Managing for Change

Fixed Income Macro View

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Introduction

The time for change has arrived. Not the empty political rhetoric kind, but something far more profound for economies and societies alike. The impact of COVID has been shocking, in both an immediate and tragic way, and in the extent to which it has accelerated pre-existing trends (digitalisation, inequality etc). Much of this has been well documented and need not be expanded upon here. What happens next from a political and economic standpoint, while perhaps not as clear, is no less important. The ability to manage these tumultuous periods as we look ahead will be of fundamental importance for governments, business and investors alike.

Crisis Point

In a research note in 2016, Rubrics discussed a socio-economic paradigm which tracked the evolution of a debt crisis through various stages ending in political turmoil. At the time we felt the conditions in western economies were well represented by this framework, although we had not yet completed the square (see chart opposite). The events on Capitol Hill on January 6th would seem to provide confirmation that we finally have. To blame the entire episode on Trump would be to miss the larger point. The president needed his enablers of course, from his loony tune lawyers to members of the

Crisis Paradigm

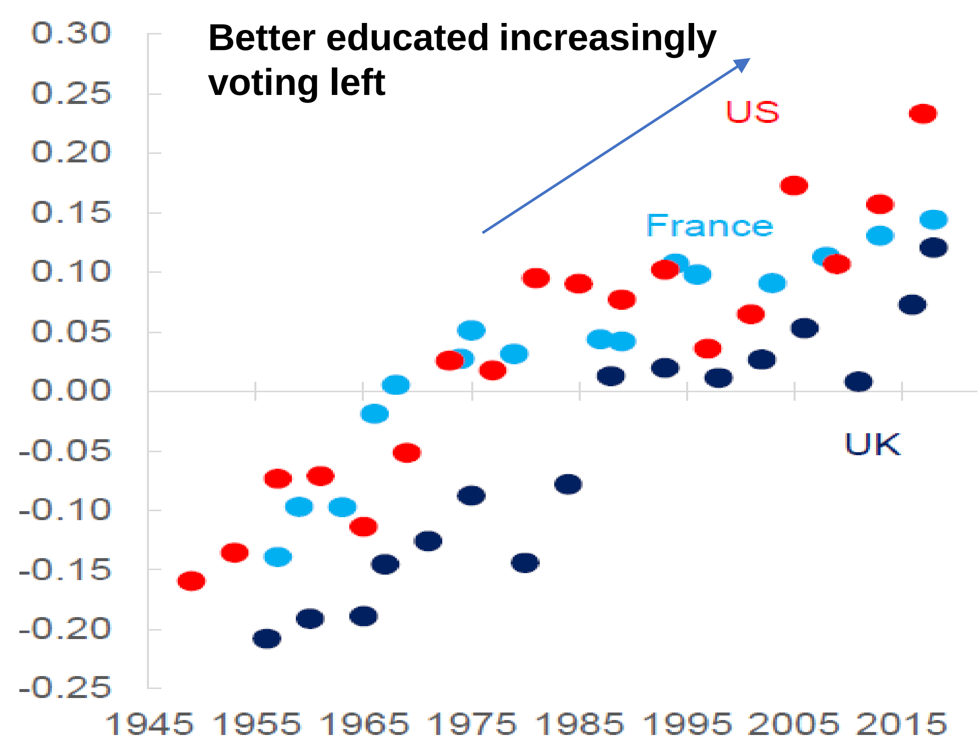
Source Rubrics AM 31/01/2021

Republican party that have undermined democracy every bit as much as the brain-washed mob that invaded the capital. However, the real perpetrators of the insurrection are the corporate actors and political class in America, too consumed by self-interest to be concerned with the realities of millions of disenfranchised citizens. We have undoubtedly reached a crisis point, but from such moments real change can emerge. Out of the devastation of WW2 for example, a transformed economy emerged that saw workers given a voice through unionisation, the introduction of social programmes as well as higher taxation for the rich. What we face today is of course very different, but the need for a system re-calibration is no less acute. The pursuit of a better living standard for a larger proportion of the economy must surely represent a more sustainable model than one which favours an elite minority. Better for business, better for employment, and perhaps even social cohesion.

Seeds of Discontent

The aspirations of many Americans on both the left and the right have been progressively suppressed for generations. This is most apparent among Trump's vocal voter base, for whom a combination of globalisation and technological change has severely constrained social mobility along with a decline in educational standards. Meanwhile on the left, high levels of academic achievement are not being met with an increase in earnings potential. Too many PHDs and not enough skilled jobs - a breakdown of the meritocratic system. The extremities on both sides of the political spectrum continue to pull Democrats and Republicans in opposite directions leaving the centre ground isolated. AOC on the left and Ted Cruz on the right have both engaged in open hostilities with their party's more centrist leadership, leaving Joe Biden with an unenviable task in trying to unite an extremely polarized partisan set up. Part of this challenge will involve finding and executing an economic plan which both parties can get behind. While it will not be easy, relying on the old playbook will not cut it either. The economist revolution that began in the 1970s has run aground. The nature of the challenges facing the economy in the coming years demands evolved thinking, with everything from employment and taxation to financial asset prices heavily dependent on the chosen path.

Difference between % voting left among top 10% by education and bottom 90% after controls*



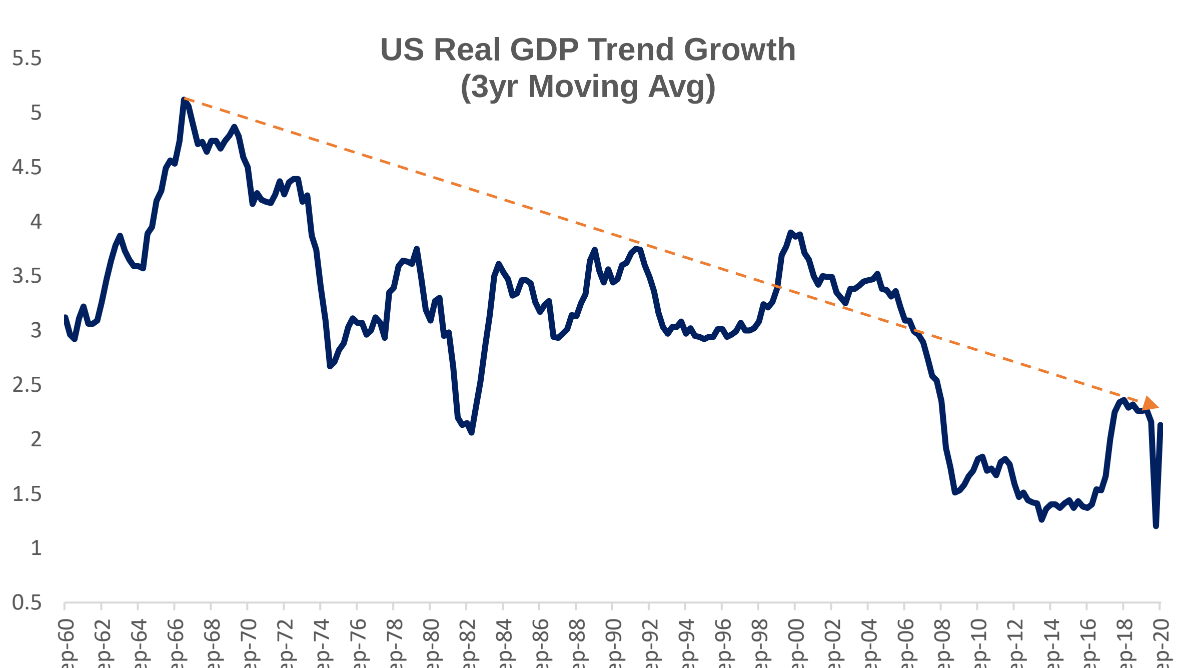
Source Citigroup as at 31/12/20

* For age, gender and income

End of Monetary Supremacy

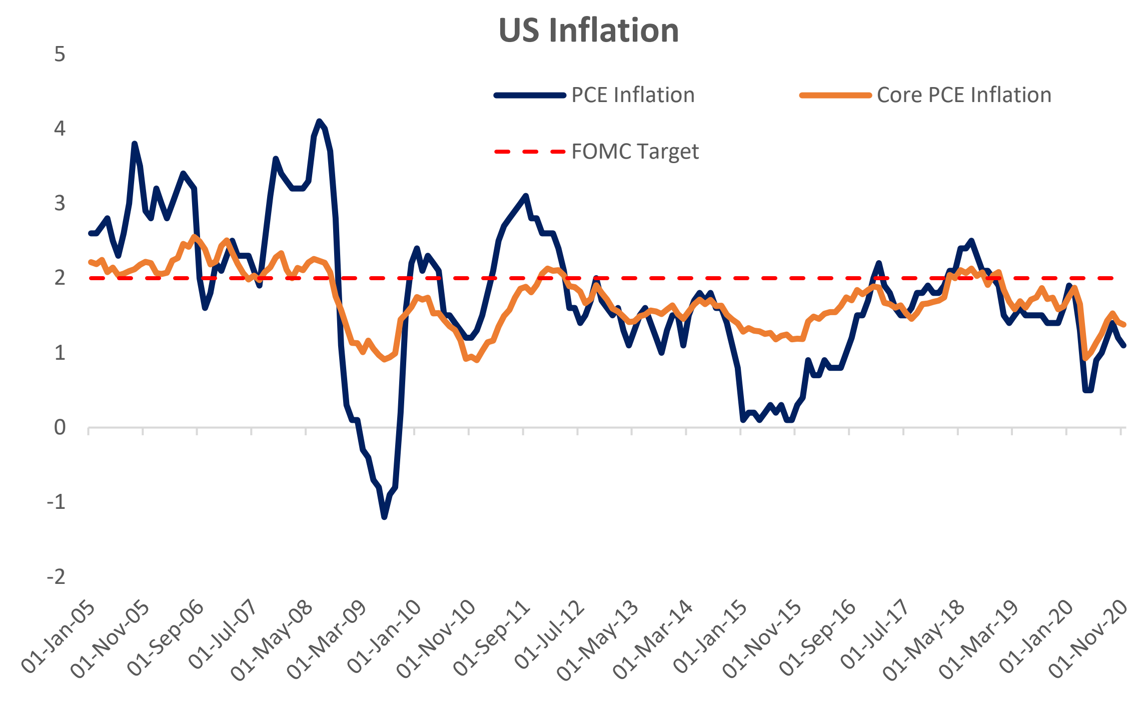
The cycle of monetary-led capitalism inspired by Milton Friedman and unleashed on the world by Greenspan and Reagan, looks to be coming to an end. With interest rates stuck at zero indefinitely and balance sheets bloated with all kinds of debt, it feels like the regime has run out of road. It is often at these moments that the Enron's of the world emerge, or indeed Wirecard for a more contemporary audience. What this tells us is that a policy reboot is required. Powell understands this, as Draghi did. The benefits are too few for the escalating costs to simply plough ahead with the same strategy. Wall St won't like it and are unlikely to go quietly into the night. Central banks may have a tough time on their hands. Not that any of this is evident at present. In fact the noises coming from the Fed, ECB et al reveal an increased emphasis on solving social issues and tackling climate change – yes really, through monetary policy. This has a familiar hint of hubris about it. Lofty ideals such as the creation of lasting economic prosperity have long been a focus of the Fed and ECB, as they progressively encroached on the domain of government policy. Herein lies the problem. Through constant intervention, central banks have essentially given governments a free pass, allowing a bad political culture to develop and creating an ideal breeding ground for populism. Meanwhile trillions of dollars of QE, never ending ZIRP and yet more trillions in fiscal spending have done little to improve economic conditions over the last dozen of years, perhaps even as far back as the bursting of the dot come bubble. Something must give.

Declining Trend Growth (US)



Source Bloomberg as at 20/01/2021

Stagnant Inflation (US)



Source Bloomberg as at 20/01/2021

This transformation will come (in the US) either through Biden, which will be the least painful way, or through a more extreme form from either side of the Democrat or Republican party. This could be hugely significant for the asset management industry. The central bank backed capital markets have favoured passive investment strategies, often inherently riskier, over a more fundamentally driven approach. This pattern could soon be turned on its head as we have seen repeatedly in previous cycles.

Age of Disorder

Faced with such uncertainty, financial markets seem remarkably sanguine. Several long-term global trends indicate we are closer to an inflection point than many dare to consider. In an excellent piece late last year Jim Reid of Deutsche Bank[1] highlights six distinct periods of economic development and their associated impact on financial markets (stocks and bonds).

1. Source Deutsche Bank: https://www.dbresearch.com/

Periods of Economic Development

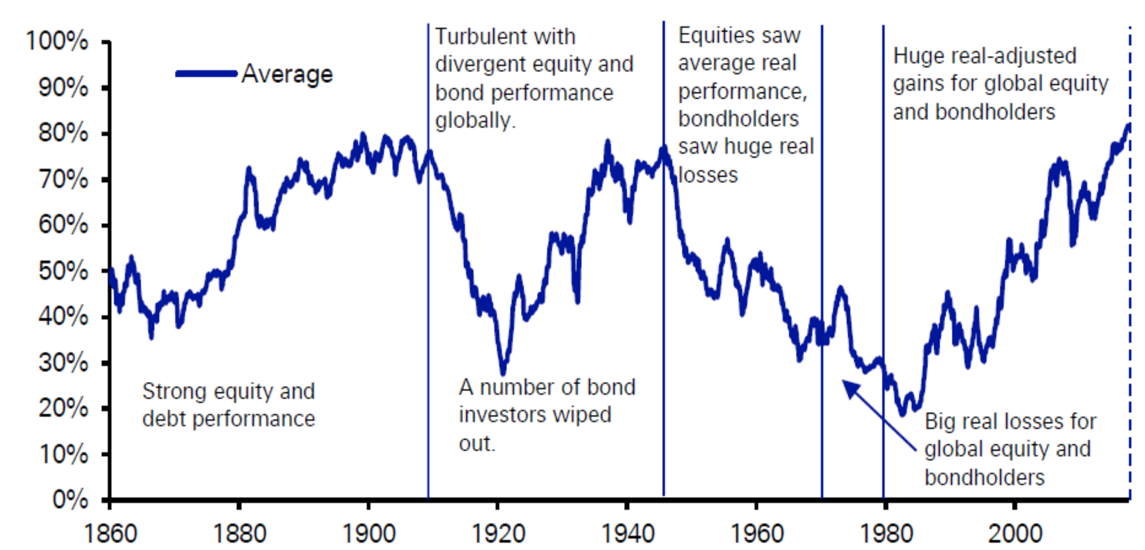
1. ***The first era of globalization (1860-1914)***
2. ***The Great Wars and the Depression (1914-1945)***
3. ***Bretton Woods and the return to a gold-based monetary system (1945-1971)***
4. ***Fiat money and the high-inflation era of the 1970s (1971-1980)***
5. ***The second era of globalization (1980-2020?)***
6. ***The Age of Disorder (2020-?)***

While we won't try to forecast financial market valuations decades into the future, we can highlight some of the key themes which we think can act as agents for change within financial markets in the post COVID world. We will discuss climate issues at later date as it likely warrants its own analysis.

Fiscal vs Monetary Policy – Something we have been discussing since the early days of the pandemic. It has become increasingly evident that government spending will play the dominant role in attempting to drive the recovery. The latest US fiscal programme broadly represents more of the same, certainly in respect of the direct cash disbursements. In the near term, the extent to which this cash can find its way into the real economy would appear to hold the key to whether or not we see the meaningful uptick in inflation that many are predicting.

Longer term, the nature and scale of fiscal spending will depend on the strength of the prevailing political mandate. What the recent US election told us is that we are not yet at the point of unfettered MMT, and despite a Democrat win in the Senate, Biden and co will have a fight on their hands in passing wide ranging spending plans. The fact remains however, that if inequality continues to grow, sooner or later governments will possess a stronger platform for change.

Aggregated 15 DM country average bond (nominal yields) and equity percentile valuations (100% = most expensive)



Source : Deutsche Bank, GFD

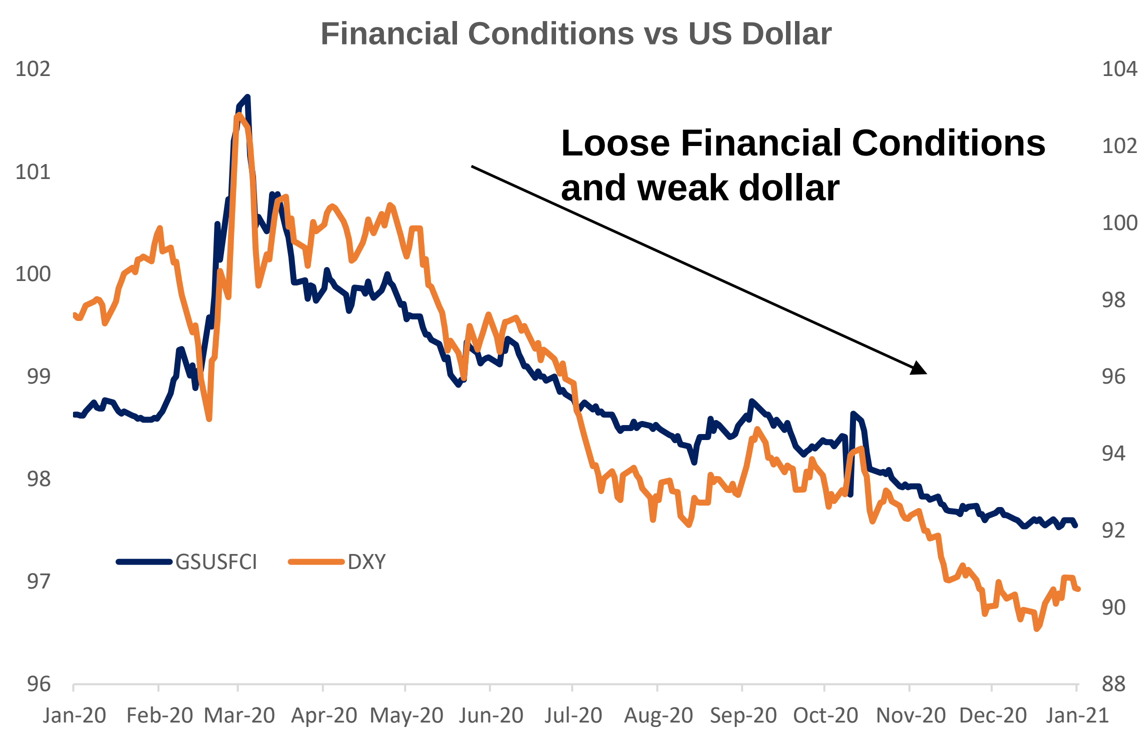
Source Deutsche Bank as at 30/09/20

Rise of China – China's ascent to the top of the global GDP ladder has accelerated throughout 2020. The comparative success they have had in dealing with COVID is likely to strengthen the belief in the superiority of their system vis a vis the West. As the soon-to-be world's largest economy, the extent to which they look to increase their influence in their relations with Western economies potentially still grappling with the fallout from the virus will be critical.

The inflows into Chinese financial markets, strength of the Yuan and higher bond yields (relative to other DMs) have been a feature of financial markets since March 2020. How these dynamics play out will be fundamental to the directionality of the global economy in the years ahead.

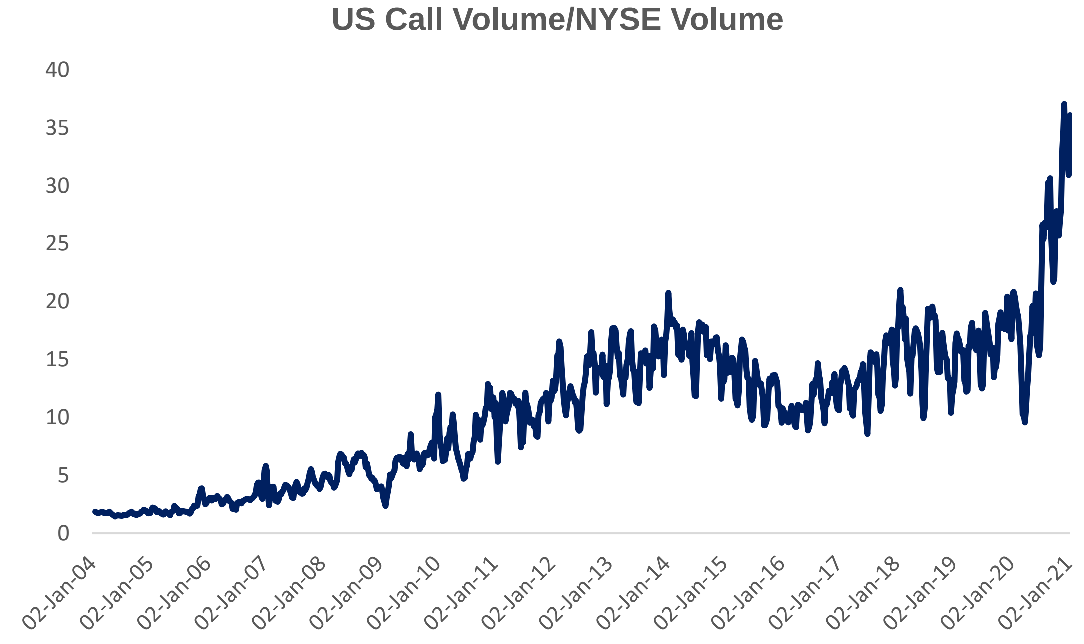
US Dollar and Reserve Currency – Much talk of late has concerned the future of the dollar as global reserve currency, with some contending that recent weakness is the beginning of the end for the greenback. At Rubrics we have always maintained that it will be a strong dollar that will bring about its denouement and not a weak one. At present, a declining USD is having a positive impact on global financial conditions, reducing the burden of growing $ debt liabilities and generally keeping financial conditions loose. As long as this continues, financial markets will not be overly concerned.

Financial Conditions and the Dollar



Source Bloomberg as at 20/01/2021

Market Exuberance – Call Volume as % Total Volume



Source Bloomberg as at 20/01/2021

It is the spectre of higher inflation/rates in the US that could spark a reversal of this trend and give policymakers a real headache. When the dollar hits a level that is no longer sustainable for the given amount of USD debt outstanding, that is when the reserve currency question will emerge front and centre once again.

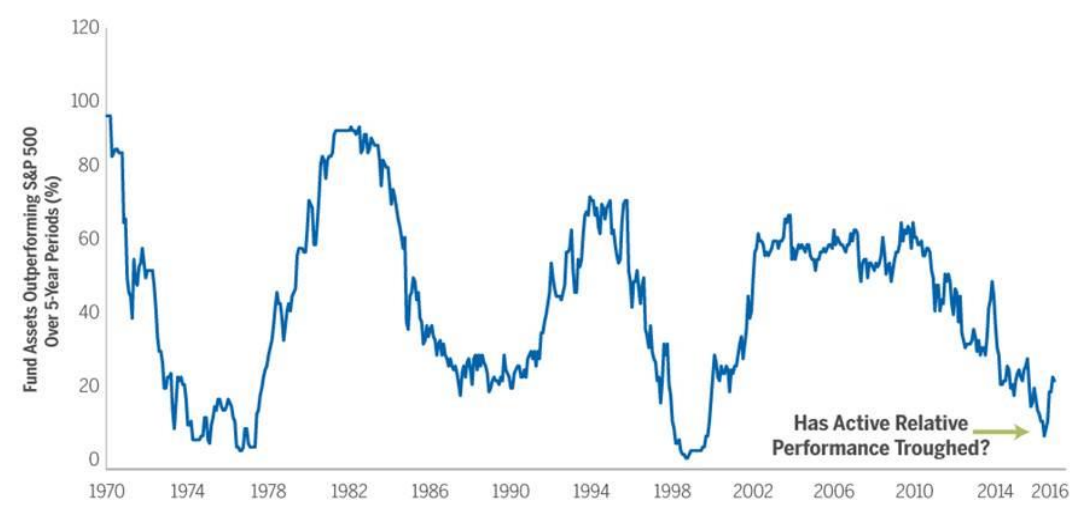
Global Indebtedness – The central bank and government response to the pandemic has centred around the further expansion of credit. Governments have raised deficits to what would have previously been considered obscene levels, while in effectively underwriting the corporate debt markets, central banks have facilitated the largest leverage increase in living memory. That there have been benefits to this in terms of preserving livelihoods is not in question. However if pre-pandemic global leverage was at all-time highs, where we are today is simply unsustainable, particularly in the context of longer term economic growth targets.

Draghi, Rajan et al recently noted[2] the need for creative destruction as a necessary requirement for the world to return to more sustainable growth levels. Some degree of de-leveraging must therefore occur, at the corporate level at least. While this may not be likely in the immediate future, as emergency pandemic programmes remain in place, tougher decisions will need to be made down the line as the recovery moves into the next phase.

Managing for Change

In this period of central bank capture of capital markets, all risk assets are perceived to have much lower risk than is actually the case. The longer the bull market runs, the greater the collective cognitive bias as recent performance dominates the psyche. 70% of today's mutual fund managers were not running funds during the Global Financial Crisis. Far less still would have any concept of what happened during the dotcom bubble. Investors in these funds are for the most part focused on the short-term which, ironically, drives a counter-intuitive investment cycle. The higher market values rise, the more bullish investors becomes, the greater the risk. Over the past few years, focusing heavily on recent performance via passive strategies has in most instances been the correct approach.

Outperformance of Active vs Passive – Hitting a Trough?



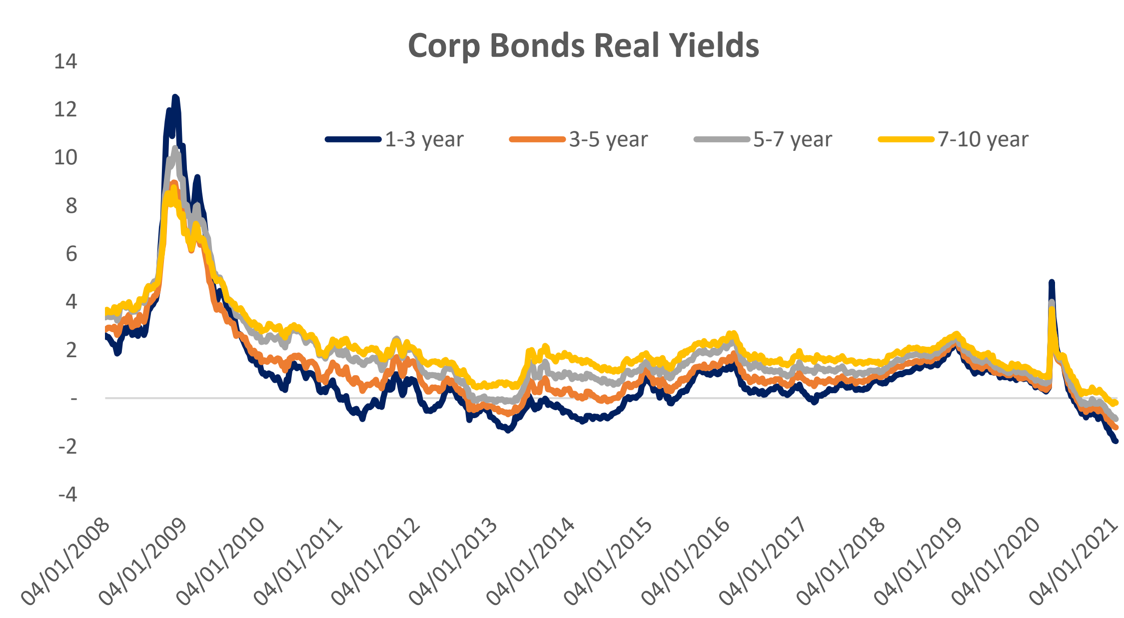
Source: Nomura as at 31/12/2018

Looking ahead however the investment mindset must shift, in line with the political imperative to focus on a more inclusive economic model. Help the real economy not wall street.

Rubrics Investment Strategy – The Laddering Effect

While the mania of the latest FOMO bubble looks unshakable at present, the risk/reward payoff promises poor investment returns going forward. However, as asset prices become more volatile

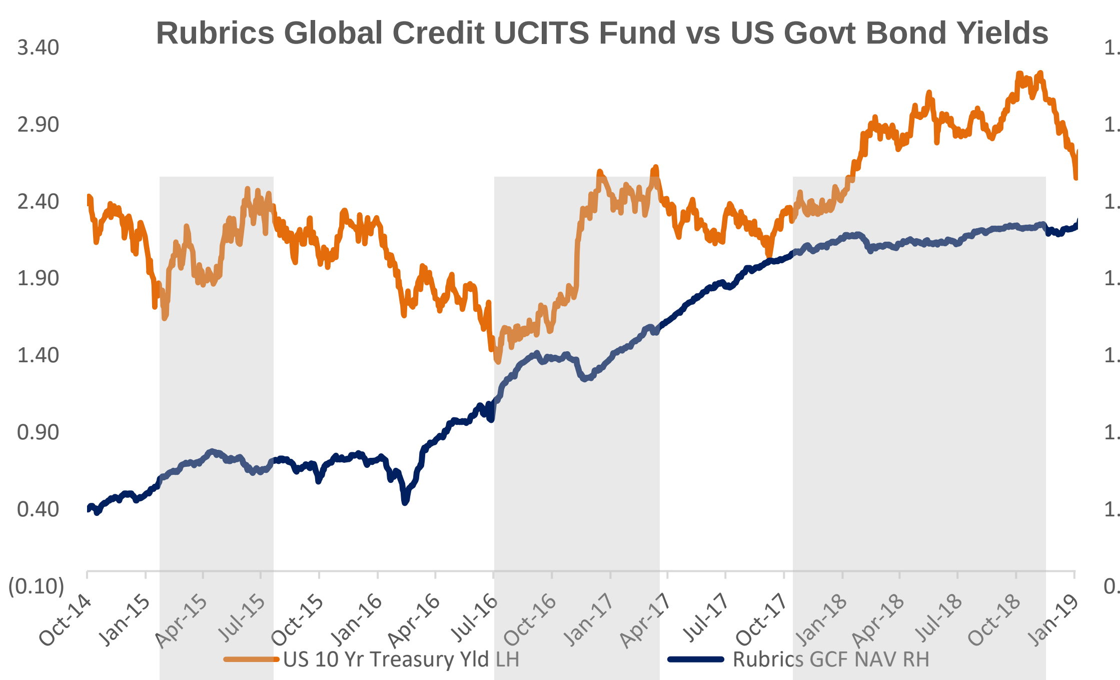
Corporate Bond Real Yields Turn Negative



Source Bloomberg as at 20/01/2021

2.https://group30.org/images/uploads/publications/G30_Reviving_and_Restructuring_the_Corporate_Sector_Post-Covid.pdf over the next 12 months, so too will return expectations – they should in fact increase. With little or no return offered by more illiquid long dated corporate bonds, short dated positive yielding paper offers a more favourable alternative from the perspective both of providing decent carry and liquidity for future reinvestment.

Rubrics GCF in Rising Yield Environments



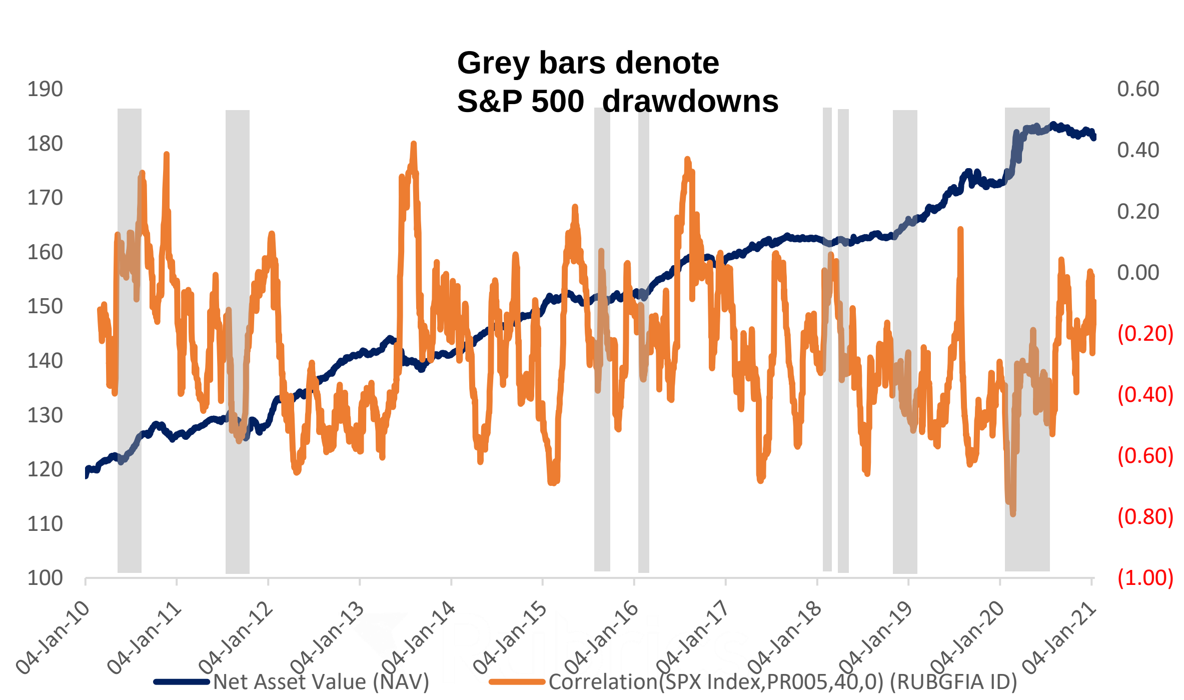
Source Bloomberg as at 20/01/2021

As a result, a rising yield environment has historically been favourable for Rubrics Funds, with the Global Credit Fund in particular offering a good hedge against rising rates. Improving credit quality while many in the market move in the opposite direction, is a good way to avoid the excessive build-up of risk in a portfolio. As mentioned above, a critical component of any transformation, either political or economic, is to leave bad businesses behind. Something Japan has failed to do and paid the price in terms of economic stagnation. The political pressure in the less homogenous economies of the West will require some form of creative destruction. Resources will need to be allocated to productive businesses if trend growth rates are to stabilise let alone pick up. China is already going through this process. With central bank supervision (ie liquidity provisions) this process, while potentially painful in the short term, can help growth in the longer term, outweighing some of the initial negative impacts. Again, Rubrics has a history of strong performance during these periods.

Portfolio Diversification

We are aware that Rubrics does not live in a vacuum relative to other fund managers. Nor do we live in an alternative universe where we have perfect timing. What we have done with a degree of success is continue to offer an investment process that demonstrates the benefits of active management. Our approach as part of a broader diversified portfolio, we believe can offer an outcome less impacted by the extremes of market mania than most peers.

Rubrics GFI Correlation vs S&P 500



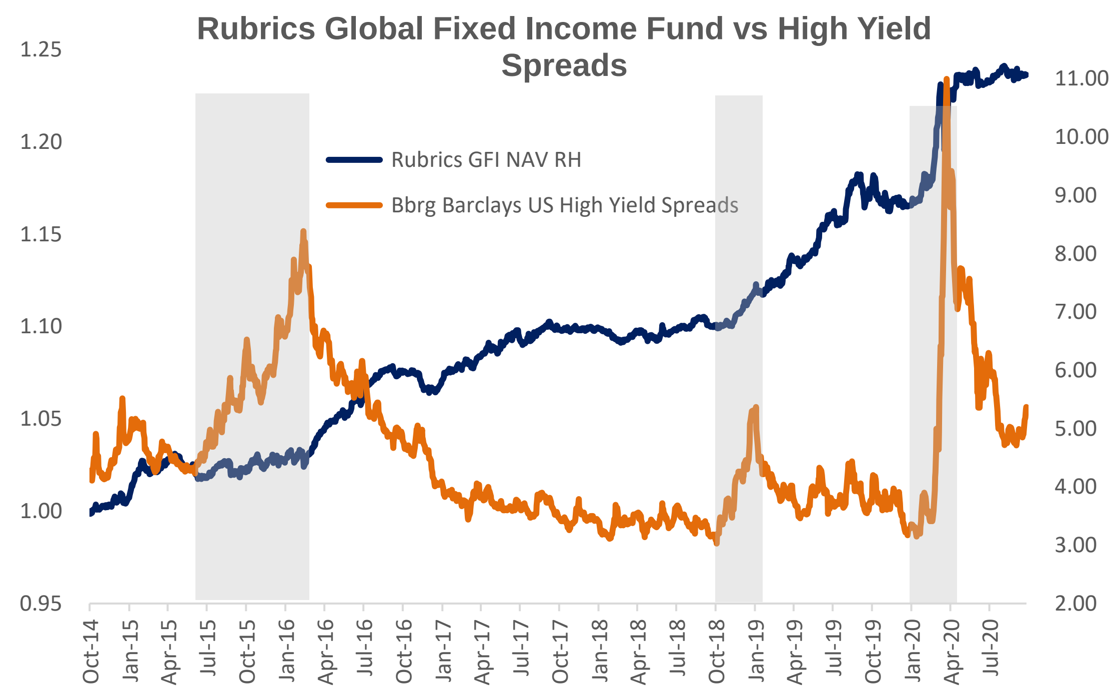
Source Bloomberg as at 20/01/2021

Rubrics Fixed Income Macro View

Our objective of delivering strong performance over the medium term is not curtailed but we believe a cautious and methodical approach is warranted.

At present it is certainly difficult to get excited about future return prospects. Indeed, per the table opposite, looking at it purely from a valuation perspective the outlook has not looked as challenging for decades. With bond yields at historic lows, many are questioning their effectiveness as a hedge to equity within a traditional portfolio. In respect of long duration passive fixed income, perhaps this is a valid point. However as always it is a question of suitable alternatives. Given current valuations, we believe that a process that involves prioritising liquidity and active duration management, will be the most effective way of managing volatility looking ahead. The coming political and economic changes will alter the asymmetric return dynamic from current extremes. Worrying about risk and the quality of assets one buys will matter, irrespective of how long rates stay at zero.

Rubrics GFI in Rising Spread Environments



Historical Returns of a Traditional 60/40 Equity Bond Portfolio

	S&P 500	S&P Adj P/E*	Barc US Agg	Barc Avg Yield*	60/40 PF Ret	Total Stimulus**	Cum Stimulus
2002	-23.4%	*27.2*	10.3%	*5.6%*	**-9.9%**	301	301
2003	26.4%	*19.2*	4.1%	*4.1%*	**17.5%**	439	740
2004	9.0%	*20.5*	4.3%	*4.2%*	**7.1%**	438	1,178
2005	3.0%	*18.5*	2.4%	*4.4%*	**2.8%**	359	1,537
2006	13.6%	*17.0*	4.3%	*5.1%*	**9.9%**	231	1,768
2007	3.5%	*16.6*	7.0%	*5.3%*	**4.9%**	208	1,976
2008	-38.5%	*18.2*	5.2%	*4.9%*	**-21.0%**	2,029	4,005
2009	23.5%	*16.8*	5.9%	*4.0%*	**16.4%**	1,466	5,471
2010	12.8%	*19.4*	6.5%	*3.7%*	**10.3%**	1,461	6,932
2011	0.0%	*15.4*	7.8%	*3.0%*	**3.1%**	1,755	8,687
2012	13.4%	*13.5*	4.2%	*2.2%*	**9.7%**	1,042	9,729
2013	29.6%	*14.4*	-2.0%	*1.7%*	**17.0%**	1,685	11,414
2014	11.4%	*17.4*	6.0%	*2.5%*	**9.2%**	953	12,367
2015	-0.7%	*18.3*	0.5%	*2.2%*	**-0.2%**	464	12,831
2016	9.5%	*18.8*	2.6%	*2.6%*	**6.8%**	546	13,377
2017	19.4%	*20.5*	3.5%	*2.6%*	**13.1%**	678	14,056
2018	-6.2%	*21.3*	0.0%	*2.7%*	**-3.7%**	500	14,556
2019	28.9%	*16.6*	8.7%	*3.3%*	**20.8%**	1,112	15,668
2020	16.3%	*21.2*	7.5%	*2.3%*	**12.8%**	6,546	22,214
2021		*30.0*		*1.1%*			
Avg	**8.0%**		**4.7%**		**6.7%**		

Source Bloomberg as at 20/01/2021

* P/E and Average Yield are taken as at the previous year end

** Total Stimulus relates to the YoY increase in the Fed balance sheet plus the yoy increase in fiscal deficit in USD Bln

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Source Bloomberg as at 20/01/2021

IMPORTANT INFORMATION

January 2021

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