Q4 2016 Portfolio Review & Outlook

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NORTHWEST PASSAGE
CAPITAL ADVISORS

Q4 2016 Portfolio Review & Outlook: EM Sovereign Debt Portfolio

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Summary:

- In Q4, the EM Sovereign Debt Portfolio retreated 3.91%, equal to benchmark's return. In 2016, the portfolio returned 8.48% v. the benchmark's 6.07%.
- Q4 results reflect the sharp sell-off in Treasury bonds following the US presidential election in November.
- The Trump administration raises political uncertainty, notwithstanding recent market reactions.
- The present economic expansion is shaping up for a very conventional end, catalyzed by tighter monetary policy.
- Going forward into 2017, we expect a roughly coupon return for the asset class.

Q4 Review

The Northwest Passage Capital Advisors' EM Sovereign Debt Portfolio retreated 3.91% in total return for Q4 2016, against an identical loss of 3.91% over the same period for its benchmark, the Barclays Emerging Market USD Sovereign + Quasi-Sovereign Bond Index. For 2016, the EM Sovereign Debt Portfolio has returned 8.48% against 6.07% for the benchmark. The portfolio's relative excess return is thus 0.00% for Q4, and 2.41% for the full year 2016.

Returns for both the EM Sovereign Debt Portfolio and emerging market (EM) fixed income as a whole were significantly negative in Q4, primarily reflecting the effects of a sharp sell-off in Treasury bonds following the surprise outcome of the US presidential election in November. The Barclays US Aggregate Bond Index lost 2.98% during the quarter, with its IG Corporate subcomponent losing 2.83%. US junk bonds bucked the overall negative fixed income trend during the quarter, gaining 1.75% during Q4 (according to Barclays data) on a sharp compression of credit spreads, particularly in the energy, financial, and pharmaceutical sectors. Hard currency emerging market bonds did not keep pace with the credit rally in US high yield, with the J.P. Morgan Emerging Market Bond Index (EMBI) Global Index falling 4.21% during the quarter and the Barclays USD EM Aggregate Index falling 2.61% during the same period. Within the Barclays USD EM Universe, high-yield EM bonds outperformed IG EM bonds, with the junk subindex returning -1.36% versus -3.39% for the investment grade subindex for Q4.

Treasuries endured their worst quarter since the 2013 taper tantrum, with the Treasury subcomponent of the Barclays' Aggregate Bond Index falling 3.84% during the quarter on a 95 basis point rise in nominal 10Y yields and a 75 basis point rise in nominal 30Y yields. Indeed, in price terms, Treasuries posted one of the worst quarters in more than 15 years, as the low level of absolute yields translated to large price moves on comparatively small yield changes. The bulk of the rise in base rates occurred in November, with 10Y yields rising 55 basis points in the two weeks immediately following Donald Trump's surprise victory in the presidential election on November 7th.

While observers continue to debate the economic and policy rationale for the sharp repricing of interest rates higher following the Trump victory, markets endorsed a reflationary view of the election outcome by pushing 10Y inflation breakevens 30 basis points higher, tightening credit spreads, and sending cyclical sector equity prices sharply higher. US investment grade corporate bond spreads tightened 16 basis points during the quarter, while high yield credit spreads tightened a notable 76 basis points according to Barclays index data. Remarkably, US high yield corporates built on their strong Q3 performance by outperforming investment grade corporates in Q4 by the largest margin in at least five years. Consistent with a broad reflationary theme, markets also pushed implied real interest rates higher, fully priced in a (subsequently realized) December Fed hike, and further endorsed as many as three additional interest rate increases by the Federal Reserve over the course of 2017.

In contrast to Q3, emerging market bonds did not keep pace with the overall rally in credit spreads after the election, with spreads widening +3 basis points during the quarter for the portfolio, +2 basis points for the benchmark, and +5 basis points for the JP Morgan EMBI (a hybrid credit benchmark which is split evenly between IG and junk-rated issuers). In the initial stages of the post-election bond sell-off, EM bonds underperformed for a variety of reasons, including concern over the effects of a strong dollar, the possibility of significant protectionist policies from the new administration, and specific Trump-ian rhetorical attacks on major EM issuers including China and Mexico. The worst performing sovereign EM credits in spread terms were investment grade Asian credits, including Malaysia, China, Korea, and Indonesia (all of which widened 5-20 basis points) during the quarter; Mexico, whose sovereign spreads were flat to slightly wider on Trump related anxiety; and Turkey, which saw continued spread widening in the aftermath of its recent downgrade to junk status. Conversely, and perhaps not surprisingly, Russia was the best performing major EM sovereign credit during Q4, with its 5Y CDS spread tightening more than 55 basis points in the aftermath of the election. South Africa and Saudi Arabia were also strong relative credit performers during the 4th quarter of 2016.

The Northwest Passage strategy performed exactly in line with the benchmark during Q4, reflecting our strategy to de-risk the portfolio (particularly with respect to duration) over the course of the summer and fall. We began Q4 with a modified duration of 6.56 years, 0.18 years shorter than the benchmark duration of 6.74. In terms of factor attribution, the yield curve positioning subtracted 8 basis points of relative performance, as the overweight in very long duration 30Y bonds offset our overall average duration underweight; carry income added 9 basis points; credit positioning added 5 basis points, and currency exposure (primarily a small Mexican peso position) subtracted 6 basis points. Overweight positions in South Africa and Saudi Arabia contributed positively to our relative credit performance, partially offset by our overweight position in Turkish sovereign bonds.

Perspective on Trumponomics

As should already be apparent from the reaction of financial markets in Q4 2016, the election of Donald Trump as President of the United States has the prospect to become one of the most consequential political events in modern American history. The potential importance of Trump's accession stems not from any program or policy that he has advocated, but rather from the complete absence of such policies or programs, articulated with any consistency. President Trump is a political Rorschach Test like no other, with his supporters and detractors alike content to see in his various contradictory pronouncements whatever policies they most desire or most fear. The governing principle of the Trump era, so far, is uncertainty. To an unprecedented degree for a new administration, few observers have any idea what the new president intends to do on key policy priorities, perhaps least of all, Trump himself.

William James observed that "the art of being wise is the art of knowing what to overlook." Never has this advice been more applicable than in attempting an analysis of the Trump administration. The new president confronts markets with a welter of rhetoric, demagoguery, stream-of-consciousness philosophizing, and off-the-cuff policy proposals, which change according to the day, the hour, Mr. Trump's mood and perhaps the breakfast menu at the Trump Grill in New York – in short, what market participants commonly call "noise." Separating the Trump-ian noise from signal will be the preeminent investing challenge of 2017, and a task which we believe the current herd of bond bears and equity bulls significantly underestimate in difficulty.

To the initial surprise of many, financial markets have greeted the incoming Trump administration with enthusiasm, moving prices in a direction consistent with expectations of higher economic growth and higher inflation over the next two years. As noted above, stocks rallied strongly in the aftermath of the election (led by cyclical sectors like energy and banks), corporate credit spreads narrowed, and Treasury yields rose on both higher real rates and wider inflation expectations. The US dollar also strengthened significantly against major developed and emerging market currencies, reflecting higher interest rate differentials in favor of the dollar and possible dollar positive trade effects from import tariffs and/or reform of the US corporate income tax in favor of something resembling a value added tax (VAT). Paradoxically, US stock and bond markets have so far largely ignored the negative consequences for economic growth and corporate profits which usually follow from a sudden general appreciation of the dollar.

Pundits and prognosticators (most of whom predicted a dire collapse in risk assets should an unlikely Trump victory come to pass) were caught flat-footed by the positive market reaction to the election, and in recent weeks have been furiously spinning a narrative to justify, *post hoc*, a judgment which has already been rendered emphatically by investors. This story, implausible as it may seem, has the elements of a fantasy dreamed up by precisely the libertarian, corporate, and country-club Republicans, whom Trump so brutally defeated in the Republican primaries. In this Republican establishment fairy tale, a Trump administration means:

- Massive cuts in personal and corporate income taxes
- Significant reduction in bureaucracy and federal administrative rules
- A tax holiday leading to large-scale repatriation of overseas profits
- A domestic capital investment boom funded with those repatriated profits
- Positive demand shock from lower taxes and targeted fiscal stimulus
- ACA repeal without a negative demand shock from lower healthcare spending
- A bonanza of infrastructure investment funded without taxation
- Higher interest rates reflecting sustainably higher economic growth
- No significant disruption to US trade or labor arrangements
- A general rise in economic "animal spirits" and economic activity
- Donald Trump turns out to be the second coming of Ronald Reagan

Reviewing this list, one would think America has just elected the Koch brothers or Paul Ryan to the presidency instead of Donald Trump! We are, of course, skeptical of this optimistic narrative. In the first place, this bullish story conveniently neglects the one policy priority on which Donald Trump has been consistent – a more confrontational and protectionist approach to trade policy, including renegotiation of NAFTA and existing trade agreements with China. It overlooks Mr. Trump's tendency towards direct intervention in the management and investment decisions of major American corporations (Boeing, Ford, Carrier, Lockheed, and GM at last count, among others). It discounts the disruptive effect of "regulation by Twitter" instead of regulation by rule. It supposes that a root-and-branch reform of the corporate tax code will somehow contrive to capture even less of the corporate profits, which so easily evade taxation under present law. It ignores Mr. Trump's various pledges to preserve universal health insurance in some form and to protect or expand various other popular entitlement programs. It assumes Mr. Trump will maintain smooth relations with Republican majorities in Congress, and will passively acquiesce to the legislative agenda of the congressional Republican leadership which actively opposed him in the election. In short, the bullish narrative assumes that Donald Trump intends to govern as someone other than Donald Trump.

We suspect that many of President Trump's newly acquired fans in the stock market are in for a rude awakening after Inauguration Day. Indeed, as students of the so-called "Presidential Cycle" know, disappointment is something of a tradition for new Republican administrations. Following an initial burst of euphoria, both Ronald Reagan (1980) and George W. Bush (2000) found their new administrations bogged down in economic recessions within two years of election day. The promise of tax cuts, deregulation, and expansive new deficit-financed government spending did not spare Reagan from a near 20% decline in the S&P 500 from election night 1980 through August 1982, nor did a similar program save George W. Bush from the embarrassment of a more than 40% decline in equity prices from election night 2000 through October 2002. It is perhaps more than a historical curiosity that even earlier Republican transitions (Eisenhower in 1952 and Nixon in 1968) also saw negative S&P 500 returns during the first year after the election.

Inflation & the Federal Reserve Likely to Matter More than Politics in 2017

Republicans' bad luck with the "Presidential Cycle" is a reminder that, good or bad, presidential administrations and political regimes have less fundamental influence on the economy than politicians would like to admit. In this sense, the most troubling prospect for the Trump administration is not what policies it may or may not enact, but the advanced age of the current US business cycle. The current economic expansion (coinciding with the entirety of the Obama administration) is now eight years old. Although the average pace of growth during this expansion has been frustratingly modest given the severity of the recession which preceded it, the "Obama recovery" will shortly become the longest uninterrupted period of economic growth in postwar US history. The record of past economic cycles suggests that it is exceedingly unlikely that this uninterrupted winning streak will extend to 12 years, and that it is, therefore, likely that a recession will occur at some point during the Trump administration. This is a view not driven by politics, but by empirical observation of the natural ebb and flow of US economic activity.

While attention will naturally be focused on the political dramas of the next two years, we believe the present economic expansion is shaping up for a very conventional end, catalyzed by tighter monetary policy. Weak as the expansion has been, conditions are now in place to keep the Federal Reserve on a tighter course. In particular, the low level of the headline unemployment rate (last 4.7%) and the comparatively high level of core inflation (last 2.2% on the CPI ex-food and energy and 2.6% of the Cleveland Fed median) mean that the Federal Reserve is now far behind the curve relative to its pre-2008 reaction function. Based the historical relationship between unemployment, core inflation and the Federal Funds rate from 1988-2013, we estimate that current conditions now warrant a Fed Funds rate of more than 3.50%. Though the Yellen Fed has consciously pursued a policy of allowing the economy to "run hot" by slow pedaling interest rate normalization, the moment has at last arrived when the Fed will be forced to prioritize the inflation objective of its dual mandate. With wage growth nearing 4.0% (an eight year high according to the Atlanta Fed), stabilization of the labor force participation rate, and anecdotal evidence of emerging labor shortages in construction and other industries, we think the Fed will finally have enough confidence in the growth outlook to follow through with its plans for at least three interest rate hikes in 2017.

As is well known, tighter monetary policy ultimately works to slow the economy (and damage risky asset returns) through numerous channels, including higher long-term interest rates, tighter credit, and currency appreciation. An inflation-focused Fed certainly means higher overall interest rates in the short-term, but we believe that bond bears and economic bulls vastly overestimate the level to which US interest rates can rise without triggering a recession. We also disagree with expectations, commonly expressed after the election, that the US yield curve will steepen to reflect higher inflation and growth in 2017. Over the past several cycles, Fed tightening has been associated with aggressive yield curve flattening, particularly in the late stages of long expansions. To expect a steeper curve in the face of a more hawkish Fed is thus to defy three decades of recent financial experience. We think it is more likely that 2 and 5 year rates will rise more than 10 and 30 year rates over the course of 2017, and that bond markets will see a return of Alan Greenspan's famous "conundrum" as the 2s10s and 5s30s term premium heads towards zero or even inverts. As we noted in our last quarterly outlook, the US yield curve is already well advanced in a flattening trend, itself a highly reliable indicator that the expansion is approaching its end.

Our view is that the US economy remains in a fragile state and that it will not take much in the way of higher interest rates to provoke a slowdown. Financial conditions are already much tighter than many realize, with the contraction of private credit markets having done much of the Fed's dirty work for it. We think investors (particularly outside of the fixed income market) continue to underestimate the importance of the structural change in the US money market, which has occurred with the virtual elimination of prime money market funds. Almost $1 trillion has flowed out of funds which used to invest in the global interbank and commercial paper markets, into funds that invest strictly in short-term government bills. This has been a major shock to the shadow banking system, and over the course of 2015 and 2016 has led to a permanent and substantial shift higher in front end credit spreads. This is apparent in not only the short-term TED (Treasury-Eurodollar) and LIBOR-OIS spreads but in swap spreads and FX basis swaps. The distortions in FX basis swaps are especially interesting, as they are common across a wide range of currencies including euro, yen, sterling, Swiss franc, and the Canadian dollar. In effect, all of these currencies have moved to a large negative basis versus the dollar, to imply a significantly higher offshore funding cost for foreign firms seeking to borrow US dollars versus the rate at which US firms can borrow dollars onshore. The net consequence of these developments is that it is getting harder for companies to find short term money, and especially so for foreign firms. Collectively, the widening of various credit spreads has added around 50 basis points to short-term global dollar borrowing costs since 2015, essentially doubling the effect of the two Fed hikes over the same period.

These dislocations in short-term credit markets (quite apart from their disturbing echoes of 2007-2008) are symptomatic of a more general retreat in the tide of global US dollar liquidity conditions as the Fed has gradually shifted from open-ended QE to an inflation fighting bias. Another indication of this retreat is the decline in global sovereign foreign exchange reserves, which have fallen (according to Bloomberg) from a high of $12.03 trillion in August 2014 to $10.81 trillion as of January 2017. This collective outflow of $1.2

trillion in aggregate FX reserves is larger, in both absolute and percentage terms, than the aggregate drawdown seen during the 2008-2009 crisis period. For the most part, the decline reflects the adverse commodity shock which has turned Middle Eastern oil producers from savers to spenders on the current account, and persistent capital flight problems in China, which by itself has seen a decline of almost $1 trillion in FX reserves since 2014. While FX reserve levels remain ample in most countries relative to history and foreseeable external financing needs, it is notable that two of the biggest net dollar savers (China and Saudi Arabia) of the past decade have in recent months become net dollar spenders. Net dissaving by China and the Gulf petrostates has, in turn, led to a shrinking (but still large) pool of savings available to other emerging markets, helping to drive short- and long-term dollar borrowing costs wider in numerous other countries.

We are concerned that current trends driving savings back into the United States and out of foreign money markets will have a self-reinforcing character in 2017, especially given the divergence between the Federal Reserve's tightening bias and the easy monetary policy currently prevailing in other major developed economies. We can envision a scenario in which more Fed tightening (even just 1-2 hikes) draws more funds out of overseas dollar money markets, driving up offshore dollar funding spreads. This in turn drives up US dollar hedging costs and drives further dollar appreciation, expectations of which drive even more inflows into the United States in a potentially destabilizing feedback loop. As noted above, the disappearance of the prime money market fund industry has compromised the ability of US capital markets to recycle inbound capital flows to the rest of the world, setting the stage for a relative dollar shortage abroad. Paradoxically, this overseas dollar shortage could then rebound on the US itself in the form of higher private credit spreads. The essential point is that conditions are ripe for markets to amplify even modest tightening by the Federal Reserve in 2017— a small action in the US could provoke a much larger global liquidity reaction than either the Fed or markets anticipates. It is a dangerous situation when the driver of a car does not fully comprehend the sensitivity of the brakes.

What does this mean for EM?

In the discussion above, we have sketched a scenario in which US growth in 2017 is strong enough, initially, to keep the Fed focused on inflation and willing to roll the dice on additional interest rate increases. In turn, we argue that the Fed will underestimate the global effect of its actions, leading to overtightening of dollar liquidity conditions abroad, excessive dollar strength at home, and continued upward pressure on credit spreads in the interbank and money markets. Eventually, these developments will hurt the US economy through reduced private investment, housing, and construction activity, and lower corporate profits due to dollar strength. As it did in the past three business cycles, Fed tightening will eventually bring the current US expansion to a close, with the eventual recession prophesized well in advance by a flat to inverted yield curve that will, at the time, strike many bond market participants as nonsensical.

This is a challenging situation, even assuming that the Trump administration does not catalyze a more immediate economic crisis by launching a trade war. Our economic scenario, it is safe to say, is also not exactly bullish for emerging markets, which have a well-known reputation for pro-cyclical sensitivity to US liquidity conditions. That said, in the external credit space, we do not see a pressing need for investors to panic. As we have noted, EM reserves, while shrinking, remain ample (indeed, one might say excessive) relative to the current account and refinancing needs of most major EM economies. As dollar-based investors, we ultimately welcome the ongoing FX depreciation in countries like Mexico and Turkey, which has the effect of improving external competitiveness and forcing current account adjustment without wasting reserves on pointless exchange rate defenses. As we argued in the recent Russia and Brazil crises, it is sensible and good macroeconomic management to use the exchange rate as a shock absorber, and permitting necessary depreciation in a flexible currency regime is often a first step towards restoring or improving overall sovereign creditworthiness. We are more concerned about countries like China and Saudi Arabia, who continue to resist a free float of their currencies, although both countries can, for the moment, sustain their fixed/managed exchange rates due to the large excess of external assets over external liabilities, which characterizes both.

Because external and fiscal buffers remain healthy across the emerging markets, we see no reason for, or likelihood of, sovereign credit distress in any major EM country except Venezuela in 2017. Our base case is that our core countries will muddle through again this year, amid tepid international investor interest, without a dramatic widening in sovereign spreads, but likely without significant tightening. Thus, we are expecting a roughly coupon return for the asset class in 2017.

Our view of the US economy, articulated above, suggests that an economic crisis is not imminent, but that trouble is on the horizon, perhaps within 12-24 months. Sensing a storm, a prudent sailor begins to “batten the hatches” well in advance of the storm’s arrival. For our portfolio in 2017, this means a gradual and patient upgrade in the quality of the portfolio. Given the recent sell-off in duration and our expectation of a significantly flatter yield curve, we are also comfortable extending portfolio duration in highly rated sovereign credits. Despite the fact that the US dollar has become fundamentally overvalued against virtually every developed and emerging market currency, we intend to avoid additional FX exposure during the first half of 2017. Many emerging currencies (notably the Mexican peso, South African rand, and even the Turkish lira) have become spectacularly undervalued on a number of fundamental measures and, doubtlessly, will offer attractive returns when the world moves to a different macroeconomic policy configuration. However, until dollar strength and economic deterioration force the Fed to cry “uncle” on its current tightening bias, we argue for extreme caution in undertaking EM currency risk.

Portfolio performance information referenced in the report is unaudited and prepared by Northwest Passage Capital Advisors based on our internal pricing and valuation procedures. Returns are presented gross of management fees on a time weighted basis. Historical return data presented in this report represents a single non-discretionary managed account for one client. Performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted.

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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.

The **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.