2018 Emerging Markets Fixed Income Investment Outlook

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NORTHWEST PASSAGE
CAPITAL ADVISORS

2018 Investment Outlook

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Summary

- U.S. economy is in the late stages of an expansion, and speculative excesses are beginning to proliferate. Risk assets will probably perform well in 2018 but increasing caution and portfolio conservatism are warranted.
- Global growth outlook is good for 2018, with non-U.S. economies poised to catch up to the U.S.
- The Fed will continue to raise rates while ECB, BOJ and EM will become more hawkish. Policy re-convergence favors further U.S. dollar weakness.
- EM economies have lagged the U.S., creating opportunities in commodity exporting EMs including Argentina, South Africa, Brazil and Middle Eastern oil exporters.
- Yield curve may continue to flatten in 2018, with equity volatility and credit spreads making new lows. Environment favors a barbell duration strategy, continued migration into higher quality credits, and modest local currency exposure.

Dinner at the Shed in Dulwich

"Men make their own history, but they do not make it as they please; they do not make it under self-selected circumstances, but under circumstances existing already, given and transmitted from the past. The tradition of all dead generations weighs like a nightmare on the brains of the living." – Karl Marx, 18th Brumaire of Louis Napoleon

"Hegel remarks somewhere that all great world-historic facts and personages appear, so to speak, twice. He forgot to add: the first time as tragedy, the second time as farce."
– Karl Marx, 18th Brumaire of Louis Napoleon

It is said that there are old traders, and there are bold traders, but there are no old, bold traders. For old financial market survivors like us, these are difficult times indeed. Memories of past market follies are a heavy burden to bear in a global economy increasingly borne aloft by the dreams of the young, the optimistic, and less charitably, the ignorant. Professional pessimism, so necessary to survival in the management of fixed-income portfolios, seems ever more irrelevant, outdated and useless. In 2018, caution born of experience is merely, in Marx's memorable phrase, the unwelcome "tradition of all dead generations [which] weighs like a nightmare on the brains of the living."

As 2018 begins, it is difficult to be enthusiastic about any category of financial assets, at least from a historical valuation perspective. U.S. equities continue to extend a spectacular eight-year run, pushing trailing earnings multiples well into the extreme territory that preceded the last two major market drawdowns in 2000-2002 and 2008-2009. Credit spreads are very near historical tights, while equity, fixed income and commodity implied volatility continue to plumb new lows. Like Odysseus tied to the mast of his ship, sensible investors must strive mightily to resist the Siren-call of speculative profits, led most outrageously by Bitcoin's 1,500% annual appreciation in 2017, but trailed more substantively by a 22% annual total return in the S&P 500, a 30% gain for the NASDAQ Composite Index, and 50%+ gains by favorite large-cap technology stocks including Amazon, Facebook and Netflix, and, more surprisingly, old economy industrial stalwarts such as Boeing, Caterpillar and CSX. In a world where triple or double digit annual returns are so easy to come by, pity the sad fate of investment-grade, fixed-income investors. Though the Bloomberg Barclays U.S. Aggregate Bond Index returned a respectable 3.54% in 2017 (with investment-grade corporates gaining 6.54%), bonds are clearly not where the action is for today's cool investment kids. Even the usually exciting worlds of high-yield and emerging market (EM) bonds were ho-hum in comparison to the equity party, with the Bloomberg Barclays U.S. Corporate High Yield Bond Index gaining 7.50% in 2017 and the J.P. Morgan EMBI Global Index (more than 50% junk-rated) advancing 9.32% for the year.

In a desperate bid for cultural relevance, perhaps stodgy old bond investors can learn something from Millennial colleagues. Conventional wisdom advises that the Millennial generation values experiences over things. Vice News, an edgy digital chronicler of the crypto-cohort, helpfully illustrates the principle in a most interesting recent restaurant review by writer Oobah Butler.[i] Butler's subject is a UK restaurant called the Shed at Dulwich, which bills itself as an "appointment-only restaurant located in South London." What makes The Shed at Dulwich interesting is that, as of November 2017, it was the top-rated restaurant for of all of London on TripAdvisor (the popular travel review site), besting more than 18,000 other reviewed restaurants in London including dozens with worldwide reputations and numerous Michelin stars. What makes The Shed even more interesting is that the restaurant does not in fact exist, but is rather a hoax, a figment of Butler's imagination based on his small suburban garden shed, created expressly to demonstrate the power virtual reality has to influence real people in the real world. Even though no one had ever seen the restaurant, much less eaten there, Butler was able to convince the world that his garden shed was in fact the best, most sought after dining establishment in one of the world's foremost cultural capitals. All it took were some staged photos of fake food, a hard to find address (because it didn't exist), a little online buzz and a clever, concerted campaign of disinformation on social media. Yet in the end, The Shed was simply a shed- a nothing, a nullity, a vacuum. Not only did it not serve steak, it couldn't manage either sausage or saltines.

The Shed at Dulwich is hardly the first case of a prankster or confidence man convincingly passing off a nothing as a something. But amusing as the story is, The Shed at Dulwich is a deadly serious metaphor for our times - it reminds us that we live in an era of belief, of credulous faith, in delusions, nonsense and dangerous dreams. The politically minded will express dismay at "Fake News" or "alternative facts," but in our view, the air of unreality is most pronounced in the related domains of economic analysis and financial speculation. For investors of a certain age, there is an electricity in the financial atmosphere - still early perhaps - that calls to mind the fevered days of late 1999 and even earlier periods of financial excess. Story stocks abound, while talk of a new paradigm, that stocks may have once again reached a permanently high plateau, is increasingly common. No price is too high to pay for attractive growth stories, and those who question the FAANG[ii] technology juggernaut - like those who doubted the Nifty Fifty[iii] in the 1970s, are quickly dismissed as malcontents and fuddy-duddies who just don't get it. Fear of Missing Out (FOMO) dominates fear of capital loss to a degree not seen in a generation in U.S. equity markets. The ruling passion of equity investors in 2018 is neatly summarized by Fidelity portfolio manager Mark Schmehl in a recent Bloomberg interview, who proudly avers that "I don't believe in Warren Buffett. I care about new things, things that are innovative, that are growing, that are changing the world…Valuation is an immaterial part of the process for me…It's the least useful piece of information you will ever get, because everybody knows what the valuation is."[iv]

Traditional signs of speculative excess proliferate, from questionable IPOs to increasing corporate leverage to the emergence of swindles and frauds on the periphery of mainstream financial markets. No recent indicator of speculative mania is more spectacular than the rise of Bitcoin and other cryptocurrencies, whose meteoric ascent appears to have no mathematical precedent in the long history of ill-advised financial euphoria. Despite its shadowy provenance and lack of apparent utility for any legitimate (i.e., non-criminal) real world application, Bitcoin's relentless rise has attracted a flood of imitators, inspiring countless "Initial Coin Offerings" of dubious worth, sponsorship, application or even legality. While reasonable people can and do disagree about whether stock market valuations are currently irrational, there can be no doubt that the feverish multiplication of cryptocurrency schemes represents a true bubble phenomenon, fully worthy of inclusion in Charles Mackay's classic 1841 study, *Extraordinary Popular Delusions and the Madness of Crowds*. Indeed, Bitcoin and its crypto-progeny find their spiritual ancestor in Mackay's most famous South Sea Bubble company, the immortal "Company for carrying on an undertaking of great advantage, but nobody to know what it is."

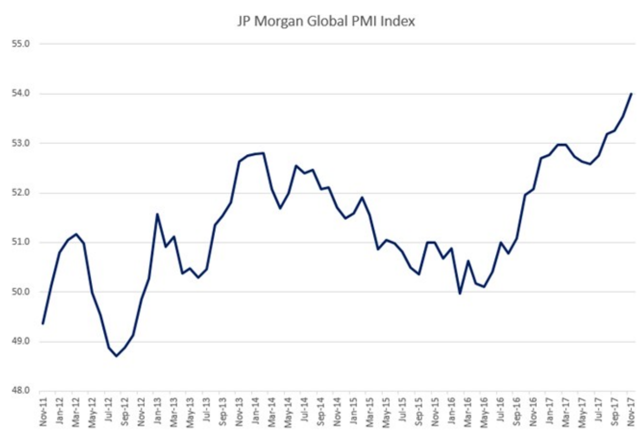
Economists from Walter Bagehot to Hyman Minsky have diagnosed financial insanity as an inevitable byproduct of easy money. Bagehot - an early editor of the *Economist* magazine, observed in 1873 that "John Bull can stand many things, but he cannot stand two percent." He noted the tendency of low interest rates to drive economic actors quite literally insane, pushing businessmen into ever riskier, ever more speculative, ever more dubious projects - leading to an eventual crash. Our own age is not the first to complain of low yields on safe assets, nor is it the first to respond by chasing yield in all sorts of inappropriate and unlikely places. The path of boom and bust is well travelled in financial history, with even the shrewdest and wisest among us succumbing to the lure of easy money. Isaac Newton, one of the most brilliant human beings who ever lived, was a loser in the South Sea Bubble; Charles Mackay, the scolding historian of centuries of financial bubbles, himself lost a fortune in the British railway mania of the 1840s.

Memories are short in financial markets, and almost a decade later the most salient legacy of the global financial crisis which engulfed the world from 2008-2009 are the very low real interest rates which persist across the developed world. These ultra-low interest rates are themselves an artefact of bureaucratic caution, as global central banks, in their eagerness to fight the last war, have extended accommodative policies long past the end of the recessionary economic conditions which engendered them. The result has been, to borrow a Greenspan-era idiom, a decade-long "Goldilocks" period for risk assets. Virtually every category of financial asset, from stocks to corporate bonds to commodities to physical currency, has offered more yield than cash, T-Bills or riskless bank deposits for the better part of ten years. Central banks have discouraged caution, and encouraged risk taking, by forcing cash rates to zero or below in the U.S., Europe, Japan and Switzerland. Planning for liquidity has become an afterthought while increasing leverage has come to be regarded as a source of investment alpha in popular (and coincidentally illiquid) institutional strategies ranging from risk parity to private equity to real estate. Low interest rates have in turn encouraged corporates to borrow money to buy back shares and pay dividends, leading to the highest levels in median non-financial corporate leverage in decades.

"Don't fight the Fed" has proved compelling and correct advice during the long summer of easy money and rising asset prices; yet investors, to their eventual cost, now seem eager to defy the Federal Reserve as it begins to withdraw liquidity and lean against the tide of rising asset prices. For there is no doubt that the Federal Reserve has embarked upon a bona fide tightening cycle. The painfully slow pace of rate increases has numbed markets to the Fed's intentions and invited optimism that such gradual normalization will have little to no effect on the economic expansion. But the fact remains that by the end of 2018, according to current market understanding, short rates in the United States will reach 2.50% or higher, and the Fed will be draining high powered money (through balance sheet reduction) at a run rate of $600 billion per year. Indeed, year over year growth in M2[v] (a Conference Board leading indicator) has already fallen to 4.7% as of November 2017, the slowest rate of money growth since 2010.

Incoming economic information has strengthened the Fed's hand in committing to higher interest rates. At 4.1%, the headline unemployment rate is near a two-decade low and appears likely to continue falling in the short run. Indicators of industrial activity are rising across all major economies (with J.P. Morgan's Global PMI Index at a six-year high as shown in Figure 1 below), commodities are rallying, and measures of inflation are moving higher. Combined with robust advances in asset prices and the prospect of additional economic stimulus from the recently enacted U.S. tax cut, virtually all the factors traditionally relevant to Fed policymaking are aligned in favor of more aggressive monetary tightening relative to the emergency policy settings still in place. We think monetary policy risks in 2018 are consequently biased in favor of hawkish surprises. Newly appointed Federal Reserve Chairman Jay Powell can fairly adapt a slogan from the president who hired him: in 2018, we expect Powell and his colleagues to "Make Cash Great Again."

Figure 1: Industrial Activity Is Rising Globally, Not Just in the U.S.



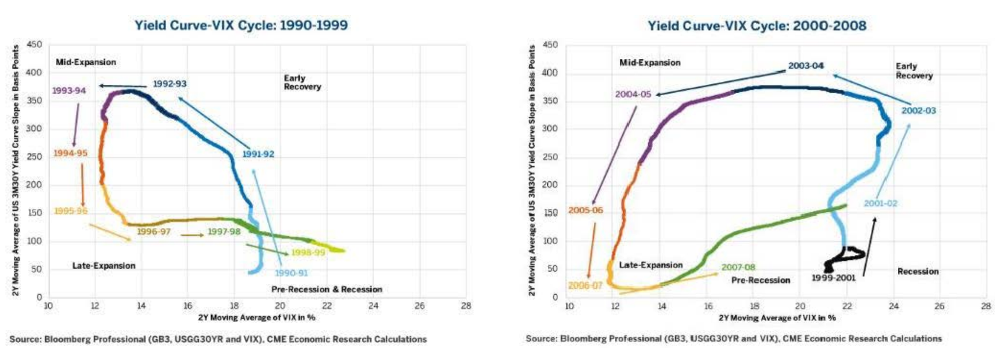
Source: J.P. Morgan, Northwest Passage, November 2017

How is a world that has been taught to believe that "cash is trash" for the past ten years now to react to changed circumstances, in which the yield on two-year Treasury notes and 12-month LIBOR deposits once more exceeds the dividend yield on the S&P 500 (a crossover which occurred this month for the first time since 2008)? Economist Rudiger Dornbusch articulated the principle that "in economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." It is one thing to recognize the conditions that may lead to the next crisis, but quite another to forecast either the timing or magnitude of such an event with any precision. It does not follow that the death of easy money must immediately lead to Armageddon for risk assets, or in fact, even to trouble for the most interest rate sensitive of assets, long duration government bonds. Experience shows that although tighter monetary policy eventually makes leveraged strategies and high-risk assets less attractive, it often takes financial markets a long time to fully process the implications of more expensive credit.

In previous reviews and outlooks, we have discussed the importance of the shape of the yield curve (the spread between long-term government bond yields and short-term government bond yields) as a business cycle indicator. Extensive postwar empirical evidence documents the cyclical transitions between a steep yield curve in the early stages of economic expansions to a flat or inverted yield curve on the eve of recessions. In the past several cycles, the yield curve has tended to reach its flattest or most inverted point anywhere between 12 to 18 months before the officially recognized start of a recession. It is therefore notable that the U.S. yield curve (proxied by the spread between 10Y Treasuries and 2Y Treasuries) has in recent months been flattening at the fastest pace in a decade, with the 2s10s spread reaching just 52 basis points at the end of 2017, its narrowest level since 2007. Extrapolating the recent rate of flattening (admittedly a dangerous exercise), it is plausible to anticipate the yield curve reaching zero or even inverting by the second half of 2018. Such a development would be a worrying sign for risk assets, but based on historical experience, not an imminent crisis. For investors, the initial appearance of a flat or inverted curve means adopting an attitude towards risk akin to the youthful St. Augustine's view of sin: "Lord, make me chaste, but not yet."

The economics research staff of the Chicago Mercantile Exchange provides an insightful approach to visualizing the business cycle in a series of charts (Figures 2 and 3 below) which plot the joint evolution of equity volatility and the yield curve slope through time. Assessing the last two full cycles (1990-2000 and 2000-2008), one can see a clear counter-clockwise progression in these charts, with the economy starting from a high implied volatility/steep yield curve regime at the end of the prior recession, advancing to a low volatility/steep yield curve regime in the middle stages of the expansion, to a low volatility/flat yield curve stage in the late or end stage of the expansion and finally a high volatility/flat yield curve stage on the eve of the next recession.

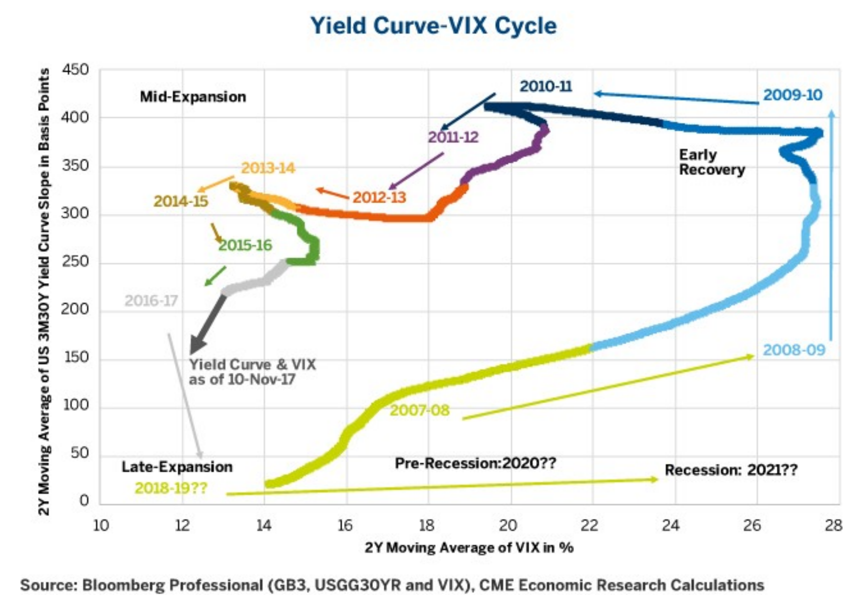
Figures 2 and 3: Evolution of Past 2 U.S. Business Cycles in Volatility-Yield Curve Space



Source: Bloomberg, CME Economic Research, January 2018[vi]

Figure 4 below analyzes the evolution of the current business cycle, which began with the formal end of the last recession in early 2009. As in the case of the 1990-2000 and 2000-2008 cycles, the current expansion commenced from a set of financial conditions characterized by very high implied volatility combined with a very steep yield curve. As the expansion has progressed, implied equity volatility has fallen precipitously, reaching record low levels by the end of 2017. With yield curve flattening accelerating through 2017 and so far into 2018, the current cycle has now moved decisively into the "late expansion" quadrant of the business cycle phase diagram, awaiting only a modest amount of further flattening and sustained rise in equity volatility to announce the arrival of another recession.

Figure 4: Evolution of the Current U.S. Business Cycle in Volatility-Yield Curve Space



Source: Bloomberg, CME Economic Research, January 2018[vii]

Consistent with our earlier characterization of recession lags following a yield curve inversion, the diagram above also argues for a cycle top occurring at least 18-24 months from today, with the real economy (and risky asset markets) unlikely to roll over until at least late 2019 or early 2020. The bad news for bears is thus that, as crazy or frothy as speculative markets might currently seem, there is considerable opportunity for them to become frothier still. The late-cycle stage of an expansion is understandably tricky for investment managers, and fraught with risk for both bulls and bears as survivors of the similar late cycle periods of 1998-1999 and 2006-2007 know too well. It is the moment when leaving too early (or worse getting short) risks missing spectacular blow-off tops, against the risk of staying too long and becoming trapped in a sudden collapse of asset prices. Attempting to identify the precise tipping point is usually a fool's game.

Nevertheless, our sense is that time enough remains for the party to roll on through 2018. We expect economic data to stay sufficiently strong to keep the Fed on track, and for the yield curve to keep flattening and eventually invert by the end of the year. We think implied equity volatility will stay low (with the possibility of occasional short-lived spikes), and that U.S. equity prices and valuations will continue to trend higher, perhaps spectacularly so. A low-volatility, equity-positive, curve-flattening environment is generally quite positive for credit assets, and so we expect credit spreads to continue grinding tighter through the course of the year. Given exceptionally low levels of equity volatility, we think it is possible that both U.S. investment-grade and high-yield corporate bonds could see all-time tights during the course of the year. We expect emerging market sovereign and quasi-sovereign spreads to similarly follow U.S. corporate spreads tighter.

In view of our late-cycle anxieties, however, we do not think it is a good idea to simply pile on credit risk in anticipation of another good year for the highest-yielding bonds. As the investment landscape becomes more treacherous, it becomes more important to resist the temptations of high carry and to focus active investment risk on high-quality, differentiated stories that are well-equipped to handle tough economic times when they eventually occur. As has been the case since the end of 2016, our bias is to move up in credit quality, increase the overall credit rating of our portfolio, and focus our risk taking in more speculative credits in countries which offer the clearest relative value advantages. We are reasonably comfortable with duration risk in the late stage of the credit cycle; however, given our expectation of a further bear flattening move in the U.S. yield curve, we believe the portfolio duration target is best achieved through a barbell profile, which underweights intermediate maturities in the five to ten-year range in favor of overweight position in short-dated (under three year maturities) and very long duration bonds (30 years or longer).

In terms of specific credit stories in emerging markets, we are most positive on countries which suffered the most in the 2014-2015 commodity mini-bust, catalyzed by both a slowdown in Chinese investment activity and the sharp decline in oil prices caused by overproduction of U.S. shale oil. These dislocations led to a large divergence in the economic cycles of many emerging economies versus the developed world, as shown in the illuminating chart from Goldman Sachs below (Figure 5).

Figure 5: Late Cycle in U.S. & DM Markets, But Still Early in Many EM Economies

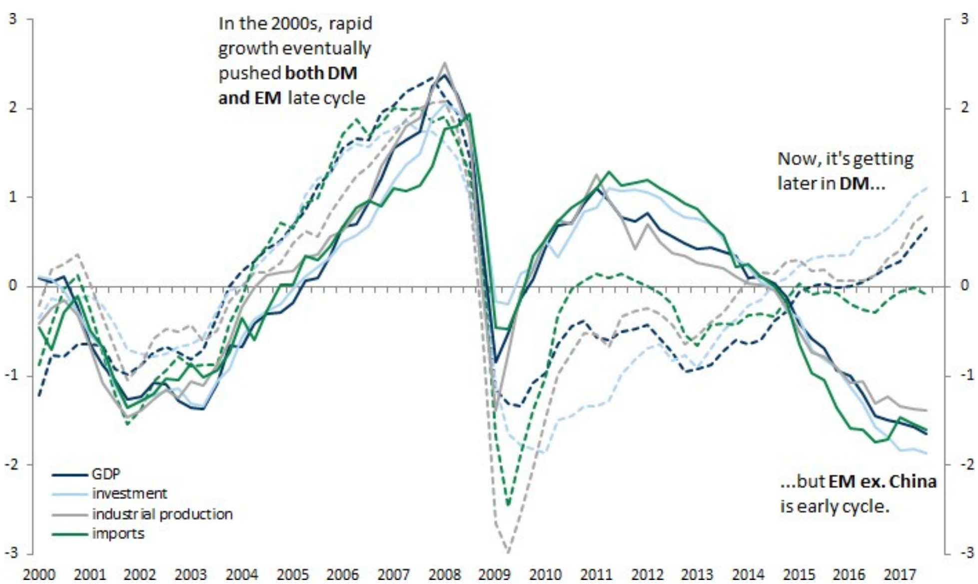
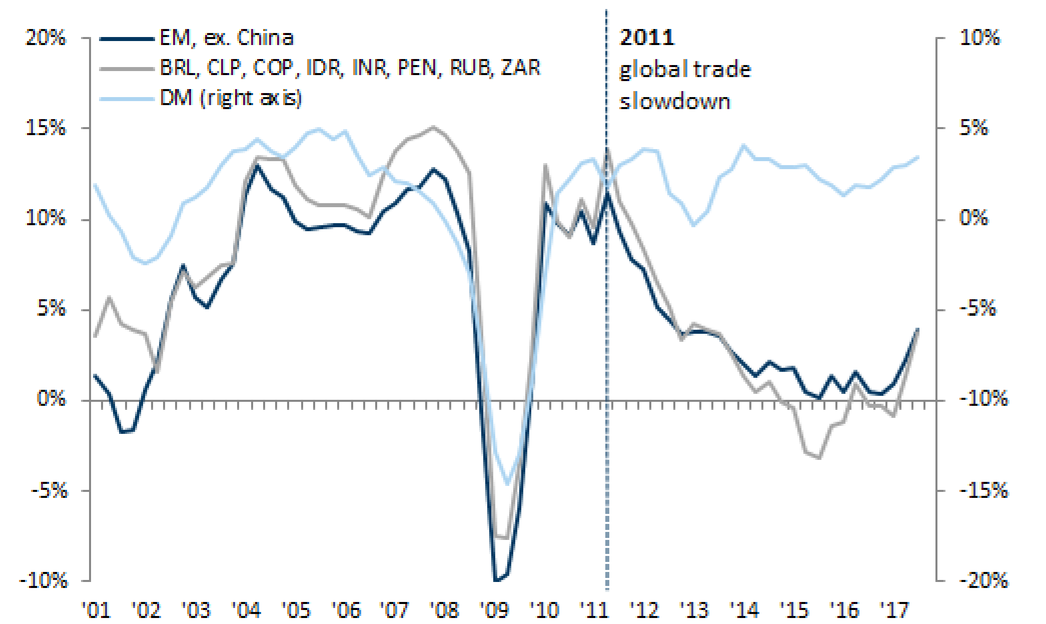


Chart shows standard deviation of each series from its 2000-2017 trend.
Dashed=Developed Markets, Solid=Emerging Markets ex China

Source: Goldman Sachs Economic Research, January 2018[viii]

Commodity exporting economies including Brazil, Russia, South Africa, Chile and Middle Eastern oil exporters were hurt particularly hard by a resultant economic slowdown, as fiscal consolidation and a precipitous drop in commodity-linked capital investment exacerbated the negative term-of-trade shock to exports. The silver lining of this negative economic shock has been a decoupling of many EM economic cycles from the maturing U.S. cycle, with many key EM countries only just beginning to recover. As another excellent chart from Goldman Sachs (Figure 6 below) indicates, investment activity has begun to accelerate from depressed levels across a broad swath of the emerging world, with recent laggards Brazil, Russia and South Africa leading the charge. To this list we would add Argentina (starved for investment for 15 years due to the unresolved fallout from its 2002 financial crisis), and perhaps most importantly, all of the wealthy Middle Eastern oil exporters, led by Saudi Arabia.

Figure 6: Investment Across Major EM Countries Only Just Beginning to Catch Up

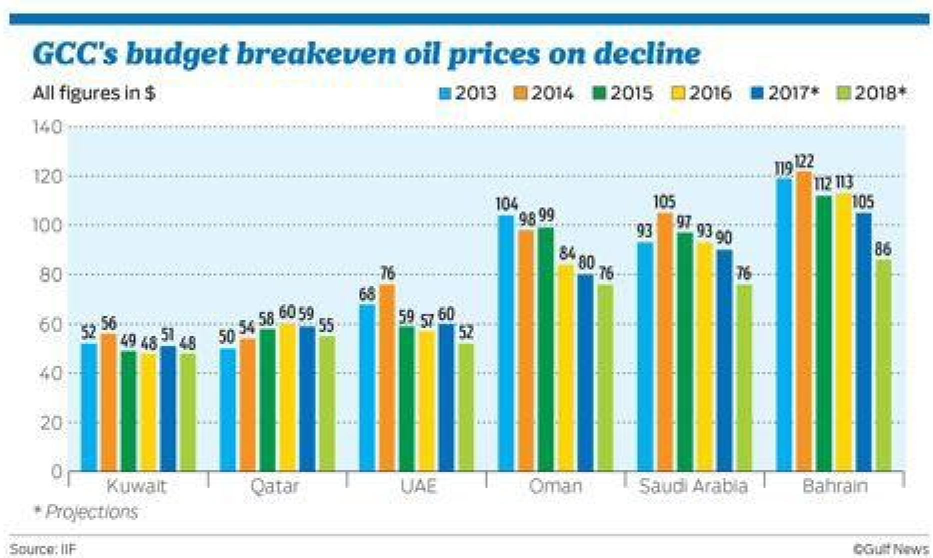


Source: Goldman Sachs Economic Research, January 2018[ix]

Many EM countries outside of China are paradoxically on the cusp of a virtuous economic cycle, with investment and growth accelerating, while inflation falls helped by currency appreciation. As growth and inflation improve, more money is drawn into these countries, driving further asset price and foreign exchange appreciation in a self-reinforcing process. As noted, countries at the forefront of this rebound include South Africa, Brazil and Argentina, all countries which we are overweight relative to our benchmarks.[x] These credits offer in our view a compelling combination of relative spread value and an improving economic story. Argentina, Brazil and South Africa also benefit from good political and institutional reform stories in 2018: In Argentina, the Macri government continues to drive an impressive, market friendly reform agenda; in South Africa the recent victory of Cyril Ramaphosa in the African National Congress leadership election promises to bring an end to the corruption and incompetence of the Jacob Zuma era; and in Brazil, October elections will end the drift and uncertainty of the unpopular Temer caretaker government.

Our largest regional overweight is in the Middle East, a region which we think offers the best overall credit story in 2018. In particular, we are overweight the sovereign bonds of all Gulf Cooperation Council (GCC) members except Bahrain - Saudi Arabia, Qatar, Oman, Kuwait and the United Arab Emirates. As in the case of other commodity exporters, we expect the economies of all Middle Eastern commodity exporters to rebound strongly in 2018, driven primarily by the effects of a rebound in international oil prices which has not yet been fully discounted in sovereign credit spreads. Following the late 2014 collapse in oil prices, all GCC countries were forced to cut public spending and investment sharply, pushing many into or very near a recession. These adjustments have been painful, but are now largely complete, in every country but Bahrain - just in time to greet the unexpected and welcome news of higher than forecasted oil prices at the end of 2017. Should oil prices continue to surprise to the upside in 2018, the economic performance of the GCC countries is likely to significantly outpace the recently upgraded forecasts for the region issued by the IMF, with faster growth, smaller fiscal deficits, larger current account surpluses, rising foreign exchange reserves and most importantly for credit investors, materially reduced issuance by sovereign borrowers. With Brent Crude prices moving higher, and fiscal breakeven oil prices moving lower (Figure 7 below), we believe markets have been slow to recognize and properly price the rapidly improving macroeconomic story underway in the Middle East.

Figure 7: Falling Fiscal Breakevens & Rising Brent Crude Oil Prices Could Move GCC Countries Back to Budget Surpluses in 2018



Source: Institute of International Finance estimates (IIF) via Gulf News, June 2017[xi]

The Gulf countries, somewhat uniquely in emerging markets, combine an attractive spread compression story with exceptional underlying creditworthiness secured by a rock-solid external balance sheet. Considered as a whole, the six countries of the Gulf Cooperation Council command $2.3 trillion of public foreign assets, down only slightly from a peak of $2.6 trillion in 2014 just prior to the fall in oil prices. According to data from the Institute of International Finance (IIF), approximately 30% of this amount, or more than $700 billion, is held as foreign exchange reserves, with the balance of $1.6 trillion managed by sovereign wealth funds in a mix of public equity and fixed-income securities, real estate, private and other investments. This pile of foreign assets compares favorably against the total external debts of the region of $732 billion, only a small fraction of which (<30%) represent direct sovereign external indebtedness. We are enthusiastic on the region not only because of positive expected returns from spread compression, but because the singular balance sheet strength of the region provides an opportunity to upgrade portfolio quality and reduce intrinsic credit risk in preparation for the hard market times ahead.

GCC sovereign credit spreads are currently elevated, in part, to reflect perceived political risks in the region. These perceptions are centered on the efforts of Saudi Arabia's young new Crown Prince and heir apparent, Mohammed bin Salman (commonly known as "MBS") to consolidate his power against the numerous other branches of the Saudi royal family. These efforts have led, directly or indirectly, to rising confrontation with Iran in proxy conflicts in Yemen and Lebanon, a diplomatic standoff with Qatar, and most recently an “anti-corruption” purge of the Saudi royal family which has, amusingly, transformed the Riyadh Ritz-Carlton into a short-term prison. To check out from this gilded incarceration, various subsidiary princes of the House of Saud have been forced to purchase their freedom through affirmations of loyalty to MBS and a substantial contribution of their personal wealth to the Saudi Treasury. Whatever the justice of the case against them, tribute from the princes could add as much as $100 billion to the Saudi government assets in 2018, as much or more than the expected proceeds from the planned initial public offering of state oil company Saudi Aramco.

While high-handed actions by MBS (against the royal family, Lebanon, Qatar and Yemen) have caused diplomatic consternation and some degree of spread widening in Saudi Arabia and Qatar, we are ultimately relaxed about the political tumult in Saudi Arabia. We think MBS’s purge of his potential opponents is, in fact, a positive sign, as it secures his position and removes all uncertainty about the Saudi royal succession. At just 32 years of age, MBS is poised to rule the Kingdom for many decades, eliminating the speculation and instability that has attended Saudi Arabia’s more recent string of geriatric rulers. For all his autocratic impulses in securing his power, MBS appears to have an ambitious social reform agenda aimed at reducing the influence of Saudi’s religious bureaucracy, creating employment opportunities for the young and liberalizing the country’s notorious strictures on its female population. In a small step for most other countries, but a giant one for Saudi Arabia, King Salman (at MBS’s instigation) shocked the world in recent months by announcing that Saudi Arabia will now issue driver’s licenses to its women citizens. Headlines notwithstanding, Saudi Arabia’s relationship with the United States has rarely been better, and there are even signs of a growing unofficial détente with Israel. As 2018 progresses, we expect domestic politics in Saudi Arabia to comfortably settle into a new, more stable equilibrium, with a resultant decline in both headlines and political risk across the region.

Another important source of active portfolio return we like for 2018 is foreign currency risk. We believe economic forces remain aligned in favor of a weaker U.S. dollar, and we expect the greenback’s weakness in 2017 to extend over the course of 2018. We see the dollar’s prospects dimming on the reconvergence of global economic cycles discussed above: namely, that the rest of the world is catching up to the United States in terms of post-crisis economic growth, and eventually, investment performance. We think that the policy and economic divergence trade of the past several years has already reached its zenith, and that the spread between U.S. interest rates and those of other developed countries is poised to prospectively tighten over a multi-year horizon. The Fed, of course, is far from the only central bank who is beating a retreat from the low rate legacy of a financial crisis now 10 years in the past. It is merely the most advanced in the process. But make no mistake, the Fed’s peers at the European Central Bank (ECB) and the Bank of Japan (BOJ) are groping for the exits as well. Paradoxically, the markets are most acclimated to the prospects of higher rates in the U.S.; we believe the greatest possibility for central bank driven volatility in 2018 comes from Europe, where policymakers have been excessively cautious in adapting to the reality of an improving economic situation.

With German nominal GDP growth topping 4.0% in 2017, it is increasingly untenable for the ECB to continue a policy which keeps nominal bond yields pinned at 0.50% or below. Looking beyond Germany, the gap between Eurozone-wide nominal GDP growth (3.8% in Q3 2017) and Euro 10Y swap rates (0.90% at year-end 2017) is by far the widest recorded in the 20-year history of the single currency. Economic conditions in Europe no longer call for such aggressive monetary stimulus, with the European Commission Europe-wide economic sentiment indicator printing the highest levels since 2000 at the end of 2017. Both current activity readings and forward indicators are the strongest they have been across Europe in nearly two decades; in our view, it beggars belief that European interest rate futures continue to price an expectation of negative three-month Euribor (Euro Interbank Offered Rate) rates through mid-2019. We think a violent change is coming in ECB policy in 2018, both sooner and in greater force than the gentle wind down in asset purchases currently expected to begin in the fourth-quarter of 2018.

ECB Governor Mario Draghi's term expires in October 2019. In the opaque and informal consensus-building process which determines the leadership of key European institutions, Draghi's successor is likely to be identified and agreed by the end of 2018. Since the creation of the euro, a German candidate has not yet held this powerful post, with Germany having so far deferred to a Dutch, French and now Italian ECB governor. As the only one of the Big Three European economies, France, Germany and the United Kingdom, which has not yet led the ECB, Germany has both the moral and practical inside track to choosing Draghi's replacement. Jens Wiedmann, the current head of the Bundesbank, is in our view the most likely candidate as the next ECB governor. Wiedmann is a known hawk and an outspoken critic of the ECB's current asset purchase program. He will be keen to accelerate the unwind of Draghi era stimulus programs given current economic conditions and particular fears of an emerging German real estate bubble due to ultra-low interest rates. While other European constituencies - notably the southern peripheral countries - may oppose Wiedmann for the top job, we think any successful attempt to block Wiedmann will be purchased only at the cost of substantial concessions to Germany's hawkish policy preferences.

The dollar looks rich in terms of relative purchasing power versus most developed and emerging currencies, and is further hamstrung by an exceptionally weak balance of payments position. The U.S. ex-petroleum trade deficit recorded its worst level ever (at more than $45 billion per month) at the end of 2017, breaking through levels not seen even during the ferocious dollar bear market from 2002-2008. Meanwhile, the Eurozone current account runs at a $50 billion per month surplus, near the highest ever readings since the creation of the euro, and far above the balanced current account position which prevailed when the euro recorded its record $1.60 exchange rate against the dollar in early 2008. The dollar has been supported in the face of a weak current account by capital flows, which have sought ought high relative interest rates in the U.S. bond market and high absolute returns in the surging U.S. stock market. As growth and interest rate prospects brighten in the rest of the world in 2018, we expect some of these capital flows to reverse. Since the beginning of the European quantitative easing experiment in 2014, we estimate that more than $1 trillion in mostly unhedged bond flows have entered the U.S. fixed-income market from Europe alone. The backflow of this investment to Europe will dwarf the much-ballyhooed repatriation flows from U.S. corporates responding to the recent tax reform, as most U.S. corporates were already permitted to invest their "overseas" cash in U.S. government and corporate fixed-income securities. Accommodating an outflow on the capital account of this magnitude will require a significant downward adjustment by the USD, to a degree that could shock the thinning herd of dollar bulls. We do not think it is unreasonable to think about EURUSD recovering, and surpassing, its former all-time highs on two to three-year horizon.

If we are correct that the dollar may be at the beginning of a multi-year down cycle against the euro, we naturally expect the dollar to weaken against most other major and emerging market currencies. A weak dollar has a well-established positive association with commodity prices, which tend to rise as the dollar falls. Commodities have already commenced an impressive rally in 2017, with Brent Crude oil rising 50% off its mid-year lows to finish the year near $70/barrel (a three-year high). Oil has been joined by numerous industrial metals, including palladium, copper, nickel and aluminum, all of which have decisively bounced off early 2016 lows and now trade at or through three-year highs. With global industrial activity surveys at high levels and growth accelerating outside of the U.S., there is every reason to expect the commodity rally to continue in the intermediate term. We consequently expect commodity exporter currencies to perform well in 2018, including the South African rand, the Brazilian real, the Russian ruble, the Chilean peso and the Indonesian rupiah. Consistent with this view, we plan to maintain a modest overweight in select EM local bonds in 2018 as permitted by our relevant investment guidelines and portfolio risk tolerances.

Finally, a word on the outlook for oil prices. One of the more surprising developments in 2017 was the unexpected rally in global oil prices to near $70 a barrel, ending the year near three-year highs. This advance has been met by a great deal of skepticism, as energy sector investors burned by the 2015 bust in the U.S. shale sector have assumed that U.S. shale producers can and will quickly ramp up production to meet the rise in prices (thereby snuffing it out). We think this expectation is mistaken for several reasons. First, the rise in prices has favored the global benchmark (Brent Crude), reflecting the fact that global demand growth is being primarily driven by China and the emerging markets. U.S. shale output cannot easily supply foreign demand, and due to its very high specific gravity (>40 API[xii]) is not well suited to global refineries optimized to run on much heavier Middle Eastern grades (~30 API). Secondly, oil bears obsessed with the prospect of more U.S. supply are neglecting important supply disruptions elsewhere in the world, notably Venezuela, Nigeria and Libya. According to December reports, Venezuela's production of crude oil dropped below 1.7 million barrels per day, the lowest level in 30 years and less than half of peak production levels in 1999. Venezuela has lost as much production as the U.S. has added in 2017, and the rapidly accelerating collapse of its oil industry is a disruptive event for global markets. Because Venezuela also produces very heavy (~20 API) grades, the fall of Venezuelan output has tightened the availability of heavy crude grades available for blending, and has thus impaired the ability of U.S. refineries to process more of the very light U.S. shale output. Thirdly, U.S. shale producers continue to fail to generate reliable cash flow in the current price environment, and following horrific losses in 2015, investors are far less willing to fund the capital spending dreams of the U.S. industry. We expect global energy demand to surprise to the upside in 2018 (led by China, now the world's largest automobile market, where car purchases continue to surge), while U.S., and global, supply growth will disappoint expectations. The result, in our view, will be stable to higher crude oil prices in 2018, with an increasing premium of Brent over West Texas Intermediate. We expect higher global oil prices to underpin our other key macro views, for rising inflationary pressures, more hawkish central banks globally, a weaker U.S. dollar, and generally good performance for EM credit spreads and foreign exchange.

The investing challenge in 2018 is to find value in a fully priced investment universe which seems to offer so little of it. The latter phases of the business cycle are treacherous, but ultimately reward both conservatism and judicious optimism. Our strategy continues to balance these conflicting objectives, by raising overall portfolio credit quality while targeting the thematic pockets of value discussed above. It's hard to get a table at the Shed at Dulwich, but history teaches that staying to closing time will lead to a most unpleasant case of indigestion.

Indices:

The **Bloomberg Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Bond Index** tracks fixed and floating-rate U.S. 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 Bond 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 U.S. Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, USD-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, U.S. Aggregate eligible securities also contribute to the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt. The U.S. Aggregate Index was created in 1986 with history backfilled to January 1, 1976. The Bloomberg Barclays U.S. Aggregate Corporate Bond Index, the Bloomberg Barclays U.S. Aggregate Long Treasury Index and the Bloomberg Barclays U.S. Aggregate Long Corporate Index are subindices of this index.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in Industrial, Utility, and Finance sectors with a minimum $150 million par amount outstanding and a maturity greater than 1 year. The index includes reinvestment of income.

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.

The **J.P. Morgan Emerging Markets Bond Index Global Diversified USD Investment Grade** is the investment grade credit subindex of the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified) which is a uniquely-weighted version of the EMBI Global limiting the weights of those index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

The **J.P. Morgan Global Manufacturing PMI Index** is a composite index produced by J.P. Morgan and IHS Markit in association with ISM and IFPSM.

The **NASDAQ Composite Index** includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad-based Index.

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 comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Indices are unmanaged and cannot be invested in directly.

[i] "I Made My Shed the Top-Rated Restaurant on TripAdvisor" Oobah Butler, Vice News, December 6, 2017
https://www.vice.com/en_uk/article/434gqw/i-made-my-shed-the-top-rated-restaurant-on-tripadvisor
[ii] FAANG is an acronym for Facebook, Apple, Amazon, Netflix and Google.
[iii] Nifty Fifty refers to the historic benchmarking index that was used in the 1960s to reflect the stock index. It contained 50 popular large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy and hold growth stocks.
[iv] "This Fund Manager Doesn't Believe in Buffett and Is Buying Everything Crypto"- Bloomberg News, December 13, 2017

https://www.bloomberg.com/news/articles/2017-12-14/fidelity-manager-buys-everything-crypto-in-disruptor-strategy
[v] M2 is a measure of the money supply that includes all elements of M1 (cash and checking deposits) as well as "near money" (savings deposits, money market securities, mutual funds and other time deposits.
[vi] "VIX-Yield Curve: At the Door of High Volatility?" Erik Norland, CME Group Economic Research, Nov 29th, 2017
http://www.cmegroup.com/education/featured-reports/vix-yield-curve-cycle-at-the-door-of-high-volatility.html
[vii] "VIX-Yield Curve: At the Door of High Volatility?" Erik Norland, CME Group Economic Research, Nov 29th, 2017
http://www.cmegroup.com/education/featured-reports/vix-yield-curve-cycle-at-the-door-of-high-volatility.html
[viii] "Global Markets Analyst: EM is Early Cycle" Ian Tomb, Goldman Sachs Economic Research, January 19, 2018
https://research.gs.com/content/research/en/reports/2018/01/19/fce5a477-1904-4282-bdc9-59253ae27c48.html
[ix] "Global Markets Analyst: EM is Early Cycle" Ian Tomb, Goldman Sachs Economic Research, January 19, 2018
https://research.gs.com/content/research/en/reports/2018/01/19/fce5a477-1904-4282-bdc9-59253ae27c48.html
[x] As of December 29, 2017, Northwest Passage Capital Advisors LLC uses the J.P. Morgan Emerging Markets Bond Index Global Diversified Investment Grade and a customized version of the Bloomberg Barclays Emerging Markets USD Sovereign + Quasi-Sovereign Bond Index as its benchmarks.
[xi] http://gulfnews.com/business/economy/falling-fiscal-break-even-oil-prices-bring-relief-to-gcc-1.2047328
[xii] API gravity expresses the gravity or density of liquid petroleum products.