RUBRICS ASSET MANAGEMENT

Global Reflation Fades

March 2019

OVERVIEW

2019 has seen continued divergence between financial markets and economic reality. Risk assets have had one of their strongest starts ever despite the clear decline in economic data - a theme that has become especially prevalent post 2008.

We examine in this piece some of the current macroeconomic trends which have supported financial markets in the past 3 months, whilst exploring the longer term sustainability and effectiveness of further central bank support. Lastly we highlight what we believe might be the catalyst for renewed volatility.

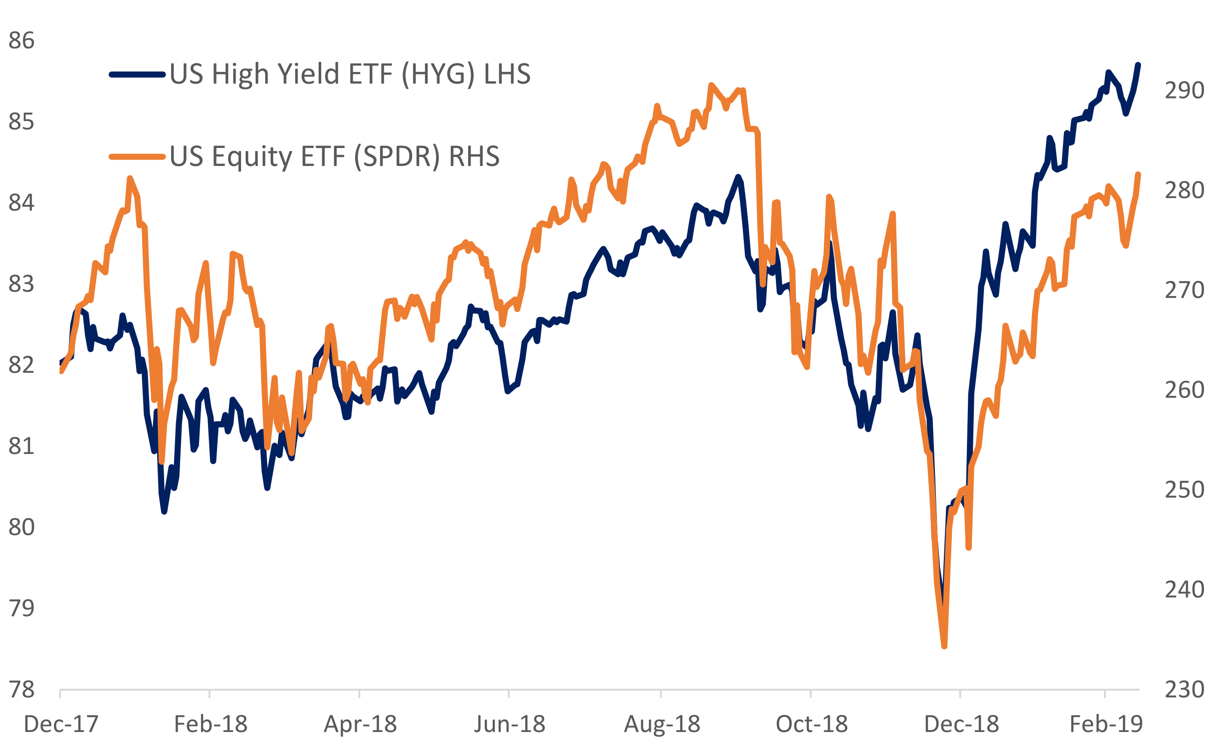
Global Reflation Fades

Overview

2019 has seen continued divergence between financial markets and economic reality. Risk assets have had one of their strongest starts ever despite the clear decline in economic data - a theme that has become especially prevalent post 2008. We examine in this piece some of the current macroeconomic trends which have supported financial markets in the past 3 months, whilst exploring the longer term sustainability and effectiveness of further central bank support. Lastly we highlight what we believe might be the catalyst for renewed volatility.

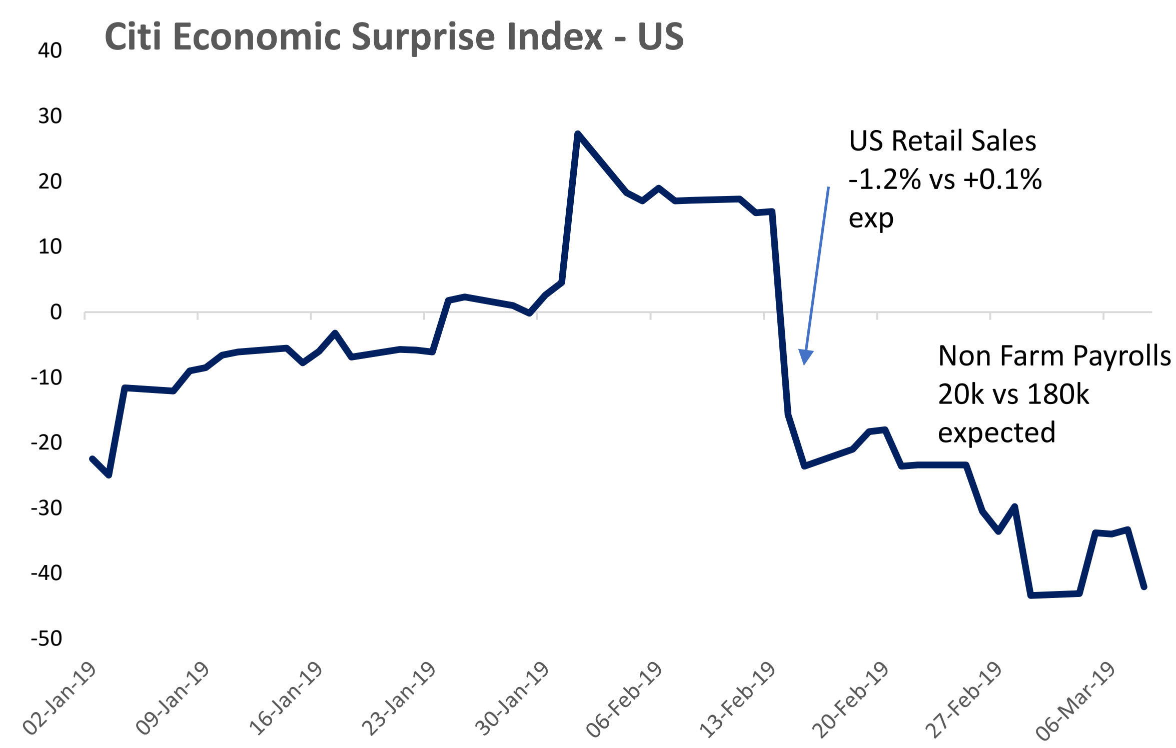
Current Dynamic – Risks Assets vs The Real Economy

2019 Surge in Risk Assets



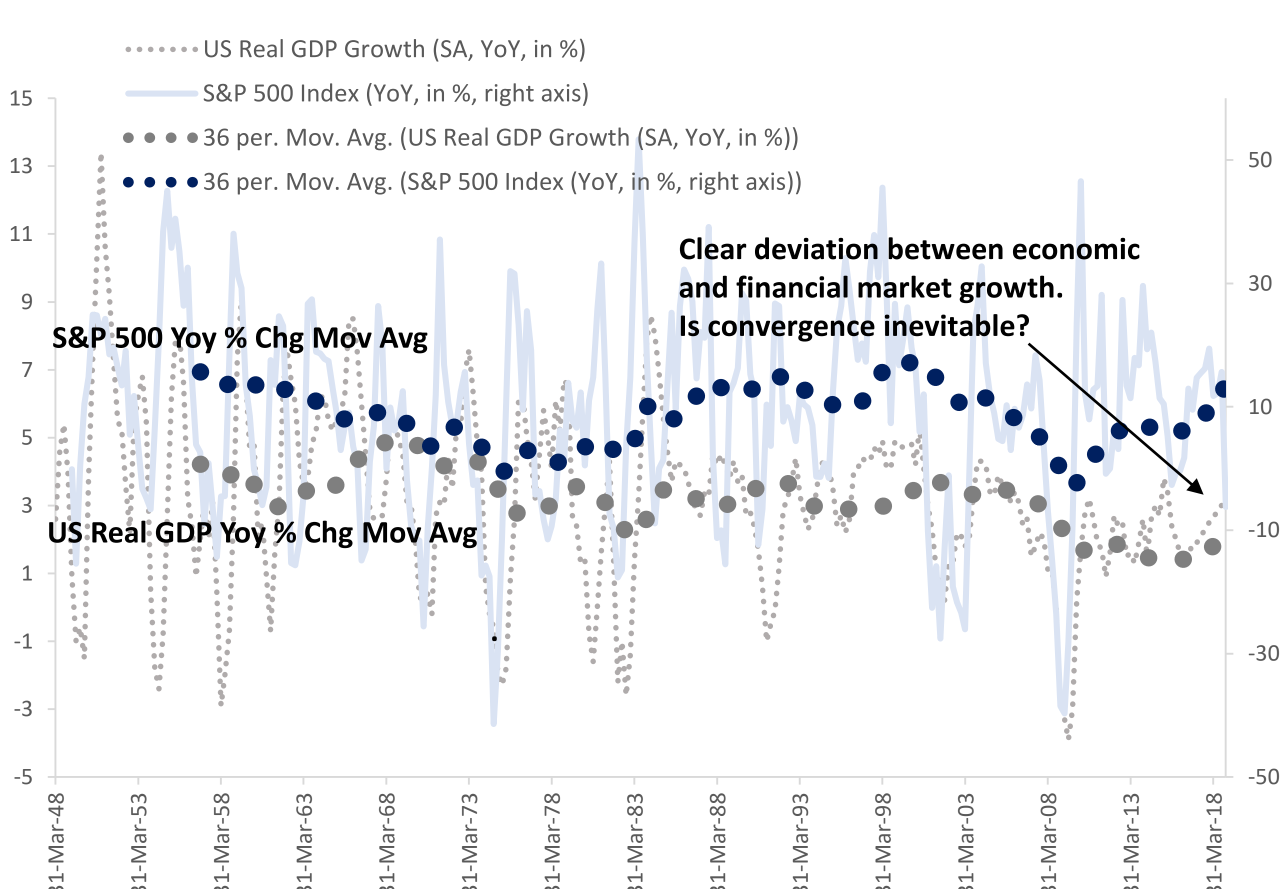
Source: Bloomberg

2019 Economic Data Disappointment



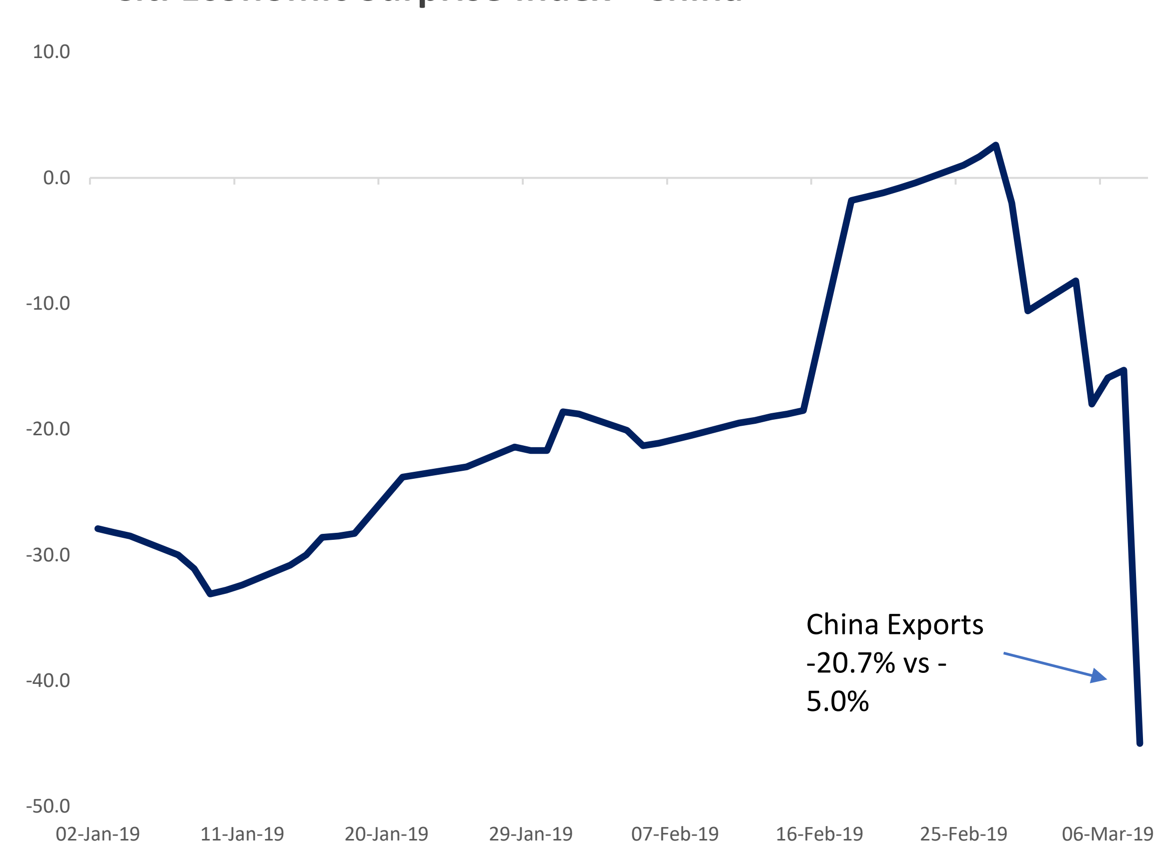
Source: Bloomberg

Historical Performance Dichotomy - S&P 500 vs US Real GDP



Source: Bloomberg

Citi Economic Surprise Index - China

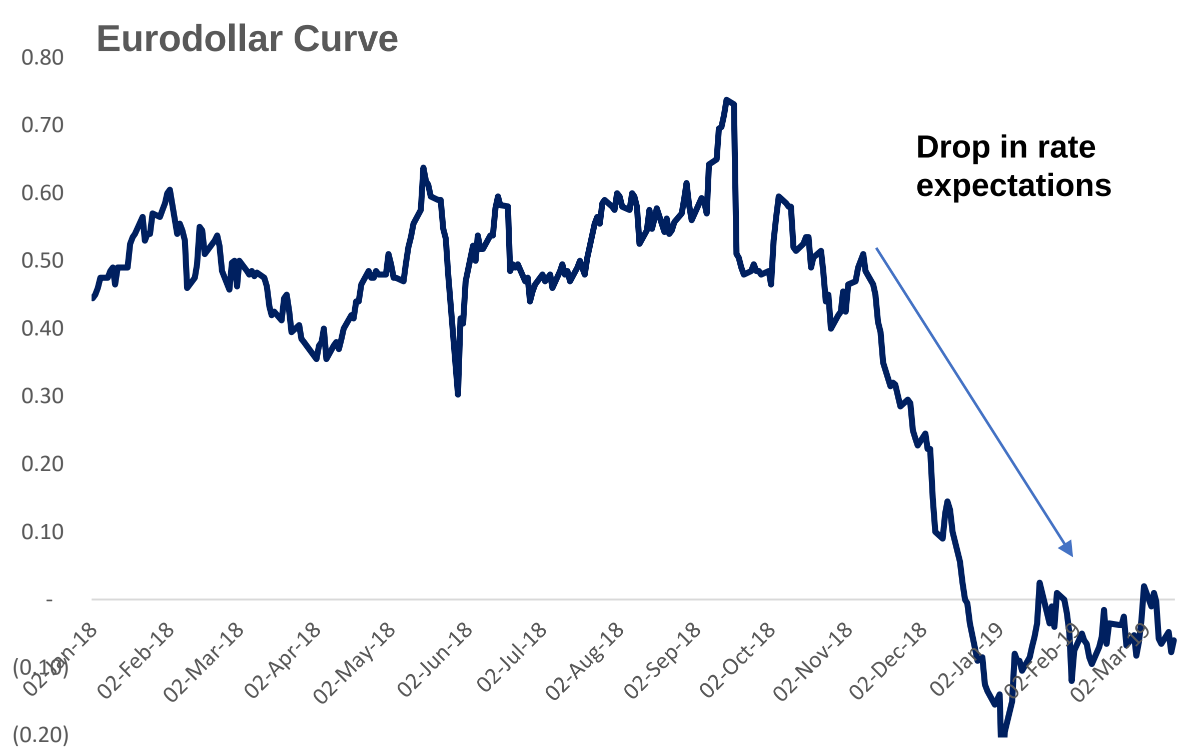


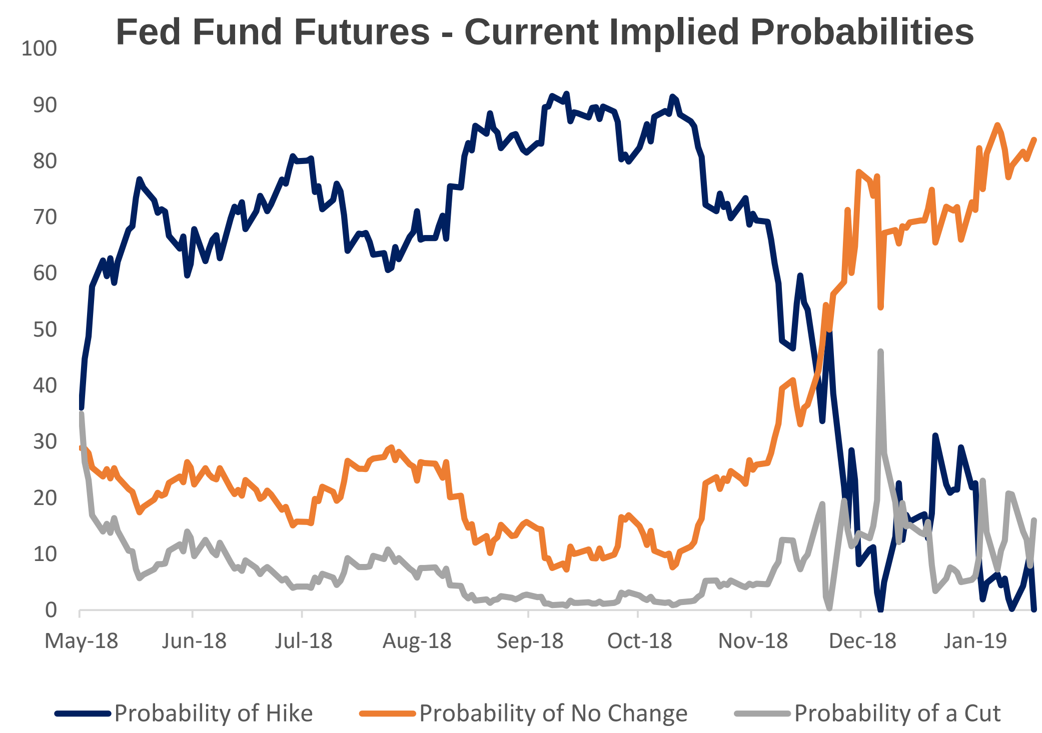
Source: Bloomberg

Reflated Expectations

Notwithstanding news headlines on trade war resolutions, Brexit agreements etc., the dramatic turnaround in risk assets from December ‘18 lows has been driven mainly by the substantial shift in global central bank positioning to a more dovish stance. This change has emanated from the Federal Reserve, the People’s Bank of China and the European Central Bank.

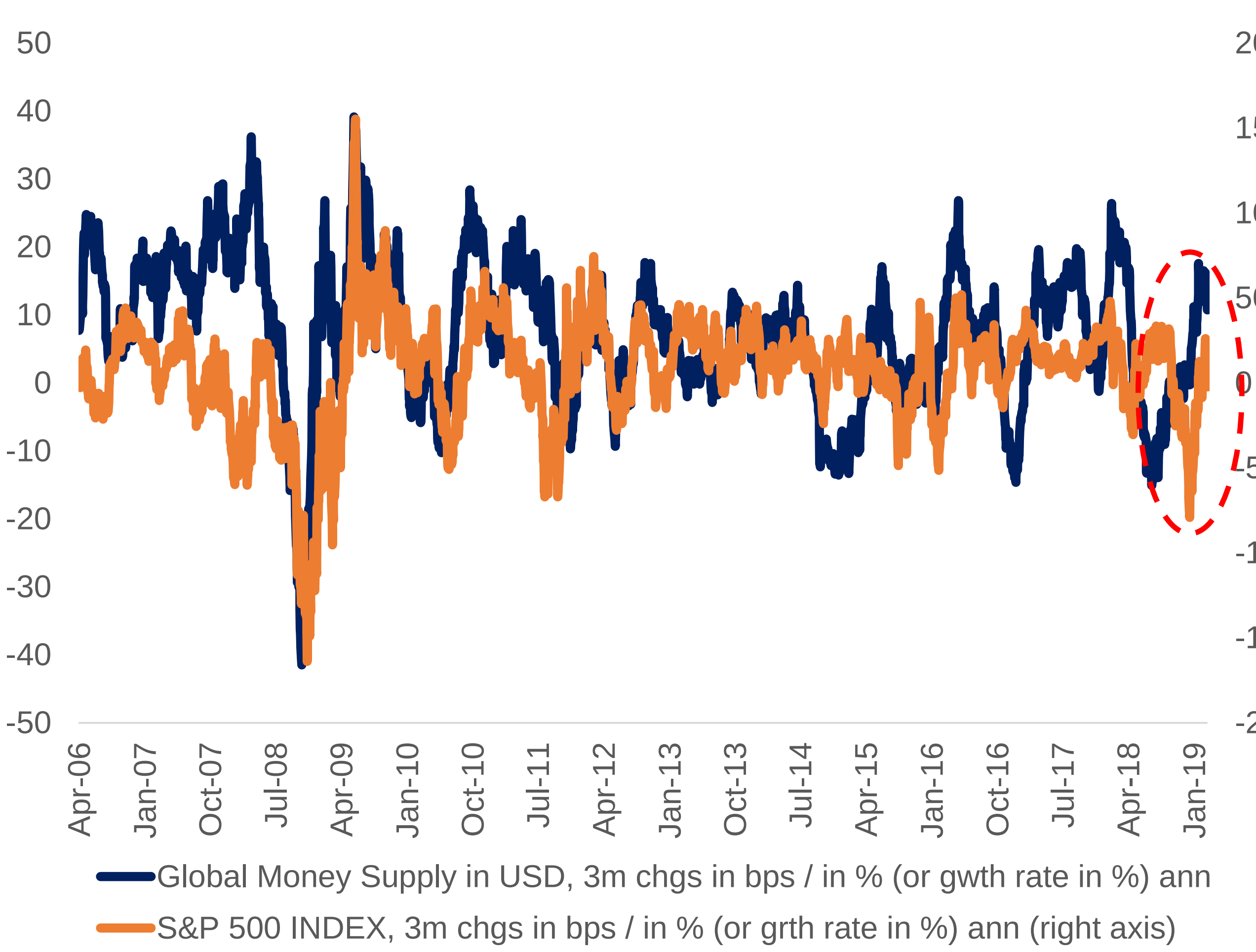
Shifting Rate Outlook



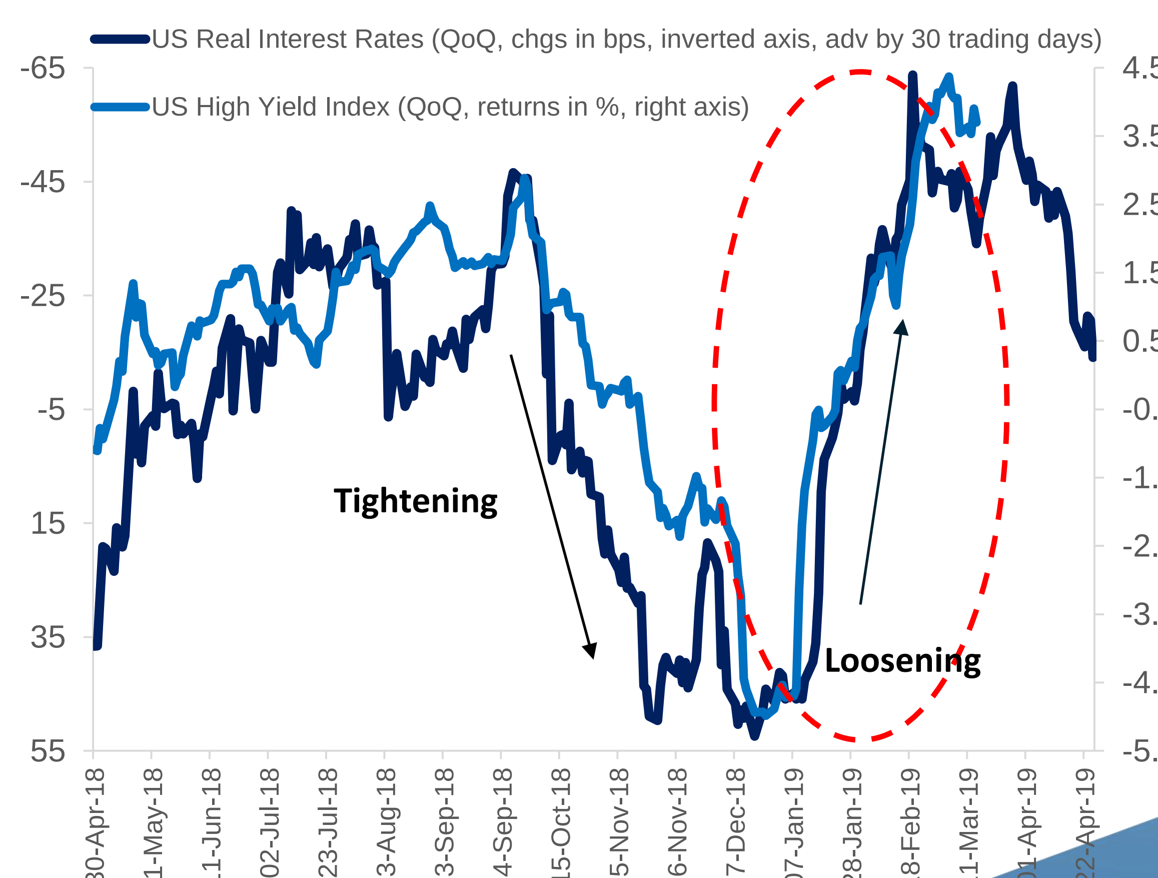


Along with the change in expectations, in the past 3 months the global system has seen an increase in USD liquidity (approx. +$250bln), a drop in US real rates (approx. 70bps) and a non-appreciating US Dollar (a critical element). All positives for risk assets. While heightened anticipation of increased monetary support has no doubt buoyed market sentiment – how likely is this to materialise in reality? And furthermore, do the credit markets have sufficient capacity to make these policies as effective as in previous cycles?

Global USD Liquidity Impulse and Risk Assets



US Real Rates and US High Yield Performance



Source: Bloomberg

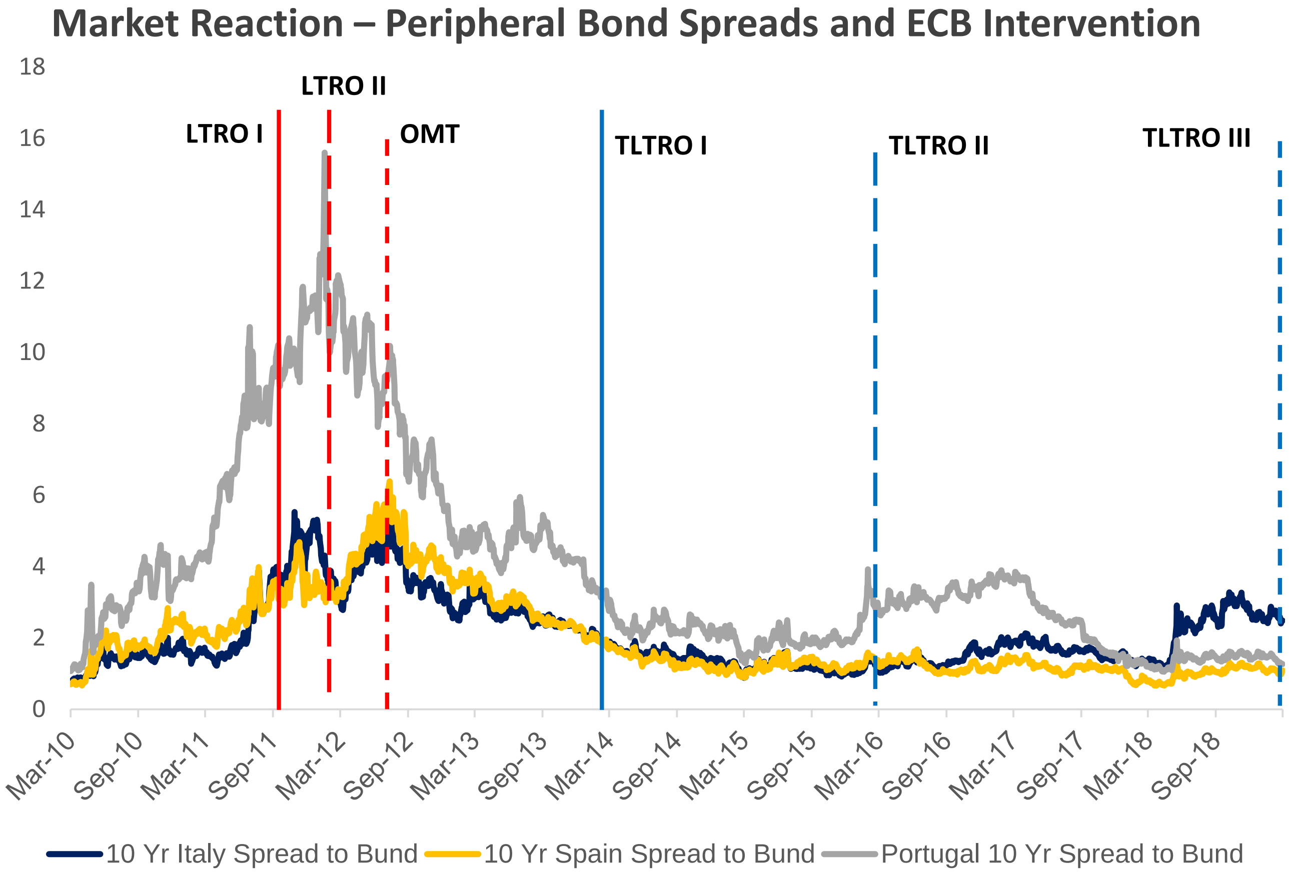
Future Stimulus Constrained

With the so called 'Shanghai Accord' of early 2016 still relatively fresh in the memory, the heightened level of investor expectation for a renewed stimulus push is palpable. We are not so convinced however. For one, we do not believe that central banks currently have the ammunition (political) for such a co-ordinated action. Secondly, we would strongly question the current global capacity for yet another round of expansion due to the highly leveraged nature of the world's largest economies and thirdly, we feel the effectiveness of potential future programmes would be limited with markets at current valuation levels.

ECB – Diminishing Marginal Returns

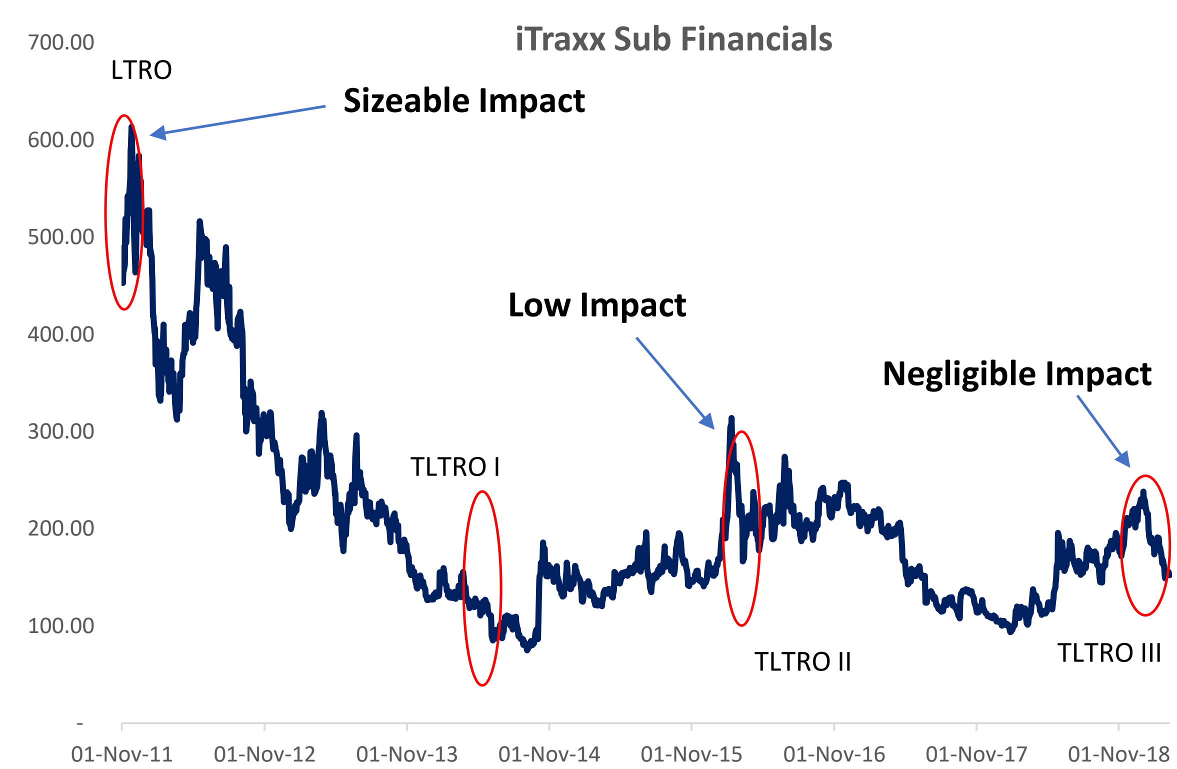
Previous ECB programmes have had the undoubtedly positive impact of compressing peripheral bond spreads, reducing corporate borrowing costs in addition to helping promote a degree of growth in the money supply. However as noted above, with spreads currently close to all time lows, the impact of further stimulus would surely be negligible – witness the muted response to the latest ECB TLTRO announcement.

Market Reaction – Peripheral Bond Spreads and ECB Intervention



Source: Bloomberg

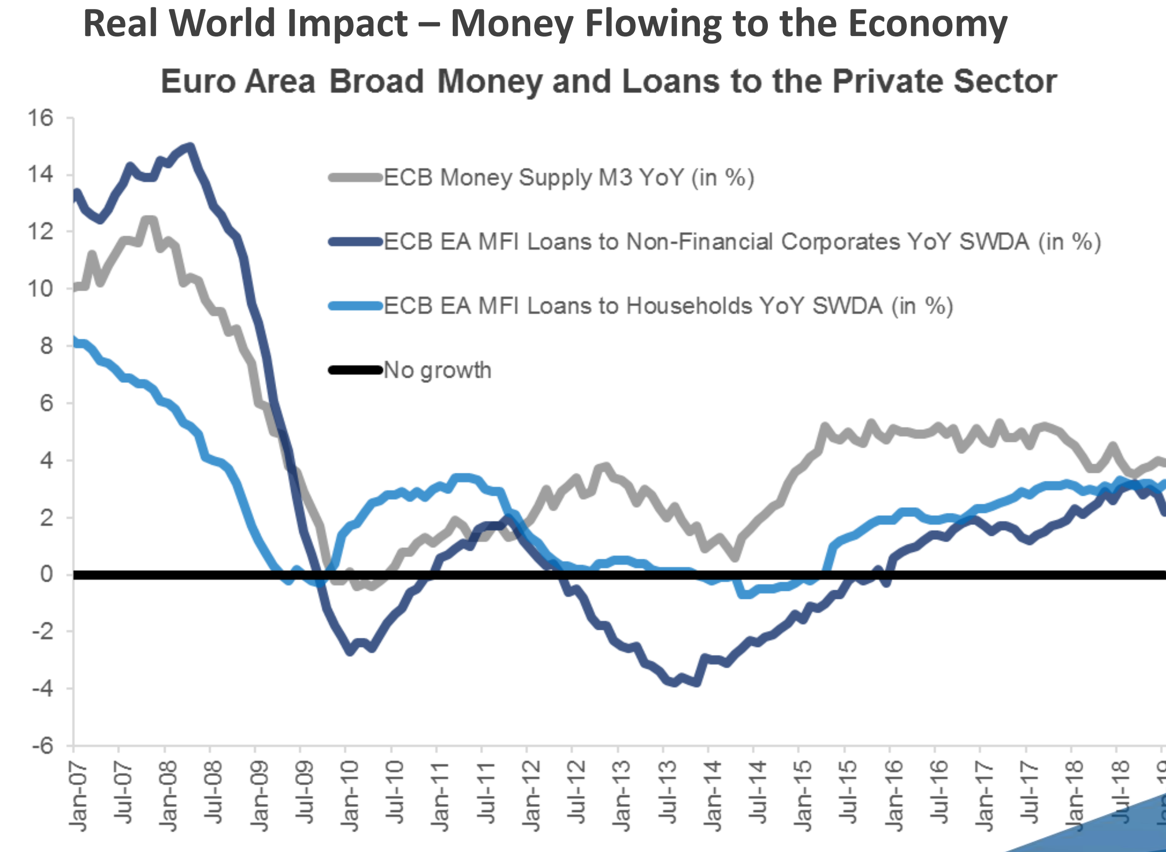
Market Reaction – Sub Financial Spreads



Source: Bloomberg

Meanwhile the failure of previous programmes to create sustainable growth in money supply is likely indicative of a problem with the transmission mechanism. Put simply – do banks want more central bank liquidity? Lest we forget, the new dovish policies being hailed by financial markets do not represent fresh stimulus, but are merely replacement financing for existing programs which begin to roll off in 2020.

Real World Impact – Money Flowing to the Economy

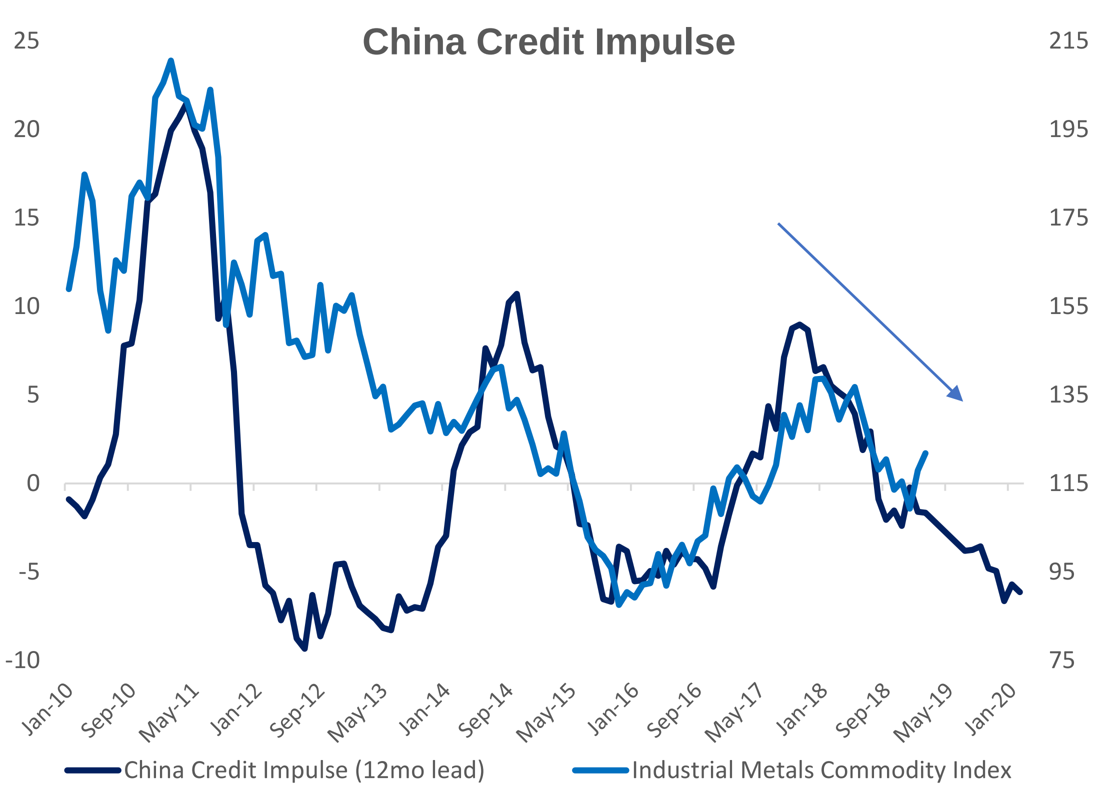


Source: Bloomberg

China – Unstable Credit Dynamics

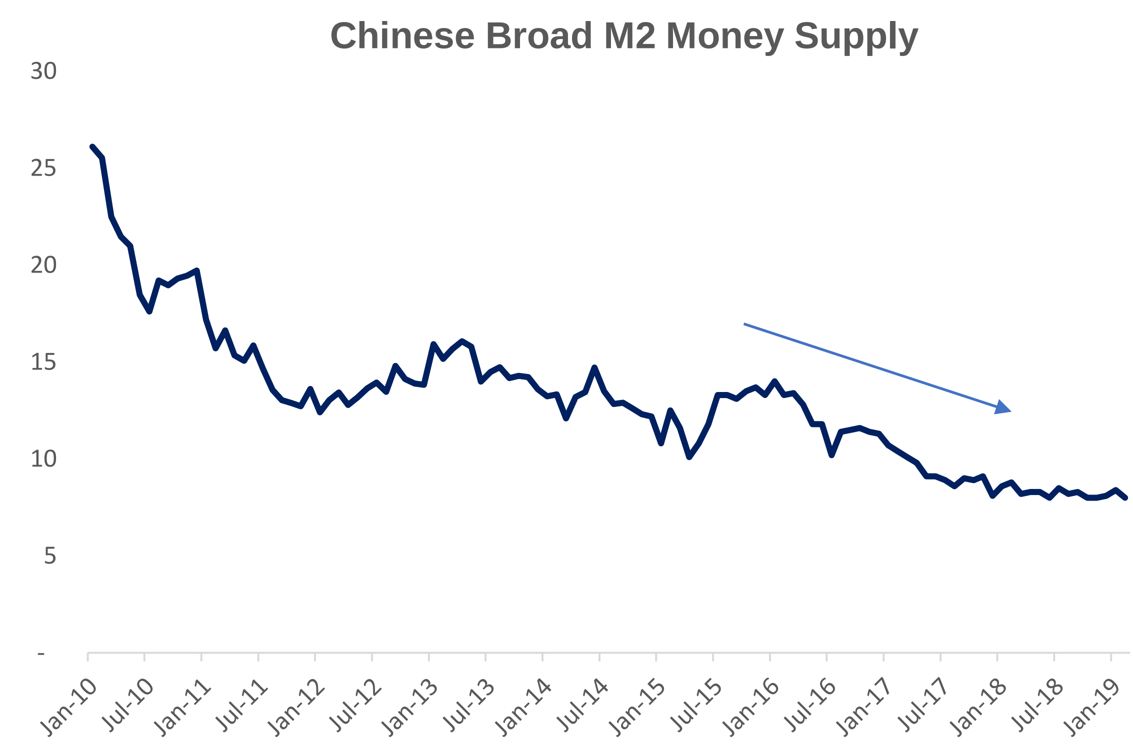
After a decade of substantial stimulus - both monetary and fiscal – allied to a still favourable demographic profile, China's capacity to continue on its elevated growth trajectory has come into question. Despite $trillions in fiscal and monetary intervention, economic reflation has ultimately proved unsustainable. Headline figures like credit defaults and elevated shadow banking markets combined with slowing money supply demonstrate the challenging environment for the PBOC. Recent stimulus package announcements have been conspicuous in their lack of size compared to previous stimulus efforts e.g. 15 March NPC announcement.

China Credit Impulse and Global Commodities



Source: Bloomberg

China Money Supply

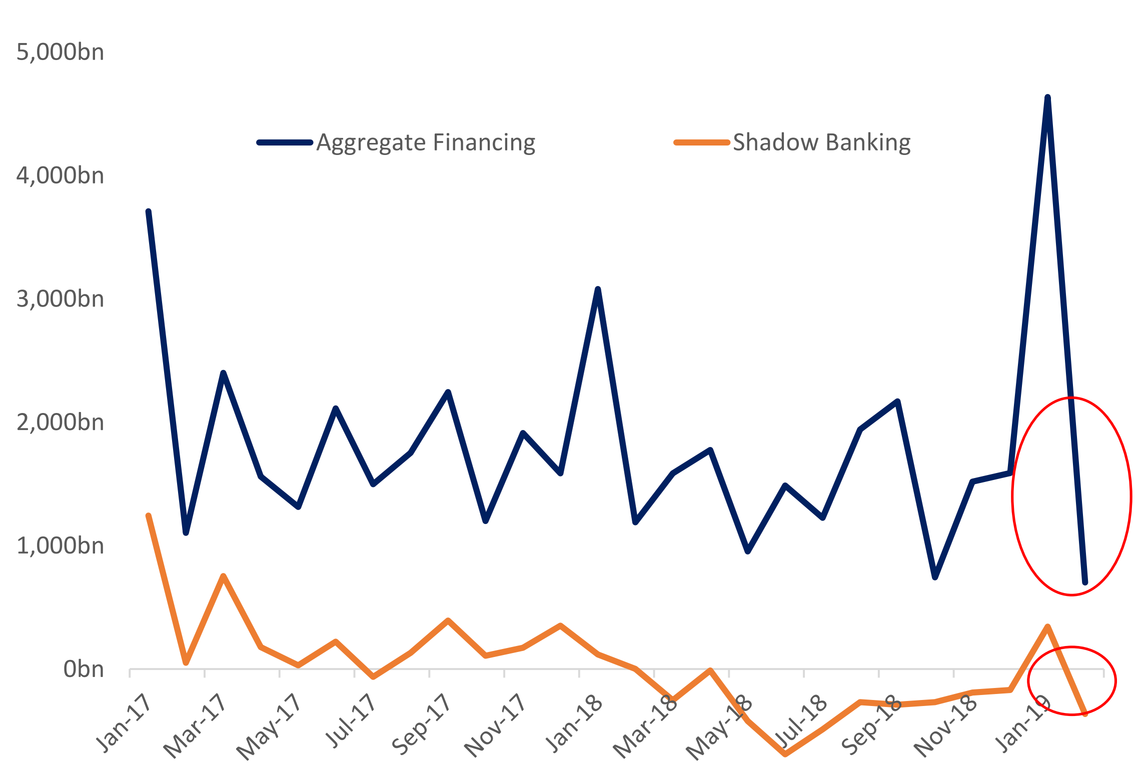


Source: Bloomberg

What Reflation?

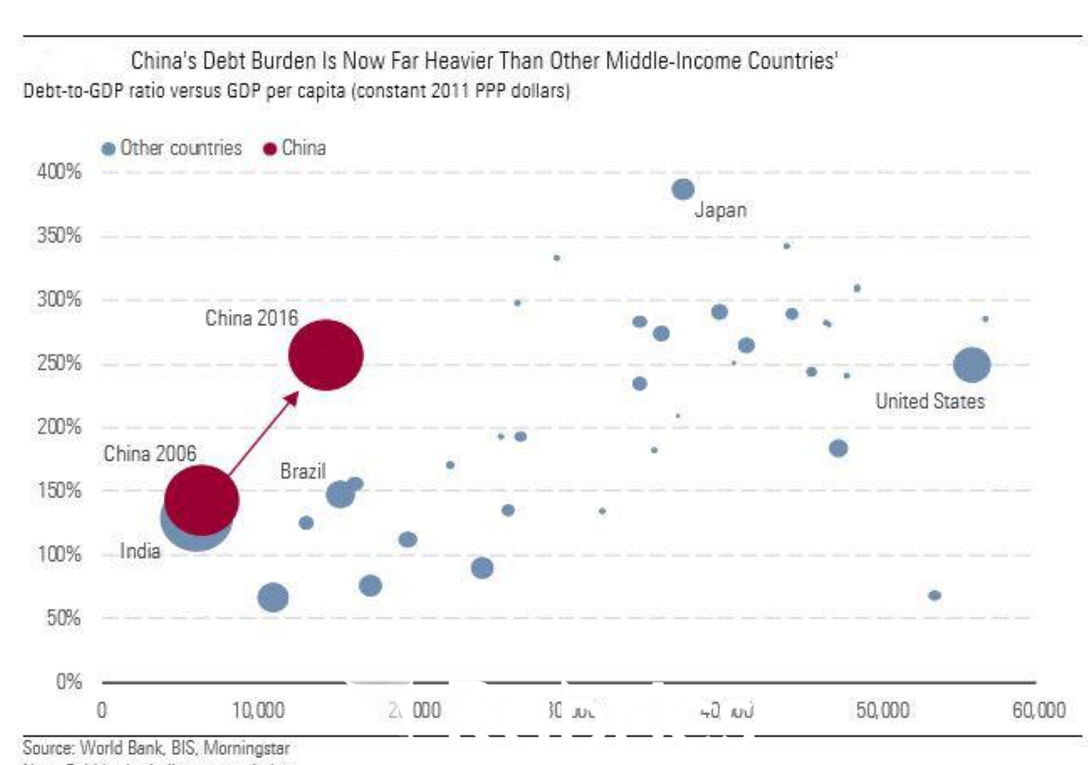
The spectacular jump in Chinese Aggregate Financing in January generated heightened optimism in financial markets of a renewed credit expansion. The subsequent follow through however has been underwhelming. Despite recently announced measures (VAT reductions etc), China remains a long way away from matching the size of the 2015/2016 stimulus which had a real impact on China's (global) credit impulse. As with the world's other largest economies, question marks remain over the likely effectiveness of further programmes given a) the scale of China's debt burden and b) the level of industrial over-capacity, both of which are creating a drag on economic momentum.

China Fiscal Stimulus - Aggregate Financing



Source: Bloomberg

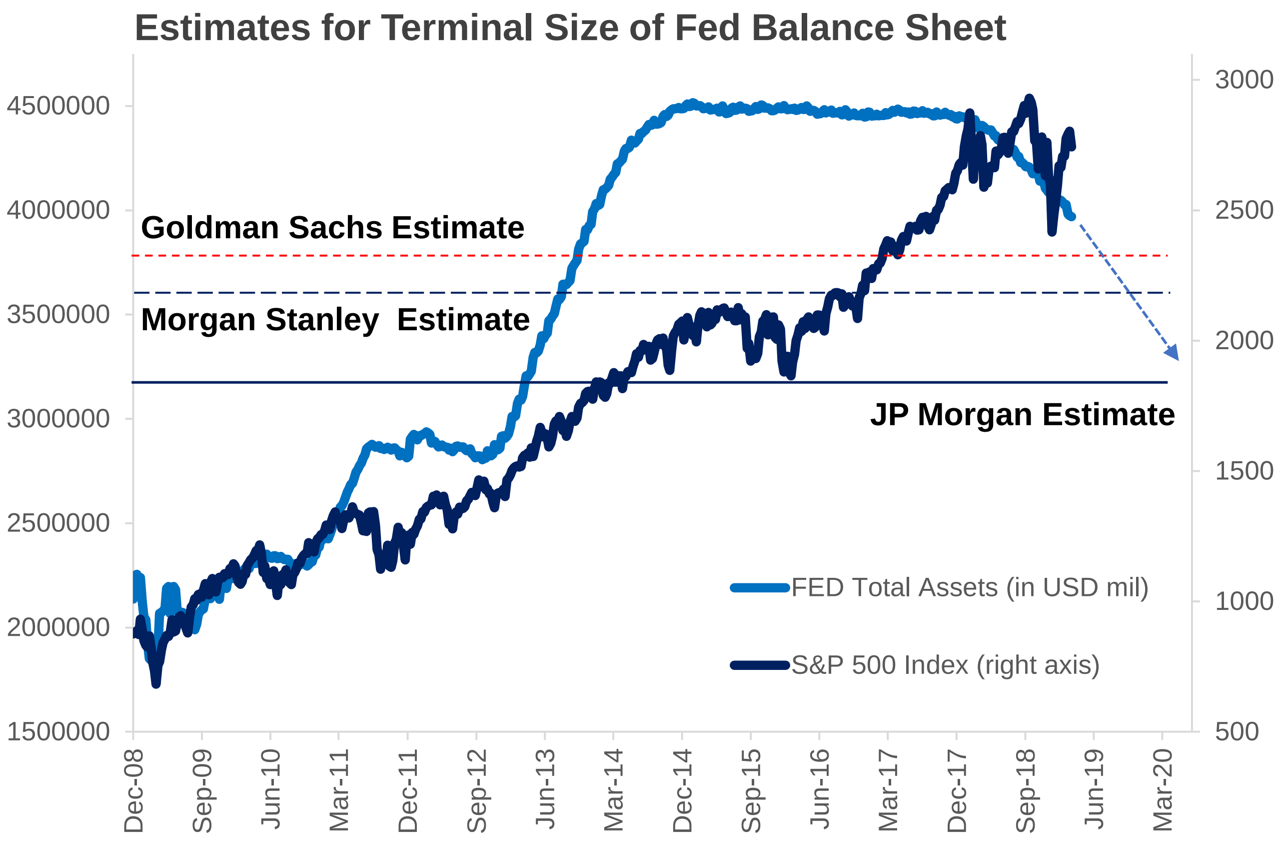
China Debt Burden



Source: World Bank, Morningstar

US – Balance Sheet Conundrum

Following the previous discussion on the re-alignment of rate expectations in the US, there has also been a decided shift in the narrative coming from Fed Chair Powell regarding the balance sheet runoff programme. In a short period of time (late November to late December) the Fed have shifted from a stance of 'QT on autopilot' to one where they 'wouldn't hesitate' to adjust the normalisation process in response to market turmoil.

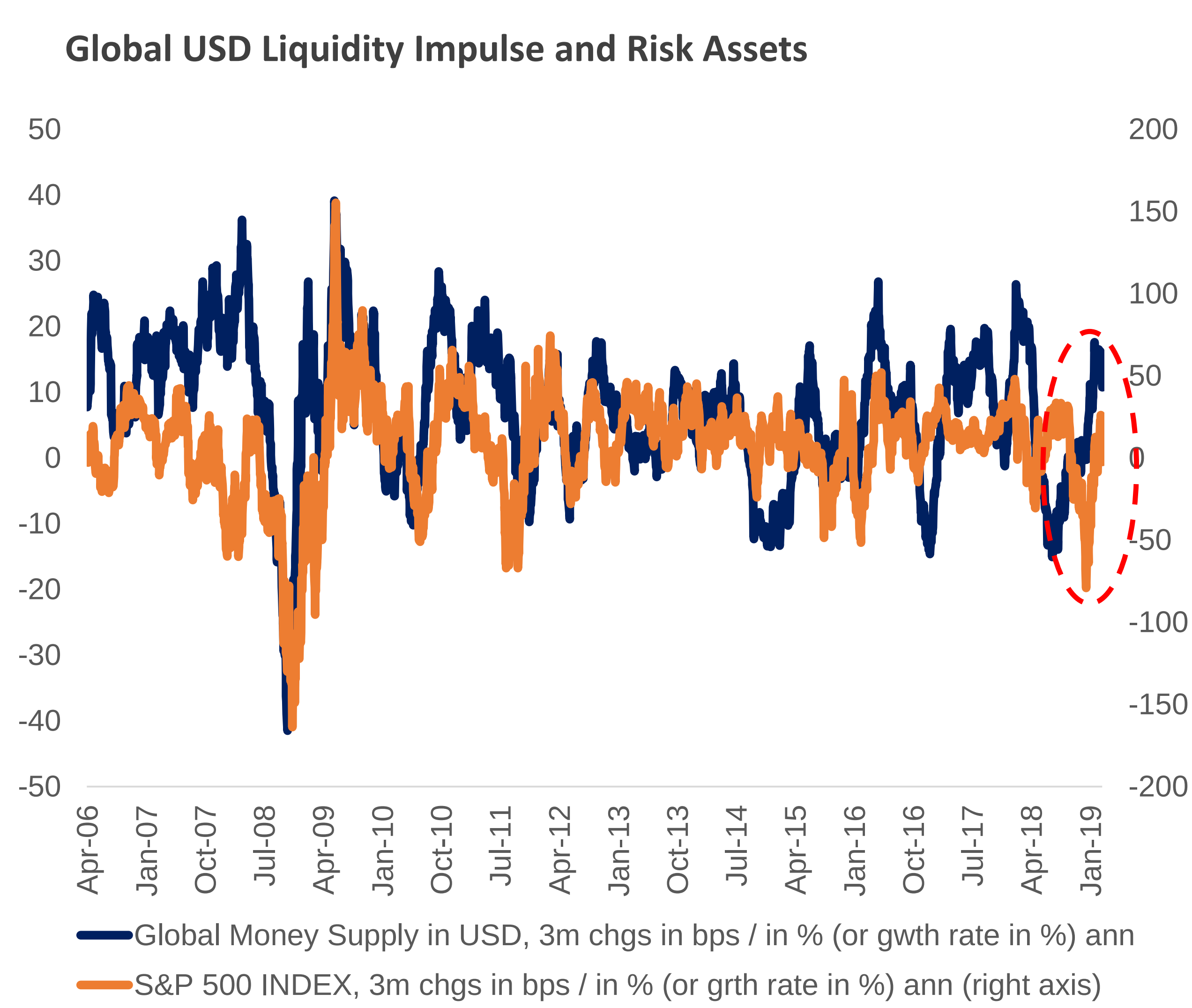


Source: Bloomberg

Whilst it is clear that the terminal size of the Fed's balance sheet will be significantly larger than pre-crisis levels, there are differences of opinion in exactly how far the Fed will go in its normalisation.

Soundings from the Fed have been decidedly more dovish in this regard in the aftermath of December's market correction. Nonetheless, it has been mentioned numerous times by Federal Reserve governors that they will act on rates first in response to a deteriorating growth environment. Any policy change regarding the balance sheet will be a second order occurrence perhaps in response to a larger correction in asset prices.

Not only is credit creation important for continued economic growth, but it is also fundamental to the central banks' ultimate goal of supporting economic growth through a wealth effect. Over the last decade central banks have facilitated rising markets in two essential ways; firstly, by keeping nominal rates low it has boosted valuations of many different asset classes like equities and corporate bonds that benefit from lower discount rates. Secondly, Quantitative Easing has encouraged excessive credit creation and facilitated higher leverage ratios. This in turn has supported markets as improved fundamentals have underpinned further asset price appreciation. These actions, while positive for asset prices, have unintended consequences when things start going the other direction.



Source: Bloomberg

Rubrics Asset Management

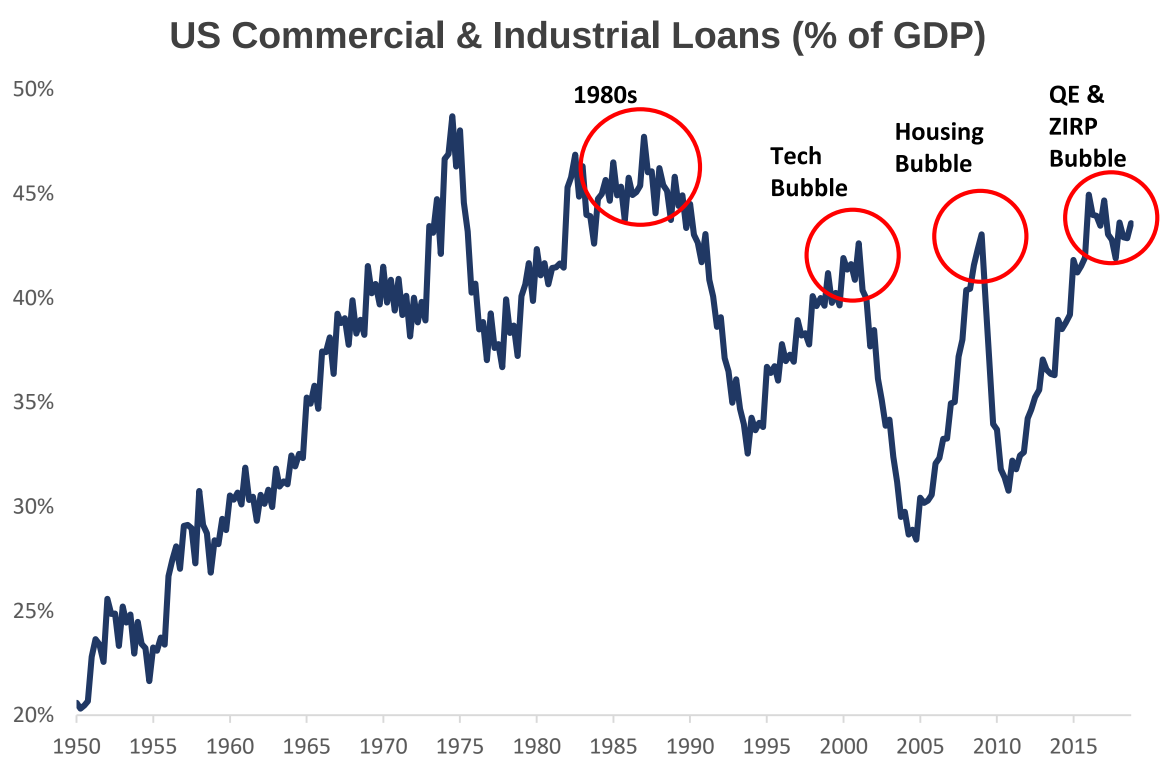
US – Credit Constraints

The impact of nearly a decade of expansive monetary polices has certainly been felt in the amount of debt taken on in the US system. Consumer debt via auto loans, student loans and credit card debt continue to hit new highs while on the corporate side, C&I loans, corporate bonds and leveraged loans have also seen exponential growth. As a % of US GDP, the amount of non-financial corporate debt continues to surpass the tipping points of previous cycles. Morgan Stanley's analysis on the investment grade credit market showed how on leverage ratios alone, 50% of investment grade corporate bonds would in fact be high yield[1]. Meanwhile 72% of EPS growth since 2012 has been driven by share buy backs[2], a great deal of which were financed by this explosion in corporate debt.

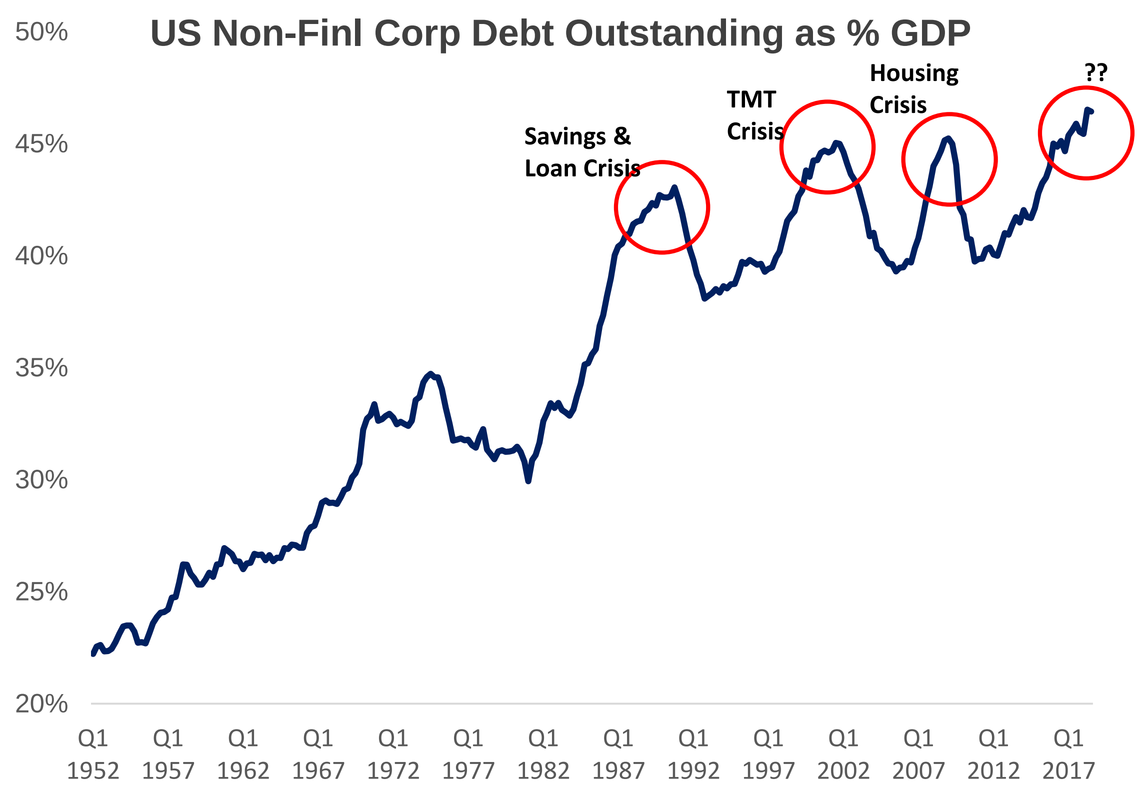
Diminishing Marginal Returns on Credit Expansion

Our concern at the moment is not whether we are facing another credit crisis this year (we still believe financial conditions are OK) but as explored previously, how effective more stimulus be. Yes, low rates can help expand future debt levels, however as with previous cycles, at some point the threshold will be breached and a similar outcome reached. Credit has been <u>the</u> major driver of growth over the last 20 years and as a result of chronic over capacity, we are now facing major constraints in terms of further debt creation. It is our belief that any future stimulus announcements will ultimately disappoint in terms of their economic outcomes and could create an environment even less sustainable than the current one.

US Debt Capacity



Source: Bloomberg



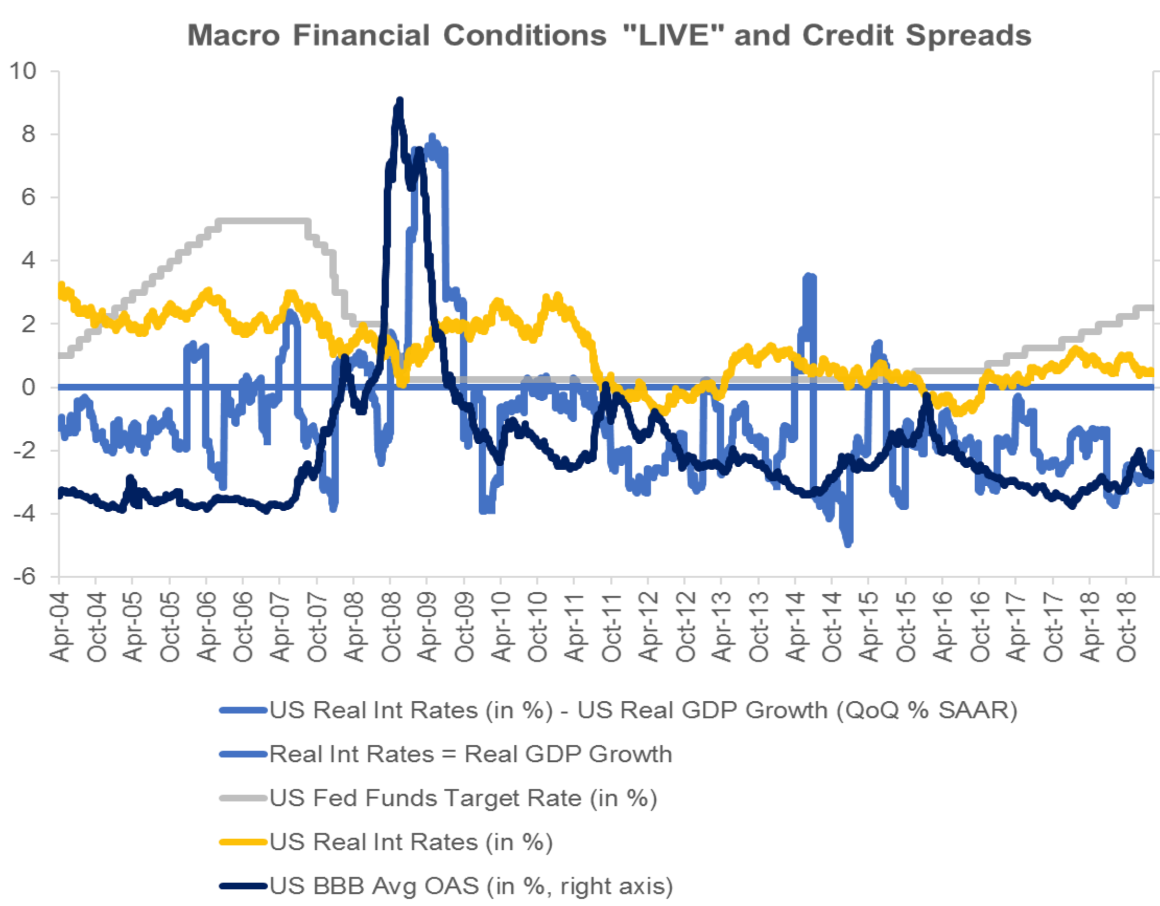
Source: Bloomberg

1. https://www.bloomberg.com/news/articles/2018-11-16/morgan-stanley-warns-bond-boom-and-b-b-bust-would-hit-growth
2. https://seekingalpha.com/article/4157367-stock-buybacks-driving-market-current-status?

Macro Financial Conditions – Tightening in store?

Whilst we have witnessed pockets of volatility in credit over the past 12 months, driven by tightening central bank liquidity and an increase in real rates, the key component of the financial conditions equation (growth) remained in tact. With an aging business cycle and falling growth this can cause a tightening in macro financial conditions leading to a significant re-pricing (amongst other things) of credit risk.

Macro Financial Conditions: Real Rates – Real GDP



Source: Bloomberg

Selection of Global Manufacturing PMI Data

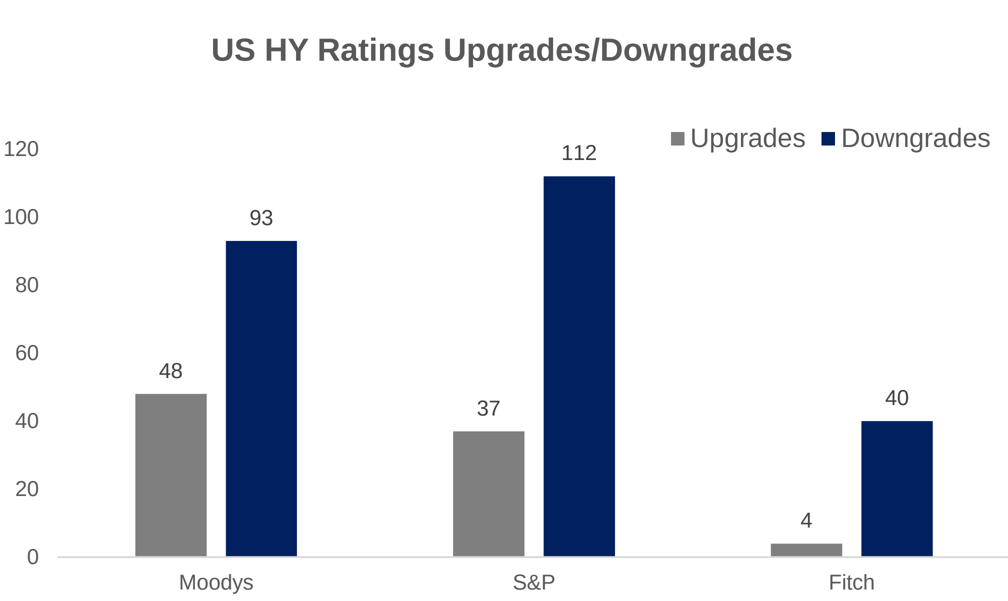
	Feb 2019	Jan 2019	Dec 2018	Nov 2018	Oct 2018	Sep 2018	Aug 2018	Jul 2018	Jun 2018	May 2018	Apr 2018	Mar 2018
Brazil	53.4	52.7	52.6	52.7	51.1	50.9	51.1	50.5	49.8	50.7	52.3	53.4
Canada	52.6	53.0	53.6	54.9	53.9	54.8	56.8	56.9	57.1	56.2	55.5	55.7
Mexico	52.6	50.9	49.7	49.7	50.7	51.7	50.7	52.1	52.1	51.0	51.6	52.4
U.S.	53.0	54.9	53.8	55.3	55.7	55.6	54.7	55.3	55.4	56.4	56.5	55.6
Austria	51.8	52.7	53.9	54.9	53.8	55.0	56.4	56.8	56.6	57.3	58.0	58.0
Czech Republic	48.6	49.0	49.7	51.8	52.5	53.4	54.9	55.4	56.8	56.5	57.2	57.3
France	51.5	51.2	49.7	50.8	51.2	52.5	53.5	53.3	52.5	54.4	53.8	53.7
Germany	47.6	49.7	51.5	51.8	52.2	53.7	55.9	56.9	55.9	56.9	58.1	58.2
Italy	47.7	47.8	49.2	48.6	49.2	50.0	50.1	51.5	53.3	52.7	53.5	55.1
Spain	49.9	52.4	51.1	52.6	51.8	51.4	53.0	52.9	53.4	53.4	54.4	54.8
Turkey	46.4	44.2	44.2	44.7	44.3	42.7	46.4	49.0	46.8	46.4	48.9	51.8
China	49.9	48.3	49.7	50.2	50.1	50.0	50.6	50.8	51.0	51.1	51.1	51.0
Japan	48.9	50.3	52.6	52.2	52.9	52.5	52.5	52.3	53.0	52.8	53.8	53.1
South Korea	47.2	48.3	49.8	48.6	51.0	51.3	49.9	48.3	49.8	48.9	48.4	49.1
Taiwan	46.3	47.5	47.7	48.4	48.7	50.8	53.0	53.1	54.5	53.4	54.8	55.3

Source: Bloomberg

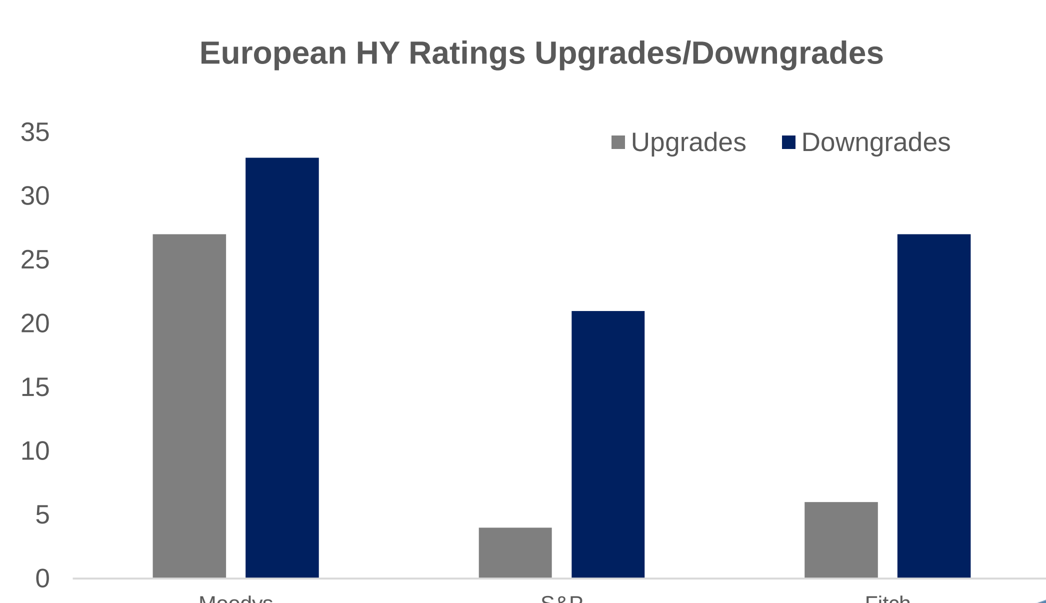
Contraction Decline Expansion

Micro Level – Defaults rising

Spreads on US high yield have so far tightened by approximately 160 bps in 2019 with aggregate levels now back below 400 basis points[1]. In spite of this, ratings agencies are downgrading more companies than they are upgrading in the high yield space with US issuers in particular seeing a higher downgrades to upgrades ratio. In addition, there have been some reasonably sized debt issuers filing for bankruptcy – e.g. PG&E (~$18bn of long term debt) and Windstream ($3.5bn of debt) - with the "pipeline" of companies that may file in the next year adding up judging by the number of bonds trading at distressed levels.



Source: Bloomberg



Source: Bloomberg

1. Bloomberg Barclays US Corporate High Yield Average OAS

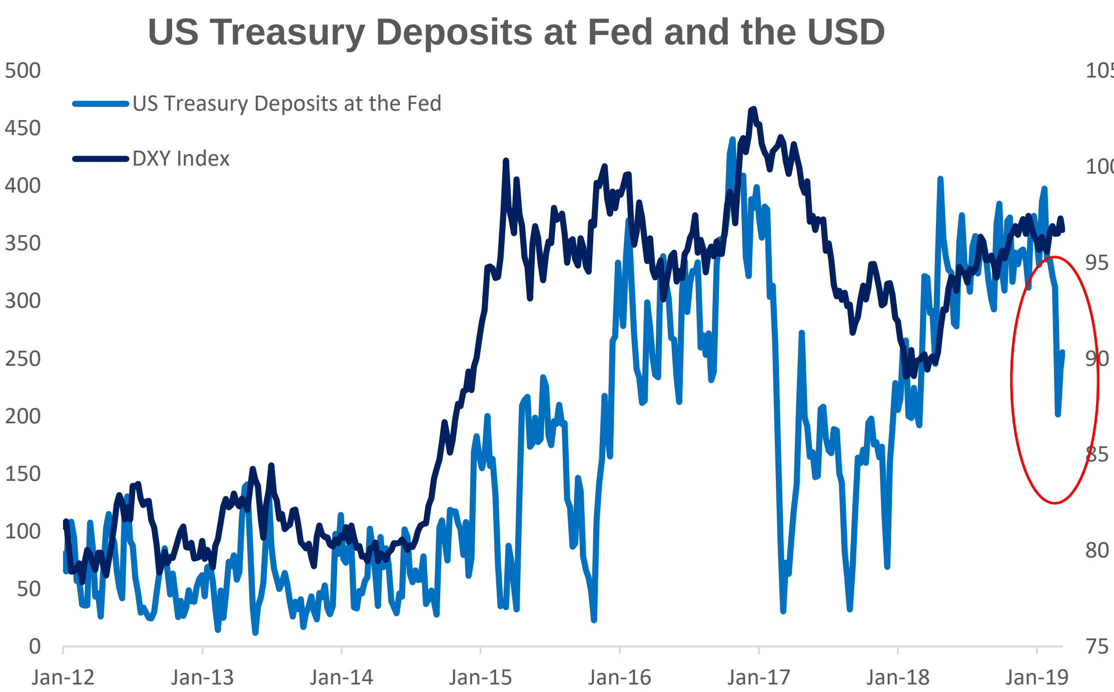
Rubrics Asset Management

Headwinds / Tailwinds

We have examined some of the longer term factors which we believe will act as catalysts for an environment of increased volatility. Ultimately it will come down to concerns about the future growth outlook and the potential effectiveness of future central bank policy actions. In the short term however there are a few factors worth mentioning which can potentially act both as a tailwind or headwind for risk assets.

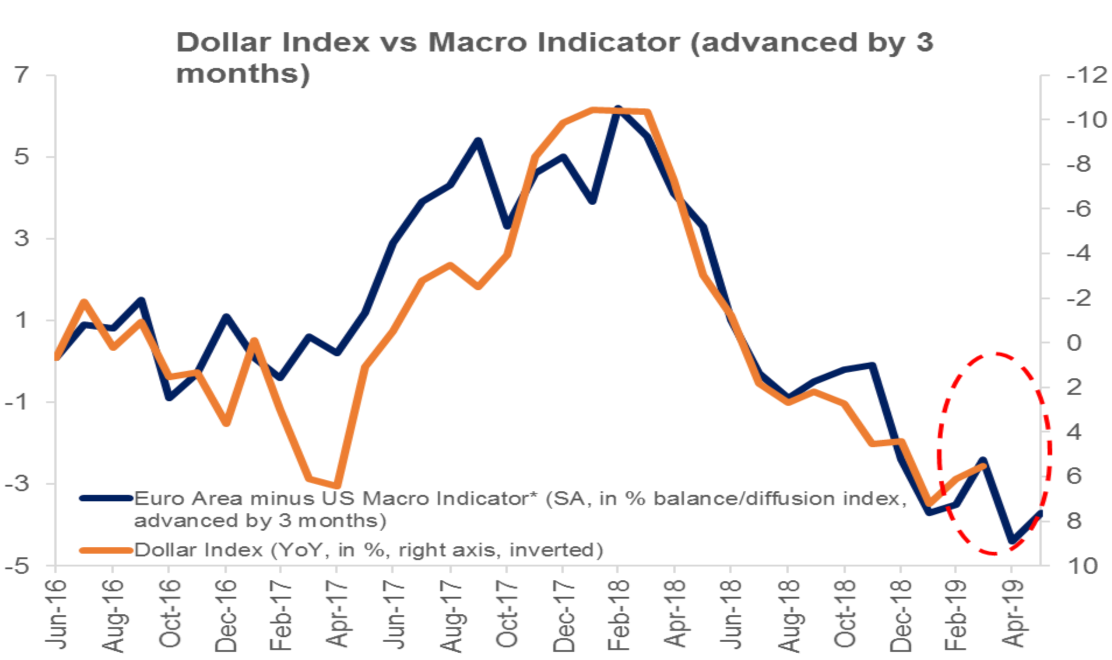
US Dollar

As we had indicated at the beginning of the year, US Treasury Deposits held at the Federal Reserve dropped as a result of the upcoming debt ceiling impasse on the 2nd of March. This dynamic has in the past tended to create an increase in excess USD liquidity. We believe a reversal of the aforementioned trend (increase in treasury deposits) could represent a de facto tightening in USD liquidity. This could potentially be more dollar bullish, however if this tightening of dollar liquidity coincided with weaker US growth and an even more dovish Fed in respect to actual rate cuts, the dollar would ultimately be softer.



Source: Bloomberg

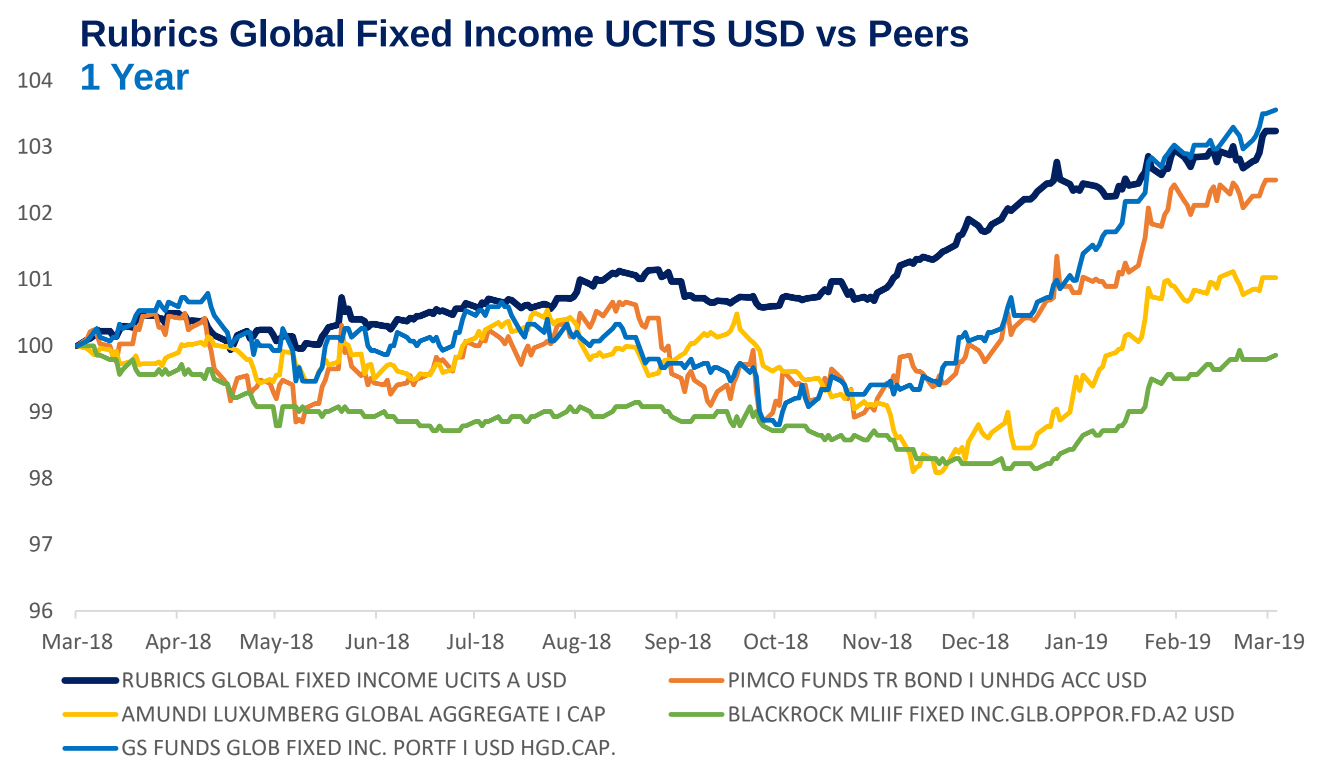
The macro growth differential between the Eurozone and US has been effective in explaining the directionality of the USD over the past 12 to 18 months. While US economic outperformance led a stronger dollar throughout most of 2018, looking ahead a reversion of US growth to that of Europe can conversely create pressure on the USD to weaken. The caveat to this would be a sharp decline in growth leading to a classic risk off scenario.

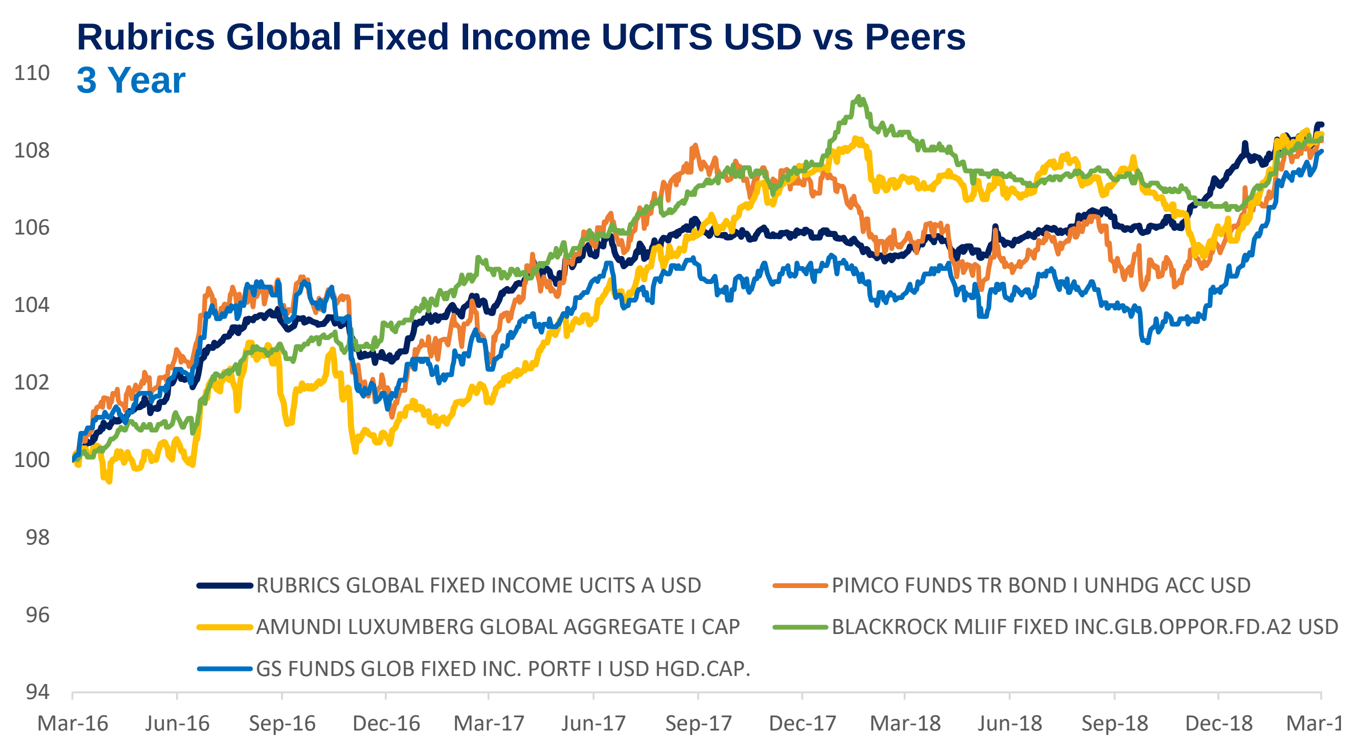


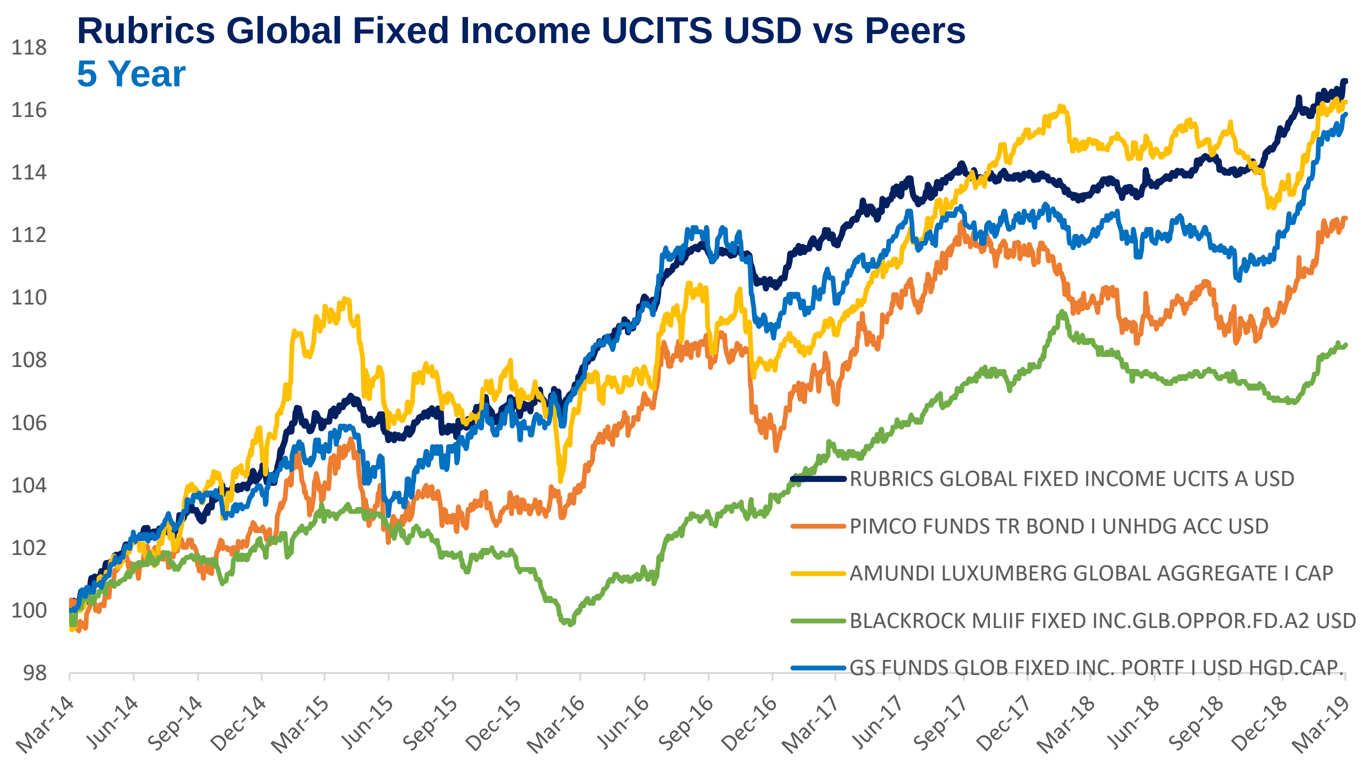
The Trump Effect

With Trump on the campaign trail ahead of the 2020 election, the incentive for strong equity market performance will be significant. The US President has linked the performance of the US equity market to his presidency and speculation is mounting that he is keen to reach a deal with China in order to give markets a boost ahead of the 2020 campaign. In December Treasury Secretary Mnuchin reportedly organised a call with US bank CEOs to address stock market weakness in an example of the administration's willingness to intervene in markets. Whether this type of intervention can lead to sustainable market strength or economic growth is doubtful.

Fund Performance – Rubrics Global Fixed Income UCITS USD A







Source: Bloomberg

Positioning in the Global Fixed Income Fund over the past 12 months has reflected our broader macro view - that a decline in global growth can lead to tighter macro financial conditions.

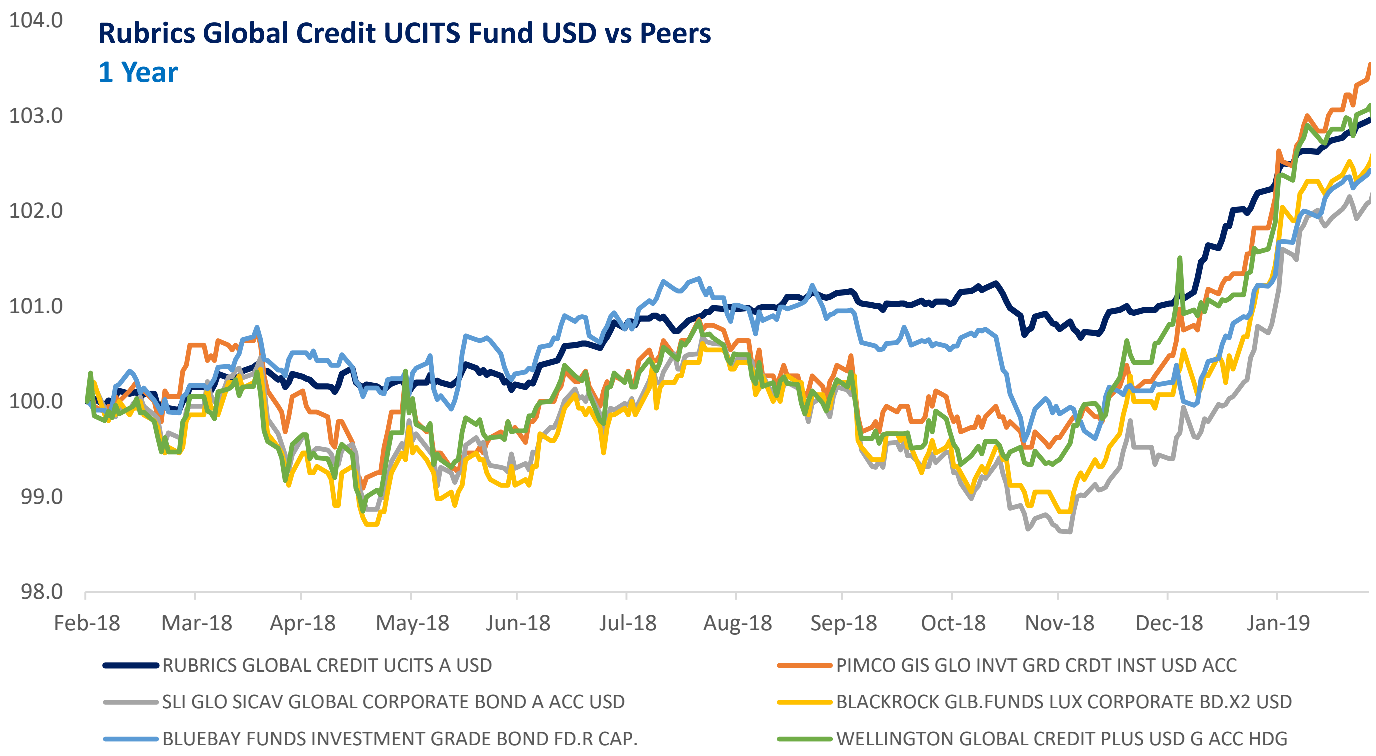
Throughout 2018 a combination of carry from our short dated corporate and government securities, in addition to active duration management of 5, 10 and 30 year government bond exposure ensured the fund was not only able to preserve capital in a difficult year but also achieve some capital gains (+1.81% in USD)

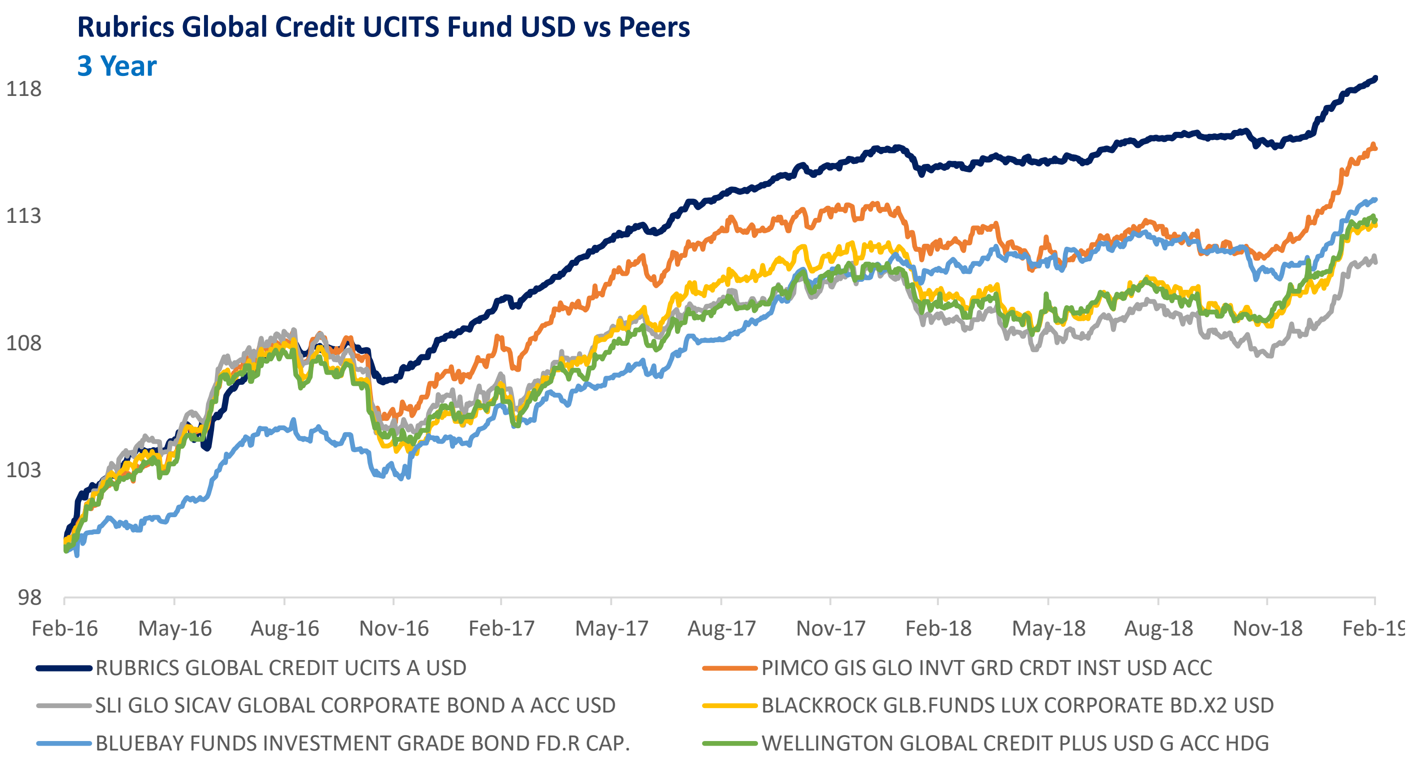
The Fund has not looked to add to credit exposure so far in 2019 both on account of our macro view in addition to what we believe is inadequate compensation for risk/liquidity. Should we see increased volatility heading into Q2/3, the fund is very well placed to capitalise given the high levels of liquidity in the portfolio.

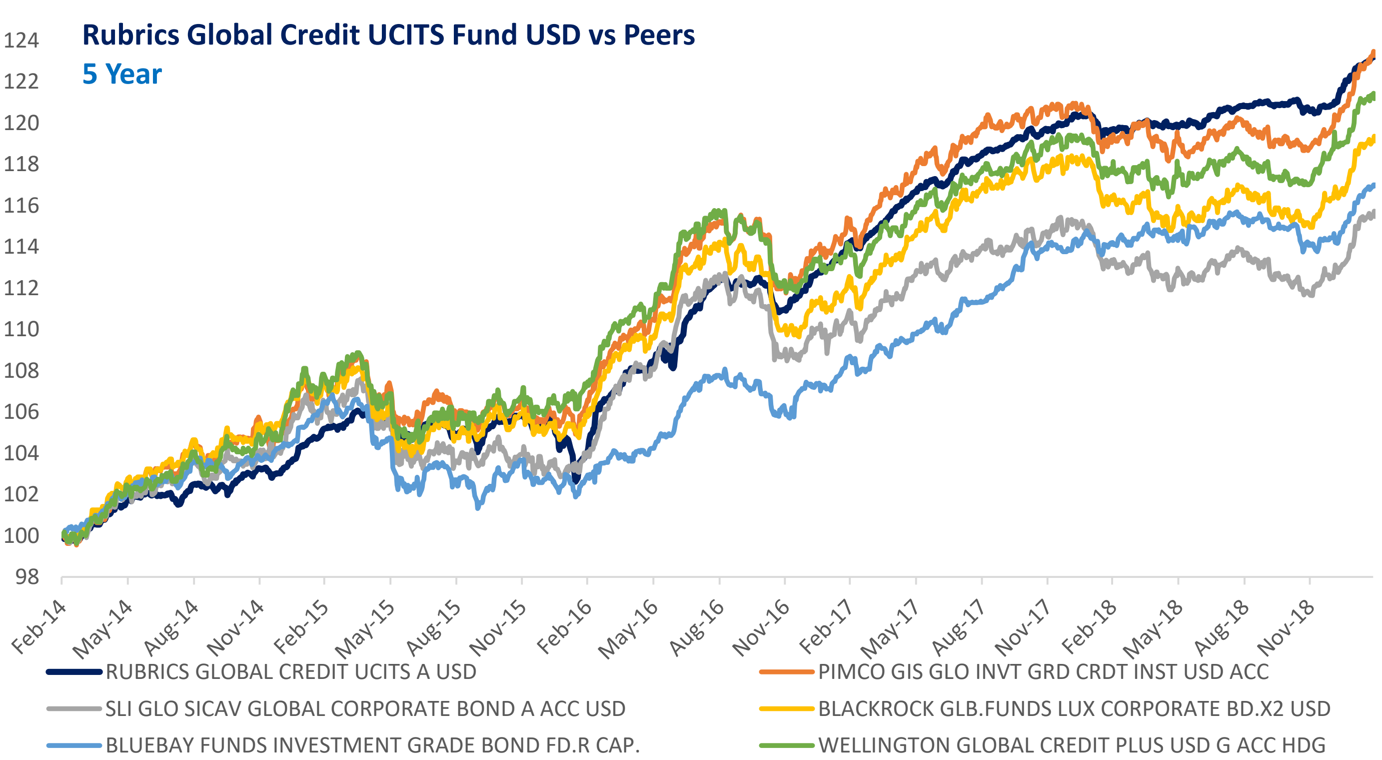
We believe that 2019 ca provide us with the entry point to significantly increase yield in the portfolio and build out return.

	Annualised Return (5 Yr)	Annualised Volatility	Sharpe Ratio
Rubrics	***3.17%***	***1.48%***	***1.59***
Pimco	2.39%	2.92%	0.54
Amundi	3.06%	2.53%	0.88
Blackrock	1.64%	1.50%	0.55
GS	2.99%	2.20%	0.99

Fund Performance – Rubrics Global Credit UCITS USD A







Source: Bloomberg

In line with our macro view, the reduction in duration and credit risk in Q1 2018 involved taking profits on "core" & "tactical" bonds acquired in 2016. This helped limit drawdowns driven by spread widening in credit later on in the year.

Purchasing activity over the past 12 months has centred around "roll-down" bonds which have tended to generate attractive low-vol carry. Credit opportunities have tended to centre on less crowded areas, e.g AUD Sydney Airport 2020 Inflation Linker @ ~4% in USD terms for short dated IG rated paper.

Valuations in 2019 have tightened significantly on risk assets, which has benefitted the portfolio from a return perspective. It has also resulted in modest purchasing activity and more defensive positioning. Currently the portfolio has approximately 8% in cash and cash equivalents.

With a portfolio yield of 4.4% and duration less than 2.0 we remain well placed to generate solid carry and potentially capture future volatility by building in higher yields into the portfolio.

	Annualised Return (5 Yr)	Annualised Volatility	Sharpe Ratio
Rubrics	***4.28%***	***1.4%***	***2.5***
Pimco	4.27%	2.6%	1.3
Std Life	2.92%	3.0%	0.7
Blackrock	3.56%	2.7%	1.0
Bluebay	3.19%	2.0%	1.2
Wellington	3.93%	2.8%	1.1

IMPORTANT INFORMATION

March 2019

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