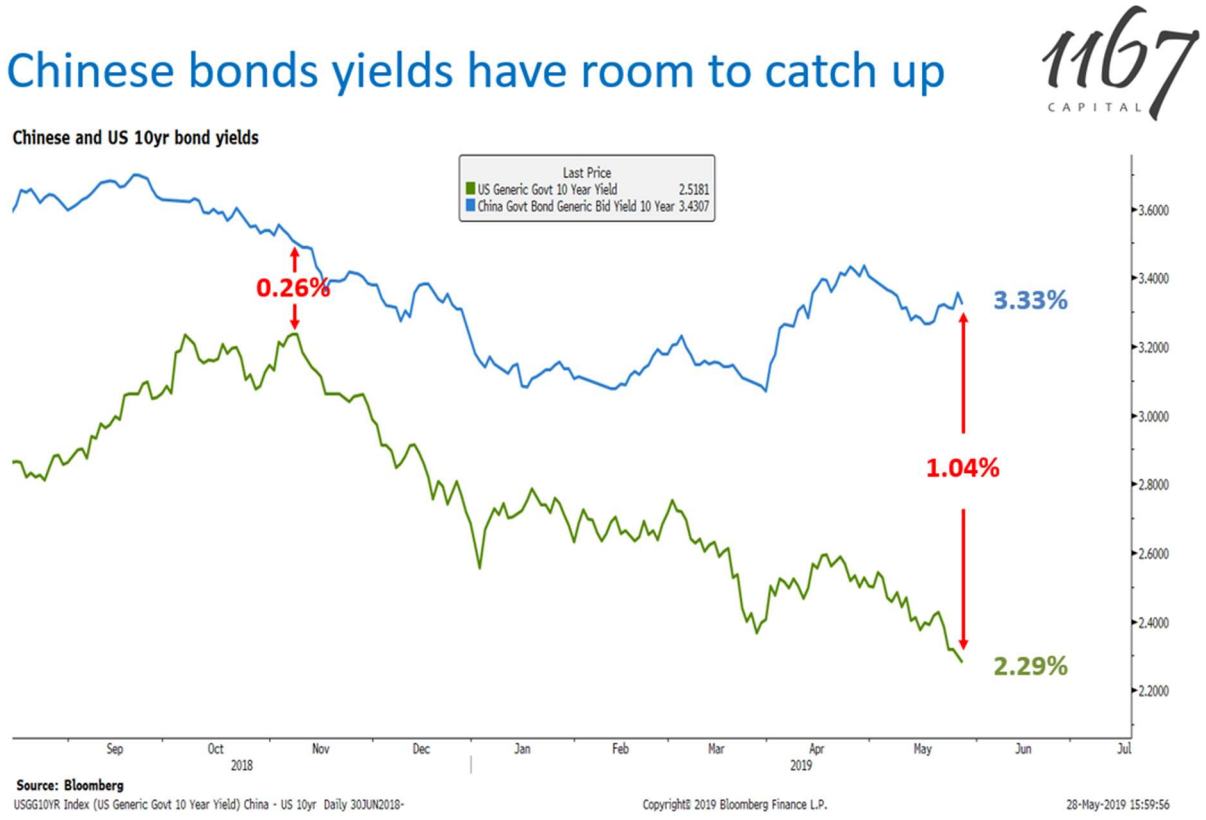
Threat 2: The US-China trade war

Assessment: Our view is that the twists and turns of the week-to-week trade negotiations are a distraction. The big picture is of a long term, strategic confrontation, which is not going to dissipate any time soon, and is likely to take place on many different levels. What matters most for markets in the short term is the effects of the trade dispute on the outlook for US and Chinese growth, and how the US and Chinese authorities respond.

There is no need to overthink the answer. Both Trump and Xi are dead set on trying to cushion the damage as far as possible in order to head off domestic pressure to fold their hand in the trade war.

The US currently finds itself more constrained than its opponent. Fiscal policy has already shot its bolt, with the stimulus of the big tax cuts of 2017 now beginning to wane, and the loss of Congress to the Democrats making any further boost before the 2020 Presidential election highly unlikely. Hence Trump has been reduced to small change compensation payments to affected groups, such as the $16bn doled out to farmers recently. US monetary policy, meanwhile, seems to have got itself the wrong way round, as detailed above – with the Fed having been on a hiking cycle until four months ago, and until recently seemingly impervious to Trump's pleas for monetary stimulus.

China too has already fired a lot of bullets when it comes to stimulating its economy. Most notably, China's appetite for further stimulus either via fiscal policy or via expanding officially directed credit looks limited. In respect of monetary policy, however, China still has significant leeway – and of course isn't constrained by the niceties of the US constitutional separation of powers in deploying it. Put bluntly, Chinese long end government bond yields are currently more than one percentage point higher than their US equivalents. In our view, the path of least resistance is for this differential to narrow – perhaps dramatically.



Positioning: The views above are reflected in two main ways in the portfolio:

- <u>Tactical: reduce EM Asia currency exposure.</u>
  - The prospect of looser Chinese monetary policy has shown up first in a weakening of the Chinese yuan – and in sympathy with it, of other EM Asia currencies.
  - In April we therefore reduced the Funds' exposure to the Indonesian rupiah by hedging the rupiah exposure assumed from Indonesian government bond holdings; and in May, we have closed exposure to the Malaysian ringgit.

- Strategic: position for lower Chinese interest rates.
    - We believe looser Chinese monetary policy is the most likely outcome of the ongoing US-China confrontation.
    - In the short term, we intend to position the Funds for such an outcome by receiving non-deliverable Chinese yuan interest rate swaps (off-shore, US dollar-settled IRS instruments contracted between the Funds and their investment bank counterparties which would allow the Funds to profit if Chinese interest rates fall). As cash does not need to be deployed, IRS have the advantage of not being exposed to the currency (which we wish to avoid for the moment).
    - For the longer term, we are well advanced on having the Funds approved by the Chinese regulator to invest directly in Chinese Government Bonds (CGBs). Starting in April, CGBs have begun to be introduced into all the main global and EM bond indices – yet anecdotally most foreign funds are still far from being able to invest (Citi's main strategist reported last week that on a recent trip to Germany he had encountered only one firm whose funds were able to do so!). We have been working to have our Funds approved for trading in CGBs for some months now, and are, we believe, close to approval.

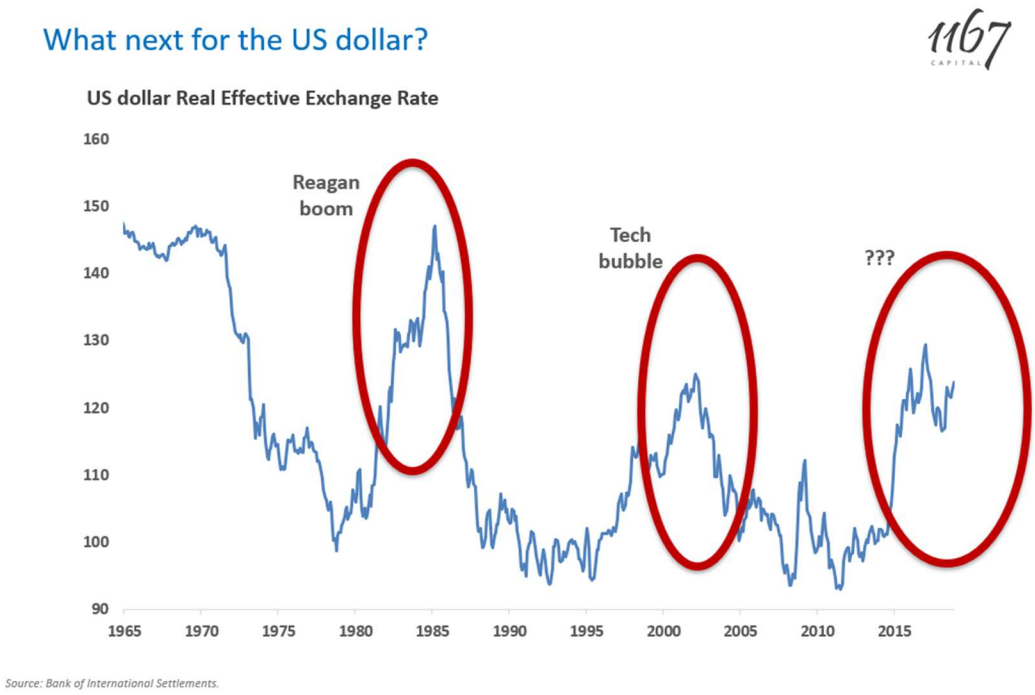
Outlook: The recent actions above are aimed at hedging against and taking advantage of the immediate consequences of looser Chinese monetary policy. We believe that the portfolio is already well positioned for the longer-term impacts.

The Chinese authorities have already announced a new drive for import substitution, aimed at mitigating the effects of the US' decision to protect IP and slowing China's shift towards a current account deficit. This policy will in our view have a much greater effect on DM exporters than EM exporters, however, especially EM commodity exporters, for the simple reason that China is unable to produce many of its commodity needs domestically (save for the "rare earth" elements of course).

We therefore remain comfortable on these grounds maintaining bond allocations to EM exporters exposed to China (e.g. Peru, South Africa, and Indonesia), and limiting protective activity to currency hedging.

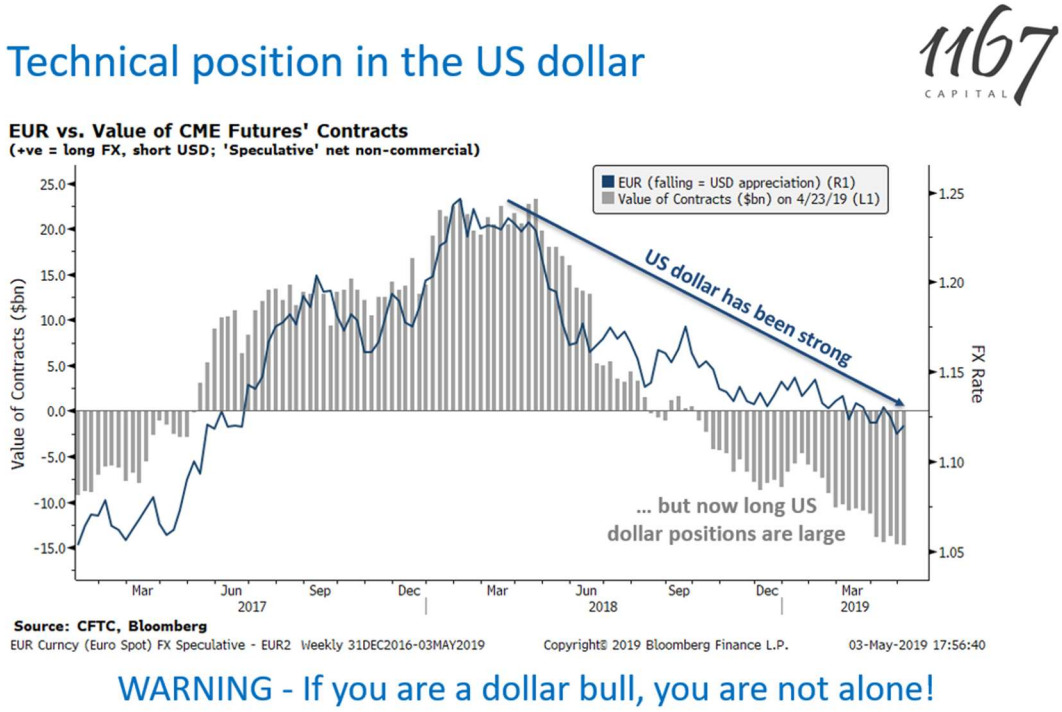
Threat 3: The strong US dollar

Assessment: In January we spelled out the reasons why we think the US dollar may be more vulnerable than it seems. Our first argument rests on valuation: in real, trade-weighted terms, the US dollar is historically rich relative to other currencies, as shown in the next graph. That would suggest that the real economy and trade flows will begin to exert pressure for a weaker US dollar.



Our second argument was cyclical: with the US running a fiscal deficit unprecedented outside of recessions or wars, its public debt projected to balloon to Italian levels within a decade, and the Fed's dramatic pivot on interest rates seeing the yield differential with Europe collapse, the medium-term capital account drivers of US strength look under threat.

Our third argument was technical: data from the US Commodities and Futures Trading Commission (shown in the next graph) suggests that long US dollar positioning is once again quite extreme – indeed, approaching the level it hit in late 2016, before the US dollar weakened significantly against other currencies throughout 2017.



WARNING - If you are a dollar bull, you are not alone!

What do we make of the US dollar's behaviour so far in 2019? The short answer is that we remain entirely convinced that the factors above spell weakness for the US dollar over the medium term. Nevertheless, we are quite ready to acknowledge that the rise in global risk-aversion resulting from the two previous themes above has worked in the opposite direction to produce a stronger US dollar in the short term – albeit only modestly stronger. There is nothing more foolish than dogmatism in currency trading – and our investment process, with the weight it gives to technical factors on the currency side, recognises this.

Positioning: These views are currently reflected in two aspects of positioning:

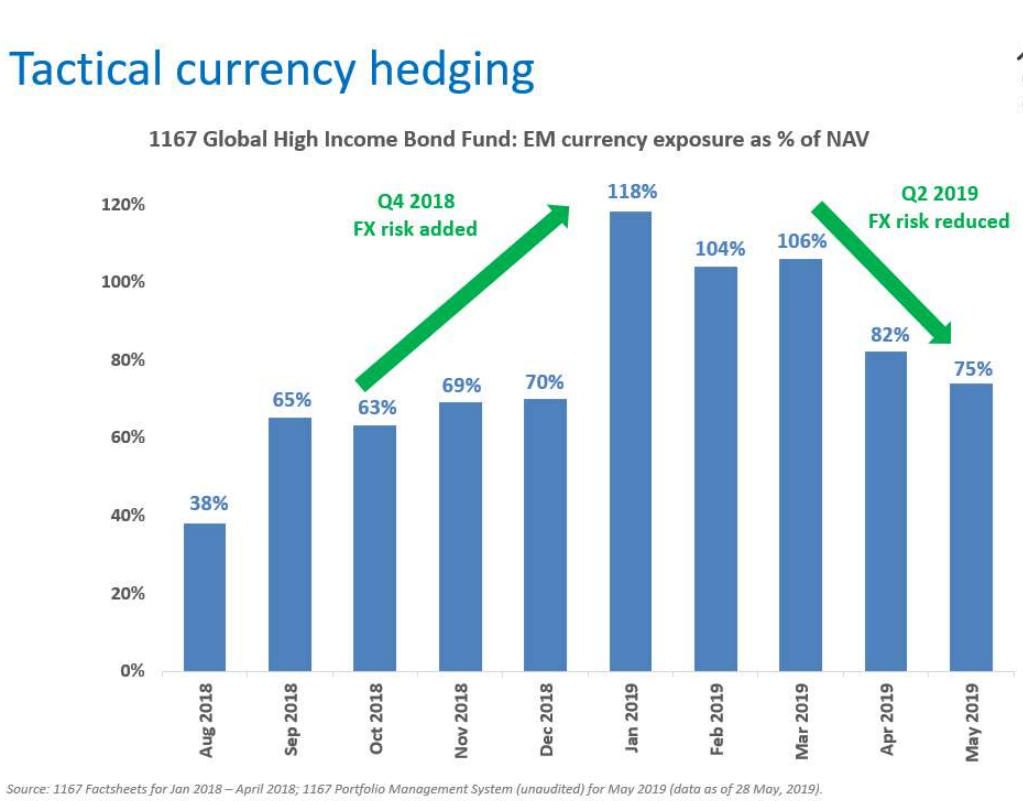
- Long positions in several CEE currencies (but not bonds).
    - The cleanest expression of our strategic view of a weaker trade-weighted US dollar is via long positions in the CEE currencies, being the EM currencies most closely correlated with the euro.
    - The Funds therefore have a c. 25% weighting to CEE currencies (of which c. 15% is to the Polish zloty).
    - This exposure is achieved through simple forward purchases of the currencies in question, rather than through bond holdings – thereby avoiding duration risk in these markets, which we do not think is attractive given their low interest rates.

- Overall FX exposure reduced.
    - On the more tactical timeframe, we took advantage of the rally in EM currencies in Q1 2019 to reduce overall EM currency exposure significantly from a fully invested position in March to less than 75% today.
    - Though concentrated in the more liquid crosses we believe to be most sensitive to global risk aversion (such as the Mexican peso and South African rand), this reduction in effective short US dollar exposure has been widespread, reflecting its motivation.

Outlook: Once again, we have not allowed a tactical view on currencies to contaminate our strategic desire to maintain quite high duration risk in those EM LC bond markets which we see as trading at fundamentally attractive real yields, and which we believe will benefit most from a re-convergence of global bond yields after the Fed's pivot on its hiking cycle. This is particularly true in the case of this strong US dollar theme – because we believe the reasons why the US dollar is currently bid (essentially, global risk aversion driven by Threat 1 and 2 above) are ones that are likely to make global bond markets rally even more than previously expected.

What could be the trigger, meanwhile, for the US dollar's growing accumulation of structural baggage finally to overcome the safe haven bid?

One important shoe that has yet to drop, we suspect, is the behaviour of short-end US interest rates. US yields at longer maturities have already fallen significantly since Q4 2018, closing the gap with other G10 equivalents. The same is not true yet of US interest rates at short maturities – which are historically more closely tied to currency movements. If three-month or six-month US rates (currently more or less unchanged since November, 2018) started to fall towards the two-year rate (already significantly lower), might that finally kick away one of the dollar's key supports? What we do not doubt is that any generalised US dollar weakness would go along with stronger EM currencies, given their historically favourable valuations.



Conclusion

In our view, the underlying three drivers of performance over the coming 18 months are going to be quite traditional:

- **Ongoing Income Yield; The yield differential between EM and the US.** At nearly 5 percentage points, the differential between the average yield on EM LC government bonds and US 10-year Treasuries is back to the wides reached in 2018 – an historically significant advantage for EM LC bonds over their US (let alone other G10) counterparts.

- **Capital Gains from Bonds; The potential for capital gains from easing EM yield curves.** The Fed's major pivot in January is only likely to be extended by any escalation in the US-China dispute, yet several large EM LC bond markets front-ran a much more aggressive Fed hiking cycle in H2 last year, resulting in high real yields and giving ample space for those bond markets to rally.

- **Capital Gains from Currencies; The potential for capital gains from a weaker US dollar.** Our view is that the US dollar is currently quite vulnerable on valuation, positioning and policy grounds. Thus far, 2019 has delivered no definitive verdict one way or other – but we suspect that any significant decline in short-end US rates would quickly return the dollar's structural baggage into the limelight.

In the shorter term, however, we see the three major threats assessed above – and the increased volatility they are generating – as a significant opportunity for active positioning to add value. For these reasons we have:

- Increased portfolio duration from around 4 in Q4 2018 to around 8 today.
- Dialled back EM currency exposure from more than 100% in March, to less than 75% today.
- Given zero weightings to EM LC bond markets with inadequate policies (e.g. Brazil, Turkey).
- Maintained long exposure in EM LC bond markets with high real yields (e.g. Mexico, Indonesia, South Africa) with currency exposure, as discussed, hedged in some of them.

We argued at the start of the year that raw probabilities alone would suggest that the environment of exceptionally correlated returns in EMD obtained throughout 2017 and 2018 was likely to become less synchronised and more volatile in 2019. The ability to navigate the resulting risks with lower volatility and higher returns than a passive strategy is what should set active management apart.

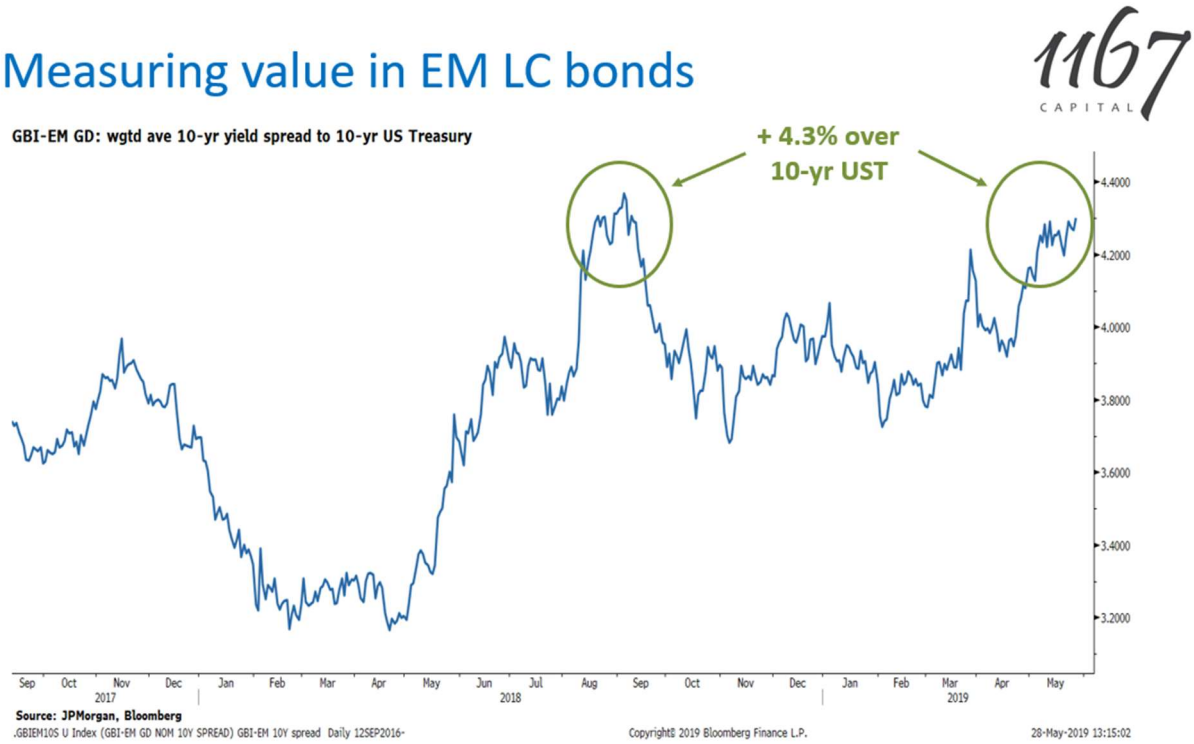
Idiosyncratic News Flash: Argentina

For much of this year the Funds have held c. 5% in Argentinean HC (US dollar) bonds. The factors for (right economic policies in conjunction with the IMF) and against (lots of difficult adjustment still to come) offer a favourable risk-reward as long as President Macri continues to have a reasonable chance of beating Cristina Kirchner in a Presidential run-off. Cristina Kirchner's recent surprise announcement to not run for President but instead to run for Vice-President on a ticket headed by her former Chief of Staff (who has a much lower rejection rating), greatly improves the chance of her pulling the strings in a future Administration. The investment case now relies heavily on the outcome of the election later this year (October) with a material increase in the probability of Kirchner being involved in the country's governance. Therefore we have decided to sell entirely the Funds' exposure. Argentinean exposure has neither added nor subtracted from the Funds' total returns this year, as the high income yields have compensated for the fall in bond prices during April.

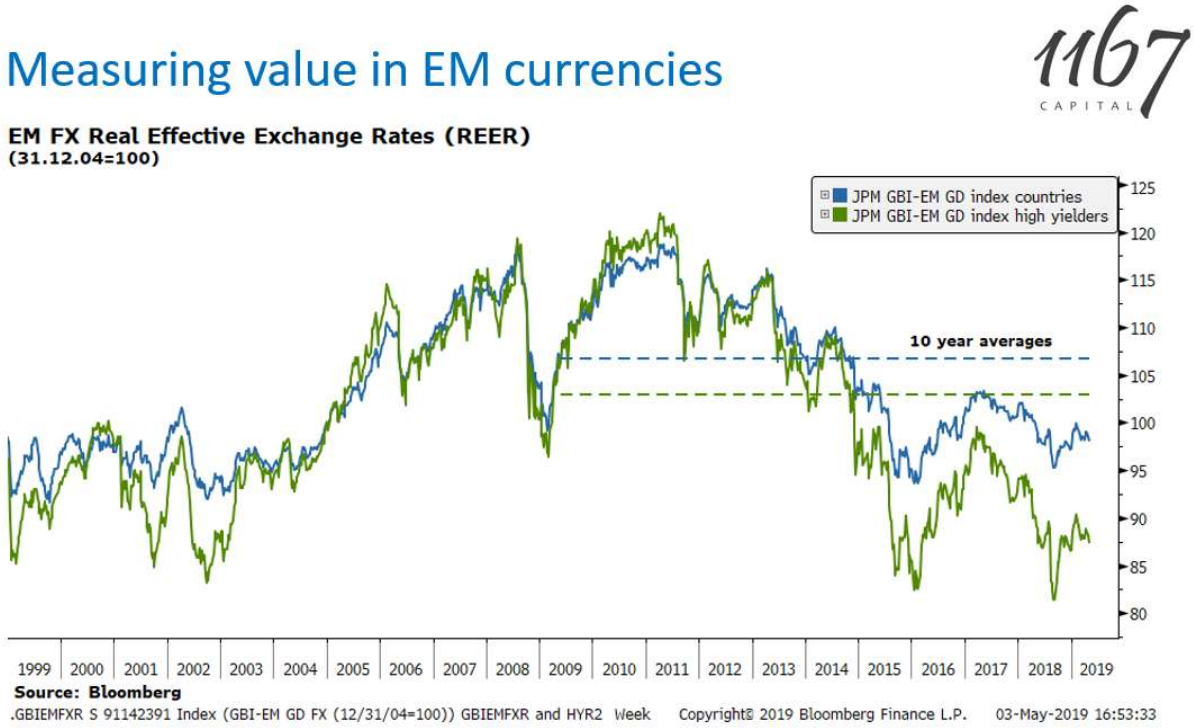
Michael Mabbutt & Felix Martin

Partners and Fund Managers, 1167 Capital

Annex 1 – Current valuation metrics in EM LC bond and currency markets



EM bond yields offer sizeable pick-up over US



EM currencies are historically cheap

Important Notice