Q3 2016 Portfolio Review & Outlook

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NORTHWEST PASSAGE
CAPITAL ADVISORS

Q3 2016 Portfolio Review & Outlook: EM Sovereign Debt Portfolio

William C. Slaughter
wcs@nwpcapital.com
414.755.0461 ext. 103

172 N. Broadway, Suite 300
Milwaukee, WI 53202

Summary:

- In Q3, the EM Sovereign Debt Portfolio returned 1.73% v. 1.79% benchmark return. YTD, the portfolio has returned 12.89% v. the benchmark's 10.39%.
- Q3 returns were primarily driven by spread tightening rather than falling interest rates.
- Strategically, we continued reducing portfolio duration and upgrade credit quality.
- The corporate and EM credit rally has occurred in the face of a significant widening in short end funding spreads.
- Going forward, expect the momentum in emerging market bonds to slow considerably.

Q3 Review

The Northwest Passage Capital Advisors' EM Sovereign Debt Portfolio returned 1.73% in Q3 2016, against a 1.79% return for its benchmark, the Barclays EM USD Sovereign + Quasi-Sovereign Bond Index. On a year to date basis, the EM Sovereign Debt Portfolio has returned 12.89% through September 30, against 10.39% for the benchmark over the same period. The strategy's relative excess return is thus -.06% for Q3 and 2.50% for all of 2016 through September 30.

Returns for both the EM Sovereign Debt Portfolio and emerging market fixed income as a whole were positive for the third consecutive quarter, reflecting a supportive backdrop for fixed income assets in general and emerging market (EM) assets in particular. The Barclays US Aggregate Bond Index returned 0.46% during the quarter, with its IG Corporate subcomponent returning 1.41%. US junk bonds returned 5.55% during Q3 (according to Barclays data), while the JP Morgan Emerging Markets Bond Index (EMBI) rose 3.73%.

In contrast to the first half of 2016, fixed income returns during Q3 were primarily driven by spread tightening rather than a fall in general interest rates. IG corporates outperformed Treasuries by the largest margin in three years during Q3 (with IG corporate spreads tighter by 18 basis points), while high yield corporates outperformed IG corporates by a remarkable 4.14% (representing a junk spread tightening of 114 basis points). In fact, Q3 2016 marked the best overall performance in spread terms for US corporate fixed income credit since the first quarter of 2012. This strong credit performance is especially remarkable given the lackluster equity returns observed during Q3, which is a marked contrast to prior credit bull markets in which equities have taken the lead for risk assets.

Emerging market bonds fully participated in the rally for credit assets, with spreads tightening 29 basis points (bps) during the quarter for our portfolio, 32 bps for the benchmark, and an impressive 47 bps for the JP Morgan EMBI (a hybrid credit benchmark which is split evenly between IG and junk-rated issuers). As was the case for US corporates during the quarter, junk-rated issuers led the way in EM during Q3, with the Barclays Emerging Markets High Yield Index returning 5.43% for the quarter driven by an aggregate spread tightening of 94 bps. The lowest rated, most speculative credits delivered the best returns during Q3, as demonstrated by CCCrated Venezuela, whose dollar bonds returned 26% just during Q3 and are up an impressive 49.4% year to date. Other top performing EM credits during Q3 included Brazil (dollar bonds up 26% year to date), South Africa, Hungary, Indonesia, and Malaysia.

The EM Sovereign Debt Portfolio trailed its benchmark by 6 bps during Q3, reflecting our strategy, after strong outperformance in the first half of the year, to reduce our more aggressive duration and credit positioning versus the benchmark during Q3. Over the course of the quarter, we used purchases and sales to continue reducing portfolio duration and upgrade credit quality. As a result, we ended Q3 with a modified duration of 6.56 years, 0.18 years shorter than the benchmark duration of 6.74. The average portfolio option adjusted spread ended Q3 at 215 basis points versus 187 bps, the narrowest relative spread premium we have run in more than two years. In terms of factor attribution, our duration underweight added +4 basis points of relative outperformance, carry income added +6 bps, credit positioning subtracted -10 bps, and currency exposure (primarily a small Mexican peso position) subtracted -6 bps. Despite a continued overall decline in credit spreads, our portfolio trailed the benchmark slightly in credit performance during Q3 due primarily to our overweight position in Mexico and our underweight position in China. Mexico has underperformed other Latin American credits in recent months due to (in our view misplaced) concerns over the outcome of the US presidential election, while China has outperformed other A-rated EM sovereigns on improved economic data. Notably, Turkey had a very limited impact on our portfolio despite the fallout from a failed coup attempt in July and the subsequent sovereign downgrade to junk status by Moody's in September. Our Turkish positions subtracted -12 bps of absolute return during Q3, exactly in line with the benchmark, and so had no effect on a relative return basis versus the benchmark for the period.

Outlook

The tremendous rally in EM sovereign credit over the course of 2016 has been supported by significant new money inflows into the asset class and to credit products in general. These flows continued apace in Q3, with the shares outstanding of the most widely traded emerging market bond ETF (the iShares EMB) rising by more than 30% between June 30 and September 30. Flows into EM credit products have been mirrored by equally dramatic inflows into investment grade and junk-rated US corporate funds. The spectacular rally in credit of all stripes so far in 2016 has made it easy to forget that credit, as an asset class, was widely hated at the start of the year. As late as February of this year, the average spread on virtually every US dollar bond index, whether domestic or foreign, IG or junk, was testing five-year wides. It is difficult to find justification for such a violent compression in risk premiums in fundamental developments over the past eight months. While credit markets have been celebrating, U.S. economic data has softened, with Q3 GDP growth estimates falling from 3.6% in July to 2.0% by October according to the Federal Reserve Bank of Atlanta. At the same time, measures of core inflation have crept higher, encouraging the Federal Reserve to contemplate another long delayed rate hike by year end.

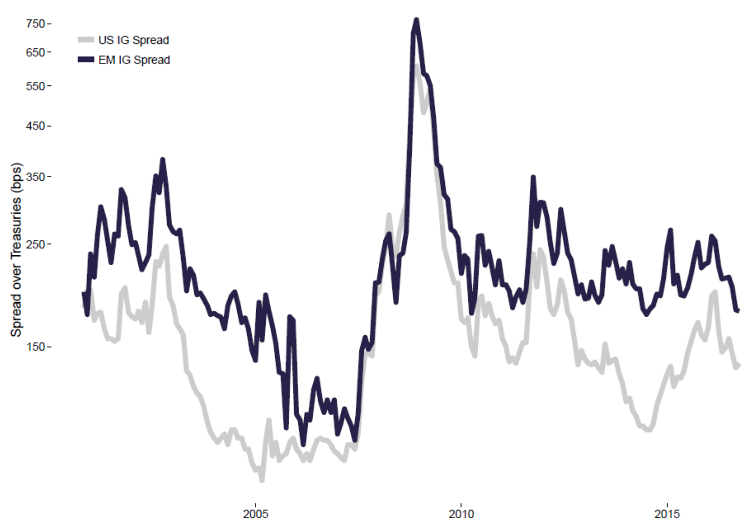
Perhaps the most remarkable feature of the corporate and EM credit rally is that it has occurred in the face of a significant widening in short end funding spreads. The harbingers of the 2008 banking crisis- swap spreads, the TED spread, and the LIBOR-OIS spread, have all moved substantially wider in 2016 towards post global financial crisis highs. Indeed, according to Bloomberg data, the correlations between IG corporate bond spreads and the TED spread / LIBOR-OIS spread were 0.714 and 0.824 respectively in the eight years before 2016. Over the past year, these historically strong positive correlations have turned negative, with corporate bond spreads realizing -0.741 and -0.661 correlations, respectively, with the TED spread and LIBOR-OIS so far in 2016.

This puzzling divergence between corporate bond spreads and short-dated funding spreads appears to reflect the influence of structural reforms to the US money markets due to take effect this month. Specifically, institutional money market funds in the U.S. may no longer quote a "stable $1.00 net asset value," but must either quote a floating net asset value reflecting market prices or impose a "liquidity fee" on investors seeking to redeem their investments during periods of significant withdrawals (as occurred during the 2008 crisis). Simply put, these overdue reforms to money market funds (typically used as cash substitutes) have altered investors' risk calculations from both a credit and liquidity perspective. As a result, investors have been redeeming from money market funds *en masse* ahead of the new rules, and redeploying their money to intermediate and longer term bond funds which offer more yield for price risk. These money market reforms have thus put a large amount of cash in motion from short-term securities into longer-dated securities, significantly disrupting the commercial paper market and leading to a flattening of credit curves to the benefit of longer-dated bonds.

Whatever the cause of the recent euphoria in credit, we expect the momentum in emerging market bonds to slow considerably in the quarters ahead. The surprising strength of the asset class in 2016, to a large extent, reflects the unwinding of excessive pessimism priced into emerging markets at the end of 2015 on low commodity prices and the Brazilian sovereign downgrade. Although a modest rebound in oil and other commodity prices in 2016 has relieved some of the economic pressure on commodity exporters, we do not expect oil prices to rebound towards pre-2014 levels for the foreseeable future. At the same time, the growth outlook for developed markets—in the US, Europe, and Japan—remains poor, while growth in China continues to slow versus historical levels on the country's ongoing structural transition from investment to consumption.

The most that can be said for investment grade EM bonds is that spreads remain somewhat historically wide relative to IG US corporates (Figure 1), albeit less attractive than in early 2014. We think EM bond premiums can continue to compress if US corporate spreads remain stable or retest historical lows. However, it remains to be seen whether credit spreads will stay well-behaved if the Federal Reserve follows through on its half-hearted threats to raise interest rates into year-end. Looking into 2017, we see particular relative value opportunities in Mexico versus the rest of Latin America, Saudi Arabia, and other GCC countries amidst a busy issuance calendar and higher oil prices, and Turkey (a fundamentally solid sovereign credit in our view) in the aftermath of its demotion to fallen-angel status. We hope to use any volatility or retrenchment in credit markets in Q4 to tactically increase exposure in these areas ahead of year end, amidst a broader overall de-risking of the portfolio on both duration and credit.

Figure 1. EM USD IG Spread v. US IG Corporate Spread, 2000-2016



Source: Northwest Passage, Barclays Aggregate Corporate Bond Index and Barclays EM USD Investment Grade Bond Index, as of October 20, 2016.

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Indices are unmanaged and cannot be invested in directly.

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 High Yield Index** is a subindex of this index.

The **Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Bond 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 (EMBI) 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.