Income & Fixed Interest Newsletter

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Hitting the reset button

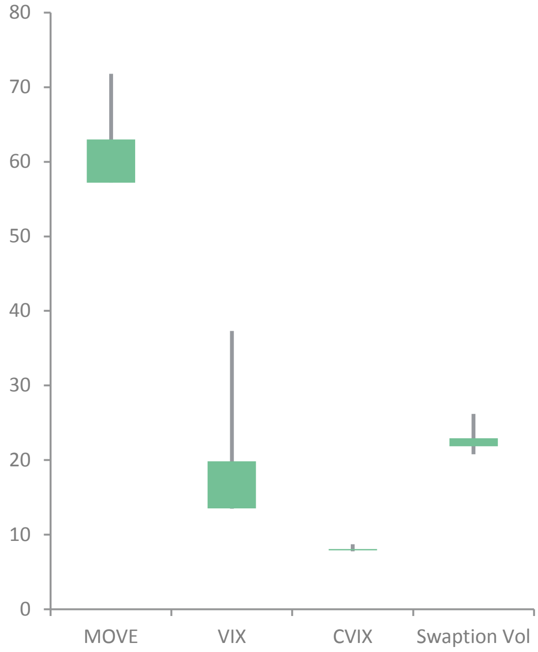
There are two attitudes you can take to the February 2018 "flash crash". The first, and overwhelmingly the most popular, is that this was a technically driven correction in the markets, exacerbated by carry monkeys such as the short-VIX crowd, and that the pause since then has provided a refresh in a bull trend that remains well and truly intact. The second view, and much closer take to ours, is that the highs seen in the S&P 500 index on 26th January will be the highs of this cycle and the ensuing volatility marked the beginning of a protracted period of adjustments needed to realign asset valuations with a new reality. I suppose there could be a third attitude which is that the February crash signalled "game over" and equity markets are going to be taken round the back of the bike sheds for a kicking, and normally I would be the first to voice that position, but not right now. Not yet.

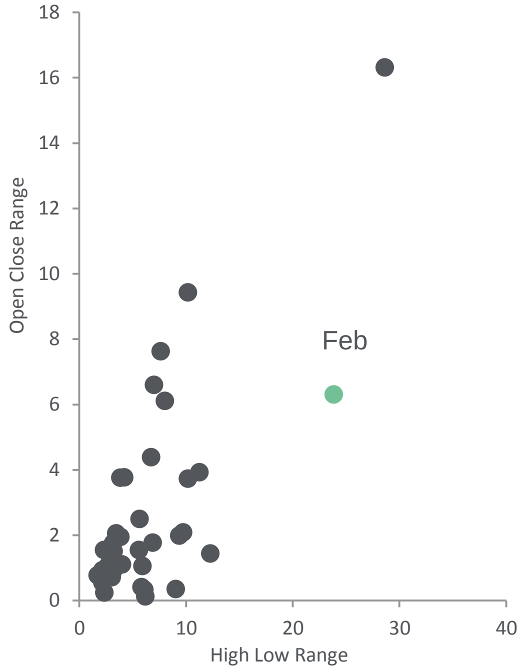
As Q1 drew to a close, we were hearing a mix of optimism and caution among our client base, with questions ranging from "shouldn't you be less bearish given the tax deal struck in the US?" to "why has LIBOR-OIS widened to crisis levels and does this mean we're on the doorstep of the next market melt-down?" Certainly a lot has happened over the last three months, some of which have been obvious (US tax reform) and others less so (LIBOR-OIS), and a lot is still going on (threat of trade wars, Facebook probes). In this month's newsletter, I'll try to piece together the bigger picture as we see it, what it means for markets and asset allocation, and how we'll position for our views.

Bought the dip? Whoops!

For a short while after the February sell-off, the market was back in buy-the-dip mode. This mentality can be seen in the disparity between large intra-month ranges in markets versus small open-close ranges of the month. Even the VIX, which saw intraday highs in the 50s, ended the month only around six points higher than where it had started.

Charts 1 & 2:
Volatile volatility, who'd have thunk it?





Daily close range

Source: Bloomberg

Against market consensus we viewed the February market moves as a foreshock before the main earthquake. This view is being backed up as new sources of volatility have emerged over the course of this month, including new trade tariffs which prompted Cohn's resignation, Tillerson and McMaster being told "you're fired!", and renewed instability led by the FAANGs. But one way or another, we think the S&P would have eventually found its way back down to the key technical levels on which it is now poised.

Chart 3 shows that despite the February dip being bought, the subsequent rally has failed. The market's near term focus has shifted from looking for the next new high to wondering whether the technical supports will hold (as at time of writing on Tuesday 3rd April, they look like they have broken). Also different to February, larger intra-day ranges are being accompanied by larger high-close ranges, which is typical of a rising volatility environment.

Chart 3:
Watch out below

S&P 500 Index candlestick

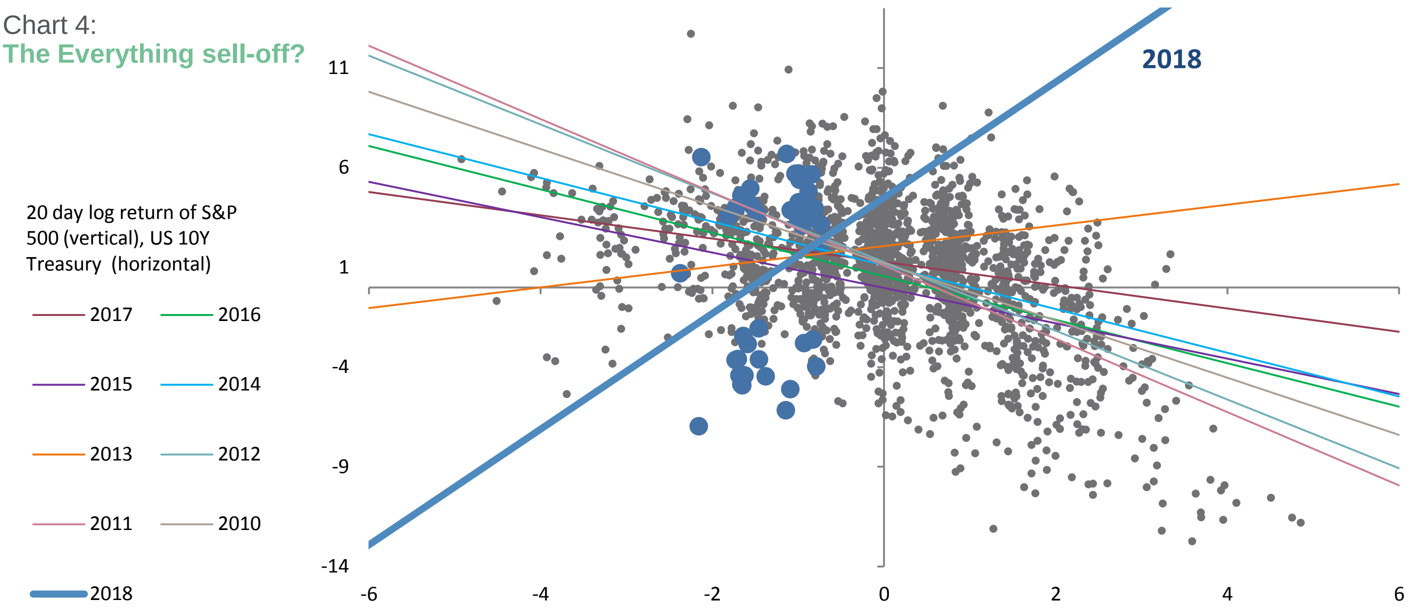
200 per. Mov. Avg. (Close)

100 per. Mov. Avg. (Close)

Source: Bloomberg

But those who rush to bonds for protection are facing an added challenge. As chart 4 shows, for most of this cycle, bond and equity market moves have been negatively correlated with each other. The exception was 2013 and the explanation was the Taper Tantrum. This correlation has flipped to positive in 2018, leaving no place to hide for a traditional balanced portfolio. In this new environment volatility, as an asset class, is the only clear winner and it is for this reason that we are looking to launch the new BTIM Active Volatility Fund (expected to launch late April).

Chart 4:
The Everything sell-off?



Source: Bloomberg

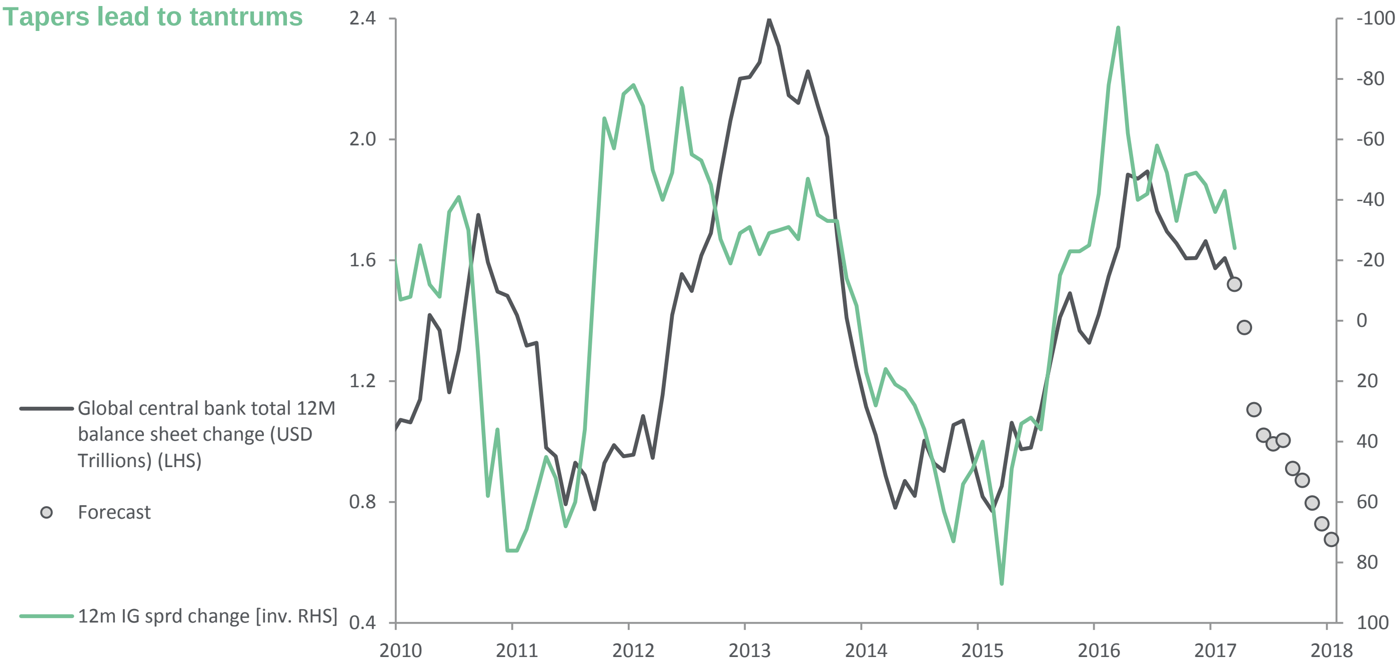
In a way, 2018 is experiencing Taper Tantrum II, a supercharged version, as not only are central banks stepping back from extraordinary liquidity provision, they are also trying to normalise interest rates. The US Federal Reserve's interest rate hiking cycle is well and truly under way because the economic picture clearly justifies it. Other central bankers are getting anxious not because their economies are in danger of overheating, but because when the cycle turns (led inevitably by the US), they are going to need some dry powder in their policy tool box.

Volatility – the return of an old friend

Regular readers will know that we have been calling for a normalisation from the extreme (low) volatility environment for some time. We were too early initially, and last year, we found a smarter way to structure our positioning for this view that afforded us the ability to wait it out. This is important because such views are difficult to time, but our investors rely on us to not only grow but also to *protect* their assets. If we're late, we might as well go home.

Chart 5 shows the main reason for our belief that volatility is headed higher. While the market focus is on central bank's rate hikes, our interest is on the action in the balance sheet. Here central banks are taking away the punch bowl, be it the sell-down of the Fed's balance sheet or the reduced pace of buying from the ECB and the BoJ. As we've shown previously, changes in this global liquidity picture is closely mirrored in market volatility.

Chart 5:
Tapers lead to tantrums



Source: Bloomberg

The intuitive explanation for this relationship is that through the deployment of their balance sheets in massive size, central banks implicitly provided a "put" for asset valuations, whose strike price is only very slightly out-of-the-money. When central banks become the marginal buyer in the market on government and mortgage-backed securities, private investors are crowded out and down the risk curve. This is the much lauded portfolio rebalance effect, and it pushes up asset prices on all other investments until their yields converge on the risk-free rate. Obviously this pushes end investor's portfolios further and further out the risk spectrum, as they chase falling yields, due to the lack of moral hazard in the market.

Not only is it economically appropriate right now to wind back this extraordinary liquidity provision, it is vital if central banks want to re-establish their role as lenders of last resort. Central banks should absolutely step in to end a crisis but they should also not get in the way of a normal economic cycle. We strongly believe that the central bank put should be much further out-of-the-money and we think that's a view that's shared by the new Fed Chairman, Jerome Powell.

The low volatility picture has also been helped by incredibly benign inflation outcomes. When inflation is low and stable, it is a sign that there is a high degree of economic certainty, which is a necessary ingredient to feed risk appetite. However, inflation expectations are starting to tick higher (at least in the US) and coupled with the likelihood of seeing a net drain on global liquidity by early next year, the return of volatility looks to be inevitable to us.

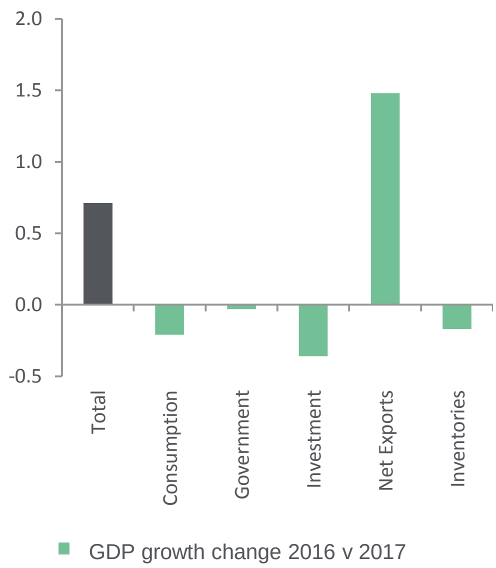
Good, but not that good

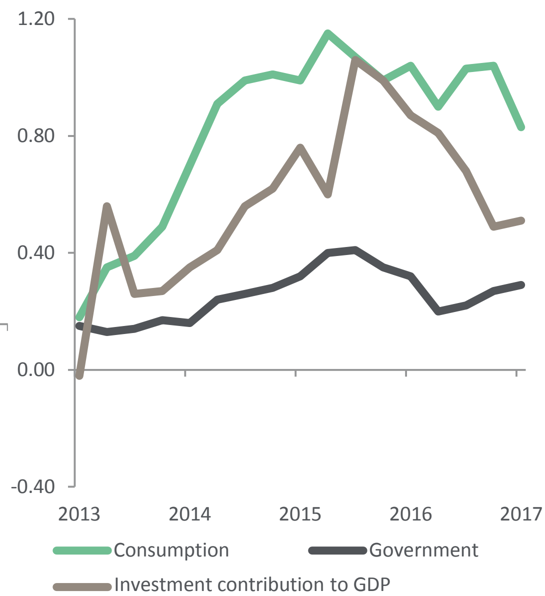
Perhaps I wouldn't be so concerned if we felt that there were sufficient room for fundamentals to improve from here, or if valuations contained a healthier cushion. Currently on both these counts, we find little reason for comfort.

The consensus view, despite some recent doubt, is that it is too early for equity markets to enter a bear market because the fundamentals are just too good. Following a stronger than expected 2017, the World Bank is forecasting global growth to reach 3.1% this year, which if achieved, will be the first time since the GFC that growth will be operating at its full potential. That does sound good, but good enough to warrant the 2,872 seen on the S&P500 index on 26th January? We doubt it. Global growth is humming along, but disguised in that World Bank revision is the disparity between the US economy and the rest of the world.

I've highlighted in previous newsletters how impressive Europe's growth surprise was last year. While initially led by phenomenal export growth, for a short time last year it looked like this momentum was spilling over into endogenous sources of growth throughout the Eurozone economy. The sad news, as chart 7 shows, is that these spill-over effects did not stick, and measures of consumption, investment and government spending show that European growth drivers have been in decline for several months.

Charts 6 & 7:
This doesn't look self-sustaining to me

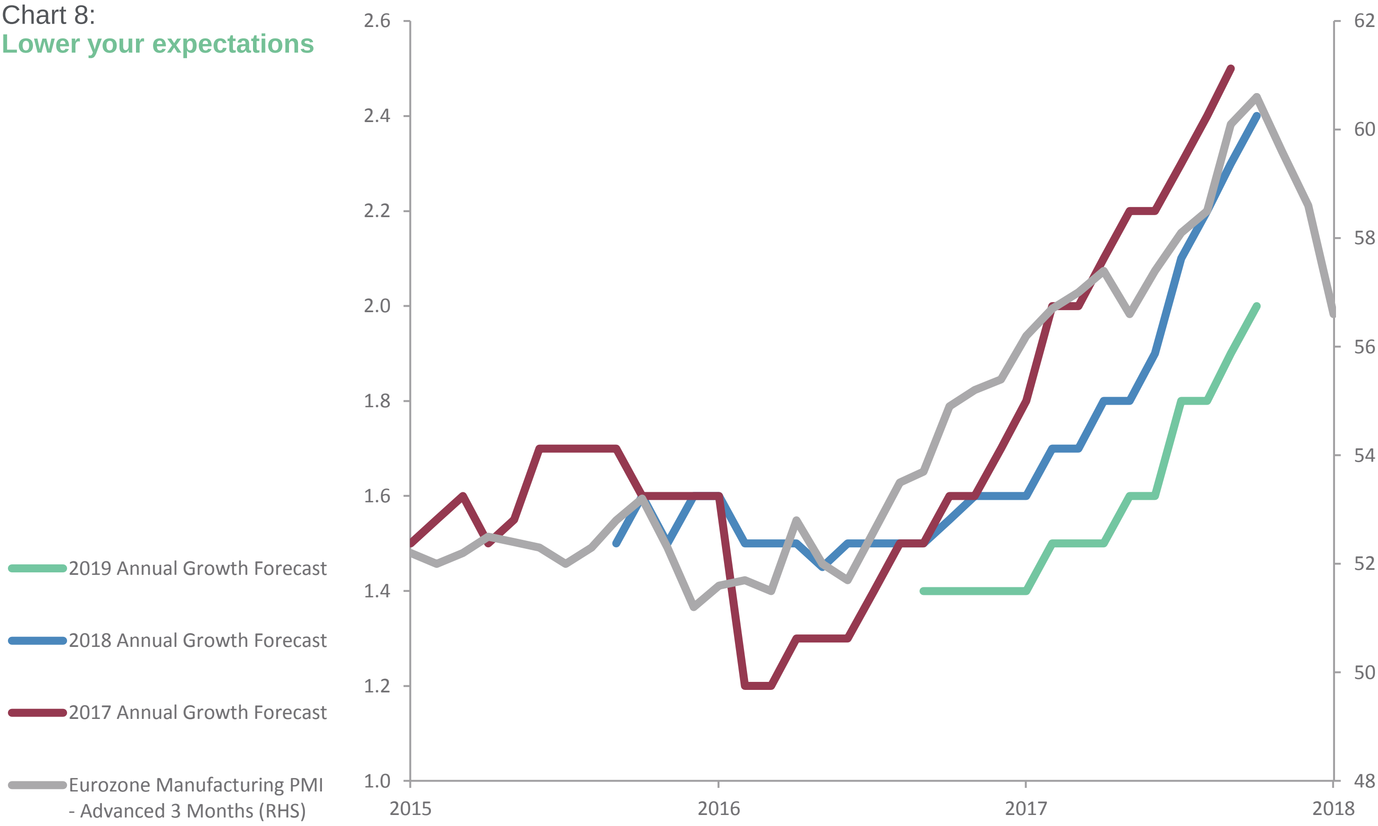




Source: Bloomberg

This is now starting to reflect in manufacturing surveys, which have proven to be a consistent leading indicator to changes in economic conditions. Chart 8 shows that growth forecasts last year took a long time to catch up to reality, but that reality (in the form of European PMIs) has now turned down and will likely deteriorate further as the year goes on.

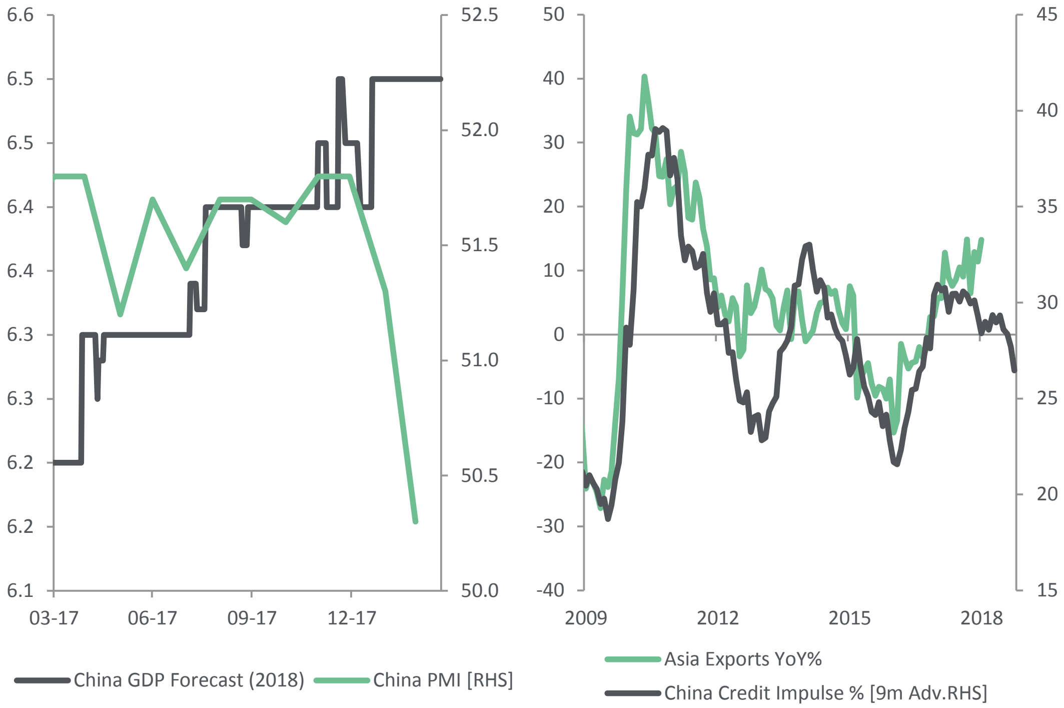
Chart 8:
Lower your expectations



Source: Bloomberg, BTIM

If exports are Europe's last hope on the growth front, then I'm afraid we'll have to dash those hopes as well. The reason for Europe's phenomenal export growth last year was the same as for every other export-led region in the world: China. Chinese growth managed to surprise at 6.9% for 2017, despite concerns over deleveraging and reform, simply because of the sheer economic momentum created by the credit stimulus of 2015/16. The hard work only began at the end of last year, and economic forecasts have yet to catch up with the reality that Chinese PMIs have also turned down significantly. As chart 10 shows, when China slows it will demand less from other exporters, and global trade as a whole will suffer.

Charts 9 & 10:
When China sneezes



Source: Bloomberg

Trade wars *are* easy to win

Over the course of this last month, you will no doubt have seen this Trump quote which has been cited as evidence of his stupidity. Unfortunately for Europe, and especially its car makers, we think Trump is right on this one. As with many of his ideas that have been pooh-poohed by the media (aka "Fake News"), there is validity in his argument that the US needs to seek fairer trading terms with other countries. But the sloppiness of his execution and his inability to articulate those ideas are what typically exposes them to common ridicule.

The Eurozone economy as a whole makes up 20% of the total US trade deficit. Passenger cars form the bulk of European exports, and the US imports nearly 40% of them. The current US tariff charged on an imported Golf is only 2.5%, whereas the Europeans charge 10% on every Mustang and Chevy it imports from the US. If this isn't an easy battle to win, then I don't know what is. What a good job that the Chinese still love Mercs and Beemers. What a shame that economy is also slowing.

Add to this a returning theme: European political instability. We think this is a risk that is growing but largely going unnoticed by markets. The Macron win (or rather, the Le Pen defeat) a year ago in France had restored the market's faith in Europe, and the recent political turmoil unfolding in Italy has been brushed under the carpet as "noise". Quite the opposite is true. The tailwinds from the French election have faded, and Europe has started to face political headwinds again when it least wants it.

Fundamental shifts

With the major economies of Europe and China changing down gears this year, this leaves the US the bright spot in the global economy, not least due to the recently passed tax bill. These tax changes will likely benefit corporate America but only leave pennies for the average American household. Winners of the tax bill include companies like Macy's, who desperately need the extra cash to buy back debt and retain their investment grade rating, whereas losers include retailers like JC Penney who haven't yet returned to profitability but have bloated balance sheets that will suffer from reduced limits on interest expense deductibility. Both these stories paint a sluggish image of the American consumer, for whom QE mattered little.

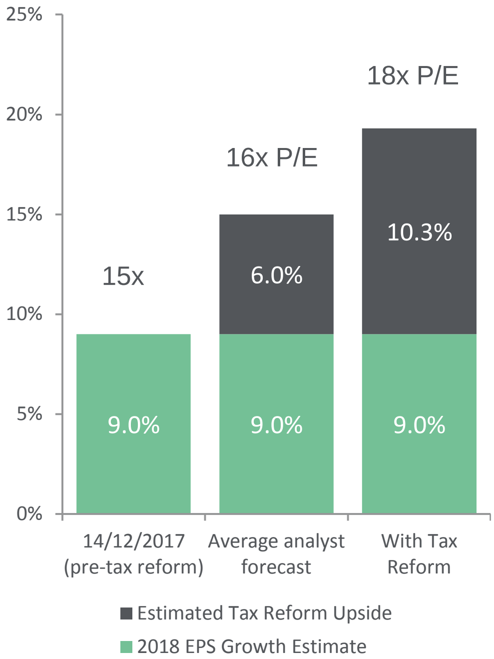
Regardless of the appropriateness in timing, the net result from this fiscal stimulus for equities should be positive. One day before the tax bill was passed, the market had priced in 9% earnings growth for 2018 for the S&P500. This looks solid relative to the 5.5-7.5% growth we've seen in recent years. Our estimates of the full effects of tax reform would lift growth expectations by a further 5-6%, allowing for no negative wage impacts and assuming all tax savings are reinvested. Yet the market has priced in over 10% since last December.

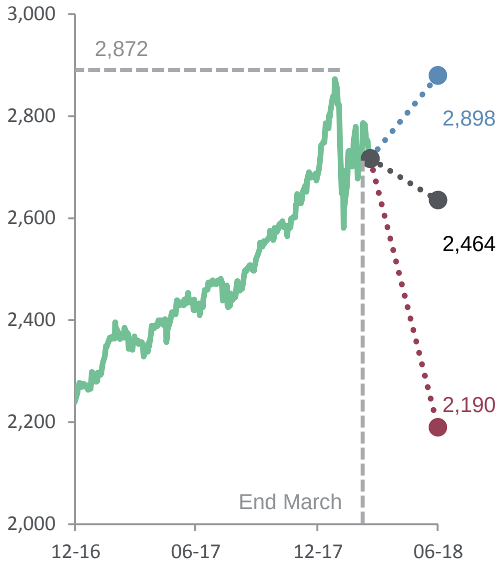
Valuations (forward PE multiples) peaked when the tax bill was passed, which coincided with the day that Bitcoin peaked. Perhaps we'll look back on December 2017 as when we saw excitement reach a peak in this cycle. After all, in order for continued multiple expansion to occur the market has to buy into the improving quality and sustainability of higher earnings. That's a tall order for this part of the economic cycle, and especially given that only around one-third of US companies have indicated any intentions to reinvest their tax savings so far. Even for those dying to reinvest every penny back into their businesses, they may be facing growing wage bills that force them to divert some cash flows away from capex.

Nevertheless, if you put together an optimistic/unrealistic assumption for earnings growth (20.3%) and a hope-fuelled multiple expansion (back to 18x), you only see the S&P500 index rise back to the January highs. A bullish but more realistic earnings assumption coupled with current market multiples leads you to where the index trades today. If you think 9% earnings growth sounds about right, and that multiples compress ever so slightly this year because interest rates and market volatility are both rising, that puts the current S&P500 about 15-20% higher than its 'fair-value'.

The assumptions driving such an over-valuation seem rather benign. Above-average earnings growth relative to the past few years, coupled with only half a turn of compression in valuation multiples, and all of a sudden this warns of the risk of a not insignificant derating in the world's largest equity market.

Charts 11 & 12:
Bulled up much?





Source: Bloomberg

The cycle bites… eventually

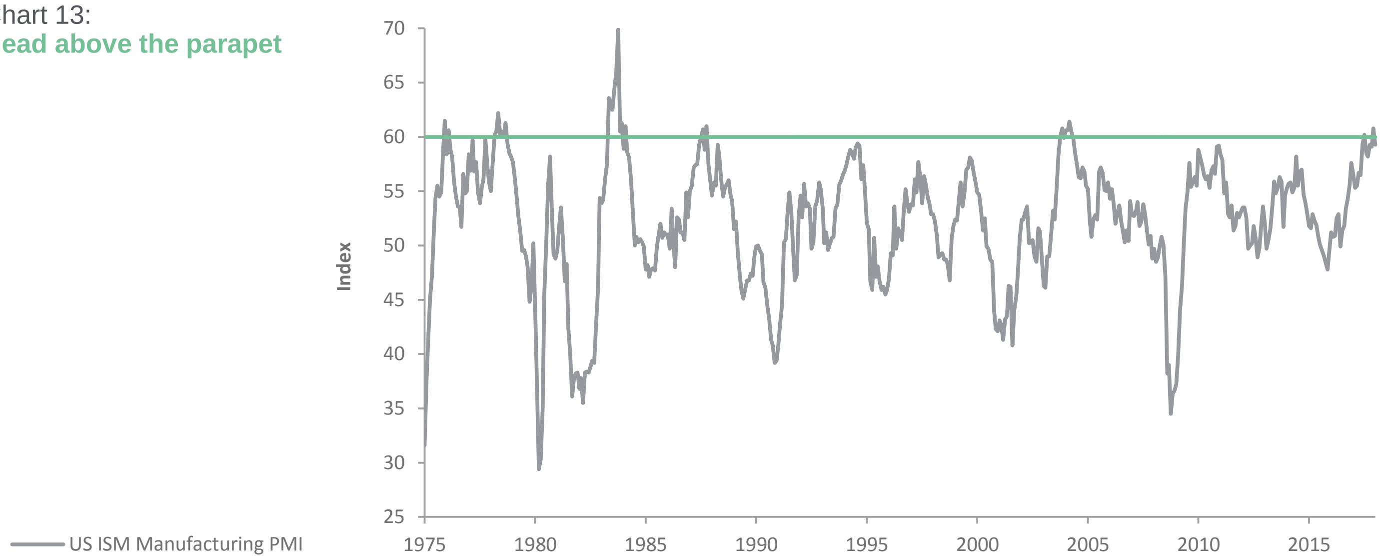
It is crucial to emphasise here that such a correction doesn't employ the use of any recessionary assumptions. As far as we can tell, the cycle's still going but tax reform and the lifting of the US debt ceiling has just accelerated its magnitude and progression. The 'late-cycle' argument for maintaining a bearish stance to risk assets is an issue that comes up for debate often within our team. Economic and market cycles, when central banks allow them to happen, are organic and differentiated, which makes it difficult to identify the turning points until after they've happened. The obsession with late-cycles has to do with how differently the equity market responds to any amount of negative news compared to the rest of the cycle.

Roughly speaking, 'late cycle' refers to the final phase of global economic expansion, during which strong growth expectations start to be muddied by rising inflationary expectations, causing policy uncertainty. The fear of overheating makes the equity market highly sensitive to any deceleration in earnings growth, or any downgrading of earnings expectations. Interest rates become a double edged sword. If earnings do indeed slow, the rally in interest rates will be consistent with the end of the cycle, causing rebalancing of fund flows from equities into bonds. However, if earnings continue to post strong growth momentum, there will be growing risk that central banks have fallen behind the curve, and the overshoot in interest rates causes equities to sell off.

There is a lack of clarity over the US output gap, the slope or even the existence of the Philips curve, and if we are in a 'late-cycle', how long until this cycle ends. But for simplicity's sake, let's assume that 5% unemployment marks the pivot point for the US cycle. The Fed used to believe this was NAIRU (but even they don't know anymore). Let's assume that US manufacturing surveys (ISM) are a strong leading indicator of the economic cycle. Certainly, our investment process employs the use of manufacturing surveys to signal market turning points, and the long term performance of these signals would corroborate that assumption. What's alarming to us is that since 1960 when unemployment has fallen below 5% in the US, regardless of starting valuations, any declines in ISM has resulted in a decline of the S&P500 index in that quarter, with average quarterly annualised declines of around 24%. The US unemployment rate is currently 4.1%, but ISM hit a new cycle high in February of 60.8.

History repeats *and* rhymes

Chart 13:
Head above the parapet



Source: Bloomberg

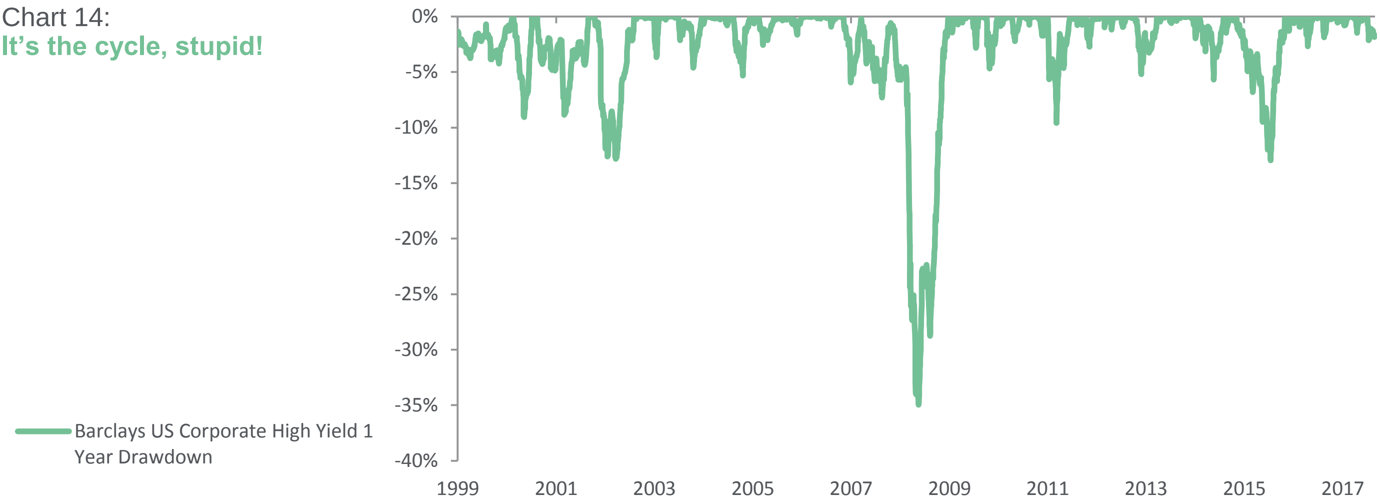
As chart 13 shows, ISM prints of 60 or above have only occurred around 5% of the time since 1975. That February's 60-plus print was the second such print since September 2017. History shows us that within six-to-twelve months of a 60-plus ISM print, the index falls by an average of ten points. Not so bad, since a 50-reading is neutral and indicative of economic activity neither in expansionary nor contractionary mode. However, history also shows us that if the Fed has hiked interest rates in the prior year, the average fall becomes 13.4 points, which would take the index to around 47. At this level on the ISM, America's manufacturing sector is shutting down productive capacity, and bracing itself for a very likely recession ahead.

Late cycles share some common characteristics. Corporate earnings will typically peak, inflation will likely be rising, both of which will bring about the rising cost of capital. Q1 has witnessed two of these three developments, but corporate earnings growth still remains strong. We have shown that earnings expectations are still likely far too high, pricing for significant structural earnings growth this year despite that three-quarters of the S&P500's EPS growth since 2008 has been due to share buy-backs. With tax reform likely distorting the bottom line, the market will likely increase its focus on the trends in operating margins as a gauge for earnings quality.

Pet peeve or silver bullet?

Over the last couple of years, I am sure I have garnered a reputation as "the guy that loves to hate credit". I don't hate credit all the time, just right now. Most credit asset classes have the best Sharpe ratios in the world, when times are good. But when times turn to being less than good, higher yielding credit becomes a punching bag. Chart X below shows that 10-15% drawdowns in high yield markets are fairly normal in many cycles. Credit spreads also have a strong positive correlation with volatility and no more so than after a period of supernormal global liquidity. If we are indeed in late-cycle territory, bonds won't provide sufficient shelter from the storm, and may in fact add to the damage. Shorting credit will cost us negative carry, but in an environment where volatility is bound to rise, this is protection worth paying for.

Chart 14:
It's the cycle, stupid!



Source: Bloomberg

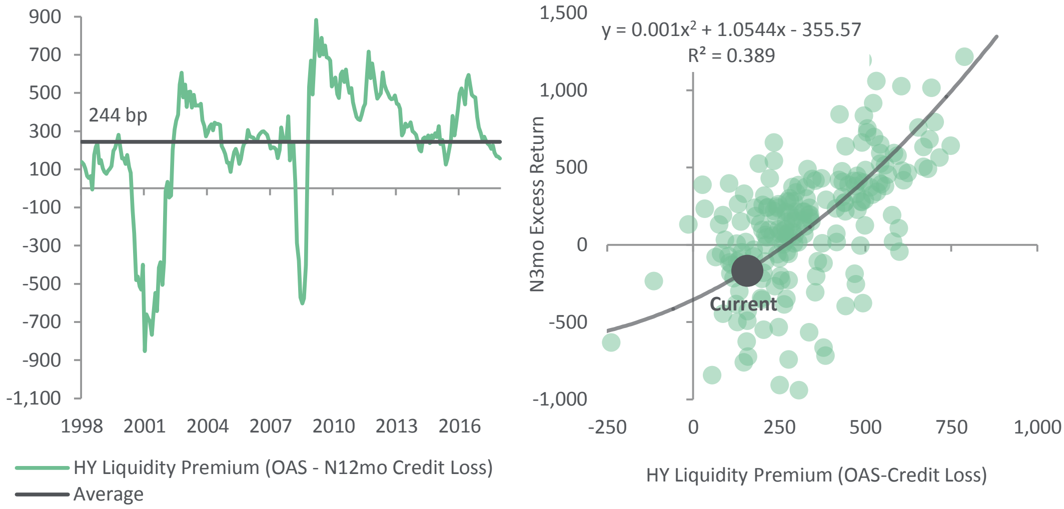
Not all credit asset classes are equally vulnerable, and generally speaking we think US high yield still looks too stretched. As QE displaces private investors into higher risk opportunities, US high yield has benefited from all kinds of new buyers, many of whom have no business being there. We call them high yield tourists. The fundamental vulnerabilities in the retail and telecoms sectors were there even prior to tax reform, but now US homebuilders are facing the prospect of housing recession brought about by reduced deductibility for home loans - another facet of the much hailed tax reform.

The market cares about these fundamentals, but not that much. Typically, these concerns drive differences in performance within the sector throughout most of the economic cycle, and only begin to impact the performance of the entire asset class when people believe defaults are likely to be on the rise. This usually only happens when the market anticipates recession. As we alluded to earlier, the history of ISM tells us to be ready for a recession, but it doesn't appear to becoming just yet.

Like US equities, we have a problem with how the market is valuing US high yield. The CDX HY index traded to a cycle low of close to 290bps on 8th January this year. If you assume defaults are likely to be lower than average this cycle, say around 3%, and recoveries hover around the long-term average of 40%, around 180bps of that spread forms your compensation for expected losses. But what if default rates return to their long term average of around 4-5%? At the same time, it is likely that the rise of a FAANG-heavy, asset-lite world means investors should expect lower bond recoveries in the event of default, let's say 25%. In that case, you'll need a spread of 375bps to compensate you for expected losses. Even with the significant underperformance of the US high yield market relative to equities since January this year, this index still only traded at 360bps at the end of March.

Chart 15 shows that on top of the market needing to be compensated for expected losses, high yield spreads typically trade with a hefty liquidity premium. This makes sense, because as far as risk markets go, high yield is not the one you can count on to get your money back stat when things go wrong. This additional premium averages around 244bps. Although this premium has drifted lower for long periods of time, chart 16 shows that the odds of positive excess returns in the next period start to shrink. For high yield to price even close to fair value, credit spreads should be closer to 575bps. On a five-year credit index, this equates to a repricing of around 9.7%, and fully consistent with a normal cyclical correction.

Charts 15 & 16:
Not paid to own junk



Source: Deutsche Bank, credit loss assumes a 3.25% default rate and 45% recovery rate

What's LIBOR got to do with it?

Since the US tax bill was passed, our concerns have spread from US high yield to US credit in general. The retreat of central bank liquidity has recently revealed plumbing vulnerabilities in the global funding system, symptomised by the widening of LIBOR-OIS spreads (Chart 17), and these vulnerabilities weigh heavily on US investment grade credit.

Put simply, the widening of LIBOR to OIS signals liquidity stress in the global dollar funding market. This stress has been latent since money market reform in late 2016, but has been exacerbated by US fiscal reform. The repatriation tax incentive is causing US corporates to bring back upwards of $1trn to the US, draining the global (Eurodollar) market of the stable funding pool it has come to rely on in recent years. This change is structural. At the same time, the lifting of the debt ceiling coupled with a massive spending plan is causing the US government to issue large amounts of T-bills which are competing with tapering-related issuance that was already ongoing.

With the widening of the LIBOR-OIS spread, the cost of hedging USD FX risk has spiked for foreign investors. This matters when yields and spreads were already so low, and even more so when 40% of the US credit market is held by foreign investors. At the margin, this has also hurt our banks, which have used the offshore CP markets as a cheap and alternate source of funding.

Chart 17:
Pent up frustrations

Source: Bloomberg

When the tide goes out…

The shrinking of global dollar liquidity does not bode well for emerging market economies. In addition to central bank tapering, the US wants to reduce its trade deficit while simultaneously pushing domestic output higher. This will exacerbate the global liquidity shortage as surplus exporting economies see a net decline in their savings whilst US interest rates are rising. Just as with the US corporate market, economies that have relied heavily on deep pools of international Dollar liquidity are going to face a reset in valuations.

The good news is that April may bring about some respite. Globally, this is a time when surplus economies export long-term capital (the Japanese year-end effect). April is also likely to see some easing in the pace of US T-Bill issuance, which is likely to act as a release valve on short term funding pressures elsewhere. The feel-good factor may also be boosted by some near-term easing of protectionism rhetoric. However, these effects will be temporary, providing attractive entry points to further express our theme of rising volatility.

In Europe, we expect poorer growth outcomes to be damaging to the Euro, whilst supporting core European rates markets. In Asia and EM, we expect a weaker China coupled with tighter global funding conditions to trigger significant unwinds of lazy carry trades, and the recently announcement of China's inclusion into the Bloomberg Global Aggregate index will only exacerbate unwinds for assets such as Indonesian bonds. In the US, we continue to be bearish on credit, bullish on the big Dollar. Interestingly, the April effect may see a weaker Yen which we will use as an opportunity to add to longs. Overall, as you can tell for the arguments in this newsletter, our stance is to be defensively positioned but with room to increase our exposure should we get a near-term risk-asset bounce.

The new reality

We recently presented our views in our semi-annual I&FI roadshow, and after one of these sessions, a client remarked that we had left him feeling very bearish. Highlighting the risk of a 10% correction in high yield credit, and 15-20% correction in US equities does sound gloomy in the context of the last few years. But when you consider that a 15-20% US equity correction only puts us back a year, and that such a correction would be driven by fairly innocuous valuation assumptions, it puts current market valuations into perspective.

The point is that valuations have some ways to go to reconcile themselves with the new reality. This reality involves the re-striking of the central bank put, and as a result we have seen that volatility is already on the rise. This reality recognises the uncertainties around the net effects of tax reform, combined with the delivery of fiscal stimulus that the US economy most certainly doesn't need. This reality sees the drain of global liquidity being exacerbated by US economic policy which is increasing inwardly focused. Having said this, a correction in valuations need not be synonymous with the next crisis or even the next recession. Hence, while the risk asset correction we expect probably isn't the "big one", it's one that's definitely overdue.

For more information

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