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"Gimme Shelter"

By Jefferson V. DeAngelis, CFA, Chief Investment Officer

With the markets responding to the threat of declining liquidity, the value restoration process is underway. The Federal Reserve has been raising interest rates since December of 2015 in a gradual, measured manner which is finally starting to bite. There is a hint of tighter policy in Europe, and even in Japan. Over half of emerging market central banks have begun to increase interest rates. It has been over a year since the Fed began quantitative tightening to reverse the unconventional use of their balance sheet. In the process, they have reduced their holdings of bonds by over $240 billion. While the Fed may lack the backing of Donald Trump, they do have the political cover of a strong U.S. economy to support their desire to normalize interest rates.

The recent upgrade to U.S. economic growth has several consequences for global markets and particularly emerging market debt. As is often the case, faster economic growth consumes liquidity. Money and capital are being redirected from financial markets to the underlying real economic opportunities. Interest rates are rising, and the divergence between U.S. and global rates is leading to a stronger dollar. There is also the underlying fear of inflation with investors increasingly concerned about the sustainability of debt-fueled growth. This is typical of late cycle economies. Rising interest rates compete with high equity valuations for investor attention. Meanwhile, risk expressed through higher volatility make portfolios work harder to earn decent returns.

Higher bond yields can offer an attractive alternative to overvalued equities at some point within an economic cycle. We are approaching although not yet at the inflection point. The signs are out there –the Fed is signaling more interest rate hikes and the European Central Bank is scaling down its bond buying program. The interest rate curve in the U.S. still has further to travel before it inverts. Though the U.S. economy is likely to slow back to its trend of 2.5% in the next several quarters as the fiscal stimulus from tax cuts wears off, a recession in the next year is unlikely. We are hopeful that growth in China and Europe will start to catch up but also mindful of a possible global slowdown. If global growth should falter, investors need to be prepared to de-risk.

China could be having a Minsky moment. Trade tensions are accelerating the need for policymakers in Beijing to redirect resources from state-owned institutions to private enterprise. The Chinese do not appreciate having their hand forced. The Party Congress envisioned a more gradual shift away from their dependence on private savings. They hoped for the "new" consumption-led economy to support the liquidation of the "old" production-led economy. It now appears unlikely that they will either grow or inflate their way out of their mounting bad loans. An untimely decline in growth will accelerate the recognition of decades of bad investment and the necessity for the Chinese to "bailout" the system.

Across the Atlantic, Europe cannot seem to rid itself of the subsidy it provides to its southern partners through debt support. Without domestic fiscal discipline or willingness to support austerity, the European experiment with a single currency is doomed to fail. In the short run, there is a good chance that Italy will not choose to be the catalyst. However, the failure of Brussels and Rome to reach an agreement could certainly threaten Europe's fragile recovery.

Of the macro factors potentially contributing to slower growth, higher energy prices stand out as rising prices act as a tax on the global economy. However, slowing global growth will gradually reduce demand. Moreover, oil prices continue to face headwinds from traditional supply/demand factors. Currently, supplies appear ample baring a disruption caused by geopolitical risks. That said, U.S. sanctions against Iran, and the potential of sanctions against Saudi Arabia, could lead to a significant increase in oil prices which would be destabilizing for global growth.

Another disruptive macro factor is the evolving trade dispute between the U.S. and China. It almost goes without saying, that the outcome of trade tensions between the U.S. and China will have a major impact on financial market performance, as well as the prospect for global growth over the intermediate term. There is little chance of China and the United States sitting down to resolve their trade issues before the U.S. midterm elections. The window to negotiate or resolve trade issues will close as we approach year- end when President Trump will likely impose further tariffs against Chinese imports. A failure to resolve the trade dispute this year not only risks the outlook for global growth but threatens a breakdown of Sino-American relations unseen since President Nixon's historic trip to China.

Nevertheless, despite all the uncertainty, there has been only a modest adjustment in the investment opportunity within emerging market debt. The reduced growth prospects, within the context of rising rates and spreads, offer investors a reasonable entry point into the asset class. The major risks are limited to local currency markets, as shown recently in Turkey and Argentina. Surprisingly, the shift to slower growth creates relative value between emerging market equity and debt opportunities. Investment grade sovereign emerging market debt, denominated in hard currency, can be viewed as defensive in nature given the volatility associated with the uncertainty surrounding the asset class. For the most part, the investment grade sector of emerging market debt has traded in line with investment grade corporate bonds. Emerging market debt has not shielded investors from the general increase in interest rates; however, we believe this is in the process of peaking. Slowing global growth, should it occur, will reverse the path of global interest rates. Interest rates are just as likely to fall as to rise over the next year with higher quality credit outperforming lower quality credit.

Investors will be well served to gradually reduce risk in favor of higher quality investments. The global economic cycle in place since the great recession has been extended by the Trump tax cuts; however, it is unlikely to persist in perpetuity. The next recession, when it comes, will claw back some portion of gains provided to risk-seeking investors incentivized through accommodative central bank policies. Prudent investors should consider expanding their opportunity set by considering higher quality fixed-income sectors to diversify risk and provide shelter from the storm.

172 N Broadway, Suite 300 | Milwaukee, WI 53202 | 414.755.0461 | www.nwpcapital.com