Letter from the CIO

January 2018

Recapping 2017 and Moving Into 2018

The past year has seen better market performance than we anticipated this time last year. Looking back on 2017, I think that we were a little too cautious but were correct to suggest that relative value decisions would play a more significant role. We are not changing our secular views but we do see potential policy initiatives that point in the right direction.

After the geopolitical surprises of 2016 the relative calm of 2017 was broadly welcomed by investors.

The S&P returned 22.1% in 2017, taking P/E ratios to over 22. Credit markets have performed well with option adjusted spreads in U.S. high yield and emerging markets debt narrowing in excess of 60 basis points (bps). Ten year U.S. Treasury yields finished the year almost exactly where they started as did Japan Government Bonds (JGBs), although that put U.S. Treasury yields at 2.50% while JGBs yielded 4 bps. Bunds are marginally higher in yield at 37 bps compared to 20 bps a year earlier. On the currency front, the U.S. dollar index declined by 9% against a broad basket of currencies. Economies have performed well, if not spectacularly, and our chief economist now expects U.S. growth to come in at 2.2% for 2017, Euro area growth to register 2.4% and Japan 1.8%. These are all above recent trends but not so far above as to cause immediate concerns about overheating. In response, the U.S. Federal Reserve (Fed) raised rates three times in a series of well signaled moves and the European Central Bank (ECB) has indicated the beginning of quantitative easing (QE) tapering.

The past year has seen better market performance than we anticipated this time last year. Two sentences stand out from my letter last January: "Valuations are somewhat expensive but not prohibitively so" and, "For the moment this may be a time to tread carefully, focusing on relative value opportunities while holding some firepower in reserve". Looking back on 2017, I think that we were a little too cautious but were correct to suggest that relative value decisions would play a more significant role. While spread compression over the course of the year was relatively comparable between U.S. high yield and emerging markets debt, the former clearly led the way in the first half of the year with the latter dominating the more recent period. As for our positioning, by February we recognized that the spread tightening might go further than we originally thought and allowed portfolio risk levels to move higher during the early part of the year. We also captured the rotation into emerging markets debt as we moved through the second quarter.

What did we learn from last year? First, volatility can decline more than we imagined. Before 2017 the VIX never recorded a weekly close below 10%. There were 15 weekly closes below 10% in 2017 with 11 of these coming after the middle of September. For me this was the biggest surprise of 2017. In seeking an explanation, I can point to large scale ETF inflows as effective sellers of volatility and I can also highlight the impact of the Goldilocks nature of growth and inflation, particularly in the way that allowed the Fed to telegraph each tightening. I suspect another major lesson from last year is that politics impacts markets only to the extent that it impacts growth.

Psychologists describe a confirmation heuristic, the ability to look at each data point to confirm pre-conceived views. There were certainly plenty of political "data points" in 2017, which gave observers opportunities to confirm their biases on a variety of issues! The reality is that all this activity was largely noise and had little or no impact on the economy.

So how do things look for 2018? I have written on the differentiation between secular and cyclical themes in previous letters and I will again return to some of these topics but with some new wrinkles.

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But first let me make a broad observation. Valuations, if expensive last year, are more so this year. As we all know, markets are a discounting mechanism and do not solely reflect contemporaneous activity. When markets move into highly valued territory we have to ask ourselves a series of key questions:

- Are things different this time? It is always tempting to dismiss the notion that things are different as merely a justification for high valuations but let us not forget that the "new normal" theme was very much based on the notion that things are changing. I will review our secular themes, but while we have some tentative causes for optimism, they are too tentative to argue that things are genuinely different.
- Where are we in the cycle? While we have held secular views that might be best described as "slower and lower" we have never denied that the cycle remains.
- Do high valuations and impulsive moves higher in markets indicate that investors are overly enthusiastic?

Secular Themes: Too Little to Argue for a Change

Previously we've discussed the role of three broad secular themes; poor demographics, low productivity and excessive leverage, as the root causes of what is now commonly known as the "new normal".

Poor demographics are a long term issue but may not necessarily limit growth if a steady and compensating improvement in labor force participation rates can be delivered. How might this be achieved? One obvious way is to increase female participation in the labor force. Across virtually all countries that track the data, female participation in the labor force is below that of men. This negative gap in developed markets ranges from below 5% to as high as 20%. Germany and the Scandinavian countries all record gaps close to or below 5%. At the other end of the spectrum, with gaps close to or in excess of 10%, lie the U.S., the U.K., Japan, France and Italy. Rising female labor market participation also leads to potential gains in productivity. This has become something of a hot topic recently but only Japan has really started to make transformative changes. While important to monitor, we are not yet at a stage where we can genuinely argue that the case for demographic constraints has been changed.

Productivity measures have improved recently, especially in the U.S., leading some to argue that we may be at the point of a step change. Investment has certainly picked up and many are arguing that this will continue, driven in part by deregulation and tax reform which in turn drive further improvements in productivity. We are watching these developments closely because the combination of continued deregulation and full implementation of the tax cuts have the potential to create real fundamental change.

Leverage remains a concern. High levels of leverage make economies more vulnerable. Nearly all cycles end with a surge in leverage which is then, in significant part, reversed during the ensuing economic slowdown. This has been less evident since the financial crisis and has two consequences, in our view. First, higher leverage leaves companies more vulnerable to both economic downturns and refinancing at higher interest rates. It also implies lower recovery rates in times of stress. Second, sustaining economies with higher

levels of debt implies a need for lower interest rates. This is all part of the new normal. High levels of leverage have been encouraged, in the U.S., in part by full tax deductibility of interest expense for corporations. While we have some concerns around the U.S. Tax Cuts and Jobs Act recently signed into law by President Trump, one significant step in the right direction in our view is the limiting of the deductibility of business interest expense to 30% of income. This may encourage some deleveraging at the corporate level and improve company stability. Lower leverage levels imply higher credit ratings and tighter spreads. I will discuss valuations shortly, but an element of our strategy discussions, and one that is likely to continue, is the likelihood that spreads will move to a tighter range. However, while the tax bill may serve to lower corporate leverage it is likely to increase government borrowing. Are we entering a period of higher U.S. Treasury yields but tighter corporate spreads? There is still analysis to be completed but, from a credit perspective, the recent tax reform might help address some of our secular concerns on leverage.

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What is the Economy Telling Us?

Will 2018 be the year in which we start to recognize downside risk to the economy? This is a little discussed concern at a time when economic momentum is solid and the level of surprise in the data remains positive. Our economists paint a positive picture for next year with above trend growth in most major economies. The Fed and the ECB seem to be describing a clear path for monetary policy, the former suggesting three rate rises in the coming year and the latter, a very gradual reduction in the scale of QE. The market currently assigns a one-third probability of three rate hikes by the Fed in 2018. There is room for this probability to move higher likely pushing U.S. Treasury yields higher. While the ECB is not expected to hike rates in 2018 it will likely move its rhetoric in this direction leading to higher yields in Europe.

Let us also not forget the extent to which rates have already risen. Over the past two years the U.S. five year Treasury yield has risen by nearly 50%. This is not dissimilar to the scale of move seen prior to the downturns of 2007, 2000, 1995 and 1990. While history never repeats itself, one cannot help thinking that excessive focus on current economic momentum might well be masking the extent to which the economy is becoming increasingly vulnerable. We would not be surprised if 2018 becomes a year of two halves, positive momentum near term followed by growing concern thereafter.

All-important Valuations

Credit valuations remain tight. With our secular themes still in place and concerns that the economy may be more vulnerable than generally perceived, tightness in spreads should be a concern. My high yield colleagues highlighted that across nearly all industries, spreads are at or near record tights. On the other hand, while spreads are tight, they have typically been this tight about 25% of the time historically. We do not see the immediate credit excesses that have often accompanied a downturn, but leverage remains high and central bank flexibility to support a failing economy is more constrained than in previous cycles. The balance-of-risks point us toward a relatively cautious stance.

On a more optimistic note, relative valuation opportunities were highlighted by team members. For the first time since we started these meetings, the relative attractiveness of the economic cycles in Europe and Japan were highlighted. In the former case, the early stage of the cycle and the continuing strength of growth, combined with economic slack, suggest to us that risks may be less asymmetric than in the U.S. In the case of Japan, we believe strong growth and improving labor market dynamics, particularly in relation to female employment, suggest that there may be room for the economy to maintain

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its current strong performance. Emerging markets also look relatively attractive to us both from an economic and credit perspective. Spreads in emerging markets debt have tightened and the typical later cycle compression of high yield spreads versus investment grade spreads is evident, but when compared to the broader spectrum of higher yielding credit asset classes, we see sovereign emerging markets spreads offering value whether we look at a short or longer term historical comparison. Supporting this, our emerging market economist points out that the growth pickup in some key emerging countries is now exceeding the developed markets average and, with global trade expanding, the economic outlook for emerging markets is positive despite the expected modest slowdown in China. For example, Brazil, Argentina, Russia and Turkey all had accelerating growth in 2017 as their economies recovered from the downturn of 2015 and 2016. This has not been reflected in price action, in our view. With firm global growth, improving trade and firm commodity prices we believe higher yielding sovereign credits denominated in both hard and local currency are likely to continue to perform well in 2018.

Conclusion

Compared to this time last year valuations are tighter. This would be the case, although to a lesser extent, even if we assume a significant level of post tax reform corporate deleveraging in the U.S. While economies appear to be on a more solid footing than last year, monetary authorities in the developed world have taken notice. The Fed has progressed in its tightening cycle and appears set to move further. The ECB and the Bank of Japan appear to be positioning themselves to reduce the degree of available monetary accommodation. The credit cycle looks advanced but tax cuts and deregulation leave room for a first half upswing in the economy and in corporate profitability. In the second half of the year we will likely see increased Treasury issuance and reduced ECB support for credit markets. This may well turn out to be a year of two halves with the early part of the year rewarding investors willing to assume risk, but with those risks ultimately leading, at some point, to a noticeably more difficult environment. As ever the precise timing of this transition will be difficult to judge and we will likely only know it when it is upon us. For now we prefer to tread carefully, maintaining a somewhat cautious, but not outright bearish stance. Our focus on relative opportunities is heightened but we are conscious of the need to retain some fire power.

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Let me end by wishing you all a happy and successful New Year from all of us at Stone Harbor.

Peter J. Wilby, Chief Investment Officer

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