BEYOND Post-Truth

January 2019

A YEAR OF COLD REALITIES

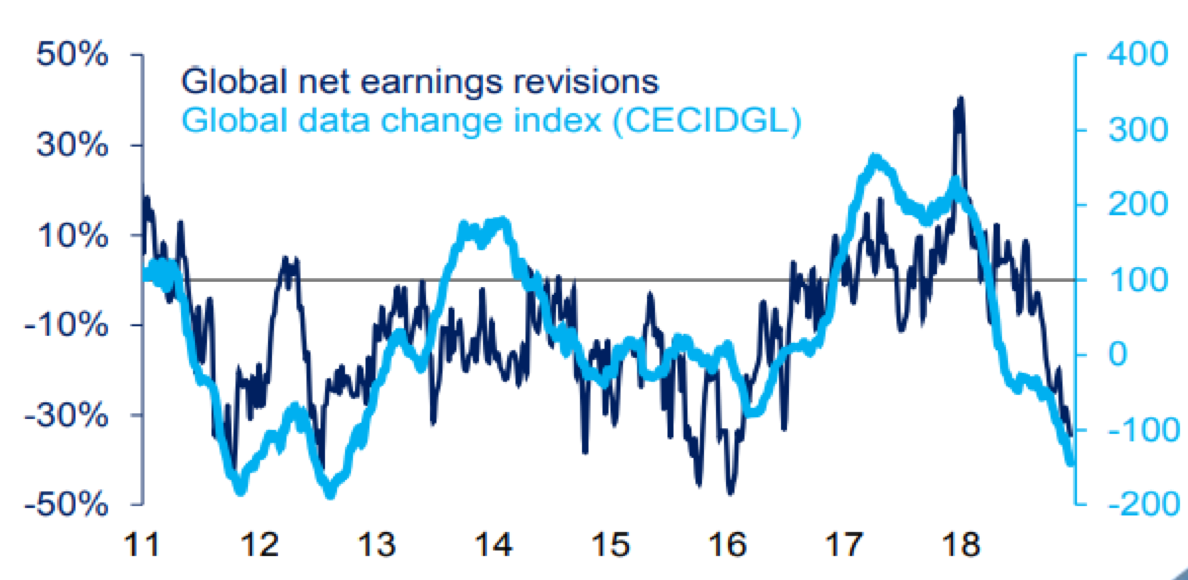
With the end of Central Bank stimulus (for now), will political and economic reality start to drive the capital markets? After a near two-year barrage of 'fake news' are the markets at last beginning to distinguish between economic and political reality?

With Trump, Brexit and even Facebook each suffering an erosion of trust, are people finally waking up to a world in which monumental challenges still exist? As well as opportunities? Without a Fed or ECB stimulus to hold their hands? How will the global populist movement react to this and how will their current champions be able to cope?

The volatility experienced at the end of 2018 might just be a taste of what we might expect in 2019. The world economy is in a precarious state.

What comes next may come to define the political and investment landscape for years to come - more populism or a turn towards more 'enlightened' thinking? That is one of the hardest questions to answer and right now and one of the most important to get right.

Global Data Changes and Net Earnings Revisions



Source: Citi Research.

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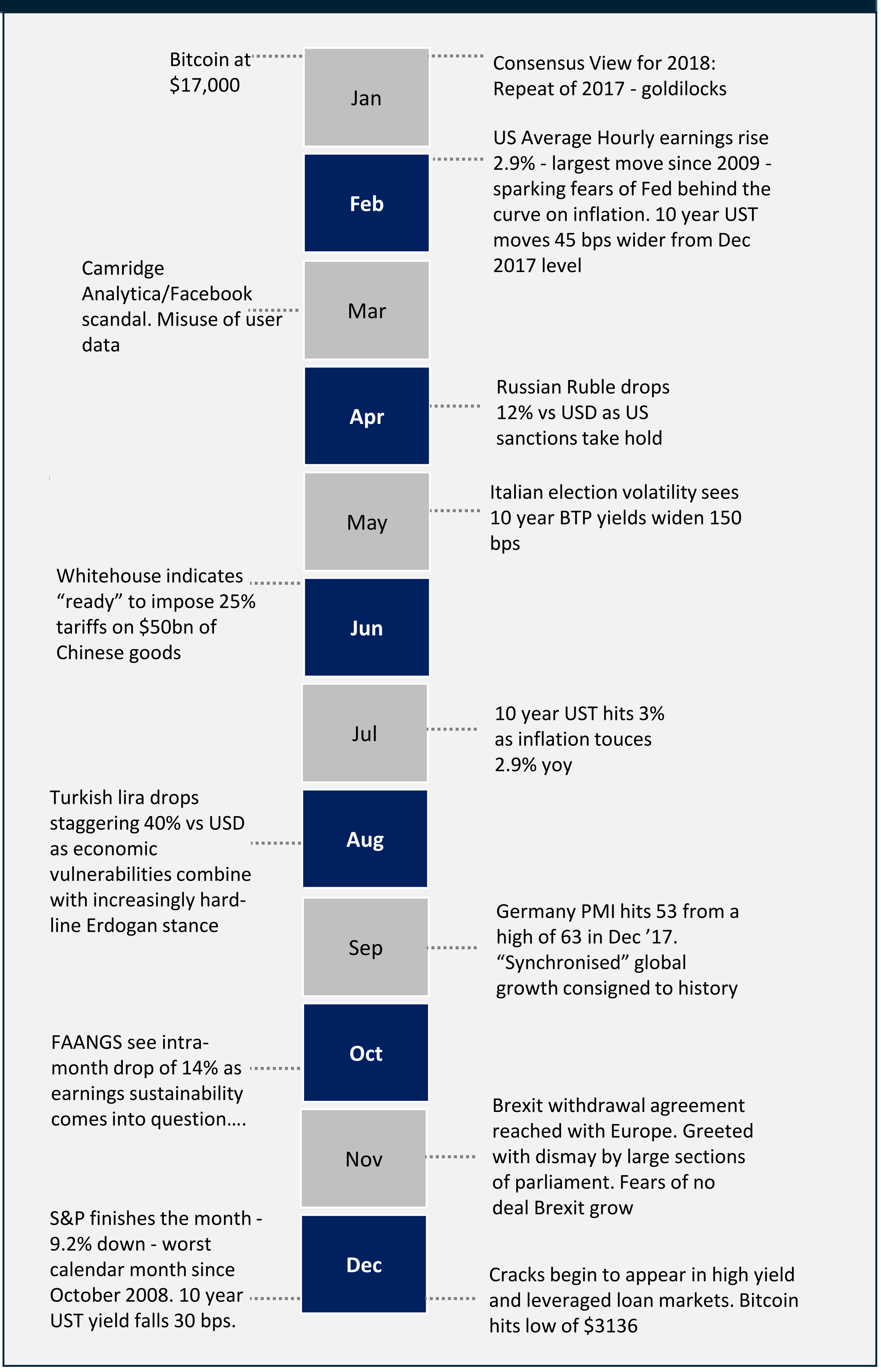
DEBUNKING THE POPULAR MYTHS

The economic 'herd' and political 'populist' thinking that became something of a global consensus from Mid-2016 to 2017 appears to have been dealt a series of damaging blows. *No Mr Trump, trade wars are not 'easy to win'* and contrary to your assertions Mr Gove, the UK *did not* 'hold all the cards' in Brexit negotiations. Theresa May *you were wrong* to suggest the UK will have the 'same trade benefits' outside of the EU as inside.

As for some leading economists, the idea that QT would have 'little impact on financial conditions' - we will leave that to you Janet Yellen et al to contemplate. We won't let Wall Street off the hook either. The consensus view at the beginning of 2018, for another year of perfect trading conditions was considerably wide off the mark.

2018 TIMELINE of Events



Of course, things are rarely black and white, and we do recognise the merits to some of the positions adopted above. China does have a case to answer for regarding intellectual property theft, the EU is an imperfect construct without fiscal harmonisation; which as it stands looks a long way from fruition, and in a normal world, quantitative tightening should not be a disaster.

However, we are not in a normal world. The problems we face are far more complex than a Trump or a Boris Johnson could ever understand. Global Central Banks have been similarly guilty of suspending reality when weighing up the potential costs and benefits of their erstwhile extraordinary policies.

POLITICAL LANDSCAPE

Rubrics published a report in 2016 showing the last leg of this cycle (as with all previous debt cycles) ending in political crisis. As we write today, surveying the current political landscape does not inspire confidence.

The White House is no longer providing the kind of leadership we have grown accustomed to, the UK has reached a political standstill (with a range of outcomes from no deal to no Brexit still in play), whilst Italy, despite securing budget approval from Brussels, could yet be moving toward another populist election in 2019.

We haven't yet mentioned the growing public discord in France. The seeds of unrest had been laid many years ago with the problems becoming increasingly evident.

Globalisation has clearly not worked for everyone. In particular, the working classes of the developed world who have been supplanted by the cheap labour of the emerging markets.

A great recession and an accompanying debt crisis provided the additional impetus for the situation we see today. ***This discontent has been compounded by QE-induced asset price inflation in a broad range of global asset classes that include properties in Sydney to classic cars***. Emerging markets also saw their fair share of political upheaval in 2018.

An Increasingly hard-line stance from Turkey toward the USA, increased tensions with Saudi Arabia and the rest of the region, populist victories on either end of the spectrum in both Mexico and Brazil and ***Imran Khan's election win in Pakistan, halting decades of power dominated by the Bhutto and Sharif family dynasties***, were amongst the highlights.

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CHALLENGES

The challenges facing the world economy going into 2018 were easy to see, for those willing to look. Most however were too intoxicated by the monetary high from central bank support and the fanciful notions of America being made great again.

The Trump economic stimulus, given when and how it was executed, was always going to be short lived and has put the US economy and its fiscal position on a dangerous footing. The capital markets were never going to survive the tightening of financial conditions by the Fed, ECB, BOE, BOJ given they were so inextricably linked by years of central bank stimulus. And the UK was never getting any deal over Brexit other than the one on the table now.

This inherently flawed thinking planted the seeds for the harsh economic realities to finally hit home in 2018, notwithstanding relatively healthy economic conditions. Trump's leadership, Brexit and the Fed's attempts at normalisation have hit a brick wall of reality.

BREAKING THE CYCLE

For over a decade, economic commentators and investors focused on cheap money and spent little time studying the harsh economic realities of extremely low productivity levels, stagnant wages and rising inequality.

The markets focused on financial engineering and share buybacks financed by massive debt issuance to boost earnings per share. Debt expanded at multiples of underlying growth, which meant that every time stimulus was reduced (a la the taper tantrum in 2013), the collective market convulsions were such that more stimulus was immediately required.

Stephen Roach, former Chief Economist at Morgan Stanley recently pointed out this insanity in a note, outlining the continuous boom-bust cycle the Fed reserve has been pursuing since the mid 1990's. It had to stop at some point, and perhaps now might be the time?

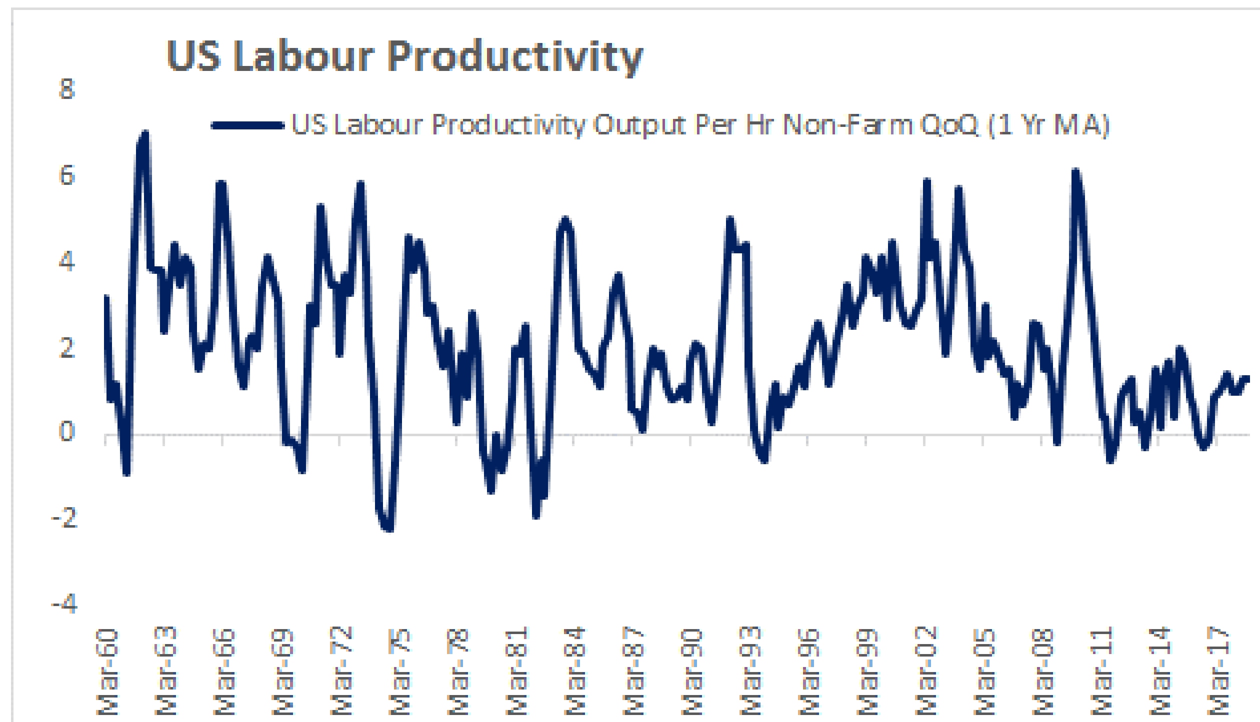
2019 OUTLOOK

2019 will begin with a great deal more realism than 2018. Valuations on many asset classes are looking more attractive than they did even six months ago.

However, the realities of a trillion-dollar US deficit in tandem with a slowing and non-productive economy represents a major concern . How will the Treasury fund these deficits without crowding out any potential private investment cycle? How will Europe cope with a recession if it refuses to remove the straight jacket on deficit spending? How can the UK leave Europe without major economic damage?

Getting portfolio positioning correct can enable performance levels to pick up from what was witnessed in 2018. Although there is a caveat to this – passive strategies will continue to struggle as the worst of the excesses of the last decade are firmly embedded in these strategies.

The ability of managers to readjust portfolio positions to reflect changing economic realities will be challenging in a sub-optimal market in terms of liquidity and price transparency. Active investment management may just have the upper hard for the first time in quite a while.

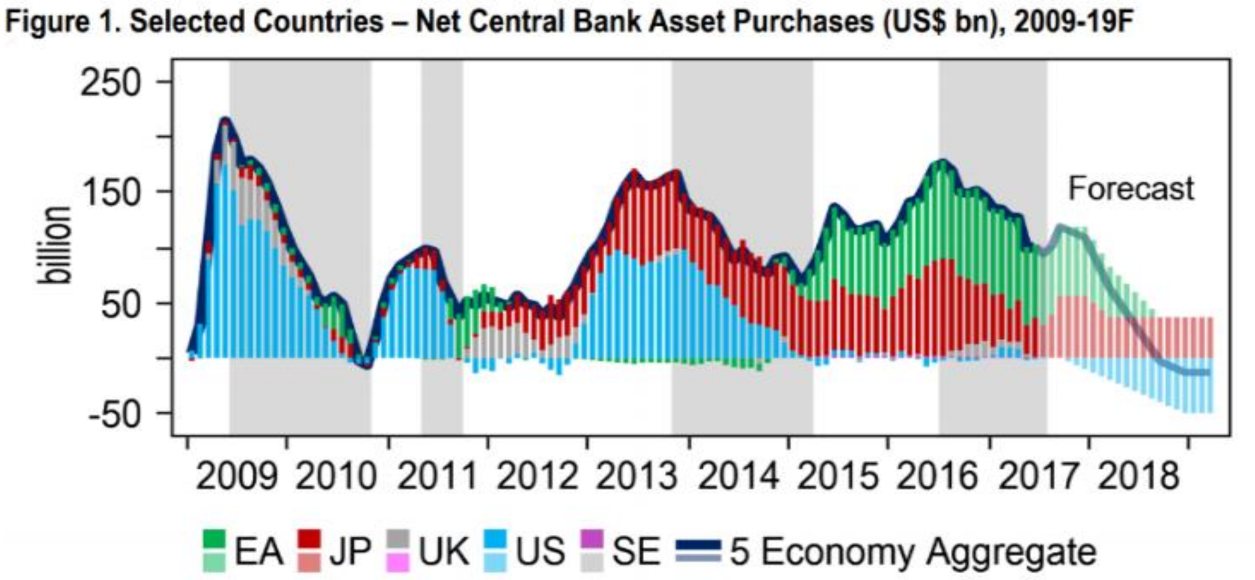


Source: Bloomberg, Rubrics AM

MONETARY STIMULUS

Throughout 2018 we highlighted the fact that aggregate monetary stimulus would move into negative territory by the end of the year for the first time. While markets will always look for a narrative - especially in times of volatility (trade war talk, Fed hikes etc), when all said and done a contracting money supply is never positive for financial markets.

Figure 1. Selected Countries – Net Central Bank Asset Purchases (US$ bn), 2009-19F



Note: 3m rolling sum of change in domestic currency securities holdings expressed in USD at market exchange rates. EA: euro area, SE: Sweden. Citi forecasts Source: Haver and Citi Research

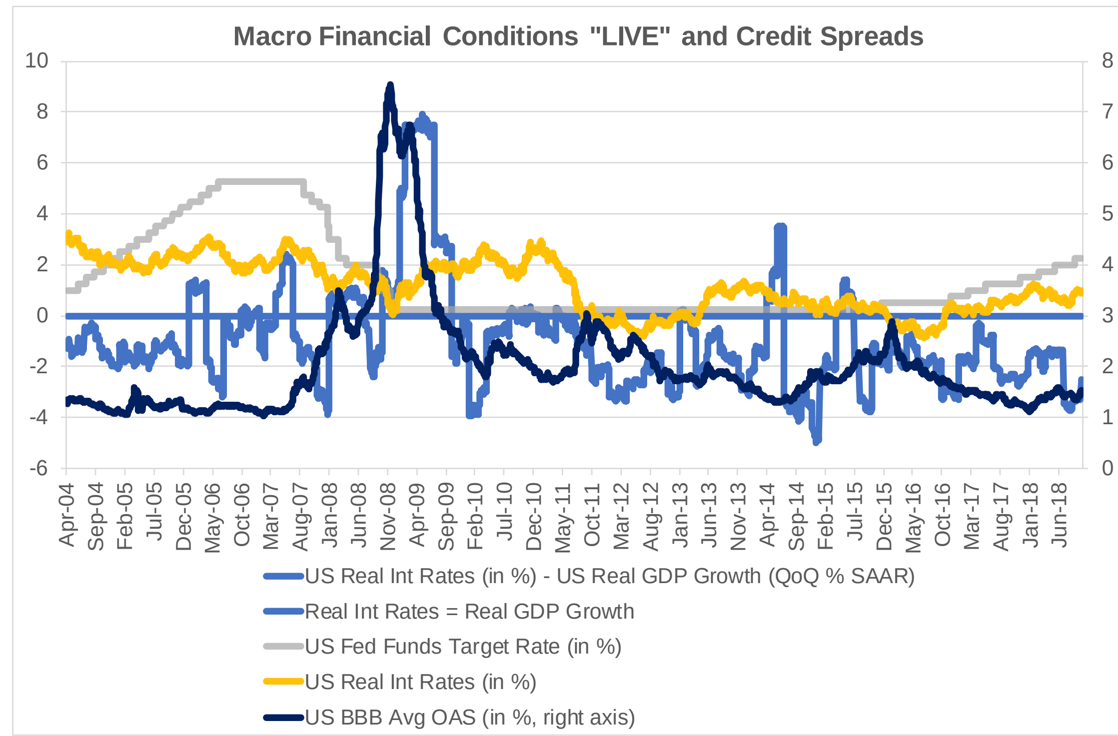
Lest we forget, there have been multiple examples in the recent past of extremely negative political news that somehow coincided with bullish markets, when monetary conditions were loose. Money supply and monetary stimulus are the true barometer of market conditions - not Trump's twitter account. The penny may finally be dropping for the president on this last point.

CREDIT VIEW – TOP DOWN

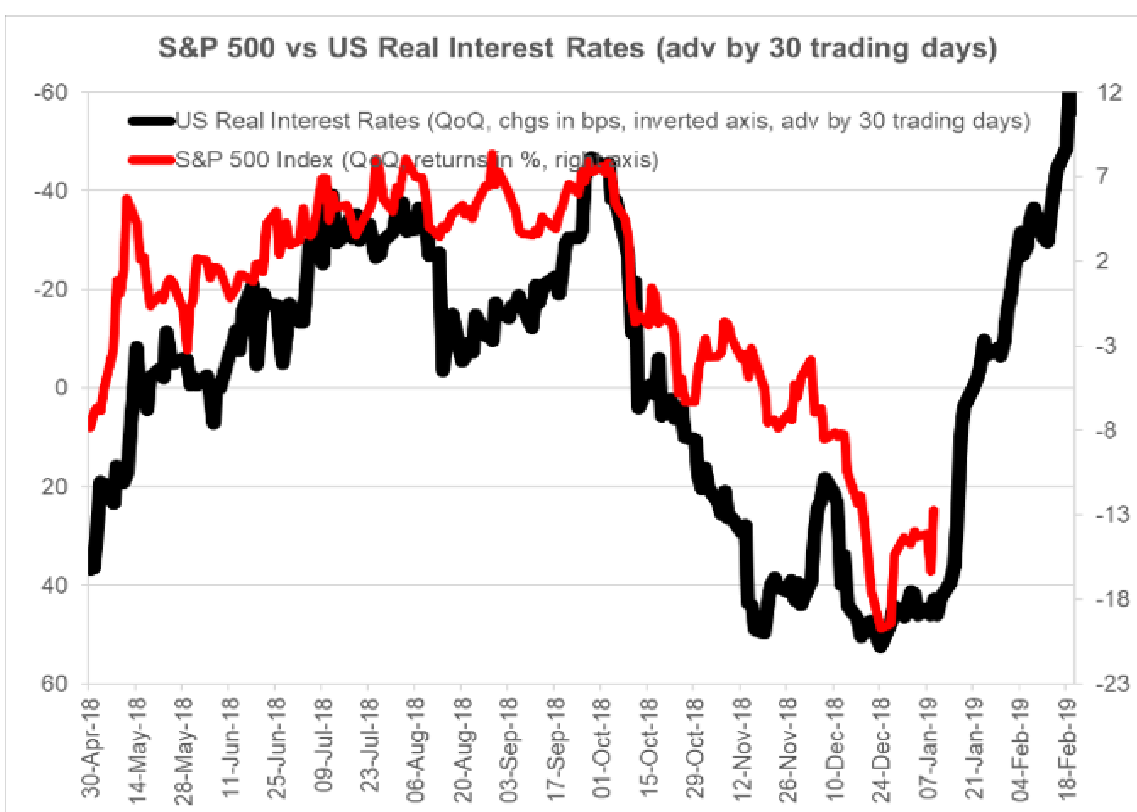
From a macro perspective, the relationship between real rates and growth has historically been the chief indicator of macro financial conditions and the health of the credit markets in general.

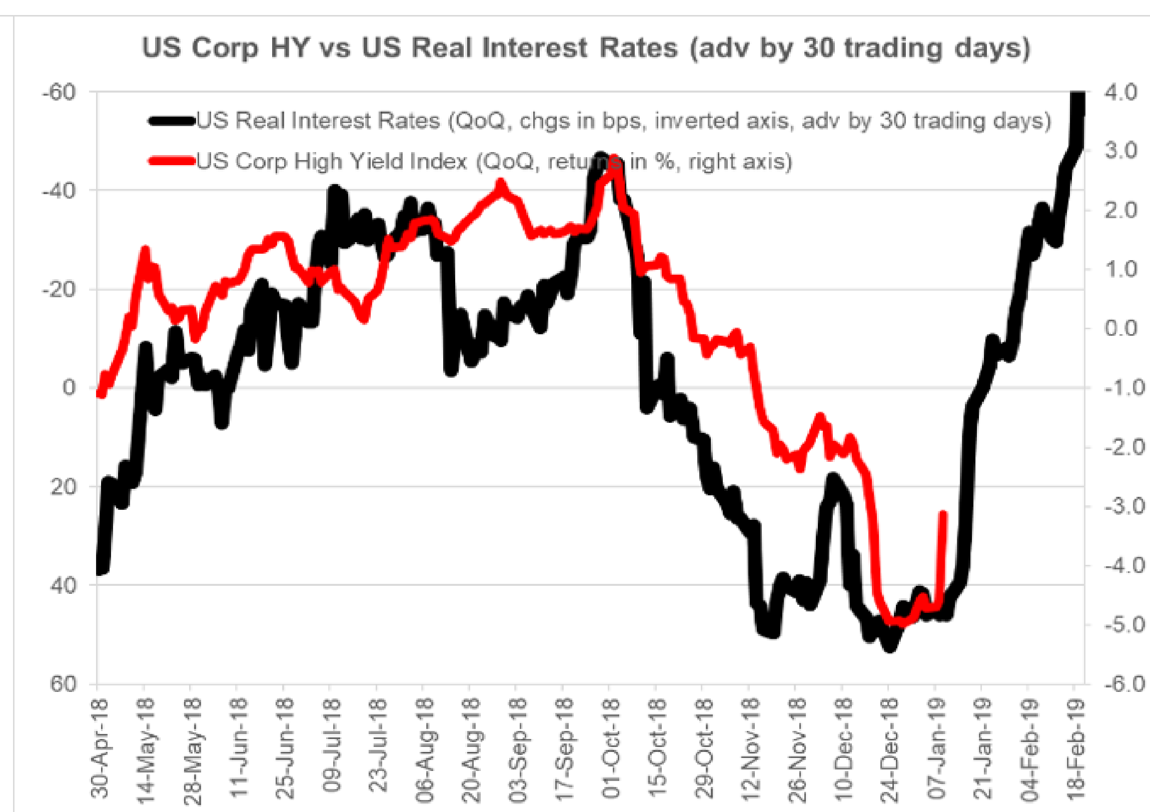
Historically, pronounced periods of credit market weakness have coincided with considerable declines in growth relative to real rates. With US growth remaining robust throughout 2018, it was sharp rises in real rates that were the most timely indicator for the various periods of risk asset weakness seen (below).

These periods of market volatility have so far been contained. As above, this relates largely to the fact that overall financial conditions have remained loose with little follow through into broader economic credit creation.



Source: Bloomberg, Rubrics AM





Source: Bloomberg, Rubrics AM

In the last 2 months of the year however, we did notice a deterioration in some real-world measures of financial conditions:

- Filings for bankruptcies increased quite significantly in November in the US
- There was no US HY issuance in December
- No GBP bond issuance between November 15 and the end of the year
- Jump in the margin on US Institutional loans (+57bps in December 2018, highest since Aug-16)
- A pause in new Equity IPOs and poor secondary market performance of IPOs issued in 2018

Longer term directionality in risks assets and credit spreads we believe will be determined by underlying growth and central bank liquidity. So far in 2019, the drop in real rates has provided some respite for risk assets and looking ahead we will be following both themes very closely.

CREDIT VIEW – BOTTOM UP

2018 turned out to be a very tough year for benchmark Credit investors. Low coupon bonds issued to benchmark investors in the QE-era between 2016 and early 2018 suffered last year as the bond market adjusted towards higher treasury yields in the first two quarters, and then spread widening which gathered pace in Q4.

Security	Issuer	Mid Px	Mid Yld	Comment	Moody	S&P	Fitch
ARNDTN 2⅛ PERP	Aroundtown	84.20	5.9	IG Corp Hybrid	N.A.	BBB-	N.A.
BACARD 2¾ 26	Barcardi	86.33	5.0	IG issuer	Ba1	BBB-	BBB-
BATSLN 2 ¼ 52	BAT	65.0	4.2	IG rated Tobacco	Baa2	BBB+	BBB
CCBGBB 3⅝ PERP	Belfius	75.10	8.9	AT1	Ba2	BB+	N.A.
COGARD 5⅛ 25	Country Garden	83.78	8.6	IG China Property Developer	N.A.	N.A.	BBB-
DIASM 0 ⅞ 23	DIA	60	14.0	Spanish Retailer	Caa1	CCC+	N.A.
DB 4⅞ 32	Deutsche Bank	78.39	8.4	Subordinated DB	Ba2	BB+	BBB
EGYPT 5⅝ 30	Egypt Sovereign	86.62	7.5	EM HY Sov	B3	B	B
F 3.815 27	Ford Motor	84.23	6.2	IG Autos	Baa3	BBB	BBB
ISPIM 4⅜ 48	Intesa Sanpaolo	75.14	6.3	IG Italian Bank	Baa1	BBB	BBB
IVYCST 5¾ 30	Ivory Coast	89.04	6.8	EM HY Sov	Ba3	N.A.	B+
LGEN 5.55 52	Legal & General	89.13	6.9	IG Insurer	A3	N.A.	BBB+
LLOYDS 4.344 48	Lloyds Bank	78.06	6.0	IG UK Bank	Baa1	BBB-	A-
MO 3⅞ 46	Altria	76.82	5.5	IG rated Tobacco	A3	BBB	BBB
MONTE 5⅝ 28	Monte Paschi	57.35	22.6	Italian Bank Sub	Caa2	N.A.	CCC+
MTNLN 9½ 24	Matalan	80.91	15.0	UK Discount store	Caa2	CCC	N.A.
NWIDE 4⅛ 32	Nationwide BS	87.62	6.0	Largest UK BS	Baa1	BBB	A-
PCG 2.45% 22	PG&E	83.5	7.6	US Gas & Electricity Co	Baa2	BB-	BBB
SANTAN 4¾ PERP	Santander	78.24	9.4	Bank AT1	Ba1	N.A.	N.A.
TTMTIN 4½ 26	Jaguar Land Rover	83.25	7.6	Autos	Ba3	BB- *-	BBu
UCGIM 5.861 32	Unicredit	88.13	7.8	Italian Bank Sub	Ba1	BB+	BBB-
VKFP 6⅜ 23	Vallourec	73.18	14.4	French HY issuer	N.A.	B-	N.A.

Source: Bloomberg, Rubrics AM

Medium and longer dated bonds were impacted the most, which resulted in swathes of bonds in these tenors trading at material discounts to par. Investors who had purchased these issues had effectively lost several years of coupons within a very short period of time, due to capital losses.

It's worth noting the breadth of the list above, which contains a mix of currencies, sectors (IG, HY, EM, Financials) and maturities, again re-iterating that there were very few places to "hide" if you were a benchmark investor in 2018.

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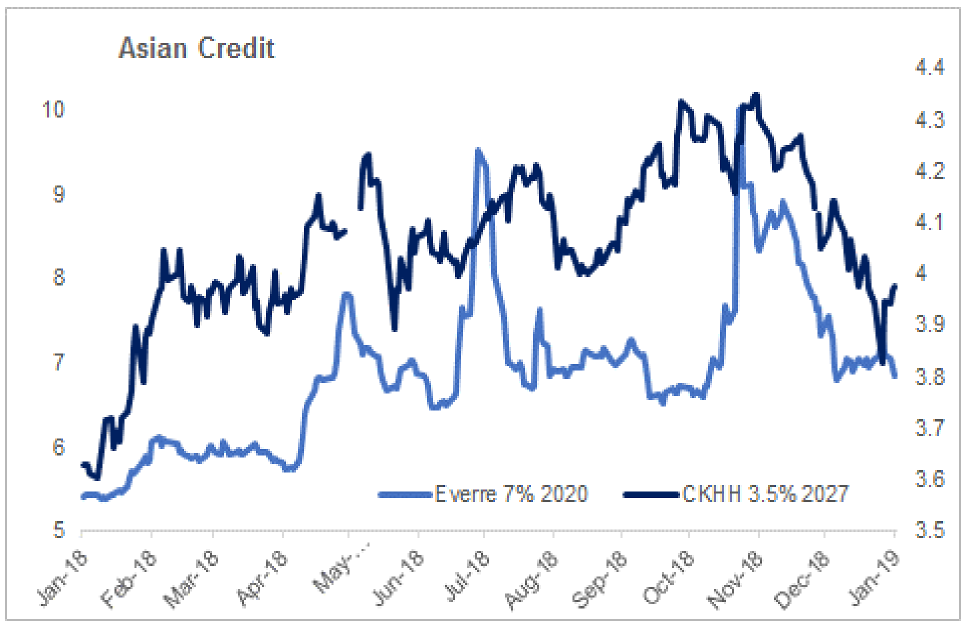
LOOKING AHEAD - CREDIT

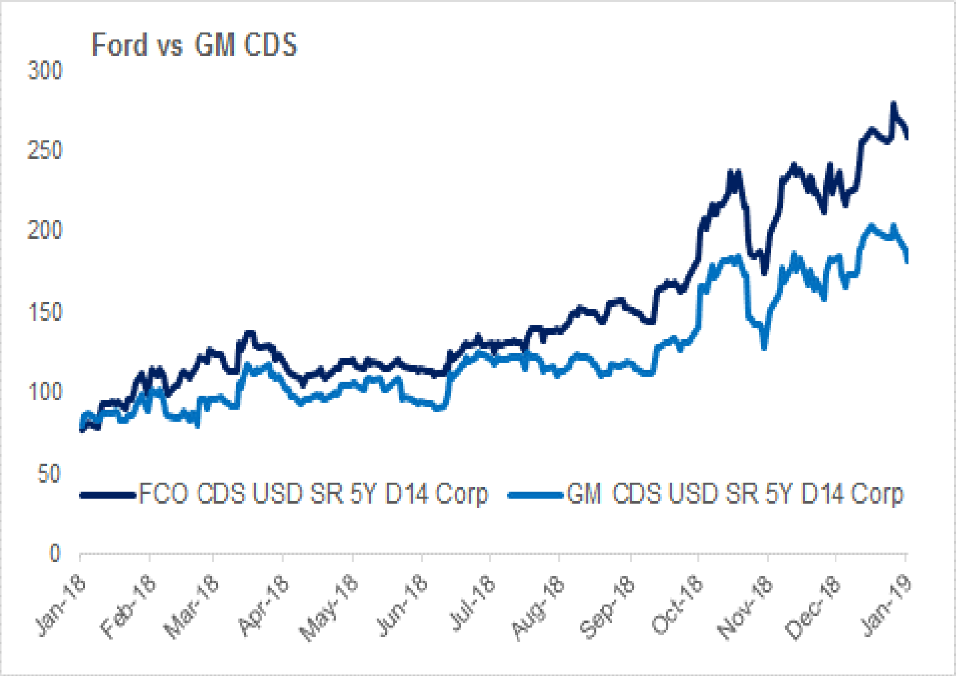
As we have seen in the latter part of 2018, many issuers (big and small) have struggled to raise financing at satisfactory rates, and some have not managed to issue at all. Investors, for the first time in a long time, may now have greater power in controlling pricing on new issues. Issuers that fail to secure financing and have no alternative means of accessing finance, will struggle in this new environment.



Source: Bloomberg, Rubrics AM

December 2018 and the beginning of 2019 have thrown up some interesting developments. Large liquid Asian hard currency bonds appear to have tightened in materially since the start of October in both IG and HY. For example Evergrande 2020, the large HY Chinese property developer, whose 2020 bonds have tightened in 300bps in 2 months. Additionally, there is an A rated CK Hutch, another Asian issuer whose bonds have tightened in 50 bps in the same period, a material move for a highly rated credit.

In developed markets credit, the early signs are that investors appear to be more selective in which credits they buy, which is different to the approach in 2018, when many benchmark investors just piled in indiscriminately into new issues. This is demonstrated well by the difference in spreads for the two largest US Auto Manufacturers *GM* and *Ford.* The spread differential between the two has diverged as benchmark investors prefer to own a name (GM) which has less downgrade risk, since they typically need two agencies to rate a bond investment grade to own it.

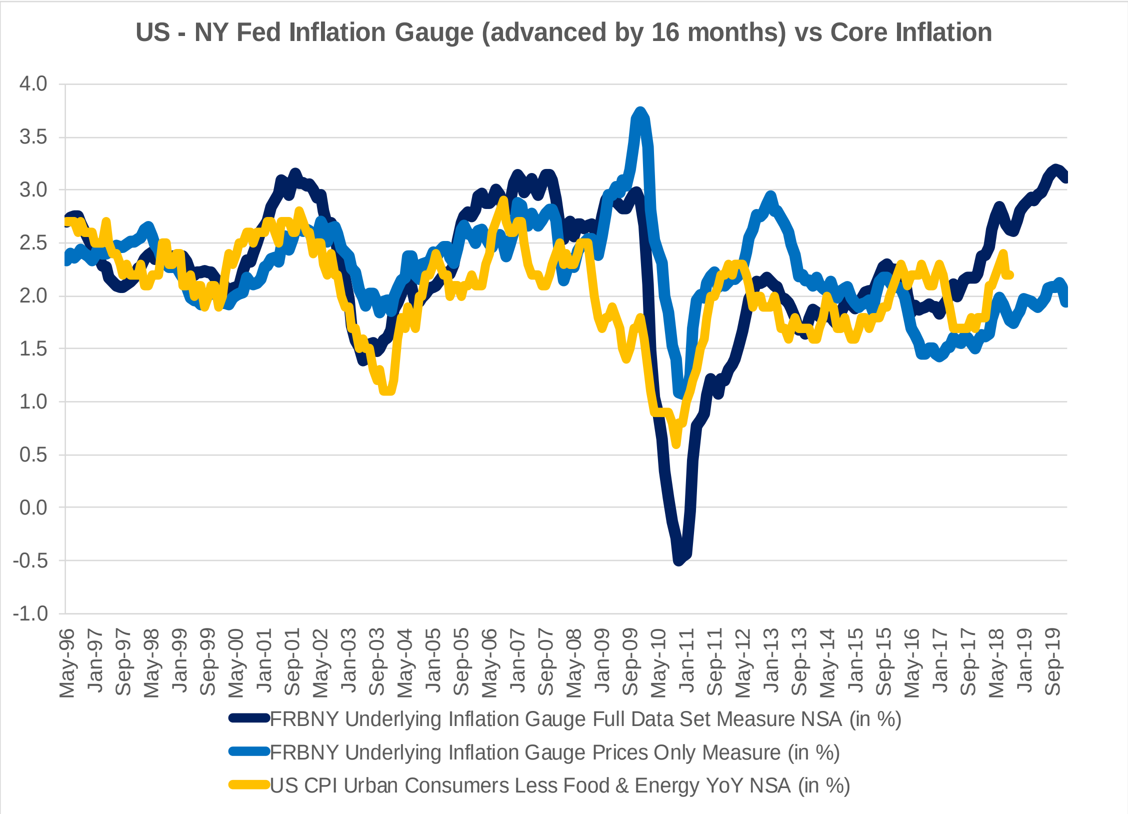


Source: Bloomberg, Rubrics AM

There appears to be a preference for higher rated, short dated paper from investors. Some of these characteristics play into our favour as this is a natural area of operation for Rubrics funds. It would be unwise to extrapolate the above trends seen in DM and EM for the remainder of 2019, however what appears more certain is that there will be more frequent bouts of volatility and illiquidity due to a combination of more uncertain economic trend, corporate profits and the actions of Central Banks.

RATES

A mixture of stronger economic fundamentals – growth, inflation, wages etc. - tighter US monetary policy and forecasts for heavy US treasury supply saw US bond yields move progressively higher throughout 2018. 10y US treasury yields peaked in early November.

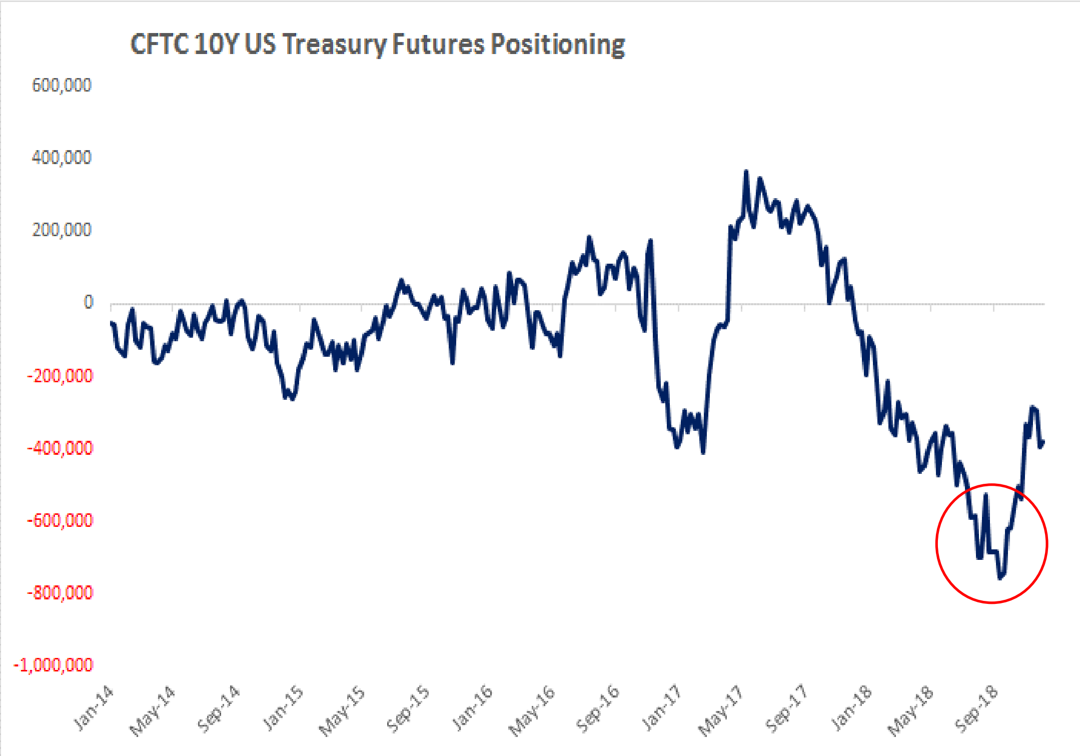


Source: Bloomberg, Rubrics AM

Very few if any analysts called for the sharp correction lower in yields that ensued in December. Many forecasts involved yields moving moderately higher or remaining close to unchanged for 2019 on the back of moderating growth and a slowing Fed.

CFTC positioning data was instructive in revealing speculative market positioning in US treasuries was at its shortest ever at the end of Q3 2018 - the type of positioning that exacerbates moves through short covering.

Looking ahead the key question for 2019 is whether the economic data will validate the market's current pessimistic outlook, or whether a repricing in anticipation of a less severe growth slowdown will take place.



Source: Bloomberg, Rubrics AM

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In previous times, the market has been better at predicting recessions than the Federal Reserve. The 2s10s US treasury curve, not quite inverted at current levels (16bp), is an indicator that deserves close attention in 2019.

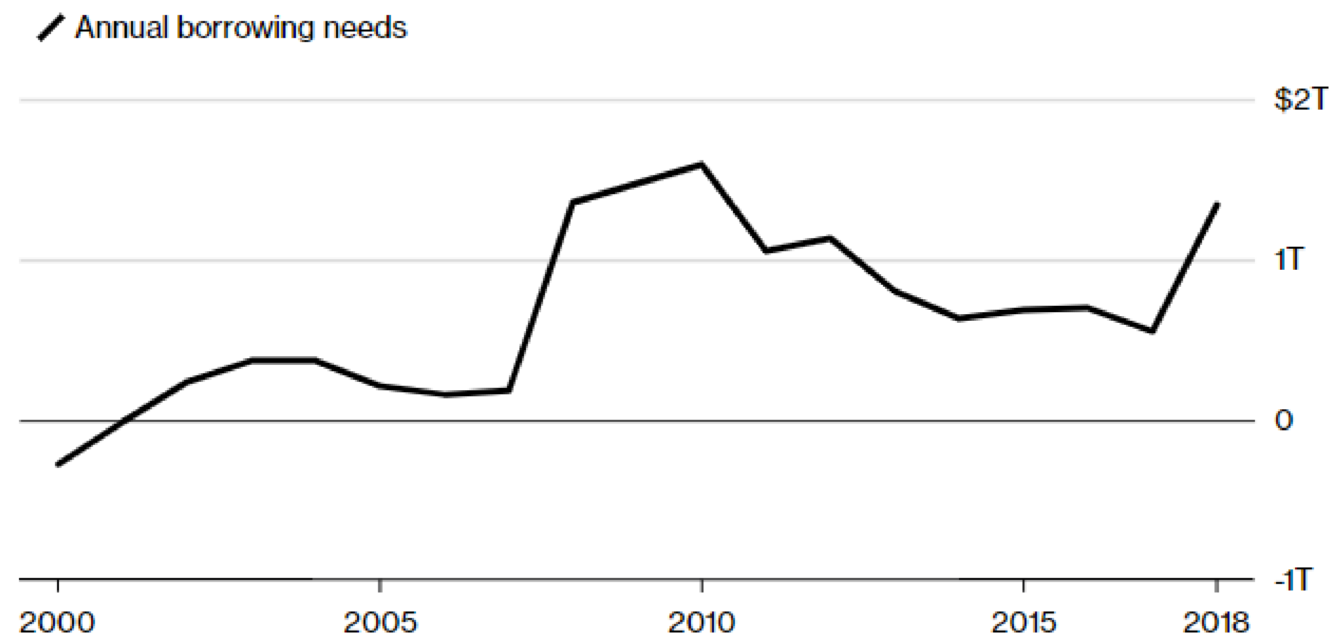
Acting as something of a counterbalance to the above will be the heavy borrowing requirements of the US Treasury in 2019. Our base case view in regard to the debt ceiling, is that there will be no standoff (neither side has the stomach for it politically).

As such US Treasury issuance is set to increase significantly.

With question marks surrounding the market appetite for this excess supply, formulating a clear view on the directionality of rates will be challenging.

Funding the Deficit

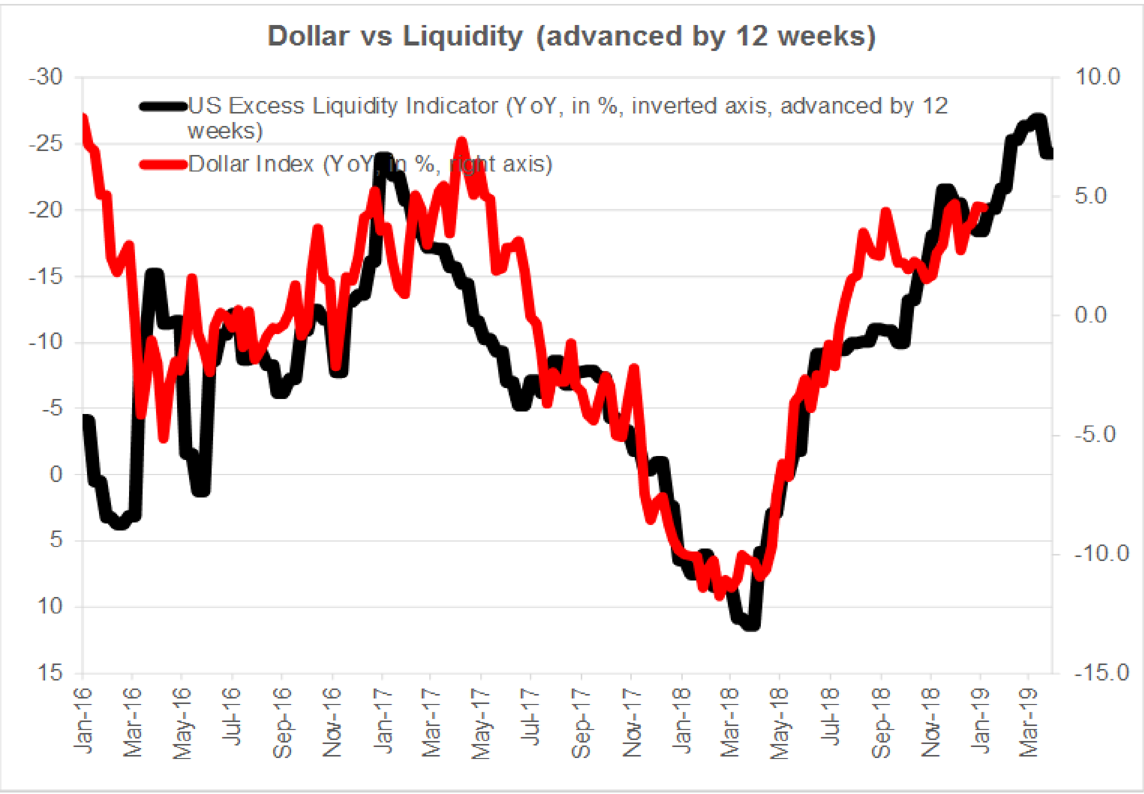
U.S. government borrowing will more than double this year from 2017

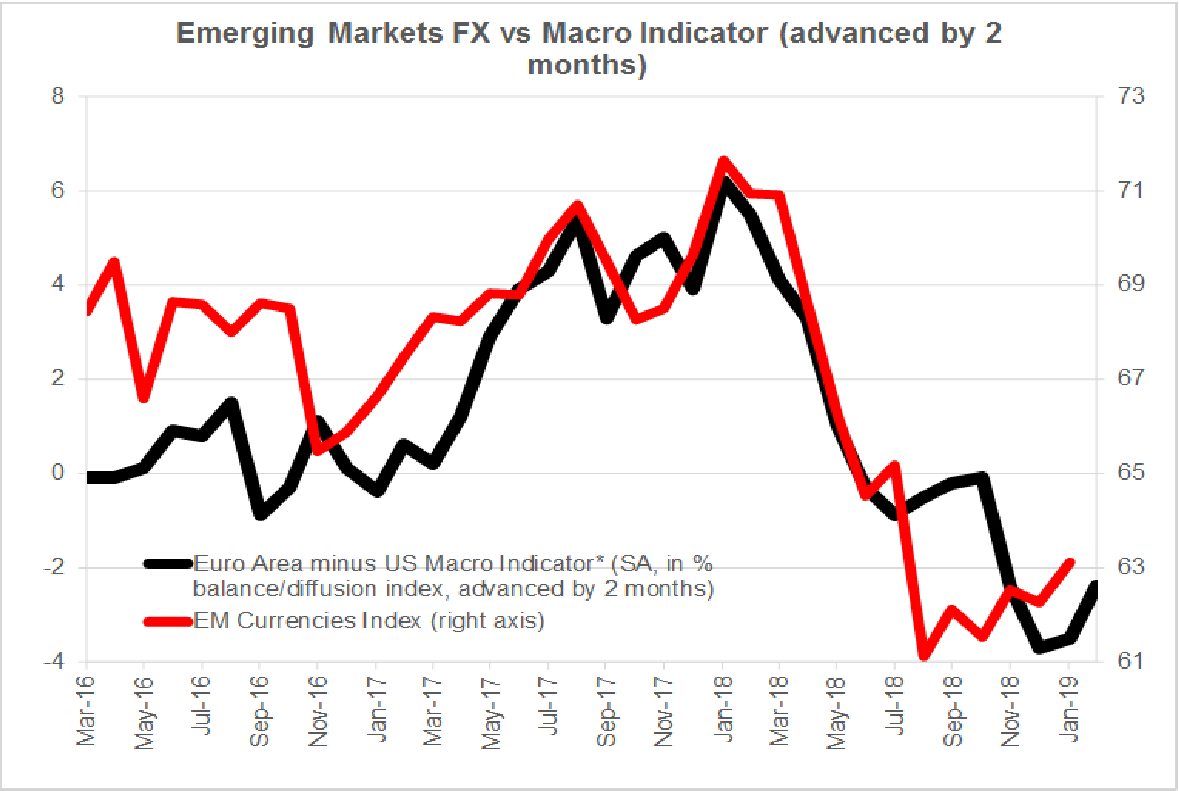


Source: Treasury Department data compiled by Bloomberg
Note: 2018 figure includes forecast for fourth quarter

US DOLLAR

Dollar strength was one of the main themes of 2018 with EM currencies the chief casualty of this phenomenon. There were a variety of factors behind this, including the drop in central bank USD liquidity, global inflation differentials in favour of the US in addition to stronger macro indicators (PMI etc).



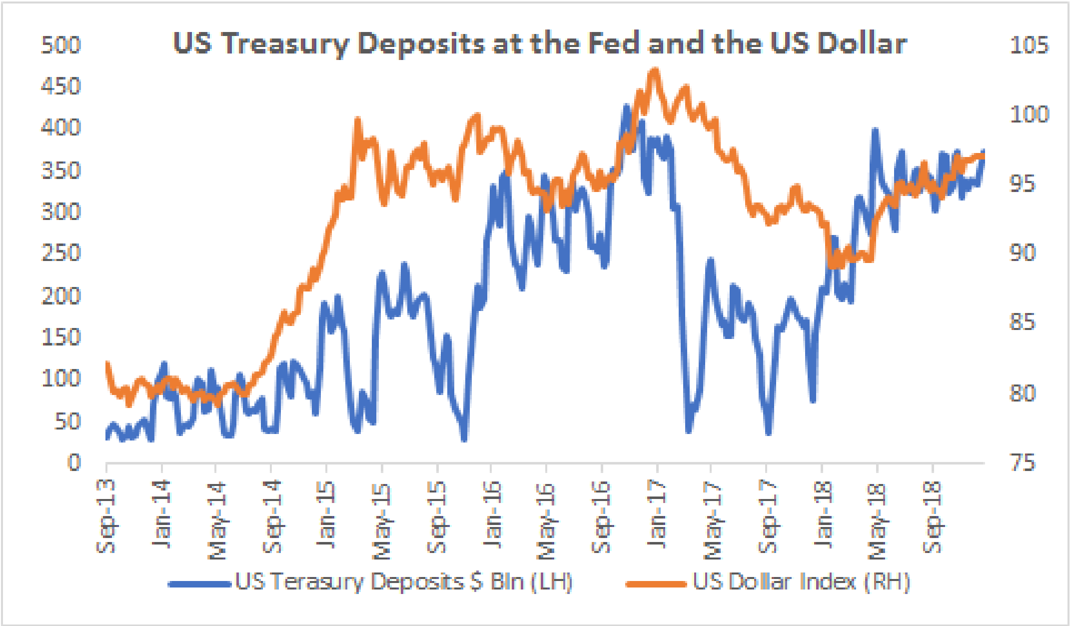


Source: Bloomberg, Rubrics AM

Looking ahead we see the following factors at play for the US Dollar:

Fed balance sheet strategy – Quantitative Tightening (plus new UST issuance bought by banks) is dollar bullish. This involves an increase in deposits at the Fed resulting in a removal of USD liquidity from the system. Recent comments by Fed Chair Powell may indicate a willingness to adjust the balance sheet run-off strategy in response to excessive market volatility if necessary.

Debt ceiling standoff – Similar to Q1 2017, there may potentially be an increase in excess USD liquidity in the event of renewed brinksmanship over the debt ceiling issue in March. US Treasury deposits at the FED would drop materially (as the Treasury would require funds), whilst there would be less issuance and larger excess liquidity.



Source: Bloomberg, Rubrics AM

Beyond this, the long-term story on the US twin deficits is also a factor and can put pressure on the currency to depreciate. Although, it is far more structural in nature and tends to less instructive as regards shorter term directionality.

IMPORTANT INFORMATION

January 2019

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