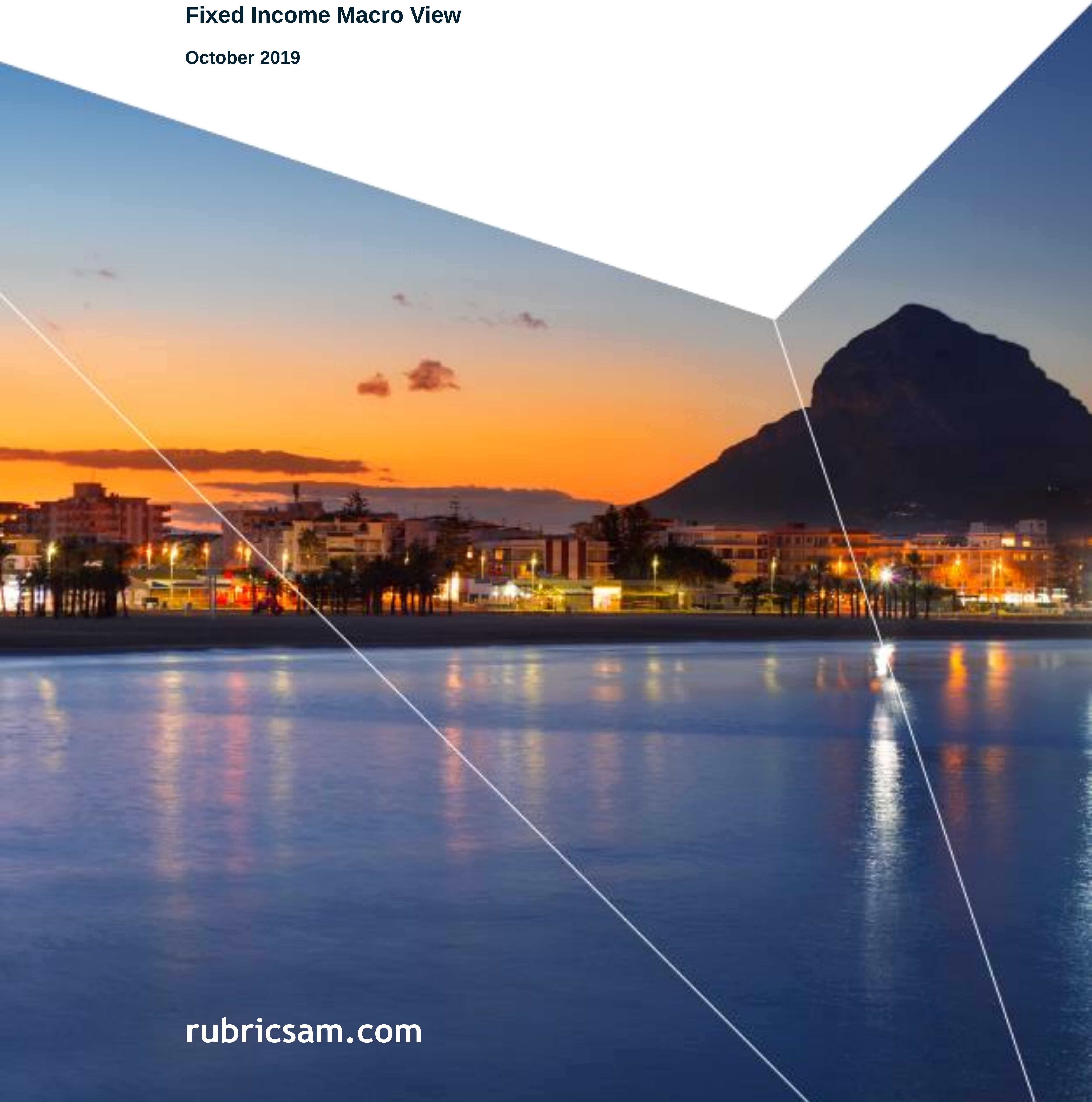
Politics of Economics

Fixed Income Macro View

October 2019



rubricsam.com

Politics and Economics Intertwined

Are today's political institutions fit for purpose? Such has been the level of recent upheaval this might not be as churlish a question as it seems. In order to address it, we must look at the root causes of the current political maelstrom. The scale of the economic crisis in 2008 in many ways made inevitable the level of strain that the world's liberal democracies are currently enduring. We have written in the past about how debt and economic crises ultimately morph into social and political ones. Today we find ourselves at the end of this causal chain. How we got here is in no small part due to policymaking. Specifically the failure to recognise that decisions based on theories and mathematics have real world consequences – negative ones at that. The simple fact is we cannot separate politics and economics. For every economic decision, some benefit at the expense of others. Continued financial repression is a clear policy choice that will eventually have severe political consequences - as the ECB will likely find out. It is possible to limit collateral damage if decisions are taken for the "greater good". However when the net benefits are restricted to so few at the top, political problems are inevitable

Debt Crisis

- US – subrime mortgage crisis, student/auto loans
- Europe – Europe's periphery
- China -$23trln in additional debt since 2008

Economic Crisis

- Global – trade deterioration, currency wars
- Developed Market – wage deflation/inflation in cost of living
- Emerging Market – balance of payments crises, fiscal mismanagement
- Monetary – zero/negative interest rates, liquidity preference theory

Social Crisis

- Social partnership breakdown – housing, health and pension crisis
- Inequality acceleration
- Social mobility decline
- Social discord surge – US, UK, France, Middle East

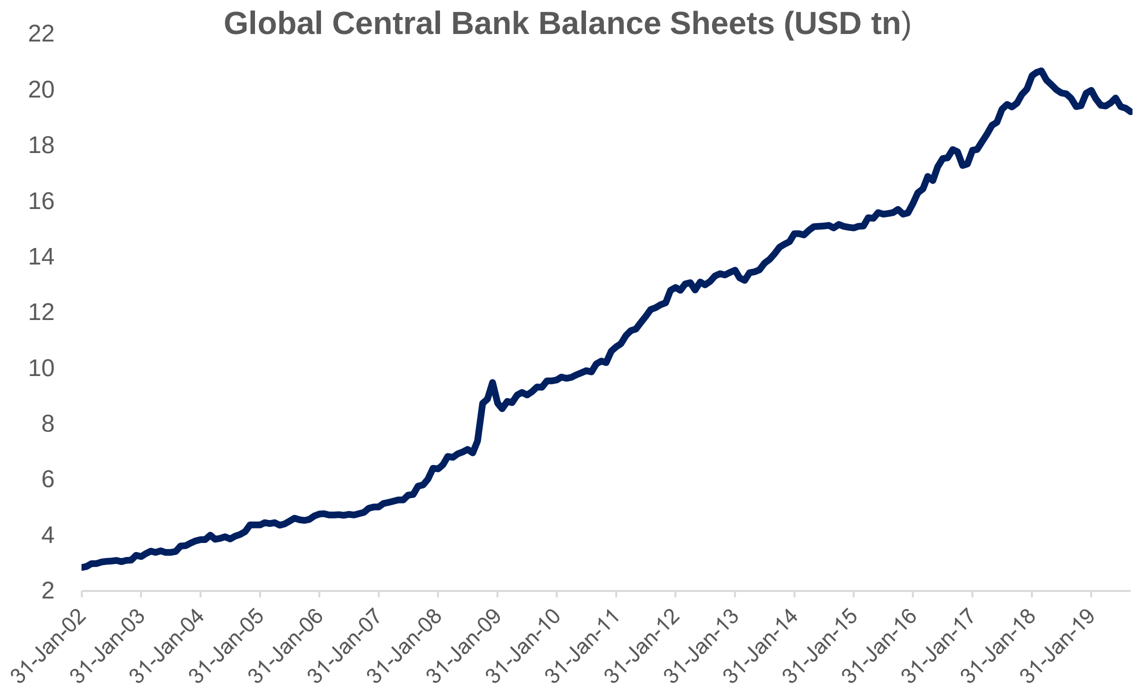
Political Crisis

- Rise of nationalism
- Rejection of globalisation
- Increased protectionism – trade barriers, currency debasement
- Corporate and political conflict

Low Rate Repercussions

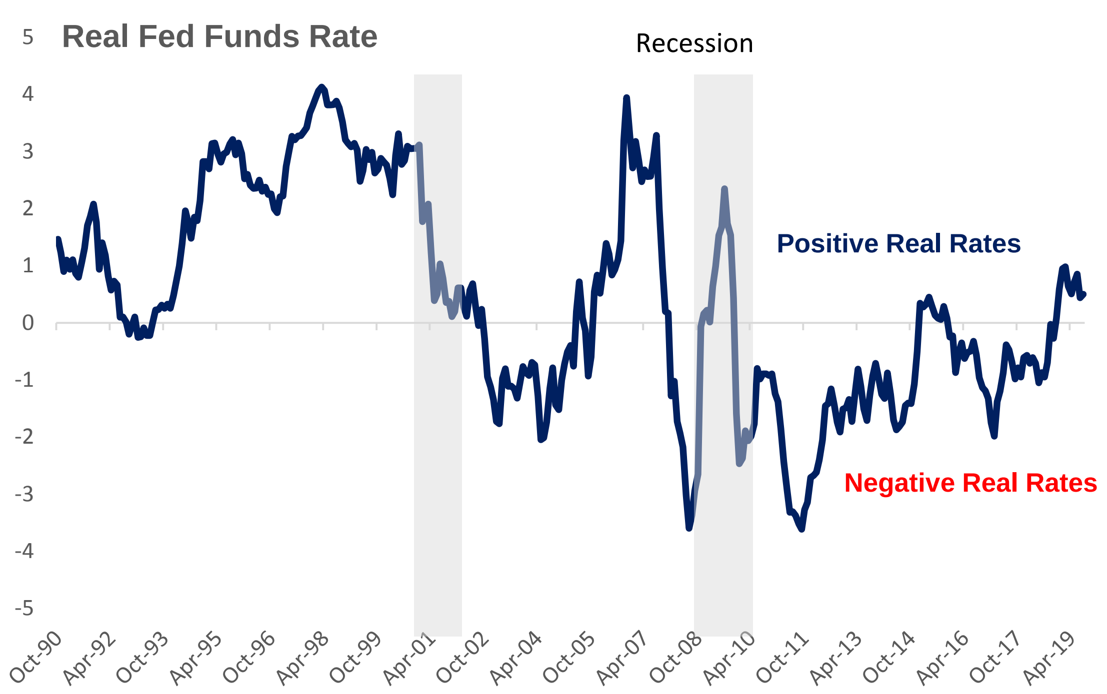
It will not come as a shock to many of you to hear that I have disagreed with much of what central bankers have done in the last 20 years. One particular theory, espoused by Ben Bernanke and borrowed from Paul Samuelson[1], has stuck with me. That is, if real interest rates can be brought to zero, almost any investment is profitable. Furthermore if this is applied in aggregate, broader economic activity should benefit. Perhaps in its crudest form this could make sense. However, the reality is very different.

Central Bank Balance Sheet Expansion



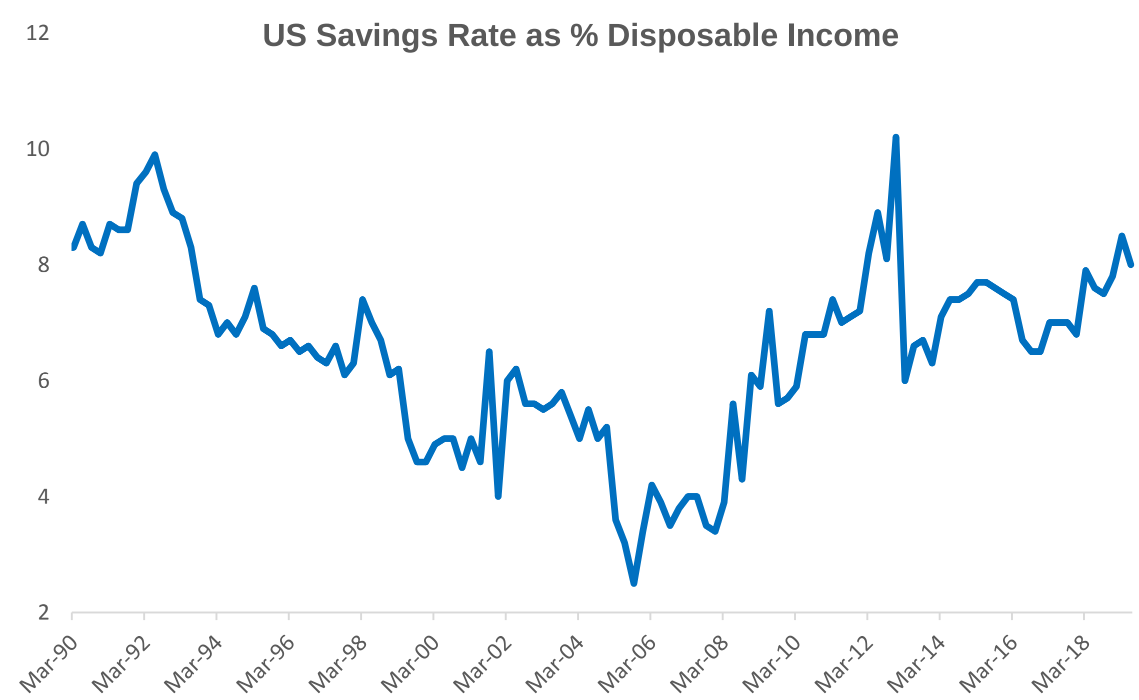
Source: Bloomberg, Rubrics as at 30/09/19

10 Years of Zero/Negative rates



Source: Bloomberg, Rubrics as at 30/09/19

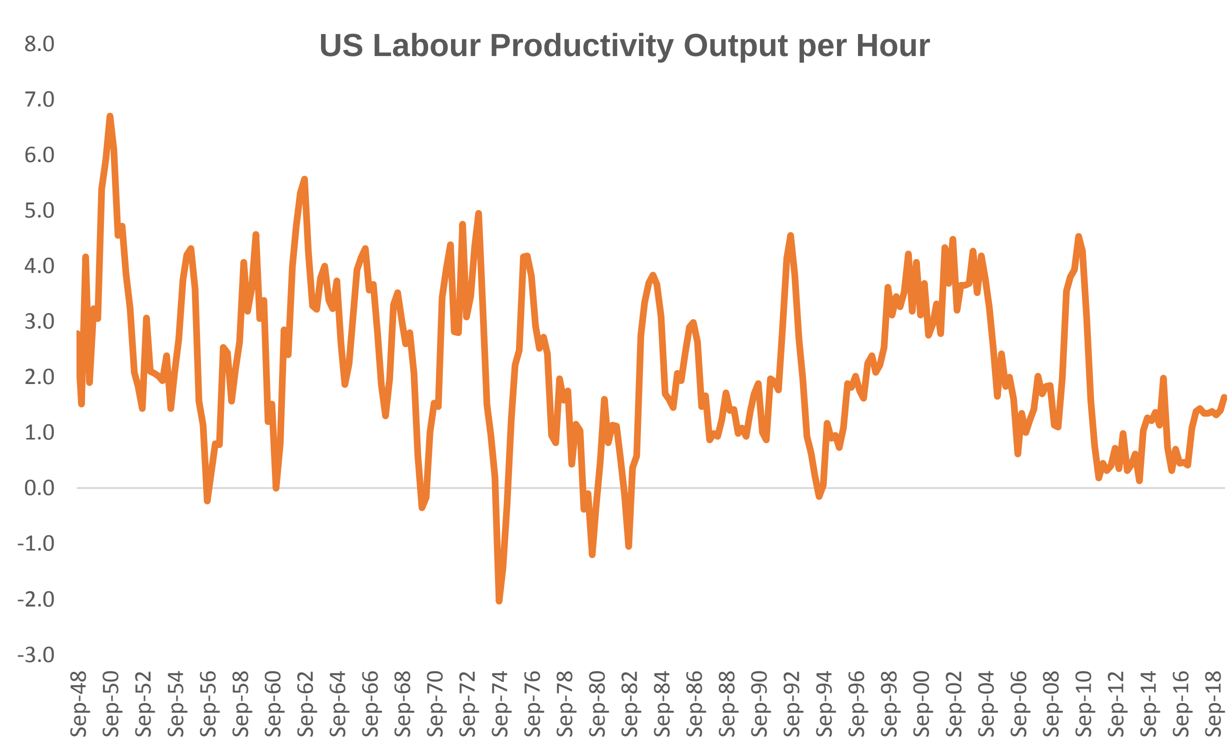
Increase in Savings Rates



Source: Bloomberg, Rubrics as at 30/09/19

Post 2008, multiple trillion-dollar stimulus packages have hidden (in plain view) stagnant productivity, static corporate profitability and rising savings rates. Meanwhile the real world fallout from $17trillion in negatively yielding debt is now being clearly felt in Europe and perhaps most acutely in Denmark. As a University of Chicago[2] paper points out, ultra-low interest rates have discouraged small businesses. This phenomenon appears to have been especially strong in Japan, where almost no major new companies have emerged since 1990.

Stagnant Productivity

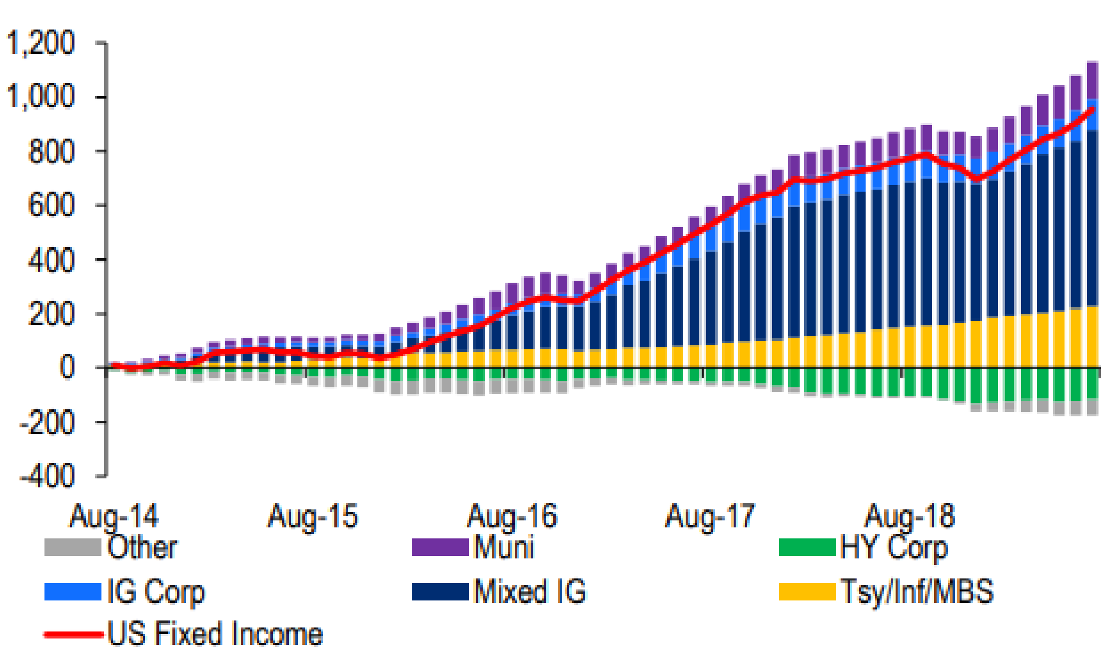


Source: Bloomberg, Rubrics as at 30/09/19

1. https://www.brookings.edu/blog/ben-bernanke/2015/03/31/why-are-interest-rates-so-low-part-2-secular-stagnation/
2. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3320551

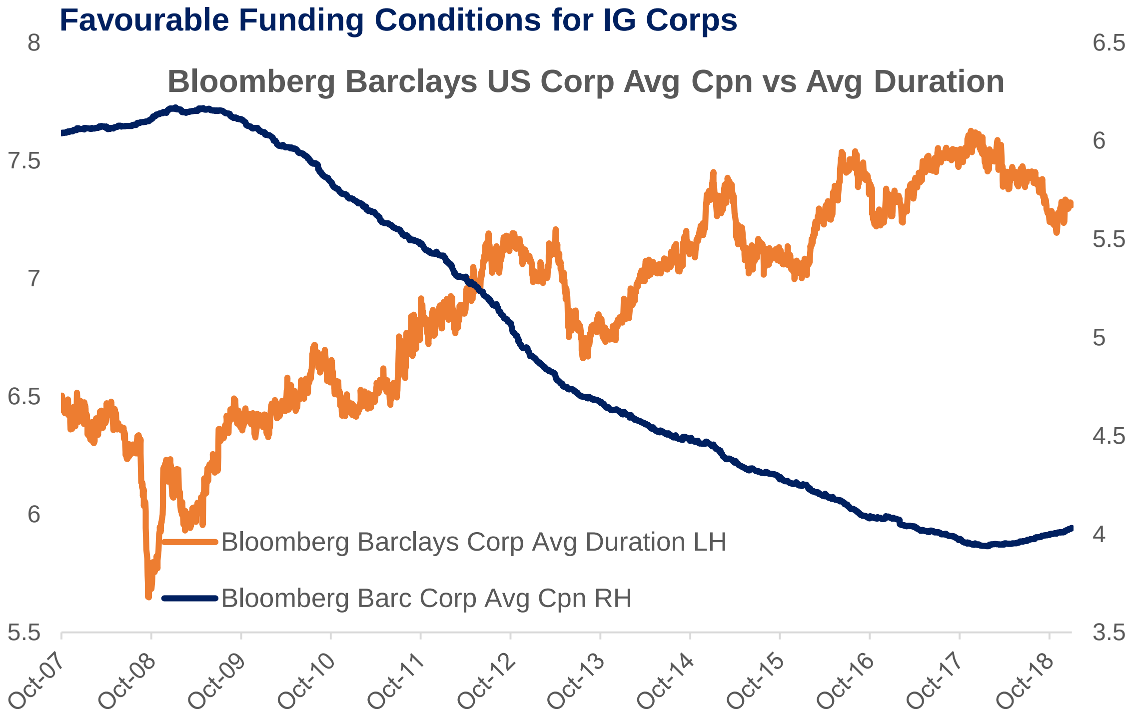
At a micro level, how a company such as WeWork could hold a valuation close to $47billion (with only $47billion in leases to show for $12billion in spend) is a real mystery. However the more interesting story is not the bubble in such loss making unicorns, but rather former industry titans like Boeing and General Electric. Both companies for generations were industry leaders in innovation and productivity. However free money (and near monopoly positions) has corrupted them to the point where the only engineering seemingly taking place is of the financial variety. And how they have excelled at that. General Electric no longer makes the bulbs that it sells (Thomas Edison must be turning in his grave) and Boeing can no longer make safe aircraft. But it's worse than that. The unstated goal of these businesses has become the enrichment of management and shareholders (again management) facilitated by billions in share buybacks and generous 8 figure remuneration packages. Meanwhile contracted engineers receive $9 dollars an hour.

US F.I Flows - Cumulative flows over 5 years in $bn



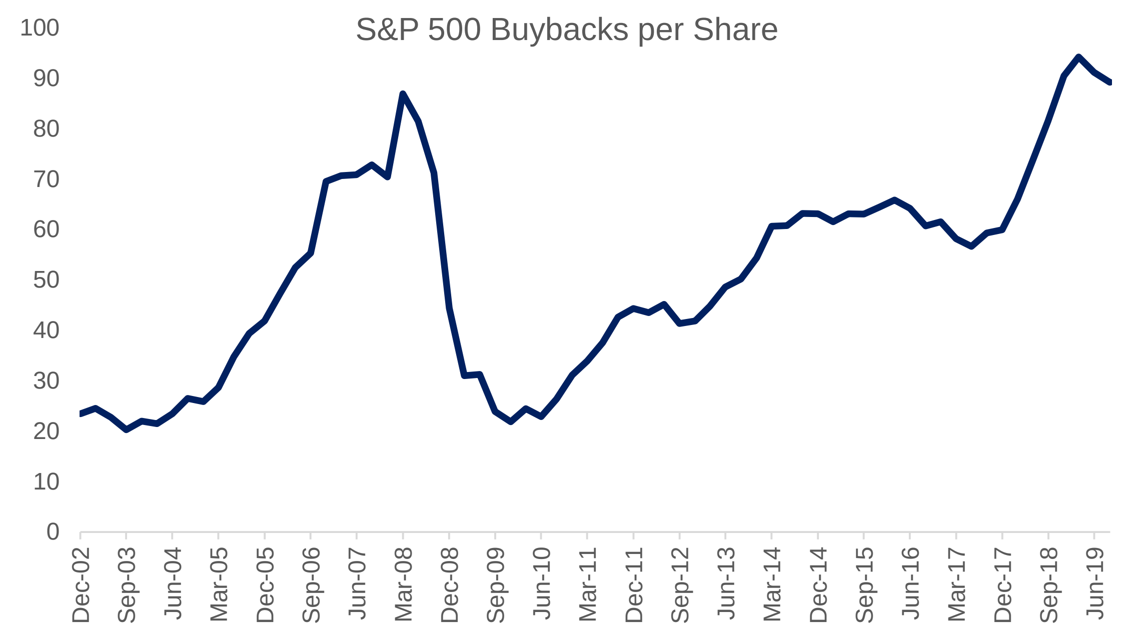
Source: Citi Research

Favourable Funding Conditions for IG Corps



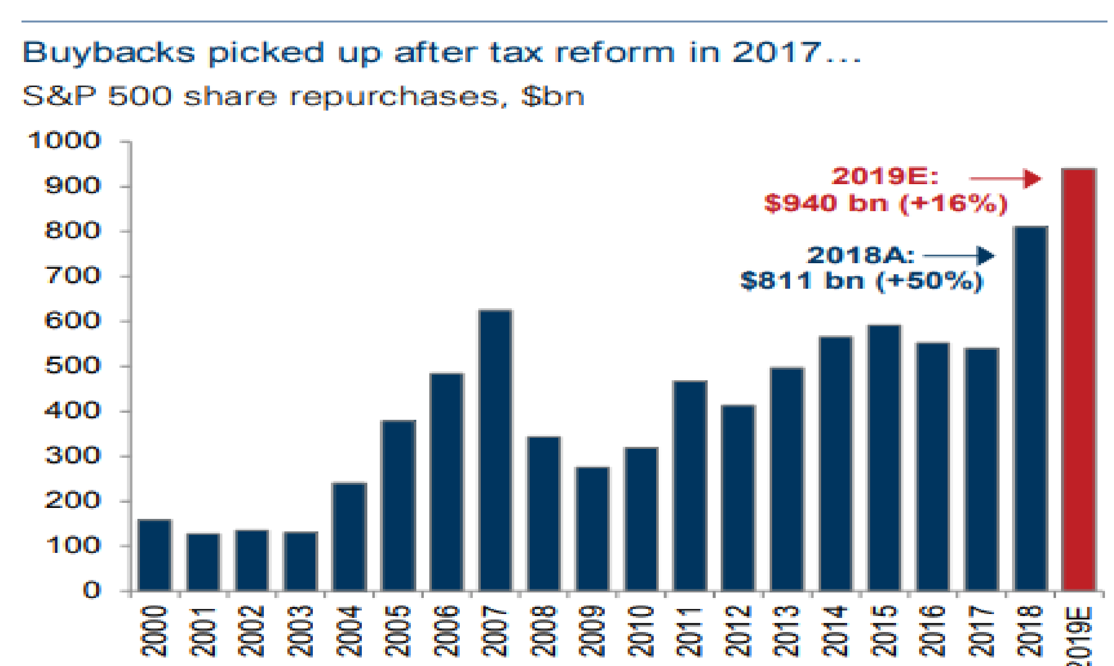
Source: Bloomberg, Rubrics as at 30/09/19

Increase in Share Buybacks (per share)



Source: Bloomberg, Rubrics as at 30/09/19

Increase in Share Buybacks ($)



Source: Compustat, Goldman Sachs Global Investment Research.

So how did this become possible? Two reasons: Firstly, the incentive structure of the markets change when interest rates go to zero. Access to cheap capital has been abundantly available to the largest companies who have been able to stifle competition to the point where they no longer need to be competitive. Secondly, through shifting (implicit) business objectives towards share price maximisation and away from profitability and productivity. Profit centres of the more 'successful' businesses today like Google and Facebook depend on their ability to extract and monetise personal data at the expense of creating things of tangible productive value.

There are three critical geopolitical risks out there at the moment. Brexit, trade war and Iran. Brexit has descended to a point where it may require action by the EU to facilitate a hard exit. It is difficult to see how a more positive outcome can be achieved. It may just be that the ugly aftermath can concentrate the minds (on both sides) to finding a sustainable resolution. Trump's current status in the polls is pushing him to re-consider his position on pretty much everything. He wants a deal - at any cost - to tweet about. Indeed his base will likely buy it. In this vein, a war with Iran the last thing he wants – an unwinnable conflict that will sink his chances of re-election.

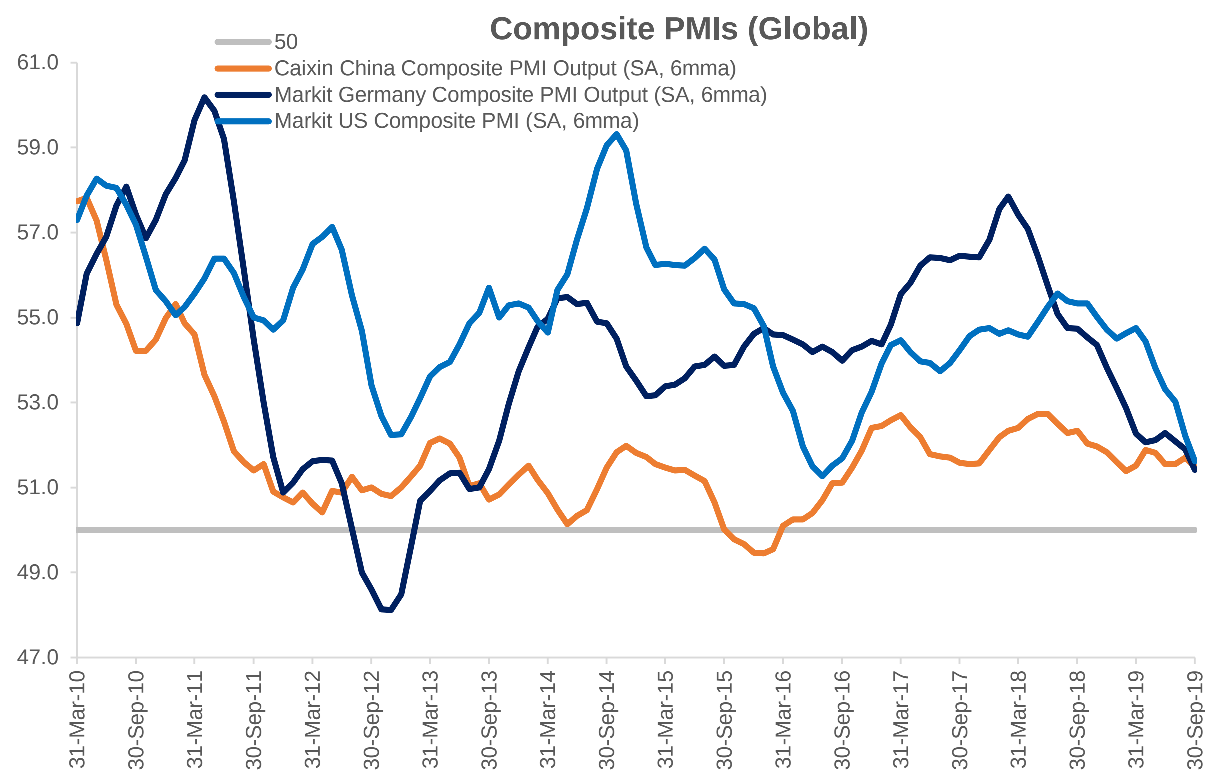
However, in spite of these geopolitical escalations, all is not lost. Brexit can come and go with a deal following quickly afterwards, Trump can cast aside the wishes of his negotiating team and cut a great deal for China, and the Germans can get their collective rear in gear and look to stimulate their ailing economy. All of these would be positive developments in the short and potentially even medium term. However this does not solve the overriding issue that the incentives in our current global economic system are sub-optimal. We need to forget about rational expectations and 60-year-old economic theories. Bring back real competition in a balanced economy and put an end to corporates acting like hedge funds. That way politicians will be free to focus on the need to ensure a healthy environment for the next generations to enjoy.

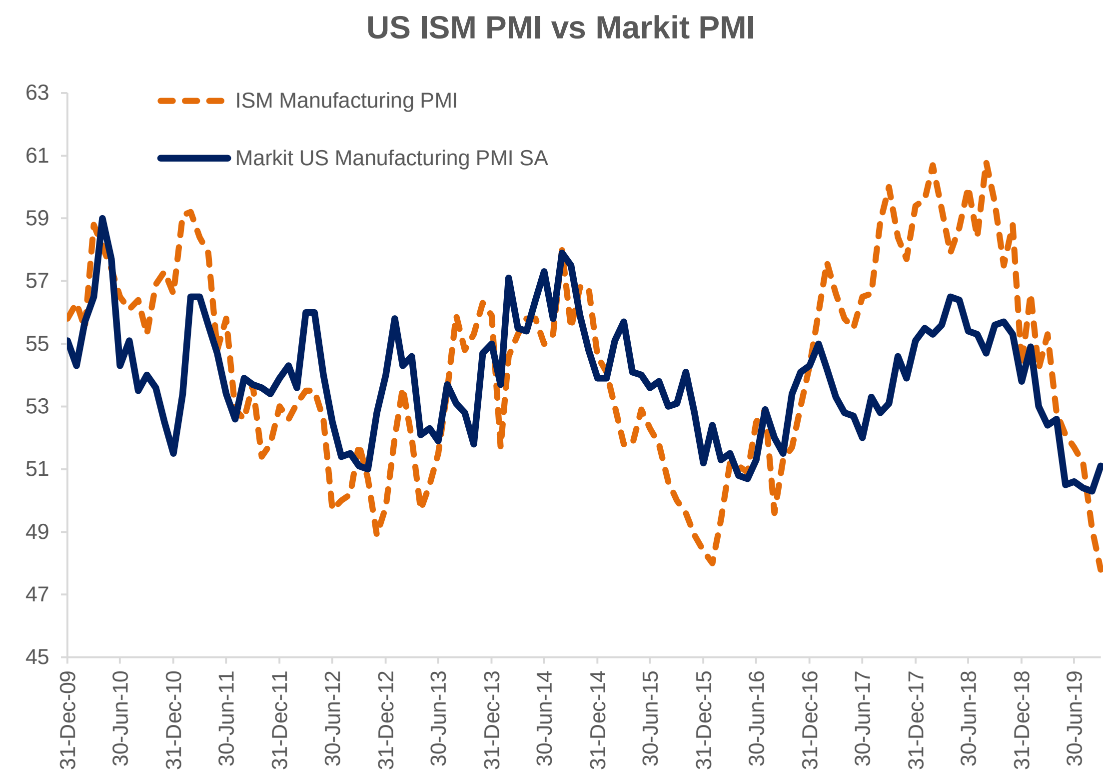
Rubrics Fixed Income Macro View

View from the Top

The economic picture globally continues to deteriorate. Below is a cross section of some of the areas currently under scrutiny. Whilst some show clear signs of weakness (manufacturing) others (housing and employment) have held up. The question on most people’s minds therefore concerns whether the data is bottoming out, or we are indeed on the cusp of a recession.

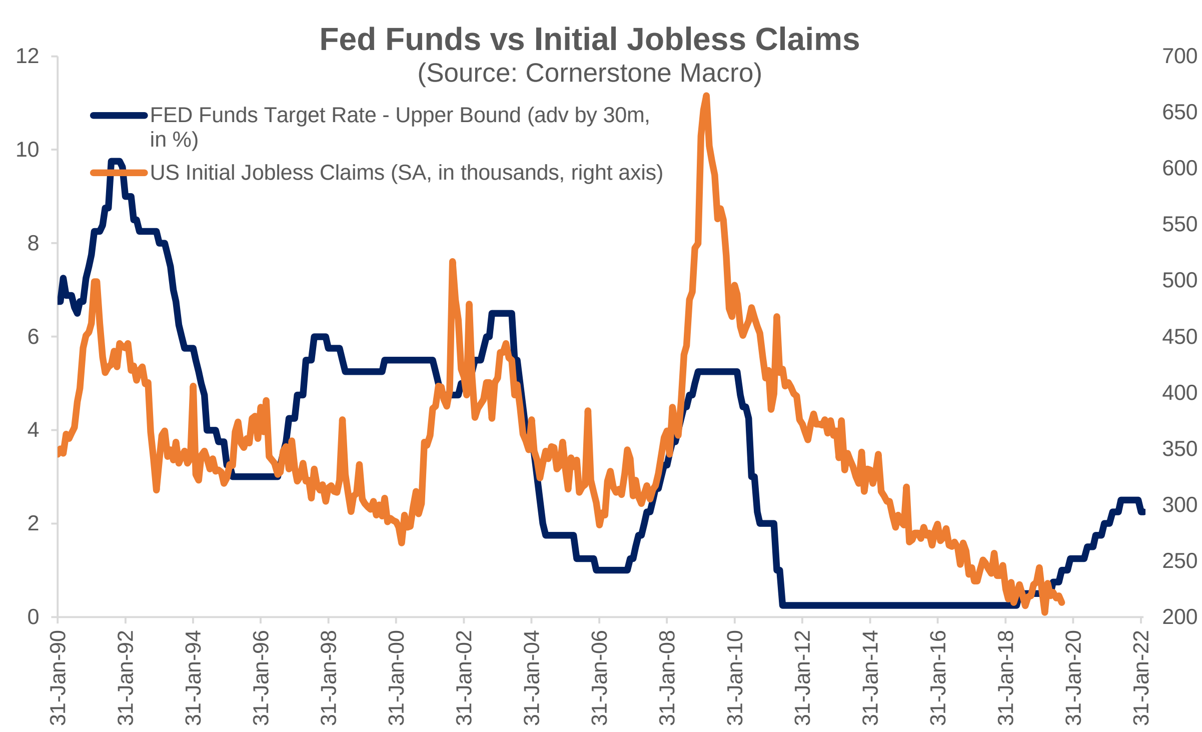
PMI – contracting globally



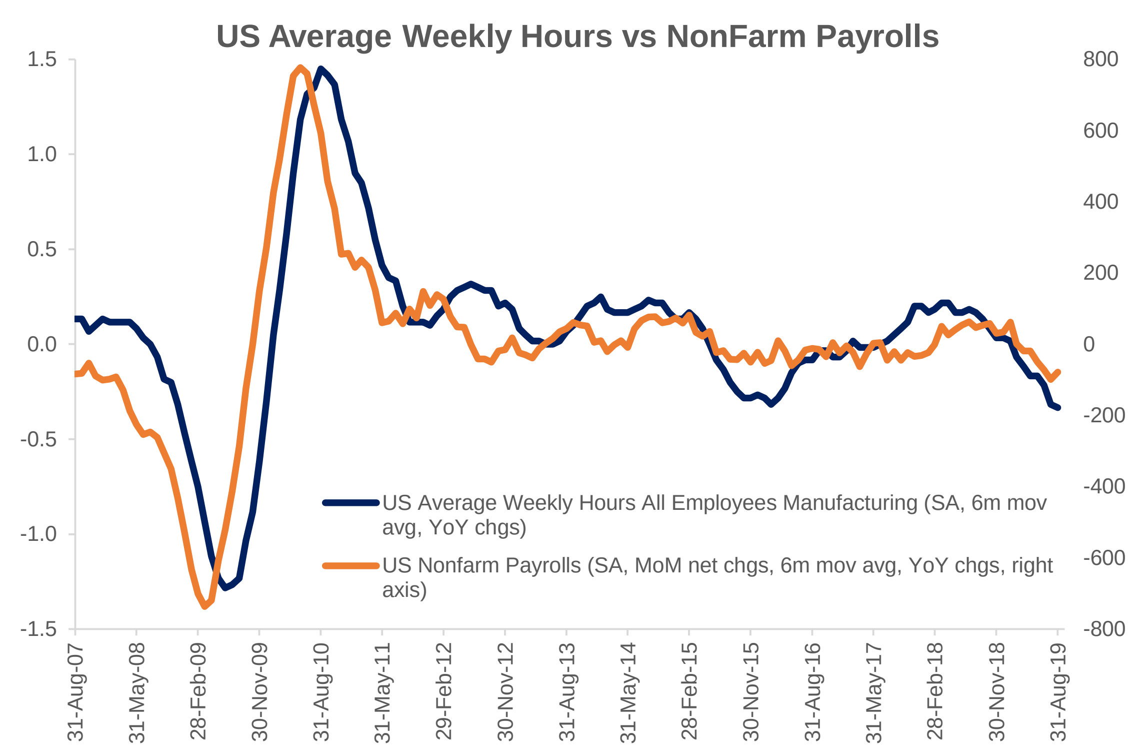


Source: Bloomberg, Rubrics Asset Management. Copyright © 2019, Markit Economics Limited. All rights reserved and all intellectual property rights retained by Markit Economics Limited.

Labour Market (US) – on the cusp of contraction?

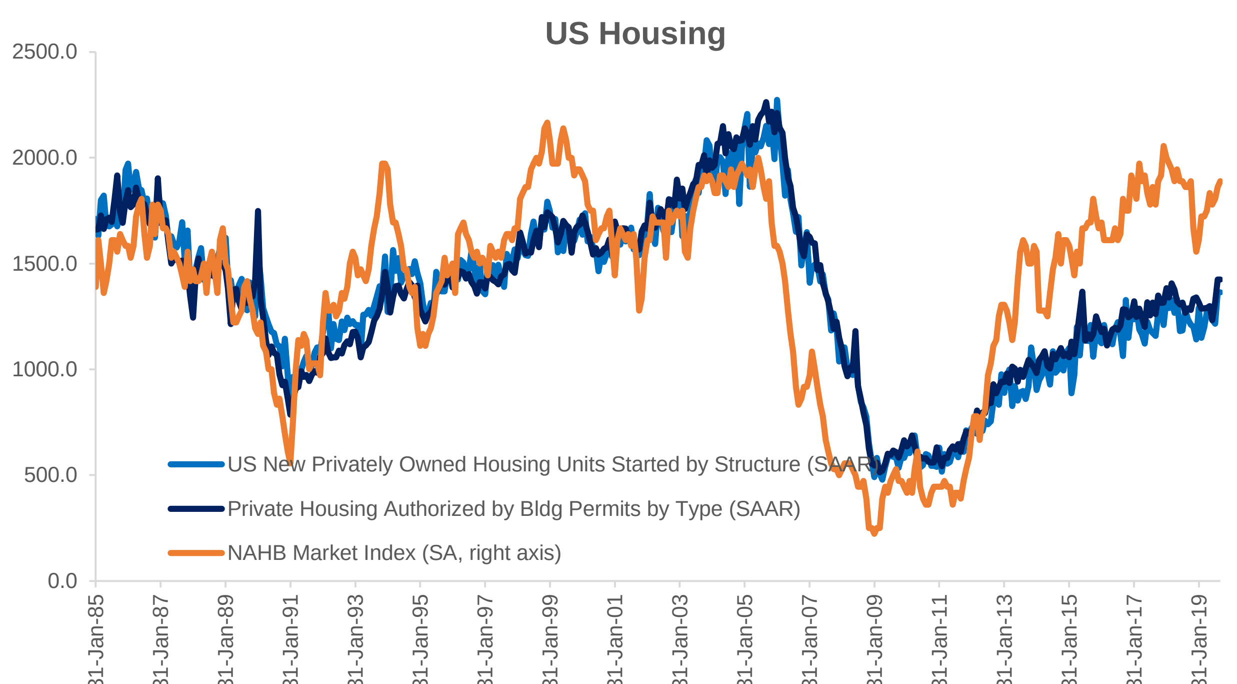


Source: Bloomberg, Rubrics as at 30/09/19

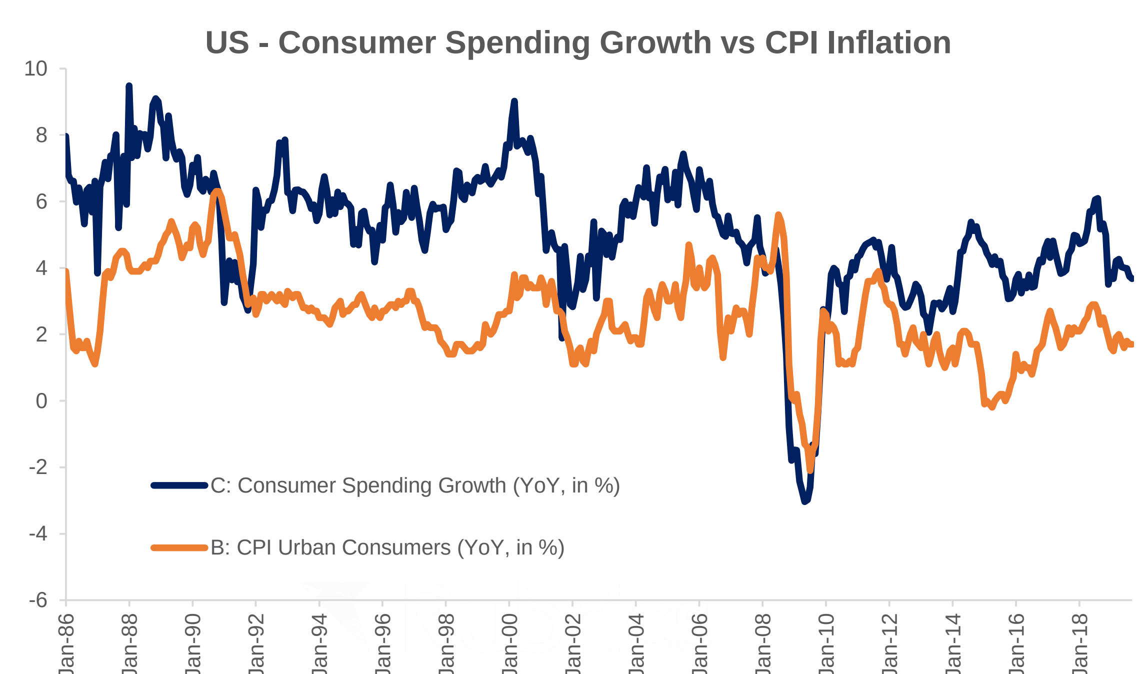


Source: Bloomberg, Rubrics as at 30/09/19

Housing and Consumer (US) – housing buoyant, consumer showing signs of slowing?



Source: Bloomberg, Rubrics as at 30/09/19



Source: Bloomberg, Rubrics as at 30/09/19

Rubrics Fixed Income Macro View

October 2019

View from the Bottom

Two tier credit market

September IG corporate issuance set a record at $158bn (for September). BB rated and better issuers have had very little difficulty in issuing cheap, long dated funding. Meanwhile, it has been a more challenging environment for some HY and high beta issuers. September saw several deals postponed for issuers in the US HY and Lev Loan markets including Peabody (Coal Miner), Sirius Mining (Potash Mine), Stelco.

Cracks appearing in the distressed space

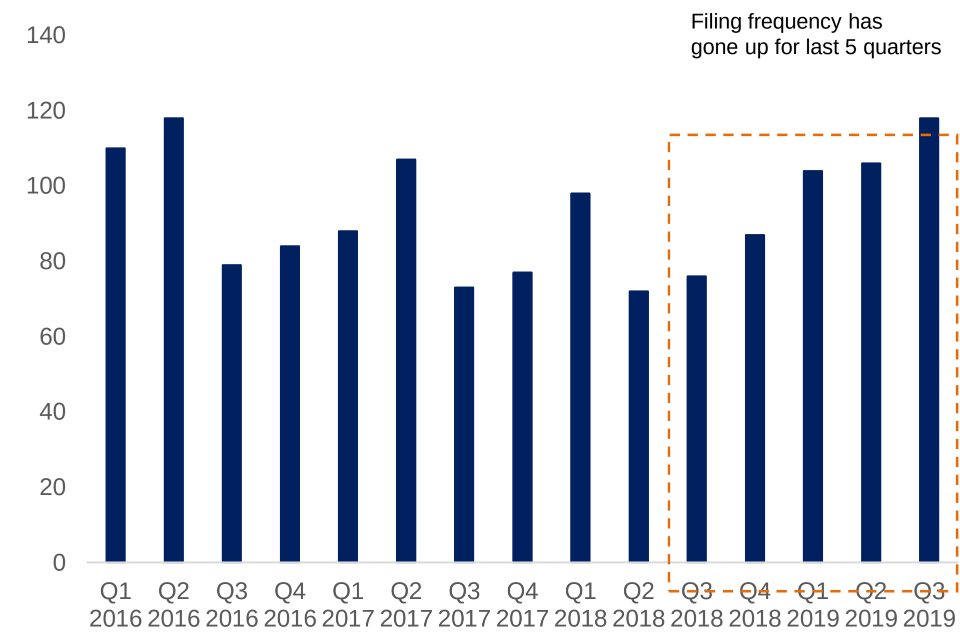
The distressed debt space is seeing increasing activity after a relatively benign few years. Chapter 11 filings have gone up for the last 5 quarters. YTD, US HY downgrades are exceeding upgrades with ratings deterioration concentrated in lower quality single B and CCC paper. CCC spreads widened 87bps in September, compared to all other credit asset classes which tightened.

In the EM space, swathes of Argentina bonds are still trading in distressed territory (mostly 40s-50s) with dip buyers "MIA" ahead of the election result (Nov-19). Large single B EM issuer Lebanon got downgraded to the CCCs as worries over debt repayment escalated. The above developments in EM optically make EM HY look attractive vs US HY as per the chart across

Weak IPO market - read across for debt investors

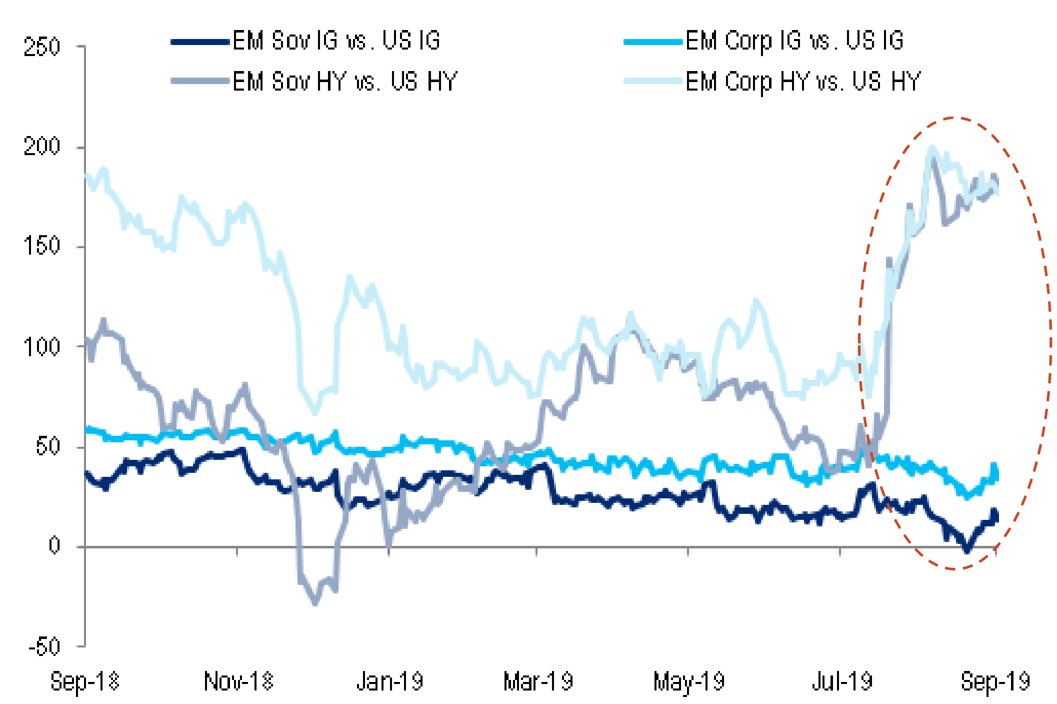
2019 as seen a slower IPO market vs 2018. Many issuers globally have decided to postpone, or seek alternatives to issuing public equity. Many IPOs have been priced at the bottom end of the asking price, e.g. Budweiser APAC (2nd largest IPO this year), Airtel Africa, Traton. Delayed IPOs push back de-leveraging targets for privately owned HY issuers. A high-profile victim of this has been WeWork, whose bonds have traded down as IPO plans got pushed back.

Quarterly US Chapter 11 Filings



Source: ReOrg Research

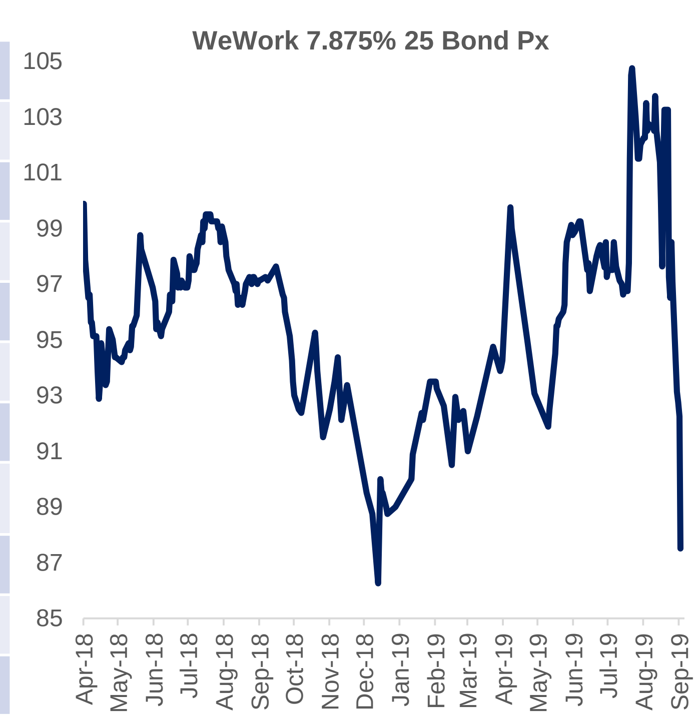
Material widening in EM HY vs US HY – Led by Argentina



Source: Citi Research as at 26 September 2019

Recently Postponed IPOs and the impact on WeWork Bonds after IPO scrapped

Caixa Cards IPO
Dangote Cement
Domestic & General
Endeavor Group
KazMunayGaz
Lendinvest
Palantir
ReAssure (owned by Swiss Re)
Toshiba Memory
Virgin Trains USA
WeWork



Source: Bloomberg, as at 30 September 2019

IMPORTANT INFORMATION

Rubrics Global UCITS Funds Plc is a variable capital umbrella investment company with segregated liability between sub-funds; incorporated with limited liability in Ireland under the Companies Acts 2014 with registration number 426263; and authorised by the Central Bank of Ireland pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, as amended). This document is for information only and does not constitute an offer or solicitation to deal, whether directly or indirectly, in any particular fund. Nothing in this document should be taken as an expressed or implied indication, representation, warranty or guarantee of performance whether in respect of income or capital growth. No warranty or representation is given as to the accuracy or completeness of this document and no liability is accepted for any errors or omissions that the document may contain. The Key Investor Information Documents ("KIIDs") and prospectus (including supplements) for Rubrics Global UCITS Funds Plc are available at www.rubricsam.com. The management company of Rubrics Global UCITS Funds Plc is Carne Global Fund Managers (Ireland) Limited (the "Management Company"). The Management Company is a private limited company, incorporated in Ireland on 16 August, 2013 under registration number 377914. The investment manager of Rubrics Global UCITS Funds Plc is Rubrics Asset Management (Ireland) Limited (the "Investment Manager"). The Investment Manager is a private company registered in Ireland (reference number:613956) and regulated by the Central Bank of Ireland in the conduct of financial services (reference number:C173854). Details about the extent of its authorisation and regulation is available on request. Data Source: © 2016 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. www.morningstar.co.uk.

For South African investors: In the Republic of South Africa this fund is registered with the Financial Sector Conduct Authority and may be distributed to members of the public. In addition to the other information and warnings in this document, the Financial Sector Conduct Authority of South Africa requires us to tell South African recipients of this document that collective investment schemes are generally medium to long-term investments, collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending and that a schedule of fees and charges and maximum commissions is available on request from the manager. Because foreign securities are included in the investments within this collective investment scheme, we are also required to disclose to you that there may be additional risks that arise because of events in different jurisdictions: these may include, but are not limited to potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks and potential limitations on the availability of market information.

Additional Information for Switzerland: The prospectus and the Key Investor Information Documents for Switzerland, the articles of association, the annual and semi-annual report in French, and further information can be obtained free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, tel.: + 41 22 7051178, fax: + 41 22 7051179, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva. The last share prices can be found on www.fundinfo.com. For the shares of the Funds distributed to non-qualified investors in and from Switzerland and for the shares of the Funds distributed to qualified investors in Switzerland, the place of performance is Geneva.