Letter from the CIO

July 2017

Outlook for the Remainder of 2017

Markets have been investor-friendly over the first half of 2017. We suspect that the benign environment will likely continue for a while. We will remain biased towards caution, reserving some dry powder, given amber valuations and the low level of volatility priced into markets.

We recently held our latest semi-annual investment off-site meeting and I wanted to take this opportunity to update you on our thinking for the remainder of this year. Markets have been investor-friendly over the first half of 2017 while growth readings appear to have improved modestly after a weak start to the year in the U.S. Globally, government bond markets have stabilized and improved with 10 year yields across the U.S. and the Eurozone declining between 9 and 22 basis points (bps) respectively. This is in stark contrast to the sharp rise in yields seen in the latter half of 2016 and comes in the face of continued U.S. Federal Reserve ("Fed") monetary tightening. With growth broadly solid, credit spreads have performed well. Option-adjusted spreads across U.S. investment grade, U.S. high yield, emerging markets debt and European high yield markets have narrowed by between 15bps and 90bps. It is worth noting that much of this spread tightening took place in the first quarter of the year and we have been in more of a "coupon clipping" environment in recent months. Equity markets have all performed well and we certainly sense, judging from our discussions, that we may have moved to the point where significant gains, if they come, may well have to come from the lowest part of the capital structure. All of this has been imbedded in volatility measures. The VIX, a measure of implied U.S. equity market volatility, has closed below 10% on 11 occasions in the past 20 years, seven of which have been in the last month at the time of writing. Markets are remarkably benign and I will return to this a little later.

Valuations on amber

Credit market valuations remain modestly extended. For example, U.S. high yield spreads have, since 1991, been tighter than today's levels some 25% of the time. For sure spreads are tight when we look simply at the historic highs and lows, but this ignores the interest earning characteristics of debt investing which is why we believe the amount of time spent at spread levels is as important as the levels themselves. Looking more closely at the U.S. high yield market, it certainly seems that the average spread may be pulled wider by a few sectors facing some secular issues, such as retail, but at the same time other metrics read positively. For instance, issuance remains highly focused on balance sheet management and coverage remains high. So we view high yield spreads with a "be cautious" read but not a "flee the scene" signal. These valuation signals also run across the broad higher yielding corporate sector encompassing Europe and the emerging markets. The emerging markets sovereign sector appears to offer better value, in our view, with spreads wide to their averages versus high yield markets on both absolute and risk adjusted measures. This is in part a lagged effect from President Trump's threats of trade action but it also no doubt reflects past U.S. dollar strength which saw emerging markets debt allocations,

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especially during 2014-2016, reduced. Indeed we ran low allocations during this period. Beyond simple relative spread analysis, the emerging markets have adjusted fiscal plans to a new reality; are seeing improved intra-regional growth and positive current account momentum; face a less aggressive Trump administration than feared; and have perhaps seen the worst of the dollar strength as the market prices Fed rate increases but senses some downside risk to the economy. We have begun and expect to continue to increase our allocations to emerging markets in our multi-sector portfolios and are likely to finance these through a reduction in higher yielding corporate exposure. To be sure our overall stance remains biased towards caution but we see areas of real relative value.

The economy – neither too hot nor too cold

Our outlook for growth globally remains largely positive but our certainty around that is somewhat diminished. Hopes for a rapid implementation of substantial tax reform and increases in infrastructure spending in the U.S. have diminished. It appears likely that the scope of these fiscal reforms will fall far short of the most bullish expectations of a few months ago. This realization may be why the "soft data" has surprised so negatively over recent weeks but we should also note that "hard data" has moderated as well. Data in Europe and the emerging markets has remained reasonably positive in our view. We like to monitor the extent to which data surprises to the upside or the downside. Rising positive surprises tend to result in upward revisions to growth forecasts and with them higher yields, and vice versa. Global readings were extremely positive last March (near highs of the last 15 years) and it was relatively easy to make the call that positive surprises would start to fall. Despite expectations of Fed rate hikes, this suggested to us that duration should be lengthened. Our global surprise index has now turned negative, although only slightly so, led by very dramatic declines in U.S. and U.K. readings and some noted moderation in emerging market levels. European data surprises remain positive but hint at a downturn. Overall this suggests to us that the current modest declines in bond yields may have slightly further to run. It also suggests that while the Fed is expected to continue to tighten policy and begin to reduce the balance sheet, the risks around this are moving modestly towards less tightening rather than more.

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Growth in Europe is expected to remain firm and above trend although we may see some modest slowdown. Inflation remains subdued and this is likely to limit any moves by the European Central Bank ("ECB"). Recent comments from Mario Draghi have pointed to a potential moderation in the pace of quantitative easing ("QE") around the end of the year but he has also stated that official interest rates will remain at their current low levels for some time thereafter. We expect any move to moderate the pace of QE to be very modest and measured.

We spent some time discussing the impact of Fed balance sheet reduction and our conclusion is that "it depends". First, it was noted that a balance sheet reduction is a decline in demand for U.S. Treasuries and that should push yields higher. In turn, higher yields may reduce demand for credit (essentially reversing the QE process) and so there may well be some balance between higher government bond yields and higher spreads. At the same time it was noted that balance sheet reduction carries risk and that risk is likely to be perceived as a downside for the economy. This will likely increase demand for U.S. Treasuries. On top of that, the Fed is likely to move only modestly and predictably, with a clear willingness to stop and reverse if needed, and this ought to constrain any impact. Finally, as in most time periods, the trajectory of growth and inflation most likely will dominate the direction of yields.

Where has all the volatility gone?

As I mentioned earlier, volatility remains at historically low levels despite what many of us would consider high potential uncertainties including U.S. fiscal, tax and trade policies; Brexit and European bank recapitalization; and strong but less efficient credit growth in

China. We can identify but not necessarily quantify one potential contributory cause: passive investing. The growth in passive equity investing is a natural volatility suppressant in the current environment because investors buy but seem reluctant to sell. Passive funds grew by some $563 billion in 2016 while actively managed funds suffered redemptions on the order of $325 billion. These passive funds which seek to replicate indices purchase at the point of inflow and then are only likely to sell when either clients redeem or individual companies fall out of the index. Having seen substantial net inflows for some time now passive investing has served, we believe, to take volatility out of the equity market. Investors' decisions are reduced to being in or out of the market and no one wants to be out today. But it goes further. There is no process in these strategies for differentiating between good and bad companies. Vanguard alone holds more than 5% of 468 companies in the S&P500. This likely serves to reduce differentiation in equity performance across companies and in turn eliminates one of the early warning signals that we as credit lenders look at to identify areas of potential risk. Indeed a lack of signal may well be taken by many to suggest a lack of problems and that in turn serves to reduce credit market volatility, as we have seen. Passive investing in credit funds is limited for good reason; portfolios have to be more concentrated than the market which in turn creates credit risk which needs to be analyzed and managed. Consequently, credit markets seem likely to be more influenced by insights gathered from fundamental research than equity markets. Indeed it is quite possible that this structural change in relative investing patterns will cause credit markets to be an early warning signal of impending broad equity market risk. This will only be realized when investors become net sellers of active funds at which point it is hard to see who the buyer of last resort will be. While we continue to debate these issues internally, our discussions pointed to a growing concern that these flows into passive investing have a herding characteristic which crushes volatility today but when reversed will potentially result in a tendency to a jump towards higher volatility.

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Navigating...

So where does this leave us and where are we going? Starting from setting risk levels, we will remain biased towards caution, reserving some dry powder, given amber valuations and the low level of volatility priced into markets. Risk levels will be adjusted tactically and not set at strongly defensive levels but we will continue to monitor closely for any signs that volatility is likely to jump higher and will adjust our positioning accordingly. It is not time to jump off the bus but thinking about it is not a bad idea.

Within our targeted risk level, how will we allocate across credit markets? Our bias is to increase exposure towards emerging market sovereign debt. Valuations are relatively attractive when compared to higher yielding corporate debt, domestic growth drivers look more secure, progress is being made with reform and the threat of trade wars seems to have diminished. Conversely, developed market corporate debt in both the U.S. and the U.K. is unlikely to see the policy progress hoped for with tax reform in the U.S. less likely and calls for less austerity in the U.K. likely to limit room for lower corporate taxes.

Finally, what about duration? The ECB and the Bank of Japan remain strongly biased towards accommodation. While the Fed is set to remove some accommodation this is against a back drop of subdued inflation readings and growth which remains constrained. Under these circumstances we believe the yield curve likely offers some value and duration may well act as a modest hedge against higher volatility.

Two thousand and seventeen has been friendly towards credit investors so far. We suspect that the benign environment will likely continue for a while. With valuations where they are it is improbable that this year will see returns of the magnitude of last year and nor should it, but we anticipate returns will likely end the year at attractive levels.

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