Q2 2016: Winter is Coming:

Interest Rates and the Heat Death of the Universe

The Second Quarter (Q2) of 2016 proved to be another positive quarter for emerging markets (EM) fixed income, with the JP Morgan Emerging Market Bond Index Global Index (EMBIG) returning 5.40% during Q2, and the Barclays Emerging Market USD Investment Grade Aggregate Index returning 3.62% over the same period. Strong performance over the quarter brought the EMBIG's year-to-date total return to 10.90% and the Barclays EM USD Investment Grade Aggregate Index to an 8.23% total return for the same period. We are pleased to report that Northwest Passage's EM Sovereign Debt Portfolio (Portfolio) fully participated in this continuing bull market for EM bonds during Q2, with a gross of fees return of 4.13% (4.02% net of fees) during the quarter. On a year-to-date basis, the Portfolio has returned gross of fees 10.98% (10.77% net of fees) through June 30, 2016. Relative performance continues to be strong, with the Portfolio outperforming its Benchmark, the Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Index (Benchmark), by 2.54% since the start of the year.

The positive return performance for the Portfolio and emerging market fixed income, in general, has occurred against a very favorable backdrop for all fixed income assets globally. Indeed, using Barclay's index data, we note that US investment grade corporates have returned 7.68%, US high yield has returned 9.06%, and US Treasuries have returned 5.37%, year-to-date. Long duration US Treasuries (despite their universally reviled status by observers decrying yields which are "too low") have returned an astounding 15.12% over the past six months, beating most other fixed income categories and more than quadrupling the year-to-date total return of the S&P 500 equity index. Like most investors in 2016, we have been surprised by the strength in global fixed income markets through the first half of the year, and by the relentless strength of the bond rally in the face of indications of rising inflationary risk.

From an emerging markets credit standpoint, we note that in Q2, returns were primarily driven by duration and the continued fall in Treasury rates; this is in marked contrast to Q1, where compression in both EM sovereign and corporate spreads were a key driver of returns. The latest leg of the EM rally has thus been more of a global macroeconomic story rather than one focused on the idiosyncrasies of emerging markets. The average option adjusted spread for the Portfolio's Benchmark compressed just 11 basis points during the quarter, leaving the bulk of returns to be driven by the surprising fall in Treasury rates during the quarter. On a year-to-date basis, outperformance in the Portfolio was primarily driven by spread compression. The bulk of relative spread performance came from overweight positions in Latin American countries including Brazil, Mexico, and Chile, as well as strong relative performance from overweight positions in other commodity exporters including Saudi Arabia, South Africa, Russia, and Malaysia. Brazil and Chile have been the two most significant positive sovereign credit drivers for the portfolio; there have been essentially no negative credit drivers at the country level given the strong overall performance environment for the asset class.

Though only July, falling yields put us in the mind of falling temperatures—a reminder that "winter is coming" for the global economy. But instead of the fictional Ned Stark from *Game of Thrones*, we think of the very real scientist William Thompson, later known as the 1st Baron Kelvin. Lord Kelvin is remembered today primarily for his contributions to the theory of thermodynamics. Lord Kelvin was the first to calculate precisely the value of absolute zero, the lowest possible limit on temperature at which all molecular or atomic oscillations cease in an ideal gas. As an extension of his pioneering work in thermodynamics, Lord Kelvin proposed the gloomy notion of the "Heat Death of the Universe," a possible future in which all mechanical energy is dissipated, leading to a uniform distribution of heat, exhaustion all of potential energy, and the cessation of the possibility for useful work. In Kelvin's view, the world will thus end in ice rather than fire, with a "state of universal rest and death" awaiting all of existence at the end of time. Surely a contemporary observer of interest rates must be reminded of Lord Kelvin's prophecy of universal heat death, as US Treasury yields plumb historic lows on a daily basis and nominal interest rates around the world—from Japan to Switzerland to Germany and beyond—slide to zero and below. With more than $10 trillion in global government bonds already yielding below zero, and the $15 trillion US Treasury market threatening to follow suit, one wonders if we are witnessing a kind of financial heat death of the universe, a state where all term and risk premiums are extinguished and financial intermediation as the world has known it becomes impossible.

More recent commentators, among them economists Larry Summers and Robert Gordon, see in low interest rates evidence for a more fundamental "secular stagnation" of the global economy. Gordon's view is the most pessimistic. Gordon argues that steady economic growth is neither inevitable or common in the historical record. The recent disappointing growth performance of the developed economies is a reversion to a norm of narrow and incremental technological progress which has been typical of human civilization for thousands of years.[1] Summers takes a more Keynesian tack, rooting his diagnosis of secular stagnation in structural changes, including demographics, technology, and wealth inequality, which lead to a global failure of aggregate demand versus the aggregate desire for savings. [2] In such a world, US 10-year Treasury yields, even at 1.50%, continue to look exceptionally attractive against 10-year Japanese government bond yields of -0.25%.

If the "yield desert" in which bond investors find themselves persists, where should fixed income buyers turn? In the search for higher real interest rates than those which are likely to prevail in the developed economies, one might usefully turn the secular stagnation hypothesis of Summers, Gordon, and others on its head to ask: "What do countries that can support high real and nominal interest rates look like?" By inverting the secular stagnation argument, high interest rate countries would in general have:

- Younger populations
- Lower technological sophistication (allowing faster productivity growth as technology improves)
- Lower capital stocks per capita (permitting faster growth through capital deepening)
- Low levels of income and wealth inequality
- High levels of investment relative to savings
- High levels of GDP growth
- Low levels of household debt

The countries which most closely resemble this high real rate profile are precisely those developing countries which investors label "emerging markets." Beginning about 15 years ago in the early 2000s, emerging economies opened up an annual real growth advantage of 3% or more over the developed world.[3] This growth gap favoring emerging markets has persisted over the past decade, through the global financial crisis of 2008-2009, and looks to be widening again given the low rates of post-crisis GDP growth in the major advanced economies. Thus, secular stagnation, if it is indeed a correct diagnosis of the global economy, is primarily a disease of the rich countries. The good news, for developed country bond investors, is that emerging market bonds could offer a partial solution to the quandary of persistently low developed country interest rates.

The past several years, beginning with the crisis years of 2008-2009, have been a period of continuous stress for emerging market sovereigns. In our view, the asset class has, for the most part, passed the test and proved far more resilient than its critics would have expected. Despite all of this drama, only one EM sovereign (Ukraine) has so far defaulted on its debts in a way that impaired creditor claims. Even the weakest EM credits—like Venezuela—have thus far weathered a series of economic and political storms with more resilience and stability than typical of the asset class in prior cycles.

Crises come and go in emerging markets, but attractive long-term performance has been a consistent reality since the beginning of the last decade. Investors in EM external debt who have kept faith with the asset class have been rewarded for their commitment over the past three years, with broad EM bond indices outperforming both US corporate and high yield indices over this period. Even after this run of outperformance, EM bonds continue to offer an attractive spread premium to US corporates, particularly in the investment grade space. With a long and cold winter looming on the horizon for traditional fixed income returns, we think recent experience demonstrates that the greatest risk associated with investing in emerging markets is to not invest in them at all.

Indices:
The **Barclays Emerging Markets USD Aggregate Index** is a flagship hard currency Emergency Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classification. The index was previously called Barclays US EM Index, and history is available back to 1993.

The **Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Index** tracks fixed and floating-rate US dollar-denominated debt issued by sovereign and quasi-sovereign EM issuers. Corporate issues are not eligible. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications. The EM USD Sovereign + Quasi-Sovereign Index is a subset of the flagship EM USD Aggregate Index. Country capped versions of this index are also available. Historical index returns are available from January 1, 2003.

The **Barclays US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate eligible securities also contribute to the multi-currency Global Aggregate Index and the US Universal Index, which includes high yield and emerging markets debt. The US Aggregate Index was created in 1986 with history backfilled to January 1, 1976. The **Barclays US Aggregate Corporate Bond Index** and the **Barclays US Aggregate Long Treasury Index** are subindices of this index.

J.P. Morgan Emerging Market Bond Index Global Index tracks the total return for the U.S. dollar-denominated emerging markets debt, including Brady bonds, Eurobonds and loans. It does not include fees or expenses.
The **S&P 500** is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets compromising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

[1] Gordon, Robert. "Secular Stagnation: A Supply-Side View", American Economic Review vol105, no5 (May 2015): pp 54-59. https://www.aeaweb.org/articles?id=10.1257/aer.p20151102.
[2] Summers, Lawrence H. "Larry Summers: The Fed Is Making the Same Mistakes over and over Again." Washington Post. June 14, 2016. https://www.washingtonpost.com/news/wonk/wp/2016/06/14/larry-summers-the-fed-is-making-the-same-mistakes-over-and-over-again/.
[3] International Monetary Fund, *World Economic Outlook* (April 2016)