



Macro Investment Framework

May 12, 2017

**A Standard
of Performance**

All views expressed and analyses made are those of Rubrics as of 12 May 2017. They are subject to change at any time due to changes in macroeconomic and financial markets conditions

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Introduction

Since 2008 much has changed. The myriad of data points we used to follow with such intent on a weekly, monthly and quarterly basis, have become a side show. The central banks have become the new masters of the capital markets. The once hypothetical “Greenspan Put” became a reality under Fed Chairman Ben Bernanke. Our greatest challenge as asset managers today is making sense of this environment.

Many of the current macroeconomic strategies developed and employed by central bankers are untested on this large a scale. At Rubrics we still believe fundamentals are the key drivers of asset prices over the medium to long term. Undoubtedly the world has suffered from overcapacity (excess supply) and debt induced demand for a long time. The rebalancing away from this is certainly underway but it has not occurred in a straight line. Furthermore there are still many pitfalls policy makers and investors can and will fall into.

Our macro economic research is based upon two goals. Firstly, attempting to understand the general direction of the global economy and its key growth and inflation trends. Secondly but of equal importance, understanding the direction and movement of liquidity flows (private and public). Due to the significant part global central banks have played in the manipulation of both economic conditions and asset prices, our job has not been easy with few if any clear answers.

In these macro packs that we compile on a quarterly basis, we attempt to examine the factors we think will be most prevalent to fixed income markets over the coming months. This top down work is supplemented with rigorous bottom up analysis from our investment team to create a framework on which we can build our investment process.

Current Macro Drivers

1. Political risk has been a central driver of market returns since the summer of 2016 (Brexit, Trump) and will continue to be so throughout 2017
 - Key elections in France, Netherlands and Germany
2. Central banks have slowly started to retreat from post 2008 ultra accommodative stance – Fed raising rates and ECB talk of tapering
 - To what extent will this continue and how will it impact global markets?
3. Market expectations of fiscally-led growth have been elevated since Trump election
 - Will the new administration fulfil promises on infrastructure spending, lower taxes etc and in what timeframe?
 - If not, what impact could the disappointment have on markets
4. Risky assets (equities, credit spreads etc) have performed strongly since the Trump election
 - Are markets looking stretched from a valuation perspective?
 - Soft and hard data telling different stories

Trump's Fiscal Agenda

Big Expenditure

- Tax cuts
- Increase in defence spending (+\$54bln)
- Increase in infrastructure spending (+\$1trln ...)

Financed by

- Repeal of Obamacare and changes to Medicaid – faces significant challenges in the Senate
- Cuts to UN funding and other International Agencies
- Cuts to Education, Environment, State Department, Agriculture, Housing etc

Impact on Debt Ceiling?

What the theory says

Implement Tax Cuts:

- Best case shows decreasing taxes having a stimulative impact on the economy – *but at the cost of increasing the deficit and debt with respect to GDP*

Increase in Government Spending:

- Best case as above but can't be excluded that the stimulative effect on the economy does not materialize – *because of the subsequent increasing in taxation*

Fiscal Multiplier:

- A multiplier of 3 or more (in absolute value) and very distortionary taxes *would decrease the deficit and debt with respect to GDP*

Empirical Evidence:

- Multiplier lower than 3. Historical experience of the US suggests *a government spending multiplier between 0 and 0.5 in expansions and 1 and 1.5 in recessions*

Source: Roberto Perotti. "The Debate on the Effects of Government Spending and Taxes." February 14, 2017;

Auerbach, Alan J., and Yuriy Gorodnichenko. 2012. "Measuring the Output Responses to Fiscal Policy." *American Economic Journal: Economic Policy*, 4(2): 1-27;

Rubrics Asset Management Ltd

And what empirical research tells us (1/2)

Table 1.
Ranges for U.S. Fiscal Multipliers

Type of Activity	Estimated Multipliers	
	Low Estimate	High Estimate
Purchases of Goods and Services by the Federal Government	0.5	2.5
Transfer Payments to State and Local Governments for Infrastructure	0.4	2.2
Transfer Payments to State and Local Governments for Other Purposes	0.4	1.8
Transfer Payments to Individuals	0.4	2.1
One-Time Payments to Retirees	0.2	1.0
Two-Year Tax Cuts for Lower- and Middle-Income People	0.3	1.5
One-Year Tax Cut for Higher-Income People	0.1	0.6
Extension of First-Time Homebuyer Credit	0.2	0.8
Corporate Tax Provisions Primarily Affecting Cash Flow	0	0.4

Source: Congressional Budget Office (CBO).

Note: The estimates above were produced for CBO's analysis of the American Recovery and Reinvestment Act of 2009.

Table 2.
The Effect of a \$1 Increase in Aggregate Demand Over Eight Quarters

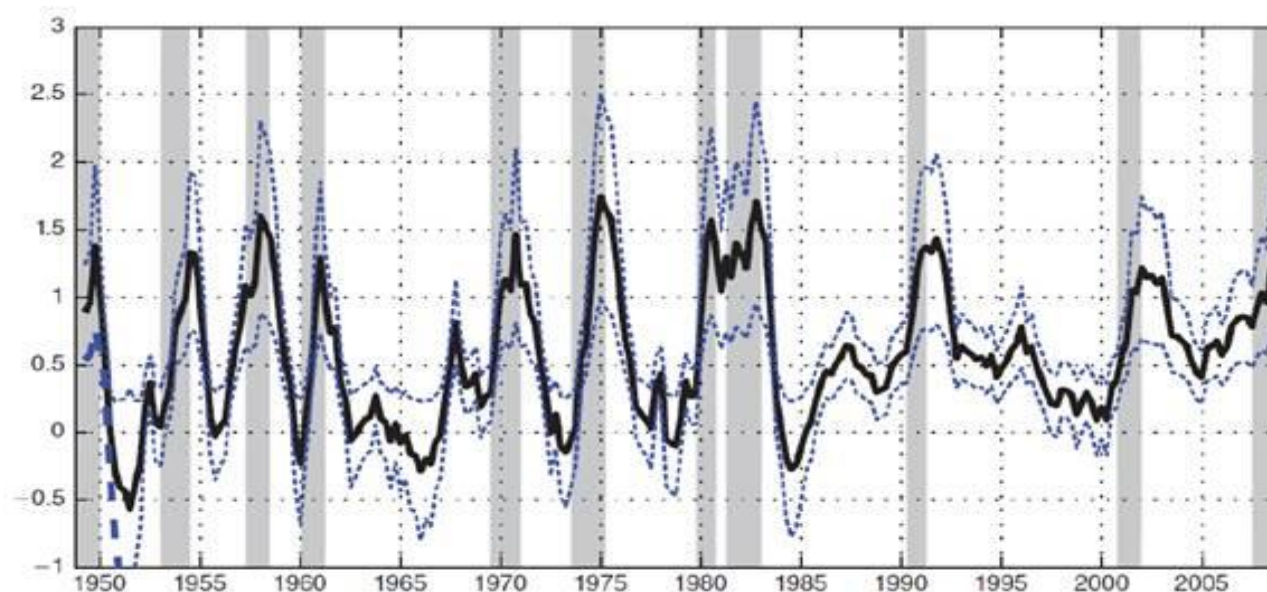
Quarter	When Output Is Well Below Potential And Federal Reserve Responses Are Limited		When Output Is Close to Potential And Federal Reserve Responses Are Typical	
	Low Estimate	High Estimate	Low Estimate	High Estimate
1	0.50	1.45	0.50	1.43
2	0	0.60	-0.03	0.48
3	0	0.30	-0.04	0.10
4	0	0.15	-0.05	-0.10
5	0	0	-0.06	-0.30
6	0	0	-0.06	-0.28
7	0	0	-0.05	-0.25
8	0	0	-0.05	-0.25
Cumulative Effect After 8 Quarters	0.50	2.50	0.17	0.83

Source: Congressional Budget Office (CBO).

Notes: CBO published these estimates on October 11, 2012, as a supplement to Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, CBO Working Paper 2012-08 (May 2012). In that data release, "When Output Is Well Below Potential . . ." is described as "When Short-Term Interest Rates Are Close to Zero" and "When Output Is Close to Potential . . ." is described as "When Short-Term Interest Rates Are Not Close to Zero." See www.cbo.gov/publication/43278.

There are no effects after eight quarters.

And what empirical research tells us (2/2)



UPDATED FIGURE 3. HISTORICAL MULTIPLIER FOR TOTAL GOVERNMENT SPENDING

Notes: Shaded regions are recessions defined by the NBER. The solid black line is the cumulative multiplier computed as $\sum_{h=1}^{20} Y_h / \sum_{h=1}^{20} G_h$, where time index h is in quarters. Dashed lines are 90 percent confidence interval. The multiplier incorporates the feedback from G shock to the business cycle indicator z . In each instance, the shock is a 1 percent increase in government spending.

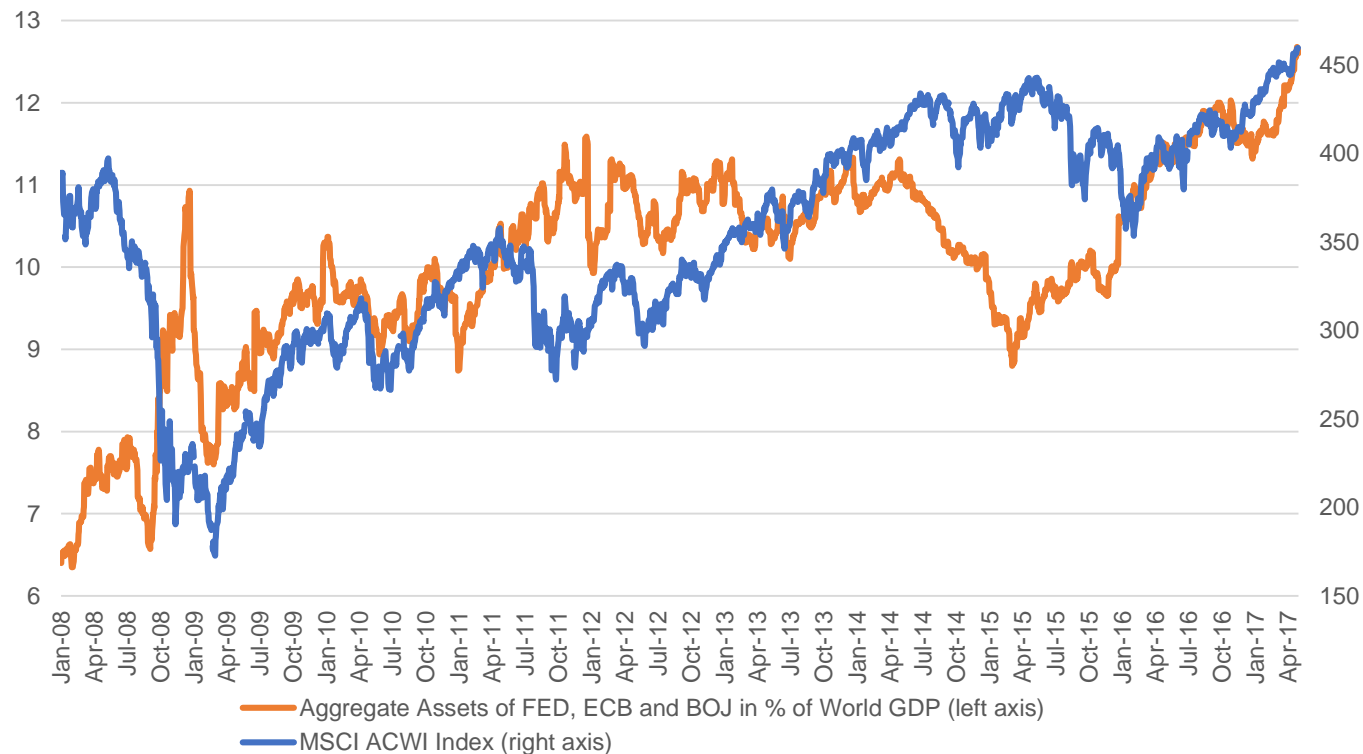
Source: Auerbach, Alan J., and Yuriy Gorodnichenko. 2012. "Measuring the Output Responses to Fiscal Policy." *American Economic Journal: Economic Policy*, 4(2): 1-27;

Auerbach, Alan J., and Yuriy Gorodnichenko. 2013. "Corrigendum: Measuring the Output Responses to Fiscal Policy." *American Economic Journal: Economic Policy*, 5(3): 320-22;

David Romer. "The Effect of Fiscal Changes: Aggregate Evidence." September 14, 2016

But in the last decade the great bull market has been backed by central banks

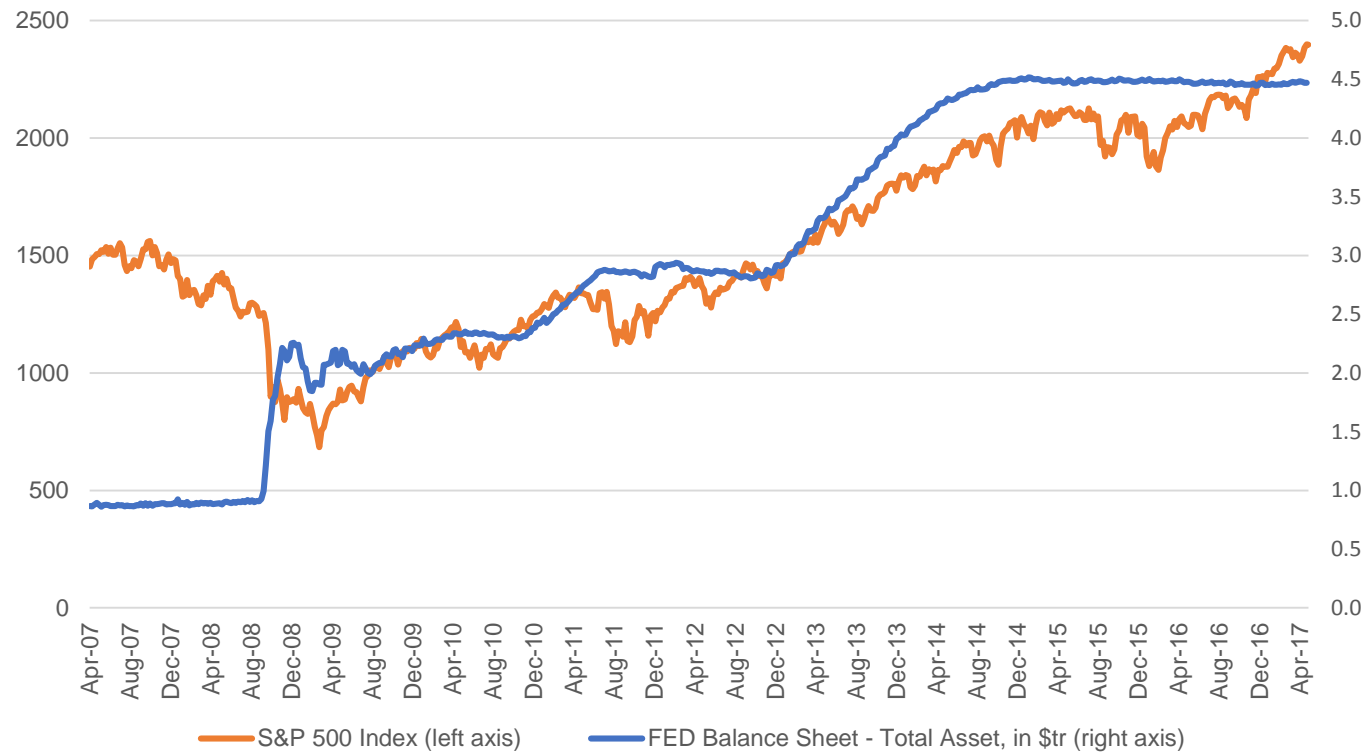
Strong Correlation between World Equity Markets and Aggregate Assets of FED, ECB, BOJ in % of World GDP



Source: IMF WEO (April 2017); Bloomberg; Rubrics Asset Management Ltd

With strong correlations to risky assets

Strong Correlation between S&P 500 and FED Balance Sheet



Source: Bloomberg; Rubrics Asset Management Ltd

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FED balance sheet before and after the crisis

The simplified balance sheet of the Fed on September 6, 2007

Securities	779,641	Currency in circulation	814,941
US government securities	779,641	Reserve balances (required and excess)	5,959
Mortgage-backed securities	0	Capital	40,610
Discount window	1,341	Other	46,950
Other	127,478		
Total	908,460	Total	908,460

Millions of dollars

Source: [Federal Reserve Statistical Release H.4.1](#)

The simplified balance sheet of the Fed on July 14, 2016

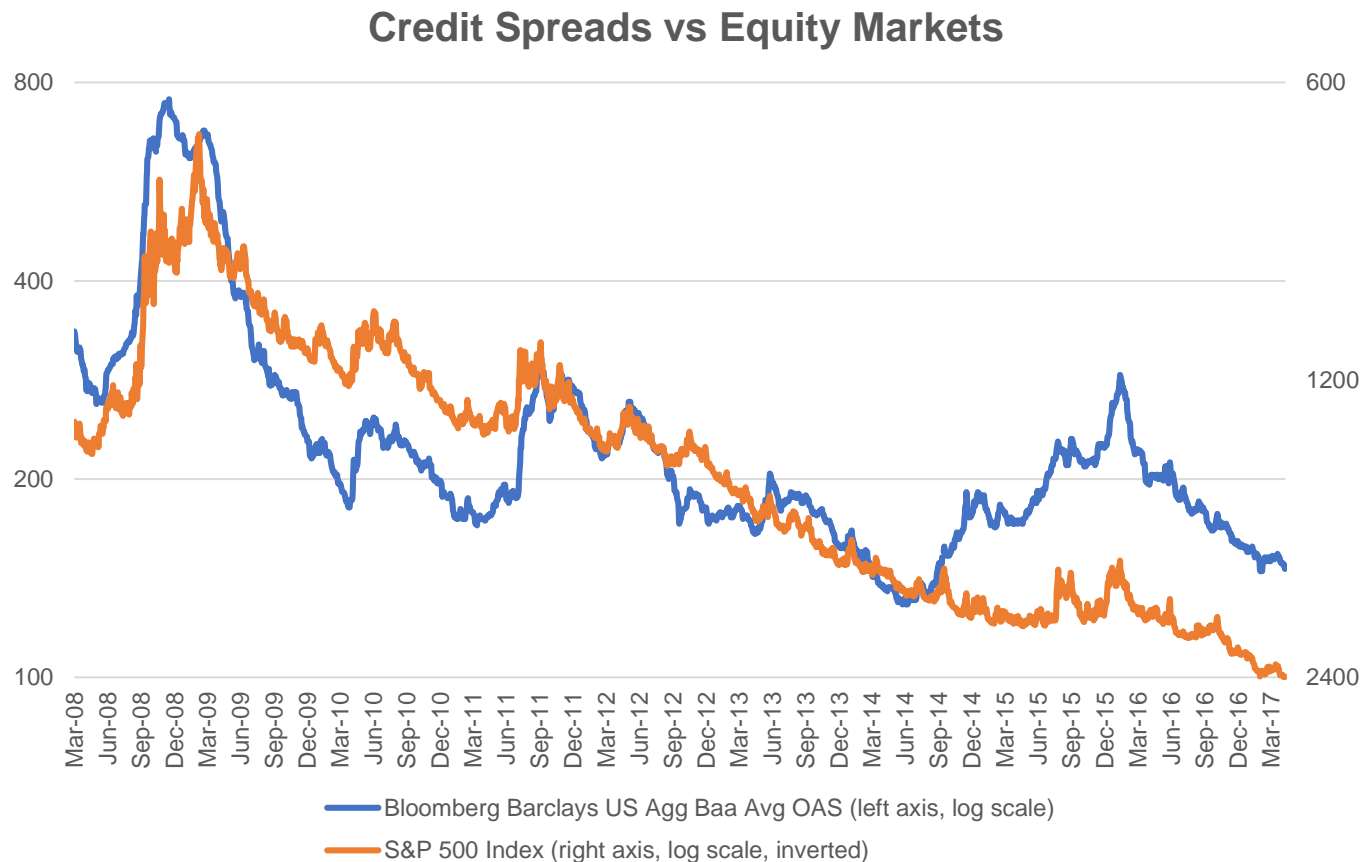
Assets		Liabilities	
Securities	4,231,137	Currency in circulation	1,464,902
US government securities	2,462,449	Reserve balances (required and excess)	2,310,766
Mortgage-backed securities	1,743,541	Capital	48,084
Discount window	184	Other	696,304
Other	285,735		
Total	4,517,056	Total	4,517,056

Millions of dollars

Source: [Federal Reserve Statistical Release H.4.1](#)

Source: Roberto Perotti. "The Monetary Base and the Money Supply Process." February 12, 2017

The impact on capital markets has been pronounced



Source: Bloomberg; Rubrics Asset Management Ltd

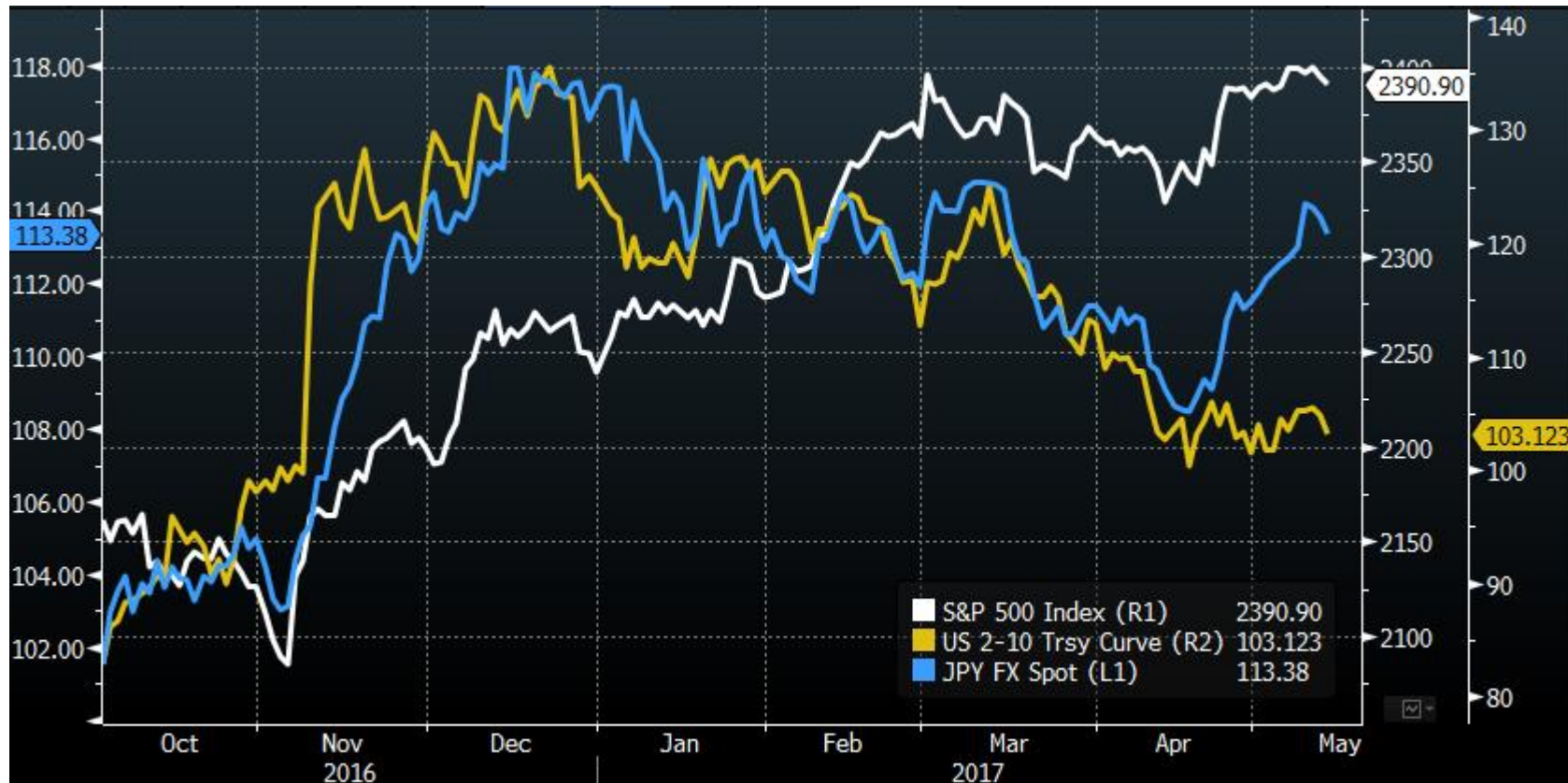
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Yen reflation linked with industrial commodities



Source: Bloomberg

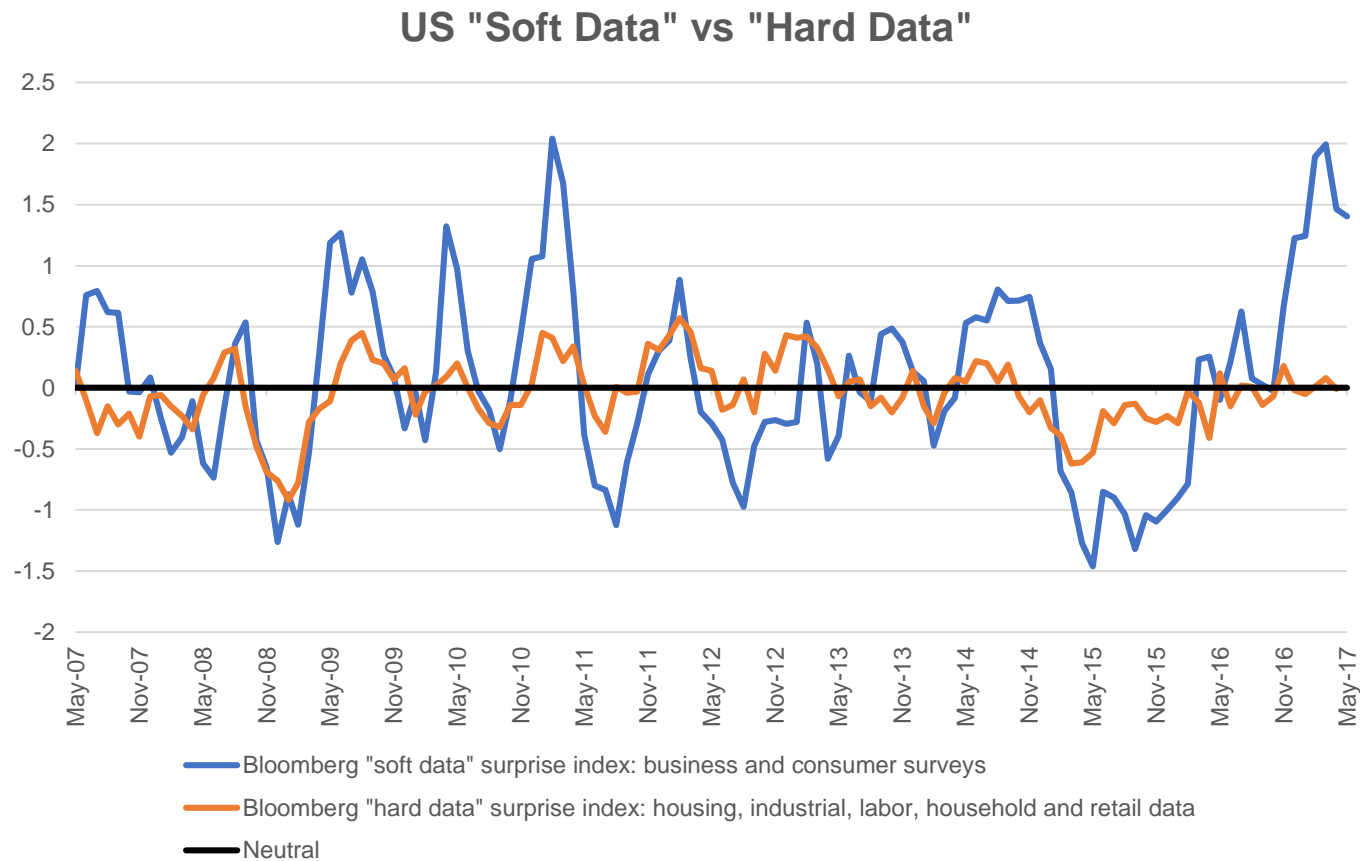
But the reflation trade appears to be losing momentum



Source: Bloomberg

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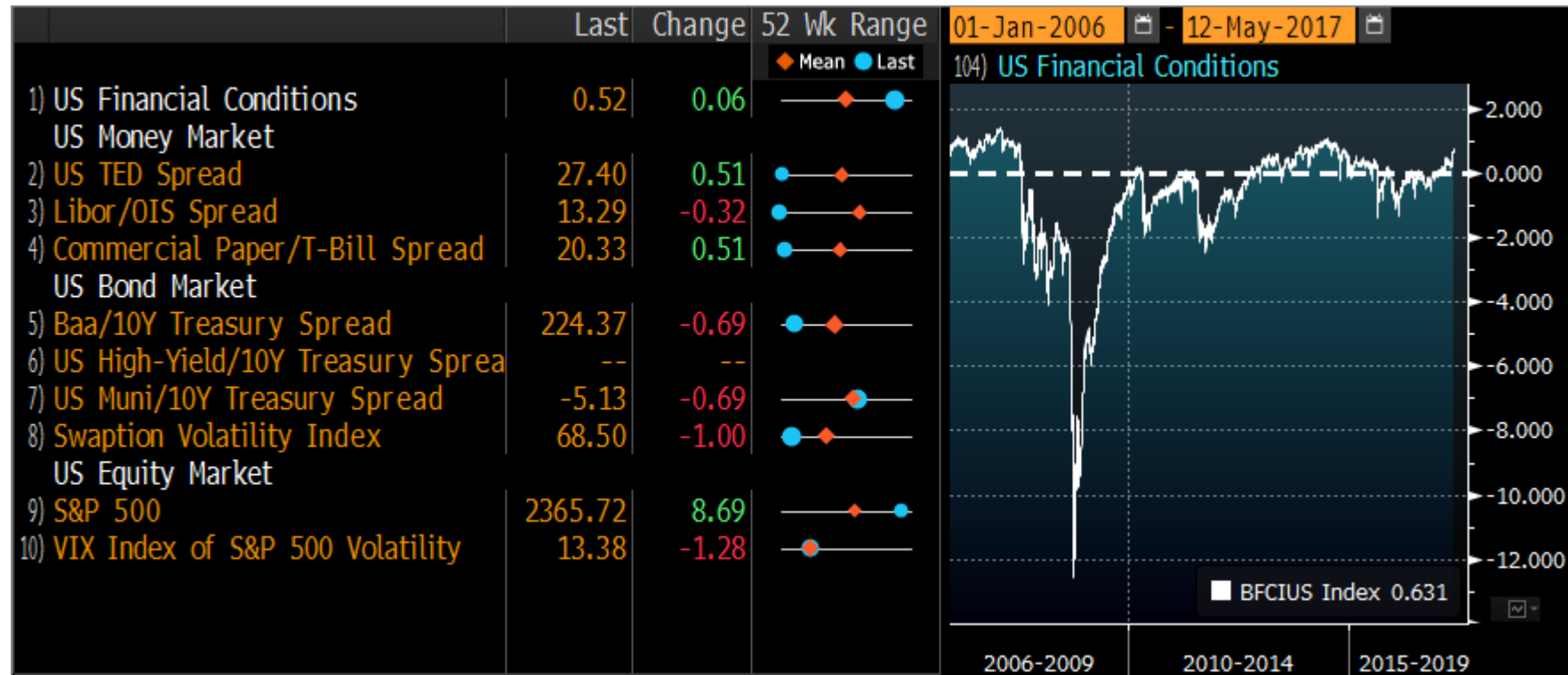
Soft vs. hard data disconnection



Source: Bloomberg; Rubrics Asset Management Ltd

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US financial conditions are very accommodative and the market is currently pricing very low / no tail-risk



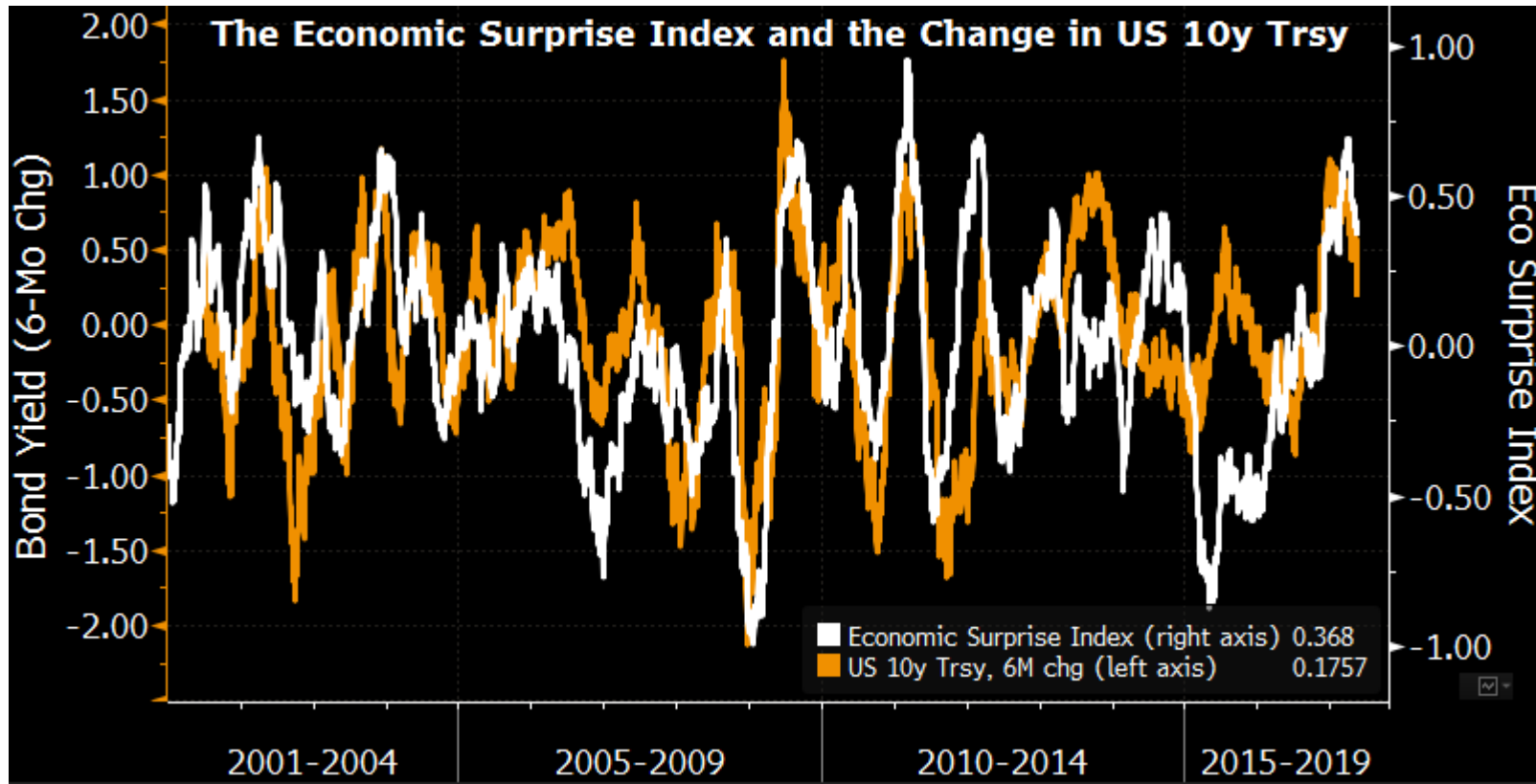
Source: Bloomberg

But looking at economic surprise index some downside surprise has emerged



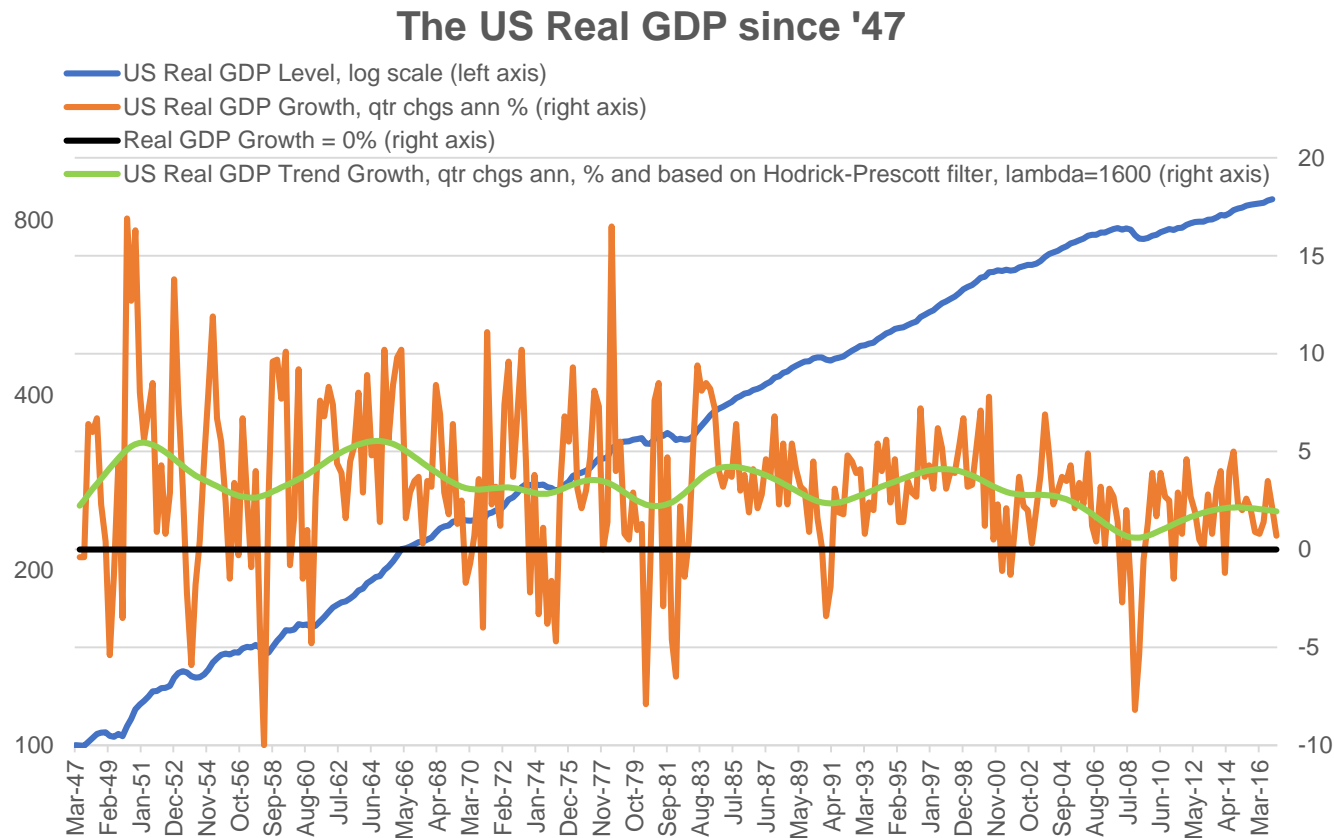
Source: Bloomberg

Nevertheless market expectations of a better economic outlook post Trump's election have driven US Treasury rates up



Source: Bloomberg

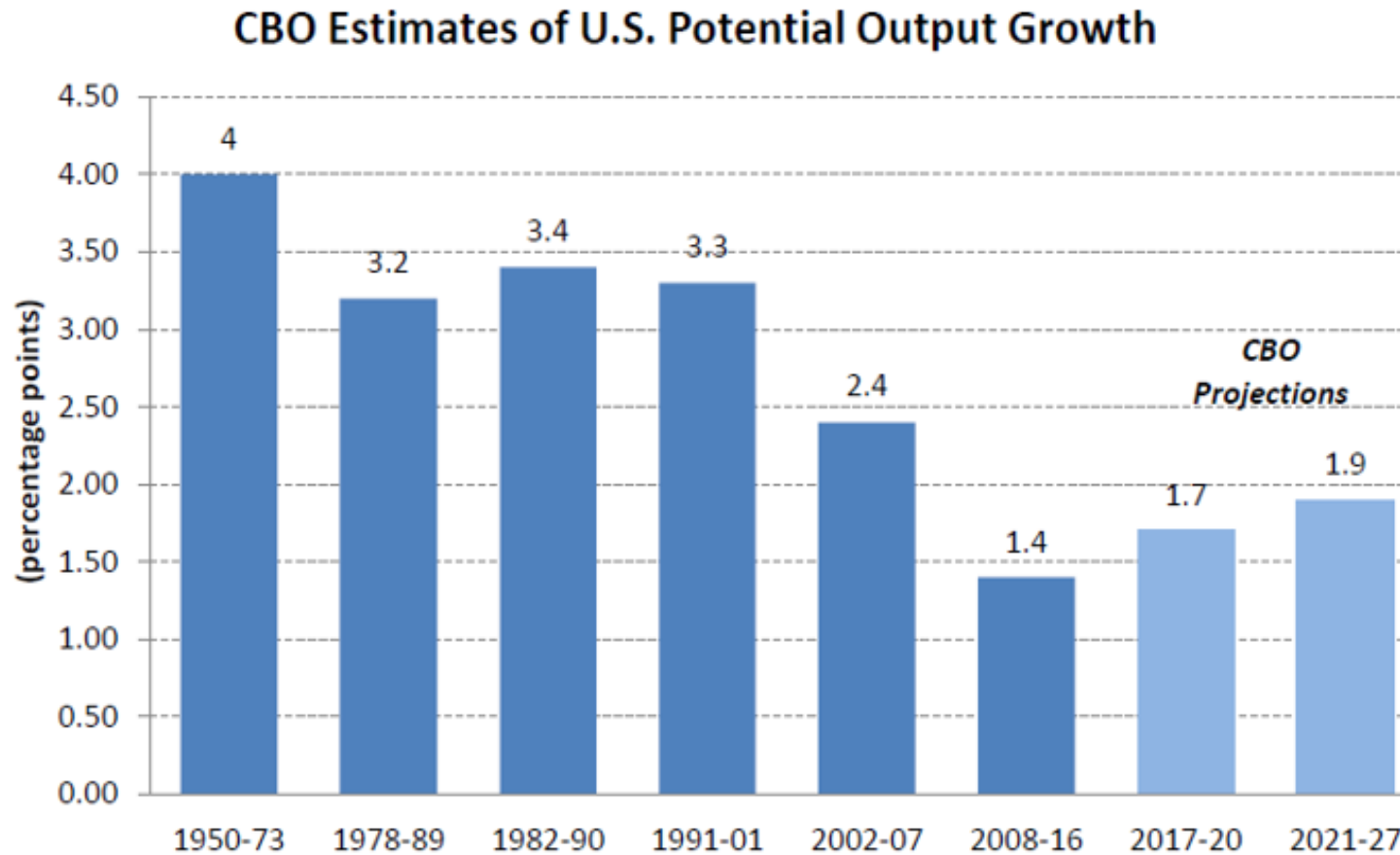
US expanding at a low 0.7% rate in Q1, with long term trend growth currently estimated at about 1.9%



Source: Bloomberg; Rubrics Asset Management Ltd

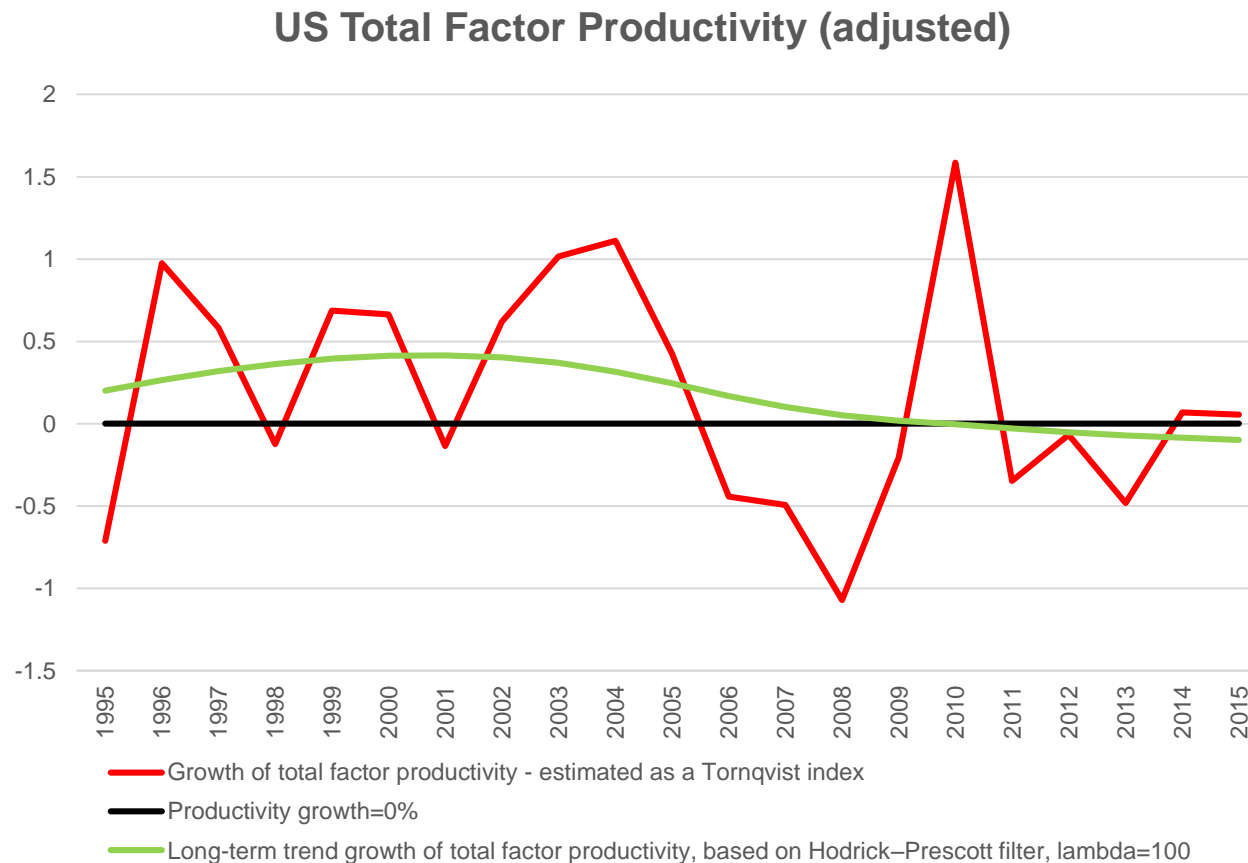
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Broadly in line with CBO current projections



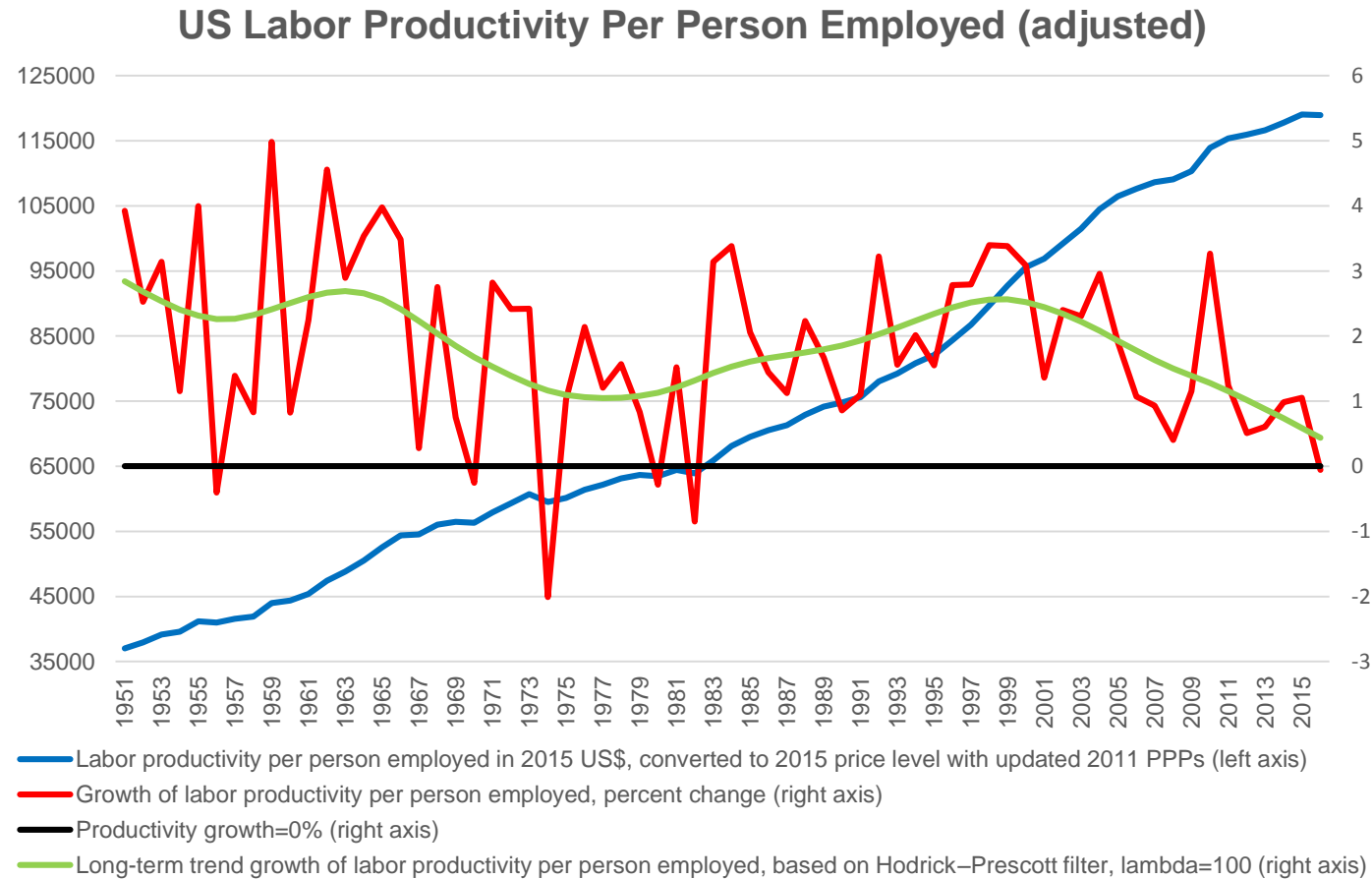
Source: CBO; Bloomberg

US total factor productivity virtually flat



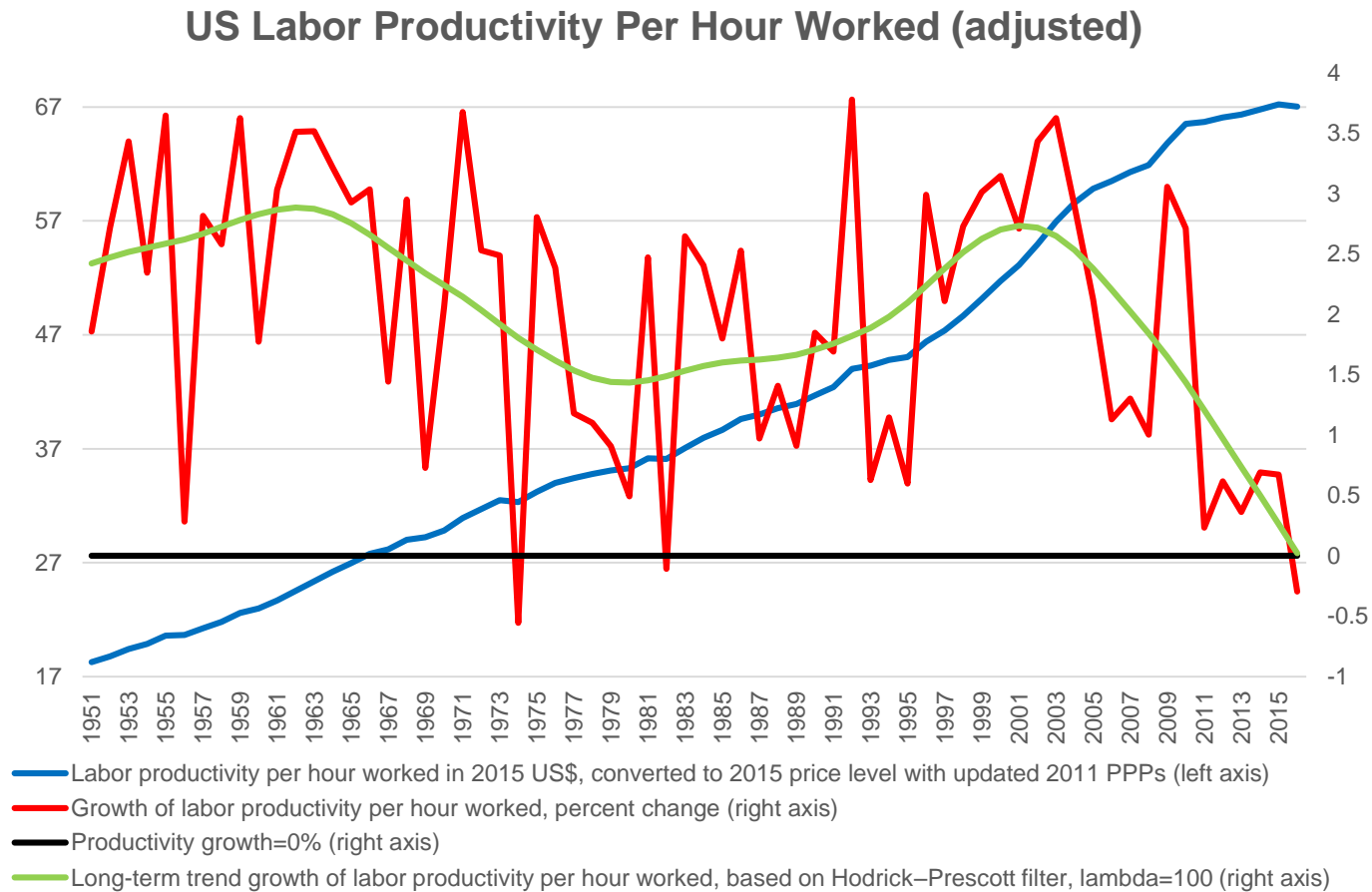
Source: Total Economy Database™, Growth Accounting and Total Factor Productivity, 1995-2015. November 2016; Rubrics Asset Management Ltd

US labour productivity per person employed declining



Source: Total Economy Database™, Output, Labor and Labor Productivity, 1950-2016. November 2016; Rubrics Asset Management Ltd

And US labour productivity per hour worked declining



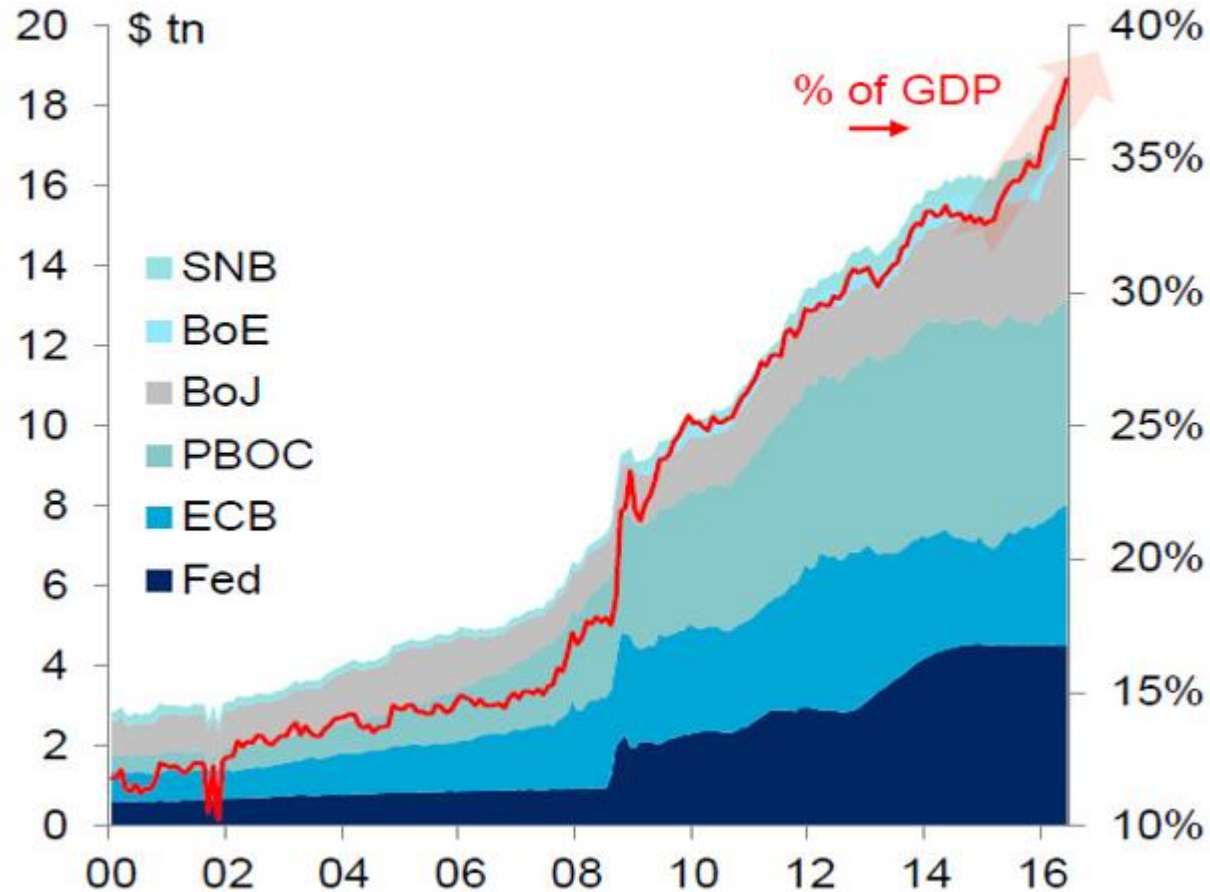
Source: Total Economy Database™, Output, Labor and Labor Productivity, 1950-2016. November 2016; Rubrics Asset Management Ltd

Monetary Activity

Aggregate Central Bank Balance Sheet Expansion

More and more and more!

Aggregate balance sheet of large central banks, \$tn & % of GDP

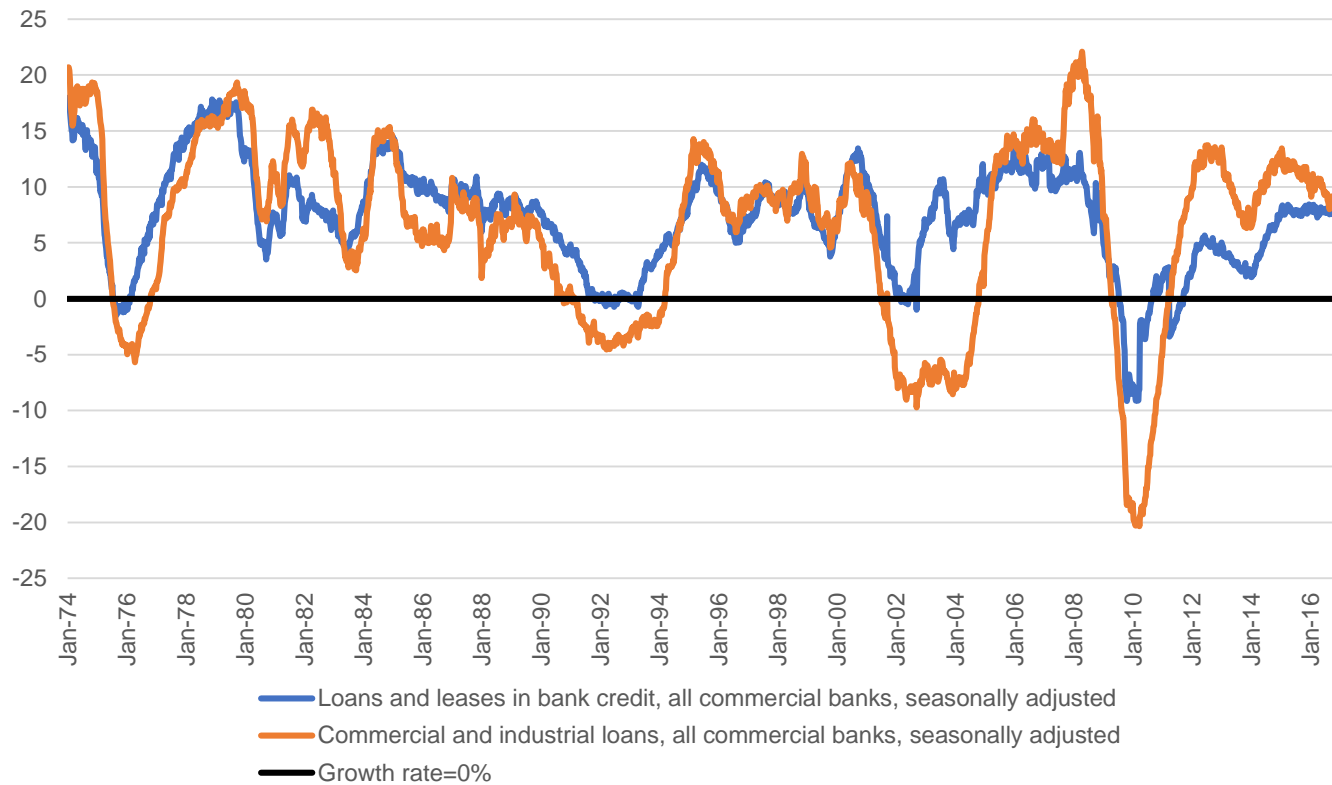


Source: Citi Research; Haver

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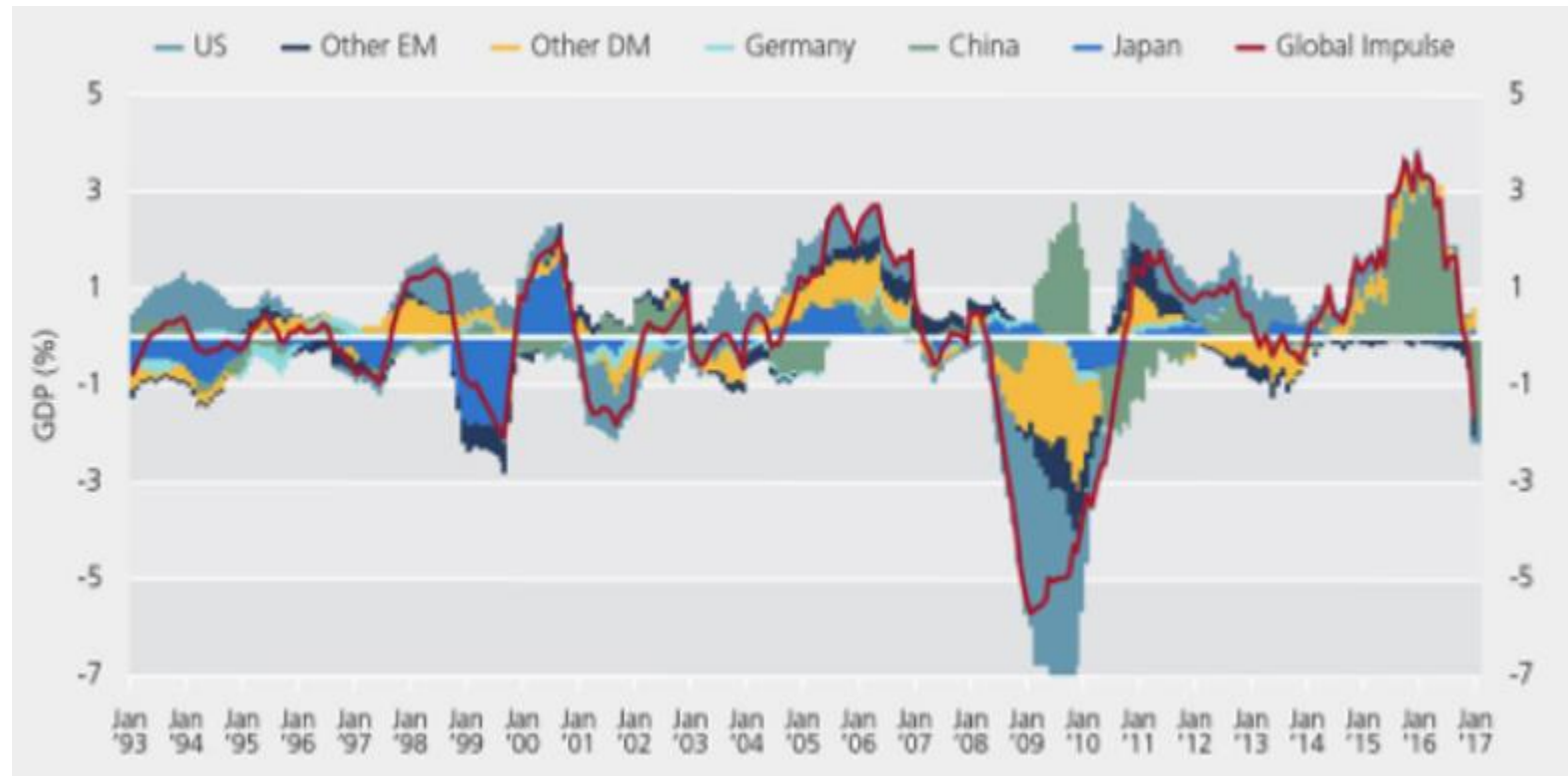
US C&I loans and leases declining too

C&I Loans vs Loans and Leases - YoY% Changes



Source: Assets and Liabilities of Commercial Banks in the United States - H.8, Board Of Governors of the Federal Reserve System. May 5, 2017; Rubrics Asset Management Ltd

Together with global credit impulse

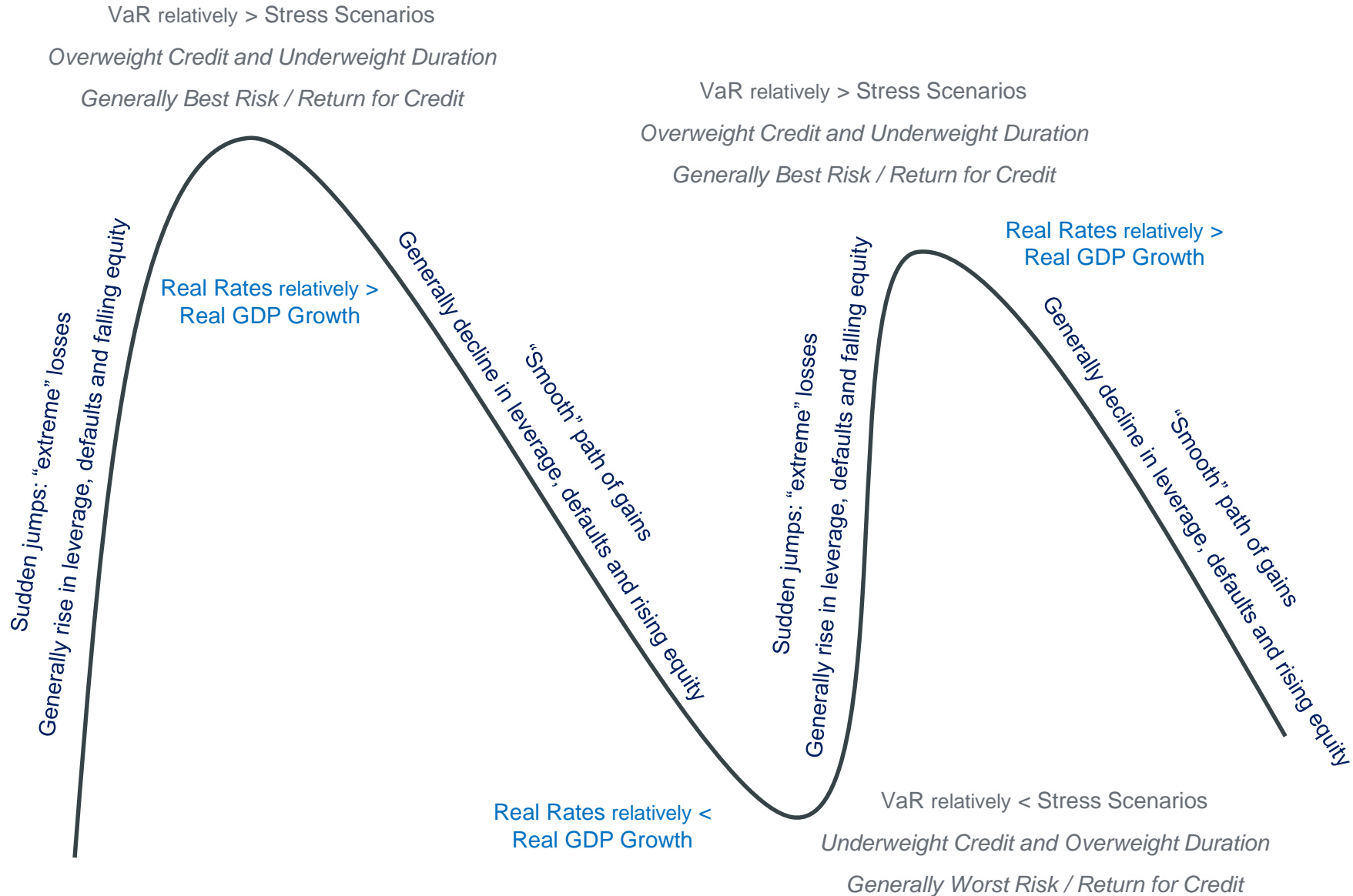


Source: UBS as of 31 January 2017; PIMCO

Rubrics Portfolio Strategy Macro Indicators

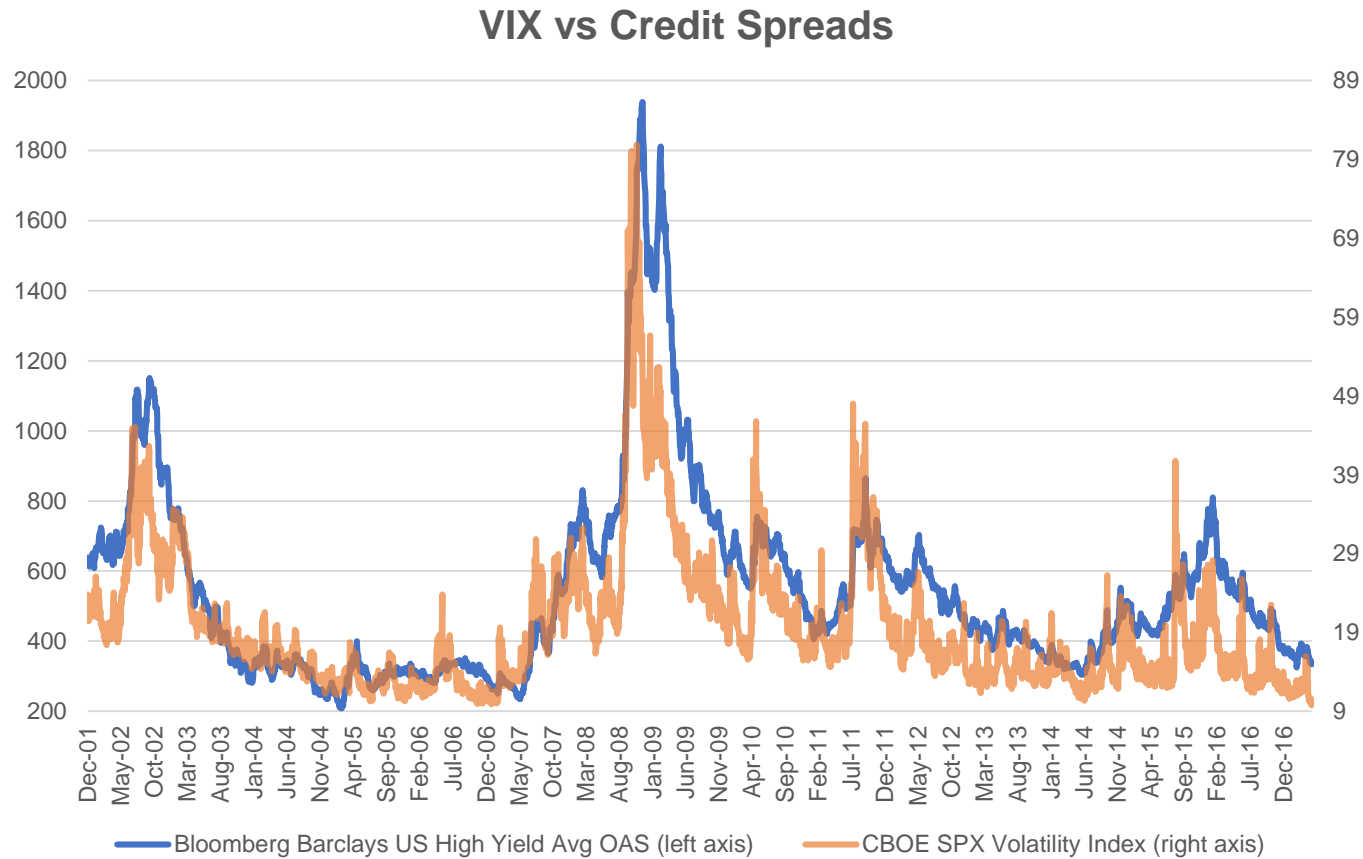
Portfolio Strategy

Implied Volatility and Credit Spreads - Cyclical Path



Source: Rubrics Asset Management Ltd

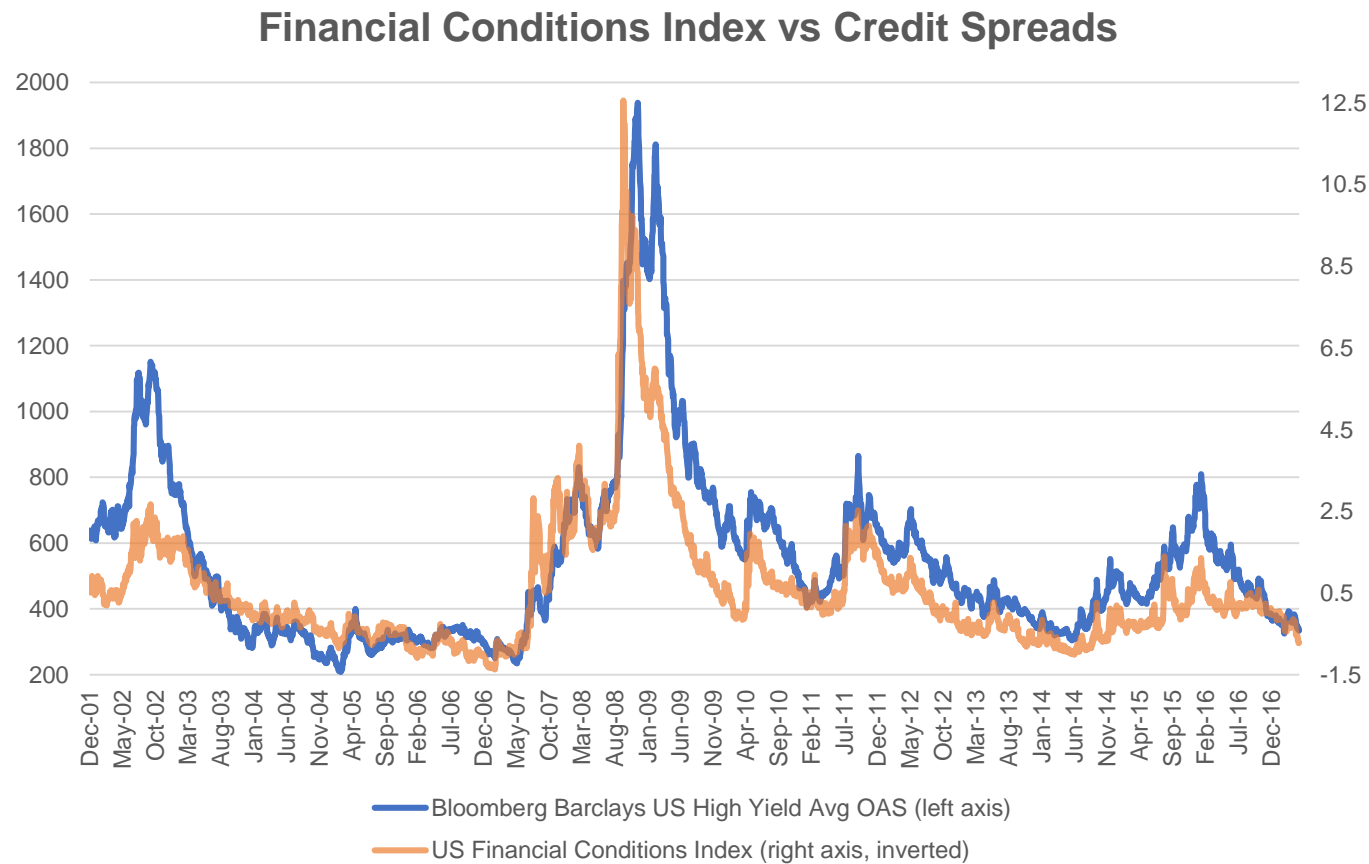
A strong cyclical path for implied volatility and credit spreads



Source: Bloomberg; Rubrics Asset Management Ltd

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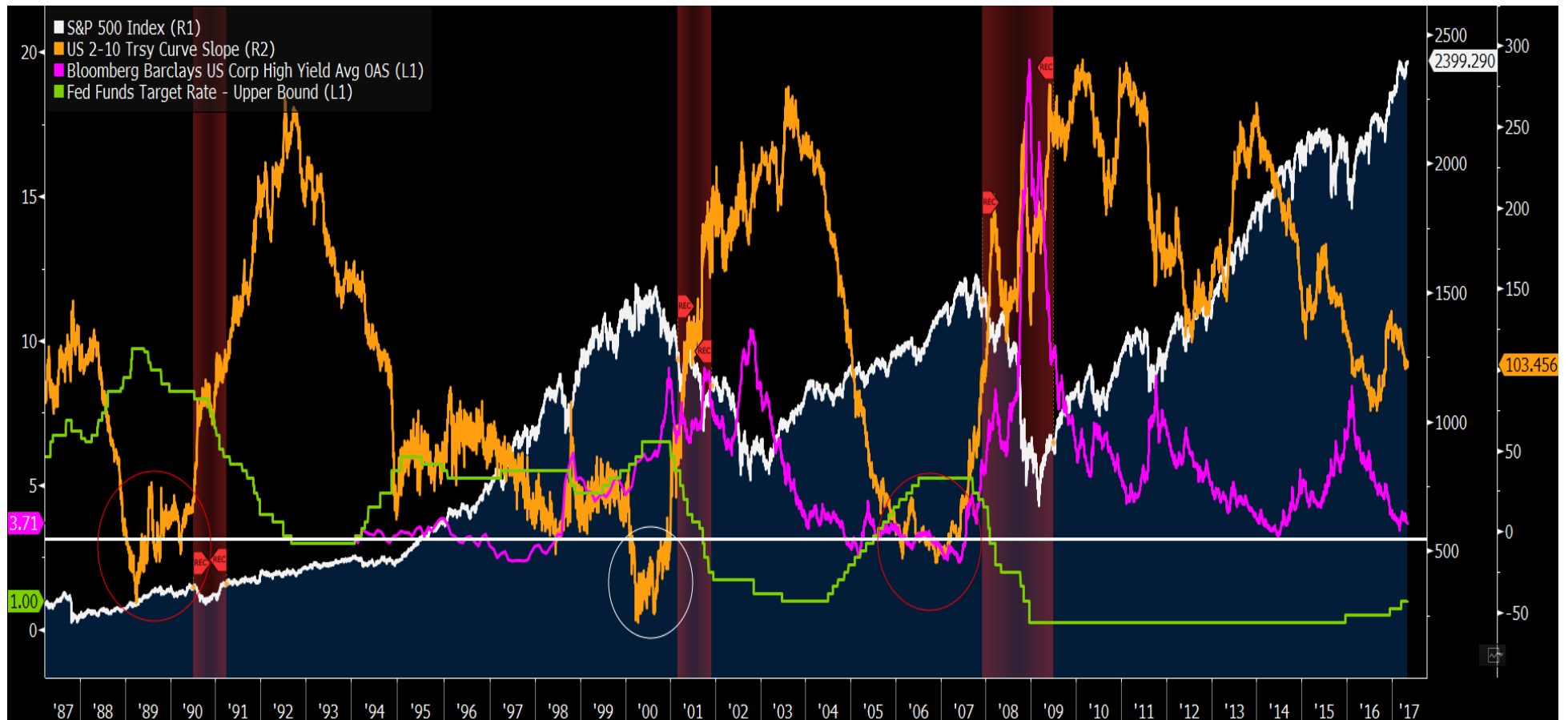
And for financial conditions



Source: Bloomberg; Rubrics Asset Management Ltd

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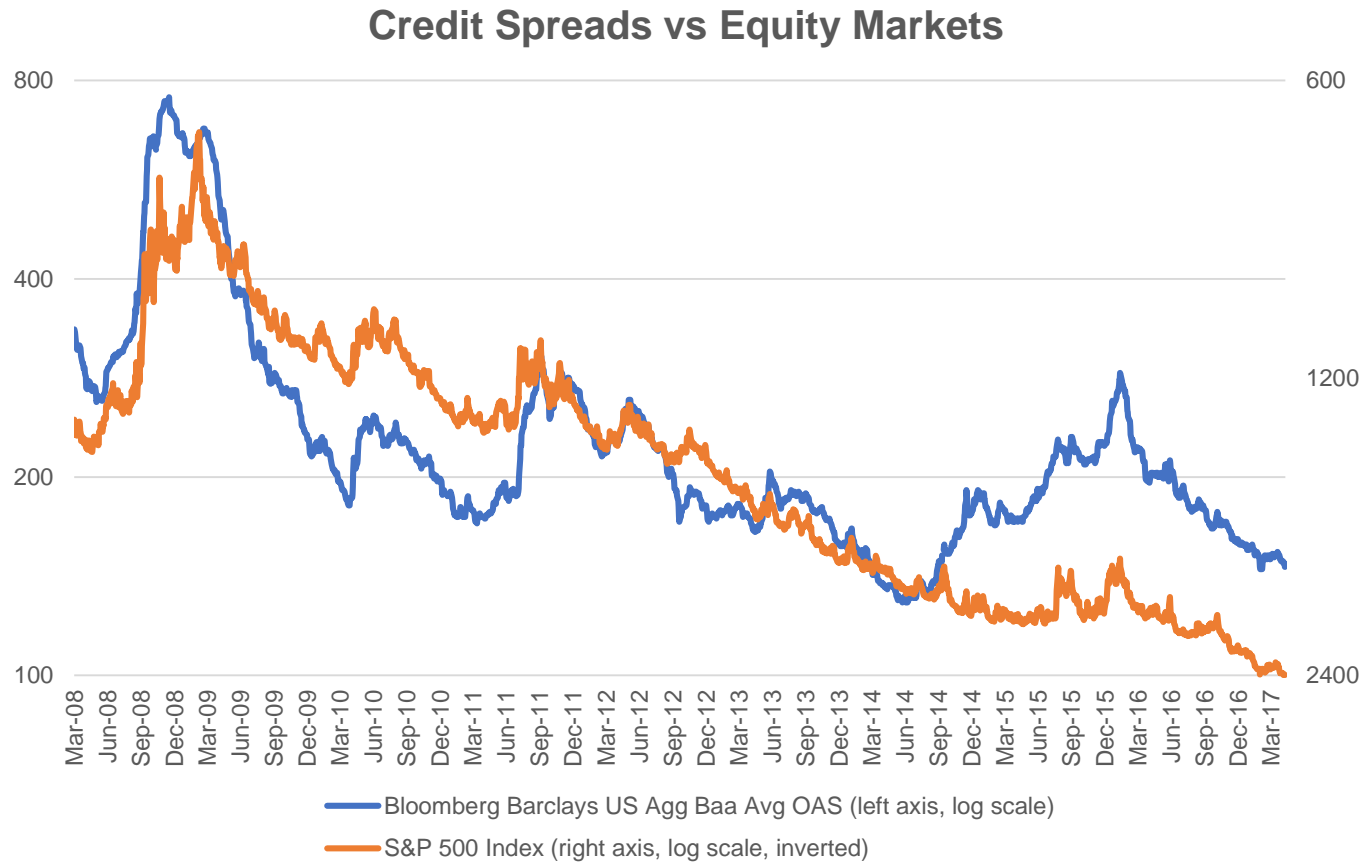
The slope of the treasury curve, the credit spreads and the equity market in the last 3 decades



Source: Bloomberg

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Rising spreads, falling equity and vice versa

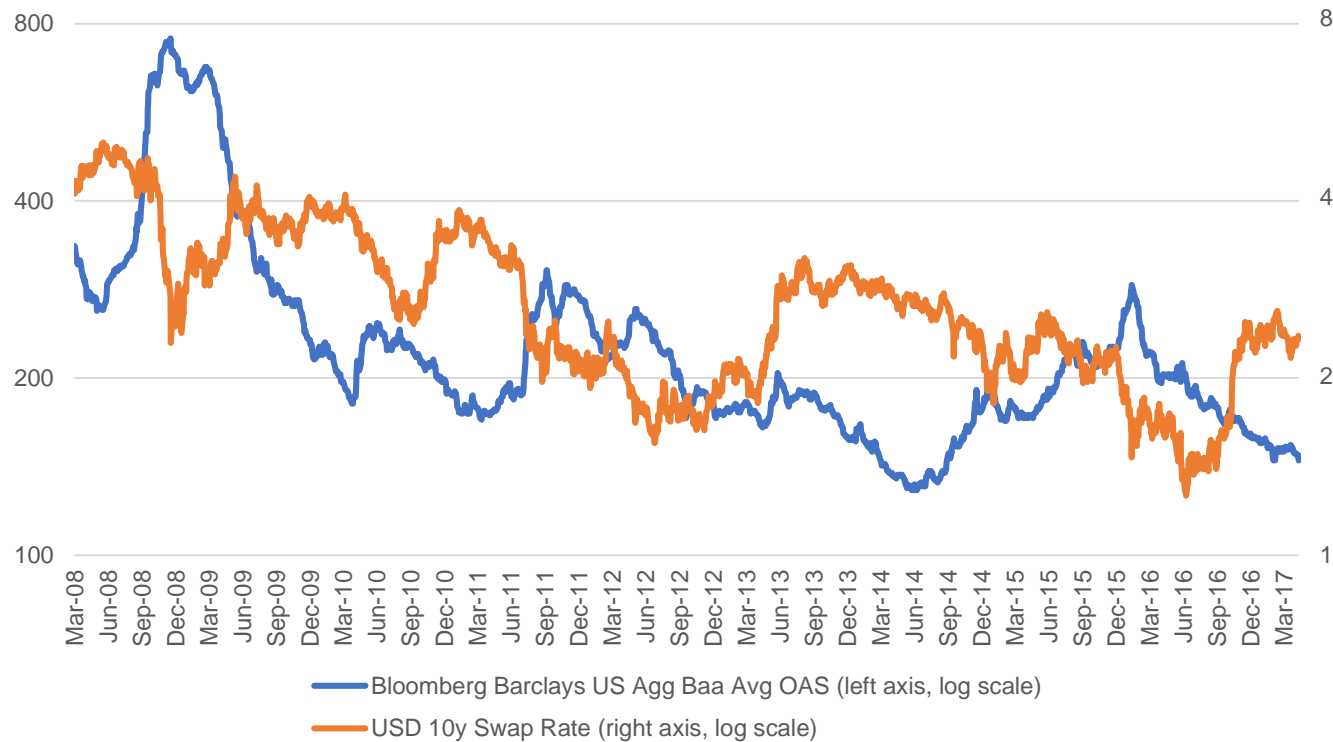


Source: Bloomberg; Rubrics Asset Management Ltd

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Underweight credit and overweight duration or vice versa

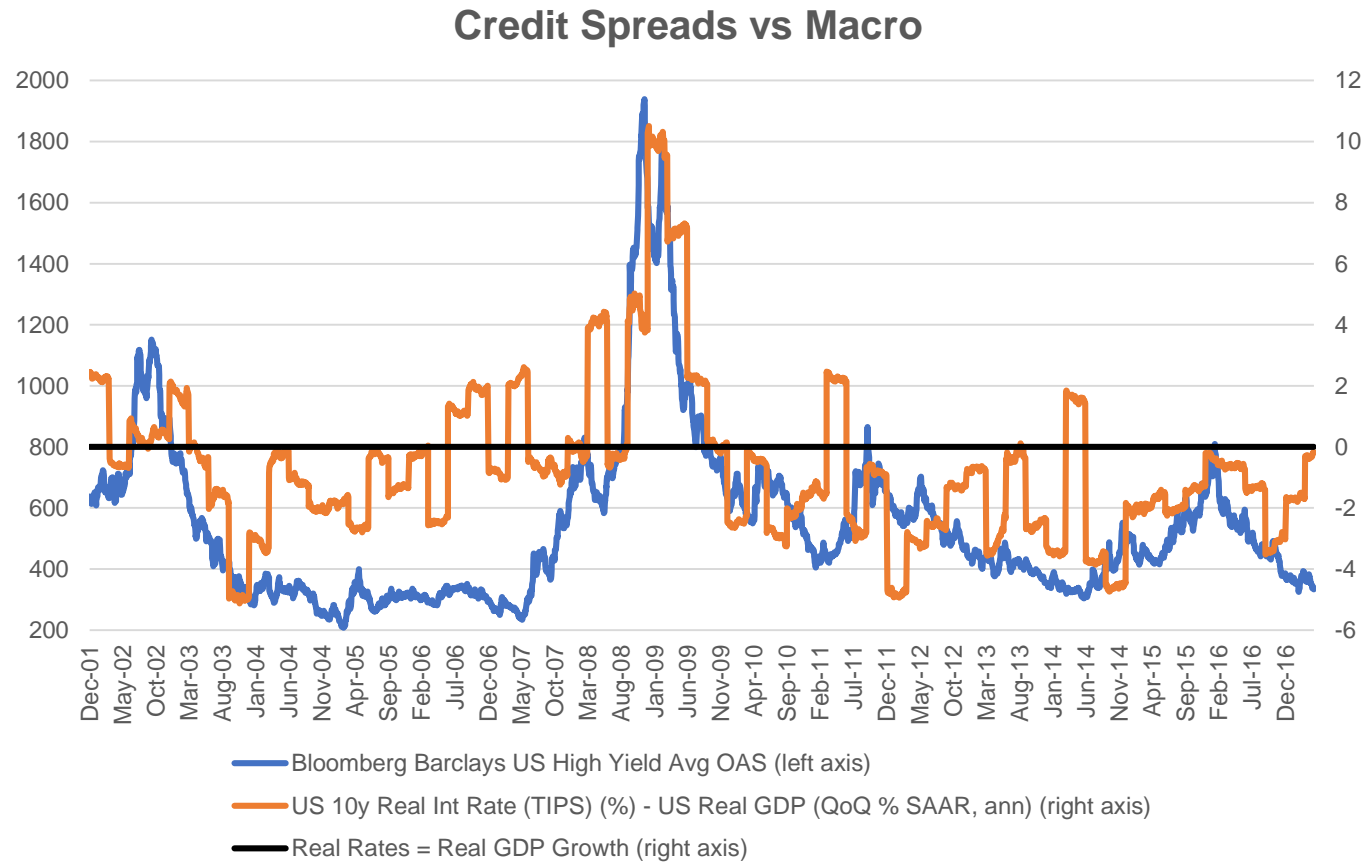
Credit Spreads vs Nominal Rates



Source: Bloomberg; Rubrics Asset Management Ltd

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Credit conditions are still accommodative at macro level

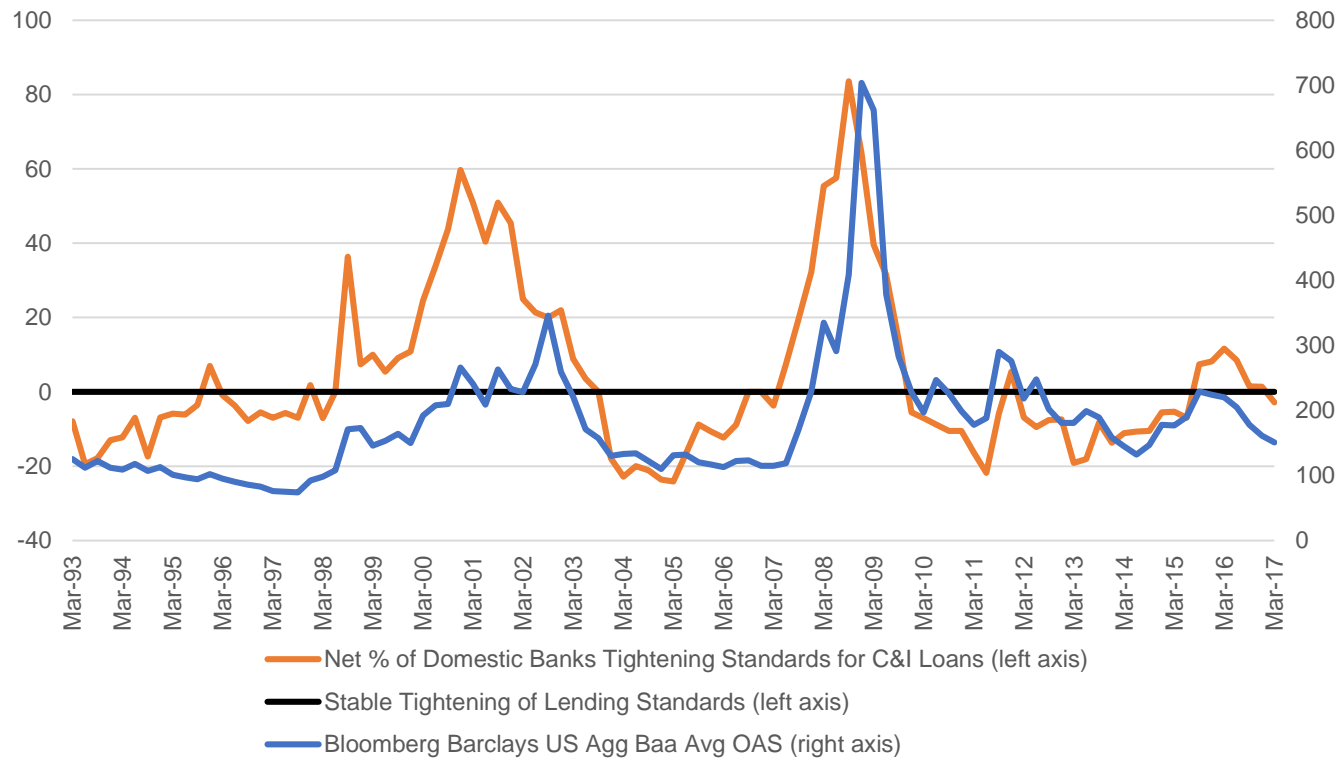


Source: Bloomberg; Rubrics Asset Management Ltd

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At corporate level

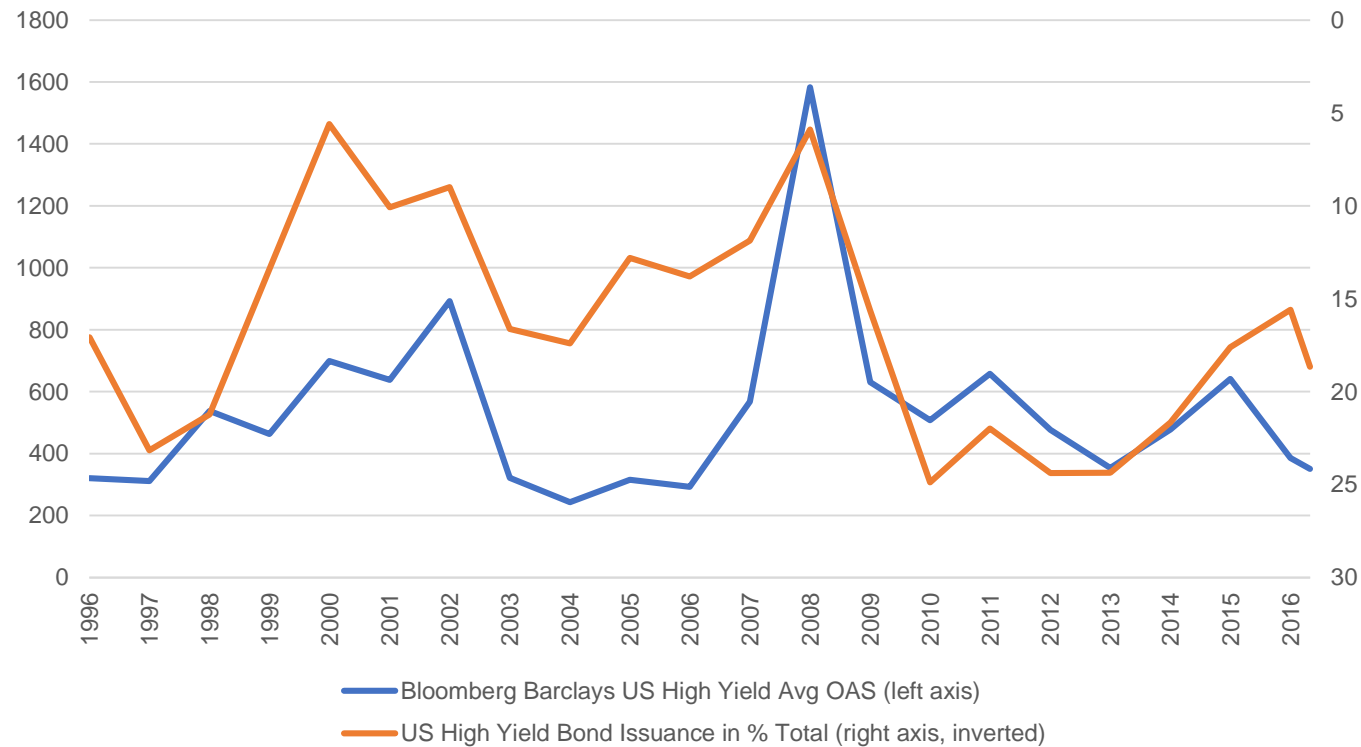
Credit Spreads vs Net % of US Banks Tightening Lending Standards



Source: Bloomberg; Board of Governors of the Federal Reserve System (US); Rubrics Asset Management Ltd

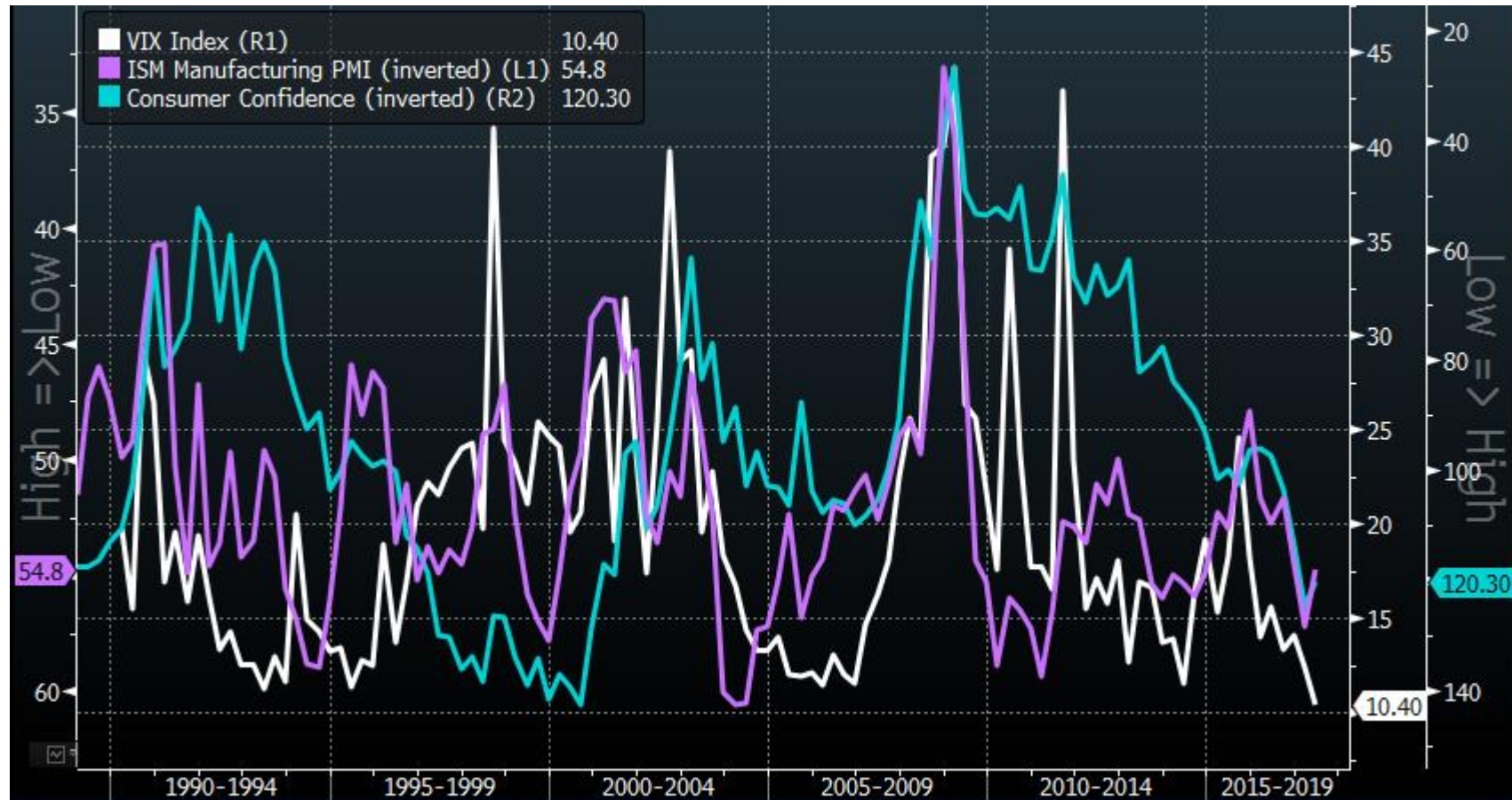
And at high yield level

Credit Spreads vs US High Yield Bond Issuance in % of Total (inverted)



Source: Bloomberg; SIFMA; Rubrics Asset Management Ltd

With high consumer confidence and very low VIX, nothing to worry about?



Source: Bloomberg

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