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Politics Driving Economic Discourse - Risks to Capital Markets?

Fixed Income Macro View

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Rubrics Fixed Income Macro View

Introduction

"How much debt is too much? The interesting answer to that is, nobody really knows……"

- John Oliver, The Tonight Show, April 4th 2021

The idea that debts and deficits don't matter has now permeated popular culture. John Oliver, host of the Tonight Show, is the latest to put forward the argument that as long as rates stay low and we can create growth in excess of interest repayments, then debt levels really shouldn't matter. A theory that is evidently gaining traction across a wider section of society, but one that fundamentally ignores economic reality. The fact is we have seen a consistent decline in the marginal returns from debt for the past 40 years or so. Setting this aside, that the discussion has reached the mainstream says a lot about how far things have come in the past 12 months. The unprecedented nature of the pandemic has given policy makers carte blanche to 'go big or go home' and put previously considered radical ideas like MMT firmly on the table. The imminent introduction of such policies, however, is far from a fait accompli. As the global economy continues its recovery from the depths of the pandemic, with vaccinations gathering pace and economic data getting continually stronger, the voices questioning whether policy has gone too far grow persistently louder. At what point will the scale of monetary and fiscal accommodation come into question? Whichever way you look at it, some important policy decisions will need to be made in the coming months, which we think will shape the directionality of the (highly leveraged) capital markets for years to come. Unfortunately recent policy making has tended to reinforce existing economic weakness. Will next time be any different?

History of Policy Failure

Along with most democratic governments, all economic policies have a shelf life. Failure is inherently part of the process. As in life however, it is the actions we take in response to setbacks that tend to define us. So it is with policy. A combination of demographic, technological and structural forces meant global growth was always likely to face headwinds in the late 90s/early 000s. It was however the (repeated) response of ever-looser monetary policy/ever-increasing debt load that has led the global economy down the path to incapacitation. Over-burdened by debt, underserved by productive assets.

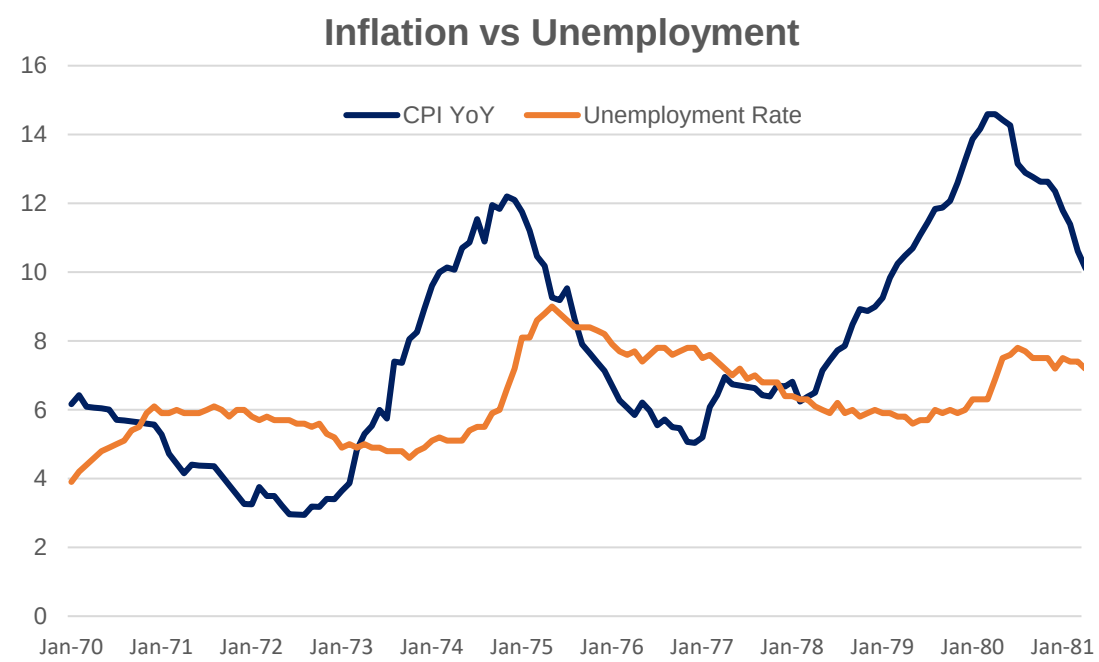
Diminishing effectiveness of credit represents the ultimate failure of Milton Friedman's Monetarism

The incentives set by central banks, regulators and political administrations (corporate owners) fed into this by encouraging consumption over production (investment), capital over labour.

Source: NBER as at 31/03/2021

After spectacular early success we have seen a consistent contraction in productivity and real wealth creation combined with a dangerous de-stabilising of financial markets.

Stagflation was the ultimate failure of Keynesianism in the 1970s



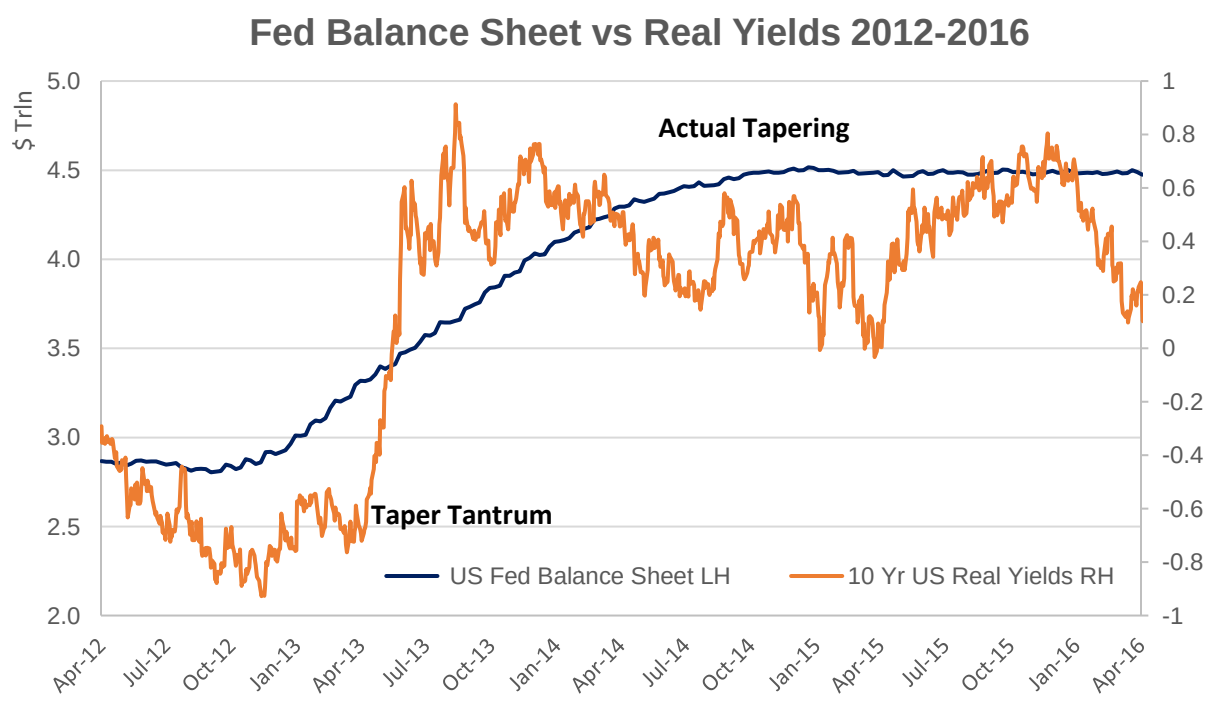
Source: Bloomberg as at 20/04/21

The cornerstone of capitalist ideology - creative destruction – has been side-lined for the 'greater good' of ~~main street~~ wall street. Increasingly reckless behaviour (excess risk taking) has been encouraged by policy makers while regulators like the SEC have been depowered. In essence we had the perfect environment for episodes like the sub-prime crisis, where there were little or no repercussions for bad actors as profits were privatised and losses socialised. Instead of focusing on the next crises however, central banks and regulators continue to fight the old ones. Risks have been transferred to new institutions as regulation belatedly tightened. Witness the shifting of too big to fail risks from investment banks to the asset management behemoths. No coincidence then that the Biden administration is laden with ex-Blackrock executives, supplanting Goldman Sachs as the prominent political power in the world of finance. How will this play into the policy choices made in response to the next crisis?

Policy Dilemma

Given we have already exhausted almost every possible option from zero/negative interest rates, direct purchases of risky assets and fiscal transfers, it is not surprising that policy options are becoming more extreme. However before we make the jump to MMT 'light speed', there is the small matter of the here and now to deal with. As the global recovery continues to gather pace, policy makers will have to contend with stronger incoming data and a potentially inflationary environment. Why is this important? The market has been hooked on low rates and central bank asset purchases for well over a decade, perhaps even two. Higher inflation represents the clearest threat to this as it has the potential to force the Fed's hand in tightening policy. But under what circumstances? Fed Governor James Bullard[1] recently stated a vaccination rate of 75% would be enough to begin the taper discussion. An attempt to take some froth out of an (extremely) elevated market? An unsuccessful one if so. If genuine, it is unlikely to be taken well by the market.

Considerable time lag between market 'taper tantrum' and actual slowing of asset purchases



Source: Bloomberg as at 20/04/21

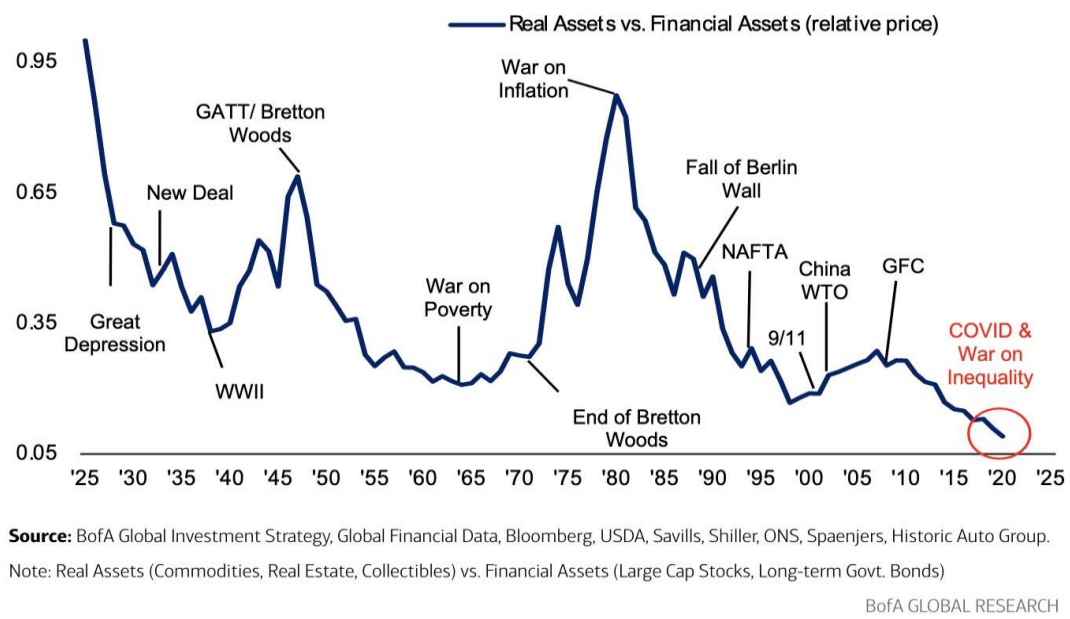
1. https://www.bloombergquint.com/global-economics/fed-s-bullard-says-75-vaccinations-would-allow-for-taper-debate

As former Fed Governor William Dudley noted, "you are either all-in or you're not" as regards asset purchases in arguing that it will be very difficult for the Fed to avoid a bond taper tantrum. Given markets are forward looking, and that we have a reference point in respect of the 2013 taper tantrum (which occurred some 18 months before asset purchases actually stopped increasing) markets may react to this possibility sooner than many believe. This brings the upcoming data flow into sharp focus, in particular that of inflation.

The Inflation Question

Balance sheet inflation has long been a by-product of Milton Friedman's monetary mechanics. Ever increasing money supply drives credit expansion and asset price appreciation. The housing market, for example, is nothing more than a market for debt (mortgages), while the cost of education has risen exponentially along with the increase in student loans. The same phenomenon is evident in the financial markets where margin debt has helped propel asset prices to record levels.

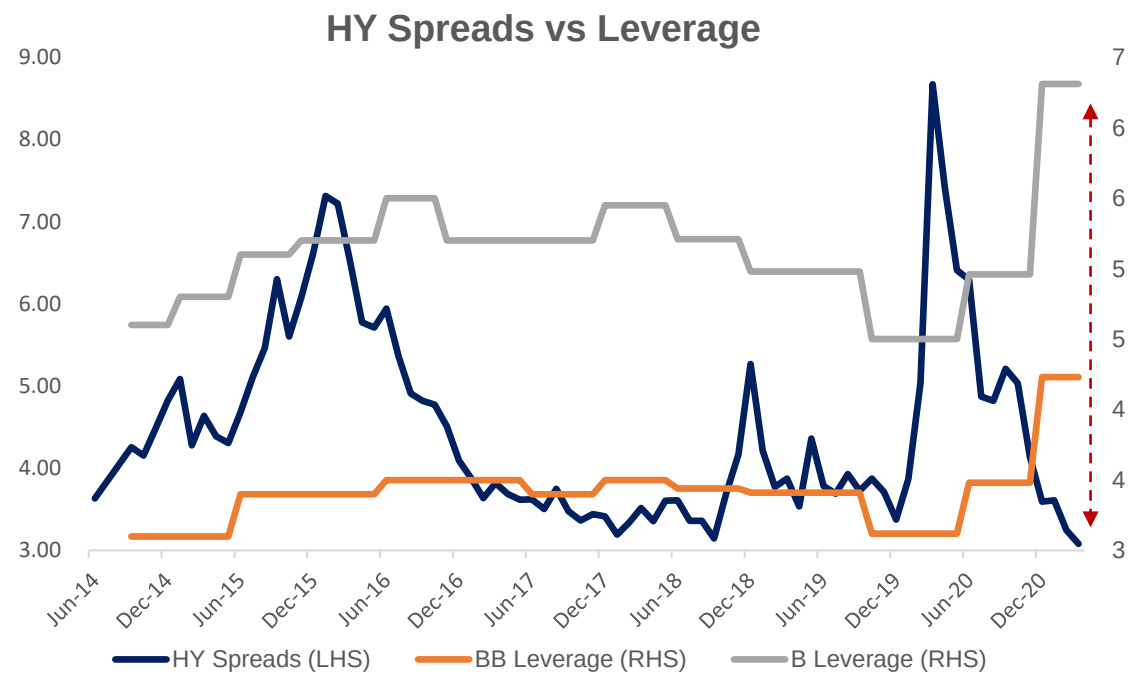
Ratio of Real to Financial Assets at Record Lows



Source: BofA 31/12/20

Away from this, the story is very different. A pandemic driven stalling of growth has seen a further collapse (it has been falling for 25 years) in the velocity of money and with it a near flatlining of key inflation indicators like CPI and PCE. This has (conveniently) helped the Fed (and others) continue their ultra-easy policy in pursuit of long-term goals. Strangely their greatest policy success, the rise in financial asset prices, has taken place without any notable increase in underlying productive value. Equity valuations, for example, have risen sharply while profitability has essentially stagnated, corporate bond yields have collapsed as aggregate credit quality has deteriorated, and against the increase in house prices referenced above, household incomes have barely budged.

High Yield spreads at odds with increase in leverage



Source: Bloomberg as at 31/03/21

Ultra-easy monetary policy has created this uniquely paradoxical world of hyperinflation on the one hand and deflation on the other. Since the onset of the pandemic however, certain developments have taken place which we believe could prompt a continued rise in consumer inflation measurements. Unlike what has been witnessed in the financial economy, this can have the potential to put policymakers in a very difficult position (see next page).

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Short Term Inflationary Catalysts

- Supply side shocks – The fallout from COVID related restrictions on the production and transportation of goods continues to be felt – witness the lack of supply of microchips to the auto industry or the price of lumber.

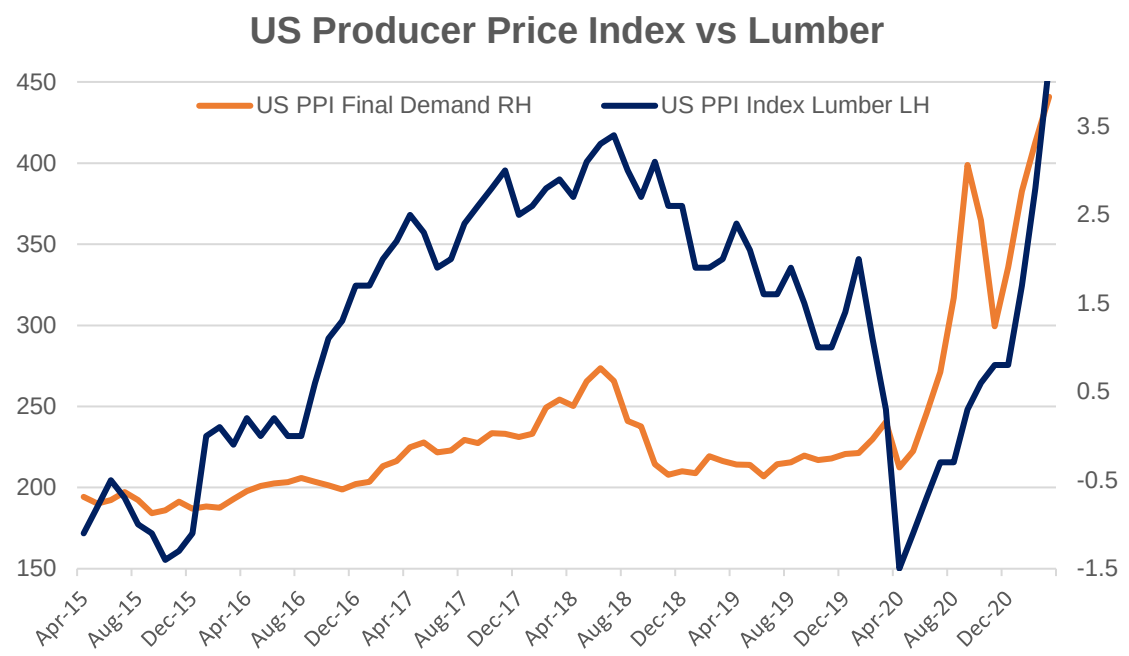
- Demand side shocks – The direct income hit to the US economy due to covid was approximated at $300billion. The combined fiscal transfer and furlough payment from government is over four times that number - a considerable addition to savings and ultimately pent-up demand.

- Deglobalisation/geopolitical tension – globalisation has played a significant role in bringing $billions of cheap labour to the market place and with it deflation. A partial reversal of this model can see costs rise, in a similar fashion to the fallout from COVID-led supply disruptions.

The longer-term dynamics, however, paint a very different picture. Excessive debt has been one of the primary causes of years of subdued economic activity in developed economies for decades. As debt rises various factors have combined to dampen growth prospects:

- Balance sheet expansion facilitates higher asset prices and ultimately capital gains as future profits are enjoyed today, further supporting short-term consumption. The front loading of these benefits however, comes ultimately at the expense of longer-term prosperity.

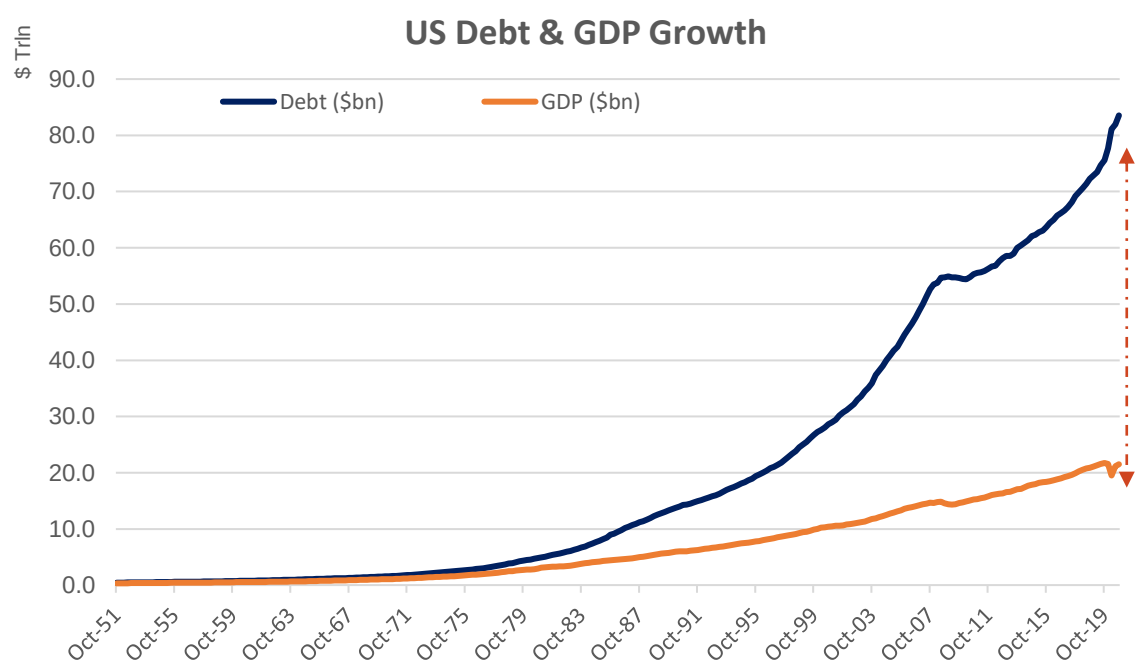
Short-term inflationary pressures



Source: Bloomberg as at 31/03/21

- As debt rises, future growth must be discounted by the degree to which future earnings are required to service the debt. If the increase in debt outweighs the productive uses that can be found for it, economic growth will suffocate. The award-winning book by Reinhart and Rogoff[1] attempts to quantify the long-term costs of excessive debt - defined by the authors as anything above 80% of GDP at a national level (some variations do apply). This has clearly been surpassed by most large countries quite some time ago. The diminishing marginal returns on debt has pushed economies into a liquidity trap where normal policy tools become ineffective.

Debt vs GDP Dichotomy

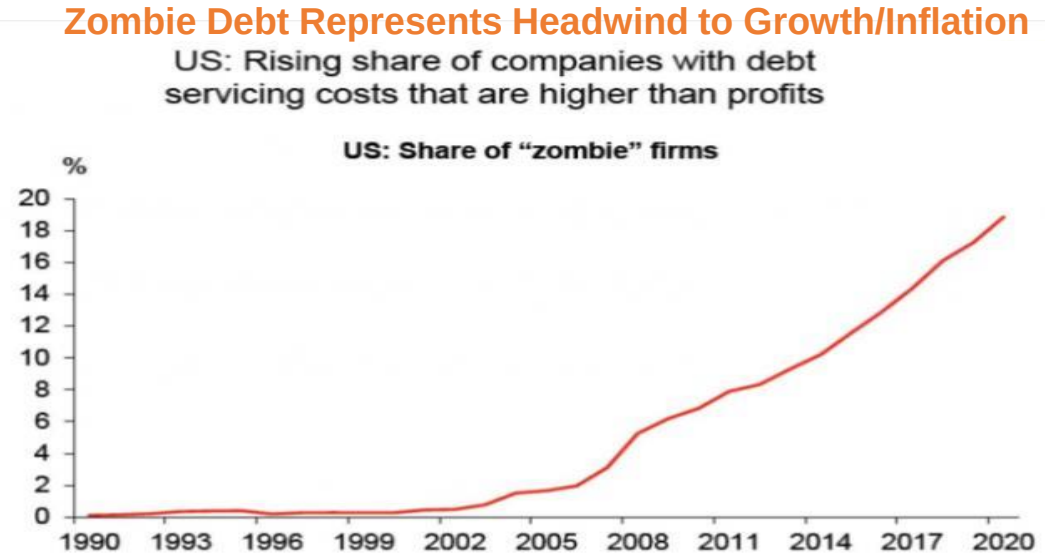


Source: Bloomberg as at 31/03/21

1. This Time is Different: Eight Centuries of Financial Folly, Reinhart & Rogoff

- Another significant factor at play is zombification. Japan has demonstrated the damage that Zombie companies can inflict on the productivity of an economy. Academic research[1] has determined that once the level of zombie corporations in an economy reaches a certain threshold, lasting cyclical upswings in economic performance become unattainable. The US should take notice, given approximately 20% of corporations currently fit this classification.

Zombie Debt Represents Headwind to Growth/Inflation



Source: Deutsche Bank as at 31/12/2020

There are significant conflicts between the inflationary impacts of current policy and the long-term deflationary effects of the crippling debt overhang. The Fed's own research shows that it is impossible to outrun the debt burden by inflation alone. As inflation rises so too does the cost of servicing the debt, in addition to the unfunded liabilities (pensions etc) of most western governments. If you want inflation to pay off your mortgage then don't expect to get free health care from the government in your old age. The most likely outcome in the near term will be somewhat higher inflation, however short-lived. Beyond that further policy decisions, like Yield Curve Control, or even MMT can play an important role in future inflationary outcomes.

1. Zombie Lending and Depressed Restructuring in Japan, Caballero et al 2008

Current inflation expectations are based on existing policy, however new choices will bring new outcomes. Fed governor Powell, amongst others, will know that going down the more radical route can bring some positives but plenty of negatives too.

Financial Market Fragility

History is littered with financial market boom bust cycles - 1929 , 1989 (japan), 2001 and 2008. In each instance, hyperinflation was nowhere to be seen. In fact, these financial crises had more to do with large market imbalances, excessive credit expansion and reckless market behaviour due to excessively loose financial conditions. In addition, each was preceded by early warning signs which were either ignored or dismissed.

In 2007 the blow up of Bear Sterns was put down to a problem with two mortgage hedge funds managers, with scant consideration of the wider or more systematic issues within the banking sector – remember Fed Chair Ben Bernanke reassuring the markets that nationally house prices "couldn't go down"? Bear Stearns in hindsight was a clear sign of the wider risks to the economy due to widespread recklessness in the mortgage market. Is Archegos today's Bear Stearns? Or could it be Greensill? What about GameStop and the Melvin Capital implosion? We shouldn't forget Wirecard or the huge Softbank-led gamma squeeze on the Nasdaq 100. Does Tesla's stock price tally with a company that still struggles to make money from selling cars? Where do we even begin with Bitcoin. You get the point, how many warnings do we need?

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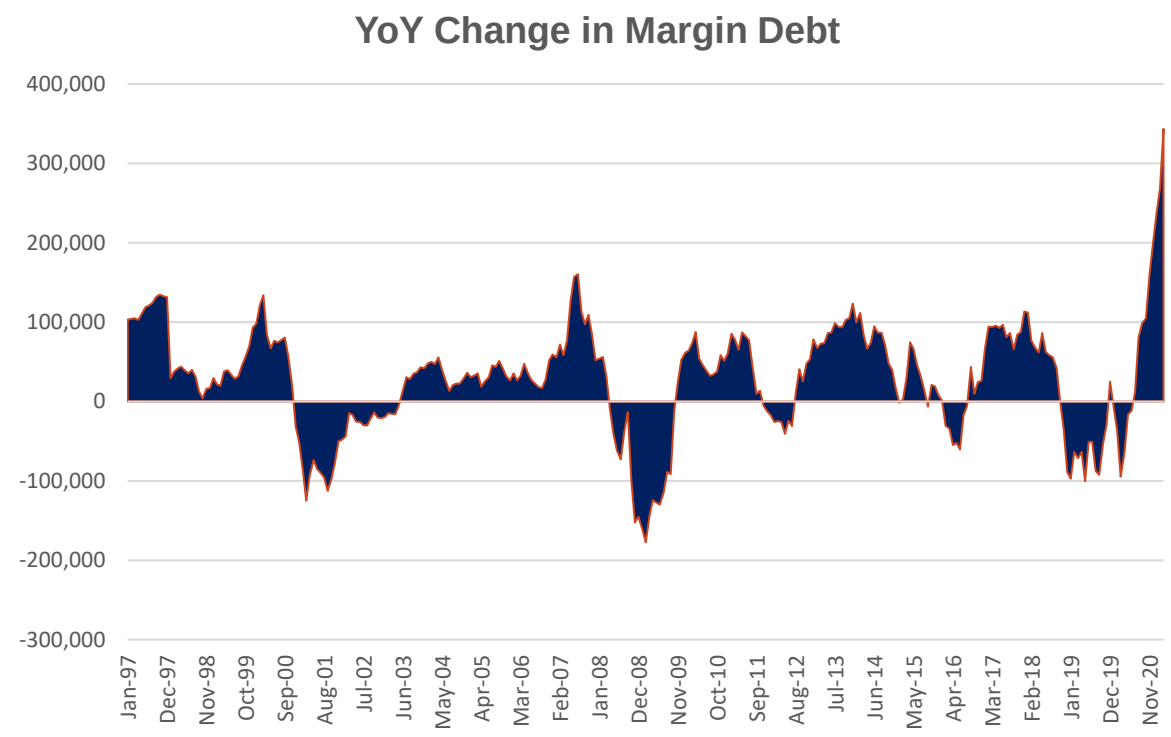
After prolonged periods of excessive risk taking and capital mis-allocation even the slightest tightening in financial conditions can have a substantially negative impact on asset prices. The scale of the fallout is directly related to the extent of the leverage in the system. The size of the more recent market sell-offs be it the taper tantrum of 2013, the 2016 deflation scare, 2018 QT crisis or 2020 Covid crash clearly demonstrates the exponential growth of each market dislocation. Of course the larger the correction the greater the cost to the Fed (and other central banks) of putting Humpty Dumpty back together again. Imagine the impact of a sudden sharp tightening of financial conditions today?

Future performance is directly related to the price one pays for an asset. In a buying frenzy this basic fact is often forgotten. At best, even the most bullish investment bank would find it difficult to project anything but flat returns over any meaningful period looking ahead. By 'at best' we mean the absence of an exogenous hit. In other words markets are priced to perfection. In basic terms the opportunity cost of not playing at the roulette table is now minimal, but the potential losses given recent market behaviour are significant. The maths are pretty simple.

The opportunities waiting around the corner in fixed income are compelling. Higher realised inflation will provide an opportunity in lower bond prices, lower realised inflation in wider credit spreads. As for future policy, implementation of some form of YCC from the Fed can see non-dollar assets outperform. We haven't even mentioned the potential for policy mistakes at the BoJ, PBoC or ECB.

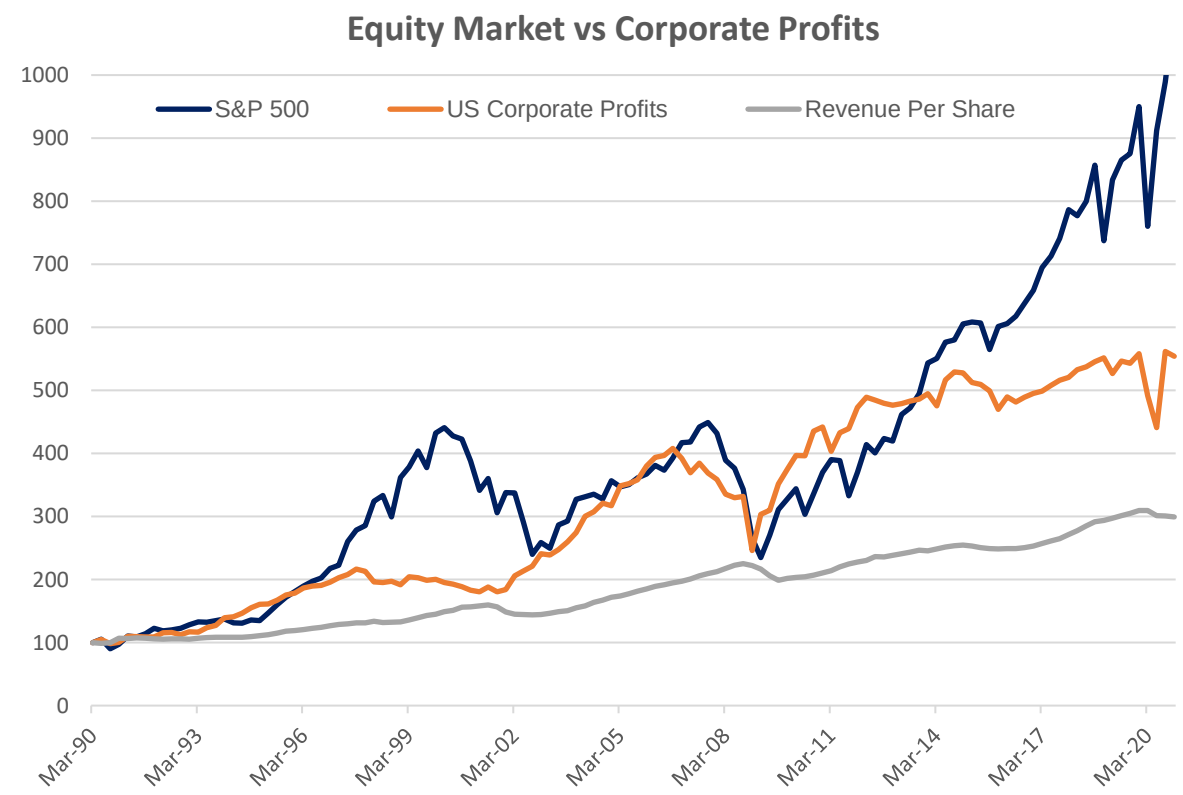
Margin debt at dangerous levels



Source: Finra as at 31/03/2021

With the potential for volatility therefore extremely high, the current upside left in risk assets is negligible. Preserving capital in the meantime will be critical for medium term performance.

Equity market valuations completely detached from underlying profits



Source: Bloomberg as at 31/12/20

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Rubrics Portfolio Outlook

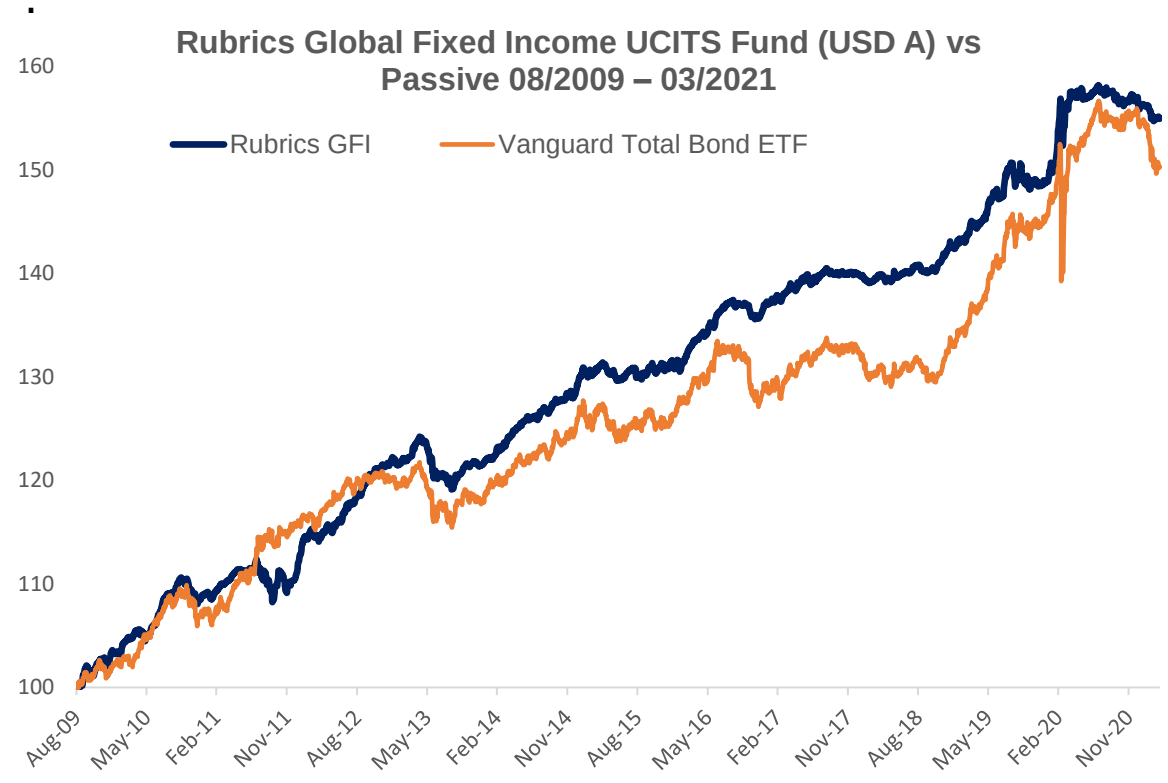
Over the course of managing our funds since 2003 we have faced many difficult periods with 2008 the standout for many reasons. Throughout we have always stood by our process which has ensured our portfolio's limited exposure to risks where we felt the upside outweighed the downside. Our macro analysis has been fundamental to this.

Traditionally we have outperformed in volatile markets and often underperformed in extremely bullish market periods. This has resulted in a well-balanced capital appreciation over the medium term. We have achieved this by the simple idea that extremely elevated markets coincide with non-existent risk premia. Today's elevated markets offer the worst risk/return payoff we have arguably ever seen.

Over the second half of 2021 we will learn a lot about the scarring of covid, the impact of heightened digitalisation on our economies and more importantly the future direction of global policy actions. Our current positioning across the funds, we believe, protects us from a potential inflation scare or even a significant growth disappointment. Much more pertinently it protects us from the coming 'discussion about the discussion' on QE tapering. Our focus in the short term will be to continue to build carry in areas we feel best protects us from the extensive market risks at play, while also leaving us well positioned to outperform the majority of our peers on the downside.

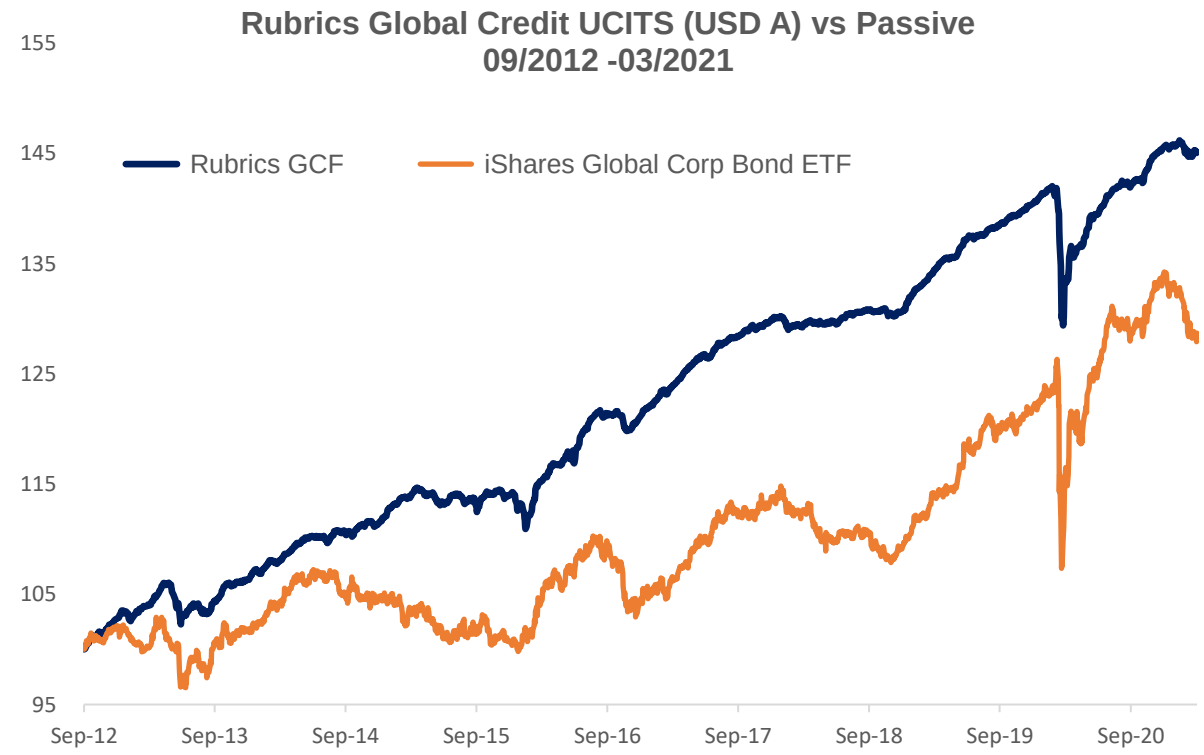
Long Term Performance

Global Fixed Income



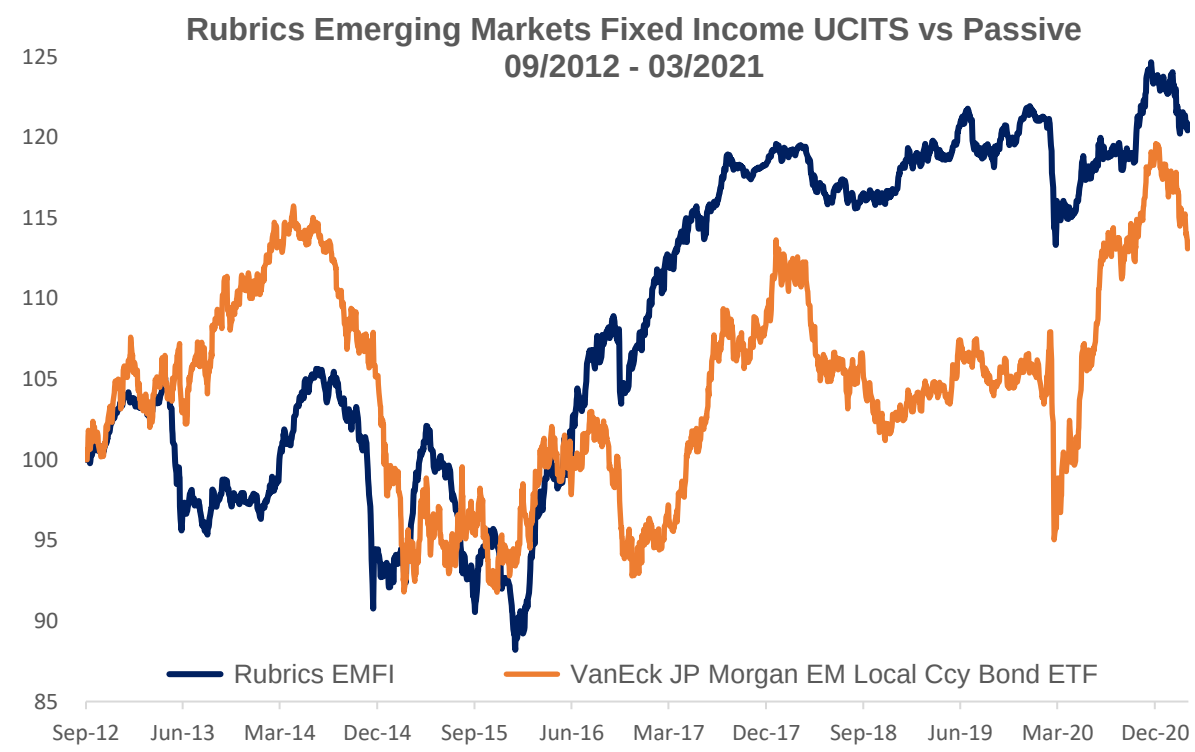
Source: Bloomberg as at 31/03/21.
Chart dates back to beginning of daily NAV availability for Rubrics Global Fixed Income UCITS Fund

Global Credit



Source: Bloomberg as at 31/03/21.
Chart dates back to beginning of daily NAV availability for iShares Global Corp Bond UCITS ETF

Emerging Markets Debt



Source: Bloomberg as at 31/03/21.
Chart dates back to beginning of daily NAV availability for VanEck JPM Local Ccy ETF

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