Q1 2017 EM Review & Commentary

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Q1 2017 Review & Commentary: EM Sovereign Debt Portfolio

Summary:

- In Q1 2017, the EM Sovereign Debt Portfolio gained +3.80%, exceeding the benchmark return by 0.77% for the period.
- Q1 2017 results reflect a significant reversal in Q4 2016 post-election trends, with lower Treasury yields and tighter credit spreads driving fixed-income returns to start the year.
- Fixed-income markets ignored continuing political risks in the US, Europe and emerging markets, a more hawkish Federal Reserve, and mixed US economic data, to deliver strong returns in a complete unwind of the “Trump trade.”
- Despite the strong start to the year, historically tight credit spread levels for EM and US corporate debt, along with weakening US economic data, mean further credit gains in fixed income should be limited in 2017.

Q1 Review

The EM (Emerging Market) Sovereign Debt Portfolio advanced +3.80% in total return for Q1 2017, against a gain of +3.03% over the same period for its benchmark, the Bloomberg Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Bond Index. The portfolio’s relative excess return is thus +0.77% for Q1.

Returns for both the EM Sovereign Debt Portfolio, and fixed-income assets generally, were positive across the board in Q1, as markets largely reversed the sharp fixed-income losses which followed in the wake of Donald Trump’s surprise election win during Q4. Although longer duration Treasury yields fell slightly during the quarter, bond returns were primarily driven by tighter credit spreads across the fixed-income universe. The Bloomberg Barclays US Aggregate Bond Index gained +0.82% during the quarter, with its investment grade (IG) corporate subcomponent rising +1.22%. US junk bonds likewise gained +2.70% during Q1 (according to Bloomberg Barclays data) as junk-rated paper recorded its fifth consecutive quarter of spread compression. Hard currency emerging market bonds outperformed US corporates in both the investment grade and junk categories, with the J.P. Morgan Emerging Market Bond Index (EMBI) rising +3.90% during the quarter and the Bloomberg Barclays Emerging Markets USD Aggregate Index gaining +3.28%. Within the Bloomberg Barclays USD EM universe, high-yield EM bonds again outperformed IG EM bonds, with the junk subindex returning +3.89% versus +2.90% for the investment grade subindex during the period. Treasuries rebounded slightly in Q1 after their historic post-election drubbing, with the Treasury subcomponent of the Bloomberg Barclays US Aggregate Bond Index rising +0.67% during the quarter. Treasury gains were concentrated in the long end of the curve, with 10Y yields falling 9 basis points (bps) during the quarter and 30Y yields 7 bps lower over the same period. The US yield curve continued to flatten in Q1 on mixed US economic data and a somewhat sooner than expected March rate hike from the Federal Reserve, with the 10Y-2Y term spread ending the quarter 13 bps flatter than versus year-end levels. Inflation expectations continued to rise slightly in Q1 (building upon a large advance in Q4), with 5Y TIPS breakeven inflation levels rising 10 bps during the quarter.

As noted above, spread compression was the primary driver of fixed-income returns in Q1 for both investment grade and junk rated names. According to Bloomberg Barclays index data, US IG corporate spreads finished Q1 4 bps tighter than year-end levels, while US junk bond spreads tightened by 21 bps. Credit performance was even stronger in emerging markets, with the Bloomberg Barclays Emerging Markets Investment Grade Index spread tightening by 23 bps during the quarter, and the Bloomberg Barclays Emerging Markets High Yield Index tightening by 49 bps. The weighted average credit spread for the portfolio tightened by 39 bps during the quarter, versus 24 bps of credit tightening for the portfolio benchmark.

The strategy for the EM Sovereign Debt Portfolio outperformed its benchmark by 77 bps during Q1, reflecting diverse sources of active risk. In terms of factor attribution: yield curve positioning added +17 bps of relative performance, reflecting the decision to shift from an underweight to overweight duration posture in late Q4; carry income added +6 bps; credit positioning added +41 bps; and currency exposure added +13 bps, as the Mexican peso rebounded strongly during Q1. Credit returns were disproportionately concentrated in long duration bonds, with credit curves flattening aggressively in Q1 following a sharp Q4 steepening in the aftermath of the election. Key performance drivers for the portfolio in Q1 were long duration bonds in Mexico, Indonesia, Saudi Arabia, and Bahrain.

Q1 Commentary: *Cognitive Dissonance*

Psychologist Leon Fetsinger coined the phrase “cognitive dissonance” in 1957, to describe the mental distress that human beings experience when confronted with facts or information which are inconsistent with strongly held prior beliefs. In Fetsinger’s model of cognitive dissonance, the psychological discomfort of contradictory information motivates people to reduce the conflict by either 1) avoiding or ignoring unpleasant information altogether, or 2) modifying beliefs to justify existing behavior in light of the unpleasant information. One might extend the theory of cognitive dissonance to business cycles. Economic expansions continue as long as market participants can maintain an optimistic narrative with respect to economic developments. Recessions happen in the sudden, crystalizing moment in which the market realizes the prevailing narrative can no longer be sustained in the face of facts, leading to uncertainty, caution, doubt, delay and a collapse in investment expectations.

While current political discourse concerns itself with the idea of “fake news,” we are more troubled by cognitive dissonance in the financial markets in 2017- specifically by what appears to us to be a divorce between investor perceptions of US economic strength and the actual reality of US economic performance. As we write, the “Trump trade” continues to power ahead in US equity markets (although not in the Treasury market), with major equity indices setting new record highs on a daily basis. Aggregate stock valuations, whether measured by price-to-book, price-to-earnings, price-to-sales, or enterprise value to EBITDA multiples, are revisiting levels last seen on the eve of the 2000 tech bubble crash. The euphoria is not confined to stock markets, as credit markets are also celebrating the apparent return of happy days in perpetuity with credit spreads at 10-year lows for both investment grade and junk-rated US corporate issuers. The VIX implied volatility index, often seen as a general-purpose fear gauge for financial markets, hovers at 10%, matching the lowest levels seen in nearly 30 years.

The confidence of risk-asset buyers is mirrored in several economic sentiment surveys. The Conference Board reports overall consumer confidence as the highest it has been in 17 years. The Institute for Supply Management (ISM) manufacturing purchasing managers' survey sits near a seven-year high, alongside small business optimism at 13-year highs. Initial jobless claims are at 50-year lows, while the Job Openings and Labor Turnover Survey (JOLTS) series reports job openings at a 15-year high. Across a broad swath of data, the 2008-2009 recession seems a distant memory, with the stage apparently set for vigorous hiring, rising wages, growing incomes, and vigorous consumption.

And yet—an annoying refrain from gloomy fixed-income types like us—there are worrying cracks in this pretty picture. Dissonant information which, when we stare it in the face, makes us profoundly uncomfortable about the present state of financial markets. To begin with, there is the divergence between the so-called hard and soft economic data. While sentiment surveys are high, the just released Q1 GDP report was highly disappointing—at +0.7% it was the slowest pace of growth in three years, and well below expectations of 2.5% or higher which were common at the start of the year. Through ups and downs, real GDP growth has stubbornly refused to move above 2.0% throughout the course of the post-recession recovery, making the present recovery the weakest in post-WWII economic history.

Despite high levels of reported consumer confidence, retail sales have consistently disappointed versus expectations, particularly in traditional retail categories excluding automobiles and gasoline. In the just reported Q1 GDP figures, growth in personal consumption expenditures (representing almost 70% of GDP) was just 0.3%, the weakest observed level since 2009. How also are we to reconcile high levels of consumer confidence with the obvious distress of the retail sector, which in recent months has seen the fastest pace of store closings and employee layoffs since the depths of the last recession? Credit Suisse recently surveyed the emergent depression in the retail sector: so far in 2017, 2,880 store closings have been announced through March, more than twice the pace of store closings seen in 2016. 2017 is on pace to register more store closings (8,640) than any year in the last two decades, and will likely exceed the 2008 recession peak by 30%. At least ten retail chains have filed for bankruptcy so far in 2017, with many other well-known stores (from Neiman Marcus to J.C. Penney) exhibiting signs of significant financial distress. Most traditional department store and retail stocks now trade at multi-decade lows, while their bonds have fallen deep into junk territory. The damage extends to commercial real estate, where mall REIT shares are falling and commercial mortgage-backed securities (CMBS) with exposure to retail properties have seen a sharp widening in spreads. Department stores and general merchandise retailers have eliminated hundreds of thousands of jobs over the past three years, with the latest round of layoffs contributing to a net decline of 32,000 retail trade payrolls in the March employment report. The retail trade, which collectively still employs more than 15 million Americans, has in recent months become one of the worst performing employment sectors, joining energy and manufacturing which have been in the doldrums since the beginning of the 2014-2015 energy bust.

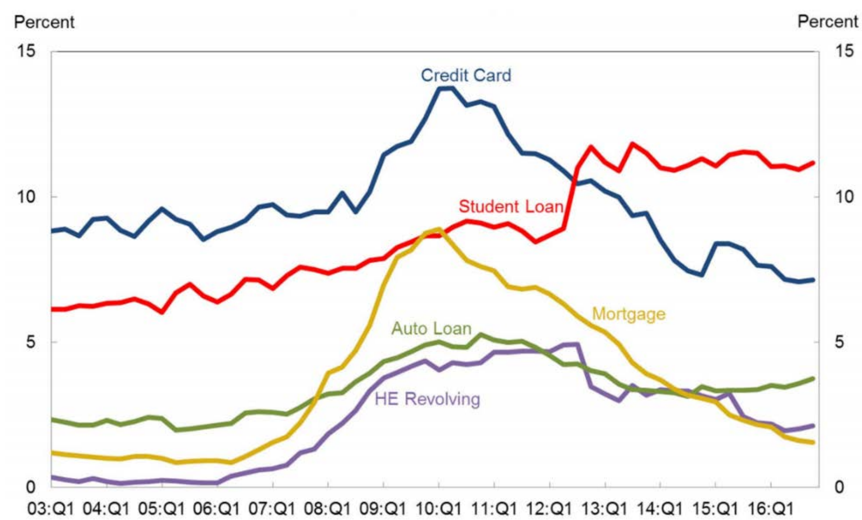
One may explain away some of the “retail apocalypse” by changes in consumer behavior—notably a shift to online shopping (where Amazon has been the big winner) and to hyper-efficient warehouse style stores such as Wal-Mart, Home Depot, and Costco. There is no doubt that many incumbents in the retail space are experiencing deserved “disruption” due to changing consumer tastes and antiquated business models. But we think it is foolish to believe such disruption will occur smoothly and painlessly, without sending significant shockwaves throughout the rest of the economy. As noted, the retail sector still employs more than 15 million people in the US, roughly 10% of all employees. Of these, only 351,000 (or 2%) work for Amazon. The legacy retail sector also has important linkages to the economy through the financial system, as an originator of large amounts of consumer credit and especially through the commercial real estate market which secures nearly $3.8 trillion of bank loans, mortgages, and CMBS securities. The retail sector accounts for approximately 30% of the US commercial property market by value, suggesting that more than $1 trillion of commercial real estate loans throughout the US financial system may be tied to retail properties at risk of substantial depreciation. This risk is already apparent in the CMBS market, where numerous loans originated in 2007 are having difficulty being refinanced. Thus, CMBS delinquencies are rising, and CMBS credit spreads have moved wider over the past 18 months, with BBB rated CMBS deals trading 200-300 bps wider than comparably rated corporate bonds (i.e., well into junk territory).

The first quarter also saw troubling news with respect to consumer credit, with early signs of distress emerging in credit card, auto, and student loans. After falling continuously from a 2009 peak, 90-day auto loan delinquencies in the US began rising in late 2014 and now stand at a post crisis high of 3.75% per Federal Reserve data. A recent article from Bloomberg observes that an increasing percentage of new auto loan originations underlying the asset backed securities (ABS) market are themselves “deep subprime.”[1] Auto loans have grown roughly $400 billion from their post crisis trough to $1.2 trillion outstanding, and have been a key support to the recovery of both the US car industry and US manufacturing. With loan delinquencies rising and used car prices falling, per recent data, one wonders if the US auto sector, despite high consumer confidence, is on the cusp of a significant downcycle.

The news is no better in credit cards. In their just reported Q1 results, major credit card issuers including Citibank, Discover, Capital One, and Synchrony all reported disappointing earnings on higher than expected loan write-offs and rising delinquency rates. Federal Reserve data reveals delinquency rates for credit cards across all commercial banks as bottoming in early 2015 and have now been edging higher for most of the past two years. As in auto loans, an increasing proportion of new credit card accounts are being opened by subprime borrowers, with delinquency rates on new credit card accounts opened since 2015 nearly twice the overall rate.

The disastrous state of the student loan market is perhaps more well-known than the cracks appearing in auto loans and credit cards. Federal Reserve data show student loan balances now standing at $1.3 trillion, and are now the largest category of nonmortgage consumer debt, ahead of auto loans ($1.2 trillion) and credit cards ($0.8 trillion). Student loans have been the fastest growing category of consumer debt over the past 15 years, with outstanding balances growing 500% since 2003. During this time, serious delinquency rates on student loans have doubled from 6% to more than 12%, with delinquency rates failing to fall even as credit trends improved for every other consumer credit category during the post-recession recovery. The Wall Street Journal reports that more than 40% of all outstanding student loans are currently not making any payments due to deferral, delinquency, or default.[2] Though much of this debt is guaranteed by taxpayers, it seems probable that much of the current mountain of student loan debt will never be repaid. Student loans have become a "subprime in disguise" credit lifeline for financially stressed households—we question, however, how long the student loan market will be able to sustain 15% annual growth on current nonpayment trends.

Percent of Balance 90+ Days Delinquent by Loan Type



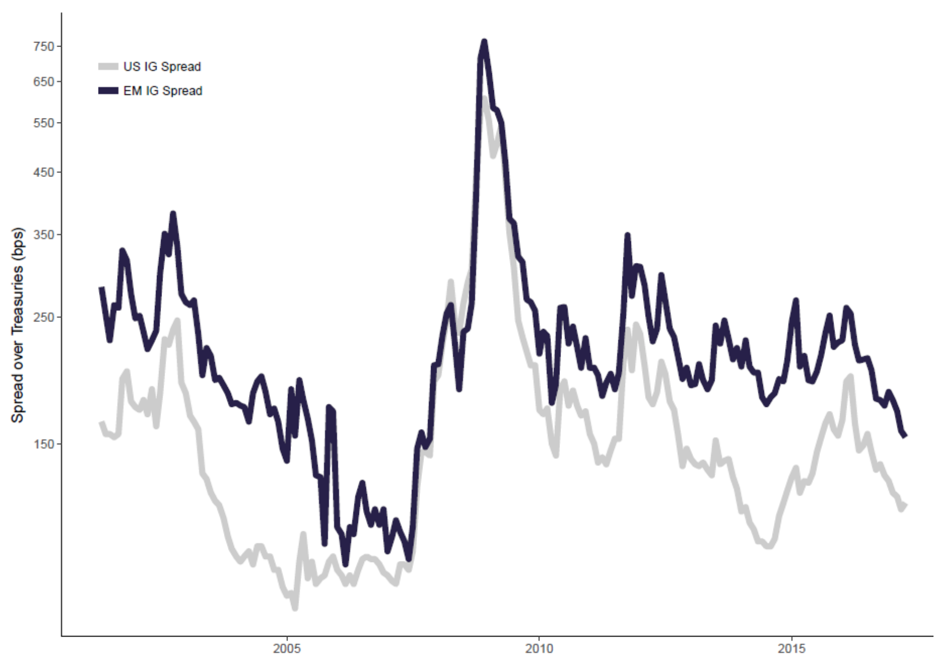
Source: New York Federal Reserve, "Q4 2016 Report on Household Debt and Credit", February 2017 (https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2016Q4.pdf)

It is at minimum puzzling that credit stress should be rising across so many sectors of the US economy (credit cards, auto loans, commercial property, and student loans) at a time when consumer confidence is high, unemployment is low, and the Federal Reserve is feeling confident enough in US economic prospects to be raising base interest rates. The continued advance in equity prices (albeit with increasingly narrow leadership) makes it easy to overlook disconfirming information that challenges the generally positive narrative for the US economy. We would argue that the household credit trends discussed above, and the related fallout in the retail sector, nevertheless mean that the US credit cycle has peaked, and indeed has turned in a negative direction. We feel confident that the Fed's apparent insistence on tightening policy (through further interest rate increases and possible reduction in the size of its balance sheet later in the year) will only accelerate these trends. As we noted in our last quarterly commentary, the current US expansion is mature, and aging rapidly.

Given our sense of building negative credit trends at the consumer level, it is hard for us to be bullish on credit at the corporate level. To chase corporate credit spreads lower from the tightest levels in a decade is to seek, as Samuel Johnson said of second marriages, “the triumph of hope over experience.” In a similar vein, equities seem to us to carry the risks of a marriage to actress Elizabeth Taylor. Against high expectations, Citibank’s index of economic surprises has turned sharply negative at the beginning of May, in the wake of the poor Q1 GDP report. So far, financial markets have not reacted, choosing instead the cognitive dissonance strategy of simply ignoring unpleasant information. Given the multiple sources of fragility in what has been a very fragile US expansion, we think other negative shocks are likely in 2017—perhaps from a renewed investment collapse in the energy sector if oil prices fall, perhaps from a drawdown of excessive automobile inventories, or perhaps from further retail bankruptcies and commercial real estate liquidations. We think corporate bond markets are mostly unprepared for any bad news.

We are, of course, a manager of emerging market bonds. It may, therefore, seem that we have spent an inordinate amount of time reviewing risks to the US economy that have little to do with the far-flung economies of Indonesia, South Africa, Turkey, Brazil and the like. The reality of financial markets is such, however, that EM bond spreads are highly correlated to US corporate spreads, and especially to high yield bond spreads. Over the past five years, we calculate the return correlation between the Bloomberg Barclays Emerging Markets USD Aggregate Index and the Bloomberg Barclays US Aggregate Corporate Bond and Bloomberg Barclays US Corporate High Yield Bond indices at 0.63 and 0.80 respectively. Regardless of what happens economically in emerging markets, EM bond returns are likely to suffer if investors rethink corporate credit risk in the United States.

Emerging Market USD IG Spread vs US IG Corporate Spread, 2000-2017



Source: Northwest Passage, Bloomberg Barclays. “US IG Spread” is the Option Adjusted Spread of the Bloomberg Barclays US Aggregate Corporate Bond Index, “EM IG Spread” is the Option Adjusted Spread of the Bloomberg Barclays Emerging Markets Investment Grade Bond Index.

We remain confident in EM economic fundamentals, which have generally shown improvement for most countries over the past 12 months. Indeed, the same Citibank surprise indices which are currently turning negative in the US also show positive surprises versus expectations for the majority of EM regions. Nevertheless, as the chart above indicates, EM bond spreads have priced a great deal of good news over the past 16 months, with IG EM spreads falling to their lowest levels since 2007, and hovering not far off their pre-crisis tights.

EM credit has performed strongly so far in 2017, shaking off Trump-related fears and joining US corporate assets in a kind of post-apocalyptic euphoria. Though they were gloomy on election night, economists have recently joined in the cheerleading. It is precisely when things are going well that it is easiest to ignore the minority view, push aside the inconvenient information, and resolve cognitive dissonance by ignoring the parts of the picture that do not fit. Long-term investment success, however, demands that this temptation be resisted.

We are confirmed skeptics of the US economy at this stage of the business cycle, and view the present strength in risk assets as an opportunity to take profits and position defensively. As such, our strategy remains to gradually sell down higher risk credits in the portfolio, move up in credit quality, and position for lower, rather than higher, US interest rates. To this end, we are willing to accept greater duration risk in high-quality sovereign and quasi-sovereign bonds, where we have been extending duration in A-rated and higher securities. We have also been impressed by recent dollar weakness against EM currencies, and believe the strong dollar could become a casualty of changing perceptions of the strength of the US economy versus other regions. We are thus cautiously and opportunistically replacing high-yield credit spread risk in the portfolio with sovereign local currency risk (although we expect such foreign currency risk to remain less than 5% of the portfolio). Our overall objective, however, is to reduce aggregate risk across all portfolios, in the expectation of better credit buying opportunities later in the year.

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Indices are unmanaged and cannot be invested in directly.

Indices:
The **Bloomberg 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 **Bloomberg Barclays Emerging Markets Investment Grade Index** and **Bloomberg Barclays Emerging Markets High Yield Index** are subindices of this index.

The **Bloomberg 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 **Bloomberg 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 **Bloomberg Barclays US Aggregate Corporate Bond Index**, the **Bloomberg Barclays US Aggregate Long Treasury Index** and the **Bloomberg Barclays US Aggregate Long Corporate Index** are subindices of this index.

The **Bloomberg Barclays US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The Corporate Index is a component of the US Credit and US Aggregate Indices, and provided the necessary inclusions rules are met, US Corporate Index securities also contribute to the multi-currency Global Aggregate Index. The index was launched in July 1973, with index history backfilled to January 1, 1973.

The **Bloomberg Barclays US Corporate High Yield Bond Index** tracks USD-denominated, high-yield, fixed-rate corporate bonds. Included securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/ BB+ of below. Bonds from issuers with an emerging markets country of risk, based on indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices. The index was created in 1986, with history backfilled to July, 1, 1983.

The **J.P. Morgan Emerging Market Bond Index (EMBI)** tracks the total return for the US dollar-denominated emerging markets debt, including Brady bonds, Eurobonds and loans. It does not include fees or expenses.

[1] Scully, Matt. "'Deep Subprime' Auto Loans Are Surging." Bloomberg.com. March 28, 2017. Accessed March 29, 2017. https://www.bloomberg.com/news/articles/2017-03-28/-deep-subprime-becomes-norm-in-car-loan-market-analysts-say.
[2] Mitchell, Josh. "More Than 40% of Student Borrowers Aren't Making Payments." The Wall Street Journal. April 07, 2016. Accessed April 10, 2017. https://www.wsj.com/articles/more-than-40-of-student-borrowers-arent-making-payments-1459971348.