Northwest Passage Q4 2015 Portfolio Review: "Maozymandias"

I met a traveller from an antique land
Who said: "Two vast and trunkless legs of stone
Stand in the desert. Near them on the sand,
Half sunk, a shattered visage lies, whose frown
And wrinkled lip and sneer of cold command
Tell that its sculptor well those passions read
Which yet survive, stamped on these lifeless things,
The hand that mocked them and the heart that fed.
And on the pedestal these words appear:
`My name is Ozymandias, King of Kings:
Look on my works, ye mighty, and despair!'
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare,
The lone and level sands stretch far away".
"Ozymandias" – Percy Bysshe Shelley (1818)

Q4 and FY 2015 Performance Review

Emerging market bonds rebounded slightly in the fourth quarter of 2015, with the main Northwest Passage portfolio returning +1.17% in Q4 against +0.56% for the Barclays' Investment Grade EM Sovereign + Quasi-Sovereign Index. For the full year 2015, the gross return for the Northwest Passage portfolio was a loss of -1.04%, against a gross return 0f -1.33% for the Barclays benchmark, resulting in cumulative outperformance for the NWP portfolio of +0.29% for the full year.

Negative full year returns for both our portfolio and the Barclays' benchmark reflect a broadly negative backdrop in 2015 for credit products, emerging markets, and commodities. Using Barclays data, US investment grade corporate spreads widened 34 basis points in 2015, while US high yield bond spreads were wider by 177 basis points. The Barclays USD EM aggregate index (including both IG and junk issuers) finished 18 basis points wider in spread, reflecting significant widening in IG sovereigns and corporates (especially Brazil, which transitioned from investment grade to junk during the year), offset by spread tightening in beaten down high yield sovereigns including Russia, Argentina, and Ukraine. The weighted average option-adjusted spread for the Northwest Passage portfolio widened 55 basis points over the course of the year, accounting for a negative spread return for the portfolio of -4.65% during the year.

Slightly higher Treasury yields and a stronger dollar contributed further losses of -0.75% and -0.23% respectively to the full year portfolio performance, offset by a positive +4.59% contribution from portfolio carry and income. On a relative basis, the portfolio outperformed its benchmark by +0.84% on carry and income and + .01% on yield curve movements, partially offset by -0.33% of spread underperformance and -0.23% of currency underperformance.

On a sovereign basis, negative returns in the asset class in 2015 were driven primarily by spread widening in commodity exporting countries, especially in Latin America and Brazil in particular. Asian and Eastern European issuers generally outperformed during the year, with Latin America the primary regional underperformer. On a relative basis, the portfolio suffered the most from its overweight position in the long duration bonds of higher credit quality Latin American countries, including Mexico, Chile, Peru, and Colombia, where a significant steepening in IG sovereign spread curves in the 30 year sector drove underperformance. Conversely, the portfolio gained relative performance from its out of benchmark Russia exposure and from its shorter duration Brazilian risk following Brazil's sovereign downgrade to junk in September 2015.

2016 Outlook

As 2016 begins, the question which hovers over emerging markets, and indeed financial markets the world over, is simply "What's going on in China?" Whether directly invested in China or not, investors begin the year with a sense that the mighty economic engine which has sustained global growth over the past 15 years has begun to sputter, with troubling prospects for a quick or easy repair. The chill wind from China has already blown through global commodity markets, with many industrial, agricultural, and energy products trading at decade lows after dramatic falls in 2015. Recent market developments, including a renewed collapse in Chinese stock prices (after numerous ham-fisted intervention attempts by the government) and further depreciation pressures on the Chinese yuan, have added to a sense of impending crisis in the world's 2nd largest economy.

Investors trying to make sense of China could do worse than to start with a recent news story out of Tongxu County in the Henan province of China, about 500 miles northwest of Shanghai. Located in one of the poorer regions of the new China, Tongxu County recently received a gift from a local businessman and communist party boss: a giant, 120-foot high golden statue of a seated Mao Zedong.[i] The giant concrete statue (shown above) quickly attracted the attention of Internet admirers across China and the world. Unfortunately for fans of the newly-minted mega Mao, gilding the Great Helmsman on such a colossal scale proved to be embarrassing for provincial officials, who ordered the statue demolished almost as soon as it was completed. Evidently Henan party leaders found the statue to be an unseemly extravagance in a poor region, as well as a too visible symbol of local government spending run amok. Jilted Mao admirers in Henan must now soothe their disappointment by travelling 500 miles to south, where they will find an equally impressive 105 foot tall granite sculpture of a younger Mao's head outside Changsha in Hunan province- the latter statue completed in 2007, under a presumably more lenient public spending regime.

The sad tale of Golden Mao- or "Maozymandias" as the poet Percy Bysshe Shelley might have dubbed him - is a perfect illustration of the economic conundrum which China now faces. He is a symbol of the limits of China's unbalanced growth model, in which investment for investment's sake has made the Chinese economy a caricature of John Maynard Keynes' plan to generate employment by hiring one set of workers to fill up the holes just dug by another. In China this activity takes the form of building unoccupied apartment buildings and then tearing them down to build anew; in the construction of vacant shopping malls and famously empty “ghost cities”; in the operation of sparkling new airports and bullet trains with no passengers; and the building of 800 million tons of new steelmaking capacity (more than the rest of the world’s output combined) in just the last 15 years. China saves and invests on a prodigious scale- fixed asset investment at more than 50% of GDP ($3.5 trillion a year and growing) has made China’s building boom over the past decade the largest in history. Economist Vaclav Smil reports that the Chinese economy consumed 50% more concrete in just the three years 2011-2013 (6.6 gigatons) than did the US economy during the entire 20th century (4.5 gigatons).[ii] For every Golden Mao or deserted skyscraper which makes the news in China, there are hundreds more white elephants which don’t.

Leaving aside anecdotes, the macroeconomic evidence for an unsustainable investment bubble in China is strong. In our view, the most persuasive analysis compares the rate of Chinese investment to that of other fast growing Asian economies when they were at a similar stage of development to China today. In a recent paper, David Dollar of the Brookings Institution does just this.[iii] He finds that China’s current rate of investment to GDP (roughly 50%) is almost 20 percentage points of GDP higher than the trend average for Japan, Taiwan, and Korea (roughly 30%) when those economies were at China’s current level of GDP per capita. Indeed, investment rates in Japan, Korea, and Taiwan never exceeded 40% of GDP at any point during their post-war development trajectories. China’s higher rate of investment cannot be justified by higher capital returns, as Dollar also finds that China’s incremental capital output ratio (ICOR) is much higher than the Japan, Korea, and Taiwan peer group average at similar GDP per capita levels. ICOR essentially measures the amount of capital spending necessary to generate an additional dollar of GDP. China currently spends $5 to create $1 of additional economic output, 67% more than the 3-to-1 ratio that was typical for Japan, Korea, and Taiwan during their respective rapid development phases. Simply put, China is spending more, and getting less in terms of incremental economic output, than any emerging economy in history.

No economy can simply build its way to prosperity. Eventually desirable capital deepening turns to overcapacity and then just simply to waste- the building and demolition of so many golden idols. Persistent diversion of resources to unnecessary capital projects comes at the expense of consumers and households, and distorts the financial system in ways which make future economic adjustment difficult or impossible. Recent data suggest that capital efficiency and total factor productivity have fallen significantly in China over the past few years, providing quantitative support to the anecdotal perception that overinvestment is rampant in China. The table below is drawn from a March 2015 review of the Chinese economy by the Organization for Economic Cooperation and Development (OECD).[iv] It estimates recent trends in the macroeconomic drivers of Chinese growth, including capital investment and productivity. Importantly the OECD analysis documents steadily declining returns to capital in China, reflecting large declines in total factor productivity and a rapidly rising ICOR.

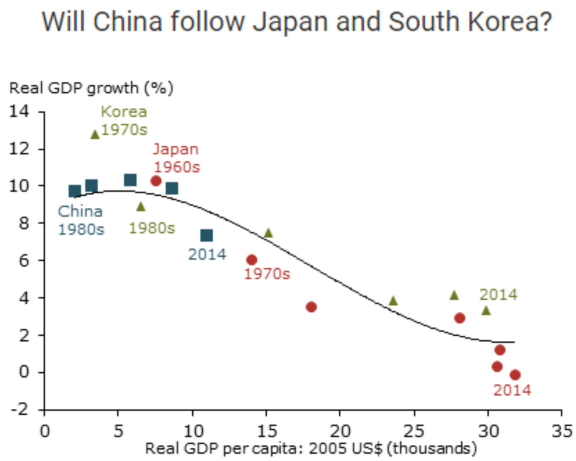
Capital Efficiency is Declining Across China

Source: OECD Economic Surveys – CHINA, March 2015

The evidence suggests that what ails China in 2016 is not a temporary cyclical slowdown, but a deeper reality that the laws of macroeconomics have finally caught up with the Chinese growth miracle. The levers that have traditionally sustained the rapid pace of Chinese growth- more savings, more capital, and more fixed asset investment- simply do not function anymore. China is choking on the excess of its own savings. No matter how many Golden Maos it builds and destroys, the Chinese economy can no longer absorb the vast streams of household and state-owned corporate savings which its institutions have traditionally channeled into capital projects. These flows are less effective at generating growth, and increasingly spill over into the rest of the world in the form of capital flight.

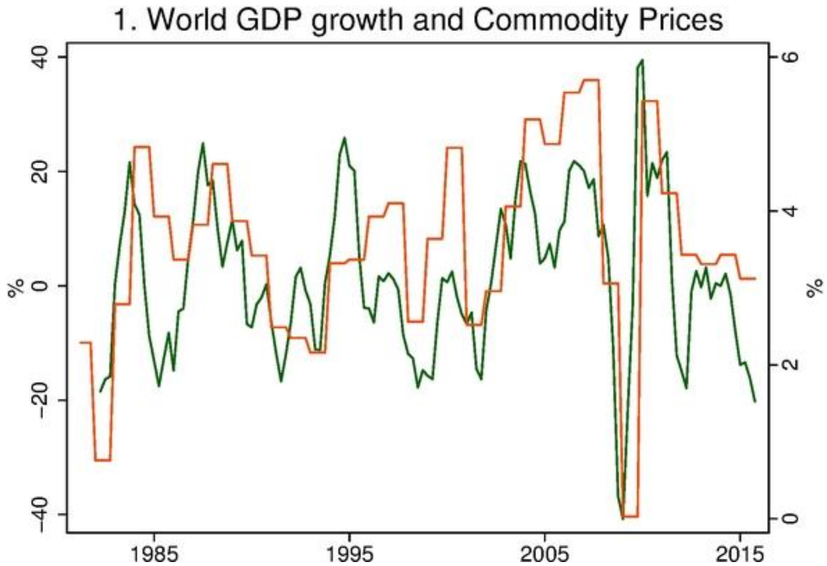
Optimists on the Chinese economy argue that China's unprecedented investment boom can be sustained for many more years because China's aggregate capital stock per head is still far below developed country averages. Pessimists counter that China lacks the proper institutional strength and overall level of development to usefully absorb its savings, and that excess investment tends to be directed into low value sectors (e.g. basic industries, real estate development, construction) which already suffer from large overcapacity. Falling rates of return on capital in China supports the pessimists' position. Diminishing returns to the sectors which have historically led the Chinese economy indicate that deep structural change is necessary to restore China to the high growth rates of the recent past. Most economists advise reforms which will raise household incomes (such as increasing domestic interest rates and distributing more profits from state owned enterprises), increase public spending on consumer facing services such a healthcare and education, and reforming the financial sector so that it directs more credit to employment generating service industries and private small businesses. Unfortunately, deeply entrenched interests in China strongly oppose such reforms. SOEs will not easily agree to paying higher taxes or dividends to the

Chinese government where profits exist; banks will resist reducing the flow of credit to SOEs particular if doing so will result in bad loans and credit losses. As such, China's transition to a consumption led economy is unlikely to be as smooth or painless as optimists hope. If the experience of prior Asian Tigers is a guide, it is probable China will face a prolonged period in which the growth in consumption/service sectors is too slow to offset the contraction in investment sectors, resulting in an overall decline in the country's potential growth rate and allowing for occasional lapses into outright recession. In following such a trajectory, China would mirror the similar experience of Japan and Korea, which both saw sharp decelerations in their growth performance following sustained high investment periods (see chart from San Francisco Fed research below). Given the higher observed peak in China's investment rate versus preceding booms, we think it is reasonable to speculate that China's "bust" during the investment transition will be deeper than for Korea or Japan.



Source: Zheng Liu, Federal Reserve Bank of San Francisco, Economic Letter August 10, 2015[v]

The impact of the Chinese transition – and the accompanying downshift in Chinese growth rate – has far reaching consequences for every economy outside of China. Investors quite naturally extrapolate the risks of the Chinese transition to other emerging markets, but we think they underestimate the risks that China poses to other developed markets and especially the United States. The nature of the Chinese slowdown has particular bearing on the question of secular stagnation- is the world caught in a permanently slow growth (and thus deflationary) rut, or will cyclical headwinds in China, Europe and the US soon clear away, permitting a return to pre-2008 trend growth and "normal" interest rates? Ignoring the warnings of Larry Summers and others, monetary authorities in the US ended 2015 by choosing to bet against secular stagnation, looking through the epochal collapse in global commodities as a merely transitory factor. In a world where China by itself was responsible for 50% of all global GDP growth over the past decade, we find this to be a dangerously cavalier attitude on the part of the Federal Reserve. The Fed is making a bet that "this time is different"- as shown in the chart below, significant declines in global commodity prices are strongly associated with global recessions.



Source: Bob Barbera, Johns Hopkins Center for Financial Economics, using data from CRB and the IMF[vi]

Optimists on the US economy- evidently including the FOMC- think that the US can decouple from developments in China and emerging markets. Yet the 20% decline in the broad CRB commodity index in 2015 (a selloff extending into 2016) is the worst decline in global commodity prices since 1980 (outside of the crisis period 2008-2009). It would be a significant departure from past correlations to experience such a sharp contraction in the commodities sector without a global recession- especially in a world which has become so reliant upon China and emerging markets for growth.

Decoupling advocates cite the comparatively small direct exposure of the US economy to China trade as a reason not worry. Direct exports to China are less than 2% of US GDP, and exports of all kinds are less than 10% of US output. We think such comparisons significantly understate the US economy's real reliance on China however. Large amounts of domestic economic activity indirectly depend on Chinese growth conditions. In particular, domestic capital spending in the US energy, mining, and resources sectors has exceeded $300 billion since 2008-2009, mainly on the strength of high global commodity prices sustained by Chinese demand. A major portion of the rebound in US manufacturing activity since 2008 has in turn gone to support this capital investment boom, from drill pipe in the shale industry to machinery and auto sales to the mining and agricultural sectors. Chinese and emerging market demand have also sustained high corporate profit margins for many US based multinationals who operate abroad. It is clear that weakness in China and EM has already had a disproportionate effect on US industrial production despite the assurances of the decoupling crowd. US industrial production fell almost 2% in 2015 in real terms, driven by broad-based weakness in energy, mining, utilities, and capital goods manufacturing. Industrial production declines of this magnitude have ***never*** occurred in the US outside of a recession since 1960. We note also that nominal US exports have declined 7% from their 2014 peak- declines in export values of greater than 3% have typically only occurred during recessions in postwar US economic history.

We believe the rest of the US economy cannot ignore the recessionary conditions in the industrial sector for much longer. We expect that lagging indicators such as employment and corporate profits will eventually start to reflect the weakness already apparent in cyclically sensitive manufacturing indicators.

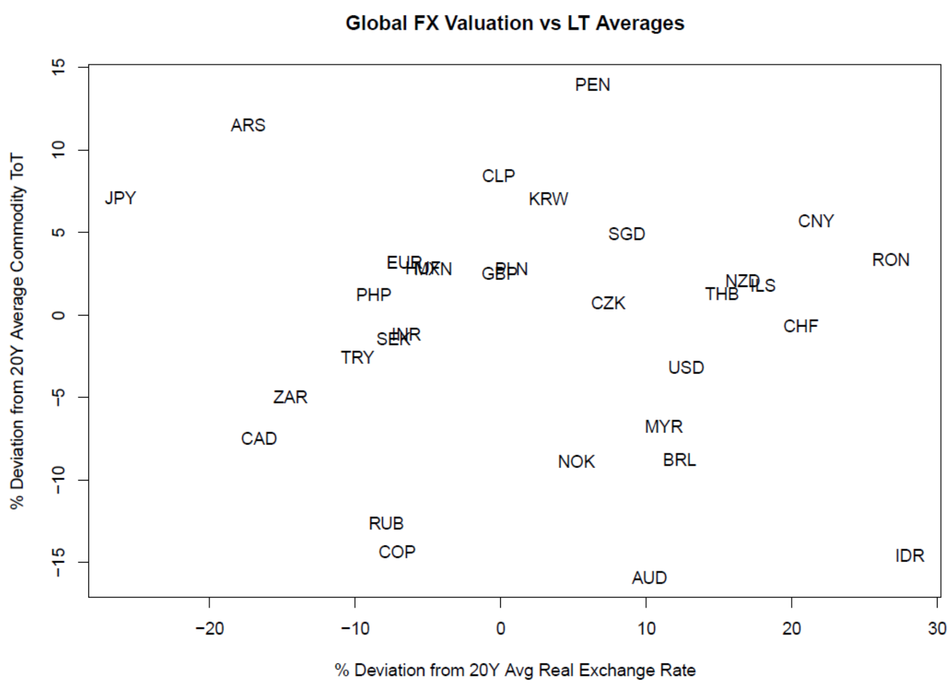
At minimum, we think US growth is likely to disappoint again in 2016, with real GDP growing well under 2.0%. We speculate that a mild capital spending-driven recession is possible in 2016, along the lines of the 2001 capex-driven "tech wreck" recession. However, even a mild US recession could provoke dramatic dislocations in the US fixed income market, as we think the Fed will be forced to abandon its attempt to raise US interest rates. A market retreat from the US divergence trade could result in substantially lower Treasury yields, a weaker dollar, and further turbulence in equities beyond the 8% decline in the S&P 500 through the first two weeks of 2016.

Oddly enough, we think the upheavals in the Chinese economy will have fairly limited direct consequences for our asset class (external sovereign and quasi-sovereign debt) within China itself. China has indeed reached a moment of economic crisis; however, its difficulties have far more in common with Japan in 1990 than with the more traditional EM balance of payment crises in Latin America in the 1980s, Mexico in 1994, Asia in 1997, Russia in 1998, Argentina in 2002, and Greece in 2012. China remains an enormous net creditor (more than $4 trillion in net international investment position) to the rest of the world. As was the case for Japan during that country's lost decades, China's high savings rate and large foreign savings mean that China does not require foreign capital, and has the capability to self-fund bank recapitalizations and corporate bailouts as they become necessary. We expect that significant financial distress will emerge among 2nd and 3rd tier state-owned enterprises in China, particularly in overdeveloped industries like steel and cement. However, we believe the Chinese state will use its considerable resources to insulate systemically important "national champions" from default, including the Big Four Chinese state banks and major state owned conglomerates such as Sinopec, Sinochem, CNOOC, China Overseas Shipping and even Baosteel. As in Japan after 1990, we think the painful process of China's adjustment will primarily occur through persistently low growth and economic sclerosis rather than disorderly financial collapse. Consequently, we think the dollar bonds of systemically important Chinese firms offer value at current and wider credit spreads.

Elsewhere within EM, the end of the Chinese investment boom has clear negative consequences for commodity exporters, which benefited not only directly from favorable terms of trade shocks and rising exports to China, but from significant capital spending "echo booms" in the agricultural, mining and energy sectors. It is the collapse of these echo booms, far afield from China, which currently account for the malaise in Brazil and Russia and many smaller EM economies. The negative demand shock from commodities and declining capital spending has in turn triggered secondary negative shocks from fiscal policy, monetary policy, and tightening domestic financial conditions. Many EM governments collect a significant portion of their revenues from direct commodity sales or royalties, or from taxes on major commodity firms who dominate the domestic formal sector. As tax collections have fallen, EM governments have been forced to curtail spending, putting further downward pressure on growth. Similarly, capital flight from emerging countries has acted to contract domestic money supplies, while higher inflation from exchange rate depreciation has prevented EM central banks from easing monetary policy in response.

The recent experience of Brazil illustrates the general problem of bursting of EM echo booms in microcosm. We think that Brazil's present economic difficulties are at this point well understood (and indeed, over-discounted) by financial markets. What is less well understood is how Brazil got there. The main contributor to Brazil's current recession is a spectacular collapse in capital spending: after averaging almost 10% per year in the 6 years ended 2012, the rate of real gross capital formation in Brazil fell to annual *contraction* of -15% per year at the end of 2015. This amounts to a swing from adding +2% per year to Brazil's aggregate GDP growth to subtracting -3% per year, in a sector which generally accounts for less than 20% of total GDP. While household consumption has also fallen dramatically in Brazil (from an average real growth rate of about +5% in the 6 years ended 2012 to -4% in 2015), the magnitude of the deceleration in consumption is roughly one third of the decline in capital spending.

There are silver linings- or perhaps "green shoots" of growth – to be seen among the wreckage of the EM echo booms however. At least, there is reason to believe that the worst of the necessary post China boom adjustment is already behind countries like Brazil, Russia, Indonesia, Chile and South Africa. Once positive factor is that outside of Russia and the Middle East, most EM countries are either net oil importers, or like Mexico or Malaysia, receive comparatively small oil export rents relative to the size of their economies. Cheaper energy prices provide a countervailing stimulus to consumers, and in countries like Brazil or Indonesia which have historically subsidized energy prices, reduce the fiscal burden of such subsidies. Secondly, currency depreciation across emerging markets has been fast and deep in 2015, with real exchange rates catching up to and in many cases exceeding the long term decline in the terms of trade (see scatterplot below). Our analysis of long term trends in both real exchange rates and relative commodity terms of trade suggests that many EM currencies (including the Mexican Peso, South African Rand, Turkish Lira, Korean Won, and Chilean Peso) have moved back into fairly valued territory. Although further near term weakness in EM currencies is likely in our view, we think the majority of the damage has been done versus the US Dollar (itself now considerably overvalued).



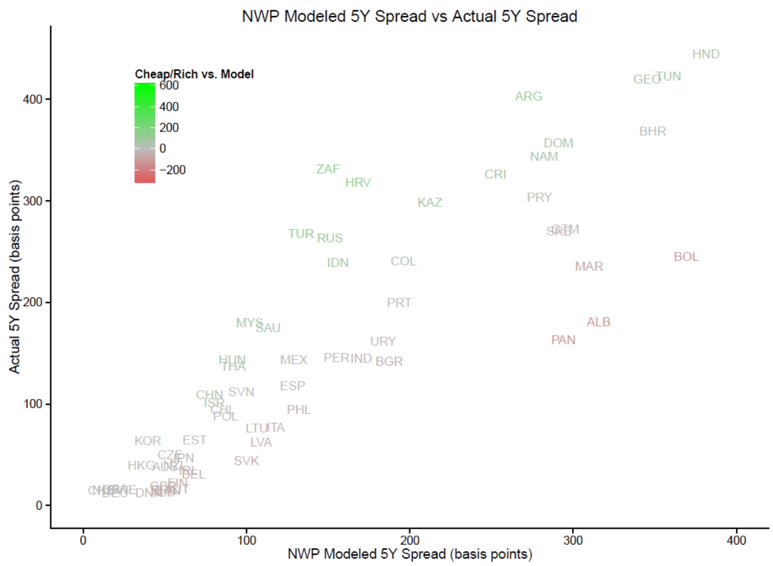
Source: Northwest Passage, with data from JP Morgan and Citibank

One important consequence of EM exchange rate depreciation (and the collapse of associated domestic credit booms) is that EM external balances have begun to improve dramatically. Although the value of EM commodity exports has fallen with prices, EM import demand has fallen even more due to domestic economic weakness.   The rapidly growing ranks of bears on the Brazilian economy have overlooked the fact that Brazil's trade balance has rapidly reversed from deficit into surplus, providing a positive offset to the steep contractions in in investment and consumption spending.

What does the reality of permanently slower growth in China mean for emerging market assets, particularly the hard hit commodity exporters who have contracted economic pneumonia from China's common cold?   We think that our asset class, hard currency sovereign and quasi-sovereign external debt, is the best house in what is currently a bad EM neighborhood. As emerging markets work through the hangover of past capital booms and EM consumers adjust their spending aspirations lower, we expect a continued period of negative to slow GDP growth in non-China EMs over the next 1 to 2 years.   We consequently expect earnings performance to remain poor in emerging equity markets, and for negative pressures on exchange rates to persist, although reduced from 2015 levels.   We think it is therefore unlikely that a sharp rebound in either EM equities or local currency bond markets will occur in 2016.

On the external credit front, we are more constructive. As we highlighted in our last quarterly letter, EM sovereigns have spent much of the past decade building impressive fiscal and external buffers. Despite weaker near term economic performance, these buffers still exist, and will take many years to dissipate. By developed country standards, sovereign debt levels remain low across emerging markets. External sovereign debt levels are lower still, with most countries carrying foreign currency sovereign liabilities well below 20% of GDP. Even accounting for larger stocks of private external debt, virtually every country in our coverage universe holds foreign exchange reserves which exceed the total stock of short term foreign currency debt, public and private, in the economy.   Given the rapid improvement in current account balances occurring in many EM countries, these external currency buffers are likely to grow in size, as has been the case in Russia despite a 70% decline in oil prices. We remain confident in our view that sovereign default remains a remote prospect for most countries in the EM universe, with Venezuela being the notable exception.

We think that EM sovereign spreads have mostly overreacted to the recent deterioration in the emerging economic outlook, and that most emerging sovereign spreads currently trade well wide of expected levels when compared to developed market sovereigns with similar or worse quantitative risk factors.   Perhaps the best country level example of this is the recent sell-off in Saudi Arabian quasi-sovereign bonds and CDS. Following the decline in oil prices, Saudi 5Y sovereign credit risk has increased considerably, and now trades wide of 5Y Portugal sovereign risk. Declining oil prices aside, we think Saudi Arabia's credit profile (zero sovereign debt and net foreign assets exceeding $700 billion) compares favorably with Portugal (sovereign debt of more than 120% of GDP, and a negative international investment position of minus $240 billion). Even if we assume oil prices remain at $30 for the foreseeable future, it would take Saudi Arabia almost a decade of running budget deficits of $100 billion a year to match Portugal's aggregate level of sovereign and external indebtedness today. The sharp decline in global energy prices poses significant challenges to Saudi Arabia's oil export focused economy; but it is a bridge too far to believe that the Kingdom faces any near term sovereign credit stress. More than most other EM countries, Saudi Arabia has enormous financial shock absorbers from its accumulated foreign savings which will allow it to adjust gradually to lower commodity prices.

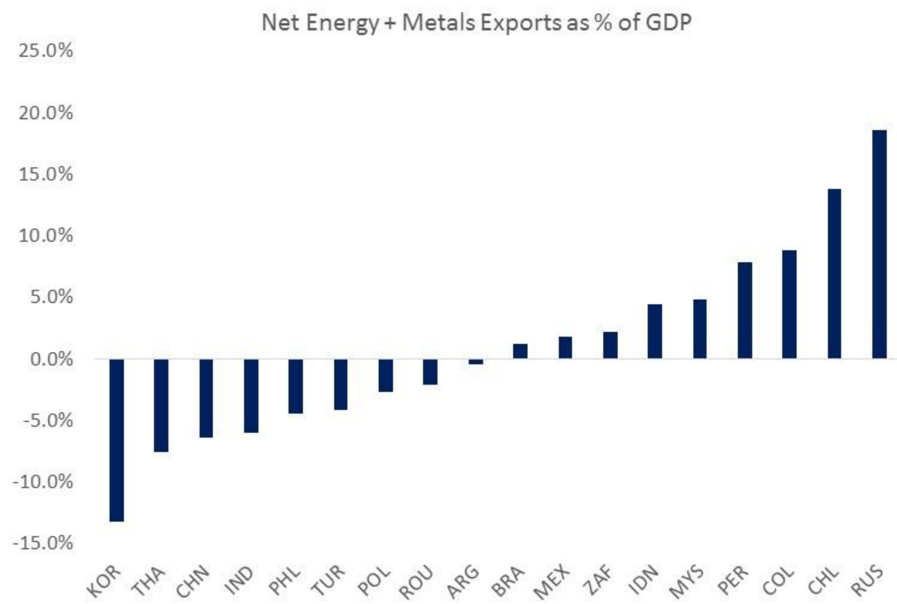


Source: Northwest Passage

As has been the case since the 2013 taper tantrum, EM investment grade spreads continue to trade at comparatively wide levels versus US investment grade corporates, offering approximately 100 basis points of incremental spread according to investment grade indices compiled by Barclays. Given the extreme weakness in the US high yield market and negative global equity returns which have characterized the start to 2016, we would not be surprised to see the EM premium widen further in the investment grade space, although we would attribute any such widening primarily to global liquidity and risk aversion factors rather than any real increase in relative default risk.

Source: Northwest Passage, with data from Barclays

In view of the hybrid nature of emerging market credit, falling somewhere between US IG corporates and US high yield in its risk characteristics, we do not have high hopes that EM credit returns can improve until US junk bonds find a footing. Stability in the US junk bond market, in turn, seems to require that oil and commodities find a bottom. Near term, we see the most value in emerging market credit in those countries which are neutral to net importers of the commodities- especially metals, coal, and energy- which have fueled the dying Chinese investment boom. While prices of these commodities may soon stop falling, we think they are unlikely to rebound towards anything close to prior highs for the foreseeable future. Cheaper energy is ultimately a blessing for net energy importers and will work to stimulate their economic performance. The chart below sorts major EM countries in our universe by their combined net exports of energy (oil, coal, and natural gas) and industrial metals (iron ore, copper, and precious metals). The table indicates that the big EM winners from the global commodity bust are, ironically, China itself plus other oil importing Asian economies including Korea, Thailand, India, and the Philippines. Outside of Asia, eastern European credits including Turkey, Poland, and Romania are beneficiaries of the commodity bust.



Source: Northwest Passage, with data from The Economist and UNCTAD

Elsewhere in EM, particularly in Latin America, we think that markets tend to overestimate the economic exposure of many economies to commodity exports. We note that net metals and energy exports are below 2% of GDP in Brazil, Mexico, and South Africa- the bust will hurt in these countries (primarily through a drop in mining and energy related capital expenditure) , but otherwise the terms of trade shock will have a limited overall impact on the economy going forward. Indonesia and Malaysia are somewhat more exposed in Asia, with net energy + metals exports at roughly 5% of GDP. The bust will be painful in Peru, Colombia, and Chile, where net metals + energy exports approach or exceed 10% of GDP, and will trigger deep recessions in petrostates including Russia, Saudi Arabia, Kuwait, and the UAE, where energy exports exceed 20% of GDP and approach 45% in many cases. Despite looming economic hardships, the major oil exporters are generally well prepared for the coming slump, with large amounts of foreign reserves and generally low (Russia) or non-existent (Saudi Arabia and other Gulf Countries) stocks of sovereign debt. The notable exception among OPEC countries is Venezuela, whose oil dependent state faces $30 crude oil with depleted FX reserves, 200%+ inflation, the economy in a shambles, and a completely hopeless fiscal position. We believe the recent further slump in global oil prices makes a sovereign default by Venezuela exceptionally likely in 2016.

Outside of Venezuela, however, we believe the bulk of emerging market credits will prove resilient to the Chinese slump and global commodity collapse. We believe markets have already priced a significant amount of bad news for virtually every country in our universe, while neglecting the significant adjustments in trade balances, exchange rates, and capital spending budgets that have already occurred. While we certainly don't expect EM countries to boom in 2016, we think economic news for many countries could begin to surprise positively during the second half of the year, if only because expectations have become so negative. We expect markets to continue favoring the net commodity importers in Asia and Eastern Europe in early part of the year, but think some of the harder hit commodity sensitive names could rally later in the year as markets accept that fiscal and external buffers will keep sovereign default risks remote. We see particular value in quasi-sovereign issuers in highly rated countries such as Chile and Saudi Arabia, where the comparative export concentration of the national economy has caused investors to overlook exceptionally strong sovereign balance sheets.

As disappointing returns for the asset class have demonstrated, emerging markets credit was an uncomfortable home for fixed income investors in 2015 amid worries over a wobbly Chinese economy, collapsing commodity prices, and rocketing high yield bond spreads. 2015 was a reminder to investors that the risk premium in the asset class exists, after all, to reflect risks. We think 2016 will likewise show that investors cannot hide out from global risks by staying home in US markets. China and its smaller siblings in the emerging markets have grown too big to be safely ignored by US and developed market investors. We think it is the US economy, above all, which carries the greatest unpriced risk from the structural changes in China. With significant portions of the US industrial economy already in a contraction phase (energy, mining, utilities, and capital equipment), we think US markets start the year underpricing recession risk, and that 2016 could see a dramatic reversal in consensus expectations for both Fed policy and higher interest rates. As fixed income investors accept that "we're all in this together," we expect to see the combination of persistently low yields in US investment grade bonds and the outstanding relative value in emerging market bonds once again push US investors out the risk curve in a renewed search for higher returns.

Best Regards,

The Northwest Passage Investment Team

Jeff / Will / Michael /Rocio

Disclosures:

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